HOLT CAPITAL
PARTNERS, L.P.

FIRST QUARTER FINANCIAL MARKET COMMENTARY

"NINETY DAYS IN NINETY SECONDS"

MARCH 31, 2020

COVID-19

- The coronavirus is likely to have a long lasting impact on the economy and how people live, work, travel, and spend. Beyond these lifestyle issues, municipalities will experience shrinking tax revenues, while businesses will see a lengthening of just-in-time inventory cycles and the need to re-domesticate manufacturing facilities.

- The current range of forecasted outcomes, from best-case to worst-case, is extremely wide. The best-case scenario for the U.S. looks more like Korea, China, and Singapore where the "curve has flattened." The worst-case scenario views Italy as a model and is much more devastating.

- As the country moves through this unprecedented period, difficult decisions around the trade-offs between economics and health issues will ultimately be required. In the midst of this uncertainty, the road to recovery on both Main Street and Wall Street will be bumpy. Importantly, stock prices are forward-looking and the decline in stock prices already incorporates a substantial amount of bad news.

POLICY RESPONSES

- The Federal Reserve announced a number of massive monetary policy initiatives during March. Unlike the Great Depression and the 2008 Financial Crisis, Fed Policy is clearly ahead of the curve. New lending programs by the Fed have improved liquidity and confidence in the government, corporate, and municipal bond markets. However, parts of the high yield and mortgage markets are still experiencing significant dislocations.

- Congress passed a broad $2 trillion fiscal stimulus package. This significant government response is expensive, but necessary to prevent temporary revenue declines from becoming permanent business impairments. The hoped for result is a shorter recession, less unemployment and reduced economic suffering.

- Health care policy is currently focused on mitigating transmission to "flatten the curve" and prevent overloading hospitals. The next phase must find a way to safely resume semi-normal daily life. Dr. Fauci and Dr. Birx have been praised for their leadership and communication skills.

BUNGEE JUMP RECESSION

- The past six weeks have been dominated by extreme levels of fear that is both uncomfortable and unquantifiable. Interspersed with this fear has been a sharp spike of greed and relief associated with the three day fiscal stimulus-inspired rally in late March.
- Economic activity has effectively ceased, but just temporarily. Unprecedented levels of economic weakness in March will carry over into the second quarter. However, unlike the more complex breakdown of the financial system the country experienced in 2008, this recession started on Main Street with governmental shut down orders.
- I would describe the economic environment of the next several quarters as a "bungee jump recession." After a record near-term drop in economic activity, the economy is likely to make a quick u-shaped bottom as businesses begin to reopen and lockdowns are lifted. This should be a mid-to-late second quarter phenomenon. The absolute size of economic and unemployment statistics will sound scary when they are reported, but they will simply be quantifying what everyone already knows about the abrupt pause in economic activity.
- A historic economic rebound driven by the normalization of consumer activity and pent-up demand should occur in the second half of 2020. Business and consumer activity in 2021 should return to normal and reflect growth versus 2019.

OIL PRICE WAR

- Saudi Arabia and Russia are engaged in a destructive market share war in which competitive increases in supply are colliding with weakened global demand. These factors have pushed crude oil prices to eighteen year lows. The duration of this extreme geo-political gamesmanship is unknown, but it is producing significant near-term financial stress on the energy sector, as well as lenders.
- The industry adage that "the cure for low prices is low prices" implies that drilling activity will slow and lead to lower supplies of crude oil in the future. The bullish view is that the decline in production will overshoot on the downside and create an oil price "super cycle" in 2022. In the meantime, cutting costs, selling assets, and managing the balance sheet will be the keys to survival for the industry.

DEFLATION OR INFLATION?

- The near term answer to this question is that skyrocketing unemployment and collapsing commodity prices will restrain inflation until economic activity normalizes. Longer term, unprecedented monetary policies and higher budget deficits, combined with an expected reduction in the use of low cost global supply chains, are likely to prove inflationary.

Markets

- Panic selling has resulted in fundamental business values totally disconnecting from market prices. The true value of a business rarely changes by ten or twenty percent in a single day. The stock market simply provides a liquidity mechanism that allows supply and demand to determine market prices. Sometimes factors as diverse as emotions, margin calls, or uncertainty about the future have an outsized impact on the market's price discovery function. In contrast, the drivers of long term business value are cash flow, growth in cash flow, quality of growth, and balance sheet strength.

