Holt Capital
Partners, L.P.

Third Quarter Financial Market Commentary

"Ninety Days in Ninety Seconds"

September 30, 2019

Wall of Worry

- While stocks rose during the volatile third quarter, financial market performance was broadly consistent with growing concerns about the potential for a recession. Bond yields declined and the yield curve remained inverted. The best performers in the equity market were defensive sectors that tend to be less sensitive to economic activity and/or beneficiaries of lower interest rates including utilities, consumer staples, and real estate. Economically sensitive sectors lagged, including poor performance by energy stocks.
- Risk aversion increased, especially in September. One of the factors that has been successful over the past few years is price momentum, i.e. buying the stocks that have performed the best over the last year, in the hope that they will rally further. A widely noted "momentum breakdown" witnessed brief but extreme underperformance by these stocks, which included many highly valued secular growth stocks. Pundits have noted this same dynamic occurred prior to both the 1998 and 2008 market downturns, but the divergence would need to persist to give veracity to the comparisons. Recent IPOs have also performed poorly culminating in the withdrawal of the highly controversial The We Company (a.k.a. "WeWork") offering. Merger and acquisition activity also slowed.
- The news cycle has been unrelentingly negative, which we see as mostly noise, except possibly as a highlight of the degree to which slowing growth seems to be self-inflicted. But then again, policy induced slowdowns are hardly without precedent.
- The question of a recession is always really a question of when rather than if. Will it be sooner or later is the proximate market uncertainty. We continue to believe the keys to extending the economic cycle, and triggering a rebound in global growth, are the effectiveness of monetary policy and the potential for a trade resolution. This has been our common refrain, so we will take a fresh approach in this edition of our Market Commentary and outline the bullish and bearish case for each issue.

To Trade Or Not To Trade

- The US-China trade dispute has persisted for over two years and has resulted in a tit-for-tat series of tariff escalations. Regardless of one's view of the long-term benefit of rebalancing the global terms of trade, the near-term cost is a slowing of economic activity. An imminent trade deal between the U.S. and China, however imperfect, is likely necessary to prevent a recession next year.
- The argument that such a deal is likely centers around the political incentives of both Chinese President Xi Jinping and President Trump. Both face political pressures with slowing economies and both have shown a willingness for political expediency. Trump would seem especially interested in a deal that declares victory in order to satisfy markets and boost the economy ahead of next year's Presidential election.

To Trade Or Not To Trade (continued)

- The argument against a near-term deal centers on the view that China cannot accept U.S. demands for structural reforms that it sees as an attempt to thwart its economic rise. While for the U.S., the trade war is really a broader shift toward a containment policy that ultimately seeks to diminish Chinese importance to U.S. supply chains. President Trump may believe his base of support will not waiver.
- The two positions are not, in fact, mutually exclusive. We believe a temporary bargain that creates a thaw in trade relations seems like the base case. That should pacify markets, but will also need to feed into business confidence to revive economic activity. Finally, it is worth noting that we will probably still be discussing China for years to come.

Too Little Too Late

- The current slowdown was likely triggered late last year in part by financial conditions that grew excessively restrictive as central banks began to normalize monetary policy into a strong economy just as trade tensions started to bite. How the Federal Reserve and other central banks respond from here is critical to the economy's path.
- The case that monetary policy will be effective in re-accelerating the economy is centered on the sheer extent of the reversal in policy from tightening to easing. The Fed cut interest rates twice in the quarter. Recall the consensus late last year was for multiple rate *increases* in 2019. The European Central Bank unveiled a decisive package of monetary stimulus, which on the eve of ECB President Draghi's term ending, is reminiscent of his 2012 "whatever it takes" response to the Euro crisis. In fact, central banks in at least 11 countries have cut rates since May.
- The case that monetary policy will be ineffective has two elements. The first is a form of "pushing on a string", which postulates that monetary easing as a tool to promote demand will be impotent against the "supply shock" of trade disruption. The second is a "low on ammunition" argument that worries already low rates will inhibit central bank power in this cycle. Proponents of this view point to yield curve inversions around the globe as supporting evidence.
- In our view, global central banks are responding decisively and appropriately to evolving economic data points. In this environment, the old market adage of "Don't Fight The Fed" seems appropriate.

Conclusion

- The markets have been bombarded by a lengthy list of negatives. The economic slowdown, hyper-political partisanship (including Brexit), and trade strife are well known. Isolated events such as the Saudi oil refinery attack, the GM strike, grounding of the Boeing 737 MAX, and the Hong Kong protests have also contributed to investor concerns.
- Of course, the economy could continue to weaken, or we could endure additional unforeseen shocks. But a small amount of good news could also trigger a rally. While stocks are up strongly for the year-to-date period, most indexes are flat on a price-basis for the last 20 months in spite of rising earnings.
- Equity market valuations that are near the average of the past 25 years provide for acceptable mid to high single digit long-term equity returns, which remain attractive in comparison to historically low bond yields.
- Without visibility to an inflection in economic growth, we expect volatility to remain elevated. Nevertheless, we recommend remaining committed to a sensible asset allocation that emphasizes long-term ownership of businesses via equity investments.

