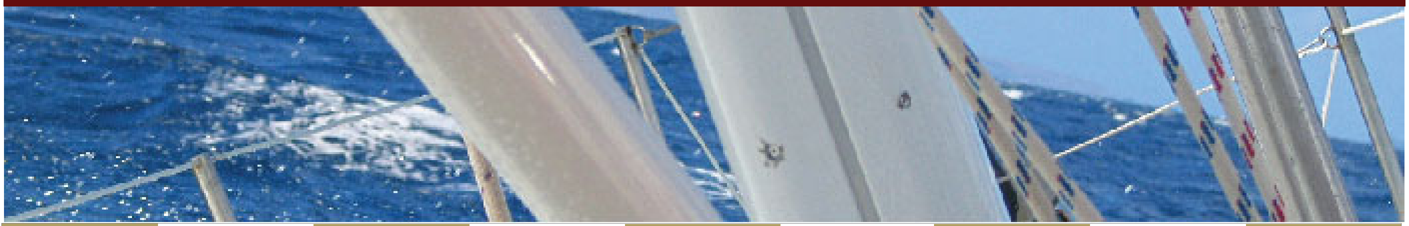
Carret Equity Insights



And I don't see why you can't just teach us history instead of always harping on the past.

Galinda to Dr. Dillamond in Wicked, 2003

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Firm AUM

$3.116 Billion

Living in NYC for some time, I have been to Broadway openings and Broadway revivals. Yet it was only a week ago that I attended my first revival of a show where I had also been at the opening. What dramatic work was this you might ask? Those who know me will not be surprised: it is Spamalot, now appearing at the St. James Theater, fresh from its premiere at the Kennedy Center in DC. While the original featured veteran actors including David Hyde Pierce, Tim Curry and Hank Azaria to name a few, the revival featured a cast of talented but relative newcomers, at least to me. The joy of the original was in watching these notable stars prancing around in the original Eric Idle production "lovingly ripped off from Monty Python and the Holy Grail," indeed a source where I knew every line; the joy in the revival was in seeing a cast which truly seemed to enjoy being part of an ensemble. In the revival, the jokes were broadened, the musical riffs were updated to include Wicked as well as Company, and there appeared to be more improvisation, topical references and fun in this production. They even managed to skewer George Santos. I loved it. But I saw the original three times, so I clearly loved it too. It was the *same* show; it was a *different* show. In the keeping of my habitually tortured analogies, at the end of 2021, the S&P 500 closed just below an all-time high at 4766, which we will take as the *Broadway opening*, and closed out 2023 at 4770, which we will take as the *Broadway revival*. It is the *same* market price; yet it is fundamentally a *different* market price.

Key Market Levels	12.31.23	12.31.22	12.31.21
S&P 500	4,770	3,840	4,766
Dow Jones Industrial Average	37,690	33,147	36,338
NASDAQ	15,011	10,466	15,645
S&P 500 Dividend Yield	1.42%	1.65%	1.20%
S&P 500 Trailing 4 Quarter P/E	21.9	17.6	23.1

Source: FactSet

We should review some of the similarities between the two dates, starting with the valuation of the market. At the 2021 close, trailing earnings suggested a P/E of 23. At the 2023 close, trailing earnings suggest a P/E of 22. This is neither a *bargain* nor a *bubble* price. Next, we note that the earnings of the S&P 500 have been essentially unchanged for two years. In 2022, the S&P 500 earned $218, having been revised downwards from an initial target of $225. The S&P 500 earned $218 in 2023, having been revised downwards from an initial target of $229. The last time we observed this development of flat S&P 500 earnings, we famously quipped "no earnings growth, no market growth," or something to that effect. The fact that the S&P price ended 2021 and 2023 at the same level can be viewed quite simply in light of the stagnant earnings over the period. The third similarity between the two periods is the impression that the "market" and "investors" believe that the Fed has their back, and that nothing can go wrong. This last point deserves to be greeted with some skepticism, and we will spend some time offering our thoughts on this perception.

Why are we skeptical? Because of perhaps the most important difference between today and two years ago. The Federal Reserve has spent most of the past two years using the tools at its disposal to tame inflation by slowing the economy. The Fed has raised short term interest rates from 0%-0.25% to 5.25%-5.50% today, through a series of eleven rate hikes. At the same time, the Fed has embarked on a reduction in the monetary base, which we refer to as *quantitative tightening*, and has removed some $1 trillion dollars of liquidity from the financial system. You will recall that during the pandemic crisis, the Fed essentially doubled its balance sheet through a process known as *quantitative easing*. This allowed the Fed to provide liquidity to the financial system, which in essence supported the economy and the market through the prolonged period of uncertainty. The third tool at the Fed's disposal is *jawboning,* or talking the stock and bond markets into a position that makes the Fed's work a self-fulfilling prophecy. The Fed has stressed that their objective is to bring inflation down to its target 2% rate, and not to instigate a recession. However, in the process of slowing inflation, we can expect that there will be some collateral damage. The terms "soft landing" and "hard landing" are bandied about in the *lingua franca* of 24-hour cable news. A *soft landing* implies *no recession*, a *hard landing* suggests *recession*. The consensus today is for a soft landing. But the market seems to expect actions from the Fed that would be consistent with a hard landing, specifically immediate rate cuts. We will review this contradiction presently. Our current focus is on earnings. Consensus estimates for 2024 stand at $243 for the S&P 500. We believe that those numbers are too high, and that we will likely be seeing downward revisions, perhaps even towards that $218 level as the year progresses. The principal reason behind this belief is that soft landing or hard, the Fed's actions have slowed the economy, which in our world view means slowed earnings growth.

