



STEPPING STONES MANAGEMENT, LLC

First Quarter 2019 Commentary

April 22, 2019

When the Pilgrims sailed to the new world it was a group effort. Those seeking religious freedom were not enough to fund the voyage, even after joining with an equal number seeking other freedoms. The Mayflower required funding by British investors whose contract claimed half of the production of the new colony for seven years. After 2 months at sea and with Cape Cod in sight, the 101 “Saints” and “Strangers” as they called themselves further agreed to the Mayflower Compact promising to equally share all the domestic returns of their venture. The details were recorded in the Journal of William Bradford who has a strong claim to being the father of America.

When they came ashore and made their first settlement at an abandoned Indian farm, their first task was to build a common house for all their goods and then cottages to live in. The seeds they brought from the old world didn't take well in the Massachusetts soil and without the kindness of some friendly Indians, they would have all starved. Even with Squanto's help, there wasn't enough to feed everyone. Disease and hunger claimed a large percentage of the colony. Bradford's journal recounts the stress and resentments among those who worked hard while others shared equally in the fruits of their labors. The “common course and condition...was found to breed much confusion & discontent, and retard much employment that would have been to their benefit and comfort.” As Governor of Plymouth Plantation, William Bradford struggled with policies inspired by Plato's views on common property being apportioned by enlightened leaders. The idea had yet to be implemented in world history making the early American economy the first attempt at socialism.

Like all attempts that followed, it was a disaster. The British investors were alerted to the troubles and accepted a ship loaded with lumber and beaver skins as their only return on the investment (that was subsequently plundered by pirates on its way back to Britain.) So “that they might not still thus languish in misery,” a major course correction had to be implemented. Bradford apportioned the settlement equally and decided that every man should plant corn for his own use which incentivized each family to produce to their maximum abilities. The experiment brought “very good success” creating surplus goods to trade. Other common property like cattle was eventually privatized too. Later years of Bradford's Journal report a burgeoning economy that began to attract the entrepreneurial from around the Old World to come make the most of their lives in the New World. Never before had free market capitalism been employed to such an

extent and never before has one nation's economy so dominated the world. It's been true for most of the 400 years since Bradford ditched socialism and it was clear in the first quarter when US stocks returned 13% in a rebound from last year's losses. President Trump found his most popular stump speech line in the first quarter to be "America will never be a socialist country!"

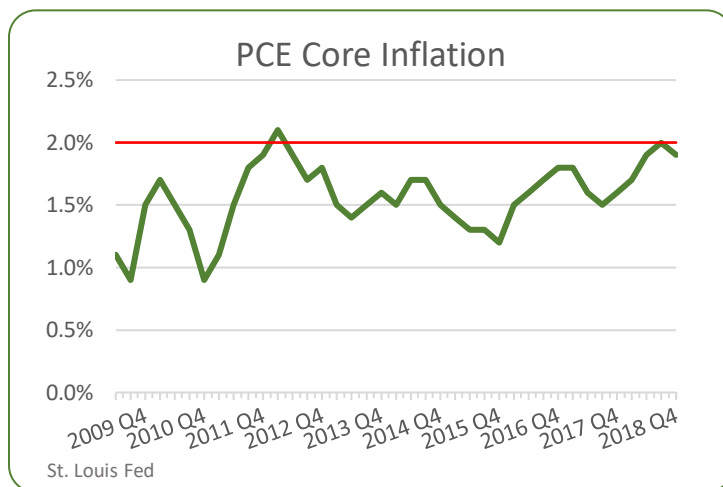
AOC and MMT

The line draws applause as a retort to Rep. Alexandria Ocasio-Cortez's calls for an American implementation of "democratic socialism." The democratic modifier is needed to distinguish from all other attempts at socialism that required a suppression of democracy so enlightened leaders could make decisions on behalf of their people. It gleams with novelty and excitement, but the democratic socialist movement that gained prominence in the first quarter is nothing more than shiny polish on old ideas. The original democratic socialist and leader of the Democratic presidential field, Sen. Bernie Sanders, has expressed admiration for other socialist movements hoping each will be the one that gets it right. He thought he found it in Hugo Chavez but we are all witnessing what socialism did to Venezuela.

My new Congressional Representative from The Bronx laid out what she thinks is the right way in March with her Green New Deal. The policy platform has gained support from most Democrats, until it was put to a vote. The program is designed to wean our economy off of fossil fuels and promote social justice with free medical care and college education. The plan also calls for an end to large scale farming, a massive infrastructure rebuilding and retrofitting all buildings in the country for maximum energy efficiency. Most of the criticisms have centered on the impracticality of the whole idea. No fossil fuels means no airplanes. No cattle farms means no hamburgers and steaks. Free health care for all would probably mean a delivery system no better than the Veterans Administration which barely cares for our heroes. No one says how it will be just to the doctors and professors whose expertise and services will be provided for free.

When asked how we could afford to do things like retrofit every building in the country, the leader of The Green New Deal turns the question around asking how can we afford not to? Rep. Ocasio-Cortez called the program a "wartime-level, just economic mobilization plan to get to 100 percent renewable energy ASAP!" She should have a ready answer to the fiscal question. Anyone who studied economics during the last decade, and certainly one who earned their degree from Boston University, was taught how monetary policy can solve any fiscal challenge. We have come through the age of Ben Bernanke's quantitative easing, a revolutionary monetary idea that created new money to meet our fiscal deficits. Its academic descendant is modern monetary theory (MMT) and the financial commentariat was discussing it vigorously during the first quarter.

