Carret Insights

The Queen is dead! Long live the King!

The Lord Chamberlain, at Balmoral Castle, September 8, 2022

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Firm AUM

$2.872 Billion

Even the most cynical amongst us must certainly be impressed by the rites, symbols and pageantry surrounding the death of a monarch and the ascension of the heir to the throne. The iconic proclamation, quoted above, has its roots in fifteenth century France, translated from *Le roi est mort, vive le roi!* which was first declared upon the accession to the French throne of Charles VII after the death of his father Charles VI in 1422. The phrase arose from the law of *le mort saisit le vif*, that the transfer of sovereignty occurs instantaneously upon the moment of death of the previous monarch. "The Queen is dead!" is the announcement of a monarch who has just died; "Long live The King!" refers to the heir who immediately succeeds to a throne upon the death of the preceding monarch.

At the time, French was the primary language of the nobility in England and the proclamation was quickly adopted. However, the English had been observing the same tradition for some 150 years going back to 1272, when Henry III died while his son, Edward I, was fighting in the Crusades. To avoid any chance of a war of succession erupting, the Royal Council proclaimed: "The throne shall never be empty; the country shall never be without a monarch." Thus, Edward was declared king immediately, and he reigned *in absentia* until news of his father's death reached him and he returned to England. Back then, Wars of Succession were a thing. Not so much anymore. Can you imagine if Prince Andrew took up arms against his brother? But I digress.

In the transition from *bull market to bear market*, there is a threshold that is crossed when the market is down 20%, where one might very well exclaim, “the bull is dead, long live the bear.” However, the transition from *bear market to bull market* is more fluid, more intangible, more easily misidentified: in a word, *enervating*. In historical terms, bear markets are not only finite, but are far less lengthy than bull markets. Yet the steady drum beat of down days tears at one’s confidence. Simply not looking at statements or turning off the nightly business report are not sufficient remedies. It is hard to see how we get out of this situation. Indeed, the publisher Horace Greeley once offered that “the illusion that times that *were* are better than those that *are* has probably pervaded all ages.” We are confident the inexorable growth in the market will be restored in time. We would like to take these pages to review the various sides of the “tug-of-war” that are at play here.

Key Market Levels	9.30.22	12.31.21	12.31.20
Fed Funds Rate	3.00% – 3.25%	0.00% – 0.25%	0.00% – 0.25%
3 Month U.S. T-Bill	3.23%	0.05%	0.08%
10 Yr U.S. Treasury Bond	3.80%	1.51%	0.92%
10 Yr AAA Municipal Bond	3.30%	1.03%	0.71%
10 Yr A Corporate Bond	5.59%	2.31%	1.62%
S&P 500	3,586	4,766	3,756
S&P 500 Dividend Yield	1.73%	1.20%	1.51%
S&P 500 Trailing 4 Quarter P/E	16.9	24.6	28.2

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

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We believe that the Federal Reserve made a tactical error in delaying rate hikes during the evident post-Covid recovery. 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 money, 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 recent 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 from an historical perspective are merely moving to a "neutral" position are being *perceived* as "slamming on the brakes."

We can identify the main protagonists in the daily struggle for market supremacy. There are those who think that the Fed will continue to aggressively raise rates until the economy collapses in recession. This camp is highly influenced by the historical experience of Paul Volcker's term as Fed chair. Every time Jerome Powell speaks, this camp hangs on every word about his being tough on inflation. We caution that this crowd has forgotten the third arrow in the Fed's quiver, *jawboning*. Perhaps Powell is saying, "don't even think about raising prices, or I will come and find you." Under any circumstance, Powell must feel somewhat behind the curve, and his language is going to be coarser than the "we believe inflation is transitory" patter of the recovery.

We have remarked that the *economy's strength is both the challenge and the opportunity* here. With the recent strong jobs report, "investors" seized on the likelihood of further rate increases killing the economy. Wait a minute, folks; The Fed's goal is to kill inflation, not the economy. It is possible that the underlying strength of the economy will allow the sought-after "soft-landing" to materialize.

