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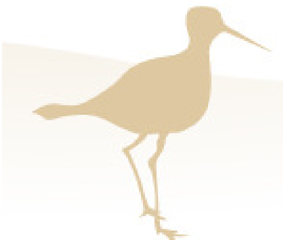
Sandpiper Capital

Gleanings

Market Returns Annually and Through 10 Years Ending 12/31/2013

Index	2011	2012	2013	10 Yrs
S&P 500	2.1	15.9	32.4	**7.4%**
ML 1-5 yr Gov't/Corp	3.1	2.5	.3	**3.4%**
EAFE (Dev Fgn Mkts)	-12.2	17.2	22.8	**6.9%**
Gold	10.1	7.1	-28.3	**11.2%**



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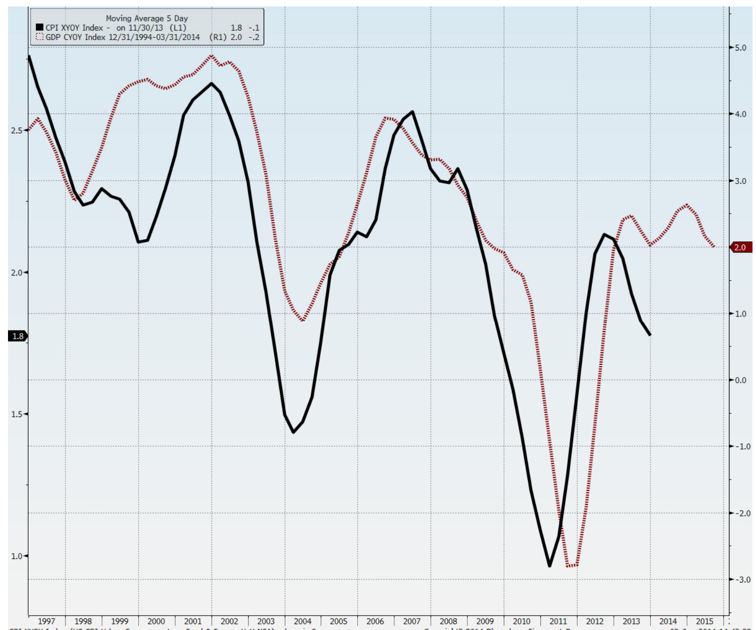
"We had a 3.7% annual growth rate for S&P sales and earnings over two years but a 24%/year increase in the market."

"The last war…"

