CARRET
Asset Management

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Carret Insights

When in doubt, observe and ask questions.
When certain, observe at length and ask many more questions.

General George S. Patton, Jr. 1880-1945

I just returned from my 45th College reunion, where I got the chance to witness first-hand how organizers, despite laudable intentions, created a supply chain crisis and a labor shortage from scratch. The College determined to hold not only the regularly scheduled 2022 Commencement, but also make-up commencements for the classes of 2020 and 2021, which had held only virtual celebrations during the Covid lockdown. Organizers then added a newly created "Alumni Day," the centerpiece of some ten quinquennial reunions. As a result, *demand* for goods and services, including but not limited to, event tents, folding chairs, tables, tablecloths, bar setups, bartenders, food service, audio/video personnel, shuttle transportation, on-campus housing, classrooms for reunion programming, bedding, towels, and local hotel rooms *skyrocketed* from what might have been called normal levels. The demand crunch was aggravated by a supply chain stressed from two years of Covid-related disruptions. I observed that this *bottleneck* was unsolvable at any *price*. Inflation classically assumes that there are too many dollars chasing too few goods, but also that at some price you can get what you want. In the case of my reunion, there was no way for *inflation* to take root; instead, we did without bartenders and towels. In short, demand went unsatisfied.

My resource-constrained reunion suggests that the College is an imperfect model of the universe, preconceptions notwithstanding. Or is it? Out in the real world, prices for goods and services are climbing at a rate not seen in forty-five years. The broad increase in *demand relative to supply* as the economy reopened, compounded by the spike in energy prices, has indeed created classic inflation, and the Fed is responding in a classic manner. But there are two important aspects to today's price spiral over which the Fed is largely powerless, at least one which resonates from my recent experience.

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Firm AUM

$3.046 Billion

Key Market Levels	6.30.22	12.31.21	12.31.20
Fed Funds Rate	1.50% – 1.75%	0.00% – 0.25%	0.00% – 0.25%
3 Month U.S. T-Bill	1.64%	0.05%	0.08%
10 Yr U.S. Treasury Bond	2.98%	1.51%	0.92%
10 Yr AAA Municipal Bond	1.62%	1.03%	0.71%
10 Yr A Corporate Bond	4.62%	2.31%	1.62%
S&P 500	3,785	4,766	3,756
S&P 500 Dividend Yield	1.59%	1.20%	1.51%
S&P 500 Trailing 4 Quarter P/E	17.4	24.6	28.2

Source: Bloomberg, Wall Street Journal, Reuters, Municipal Market Data (MMD), FactSet

Poor planning, and in some cases greed, by corporate decision-makers have caused labor and supply-chain shortages so dire that in some industries, consumers can't get what they want at any price. As an example, hundreds of airline flights are canceled daily because of the avoidable shortage of pilots, flight attendants and mechanics. These shortages are the direct consequence of actions taken during the Covid slowdown, including layoffs, curtailed training, and delayed recruiting of personnel. In a similar vein, we can look at the auto industry, where supply chain disruptions led to shortages which mean the car that you want may not be available for two years or more. *Monetary policy* can't do anything to relieve these *bottlenecks*; until the airlines hire and train the employees they need, and carmakers take delivery of their components, consumers will just have to wait. Although *unemployment* rates are low, labor force *participation* rates are dismal, further confounding policy makers.

The story driving oil developed as follows: Demand was increasing due to the Covid recovery. Your local gas station hikes prices to stay ahead of the cost increases that they anticipate. Exchange-traded oil prices moved up because they moved up the day before. Higher fuel costs feed higher transportation costs, which feed higher retail prices that are raised to cover the increased delivery costs. The problem is that we don't think that the Fed has the tools to manage this sort of *speculative* inflation. And *mirabile dictu*, the price of oil has been falling since June 8. Why? Because the *pending global recession* will curb demand. Now, oil is moving down because it went down the day before.

