HOLT CAPITAL
PARTNERS, L.P.

SECOND QUARTER FINANCIAL MARKET COMMENTARY

"NINETY DAYS IN NINETY SECONDS"

JUNE 30, 2022

THE "R" WORD

- Recession is an emotionally charged word. Its recent usage by politicians, the media, and some economists make a sharp downturn seem like a foregone conclusion. One might even argue that all this handwringing is serving to talk ourselves into a recession. However, the reality is much more nuanced. The timing, depth, and breadth of an economic contraction are the key factors for investors.

- Most companies continue to report strong end market demand for their products. The labor market is extremely robust, with two jobs available for every job seeker. These conditions are not consistent with an imminent recession.

- The economy is slowing from unsustainably rapid growth last year. This may turn out to simply be a growth scare in which the economic cycle moderates before resuming solid growth. Alternatively, interest hikes by the Federal Reserve could push the economy into a mild recession. Lastly, the financial markets appear to be discounting a severe downturn. In our view, this last scenario seems unlikely.

- Certain industries are classically interest rate sensitive and cyclical, including construction, consumer durables, and other credit-dependent businesses. These data points often make headlines but are not necessarily predictive of the health of the broader economy.

BACKGROUND

- The S&P 500 reached an all-time high in early January. Since then, investors have had to reconcile the unprecedented demand stimulus from pandemic fiscal and monetary policy, the ongoing war in Ukraine, the highest inflation in forty years, and a major pivot in Federal Reserve policy. Throughout this turmoil, corporate profits have continued to grow.

- In most recessions, end-market demand from businesses and consumers has been negatively affected. The pandemic was different. The fiscal and monetary response to the pandemic supercharged demand and produced the unintended consequences of persistent shortages of raw materials, finished goods, and workers. This response, while well-intended, was overzealous and resulted in policy errors that are now forcing the Fed to aggressively raise interest rates to catch up with the spike in inflation.

INFLATION AND INTEREST RATE RISKS

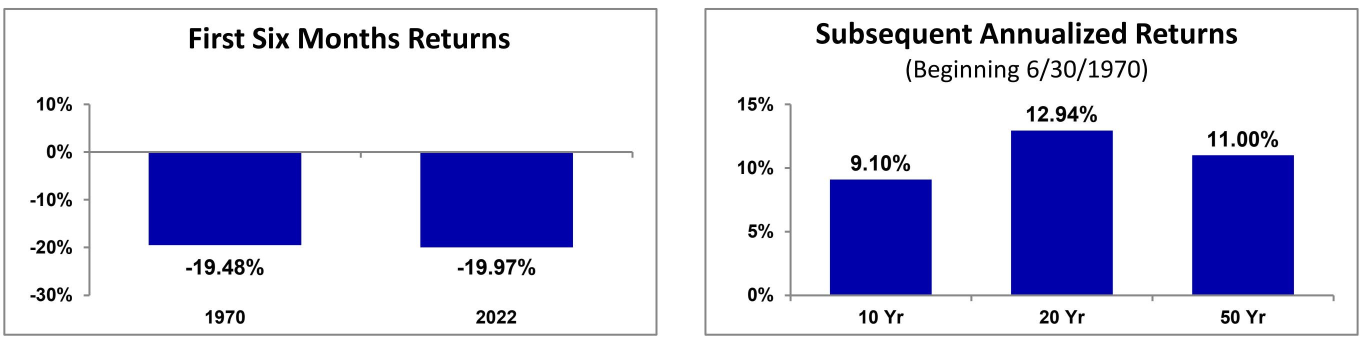
- Inflation data has exceeded the forecasts of even the most bearish economists. This is a global phenomenon, not just a domestic problem. In response, most developed country central banks are tightening policy and raising interest rates.

- It is important to recognize that the "surprise" of higher inflation and interest rates is now well recognized in the valuation of stocks and bonds. The negative impact of supply chain issues on inflation should diminish in the second half of the year. Copper and other commodity prices have recently declined sharply. Investor sentiment around inflation is so negative that even a hint of good news should be positively received by all asset classes.

