CARRET
Asset Management

October 2023

Carret Equity Insight

We are navigating by the stars, under cloudy skies.

Federal Reserve Chair Jerome Powell, August 25, 2023

Portfolio Managers

Wayne S. Reisner
212.207.2345
wreisner@carret.com

Elizabeth A. Newberry, CFA
212.207.2346
enewberry@carret.com

In the early morning of May 20, 1927, Charles Lindbergh took off from Roosevelt Field on Long Island. His destination was Le Bourget Field outside of Paris, some 3,610 miles from his starting point. Twenty-seven hours later, Lindbergh saw "porpoises and fishing boats," a sign he had reached the other side of the Atlantic. He circled and flew closely, but no fishermen appeared on the boat decks, although he did see a face peering back from a porthole. Ireland was in fact the first European land that Lindbergh encountered; he veered to get a better look and consulted his charts. The *Spirit of St. Louis* was several hours ahead of schedule and less than three miles off course. Navigating by dead reckoning alone, as he was not proficient at using the sun and stars as his guide, Lindbergh had flown almost precisely to the coastal point he had marked on his chart.

We have written on several occasions about the vague terms "soft landing" and "hard landing." I have friends who pilot their own aircraft and friends who flew in the military in their younger days. There is a saying that *any landing that you can walk away from is a good landing*. Perhaps we should stop and consider how the Fed might be managing the final approach to whatever landing we are *en route* to making. Because the Fed does not have perfect information about inflation, and it can be argued that the statistical measures of inflation are in and of themselves suspect, and moreover, whatever data we do have is not real time, the *recent two pauses* were in fact a brilliant move on the part of the Fed. Like Lindy, they looked out the *window* to see how close they were to their *destination.* It is not a bad strategy when you are dead reckoning. In fact, such sightings are an integral part of the process. Fed Chairman Powell's recent words at Jackson Hole, quoted above, show the difficulties in navigation that one might encounter on an extended voyage to quell inflation. Unlike Lindy, who arrived at his destination with fanfare and accolades, we may not know when the Fed has completed its mission, as there is nothing in their charter that requires them to announce, "mission accomplished."

Firm Assets Under Management

$2.970 Billion

We remain concerned about a vocal segment of the investing population that expects the Fed to begin to cut rates as soon as the tightening is done. These people are clamoring for a so-called "pivot," and we have maintained for some time that this is an unlikely scenario, unless the Fed does in fact precipitate a recession by its continued restrictive policy. And if the Fed indeed causes a recession, we will have to contend with the impact on earnings and consumer confidence that will ensue before we can truly begin the next bull market celebration. In the trading session immediately after the Fed completes its periodic announcements, we observe the palpable disappointment in this wing of the party when the Fed insists on maintaining its stated course; quite frankly, after a year and a half of Fed restrictive policy, we are truly astounded that this viewpoint even holds any currency. I hate to be labeled a "scold," but for sanity's sake, please stop viewing "pivot" as an investment strategy, people.

The morning of the September 20th rate announcement I walked into Jack's office and declared, "The Fed is going to pause, but the comments will be hawkish. What would you do with that certainty?" Absolutely nothing, we agreed, as we have been paying heed to the Fed's message since before it began this cycle of tightening. We believe that the Fed still has a bit further to go before it is done with the cycle, and future *truculence* on the part of investors which we would read as *turbulence* might reasonably be expected. Simply put, *uncertainty* about the outcome of the Fed's eventual touchdown will lead to continued *volatility.* But as we have said before, volatility leads to *opportunity*.

Our research reveals that the only time in the postwar era that we have ever experienced a soft landing, defined as a tightening which does not lead to a recession, was 1994. The Fed subsequently held rates steady after a dramatic 300 basis point rise over twelve months. There was no *pivot*, there was no *announcement*, but rather, the *cessation of hostilities*, as we have termed it, led to a benign environment for investing as a bull market followed that lasted until the Fed cut rates during 1998 in response to the Russian Debt default and the Long-Term Capital implosion. The backdrop for investing in that period featured reasonable valuation and robust earnings growth. We need to examine whether those conditions do present themselves today.

