Holt Capital
Partners, L.P.

Second Quarter Financial Market Commentary

"Ninety Days in Ninety Seconds"

June 30, 2021

Is The Spike in Inflation Transitory?

- The answer to this question is critical for the financial markets. Unfortunately, no one knows the answer. There are a number of data points that imply that the current price spike is primarily related to the reopening of the economy and as economic activity normalizes, so will inflation. The biggest risk is that consumers and businesses develop an inflation psychology that becomes self-fulfilling. Higher wages, signing bonuses for low wage workers, and higher home prices are all factors that have the potential to create a more persistent inflationary mindset.

- Historically, higher levels of inflation are accompanied by higher interest rates in the bond market. Late in the second quarter a more optimistic view of the intersection of inflation, Federal Reserve policy, and interest rates emerged. Several Federal Reserve officials commented that strong economic growth and higher inflation should drive a more rapid reduction in monetary stimulus than the official consensus. That could mean higher short term interest rates as soon as next year. Rather than focusing on the direction of policy rates, bond investors have interpreted these comments as implying fewer rate hikes. The perverse market reaction to higher inflation data has been a decline in yields on the benchmark ten year bond.

- Is this interpretation too rosy? Probably not, if the monthly inflation data moderate later this year. However, hotter than expected inflation metrics are impacting business cost structures, as well as consumer purchasing decisions. If businesses are unable to pass along higher costs, then margin and profit forecasts could be too high. Conversely, if pricing power allows these costs to be passed through to end users, higher inflation probably is not as transitory as policymakers currently believe.

Earnings Drive Stocks

- This is an old adage, but it has defined the post-lockdown rebound in stock prices. In our firm's first quarter market commentary we commented that consensus expectations for +27% earnings growth in 2021 were too low. Estimates are now +37%, which would be the best year for earnings growth since 2010. If current profitability trends hold, current estimates are still too low.

- In response to the robust rebound in corporate profits, the S&P 500 has gained more than 5% for each of the past five quarters. To put this euphoria into perspective, it is only the second time since 1945 that such a streak has occurred.

The Disconnect Between Stock Prices and Bond Yields

- Earnings expectations continue to rise and stock prices are near all time highs, which supports an optimistic interpretation of future economic growth. On the other hand, bond investors are signaling a slowing economy by pushing ten-year Treasury yields sharply lower. The two markets are reflecting distinctly different points of view. A robust economy should favor cyclicals and value stocks. However, if the economy does begin to slow and growth becomes scarce, then secular growth stocks would be the logical beneficiaries. Both markets cannot be correct and the implications are far reaching for all investors.

- A major catalyst for this debate has been the increasingly divergent views within the Fed regarding the need to reduce monetary stimulus. Investors have generally viewed the recent spike in inflation as transitory. If the Fed potentially tightens policy earlier than expected, then economic growth could be short circuited. This scenario is one of the reasons that ten-year Treasury yields have moved lower in the face of higher inflation reports.

- This fear can be clearly seen in the differential between value and growth returns in the month of June. Value stocks are generally perceived to be beneficiaries of an extended economic recovery and this cohort underperformed growth issues by almost seven percentage points, which was one of the widest monthly spreads on record.

A Healthy Banking System

- The Federal Reserve recently announced the results of its annual stress testing for the 23 largest banks. All banks passed easily. Clearing this regulatory hurdle should allow banks to return about $200 billion to shareholders in dividends and buybacks over the next four quarters. This is in sharp contrast to the weakened condition of banks after the Great Financial Crisis and should provide a solid foundation for lending to support the recovering economy.

- Financial stocks meaningfully lagged the market rally in 2020 and have begun to rebound this year. The combination of strong balance sheets and modest valuations should be positive catalysts for the group. From a contrarian perspective, the sector remains very out of favor and under-owned by institutional investors, which should be bullish for future returns.

