

# Gleanings

## The Price of Risk

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***“Current levels of economic activity imply that the earnings recovery will continue through at least the next two to three quarters with the S&P 500 price index also likely to approach previous peaks.”***

Positive earnings momentum for the companies that comprise the S&P 500 continued through the most recent quarter, with total quarterly profits of the non-financial sector recovering half of its recession related retrenchment, (back to \$145b now vs. a peak of \$175b in '08 and a low in March of \$112b). Not coincidentally, the S&P price index has also recovered about half of its fall from the peak, (1550 down to 735 and back to 1138). We're trying to ignore financial sector earnings for the time being, as we would also encourage you to do, as the numbers being reported are not particularly useful in predicting future levels of profitability. We don't know how long the Federal Reserve will continue to subsidize the banks' cost of funds, nor do we know how long and to what degree the quarterly charge off of bad loans will continue. (We expect that the answer to both questions

is the same.) Both of these dynamics, while offsetting each other, are tremendously large relative to the size of the sector, swamping any practical notion of normalized profitability with essentially political considerations. Focusing on the real economy does bring some optimism, however, as cost savings from layoffs has levered the impact of recovering demand. Current levels of economic activity imply that the earnings recovery will continue through at least the next two to three quarters with the S&P 500 price index also likely to approach previous peaks.

We are treating such prospects with a heightened sense of caution, however, as forward looking markets

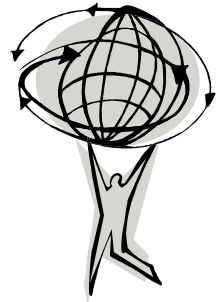
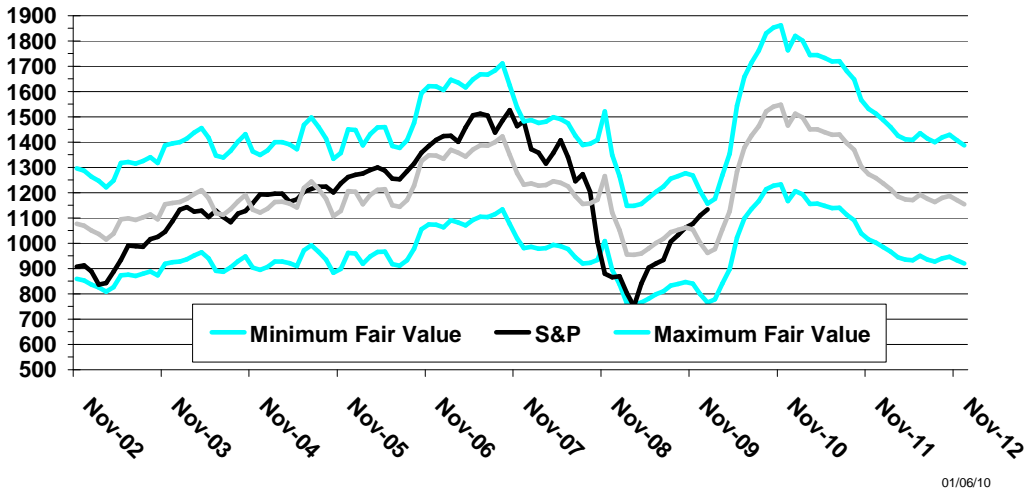
could well begin to worry about resurging inflation in 2012. It would be very unusual indeed for there *not* to be some payback for all the excess cash pumped into the system last year. (You'll observe on the inflation chart printed on the reverse of this page that there's typically several years lag between cause and effect.) Also, a quick note on the two year index returns in the table just above. Contrary to intuition, down 53% followed by up 79% does not get you back whole again. Compounding returns means that when you lose money, you don't have as much left to make money with during the good years. Losing less earns you more in the long run.

## Market Returns through 12/31/09

Index	2008	2009	'07-'09
<b>S&amp;P 500</b>	-36.9	26.5	-20%
<b>ML 1-10 yr Gov't/Corp</b>	4.1	5.7	10%
<b>EAFE (Developed Mkts)</b>	-43.3	31.8	-25%
<b>Emerging Markets</b>	-53.2	78.5	-17%

## Gleanings

Unprecedented monetary stimulus brought unusual resilience to the stock market pushing valuations to peak levels. The market ignored the 75 basis point rise in inflation expectations last quarter, (captured by the model's downdraft in fair value estimates) and instead focused on next year's rosy profit picture.



The good news is that the earnings recovery is real and is expected to continue as industrial production grows to fill the gap left by lean inventories. Our fair value numbers for next year reflect this expectation. The bad news is that excess money creation (purple line in the chart below) generally engenders inflation (blue line) eventually. That prospect substantially reduces our fair value estimates in 2012. Predicting the future is always problematic, this time especially so given the volatility implicit in these forecasts.

