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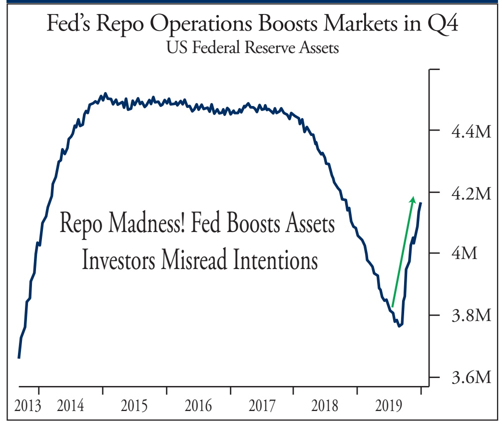
Repo Madness – Fed Actions Cause a "Melt-Up" in Equities

"Those who want to get rich fall into temptation and a trap and into many foolish and harmful desires." 1 Tim 6:9

Chart 1



Source: US Federal Reserve Bank

The financial markets act crazy at times. 2018 ended badly with the market melting down over fears of a Fed induced recession that was not yet a realistic possibility. 2019, however, veered in exactly the opposite direction with the market closing out the year by melting-up (Table 1) even as the odds of a recession remained elevated. The rapid advance in share prices in the fourth quarter came on the back of the Fed sharply boosting its balance sheet (Chart 1) via injecting liquidity into banks in something referred to as a "repo" transaction. A repo transaction involves the Fed purchasing Treasury Bills from banks with the bank taking on the obligation to repurchase those T-Bills from the Fed after a short period of time. The goal of this is to provide the banks with short term cash to help meet unusual spikes in their customer's temporary liquidity needs. Any direct connection between the Fed engaging in repo transactions to provide short term liquidity for banks and rising share prices, however, is tenuous at best. Indeed the market should have been more concerned about why and how the banking system had reached this point where it needed this substantial temporary liquidity boost. The onset of this liquidity crisis at the banks was sudden and unexpected. Traders assumed, incorrectly in both our and even the Fed's own view, the Fed's response was some sort of new backdoor quantitative easing effort by the Fed. They rushed to buy stocks thinking the Fed's real goal was to once again use their considerable power in the markets to artificially boost financial asset prices, thereby complementing their earlier three rate cuts which the Fed deemed necessary to hold off the rising recession threat. In our view, the resulting advance in share prices was the market indulging in yet another bout of market madness, a bookend to the big sell-off at the end of 2018. With the market surging on what amounts to fake news, sensibly managing money is an increasingly difficult proposition. The financial markets are always a bit crazy, even in the best of times, but the manic swings over the last 15 months - based on few real facts - have been more extreme than normal.

Table 1

4Q19 Total Returns

US Indices	4Q19	YTD	5y Ann
S&P 500	9.1%	31.5%	11.4%
S&P 500 Value	9.9%	31.9%	10.2%
S&P 500 Growth	8.3%	31.1%	12.3%
NASDAQ	12.5%	36.7%	13.4%
S&P 400 (Mid Cap)	7.1%	26.2%	9.5%
S&P 600 (Small Cap)	8.2%	22.8%	10.0%
Treasury Bonds	-0.8%	6.9%	2.2%
High Grade Corp. Bonds	1.2%	14.5%	4.7%
High Yield Corp. Bonds	2.6%	14.3%	7.1%
Gold	3.0%	18.3%	7.4%
Global & International Indices			
MSCI World	8.6%	27.7%	8.9%
MSCI EAFE	8.2%	22.0%	5.8%
MSCI Euro	7.9%	22.9%	5.7%
MSCI Far East	7.6%	18.2%	6.0%
MSCI China	7.6%	19.6%	5.8%
MSCI Japan	14.7%	23.5%	9.3%
MSCI Emerging Markets	11.8%	18.4%	9.1%
US Economic Sectors			
Energy	5.5%	11.8%	2.9%
Materials	6.4%	24.6%	9.0%
Industrials	5.5%	29.4%	10.0%
Consumer Discretionary	4.5%	27.9%	11.0%
Consumer Staples	3.5%	27.6%	6.9%
Health Care	14.4%	20.8%	8.9%
Financials	10.5%	32.1%	11.5%
Information Technology	14.4%	50.3%	18.8%
Telecom	9.0%	32.7%	7.2%
Utilities	0.8%	26.3%	11.4%

Source: Bloomberg

Following the huge sell-off in the markets in the fourth quarter of 2018 on fake recession fears, the market quickly returned to its senses in early 2019. Share prices rose rapidly in the year's first quarter, and into the second quarter as well, helped by the Fed communicating a more dovish tone to the markets. In May, however, the potential for an actual recession was no longer fake news but a real and growing threat, causing a sell-off in share prices. The Fed then began communicating an even more dovish stance in June and eventually cut interest rates three times in the ensuing four months. Still the threat of a recession lingered and the market moved sideward during the summer months as it warily viewed incoming economic data for evidence of weakness. Once the Fed's balance sheet started growing rapidly again, reversing the previous "quantitative squeezing" policy that was slowly and systematically unwinding the huge asset growth seen during the Fed's multiple quantitative easing efforts in earlier years, the market took off higher as traders figured the Fed once again was taking risk away and there were only returns to be enjoyed. While we do not believe this was an accurate understanding of what the Fed was doing, it nevertheless became a self-fulfilling prophecy as stocks surged higher even as economic performance remained sketchy.

The market's big fourth quarter advance on the back of this misinterpretation has no firm foundation and is therefore at risk of a quick reversal. Earnings growth in 2019 was minimal and earnings actually fell year-over-year in the third quarter and may fall again in the fourth quarter. As a result, most of the advance in share prices occurred on the back of widening valuations given the skimpy growth in actual earnings. With valuations now at stretched levels and sentiment indicators highlighting the market is in "greed" mode, risk of a sell-off is quite high. Moreover, the recent developments with Iran highlight how the market could quickly face risks it was not anticipating. The risk of a sudden downturn in equities is high.

While Stewardship Partners navigated the first nine months of 2019 reasonably well, our defensive posture cost us in the fourth quarter as the market melted-up in what we view as a mistaken investor response to the Fed's repo operations. Additionally, while many of our holdings did very well in 2019, the poor performance of some larger holdings hurt our overall performance. These trends are at extreme levels and could easily reverse in 2020 to our clients' benefit.

Economic Growth Remains Fragile

"What they trust in is fragile; what they rely on is a spider's web." Job 8:14

The purpose of quantitative easing was to use the Fed's immense capabilities to manipulate asset prices higher, thereby creating both financial wealth and confidence among consumers so they would in turn drive economic activity higher. This innovative effort by the Fed in the post-Great Recession years was largely successful and helped eliminate the risk of a painful deflationary spiral in both the US and the global economy. With many traders incorrectly interpreting the Fed's recent repo operations as a kind of backdoor quantitative easing, share prices have again risen. The Fed itself has tried to communicate the repo operations are not quantitative easing but investors have ignored them. While it may be too early to evaluate the benefits to the real economy, thus far there is little evidence the asset growth from the Fed's repo operations has supported economic growth. As seen in Chart 2, the index of Leading Economic Indicators, when share prices are removed from the index, has been heading lower for some time and recently moved into negative territory. Thus, components of the index which measure actual economic activity are weakening and may be signaling a looming recession. Many models which predict future recessions also incorporate share prices as equities have historically been a good leading indicator of economic weakness. But when the Fed, either intentionally or simply because traders are misinterpreting their intentions, is manipulating share prices higher, the signals given off by recession prediction models which incorporate share prices and other data series like the Leading Economic Indicators may prove to underestimate the actual risk of recession.

