STEPPING STONES MANAGEMENT, LLC

Fourth Quarter 2019 Commentary

January 21, 2020

Growing up a few blocks from US Route 1, it was only a short walk through a couple of back yards and up a block to the nearby gas station and its soda machine. I didn't know anything about compound interest rates as a kid but I noticed how quickly a can of soda rose in price from a dime to a quarter. I knew it was because of that word I kept seeing on the newspapers I delivered, inflation. The 1970s were a dark period in US history. Our economy was suffering from high inflation and high unemployment that economists had always said couldn't coexist. They had to create the word stagflation to describe it. President Jimmy Carter was struggling with the inflation ignited by the Fed's easy money after the Nixon Administration abandoned the convertibility of US dollars into gold. Carter knew there was no going back to the gold standard but he also knew that Nixon's wage and price controls were making problems worse. He ripped off the band aid by beginning to deregulate Nixon's destructive policies.

The initial response to deregulation was even higher prices which intensified in November 1979 when Iranian revolutionaries seized the American Embassy and President Carter imposed an embargo on Iranian oil. The price of energy that was gradually becoming deregulated rose even higher as the oil imports on which America relied became scarce. President Carter pledged to combat the malaise in America with further economic reforms. In perhaps his most consequential act, on July 25, 1979 he nominated Paul Volker to be Chairman of the Federal Reserve Board. The current chairman of the Federal Reserve Bank of New York had served as Nixon's undersecretary of the Treasury for international monetary affairs and had to manage the disruption from the US dollar no longer being fixed to something tangible. He considered the abandonment of the gold standard the single most important event of his career. Volker was quickly confirmed by the US Senate and took control of monetary policy on August 6, 1979 with a mandate to halt inflation. At 6 feet 7 inches, "Tall Paul" had the fortitude to take on the heavy task of combating inflation running at almost 15% annually.

He knew that raising interest rates higher than the inflation rate would cause a debilitating recession which would worsen already high unemployment. The alternative was to watch inflation expectations and wages continue to spiral upwards. He administered the tough medicine that slayed the inflation monster and has been an economic elder statesman ever since, until his death last month at the age of 92. A generation later, his monetary policy protégés are battling deflation, fearing that lower prices will wreak havoc with highly leveraged balance sheets that need to be supported by ever higher asset prices. Current Fed Chairman Jerome Powell abandoned his hard money rhetoric in the fourth quarter and engineered the creation of $308 billion dollars to meet unprecedented demand for funding in the short term money markets. The 8% increase in the Fed's balance sheet corresponded with an 8.5% increase in the S&P 500 in the fourth quarter, bringing the 2019 return to almost 29% on a price basis.

The Way We Were

It was a much different story 40 years ago in the fourth quarter of 1979 when the new Fed chairman embarked on his seminal battle and was confronted with an 8% decline in the S&P 500 over the first few weeks of his first full quarter on the job. Until then, Fed policy had been focused on the spread between certain short term interest rates that would foster or inhibit growth in the money supply. A large spread would induce banks to borrow at the lower rate and lend at the higher. Volker came of monetary age under Milton Friedman's Nobel winning insight that inflation is a function of too much money chasing too few goods, so he changed the central bank's focus from the interest rate spread to the money supply.

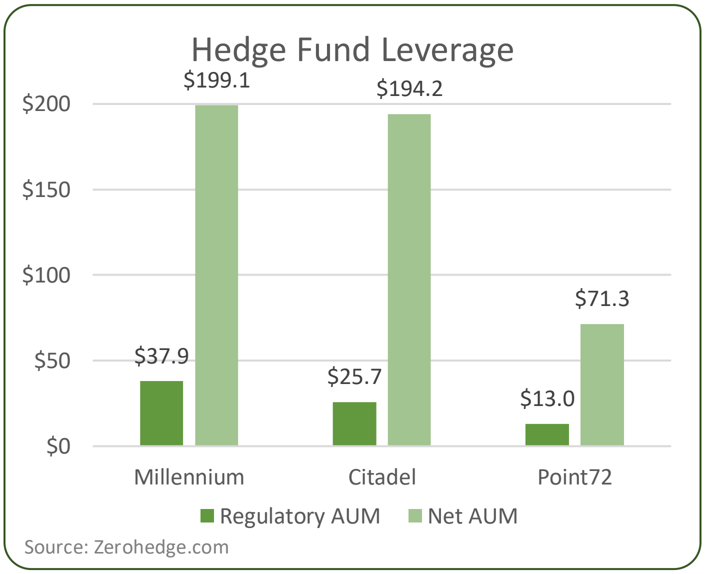
The Fed didn't release data pertaining to its balance sheet in those days so we can't easily compare their actions to policies today. We know that Volker did raise short term interest rates above the inflation rate and the US economy suffered two recessions in three years. He would recall later that the battle against inflation proved more difficult than he expected. It was worse for Jimmy Carter who was forced to campaign for reelection during a deep recession. He was quoted after Volker's passing saying "Paul was as stubborn as he was tall, and although some of his policies as Fed chairman were politically costly, they were the right thing to do." The 1980 election was contested after US consumers experienced long gas lines and rationing throughout the US. Volker proved his bipartisanship by not letting up under Reagan who was met with an even deeper recession in his first term.

