Holt Capital Partners, L.P.

First Quarter Financial Market Commentary

"Ninety Days in Ninety Seconds"

March 31, 2024

Investor Friendly Federal Reserve Policy?

- The Fed's March meeting concluded with the release of forecasts for economic growth and inflation that were revised higher. At the same time, expectations for three interest rate cuts this year were unchanged. In theory, forecasts of stronger growth and higher inflation should have translated into a "higher for longer" projection for rates. One conclusion from these divergent data points is that the Fed is anxious to cut rates and is willing to see the economy run hotter as a result.
- The Fed's mandate is to promote maximum employment and stable prices. This is presenting a policy dilemma. Interest rates were pushed steadily higher in 2022 and 2023 with the goal of driving inflation down to the Fed's 2% goal. Inflation has come down but has not yet reached the Fed's target. Cutting rates too soon would signal a victory before crossing the finish line and could re-ignite inflationary pressures. Alternatively, waiting too long could push the economy into a period of slower growth.
- Strong growth is currently evident in macroeconomic statistics, corporate profits, and the labor market. This growth is occurring despite current interest rate levels. Except for commercial real estate lending, credit availability for corporate borrowers is as loose as it has been in many years. A decision to aggressively cut rates could spark a concern among investors that the Fed sees the economy weakening, which would be inconsistent with the prevailing Wall Street view of strong revenue and profit growth.

The Federal Reserve and the Presidential Election

- Complicating the non-partisan Fed's decision on interest rate policy is the upcoming presidential election. During the period of zero interest rates, savers and retirees were penalized with extremely low returns on cash and fixed income investments. Now, returns are more normal, but concerns have shifted to the impact of borrowing costs for the lower end of the economic spectrum. There are election implications for these two voting blocks. The Fed is determined to stay out of the political fray, which could impact the timing of any change in interest rate policy.
- There are times when Fed policy is straightforward. This is not one of them. Inflationary trends, economic growth, bullish investor expectations, and the rhetoric around the election could create unexpected financial market volatility.

Goldilocks

- Economic growth is fueling strong job gains and robust consumer spending. The manufacturing side of the economy has rebounded sharply over the past six months. In this environment, forecasts for corporate revenues and profits continue to rise. While there is some near-term uncertainty about the path of inflation, it has fallen sharply over the past two years. As we discussed last quarter, these are characteristics of an economy that the pundits often refer to as Goldilocks, i.e., "not too hot, not too cold."

History Is A Poor Guide For This Economic Cycle

- Stock market bulls cite the presidential election year as a positive factor because the S&P 500 has rallied in every election year since 1944. In addition, corporate revenues, margins, and earnings are all expected to post strong gains this year. During 2023, earnings growth was barely above zero, but stock prices rose based on an expansion in price-to-earnings multiples. This year strong fundamentals should provide a tailwind for stocks, even without any further multiple expansion.
- On the flip side, the yield curve has been inverted (2-year yields are higher than 10-year yields) for 434 consecutive trading days, which is a record. All eight previous occurrences of an inverted yield curve have been followed by a recession. Unemployment is clearly still low, but the unemployment rate has risen from its low point of 3.5% in April of last year to the current rate of 3.9%. Another uptick in the unemployment rate would produce a 0.5% increase from the lows. A movement of that magnitude has also always preceded a recession.
- Current trends are defying historical analogy, making forecasts tricky. However, we remain in the strong growth camp and do not expect a recession in the foreseeable future.

How Vulnerable Are The Magnificent Seven?

- Some members of the Magnificent Seven appear to have lost the ability to levitate above the rest of the stock market. Only NVIDIA, Meta Platforms (formerly Facebook), and Amazon produced first quarter performance that was meaningfully above the S&P 500.
- Tesla has had to cut prices aggressively in all markets as competition has increased and customer demand has failed to broaden as fast as expected. China has been Tesla's biggest market and sales growth in that country has slowed sharply. The company's first mover advantage seems to be fading and the 30% decline in the stock price reflects these issues.
- Apple is facing headline risk from regulatory issues, slower sales in China, and a perceived lag in adding AI features to their products. None of these are new developments and the company's $175 billion cash position and massive free cash flow mean that it is not facing any financial risks. Apple's P/E ratio is in-line with its five-year average, so its valuation is not extended. The fundamental case for Apple remains solid and this is especially true for long term taxable shareholders with an extremely low cost basis.

