WATERSTONE
ADVISORS LLC

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

July 2022

As Market Sentiment Falters, Investors Search for Clarity

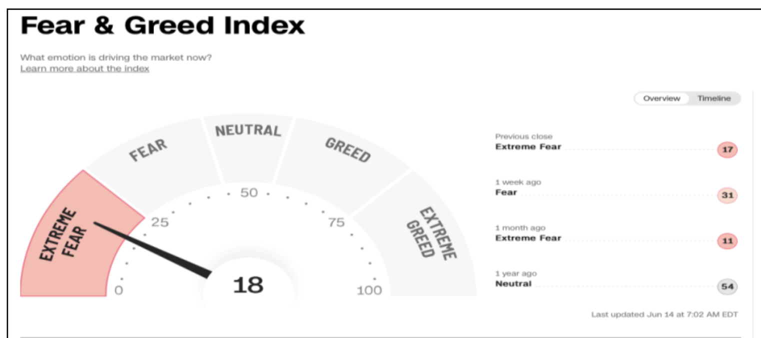
Using "Ockham's Razor" to Untangle the Markets

Simplicity is a much easier concept to understand than to practice. Yet, throughout the ages and in almost all cultures simplicity has been extolled as a valuable guiding principle in every facet of life. Simplicity leads to a clarity of mind and purpose that allows us to have a more confident sense of direction than we might otherwise. It allows us to form a rational and understandable assessment of what is important and what is not.

One of the great proponents of simplicity in critical thinking was William of Ockham, a 14th century English ecclesiastic and philosopher who posited that if a thing can be explained simply and with fewer parts, then it is preferable to a more complicated explanation with more parts. The phrase "Ockham's Razor", or "Occam's Razor", has come to signify this philosophy, with the razor being a rhetorical instrument used to shave away all that is extraneous in a theory.

Ockham's Razor encapsulates a useful concept for us today as we examine what has been driving the stock market lately, and where the market may be heading in the future.

Investors Today Are Worried About Everything



Investor psychology is cyclical. It fluctuates from greed and euphoria at the top all the way down to fear and depression at the bottom, and back again. At each stage, investors choose to either ignore or to focus on problems that may have always existed in the background, or that may be completely new.

Investors today are understandably worried about a host of things including inflation, interest rates, gas prices, energy prices, food prices, supply chains, tariffs, unemployment, labor shortages, trade imbalances, political divisions, and the federal budget deficit, among other things. If the

stock market were a person, we could characterize it as a worrywart as the recent graphic of CNN's "Fear and Greed Index" above clearly shows.

Some of these worries, like trade imbalances and budget deficits, have been with us for a long time and have become part of the investing background where they are routinely ignored by investors. Others, like spiking gas and food prices are newer and are cause for concern among anxious investors.

War is another topic of concern today and has been front and center since Russia's invasion of Ukraine in February. It is worth looking briefly at war's effects on stocks historically and the significance this particular war may have on equity prices.

Looking over the globe, what is astounding is the number of active conflict zones that exist now and that have, in fact, existed for decades in many cases. From Europe to the Caucasus to the Middle East, from Africa to large swathes of Asia, active wars are to be seen everywhere. All in all, the Council on Foreign Relations, which keeps track of these things, lists 27 war zones around the world where some degree of armed fighting is ongoing. What should be noted as well is the number of other regions where conflict is simmering just beneath the surface, as in the Balkans, or the Baltic states.

The war in Ukraine is both tragic and inexcusable on a human level. It is a glaring reminder that mankind's behavior does not change from age to age and that the tough and painful lessons of the past have to be learned and re-learned by each successive generation. There is an element of historical vigilance that humanity as a whole requires, but generally lacks. In the modern world the new is often more valued than the old, and history is often relegated to the book shelf in favor of the newest distractions, whatever they may be.

