Fourth Quarter 2021 Commentary

January 21, 2022

It was the best of times, it was the worst of times. Cities worldwide ended 2021 spellbound by a tale of record high financial markets and covid cases. The fourth quarter began differently as September's Delta surge had trimmed about 5% from the stock market. As case counts settled down, financial markets resumed their ride on the $120 billion monthly wave of Federal Reserve cash injections. Hoping to be reappointed to another four-year term, Chairman Jerome Powell remained confident that heightened inflation would prove transitory and the Fed could be patient about ending their historic monetary expansions.

Asked in October about the Consumer Price Index (CPI) growing above 5% annually for most of the summer, he said it was too early to consider rate hikes, and reiterated the Fed's plan to begin tapering their monthly bond purchases in November. He expected supply chain constraints to ease in the new year, and assured markets that the Fed stood ready to deploy the tools at their disposal if inflation persists.

The Biden Administration addressed higher energy prices by announcing a release of stockpiles from the Strategic Petroleum Reserve, which didn't prevent the barrel price of oil from climbing back above $80. Other prices continued to rise too, reflected in November's CPI recording the highest annual inflation since 1982. The White House complained that "greedy corporations are charging Americans extra just to keep their stock prices high" and echoed the Fed's assurances that transitory inflation will subside with the pandemic. The Administration argued the best cure to inflation would be to pass the multi-trillion dollar Build Back Better Act as a follow up to the $1.2 trillion bipartisan infrastructure bill signed in November.

Thanksgiving weekend brought news of the rapidly spreading Omicron variant, and a thousand point drop in the Dow Jones Average. That was quickly reversed when markets learned it was a far less virulent strain of the virus that has been vexing humanity for two years. By Christmas, cases had surged far above the prior peaks, disrupting the holiday plans of most Americans. We all know people who caught the latest waves and became sick or just tested positive; most of whom were vaccinated. Their need to quarantine suspended a major portion of the workforce while other workers lost their jobs for violating vaccine mandates. Even those with natural antibodies who object to taking the vaccine have been excluded from polite society, as foreign as that notion has become.

By the end of 2021, the Fed slowed their music slightly, but most investors kept dancing into 2022. Some corporate insiders took their chairs as a choppier stock market clawed to more record highs. The end of quantitative easing combined with accelerating inflation, and rate hikes expected to come

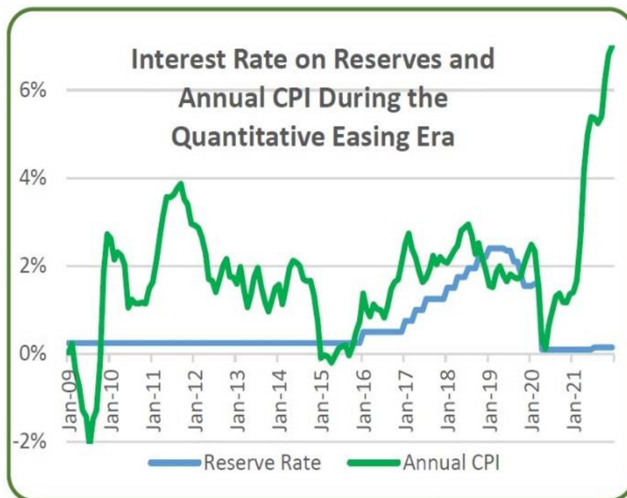
sooner and faster to combat it, weren't enough to suppress the S&P 500 from gaining over 10% for the fourth quarter and almost 27% for all of 2021.

Fueling Inflation

The Fed's balance sheet grew by more than $100 billion in December, and the CPI rose by 7% in 2021. They will need to pick up their pace to wind the monthly expansions down to zero by their new goal in March. The Fed's preferred inflation measure is lower than the CPI but still more than double their 2% target. Simply holding to their tightening plans ensures they will fuel inflation at least for the rest of this quarter before the first rate hike comes in March.

With his reappointment out of the way, and inflation becoming entrenched, Powell conceded it was time to retire the word transitory. He admitted to underestimating the supply chain disruptions and said getting back to the strong pre-pandemic job market will require price stability. Other Fed board members projected that rates may need to rise before fully achieving maximum employment.

