Holt Capital
Partners, L.P.

Third Quarter Financial Market Commentary

"Ninety Days in Ninety Seconds"

September 30, 2023

The Fed's Rate Hikes are Starting to Bite

- For most of the past year, bond market investors have been in denial. Market sentiment has been focused on when the Fed would begin *cutting* interest rates. Therefore, the increases in short-term rates by the Fed were not fully reflected in longer term rates. That denial was one factor that created the sharply inverted yield curve.
- During the third quarter the bond market began to reflect the "higher for longer" mantra of several Federal Reserve governors. The yield on ten-year bonds rose by 73 basis points in the third quarter to 4.57%, its highest level since 2007. This is important because ten-year government bonds are a key benchmark for corporate bonds, mortgages, and bank lending. The impact of higher yields will begin to spread across the real economy over the next several quarters. This will be especially true for businesses and consumers with weaker credit profiles.
- In the aftermath of the Great Financial Crisis, the Fed pushed rates to near zero and effectively maintained that level for 14 years. This exceeds the memories of many investors, as well as the careers of a generation of professional investors. However, the average yield on ten-year bonds has been 3.84% over the past thirty years and 5.05% over the past forty years. In a historical context, the current 4.57% yield on ten year bonds is not extreme, but actually rather normal!

Conundrums

- Former Federal Reserve Chairman Alan Greenspan brought this word into the financial lexicon in 2005 when he responded to a question about the relationship between short-term and long-term interest rates by describing it as a "conundrum." Today's financial markets are full of conundrums, or confusing and unexplainable relationships.
- The Fed has raised rates by an almost unprecedented 525 basis points over the past eighteen months with little noticeable impact on the economy. A conundrum.
- The seven largest mega-cap stocks are as expensive as they have been since the dot-com bubble, yet sentiment can best be described with those dangerous five words "it is different this time." The other 493 stocks in the S&P 500 Index are valued at levels consistent with prior market lows. Good companies trading at modest valuations and yet still unloved. Another conundrum.
- Even more extreme is the low valuation of small and mid-cap stocks. Price to earnings ratios for this segment of the market peaked at a price-to-earnings ratio of 21x in 2002 and now trade at a P/E of 12x. Current valuation levels are similar to the lows of the past 25 years and those low points typically provided excellent entry points for above average long-term returns.

MEGA-CAP OR NOT?

- With the exception of 2022, one could assume that mega-cap growth stocks should simply be viewed as consistent winners. That would be a mistaken conclusion.
- The Russell Top 50 Index began on January 1, 1999. During the ensuing 25 years, mega-caps outperformed the S&P 500 Equal Weighted Index in 12 periods and underperformed that index in 13 periods. The cumulative returns are even more striking with significant underperformance compared to large, mid, and small cap indexes. The historical data is presented in the graph below.

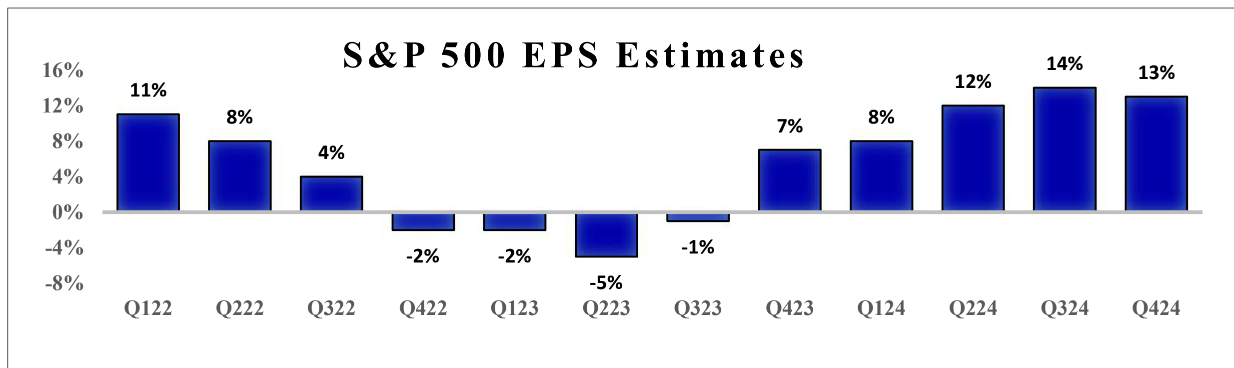
RTOP50 Index | Settings | Comparative Returns
Range 12/31/1998 - 09/29/2023 Period Daily No. of Period 9038 Day(s) Table

