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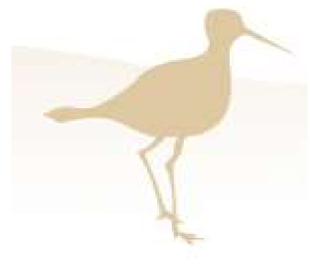
Sandpiper Capital

Gleanings



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

www.sandpiper-capital.com

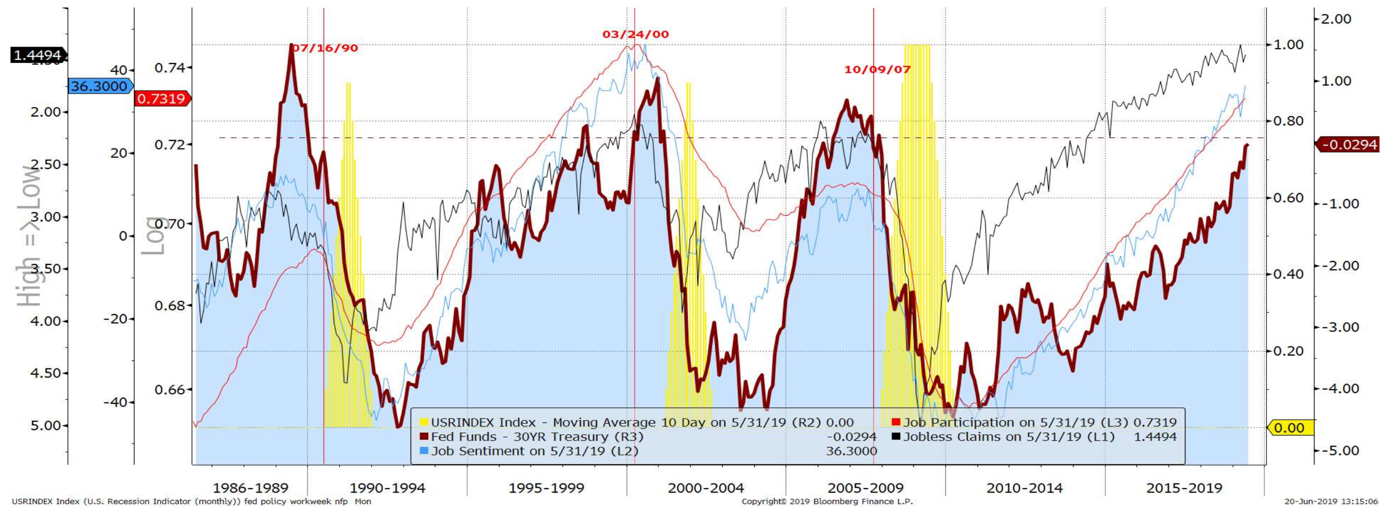
"There are currently fewer full time jobs per household than there were at the bottom of the last two recessions."

