CARRET
Asset Management

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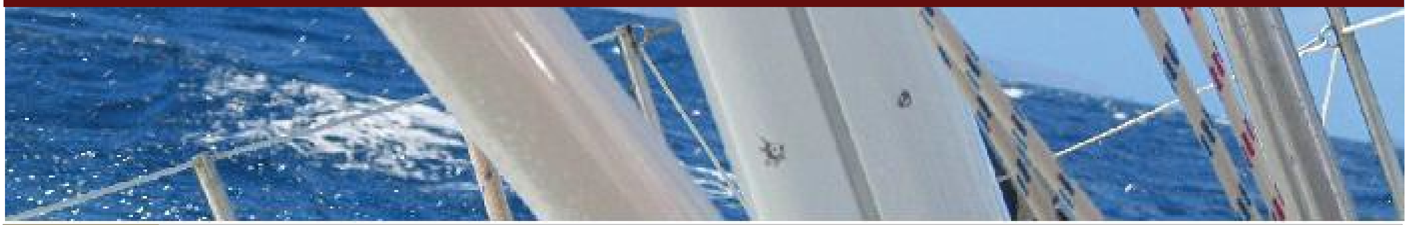
Carret Equity Insight



"Could you do me eggs, bacon, spam and sausage without the spam, then?"

Monty Python, 1970

Firm AUM

$2.6 Billion

In 1970, my father and I, along with a group of cousins and friends, ventured down the Colorado River on a rafting expedition. After a long hike from the South Rim to the launch point at Phantom Ranch, we were welcomed by our guides with a sumptuous meal of steak and potatoes with all the trimmings. This was going to be both a great adventure and a culinary experience. Several days later, after we navigated the Class 10 Lava Falls rapids, our hosts again prepared a mouth-watering luncheon, this time of Spam and Cheese Whiz. Our circumstances had certainly changed. This was hardly a "bait and switch," but rather an honest reflection of the impossibility of transporting perishable goods for extended periods in the desert. Thus began my lifelong appreciation of Spam. Spam was first developed by the Hormel Company in 1937, and is made from pork shoulder, salt, sugar, and potato starch. When I was an analyst following the food companies, I saw Spam being produced. Like Philadelphia Scrapple, it is best described as "everything but the oink." Debate swirls about the origins of the name which, like the Coca-Cola formula and Colonel Sanders' famous recipe, remains a closely guarded company secret. Spam went on to help win WWII, with some 150 million pounds delivered to our troops and allies during the conflict, forever changing dietary habits in the Pacific. My affinity with Spam continued when I worked as a sailing instructor at a camp on Lake Winnipesaukee during my college summers; we would routinely provision our sailing voyages out of the mountain trips department, where Spam was a key consumable for the very reasons that the Army and Colorado River guides favored it, indestructibility. However, as sailors, we found a secondary use for the Spam, as a sacrifice to the God of the Wind, Phil. We would present a burnt offering, accompanied by a prayer appropriated from Mel Brooks' 2000 Year Old Man: "Oh Phil, Don't throw rocks at us, don't poke our eyes out, don't pinch us, Oh-meyn." Eventually, we realized that we did not need to eat the Spam to appease Phil, and so we would recite the prayer and then just chuck the contents of the can into the water. I carry on this tradition to this day, and always bring a can of Spam on any sailing adventure. Indeed, generations of fish in Buzzards Bay and the Sir Francis Drake Channel have dined on Spam that I have offered in supplication for *fair winds and following seas.* But I digress. A dear client recently shared a news story with me over lunch by the shores of that very same Lake Winnipesaukee. *Are you ready for this?* Hormel reported that sales of Spam were being hurt by retaliatory trade tariffs implemented by China, Canada and Mexico against US meat producers.

Market Metrics	9.30.18	12.31.17	12.31.16
S&P 500	2,914	2,674	2,239
Dow Jones Industrial Average	26,458	24,719	19,763
NASDAQ	8,046	6,903	5,383
S&P 500 Dividend Yield	1.74%	1.79%	1.95%
S&P 500 Trailing 4 Quarter P/E	20.3	21.9	19.1

Source: FactSet

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Quarterly sales forecasts at Hormel were slashed by up to $500 million. Growing stockpiles of unsold meat products suggest further price weakness ahead. This is not good for farmers or food processors. Trade wars are neither easy to win, nor predictable in their development or denouement. We would like to use this shocking news to re-introduce the concept of the law of *unintended consequences*. We believe that this may provide the best insight into the potential risks and rewards ahead of us as we enter the fourth quarter.

