CARRET
Asset Management

January 2021

Carret Equity Insight

Now is the winter of our discontent made glorious summer by this sun of York…

Wm. Shakespeare, Richard III, 1591

Firm AUM

$3.086 Billion

Despite my constantly proclaiming the benefits of a liberal arts education in the conduct of our business, I must confess that I managed to escape Roxbury Latin and Harvard without ever having read Shakespeare. For years, I thought that “Now is the winter of our discontent” was a standalone phrase that could be used to describe a difficult or challenging time, and I did in fact caption at least one mid-winter investment newsletter based on that premise. Several years ago, I became aware that the second part of the line was integral to the thought, and signified, in one sense, that whatever difficulties we had encountered were now turning to opportunities. The phrasing still bothered me, and I recently recast the line as: “The winter of our discontent is *now* made glorious summer…” This somehow made more sense to me. I ran this by my son, Eliot, who has not only studied but has also acted Shakespeare. While he acknowledged that the transposition of the adverb might work, he further enlightened me to the fact that this is just the first line of the first act out of five, and he steered me to the last line of the opening soliloquy for a clue as to what was in store should I ever deign to read the work in its entirety. Indeed, “I am determined to prove a villain and hate the idle pleasures of these days” provides a cautionary counterpoint to those who would dare succumb to *hubris* or our old bugbear, *complacency*. In a sense, the winter of *our* discontent ended on March 23, 2020, with the market bottom. The deliberate actions of the Federal Reserve and the Congress, the prospect of a successful vaccination program, and the likelihood of improved corporate earnings for 2021 and 2022 have ushered in a glorious summer for equities that has remained largely intact, despite the obvious concerns about unemployment and coronavirus mortality rates. In this piece, we will review the underpinnings of this glorious summer and discuss the potential villains that might disrupt the idle pleasures of these days.

At the start of 2020, consensus estimates for S&P 500 earnings for the year were around $177. It appears that final results will come in around $136, some 15% below 2019. Earnings are, *mirabile dictu*, expected to rebound to $165 in this current year. One can only assume that projections for 2022 will settle in well above that old $177 target as they are developed. We can make several observations here. First, is that the earnings *estimates* are just that, estimates, and are likely wrong. Indeed, 2019 started the year at $177 and ended at $162, as the economy slowed under the weight of trade uncertainty even before the pandemic. But we should take note of the *direction* and trends.

Market Metrics	12.31.20	12.31.19	12.31.18
S&P 500	3,756	3,231	2,507
Dow Jones Industrial Average	30,606	28,538	23,327
NASDAQ	12,888	8,973	6,635
S&P 500 Dividend Yield	1.51%	1.74%	2.06%
S&P 500 Trailing 4 Quarter P/E	28.2	21.2	16.6

Source: FactSet

Second, a similar pattern of earnings recovery was seen during the financial crisis and its aftermath, although with five years and a decline of 45% separating the pre-event peak earnings in 2006 and the next new high in 2011. At the time, the market appeared to rationally anticipate the earnings trends on both the downside and upside. The third observation is that we can reasonably expect the market to continue to rationally anticipate an earnings recovery; in fact, it has been doing so since the March 23rd low. The unquestioned belief in the *resumption of earnings growth* after a modest interruption is one of the pillars of the glorious summer that we have been enjoying.

Perhaps a fourth observation is that one might reasonably ask how this optimistic outlook could have arisen, given the absolute human toll of this crisis both in terms of unemployment and mortality. We believe that the answer lies in the *swiftness* and the *magnitude* of the monetary and fiscal response of the Federal Reserve and the Congress, unlike the 2007-2009 period, where both the Fed and the Congress were very slow, even hesitant, to act dramatically. Recall that it took about a year for the Fed to devise the TARP program and about two years for the Congress to deploy the American Recovery and Reinvestment Act. This time both *monetary and fiscal policy* actions have been rapid and targeted appropriately, allowing the market to focus more immediately on the upside potential of a recovery. Rather than merely providing liquidity to a financial system that is somewhat difficult for the average mortal to comprehend, let alone benefit from, these actions have provided direct cash payments to individuals through the two rounds of stimulus checks, the Payroll Protection Program, and enhanced unemployment benefits. The impact of these direct transfers has been to raise aggregate personal income. With fewer opportunities to spend, the national savings rate has also increased, contributing to opportunities for investment. These macro-economic results overshadow the dismal headlines, even if it does not seem logical or even *fair*.

