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Sandpiper Capital

Gleanings

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Both feet on the brakes

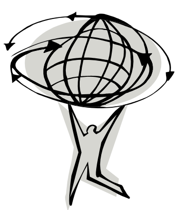
Market Returns Annually

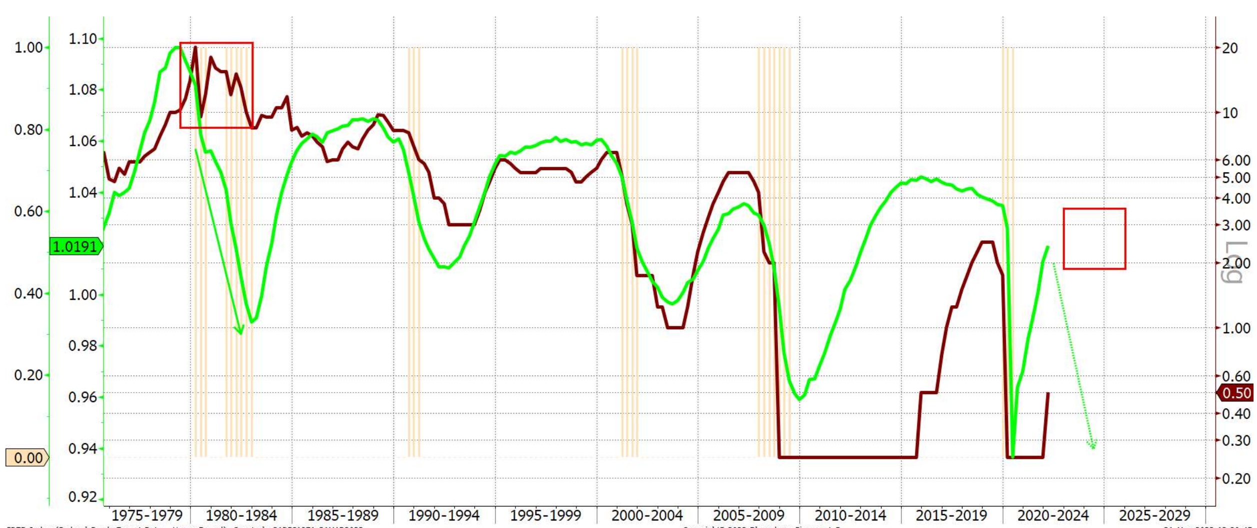
Index	2019	2020	2021	2021
S&P 500	31.5	18.4	28.7	-4.6%
ML 1-5 yr Gov't/Corp	5.1	4.7	-.9	-3.5%
EAFE (Dev Fgn Mkts)	22.0	7.8	11.3	-5.9%
Emerging Markets	1.0	18.5	-2.5	-7.0%

Government largesse over the last two years, both direct payments as well as indirect subsidies, has swelled accumulated wealth in the U.S. by over $40 trillion, the largest percentage and, by far, the greatest dollar amount since records began in 1947. The intention; preventing a devastating recession caused by pandemic related business closures and job losses, was laudable. The unintended consequence; rampant inflation and depleted government resources, while maybe unavoidable, now presents its own challenges. Compounding the risks is the speculative bubble in financial assets, from meme stocks and junk bonds down to investment classes that didn't even exist before like crypto-currencies ($2 trillion+ worth now) and imaginary "meta" assets that are nonetheless trading hands in the $100's of millions.

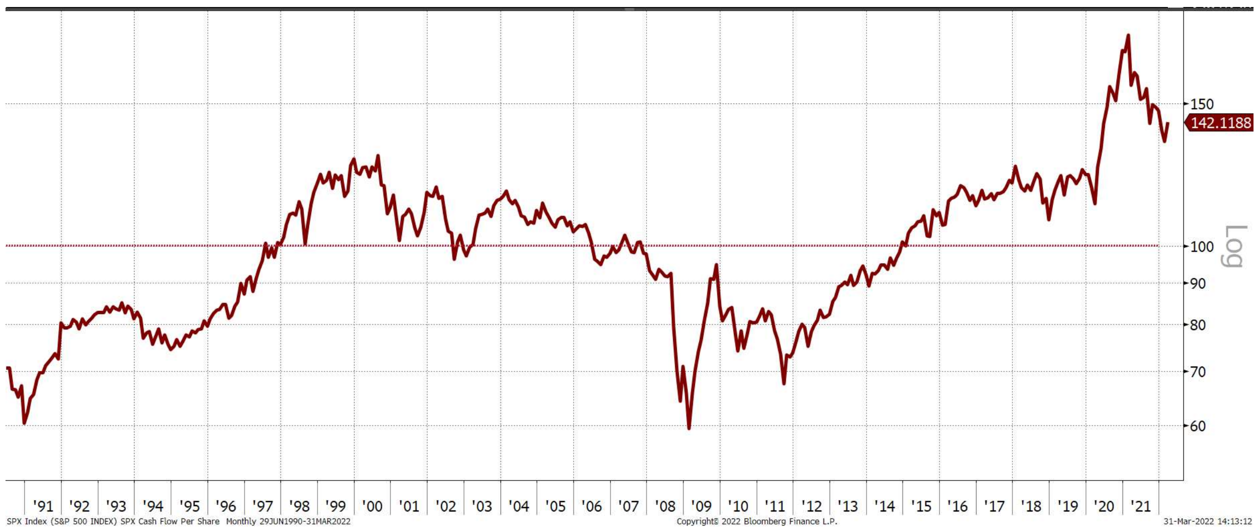
> "It is probable that, unlike recent experience, we may well see persistently high rates (to 3% on the inter-bank rate but 5.5% on mortgages) for longer than we would like."

