Holt Capital
Partners, L.P.

Fourth Quarter Financial Market Commentary

"Ninety Days in Ninety Seconds"

December 31, 2015

This Year Was All About Crude Oil, The Federal Reserve and "FANG"

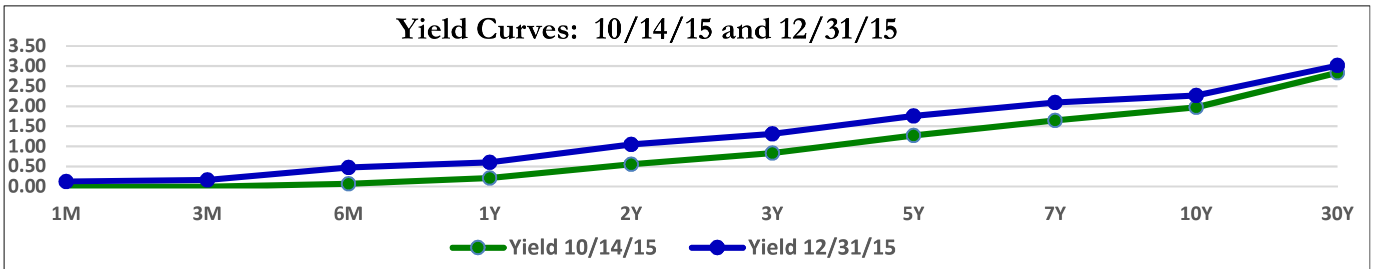
- Looking back at 2015, crude oil dominated the news as prices fell, and fell, and then fell some more. Each step function lower in price broadened the web of industries, companies and workers that were negatively impacted by the decline. Surprisingly, consumer spending has yet to see a big boost from lower prices at the pump.
- The Federal Reserve finally raised interest rates by a quarter of a percentage point and contrary to some fears, the world did not end! Our long held view has been that this hike and future moves will be seen as validating a slow, but steady pattern of domestic economic growth. This growth has now become self-sustaining and the economy is simply being taken off the monetary policy equivalent of life support.
- Leadership in the stock market was unusually narrow during 2015. Earlier this year, the clever acronym of "FANG" began to be used to describe four large cap growth stocks: **F**acebook, **A**mazon, **N**etflix and **G**oogle (which recently changed its name to Alphabet). During the past year these stocks rallied between 34% and 134% and overwhelmed the fact that over 37% of the constituents in the S&P 500 fell by ten percent or more. In a comparison that is eerily reminiscent of the dot-com era, Facebook has a larger market cap than General Electric and Netflix has a valuation that is comparable to Time Warner or General Motors.
- Going back nine months to our First Quarter Commentary, we described 2015 as a year that was "likely to be characterized by modest rallies and modest declines that culminate in only a small net change by year end". That forecast was fairly accurate and our view remains that 2016 will be a year in which consumer incomes recover and earnings growth returns to the domestic economy.

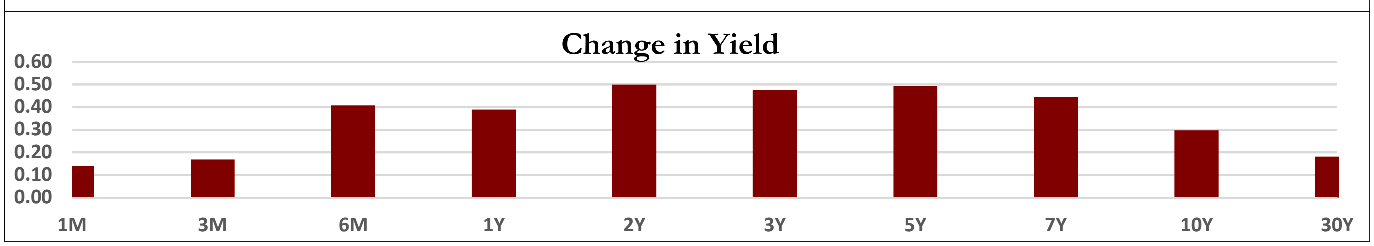
The Big Five Should Move Higher Together in 2016

- Big game hunters might define the Big Five in terms of an African safari. However, investors are likely to find economic growth, interest rates, inflation, crude oil and stock prices much more highly correlated in 2016. Economic growth will help stimulate demand for crude oil and when coupled with reduced U.S. production, should bring stability and balance to the oil market. The Federal Reserve is likely to raise short term interest rates several times in 2016 based on the expectation of a normalization of economic growth and a return of inflation to targeted levels. Increases in these measures of economic activity would be reflective of a healthy economy and should lend a bullish bias to stock prices over the course of the year.

