STEPPING STONES MANAGEMENT, LLC

Fourth Quarter 2018 Commentary

January 22, 2019

It was a colder than usual Thanksgiving in New York City last quarter but the winds were not strong enough to cancel the famous Macy's parade. In fact, it was a perfect day for Wall Street's most fun indicator to give a bullish signal. If Santa is especially jolly atop the final float then we can expect an especially strong Santa Clause rally in the days before Christmas. Of course he's always jolly and there is always a Santa Clause rally. The bankers and advisors were gathered with their families in their offices above Sixth Avenue waiting for the final float to come by. Those of us watching at home were shocked as it came into view with Santa comfortably ensconced in his red velvet throne. Not even jumping up and down to keep warm. No "ho ho ho's" for the adoring crowds below. Not until he saw the TV cameras pointed at him did he get up and dance, but it was too late.

Maybe Santa has a portfolio of tech stocks which had been among the fourth quarter's worst performers to that point and beyond. Most investors were not feeling jolly then either. The quarter began at an all-time stock market high but it was downhill from there. The Fed rate hike in late December was expected but Chairman Powell's press conference shook confidence that he would be as concerned about the stock market as his predecessors were. Although he said monetary policy had "arrived" at the lower end of the neutral range, there was no rejoicing that the rate hikes were nearing an end. Rather, the market looked at what it didn't get, a retrenchment of the $50 billion being allowed to retire from the Fed balance sheet each month. Chairman Powell's assurance that "we don't see the balance sheet run-off as creating significant problems" seemed to trigger algorithmic sell programs.

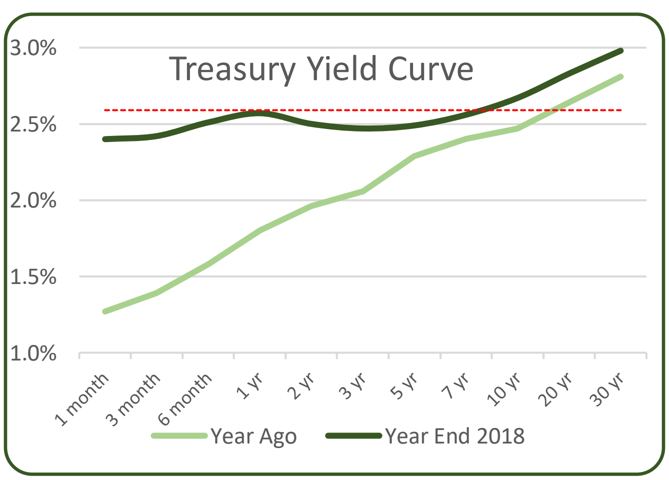
Wall Street was coming to grips with higher interest rates beginning to squeeze corporate profit margins along with increased tariffs fueling higher expenses. At least we could be thankful for higher wages but that's also not good for shareholders and stokes the Fed's worries about inflation. Could the record long bull market withstand all these headwinds? Santa sitting in his seat was too much to bear. Good retail reports over Thanksgiving provided a weeklong rally but December came in with an inverted yield curve and a series of triple digit Dow declines which became a hallmark of the quarter. Stock prices had their worst December since the Great Depression and the worst Christmas Eve in history. When it was over, the S&P 500 declined by almost -14% in the fourth quarter and -6.24% for 2018, the first down year since 2008. It was a year without the Santa Clause rally.

Pride Goeth Before a Fall

Unlike December's "arrival" message, Powell told a PBS interviewer early in the quarter that the extremely accommodative monetary response to the 2008 financial crisis was no longer necessary. He said the Fed may raise rates above a neutral rate and added "we're a long way from neutral at this point." The suggestion of indefinitely rising rates was enough to take more than 380 points off The Dow Jones Average over the next two days and the benchmark 10 year Treasury rate rose to its highest level in seven years. The higher rates are impacting profit margins of companies that have feasted on low cost debt for the last decade. Companies began to reduce earnings expectations and stock prices continued to drop into the following week. On October 10 the Dow dropped more than 830 points as investors were unwilling to step in. The buy the dip mentality that has proven so profitable since 2009 was nowhere to be found. President Trump who has extolled the bull market as a reflection of his presidency had to shift the blame telling the press "the Fed has gone crazy."

Every new Fed chairman gets tested and orchestrating history's greatest monetary retrenchment was sure to challenge Jerome Powell eventually. He knows the Fed needs to normalize rates so they have room to cut rates when the next recession arrives. With economic statistics so strong he is doing what should have been done years ago. The Fed went crazy when it held interest rates at zero for so many years and created trillions of dollars to buy government bonds. Powell is trying to return it to sanity. Using the logic that quantitative easing raised asset prices and strengthened the economy it only makes sense that quantitative tightening would have the reverse effect. Chairmen Bernanke and Yellen were unwilling to administer the medicine when they were challenged but Powell responded to the president's taunts saying "Nothing will deter us from doing what we think is the right thing to do." He surely remembers Chairman Arthur Burns acceding to President Nixon's complaints and letting the disastrous inflation of the 1970s take hold. Trump threatened to fire Powel until someone told him he can't. The Fed is independent by statute if not in practice.

