Holt Capital Partners, L.P.

Fourth Quarter Financial Market Commentary

"Ninety Days in Ninety Seconds"

December 31, 2023

A Surprising and Unpredictable Year

- One year ago, most economists were predicting a recession and the stock market had just experienced its worst year since 2008's Great Financial Crisis. As it turned out, there was no recession in 2023 but the year included many unexpected negative developments, including a regional banking crisis, an economic slowdown in China even after COVID re-opening, and the Israel-Hamas conflict.
- Despite widespread recession fears and geopolitical uncertainty, the U.S. economy finished 2023 with low employment, steady economic growth, and meaningfully slower inflation.
- Our view going into last year was that corporate profit growth would allow stocks to move irregularly higher in 2023 and outperform other asset classes. Our expectation for a mid-to-high single digit return was significantly ahead of the consensus, but still proved to be too low.

The Never-Ending Cycle of Fear and Greed

- Stock market valuations are an important guidepost for long-term investors. However, valuations are not a market timing tool. Instead, the pendulum of investor sentiment swinging between fear and greed is the major driver of short-term returns.
- The combination of soft inflation data and Federal Reserve commentary about an upcoming pivot to lower interest rates flipped sentiment from fearful in the third quarter to greedy in the fourth quarter. Given the broad rallies in both the stock and bond markets, some commentators have referred to the past couple of months as the "everything rally."
- The rally in the bond market was driven by increasing conviction among investors that the Fed is finished raising rates and that the new year will see a series of rate cuts. Ten-year government bond yields staged a major rally that dropped yields from 5.00% in October to 3.86% at year-end.

The Consensus is a Comfortable But Dangerous Place

- The consensus view among investors is that the Fed will cut rates as many as four times, which will allow the economy to avoid a recession. In that scenario, earnings growth should accelerate, and the labor market should remain robust. That is not an unreasonable forecast, but it is a view that is much too commonly held. The age-old adage that the financial markets will move in a direction that proves the largest number of people wrong is worth noting.
- The new year will present investors with a range of uncertainties. From an economic perspective, inflation will remain the major focal point. Further progress on inflation will be necessary for bond yields to continue to drop. Geopolitical events are multiplying, but the markets do not seem to care. Although we remain confident regarding earnings growth, recent disappointing earnings reports from Nike, General Mills, Adobe, and Oracle are concerning.
- Even though the yield curve continues to be inverted, the biggest surprise would be the emergence of a recession in 2023. The past eight occurrences of inverted curves have all been followed by recessions, so the consensus believes this time will be different. Additionally, the impact of monetary policy is classically described as having long and variable lags. The lagged effect of the Fed's seemingly successful, but aggressive, tight policy stance remains to be seen.

Inflation and the Federal Reserve

- Chairman Powell and the Federal Reserve deserve high marks for their success in slowing inflation over the past year without causing a recession. While it is too early to declare victory, further progress on reported inflation data is highly likely as declining housing costs and rents have a lagged impact on CPI data.
- Last year saw a new more complex measure of inflation, referred to as "supercore," become one of the Fed's preferred inflation metrics. Supercore inflation measures the cost of core services, excluding housing. Services prices are rising as consumers shift from purchasing goods to experiences and services. In addition, the price of services often includes a high labor component and Fed policy wants to avoid wage inflation becoming embedded in the economy.

A Presidential Election That is Without Precedent

- All aspects of the upcoming presidential election are fraught with uncertainty. Most polls reflect voter discomfort with a choice between the two frontrunners. President Biden's age is widely viewed as a negative, as are the indictments that Trump is facing. It is worth recalling that Lyndon Johnson did not withdraw from the 1968 presidential election until March 31st of that year. Presidential primaries, political pressures, as well as potential health and legal issues, could change the calculus of this year's election. While this is not a high probability outcome, it is worth contemplating.

