Waterstone Advisors, LLC
10 Brook Street, Walpole MA 02081
Tel. 978-828-2188
vha@waterstoneadvisorsllc.com
www.waterstoneadvisorsllc.com

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The Economy: Firing on All Cylinders, but Running out of Gas?

The great British-American investor, Sir John Templeton, once said "The four most dangerous words in investing are: 'this time it's different'." How true that observation is. Human nature being what it is, we each often think our particular circumstances are unique.

In reality, the natural laws of economics never change. Each economic event produces a reasonably predictable outcome, as it has in the past. Nothing is static, but nothing is entirely new either. Those economic ebbs and flows move the stock and bond markets and are, therefore, vitally important to investors as a frame of reference for their expectations and actions.

The Economy is Firing on All Cylinders

The Trump administration has been vigorously pursuing policies to boost the economy. Economic growth after the 2008 financial crisis has been lower than average at roughly 2% per year. That said, considering the economy's near-collapse in 2008, a 2% average growth rate has been a positive achievement. By comparison, in the boom years of the 1980s and 1990s economic growth at times stood at more than 5% per year. The difference may be partly due to the direction of interest rates. They peaked in 1981 at 18% and proceeded to decline steadily for the next 35 years, reducing borrowing costs and spurring economic activity.

Today, Washington's economic focus appears to be primarily on bringing back manufacturing to the United States, re-energizing businesses, and boosting consumer spending. The 2017 tax cuts are a part of that plan, as are the rollback of numerous regulations on industry. The Administration's business-friendly stance has invigorated the national mood and led to increased economic activity to the point that we can now say the economy is firing on all cylinders. Employment is strong, inflation is manageable, consumer confidence is buoyant, and business activity is robust nationally. In Q2, U.S. GDP is expected to grow at roughly 4%.

In view of this strength, the Federal Reserve Bank has raised its Fed Funds rate twice this year and aims to raise it twice more before the end of the year. For the bond market, this means that prices on existing bonds will decline as rates go up. Fixed income investors will always prefer

similar quality bonds with higher yields to the lower yielding ones they currently own. Equity investors will question the impact higher interest rates will have on corporate earnings - not a positive impact for sure. For both asset classes, total returns will become increasingly more difficult as rates rise.

Companies are Delivering Strong Earnings Growth

The 2017 tax cuts and the strong consumer economy continue to drive healthy profits growth year-to-date. The component companies of the S&P 500 are expected to log a collective 21% increase when Q2 results are all done and accounted for in August. Consensus earnings estimates, as measured by Factset Research, are calling for earnings to increase more than 20% in Q3 and for sales to rise by 9%. On the whole, business confidence has been positive so far this year.

The 2009 Bull Market is Intact, Despite the Current Correction

With a strong economy as its backdrop, the 2009 equity bull market will continue higher after the stock market's current correction ends. The correction started at the beginning of 2018 and has seen the S&P 500 trade in a range of 2533 to 2873. The duration and ultimate shape of the correction are unclear. Corrections can last for months or years, and can pull the market down considerably. They can also move the market sideways in a holding pattern while investors await clarity on corporate earnings or as valuations adjust to new earnings figures. To-date, the correction appears to be of the "catch up" type where investors are marking time, waiting for earnings to match lofty valuations.

As companies release their second quarter earnings results over the coming weeks, we will have a clearer picture on the health of the corporate sector, as well as consumers. The effects of the 2017 corporate and personal tax cuts should be clearly reflected by now in earnings results, while the effects of the new tariffs imposed on China and other countries may be less clear until the third and fourth quarters of this year.

Risks to the Economy and the 2009 Bull Market are Steadily Increasing

To most observers, we are living in the best of all possible economic worlds, filled with low inflation, high consumer demand, and more jobs than we have workers. This scenario is a noteworthy achievement of the American capitalist system - after a near-collapse of the U.S. economy in 2008, we are now sitting on what appears to be a mountain of prosperity. Market forces drive every aspect of our economy, and those forces have pushed our collective lot higher over time, and certainly over the past ten years. This is a credit to our free market economy and to the system of international trade America and the West have built over two centuries.

However, below the surface, forces are starting to build that could eventually cause disruptions to our otherwise prosperous economic scenario and derail the 2009 equity bull market with it.

The phrase “forewarned is forearmed” is always apropos to investing and it is never too soon to think about future possibilities. The forewarning signals for both the economy and the markets are the following:

- stock market valuations are trending higher;
- interest rates are rising;
- trade wars are materializing;
- the personal savings rate is declining;
- wage growth is weak; and
- the yield curve is flat-to-inverting.

These are warning signs that investors must watch.