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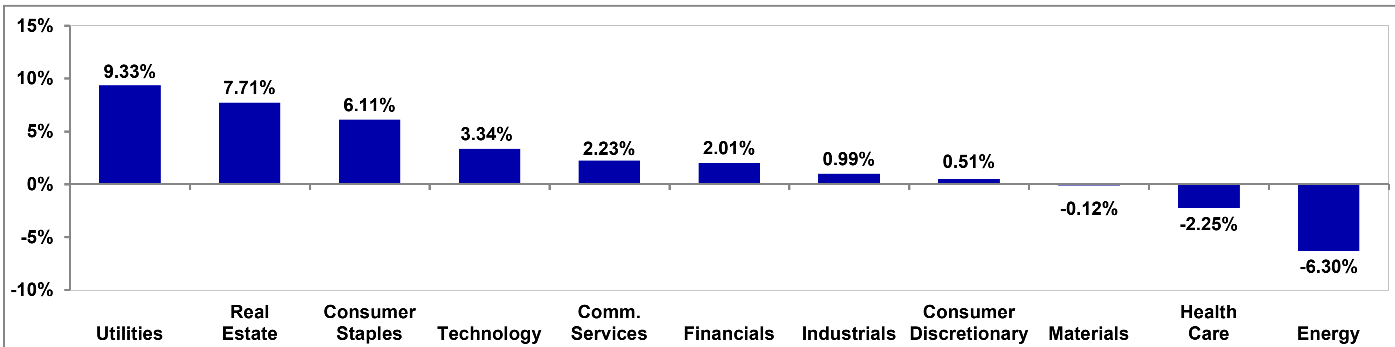
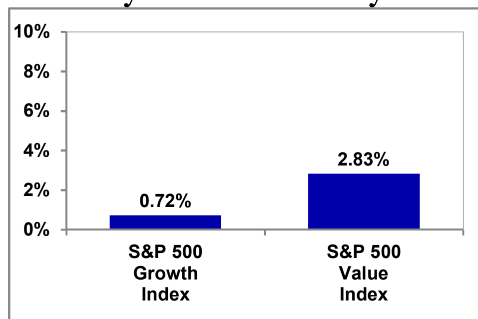
Third Quarter Investment Performance (including income)

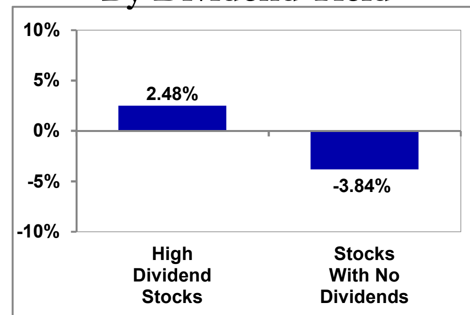
By Economic Sector



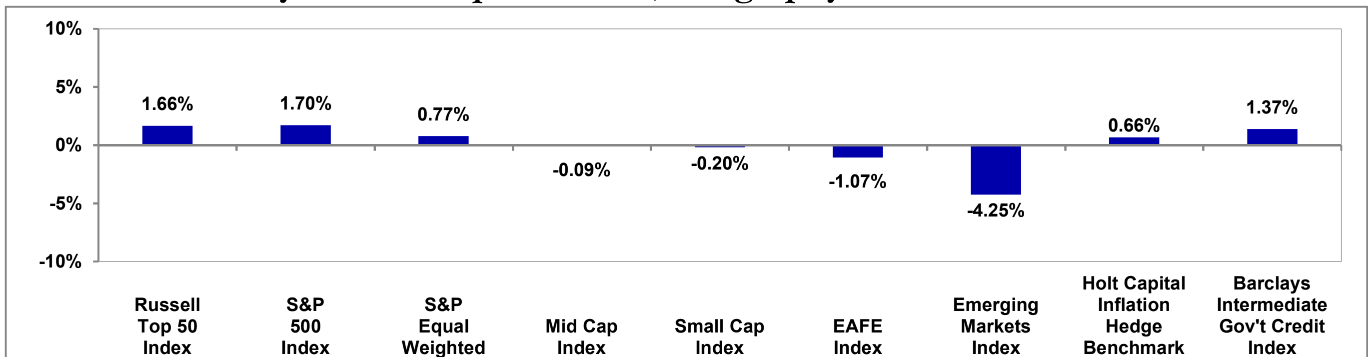
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- Interest rate-sensitive sectors provided stock market leadership, while the beleaguered energy sector fell along with crude oil prices.
- Value stocks outperformed growth stocks in a rising market for the first time in 11 quarters. During the third quarter, value stocks traded at their most depressed levels versus growth stocks since 1975!
- The risk aversion that we discussed on the first page was clearly evident in the outperformance of high dividend yields compared to stocks with no dividend yield.

