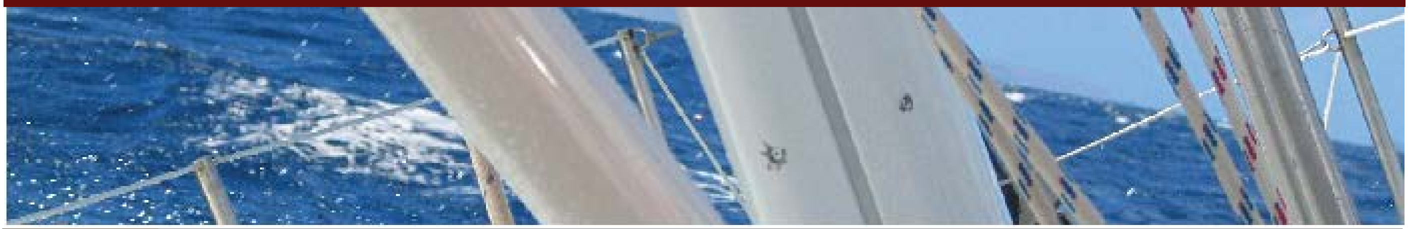
CARRET Asset Management

January 2020

Carret Equity Insight



Never give up, never surrender…

Commander Peter Quincy Taggart, Galaxy Quest, 1999

Firm AUM

$2.966 Billion

It is said that dogs have owners, and that cats have staff. I have had the opportunity to serve as Chief of Staff to four delightful cats over the past thirty years. Samuel Adams, the Patriot Cat (1988-2001), Dusty, Duchess Muffin of Pork (1998-2016), both strays who adopted us, Pinchus Kremegne (2017-), and Maxime Rudnick (2017-), our two pedigreed Russian Blues named for emigrant ancestors, have all been wonderful additions to the Golding family. To cite the proper Greek appellation, I am, without a doubt, an *ailurophile*. Not surprisingly, I saw the musical, CATS, three times during its original engagement, during which it actually became the longest running show in Broadway history. Fast forward to 2019, when the much-anticipated and now much-reviled movie version was released. While I was aware of the horrendous Rotten Tomatoes score building for the film, I really wanted to see it, and did so in its first weekend. I truly enjoyed the renditions of my two favorite musical selections, Skimbleshanks, the Railway Cat, and Gus, The Theatre Cat. I loved The Ad-dressing of Cats as sung by Dame Judi Dench at the denouement. I had no issue with the anthropomorphic mash-up of live actor's faces and CGI cat bodies. I had no issue with the sets. I had no issue with the attempt to run a slender plot thread through what was essentially a musical revue, for the purpose of continuity. I am aware of Abraham Lincoln's comment on such matters, "People who like this sort of thing will find this the sort of thing they like." To be honest, I really liked it. Some of you are probably saying, "Golding, I am glad that I didn't hire you to pick Oscar contenders. Stick to stocks and bonds." But that would be missing the point. I have a clear predilection for the subject material, I appreciate the various treatments, and I will be unshaken in my preference despite the volume of noise and the clamoring trying to prove me wrong. Where are we going with this? Why, of course, it is to discuss *risk tolerance and asset allocation and personal investor preferences*. This is a subject that we touch on in each of our quarterly missives. But after a one year S&P 500 return of 31.5% and a 450% return over a ten-year plus bull market run, it is imperative that we not lose sight of our fundamental belief that our successful work requires an honest assessment of goals and objectives that is not swayed by the recent performance of any one asset class, or perhaps, more to the point, what recent opinion anyone else not directly involved in the decision making process might have to offer on the subject.

Market Metrics	12.31.19	12.31.18	12.31.17
S&P 500	3,231	2,507	2,674
Dow Jones Industrial Average	28,538	23,327	24,719
NASDAQ	8,973	6,635	6,903
S&P 500 Dividend Yield	1.74%	2.06%	1.79%
S&P 500 Trailing 4 Quarter P/E	21.2	16.6	21.9

Source: FactSet

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Two divergent news stories prompted very productive incoming client calls in the past week. "An Epic Stock Market Crash Is Looming, Analysts Warn," reported ccn.com, while cnbc.com flashed, "Don't look now, but Goldman Sachs is saying the economy is nearly recession-proof." We note the sources, with ccn.com being the niche market Crypto-Currency Network based in Norway, while CNBC is perhaps Wall Street's best answer to ESPN, reporting broadly on the major financial topics of the day. We will review some of the themes in these two articles presently, but let me stay on topic a bit longer. Our discussion focused on what the respective client's reaction would be to either of those scenarios. It was determined that with no changes in outlook from the clients' perspective, whether in retirement planning, spending levels, educational commitments or legacy goals, it was apparent that there was no need to adjust our investment strategy. 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 can likewise minimize our response to *anticipated* changes in the market, despite what these two headlines might suggest. 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. Because of the recent strength in the S&P 500, the action of rebalancing the portfolio takes on some importance. A portfolio that began the year at 60/40 is now at 65/35, and a portfolio that began at 70/30 is now close to 75/25. *A tactical move back to the baseline is prudent to consider*. Over ten years, a portfolio that began at 60/40 is now 80/20, and one that began at 70/30 is now 85/15, if no rebalancing ever occurred.

