STEPPING STONES MANAGEMENT, LLC

First Quarter 2012 Commentary

April 17, 2012

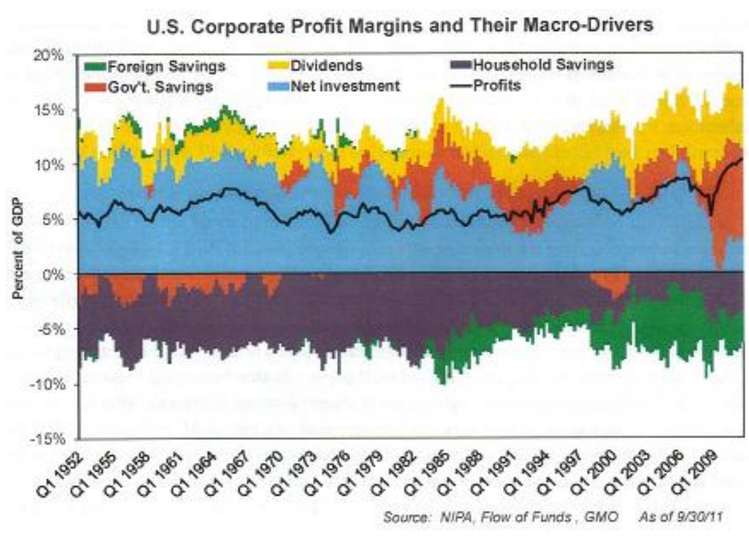
When the auto racing season got underway at February's Daytona 500 it wasn't just gentlemen starting their engines. Nascar's newest recruit, Danica Patrick, was asked before the race what she thought of the biggest issue of the day, the Obama Administration's mandate that all health plans cover birth control with no co-pays. Ms. Patrick answered: "I leave it up to the government to make good decisions for Americans." Rush Limbaugh responded: "What do you expect from a woman driver." This flippant debate sums up the first quarter of this election year where our historic fiscal deficit and stagnant economy are secondary issues to entitling an everyday product to a key voting demographic. No doubt the new mandate will be popular among college women and their boyfriends while political scientists will study for years the effects on the Administration's church lady base. Danica Patrick is also a new recruit to the Catholic Church whose lead spokesman on the issue, New York's Cardinal Dolan, complains that the mandate runs counter to Church theology in a nation founded on religious freedom. He says it will make it impossible for the Church to continue as the largest provider of health care to American women, not surprising when one considers the Catholic Church is among America's largest employers and operators of hospitals and health clinics. The episode is but one example of the problems we are finding with the Affordable Care Act of 2010. If a democrat can mandate free birth control for a key part of their voting base, without an act of Congress, a republican could just as easily mandate free Viagra and Lipitor to enthuse their middle aged male base. Legislation that empowers politicians to so easily reward their friends should not be expected to also lower costs. The US government continues to borrow 36 cents on every dollar it spends but now less than half that debt is actually being absorbed by the market. In 2011, 61% percent of Treasury issuance was funded by newly created dollars at the Federal Reserve, if only Greece had its own central bank and currency.

The Greek crisis was solved in the first quarter by writing down 76% of their outstanding debt. The evaporation of over 150 billion Euros from European bank balance sheets was eased by the European Central Bank conjuring up over 500 billion new Euros, enough to fill the hole from the write down and the exposure from all the credit default swaps written by European banks. Such an easy solution to such a vexing problem logically explains the first quarter's 12% rise in the S&P 500. It was a "risk on" quarter as financial assets rallied with the river of central bank liquidity and government deficit spending. Following the pattern of last year, fourth quarter economic strength continued into the first and optimism for a sustainable recovery blossomed with the spring flowers. Ominous signs abound however.

The strong stock market rally occurred in an environment of surprisingly low volume, something technicians regard as a non-confirmation. News has also been reported in recent days of an unusually large trade at JP Morgan in the market for high grade corporate credit insurance. Traders have come to rely on someone they call the "London Whale" to take the bullish side of any trade in that market. The reports say his trade has accumulated a notional value of over $350 billion, almost double JP Morgan's net worth. In our highly interconnected financial markets such a trade, even assuming much of that value represents hedges, would have surely contributed to the quarter's rise in the equities of those same debt issuers. Now that the London Whale has been exposed, there are plenty of Captain Ahabs navigating their hedge funds to spear him, but hedge fund predators aren't the worst threat facing the market. That was articulated by Ben Bernanke to a Congressional hearing on the US fiscal situation.

