October 2018
Volume 11, Issue 1

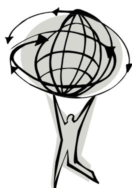
Sandpiper Capital

Gleanings

500 E. Plume St #109
Norfolk, VA 23510
(757) 512-6933

www.sandpiper-capital.com

"Eventually we get to the point where the interest cost gets unsupportable and spending (and wages) quickly drop. Looking at expected rate hikes, I get the sense that we are about a year away from the point where they become a problem."

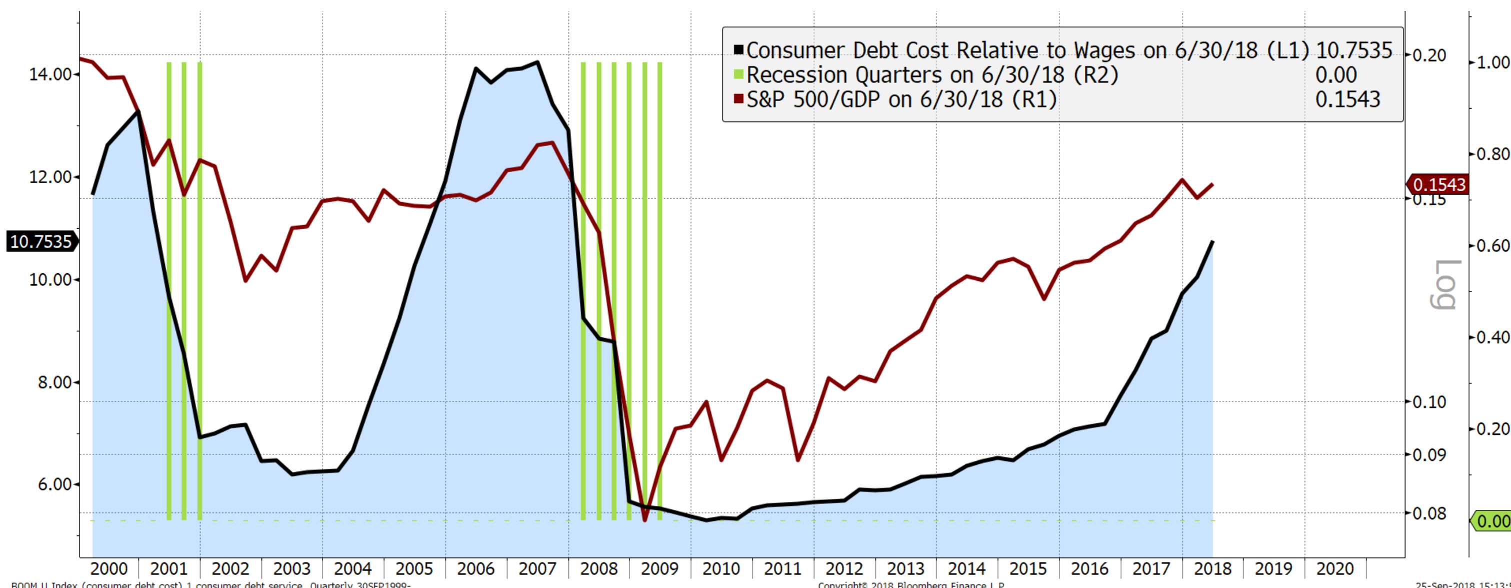


Market Returns Annually and Year to Date

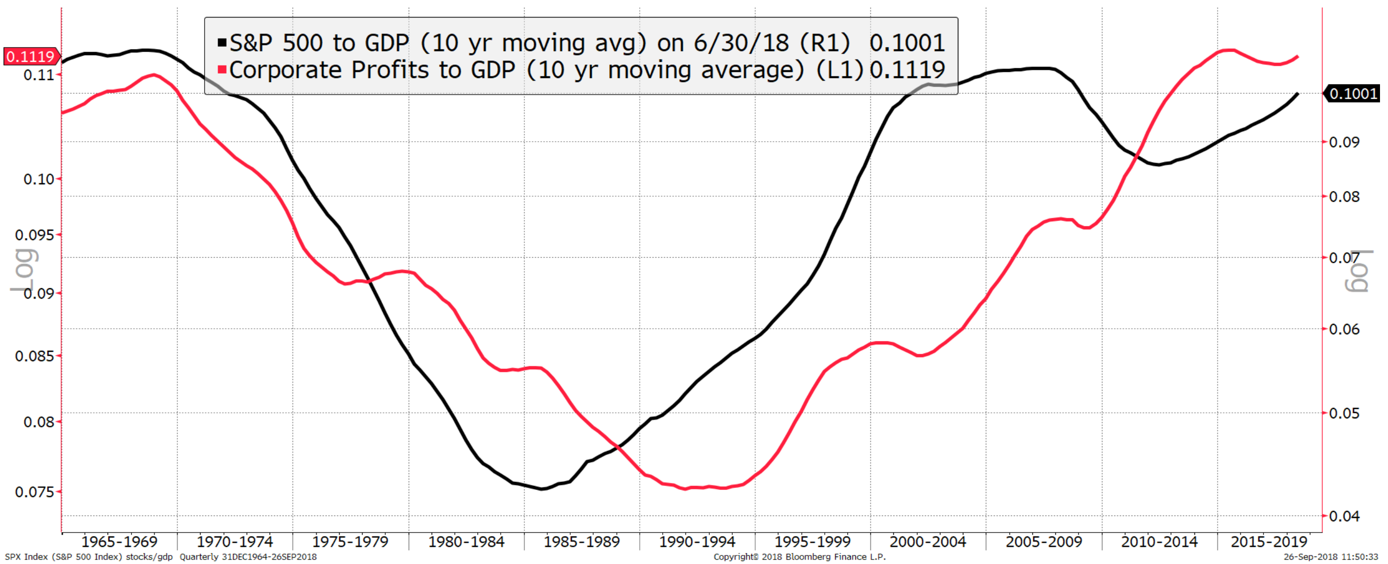
Index	2015	2016	2017	YTD
S&P 500	1.4	11.9	21.8	**10.6%**
ML 1-5 yr Gov't/Corp	1.1	1.6	1.3	**-.0%**
EAFE (Dev Fgn Mkts)	-.8	1.0	25.1	**-1.4%**
Emerging Markets	-14.8	11.5	35.8	**-7.5%**

