First Quarter 2022 Commentary

April 22, 2022

"Your dollar will be worth just as much tomorrow as today" Richard Nixon told the nation after he suspended its convertibility into gold on August 15, 1971. While true on August 16, by 1973 his momentous decision drove the annual change in the Consumer Price Index (CPI) from 3.7% to 8.8%. Nixon defended his action as a countermeasure to protect the dollar from international speculators who were challenging the gold exchange rate after America's spending spree to simultaneously support the Great Society social programs and the Viet Nam war.

The CPI had already peaked about a year earlier and his wage and price controls appeared to be working when Nixon cruised to reelection in 1972. The wheels came off his presidency as the CPI rose again in 1973. Historians can argue whether anyone would have cared about the Watergate scandal if inflation had remained below 5%.

We had election year expansionary fiscal policy matched with a compliant Federal Reserve controlling a newly unanchored currency. It was tinder waiting to be ignited by the Arab oil embargo resulting from US support of Israel in 1973's Yom Kippur War. The torrid inflation was running over 12% annually by late 1974. It slowed down to 5% before the 1979 Iranian Revolution caused another oil supply shock that drove the CPI up to almost 15%. We finally won the battle with inflation in 1982 after Fed Chairman Paul Volcker raised interest rates higher than the inflation rate, which caused a debilitating recession. The S&P 500 declined by 15% over its "lost decade".

The parallels to the first quarter of 2022 are ominous and financial markets may be taking their cue as interest rates moved higher and stock prices lower. Each month of the first quarter saw the CPI climb to a new forty year high through March's annual reading of 8.5%. The US has again come to the aid of a nation besieged by a stronger oil producing enemy, just north of the Middle East. Supply chain disruptions are fueling accelerating inflation while economic reports have begun to wane.

The Federal Reserve formally ended their latest quantitative easing program in March, culminating a thirteen year monetary expansion made possible by Nixon's 1971 action, and unprecedented in world history. Their quarter point increase in the overnight lending rate was less than the feared half point hike that is now expected from forthcoming consecutive meetings. Planned reductions in the monetary base, also known as the Fed's balance sheet, will probably prove more consequential.

Important financial benchmarks reacted with rising interest rates pushing conventional mortgages above 5% which is cooling the overheated housing market. The world's most important financial benchmark, the S&P 500 turned in its first negative quarter since 2020, declining by almost 5%.

Putin's Price Hikes

Having campaigned to end America's use of fossil fuels, President Biden used his first day in office to sign executive orders halting US pipeline construction and oil exploration. With the climate crisis being the Administration's primary regulatory focus, many administrative nominees advocate for "debanking" the fossil fuel industry. As intended, energy producers retrenched and prices increased. President Biden's first year in office saw the barrel price of oil climb back above $80 for the first time since 2014, which was also the last time Russia invaded Ukraine. Putin's prior incursion was in 2008 when the oil price previously spiked above $80. There is a clear pattern of increasing oil revenues fueling Vladimir Putin's worst instincts. $4 gas is not because of Putin as much as it is enabling him to commit atrocities that shock the world.

Although driving an expensive electric vehicle is one way to relieve the pain at the pump, we are seeing how high energy prices have pernicious effects throughout the economy. Energy is a major expense in producing and transporting everything we buy. Already struggling under worker shortages and supply chain bottlenecks, our economy can ill afford more stress.

Fertilizer is an energy byproduct and a primary farming expense. Prices had already spiked before the spring planting season and have generally doubled from last season since Russia invaded Ukraine. The war has hindered supply from the world's largest fertilizer producing region just as the planting season begins. Ukraine is also Europe's largest supplier of wheat and grains and their farms are going largely unplanted this season. Farmers worldwide have reacted to higher fertilizer prices by planting fewer acres, which will have knock-on effects to world food supply at least through 2023. The prediction of transitory inflation is looking more like the myth it always was.

Western sanctions on Russia have made their products worth more on the gigantic Indian and Chinese black markets. Cutting their banks off the SWIFT international banking network has resulted in a strengthening of the Russian ruble as buyers of Putin's now illicit commodities have to pay with his desired currency. As long as the world depends on Russian commodities, Putin will have the power to destroy his neighbors like we are witnessing today.

The US seizure of Russia's currency holdings at the Federal Reserve represents a historic response which has clouded the US dollar's durability as the world's reserve currency. Our harsh penalties are being said to hasten the world's movement away from holding currency reserves in US dollars. Controlling the world's single most important trading currency has brought advantages to the American economy. Broad international demand strengthens the dollar and makes imports cheaper for US consumers. The other side of the coin is that it makes our exports more expensive to foreign consumers. It is said to reduce our interest rates, but the Fed has been manipulating them at the zero bound for more than a decade anyway. Declaring a fiat currency backed by nothing but the Fed's credibility has not made our financial markets and economy more stable since 1971, and it has strengthened the speculators it was targeted against.

Even before we deployed our economic weaponry against Russia, the Fed's credibility was under stress from increasing the monetary base tenfold since the 2008 Global Financial Crisis. The Chinese Yuan has been the primary recipient of international currency flows in recent years. The strengthening alignment of China and Russia makes a currency block between those two countries more likely, which will attract other nations seeking to avoid the expenses of complying with western sanctions.

