STEPPING STONES MANAGEMENT, LLC

First Quarter 2016 Commentary

April 21, 2016

The hottest show on Broadway as the first quarter turns into the second is *Hamilton*, the hip-hop musical portraying the life of founding father Alexander Hamilton. If you have a line on tickets you could make my ten year old son very happy. The show opens with the revolutionary hero claiming to be "just like my country, young, scrappy and hungry, and I'm not throwing away my shot!" The message relates how America's entrepreneurial roots go all the way back to our founding. At 19 years old, Hamilton had learned to manage his disadvantages and would "amaze and astonish with brains but no polish." The show's appeal is a powerful example that one of the most important stories in world history still resonates. The success of the fledgling country was as unlikely as a wed-locked orphan being accepted among the leadership of a foreign land. Succeeding in war against the world's sole superpower was as unlikely as managing to unite 13 distinct states who all valued their sovereignty. He authored the majority of the *Federalist Papers* in 1787-8 laying out the concepts for the US Constitution along with James Madison and John Jay, probably his greatest but surely not his only gift to humanity.

Serving as General Washington's right hand man and then President Washington's Treasury Secretary also hugely impacted and shaped the young nation. Hamilton advocated a strong central government, the federal assumption of states' debts and the establishment of a national bank. This brought him into conflict with his constitutional partner, James Madison and Thomas Jefferson who advocated for state's rights and feared the power that could amass in a central government. As a check on that power, in Federalist #78 Hamilton lays out the concept of an independent judiciary to review the constitutionality of the laws passed by Congress and the President. That issue of course became prominent in the first quarter with the death of Supreme Court Justice Antonin Scalia leaving our nation's highest court in an ideological split and increasing the stakes of this year's election.

The debate about the amount of power in our federal government has driven our politics longer than the 230 years since Hamilton and Jefferson argued their points, but the issue of a central bank has seldom been as prevalent as it was then and now. We began the first quarter of this election year with the Fed having embarked on the process of normalizing interest rates which had been pegged near zero for almost eight years, a historically unprecedented policy. After December's first interest rate increase since 2006, Yellen's Fed was guiding markets to expect four more quarter point increases during 2016. The stock market made its displeasure evident with the worst start to a calendar year in history. By early February, the S&P 500 had lost more than 10% for the year and 14% since its high last May. The volatility convinced central banks in Europe and Japan to drive interest rates further into negative territory while promising to expand their quantitative easing programs, creating money to buy financial assets. The Fed simultaneously began to backtrack on its plans for four more rate hikes this year, current expectations now call for two. All the additional money sloshing around the globe and the Fed's retreat were enough to bring the bulls back to Wall Street and the S&P 500 rallied to finish the quarter with a slight gain.

Normalizing NIRP

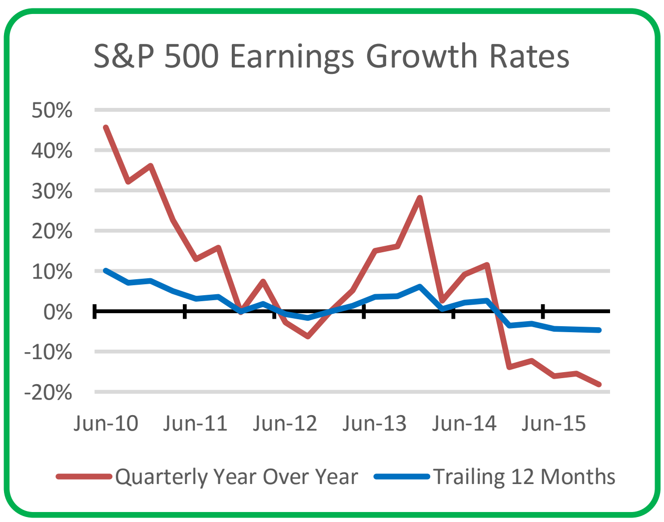
It looks increasingly like the data on which the Fed depends is the level of the stock market. Their latest stated objective to get core inflation to rise above 2% was achieved for the fourth consecutive month when they met in March, so another reason to keep rates near historic lows was needed. They predictably attributed their reconsideration to "international developments." The aforementioned European Central Bank (ECB) deepened its experiment with its negative interest rate policy (NIRP) because it is obviously working so well. Its counterpart in Japan also joined the party and quickly expanded its nascent experiment when the yen unexpectedly rose in value after officials pledged to purchase additional bonds and equities of Japanese companies. The Bank of Japan (BOJ) already owned more than half of all Japanese ETFs by the end of last year. Traders around the world are buying yen denominated assets that they can flip to the BOJ acting as the buyer with the ultimate wallet. All the opportunistic money pouring in, drives up the value of the yen. This makes it more difficult for the export driven economy to operate. The BOJ's ongoing purchases have not been enough to support the Japanese stock market which finished the quarter 20% off its highs from last spring. Pride prevents the central bankers from conceding that their medicine may be harming the patient.