The inflation print of 3.4% released on January 11 suggests that the Fed has begun to tame inflation, or perhaps more aptly, inflation *expectations*. But we note that this is still above the Fed's target of 2.0%. We wonder if the Fed's initial reaction to pandemic-induced inflation as being "transitory" may have actually been correct; it is merely that "transitory" has no specific time frame attached to it. But the Fed took a page from the inflation playbook and used the visible interest rate hikes and less visible liquidity drawdown to slow inflation by slowing the economy. Based on recent GDP growth estimates, it would appear that the Fed may actually be close to achieving the soft landing and possibly close to declaring "mission accomplished." As we have mentioned before, the only other time in postwar history that the Fed pulled this off was 1994. After that success, the Fed essentially left rates unchanged until 1998, when the Russian Debt Default and Long-Term Capital debacle threatened the financial system and forced the Fed to cut rates and to dramatically increase the monetary base. In 1994, there was no announcement about future Fed actions, there was merely what we might call "the cessation of hostilities" on the part of the Fed. In today's *revival*, the market rallied over 11% in the fourth quarter, *despite negative earnings revisions* in record amounts, based largely on one word: *pivot*.

Part of our mission is to be skeptical when something in the investment *zeitgeist* seems to conflict with our experience, knowledge of history and our collective wisdom. If the Fed has indeed engineered a soft landing, defined as *tamed inflation, no recession*, why would the Fed have any need to cut rates? In our view of the past, so aptly expressed in the opening quote, the Fed generally only cuts rates in times of economic distress, be it recession, or some shock to the system. There is an academic economic theory in which the Fed eventually moves towards a "neutral" rate, but no one knows exactly *what* that rate is or *when* the Fed should get there.

You will hear repeatedly that the Fed has *signaled* rate cuts in the coming months. *Actually, they have not*. What the Fed did was share the results of something called the "dot plot," which is a compilation of the individual Fed members' expectations about where interest rates might be at various points in time. We would prefer that you think of this analysis as something akin to a Las Vegas betting sheet, or an office Super Bowl pool rather than a "signal" from the Fed about their future actions. The historical accuracy of the dot plot projections has been *dismal*. While we disagree with the premise of the dot plot being a useful data point, we will acknowledge that it may very well be used to divine the mood of the Fed. One can say that the Fed, at this juncture, is leaning towards a *less restrictive/more accommodative stance* than it held six months ago. But that does not immediately translate to rate cuts. It is perhaps more appropriately assigned to the jawboning toolbox, where the Fed has essentially nudged long rates down by *lowering expectations of further tightening*. One might argue that this is a key factor in the Fed's ability to pull off the expected soft landing. And possibly, questions about the Fed's next actions may have been moved from the unstable concept of *vague uncertainty* towards the more palatable *known certainty,* a market factor about which we have written at length. In short, the question shifts from how much longer the Fed will continue to hike rates, to when will the Fed begin to cut rates. These are powerful emotional forces behind market volatility and worthy of consideration.

Recall that in the 1994 soft landing, the "pause" lasted some four years. The stock market responded very well to this *stable rate environment*. For the Fed to move to immediately cut rates suggests that something is amiss with the consensus soft landing scenario. It is possible that the Fed's actions may have overshot their target, and it is only time and the lag in reporting that keeps us from seeing this. Certainly, if you follow Purchasing Managers' Index data for Manufacturing and for Services, the economy continues to slow dramatically. We referred earlier to our concern about the impact on corporate earnings of a slowing economy. We have seen tech giants engage in massive layoffs; we have seen corporate acquisitions that made sense at essentially a zero cost of funds get unwound at a 5% borrowing cost. We understand that upheavals in the corporate real estate market may have some lenders and investors scrambling towards an unpleasant exit. Any one of these factors, among others, might cause the Fed to be more accommodative in its stance, but we do not see how that occurs without a tendency towards a *hard landing,* and a serious revision in the *forward earnings outlook*.

To be honest, our *Broadway revival* opening is a bit strained. The market in 2023 merely recovered what it lost in 2022. That recovery took place in the face of *restrictive Fed policy* and *declining earnings estimates*, which is truly remarkable. We are not sure if one would have bet on that a year ago. It stands to prove the *resiliency* of the stock market, the value of Phil Carret's dictum of *patience*, and our belief that one should not adjust portfolios or *risk tolerances* based on the recent actions of any asset class.

Laurence R. Golding, Managing Director, January 16, 2024

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