

# Sandpiper Capital

## Gleanings

### Market Returns Annually

Index	2020	2021	2022	YTD
S&P 500	18.4	28.7	-18.3	12%
ML 1-5 yr Gov't/Corp	4.7	-.9	-5.5	1.5%
EAFE (Dev Fgn Mkts)	7.8	11.3	-14.4	4.5%
Emerging Markets	18.5	-2.5	-20.9	1.8%

### Markets yields to rates

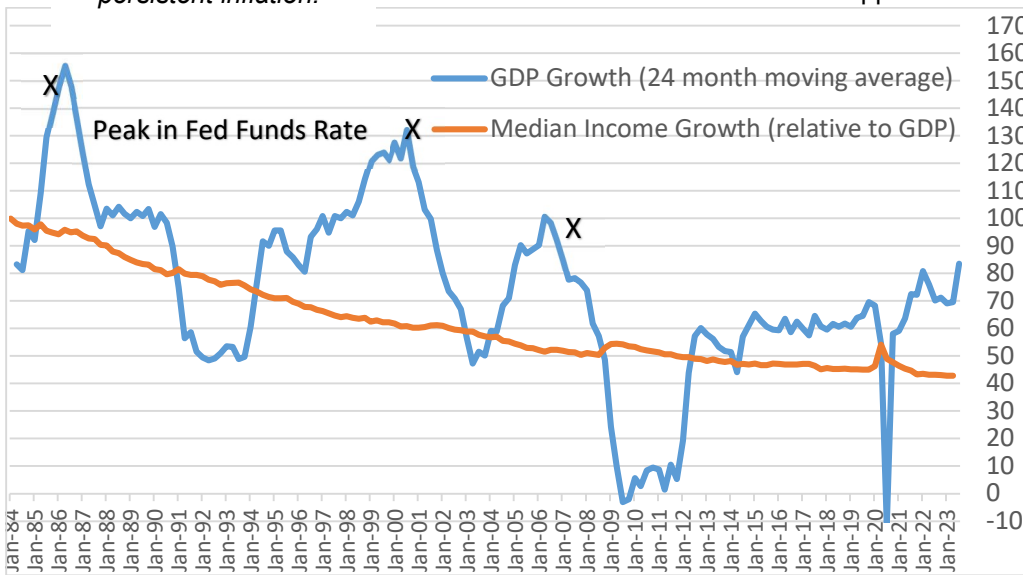
With the Federal Reserve increasing its policy rate to 5.5% from 2.5% a year ago as well as draining reserves from the banking system by selling close to a trillion dollars in Treasuries, the markets have begun to display some

expectation of more pain to come. Service price inflation has stalled at about double the Fed's target and the housing market has stayed much stronger than expected on corporate investment in single family housing (28% of purchases last year). The upshot is that high rates will stay high for longer. In past cycles, rates stay up for an average of 25 months. Preceding the recession of 2009, it was 37 months. As the first rate hike this time came in March of last year, that would put the first rate cut somewhere between April of 2024 and May of 2025. From the duress of higher rates, we can expect slower economic growth, a reduction in wage growth and lower stock prices. If growth slows to pre-pandemic rates, inflation will come back under control and the Fed can then cut rates to a level that will support the markets and the economy.

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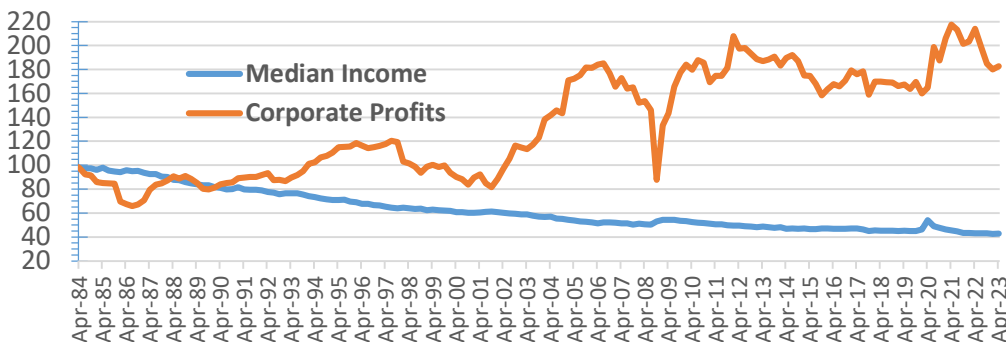
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*"The repercussions are that having injected trillions to avoid deflation, we've overshot and created a stubbornly persistent inflation."*

