CARRET
Asset Management

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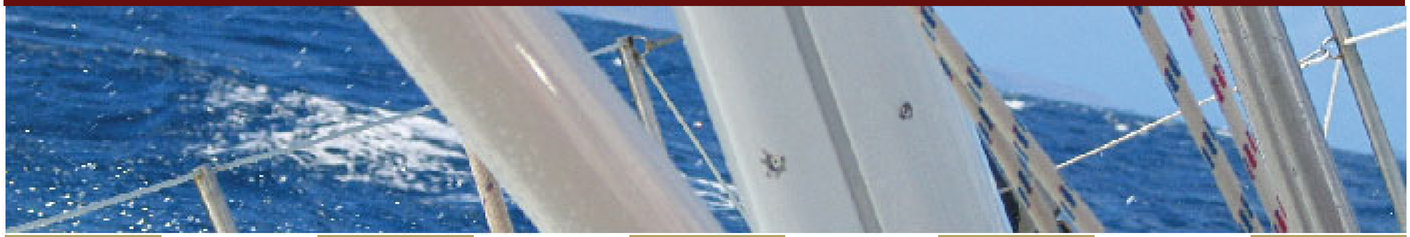
Carret Equity Insight



Set your course by the stars, not by the lights of every passing ship.

Omar N. Bradley, 1893-1981

Firm AUM

$3.4 Billion

In 1890, a 15-year-old boy from Odessa, then a part of the Russian Empire, now Ukraine, faced a terrible choice. He could *remain* at home, in the land of his ancestors, living under the repressive rule of Tsar Alexander III. He would face the twin threats of *conscription* into the Imperial Russian armed forces for a fifteen-year tour of duty and *persecution* or possible death in a pogrom. Or he could leave home and try his luck as a stranger in a strange land. Assessing this *dilemma*, that boy and his family decided to leave their homeland, and to seek out a better life in a safer place. That boy was my great-grandfather, Benjamin Hirsh; even today, I can still feel the stubble of his beard.

Leaving Odessa, Benjamin's family was fortunate enough to find a place in Baron de Rothschild's *Richon LeZion* settlement in the Ottoman Empire, on land that is now part of the State of Israel. Unfortunately, his family were grain farmers, and the settlement had been conceived as a wine-growing enterprise. Soon enough this incompatibility of skills proved too much, and the family once again sought shelter in a distant land, this time, in America. But upon reaching the port of embarkation in Portugal, they found that there was not enough money to bring the entire family over together. My great-grandfather remained behind, alone, in Lisbon, and worked as a tutor until he could secure enough money to make his own trans-Atlantic journey. Landing in Boston, he settled ultimately in North Adams where he found *employment* in the flourishing *textile mills* of the Hoosic Valley, married my great-grandmother, and the rest, as they say, is history.

I relate all this not only because the current situation in Ukraine has caused me to reflect on my family's own history with Russian aggression, but also because of the lesson contained in my great-grandfather's multi-stage journey to find *safety, security, and prosperity*. I thought it was important to describe the sense of déjà vu that I am keenly aware of, and also to draw a circuitous story about the necessity of taking the proper action when fleeing a difficult situation.

Some context to start: Over the past ten years, since the financial crisis, we have had only six *corrections,* defined as a market move top to bottom of 10% or more. In each of these cases, the market has recovered in short order, and only afterwards does the punditry have the chance to assign a *cause*, be it Oil Collapse (2015), China (2016), Fed Tightening (2018), Onset of Covid (2020), 3rd Wave (2021) or the present one, which started as Fear of Fed Tightening and has morphed into Fear of Putin. Corrections, by definition, come as a surprise, are always measured from a recent high in the market and are usually resolved quickly as whatever *vague uncertainty* that set them off is resolved into *known certainty;* the market can find its footing again. Another constant in these corrections is that earnings *estimates* for the market as a whole are relatively unaffected, so in essence, valuation improves as a result of the downward move. Because corrections do take place off the recent high, one cannot discount *profit taking* as the proximate *reason* for the move, even though the punditry will attribute the action to some *excuse*.

In my youth, corrections took place much more frequently, and *volatility* was an accepted part of doing business in this arena. This lack of volatility over the past ten years has led to *complacency* which has led to the increased *risk* in the market that culminated at year end. But you have heard me preach this before.

