Holt Capital
Partners, L.P.

Fourth Quarter Financial Market Commentary

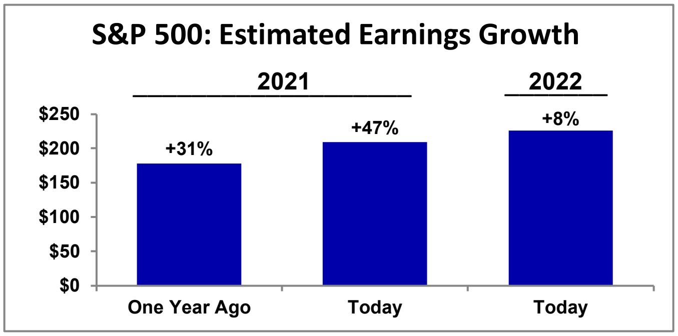
"Ninety Days in Ninety Seconds"

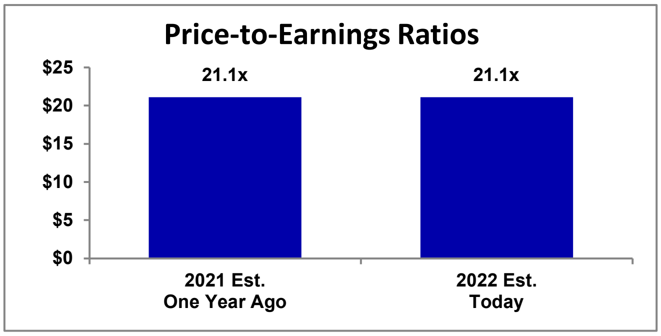
December 31, 2021

Earnings drive Stocks

- One year ago corporate profits were expected to rise by an impressive 31% in 2021. Over the course of the year estimates of profit growth have accelerated to a phenomenal 47% growth rate. Although this growth is partly a function of a depressed earnings base in 2020, the past year has clearly been a period in which corporate America has demonstrated tremendous adaptability in dealing with difficult pandemic and supply chain issues. Estimates for 2022 and 2023 imply continued earnings growth, but at a more normal pace of 8% to 10% per year.

- While stocks produced outsized returns in 2021, the fact that earnings expectations have continued to rise means that price/earnings are no higher today than twelve months ago.





Interest Rates and Federal Reserve Policy

- The traditional response of Federal Reserve Policy to sharply rising inflation would be to slow the economy by raising interest rates. Fed Chairman Powell has acknowledged that "transitory" is a word that should be retired when describing inflation and policy needs to become more restrictive. However, the impact of Covid, supply chain issues, and labor force participation all serve to complicate the aggressiveness of policy responses. In addition, the easy money policies of other developed economies continue to produce negative bond yields in Europe and Japan. These negative yields are acting as a cap on U.S. bond yields.

- Unfortunately, the net result of low interest rates is diminished purchasing power for domestic fixed income investors.

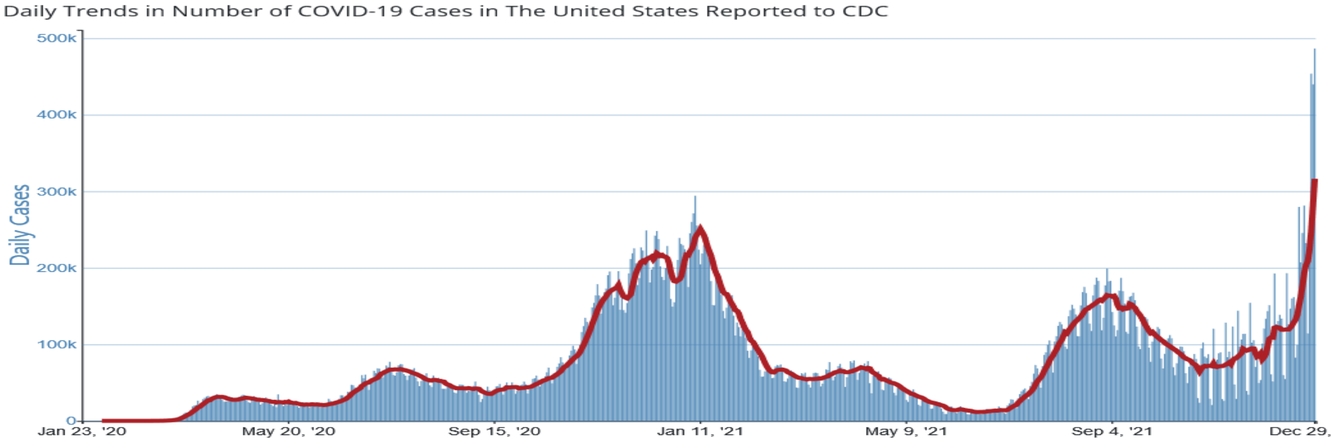
Valuation and Earnings Growth

- Our commentaries regularly focus on near-term revenue and earnings growth because those are important drivers of stock prices. However, other factors determine the price that investors are willing to pay for those earnings. Valuation is based on expectations around the durability of revenues and earnings. We believe that the durability of longer term revenue and margin trends has been enhanced by the stresses of Covid, supply chain issues, and labor shortfalls.

