STEPPING STONES MANAGEMENT, LLC

Four Quarter 2020 Commentary

January 21, 2021

It was a hopeful beginning to the final quarter of the most historic year of the modern era. Virus cases were rising as we were all getting tested in order to go back to work and school. Hospital admissions were also rising, but it didn't feel like the initial surge in the spring. There was a sense of the situation being under control. Stock prices rose with every report of progress on the various vaccines that were on target to arrive before year end. People were trying their best to get back to life. New York City restaurants began the quarter with the first reopening of indoor dining since the spring lockdown. And we all had reason to hope our preferred candidate would prevail in the most unusual election in anyone's life.

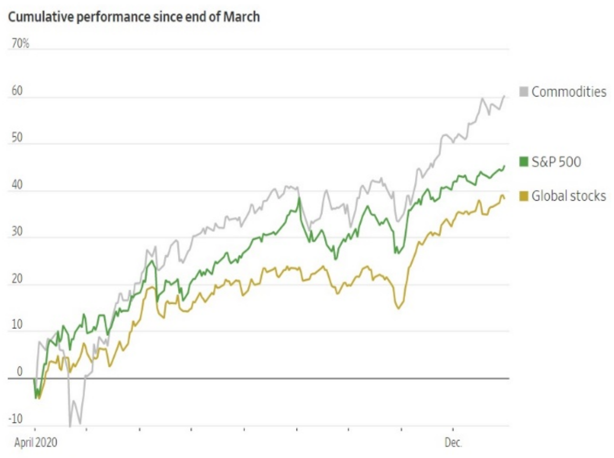
The stock market led the party, continuing the rebound after September's almost 10% decline from its record a few weeks earlier. That scare was enough to bring political adversaries together suggesting further stimulus would be forthcoming and the Fed added their assurance of continued monetary accommodation. Markets took the cue and investment flows resumed into the major technology companies that have dominated the covid rally. Americans locked out of their favorite main street merchants have been left to spend their government issued debit cards at the dominant digital retailers. That has been great for big tech earnings but the rest of the S&P 500 is expected to see earnings fall about 12% below the year ago level, even though sequentially improved upon the third quarter's rebound from the pandemic low.

A strong rally in most commodities suggests either demand is rising beyond supply, or excess monetary accommodation is beginning to have inflationary effects. The Fed is breathing easier under its new relaxed inflationary framework which they say is not at risk of being triggered at this early stage in the recovery. Their greater concern is maintaining low interest rates in the face of the tsunami of new US Treasury debt. We knew that previously unimaginable federal deficit spending was in order regardless of the election outcome. The ultimate resolution suggests it will be at the larger end of expectations.

The quarter was volatile until the contested election apparently delivered exactly what the market wanted, setting off a steady rally for the final eight weeks of the year. The positive economic and earnings growth discussed last quarter continued at a slower pace and markets across the financial spectrum enjoyed record rallies despite the dire economic circumstances. The arrival of two vaccines with others on the way lent to the euphoria as the world patiently awaits deliverance from the pandemic. Looking beyond the deepest annual economic contraction since 1946, the S&P 500 presented a striking dichotomy with its 11.7% fourth quarter gain bolstering its annual rise of 16.3%.

Everything Rally

The normal course of action for financial markets in a given period is for some asset classes to rise while others fall in price. The classic combination is stocks and bonds which tend to experience low correlation as money moves from one to the other with the ebb and flow of risk appetites. Risk parity strategies, where a combination of asset classes are held to offset the uncorrelated risks and capture the gains, have become the most popular asset management products. The risk has been absent for most asset classes as tightening lending standards at banks have forced the giant monetary flows into financial assets of all varieties, including art and cryptocurrencies. The nearby chart is reprinted from a recent Wall Street Journal story on the "Everything Rally" showing the rising correlations and prices since the pandemic lows through year end. While it doesn't chart the double digit gain of the Barclays US Aggregate Bond index, it portrays the major benchmarks for US equities, global equities, and broad based commodities, rising together in excess of 35% since March. That hasn't happened since 2009, which was the first time ever. Both occasions were reactions to unprecedented monetary expansions.



¹Measured by S&P GSCI index ²Gauged by MSCI AC World ex USA index
Source: FactSet via Dow Jones Market Data

The same article spoke of fund managers holding cash at bare minimum levels and increasing exposure to riskier emerging markets. Risk assets are rising across the board and leveraged ETFs are reflecting sentiment exceeding bullish extremes. Valuations have been stretched far beyond historical norms. The raging equity rally enticed a record number of initial public offerings which raised almost $180 billion in 2020, twice as much as the previous annual record. A higher percentage of those companies than ever before were also losing money, establishing a new extreme in that multi-year trend. 2020 also saw an explosion of companies going public through reverse mergers. Almost half of the year's IPOs were of Special Purpose Acquisition Companies (SPACs) which have no business other than raising money in order to purchase private companies to merge into their public shells. Often sponsored by successful venture capital investors, the SPAC raises money from people wanting to get in on their next big hit. The last time SPACs garnered so much attention was before the 2008 Global Financial Crisis which most of them did not survive. When there isn't even a company whose prospects can be evaluated, buying shares of a SPAC can hardly be called investing. The wild euphoria in the equity markets is reminiscent of Citigroup's chairman famously saying in 2007, "as long as the music is playing you've to get up and dance." That was his final dance before crashing the bank.

