WATERSTONE
ADVISORS LLC

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

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The Price of Cheap Money

Lessons for Investors From a Once Great Empire

This summer my wife and I had the pleasure of visiting Portugal, a country that I had never visited before and about which I knew very little. During my youth, Portugal was out of bounds for Americans. It was ruled by a dictatorship much like the one next door in Spain and relations with the United States were strained, at best. Travel to the region was not encouraged, and for the Portuguese emigration was often the only remedy for economic and political hardship. Portugal was more or less a closed country within Europe. It was technically still a colonial empire, owning Angola and Mozambique among other territories, but none of that seemed to help its economic prospects. In 1970, when its dictator died, Portugal was the poorest country in Western Europe having a per capita GDP that was only 40% of the Western European average.

Yet, just 200 years earlier in the 18th century Portugal was a substantial power, nearly on par with the British, Spanish, and Ottoman empires. And 200 years prior to that, in the 16th century, it was the world's preeminent superpower having taken possession of colonies and lucrative trade routes from Africa, to Arabia, to India, China, Indonesia, and Japan. Along with its largest colony, Brazil, it was the first global empire on which the sun never set. It had no rivals.

As a result, Portugal grew rich. Not only did it control trade routes around the globe, but it also controlled lands rich in natural resources. Most importantly, its gold and silver extractions from mines across its colonies flooded the Portuguese mainland with precious metals used to decorate countless churches, monasteries and palaces. In their monetized form these precious metals were used by the Portuguese Crown to fund every aspect of the economy, including the expansion of the empire. Over a period of decades, monetized gold and silver poured into the Portuguese economy without the Portuguese having to do much in the way of productive work to earn these riches. They essentially got something of great value without having to produce and sell other things of equal value in return.

Ultimately this large volume of cheap money resulted in three critical and lasting negatives.

First, it created an addictive dependence by the Portuguese on cheap money from their colonies. Money may not have grown on trees, but it literally came out of the ground.

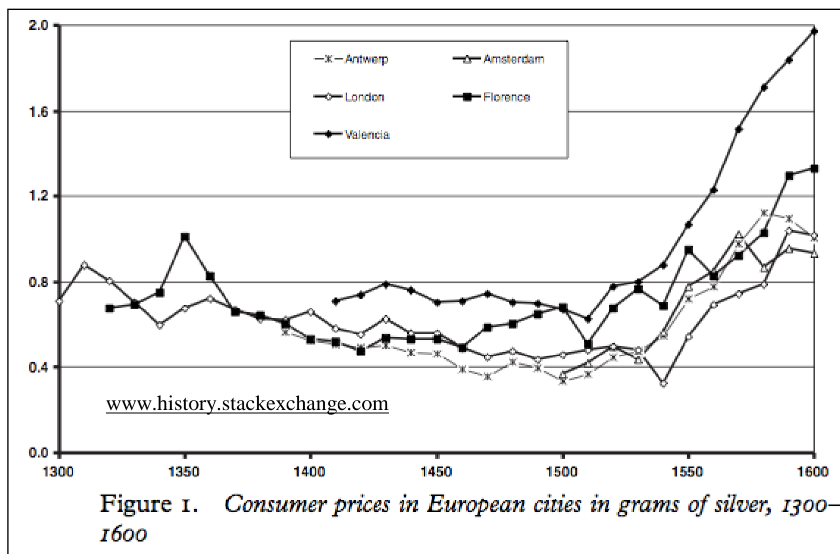

Figure 1. *Consumer prices in European cities in grams of silver, 1300–1600*

Second, after centuries of stable prices and very low sub-1% inflation, the over-supply of gold and silver doubled the country's inflation rate by the 16th century, thus reducing the country's purchasing power. The chart on the left highlights this phenomenon in Spain, a proxy for Portugal - both empires experienced the same problem of excessive inflation due to the influx of gold and silver from their colonies.

And third, since collectively workers such as artisans and farmers did not have to produce anything of equal value in exchange for this new supply of money, they became inclined to be less productive. Money flowed into the economy no matter what the quality or quantity of Portuguese industrial or agricultural output may have been.

