CARRET Asset Management

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Carret Equity Insight

"Yes! There will be growth in the spring!"

Chance, the Gardener (Peter Sellers), Being There, 1979

Firm AUM

$2.4 Billion

I recently completed my fourth sailing trip in as many years, and upon my return to 320 Park Avenue, hurried to the office of my colleague and editor of these missives to share with him my thoughts and ideas for this piece based on my recent experience. Jack was skeptical to say the least, as I had already written about two voyages, and "Where are the customers' yachts?" hardly seemed like an appropriate opening quote. I persisted. I am not writing about sailing, *per se*, I am talking about navigation. Hear me out, please! When I first started to sail offshore some thirty-five years ago, I studied coastal navigation. This involves detailed use of charts, along with mechanical aids such as compass, protractor, dividers and parallel rules; most importantly, it requires the constant updating of your position via sightings of identifiable landmarks including buoys, lighthouses, headlands and other fixed points of reference. The math involved is not complex, but the discipline involved is elegant. One can find one's location, estimate speed over ground, and make note of drift and deviations from plan by following a course of *deduced* or, as it is colloquially referred to, dead reckoning. Alas, advances in technology have made that cherished skill well nigh obsolete. Every boat I have sailed in the past several years has been outfitted with state-of-the-art navigation equipment, including digital chart displays, course plotting devices, links to apparent wind indicators aloft, and readouts of data from speed over water to speed over ground. The whole thing can be linked to the autopilot, eliminating the need for me as Captain! In a recent discussion with a friend in the Coast Guard, I lamented the demise of the old skills. He agreed, and confessed that when he takes new cadets out on the 42' cutters, he pulls the fuse on the electronics and forces them to resort to the ancient disciplines. Bravo Zulu, Mr. Church! Now think of your car's GPS. Recent studies about the ubiquitous devices have highlighted that increasingly, reliance on the external input alone had led to a series of disasters in which people navigating with tiny screens have driven into danger, or worse. Indeed, on several occasions, I have had to cede right of way to captains clearly following a computer screen rather than observing the horizon. Scientists have identified that the process of blindly following GPS instructions actually *atrophies the hippocampus*, a part of the brain believed responsible for memory and our ability to ponder the future. Let us review this analogy for investors. Simply put, you can navigate by looking at a screen or by looking at the horizon. You can invest your hard won assets in the same manner. We have discussed this before.

Market Metrics	3.31.17	12.31.16	12.31.15
S&P 500	2,363	2,239	2,044
Dow Jones Industrial Average	20,663	19,763	17,425
NASDAQ	5,912	5,383	5,007
S&P 500 Dividend Yield	1.91%	1.95%	2.02%
S&P 500 Trailing 4 Quarter P/E	20.0	19.1	17.8

Source: FactSet

The strong performance of the market since the November election can be considered from the perspective of a screen versus a horizon view. The *screen* view, if you will, suggests that the exuberance that has persisted since November 9 reflected a notion that an aggressive regulatory and tax environment might yield under a new administration to one that favored *deregulation*, *tax reform* and *infrastructure* spending: all bullish, pro-business factors. As we cautioned in our last piece, until legislation actually begins to wend its way through the hallowed halls of Capitol Hill and finds its way to the President's desk, the bullish case is irrefutable. We noted that the entire agenda will not be delivered; there will be disappointments along the way; the new management style will be noisome to many. But here we are, some months later; no progress has been made and Congress is on spring break. The chorus of punditry calling for a collapse in the market based on the failure to date grows louder each day. A screen view suggests that we must sell into this rally before anyone finds out. Indeed, we do get the occasional call from a client suggesting that this is the only course of action to take.

We want to posit the *horizon* view that the 10% advance in the S&P 500 from the election to quarter's end has less to do with the vague promise of the new administration and everything to do with a sea change of underlying fundamentals, specifically, the reacceleration of earnings growth, reflecting the cumulative impact of steady improvement in our economy. Quarterly earnings, on a year over year basis, turned positive for the 4th quarter of 2016. We call this *earnings visibility*, and it has been largely absent since the 1st quarter of 2015. This trend is actually accelerating into the 1st quarter of 2017, which will be reported over the next several weeks. If this momentum continues, perhaps the S&P can earn that elusive but projected $129 in 2017, after having been flat in the $116 to $118 range for several years. In this case, the S&P 500 is priced at around 18 times current year's earnings. Not a bargain necessarily, but not unsustainable, either.

