STEPPING STONES MANAGEMENT, LLC

Second Quarter Commentary

July 25, 2019

The stock market in the second quarter had something for everyone. April rolled in on the strong first quarter momentum which had largely erased the fourth quarter's sharp decline. Optimism about trade negotiations between earth's two largest economies and the Federal Reserve backing off its' recent hawkish posture were enough to add another 4% for the month and set a new high in the S&P 500. However, market lore advising to sell in May and go away took over in the next month as President Trump and Chairman Xi failed to justify earlier optimism about their negotiations. By the time additional tariffs were imposed in mid-May, stocks had given up all of April's gains. It got uglier into the end of the month as interest rates dropped sharply on concerns that the world economy was falling into recession. It was time to call out the plunge protection team. Central bank officials around the world spoke out dovishly and the European Central Bank extended their ultra-loose monetary policy from the end of 2019 through at least the first half of 2020. The 10-year German bund fell to an all-time low below -0.25% and continued lower to close the quarter. The negative rate didn't help the European stock market which was dragged down by bank stocks. Indeed, negative rates have brought the once mighty Deutsche Bank to the brink of insolvency and forced to fire tens of thousands of workers. On our shores, Fed Chairman Jerome Powell highlighted the strong US economy while citing "crosscurrents, including trade developments and concerns about global growth" that may "call for additional monetary accommodation." The Fed is signaling preemptive action to protect the strong US economy from being upended by these "crosscurrents." Market lore also says don't fight the Fed so it was "risk on!" again in June. The quarter ended with a Group of 20 summit in Japan where Trump and Xi agreed to a ceasefire in their trade war. The US will hold off on additional tariffs and China will buy more US soybeans.

In only three months, we saw the world's largest central bank move from a pause within a tightening policy to a neutral and data dependent posture before declaring an accommodative position in late June. Likewise, the market transgressed through its stages of euphoria and despair which typically evolve over quarters and years rather than weeks and months. Powell's Fed says they are data dependent but hardly enough data can be gathered within a three-month period to move policy so dramatically unless the central bank is trying to fine tune the economy with the blunt instrument of monetary policy. That may be the new world order as politics demands easy money to solve every problem. The market knows the Fed's fine tuning usually fosters speculation so the algorithms clicked to buy and the S&P 500 closed the first half above 3,000 for the first time, registering a quarterly price gain of 3.79%. Thank you Chairman Powell.

The Powell Put

In the long sweep of monetary history, central banks have never been called on to manage their economies to such a degree and have rarely displayed such concern for other nations' economies. As these letters have chronicled, these are uncharted times in monetary history. Powell's Fed has mostly normalized the overnight lending rate at a range between 2.25-2.5% but the market is calling for that to be cut by a half percentage point. More important is the rate the Fed pays on the excess reserves that banks hold at the central bank which move in-line with the Fed's bloated balance sheet. Chairman Bernanke initiated the policy of paying banks interest on those reserves so the money does not get out into the broader economy and ignite inflation. Adjusting that rate could have more of an economic impact since that's where all the money is.

Once the taboo of bloated balance sheets was broken, central banks needed new tools to manage all the money they created. Interest on reserves is one of those tools. Since they have taken on such detailed responsibilities, the Fed governors must feel obligated to employ their new tools to confront any disturbance. Mere words are usually enough to spark a rally but must eventually be backed by action. European Central Bank President Mario Draghi famously said he would do "whatever it takes" to keep the Euro currency viable. That was enough to calm disturbed markets and seven years later it has meant an unprecedented era of negative interest rates, another new central bank tool. Upon his upcoming retirement, Draghi will be replaced by Christine Lagarde who currently chairs the International Monetary Fund which steps into most financial crises around the world. She has plenty of experience and bona fides with the world's central banks and politicians.

The world's most articulate observer of interest rates, James Grant, writes "in today's monetary regime, some $13 trillion of debt securities world-wide are priced to deliver a yield of less than zero. There's been nothing like it in 4,000 years of recorded interest-rate history." Many of those bonds are in the high yield category issued by low rated companies who are now able to take on debt at a negative rate. That is just one example of the malinvestment that occurs when interest rates are manipulated. We saw how the low interest rates of the post crisis era resulted in low investment and low productivity. Those are two reasons why economic growth was so weak during the period. Heavy regulation was another. Since the Fed has been attempting to normalize rates, we have seen both investment and productivity increase which have combined to kick our economy up to a higher growth rate. Everyone has benefited except borrowers who are still enjoying historically low rates.

