STEPPING STONES MANAGEMENT, LLC

Second Quarter 2017 Commentary

July 21, 2017

Growing up in the waning years of the Roman Empire, it wouldn't be unusual for a young man from a good family to cast off his religious upbringing and live a hedonistic lifestyle. One of the most famous of those young men inherently knew the errors of his ways and coined a prayer saying "Lord, grant me chastity, but not yet." Saint Augustine knew his wanton lifestyle was not good in the Socratic or any other sense but he was having too much fun to change his ways. He eventually did take up a chaste life and developed a philosophy that has underpinned Christianity for the 1,600 years since.

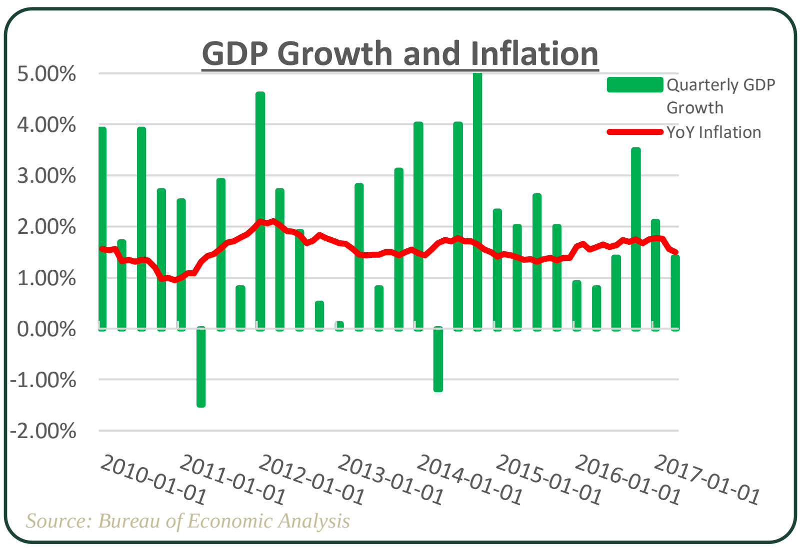
This third quarter of 2017 began with a striking image of a group of Christian minsters laying their hands upon the President of the United States who has become besieged by a Washington DC maelstrom portraying him as a secret agent of the Russian government. Nevermind that this grandest of all conspiracy theories has no evidence to sustain it. Plenty of sustenance is coming from 24/7 news coverage and leaks from the government bureaucracy the president has been unable to replace with his own appointees. There were no hearings in the second quarter on health care or tax reform, those bills are being written behind closed doors without input even from the majority party rank and file who can't deliver on their core campaign promises. The hearings Congress decided the American people most needed to witness concerned the allegation that Donald Trump colluded with the Russian government to steal the election of 2016. It is easier for the NeverTrumpers in both parties, the courts and even embedded in the Administration, to believe this than to believe that they have so mismanaged our government that voters thought a reality TV star would do a better job.

It's as mysterious as evangelical Christians embracing a man like Donald Trump. It's mysterious that Republicans could promise health care reform for seven years and not deliver when they were finally entrusted with full control of the government. It's mysterious that the supposed party of smaller government is presiding over deficits approaching those following the financial crisis. Perhaps most mysteriously of all, the stock market looked past the Russia hysteria and political dysfunction and built on the rally since Election Day which has driven the S&P 500 up by 17% with almost 3% of that coming in the just completed second quarter.

Monetary Conversion

St. Augustine changed his ways after hearing a childlike voice telling him to “take up and read the book.” Federal Reserve Chairman Janet Yellen progressed last quarter on her conversion away from wanton monetary profligacy and back to monetary rectitude. Maybe she read economic history that clearly shows debasement leading to pain and suffering. Perhaps she is even willing to accept the growing evidence that the Fed’s almost decade of suppressed interest rates has also led to suppressed economic growth. Whether she really found economic religion or has less pure motives, the second quarter experienced another Fed rate increase and confirmation that the central bank is planning to begin the process of shrinking its balance sheet later this year. That means they are going to make the Trump Treasury Department pay back the debt they extended to the Obama Treasury Department.

The Federal Reserve, chartered by Congress to manage the nation’s money supply, has a dual mandate to foster maximum economic growth while maintaining stable prices. Their quantitative easing (QE) policies created $3.5 trillion during the past nine years that was justified as necessary to avoid recession and deflation. Annual price increases below 2% were said to be dangerously close to an overall decline in prices that could wreak havoc on the economy. If companies have lower sales, they may fail to pay back loans which could bring about another financial crisis.



The Donald Trump presidency is primary evidence that their extraordinary policies did not drive higher economic growth or higher prices. That is further illustrated on the chart showing trendless GDP growth mostly stuck below 2%. The data provided by the US Commerce Department also include a measurement of inflation that is the Fed’s preferred gauge and that also shows trendless growth below 2%, represented by the red line. The decline this year is sharper than those that brought on prior rounds of monetary printing. There is a discernable downtrend in growth; except for the rising green bars leading up to Election Day showing how the politicians can get the economy moving when they need to.

