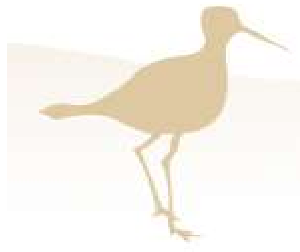
January 2018
Volume 10, Issue 2

Sandpiper Capital

Gleanings



500 E Plume St. #109
Norfolk, VA 23510

Phone 757-962-4596
Fax 757-962-5038

www.sandpiper-capital.com

"Assuming that we were fairly value in 2007, we are still fairly valued now."

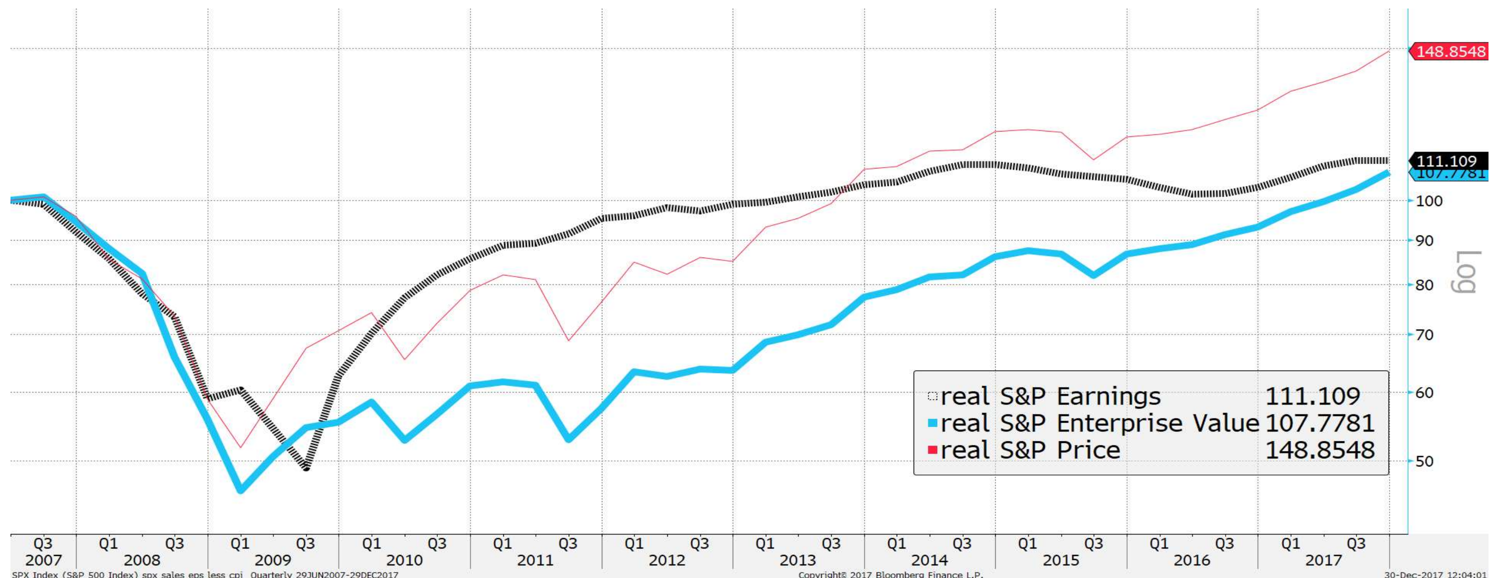
More of the same…

Euphoria over deregulation and corporate tax cuts has lifted the stock indexes to new highs as investors act upon their fears of missing out on this new era of corporate prosperity. Reduced tax and regulatory expense will mean more money for capital investment and the resultant boost in productivity will improve net profit margins.

