STEPPING STONES MANAGEMENT, LLC

Second Quarter 2012 Commentary

July 16, 2012

Paying homage to the convalescing Alex Trebek, the answer is “excise tax”. The question was posed by Chief Justice of the US Supreme Court John Roberts when he asked the government’s lawyer what, if any, limiting principle would prevent an Obamacare precedent from enabling the government to force citizens to do something as absurd as buying broccoli, since eating healthily has a greater effect on health care costs than carrying insurance. The government was unable to postulate any such limitation saying that if the Commerce Clause of the US Constitution could enable the government to regulate a farmer growing wheat to feed his own family and livestock, it could enable anything. The Chief Justice achieved a milestone of conservative jurisprudence since that Great Depression precedent by declaring there is such a limit and the Obamacare insurance mandate exceeded it. The bad news is that he found a heretofore unknown and seemingly unlimited power to tax under which he upheld the legislation.

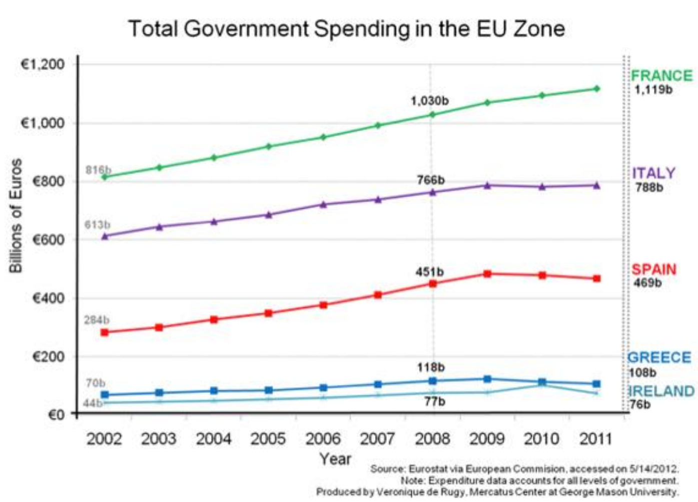
The US Constitution enumerates several distinct and limited powers granted to the federal government leaving all others to the individual semi-sovereign states. On the issue of taxation, there are three areas where such power is enumerated: a poll tax that impacts all the states equally according to census; duties, imposts (tariffs) and excise taxes; and the 16th Amendment that authorizes an income tax. The Obamacare tax is obviously not in the first or third categories so it must be in the second. It is obviously not a duty or a tariff so it must be an excise tax. Looking up excise tax in the dictionary shows it is a levy added to the price of something produced or consumed, usually with an objective of discouraging such production or consumption. Tobacco and liquor taxes are typical examples. Chief Justice Roberts doesn’t see the limiting principle in this definition and points out that the government grants tax *credits* for such things as buying a home and undertaking professional education so the definition of excise tax must be interpreted broadly enough to uphold The Affordable Care Act of 2010. Leaving 200 plus years of dead Congressmen spinning in their graves at the thought of all the foregone revenues they could have spent, Judge Roberts goes on to say this is not a new power to tax, it has always existed.

After an initial drop when the ruling was announced, the stock market went on to rally strongly for the final day and a half of the quarter but it wasn’t driven by John Roberts’ solo Supreme Court opinion, it was because of that other issue that again drove the stock market during the second quarter, the European financial crisis. That day brought news that European leaders were close to agreement on a solution to their festering crisis. The quarter saw the crisis spread to

Spain which became the fifth Euro member whose banks needed a bailout. The S&P500 fell by -3.29% in the second quarter which would have been worse without a 2.5% rally on the last day. The anticipated European solution has failed to impress markets since its announcement and Spanish government bonds yields are again at new highs as the contagion begins to spread to Italy. The agreement calls for the European Stability Mechanism (ESM) to be used to inject funds directly into European banks as opposed to its original charter to be used only to inject funds into European governments. The leaders also agreed to appoint a single European bank regulator, something many people thought had been done with the creation of the European Central Bank in 1998. No word on what will replace the €500 billion ESM when it becomes depleted at a now faster rate.

