**Sandpiper Capital**

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# Gleanings

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*"What's driving the change in valuations over the past thirty years are three secular trends that have produced dramatic benefits to corporate profits; falling inflation, falling labor costs and falling taxes."*

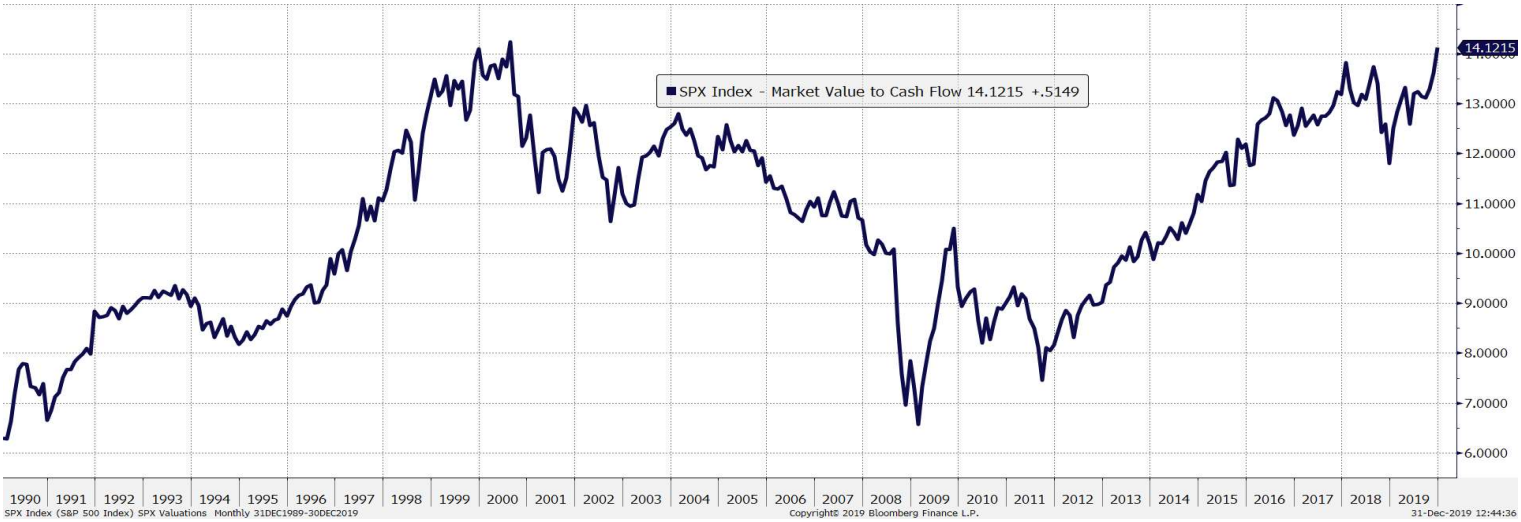
## 2020 Hindsight

For those of us who have been investors over the last couple of decades or so, economic cycles - the periodic contractions in the economy and the markets - have been an over-riding concern in our thoughts about potential future stock returns. But on the twentieth anniversary of this century's start, I thought it would be useful to look back at the long term *secular* trends - those long term underlying factors - that have moved the markets to the levels at which we currently find them; that is, richly valued.

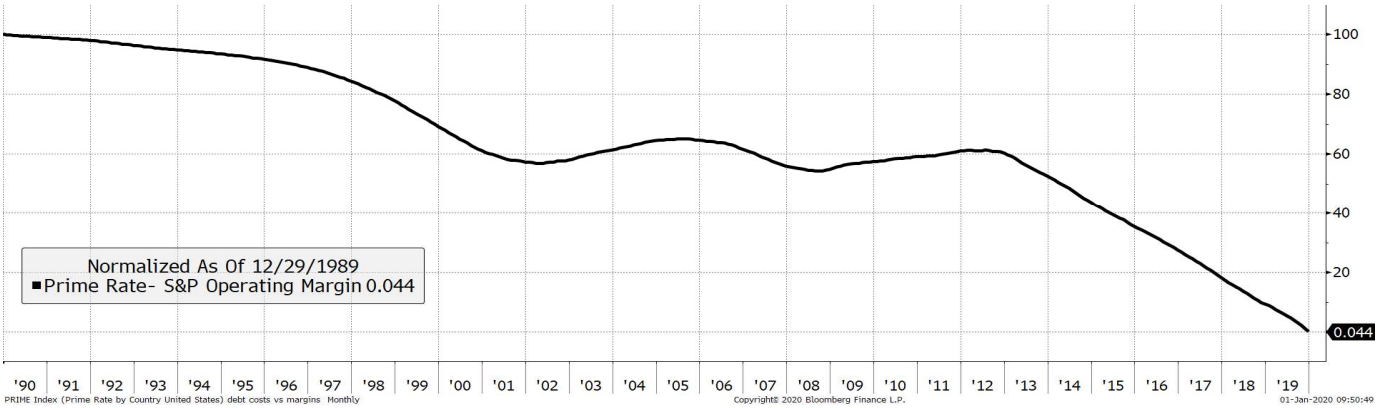
So first, let's define "richly valued". In the chart below, you'll see a history of the S&P's valuation over the last thirty years. It's the ratio of the market value of the companies in the S&P 500, (both their stocks and bonds less cash, i.e.; "enterprise value") to their cumulative cash flows. The current valuation was only exceeded once in the last thirty years and then only by a fraction. Compared to the thirty years ago, the S&P is more than twice as expensive now. So, what has changed? In the second chart below, you'll see the S&P price graphed relative to S&P sales. While sales have trebled, a 3.8% annual increase, the market in the meantime is up 936% or 7.8% per year. So, what else has is different?