	Security	Currency	Price Change	Total Return	Difference	Annual Eq
1)	RTOP50 Index	USD	170.47%	315.34%	-137.52%	5.92%
2)	SPX Index	USD	248.84%	452.87%	--	7.15%
3)	SPXEWI Index	USD	453.45%	619.22%	166.35%	8.29%
4)	MID Index	USD	537.79%	801.65%	348.78%	9.29%
5)	SML Index	USD	549.11%	764.80%	311.93%	9.10%
6)						

- This history is not meant to minimize the dramatic performance differential that has occurred thus far in 2023, but it is an aberration. The year-to-date performance advantage of the top 50 stocks compared to the average stock in the S&P 500 is almost twice as wide as any prior year in 24 calendar years of data.
- This environment has created a difficult period for all active managers. The seven biggest stocks in the index rallied an average of 87% each, while the average return of the other 493 stocks was slightly below zero. Stocks are often subject to the statistical phenomenon of reversion to the mean. This would appear to be the perfect setup for a major rebound by the "Forgotten 493."

Earnings: The Quarterly Progression is Set to Improve

- Stocks have experienced an "earnings recession" over the past three quarters with negative year-over-year growth rates. That streak is likely to end with third quarter results and should be followed by accelerating growth throughout 2024. The bar graph below illustrates the recent pattern of earnings growth and our expectations for the next several quarters.
- While revenue growth has been positive over the past three quarters, the decline in earnings has largely been the result of lower profit margins. Growth has also been negatively impacted by weak energy sector earnings which were driven lower by the decline in crude prices over the twelve months ending in June.



Crude Oil

- Oil prices surged in the third quarter after OPEC+ extended its 1 million barrels per day production cut through year-end. The risk to the oil market is that artificially constrained supply cuts can easily be reversed and global demand, particularly from China, remains weak. Higher oil prices, higher interest rates, and a strong dollar all act to put a cap on crude oil demand and prices. The combination of these items probably leaves crude prices rangebound over the near term.

Conclusion

- The financial markets are having to digest more conflicting data points than normal. The positive factors have not changed much. The consumer is still strong, the labor market is tight, and corporate revenues, profit margins, and earnings are on an upward trajectory.
- The rising yield on ten-year bonds represents an increasing concern for economic and profit growth in 2024. Also reflecting a tightening of financial conditions is the sharp rise in real yields, which represent bond yields minus the rate of inflation. Additional cautionary factors include a dysfunctional political class, labor strikes, and trade issues.
- The fact that the average stock has not participated in the year-to-date market rally, combined with expectations for earnings growth in 2024, results in valuations that are more attractive than they were at the end of last year. Low valuations and solid fundamentals are ingredients for a rally. While short term volatility could continue, we are optimistic regarding the next several quarters.

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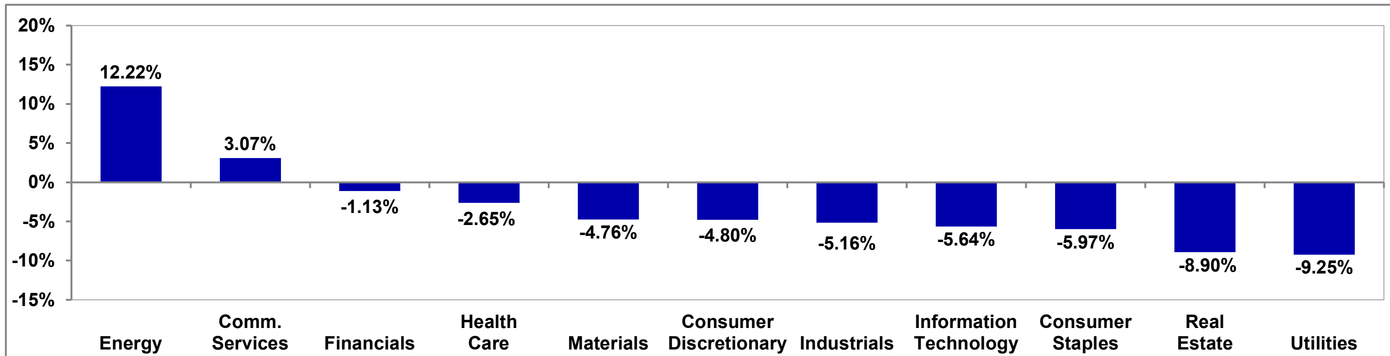
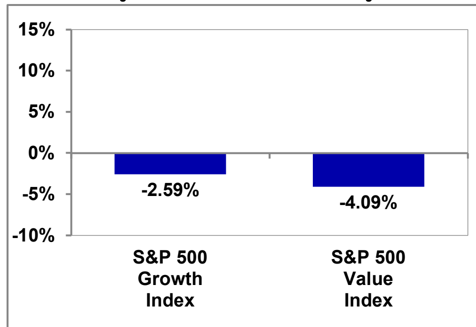
Third Quarter Investment Performance (including income)