Where are the salient and latent risks to the market? We have noted the long-term correlation between earnings growth and the market's inexorable advance. Over the course of this bull market, S&P 500 earnings have climbed from the 2008 trough of $49.50 to 2019's estimated $162. But there is a short-term correlation as well. That $162 estimate has been revised downward over the course of the past year from $177, and the 2% growth is forecast to be back-end loaded in the last quarter, not yet reported, which makes it suspect. Recall 2015, where *flat earnings* led to a *flat market*. Eventually, higher estimates for 2020, currently at that same $177 and already revised down from $184, may take hold, but for now, the caution flag is out. We can observe that sometimes stocks move in advance of earnings growth, often through the expansion of price/earnings multiples, and this can create valuation stress, suggesting selling as perhaps the best course of action. And sometimes, stock prices decline in the face of earnings growth, creating a valuation opportunity, suggesting that it is perhaps time to buy. Right now, we are at somewhat of a crossroads, with neither *compelling valuation*, nor reasonably assured *earnings visibility* at the forefront.

Although it might appear that the *headline risks* of a trade war have diminished as "progress" has been reported on several fronts, the reality is that damage has already been done, yet may be hard to recognize in the short term. Corporate decision-making, which in our view is extremely sensitive to *vague uncertainty*, may take some time to respond. We are convinced that investments in plant, equipment, personnel, and new products have been restrained by the noise and confusion surrounding the trade campaign. Moreover, economic disruptions to exporters, including farmers and capital goods suppliers, will take some time to recover. If one examines the Purchasing Managers' Index data, for example, one sees an economy that is slowing, although not necessarily in crisis. We think that trade uncertainty is a principal cause here.

Despite our own skepticism, there is a sense of complacency that one can observe from a perusal of the popular press and the cable business channels. Starting with the premise of a "full employment economy" and concluding with assessments of "high, but still reasonable valuations," it is tempting to view this as an orderly bull market that is devoid of worrisome volatility and full of upside potential. Our experience cautions against such displays of *hubris*. The market may be vulnerable in the short run to such surprises as a reversal in trade progress, disappointing earnings from high valuation companies, and, as revealed this week, unanticipated changes in geo-political fundamentals that might weigh on the global economy.

We have written at length about the tools that the Fed has at its disposal to manage the economy, and by proxy, to impact the market. There are changes to the highly visible *short-term interest rate*, adjustments to the less visible, but nonetheless significant *monetary base* or balance sheet, and, finally the tenor of its *public pronouncements*, or “jawboning.” In 2015, the Fed began to ratchet down the aggressive accommodation put in place during the Great Recession, by raising short term interest rates and by curtailing expansion of the monetary base. At the start of 2018, the Fed began to sharply reduce the size of the balance sheet. We believed that the Fed was attempting to restore its flexibility by creating some dry powder to be used in the next downturn. Our concern was that the Fed would overreach and precipitate the very event that it was trying to anticipate. By the fourth quarter of 2018, we would argue, a tipping point had been reached, and the impact of the intentional tightening was felt in a dramatic 19% correction that ended Christmas Eve. During 2019, the Fed reversed course, cut interest rates three times, and began to restore what was once known as *quantitative easing*. The pace of this new expansion is so pronounced that we find it hard to believe that a downturn of any consequence is likely while it is in effect. We would prefer to see higher valuations based on stronger fundamentals, rather than merely Fed policy, but for now it appears that the wind is at our backs.

When we first presented our opening quotation, we realized that it might best have been saved for one of those periods of extreme market stress, where the punditry and the collective emotions of the market were tending to overwhelm even the most focused of investors, those who subscribe to Phil Carret’s dictum that *patience can produce uncommon profits*. But in the final analysis, it is merely a restatement of our fundamental premise that each client is best counseled to develop a long-term strategy and set of objectives in conjunction with their adviser, and to maintain that discipline despite the occasional setbacks of swift and brutal market corrections or the euphoria of recent above-average market performance.

Laurence R. Golding, Managing Director, January 13, 2020

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.