STEPPING STONES MANAGEMENT, LLC

First Quarter 2021 Commentary

April 21, 2021

2021 came in with a sense of renewal as vaccinations were ramping up and the tumultuous Trump era was reaching its end. Washington was celebrating the latest corona relief Christmas tree with $900 billion added to the largely unspent $3 trillion from months earlier. After losing two runoff elections in Georgia, it turned out to be the Republicans' last act in control of the US Senate. Except for tallying the votes of the Electoral College on January 6th, which was disrupted by an angry mob breaking into the US Capitol. President Biden was inaugurated a couple of weeks later on Capitol Hill encircled by streel fencing, razor wire and thousands of National Guard troops. He promised a new era of unity for all Americans then proceeded to dismantle the Trump agenda in his first few days with dozens of executive orders.

As President Biden was restoring democracy to America, Robinhood Markets, Inc. was doing the same to investing, or so their ads say. In fact, the company was forced to pick sides between retail traders and the hedge fund industry when a bear raid on the shares of GameStop backfired on professional traders. The industry rallied around the hedge funds while Robinhood froze the retail traders' positions. The turmoil wiped out January's market gains but February brought rising prices back to stocks and anything else that could be bought with the swelling supply of dollars rolling off the government's machinery.

The most visible inflation gauge, retail gas prices jumped over 20% on the back of oil regaining its pre-pandemic price of $60 per barrel. They were among many commodities reaching new highs and driving the annual rise in the producer price index to a 10 year high above 4%. Fed Chairman Jerome Powell assured markets that inflationary trends would be transitory and several members of his board of governors gave speeches promising not to take away the easy money punchbowl. Washington's new majority passed another $1.9 trillion stimulus bill including $1,400 for every American, and the stock market began to melt up to fresh record highs.

With stocks back on their record pace and Americans happily spending their stimmies, the culture turned to canceling unwelcome voices such as Donald Trump and everyone on Parler, the only competitor to Twitter. The dominant social media cartel has silenced anyone not toeing the official government coronavirus line as science and reason have become subservient to political correctness. By the end of March, the bond market had sustained historic losses as inflation gets factored into interest rates. The money flowed into stocks driving the S&P500 to a 6% quarterly gain near a record just shy of 4,000.

Game On

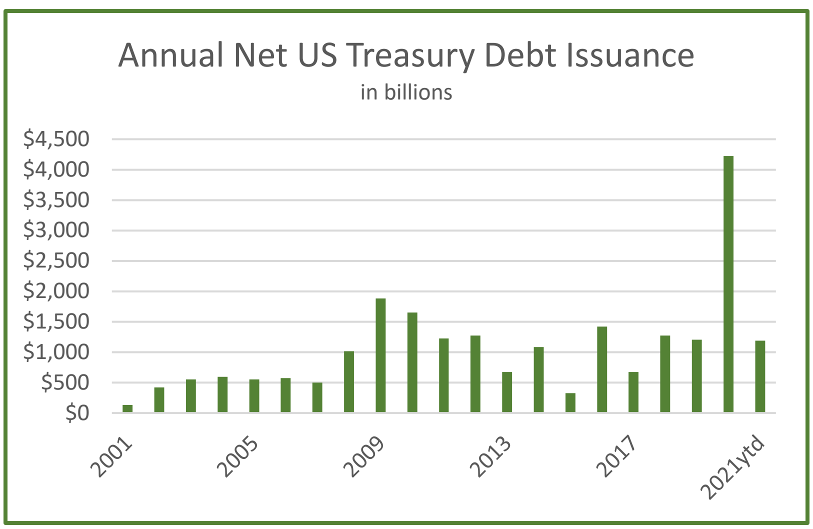
Everything appears well as long as the money keeps flowing. The ballooning issuance of Treasury securities provides further collateral for the hedge funds to deploy with sophisticated strategies. The aforementioned shares of GameStop were targeted by the professional investment community as bankruptcy bait, since the company is saddled with high rents in empty shopping malls while video games are now sold online. The Robinhood traders know that today's games are too large for their computers so they still stand on line at Gamestop to buy disks. They didn't appreciate seeing their favorite retailer get 140% of their shares sold short. To correct what shouldn't be allowed to happen, they used social media to organize a wave of buying forcing the shorts to cover, and launching the stock like a rocket to Mars.