Not surprisingly, most investors don't like the uncertainty and disruptions that wars and conflicts cause to economic activity, and hence, to stocks. The great 18th century Scottish economist and philosopher, Adam Smith, noted that the three most important prerequisites for a healthy economy were "peace, easy taxes, and a tolerable administration of justice". No doubt, he placed peace first because much else depends on it, including a healthy economy and, ultimately I would add, an ebullient stock market.

From a U.S. corporate perspective, not all wars around the world are equal in terms of their commercial significance. Most of the wars in the 27 regions noted by the Council on Foreign Relations have little economic importance to the U.S. If certain wars do have significance to U.S. corporate interests, companies often learn to work around them. Companies within a free market system, like that of the U.S., tend to be resilient. They seek solutions and learn new ways of dealing with challenges such as supply chain constraints and shortages. As a result, the stock market does not react to most wars unless they disrupt the ability of companies to make a profit, or have the potential to do so.

Ukraine's and Russia's significance to the U.S. is that they provide about 30% of the world's wheat supply, and nearly 40% of Europe's energy supplies either through extraction, as in the case of Russia, or through transport, as in the case of Ukraine. Any weakening of key American

trading partners like those in Europe or Asia would have a knock-on effect on U.S. businesses and on U.S. share prices. And with the E.U.'s decision to cut the flow of Russian oil into Europe by the end of this year, the value of two increasingly dwindling yet vital natural resources, namely oil and gas, has skyrocketed. I would point out that oil is used not just for transportation and heating as we often think, but in the manufacture of more than 6,000 products, many of which we use daily. Hairbrushes, detergents, umbrellas, plastic bags, and roofing tiles come to mind.

Over Time, One Factor Consistently Moves the Stock Market More than Others

In the spirit of Ockham's Razor, and in the face of the many factors worrying investors, I offer the idea that at the end of the day one fundamental factor affects share prices more than others on a secular basis, namely corporate profits, also called corporate earnings. Everything else, all the things investors are worried about currently, could and should be evaluated in the context of this factor, especially the big trio of current worries, war, inflation, and interest rates.

At their core, stocks are ownership interests in real companies. We buy stocks because we want to own a piece of a good company and to share in that company's sales and profits growth over time through dividends and stock price appreciation. If a company never makes a profit and we as shareholders never receive the benefits that go with being partial owners, then there is no reason to own that company. Every external event should be run through this filter to judge whether the event will have an effect on the company's profitability or not. That includes all the specific events that are worrying investors today. It is not an easy task, but is well worth the exercise.

Consensus Earnings Estimates for 2022 Remain Positive Despite the Many Challenges

Wall Street is not always known for making timely and spot-on predictions about corporate earnings. However, it is always worth taking their views into consideration, especially when thinking about the magnitude and direction of their projections for corporate sales and earnings growth.

According to FactSet, the firm that compiles and analyzes Wall Street analysts' projections, Wall Street's latest call is for the member companies of the S&P 500 Index to deliver bottom-up sales growth of 10.7% this year, and for earnings to grow by an average of 10.0% for all of 2022. For 2023 the consensus expectation is for earnings to rise by 9.1%.

FactSet notes that analysts have been slow to make downward revisions to their estimates, though FactSet does not offer a reason for that. One explanation from a positive standpoint may be that analysts are reflecting what they are seeing and hearing from the individual companies that they cover. That contrasts with a top-down approach that economists use when making predictions that are relevant to investment decisions. Both have validity, but a bottom-up approach adds a great deal of color on individual investments that may not be available from a 40,000 foot view. In the current environment where there is so much to worry about, a macro approach can seem overwhelming and may be less reliable than a consensus bottom-up view.

Is it possible that Wall Street analysts are wrong, or too optimistic? Yes, it is. But in a market downturn when we are carefully looking for signs of green shoots pointing to the market's recovery, their viewpoints can be helpful in setting the backdrop for what comes next. Analysts'

earnings projections may change over the course of the quarter, but for now their collective assessment of both revenue and earnings growth into next year is positive. If this holds it will be supportive for stocks.