Although the economy has been weakening, last year’s inflation rise was one reason given for the current tightening cycle. Fed governors are also citing elevated asset values as warning signs that monetary policy has been too loose. Recent record stock prices are more worrisome than prior record prices while recent declines in inflation do not signal deflation like prior ones did. The Fed’s attempts at transparency only make their policies more mysterious. Whatever their motives, positive interest rates will be the first step back to economic normalcy and the policy reversal has not resulted in a market disruption like these letters have predicted, but the tightening cycle has barely begun.

The record run in the quarter was most impactful on the international positions in the Stepping Stones fully invested ETF strategy. Continued QE from the European and Japanese central banks helped our positions in those regions gain more than 7% and 4% respectively while the China fund rose more than 3%. The semiconductor position rose more than 2% as did the utilities fund whose dividend looks increasingly attractive in a zero bound interest rate environment. Consumer staples also provide a little yield but their defensive nature was out of favor. That position was flat in the quarter which is better than the value fund which declined by 1.57%. The gold miners fund was about twice as bad and the two energy positions were worse as spiking US production kept a lid on prices. Our premise with these positions is the US energy revolution will be more beneficial than destructive to the industry and current prices mostly reflect the latter. On a combined price basis, the portfolio declined by 0.67% in the second quarter while the S&P 500 gained 2.57% and the MSCI All World Index gained 3.53%.

Oceans of Money

Even though the Fed has tempered their indulgences, the world's other central banks have yet to wind down their similar programs. In many cases this means creating so much money to drive bond prices high enough that their yields turn negative. That means the central banks will lose money by holding the bonds to maturity, as will anyone else buying bonds at such high prices. The Swiss National Bank is creating Swiss francs that they then sell for US dollars to prevent unwanted currency appreciation that curtails Swiss exports. They have been using the dollars they buy to invest in US common stocks which surely accounts for some of the resilience the US stock market has shown in the face of the Fed's tightening. The Swiss are reacting to the European Central Bank's own QE policy which is scheduled to run until year end. The impending conclusion has fueled a selloff of most developed market government bonds driving interest rates higher. Bond holders are sensing the end is near and want to get out before the big buyer leaves the party.

They don't need to worry about the Bank of Japan which is undeterred by the failure of their QE policy to bring about economic growth or inflation. When global interest rates began to rise at the end of the second quarter, the 10 year Japanese government bond yield rose to 0.1%. That was too much for the Bank of Japan who announced they are prepared to buy an unlimited amount of bonds to keep yields pegged at zero. Although the tsunami of central bank liquidity may be ebbing, the BOJ is now the buyer that will do whatever it takes to keep markets liquid. The stock market takes solace but at some point the cycle always turns.

It may be that central banks have achieved the elusive soft landing from their unprecedented expansive policies. Our stock market could be reaching new records thanks to the Trump deregulatory agenda which is happening despite Congressional gridlock. It's difficult to recognize the effects of lower regulations but one piece of evidence is the United States has become the world's largest energy producer. It wasn't long ago that we were told our reliance on foreign energy will destroy us. The market could also be signaling that the Republicans will be able to achieve their health care and tax reform agendas even as both look less likely. Or it may be signaling that recent softness in GDP and inflation will deter the Fed from further rate increases or balance sheet reductions.

We can only hope the stock market is discounting better times ahead because current conditions are raising concerns. Retail establishments across the country are closing at record rates which is partly a function of Amazon's success but that doesn't explain the crash in auto sales. Our politicians need to accept that Donald Trump did not win the Presidency because of Russian meddling but because Americans are unsatisfied with our state of affairs. JP Morgan CEO Jamie Dimon expressed it well during the bank's quarterly conference call when he said the inability to get policy right is hurting Americans. He does not accept that we are relegated to growing at less than 2% annually saying it is because "we have become one of the most bureaucratic, confusing, litigious societies on the planet." He added a vulgarity that ensured wide coverage in the 24/7 media.

The reason it has become that way is because politicians have an interest in making it so. They surely know it is not the way to good policy but it strengthens their power and brings in the dollars they need to get reelected. They want to do what is right and good, but not yet. We admit to being mystified by the stock market rally in the face of Fed tightening, slowing economic growth and a Washington establishment seemingly divorced from the interests of their constituents. If the sharp rally since Election Day is premised on the Trump agenda getting enacted, that is looking increasingly flawed. The rally has stretched the historic valuations these letters have been warning about to where expected returns approach the prevailing zero bound, or lower. Meanwhile, politics has become less about Democrat vs Republican and more about insider vs outsider in an epic battle that could produce collateral economic damage. Absent our leaders finding political religion, the heightened risk arising from an extended market rally and Washington's dysfunction leads us to maintain our cash positions until the lunacy is discounted in stock prices.

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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