Transient Volatility

- We often discuss with clients that transient volatility is a necessary component of enjoying the positive long-term benefits of owning shares of high quality, profitable businesses. However, the uncomfortable aspect of enduring that short term volatility has certainly been driven home this year.
- It is important to differentiate transient volatility from a permanent loss of capital. In our December 2020 year end commentary, we highlighted the price risk in innovative, but unproven and unprofitable technology stocks. Within six weeks an index of those unprofitable stocks peaked and has now declined 68% from its February 2021 high. Investors that speculated on these companies have likely experienced the much different outcome of a permanent loss of capital.
- The financial media has repeatedly highlighted the fact that this is the worst first half for stocks since the first half of 1970. While that is true, the important implication for investors with an extended time horizon is what happens next. The graph below highlights the positive returns in subsequent decades.

Media Headline: "Worst Start to a Year Since 1970"



The news media reports on events that have already occurred. The issue for investors is what happens next, and that news is good.

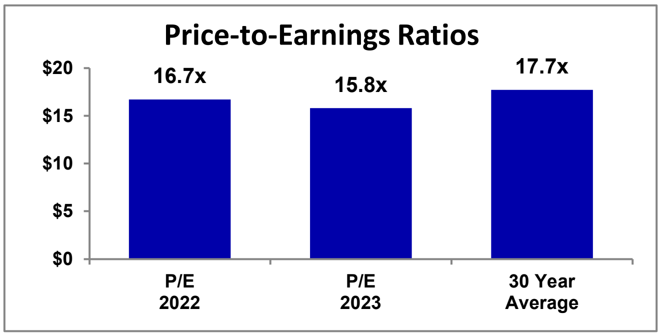
Investor Sentiment

- Investor psychology, often referred to as investor sentiment, is much worse than company fundamentals. Investor sentiment surveys are at multi-year lows. Likewise, hedge fund positioning is at its most bearish level since 2009. Selling over the past several months by both groups of investors may have contributed to the year-to-date decline, but at this point these are strongly positive contrarian indicators.
- While other investors ran for the exits, company managements have sharply increased corporate buybacks during the decline. The corporate buyback group at Goldman Sachs saw volume triple on big down days in late June. This action should be indicative of company fundamentals that are more positive than bearish market trends would imply. In addition, insider buying has recently exceeded insider selling for the first time since the pandemic.

Earnings and Valuation

- Second quarter earnings and management commentary regarding the outlook for the third quarter will be critically important data points. Although earnings forecasts in an uncertain economy could have downside risks, demand exceeds supply for many companies and should continue to drive revenue growth. Cost pressures from disruption in commodity markets, labor shortages, and global supply chain issues are "old news" and are more likely to move toward resolution in the future than to become more problematic.

- As illustrated in the graph below, valuation in the stock market for both 2022 and 2023 is meaningfully below the average price/earnings ratio over the past thirty years.



Valuations are not expensive relative to history.

Conclusion

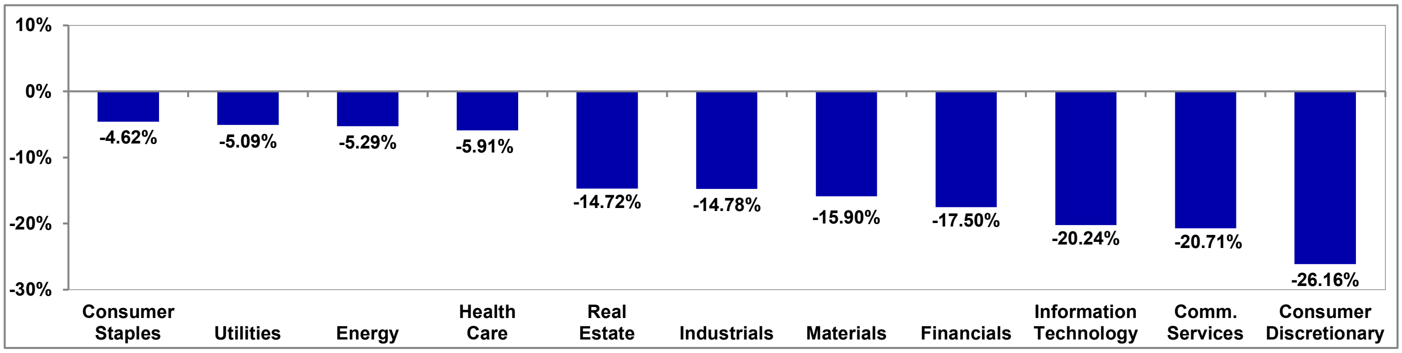
- Economic growth is slowing, but it is not contracting, and that is an important distinction. We believe that the current economic environment will ultimately be characterized as a growth scare, rather than an imminent or deep recession.