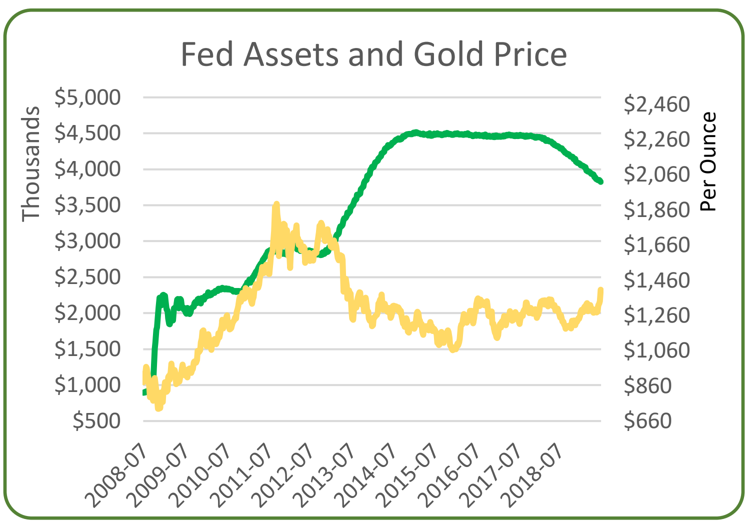
The biggest borrowers are governments and Wall Street and both are squawking for lower rates. Governments are obviously being squeezed as they refinance maturing debt at higher interest rates leaving less money to distribute to voters. The Wall Street model is to fully exploit the tiniest of margins so higher costs of funds act counter to that. The politicians exert pressure by threatening the bankers' exalted positions, even if Trump can't fire Powell. Wall Street exerts pressure by selling stocks and driving down the S&P 500, the ultimate economic barometer. This is what happened last fall when the Fed was progressing along its normalization course. By January, the damage was too much and Chairman Powell rescued stock prices with soothing talk which has culminated in an expected rate cut later this month. It's being called the Powell Put equated to a put option giving the holder to right to sell falling shares at a higher price. It's a tool used by all Fed chairmen since Alan Greenspan.

Steady rates at a low level and solid economic growth should make everyone happy but don't expect stock prices to hold their highs if the Fed fails to deliver a rate cut. The traders and their algorithms need movement so if the Fed keeps the spigots open the robots will keep buying. If not, the movement will be in the other direction like we saw last fall. There is no happy medium, the Fed has found itself stuck between uninhibited speculation or a painful selloff. Eventually they will have to take away the punchbowl, no matter what kind of tantrum Wall Street throws. These letters have warned for years about the backside of an historic monetary expansion. The easy path will eventually lead to massive inflation to match the Fed balance sheet. That may be the central bank's secret wish.

The Fed's new accommodative stance could account for the breakout seen in the price of gold which has surpassed $1,400 per ounce for the first time in six years. We have expected the balance sheet reductions to be more difficult to deliver than discuss which is why we have held the gold miners position in the Stepping Stones fully invested Equity ETF strategy. That position gained 14% in the second quarter easily surpassing all others in an indictment on the Fed's credibility. It is not necessarily signaling inflation because oil did not participate as international economic worries dampened demand expectations. Our oil positions were down about 10%. Our China and Japan funds were the other negative performers. The crosscurrents confusing the Fed were evident in the portfolio too as the semiconductors bucked the economic worries with a 5% gain as did the ValueLine Timeliness fund. You wouldn't know Europe's economy was struggling from the almost 7% gain in our European fund. Our consumer staples fund barely managed a gain while the Utilities rode lower rates to a 3.35% gain. All together the portfolio rose 3.26% on a price basis in the second quarter compared to the S&P 500 which gained 3.79% and the MSCI All World Index which returned 2.16%.

