Holt Capital Partners, L.P.

First Quarter Financial Market Commentary

"Ninety Days in Ninety Seconds"

March 31, 2018

The Psychology Of The First Quarter Correction

- The tranquility of positive returns for 15 consecutive months, the longest monthly streak since 1950, concluded with January. Returns in February and March were negative. Stock market corrections are common, with most years experiencing mid to high single digit declines at least once during the year. In that regard, the first quarter was not unusual.
- Simplistically, most market corrections can be put in one of two buckets: "inflation scares" or "growth scares". An "inflation scare" correction is driven by concerns that a robust economy might force the Fed to raise interest rates more aggressively than previously believed. A "growth scare" correction is triggered by fears that the economy may slow and hurt earnings, and is often triggered by some exogenous cause.
- The sharp stock market decline that began in late January was an inflation scare. The year started with stocks rising briskly in response to powerful synchronized global growth. Inflation expectations and bond yields rose, which along with excessive euphoria, triggered a broad pullback with all sectors experiencing roughly similar declines.
- The mid-March decline, which may be on-going, was a growth scare triggered by fears that the Trump administration tariffs proposal might start a trade war and derail global growth. Inflation expectations eased, bond yields fell, and defensive sectors faired notably better than economically-sensitive sectors.
- The unique character of the first quarter was not the correction itself, but that an "inflation scare" and a "growth scare" coincided in a single quarter.

What Is Volatility?

- Volatility refers to fluctuations in prices. When volatility is low, as it was in 2017, fluctuations are muted. When prices swing wildly, as they did in the first quarter, volatility is described as high.
- As Modern Portfolio Theory gained acceptance over the last 30 years, volatility became synonymous with risk. The result has been a massive movement within investment management to temper volatility, and that has come at great cost to many long-term investors. If you think about volatility as a manifestation of human emotions, it makes much more sense that it should be understood rather than simply avoided.
- Driven by fear and greed, the fluctuations in stock prices are more pronounced than are changes in underlying business values. This is a simple idea that intuitively makes sense to most business people. Markets tend to be myopic and overreact to today's news while underappreciating the durability of the actual businesses. To quip, price is different than value, and fear is different than risk.
- Volatility has always been a characteristic of common stock ownership. Prior to 2017, the S&P 500 Index had experienced intra year price declines every year since 1980 that ranged from a modest -3% to an extreme in 2008 of -49%. Despite that volatility, the S&P 500 has generated a cumulative total return over the past 37 years of a remarkable +5,106%. This equates to an annualized return of +11% and is a testament to the power of ignoring those interim price swings – what we refer to as "transient volatility" – and allowing returns to compound over long time periods.

Volatility Has Its Benefits

- Volatility is opportunity. Since prices swing more wildly than values, volatility provides opportunities for investors to buy stocks – sometimes the market overall and at other times specific sectors or shares of individual companies.
- Volatility is important to keeping the financial system healthy. Extended periods of low volatility lead to complacency. Speculation builds as investors feel they can't lose and leverage becomes more prevalent as debt is employed to magnify returns. Since financing is easy, businesses accept lower quality projects. The economist Hyman Minsky, noted for his work on financial market fragility, described how prosperity and related stability sowed the seeds of its own undoing by encouraging excessive risk taking. Regular bouts of volatility mitigate such complacency.

In The News

- How much does Facebook know about you? Technology stocks have come under pressure as privacy concerns have highlighted potential abuses of monopoly power and raised concerns about the potential for growth-limiting regulation. Trump, whose administration has rolled back regulation broadly, has ramped up political rhetoric challenging technology companies, especially Amazon. Given the high valuation of many internet-related stocks, realization of high expected growth rates will be key to long-term returns of technology shares.
- Tariffs are negative for the stock market. Many US companies operate in global markets and rely on the rules-based system of trade established after World War II. And while specific tariffs can create winners and losers, economists agree that tariffs will slow growth overall. To date, the proposed tariffs are limited and most believe them to be acts of brinksmanship designed to win concessions from China. Given Trump's tendency to pivot after bold opening provocations, we tend to be in this camp and do not expect escalation to a full-scale trade war. Trump has in the past pointed to the rising stock market as validation for his policies. As such, we hope the negative response from the stock market over tariffs will be disciplining.
- In our world of enormous media noise, both issues are meaningful and worth following closely.

Conclusion

- Market behavior in the first quarter, the "inflation scare" and "growth scare" mentioned earlier, suggests some investor confusion about where we are in the economic cycle. The expansion's long duration and Fed tightening are cause for caution but fiscal stimulus and robust economic indicators are positive. It feels more mid cycle to us, with a recession still a couple years off. But history has taught us that a policy mistake, such as a trade war, can meaningfully dent confidence and slow economic activity.
- Global economic strength and more visibility into the impact of tax reform have contributed to a rise in consensus earnings estimates since the end of the year. At the same time, stock indexes are marginally lower. These factors have combined to push price-to-earnings ratios lower over the past three months, which are now near median levels since 1990.

