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

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Pragmatic Optimism

A Perspective for Investors

The start of a new year is always a good time to step back and to reassess where we have been and where we are going. I find that it is also a good time to reaffirm the philosophical foundations on which our investing activities are based. Wisdom is as vital to successful investing, as is any knowledge of markets and securities, and it helps to underpin our buying and selling activities.

Sometimes stock market wisdom comes from truly unexpected and odd places. While considering the performance of the markets over the past twelve months, speculating what might lie ahead for investors, and doing research for this letter, I came across a striking quote from the late country music singer Jimmy Dean - yes, the same Jimmy Dean who lent his name to a brand of excellent breakfast sausages that many Americans enjoy. He was quite a light-hearted and upbeat popular personality during my youth, and he once said *"I can't change the direction of the wind, but I can adjust my sails to always reach my destination."* I do not know if he ever set those words to music, but Dean voiced what may be one of the most profound guiding principles for successful long-term investing, as well as for a happy life. He was not the first one to express this sentiment, but he may have been the most colorful.

What strikes me about Dean's statement is its inherent optimism and pragmatism. Dean did not say that everything in the world would be alright all the time. He knew that the winds could shift abruptly and could make for rough sailing. Instead, he implicitly expressed optimism and confidence that he himself had the knowledge, the tools and the wisdom necessary to bring himself safely to harbor no matter which way the wind may have been blowing. This is a healthy and rational optimism and it is a maxim that guides my investment outlook. This type of optimism does not depend on hope and luck. It is not cockeyed and fanciful. Instead, it is grounded in self-reliance, that most American of virtues.

"*I Believe": The Importance of a Guiding Ethos*

When I teach my summer interns how to pick stocks, I ask them to write an "I Believe" statement that sums up what they believe makes for good and successful investing. They may not get their philosophical framework completely right from the outset, but the exercise helps them to develop the wisdom they need to become more successful investors over time.

My own foundational beliefs are straightforward and, by now, time-tested. They act as a reliable compass and as my source of optimism, the knowledge that no matter which way the wind of investing fortune blows, our sails can be adjusted to reach the harbor.

As an investment advisor who focuses mainly on portfolios of individual stocks, I believe in six broad foundational principles of investing. They are:

1. Investing is a ***long-term*** endeavor designed to help investors achieve their most important financial goals and to grow and preserve their wealth;

2. Corporate ***earnings*** drive long-term stock returns; healthy and consistent earnings growth is one of the key factors to consider when selecting securities; high quality portfolios often consist of shares of companies that have a history of stable or rising earnings;

3. ***Dividends*** matter as a driver of secular outperformance; companies that pay dividends show a commitment level to their shareholders that signals confidence in the company's future prospects;

4. ***Valuations*** are an important measure of investor sentiment and should be a key deciding factor in both the purchase and the sale of stocks for prudent investors;

5. ***Minimizing portfolio risk*** should be a key objective in portfolio management, and is vital for long-term investing success - it can be achieved through diversification and manageable position sizes, among other ways; and

6. In-depth ***research and thoughtful analysis*** are vital for minimizing portfolio risk and maximizing portfolio returns over time; analyzing the full range of factors affecting individual stocks enables investors to benefit over time; these factors include historical perspective, macroeconomic and geopolitical events, sector and industry developments, and company-specific views.

Secular Optimism Drives the Markets

Beyond Jimmy Dean's self-reliant type of optimism, there is a kind of big picture optimism that drives the stock market decade after decade and that is also worth noting. It is a sense among long-term investors that the future will be brighter than the past. It comes from the belief and the knowledge, that over time, our American economy and our American companies grow and prosper as indeed they have since the founding of the nation 245 years ago. There have been economic ups and downs in the U.S., manias and depressions, for sure, but over time a healthy underlying optimism about the great economic value that Americans produce has propelled the stock market ever higher. In fact, looking at the period from 1929 to now, we know with certainty that about 67% of the time, stocks move up. During the other 33% they either move sideways or down. It is rarely a good idea to bet against the American stock market for very long periods of time. Optimism is the stock market's core driving sentiment on a *secular* basis.

Euphoria, However, is Not Optimism

When investment advisors talk about optimism in the stock market, they often refer to it as a kind of unreasonable positive sentiment by 'the crowd' to every bit of good news that comes over the wire, or a dismissal of obviously bad news by the same people as if that news were inconsequential. The word optimism is often used to mean euphoria, an extreme and highly emotional form of short-term optimism that is often devoid of rationality and common sense. Euphoria encompasses FOMO, or the fear of missing out, and it has the great potential to lead to loss. Alan Greenspan famously called this sentiment "irrational exuberance".

