STEPPING STONES MANAGEMENT, LLC

Second Quarter 2021 Commentary

July 21, 2021

Although he couldn't have played a fiddle, which wasn't invented yet, historians believe Nero welcomed the fire that destroyed Rome in the year 64. Realizing the expenses to build his new palace would exceed the Roman Treasury holdings of gold and silver brought about his most notable legacy, the invention of monetary debasement. To meet the shortfall of precious metals coming from plunder, taxes and tariffs, Nero had the ingenious idea of adding base metals to make a precious mix go farther. He also lowered the weights of Roman coins to make more and satisfy all his extravagant desires. Popular with the masses until the end, his monetary theories didn't work out well for the asset holders. Nero committed suicide after being sentenced to death as a public enemy, marking the end of the Julio-Claudian dynasty.

In 1914 the German Empire was dominating Europe with an economy supplied by 6 billion gold backed German marks. The First World War cost Germany 160 billion marks and the gold guarantee was repealed. The 1919 Treaty of Versailles burdened an already stressed government, but the magic elixir of money printing eased their pain. By 1923 there were 1,280 billion marks in circulation and the exchange rate with the US dollar had gone from 7.5/1 to more than a trillion/1. The mark became worthless as a store of value or a medium of exchange. German agricultural areas issued bonds backed by rye as other commodities like coal and potash also became currency proxies. Official exchange rates hid the facts which allowed foreigners to buy up German assets and fuel an historic speculative wave. This failed to compensate the asset holders whose rents hadn't kept pace with inflation while the political instability sowed the seeds of humanity's worst disaster.

Franklin Roosevelt struggled with monetary policy and the gold standard. He lowered the dollar-gold exchange rate, but it didn't prevent the ongoing economic crisis from becoming the Great Depression, which was only solved by another horrifying world war. The greatest generation sacrificed to get the world back on track until the Cultural Revolution shook society again. With the stroke of his pen, Richard Nixon answered the needs of the Great Society social programs almost 50 years ago on August 15, 1971. Implementing the most consequential economic act since Nero, he ended the US dollar's convertibility into gold.

Abandoning the gold standard resulted in the historic 1970s stagflation, but that lesson is silent in today's monetary policy. The US Federal Reserve is continuing their Covid response by printing $120 billion every month to buy US Treasury and mortgage debt. Chairman Jerome Powell congratulated his board telling Congress that US economic growth is on track "to post its fastest rate of increase in decades." The stock market also applauded, rising more than 8% to close the second quarter at a record.

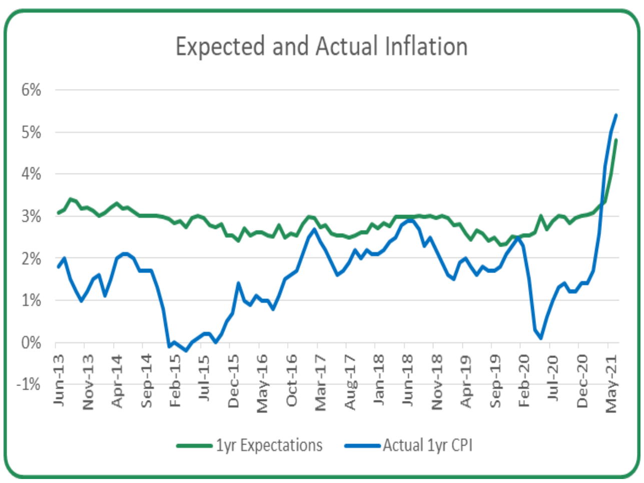
Monetary Lessons

Powell prefers the lessons of Ben Bernanke's quantitative easing response to the 2008 Global Financial Crisis. That revolutionary monetary experiment was inspired by Japan's reaction to their 1989 financial crisis, and made possible by Nixon's decision decades earlier. The initial lessons from adopting fiat money not backed by anything tangible, are a stark memory to anyone around in the seventies. Rampant price increases from sometimes exogenous events like a Middle East war, got incorporated into future expectations, and current prices for wages and goods. The resulting wage-price spiral became an uncontrollable inflationary force that repressed economic activity. Japan's policies never brought about inflation which gave our central bankers confidence that they could engineer the same soft landing.

It’s important to notice that over thirty years later, Japan’s economy has still not recovered to its 1989 peak. The more the experts engineer the economy, the slower it grows. The fallacy is that central banks can exit from such activist policies. Twelve years after the Fed’s emergency response to the Global Financial Crisis, they are still printing ever-increasing amounts of new money. Sixteen months after their nuclear response to Covid, with the economy growing faster than anyone expected, and they still have policy at its extreme. They proclaim the tools to combat inflation won’t be needed until at least 2023.

