STEPPING STONES MANAGEMENT, LLC

First Quarter 2015 Commentary

April 23, 2015

It was MIT student Leonard Kleinrock who originally envisioned the internet in a doctoral thesis from May 1961 that caught the eyes of his professors and the US Department of Defense Advanced Research Projects Agency (ARPA). Further research over coming years culminated in a million dollar contract to build the first refrigerator sized Interface Message Processors (IMP) enabling communication between computers over telephone lines. In 1969, while Al Gore was shipping off to Vietnam and still years away from his Congressional career, US Senator Ted Kennedy helped his constituents at Cambridge Massachusetts BBN Inc. get the contract to build the first IMPs. He clearly did not realize he was helping to create the internet when he sent a telegram congratulating the company on the contract for the “Interfaith Message Processor” and thanking them for their ecumenical efforts. It would take a generation until local churches around the world had their own websites but the new electronic network called ARPANET grew quickly within the academic and defense research communities. The first four IMPs were installed at university research facilities and grew to fifteen nodes by 1971. By 1990 that number exceeded 100,000 worldwide when ARPANET was replaced by the National Science Foundation’s NSFNET.

There was a strict prohibition on any non-research related use of NSFNET. Professors were not even allowed to use the new electronic mail features for any personal communication with others on the network. In March 1991, The NSF finally permitted commercial use of the internet and the number of hosts exploded to over 1,000,000 by the following year. As we all know, the biggest economic boom that anyone has ever seen quickly followed. In the last thirty years the internet has led to previously unimaginable technologies that make our lives better. All that takes investment which was also flowing freely in the late 1990s without any help from the Federal Reserve. The internet has been one of the few areas free from excessive government regulation, however that changed in the first quarter when the Federal Communications Commission declared the internet to be a public utility subject to the same Depression era laws that govern telephone lines. The scope of the “net neutrality” regulations surprised and disappointed even companies like Google that had invested millions in lobbyists to champion the regulations. The telecommunications companies were more disappointed after they lobbied for the freedom to charge rates on their multibillion dollar networks that make the most commercial sense. They are among the few that are actually investing in durable fixed equipment in today’s economy. Most of the investment being spurred on by the Fed’s historic Zero Interest Rate Policy has been limited to financial assets like stocks and bonds but even those flows began to slow in the first quarter that saw the S&P 500 manage a slight gain of 0.44%.

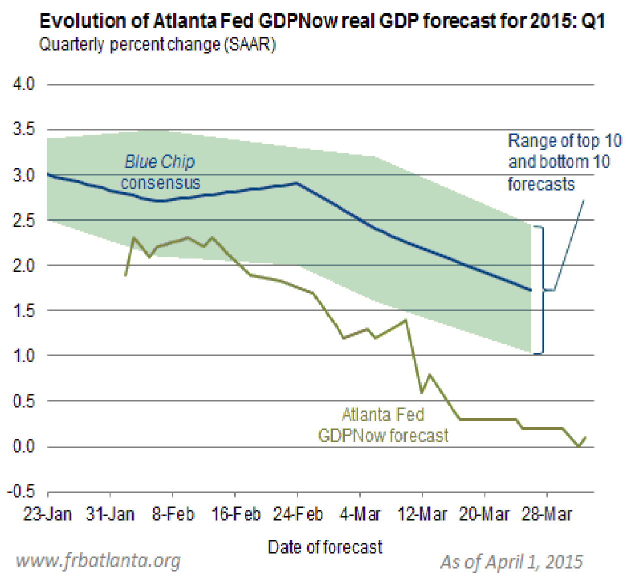
That was the lowest quarterly advance since the fourth quarter of 2012 when the market was gripped with fears of the fiscal cliff. Government's modest retrenchment from the economy did not result in disastrous consequences then, in fact economic growth picked up. Voices now fear that the end of accommodative monetary policy could also result in disastrous consequences. Those on the right side of the political aisle are sensing that the Fed will not raise rates until one of their own is sitting in the Oval Office. They are beginning to call foul and it seems to be striking a nerve inside the Fed's marble walls.

Auditing the Fed

The political vehicle is US Senator Rand Paul's proposed legislation to audit the Fed. The Congress is constitutionally charged with oversight of the nation's currency but delegated that authority to the Federal Reserve 100 years ago. It was deemed wise to protect such an important function from the shenanigans of the political realm. For most of the past century that arrangement has been credited with making the US dollar the world's reserve currency. Fed Chairman Janet Yellen vociferously opposes the legislation and points to a litany of ways the Fed is already audited. Various government agencies and actual accounting firms audit the books and issue public reports. The Fed's balance sheet and holdings are published weekly on its website and Yellen makes regularly scheduled public appearances before relevant Congressional committees. Other Fed officials appear throughout the year in media and at conferences so everyone can be fully aware of the various points of view that distill into Federal Reserve policies. Positions and votes on those policies are announced and meeting minutes are published with a six week delay. It is fair to say the Fed is the most audited and transparent institution in the world.

