STEPPING STONES MANAGEMENT, LLC

Second Quarter 2020 Commentary

July 20, 2020

The Oracle at Delphi concluded that no human was wiser than Socrates because he did not fancy he knew what he did not know. Among the founding fathers of western civilization, the first philosopher to gain a wide following became known for using logic and reason to arrive at the truth. He was a gadfly among the elites who ruled ancient Greece, finding them all lacking in knowledge but thinking that they knew much. He would have found the second quarter of 2020 to be quite a conundrum.

On April 1, New York City was in the grips of the Covid-19 crisis and the world remained shut down. The stock market had rallied off its low point of a week earlier and we all hoped that doctors and nurses were finding effective treatments for the mysterious virus. By Easter we saw the curves turning down and we were all ready to come out of our quarantines. The two week lockdowns had become thirty days, which then became indefinite. The Robinhood free trading app enjoyed unprecedented activity as sports fans like Barstools Sports founder Dave Portnoy found day trading to be easier than sports gambling because stocks "only go up." Declaring himself the world's greatest day trader, he formed a hedge fund called Davey Day Trader Global and tweeted that Warren Buffet is "washed up, I'm the captain now."

This was when the Federal Reserve was deploying the $3 trillion they announced in prior weeks as even the junkiest bonds found bids. It was as if all those corporate issuers were generating enough cash from their operations to pay all the coupons on those bonds. In fact, corporate operations nationwide were generally paused and cash was flowing in the financial system but little elsewhere. Workers were waiting on governors to decide when it was safe to resume economic activity. States that seemed to avoid the pandemic began to reopen in the face of fierce opposition falling along political lines as this most unusual election year takes shape.

When the weather got nice, people began to come out, and on May 25th George Floyd was murdered by a Minneapolis police officer. The protests that followed turned to riots as most American cities experienced widespread fires and looting. Soho and Fifth Ave become war zones where NYPD officers sustained assaults during days of general mayhem. The riots calmed but the demonstrations in the name of social justice grew nationwide with sporadic violence continuing. The protests developed into forceful removals of confederate statues that progressed to even Abraham Lincoln and George Washington being torn down and defaced. Columbus is marking his days at Central Park's southwest corner.

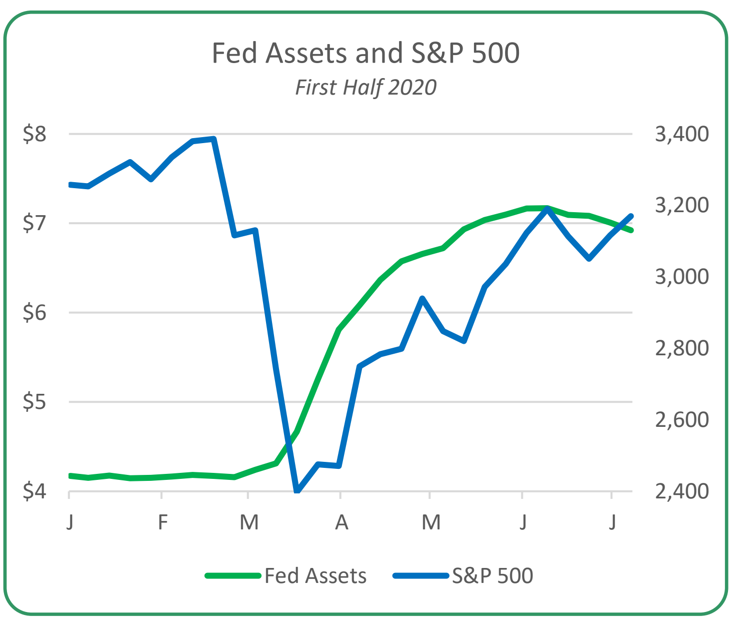
Through all the unrest, the stock market continued to price in a V shaped recovery. Economic numbers came in worse than anything ever seen but better than expected and workers slowly began to return to their jobs in May and June. By June 3rd, The Dow Jones Industrial Average had gained more than 40% from its low in what President Trump correctly characterized as "the fifty best days in stock market history." The economy still has a long way to recover but the market looks forward and by the end of June the Dow had returned almost 18%, its highest quarterly return since the first quarter of 1987.