- Valuations are historically rich today. However, growth has been exceptional and the outlook for revenue growth and margin expansion remains solid. If one were to assume earnings growth continues to exceed expectations, then P/E ratios for 2022 and 2023 appear reasonable.

Omicron

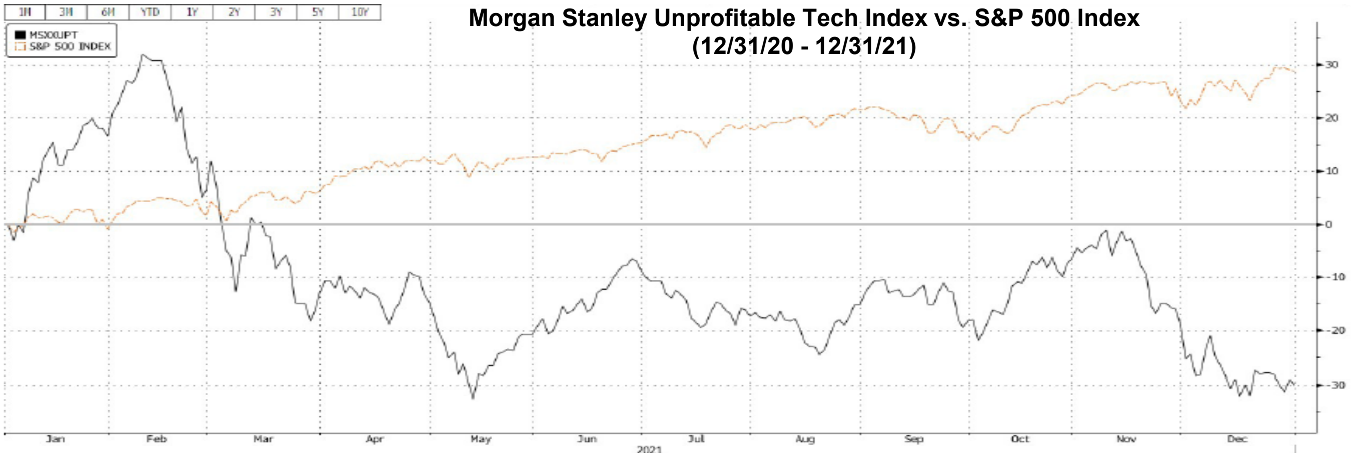
- The country had made great strides in its return to normalcy prior to the Omicron variant. While scientific studies suggest a much higher level of transmissibility, this variant appears to produce less severe symptoms. The surge in cases is coinciding with the return of students to school and the planned return of workers to offices. It is important to recall that prior spikes in Covid cases have been relatively brief and followed by sharp declines. Investor anxiety has thus far been mitigated by these historical patterns.


Daily Trends in Number of COVID-19 Cases in The United States Reported to CDC

Disruptive Technologies Faded

- Innovation and so-called disruptive technologies have been popular media topics for the past couple of years. We accurately highlighted the risks in SPACs and solar technology stocks in our year-end 2020 Market Commentary. The problem with most of these stocks is that the companies are likely to remain unprofitable for the next several years. Without any kind of valuation "backstop" from earnings, book value or traditional assets, stock prices become driven by investor sentiment, rather than fundamentals.

