Third Quarter 2019 Commentary

October 24, 2019

The third quarter floated in with a state of euphoria as president Trump and Chinese Chairman Xi agreed to a truce in their trade war. The stock market had been rallying since early June and continued to a new high to begin July and a series of higher records as the month progressed. It was the beginning of a long hot summer though with a blackout in New York City leaving people stranded for hours in elevators and subways. The algorithms (algos) at the New York Stock Exchange had backup power to keep their air conditioned server rooms cool as they kept the market humming as well. The rest of the city had to sweat it out through a summer with barely enough electricity to keep cool and often not enough to power the lights. The metropolitan area hasn't built any new power plants in decades as demand for power has grown from all the housing development and people watching Netflix in their Teslas. It was hot overseas too as protests in Moscow, France, Iraq and Hong Kong drew fuel from the summer heat.

It was also gloomy in Britain as Theresa May's latest attempt to reach a Brexit deal with the European Union brought down her government. On July 24th Queen Elizabeth introduced Boris Johnson as the new Prime Minister. Two days later the S&P 500 marked its all-time high after the Federal Reserve cut its key interest rate. Trying to dispel hopes for a series of rate cuts to follow, Fed Chairman Powell described the action as a "midterm correction in rates." It was also the week that Robert Mueller testified to Congress about his investigation that found no collusion between the Trump 2016 campaign and the Russian government. With the witch hunt finally over, a confident President Trump declared that Apple's iphones and ipads would be hit with his upcoming round of Chinese tariffs. The stock market dropped more than 6% in the following week.

August reminded us that stocks can be volatile. Increasing trade tensions cast doubt on the strength of the international economy which drove investment capital into the relative safety of US Treasury debt corresponding with a remarkable drop in interest rates and a panic selloff of stocks. As the S&P 500 fell, the 10 year Treasury yield dropped below 1.5%, matching all-time lows seen in 2012 and 2016. Stocks tried and failed to rally for the rest of the month until central banks around the world announced new rounds of monetary expansions. The market got a lift when the Fed signaled its midterm correction in rates could have further to go. Despite lower interest rates and more easy money, the S&P 500 was unable to make a new high and closed the quarter on a weak note but managed a price gain of 1.2% for the third quarter.

Repocalypse

Anticipation of the Fed's late September meeting drove stock prices higher on signals of another coming rate cut. Weak retail sales reports from August lent credence that the economy needed more accommodation even with a historically low unemployment rate and inflation near the Fed's objective. As the meeting approached, expectations grew for an unusual half percentage point cut in the overnight lending benchmark. Not only would such a cut be unusual but at the same time there was an unusual

spike in overnight lending rates in the repurchase market, where most overnight lending occurs. Although the benchmark was set at a range of 2%-2.25%, on Monday September 16 some overnight rates rose as high as 10% and the Fed needed to inject more than $50 billion to meet demand for US dollars and bring rates down to its target. The spike was attributed to corporate tax payments being due on the same day that a large Treasury bond hit the market. When the Fed needed to inject another $75 billion the next day it was attributed to a kind of ripple effect. On Wednesday, they cut their overnight benchmark by a quarter point, as most expected, and Jerome Powell answered questions in his post meeting press conference.

He said a modest decline in private fixed investment has been offset by strength in consumer spending as low unemployment and rising wages have supported household finances. With everything so good, the Fed chairman had to point to trade tensions threatening global growth as the reason to lower the overnight benchmark to a range of 1.75%-2%. That rate remains higher than most of the maturity spectrum perpetuating the inverted yield curve that has troubled markets for the past year. Although it sometimes takes more than a year, yield curve inversions have always been followed by recessions. That could be the reason for the flight to the safety of US Treasuries as the algos know their history and position themselves accordingly.

The market wanted the benchmark cut by a half point to get below the rest of the yield curve. Although disappointed, the algos got something better when Chairman Powell mentioned "the question of when it will be appropriate to resume the organic growth of our balance sheet." It wasn't a matter of "if" but "when" the Fed would return to expanding the monetary base. With that comment, Powell dispatched with years of Fed assurances that the monetary expansions through three rounds of quantitative easing were temporary and would be reversed. Gone were pledges over recent months that the reversals were only being paused. Now it's a matter of how much money the Fed will create to keep everything running smoothly.

Asked about the tumultuous repurchase market, Powell said "while these issues are important for market functioning and market participants, they have no implications for the economy or the stance of monetary policy." He may have been unaware that the ripples were still rippling and his colleagues were injecting another $75 billion that day. Over the remaining eight days of the third quarter, daily injections averaged $58 billion and the Fed grew its balance sheet by more than it ever has since the height of the financial crisis. After abating somewhat to begin October, the injections have risen back to the Fed's $75 billion daily limit for most days so far this month. We haven't heard from Fed officials on why they think such extreme conditions are persisting. As the Fed balance sheet grows daily by amounts that took weeks during the most aggressive periods of quantitative easing, nobody has an explanation for the disruption in the overnight lending market.

The large banks with ample reserves on deposit with the Fed didn't lend at rates higher than the Fed was paying because they have less on reserve as the Fed shrank its balance sheet. JP Morgan has reduced its Fed reserves by almost half and has been shying away from the repo market which subjects the bank to capital surcharges under the post crisis Too Big To Fail regulations. This is a very esoteric consequence of the Fed's post crisis balance sheet expansions that was never contemplated by successive chairmen who assured us of their policies' soundness. It's a different sort of ripple effect, analogous to a drug addiction which requires ever more liquidity just to maintain an economic status quo.

