Holt Capital
Partners, L.P.

First Quarter Financial Market Commentary

"Ninety Days in Ninety Seconds"

March 31, 2015

How Will Stocks Behave Without "Patience" From The Federal Reserve?

- After the March meeting of the Federal Reserve, Janet Yellen removed a line from the Fed's policy statement in which it had pledged to be "patient" before raising interest rates. This had the potential to signal a major shift in policy. However, data was also released that showed most committee members now believe that the economy will dictate a slow pace of interest rate increases. This implies that rates will stay relatively low for longer than expected in previous forecasts. The stock and bond markets both rallied in response to these shifts in Fed policy. Despite this positive reaction, interest rates and economic growth will likely remain wildcards for the financial markets this year.

Stocks - Attacked From Three Sides?

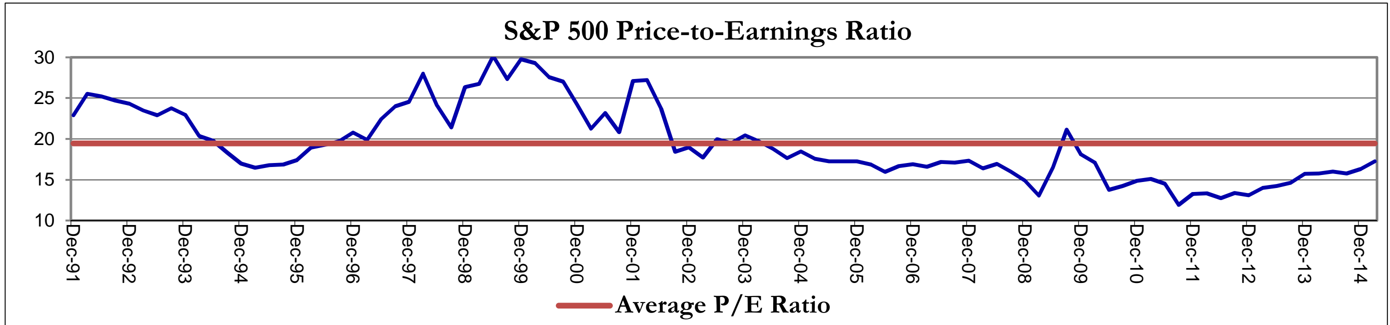
- Stock prices are usually driven by some combination of *earnings growth, valuation changes* or *interest rate policy*. It does not look like 2015 will be a big year for earnings growth. The biggest culprit is low oil & gas prices, which will cut energy sector earnings by about 60% compared to 2014. The U.S. dollar has rallied this year and the strong dollar puts downward pressure on the foreign earnings of U.S.-based global companies. While it is part of the mosaic of investing to analyze earnings trends, historical data shows a number of years in which earnings estimates declined, but stock prices rallied.

- From a long term perspective, valuations are still attractive and are below the average of the past twenty-five years. However, price-to-earnings ratios are currently at the upper end of their most recent ten year range. Based upon this data, P/E ratios can be described as reasonable, but not at levels that would make stocks "cheap".

- Our view regarding interest rates is that they are likely to rise over the next six to eighteen months. The increase may not result in a steep rise in rates, but the direction is clearly expected to be higher. This is consistent with our belief that the economy is fundamentally sound and that stronger credit demand is consistent with continued revenue and profit growth.

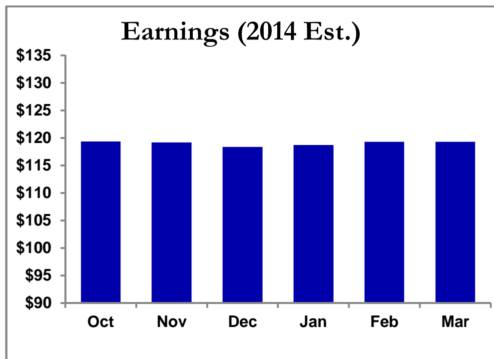
- Are these factors a precursor to the end of the bull market? Not at all. Capitalism is not like a basketball game in which the seconds tick off the clock as the buzzer sounds. Generation after generation of management teams work to create value for shareholders, with some years being better than others. This year is likely to be characterized by modest rallies and modest declines that culminate in only a small net change by year end. It could also prove to be the pause that refreshes, as consumer incomes recover and earnings growth returns in 2016.

