Holt Capital
Partners, L.P.

First Quarter Financial Market Commentary

"Ninety Days in Ninety Seconds"

March 31, 2019

The Powell Pivot

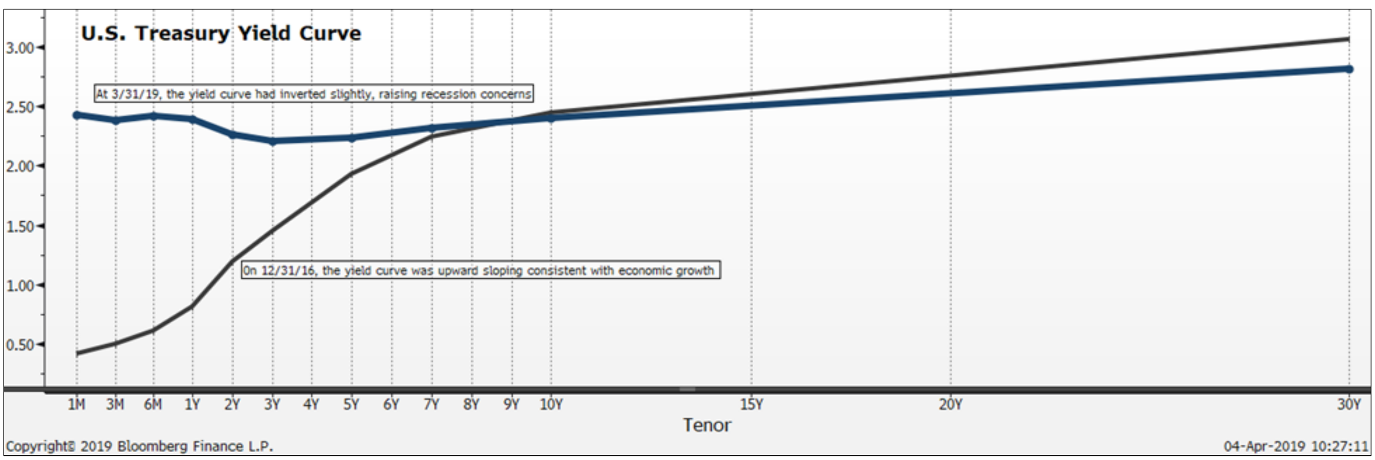
- The equity markets produced extremely strong gains in the first quarter. For context, only seven of the 240 quarters over the last 60 years enjoyed a total return equal to or greater than the S&P 500's total return in the first quarter of this year. The market gains were broad-based, encompassing all sectors, growth and value, large and small.
- The significant first quarter stock market move originated from a "v-bottom" in late December that was triggered by a change in monetary policy guidance from the Fed.
- Recall that the Federal Open Market Committee meeting in December resulted in an increase in the Fed Funds rate and a signal of more rate increases planned for 2019. At the time, most market observers believed financial conditions had already tightened and the Fed was at risk of choking off the economic expansion. As stocks reacted with accelerating declines, some Fed governors "walked back" the hawkish stance, but Chairman Powell's comments indicated a reluctance to change his view on the direction of future monetary policy.
- As the first quarter progressed, Chairman Powell's position became much more "dovish," meaning monetary policy was becoming more accommodative, signaling no further rate increases likely in 2019 and a slowing of Fed balance sheet shrinkage.
- The best way to observe the dramatic change in expected monetary policy is by observing the bond market's probability of Fed interest rate actions. During last year's fourth quarter, there was a 90% probability of at least one rate hike in 2019. By the end of the first quarter, the expectation had collapsed to a 60% probability of a rate <u>cut</u> in 2019!
- The availability and cost of credit, referred to as financial conditions, have always been, and will always be, important to performance of stock and bond markets. However, the recent severe market response, in both directions, to Fed policy probably means that the extraordinary monetary policy that has existed since the global financial crisis has yet to be fully returned to normal. On the other hand, rapid and stern market feedback likely reduces the chance of a policy mistake by the Fed.

The Importance of an Inverted Yield Curve

- The US government issues debt across a range of maturities from one month to thirty years. The plot of interest rates from the shortest maturity to the longest is referred to as the yield curve.
- A healthy and growing economy is normally associated with an upward sloping yield curve, where interest rates on long-term government debt exceed rates on shorter maturities. The economic theory behind the shape of the yield curve has to do with the trade-off between saving and consumption, with higher interest rates necessary to induce investors to tie up their money for longer periods. That relationship feels intuitive.
- An inversion of the yield curve, when short-term rates exceed long-term rates, is widely interpreted as a warning of impending recession. In the simplest terms, an inverted yield curve is usually signaling that monetary policy is too tight, which is threatening to economic growth. The difference between the 10-year yield and the 3-month yield was briefly negative by several basis points for five days in late March, which means the yield curve inverted for the first time since 2007.

