Holt Capital
Partners, L.P.

Third Quarter Financial Market Commentary

"Ninety Days in Ninety Seconds"

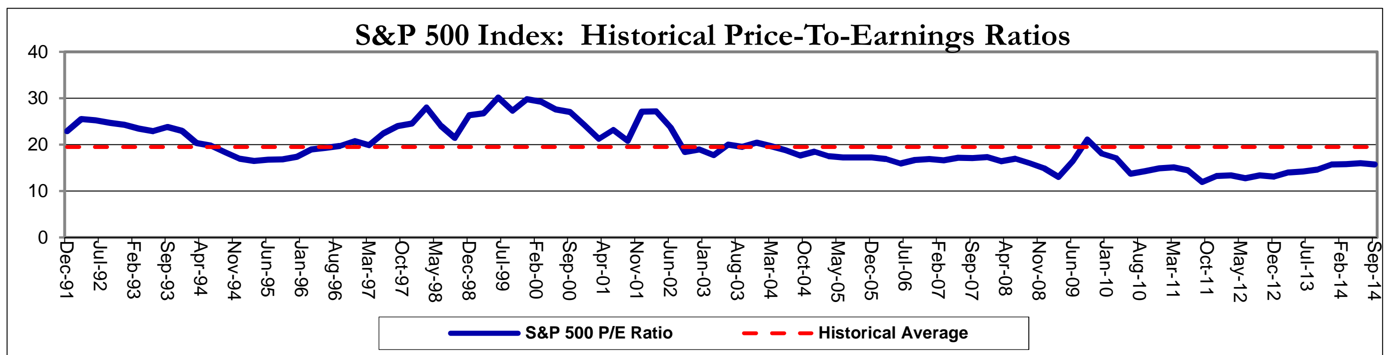
September 30, 2014

The Best House in the Global Neighborhood

- As the global economy attempted to rebound from the 2008-2009 financial crisis, the recovery was uneven and often characterized by policy missteps and debt market meltdowns. During this period, the U.S. equity market was frequently referred to as "the best house in a bad neighborhood". I think that it is time to simply declare the domestic economy and our equity market as the best house in the global neighborhood. New job creation has accelerated, real estate markets have recovered and corporate profits continue to grow. The balance sheets at the biggest U.S. companies are healthier than they have been in decades. In contrast to our federal government finances, companies in the S&P 500 Index have the lowest net debt to earnings ratio since 1990. U.S. companies are benefiting from the tailwind of a strengthening domestic economic recovery, in contrast to sluggish growth in Europe and parts of Asia.

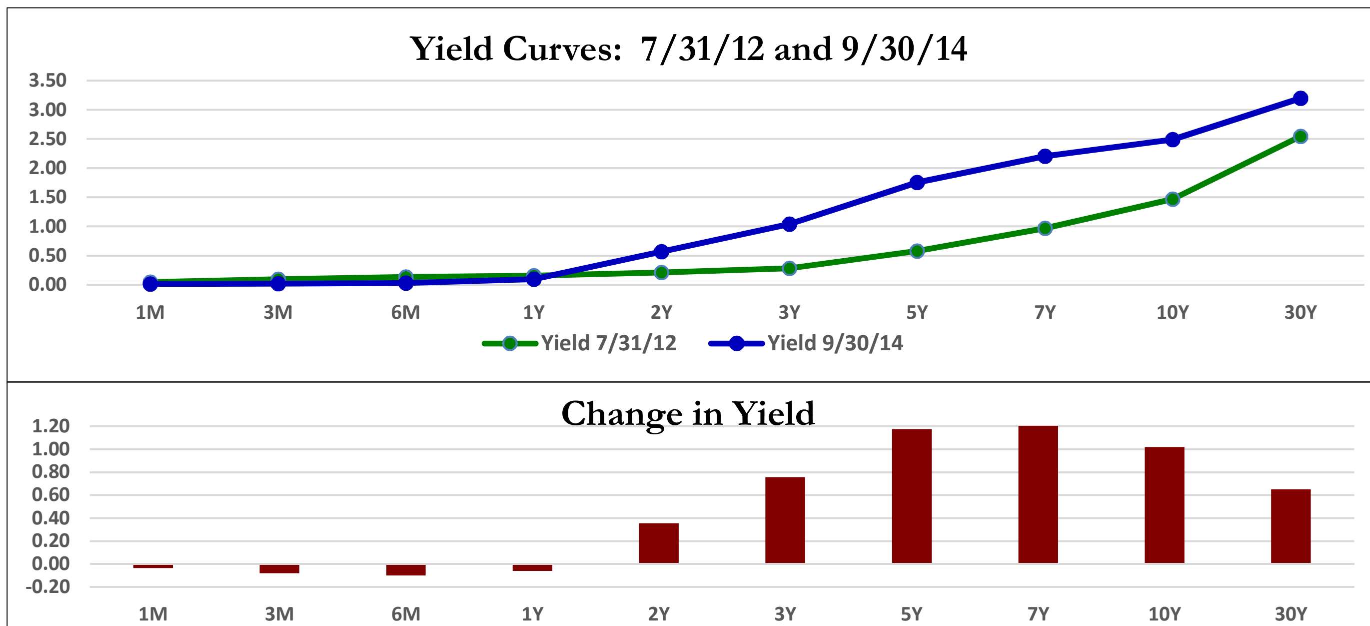
Are Stocks Expensive?

