HOLT CAPITAL
PARTNERS, L.P.

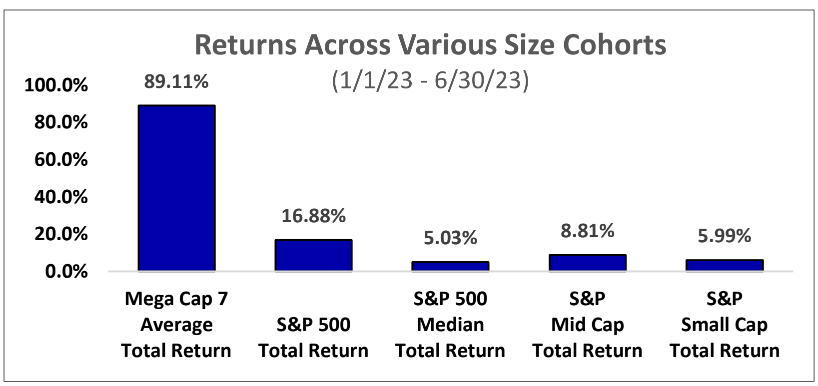
SECOND QUARTER FINANCIAL MARKET COMMENTARY

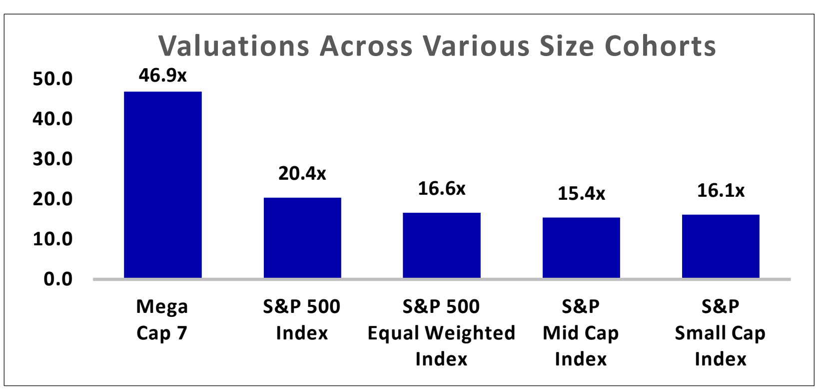
"NINETY DAYS IN NINETY SECONDS"

JUNE 30, 2023

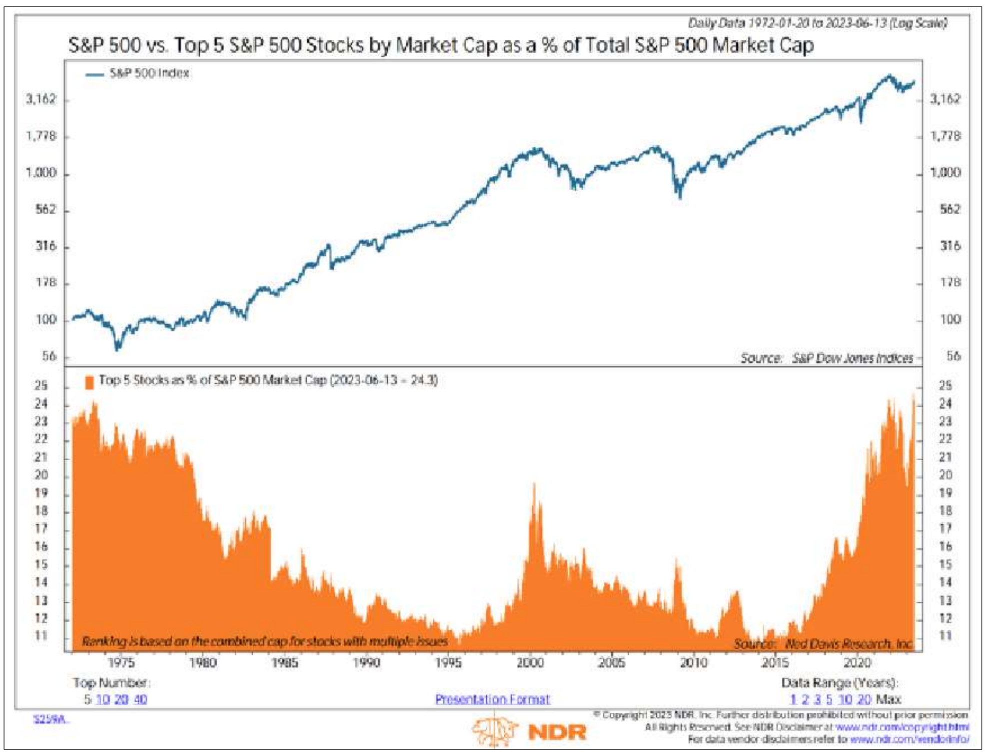
WHAT DOES NARROW LEADERSHIP MEAN AND WHY IS IT IMPORTANT?

