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Sandpiper Capital

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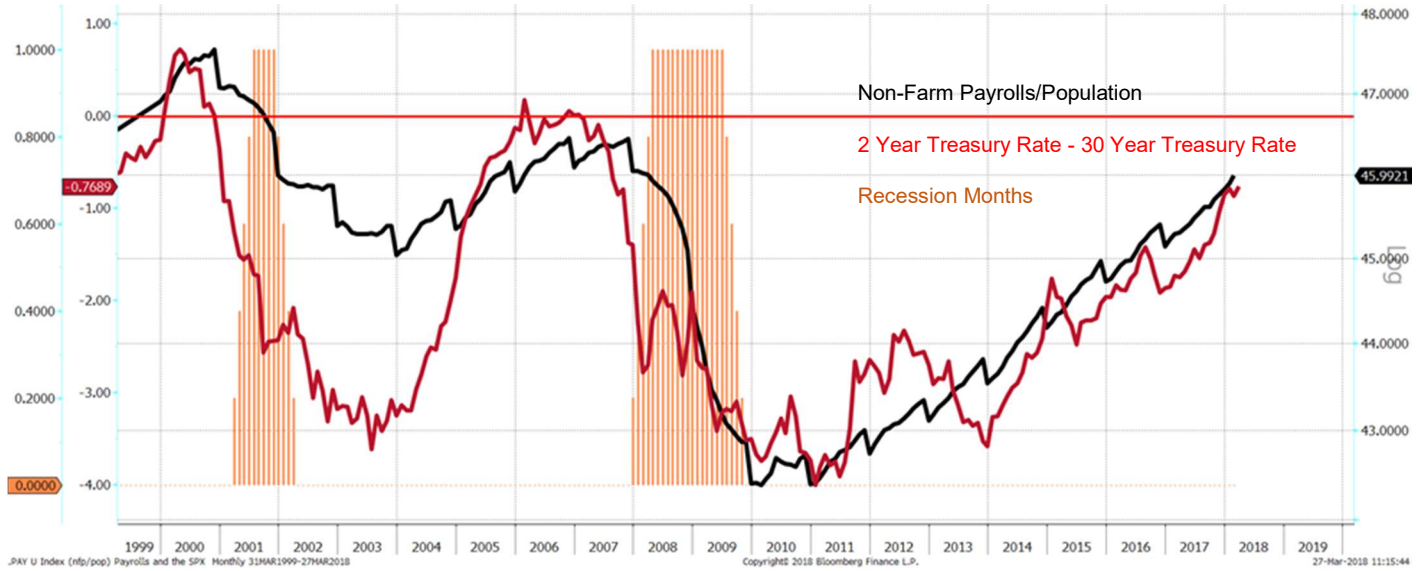
Beginning of the end?

It's not like there is some law of nature that says that the economy has to contract periodically. Certainly with the service sector twice as large as the industrial sector, you would expect more stability than there was in the past. We do see recessions routinely though and most of that is attributable to what the Federal Reserve defines as its "dual mandate". That is; to maintain price stability as well as full employment. The conflict in these two objectives arises because, while they cite the Personal Consumption Price Index as the barometer that defines price stability, they operate as if wage stability were the primary goal. Every time that we do approach full employment, (the black line in the chart below), the Federal Reserve raises interest rates (the red line). Full employment is only a priority until wage costs rise. Most recessions in developed economies are caused by interest rates being increased by central banks to the point of restricting economic growth. The resulting months and often years of consolidation accomplishes the central banks' goal of stemming wage inflation through layoffs, plant closings, mergers and reductions in force. The fact that, in a recession, companies can buy in their stock cheaply, acquire competitors' businesses at a discount and reprice the executives' stock options to the new low prices are just bonuses to the cycle.