All that is not good enough for Sen. Paul and supporters of the legislation who want to know how foreign and domestic financial firms have benefited from the unprecedented policies of recent years. They have certainly benefited greatly and the legislation would not have any political traction if more of the country had also benefited. Most people who are suffering with lower income year after year and no longer earn any interest on their savings fail to see the benefits. That explains why the legislation has 30 Senate cosponsors. Republicans also see a Democratic administration racking up record debt to buy political support with the Fed financing most of the bonds. Their *macro prudential regulations* incentivize the banks they regulate to buy up the rest while penalizing bank holdings of private debt. Yellen opposes the legislation because she says it would "politicize monetary policy." It is easy to understand why Republicans think that has already happened.

Yellen was joined by other Fed officials who were more vocal than usual in the first quarter. Dallas Fed President Richard Fisher backed up the Chairman from the opposite side of the ideological spectrum when he said, "Who in their right mind would ask the Congress of the United States — who can't cobble together a fiscal policy — to assume control of monetary policy?" Cleveland Fed President Loretta Mester also criticized the legislation as "misguided" but used two other speeches in the quarter to echo her colleagues in guiding markets to expect rate hikes between June and September this year. St Louis Fed President James Bullard said "The market has a more dovish view of what the Fed is going to do than the Fed itself," and that it is "reasonable" to expect an increase in June or July. Monetary hawks like Richmond's Jeffery Lacker even want the Fed to begin shrinking its balance sheet "relatively soon" after the first hike. More dovish views were expressed by Boston's Eric Rosengren who voiced concerns about "international developments" and said the Fed is "still a long way from normalizing." Minneapolis' Narayana Kocherlakota thinks a 2015 rate hike would "be a mistake" and more recently said that there is a "theoretical argument" to be made for more asset purchases. That means QE4 but neither of those monetary doves are voters this year. Yellen has many views to consider and the market especially looks for guidance from her former research director and successor as President of the San Francisco Fed, John Williams. He is widely viewed as favoring easier money but made a strong case for a mid-2015 rate normalization in a speech on March 5th. He said "there's a difference between easing off the gas and applying the brakes… When you're driving towards a stoplight, you don't keep your foot on the accelerator; you ease off so you're ready to stop at your target. Otherwise you slam on the brakes—and probably wind up in the middle of the intersection." His employment and inflation indicators say that stoplight is approaching.



Financial markets also express clear rate expectations. Futures prices at the beginning of the year were predicting a rise in September but weakening economic statistics reported throughout the first quarter have pushed expectations out to November. The Atlanta Fed visualizes that deterioration in a daily model of US GDP growth for the current quarter called GDPNow. Expectations in January were for first quarter growth of about 2%, compared to the Wall Street Blue Chip consensus around 3%. As the regular economic reports were issued throughout the quarter, the model's expectation came down closer to zero while the Wall Street consensus ranged from 1% to 2.5%. You can see the green line on the chart dropping most precipitously in March reflecting the harsh winter climate that has been blamed for bringing the economy to the edge of recession for the second year in a row; but we don't want to be too hard on Al Gore in this letter.

The harsh winter wasn't enough to boost energy prices which declined further in the first quarter but the two energy service positions in the Stepping Stones fully invested equity ETF strategy managed gains of about 7%. That suggests the bear market in energy prices could be nearing an end. Two of the ten ETF positions were negative in the quarter, the Utilities fund suffered under rising rate fears and the Gold Miners fund met its role as a diversifying agent. The Japanese currency hedged fund was the strongest performer rising almost 12% with the China fund gaining almost 7% and the Europe fund more than 6% in the quarter. The Consumer Staples and Value funds did better than the Semiconductor fund as the market began to discount risk more than it has recently. Overall the strategy gained over 4% in the first quarter compared to the S&P500 return of less than 1%.

Negative Normalizing

One reason for the Fed to raise rates would be to give themselves room to react should a recession occur. Although at this point, any necessity for further monetary accommodation would prove not only how ineffective it has been but even its damage to the overall economy. If New Age monetary policy was working, the Fed's independence would not be under attack, the gathering political winds should be a message for the institution that it isn't working. As mentioned in last quarter's letter, the European Central Bank has joined their counterparts in the US and Japan in buying government bonds to the point where interest rates across Europe are now negative for the first time in the history of money. Banks are actually having to pay borrowers who have adjustable rate loans; for European savers, their sock drawers really are better investments than the banks. These are not normal times.