Chart 2

Leading Indicator Index Weakening

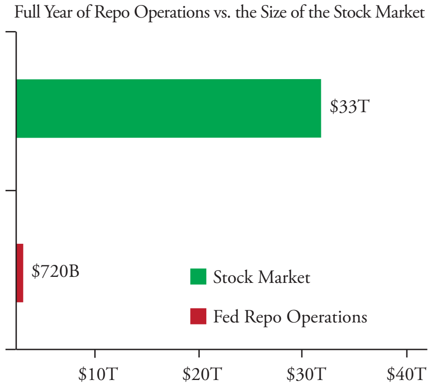
Leading Economic Indicators Excluding the S&P 500

Source: Haver Analytics, Rosenberg Research

Chart 3

Fed's Repo Operations are Actually Quite Tiny

Full Year of Repo Operations vs. the Size of the Stock Market



Source: Charles Hugh Smith, www.oftwominds.com

Moreover, the Fed's repo activities, even if continued for a year (they are supposed to end in April 2020 and the banking industry's need for the liquidity injections has already fallen off a great deal since the start of the program), are tiny relative to the huge size of the stock market as portrayed in Chart 3. To the extent the Fed is attempting to manipulate share prices higher with its repo program (we doubt this is the case), it can really only be successful in doing so if lemming-like stock traders take the bait and create a broader buying spree of stocks. To a certain extent, the Fed could be accused of acting much like the Wizard of Oz and there really is not much of substance behind their curtain. Because of the Fed's previous success with quantitative easing, traders - perhaps incorrectly - have rushed to get fully invested when the actual data on economic activity does not justify such a favorable reaction.

The principal weakness in the US and global economy at the moment is in the manufacturing sector. Chart 4 highlights the continued and deepening weakness in this sector of the US economy, despite the Fed's three rate cuts and its perhaps unintended, back-door quantitative easing through its repo operations. The most recent data for December 2019 actually indicates acceleration to the downside and this measure has now reached the lowest level since the Great Recession. While manufacturing is not a large component of the overall US economy, weakness in this area can trigger job losses and knock-on negative impacts throughout the rest of the US economy. Overseas, however, manufacturing appears to be finally recovering but remains weak overall.

Chart 4

Manufacturing is Weakening and Already in a Recession

US ISM Manufacturing Production Index

Source: Bloomberg

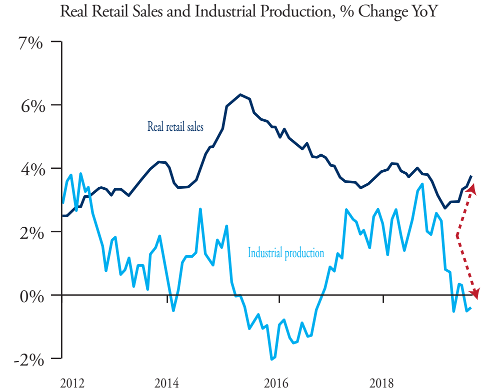
Of course the largest part of US economic growth comes from the consumer sector. With unemployment still at historically low levels, the average consumer remains in a very good spot. Wages, particularly for lower skilled workers, are rising rapidly and consumer debt levels have not gotten as extended as they were just prior to Great Recession. As revealed in Chart 5, retail sales, an indicator of the health of the consumer sector of the economy, have been rising recently even as Industrial production continues to falter. Hopefully, the consumer sector will pull the manufacturing sector out of its downtrend before the opposite occurs. We hope this will be what happens but these trends bear watching. Some early indicators are suggesting the consumer sector may weaken.

Chart 5

How Will This be Resolved?

Will Consumers Pull the Industrial Sector Out of Recession, or Vice Versa

Real Retail Sales and Industrial Production, % Change YoY



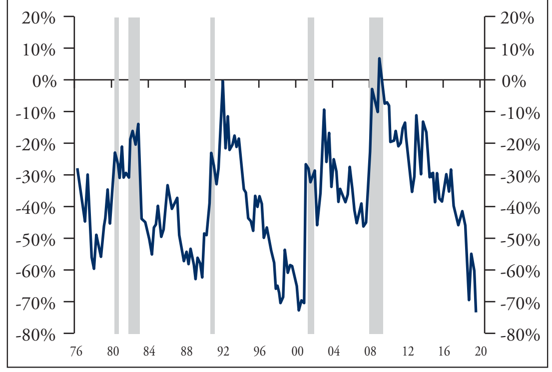
Source: The Capital Group

Consumers, however, often tend to be relatively unaware of clouds growing on the economic horizon and do not adequately prepare for the potential of a recession. Businesses, however, are acutely aware of the weakening trends and often are better at preparing for future economic problems, often by laying off employees. As can be seen in Chart 6, the expectations of CEO's are far less than the average consumers. Indeed, this measure has retreated all the way back to the level seen during the internet bubble at the turn of the century and well below the readings seen before prior recessions. Perhaps the rosier outlook of the average consumer will ultimately cheer up the average CEO, but the trend and the historical record of predicting a future recession should cause investors to reflect on the growing evidence of recessionary conditions.

Chart 6

Record High Discrepancy Between Corperate Confidence and Consumer Confidence

CEO Expectations MINUS Consumer Expectations



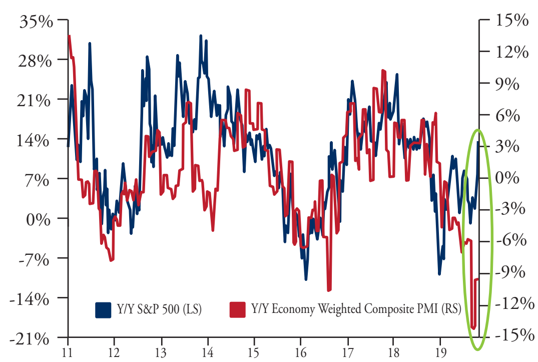
Source: The Conference Board, Haver Analytics, DB Global Research

Investors apparently share the views of consumers more than the CEO's they should be listening to as they have gleefully ignored the weak manufacturing sector trends as they have bid up share prices. As shown in Chart 7, it is not typical that the S&P 500 rises in the face of weakness in the PMI Index. It should not take too much longer to find out who is correct, investors showing optimism a rebound in manufacturing activity is at hand or the CEO's who are expressing a greater degree of pessimism as these two trends cannot diverge for long. The PMI index also is tightly correlated with corporate earnings. Corporate earnings in 2020 are already expected to grow quite slowly. Should expectations for even that feeble earnings growth start to diminish, the correction in share prices could be nasty as stock prices are discounting a lot of unjustified optimism already.

Chart 7

Equities Break from Normal Relationship with PMI

How will this Difference be Resolved?



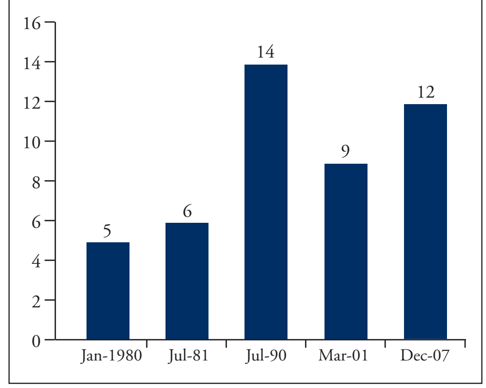
Source: Bloomberg, Morgan Stanley Research

We might already be in a recession and not even know it yet. Typically, the start to a recession is determined months after it actually began. Chart 8 indicates the length of time between when a recession begins and when the National Bureau of Economic Research (NBER) finally figures it out can be between 4 and 14 months. Normally, the stock market understands we are in a recession well before the NBER does. With the Fed repo operations being viewed as backdoor quantitative easing by many investors, however, the stock market may not be as accurate as in the past at sensing the onset of a recession. While we do not believe a recession has already started, it is worth noting auto sales are faltering, unemployment claims are finally beginning to rise and signs of distress among debt holders is beginning to grow. Moreover, outside the US, many countries, including China, may already be in recession. Chinese auto sales have fallen sharply over the last two years which normally is associated with a recession. Europe's economy, while showing some signs of life on the margin, remains moribund. The risk of recession should not be ignored.