Negative interest rates are supposed to stimulate lending because borrowers would surely want to take advantage of free money. The problem is on the supply side. With deposit rates at zero, or worse, there is no incentive to save, so banks have less money to lend. Home safes have become wildly popular consumer items in Japan. People are taking their money out of the banks and keeping it in their closets where no penalty rate gets assessed. Policymakers are silent on how this is good for the financial system but loquacious on how to confront their new problem. The ECB is discussing terminating the 500 Euro note while former Treasury Secretary and Harvard president Lawrence Summers makes his case for a return to Alexander Hamilton's old post by calling for the abolition of the $100 bill. People may need to get bigger safes. They claim to be fighting terrorism and international crime but we never heard such proposals until interest rates went negative around the world.

Banks won't make loans to businesses without the incentive of a positive interest rate so instead they make loans to their governments with money provided by central banks. The Fed has created almost $4 trillion since 2008, 80% of its balance sheet, to buy US Treasury and mortgage bonds which have funded the government deficits of those years. The 2010 Dodd-Frank Act placed even more power in the Fed to regulate the banking system. One of its main features is the risk weightings that incentivize banks to hold government debt. By skewing their holdings toward government bonds which do not require capital set asides, like commercial loans do, the banks keep more of their capital working. Our strong central government has worked closely with our strong central bank to make sure its needs are met. This enables the politicians to spread the free money around to their cronies and constituents, it's no wonder they think the economy is doing fine. It is for them but as mentioned last quarter, the people lining up to hear Bernie Sanders and Donald Trump rail against the rigged economy think otherwise. One is a proud socialist and the other quotes Mussolini, both representing other forms of strong central governments that have proven less durable than the one devised by Hamilton's genius.

The Dodd-Frank Act also established a committee of government officials to designate systemically important financial institutions (SIFI) to come under their purview in order to protect the broader financial system if they should fail. Such a designation brings benefits of being in the too big to fail club, but MetLife took issue with the opinion of its interconnectedness and the meddling that government bureaucrats were imposing on its insurance business. The company sued in federal court and won a victory on March 30th that could ripple through the regulatory state. The judge ruled that agencies cannot base their decisions on predictions unsupported by evidence. She said the council "never projected what the losses would be . . . or how the market would destabilize as a result." The decision marks a departure from the judicial trend of showing deference to the expert opinions of federal regulators. Such deference allowed Congress to avoid the difficult votes that are supposed to determine regulations and the federal bureaucracy blossomed. A Supreme Court consideration of the case would have ramifications far beyond the Dodd-Frank Law, adding to the stakes in this year's election.

They Didn't Earn That



All the regulatory meddling is apparently a more powerful force than the free money because corporate earnings have continued to weaken. First quarter expectations call for the trend of negative growth to stretch into its sixth quarter. As you can see on the chart, the rate of earnings growth has been declining consistently for more than two years and the past five years clearly show a negative trend. S&P 500 quarterly earnings per share have fallen to a level first reached 10 years ago when the index was trading 40% lower than today. The problems are not limited only to energy companies as seven of the ten market sectors expect to see lower earnings than the first quarter of last year. Health care has been the strongest outlier enjoying the wave of government spending since Obamacare became law. The terrible inflation that created the political will to pass that historic legislation has only gotten worse for most people not eligible for government subsidies. However, even with all the new compelled and subsidized customers, health care providers throughout the country are closing as the business model no longer works. Businesses across the economy find themselves more focused on complying with regulations than on providing goods and services at practical prices. Glance at a job posting site and you will notice the preponderance of compliance positions in various industries. The need for these kinds of jobs is just one reason why productivity is suffering and weighing on corporate profits.

