Holt Capital
Partners, L.P.

# Fourth Quarter Financial Market Commentary

"Ninety Days in Ninety Seconds"

December 31, 2022

## 2022: Interest Rate Fears Drive Multiple Compression

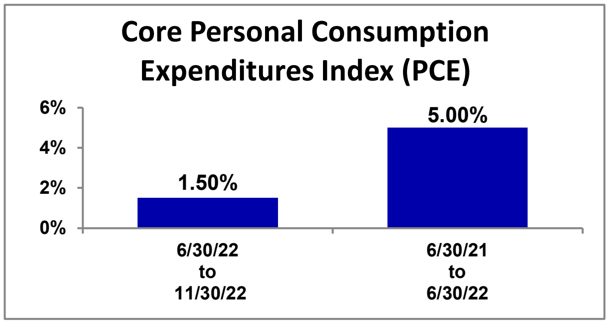
- One year ago, we wrote that the stock market was richly valued, and that inflation was persistent and not transitory, as the Fed was articulating. We expected inflation and interest rates to rise. Finally, we were confident that corporate profits would remain strong, and that a recession was not imminent. So far, so good.
- We did not anticipate the magnitude of the rise in interest rates or the negative impact of recession fears on valuations and investor psychology. Corporate profits have been slightly better than expected, but the valuation multiple that investors were willing to apply to those earnings fell sharply during the year.
- Most companies with unsustainably high growth rates, high valuations and minimal profits have experienced traumatic valuation resets during 2022. We wrote about speculative excesses two years ago and called out SPACs, electric vehicle hype, and work from home stocks. Many of these companies have either failed or are experiencing severe financial distress.

## 2023: An Impending Slowdown

- The current economic environment is unusually complex, with a wide range of possible outcomes. The prospect of a recession is primarily a byproduct of the Fed's interest rate-driven battle against inflation. If inflation subsides, then there will be an inflection point in the interest rate cycle and the economy will stabilize and rebound. The reverse is also true.
- Federal Reserve policy operates with long and variable lags. Last year's interest rate hikes will primarily impact economic growth in the second half of 2023. The pace of rate hikes should slow in the first half of the new year, but the Fed's aggressive policies have likely set the stage for a period of flat or slightly negative growth in 2023. Based on today's reduced stock market valuations, a mild recession, or so-called "soft landing," appears to be largely factored into current stock market prices.
- The Federal Open Market Committee (FOMC) is the group within the Fed that sets interest rate policy. After every meeting, the projections for future Federal funds rate levels from FOMC members are presented in a graphic format referred to as a dot plot. At the FOMC meeting in December 2021, the dot plots implied a Fed funds rate of 1.00% at the end of 2022. Fed funds actually ended the year at a range of 4.25% to 4.50%. The FOMC dots now project a peak Fed funds rate in 2023 of 5.10%. Even the Fed finds forecasting the future difficult and error prone!

## Peaking Core Inflation?

- Many different versions of inflation data are released each month. The Fed's preferred inflation gauge is the Core Personal Consumption Expenditures Index (PCE). Core inflation calculations remove the impact of volatile food and energy prices. As measured by both the PCE and CPI indexes, core inflation pressures have eased over the past six months. The graph below compares the core PCE inflation rate for the past five months to the prior twelve-month period. The ultimate path of inflation is complicated and unfortunately unknowable at this point. However, our expectation is that inflation should decline in 2023.




## Risks for 2023

- The supply and demand for labor continues to be in disequilibrium. Easing labor market shortages and wage pressures are primary goals for Fed policy, but they are also the biggest complicating factors for the future direction of interest rates.

- If Fed policy is not tight enough to slow inflation and the labor market, then the Fed may choose to raise rates higher than expected and keep rates elevated for longer. Current Fed funds rates are still below the rate of inflation. Historically, this has not been characteristic of tight monetary policy.

