LUTHER KING CAPITAL MANAGEMENT

FIRST QUARTER 2022 REVIEW

Many investors saw inflation as the primary risk to the economic outlook as we entered the year. The combination of high demand for consumer goods and deep supply constraints ignited inflationary pressures last year. U.S. consumers historically spend roughly two-thirds of their dollars on services and only one-third on goods. Manufacturing efficiencies and global supply chains have dramatically reduced the cost of producing goods over multiple decades. For example, the American Iron and Steel Institute reports that it took 10.1 hours to produce a ton of steel in 1980 versus 1.5 hours today. This type of dramatic productivity gain has a deflationary influence on the price of goods. Since 2000, core goods inflation has been negative roughly half the time, meaning the price of goods (on a quality-adjusted basis) fell on average. Our recent experience of very low goods inflation makes the current inflation spike feel even more jarring.

The harrowing humanitarian crisis that is unfolding in Ukraine because of the Russian invasion is adding to inflationary pressures. According to the United Nations refugee agency, ten million people, or about a quarter of the Ukrainian population, have been displaced. Nearly four million of these refugees have fled to neighboring countries, including Hungary, Moldova, and Poland. Russia's invasion of Ukraine is generating economic ripples through the global economy by impairing the supply of commodities in markets that were already quite tight. Beyond persistently high energy prices, base metals, and food, Ukraine is an important source of neon required for semiconductor manufacturing. Western sanctions rightfully placed on Russia exacerbate the inflationary situation.

The Standard & Poor's 500 Index suffered its first quarterly decline since the depths of the pandemic in the first quarter of 2020. The most significant economic development in the first quarter was the dramatic repricing of the likely path of the Federal Reserve's benchmark interest rate. In January, bond traders were pricing the Federal Funds rate no higher than 1.0% by the end of this year. Now, they are anticipating it to be 2.5%. As a result of inflation concerns, the Bloomberg Intermediate U.S. Government/Credit

Bond Index declined 4.5% in the first quarter, its second worst quarterly loss since the inception of the index in 1973.

Although we believe the probability of a U.S. recession unfolding in 2022 is low, the odds did rise in the first quarter. Despite 40-year high inflation, consumer spending should remain robust in the year ahead, buttressed by a strong job market, healthy consumer balance sheets, and the reopening of the services sector as pandemic headwinds fade. We are optimistic, however, about capital investment as supply chains are reconfigured in response to the likely deglobalization tilt spurred by the pandemic and rising national security concerns.

ECONOMY

Negative supply-side shocks to the economy have played a central role in shaping U.S. economic history over the last half century. Such shocks have generally arrived in the form of sharp spikes in oil prices, as historically energy price-induced shocks have been more acute than other supply side shocks. Aside from being an important production input for many goods, oil is also a consumption good and hence its price directly affects consumer pocketbooks. Approximately 43% of each barrel of oil is refined for gasoline and 33% is refined into diesel and jet fuel. The greater risk, ironically, is that workers offset the erosion of their real wages by seeking higher nominal wages that are passed through to consumers with higher prices of goods and services. This pattern of price increases is often referred to as a wage-price spiral.

Negative supply-side shocks create a devilish challenge for the Federal Reserve as they tend to reduce growth, while increasing inflation. Therefore, monetary policy makers face the worst of two evils. If monetary authorities maintain real economic activity, they will risk setting off an inflationary spiral. Alternatively, policy makers can tighten monetary policy to combat inflation but risk slowing economic activity to the point of recession.

Federal Reserve Chairman Powell emphasized the health of the labor market repeatedly in his press conference following the announcement of a 0.25% increase in the target Federal Funds rate in March. Within the framework of the central bank's dual mandate of price stability and full employment, our interpretation of Chairman Powell's comments is that he is willing to trade higher unemployment for lower prices. The unemployment rate is currently 3.6% compared to 3.5% immediately preceding the pandemic. Had the unemployment rate not ticked down to 3.5% in February 2020, the current 3.6%

reading would be the lowest in 54 years. The central bank's calculus appears to be reducing 40-year high inflation at the expense of nearly 54-year low unemployment.