A Fiscal Cliff

The Fed chairman who has been funding the profligacy of the politicians told them it cannot continue, but we've all heard that before. This time, the lack of consensus in Congress has led to automatic fiscal tightening scheduled to occur in January 2013 if nothing is done to alter course. Taxes will go up across the board but mostly on middle income earners and spending will be cut most heavily in the favored health care and defense programs of Congressional spenders. Economists across the political spectrum are echoing Bernanke's characterization of the economy drifting towards a fiscal cliff. These letters have examined the relationship between economic growth and deficit spending and the data from 2011 continue the trend. The US government ran a fiscal deficit in 2011 of $1.3 trillion, almost 8% of the economy which grew by $570 billion giving us less than 50 cents of economic growth for every dollar borrowed/created. Keynes must be toasting Hayek wherever they may be.



All that money makes it into corporate earnings as shown on the accompanying chart going back to 1952 produced by GMO Research and published on their website. First, notice the recent spike into record territory of the black line representing corporate profit margins. These are the profits that have been justifying the three year old bull market. More important are the colored areas, each column of color represents the contributors to profit margins in a given calendar quarter. Notice that corporate profit margins have historically been driven by the blue investment sector of the economy. This could be investment in plant and equipment, inventory, intellectual property or anything on which businesses spend money in order to make money. The red areas represent the fiscal deficit, which economists call government savings. Notice the elimination of the red area in the late 90s when we ran a fiscal surplus and its return after 2001. It's hard not to conclude that the recent spike in corporate profit margins has been driven by the coincident ballooning in the red area of deficit spending. Everyone agrees that we need to shrink that profit driver.

Keynesian economists say we need to shrink it slowly so as not to expose the hole in the economy from the diminished blue investment component. Those inclined towards Friedrich von Hayek's Austrian school of economics say the large red area is smothering the ability of businesses to invest. Germany's current fiscal model is based on this Austrian school premise and it has been successful enough that everyone is looking to the Germans to save the rest of Europe, although that may be asking too much. Austrian economic principles have also been employed in Sweden which responded to the 2008 financial crisis by cutting taxes and spending. The country has the advantage of learning from its own financial crisis in the early 90s when many of its market reforms were initiated. While cutting taxes on the wealthy was anathema to the Swedes' egalitarian sensibilities, they prefer jobs to government checks and they have managed to produce plenty of the former. Sweden enjoyed Europe's highest economic growth in 2011, a seminal year in which the country also eliminated its budget deficit.

The Keynesians point to economic growth finally emerging in the US as proof that the stimulus spending has worked. Not so fast says the world's best economic forecasting firm which is notably out of step with the consensus. The Economic Cycle Research Institute (ECRI) has correctly predicted every recession and recovery for the last 25 years and last August they predicted a worldwide recession was approaching. In January they produced an interesting white paper on why they are sticking to their call. In it they explain how the economic numbers reported by various government and non-government agencies are adjusted for seasonality. Entirely necessary for accurate context, the adjustment process looks at seasonal variances in prior years. The problem arises because the fourth quarter of 2008 and the first quarter of 2009 experienced a climatic economic contraction that is now reflected as part of the normal seasonal variance. This has produced a pattern where the economy looks stronger in the fourth and first quarters than it would have if that climatic contraction had not skewed the numbers down. The flip side is that the second and third quarters appear weaker. Right on schedule, recent employment reports are missing expectations.

Financial Repression

Falling earnings estimates are another non-confirmation of the rally and we are entering the quarterly reporting season as I write. If the economy was as strong as the numbers suggest then earnings should be accelerating rather than decelerating. Earnings can't be adjusted for seasonality, as some Enron executives can tell you from prison, making them a primary economic indicator. Too many other useful statistics have lost much of their relevance as the Federal Reserve distorts price signals throughout the economy. The relationship between corporate earnings and market interest rates was once the most reliable indicator of the market's valuation. That long term correlation broke down in late 2001 with the Fed's aggressive monetary response to the terrorist attacks and has diverged even further since the 2008 financial crisis and the Fed's ensuing zero interest rate policy (ZIRP). Commodity prices have lost much predictive power as they react to central bank liquidity as much as supply and demand. Other Fed initiatives such as buying mortgages and longer term Treasury debt have managed to lower mortgage rates but have failed to bolster real estate prices. Most egregious is how all these actions have aggregated to distort price signals. Bernanke takes credit for higher stock prices but blames other factors for higher oil and food prices. He should look at all the money flowing into commodity based ETFs in search of return. We hear that the deficit is not a problem right now because interest rates are low and buyers of our debt are plentiful, but 61% of that debt was bought by the Federal Reserve with newly printed money. We can only imagine what interest rates would look like had the Fed not employed such unprecedented and extreme measures. We may find out the hard way as the Fed has signaled they are done expanding the monetary base. They may sing a different tune if the economy looks to be weakening in the second and third quarters.