MMT brings academic credibility to the concept of printing money to meet populist demands. It's most vocal proponent is Dr. Stephanie Kelton of Stony Brook University and an economic advisor to Bernie Sanders. Her theory of monetary policy states that inflation is the only limit to how much money can be created. As long as inflation is at an acceptable level, we should print as much money as needed to undertake desired infrastructure and social justice spending. This could be done by the Treasury Department simply issuing more currency to pay for legislative spending or the way it has been done by the Federal Reserve creating money to buy the Treasury bonds that fund the spending. MMT proponents will point out differences with The Fed's quantitative easing programs since 2008, but the main distinction is that the Fed's 2% annual inflation ceiling is too low for MMTers to turn off the spigots.



As you can see on the chart, the Fed's preferred measure of core inflation, the Personal Consumption Expenditures Index excluding Food and Energy, has been on a steady increase since late 2015 towards their 2% target. As the index approached the target last fall, the Fed maintained a hawkish position saying in October that interest rates are "a long way from neutral" and raising rates in December while reiterating that the balance sheet run off will be

on "automatic pilot" for several more years. After the fourth quarter's market turmoil, the index retreated in the first quarter and the Fed sang a dovish tune of "flexibility" and "patience." More importantly, the balance sheet reductions, absorbing all the excess money created during the quantitative easing years, will now be curtailed by the end of the year. The Fed could be excused for thinking its fine-tuning is exerting similar control over the broader economy, but history would advise humility. I haven't studied MMT enough to know how inflation could be tamed once unleashed but perhaps Dr. Kelton could advise the Venezuelan government struggling with unmeasurable hyperinflation with prices doubling every couple of weeks. It's the current extreme example as she and other MMT proponents might not be old enough to remember the US inflation of the 1970s and the double-digit interest rates needed to break it.

Instead they point to how the Bank of Japan has expanded its balance sheet for a generation without inflation. Never mind their shrinking economy during that time. The fact that a decade of quantitative easing hasn't brought inflation to the US is a strike against classical economics and an opening for a return to Nero's theories of monetary debasement. Never mind the fall of Rome. Indeed the world is already making MMT look old with the Bank of Japan continuing to lead a course for the European Central Bank and Bank of China to follow. The worldwide trend

of expanding central bank balance sheets is hindering the Fed's attempts to put the monetary genie back in the bottle. Whether they surrendered to President Trump's taunts, or AOC's Green New Deal, or Wall Street's temper, the Fed reversed course in the first quarter quite dramatically from the prior quarter's hawkish rhetoric. With the Fed now positioned in a neutral stance, markets expect the next move to be an easing.

Those favorable expectations brought the animal spirits back to Wall Street with growth orientated sectors outperforming in the first quarter that recovered most of the fourth quarter's losses. This was especially evident in the 21% gain enjoyed by the Semiconductors position in the Stepping Stones fully invested Equity ETF Strategy. The Value Line timeliness fund and our China position also outperformed. Similar gains in our energy positions could portend expanding economic growth or a return of inflation. That inflation chart above would look steeper if it included energy prices. The Europe and Japan positions struggled to keep pace but returned about 10%. Our defensive consumer staples fund was out of favor but still returned almost 9% and the utilities fund gained almost 11% in the favorable interest rate environment. Buoyant markets like this tend to shun gold but inflationary fears helped the gold miners fund gain over 6% in the first quarter that saw the S&P 500 gain 13.1% on a price basis. The strategy did almost as well gaining 11.8%.

If the Fed's next move is an easing it would be a reaction to bad economic news which wouldn't be good with stock prices and economic indicators in late cycle stages. The Fed and the MMT movement agree on using inflation as a monetary mechanism but they disagree on the current 2% target. Letting inflation rise a little higher could lead to higher corporate earnings but also lower valuations and higher interest rates, which have proven to be bull market killers.

China's Bradford

This spring marks the 40th anniversary of another seminal economic event when farmers in the Chinese village of Xiaogang reported a grain yield of 66 metric tons, 20 times more than their quota. Since Mao's socialist revolution 30 years earlier, the government seized most of the village's annual production for redistribution and their quota was steadily declining. Without an incentive to work, production floundered and the village was faced with starvation reminiscent of the great famines of the late 1950s. "Work hard, don't work hard — everyone gets the same, so people don't want to work" said Yen Jingchang who led the village farmers in a secret agreement to divide their commune into private parcels where each family could grow as much as they desired. The state would get their quota and the farmers would secretly keep the rest. "You can't be lazy when you work for your family and yourself," said one of the farmers.

The local commune official threatened the group with prosecution for their act of insurrection saying they had "dug up the cornerstone of socialism." Fortunately, a higher official recognized

the great success and said he would protect the farmers as long as they kept quiet about their experiment. However, word of the harvest spread all the way to Beijing where China's economic reformer, Deng Xiaoping favored the Maoist expression "seek truth from facts." The facts led Deng to scrap Mao's collective farming for the method of chengbao based on private production and unregulated prices. The state still owns the land but farmers can grow what they want and charge whatever they can for it. Deng's reforms 40 years ago led to "the fastest sustained expansion by a major economy in history" according to the World Bank.

The history of socialism is long and clear and advocates of supposedly new forms should be challenged to tell how it would be different from all the others. The history of excessively easy monetary policy had also been clear until the last decade when unprecedented amounts of new money have driven up asset prices but not inflation. After a decade of monetary policy that enriched the already rich, we shouldn't be surprised to hear a populist call for free money for the rest of society. That is often how socialist movements come about and they have always ended badly for everyone. We can only hope that most Americans realize the truth and turn away from the siren song of socialism and modern monetary theory. I am hopeful as the early season talk around my local Bronx little league field is who is going to challenge AOC in the next Democratic primary.

Please contact us 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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