Our strategy has been to keep some of our cash sedentary, waiting for a better tune, as we dance with the fully invested Stepping Stones Equity ETF portfolio. Our exposure to the strong commodity markets resulted in an almost 40% gain for our energy position that had caused so much heartache in recent years. Our basic materials fund performed in line with the broad market. Not wanting to make a wrong bet on future technologies, we have gained exposure to the tech rally though our semiconductors fund which gained almost 25% in the fourth quarter. A current global shortage of semiconductors has the position off to a great start in 2021. Another quarterly standout was the small cap value fund which overcame the headwind of a weak currency to benefit from the trend towards American onshoring. Our European and

Japanese positions slightly lagged the strong US benchmarks and the risk adverse staples and utilities funds managed mid-single digit gains. The Value Line fund was merged into their dividend strategy which lagged with a slightly positive return. The only negative performer was the gold miners fund, down about 8%, giving back some of its recent gains. Those looking for dollar alternatives in the fourth quarter chose bitcoin instead of gold. In total, the portfolio gained 14.18% for the fourth quarter and 18.16% for 2020 on a price basis, compared to the S&P500 which gained 11.7% and 16.26% respectively.

The Asset Class

With risk assets being priced so high, there is little room for any reward to develop. Dave Portnoy's second quarter insight that "stocks only go up" is parody becoming reality. As Chairman Jerome Powell turns his focus towards the end of his term, printing more money to keep the politicians happy is probably his best course to renomination. He also remembers the fourth quarter of 2019 when the strong economy wasn't enough to hold off turmoil in the repo cash markets. The Fed needed to inject over $300 billion then to rescue the financial system from crashing, for no apparent reason.

The momentum building in commodity prices has yet to appear in finished goods inflation but if the inputs of production continue to rise like tech stocks, it will only be a matter of time until inflation rears its ugly head. If prices grow beyond the Fed's wider targets, any monetary restriction will not only stress financial markets more than last year but will also stress governments feasting on zero percent interest rates. Since the quantitative easing era emerged in 2009, there have been two attempts at monetary restraint which were each met with financial disruptions that brought even bigger interventions.

If the Fed continues to backstop asset values from experiencing any meaningful decline, the prices of basic goods and services will eventually rise on an inflationary wave sustained by their monetary adventures. That may be the ultimate plan to grow out of all the accumulating debt. All indications have been that current policy is on autopilot for at least a few years. With former chairman Janet Yellen soon to be the US Treasury Secretary overseeing an unprecedented fiscal expansion, the independent central bank will be more closely aligned with the government than at any time in its hundred year history. That independence was the reason why the US dollar became the world's reserve currency. It remains to be seen how far the world will let us exploit that status. The Bank of China has curtailed their purchases of US Treasury debt leaving the Fed as the dominant world buyer of our own debt with money conjured from their keyboards. Nero must be blushing somewhere.

The age of Modern Monetary Theory is upon us. These letters have covered the concept that says we can print money to solve all of society's problems as long as inflation doesn't emerge. We are about a decade into the experiment but that's a short time in the grand scheme of history. As markets signal success, our political and intellectual leadership is quickly losing credibility as society becomes torn and frayed. Our economy has become almost completely reliant on debt and stimulus to keep asset prices inflated without any opportunity for repricing. Suppressing the business cycle has been great for those with assets who get richer even as the working class suffers to make ends meet. Allowing prices to correct used to be the path to rebirth and regrowth but not in this new monetary era. The Fed protects the asset class without regard to the working class.

Although vaccines are finally being administered to society's most vulnerable with the rest of us waiting patiently, the return to normal is not yet upon us. More schools are being forced into remote learning and offices are closing as mounting cases require more of us to quarantine. Indoor dining in New York City has been suspended again and unemployment claims are rising. More massive fiscal stimulus is at the ready and equity markets are overlooking the dark winter and hoping for a spring renewal. Meanwhile, interest rates have begun to diverge as the bond market challenges the Fed's position. We believe that classical economics will ultimately prevail over Dave Portnoy's new age revelation. The risk of our cash positions being devalued by inflation is becoming more salient but we are waiting for a repricing of risk assets to a level from which we can expect to reap rewards.

Especially in these volatile times, 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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