Holt Capital
Partners, L.P.

Third Quarter Financial Market Commentary

"Ninety Days in Ninety Seconds"

September 30, 2018

Big Headline Numbers

- U.S. stocks had an excellent quarter. The most widely quoted U.S. stock market index, the S&P 500, returned 7.7%. That is the best quarter since 2013 and exceeds the entire year prediction of many pundits as we entered 2018. Using statistics to put the quarter into historical context, the return was not quite one standard deviation above the average quarterly return using data since 1960. So, while the quarterly return is pleasing, especially in the context of the low expectations entering the year, it was not an extreme event.

- The economy is booming. Second quarter real GDP (released in the third quarter) exceeded 4%, making it one of the best performing quarters of the expansion thus far. The unemployment rate is a low 3.9% and the less-watched underemployment rate is back to the low levels of the late 1990s; initial jobless claims are at the lowest level since 1969. Despite a near-record 111 months of expansion, notable indicators that we watch closely have a mid cycle rather than late cycle character. For instance, the Index of Leading Economic Indicators is solidly positive, Consumer Confidence appears unsustainably high but has yet to roll over as is typical ahead of pending recession, and the ISM Purchasing Managers Index continues to suggest brisk business conditions.

Notable Divergences and Extremes

- While stock market returns and economic data appear to reflect a genuinely robust environment, we are all programmed to feel good about "confirming" data points. So, it is useful to look for facts that stand opposed to the prevailing sentiment.

- U.S. stock market gains in the quarter were more inclusive than earlier in the year. Through the first half of 2018, seven stocks, all technology related, accounted for the entire S&P 500 gain. The return from all of the other stocks in the index netted out to zero! The same measure broadened out to 64 stocks in the third quarter and included contributions from healthcare and industrial companies among others. But, stock market leadership remains historically narrow. Growth stocks, driven by large technology companies have outperformed by a significant margin, as we also noted in our second quarter market commentary. Small stocks, despite performing well in absolute terms, failed to confirm the recent new S&P 500 high, which some view as a "canary in the coal mine" sign of a market top. There are also more stocks making new 52-week lows than highs on the NYSE. Ultimately, a bull market requires broad participation for sustenance.

- U.S. stocks have outpaced international stocks, also by a historic margin. There are good reasons for this, including stronger growth and rising interest rates versus much of the world, country specific problems in several emerging markets, and trade tensions. But, the U.S. and global economies are integrated, so the degree to which they can diverge is ultimately limited. The graph on the following page illustrates the divergence between the MSCI All Country ex U.S. Index and the S&P 500.

Notable Divergences and Extremes (continued)

- On the economic front, we can't ignore the reality that, at some point, good becomes too good. The economy is likely growing above "sustainable" GDP and unemployment is now below the natural rate of unemployment. Both measures indicate unsustainable economic momentum.

Watch the Fed

- As the quarter came to a close, the Federal Open Market Committee raised the policy Fed Funds rate for the third time this year to an upper bound of 2.25%. Members of the committee signaled an increase in December with several more increases expected in 2019. However, market-based measures of expected future rate increases have begun to anticipate the end of tightening.

- In a symbolic but important step, the FOMC eliminated the phrase "monetary policy remains accommodative" from the post meeting statement. The implication is that interest rates are closer to the so-called "neutral" rate that is neither accommodative nor restrictive to economic growth.

- Fed Chairman Powell gave an important speech in Boston recently regarding his belief that accelerating wage growth need not trigger inflation. His remarks signaled policy flexibility around the econometric relationship between labor market tightness and inflation referred to as the Phillips curve and advanced by Milton Freidman in the 1960's and 1970's.

- The Fed's deftness in normalizing post financial crisis interest rates without triggering a downturn is an important consideration for economic and financial market performance into 2019.

Indexology

- A significant change in the composition of the eleven economic sectors was implemented by Standard & Poor's at the end of the third quarter. The telecommunications sector was renamed communication services and broadened to include companies previously classified as consumer discretionary and technology. The telecommunications sector was at one time a robust group of the "Baby Bells" and a number of independent telephone companies. However, it is currently only comprised of three companies, AT&T, Verizon, and CenturyLink. As the way people communicate has evolved, telecom, media and the internet have all begun to converge. The new communications services sector will be comprised of 26 companies. In addition to AT&T and Verizon, some of the bigger companies in the new sector will be Alphabet (formerly known as Google), Facebook, Comcast, Disney, and Netflix. As illustrated by our recurring presentation of sector returns each quarter, we view analyzing sector trends as important and the broader composition of this new sector should provide greater insights into the performance and valuation of companies in this area of the stock market.