The more optimistic wing of the bear market crowd hangs on every shred of evidence that the economy is slowing, and that inflation is relaxing its grip. The September PMI report, released October 3, showed such progress, if you will, and resulted in a 5.5% two-day rally in the S&P 500. What is driving this bullishness? The thought is that the Fed will see that inflation is slowing and therefore can back off on the tightening program. As much as we would like to see this, we do believe that it is not the most likely near-term outcome. What that two-day rally did show us was the tremendous amount of money that *wants to come back to work* in the market. The September 30 sell-off, was likely caused by "investors" wanting to show cash reserves at quarter-end. It is called window-dressing. We do not practice that sort of legerdemain. We caution against overanalyzing any one day's market activity. It is our goal to identify sustainable trends. But the increase in volatility is noteworthy.

When we speak of bear markets, we are referring to a change in P or the *price* of equities, either individually or as an index. There is another component, that is the change in e or the *earnings* of equities, either individually or as an index. We must bear in mind that *we invest in earnings*. To recap recent history, S&P earnings bottomed at $49.50 in 2008, and climbed to $162 in 2019, pre-pandemic. The economic shock of Covid dropped earnings to $138 in 2020. The combined monetary and fiscal stimulus allowed earnings to recover to $206 in 2021, and the estimates for 2022 started the year at $225 and are $222 as of this writing. In short, the S&P 500 earnings advanced 4.5 times from the low to today, while the S&P 500 index has advanced 5.4 times over the same period. Indeed, we saw some multiple expansion over the course of the bull market. We have given back some of that premium in the bear market to date. But earnings outlooks have not collapsed.

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The third quarter reporting period is upon us. October gets its bad reputation from the fact that this is when most companies offer their first glimpse on the next fiscal year. One can imagine that very few companies will announce optimistic projections at this time. There simply is no percentage in taking that sort of risk in the face of such visible and *vague uncertainty*. Besides, companies are generally rewarded more by earnings surprises over time than they are penalized by earnings disappointments. With the market already down, supposedly reflecting that pending bad news and uncertain outlook, one might argue that the price has already reflected the risk. But we have observed the salient flaw in that assumption. Several companies who have boldly pre-announced their outlooks, cut forward earnings estimates and generally painted a dismal portrait of the future, have been immediately punished with a further sell-off. All the bad news was clearly not in the stock. Right now, these companies are slashing costs, curtailing hiring and even beginning layoffs as they prepare for the uncertain future, or rather, prepare for the talked about headline uncertainties of recession.

We reviewed the pieces that we wrote just before the market turns in 2003 and 2009, both of which followed Federal Reserve induced bear markets and recessions. Upon reflection, the world was pretty dismal then, with terrorism, bank failures and high unemployment among the noisome headlines. Somehow, just dealing with inflation in a strong economy seems somewhat manageable. At the previous turns in the market, one could posit a theory about the *possibility of renewed economic growth*. As at those junctures, no one will announce, “Long live the bull!”

If we are looking for a sign that the market has indeed bottomed, one might argue that it will be when further bad news no longer impacts individual stock prices. That is, all the negatives are already known and impounded in the price. We have made the argument before that eventually repeated selling on the same news becomes an exercise in futility. 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. The market will focus on the *restoration of growth*, as it has throughout history. We take nothing for granted. As we have long argued, our asset allocation 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.