To be honest, I think the market with its ADD does not know how to focus on two uncertainties at once. The Fed has tried to explain, telegraph, pre-announce, figuratively bare its soul with respect to its intentions, and the market has generally responded positively to Chairman Powell's comments. It removes the *uncertainty.* But there is always room for more anxiety. For example, a larger than expected payroll increase, nominally a good thing, can be interpreted as "OMG, the Fed is going to have to be more aggressive in tightening than they promised just two days ago!" By the way, much of that interpreting is being done by *AI or algorithm driven trading*, not by seasoned investment counselors deliberating in their oak paneled conference rooms. Unfortunately, that computer trading does create a good deal of noise that we must navigate around.

The Putin thing is a bit trickier. The market can generally *absorb* bad news as long as it is *certain* about what is going on. But the rapaciousness, if you will, of Putin's drive into Ukraine has been shocking. It is hard to see how this gets resolved soon, so the *vague uncertainty* may in fact persist for a while.

But recall what I said above, "another constant in these corrections is that earnings *estimates* for the market as a whole are relatively unaffected, so in essence *valuation* improves as a result of the downward move." Consensus estimates for the S&P 500 have actually moved up over recent weeks. That's the macro picture. If we look at representative holdings in your portfolio, we can ask, what is the *impact* of the current crisis on their *earnings* prospects? For now, there is not much to see here. The stocks simply *appear* less expensive.

But we do have to spend more time discussing the Fed, its intentions, and the hazards that the Fed introduces in its quest to manage *risk.* Between 2015 and 2018, we wrote repeatedly of the Fed's efforts in removing emergency-level monetary stimulus coming out of the financial crisis. As inflation was not in the picture, the nine rate hikes and overall reduction in the Fed balance sheet were arguably geared to restoring some level of *normalization*, an insurance policy, if you will, against the time when the Fed would have to rescue the economy once again. We observed that the greatest risk was that the Fed overshot its goal and precipitated the very crisis that it was trying to avert. Indeed, by the 4th quarter of 2018, the market anticipated that the Fed had exceeded its brief, and the 20% correction ensued. We think that it was the market that *overreacted.* There was no contraction in the economy, nor in the earnings estimates that drive the market.

But this round, the Fed not only has to work towards normalizing its stimulus levels, it also has to deal with *inflation,* a bugbear that has not been truly in the picture for some forty years. The nature of that inflation has presented a sort of moving target. It started as arguably the result of *supply chain* bottlenecks caused by the re-emergence of the economy after lockdown. Bear in mind that the economy is essentially the function of myriad individual rational decisions by consumers and corporations. Simply put, with the specter of shortages and empty shelves fresh in many minds, there may have been a degree of *over-ordering* that strained the system. The Fed believed that these supply chain issues would be self-correcting. In fact, we quipped that once all of the toilet paper was offloaded from those ships anchored off Long Beach, the price of the precious commodity would plummet. While this argument may still be valid, it soon became apparent that cost increases caused by or inspired by shortages were being swiftly passed through as *price increases*, threatening the start of an inflationary spiral that those of us who remember the 1970's recall only too well.

And then *oil* decided to join into the fray. There is in fact minimal marginal change in the supply/demand equilibrium. Historically, most oil was purchased and traded by oil refiners, trucking companies and airlines. In the modern era, the *oil derivatives* market has overwhelmed the *physical delivery* market. In other words, most oil is now traded by *hedge funds* rather than actual *users*. Demand is increasing due to covid recovery; hence the increases that go back to the fall of 2020. The cancellation of the pipeline caused prices to rise; in reality, that oil was not destined for North America. Now, a war with Russia will cut off supplies and force higher prices. Because the futures market feeds the spot market, the price of oil is going up. Your local gas station hikes prices to stay ahead of the cost increases that they anticipate. The pending boycott will raise prices further; hold on, that is already discounted. Oil is moving up because it moved up the day before. The problem is that we don't think that the Fed has the tools to manage this sort of *speculative* inflation.

We can observe that the market faces more *headline risks* than *fundamental risks* at this time. Even if the Fed misjudges the amount of stimulus to withdraw, it is hard to argue that such a miscue would lead to two quarters of negative growth, which is how a recession is defined. With a single interest rate hike, the Fed has changed the shape of the yield curve, caused mortgage rates to spike, reduced consumer confidence, and slowed business activity. We don't think that the Fed will have to be terribly aggressive to accomplish its mission. Because of the Fed's action, we note that both halves of a balanced portfolio suffered during the first quarter; the S&P 500 index declined 4.59% while the Barclays Intermediate bond index was off 4.52%. To some extent, that anomaly was reminiscent of my ancestors fleeing East before heading West. That is to say, the first instinct may not be the best instinct. We do not change our approach because of the recent performance of any one asset class. We should heed General Bradley and recall Philip Carret: *Patience can produce uncommon profits*.

Laurence R. Golding, Managing Director, April 19, 2022