Holt Capital
Partners, L.P.

Fourth Quarter Financial Market Commentary

"Ninety Days in Ninety Seconds"

December 31, 2019

Looking Back

- This past year has seen a remarkable shift in policy, sentiment, employment, and economic outlook. Most significantly, the Federal Reserve pivoted from a policy of normalizing interest rates with four interest hikes in 2018 to a stimulative policy in 2019 with three interest rate cuts. At the end of 2018, business confidence was depressed and fears of recession were rampant. In hindsight, the fourth quarter of 2018 serves as a vivid reminder that fear-driven selling can be very costly in the context of long term portfolio returns.

- In contrast, this past year ended amid robust confidence, a record low unemployment rate, progress on a trade agreement with China, and more certainty around Brexit. Stocks responded to these events with the second best annual return since 1997.

Looking Forward

- Over the past several months investors received more clarity on several key macroeconomic issues, including Federal Reserve policy, Brexit, and trade policy with China. The Fed has described interest rate policy as "being in a good place" and does not currently expect any interest rate changes in 2020. Boris Johnson won a resounding election victory in the U.K. and this appears to pave the way for the U.K. to exit the European Union early in 2020. Lastly, the phase one deal with China on trade should be signed in early January. Much of this good news is likely already incorporated in current stock prices. However, low interest rates, a rebound in global growth and a high single digit growth rate in corporate profits should buffer any major downside volatility in the new year.

A Year Of Multiple Expansion

- Over long periods of time, rising earnings are the biggest driver of stock prices. Shorter time periods are often a confluence of news headlines, earnings changes and movements in valuation, i.e. price-to-earnings ratios. This past year, stocks were primarily propelled by an expansion in the price-to-earnings multiple. This can be thought of as a numerical measure of investor sentiment, business confidence, and macroeconomic expectations. As 2018 ended, recession fears were widespread and the forward P/E of the S&P 500 was 14.4x. Today, investor optimism has shifted 180 degrees from a proverbial sea of red to fields of green. The P/E ratio based upon 2020 earnings estimates is now 18.1x. Further gains will need to be driven by rising earnings and a continuation of the view that geopolitical policy will remain focused on economic growth.

Election Year 2020

- Presidential elections are the classic intersection of politics and finance. Based upon history, the third year of a president's term tends to be strong and that was certainly the experience in 2019. Election years tend to produce mediocre and occasionally tumultuous returns. With a sharply divided electorate, forecasting is probably more treacherous than normal this year. However, any perceived shift toward less business-friendly candidates could spark a sell off in the stock market.

Inflation - The Surprise of 2020?

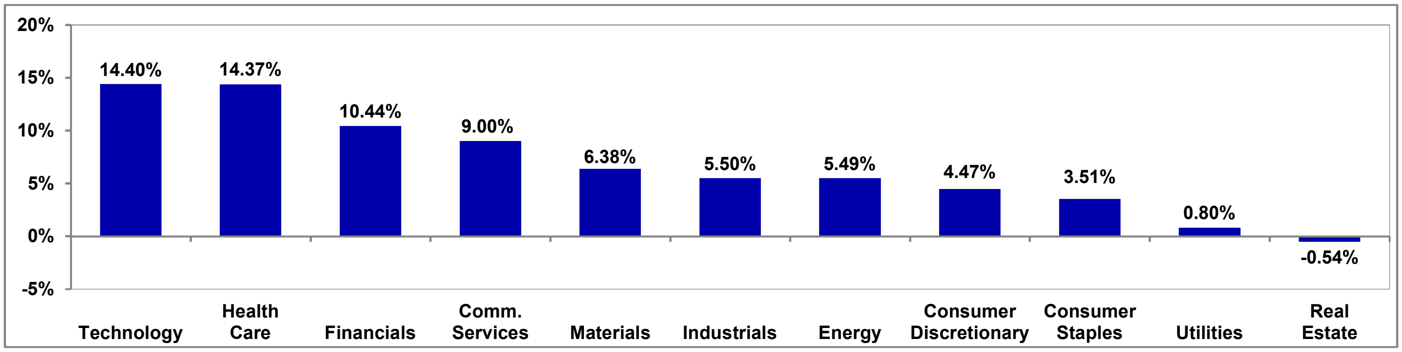
- Accurately measuring inflation has always been difficult. However, wage growth, energy prices, and housing costs are three key inputs. The job market outperformed expectations in the latter part of 2019, with unemployment hitting half-century lows and wages accelerating. Crude oil surprised most pundits and rallied 34% in 2019. According to government data, housing costs rose about 3.3% in the past twelve months. These pressures have been largely offset by the "Amazon Effect" on retail pricing for consumer goods and weak business capital spending.
- Both the widely quoted Consumer Price Index and data from the Dallas Fed's "Trimmed Mean" measure of inflation have consistently been around 2.0%. The ten-year government bond yield is about 1.8%, which based on the current inflation rate results in a loss of purchasing power for investors, even on a pre-tax basis. If several of these individual factors begin to inflect higher and impact the economy more broadly, the Federal Reserve may surprise investors and begin to achieve its long-held goal of 2% or higher price inflation.