The development of the multi-front trade war from campaign *promise* to actual administration *policy* is remarkable. 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 steel and aluminum may come at the expense of many more jobs in the so-called metal bending industries, several of which have already announced changes to their production deployment. Further, our erstwhile trading allies may not target the same manufacturers that we are attempting to rein in, and may inflict damage on such industries as agricultural processors, whose business is largely dependent on export demand. The Spam story is such an example. Eventually, we may be forced to reckon with the response of the ultimate victim, the American consumer, who will either absorb higher import costs, be forced to trade down in their purchases, or even worse, suffer a job loss as result of this conflict. What we are concerned about is the collateral damage of an escalating trade war, the spreading of *fear, uncertainty and dread.* The impact of **FUD** on investor sentiment tends to be negative; the impact on consumer confidence may be similarly unpleasant; the impact on corporate decision making tends to lead to retrenchment in spending and hiring. Perhaps the recently negotiated recast of NAFTA mitigates some of this concern. But without a doubt, the likely consequences of a trade war with China and Europe will be unintended.

We have written at length about the role of the Federal Reserve in *extending* or *curtailing* this economic expansion, and we have 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 from 2008 to 2015 and the parallel aggressive interest rate policy 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. Since 2015, the Fed has been very deliberately raising interest rates and very gradually reducing the size of the balance sheet. 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. But we are skeptical about whether the Fed's communication effort will mitigate the ultimate impact of this effort. Eventually, a tipping point may be reached. We are convinced that the Fed is 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, as well as to forestall the development of an unsustainable asset bubble. Our concern is that the Fed initiates the inevitable downturn in the process of exercising such caution.

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 to be forecasting slower economic growth and inflation than recent trends indicate, 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. This eventuality is one possible mechanism by which the Federal Reserve's actions might lead to such unintended consequences.

We can view *complacency* as an unintended consequence of a nine and one half year old bull market. Although there were two swift corrections earlier this year, from the April 2 low, the S&P 500 has registered a steady advance with minimal volatility. This is not the natural order of things. We would prefer a market with enough gut-wrenching volatility to keep *pessimism* alive. We observe that the top fifty performers so far this year carry an average price/earnings multiple of 60, over three times that of the market. This is another way of looking at degrees of risk assumed by investors. We have noted that *risk is greater at market highs than it is at market lows*, contrary to popular belief. Initial public offerings have increased at a notable rate recently, of which fully 80% have had no reported earnings over the past twelve months. While we had previously hailed the net *reductions in supply* of equities as a result of share repurchases, mergers and acquisitions, the very predictable late-stage appearance of more aggressive IPO volume will tend to reverse that prior benign trend. Anecdotally, we are seeing a greater appetite for risk by market participants, but we can report that our clients generally subscribe to our long-held belief that one does not change one's risk tolerance based on the recent performance of any asset class.

On the positive side, earnings trends for the S&P 500 basket of companies remain robust. Although we appreciate that next year's earnings estimates are likely derived from mere extrapolation of near term trends, the *long term correlation between earnings growth and market appreciation is irrefutable*. The four-fold appreciation in the S&P 500 since the 2009 bottom tracks and slightly exceeds the appreciation in earnings over this period. Commentary surrounding third quarter reporting generally sets the tone for the next year's outlook, and we would expect a favorable tone to be maintained at this juncture.

Despite the strong market advance year-to-date, we note that not all stocks have fully participated, and that there are still opportunities to acquire companies with reasonable prospects selling at reasonable prices. It is not appropriate for us to call a market turn or top, but we are reminded that each client must reasonably assess their own risk tolerance and return requirements in conjunction with their advisor. Philip Carret's dictum that *patience can produce uncommon profits* continues to guide us in our efforts on your behalf.

Laurence R. Golding, Managing Director, October 5, 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 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.