Valuations - For at least the past couple of years, I have been saying that the stock market’s valuations are too high, particularly as measured by the Shiller P/E and the S&P 500’s price-to-sales ratio (P/S). Both of these metrics make a great deal of sense to me, which is why I point to them. The Shiller P/E measures the current price of the S&P 500 relative to its trailing 10 years of earnings. The ratio changes slowly and is a better indicator of long-term valuation extremes than the traditional 12-month trailing P/E used by many investors and managers. The price-to-sales ratio is a simple metric that cannot be tampered with by fancy corporate accounting tactics - it is an honest metric that conveys value. By both measures, stock market valuations have been high over the past couple of years, are currently high, and are trending even higher.

The Shiller P/E stands at 32.48, which is 16.32 points above its long-term average of 16.16. The S&P’s P/S ratio is 2.23, a multi-year high and well above its 2008 figure of 0.80. Such extreme valuations indicate that investors have outsized expectations for the stock market’s future earnings growth. If those expectations materialize and earnings growth is robust, then valuations will adjust accordingly, and the stock market will continue to rise. If, however, those expectations do not materialize, and earnings growth disappoints investors, then the market could sell off. The more stretched the valuation, the greater the market’s fall. This is the risk and this is why valuations matter.

Interest Rates - From 1982 to 2010 interest rates were on a downtrend, falling from a high of 18% to a low of 0.25% during that period. Now, however, interest rates are rising as the economy is in full swing. While the absolute level of interest rates is not yet high enough to hold back economic growth, the anticipation of higher rates in the future could cause businesses to reign in growth plans. This has not happened yet but is a risk factor to bear in mind.

China Tariffs - In my April investment letter, I discussed the threat that China poses to the global supremacy of the U.S. dollar. China’s long-term aim is to supplant the dollar with the renminbi for global trade in commodities, goods, services, and investments. The Chinese want to see the

renminbi's profile as a reserve currency rise from its minor position now, where it represents only 4.5% of global reserves, to a much more dominant position relative to the U.S. dollar.

Since that investment letter, the U.S. has imposed $34 billion worth of tariffs on Chinese goods as a punitive measure for China's anti-competitive practices against U.S. companies, particularly their practice of compelling American companies to share their intellectual property secrets with them. While China's long-term threat to the U.S. dollar is clear, and the need to stop intellectual property abuses is urgent, tariffs may not be the best tool against China's trading offenses, or as a way to thwart their expansionary plans. Tariffs are a blunt instrument and are very much like using a hammer to clear out a hornet's nest. If applied widely enough on our international trading relationships, tariffs could have a scattershot effect, harming China and others, while at the same time hurting U.S. farmers, corporations, and consumers who would suffer from retaliatory tariffs. Specifically as it relates to investing, tariffs act as a tax on economic activity, reducing sales and income, and directly impacting corporate earnings and stock market valuations.

Beyond dollars and cents, tariffs produce a negative psychological effect on consumers and corporations. Companies and the news media are reporting that the mere threat of an escalating tariffs war is already having tangible negative effects on U.S. businesses by making planning for future business activities difficult. CEOs are expressing their reluctance to approve business plans or trading agreements, without first having some clarity about the tariff status of their products and services. A lack of both clarity and stability means corporations will effectively march in place until they see a clearer path forward. Ultimately, a tariffs war muddies the investment waters.

Savings Rate and Wage Growth - Another sign of underlying weakness in the economy is the downturn in the personal savings rate (please see chart below).

Over the past three years, the personal savings rate in the U.S. has been declining even as consumer spending has been rising. This indicates that consumers are dipping into their savings to purchase goods and services rather than paying for them directly from their wages. In other words, wages are not keeping pace with consumer demand. In a booming economy such as the one we have now, one would expect wage growth to keep pace with economic growth, but that has not been the case. The Labor Department's statistics indicate that wage growth has been stagnant for the past 17 years (see chart below) and is still not rising. Since consumer spending accounts for roughly 70% of U.S. GDP, this combination of slow wage growth and diminishing savings does not bode well for future economic growth.

Yield Curve - Perhaps the greatest indicator of a potential recession is the inverted yield curve. Typically, long-term bond yields are higher than short-term bond yields as investors demand higher returns for taking risk further out. However, in uncertain economic times, short-term yields can actually be higher than long-term yields, as investors express less confidence in the future and demand higher yields now. When short-term yields are higher than long-term yields,

the yield curve is said to be inverted. While the curve has not inverted yet (see chart below), it is close to it, and the prospect that it will do so in the near future means that, based on historical experience, we could expect a recession 6 to 24 months *after* it inverts. According to a recent Forbes Magazine article by investor John Mauldin, "…the yield curve is still abnormally flat. The gap between 2-year and 10-year Treasury yields hasn't been this low since before the last recession. This gap dropped below zero—i.e. inverted—shortly before the last three recessions… We haven't seen it yet in this cycle. But we certainly *could* see inversion within the next year or so if it keeps dropping at the current rate." Clearly, the yield curve is a metric to watch!

