LUTHER KING CAPITAL MANAGEMENT

SECOND QUARTER 2016 REVIEW

Referendums are a peculiar way to govern. They embody the very soul of democracy by placing before the electorate an issue which either stands or fails based on the collective desire of the people. The Swiss use referendums liberally to decide issues of national concern, while other countries, particularly in the Commonwealth, use them in limited fashion. Yet as the implications of the Brexit results sunk in, the enormity of what had occurred seemed to leave the electorate gobstruck. Even leaders of the Leave campaign were quick to signal that expectations, financial and otherwise, should be significantly lowered.

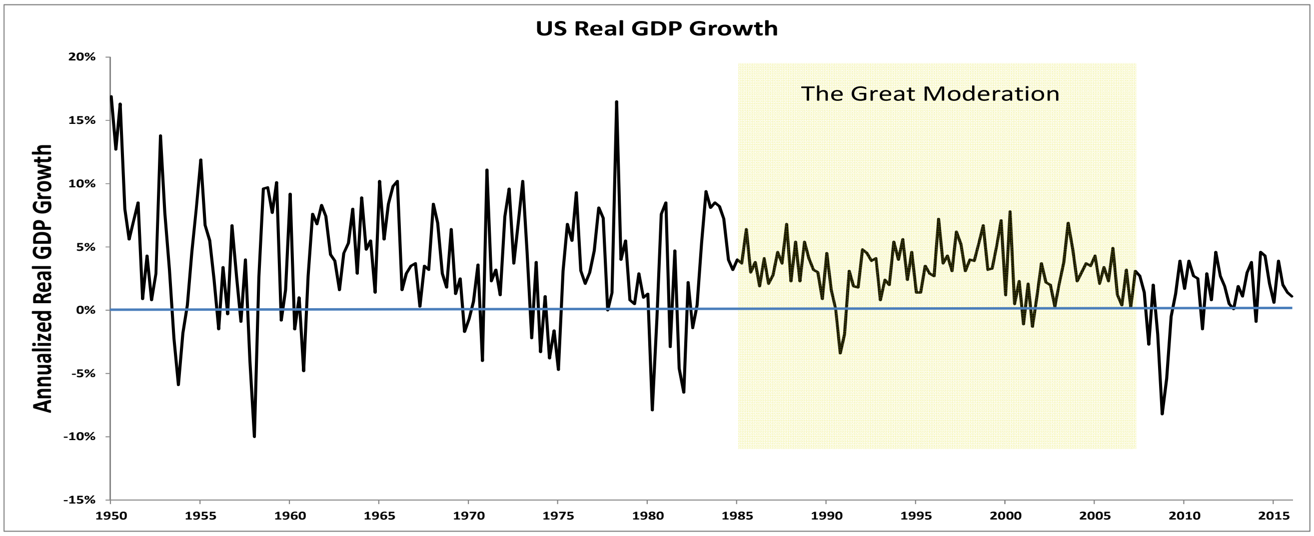
Capital markets were blindsided by events across the Atlantic, with investors bidding up the price of equities around the globe as well as the pound sterling on the eve of the Brexit vote. There was a low double-digit block of undecided voters according to polls, and, similar to Quebec's independence vote in 1995 and the Scottish independence ballot in 2014, swing voters were expected to ultimately maintain the status quo. As a result, the price action of equities the days following the result were jarring. The primary U.K. equity market index, the FTSE 100, closed the quarter 2.62% higher than the day of the vote. However, given the sharp move lower in the pound sterling versus the U.S. dollar, U.K. equities declined 8.06% in U.S. dollar terms.

Domestically, economic data including real personal income, initial jobless claims, and housing prices improved during the second quarter lending support to the consumer. Business investment remains somewhat muted because of low oil and gas investment and the impact of a stronger U.S. dollar over the past two years. As these twin headwinds abate, capital investment is likely to rise. While corporate profit growth has been challenging, we anticipate year-over-year growth will resume in the second half of the year.

LKCM
LUTHER KING CAPITAL MANAGEMENT

ECONOMY

The Great Moderation was a term that rose to prominence in the 1980's to describe the reduction in amplitude of economic cycles. Taming the economic cycle ushered in a period of falling inflation and rising bond and stock values with intermittent bear markets.



