Holt Capital
Partners, L.P.

Second Quarter Financial Market Commentary

"Ninety Days in Ninety Seconds"

June 30, 2020

What a Quarter

- Covid-19 cases have surged. Unemployment is near record levels. Corporate profits will decline sharply. So does it make sense that the S&P 500 rallied 20% during the quarter?
- We live in a complex and uncertain world and companies have "lost" a significant amount of their earnings in the current year. But assuming most of the damage to the economy is transitory, then future years and decades should see relatively modest profitability impacts. In addition, historically low interest rates mean the present value of those future earnings is higher than would be the case in a more normal interest rate environment.
- Stock price volatility is almost certain to remain elevated and will be highly correlated with pandemic headlines. Most media coverage of the late June spike in Covid-19 cases focused on the health care aspect of states and municipalities being lax in social distancing standards. However, from an economic perspective the initial surge in business activity as states reopened is a real time testament to pent-up consumer demand and consumer confidence.

The Federal Reserve to the Rescue

- The Federal Reserve has earned high marks from virtually every segment of the economic spectrum for timely and aggressive policy moves during the pandemic. Driving interest rates toward zero and providing unprecedented liquidity to support the corporate credit markets have combined to create an enormous amount of investor confidence.
- Two consequences of the Fed's supportive policies are that stocks are perceived as being less risky and bond yields are seen as capped at current levels for an extended period of time. This scarcity of yield will continue to push income-seeking investors into owning stocks.

The Stock Market and the Economy

- The headlines are full of bad news about unemployment, small business struggles, reopening controversies and PPP loans. When seen in this light, the rebound in the market may seem out of sync. Certainly, many consumer-facing businesses, such as travel, restaurants, hotels, retail and entertainment, as well as their employees, are struggling. Unfortunately, some of these industries will be permanently impaired by the pandemic. But within the S&P 500 Index, those industries only represent 4.9% of the index. By comparison, health care, consumer staples, and technology, which have been less impacted or in some cases are beneficiaries of the Covid crisis, represent 49.0% of the index. Stated differently, public company revenues and earnings are more stable than implied by media coverage of the business impact of the pandemic or most consumer's day-to-day experiences.

Voting Machines and Weighing Machines

- The famed value investor, Ben Graham, once described the stock market as a voting machine in the short term, but a weighing machine in the long run. In other words, human emotions and crowd psychology can cause the market to overreact to information in the short run. However, in the long run company fundamentals such as earnings, leverage, growth prospects, and valuation set market prices.

- Over the past six months, investors witnessed a violent shift from a voting machine that was driven by fear on the way down to a weighing machine based on a combination of Fed policy that eliminated the worst-case outcome and company fundamentals one to two years in the future. The importance of a consistently applied investment philosophy is that it allows proactively taking advantage of voting machine mispricings, as well as not being tempted to follow the madness of the crowd by selling an asset for less than its true weighing machine value.

Tax Rates and the Election

- Some investors fear that a Biden presidency would result in higher corporate tax rates and that would serve as a catalyst for stocks to decline. Estimates of the impact of a partial reversal of the 2017 tax cuts are a reduction in S&P 500 earnings of between 5% and 10%. However, an offset could be additional stimulus spending directed at infrastructure and further aid to state and local governments. At this point, a potential corporate tax rate increase is surrounded by too much uncertainty to be a major focus of investors.

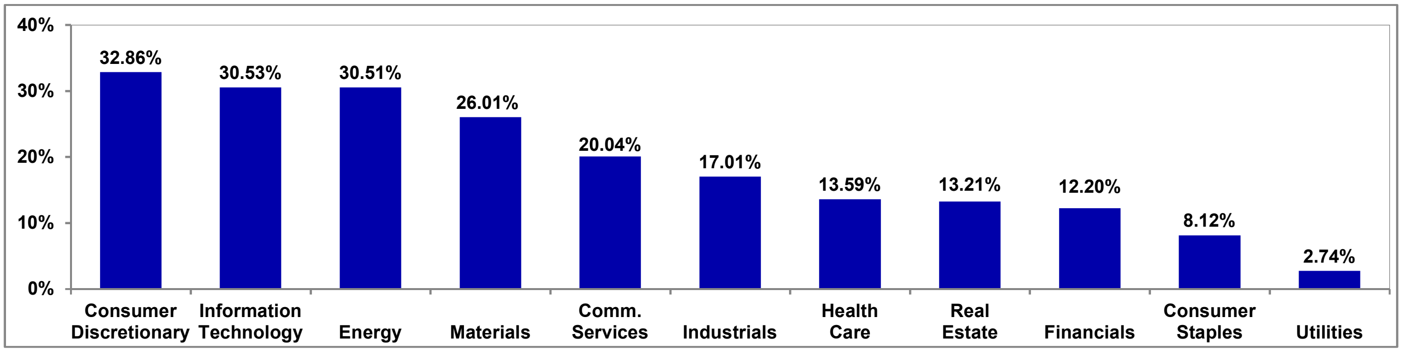
Tomorrow's Newspaper

- We used this heading a few years ago and it seems equally appropriate today. Over the balance of the year a number of topics that either represent negatives today or else are not widely discussed are likely to include some of the following:

