STEPPING STONES MANAGEMENT, LLC

Second Quarter 2022 Commentary

July 26, 2022

The second quarter of 2022 proved seminal for several reasons. The Federal Reserve sped up their pace of interest rate normalization with June's 75 basis point hike in the overnight interest rate to 1.75%, their largest increase since 1986. Perhaps more important, in late June the central bank began to shrink its balance sheet. The process of "quantitative tightening" will remove some of the money the Fed created in response to troubled markets over the past 13 years. Exactly how much is the $9 trillion question.

They announced a plan to gradually wind down the monetary base by a rate that will get to $95 billion per month this quarter. Left unsaid is how long the Fed plans to continue removing money at that pace, towards their 2% inflation target. Early reactions to the new monetary regime have been harsh in the normally steady short-term bond markets, which have never had to deal with rates rising eightfold in four months. That's because rates have never begun to rise from such a low level. The unprecedented monetary policies are proving to have unprecedented repercussions.

One repercussion has been the end of the "Everything Rally" of the quantitative easing era. The animal spirits have departed the most aggressive positions as a new bear market takes precedence on Wall Street. The S&P 500 had the worst first half since 1970 declining by -20%, which was mild compared to the NASDAQ index which dropped by -30% and Bitcoin which lost -60% in the first six months of the year. Even hard assets like real estate are bearing the brunt of higher interest rates.

Markets are being forced to discount a historic wave of inflation, becoming more like the 1970s with every monthly report. June's 9.1% annual rise in the Consumer Price Index was the highest since the end of that previous battle in 1981. Consumers paying more for food and energy have less to spend elsewhere and the Atlanta Fed's GDP model predicts we entered a technical recession with the second quarter's second consecutive drop in Gross Domestic Product.

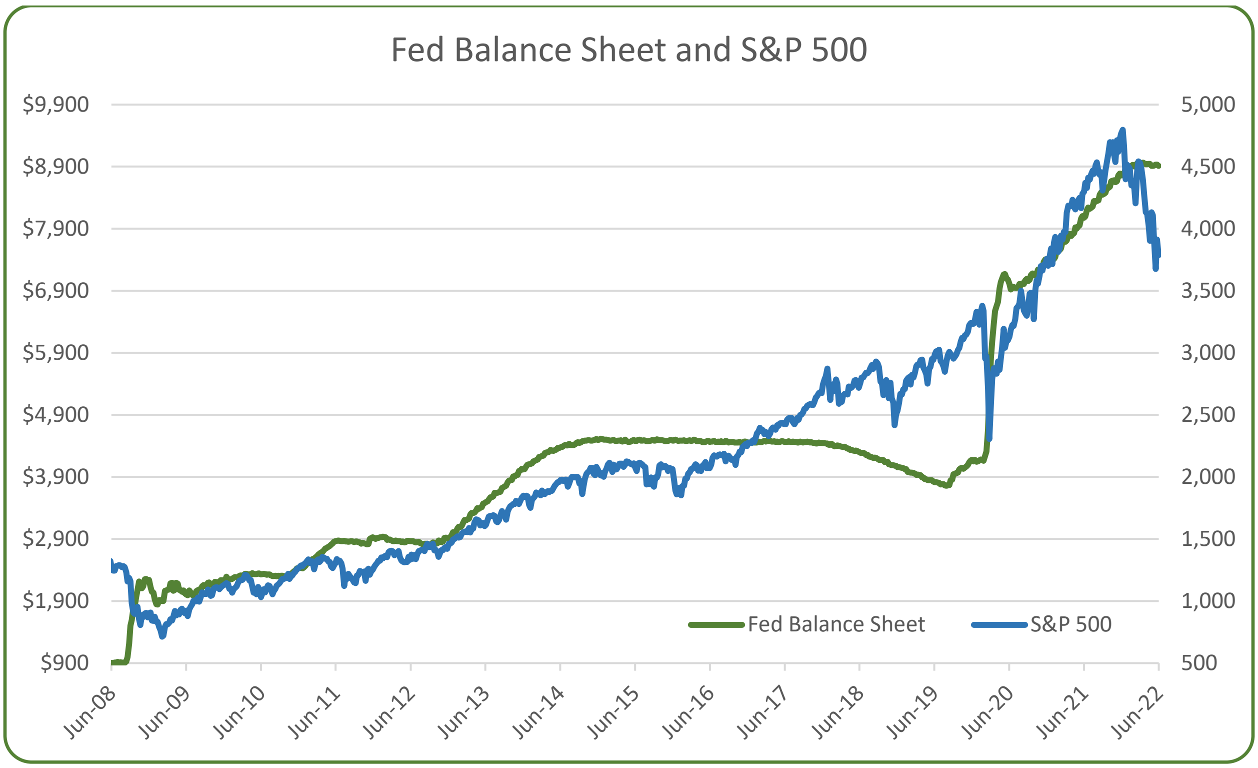
Having assured the world that inflation would be transitory, the Fed is now woefully behind the curve of interest rate normalization, and forced to tighten monetary policy in the face of a recession. Either they repeat the mistake of 1930, that former chair Ben Bernanke characterizes as causing the great depression, or they keep monetary policy loose as inflation rages. They find themselves caught between the proverbial rock and a hard place and have warned markets they might not be able to engineer a soft landing.

I have long predicted such a predicament and have marked the second quarter of 2022 as the last full quarter for Stepping Stones Management, LLC to be operating as a Registered Investment Advisor. This seminal event for me comes when my clients need a more skillful team to navigate these treacherous times.

