Holt Capital Partners, L.P.

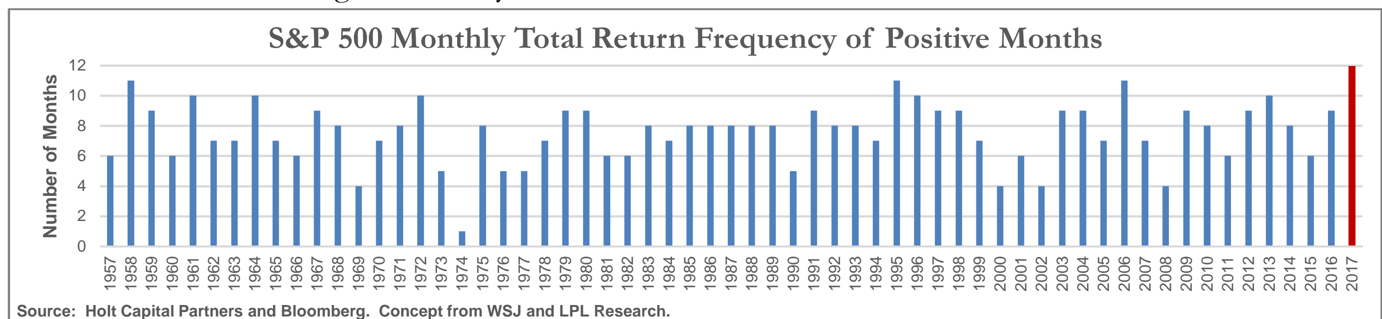
Fourth Quarter Financial Market Commentary

"Ninety Days in Ninety Seconds"

December 31, 2017

How Incredible Was The Stock Market in 2017?

- Amid widespread skepticism, 2017 was much more buoyant than most pundits had expected twelve months ago. In the end, fundamentals mattered more than sentiment and earnings growth exceeded expectations. In fact, earnings estimates for the S&P 500 rose throughout 2017, which is unusual. Estimates tend to start out optimistic and decline over the course of a typical year.
- In the last 50 years, the S&P 500 returned greater than 20% in a calendar year about one-third of the time. Most of the time, those big years were followed by another year of positive returns. The four years that were followed by declines were 1976, 1980, 1989, and 1999. All of these instances occurred as monetary policy was tightened into a rising market.
- 2017 was the ninth consecutive year with a positive total return for the S&P 500. This is not unusual given the severity of the bear market that accompanied the Global Financial Crisis. In fact, both the 1980's and the 1990's were characterized by long winning streaks by the S&P 500, which in both cases were arrested in part by tighter monetary policy.
- The low volatility of stock prices in 2017 has received a lot of press. To put it in perspective, the maximum intra-year decline in 2017 was about -3% while mid to high single digit "drawdowns" are more typical and greater than 10% intra-year declines occur more than half the time. Last year was the first time since the inception of the S&P 500 in 1957 that the total return was positive for all twelve months of a single calendar year.



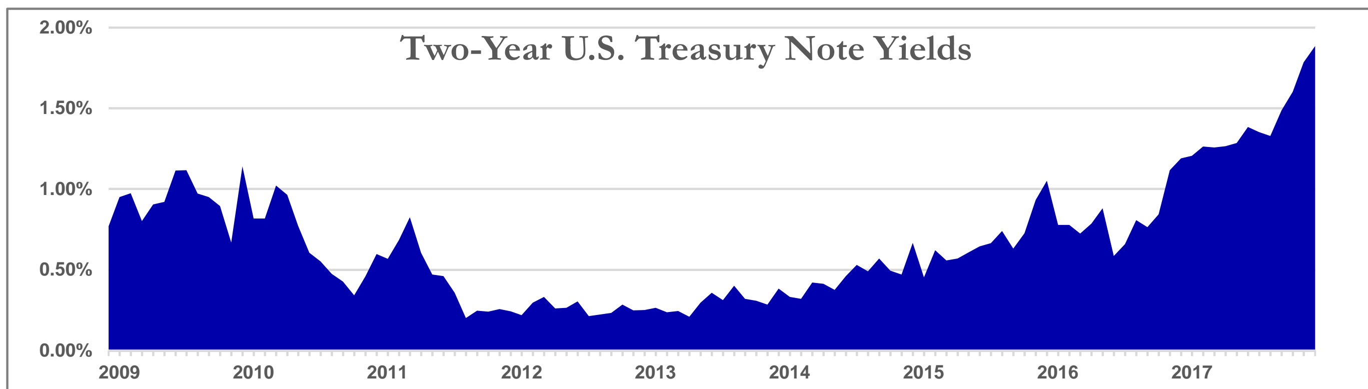
Source: Holt Capital Partners and Bloomberg. Concept from WSJ and LPL Research.

