STEPPING STONES MANAGEMENT, LLC

Second Quarter 2010 Commentary

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A policy fissure has emerged between the West's most developed nations. On the American side we hear that now is not the time to take our foot off the stimulus gas pedal. In the White House's view, our current "Summer of Recovery" requires more government deficit spending to keep the encouraging economic statistics growing. Economists who share this view say the recovery is lackluster because our stimulus spending was not enough to offset the huge decline in private demand resulting from the financial crisis two years ago. If governments around the world spend more, they think the economic numbers will begin to resemble a typical V shaped recovery. Despite assertions from the White House, not all economists share this view. German Chancellor Angela Merkel articulates the opposing view saying Germans are more likely to engage in economic activity if they feel their government "is taking precautions" to ensure sound fiscal policies. The American view implies that consumers need the government to bring the economy back to healthy growth before they will part with their hard earned dollars. The German view implies that government deficit spending is the reason those consumers are reluctant to spend.

A Confidence Game

Both views correctly place the problem as a lack of confidence. Whenever anyone makes a purchase, they do so with the confidence that what they are buying will give them utility exceeding the dollars spent. That could mean when someone purchases a book they expect to get entertainment exceeding the solace of having that money in their bank account, or a machine purchase will generate greater dollars for a business than holding the funds in an interest bearing vehicle. The utility is also factored as a function of what that money could otherwise be used for. If someone is concerned about the longevity of their job, their funds in the bank take on greater utility than if they are guaranteed income for the foreseeable future. For many, the utility of money in the bank is growing as the economy struggles to grow.

That struggle has been exemplified by the mixed employment statistics. The second quarter saw our economy add 357,000 private sector jobs compared to 236,000 added in the first quarter. Although 50% growth is a good number, the actual number of jobs created is barely enough to absorb the college graduates looking to pay off their student loans. The weekly initial claims for unemployment insurance remain stubbornly in recessionary territory, averaging above 450,000 per week compared to below 300,000 in a normally growing economy. As long as people are concerned about their jobs they will spend less.

Corporate investment has been among the best parts of a bad economy, but that sector also shows a lack of confidence. The Federal Reserve reported in early June that US non financial companies increased their cash reserves at the highest rate on record as of the end of March. US corporate balance sheets, which were generally strong coming into the Great Recession, are a rare bright spot in an otherwise gloomy economic picture. A popular bullish argument coming into 2010 was that healthy corporate balance sheets would lead to a wave of mergers and acquisitions as assets and other companies can be bought cheaply. In a struggling economy, companies need to make acquisitions in order to generate the earnings growth that shareholders demand. The current earnings recovery has yet to turn into an expansion, but corporate boards feel better foregoing investing for earnings growth in favor of husbanding cash. That's not a sign of confidence.

The Stock Market Game

Investing in stocks requires confidence in earnings growth and confidence that the market is fair. The "Flash Crash" on May 6th that saw the Dow Jones Industrial Average drop almost 1000 points in minutes only to gain most of it back as quickly, did not bolster such confidence. The best explanation for what happened that day is that High Frequency Traders stepped away from the market after it dropped 300 points depriving sellers of buyers on the other side. High Frequency Traders are computer programs set up according to algorithms based on historical market data. When the market does something, the computer is programmed to participate in a given way. However on that day, as Greek protests were being broadcast live, the market declined to where the algorithms didn't have sufficient historical data on how to act, so they simply turned off. This doesn't sound like much of a problem until you realize that these High Frequency Traders account for almost two thirds of the total market volume. The programs are so popular because they get price data a fraction of a second before the rest of the market giving them an opportunity to make profits in front of the regular traders. So on that day, two thirds of the potential buyers exited the market leaving prices to drop to extreme levels. Buyers did come in to take advantage of the low prices and the market rebounded. All's well that ends well, right? Not if you were a conservative investor using wide stop levels only to see your stock sold at those low prices before rebounding to the prior level. People who sold stock far below value may not have confidence that the market is fair.