What *pending global recession* you might ask? Some forty-five years ago, a Cornell economist named Alfred Kahn was appointed by President Carter to be Chairman of the Council on Wage Price Stability, colloquially, *the inflation czar*. Kahn was admonished by the administration not to use the word "recession" as the very word itself could cause consumers to stop spending and make for a self-fulfilling prophecy. Kahn henceforth used the term "banana" in his testimony to Congress on the risks facing the economy. This prompted columnist William Safire to write a piece on why banana was such a funny word, and the Chairman of United Fruit Company to decry the denigration of its signature product. Kahn subsequently used the term "kumquat."

Tune in to any financial news program and the topic of discussion is likely to be one of the following: are we in a *kumquat*, are we heading for a *kumquat*, or can we avoid a *kumquat*? The Federal Reserve and the Congress moved swiftly to respond to the unknowns of the Covid lockdown by increasing liquidity both through monetary and fiscal means. We have repeatedly referred to these as *quantitative easing* and *direct stimulus* payments. Both had the effect of creating dollars, the classical *too-many*. Covid set up a situation where supply was constrained, either through unavailability or inaccessibility, the classical *too-few*. That the inevitable outcome was inflation should not be a surprise. The fiscal programs were writ large; there had been much concern about the sluggish response to the financial crisis of 2007-2009. But the Fed had some experience in normalizing monetary accommodation coming out of a crisis, as is demonstrated by its purposeful actions from 2015-2018, the period that we refer to lovingly as the *taper tantrum*. We do not know why the Fed did not move to "take its foot off the gas pedal" earlier as the recovery became evident. But by delaying, actions that in essence are merely moving to a "neutral" position are being *perceived* as "slamming on the brakes." Legendary Fed Chairman William McChesney Martin described the role of the Fed as "leaning against the winds of deflation or inflation, whichever way they are blowing." He also coined the oft-cited *take away the punchbowl* metaphor. The punchbowl has been cleared, and the lights in the hall are now turned up.

With the lights up, we can see what went on. *Excess liquidity* not only encountered an insufficient supply of goods and services, excess liquidity also bid up the price of speculative assets from crypto currencies to SPACs, awarded high valuations to companies with what might best be described as "aspirational" earnings, and for good measure, tacked on a few extra multiple points for companies with assumed growth into the future. Although the Fed signaled its intentions for some time before acting, the change in Fed posture, starting with the first quarter-point increase through the most recent three-quarter-point increase, is simply jarring to the market. It seems desperate; it elicits the comment that the Fed is behind the curve. It is redolent of the times when such downturns were labelled "panics."

The descent to a bear market level, off 20% from the recent high, tends to put both nightly business reporting and investor psychology in a bad place. In a bull market, "investors" are willing to overlook imperfections in a company's fundamentals and tend to look far into the future to justify high valuations for favorite names. In a bear market "investors" are unwilling to overlook imperfections in a company's fundamentals and tend to look only to the present to justify a wholesale downward revision in valuation. In a bull market, "investors" look over valleys to the next summit. In a bear market, "investors" see the next valley as an abyss. In a bull market, "greed" is the dominant animal spirit. In a bear market, "fear" is the dominant animal spirit. In a bull market, **FOMO**, *fear of missing out,* is the relevant acronym. In a bear market, **FUD**, *fear, uncertainty, and dread,* is the relevant acronym. Our job in exuberant times is to provide a countervailing level of skepticism. Believe it or not, our job in the scary times is exactly the same.

Demand that was supported by stimulus checks and enhanced unemployment benefits has begun to wane. More discretionary dollars are being spent on fuel and food. The cost of borrowing has climbed. The mix changes revealed in the recent quarterly releases from retail companies suggest that the Fed's intention to slow the economy is already taking hold. We can envision a scenario where the *slackening of demand* leads to *lower inflation* in short order, without the need for the Fed to actually "slam on the brakes." Indeed, earnings growth will slow, but that does not necessarily mean that earnings will collapse. There is, *per se*, no reason why the Fed's actions must lead to a recession. The late economist Paul Samuelson once observed that "the stock market has predicted nine of the past five recessions."

