STEPPING STONES MANAGEMENT, LLC

First Quarter 2020 Commentary

April 20, 2020

It seems like ages ago that the first quarter of 2020 began with the Dow Jones Industrial Average gaining more than 300 points on optimism that healthy jobs and income gains would continue into the New Year. The next day brought a decline of more than 200 points after US forces killed Iranian Revolutionary Guard commander Qasem Soleimani. The January indicator was pointing to a volatile quarter. By the time the monthly employment report arrived on January 10th, stories of the Wuhan Flu were spreading along with the virus itself. Stock prices fell as strong jobs brought fears of tighter monetary policy. Or maybe because that same day, China's government confirmed the existence of the novel coronavirus-19 and published its genetic information. They assured the world that it could not be transmitted between humans and all appropriate measures were being taken to contain it.

Plans for the January 25th Lunar New Year celebration, and the week-long holiday to follow, proceeded apace in China as the American CDC began screening people arriving at US airports for fevers and other symptoms. With stocks trading near record highs, volatility increased among various asset classes. On January 29th, Fed chairman Jerome Powell said he was uncomfortable with inflation too low, a gentle reassurance that he wasn't inclined to tighten monetary policy. Two days later, the US declared a public health emergency and banned travelers from China. In his State of the Union message on February 4th, President Trump said he was working closely with Chinese authorities and would take all necessary steps to protect Americans from the threat. Nancy Pelosi famously ripped up the speech, perhaps upset about the president's expected acquittal by the US Senate on impeachment charges the next day. Another strong jobs report propelled the Dow Jones Industrial Average to its all-time high recorded on February 12th at 29,551.

Then the rickety financial markets we wrote about last quarter began to tremble. Maybe it was just profit taking, but with stock prices and interest rates falling so much, it was feeling like some major hedge fund might be pivoting or perishing. The CDC issued a warning on February 25th that "community spread" in the US was not a matter of if, but when. Meanwhile, images emerged of overrun hospitals and morgues in Italy. By the end of February, the Dow suffered its worst week since 2008 with a decline of 11%. March came in with an unexpected emergency half point rate cut from the Fed which was met with a 3% drop in the Dow as the annual South by Southwest festival was cancelled. The Saudis threw gasoline on the fire on Sunday the 8th declaring an oil price war with Russia which had the added advantage of decimating the American threat to their national industry. On Tuesday March 10th Gov. Andrew Cuomo declared a "containment zone" with a 1 mile radius around a synagogue in New Rochelle NY. The NBA suspended its season on Wednesday and President Trump addressed the nation. Air travel from Europe was halted after bans from China and Iran in prior weeks. On Thursday, Dr. Anthony Fauci told a Congressional hearing how the coronavirus testing debacle had exposed deep structural problems in the nation's public health system. The Dow had its worst day since 1987's Black Monday dropping more than 2,300 points or 10%, and Broadway went dark. Friday the 13th was the National Emergency declaration asking all American's to shelter at home for fifteen days and practice social distancing. Discussions emerged about a fiscal stimulus to "make Americans whole" and the Dow rose more than 9% that day to finish a week that saw 1,000 point changes every day, up or down.

With the US economy put into what's best described as an induced coma, the Fed watched the public health crisis become an economic crisis. They brought out their heaviest artillery to avert a financial crisis. Before Asian markets opened on Sunday night, March 15, the Fed declared an "exigent circumstance" under Section 13(3) of their charter that permits the implementation of monetary tools not seen since the last crisis. This time to a far greater degree over an almost immediate time frame. Overnight rates were dropped to zero and quantitative easing officially resumed with purchases of $500 billion of Treasury and $200 billion of mortgage backed securities. No one could accuse them of timidity but the Dow lost 3,000 points on Monday. The 12.93% decline marked the worst day of the quarter. Once rare double digit percentage daily moves had become common. Not all American's stayed home as Costco and other stores saw crowds clear the shelves, fighting especially hard over toilet paper. The Canadian border was closed to non-essential traffic on Wednesday the 18th and the Mexican border on Friday. The Dow closed the week 35% below the highs of six weeks earlier. Never before has the index fallen so far and so fast from a record high.