Source: Bloomberg, LKCM

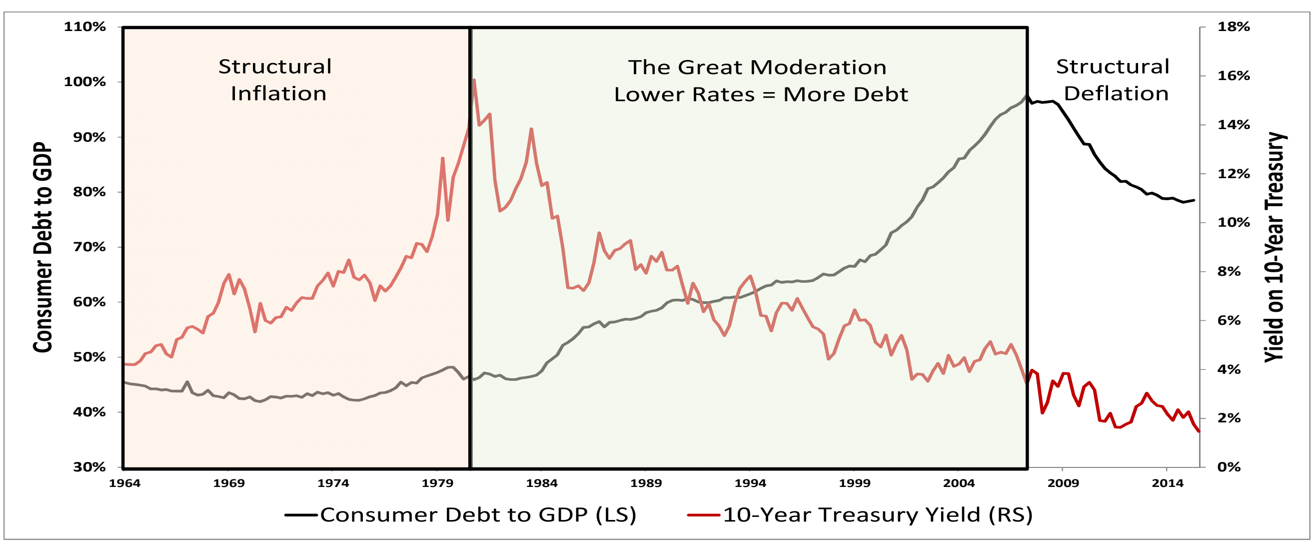
Essential to the Great Moderation was financial innovation such as the pooling of mortgage and consumer debts to create asset-backed bonds. This enabled consumers to pull forward future demand via the use of credit. Equally important was the Fed's success in breaking the grip of crippling inflation under the leadership of Chairman Paul Volcker. Inflation peaked at 14.8% in March 1980 and fell below 3.0% by 1983, after an almost doubling of the Federal Funds interest rate to 20%. In the intervening years economic growth would occasionally overheat, driven largely by consumption. The Fed would simply raise interest rates to squelch inflation, only to reverse course and ease rates to stimulate growth with cheaper credit as the business cycle ebbed and flowed.

There were few extraneous shocks to the economy over this period. The oil crisis of the 1970's was in the rearview mirror. During the Great Moderation, the Cold War ended, trade agreements multiplied and the world witnessed a period of globalization. National economies grew more interconnected through free trade. The standard of living climbed as consumers benefitted from cheaper goods and better employment opportunities. There were other structural tailwinds during the Great Moderation, such as the change in the complexion of economic activity, as more volatile segments of the economy like energy were outweighed by significant growth of service industries. Technology brought about very tangible economic benefits such as just-in-time inventory management, which improved the efficiency of the supply chain and allowed businesses to adjust more quickly to changing economic conditions.

The structural forces that brought about the Great Moderation are now waning. Fed Chairwoman Janet Yellen has referred to this slow growth environment as the “new normal”. Monetary policy is losing its potency, and its primary transmission mechanism, influencing credit demand and supply, has been choked off as rates have become so low as to be negligible. As a result, central banks have pivoted to the two other channels of monetary policy, asset prices and currency exchange rates. Quantitative easing by central banks was successful in lifting asset prices, but has been phased out as its incremental impact shrunk with each successive round. Finally, many central banks have engaged in currency depreciation in a bid to artificially produce a global competitive advantage by making exports more attractive in the global marketplace.