A Cautionary Tale for America and the World

Today in America we do not have an inflow of unearned monetized gold and silver into our treasury, but we do have a situation where our money supply has been increased by roughly $5 trillion, or nearly 20% of GDP, in the span of two years. Since the onset of the covid-19 pandemic in 2020, the Federal Reserve Bank and the federal government have injected cash into our economy in order to prevent economic collapse at a precarious time in U.S. history. To-date, we can say that this strategy has done what it was intended to do on a macro level - it has kept American businesses out of wholesale bankruptcies, prevented mass layoffs, and not surprisingly, it has reduced the poverty level in this country. Those are all good things.

However, increasing the money supply always, and in every country, carries the risk of inflation. Once a government has injected large quantities of liquidity (i.e. money) into the economy, or kept interest rates artificially low to encourage borrowing, inflation of some magnitude becomes inevitable. That is what we are seeing today in our economy. Inflation has now become the number one economic challenge facing consumers, businesses, governments and investors in the U.S.

Yet, inflation is not just an American problem - it is global, as the table below from Trading Economics shows. Many parts of the world are suffering the same fate, and often for the same reasons - low interest rates, excessive money printing, supply chain constraints, high oil prices, and so on.

Country	Last	Previous
Turkey	83.45	80.21
Argentina	78.5	71
Russia	14.3	15.1
Netherlands	12	10.3
Euro Area	10	9.1
Germany	10	7.9
United Kingdom	9.9	10.1
Spain	9	10.5
Italy	8.9	8.4
Brazil	8.73	10.07
Mexico	8.7	8.15
United States	8.3	8.5
South Africa	7.6	7.8
Singapore	7.5	7
Canada	7	7.6
India	7	6.71
Australia	6.1	5.1

A notable standout among the larger economies of the world is Turkey. It now has an official inflation rate in excess of 83% per year compared to the U.S.'s 8.3%. That has been made worse by the country's unorthodox strategy of lowering interest rates at a time of rising inflation - all other countries are doing the precise opposite, they are increasing interest rates. Unchecked inflation has the potential to derail an economy by discouraging consumers, businesses, and governments from buying goods and services at ever rising prices. Inflation can also cause civil strife and social instability.

Among the top 10 global economies, the U.K., which is ranked 5th, has been a standout recently for its seemingly chaotic way of dealing with inflation. The new government has set a cap on energy prices to protect consumers from dramatic energy inflation, while simultaneously proposing to cut the tax rate across the board, but especially on top earners who typically pay as much as 45% in income taxes. These moves have caused confusion and alarm within the international currency markets because price caps interfere with the free market's ability to adjust prices according to supply and demand, while tax cuts reduce revenues to the national treasury. That makes it tougher for the government to subsidize household energy costs. The British pound now finds itself in the unenviable position of falling against the U.S. dollar. While that makes U.K. exports cheaper on the one hand, it also makes imports more expensive. If these plans are implemented, the net result may be a U.K. recession with spillover effects on the E.U. and other regions.

In the Eurozone, inflation has now reached 10.0%, prompting the European Central Bank (ECB) to raise the bank's lending rate from 0.50% to 1.25%. And in the U.S. the Federal Reserve Bank, the Fed, has recently raised the country's base Fed Funds lending rate to a range of 3% to 3.25% and has promised to raise rates even further in the coming months. Only two years ago the base rate stood at 0% to 0.25%.

What Investors Can Expect in a Rising Interest Rate Environment

The media have said much lately about the new cycle of rising interest rates initiated by the Fed. A great deal of the media's narrative has concluded that a dire scenario awaits both the economy and the investment markets at the end of these rate increases. That viewpoint is understandable,

though off the mark. When the road ahead looks foggy and impassable, our natural tendency is to worry.

My reading of the situation is less gloomy and more focused on prospects for the longer term. Once the Fed has finished its interest rate increases over the coming months, and we have made our way through the current stock and bond market downturns, our investment prospects are likely to remain positive.

