



STEPPING STONES MANAGEMENT, LLC

Third Quarter 2017 Commentary

October 19, 2017

Reminiscent of the terrible 2005 Hurricane season, the third quarter of 2017 witnessed a series of natural disasters which caused historic flooding in Texas, ravaged the entire Florida peninsula and devastated the island of Puerto Rico. Out West, destructive wildfires are leaving some of America's finest wineries in ashes. All are producing promises of government assistance which has economists busy calculating the stimulative effects of the increased spending. Replacing almost a million cars in Houston and rebuilding homes throughout the affected areas are sure to generate brisk sales, but the premise that destructive events are good for the economy was disproven centuries ago. French economist Frederic Bastiat posited his "Broken Window Fallacy" in 1850 telling a story of a child who breaks a shopkeeper's window. The glazier hired to fix the window obviously benefited, so maybe it would make economic sense for more children to break more windows. The absurdity is revealed on the "unseen" side of the story when the shopkeeper doesn't have enough money to buy a new pair of shoes after paying to repair his window. The glazier benefited at the shoe salesman's expense and the shopkeeper was no better off and had less money in his pocket.

While still very early, we have yet to see any benefits of the recent disasters. The September employment report came in negative for the first time since the last recession, with waiters and bartenders suffering a monthly decline of more than 100,000 positions. That will be reflected in lower sales and earnings at their employers. The economic effects of 2005's storms were mostly restrained with a growth spurt several months later which may be why the stock market showed little concern this time. The S&P 500 continued its rally finishing the third quarter at another record, and as these letters have highlighted recently, with valuations extended. The almost 4% quarterly gain brought the post-Election Day rally to more than 20% with the index trading at 25 times reported earnings over the past year. Aside from recessions, that price earnings ratio has only been exceeded around the crashes of 2001 and 2008.

That valuation is probably not driven by expectations of the Trump Administration reforming health care and taxes. The former crashed and burned again in the third quarter as the swamp masters in the US Senate seem to want the President to fail more than they want their own agenda to succeed. It is hard to fathom how Republican Senators from high tax states will support the proposed tax reform that abolishes the deduction for state and local taxes. Meanwhile Democrats

are firmly ensconced in the #NeverTrump camp forestalling any hopes of bipartisan reform. Despite legislative gridlock, the Administration's regulatory rollback is clearly benefiting the economy which could account for the 3.1% economic growth reported for the second quarter, the strongest in over two years. The storm ravaged third quarter is unlikely to match that but a sustained growth rate above 3% will work wonders on the deteriorating US budget deficit. Maybe the market is hanging its hat on America becoming at least less bureaucratic if not great again.

The VIX Is In

Another case for record valuations is the new moderation that central bankers have seemingly achieved with their quantitative easing programs that have added more than \$12 trillion to financial markets worldwide. We will soon see the other side of those programs as the US Federal Reserve has confirmed it will begin reversing their expansions beginning this month. Since 2009, the Fed has created \$3.6 trillion to buy mostly US government bonds which will now begin to mature and "roll off" the balance sheet. That means the money created to buy the bonds will be eliminated after they are redeemed rather than reinvested into new bonds. This has never happened before. Fed Chairman Janet Yellen is undertaking what has been dubbed the Great Unwinding, it is projected to continue beyond her successor's term that begins next February. She and her colleagues assure us the economy and markets are firm enough to sustain a multiyear removal of liquidity and markets seem unbothered by the clear signaling.

The Fed's unprecedented policies were intended to drive interest rates near zero so that money would flow into risk assets like stocks and real estate. They have succeeded to such an extent that risk has been driven out of those markets. The price of options to buy and sell stocks at various points in the future factor a measure of the underlying asset's volatility, interpreted as its risk. If the asset price continuously rises, the volatility goes down. Combining the volatility measures of all the companies in the S&P 500 produces a market wide volatility index commonly known as the VIX, and of course there are myriad securities derived from that. With stocks trading at record highs, the VIX closed the third quarter at an all-time low.



In our financial markets driven by algorithmic trading, lower VIX readings are programmed to increase stock exposure. Enough are piling into this trade that the short interest in VIX contracts on the Chicago Board Options Exchange are also at historic levels, as you can see on the accompanying chart. The winning strategy has been to enlarge and extend these short positions while adding to equity portfolios but at some point these trades will have to

be unwound. If it coincides with the Fed's Great Unwinding we should be prepared for a similar unwinding of stock prices as the VIX reverts to its mean.