Distorting these important price signals has come to be called financial repression and it takes other forms too. Last summer's European crisis was largely driven by US money market funds withholding investments in European bank debt. With the European Central Bank taking up the measures of its US counterpart by engaging in large monetary expansion, the message was sent that they will not let the banks default on these instruments. In a textbook case of moral hazard, US money market funds are once again heavily weighted in European bank debt. Greece is out of the woods now but the swap vigilantes who brought that country to the brink of collapse are beginning to target Spanish government debt which far exceeds the market for Greek debt. It is unreasonable to expect a proportional ECB response to Spain because it would entail printing too many Euros. Stepping Stones clients don't want to find out if one of these money market funds could fail like we saw in 2008, none of our cash is held in such funds, choosing instead insured savings accounts at TD Bank. In the age of ZIRP, there is minimal opportunity cost to shunning money market funds investing in European bank debt.

There has been an opportunity cost to our large cash position however as the stock market marches onward. Watching the indices rise ever higher masks the underlying market though. So many of the indices are over weighted by a few large names such as Apple Computer that they can rise even when most of their components are falling. Most of the areas in which we are looking to build exposure are signaling us to wait. Plummeting natural gas prices have prevented Chesapeake Energy from fully participating in the rally as they have become a victim of their own success. Fortunately, the company has shown a keen ability to sell assets at favorable terms to reduce its indebtedness. Many of their recent deals involved oil based assets trading at highs. Eventually all the natural gas that America is producing will find uses and Chesapeake will be vindicated. General Motors has announced new models of pickup trucks that run on natural gas as they curtail production of the politically charged Chevy Volt. Chemical companies are building refineries that use natural gas instead of oil to make important industrial chemicals like ethylene. We plan to add to our Chesapeake positions when we see stabilization in the natural gas prices to which they are so exposed. Emerging market and commodity positions are also not confirming the recent rally so we have held off allocating some of our cash to those areas. Even the large cap dividend payers that JP Morgan's whale is betting on are beginning this second quarter with a sharp correction. Although our large cash position kept our results below the indices, we did enjoy gains.

Ben Bernanke seems to share our concern referring to the current "unusually uncertain outlook" which can be attributed to the faulty price signals resulting from his economic distortions. He famously told Milton Friedman that he was right and the Fed did indeed contribute to the Great Depression with their unusually tight monetary policy and his Fed wouldn't repeat that mistake. Acknowledging the power of monetary policy to cause such adverse effects, he fails to imagine that an extremely easy monetary policy could also have harmful effects. One such effect is that politicians are saying today's low rates prove the deficit is not a problem, encouraging them to spend more money that we don't have. Whether the deficit is dire or not should be the conversation that drives the markets from now until Election Day. One side will tell us the economy is still too fragile to reduce government spending while the other will tell us the historic deficit is the reason for the economic fragility. Everyone knows that the main drivers of our deficit, Medicare/Medicaid and Social Security, need to be restructured to reflect the United States' changed demographics and life expectancies. The sooner we do that the easier the fix will be. Simply printing dollars to pay our bills may look painless now but there is plenty of history that proves otherwise.

Looking at recent election years, 2008 is the exception where we saw a gradual but consistent decline into the yearend financial crash. 1996, 2000 and 2004 were all volatile years where the stock market traded within a wide range hitting the top and bottom several times, that is the pattern we think is most probable this year. Either way the election goes, come January we are likely to see a contraction in that driver of corporate profit margins, the federal deficit. If it is combined with pro growth reforms, the German and Swedish experience tells us the market will look forward to the growth to come rather than the contraction at hand. That would require our political leaders to debate these important issues rather than demagogue on extraneous topics like free birth control. Between now and then many cross currents will drive economic numbers and stock prices. We can expect an upturn in economic activity in front of higher tax rates but one such activity would be selling stocks to lock in lower capital gains rates, like the owners of Facebook have decided to do. Most importantly in this age of financial repression, we need to expect the unexpected. We plan to use any volatility to continue to reallocate our cash expecting the electorate will choose to give up some of the deficit spending as long as it is accompanied by pro growth reforms of those deficit drivers. If they can do it in socialist Sweden there's no reason why we can't do it here. The alternative is the southern European model that is failing before our eyes. In these volatile times I want to especially thank you for your trust and as always 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
www.steppingstonesmanagement.com