Stepping Stones Management, LLC

Third Quarter 2020 Commentary

October 23, 2020

On a cursory glance, you might think America in the third quarter was the Promised Land flowing with milk and honey. The economic rebound from the pandemic lows was shaping up to be one of the strongest growth quarters of all time. New businesses were springing up among the economic wreckage as applications for employer identification numbers rose sharply in the summer months. New home sales were also at levels associated with boom times, although usually not with a corresponding migration out of cities into suburbs. The September unemployment rate at 7.9% was 3.2% below June's level, a record quarterly improvement. The stock market led the parade with one of its strongest rallies of all time.

Meanwhile, the count of new coronavirus cases rose like the stock market although we thankfully haven't experienced a commensurate rise in hospitalizations and deaths. Corporate earnings are expected to rise nicely from the second quarter trough, but still fall about 20% lower than a year ago. While new businesses are popping up, Yelp reports that 60% of the businesses closed during the pandemic will never reopen. Millions of workers are slowly streaming back to their jobs, but others are finding their jobs eliminated as many companies reorganize their workforces in response to the recession. Initial claims for unemployment insurance have remained stubbornly above 800,000 each week compared to a little more than 200,000 before the pandemic.

The lingering economic wounds may have contributed to the summer of discontent in America's cities where peaceful protests for racial justice often provided a front for rioting and looting. Politicians lost credibility with their strict enforcement of virus protocols while excusing protestors in the streets. Instead they argue about showering more money on their favorite voters who are left to choose between the administration presiding over all the trouble and the challenger leading in the polls promising to be the most progressive president in history.

The surprisingly resilient economy is not enough to ease the concerns of the Federal Reserve governors who issued a new framework for monetary policy that aims to maintain today's historically low interest rates indefinitely. Even with their new flexibility, Chairman Powell expressed concern about the recovery as he crossed another historical red line in urging Congress to pass further stimulus spending. Markets around the world looked past the stormy circumstances and drove indices to record highs. The S&P 500 closed the third quarter slightly off its record but 8.5% higher than three months earlier.

Simple Twist of FAIT

The stock market began the third quarter with the bulls regaining their momentum after three weeks of doubt to end the second quarter. The strong rally into July put the S&P500 back on the trend established after the pandemic lows in March. That trend line quickly reached the February highs without worry about valuations being richer than the pre-pandemic records.

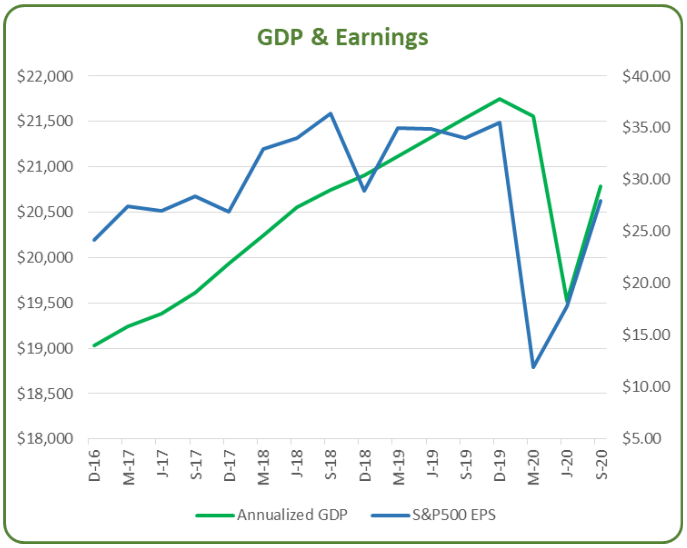
Masayoshi Son, the investor and founder of Softbank, tried to recoup his losses from WeWork, mentioned in our letter a year ago, with a massive bet on Apple, Amazon, Netflix and Tesla. Those companies became leading performers in the quarter and other tech names joined the rally. He purchased over $4 billion in options representing over $50 billion of market value. The counterparties had to hedge all those options by purchasing the underlying shares. Maybe he was hoping to build his position and then talk his book so others would buy as he unloaded. Instead, the revelation marked the top of the tech rally as investors closed out the quarter by reducing their positions in Mr. Son's favorite names. Reports have Son increasing his exposure by an additional $20 billion in recent weeks. He's either supporting his position or throwing good money after bad like he did with WeWork.

Markets often get weak in August and one reason is to shake up the attendees at the Federal Reserve Bank of Kansas City's annual conference in Jackson Hole, Wyoming. This year's virtual conference featured Chairman Jerome Powell unveiling the Fed's "new framework" of monetary policy. The previous framework of targeting inflation at 2% would become too restrictive if that target were ever reached on a sustained basis. Rather than be forced to raise interest rates in such a scenario, they are planning to have a flexible averge inflation target (FAIT). That means the inflation rate can exceed 2% for a period of time before the averge catches up with the target. How far and how long depends on the length of the averaging period and flexibility of the target. The FAIT framework will give the central bank flexibility to keep rates lower for longer without being beholden to a particular monetary stance. It represents a departure from the forward guidance policy of the last twelve years which sought to manage and meet market expectations. Chairman Powell added some clarity at the end of the quarter when he assured nervous markets that short term rates would remain near zero for at least three years.

