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Sandpiper Capital

Gleanings

Cyclical Momentum

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"We think the key in the near term is to not confuse the poor health of the US economy or the distress of the American consumer with the prospective profitability of multinational corporations."

Last spring's tremendous monetary stimulus (money growth in excess of GDP growth) has worked its way through the financial system and with it, the market's appetite for risk. Our fiscal crisis averted (delayed), the U.S. economy has clearly bottomed, although we do expect to see global leading economic indicators begin to flatten from here. Second quarter earnings results benefited from reduced payroll expense which should continue through next year. We expect profit margins should show year over year improvement through Summer 2010, with S&P earnings recovering to the $15 to $17 range by then. (First quarter was $10, second-$14.)
While the S&P is trading at fair value on current earnings, we are likely to get some excitement over the next few quarters as reported earnings come in ahead of analyst's projections. We could well see another 7 to 10% return (1150 to 1200) from the S&P on the euphoria elicited by the perception of a V shaped recovery. We don't actually need the consumer or retail sales to recover to move profits up from last year's abysmal levels, cost cutting is already accomplishing that. For the moment, the impetus for market gains will continue to be surprising corporate profitability in spite of the sluggish economy. We think the key in the near term is to not confuse the poor health of the US economy or the distress of the American consumer with the prospective profitability of multinational corporations. Every domestic job replaced is money saved from current expense. The peak in year over year cost savings is still in front of us.
Prospects for margin improvement beyond 2010 are fairly dim, however, as there are political limits to layoffs during a profit recovery.
While consumption growth in China may well continue at 15 - 20% per year, at a tenth of the level of the US, it'll be a decade before they can replace the spending we can no longer afford.

Market Returns through 09/30/09

Index	Month	Quarter	YTD
S&P 500	3.7	15.6	19.3%
ML 1-10 yr Gov't/Corp	.9	3.4	5.4%
EAFE (Developed Mkts)	3.8	26.1	29.0%
Emerging Markets	9.1	21.0	64.1%

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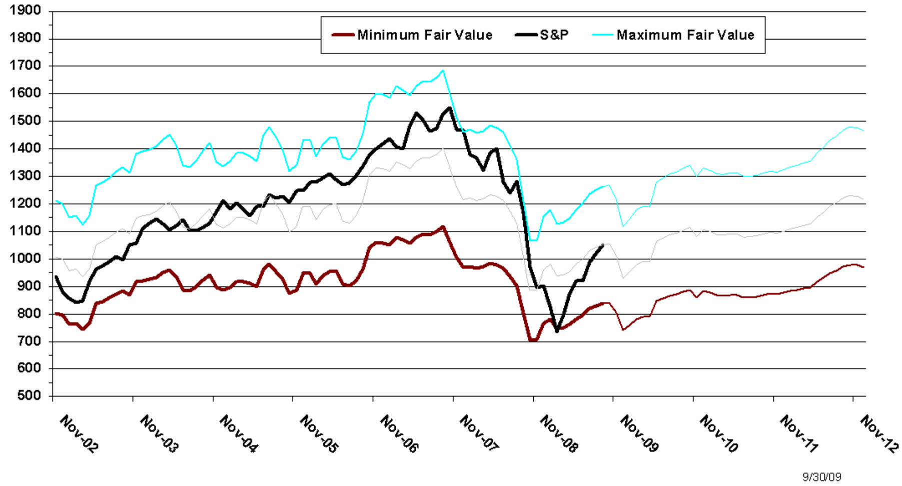
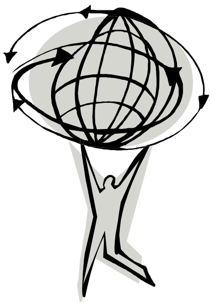
Proving the exception to the rule, the market actually went up just as fast as it came down, bouncing immediately back from bear market valuations to about our calculation of fair value. We do see the possibility of a December inflation scare that could temporarily impede progress, however we expect that any selling that brings us below 1000 will be an opportunity to add to stocks, as cyclical momentum continues to improve earnings in 2010.





As the quantity of $ money has expanded, its price (the rate of exchange) has contracted. Excess global manufacturing capacity will likely keep the inflationary impact of a weakening dollar from affecting domestic inflation. While the Fed won't worry, be sure the markets will be looking closely at import price inflation and the CPI.