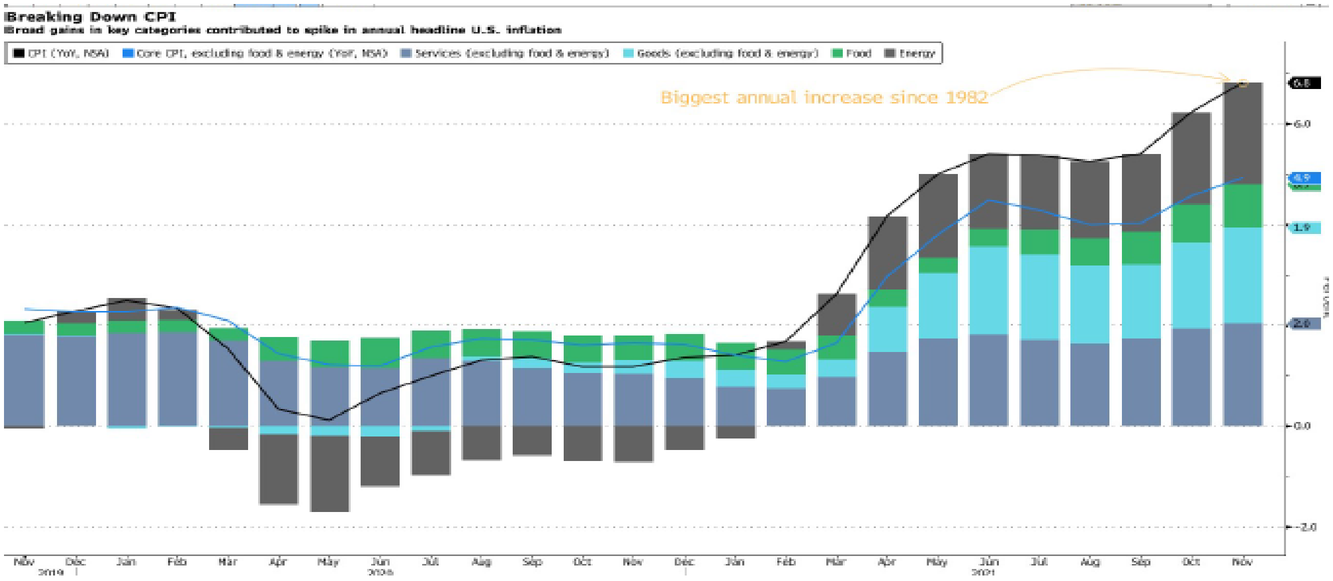
- Companies like telemedicine provider Teladoc, exercise equipment maker Peloton, or ridesharing company Uber Technologies may all become profitable and sustainable businesses over time. However, the following graph illustrates the volatility of unprofitable tech companies, even in the midst of a broad bull market.


Morgan Stanley Unprofitable Tech Index vs. S&P 500 Index
(12/31/20 - 12/31/21)

Persistent Inflation

- Inflation has proven not to be "transitory" and is clearly rising faster than previous Fed expectations. Some elements of inflation, such as supply chain issues, are likely to ease over the course of 2022. However, housing and labor cost pressures are probably more durable. The challenge of creating policies that can fight inflation while also acknowledging political pressures to be supportive of full employment will test Chairman Powell and the Fed.

- The graph below provides a more detailed view of inflation as measured by the Consumer Price Index. Over the past six months prices for goods (light blue) and energy (dark grey) have been large contributors to overall inflation. The goods category includes housing costs and both housing and energy reflect demand outstripping supply. We believe that inflation data will get worse before it gets better.



Odds and Ends

- The funded status of U.S. corporate pension plans jumped to 96% in 2021 according to Willis Towers Watson estimates. This is the healthiest position for large company pensions since 2007.

- The conglomerate business model continues to lose favor among giant corporations. General Electric announced plans to split into three public companies and Johnson & Johnson plans to spin off its consumer health business. Both of these changes follow DuPont's separation into three companies in 2019. The trend toward smaller more focused businesses continues to gain momentum.

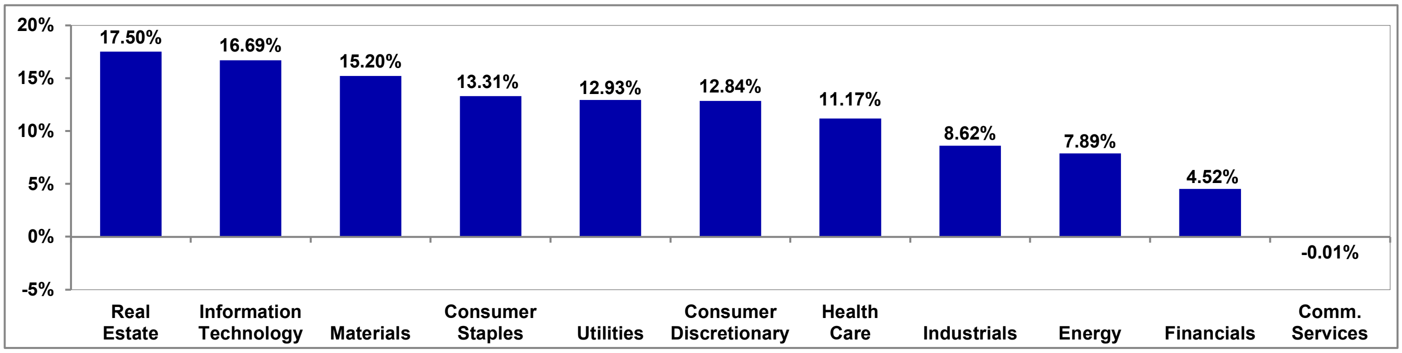
Conclusion

- Higher interest rates are likely in 2022, but that is not necessarily bad for the stock market. The S&P 500 rose an average of 5.3% in the twelve months following the first increase in seventeen tightening cycles since 1946, according to Ned Davis Research study.