As the press fueled the Trump vs. Powell meme, corporations began to guide earnings estimates lower. Although employment statistics remained strong, other indicators suggested the nine year economic expansion may be nearing an end. Among those is the indicator with the best track record, the shape of the yield curve. On December 3rd the 3 year Treasury rate rose above the 5 year rate and on December 4th the Dow lost 799 points and the trend continued into year end. Looking at the accompanying chart, the light green year ago yield curve has a normal upward slope. Shorter term rates to the left are lower than longer term rates at the right. The dark green year-end 2018 curve has a flatter shape. That is partly due to the Fed raising short term rates but that would usually shift the whole curve higher. When the long end refuses to rise accordingly it is signaling that inflation is less of a risk, maybe because the economy is going to weaken over the time period. A flatter yield curve may simply mean that inflation is contained but when the curve inverts a recession has almost always followed, sometimes more than a year later. The dotted red line marks the 2018 year end rate on the 1 year Treasury note of 2.57% which is higher than all but the 10 year and longer rates. With the unwinding of



history's greatest monetary expansion it's tempting to say it's different this time but those are the most dangerous words on Wall Street.

Rising short term rates attract money flows into the US dollar which outperformed most asset classes in the fourth quarter. That would usually be bad for gold prices but disruption in the stock market is a more powerful opposing force. In the Stepping Stones Equity ETF strategy, our gold miners position was the strongest, gaining more than 14% in the fourth quarter. It performed exactly as expected in a volatile period. The only other gainer is also affected negatively by higher rates. The Utilities fund however is another safe harbor when economic views get murky. Our consumer staples fund was also defensive losing less than -10%. Our weakest positions were in the energy sector but we have gotten used to their volatility and still want to participate in America's energy renaissance. The Value Line timeliness fund reflected what a bad time the fourth quarter was losing more than -18%. The economically sensitive semiconductor sector outperformed that by a few percentage points. It wasn't just the US as our currency hedged Japan fund lost more than -19%. Our Europe position was better losing almost -13% and the China fund was our best international position, only losing -7.7% in a quarter that the S&P 500 declined by -13.97% and the MSCI All World Index lost -13.6% on a price basis. The strategy did better than both losing -10.88%.

The Fed's monetary retrenchment is not the only problem facing the market, in early December the European Central Bank confirmed the end of their monetary expansions and stock prices worldwide took another step lower. Rising tariffs added additional lumps of coal to investor's stockings. Trade tensions with China were blamed by companies as diverse as Apple, Boeing and Caterpillar who all reduced their earnings expectations. Of the 63 trading days in the quarter, the Dow moved by triple digits on 42 of them, and rose by more than a thousand points on the day after Christmas. Whether bullish or bearish, the moves were usually attributed to positive or negative rumors about negotiations with our largest trading partner. Trump's trade war with China may be hurting their economy more than ours. While the economic statistics from China are unreliable, their negative trend is notable. Major Chinese conglomerates have shifted from accumulating assets to downsizing. Trade tensions and tighter money are also causing slowdowns in the Japanese and European economies.

The biggest story of the quarter in the US was the Democrats winning control of the House of Representative and the epic pride match developing between President Trump and Speaker Pelosi. It may be a market factor or not, gridlock in Washington is often bullish. Some companies have reported lower sales due to the government shutdown but the stock market has had a powerful 10% rally through the month that it has been closed. At this writing, the S&P 500 is almost back to its Election Day level.

The fourth quarter volatility may have little to do with the actual economy and more to do with the new nature of our stock market where 85% of trading is executed by robots. Many of the algorithmic trading programs operate on momentum which was great during the nine year bull market. However, the momentum in the fourth quarter was to the downside and the trading programs rode those waves down just as they rode the rally up. Our first quarter 2018 review explained how banks curtail their most liquid loans to hedge funds when the Fed is shrinking their balance sheets. 2018 began with a record amount of hedge funds formed and their losses by the fourth quarter drove many out of business. The banks extending them credit didn't need to decide whose loans to call in but the shrinking balance sheets of Fed member banks will continue to exert a downward force on stock prices. The final days of the year saw a strong rally as "Risk Parity" funds programed to hold defined proportions of asset classes had to buy stocks after their weightings fell below prescribed levels. That created some momentum for the robots to rally on or maybe the market likes the government shutdown. You can never know for sure what is moving markets.

The stock market's direction may be determined by the ongoing grudge matches between President Trump and the Fed, the Chinese and Speaker Pelosi. Stock prices continued their year-end rally after Chairman Powell told an audience on January 4 that the Fed is "prepared to adjust policy quickly and flexibly" if necessary. We will see what he considers necessary. Rumors of a trade truce with China have also provided a bullish tailwind but we have seen those winds shift several times. There seems to be no end in sight to the government shutdown but the market has been unconcerned thus far about the bureaucrats being out of work. Notwithstanding his avowed flexibility, Chairman Powell has staked out his position on normalization of interest rates and shrinking the Fed's balance sheet and we expect him to hold firm to his plan. It is impossible to precisely define the neutral overnight interest rate that is neither restrictive nor accommodative but a consensus is forming on the Fed board that we are near that point. Meanwhile, none of his fellow board members have questioned the balance sheet plan so we expect that policy to remain on course. We have maintained that quantitative easing helped stock prices more than the economy and we think the latter can withstand normalization better than the former. Even if the economy remains on a growth trend, as long as the Fed is draining liquidity from the banking system, more hedge funds will see their lines of credit cut which we see as the primary threat to higher stock prices and a reason why cash may continue to outperform other asset classes.

Please contact 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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