CARRET Asset Management

April 2019

Carret Equity Insight

Tastes great…less filling.

Miller Brewing Company, 1973

Firm AUM

$2.7 Billion

On a recent trip to California, I drove from Rancho Palos Verdes to Palm Desert. En route, I encountered the most amazing man-made structure I had ever seen, the San Gorgonio wind farm. Some 4,000 turbines arrayed over 70 square miles stand ready to power the city of Palm Springs. Let me disclose that I am as concerned about climate change as anyone, and I believe that we should be exploring energy alternatives including wind, solar, nuclear and the like. But I would like to believe that I understand basic economic realities. As I contemplated the world that evening, I reflected on the fact that Palm Springs itself occupies some 94 square miles in area, so one can posit that it takes a lot of land to light up a city. I noted that the development of such massive infrastructure requires a great deal of incentives, subsidies and such, so one can posit that it takes a lot of tax dollars to light up a city. And although it was windy while I was in residence in the valley, I am aware that this is not necessarily a constant, so one can posit that it takes some measure of back-up generating capacity, be it coal-fired or natural gas, to light up a city. Because the electricity grid is not a storage device, the supply of electricity must be perfectly matched to meet demand. As swing capacity meeting that demand largely comes from coal-fired plants, it becomes more difficult to achieve real environmental gains. If the costs of wind energy are fully recognized and passed through to the consumer, one can posit that the negative economic impact may outweigh any positive environmental benefit. This is the case with ethanol, where a thorough analysis of all of the costs associated with its inclusion in the gasoline supply tends to temper one's appreciation for the additive, I began to wonder whether wind power was truly the solution to this real concern, or was it just something that felt good, but if totally deconstructed, would leave one feeling less than satisfied. We turn to the caption above, taken from Miller's foray into the emerging low-carbohydrate beer market some forty-five years ago. In truth, it does not taste great, and it is less satisfying. But the concept of a lower calorie beer appeals to many. Where are we going with this, you might ask? What if the Federal Reserve is engaging in behavior that tastes great but is less filling? *What if the Fed's well-articulated strategy of the past several years has been abandoned in favor of one that has real popular appeal, but less economic justification?* Let us review the recent history of the Fed's work.

Market Metrics	3.31.19	12.31.18	12.31.17
S&P 500	2,834	2,507	2,674
Dow Jones Industrial Average	25,929	23,327	24,719
NASDAQ	7,729	6,635	6,903
S&P 500 Dividend Yield	1.89%	2.06%	1.79%
S&P 500 Trailing 4 Quarter P/E	18.3	16.6	21.9

Source: FactSet

Over the past several years, the Fed has been embarked on a mission to reduce the *monetary accommodation* that was put in place a decade ago to combat the Great Recession. Beginning in 2015, a series of nine quarter-point hikes in the Fed Funds rate were geared towards restoring the short-term interest rate, truly the only rate that the Fed can control, towards normal, or, perhaps more to the point, neutral levels. In our youth, we paid heed to two market adages, "three steps and a stumble," and "don't fight the Fed." In this case, the broad averages powered to new heights until the third and penultimate move of 2018, at which point the market began a swift and violent correction, defined as a 10-20% downward move from the recent high. While we noted the propriety of such a gradual and well-intentioned rate increase program on the part of the Fed, we wrote at length about the risks of the Fed's corresponding decision to curtail and actually reverse *quantitative easing*, which had been the means by which the Fed had provided liquidity to the system. We believe that a certain level of growth in the monetary base is required to support long term economic expansion. There are risks of bubble formation that appear when that growth is too aggressive, but there are severe risks of contraction if that growth is insufficient, or in this case, retrograde. Essentially, robbing fuel from the economy, the Fed began to reduce the absolute level of the monetary base from a peak of $4.1 trillion on April 15, 2015 to $3.3 trillion on December 19, 2018, coincidentally, the date of the last rate hike. We commented extensively about the possibility of the Fed accidentally precipitating the next downturn in the process of creating the cushion it sought to combat that very next downturn. In our view, by the fourth quarter of 2018, a tipping point had been reached, and the market began its long-awaited, but nonetheless surprising "correction."