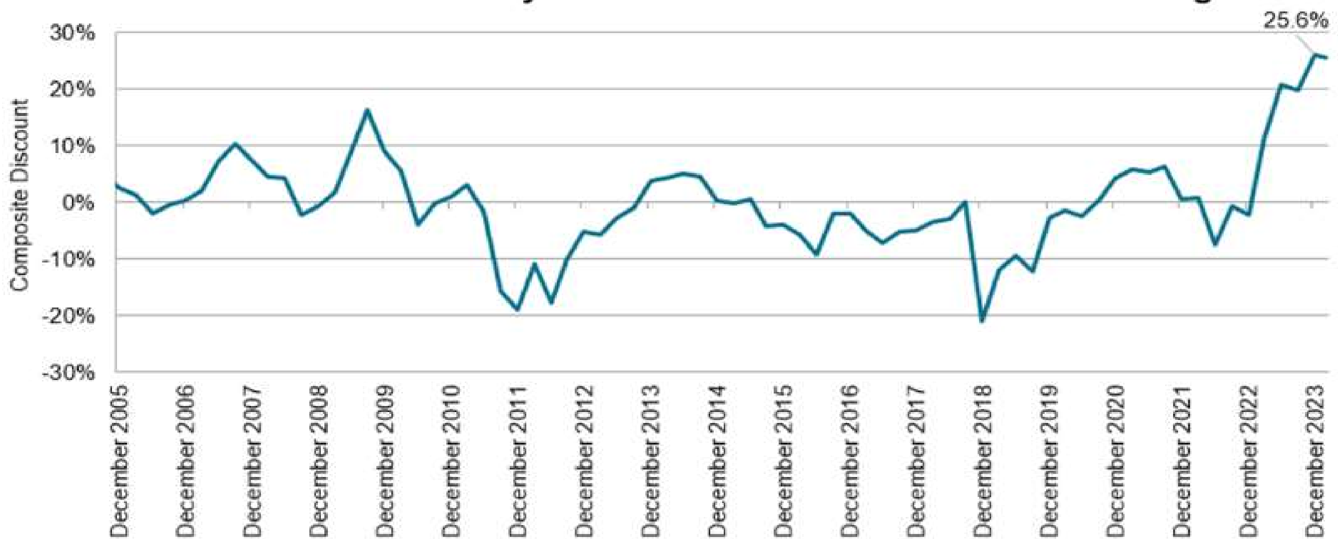
Iconic Companies, But Stock Market Laggards

- Much has been written over the past year about the performance of the Magnificent Seven and other volatile highly valued technology stocks. The returns from this handful of stocks have dwarfed most other segments of the stock market and spawned comparisons with the dot-com bubble of the late 1990s. A different illustration of the market's narrow leadership comes from the solidly profitable and defensive companies that comprise the S&P 500 Low Volatility Index.

Iconic Companies, But Stock Market Laggards (continued)

- Over the past twenty years, this index has produced returns that are similar to the S&P 500, but with lower price volatility. However, the recent underperformance of these stocks belies their long-term record. Representative companies in this 100 stock index include blue chips such as Coca-Cola, Colgate-Palmolive, Johnson & Johnson, and Duke Energy. The interesting aspect of this recent underperformance is what it could mean for the future. As the graph below illustrates, this index of less volatile companies is trading at relative valuations that are at twenty-year lows. Valuations are not a short-term market timing tool, but the price that investors pay for companies has a significant long-term impact on future returns.

Exhibit 4: S&P 500 Low Volatility Discount versus S&P 500 over the Long Term



Source: S&P Dow Jones Indices LLC. Data from Sept. 30, 2005, to Feb. 29, 2024. Index performance based on total return in USD. The S&P 500 Low Volatility Index was launched April 4, 2011. All data prior to index launch date is back-tested hypothetical data. Past performance is no guarantee of future results. Chart is provided for illustrative purposes and reflects hypothetical historical performance. Please see the Performance Disclosure linked at the end of this post for more information regarding the inherent limitations associated with back-tested performance.

Conclusion

- The rally that began in late October was sparked by renewed optimism regarding a shift by the Fed to a policy of lower interest rates. It was further spurred by strong fourth quarter earnings and expectations for sustained earnings growth in 2024 and 2025. The straight up nature of the rally has been impressive, but volatility has always been a component of equity ownership. We expect 2024 will be a strong year for stocks, but the balance of the year is likely to see a return to more normal ebbs and flows in prices.

