STEPPING STONES MANAGEMENT, LLC

First Quarter 2009 Commentary

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When I began my career my father advised me not to discuss politics with clients. However, in reviewing the first quarter's market performance it is impossible to avoid the subject as the locus of our economy has moved from New York City to Washington, DC. It began with the Bush Administration's AIG bailout and TARP plan for banks last fall and has continued with the Obama Administration's management of those government interventions into the private sector as illustrated by the ouster of General Motors' CEO. After only a few days in office, President Obama declared that now is not the time for profits, and the stock market reacted accordingly. The selloff persisted through the month of February, wiped out all the gains of the rally that began in November, and made new lows. A bottom was established in early March as the Congress announced hearings to address mark to market accounting rules which have now been relaxed. Coinciding with that, President Obama began to sound a more optimistic tone in his economic rhetoric and actual economic statistics began to suggest the recession may be abating. These economic green shoots (to use Ben Bernanke's spring term) include increases in retail sales, home sales, industrial production and even auto sales. It seems that lower prices meeting pent up demand are bringing the economy back to a natural growth phase. Can it continue?

I wrote last quarter of the similarities between the crashes of 1929 and 2008 and warned of excessive government spending and policies reminiscent of the 1930s. We often hear of Herbert Hoover doing nothing in the face of that prior market crash, but history tells a different story. Hoover in fact can be described as the first Keynesian as he was vastly increasing government spending in the face of that crisis. The Hoover Dam is but one example that led John Maynard Keynes himself to approve of his Administration's interventions. FDR came into office in 1933 and ramped up the interventions. He liked the Hoover Dam so much (although not the name which he changed to the Boulder Dam) that he decided to build several dams in the Tennessee Valley and create the Tennessee Valley Authority to sell cheap electricity to underserved area residents. This was great for the people living there but terrible for the utilities that were already providing electricity to those areas and were now priced out of the market. The utilities were also constrained from raising capital because investors didn't want to invest in a corporation that was competing with the government. An analogy to today could be health care where the government is proposing to provide health insurance which will compete with private sector providers. The Health Care Sector ETF lost 15% of its value when the Obama Budget was unveiled and has lagged in the current rally. I'm concerned when I hear President Obama state that FDR will be a model for his Administration. While the economy did grow during the Great Depression of the 1930s, it was stagnant growth that did not lift employment. Government certainly instituted necessary reforms in those years which still provide a social safety net today, but the interventions into the private economy crowded out private innovation and I believe contributed to the poor economy of those years. Now Treasury Secretary Geithner is proposing vast expansions of government's power over publicly traded companies including reviewing executive compensation and seizing companies it deems present systemic risks. The disastrous Sarbanes-Oxley legislation of 2002 which resulted in the world financial capitol moving from New York to London provides an important lesson here. Most start-ups today have no plans to ever go public due to the regulatory environment.

A heavy regulatory hand is not the market's only concern. The Obama Administration has proposed a level of spending that even has the Europeans and Chinese objecting. I wrote last quarter of the Obama campaign promise to keep government's share of the economy at 18.5%. Granted, that promise was made before the market crash but the Administration's long term plan calls for government's share of the economy to remain well in the 20s even under rosy growth assumptions. Our government has never been this large in relation to our economy for a sustained period. The budget calls for deficits in these growth years that Obama's own budget director has called "unsustainable". Those deficits will have to be financed with Treasury debt whose buyers will require much higher interest rates to induce them to buy. Not only will this raise interest rates for private borrowers but it will also crowd them out of the limited pool of investment dollars. Remembering my father's advice I don't want to sound too partisan, and I place much blame for the financial crisis on the Bush Administration. I completely agree with President Obama when he decries the deficit that he "inherited" but it is a non sequitur to then propose to triple that deficit. Milton Friedman said inflation is caused by too much money chasing too few goods and I think we are setting ourselves up for just such a scenario.

Too much money is not just coming out of the Congress and Administration. The Federal Reserve has dramatically increased the money supply and I have been generally supportive of Fed Chairman Bernanke's actions thus far. He is nicknamed "Helicopter Ben" because he quipped once that we shouldn't worry about deflation because we could always solve it by dropping money out of helicopters. The deflationary problem that we have been struggling with since 2007 has been a bit more difficult to tame but Bernanke has stopped at nothing to halt it. The recent announcement that the Fed will buy mortgage backed securities has been a successful attempt to lower mortgage rates with hopes of halting the decline in house prices that the Fed sees as the source of our deflation problem. Fully implemented, the plan will increase the size of the Fed balance sheet almost fivefold – that's a lot of money chasing any amount of goods. The Fed tells us that they will remove that liquidity when the economy recovers but I am skeptical that it will be that easy. To reduce that liquidity will require interest rates rising to a point that will put the economy back into a recession. The template here would be the way Fed Chairman Paul Volker (now an Obama advisor) slayed the inflation dragon of the 1970s by driving interest rates up to 20% in the early 1980s which put the economy in a deeper recession than this one has been thus far. It was worth it though, the inflation was worse.