This is What Democracy Looks Like

The markets spent much of the second quarter anticipating elections in Greece and France where the former elected a government committed to remaining in the Euro currency block and the latter elected a socialist promising to reverse his predecessor's mild reforms. The New Democracy party in Greece promises to renegotiate the stringent terms of that country's 2011 bailout and new French President Hollande has already fulfilled his promise to move the retirement age back down to 60 from 62. German taxpayers, who cannot retire until age 67, are expected to fund these benefits through the issuance of Eurobonds that they will ultimately guarantee. German Chancellor Angela Merkel is deftly balancing between those forces that want to maintain the Euro currency block in its current form and those who don't want to sustain benefits for Greeks and Frenchmen that are richer than their own. The French meanwhile are adamantly opposed to ceding any sovereignty over their fiscal policy to bureaucrats in Brussels which would predicate the issuance of Eurobonds. Merkel's next election is in late 2013 and her party has been losing regional elections as she pursues the Euro agenda, although her popularity has seen a recent spike as she offhandedly commented that Eurobonds would not happen in her lifetime. When the Euro was launched, Milton Friedman warned that people must share a culture before they share a currency. While the markets are watching for the "Grexit", it may make more sense for Germany to leave the Euro and Greece to stay in. German taxpayers don't want to bear the burden of further subsidizing Southern Europe's more leisurely culture but exporters fear the difficulty of selling their products in a highly valued new Deutsche Mark. Those fears may be unfounded though as Sweden offers an example of a country prospering with a strong currency and George W. Bush gave us evidence that a weak currency is not a path to economic strength.



The economic debate about the way forward in Europe continues to revolve around those concepts of government stimulus versus austerity. The new European recession is supposedly indicative of the failure of austerity to fire up the animal spirits that Adam Smith said are so necessary for economic growth. Paging through our dictionary from excise tax to austerity shows a definition dealing with frugality in expenditures. Looking at the government expenditures among the troubled European nations shows scant evidence of frugality. On the chart prepared by the Mercatus Center at George Mason University we can see a slight drop in government spending in Greece, Spain and Ireland but no substantial reduction in government expenditures throughout Europe. Austerity measures in those countries have mostly taken the form of tax increases that have failed to generate the necessary revenues and worsened the economic contraction. To paraphrase Margaret Thatcher, those governments have run out of others people's money to spend.

Another Supreme Court Justice, Louis D. Brandeis in 1932 described the disparate United States as "laboratories of democracy." Around that time, "Fighting Bob Lafollette" conducted a progressive experiment in the State of Wisconsin leading an activist government to correct the social ills of the early industrial age. Almost a century later, voters in that epitome of progressive states elected a government to cut through the accumulated taxes and regulations and in the second quarter they voted to reaffirm those reforms. On the same day, voters in San Diego and Sacramento California, other very blue electorates, voted for similar reforms. They too are running out of other people's money to spend on generous pay and benefit packages for their public servants. Voters in these states who aren't getting those benefits want their states to be more like the red states where economic growth is consistently outperforming the rest of the country. European aircraft conglomerate Airbus recently announced its new plant will not be in Europe or California but in the very red state of Alabama. The reforms that voters are affirming in these blue US states with the worst fiscal deficits will have to be instituted in other states as well as in Europe where they have yet to attain a popular mandate. Large employers like Airbus will continue to source jobs in those jurisdictions that they believe will provide the best business climate for the long term.

"Done…for you, big boy"

While the European politicians dither, central banks around the globe continue to create money in hope of forestalling the crisis. The European Central bank began this third quarter by lowering deposit rates to 0% which is a lousy way to encourage savers to deposit money in their local bank. While loans in Europe will be a little cheaper, there doesn't seem to be much demand for the extra money. The cost of dollar loans is captured daily by the London Interbank Offer Rate, better known as LIBOR. This is an interest rate based on bankers telling a survey the rates they are paying to borrow in the interbank market and it governs hundreds of trillions of dollar loans worldwide, including my own mortgage. Late in the second quarter, it was disclosed that British bank Barclays settled a criminal complaint that its traders have been manipulating the rate. The company paid a large fine and replaced its top leadership while bracing for further charges against some of its employees. A dozen other banks are reportedly also under investigation. The settlement followed disclosure of emails from traders throughout the international financial system. The financial media is portraying the scandal as a victimless crime since it is alleged the traders manipulated the rate lower to hide their own financial vulnerability. Take that with a grain of salt as those reporters are reliant on ad sales to those same firms to pay their salaries. In the decade that I have had my LIBOR based adjustable rate mortgage, I have noticed the rate usually rises into the June 1st reset date. Not surprisingly, one of the e-mails from May 31, 2006 shows a trader telling his colleague at another firm that "we have another big fix tomorrow and I was hoping we could set the (rate) as high as possible." Another writes: "Done…for you, big boy."

