Holt Capital
Partners, L.P.

Fourth Quarter Financial Market Commentary

"Ninety Days in Ninety Seconds"

December 31, 2020

Market Leadership

- While the biggest story of the year revolves around the extraordinary volatility that investors have endured, the fourth quarter produced dramatic shifts that were less visible, but equally significant. As we have previously discussed, the first nine months of the year were dominated by mega-cap growth stocks. The pandemic pulled forward revenue and earnings growth for software and e-commerce companies that would have likely occurred over the next several years. This phenomenon selectively created massive stock market winners. At the end of the third quarter the return differential between growth stock indexes and value stock indexes reflected the most extreme underperformance of the value factor in 84 years of data.

- In contrast, the fourth quarter was a very broad rally, characterized by equal weighted, mid cap and small cap indexes trouncing the return of mega-cap stocks. Likewise, value indexes and dividend strategies outperformed growth stocks. The dual catalysts for this rotation were reduced political uncertainty and the reality of an effective vaccine. Broader leadership tends to be viewed as a healthy sign for markets.

- Interestingly, the sector and style trends in the fourth quarter were somewhat reminiscent of the significant rotation in leadership that accompanied the bursting of the dot com bubble in 2000. As you may recall, the NASDAQ market fell sharply until reaching a bottom in 2002. Small stocks and value stocks were relatively safe havens in the midst of the dot com bust.

Pandemic to Vaccine

- Technology stocks were big beneficiaries of the pandemic as consumers worked from home, spent on-line, and acquired new technology tools. These technology-driven behavioral changes are likely to shape how we work, spend, and travel for years to come. An interesting analogy is how email has revolutionized written communication over the past two decades. A recent McKinsey study predicted that a quarter of business travel will be permanently replaced by Zoom meetings. Replacing face-to-face meetings and travel with video conferencing could have the unanticipated impact of extending the careers of many white collar workers.

- Vaccines should boost reopening beneficiaries in an economic environment that tracks the classic recovery phase of a new business cycle. Dislocated consumer businesses, cyclical industries, financials, and value stocks are typically the best relative performers early in an economic cycle.

Election Impact

- Rapid and effective mass vaccination, which is underway, is more important to the economy and the stock market than the results of the November elections.

- Biden's cabinet appointments have generally been well received by the business community and that is particularly true about Janet Yellen's nomination to be the Secretary of the Treasury. Other nominees tend to reflect the high value Biden is placing on experience and expertise. If the narrow margin in both the House and Senate drive policy toward the political center, such a shift should be supportive of economic prosperity and a higher stock market.

- The surprise results of the Senate races in Georgia make a prolonged period of fiscal stimulus more likely. The fourth quarter rally has carried over into early January, especially in shares of cyclical stocks, and is supported by the likelihood of federal aid turbocharging the economic recovery. At this point, investors seem unconcerned about the real prospect of increased regulatory burdens, as well as higher corporate and individual tax rates.

Opportunities and Risks in the New Year

- The consensus view is that this is the best of all worlds for the stock market. Positive factors include the emergence of a vaccine which should allow a robust reopening of the economy, fiscal stimulus to help carry the economy through the depths of the pandemic, very supportive monetary policy, rising profit margins, and potentially the start of a new economic expansion. This is a very plausible scenario and we are optimistic about these factors. We also believe that the combination of pandemic-related cost reductions by companies and the pent-up demand for consumer goods and services will boost corporate profits. Risks revolve around regulatory and tax policy, vaccine safety and distribution, as well as the current elevated level of investor optimism.

- Employment statistics reflect a loss of almost 10 million jobs since the start of the pandemic. Federal stimulus programs and state unemployment benefits have muted the impact of these lost jobs, but continued economic growth will ultimately be necessary to return these workers to the workforce. The impact of the large drop in employment is also visible in the restrained rebound in consumer confidence.

