Holt Capital
Partners, L.P.

First Quarter Financial Market Commentary

"Ninety Days in Ninety Seconds"

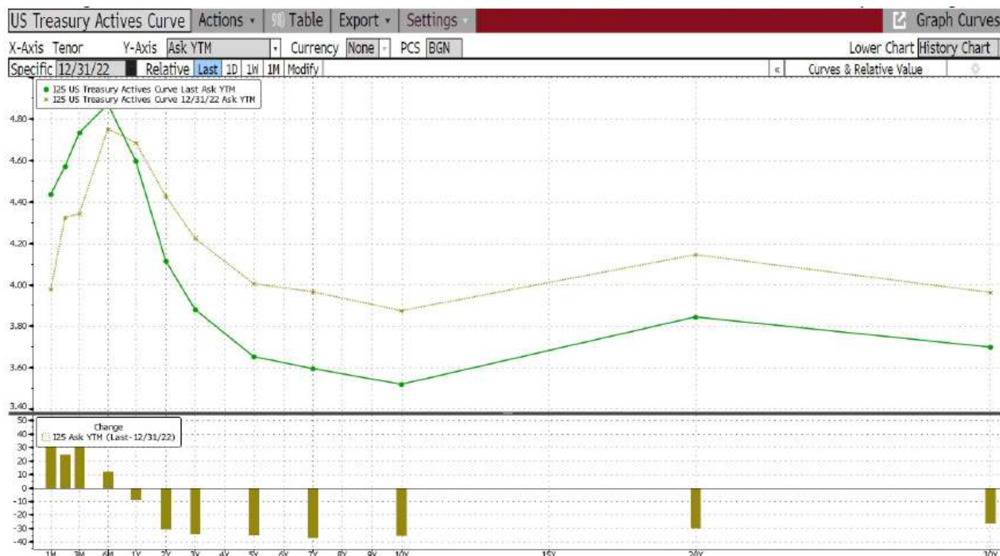
Stocks Rally Amid Disconcerting News

- Most of the financial news during the first quarter was bad. Bank failures, two rate hikes by the Federal Reserve, and rising fears of recession all generated investor angst. However, the health of the consumer remains solid, the labor market is robust, and inflation is slowly declining. These uncomfortably diverse economic signals characterize the current economic environment. While day-to-day market volatility can be seen as troubling, the stock market was able to climb the proverbial "wall of worry" during the first quarter.

Conflicting and Unresolved Signals in Three Graphs

- The Federal Reserve continues to raise short term interest rates and articulates an "overarching focus" on bringing inflation down to its 2% goal. Bond market investors see the future differently and have driven yields lower in expectation that the Fed's tightening cycle is over. This appears to be the financial market version of the game of "chicken!" The evolving banking crisis further complicates Fed policy and increases the likelihood of a recession. The following graphs, and associated commentary, highlight the changes that the economy has endured in the first quarter.

- Bond market investors pushed yields sharply lower in March, effectively betting that rate hikes by the Fed are over and that a recession is likely. Conversely, the Fed is focused on stubbornly high inflation and a tight job market. The Fed's "dot plots" of rate expectations by the members of the FOMC forecast at least one more rate hike and a very slow decline in rates during 2024. The yield curve plots government bond yields at various maturities from 3 months to 30 years. As depicted below, yields collapsed during the quarter. In addition, the spread between 3 month and 10-year yields, which has historically been a reliable predictor of recessions, is currently more negative than it has been in 50 years. Clearly, the bond market is forecasting a different future than either the Fed or stock market investors.



Conflicting and Unresolved Signals in Three Graphs (continued)

- We are now in the age of Twitter-driven bank runs as investor panic and smartphone banking apps overwhelmed traditional regulatory backstops. The likely result of this crisis of confidence is tighter regulations, deposit outflows, upward pressure on deposit pricing, downward pressure on bank profitability, and more cautious lending policies that could lead to a credit crisis. Investors sold bank stocks aggressively in March and created a negative feedback loop among depositors. The S&P 500 bank index fell about 20% since the beginning of the crisis. The panic around banks may be overblown, but evolving fundamental challenges are likely to create long term industry headwinds.

