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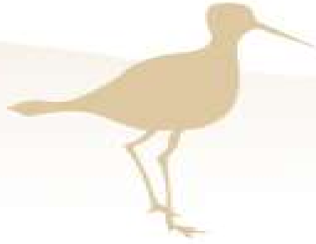
Sandpiper Capital



Gleanings

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> *"As painful as it has been, we started from record high valuations, so we still have a long way to go to get to levels similar to past market bottoms".*

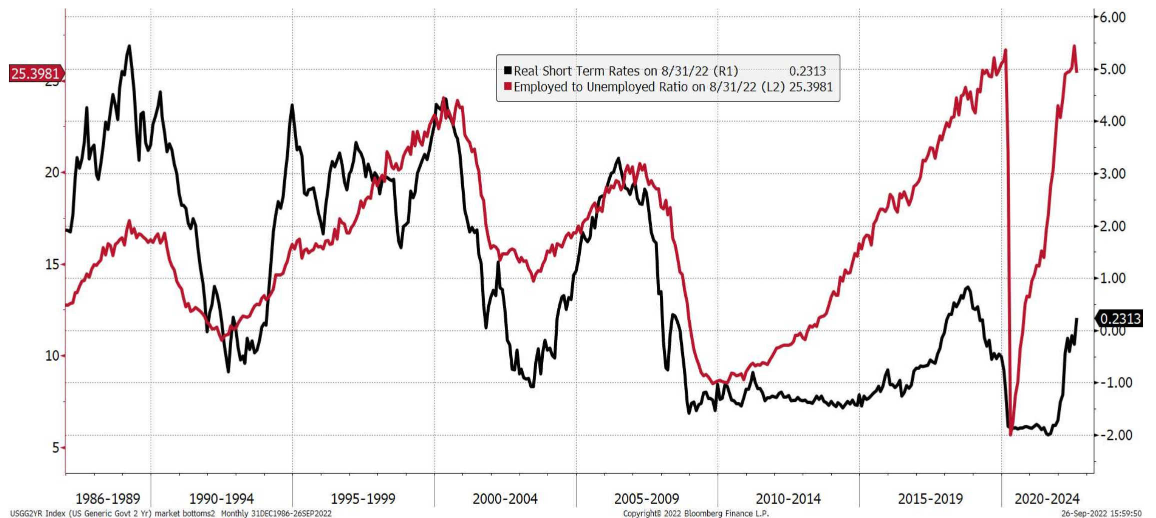
Market Returns Annually

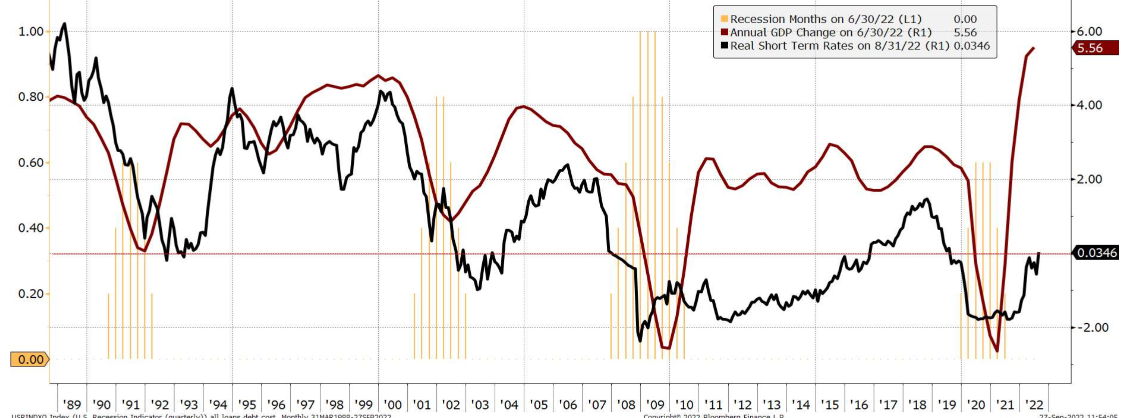
Index	2019	2020	2021	YTD
S&P 500	31.5	18.4	28.7	-22.3%
ML 1-5 yr Gov't/Corp	5.1	4.7	-.9	-4.9%
EAFE (Dev Fgn Mkts)	22.0	7.8	11.3	-26.5%
Emerging Markets	1.0	18.5	-2.5	-27.4%