Market Returns

Index	2015	2016	2017
S&P 500	1.4	11.9	21.8
ML 1-5 yr Gov't/Corp	1.1	1.6	1.3
EAFE (Dev Fgn Mkts)	-0.8	1.0	25.1
Emerging Markets	-14.8	11.5	35.8

In the chart below, you can see by the way that the red line is steadily approaching the point, indicated by the horizontal line, where the cost of money exceeds the underlying growth rate of the economy, that with three more 25 basis point increases projected over the next four quarters, early 2019 will likely see that inflection point. Much of the volatility in the stock market has that eventuality in mind. The tax stimulus and synchronized global growth that have been fueling the stock market thus far has hit a determined Federal Reserve head on, stalling any further progress unless or until we can see a change in Fed policy. Is further tightening inevitable? The employment line below is calculated as the proportion of the population that has a job. What it doesn't show is the nature of that job. In 2018, a much greater proportion of employment is non-union, part time and increasingly reflects one worker holding down multiple jobs. This may explain why, despite the growth in the overall payroll numbers, to date wage growth has only reached 2.5% per year compared to 3.6% in 2007. If tax policy and global economic growth raise corporate earnings without raising the cost of labor, the Federal Reserve might stay their hand.



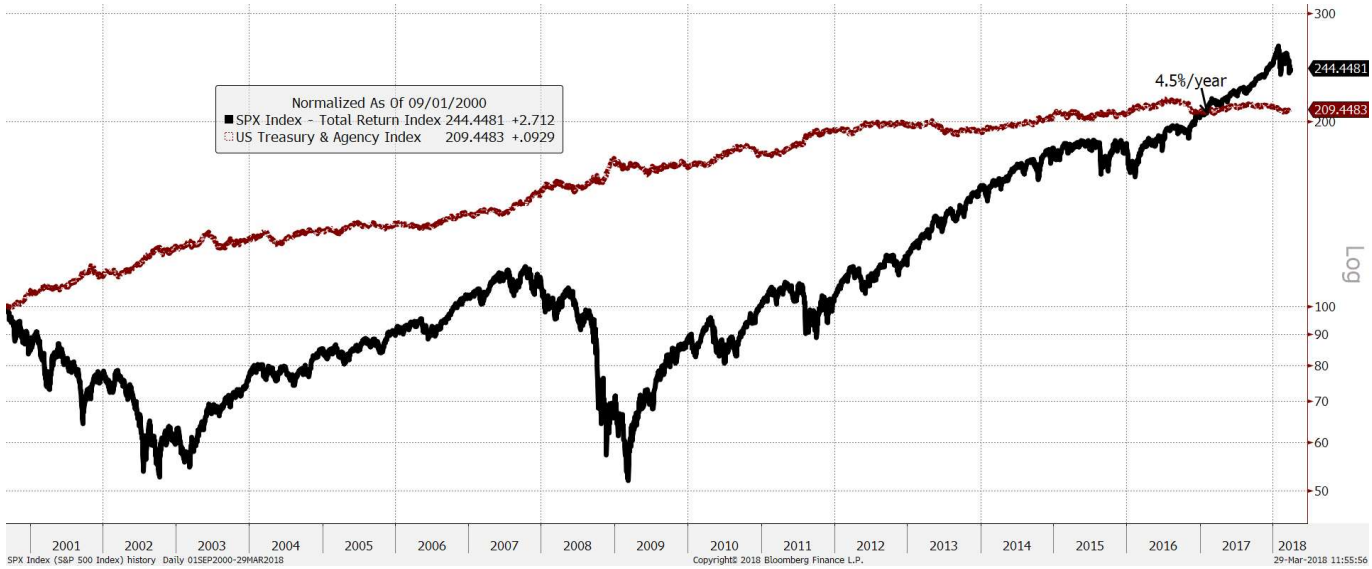
With the average stock market drop over the last seven recessions of 33% (requiring an up 50% to break even); let's just say it's really important to dodge them when you can. Those who stuck with their S&P index fund in March of 2000 waited seventeen years to catch up to where they would have been had they switched to government bonds. The flip side of that equation is the potential for outsize returns to those who invest in the stock market *during* recessions. Typically, you'll see from the table to the right, credit markets peak first, then the stock market, then the economy. This cycle credit peaked in December of 2017. If the labor cycle theory of recessions holds true then, looking at the bottom chart, you will see that **jobless claims** hit their low (it's an inverted scale), then the **jobs plentiful survey** peaks, followed pretty quickly by **the stock market**. We won't know until they decline, but so far we may not have yet seen either of these labor indicators make the top that's associated with a change in the cycle. When they do, we will dramatically cut your exposure to the stock market.