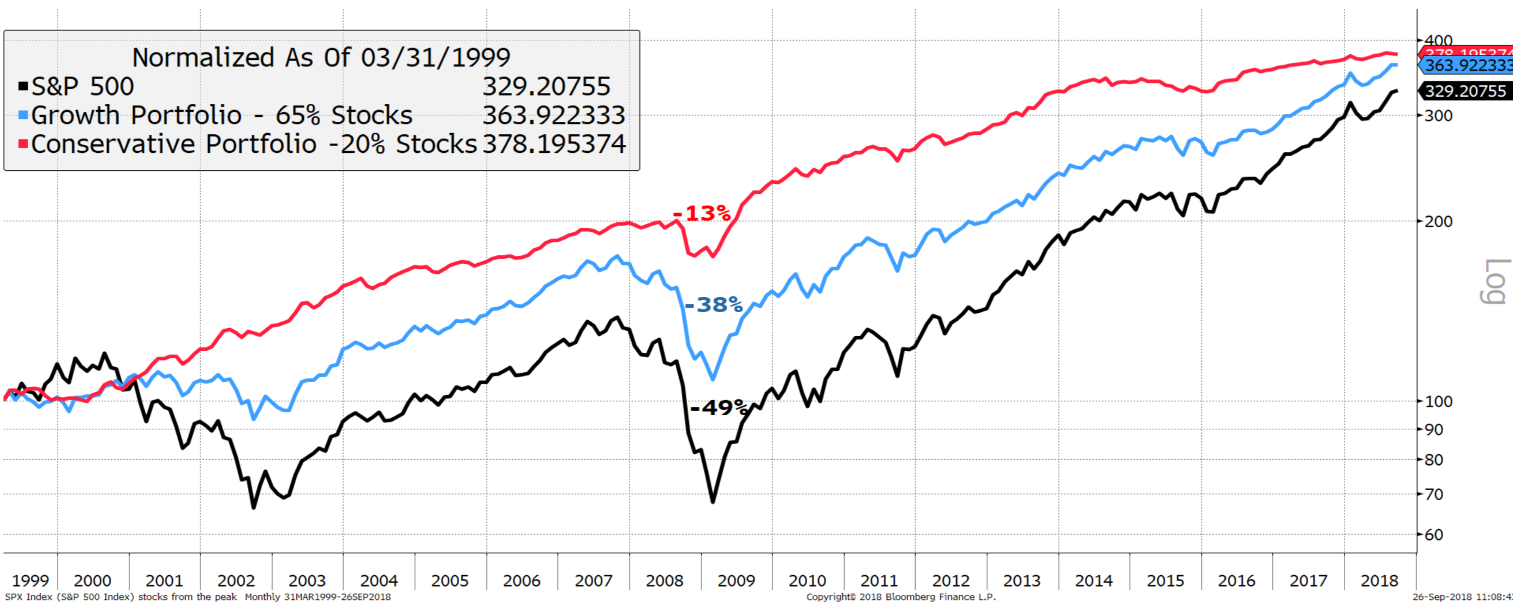
Debt, Wages and the Market

One of the consequences of the low interest rate regimen of the last twenty years is that when there's confidence in the future, people (and businesses) will borrow more than they otherwise would. If your house or your business is growing at 6%, then why not get a bigger house or more business assets if you can borrow at 4%. That optimistic attitude will fuel overall economic growth and that, of course, is the plan. We *have* been benefiting from low interest rates since 2009, with wage growth and therefore, economic growth, starting to rise as we've seen improving optimism. While the link isn't one to one, that is, wages and sales won't grow as fast as businesses do because a greater percent of that growth goes to executive pay and corporate profits, nonetheless, wages and the willingness of businesses to increase them have been growing. There are obvious limits to a debt fueled strategy however, as optimism can be pretty ephemeral, especially when loans start getting more expensive. That's where we are now, with the Federal Reserve attempting to slow debt growth by raising borrowing costs. We've seen the prime rate rise two percent already and that pace is expected to continue as borrowing has shown no signs yet of slowing. I've illustrated the dilemma this presents in the chart below. The black line is the proportion of wages that is going to paying the interest on consumer debt. The green bars indicate when we're in a recession. The red line is the "Buffett Indicator" – the value of the 500 companies in the S&P index as a percentage of the economy. As the economy grows after a recession, so does debt. Eventually we get to the point where the interest cost becomes unsupportable and spending (and wages) quickly drop. Looking at expected rate hikes, I get the sense that we are about a year away from the point where higher rates become a problem. We're not there yet, but with the stock market approaching the peak values that it hit in 2000 and 2007, there is certainly more downside risk in the next couple of years (-50%) than upside potential (+10 to 20%).



While one can certainly argue for having 100% of your portfolio in stocks in the depths of a recession when prices are depressed, (and looking back, I wish I had been that brave), after a long recovery, when prices are at their peaks, there's an equally persuasive argument for owning no stocks at all. I don't follow either of those precepts in practice however because predicting the exact timing of these turns is problematic at best, impossible is more like it. I lost more accounts and had more unhappy clients in 1999 than anytime since because I sold too early, never believing that the market could continue to go up. And if you look back at the 2009 editions of this market commentary, I had plenty of sound (but, as it turned out invalid) reasons to wait before going back into the market. Fortunately, you – my clients- are pretty understanding as well as sharing my aversion to losses. So, in practice I like to have enough in stocks to enhance the steady bond returns, but not so much that the inevitable drops on the market will hurt. We have been in a great bull market for stocks since 1981. But in spite of the fact that we are valuing the stock market at close to the highest level in fifty years – see the black line on the chart immediately below - and in spite of the fact that corporate profits' share of the economy are also at a fifty year high (the red line), buying at a premium valuation at the top of an economic cycle has still been a losing proposition. In the chart at the bottom, there's a total return history of three different investment portfolios going back to about a year before the market top in 2000. This is arguably about equivalent to where we are now, within a year of the top of this economic and market cycle and with valuations at highs. While those 100% invested in an S&P index fund had a lower return (equivalent to 6.25%/year) than those on the Conservative portfolio (7%/year), they suffered through some pretty heart-wrenching declines. If we begin a political cycle less friendly to profits, the next twenty years will be much worse.





Tom Lukic