Equity Valuations Have Improved, but Remain High

A second important factor to consider when evaluating stock market prospects is valuations. The decline in the stock market since December 2021 has been precipitated at its core mainly by one factor, the overvaluation of the stock market. Prices had gotten too far ahead of the fundamental and macroeconomic picture. There was too much froth built into valuations, meaning that investors were more focused on rising stock prices than on prospects for corporate profits. Investors and speculators alike were buying the market because the market was going up, not because the fundamentals supported higher valuations.

Valuation is a less reliable timing tool for the stock market's movements than earnings, but has considerable importance as a barometer of the general investing atmosphere - when valuations are high, we can expect the risk of a decline in share prices to be high, and when they are low we can expect stocks to rise more easily.

However, the Shiller P/E (above chart) which measures longer-term stock market valuation has declined from its recent high of 39 but still remains elevated at 29. Its long-term average is 16. This implies that stocks are still expensive on a long-term basis and selectivity is still warranted in our investment approach.

The Fed's Actions Could Foster Economic Growth Beyond 2023

Fed policy has been much criticized in the media for being slow, behind the curve, and out of touch with reality. That is true to a great extent, but that does not make the Fed irrelevant to our investing decisions. On the contrary, ignoring the Fed can be perilous. Politics and criticisms aside, the Fed's move to increase the nation's base interest rate by 75 basis points (0.75%) to about 1.75% on June 15th was a much needed signal that tackling inflation and stabilizing the employment market were front and center for the bank's policymakers.

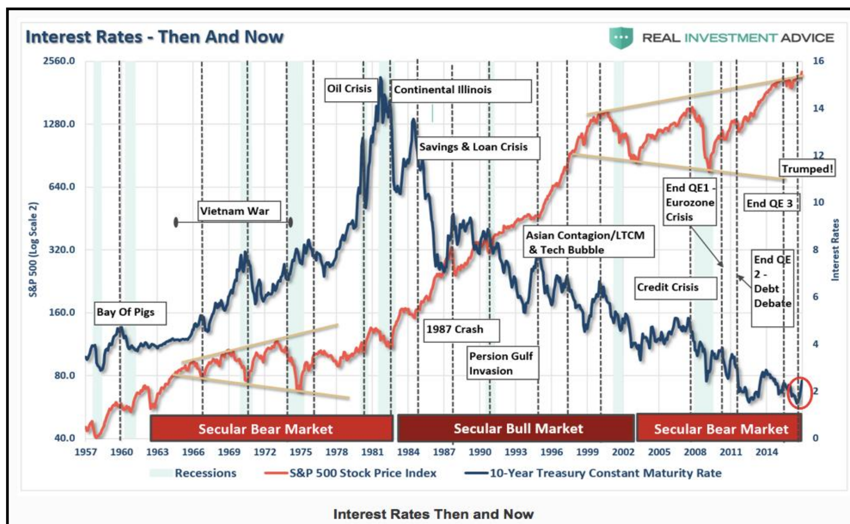
That said, beating inflation may not come without a cost to the economy. Large interest rate hikes in the magnitude of 50 or 75 basis points, risk quickly slowing both domestic and international economic activity and tipping the U.S. and the developed world into a recession. Keeping in mind that 40% of the sales generated by companies in the S&P 500 come from abroad, the global economy is important to U.S. corporations. The stock market may anticipate a recession

by a period of months, and we could see stocks selling down to lower valuations than we currently have.

If there is a bright side to this scenario it is that the Fed has indicated their expectation that inflation will drop from its current 8.6% annual rate to only 2.6% by the end of 2023. Their longstanding target for inflation has been, and still is 2%. If they are able to achieve that rate the economy could grow comfortably over time without the excesses that come from either no inflation (no economic growth), or high inflation (bubbles). Lower inflation rates may be a late 2023 reality and could offer positive support for stock prices in the years ahead.