For thirteen years, the Fed has assured us that creating money to purchase bonds from member banks would not be inflationary because emergency legislation from 2008 allows them to pay interest on the reserves they create. Although the reserve rate cannot exceed the general level of short-term interest rates, the extra income would discourage banks from lending the reserves into the market and generating inflation. After the emergency passed, the Fed would retire the excess reserves and the balance sheet would shrink back towards its original size. In reality, the Fed had to keep the rate above their overnight market rate that was pegged near zero for eight years, and the emergency didn't pass. Earlier in the experiment in 2013, with the rate at 0.25%, St Louis Fed President James Bullard feared the public relations problem of paying Fed member banks more interest on reserves than their entire profits. In 2016, they raised the reserve rate to 0.5% in the first of several steps up to a high of 2.4% in 2019, along with increases in the overnight market rate.



You can see on the accompanying chart how the blue line representing the reserve rate began to step up in 2016 when the Fed attempted to exit from their quantitative easing policy. The process proceeded smoothly until their modest attempt to shrink the balance sheet in 2018. The result was a negative year for the stock market and a stealth financial crisis in 2019 that required more quantitative easing, before anyone had heard of covid. You can see how moderate inflation represented by the green line gave them cover to resume bond purchases and ease the blue interest rate line lower, before the pandemic suddenly drove both to zero.

Once the reserve rate fell back towards zero in 2020, there was no incentive for banks to keep the funds on reserve, which ignited twelve years of inflationary fuel driving the CPI up to 7% by December. Bipartisan politicians did their best to fan the flames by passing $6 trillion in spending over the last two years. The Fed rarely mentions the tenfold inflation of their balance sheet since 2008, compared to 20% cumulative growth in the prior decade. Sounding certain that current

inflation is only from covid related supply chain disruptions, they retired the word transitory but not the concept.

Regular readers of these letters may wonder what Modern Monetary Theory says about current inflation. The promoter of the avant-garde policy, Professor Stephanie Kelton of Stony Brook University, proposes the only limitation to government deficit spending should be inflation. She has warned about current prices, saying supply chain bottlenecks warrant a careful approach. Not at the Fed, but by government agencies charged with deploying all the spending. However much inflation is too much hasn't been reached yet, as her year end blog post criticized Sen. Joe Manchin (D-WV) for killing the Build Back Better Act "on the eve of Christmas."

We have been taking the inflation threat more seriously and positioned the Stepping Stones fully invested equity ETF strategy towards sectors that we hope to be safe havens. That usually means exposure to gold, but the classic inflation hedge did not perform as expected as the CPI gained 7%. Maybe the market believes the Fed really does have it under control. Our gold miners position did well anyway, gaining almost 9% for the quarter. Supply chain bottlenecks are still keeping semiconductor prices high and our position in that sector was the portfolio's top performer gaining over 21% in the fourth quarter. With so much US production taken off line, energy prices rallied strongly, but the year-end economic disruption from Omicron made investors fearful that nobody would drive to work or fly on airplanes. Our energy position suffered with a slightly negative quarterly return. Our basic materials position is another inflation hedge that worked well, gaining almost 15%. Pricing for consumer staples is strong, but inflation is hurting retail sales and margins are getting squeezed by raw material costs. Our position in that sector returned about 10% for the quarter. Margin compression is also the story with small cap companies who tend to be price takers more than price makers. We hold this position because smaller companies employ less financial engineering, which is often fatal in bear markets. The position underperformed with a gain of almost 6% in the quarter. A warm fall, higher energy costs, and rising rates were not enough to keep our utilities fund from outperforming with a 12% gain. Dividend payers are defensive by nature but carry some interest rate sensitivity. Despite rising rates, that position gained almost 10%. Internationally, our European fund reflected the continent's earlier bout with Omicron by underperforming with a 3% gain, and the currency hedged Japan fund was slightly negative as the country wrestles with political uncertainty. The strategy returned 10.31% in the fourth quarter on a price basis compared to the S&P500 which gained 10.65% and the MSCI All World Index gaining 5.86%.

