Holt Capital
Partners, L.P.

Second Quarter Financial Market Commentary

"Ninety Days in Ninety Seconds"

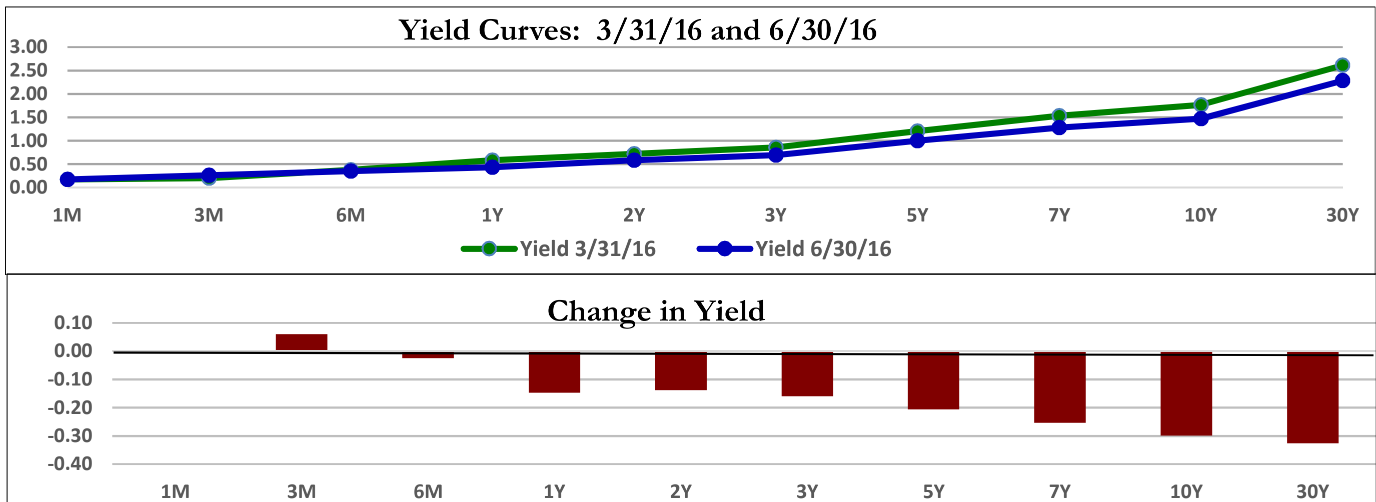
June 30, 2016

The Exit Of The UK From The European Union

- After a bruising election battle, the UK has voted to leave the EU. This is the most significant retreat from global integration and free trade since World War II. The path forward for the global community is not completely clear. The immediate impact of the vote has been increased volatility in the global financial markets and concerns about lower economic growth in the UK, as well as the EU.
- The timeline for the formal withdrawal from the EU is likely to be two or more years. The process will involve renegotiating 80,000 pages of agreements with the EU. The biggest economic impact will likely be seen in slower trade with the EU, which accounts for half of the UK's trading volume and 13% of its GDP. A longer term impact could be the decline of London as a major financial hub, as access to EU markets diminishes and individual countries will once again set regulatory requirements.
- While "Brexit" has dominated global headlines, it is important to keep the size of the UK economy in perspective. The country is only the seventh largest trading partner of the U.S. and exports to the UK last year were just over 0.3% of our gross domestic product. The decline in U.S. trade with China probably was more impactful in 2015 than any decline in exports to the UK in 2016 or 2017. From a macroeconomic perspective, this does not have the scope of the fallout from Lehman Brothers, which contributed to the financial crisis in 2008-2009. The major central banks have all pledged to provide cash to keep the banks liquid and safeguard financial security. As the political and macroeconomic uncertainty abates, market volatility will subside, and company-specific events will return to the forefront for investors.
- The passage of the Brexit referendum reflects the growth of populist sentiment in the UK and many other countries. Large voting blocks expressed unease with their job prospects and the influx of immigrants. Contributing to this viewpoint is that while the benefits of global trade have enhanced corporate profitability and produced lower consumer prices, the impact on traditional manufacturing jobs has been mixed. This same grass roots populism is also growing in the U.S., as evidenced by the success of the presidential primary campaigns of Bernie Sanders and Donald Trump.
- The political fallout from the Brexit vote has been swift, but the more significant risks for investors revolve around trade, sentiment, and credit. Weakness in the value of the pound will make imported goods more expensive in the UK. However, exports should become more price competitive. Volatility in the pound will also drive shifts in investor sentiment and possibly exacerbate problems in the UK economy. Lastly, strains in the credit markets would be a major negative, but there is little evidence of financial distress in the debt markets at this time.

Interest Rates Around The Globe

- One of the biggest surprises in the second quarter was the sharp drop in yields on U.S. government bonds. The benchmark ten year yield fell from 1.77% to 1.47%. While these yields might seem unattractive to domestic investors, about $12 trillion of government debt around the globe now trades at negative yields! Across major markets such as Germany, France, and Japan almost all bonds with maturities of ten years or less trade at negative yields. That means investors that hold the bonds to maturity will receive less cash between now and maturity than the current value of their bonds. In Switzerland, all government bonds trade at negative yields levels.



A Contrarian Indicator

- An old financial market adage is that the stock market will do whatever it takes to prove the most people wrong. The current environment has been full of worrisome issues for some time. However, offsetting policy shifts or changes in the underlying economy have tended to mute the stock market impact of many of those negative factors. One way to quantify the extent to which investors have already acted upon those worries is to monitor cash levels. High cash positions are a contrarian indicator and imply that investors with negative outlooks have already sold. Therefore, the next decision of those bearish investors will be when to redeploy the cash back into the market. While there are no foolproof indicators, it is interesting that a recent BofA Merrill Lynch survey of global fund managers found cash levels are higher than at anytime since November, 2001.