An Exceptional and Tumultuous Year In Politics

- Political partisanship reached new extremes and added to the frustration of both Republicans and Democrats. The result was a string of failed legislative efforts that hampered progress on the Trump Administration's first year agenda, with two exceptions.
- Passage of a major overhaul to the tax code late in the year was a significant, if partisan, legislative victory. On balance, it was a move in the right direction with lower marginal rates and a reduction in itemized deductions in exchange for a higher standard deduction. Unfortunately, this bill did not achieve the oft-stated goal of tax simplification that would lead to the most economically impactful re-ordering of incentives. Lower corporate tax rates will result in modestly higher earnings for many companies.
- Much less discussed, but very meaningful for economic growth, has been the roll back of a broad range of regulations. This may be the single most important factor driving the renewed corporate confidence that has spurred growth in capital investment. In our discussions with management teams, the stifling impact of increased regulation had been a recurring theme for several years.

The Federal Reserve And Interest Rates

- Fed Chairman Yellen's four-year term expires in February and Jerome "Jay" Powell has been appointed as her replacement. She has overseen an economic expansion that is now in its ninth year, with unemployment at a sixteen-year low. Powell is viewed as a pragmatic policy maker that will bring continuity to monetary policy. As the Federal Reserve continues its transition to a more normal monetary policy, stability in leadership will be critical for the financial markets.
- Interest rates on intermediate and long-term bonds have remained surprisingly low and stable. This is partly attributable to subbornly low inflation rates that Chairman Yellen has referred to as "a bit of a mystery". It is also a function of central bank easing around the world. Foreign investors continue to view U.S. government bonds favorably, since a yield of 2.48% looks attractive compared to German ten-year yields of 0.42% and yields of 0.04% in Japan.
- While many investors focus on ten-year bond yields as a benchmark, especially for mortgage lending, the impact of Fed policy is much more tightly linked with two year note yields. Given pervasive headlines that describe interest rates as low, most investors would likely be surprised to find that two-year yields of about 1.9% are at their highest level in nine years! In the current environment, this maturity provides a reasonable yield without assuming much price risk.



Economic Growth and Monetary Policy

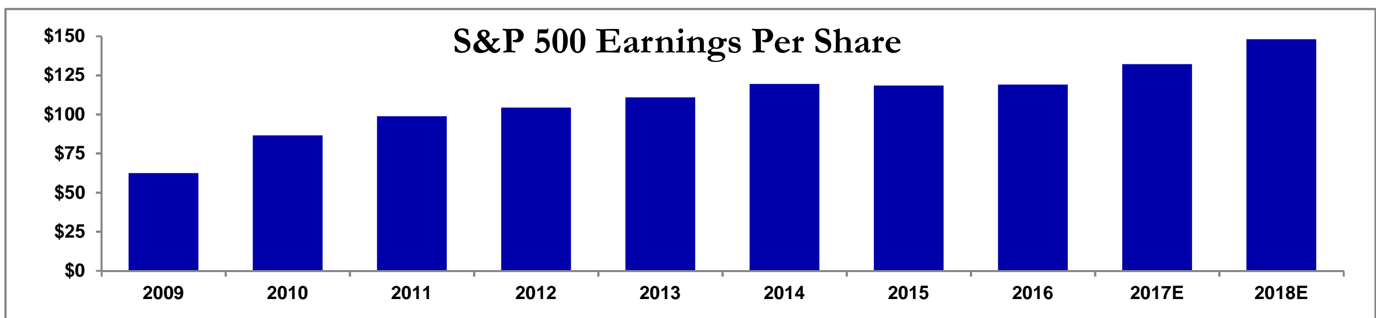
- For the first time in almost a decade, investors are entering the new year with synchronized global growth. This is evidence that the hangover of the Global Financial Crisis has been shaken off.
- We believe 2018 will be defined by the interaction of economic growth and the tightening of monetary policy. The Federal Reserve started raising rates in late 2016, a so-called "normalization" from the extreme measures taken following the Global Financial Crisis, and is expected to hike rates three more times in 2018.
- Monetary policy and expectations for economic growth are locked in a complex feedback loop. The early pick-up in growth is very positive for markets as it feeds earnings growth without worrying the Fed. As the economy heats up, the Fed (and other central banks around the world) become more vigilant about inflation, which itself slows economic activity.
- For the first time since the Global Financial Crisis, the "output gap" is positive with GDP growth exceeding our economy's long-term potential. That is also true for many countries around the world. Potential GDP is notoriously difficult to measure and subject to much debate, but suggests the markets will be keeping close tabs on central banks in 2018.

