Holt Capital Partners, L.P.

First Quarter Financial Market Commentary

"Ninety Days in Ninety Seconds"

March 31, 2017

Policy Versus Personality

- The early days of the Trump administration have been characterized by seemingly ill-advised comments, populist rhetoric, contested executive orders and the withdrawal of several cabinet-level nominees. The financial markets have shrugged off these issues and continue to focus on three key pillars of policy: tax reform, deregulation and fiscal stimulus. As long as these policy efforts remain viable, they represent structural drivers for a stronger economy and provide support for stock prices.

- In hindsight, the health care reform bill was dead on arrival. Its failure highlighted the fractured state of the Republican Party and it probably should have been positioned to follow tax reform and fiscal stimulus, rather than preceding those less controversial topics. The failure of this bill is probably more damaging inside the Beltway than it is among the rest of the population. Therefore, a renewed focus on economic policy items should limit the financial market impact of this bruising political power struggle.

- The current environment in Washington reminds me of a political cartoon that appeared when Congressional term limits were a popular topic. The cartoon showed a man with a sign that read "Throw The Bums Out" and next to him was another sign with a slightly different sentiment, "Except For My Bum!" The electorate has clamored for change, except where they want to maintain the status quo, which creates a conflict that always becomes most acute when big ideas are crafted into actual laws. Since the policy prescriptions of the current administration do not fit neatly within the typical ideological platform of either Republicans or Democrats, it should not be surprising that both sides of the aisle are uncomfortable.

Federal Reserve Policy and Interest Rates

- The job market has been stronger than expected, retail sales are picking up and consumer confidence is at a fifteen year high. This robust economy has cleared a path for Janet Yellen and the Federal Reserve to raise interest rates. After keeping rates near zero from 2008 through 2015, the Fed has now raised rates three times in the past sixteen months and at their March meeting officials signaled two more increases are likely this year.

- The most recent increase in the Federal Funds rate was widely anticipated and was preceded by a move in two-year note yields to their highest level in over seven years. Likewise, yields on ten-year bonds have moved from a Brexit-induced low of 1.36% in July of 2016 to 2.39% as of the end of the first quarter. A strengthening economy is usually good for corporate earnings and job creation, but often puts upward pressure on interest rates.

Valuation and Volatility

- The most frequently cited measures of valuation are price/earnings, price/book value, and price/sales ratios. Based on these measures, the S&P 500 Index is slightly above its twenty-five year average, which seems justified to us with interest rates at a low level and profitability measures that have continued to expand.

- Volatility can be loosely defined as the degree to which stock prices bounce around on a day-to-day basis, and price volatility hovered near historical lows during the first quarter. Prior to a sharp drop near the end of the quarter, it had been 109 days since the S&P 500 suffered a daily price decline of one percent. This was the longest streak since 1995. Such a low level of volatility indicates a lack of investor fear and, for that reason, low levels of volatility are often associated with slightly elevated levels of valuation.

Conclusion

- Much has been written about the sluggishness of the post financial crisis economic recovery. There are a number of theories that attempt to explain the malaise, but poor policy decisions that have burdened the cost structure of free enterprise seem at least partly to blame. Tax reform, deregulation, and fiscal stimulus in the form of productive infrastructure investment are likely to prove very powerful in revitalizing the economy.

- The popular adage "don't fight the Fed" warns investors to beware of stocks when the Fed tightens. But following the recent prolonged period of abnormally low interest rates, a "renormalization" of Fed policy could well have a positive effect on the economy and financial assets.

- We expect volatility to pick up from abnormally low levels and increased volatility may include a healthy pullback in stock prices at some point this year. Market timing is tax inefficient and often perilous, causing investors to miss large gains rather than avoid losses. Riding out such short term volatility has proven to be the more productive path to growing wealth. The key will be to keep our focus on the long term and use any decline to seize opportunities.

- Valuation is not a market timing tool, but it is a critical measure for long term investors. Buying an asset at an attractive valuation is the single best determinant of long term returns. One of the tricky aspects of identifying attractively valued assets is that it is a lonely task. When assets are cheap, consensus opinion is invariably negative and visibility regarding an improvement in fundamentals is typically low. We continue to see opportunities at both the individual stock level, as well as the index level, in areas as diverse as retail, where many stocks are supported by real estate values and in the energy sector, where normalized earnings are substantially above current levels. Value investing rewards those with the analytical vision to avoid the perils of a herd mentality and the patience of a long time horizon.

