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Sandpiper Capital

Gleanings

The Elephant…

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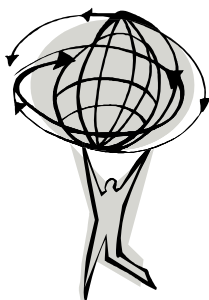
"All things held equal however, an economy that grows at 6% brings profits that increase at 6% and a stock market that returns 6%."



It was six men of Indostan to learning much inclined,
Who went to see the Elephant (Though all of them were blind),
That each by observation might satisfy his mind.
The First approached the Elephant, and happening to fall
Against his broad and sturdy side, at once began to bawl:
"God bless me! but the Elephant Is very like a wall!"
The Second, feeling of the tusk, Cried, "Ho! what have we here
So very round and smooth and sharp? To me 'tis mighty clear
This wonder of an Elephant Is very like a spear!"
The Third approached the animal, and happening to take
The squirming trunk within his hands, thus boldly up and spake:
"I see," quoth he, "the Elephant is very like a snake!"
The Fourth reached out an eager hand, and felt about the knee.
"What most this wondrous beast is like is mighty plain," quoth he;
" 'Tis clear enough the Elephant is very like a tree!"
The Sixth no sooner had begun about the beast to grope, than,
seizing on the swinging tail that fell within his scope, "I see,"
quoth he, "the Elephant is very like a rope!"
And so these men of Indostan disputed loud and long, each in
his own opinion exceeding stiff and strong, though each was
partly in the right, and all were in the wrong! -John Godfrey Saxe

As often as I've referred to this parable over the years as a metaphor for a lot of the commentary we hear about the stock market, its lesson seems particularly relevant now.

While it is certainly relevant that corporate profits have increased 18% per year since 2009 or that the S&P is still 15% below its peak in 2007; sometimes a true and accurate picture of the market requires that we step back a bit.

Market Returns through 03/31/2011

Index	2008	2009	2010	ytd
S&P 500	-36.9	26.5	15.1%	**5.9%**
ML 1-10 yr Govt/Corp	4.1	5.7	6.0%	**.3%**
EAFE (Dev. Mkts)	-43.3	31.8	7.8%	**3.5%**
Emerging Markets	-53.2	78.4	19.0%	**1.0%**

In the two charts on the reverse we attempt to do just that with a fifty-five year perspective on the S&P's relationship to the overall economy. The primary scale on the right (that ranges from 60 to 4000) measures the long term growth trends of GDP (in Black), corporate profits (in red) and the S&P (blue). The secondary scale on the right (that ranges from .3 to 10) refers to the inflation rate, while the vertical bars represent recession quarters.

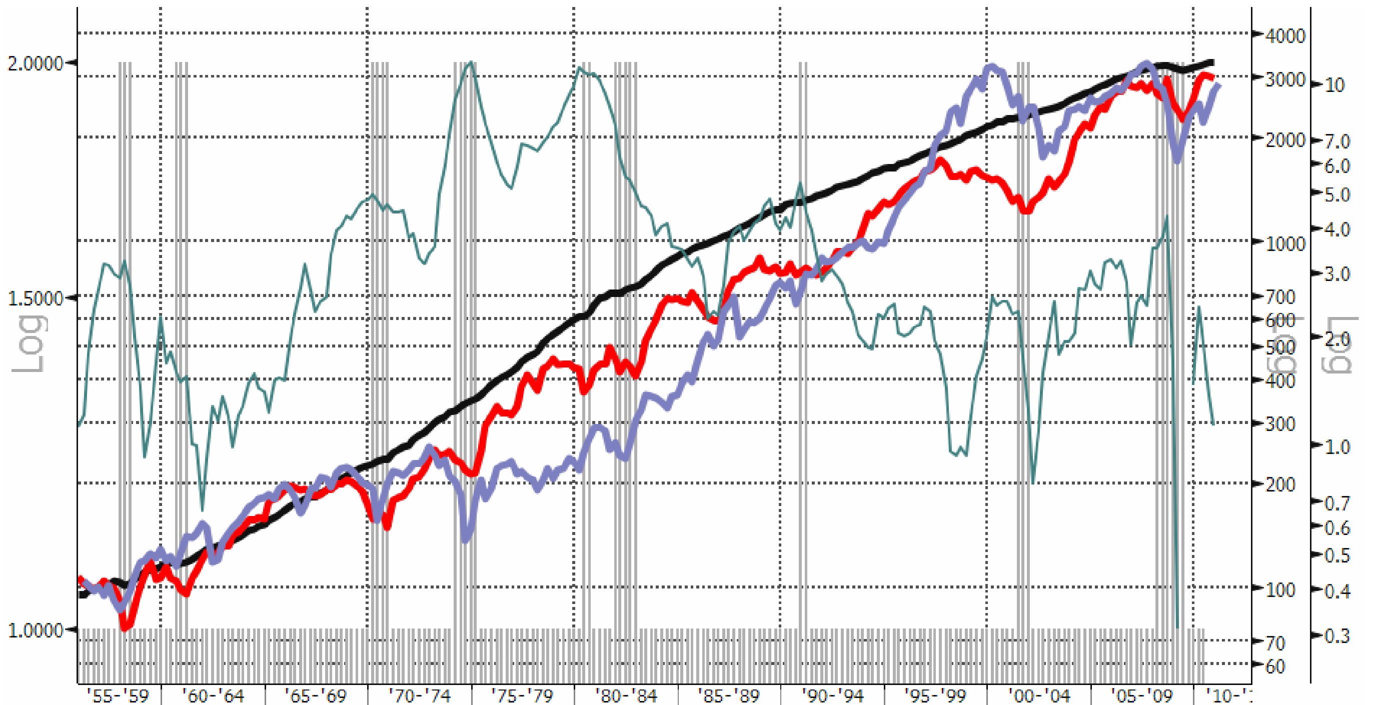
It certainly seems sensible that over the long term, the secular growth rate (that increases each 30 fold from 100 to 3000) of the economy, corporate profits and the stock market should be the same, as each is derived from the other. Certainly recessions and recoveries send profits and the market through very meaningful short term swings. The record also makes obvious that high inflation is bad for market valuations. All things held equal however, an economy that grows at 6% brings profits that increase at 6% and a stock market that returns 6%.

