Holt Capital Partners, L.P.

Fourth Quarter Financial Market Commentary

"Ninety Days in Ninety Seconds"

December 31, 2018

2018 - In With A Bang, Out With A Whimper

- It is the time of year for looking both backwards and forwards. Backwards first. The stock market rang in 2018 with a strong January, which often augers for an up year. But stocks finished with a terrible December, pushing the year into negative territory for the S&P 500.
- In a year of almost frantic news, a few themes strike us as the most important. The synchronized global economic growth that prevailed as we entered 2018 gave way as international economies slowed because of both local issues and a stifling of cross border activity from trade tensions and Brexit. Despite that, U.S. economic strength persisted as deregulation proved to be a meaningful positive for business investment, spurring employment growth and consumer confidence. Importantly, while government seemed increasingly dysfunctional, corporations generated record profits.
- It is understandable to be pessimistic after a year where most well-diversified portfolios recorded modest negative returns. But, a much more optimistic perspective on 2018 is that it marks the end of the Financial Crisis era. The economy grew with robust employment and investment while the Fed normalized monetary policy. That is a sign of health, not cause for despair.

A Note On Volatility

- After the docile year of 2017 which experienced the fewest +/-1% daily moves in 50 years, 2018 saw the most +/-2% daily moves since the Financial Crisis year of 2008. That sharp contrast has been unnerving to some investors.
- Volatility can be measured in many ways but, in a nutshell, refers to fluctuations in prices. The primary cause of volatility is uncertainty about the immediate future as investors react to new information. Market structure issues – the efficiency with which buyers and sellers are matched – can also contribute to volatility. This year, the slowing global economy, Fed tightening, and prolonged trade tensions came together to cause investor uncertainty about the durability of economic growth in the U.S.
- We wrote extensively about volatility in our March 31, 2018 Commentary. Our primary conclusions were that volatility is a characteristic of common stock ownership and the short-term discomfort it causes is overwhelmed by superior long-term returns. Further, some volatility is essential to keeping the system healthy and it can provide opportunity for long-term investors to make portfolio adjustments.
- It is also worth remembering the noteworthy quip by the late Nobel Laureate economist Paul Samuelson: "The stock market has forecast nine of the last five recessions."

The State of the Economy

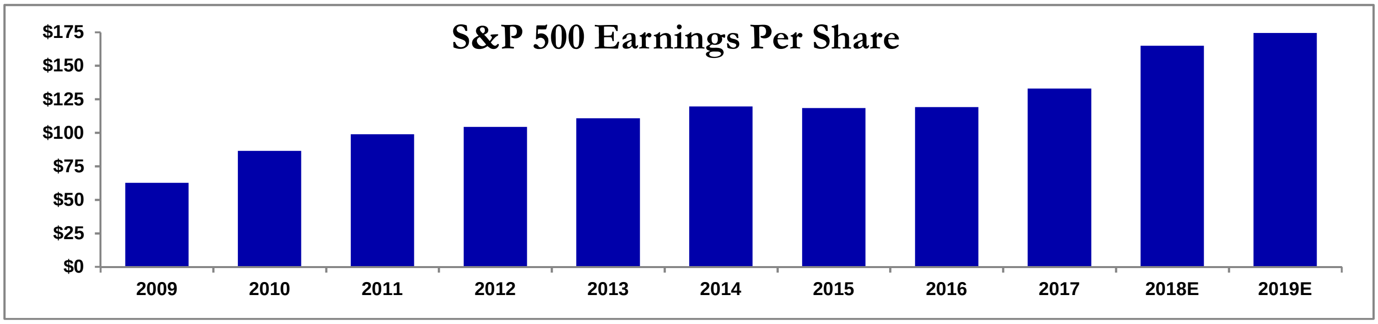
- The economy remains strong, having slowed from unsustainably robust levels at mid-year. Real GDP growth was 4.2% and 3.4% in the second and third quarters, respectively, above the median growth of about 3% since 1950.
- The underpinnings of consumer and business spending are positive. The unemployment rate, at 3.7%, is the lowest in fifty years, which is supporting wage growth of 3% or more. With the labor force participation rate below historical levels, there is room to pull even more workers into the economy. Anecdotally, reports of strong holiday sales by the likes of Amazon and Visa are the direct result of strong employment. Business conditions remain positive too. The Office of Information and Regulatory Affairs reports a dramatic reduction in costly regulations which, along with tax reform, is encouraging business investment.
- On the cautious front, interest-rate sensitive segments of the economy, most notably housing but also autos and durable goods, have slowed. That is an early indicator that higher interest rates are beginning to bite. Also, economic activity outside the U.S. has slowed meaningfully. The old saw that "when the U.S. sneezes, the world catches a cold" illustrates the economic leadership role of the U.S. In this reverse case, we suspect that trade tensions have clogged the transmission of U.S. strength to the rest of the world, especially China.
- Indicators with a strong record and long lead time are not signaling the prospect of a recession in 2019, although that is what many investors seem to fear. A few indicators that we watch including the Index of Leading Economic Indicators, the ISM Purchasing Managers Index and Consumer Confidence all remain constructive. The fundamentals are in place for real GDP to grow 3% in 2019 barring some exogeneous disruption.