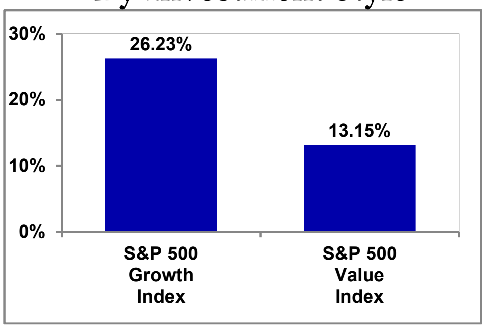
  - A vaccine or a therapeutic treatment gets approved, but production volumes are an issue.
  - Continuing claims for unemployment reflect faster than expected re-hiring by companies.
  - Companies begin resuming dividend payments after suspending them in the midst of the pandemic.
  - Corporate profit margins exceed expectations, aided by permanently lower discretionary expenses.
  - Record levels of assets in money market funds begin to reverse as investors seek higher returns in stocks.
  - Cyclical stocks and value stocks begin to outperform growth and defensive sectors as the economic recovery gains momentum.

Second Quarter Investment Performance (including income)

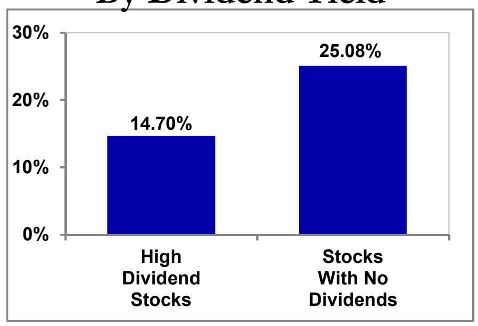
By Economic Sector



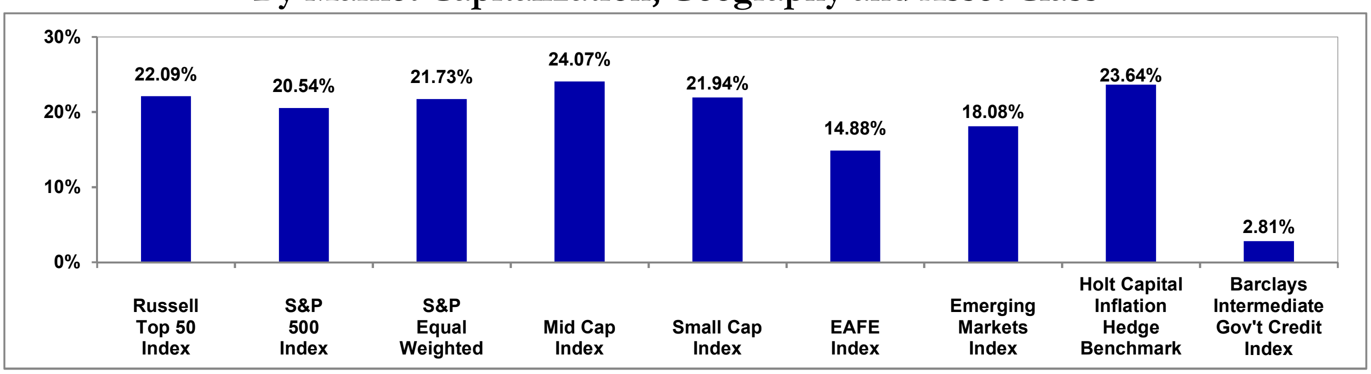
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- Economic sectors that are likely to be beneficiaries of a reopening of the economy, such as consumer discretionary and energy, were among the best performers during the quarter.
- After being among the market leaders in the difficult first quarter, traditionally defensive sectors, such as consumer staples and utilities, were laggards in the second quarter rally.
- Given the large number of companies that have temporarily suspended their dividends this year, investors have become skeptical regarding the sustainability of dividends. This negative view of dividend-paying stocks hurt performance in the second quarter and is unreasonably punitive in our view.