Artificial Intelligence, Banking Turmoil, Commercial Real Estate, and Labor Gains

- This past year will be remembered for the emergence of AI and the "Magnificent Seven" (Apple, Microsoft, NVIDIA, Google, Amazon, Meta, and Tesla), but it was so much more. After the Fed hiked short term rates at the fastest pace in 40 years, three bank failures threatened to derail the economy during the spring. Quick action by policy makers avoided contagion and the banking crisis was short-lived.
- Losses in commercial real estate have been widely reported, but the seeds of those losses were planted years ago with high purchase prices for long term assets that were financed with short term debt. Two recent stories have cited prominent Los Angeles office properties that were sold at roughly 50% below their previous transaction prices. The more important story is that this is part of the market clearing process. The opportunity for investors to acquire well-located assets at discounted prices is often a formula for significant long-term returns.
- It was a historic year for labor. Wage and benefit hikes for auto workers, pilots, UPS workers, and actors reflect a major power shift toward unions. Isolated attempts at organizing have also been seen at Starbucks, Amazon, and Wells Fargo. While profit margin expansion has outpaced labor costs for over a decade, these recent victories could complicate the willingness of the Fed to ease policy as much as the markets expect and could also exert pressure on corporate profits.

Conclusion

- The Fed appears to have engineered a proverbial soft landing for the economy. A historical precedent could be the period of the mid-90s in which the Greenspan Fed began cutting rates and spurred a golden era for both Wall Street and Main Street. It was then that the term "Goldilocks" was first used to describe the "not too hot, not too cold" economy. However, the current period is different and arguably more complex.
- As tempting as it is to cite macroeconomic drivers for the stock market, it is earnings, valuations, and interest rates that are usually the critical variables. We expect earnings to rise steadily in 2024 and valuations for the average stock are reasonable compared to history. Interest rates will be the wild card and the biggest risk is that bond investors have pushed rates down too far and too fast. A return to a more hawkish policy stance by the Fed would certainly be a negative surprise.
- Since the Fed began to embrace lower policy rates in late 2023, participation in the market rally has broadened to include value stocks, mid cap stocks, small caps, and quality dividend payors. We believe that this trend will continue in the new year.

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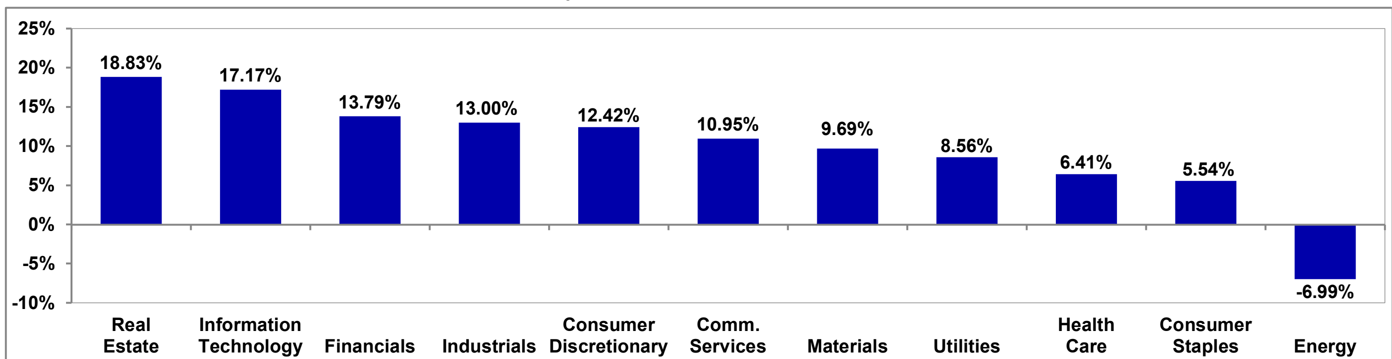
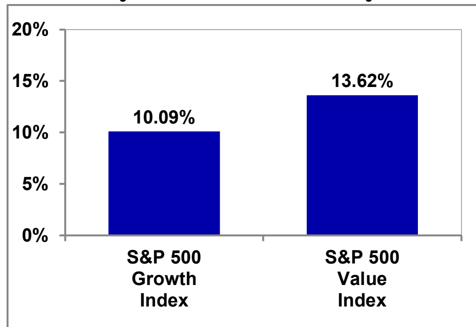
Fourth Quarter Investment Performance (including income)