Another blow to Wall Street's credibility came with Facebook, the most anticipated initial public offering in many years. Lead underwriter Morgan Stanley set the price at $38 per share, the high end of the anticipated range, and added to the amount of shares being offered. This was despite a profit warning from Facebook in the weeks prior to the offering which depressed institutional demand for the shares. No worry though as demand among the retail investors who use Facebook was greater than anything seen before, or so it was thought. The NASDAQ market where Facebook listed had not issued any other public stock with such a high percentage of retail orders and their vaunted technological network proved unable to handle the order flow. When investors sensed trouble in those opening hours, orders were cancelled and the stock dropped from its opening price and fell below its offering price where it remains at this writing. Some small investors ended up buying shares they didn't order or want and day traders had no way of knowing if their orders had been filled as NASDAQ's reporting system broke down. Days after the IPO, Morgan Stanley CEO James Gorman told CNBC that "our intent is to support our client," referring to Facebook which got $38 for shares the market now values substantially less than that. Not mentioned were all of Morgan Stanley's retail clients who didn't get the profit warning phone calls from their brokers and ended up holding shares at a loss. While Facebook may be happy with the higher proceeds and "support" they received, their stock is now tagged as a monumental loser. They may have been better off if they bypassed the Wall Street "big boys" and sold their shares on their own vaunted network which seems to be technologically superior to NASDAQ's.

Stepping Stones clients don't own Facebook but we do own another high profile troubled equity, Chesapeake Energy. The second quarter brought news that the company's founder, Chairman and CEO, Aubrey McClendon, had some unconventional deals where he invested alongside the company's interests in gas and oil wells. While there is no evidence of his having any interest contra to shareholders, the requirements that he invest along *all* wells caused personal financial strain as the company drilled more wells than anyone else. He needed to raise funds to meet his obligations which he borrowed from parties who were doing business with Chesapeake, raising concerns about conflicts of interest. Having followed the company for many years, we know Mr. McClendon as an aggressive wildcatter but we have never seen an example of him putting his own interests in front of shareholders. Indeed, his trouble arose from the company operating more aggressively than he personally could afford. If he was out solely for himself he would not have entered into so many deals. The revelations brought the stock down to almost $13 per share at which point the board of directors took action by stripping Mr. McClendon of the chairman's title, in essence giving him a boss. Several board members were also subsequently replaced. The stock has since recovered to $19 for a 19.4% loss for the quarter. We did not increase our position for a couple of reasons. Most importantly, the company disclosed that its financial statements are more opaque than previously thought with some liabilities not clearly expressed on the balance sheet. Our thought now is to increase exposure in the natural gas sector through an ETF in order to mitigate risk at any one company. Recent economic deterioration continues to keep us on the sidelines for now though.

It remains to be seen if the worsening economic statistics are indicative of a looming recession or seasonal anomalies like we saw the last two years. Those prior examples got worse through the summer months until the Federal Reserve announced more simulative measures at their annual Jackson Hole retreat in August. Central banks around the globe have been actively expanding monetary policy this spring to little positive effect. Europe is in another recession and Asia is slowing down at a meaningful rate. If the US falls into another recession, monetary policy may not be able to help much. To solve these problems, voters must decide what level of benefits they want from their governments and how they can sustainably fund them; raising taxes on people who make over $200,000 will not get the job done. Judge Roberts said the wisdom of the Affordable Care Act should not be decided in his court but at the ballot box, which is probably most healthy for our democracy. The legislation has imposed numerous mandates that have driven up the cost of health insurance and not resulted in the promised job creation. July brought news that the US economy created only 80,000 jobs in June compared to 85,000 people who began receiving Social Security Disability benefits that month. The US Department of Agriculture is running advertisements to encourage people to sign up for food stamps, despite the First Lady crusading against childhood obesity. These are but two examples of our exploding use of government benefits. If we exploit our social welfare programs to buy votes from the middle class, the programs will not be able to serve those for whom they are intended. As Americans watch the trouble in Europe from across an ocean, we will spend the summer assessing the direction we want our country to take. The last president to preside over an economic boom said "the era of big government is over." Voters will decide this fall whether Bill Clinton was right or wrong.

We don't plan to wait on the election to reallocate some of our large cash position but if another global recession is imminent US dollars will be the best place to keep your money. The best time to invest is in the depths of a recession and seeing the chance of that rising we are hesitant to act prematurely. Please feel free to contact us to discuss any of these issues more fully. 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
501 Madison Avenue, Suite 501
New York, NY 10022
direct: 646-723-6262
www.steppingstonesmanagement.com