HOLT CAPITAL
PARTNERS, L.P.

THIRD QUARTER FINANCIAL MARKET COMMENTARY

"NINETY DAYS IN NINETY SECONDS"

SEPTEMBER 30, 2022

WHERE WE STAND

- The domestic financial markets have been primarily focused on the impact of Federal Reserve policy on the economy. Our market commentary offers a series of vignettes about the interaction of policy, growth, and inflation. We believe that the most likely scenario is that the Fed continues to tighten policy, but less aggressively than the current consensus. Economic growth will slow next year, but the decline in activity should be mild. In our view, inflation is likely to fall into the low single digits, but probably won't hit the Fed's 2% target in the near term.

- This view does not minimize the numerous unnerving risks present throughout the globe, ranging from inflation to recession and geopolitical conflict. These are all significant points of concern and may represent tail risks (see page 2) or simply the proverbial "wall of worry."

REVISITING THE "R" WORD

- Last quarter we wrote that economic conditions were not consistent with an imminent recession. Given the continuing strength in the labor market and strong end-market demand, that assessment proved to be correct. However, two factors have changed over the past quarter. Inflation has meaningfully exceeded the expectations of virtually every forecaster. In response, the Federal Reserve Chairman has repeatedly stressed the committee's resolve in bringing down inflation and acknowledged that goal may result in "some pain ahead." That phrase has been interpreted as Fed-speak for a willingness to tolerate a recession in order to achieve the objective of lowering inflation.

- We have often written about the potential risk of a policy mistake by the Federal Reserve. We are currently living through the repercussions of last year's policy failures. At this point, an economic slowdown appears likely in 2023. Investor fears around a recession are pervasive and could become a self-fulfilling prophecy, irrespective of Fed policy decisions. Even Chairman Powell admits that the depth, breadth, and duration of the slowdown are unknowable at this time.

POWELL'S VOLCKER MOMENT

- Former Fed Chairman Alan Greenspan was notorious over his nineteen year tenure for speaking in a manner that was hard to interpret. He famously acknowledged his ambiguous style by stating "If I seem unduly clear to you, then you must have misunderstood what I said."

- Chairman Powell is much clearer in his statements to the press, but sometimes historical context is important. Greenspan's predecessor was Paul Volcker, who is so highly admired that he is known as "Saint Paul" inside the Fed. Powell channeled his inner Paul Volcker by referring to his resolve to fight inflation as "we will keep at it" twice during his Jackson Hole speech in August. That phrase is almost identical to the title of Volcker's biography, Keeping At It.

- Powell's forceful vow to "keep at it" could also be seen as a rallying cry for global monetary restraint. The historical precedent for such a catchphrase was Mario Draghi's willingness to "do whatever it takes" to resolve the European debt crisis in 2012. Draghi's phrase came to represent the commitment of central bankers around the globe to stimulative economic policies for a number of years.

Mixed Signals

- Labor markets continue to be very robust. Many capital goods and technology companies, as well as higher-end consumer businesses, are experiencing strong end-market demand. Although these data points are not necessarily considered leading indicators, neither are they characteristic of a recession.

- Offsetting these positives are cyclical and interest rate-sensitive industries that are experiencing slowing growth in revenues or orders. Credit markets also reflect a slowing economy and are requiring much higher yields for lower rated borrowers.

- These factors present a complicated economic landscape for the Fed to navigate. The speed at which the economy reacts to new data also makes forecasting difficult. The very recent collapse in oil, natural gas, cotton, and lumber prices, as well as the softening in housing prices, could lead to a faster decline in inflation than is currently expected by the Fed or investors. These volatile real time data points are in contrast with monetary policy which operates with long and variable lags, typically ranging from twelve to eighteen months.

Tail Risk

- Tail risk is the chance of a loss occurring as a result of an event that is highly unlikely based on a probability distribution. Geopolitics, monetary policy, and company-specific issues all represent sources of low probability events that could roil the financial markets. By definition, tail risks are unlikely. We believe that low valuations, cautious positioning by hedge funds, and bearish investor psychology reduce the intermediate and long-term price risk of unexpected negative events.

