STEPPING STONES MANAGEMENT, LLC

Second Quarter 2014 Commentary

July 15, 2014

Walking along a beach almost 2,500 years ago, Aristotle noticed that ships sailing beyond the horizon disappeared from the hull first and top of the mast last. The observation led to his geocentric philosophy of a round earth at the rotational center of the universe. This became the basis of scientific knowledge for almost 2,000 years. The son of a physician in ancient Greece and student of Plato, Aristotle devised the first forms of scientific classification pertaining to topics ranging from the cosmos to plants and animals here on earth. His overriding philosophy was that we use our senses and observation to gain knowledge of the world around us. This concept of using observed facts to discern knowledge will provide the foundation of the scientific method formalized in the Renaissance almost 2,000 years later.

The greatest scientist of that era was Galileo who would probably defer his Father of Science title to his ancient Greek predecessor. Galileo took Aristotle's love of numbers and measurement steps further and did indeed gain new knowledge, knowledge that would land him under house arrest for the final decade of his life. He devised a new telescope that enabled him to see previously invisible shadows on the planets proving that the earth must be part of a cosmos that revolved around the sun. Not only did his observation disprove the accepted geocentric science of prior millennia, but more importantly it violated Holy Scripture stating the earth does not move. The leader of the western world at that time, Pope Urban VIII, was a friend and admirer of Galileo's but nonetheless could not have his authority questioned in such a way. He banished his friend to house arrest where fortunately for humanity Galileo continued his scientific endeavors.

While scientists continue their search for knowledge today, political considerations may not be able to land them in jail but often lead to preordained conclusions to their experiments rather than unbiased discovery. Like earlier times, the people paying for the science will usually get what they want. When the science pertains to an early field of study, the lack of comprehensive data hinders the search for truth. Even though economics has been studied at least since Adam Smith in the 18th century, it is still a relatively undeveloped science. In fact, we are living through the greatest economic experiment of modern times and most academics are telling us that the Federal Reserve's policy of quantitative easing (QE) combined with activist government policies are the correct prescription for our ailing economy. We are told it would have been much worse otherwise even though no data can support a counterfactual. The second quarter ended with the report that the US economy experienced a surprising contraction in the first quarter but that was not enough to restrain the S&P 500 from gaining 4.69% for the second quarter and 6.05% for the first half of 2014.

Starry Messenger

The second quarter introduced us to Thomas Piketty a Paris School of Economics professor who published a comprehensive study of income disparity through the centuries. His almost 700 page *Capital in the Twenty-First Century*, titled in homage to Karl Marx, became a best seller as the New York Times feted the "Rock-Star economist" with glowing coverage of his call to rectify wealth disparities. Never before has any economic study gathered such wide-ranging income and wealth data across societies covering three centuries.   That by itself will cement Piketty as an important scientist in the field of economics, especially since he respected the scientific method by posting all of his data online for peer review. A major difficulty in comparing disparate data is to normalize it so conclusions can be drawn, and that is where Piketty's work has come in for the most salient criticism from his peers and others.

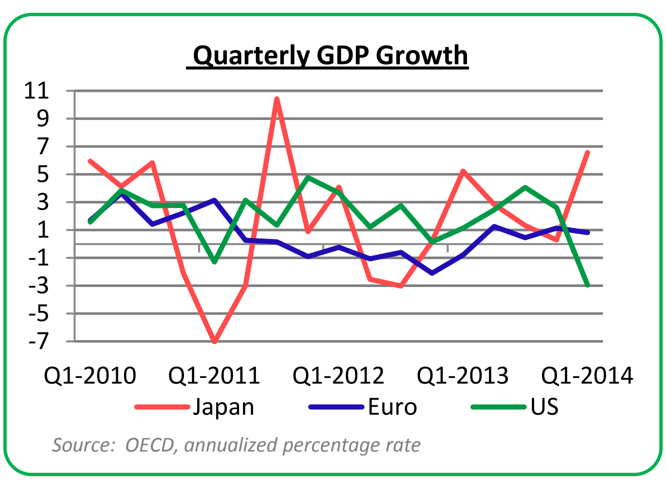
Not being one of those peers, I have only read about the book whose central premise is the unfair returns earned from capital versus labor. Piketty's remedy seems to be to raise taxes on high incomes, not to raise revenue for redistribution but to discourage those incomes from even being paid. If annual income over $500,000 were taxed at 80%, then corporate boards of directors would not award such compensation to their executives, leaving more for the other workers. He also advocates large inheritance taxes so that wealthy people would be spared the difficult but right decision to force their children to make it on their own. His data is deep but the peer review studies have not been able to find support for these prescriptions. The premise ignores that most incomes above that level are earned by privately held businesses and not set by greedy executives with beholden boards of directors. It also ignores that family held businesses often want to hand control over to family members who have knowledge gained from being intimately involved for their entire lives.

