Holt Capital
Partners, L.P.

Third Quarter Financial Market Commentary

"Ninety Days in Ninety Seconds"

September 30, 2017

Goldilocks Economy

- The global economy is enjoying synchronized growth while inflation and interest rates remain low. In other words, not too hot, not too cold. This environment is contributing to record corporate profits. The combination is potent and is the best explanation for the surging stock markets, both in the U.S. and around the world.
- The endemic caution of both consumers and businesses since the Global Financial Crisis seems to have faded, which bodes well for the economic outlook. Nominal GDP in the US is now expected to exceed 4% in 2018.
- Both orders and shipments of capital goods are in an uptrend, with equipment spending tracking above 9% annualized growth in the 3Q. The rise in economic growth and profits that we wrote about last year in our third quarter market commentary may be reviving business investment after a long period of lackluster capital spending. The weak dollar coupled with improving overseas economies provides opportunity for a positive surprise in export growth.
- Consumer confidence and spending growth are both positive, likely a response to an upbeat labor market. However, residential housing, which had experienced a large post-crisis recovery, has recently hit a soft spot.

The Parable of the Punchbowl

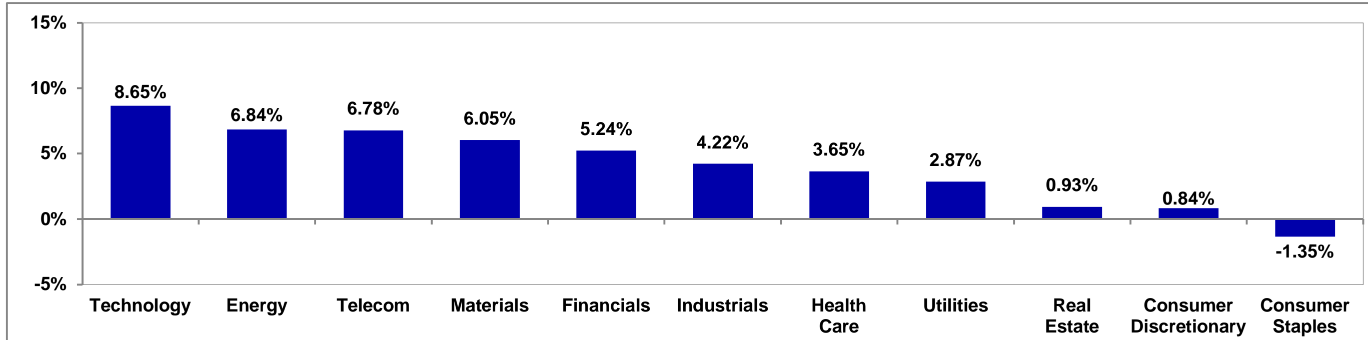
- In October of 1955, speaking to a ballroom of investment bankers at the Waldorf Astoria hotel, then Fed Chairman William McChesney Martin explained monetary policy as "the chaperone who has ordered the punch bowl removed just when the party was really warming up."
- The Federal Reserve is entrusted by Congress to manage the money supply, ensuring that money is sufficiently available to support economic growth, but not so excessive as to stoke inflation ("easy money") or so deficient as to contribute to deflation and recession ("tight money"). Monetary policy is conceptually difficult and we most often think about it in terms of the Fed lowering or raising interest rates.
- The Financial Crisis led to an unprecedented increase in monetary accommodation that has been maintained for almost a decade. The Fed has begun to remove money from the economy and recently ended a bond buying program that has been a key policy tool. The normalization of monetary policy will include another interest rate hike in December, with several more increases currently expected next year.
- The degree to which the Fed "tightens" is probably the pivotal issue for economic growth and financial asset returns over the next year. We will be watching the impact of interest rate increases on long-term bond yields, credit spreads, and the growth rate of bank lending. Additionally, the ideological leanings of upcoming appointments to the Federal Reserve Board of Governors are likely to be telling, especially for the nominee to be the new Fed Chairman.
- The Martin quote is especially relevant today because it reminds us that any short-term impact from normalizing monetary policy constitutes the necessary prudence that is at the foundation of our free enterprise system.

