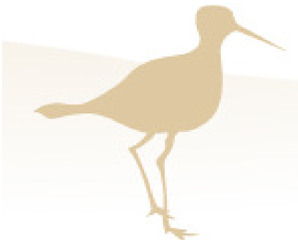
October 2014
Volume 6 Issue 4

Sandpiper Capital



Gleanings

1613 Laskin Rd., #200
Virginia Beach, VA 23451

757-962-4596
Fax 757-962-5038

www.sandpiper-capital.com

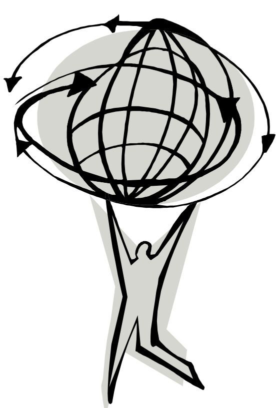
Market Returns Annually and for Year to Date and Ten Years Ending 09/30/2014

Index	2012	2013	YTD	10 Yrs
S&P 500	15.9	32.4	8.3	**8.1%**
ML 1-5 yr Gov't/Corp	2.5	.3	.4	**1.1%**
EAFE (Dev Fgn Mkts)	17.2	22.8	-1.4	**6.3%**
Emerging Markets	18.7	-2.5	2.6	**11.1%**

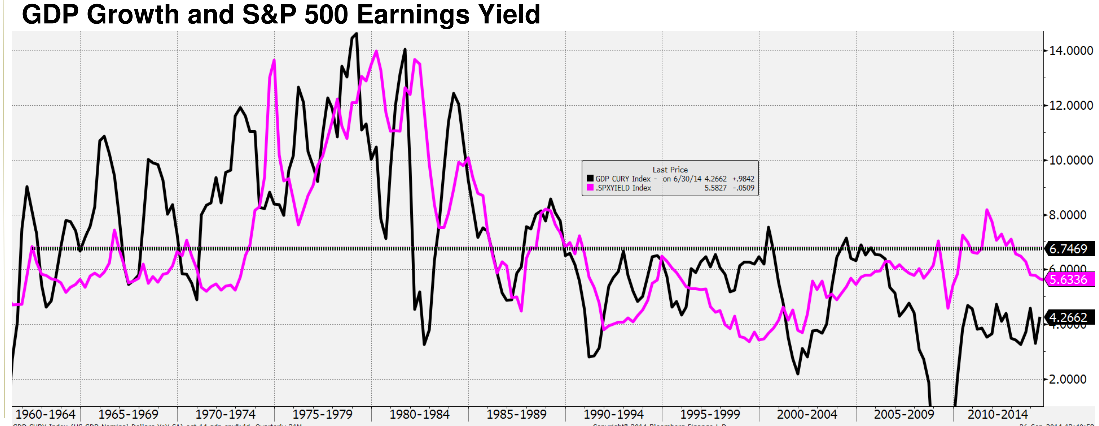
Slow Growth, Higher Valuations…

In my opinion, in the investment world as in every other aspect of life, maintaining perspective is a requirement for making good choices. With as much information (and dis-information) as there is out there, the effort to put financial decision making in an appropriate context requires a conscious effort to tune out all the noise, to take a step back and to think about the markets much more broadly and with attention to many decades not just years of history. While certainly there are plenty of cyclical trends and influences unique to each market, motivations always remain the same: to earn a competitive return. Discovering what market participants require from a market return for it to be defined as "competitive" goes a long way towards an understanding of the forces that inexorably move prices decade after decade. In the chart below, you'll see year to year changes in economic grow in the US (GDP) charted in black against each year's S&P 500 earnings yield (in purple). We simply divide the earnings per share for the market into its price to determine the market's yield. The two horizontal lines (they are on top of each other at 6.75%) are the average for each over the last fifty-four years. A valuable insight that can be gained from this exercise is that, on average, when market participants expect that the economy will grow at 10% they will only pay a price for stocks that will earn a 10% return, that is; ten times earnings. When the economy is growing at 5% they are OK with paying 20 times earnings for the S&P to net a 5% return (yield from earnings). What is a fair price for the market is simply and primarily determined by people's expectation for what is a fair estimate of growth for the whole economy. The realization that four to five percent overall economic growth is likely to persist into the foreseeable future eventually brings buyers to the conclusion that a four to five percent per year return from a broadly diversified portfolio of the largest companies in the country is a fair bargain.

"The realization that four to five percent overall economic growth is likely to persist into the foreseeable future eventually brings buyers to the conclusion that a four to five percent per year return from a broadly diversified portfolio of the largest companies in the country is a fair bargain."