What will turn this market around? It will eventually recognize that the downward revisions in *price* have overshot the downward revisions in *earnings.* Inflation could slacken as softer demand moderates supply chain pressures. That would reduce fear of the Fed overreacting. In time, the selling pressure will become "exhausted" as investors slowly come to the realization that there is no new news here, and to sell repeatedly based on the same fears becomes an exercise in futility. The market will focus on the *restoration of growth*, as it has throughout history. Patton's words, highlighted above, suggest that we take nothing for granted. As we have long argued, our asset allocations should consider the eventuality of such reversals as we are currently experiencing. One should not change one's approach to the market based on the recent performance of any asset class. This is true on the downside as well as the upside. *Patience can produce uncommon profits.*

Laurence R. Golding, Managing Director, July 12, 2022

Credit Insights

After an extended period of telegraphing its intentions, the FED raised the Fed Funds rate, the short-term rate that it controls, three times in the first half of the year with 50 basis point jumps in March and May and one 75 basis point hike in June. A further move of 75 basis points is anticipated before the end of the July 26-27 FOMC meeting. The objective and the tough challenge facing the FED is to bring inflation under control without tipping the economy into recession. It has a secondary goal of "normalizing" monetary policy from the emergency measures that were taken during the pandemic. This would restore the FED's arsenal if the economy does indeed contract and require future support. The consequence of the FED's moves on the fixed income markets was understandably pronounced. While the Fed Funds Rate rose from 0.0% to 1.75% in the 1st half, the 10 Year UST climbed from 1.52% to 3.02%. The impact on existing holdings was to some extent offset by the opportunity to invest new proceeds and maturities into higher yielding bonds. Please see our commentary below for further discussion on these and other topics of interest.

Data as of June 30, 2022	Taxable Fixed Income	Municipal Fixed Income	Opportunity Fixed Income	Enhanced Cash
Maturity	3.66	6.65	2.86	0.38
Duration / Dur to Worst	3.3	5.5 / 4.1	2.5	0.38
YTM / YTW	4.17%	3.10% / 2.66%	6.74%	2.62%
Taxable Equiv YTM/YTW *		6.00% / 5.15%		
Coupon	3.60%	4.56%	5.53%	2.77%
Credit Rating	BBB+	AA-	BB	A

** Assumes a combined effective tax rate of 48.30%*

Sector Allocations:				
U.S. Treasury	3%			12%
Government Agency	3%			5%
Corporate - Inv Grade	87%	4%	25%	73%
Corporate - High Yield			65%	
Preferreds	5%	1%	8%	
Convertible				
Municipal		94%		6%
Cash	2%	1%	2%	4%

Taxable Fixed Income Strategy:

- Investment Grade (IG) corporate bond yields climbed during the 2nd Q of 2022 due to rising U.S. Treasury (UST) rates and widening spreads. During the 2nd Q, 5 Yr UST yields increased 58 bps, increasing from 2.42% to 3.00% and have now increased 174 bps YTD.
- Corporate IG spreads, as measured by the 3-5 Yr A rated FactSet index widened by 50 bps during the Q, increasing from 78 bps to 128 bps and have now increased 87 bps YTD.
- Corporate IG spreads, as measured by the 3-5 Yr BBB rated FactSet index widened by 70 bps during the Q, increasing from 126 bps to 196 bps and have now increased 117 bps YTD.
- The Taxable Fixed Income Strategy gross return for the 2nd Q was -2.8% versus the Barclays Intermediate Gov't Credit Index's return of -2.4%. For the YTD period, the gross return for the strategy was -7.0% versus the index's return of -6.8%.
- The Strategy's duration shortened from 3.4 to 3.3 Yrs Q / Q, as the relative flatness of the long end of the yield curve is not compelling from a risk/reward perspective.
- Average portfolio quality held constant Q / Q at a BBB+.
- The Strategy continues to benefit from a shorter duration relative to the Index as UST yields rose across the curve. The overweight allocation to corporate bonds provides incremental cash flow over UST which we anticipate will aid relative performance in the second half of the year.
- We remain comfortable owning corporate credits – S&P 500 earnings are estimated to grow (despite a slowing rate of growth) and corporate America has taken measures over the last few years to strengthen balance sheets.
- As high inflation continues, corporate earnings will feel the brunt of rising costs. Companies maintain flexibility in passing higher costs on to the end consumer in the form of higher prices. While concerning that consumer demand and confidence is softening, bond investors can remain confident that the IG bond market will be resilient.
- The Strategy's modest allocation to preferred securities increases the total yield and increases cash flow (a positive for reinvestment opportunities in a rising rate environment).