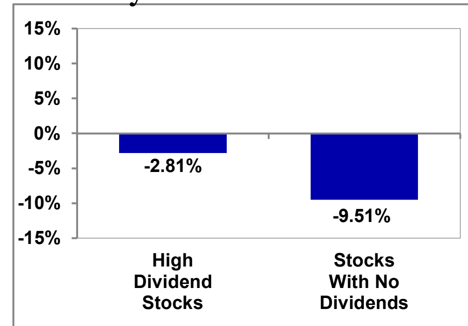
By Economic Sector



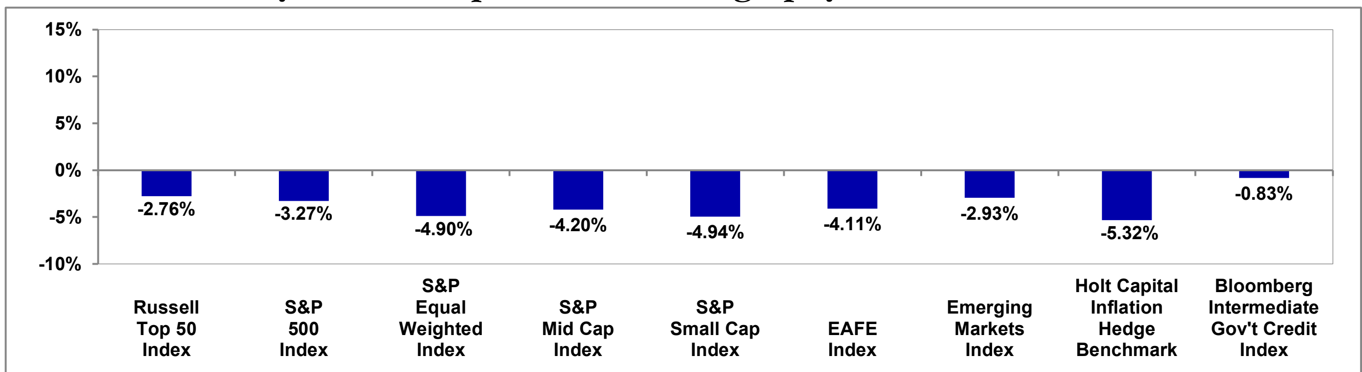
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- Stocks ended the third quarter near their three month lows. The energy sector was the best performer, while interest rate sensitive sectors, such as real estate and utilities were especially weak.

- Stocks with above average dividend yields tend to be categorized as value stocks and stocks that do not pay a dividend are often viewed as growth stocks. The middle panel shows a breakdown in those typical relationships. In contrast with the slight outperformance of the growth index, dividend stocks were relatively defensive performers, while non-dividend payors were particularly weak.

- Neither geographic nor asset class diversification provided much benefit during the quarter, as both foreign stocks and bonds posted negative returns. Although we always reference an intermediate maturity bond benchmark, long term government bonds were painfully weak. The total return on the thirty year Treasury bond was -12.58%.