The government is addressing the inflation risk by raising rates. In the chart below, the red line is the inter-bank lending rate set by the Federal Reserve, the green line is the change in the number of people on payrolls. The vertical bars are recession quarters. Raising rates cools the economy and as people lose their jobs, labor cost inflation (the one that the government is most concerned with controlling) comes down. The higher inflation is, the longer rates stay up and the more people lose their jobs. In the late 70's, the last time that inflation was as high as now, rates stayed up for three years and the unemployment rate went to well over 10%. While this is certainly a different world now, it is probable that, unlike recent experience, we may well see persistently high rates (to 3% on the inter-bank rate but 5.5% on mortgages) for longer than we would like. Layoffs, restructurings and other corporate retrenchments would also last longer than we are used to as the inflationary impact of the last couple of years' of unprecedented government spending gets us unprecedented persistence in cost pressures.

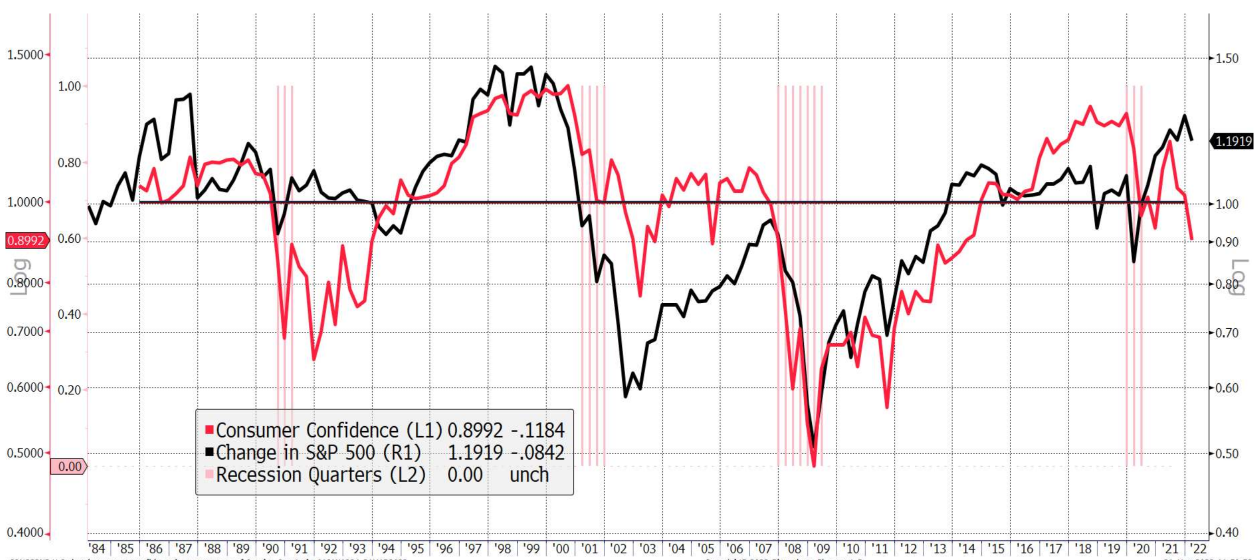




As rates go up and the economy cools, you can certainly expect some of the market excesses of the recent past to reverse. By most measures the S&P is about 50% overvalued based on historical averages, (price to profits-65%, value to GDP-31%, price to sales-89%). In the chart below is the S&P's price to cash flow compared to the average level of the last thirty years. At 142% of normal, a correction to the average would bring it down 30%. You'll note recession lows are another 30%-40% below that.



As I noted before, rates are already going up. Thirty-year mortgages are already at 4.8%, up from under 3% nine months ago. Consumers are aware of the pressures of gas and food prices and have been echoing their concerns in surveys of their expectations for the future. Unsurprisingly, the most recent readings (the red line below), show a lower level than at any time in the last seven years and a decline very similar to that just before the market peak in 2007. Surprisingly, the market drop (the black line) so far has been pretty mild. As consumer spending is over 70% of the economy, I expect that to change as 2022 progresses.



Tom Lukic