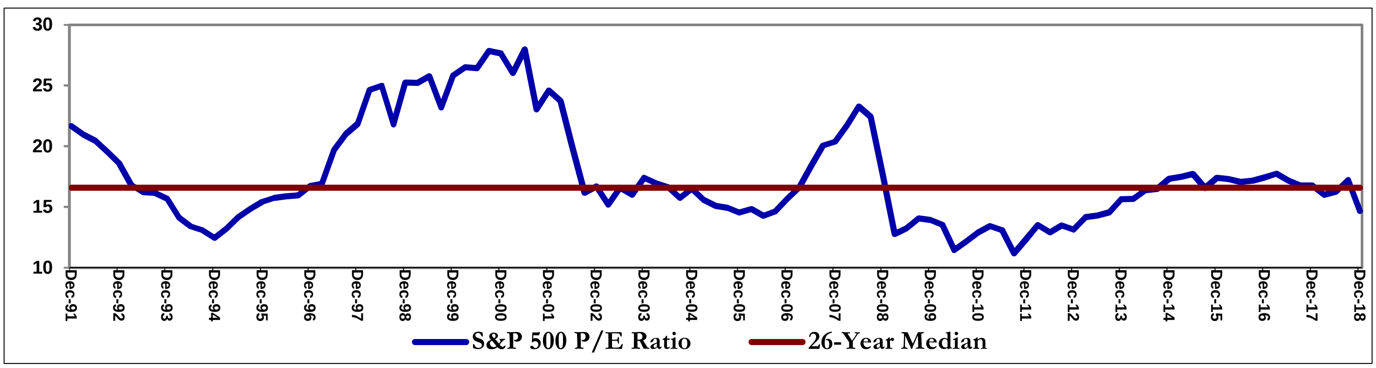
The *De Rigueur* Buzz Phrase: "Policy Mistake"

- Over the last couple of years, a popular media refrain pointed to the length of the current expansion as an argument that it must end. But there are many variations of the saying that expansions (and bull markets) don't die of old age; they are murdered. One culprit is a policy mistake and that will be the media phrase for 2019. Trump and the Fed are the two places to watch.
- The Federal Reserve raised the policy Fed Funds rate by one percentage point in 2018, moving incrementally at 25 basis points in each calendar quarter, while reducing the size of its balance sheet, also a form of policy "tightening." The Fed's actions in 2018 were prudent given economic strength and important steps in normalizing monetary policy.
- In its most recent move, the Fed signaled a slowing of rate increases in 2019. Our view is that the Fed should more explicitly shift from forward guidance that assumes continued rate increases to what is referred to as a "data dependent" approach, relying on economic conditions to dictate further rate actions.
- The prospects for policy mistakes from the Trump administration are two-fold. The first is trade policy, which we wrote about twice this year. Financial market patience with brinkmanship has worn thin. Despite potential for long-term benefits, disruptions to growth are now imminent and the need to finalize trade deals is at hand. Second, erratic twitter pronouncements and policy about-faces are finally impeding confidence and, with that, pressure to formalize administration policy making is building.