The latest central bank experiment of negative rates appears to be losing its efficacy. Without monetary policy to act as a shock absorber, the global economy becomes more brittle and vulnerable to economic disappointment. The impact of the uncertainty wrought by Brexit is that global monetary policy will remain looser for longer, which should be positive for domestic economic data and supportive of equity values. Lower global interest rates typically take eighteen months to work their way into measurable economic positives, which suggests that economic data in late 2017 should benefit. In the immediate term, strength in housing should be sustained as mortgage rates will remain near historically low levels.

The chart below illustrates three unique phases of the economy beginning in 1965. As the inflation fever broke, the Great Moderation was placed into motion. Today, falling interest rates accompanied by continued consumer deleveraging illustrates the structural challenge facing our economy.



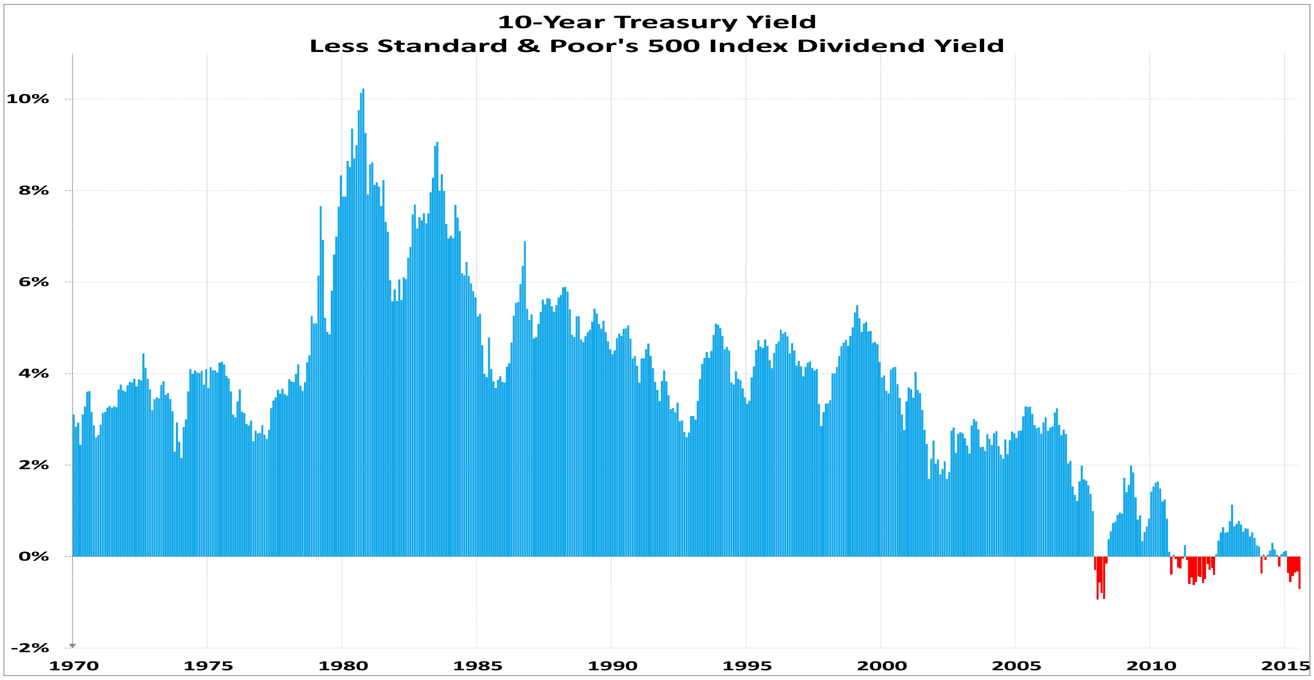
Source: Cornerstone Macro, Bloomberg, LKCM

It is paramount to remember that structural forces can be overwhelmed by cyclical tailwinds, a notion Japan knows all too well. Some market observers want to draw parallels between the U.S. economy and that of Japan. A key, and often overlooked, component of such analysis is that the U.S. is in a much better demographic position. Today, there are more Millennials in the U.S., those born between 1980 and 1999, than Baby Boomers (1946-1964). Interestingly, consumer confidence has been relatively stable the past 18 months, but that belies that fact that consumer confidence for the 18-35 year old cohort has reached a new high while consumer confidence for those over age 55 has eroded. While there are structural headwinds in the U.S. economy, we remain positive on the prospect for continued economic expansion on the order of 2.0% - 2.5% real growth, which should extend this current expansion and continue to provide a favorable backdrop for equity prices.