- A small group of mega-cap technology stocks drove the S&P 500 Index and the NASDAQ 100 sharply higher during the first half of the year. The S&P 500 is a capitalization-weighted index and the seven biggest stocks (Apple, Microsoft, Amazon, NVIDIA, Alphabet (formerly Google), Tesla, and Meta Platforms (formerly Facebook) currently comprise almost a 28% weighting in the index. The transformative potential of artificial intelligence ("AI") is responsible for a large portion of this move. However, the vast majority of stocks have been much more modest performers over the past six months.
- The graphs below illustrate the divergence in year-to-date performance and valuation between these seven mega cap growth stocks and the broader stock market. We have also included the return for the median stock in the S&P 500 Index, which is the stock in the middle when the constituents are ranked by return. This view of the market illustrates that one half of the constituents in the index had year-to-date returns that were higher than 5.03%, while the other half of the stocks generated returns below 5.03%. Further highlighting the narrowness of performance, over 38% of the S&P 500 constituents declined during the first half of the year.





- Mark Twain once observed that "history doesn't repeat itself, but it often rhymes." That aphorism is often applied to the economy and the stock market. The nifty-fifty era of the early 1970's and the dot-com bubble in 2000 were the only previous periods during which market leadership was this narrow. In those periods, technology stocks were also the market darlings and each period was followed by painful multi-year declines for the previous mega-cap leaders. Interestingly, these prior periods of index concentration were succeeded by 10 to 20 years of outperformance by broader indexes, as well as mid and small cap stocks. The global dominance and financial quality of this year's tech winners appears significantly different than the dot-com era. However, the divergence in valuations reflected in the previous chart is a source of concern for the handful of market leaders and a reason for optimism around large pools of companies.



