STEPPING STONES MANAGEMENT, LLC

First Quarter 2011 Commentary

April 15, 2011

Responding to criticism about changing his opinion on monetary policy during the Great Depression, economist John Maynard Keynes famously said, "When the facts change I change my mind, what do you do sir?" Adherents of the economic philosophy that bears his name may want to consider that quote in the wake of the greatest Keynesian economic intervention in history. The economic stimulus plan enacted in early 2009 was said to be "targeted, timely and temporary" and that for every $1 spent we could expect to see $1.56 in economic growth. In the third year of our country running deficits over a trillion dollars, we now know it wasn't temporary. The $1.56 projection was also way off the mark because it ignored the chilling effect that increased government spending has on the overall economy. Although the economy may not be growing at those projected rates, it is in fact growing and fueling the animal spirits of stock buyers. The S&P 500 rose 5.42% in the first quarter and even the much maligned municipal bond market saw a partial rebound and stabilization after its fourth quarter rout. The investing philosophy that ruled the quarter was "don't fight the Fed" as easy money continued to drive prices of most everything higher. Everything except the one thing the Fed is trying to reflate, home prices which are undergoing a double dip.

Stubborn Facts

Although I don't have a university economics department at my disposal, I wanted to study the $1.56 multiplier mentioned above. A full econometric study would find ways to isolate exogenous factors; I simply looked at how the economy has historically grown during times of deficit spending. The data provided by the White House go back to 1940 so I looked at growth starting in 1941. I also eliminated the 12 years that the United States did not run a budget deficit. In the 58 remaining years, 34 saw deficits of less than 3% of the nation's Gross Domestic Product (GDP). In those years, the economy saw growth of $7.28 on average for every $1 of deficit spending, a record that would encourage any Keynesian. In the 14 years that the deficit was between 3% and 5% of GDP, the economy only grew an average of

$1.73 for every $1 of deficit spending, showing the deleterious effects of increased government spending but mostly conforming to the White House projection. The problem arises when we run deficits larger than 5% of GDP in which case the average multiplier falls to a *divisor* of 0.68, meaning for every $1 of deficit spending the economy has only grown by 68 cents on average. If we remove the single full year of negative GDP growth, 2009, that number rises to 78 cents. Again removing the tumultuous year of 2009 and only looking at the rebound year of 2010, we saw growth of about 3% or $411 billion in GDP. People applauding that growth ignore that it cost over $1,450 billion, the 2010 budget deficit. For every $1 of deficit spending in 2010, our economy grew by only 32 cents, that's a number that ought to make even John Maynard Keynes change his mind.

Madness in Wisconsin

Americans have been getting a good look at how Wisconsin voters see the issue as the politicians they voted for last fall try to enact their agenda. I have been writing for several quarters about the disparity in compensation between government and private sector workers where the former make far more in wages and benefits than those paying their salaries. One disparity is in retirement benefits where government workers get rates of return on their retirement plans pegged to historical stock market returns without the risk that such returns entail. After 12 years of a flat stock market, people with 401(k) plans are coming to grips with the likelihood that they will have to work beyond their planned retirement age because their retirement funds are not enough to support as many idle years. Government workers don't have this problem because the taxpayers make up the shortfall. If a private sector worker wanted such retirement security he would have to invest in Treasury securities which mostly yield below 3% and wouldn't provide the lifestyle in a several decade retirement that 8% returns would. The cost of that benefit is painfully clear in the amount that states and cities are being forced to contribute to their workers' retirement plans at the expense of other social services.

The contentiousness of the issue suggests that our country is at a tipping point where those living on government funds outnumber those funding the government. Polls in Wisconsin said that voters oppose *stripping* government workers of their collective bargaining *rights*, but other polls conversely said that voters approve *limiting* government workers' collective bargaining *powers*. That's why we need to be cautious about assigning too much importance to media polls. The only polls that really matter are the ones on Election Day in the privacy of the voting booth. Wisconsin had one of those last week for their Supreme Court that became a referendum on the reforms that the Republicans were able to pass despite the absence of their Democrat colleagues. The Republican narrowly won the election which may be headed for a recount. This issue isn't going to be settled easily, people aren't going to willingly give up government benefits no matter how big our deficits become.