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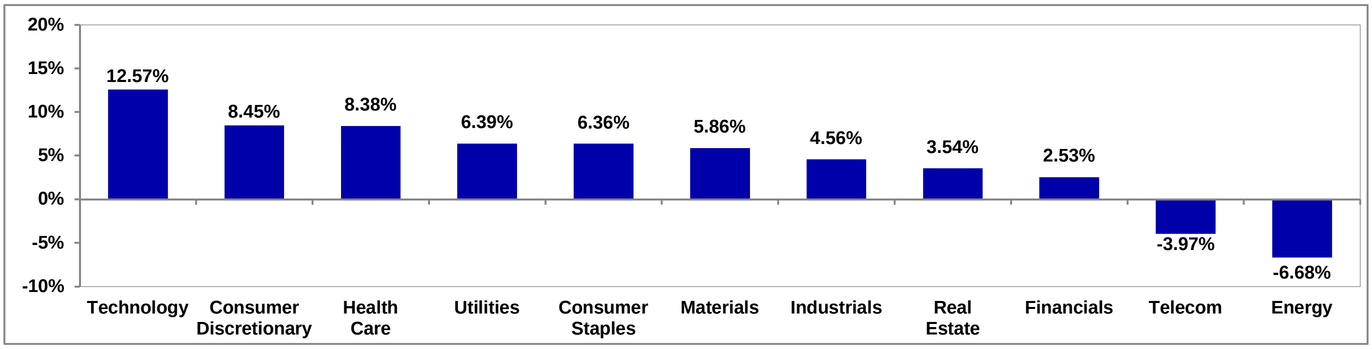
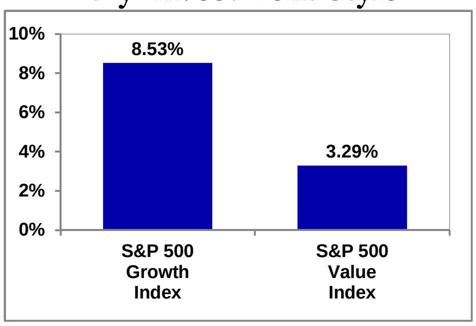
First Quarter Investment Performance (including income)

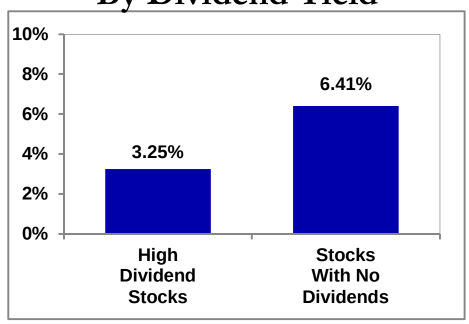
By Economic Sector



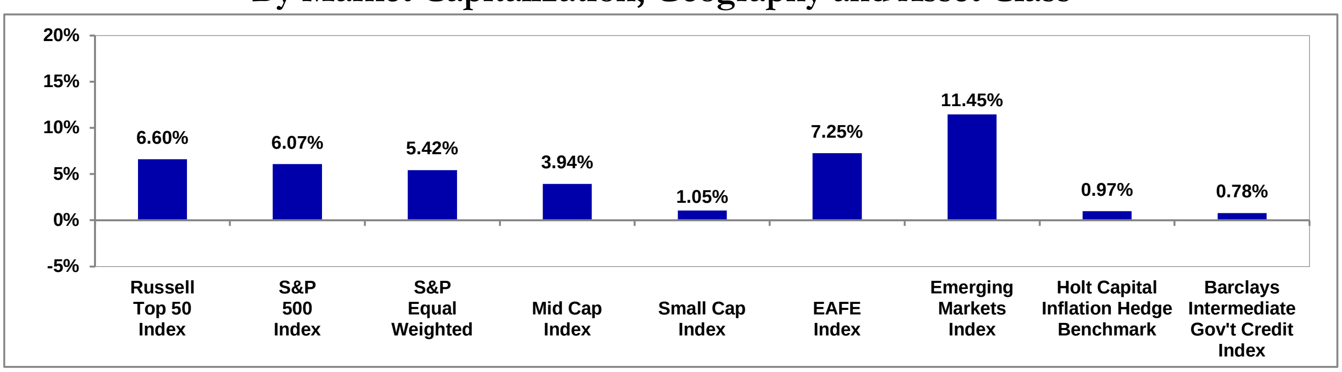
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- Sector rotation within the stock market moved dramatically toward large cap growth stocks and away from value and small caps during the first quarter. This was a complete reversal from the leadership in the fourth quarter, which tended to favor potential beneficiaries of changes in policy.
- Somewhat surprisingly, the relative performance of various size cohorts in the first quarter was more typical of a declining market in which investors sought the safety of mega caps and exited the higher perceived risk of small caps. The fact that mega cap stocks outperformed small caps by over six percentage points in a rising market environment highlights the unusual nature of the first quarter.
- Technology, health care and consumer discretionary were the three best performing economic sectors. These three sectors comprise over half of the Russell Top 50 Index of mega cap stocks, so there was clearly substantial overlap between these two trends. Energy was the worst performing sector and moved lower in sympathy with crude oil and natural gas prices.