**Market Returns Annually**

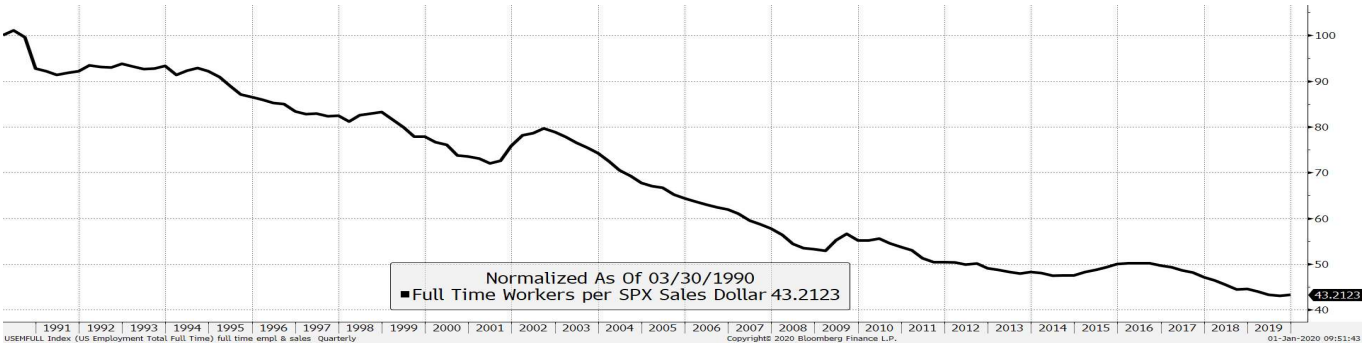
| Index | 2016 | 2017 | 2018 | YTD |
|---|---|---|---|---|
| S&P 500 | 11.9 | 21.8 | -4.4 | 31.5% |
| ML 1-5 yr Gov't/Corp | 1.6 | .4 | 1.2 | 5.1% |
| EAFE (Dev Fgn Mkts) | 1.0 | 25.1 | -13.8 | 22.0% |
| Emerging Markets | 11.8 | 37.9 | -14.5 | 1% |




What's driving the change in valuations over the past thirty years are three secular trends that have produced dramatic benefits to corporate profits; falling inflation, falling labor costs and falling taxes. Each of the charts below has been indexed to show its change relative to 12/31/1989. The first chart shows corporate borrowing costs that have come down as inflation was reduced. Comparing benchmark debt costs to corporate operating income, those relative expenses have almost been eliminated.




Labor costs have dropped dramatically as well, with union membership down, right to work up, and gig workers replacing full time employees. Below you'll see the number of full time employees of S&P companies compared to S&P sales. Each dollar of S&P sales is produced with fewer than half the full time employees required in 1989.




Corporate taxes have had a similar reduction, especially over the past twenty years, with the recent cut bringing them down to a proportion of profits that is about a quarter of that three decades ago.


Returning to the idea that we can use these hind-sights to help us think about future returns, I have to observe that: Valuations are at record highs. Debt costs are at absolute lows. Labor costs and tax rates may come down further, but the odds are that reductions similar to the last three decades are unlikely. As periodic economic contractions are the mechanism by which labor costs (layoffs) and interest rate expenses (Federal Reserve policy) are reduced, I think it's prudent to check the greed that recent market advances engenders and remember the fear that can protect you from the inevitable changes in both cyclical as well as secular trends.

*Tom Lukic*