The New Monetary Era

Optimistic investors see a looming recession as the cure to inflation, holding tight to the Phillips Curve which says inflation is caused by excess demand. They think a recession will cool off demand and reduce inflation. Many analysts believe inflation has peaked and are expecting a "bullwhip effect" as swollen post pandemic inventories are priced down to clear. This could lead the Fed to pivot back to easy money earlier than markets expect. Such a scenario could bring relief to inflation categories other than food and energy, but would come at the expense of corporate earnings.

Monetarists believe that inflation is caused by too much money chasing too few goods, and that the Fed needs to reduce the amount of money they created since 2009. The plan to do just that was executed in late June at a rate of about $20 billion per week so far, which will grow to a monthly pace of $95 billion by September, and continue at that pace for an undetermined period. A rate of a trillion dollars per year will take almost eight years to get back to the pre 2008 monetary base that prevailed for many years, which nobody expects to happen. That same pace would take four years just to get back to the 2019 level. The Fed has signaled a multi-year process to get to a non-inflationary monetary base.



These letters have long maintained that the "Everything Rally" was sustained by, and would have been impossible without, the massive monetary expansion since 2009. The chart above plots the Federal Reserve balance sheet along the left axis (in billions) and the S&P 500 along the right. You can see the correlation, and it isn't because the balance sheet is following the stock market. The balance sheet shot up during the panic of 2008 and the stock market eventually followed its sustained rise. When the Fed stopped printing money, shown by the flattening green line, the blue stock market line would falter until further balance sheet expansion pulled it back up. By 2018, the economy seemed robust enough to support the stock market as the Fed initially embarked on their tightening plan. It wasn't until the "Repocalypse" in short-term money markets forced an aggressive monetary expansion to ease spiking market interest rates in late 2019. The newly expanding balance sheet drove the S&P 500 to a record high in February 2020 when we all thought covid was only a China problem. Then the post pandemic monetary expansion and stock market rally both went parabolic like the world has never seen. Now that it is over, we are seeing everything trade lower.

While we expected the paradigm to shift, the Stepping Stones fully invested Equity ETF strategy was not immune from the tough market. Our primary hedge to tumult is the gold miners fund which was the worst performer losing more than -29% in the second quarter. Semiconductors remain in short supply but were almost as bad with bloated inventories of electronic goods and a slowing economy driving money out of the technology sector. Small caps also felt the brunt of aggressive money leaving the market with that position lower by almost -14%. Even our inflation plays cooled off with the materials and energy positions each down in the mid-teens. The consumer staples fund outperformed, losing almost -3%. Our income plays discounted rising rates with the utilities and dividend positions both losing more than -5%. Internationally, our Europe position underperformed, declining by more than -17% while our Japan hedged position was only slightly negative. Our last quarter of operations saw the strategy slightly underperform our benchmarks while we outperformed for the first half. Since inception, our international component kept the strategy behind the S&P 500 while our US focus kept it ahead of the All World index.

	Equity ETF Strategy	S&P 500	MSCI All World
2nd Quarter 2022	-17.03%	-16.68%	-16.09%
1st Half 2022	-14.32%	-20.58%	-20.69%
Since Jan 2014 inception	63.60%	108.18%	48.98%

Shelter Rock Management

I have gotten to know the skillful team at Shelter Rock Management over the past several years that I have considered affiliating with the company. Stepping Stones clients will see new positions in their portfolios, but the reasons for investing revolve around the same proven investment themes. Portfolio Manager Sean Chaitman brings a credit analyst's discipline to bond and equity selection. His attention to cash flows may keep him out of the hottest stocks but has kept his clients in some of America's best companies, through a handful of economic cycles over fifteen years. While he may take advantage of occasional rating and price anomalies, none of his bonds have ever defaulted, even after a worst in a century global financial crisis. That's the skillful management that is needed in the new market environment taking shape.

The firm's philosophy aligns with mine and Andy Frank keeps the clientele well informed of the issues that Sean is managing throughout their portfolios. Shari Edelstein administers the back office and deals with the robots at Fidelity, the firm's custodian. Throughout the new millennium's Fed fueled market gyrations, Shelter Rock's portfolios have produced excellent risk-adjusted returns, which I will sell to the commercial real estate clientele that now occupies a larger share of my time. This will be my final quarterly letter, but I will continue to practice my writing at AClassicPath.com and a real estate blog under consideration. I will keep you posted.

On the precipice of history's greatest monetary retrenchment, Shelter Rock Management offers the financial management I am confident referring to my clients. Sean always stands ready to take advantage of price anomalies and is looking at the new bear market opportunistically. If we are facing an economic hurricane, like JP Morgan Chase CEO Jamie Dimon has predicted, Shelter Rock's portfolio of well-run companies producing consistent cash flows will see their clients through the storm.

Whether the bullwhip bulls are correct about peaking inflation or Jamie Dimon's forecast proves prescient, the seminal second quarter marks the end of history's greatest monetary expansion and history's greatest bull market. As the Fed consistently had the market's back, they spoke empathetically about the social discord arising from constantly bailing out wealthy stockholders, but they kept doing it as long as inflation was low. Even if inflation has peaked, they no longer have the luxury to print money. I won't be here to write about the repercussions, but affiliating with Shelter Rock Management will give my clients the safe harbor needed in these trying times.

I am grateful beyond words to a clientele that has stuck by me through the dot com bull and bear markets, the Global Financial Crisis, and the pandemic that shut down the world. For the final time in fourteen years of these quarterly letters, and as always, I'd like to thank you for your trust and thank you for your business.

Yours truly,

Dan Hickey

Daniel D. Hickey
STEPPING STONES MANAGEMENT, LLC
PO Box 263
City Island, NY 10464
direct: 646-723-6262
www.steppingstonesmanagement.com

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