The Importance of an Inverted Yield Curve (continued)

- Does the yield curve inversion mean a recession is imminent? First, the empirical evidence. Every U.S. recession in the past 60 years was preceded by a sustained inversion of significant magnitude. On only one occasion, in the mid-1960s, did that occur but a recession was avoided. The pioneering empirical work on yield curve inversions was done at the University of Chicago in the 1980s and concluded that a yield curve inversion was a powerful signal of a recession within a year to eighteen months when the 3-month yield exceeded the 10-year yield for at least a full three months.
- However, some economists believe that quantitative easing by the Fed since the financial crisis may be distorting the yield curve signal. The correlation between a "flattening" of the yield curve and slowing growth has been less pronounced over the last decade, which is mild support for this theory. However, it is notable that rational arguments for why "this time is different" have occurred in every cycle.
- Our conclusion is that the yield curve remains an important warning sign, but that the small magnitude and short duration of the March inversion does not indicate recession is imminent, which is consistent with our take on other indicators.
- The graph below illustrates the contrast between a positively sloped yield curve from 2016 and the current yield curve that is slightly inverted on the short end.



A Note on China

- Along with the United States and the Eurozone, China is one of the world's largest economies. Even having slowed from the torrid growth of the past, China remains the fastest growing large economy and is integrally linked to the world economy via trade and outbound investment.
- The slowdown in China in the fourth quarter fed into the slowing of the global economy, including the U.S. manufacturing slowdown. Given China's size, growth potential, and participation in the global economy, the performance of the Chinese economy has implications for U.S. economic activity and may even be the linchpin of this cycle.
- China's economy faces many challenges, with two of the most important being its high debt levels and its cross-border relationships. Both of those slowed growth in the fourth quarter. Last year, China's central bank had tightened monetary policy to discourage speculative credit expansion. The firm stance toward China by the U.S., and increasingly Europe, regarding trade and investment was also a drag on economic activity.

A Note on China (continued)

- Both issues will remain for years to come, but cyclical pressures may be abating. China's monetary and fiscal policy has become more accommodative, both relaxing bank reserve requirements and lowering the value added tax. Trade discussions continue to move, albeit glacially, toward an intermediate accommodation. An inflection for the Chinese economy, which seems probable, would be positive for U.S. and global growth.

Strong U.S. Jobs

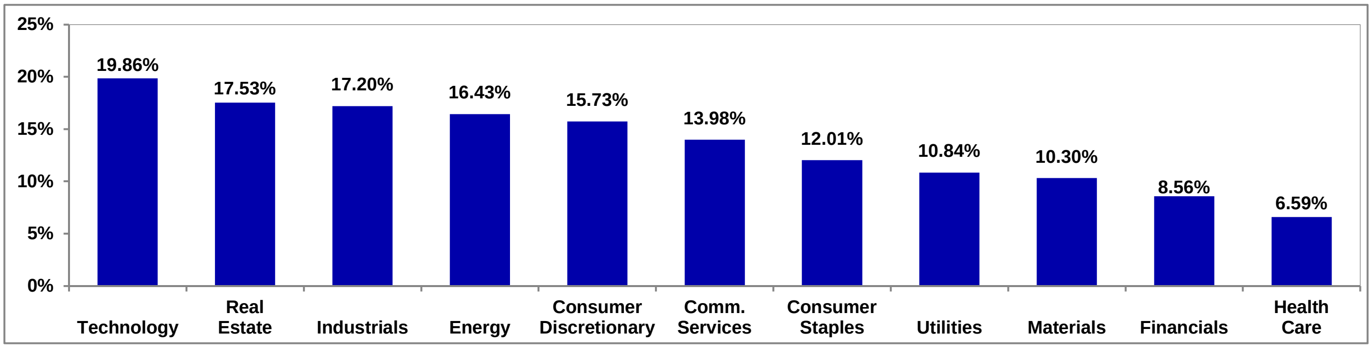
- Former Fed Chair Janet Yellen recently spoke at TCU and her conclusion about monetary policy was that the Fed was likely on hold for the balance of 2019 and would remain flexible to changing conditions. But, an almost off-hand remark she made struck us as very important: the economy continues to crank out an average of about 200,000 new jobs a month, which is a healthy sign for the economy. We agree.
- There are other signs of a strong jobs market too. The underemployment rate, which includes workers that have jobs below their training level or less than full time, is now below pre financial crisis levels. Importantly, wage growth is showing signs of life, with average hourly earnings rising at an annual rate of +3.4% in February.
- It is worth noting that we watch wage growth as an underlying driver of cost-push inflation. Wage growth does not appear to be showing up in inflation expectations. Productivity driven gains in wages are not inflationary and would be a very positive development for continued growth. This is something to watch closely.