With my adolescent entrepreneurial juices flowing, I found extra earnings by loading a cooler full of sodas onto my newspaper wagon to sell to people on the gas lines. I was doing well enough that I took my considerable savings to my father's Merrill Lynch office seeking investment advice. He advised me to walk up and down Park Ave and open an account at the bank with the highest 6 month CD rate. I probably got more than 20% annualized. The concept of compound interest was coming into my consciousness.

Higher interest rates work counter to asset prices but Volker was undeterred by pain on Wall Street and pushed on with tacit approval from both the Carter and Reagan Administrations. That's in sharp contrast to the fourth quarter of 2019 which began with the disruption in the overnight repo market discussed in last quarter's letter and resulted in the reflating Fed balance sheet. The mysterious causes prompted the Bank for International Settlements (BIS), known as the bank for central banks, to study the situation. They reported the unprecedented demand for cash in the overnight markets was attributable to highly leveraged hedge funds who have increased the size of their positions in today's historic low interest rate environment. This is a legacy of the last financial crisis and also lies under the long shadow of Paul Volker.

When the financial system's elder statesman was called upon in 2009, he held that banks receiving taxpayer support should not be able to use that money to make speculative trading bets. Most of the banks that got in trouble did so by loading up on the toxic credit default swaps that defined that crisis. The Dodd-Frank financial reform of 2010 included the Volker Rule which prohibits banks from trading for their own accounts. Instead, the Fed member banks have used the ballooning amounts of cash added to their balance sheets to make loans to hedge funds. The liquid collateral allows these loans to be called on a moment's notice and their higher rates are superior to loans backed by commercial assets that take months to sell.

Last quarter's letter mentioned how JP Morgan has pulled back from lending its excess reserves into the repo market, which may have triggered the extreme liquidity constraints that persist to this writing. CEO Jamie Dimon was among the few to stray away from the toxic debt of the last crisis and maybe he sees similarities today. That has left the Fed to meet the heightened demand while their assurances that the issue would not affect monetary policy have gone by the wayside. They are now contemplating making repo market cash injections available directly to hedge funds.



The writers at ZeroHedge.com have observed that the three largest hedge funds hold assets under management (AUM) worth more than five times their net worth, as shown on the accompanying chart. That means for every dollar raised, they have purchased more than $5 of assets. Many others hold up to ten times their net AUM. Their favorite assets are S&P 500 equities while they also buy short term Treasury securities for use as collateral to expand their leverage. Individual investors are usually allowed to leverage their investments by only two times in the interest of financial stability. The BIS study states that a key factor behind the trouble in the repo market is "high demand for secured (repo) funding from non-financial institutions, such as hedge funds heavily engaged in leveraging up relative value trades." Since interest rate spreads are so low in today's era of suppressed and negative rates, hedge funds need to leverage up their trades in order to make the same profit. When slight variations hit the prices of these highly leveraged assets, the firms need to raise cash to cover margin loans. The result has been an overloaded financial sector with a constant thirst for liquidity.

The reason why the Fed has to act so aggressively is that if the hedge funds don't get the financing they need, they will be forced to liquidate positions. If enough of them did that all at once, it would cause a cascade throughout world financial markets. The fourth quarter shows that everything is fine as long as huge amounts of money are added to the system. When the Fed stopped doing that a year ago we began to see financial assets lose value. The 19% stock market correction to end 2018 was too much for the Fed to bear so they reversed course in 2019. Halting their balance sheet shrinkage was enough to get back most of those late 2018 losses but then the market wanted more. The summer was marked by fits and starts until the "repocalypse" emerged to end the third quarter. From the despair of recessionary fears in the summer, the gusher of cash in the fourth quarter has brought us record stock prices and valuations. There seems to be no stable equilibrium.

