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Sandpiper Capital

Gleanings

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

757-962-4596
Fax 757-962-5038

www.sandpiper-capital.com

As good as it gets…

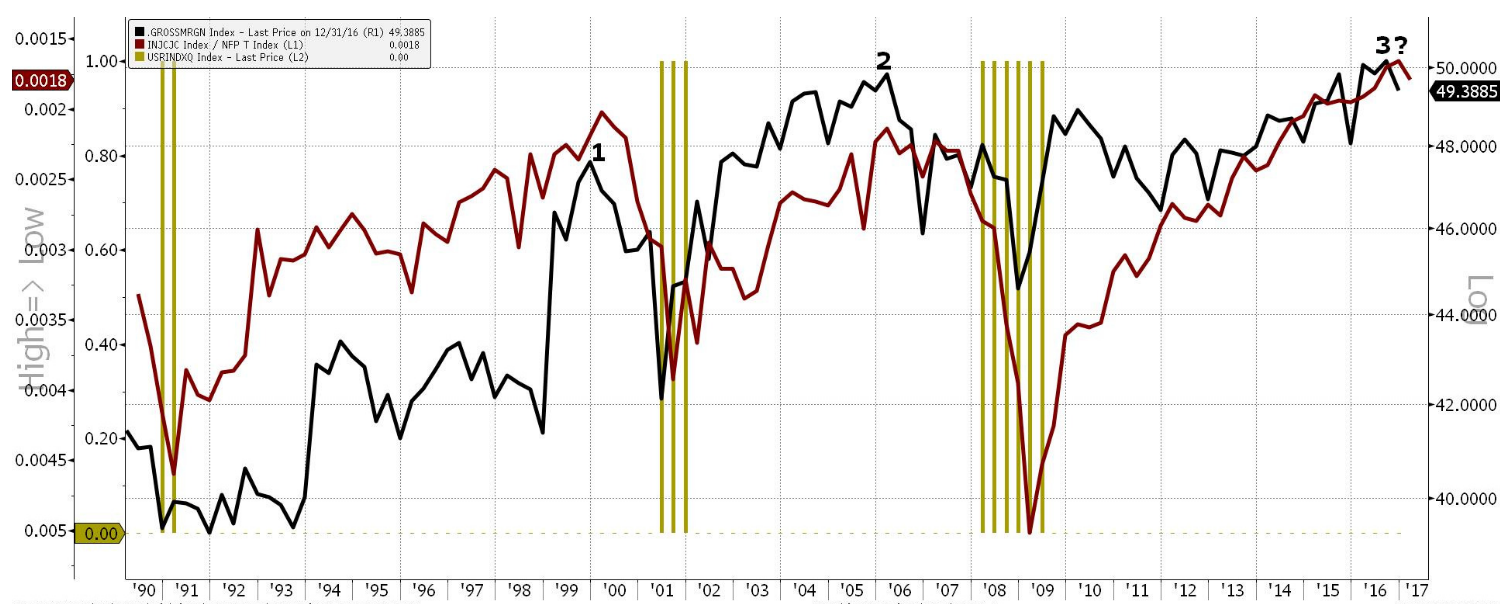
The benefits of global trade to multinational corporations have been immeasurable as not only have new markets opened up in which they can market their products, but also a world of potential suppliers have been clamoring for the opportunity to provide labor and material inputs for their production.

Market Returns Annually and Ten Years Ending 03/31/2017

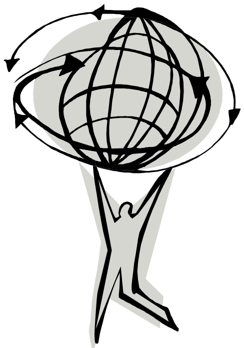
Index	2014	2015	2016	10 Yrs
S&P 500	13.7	1.4	11.9	**7.5%**
ML 1-5 yr Gov't/Corp	1.5	1.1	1.6	**1.9%**
EAFE (Dev Fgn Mkts)	-4.9	-.8	1.0	**1.1%**
Emerging Markets	-2.1	-14.8	11.5	**3.0%**

Old limits to sales have disappeared at the same time that costs have fallen. Not to say that cost control isn't a priority. We still have points in time when domestic labor costs are not as constrained as usual because the pool of the un- or under employed shrinks. In the chart below, the red line indicates initial claims for jobless benefits as a proportion of the workforce (inverted). The black line is the quarterly gross margin (what % profit they made after subtracting the cost of production) for an index of big multinational companies. You can see a reduction in costs over the last twenty-five years that has improved profit margins substantially. However, there are also episodes where profits pull back (the black line) as the jobless pool shrinks, (indicated by the peaks in the red line). When profits get constrained by labor costs, plants get closed, workers get furloughed and the red line drops again indicating more and more people out of work. It's not surprising that we then enter a recession (the yellow bars) in a year or two as households cut spending. It may well be that margins didn't peak last September, but we will be watching both profits and claims very closely over the coming months to see.

