

# LUTHER KING CAPITAL MANAGEMENT

## *FIRST QUARTER 2024 REVIEW*

The best characterization of the domestic economy is that it remains “resilient.” In response to surging inflation, the Federal Reserve initiated a dramatic tightening of monetary policy two years ago. Yet the anticipated economic bite of sharply higher interest rates has been surprisingly mollified by stronger-than-anticipated labor supply and productivity gains. We expect these favorable supply-side dynamics will fade over the balance of the year, contributing to slower economic growth this year compared to 2023. The behavior of economic demand has been less surprising over the past two years as government transfers supported sizeable disposable income growth, allowing households to put more money into their pockets, purchase houses, or reduce their debt burden. We likewise see these demand tailwinds beginning to dim looking forward.

Contrasting the current interest rate cycle to previous cycles, the central bank has achieved a remarkable feat in curbing a sharp inflation spike while maintaining the unemployment rate at its lowest level in nearly 50 years - an unmatched accomplishment in the post-World War II era. Despite this crowning achievement, inflation remains above the Federal Reserve’s 2% target with gathering headwinds. Many commodities, including crude oil, posted substantial gains in the first quarter. Moreover, following sixteen consecutive quarters of contraction in manufacturing activity, the ISM Manufacturing Index turned expansionary in March. Given the economy's current strength, policymakers may prove reluctant to stoke the economy through multiple interest rate cuts.

The equity market was strong in the first quarter, driven by above-trend economic growth, optimism around Generative Artificial Intelligence (AI), and the market’s expectation for six quarter-point interest rate cuts this year. However, stronger-than-expected inflation readings in January and February dramatically recalibrated interest rate futures from six interest rate cuts to three. Despite the bifurcated data, the Standard and Poor’s 500 Index hit its first record high in two years in January and tallied twenty-two new highs during the quarter.

## *ECONOMY*

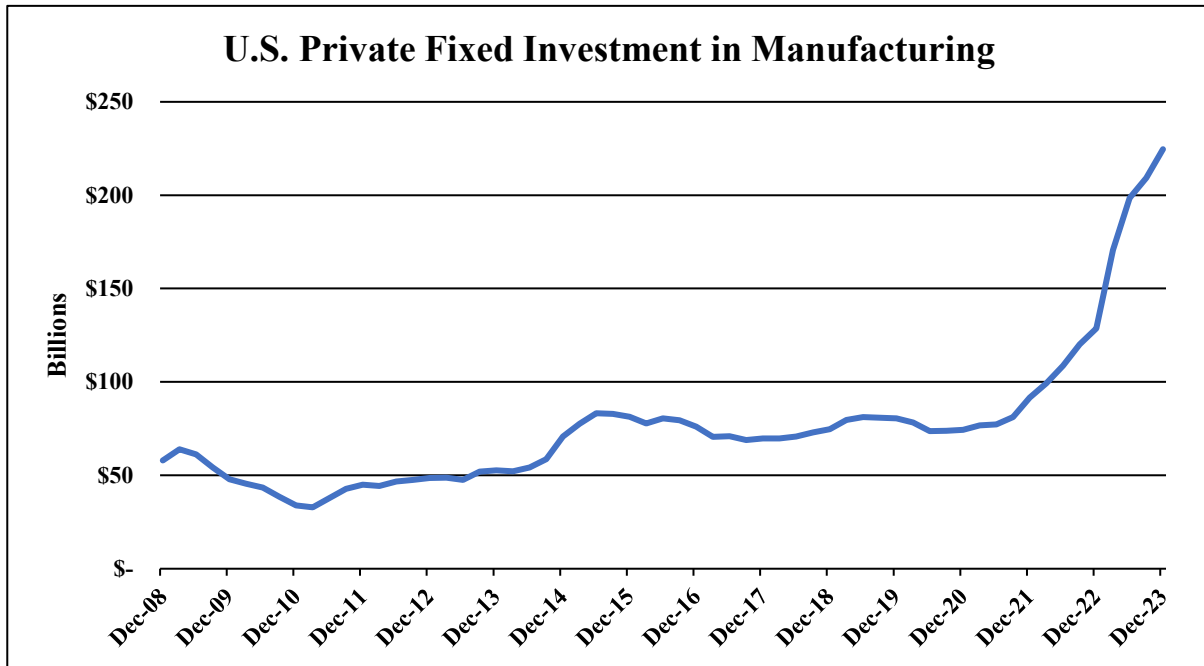
The current economic expansion has exhibited few signs of slowing. Nonfarm payrolls surged in March with an increase of 303,000 jobs, higher than the average monthly gain of 231,000 over the prior twelve months. Demand for labor is derived from consumer demand for goods and services, as well as demand for investment inputs. Therefore, the continued strength in the underlying economy continues to drive solid job gains. A strong labor market and resilient consumer demand have contributed to the upturn in the manufacturing sector.