The PhD Standard

When the market does well the central bankers congratulate themselves and when turbulence strikes they ride to the rescue with more easy money. Chairmen Bernanke and Yellen assured us that all the money they created to buy government bonds would not leak out into the economy and ignite inflation because they were paying the banks to keep that money on deposit with the Fed. Once the crisis passed, they told us the new money would be canceled and the Fed's balance sheet would return to pre-crisis levels. When the tough job of mopping up all the excess liquidity fell to Jerome Powell, the pre-crisis balance sheet level was abandoned for something maybe about half the record size. Now rhetoric about shrinking the balance sheet has gone by the wayside which may account for the rise in gold which has a better long term record of maintaining its value than the US dollar or any other major currency. For most of the Fed's century in operation, the US dollar was backed by gold which limited the Fed's ability to alter the money supply in response to economic developments. Since abandoning the gold standard in 1971, the central bank has been unrestrained in how it conducts policy and not surprisingly they have found a slew of new tools to employ. James Grant calls it the PhD standard.



We can see on the accompanying chart how the price of gold exploded when the Fed began its quantitative easing (QE) policy, tripling in price as the Fed tripled its balance sheet. When the initial round of QE ended the gold price dropped about 15% before enjoying another rally when it became clear that more QE was coming. Firm talk about not letting the monetary expansions spark inflation kept a lid on the price per ounce and then the bear market in gold came as inflation looked to be a thing of the past. However, something seems to have happened when gold bottomed 5 years ago. Since then the price has seen a series of higher lows and broken out to a new recent high. Plans to curtail all the monetary accommodation were delayed even as officials hewed to their hawkish rhetoric. The gold rally tells us that actions speak louder than words. Now with major balance sheet reductions off the table, gold has some catching up to regain its former correlation with the Fed balance sheet. Looking at the chart, if the balance sheet settles around an expected $3.75 trillion, the price of gold should settle around $2,000 per ounce, more than 40% above current levels. The Fed may be off the gold standard but to their dismay, the barbarous relic has a way of remaining relevant.

The Fed is not only challenged by the gold market questioning their credibility, now Facebook is getting in on the action with the creation of their own blockchain based currency called Libra. With about a third of humanity as their customers, the social network operator is rolling out another feature to keep those users within the company's walled garden. Developing a bitcoin protégé is Facebook's way to give their users access to a currency not manipulated by central banks and politicians. It may not be as easy as they think as the central bankers and politicians control the currencies into which Facebook wants Libra to be convertible. Moving from the internet to the financial markets, Facebook is about to go from the most lightly regulated industry to the heaviest. It ought to be quite a lesson in corporate regulation.

Most companies are enjoying a lighter regulatory load in recent years but much of that benefit was realized early in the Trump Administration. Comparisons to those years are becoming more difficult and earnings growth rates are falling. S&P 500 earnings in the first quarter were slightly lower than the year prior and the second quarter expectations call for a 3% decline which would be the biggest earnings drop since the second quarter of 2016. Companies may be lowering the bar to make it easy to beat but another quarter with lower aggregate earnings would constitute an earnings recession although not an economic recession. The Fed is not supposed to be concerned with the level of corporate earnings but in the new era of monetary micromanagement, every economic statistic is said to affect their mandate of price stability and full employment.

The Fed fears lower prices, or deflation, because it would ruin bank balance sheets as their assets would decline in value while their liabilities would not. Their QE policies have bid up bond prices to where their returns are almost negative which has in turn almost guarantees their worst case outcome. When rates eventually normalize, those bonds will be worth a lot less and the banks holding them will feel the bite of Fed induced deflation. That's why the Fed may secretly wish for higher inflation so that all the governments gorging themselves on debt will find it easier to redeem. With inflation at the Fed's 2% target, unemployment at an historic low level and GDP trending at multiyear highs, it doesn't make sense that rates need to be cut. Unless the Fed is trying to spark inflation much higher than their 2% objective. Another piece of market lore says that Mr. Market will do whatever causes the most pain to the most people. For most of this bull market that has affected those choosing to remain on the sidelines. The Fed and all the positions riding along with them should take heed, eventually massive money printing will not be bullish because inflation is not bullish.

Please call us to discuss 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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