STEPPING STONES MANAGEMENT, LLC

Second Quarter 2009 Commentary

July 21, 2009

Working on my lawn in late June I noticed that despite all the rain we had in the New York area, the grass looked yellow and weak. Borrowing from Chauncey Gardener (the Peter Sellers character in *Being There*), I think the economic green shoots that I wrote about last quarter are suffering from a similar lack of economic sun. The stimulus package passed in February was said to provide the irrigation the economy needed but evermore government interventions into the economy cloud the rays of the free enterprise system and forestall economic growth. As I have expressed in recent letters, I even doubt the irrigating effects of the stimulus package. Banks are making loans but they aren't making them to businesses, they are making them to the government in the form of Treasury note purchases. Why make a risky loan to a small business in this environment when there is ample issuance of guaranteed Treasury paper flooding the market. The federal government is transferring most of this money to state governments who rather than implementing new shovel ready projects are using the money instead to fill budget holes. The cap and trade legislation being debated in Congress is another cloud that will provide politicians with a new tax regime which cannot be good for the economic climate even as it promises to do very little for the atmospheric one. All this has consumers and businesses hunkering down rather than spending as they fear what their income statements or balance sheets will look like when the inevitable tax hikes hit the economy. This retrenchment is helping to pay down the excessive debt built up in recent years but it brings up the economic theorem called the paradox of thrift. It is good that as a society we are now saving more of what we earn but it is bad that those dollars are not buying goods and services that the economy needs to move. I've written of inflation being too much money chasing too few goods but unfortunately there are plenty of goods piling up on inventory shelves which has held off inflationary threats and failed to put the deflationary forces to rest.

Getting Worse at a Better Rate

The seeds of those deflationary forces are housing prices which have not stopped going down. A pickup in unit home sales is encouraging even if it is skewed by foreclosures, but without prices bottoming the whole financial recovery is in doubt. Housing is the biggest expense most of us have each month and it is the biggest asset class on most of our balance sheets as well as the balance sheets of our financial institutions. Further declines will lead to further foreclosures which will further weaken consumers and the financial institutions that we need to make loans to growing businesses. "Second differential" improvements, where prices are declining at a slower rate, are nice but at some point we need prices to start back up or at least stop going down. Alas, that has yet to happen leaving the economy in the grips of the deflation that we have been struggling with for almost two years. Another one of those second differential improvements had been employment where job losses were shrinking month over month, but that green shoot withered with the June employment report showing an acceleration of job losses and a record low in average hours worked of 33 hours per week. Businesses are struggling to not fire workers by giving them fewer hours and holding off pay raises. The result is lower take home pay which means less discretionary income to be spent on goods and services. The scheduled minimum wage hike coming later this month which affects many low-skilled workers who get paid a spread over the minimum wage will put further pressure on employment and the economy.

Helicopter Ben Bernanke continues to do everything he can to hold off these deflationary forces short of actually dropping dollars from helicopters (the quip for which he got his nickname), a fed funds rate of about zero is making money available to any bank that wants it. His efforts are fueling the inflationary fear that he won't be able to remove the liquidity fast enough when the economy does indeed improve, although aggregate money supply figures suggest some of that liquidity is being removed already. The fact that Bernanke's term expires in January has the market concerned that he won't even be around to raise rates when necessary and that his rumored successor, Larry Summers, may be too political to want to do so. The Administration could remove this uncertainty by announcing its Fed choice now. Mr. Summers, an Obama economic advisor, was part of the Clinton economic team and served as Treasury Secretary at the end of that Administration so he has economic credentials that should be welcomed by the market. If he were named Fed Chairman, he would likely be more concerned with his legacy in that position than any Obama political considerations. I think either choice would be fine but it would be best to clear the issue and announce the choice sooner rather than later. I would prefer Bernanke get a chance to finish what he has begun but I wouldn't fear Summers and his Clintonian economic credentials of a strong dollar, low inflation and good economic growth.

