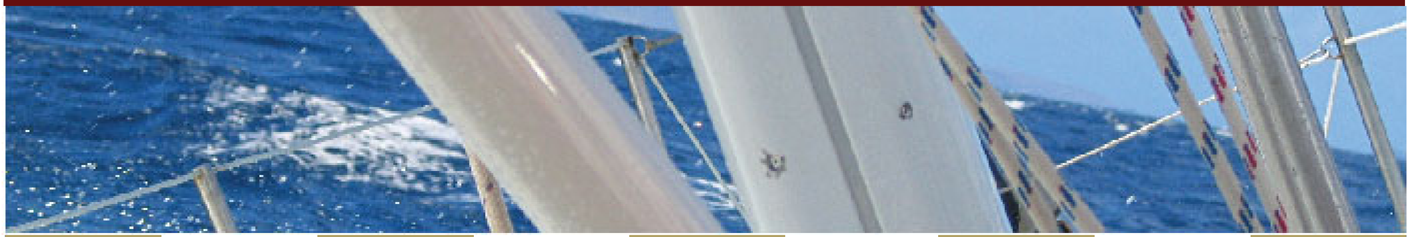
Carret Equity Insight



In preparing for battle, I have always found that plans are useless, but planning is indispensable.

Dwight D. Eisenhower, 1890-1969

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Firm Assets Under Management

$3.39 Billion

I went to my habitual lunch spot to pick up my usual salad. Upon check out, I was asked if I wanted a bag. Of course, I did, puzzling at the heretofore unasked question. My tab was immediately increased by a nickel. In my most polite manner, I demanded to know what that was about. The clerk pointed to a sign, dated March 2020, indicating the introduction of a bag tax. I offered that I had been frequenting this establishment since the restoration of in-office time last September, and that such an excise fee had previously not been levied. She pointed out that they did not charge the fee during Covid. Okay, there you have it, straight from the cashier at the Duke Eatery on 49th Street, the crisis is officially over. We now can calibrate the impact of recovery on my daily lunch habits. What does this mean for the economy and the markets overall?

This is where a venture into the history books is fascinating, if not instructive. Some have observed that the plagues of the Middle Ages led directly to the Renaissance, but I think that a look back to the recovery from the 1918-1919 pandemic may offer some more useful insights. As is the case now, the impact of that scourge was felt unevenly, with noted divergences between young and old, urban and rural, manufacturing and farming. The death toll at a similar 650,000 was a larger percentage of the US population. The crisis ended with the passage of time and the imposition of social distancing in the form of masks, without the benefit of any vaccine discovery. Just as now, there were numbers that resisted the mandating of any sort of discipline to stem the tide. We even stumbled upon a notice of an Anti-Mask rally in January 1919, where the featured speaker was the former Mayor of San Francisco. There was indeed a concomitant *recession* that set the stage for recovery. The hallmark of that economic resurgence was the unleashing of pent-up demand. We had been at war for two years prior to the outbreak, and the cumulative sacrifices of the war and the pandemic led to robust economic *growth* in short order. Most notably, this demand was met with a seemingly endless supply of new and innovative goods, including automobiles, household appliances, radios, and the like. Moreover, investments in infrastructure, namely the Federal Aid Highway Act and the electrification of much of America, contributed to the dramatic recovery. For a time, Warren G. Harding was considered one of the most successful Presidents in history. In short, the Roaring Twenties were aborning.

We are not forecasting a return to the era of Prohibition, Al Capone, Teapot Dome, the Emergency Quota Act, along with Sacco and Vanzetti, but we can observe that *pent-up dem*and is likely to be a significant driver of *economic growth* for the foreseeable future. Now some skeptics might question that source of demand, given that everything was available from Amazon, Seamless, Instacart, Netflix and the like during lockdown; we note that travel, tourism, public events, Broadway and Ivy League football are just restarting. Furthermore, the dramatic increase in the national savings rate over the past year and a half, due to the influx of government stimulus checks and the reduced opportunities to spend, suggests that there is a coiled spring here ready to unwind. Indeed, the economy is entering its thirteenth consecutive month of growth as measured by the Purchasing Managers' Index, and GDP growth was recorded at 6.4% in the first quarter, up from 4.3% in the fourth quarter of 2020. The swift response of the Federal Reserve and the Congress allowed the market to anticipate this *recovery*, by seemingly looking past the immediate perils of the pandemic to the eventual restoration of some sort of normalcy. Now that this recovery is upon us, we are aware that many market participants are *obsessively* focused on the eventual end of such accommodation.

