Holt Capital
Partners, L.P.

Third Quarter Financial Market Commentary

"Ninety Days in Ninety Seconds"

September 30, 2021

The Slow Evolution of Federal Reserve Policy - What's Next?

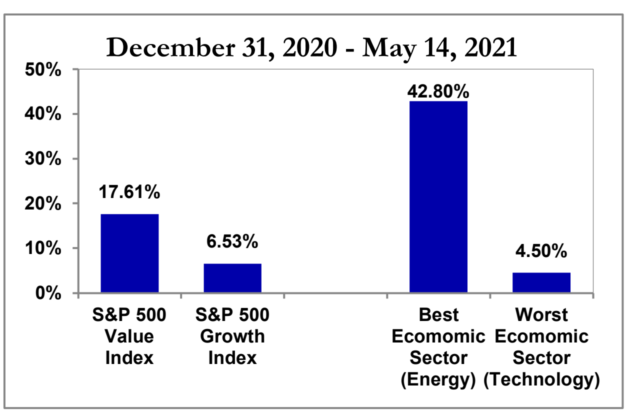
- The Federal Reserve often communicates policy with language that is opaque. As a result, it can sometimes be insightful to review the evolution of comments over time. The Fed began the year concerned about inflation tracking below two percent. In the spring, Fed officials acknowledged a spike in inflation but attributed it to transitory factors. Last month Chairman Powell, along with a chorus of Fed governors, began to discuss withdrawing monetary stimulus in a process referred to as "tapering." During the pandemic the Fed bought government bonds in order to keep interest rates low. Throughout this year the Fed has purchased about $120 billion per month in bonds. It is likely they will announce a phased ending to these purchases in November. This tapering will probably last until next summer. The next step for the Fed will be to actually raise short term interest rates, which is currently expected to occur in the second half of 2022.

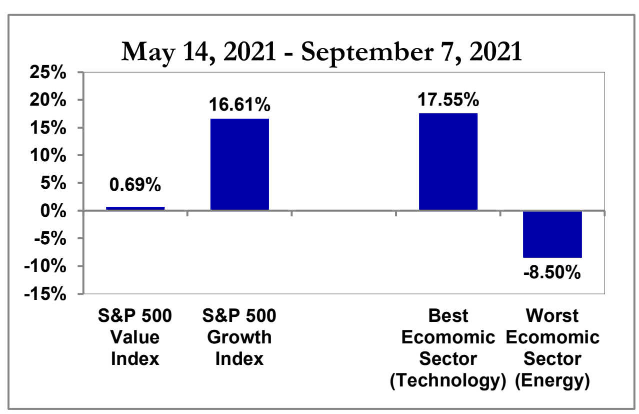
- This process, while well-intentioned, may ultimately put the Fed behind the curve with respect to interest rate hikes. If the central bank is forced to play catch-up and raise rates more aggressively, then the risk of short-circuiting economic growth increases. The yield on the benchmark ten-year Treasury bond has already rebounded from its pandemic low of 0.51% and returned to its pre-pandemic range of over 1.50%. If robust job growth and persistently high inflation continue into 2022, the Fed will likely be forced to accelerate the tapering process and their interest rate forecasts may prove too low.

Market Leadership and Sector Rotation

- Incoming macroeconomic data impacts market leadership. The year began with strong value factor outperformance driven by positive macroeconomic data, an acceleration in inflation, and a sharp rise in ten-year bond yields. A reversal of this phenomenon began in mid-May and continued into September. As new cases of Covid surged and supply chain issues intensified, economic forecasts were cut, interest rates slipped, and growth stocks outperformed.

- We have often commented that stock market performance cannot always be captured by a single rate of return figure. That has been especially true this year. This sector and style rotation is illustrated in the graphs below. Note that the best performing sector in the first period became the worst performer in the second time frame and vice versa.