CAPITAL MARKETS

Capital markets are simply a discounting mechanism. They take into consideration all known information and probability-weight future expectations, which become reflected in the clearing price of stocks, bonds, currencies, and any other marketable financial instrument. This process takes place in a globally integrated marketplace on the order of trillions of dollars a day. It is rare for capital markets to be so wrong in forecasting the outcome of a large event such as Brexit. Equity markets around the globe including the U.K, the U.S., Germany, France, and Japan all traded higher on June 23rd, the day of the referendum. The pound sterling strengthened slightly less than 2.0% that same day as the Remain camp looked to gain traction. As a result of the surprise outcome, the U.S. equity market fell sharply the two trading days following the ballot; however, it recovered quickly as investors received better domestic economic data.

Regarding interest rates, we have written previously about the extent of negative bond yields in the marketplace. With nearly all negative-yield debt concentrated in the Eurozone and Japan, it is little surprise there has been record demand at U.S. government debt auctions this year. In May, demand for the two, five, and seven-year U.S. Treasury notes soared to all-time highs. Relative to equities, Treasury bonds are overvalued. The yield on the 10-year Treasury note closed the quarter at 1.47%, the lowest level since August of 2012. Put into context, the dividend yield on the S&P 500 Index was 2.18%. Treasury notes have only been more expensive on two other occasions: 2008 and 2012. In both cases, Treasuries went on to post their worst annual return on record the following year, losing 3.7% in 2009 and 3.4% in 2013.



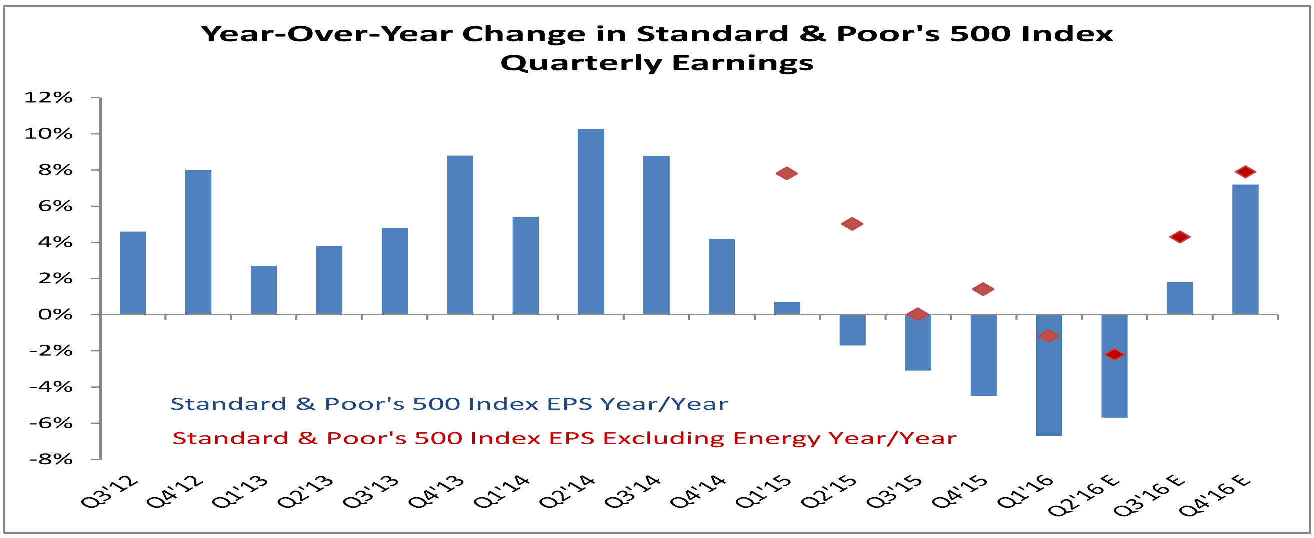
Source: Bloomberg

The corrosive effect of negative interest rates will become more apparent over time. Negative interest rates punish savers while at the same time compel them to set aside even greater sums. We believe this will have negative repercussions for economic growth over time, contrary to the intent of the exercise. Even low interest rates domestically are unsettling. The yield curve, or the rate of interest for successive years, is naturally upward-sloping. This is because the interest rate on the 10-year Treasury note should be the same, in theory, as the rate of a 1-year Treasury note rolled ten times plus a slight premium for the uncertainty of owning a longer-dated asset and its potential erosion in value due to inflation. Therefore, what long-term interest rates are implying is that not only is economic growth tepid now, but economic growth is expected to be lackluster for the next ten years. We do not believe that interest rates are the clarion indicator of future economic growth because of current distortions.

