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July 2017

The U.S. Dollar, Washington Politics, and the American Dream

In an era in which life seems to move at lightning speed, it's helpful to step back for a moment and to take a 10,000 foot view of the investment landscape and the broader implications of all the short-term news that comes across our screens every day. Successful long-term investing requires a high level perspective that more clearly defines the lay of the investment landscape and helps us to see where we are going and where we should go!

In that spirit, let me offer some context for the ongoing stream of short-term news events that individually have only a momentary impact on the markets, but that in aggregate point to significant implications for our portfolios in the future. In fact, they may hold important implications for the very core of American life, namely the American Dream.

Since March 2009, the stock market has been on a steady climb upward. From its lows that year to its recent highs, the stock market has risen 268%, making the 2009 bull market one of the best performing and longest-running since World War II.

Despite that healthy run-up and the resulting rich valuation most stocks are enjoying at the moment, the market still has more room to rise before we need to sound alarm bells about its end. Why? Because corporate earnings are re-accelerating after being weak for the past three years. A rise in earnings should adjust equity valuations downward to more reasonable levels and help to make stocks more attractive to investors, thus prolonging the bull market. S&P 500 earnings are projected to rise this year at a 10% clip, versus 7% last year and -16% in 2015 (Source: multipl.com). In addition, at the moment investor sentiment is neither exuberant nor depressed, making both sentiment and earnings positive for equities.

That said, and the cyclical nature of life being what it is, the question looms: When will this longer-than-average 2009 bull market end? To many, including the financial press and the members of the investing community, it feels as if it has gone on for too long and should now be viewed with wary eyes. Since World War II, the length of the average bull market has been about 54 months, with the longest being 113 months from October 1990 to March 2000, and the shortest being the 1947 to 1948 bull market which lasted a mere 13 months. (Source: Fortune/CFRA/S&P Global). The 2009 bull market is now well past the average length at 100 months and counting.

An equally important question is: *What* could ultimately bring about the end of the 2009 bull market? If we can think about the "what", that might help us to answer the "when".

With history as our guide, one distinct possibility is worth considering in light of the political atmosphere permeating this country at this time and the proposed economic policies emanating from Washington. Admittedly, this possibility is just one of many potential factors to consider and is firmly in the realm of speculation at the moment. But analyzing "what ifs" is a part of investment management, so plausible possibilities about the end of a marathon-like bull market are worth considering. Ironically, this particular possibility has precedence in British, rather than American, history.

Rule Britannia!

A century ago in 1917, the British Empire reigned supreme on the planet. Under Queen Victoria in the nineteenth century and subsequently her successors in the twentieth century, the British built an expansive global empire, the likes of which the world had never seen before. British territories stretched from The Americas to Europe to Africa to Asia to Australia and to thousands of islands around the globe.

Most importantly, Britain ruled the waves, which meant she ruled international trade. The British enjoyed a position that was the best of all possible worlds. As a nation, they possessed riches beyond any in human history, including natural resources that could be extracted from six continents and wealth that could be gained by trade with almost any country on earth - all at prices they could afford because of one important factor: their currency. The Pound Sterling was strong, in demand, and was the currency of choice for international commerce. By the start of World War I, the British Pound was universally used for international commerce and finance and was the major reserve currency of the world. It was the envy of other great European powers and the United States. The U.K. and its currency were viewed as predictable and safe from the turbulence of the world.

Fast forward 27 years from 1917 to 1944. After two intervening world wars that effectively destroyed the British Empire along with much of British industry at home and led to the country's relative impoverishment, the British Pound had lost its power and its attraction as the world's reserve currency. The international community had lost faith in Britain's ability to protect the world's financial interests by means of its Pound Sterling.

Enter the U.S. Dollar

In 1944, near the end of World War II, a group of 44 nations met at Bretton Woods in New Hampshire, and ironed out an international monetary system that put the U.S. dollar, not the British Pound, at the center of the world's financial order as the world's currency of choice for trade and finance. By the war's end less than a year later, the United States had become the most powerful economic force on earth, credited with winning the war for freedom and democracy – it seemed only fitting that the dollar should have been made the world's reserve currency.

