Holt Capital
Partners, L.P.

Third Quarter Financial Market Commentary

"Ninety Days in Ninety Seconds"

September 30, 2024

The Federal Reserve Goes Big

- After pushing borrowing rates to a two-decade high, the Federal Reserve cut policy rates by an unusually large one-half percentage point. It is easy to be euphoric about this long-awaited policy shift. Borrowing costs are now lower and stocks rallied sharply the day after the announcement. Unfortunately, it is more complicated below the surface.
- Over the course of the past several months, data from the labor market indicates new job creation has slowed, and the unemployment rate has risen. Chairman Powell described this policy shift as a "recalibration" toward a more balanced approach to the economy and the labor market. The Fed is clearly shifting its focus away from price stability to emphasize the other component of its dual mandate, keeping the job market strong. The successful execution of this recalibration should result in the economy achieving the elusive soft landing in which inflation remains subdued and the economy avoids a recession.
- While the interest rate cut will provide some relief to consumers and businesses with variable-rate debt, yields in the bond market have been falling since May in anticipation of future rate cuts by the Fed. The reality is that the Fed's long-stated two-percent inflation goal has not yet been achieved and most economic statistics reflect a strong economy that is not in need of large doses of interest rate induced stimulation. Even among the members of the Federal Open Market Committee (FOMC), there are a wide range of opinions about the future path of short-term interest rates. Renewed labor market strength, a rebound in housing values, or a rally in risk assets could muddle the direction of policy and slow the pace of rate cuts.

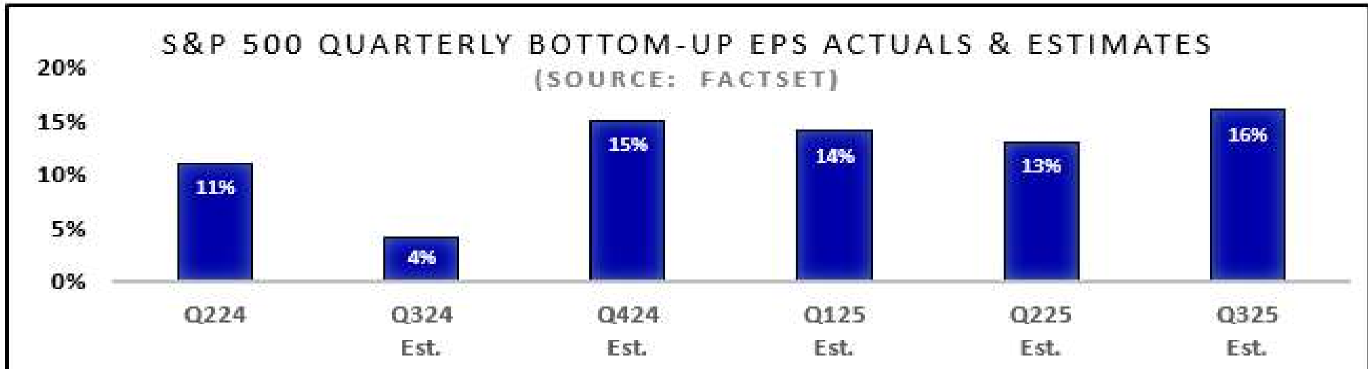
Robust Corporate Profits

- Corporate profit forecasts provide an interesting counterpoint to the Fed's policy pivot. Wall Street analysts expect earnings growth over the next five quarters to accelerate for companies in the S&P 500. These estimates are driven by the forecasts of stronger revenue growth and expanding margins. Unlike the recent past when mega-cap growth stocks disproportionately drove index-level earnings, the next several quarters will be characterized by much more widespread growth. Eight out of eleven economic sectors are expected to produce double-digit earnings growth in 2025. This is an improvement from six double-digit growers in 2024 and only three in 2022.
- The first chart provides annual projections for revenues, profit margins, and earnings. The second chart illustrates the quarterly growth forecasts for the S&P 500 Index.

	2022	2023	2024E	2025E
S&P 500 ex. Fin, RE, Utils				
Sales growth	13%	3%	5%	6%
Profit Margin	**11.6%**	**11.1%**	**11.5%**	**12.8%**
Yea/Year growth	(21) bp	(50) bp	39 bp	131 bp
S&P 500 adjusted EPS	**$ 222**	**$ 223**	**$ 243**	**$ 280**
Year/Year growth	6%	1%	9%	15%