- The demise of Silicon Valley Bank could have long term negative repercussions on venture capital investments in unprofitable growth companies and the so-called "innovation economy." However, many mega-cap technology companies have recently pivoted their business models from a primary focus on revenue growth to a mindset of cost discipline and higher profitability. This strategic shift has resulted in the technology sector flipping from one of last year's biggest losers to the best performer in the first quarter. With their strong cash positions and broad operational moats, investors have ironically begun to view highly valued tech stocks as a safe haven amidst the banking crisis.

Heightened Price Dispersion and Narrow Leadership

- Market leadership refers to the breadth of an advance or decline. Broad leadership, with most stocks moving in the same direction, is generally considered a measure of the durability of investor conviction. Although the S&P 500 rose during the quarter, leadership was very narrow. Of the ten largest weights in the index, eight rose in price. These gains ranged from 17% to an amazing 90% and these stocks collectively represent 25% of the index. This is in stark contrast with the 73 index constituents that fell between 10% and 88%. This narrow leadership created a mathematically difficult quarter for broadly diversified portfolios.

Earnings - A Lost Year of Growth?

- S&P 500 Index earnings were $222 in 2022 and the consensus for 2023 was about $240 as recently as last summer. Today, earnings estimates are about $224 for this year and about $247 for 2024. Effectively, corporations have "lost" a year of earnings growth amid recession fears, continuing supply chain issues, rising labor costs, and higher interest rates.

- Rather than view these facts as negative or surprising, these are known factors that are already reflected in the rise in stock prices since June of last year. A meaningful decline from current levels would require "new" news that negatively impacts earnings expectations beyond the current roster of fears.

S&P 500 Index Trivia

- In order for the index constituents to better represent their respective economic sectors, Standard & Poor's implemented a major index rebalancing in March. Fourteen companies with a combined market value of $1.4 trillion changed sectors. The biggest impacts were the shift of Visa and Mastercard from Technology to Financials and the movement of Target from Consumer Discretionary to Consumer Staples. The net result of these changes is the Technology and Discretionary weightings within the index will fall slightly while Financials and Staples will rise.

Conclusion

- A recent survey of CFOs by a major accounting firm revealed that most CFOs are *focused* on a recession but *planning* for a recovery. That is an appropriate description of our outlook. A tight labor market and strong consumer spending, especially on services, are not signs of economic weakness. However, the negative implications of the banking crisis are likely to be far reaching and increase the odds of a recession.

- Irrespective of the macroeconomic headwinds of the first quarter, our outlook remains largely unchanged and therefore the last paragraph of our conclusion from three months ago bears repeating. Stock prices will remain volatile. By year-end, we believe that stock prices should have moved irregularly higher, supported by expectations of corporate profit growth in 2024. A mid-to-high single digit return from stocks should outperform most other asset classes.