While future economic growth expectations are imbedded in the level of U.S. Treasury rates, there are additional forces pulling rates lower. Negative interest rates in parts of Europe and Japan are exerting a gravitational pull on our domestic rates. While an interest rate around 1.50% for a 10-year maturity Treasury is not exciting in a historical context, it is downright exhilarating compared to -0.13% in Germany, -0.22% in Japan, and -0.58% in Switzerland. As a result, the U.S. Treasury has registered record demand at recent auctions.

The year-over-year change in corporate profits for the Standard & Poor’s 500 Index will be negative for the second quarter of 2016, marking the fifth consecutive quarter of negative growth. The level of the Standard & Poor's 500 Index has essentially moved sideways since the beginning of 2015 with episodic drawdowns primarily related to economic growth concerns. Over the past eighteen months, corporate profits have been hindered by negative earnings in the energy sector as well as the negative impact of a stronger U.S. dollar. Both of these headwinds are fading and will result in the resumption of corporate earnings growth as we enter 2017. This has the potential to boost equity markets in the second half of this year as investors focus on future earnings expectations, particularly once we get beyond the fall elections.

The following chart illustrates the impact of the energy sector on earnings during 2015 and 2016. The red diamonds indicate what the index earnings growth would have been excluding the impact of energy.



Source: Bloomberg, LKCM

CONCLUSION

Labor's declining share of national income, rising income inequality, and stagnant wages in the middle class appear to be creating social fissures. Add angst over immigration and headlines of terrorism to these economic stress points, and the result is a ripple of populism, nationalism, and isolationism. The question is whether or not this ripple becomes a wave. It was encouraging to see the elections in Spain reject the far-right nationalist party in the week following the U.K. ballot. Brexit will be a long drawn-out process; however, the potential negative drag on European economic growth will be met with further easing by the European Central Bank. In terms of the impact on the domestic economy, further easing in Europe is likely to keep U.S. interest rates lower for longer. The element that could change this landscape is inflation. While inflation expectations have recently dipped, anyone who has recently dined at a restaurant, visited an auto dealership, or purchased a home can attest to higher prices. The job market will remain a key focus for investors.

The broad equity market trend may continue to be lateral as investors wait for confirmation of better corporate earnings growth, which we believe is likely to occur in 2017. We continue to favor equities over bonds as a tightening labor market contains the potential to accelerate wage growth. This could lead to higher inflation readings, which would have negative implications for the bond market. Fiscal policy remains largely absent. After the fall elections, there is the possibility that our national leadership focuses on steps to spur economic growth outside of monetary policy, which has carried the torch as far as possible.

*FINANCIAL MARKET TOTAL RETURN**

	Second Quarter 2016	**Six Months Ending 06/30/16**	**One Year Ending 06/30/16**	**Annualized Return Two Years Ending 06/30/16**	**Annualized Return Three Years Ending 06/30/16**	**Annualized Return Five Years Ending 06/30/16**
Standard & Poor's 500 Index	2.46%	3.84%	3.99%	5.69%	11.66%	12.10%
Russell 2000 Index	3.79%	2.22%	(6.73%)	(0.34%)	7.09%	8.35%
Value Line Composite Index	1.77%	3.97%	(6.48%)	(2.71%)	5.12%	5.74%
Dow Jones Industrial Average	2.07%	4.31%	4.50%	5.85%	8.99%	10.41%
NASDAQ (OTC) Composite	(0.22%)	(2.61%)	(1.58%)	6.18%	13.91%	13.28%
Barclays Capital Gov't/Credit Intermediate Bond Index	1.58%	4.07%	4.33%	3.00%	2.95%	2.90%

** Total Return Includes Income*

Michael C. Yeager, CFA
July 6, 2016