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Sandpiper Capital

Gleanings

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"If labor costs are a problem, then we are certainly close to the point where you'd see that start to come into the market's focus."

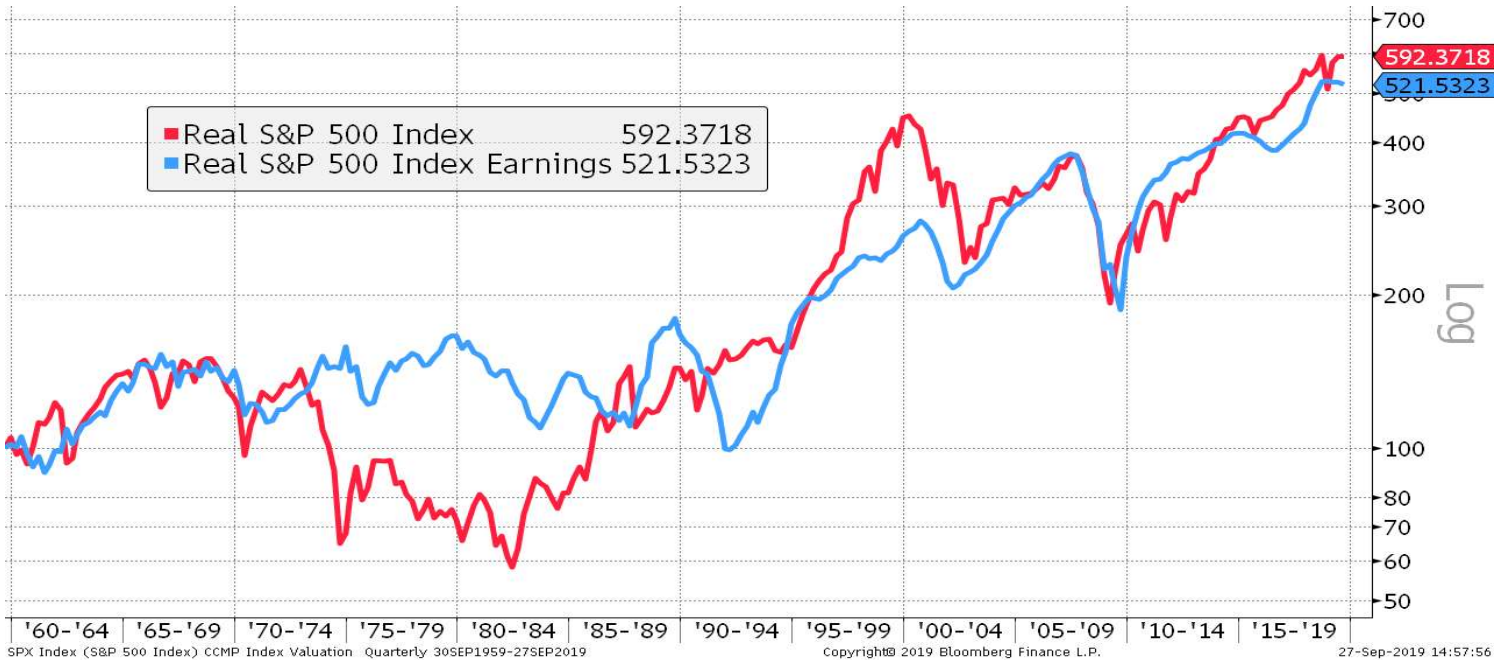
Time to conserve your capital

You'll notice in your portfolio review for this quarter that I have substantially cut the proportion of your investments in stocks in favor of bonds and/or bond funds. "Don't fully invested stock portfolios always outperform?" you ask. Why no, no they don't. The cost of being out of the market is largely born by the commissioned sales part of the industry who would rather you stay in at all times. There is considerable marketing effort put into convincing you that the risk of missing returns by not being fully invested in stocks at all times outweighs the savings to be had by avoiding down markets. Umm, try that argument on anyone who had been a long term buy and hold investor when I started my career in 1981. The seasoned stock brokers working at the time might have laughed at that notion as the real value of the S&P was down 50% from twelve years previously and unchanged after twenty five years. Not coincidently, labor cost inflation had been five times higher in the 70's than it was previously (7% vs 1.3%). It wasn't until consistent regulatory and political effort brought labor costs down that corporate earnings and the market took off. The battle to control wages continues to be fought periodically, every time (like now) that low unemployment increases workers bargaining power. Layoffs, offshoring and plant closings work well for that but also mean recessions and periodic *significant* bear markets.