- In our view, the most likely surprise in 2021 will be corporate earnings that exceed expectations. Analysts have consistently underestimated the ability of companies to control costs and drive revenues during the pandemic. These management actions are likely to continue to impact reported profits in the new year.

- The acronym, TINA, which stands for "There Is No Alternative," is also a potential demand driver for stocks. Money market fund assets exceed $4.2 trillion and near zero yields will act to encourage a portion of that cash to move into stocks.

Bubble Trouble?

- Two metrics have characterized the stock market's post-COVID-19 rally. Earnings have been much better than initially feared and valuations have remained above average. These data points are interrelated and neither fundamentals or valuations appear to imply significant risk for major stock indexes.

- However, there are worrisome pockets of speculation in the market that are worth noting, including several groups of stocks with business models that can be broadly categorized as disruptive technologies. Most of these companies have two characteristics in common: minimal or negative earnings and high valuations. Electric vehicles, clean energy, "work from home" stocks, and special purpose acquisition companies, also known as SPACs, all trade with high levels of price volatility and appear to embody speculative excesses.

- A common factor in many of these stocks is a high level of individual investor ownership. Retail investors accounted for over 25% of trading volume over the summer compared to 10% in 2019. The proliferation of commission-free trading apps, such as Robinhood, combined with a pandemic-related reduction in sports betting have pushed a casino mindset into a number of stocks. Although nobody knows when bubbles are going to burst, the outcome is never pretty.

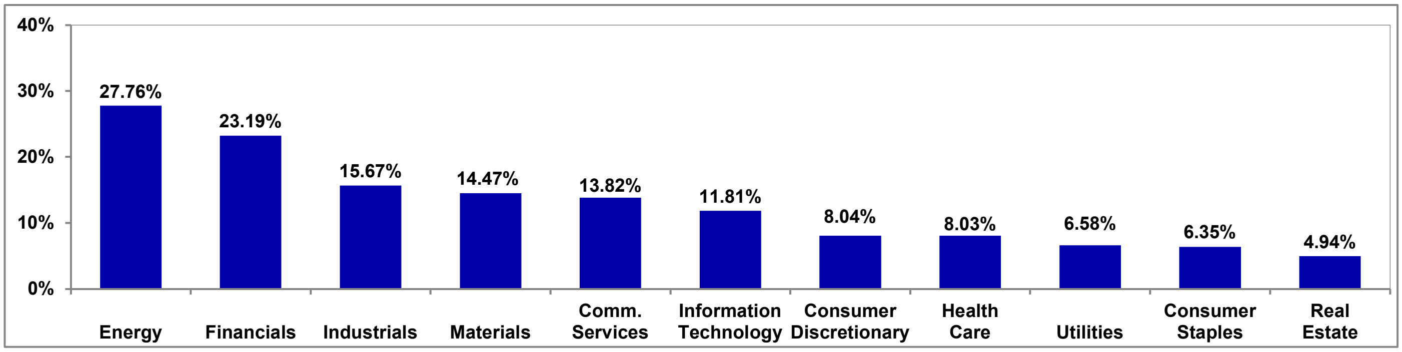
Conclusion

- Stock market volatility is unsettling. However, this past year proved the importance of maintaining a long term perspective that is not derailed by near term events. The new year is not without its share of pandemic, political, and economic challenges. In such an environment, volatility is likely to remain a constant.

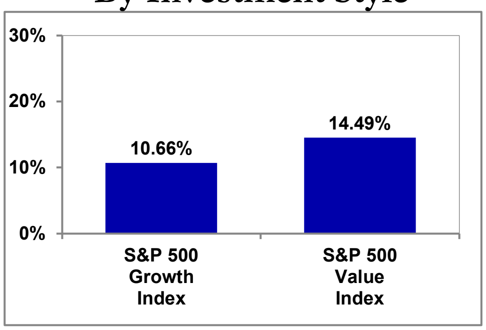
- As we move through the year, a vaccine-driven reopening combined with the wealth effect of higher stock prices and home prices should result in strong earnings growth from the majority of companies. Low interest rates and rising corporate profits should combine to push stocks higher by year end.