Earnings and Valuation Provide Support

- Earnings growth was strong in 2018, in part because of one-time benefits related to tax reform, but also because of strong business fundamentals. After a year of 25% earnings growth, consensus 2019 estimates for the S&P 500 Index expect 5 - 8% earnings growth and 6 - 8% growth in dividends.
- The P/E multiple of the S&P 500 is now at a discount to the median level since 1950 and is about 14.4x 2019 EPS, the cheapest level since the Financial Crisis. In addition, the current valuation of many companies, especially economically-sensitive stocks, appear close to discounting a recession.
- While valuation is not a great predictor of short-term market moves, the current values look appealing to us and are consistent with mid to high single-digit long-term returns.





Conclusion

- The right questions seem obvious: Will a monetary policy error by the Fed and/or a trade policy error by the Administration tilt the economy into recession? The answer is consequential to the performance of financial assets over the next twelve months.
- For those with a long-term horizon, the importance of price action over the next year is almost insignificant given valuation levels that are consistent with attractive long-term equity market returns. In other words, any declines are likely to be transient, rather than inflicting a permanent loss of capital.
- It is interesting to consider the prospect for a near-term rebound, which history would suggest is more likely than not. As we pointed out in our Market Commentary for the fourth quarter of last year, we had identified four episodes where monetary policy was tightened into a rising market and resulted in a down year, which is analogous to 2017/2018. Of those instances, only 1999/2000 turned into a sustained bear market as a result of the internet bust. Three of the four years produced a “pause that refreshed,” setting up further market gains over the following several years. After an average decline of about -10%, the following year was up about +14% on average. More importantly for long term investors, market gains continued for another three to eight years.

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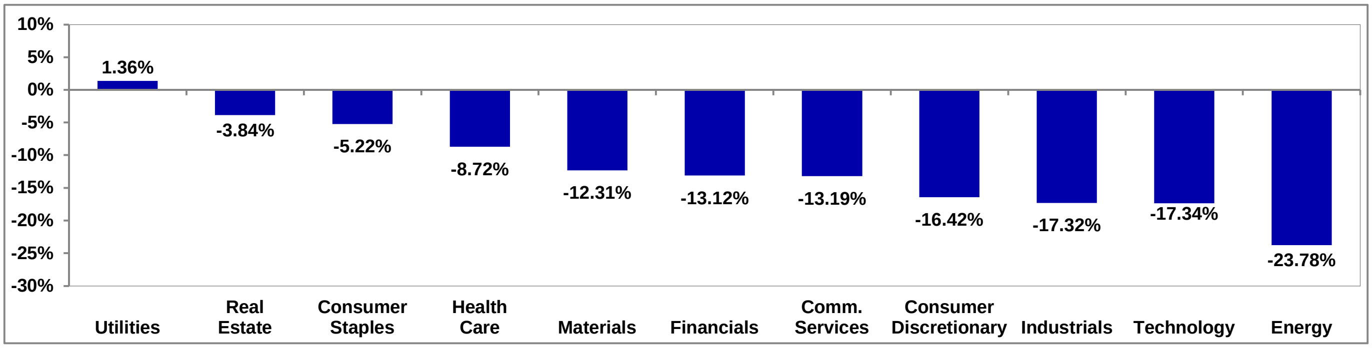
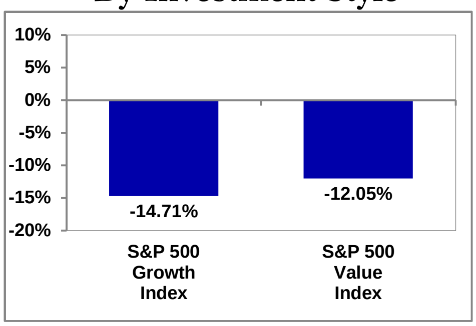
Fourth Quarter Investment Performance (including income)