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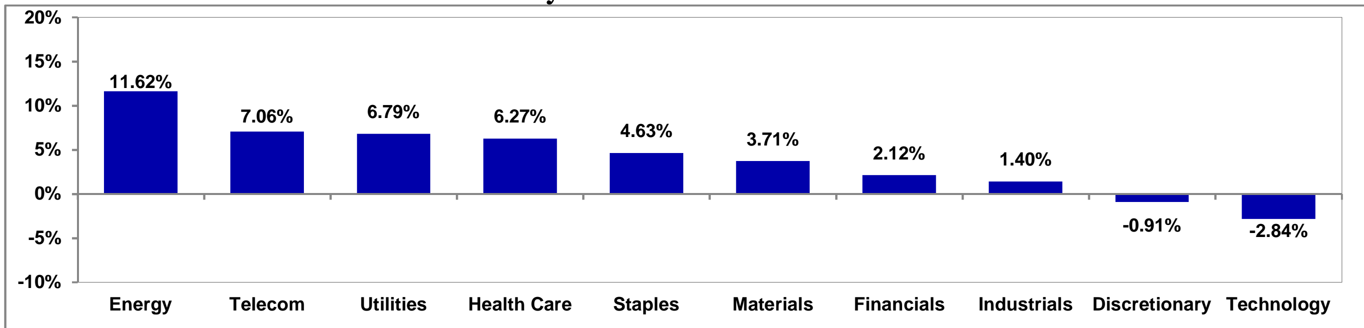
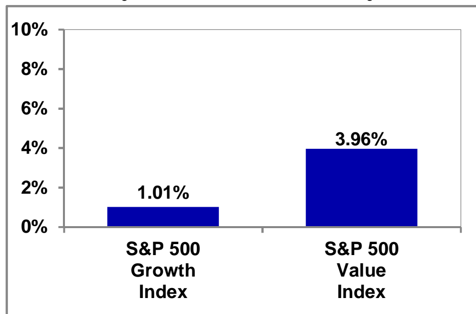
Second Quarter Investment Performance (including income)

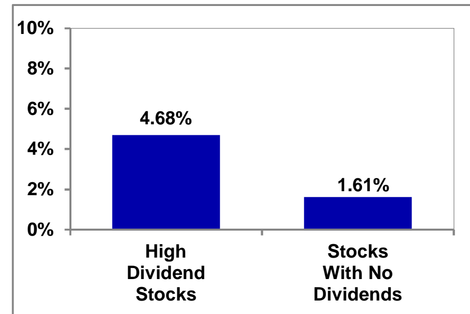
By Economic Sector



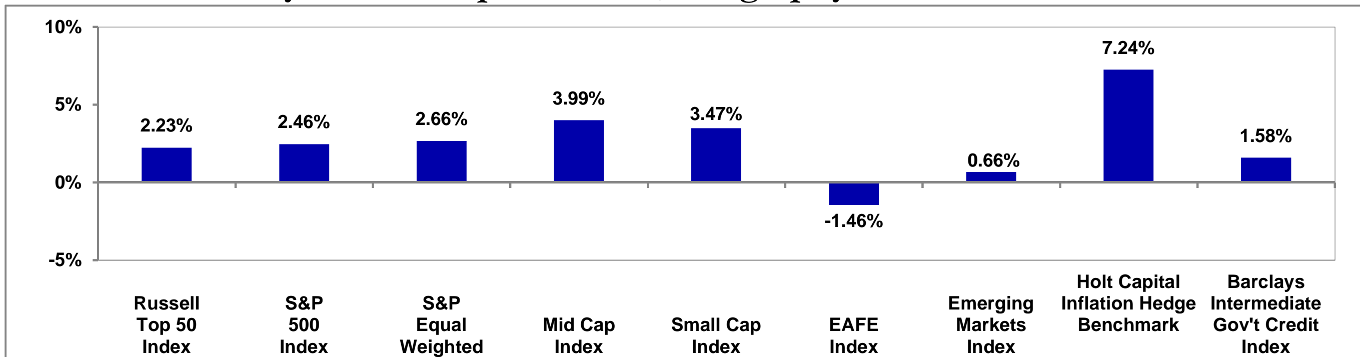
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- Crude oil and natural gas prices moved sharply higher during the second quarter. Those gains drove rallies in energy stocks, high yield bonds, and other inflation sensitive assets.
- Government bond prices rallied and that was bullish for the stocks of companies with above average dividend yields. At the sector level, strong performance was generated by telecom, utilities, and consumer staples, which are traditional sources of high dividend yields. Conversely, growth stocks often do not pay dividends and growth indexes are typically overweighted with consumer discretionary and technology stocks. As illustrated in the chart above, those factors all contributed to relatively weak performance for growth stock indexes during the quarter.
- Domestic equities continued to be perceived as a safe haven by global investors and outperformed international indexes during the quarter.

Conclusion

- The presidential election is a wildcard in the outlook. Each major candidate has negative ratings that are unprecedented, but the likelihood of political gridlock should minimize the implementation of extreme policies by either candidate.

- The Federal Reserve is in a difficult policy position and appears to be willing to delay future increases in short term interest rates. Monthly employment reports have been inconsistent with respect to new job creation, but the unemployment rate is very near the level that economists consider full employment. Tight labor markets typically produce wage inflation, which would suggest the need to push interest rates higher. Offsetting these domestic factors are deflationary headwinds from our global trading partners and negative interest rate policies by foreign central banks.

- Domestic equities continue to be the best house in a bad neighborhood. Economic stability and the return of year-over-year earnings growth should be supportive of stock prices. Yields on bonds remain unattractive on a historical basis.