STEPPING STONES MANAGEMENT, LLC

Second Quarter 2015 Commentary

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These letters often stray from the rule to avoid politics and religion but they rarely venture into the latter realm. However, one of the major stories of the just concluded second quarter was the papal encyclical admonishing humanity for turning the earth, God's creation, into "an immense pile of filth." In *Laudato Si' – Our Care For Our Common Home,* Pope Francis is asking us to see our world more like his namesake St. Francis of Assisi who viewed all of the earth's plants, animals and other wonders as his brothers and sisters. The pope highlights how economic growth of the past two centuries has not always led to improvements in the quality of life and that "the way to a better future lies elsewhere." Continuing his criticisms of "unfettered consumerism" (not unfettered capitalism as widely reported) he wishes for humanity to appreciate nature more than material possessions. The pope who hails from the third world and has a master's degree in chemistry has seen how the developed nations' insatiable demand for natural resources has damaged the environment and left indigenous people impoverished and war torn. He predicts that the post-industrial period will be remembered as one of the most irresponsible in history but has hope that the twenty-first century "will be remembered for having generously shouldered its grave responsibilities."

The scientific basis for the encyclical comes from the Pontifical Academy of Sciences, the Vatican's scientific advisory board that dates back in different forms to the original one presided over by Galileo in 1603. The Academy is comprised of about 80 eminent scientists in various fields selected among themselves and appointed by the pope for life. They come from a wide range of faiths and viewpoints and their deliberations are independent of any papal influence. The current president is a Nobel Laureate who is not even Catholic. Meetings are held under a bust of Pope John Paul II and his 1992 apology for the banishment of Galileo who disagreed with the scientific consensus of 1633 that the universe revolved around the earth. John Paul II extolled "the profound harmony that can exist between the truths of science and the truths of faith." In 1994 he added a Pontifical Academy of Social Sciences from which Francis' encyclical is also largely drawn.

The encyclical became such a major economic story because His Holiness endorsed the consensus view that carbon dioxide and other greenhouse gas emissions cause global warming. Citing examples addressing hazardous waste and endangered species, he calls for supranational bodies to confront the crisis and enforce globally accepted rules restricting the use of fossil fuels. That got some who usually have no regard for Vatican pronouncements to sound like church ladies praising the papal wisdom. It was an interesting phenomenon in the second quarter that saw the S&P 500 drop a slight 0.25%, its first quarterly price decline since 2012.