- Conflicting statements from various "experts" seem to dominate most media discussions of the stock market's current valuation level. The graph below plots the price-to-earnings ratio for the S&P 500 Index since 1991. This diverse period begins with Hilary Clinton's early attempts at health care reform, and includes the tech boom and bust, the 9/11 attacks and the financial crisis. Valuations ranged from 30x at the peak to 13x at the bottom in March 2009. The average P/E ratio over this period of almost two and one half decades has been 19.5x. The S&P 500 currently trades at 16.5x estimated earnings for 2014. As the calendar year moves rapidly to a close, investors will begin to focus on expectations for higher earnings in 2015, which will reduce the index's P/E multiple to 14.8x. Both of these figures support our view that stocks continue to be reasonably valued at current levels.



Interest Rates and Federal Reserve Policy

- All eyes are on the Federal Reserve and the potential for a shift in the interest rate policy. When has this statement not been true? The prospect of rising interest rates has been anticipated by bond market investors for several quarters, if not several years. The graph below plots the level of yields on U.S. Treasury bonds beginning with data from July 31, 2012.



- The line graph represents the so-called yield curve on 7/31/12 and 9/30/14. The Federal Reserve has succeeded in holding short term rates near zero, but as the bar graph indicates, over the past two years investors have quietly pushed yields higher on securities ranging from two year notes to thirty year bonds. The yield on five year notes has more than tripled over this time period from about 0.50% to 1.75% at quarter end.