Rates are still positive in the US but anecdotal evidence suggests negative rates are infusing themselves here too. JP Morgan has begun to charge their institutional clients for large cash balances. The bank is compelled to assess the negative rate because the Fed's regulations force them to carry more reserves against such deposits than are commercially viable. When the nation's largest bank is turning away deposits from their largest customers we should not be surprised to see them also turn away loan applications. Credit tightening trends emerged in March that are indicative of a sharp economic contraction to come. Weakness in the energy sector is likely responsible for most of those trends but the rest of the economy is looking far from strong. It could signal a recession or it could be a result of central bank interest rate manipulation clouding traditional economic metrics and degrading their usefulness. However one thing seems clear, with major banks turning away deposits, we can't expect loan growth to save the economy.

The Fed tells us the timing of the first interest rate increase in nine years will be dependent on the economic data. Even as that data reveal a weakening economy, Fed officials speaking with the press suggest it is not enough to take them off their course towards interest rate normalization this year. Wall Street prefers the message from their man at the New York Fed, President William Dudley formerly chief economist at Goldman Sachs. He may have given up the ghost on exactly what kind of data the Fed will be dependent and what kind of asset prices they are trying to boost. Referring to the stock market on April 8th he said, "How we react after liftoff will depend on how the market reacts." The message is if the market reacts poorly, the Fed will stop raising rates. His is the branch that most interests Sen. Paul as the New York Fed is where all the central bank's open market operations are conducted. For good reason those operations are shrouded in more secrecy than the other branches. It is already easy enough for Wall Street to print money in the era of quantitative easing, there is no reason to enable them to also build algorithms to front run the central bank.

We are looking forward to interest rate normalization and expect economic normalization to follow, albeit after some disruption. Only when banks begin to offer interest on savings will they again begin to grow their loan portfolios. The era of zero interest rates has not been associated with strong economic growth anywhere it has been tried. Economic growth depends on healthy investment which depends not only on reasonable interest rates but also on a fertile regulatory environment. Al Gore's internet bona fides come from his US Senate career when he passed the "Gore Bill" signed by the first President Bush in 1991. Based on research by Leonard Kleinrock, who had graduated to become a Professor at UCLA, the bill allocated $600 million to academic researchers who ultimately built the Mosaic web browser. Vice President Gore gave a speech in 1994 saying we can't subject the internet to "the hands of either government regulators or would-be monopolists." That philosophy drove the Telecommunications Act of 1996 seeking to promote long term investment in "information service providers" who were carved out from the law's more onerous regulations; the hands-off approach worked splendidly. The Mosaic browser was the product offered by Netscape communications whose IPO in 1995 sparked the dotcom craze. Anything but accommodative, in December 1996 Fed Chairman Greenspan warned about irrational exuberance while interest rates were several times higher than today and the US Treasury espoused an unmistakable strong dollar policy. Investment from around the world flowed into America's great new technology that enriched the nation in a rising economic tide. The FCC's net neutrality rules erase that hands-off policy and will force internet providers to get government approval of the prices they charge. As government control of banking has had the opposite effect of spurring lending, subjecting telecommunications companies to the approval of government bureaucrats can be expected to have similar effects on their capital spending plans and the rapid innovation that has been improving our lives.

The heavy hand of government throughout the economy seems to be taking its' toll, earnings growth expectations for the first quarter are worse than any time since 2009. Improving economic statistics from the middle of 2014 have faded into calls for more Fed accommodation. We think Chairman Yellen wants to avoid the damage to the central bank's credibility that would come from failing to raise rates after all their recent rhetoric. She is running out of time to avoid the political heat of raising rates during a Presidential election. Complicating her mission, the economic data seems to be more reliant on the Fed than the other way around. Atlanta Fed President Dennis Lockhart, whose GDPNow model provides the clearest view of current economic growth, told CNBC last week that it is a "bad time to make a major policy decision" because the "data is murky." The data is murky because the Fed has manipulated interest rates so much, masking the true health of the economy. We continue to prepare for the normalization of interest rates which we think will coincide with a normalization of the stock market valuation that has exceeded the levels prior to the Great Crash of 2008; although it remains below the most extreme levels of 1999. A stock market correction could even spur a normalization of the regulatory environment, but that could be too optimistic.

Please feel free to call us to discuss any of your financial concerns. 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
PO Box 263
City Island, NY 10464
direct: 646-723-6262
www.steppingstonesmanagement.com