> "When profits get constrained by labor costs, plants get closed, workers get furloughed and the red line drops again indicating more and more people out of work."



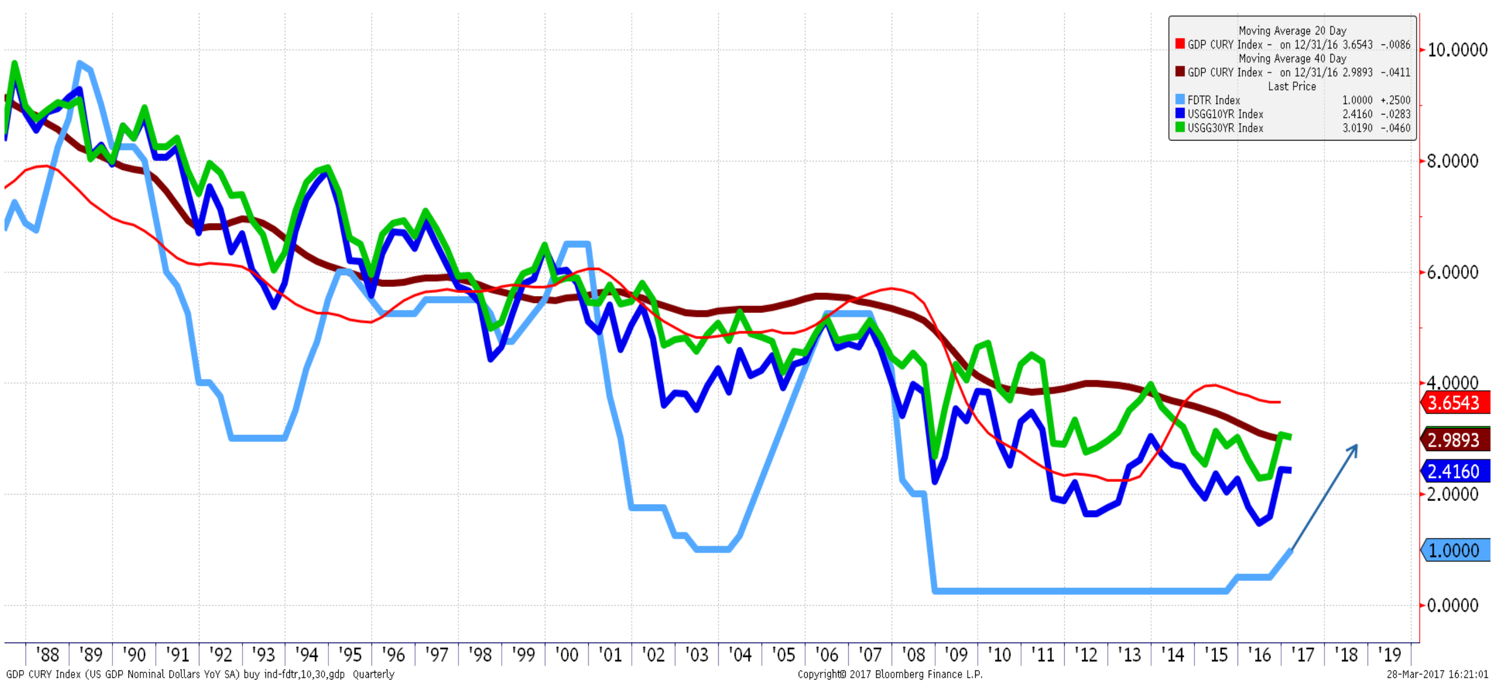
An economy approaching peak levels means higher short term interest rates.



While it has certainly been a shallow recovery by most measures, it has also been a long one, now into its eighth year. With improving consumer demand, the really low rates of the last few years have started to disappear. Higher rates will dampen economic growth however, with the Federal Reserve ready to stop the increases as soon as they see signs of moderating growth.

In the chart below, you can see rates following the economy. The brown GDP line is a ten year trend. The red is the five year GDP trend. When recent growth exceeds trend, (the red crosses up over the brown) the Federal Reserve raises short term bank rates, (in light blue) right up to and sometimes though that trendline growth. This will slow the economy as the cost of money is now greater than the economic return on investment. Ten year and thirty year rates will generally hover at the same level as short term rates until the economy slows sufficiently for the Fed to start dropping their target rate again. Looking out to next year, a good guess is that everything converges at a little under 3% - a big change for certificates of deposit and adjustable rate mortgages but not that different for thirty year bonds or mortgages.

The challenge for the Fed is to accurately discern whether the recent pickup in consumer spending represents a favorable change in households' economic prospects or people are just catching up on purchases that they've deferred for the last eight years. While employment has recovered substantially, wages have not as part time employees have replaced full time and service jobs have replaced manufacturing. Permanent upticks in spending (and more than a moderate number of rate hikes) may not be in the cards.



Tom Lukic