That 70s Show

This same debate is going on in Washington, DC where Democrats say our economy is too fragile to pull back on government spending just yet, so much for the stimulus being temporary. A Goldman Sachs economic report bolsters their view by saying the Republicans' proposed budget cuts would lead to 700,000 jobs being lost. The economist bravely used a model like the one that said the 2009 stimulus bill would create over 3 million new jobs, which was not achieved. These models ignore the effect that such government interventions have on the overall economy either by crowding businesses out of the available funds that they need to grow or by scaring them from expanding with fears that their taxes will have to go up or their businesses will be hurt by government intervention in their industries. New regulations are also burdening small businesses that are forced to pay more for their workers health care because of added mandates. They will have a harder time competing with bigger rivals who can afford to hire a Washington lobbyist to get them a waiver from the new regulations.

These are some of the reasons why growing government, either through spending or regulation, is not commensurate with growing economies. The late 1960s saw our country enact reasonable sounding government programs that were not sustainable. The Federal Reserve followed an easy money policy in the 1970s to provide funds to keep the Great Society programs alive. Economists were mystified by the stagflation that followed because all their models said that inflation couldn't happen in an economy with such excess capacity. They said the inflation was the fault of the Middle East oil embargo and not Fed policy.

Likewise, Fed Chairman Ben Bernanke says the current inflation he acknowledges the economy is experiencing is "transitory" and the result of increased demand for commodities from the emerging world and not the increased money supply he is creating. Maybe he thinks the emergence of the emerging world will only be transitory. The rise in the price of oil doesn't seem to be demand driven though as oil inventories are rising. The revolutionary wave roiling the Middle East seems to be a more likely reason why traders are bidding up oil prices, a trade made easier by low rates and easy Fed money. Easy money also makes it easier for traders to buy the commodities whose prices are rising at double digit rates and will eventually crimp corporate profits. As these prices continue to rise, demand is stimulated as buyers stock up at current prices, but supply suffers as sellers hold out for higher prices. Higher demand plus lower supply equals higher prices. Retail sales are doing well which could be a function of improving employment but could also be a function of consumers buying before prices rise much more. Wal-Mart says high gas prices are driving higher sales as customers "stock up" on pantry items. If incomes don't keep up with prices, those strong retail sales reports will be short lived. Inflation doves say we can't have broad based inflation like we saw in the 1970s without wage gains, and with a smaller percentage of our economy being unionized those wage hikes will be unlikely to occur. Putting aside the fundamental bearishness of that scenario, it ignores what's going on in Wisconsin and implies that workers who aren't represented by a union won't be able to bargain for higher pay. Google, thought to be immune from higher commodity prices, reported disappointing earnings due to higher wage expenses.

I have been concerned about incipient inflation for several quarters but I am now more concerned about the overall economy. If higher prices and the end of government stimulus lead the economy down, much of the hot money that has driven commodity prices higher will come out of those markets. The commodity that is said to deserve a PhD in economics for its forecasting prowess, Dr. Copper, is not making new highs. Stock markets in emerging markets have also not confirmed the US market's post recovery highs. These emerging economies are much more susceptible to higher commodity prices than developed markets and recession there would hurt us to the extent that our economy is reliant on sales in those markets. To protect against a market drop we purchased an ETF that tracks the S&P 500 volatility index known as the fear gauge because it goes up when the stock market goes down. We entered the trade when Libyans began to revolt fearing that these demonstrations could spread to other oil producing countries in the region. The revolts spreading across the Middle East are an amazing historic event and I don't pretend to know how it will all come out. Some say no matter who wins, they will want to pump oil in order to fund their governments, but the question is how willing oil service firms will be to work in countries that have much higher political risk. Iran has never come close to producing the amount of oil they produced before the Islamic revolution in 1979. If these revolts reach into Saudi Arabia we can be sure to see much higher oil prices which would likely tip the economy back into recession. Fearing that, oil markets were waiting anxiously for the Saudi "Day of Rage" on March 11. Government security forces massed in the major public squares the night before, even shooting on some smaller demonstrations with rubber bullets which seems to have been enough to discourage the demonstrators from showing up after Friday prayers, at least for now.

Instead, March 11 brought us nature's day of rage with a massive earthquake and tsunami devastating Japan and creating a nuclear crisis that persists to this day. The destruction in Japan will lead to one of the world's biggest rebuilding efforts that some say will be economically stimulative. 19th Century French economist Frederic Bastiat has something to say on that with his "broken window fallacy." The parable describes a shopkeeper who finds his window broken. Onlookers notice that the window glazier hired to fix it benefited and see the broken window as a positive development. Bastiat however tells how the shopkeeper was unable to buy a new pair of shoes thus hurting the neighborhood cobbler who would have had his business if the window had not been broken. Think about that when you think about all the businesses that are now unable to operate in Japan. Many nations are refusing to admit certain Japanese exports into their markets fearing the radiation that those items may be carrying, which poses another problem for the export driven Japanese economy. This will also affect producers around the world who rely on supplies from Japan. One positive note that I take from the disaster in Japan is that an extremely indebted government sector does not necessarily tear apart the fabric of a society. Anyone watching the Japanese people deal with the disaster must be impressed at how that society is handling its hardship.