INTEREST RATES AND THE FEDERAL RESERVE

- During prior interest rate tightening cycles, the concern was often expressed that the Fed was "behind the curve" in terms of the pace of interest rate increases. One of the most widely anticipated 0.25% increases in the Fed's short term interest rate target has now occurred. However, based upon the jump in two year note yields from 0.55% on October 14th to 1.05% at year end, the bond market had clearly anticipated the move for sometime and expects more increases in 2016. Balancing rate hikes and market expectations will be important for the Federal Reserve in the new year.





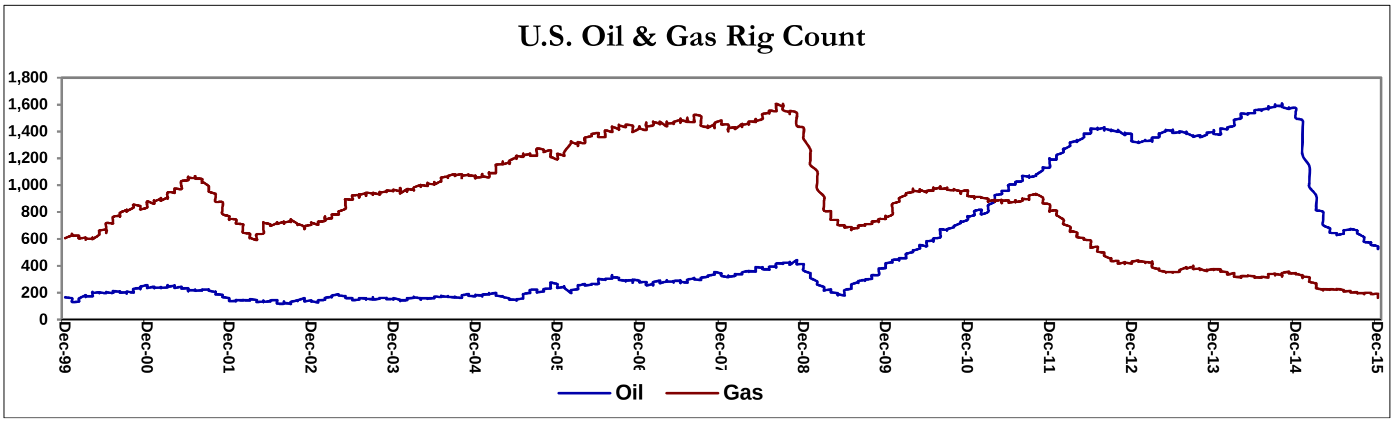
CRUDE OIL HAS ALWAYS BEEN A CYCLICAL COMMODITY

- The current prices of crude oil and natural gas are unsustainably low. It is simply uneconomic to drill in most basins at these prices. This is both good news and bad news. It is bad for investors at this point, but periods of excess supply have historically been part of a self-correcting cycle. The number of oil and gas rigs operating in North America has fallen sharply over the past several years and production has recently begun to decline. The capital markets are largely closed and the upcoming bank redetermination process is expected to see reductions in credit lines. All of these factors point to a continued slow decline in domestic production. When coupled with existing global demand growth, this should eventually lead to a balance between supply and demand.

- The impact of this over-supply of crude is widespread, with major integrated companies talking about "protecting the dividend", while the management teams at financially leveraged producers talk about being in "survival mode". Even Saudi Arabia is experiencing a 20% budget deficit and is considering a public offering of Aramco, its state-owned oil company.