Fourth Quarter Investment Performance (including income)

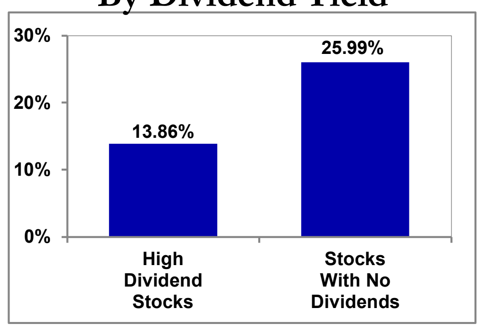
By Economic Sector



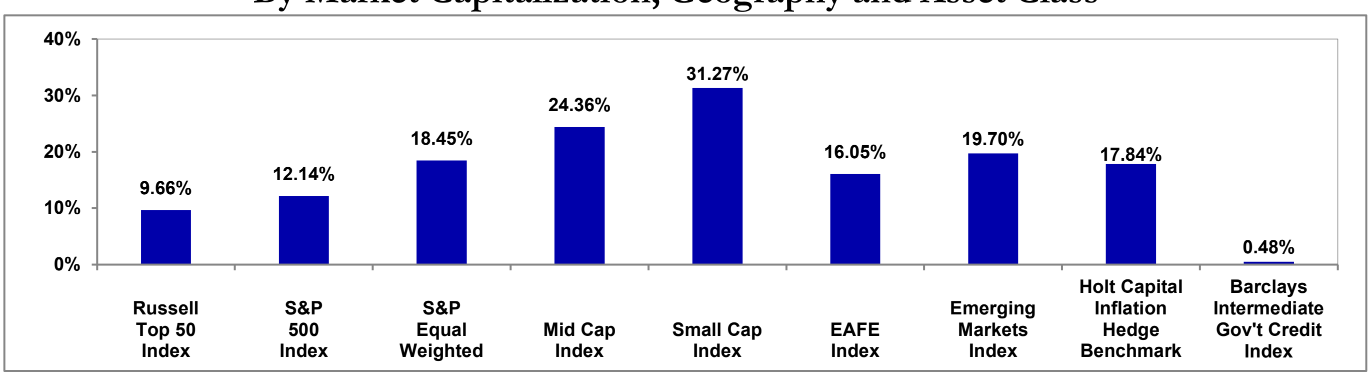
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- The traditional bull market relationship among size cohorts returned in the fourth quarter with massive outperformance by smaller market cap companies. This rebound partially offsets the dominance of mega-cap stocks that characterized the first nine months of the year.

- Higher commodity prices, higher yields on government bonds, and additional fiscal stimulus should continue to favor value stocks, including financials, energy, and domestic-oriented small/mid caps.