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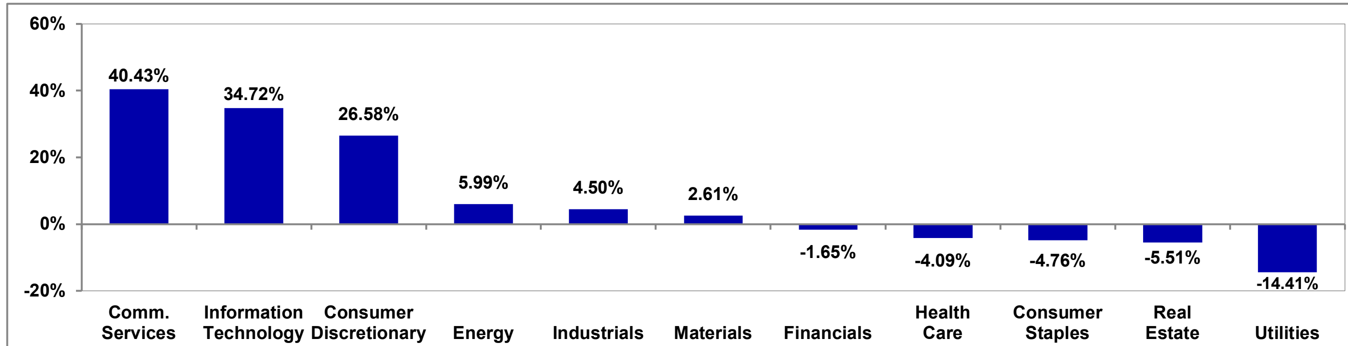
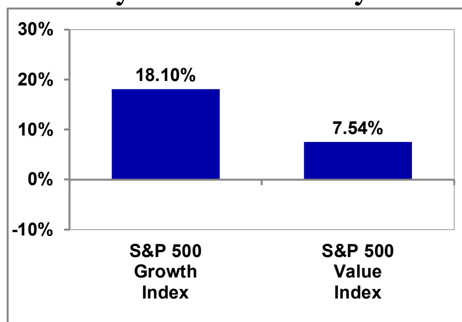
Year-to-Date Investment Performance (including income)

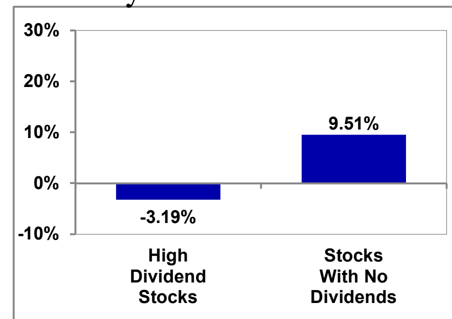
By Economic Sector



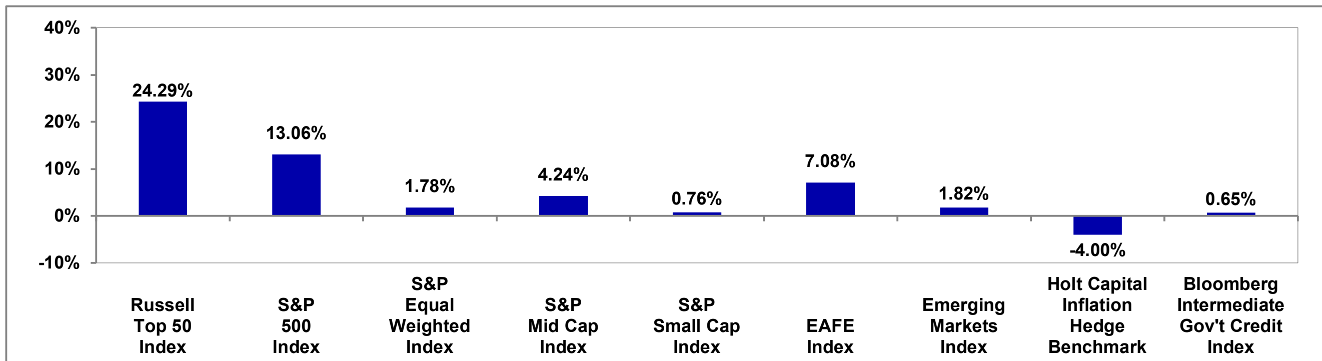
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- The stock market's narrow leadership over the past nine months is clearly visible in each of the above sets of graphs. Mega-cap growth stocks dominated.
- The Russell Top 50 Index is dominated by the so-called "Magnificent 7" which include Apple, Microsoft, Amazon, NVIDIA, Alphabet, Tesla, and Meta. Growth expectations and valuations are both very high for these globally dominant companies.
- In contrast, the average stock in the S&P 500, as depicted by the equal-weighted index, barely moved. Virtually all of the return was the result of dividend income.