Conclusion

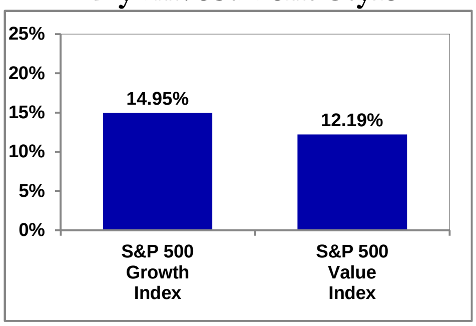
- The prospect for a monetary policy mistake that concerned us in the fourth quarter has reversed and is reflected in stock prices.
- While economic growth slowed meaningfully in the first quarter, growing evidence suggests it was a "pause that refreshes" rather than the onset of a contraction. Consensus estimates for real GDP growth are +1.5% for the first quarter and +2.4% for the year as growth improves over the balance of the year. Barring an unforeseen shock, the annual expectation may prove conservative.
- Consensus estimates for company earnings, as measured by the S&P 500, have come down to about 5% growth for 2019, below the unusually strong growth of last year, but still acceptable. As stock prices rose and earnings expectations declined, the S&P 500 P/E rose to about 16x, right on the 25-year median and consistent with mid to high single digit long-term equity returns.

First Quarter Investment Performance (including income)

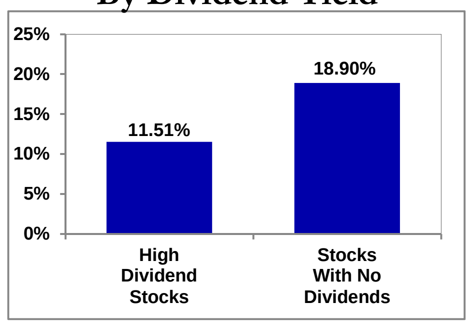
By Economic Sector



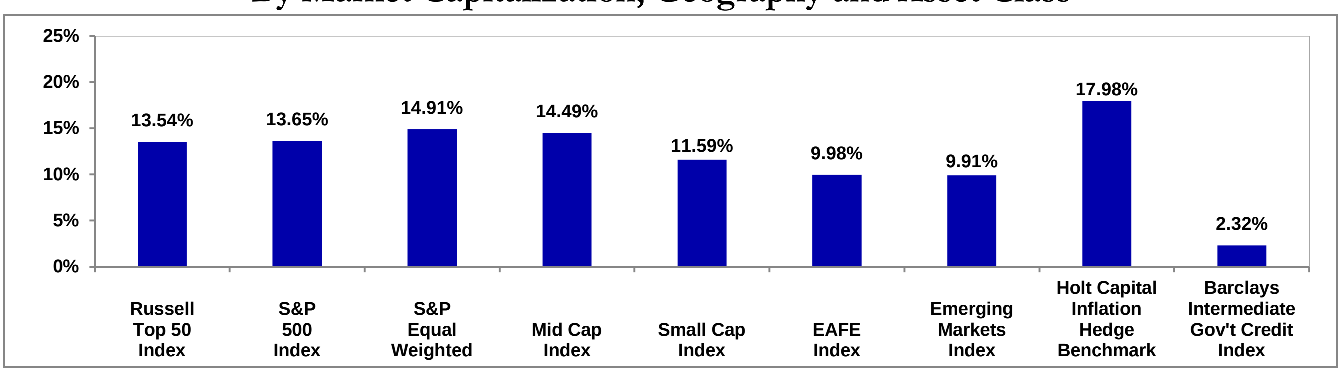
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- The shift by the Fed to a more accommodative monetary policy encouraged traders to reposition from the defensive winners of the fourth quarter into more economically-sensitive sectors.
- Growth stocks tended to outperform stocks with lower valuations and higher dividend yields. International stock markets rallied, but weak economic activity in a number of geographic regions continued to be a headwind.
- Both investment grade and high yield bonds rallied sharply and produced total returns that were among the highest since the financial crisis.