Greek Exceptionalism

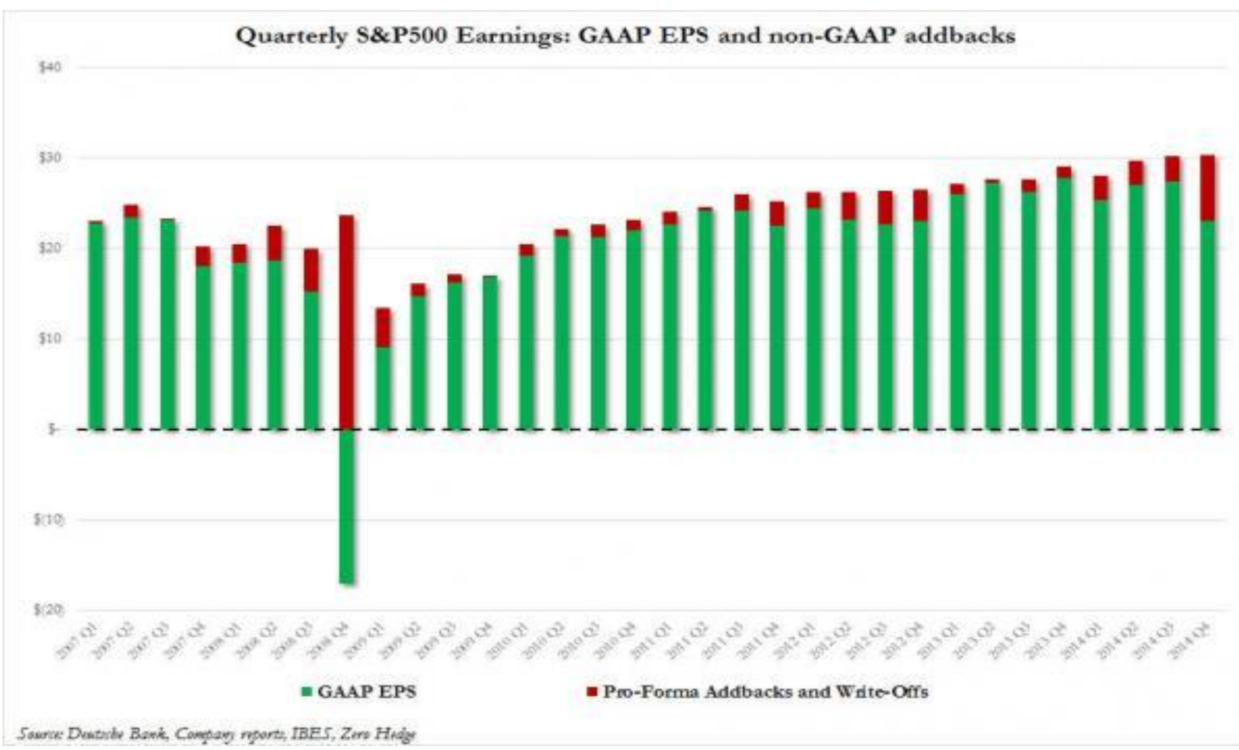
Financial markets had time to meditate on the Pope's metaphysical musings as we all waited for a resolution to the most recent crisis in Greece whose government continues to pay its public employees and pensioners more than it has been willing or able to tax from its citizens. The difference has been covered by debt issuance and bailouts with the most recent program set to expire at quarter's end. European political leaders worked feverishly towards an agreement acceptable to mostly northern European countries where people work well into their sixties, unlike Greeks who commonly retire in their fifties. The acrimonious negotiations exacerbated a European rift as Greece's new socialist government claimed "blackmail" by Germany whose leader Angela Merkel said she refused to be "blackmailed" by Greece's threat to leave the Euro. The feared Grexit could prompt other European nations like Spain, Portugal, Italy and Ireland to also exit the common currency. France and Italy took the Greek side and worked to lessen the severity of the terms. Ironically, or not, the crisis weakened the euro which mostly benefited German exporters. Greek Prime Minister Alexis Tsipras declared an inviolable electoral mandate rejecting further austerity. It came to a head on the last Friday in June when he put the terms to a July 5th referendum of the Greek electorate who overwhelmingly voted "no" in an election whose issue was not quite clear. The vote was widely seen as rejecting membership in the euro although the prime minister said the country would remain in the common currency either way.

The search for truth in the Greek crisis is a cumbersome one. Since joining the monetary union in 2001 Greece's membership has been based on deception. The country gained admission after hiding much of its debt through complex swap arrangements with Goldman Sachs. Mario Draghi became Goldman's International Managing Director a few months later and currently serves as the head of the European Central Bank (ECB). He claims no knowledge of the swaps until they became public during the 2010 crisis even though similar transactions occurred under his watch. The 2010 Greek bailout effectively transferred Greek debt from the world's major banks, like Goldman Sachs and Deutsche Bank, onto the books of the ECB which is why the consensus views a Greek default as not having far reaching ramifications. The ECB is currently printing more euros than it would conceivably lose in a default anyway. The referendum suggests that Greek voters want to go back to the drachma that their own central bank could also print at will, as do the ECB and the US Federal Reserve. Europe's other weak sisters mentioned above have taken difficult steps to correct their imbalances. Concern about the moral hazard of a third Greek bailout in five years is offset by images of people lining up at ATMs with fleeting hopes of getting $50 while struggling to acquire basic necessities like food and medicine in an economy that virtually shut down when banks were closed June 29th. The sad images should provide lesson enough to those countries to remain on their programs.