Others identify the need for cash as the consequence of negative interest rates around the world. If all the banks that serve your currency are going to confiscate some of it, you will look for ones that won't. If you are European or Japanese that means buying US dollars. All those foreigners looking for yield are

buying Treasury bonds for their positive albeit miniscule rates. It's a good thing they are since the US Treasury has to issue ever increasing amounts of debt to fund our ever increasing budget deficits as more baby boomers draw on Social Security and Medicare. Occam's Razor says the simplest answer is probably the right one so maybe the increased demand for cash is due to the US government's increased demand for cash.

The tumult in the money markets also followed a brazen multi-pronged attack on Saudi Arabian oil infrastructure which was attributed to Iran. If such an event had occurred anytime other than recent years the price of oil would have surely spiked high enough to tip the world economy into a recession. While energy prices did initially rally after the attack, the ample supply coming out of the US was enough to hold prices stable. We used the reflex bounce to lighten up on some of our individual energy positions but maintained the sector's overweighting in the Stepping Stones fully invested Equity ETF Strategy. Our two energy positions were the portfolio's weakest experiencing double digit declines for the quarter as economic worries cast doubt on any sustained energy price gains. Defensive positions like our utilities and consumer staples funds were the portfolio's strongest as safe havens with yield drew investment flows. Our growth orientated semiconductors fund also gained nicely as did the gold miners fund which we expect to outperform as the Fed ramps up the printing presses yet again. Our China fund lost almost 7% as the trade war provided volatility with every presidential tweet. Our European fund was also down modestly even though European Central Bank Chairman Mario Draghi initiated another round of monetary expansion. He leaves his post this quarter to Christine Lagarde who has left her post heading the International Monetary Fund. That decline as well as the US market's muted response to the Fed's newly expanding balance sheet suggests the quantitative easing game may not pack the same equity punch as it used too. In total, the strategy gained 2.4% on a price basis for the third quarter compared to the S&P 500 which gained 1.19% and the MSCI All World Index which was basically flat with a slight gain of 0.05%.

"See you at the polls"

Maybe investors are realizing how the recent era of extreme liquidity has not been one of strong economic growth and could even be leading to the wealth disparity and social upheaval throughout the world. The protests that swept the world last summer have not abated with autumn's cooler weather. Hong Kong protests marred the 70th anniversary of The Peoples Republic of China and continue to this writing. An interim trade agreement was reached between the US and China taking some of the heat off that war but European subsidies have come to be an issue and a recent Brexit deal seems to be falling apart. The stronger US dollar has taken some bite off the tariffs but US politics are a total disaster. It's hard to imagine even the rewritten North American trade agreement getting passed despite broad bipartisan support. Washington DC being paralyzed is a net positive for Wall Street but we shouldn't expect fiscal policy to help if the economy falters going into the election year.

Unfortunately, one of America's most vibrant economic engines has been slowed down to begin the fourth quarter as the public utility PG&E has been forced to cut off power to large areas of California. The company is a leader in generating renewable electricity and it spends extravagantly on political lobbying to expand renewable energy mandates, but it has not expended the necessary capital to maintain its power lines. The company has been sued into bankruptcy over fires caused by its neglected infrastructure, and has cut power to millions of its customers as seasonal winds have picked up. PG&E sits atop all the social justice rankings but it can't provide electricity to many Californians. Tesla owners have been warned to charge up whenever they can. That wasn't the only trouble to hit the golden state.

We have seen some of the year's most high profile initial public offerings (IPOs) trade below their offering prices and other Silicon Valley unicorns have had their horns cut. San Francisco darling Uber Technologies emerged from its second quarter honeymoon and lost about a third of its value in the third quarter. Losing money on a high profile private investment is totally foreign to generations of tech entrepreneurs and is now becoming commonplace. New York based co-working space pioneer We Work had to reduce its valuation from $48 billion to less than $20 billion before launching a public offering which preceded a total evaporation of the confidence surrounding the company. The offering was pulled and the Japanese conglomerate that has backed We Work had to increase its private investment at a valuation of $8 billion, 84% below the company's last round of capital. Fitness equipment maker Peloton made it to the public markets in late September but has declined by over 20% since its debut. The world's biggest IPO was also shelved as Saudi Aramco decided now is not the best time to go public. Maybe it's the war with Iran or maybe their bankers can't ensure the stock would be supported in the public markets.

Back on our shores it promises to be a long hot election season, with more than a year to go. A recent White House cabinet room meeting with Congressional leadership devolved into an argument with reports that President Trump shouted "I'll see you at the polls" as Speaker Pelosi prematurely left the room. The impeachment hearings that began with a parody have become even more ridiculous which is probably why they are being held in secret. The last time Speaker Pelosi asked her caucus to vote for something without knowing what's in it she lost her speakership. With so many powerful interests rooting for disaster, we don't expect anything good to happen in the political realm. Growing demands on Social Security and Medicare are sure to bring the US Treasury to market with more and more debt. Despite a voracious appetite worldwide for positive yields, the Fed has been forced to print the dollars to ultimately pay the beneficiaries. Something is amiss and nobody has any idea why. However, for all the lack of confidence in society's institutions, regular people seem to be unperturbed and employment and income trends remain favorable.

Combine the toxic political environment with tumult around the world and a Federal Reserve that has lost control of its primary function and it is difficult to envision higher stock prices. Bull markets climb a wall of worry but this one keeps looking steeper. The issues that have kept the stock market in a state of fits and starts throughout 2018 and 2019 seem to be gaining steam as we go into 2020 so we are maintaining our defensive posture while hoping the job market remains vibrant enough to offset all these troubling issues.

Please call us to discuss any of your financial concerns. Until then and as always, 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

This commentary is provided for informational purposes only. It does not constitute a recommendation to invest in any specific investment product or service. Proper due diligence should be performed before investing in any investment vehicle. There is a risk of loss involved in all investments.