Fed's tightrope

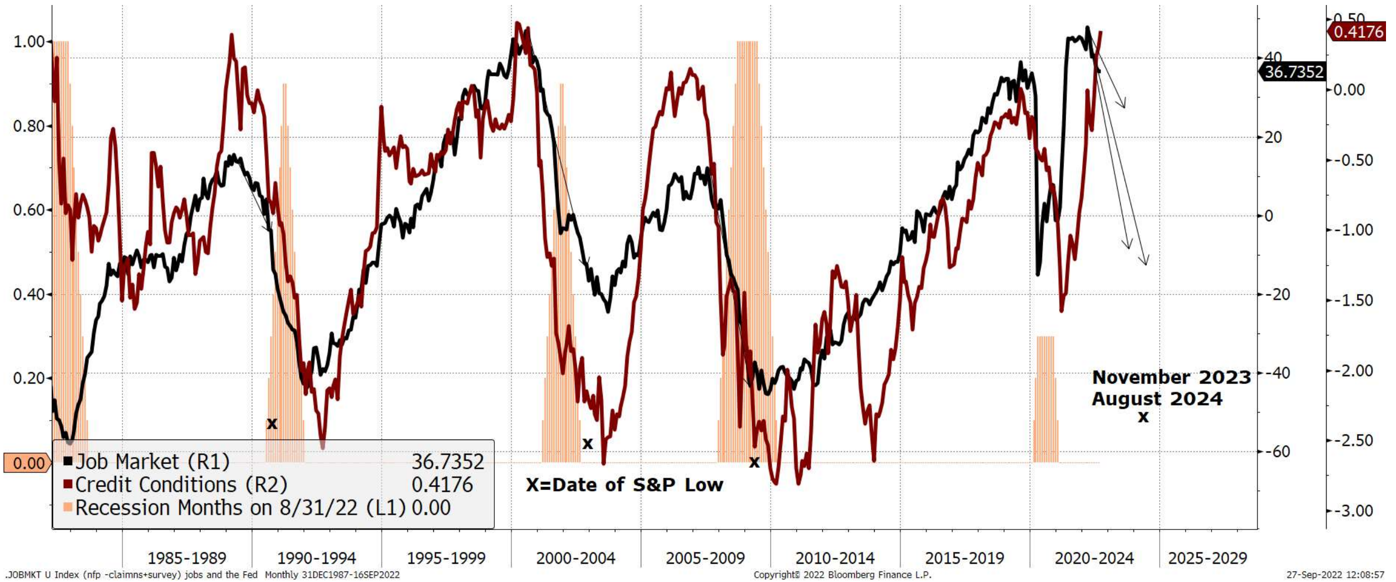
With the strongest labor market in thirty years, concerns at the highest levels of political influence about record wage growth are being addressed by the Federal Reserve, with short term interest rates being increased at the fastest pace since 1980.

The urgency is acute because rates were held low for so long that even an increase of three per cent in six months is still short by about two percent from what had been needed in the past to get the desired effect, (an increase in unemployment). The challenge is that even though in each of the last four recessions, the Fed raised real rates less than the time before (the black lines below), the fall in GDP (red line in the second chart) was increasingly more severe as the higher rates were being applied to greater and greater debt loads. The drop in the S&P in the last quarter of 2018 was enough to prompt a sudden about face in policy even though the job market was still booming. That rate decrease, multiplied by trillions in pandemic related stimulus, has pushed employment and wage inflation to record levels. The solution, (another 2-3 percent increase), is both necessary and risky. Caving to market pressure again would make the next round even more dramatic.