Chart 8

Economists are Always Late in Calling Recessions

Months Between Recession Start and NBER Announcement



Source: TS Lombard

The Debt Threat to Economic Growth

"Let no debt remain outstanding, except the continuing debt to love one another…" Romans 13:8a

During the middle of the fourth quarter, real-time GNP trackers published by various Federal Reserve banks were indicating economic growth was likely to fall below 1%. Such a low level of growth would have put the US on the cusp of recessionary growth levels. With the end of the General Motors strike, however, economic data jumped somewhat towards the end of the quarter and those same trackers now indicate fourth quarter GNP growth will come in closer to 2%, still a low level but far less concerning than what seemed likely in late November. For the moment, and despite some early worrisome trends, a recession has likely been postponed. One will eventually occur but it is nearly impossible to know exactly when. As noted above, we will likely only realize a recession has started after it has already begun.

Chart 9

Corporate Debt at Levels Seen Prior to Past Recessions

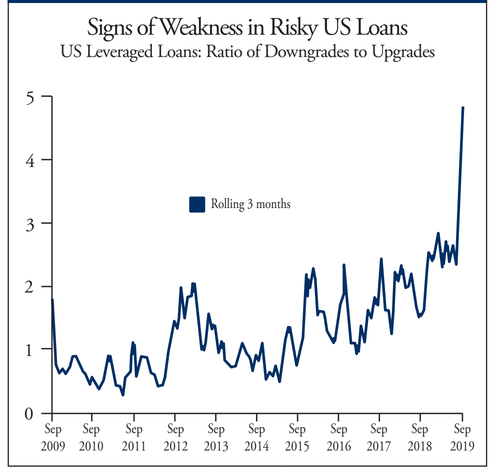
US Corperate Debt to GDP Ratio

Source: Haver Analytics

The record long expansion the US economy has enjoyed, coupled with ultra-low interest rates, has led to some troublesome economic excesses being built up in the US economy.

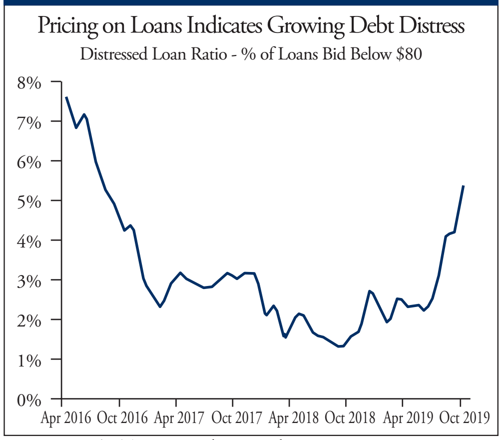
Notable among these is the growth in corporate indebtedness, as seen in Chart 9. When corporate debts reached this level of GNP in the past, a recession was not far behind. Additionally, corporate profit margins have been falling lately, which should make CEO's increasingly uncomfortable with their higher than normal debt load. In response, the average company management team is likely to make debt reduction a higher short term priority than expansion. This can lead to job cuts and reduced spending on items meant to expand the company's operations. That, in turn, triggers slower growth throughout the economic system. Naturally, the most indebted companies are the first to feel the pinch and, in some cases, this difficult corrective process will lead to bankruptcies. Already, there appears to be a growing threat of bankruptcy in certain overbuilt and over-levered sectors of the energy industry. Moreover, due to the unusually low interest rates, some weak companies across various industrial sectors gorged on debt. Recently, these companies have increasingly been becoming distressed leading to a rapid increase in the number of such companies facing crippling rating downgrades (Chart 10). The resulting retrenchment among these companies and the banks taking losses on their loans could help spark a recession. Fortunately, debt ratings on higher quality companies have been improving, so this problem should be contained to those highly indebted companies.

Chart 10



Source: S&P/LSTA Leveraged Loan Index

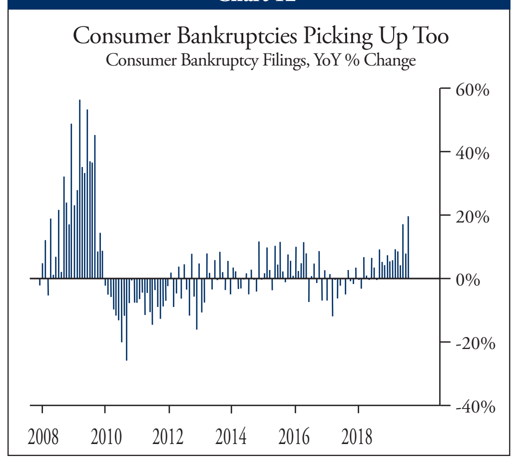
Chart 11



Source: S&P/LSTA Leveraged Loan Index

Not surprisingly, these falling debt ratings are being reflected in the price leveraged loans are traded at in the financial markets. Chart 11 indicates investors in highly leveraged loans have become much more cautious in 2019 as the cycle has clearly turned for these risky loans. As this cycle follows what likely will be the inevitable path towards an ultimate wash-out of the poorest performers, scary headlines will get more frequent and investor confidence will be dented. At the moment, however, we suspect the damage will be limited to the most risky loans and a broader meltdown in credit will be avoided. But we will be monitoring these trends closely to see if a broader problem with the high level of corporate debt is developing as this could easily occur if the economy slows towards recessionary levels, thereby compounding the decline in economic growth.

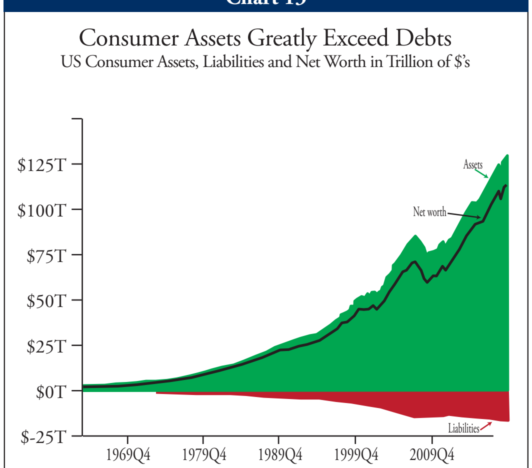
Chart 12



Source: OSB, Bloomberg

While corporations have taken on more credit risk than we would prefer in recent years, the situation with regard to consumers has been less alarming. Following the mortgage and credit card crisis that led to the Great Recession, banks have been much more disciplined in providing credit. As a result, the average consumer is actually in much better financial shape than at the end of the last credit cycle, despite the extended economic cycle that would typically result in a greater proportion of the consumer sector representing high risk of default. Even so, however, there are always some people who manage to get themselves too heavily indebted during periods of extended economic growth. Chart 12 describes the increasing occurrence of consumer insolvencies in recent months. While still well below the levels seen during the worst of the Great Recession, the recent trend is disconcerting and is one we will be watching closely.

