STEPPING STONES MANAGEMENT, LLC

Second Quarter 2013 Commentary

July 23, 2013

With Wagner's *Ride of the Valkyries* blaring from loudspeakers, New York Federal Reserve President William Dudley flew the Fed's helicopter to its lower Manhattan fortress dropping $100 bills, better known as Benjamins, in its wake over Wall Street. His message to the gathered financial press was that the market doesn't get it, easy money is here for a long time so get on your surfboards, it's risk on! It was the end of the second quarter that saw the stock market reach record highs before suffering a 6% correction after Federal Reserve Governor Esther George was quoted in meeting minutes as favoring "a tapering" of the Fed's Quantitative Easing (QE) program. Governors Williams and Plosser also gave speeches in May favoring a prompt tapering. Representing the other side of the Fed's ideological divide, Dudley made the case for further bond purchases saying "the labor market still cannot be regarded as healthy" and "federal fiscal policy has recently become quite contractionary." The latter point does not refer to federal outlays that are projected to increase by almost $150 billion this year; he refers to the projected $260 billion in higher tax receipts.

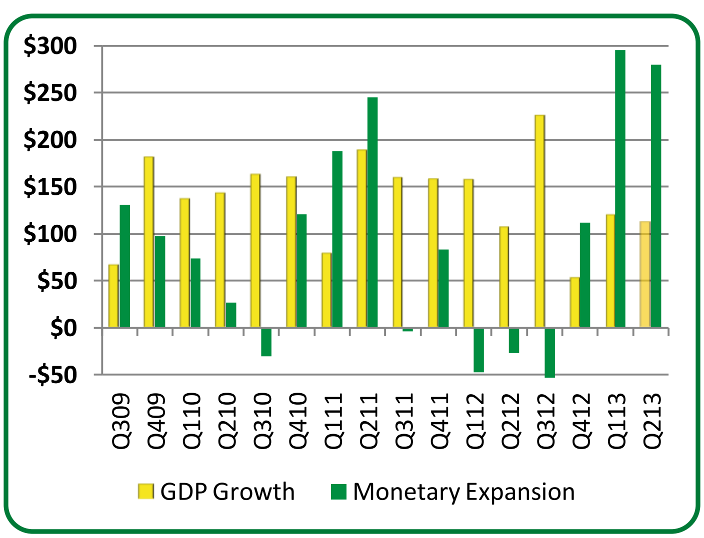
That 6% appears to be the new limit that the Fed will let stock prices decline before reassuring markets that the central bank will continue to create enough dollars to keep any rally going. The bond market experienced worse volatility as leveraged banks and hedge funds stampeded out of long term bonds since the dominant buyer is preparing to exit the market. Fixed income mutual funds and ETFs experienced their worst outflows in history and the yield on the benchmark 10 year Treasury bond rose from below 2% to more than 2.5% even as the central bank was exceeding its target of $85 billion in monthly bond purchases. The Fed was apparently unprepared for such a rise in rates and Dudley's walk back was repeated by other Fed governors. Even Bernanke declared to economists on July 10th that "highly accommodative monetary policy for the foreseeable future is what's needed in the US economy." That was enough to send the S&P 500 to a new high even though the 10 year Treasury bond remains elevated around a historically low 2.5%.

The Fed expanded its QE program last fall to create $85 billion per month with which it purchases Treasury and mortgage backed bonds in an effort to keep interest rates low and foster economic growth. It has certainly achieved the former and Bernanke likes to point to higher stock prices as signaling expectations for better economic growth. The stock market has historically been a reliable predictor of economic growth but the Fed's financial repression (discussed in our First Quarter 2012 review available under the commentaries tab at www.steppingstonesmanagement.com) has rendered such historical indicators obsolete. Price earnings ratios had been rising more slowly than stock prices, suggesting better economic growth but aggregate earnings have actually declined for three straight quarters with the differences made up through stock buybacks. The quickening rise in price earnings ratios this year is exposing the limits of that strategy. An example of how it works was the second quarter's record $17 billion bond offering from Apple Inc., a company sitting on $140 billion in cash and liquid securities. They took on debt to buy back shares so that earnings per share numbers can rise even if their net income is falling. Apple did not use their cash for the buyback because most of it is sitting overseas untouchable without giving a third of it to Uncle Sam. Far better to take on debt whose cost is a touch above US Treasury rates.