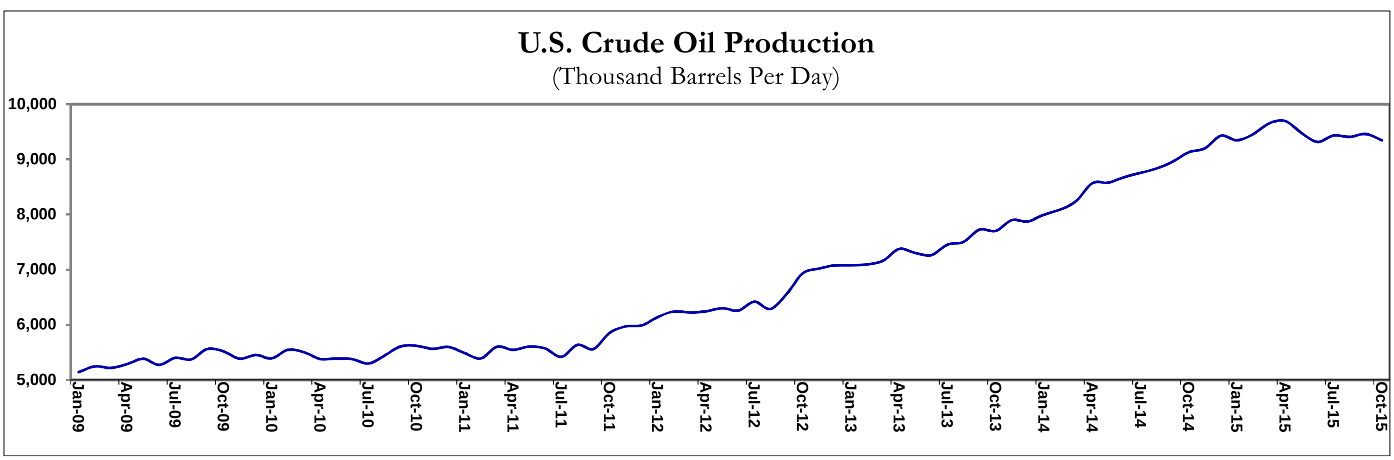
CRUDE OIL HAS ALWAYS BEEN A CYCLICAL COMMODITY (CONTINUED)

- The upcoming year will likely see bankruptcies of numerous smaller producers and oil service firms. An acceleration in merger activity should also materialize in 2016 and provide significant synergies for the acquirers. The oil market should reach a more balanced supply and demand position by the second half of the year. Natural gas, which is more sensitive to weather and is continuing to be impacted by prolific shale production, may not begin to see prices recover until 2017.



Source: Baker Hughes

- Drilling activity has been sharply curtailed in most fields, with the exception of the Permian Basin.



Source: U.S. Energy Information Administration

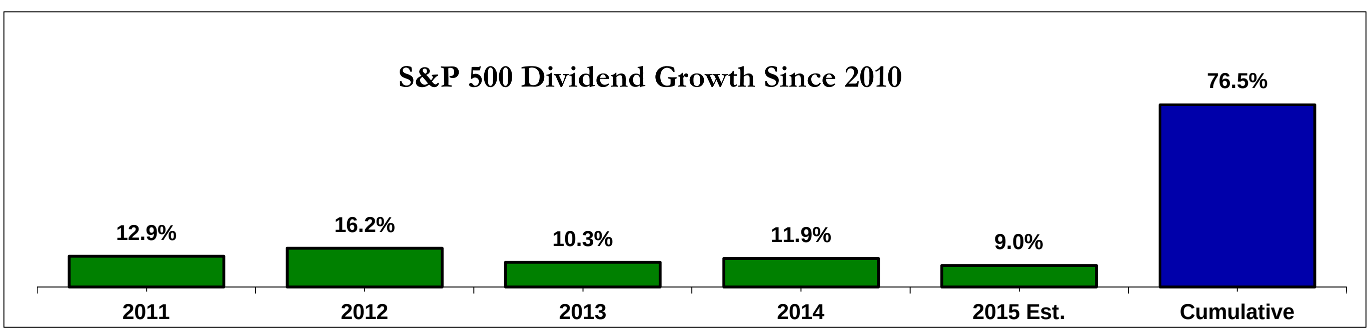
- Domestic production peaked in April and should decline further in 2016.