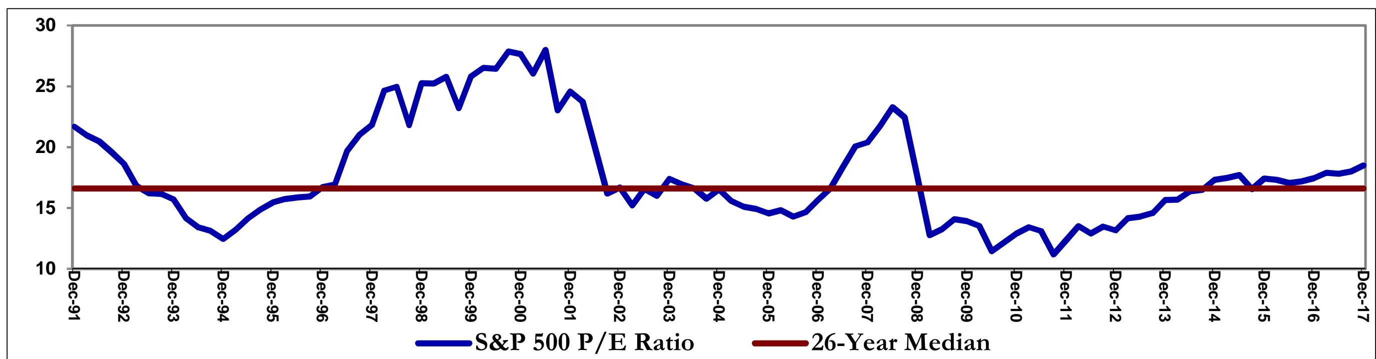
Economic Growth and Monetary Policy (continued)

- The tempo of this monetary dance seems just right, strong growth with a measured Fed response, which supports moderately above average equity valuations.

Fundamentals, Valuation, and Sentiment

- Earnings grew about 11% in 2017 and are expected to grow another 12% in 2018. However, stock prices rose 15% - 20%, depending upon the index, which means that stocks are more highly valued today than was the case twelve months ago. Valuations, as measured by price-to-earnings ratios are currently above their 26-year median, but are consistent with historical periods of low inflation. Valuation is a poor market timing tool but is the single best predictor of long-term returns, which are now below average but in our view remain far superior to other alternatives.





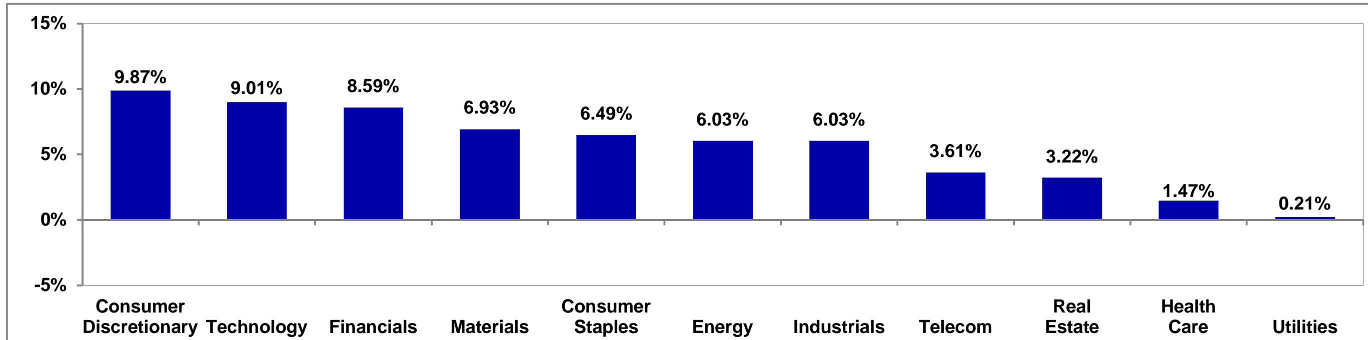
- A full stock market cycle is often described as beginning with despair and passing through relief, hope, optimism, and exhilaration. Market tops are usually a period of euphoria. The 2008-2009 financial crisis certainly epitomized despair. The irony is that in February 2009, our firm's valuation studies indicated that 84% of all large cap stocks were being valued in the bottom decile of their fifteen-year valuation band. Cheap stocks were plentiful, but the environment was scary. Likewise, the dot-com bubble in 1999 was certainly euphoric, with traditional measures of value discarded by internet investors.

