Stepping Stones Management, LLC

First Quarter 2017 Commentary

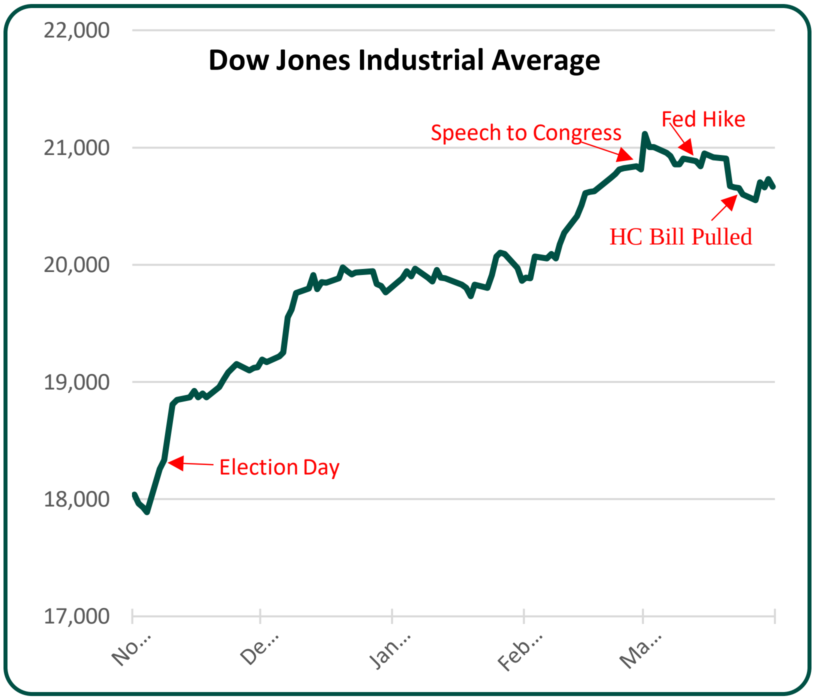
April 24, 2017

Our nation's capital is no stranger to division and strife. When confronted by rioters demanding pay for their service in the Revolutionary War, the precursor to the US Congress was forced to flee Philadelphia to Princeton NJ. Seemingly unwelcome anywhere they went, the Congress of the Confederation also met in Annapolis, MD, Trenton NJ and New York City. A deal was brokered by Alexander Hamilton where the northern states agreed to locate the capital along the Potomac River in exchange for Southern states agreeing to nationalize the war debt. Peter Charles L'Enfant was tasked with laying out the city and chose "Jenkins Hill" for the "Congress House" with a grand avenue leading to the "President's House." Thomas Jefferson changed the name to Capitol Hill after Rome's Capitoline Hill known for its Temple of Jupiter, the most important temple in ancient Rome. It's not known if Jefferson intended any irony.

L'Enfant's plans had other problems beyond the names, forcing President Washington to dismiss him in 1792. Secretary of State Jefferson proposed a design competition for the Capitol and President's House. Washington praised the "Grandeur, Simplicity, and Beauty" of a late entry by amateur architect William Thornton who he appointed the first Architect of the Capitol. The expected winner, a French trained architect named Stephen Hallet was mollified in his loss by an appointment to oversee the amateur. Hallet picked apart Thornton's design to where another party had to be brought in to bridge their differences. Hallet even changed features that Washington and Jefferson expressly desired, so he was fired in 1794. By 1800, the north Senate wing was incomplete and the House of Representatives was a semi attached shack when President John Adams urged the Congress to convene in its new home hoping to secure enough Southern electoral votes to win reelection. The House of Representatives eventually got their wing and a dome was added and later enlarged to its current form. By the time it was done, The Capitol had many illustrious names attached to various aspects of its design and construction before the British tried to burn it down in the war of 1812.