Some years ago, we wrote often about the tough position that the Federal Reserve was in as it sought to reduce monetary accommodation. During the period, roughly 2013-2018, when the Fed was actively slowing and subsequently reversing its role in supporting growth, we focused on two factors, one, the *taper tantrum*, as the markets reacted to the removal of the proverbial *punchbowl*, the second, the risk that the Fed would overshoot its target and precipitate the *downturn* for which it was deliberately preparing. We believe, as we did then, that if the economy is strong enough in the judgement of the Fed for it to *begin* to withdraw accommodation, that is a good thing, and not to be viewed as a negative. We also believe that the Fed learned its lesson in 2018, when the reversal of monetary accommodation precipitated a brief bear market.

What are the markets on about? We will start with the most salient headline risk, *inflation*. The Commerce Department's Personal Consumption Expenditure Index was recently reported in at 3.9%, about twice the Federal Reserve's announced target level. The Fed had said that it was seeking to have inflation run at 2% or higher before it considered any move towards eliminating stimulus. After more than a decade with less than anticipated inflation, the change is unnerving to many observers. Yet the Fed seems unwavering in its continued accommodative stance. Wherefore this conundrum? We are very sure that the Fed believes that the current reported inflation is *transitory* and *not structural*.

We can review several factors that lead us to this conclusion. Over the holiday weekend, higher gas prices were reported as the bane of travelers' existence. Yet we still have abundant energy supplies, a factor that had *restrained costs* pre-pandemic. There was a major supply disruption with the shutdown of the Colonial Pipeline six weeks ago. This led to *hoarding and higher prices* at the pump which did not immediately respond to the resolution of the interruption. Further, we are told that a shortage of drivers is interfering with the normal distribution of ample fuel supplies. We have every reason to believe that these supply issues will be resolved in time. The driver shortage story leads to another purported risk, of *wage inflation*. Anecdotally, individuals are preferring enhanced unemployment benefits to real wages, and as a result, employers must raise wages to attract needed help. Perhaps, but those enhanced benefits are set to expire, and we still have a 5.9% unemployment rate. That issue should be self-correcting. Prices for new cars are showing signs of inflation, but that can be attributed to electronic parts shortages caused by pandemic-related interruptions. This in turn has caused used car prices to soar.

Similar supply chain issues are reported in lumber, and certain grocery items, among others. We reiterate that *supply side disruptions* are inherently self-limiting, and not a harbinger of inflation. It appears that some market participants are anticipating that interest rates will rise as the Federal Reserve responds to inflation pressures. But the ten-year Treasury yield *fell* during the quarter. For now, we will take the Fed at its word that accommodation will remain in place for a while.

There are some questionable items on the radar screen. The massive *infrastructure* program is supposed to provide further stimulus to the recovering economy. Speaking as someone who bought pothole damage insurance on my new leased car, this purported benefit is a bit of a *canard.* It is a form of stimulus that does not necessarily reach its intended targets. Much is wasted or siphoned off to unproductive uses. Further, it takes too long to deploy. And a *rebuilding* effort does not compare to the excitement of an Erie Canal, a Transcontinental Railroad, the Interstate Highway System or even, more prosaically, the Internet.

The market at all time highs has led to a spate of offerings of dubious merit. We have commented on the Special Purpose Acquisition Company (SPAC) fad. These entities go public without revealing what business they are intending to pursue. Often, these entities are *acquiring*, and essentially *monetizing*, business models that would otherwise be *unable to access* the equity markets. On top of this disturbing trend, we note that an increasing number of companies are coming public with no earnings visible for the foreseeable future. Over time, our supply/demand model of the market suggests that increased supply may tend to reduce prices.

At 23 times current year's earnings and 20 times next year's, the market is not necessarily cheap. Although bull markets do not fundamentally end as a direct result of extended valuation, higher valuation does compromise downside protection in the event of an unforeseen reversal. *Chronically low interest rates* tend to foster an *extended price/earnings ratio* for the market, suggesting some risk when the interest rate scenario changes. But we have often observed that at its essence, the market tracks earnings, and everything else is just noise. The economic boom, as it were, is driving *earnings*, and more importantly, earnings *expectations*. The financial crisis of 2007-2009 took five years to see earnings recover to new highs; this time it looks like it will be just one year. From the 2008 low of $49.50 in earnings for the S&P 500, we are looking at $189 for 2021 and $211 for 2022. If the current recovery continues apace, and the Fed holds fast to its stated mission, then those forecast earnings may be too conservative, and the valuation picture improves accordingly.

We do not know when this current environment will be overwhelmed by adverse changes and the onset of vague uncertainty. While Phil Carret would counsel *patience* to achieve uncommon profits, to parse Ike's comments at the top, we cannot *plan* to sell now and buy back on the "inevitable" decline. We can, however, engage our best *planning* resources to develop individual assessments of risk tolerance, required returns, and the best means to meet these constraints and objectives.

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