Conclusion

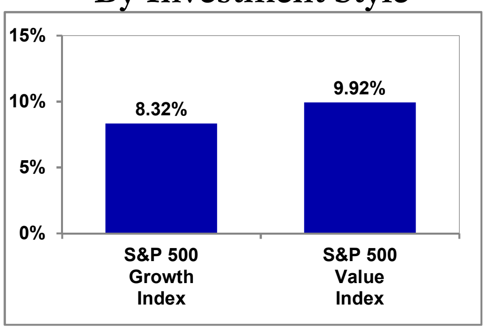
- It is probably insightful to put last year's returns in a historical context. The S&P 500 posted its eighth best year in the past half century. Only 1975 and 1995 generated meaningfully higher returns. As we move into 2020, volatility is likely to increase from the tranquil conditions of last year. Temporary price declines often serve a healthy role in controlling overly aggressive risk-taking and should be considered normal by long term investors.
- While the current economic expansion is the longest in the post-war period, it is also the slowest. Recessions and bear markets tend to result from excesses and bubbles in the economy. As was our view last year, leading indicators of a recession continue to appear muted.
- Earnings will be a key driver for stocks in 2020. Although P/E ratios are above their long term average, price-to-free cash flow is slightly below average. Estimates for S&P 500 earnings currently imply a mid single-digit growth rate. The combination of this level of earnings growth, along with dividend yields of around two percent, could produce high single-digit returns for the upcoming year.
- Low interest rates and a healthy consumer should continue to support the domestic economy, but the Presidential election and Middle East tensions inject some unpredictability into the outlook. Upside could result from a further stabilization of trade frictions with China and a rebound in domestic capital spending.

Fourth Quarter Investment Performance (including income)