The parcel of land that became Washington DC has been relatively placid since then but that may have changed in the just completed first quarter as our amateur President challenges the established order. Last quarter's letter covered the Trump Effect that saw markets buoyed by optimism about pro market policies at both ends of Pennsylvania Avenue. Now in office, reality has taunted many of those early hopes. We have seen the President's conversations with world leaders leaked by intelligence agencies that supposedly work for him as our troubled world challenges his "America First" intentions. The Republicans' signature plan to repeal and replace Obamacare crashed and burned without even a vote. The Federal Reserve is accelerating its wary exit from a decade of unprecedented monetary easing but none of that was enough to restrain the stock market from finishing the quarter with a healthy 5.5% gain.

Seven Days a Month



That quarterly rally was on the back of a 7% rise since the election and it reached its peak the day after President Trump's first address to a joint session of Congress. The moderate tone of the speech was enough to send the Dow Jones Industrial Average up more than 300 points to its first close above 21,000. It only took 24 days since crossing the 20,000 milestone which is tied for the quickest 1,000 point gain with the move from 10,000 in 1999. The President's departure from his strident campaign rhetoric signaled his willingness to make deals with our nation's varied special interests. Much of that gain dissipated over subsequent days until the market got another boost when the Federal Reserve raised its overnight lending rate for the third time in almost a decade and second since Election Day. Markets interpreted the increase as signaling a stronger economy. As you can see on the chart however, the rally fell short of its level of a couple of weeks prior. The reality is that tighter money historically correlates with lower stock prices. As the Fed raised rates, a Congressional Budget Office review predicted the Republican's health care legislation could result in 24 million Americans losing their insurance over the next decade.

That would be expected to shake moderate Republicans away from the legislation but it was the conservative wing of the party that abandoned what they dubbed "Obamacare Lite". Counter to the promises of regular order and open debate, the legislation was written behind the same oak doors of the Congressional leadership offices and presented as the only option. Gone were the dozens of repeal and replace bills the party leaders bragged about passing in the last eight years. Instead, a three stage process was presented to work around arcane Senate rules. The holdouts didn't believe they would ever see the second two stages which was enough to bring down the whole effort. Lacking the unity Republicans have rarely shown, the Speaker of the House withdrew the legislation instead of seeing it suffer a losing vote. Democrats cannot be expected to lend a hand in dismantling their party's signature legislation in more than a generation, especially as they are entirely focused on figuring out how Russia hacked the election. Hewing to their rhetoric, the president and Congressional leadership said that was their only chance and they would now move on to tax reform.

By quarter's end, it was clear that tax reform would only get through the budget processes after the subsidies baked into the Affordable Care Act were repealed. So goes draining the swamp. As predicted last quarter, the reptiles all want to get fed. Health care covers almost a fifth of the economy but tax reform hits all of it. Reform of either will require a new approach by the Congressional leadership. Since 1800, the best way to pass legislation has been to hold hearings and debate on the grand floors of the Capitol. Let all the illustrious members add their input and win the votes of their colleagues. However, those floors are currently quiet as the House of Representatives is only in session for seven days this month. They have a knack for feeding cynicism.

As reality sets in to the Capitol, economic reports are diverging from the heightened optimism that has driven the recent rally. Anecdotes about inventories growing as sales decline are bolstered by high profile retail closures even as Amazon appears to have enough profits to develop space tourism. A favorite coincident indicator of these letters has been the Atlanta Fed GDPNow model which is predicting the economy grew at a miniscule 0.5% in the first quarter. Markets began the year optimistic about finally breaking out above the 2% growth celling of recent years. The lesson of the quarter is that it's not going to be easy to make America great again.

Despite the weakening economic numbers, it was the higher risk holdings in our fully invested equity ETF strategy that outperformed in the first quarter. Our China and semiconductor positions both enjoyed double digit gains and the gold miners and Europe funds were close behind. Even though the Fed is raising rates, market rates declined in the quarter which helped the interest rate sensitive utilities fund also outperform the broad market. The value, consumer staples and currency hedged Japan positions all gained but underperformed. It was our long beleaguered energy positions which dragged down performance but are still in an upward trend off their 2015 lows. If the economy keeps weakening we will have to give up hopes of higher energy prices but rising inflation would support these positions. All totaled, the strategy gained 4.91% on a price basis for the first quarter compared to the S&P 500 which gained 5.53% and the MSCI All World Index rising 6.91%.

