CARRET
Asset Management

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Carret Equity Insight

My center is giving way, my right is in retreat; situation excellent. I shall attack.

General Ferdinand Foch, 1914

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Firm Assets Under Management

$3.02 Billion

A commentator on CNBC recently used the term "bottoming process" to characterize the market's repeated attempts to rally. I thought that the phrase was redolent of a George Carlin bit on air travel. "*Something else we have in common… flying on the airlines and listening to the airlines' announcements and trying to pretend to ourselves that the language they're using is really English. Doesn't seem like it to me…Whole thing starts when you get to the gate… first announcement: 'We would like to begin the boarding process…' Extra word, 'process', not necessary, 'boarding' is enough; 'we'd like to begin the boarding…' simple, tells the story. People add extra words when they want things to sound more important than they really are. 'Boarding process' sounds important… it isn't. It's just a bunch of people getting on an airplane! People like to sound important; weathermen on television talk about 'shower activity'… sounds more important than 'showers.' I even heard one guy on CNN talk about 'a rain event.' Swear to God, he said 'Louisiana is expecting a rain event.' I thought, 'I hope I can get tickets to that!'… 'Emergency situation…' News people like to say, 'Police have responded to an emergency situation.' No, they haven't, they've responded to an emergency. We know it's a situation… everything is a situation!*" What, then, is the "situation" in which we find ourselves? What do we know about likely market "events?" Just why did that panelist use the term bottoming "process?"

The first *situation* to consider is where the market action of 2022 has left us. We habitually refer to "corrections" as market declines of 10-20%, and "bear markets" as market declines of 20% or more. The S&P 500, on a total return basis, declined 18.1% for the year. That sounds rather optimistically like a correction. Indeed, my working "quote" for this piece was "Once more unto the breach, dear friends, once more" from Henry V. There is so much money that desperately wants to get back into equities; evidenced by the oversized rallies that occur on what appears to be "good news" either from the Fed itself or from statistics that are likely to influence the Fed's behavior. *Corrections, as we know them, tend to be short lived and unanticipated, both in their onset and their resolution.* Unfortunately, this description does not fit the current market situation.

We have expressed skepticism about the prevalent bullish scenario wherein the Fed sees *inflation slowing* and dramatically *curtails the tightening* effort, both through rate hikes and quantitative measures. There is a fairy tale element to this belief that suggests that the Fed will begin to lower interest rates immediately. We think that the Fed is committed to a course of action to reduce the rate of inflation back to some acceptable level close to its target 2%. A "slowing" in the rate of inflation from 9.1% to 6.5% is a step in the right direction, but far away from the mark. The adage "don't fight the Fed" seems to be dominant here. If one is looking for nuance, one might interpret recent Fed actions as "slower" but not "lower." But we believe the market *situation* suggests that the yearning for an "optimistic" scenario is likely to lead to disappointment in the near term.

That being said, we have often observed that the market follows earnings over time. Indeed, earnings have not collapsed, and estimates for 2023 are still expected to be up for the S&P 500 index. So, perhaps a more plausible bullish scenario may be that prices will have come down more than earnings prospects, creating a *valuation opportunity*. The opposite, of course, is when the earnings outlook worsens ahead of the stock price, creating *valuation stress* and suggesting a selling opportunity. The economy is showing some resilience as evidenced by retail sales and employment statistics. We note that the market bounced between down 20% and down 10% for most of the past year. Forecast earnings growth has likely forestalled a 2008 type market decline so far. Whereas in 2008, we had high unemployment and bank failures among the noisome challenges to contend with, this time we just have a strong economy with some inflation to be reckoned with. Seems like it should be solvable in time. But the second market *situation* to be considered is the absolute dedication of the Fed to its mission. And it appears that "investors" keep forgetting that the Fed is determined to bring inflation under control. Acknowledging that the Fed was behind the curve, having initially viewed inflation as transitory, it is now determined to use the tools at its disposal to bring inflation to heel.

