STEPPING STONES MANAGEMENT, LLC

Second Quarter 2016 Commentary

July 20, 2016

The Armageddon countdown clocks were back, ticking away the second quarter in the bottom of our TV screens as the world awaited the June 23rd Brexit vote determining if Great Britain would leave the European Union. The referendum was considered a joke until recent polls showed it having a chance to pass which kicked the ruling class into gear saying the Euroskeptics should not be taken seriously. President Obama went to London to warn against Brexit saying "The UK is going to be in the back of the queue" when the US negotiates trade deals. His comments were followed by a surge in the polls for the Leave campaign that focused on British sovereignty regarding issues like immigration and regulation. The bottom line was the bottom lines of average British citizens which have fallen to levels of twenty years ago. Just like their middle class counterparts in most of the developed world.

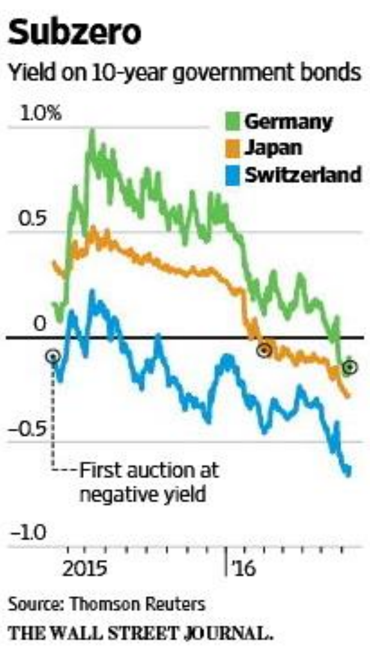
Those who complained about changing complexions of cities and towns were dismissed as ignorant bigots without addressing the wage pressure from immigrants who work for less than other British workers. Complaints about popular electric tea kettles being banned by EU bureaucrats were dismissed as silly without recognizing the impact on individual daily lives. There was nary a peep from the enlightened elites supporting the separation. The International Monetary Fund (IMF) put their best and brightest to work analyzing a series of scenarios and warned that "the net economic effects of leaving the EU would likely be negative and substantial." The US Federal Reserve postponed their interest rate normalization process due to the heightened "uncertainty" caused by the referendum, even though their data dependent goals have been reached. Proponents argued that leaving the EU would free Great Britain to make better trade deals and reduce the regulatory burdens on businesses, but the IMF said it was doubtful that an easing of regulatory burdens would boost growth. The blindness to the economic impacts of regulations is at the heart of the political convulsions occurring throughout the world where crony capitalism has benefited the entrenched at the expense of everyone else. Those doing well appear to have no idea how bad it is for the rest of society.

The British government's "Project Fear" campaign seemed to work as markets rallied in the days leading up to the vote when polls showed Remain boosting its lead. The odds at London's famous bookmakers confirmed the expectation but one betting house observed that while more money had been bet on Remain, almost twice as many bets had been placed on Leave. The big money in London skewed the odds but in a democracy rich and poor still have the same vote. Late in the evening when Asian markets were opening, we learned that Leave had won the referendum. The elites were wrong on the electoral outcome but appeared to be right on their warnings as world equity markets suffered their worst two days in history, losing $3 trillion in value. The British pound fell to a thirty year low against the dollar. Then a funny thing happened after all the wrong financial bets were unwound. Central banks reiterated their pledges to keep markets fully liquid and the selloff quickly reversed driving the world's largest stock index, the S&P 500, to finish the quarter up 1.9% and near its all-time high. Maybe traders in London noticed that the BMW and Mercedes dealers were still open and maybe they wouldn't have to relocate their trading desks to Frankfurt.

Keep Calm and Carry On

European Commission President Jean-Claude Juncker reacted to the vote with a hard line saying Britain will not have access to the European market unless any European is able to live and work in the UK. He failed to realize that Europe needs access to the British market more than the other way around. Great Britain is running the worst trade deficit as a percentage of its economy since King George III lost his battle with George Washington. British trade should see a tailwind now that the British pound has fallen so much. Currency is a zero sum game so any benefit to the UK will be at the expense of international competitors whose sales will translate back to fewer dollars, euros and yen.

