Holt Capital
Partners, L.P.

Second Quarter Financial Market Commentary

"Ninety Days in Ninety Seconds"

June 30, 2017

Mixed Signals

- The stock market marched steadily higher throughout the first half of this year. While we do not disagree with that positive interpretation of the economic and profit data, a number of inconsistencies have developed.

- The optimism of the *stock market* is at odds with caution in the *bond market*. Ten year U.S. Treasury note yields have fallen from 2.45% at year end to 2.30%, while the Federal Reserve has raised short term rates three times in the past seven months. The result is a "flatter" yield curve that usually indicates slowing economic activity and moderating inflation expectations. Economic indicators have diverged with strength in the so-called "soft" measures but tepidness in "hard" measures. Soft data includes surveys such as consumer sentiment and the Purchasing Managers Index, while hard data seeks to tabulate economic activity such as retail sales and industrial production. Soft measures can be fickle, but confidence or so-called "animal spirits" can itself drive future growth.

- Synchronized growth in the G-20 appears to be accelerating, while inflation remains subdued. This is one of the biggest economic puzzles of the post-crisis era. For instance, the U.S. job market has tightened, especially for skilled workers, but wage pressures have yet to materialize on a broad scale. The reported inflation rate continues to be below the Federal Reserve's two percent target. The 5-year TIPS ("Treasury Inflation Protected Securities") implied inflation rate is also below 2%.

- These mixed signals likely result from an inflection in monetary policy. Not only is the Federal Reserve increasing short-term interest rates, but the FOMC indicated for the first time in April that the Fed would likely begin to shrink its balance sheet this year. In fact, central banks globally have taken a "tighter" stance on monetary policy including the Bank of England and the European Central Bank. The post-crisis era of "easy" monetary policy may be coming to a close.

- The tension between tighter monetary policy (i.e., higher interest rates) and accelerating global growth is the key relationship to watch during the balance of 2017.

The Banking Industry's Dividend Bonanza

- The country's biggest banks recently announced plans to increase dividends and share buybacks to their highest levels in years. This is in reaction to the approval of capital plans for these banks after being subjected to the Federal Reserve's annual stress tests. While positive announcements were broadly anticipated, the magnitude of capital returns was a surprise to investors. Most banks boosted dividend levels by double digit percentages, with many in the range of 30% to 100% increases.

- Prior to the Financial Crisis, bank stocks provided a source of reasonably high and predictable dividend yields. We have been positive on the improving health of the banking industry and viewed the prospect of market-leading dividend growth as a key driver. This most recent round of stress tests confirms that the industry is much better positioned to weather an unexpected financial shock and can also safely reward shareholders with higher dividends and larger share buy backs.