## Bullish Observations About 2023

- The pace of interest rate increases slowed in December from four consecutive hikes of 0.75% to a 0.50% move. This could mark a bullish peak in "hawkishness" by Fed policy makers.

- Corporate merger & acquisition activity has recently picked up with announced deals from Johnson & Johnson, Walgreens, Thermo Fisher Scientific, and Kroger. These transactions are signs of optimism from corporate executives and boards.

- Assuming corporate profits do not prove to be disappointing, valuations for most companies are below average versus history. This is especially true for mid-cap and small-cap stocks.

- Investor sentiment is often said to vacillate between greed and fear. Fear and pessimism are pervasive among investors, which is ironically bullish signal. Historically, markets make a bottom and begin to rally before any turn in fundamentals is visible.

- Consensus earnings estimates for 2023 were cut during the fourth quarter, but stock prices rose. A case can be made that lower earnings and a mild economic slowdown are already priced into the market.

- Market dominant companies with strong fundamentals will emerge from this downturn leaner and stronger. Weaker competitors will fall by the wayside. For long-term investors, this is a very healthy occurrence. As the new year begins, quality companies are trading at attractive valuations which should set up solid returns for the next decade or more.

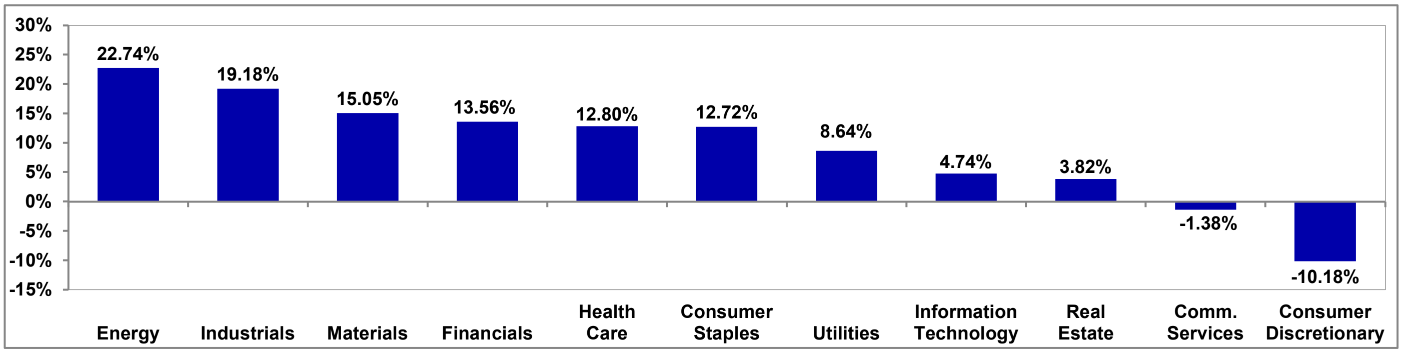
## Conclusion

- Fed policy and inflation are the two biggest uncertainties for 2023. Our base case is that inflation subsides but remains above the Fed's 2% target, consumer spending remains resilient, and corporate profits are better than feared. If a recession is not avoided, it will likely be concentrated in rate-sensitive pockets of the economy and generally be mild.

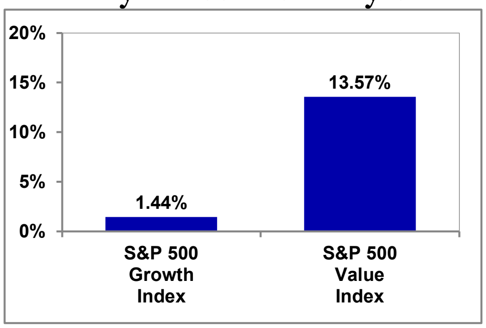
- Amid this uncertainty, stock prices will remain volatile. By year-end, we believe stock prices should have moved irregularly higher, supported by expectations of corporate profit growth in 2024. A mid-to-high single digit return from stocks should outperform most other asset classes.