Piketty also advocates increasing the minimum wage based on two narrow studies from 1994 and 2000 that compared income and employment levels in New Jersey which increased its minimum wage and Pennsylvania which did not. He writes that the minimum wage was frozen under Presidents Reagan and both Bushes but raised by Clinton and several times by Barak Obama but the facts do not comport with the professor's political assignments. President Reagan did hold the minimum wage constant but he also expanded the Earned Income Tax Credit (EITC), paying direct benefits to the working poor. President Bush raised the minimum wage twice in 1990 and 1991 and the recession that followed disproportionately hit employment at those lower income levels. President Clinton raised it again in 1996 and 1997 but the positive supply side effects from his work requirement for welfare led to a great period for low-income workers. That was exactly opposite the conventional economic science predicting the work requirement would swell the unemployment rolls. Today's academics should remember that was also a time of budget restraint coinciding with an economic boom. President George W. Bush signed a minimum wage increase in 2007 that took effect over three years and the resulting effects on entry level jobs have been an unmitigated disaster. That may be why President Obama did not raise it again when his party controlled the Congress. It is true that nobody can raise a family on the minimum wage which is why we have the generous EITC. It is rare to see a broad credible study showing that raising the minimum wage helps low-income workers on net; it usually acts to remove the lowest rungs of the employment ladder. Raising the minimum wage does help the union workers whose pay is set as a spread over it and hence it helps the political party they support. Studies advocating minimum wage increases should be relegated to political science and not economic science.

The Tuscan Artist

The politicians always want more money to spread among their voters and two of the world's central banks have been more accommodative than ever creating trillions of yen and dollars to buy Japanese and US Government bonds. Their stated objectives have been to drive down interest rates to prevent deflation from corroding asset prices. All the science will say they have achieved that. However when we broaden the lens, we can observe some other consequences that their practitioners would rather disregard. Both economies are enjoying historically low interest rates which their governments are fully exploiting to borrow and spend money to boost aggregate demand in their economies. However both are suffering under long term stagnant levels of aggregate demand. The world's other major monetary authority, the European Central Bank (ECB), does not enjoy the autonomy of its counterparts but is rather an amalgamation of the central banks of all of its member countries who take it upon themselves to implement any agreed upon policy. Getting 18 banks to agree has been a challenge to ECB President Mario Draghi who began his career in the cradle of the Renaissance at the University of Florence, in the city where the Medici family created international banking.

As President of the ECB, Draghi has been determined to prevent deflation from affecting the European economies but Germany's Bundesbank, among others, opposes the kinds of monetary expansions underway in Japan and the US. Draghi's innovative contribution to monetary science is the ECBs latest policy of *negative* interest rates where member banks will actually pay to keep reserves at the respective national central banks. The experiment follows the theory that the negative rate will generate economic activity by enticing banks to make loans instead of holding reserves. Another option might be to continue to reallocate capital into other assets, like equities. Time will tell how the member banks react but the ECB's deviation from its counterparts' popular expansions has resulted in economic trends noticeably different from Japan and the US.



The chart shows the quarterly change in GDP growth, on an annualized basis, of the Japanese, US and Euro 18 economies. While the red and green lines show that higher rates of growth have been achieved under the QE policies, it has been sporadic and trendless; at least we hope the recent US plots do not make a trend. The 18 nations that use the Euro currency however have seen lower growth but with a steady upward trend since dealing with some of their sovereign debt problems of recent years. More importantly, major Euro members like Spain and Italy have begun to institute structural economic reforms heeding Chairman Draghi's exhortations that Europe's problems cannot be solved with monetary policy alone.

Of course, monetary policy can cause problems too. The Bank for International Settlements, a consortium of central banks, closed the second quarter with their annual report warning of the reallocation of central bank assets into riskier areas. The report states "as risk spreads narrow, increasingly more leveraged positions are required to squeeze out returns. And even if no leverage is involved, investors will be lured into increasingly risky and possibly illiquid assets." Many of those assets are held by the central banks themselves that appear hesitant to sell out of fear of disrupting the markets which could put them behind the curve if markets act first.