The weak corporate profit environment has weighed on our fully invested Equity ETF strategy with half of the ten positions registering declines for the first quarter. The currency hedged Japanese fund was the worst performer losing more than 12% and one of our two energy positions lost another 8%, the other gained slightly. Oil prices have risen 50% off their lows and some balance seems to be emerging in the international energy markets. Our China and Europe positions each experienced mid-single digit declines. The gainers were led by the long beleaguered gold miners ETF which added more than 45% in the quarter. Gold prices are finally reacting positively to all the central bank money printing. Thanks to that performance, the ETF portfolio rose almost 7% in the first quarter compared to the S&P 500 rising by 0.77%. We are hopeful that the worst of the energy declines are behind us. A seminal point may have been the federal indictment of Aubrey McClendon, the former CEO of our longtime holding Chesapeake Energy, on price fixing charges. The controversial wildcatter said he was innocent of the charges that have never before been brought in his industry, but he never got to plead his case. He was killed in a high speed car crash that appeared to be a suicide the day after the indictment. The stock had fallen to a multiyear low but has since tripled off that level with the cloud of federal charges removed. Few men have done as much to make America energy independent again; it is a sad story all around.

Stock prices ultimately follow earnings and the gradual erosion of corporate profits is only getting worse. If an economic recession were to follow this earnings recession, we would likely see a sudden drop in earnings and stock prices. History suggests that is more likely than the upward spike that analysts continue to predict in coming quarters. The market is dismissing a recession scenario at its peril. The financial press cheers as low expectations are being exceeded even as earnings fall. As these letters have expressed through much of the Fed’s QE era, the earnings that have fueled the bull market have been largely engineered with the help of ultra-low interest rates. Rather than providing funds for investment, Fed policies meant to stimulate economic growth have instead compounded the adverse effects of rising government regulations.

The Supreme Court could become another factor adding to the forces of our leviathan government. We saw an even split in March arguments about whether the Little Sisters of the Poor should be forced to violate their religious beliefs and provide birth control and abortion coverage for their employees. Justice Sotomayor rhetorically asked the government’s counsel “How will we ever have anything that the government can demand people to do” if the nuns were not compelled to provide such services. A split decision will let stand a lower court ruling imposing massive fines which would end the sisters’ ministry to the poor and elderly. History is rife with examples of governments based on demanding citizens to do things and they usually turn out bad. The first quarter turning into the second brings a vivid example where South America’s largest economy is failing in the wake of populist politicians making unrealistic promises to seize more government power. Brazilians thought they were voting for the candidates who would do the most for them but the lure of power and money was too great. Their economy has been roiled by political and financial scandals culminating in impeachment proceedings against the president. Things are even worse in Venezuela where water is yellow, air is grey and toilet paper has become a luxury item.

Hamilton and Madison knew that we are not angels and the checks and balances they devised for the US Constitution make it more difficult for populist politicians to amass such destructive power; but our federal government has grown beyond any historical relationship to our economy. Hamilton's advocacy of a strong central government never envisioned the role ours is playing now. We are happy to hear that the cabinet department he created will keep his image on the $10 bill and replace the populist Andrew Jackson with Harriet Tubman on the $20 bill instead. Let's also cheer the popularity of the Broadway musical and the Pulitzer Prize for Drama awarded to it this week. It is an important story that presents the man with all his foibles. He founded the Bank of New York, the oldest company in America today, before he founded the First Bank of the United States, a precursor to our Federal Reserve, but he was brought down by financial scandal. Accused of misappropriating funds, he was in fact concealing an extramarital affair. He had his troubles but he got his shot and made the best of it for the benefit of generations to come that enjoyed living in freedom and prosperity. He compromised on his centralized government principles and the ratified US Constitution was better for it, providing the foundation for the world's sole superpower today.

Lest we bemoan how far our politics have fallen, it was worse back then. Hamilton of course took his ultimate shot in a duel with Arron Burr atop the cliffs of Weehawken NJ. It was the result of a political difference where he refused to endorse his old friend for Governor of New York. His farewell letter to his forgiving wife displayed the pride that led to his death, saying he would be "unmanned" if he told her what he was about to do. Thankfully, we learn from such lessons and politics hasn't returned to death matches since. We wish the central banks doing such harm to the global economy would learn the classic lessons of how destructive pride can be and truly normalize their policies. In the meantime, let's enjoy the political spectacle unfolding before us but hope for the pendulum to return to the era of big government being over, because history shows that to correlate most with prosperity. For our accounts we want to see better earnings before committing our cash reserves. Corporate guidance in this earnings season has been generally discouraging and the recent rally has driven valuations to levels that have historically resulted in poor returns. We're confident that a better buying opportunity awaits.

Please 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,

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