CARRET
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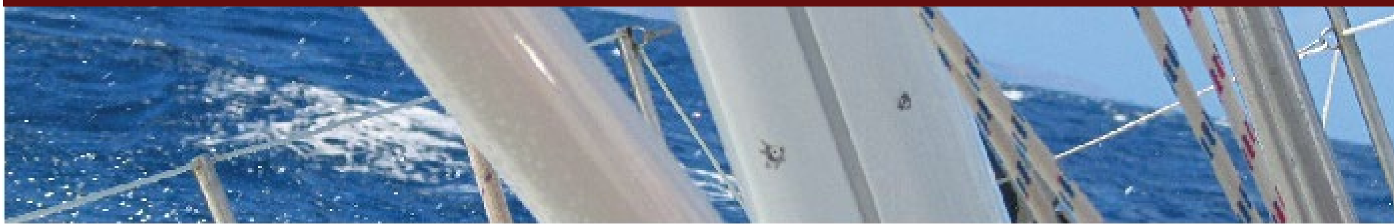
Carret Equity Insights



Nuts!

Brigadier General Anthony McAuliffe, December 22, 1944

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Firm AUM (12/31/24)

$3.237 Billion

The Smoot is a non-standard unit of length that was conceived in 1958 by Oliver Reed Smoot, an undergraduate at the Massachusetts Institute of Technology. The story behind it, blending humor and practical problem-solving, stemmed from a classroom project to measure the length of the Harvard Bridge spanning the Charles River from Cambridge to Boston. The bridge was long, and traditional methods of measurement were tedious, so the group came up with an imaginative solution. Smoot, who stood at 5 feet 7 inches tall, volunteered to be the unit of measurement. His friends then used his body as a human ruler. Smoot lay down on the bridge, and his classmates marked the distance along the bridge by counting how many "Smoots" it took to cover the entire span, picking him up and marking each successive Smoot. The final measurement ended up being 364.4 Smoots. This quirky methodology, though initially intended as a joke, became an enduring part of MIT tradition. The markings painted along the bridge remain, and the Smoot has become a symbol of MIT's playful spirit, as well as an example of how to apply creativity to the accomplishment of seemingly mundane tasks. However, Smoot's distant relative, Senator Reed Smoot, left a far more serious and damaging legacy to the nation a generation earlier.

Key Market Levels	12.31.24	12.31.23	12.31.22
S&P 500	5,882	4,770	3,840
Dow Jones Industrial Average	42,544	37,690	33,147
NASDAQ	19,311	15,011	10,466
S&P 500 Dividend Yield	1.22%	1.42%	1.65%
S&P 500 Trailing 4 Quarter P/E	27.0	21.9	17.6

Source: FactSet

Senator Smoot, Chairman of the Senate Finance Committee, co-sponsored the Smoot-Hawley Tariff, enacted in 1930 during the presidency of Herbert Hoover. Smoot believed that raising tariffs would shelter American industry and agriculture from the economic pressures of international markets. At the time, many U.S. farmers and manufacturers were struggling with low prices due to overproduction and competition from cheaper foreign products. By the late 1920s, the U.S. economy had made exceptional gains in productivity because of electrification, which was a critical factor in mass production. Gains in productivity were also spurred by trucks and tractors replacing horses and mules. One sixth to one quarter of farmland, which had been devoted to raising and feeding draft animals, was freed up, contributing to a surplus in farm produce. Although nominal and real wages had increased, they did not keep up with the productivity gains. If this sounds vaguely familiar, stop and consider the nascent impact today of AI on productivity. Smoot-Hawley sought to protect American businesses and farmers from foreign competition by raising tariffs on over 20,000 imported goods. The tariff applied to a wide range of products, including agricultural goods, manufactured items, and raw materials.

Every Congressman tried to get something to protect their constituents' interests. The concept was that domestic demand would be stimulated by the reduction in foreign competition. However, the tariff led to a significant decline in global trade. In response to Smoot-Hawley, other countries retaliated by imposing their own tariffs on American goods. This escalated into a global trade war, worsening the economic situation at home and abroad. The tariff is often cited as a factor that deepened the Great Depression. As international trade shrank, U.S. industries that relied on exports suffered, leading to further economic contraction. The lesson learned from the Smoot-Hawley Tariff is often used as a warning against protectionist trade policies. Or so we hope. Ironically, the "pork barrel" nature of Smoot-Hawley led ultimately to the Executive Branch being granted the power to levy tariffs in 1934.

We are aware that the extent to which recent campaign *promises* become administration *policy* may be unclear for some time; the risk is that *vague uncertainty* engendered by this unknown factor may be disruptive to market confidence in the near term. There are some specific questions that one might ponder, in no order. What if panic buying, i.e., stockpiling, results in unintended gluts? What if purchasing managers hold back in the face of uncertainty? More granularly, what if AI chips cannot be sourced? That would certainly constitute a blow to the consensus expectations. And one might be advised to recall my October 2018 commentary on SPAM® in which I discussed how a tariff on imported appliances resulted in an asymmetrical, but nonetheless retaliatory, tariff levied on exported pork products. Eventually, we may be forced to reckon with the response of the ultimate victim, the American consumer, who will either absorb higher import costs, be forced to trade down in their purchases, or even worse, suffer a job loss as result of this conflict. We are particularly interested in any impact that might influence Federal Reserve policy, such as an *uptick in inflation or a downtick in GDP growth*; this would be most unsettling if it caused the Fed to pivot away from its recent messaging towards accommodation.