Trade is just one of many facets of the world economy that has been upended by the monetary policies underway worldwide as every nation tries to weaken its currency. The agreements governing international trade took years to negotiate as parties assessed the subsidies and regulatory structures that governments provide to their domestic industries. Aviation is a prime example where the government run US Export-Import Bank helps foreign airlines buy Boeing aircraft while European governments subsidize Airbus. Meticulously negotiated trade agreements that define the rules down to the minutiae are meaningless now that the European Central Bank (ECB) is buying the debt of European companies like Airbus. Especially considering the purchases are increasingly made at negative interest rates, meaning companies can issue debt and pay back less then they borrow from the central bank. If that isn't a subsidy then nothing is.



The experts in whom we place so much trust continue to use more unconventional measures to get us out of the current malaise. As these letters have chronicled, the move into negative interest rates becomes more surreal as we drift further through the looking glass. Currently, a quarter of all debt outstanding worldwide, worth approximately $13 trillion, trades at a negative yield; and about a third of all government debt. The accompanying chart from a recent issue of The Wall Street Journal shows how it has gotten to the point that the governments of Germany, Japan and Switzerland are getting paid to borrow for ten years. To drive interest rates so low, the ECB has needed to buy so much debt that the market is running out of qualified bonds. That will likely presage a loosening of their standards meaning even more subsidies for European companies. The Japanese and Swiss central banks have even become major holders of corporate equities. The consternation we hear about disrupting established trade agreements ignores the subsidies that central banks are providing to their domestic corporations.

While we should have little faith in the consistently wrong IMF economic models, their warning that "domestic political pressures may cause import tariffs to rise" is salient. Usually enacted in the name of protecting workers, import tariffs more often result in sclerotic industries that fail to keep pace with innovation. Freer trade enables companies to source more efficiently and devote their workforce to higher value added roles. Workers whose jobs get offshored have typically picked up better jobs at startup companies that have historically provided most of the new jobs in a normally growing economy. Unfortunately, the US economy has suffered a persistent multiyear downtrend in business startup activity so those affected by trade have not had as many reemployment opportunities. As developed world governments increase the burdens on employers, it should not surprise us that employers are reluctant to hire. When forced to provide increasingly expensive benefits, businesses outsource or hire labor as independent contractors who are responsible for their own benefits. The economic stagnation currently plaguing the globe is frequently blamed on trade while ignoring the growing dominance that governments have assumed over their economies. For the British that meant an unelected government in Brussels telling them how to brew their tea. Economic science clearly shows growth rates to be inversely correlated with government's role in the economy and positively correlated with freer trade. It is the clear lesson of the Great Depression and the 1990s economic boom.

Power to the People

Economists are in rare agreement that what's plaguing the economy is a lack of productivity growth. The first quarter rate, announced by the US Department of Labor in June, came in negative for the tenth quarter out of the last twenty one, marking one of the weakest five year periods since World War II. Typical disagreement surrounds the reasons. Some echo the arguments made during the 1970s malaise that we have reached a new normal where the easy growth has been achieved. Others point to historically low levels of investment spending with different theories as to the cause. These letters have argued that we should not be surprised that investment is low when interest rates are being suppressed to zero and worse. Nobody wants to lend for zero return. Zero and negative interest rate policies (ZIRP and NIRP) are also harming the banking system unable to grow profits in such an interest rate environment. Major world banks have seen their equity values deteriorate to below book value, signaling more stress ahead. Meanwhile, savers have forgotten what it means to earn interest and see banking as an expense. Negative rates may not have arrived in America yet but fees that often exceed interest income have the same effect. The only beneficiaries are holders of the financial assets that the central banks are bidding up to record highs in the most regressive wealth transfer of all time. Rising political volatility suggests the people are catching on; even an ignorant bigot knows that negative interest rates make no sense.

