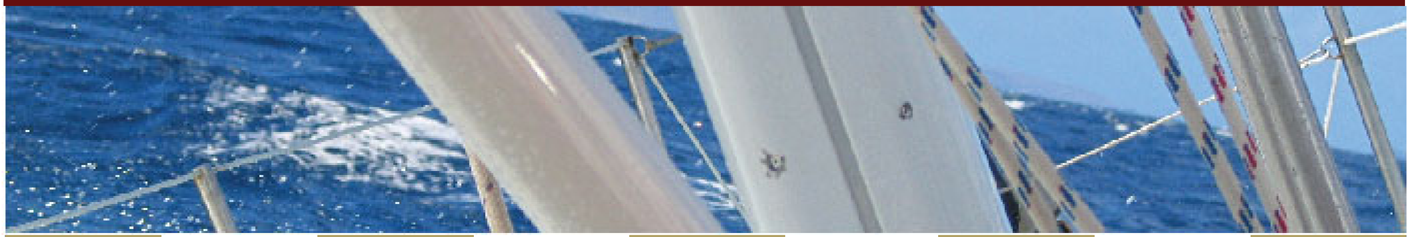
CARRET
Asset Management

October 2021

Carret Equity Insight



There's two buttons I never like to hit: that's panic and snooze.

Ted Lasso, 2021

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Firm Assets Under Management

$3.37 Billion

The late market pundit, Yogi Berra, once remarked, "you can observe a lot just by watching." I brought a suit into the cleaners that I had not worn in eighteen months, but which really needed a pressing prior to the weekend. In the *before* times, same day or next day service had not been a problem. This particular morning, I was told that there were no guarantees as to when it would be returned. Inquiring further as to the reason for this material adverse change in the expected service delivery, I was told that the plant was experiencing severe staffing issues and could no longer offer any promises as to turnaround time. Obviously, dry cleaning demand has suffered over the past year and a half, but we were curious as to whether the staffing issues were due to management's reluctance in rehiring due to business uncertainty or because of reluctance on the part of past or prospective employees to take the jobs given other options. Later that day, I stopped for lunch at a favorite suburban restaurant, which displayed this sign in its foyer: *The whole world is short-staffed, please be patient.* I interviewed the harried manager, who exclaimed as he bused my table, "I cannot find anyone to work."

Staffing issues affect not just my dry cleaners and the local bar and grill, but also bellwether Fedex, which just reported disappointing earnings that the company blamed on *labor costs* and *supply chain* disruptions. That revelation cost the company some 12% in market value during subsequent trading sessions. Should we be surprised if that pattern occurs in other stocks? If we expect it to occur, what action should we take? Historically, October is a volatile month, because that is when management offers the first insight into the next calendar year. As you might imagine, over the past months, we have been looking for clues that will shape our opinion of where the market is heading, and we believe that these clues will come from consideration of the economy and its progress. We have been concerned about the practical aspects of *reopening* the economy, including both *demand and supply* dislocations. In our last piece, we argued that supply disruptions were essentially self-limiting, and would be worked out in time. Concerns over the inflationary effects of such dislocations remain, but they do not necessarily augur for a *pervasive change* in the rate of inflation, although there may in fact be a very visible short-term impact on the nature of pricing.

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As we suggested in our previous missive, *pent-up demand is driving the economy* and is in fact at the heart of the *supply chain crisis*. The hundreds of ships waiting offshore at West Coast and East Coast ports are there because goods were ordered in quantities that outstripped previous levels. The problem is that off-loading capacity is limited by physical constraints at the several ports, exacerbated by a shortage of drivers needed to haul the goods and products away to their intended destinations. The driver shortage is related to the shortfalls in waiters, dry cleaners and Fedex delivery personnel, among others. With reported unemployment at 4.8%, is this labor shortfall a function of extended unemployment benefits which may take some time to runoff, or has Covid-19 introduced a societal change reflecting a new attitude towards work, particularly at the hourly wage level? Is the willingness of employed persons to lose their jobs over vaccine mandates somehow related to this new attitude towards work, or is it just coincident?

The answers to these latter questions may be beyond the scope of this treatise, but it is clear that the economy is recovering at a pace that generally exceeds expectations. This rebound is driving anticipated corporate earnings growth, which in turn is driving a robust stock market. We have argued that the *market follows earnings*, and that everything else is just *sophisticated noise*. And believe me, as we set about to compose this piece, we were struck by the amount of noise that was present: a selloff in large cap tech names, which had generally led the market higher over the past year and a half, caused a 6% reversal in the NASDAQ; a narrowing of breadth in the market found some 50% of companies in the S&P 500 at least 10% below their all-time highs, what we would term a *correction*; further, that same index turned in a truly lackluster quarter, up around 0.58%, having reported an above average 15.9% return for the nine months to date. To add to the *cacophony,* a major Chinese real-estate development company, Evergrande, appeared to be figuratively on shaky ground, while our own government leaders debated the merits of an impending debt ceiling breach and the implications of default. And throughout, all eyes remain on the Federal Reserve and its plans to reduce monetary accommodation.