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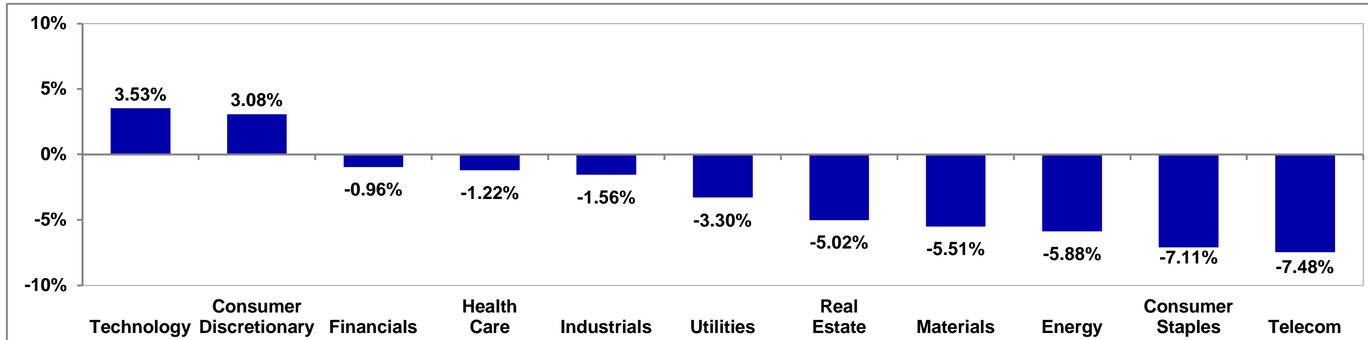
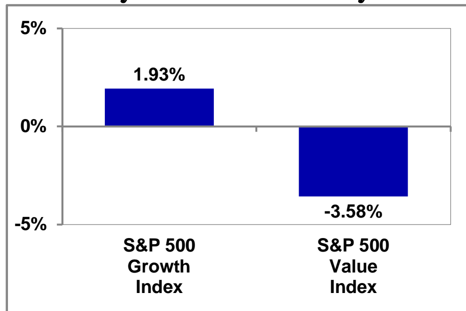
First Quarter Investment Performance (including income)

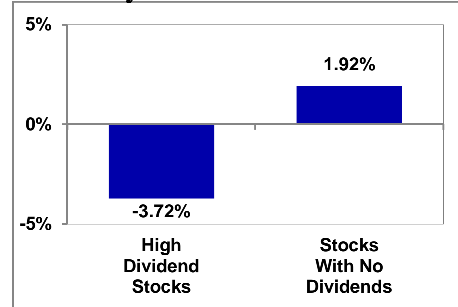
By Economic Sector



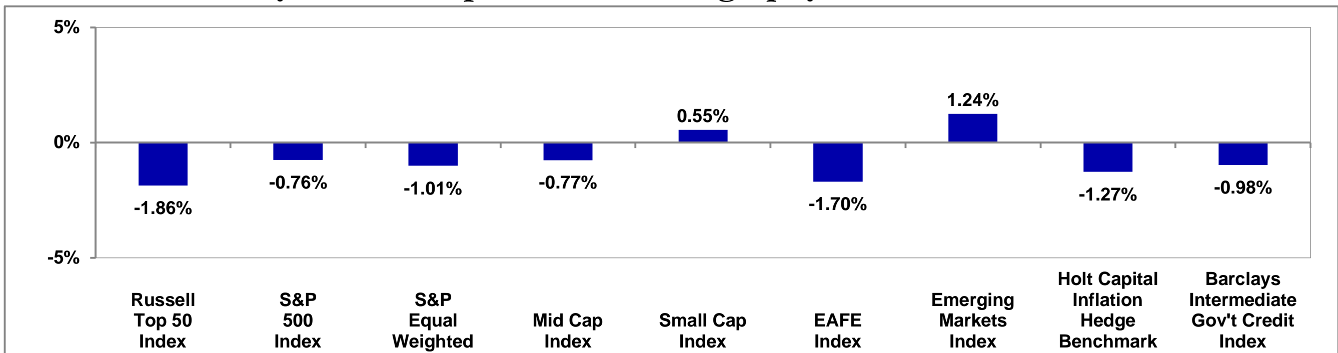
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- The full quarter results disguise what was a Jekyll and Hyde period. The S&P 500 was up 5.6% in January led by a +7.6% surge in technology stocks. A sharp reversal followed in February and March with the S&P 500 closing 8.1% off the January high.
- Only two economic sectors generated positive total returns during the first quarter. At the sector level, positive returns were limited to the month of January and all eleven economic sectors fell during the last two months of the quarter.