And Yet, It Moves

While the Fed and Bank of Japan celebrate higher asset prices the BIS warns that markets are out of step with their underlying economies. Markets have traditionally been leading indicators but the huge asset flows engineered by central banks have degraded the predictive effect of asset prices. Stock prices have been further supported by large share buybacks at companies like IBM and Apple boosting earnings per share figures as growth in sales and profits slow. Overall US corporate profits declined by double digits in the first quarter which would typically not be commensurate with the stock market at all time highs.

The stunning almost 3% annualized first quarter contraction in the US economy provides an example of the problem of financial repression caused by the Fed's manipulation of interest rates. Business and academic economists have spent decades building highly predictive models of our complex economy and none of them were able to discern the contraction. Not only does the Fed's manipulation of the risk free rate distort the models but so does the effect of those rates in the reallocation of assets to riskier areas further skewing the models to a pro growth stance. If risky assets are rising in price the models say the economy must be expanding even as that was not the case in the first quarter.

In the Stepping Stones fully invested Global Equity ETF strategy, we moved out of positions in the SPDR Technology Sector ETF and reallocated the proceeds to the First Trust Consumer Staples AlphaDEX ETF. That portfolio gained 7.43% in the second quarter and 8.11% for the first six months of 2014 compared to 4.69% and 6.05% for the S&P 500. Unfortunately we have not allocated more of our cash balances to the strategy as the underlying economic conditions keep us more risk averse than the market. We still see the rally we have enjoyed as largely a result of the Fed's quantitative easing which is coming to an end late this year. After that, most analysts are looking at when the central bank will actually raise the overnight rate from its current level just above zero. A more important metric may be the size of the Fed's balance sheet which has grown in lockstep with the stock market in the QE era (see our 3rd Quarter 2013 Commentary). Janet Yellen told a Senate hearing in May that returning the balance sheet to pre crisis levels could take 5 to 8 years. That would be the mother of all tightening cycles and we doubt market prices are discounting such a possibility. Yellen has a reputation as a monetary dove but circumstances could make her the tightest Fed chairman ever.

She is only the third academic to lead the organization which has usually had a banker at the helm. The first Fed chair to come from academia was Arthur Burns who provided Richard Nixon with accommodative policy to insure his reelection in 1972 but unleashed the inflationary wave that engulfed the US economy by Burns' retirement in 1978. Twenty-eight years later, Ben Bernanke became the next academic to lead the Federal Reserve and his was the most accommodative policy ever. It will fall to Janet Yellen to make sure her predecessor's policies do not lead to a similar outcome like we saw in the 1970s. If she maintains the Fed's bloated balance sheet when the economy gets back to normal then we should expect a corresponding rise in inflation. Economic science looks at full cycles and Janet Yellen has the credibility of the academies at stake.

Having a position counter to conventional wisdom is not comforting but most of our reasons for caution remain unresolved. Our observations include a weak economy with scant growth in revenues at companies or incomes to consumers. We see share prices supported by easy money and financial engineering which usually ends painfully. We face an environment where it has become almost impossible to even discern what is going on in the economy due to the Fed's financial repression. The bullish case has become that there is no alternative to stocks because everything else yields so little. Prior experience from similar circumstances suggests the outcome but even Aristotle was wrong about the sun. If the economic scientists got it right and we can indeed print our way to prosperity, it would be the first time since the Medici started lending money in the Renaissance. Equity prices could continue to rise beyond the Fed's expansion and since their growing balance sheet didn't help the economy much on the way up it may not hurt too much on the way down.

However if equity prices have been supported by that expansion then we should expect a corresponding shrinkage if Yellen's Fed does shrink the balance sheet. Logic says the market will act in front of the Fed. Our error in recent years has been to underestimate how much the Fed would expand its balance sheet even after meeting its stated objectives. Further economic weakness could lead to even more liquidity but would also confirm the inability of scientists to manage something as complex as a national economy. Some voices on the Fed are already acknowledging that. We are confident that the US quantitative easing experiment is coming to an end but not confident about what happens on the unwinding. Most importantly, we want to see solid growth in sales and earnings at the companies comprising the stock market rather than earnings per share gains achieved by stock buybacks and financial engineering.

Please feel free to call us to discuss any of your financial concerns. Until then and as always, thank you for your trust and thank you for your business.

Yours truly,

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