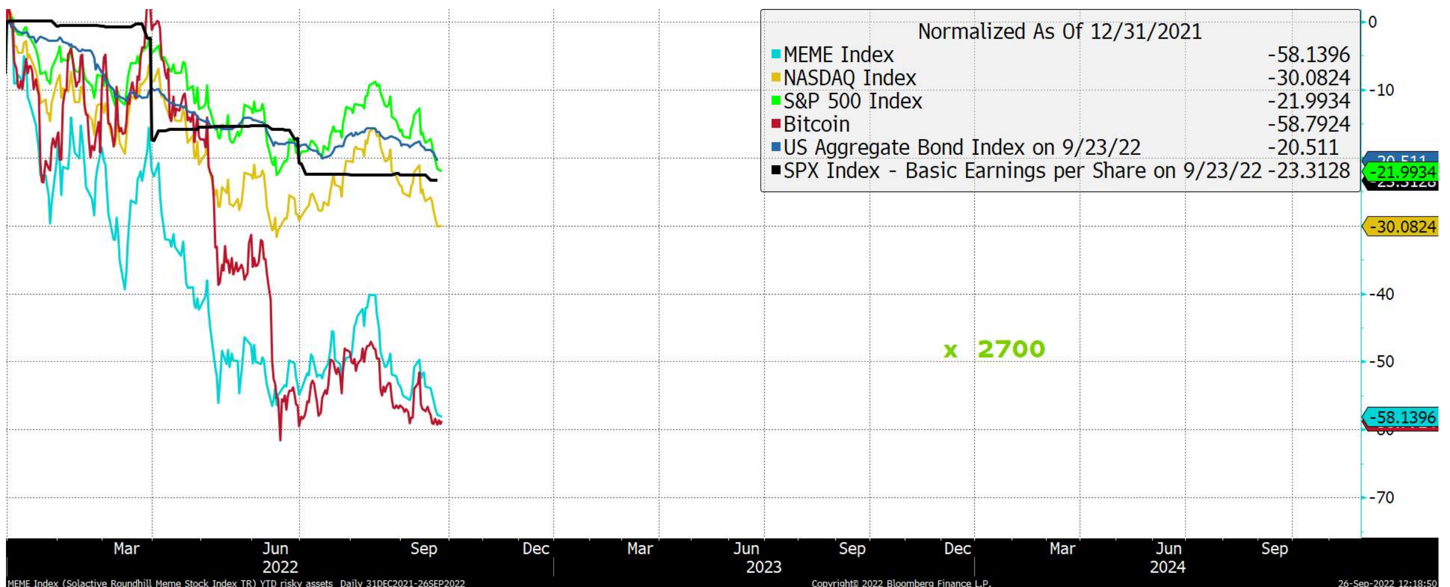




Looking at previous cycles, you can see that tightening credit conditions created recessions and weakened the job market. The red lines are real (inflation adjusted) interest rates. The black line is an index that shows how strong the job market is (people employed, sentiment, jobless claims and unemployment). As real interest rates go up, job conditions deteriorate, and labor costs recede. Some collateral damage (recessions and a drop in the stock market) are to be expected. The arrows at the end of the chart are copies of the drops in the job market that occurred before the stock market made its low (the black x's) in previous cycles. The red line showing credit conditions is trailing the black line of job market conditions this time, as the Federal Reserve has been well behind the curve. That might affect the timing, but if past is prologue, we might expect the S&P to make its lows about this time next year. As we are at the very beginning of this cycle, some patience may be required.



As painful as it has been, we started from record high valuations, so we still have a long way to go to get to levels similar to past market bottoms. S&P earnings are down 23% to date and the S&P is down as well. More speculative sectors have been fairing much worse and even corporate bonds are well in the red. While certainly there are many ways that the next year might evolve, my guess is that as the economy slows, we will see much lower earnings and a continuing drop in the market. The challenge for the next year is to ignore the ensuing gloom and doom and have the courage to buy into the selling that comes as we head into a recession. I have no doubt that short term rates near zero are in store for us once unemployment gets to desired levels.



Tom Lukic