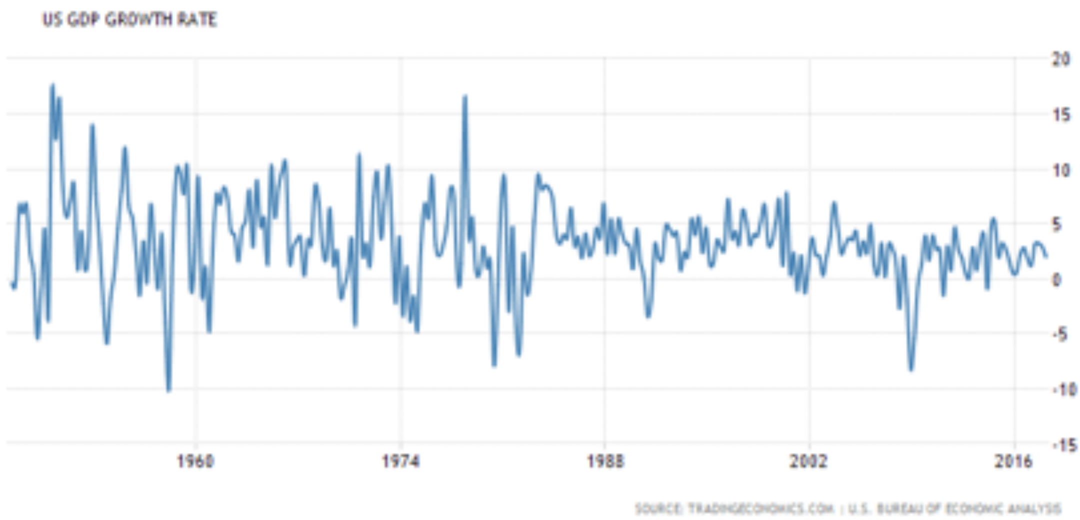
Focus on Quality Stocks and Sound Investment Principles

John Templeton's words are as true today as they have ever been. This time is not different--even though the circumstances may be. Because of this, when it comes to managing portfolios and selecting stocks, tried and true methods are best. As always, I favor higher quality companies that have sound fundamental characteristics such as low debt levels, adequate cash, a consistent history of profits, healthy margins, a long record of dividend payments, valuable products and services, the ability to raise prices over time, and strong management teams with a vision for the future. I also favor companies whose stocks trade in the market at reasonable valuations. Most of the fundamental factors do not change from quarter to quarter, which means the portfolios I construct for clients tend to have low turnover of names.

Valuations, however, do change. They help to provide clues about entry points for stocks or, conversely, about exit points. As I have pointed out in past letters, stock market valuations are very high at the moment, and have been trending steadily upward since 2008. This fact means that investors as a whole have high expectations for the market's growth prospects. If those expectations do not materialize for any reason, then stocks could decline as a group. That is the underlying risk with the stock market and the core reason why caution has been my mantra for some time. From a practical point of view, finding stocks that do not trade at a high valuation has become more challenging for conservative investors.

To cite one of history's most successful investors, Warren Buffett once said, "Successful investing takes time, discipline and patience. No matter how great the talent or effort, some things just take time." Having experienced a number of market cycles over the past 30 years, I know that Buffett's wisdom is spot on. The markets have their own pace. They cannot be rushed. When they are overextended as they have been for some time, they eventually return to earth and provide better buying opportunities. The prudent strategy is always to take calculated risks, focusing on good fundamentals and reasonable valuations wherever they can be found, and to seek balance between risk and return.

V. Henry Astarjian



Shiller P/E (Source: multpl.com)

Wage Growth Tracker
three-month moving average of median wage growth
Overall unweighted
Overall weighted
Services
Usually full-time
College degree
Prime-age
Female
Male
Job stayer
Job switcher
Overall, back to 1983
Percent
6
5
4
3
2
1
0
1998
2000
2002
2004
2006
2008
2010
2012
2014
2016
2018
Sources: Current Population Survey, Bureau of Labor Statistics and author's calculations
FEDERAL RESERVE BANK of ATLANTA

U.S. yield curve
The yield curve inverted before the past three recessions
3.0
2.5
2.0
1.5
pct
1.0
0.5
0.0
-0.5
-1.0
0.32
0.24
1990
1995
2000
2005
2010
2015
U.S. 2-year to 10-year Treasury yield spread
U.S. 5-year to 30-year Treasury yield spread
Recession
Recession
Source: Thomson Reuters Datastream/By Richard Leong 7/3/2018 @RichardLeong2

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