Contrarian Observations

- The financial media is treating the economic and interest rate projections of the Federal Reserve members as immutable truths. However, the massive revisions that have occurred in the so-called "dot plots" of the Federal Open Market Committee this year are a testament to the difficulty of economic forecasting. The old adage about forecasting seems appropriate: "If you are going to forecast, forecast often."

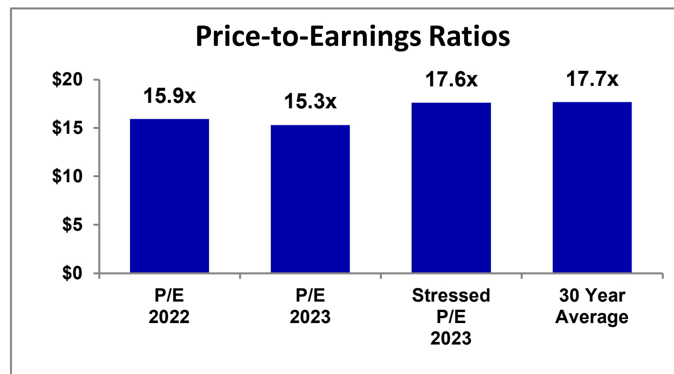
- It is probably worthwhile to consider various alternative economic outcomes. Very recent data reflects an accelerating housing recession, intensifying negative wealth effects, policy-induced demand destruction, and early signs of disinflation in commodity prices. Some or all of these factors could gather momentum and result in restrained inflation data and smaller than expected interest rate hikes at the Fed meetings in either November or December.

- A recession is largely determined by changes in a country's Gross Domestic Product (GDP). Stocks are valued based upon earnings growth, which is correlated with GDP, but not identical. Companies will report third quarter earnings over the next several weeks. Management statements often provide information that is more timely and insightful than government data. Well managed companies have historically been able to successfully navigate around temporary economic obstacles.

EARNINGS AND VALUATION

- Earnings estimates for 2022 have remained stable, while 2023 estimates have drifted modestly lower. During volatile market or economic conditions, consensus earnings estimates can become lagging indicators and need to be viewed with some skepticism.

- The price/earnings ratios in the graph below reflect consensus earnings estimates for both 2022 and 2023. The third column reflects a stress test that assumes earnings fall 10% in 2023. Valuations are historically attractive, even if earnings decline next year.



Valuations are not expensive relative to history.

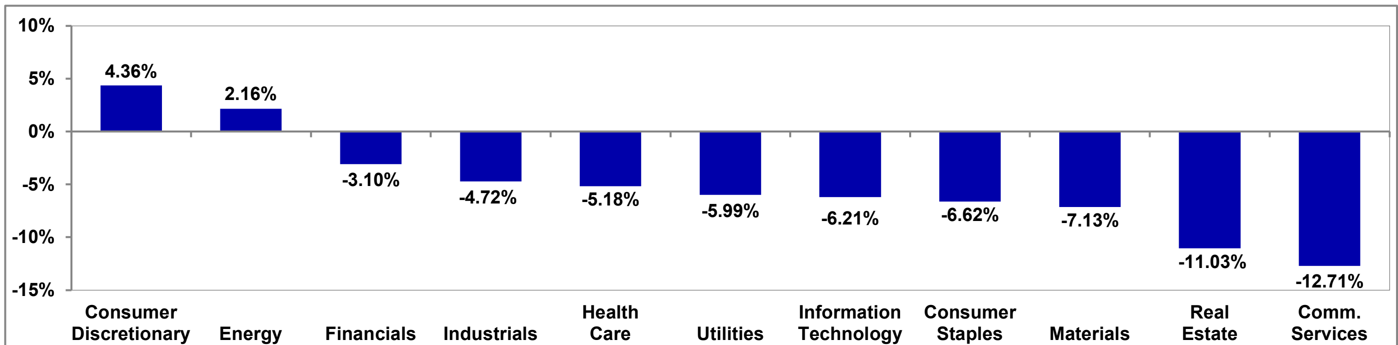
CONCLUSION

- Volatility in the financial markets is unsettling. Even more than usual, the future direction of stock prices will be a function of the extent to which markets have properly priced in today's myriad of risks.