More specifically, over the course of 2022 and 2023 we could see the following chain of events where:

- The Fed raises interest rates in an effort to lower inflation;
- The U.S. economy slips further into recession and unemployment rises;
- Corporate sales and earnings growth decelerates;
- Stock and bond markets decline below their recent lows;
- Inflation reaches the Fed's 2% target sometime in 2023;
- The Fed ceases interest rate increases and eventually switches to a cycle of interest rate reductions in order to revive the economy;
- Stocks and bonds become more reasonably valued;
- Investors find improved long-term buying opportunities once again; and finally,
- The stock and bond markets start a new bull cycle.

This is one possible scenario for the economy and the markets. Its timeline may be shortened to early 2023, or it may be stretched into 2024. It all depends on how events play out and what the Fed does. Overall, envisaging the broad possibilities is a useful exercise for understanding what may lie ahead, and may help to lift some of the fog that clouds the road ahead. As with all predictions on complex human events, this scenario is not cast in stone and is subject to change.

Strategy Favors Caution, Selectivity and Preservation of Capital

For some time, I have been saying that the stock market is overvalued and is at risk of declining. This has been the basis of my consistent call for caution and selectivity, especially when stocks were reaching all-time highs and investor euphoria was at historically elevated levels.

So far this year we have seen one of the worst stock market performances in decades. From December 31, 2021 to September 30, 2022 the S&P 500 Index has fallen by -24.77%. If that figure turns out to be the final return for all of 2022, then 2022 will go down in the record books as one of the 6 worst years for the S&P 500 since 1928, after 1931 (-47.07%), 1937 (-38.59%), 2008 (-38.49%), 1974 (-29.72%), and 1930 (-28.48%).

In anticipation of this challenging investment environment, I have kept cash allocations higher than normal for most clients for some time, partly as a hedge and partly because attractive buying opportunities have been few and far between for an extended period of time.

What we have seen and experienced in the stock market since the start of 2018 is a broad market correction, full of choppy rides and downside turbulence. That has made steady investing and a

fuller use of cash more difficult than during a steady bull market. The price graph below shows the often dramatic ups and downs that have essentially moved the stock market sideways over the past four years.

Higher cash allocations have served us well during the recent corrections especially in periods of dramatic volatility such as the months between December 2021 and June 2022.

During that time, the S&P 500 Index declined -20.58%. A hypothetical 70/30 portfolio consisting of a 70% weighting in the S&P 500 Index and a 30% weighting in the Vanguard Total Bond Market ETF, the BND, was down -17.77%. The 60/40 combination of the two was down -16.83%. By contrast, the average Waterstone portfolio declined by about -12%, partly due to the higher-than-usual cash cushion, as well as the conservative lineup of dividend paying stocks that clients have in their portfolios.

If the stock and bond markets are heading further down on a net basis over the next 12 to 18 months, as I anticipate they may be, then a continued focus on higher quality, dividend paying stocks, combined with higher cash allocations should continue to serve us well. With bond yields at their highest level in many years, fixed income securities now offer more attractive yields, and may increasingly be more suitable additions in our conservative asset mix than they have been for some time.

Minding the Lessons of History and Staying the Course

Portugal has offered us an instructive historical example of a country whose money supply expanded almost exponentially from a low base. The outcome was inflation, a loss of productivity, and a societal expectation that cheap and easy money would last forever.

In the 21st century, America enjoys the benefit of historical hindsight as well as 200 years of trial and error through which modern economic theory has come to be developed and understood.

Additionally, we have the benefit of years of empirical observations that inform our economic and investment decisions. From that perspective, we are forewarned when we see excessive liquidity in the economy - we know that the resulting inflation could lead to a cascade of events that make it more difficult for consumers to consume, for companies to profit, and for investors to invest successfully, at least in the short run. As the saying goes, forewarned is forearmed.

Our refrain this quarter, as in all quarters, is to stay the course and to focus on the long game.

V. Henry Astarjian

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