In our last missive, we expressed some concern about market breadth, defined as the percentage of S&P 500 stocks beating the index versus lagging the index. The narrower the breadth, the greater the concentration, and the more risk in the market. From the end of the third quarter, we have observed the percentage of S&P stocks beating the index has increased, suggesting a broadening of market participation. While the first nine months of 2020 saw the market's favoring of a certain narrow group of stocks, namely technology, this appeared to be quite rational, although the concentration in the top five names was disconcerting. These companies exhibited strong *revenue and earnings growth* in the uncertain environment that we faced, while the broader class of stocks with *economic sensitivity* might be expected to lag the market for a time. However, we now see that the Purchasing Manager's Index data has turned markedly positive, business optimism has increased and that earnings expectations for 2021 and 2022 are up as well. We also like to examine the relative performance of an equally weighted index against that of the capitalization weighted S&P 500 as a further measure of breadth. For the first nine months of 2020, the *weighted index was up*, while the *average stock was actually down*. In the fourth quarter, however, the *average stock* added 18% versus the 12% gain in the *weighted index*. This makes sense, as more positive expectations about the economy at large are reflected in earnings estimates for the year ahead. We must caution that economic impacts stemming from the magnitude of this third wave of coronavirus cases may erode the emerging confidence in the broad-based recovery. Further, any number of events might precipitate a correction, which by nature is *unexpected*, and only *rationalized* after the fact. But we see the ultimate deployment of a successful vaccine program, the likelihood of further direct cash payments and indirect investment stimulus, coupled with the confirmed *accommodative* stance of the Federal Reserve as leading to a continued, glorious summer.

Any decent Shakespearean analysis should include a discussion of events that might *prove a villain* and disrupt the *idle pleasures* of these days. It has been a while since we have spoken of valuation concerns, but as with any good or service we must reflect on what we are paying for the value received. We have observed that sometimes the market underestimates earnings potential, creating *opportunity*, and sometimes the market overestimates earnings potential, arguing for *caution*. Since the 2009 bottom, the market has more than quintupled, while earnings have merely tripled. Put differently, at the bottom, the market sold at about twelve times forward earnings, while today that price is some twenty-four times. At the 2000 peak, known as the bursting of the tech bubble, but truly an event fomented by an abrupt change in Federal Reserve policy, the price-earnings ratio was some twenty-six times. Is the market ahead of itself?

This is not a simple analysis; the absolute decline in interest rates does affect the prices that we might be willing to pay. Further, if the 2022 consensus estimates rise to the $190 or $200 level that are currently out there at the fringe, then we are now talking about a forward p/e of some nineteen or twenty times. Much more reasonable, but still not cheap. In short, a cursory examination of valuation suggests a *cautious* approach.

Long term readers of these pieces will recall our 2018 letter in which we discussed how the economics of SPAM® were impacted by the trade war with China. The destruction of demand led to falling prices for pork and its by-products. The pork cycle is like any other commodity boom/bust series, where lower demand leads to lower prices which leads in turn to lower production, and higher demand leads to higher prices which leads in turn to higher production. Eventually, changes in demand at the margin reverse the trend. The recent decline in pork prices apparently had one beneficial effect, in that it allowed McDonald's to reintroduce the McRib® sandwich. Is it the flavor, the scarcity, or the mystery that makes the McRib® so precious? In time, demand for the McRib® will raise pork prices and cause MCD to withdraw the savory treat. In my opinion, there are several useful metaphors in this little digression. One can observe when it comes to market behavior that higher prices attract more demand, also known as *fear of missing out* or FOMO, while lower prices tend to lead to lower demand, also known as *fear, uncertainty and dread* or FUD. We have previously expressed our concern about the frothy nature of the IPO market of late, with some $368 billion in new issues last year, well above the prior high. The McRib® also stands for the unknown. *What is in it?* What is the economic value of a Special Purpose Acquisition Company or SPAC? Will Airbnb ever be profitable? Will the individual who purchased FROG at $95 on October 26th ever see a profit? When will the nascent risks prove the villain that disrupts the glorious summer? We are aware of the rewards of being cautious investors. Risk tolerance should be a constant, changing only with personal circumstances, and not based on the recent performance of any asset class. We think that Phil Carret put it best: *patience can produce uncommon profits.*

Laurence R. Golding, Managing Director, January 12, 2021

Separately Managed Account Strategies:

Large Cap Equity: Carret's Large Cap Equity Strategy seeks 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.