CARRET Asset Management

July 2020

Carret Equity Insight

There are three kinds of lies: lies, damned lies, and statistics…

Mark Twain, 1835-1910

Firm AUM

$2.924 Billion

I have often noted in these pages that I am not an economist, but, rather, an historian by training. To be sure, after my disastrous outing in Math 1A freshman year, I was quite shaken as to my fitness for higher level quantitative analysis. But my Medieval Studies professor, David Herlihy, introduced me to the joys of using data and rigorous mathematical reasoning to compel history to divulge its most precious secrets. From there, the transition to securities and market analysis has been relatively direct, and very productive. We have learned that sometimes the first pass can be misleading, and that several layers of digging may be required before the truth is revealed. There is a major metropolitan hospital that, like so many institutions, met the Covid-19 crisis head on. Within a few weeks of its onset, an alarming statistic was revealed, that some 6% of the hospital personnel had tested positive for coronavirus. This was of major concern because hospital safety protocols were in place, PPE was plentiful, and as part of a major university teaching complex, all available information was being utilized on a real-time basis. Moreover, this statistic was apparent while the "curve" was still climbing. Seemingly, the hospital would need to protect its staff if it were to complete its mission to protect the community. Some further analysis was summoned. To everyone's surprise, it was learned that clerical and nursing staff had the highest incidence, close to 11%, while front line doctors had the lowest incidence, less than 1%. In fact, if you posit that administrative staff admits you and handles paperwork, that nursing staff takes patient histories, doses medication, takes blood and temperatures, and along with doctors are in the closest proximity to patients for the longest periods of time, the expected correlation between patient exposure and the risk of contracting the virus seems somehow upended. I am going to pause here and let you think about this conundrum for a brief paragraph.

This crisis has myriad components, to be sure, but the responses to the health crisis and to the economic crisis are intertwined. As investors and advisers, we are probably best prepared to comment on the economic side, but we do keep in mind the realities of the health issues. From the start, we have seen a tremendous need for *testing and tracing* which will provide the *data* for better decision making and planning, but data-driven analysis has been hard to come by over these past months. But I digress…

Market Metrics	6.30.20	12.31.19	12.31.18
S&P 500	3,100	3,231	2,507
Dow Jones Industrial Average	25,813	28,538	23,327
NASDAQ	10,059	8,973	6,635
S&P 500 Dividend Yield	1.87%	1.74%	2.06%
S&P 500 Trailing 4 Quarter P/E	21.5	21.2	16.6

Source: FactSet

Back to our story. By now you have correctly deduced that the incidence of Covid-19 had nothing to do with exposure in the hospital, but rather was attributable to other factors, which we can best summarize as *lifestyle*. Although one can assume that hospital employees are perhaps more diligent and aware than the average population, one can see that employees commuting in their private cars may encounter a different set of risks than employees taking public transportation. This is not elitist, sexist or racist; it is just an observation. And in the case of our hospital, it was the determinant factor. The remedy was to provide best practices information to employees for their personal use and to maintain efforts to ensure that the hospital environment remained as secure as possible.

What then about our own data points? The S&P 500 is up 20.5% for the quarter, and some 38% from the March 23rd low, closing off 3% from year end. S&P 500 earnings for the current year have been revised to $125.50, down some 22.5% from 2019's record $162.35. That puts the market p/e at around 24 on the current year. The market p/e at the start of this year was around 20. From this standpoint, the market is not a bargain here. I know what you are thinking, those are trough estimates and of course, the p/e is higher on this year's numbers. Consensus estimates for 2021 show a nice rebound to last year's $162 level, or a forward p/e of 19. This is the quantification, if you will, of the supposed "V-shaped" recovery. While certainly an outcome devoutly to be wished, this just seems too easy. The quarterly breakdown of the earnings forecast is revealing, down 40% for the 2nd quarter, 20% for the 3rd quarter, flat for the 4th quarter, and up from there. In other words, the anticipated reopening of the economy resolves all uncertainty. But in a nagging sense, this concept smacks of the bugbear that we have written about so often, *complacency*.