Unfortunately, Apple isn't using that low cost money to expand their operations designing products in California, choosing instead to shrink their equity capitalization. Although insatiable demand for yield is driving companies without Apple's strong balance sheet to the hospitable debt markets, all the extra money isn't spurring the Fed's second objective of fostering growth, nor is the expected wealth effect from higher stock prices. As Bernanke announces ever-larger interventions, the economy's weak growth has deteriorated and Wall Street declares the central bank is not doing enough. Markets have become all consumed with Fed policy as they disregard deteriorating fundamental drivers of valuation.

Don't let the door hit you on your way out

The chart below shows the amount of money the Fed has created represented by the growth of its balance sheet, alongside the amount that the economy has grown in each quarter since the third quarter of 2009 when growth turned positive. Compiled with data from the Federal Reserve and the Department of Commerce, it covers the period through the second quarter of 2013 (the last GDP bar is estimated). The chart shows the economy has grown at about $140 billion on average per quarter while the Fed has created $80 billion on average per quarter, though not as steadily as they created almost $300 billion in each of the last two quarters. You can see that any correlation looks more negative than positive with the highest economic growth occurring when the Fed shrank its balance sheet the most. That was the third quarter of last year right before QE3 more than doubled the rate of accommodation. You can also see that economic growth in last year's fourth quarter and this year's first are among the lowest levels since we emerged from the Great Recession and expectations for the just completed second quarter are for a similar low rate even though that green bar is near its high. Three quarters into QE3 should be showing positive results if the policy was working. There is positive correlation to the S&P 500 where the green bars spike up after corrections each year. While the



corrections have become milder, the interventions have become more extreme. The Fed says their bond purchases are data dependant but it seems to be most dependent on stock prices. They assure us that the program will be tapered soon yet it keeps expanding. The chart shows the diminishing effectiveness of the policy as the rate of economic growth per dollar created has dropped dramatically. It is a classic example of a liquidity trap or what John Maynard Keynes characterized as “pushing on a string.”

January marks the end of Fed Chairman Bernanke’s term and investors had been wondering whether he would be reappointed to a third term to unwind his unprecedented interventions, or if he even wanted one. The question was preempted when President Obama told an interviewer in June that Bernanke has already stayed a lot longer than he was supposed to. The ungracious gesture to the man who more than any other has funded the Administration’s record deficit spending was a clear signal that the Chairman is at the end of his term. This has generated speculation about who Bernanke’s replacement will be and how they might continue the Fed’s bond purchases. It is a safe bet that the next Fed Chairman will be someone who believes in the monetary expansions of the last four years despite their ineffectiveness. The political class needs the buyer for their bonds.

Japan’s Third Arrow

Across the Pacific, Japan’s monetary experiment is going full speed ahead and rates have surprisingly risen there too, even as the Bank of Japan has undertaken a similarly aggressive policy that targets a doubling of its monetary base. It is the second part of Prime Minister Shinzo Abe’s plan following major public works projects financed with deficit spending. In the second quarter he unveiled his “third arrow” saying it will lead to an “explosion of private sector vigor.” It was comprised of mild proposals that missed the target of widely expected labor market reforms and failed to impress the Japanese stock market which reacted vigorously to the downside losing more than 20% in 3 weeks. The Fed’s subsequent assurances of continued easy money halted the stock market slide in Japan that was coinciding with our own and suggests that stock prices around the world are reacting to US Federal Reserve policy more than economics and earnings. The need for the third arrow proves the point that monetary policy alone cannot rescue an economy suffering from structural problems. Indeed the monetary creation enables the politicians to ignore those problems.

