CARMICHAEL CAPITAL INC.

CLAUDE R. CARMICHAEL CFA, PRESIDENT
339 MAIN STREET, 2ND FLOOR, FRANKLIN, TN 37064
(615) 595-5800 – NYC (212) 580-5200 – FAX (615) 595-5825
claude@carmichaelcapital.net

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2019 Year-End Review
"A Tale of Two Feds"

2019 turned out to be one of those years when stocks did much better than the economy seemed to justify. The casual observer might have missed the fact that, even with strong stock market advances, total S&P 500 corporate profits actually fell (year-over-year) in each of the last four quarters. Stock buy-backs reduced the number of shares outstanding, so earnings *per share* were basically flat. Yet the stock market indexes leapt over 20%. What is going on?

"It was the tightest of Feds. It was the easiest of Feds."

We should remember that, by the end of 2018, the Federal Reserve Board (the Fed) had raised interest rates four times and was attempting to return the economy to "normal" interest rate levels. (Remember when you could get 4% to 5% from a money market fund?) The Fed was also committed to shrinking their balance sheet and removing the extraordinary liquidity measures that had been implemented after the Great Recession; measures that had been intended to be temporary and to be removed once the economy recovered. Investors were alarmed, to say the least, by this attempt to return to "normal," and markets tumbled dramatically into the end of 2018.

At the beginning of 2019, the Fed began a dramatic "about-face" by pausing their rate-raising campaign of 2018, then cut interest rates 3 times through the end of the year. The casual observer might also have missed the liquidity crisis this past September in the "repo market" where the US Treasury provides short term funding to banks. The repo market almost "froze" and short-term interest rates temporarily skyrocketed to over 10% until the Fed intervened and injected more money into the system. By last week, the Fed had increased its balance sheet by $310 billion just since September, providing a gush of liquidity that has buoyed financial assets including stocks. It also appears that the Fed is unwilling or unable to raise interest rates for the near term, so stocks appear more attractive as compared to short-term bonds.

You may hear analysts' comments that the market's advance represented "P/E expansion." P/E (price/earnings ratio) represents nothing more than the price of a stock divided by the company's earnings per share. Over the last several years, the average P/E ratio for the S&P 500 has been 15, and that's roughly where it stood at the beginning of 2019. With rising stock prices and flat earnings, the "P" went up while the "E" remained stagnant. Therefore, the P/E ratio now stands at 19, which is getting on the high side historically. In other words, stocks just got more expensive without an increase in earnings. However, there are some plausible justifications for these higher prices.

Investors now find themselves with a friendly Fed, ample liquidity, lower interest rates, and the possibility of a resumption of growth powered by potential resolution of international trade tensions. Stock buybacks have reduced the number of shares outstanding, so simple supply/demand pressures could continue to support stock prices. There is a saying on Wall Street that "bull markets don't die of old age." It usually takes an unfriendly Fed or an exogenous event to kill the bull. The Fed will probably

remain accommodative, at least through the presidential election. The administration will likely do all in its power to keep the good times rolling in order to increase the chances for re-election.

So, it's clear sailing for stocks, right? Maybe not. Exogenous events are much harder to anticipate. As an example, we have already been to the brink of war and back in the first days of the new year. We have political uncertainty with an impeachment probe and elections approaching; the results of which may lead to vastly divergent market reactions. We have exploding government deficits and record high debt loads for governments, corporations, and households. We have sub-par growth in the domestic economy, slowing growth world-wide, and actual contraction in many manufacturing sectors. At the same time, there are a number of valuation and sentiment indicators at extreme levels, including price/sales ratios and greed/fear indicators. In spite of the rising risks, the stage may be set for a market "melt up" as investors and managers who have kept cash reserves feel forced to buy into a seemingly invincible market. This would not be too surprising an ending for such a long bull run in stocks. So, stocks are expensive but may still rise on the tidal wave of liquidity and investor enthusiasm.

Technology stocks have led the recent advance while energy stocks have suffered the greatest declines. Banks have done well while precious metals have quietly resumed an uptrend and may have started another significant move higher. Pharmaceutical stocks have risen recently but may be vulnerable to reforms brought about by democratic victories in the Senate and/or the presidency. Capital gains rates are probably as low as they are going to be in our lifetimes, so it would seem prudent to book some of those long-term profits this year. Energy stocks may make a good contrarian investment as they are cheap and generally shunned.

Schwab and other brokerage firms recently eliminated commissions on stock and ETF trades. As a result, we can now diversify smaller portfolios into more positions without the prohibitively high commission costs on small dollar purchases. We can also divest small positions that are spun-off from our larger holdings without having a large percentage of them go to transaction costs.

Enclosed you will find your 2019 reports and statements. As a reminder, you should rely upon the capital gains reported by the custodian (e.g. Schwab) since ours should be regarded as a close approximation. Please review these at your leisure and give me a call with any questions or suggestions you may have.

It is a pleasure working with you on your investments, and we hope to continue to prosper in the coming year.

Best regards,

Claude R. Carmichael CFA