## Fourth Quarter Investment Performance (including income)

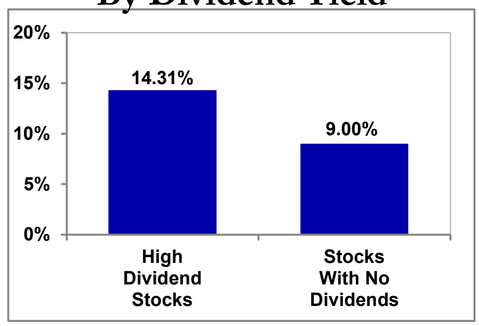
### By Economic Sector



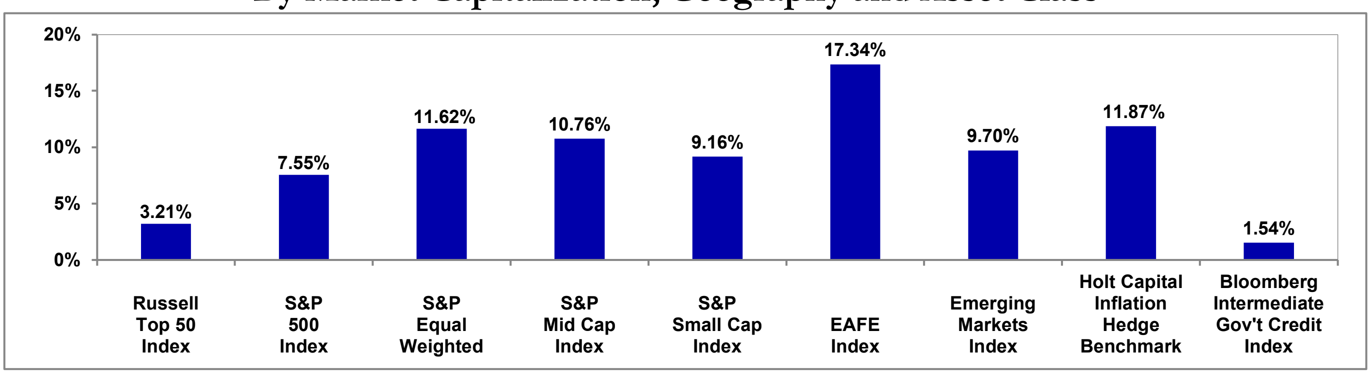

### By Investment Style




### By Dividend Yield




### By Market Capitalization, Geography and Asset Class




- So-called "old economy" stocks were the best performers in the fourth quarter. Growth stocks were laggards. Large price declines by Tesla and Amazon materially impacted the return of the consumer discretionary sector.
- The trend of outperformance by value stocks and dividend payors continued in the fourth quarter.
- Returns from domestic stocks moved progressively higher as market capitalizations fell. The once popular "FAANG" stocks hurt returns from the Russell Top 50 Index.
- International stocks benefited from low valuations and reduced risk of an energy price shock in Europe.

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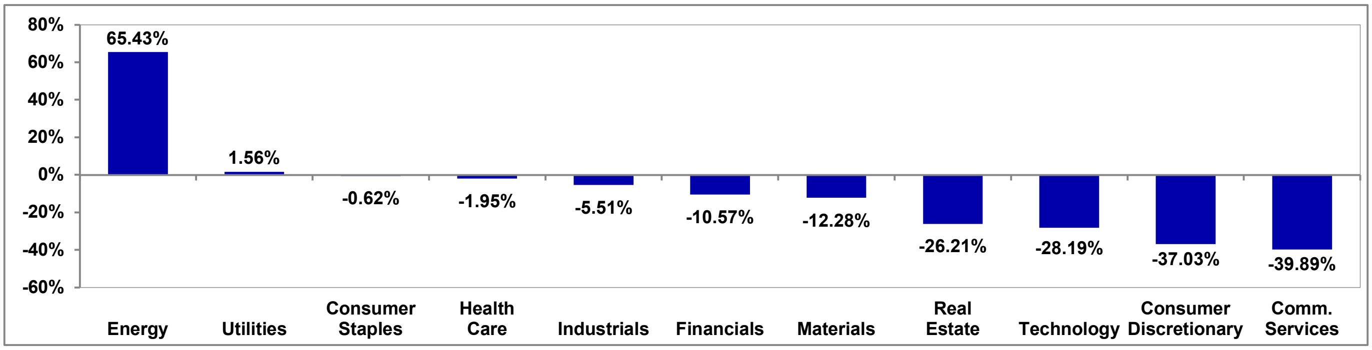
## 2022 Investment Performance (including income)