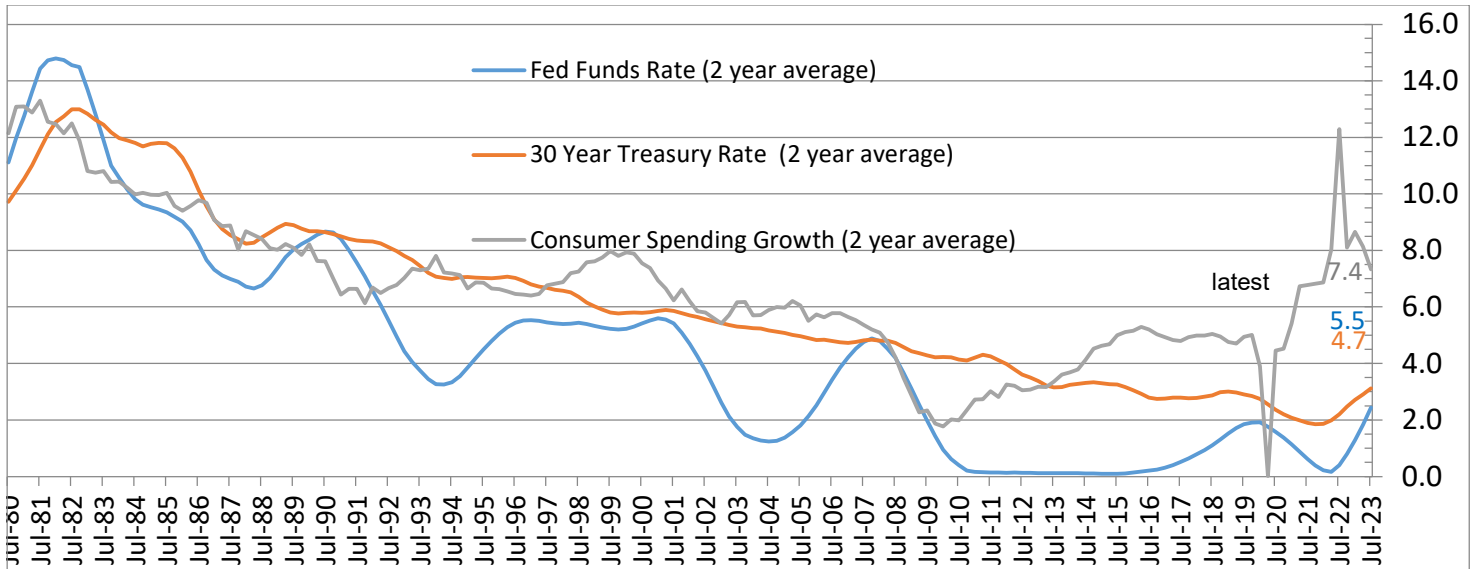


In the top graph to the left, I've put x's at the dates when the Federal Funds rate hit its peak. This was soon followed by a drop in economic growth as well as the rate that incomes increased. (Both lines are indexed to 100). Slowing GDP growth doesn't explain all of the drop in wage growth even though both have been in a clear downtrend. In the bottom graph, you can see that the share of GDP that wages have lost, (to less than half what they were as a proportion of the economy) has gone to corporate profits, whose share has doubled. Technology has fueled productivity and increased profit margins but has also reduced job growth. It takes half as many employees to produce the same level of output as it did 25 years ago. Pay has grown 15% in the last 45 years while productivity grew 65%, (CEO pay btw, is up 1437%). As we are on the threshold of a similar renewed shock to the job market, (if you haven't experimented with ChatGPT, you should), we can expect the next 25 years to be at least as dramatic. The benefit will be higher and higher profit margins. The economic cost will be slower and slower increases, if any, in consumer spending.

### Income vs. Profit Growth Relative to GDP



The periodic hikes in the Fed's target rate) that were intended to slow the economy and quell inflation, when combined with the continual erosion of wage gains, have punctuated the steady drop in the rate of growth in consumer spending with periods of even sharper declines as job losses took their toll. Consider the times when short-term rates (the blue line in the chart below reflects the two-year average Federal Funds rate) were higher than the 30 year Treasury rate (which is a reflection of normal GDP growth). If the cost of money is greater than the overall growth rate of the economy, losses ensue and the economy contracts. To stimulate us out of a recession, the Fed then drops rates, and if necessary, keeps them low for years. (It took 9 years of near zero rates to finally lift spending back towards pre-recession levels). The drop in short term rates combined with the lower estimates for economic growth then brings down long term Treasury rates. Recent experience with emergency spending during the pandemic has created a really big exception however, as the resulting spike in spending during the last two years has pushed rates much higher than the 43-year history would imply. My expectation is that it will take some time to get the results that the Fed wants, but that inevitably we are headed for even lower spending growth and interest rates.



Those of you who have been reading these gleanings for any time will have to acknowledge that I am worried about stock market declines *all the time*. Sandpiper's mantra has always been that if you can avoid losing money, making it takes care of itself. Thinking that there must be alternatives to keeping a lot in cash and bonds, I've been doing a lot of research and I thought I'd share what I learned. What I wanted to achieve was a strategy that would allow me to invest in stocks even when I saw the potential for a significant drop in the market. That led me to the backtested results that are in the chart below. First, observe that the bars are five-year trailing returns. That is, the caveat is you need to hold onto the investments for at least five years. Shorter terms have more volatility, meaning more down years. For the S&P 500 index, most five-year compound returns average around 10% per year, with about a quarter of them around zero. The strategy in blue buys the five lowest risk stock in the S&P (measured by the stability of their quarterly cash income for the preceding ten years). These are boring companies with good businesses that are often overlooked. I am elated at the results but remember, this is history and may not look the same in the future. I do believe, however that following this model with a portion of clients' portfolios makes sense.