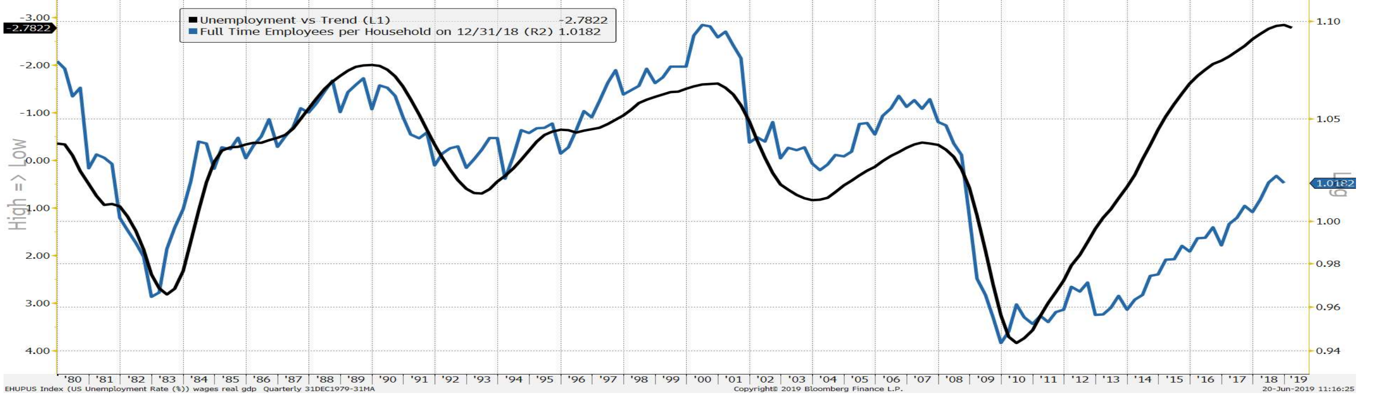
Market Returns Annually

Index	2016	2017	2018	YTD
S&P 500	11.9	21.8	-4.4	**18.5%**
ML 1-5 yr Gov't/Corp	1.6	.4	1.2	**3.6%**
EAFE (Dev Fgn Mkts)	1.0	25.1	-13.8	**14%**
Emerging Markets	11.8	37.9	-14.5	**10.7%**

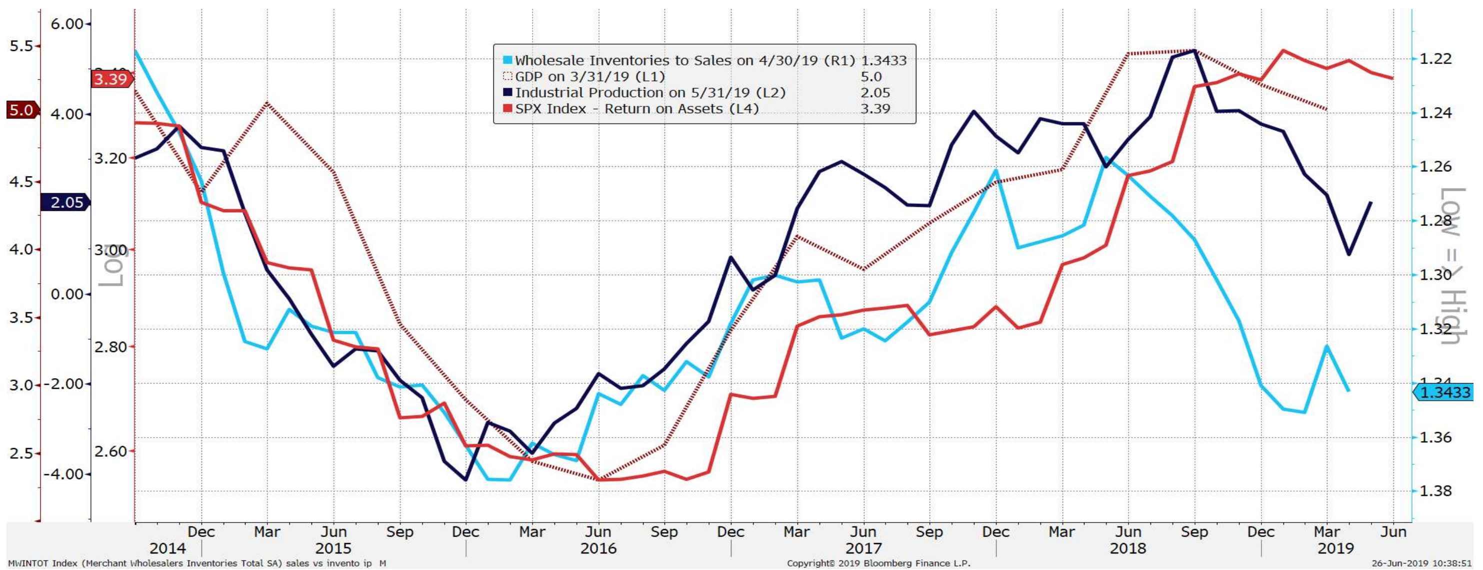
This time it's different….

The stock market has been having a tough time making any progress over the last 18 months, with profit margins lower and sales up just 3.5% from the post-tax cut levels of Spring 2018. One could certainly argue that higher short term rates have had their intended effect of slowing the economy marking a peak in valuations similar to the peaks seen in 2007 and 2000. That is certainly the result that I was expecting, at least until the Federal Reserve started signaling that the next rate change would be a cut. The two graphs immediately below help explain that policy shift, however, with the top chart showing the Fed raising rates (in red) whenever the job market approached peaks so as to head off wage inflation. The past three episodes cured the tight labor markets by bringing on recessions (whose onsets were predicted by peaks in the stock market on the dates indicated). Seen in a different light in the next chart that tracks unemployment (black line) as well as the number of full time jobs per household (blue line), you can see that in spite of record low official unemployment readings, there are currently fewer full time jobs per household than there were at the *bottom* of the last two recessions. No wonder they're not worried about wages. If you consider employment costs as the enemy of profitability, you might say that war to keep them suppressed has been won.

