Waterstone Advisors, LLC
10 Brook Street
Walpole, MA 02081
vha@waterstoneadvisorsllc.com
www.waterstoneadvisorsllc.com

October 2021

"What is the Stock Market?"

As Stocks Rise, Retail Investors Fuel Momentum

In a recent Washington Post article, economics columnist Heather Long noted, "Only a few months ago, it seemed that September could be a turning point for a return to normal in the United States. Instead, it has become a renewed period of anxiety. For many Americans, this is fast becoming the 'I don't know' economy. Business leaders don't know when supply chains and shipping bottlenecks will subside. Parents don't know whether school or child care will be disrupted again. And many workers don't know whether they will go back to the office in the coming weeks."

To most of us, Long's comments come as no surprise. Yet, they neatly encapsulate the challenges facing both the economy and the investment environment. All is not well. Circumstances are challenging. The markets are uncertain. Investors are now left to make what often seem like no-win choices between equally unappealing asset classes. Should we buy stocks today despite the expensive market, or should we wait for better valuations? Are bonds a good bargain or should they be avoided?

High valuations are a headwind, and murky fundamentals add to the uncertainty. Two of the most critical questions in investing, namely where and when to invest, are more difficult today than they have been for some time.

Yet, in the midst of uncertainty, the stock market itself continues to rise, defying that old truism that investors hate uncertainty. They do not appear to hate it now. Does that mean then that the old paradigm has changed and now requires a different approach? The answer is, probably not. Not all things happen in an instant or on a pre-set timetable when it comes to investor sentiment. In fact, changes in sentiment can be glacial, especially when the stock market appears to offer easy profits.

The Demographics of Market Cycles

Markets are people, buyers and sellers who look after their own self-interest and who hope to make money by trading assets.

As manifestations of mass psychology, markets move in cycles that mirror the “moods” of these buyers and sellers. At the bottom of the cycle when asset prices have fallen to low points, the mood is depression, while at the top it is euphoria. Each phase of the cycle attracts different kinds of buyers and sellers, with personalities and motivations as varied as humankind.

At the bottom of the stock market’s cycle, buyers tend to be larger institutions, like banks, mutual funds, and insurance companies, among others. They have the expertise to judge a good opportunity and the capital to back up their convictions.

But at the very top of the market, where money-making seems easiest, institutional buyers are often replaced by retail participants. These are individual investors rather than professionals, who are often of the mindset that the market will continue to rise because it has risen for some time. This is a circular argument of course, and it focuses more on the past than on the future - something will continue to happen because it has been happening. Consequently, retail investors tend to pile into stocks at the top of market cycles, convinced that the upward trend will continue unabated.

At times like those, retail participants seem to mirror that bit of Newton’s First Law of Motion that states, “A body in motion will remain in motion…”, but they forget the rest of the theorem, “…*unless* it is acted upon by an external force.” “Unless” is an important word in the world of investments, because there is always an “unless”. It is what we otherwise call risk and uncertainty. External forces in the guise of millions of market participants, with their opinions and motivations, are the “unlesses” that push the stock market off its trajectories, up and down, each and every day, sometimes by a lot.

Retail investors are often less concerned about certainty or uncertainty in the economic and corporate spheres than they are about hopping onto a moving train. If the train is climbing to the top of the mountain, they are getting on for the panoramic views no matter how cloudy the summit may be at the moment. Online chat rooms often serve as the foundation upon which retail investors build their confidence. Participants encourage each other to buy or to sell stocks based on their opinions and discussions. Unfortunately, this is often a case of the blind leading the blind.

The retail set, represented most prominently by discount broker Robinhood’s 20 million active users, may now be driving the markets. The average age of a Robinhood user is 31, with about half of all users being between the ages of 18 and 35. In March of this year, online Wall Street Journal affiliate, MarketWatch, citing research conducted by Oklahoma State University, revealed that the three most commonly searched terms by Robinhood's participants were, “What is the stock market?”, “What is the DJIA?”, and “What is the S&P 500?” The survey’s authors went on to conclude that “Taken together, the findings support the view that the popularity of zero-commission brokers has attracted a new type of uninformed equity-market participant that in aggregate has negative effects on market quality.”

The most recent mantra we are hearing from retail investors and some in the media is “buy the dips”. On its surface, this sounds like reasonable advice. If you are a 30-something year old and have a 30 or 40 year investment horizon ahead of you, then it might make sense to buy the dips since the stock market tends to rise over the long run. However, if your timeframe is much shorter, perhaps 3 to 5 years, or even 10, that advice can be counterproductive. It is like telling a kayaker to keep paddling through the ups and downs of the rapids even as he approaches the edge of Niagara Falls, just before the long drop to the bottom. Risk controls are simply not there.

No doubt, many who seek the advice of others online are genuinely confused and are looking for good investment opportunities at a time when few seem apparent. Others, of course, are looking for fast money, which they may or may not make by listening to people who may be just as lost as they are.

If any generalization can be made about retail investors, it is that as a group their timing tends to be off. They frequently buy when they should be selling, or sell when they should be buying. They are often viewed as a contrary indicator for asset prices, making their latest enthusiastic foray into stocks questionable.