Fed Overseer

The Federal Reserve is the designated institution for oversight of systemically important financial institutions in the Administration's financial regulatory reform proposal. While I think the Fed has the most credibility to undertake such a role, it is proposed to come at the cost of removing some of the Fed's political independence which I think is a mistake. It is very important that our monetary policy be free of political influence and the proposed reforms chip away at that independence. Politicians are understandably frustrated with the Fed gaining influence as more financial companies classify themselves as banks. I would prefer to see the Fed oversee only traditional banks that make loans, and keep its independence intact. An example of the problem I see is the recent blowout earnings report from Goldman Sachs. While it's impossible to know exactly how the company achieved record quarterly profits in this environment, I suspect some of those gains came from borrowing in the fed funds market at close to zero percent (which their new status as a bank allows them to do) and buying higher yielding securities with the funds. If true, then public monetary policy is allowing them to make private profits in their trading accounts. They didn't make all that money by making loans to businesses and I don't think they should be able to take advantage of fed funds borrowing to make speculative trades. There's nothing wrong with trading operations which provide important liquidity to financial markets, but private profits should be funded by private capital not public capital. Profits like these will inevitably lead politicians to call for more restrictions on Federal Reserve operations which will impinge on their ability to maintain the purchasing power of the US Dollar, their primary objective. Furthermore, financial regulation belongs in the political sphere where the architects of regulations are politically accountable to voters. Keeping these issues out of the prerogative of an independent central bank gives that central bank more credibility on its most important mandate of preventing excessive inflation or deflation.

Inflating the Federal Income Statement

The story of the second quarter was the battle between those inflationary forces of massive monetary and fiscal liquidity and the deflationary forces of declining wages and home values. April began with a rally in the inflation trade where commodity, energy and basic material stocks reflected the market's expectations of an inflationary economic recovery. Technology companies that provide businesses with the ability to enhance productivity also performed well. That trade withered along with the green shoots in early June as it looked like the economy was losing some of the fragile momentum that emerged in the first quarter. Money began to flow out of those economically sensitive areas and into the companies that provide things we can't do without, consumer staples and health care. I believe the latter is catching up with the rest of the market as the health care reform agenda is cast in doubt. President Obama insists that any reform be deficit neutral while the bills in Congress range in cost from $500 billion to $1.5 trillion over the next decade, that's a big gap to close. That reform will be even more difficult to achieve when the semiannual deficit projections come out next month which will surely show a worsening budget gap. My thought on this issue is that we could lower health care costs substantially by allowing anyone to purchase health care policies across state lines. States like Wyoming or Utah offer lower priced plans than states like New York and New Jersey because they aren't mandated to cover services that most consumers would never need. Such a reform wouldn't cost the federal government anything and would save a substantial amount of money in transfer payments to people that can't afford plans in the higher cost states. I don't hear any politicians on either side of the aisle talking about it though. In fact the current House plan even negates Health Savings Accounts that enable the actual consumers of health care to be the payers as well; another reform that I think would go a long way to reducing costs. Politicians all seem to want reforms that enhance their involvement in our lives, so much for not letting the government get involved in the doctor patient relationship. Please pardon my politicking.

For the whole second quarter the S&P500 gained just over 15% as economic optimism carried much of the three months. Growth outperformed value, small company indices did better than large and international did better than domestic US. All are indicative of risk tolerance returning but perhaps do not adequately capture the change in sentiment that hit the market in June. July has so far seen a resumption of optimism as earnings reports have not been as bad as expected. I was not so risk tolerant in the quarter and kept a substantial cash position that held back the quarterly return. Realizing that the market leads the economy, it was still difficult to accept the market's all clear sign as the economy continued to weaken. Before buying into the sectors I mentioned three months ago, I would like to see some compelling earnings releases, accompanied by better economic numbers. Absent that, cash is a good investment in a deflationary period. The current earnings season is surprising on the upside but most of the positive reports still show a decline from a year ago when we were already in the recession, although not yet suffering from the financial crisis that hit in September. It's creating quite a debate as to whether or not the green shoots are coming back to life.

It is hard for me to accept that the economy has come back to health when I see all the economically destructive policies emanating out of Washington. If republican profligacy earlier this decade was so destructive to the economy I can't see how democrat policies that compound that spending would be good. Policies that seem to make sense, like the multiplier effect of government spending, usually have unintended consequences. I didn't see anyone predict that the stimulus package would provide banks with a risk free way to make loans to the federal government rather than to businesses, but that is what appears to be happening. It is a classic example of the crowding out principle where small businesses can't compete with the government for the limited amount of investment dollars, resulting in a negative multiplier effect. Additional policies that make hiring more expensive won't do anything to help employment which will further pressure our fragile real estate market. Unemployment is a lagging indicator but net job creation is a coincident one. I'd like to see some stability there before getting too bullish. I was comfortable buying at those March lows and would be again if we get a similarly panicky market. Contrary to my bearish view is the bullish one that says stock prices will rise before the actual statistics confirm the move. I am flexible in my views and would be willing to adjust your portfolio strategy in a more bullish way if you would like, or if market action proves me wrong. I'm not pretending to know what lies ahead, rather just trying to read the tea leaves. I will call you in coming days to discuss this further and in the meantime I want to again thank you for your trust and thank you for your business.

Yours truly,

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