



STEPPING STONES MANAGEMENT, LLC

## **First Quarter 2010 Commentary**

April 21, 2010

The last two years have certainly disrupted many investment tenets, the latest one being the relationship between risk and return where investors assume more of the former to get more of the latter. The securities with the lowest risk are those issued by the US Treasury Department who can actually print the dollars to pay back the debt, and those have historically had the lowest after tax return. However, on the Monday after the US Congress passed its health care reform, Bloomberg News ran a story highlighting several corporate debt issuers that are actually getting lower yields than Treasury securities. Proctor & Gamble, Johnson & Johnson, Abbott Laboratories, Lowe's, Royal Bank of Canada, and Warren Buffet's Berkshire Hathaway all have debt outstanding that sells at lower yields than Treasury debt of the same maturity. The reason could be seen in a story a week earlier where bond rater Moody's Investors Service said the US Treasury could lose its triple-A rating as the cost of servicing our debt rises. Moody's, who had no problem bestowing their highest rating on subprime mortgage debt, said under adverse conditions the US could see our debt service payments amount to 15% of government revenues which is above their 14% threshold for a triple-A rating. The stock market in the first quarter shrugged off these concerns as optimism about the economy and corporate America drove the S&P 500 up about 5%, despite sustaining an intra quarter drop of over 8% when Greek debt fears roiled world markets. The Greek situation affected demand for other sovereign debt which could explain the strange circumstance of US corporate issuers paying less than the US Treasury. Investors may be ignoring the rating agencies' subprime mortgage fiasco and pricing Treasury securities at a double-A rating already. Or, more ominously, the Treasury Department may be saturating the market for its debt.

### **Swap Vigilantes**

Last quarter's letter explored the situation with the European PIGS (Portugal, Ireland, Greece and Spain) which exploded in the first quarter as Greece became perceived to be unable to refinance its debt. While several rescue agreements have been announced, Greece is paying ever higher rates in the market. Ireland has taken drastic steps of cutting government worker pay and has gained the good graces of the bond market. Portugal and Spain are on the brink as they need to refinance more debt than Greece. Holders of that debt can insure against default by entering

into a credit default swap (CDS) agreement which will pay off if the issuer defaults. As we learned in 2008, CDS are not limited to those with an insurable interest as anyone can make these bets even if they don't own the underlying debt. The extra demand for the CDS drives up its price, providing profits to the buyer but making it more expensive for actual holders of the debt to hedge their positions. The result is that issuers are forced to pay higher yields to compensate for that insurance as Lehman Brothers and Bear Stearns painfully learned. The buyers of those CDS saw the value of their contracts skyrocket and made billions. Unremorseful, they claim their activities only accelerated the inevitable and that Lehman Brothers and Bear Stearns bore responsibility for their downfall and the Swap Vigilantes, as they have become known, only recognized what all of us would eventually.

A February Wall Street Journal story said these hedge fund managers are putting on a new "career trade" regarding an implosion of the Euro. At an "idea dinner" attended by representatives of some of the biggest hedge funds the Euro was said to be "an early domino to fall in a contagion that eventually will hit U.S. Companies, municipalities and Treasury securities." Surprisingly, representatives of these funds were willing to speak on the record about the idea dinner and not surprisingly, the Securities and Exchange Commission (SEC) announced an investigation into possible market collusion soon after the story was published. Other components of the US financial regulatory apparatus are also gearing up to limit the power of these players. One example is a proposal to clear all CDS contracts through a centralized clearinghouse like a national stock market such as NASDAQ. The swap holders say this is unworkable as the contracts are all individually unique and cannot be organized as commodities, even though they trade as such in a multi trillion dollar market. They also say their agreements are individual contracts between sophisticated consenting parties and the government has no place in regulating such activities. Don't tell that to our current ruling class in Washington DC where the SEC has filed suit against Goldman Sachs regarding its activities in mortgage related CDS.

