CARRET
Asset Management

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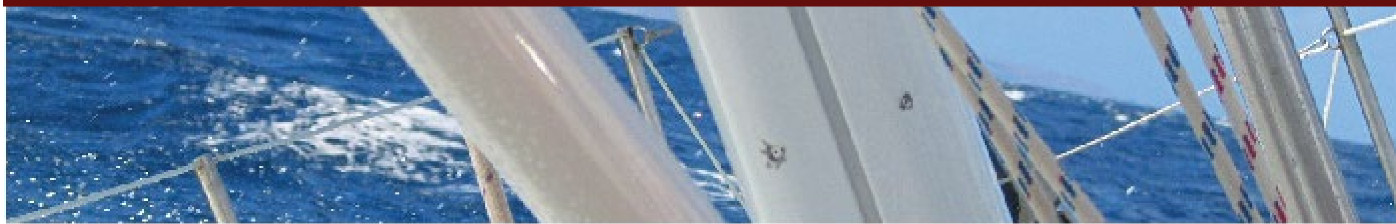
Carret Equity Insights



"Damn the torpedoes, full speed ahead!"

David Glasgow Farragut, 1864

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Firm AUM

$3.139 Billion

On August 5, 1864, at the Battle of Mobile Bay, Union Admiral David Farragut (1801-70) led his flotilla through the Confederate defenses to seal one of the last major open Southern ports. The fall of Mobile Bay was a major blow to the Confederacy; the victory was the first in a series of Union successes that helped secure the re-election of President Abraham Lincoln later that year. Farragut's flagship, the sloop-of-war steamer *Hartford,* entered the bay. Farragut, hoping for better visibility, climbed the rigging. A quartermaster passed him a line so that he could secure himself, some hundred feet above the deck. The iron-clad monitor *Tecumseh*, just ahead, was sunk by an underwater mine or "torpedo," as they were called. There was some momentary confusion in the fleet. But the ships steamed on, inspired by Farragut's famous command: "Damn the torpedoes! Four bells! Captain Drayton, go ahead! Jouett, full speed!" "Four bells" was the command to the engine room. Recognizing hesitation from his subordinate commanders, he took the bold and decisive action of placing his flagship, *Hartford*, in the lead and giving the order which we have come to know as "Damn the torpedoes, full speed ahead!" His leadership in the face of danger led the flotilla to victory.

Now, a novice reader of these reports might be tempted to assume that we offer this story to suggest that, in spite of *salient risks in the market*, we are arguing for an aggressive posture towards investing. An experienced reader will understand that we have already secured your proper *asset allocation* in discussion over time, and that there is no need to alter course, even considering the recent strength in any one asset class. In that case, it is truly full steam ahead. But as we write these words, the real metaphor that we want to stress is that of Farragut scampering up the shrouds for *visibility* in the smoke and confusion of battle. We hope in these next paragraphs to provide some insight into the smoke and confusion that is the very essence of investing.

Key Market Levels	3.31.24	12.31.23	12.31.22
S&P 500	5,254	4,770	3,840
Dow Jones Industrial Average	39,807	37,690	33,147
NASDAQ	16,379	15,011	10,466
S&P 500 Dividend Yield	1.30%	1.42%	1.65%
S&P 500 Trailing 4 Quarter P/E	21.7	21.9	17.6

Source: FactSet

Just as we appreciate that Farragut's mission was to deprive the Confederacy of the last port open to the fragile supply chain of blockade runners on the Gulf of Mexico, we should probably restate our mission to clarify our singular focus through all the smoke and confusion. The hallmark of a wise investment program is that it seeks to achieve *above-average returns for clients over time, while incurring below-average risk.* By the careful understanding of a client's needs and objectives, and the diligent application of a consistent investment discipline, these goals can be achieved. Put simply, at Carret, we believe that by making our clients the owners of companies with attractive *investment prospects*, driven by new product activity, balance sheet and cash flow strength, management ability and incentive, and by acquiring this ownership interest at a *reasonable price*, commendable equity performance can be realized over time. In this space, we tend to review important factors affecting the investment climate, including Fed policy, fiscal policy, the market's overall valuation levels, and from time to time, even the political environment. This is our best way to acknowledge the smoke and confusion of the investment arena. Nonetheless, please bear in mind that at the end of the day, we are much more concerned about what we own than about what people are saying.

In our last piece, we suggested that "investors" counting on a near term *pivot*, that is, a reversal in Fed policy, were likely to be disappointed. I actually accepted a wager from a very astute market player who insisted that the Fed would cut rates by March 31st; I am looking forward to my lunch. The interesting thing is that the market took the disappointment in stride, and the S&P 500 continued its advance from the October 27th lows and added some 10.5% in gains during the most recent quarter. One could surmise that the market was comforted by the generally *accommodative signals* from the Fed, both in words and the so-called "dot plot" projections; investors settled in to await the "eventual" pivot. The only time the Fed has accomplished a *soft landing*, that is, *no recession*, was in 1994; rates were subsequently flat for four years. No pivot, just the *cessation of hostilities*, as it were. But this scenario is still perhaps overly optimistic. What if inflation remains sticky on the upside? We can imagine that every algorithmic trading program on the planet is set to sell on news of such an uptick. Indeed, we got a glimpse of this potential response during the week of April 8th. But for argument's sake, assume that we are more confident in the ability of our portfolio names to *weather* inflation, than we are in our ability to predict *when* inflation will *subside* to the Fed's target 2% level.