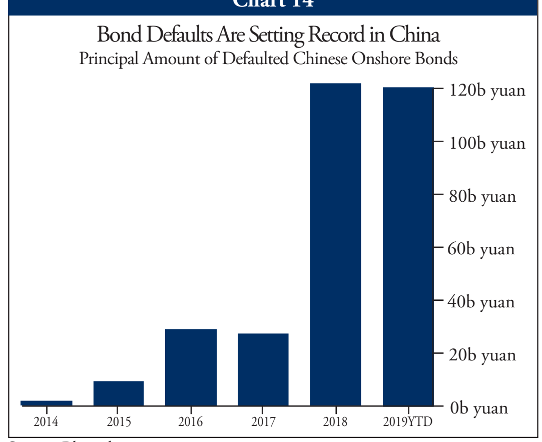
Chart 13



Source: Federal Reserve and Michael Shedlock

As long as unemployment remains low in the US, most consumers should be able to relatively easily service their debts. Should we begin to see the unemployment rate tick higher, however, then we should expect to see the trend towards higher consumer insolvencies accelerate. Nevertheless, it should take some time before this trend accelerated to a point where it became destabilizing to the overall economy. While there are always going to be some undisciplined consumers who cannot manage their finances well and others who just get unlucky by losing their job and are unable to repay their loans, on average, consumers have far more assets than liabilities (Chart 13). Accordingly, this should help limit any damage to the overall economy from a souring of consumer debt. The greater risk to economic growth from excessive debt levels comes more from the corporate side of the economy.

Chart 14



Source: Bloomberg

Beyond the US, the biggest debt risk comes from China. China's debt growth has been huge and such rapid growth almost always ends badly. Moreover, the growth in debt in China is likely worse than the official statistics suggest. Corporate defaults have already risen to very high levels in China in the last two years (Chart 14) and the Chinese authorities admitted that 13% of their banks are at risk of failure. The greatest debt risk, therefore, comes from China where the possibility of a Great Recession is very real and could have global economic consequences.

The Market is Clearly Overheated

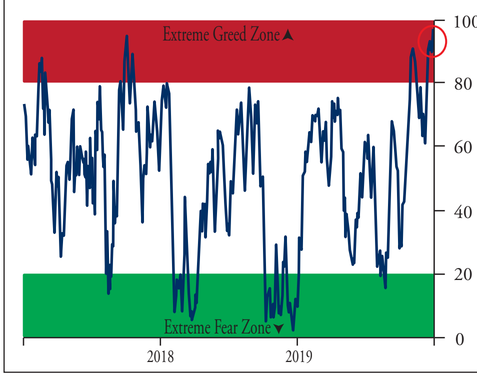
"Be sure you know the condition of your flocks, give careful attention to your herds" Proverbs 27:23

With equities surging higher in the fourth quarter market sentiment began to get frothy. No matter which measure of speculative activity you look at, virtually all are now painting a picture of a market that is unusually risky. Perhaps the best way to put it is the market has gone from a place of extreme greed to one of extremely, extreme greed as 2020 begins. Chart 15 indicates that on one measure of fear and greed, greed is now very close to its highest possible score. The investment risk the various measures of speculative activity are now highlighting is not a risk related to weak earnings, geopolitical risks or a possible recession but rather is simply indicating the market has gotten too exuberant in the short term. In cases like this, the market can suffer a short setback, or go sideward for a longer period of time, in order to alleviate the overbought condition, even if economic developments or Fed policies remain positive for the market. When bullish sentiment is running this hot, a cool down period is inevitable.

Chart 15

Investors are Currently Very Greedy

CNN Business Fear And Greed Index Reading Over Time

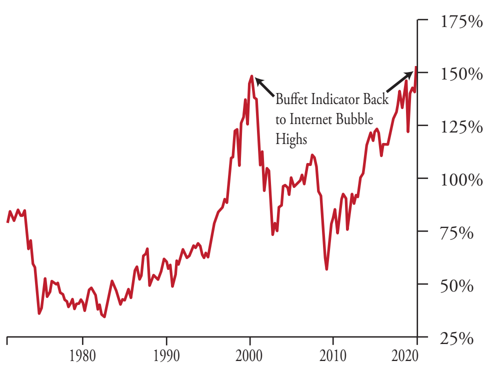


Source: CNN Business

Chart 16

Buffet Indicator is Signaling Caution

Total US Stock Market Cap Divided by US GDP



Source: Bloomberg

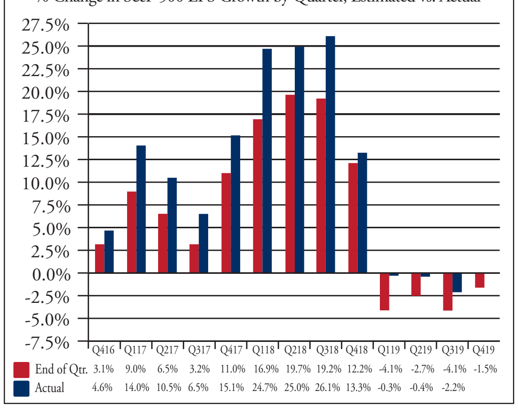
Valuation measures are also running higher than normal which presents additional risks for investors. While most measures relative to earnings, cash flow or book value are not yet near the insane levels seen during the internet bubble, the ratio of the total market capitalization of stocks to US GDP has again reached the internet bubble levels (Chart 16). This indicator is often referred to as the Buffett indicator as it is one of the investment legend's favorite ways of determining if stocks are too expensive. Not surprisingly, Buffett, like Stewardship Partners, has been building a stockpile of cash he clearly hopes to deploy more profitably once stocks falter from the current highly priced levels. Selling when others are manically buying is never easy, but it normally turns out to be the best course of action for investors with a long term orientation. It is near impossible to accurately call a top in the stock market but we can have a high degree of confidence we are currently in the vicinity of at least a temporary high in the market.

Chart 17

2019 S&P 500 Earnings Fell While Stocks Rose

The Foundation For Share Prices is Weak

% Change in S&P 500 EPS Growth by Quarter, Estimated vs. Actual



Source: Factset

Another cause for concern for investors has been the market's big advance in 2019 came on the back of weak earnings, as seen in Chart 17. When stock prices rise without any earnings support, the gain is entirely due to investors being willing to pay premium prices for earnings. That is not a firm foundation on which to build a long term rally in stock prices. As prudent money managers, we are always seeking to buy those shares offering the most compelling price in relationship to future earnings. In the current environment of higher than average valuations we are often finding the prices we need to pay are just too high to justify the investment. With the added uncertainty of potentially increased terrorism sponsored by Iran at this time, caution seems especially advisable.

