CARRET
Asset Management

January 2018

Carret Equity Insight

"The pessimist complains about the wind; the optimist expects it to change; the realist adjusts the sails."

William Arthur Ward 1921-1994

Firm AUM

$2.6 Billion

Have you ever heard of the *Era of Good Feelings*? It was a period in American History immediately following the War of 1812. Nationalistic sentiment abounded, the Republican Party of the time dominated politics, and the demise of the opposition Federalist Party all but eliminated partisanship. Economic prosperity was robust, driven by strong global demand. The term was coined in 1817 by a Boston paper following President Monroe's goodwill tour. There, in the heart of Federalist territory, Monroe gained the primary goal of his tour: in effect, permitting the Federalists by solemn public demonstrations to reaffirm their loyalty to the government and their acceptance of Republican control. Monroe was assiduous in avoiding any remarks or expressions that might chasten or humiliate his hosts. He presented himself strictly as the head of state, and not as the leader of a triumphant political party. Historians often refer to the era with a certain sense of irony. Indeed, the Panic of 1819, brought about by aggressively tight monetary policies of the 2nd Bank of the United States; the imposition of a tariff that coincided with the postwar recovery in Europe; and the widening sectional differences over slavery, resulting in the Missouri Compromise, brought the era to a rapid close. I will leave it to our gentle readers to offer their own sense of irony and speculate upon what today's era might be called by future historians. But I digress...

Clients have called and asked a very simple, yet telling, question: "How long will this strong market last?" While it is tempting to respond "not much longer" and begin a discussion about defensive actions that might be taken, it is equally plausible to respond, as indeed I have, "Forever, unless something changes."

You may recall our discussion about Newtonian physics from this time last year. It was Isaac Newton who famously remarked, "I can calculate the motion of heavenly bodies, but not the madness of people." Despite his own skepticism, Newton does offer us some insight. Newton's First Law of Motion states that *an object in motion continues in motion with the same speed and in the same direction unless acted upon by an unbalanced force*. The Federal Reserve generally provides this unbalanced force to the economy. Congress can act in concert, theoretically.

Market Metrics	12.31.17	12.31.16	12.31.15
S&P 500	2,674	2,239	2,044
Dow Jones Industrial Average	22,719	19,763	17,425
NASDAQ	6,903	5,383	5,007
S&P 500 Dividend Yield	1.79%	1.95%	2.02%
S&P 500 Trailing 4 Quarter P/E	21.9	19.1	17.8

Source: FactSet

Newton's Second Law of Motion states that *the greater the mass of the object, the greater the force needed to accelerate or decelerate the object.* In this case, the nineteen trillion dollar economy at the end of 2017 will require a considerable force to change its direction. Newton's Third Law of Motion states that *for every action there is an equal and opposite reaction.* This is the premise upon which Federal Reserve actions are predicated. The possible Fed actions include the three tools at its disposal: changes in the monetary base, changes in the short term interest rate, and public pronouncements or jawboning. We reiterate that we do not see the Fed as being in a position to aggressively apply the brakes at this time. It is up to the Fed to judge if and when faster growth leads to higher inflation, and if and when it is time to begin to apply its own version of Newton's Second and Third Laws on the massive United States economy. The Fed began a gradual series of interest rate hikes two years ago, and the only real question is how far and how fast the Fed will eventually have to go to slow economic growth. We recognize that while we speak of engineered soft landings, in reality, the Fed at best wields a collection of blunt instruments. Nonetheless, with no dramatic action on the part of the Federal Reserve in sight, the *reductio ad absurdum* argument of "forever, unless something changes" takes on some degree of credibility.

The three-fold advance of the market since the 2009 low to the recent all-time high tracks the three-fold change in S&P 500 earnings from the 2008 trough of $49.50 to the projected $146.50 earnings projected for 2018. *Coincidence?* We think not. Earnings are the driver of market action, as has been demonstrated time and again. As we accept that the stock market essentially reflects the direction of corporate earnings, we note that as the Fed *accelerates* the economy, earnings generally rise; and if the Fed *contracts* the economy, earnings generally fall. Will the S&P 500 earn the projected level for 2018? The answer calls for speculation. But Purchasing Managers' Index Data, consumer confidence and the prospective corporate tax cuts suggest that earnings should advance through this year. *An object in motion continues in motion…unless acted upon.*

The role of the Federal Reserve in *extending* or *curtailing* this economic expansion is assumed, and we believe that changes in the monetary base might provide a clue as to near term market direction. The expansion of the Fed balance sheet since 2008 and the parallel aggressive interest rate policy have provided the fuel for the economic recovery that we have seen, as well as the liquidity supporting the corresponding rise in asset prices that we have enjoyed. This suggests that the unwinding of the monetary accommodation might pose some risk. We believe that the Fed is telegraphing its intentions with the desire to eliminate the old bugbear of *vague uncertainty* that we know the markets abhor. The unprecedented accommodation will require an unprecedented effort to restore the *status quo*, if in fact, that continues to be the Fed's objective. It may never be accomplished; we do not know what economic straits may lay ahead. We believe that the Fed is motivated by the desire to prepare "dry powder" for the inevitable future downturn. Our concern is that the Fed initiates the inevitable downturn in the process of generating that very cushion for the future.

What, then, is the impact of the new tax law? Some individuals will benefit, some will not. Some corporations will benefit, some will not. Our classical economic training leads us to question why one would offer tax cuts in the ninth year of an economic recovery with record earnings and low reported unemployment, particularly as the Congress was unable to deliver such a needed package in the midst of the Great Recession. However, all else being equal, lower taxes should drive *higher corporate earnings*. We do not necessarily expect that corporations will raise wages or increase hiring as a result, but again, increased dividends and share repurchases generally accrue to our favor. We note that the *unintended consequences* of higher deficits or of increased tax burdens in certain states will not be identifiable for some time.

What then, short of a tactical error in Fed policy, could provide the *unbalanced force* that curtails this market advance in the near term? There is always the possibility of a correction, which by definition is unanticipated. We can observe that the complacency noted in the market today, as evidenced by bullish sentiment indicators and historically low volatility, suggests that *there is some risk of a short term reversal.*

There is risk to the market from a nascent competitiveness of bonds. At year end, the ten-year Treasury bond yield stood at 2.4%. The earnings yield on the S&P 500 is 5.4%. Several years ago that spread was much wider, suggesting the relative appeal of stocks. We note that these yields are essentially unchanged from year end 2016, but we are aware of expectations of higher interest rates ahead. *At major inflection points in the stock market, bonds have provided a reasonable alternative for investors.*

We have observed that the long term annual return for the S&P 500 is around 8%. Looking at the past ten years, we are right on track; the twenty year trend is also intact. But for the past five years, the compounded return is closer to 15%. 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.* Indeed, ebullience in raising estimates on the part of investment analysts foreshadows a time when the earnings projections become unattainable.

There is 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. Today's high valuation could be resolved over time if earnings advance, but prices stagnate.

At bull and bear market extremes, trends remain in place longer than logic or analysis might dictate. 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 horizon, we see rates potentially rising, and sentiment at bullish, even complacent levels. Risk is much greater now than it was at the market bottom when risk was *perceived* as greatest. As always, each client's asset allocation should reflect each client's risk tolerance and return requirements. Our quotation above suggests the need to adjust the sails in response to an uncertain environment. Any correction will begin as profit-taking, and only in hindsight will the true cause be revealed. Nonetheless, Philip Carret's dictum that *"patience can produce uncommon profits"* will continue to guide our approach to equity investing.

Laurence R. Golding, Managing Director, January 10, 2018