Stepping Stones Management, LLC

First Quarter 2013 Commentary

April 19, 2013

It was a golden apple that led to history's most famous war as Aphrodite promised Paris the love of Helen, the beauty that would launch a thousand ships, if he declared her the fairest among her goddess sisters and deserving of the apple. Paris complied and took Helen home to Troy which became besieged for 9 years by Greeks avenging Helen's husband and their king. More than 3,000 years later, a world recovering from the war to end all wars engaged in a currency war revolving around gold and international trade. The 1930s saw most major economies either devalue their currencies in relation to gold or abandon their gold standards altogether in hopes of spurring exports while making imported goods more expensive. The success of that strategy can be summed up in two words: Great Depression. One of the world's foremost students of that period in economic history is Federal Reserve Chairman Ben Bernanke who says his quantitative easing (QE) policy is not designed to devalue the US dollar but offset the deflationary forces that are otherwise depressing asset prices. He points to the rising stock market as evidence that his policy is working despite the poor economic growth that necessitates ever increasing amounts of his medicine. The economy slowing to a dismal 0.4% growth rate in the fourth quarter of 2012 was not enough to offset all that Fed liquidity which drove the stock market to new record highs in 2013's first quarter on hopes that a nascent housing recovery will boost the employment recovery which has been in its own nascent stage for more than 3 years. By the end of the first quarter, the S&P 500 had risen by 10% as the price of gold began what would culminate in a dramatic selloff in recent days.

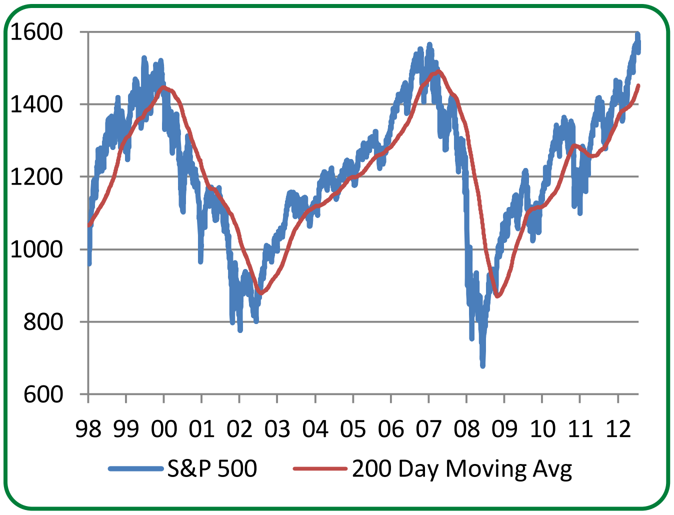
Aphrodite's Plight

Before she was causing trouble among the mortals, Aphrodite, the goddess of love, arose from the sea foam surrounding Cyprus, the Mediterranean island that captivated the world in the first quarter. This time it wasn't Greeks hiding in a hollow horse but devalued Greek sovereign debt on the balance sheets of Cypriot banks. It is said that German Chancellor Angela Merkel was unwilling to bail out the Cypriot banks that cater to Russian criminals in a German election year which means the taxpayers being asked to finance the bailouts are finally getting their say. In the end it will be the banks' uninsured, meaning large, depositors who will bear the brunt of the losses which provides an important lesson that higher yields carry higher risk, even those as paltry as Cypriot banks were paying. The initial solution called for insured depositors in the banks to share in the losses, but that was wisely reversed in the face of public outcry. As the dust settles, northern European finance officials declare the Cyprus solution to be a model for other troubled banks, raising the risk of deposit flight out of those in Portugal, Spain and Italy.

Legend says the vanquished Trojans eventually founded Rome on the banks of the Tiber River and all eyes are on those Italian banks now where Italy's fiscal policy has been roiled by politics leaving the country without a president and no party in command of Parliament. Their countryman, European Central Bank Chairman Mario Draghi, has not been willing to expand the ECB's already expansionary monetary policy as much as his US and Japanese counterparts have. He is sticking to the rules as most of the economies that comprise the Eurozone are sinking deeper into recession while their stock markets fall. In Portugal, a judge has invalidated that country's budget cuts saying they fall too heavily on public workers who account for most of the budget in the first place. The next round of austerity is thus likely to resemble ineffective prior rounds comprised of higher taxes with few budget cuts. Despite their difficulties, the Portuguese government easily sold more debt in February to international fixed income investors hungry for yield. Cyprus hasn't been as lucky, their central bank has announced the need to sell some of its gold reserves and it is rumored that other troubled Mediterranean nations are undertaking similar actions. The proverbial can has been kicked to oblivion as they are running out of other people's money, to paraphrase the late Margaret Thatcher. While Portugal had no problem selling more debt, it has been Aphrodite's lion headed son Phobus, the god of fear, ruling European equity markets this year as investors take flight not knowing what happens next in our new world of uncharted monetary policy.

