First Quarter 2018 Commentary

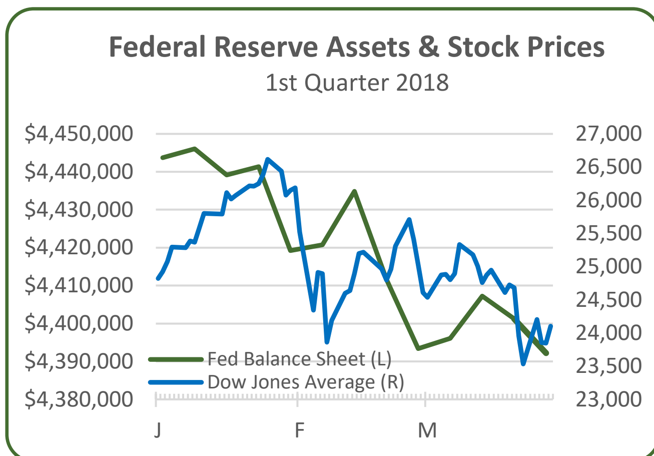
April 20, 2018

Hyman Minsky never enjoyed wide acclaim among his fellow economists. His theories basically built on those who came before him, such as John Maynard Keynes whose avocation of government intervention inspired this son of socialist immigrants. Minsky's explanation of how business cycles progress through stages of euphoria leading to excessive debts which lead to stages of despair were not groundbreaking but his Financial Instability Hypothesis was unique in stating that the financial system "swings between robustness and fragility" and it is during these periods of fragility that financial crises occur. He died a decade before subprime mortgages exposed the fragility of the modern financial system but an early 2008 New Yorker article lent to his immortality by describing the burgeoning crisis as a "Minsky moment."

If Minsky were alive then, he probably would have approved of Fed Chairman Ben Bernanke's innovative quantitative easing response that created money to buy Treasury and mortgage backed securities. Although the size and duration which increased the Fed's balance sheet from under $1 trillion to over $4.5 trillion may have been too much for even the diehard Keynesian to accept. Chairman Bernanke, and Yellen after him, both assured markets that the excess money would be retired at an appropriate time but it wasn't until a decade after the crisis that the time finally came. Janet Yellen allowed about $7 billion worth of securities roll off the Federal Reserve balance sheet for each of her last three quarters but it wasn't until her final week in office that she took meaningful action and let more than $22 billion of bonds mature without reinvesting the proceeds. Almost simultaneously, the Dow Jones Industrial Average lost about 1,500 points. Incoming Fed chairman Jerome Powell actually increased the Fed's holdings over his first couple of weeks before making his commitment to the established winding down policy clear by overseeing more $20 billion declines in subsequent weeks that were matched by further stock market declines. By the end of the quarter the Fed's balance sheet was $56 billion lighter and the S&P 500 had its first negative return since the third quarter of 2015, at -1.22%. That was also the last time the Fed let its balance sheet suddenly shrink by more than $50 billion. The financial media attributed the volatility to proposed tariffs sparking an imminent trade war making President Trump an easy foil for the volatility. Whatever the reasons, there are enough to raise concerns about whether we have arrived at another Minsky moment.

Long Strange Trip

Since the monetary expansion was so large, unwinding it will be a major undertaking. As a Fed governor, Jerome Powell helped craft the policy that prescribes $20 billion of net redemptions per month in the first quarter, increasing to $30 billion monthly until June, $40 billion monthly in the third quarter, and then registering at $50 billion per month thereafter. A precise endpoint has not been targeted yet but markets expect the balance sheet to settle at more than double the 2008 level which entails a process that would last for several years. Whether or not stock prices will be as sensitive to that retrenchment as they were in the first quarter is the $4.5 trillion question.



The Fed's balance sheet is basically a conglomeration of the balance sheets of its member banks so when those bonds mature and the money is retired the member banks have less money to loan out. This is a carefully gauged metric where every bank has Fed officials actually residing in their offices making sure they don't lend more than their capital requirements permit. When their Fed assets decline, the banks must call in some loans. These won't be mortgage loans with hard collateral but prime brokerage loans to hedge funds whose collateral can be redeemed instantly. These firms typically use algorithms to run their stock trades and carry as big a book as their bankers allow so when loans get called in, positions get sold. On the accompanying chart, you can see the blue Dow Jones Industrial Averge line following the green line representing the Fed's balance sheet in $millions. Our October 2013 letter highlighted the correlation on the way up and we are anxious about the correlation applying on the way down too. Draining liquidity on such a scale for so many years will present a headwind that the stock market has never faced before.

While the Fed shrinks its balance sheet, they are also in the process of normalizing interest rates that have been suppressed near the zero bound since 2008. The overnight lending rate was raised a quarter point in December 2015 and then four quarter point increases through 2017. Expectations are for three similar hikes this year and two more in 2019 to reach a neutral rate approaching 3%. The market seems comfortable with that, but minutes from the Fed's March meeting reveal concerns that the recent tax cuts and spending bill could cause the economy to overheat forcing rates to rise quicker and further. Higher import prices resulting from a trade war could present yet another inflationary force for the Fed to fight.

With all the money that has been created, acting too slowly risks uncontrollable inflation. Having reached their target of 2% core inflation and with the economy growing at or near 3%, the Fed is in a race to remove the tinder before the flame reaches it. Everyone celebrates the higher wages that have crept into economic reports except the Federal Reserve governors hired to remember the wage/price inflation spiral of the 1970s. They are currently presiding over a far greater monetary expansion than the one preceding that period.