While we cannot quantify the impact on inflation of tariffs put in place during the period from 2017 to 2021, there appears to have been *minimal effect* on prices *overall*. However, it is easy to construct an *argument* that domestic suppliers, retailers, and OEMs will simply pass on increased costs to customers. The *uncertainty* of the outcome at this juncture leads to some *risk* that we can observe. On December 18, the Fed cut interest rates by an expected one-quarter percent but signaled a cautious approach to further rate cuts. The stated reason was that inflation had not yet come down to the Fed's target range of 2%, but our take was that the Fed felt the need to hold back because of the risk of *tariff-inspired inflation*. Since that date, the market has notably demonstrated increased *volatility*. The jury is out, but more telling perhaps is the increase in yields on the longer end of the Treasury curve, even as short-term rates have declined. The bond market is historically recognized as the *guardian against inflation*.

Much has been written recently about the fact that 2024 represents the first time since 1998 that the S&P 500 has registered back-to-back gains of over 20%. Most pundits extrapolate that into a prediction of further gains in 2025. After all, we were taught in grade school that "the trend is your friend." We should unpack these observations. In 1998 as in 2024 the market was driven by an earnings outlook that suggested double digit gains ahead. In 1998 as in 2024, the Federal Reserve was cutting interest rates. In 1998 as in 2024, a very narrow group of tech stocks was driving gains. By the way, in 2000, it all collapsed when the Fed *reversed course*.

We began by quoting General McAuliffe at Bastogne. Eighty years ago, he was awakened by his staff with news of the German surrender demand. His immediate reaction, "Aw, nuts," was noted by his officers. When he asked for thoughts on how to respond to the demand, his staff suggested that he already had given his answer. Hence, the legendary message was delivered. Four days later, Patton's Third Army relieved the besieged troops of the 101st Airborne. *Of late, the question of concentration has become somewhat akin to a surrender demand in the construction of portfolios*. Specifically, the ten largest U.S. companies accounted for some 14% of the S&P 500 index a decade ago. As of today, the so-called "Magnificent Seven" technology stocks account for some *one-third* of S&P market *capitalization*, and *over half* of the S&P *return* in 2024. Some fear that such concentration may put *investors at risk*. Some think it's not a big deal. Those who express concern about concentration may be operating on the instinct that a 7% position in AAPL, for example, would be ripe for profit-taking, not new purchases. In a sense, *concentration* flies in the face of *diversification*, which has always been the hallmark of sound portfolio management.

The argument *for* concentration is, to paraphrase Willy Sutton, "because that's where the money is." Of the estimated $272 in S&P earnings forecast for 2025, some 58% is expected from the technology sector alone. From another perspective, while the S&P earnings are expected to increase by 14.5% this year, technology sector earnings are expected to rise some 22%. We must ask how S&P earnings can reasonably deliver on expectations that growth will *accelerate* in 2025, given such questions as the quantitative uncertainty as to how exactly AI will be monetized, as well as the lingering impact of the recent *deceleration* in the economy driven by the Fed's inflation stance. As general practitioners of the investment style known as GARP or *growth at a reasonable price,* we will continue to be mindful of both the risks and rewards of concentration and will let our valuation discipline be our guide in this environment, remaining skeptical as to price. We caution that a market P/E of 22 on the current year estimate of $272 is *neither cheap nor excessively dear*.

A market that has climbed for over two years with barely a correction presents some unique challenges. We recognize that the *risk is greater* than it was at the October 2022 lows. We acknowledge that an uninterrupted advance is a breeding ground for *complacency*. We reiterate that markets and individual stocks do not necessarily collapse because of *high valuation*, they collapse because high valuation makes them *vulnerable to disappointment*. What happens when the growth rate of the market leaders decelerates? What happens if the inflation rate remains sticky on the upside, forcing the hand of the Federal Reserve? What happens if the five-year compounded returns of 15% begin to regress to the mean of 10%?

By the same token, we acknowledge that from a macro standpoint, we remain in a benign investing environment. We have a Federal Reserve that has been signaling an accommodative stance for some time, a consensus earnings estimate for 2025 of $272 overall that reflects continued expansion from the recent 2020 low of $138, a technology revolution in the form of AI, and a new administration promoting lower taxes and less regulation. What's not to like? Part of our role as an investment advisor is to remain skeptical and vigilant in these times. Part of your role as a client is to be honest and reflective about your true risk tolerance. Phil Carret counseled patience; to this we would add awareness.

Laurence R. Golding, Managing Director, January 14, 2025

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