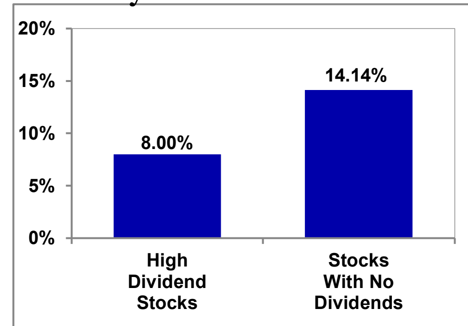
By Economic Sector



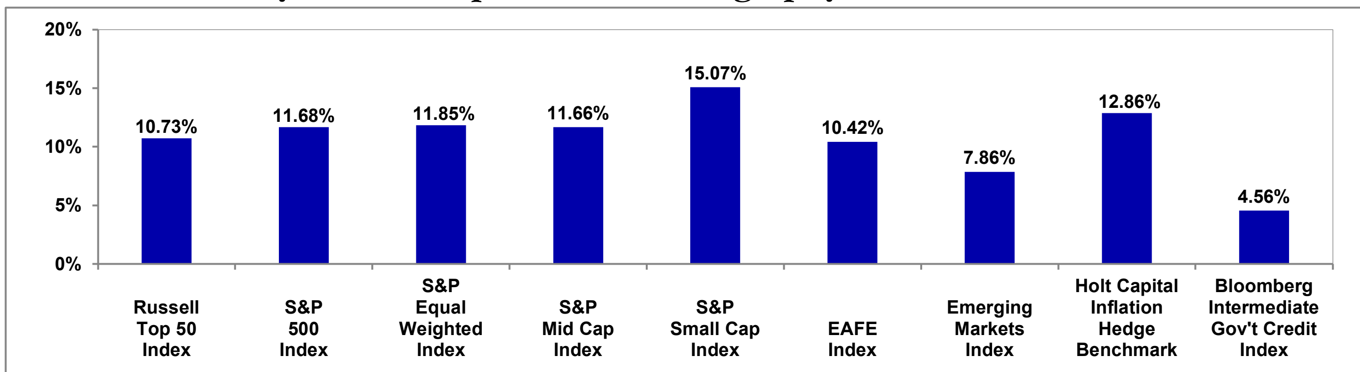
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- The fourth quarter saw a broadening of the stock market rally. Unlike the first three quarters of the year, most size cohorts produced similar results with small caps posting the highest return.
- The real estate sector was a big beneficiary of falling interest rates. The only sector to decline in price was energy, which fell along with crude oil and natural gas prices.
- Bond yields fell dramatically, which drove returns for the government/corporate bond index to the best quarter since the fourth quarter of 2008. Within the fixed income market, the high yield segment was the best performer, followed by investment grade corporates, with price gains for government issues lagging other bond categories.

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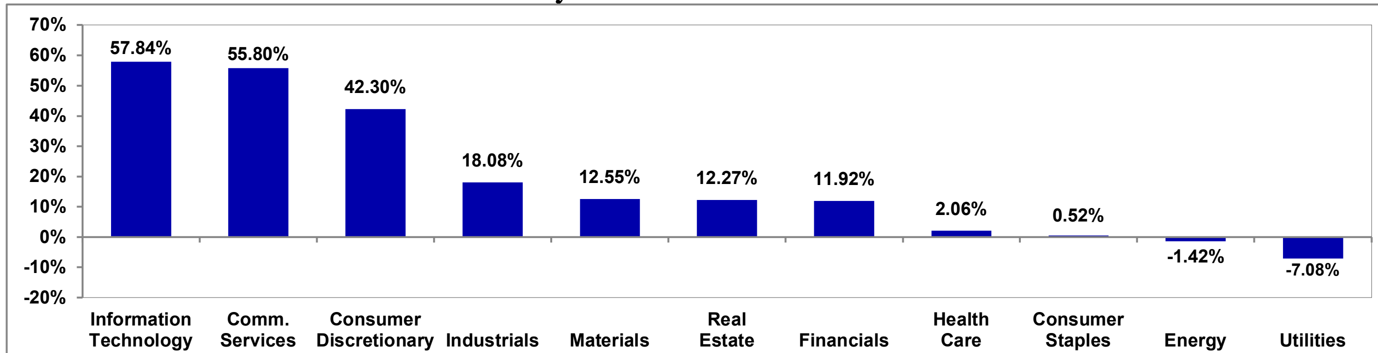
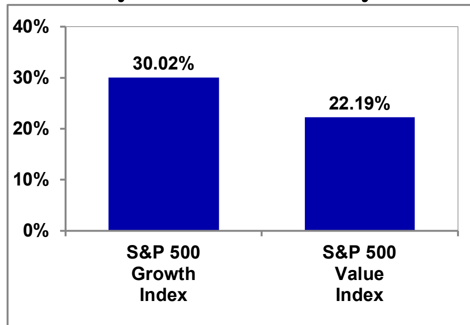
2023 Investment Performance (including income)