Domestic and global manufacturing activity is displaying signs of greater vitality. Although manufacturing is a small part of the world economy, it is frequently a harbinger of where the global economy is heading. Notably, U.S. manufacturing and services managers' indexes (PMIs) are now in expansionary territory for the first time since October 2022. Moreover, the underlying data for manufacturing new orders suggest that the upward trend may continue.

Economic activity has remained robust while the inflation rate has continued to fall. This dynamic suggests that the disinflation we have witnessed has been primarily driven by improvements in the supply side (e.g., labor) rather than a falloff in demand. Typically, when demand runs hot, price pressures increase, but that was not the case last year. Historically, there have been a few periods where we have seen both significant economic growth and disinflation, but that was the case last year. The economy's resilience despite high real interest rates suggests the presence of the most remarkable economic phenomenon – strong productivity growth. A well-known Nobel laureate in economics, Paul Krugman, once said, “Productivity is not everything, but in the long run, it’s almost everything.” Productivity can raise the standard of living for all by creating conditions where the economy can grow faster at full employment without a commensurate uptick in inflation.

Productivity rose 3.2% on an annualized basis in the fourth quarter compared to 2.1% in the year-ago quarter. To put this into perspective, productivity has averaged a 1.5% increase over the past decade. It is unclear whether this post-pandemic lift in productivity is a one-time jump or represents a fundamental shift. We are unlikely to know the verdict for several years. However, it is often during periods of high inflation, elevated borrowing costs, and tight labor markets when businesses invest heavily to become more efficient. Serendipitously, this drive for efficiency occurs at a time of record fiscal deficit spending within the context of an economic expansion! The CHIPS and Science Act, the Infrastructure and Investment Act, and the Inflation Reduction Act have partly contributed to the staggering investment in

manufacturing capacity. The potential for Generative AI to unleash a new wave in productivity growth will be a dominant investment theme for the balance of the decade.



Source: Bureau of Economic Analysis, LKCM

Within the medium-term productivity narrative, investors are near-term focused on deftly timed interest rate reductions meant to sustain the economic expansion. Monetary policy is a rather blunt instrument that impacts vast swaths of the economy in variable and unpredictable ways. Further, it has traditionally been understood that changes in interest rates take several quarters to flow through the economy. Thus, calibrating the amount and timing of monetary stimulus is difficult. The primary challenge for the central bank is gauging when the economy is sufficiently weak to warrant an easing of monetary policy. The Atlanta Federal Reserve Bank president, Raphael Bostic, framed the risk of the central bank moving too early as unleashing “pent-up exuberance.” If consumers and small businesses are waiting for lower interest rates before purchasing homes, autos, and durable goods, while businesses begin to invest in more inventory and capital equipment the economy could indeed experience an acceleration. Such action could reignite inflationary pressure in the economy, necessitating a reversion to tighter monetary policy. This conundrum presents a challenge for the central bank and investors over the next few quarters. We would not be surprised if policymakers proceeded with extreme caution when considering interest rate cuts.

