STEPPING STONES MANAGEMENT, LLC

Fourth Quarter 2016 Commentary

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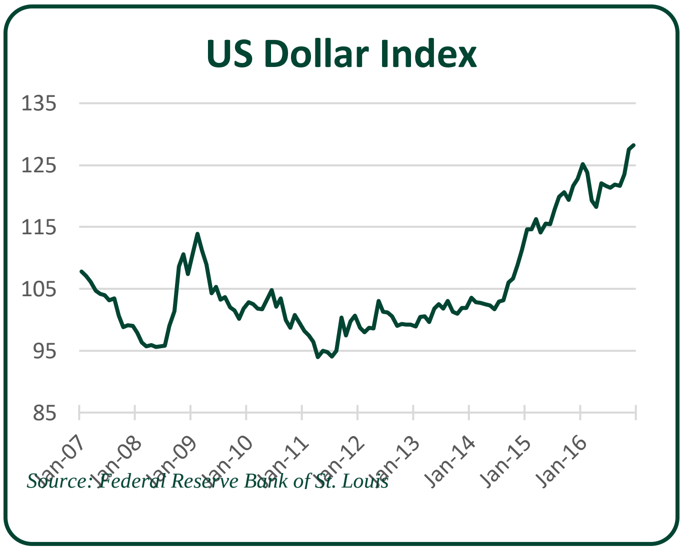
If the Seven Wonders of the Ancient World were not limited to the Mediterranean region, the Great Wall of China would likely make the list. The one that made later lists was mostly built in and after the 14th century but prior walls were built as far back as 200 BC. Defending against Mongol raids was the most obvious purpose but trade and immigration control were also reasons why the Han Dynasty built the early earthen barriers so that workers and goods were accounted for and taxed. Silk, spices and the rest of Asia's finest products travelled along the Silk Road from China through today's Kazakhstan ultimately reaching Europe to trade with their Mediterranean counterparts. Roman glassware has been found in tombs of Chinese kings who ruled the ancient world's largest economy.

Trade played a major role in the development of ancient civilizations and the economic and political relations between continents. The term Silk Road came to represent other trade routes over water as well as the original land route. Fast-forward a couple of millennia to the forthcoming new Great Wall along America's southern border promised to better control our trade and immigration. It is also promised to have a big beautiful door to let in goods and guests; and of course Mexico is going to pay for it. President Trump likes to remind us that he knows how to build things and he has redrawn enough city skylines to back up his boast. Trade was a focus of his campaign and particular targets of the new Administration have been China and manufacturers selling Mexican made products into the US market. Several companies are taking him seriously enough to announce plans to relocate manufacturing inside the new Great Wall. The stock market has inferred the anecdotes to represent a new trend of blossoming US economic growth that will drive earnings into already lofty corporate valuations. The surprising Trump election was followed by an equally surprising rally that drove the S&P 500 to a 3.25% quarterly rise closing 2016 in record territory with a 9.54% annual gain.

Trump Effect

In the first presidential debate we heard candidate Trump make one of his most important and least covered points. He mentioned that since NAFTA partners Canada and Mexico both have Value Added Taxes (VATs), our goods face an effective import duty of approximately 16% while their goods come into the US tax free. A solution that comes in various forms is a border adjustment tax. The US House of Representatives is discussing a plan that would exclude the cost of imports from being expensed and exempt exports from taxation. This would incentivize domestic manufactures to use American components in their finished products and generate enough revenue to build America's Great Wall. The eminent Harvard economics professor, Martin Feldstein observes that this would give the US the benefit that other countries get from a VAT without having to impose any import duties. He and other economists agree that one effect of such a plan would be a higher value for the US dollar.

At the newly established 20% corporate tax rate, exports will be 20% cheaper to produce while imported products will become 20% more expensive. Cheaper exports would be expected to rise while more expensive imports would decline which would drive the value of the dollar higher. Our appreciated currency would counter those trends so that net exports might not change too much but the United States Treasury would take in over $100 billion annually. That revenue would not be collected from the foreign producers directly but the higher import prices would have the same effect as an import tariff.



The accompanying chart of the Federal Reserve's trade weighted dollar index shows the market may have already factored in passage of the new plan with the dollar reaching its highest value in more than a decade. The appreciation against the Chinese Yuan has been even more pronounced which is fueling tensions along with the new Administration's strident rhetoric. These letters have consistently extolled the virtues of a strong dollar and the healthy economic growth that has historically correlated with such times, but corporate America generally holds an opposing view.

A stronger dollar means that a given profit overseas translates to lower US earnings. Combine that with the higher price for US products and even those earnings are jeopardized. That explains why the world's major central banks have been furiously expanding their money supplies to devalue their currencies. President Trump likes to criticize China's monetary policy which is simply the same as the US Federal Reserve's and their counterparts around the developed world. The result has been suppressed savings rates, slow growth and lower incomes which have fed the populist movements that these letters have highlighted over recent quarters.

Domestic manufacturers with significant exports have told investors that the border adjustment tax should be beneficial while retailers and clothing manufactures who sell mostly imported products have warned that earnings would be hurt. Manufacturers of domestic products made with imported components have also issued warnings. They will be incentivized to source components made by US workers. The perverse incentives for companies to relocate overseas will also be eliminated as will the incentive to keep foreign earnings overseas. The repatriation of foreign profits alone could fund meaningful economic growth in coming years without any cost to taxpayers. There is widespread agreement on the inefficiencies of the US corporate tax code, so reform is high on the new agenda.