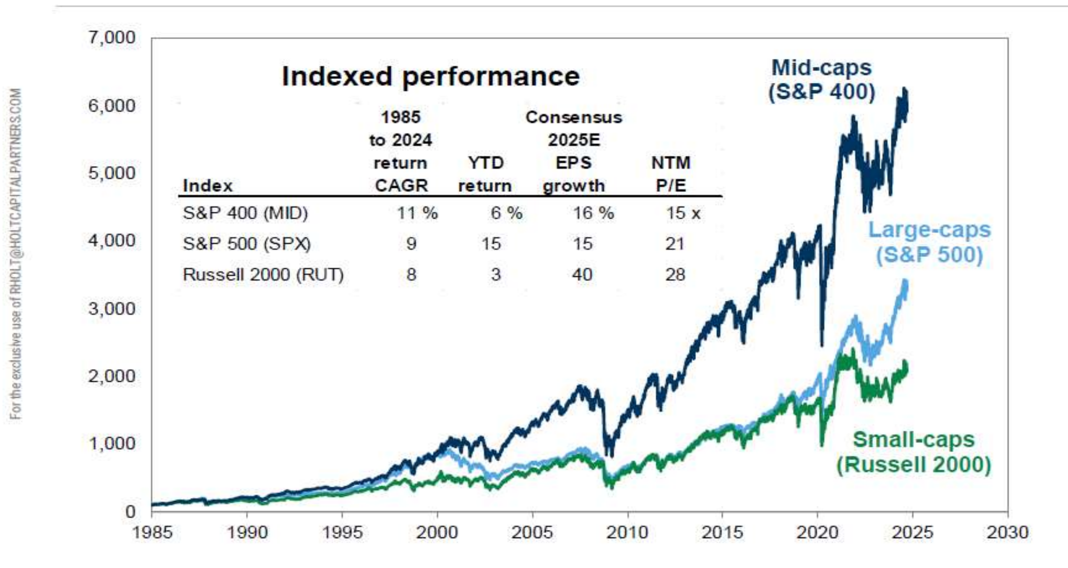
Source: Goldman Sachs

Robust Corporate Profits (continued)



Are Equity Valuations Expensive?

- Stock prices have moved higher this year, but are they expensive? The technology sector represents about 30% of the weight of the S&P 500 Index and the sector's expensive valuations are supported largely by current and projected demand for AI-related hardware and applications. Beyond those robust growers, each of the ten other sectors are valued below their ten-year averages on virtually every valuation metric.
- Reasonable valuations can also be found in mid-cap stocks. The chart below reflects the significant valuation discount of the S&P Mid-Cap Index compared to the S&P 500 Index. Earnings growth in 2025 for mid-cap companies is projected to exceed the S&P 500, but the index trades at a P/E ratio based upon the next twelve months earnings of only 15x. As illustrated in the chart below, mid-cap stocks have outperformed large cap stocks over the past forty years. The combination of faster earnings growth and lower valuations could provide a starting point to reignite that trend in the future.



Index	1985 to 2024 return CAGR	YTD return	Consensus 2025E EPS growth	NTM P/E
S&P 400 (MID)	11 %	6 %	16 %	15 x
S&P 500 (SPX)	9	15	15	21
Russell 2000 (RUT)	8	3	40	28

Campaign Promises With No Fiscal Discipline

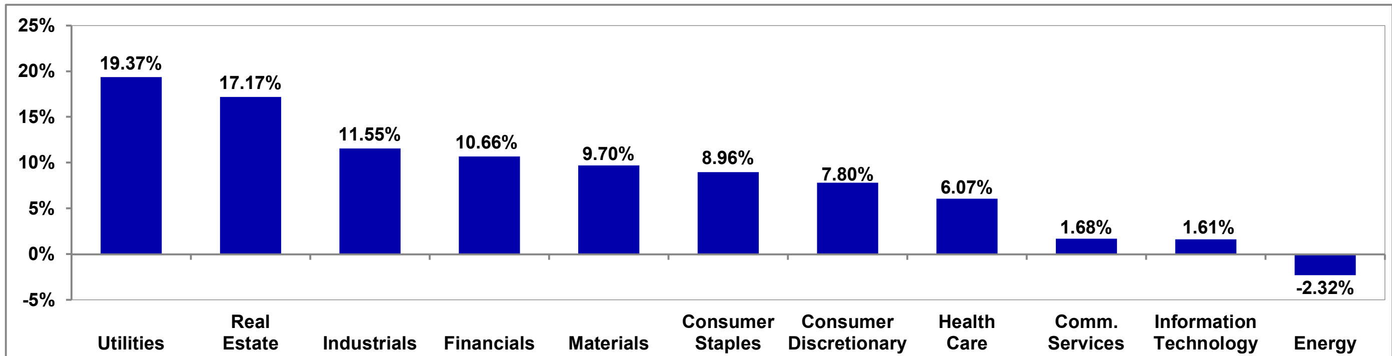
- Both presidential candidates have made campaign promises that involve lavish spending and costly tax breaks. These populist platforms include excluding tips from taxation, $25,000 down payment assistance for first-time home buyers, and reinstating state and local tax deductions (known by the acronym SALT). Except for discussions around tariffs, there are only minimal policy proposals about how to pay for these programs. The country's $35 trillion of debt and $2 trillion annual deficits are not being mentioned.
- These are not debilitating problems in the short run and so the financial markets have not tended to focus on them. However, they are massive long-term problems and there is no political constituency seeking a solution. Unfortunately, President Obama's National Commission on Responsibility and Reform, chaired by Erskine Bowles and Alan Simpson in 2010, was the last serious effort at reigning in federal spending.