By this time, field hospitals were built in the Javits Center and Central Park as New York City hospitals and funeral homes became overwhelmed. Americans hunkered down watching the numbers closely track the horrifying situation in Italy. No work, no school, no church, no friends, just sheltering at home. Except for the health care workers who heroically manned the front lines watching colleagues fall victim to the virus and unsure if they were bringing it home to their families. Reminding us of the firefighters running up the burning towers, our friends and relatives who never signed up for combat duty used American perseverance and ingenuity to fight the invisible enemy. Sharing in their exasperation, their fellow citizens come out each evening for a 7pm ovation.

Nobody had any idea how bad it could get. The experts urged us to flatten the curve but that also means to lengthen it. How long can the economy remain closed? The Fed saved their nuclear weapon for Monday March 23rd, before markets opened, when they announced an open ended program to purchase municipal and corporate bonds. Never before has America's central bank invested directly in American companies, some rated as low as junk. The Dow lost almost 600 points that day but the 3% decline seemed modest, like the bear market curve might be flattening out. In fact, at 37% below its closing high of six weeks earlier, the Dow Jones Average marked the quarter's low point closing at 18,592. Congress came together to pass the $2.2 trillion CARES Act and the Dow gained more than 2,100 points on Tuesday, or 11.37%, its biggest percentage gain since 1933. The images and stories from New York City got worse but the market got better. By Friday, General Motors was ordered to make ventilators under the Defense Production Act and Pope Francis prayed in an empty St. Peter's Square.

The final weekend of the quarter brought US Navy hospital ships to Los Angeles and New York City and shelter at home guidelines extended until at least April 30th. Hopes built for effective treatments as the situation worsened worldwide. Stocks rose from their lows and marked a milestone on Monday the 30th with the Dow closing 20% above the low of a week before. It was officially a new bull market, and the quickest in history! With most international borders closed, an estimated half of humanity living under lockdowns, and the world's greatest cities silenced, the Dow Jones Average finished the most historic quarter ever with a decline of -23.2%.

Wuhans Flew

At the confluence of the Yangtze and Han rivers and transcontinental railroads to every province in China, is the city of Wuhan, known as The Chicago of China for its central location at such critical transportation hubs. Central China's export powerhouse is a critical component of the government's mercantilist foreign policy. Historic and persistent floods in the area are said to be controlled by the nearby Three Gorges Dam which Communist Party officials point to as an engineering and economic marvel that demonstrates China's arrival as a legitimate world power, even if the dam was controversial for the cultural displacement it caused. Wuhan is also home to some of China's best universities and science labs, including the nation's only Level 4 biosafety lab, an international designation identifying facilities that handle the world's most dangerous infectious pathogens, like the Covid-19 virus.

Chinese authorities assure the world that the virus did not leak out of that facility, rather they say it likely came from a nearby "wet market" where people buy groceries including exotic live animals such as bats. China's explanation reveals a country that has the capability to build gleaming cities and engineering marvels but lacks the basic logistical infrastructure to provide safe food for its people. The government hasn't built the fundamental underlying infrastructure that other developed nations have because it hasn't been a priority for the privileged few party leaders who make those decisions. China's most powerful leader since Mao, President Xi Jinping handled the coronavirus outbreak the way his predecessor handled the SARS outbreak in 2002, by lying about the facts and covering up any investigations. This time, whistleblowers were silenced as Xi restricted access to US scientists and expelled US reporters from the country. Any self-respecting corporate board will no longer be able to ignore the depredations of the Chinese regime. Those reliant on supply chains from China would be derelict if not already considering alternatives. We learned many lessons in the first quarter and one outcome will certainly be a world that becomes less reliant on China.

Western investment has poured into China from companies facing fewer opportunities for growth in their home markets and want access to the country's 1.3 billion consumers. That investment, controlled by government central planning, has allowed China to produce some of humanity's most important products more cheaply than anyone else. Almost unaware, we have become completely reliant on China for most of our medical products, including vital medicines like antibiotics. Considering all the markets that China has cornered, perhaps Wuhan's most consequential export attached itself to a 35 year old visitor who returned to Snohomish County Washington on January 19, 2020. America's first case of Covid-19 spent sixteen days under CDC care with severe illness.

