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

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The Year of Great Uncertainty

Dear Clients and Friends,

Mankind's discomfort with ambiguity is the stuff of literature, physics and philosophy - the angst of the obscure has been at the heart of Hamlet's famous soliloquy, Einstein's characterization of quantum mechanics as "spooky," and Aristotle's founding of the field of epistemology. So perhaps it's not surprising that market mavens and casual observers are throwing their hands up at what I have coined the "Year of Great Uncertainty."

The defining characteristic of the 2016 investment landscape has, in fact, been its very cloudiness in four critical areas: interest rates, corporate earnings, Brexit, and the U.S. presidential election. These factors have dominated the news flow throughout the year and are still very much at the forefront of investors' minds, even as we approach the last quarter of the year. As each new development has played out, it has created new questions and new uncertainties.

Navigating the investment waters in this opaque environment has required a plan of action and a set of working assumptions as our guides. In managing the Waterstone portfolio, I have developed a set of assumptions based on data, historical trends, and an experienced interpretation of investor sentiment. These assumptions are that:

1. interest rates are likely to rise by a small increment in the near future;
2. corporate earnings are likely to rally into positive territory over the span of 2017 after several quarters of negative growth in the past year;
3. Brexit is likely to be a benign event in the short-term despite the market's concerns;
4. investor caution and fear will slowly turn into optimism as 2017 unfolds and the economy strengthens; and
5. volatility in the markets is a very real possibility in the near-term.

Based on these expectations, my plan of action continues to be one of caution combined with selective investments in good quality stocks and ETFs. As always, cash will be deployed carefully and slowly.

Cash

This period of great uncertainty calls for a brief word on cash. Cash is not a growth asset and returns on cash are still paltry by historical standards. However, higher-than-normal cash balances do serve some very important functions in a well-constructed portfolio, especially during times of uncertainty. Cash acts as ballast to a portfolio during market storms, often preventing portfolios from fluctuating as much as the market itself. This has tremendous significance to investors as it keeps the value of their portfolios more stable, while allowing them the opportunity to make rational, calmer decisions about their investment portfolios. In a low inflation rate environment such as the one we are in now, cash is a steady source of value that can be exchanged for growth assets when circumstances call for it. That said, Waterstone's accounts are actively managed, and continually monitored for fundamental market changes that would call for the deployment of cash into higher risk assets. As always, should new information or different outcomes prevail, portfolios will be adjusted accordingly.

Interest Rates

Looking back at U.S. interest rate policy over the 3rd quarter, the uncertainty of the environment has been in evidence at the Fed, as FOMC members have vacillated between dovish and hawkish sentiments. There is now speculation that an interest rate hike could come in December of this year, a move that I believe would be beneficial; as you may recall from my previous investment letters, I have favored small interest rate increases this year as a way for the Fed to signal that a recovery is taking place in the economy and that consumers are better off borrowing and spending today, rather than risking higher borrowing costs tomorrow. This may not be a popular stance on a personal level, but in fact the economic well-being of the country may depend on it. No one particularly relishes higher inflation from higher interest rates when it comes to their own purchasing, but on a national level inflation is a bit like blood pressure - it should not be too low or too high - it should be sufficiently vigorous to allow the economy to function at optimal health, creating consumer demand, jobs, and wage growth, all of which lead to a general mood of prosperity.

Corporate Earnings

As depicted in this bar graph, U.S. corporate profit growth remains negative but has been heading into positive territory quarter by quarter since the beginning of 2016. This is encouraging for the longer-term. Unemployment is now at 5%, within the low end of its historical range. With household incomes now higher than in the past 9 years, corporate earnings are likely to follow this trend upwards. The only question may be the pace at which earnings rise. As you can observe in the "Nonfarm Payrolls" chart below, the current U.S. economic recovery has been an unusually slow one and a

source of economic and political frustration. However, the employment recovery trend is positive. Eventually, this upward trajectory will correlate to higher company earnings, which in turn will boost share prices.

Brexit

Brexit has continued to play out, particularly through the British pound, which has lost value against the dollar, falling from a pre-Brexit rate of 1.54 to 1.20 recently. Nevertheless, British economic growth is reasonably stable for the moment which bodes well not only for the U.K., but also for the E.U and the U.S. The Brexit process has to go through a formal reckoning in which the two sides, the U.K. and the E.U., work out the terms of the exit. That could take two or more years. Already, we are seeing challenges to Brexit in U.K. courts. Opponents are suggesting that Parliament first conduct a formal vote before finalizing the exit. In fact, the majority of U.K. parliamentarians are opposed to Brexit and would likely vote to keep the U.K. in the E.U. When and how Britain actually exits the European Union is far from a done deal. Clarity on the U.K.'s relationship with the E.U. will take time, but at the moment Brexit is unlikely to have an immediate effect on the U.S., especially on U.S. corporate earnings which are the key drivers of share prices.

