Holt Capital
Partners, L.P.

First Quarter Financial Market Commentary

"Ninety Days in Ninety Seconds"

March 31, 2022

Ukraine

- The unprovoked invasion of Ukraine is a humanitarian crisis that will likely have a long-lasting isolationist impact on Russia. In response, governmental and private sanctions from around the world have been implemented with great breadth and speed. These are the toughest array of economic sanctions ever imposed on a major power and in the long term will result in economic and technological attrition. Many observers believe that Putin did more in the first few weeks of the invasion to strengthen NATO than any of the member nations have been able to accomplish since WWII. Hopefully, a diplomatic solution can be reached over the near term as Putin realizes the conflict is unwinnable.

- Globalization has been dealt another blow. The Russian invasion has compounded the parts shortage and transportation delays that were initially sparked by Covid shutdowns. The emerging trend toward onshoring will reorient supply chains from cost minimization to resilience and risk mitigation. However, the cost of domestic manufacturing will put upward pressure on prices and potentially reduce global economic growth.

- Although the domestic stock market has declined in a volatile pattern on a year-to-date basis, the incremental move since the day of the invasion has resulted in appreciation of about five percent. This is partially a reflection of Russia and Ukraine representing only a minimal amount of revenues and profits for U.S. companies. The initial sell-off in response to the invasion was a classic market reaction that overemphasized uncertainty in the short run before investor focus returned to a longer term perspective.

Ever-Present Risks

- There are always risks and uncertainties in the outlook for the economy and the financial markets. Today is no different. Most non-Ukraine concerns fall into one of two buckets.

- The Fed is late in responding to the spike in inflation and has indicated a plan to raise interest rates at each FOMC meeting this year. This trajectory has been well telegraphed to the market and assuming that the pace of tightening does not accelerate, should be a fairly benign risk factor over the balance of the year. The Fed's goal is to engineer a "soft landing" in the economy that will temper inflation, but not cause a recession. Historically, stocks have tended to rise in the first year of a tightening cycle. However, this balancing act will be a focal point for investors throughout this year and into 2023.

- Inflation is at a 40 year high and is likely to move higher over the course of the second quarter. The primary drivers are higher oil, labor, and food prices. Inflation will eat away at nominal wage gains, but consumer balance sheets are strong and retail sales growth implies a vibrant demand environment for goods and services.

CAN THE INFLATION GENIE BE PUT BACK IN THE BOTTLE?

- Consumer prices rose 7.9% in the past twelve months, which is the highest reading in 40 years and the April data is likely to be even higher. For a number of quarters, we have been of the opinion that inflation is more broad-based and less transitory than policy makers anticipated. Our view has now become mainstream. The next question is whether policy actions and supply chain normalization will succeed in lowering inflation toward the Fed's two percent target.

- Although the Ukrainian conflict has recently exacerbated supply chain issues, demand and supply for most goods should begin to return to a more balanced state by year-end. Crude oil prices are likely to remain elevated as the global economy continues to reopen and travel increases. Constraints on domestic crude oil production include industry capital allocation strategies that favor cash generation over capital expenditures and labor shortages.

- Housing prices and rents continue to rise at a rapid pace. Not only are these factors likely not fully reflected in current CPI data, but demand for homes and apartments continues to remain robust. Finally, agricultural commodity prices continue to put upward pressure on items as divergent as bread, eggs, and beef.

THE FED RAISES SHORT TERM INTEREST RATES

- In a widely anticipated announcement, the Fed belatedly began to tighten credit conditions in March. The government and corporate bond markets have reflected a new tightening cycle for months and are considerably ahead of the policy makers at the Fed. The two-year Treasury is highly sensitive to changes in monetary policy and is a good predicter of the fed funds rate twelve months from now. Ten-year government bonds are widely used as a benchmark for residential mortgage debt and corporate borrowing. The charts below indicate the magnitude of the move in market interest rates this year.

U.S. Treasury Notes					
2 Year Yields		10 Year Yields		Change in 2 Year Yield	Change in 10 Year Yield
12/31/21	3/31/22	12/31/21	3/31/22		
0.73%	2.34%	1.51%	2.34%	+161 b.p.	+83 b.p.

Investment Grade Corporates	
Yield Spread Over Treasuries	
12/31/21	3/31/22
+92 b.p.	+116 b.p.

High Yield Bonds	
Yield Spread Over Treasuries	
12/31/21	3/31/22
+283 b.p.	+325 b.p.

- Since corporate debt is usually priced off of the yield of a U.S. Treasury issue with a similar maturity, one can see the combined impact of higher rates and higher spreads. As an illustration of the magnitude of credit tightening that is already present in the bond market, a hypothetical investment grade borrower would currently pay about 3.50% to borrow for ten years. This is the sum of the ten year government bond yield, plus the credit spread of 116 basis points. This compares to 2.43% (1.51% + 0.92%) just three months ago.

Conclusion

- The decline in stock prices during the first quarter has lowered valuations. This is especially true in the most speculative areas of the market, such as unprofitable technology stocks. Bursting speculative bubbles is healthy for higher quality companies in the market.

- Dividend growth should accelerate this year. While earnings grew almost 50% last year, dividends only grew 4%. We expect dividends to grow 10% in 2022, which will likely be slightly faster than earnings growth. Share repurchases should grow about 12% this year and exceed $1 trillion. Both of these areas of capital return imply confidence on the part of corporate management teams in the health of their companies.