They may regret that forward guidance as the second quarter brought the highest inflation statistics in generations, with most measures currently registering above 5% annually. Price increases are coming from pent up demand meeting government stimulus spending, and funded by the Federal Reserve creating the money to buy the bonds. Record stock and real estate prices are also making consumers looser with their wallets, and willing to pay higher prices.

Powell attributes the heightened inflation statistics to the pandemic lows being factored into the calculations, although those known levels only account for the expected increases, not the surprising amounts. He also points to supply bottlenecks caused by shutdowns still underpinning price increases. Now that restaurants aren’t building sheds in the street, we have seen the lumber bottleneck ease as prices give back most of their recent spike. The Fed expects these and other transitory supply effects to abate which should bring inflation back to their long run goal of 2%. The head of the world’s largest conglomerate, Warren Buffett, disagrees saying “We are seeing very substantial inflation… We are raising prices. People are raising prices to us, and it’s being accepted.”



The Federal Reserve Bank of New York has been conducting a survey of consumer inflation expectations since 2013, as displayed in the nearby chart. You can see how the green one year expectations line has been anchored around 2.5%, above the more volatile blue line representing the actual annual change in the Consumer Price Index. Both shot up in the second quarter with actual inflation overshooting the now unanchored expectations. Many prices will very likely recede as lumber has, but nobody knows where that new level will rest. Lumber prices have fallen 70% from their peak in May, but remain 15% higher than before the pandemic.

Consumer inflation expectations are driven by gas prices more than any other factor, which explains some of that spike. Gas prices have risen as the price of crude oil gained over 20% in the second quarter. The Stepping Stones fully invested equity ETF strategy benefited with a 19% rise in our energy position. That was more than double the performance of our semiconductors position which is also enjoying inflationary prices arising from supply and demand imbalances. Gold has yet to fully appreciate the monetary debasement, but our miners position gained almost 5%. Our new basic materials position rose almost as much, as did our dividend and small cap funds. Our Europe position returned 5.2% in the quarter while the currency hedged Japan fund was slightly negative. The consumer staples and utilities positions were also slightly negative as inflation weakens their income statements. The strategy returned 5.14% on a price basis in the second quarter that saw the S&P 500 gain 8.17% and the MSCI All World index rise by 6.35%.

Fed on Frontline

Testifying to Congress last month about rising inflation, Jerome Powell said “We’re humble about what we understand. We’re trying to understand both the base case and also the risks.” The risks to financial stability are his reason for continuing to print so much money even with the economy racing ahead. Accepting his prediction that current inflation will be transitory doesn’t answer why an emergency policy is still needed. Certainly the humility Powell claims would require at least a modest pullback from the extreme, but he says that would risk interrupting the rebound in the economy.

Whenever the Fed has reversed an accommodative monetary policy, a recession has always followed. Therefore, whenever the stock market has signaled economic troubles, they have flooded markets with a greater gusher of money to keep the banks solvent. They are unwilling to sustain a normal bear market. The result is a financial system that appears healthy, only as long as it’s getting enough new money. The fourth quarter of 2019 exposed the instability when the Fed’s attempt at restraint created a financial disruption requiring another massive infusion. A few months later, the pandemic brought the expansions a step higher on the logarithmic scale.

A recent episode of Frontline on PBS suggests the Fed’s monetary policies are helping the rich at the expense of everyone else. These letters have belabored that point for more than a decade of quantitative easing, to where we are all witnessing the current deterioration of civil society. The Fed is losing credibility like the rest of our important institutions and it appears to be resonating within their hallowed halls. Governors speak more frequently about the importance of everyone sharing in the benefits of prosperity. I am happy to see other voices echo this concern, but the Fed’s answer is to keep their extreme policy in place until it works. The people who have yet to share in these benefits are the ones being hurt most by inflation. The more the Fed claims to help them, the worse they are getting, while we hear only praises of higher stock prices.

The United States has enjoyed the benefits of a fiat currency for half a century because the world had confidence that our leaders wouldn’t abuse the privilege. Now, the exploding issuance of debt funded by central bank accommodation is resented at home and abroad. The fifty-year experiment has been successful so far, but half a century is a blink of history’s eye. Jerome Powell finds the institution he leads backed into a corner from more than a decade of extremely easy money, through three chairmen. It has fallen on his shoulders to restore credibility to the world’s most important central bank, or risk becoming another unfortunate historical lesson. He can be proactive and let asset holders realize the risks of their investments, or risk a crisis beyond the powerful tools at his disposal. Whatever the Fed does, markets are not going to like the inevitable end of America’s greatest monetary expansion.

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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