The Stepping Stones fully invested equity ETF strategy reacted to the record low VIX readings with strength in our riskier positions. The semiconductor and China positions both enjoyed double

digit quarterly returns with the energy positions and European fund close behind. The Japan and Value Line funds each rose more than 5% and as we moved down the risk scale we saw weaker performance. The defensive gold miners rose in line with the market but the utilities fund lagged at 2.9%. The only negative return came from the consumer staples fund barely missing breakeven, discarded by a market embracing risk. While we consider the portfolio to be in a defensive posture, the riskier positions made the difference generating a 6.16% quarterly return compared to the S&P 500 which gained 3.96% and the MSCI All World Index gaining 5.08%.

Reminiscences of a Market Crash

Most managers of large portfolios use VIX contracts to hedge the risks inherent in equity portfolios. As the index trades lower, that insurance becomes cheaper to deploy. This innovative tool to manage risk is akin to the portfolio insurance that became popular in the late 1980's. After rising more than 37% in nine months into 1986, the market added another 37% into 1987 largely justified by the risk reduction that these new strategies offered. As we all found out 30 years ago today, the portfolio insurance commonly used in 1987 did not reduce risk and in fact exacerbated the worst one day percentage decline in the history of the stock market.

The strategy of programming computers to sell index futures when the market declined and buy when the market rose was introduced in 1982 and became widely employed by 1983. In a March 1987 interview, New York Stock Exchange president John Phelan feared that program trading could lead to a "first-class catastrophe." That's the title that NY Times writer Diana B. Henriques chose for her recently published history of the crash of October 19, 1987 when the Dow Jones Industrial Average declined by 22.6%. It was twice as bad as the worst day of the 1929 crash and no day in 2008 even came close. The author discusses how "titans and their trading toys" linked various markets like stocks, bonds and futures so the declines were not isolated to just one asset class like prior panics had been. She explains how large pension funds were new participants in the stock market in those days and they used these strategies to hedge the risk they had added to their portfolios. In effect, it spread the risk into the bond and money markets where pension funds had previously confined their assets before these strategies enabled them to take the leap into equities. Henriques shows how the 1987 crash reflected permanent changes that technology foisted on financial markets.

20 years later, markets were again complacent about record valuations. Again a novel financial instrument, the collateralized debt obligation (CDO) was said to have mitigated risks involved with mortgage securities by dividing them into so many pieces and reassembling in a way that risk would only be realized if a national decline in housing prices were to occur; something that had never happened before. It can be argued that the first such instance of a national real estate decline and the 2008 financial crash were caused by the widespread use of CDO's and their toxic offspring. Again, the financial panic was not confined to one particular troubled asset class but infected all financial markets.

The stock market today appears as complacent as it was prior to those other debacles. Central banks around the world have been buying equities for the first time in history. They are undoubtedly using VIX instruments to hedge their newfound risks and are probably as sure of their posture as their predecessors were prior to other panics. The misconception is that VIX

signals future risk when in fact it is merely a reflection of what a particular risk has been. The lessons of 1987, 2001, and 2008 are how quickly that perception can change. Driving volatility measure down to historic levels does not mean risk is lower; it has actually masked the risks that are inherent to any economy.

The growth spurt after the storms of 2005 quickly faded into the economic downtrend that culminated in the financial crisis of 2008. That doesn't mean the hurricanes brought on the crash, but it supports Bastiat's message more than a justification for record stock prices. The crash of 2008, like the crash of 1987 was brought on by a mispricing of risk through novel esoteric financial products. Today's esoteric risk management products tell us that natural disasters, worldwide political volatility and an unprecedented monetary retrenchment are benign to stock prices. Maybe corporate earnings and stock prices are safe from these threats or maybe the market's risk measure has been skewed beyond any usefulness into a misguided justification for complacency. If so, then rising government deficits, a weak growth trend and paltry corporate earnings pose substantial risks to current prices. Valuations at levels correlated with poor returns will provide little support if risk perceptions suddenly change. While we are enjoying the record prices on our long positions we are not adding risk to our portfolios until valuations are more favorable.

Please call 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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