To be sure, from the March 23 low, there was a compelling narrative. The Federal Reserve was implementing an aggressive program of *accommodation*. The Congress had moved swiftly to implement a fiscal *relief program* including direct payments to individuals. In the main, social distancing and lockdown programs appeared to be gradually flattening the curve. Optimism was abundant about a cure or a vaccine on the immediate horizon. The economy would reopen in short order. The damage would be healed by the end of the year. The market, is, after all, a forward-looking mechanism. 2021 would be just fine. One might have summoned Admiral David Farragut at Mobile Bay: "Damn the torpedoes, full steam ahead!" We were thinking of paraphrasing the Wizard of Oz: "Pay no attention to those pesky statistics behind the curtain."

During the most recent economic and market downturn, the 2007-2009 Great Recession, we saw S&P 500 earnings collapse 43% from the 2006 high to the 2008 trough before rebounding to a new high in 2010. On a positive note, despite the enhanced volatility and uncertainty, *we made it through to the other side*. But observe the magnitude of the earnings collapse in what in hindsight was at best, a traditional, Federal Reserve induced, demand-side recession. It would stand to reason that this recession, with its tandem *supply and demand* shocks, overwhelming *unemployment* statistics and a terrifying *mortality* rate would warrant a forward earnings revision at least in line with what we saw last time. It appears that the forward earnings estimate revisions have followed the narrative, and not the other way around.

As advisers, we look for certainty in an uncertain world. The market is both a numbers game and a confidence game. In a sense, we know less than we did three months ago. At the start of the quarter, we knew that *earnings* would be decimated, that *unemployment* would spike, that a constant barrage of coronavirus and lockdown *news* would hammer away at *confidence*, but also that the Fed and the Congress would be acting to curtail the damage. At this juncture, with an ever-increasing majority of companies having suspended "guidance," we are essentially flying blind with respect to earnings. The unemployment rate did spike to 15% before recovering to 11% as of this writing as "reopening" is seen in the surveys. However, that 11% statistic still represents some 18 million individuals, with likely reverberations on economic growth. Consumer confidence has managed to rebound somewhat with the prospect of reopening but remains well below pre-crisis levels. The Fed has essentially backstopped the credit and equity markets to an extent that follows on their playbook from the last crisis, but which goes far beyond what most analysts might have anticipated. The only *certainty* is that the Federal Reserve is adding massive amounts of liquidity, in excess of $1.5 trillion since the start of the crisis, in an effort to stave off market disaster; but at the end of the day, the Federal Reserve cannot control demand or supply or, more critically, the spread or containment of the virus. We have reviewed before, but need to caution again, that we are skeptical about a market propelled merely by Fed accommodation, and not by economic fundamentals.

We are concerned that unbridled Federal Reserve accommodation can lead to speculative excesses in valuation. One need not look any further than the 20% market decline in the fall of 2018 to see that the cessation of Fed largesse in the face of economic uncertainty can be disconcerting. Moreover, the distortion of the yield curve caused by the Fed's intervention may have forced some investors into potentially risky asset allocation decisions. We have often observed that one must determine one's true risk tolerance and make asset allocation judgments based on a long horizon, and not the recent performance of any one asset class. Just as risk tolerances are truly tested at market lows, it is important for us to counsel a cautious approach when *fear of missing out* is driving the market higher in the face of overlooked uncertainty. Holding cash sufficient to meet near term needs appears to be our best defense in this environment.

In preparing for this quarterly review, we consulted several doctors engaged in the fight against coronavirus. Each one stressed to us that this is not over by any means, that testing and tracing would be key to the successful containment of the crisis, and that there was a great deal of risk in reopening the economy without planning and data. Indeed, our historical review of the 1918 pandemic taught us that the rush to reopen the economy (and celebrate the Armistice) precipitated the second and deadliest wave of that crisis. We even found an advertisement for a meeting of the Anti-Mask Society from the winter of 1919. We usually close with an optimistic reiteration of Philip Carret's time honored dictum that *Patience can produce uncommon profits.* While this adage still holds in this environment, we should best just abbreviate this to its core principle, and simply counsel *Patience*.

Laurence R. Golding, Managing Director, July 8, 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.