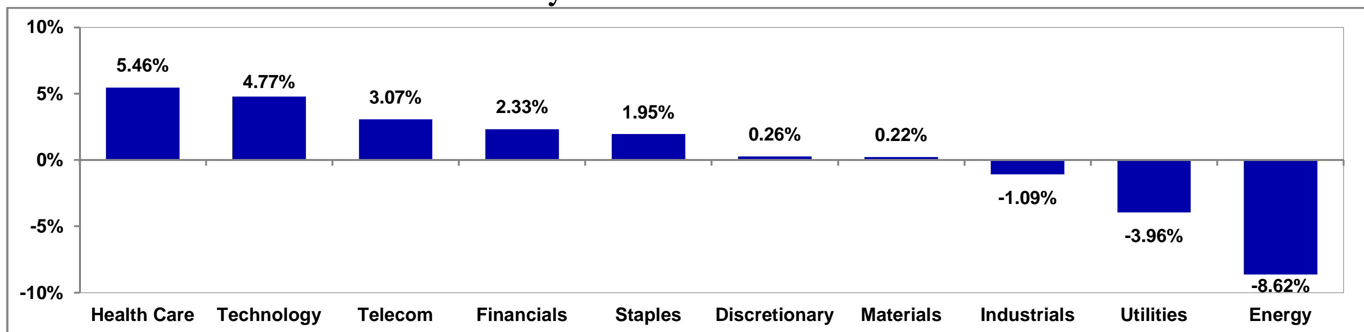
Crude Oil and Energy Stocks

- The crude oil market is being impacted by the combination of an abundance of supply and some softening in demand from Europe and China. Domestic production growth continued to accelerate from newer fields in the Bakken and the Eagle Ford shales, as well as a technology-driven renaissance in the Permian Basin. In this environment of abundant supply, crude oil fell 13% during the third quarter and natural gas prices also fell 8%.

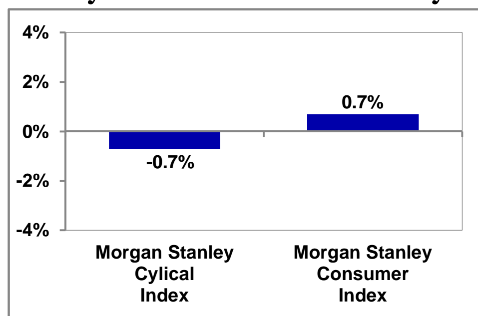
- Energy stocks struggled against the headwinds of falling commodity prices. Valuations of premier exploration & production companies with strong production growth metrics have fallen back to levels not seen since the market trough in 2009 and are priced attractively for long term investors.

Third Quarter Investment Performance (including income)