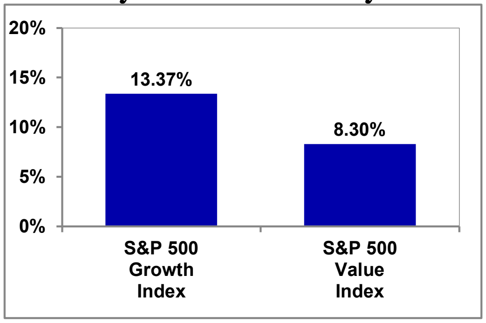
- U.S. economic growth appears robust and durable. The strength is driven by strong end-market demand with some businesses facing headwinds from supply bottlenecks and a shortage of workers. We remain optimistic about the next twelve to twenty-four months, but acknowledge that unexpected events could cause short-term volatility.

Fourth Quarter Investment Performance (including income)

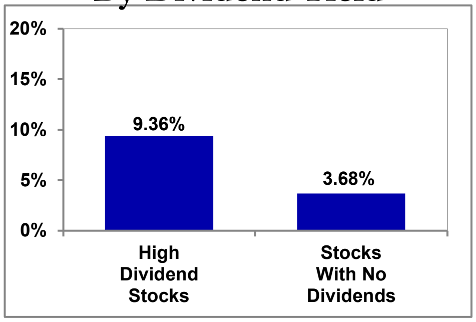
By Economic Sector



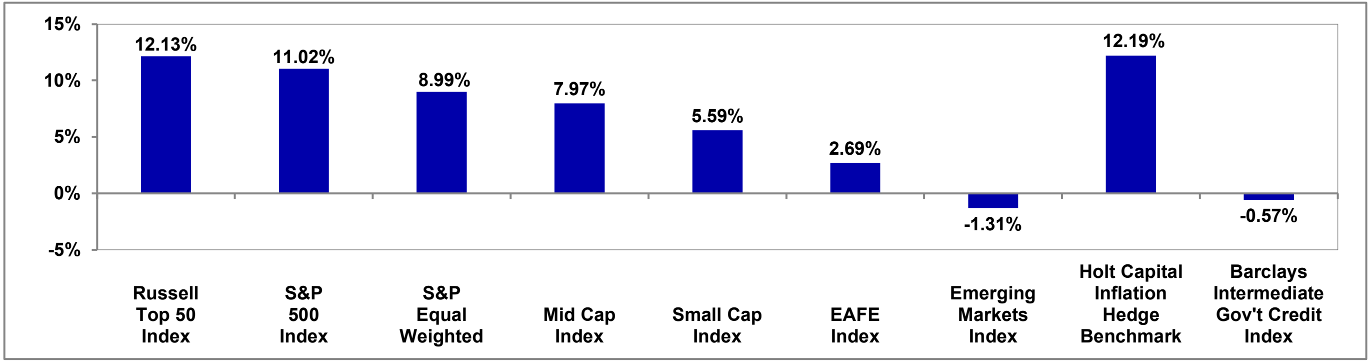
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



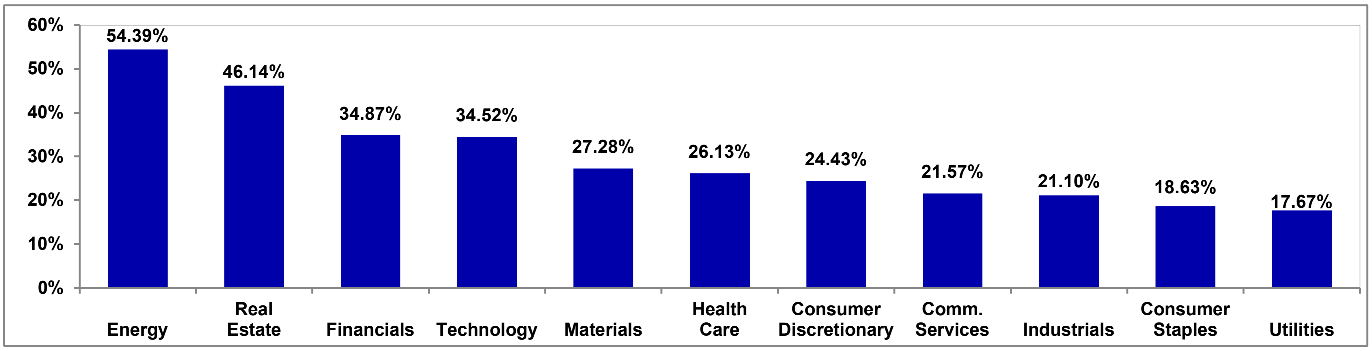
- Domestic stocks posted almost universally positive returns during the fourth quarter. Mega-cap growth stocks were the biggest drivers of returns and were led by semiconductor stocks and Tesla. Banks and telecommunications shares lagged.