The "Trump Effect" impacted the Stepping Stones fully invested equity ETF strategy in a number of ways. The China position was among the more negatively impacted by both declines in the domestic market and the currency. It was a different story across an increasing volatile Sea of Japan where our currency hedged Japanese position was the quarter's top performer gaining almost 17%. The strong dollar dealt a harsh blow to the gold miners fund losing 20% in the quarter but still in an uptrend off its lows from a year ago and up nicely to begin this year. Expectations of economic growth left the consumer staples fund behind, rounding out the portfolio's third quarterly loser. Our large cap European and US value funds managed market like gains while accelerating economic growth was signaled with the semiconductor and two energy funds all gaining around 8%. That growth tailwind offset the high rate headwind facing the utilities fund which was flat in the quarter. Altogether, the portfolio trailed the S&P 500 and All World indices with a quarterly decline of -2.8% but handily outperformed both benchmarks with an annual price gain 17% for 2016.

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While the decline in US manufacturing has correlated with the expansion of international trade, these letters have been reluctant to blame the current stagnation on globalization. Freer trade should enable employers to more easily source their supplies and reallocate funds to expand domestic operations, as witnessed in the 1990s expansion. When US manufacturers move production to another country it is not only because of lower wages but because of a lower overall cost of production, with other factors playing increasingly large roles. The ever expanding government bureaucracy has dripped on employers for decades to where small businesses are drowning in a swamp of compliance costs. Those rules have often been implemented at the behest of powerful special interests paying politicians to protect their companies from competition. Large companies can easily deal with the regulations that overwhelm their smaller rivals. It is why another principal promise of the Trump Administration is to "Drain The Swamp."

If you have spent time on Manhattan's Upper East Side in the last 25 years you may have enjoyed a meal at China Fun, a large brightly lit Chinese restaurant that stayed open late, until recently. The area's diners have to find a new place for dumplings as the restaurant closed its doors at year-end citing the overwhelming compliance costs of running a restaurant in New York City. The owner complained that "In a one-restaurant operation like ours, you're spending more time on paperwork than you are trying to run your business." Increases in the minimum wage and health insurance were among a list of issues posted for the restaurant's disappointed clientele. Mayor deBlasio's administration countered that their "Small Business First" initiative is set up to help owners navigate compliance issues. They don't realize that the need for such an initiative is the problem. Our October 2014 letter mentioned CKE Restaurants CEO and incoming Labor Secretary Andrew Puzder saying he can open a Carl's Jr restaurant in Shanghai in a fraction of the time it takes to open one in Las Angeles. He and other pro-market cabinet secretaries have been charged with lifting the boot of government off the neck of the economy so that America can be a great place to conduct business again. Not wasting any time, President Trump's first executive action was a government wide regulatory freeze.

Rising health care costs have been among the problems vexing employers for decades. The historic legislation passed in 2010 has not resulted in lower costs for most and quality has suffered despite higher prices. In addition to corporate tax reform, we can expect this issue to be front and center in the Trump Administration promising to repeal and replace the law early in the term. Repeal is said to be the easy part. There have been plenty of replacement bills passed in recent years that can be models for reform, although it is easy for politicians to support bills that have no chance of passing. Now that reform is likely to be signed, those votes will become more difficult as the vested interests fight to maintain their subsidies and regulatory advantages. The health care providers who endorsed Obamacare will likely oppose any bill that takes away their benefits and mandates. Much of the swamp that President Trump wants to drain runs through the health care financing complex.

The stock market assumes it will be easy to make America great again seeing the government regulatory pendulum swinging back to Reagan era levels. Regulatory relief is the low hanging fruit but other reforms may not go as smoothly. We should remember the Reagan boom came only after a painful recession in that Administration's early years as the Fed raised interest rates to fight inflation. Today's Fed looks ready to finally normalize interest rates that have been suppressed for nine years. We see no reason to expect their historically unprecedented policy to be easily unwound. Routine interest rate cycles tend to be troublesome on the way up and this one is anything but routine.

Fixing the interest rate problem will bring on new problems as corporate America has binged on low cost debt to mask declining businesses. As the cost of that debt rises, profit margins will shrink. Much of the stated Trump agenda will result in higher prices which will give the Fed reason for more aggressive rate hikes. Higher rates will also drive up the value of the US dollar acting as another headwind against corporate profits. The world will be better off when interest rates are normalized but the process will be difficult. We have to hope that regulatory reform will be a powerful enough growth force to offset the headwinds coming from higher interest rates and import prices.

With notable exceptions, Americans appear optimistic about the Trump Administration, especially small business owners. Several cabinet designees signal it will be pro-market and business friendly which most likely accounts for the impressive stock market rally since Election Day. The strong dollar also suggests optimism among foreign investors and could lead to greater investment in our economy. The new Administration has also appointed some strident China hawks who complain about currency manipulation over there but not at our own Fed. President Trump has decried our lopsided trade deals but our partners probably disagree so the propensity for problems is heightened while the stock market is complacent. The risk arising from a combination of high valuations and policy disruption is enough for us to maintain cash balances awaiting a better buying opportunity. Chinese President Xi told the Davos elites last week that "pursuing protectionism is just like locking oneself in a dark room. Wind and rain may be kept outside but so are light and air."

The sections of China's Great Wall familiar to us were built during the Ming and Qing dynasties that ruled China from the 14th to early 20th centuries. During that time the once great world power became insular and impoverished. It was only after China reentered the world trading community that its economy began to grow to where it is among the world's largest again. If President Trump's Great Wall becomes a symbol of insularity for the US economy then we should expect similar decline. However, if it becomes a symbol of America's newfound respect for law and order and more balanced trade policy, then our new president might be able to make America great again. As his "hour of action" has arrived, we wish President Trump success and are even willing to withstand an overdue recession on the way there.

In the meantime, please feel free to 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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