In the chart below, you can see a sixty year history of the real (inflation adjusted) S&P 500's price and earnings, normalized to a value of 100. You can see the long bear market of the 70's culminating in an eventual loss of 40% in 1982. No wonder the investment industry was a small fraction of its current size back then. Who wanted stocks?

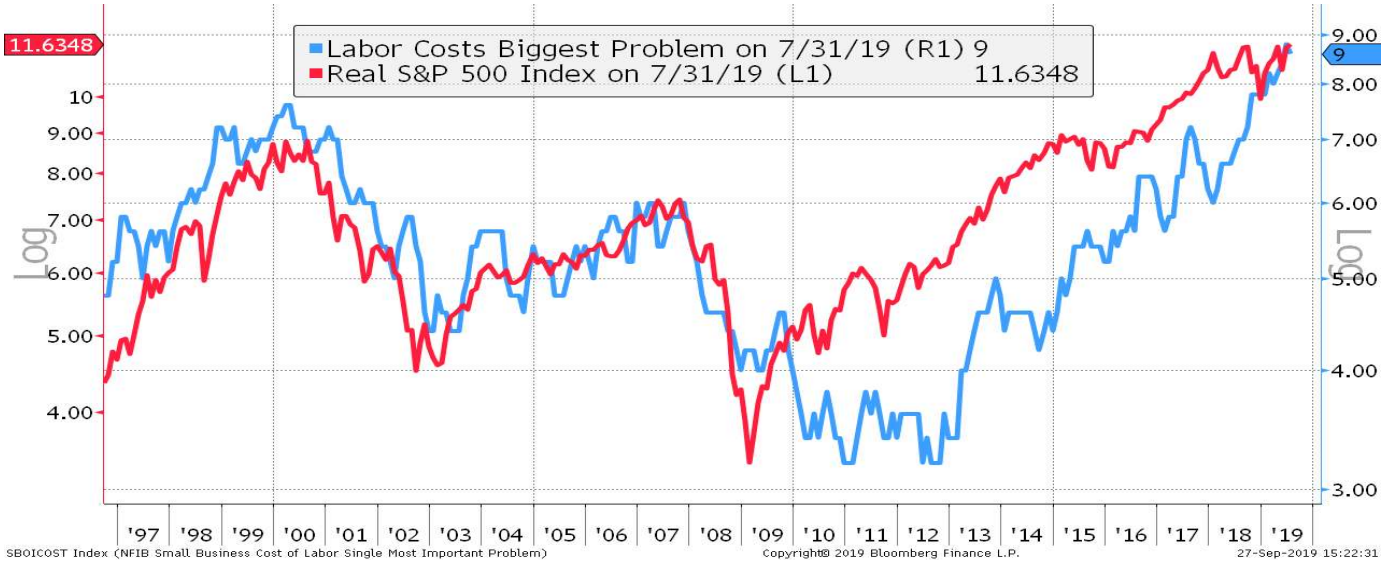
Market Returns Annually

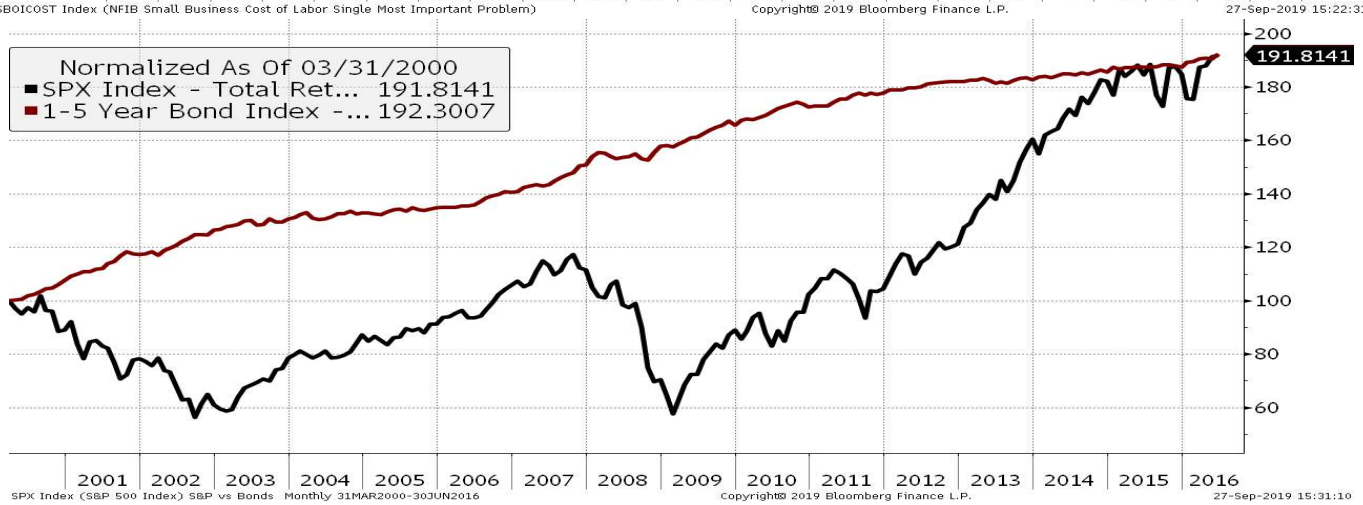
Index	2016	2017	2018	YTD
S&P 500	11.9	21.8	-4.4	**20.6%**
ML 1-5 yr Gov't/Corp	1.6	.4	1.2	**4.5%**
EAFE (Dev Fgn Mkts)	1.0	25.1	-13.8	**12.8%**
Emerging Markets	11.8	37.9	-14.5	**6.1%**

