CARRET Asset Management

October 2017

Carret Equity Insight

"History doesn't repeat itself but it often rhymes."

Attributed to Mark Twain, 1835-1910

Firm AUM

$2.5 Billion

On February 9th, 1964, the Beatles first appeared on The Ed Sullivan Show. On July 6th of that year, the film, A Hard Day's Night, was released. I was eight. I begged my then thirty-three year old mother to take me to the movie. Instead, she paid the neighbor's teenage son to take me. Maybe she thought it was just a fad and not worthy of her time. Maybe she was not as cool as I thought. He took me to the theater, but promptly left me to sit by myself when he ran into his cohort of friends. It definitely was not cool for him to be seen with an eight year old. On September 19th, 2017, I went to see Paul McCartney perform in concert at the Barclays Center, my third such outing in six years. Could anyone from 1964, my mother, Johnny, me or even Sir Paul himself, have envisioned this phenomenon lasting fifty-three years? I think not. Now, I did write about Sir Paul in a quarterly piece four years ago. I shared the story of our chance meeting on 53rd Street, during which I mentioned to him that I had been a pretty promising violinist until he arrived in Boston in 1964, quitting in favor of the guitar, an instrument that I never quite mastered. His retort: "Tell your mum I am sorry." But my main point in that missive was to comment on the fact that everyone around me had experienced the 2013 concert through the *viewfinder* of their smart phone device. How can you truly experience anything if you are literally one step removed from the activity? Did the iPhone's success portend the downfall of living experiences and real memories? Or was this an example of how our civilization had become somehow unstuck from the reality of the moment? My investment thesis was that one had to focus on *fundamentals*, and not on second hand impressions, sound bites and so called "headline risks" that were one step removed from reality. This is a point that we have argued consistently over the years, using various metaphors to emphasize our point. At this latest concert, Sir Paul himself made a crack about the phones, and he remarked that "when I sing something familiar, the whole place lights up, but when I sing something new, it is like a black hole out there." Interestingly enough, I was less perturbed by the smart phone usage this time, but by another phenomenon. Everyone around me stood for most of the three hours. It was like some communal need to pay honor and respect to a legend that may be more fragile than we'd like to admit. Indeed, he is seventy-five. His voice cracks in the upper registers. Special effects and the lightshow serve as distractions. And everyone is singing along, so no one really notices the flaws.

Market Metrics	9.30.17	12.31.16	12.31.15
S&P 500	2,519	2,239	2,044
Dow Jones Industrial Average	22,405	19,763	17,425
NASDAQ	6,496	5,383	5,007
S&P 500 Dividend Yield	1.85%	1.95%	2.02%
S&P 500 Trailing 4 Quarter P/E	21.1	19.1	17.8

Source: FactSet

So what is my tortured investment analogy? *This bull market is over eight years old, this economic recovery is surprisingly weak, and we are increasingly distracted by the fireworks and lightshow that comprise the daily news cycle. And everyone is singing along, so no one really notices the flaws*. Like Sir Paul, this equity market advance has lasted and has continued to perform to everyone's delight longer than anyone might have imagined.

In our last piece, we spent some time discussing the role of the Federal Reserve in *extending* or *curtailing* this economic expansion, and we reviewed our long-held belief that changes in the monetary base might provide a clue as to near term market direction. Simply put, the expansion of the Fed balance sheet since 2008 and the parallel aggressive interest rate policy have provided the fuel for the economic recovery that we have seen, as well as the liquidity supporting the corresponding rise in asset prices that we have enjoyed. This suggests that the unwinding or reversal of the monetary accommodation might pose some risk. We believe that the Fed is telegraphing its intentions, both with respect to further interest rate increases and its plan to reduce the monetary base, with the desire to eliminate the old bugbear of *vague uncertainty* that we know the markets abhor. We are convinced that the Fed Governors are looking at the same risks that we see. The unprecedented accommodation will require an unprecedented effort to restore the *status quo*, if in fact, that continues to be the Fed's objective. It may take years, it may never fully be accomplished; we do not know what economic straits may lay ahead. We believe that the Fed is motivated by the desire to have "dry powder" in the event of the inevitable future downturn. Our concern is that the Fed initiates the inevitable downturn in the process of generating that very cushion for the future.

The S&P 500 has advanced 14.25% year-to-date. Earnings for the S&P 500 companies are expected to rise some 10% for calendar 2017, having turned positive in the fourth quarter of 2016 after close to two years of stagnation. At its basic level, the market can be said to *anticipate earnings growth*. The 260% gain in the S&P 500 since the March 2009 bottom is neatly matched by a similar increase in S&P 500 earnings since the 2008 recent low. However, the market is selling at 19.5 times current earnings, as compared to a similar multiple of trough earnings at the bottom. The market valuation is at the high end of normal historical ranges. We note that bull market and bear market valuations can be carried to extremes, and remain in place longer than logic or analysis might dictate. If the projected earnings growth for 2018 comes to pass, then valuation is not as stretched, and we are looking at a slightly more comfortable 17.5 times forward multiple.

Perhaps more noteworthy than the S&P's absolute valuation level, which is in essence just an *estimate*, is the lack of *volatility*. Our last "correction" of 10% was at the beginning of 2016, and we have scarcely had sufficient 1% moves recently to rattle anyone's confidence. In our collective experience, this is not the natural state of affairs. While one can explain away the lack of volatility by pointing out the strong underlying earnings trends, the abundant accommodation of the Federal Reserve, and the positive impact of global money flows, our instincts caution us to be vigilant. For some time, we have been in a period extremely conducive to success in US-based large capitalization equity investing. Sentiment has improved, earnings growth has accelerated, and price/earnings multiples have expanded in response to this benign environment. Either this trend continues for a time, or it reverses. It is difficult to imagine it getting better. Such 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. What happens to these holdings if the market eventually reverses?

On the positive side, there is no 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 trends in pre-announced earnings revisions are encouraging. Moreover, a reduction in shares outstanding through repurchases, mergers and acquisitions has not been offset by the usual IPO activity that might be expected at a market high. This improves the *supply and demand* characteristics of the market, a macro consideration that is often overlooked.

On the other hand, we want to reiterate that 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.*

The recent hurricane season was noteworthy in its destructiveness. Two major storms hit the continental United States, and two hit the Caribbean. We have clients, friends and family who were in harm's way during this siege, and we acknowledge the disruption in their lives as a result. What truly struck us during this period was how the term "cone of uncertainty" entered the *lingua franca* of the meteorological business and was used unabashedly by everyone from the staid professionals on the Weather Channel to the smiling newsreaders on the local cable station. *Cone of uncertainty* is an apt term of art for our business, as well. While we do not envision the redoubtable Jim Cantore visiting our portfolios anytime soon, we want to be prepared. Our opening quote suggests that history can be our guide as we anticipate the future, but also that we recognize that to some extent, this time may, in fact, be different. The best storm-proofing that we can recommend is constant and realistic attention to our clients' risk tolerances. We have repeatedly observed that risk is greater now than at the market bottom, when risk was perceived to be the greatest. We want to be skeptical of the temptation to add to the best performing ideas, sectors and asset classes simply because they have done well recently, and we want to nurture our contrarian instincts to be skeptical where complacency is ascendant. As always, we can expect that any "correction," which is, by definition, unanticipated, will begin as profit-taking, and only in hindsight will the true cause be revealed. Nonetheless, Philip Carret's dictum that "*patience can produce uncommon profits*" will continue to guide our approach to equity investing.

Laurence R. Golding, Managing Director, October 10, 2017