Stocks Are a Good Hedge Against Sustained Inflation and Rising Interest Rates

In the face of all the confusing investment advice in the media about hedging portfolios against inflation, one fact should be noted namely that stocks are one of the best places to invest if you expect a prolonged period of inflation.



Interest Rates Then and Now

The left side of this chart shows how the S&P 500 performed from 1957 to about 1983 as interest rates (a proxy here for inflation) rose to a peak of about 15%. This was a period when two major events caused inflation to rise in the United States. The Vietnam War was partially funded by government money printing, which ultimately increased the money supply, and the 1973 oil shock which brought with it stagflation, a period when the economy didn't grow, but was still accompanied by inflation.

While one chart may not be a definitive answer to the question, it does suggest that with a lag, returns on stocks are able to keep up with, or to exceed inflation. Stocks are also able to do well when inflation declines, as the chart indicates. In periods of rising inflation, most companies are able to raise their prices to customers, while in periods of low inflation they are better able to manage their margins. These observations are for long periods of time, but are well within an investing lifetime.

A Word on Fixed Income

The fixed income space has traditionally been one in which investors seek income and stability for their portfolios. It is not a place where investors generally take big bets with the expectation of big returns. That is still the case.

When interest rates rise, existing fixed income securities lose their value. We have recently seen this quite clearly across the fixed income universe from U.S. Treasuries, to municipal bonds, to high yields, to corporates, and even to sovereigns (bonds issued by foreign governments). They have all been losing value over the past year, or longer.

For example the Vanguard Total Bond Market ETF, BND, which invests in bonds of various types of issuers, has lost more than 17% of its value since August 2020. That is not the kind of thing we have seen in quite some time, and clearly highlights the underlying changes taking place in the secular trend of interest rates. From the early 1980s until recently, interest rates had been declining, whereas now they look set to rise from near-zero levels as the Fed attempts to control inflation.

On the flip side, we are seeing more attractive yields on the fixed income ETFs that we like. The market is at a point where yields have risen and prices may have finally stabilized, meaning that buying opportunities in the fixed income space are more abundant now than they were toward the end of last year.

Keeping it Simple and Focusing on What Matters Long-Term

Among the thousands of stocks available to us on the stock exchanges, several hundred have a long history of increasing their earnings and paying dividends. These companies have a proven ability to conduct their businesses wisely through various economic conditions for the benefit of their customers, and for the profit of their shareholders.

It is predominantly these kinds of companies, with years of sales and earnings growth that are most appealing to us. These are often companies that are committed to returning part of their profits to shareholders in the form of dividends. Dividends are an important source of income for investors and an important part of investment returns. Dividend flows into a portfolio can help to alleviate some of the contraction in portfolio values during down markets. And dividends provide a source of income that investors can count on with some certainty.

Dividend paying companies often have a high level of “visibility”, a term that investment analysts use to indicate that a company’s future sales and earnings flows are more easily predictable than those of other companies. Their business prospects tend to be more certain than those of others. This is a valuable benefit that adds to the confidence with which investments can be selected.

Clarity is especially valuable in the type of environment we have today where information overload and negative news flows often lead to investor angst and confusion. The principle of simplicity embodied within Ockham’s Razor is perhaps more relevant for investors today than at most other times. Keeping it simple and focusing on what matters is not just a catchy phrase. It is an invaluable key to good investing and is grounded in timeless wisdom.

V. Henry Astarjian

Disclosures: Waterstone Advisors, LLC is a Massachusetts registered investment advisor. Registration with securities authorities does not imply a certain level of skill or training. Investing carries risk of loss, including loss of principal. The information and data presented in this note have been compiled from publicly available sources that are believed to be reliable. However, their accuracy is not guaranteed. Waterstone Advisors LLC does not guarantee the performance of the securities or strategies discussed or analyzed in this note. An investment in these securities or strategies may result in complete loss of principal. For additional information and disclosures, please see our ADV Part 2 (the "Firm Brochure”) in the Our Approach page of our website at www.waterstoneadvisorsllc.com, or contact us at 978-828-2188.