The S&P 500 bottomed on Christmas Eve. By its January 30, 2019 meeting, the Federal Reserve had backed off its planned interest rate hikes for now. Citing, in Fed-speak, "global economic and financial developments and muted inflation pressures, the Committee will be patient as it determines what future adjustments to the target range for the Federal Funds rate may be appropriate." From our standpoint, the unheralded action of the Fed in holding the monetary base steady and even allowing it to grow slightly through the end of the 1st quarter was more significant. No surprise as to what happened next. Whereas the market decline from the peak was some 19%, the recovery from the bottom has been some 21%. That almost gets us even, but not quite. *The Fed essentially rode to its own rescue*. Everybody sighed in relief.

In researching our bit about wind farms, we came across an interesting analogy. A car cruising down the highway at a steady 65 mph gets much better gas mileage and has much lower levels of carbon emissions than a car starting and stopping in city traffic. For this reason, you don't want your coal-fired backup generators starting and stopping; it sort of defeats the purpose. Here is the question that we would ask: do we want a Fed that is starting and stopping based on *market reactions*, bending to *political pressures*, or do we want a clear, data-driven strategy that is well-conceived and well-communicated. This concern has come into high relief of late.

So what does our data-driven analysis suggest at this time? *We know that the long term trends which connect market growth to corporate profit growth remain intact.* The advance in the S&P 500 over the course of this ten-year bull market tracks the development of profits from the $49.50 trough in 2008 to the estimated $167.50 for 2019. For some time, we had cautioned that a mere extrapolation of recent trends into 2019 was inappropriate, largely because the follow-through impact of the corporate tax cut was being overestimated. It now appears that forecast profit growth for 2019 has been scaled back to roughly 4%, but we are still looking at record profits this year. We caution that 1st quarter earnings are expected to be down year over year, so the increase is back-end loaded and therefore suspect. We note that multiple expansion has also played a role in the market's overall return, but the current level of 17 times earnings appears reasonable, if not necessarily a bargain.

One consequence of the Fed's actions was a brief *inversion of the yield curve* on March 29, as short rates climbed above the ten-year Treasury. An inverted yield curve is generally accepted as a necessary and sufficient condition leading to a recession. We observe that this occurrence was unusual in that long rates came down to meet the short-term returns, whereas normally both long and short rates are climbing. We do not believe that a one-day inversion is significant, but the stock market reacted poorly on that Friday.

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Purchasing Managers' Index data suggests that the economy continues to grow, albeit at a subdued rate. We note the uncertainty that was caused by the extended government shutdown during the 1st quarter, as well as the ongoing impact of undefined trade wars and tariff threats on corporate decision making. We are aware that much of the benefit of the tax reform act deployed in 2018 was invested in share repurchases, dividends and financial restructuring, as opposed to plant, equipment and employment, and there is likely little benefit to be garnered in this second year. Nonetheless, consumer confidence levels suggest that the economy remains robust, and not likely to collapse in the short run. The Fed's newly restored *accommodative stance* would seem to ensure the continuation of at least a modest expansion.

There is a potential change in the supply/demand model of market behavior, which suggests that a strong IPO market may lead to *dampened returns* over time. New offerings have been surprisingly subdued over the course of this bull market and have been largely overwhelmed by reductions in supply through share repurchases, mergers and acquisitions. The launch of some marquee unicorn names, such as Lyft, Uber, Airbnb, Pinterest and the like bears watching with some skepticism.

Despite the strong market advance year-to-date, there are still opportunities to own companies with solid prospects selling at reasonable prices. We are reminded that each client must honestly assess their own risk tolerance and return requirements in conjunction with their advisor. Philip Carret's dictum that *patience can produce uncommon profits* continues to guide us in our efforts on your behalf.

Laurence R. Golding, Managing Director, April 12, 2019

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 attractive 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.