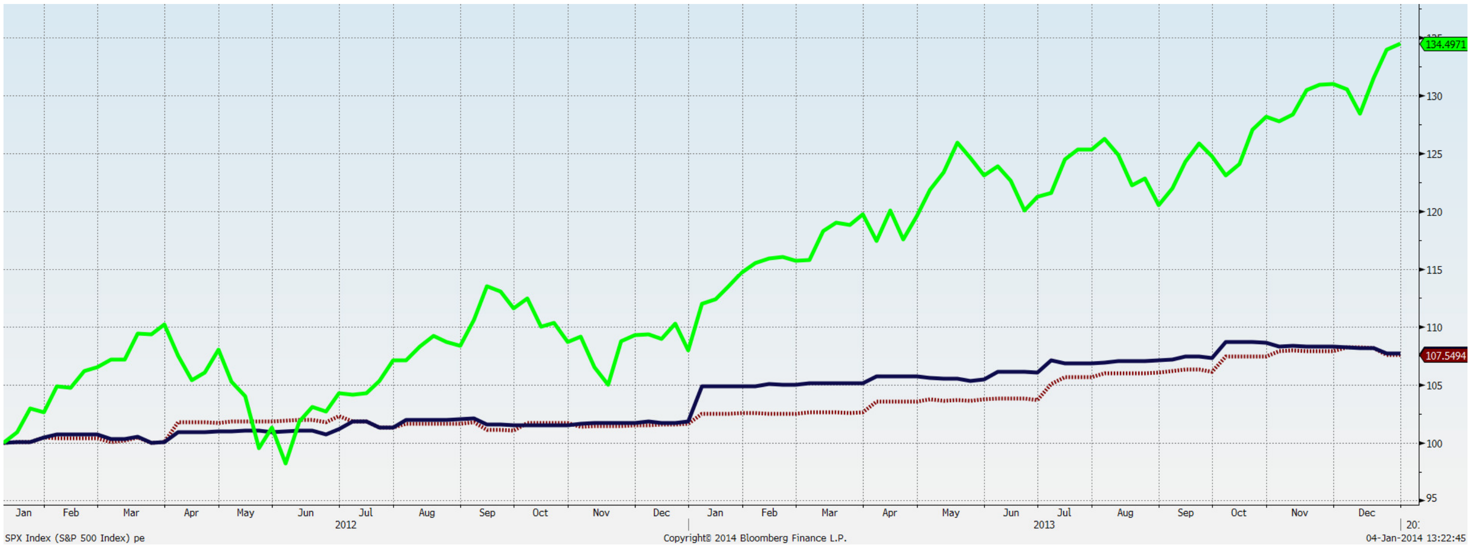
A saying goes that generals always prepare for the last war, while diplomats try to avert the war they fear at the moment. If you substitute "investors" for "generals", you can get a good sense of why bonds*, despite offering yields substantially greater than that of bank certificates or inflation, had a negative return in 2013 for only the second time in the last twenty years. A fixed return of 3.8% from a AA taxable municipal bond that is guaranteed for ten years seems like a good thing compared to 1% from the bank, but only if you believe that inflation stays low. Investors sold bonds last year because they were afraid that inflation in the next ten years will be higher than it was for the last ten (2.4%) or the ten before that (also 2.4%). Those who owned bonds during the rampant inflationary spiral of the late 70's, (or who read about it in their finance texts) know that the higher inflation goes, the lower bond prices go. Five percent inflation brings six percent bond rates making your 3.5% bond less attractive to potential buyers, about 15% less attractive. That fear of a potential double digit drop in market value caused an actual drop of 1% in two months this spring as investors looked at the economy and expected both it and inflation to recover. If you look at the chart above, you can see that there *is* a pretty strong relationship between GDP



(in red) and CPI inflation three quarters later (the black line). Both have recently shown a substantial increase from recession lows. Looking at the same numbers from a twenty year perspective however and you'll also see lower and lower peaks in both economic growth and inflation, with the most recent experience reflecting surprisingly low inflation and a disappointingly shallow economic recovery. If you'll refer back to our last Gleanings, you can reread the concerns that we have had about too many goods chasing too few dollars. Our policy has been to position accounts to benefit from these disinflationary trends. That is; 1) Lock in rates from bonds or bond funds that will allow us to benefit from bond sellers' fears. One percent over inflation is a gift of a return from a low risk investment. 2) Own gold as insurance against the risk that central banks continue to create money to combat deflation. 3.) Sell stocks into strength as risks increase with economic fragility and buy stocks opportunistically when economic weakness creates compelling values.

*As measured by the ML 1-10 year Corp/Gov Index

Our reluctance to own stocks this year was founded upon the shallow economic growth which we have been experiencing, which you can see illustrated below in the blue (S&P sales) and red (S&P earnings) lines below. While the handicaps of an over-leveraged consumer and our diminishing competitiveness in the global economy are reflected in that anemic trend (3.7% per year growth versus the historic rate of 6%), enthusiasm for stocks erupted nonetheless. The green line reflects the growth rate of that enthusiasm, it tracks the dollar amount per share that people were willing to pay for a dollar worth of earnings of the S&P, i.e; the P/E. We had a 3.7% annual growth rate for S&P sales and earnings over two years but a 24%/year increase in the market.



From one perspective, however, stocks look cheap. The chart below looks at the relationship between the long term rate of growth of the economy (the trailing ten year average annual growth in GDP) in black and the (ten year average) yield demanded from the earnings of the market, (earnings divided by price or earnings yield of the S&P). Somewhat counter to intuition, the lower the normal rate of growth of the economy, the less market participants need in earnings to persuade them to buy stocks. If bonds yield 4% and the economy is growing at only 4% then maybe a 5% earnings yield (or expressed the other way around, a multiple of 20 times earnings) is all that we should require. The caveat is that the lower the normal growth rate of the economy, the greater the risk of recession. Conservative investors should keep the 45%+ losses of the last two recessions in mind.