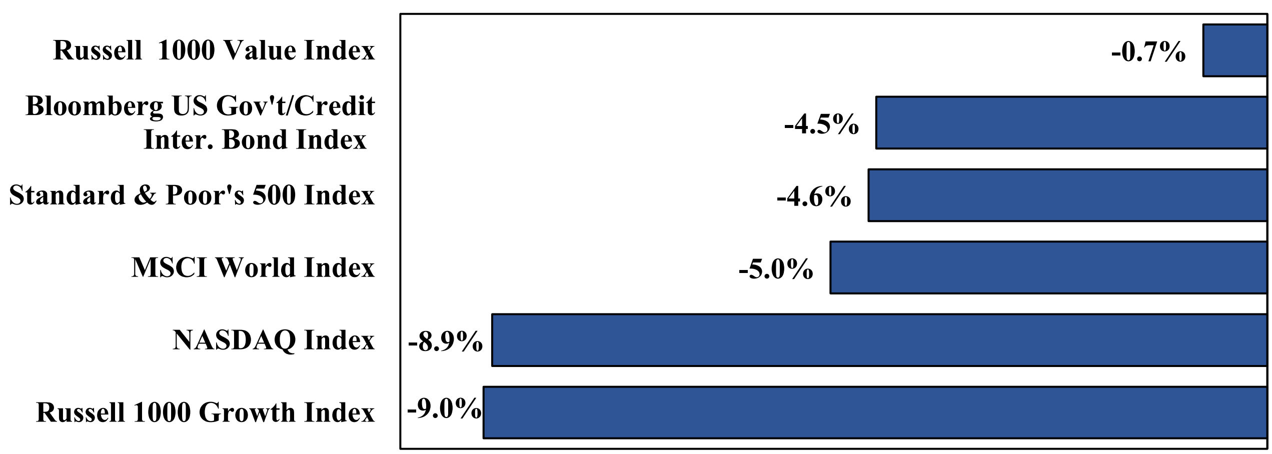
The current monetary tightening cycle is very different than prior cycles in three important ways. First, when the Federal Reserve initiated interest rate hikes in 1994, 1999, 2004, and 2015, inflation was at or below the central bank's 2% target. As a result, the pace of interest rate hikes could unfold in reaction to economic activity. Monetary tightening is meant to pre-empt inflation from rising beyond the 2% target in an expansionary economic cycle. Second, the current labor market tightness is generally associated with the end of a monetary tightening cycle, not the beginning. The current unemployment rate of 3.6% is lower than the 4.7% unemployment rate when the Federal Reserve began cutting interest rates in 2007. When the central bank cut interest rates in 2001, the unemployment rate was 4.2%. The current level of unemployment today is normally where the Federal Reserve would want the economy to be when it finishes a tightening cycle, not when it starts. Finally, the Treasury yield curve – or the spread between short-term and long-term interest rates – is currently the flattest on record at the beginning of a monetary tightening cycle.

It is impossible to know how and when the human tragedy in Ukraine will end. Russia has been subjected to a rapid financial, cultural, and technological decoupling from much of the world at large as the U.S. and its allies implement sanctions. Such international isolation contributed to South Africa's decision to end apartheid in the late 1980's. However, the economic ripples are potentially much greater from Russia than they were from South Africa. Although Russia only accounts for 1.5% of global trade, it has a much larger footprint due to its range of energy and non-energy exports. Russia supplies 40% of Europe's natural gas and together Ukraine and Russia account for nearly one third of global wheat exports. In the face of daily war atrocities, it is difficult to look beyond the hopeful near-term resolution of the war. However, this war will likely cast a long shadow politically, militarily, and economically. The February reading of the Global Food Price Index saw a 20.7% year-over-year increase and reached an all-time high. This increase is eerily reminiscent of the bout of extreme price volatility in global agriculture markets at the end of 2010. On December 17th of 2010, a Tunisian street vendor lit himself on fire after officials seized his fruit cart – depriving himself of his sole livelihood. This act inspired other imitators and motivated large street protests that quickly spread across the Middle East and North Africa in what become known as the Arab Spring. Economic shocks that impact a population's ability to secure food and shelter can have geographical consequences extending into regions and periods well beyond the initial conflict.