Exceptional Earnings Growth is Peaking

- Our prior market commentaries have consistently been optimistic regarding 2021 earnings growth. We remain upbeat and believe the current consensus of +44% growth this year may still be marginally low. Despite stellar year-to-date stock market returns, P/E ratios have actually fallen as the advance in stock prices has lagged very strong earnings growth. However, quarterly earnings growth rates are decelerating, and as the calendar shifts to 2022 growth is likely to return to a more normal level of 8% to 10%.

- The level and direction of interest rates will likely be the key determinant of stock market trends over the near-term. Higher interest rates would benefit value stocks as they tend to be more dependent upon the strength of the economy for earnings growth. Conversely, higher interest rates could weigh on so-called "long duration" growth stocks by raising the discount rates used to value profits that are many years into the future.

- Rising labor costs, supply chain disruptions, and cost inflation are potential risks and will become pervasive topics for companies on their upcoming third quarter earnings calls. A number of companies have already "preannounced" worse than expected third quarter results based upon these issues. The stock market has tended to view these as transitory issues and not penalized share prices. However, this injects an element of risk into the market as we move into third quarter earnings season and beyond.

Conclusion

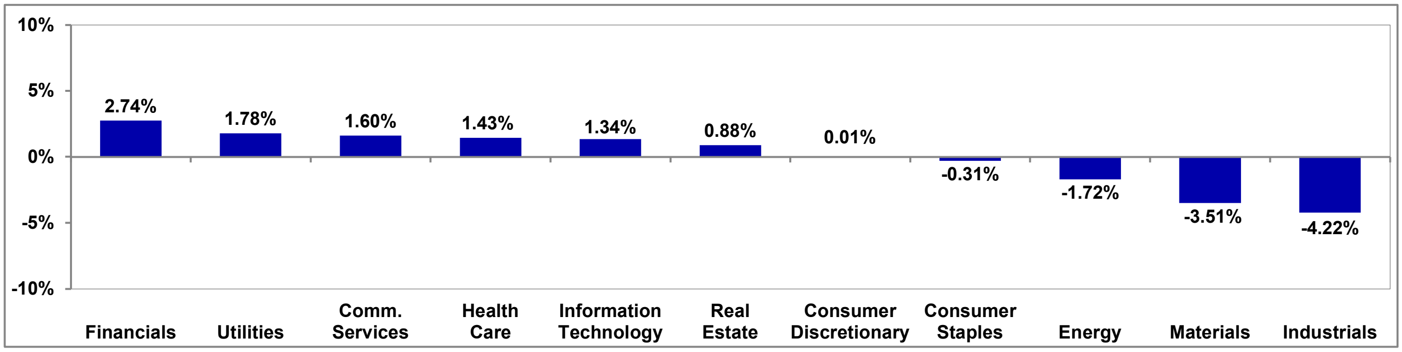
- Low interest rates are important to all aspects of the financial markets and inflation is the linchpin that investors need to watch closely. Based upon the Fed's favorite measure of prices, inflation is at a 30-year high. Another illustrative data point is that the cost-of-living adjustment for Social Security benefits could easily exceed 5% for 2022. In this environment, even Federal Reserve officials are less unified than normal regarding central bank policy.

- The rebound in earnings this year has been much more rapid than anyone could have imagined and raises questions regarding the sustainability of the operating leverage that has transformed the profitability of many companies during the pandemic. Operating margins hit a record of 13.6% in the second quarter. For perspective, margins are about 50% higher than the peak level in 2007 prior to the Great Financial Crisis.

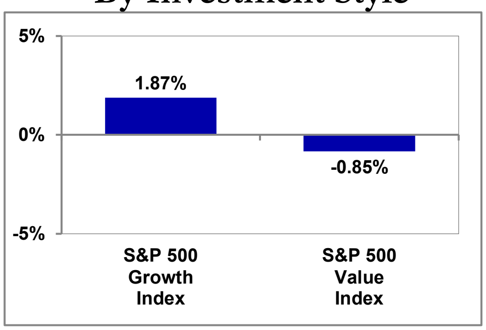
- Strong earnings growth has allowed valuations, which seemed high at the beginning of the year, to decline. Earnings forecasts for 2022 imply a P/E multiple of about 20x compared to 21.5x at the beginning of 2021. Modestly lower valuations are an encouraging sign for future returns.

