

Carret Equity Insight



“All the business of war, indeed all the business of life, is to endeavor to find out what you don’t know by what you do.”

Firm AUM

Arthur Wellesley, Duke of Wellington, 1769-1852

\$2.5 Billion

I have written often about my love of sailing and the sea, but have rarely written of my other interest and avocation, Civil War living history. I have just returned from the 155th anniversary reenactment of the Battle of Gettysburg. We had over five thousand troops on the field, infantry, cavalry and artillery, along with associated support personnel from hospitals to commissaries. We staged scenarios representing the key actions of each of the three days of the battle, culminating on Sunday with the eponymous Pickett’s Charge, the so-called “high water mark of the Confederacy.” I served as Assistant Adjutant General of the Federal Army, essentially the chief administrative officer on the staff of the commanding general, at the rank of Major, along with my trusty steed, Jackson Q. Horse, a handsome Tennessee Walker of some seventeen hands. At the end of the second day’s battle, we recreated the Council of War that General George Meade held on July 2, 1863, in which he sought the advice of his senior generals on what steps to take next. At that meeting, Meade’s chief of staff, Major General Daniel Butterfield, composer of “Taps,” a New Yorker and son of one of the founders of American Express, presented the following three questions to the assembled leaders: “Under existing circumstances, is it advisable for this army to remain in its present position, or to retire to another, nearer its base of supplies?” The second question posed, “It being determined to remain in present position, shall the army attack or await the attack of the enemy?” And, finally, if retaining the defensive, “how long could they hold their current position?” The council proceeded with the most junior officer, John Gibbon, speaking first. Gibbon favored retaining the army’s existing position but argued that the army was “in no condition to attack.” Other generals echoed this sentiment. Henry Slocum, the most senior commander, declared, “Stay and fight it out.” When the results of the council unanimously favored staying and fighting, Meade succinctly declared, “Such then is the decision.” As we performed this bit of improvisational theater for an appreciative candlelight tour, it occurred to me that Butterfield’s questions had some resonance to our current view of the market. Simply put, “Should we stay invested or should we sell? If we stay invested, should we be on the defensive or should we be aggressive? How long should we maintain this position?” With this introduction, we would like to review our thoughts, now nine and one quarter years into the bull market, but six months into a relatively lackluster year of investment performance.

Market Metrics	6.30.18	12.31.17	12.31.16
S&P 500	2,718	2,674	2,239
Dow Jones Industrial Average	24,271	24,719	19,763
NASDAQ	7,510	6,903	5,383
S&P 500 Dividend Yield	1.83%	1.79%	1.95%
S&P 500 Trailing 4 Quarter P/E	19.9	21.9	19.1

Source: FactSet

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Regular readers of these missives will recognize that our answer to each of the three rhetorical questions is a resounding “yes.” That is, we have always counseled that one should not necessarily adjust one’s approach to the market based on the recent experience and performance of any asset class, but rather that long term *asset allocation should be based on a realistic assessment of risk tolerance* and the objectives of the funds under management. This being said, as circumstances warrant, tactical adjustments to one’s long term strategy may be made in response to the current environment. While we don’t know exactly what lies ahead, we can consider what we do know, as is suggested by the Duke of Wellington, above.

From the January 26, 2018 high, the S&P 500 is off 4.6% and from the most recent low on April 2, the S&P 500 is up 5.8%. From year end, the S&P is up a modest 2.6%. *The market has been somewhat more volatile than in recent years, making the overall trend harder to discern.* In fact, the performance of the market and the performance of individual stocks appear unusually disconnected of late. We can identify a number of factors weighing on the market, and we can identify fewer factors potentially propelling the market higher.

We have discussed the old market adage, “*buy on the rumor and sell on the news.*” One can posit that the market has staged its powerful advance in anticipation of the better economy, earnings outlook and change in tax policy that is currently being realized. It is possible that the market may not respond as one might expect as this news develops further. Indeed, recent quarterly earnings reports, GDP and employment figures complete a “perfect storm” of good news to which the market may be responding in a contrary manner. Indeed, we can observe that the market reaction to otherwise bullish reporting during the quarter has been tepid at best. It may be that the market is considering that further such progress of this magnitude will be hard to obtain. The *consensus* may be saying that the best has already passed.