- Over the past fifty years there have been four major bear markets. Most people remember the pain of seemingly endless declines in stock prices. However, each of those bear markets created buying opportunities for investors because market prices were well below the long term value of the business. The current bear market is producing similar opportunities for long term investors

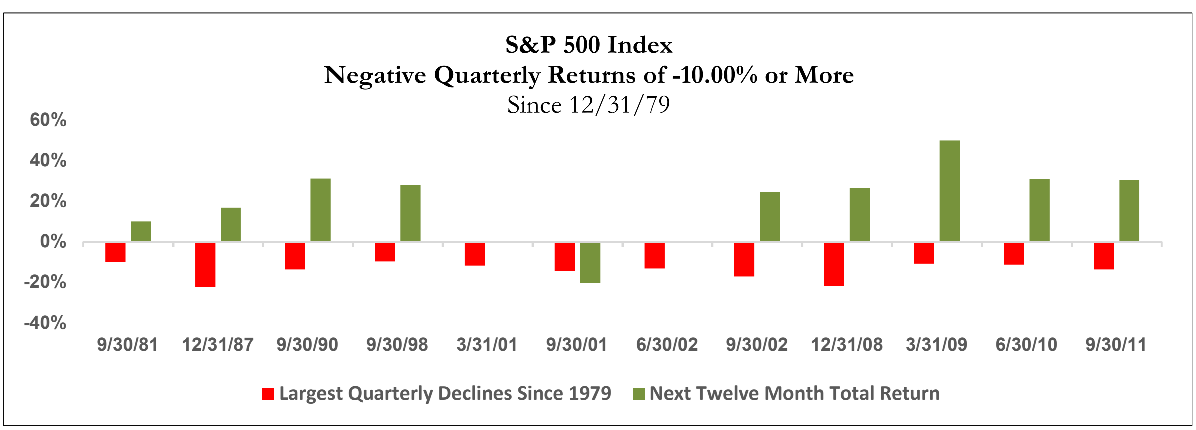
- It is human nature for the wide range of possible near-term Covid-19 outcomes to drive a high level of price volatility. As the range of outcomes begins to narrow, volatility should also subside.

- Pinpointing "the bottom" is not a productive exercise. Stocks will bottom and create a sustainable recovery long before the Covid-19 virus is in decline. In the early stages of a new bull market, stocks do not require good news, but merely a diminishing flow of bad news.

Insights From Historical Price Declines

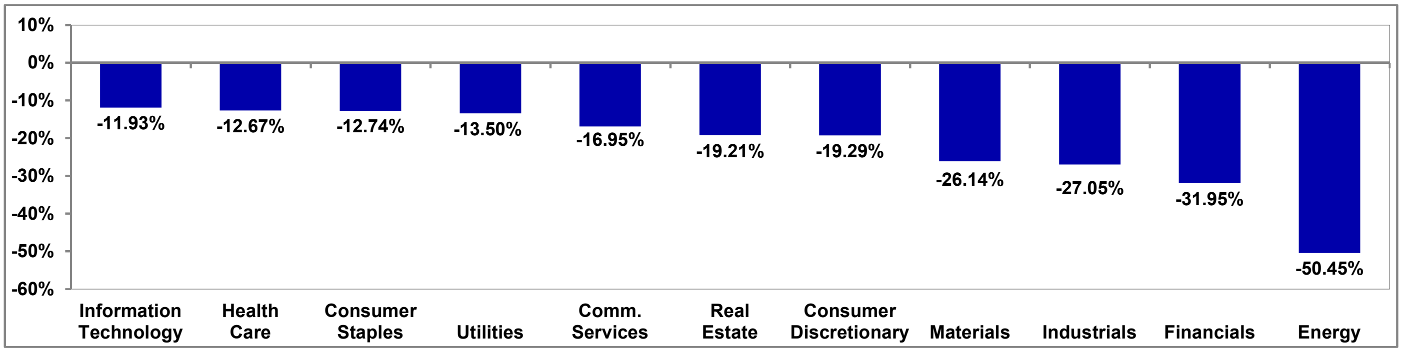
- Periods of sharp price declines, by definition, result from investors processing information that is unexpected and perceived to be negative. Those reactions typically cause prices to over shoot on the downside.