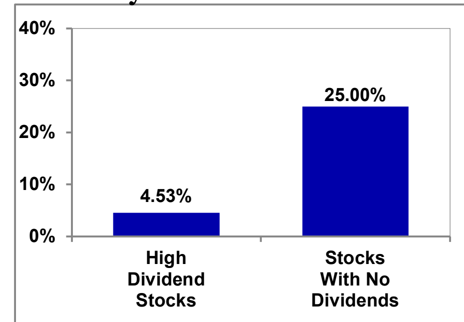
By Economic Sector



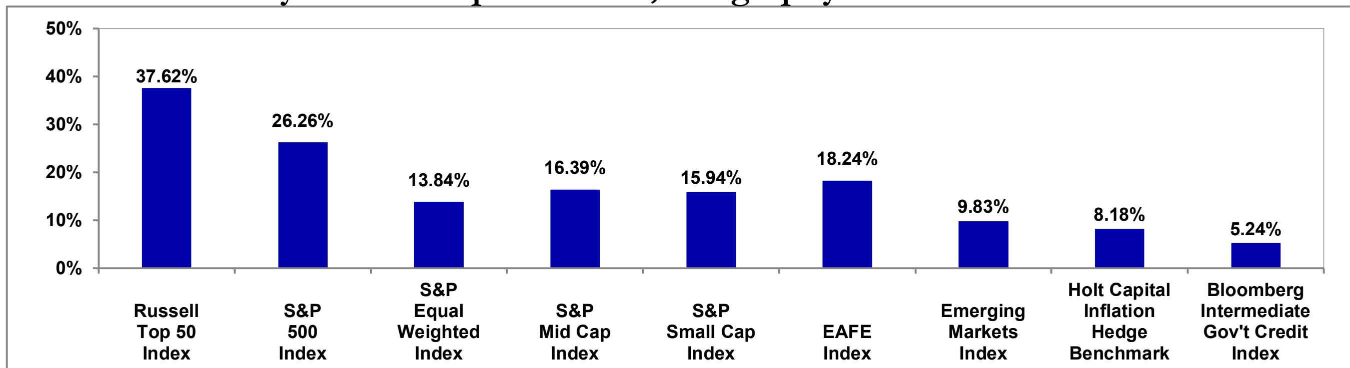
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- The past two years were mirror images in many ways. The market darlings of 2023 (technology, communication services, and consumer discretionary) were the three worst performing sectors in 2022. Amazingly, when performance is evaluated on a combined two year basis, the communications and consumer discretionary sectors posted negative returns and underperformed the S&P 500 Index.

- On the flip side, this year's worst sectors (utilities, energy, and consumer staples) were last year's best performing sectors. Over the past two years, two of these sectors also posted negative returns. This lack of consistency below the market's surface presented a challenging environment for all investors.

- During 2023 the market rewarded risk taking. Stocks with high price-to-earnings ratios outperformed more conservative companies. This trend is visible in the dividend yield chart on this page. High quality companies with above average dividend yields achieved a total return of 4.53% in 2023 compared to those with no yield that produced a return of 25.00%.