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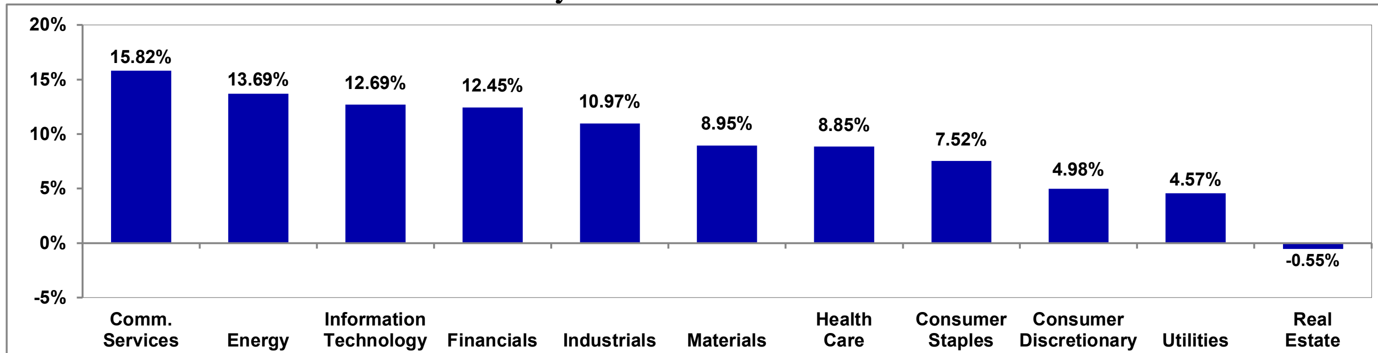
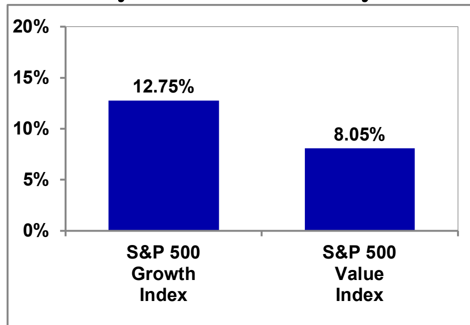
Year-to-Date Investment Performance (including income)

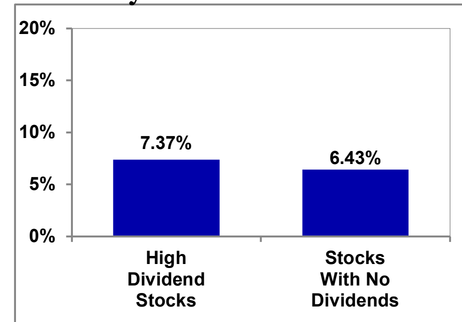
By Economic Sector



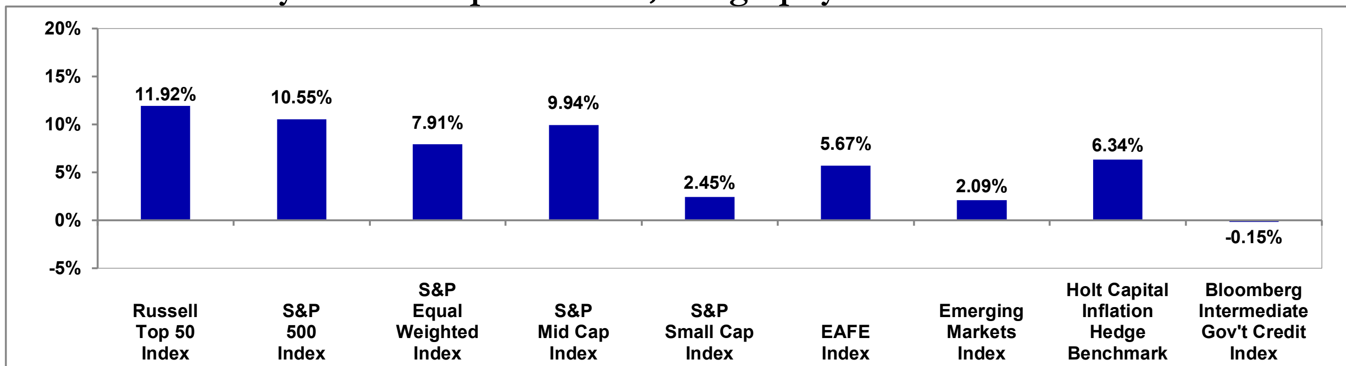
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- Stock market leadership has recently expanded beyond the AI enablers to include energy, industrial, financial, and materials stocks. Although small stocks and high-quality dividend payers lagged large cap indexes during the quarter, they exhibited renewed strength in March.
- Although the energy sector was a laggard last year, the stocks have recently benefited from extended supply cutbacks from OPEC+, as well as growing U.S. demand.
- Yields on the closely watched 2 year and 10 year government bonds rose over 0.30% during the quarter, which pushed prices lower and depressed fixed income returns. Higher yields also negatively impacted the stocks in interest-sensitive sectors, such as utilities and real estate.