As the Fed embarks wholeheartedly on their winding down course, other large bondholders will be less inclined to maintain their positions as the biggest buyer leaves the market. The world's largest foreign holder of US Treasury debt is the Bank of China who has recently announced a suspension of US bond purchases. That could be a salvo in the trade war or a reaction to the Fed pulling the plug on the punchbowl. Whatever the reason, it is likely that the bull market in bonds that began at the depths of 1982 ended in 2016. A long term rising rate environment is another phenomenon the stock market has not had to face in more than a generation.

Higher interest rates should support a stronger dollar unless foreign holders are liquidating positions. That or the trade rhetoric could have accounted for dollar weakness in the first quarter. The Stepping Stones Equity ETF strategy felt the effects as our currency hedged Japan fund had a quarterly decline of -5.8% even though similar unhedged Japanese funds had smaller losses. The falling dollar has been good for oil prices but the market is skeptical that the gains will hold or that demand will be sustained; our oil positions declined by about 6% on average. We hold these positions as an inflation hedge and the rising oil price confirms that strategy. Gold has also been rising in an inflationary confirmation but the gold miners ETF was another laggard losing over 5% in the quarter. We think the underlying commodities will prove more correct than the equities of their producers. Higher interest rates affect yield instruments most and our utilities fund was marked down accordingly by more than 3%. We continue to hold this position for its defensive nature should the economy turn down. That is also the rationale for holding the consumer staples fund, which also declined by more than 3%. Ironically in a down market, our more aggressive positions held up better. The Value Line timeliness fund was slightly positive and the semiconductors fund gained more than 6%. International diversification helped with the Europe fund declining by less than 1%. The market seems not too perturbed by the looming trade war as our China fund gained more than 2% in the mostly negative quarter. All combined, the fully invested portfolio declined by -1.72% in the first quarter compared to the S&P500 which lost -1.22% and the MSCI All World index better than both with a slighter loss of -0.54%.

China Doll

Investors don't seem to be heeding President Trump's promises to be tough on China's mercantilist foreign policy that has degraded America's manufacturing base. The Administration claims it is not simply a wage differential but industrial policy that seeks to capture market leading positions in strategic industries. Private companies do that in developed countries but China is still treated as a developing economy even though it is bigger than all others except the US. Among other offensives, China uses its status as a developing economy to impose high tariffs without reciprocity from developed countries. Technology transfers in exchange for market access are another unique requirement to conduct business in China.

The president acknowledges that some will get hurt in a trade war but he was clear as a candidate about checking unfair Chinese trade practices. It remains to be seen if making consumer products more expensive for Americans will achieve greater market access. China responded that they will make the soybeans and pork that their people rely on more expensive and somehow it will all lead to a better economic environment. As steel, soybeans and all sorts of other products are targeted for tariffs, their prices will rise, which only helps a few. If Chinese steel costs more, then US steel producers will be able to raise prices without losing market share. It won't be China paying the tariff, it will be the end users of the targeted products.

The developed world is beginning to rally around the Trump positions and China seems to be reading the tea leaves as they took some of the sting off the stock market correction by announcing greater access for foreign auto makers and other token improvements. Like winding down the Fed's balance sheet, bringing China's economy onto a level playing field with the rest of the developed world will be a long term project. The president is correct in saying a level playing field

will be a net long term benefit to the US economy but the inflationary pressures from trade restrictions will give the Fed reason to make their monetary tightening hurt even more.

It will not only hurt consumers and corporations. The US government has taken advantage of the Fed's zero bound short term interest rates by issuing most of its debt in short maturities. It would have been better to take advantage of the record low long term rates that would have cost a little more initially but prevented the need to refinance into rising rates. The Congressional Budget Office recently forecast that the federal interest expense will triple over the next decade and exceed the Defense Department budget. That scenario will play out at all the companies that have followed the same path of higher debt since the financial crisis. The current record levels of corporate debt meeting rising rates should reverse the trend of improving corporate profit margins that followed rates down.

Hyman Minsky divided finance into three units: hedge, speculative, and Ponzi. Hedge financing units are those that can fulfill all their contractual payment obligations through current cash flows. Speculative units can fund the interest payments but need to roll the principal obligations when they mature. Ponzi units are unable to fund even interest payments from cash flows and rely on issuing more debt to survive. The crisis occurs when a preponderance of speculative units become Ponzis and nobody wants to roll their debt. Rising interest rates across the maturity and quality spectrums will force many companies into stress or out of existence. Toys R Us won't be the last brand name to fall into bankruptcy before the Fed is done unwinding their experiment of the last ten years.

A long term monetary tightening accompanied by a stock market decline could expose fragility where we didn't expect like corporate and municipal pensions whose assets will decline as liabilities continue to accrue. Even well-funded institutions have fallen in prior cycles which is why these letters have been alarmed by this inevitable policy reversal. The Fed's current course is more restrictive than any other period in history and early results are in line with our expectations. We expect trade tensions to subside but the monetary unwinding to continue as scheduled. Financial media focus on where the Fed sets the overnight interest rate but what they do with their balance sheet is probably more important. We will continue to watch that metric and the stock market's ongoing reaction before becoming more aggressive.

Please call us to discuss 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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