Conclusion

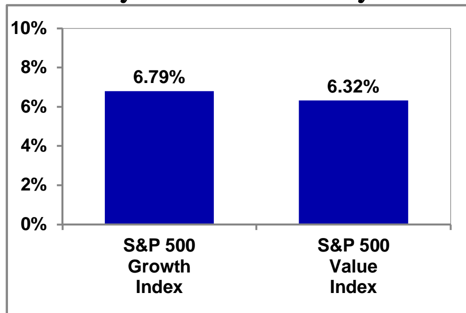
- Optimism returned to the economy and the stock market in 2017. Accelerating global growth coupled with supportive tax and regulatory policy provide a tailwind for 2018. Valuation is above average but not excessive and credit conditions are benign. Barring some unforeseen shock, the pace of monetary tightening will be the deciding factor for the financial markets in the new year, as well as into 2019.

Fourth Quarter Investment Performance (including income)

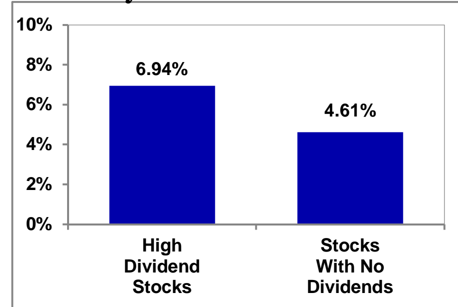
By Economic Sector



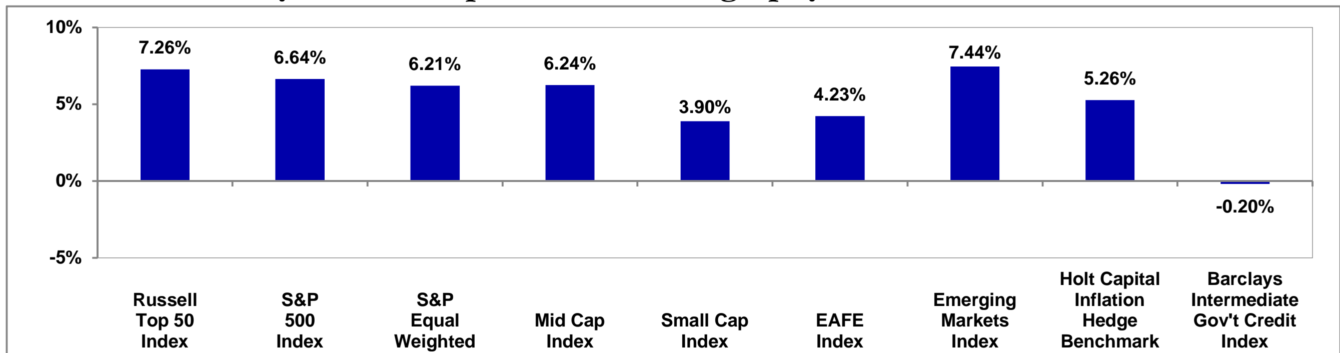
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- All eleven economic sectors generated positive total returns during the fourth quarter. Consumer discretionary stocks outperformed technology as the "death-by-Amazon" trade reversed and retailers rallied.
- Interest rate sensitive sectors, such as telecom, real estate, and utilities lagged, which is consistent with the slight decline in the Barclays Bond Index. Likewise, financial stocks, which are viewed as beneficiaries of higher interest rates, rallied during the quarter.