Exceptionally Extended Policy

Of course the hardship besetting our economy pales in comparison, but the Federal Reserve keeps its exceptionally easy money policy in place for what it still expects to be an "extended period"; even though they say the economy is on a "firmer footing", exemplified by the long awaited jobs recovery. The Fed has backed itself into a corner where it can't normalize rates for fears of causing another recession. Their program of buying Treasury debt is coming to an end in June or sooner (they have almost reached their $600 billion target) and the market wonders who is going to buy all the Treasury debt being issued when the Fed steps aside. This has led the world's largest bond mutual fund to take the unusual step of selling all their Treasury holdings and even going into a net short position on US Treasury debt (betting on a price drop). People say the stock market valuation is reasonable and inflation expectations are not elevated, but those measures are largely determined by spreads compared to Treasury securities and nobody knows what the market rates would be on those instruments without the Fed buying all the issuance. Logic says market rates will go up when the Fed stops buying, but market rates should have gone down when the Fed began buying, but they went up instead. A spike up in rates would be a drag on the economy and fears of such may explain the revived merger and acquisition activity of recent weeks as buyers look to lock in low rates now. If the Fed stays in the market to keep those rates low to foster more economic activity, it risks the inflation they say is not yet a threat, even though the Consumer Price Index (CPI) has risen the last three months at rates above 5% annualized. Even the Fed's preferred measure excluding food and energy has reached the top of their comfort zone, but they are ignoring this in order to keep the government from having to pay higher rates on its debt. Most of that debt has been issued at very short maturities which benefit from the low short term rates but will have to be rolled over at higher rates sooner or later. When that comes, the interest payments on our federal debt are going to balloon like a subprime teaser mortgage. The Republicans in the House of Representatives are trying to correct the overspending but are being met with resistance by Democrats accusing them of wanting to kill women, starve seniors, end cowboy poetry festivals and "destroy the whole wide world". It has been a wholly unserious debate thus far with much fanfare over the recent deal to cut $38 billion, about 1%, off a budget that is almost 40% out of balance. The official score on the gimmick filled deal says it will cut the deficit this year by a whopping $352 million, that m is not a misprint.

We maintained our defensive posture in the quarter and even sold some positions in addition to adding the position in the volatility index. If a breakout of certain commodity prices occurs we will allocate some of our cash position to inflation hedges, but are hesitant to do that yet as most of the world is raising rates to restrain growth and inflation. An economic slowdown will likely take the air out of a lot of those commodity prices. The stock market is struggling to gain further ground as holders are liquidating positions in an effort to grab a chair before the Fed stops the music. The municipal bond crisis is also still looming, held off this quarter by the lowest supply of new debt in 11 years. As state legislatures work out their plans to deal with their budget shortfalls we will see that supply come back in a big way, probably by the time most states see their new fiscal years begin on July first. It remains to be seen who will buy it all. Not only does this loom, but this next quarter will see the end of the Fed's Treasury bond purchases; the nation reaching its debt limit and the political fight that is sure to accompany an increase in the limit; and the fight over the 2012 federal budget where Republicans are proposing to means test entitlements, cutting what is given to the wealthy. This will all be against the backdrop of a nuclear catastrophe in the world's third biggest economy; the revolutionary wave sweeping across the Middle East; economic slowdowns in the emerging markets as they fight their own inflation problems; and even rate hikes in Europe while they deal with their festering sovereign debt problems.

There was a mortgage debt bubble that caused the last financial crisis and that has been replaced with a government debt bubble now, it can't keep growing like it has and hopefully we can get out of this one without another financial crisis. That will first entail an acknowledgment that such a problem exists, half of our politicians don't seem to be there yet. If prices break out to new recovery highs, we will put much of that cash to work expecting more inflationary Fed liquidity; but if recent price struggles foretell a correction in the sharp rally of the last two years that cash will prove beneficial in investing among the wreckage. This strategy may sound stagnant, but I thought the Fed would have normalized rates by now and brought on that correction. If the CPI continues to report inflation at 5%, that normalization will have to come soon. Until then I want to thank you for your trust and thank you for your business.

Yours truly,

Daniel D. Hickey
STEPPING STONES MANAGEMENT, LLC
501 Madison Avenue, Suite 501
New York, NY 10022
direct: 646-723-6262
fax: 646-619-4804