STEPPING STONES MANAGEMENT, LLC

Second Quarter 2011 Commentary

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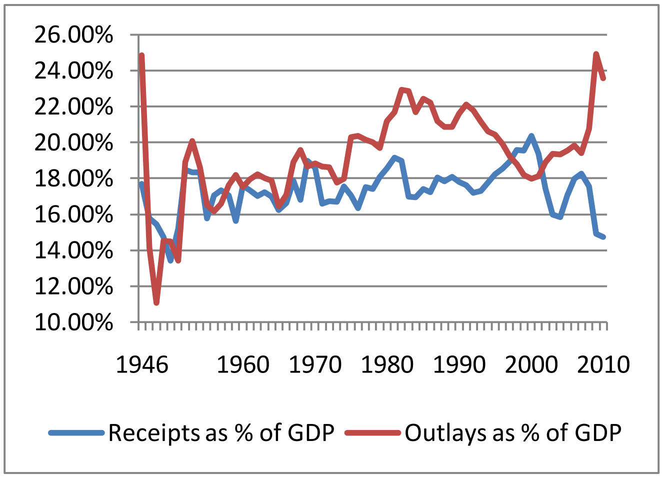
Wise men say history doesn't repeat itself but it rhymes. The second quarter of 2011 rhymed quite a bit with 2010's second quarter starting out flat but succumbing to weakness in the face of an economic soft patch in the US economy. Weekly jobless claims above 400,000 and sovereign debt fears in Europe also rhyme with the spring of 2010, but back then jobless claims were better than the first quarter, now they're worse. While that year ago quarter ended at its low point, this year saw a rally erase much of the weakness as the Greek Parliament voted to approve austerity measures projected to reduce that country's budget deficit by 90% over 5 years. If they can do it maybe we can too. For the quarter driven by a "risk off" trade in our extremely correlated financial markets the S&P500 lost -0.39% which would have been worse if not for a stunning 5% rally in the last week. The current economy is far from good but the end of the quarter did see mild improvement in some economic statistics. The question remains whether the economy will rebound from its spring slowdown like it did last year or continue to weaken and put pressure on the strong corporate earnings that have justified the two year old bull market.

A Picture's Worth A Trillion Dollars

The last day of the second quarter brought a warning from Standard & Poors that failure to timely honor US Treasury debt will result in an immediate downgrade to the lowest junk rating of "D". Such a downgrade would be a far worse financial calamity than an actual delay in payment because it would have a cascading effect throughout the international fixed income market. Anything pegged to a Treasury issue would likely also be downgraded and money markets and various other funds throughout the world would be forced to liquidate their holdings of US Treasury securities. Secretary of the Treasury Timothy Geithner has been granting interviews to say that failure among the political parties to reach an agreement on raising the nation's debt limit by August 2nd will result in such a delay in payment. This is a poisonous scare tactic with no basis in reality. If the parties have not agreed by August 2nd, our government can not issue any more debt. It can however spend all the money that is still coming in. Any maturing bonds can be paid back with reissued bonds as they won't increase the total amount of debt outstanding. Interest payments will have to be paid from current revenues but at only 6% of a budget that is 60% funded, there will be plenty of revenue to do so. It will be the Secretary's responsibility to prioritize payments, so if bondholders don't get paid it will not be "the

Republicans' fault" as Geithner has been saying, it will be his decision that 60% of other government spending is more important.



The talks over raising the debt limit have stalled over the issue of taxes and spending, or as economists say, receipts and outlays. Republicans want any increase in the debt limit to be met with a greater dollar amount of spending cuts over 10 years. Democrats say any deal must include higher taxes on "millionaires and billionaires" defined as those making more than $200,000 per year. Republicans want to get spending back down below 20% of GDP. Democrats say such a level is unrealistic considering all the demands on government today, so they want a tax regime that will sustain a higher level of government. As the chart shows however, such a tax regime is unrealistic. While the red line does show a long term uptrend in government spending as a percentage of GDP, the blue receipts line shows an upper limit of about 20%. More importantly though are the tax regimes that were in place at those prior peaks in revenue. Those peaks occurred in 1952 when the top tax rate was 92%, 1969 with a top rate of 77%, 1981 at 69% and 2000 with a top rate of 39.6%. The last lower peak in the blue line is in 2007 with the top rate at its current 35%. None of them were sufficient to fully fund a government at 20% of GDP let alone the current 24%. The chart shows that no matter what the tax regime, our economy cannot be expected to produce sustainable tax receipts greater than 20% of GDP.