Market Returns Annually and Ten Years Ending 12/31/2017

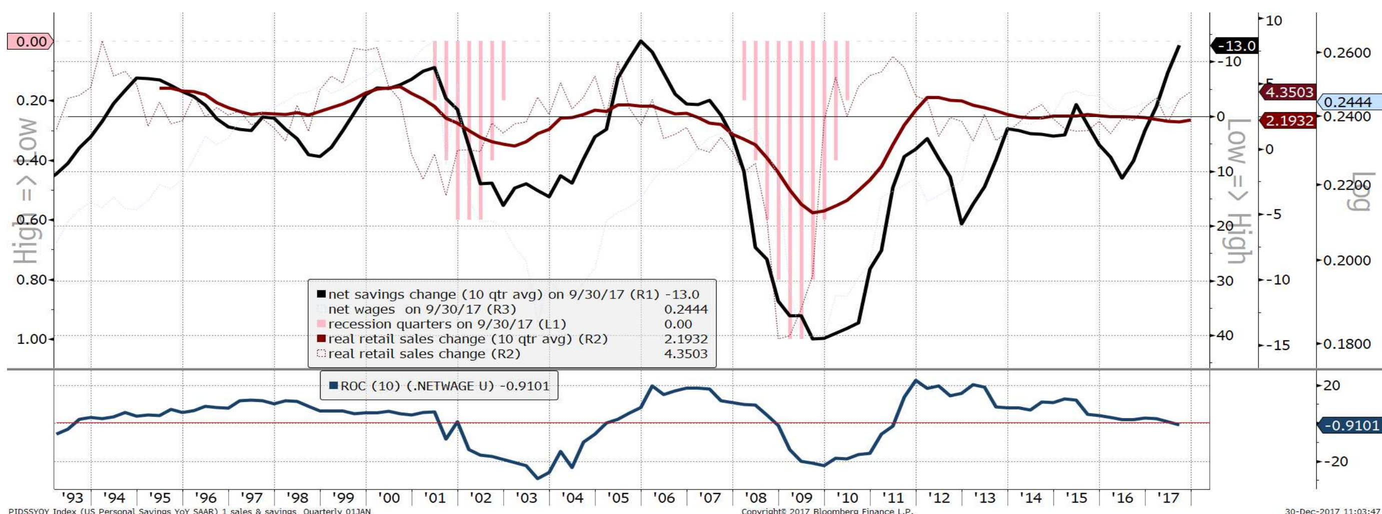
Index	2015	2016	2017	10 Yrs
S&P 500	1.4	11.9	21.8	**8.4%**
ML 1-5 yr Gov't/Corp	1.1	1.6	1.3	**2.5%**
EAFE (Dev Fgn Mkts)	-0.8	1.0	25.1	**1.9%**
Emerging Markets	-14.8	11.5	35.8	**2.0%**

No argument here… The events of 2017 are just a continuation of the trend of the last thirty plus years and there is plenty of evidence that we should expect to see new records in profitability in years to come. The question is then, how much of this is already reflected in the market's higher valuation? The chart below illustrates the relative real (before inflation) changes since the last economic peak ten years ago. While the price of the S&P has gone up 49% as its earnings have grown 11%, when you look at acquisition or enterprise value, which adjusts for the changes in debt outstanding and increase in cash on the balance sheet of the 500 constituent companies, the resulting value has only increased by 8%. Assuming that we were fairly valued in 2007, we are still fairly valued now.

