Third Quarter 2018 Commentary

October 19, 2018

Let us add our voice to those in the third quarter reflecting on the events of ten years ago, specifically the bankruptcy of Lehman Brothers Holdings on September 15, 2008. One of the seminal events in world economic history, it was the impact point of a slow speed disaster whose reverberations brought several more months of turmoil in the worst financial crisis since the Great Depression. We can point to the beginning more than a year earlier, July 16, 2007, when two hedge funds sponsored by Bear Stearns had to be assumed by the parent company after declines in their mortgage securities rendered them insolvent. Six months later Bear Stearns failed and probably would have brought on the crisis then if not for the Federal Reserve assuming some of that mortgage risk for the first time ever. Our quarterly letters and messages posted under the commentaries tab at www.SteppingStonesManagement.com recount the crisis in gory detail and a recurring theme is FAS 157, the "mark-to-market" accounting rule enacted in November 2007. It is one of the government actions that triggered and exacerbated the crisis caused by a dereliction of duty on the part of our financial and political leaders.

Near the depths we wrote how years later youngsters will be regaled with stories of the historic crisis. Now those youngsters are earning money and one effect is that they don't see banks as a place to make their savings grow but as simply a safe place to keep money and pay a modest fee for the service. To them, Albert Einstein's most powerful force on earth, compound interest, is a theoretical concept. Although the Federal Reserve did not employ the tools used with Bear Stearns in the case of Lehman, Chairman Ben Bernanke got even more creative in the aftermath employing Quantitative Easing to bring interest rates down to zero and in many cases negative. These letters have decried the distortions those radical policies have caused beyond rewarding speculators at the expense of savers. It is only now that the Fed is reversing those policies that economic growth has broken out of the "new normal' trend below 2% to one back up above 3%. GDP growing almost twice as fast means future cash flows will be higher so present values should be too. The stock market agreed as the S&P 500 added on another 7.2% to what also became historic in this year's third quarter. At 3,492 days at the quarter's end, this is the longest bull market in history, or as explained below maybe not.

Unfolding Crisis

A month before the November 2007 implementation of mark to market accounting, stock prices established an all-time high before they declined by 23% eleven months later at Lehman's fall. The Fed's Bear Stearns intervention brought on a spring rally but persistent declines in mortgage backed securities were infecting the economy beyond Wall Street. As we progressed through that long hot summer, various financial firms were failing as spiking credit default swaps similarly spiked their cost of capital. Destroying financial firms became the easy bet for hedge funds in 2008. The Wall Street Journal compared it to hyenas slaying sickly wildebeests.

Lehman Brothers was one the biggest traders of Wall Street's favorite toxic product, Collateralized Debt Obligations (CDOs), which sliced so many subprime mortgages into so many pieces that investors

thought a diversified portfolio was immune to the regular risks of real estate. The credit rating agencies, anointed by the government as the best arbiters of risk, earned handsome fees by blessing these innovative financial products with their highest triple A ratings. That enabled risk averse investors, like pension funds, to invest in the sector and made mortgage funding available to just about anyone. NINJA loans (No Income, No Job or Assets) and their subprime ilk that made up a tiny sliver of the home mortgage market in 2001 came to dominate the market by 2007. Investor demand for the higher yielding instruments was so strong that Wall Street developed synthetic mortgages once all the actual people who wanted loans got them.

Buyers of those new esoteric financial products hedged their risk with credit default swaps that pay off if the underlying investment fails. The cost of that insurance rises as the underlying security loses value. Mark to market accounting made those values spiral downward triggering capital calls at the big financial insurers. When Ambac Financial and MBIA had their credit ratings downgraded from Triple A, anyone holding securities backed by their insurance had to mark them down, adding another force in the downward spiral. Lehman Brothers assured investors through the summer that they had sufficient capital but by September that was not the case and they could not afford to raise more because their credit default swaps were so expensive. The surprise wasn't that the firm failed but that the Fed did not engineer a rescue like they did with Bear Stearns six months earlier.

Perhaps most surprised by the lack of action were the proprietors of the Reserve Primary money market fund which held Lehman Brothers debt. The firm that invented money market funds broke the buck on this fund the day after Lehman declared bankruptcy, meaning the value of their assets fell below $1 per share. This unprecedented event marked the apex of the crisis. Personally, I was busy that morning writing tickets to sell all my clients' money market funds and switch into government funds. Most financial advisors were doing the same which would have meant a halt to the US economy as even the healthiest companies rely on the overnight credit markets to operate. In his finest moment, Treasury Secretary Hank Paulson took to the microphones and announced that the United States Treasury will stand behind all money market funds. He had no authority to make such a declaration but it doused the flame.

The crisis was far from over. As CDOs were marked down below fire sale values, funds and insurers who issued credit default swaps were forced to put up more capital. The biggest such insurer was AIG who's Financial Products Group had found swaps to be far more profitable than traditional insurance. Until the storm hit. The biggest purchaser of that insurance was Goldman Sachs who had an especially keen perspective being one of the biggest issuers of CDOs. Post-crash investigations found they even designed some of these products to fail so that they and their clients could bet against them. All eyes were on AIG and what would happen if they went bankrupt. Since the AIG Financial Products Group was separate from the subsidiaries that insured regular people's lives and property, the fallout likely would have been limited to those who took the other side of their bets, mainly Goldman Sachs and its counterparties. The September 16th AIG bailout that made Ben Bernanke so sick was really a Goldman Sachs bailout. It was politically easier to pitch a bailout of America's biggest insurer than a bailout of Wall Street's biggest vampire squid.