Jack and I often play this little market strategy game. What if I told you that the Fed was going to lower rates by September 15th to 3.5% in an effort to *normalize* the Fed Funds rate to a neutral level? What if I told you that the *inflation* print of May 15th will come in above *expectations*? What if I told you that the Fed was going to *continue* quantitative tightening, and deliberately signal that *further rate hikes* cannot be ruled out? What if I told you who the next Senate Majority Leader and Speaker of the House will be? To quote the late Karl Malden in his iconic 1970s era ads for American Express Travelers Cheques, "What will you do, what will you do?" Our response invariably is a resounding: "stay the course." None of those answers to the final exam, so to speak, whether purloined through time travel or some other artifice, have immediate bearing on the stock and bond investments that we own for our clients. *Speculation*, which occupies so much of the 24/7 cable news cycle, is in the essence, just noise. We will comment on the important issues that comprise the market *zeitgeist*.

We will posit that while the Fed's actions are newsworthy, the constant speculation about the Fed's actions are truly not worthy of consideration. From the beginning of this tightening cycle in March of 2022, the Fed has been very clear in stating its objectives. The Fed's move to a *restrictive policy from one of accommodation* was geared towards lowering the rate of *inflation* back to the target 2% level by slowing the economy. The playbook means of accomplishing this goal is through raising the short-term interest rate that it controls. Higher short-term rates translate swiftly to higher borrowing costs, raising the hurdle rates for corporate investment and making credit card and housing purchases less affordable. From the Fed's standpoint, the impact from these *factors* eventually winds its way *through the economy*, increasing unemployment, lowering wage costs, and by reducing demand, eliminating some measure of inflationary pressures. Of course, the fear is that the economy tips into recession as a consequence of achieving the mission of taming inflation. The stock market will react poorly to the *uncertainty* of a recession through the diminution of earnings expectations. For those still interested in my historical thread, imagine from the Confederate view that the loss of the *Tecumseh* set in motion the chain of events that led to Farragut's order.

But consider the possibility that the old playbook has not been effective this time. We have seen a slowing of the economy at the margin, as measured by the PMI data, but it has not been sufficient to achieve the desired impact on inflation. Consumer *demand* and confidence, corporate *profitability* and outlook, and even stock market *performance* have held up despite the Fed's torpedoes laid out ahead. The service economy has been particularly resistant to Fed intervention. Meanwhile, the government's fiscal policies of *deficit spending* tend to be *inflationary*. If inflation is truly intransigent, what steps can the Fed take? There really is only one course of action, which is to resume *rate hikes* after a nine-month pause, and to continue *quantitative tightening* as they have been. Eventually, one might surmise that the Fed's efforts will yield fruit. In the meantime, every pundit who spoke of imminent rate cuts being signaled by the Fed, every commentator who suggested that the Fed might raise its target rate of inflation to accommodate the new normal, even those who called for "higher for longer" rates will have to walk back their predictions. We might have a recession, or we might not. The point is that the time and energy spent on arguments suggesting that the Fed would *change course without cause* might have been better spent on deeper analysis of company fundamentals, and more importantly, on more intimate discussions with clients on the meaning of risk tolerance and return requirements. We would like to believe that we have maintained the proper course throughout such periods of uncertainty.

In addition to the Fed, there are a few areas of macro concern that we are following. The S&P 500 has out-performed its historical long-term return over the past decade. There is a statistical concept of *reversion to the mean*, which suggests that long term trends might still be important. We can rejoin the trend line either through a market setback or a period of flattish returns. Not assured by any means, but worthy of discussion in our planning for clients. Market valuation is neither at *bargain* nor *bubble* levels. But the forward assessment of market P/E requires the forecast earnings growth of 10% for the S&P 500 to develop without incident. In recent years, we have seen those growth estimates slip as time progresses. There is a prevalence of what Alan Greenspan once termed *irrational exuberance*. Seven stocks representing 30% of the S&P capitalization is not sustainable. AI is in its early stages, and every company that touts AI will not necessarily succeed. Companies with *sustained losses* and truly *aspirational earnings* outlooks still garner too much attention. One of my colleagues suggested that the market on some days resembles Draft Kings rather than Phil Carret's concept of *patient* investing. *Skepticism is warranted* amidst the hype. As Farragut was able to see above the smoke and confusion of battle and act decisively, we will remain in our vantage point in the rigging on your behalf.

Laurence R. Golding, Managing Director, April 18, 2024

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