Tugging on Yellen's CAPE

A couple blocks off Pennsylvania Avenue on the other side of the White House is the white marble Federal Reserve Eccles Building, meant to be apart and insulated from the political branches of government. It was also designed by competition but President Franklin Roosevelt invited only established architects to compete. With their inflation targets finally being met, the Fed's overnight rate hike to 1% was not a surprise. The minutes released from the March meeting did contain unexpected news regarding the balance sheet which has grown from around $900 billion before the financial crisis to about $4.5 trillion currently. A prior letter predicted the fivefold increase in our monetary base would mean that a can of Coke will eventually cost $5. The reason that hasn't happened is that the Fed has paid their member banks not to lend that money into the economy. Instead it has been mostly invested in Treasury Bonds which in effect funded the deficits of the past eight years. While the Fed has made clear they will not afford the same generosity to our amateur president, markets expected them to continue to roll over the bonds they accumulated. However, the minutes revealed plans to retire the debt and shrink the balance sheet, so that can of Coke will never cost $5. Not only will the Fed not fund President Trump's deficits, they are going to make his Treasury Department pay the bonds from the Obama deficits. Maybe they are too close to L'Enfant's grand avenue after all.

The Fed tells us that the economy is expanding at a moderate pace and elevated values of risk assets, such as stocks, warrant a less expansive policy. Someone who knows about valuation is Professor Robert Shiller of the Yale School of Management. He has developed and maintains several confidences indices based on surveys of individual and institutional investors that he wrote about last quarter in The New York Times. Confidence that stocks will be higher in one year is at record levels even as expectations for a major decline also score high. Investors acknowledge a big drop may be coming but are bidding valuations ever higher not wanting to miss out on the last leg of the rally. Shiller says similar scenarios occurred before major declines.

One of Shiller's more famous indices is the CAPE, or cyclically adjusted price earnings ratio. It is different from the more common PE ratios in that it adjusts prices for inflation using the Consumer Price Index and uses a ten year average of broad market earnings to smooth out short term or cyclical fluctuations. Going back to 1881, he found the index to average around 15. When it fell below that level, subsequent 10 year returns tended to be good and when above the opposite tended to occur. It finished the first quarter at 30. That is higher than the level prior to the 2008 crash and is only exceeded by readings in 1929 and 2000. Shiller attributes the market's optimism to expectations of an Administration like Ronald Reagan or Calvin Coolidge. Both prior governors were portrayed as amateur presidents but fostered strong economic growth and enjoyed stock market booms. The difference is that both began with stock prices at cyclical lows, not record highs like today.

As Chairman Yellen finishes her term in a tightening cycle following her predecessor's expansion, markets will need to process the uncertainty of the next Fed Chair. If it is someone who fits the pattern of the President's other appointments, we should expect a free market advocate with real world experience. That would likely lead to the same higher rates and smaller balance sheet that Yellen is now pursuing. These letters have highlighted the correlation between the stock market and the Fed's balance sheet. Warnings of lower prices correlating with a smaller balance sheet were premature but that is what the Fed is telegraphing now. Although Yellen has been halting in her actions, she has been truer to her words than most in the Capitol.

Our nation has a rich history of amateur achievement in and out of the Capitol. Those warriors from the Revolution were barely amateurs as they defeated the world's sole superpower. The geniuses who set up our nation of laws that could survive any despot did not have scholastic training as much as real life experience. Great presidents like Reagan and Coolidge were derided early in their terms as incompetent amateurs, as was Abraham Lincoln. Aside from government, the Twentieth Century witnessed one of world history's great rises to power as amateurs invented the American industrial revolution. Americans have a penchant for backing amateurs which could explain the market optimism surrounding President Trump, even if he's not another Reagan or Coolidge. That optimism may be well placed but current reality shows a weakening economy with last quarter's improvement in earnings centered on a few industries. Remembering Reagan, we had a deep recession early in his term before the economic boom. Looking at today, the balance of risk and reward keeps us in a defensive posture expecting markets to eventually take off the rose colored glasses; even as we remain optimistic about America's return to greatness.

Please feel free to call with any of your financial concerns. Until then and as always, thank you for your trust and thank you for your business.

Yours truly,

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