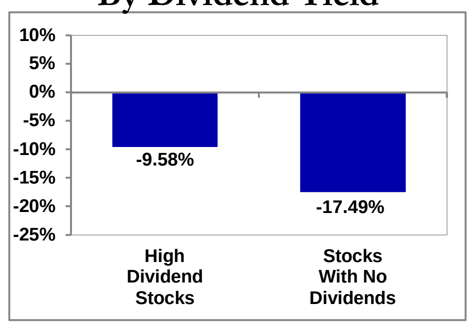
By Economic Sector



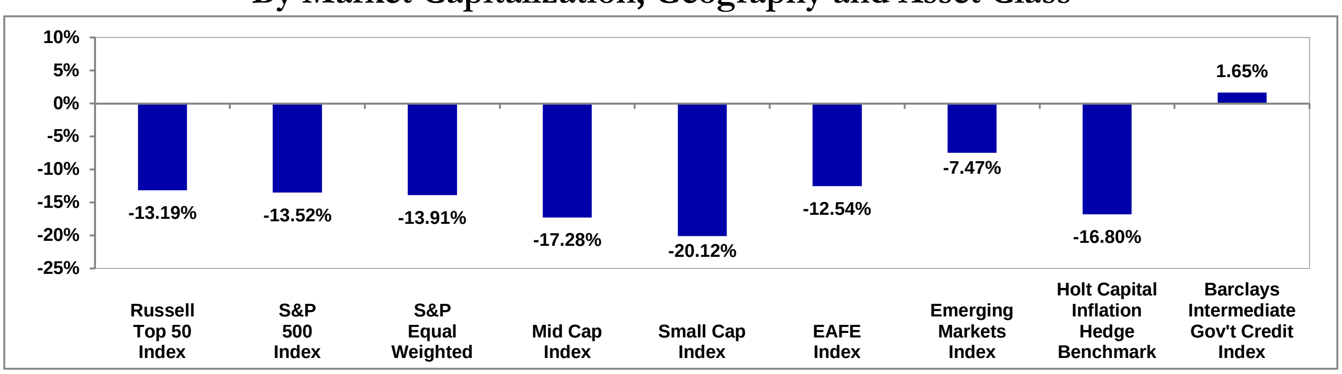
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- Traditionally defensive sectors were market leaders, while concerns about peaking economic growth dragged down cyclical and growth-oriented sectors.
- Small and mid cap stocks experienced greater downside volatility during the fourth quarter, which is consistent with the history of smaller companies.
- The price of crude oil fell 38% in the quarter, to approximately $45 a barrel from about $70. Energy stocks were the worst performing sector as a result.
- Bonds served their classic role as a safe haven in the midst of investor uncertainty.