Despite foisting a debilitating pandemic on the world, China's stock market outperformed most others in the first quarter. The China position in the Stepping Stones fully invested equity ETF strategy declined by almost 14% but that was better than all other positions other than the utilities fund which performed slightly better. Our Europe and Japan positions lost more than 20% each. Our gold miners fund didn't perform as expected in such a tumultuous quarter, moving in line with the averages, but it has rallied strongly with the price of gold so far in April. This has always been our hedge against monetary debasement and it may finally be catching up. We're sorry we can't say the same for the energy positions which both declined by more than 50% and will be combined this quarter when we reorganize the portfolio. We still believe in America's energy renaissance which should be a further inducement for manufacturing to come home. We are waiting on some clarity to emerge from the historic bullish and bearish swings the market is experiencing before deciding on positions to add and delete. We will be keeping our semiconductors fund which outperformed with a decline of 18% and we are generally satisfied with our consumer staples and growth positions. In the first quarter that saw the S&P 500 settle with a loss of -20% on a price basis, the portfolio underperformed at -22% while the MSCI All World index came out between the two at -21%.

Failing Tests

We all changed our lives last month as the virus spread so perniciously. As of this writing, experts advocate keeping shutdown orders in place at least through the end of April with some calling for a year or more. Everyone is working with the best intentions but nobody can understand the full enormity of this situation. The medical doctors are not economists. Nor apparently are traders expecting a sharp V shaped recovery. As most businesses are trying to determine what their cash flows will look like, stocks are racing towards the old highs when everyone who wanted a job could find a job. A 20% correction from a market priced for perfection does not appear to fully discount the economic calamity at hand. Fundamentals be damned, the hedge funds are positioning for a greater monetary wave than the last one.

Many Americans forced out of work are promised to be "made whole" by enhanced unemployment benefits that may exceed their actual earnings. Some employers will have to raise wages enough to lure their employees off the more attractive government benefits. Others will surely find it impossible to remain in business. There are no models to predict the unknowable economic ramifications of the unprecedented shutdown. The trillions already allocated to ease the hardships are not yet making it through the cumbersome bureaucracies established to distribute the aid. State unemployment agencies are built to deal with thousands of weekly requests, not millions. Small business loans have been quickly exhausted leaving politicians competing to add their favorite riders to any extension. The Fed is acting quickly but focusing on the largest companies with the most debt outstanding. That helps Boeing but not your favorite local business.

The health consequences of the shutdown are another unknowable. Elective medical procedures are postponed. Grocery stores have become dense gathering points, ideal for viruses to spread. Gyms are closed so some of us are not as healthy and fit. Video games and junk food sales are way up. Liquor sales are booming and we can only imagine how problems with drugs and domestic violence become worse with the anxiety of not earning a living. The models don't quantify these other health concerns and they can't measure the despair that comes from financial ruin.

The experts we entrust to protect us from faulty products squandered an opportunity to test for the virus while Germany and other countries did. When the CDC and FDA finally developed and deployed their own Coronavirus test, it was faulty and had to be recalled. We lost critical time as the virus infected an unknown number of Americans. Effective and widespread testing could have averted the crisis wave as patients would have been identified and treated earlier. The reason is that in the interest of best practices, our FDA has erected a labyrinth of procedures that companies need to navigate before offering their solutions to the crisis. Similar to the rules that prevent viruses from infecting our food markets. In a brutal twist, the emergency declaration triggered special protocols that further delayed the deployment of widespread testing until it was too late for New York. At this writing, numerous tests have been developed but far too few have been widely deployed. The experts seem to agree that we won't be able to go back to work until we have an understanding of the pandemic that can only come from robust testing like some other countries are doing.

The Fed's aggressiveness has been applauded given the unknowable impact of the economic shutdown, even President Trump said "good job". Everyone loves easy money and any previous limiting principle is no longer relevant as our central bank will likely expand its balance sheet above $10 trillion. It was below $1 trillion in 2008 and at $4.2 trillion in January, and rising after the fourth quarter repocalypse. There was room for argument as to why the monetary expansions of the last decade did not ignite inflation but if it doesn't follow this event then Milton Friedman will truly be dead. The Nobel Laureate taught generations of economists that inflation is a matter of too much money chasing too few goods. If he was correct, we are due for what most Americans have only read about. While our monetary base will likely increase tenfold from before the last crisis only a decade ago, we are now sharply curtailing the amount of goods and services available in the economy. Although the immediate problem is a collapse in aggregate demand, the intention of the $2.2 trillion CARES Act is to get people spending and paying their bills again. That's going to be a lot of money chasing fewer goods when the economy begins to reopen. Furthermore, the measures required to relocate supply chains away from China and bring essential production back onshore will likely involve substantial tariffs which will add another inflationary force.