The recent Senate hearings with Goldman Sachs executives were another confidence killer. Here we saw the leaders of the preeminent financial services firm say they do not have a responsibility to act in their clients' best interests. At issue is a complex security that Goldman Sachs allegedly "designed to fail" in order to benefit one client at the expense of another. While the company settled the SEC charges for 15 days worth of profits, the issue portrays the industry as a giant casino where high rollers are given loaded dice. Stock valuations are getting increasingly attractive partly because the investing public is leaving the market to the hedge funds and day traders to play their games.

Government Games

Perhaps the greatest confidence killer has been the massive legislation that has come out of Washington, DC. We still do not know the details of the health care legislation as most of the provisions are left to federal agencies to write. However we are learning it is not the great deficit reducer and job creator that it was claimed to be. The financial regulatory reform bill is the latest example of a 2,000 page bill that leaves details to federal agencies to write. Although Goldman Sachs' CEO told the Senate the bill will be good for Goldman Sachs, small financial firms fear they won't be able to comply with a law that giant companies can easily absorb. Rather than streamline the alphabet soup of financial regulatory agencies, the bill layers on new ones such as 20 distinct "Offices of Minority and Women Inclusion" to be placed in the various agencies across our financial regulatory leviathan. These offices are to ensure "fair inclusion" of women and minorities not only in the federal agencies but also in the private firms contracting with the government. The legal community loves terms like "fair" in legislation because millions of hours can be billed in lawsuits defining what is fair.

What the legal community likes, the business community often doesn't like. The Business Roundtable, an association of major company CEOs, used to like the Obama agenda. They were vocal supporters of the health care legislation and cap and trade energy legislation, but their leader, the CEO of Verizon Communications, recently said "By reaching into virtually every sector of economic life, government is injecting uncertainty into the marketplace and making it harder to raise capital and create new businesses." The group is apparently upset that the Administration has reneged on its promises to not tax overseas profits and to shelve its "card check" plan to ease unionization. Even General Electric CEO Jeffery Immelt who sits on the president's Economic Recovery Advisory Board has said that the US will not become an industrial powerhouse again if "government and entrepreneurs are not in synch." Business leaders across the political spectrum seem to agree that they are not in synch presently and are holding on to their cash.

What could be a worse confidence killer than the oil gusher in the Gulf of Mexico? The stock market registered its recent high a couple of days after the Deepwater Horizon explosion and it's been mostly down since then. The situation reminds us of the bureaucratic drawbacks of our huge federal government in so many ways. Federal agencies failed to adequately inspect the rig, have blocked states from taking steps to protect their coastlines, and spurned foreign offers of help saying "there is no need right now that the U.S. cannot meet" – good grief. Not letting the crisis go to waste, the Administration is making another push to pass its cap and trade energy legislation, a bill that has long been advocated by none other than BP, a founding member of the U.S. Climate Action Partnership. Big business loves government regulations that erect barriers to entry in their industries, but what's good for Goldman Sachs and BP probably isn't good for you and me.

Municipal Games

Another blow to confidence is the precarious situation with state and local finances where expenditures have exceeded revenues for decades. Those deficits have been filled by issuing municipal debt which has come to resemble the subprime mortgage debt of the last decade. Cities and states can only repay that debt by issuing more debt, usually with investment grade ratings because historically no municipality has defaulted. This is similar to the high ratings on subprime mortgage debt that were justified by low historical default rates. It never happens until it happens and signs are pointing to it happening in the municipal bond market.

One of those signs is an upward spike in municipal credit default swaps, the vehicle used by speculators to destroy Bear Stearns and Lehman Brothers in 2008. They were also the vehicle used to bring Europe to its knees earlier this year (a yet unresolved crisis). Discussing the municipal bond market in April, George Soros, one of those unabashed “swap vigilantes” that this letter discussed last quarter, said: "going short on bonds by buying a CDS contract carries limited risk but almost unlimited profit potential." Soros finds himself in the unusual company of Warren Buffet who told the Financial Crisis Inquiry Commission that municipal bond credit ratings are “crazy” and that the cost to repair municipal balance sheets today is "simply staggering." Buffet sees this as the greatest risk for an impending financial crisis pointing out that municipalities have been loath to default on their debt because they would be stiffing their own taxpaying citizens. But in the last 30 years a majority of municipal debt issues have been insured and Buffet thinks the cities and states that find belt tightening too burdensome will want to get something for all the money they paid for their municipal bond insurance. He doubts the municipal insurers are sufficiently capitalized for such a default event which would necessitate a federal bailout of municipal debt. He ought to know, Berkshire Hathaway owns one of the bigger municipal insurers and decreased the amount of insurance they issued by over 90% from 2008 to 2009.