The country's fiscal deficit is obviously an unresolved issue inhibiting lenders from extending further credit. Despite the voice of the electorate, the deal currently under consideration would restructure Greek fiscal policy on a more sustainable path aligned with Europe's other weak sisters, assuming the Greeks follow through better than they have in previous agreements. Even if they do balance their budget, their current debt is probably unpayable and also needs to be restructured. A haircut in Greece used to mean a dangerous occupation enabling barbers to retire at fifty, now it means marking down the face value of the debt the country has accumulated. Without a debt haircut, Greece will ultimately be forced to restate their obligations in a currency that their own central bank can freely print. It would likely trade at a steep discount to the euro providing their tourism sector with a huge advantage over other Mediterranean countries. The others may not feel the pain until the following summer when Germans go to Greece for vacation at a fraction of the price they would pay to visit a fellow euro member. If all the weak countries exited, the common currency would appreciate, making it more difficult for German multinational companies to export to the weaker nations. That's why Europe's best and brightest are doing everything they can to keep it all intact. Whether or not Greece remains in the euro, the inescapable truths are that they need to balance their budget and restructure their debt.

Elegant Models

US multinational companies have spent the entire Quantitative Easing era restructuring their debt, buying back stock and engaging in various other kinds of financial engineering to boost earnings per share figures (as chronicled in prior letters posted on our website). With rare exceptions, haircuts haven't been necessary as the Federal Reserve has enabled even the shakiest companies to refinance in a market starved for yield. Corporate financial officers have also found creative ways to hide expenses in "special items" supposed to be non-recurring. The Associated Press published a study in June that found the trend has reached its most pronounced extent since the financial crisis. The people at ZeroHedge.com, who have a view of truth distinctly separate from the consensus, were on the case a few months earlier and produced the accompanying chart. Each bar represents quarterly earnings per share for the S&P 500 from 2007 through 2014, as reported by the companies "before one-time items" or similar modifiers that cut profits. The green portion of



each bar represents earnings reported according to generally accepted accounting principles (GAAP), the red is the aggregate special charges assessed in each quarter. A common example is stock based compensation which has always vexed accountants but few deny is an expense. The chart does not reflect 2015 but GAAP earnings declined in the first quarter and are expected to decline further in the second. Before the financial crisis, it was fashionable to ignore GAAP earnings in favor of "operating earnings", technically called EBITDA which means earnings before interest, taxes and depreciation amortization. After the crisis EBITDA was referred to as earnings before I trick dumb accountants. Shame on us if we let the corporate finance officers fool us again. The truth in 2008 was that deteriorating GAAP earnings signaled an imminent recession. The current deterioration aligns with other indicators that are also flashing red.

The oldest stock market indicator is called Dow Theory. Developed by Charles Dow in a series of late 1800s editorials, it states that movements of the Industrials Average in either direction should be confirmed by corresponding movements in the Transportation Average. The theory being if industrial America was producing more products, they would show up in the railroads that would deliver them to final markets. As the US economy evolved so have the averages which also include the Utilities Average reflecting the correlation of energy use and economic growth. Dow Theory has remained relevant even in our modern service based economy and as the widely followed Industrials Averge has been trading near records, those secondary indices experienced steep corrections in the second quarter. A new theory about the divergence is that the Bank of Japan and Swiss National Bank are eschewing the secondary groups in their stock market purchases.

Dow Theory also describes three market phases: accumulation, absorption and distribution. The first is when the smart money, those with distinct knowledge about particular companies, accumulate positions that are being discarded at discounts to their true value. Once those positions are established, the absorption phase sees the public come in and bid prices back to their true value and higher. That's when the smart money begins to distribute their overvalued positions to the still eager public market. Emergent examples of this have been revealed recently. Energy is an obvious one where commodity prices may have stabilized from the first quarter's washout but many energy related companies have yet to see an end to the distribution. The two positions in the Stepping Stones fully invested Equity ETF Strategy experienced further declines in the second quarter with the SPDR S&P Oil & Gas Exploration & Production ETF the worst performer in the portfolio losing almost 10% in the quarter, the Powershares Dynamic ETF invested in the same sector declined less than 2%. The Utilities fund was also weak, losing more than 5% which could signal higher rates or Charles Dow might suggest reduced economic activity. Not surprisingly, our Europe position was also down but has recovered most of that in recent days. Funds addressing consumer staples, value, semiconductors and gold miners were down about 2% and could be signaling the early stages of distribution where there seems to be a supply of stock for sale near recent highs. Our Japan and China positions gained more than 4% in the second quarter but it has been a different story in the third when China's government has taken unprecedented steps to halt a 30% bear market over recent weeks that still left their market and our position positive for the year. All together, the strategy declined by about 2% in the second quarter compared to the S&P 500's flat performance and the MSCI All World index losing almost 1%, the strategy is ahead of both benchmarks for the first six months of 2015.