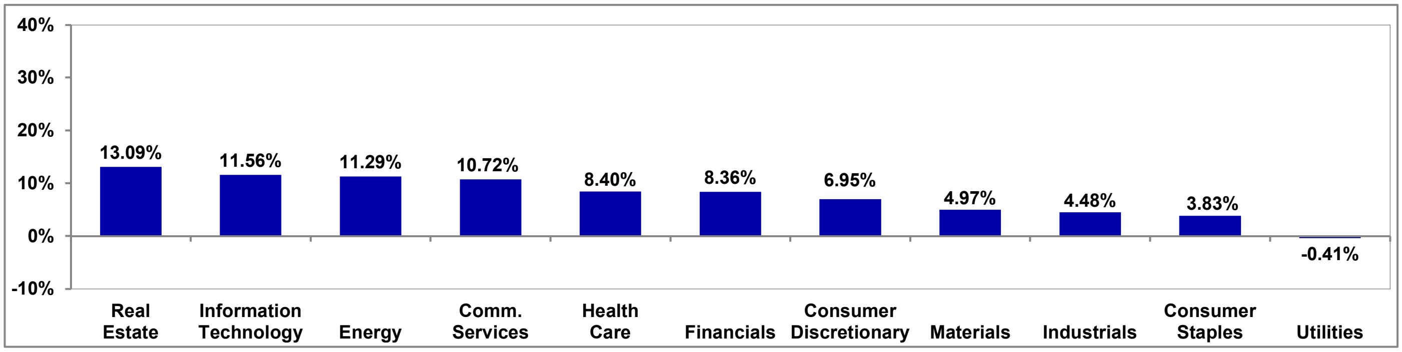
Conclusion

- Our outlook remains largely unchanged from our first quarter commentary. The balance of the year should see the consumer-facing businesses on Main Street thrive as spending and travel rebound. After the powerful rally of the past fifteen months, stock prices reflect expectations for a robust and durable economic recovery. Proposed tax and regulatory initiatives in Washington, combined with evolving Federal Reserve policy could become problematic for investor optimism as the balance of the year unfolds.

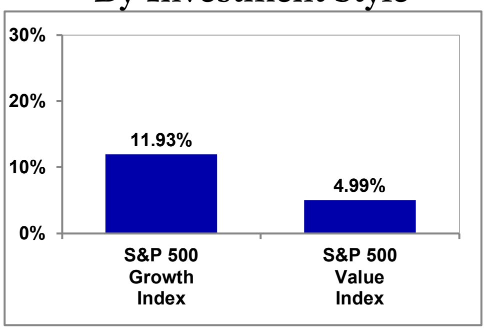
Holt Capital
Partners, L.P.

Second Quarter Investment Performance (including income)

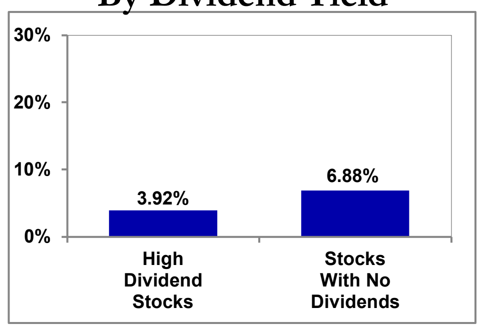
By Economic Sector



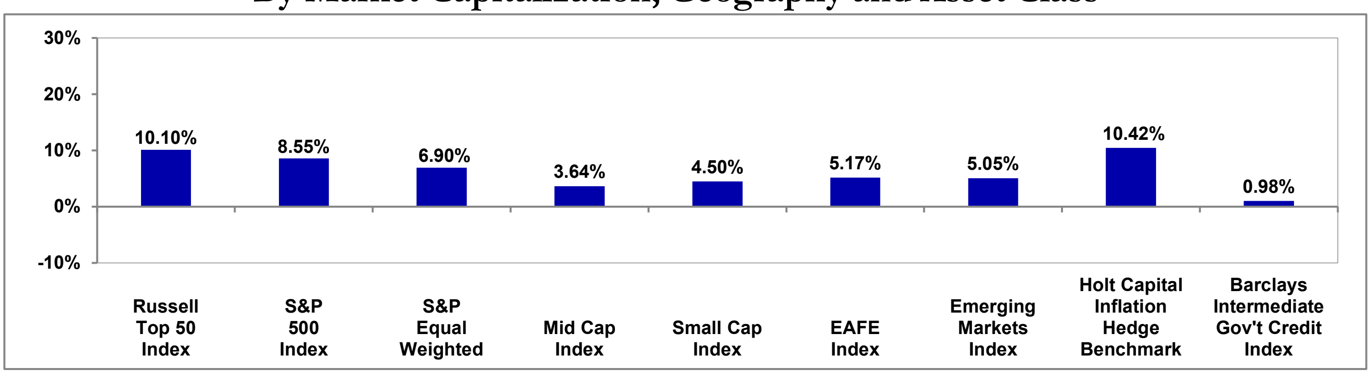
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