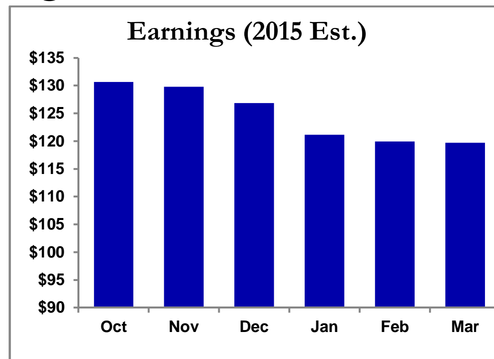
Earnings and Valuations



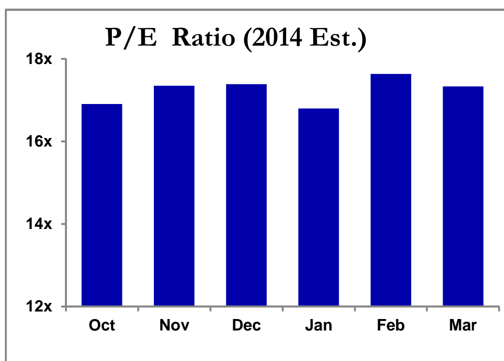
- Over the past two decades P/E ratios have ranged from 30x to 12x. Although valuations are not as depressed as they were during the financial crisis, P/E ratios are still below average when evaluated over a long period of time.