- Stock prices are likely to remain significantly more volatile than changes in the value of the underlying businesses. This is a function of headline-induced fear on the part of investors, rather than fundamental analysis.

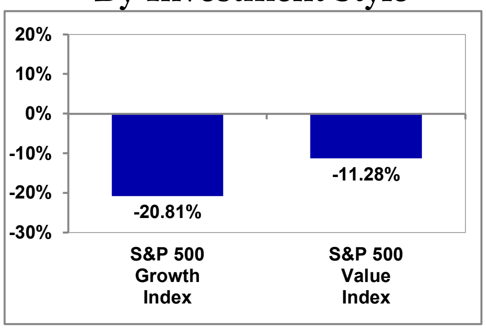
- The risks around inflation, interest rates and an economic slowdown are well known and probably overly discounted in the stock market. Valuations are historically attractive. Consumer and corporate balance sheets are strong, dividend growth is accelerating, and numerous speculative bubbles have been popped. The risk/reward looks favorable for the balance of the year.

Second Quarter Investment Performance (including income)

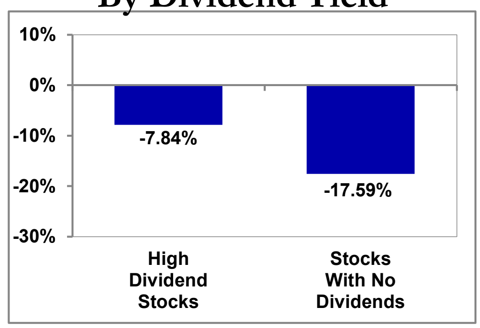
By Economic Sector



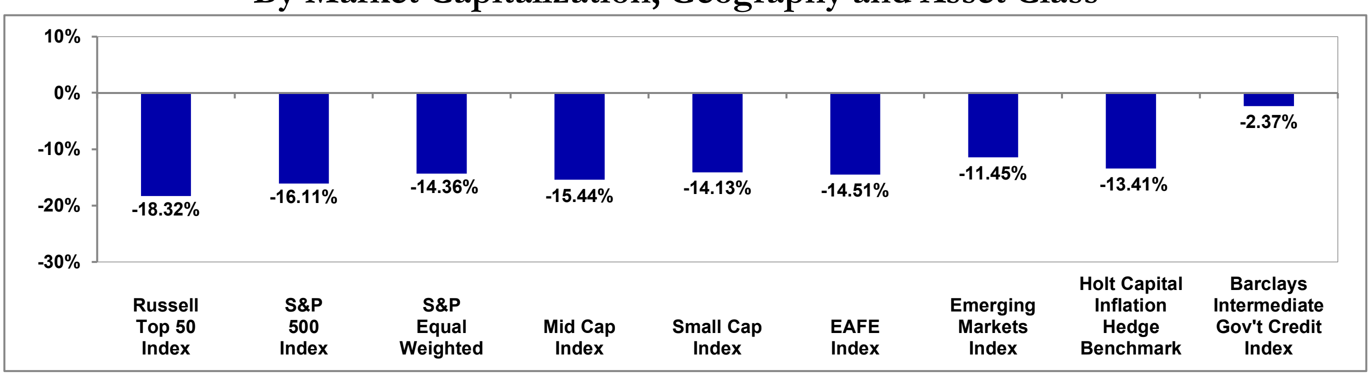
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- The second quarter was difficult. All of the indexes presented above posted negative returns. The lack of positive returns in a calendar quarter from any segment of the financial markets has not occurred since the early 1980s.
- Non-cyclical sectors, such as consumer staples and utilities were relatively defensive, but still declined in price.