GDP Growth and S&P 500 Earnings Yield

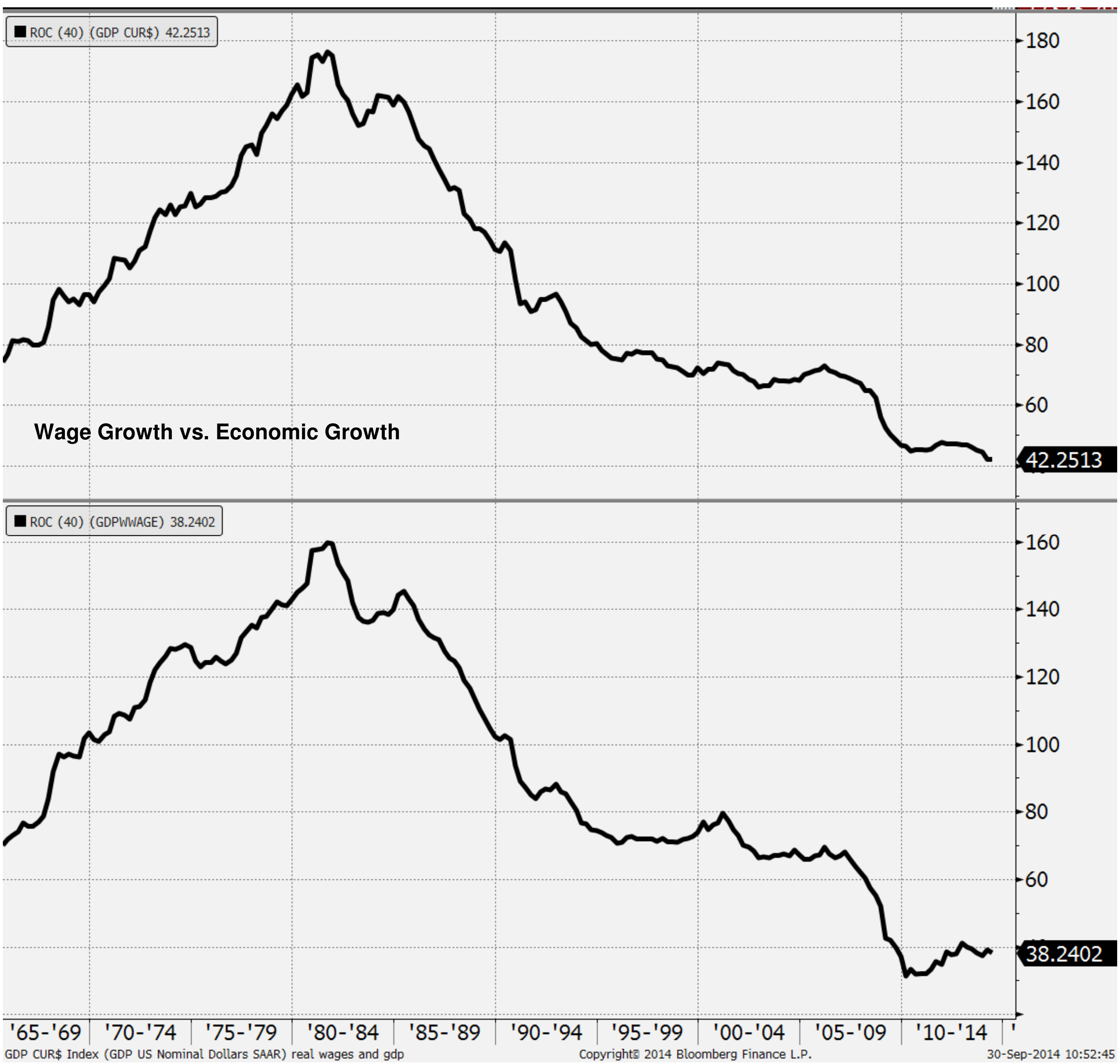


If fair price for the market is determined by the prospects for the overall economy, what rate of growth can we reasonably expect in the future?

Why has the rate of US economic growth fallen from 16% to 4% per year over the last three decades and can we expect that trend to continue?

I would argue that the major long term factors that have affected our economy for the last thirty years, that is; competition from newly industrialized, low labor cost countries; the loss of bargaining power for domestic wage earners and the deflationary pressure of over-production of industrial goods; all seem to be inexorably pushing domestic growth lower.

The chart below compares ten year wage growth with corresponding ten year GDP growth for the last fifty four years. Domestic spending is most of GDP and flat wages mean a flat economy. Any extra growth can only come from the offsetting effect of newly printed dollars that drive asset prices and wealth higher. The challenge is that increases in wealth don't get spent in anyway near as great a proportion as increases in income do. The perverse logic of the markets dictates that the very slow growth in wages we've been experiencing domestically is exactly the thing that has driven and will continue to drive the stock market to premium valuations (20 to 25 x's earnings).



Tom Lukic