When one hedge fund lost more than its net worth, the largest broker unknown to most investors, Citadel, called a stop to the game before more of its clients failed. They are also reported to own a stake in Robinhood, whose individual investors were frozen out.

Many of those traders lost more than they could afford, making a mockery of Robinhood's marketing as well as securities laws that restrict individual investors from taking on excessive risk. Click a button on an app however and you can blow all your stimulus money trading stocks and options. Laws restricting how shares can be sold short were also proven to apply selectively. Once a share is lent and shorted, it can't be lent again. It would be like taking a second mortgage on a property without accounting for the first. Not all of GameStop's shares had been lent but 140% of them had been sold short. The industry that writes the rules always makes loopholes for themselves.

Another financial game played out later in the quarter when a wealthy family office accumulated massive positions in a handful of stocks, including ViacomCBS, without ever actually owning the shares. Archegos Capital Management, with estimated net worth of $10 billion, was able to purchase custom tailored securities from major banks providing exposure to the stock that The New York Times estimated to be worth $20 billion. The private securities have the added advantage of not requiring public disclosure as the massive position was held and hedged on the banks' books. Watching the shares run from $12 a year ago to more than $100 per share in March convinced ViacomCBS management to issue more shares, some of which were slated for Archegos. When they reneged, other buyers sold their allocations and the stock began a downward spiral. The lack of disclosure caught the banks unaware that Archegos had made similar transactions at several firms who began to sell out the positions after failed margin calls. That drove the stock down further, bringing a couple of major international banks to the brink of solvency, but in the age of quantitative easing, there is always ample reserves for the banks.

All of these esoteric financial games are played with Treasury securities used as collateral, so the investment industry loves the unprecedented issuance. The chart below shows the amount of additional US Treasury debt issued each year. It steps up with the quantitative easing era since 2009 and the huge pandemic response in 2020. The year to date column does not reflect much of the money that has already been approved but not yet borrowed. The record inflows into equity funds in the first quarter were largely borrowed with Treasury securities leveraged several times as collateral. These letters have highlighted this trend since 2009 but the almost exponential upturn since last year has starkly proven the point. The Fed congratulates itself on steering the economy away from a depression while it has increased the money supply by ten times the economic growth. They disavow any threats to long term inflation when that is the most likely outcome, and the only realistic way to grow out of all the debt being heaped on future generations.



As the economy emerges from the lockdowns, bottlenecks are beginning to form. US energy production is coming under stricter regulation, causing scarcity to meet rising demand. The prime beneficiaries are the supposedly villainous oil companies watching their assets inflate. Beyond energy, pricing pressure is emerging in food, transportation and commercial rents. Bitcoin is back in the headlines and non-fungible tokens (NFTs) are the new rage with Eli and Peyton Manning marketing their Superbowl MVPs into digital investments. The double digit rise in home prices doesn't factor into official inflation statistics that use rents instead, but anyone in the market for a home is feeling it.

The Fed promises that inflation rising above their 2% target will be transitory so they plan to be patient about tightening their monetary stance. The bond market does not seem to share Jerome Powell's comfort and market interest rates are challenging the Fed's dovish position. With rates so low, it doesn't take much to register a big move. The 0.8% increase in its yield, translated to a 15% drop in the 30 year bond, its' worst quarterly return since 1919. Higher interest rates and input prices are beginning to inflict a double hit to corporate profit margins.