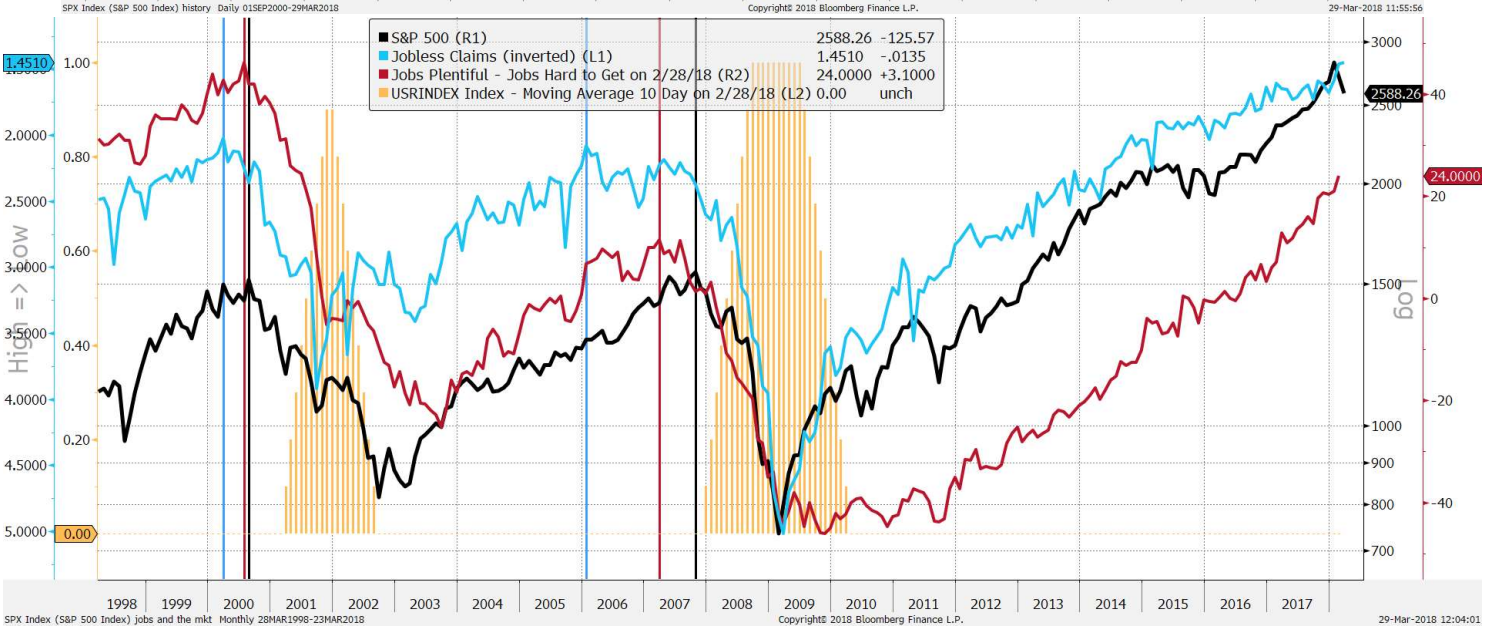
US Economic, Equity & Credit Cycles Surrounding Seven US Recessions in the Past Fifty Years

Economy*	Equities**	Credit***
Dec-69 (3)	Nov-68 (2)	Oct-68 (1)
Nov-73 (3)	Jan-73 (1)	Jan-73 (1)
Jan-80 (2)	Feb-80 (3)	Sep-77 (1)
Jul-81 (3)	Nov-80 (2)	Jul-80 (1)
Jul-90 (3)	Jul-90 (2)	Aug-89 (1)
Mar-01 (3)	Mar-00 (2)	Oct-98 (1)
Dec-07 (3)	Oct-07 (2)	Dec-06 (1)
		Dec-17 (1)

*Recession Start **S&P 500 High ***Baa Corporate Bond Yield Low

Capital Economics - Global Markets March 2018





Tom Lukic