U.S. Elections

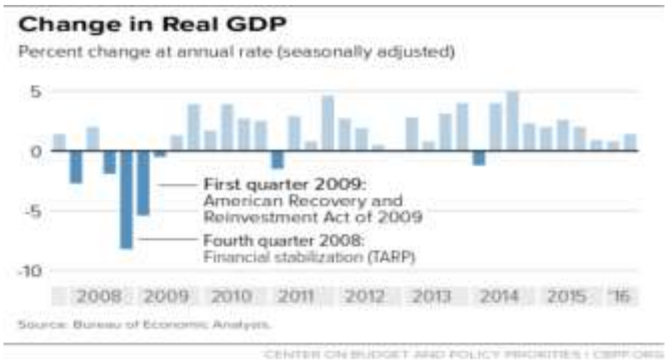
The presidential election is approaching on November 8th. Polls have fluctuated back and forth between the candidates, showing one or the other in the lead. For those of us who like clarity on these matters, the polls have been highly unreliable and have come under considerable scrutiny for their methodologies. The bottom line is that it is still unclear which candidate has the advantage. The results of this election, perhaps more than any other in recent memory, could have a profound impact on national tax and fiscal policies, and therefore on corporate earnings. More than any other variable in the stock market equation, this election could ultimately have the greatest impact. One thing we may be able to say with some certainty is that November 9th could be a volatile day for the markets, and the volatility can go in either direction, up or down. For the most part, through all of this uncertainty over the past 18 months, the stock market has traded in a "wait and see" sideways path as these key events, including the election, have played out one by one.

The Third Quarter

The third quarter of 2016 closed up for stocks. The S&P 500 gained 3% over the previous quarter, while the Dow Jones Industrial Average rose 2%. Stock market returns could have been better except for lackluster corporate earnings which have been a drag on equity performance throughout the year. S&P 500 earnings are expected to be down -2.1% on average in the quarter compared to the prior year (Source: Factset Earnings Insight). Revenues are expected to be up +2.6%, the first time a positive revenue growth figure is anticipated to be logged since Q4 2014's +2.0%. While there is a chance that 4th quarter S&P earnings growth may be negative, the upward trend in earnings growth since Q1 '16 is encouraging.

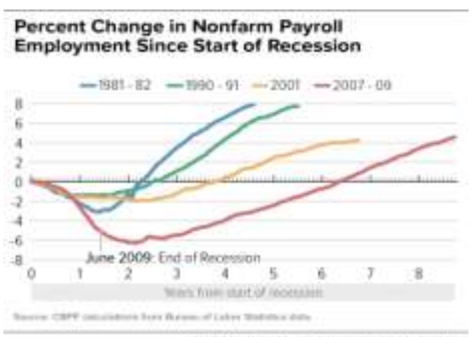
The Economy and Employment

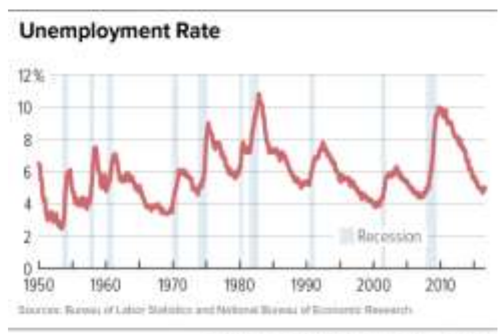
Despite challenges, the U.S. economy has continued to improve at a slow, but positive pace over the course of 2016, with GDP rising +0.8% in the first quarter and +1.8% in the second quarter. The third quarter GDP figure will be released on October 28th and is expected to show the economy growing at +2.6% according to the Wall Street Journal's Economic Forecasting Survey of 60 economists. They also anticipate 4th quarter GDP to be in the +2.3% range. These figures show a positive trend in GDP growth for this year though it remains to be seen if these estimates will actually materialize. However, on-balance, GDP growth has been positive throughout the economic recovery and may continue to be so for some time.

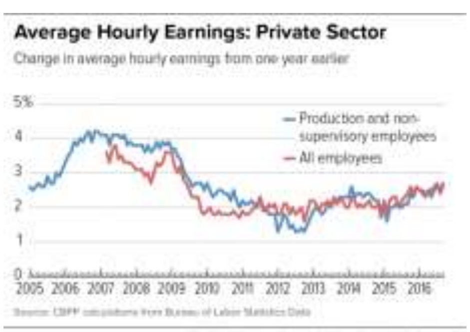


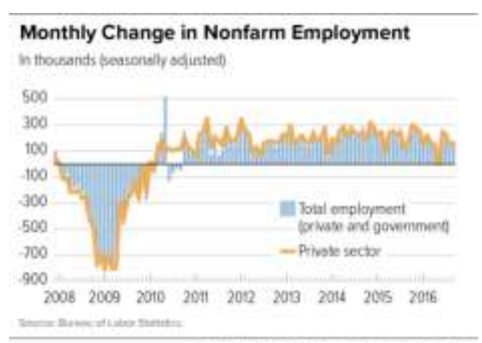
For the long-term investor, this should be encouraging. Economic growth is the foundation of stock market advances and the underpinnings of a stable bond market. Historically, over the long-run the stock market has moved higher as American economic growth has moved forward. In the long-run equity returns tend to stay well ahead of inflation and are one of the most effective ways to prudently grow assets.

Employment and wage trends have also been encouraging of-late. The economic recovery has been a slower affair than other recoveries in the recent past, but a recovery is in fact happening. Here are four charts that help to clarify the employment and wage trends:









Conclusion

Over the past 18 months, the market's movement has mostly been a sideways affair, reflecting this period of great uncertainty. I continue to invest cash slowly as a hedge against possible downside volatility over election results, potential interest rate hikes or possible weak earnings results. There will be a time for a more aggressive approach to cash deployment into stocks and bonds since the markets, like most forces, are cyclical. As there is greater clarity about the macro picture and greater political and economic stability, a more aggressive investment strategy will be justified. For the moment, prudence calls for a conservative approach.

Best to all,

V. Henry Astarjian

Disclosures