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

Credit Insights

The Federal Reserve has declared *war on inflation* and has continued its aggressive moves to slow the economy in order to accomplish its mission. Whereas in the 2015-2018 period, the Fed moved gradually to “normalize” rates in 25 bp increments, at this juncture the increases are coming in 75 bp stages and are rattling both equity and fixed income investors alike. During the quarter, the Fed raised rates twice. A further 75bp appears priced into the market for the November meeting. To be sure, December is a wild card at this point, but we should expect that the Fed will not be deterred from its path of *deliberate tightening*. As a result of the moves in the quarter, the Fed Funds rate rose from a range of 1.50% -1.75% to a new level of 3.00% - 3.25%. Interestingly, the 4.50% level that might be reached after two more rounds is still below the high of 5.5% in 2007 and the high of 6.5% in 2000. Both of those dates and data points are significant because they marked the onsets of the most recent Fed-induced recessions. We do not believe that the Fed intends to cause a *recession* in its quest to curb inflation, but collateral damage is always a risk. The Fed works only with blunt instruments, namely, changes in *rates*, changes in the *monetary base* and old-fashioned *jawboning* in performing such delicate operations as it is currently undertaking. The five-year Treasury rose from 3.00% to 4.04% over the course of the quarter, reflecting the rise in short term rates, adjusted for some skepticism about the likely outcome of the Fed’s program. We believe that the Federal Reserve will, in time, have cause to relax its stance, but it will likely not be on a timetable that suits *impatient investors*. We are taking advantage of the upward move in rates by investing maturities and fresh cash in higher yielding securities. We would like to share some more detailed thoughts on the current environment in our notes and commentary below.

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Data as of September 30, 2022	Taxable Fixed Income	Municipal Fixed Income	Opportunity Fixed Income	Enhanced Cash
Maturity	3.4	6.8	3.3	0.39
Duration / Dur to Worst	3.1	5.5 / 4.3	3.0	0.38
YTM / YTW	5.33%	3.84% / 3.58%	7.07%	4.15%
Taxable Equiv YTM/YTW *		7.43% / 6.92%		
Coupon	3.58%	4.56%	5.49%	2.93%
Credit Rating	BBB+	AA	BB	A

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

Sector Allocations:				
U.S. Treasury	3%			14%
Government Agency	3%			7%
Corporate - Inv Grade	87%	4%	28%	66%
Corporate - High Yield			62%	
Preferreds	5%	1%	8%	
Convertible				
Municipal		94%		10%
Cash	2%	1%	2%	3%

Taxable Fixed Income Strategy:

- Investment Grade (IG) corporate bond yields climbed during the 3rd Q of 2022 due to rising U.S. Treasury (UST) rates. During the 3rd Q of 2022, 5 Yr UST yields increased 104 bp, increasing from 3.00% to 4.04% and have now increased 278 bp YTD.
- IG spreads, as measured by the 3-5 Yr A rated FactSet index widened by 3 bp during the Q, increasing from 128 bp to 131 bp and have now increased 90 bp YTD.
- IG spreads, as measured by the 3-5 Yr BBB rated FactSet index tightened by 8 bp during the Q, decreasing from 196 bp to 188 bp and have now increased 109 bp YTD.
- The Taxable Fixed Income Strategy outperformed the Barclays Intermediate Gov't Credit Index during the Q with a gross return of -2.5% versus the index's return of -3.1%. For the YTD period, the Strategy has outperformed the Index, with a gross return of -9.3% versus the index's return of -9.6%.
- The Strategy's duration shortened from 3.3 to 3.1 Yrs Q / Q, as the inversion of the UST curve makes extending duration less compelling from a risk/reward perspective.
- Average portfolio quality held constant Q / Q at a BBB+.
- The Strategy benefited from a shorter duration relative to the Index as UST yields rose across the curve. Steady corporate bond spreads neither harmed nor benefitted relative performance during the Q. The overweight allocation to corporate bonds provides incremental cash flow which has aided relative performance throughout the year.
- We remain comfortable owning corporate credits – S&P 500 companies have taken advantage of record low rates over the past decade by extending debt maturities at low interest costs. The strengthened balance sheets will allow corporate America to avoid financing turbulence in the short to intermediate term.
- As high producer price inflation persists, corporate earnings could start to feel the brunt of rising costs. Companies will be forced to pass higher costs on to the end consumer in the form of higher prices. Long term IG bond investors can remain confident in corporate earnings power allowing interest and maturity payments to continue.
- As UST rates have climbed and corporate bond spreads have steadied, we have looked to slowly increase our exposure to UST bonds and Government Agency positions.