One of the hallmarks of euphoria, or irrational exuberance, is a complete lack of patience, and patience is one of the virtues necessary for successful long-term investing. Warren Buffett may have said it best when he noted, *"The stock market is a device for transferring money from the impatient to the patient."* He also observed,*"You do things when the opportunities come along. I've had periods in my life when I've had a bundle of ideas come along, and I've had long dry spells. If I get an idea next week, I'll do something. If not, I won't do a thing."* Wise words from the most successful investor of all time.

Current Investor Euphoria Ignores Medium-Term Risks to the Economy

A significant part of the investment management process is being ever-alert to risks, even when market conditions look upbeat. To the aggressive investor this may seem like an unnecessary and burdensome formality. Yet, the old maxim "an ounce of prevention is worth a pound of cure", rings true at all phases of the investment process.

Looking at today's markets, where do we stand now? Is it a good time to buy, a good time to sell, or simply a good time to sit tight? And what should we make of the developing sense of euphoria that seems to be sweeping stocks?

My preference is to continue to be selective in my purchases for clients. That involves more waiting than active buying. It is challenging to be selective and patient when the stock market is hitting new all-time highs, as it is now, because it risks missing out on a potentially bona fide long-term uptrend. Yet, patience and selectivity are choices that may be clearer to you as you read on.

Today's investor euphoria is based on the belief that the economy is booming, with no risks visible on the horizon. From an economic standpoint, investors have considerable justification to be upbeat. The American consumer continues to be buoyant and continues to spend, thereby keeping the economy afloat. The national unemployment level remains at an historically low 3.5%. Household debt has declined significantly since the Great Recession from 13.25% of household income in 2009, to approximately 9.75% now. Inflation has been mild at 2.3% on the CPI (consumer price index). Interest rates remain at historically low levels, making borrowing and financing activities more appealing and affordable for consumers and corporations. And the leading economic indicators for the United States continue to signal continued economic growth for the next three to six months.

Yet, there are also signals of recession on the horizon that should not be ignored. One measure of economic activity, the Cass Freight Index is indicating a marked deceleration in shipping and freight activity in the U.S. And last year's inverted Treasury yield curve should not be forgotten. The possibility of a recession is not farfetched, even though it seems unlikely at the moment. Our last national recession was in 2008/2009, more than a decade ago. History has shown that on average, after the Treasury yield curve inverts, recessions occur within 24 months. It stands to reason that if the yield curve inverted in the middle of last year, as it did, a recession could theoretically happen in 2020 or 2021. While no one can say with pinpoint accuracy when the next recession will occur or how deep it might be, we should nevertheless be vigilant to its signals.

Those recessionary signals may also be coming from the bottom up, from economic conditions at the individual state level rather than the national level. Recently the Federal Reserve Bank of Philadelphia in their "State Leading Indexes" report offered a state by state projection of economic growth for the next six months. The report estimates that 26 of the 50 states will have economic growth rates that are below the national average over the next six months, including 7 states projected to be in recession, defined as two or more consecutive quarters of economic decline. These worst hit states are expected to be West Virginia, Pennsylvania, New Jersey, Delaware, Vermont, Oklahoma, and Montana. The remaining 20 states in the list are either at risk of a recession within that timeframe or are expected to register low growth rates of 0% to 1.5%. By comparison, the national GDP growth rate is currently closer to 2% and is estimated by the Federal Reserve to register 2%+/- in 2020, subject to revision.

Investor Euphoria Also Ignores Risks to Corporate Profits

Corporate profits have been in recession over the past few quarters. As companies report 4th quarter and full-year 2019 earnings starting this month, we will have a better sense for where corporate profits may be headed - they may have rebounded into positive territory, or may still be in recession. We will know in due course.

If there was one theme that dominated the mindshare of corporate CEOs throughout 2018 and 2019, it was uncertainty. With tariffs on imported Chinese goods posing financial and strategic challenges and uncertainties for American CEOs, company managers often found it difficult to invest in their businesses through capital spending, or to make plans for the future. Tariffs were imposed on thousands of products imported from China across a range of industries, so the effects were broad-based. For the most part, corporations chose to absorb the cost of tariffs rather than passing them on to consumers. This had a toll on corporate profits.

At the same time that tariffs were being imposed, Washington was busily eliminating a number of longstanding Federal regulations on industry in an attempt to boost business activity. These two diametrically opposed forces, tariffs on the one hand, and deregulation on the other, left many CEOs unable to successfully navigate the foggy regulatory waters. Tariffs are a form of regulation.