Rather than engage in the necessary belt tightening that most Americans have undergone over the past two years, cities and states have decided instead to underfund long term commitments like pensions, let the next guys tackle that one. The problem is that they are now the next guys and the 50 year old retirees want their pensions paid. There are fewer buckets left to borrow from and it looks like the municipal bond market is beginning to close on these issuers. We don’t see it yet in bond prices but we do see it in the credit default swaps. Recent news stories have told of the state of Illinois not paying vendors and the state of California paying all state employees the minimum wage until a budget resolution is adopted. That ought to get the unions to the bargaining table; especially considering the US Senate recently refused President Obama’s request for $50 billion in further aid to the states. Some small cities have already declared bankruptcy (or its equivalent) and Harrisburg, PA, the state capitol, missed a bond payment that was due in early May. The municipal bond market resembles a slow speed train wreck whose impact on financial markets is difficult to quantify, but it can’t be good.

We don’t have to worry about layers of extremely complex securities like CDOs based on municipal debt, like the mortgage debt that so infected the whole financial system, they do not exist. However, if one of these supposedly safe bonds were to default, or worse, if one of the bond insurers were unable to pay their obligations, it would disrupt a segment of the market where losses are not anticipated and would have ripple effects throughout the financial markets. Referring to the debt disruptions in Europe, the Federal Reserve said that “financial conditions have become less supportive of economic growth” and pointed out that bank lending continued to contract in recent months. This was reason enough for them to reiterate their plans to keep the overnight lending rate at close to zero percent "for an extended period". If a municipal funding crisis were to hit, look for the Fed to institute a policy of buying municipal debt the same way they bought mortgage debt over the previous two years. (Despite those efforts, housing is still in decline.) Eventually these cities and states will have to rationalize their expenditures which will mean pay cuts, job cuts or both, providing another drag to the overall economy.

All these factors contribute to the reason why we are holding excessive cash which we recently raised when the market breached some technical levels early this month. That cash level helped buffer the downturn of the S&P 500's 11% drop in the second quarter. Contrarian investors see all these problems and the pessimism they create as a buying opportunity. Despite meager US growth, they see the growing middle class in the developing world as a driver of higher stock prices for US multinational companies serving those new consumers. There is reason to be optimistic as the economy is slowly growing and corporate balance sheets are in excellent shape. Earnings growth has brought the valuation of the market down to levels that have historically been very good buying opportunities. Although recent economic data says the economy is either entering a typical soft patch in the recovery or a double dip recession. Either way, GDP growth rates of plus or minus 2% would be largely indistinguishable. A municipal debt crisis and stock market drop resulting from such an event would be a time to invest idle cash as the event would force a large segment of our economy to rationalize. We are already seeing this happen in New Jersey where the new governor has received bipartisan support to actually cut state spending, fueling hope that other states will do the same.

Our cash position is the result of both the fundamental drags expressed above and technical price breakdowns that are reminiscent of prior declines. Market prices contain information not available to the public so such breakdowns warrant attention and have driven the sales that generated some of that cash. Absent any crisis in the municipal market, we'll look to invest that cash as various other market drags are resolved or valuations become too compelling too ignore. As has been the case for several quarters, employment and housing statistics are a particular focus; unfortunately they have yet to show much improvement. Like Chancellor Merkel, I think a credible plan to reduce our government spending would be the best way to bring confidence back to financial markets. Please feel free to call me to discuss any of this further and until then thank you for your trust and thank you for your business.

Yours truly,

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