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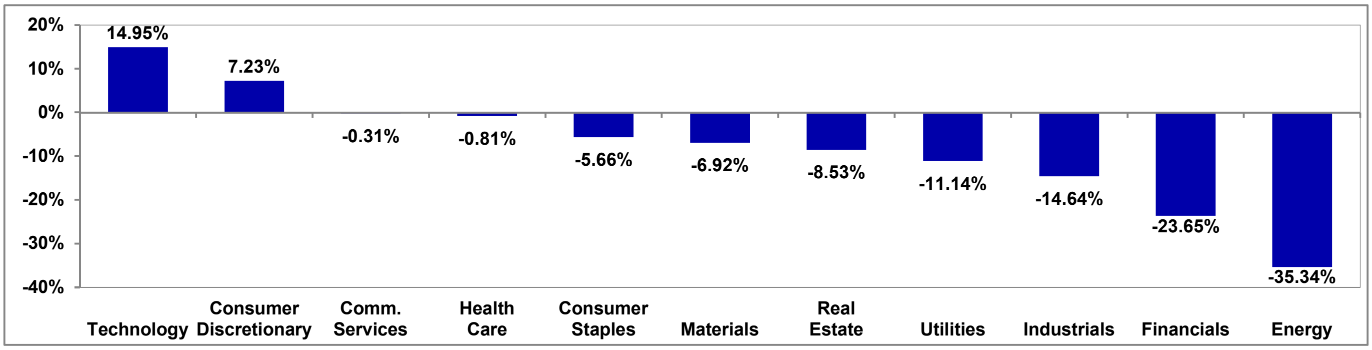
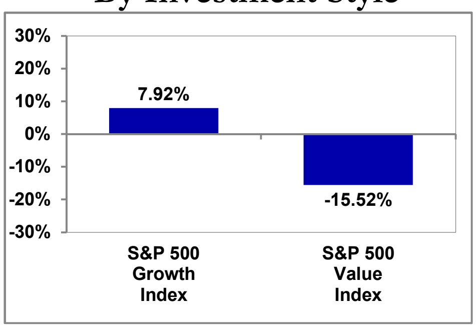
Year-to-Date Investment Performance (including income)

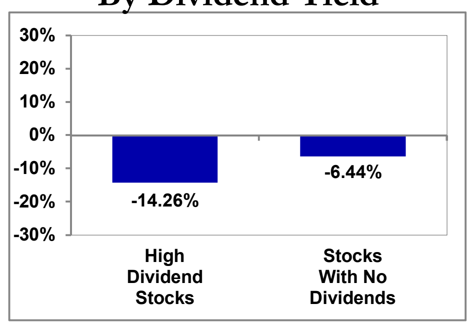
By Economic Sector



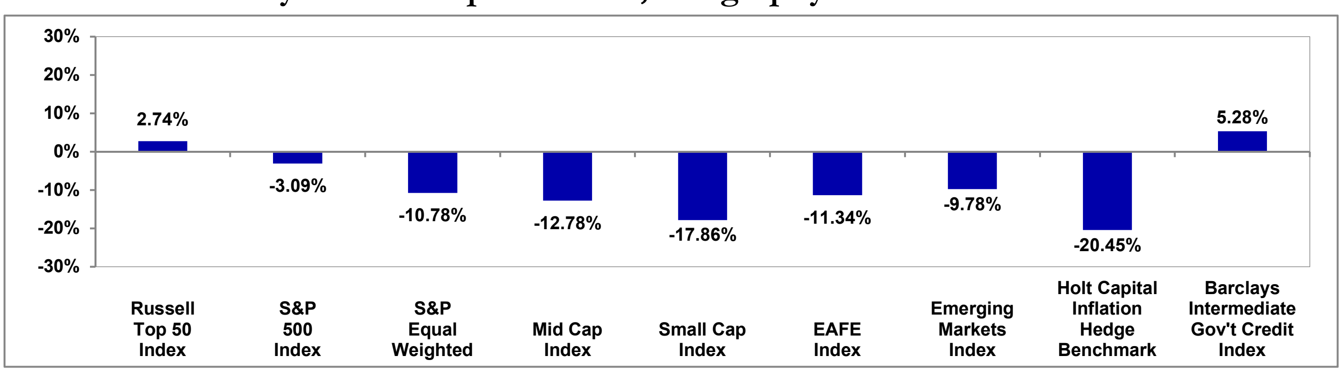
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- The so-called "mega cap" stocks that comprise the Russell Top 50 have proven to be a safe haven this year. Many of these same stocks have been the drivers of strong sector returns in technology (Microsoft, Apple, Adobe) and consumer discretionary (Amazon, Home Depot). These giant companies dominate index construction. The three technology stocks represent 46% of the technology sector and the two discretionary stocks comprise 37% of that sector.
- The S&P 500 Value Index has large weightings in the financial, industrial, utilities, and energy sectors. These sectors tend to have modest valuations, but higher levels of economic cyclicality and/or higher levels of debt. On a year-to-date basis, exposure to leveraged and cyclical companies negatively impacted S&P 500 Value Index performance and overwhelmed the traditionally defensive benefit of low valuations.