The Stepping Stones fully invested equity ETF strategy illustrated the emerging inflationary trend with a 39% quarterly rise in our energy position. The semiconductor industry is another example of shortages leading to higher prices which helped our position in that sector also outperform. The consumer staples position tends to do well in a rising price environment, as it did last quarter. Small caps usually struggle with rising costs but our value fund gained almost 20% as the stimulus driven economic growth proves more powerful. International markets are also emerging from the pandemic and our currency hedged Japan ETF gained over 12%. Europe is having a slower reopening and that position did about half as well. Our new dividend fund also outperformed along with our basic materials position. The utilities fund was among only two lagging positions as higher energy costs squeeze their margins. The gold miners was the other laggard and the only losing position in the first quarter as bitcoin has become the alternative to debased currencies. As I wrote in January 2018 (available at SteppingStonesManagement.com), the central banks could end bitcoin very easily by refusing to clear trades in their currencies, as the Turkish central bank did earlier this month. We prefer to keep our gold miners position as a hedge against the surreal monetary adventures taking an unplanned turn. It didn't restrain performance to much which came in at 8.96% for the quarter on a price basis, compared to the S&P 500 which gained 5.77% and the MSCI All World index's gain of 4.88%.

Coke is Woke

Earnings are benefiting from stimulus dollars fueling strong top line growth throughout the economy. Massive amounts of government stimulus and Federal Reserve issuance have met pent up demand from a year of lockdowns. It has been enough of a tailwind to permit several CEOs to signal their virtue by taking political positions without regard to the impact on sales. Politicizing your product may turn off customers but it often attracts investors using criteria focused on the environment, social welfare, and governance. The ESG mutual fund sector is the millennial generation's favorite way to invest with a sound conscience. Although their long term performance demonstrates a cost to such peace of mind, lately it has been all gains. Getting selected in such an index brings a wave of buying to your shares, regardless of how much sugar water your company might be selling. It gets you invited to the best parties too.

It's no wonder so many CEOs are lining up in support of those printing all the money. The ruling majority is enjoying an alliance with corporations and media outlets which is suppressing free speech and intellectual discourse. Half of America is left to lament a depressing political environment that has silenced dissent. Any discussion of coronavirus topics not approved by the government are banned from social media as is any mention of election fraud. Even previously acceptable topics have been declared racist and banned. The first quarter brought us deeper into the post truth abyss where Dr. Seuss had several children's books removed from the market and Cardi B performed on prime time TV.

It may not matter to Delta Airlines and their commodity business but Coca-Cola is a premium product in a generic and shrinking category. Both companies declared a voting reform law in Georgia to be "unacceptable" to racial justice, without saying which provisions caused the offense. Indeed the only specific criticisms of the law came from President Biden who decried closing polling places at 5pm and denying water to voters, even though neither is true about Georgia's law. Nonetheless, Major League Baseball declared their opposition and moved the 2021 All Star game out of Atlanta, a majority black city, to Denver, America's whitest city with almost identical voting laws. Atlanta's black owned businesses are the latest sacrifice to the woke mob that has penetrated America's corporate boardrooms. None of the corporate virtue extends to solidarity with China's oppressed minorities. Insulting Americans is cheaper than calling out tyranny and genocide in their most important market.

The departure from reality continued with the proposed $2 trillion infrastructure bill that has more spending for the social welfare industrial complex than money for highways and bridges. Sen. Kirsten Gillibrand tweeted that paid leave, child care and caring are infrastructure. Presumably, so are the green energy subsidies for Elon Musk. It is looking like a bridge too far even for some Democrats who don't want to vote for the proposed higher tax rates either. They must wonder why they should raise taxes at all when it is so easy for the Fed to create the money. Modern Monetary Theory demands maximum deficit spending now before inflation takes hold.

The only way out of the massive debt we are accumulating is to inflate the economy to a commensurate degree. Without admitting so, the Fed is doing all they can to achieve that end, but the best laid plans of experts often go awry. The early feeling of inflation is having a lot of money sloshing around, the later feeling of inflation is never having enough. Inflationary waves never end well but they end with real assets worth a lot more than before. We are increasingly uncomfortable holding cash that is more quickly losing its value. Despite all the financial threats, investments backed by real assets look increasingly attractive.

Please contact me to discuss any of your concerns. Until then and as always, thank you for your trust and thank you for your business.

Yours truly,

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