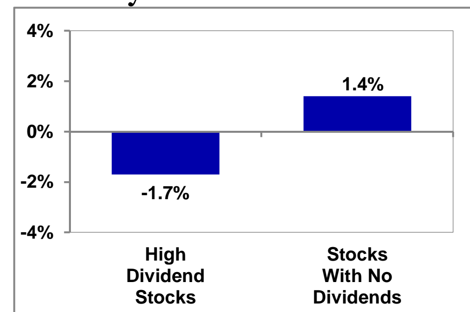
By Economic Sector



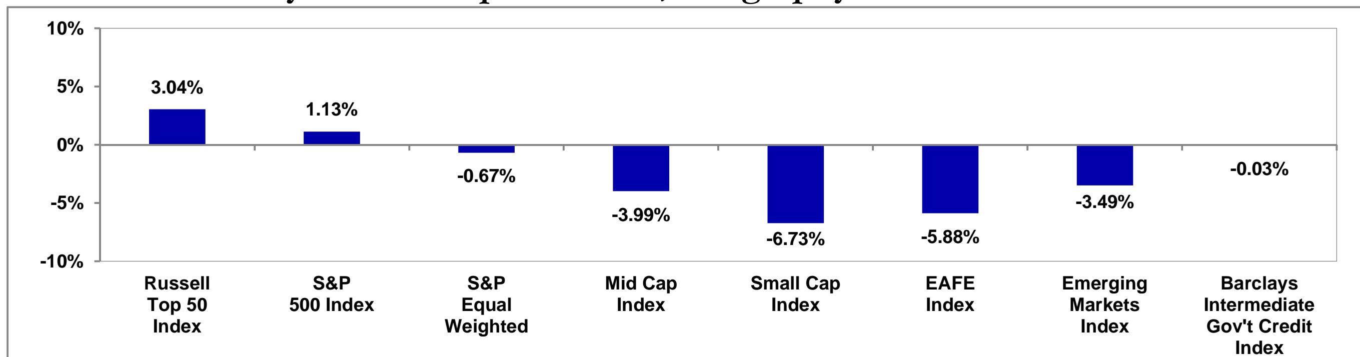
By Economic Sensitivity



By Dividend Yield



By Market Capitalization, Geography and Asset Class



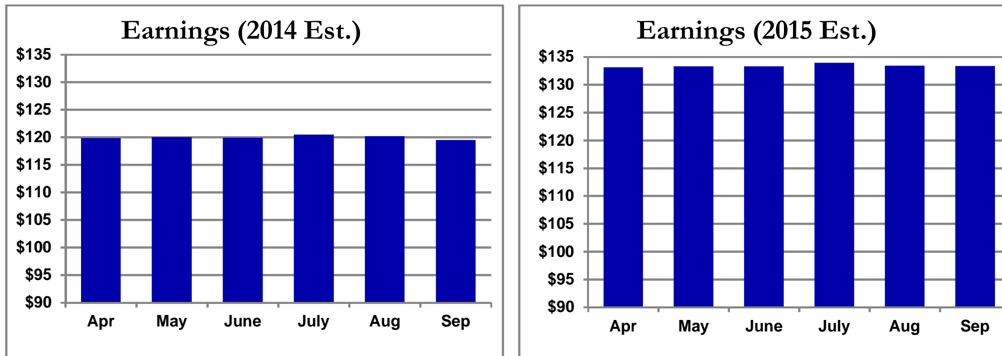
- The lack of commonality among numerous different categories of stocks made the third quarter an unusual period in the stock market. Defensive economic sectors, such as health care, telecommunications and utilities could be found at both ends of the performance spectrum. The same mixed relationship was true for the more economically sensitive sectors, such as technology, industrials and energy.

- It was also an atypical quarter from a market capitalization perspective. Usually during a period of good economic and corporate profit data, investors move down the spectrum of company size and aggressively buy lesser known companies with good fundamental stories. Conversely, shares of the biggest companies usually perform relatively well during periods of uncertainty when investors are seeking a safe harbor. These trends reversed during the third quarter, as the mega cap stocks in the Russell Top 50 significantly outperformed all other size and geographic categories.

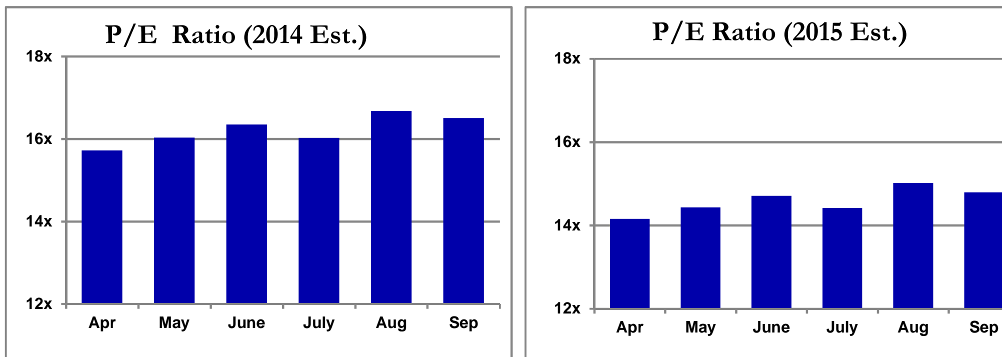
EARNINGS AND VALUATIONS

- Earnings estimates were largely unchanged for the second quarter in a row. Those estimates continue to imply an 8% growth rate for 2014 and 11% higher earnings in 2015. As discussed earlier, valuations are below the long term average with price-to-earnings ratios of 16.5x this year's earnings estimate and 14.8 next year's forecast.

S&P 500 Earnings Estimates



S&P 500 P/E Ratios



CONCLUSION

- The Federal Reserve is moving closer to ending its six year period of stimulative economic policies. The recently released payroll data for September provided additional data to support the hawkish view that the economy has strengthened and that stimulus policies are no longer needed. The eventual change in Fed policy has been well telegraphed to the financial markets, which should allow the stock market to avoid a major decline related to future Fed actions.

- Short term volatility is always a risk in the stock market and that was evident in the nearly ten percent decline that small cap stocks experienced during the past three months. Concerns over sluggish growth in Europe and Japan are also ongoing risks to global stock markets. In contrast, domestic corporate balance sheets and earnings are definite sources of strength, and an acceleration in economic growth should help drive incremental revenues for most companies. Importantly, valuations remain below average. This combination of factors should minimize near term downside risk and allow stock prices to continue to advance over time.