The stock market applauded the Fed's new framework with a 5% rally to end the summer at a new record. Then reality seemed to set in as people came back to whatever work meant in September. With Masa Son's big bet priced in, investors harvested profits to end the quarter like we saw in June. The pattern of strength looks to be repeating as the fourth quarter gets underway and Mr. Son is again directing stock market currents with a wave of his whale's tail.

The favorable currents in the technology sector buoyed the semiconductors ETF position in the Stepping Stones fully invested equity ETF Strategy. It was the second best performer in a quarter where most positions lagged the tech dominated indices. Outperforming by a tad was the basic materials fund that we hold because we think the Fed is going to reach and exceed their inflation target. The rationale didn't work out with our now single energy position which declined by double digits as hurricanes, both literal and figurative, continued to roil the industry. The storms in the energy markets are a result of American ingenuity and we still believe will make the industry stronger in the long term as international manufactures take advantage of cheap American natural gas that has made our country the world leader in carbon emission reductions. That was the only negative performer in the quarter but the staples, small cap and Europe positions all underperformed by a few points. The ValueLine and Japan positions did a little better and our other inflation hedges in the gold miners and utilities almost performed in line with the S&P 500's 8.47% and the MSCI ALL World's 8.41% quarterly gains. The total portfolio lagged at 5.24% for the third quarter.

Flattening Curves



The second quarter's unprecedented 31.4% annualized drop in GDP was followed in the third quarter by an expected rise of 35% according to the Federal Reserve Bank of Atlanta. As you can see on the nearby chart that does not yet constitute a V shaped recovery. It is more like a check which has stopped the recession and marked the beginning of whatever shape the recovery takes. The green line represents the annualized level of the national Gross Domestic Product (left scale in millions) and the blue line represents the earnings per share of the S&P500 (right scale). Both endpoints represent current expectations. The recent wave of covid infections could drive both trends to a W with a return of the economic troubles experienced last spring. That seems to be happening in Europe as widespread lockdowns have resulted from a recent spike in cases. Some economists are observing a K shaped recovery sustained by lucky workers able to work from home or collect benefits that make them whole, while others fall into economic depression. Their argument is to fully reopen the economy so everyone's lives can get back to normal.

Those economic curves were collapsing in the second quarter because the crisis demanded we flatten the curve of infections to protect our overwhelmed hospitals. Achieving that enabled our medical professionals to think creatively and develop therapies to attack the increasingly familiar virus. Spiking caseloads that have come with the fourth quarter's colder weather are generally not resulting in overwhelmed hospitals or commensurate spikes in deaths. Nevertheless, our economy remains hobbled by the horrors of the early spring. People who came out and enjoyed the summer weather helped turn the economy around but they won't be as willing to eat dinner on a cold sidewalk. A vaccine will indeed come at warp speed but that probably means not widely available until next winter or spring. New York City can't begin a return to normalcy until Broadway reopens which won't be at least until next summer. Nobody knows how many businesses will be able to survive more than a year without customers.

The stock market is discounting a full V shaped recovery, even as earnings have also merely checked their decline with an expected sequential rise in the third quarter to a level about 20% below a year ago. The analyst consensus is that the 2019 peak in S&P 500 annual earnings of $139.47 per share will not be matched or exceeded until 2021. The two year hiatus in earnings growth was discounted by the shortest bear market in history which is becoming a distant memory as stock indices trade near record levels.

The third quarter also closed out the federal government's fiscal year with a record deficit of $3.1 trillion, exceeding the previous record of $1.4 trillion in 2009. As the Fed drifts further away from the traditional moorings of monetary policy, Jerome Powell surprised markets again when he characterized the recovery as highly uncertain and urged Congress to pass additional stimulus spending. Presumably, he will buy all the bonds needed to fund the stimulus since he did not urge a commensurate tax increase to help fund the record fiscal deficit. Tax increases may become politically untenable under the Fed's new framework. Joe Biden's tax proposal would generate less than $300 billion annually which is about how much the Fed printed in the fourth quarter of 2019 before anyone thought of a pandemic. Even though much of April's

CARES Act remains unspent, politicians are haggling over Powell's call to spend more. It is certainly a luxury to live with the world's reserve currency. It would be a shame if something were to happen to it.

There are plenty of rays of hope for the stock market to discount. Treatments and a vaccine for covid have come quicker than anyone could have hoped. Even our elderly and obese president got through his bout quickly. Entrepreneurs are eager to take advantage of the post pandemic landscape as new business models take shape. Americans can be proud of our resilient culture and economy which are both rising above the once terrifying virus. The horrible 2020 is almost over! That said, a stock market fueled by ever increasing amounts of central bank liquidity and deficit spending has become grossly overvalued by any historical measurement. One of our favorites used to be Warren Buffet's favorite indicator. When the total market capitalization of the US stock market exceeded the level of GDP, it would be a signal to sell. The late 90s tech boom drove it over 150% and it reached about 110% in 2008 before dropping to Buffett's buy zone around 75% in each case. It is currently registering almost 200%.

We expect the economy will continue to recover which will mitigate the need for further fiscal or monetary support. Closing off the extra liquidity will provide the true test of where stock values will settle after discounting all that is happening in our volatile world. We look forward to a resolution of the election, whenever that may happen, and a peaceful and bright holiday season when we can all begin to make 2020 a memory. Until then and as always, thank you for your trust and thank you for your business.

Yours truly,

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