Surely White House and Congressional staffers can perform the same analysis that I just did with data from the White House's website. As I wrote last quarter, there just doesn't seem to be the seriousness in Washington DC to address the out of control spending that you can see in the last few years on that red line. The blue line is also too low and revenues must be raised to fund even a sustainable level of government. History says the best way to do that is through economic growth. Former Fed chairman, and renowned libertarian, Alan Greenspan says the deficit is so serious that he thinks we should go back to the Clinton era tax rates. The chart suggests this time he may be correct. The problem is that nobody else is recommending such a thing. Many voices endorse returning to those higher rates on only the top income brackets. The sharp drop in the blue line during what has become known as "The Second Great Contraction" suggests that our current tax regime is too pro cyclical. Tax revenues are flush when times are good but they have fallen off a cliff as a result of the recession. Contrary to popular belief, we rely too much on taxes from the rich of whom there are too few after a recession. Even those who remain millionaires and billionaires have so many tax loss carry forwards from the recession that they aren't paying as much as they otherwise would. The problem is that the various Bush tax cuts removed too many people from the tax rolls so that even though more than 90% of Americans are gainfully employed, less than half are paying income taxes. Not only did Bush remove millions of middle class earners from the tax rolls, he put them on the government benefit rolls by expanding education and health care funding. He continually approved congressional earmarks for pork barrel projects that became a national embarrassment. Democrats ran against Republican profligacy in 2006 and 2008 but have only compounded the problem since gaining power and now say all that spending is too important to cut. None of them propose going back to the policies of the only two term Democratic presidency of the modern age. Instead they propose a new era of big government funded by those earning over $200,000. Bill Clinton knew that wasn't realistic and brought government spending down to 18.22% of GDP when he left office. Doing the same today would cut about $1 trillion from our $3.7 trillion annual budget, not over 10 years but each year.

Greece is the World

The austerity measures that just passed in Greece are a step in that direction. By cutting over $40 billion from their budget over the next 5 years, the Greeks will get over $100 billion in aid from the European Central Bank and the International Monetary Fund to roll over maturing debt. The incentives were clearly there for the Greek politicians to take a difficult vote in the face of gas masked anarchists rioting against government cutbacks (oh, the irony!). Other countries in the PIGS club have come under pressure to take similar measures. All this austerity will provide a headwind to the world economy as government demand declines, but history tells us the private sector usually takes up the slack, and then some. Last year at this time we were witnessing a debate between German and American financial authorities on what is the best way to get the economy going, further stimulus or austerity. The German view that austerity would restore confidence, which would restore growth, seems to have won. German unemployment is currently at a post unification low and in a bit of rich symbolism, the German Bourse is buying the New York Stock Exchange.

American states are taking similar steps which are contributing to weakening US employment statistics. Governors and legislatures from both parties are cutting back on government expenditures and the reforms being enacted are having both short and long term effects. In Wisconsin teachers are now paying for a larger share of their retirement plans giving school districts more money to apply to educating children and retiring debt. Being freed from collective bargaining agreements also enables those municipalities to source benefits from a competitive marketplace rather than expensive union sponsored plans. Similar reforms have been enacted in blue states like New York and Massachusetts without the vitriol that occurred in Wisconsin. States are also cutting the amount of money flowing from the state level to their municipalities who are also being squeezed by property tax revenues tied to falling home prices.

That has been the premise of Meredith Whitney's prediction of a municipal bond market crisis which she still expects. State tax revenues are improving but remain below pre-recession levels so those cuts are being made to towns, cities, and other state entities that issue debt. Fortunately, many state budgets are getting worked out as I write despite exceptions like Minnesota which has shut down its government. Prices and fund flows are improving but it's too soon to declare the muni market to be out of the woods. It remains to be seen exactly how state and municipal budget holes will be filled and who will be funding them. The State of New Jersey recently established a $2.5 billion line of credit from JPMorgan Chase which is not seen as a sustainable form of state funding. Good news on this front is plentiful though, those states that have enacted reforms have less need for deficit financing. Now if only the Fed would normalize interest rates, we could buy some bonds at a fair return. Alas, Fed chairman Bernanke still says rates will remain "exceptionally low for an extended period" so it is probably still best to wait on adding to municipal bonds.

The bonds we own performed well in the quarter that saw risk coming out of most markets. Such a harsh environment would be expected to see volatility indices rise but the opposite occurred. We have exposure to stock market volatility through the ETF trading under the symbol VXX, we view it like an insurance policy that will rise if the rest of the portfolio falls. The cost of the insurance comes in the form of the managers rolling over futures contracts but has been reasonable considering how we have positioned it in portfolios. That cost does eat into performance which combined with the fierce stock rally in the last few days of the quarter led to a 28% decline in the ETF since March. Of course that rally benefited our long positions which drove portfolio performance to modestly outperform the S&P 500's quarterly return of -0.39%. Our cash in the quarter had a moderating effect and we have yet to add funds to emerging markets and commodities which still look weak and have not confirmed the recent stock market rally. This is unusual in a market that has become extremely correlated across asset classes where "risk on" or "risk off" drives most everything. Stock prices have also broken their correlation to earnings expectations which have followed the economic numbers down precipitously. Falling commodity prices have soothed some of the recent inflationary bite which could help corporate earnings, or they could signal weak corporate buying.

