Carret Equity Insight

Firm AUM

$2.5 Billion

"When you come to a fork in the road, take it."

"We're lost, but we're making good time."

Yogi Berra, 1925-2015

I recently sat down with several colleagues to review our thoughts for this piece. It occurred to me that as we had established that the recent market action was being driven by a resurgence in earnings growth, it was essential to focus on the economy, and more specifically, the Federal Reserve's response to any apparent strength in the economy. Let me be straight with you. I studied economics in college, and learned at the feet of such luminaries of the time as John Kenneth Galbraith, Otto Eckstein, Martin Feldstein and Andrew Brimmer, all listed faculty for *Ec 10, Principles of Economics*. Actually, we were not taught by those stars, but by grad students; however, those grad students included people of the ilk of Lawrence Summers, so let's assume that our basic understanding of economics is okay. Well, to be honest, I took the course pass/fail and barely escaped with my transcript intact; but I did major in history and managed to graduate some forty years ago. I always disclose that I review economic trends not as a trained economist, but rather as an historian, seeking out and identifying patterns and correlations. During our lively discussion, I realized that my colleagues had a very different viewpoint on the nature of the traditional "business cycle," engineered by the purposeful expansion and contraction of the economy by the Federal Reserve. Their world view was largely shaped by two dramatic occurrences, the dot-com boom and bust and the financial crisis, where the Fed's role was somewhat less visible in the popular mindset. Our opening quotations, both from the late market pundit and Yankees legend, are chosen to reflect the current view from the windows of The Federal Reserve at Constitution Avenue and 20th Street, N.W. We will consider whether the oft-disparaged observation that "this time is different" is operative in this instance, or whether we can be reasonably assured of a certain set of outcomes. Let us begin with some history.

Market Metrics	6.30.17	12.31.16	12.31.15
S&P 500	2,423	2,239	2,044
Dow Jones Industrial Average	21,350	19,763	17,425
NASDAQ	6,140	5,383	5,007
S&P 500 Dividend Yield	1.90%	1.95%	2.02%
S&P 500 Trailing 4 Quarter P/E	20.7	19.1	17.8

Source: FactSet

For the twenty-five year period 1983 to 2008, for which we have consistent data, the Federal Reserve generally grew the monetary base, which is the bulk of the Fed balance sheet that it can directly control, at an average of 6% per annum, compounded. Our theory was that such a long term growth rate in the monetary base would support 4% real GDP growth with 2% inflation. In short, monetary base growth provides the basic fuel for a long run economic expansion. When the economy got into difficulty or *appeared* in danger, the Fed could expand this rate of growth in the short run, and if the economy became overheated or if the Fed was *concerned* about inflation, the Fed could contract this rate in the short run. This activity was less heralded and visible than the Fed Funds rate discussion, but we found it to be a nuanced measurement of the potential direction of the equity market. Over time, we noticed an interesting correlation. To the extent that the rate of change was greater than the aforementioned 6%, the excess would often "flow" into the market; to the extent that the rate of change was below that target figure, the difference would often "flow" out of the market. Our clearest example of this is the period surrounding year-end 1999, known to students of ancient history as Y2K. In anticipation of a possible crisis of confidence, Chairman Greenspan flooded the system, boosting year-over-year growth in the monetary base to some 18%. The economy was in fine shape, as such, the excess was not "needed" by the system, and so the excess "flew" into stocks. When the lights came on the morning of January 1, 2000, the Fed was faced with the prospect of reversing course, and contracted the monetary base at a negative 4% year-over-year rate. Today, we refer to these dramatic market swings as the tech bubble and the tech bust. Less dramatically, but equally significant, the Fed gradually slowed the growth in the monetary base from the 13% year-over-year rate reached just after 9/11, in the midst of a recession, to the baseline 6% by the end of 2003 and to less than 2% by the fall of 2007. Although the market climbed during this period, the underpinnings of the advance grew more and more questionable. The discussion between my colleagues and I can be reduced to one of *causality versus coincidence*. They would argue that in both cases, overheated markets, in one instance, stocks, and in the other, real estate, were doomed to fail by virtue of weight alone; that is, by lofty valuations that proved to be unsustainable. My enlightened argument is that it took the purposive actions of the Federal Reserve to bring those "bubbles" to an end.