Table 2

One-Third of the 2019 S&P 500 Return Came from Just 10 Stocks

Ticker	Company	Market Cap Weight: Dec-18	Market Cap Weight: Current	Total Return	Contribution to SPX Return
APPL	Apple Inc.	3.4%	4.6%	88%	**3.03%**
MSFT	Microsoft Corp.	3.8%	4.5%	57%	**2.17%**
FB	Facebook Inc.	1.5%	1.8%	57%	**.86%**
GOOGL	Alphabet Inc.	3.0%	3.0%	28%	**.86%**
JPM	JPMorgan Chase	1.6%	1.6%	46%	**.72%**
AMZN	Amazon.com Inc.	3.0%	2.9%	23%	**.69%**
BAC	Bank of America	1.1%	1.1%	46%	**.50%**
MA	Mastercard Inc.	0.8%	1.0%	59%	**.49%**
V	Visa Inc.	1.1%	1.2%	43%	**.48%**
T	AT&T Inc.	1.0%	1.1%	44%	**.44%**
Top 10 Contributors		20%	23%	50%	**10.23%**
S&P 500		100%	100%	31%	**31.49%**

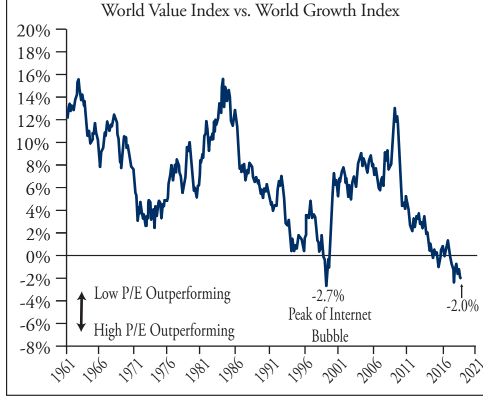
Source: Factset and Goldman Sachs Global Investment Research

Another development that causes us concern is the concentration of returns seen in 2019 in relatively few stocks. As shown in Table 2, just ten of the S&P 500's largest companies accounted for almost one-third of the indices rise during the year. Additionally, just the top five most heavily weighted companies in the S&P 500 now account for nearly 17% of the indices value, roughly the same level seen during the internet bubble. When investors start plowing more and more money into the same limited number of stocks as they are currently, it is a sure sign the market is near a high point.

Chart 18

Value Stocks Seem Overdue for a Rebound vs. Growth Stocks

World Value Index vs. World Growth Index



Source: Ken French Database

Furthermore, value stocks have been underperforming growth stocks for a decade, a remarkably long period of underperformance. As a result, the cumulative underperformance of value stocks versus growth stocks has reached the same level as during the internet mania (Chart 18). Stewardship Partners typically favors value stocks and we suspect this relationship is finally close to turning in our favor.

Melt-Up in Share Prices Signals Rising Danger of a Correction

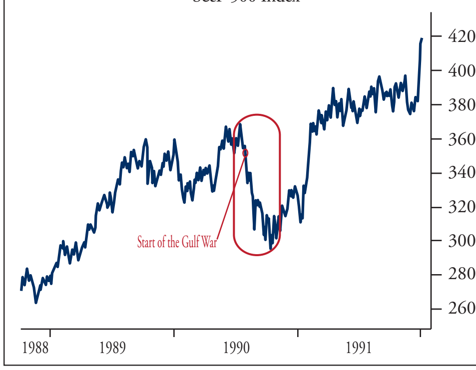
"In peace I will lie down and sleep, for you alone, Lord, make me dwell in safety." Psalm 4:8

The recent news of the assassination of Iran's leading military official erupted just as we started to write this Quarterly Commentary. While the situation initially appears to have de-escalated quickly due to President Trump's wise approach to Iran's "response", the whole episode is a good reminder for investors of just how fast the investment landscape could change in a radical and unexpected fashion. It appears a bad outcome for investors has been avoided, but that too could change quickly. Beyond concerns that would arise from a full blown war in the Middle East, especially at a time when all of the super powers are present in the region (and in view of end times biblical prophecies), higher oil prices that would likely result from such a conflict, or even a threat of conflict, could also push an already teetering global economy into a full blown recession. Moreover, even if war, higher oil prices or a recession were not the actual outcome, should President Trump be viewed by swing voters as having managed the Iranian situation badly, the market would likely take a tumble on his lowered chances for reelection. For now, however, it seems likely just the opposite has happened and President Trump is likely to have won over some voters with how he well handled this seemingly short-lived crisis. Of course, in the Middle East, the situation can change quickly so investors need to be ready to react rapidly. It is worth remembering the S&P 500 fell almost 20% in the run-up to the Gulf War in 1990 (Chart 19) based on the uncertainty over what might be the ramifications for investors from that war, even though the eventual outcome was benign for the markets.

Chart 19

Stocks Tumbled Nearly 20% as the US Prepared to Invade Iraq in 1990

S&P 500 Index



Source: Bloomberg

Table 3

Recession Risk Tops List of CEO Concerns

Top Ten Global Issues, and by How They Vary by Region, per a Servey of CEOs

External Issue	Global	USA	Europe	Lat. Am.	China	Japan
Recession Risk	1	1	1	2	1	2
Uncertainty About Global Trade	2	4	3	1	1	5
More Intense Competition	3	2	4	5	3	3
Global Political Instability	4	4	2	3	4	4
Tight Labor Market	5	3	6	10	8	1
More Demanding Customers	6	7	5	6	5	8
Cybersecurity	7	6	10	8	11	6
Less Trust in Political/Policy Institutions	8	8	7	7	8	12
Impact of Climate Change on Business	9	12	8	4	18	6
Tougher Regulatory Environment	10	9	11	11	7	10

Source: The Conference Board

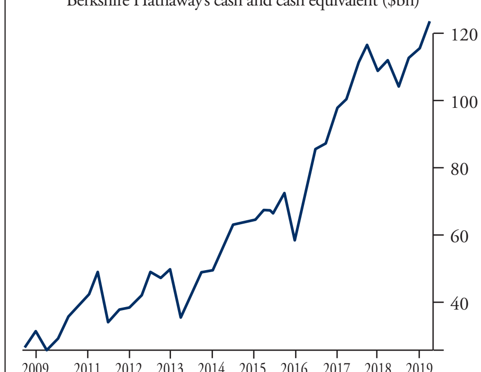
If indeed a potential war with Iran does stay out of the headlines in the months ahead, investors will likely return their focus to domestic matters. Recession risks as measured by some models have started to recede from very threatening levels, yet the risk of recession clearly remains. Table 3 highlights CEO's around the world still consider the risk of recession as their greatest concern. Moreover, a recent Federal Reserve report suggested that nine of the US's fifty states will be in a recession in the next 6 months. While the whole country may avoid a recession in the short term, many of the states the report predicts to fall into recession are ones President Trump is counting on to win the election in November. Should investors begin to believe President Trump will lose the election, there is a very good chance the stock market will be hit hard by those concerns.

We noted earlier the stock market indicator favored by legendary investor Warren Buffett is signaling the potential for a decline in share prices. And Mr. Buffett appears to be paying attention to that indicator. As shown in Chart 20, he has built the cash reserves of his company Berkshire Hathaway to a huge $124 billion, more than doubling his cash holdings in just the past three years as share prices increased. Like us, Buffett likes to buy equities when he can identify good long term value and that is quite difficult at the moment. Share prices as measured by a broader index such as the New York Stock Exchange Index, indicate equities are only about 2% above the level of January 2018. Meanwhile, some of the largest stocks in the S&P 500 and NASDAQ 100 have advanced a lot over that same period of time as the stock market became more concentrated, itself a sign of an impending top. At a minimum, the stock market seems primed for a correction (a drop of 10%) as so many short term market indicators are now very extended. Should the current melt-up in share prices go on much longer, then a full scale bear market (a 20% decline in equities) will likely hit investors before 2020 is completed.

Chart 20

Buffet is Holding Cash as Values Diminish

Berkshire Hathaway's cash and cash equivalent ($bn)



Source: Bloomberg

Stewardship Partners' portfolios are already positioned defensively both in terms of many of the shares we own and our much larger than normal cash positions. Nevertheless, we may choose to increase our defensive posture and could also begin to utilize hedges to help offset the rapidly rising risk of a sharp decline in share prices. Should the market continue to melt-up, we may try to be as clever as we can be and play along for a while, but we are very hesitant to engage in what is known as "the Greater Fool Theory" (which refers to the idea of foolishly buying shares now at too high a price on the assumption we will be able to sell them later at even higher prices to an even "greater fool" than ourselves). With the Fed's repo operations not really amounting to quantitative easing, we suspect the liquidity-fueled recent rally will run out of gas soon. Moreover, those repo operations are scheduled to end in April. At the same time, we well remember how the market stayed nutty for two and one-half years during the internet bubble.