That is why we try to maintain a balanced stance in the Stepping Stones fully invested equity ETF strategy. The money we decide to place at risk has been allocated among a group of funds that we hope will cover a wide variety of potential circumstances. During such a euphoric quarter our defensive positions tend to underperform; that happened with the consumer staples fund which gained 4% and the utilities fund which was barely positive. The broad market Value Line fund also underperformed. Energy can be a defensive sector but the fracking revolution has brought price risk into these positions like we have never seen before. So much so that the recent confrontation with Iran has had no discernable effect on energy prices. Something unfathomable in the 1970s. Despite commodity price pressure, our energy positions participated in the quarter's strong rally. Easy money out of the Fed is good for the rest of the world too which was reflected in our Europe and Japan funds which each gained about 8%. The China fund got a further boost from the "Phase 1" trade agreement finally signed last week. We hedge against the Fed's monetary debasement with our gold miners position which gained over 10% in the quarter. One of our more aggressive positions, the semiconductors fund was the top performer gaining almost 20% in the quarter that saw the combined portfolio gain 8.81% on a price basis compared to the S&P 500 which rose by 8.53% and the MSCI All World index which gained 7.46%. Rising by 28.63% for all of 2019, the portfolio trailed the S&P 500 very slightly and outperformed the All World index which rose by 23.52%.

The Modern Way

The $308 billion dollars created by the Fed in the fourth quarter was only exceeded at the height of the financial crisis in the third and fourth quarters of 2008. The policy has continued into 2020 and the Fed announced that they will begin to taper the amounts made available in the daily repo facilities by $5 billion per month beginning in March. That means the injections will proceed for most of this year if not indefinitely. The Fed answered the question from last quarter as to when, not if, they will expand their balance sheet. In addition to the repo facilities, the Fed is also purchasing $60 billion in short term Treasury securities every month. The need for this amount of liquidity during a period of steady economic growth and low unemployment suggests something is very wrong with the financial system. The S&P 500 grew by 29% in 2019 while earnings for the companies that comprise the index only rose by 1%. We can only imagine what financial markets would look like without the massive Fed distortions. Richard Nixon's chief economist, Herbert Stein, famously said "If something cannot go on forever, it will stop." That eventuality has been our overriding concern in the quantitative easing (QE) era.

The era of QE may turn out to be a more consequential event than unmooring the US dollar from gold. The economic stability thus far casts doubt on Milton Friedman's price theory that too much money causes inflation. The only inflation has been limited to financial assets owned by a minority of society. Broad based inflation fears are mitigated by the case of Japan whose central bank has been creating money to keep that economy going since their financial crisis in the early 1990s. Although they have managed to keep their economy mostly out of recession, they have also forgone normal rates of growth. Instead, the Japanese economy is burdened by zombie companies that do not have to perform because the country's central bank will keep them afloat.

A decade removed from our financial crisis, the index of America's strongest companies is only growing earnings by 1% in an economy enjoying record employment and wages. The managers of those companies are able to take on as much debt as they want and drive their stock prices higher almost regardless of how they perform. Meanwhile, those wanting to save for the future are penalized with minuscule interest rates that are often outweighed by bank fees. Convincing my kids to deposit their gifts from grandparents and earnings from cutting lawns in the bank is now a case of safekeeping only. The days when a parent could teach his children about using the power of compound interest to save for something special are a nostalgic anachronism.

Although the Fed has managed to keep the US economy out of recession in recent years, it has been at the expense of social discord as those with assets become richer while the rest stand by. By avoiding recession at all costs, the Fed has erected a rickety edifice that requires ever increasing amounts of money to maintain. We can only hope that when it all comes down the real economy will be able to get along without a financial system which has become little more than a vehicle to enrichen those running it. Maybe they will even have to bear the losses themselves this time rather than have taxpayers make them whole.

We held onto our cash through the previous rounds of QE fearing what may happen when it all ends. With the Fed signaling that it may never end we have to think harder about keeping money on the sidelines of an increasingly dangerous game. The stock market election cycle says the third year of a presidential term enjoys the best performance and the election year second best. So 2020 may not be as good as 2019 but history is favorable. Politicians will bear the blame as well as the credit for economic conditions that are often beyond their control. Jerome Powell is flexing the Fed's muscle while avoiding the steps he advocated to normalize monetary policy. He has become hostage to the major hedge funds and their threats to financial stability. In contrast, it was his predecessor 40 years ago who had the courage to undertake the difficult actions that set the stage for one of America's greatest periods of growth.

Standing on a cold Manhattan street corner a few winters ago, waiting for the light to change, I noticed the tall man in a parka standing next to me was Paul Volker. I introduced myself and expressed my admiration. We exchanged some friendly banter before I parted ways with the humble American hero feeling the gratification that comes from a brush with greatness. His wisdom and fortitude will be sorely missed.

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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