- The Strategy's allocation to preferred securities increases the total yield and captures incremental cash flows (positive reinvestment opportunities in a rising rate environment).
- With inflation elevated and an inverted UST yield curve, the Strategy's 3.1 Yr duration has enabled the reinvestment of maturities and calls, as well as coupon cash flows, into a rising interest rate environment.

Municipal Fixed Income Strategy:

- Representative AAA rated 5 Yr Municipal Bond yields continued to rise during the 3rd Q of 2022. The index's YTM began the Q at 2.22%, hit a quarterly low of 1.79% on August 2nd, and closed the Q at 3.13%. The net quarterly change was notable at 91 bp. During this same period, 5 Yr UST yields rose by 104 bp.
- In a reversal of trend, the 2Yr-to-10Yr municipal curve flattened significantly during the Q from a high of 82 bp on July 1st to a low of just 19 bp at Q end. The 3rd Q ended with the flattest yield curve of 2022. Shorter-dated bond yields rose more than the longer end of the curve in the Q driving the flatness.
- The 5 Yr Muni-to-Tsy Ratio (MOT), a key indicator of relative value, normalized during the 3rd Q after spiking in the 2nd Q. The quarterly change was only 1 bp. However, the ratio declined intra-quarter as municipal yields rose more than USTs during July and August. The 5 Year MOT ratio closed the Q at 77% indicating fair/good value in municipal bonds.
- Our Municipal Fixed Income Strategy continues to be impacted by the broad rise in interest rates. July monthly returns were positive as rates fell on optimism of easing inflation. August and September returns turned negative as the markets reacted to growing uncertainty on the path of the U.S. economy. Municipal market fundamentals remain quite positive against the backdrop of marked-to-market performance. The Municipal Strategy gross return for the 3rd Q was -2.2% while the Bloomberg Barclays 5 Yr Muni Index returned -2.7%. 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 inched higher from 4.1 Yrs to 4.3 Yrs during the Q. By comparison, the Bloomberg Barclays 5 Yr Muni Index duration extended slightly from 3.7 Yrs to 3.8 Yrs.
- Our average portfolio quality increased Q / Q from AA- to AA.
- Municipal credit health remains strong despite recent market volatility. Rainy day balances and revenue surpluses continue to be elevated as state and local economies continue to benefit from the reasonably heathy fiscal backdrop. We expect fixed income market volatility to continue to impact municipals. We are finding value in both short-dated bonds (for liquidity and reinvestment opportunities) and longer-dated municipals with high coupons (for incremental income). We believe that actively managed, high-quality, intermediate-duration municipal bond portfolios will prove resilient in the face of potential economic softness ahead. We continue to be cautiously optimistic in our view of the municipal marketplace and see municipal bonds as an opportunity on both an absolute and tax-equivalent basis.
- The surge in yields amid high volatility prompted investors to resume pulling assets from municipal bond mutual funds. Following a brief period of inflows in the early part of August, fund flows reverted to outflows over the past five weeks. On a year-to-date basis, the Investment Company Institute reported net cash outflows from muni funds totaling roughly $91 billion.
- Supply was light in the 3rd Q, with just $77 billion pricing. September in particular showed a 43% drop in issuance vs September of 2021. For the Q, overall supply was down 30% from the prior year, with taxable muni supply coming to nearly a standstill as just $11 billion was issued (a 67% decline from Q3 2021). Overall, new issue supply stands at $289 billion down 14% YTD.

Opportunity Fixed Income Strategy:

- During the 3rd Q of 2022, 5 Yr UST yields increased 104 bp, increasing from 3.00% to 4.04% as inflation challenges intensified and the Fed's hawkishness increased. The key drivers of inflation remain global supply chain struggles as China's no-covid policy continues, commodity inflation from the on-going Russian/Ukraine

war, and domestic wage gains remaining strong. For the YTD period, the 5 Yr UST rate has now increased 278 bp from a base of 1.26%.