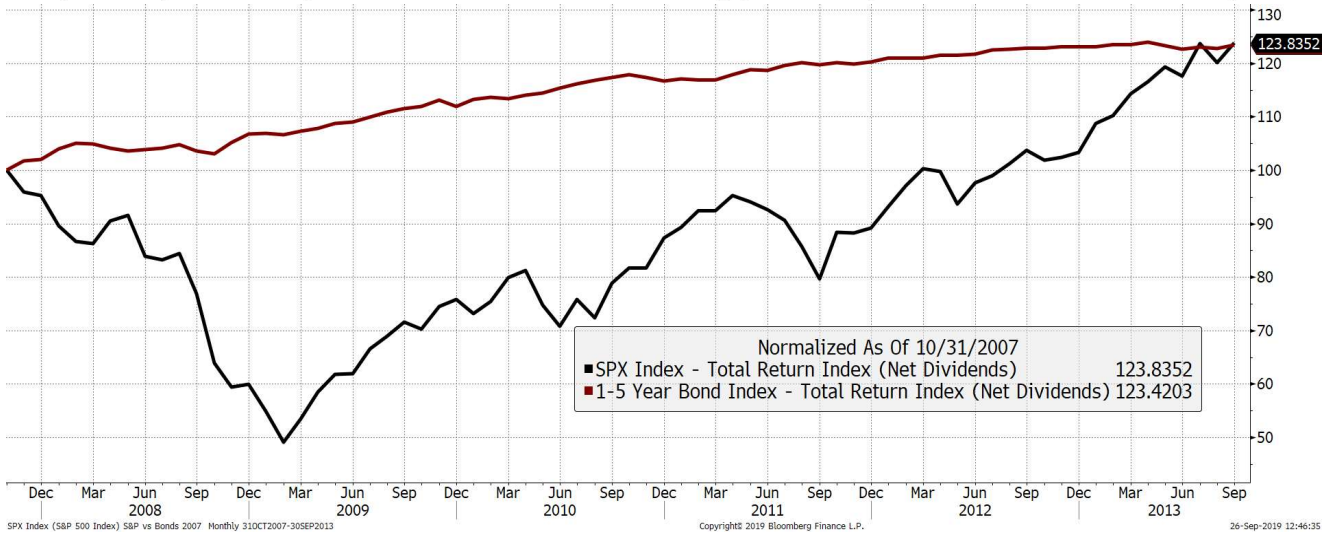


If labor costs *are* a problem, then we are certainly close to the point where you'd see that start to come into the market's focus. In the small business survey that asks that same question, more respondents said yes than at any time in the survey's history. All problems are relative of course, but switching to bonds at similar times in the past avoided the negative 40 to 50% returns that were to come, with bond returns outpacing the total return of the stock market for as many as sixteen years hence. Fully invested in stocks at labor market peaks has in previous periods been a really grievous error.

In the graph immediately below, you'll note that peaks in the labor cost survey coincided with peaks in the market. Investors that moved to bonds at past peaks outperformed those in **stocks** for many years while avoiding painful losses.







Tom Lukic