October 2007 to March 2009

- Housing prices fell 32%
- GDP contracted by 5%
- S&P 500 fell 57%
- 8.8 million jobs lost
- Unemployment rose from 4.7% to 8.7%
- Fed funds rate fell from 4.9% to 0.15%

Even still, the crisis persisted. By then companies unable to fund themselves were forced to lay off workers. By early 2009 the numbers of job losses were shocking. Accounting marks were continuing to ravage corporate balance sheets and on March 12, 2009 an amazing thing happened. A Congressional committee overseeing accounting standards held a hearing on FAS 157 and there was bipartisan consensus that the experts testifying were wrong. Republicans and Democrats agreed that the rule was "pro-cyclical" and exacerbating what had become an economic crisis. On March 17th the rule was relaxed and the stock market low set the day of the hearings remained the bottom of the historic bear market, 57% below the October 2007 top.

Not letting the crisis go to waste, government kicked in by passing the Dodd-Frank Wall Street Reform and Consumer Protection Act which streamlined the financial regulatory framework under the Federal Reserve and established a labyrinth of government bureaucracies to provide oversight and disaster readiness. The Fed was expanding its power in other ways too by creating previously unimaginable amounts of new money to purchase Treasury and mortgage bonds. Our letters since then detail all of the Quantitative Easing stages and the financial repression that resulted. Lower rates were designed to force risk averse investors into risky assets hoping the wealth effect of higher prices would spur the economy. Although zero percent rates are good for borrowers they do not encourage investment so the low rates only brought low economic growth. Now that the policies are being unwound, the economy is coming back to life.

Relieving Repression

While the fourth quarter has begun with October frights, the third quarter didn't feel the brunt of the shrinking Fed balance sheet that our last few letters have warned about. With the Fed now scheduled to retire $50 billion every month, those dollars are rising in value as they become scarcer. That's not good for the price of gold which traded down a few percentage points which drove our position in the Gold Miners ETF down by almost -17% in the third quarter. That was by far the weakest position in the Stepping Stones fully invested Equity ETF strategy. We hold the position as a hedge against a market disruption and it has performed well during this month's volatility. The China and Europe positions each had minor declines which could be related to trade frictions but that didn't prevent the currency hedged Japan fund from turning in the best quarterly performance gaining 7.35%. Risk appetites were also apparent in the Semiconductors fund gaining over 4%. The rising dollar didn't prevent the price of oil from establishing a recent high above $70 per barrel, especially notable considering the boom in supply where the United States has become the world's largest energy producer. Our two positions in the sector gained about 1% on average. Rising rates should also force income producers lower as the future cash flows are discounted at a higher rate. The utilities fund managed to gain over 2% anyway. Our two other positions gained almost 1% each but the decline in the gold miners was too much to overcome as the portfolio declined by -1.81% in the third quarter compared to the S&P500 gaining 7.2% and the MSCI All World Index which rose by 4.42%.

The Fed's financial repression isn't the only distortion that markets have grown to accept. Our government issued economic statistics have been continuously massaged to always make the politicians look good. Inflation reports are held down by heuristic adjustments that account for more powerful computers and faster bandwidth, even if those things cost more. The recovery from the Great Recession

has also been among the longest ever but slowdowns in 2011 and 2015 might have registered as recessions under previous guidelines. The recession of 1991 that cashiered a presidency does not even appear under current measurements. That was presaged by a 19.92% correction in the S&P 500 in 1990 that is generally considered a bear market. If so, then the third quarter broke the record for the longest bull market ever, if not the one that began in 1987 and lasted until the dot com implosion still beats it by a thousand days.

By any measure, the current bull market is extended. On a valuation basis we are more expensive than October 2007 although that financial crisis was not triggered by excessive stock market valuation. The dot com crash was and we have not reached those record valuations. Both market tops had the commonality of tightening Federal Reserve policy and we have that now far in excess of either of those times. The balance sheet reductions highlighted in recent letters have remained on course and are scheduled to rise to $50 billion this month and every month that follows for several years. The fourth quarter has begun like the first quarter that we attributed to the newly restrictive Fed policy then. The stock market is higher now but rising rates are beginning to take their toll. Higher interest rates weaken the profit margins of American companies that took on record amounts of debt over the last decade. We all knew the dot com stocks were overvalued in 1999 and we all knew people who were in over their heads flipping houses in 2007. The distortions facing this Fed tightening cycle may not be as obvious but there is far more junk rated debt in the economy now than at any other time in history, even though it's held by hedge funds instead of banks. It is rational to think that a decade of near zero percent interest rates has created tinder for another financial disruption.

Even companies that have no debt are priced on the present value of their future earnings. When the discount rate used in that calculation falls, the present value rises. That is one reason why the stock market did so well as the Fed drove rates to zero. However now that rates are reversing, those present values are reduced. We can only hope the increased cash flows from a stronger economy are great enough to offset the deflation from higher interest rates. If the economy weakens as rates rise we can forget about the former. The lesson of the 2008 financial crisis was that all the innovative financial products designed to hedge and distribute risk in fact magnified the risk. Federal Reserve tightening cycles have a tendency to expose hidden risk and we are inclined to see what the Fed's current tightening uncovers before becoming more bullish.

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.

Yours truly,

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