Conclusion

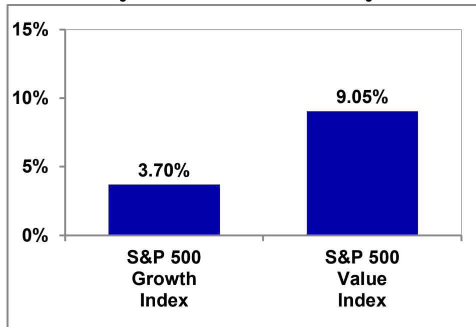
- The decision by the Fed to cut rates should be a tailwind for the equity market. Valuations appear reasonable, the economy remains healthy, and the outlook for corporate profits is encouraging. Although presidential elections tend to correlate with positive returns, this election could inject incremental volatility into returns.
- Bond yields have fallen sharply since April and current prices already embed significant Fed easing. Bond market returns are likely to be subdued over the intermediate term.

Third Quarter Investment Performance (including income)

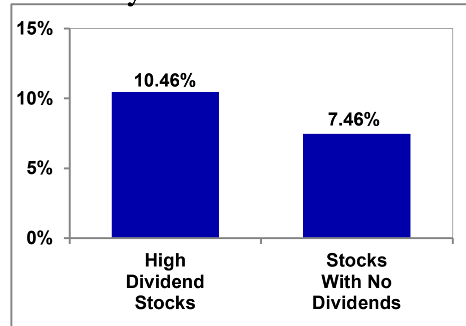
By Economic Sector



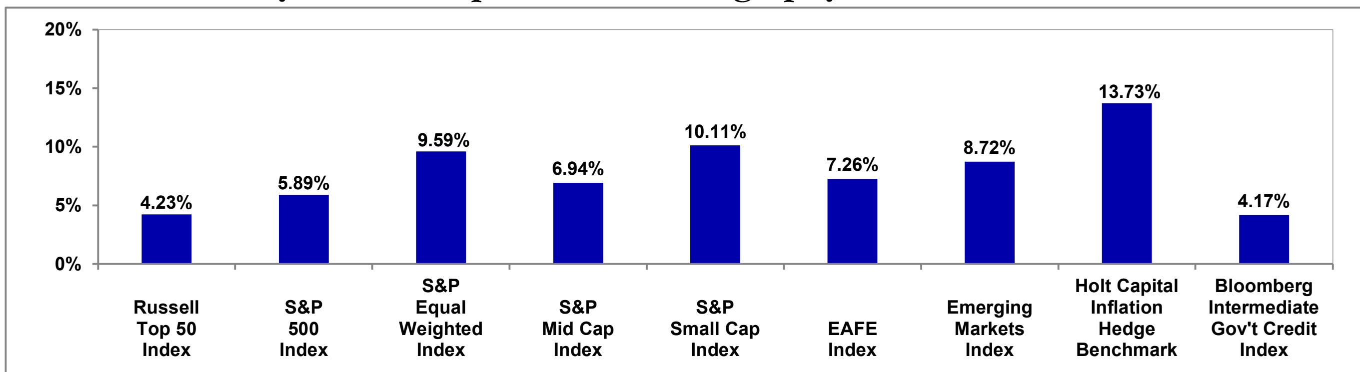
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class