Chairman Powell's Toolbox

Socrates would ask himself what factors have driven that performance. The usual explanation is that prices are discounting all the future cash flows that companies are expected to generate. That is the textbook explanation of the dividend discount model (DDM) taught to generations of investors. If it holds here, we have to assume that corporate America's profit potential is about as high as it was before the pandemic when prices were last this high. All of the foregone cash flows in recent months would be made up in the great rebound to come and the expansion to follow. Future sales will account for those foregone, and expected costs will be no worse than we previously thought. With most Main Streets serving far fewer customers and new sanitary protocols required at any that are open, it is hard to imagine cash flows will be as strong as the best case expectations that prevailed in February. Lower rates could justify higher present values but rates were already extremely low. Another challenge to the DDM explanation is that more than 40% of S&P500 companies have withdrawn their financial guidance because they simply don't know what their businesses will look like. If they don't know, how can the stock market be so sanguine?

We could speculate that the new bull market has been driven by Dave Portnoy and all the day traders following his tweets. The most active stocks on the Robinhood app closely align with the quarter's best performers. Indeed Hertz car rental, operating under bankruptcy protection, saw their stock price surge so much that the company planned to issue more worthless shares until cooler heads prevailed and cancelled the offering. Other low quality issues, like our old favorite Chesapeake Energy, also saw trading surges before expiring worthless. A more powerful speculative force than day traders are hedge funds swimming in almost free money and buying anything that goes up. These letters have long maintained that the bulging bank balance sheets have driven the bull market because loans to hedge funds are the easiest and safest for banks to make. Their highly liquid collateral can be called in and sold at a moment's notice.

Prior letters have examined the correlation between the size of the Fed's balance sheet and stock prices which closely aligned again in the second quarter, as seen in the nearby chart. As the Fed expanded its balance sheet from $4 trillion to $7 trillion, the S&P 500 rose by a third from 2,400 to 3,200. We saw similar correlations during the various rounds of quantitative easing following the 2008 financial crisis. Another trend is that each round got larger, culminating in the latest $3 trillion coronavirus response. We doubted Ben Bernanke's 2010 assertion on *60 Minutes* that the Fed could easily reverse their historic rate manipulation and we doubt Jerome Powell when he recently told the financial press "When the time comes, after the crisis has passed, we will put these emergency tools back in the toolbox." How much money will they have to print in the next round? We don't pretend to know what we do not know, but if history is a guide, that question will be answered



after the next mild stock market correction.

We have responded to the monetary expansions by holdings positions linked to hard assets in the Stepping Stones fully invested equity ETF strategy. The absence of sustained inflation during the era of quantitative easing has been a headwind for our portfolio but the second quarter saw those positions come to life. Our primary inflation hedge is the gold miners fund which rose by almost 60% in the quarter as the price of gold begins to catch up with the expanding money supply. Our energy positions are also an inflation hedge and they performed as well, before we combined the two positions into one and added a basic materials position with funds rebalanced form gains in the gold miners. We also rebalanced some gains from the semiconductors fund, which returned over 30% in the quarter, into our Europe position which gained more than 20%. Defensive positions like consumer staples and utilities underperformed and the ValueLine and Japan funds did better but also lagged the indices. Finally, we exited our China position and hope to follow manufactures back to America with a US small cap value fund. Strength in larger positions like the gold miners and semiconductors drove the portfolio to a gain of 28.32% on a price basis compared to the second quarter return of 19.95% for the S&P 500 and 17.82% for the MSCI All World index.

Murphy's Law

These letters have also long maintained that the past decade of monetary debasement has fueled the social discord experienced around the world in recent years. The Fed's responses to three financial crises in two decades have protected society's asset holders without regard to anyone else. The S&P 500 has become the all-important barometer of social welfare even though it is irrelevant to the recent college graduates and so many others protesting in the streets. Other people have exposure through retirement plans but the army of individual investors that bore the losses in the dot.com craze never fully returned to the market. The Millennials trading on Robinhood may be in for a similar experience. However, long term investors know that bear markets recover and traders who say stocks always go up know that the Fed has their back. Every modest correction is met with increasing amounts of monetary creation to bring the barometer back to an all-time high so the elites of Washington and Wall Street can congratulate themselves on a job well done. Other lives don't matter.

Higher stock values don't reflect the rising segments of society feeling that the system is rigged for those in power. Small business owners and workers eagerly await all important pronouncements from governors deciding arbitrarily when it is safe to get back to business. New Jersey restaurants were expecting to resume indoor dining earlier this month until Gov. Murphy decided to delay the opening even though there is no shortage of hospital capacity in the state. One popular chef called it "Murphy's Law." It's no wonder people are protesting in the streets. Not having a voice in the way you are permitted to live is what Rev. Martin Luther King Jr. meant by the sense of "nobodyness" that he so eloquently expressed in his Letter from the Birmingham City Jail. His classic exposition on peaceful protest.