- Twelve calendar quarters over the past four decades have had negative returns of 10% or more. Only one quarterly period was not followed by a positive return over the next twelve months. On average, the one year periods following a sharply negative quarter generated a total return of 19%.

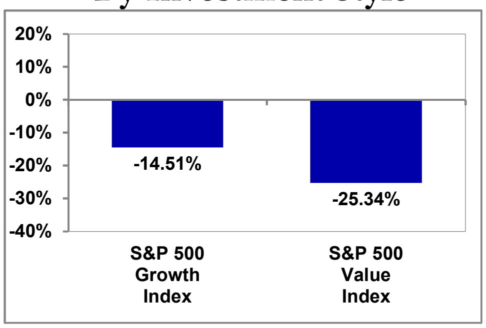


First Quarter Investment Performance (including income)

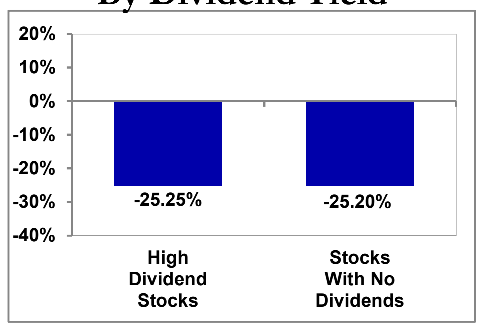
By Economic Sector



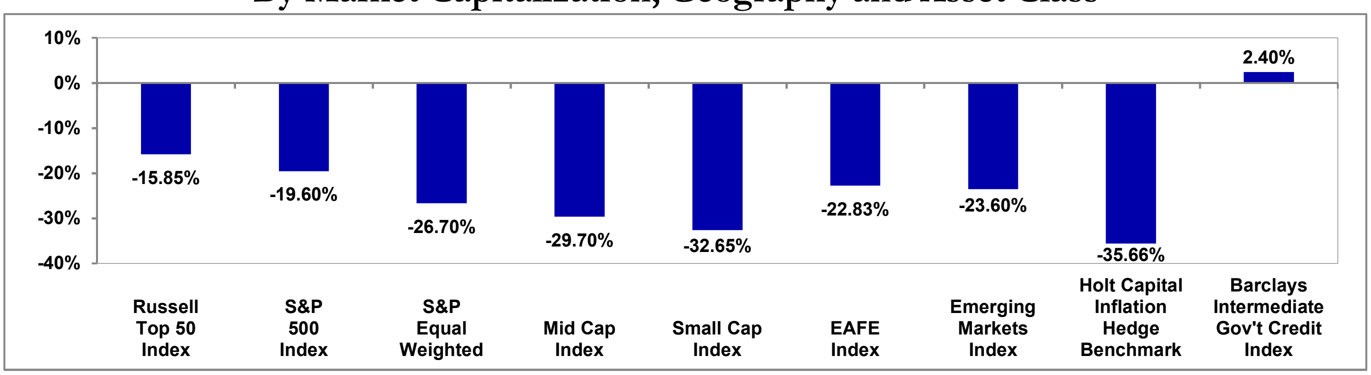
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- During the Financial Crisis in 2008, the phrase "correlations all went to 1.00" came into common usage. This observation implied that there was little discrimination among stocks based upon individual company prospects, they just all went down together. The same behavior characterized the first quarter.

- As the economy shifted rapidly from broad strength and low unemployment, the outlook for economically sensitive stocks deteriorated at an accelerated pace. Value stocks, small/mid cap stocks, and commodity-oriented sectors are often more cyclical and have been subject to seemingly unrelenting selling pressure.

Conclusion

- Corporate executives theoretically are the most knowledgeable investors regarding their own shares. In the midst of this virus-driven bear market, insider buying is at levels not seen since the Financial Crisis and the dot com period.

- How should stocks be valued in this complicated environment? The bungee jump recession will significantly distort and depress 2020 earnings. Assuming earnings in 2021 grow slightly compared to 2019, the S&P 500 trades at a price-to-earnings ratio of about 15x 2021 earnings. This makes stocks attractive compared to the thirty year average P/E of 17.5x.

- Long term opportunities are often born out of short term pain. Attractive valuations that are affirmed by insider buying, combined with unattractive yields on bonds and cash will ultimately drive a new bull market in stocks.