- High Yield (HY) rates (as measured by the iBoxx HY Index ETF – HYG) increased from 8.87% on June 30th to 9.25% on September 30th and have now increased 489 bp YTD.
- HY spreads (as measured by HYG) tightened during the Q, decreasing from 585 on June 30th to 521 on September 30th – a tightening move of 64 bp. For the YTD period, HY spreads have widened by 211 bp.
- IG spreads, as measured by the 3-5 Yr BBB rated FactSet index tightened by 8 bp during the Q, decreasing from 196 bp to 188 bp and have now increased 109 bp YTD.
- The Strategy outperformed the Barclays Intermediate Gov't Credit Index during the 3rd Q, with a positive gross return of 0.5% versus the index's negative return of -3.1%. For the YTD period, the Strategy has outperformed the index, with a gross return of -5.8% versus the index's negative return of -9.6%.
- The Strategy's duration increased during the Q, from 1.9 Yrs to 3.0 Yrs Q / Q. Given our ultra-short duration going into the Fed's rate increases, we opportunistically extended throughout the Q. The strategy's mandated duration range is from 2 to 10 years. Accordingly, we remain short duration focused as we look for opportunities to extend maturities into a rising rate environment.
- Average portfolio quality held constant Q / Q at a BB; additionally, IG exposure increased 2% from 28% to 30%.
- As we anticipated, corporate action activity in the form of tenders and calls slowed materially during the 3rd Q as increasing rates restricted refinancing opportunities.
- Reinvestment opportunities are focused on shorter / intermediate duration high coupon bonds, as higher coupon bonds accelerate current cash flow and reduce duration – a positive contributor to relative performance in a rising rate environment.
- HY and IG (BBB) markets remained volatile on a price basis. While HY markets are correlated (short-term) with equity markets, we witnessed a disconnect in the 3rd Q. The S&P 500 declined by -4.9% during the Q – one would have expected spreads to widen during a declining equity market; however, both IG (BBB) and HY spreads tightened, indicating investors' credit concerns improved during the Q. The increase in yields was driven by the 1.04% increase in the 5 Yr UST rate, not credit concerns.
- We remain defensively positioned and have ample flexibility to add value as credit and interest rate opportunities arise. On average, 22%+ of our bonds mature in the coming 12 months.

Enhanced Cash Strategy:

- Ultra-short-term interest rates moved materially higher during the 3rd Q, as the yield on the 6 Mo UST increased from 2.42% to 3.79%. YTD, the 6 Mo UST has increased 361 bp.
- IG spreads, as measured by the ICE BofA 0-1 Year A-AAA U.S. Corp Index, widened by 2 bp during the 3rd Q, increasing from 71 bp to 73 bp. YTD, IG spreads have widened by 37 bp.
- Average portfolio quality held constant Q / Q at an A rating.
- Average duration was unchanged Q / Q at 0.38 Yrs.
- The Enhanced Cash Strategy's gross return was positive during the Q, returning 0.20% and outperforming the ICE BofA 0-1 yr U.S. Tsy Index, which was up 0.16%. YTD the Strategy gross return is a positive 0.09% compared a negative return of -0.16% for the benchmark.
- As anticipated, the Fed has raised short-term interest rates aggressively thus far in 2022 and expects to maintain its hawkish stance well into the Fall. We expect that these higher short-term rates will continue to offer more impactful return opportunities for the Enhanced Cash Strategy.
- Strategy YTM has risen dramatically YTD – from 0.68% at the end of December 2021 to a 4.15% at Q end. Comparatively, Money Market fund yields have languished, currently averaging a mere 0.22% YTM. For that reason, we believe an actively managed, custom Enhanced Cash portfolio will provide a much more impactful return over time.

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.

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