CAPITAL MARKETS

During the first quarter of 2022, the U.S. equity and bond markets appear to be conveying different assessments of the economic growth outlook. The Standard & Poor's 500 Index rebounded from a greater than 12% decline through early March to end the quarter off 4.6%, including dividends. Bond investors appear more pessimistic on the economy, with the bond market posting its worst loss since the early 1970's. Bonds, which generally insulate investors from the volatility of their equity holdings, have not performed that function well this year. The primary culprit for the sharp decline in bond values - and rise in bond yields - is inflation. The chart below illustrates the unique nature of capital market returns in the first quarter as bond values declined roughly in line with equity values. Stylistically, value performed better than growth in the equity market which is reflective of a dramatic jump in bond yields. Generally, value stocks do best in an inflationary backdrop. The low inflation backdrop since the turn of the century partially explains why growth stocks have outperformed value stocks over the past twenty years.

First Quarter 2022 Index Returns



In a bull market, the source of equity volatility tends to be mostly attributable to the forward Price/Earnings ratio, while forward corporate earnings estimates remain relatively stable and tend to rise. Indeed, estimates of future corporate profits rose 2.7% during the first quarter. However, the forward Price/Earnings ratio compressed 11.7% resulting in a lower value for the Standard & Poor's 500 Index at the end of the first quarter. In a bear market, volatility is mostly to the downside, with both forward earnings and the forward Price/Earnings ratio falling. As a result, we view the current market pullback as a market correction amidst the bull market that began two years ago following the onset of the pandemic.

One reason the equity market is a good hedge for inflation is because corporate revenues capture inflation. Most market dominant companies, which represent a wide swath of the 500 largest publicly traded companies in the U.S., can pass rising input costs through to their customers. This “pricing power” and productivity gains generally help insulate corporate earnings from inflationary pressure. Although perhaps counterintuitive, the operating margin of companies in the Standard & Poor’s 500 Index historically rises in tandem with commodity prices. One of the key elements of our 2022 forecast is a record Standard & Poor’s 500 Index operating margin.

There are two clearly visible challenges for capital markets over the balance of the year, including the bond market’s confidence in the Federal Reserve’s ability to bring inflation under control. Sharp rises in bond yields typically imperil financial markets in at least one of three ways: it flushes out those actors that rely on cheap liquidity; it pressures interest rate sensitive sectors in the economy such as housing and autos; and it weighs on the valuations of other assets such as equities and real estate, especially if those valuations are already elevated. The second visible risk is the high likelihood of weaker economic readings as the Federal Reserve is successful in slowing inflation. We are already seeing very early signs of softening data such as trucking rates. As the economy cools from its 5.7% real growth rate last year, investor concern of a possible recession may rise, particularly if the Federal Reserve radically tightens monetary policy.

CONCLUSION

We anticipate capital markets will remain volatile as conditions surrounding inflation, the path of interest rates, COVID, and the war in Ukraine continue to shift in quick and surprising ways. The pandemic delivered a sharp negative supply-shock to the economy as manufacturing was hobbled by shutdowns and plagued by snarled supply chains. The government responded with a massive demand stimulus including direct-to-consumer transfer payments. A consequence of these two colliding forces was inflation that began to build a year ago. The war in eastern Europe propelled rising energy prices even higher. As a result, the Federal Reserve has made clear its resolve to tame inflation.

*FINANCIAL MARKET TOTAL RETURN**

	First Quarter 2022	Six Months Ending 03/31/22	One Year Ending 03/31/22	Annualized Return Two Years Ending 03/31/22	Annualized Return Three Years Ending 03/31/22	Annualized Return Five Years Ending 03/31/22
Standard & Poor's 500 Index	(4.60%)	5.92%	15.65%	34.47%	18.92%	15.99%
Russell 2000 Index	(7.53%)	(5.55%)	(5.79%)	35.49%	11.74%	9.74%
Value Line Composite Index	(4.84%)	(0.43%)	1.49%	36.62%	8.21%	6.20%
Dow Jones Industrial Average	(4.10%)	3.44%	7.11%	28.34%	12.57%	13.40%
NASDAQ (OTC) Composite	(8.94%)	(1.23%)	8.09%	36.93%	23.56%	20.36%
Bloomberg Gov't/Credit Intermediate Bond Index	(4.51%)	(5.05%)	(4.10%)	(1.09%)	1.50%	1.81%

** Total Return Includes Income*

Michael C. Yeager, CFA
April 8, 2022

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