- With inflation remaining near record highs, widening spreads, and a flattening yield curve, the Strategy's 3.3 Yr duration allows flexibility to reinvest maturities, calls, and coupon cash flows into an upward moving interest rate environment.

Municipal Fixed Income Strategy:

- Representative AAA rated 5 Yr Municipal Bond yields rose during the 2nd Q. The index's YTM began the Q at 2.03% and closed the quarter at 2.27%. The net quarterly change was a modest 24 bps. During this same period, 5 Yr UST yields rose by 48 bps. Municipal yields (5 Yr AAA) have risen 167 bps YTD.
- The 2Yr-to-10Yr municipal curve steepened significantly during the Q from a low of 44 bps on 4/1/22 to a high of 86 bps on 6/21/22. Although somewhat volatile throughout the first two Qs of 2022, the steepness of the curve ended the quarter at 81 bps which is exactly where the curve began the year.
- The 5 Yr Muni-to-UST Ratio (MOT), a key indicator of relative value, ranged from 75% to 94% in the 2nd Q.
- The Municipal Fixed Income Strategy continues to be impacted by the broad rise in interest rates. Negative price returns were less severe during the 2nd Q compared with the 1st Q. Additionally, portfolios still have two quarters of income returns yet to be realized in 2022. The Municipal Strategy gross return for the 2nd Q was -1.8% while the Bloomberg Barclays 5 Yr Muni Index returned -0.4%. Our slightly longer-than-index current duration and our slightly lower-than-index average coupon contributed to underperformance, relative to the index, during the 2nd Q. For the YTD period, the Strategy had a gross return of -6.7% versus the index's return of -5.5%. We continue to see good relative value in the intermediate part of the curve anchored in high-quality, premium coupon, essential revenue, and GO credits.
- The Strategy's duration-to-worst held firm at 4.1 Yrs which is marginally longer than the 3.7 Yr duration of Bloomberg Barclays 5 Yr Muni Index.
- Average portfolio quality held constant Q / Q at AA-.
- Municipal market fundamentals remain quite positive and we are starting to see signs of stabilization (yields, flows, issuance). Technical factors such as issuance and coupon payments have historically lent support in the summer months. In fact, during June, maturities and calls were significantly greater than new issuance by a large margin.
- Credit health remains strong despite recent market volatility, bolstered by positive economic growth that has lifted tax revenues for states and local governments. Rainy day balances have ballooned and are above the record set for fiscal year 2021. As we move through budget season, most states are indicating surpluses, and some more than forecast. California reported $100 billion of surplus revenue during the 2nd Q. Both Texas and Florida also boasted sizable budget surpluses of $20 billion. We continue to be cautiously optimistic in our view of the municipal marketplace and see municipal bonds as a good value on both an absolute and tax-equivalent basis.
- Municipal Mutual Fund outflows have been a contributing factor to demand and price volatility in the 2nd Q. Mutual Fund redemptions were notable during the Q as retail investors (in aggregate) perceive higher yields as risk rather than opportunity. Investors have withdrawn $88 billion from municipal funds YTD.
- 2nd Q new issuance was $107 billion which was slightly higher than the 1st Q. YTD new issuance is $208 billion which keeps the market on track for our estimated $425 to $450 billion range for 2022. The 10-year average is $407 billion with a peak in 2020 at $485 billion.