The U.S. dollar had replaced the British Pound and, combined with America's industrial might and capitalist system, had led to an ensuing period of unprecedented prosperity for America, that helped to fuel the "American Dream" of plentiful material goods at affordable prices. In fact, since then, America has taken full advantage of the dollar's attractiveness to foreigners, and its usefulness as a medium of exchange for global commerce.

Having the world's reserve currency has meant that we Americans have been able to price commodities such as oil and gold, among many others, in U.S. dollars so that every time we want to buy a barrel of oil from the Middle East, for example, or a metric ton of gold from Ghana we pay producers in our own currency without having to convert our dollars into dinars, riyals, or cedis. That eliminates conversion risk which can otherwise make commodities and other foreign goods more expensive for us if we had to convert.

America, the Safe Haven

As issuer of the world's premier reserve currency, the United States has been ordained with the moniker "safe haven", meaning that we are viewed as the safest place on earth to invest or to save in order to protect one's money, especially in our Treasury securities. "The full faith and credit of the United States" may just be the most important phrase attributed to America's strength and importance, and it has meant that we have been able to borrow trillions of dollars from eager foreigners willing to finance our government's deficits at very low interest rates because they know they will be repaid in full and with a profit! No other country on earth enjoys this privilege to the degree we do.

But our privileged position is not ironclad. Of late, there has been a great deal of talk by the Chinese and the Russians about replacing the U.S. dollar as the preeminent international reserve currency. The Chinese particularly would love to find an opening in the global commercial and financial system, as well as the political rationale to allow them to replace our dollar with their Renminbi, also known as the Yuan.

The Loss of Reserve Status: An Unwelcome Possibility!

The challenge facing the United States is that if we lose either the U.S. dollar's reserve status, or the world's faith in us as a global safe haven, our economy, our government, our social system, and our financial markets could all be in trouble. Losing that coveted status could be a black swan, an unexpected and unwelcome event, that tips the financial markets south in a very big way and that ends not only the 2009 bull market, but the much longer cyclical one that, by my estimation, has been in place since the Great Depression in 1932 (a topic perhaps for another letter).

Washington Rancor and Political Risk

The political turbulence in Washington since the 2016 election has now injected a measure of political risk into the investment picture that may be unparalleled in the history of this country, at least since World War II. The thrust toward protectionism and isolationism only adds to the sense that America is a declining power that wants little to do with the rest of the world. Neither

the political rancor nor the isolationism and protectionism bode well for the dollar's safe haven, reserve status. It is rare to use the term "political risk" to describe an American risk factor that investors have to consider vis-a-vis the U.S. markets, but that phrase now seems apropos for America. "Political risk" is a phrase usually reserved for unstable countries with doubtful regimes that lack the trust of the international community. Such countries do not enjoy reserve currency status or the economic benefit that privilege bestows on its citizens. It is perhaps easy to dismiss the current national political climate and vitriol in the U.S. as merely partisan, shallow, and transient, but our national discord could have very serious effects on the U.S. economy as a whole and could ultimately lead to a general loss of faith in our global safe haven status and our dollar. And if that happens, it could indeed come to us as a black swan event and could undermine our American Dream which is built partly on the dollar's strength and safety.

Proceed Sensibly and Mind the Gap

Granted, for now, this is mere speculation and nothing more. It is a "what if" exercise in an attempt to understand what could bring an end to the gains the stock market has enjoyed for a long time. What ultimately materializes and actually ends the 2009 bull market, may be something entirely different. Reality has many variables that it throws our way over long timeframes and those variables combine and re-combine in countless permutations to produce countless outcomes. Ultimately, whatever the factor is that breaks the bull market's back, it will have to be something that decelerates corporate earnings growth to the point that lofty share prices can no longer be supported by the earnings stream. We do not appear to be there yet, which is why the stock market probably still has room to rise further in this extended bull market.

The most sensible strategy for long-term profitability continues to be vigilance, risk management, a focus on quality companies with earnings and dividend growth, and lots of patience. Protecting clients' assets, avoiding potential risks by minding the gap between earnings and valuations, and focusing on portfolio growth over time continue to be prime goals. Those fundamental objectives will never change.

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