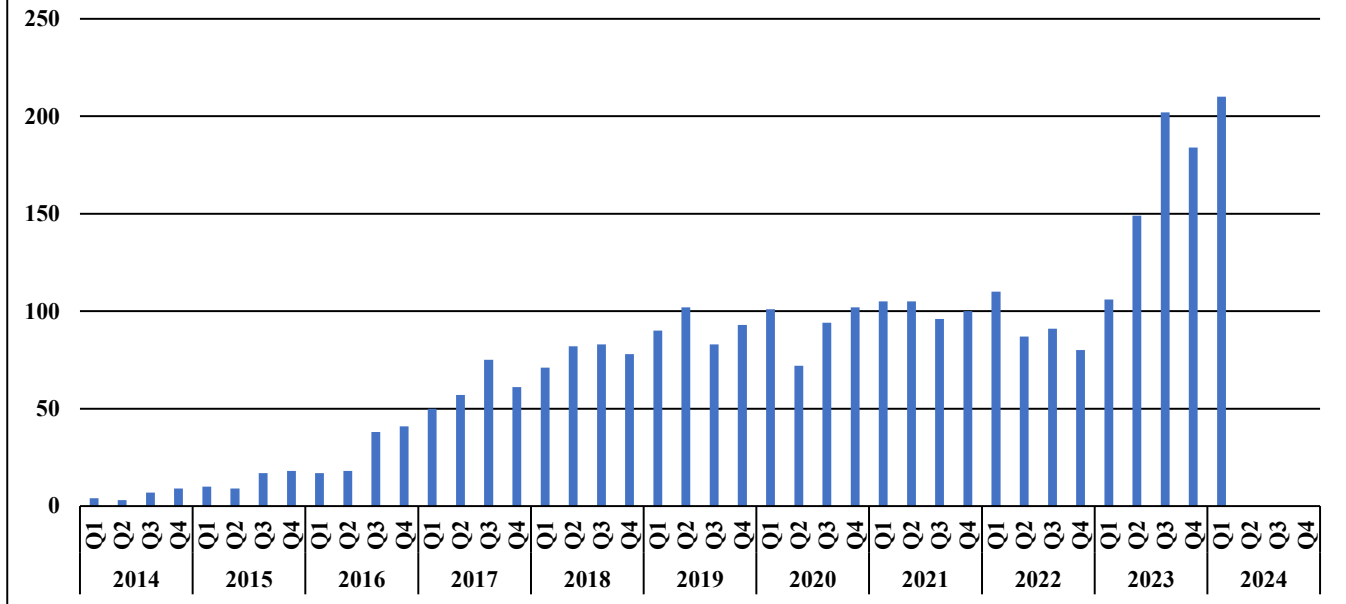
## *MARKETS*

The Standard & Poor's 500 Index returned 10.6% in the first quarter, including dividends, following a healthy rally in the final quarter of 2023 that has taken its cumulative gains since the end of September to 23.5%. This is only the ninth time since 1940 that the Standard & Poor's 500 Index has returned consecutive quarters of double-digit gains. Historically, this has been a bullish signal, as the prior eight occurrences were all followed by positive 12-month gains. Interestingly, the strongest periods of six-month rolling returns historically occur in early-cycle economic recoveries following recessions – June 1975, January 1983, and August 2009. This episode is another example of how the current economic and market cycle has been usurped by overwhelming liquidity. This contributes to continuing debate among economists and investors regarding where we are in the business cycle.

Over the past two quarters, the strong lift in the Standard & Poor's 500 Index has been partly powered by continued Generative AI enthusiasm and the prospect of interest rate cuts. The Standard & Poor's 500 Index trades at a forward Price/Earnings ratio 25% greater than the five-year average preceding the pandemic. However, roughly half of the equities in the Index trade at a discount to their 2015-19 valuations, as large capitalization and expensive names push the Index price and valuation higher. Some investors would characterize the market's historically high 22.2X Price/Earnings ratio as a harbinger of a market pullback. This view may, in fact, prove prescient. However, we would suggest that the risk is unevenly distributed within the market, just as the returns driving the market have been very unevenly distributed. For example, one stock (NVIDIA) accounted for 24% of the market gain during the first quarter, and five stocks (NVIDIA, Microsoft, Meta Platforms, Amazon.com, Eli Lilly) accounted for 49% of the lift in the Standard & Poor's 500 Index in the first quarter.

