CARRET
Asset Management

April 2018

Carret Equity Insight

Firm AUM

$2.5 Billion

"In tranquillo esse quisque gubernator potest."

Publilius Syrus 85-43 B.C.

I just returned from a week in London where I visited some museums, did some shopping and connected with some old friends. It was nice to get away from our breathless 24/7 news cycle. I was fascinated instead by the BBC coverage of the ongoing discussion, debate and division surrounding the realities of Brexit. What started as a *political* effort has now, of necessity, become a *policy* effort. Conversations with friends about business conditions suggested that although the impact of the politics of Brexit had been relatively benign, the impact of the policy ramifications of Brexit were generating some degree of *fear, uncertainty and dread*. You've heard that construct from me before, and we shall discuss the impact of FUD on our markets presently. While visiting the Churchill War Rooms at Whitehall, I picked up a mug emblazoned with the legend "Keep Calm and Carry On." The story behind this now commonplace and oft-parodied slogan is interesting. Almost 2,500,000 copies of *Keep Calm and Carry On* were printed by the Ministry of Information as part of a three-part series in August 1939 in anticipation of war, but this particular poster was not sanctioned for immediate public display, and would remain in storage for use later. Copies of *Keep Calm and Carry On* were retained until April 1940, but were then recycled as part of a more crucial paper salvage effort. The remainder of the Ministry of Information publicity campaign was cancelled in October 1939 following criticism of its cost and impact. Many people claimed not to have seen the posters, while those who did see them regarded them as patronizing and divisive. The overall campaign was deemed to be a resounding failure, representing a misjudgment of the mood of the people by upper-class civil servants. In 2000, an original poster was discovered in a book shop, which led to the emergence of its current iconic status. I offer this bit of history to begin our discussion of the market's resurgent volatility and the fear, uncertainty and dread which this is bound to engender. We will not exhort you to *keep calm and carry on*, as we do not wish to repeat the missteps of the Ministry of Information, but we will acknowledge that our comments and observations over the past several years have been in anticipation of the environment that now confronts us.

Market Metrics	3.31.18	12.31.17	12.31.16
S&P 500	2,641	2,674	2,239
Dow Jones Industrial Average	22,103	22,719	19,763
NASDAQ	7,063	6,903	5,383
S&P 500 Dividend Yield	1.85%	1.79%	1.95%
S&P 500 Trailing 4 Quarter P/E	20.0	21.9	19.1

Source: FactSet

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The Roman writer Publilius Syrus, known for his *sententiae*, brief moral sayings, maxims and adages, offers this aphorism, presented above in the original: ***Anyone can hold the helm when the sea is calm.*** This thought will lead us into our review as we celebrate the ninth anniversary of the bull market and look to the immediate future. As we set about to write this piece, we revisited the last several years' worth of commentary and observation. There were many ideas and threads discussed over this period of time, but one theme stands out, and that is our constant railing about the dangers of *complacency*. Indeed, after two years without a meaningful correction, and an even longer period of time without so much as a daily volatility of 1%, from the recent high of 2872 on January 26th, the S&P 500 has traced two 10% corrections, with apparent lows at or about the 200-day moving average, or 2585. This prompted one of our dear clients to ask, "Who would have thought this could take place?" Our simple answer: our study of market history suggests that volatility is the norm, not the exception. Moreover, we would posit that volatility is not to be feared, but rather, welcomed. Whether you subscribe to the old market adage that *bull markets climb a wall of worry*, representing the benefits of volatility, or appreciate the Ancient Greek concept of *hubris,* representing the risks of complacency, we can offer our steady hand at the helm as we begin the second quarter.

It is instructive to examine the proximate causes of the two "corrections" that we have just experienced. You may recall our oft-recited *bon mot* that everything begins as profit-taking and only later does the true reason become apparent. But the non-stop commentary of 24/7 cable news is quick to attribute cause and effect. In the instance of the first correction, the one that apparently ended February 8th, the sell-off was in response to a better than expected jobs report which showed the first traces of *wage inflation*. If one had been paying attention over the previous nine years, one might have reasonably assumed that this first blush of inflation was actually a good thing. But the visceral reaction of the market was, simply put, OMG! Inflation! The Fed will have to raise interest rates faster than we thought! Flee! Flee!