### By Economic Sector

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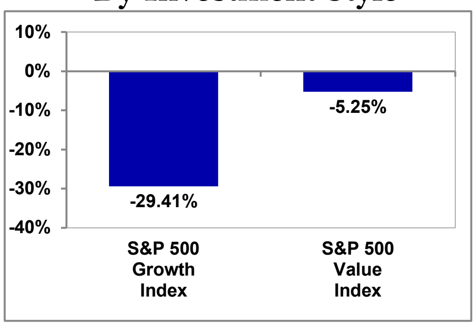


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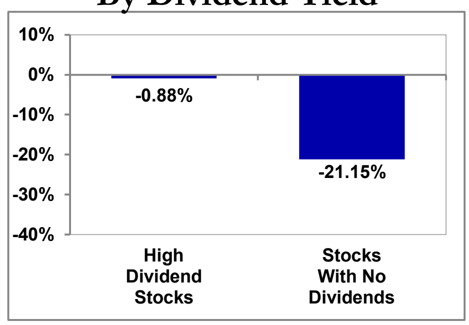


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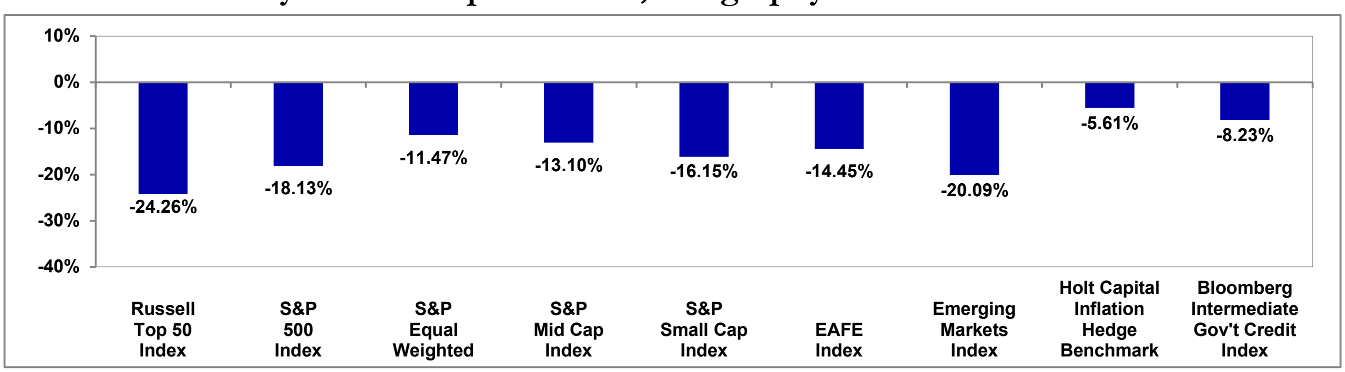


- Energy stocks benefited from higher commodity prices and increased capital returns to shareholders in the form of dividends and buybacks.
- Lower valuations and higher dividend yields helped value stocks outperform growth issues.
- Equal weighted, mid cap, and small cap indexes were less impacted by the valuation compression of high P/E growth names.
- Intermediate bonds posted their worst performance in the history of the index.