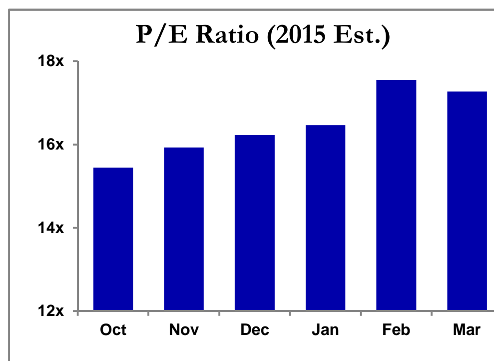
S&P 500 Earnings Estimates





S&P 500 P/E Ratios

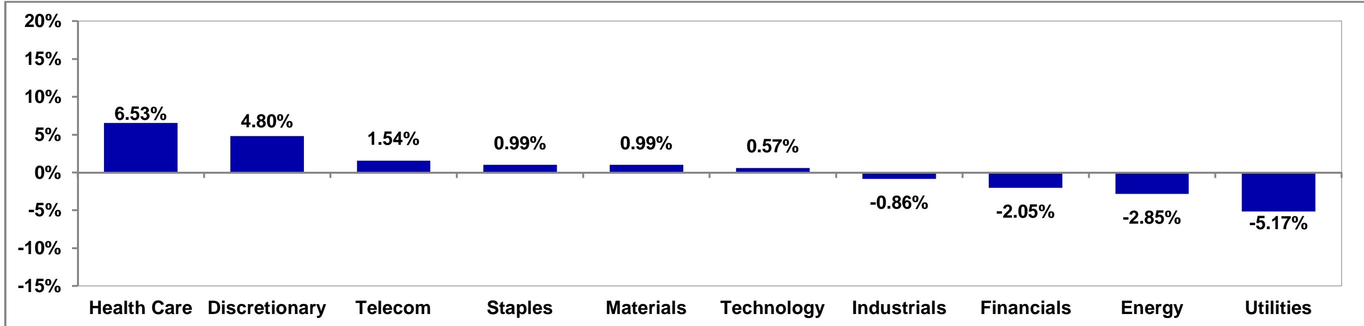




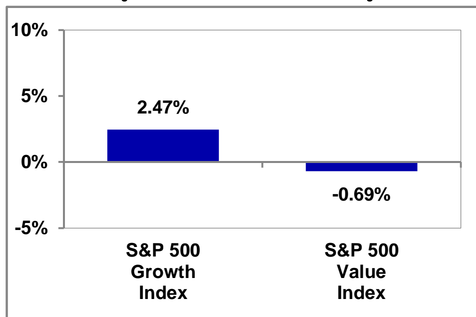
- Earnings estimates fell for nine out of ten economic sectors during the first quarter. Normally this would be a major concern for stock market investors. The biggest drop was obviously in the energy sector. This is a two-edged sword, since lower energy prices are beneficial for most other sectors of the economy. Other factors that impacted earnings during the first quarter include the strong dollar and record snowfall in the Northeast. While many of these items grabbed headlines, most could be considered cyclical or transitory and as a result, had a relatively limited impact on stock prices in the first quarter.

First Quarter Investment Performance (including income)

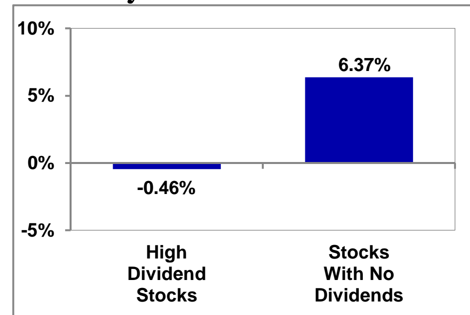
By Economic Sector



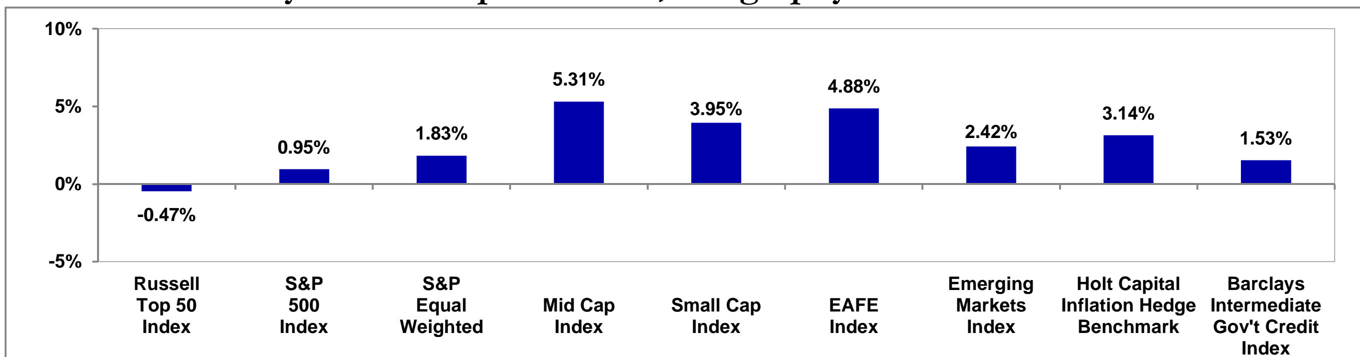
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- First quarter performance was largely driven by investors searching for non-cyclical, domestically-oriented sources of earnings growth. Domestic exposure minimized the impact of the strong dollar and these trends benefited the consumer discretionary sector, as well as small and mid cap stocks.
- It was generally a quarter that rewarded risk-taking, with strong performances from small and mid cap stocks, biotechnology, internet stocks, as well as companies that do not pay dividends.
- Large cap stocks, and more mature companies with stable dividends, tended to lag. Many of these large global companies faced accounting headwinds from foreign exchange translations.

Merger & Acquisition Activity Accelerates

- Merger activity roared back to life in the first quarter. Domestic merger volume rose 30% to over $400 billion. Inexpensive credit, the importance of scale and limited organic sales growth opportunities are all supportive of this revival.

- Large deals that have been announced this year include Kraft/Heinz, AbbVie/Pharmacyclics, Pfizer/Hospira, Shell/BG Group, and Staples/Office Depot. Over the past year, investors have increasingly applauded these transactions by not only driving up the price of the target, but also the stock of the acquirer.

Conclusion

- The fundamental backdrop for the domestic economy continued to improve during the first quarter. As job creation and wage growth accelerate, this year may be a period in which the impact of the economic recovery allows Main Street to outpace Wall Street.