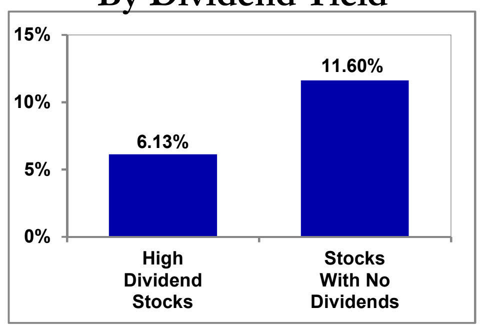
By Economic Sector



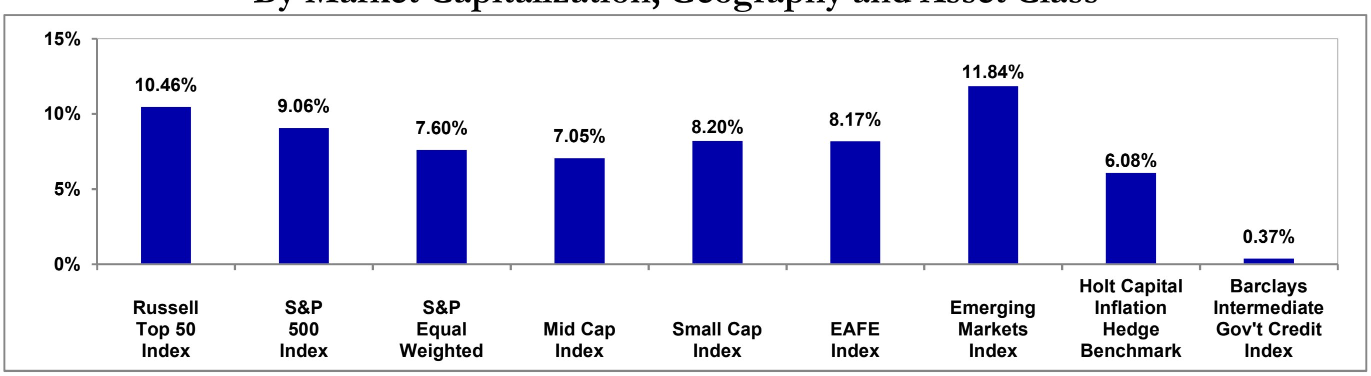
By Investment Style



By Dividend Yield



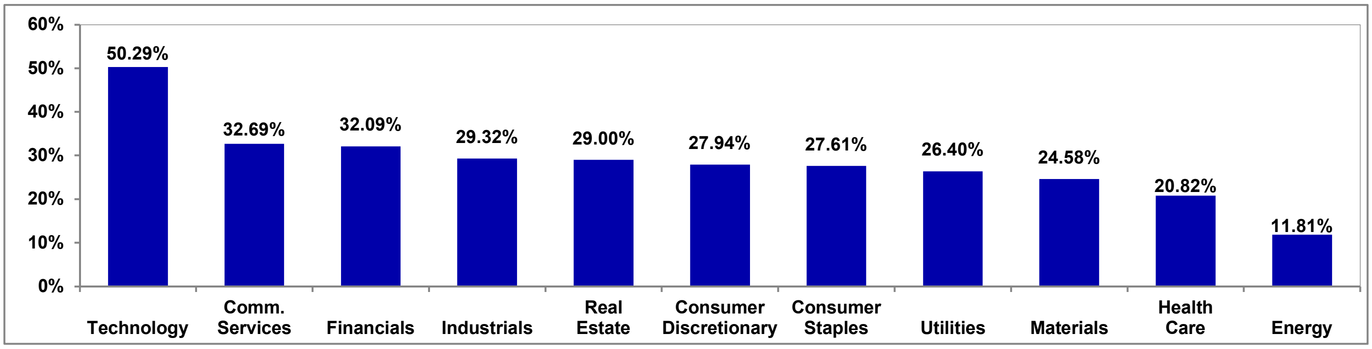
By Market Capitalization, Geography and Asset Class



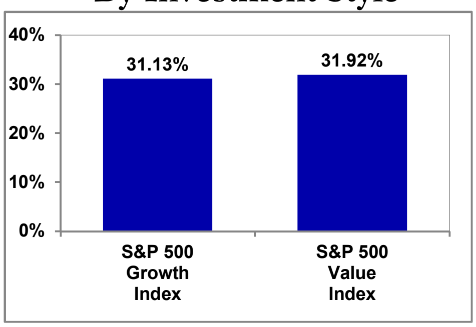
- Stocks advanced sharply during the quarter, but similar to the results for the entire year, the advance was relatively narrow. Mega cap stocks outperformed all other size categories and the narrow breadth was further highlighted by only three out of eleven economic sectors outperforming the index.
- An improving outlook for global trade helped emerging market stocks to post their best quarter in almost eight years.
- The most interest rate sensitive sectors, utilities and real estate, lagged during the quarter. This was largely a reflection of ten year government bond yields moving higher by about a quarter of a percent.

Year-to-Date Investment Performance (including income)

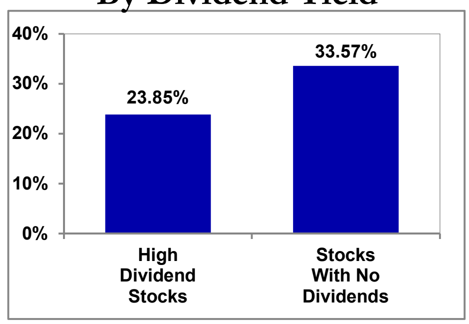
By Economic Sector



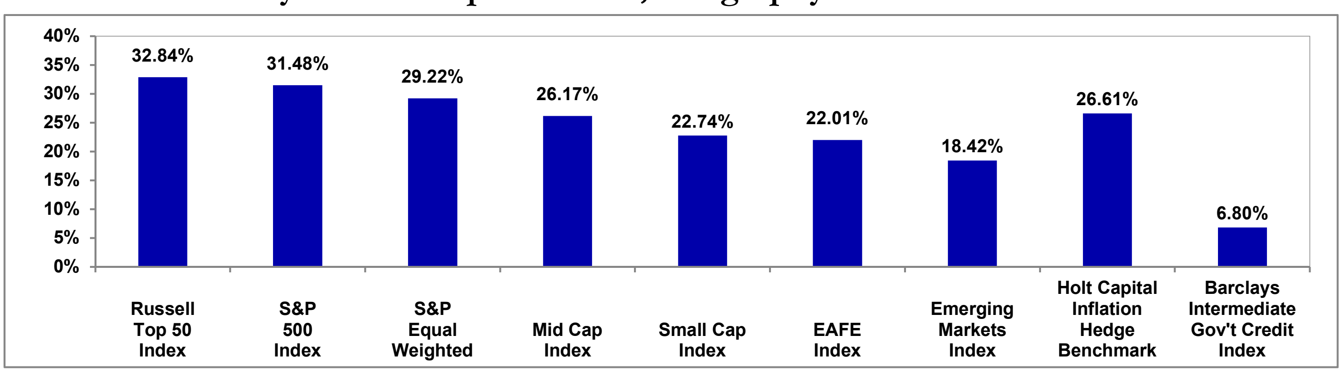
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- For the year the S&P 500 produced a stellar return, but the advance was relatively narrow. Only three sectors (technology, communications, and financials) outperformed the index, while eight sectors lagged. From a company size perspective the so-called mega cap stocks also reflected this lack of breadth and outperformed all other size categories.
- Evaluating growth and value returns in 2019 was very subjective. Based upon the S&P large cap indexes quoted above, returns were similar. However, indexes from the other major index provider, Russell, show growth beating value by ten percentage points. Russell's mid and small cap indexes also affirm the year's growth bias. A key factor that caused this divergence was S&P's inclusion of Apple in its value index, which skewed performance attribution.
- Even in an environment of rising crude oil prices, energy stocks were laggards. Amid very depressed investor sentiment, this sector could surprise to the upside in 2020.