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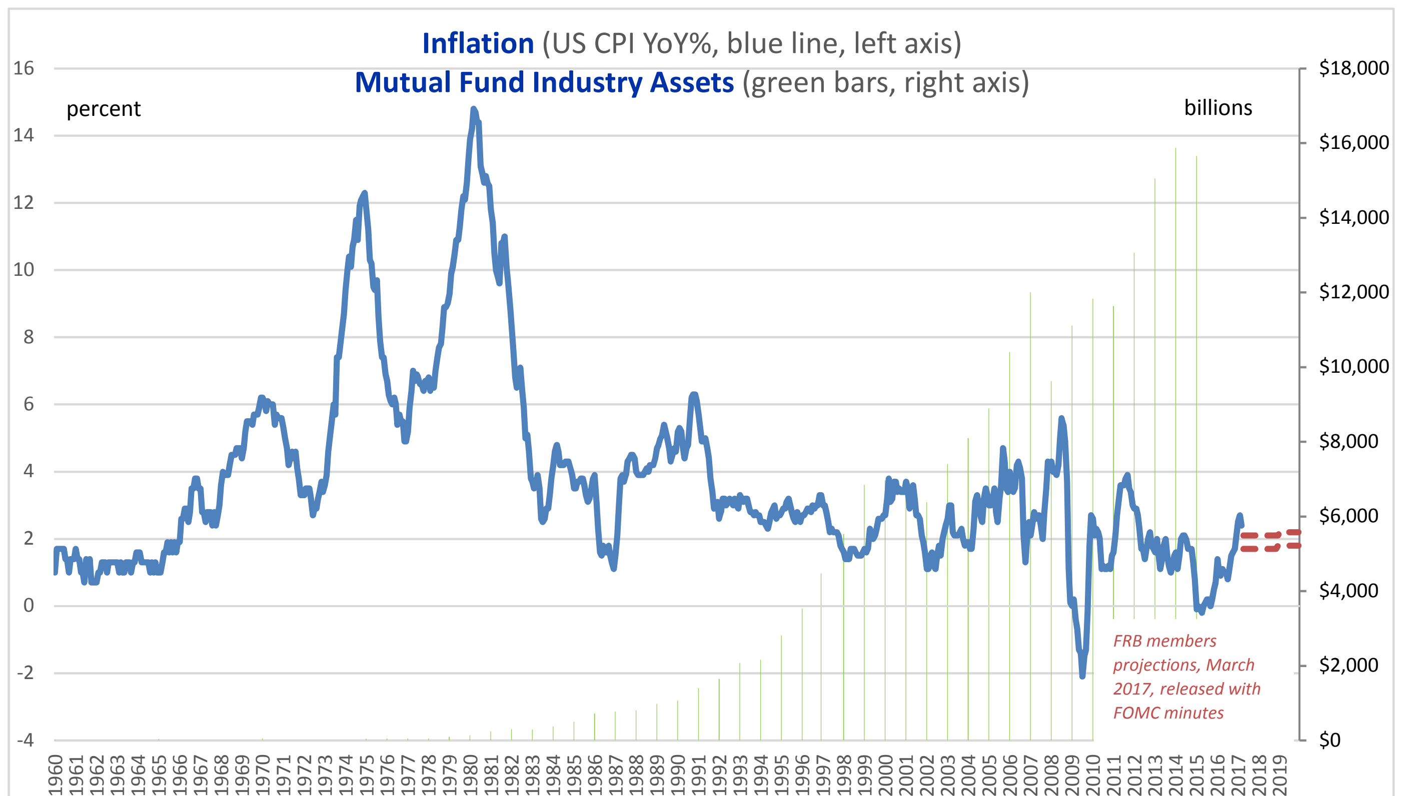

INFLATION: MUTED, MISMEASURED, OR AN UNAPPRECIATED RISK?

- Inflation remains low; some economists believe stubbornly so given the pick-up in growth.
- Virtually the entire professional money management business grew up during a period of low and stable inflation. The green bars in the graph above are mutual fund assets...but the number of CFAs or the number of CFAs per professionally managed assets would look the same. The Federal Reserve Board projections over the next 3 years, shown in red on the graph, appear to simply extrapolate the recent past. Taking a lesson from the proverbial frog that boils to death when the water is heated slowly, acclimation to our environment breeds complacency.
- Measurement of inflation has always been difficult, but the impact of technology has been incrementally challenging. While the internet has pressured a wide range of consumer prices and energy-related costs have declined, many expenses, including housing (either measured by home prices or rent), medical costs and tuition have hit new peaks.
- Investors have experienced a prolonged period of expansive monetary policy by nearly all major central banks, as well as unconventional methods of monetary easing. At the same time, rising wages in emerging markets and a reversal of globalization are potential contributors to future inflation.
- The housing market has such a scarcity of inventory in many markets that bidding wars are common, especially among first-time home buyers. In this environment, it is not surprising that new home prices are at record highs, having risen 44% in the past seven years. Given this level of home price inflation, it is somewhat counterintuitive that the reported inflation rate continues to be below the Federal Reserve's two percent target.
- While we are not predicting a spike in inflation, it is an important consideration in the construction of a well balanced portfolio.