- Although it is somewhat counterintuitive, the outperformance of growth over value did not extend to dividend stocks. High quality defensive dividend payors outperformed stocks with no dividends during the fourth quarter, as well as the calendar year.

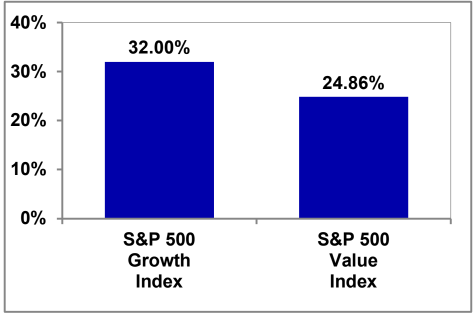
- While the Federal Reserve has yet to raise its policy rates, the bond market has seen yields rise in anticipation of Fed action. During the fourth quarter two-year notes were most impacted as yields rose from 0.28% to 0.73%.

2021 Investment Performance (including income)

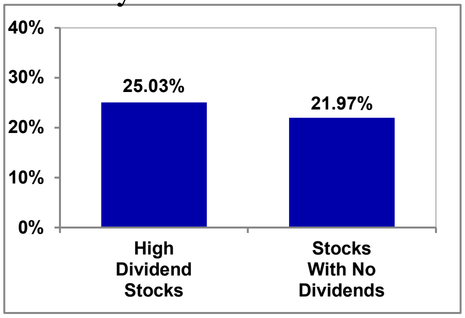
By Economic Sector



By Investment Style



By Dividend Yield



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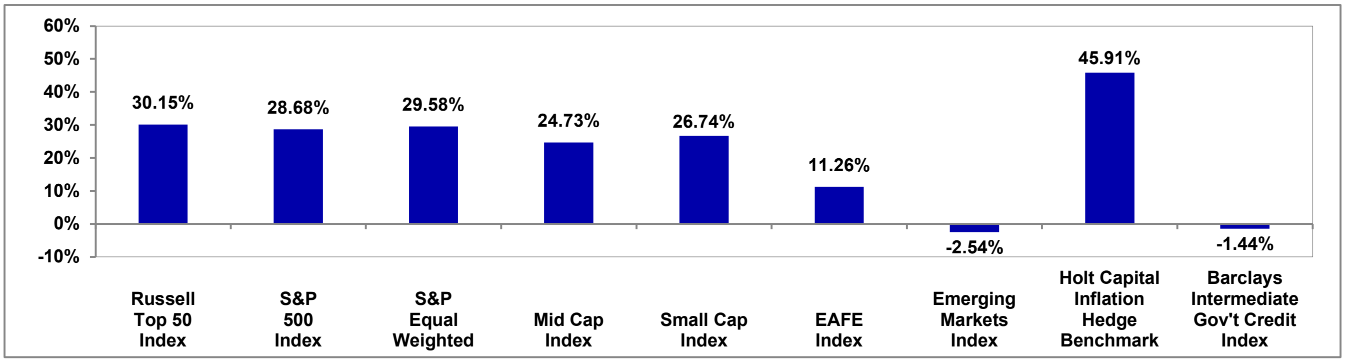

- All eleven economic sectors posted double digit gains for the first time since 2001. Energy was the best performer, after being the worst performing sector in 2020.

- Growth stocks outperformed value stocks for the year. However, as we discussed last quarter, there was significant intra-year rotation Value strategies outperformed from January through mid-May and again in December, but growth dominated during the mid-year period.

- Inflation beneficiaries, led by energy and real estate, were big winners during the year. International stocks lagged due to the combination of Covid, slower economic recoveries and China's regulatory crackdowns. Persistent inflation and the prospect of more restrictive monetary policy in 2022 depressed fixed income returns.