Our quote from "Chauncey Gardiner," whose musings are wildly interpreted by Presidents and businessmen alike, is offered for two reasons. First, we want to focus our attention on the apparent growth of earnings that is before us and take regular sightings on the *horizon* of the economy's progress as a guide towards divining the market's direction. Second, we would rather not try to interpret the daily onslaught of news from Washington, as we believe it to be less instructive, and more akin to a *screen* view. As the President, played by Jack Warden, noted, "Well, Mr. Gardiner, I must admit that is one of the most refreshing and optimistic statements I've heard in a very, very long time. I admire your good, solid sense. That's precisely what we lack on Capitol Hill."

Over the past several years of stalled S&P 500 earnings, we have had cause to reiterate the underlying premise of investing, which entails the identification of earnings growth and the application of valuation discipline to ensure success. Simply put: *no earnings growth*, *no stock appreciation*. Slightly more nuanced, then, is the observation that sometimes stocks move in advance of earnings growth, often through the expansion of the price/earnings multiple, and this can create valuation stress, suggesting selling as the best course of action. Sometimes, stock prices decline in the face of earnings growth, creating a valuation opportunity, suggesting that it is time to buy. During the recent period of flat earnings, we were at somewhat of a crossroads, with neither compelling valuation nor reasonably assured earnings visibility at the forefront. Today, we are seeing reasonably assured near-term earnings growth, and stretched, but not extreme over-valuation. This suggests a cautious approach to the market, but not a negative view by any means.

There is always the possibility of a correction, which by definition is *unanticipated*. We can observe that complacency is rampant in the market today, as evidenced by the extreme lack of volatility. In the first quarter, the S&P 500 Index had only two days of plus/minus 1%, the least measured volatility since 1972. At the end of the quarter, we had the first down 1% day in over 110 trading days. In our view, extreme complacency suggests that *there is some risk of a short term reversal*. As always, it will begin with profit taking, and only afterwards will the collective punditry assign a cause.

We have noted that the long term returns for equities average around 8%. Looking at the past ten years, we are right on track; the twenty year trend is intact, as well. But for the past five years, the compounded return is closer to 13%. We believe in the concept of *reversion to the mean*, and appreciate that the market could move sideways or even down as this statistical gap is closed over time. *It does not indicate that equities have moved to a higher long term compound growth rate.* The current stressed valuation noted above could resolve over time if earnings advance, but prices stagnate.

For some time, we have maintained that the Fed was very far from *slamming on the brakes*, in the vernacular of Fed-speak, and that modest rate hikes were akin to *removing one's foot from the accelerator*. But as the Fed becomes emboldened over the course of the year, it is possible that they overestimate the tightening that the economy requires, and precipitate a downturn in earnings. Although we speak of engineered soft landings, in reality, the Fed only has a few blunt instruments at its disposal: changes in the short-term interest rates, changes in the less visible, but equally important monetary base, and of course, public pronouncements or jawboning.

There is no immediate reason to suggest that the nascent re-emergence of earnings growth will be truncated anytime soon. It appears to be supported by both increased business activity, as evidenced by the Purchasing Managers Index data, as well as by robust consumer confidence. Of course, the *expected rebound in the energy and financial sectors* might fail to materialize, and the *relative strength of the dollar* could hurt multinational reported results. But so far, the trends in pre-announced earnings revisions remain extremely encouraging. In this case, one can argue for a continued market advance based on continued earnings visibility. Our navigation efforts will focus on identifying waypoints to assess both future earnings trends and valuation extremes.

For some time, we have been in a period extremely conducive to success in US-based large capitalization equity investing. Sentiment has improved, earnings growth has accelerated from depressed levels, and price/earnings multiples have expanded in response to this benign environment. As we contemplate the near-term outlook, we must acknowledge that risk is of course much greater now than it was at the market bottom when risk was *perceived* as greatest. But as long as each client's asset allocation truly reflects each client's risk tolerance, and not some emotional input or screen, we feel that we can continue to navigate successfully in these uncharted waters by keeping our eye on the horizon.

Laurence R. Golding, Managing Director, April 12, 2017

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