Across the world, Japanese Prime Minister Shinzō Abe rode to election last year on an agenda of increased government spending along with a weaker yen to boost exports. He called for deficit spending to increase by 2% of GDP to a now expected 11.5% of the Japanese economy. His chosen Governor of the Bank of Japan, Haruhiko Kuroda, has picked up on the number 2 by pledging to double the monetary base in 2 years by doubling its purchases of government bonds in hopes of boosting inflation to 2%. Nobody is accusing him of lacking transparency but the president of the German central bank and member of the ECB Governing Council, Jens Weidmann, has cited Japan as an example where the "politicization of exchange rates" could lead to a currency war. Japan's emerging market neighbors struggling with inflation in their home economies have also voiced resentment that Japanese actions are worsening their problems. Efforts to tame inflation in China and South Korea are restraining their economies which are important export markets for US companies. Japanese bond yields have surprisingly spiked up despite the huge upcoming government purchases proving markets don't always behave as planned. Like those in Europe, stock markets across Asia have been declining through the first quarter even while central bank printing has produced gains in the US and Japan. Europeans are especially worried about now less expensive Japanese cars taking market share away from the big German manufacturers with the financial press saying that Gov. Kuroda is scattering money from the back of a Toyota.

Maybe when he gets real big he'll get a helicopter like Ben Bernanke who is still creating $85 billion every month to buy US Treasury and mortgage bonds. The following chart of the S&P 500 covers the fourth quarter of 1998 through last night, April 18th, and shows us near record highs. The rally from the 2009 bottom has been well correlated with increases in the Fed's QE program and several Fed officials have signaled that the next move will be to "taper" the



purchases. But that was when expectations were for economic growth to accelerate towards 3% this year. March's poor employment report is reminiscent of prior years when the economy appeared to start strong but then faltered, resulting in "sell in May" corrections. This time, economic weakness could justify a reversal in Fed rhetoric and a reacceleration of the printing presses providing a win-win scenario for the stock market where good growth produces good earnings or bad growth results in more free money. An area of the Aegean Sea between ancient Troy and Greece is named for Icarus who crashed there after he flew too close to the sun and melted his wings made of wax. It is a cautionary tale that risks often lurk unseen and there is not much risk being recognized in today's markets. The win–win scenario is said to have reduced "tail risk", referring to the chance of an unlikely yet very disruptive event. However, you don't need a modern risk model to see on the chart that stock market risk is highest when the blue price line gets too far above the red 200 day moving average like it is now.

Japanese officials see that chart and all the money US politicians are able to spread around to their favorite constituencies and say why not us too. In the 40 year experiment with fiat money, politicians have finally realized that they can print and spend at will as long as they are fortunate enough to have compliant central banks. The central bankers are happy to play the heroic role of saving the economy especially when the cost is seemingly zero since that is where they have pegged interest rates. Ben Bernanke likes to point to high stock prices resulting from his policies which are a boon to the financial system he oversees. Even Fannie Mae has reported record profits! When he made his regular Congressional testimony in the first quarter, Bernanke pointed to his inflation record averaging below 2% as the best in the Fed's 100 year history. He dismisses questions about a new bubble in asset prices and says people suffering under low deposit rates can take on more risk to get higher returns. An investment manager recently told us his mother is invested in his firm's high yield bond strategy because it is the only way to get any yield. His mother is lucky that her son is a bond trader, unlike all the other old ladies blindly buying junk bond funds these days for a few points of yield like they used to get in their savings accounts. Asset flows like that have enabled bankrupt companies to emerge and raise debt financing on the cheap prompting renowned bond market historian James Grant to observe that Bernanke has taken the yield out of high yield.

Two all beef patties special sauce lettuce cheese pickles onions on a sesame seed bun

Bernanke's assertion of having the best inflation record of any Fed chairman is based on the Consumer Price Index (CPI) which has increased by a scant 1.8% annually since 2008, when his unconventional policies began. Calculated by the US Department of Labor, the CPI captures changes in the prices paid by urban consumers for a representative basket of goods and services. However, it no longer does so with the modifier of maintaining a stable standard of living.