Third Quarter Investment Performance (including income)

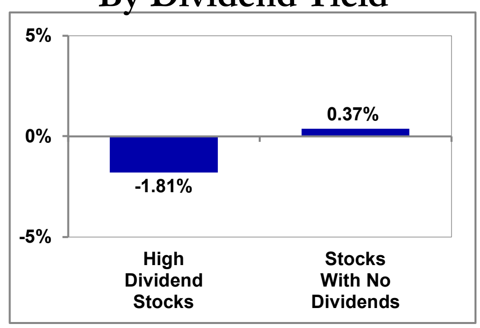
By Economic Sector



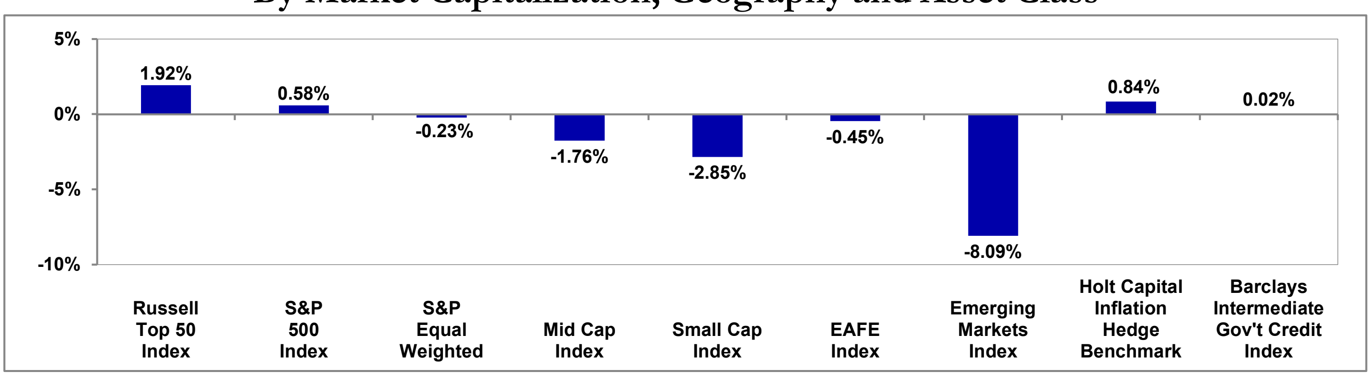
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



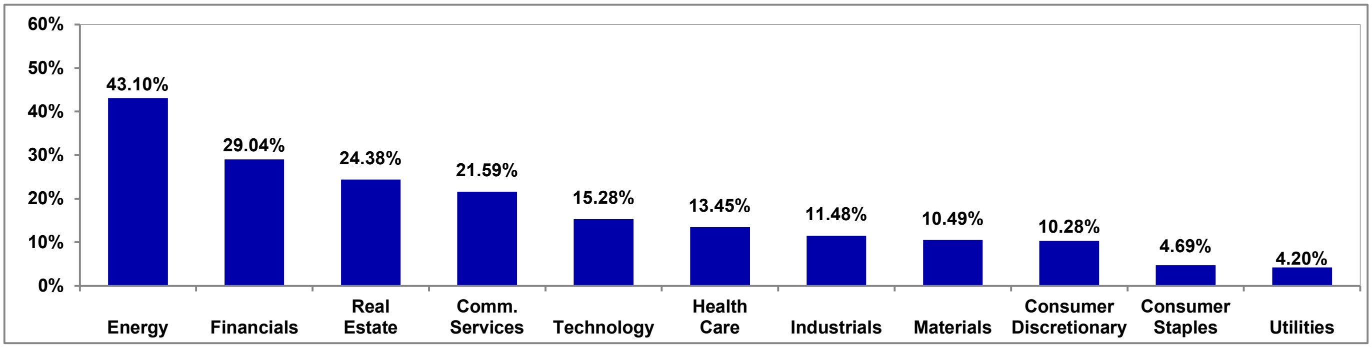
- Although most third quarter performance metrics appear subdued, each month experienced sharp but brief downdrafts related to Chinese policy shifts, the Delta variant of the Covid virus, and spiking inflationary data.