Policymakers in Japan, Europe and America are hoping for a growth spurt to solve their fiscal imbalances as they mostly pay lip service to reform. While Japan may have more severe demographic problems, Europe and the US have plenty of available workers but not enough available employers. Businesses in Europe are hesitant to hire workers that they will not be able to fire if their growth plans do not reach fruition. American businesses have been inundated with regulations that make it more expensive to hire new workers and execute growth plans. The Administration’s decision not to enforce the employer health insurance mandate in Obamacare is a prime acknowledgment of the situation even if it is a crude ploy to hold off burdensome regulations until after the next election. More companies are foregoing growth initiatives choosing instead to buy back stock and boost earnings per share numbers that way. What little growth is occurring in the world lately is coming from the emerging markets but they too have been roiled by central bank policies that have seen hot money flow into their economies stoking inflation that has to be met with policies that restrict growth. Then those flows abruptly cease with Fed comments that lead speculators to unwind their leveraged positions lest they be left standing when the music eventually stops. An economy based on savings and investment has always been more durable but that is the polar opposite of what we have gotten with the Fed's zero interest rate policy (ZIRP).

Savings and investment require incentives like positive interest rates but ZIRP encourages consumption instead. The Fed says this should stimulate final demand and employment which has been borne out in healthy retail sales, until last month, and employment gains that have been concentrated in the retail and hospitality sectors. Those are also the sectors that are comprised of mostly part time jobs which have grown faster than overall jobs in recent months fueling the positive employment statistics. If you lose your full time job and get two part time jobs it counts in the statistics as a net job gain. No wonder the Fed is pouring on the liquidity.

Lois Lerner's Legions

The aggregate level of investment that a durable economic expansion requires also requires confidence in the macro economy. The federal government currently accounts for more than 23% of US Gross Domestic Product and cities and states account for several percentage points more. The second quarter has shown our government to be hardly deserving of the people's confidence. The reprehensible actions of the IRS and Lois Lerner, their director of tax exempt organizations, in particular refusing to testify about how the President's political enemies were targeted with the government's most blunt force does not engender confidence. Especially as Ms. Lerner continues to draw a paycheck while she sits on the beach with no complaint from the White House. The second quarter saw some of our government's highest ranking officials offer testimony to Congress under oath that was promptly proven false. We also saw our nation's most important intelligence secrets stolen by a 29 year old high school dropout who is now seeking asylum in Russia. One thing we learned from the Edward Snowden affair is that there are over 1.4 million people with top secret security clearances like his. The second quarter witnessed a parade of government scandals that even Presidential advisor David Axelrod says indicate a government that has grown too big. There is an example of that elusive bipartisan agreement!

We see this government gone wild and the deteriorating macro economy and choose to maintain our large cash position. Performance across our portfolios was most impacted again this quarter by the decline in gold and our gold miners' ETF offsetting gains from other equity positions for flat to slightly negative performance in the quarter when the S&P 500 gained 2.36%. As mentioned last quarter, the decline in gold prices suggests forced liquidations which have come in unpredictable waves. Such liquidations are often reversed almost as quickly but we expect a bottom in gold to coincide with a top in stock prices and have not yet averaged down our position. Although interest rates have moved up a little bit they are still not enticing us to reallocate any money to bonds yet.

Bullish Wall Street strategists see all these concerns as bricks in the wall of worry that bull markets typically climb. They point out that there has never been a recession following accommodative Federal Reserve policy but there has also never been as long a time with such accommodative Fed policy as now, and it is clearly becoming less effective. When monetary policy is rendered ineffective there is not much left to stabilize the economy. The lesson of the second quarter is that even if central banks decide to continue buying bonds, markets will sense the end of the program and beat them to the exits. If the stock market is in a bubble inflated by speculators leveraging up with Fed liquidity, those positions will be sold when the speculators unwind that leverage. Stock prices have absorbed the increase in rates so far but only after Fed officials made the case that the economy is still too fragile to reduce the accommodation. If only they would ask themselves why that is the case with those green bars so tall. Some investors point to a win-win situation where earnings either improve with the economy or the Fed keeps printing. Whenever it becomes that easy, something is being overlooked such as the possibility that the Fed is accelerating their actions at an unprecedented pace and earnings are still falling. That reality does not appear to be fully discounted in current prices and we fear it could be. We know not to fight the Fed but we also know Herbert Stein's Law which says "If something cannot go on forever, it will stop." The Federal Reserve cannot continue its interventions forever and we are preparing for when they stop.

The bankruptcy of the once powerful city of Detroit is proof of Stein's Law and will likely be a topic for next quarter's letter. Until then, please feel free to contact us to discuss your portfolio and as always, thank you for your trust and thank you for your business.

Yours truly,

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