We have noted that the *market follows earnings*, sometimes a bit *ahead,* sometimes with a *lag.* The impact of a *recession* is felt in the stock market principally through its effect on *corporate earnings*. Consider the 2008 recession with its 40% drop in earnings or even the 2020 covid related version with its 15% decline and reflect on how dramatically the markets reacted to those deteriorations in earnings. Although we see that both the economy and the stock market rebounded handsomely from those nadirs, we must observe that a large contributor to those recoveries was the Fed's aggressive monetary policy in response to the economic crisis at hand. We have noted that no recession has ever occurred without the purposive or accidental actions of the Federal Reserve or the Congress, and we have further repeated Paul Samuelson's famous quip that "the market has anticipated nine out of the past five recessions." And we have written over the past year that the Fed's goal is to bring inflation in line, not to cause a recession. These reiterations having been stated, we view as unlikely a scenario where the Fed ceases rate hikes and then immediately begins to cut rates. Again, we observe a palpable sigh of disappointment every time evidence to this effect crosses the breathless 24/7 commentary. If there is truly a "soft landing," we are likely to see a scenario akin to 1994, where rates just stay in this range for some time. Where does this confidence come from? It stems from a cursory observation that the interest rate environment for most of the past fifteen years has been driven by *emergency* and not *normal* conditions. If we maintain an economy that manages modest growth, and provides moderate corporate earnings growth, and attractive bond yields, we are in fact returning to something akin to the period 1980-2000. It is not a bad environment for balanced investors, to be sure.

Carret Equity Insight

Let's talk about bond yields for a moment. There is a simple way to calculate the relative value of stocks vs. bonds, and that is by comparing the earnings yield of the stock market, essentially the inverse of the P/E multiple, with the bond yield, for which we normally use the ten-year at around 4.57%. At this point, the earnings yield of the S&P 500 is around 5.1%. This is about as close an observation as we have seen in some twenty years. It does confirm the acronym TARA, which we introduced in our last piece, that *there are real alternatives* to stocks at this time.

This leads naturally to a discussion of earnings growth. You may recall the period surrounding 2015 where S&P 500 earnings essentially were flat, and the market followed suit for most of that time. 2023 estimates have been coming down since the first quarter, and whatever growth is projected is back ended into the fourth quarter, and into 2024, which is always a safe bet for a macro strategist. October reports generally bring a realistic assessment of what lies ahead. A flattish earnings scenario for 2023/2022 and possibly 2024/2023 lends some caution to our approach to equities, and where suitable, suggests some commitment to bonds.

Now, in fact, we do not buy the market *per se* for our clients, but rather a highly curated group of individual stocks where we have confidence in the underlying long-term fundamentals and outlook. These stocks may become undervalued or overvalued at any time along the way. We believe that there are always stocks to buy and hold, despite the noise and volatility we may be experiencing on any given day.

Speaking of volatility, we have already noted the contribution to uncertainty of the Fed's endgame, but factors such as the prospect of a government shutdown, which will reappear as a result of the continuing resolution, the impasse of the Congressional circus, auto strikes, the restart of student loan payments, and continued inflationary pressures, all find their way into falling *consumer confidence* numbers. At some point the market will look through the current miasma, but with the market down a meaningful percentage from the recent July high, it feels logical to assume that some sort of c*orrection* is in place. As we have noted often, corrections generally start as profit-taking, and only subsequently does the punditry assign a cause to the market selloff.