At the very start of the pandemic, the Fed slashed *interest rates* and began aggressive *monetary accommodation* to support the economy through an indefinite period of uncertainty. The sweeping fiscal response of Congress through prompt direct payments, coupled with this monetary stimulus, allowed the stock market to look through to the eventual recovery that is currently at hand. One can argue that the program has been a success, as GDP has swung from the steepest decline on record of 31.2% in the 2nd quarter of 2020, to a record advance of 33.8% in the 3rd quarter of 2020, with 4.5%, 6.3% and 6.7%, reported in the subsequent quarters. Expectations for the 3rd quarter just ended reflect a very positive 5.1%, particularly noting the tough comparison with last year's explosive rebound. We don't buy stocks based on GDP growth directly, but we do pay close attention to the resulting earnings trends. 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 now looking at $198 for 2021 and $217 for 2022, up from $189 and $211 as of our last writing. For reference, the 2020 low was $138. In essence, the market is up 6 times from the 2009 bottom, but earnings are up some 4.5 times. This suggests that *valuation* may be somewhat stretched, but it does illustrate our premise that the market follows/leads/reflects earnings. If the current recovery continues apace, and the Fed holds fast to its stated mission, then those forecast earnings may be too conservative; the valuation picture improves accordingly. On the other hand, because of the lapping of the calendar, the year over year gains of 2021 will necessarily be harder to repeat in 2022. We don't know if and when the supply chain cost issues will be reflected in estimates.

Why then would the Fed want to do other than hold fast to its stated mission? Let us posit two words: *Mission Accomplished.* Contrary to popular belief, the Fed did not provide monetary accommodation to support the market, it did so to support the economy. If the cumulative effect of those four quarters of above average GDP growth has indeed brought us to some reasonable economic equilibrium, then the Fed can certainly back off on its level of accommodation. In the *lingua franca* of our people, we are talking about easing up on the gas pedal, not slamming on the brakes. There is a name for the market's *anticipatory anxiety* about the Fed's next move; it is called a *taper tantrum.* As we put it during the last round of taper from 2015 to 2018, if the economy is strong enough for the Fed to relax its stimulus, that is a good thing, and not to be feared. Earnings growth should continue in that scenario. Again, we are speaking of the Fed *lessening but* not *reversing* its stimulus program.

In our opinion, the Fed is looking at two broadly divergent factors as it contemplates its next move. First is the lingering uncertainty about Covid, reflected in still high incident rates, driven by variants and vaccine hesitancy. To some extent this uncertainty is illustrated by a stubbornly low *labor participation rate*. This argues for continued caution. The second is headline inflation, which reflects changes in labor, commodity, and finished goods costs. We have argued that this inflation is only temporary and is due to the supply chain disruptions. A critic of my theory might argue that Fedex will not be able to roll back the higher wages, to which we would counter that those one-time increases do not portend future inflation. Prices of goods now in *short supply* will necessarily fall as orders are *filled*. We believe that the Fed is betting that current inflation is transitory, and so it can defer any dramatic changes in accommodation. That being said, the Fed has done a great job of signaling their intentions, to the point that we can move an eventual taper from the category of *vague uncertainty* to one of *known certainty*. In our opinion, this should tend to reduce the investment risk of such a move.

Interest rates are not telegraphing concern, and it is said that the bond market is often wiser than the stock market. The ten-year Treasury has climbed from 0.68% to 1.53% over the past year, but the stock market has risen 29.55% over that same period. We believe that the ten-year and the *short rates that the Fed actually controls* do have some room to climb before we would argue for caution.

We became enamored of Ted Lasso during lockdown and chose to offer one of his famous aphorisms. To us, the *snooze button* represents our old bugbear, *complacency*. Every IPO is not worthy of attention, every SPAC will not bear fruit, every dip is not necessarily a buying opportunity; we are aware that one must pay attention to valuation metrics as well as company prospects. On the other hand, by understanding the value of an asset allocation that truly reflects one's own risk tolerance, rebalancing to acknowledge the outperformance of an asset class, rather than adjusting our expectations to incorporate recent history, we can navigate through the *noise and volatility* that surrounds the inexorable advance of corporate profits and stock prices, and thereby avoid hitting the *panic button*. "Coach" Carret would add this: *Patience can produce uncommon profits*.

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