In the instance of the second correction, the one that apparently ended April 2nd, the analogy to our Brexit discussion may be instructive. The *political* notion of punishing China through the imposition of tariffs had been bandied about since the beginning of the 2016 Presidential campaign. But suddenly the creation of *policy* based on that notion became terrifying. Who will be hurt? Who is our biggest exporter? Sell Boeing! Everyone knew about *tariffs*; no one considered the implications of a trade *war*.

And then, in a flash, a group of market-leading companies, known colloquially as the *FAANG* stocks, with previously *impeccable* fundamentals, proved to be quite *peccable*. Yes, that is a word; you can look it up. Although the biggest problem at *Netflix* was the revelation that Claire Foy was paid less than Matt Smith in their respective roles as Queen Elizabeth II and Prince Philip in The Crown, the calls for regulation and oversight for social media giants *Facebook* and *Google*, the China exposure of *Apple* and the Washington Post connection with *Amazon* made for some interesting bearish chatter on these companies' prospects.

What we are seeing here is the change in attitude from *complacency* to *fear, uncertainty and dread* that we would expect to accompany a correction. Whether the reversal ended on April 2nd or whether it continues for a while to come, please read the doom and gloom in the press with all of the skepticism that we have tried to instill with our words and actions to date. We remain vigilant on your behalf, but do believe that *there will be less risk in the market* at the end of this correction, than there was at the beginning of the year.

It is important to review our belief that rational decision makers are not sitting around on a Friday afternoon deciding to dump stocks. Near term volatility of this magnitude is caused by computer-driven trading. We have used the example of "a hedge fund in Greenwich which has coded its computer to sell on seeing the words 'wage inflation' while a hedge fund in Stamford is primed to sell if the market is down 250 points. Meanwhile, there is a hedge fund in Jersey City that is prepared to buy if the market is down 2% intraday, and there is a hedge fund in Tribeca poised to launch a buy program when the market completes a 10% correction." In other words, short term volatility will be enhanced by this application of *algorithms* versus *analysis* to the investment process. In a sense, we are seeing profit-taking writ large as a result of this phenomenon. Despite the apparent noise engendered by this sort of trading action, *we maintain that the market over time continues to follow underlying fundamental trends.*

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The key fundamental touchstones for us include valuation, the actions of the Federal Reserve, the interest rate environment, the direction of earnings, and a reading of market psychology. Corrections are by definition unexpected, and the onset of such an apparent reversal can be enervating at best, frightening at worst. We have endeavored to make sure that your asset allocation works for the long term and recognizes that risk is inherent in the market over the short run.

Recently, we have suggested ways that risk might become more apparent in our equity markets. One of those was the nascent competiveness of bonds. Over the quarter, the two-year Treasury yield climbed from 1.88% to 2.26%, while the ten-year Treasury yield rose from 2.41% to 2.74%. While that move is not unprecedented, it is the *trend* that may set investors on edge. The offset is that equity valuation has improved, as the earnings yield of the market stands at 6.0%, up from 5.4%, largely through the advance in earnings estimates for the year.

For some time, our overall concern has been that the Fed takes actions which have the effect of slowing the economy more than is warranted, even as the Fed tries to prepare for the next downturn. We do not see this as being a factor in the current market movement. However, the latest jobs report and emerging wage gains do provide cause for some to believe that the Fed will be more aggressive in its future movements. At this juncture, there is little evidence to suggest that the new Fed Chair will accelerate the Board's *well-telegraphed* intentions.

We have often expressed our thoughts on an old market adage of *"buy on the rumor and sell on the news."* One can posit that the market has staged its powerful advance in anticipation of a better economy, earnings outlook and change in tax policy that is only now being realized. It is possible that the market may not respond as one might expect as this news develops. Indeed, the recent quarterly earnings reports, GDP and employment figures complete a "perfect storm" of good news to which the market may be responding in a contrary manner.

We may be entering a protracted period where *volatility* and *vague uncertainty* dominate the headlines. With the understanding that each client's risk tolerance must be considered, Philip Carret's lodestar that *patience can produce uncommon profits* will guide us at the helm.

Laurence R. Golding, Managing Director, April 12, 2018

Separately Managed Account Strategies:

Large Cap Equity: Carret's Large Cap Equity Strategy is designed to provide long term capital appreciation by owning companies with superior growth prospects, and by acquiring this ownership interest at a reasonable price. We invest in seasoned companies with strong marketplace and financial characteristics.. Fundamental analysis and quantitative screening drive this active management strategy. Portfolios are broadly diversified and customized to meet client objectives and risk tolerances.