The Math of Inflation

- The methodology that underlies the primary measures of domestic inflation has a long history of politically motivated revisions that have occurred under both Republican and Democratic administrations. As a result of these changes, most economists believe that the CPI understates the rate of inflation.
- The past three months of data for the so-called "core CPI", which excludes the volatile food and energy components, has shown an increase of +0.2% each month. This produces an annualized inflation rate that is already above the Federal Reserve's two percent target. The risk is that it is difficult to put the inflation genie back in the bottle. If inflation begins to accelerate, then the Federal Reserve will need to be more aggressive with future interest rate hikes.
- Looking into 2016, the sharpest declines in energy prices were concentrated in late 2014 and early 2015. As those months drop out of the twelve month measurement period, the inflation data will begin to lose the tailwind of falling energy prices. Minimum wage legislation will also begin to pressure wage rates in the coming year.

Common Stocks Continue To Be A Sustainable Income

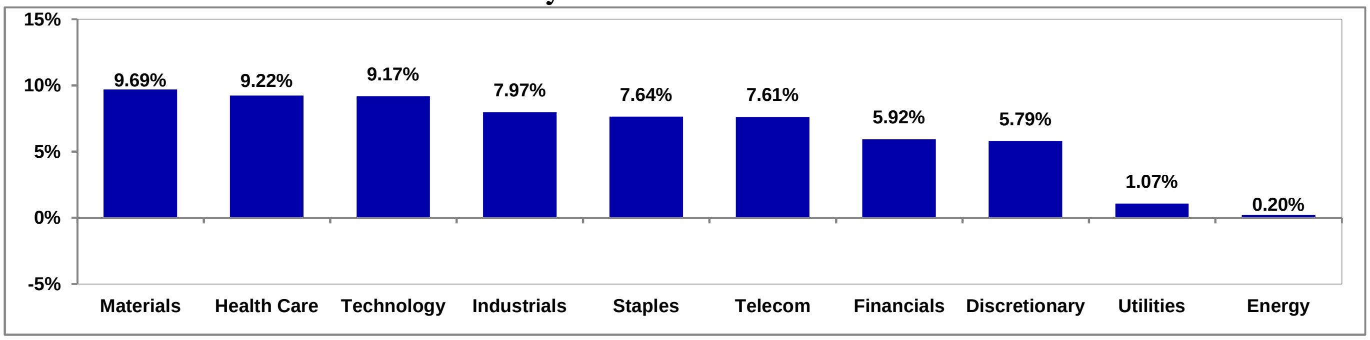
- Most investors think of dividend yield as a desirable factor when evaluating potential investments. That is partially true, but the most important aspect of dividend investing is combining an attractive dividend yield with consistent dividend *growth*. This is the fifth consecutive year of strong dividend growth. During the past year, 341 companies in the S&P 500 Index raised their dividends, which is over 80% of the 423 dividend payers in the index. Of the 81 stocks that do not pay a dividend, most have substantial share repurchase programs, which is another way that companies can return capital to shareholders.
- Over this five year period, an investor with $100 of dividend income in 2010 would have seen that income stream grow to $176 in 2015. This growth is certainly well ahead of inflation.



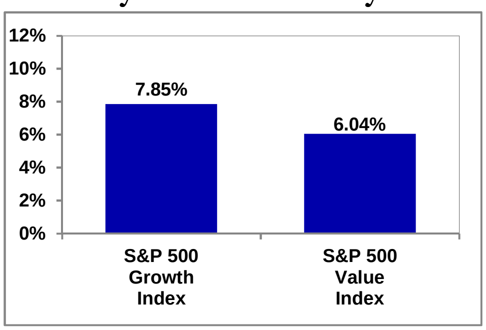
- Dividend growth is likely to be in the 7% range in 2016. Although the market value of common stocks obviously fluctuates on a daily basis, dividends have historically proven to be a good source of <u>sustainable</u> and <u>growing</u> income.

