CARRET
Asset Management

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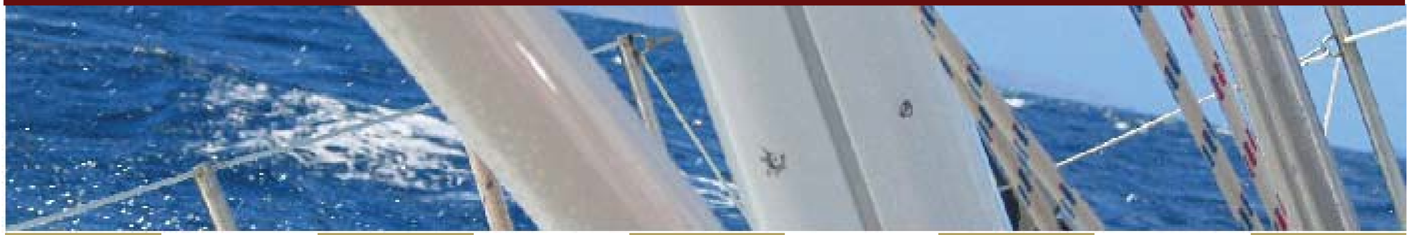
Carret Equity Insight



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Firm Assets Under Management

$2.5 Billion

Really, Dr. McCoy. You must learn to govern your passions.
They will be your undoing. Logic suggests…

Logic? My God, the man's talking about logic! We're talking about universal Armageddon. You green-blooded, inhuman...

Mr. Spock and Leonard McCoy. The Wrath of Khan. 1982

I received several complaints about my last piece in that my “shaggy dog story” about Spam was too long and too obtuse. I thought it was spot on, and introduced the concept of how the *unintended consequences* of a trade war might develop. Indeed, one of the major sources of stress to the markets over the past several months was the uncertainty over the escalating trade conflict with China. But as I was taken aback by unexpected and unprecedented criticism over my pedagogical efforts, I will withhold my humorous anecdote for this issue, and dive right into our thesis and discussion. As we say in the playground, the few who complained have spoiled this for everyone else.

I have often observed that I practice investment advisory services with a license, but that I also practice psychology without a license. We have just worked through what appears to be a *correction*, defined as a 10% to 20% move down from a recent high. But the psychological impact of this latest event appears to be unusually pronounced. I’d like to explore this further.

We are experiencing a period of “enhanced downside volatility” that has been noisome, but not wholly unexpected. On September 21st, the most recent peak in the market, we were aware that: *the Federal Reserve was tightening; corporate profit estimates for 2019 were likely too high; an inchoate and incoherent trade war was in the offing with China; Europe was slowing; Brexit was a mess; Washington was dysfunctional.* On December 24th, the most recent low in the market, we were aware that: *the Federal Reserve was tightening; corporate profit estimates for 2019 were likely too high; an inchoate and incoherent trade war was in the offing with China; Europe was slowing; Brexit was a mess; and Washington was dysfunctional.*

What has changed? *Perception and outlook, as trends and reality became more evident.* We recall that the market is essentially a *bi-polar* mechanism, with only two emotions being extant, only one at a time, *greed* and *fear*. In three short months, the pendulum has swung. This is normal market behavior. The problem is that the downside emotion has generally been absent over the course of this record-setting bull market. So clients find it enervating, and, yes, frightening. The 24/7 news media do not help things. We have planned on this sort of eventuality, and have set asset allocation parameters for your portfolio that give us downside protection as well as upside participation.

But that misses the point. The S&P 500 has climbed 340% from 666 in March 2009 to 2930 in September 2018, and is off just under 15% to the year-end close at 2506. The market set records for duration and altitude, if you will, over this time. More importantly it set a new low for *volatility* over this nine and one half year period. Hence, the re-emergence of volatility can be so unsettling.