While we are on a military theme, we should review the dispatches from the front lines of the trade war. The development of this escalating conflict from campaign *promise* to actual administration *policy* is remarkable to behold. It does not take an advanced economics degree to see that the retaliation for our sudden attack on long time trading partners will be asymmetric at best. For example, protecting a small number of jobs in the steel and aluminum industries may come at the expense of many more jobs in the so-called metal bending industries here. Harley-Davidson and General Motors have already weighed in on contemplated changes to their production deployment. Further, China may not target the same manufacturing industries that we are attempting to rein in, and may in fact inflict damage on agricultural processors, whose business is wholly dependent on export demand. Suffice it to say, despite official statements to the contrary, trade wars are not easy to win. What we may be already seeing is the collateral damage of this conflict, the spreading of *fear, uncertainty and dread*. The impact of **FUD** on investor sentiment tends to be negative; the impact on corporate decision making tends to lead to retrenchment as well.

We have spoken of the *nascent competitiveness of bonds* to equity investments. Over the past six months, the ten-year Treasury yield has climbed from 2.41% to 2.85%, and it briefly touched 3.10% in May. Significantly, the two-year Treasury yield has climbed from 1.88% to 2.52% over the same period of time. The S&P dividend yield is now 1.80%. This suggests that a short term risk free rate may be beginning to look attractive relative to holding stocks with a more modest income yield and some degree of price risk.

For some time, we have expressed our concern that in the process of “normalizing” interest rates and the size of its balance sheet, the Federal Reserve accidentally oversteps what is required and actually precipitates the next downturn in the economy. We have taken comfort in the deliberate and measured pace of their actions, and in our belief that the Federal Reserve is looking at the same risks that we are. We have been skeptical that the Federal Reserve’s telegraphing of its intentions to mitigate downside surprises would be effective. The impact would prevail whether or not rates moved up and monetary base moved down in a surprise or well-advertised fashion.

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Our overarching concern is best known as the *law of unintended consequences*. Indeed, we are seeing this today. The *yield curve*, the difference between short and long term rates is *flattening*, meaning that the premium demanded for the risk of time is decreasing. Yield curves are generally described as *steep, flat or inverted*. Inverted indicates that short rates are higher than long rates, and this has been a fairly reliable predictor of impending recession over time. We are not there yet, but the financial press is beginning to draw conclusions from the recent changes in the shape of the curve. The long end appears not to forecast robust economic growth and inflation, while the short end is responding to the Fed's purposive actions. It is too early to tell if this is a recipe for disaster or if this time is different.

On the positive side, earnings trends for the S&P 500 basket of companies remain robust. One of our research services indicates that second quarter earnings estimates are being revised upwards at close to a record pace. Although we truly appreciate that next year's earnings estimates are suspect and likely derived from mere extrapolation of near term trends, the *long term correlation between earnings growth and market appreciation is irrefutable*. The four times appreciation in the S&P 500 since the 2009 bottom tracks and slightly exceeds the appreciation in earnings over this period.

There is a supply and demand model of the market universe which is noteworthy over time. Typically at market tops, supply increases, as companies of varying degrees of quality rush to come public. As in any supply/demand model, *increase in supply tends to suppress price, decrease in supply tends to bolster price*. At this juncture, we are actually seeing supply disappearing, both through regular share repurchase programs and aggressive merger and acquisition activity. Think of the market capitalization being removed in the ATT/Time Warner, Disney/Fox, CVS/Aetna transactions alone, and you can begin to grasp the trend.

After the "high water mark" at Gettysburg, the war continued for almost two more years. Given that market trends often carry on for longer than logic and facts might warrant, current momentum may continue for some time. Following the Duke of Wellington, we can make some reasonable assertions about the future based on what we do know. With Phil Carret's dictum that *patience can produce uncommon profits*, taken in consideration of our careful understanding of our clients' risk tolerances, we can build and maintain portfolios for the foreseeable future.

Laurence R. Golding, Managing Director, July 9, 2018

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 superior 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.

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