Fourth Quarter Investment Performance (including income)

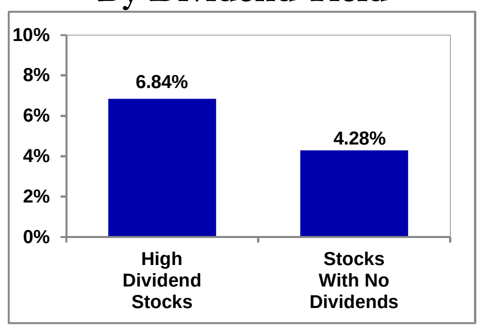
By Economic Sector



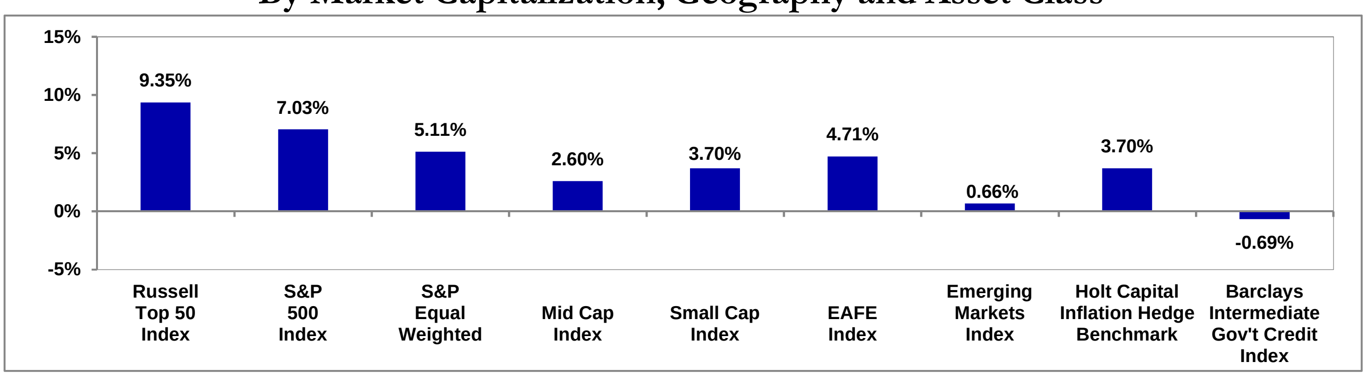
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- After a difficult third quarter, the stock market rallied broadly during the past three months, with strong gains across economic sectors, investment styles and company sizes.
- Energy stocks were up slightly during the quarter and meaningfully outperformed crude oil and natural gas prices. The materials sector was positively impacted by the proposed merger between Dow and DuPont, as well as the acquisition of Airgas by Air Liquide.
- The domestic economy is generally growing faster than our global trading partners and in that environment, domestic equities outperformed international equities. Bonds posted slightly negative returns, which reflected higher interest rates across all maturities.