Opportunity Fixed Income Strategy:

- During the 2nd Q, 5 Yr UST yields increased 58 bps, increasing from 2.42% to 3.00% as inflation challenges continued. Key drivers of inflation are continued strong domestic demand (fading), supply chain struggles driven by China's no-covid policy, and commodity inflation as a result of the on-going Russian/Ukraine war. For the YTD period, the 5 Yr UST rate has now increased 174 bps from a base of 1.26%.
- High Yield (HY) rates, as measured by the iBoxx HY Index ETF (HYG), increased from 5.87% on March 31st to 8.89% on June 30th and have now increased 468 bps YTD from a base of 4.21%.

- HY spreads, as measured by HYG, widened during the Q, increasing from 345 bps on March 31st to 585 on June 30th – a widening move of 240 bps. For the YTD period, HY spreads have widened by 291 bps.
- Corporate IG spreads, as measured by the 3-5 Yr BBB rated FactSet index widened by 70 bps during the Q, increasing from 126 bps to 196 bps and have now increased 117 bps YTD.
- The Strategy underperformed the Barclays Intermediate Gov't Credit Index during the 2nd Q, with a gross return of -3.6% versus the index's return of -2.4%. For the YTD period, the Strategy has outperformed the Index, with a gross return of -6.2% versus the index's return of -6.8%.
- The Strategy's duration decreased from 2.7 Yrs to 2.5 Yrs Q / Q, as we continue to remain short duration and are being patient as we look for opportunities to extend maturities.
- Average portfolio quality held constant Q / Q at a BB; additionally, IG exposure decreased 1% from 29% to 28%.
- Corporate action activity in the form of tenders and calls remained robust during the 2nd Q and benefitted portfolio performance – we anticipate this trend will slow materially in the 2nd H as increasing rates dampen refinancing opportunities.
- Reinvestment opportunities are focused on short / intermediate duration high coupon bonds, as higher coupons accelerate current cash flow and reduce duration – a positive contributor to relative performance in a rising rate environment.
- The volatility exhibited in both the HY and IG markets in the 1st H of 2022 are welcome events for the Opportunity Strategy, as we remain defensively positioned and have ample flexibility to add value as credit and interest rate opportunities arise. **On average, 27% of our bonds mature in the coming 12 months!**

Enhanced Cash Strategy:

- Ultra-short-term interest rates moved materially higher, as the yield on the 6 Mo UST increased from 1.00% to 2.42% from March 31st to June 30th. Over the first six months of 2022, the 6 Mo UST increased 224 bps from a base of 0.18%.
- Corporate IG spreads, as measured by the ICE BofA 0-1 Year A-AAA US Corp Index, tightened by 2 bps during the 2nd Q, decreasing from 71 bps to 69 bps. For the YTD period, spreads have more than doubled, from a spread of 34 bps on Dec 31st to 69 bps on June 30th.
- Average portfolio quality improved slightly Q / Q to A from A-, while duration shortened slightly to 0.38 Yrs from 0.47 Yrs.
- The Enhanced Cash Strategy returned 0.05% during the 2nd Q. Further, the Strategy outperformed the ICE BofA 0-1 yr UST Index, which was down -0.11%. YTD the Strategy returned -0.12% compared to -0.33% for the index.
- As anticipated, the FED has raised short-term interest rates aggressively thus far in 2022 and expects to maintain its hawkish stance at the July 26-27 FOMC meeting. Higher short-term rates will continue to offer more impactful return opportunities for the Enhanced Cash Strategy.