The US economy is the strongest in the world because our Constitution protects basic freedoms and our legal system protects property rights. Both are based on concepts dating back since Socrates began to question conventional wisdom. The canon of western civilization, built over centuries on his initial insights, has led to humanity's great advancements including the American Revolution of 1776. As Lady Liberty declares American freedom to the rest of the world, our political, legal and education systems have attracted the world's best talent to build our exceptional nation. Investors from around the world have decided to hold assets in our currency thanks to the transparency of our markets governed by strict accounting rules.

The protestors' rejection of western civilization proves that our education system has failed at least the recent generation of college graduates. Our legal system protecting rights to free speech and property have been largely suspended as the cancel culture ravages anyone who dares not accede to their radical viewpoints. Financial markets are manipulated higher as even the weakest companies can sell their debt to the central bank. Our politics have become so bizarre that the response to widespread rioting and assaults on police officers has been to defund the police. Nobody wants to assess the costs of the increasing crime wave and general social discord, better to pretend all is well as the stock market says.

Socrates preferred truth, and he would have known that the New York Police Department is the finest in the world. To call it's largely minority force systemically racist is a libel that any logic and reason can easily expose. We are watching western civilization being torn down by an ignorant mob looking to destroy the memory of our greatest predecessors, to be replaced by a woke ideology that would make corporate profits impossible. This movement is not bullish for stock prices and the stifling of free expression is not conducive to economic growth.

California and Texas announced last week that many of their students will not return to classrooms this fall which means their parents cannot return to work full-time. College football conferences have cancelled their seasons and Broadway will remain dark at least through year end. We are still a long way from a normal economy. As we all become epidemiologists, we may know as much as Dr. Fauci about this mercurial virus that changes just as we think we understand it. Advancements on a vaccine look to be progressing at a record pace while our medical professionals have found treatments to drive the Covid fatality rate below 1%. Whether or not a vaccine comes, it won't work for everyone and it may not work for long. Some will refuse to take it. Under the most optimistic circumstances, the economy will be slow to reopen as we all cope with new ways of living.

We have yet to see the dust settle on Main Street where landlords are wondering what to expect from their tenants who have been locked out of their businesses. We don't yet know how long banks and courts will hold off on foreclosures. As the major banks report their earnings, we have seen strength from trading offset by growing loan loss reserves in preparation for their newly unemployed customers to have trouble servicing all the debt they accumulated during the Fed's past decade of suppressed rates. Even if rates remain at record lows, higher unemployment leads to higher loan losses.

The worst economic pain has been held off by all the government programs that passed in March but collateral damage always results. Restaurants that are open have found it difficult to attract their workers back because they make more from the enhanced unemployment benefits than they did at work. That special benefit ends this month as the opposite houses of Congress advocate very different plans for the next round of support. The election season may get in the way of any further support. Such debates belong in the political realm and the Fed would be wise to restrain its activist tendencies.

When Chairman Powell said that "inequality is not really related to monetary policy" he betrayed a troubling obliviousness to how his organization is viewed by the public. If he is true to his word that the Fed is not targeting asset prices, then he should let them decline without rescuing investors with another huge monetary expansion the next time the market tries to discount the economic calamity currently at hand. Record stock prices amidst the destruction of 2020 should embarrass Jerome Powell and his fellow Fed governors. By insulating the banking system from that calamity, they are also insulating the wealthy and fueling social unrest. If they want to regain credibility, they need to let risk takers bear the risks they have taken on.

We expect this election season to be more volatile than usual as opposing social forces compete for the future of America. If a woke revolution leaves Socrates spinning in his grave, we can expect the stock market to be worthless as corporate profits become outlawed. Even if western civilization prevails, 2020 will sustain wounds that have yet to be fully felt, or discounted in stock prices. Washington DC politicians can rely on the Fed to buy billions of their bonds on a daily basis for the foreseeable future, but states and cities will need to raise taxes to account for higher expenses and lower business activity in their jurisdictions. Companies still have to figure out what their businesses will look like in the post pandemic world.

With the notable exception of 1776, revolution usually results in destruction but we are confident that evolution results in something better. We are betting on the latter in these volatile times while holding onto our cash reserves at least until some dust settles.

Especially in these troubling times, 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.

Take care,

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