Something that does maintain a stable standard around the world from year to year is a McDonald's Big Mac. *The Economist* magazine calculates its "Big Mac Index" to compare currency exchange rates around the world in the context of the sandwich made from a variety of basic commodities and incorporating the local prices of labor and real estate. Countries that show a higher US dollar price for it are said to have overvalued currencies versus the dollar; Japan's was slightly undervalued to start the year. Looking at the average US price over time also provides an alternate estimate of US inflation and Ben Bernanke may not be lovin' it. Since the beginning of 2008, the average US price for a Big Mac has inflated at an average annual rate of 3.36% even with zero rates for 2009 and 2013. Washington politicians across the aisle call for scaling the growth in the CPI back even further, a stealthy way to cut government spending, but whether it is Big Macs or bus tickets most Americans don't need the CPI to know they are already paying higher prices. Bernanke's assurances that he will be able to turn off the monetary spigot before inflation takes hold may be an example of that hubris common to Greek tragedies.

That price increase isn't all due to general inflation as wages have not participated in the move up. Regulations are surely accountable for some of it and now that the elections are behind us, 2013 has brought many of the most burdensome rules of Obamacare into force. We saw some encouraging new jobs numbers in the first quarter but closer inspection reveals that full time jobs actually declined as part time jobs made up all of the gains. A new term has entered the economic lexicon as "job splitting" explains part timers getting multiple jobs that each count in the monthly reports. Using McDonald's as another example, managers are said to hire part time workers and advise them that the manager at the Burger King across the street may be interested in hiring them for another 20 hours a week. That way both restaurants can keep their total full time employees below the law's 50 employee threshold where the government's standard health benefits must be provided. Business and regulators will likely play a cat and mouse game for years to come around how the regulations will be implemented and enforced rather than focusing their energies on how to provide better products and services at more affordable prices.

For the second time in the last three quarters, the first quarter earnings reports that are coming in now are expected to show a year over year aggregate decline for S&P 500 companies. Per share earnings look better due to heavy share buybacks but mask the underlying deterioration in the macro economy. It is frustrating to see markets race higher when we hold excess cash so we have not sold into the rally and are uninterested in buying bonds at unreasonably low rates. The rock solid edifice of the municipal bond market is also about to be tested as a court in California ruled bankruptcy proceedings can proceed for the city of Stockton where bond holders and the state pension fund could not agree to a settlement. Look for this fight to emerge in other troubled cities across the country as Meredith Whitney warned two years ago, she may remind us that Cassandra was ultimately correct.

Especially encouraging to some is the breakdown in the price of gold that is seen as a fear gauge. Some of that breakdown is from the central bank selling mentioned above and likely augmented by forced hedge fund liquidation, neither is a harbinger of better times but either could signal a bottom. Regardless of the reason, the gold price breakdown has hurt our position in the gold miners ETF which we plan to maintain in the face the continuing monetary expansion around the world. As international investors cash in their gold coins for bitcoins, we expect the classic store of value to be relevant again before knowing enough to write about the latter. Our large cash position and the decline in the gold miners ETF kept the performance of our portfolios behind the S&P 500's 10% quarterly rise but well positioned for any correction that may be developing.

Gold has been a good diversifying position in our extremely correlated markets and if its breakdown this week is a climatic selloff it should raise concerns of a contrarian climatic top in the US equity market. Market indicators say the risks of a large downturn are remote but those risk indicators all begin with the "risk free rate" which is now controlled by the Federal Reserve Board across the maturity spectrum. Classic economic models have been rendered obsolete but Classical Economics has a tendency to win in the end. It may be vengeful Greek gods or Adam Smith's Invisible Hand but mortals should remember Sisyphus the craftiest of Greeks who was avaricious and deceitful without consequence until being punished by the gods who forced him to forever roll a huge bolder up a steep hill only to have it roll back down each time; kind of like our economy lately.

It was another war between the Persians and the Greeks 700 years after Troy that made Marathon famous when a runner trekked the distance back to Athens to declare Greek victory. Monday's attack in *The Athens of America* reminds us that our victory in the war on terror is not yet at hand and is more complicated than a typical interstate conflict. It represents one more risk that is not being priced into our current "low tail risk" market. An incipient currency war is another risk, as are a slowing world economy, declining corporate profits and dysfunctional government budgets. Unrestrained monetary creation is not mitigating these risks but enhancing them. When the aforementioned James Grant was recently asked when he expects the reckoning to come, he responded "I hope soon because I'm beginning to sound like a car alarm." The alarms are loud and clear and that chart shows more risk than reward in the US stock market currently. Our cash should buffer any downturn and we will maintain our position in the shares of the gold miners who can still make money mining the metal which has always been better than simply printing it. Please feel free to call us anytime to discuss your portfolio. Until then and as always, 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
www.steppingstonesmanagement.com