We at Stewardship Partners continue to be grateful for the opportunity to serve your investment needs. Please do not hesitate to contact us if you have any questions or if we can be of assistance.

Biblically Responsible Investing (BRI) – Investing as Jesus Would

"Blessed are they that maintain justice, who constantly do what is right." Psalm 106:3

Stewardship Partners, founded in 2000, is a leader in the field of investing with a Christian perspective, a form of Socially Responsible Investing (SRI) known as Biblically Responsible Investing (BRI). Rusty Leonard, CFA, Stewardship Partners' founder and CEO, practiced this investment philosophy while managing over $3 billion of assets as a portfolio manager during his decade of service with the Templeton organization. He also had the privilege of working directly with world-renowned global mutual fund manager, Sir John Templeton. **By employing a BRI approach to investing, Stewardship Partners seeks to achieve long-term capital gains through ownership in securities of companies that are a blessing to mankind. Conversely, we seek to avoid profiting from owning companies engaged in sinful activities which bring physical and spiritual loss to our fellow man. Our heart's desire is to do no harm to our fellow man in the process of being the best possible guardians of the wealth the Lord has given us stewardship over.** Simply put, a "what would Jesus do" approach to portfolio management is what we seek for our clients.

Below are just some of the issues of concern to Stewardship Partners and the specific sinful activities that fall into each category:

1. **We desire <u>justice and mercy for the defenseless</u> so we seek to avoid companies involved in:**
   - Abortion
   - Life destroying or distorting scientific research
   - Human rights issues such as religious persecution, terrorism and political oppression

2. **We desire <u>justice and mercy for the poor</u> so we seek to avoid companies involved in:**
   - Greed-based marketing techniques
   - Discrimination and unjust labor practices
   - Any abuses of the poor, children and/or the elderly

3. **We have <u>compassion for those addicted to and/or engaged in sinful lifestyles</u> so we seek to avoid companies involved in:**
   - Alcohol, Gambling and Tobacco
   - Pornography
   - Homosexuality (those companies deemed to be the most active supporters)

4. **We desire to <u>protect marriage and the family</u> so we seek to avoid companies involved in:**
   - Entertainment that seeks to destroy biblically-based attitudes
   - Efforts to promote lifestyles the Bible indicates are sinful

Additionally, we favor companies that clearly embrace:

- Honesty, Compassion, Diligence, Prudence and Creativity
- Support for quality products at fair prices and constructive stakeholder relations
- Support for a sustainable and healthy environment
- Support for charitable giving
- Support for the Jewish people and the state of Israel

We obtain information on both the objectionable practices and the exemplary attributes of corporations from our affiliate **The Biblically Responsible Investing Institute** (BRII, www.BRIInstitute.com). We believe BRII gives Stewardship Partners the most comprehensive database of BRI information that currently exists and utilize much of it to realize our goal of investing in a manner that most honors our Lord. Equipped with this information, we are then prepared to make as strong an effort as possible to build investment portfolios which best reflect our clients' biblically-based Christian worldview.

Like all people, all companies are sinners. Therefore, we attempt to use the BRI information at our disposal to eliminate the worst offenders from our portfolios. At times, this is easy. For example, a company involved in making drugs used in the abortion process will always be excluded from our portfolios. In many cases, however, we need to utilize judgment, such as when a company has operations in a country that is a known violator of human rights. The type and size of that exposure, among other considerations, are taken into account before eliminating the company from our portfolios. When judgments must be made we are guided by the principal of trying to do what we believe Jesus would do if He were making the decision.

For a more in depth study of the topic of Biblically Responsible Investing (BRI), please see our paper entitled "The Scriptural Basis for Biblically Responsible Investing".

BRI in Action – Comparing Good and Bad Corporate Behavior

"Love must be sincere. Hate what is evil; cling to what is good." Romans 12:9

Below you will find an example of both a company exhibiting exemplary attributes, Realty Income, and ones we avoid, Boeing. Realty Income is a holding in some Stewardship Partners portfolios while we actively avoid ownership in Boeing to not be co-owners in enterprises engaged in, or supportive of, activities which are harmful to our fellow man and our Lord's creation.

We believe, in the long run, both countries and companies that best align their activities with biblical principles will achieve the greatest success.

The Good – Realty Income – Admirable Corporate Citizen

"Instruct them to do good, to be rich in good works, to be generous." 1 Timothy 6:18a

Realty Income, a Real Estate Investment Trust (REIT) based in San Diego, CA, was founded in 1969 by William and Joan Clark with the objective of providing a growing stream of monthly dividends to investors, a goal the company has successfully achieved now for over 50 years. Indeed, Realty Income has produced outstanding results for investors over that time with dividends growing at a compound annual rate of 4.5% annually and with total annualized returns of 16.8% since the company listed on the New York Stock Exchange in 1994. The company has increased its dividend 109 separate times since its listing on the New York Stock Exchange and has raised the dividend in each of the last 89 quarters. Since the company's founding, it has paid out a total $6.5 billion in dividends to investors. Realty Income operates over 5,900 properties in 49 US states, Puerto Rico and the United Kingdom. It counts among its tenants 274 different companies operating in 49 different industries. The buildings Realty Income leases to its tenants are typically freestanding structures with good customer access and visibility. Almost half of Realty Income's tenants have investment grade ratings and many are retail locations such as dollar stores, drug stores and convenience stores, all of which are recession resistant. Realty Income uses triple net leases, which places the burden of maintaining the property, paying insurance on the property and taxes on the tenant. Leases normally include a provision for raising the lease payments by 1% to 1.5% per year. Realty Income also maintains a conservative capital structure with roughly two-thirds of capital in the form of equity and one-third in the form of debt.

Realty Income has an impressive track record of business success, a fact which is no doubt related to the company's desire to operate in a highly ethical manner. The company put in place a comprehensive Code of Ethics which applies to all board members, company officers and all employees. The desire of company leadership is to always adhere to the highest standards of moral and ethical behavior. The company provides annual training for all employees regarding the Code of Ethics and each staff member is required to sign the Code of Ethics thereby acknowledging their commitment to follow the rules laid out therein. Realty Income maintains an anonymous whistleblower tip line which employees can use whenever they suspect something is ethically amiss within the company. This process is tested annually and the Audit Committee of the board of directors reviews its operation quarterly. Realty Income will not tolerate any form of retaliation against any employee who makes an allegation of suspected misconduct in good faith. The Code of Ethics covers a wide array of potential issues an employee might encounter, including conflict of interests, the need to maintain complete, accurate and reliable records, reporting to the public financial information in a timely and accurate manner, the need to keep privileged company information confidential, the avoidance of trading in the company's publically traded securities when in possession of material non-public information, always dealing fairly with those organizations the company interacts with in the course of its business and protecting company assets including electronic assets. Corporate gifts or donations to politicians or political parties with the intent to benefit the company are also prohibited.