Lindbergh found his destination via excellent navigation and excellent luck. Flying across the Atlantic from Newfoundland to Ireland without sighting an intermediate waypoint is quite a feat of dead reckoning. Fortunately, our Federal Reserve is not flying blind, but as we have commented repeatedly, the waypoints are often backward looking. What we are calling for are financial markets that understand the complexity of the landing the Fed is attempting to accomplish, while being realistic about what comes next after we reach the taxi way. As always, careful attention to asset allocation, risk tolerance and realistic assessment of risk are key to navigating a volatile market. As Phil Carret himself took off in, flew and landed Sopwith Camels in combat during the Great War, I am tempted to end with his usual admonition, but instead shall shorten it to *Patience.*

Laurence R. Golding, Managing Director, October 9, 2023

Important Disclosure Information

Past performance may not be indicative of future results. Different types of investments involve varying degrees of risk. Therefore, it should not be assumed that future performance of any specific investment or investment strategy (including the investments and/or investment strategies recommended and/or undertaken by Carret Asset Management, LLC ("Carret"), or any non-investment related services, will be profitable, equal any historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. Carret is neither a law firm nor accounting firm, and no portion of its services should be construed as legal or accounting advice. Moreover, you should not assume that any discussion or information contained in this document serves as the receipt of, or as a substitute for, personalized investment advice from Carret. Please remember that it remains your responsibility to advise Carret, in writing, if there are any changes in your personal/financial situation or investment objectives for the purpose of reviewing/evaluating/revising our previous recommendations and/or services, or if you would like to impose, add, or to modify any reasonable restrictions to our investment advisory services. A copy of our current written disclosure Brochure discussing our advisory services and fees is available upon request. The scope of the services to be provided depends upon the needs of the client and the terms of the engagement.

The referenced performance results reflect the reinvestment of dividends and other account earnings and are gross of applicable account transaction fees (unless indicated) and Carret Asset Management (CAM)'s investment management fee. In instances where performance figures are presented gross, performance would be lower as a result of transaction fees and CAM's investment management fee. Historical performance results for investment indices, benchmarks, and/or categories have been provided for general informational/comparison purposes only, and generally do not reflect the deduction of transaction and/or custodial charges and the deduction of an investment management fee, the incurrence of which would have the effect of decreasing historical performance results. It should not be assumed that your Carret account holdings correspond directly to any comparative indices or categories. Please Also Note: (1) performance results do not reflect the impact of taxes; (2) comparative benchmarks/indices may be more or less volatile than your Carret accounts; and, (3) a description of each comparative benchmark/index is available upon request. The historical benchmark performance results are provided exclusively for comparison purposes only, so as to provide general comparative information to assist an individual client or a prospective client in determining whether the investments meet, or continues to meet, his/her investment objective(s). It should not be assumed that account holdings will correspond directly to any of the comparative index benchmarks. No current or prospective client should assume that future performance will be profitable, or equal to either the composite performance results reflected above, or the performance results for any of the comparative benchmarks provided. For reasons including variances in strategy, account holdings, variances in the investment management fees incurred, market fluctuation, the date on which a client engaged CAM's investment management services, and any account contributions or withdrawals, the performance of a specific client's account may have varied substantially from the indicated composite performance results.

Neither rankings and/or recognition by unaffiliated rating services, publications, or other organizations, nor the achievement of any designation or certification, should be construed by a client or prospective client as a guarantee that he/she will experience a certain level of results if Carret is engaged, or continues to be engaged, to provide investment advisory services. Rankings published by magazines, and others, generally base their selections exclusively on information prepared and/or submitted by the recognized adviser. Rankings are generally limited to participating advisers. No ranking or recognition should be construed as a current or past endorsement of Carret by any of its clients.

Portfolio managers at Carret generally make collective investment decisions. However, in certain instances, portfolio managers may make client specific investment choices. As a result, portfolio dispersion may be increased in certain time periods. Dispersion can also be impacted by factors including but not limited to individual client investment objectives and guidelines, tax considerations, allocation of investment opportunities, order execution, and timing of funding. The material is intended as a broad overview of portfolio, philosophy, process, and style.

Holdings are as of the date indicated and subject to change without notice. The list does not constitute a recommendation to buy, sell or hold a security. Individual accounts may vary. The Representative Holdings have been selected based on objective, non-performance-based criteria. Holdings shown in this presentation may or may not be suitable for an individual's account. Holdings are provided to illustrate a broad view of a particular strategy and are for illustrative purposes only.

Due to various factors, including the passage of time and changing market conditions, content in this presentation may be outdated and no longer reflective of current conditions.