The net economic result of tariffs combined with government deregulation may eventually turn out to be a draw, but over the span of the past year, tariffs have muted both corporate profits and the country's economic growth. The Congressional Budget Office estimates that the current level of tariffs (before the "Phase 1" deal, which may or may not be honored by China), if left in place for an extended period of time, could reduce national GDP growth by 0.1% per year, whereas the Congressional Research Service, a division of the Library of Congress, estimates it may be as high as 0.2%. In a $22 trillion economy, that shaves somewhere between $22 billion and $44 billion from growth in year-one and accumulates over time. At the high end, that equates to the entire GDP of Wyoming at $39 billion, plus a bit more.

There is now a clear divergence between the general economy on the one hand, and the corporate sector on the other, with the economy showing resilience, while corporate profits have been in a slump. One or the other of these realities will have to change - either corporate earnings will have to catch up to the more buoyant economy, or the economy will have to adjust to the slower pace of growth in the corporate sector.

For Long-term Investors, Strong Economic Underpinnings Continue to Favor the Secular Bull Market

Time horizons matter when investing. Short horizons are often filled with buffeting economic winds and corporate earnings fluctuations, resulting in stock market volatility and the potential for real losses to investors. Longer horizons generally make for more successful, more profitable returns and tend to smooth out the short-term fluctuations, making them seem like blips in hindsight. This may well be how we ultimately see the economic and corporate issues facing us at the moment. A long-term perspective is always preferable.

During the past two years, through the stock market's ups and downs, I have maintained that on balance, low interest rates, low inflation, lower taxes, low unemployment, high consumer confidence, and greater policy certainty in Washington, will continue to support the 2009 bull market for some time yet. I still believe that.

The past 12 years, since the end of the Great Recession, have proven to be one of the most profitable periods in stock market history with the S&P 500 Index rising over 350% from its lows.

That rise has been bolstered by slow and steady economic growth which has sustained a low inflation, low interest rate recovery.

With U.S. GDP growth expected to stay in the 2% range into the foreseeable future, the economy's slow simmer may prove to be a good thing. And if we do have a recession in the 2020/2021 timeframe as the inverted yield curve suggests, we should bear in mind that secular bull markets have at times spanned economic recessions in the past. If that scenario happens again, it will not be unique.

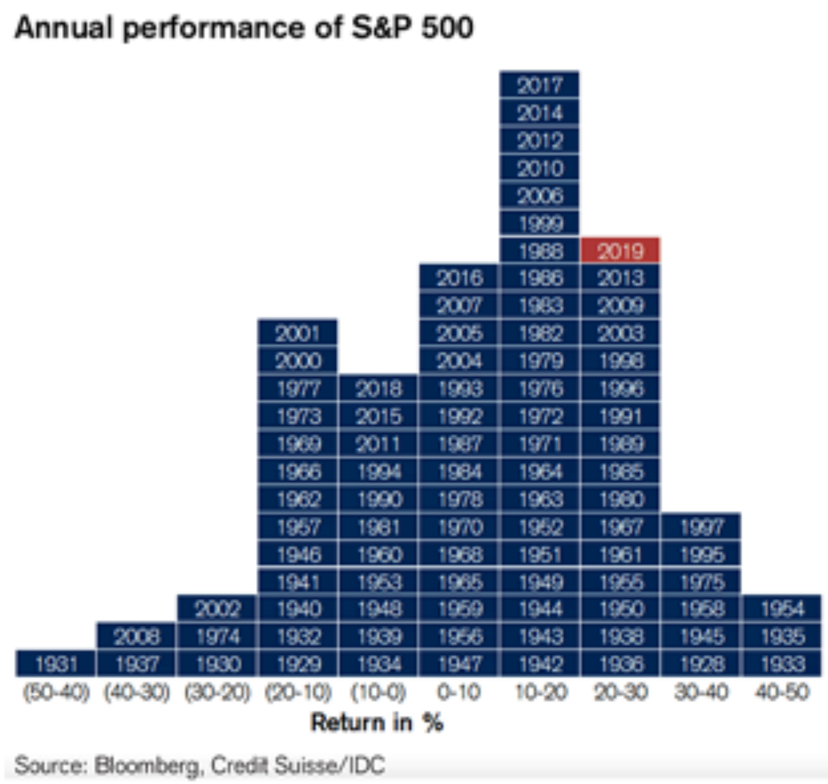
From my perspective, valuations are the primary headwind facing stocks as we enter 2020. High valuations are a signal that investors are overly optimistic, or euphoric, making investor psychology vulnerable to shocks and disappointments. Stretched valuations are more of an issue for stocks than declining corporate earnings since earnings have the potential to change very quickly to the positive. Over time, valuation levels will adjust downward either through a market correction, or a rise in earnings and revenues, making my long-term bullish scenario more viable.