- Geopolitical conflict, rising interest rates, and higher commodity prices are sources of concern. The invasion of Ukraine has structurally increased the price of food and energy, which acts as a tax on consumers. However, earnings and cash flows drive stock prices in the long run, and we remain optimistic about corporate fundamentals.

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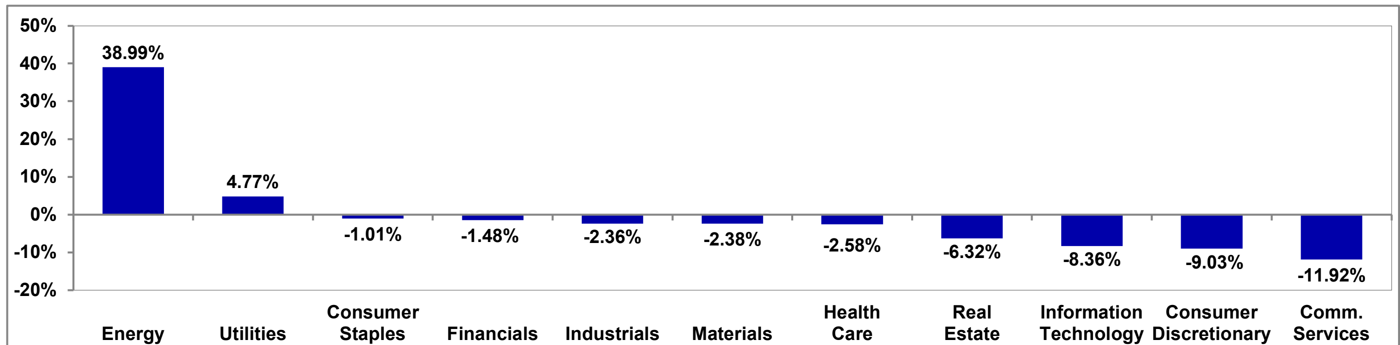
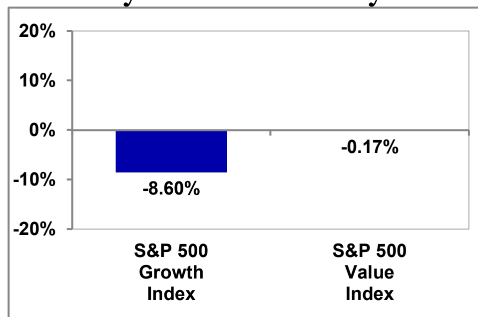
First Quarter Investment Performance (including income)

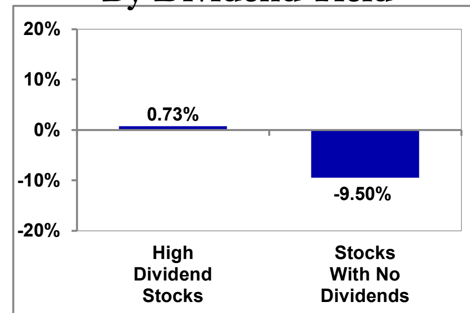
By Economic Sector



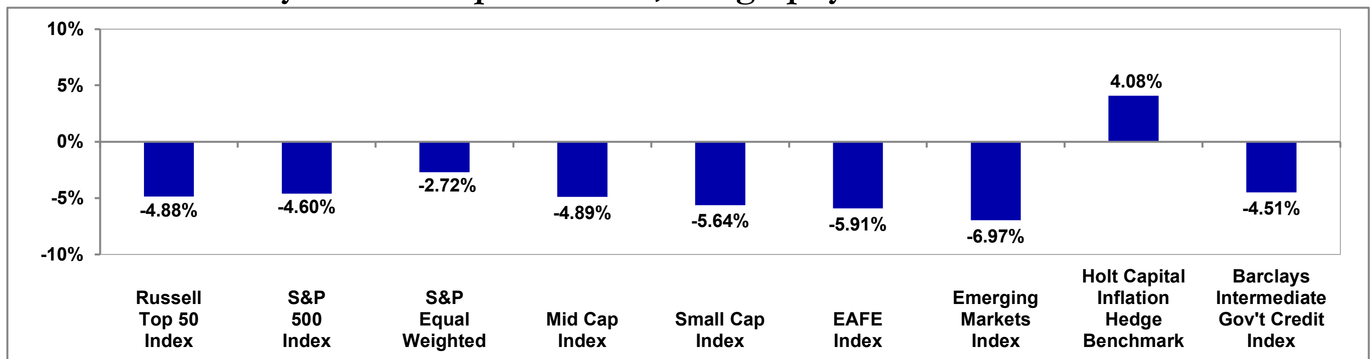
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- The overriding sector themes during the quarter were the commodity price-driven performance of energy stocks and the appeal of defensive sectors, such as utilities and consumer staples. Sector-related weakness was primarily concentrated in areas of high valuations, including technology, discretionary, and communications. Rising interest rates tend to depress valuations of high growth companies.
- These trends are also evident in the performance comparisons of growth and value indexes and dividend characteristics.
- There were limited diversification benefits available in the first quarter. Large stocks, small stocks, international stocks, and bonds all fell about 5%. Our firm's Inflation Hedge benchmark, which is a weighted average of four publicly available indexes, was positively impacted by the rally in energy stocks.