Conclusion

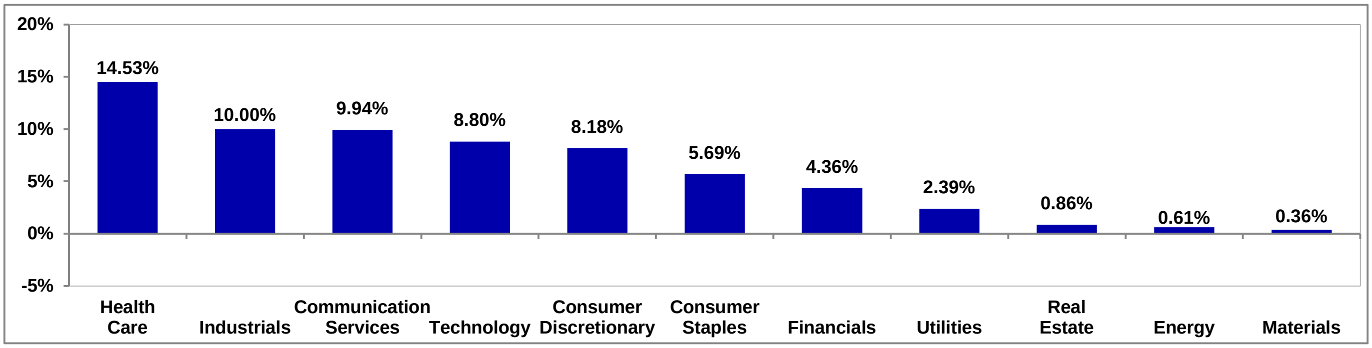
- While economic underpinnings appear strong, over the next few quarters we will anniversary the boost from tax cuts, fiscal stimulus, and defensive buying ahead of tariffs. The result will be slowing momentum in economic growth and corporate earnings.

- Actions by the Fed are critical at this stage but, thus far, seem well calibrated to extend the cycle. The 10-year U.S. Treasury yield is now above 3%, which is consistent with the strong economy. Periodically, markets will reflect concerns about rising rates, but re-normalization is ultimately necessary for long-term financial market functioning.

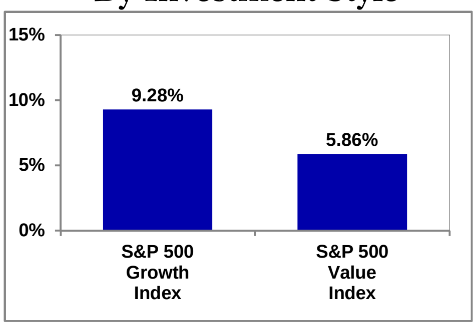
- We expect short-term market volatility to increase across asset classes. The S&P 500 P/E is about 17x, which is slightly above the historical median and consistent with expectations for mid to high single digit long-term returns.

Third Quarter Investment Performance (including income)