AI and Machine Learning continue to capture the attention of investors. The emergence of AI is arguably the most exciting investment story since the emergence of the internet. In the late 1990s, “.com” and “internet strategy” were key discussion points with management teams. Some companies even changed their corporate name to include “.com.” Utilizing Bloomberg's AI-enhanced document search tool, we track the explosion of instances in which “AI” or “machine learning” has been mentioned on the earnings conference calls of the Standard & Poor's 500 Index companies, as illustrated on the next page.

## Number of S&P 500 Quarterly Earnings Conference Calls Mentioning "AI & Machine Learning"



Source: Bloomberg, LKCM

On the fixed income side, the normative framework for bond yields is that they peak alongside the Federal Funds rate. While we don't know if we have seen the peak in the Federal Funds rate, the overwhelming market assumption has been that last July's quarter-point increase was the final increase. After all, the central bank has left the Federal Funds rate unchanged for five consecutive meetings, and the futures market began the year anticipating a 1.5% decline in the Federal Funds rate in 2024. In the current cycle, the yield on the 10-Year Treasury note continued to rise, reaching a cycle high of 5.0% last October, some three months following the final hike. Market interest rates have not fallen near what would have been expected at "peak Fed policy." Firm labor market data and uncomfortably high inflation have played spoilers to lower policy rates. The challenge for investors is that the torrid pace of stock price appreciation has been partially based on the expectation of interest rate cuts. Yet the threshold for interest rate cuts (roughly 2% inflation and/or deteriorating labor market) has not been met.

## *CONCLUSION*

The Fed is in an awkward place. Central bankers want to cut rates largely to avoid a sudden deterioration in the labor market that cannot be quickly reversed. However, the data mostly depict a strong economy struggling to get inflation down to the policymakers' 2% target. Despite remaining below last year's peaks, bond yields have moved decidedly higher this year due to firm inflation data, robust job creation,

and stronger manufacturing activity. If bond yields continue to push higher, it would not be surprising to see them weigh on the equity market just as they did in August – October last year.

Risks remain manifold with the revival of “older” risks, including inflation, cost-of-living crises, trade wars, social unrest, and geopolitical tension. While this list is largely lifted from the headlines fifty years ago, many of these risks are amplified by comparatively new developments, including unsustainable debt levels, and de-globalization. The equity market has been supported by 1) accelerating earnings growth following just 4.2% earnings progress in the preceding two years and 2) the prospect of future interest rate cuts. These dynamics have produced stronger equity gains than are historically associated with the first half of a presidential election year.

### ***FINANCIAL MARKET TOTAL RETURN\****

	<b>First Quarter 2024</b>	<b>Six Months Ending 03/31/24</b>	<b>One Year Ending 03/31/24</b>	<b>Annualized Return Two Years Ending 03/31/24</b>	<b>Annualized Return Three Years Ending 03/31/24</b>	<b>Annualized Return Five Years Ending 03/31/24</b>
Standard & Poor’s 500 Index	10.56%	23.48%	29.88%	9.47%	11.49%	15.05%
Russell 2000 Index	5.18%	19.94%	19.71%	2.87%	(0.10%)	8.10%
Value Line Composite Index	4.21%	15.38%	12.44%	0.38%	0.75%	5.01%
Dow Jones Industrial Average	6.14%	20.03%	22.18%	9.44%	8.65%	11.31%
Nasdaq (OTC) Composite	9.32%	24.44%	35.14%	8.30%	8.23%	17.23%
Bloomberg Gov’t/Credit Intermediate Bond Index	(0.15%)	4.40%	2.69%	0.49%	(1.06%)	1.09%

*\* Total Return Includes Income*

Michael C. Yeager, CFA  
April 7, 2024

## IMPORTANT INFORMATION

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