We have been at this long enough to recognize the ebbs and flows of emotions that drive our markets. And we acknowledge that unemotional computers can enhance the resulting volatility. But we are convinced that a thorough understanding of fundamentals will successfully guide us through the turbulence of a market where *Fear, Uncertainty and Dread* (FUD) may be rampant. Simply put, it is very hard to conceive of our economy going from full employment and constrained growth to recession without more development. We are reminded of the old adage from our youth: that the *market had predicted nine out of the last five recessions*. We cannot say for how long the market will resume its upward course, but we do 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 bull market tracks the development of profits from the $49.50 low in 2008 to the estimated $160.50 for 2018. 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 estimated profit growth for 2019 has been properly scaled back to roughly 7% from 11%, but we are still looking at record profits this year. *There's nothing to look at here, folks; please move along.*

We have spent a great deal of time in our writings and conversations with you outlining our thoughts about the market and the risks and opportunities that may lie ahead. Nothing has changed, truly. We have offered an assessment of the unintended consequences and risks of a *trade war*. We have railed against *complacency* and the abnormal *lack of volatility*. We have cautioned about the perilous concentration on *momentum stocks*, including the FAANG complex, names that go up because they went up the day before and whose market appreciation is further driven by funds that must continually add to holdings. We have raised the concept of *regression to the mean*, whereby a market that was outperforming the long term rate of return of 8% in the short run might have to mark time to restore the trend line. We reviewed the old market adage of *buy on the rumor, sell on the news*, which suggested that much of the market advance had been in anticipation of events, better earnings, tax cuts, consumer confidence and such that were indeed coming to pass. And we have commented on the enhanced volatility caused by computer or *algorithm-based trading*, which we likened to running ahead of a steamroller, picking up nickels, but which was hardly investing in the traditional sense. Most importantly, we have written at length about the risks inherent in the Federal Reserve's stated goal of normalizing interest rates through periodic increases, and the size of its balance sheet through adjustments to the monetary base. Our concern has been that, despite clearly telegraphing its intentions to avoid uncertainty, eventually, a tipping point would be reached where the Federal Reserve might precipitate the very downturn for which it was endeavoring to prepare.

Although we have often observed that *everything starts as profit taking and only later do we assign a cause to the downturn*, we think that the Federal Reserve is the proximate cause of our recent distress. It is not so much in the very public setting of short term interest rates to the upside that is troublesome. We are looking at the less visible, but more pronounced, *reversal of quantitative easing* leading to reduced liquidity and its role in driving the enhanced market volatility. Fortunately, the Federal Reserve can easily back off on this policy and restore the liquidity cushion to the markets, but we note that the risks of *quantitative un-easing* remain evident. Further, the same algorithms and computer programs that initiated the slide can just as easily reverse course on the achievement of certain parameters. This is why we focus on fundamentals. We do believe that the underlying nature of economic and corporate profit growth will dictate the future direction of market activity, not the noise and uncertainty experienced over the past three months.

At this time, we see a market that has experienced a profound wake-up call. We see a Federal Reserve that is somewhat chastened in its enthusiasm towards tightening. We see better valuation based on forward earnings that have not collapsed, but have perhaps been adjusted to more realistic *expectations*. We note that we have largely accomplished the regression to the mean, so that we are now under-performing the historic long term returns. And we see an economy that remains fairly robust, even as the apparent benefits of the tax cut abate. And we can observe that there is *less risk* today than there was on September 21st, when all appeared calm.

In closing, we want to revisit our periodic bi-polar diagnosis of the market. We mentioned this concept to a dear client and friend who is in fact a licensed psychologist. She immediately offered this prescription to deal with an acute episode, be it manic or depressive. *Keep everything the same; stability, predictability and routine are the order of the day*. We were struck by the relevance of this clinical response as it applies to the market's gyrations. We have long cautioned that one does not raise one's expectations or risk tolerance based on recent strength in stocks; similarly, one does not lower expectations or risk tolerance based on recent weakness in the market. We continually strive to have strategic asset allocation dovetail with a realistic assessment of your long-range goals and objectives, and to limit changes to purely tactical moves. Philip Carret's observation that *patience can produce uncommon profits* becomes even more relevant when the apparent stresses and negative emotions appear to be peaking. Market volatility can be considered an integral part of investing; it should be embraced rather than feared. Another dear client, of more artistic bent, offered this *bon mot*: "In my experience, it is best not to be too intellectual about these things." To which we would add, it is best not to be too *emotional* about these things. Hence our Star Trek exchange at the start of this missive. We stand vigilant and ready to guide you and your precious and irreplaceable assets through whatever the future may bring. We are confident in our ability to assess the true underlying fundamentals of the market and to draw real distinctions between the noise that distracts from results and the reality that drives results.

Laurence R. Golding, Managing Director, January 14, 2019