Separately Managed Account Strategies:

Municipal: Carret's Municipal Bond Strategy seeks to maximize tax efficiency through opportunistic portfolio management while preserving principal through practical portfolio structuring and fundamental credit analysis. We actively manage investment grade portfolios with a diversified blend of issuers, sectors, and maturities aimed at delivering consistent, risk adjusted returns with an emphasis on tax-efficient cash flows. Carret uses a value approach when buying and selling bonds. This method recognizes the inefficiencies of the municipal marketplace and enables clients to benefit from our expertise and market knowledge.

Our high-quality, intermediate-maturity bias is designed to balance of preservation of principal, total return, and tax-exempt cash flows. We opportunistically add value through credit research, bond structuring, and yield curve positioning. Our municipal bond portfolios are actively managed as either state-specific or state-focused (general market in approach, otherwise). Essential service revenue bonds and high-quality general obligation bonds make up the framework of our municipal bond portfolio strategy. The strategy's primary focus is on high-quality, investment-grade municipal bonds with an intermediate duration of approach (3 - 7 years), which enables utilizing bonds in a maturity range of 2 - 12 years.

Taxable: Carret's Taxable Bond Strategy seeks to achieve above average total returns with an emphasis on preservation of capital and consistent cash flow. We utilize investment grade fixed income securities and shift across bond sectors based on changing market conditions. Our intermediate duration approach (3 - 7 years) seeks to identify the sweet spot on the yield curve and structure maturities accordingly. Active management of the strategy includes forecasting the long-term direction of interest rates and credit spreads. Our fundamental credit research and active portfolio management process has provided consistent and attractive risk adjusted returns.

Opportunity: Carret's Fixed-Income Opportunity Strategies seeks to generate a higher level of current income with a secondary focus on long term capital appreciation. We utilize various types of higher yielding fixed income securities and shift among types based on changing market conditions. We actively manage risk, respond quickly to market movements, and utilize interest rate hedges to limit duration risk. We focus on high quality high yield and low-quality investment grade bonds, and couple them with preferreds and broken convertibles to try to generate above average levels of cash flow.

Our intermediate duration approach (2 - 10 years) seeks to identify the sweet spot on the yield curve and structure maturities, accordingly. Active management of the strategy includes forecasting the long-term direction of interest rates and credit spreads. Our fundamental credit research and active portfolio management process has provided consistent and attractive risk adjusted returns.

Leveraged Opportunity: Carret's Fixed Income Leveraged Opportunity Strategy seeks to utilize low cost leverage and favorably negotiated release rates to potentially enhance our existing Opportunity Strategy returns. We actively manage leverage to augment opportunities within the high yield and investment-grade sectors of the fixed income market.

Enhanced Cash: Carret's Enhanced Cash Strategy seeks to provide excess returns above those offered by cash equivalents, while focusing on capital preservation and liquidity. The strategy invests in ultra-short-duration investment grade bonds – those with a maximum maturity of 12 months, and a typical duration of less than 6 months.

Our custom, tailored approach opportunistically utilizes a thoughtful mix of Investment Grade Corporate debt, US Treasury and Agency securities, as well as taxable and tax-exempt Municipal bonds to enhance overall after-tax returns.

Large Cap Equity: Carret's Large Cap Equity Strategy seeks 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.

Mutual Fund Strategy:

Kansas Tax-Exempt: The Carret Kansas Tax-Exempt Bond Fund seeks to preserve capital while producing current income that is exempt from both Federal and Kansas state taxes. The Fund seeks to generate monthly income and principally invests in investment-grade bonds of intermediate maturity.

For more complete information on the Carret Kansas Tax Exempt Bond Fund, you can obtain a prospectus containing complete information for the Funds by calling 888.266.8787 or by downloading it from Carret's web site. You should consider the Fund's investment objectives, risks, charges, and expenses carefully before you invest or send money. Information about these and other important subjects is in the Funds' prospectus. The prospectus and, if available, the summary prospectus, should be read carefully before investing. Shares of the Carret Kansas Tax Exempt Bond Fund are distributed by ALPS Distributors, Inc., which is not affiliated with Carret Asset Management, LLC.

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