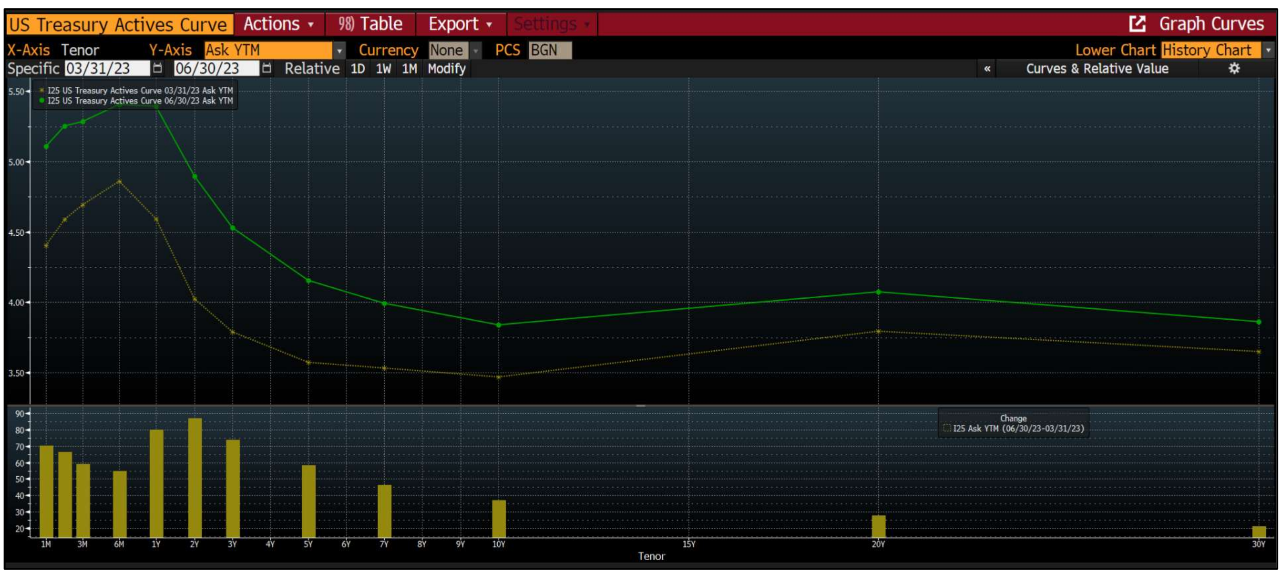
THE INTERRELATIONSHIP OF LEADERSHIP AND VALUATION

- Valuation levels for most stocks remain reasonable. The mega-cap growth names have valuations that make them susceptible to bouts of profit taking and underperformance. Looking forward, the market could experience a rotation away from mega-cap growth and into value, mid cap and small cap stocks, especially if investors look through the current period of economic uncertainty and anticipate a stronger economy in the second half of 2024.

WHEN WILL FED POLICY MATTER?

- The explosion of AI into investor consciousness that occurred with the introduction of ChatGPT shifted investor imagination from a Fed-induced recession back to the world-changing potential of technology. The decline in technology stocks in 2022 had been partially explained by higher interest rates making earnings far into the future less valuable. But with AI, investors interpreted that distant future as having arrived and those perceived winners have propelled the indexes sharply higher. However, the economic reality is that the Fed has raised policy rates by five percentage points over the past 15 months and inflation is still well above targeted levels. Although the Fed did not raise rates in June, Chairman Powell continues to reiterate that more hikes are likely.

- The yield curve illustrates the rise in yields in the second quarter across the maturity spectrum. It also highlights the inverted nature of the curve, with short term rates significantly higher than intermediate and long term rates. Although yield curve inversions of this magnitude have historically been followed by a recession, the uniqueness of the current economy is likely to result in a deviation from that historical pattern.



- Investors in both stocks and bonds remain sanguine about the ultimate impact of monetary policy. The yield on ten year government bonds ended the quarter at 3.84%. This yield is insufficient to provide investors with positive returns after inflation and taxes. Most companies have seen limited impacts from the rise in global interest rates and have not made meaningful revisions to their expectations for revenues, profit margins, or earnings. We have been consistent in our view that any economic slowdown would be mild. The Fed's monetary policy actions will likely result in some slowing of economic activity and a modest weakening in the job market, but the timing is highly uncertain. Our expectation is that this outcome would generally be described as a "soft landing," and it may not occur until 2024.

Conclusion

- The two big issues in the second quarter were the narrow stock market leadership and the future direction of Federal Reserve policy. June provided some early evidence of the market beginning to broaden. This is good news because historically broad market rallies have proven to be more sustainable. We believe that Chairman Powell and the Fed are serious about further interest rate hikes in order to bring inflation down. This will probably take at least two more rate increases.
- Most stocks appear to be reasonably valued. Mega-cap technology stocks have strong fundamentals, but those robust earnings and strong balance sheets are probably fully reflected in the group's premium valuations.

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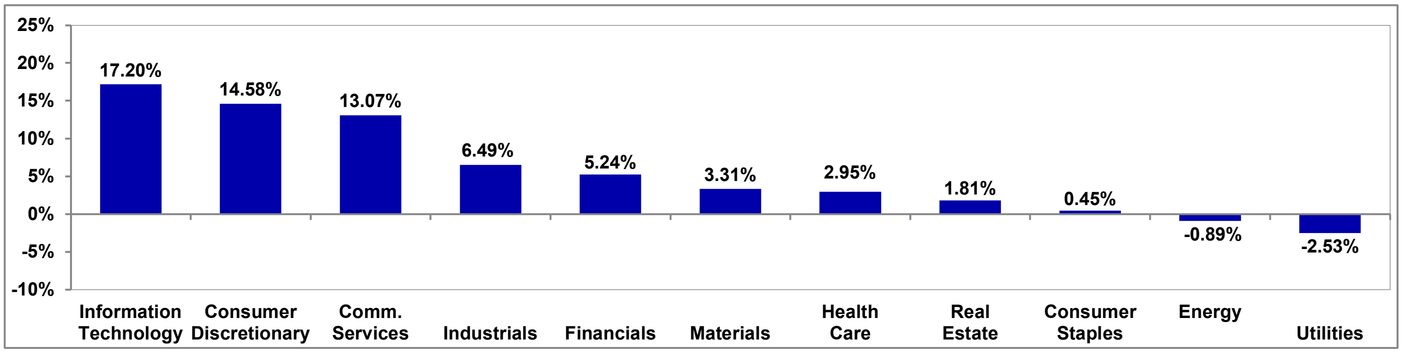
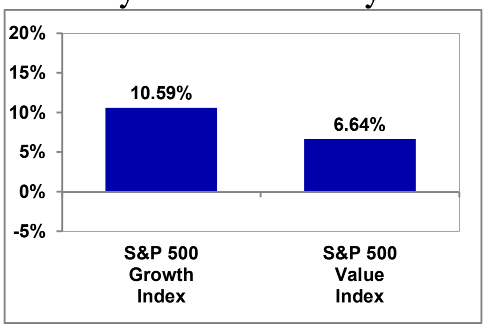
Second Quarter Investment Performance (including income)