Question Authority

Euphoric markets may take their cue from research suggesting Omicron has evolutionary characteristics of a mild virus becoming endemic in society, and not a concern for most people. Most report symptoms akin to a common cold, but some politicians are reluctant to loosen their grip on society. The government-media complex rouses our fears by focusing on surging cases, rather than declining deaths. Main street businesses are struggling with lower traffic flow as people stay home. Rigorous testing policies have forced people without symptoms to spend hours on lines at the limited number of locations. Almost two years and unknown billions of dollars after the initial testing debacle, it remains a debacle

We spent even more money researching treatments, but none of my family or friends who recently got sick were given any treatments at all, even after some had several days of serious illness. They vary in ages, genders, and medical conditions, but like most people, all of their doctors are affiliated with large corporate hospitals. As of year-end, no major medical institution or federal agency had

developed a protocol to treat covid on an outpatient basis. It is not because treatments don't exist. My independent doctor warned about the surging cases in December and we discussed, if needed, a treatment that worked well for me with another condition.

In our new age of government funded corporate medicine, it is risky to stray from the safe harbor of CDC guidance. The health care industrial complex has focused only on emergency approvals of vaccines and newly developed drugs, premised on the absence of any other treatments. The bureaucracy has subjected eminent scholars and attending physicians who dissent from the government orthodoxy to "devastating takedowns." Emails reveal scientists who initially suggested the virus was engineered, quickly changed their minds in public articles, and months later received multi-million dollar government research grants. Their credibility crumbles as they have become drunk on power.

There are wide reports of a 2021 surge of deaths among working-age adults. One insurance company CEO reported an "unheard of" 40% increase above pre pandemic levels and added that they expect a 10% deviation to occur only once every 200 years. A majority of these deaths are not from covid but medical issues not treated during the previous two years, and a tragic surge in suicides. A skew towards the southwest suggests the fentanyl pouring across the southern border is also taking its toll on the US workforce.

Actuaries will calculate how much the pandemic is increasing the costs of life and health insurance as the crime wave sweeping our cities is fueling higher property and casualty costs. Losses that may be transitory will affect premiums for many years. Employers are struggling to manage a cascade of higher costs as politicians force them to deny service to customers and fire workers who object to the jab.

People with medical issues, concerned about accumulating reports of adverse reactions, are accused of spreading conspiracy theories. Religious objections to fetal research are dismissed, even by Pope Francis. Medical professionals uncomfortable with the abridged approval process are being forced out of their careers. Rather than celebrating vaccination rates higher than anyone ever expected, politicians deflect from their own failures by blaming and shaming the unvaccinated as the reason for the prolonged pandemic. Even though the vaccines obviously do not prevent infection or transmission.

Amid this credibility crisis throughout our government, the Fed is embarking on the end to the greatest monetary expansion of all time. Bullish investors expect to be rescued from any bear markets, but we don't have the luxury of low inflation anymore. Workforce repression is fueling a classic wage-price spiral hitting corporate income statements, which higher interest expenses will pressure further. Record high valuations of leveraged balance sheets will need to be discounted at rapidly rising rates. December's negative retail sales growth is a stark example of how inflation affects the broad economy.

Confident that supply chain disruptions are the sole source of today's inflation, and not the tenfold increase of their balance sheet, the Fed expects to have their full toolbox available for any disruptions. However, their favorite tool of balance sheet expansion won't be available with inflation above their target. They will have to choose between saving the stock market at the expense of higher inflation, or taming inflation at the expense of stock prices. Their credibility has never been so tenuous.

The path is set, and its course will be determined by how much pain lies ahead. The last three Fed chairs never delivered unpleasant medicine to markets that have stretched beyond any previous speculative bubbles. They address every problem with massive money printing, assuming they can segregate and control it. Having incubated inflation for over a decade, there is no easy way out now that it has infected the economy. We learned 40 years ago that interest rates need to rise above the inflation rate to have a palliative effect, and nobody expects the Fed to raise rates over 7%. Elon Musk prepared for the end of quantitative easing by cashing out $10 billion from his Tesla holdings in the fourth quarter, just in case. We celebrate the fading threat from covid as we fear the market threats of inflation and rising rates. On the cusp of the most consequential policy pivot of the Federal Reserve's history, we plan to maintain our defensive posture for the storm we have long expected.

Please call me with 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.