The aberration of double digit financial market returns since inflation's peak in 1981 was the result of an unusually depressed starting point for S&P valuations relative to the overall economy. Likewise, corporate profits have climbed to a record percent of GDP as a consequence of a thirty year trend of reduced taxes, labor and financing costs. For those of us fortunate enough to have been stock investors over that period, the positive economic backdrop has been almost ideal.

As the global economy has arguably reached the tipping point where each additional unit of Chinese manufacturing output pushes existing prices lower, domestic inflation has become moot. We won't ignore the prospect of its recurrence. It's just not the risk it used to be.

The primary long term risk is that the current benign corporate tax environment (25% lower in the last ten years than the ten before) succumbs to the pressure to reduce the budget deficit. Otherwise, it is very likely that (at best) the next fifteen years resembles the last with the economy, corporate profits and the market doubling over that time frame. The challenge will be to handle well the cyclical swings that inevitably affect everyone's perceptions of the market. With average annual swings around that 5% mean return likely to persist at 15% to 20%, knowing where you are in the cycle is paramount.

The cyclical volatility of the stock market (blue) relative to earnings (red) and GDP (black) is pretty apparent in the 55 year history below. They are all measured against the log scale on the right however, each increasing about 30 fold or 6% per year over that time frame.



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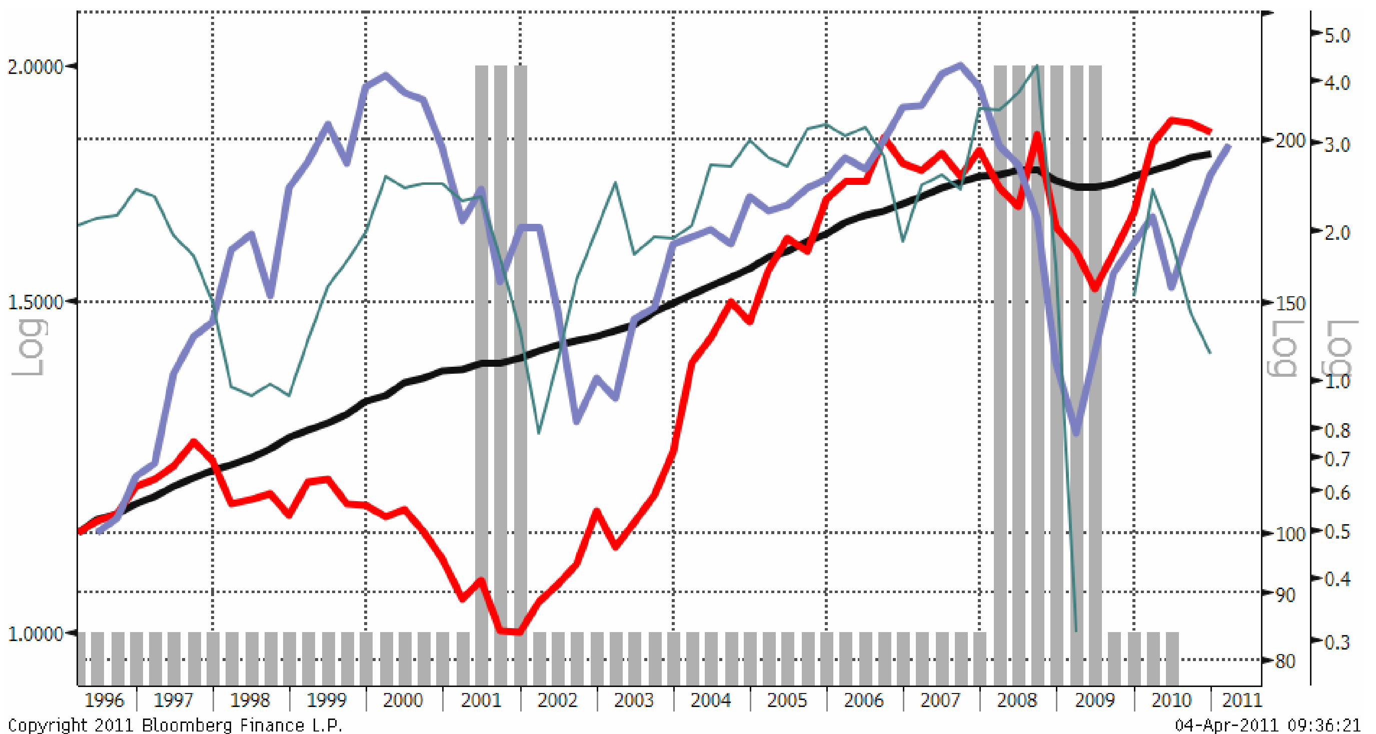
The last fifteen years has seen inflation (in green) contained within an acceptable range and profits (in red) and market valuations (in blue) quite cyclical around GDP (in black), although trendline growth has doubled all three over that time frame. I would expect much the same over the next fifteen with perhaps a somewhat flattening trend.



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