Such an alliance ruled by dictators would not have the advantages that come with the rule of law. There are enduring structural reasons why the United States is the custodian of the world's reserve currency. Our competitive advantages in global finance are not easily challenged, especially by rogue regimes

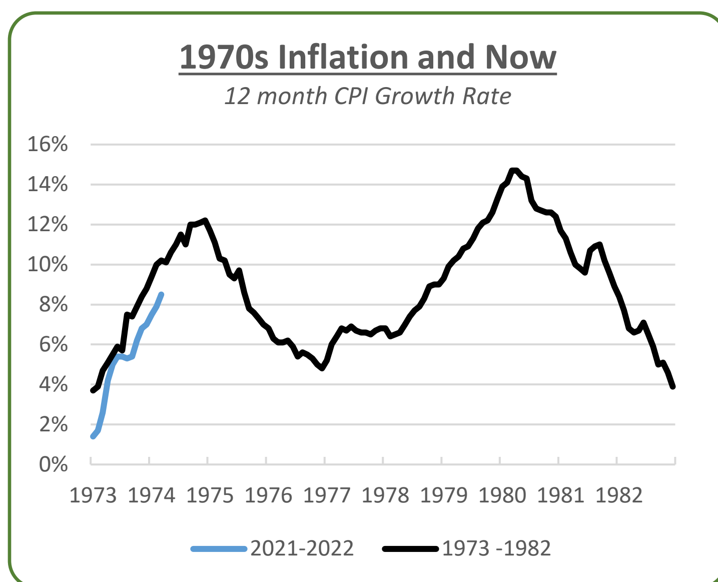
presiding in China and Russia. Perhaps the dollar would be stronger if we didn't compromise our economic principals to accommodate governments that don't conform to them.

The first step in restoring the international credibility of the US dollar is to reverse the obscene monetary policies since 2008. Now that the Fed has again announced the pivot down the path to normalization, the Stepping Stones fully invested equity ETF strategy's defensive positioning has helped avoid some recent pitfalls. Our long beleaguered energy position enjoyed a quarter in the limelight gaining over 40% as the portfolio's top performer. Our other inflation hedge, the gold miners fund, gained almost 20% in the quarter. Anyone who has visited a grocery store recently knows that consumer staples are seeing higher prices, as are the companies' share prices. Our staples fund gained almost 3% and the utilities fund rose more than 4% as those sectors enjoy inflationary pricing power. The materials position is another inflation hedge but it declined along with the small cap value fund. Higher rates discounted the dividend fund almost -2% lower. Although semiconductors remain in short supply, the market focused instead on their missed opportunities as that position lost almost -13%. Internationally, our European position declined by almost -12% while the currency hedged Japan fund gained over 2%. All combined, the portfolio returned 2.07% on a price basis during the first quarter compared to the S&P 500 which declined by -4.95%, and the MSCI All World index which lost -5.4%.

Behind the Curve

Accelerating inflation is lending urgency to the Fed's monetary retrenchment. Even the board's notable dove, Lael Brainard, has advocated for a rapid reduction in the balance sheet. The minutes from their March meeting reveal a plan to let $95 billion of Treasury debt expire each month, or a little over a trillion per year, while they raise their benchmark overnight interest rate by half percent increments as needed. The Fed hasn't carried out any half-point rate increases since 2000, and $95 billion per month is about triple the pace of quantitative tightening in 2018 that led to market turmoil and retrenchment in late 2019.

Left unsaid is how far they intend to tighten, but their aggressive plans are an acknowledgement that the bloated balance sheet is at least as inflationary as Putin's price hikes and other supply chain disruptions. It was only a matter of time before their printing generated inflation, and we learned forty years ago how difficult it is to quell. China's current lockdowns will add yet more fuel to the inflationary fire. Our political and economic leaders continue to assure us that inflation will subside in the coming months as production bottlenecks ease worldwide. Nobody expects another long battle with inflation, despite all we have done to foster one.



The nearby chart superimposes the current trend of the CPI represented by the blue line, along the inflation war from 1973 through 1982. Energy supplies are a major factor in each episode, but oil still flowed then, as it is now. The price increases were functions of elevated inflationary expectations meeting an expanded money supply in each period. Every monthly inflation report guides self-fulfilling

future expectations higher. The mid-seventies dip saw prices still rising above 5% during a recession, coining the term stagflation. The lesson then was that the overnight interest rate needed to reach 20%, which caused a deep recession. Today's hyper financialized economy has complicated the Fed's job more than it was with those speculators fifty years ago.

For forty years, the Federal Reserve respected our stewardship of the world's reserve currency and the power to print dollars at will. Nobody wanted a repeat of the seventies, until the lessons were forgotten. Since the 2008 Global Financial Crisis, they have responded to every minor retreat in stock prices by printing previously unimaginable amounts of money. Having increased the US monetary base from around $900 billion in 2007 to over $9 trillion today, The Fed has fully subjugated our economy to the speculators that Nixon vilified in 1971. They have created the most financialized economy in world history which has coincided with the highest financial valuations in history. The Fed's dexterity in unwinding their grand experiment, before inflation destroys their credibility, will determine the future status of the US dollar as the world's reserve currency, and America's economic wellbeing.

In terms of the CPI, the US dollar has lost more than 85% of its value since Nixon's 1971 action, and over 10% since 2021. Gold trading at almost $2,000 per ounce today represents a 92% dollar devaluation from 1971's $35 price. Our fiat currency appeared to be working until the Fed abandoned all traditional principles since 2008 by aggressively printing dollars to relieve any market disturbance. In addition to a gathering inflation storm, their policies have created the worst wealth disparity and social discord anyone can remember.

It took Paul Volcker's aggressive actions in 1980 to break inflation expectations. Today's Fed is talking aggressively, but their actions have yet to match their rhetoric. The market may do it for them as the Atlanta Fed's GDP Now model predicts first quarter economic growth slowed to just 1% after reaching almost 7% in the fourth quarter. A recession may moderate the rising inflation like it did in the mid-seventies, unless the politicians shower more money on voters in response. With our defensive posture finally paying off, we will hope for the best while preparing for a bear market to last as long as the Fed is tightening monetary policy. It could be years, although nobody really expects they would let it last that long.

Please call 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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