Beginning in September 2008, the Fed increased the monetary base five-fold, a 25% compound rate, from $800 billion to a high of $4.0 trillion in 2015 via a series of programs known as Quantitative Easing. The concept was that massive Fed stimulus was required to keep the economy from falling into depression given the state of the banking system, housing and employment. Whether this was successful or not depends on your point of view. Clearly, the economy is in better shape than it would have been without the Fed's action, given the deleterious effects of the dysfunctional fiscal policy of Congress, of which we have written at length. Beginning in 2013, the Fed attempted to wean the economy off this liquidity infusion in a series of actions known collectively as "taper." For the last two years, the monetary base has been roughly stable in the $3.7 to $4.0 trillion range. But we note recent periods where the monetary base has contracted, and these correlate with periods of market "correction." This leads us to consider our original thesis. If the Fed needs to grow the monetary base at some nominal level each year to fuel economic expansion, then running at a flat or slightly lower level amounts to tightening. Even if you call it *stealth tightening*, the impact is clear. Now the Fed is signaling its intention to reduce the size of the monetary base. I believe that every Fed official is aware of this history lesson, but at the same time is equally concerned about retaining the monetary base at its current size. The concern, we believe, stems from the need to have "dry-powder" in case the economy gets into distress again, and the unknown effects on future inflation of maintaining the expanded monetary base. With the stock market at all-time highs, questions about the sustainability of a "bubble" cannot be far from the minds of each Fed Governor. We believe that the Fed is taking the unprecedented step of telegraphing its intention here to assuage investors and mitigate possible damage from a pronounced contraction of the balance sheet. But, I would argue that the Fed's very action will create the reaction it seeks to prevent. Again, my colleagues will maintain that at 18 times current year's earnings, and with certain sectors selling at substantial premiums to that lofty level, the market is bound to stall in time. The nice thing about this argument is that, in essence, we can both be correct. If the market begins to slide, it will begin with *profit taking*, and only afterwards will the collective punditry assign a cause.

There is always the possibility of a correction, which by definition is *unanticipated*. We can observe that complacency is rampant in the market today, as evidenced by the absolute lack of volatility. In our view, extreme complacency suggests that *there is some risk of a short term reversal.* We note the increasing allocation of investor assets into funds that bid up the prices of existing large cap "stars" based upon their capitalization alone. The question is what happens to these holdings if the market eventually reverses?

On the positive side, there is no immediate reason to suggest that the re-emergence of earnings growth will be truncated anytime soon. It appears to be supported by increased business activity, as evidenced by the Purchasing Managers' Index data, as well as by consumer confidence. The *expected rebound in results from the energy and financial sectors* might fail to materialize, and lackluster GDP may in time result in reduced corporate earnings expectations. But so far, the trends in pre-announced earnings revisions remain extremely encouraging. One can argue for a continued market advance based on continued earnings visibility.

Long-term returns for equities average around 8%. Over the past ten years, we are right on track; the twenty year trend is intact, as well. But for the past five years, the compounded return is closer to 15%. We believe in the concept of *reversion to the mean*, and caution 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 growth rate.* Today's high valuation could be resolved over time if earnings advance, but prices stagnate.

Although we speak of engineered soft landings, in reality, the Fed only has a few blunt instruments at its disposal: changes in short-term interest rates and, as discussed, changes in the less visible, but equally important, monetary base. For some time, we have maintained that the Fed was very far from *slamming on the brakes*, in the vernacular of Fed-speak, and that modest rate hikes were akin to *removing one's foot from the accelerator*. But as the Fed becomes emboldened over the course of the year, it is possible that they overestimate the tightening that the economy requires, and actually precipitate a downturn in earnings.

As we contemplate the near-term horizon, we must acknowledge that risk is much greater now than it was at the market bottom when risk was *perceived* as greatest. But as long as each client's asset allocation truly reflects each client's risk tolerance, we can be patient while the Fed works its way through its current dilemma expressed so eloquently above by Mr. Berra.

Laurence R. Golding, Managing Director, July 12, 2017