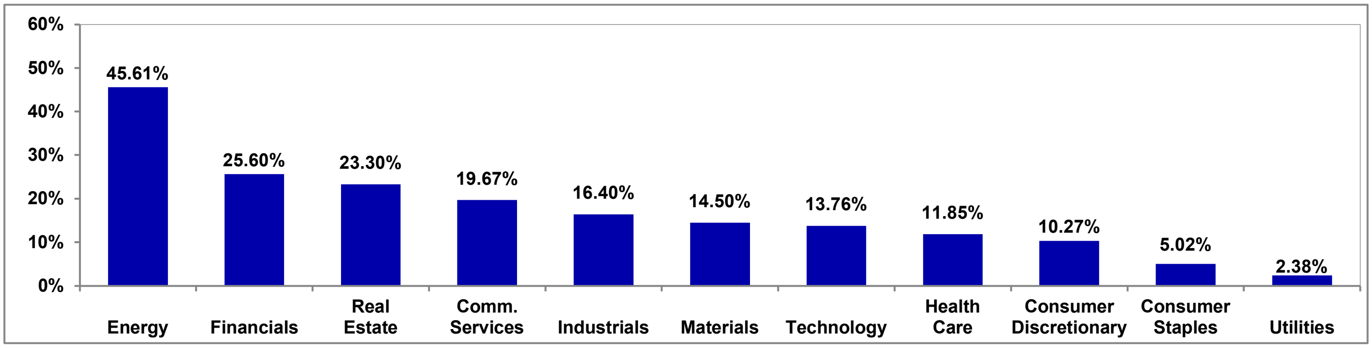
- Mega-cap growth stocks re-emerged to lead the market higher in the second quarter. Inflation beneficiaries, such as energy and real estate, also were strong performers.

- Leadership in the market was narrow during the quarter. Evaluating performance at the sector level highlights that only four out of eleven sectors outperformed the S&P 500 Index. A similar analysis of individual stocks shows that only 38% outperformed the index, while 62% underperformed.

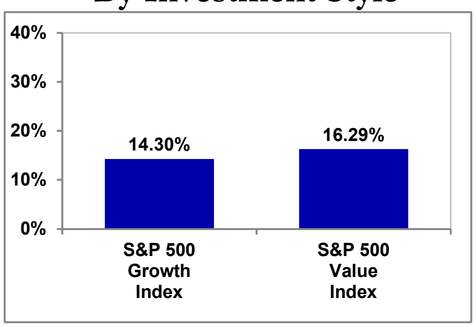
- Company size and investment style were dominant factors driving second quarter returns. After six months of outperformance in late 2020 and the first quarter of 2021, value stocks, as well as small/mid cap stocks lagged.

Year-to-Date Investment Performance (including income)

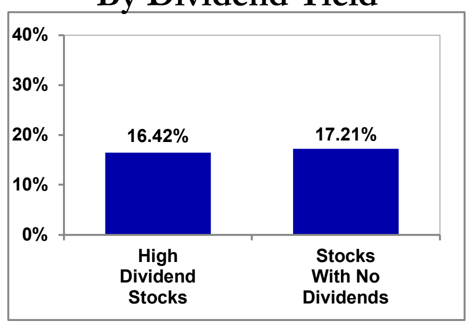
By Economic Sector



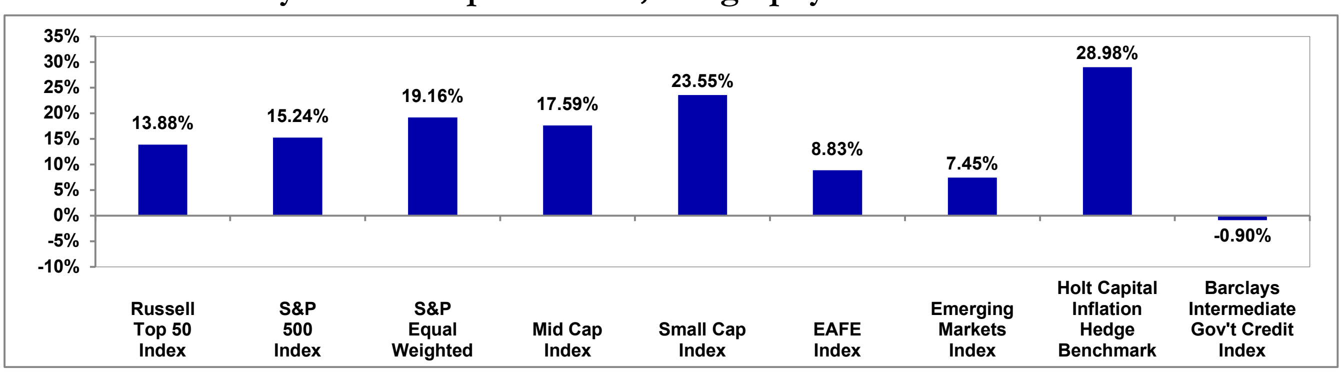
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- The breadth of the year-to-date rally can be seen in the fact that all sectors, all styles, all geographies, and all market capitalizations posted positive returns. Only bonds posted negative returns.
- The strong rally in the energy sector has been supported by higher crude oil and natural gas prices. Crude oil prices have risen 51% this year and natural gas futures ended the quarter at $3.65/MMBtu, which is a multi-year high.