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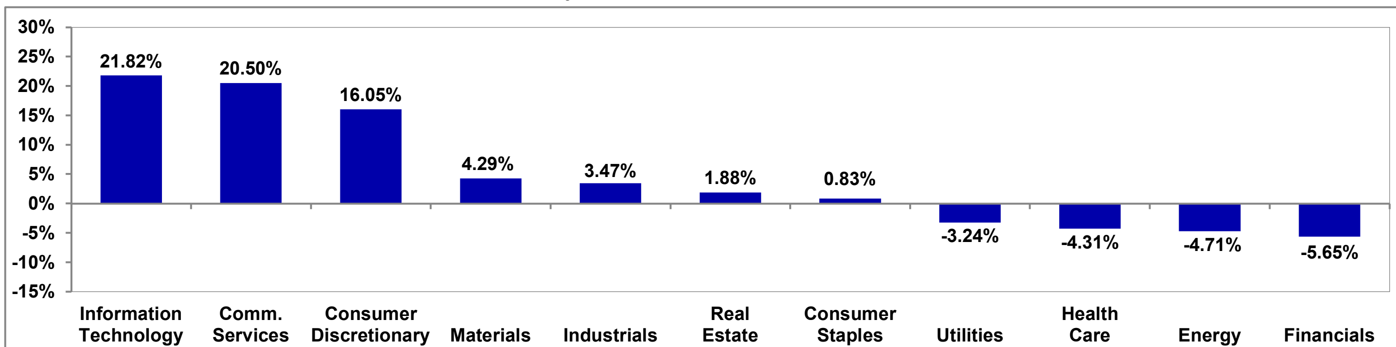
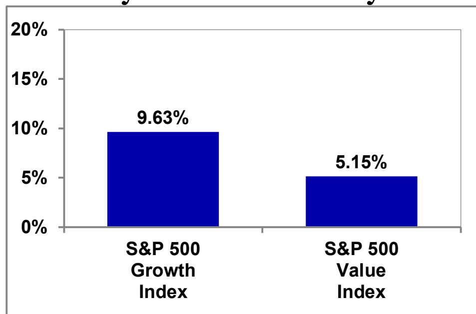
First Quarter Investment Performance (including income)

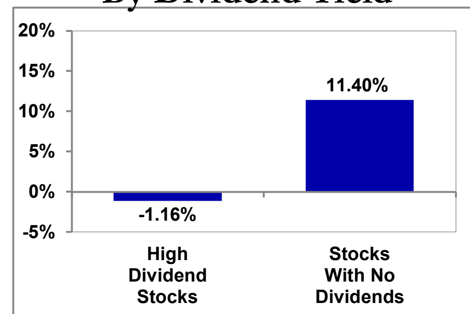
By Economic Sector



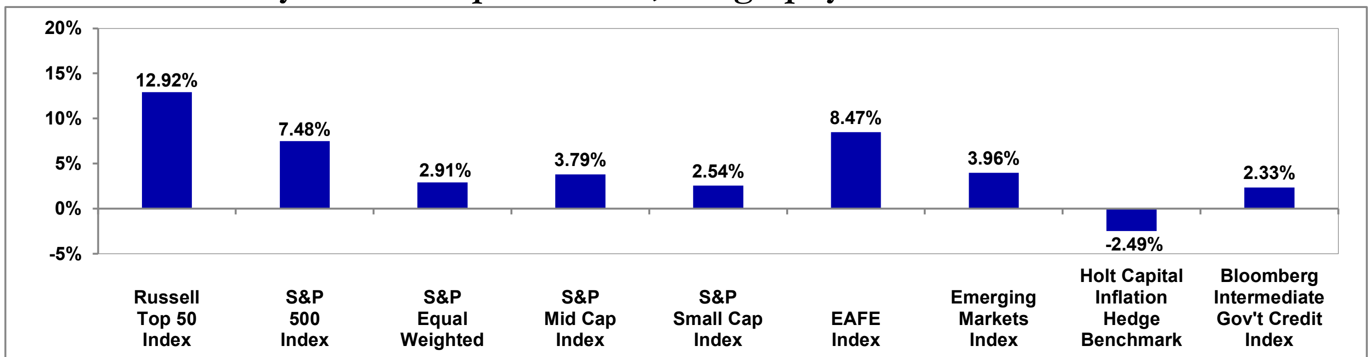
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- The first quarter marked a huge rebound for mega-cap growth stocks. This was not only evident in the Technology and Communications sectors, but also in Consumer Discretionary where the weightings of Tesla and Amazon comprise about 40% of the sector.
- In this "risk-on" environment, high quality dividend paying stocks lagged. The comparison of dividend stocks and non-dividend payors is a dramatic reversal of last year's experience. It also highlights the internal divergencies in first quarter performance.
- With the exception of the first quarter of the pandemic, mega-cap stocks have not outperformed small caps by such a wide margin in the 25 year history of the data.
- Fixed income returns rebounded from last year’s historically poor results. Yields on government bonds fell by over 40 basis points across most intermediate maturities.