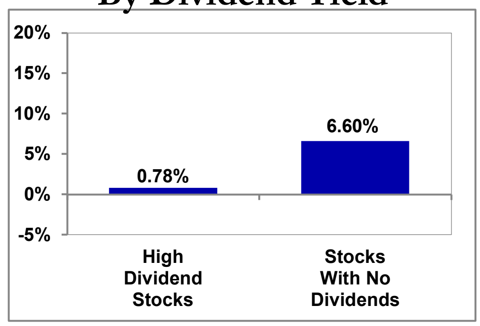
By Economic Sector



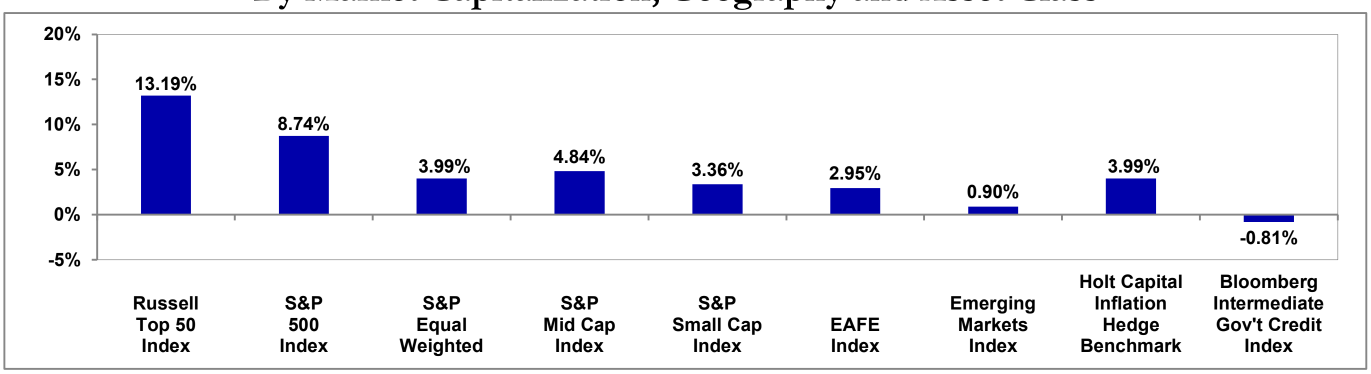
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- The stock market's narrow leadership is clearly visible across all of the above comparative index data.
- One bit of analytical trivia that is often overlooked is the impact of one or two stocks on individual sectors. Within the technology sector, the weightings of Apple, Microsoft, and NVIDIA exceed 51% of the sector. Likewise, Meta and Alphabet represent 46% of the communications sector, while Amazon and Tesla comprise 42% of the consumer discretionary sector. While those three sectors were the best performers, that performance was really driven by the so-called "mega cap 7."
- Away from this small group of mega cap growth names, stocks across most economic sectors and sizes rose modestly during the quarter.