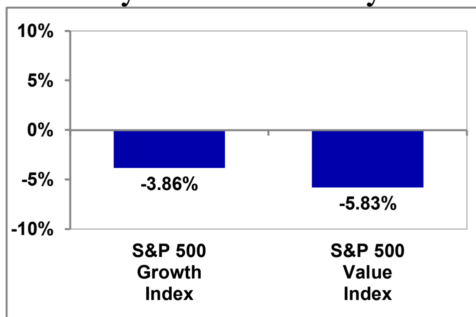
- In spite of the downward trend of stock prices over the last half of the third quarter, most indexes are only modestly lower since mid year. Likewise, our outlook remains unchanged. Valuations are historically attractive. Consumer and corporate balance sheets are strong, dividend growth is accelerating, and numerous speculative bubbles have been popped. We believe that the risk/reward looks favorable over the next several quarters.

Third Quarter Investment Performance (including income)

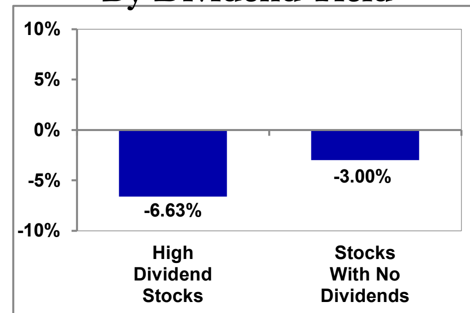
By Economic Sector



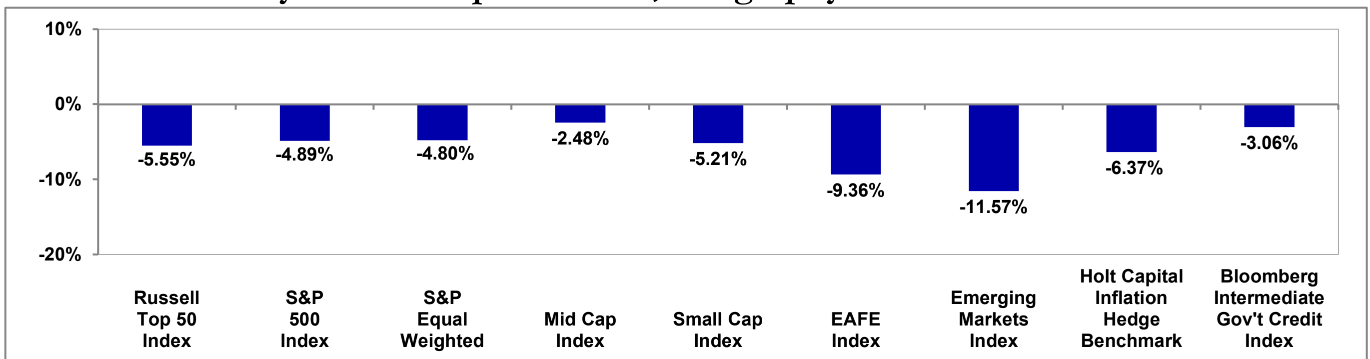
By Investment Style



By Dividend Yield



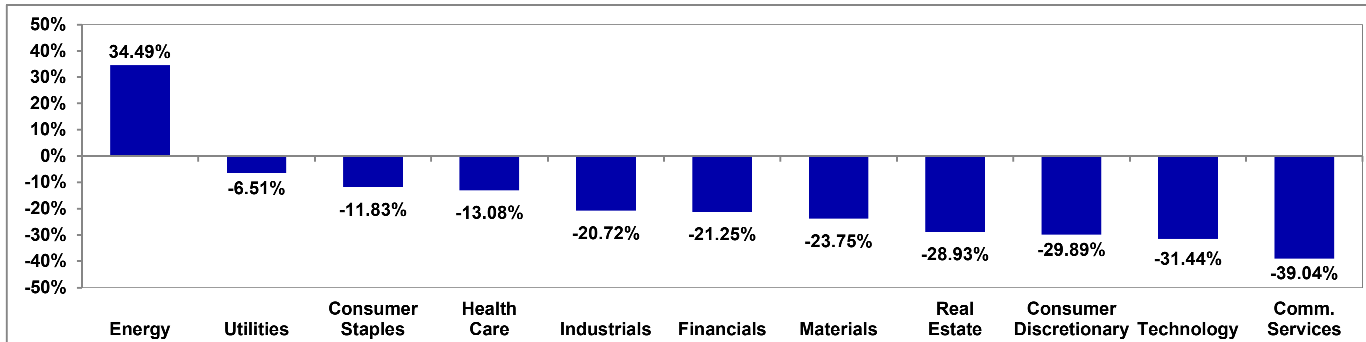
By Market Capitalization, Geography and Asset Class