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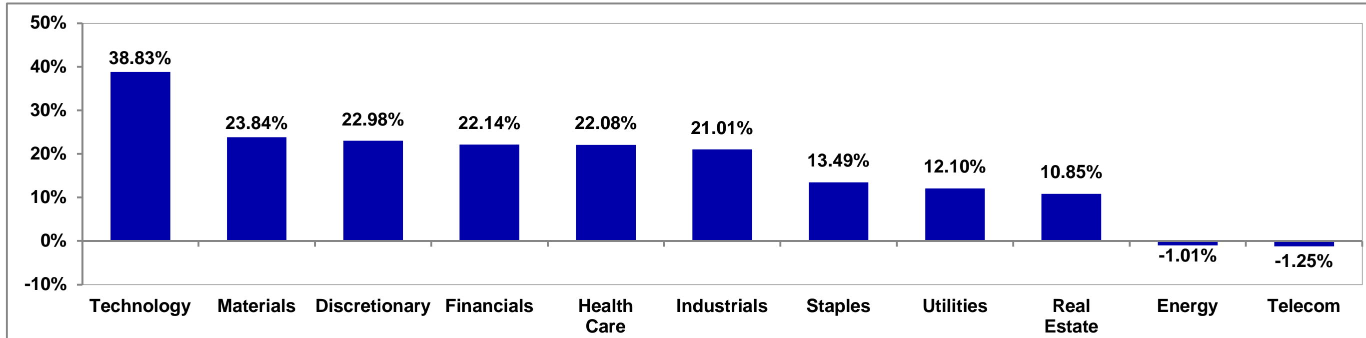
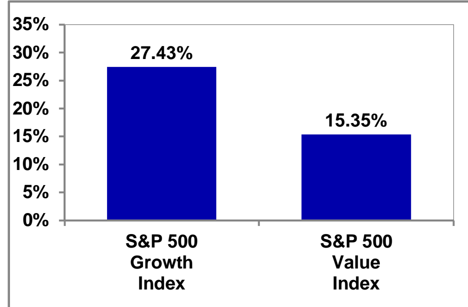
2017 Investment Performance (including income)

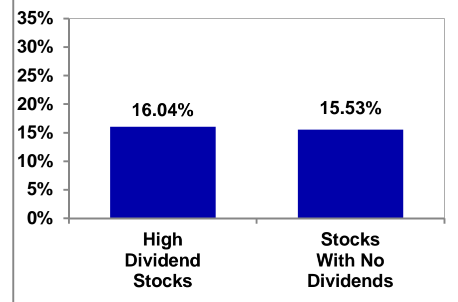
By Economic Sector



By Investment Style



By Dividend Yield



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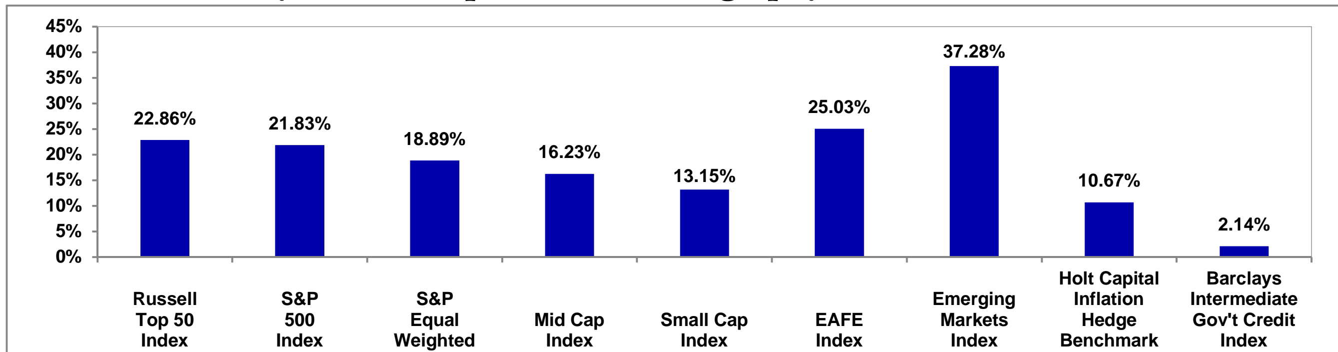

- It was a big year for growth stocks, as the technology sector dramatically outperformed and terms like FAANG (Facebook, Apple, Amazon, Netflix and Google) moved from the lexicon of investors to the mainstream media.
- Traditional dividend payers in sectors like consumer staples, utilities, and telecom tended to lag sectors that have more economic sensitivity.
- After almost a decade of poor performance, foreign stock markets posted big gains that were driven by improving fundamentals and low valuations.
- The bond market eked out a modest return again this year. While short and intermediate term bonds remain our preferred asset class for portfolio diversification and stability, modest positive returns represent a best-case scenario for the next several years.