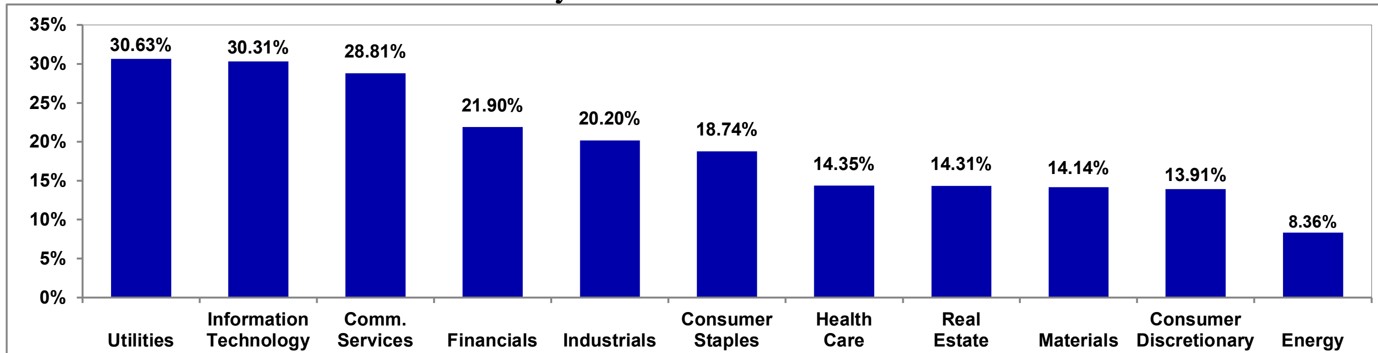


- The third quarter saw the market broaden out and the tech sector became a laggard. That trend was evident in the outperformance of value versus growth, small stocks versus large, and dividend payors versus non-payors.
- Utilities and real estate are the ultimate interest sensitive sectors. Two year U.S. Treasury yields fell over 100 basis points and drove outperformance by these two sectors. Recent history would indicate that outperformance by these two sectors is fleeting. They were the top two sectors during the "growth scare" in the fourth quarter of 2018. However, for the five and one-half years prior to this year's third quarter they were the worst performing sectors and only produced cumulative returns in the mid-single digits.
- The intermediate bond index produced its second best quarterly return in the past 22 years.

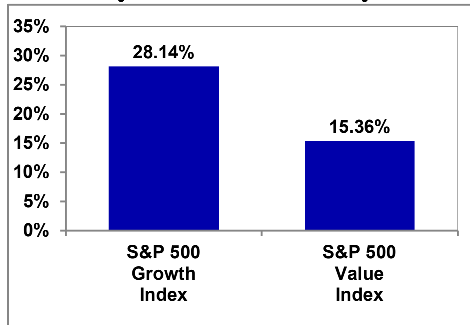
Holt Capital Partners, L.P.

Year-to-Date Investment Performance (including income)

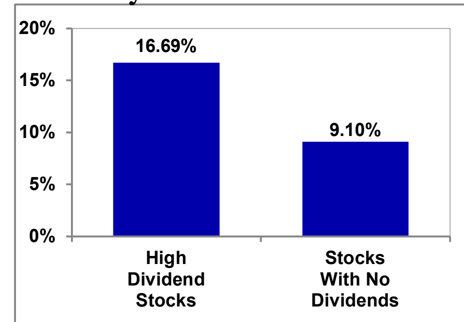
By Economic Sector



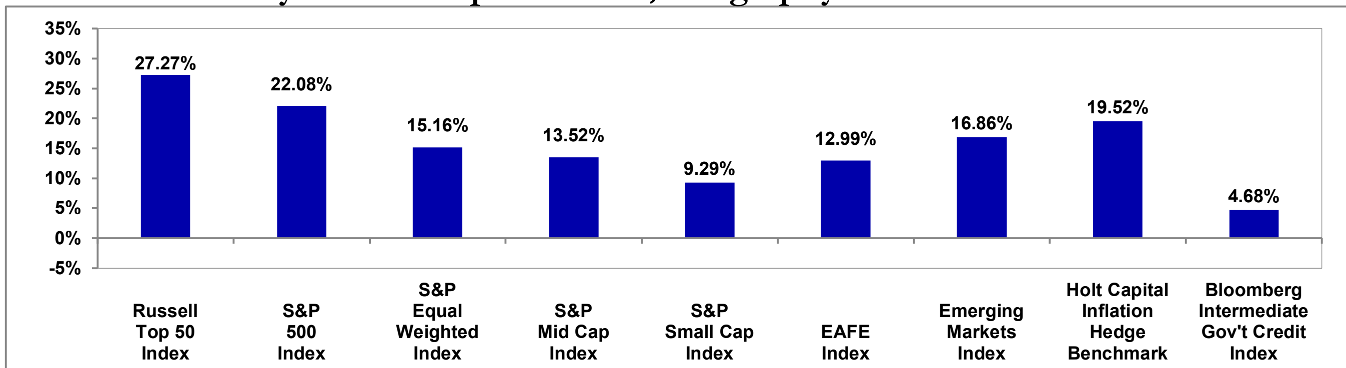
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- Year-to-date returns remain skewed toward mega-cap growth stocks. The exception is the utilities sector which has been propelled higher by the decline in interest rates, as well as electricity demand from data centers to power artificial intelligence processors.
- The performance of value indexes and stocks with above average dividend yields is usually highly correlated, but the third quarter rally in the utilities and real estate sectors had a disproportionately positive impact on year-to-date dividend stock returns relative to non-dividend payors.