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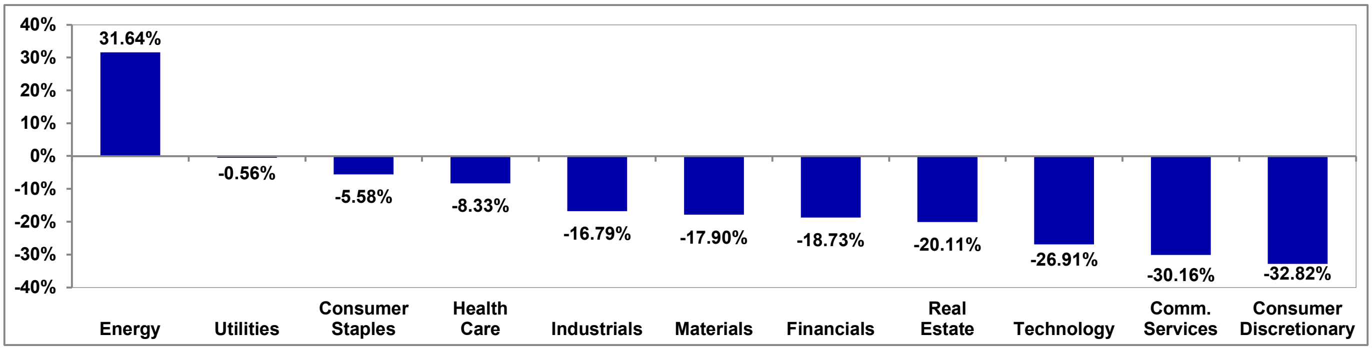
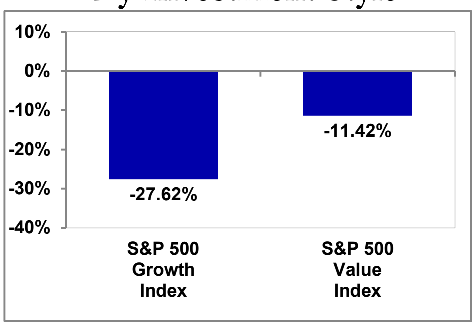
First Half Investment Performance (including income)

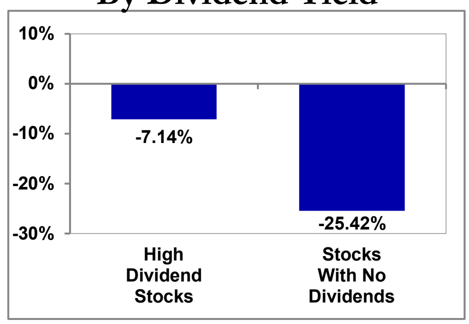
By Economic Sector



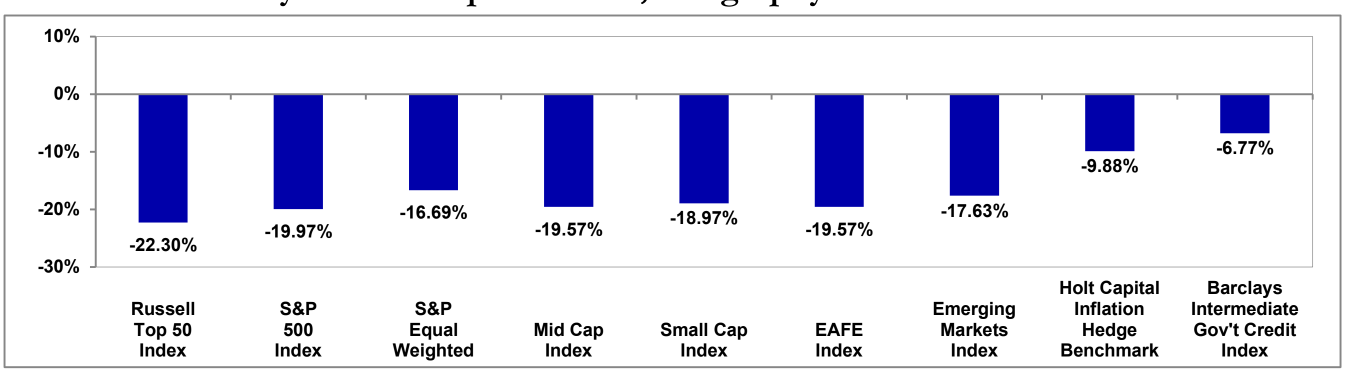
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- Sectors characterized by faster growth rates and higher valuations were hit the hardest. After lagging for most of the last decade, value stocks outperformed their growth counterparts. Lower valuations, stable business models, dividends, and free cash flow became more desirable characteristics.
- Energy stocks were the only bright spot in the first half of the year. Crude oil and natural gas prices rose over 40%.
- Fixed income performance was the worst since 1980. Even for conservatively positioned portfolios, the rise in interest rates has been staggering. Two year government bond yields, which are highly sensitive to Fed policy, rose from 0.73% at year end to 2.95%. Likewise, ten year bond yields doubled from 1.51% to 3.01%.