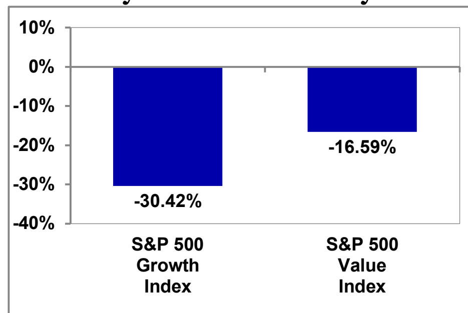
- Stocks and bonds fell for the third consecutive quarter. This is the longest streak of negative performance for both asset classes in almost 50 years.
- Growth stocks declined less than value stocks during the quarter, but there were very few pockets of the market that did not fall.
- International equities were negatively impacted by the strong dollar, Covid lockdowns in China, energy concerns in Europe, and confusion regarding economic policy in the U.K.
- Bond yields rose across the maturity spectrum. The yield on two year government bonds rose 132 basis points, while ten year yields rose 82 basis points.

Year-to-Date Investment Performance (including income)

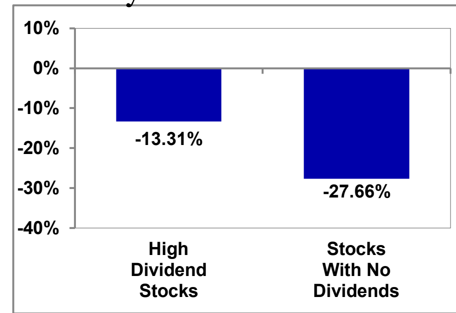
By Economic Sector



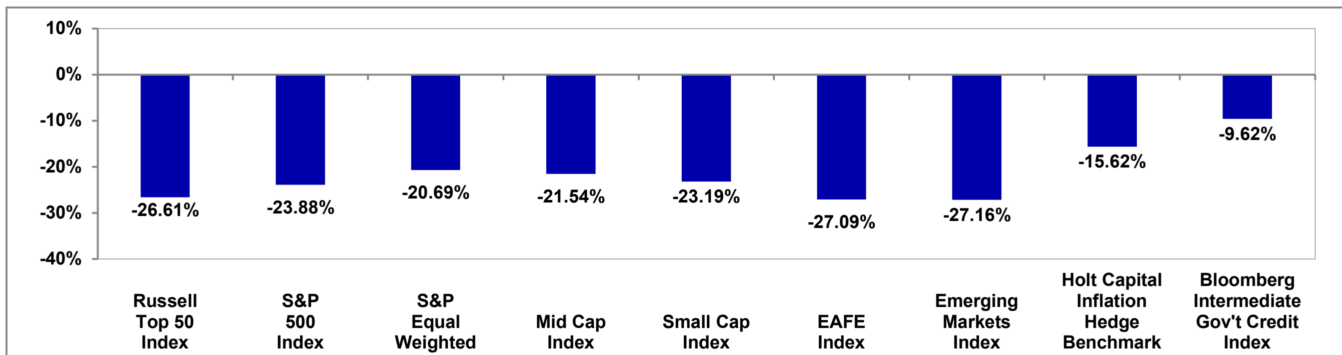
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- Corporate earnings have been resilient, but the stock market has experienced massive downward pressure on price-to-earnings multiples. Over the past nine months P/E multiples have fallen from 21x earnings at year-end to about 16x at September 30th.
- Energy stocks traded higher along with crude oil and natural gas prices. Growth-oriented sectors struggled as a result of higher interest rates compressing valuations.
- Defensive stocks tended to maintain value better than more economically-sensitive issues or long duration growth companies, but negative returns were pervasive.
- The fixed income bear market is among the worst on record. It is similar in magnitude to the bear markets that followed World War I and World War II.