If Dr. Friedman was wrong all along, better to study up on Stony Brook University Professor Stephanie Kelton who we wrote about in our letter last April and posted with others at steppingstonesmanagement.com. Bernie Sanders' economic advisor is the leading light of Modern Monetary Theory (MMT) which advocates for government printing as much money as it takes to solve all of society's problems, to be limited only by inflation. If inflation runs too high, the theory says people will demand corrective measures to bring it under control. We wrote last quarter about the pain those measures can inflict when we remembered Paul Volker's epic victory over the 1970s inflation monster.

The Great Reset

Today's doctors and nurses, first responders, grocery store workers and everyone providing America's basic necessities have begun to feel more in control over the monster at hand. Supplies are being delivered and treatments are showing promise. Easter brought a new low in New York City hospitalizations. Worst case projections are being reduced and the Fed continues to throw previously unimaginably large amounts of money at the previously unimaginable problem. Many rent and mortgage payments were missed on April 1st and not many people are working. Landlords know their tenants don't have cash flow and banks know their clients' amortization schedules will need to be reconstructed. The process will take time to work out and will work best without the kind of top down solutions that hampered the last recovery.

There will be a great reset. New rules of social interaction and conducting business will take hold. Will companies need to rent as much office and retail space, or spend as much on travel? Will parents still need to take out mortgages so their kids can live on extravagant college campuses? Will consumers continue to receive health care online and across state lines? Will other regulatory exemptions become permanent? There will be bankruptcies and new businesses formed. Assets and professionals who know how to deploy them will be in supply, and it looks like money will be too, if our government can manage the distribution better than it manages pandemic testing. There will probably also be a new price level. Try to imagine a can of Coke costing $10 while the person serving it to you makes $100 per hour. That should be good for the prices of real assets like commodities and real estate but those are feeling the most pain currently. We should expect a bumpy ride to wherever the new equilibrium settles. Publicly traded corporations are now incentivized to take extra charges to earnings when everyone expects disastrous numbers. Then, phantom income can be gradually added back over coming years to support earnings growth. That's the lesson of the last crisis during an era when balance sheets and book value didn't matter. Will they matter again? Will the Fed simply reflate the bubble as its colossal interventions become the new benchmark? We will need to find a way to grow out of the massive debt being imposed on the economy. Inflation could be the easiest path out but the Fed's efforts to stimulate a mere 2% rate have been constantly frustrated. The $10 can of Coke is not preordained, if trends to greater efficiency limit inflation, it will leave future generations to repay the debt incurred in this crisis, on top of that incurred already.

I hope we shake hands again and I hope we go to restaurants again. I hope the Fed lets those who took on excessive risk learn what risk is. So far they are doing everything they can to prevent that. We used to have a financial crisis once a generation, this is our third in twenty years. China will bear responsibility for the virus and cover-up, but our monetary masters need to study the extent of their responsibility for what have become regular financial bubbles and panics that are calmed by increasingly large interventions. We are in need of monetary and financial humility. Printing more money will not solve every problem forever and America might just be able to get along with less liquidity on Wall Street. There has been no discussion of how to pay for the CARES Act, it is simply accepted that the Fed will print the money to buy the bonds. Bernie Sanders may have suspended his campaign but MMT is being implemented anyway. The experts congratulate themselves for how well it worked after the last crisis while ignoring the lesson that inflating asset prices did not produce a better society but one riven by wealth disparities and social discord. Let some hedge funds fail, even it means some banks might also fail.

We are lucky COVID-19 is not more lethal and we can only hope our government has learned valuable lessons to prepare for a pandemic that will be. We learned that Americans are willing to come together and make great sacrifices for the common good while exceptional individuals pursue solutions to our problems. There has never been a greater force for human progress than American ingenuity. While viewing the new bull market as premature, we will gauge the financial markets fueled by a tsunami of liquidity amid collapsing economic conditions. We are ready to deploy our cash as valuations become reasonable again but that is impossible to assess as long as business remains closed. Let the experts get the testing done and let great Americans get back to work!

We pray for all those suffering and serving in these difficult times and hope you and your loved ones are healthy and well. Especially with markets so volatile, 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.

Stay safe,

Dan Hickey

Daniel D. Hickey
STEPPING STONES MANAGEMENT, LLC
PO Box 263
City Island, NY 10464
direct: 646-723-6262
www.steppingstonesmanagement.com