Realty Income has over 190 employees and the average tenure at the company for those employees is six years, an indication of how well the company provides for its workers, particularly in the current red-hot job market. Realty Income provides health insurance coverage for their staff and their employee's dependents as well. The various health coverages include medical, dental and vision insurance. The company offers both Flexible Spending Accounts and Health Savings Account options. Moreover, Realty Income provides life insurance and disability insurance as well and staff can access supplemental life insurance as well. The company also provides mental health care for their workers. To assist their staff with the rigors of life, Realty Income also allows new mothers to bring their infants to work, offers a wellness program and also gives employees access to free on-site dry cleaning and car washes. Free lunches and snacks are also available to the company's staff. The company also grants attractive maternity and paternity leave programs, leave for family medical issues and military service leave. For workers who need to craft a creative schedule due to the needs of their family life, Realty Income will work to allow reduced or flexible hours to accommodate such needs. Longer term unpaid leave of absences can also be arranged if circumstances arise which require such an option for an employee. The company provides employee assistance programs to help with a variety of real life difficulties members of their team may encounter. This also includes legal assistance when necessary. Realty income also offers workers a variety of ways to take time off as necessary, including an allotment of sick days, paid vacation, eleven paid holidays, bereavement leave and time for employees to assist with a charity of their choice. Realty Income also has a program that avails employee's discounts on certain products and services and even sponsors a credit union employees can utilize for attractively priced financial services. From a compensation perspective, the company provides a competitive compensation package in line with its position as a leader in the REIT industry, including restricted stock plans and matched 401-k contributions.

While even a relatively large REIT like Realty Income is not an employee intensive business, both the company and its staff try to make a positive difference in their San Diego community via charitable efforts. The company views its charitable work as an extension of their mission to improve the lives of their workers, their families and the company's shareholders. Realty Income believes it is important for the company to be a responsible corporate citizen and take an active role in promoting the betterment of the community in which it operates. Accordingly, the company has a long partnership with Habitat for Humanity and they have also worked with at-risk youth, senior citizens, have funded local food banks and provided toys for underserved children. Realty Income staff have not only participated in construction projects for Habitat for Humanity but have also assembled playhouses for another charity called Head Start. Realty Income has a matching gift program for charitable donations its employees make and also offers a Dollar for Doers program where it provides funding to employees volunteering at local charities. The goals of Realty Income's charitable efforts are to strengthen its community and support it through education.

Realty Income's numerous good works are, of course, no guarantee of long-term investment success. As Biblically Responsible Investors, however, the company's commitment to being an exemplary corporate citizen as well as its outstanding treatment of its employees, allows us to know we are shareholders in a company seeking to be a blessing to all. While no company, like no person, is perfect, this is a company which seeks to benefit all those it comes into contact with and is an organization we can be proud to be part-owners of! Realty Income is one of the few companies in the S&P 500 with no violations of any kind recorded in our BRII database.

The Bad – Boeing – Putting Profits over Saftey

"Things that cause people to sin are bound to come, but woe to that person through who they come." Luke 17:1

Boeing has been in the news recently for very unfortunate reasons. Due to design flaws, of which the company was aware, to its recently rolled out 737-Max aircraft, hundreds of lives were lost as a result of two separate crashes. It has been widely reported that Boeing was pushing to get this new version of the 737 aircraft launched as quickly as possible because it had fallen behind a competing product produced by Airbus. The FAA also made the mistake of allowing Boeing itself to complete some of the final safety checks for the new aircraft. Investigators discovered that Boeing failed to properly analyze important safety data coming from re-engineered software that aided in the maneuvering of the aircraft. As a result, the 737 Max had a propensity to suddenly dive. Moreover, as was discovered in the second crash, the instructions Boeing gave pilots to deal with such situations failed to correct the problem. Additionally, Boeing did not make sure pilots received adequate training on the new version of the plane. Recently, Boeing has been coming clean with regard to internal communications at the company which raised further doubts about the company putting profits ahead of passenger safety. The board of directors recently fired Boeing's CEO in response to these revelations. While miniscule in relation to the unnecessary loss of life, Boeing has lost more than $10 billion as a result of the 737 Max debacle and its reputation has been severely tarnished. There is little doubt that the ultimate cost to Boeing and its shareholders will greatly exceed $10 billion.

We seek to avoid investing in companies like Boeing. As BRI investors seeking to please and honor our Lord, we naturally look elsewhere to achieve investment success as we do not want to be associated with a company using shareholder resources in a manner the Bible defines as sinful and which can have a negative impact on individuals and society in general.

Our Ultimate Goal – Funding the Lord's Work

"Therefore go and make disciples of all nations." Matthew 28:19a

It is our hope that Stewardship Partners' ability to create an abundance for you will help you to share with those who are in need and assist in fulfilling the Great Commission. Our non-profit ministry affiliate, Wall Watchers, provides a free service to help you educate yourself about the many wonderful Christian giving opportunities available to wise donors. We invite you to join the thousands of visitors to our ministry's website at MinistryWatch.com, as best we can tell, the Internet's top site for donors to Christian ministries to gather critical information about the ministries they are considering supporting. The site contains a variety of helpful information about hundreds of the largest US-based Christian ministries including ministries statements of faith, the history of the ministry, program accomplishments, ministry financial statements and financial efficiency ratings. Please feel free to utilize this free resource as you seek to be a wise and effective donor to Christian ministries. We would be pleased to help you bless God's people who are in need and clients of Stewardship Partners have access to further resources from MinistryWatch.com. It is our sincere desire to see Christians leading the way in giving generously, wisely and effectively so that the Lord's work on earth can be completed and many can be both blessed and saved.

Featured Ministry – Safe Families for Children – Doing the Lord's Work

"Whoever welcomes one of these little children in my name welcomes me..." Mark 9:37 (NIV)

Safe Families for Children was founded in 2003 by Dr. Dave Anderson who had studied the impact of abuse and trauma on the lives of children and sought to provide a means to address the significant needs children face in times of family crisis. The ministry is an effective alternative to the often bureaucratic, cumbersome and sometimes dangerous foster care programs children are forced into when families face serious struggles. Dr. Anderson has seen the Lord provide for their organization at just the right time at many key moments in the ministry's history and is grateful for the opportunity to build a charity which is returning the church to its biblical roots of providing for widows and orphans. Safe Families for Children provides much needed support for parents in crisis, giving them time to get back on their feet while their children are cared for in a safe and loving environment. Parents who recognize their family is in crisis and desire to protect their children as their difficult and unfortunate circumstances are addressed voluntarily approach Safe Families for Children seeking a Host Family to care for their children. Families in crisis can refer themselves but a network of referral sources also exists that assist troubled families in sorting out their family difficulties while keeping their children safe. Since this is a completely voluntary arrangement, it avoids the many complexities and legal entanglements involved when the state or local government intervenes in such situations. As a result, families can reunite with their children at any time they choose. Host families are heavily vetted and are themselves volunteers who receive no compensation for their work. Additionally, there is no expectation the host family will adopt the children should the family's crisis prove unresolvable and a new permanent home is needed for the children. Host Families are identified through partnerships with local churches across the United States, Canada and the United Kingdom.

Safe Families for Children has had a sizable impact on the communities it serves. The ministry has partnered with more than 4,600 churches and its volunteer Host Families have stepped up to assist those in desperate need more than 35,000 times since the ministry was founded. On average, a child stays with a Host Family for an average of nearly 45 days. During this time the ministry also assists the parent in a variety of material ways in order to expedite the family members being reunited in a healthier living environment. Another group of volunteers referred to as Family Friends helps parents with a variety of tasks such as finding clothes for job interviews and providing transportation. They also assist Host families by providing meals and baby-sitting, among a wide range of other tasks. Most children that are hosted are under 5 years of age and 93% of them are returned to their parent of a close relative. The number of volunteers in Host Families exceeds 25,000 but these are also backed up by a number of other helpers who might be 2-3 times as large. It will come as no surprise that Safe Families for Children ultimately keeps families together. Research shows that children who grow up in their own families leads to better outcomes in terms of their sense of identity, educational attainment, overall stability, and employment.