The Chinese market intervention is the latest chapter in the government knows best saga whose necessity is another warning indicator. Commodity prices in general have fallen down to or below the prices seen in 2009 and one of our favorite indicators Dr. Copper, the commodity with a PhD in economics, does not have a favorable prognosis for the international economy. Heavy selling may be related to Chinese collateral calls, where the metal has backed many loans over recent years, or it could signal an international economic contraction. Another signal of distribution is the fact that 78% of IPOs in the first half of 2015 were from companies yet to earn a profit, a record percentage even exceeding the peak of the dot com boom. For whatever reasons, their owners feel compelled to sell now rather than wait for profitability and presumably higher values.

Dow Theory has a longer and more reliable track record than the Wall Street models that keep saying we are on the verge of an economic liftoff. Twelve individuals controlling the maturity spectrum of the risk free rate, the most important metric, for the first time in history is surely part of the reason for the diminished effectiveness. Constant tweaking that adds complexity is another factor. Our GDP statistics have gone through so many adjustments that the early nineties recession has vanished while we came close to recessions in the first quarters of the last two years. The Economic Research Department at the Federal Reserve Bank of San Francisco, Janet Yellen's previous employer, solved what they characterize as "the puzzle" in a May research report. They suspect the seasonal adjustments are the culprit writing "We find that a second round of seasonal adjustment implies that real GDP growth so far this year appears to have been substantially stronger than the BEA initially reported." So the seasonally adjusted seasonal adjustments reveal that everything is fine, which means the Fed should follow through with its plans to begin interest rate normalization this year.

That will be good news for Francis' church that has been forced to scale back its social services as the interest earned on its endowments has dwindled almost to nothing. When the pope comes to New York later this quarter he will find fewer Catholic parishes, schools and hospitals than his predecessors saw. He will also find his Little Sisters of the Poor being forced to violate his teachings by a well-meaning government trying to provide health care to its citizens. The same kind of enlightened thinking he calls for in his encyclical but has resulted in regular people being coerced to pay more for less. He will find the "throwaway culture" that cares too little for our brothers and sisters but who will hopefully hear his message of the virtue in consuming less, recycling and minimizing our impact on the earth.

Lest he worry too much about "this wounded world," His Holiness will also see an urban environment that has become cleaner as the economy grew. When Pope John Paul II visited New York in 1979 the Long Island Sound was barely swimmable and the upstate mountains were laid waste by acid rain. This pope will find a Sound cleaner than at any time in the century of records and an upstate teaming with our brothers and sisters in nature. The truth is the economic booms of the eighties and nineties provided the resources to clean our resilient environment more than ravage it. The postindustrial era was irresponsible in all the ways Pope Francis lays out but it was also a time when billions of God's children rose out of poverty and gained the comforts of modern life. Furthermore, the latest Greek tragedy teaches us how important economic growth is to generate the tax revenue that supports aged pensioners, if not the young ones too.

Those war torn areas where the worst environmental offenses occur are governed by command and control more than capitalism. Even in the more democratic countries, attempts to adhere to government set carbon mandates have had the opposite effects. Europe's conversion to unreliable renewable energy sources has led to increased coal consumption and higher carbon emissions. The United States rejected treaties like Kyoto but our emissions have gone down thanks to the development of natural gas fracking that has also brought great wealth to individual land owners and their communities. *Laudato Si'* clearly endorses the consensus preference for Europe's approach despite the contradictory empirical data. In the same way, our political leaders pursue economic theories with similarly poor results. As the harmonies of truth are revealed in both cases, contradictory views are banished by a consensus invested in the status quo. Galileo must be up there smiling in his carbonless state.

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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