- Mega cap growth stocks provided leadership throughout most of the quarter until a rotation into defensive value names occurred in early September.

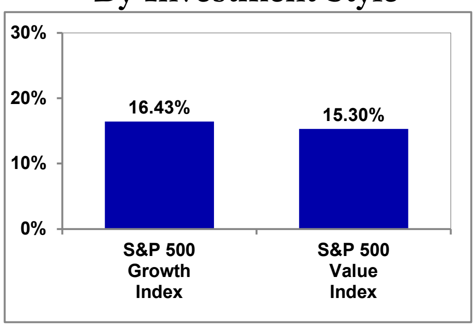
- Emerging market stocks were negatively impacted by shifts in Chinese policy toward wealthy citizens and financial distress surrounding property developer Evergrande.

Year-to-Date Investment Performance (including income)

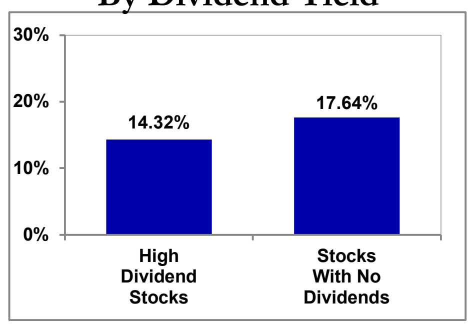
By Economic Sector



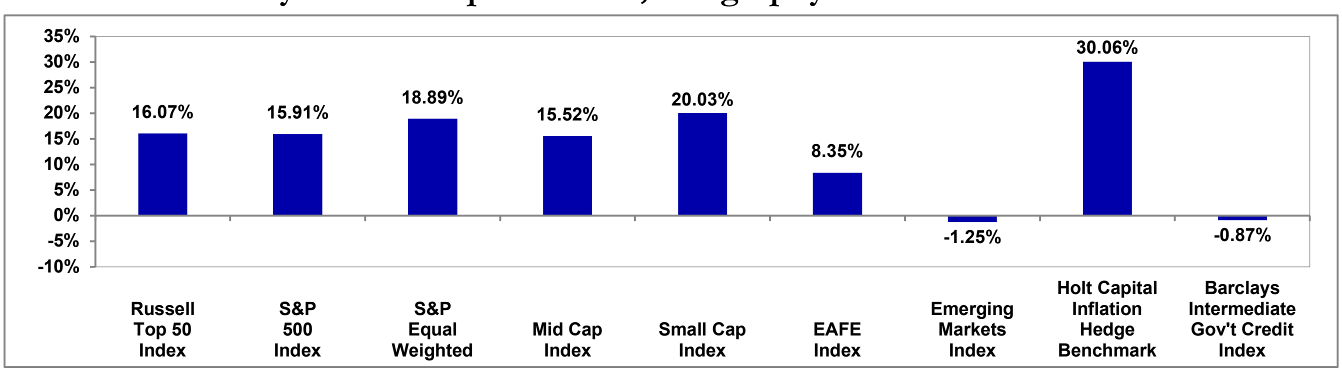
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- Returns for the year-to-date period have been driven by inflation beneficiaries, including energy, real estate, and financials. Unsurprisingly, intermediate bond returns were slightly negative in this environment.

- Most size-related segments of the market produced mid-teens returns. The strength in small cap stocks was concentrated in the first quarter.

- The health care and energy sectors, as well as small cap stocks, have the most favorable valuations compared to the past 20 years of historical data.