THERE WILL BE ANOTHER BEAR MARKET

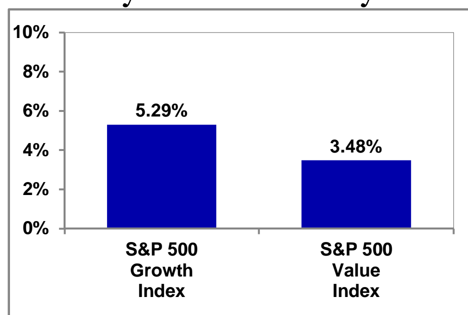
- It is true, there is another bear market in our future. The other truism is that with the exception of pure luck, no one can predict when it will occur. Enormous energy is spent trying to time bear markets. This is often perilous for investors, as the fear that encourages the selling of stocks is the same emotion that prevents buying after a market decline. Both decisions must be correct to prevail.
- Based upon history, there are warning signs that we can observe and evaluate. Bear markets usually are accompanied by recessions, an inverted yield curve (short term interest rates higher than long term rates), or an unexpected economic shock. With the exception of an unthinkable conflict with North Korea, none of these precursors are currently on the horizon.
- History can also be a guide to the potential severity of a bear market. The best indicator for the risk of a severe bear market is extremes in valuation. This was clearly the case when the dot.com bubble burst. High valuations for technology stocks caused a severe 82% drop in the NASDAQ market by 2002.
- Rather than pursuing the folly of market timing, our primary focus is on valuation. Current valuation metrics are less than one standard deviation above 25-year averages, which is a level that we believe continues to offer long-term average annual return potential in the mid to high single digits. Second, long-term compounding overcomes the rough patches. As an example, if one had invested in the S&P 500 at the absolute pre-crisis peak, it would have nonetheless generated an impressive total return of +101%.
- The lack of price volatility and the stock market's nearly unrelenting march higher may have lulled some investors into a false sense of security. We remain vigilant and focused on the early warning signs of any potential meaningful decline. At this time we remain comfortable that well constructed portfolios offer a solid balance between risk and return.

Third Quarter Investment Performance (including income)

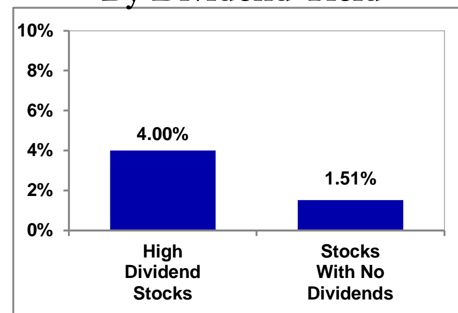
By Economic Sector



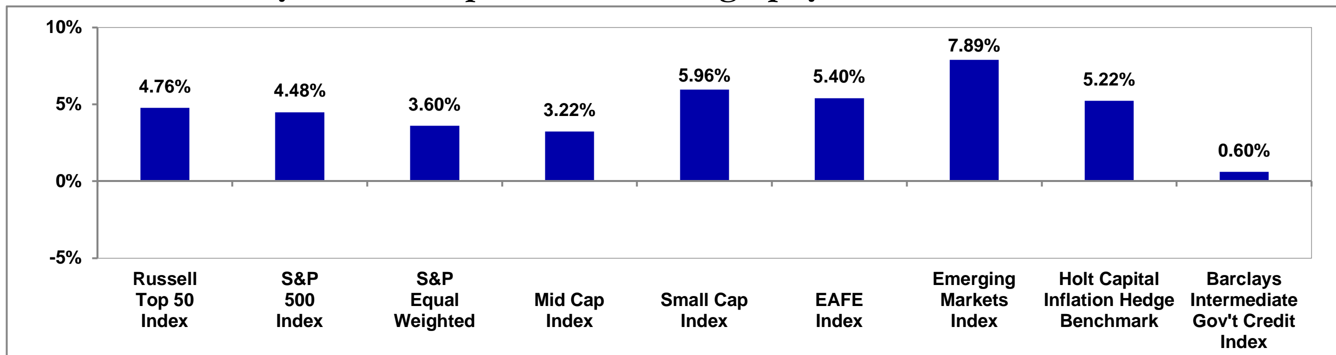
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- Stock market performance during the first two months of the quarter continued to be dominated by technology stocks, especially FAANG (Facebook, Amazon, Apple, Netflix and Google). However, energy, telecom, financials, and other classic value stocks roared back to life during September.
- Stocks with above average dividend yields and above average dividend growth also performed well during the quarter. Dividends remain an important component of total return and represent an income source that can meaningfully enhance purchasing power over time. Companies in the S&P 500 are on track to raise dividends by 8% this year, up from a 5% growth rate last year.
- Smaller companies tend to operate with more of a domestic focus than their larger peers. Therefore, renewed talk of tax cuts contributed to a surge in small cap stocks during September.
- International stocks continued their year-to-date rebound, after several years of underperformance compared to domestic equities. Valuations remain lower for most foreign markets.