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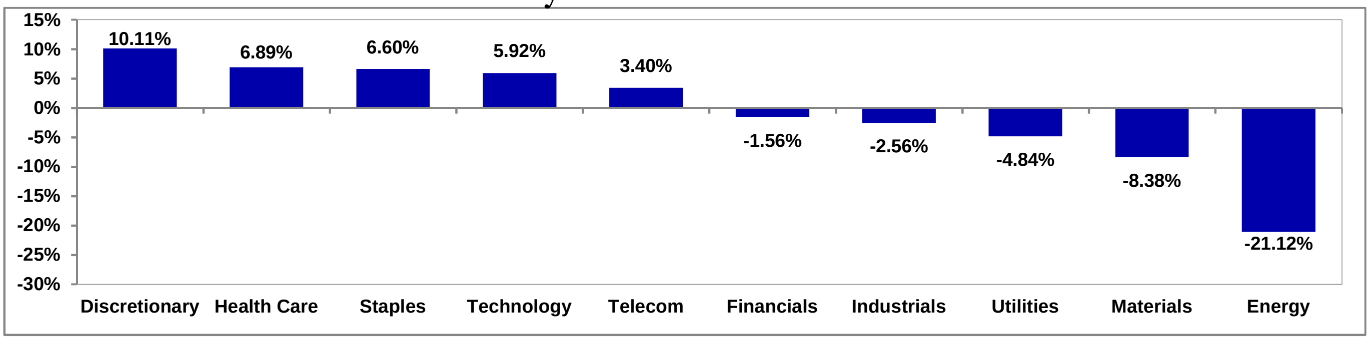
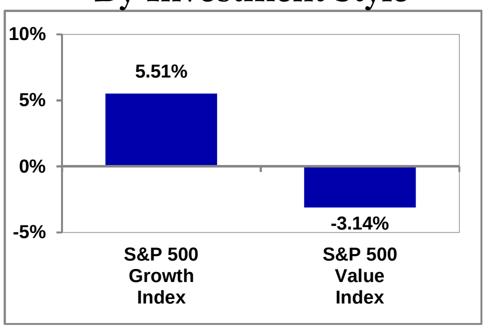
2015 Investment Performance (including income)

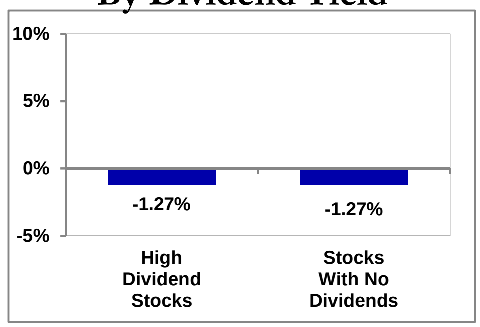
By Economic Sector



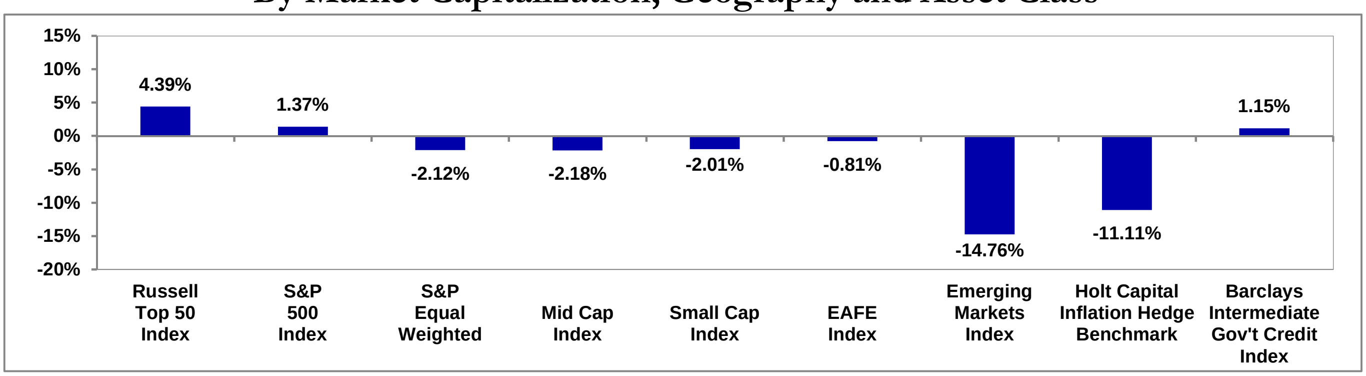
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- The impact of weak commodity prices permeated the energy, materials and industrial sectors. Those sectors are typically overweighted in value indexes and consequently value stocks underperformed growth strategies. Most emerging market countries tend to be large commodity exporters, so difficult economic conditions resulted in emerging market stocks lagging behind the developed markets.

- We have previously commented about the significant outperformance by the mega cap stocks in the Russell Top 50 Index. While Amazon and Netflix had an impact on this outcome, it is still historically unusual for mega caps to lead other size categories in a rising market. Dividends were not a differentiating factor for returns last year, but volatility was certainly higher for the non-dividend payors.