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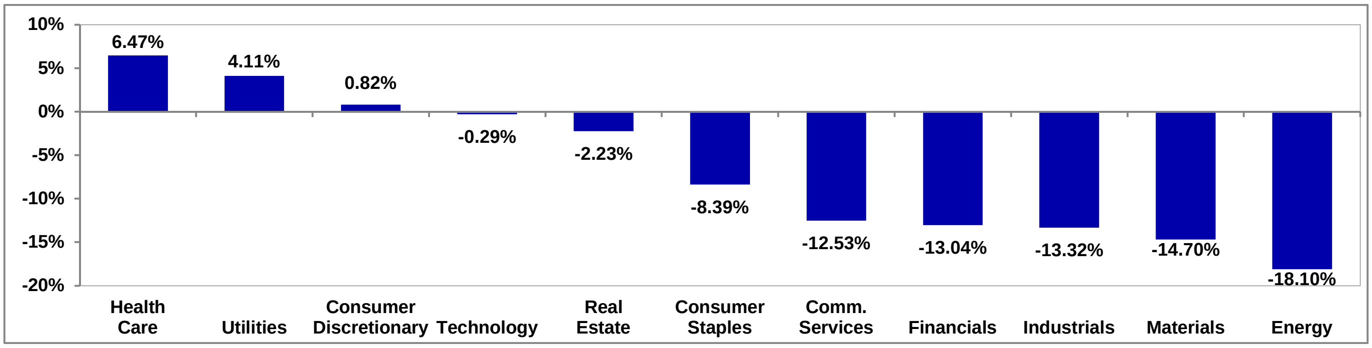
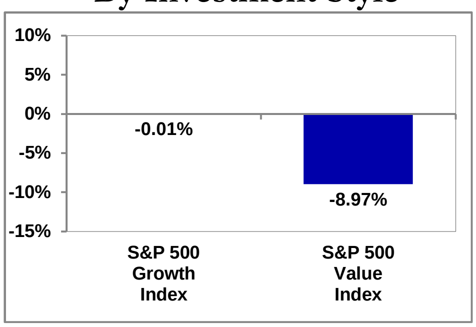
2018 Investment Performance (including income)

By Economic Sector



By Investment Style



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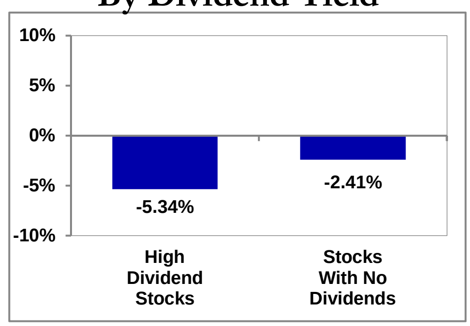

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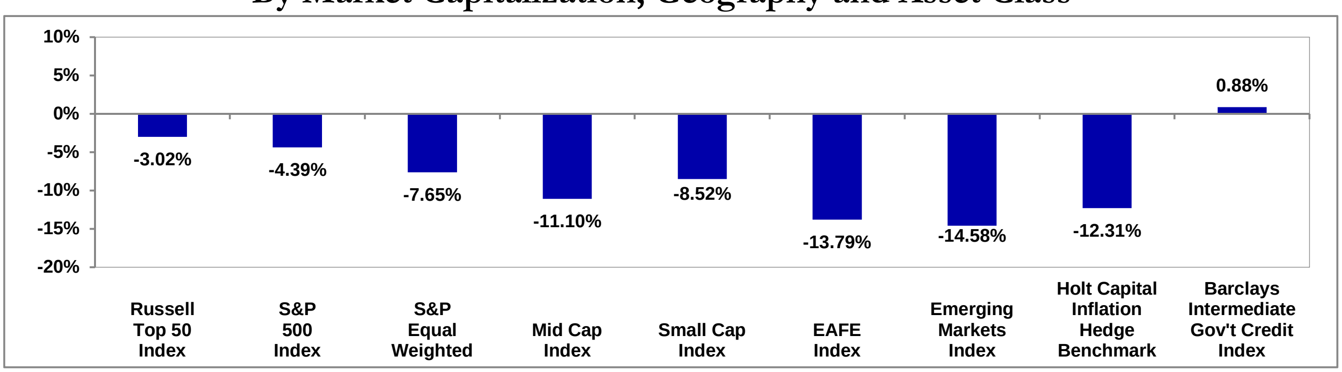

- Although growth stocks declined sharply in the fourth quarter, the health care, consumer discretionary, and technology sectors maintained their leadership for the calendar year.
- In most periods of negative returns, mega cap stocks tend to outperform smaller companies, as well as international shares. Performance in 2018 was consistent with history.
- The underperformance of value versus growth is the most extreme since the dot-com bubble of 1999. Stocks that are sensitive to economic activity and energy prices, both common constituents in value indexes, are especially depressed with many valuations seemingly near recessionary levels.