Workers become more productive when others invest in tools and ideas to provide better goods and services. Better products translate to higher sales which lead to rising income for the workers producing them. That leads to peace and prosperity. When better ideas do not get funded, sales do not grow and incomes do not rise. When people make less and less year after year we should expect, and indeed hope for, political volatility. The ruling class uses "uncertainty" caused by the volatility as an excuse to tighten their grip on power, as if the future is ever certain, and the situation worsens. Brexit is symptomatic of a broader worldwide phenomenon that was also on display last month in Italy where the populist Five Star Movement, led by a comedian, won nineteen out of twenty municipal elections. They could take over the government in national elections scheduled for later this year. Two days after the Brexit vote, there was a similar overturning of the established political order in Iceland where a political novice opposed to EU membership defeated the president of twenty years. Populist revolts are exciting but do not always work out well. The Middle East has become more oppressive since the Arab Spring and the situation in Venezuela mentioned last quarter has become almost apocalyptic. Heavily armed food trucks are routinely hijacked and looted by hungry mobs. Last week, the Socialist government seized Kimberly-Clark's toilet paper and diaper factory that the company had been unable to operate.

Economists expected negative rates to spur investment, instead companies have used the free money to buy back stock to hide their shrinking businesses. Not enough though as the weakening sales and earnings trends discussed last quarter continued to deteriorate. Second quarter earnings per share for the S&P 500 are expected to report the seventh consecutive year over year decline and sixth consecutive for blended top line sales. Such a trend is unprecedented without a recession occurring so we continue to keep a defensive posture in our portfolios. Despite rallying to new highs, the market is appearing more defensive too. In the Stepping Stones fully invested Equity ETF strategy, the second quarter brought healthy gains in the more defensive value, staples and utility funds and smaller gains in the more growth orientated semiconductor and China funds. The two areas of the globe currently pursuing the most extreme monetary policies returned the only losses in the quarter. Our Europe fund lost almost 4% and our currency hedged Japan fund declined more than 10%. Each respective central bank has answered the conundrum by pushing interest rates further into negative territory, because it is obviously working so well. The best performers in the quarter were our long beleaguered but now rebounding energy positions and the standout gainer was the gold miners fund rising almost 40% as the gold market is finally recognizing the radical monetary policies sweeping the planet. The strategy gained 9.76% for the second quarter and 17.24% for the first half compared to the S&P 500's six month return of 2.69%.

The future is uncertain for sure as America's populist celebrity candidate barnstorms the country with a campaign unlike any we have ever seen opposing the establishment's candidate promising an experienced hand on the levers of power in our volatile world. The ruling class will do whatever they can to maintain the status quo so markets do not expect any more Fed rate hikes between now and Election Day. That has driven the S&P 500 to its first new high in thirteen months but earnings are not confirming the rally. Rather, it has more likely resulted from foreign central banks purchasing US stocks and other correlated financial assets. It is getting harder for the economic science to endorse these policies and if academia doesn't put an end to it, the people will. We don't fear government of the people, by the people, and for the people but hope for a return to faith in markets rather than central planners. Hope is not an investment strategy but we are averse to buying into a declining earnings environment and are maintaining our cash positions. If the populists continue to win, the establishment could use their power to discredit them by causing so much pain that the electorate never looks their way again. Maybe ZIRP and NIRP will only end if Donald Trump gets in the Oval Office.

Everyone knew the dot com stocks of the late nineties were grossly overvalued. Similarly, we all expected that people flipping McMansions were in for pain before the last crash. There was no way to know when or how badly either would end but nobody was surprised when they did, evaporating years of gains. Any reasonable analysis today will conclude that government bonds and virtually all debt is valued unreasonably. The Federal Reserve has abandoned the data on which they claimed to depend in favor of subjective concepts like "uncertainty" while they continue to say interest rate normalization is forthcoming. It is taking longer than expected but we think it will coincide with the next financial disruption and the next great buying opportunity. And we think the establishment is getting ready for that too.

Until then and as always, thank you for your trust and thank you for your business.

Yours truly,

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