### **Return to Clintonomics?**

As anyone with a pulse realizes, the regulatory burden on the economy is going nowhere but up. However, these financiers think they can reap huge profits as they leave our economy in tatters without any recourse from the rest of society. While we should limit their ability to wreak such havoc, we should also pay attention to their message as they were correct about the subprime real estate market. It would be best to follow Ireland's example and actually reign in unsustainable spending throughout our government sectors and take away the career trades that will decimate our economy as these hedge fund managers reap billions. Instead, we have a federal government spending ever more on jobs programs which fund exorbitant public sector salaries and benefits. Despite the economic recovery, these supposedly temporary stimulus measures get baked into the baseline budget assumptions with more spending piled on top. The result is exponential growth of our fiscal deficit. Some benefits have been seen as employment statistics have finally turned positive, but the cost is yet to arrive which has many investment strategists expecting a stock market drop when the coming tax hikes hit the economy. Bulls counter that the economy and stock market did fine with these higher tax rates in the 1990s but they are missing some points.

The first is that the economy slowed substantially after the 1993 tax increase and the market had a tough year in 1994. It was the return of divided government (the market's favorite scenario) after the 1994 Congressional elections that ignited the historic late Nineties rally. It was after that election that the Clinton Administration famously pivoted towards the center. President Clinton signed welfare reform, free trade deals like NAFTA (passed in 1993), a capital gains tax cut, and lowered government's share of the economy. In fact, from 1995 to 2000 federal spending grew at the slowest pace since Calvin Coolidge presided over the Roaring Twenties. Coolidge was famous for saying "the chief business of the American people is business" and he successfully kept government out of the way. Bill Clinton famously said "the era of big government is over" as he presided over the elimination of the federal deficit. The late Nineties boom was similar to the Roaring Twenties but the policies that produced each are hardly similar to anything we are seeing today.

Another point is that the proposed level of taxation in early 2011 will be higher than any during Clinton's presidency. The recent health care bill not only subjects all sorts of medical supplies and insurance policies to new taxation but investment income is now subject to the 3.8% Medicare tax. Additionally, states and municipalities mostly have higher tax rates compared to the 1990s after being subject to decades of increased federal mandates and voracious public sector labor unions. Energy taxes are also on the Congressional agenda which will hit every part of the economy as will the much discussed Value Added Tax (VAT) which, if enacted alongside the income tax, will transform America into a European style social welfare state. The tax with perhaps the most impact on the economy is the capital gains tax, which will go from 15% to almost 24%. Historically this has led to lower tax revenues despite the higher rate as capital gets locked into current investments to avoid the higher tax. The best way to raise capital gains tax revenue has always been to lower the rate to free up capital which then gets invested in new businesses that will hire new workers who will also pay income taxes. That is what happened in the late Nineties. Alas, the lessons of the past century's tax policies and their implications seem lost on today's policymakers. Those lessons clearly demonstrate that incentives matter to economic activity and those incentives all seem to be moving in the wrong way.

### **The Laffer Lesson**

One of the most striking differences between the 1990s and today concerns the subject of entitlements. Clinton's embrace of welfare reform forced a whole segment of society that had grown up relying on a government check to go out and get a job instead. Not only did this lower the amount of money the government was issuing in benefits, but it increased the amount collected in income taxes. More importantly, it's impossible to calculate how many young workers have a strong work ethic today because they grew up watching their single parent work hard to support the family rather than sit around every day waiting for the check to come from Uncle Sam. It's not that they were necessarily lazy. If they did get a job they would lose their welfare benefit that may have been more than any job would pay. They were acting rationally like most people do. On the other end of the income spectrum, a top earning executive may think it worth the extra work hours and stress to earn hundreds of thousands of dollars a year as long as he or she can keep at least half of their earnings. If they can keep only 40% of those earnings some of them will most certainly opt for fewer hours and less stress even though it means lower take home pay.