Rhyming History

Rhyming with 2008, much of the second quarter was driven by fears of contagion among the international banking industry. The crash of 2008 was of course caused by toxic subprime mortgage debt but the crisis metastasized as banks feared lending to one another, not knowing how exposed each were to such debt. While less severe, the second quarter saw similar fears with European sovereign debt replacing subprime debt, the financial sector was the weakest of the market in the second quarter. The sovereign debt troubles are far from solved and the issue keeps the easy money flowing from the Fed which has never led to a recession, so bulls say to keep buying. Most recessions are preceded by rising rates and although the typical preconditions for a recession are not present, neither are the preconditions for an economic expansion. Those conditions have usually included strong housing and employment. Maybe our economy can grow without the housing sector participating but employment is critical and the encouraging statistics of recent months have hit a wall. The political bickering over the debt ceiling is also not encouraging. If Secretary Geithner calls the Republicans' bluff and withholds interest payments on Treasury debt we can forget about any recovery, the world economy will be in worse turmoil than late 2008. He certainly knows this so don't expect it to happen. More likely is a political stalemate that will result in a partial government shutdown which is not the optimal way to balance the budget. Even more likely is that the parties revert to form and agree on a plan to cut spending several years out which will do nothing for our current deficit problem. The third year of a presidential term is usually bullish for equities as politicians spend money to buy votes, however, this year most voters seem to want less spending from Washington DC, regardless of the economic consequences. The deficit is not going to be eliminated but most expect it to shrink and we should worry what will happen to corporate earnings as all that money flowing into the economy ebbs.

Looking at another rhyme, there is one with 1977. That year saw a market rebounding strongly from a generational low only to realize that the problems that led to the 1975 crash were still affecting the economy. Two years after the end of the worst recession since the Great Depression the US economy was struggling to register a typical recovery. Unemployment was stubbornly high at 6% and inflation was running a bit higher than that, despite meager GDP growth. Cities were struggling to regain the revenue levels seen prior to the recession (New York City was recovering from its near bankruptcy) and policymakers couldn't understand why their models weren't working as planned. Furthermore, the stock market was trudging through a lost decade of no net gains. Sound familiar? In a classic correction, the market gave up over 40% of its rally which would put today's market where it was in last spring's soft patch. The rally since that soft patch was fueled by the Fed's QE2 program and Bernanke has made clear that there will not be a QE3 with inflation running higher than the Fed's comfort level. Bernanke must be resting a bit easier these days as the inflationary surge of the first quarter has lost some steam. High food and energy prices did indeed make strong emerging market demand for those goods transitory but we now need to hope that those emerging market slowdowns are also transitory as our economy is reliant on sales to those countries. The economy of 2011 is recovering from a worse recession than what preceded 1977 and we should expect ripple effects to occur for even a few years after such a calamitous event, especially considering the regulatory onslaught we are facing.

Since the fundamentals of the economy are so unclear we are looking more at technical chart patterns to determine investment timing. US stock prices are looking better but those in the areas we are looking to invest, emerging markets and commodities, have yet to see such improvement. The sharp drop in fear gauges like the volatility index that we own also signal a concerning level of complacency. Bulls say any economic weakness will be met with aggressive Fed action but their last aggressive actions caused the price spikes that have contributed to the current weakness. If the stock market pulls those other markets up, we will invest idle cash at that point. Conversely though, the sharp two week rally we have seen could be a false start and the correction we have been experiencing may have further to go.

Corrections are necessary and healthy and this one may have run its course, only hindsight will tell. The recent rally could signal that important fiscal issues are finally being addressed. However, the debt limit debate, also necessary and healthy, is showing our politicians in full campaign mode which will make it difficult for either side to make any large concessions. A government accounting for almost a quarter of the economy cannot be funded by lengthening depreciation schedules on oil inventories and corporate jets; it would require tax increases on the middle class because like Willie Sutton said, that's where the money is. The American electorate knows that and has clearly expressed a preference for the small government policies that presided over the 1990s boom. Politicians of both parties with their ear to the ground are heeding the message and giving the voters what they want. It is happening in the states and will have to happen in Washington DC as well, it will be very bullish when it does. Please feel free to call to discuss any of these issues further. Until then, thank you for your trust and thank you for your business.

Yours truly,

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