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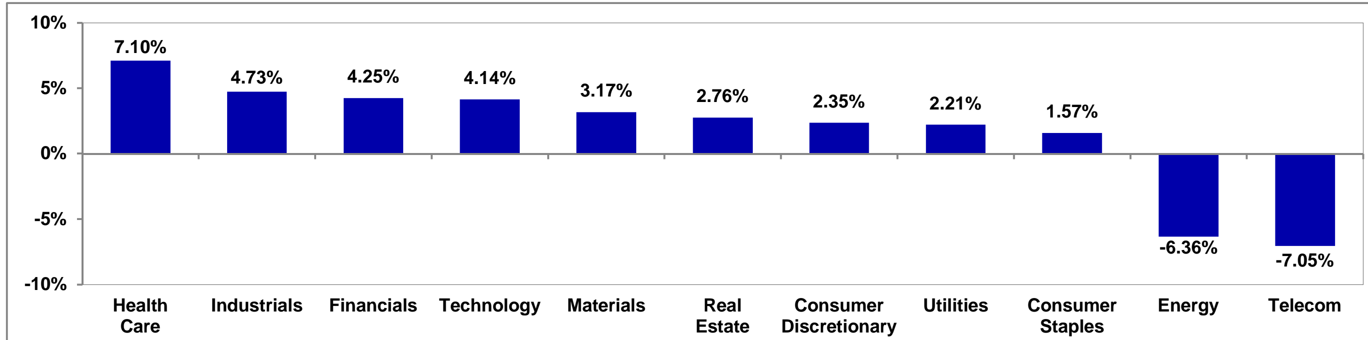
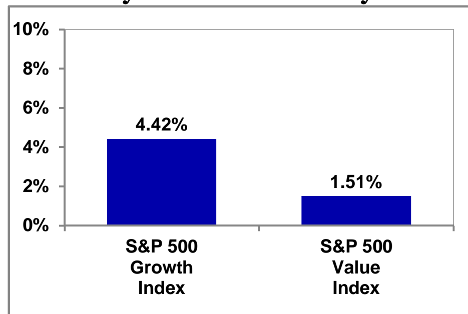
Second Quarter Investment Performance (including income)

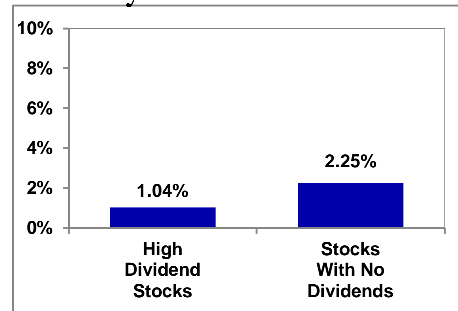
By Economic Sector



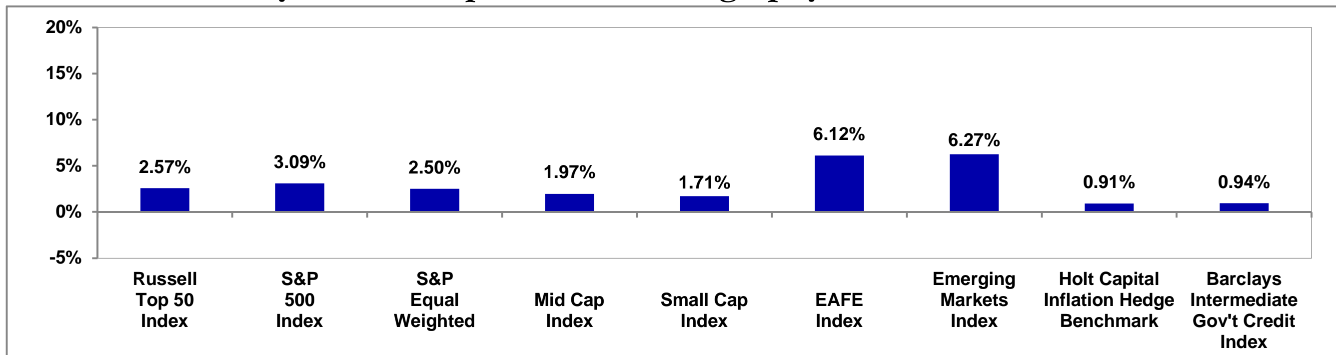
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- Stock performance during the quarter was broadly consistent with stronger global economic growth, with a couple exceptions.
- Large stocks continued to outperform small stocks, in part reversing a price surge by small stocks after the Presidential election.
- Energy stocks fell sharply along with a decline in the price of oil and despite an increase in the U.S. land rig count. As the global swing producer of crude oil shifts from OPEC to U.S. shale, marginal production is driven by economics more than politics and energy prices are quick to respond to changes in activity. It also appears that technological advances have lowered the break-even oil price in most basins.
- While not visible in the sector performance, it's worth noting that retail stocks were under pressure in the quarter as lackluster sales intensified fears of overbuilt retail capacity amidst a shift to on-line shopping. An interesting array of competitive responses have begun to emerge, with Amazon's acquisition of Whole Foods and the potential privatization of Nordstrom as prime examples.