That is why there is an optimal level of taxation which balances those competing forces and keeps the most people working the hardest. Economist Arthur Laffer illustrates this with his Laffer Curve. Plot an upside down letter U on a standard graph with the horizontal axis measuring the tax rate, place the two ends of the U on the tax rates of 0% and 100%. The vertical axis is the revenue raised from any tax rate with \$0 raised at a 0% and 100% tax rate - no one would work at a 100% tax rate. The top of the revenue curve will align with the optimal tax rate. Higher rates will result in lower revenues as people will have less incentive to work and lower rates will produce lower revenues as incentives are already maximized. That optimal level of taxation has been considered to be 18.5% by Administrations of both parties. Indeed, candidate Barak Obama's chief economic advisor called for the overall level of taxation to be no higher than 18.5% of GDP. That doesn't square with President Barak Obama's plan to have federal spending account for over 25% of the economy. A 6.5% deficit may look good compared to today's level of about 10% but it can't be sustainable.

It seems that all the policy prescriptions to close the deficit are driving us further into what Dr. Laffer calls the "Prohibitive Range" of his curve that will result in slower economic growth and lower revenues which could ironically be collected equally at the corresponding lower rates from the other side of the curve. To get in front of that higher level of taxation, Laffer predicts 2010 will see higher economic growth than otherwise would be the case as people accelerate income into 2010 away from 2011. That could explain the encouraging economic statistics we are seeing despite these looming threats. The prediction bodes ill for 2011.

### **A Tipping Point**

Higher taxes are not the only threat. Increased regulations are another cost borne by businesses that aren't reflected in tax rates. The health care bill has passed but we have yet to find out what's really in it as nearly 100 new bureaucracies have yet to write their new regulations, putting businesses in a wait and see mode before initiating new ventures. Although economic statistics have been more encouraging lately, the extraordinary measures undertaken by the federal government and the Federal Reserve are still in place. It's hard to get too excited about the economy as long as it still requires training wheels. If the Fed were to normalize rates they fear an upward spike in interest rates that are currently held down by the attractive yield spread inducing banks to borrow from the Fed and buy higher yielding Treasury securities. Take away that yield spread and you take away the demand for Treasury securities. We are already seeing signs of strain in the Treasury market even with this historically high spread and it is scary to think what will happen when the Fed inevitably raises rates which will have to be soon if the economy is indeed recovering, lest we provoke a 1970s style surge of inflation. China has moved from not buying our debt to actually selling their Treasury securities and reducing their exposure to the US. There are numerous signs that a tipping point is being reached in the amount of debt our nation can take on. Hopefully, another tipping point is close at hand where voters finally decide they want a smaller government providing fewer services. The Tea Party movement may be portrayed as a bunch of cranks but it is the biggest social opposition movement since the Viet Nam war protests. Those protests got us out of a disastrous war, maybe these will get us out of a disastrous fiscal trend.

This leaves us with questions as to how to navigate the current environment. The stock market's first quarter did see a small correction but rode the trend of improving corporate earnings reports to a 5% gain. Our portfolios gained a lesser amount as our cash position held back the gains. If Dr. Laffer is correct and we see a weakening economy as 2011 approaches then that cash position will have been the right strategy. If however the economy continues to strengthen and is able to absorb the higher taxes and regulations then we will end up deploying that cash into a higher market having missed an opportunity to fully participate. A divided government outcome to the November elections may lead to higher prices as investors reminisce about the 1990s, although whichever party wins will have a terrible deficit to tame with few good options. These looming threats inhibit me from initiating new positions but I am inclined to hold current positions and enjoy the dance as long as the music is playing despite my underlying bearishness.

A first quarter milestone was the one year anniversary of the Obama Administration where the stock market returned almost 33% over the previous 12 months. The only president to beat that figure in his first year was Franklin Roosevelt who is said to be a model for our current president. While the market did go higher through 1934 and beyond, it did not mark the dawning of prosperous times and stocks were lower 8 years later. If only Bill Clinton were his model. Please feel free to call me to discuss any of this further and until then I would like to thank you for your trust and thank you for your business.

Yours truly,

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