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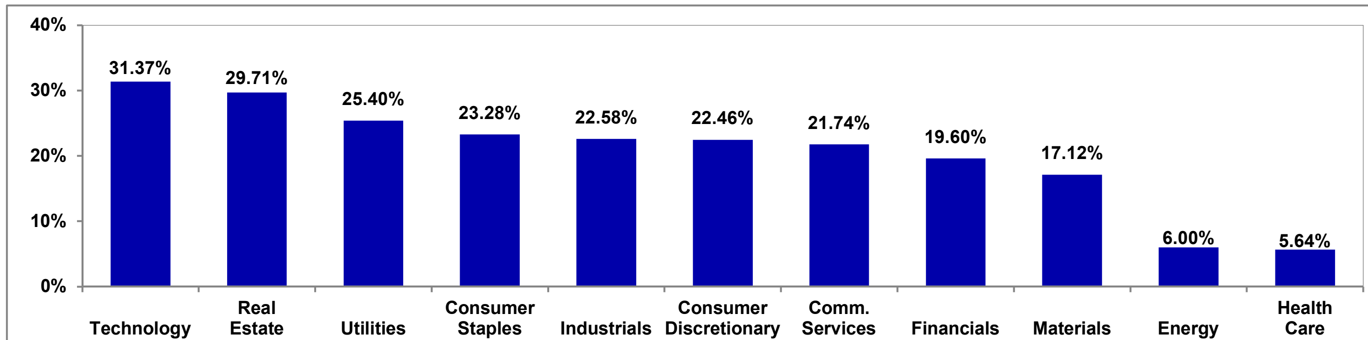
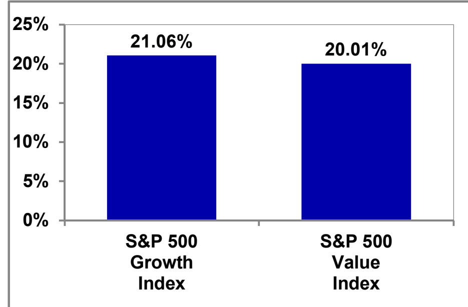
Year-to-Date Investment Performance (including income)

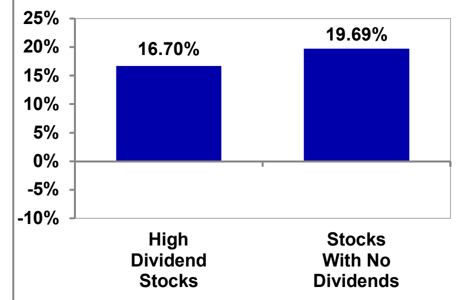
By Economic Sector



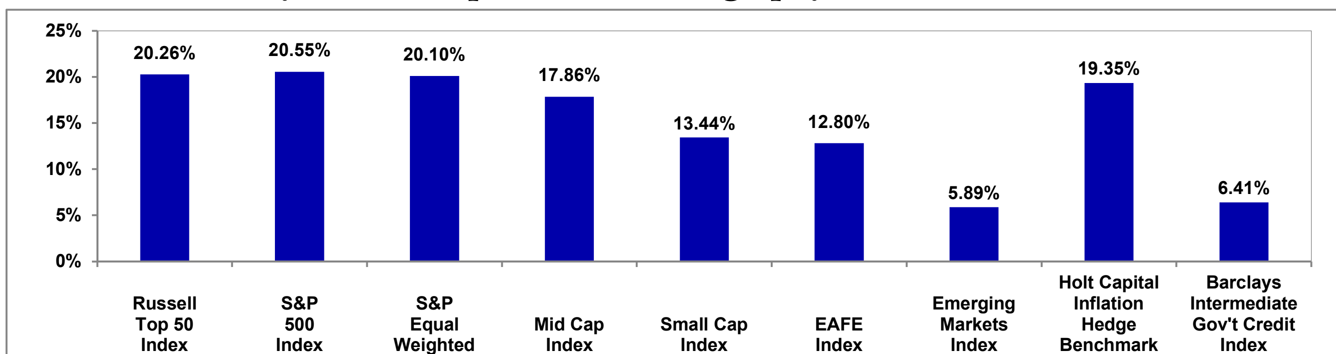
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- These year-to-date returns look impressive, but they are arguably misleading. The first quarter rebound merely offset the decline in the fourth quarter of 2018. On a trailing twelve month basis, large stocks have produced a total return of about 4%, while mid and small stocks are down 2% and 9%, respectively. This supports our view that equity market valuations are not stretched.
- Health care stocks have faced political headwinds over drug pricing and alternative health care coverage proposals.
- Yield-starved investors have driven the utilities sector sharply higher this year. These slow growing, regulated, and leveraged stocks are now valued at their highest price/earnings ratios in the past twenty years. Amazingly, electric utilities currently have slightly higher P/E ratios than technology stocks!
- The "best house in a bad neighborhood" continues to describe the returns in the domestic stock market compared to foreign markets.