Inflation makes it harder for corporate managers to make investment plans so many never get implemented. The term used to describe the 1970s was "stagflation" – stagnant economic growth with high inflation. On balance, the stock market did nothing good during that decade but there were rallies from low levels and some sectors that benefit from inflationary pricing did well. We will look to those areas in coming quarters which include technology companies that enable their customers to produce more efficiently and basic materials companies that enjoy rising prices for their products. Inflation is good for debtors whose debt becomes relatively smaller in relation to income but conversely it is bad for creditors. Financial companies are the biggest creditors in our economy and while I think they will continue to rally from here, now that mark to market accounting rules have been fixed, we will look to avoid that sector after the recovery runs its course, which typically occurs when the yield curve begins to flatten (short rates rise closer to long rates.) Gold also tends to do well in an inflationary environment and I will look to add exposure to the yellow metal in coming quarters, hopefully when it's not such a crowded trade.

These themes were not prevalent for most of the first quarter that was focused more on the deteriorating economy and deflationary forces but they did emerge in the rally that began in early March. For the quarter, growth stocks outperformed value stocks and technology and basic materials were the top two sectors. The market seems to be betting that those green shoots referred to above will continue to blossom into May flowers. We went into the quarter holding higher than normal cash levels and sold more positions as the November levels failed to hold. We did go back into the market near the March low but continue to hold more cash than our long term plans call for as the rally has been very strong and hasn't provided the pullbacks we are looking for to add more equity exposure. My expectation is that a pullback will come as those May flowers lose their petals, providing us an opportunity to buy in at a lower level than present, maybe not the March lows but more likely the November lows. If that happens, the cash position we hold now will buffer any losses in such a downturn and present buying opportunities into the sectors I mention above. We did deploy some of the cash raised into the S&P500 ETF which I see as a place holder until those other buying opportunities present themselves.

I think the worst of the market decline is behind us although I see more trouble ahead. Unemployment is a lagging indicator and we should expect to see it worsen even if the overall economy continues to improve, which could lead to another drop in consumer spending. Data releases that suggest such an occurrence could trigger another selloff and bring us down to retest the lows like I mention above. Another such trigger could be more government initiatives or interventions into our economy. Government does of course have a role to play and the regulatory regime of our financial markets is sure to be restructured. The question is not more or less regulation (virtually every financial transaction is already regulated in some way) but smarter regulation. The financial crisis has not only exposed the financial firms' own inadequate risk processes but also the government's inadequate regulatory structure. The alphabet soup of regulatory agencies should be streamlined and companies like AIG should not be able to choose to be regulated by a small regulatory agency unequipped to monitor their company's business. Any reforms should also reflect that money and financial transactions can always escape an overly burdensome regime by going overseas. The issue of self regulatory agencies, such as FINRA which regulates brokerages, will also be addressed. They exist because those parties know how to regulate their own industries better than government bureaucrats do. It's a legitimate point. There are no clear ideological fault lines with this issue so hopefully it can be done without the bitter partisanship that dominates our nation's capitol.

Another issue facing our economy is ongoing deleveraging. Simply put, this is the process of debtors reducing their debt. Prior periods of deleveraging were marked by years of subpar economic growth and the amount of leverage in our system at the beginning of this one was greater than prior ones. There isn't a magic figure of the correct amount of debt that an economy can sustain but it is recognizable in hindsight (the level in 2007 was too high). I had an opportunity recently to ask a Citigroup director how far along he thinks we are in the process and he said it can't be answered but he did think we are coincidently in a "re-equitizing" process where that leverage is being replaced with equity capital. My own hunch is that corporate America has been deleveraging since the dot com collapse and that most of the leverage in the system today is concentrated in the financial sector (and has largely funded real estate and consumer debt). Those companies have already discounted this deleveraging in a painful way and the economy seems to be operating on a cash basis now rather than a credit one. This suggests that the nascent growth we see today can progress absent further shocks such as rising unemployment, inflation or a spike up in interest rates. How far this deleveraging has to go is one of the great economic questions of our day that I expect to hear more about in coming months. Much of that leverage has been produced through the securitization process which is another topic that will be prevalent in economic discussions. You may have heard of the "shadow banking system" of private financiers who provide debt capital through their purchases of debt instruments. This topic combines the deleveraging theme with the regulatory reform theme and I suspect will be fodder for future market commentaries.

Getting back to my historical analysis, the president with the worst stock market performance was Herbert Hoover who increased government spending by about 50% and saw the stock market decline during his term by 83%. The president with the second worst stock market performance was George W. Bush who also increased the size of government by about 50% and saw the stock market decline by 22% during his term. As of the end of February, Barak Obama was third on that list. Since then the Administration has begun to soften its tone but we will have to watch its actions more closely than its rhetoric. I have never seen an example of a successful Keynesian intervention and this one is staggering in its size. We will look to allocate our investments in accordance with what emerges from our government which is unfortunately becoming more involved in our economy. Recognizing the disgraceful job they have all done with AIG, I hope the appetite for further government interventions wanes and we can get back to keeping business and politics separate. The first quarter has made clear that government is not structured to run businesses.

In this spring season of renewal, my hopes are that we have overly discounted the serious problems facing our economy and are in fact correcting those problems and building a stronger financial system. Not all of the financial innovation that has developed over the past 20 years is undesirable. Our financial and political leaders should be able to determine what works and what should be corrected and build the foundation of our new 21st Century financial system. I look forward to discussing any of these issues I have raised more fully when we speak next, or any other issues that concern your financial life in these turbulent times. Until then, thank you for your trust and thank you for your business.

Yours truly,

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