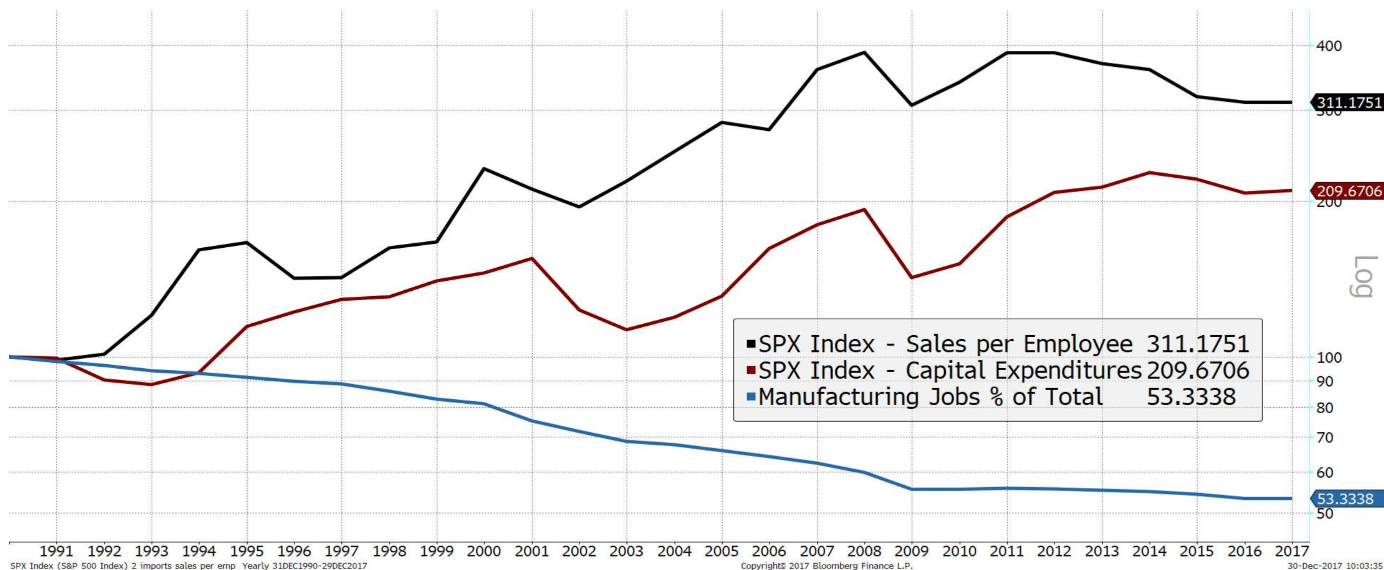


If we are fairly valued, is there still money to be made? The improvement in corporate taxes will, by definition, raise after-tax margins. Combined with lower regulatory expense, we may well see 11% net margins versus the historic peak level of 10%, lifting earnings to about $132 from $120 currently. Going forward, however that new level of profitability will be applied against sales that have been growing at less than 4%/year since 1990 and that are essentially flat since the last economic peak. As has been the case historically future S&P sales will grow at about the same pace as the US economy. The dilemma for earnings is that wage growth =economic growth = sales growth. While there has been a recent uptick in real retail sales (light red - up 4.35% over last year at this time), looking at the chart that follows on the reverse, you'll see that it has been fueled by consumers spending down savings (black) in a clearly unsustainable way.

The longer term trend in sales (red) has followed the long term trend in wages (blue) which have been steadily declining since 2012, as labor costs have stayed subdued in spite of the recovery. I don't see any reason for that to change. Four percent sales growth x's 11% margins still equals 4 percent earnings growth and only for so long as peak stays at peak.



What about the potential for an increase in capital spending that will fuel productivity and wage increases? Well, there *is* a relationship between capital spending and wages but it goes the other way. Indexed to 1990, the chart below shows sales per employee going up, as you might expect, whenever capital spending does. The benefit hasn't accrued to the now more productive employees however, as the best paid workers become subject to layoffs. The number of manufacturing jobs as a proportion of all jobs has been cut in half since 1990. Anecdotal evidence and recent studies have suggested that automation will increasingly affect service workers as well. From automated sushi and salad making machines to self-driving tractor trailers, future productivity related reductions in force may well eliminate a quarter to a third of all jobs in the next few decades. Regulatory reductions that reduce corporate overhead may negatively affect economic growth as well. The social cost of less regulated industries is passed on to the broader economy as increases in malfeasance, environmental hazards, negative outcomes in employee health and welfare and a host of other potential unintended consequences are absorbed and discharged, reducing capital available that could be more productively employed (training and education for example).



Tom Lukic