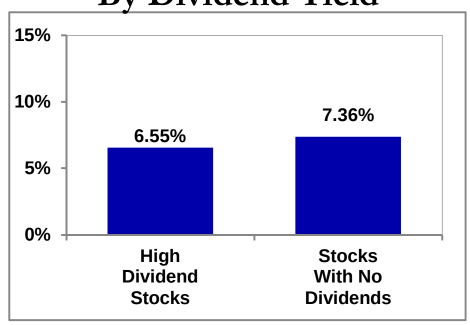
By Economic Sector



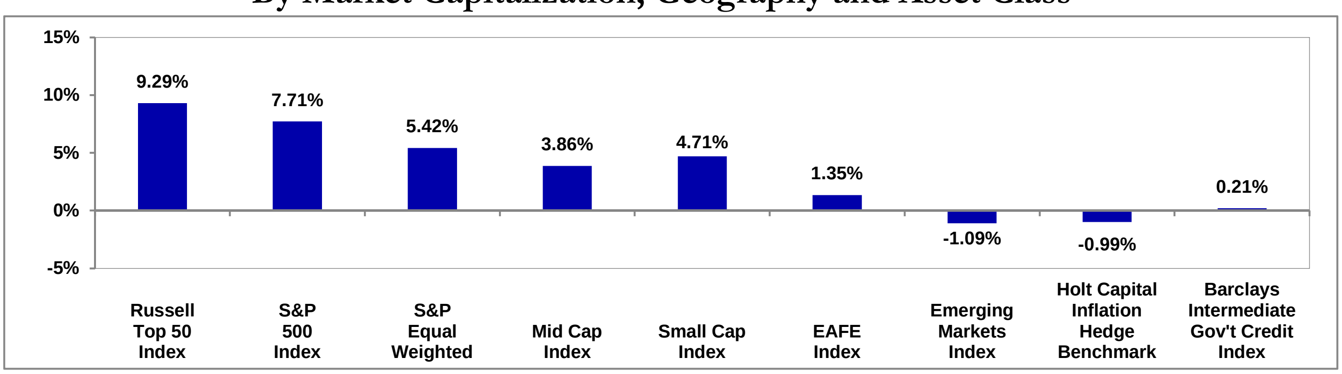
By Investment Style



By Dividend Yield



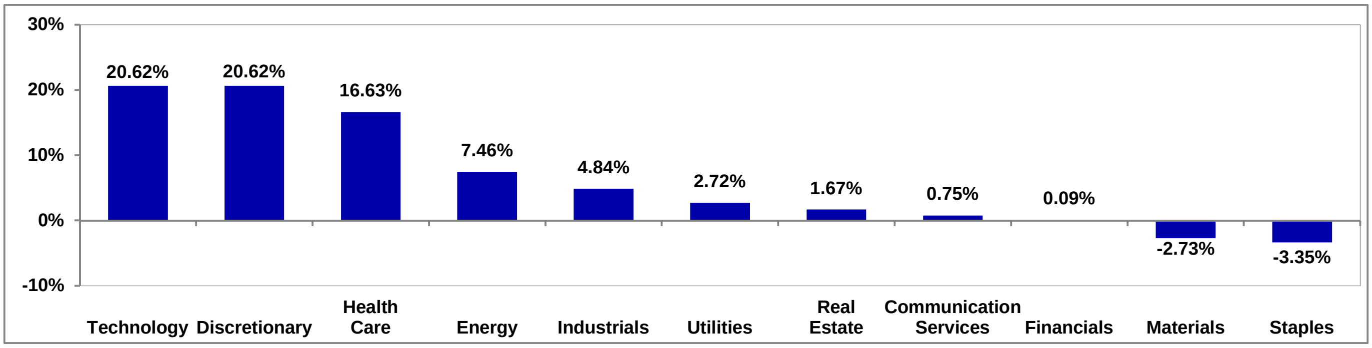
By Market Capitalization, Geography and Asset Class



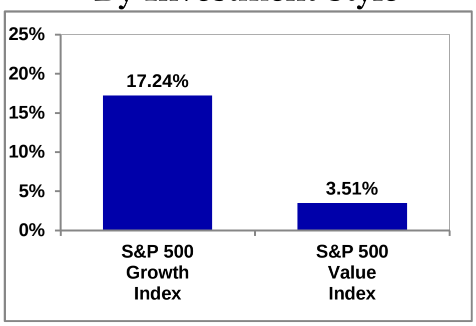
- After posting lackluster performance in the first half, the health care sector roared in the third quarter as investors broadened their search for earnings growth.
- During stock market rallies, smaller stocks typically outperform their larger peers. The strength of the mega-cap stocks in the third quarter defied this historical relationship.
- Correlations among interest-sensitive sectors were atypical during the quarter. Financial stocks usually outperform utilities and real estate when interest rates rise. However, performance was broadly similar and all three underperformed the S&P 500. Likewise, cyclical sectors such as materials and industrials typically move together. This quarter, they were at opposite ends of the performance spectrum.

Year-to-Date Investment Performance (including income)

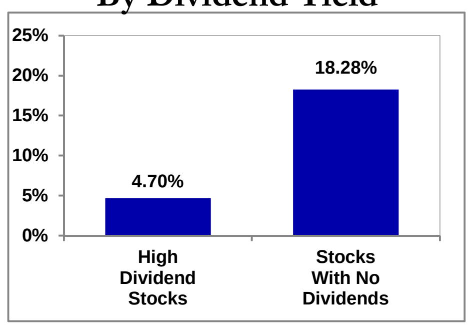
By Economic Sector



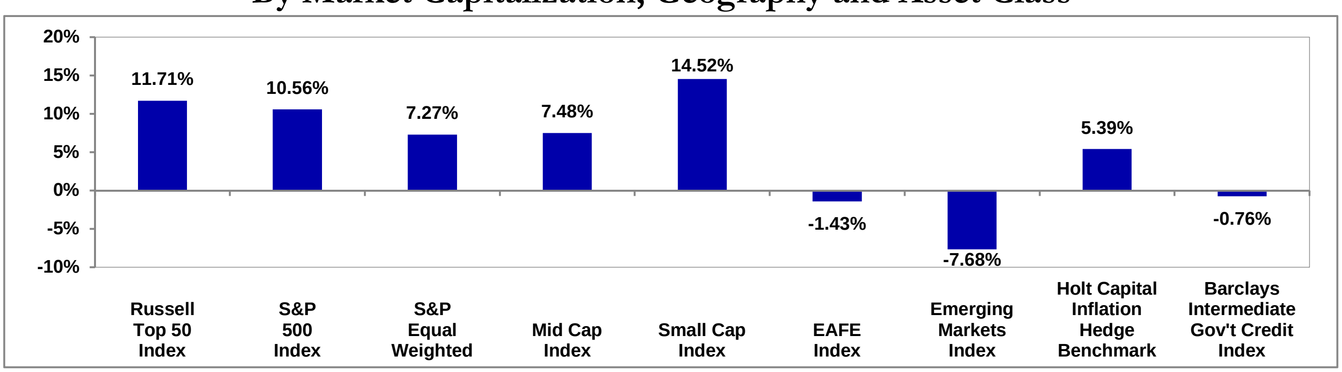
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- Stock market leadership has been relatively narrow this year and has been concentrated in shares of mega-cap growth companies.
- At the sector level, only three sectors outperformed the S&P 500 Index, while eight sectors underperformed.
- The dominance of growth stocks can be seen in the top chart, which provides sector returns, as well as in the style, dividend yield, and market capitalization charts. Slowing growth in many overseas economies contributed to the wide differential in performance between domestic and international equities.