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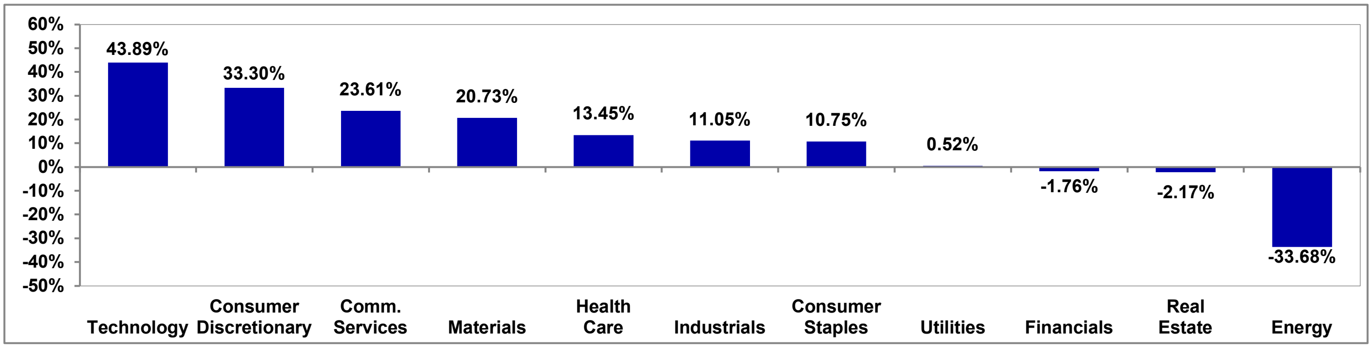
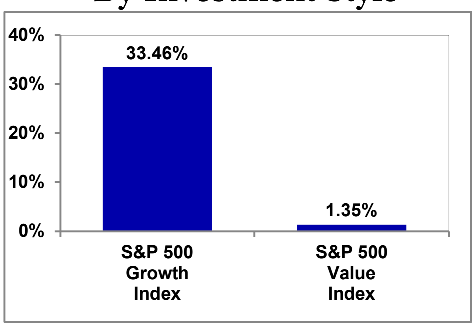
2020 Investment Performance (including income)

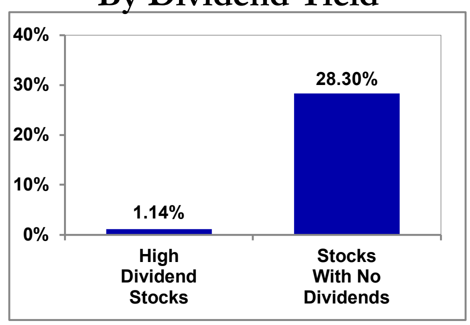
By Economic Sector



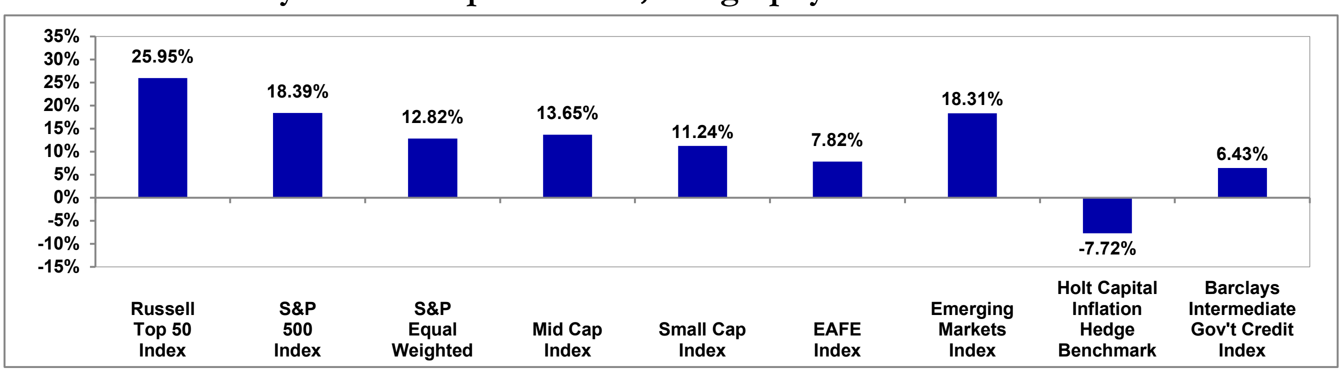
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- Although the Top 50 Index of mega-cap stocks lagged in the fourth quarter, it still produced the best returns for the year. Other size categories generally produced mid-teens returns.

- Growth stocks dominated returns in 2020, but P/E multiples for many of these disruptive technology/work from home/e-commerce companies are well above historical ranges.

- Valuation is not uniform across the stock market. The highest valuation quintile of stocks recently had an average price/earnings ratio of 35x, while the lowest quintile was valued at only 11x earnings. This is the widest spread between the most popular stocks and the most hated stocks since the tech bubble in 1999.