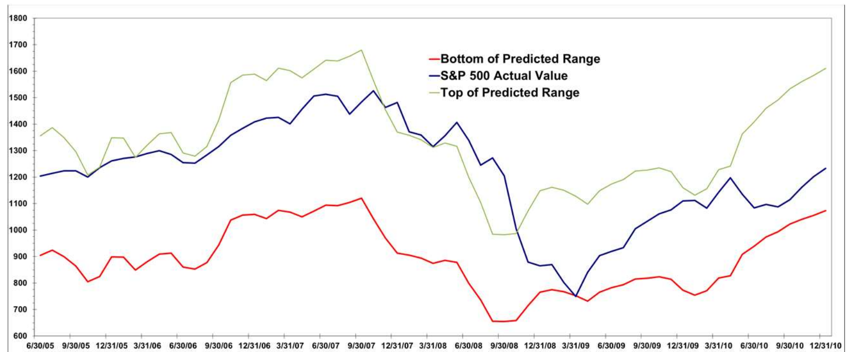


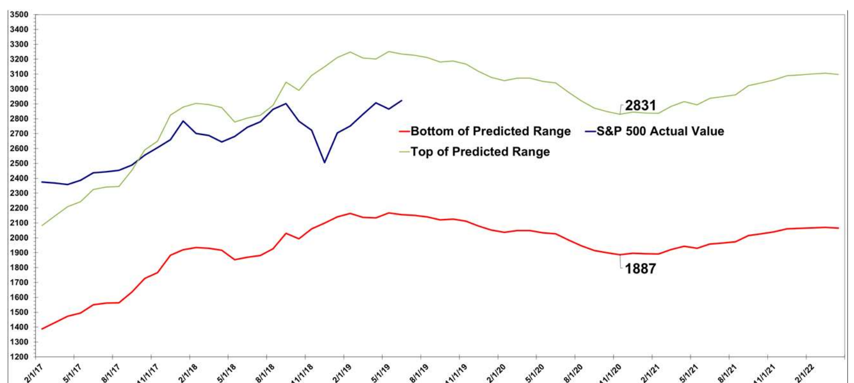


So, conceivably, we may well avoid a recession this time around because the Federal Reserve will reduce rates as it sees that wage inflation is not going to be a problem. If no recession, what then? What's that imply for the stock market? Inevitably, if you have low wage growth then you have low sales growth and tariffs on Chinese goods will only reduce consumption more. We can see that already in rising wholesale inventory levels (blue line, inverted). The resulting drop in industrial production generally suggests a coming drop in GDP growth as well as S&P profitability. That doesn't mean that profits will disappear. They just are likely to contract for a while. Interest rates at a little over 2.5% on long term Treasuries already reflect that likelihood, with the implication that we might find ourselves in a very low economic growth environment for many years to come. If wage inflation and interest rates stay low as expected, the stock market might see higher values yet even if it doesn't see higher earnings. The earnings yield that stock market participants require, that is, earnings divided by price, ought to fall as well, possibly extending this bull market quite a bit farther out into the future.



What are the risks? I've entered a mild earnings recession that's consistent with the current environment into our valuation model and you can see the expected range for the S&P 500 in the lower of the two charts to the right. In this model, we have only two inputs; earnings and inflation. If we avoid a recession, we would normally expect to see the market trading between the red and green lines, hitting the lows when market participants are pessimistic (afraid) and the highs when they're optimistic (greedy). That implies a trading range of about 1900 to 2800. If we do get a recession, the range will drop in a similar way to what we saw in 2009, with the model showing a drop in fair value first, closely followed by actual traded prices. Anything to the right of June 2019 in the chart is just where I have entered my best current guess as to future earnings and inflation. I think it's helpful to know the likely range. I update the numbers as soon as they're available. Let's hope my guesses are close.





Tom Lukic