Anticipate an Earnings Slowdown Into 2022

In the current environment of uncertainty, can stocks continue to rise? The short answer is, yes they can. But the rise may be fueled by the investing equivalent of gasoline vapors rather than liquid fuel.

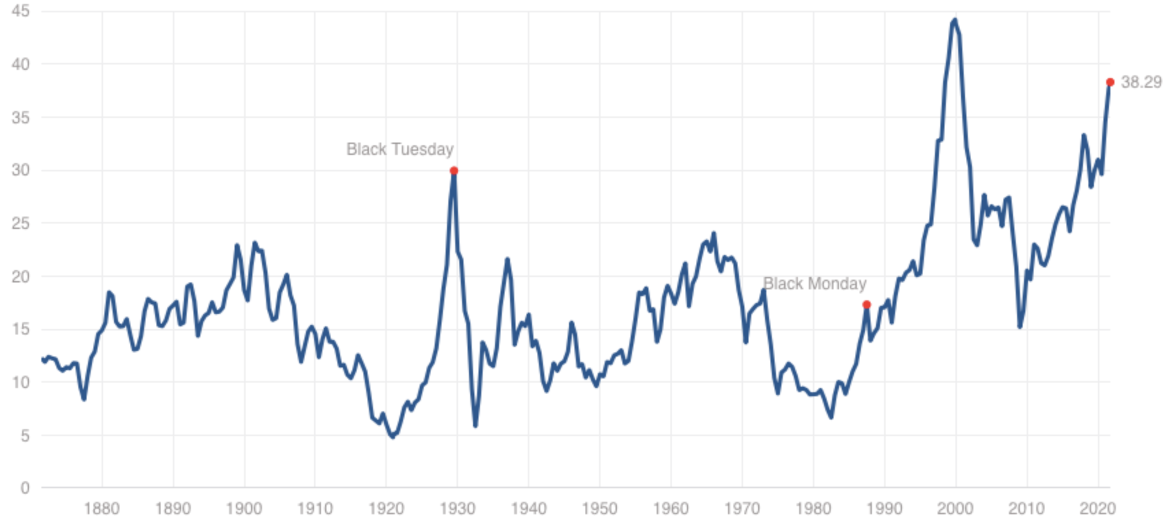
The key to sustained stock market growth is sustained corporate earnings growth. Investors need to be reasonably confident that future earnings growth is enduring. In the short-term, certainty may mean very little to speculators, as we are seeing now. In fact, it may be just an inconvenient roadblock for some. In the long-term, however, it means a great deal to investors who invest for meaningful goals such as retirement, education, home ownership, cultural activities, or charitable giving, among others.

Certainty seems to be evading institutional portfolio managers as well. They have recently become less bullish on the economy and are more likely to believe that a stock market correction is increasingly possible. In its recent Fund Managers Survey that gauges the views of 258 managers running $839 billion in assets, Bank of America reports that managers have increased their cash positions slightly and have redoubled their portfolios in relatively conservative sectors such as materials, energy, and commodities. The survey’s most striking finding is that only 13% of these managers now believe that the global economy will improve over the next 12 months. In March 2021 that figure was 91%.

Uncertainty has also permeated the economic outlook. MarketWatch recently reported that “Over the past week, economists across Wall Street have shredded third-quarter gross-domestic-product forecasts. To name a few: Goldman Sachs cut its forecast to 3.5% from 5.25%, Oxford Economics revised its call to 2.7% from 6.5%, and Morgan Stanley lowered its estimate to 2.9% from 6.5%. That’s as the Atlanta Fed’s GDPNow model predicts 3.7% for the quarter, down from 5.3% at the start of the month.”

Slower economic growth implies the possibility of slower corporate earnings growth as well, in which case valuations should be lower than they are now. One of the most widely followed stock market valuation measures, the Shiller P/E, currently stands at 38. Its historical average from

1870 to now is 16 (please see chart below from multpl.com). The significance of this measure is that it gauges investor sentiment over a long time span. What the chart is telling us yet again this quarter as in the recent past is that investors are pricing the stock market for perfection. As a whole, they expect everything to go well in the economy and in the corporate world. This is unrealistic and unsustainable. The higher the market's valuations rise, the more cautious we ought to be.



Investing During a Period of Uncertainty and Peak Valuations

All investing at all times is done under some degree of uncertainty. Uncertainty is the underpinning of risk, and risk is that portion of the investment picture that we don't know and may not be able to predict with complete accuracy. Managing uncertainty and risk in order to produce healthy returns over time requires ongoing research and analysis on the one hand, as well as tested investment strategies, on the other. Adding a dose of imagination, experience, patience, mindfulness, objectivity, simplicity, and flexibility, helps to improve the odds.

As the stock and bond markets continue to digest the ever-changing realities of an uncertain economic period, and as stock market valuations in particular continue to rise to historical highs, a conservative investment approach becomes all the more important. Beyond a paced and methodical approach to buying good quality stocks and fixed income securities, higher cash allocations allow us a degree of hedging against market corrections. Sufficient levels of cash also allow us to buy attractively valued securities when market conditions are more favorable.

The unchanging cycles of investor sentiment assure us that one period will flow into another over time. The current peaks will give way to future troughs that will eventually wind their way back up to new peaks. Our aim is always to navigate the cyclical ups and downs, and to grow and preserve assets, balancing risk and return.

V. Henry Astarjian

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