You may recall our discussion about Newtonian physics from this time four years ago. It was Isaac Newton who famously remarked, "I can calculate the motion of heavenly bodies, but not the madness of people." Despite his own skepticism, Newton does offer us some insight here. Newton's First Law of Motion states that *an object in motion continues in motion with the same speed and in the same direction unless acted upon by an unbalanced force*. The Federal Reserve generally provides this unbalanced force to the economy. Congress can act in concert, theoretically. Newton's Second Law of Motion states that *the greater the mass of the object, the greater the force needed to accelerate or decelerate the object.* In this case, the $21 trillion economy will require a considerable force to change its direction. Newton's Third Law of Motion states that *for every action there is an equal and opposite reaction.* This is the premise upon which all Federal Reserve actions are predicated. The possible Fed actions include the deployment of the classic tools in its arsenal: changes in the monetary base, changes in the short-term interest rate, and public pronouncements or jawboning. In essence, in early 2022, the Fed began to apply its own version of Newton's Second and Third Law on the United States economy. The Fed began a dramatic series of interest rate hikes, and even more drastically, has curtailed and reversed the monetary accommodation that had been in place for some time. The only real question is how far and how fast the Fed will eventually have to go to slow economic growth in order to tame inflation.

We recognize that while we like to speak of engineered *soft landings*, the Fed at best wields a collection of blunt instruments. While the media tends to focus on the interest rate hikes and the official accompanying pronouncements, we are acutely aware of the potential damage to the economy from the absolute reduction in liquidity from quantitative tightening, the equal and opposite force to the quantitative easing that was the hallmark of most of the past decade and a half. Simply put, we believe that a certain amount of monetary accommodation is necessary to support growth. To stamp out inflation, the Fed risks fomenting a recession.

Truly, the debate between "bullish" and "bearish" investors is over the likelihood of the Fed *accidentally or intentionally* bringing on such a downturn. This is of concern to us because those S&P 500 earnings estimates today do not reflect the impact on corporate earnings from a full-blown recession. At worst, current estimates reflect the proverbial soft landing, in which the Fed achieves its goal without breaking anything.

In a sense, the swift collapse of speculative investments reflects the reality that Fed accommodation can artificially inflate certain asset prices, and the removal of that accommodation can bring swift reckoning before the impact is felt across the broad economy. As one of my colleagues put it, in 2022, the junk stuff got clocked, the high valuation growth stocks underperformed, and the boring stuff outperformed. At this time, we cannot determine what the impact of a potential recession will be on 2023 corporate earnings. It is extremely likely that forecast earnings growth will not materialize. We can look back to the 2015 period to determine the impact of flattening earnings on the market. No earnings growth; no market growth. Unfortunately, 2008 provides the example of what might occur in a collapsing earnings environment. Therefore, the first important market *event* will be the commentary surrounding the reporting of FY22 earnings starting in January. Will corporations bend to the nature of the *vague uncertainty* and paint dismal pictures of the near future, at least partially in the hope of eventually delivering earnings "surprises?" Already, the ISM PMI report is showing signs of the type of *contagion of uncertainty* that does not bode well for near term earnings.

The next series of market *events* that will be of importance will be the Fed's successive rate moves, and the commentary that is issued alongside. Again, there is a very visible bloc that wants to read good news into every pronouncement. We have already disclosed our skepticism about the rosy scenario in which the Fed declares *mission accomplished* anytime soon. We therefore would argue that volatility, long absent from the picture, is back and here to stay. When the market starts to focus on 2024, we might expect a more consistent upbeat tone to things. Despite our current skepticism, we do know that the market will likely begin to move before the Fed announces, "Our work here is done." The term *bottoming process* allows for the fact that we cannot tell when the market will decidedly focus on the restoration of growth. It is more productive to focus on *time in* the market, rather than on *timing* the market. We therefore spend a lot of time counseling patience and argue for realistic assessments of true risk profiles. And of note, the old **TINA** argument for stocks, *There Is No Alternative*, has been challenged by the more attractive yields now available in the bond market. This can truly ease the burden of perseverance. General Foch saw a dismal situation ahead and yet decided to remain on the battlefield. Phil Carret offers that patience can produce uncommon profits. They are in fact on the same page. And we heartily concur.

Laurence R. Golding, Managing Director, January 12, 2023

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