Safe Families for Children is not currently rated by MinistryWatch but was featured in our Shining Lights Ministry section recently due the great work this ministry is doing around the US and in Canada and the United Kingdom. Safe Places for Families is a great example of an effective Christian response to a serious issue facing our communities and restoring families to health is clearly a worthy objective of the church. Here is a link to MinistryWatch's recent story highlighting Safe Places for Families:
https://ministrywatch.com/safe-families-for-children-an-alternative-to-foster-care/

STEWARDSHIP PARTNERS MINISTRY COMMENTARY

The Christian Ministry Marketplace – Helping Donors Give Wisely

"A generous man will prosper, he who refreshes others will himself be refreshed." Proverbs 11:25

Much like the stock market provides for a sensible and efficient allocation of capital in our economy, the rise of a Christian Ministry Marketplace is providing donors with a myriad of helpful resources to maximize the impact and joy of giving to the work of the Lord. As donors begin to take their giving as seriously as their investing, they will find the assistance offered by the groups listed below to be invaluable. By utilizing these resources, donors are not only likely to make better personal giving decisions, but are also contributing to the growth in the marketplace itself. By so doing, they are helping to lay a foundation for wiser giving for all who follow in their footsteps. Accordingly, we encourage donors to investigate how these groups might help you to give more wisely, achieve a greater impact and create increased joy for both yourself and receivers of your gifts.

The Christian Ministry Marketplace
Resources for Christian Donors

WHY
to give to Christian ministries?

Teaching on Stewardship:

- Crown (crown.org)
- Eternal Perspectives (epm.org)
- Generous Giving (generousgiving.org)
- Global Generosity Movement (generositymovement.org)
- The Steward's Way (thestewardsway.org)
- The Gathering (thegathering.org)
- MaximumGenerosity.org (maximumgenerosity.org)
- Stewardship Ministries (stewardshipministries.org)

HOW
to give with a discerning mind?

Professional Advisors:

- Kingdom Advisors (kingdomadvisors.org)
- National Association of Christian Financial Consultants (nacfc.org)
- WaterStone (waterstone.org)
- National Christian Foundation (nationalchristian.com)

Donor Advisors:

- Excellence in Giving (excellenceingiving.com)
- Calvin Edwards & Company (calvinedwardscompany.com)
- E Six-Thirteen (esixthirteen.com)

WHERE
to invest in kingdom ministries?

Ministry Research:

- ECFA (ecfa.org)
- MinistryWatch.com (ministrywatch.com)
- Acton Institute (acton.org/public-policy/effective-compassion)
- Intelligent Philanthropy (intelligentphilanthropy.com)

Ministry Mutual Funds:

- National Christian Foundation (nationalchristian.com)
- Strategic Resource Group (srginc.org)
- Sovereign's Wealth Fund (kingdomimpactfund.com)

Featured Ministry Marketplace Participant – Excellence in Giving

"You will be made rich in every way so that you can be generous on every occasion." 2 Corinth. 9:11

One element that has long been missing from the Christian Ministry Marketplace has been the aid and counsel that qualified, experienced advisors can bring to a giving decision. Due to the absence of such guidance, many well-intentioned donors have made giving decisions that proved to be less than optimal. Excellence in Giving (EIG) seeks to fill that gap and thereby bring forth more resources for the Lord's work. Founded by Wall Street veteran Al Mueller, EIG is one of a group of philanthropic advisors that seek to transform the burden of wealth into the joy of generosity for major donors. The goal of the firm is to maximize the value and satisfaction of their clients' charitable giving. This is accomplished through a four-step process:

1. **Discovery** - EIG explores the issues their clients care most about, the values that they want to pass on to their children and the legacy that they would like to be remembered for.
2. **Evaluation** - EIG reviews their clients' current giving and produces an impact and satisfaction assessment. Analysis of new opportunities combined with the establishment of giving guidelines and initiation of a due diligence process are part of a course of action that leads to a Giving Game Plan.
3. **Participation** – EIG works with its network of contacts to identify the best opportunities, manages every aspect of the giving process from project evaluation, negotiation of grant terms and outcome measurements and seeks to partner with others, where appropriate, to leverage the client's gift.
4. **Celebration** – EIG provides both a quantitative and qualitative review of the giving process and the positive results achieved are celebrated.

EIG also offers access to a database of information on a variety of charities. This information can be found at www.Intelligentphilanthropy.com and for a small charge, donors can gain obtain a two page report that is certain to enhance the quality of their giving. Full Disclosure: The Biblically Responsible Investing Institute is a small equity owner in Excellence in Giving.

Knowing Jesus Christ as Your Lord and Savior

While most of those reading this will have already established a personal relationship with Jesus as their Lord and Savior, it is very likely that many have not. If you are someone who has not yet turned your life over to your Creator, we would have failed you miserably if we presented only information relating to your investments yet did not share with you the most important information of all: truths which have eternal significance for your soul and that will have an overwhelmingly positive impact on your life on this earth.

The gospel message is a simple one, far less complicated than the global impact of rising oil prices or the effect of a revaluation of the Chinese currency. For most people, the first part of it is easy to relate to – you are a sinner. If you are anything like the rest of us (and you are) more often than you probably would like to admit, you either do, say or think something that is clearly wrong and which you are ashamed of. “But what’s the big deal”, you might say. “If everyone has this problem with sin, can’t we all just accept the fact and try our best to get along?”

Well, on this earth, that is exactly what we try to do. We forgive one another’s faults and press on with life. From an eternal perspective, however, there remains a problem. Our Creator, who loves us with a love that can only be described as extravagant, has prepared an eternal home for us that He very much desires to share with us. Unfortunately, in our sinful state, we are unable to enter into heaven, which is by its very nature perfect. Desperate not to be separated from us for an eternity, our God devised the only possible solution – a divine exchange. He sent His very own son, who was perfect and thus without sin, as a sacrifice to pay the penalty for our sins. In this exchange, Jesus bore, through His death, all of our sins, so that we in turn could receive all the glory that was due to Him. He was made sinful while we were made perfect and, in our now perfect state, we are able to enter into the eternal home our Lord has prepared for us.

What then gives each of us access to participate in this divine exchange? By responding to this incredible demonstration of extravagant love by our God through an amazing act of your own. As you let the realization of just what your Lord has done for you filter through your heart, mind and soul, you will unavoidably desire to humbly come before Him, acknowledging that it was your sin that led to His sacrifice and recognize His Lordship in your life. And with this step of faith, the divine exchange is completed in your life, and along with it, the assurance of eternal life with a Lord whose love for you knows no bounds. If you have not done so already, we encourage you to take this time to contemplate the issue of your eternal destination and to take that step of faith that will make all the difference in your life, both now and eternally. Based on my experience and the experience of literally millions of others throughout history, it is the most satisfying, enriching and worthwhile choice you will ever make. Years of wonderfully inspiring spiritual growth await you and, if the Bible ever seemed confusing to you in the past, you will now find its wisdom leaping off the pages and into your heart.

If we at Stewardship Partners can be of any assistance to you in this all important matter of your eternal destiny, please do not hesitate to contact us. Like Jesus, we also greatly desire to share an eternal heavenly home with you!

STEWARDSHIP PARTNERS

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