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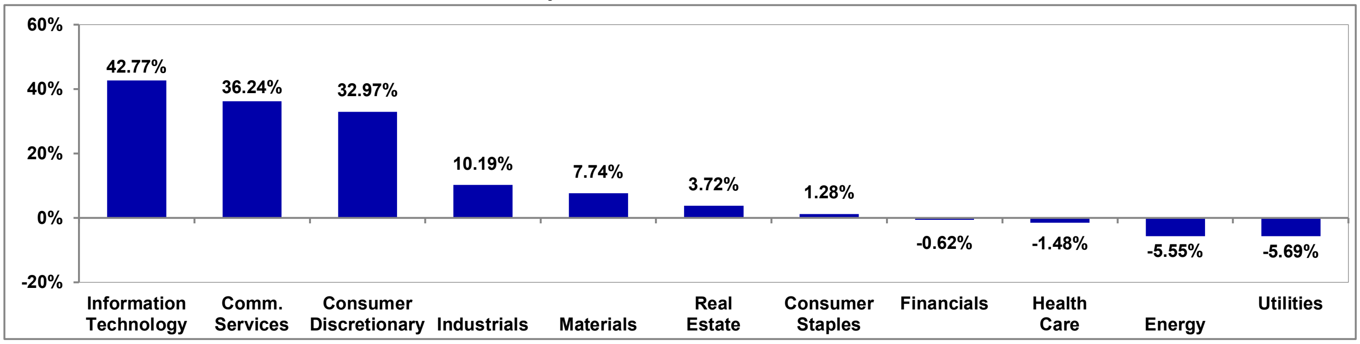
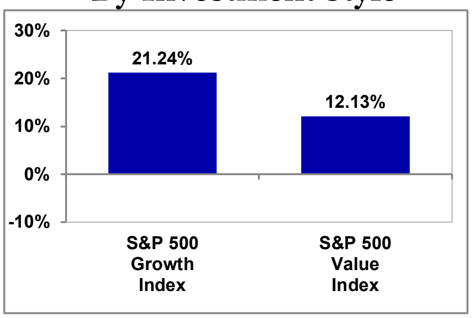
First Half Investment Performance (including income)

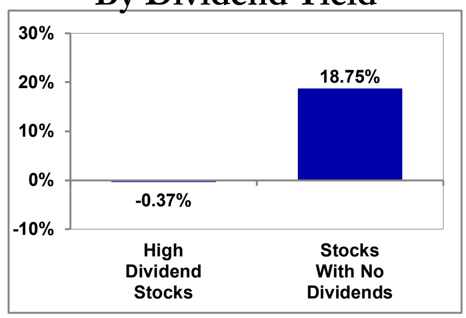
By Economic Sector



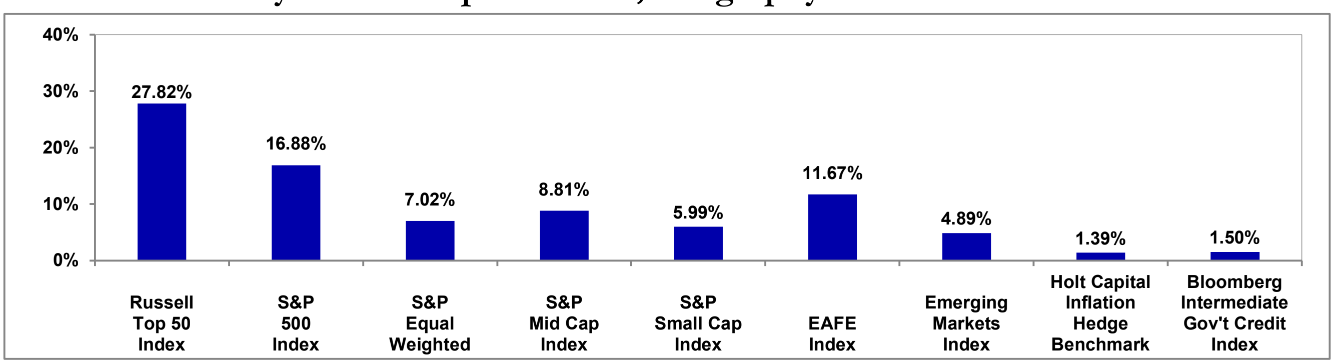
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- It was clearly a favorable six month period for mega cap growth companies. This was a complete reversal of the performance that these sectors generated in 2022. While energy brought up the rear on a year-to-date basis, it was a huge performer over the past eighteen months with a 56% total return. Similarly, the communications and consumer discretionary sectors are still posting large declines for the period since 12/31/21.

- An old adage is that "price is what you pay and value is what you get." The substantial appreciation in growth stocks and the flattish performance of many value names has resulted in the relative valuation of many value stocks becoming very attractive.