In the meantime, heeding Jimmy Dean's sage advice, assess the wind, adjust your sails, and patiently make your way to port. Pragmatic optimism at work.

Happy New Year!

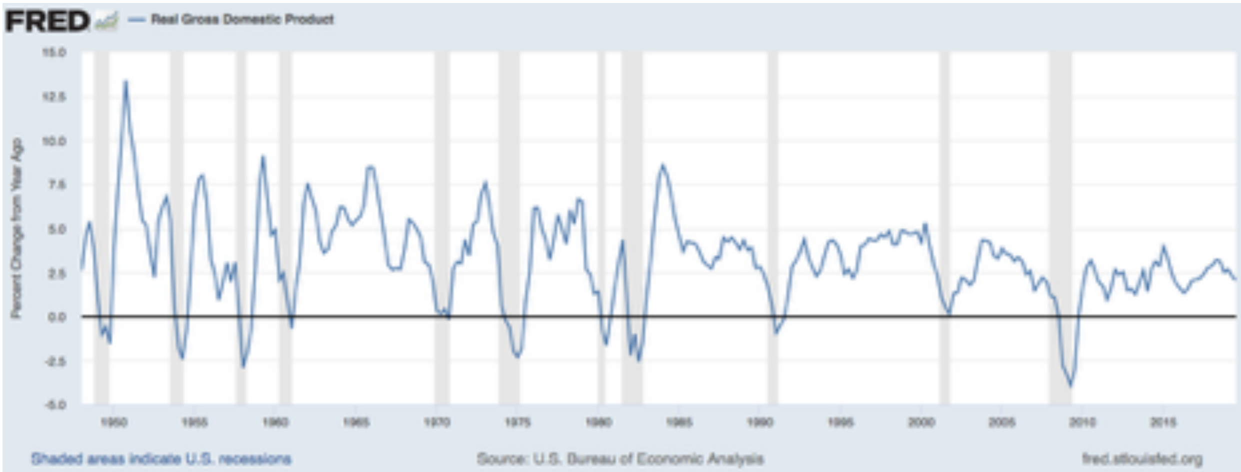
V. Henry Astarjian

Charts and Tables



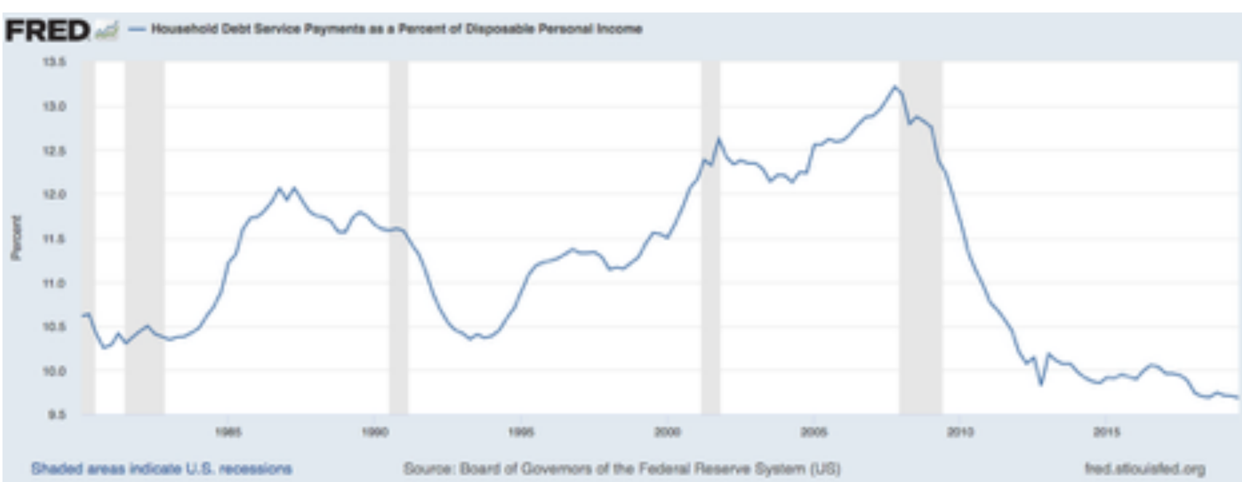
Cass Freight Index: Shipments

U.S. Real GDP Growth (To Q3, 2019)



S&P/Case Shiller U.S. National Home Price Index

Household Debt Service Payment as a Percent of Disposable Personal Income



Dow Jones Industrial Average (DJIA), January 2017 to January 2020

S&P Dow Jones Indices LLC, Dow Jones Industrial Average [DJIA], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/DJIA, January 16, 2020

Leading Economic Index for the United States

The Inverted Treasury Yield Curve

Disclosures