STEPPING STONES MANAGEMENT, LLC

Third Quarter 2010 Commentary

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In “Oh! The Places You’ll Go” Dr. Seuss tells of the Waiting Place where people are “Waiting for a train to go or a bus to come, or a plane to go or the mail to come, or the rain to go or the phone to ring, or the snow to snow or waiting around for a Yes or No or waiting for their hair to grow. Everyone is waiting.”

The third quarter saw our economy and stock market stuck in that waiting place with bulls waiting for positive data to accelerate and bears waiting for the deterioration to turn into a crash. The mixed data held stock prices mostly within a 10% range with positive consumer spending pushing us to the top of that range but weak employment and housing data driving us to the bottom. By quarter’s end the bulls won out with a breakout above the top fueled by a declining US dollar. In fact, the 10% quarterly gain in the stock market matched the roughly 10% decline in the value of the dollar so maybe stock prices are just factoring in the declining value of the currency they are priced in. The weakening dollar can be attributed to Fed Chairman Ben Bernanke’s speech at a conference in Jackson Hole, Wyoming where he said the Federal Reserve stands ready to combat “unusual uncertainty” with further monetary policy tools to bring the inflation rate up to a desirable range.

QE2

A Fed chairman calling for higher inflation is a rare event and the market took notice. One of the tools he mentioned was more purchases of the Treasury debt being issued at an unprecedented rate. They make these purchases with money created out of thin air which drives down the value of those dollars which will ultimately correspond to higher prices for consumer goods. The Fed hopes to also push up real estate prices to relieve the pressure on banks’ balance sheets so that they can resume lending to businesses who can hire all the unemployed people in our economy. With the Fed Funds Rate already at zero there is no room to ease further so the bond purchases are called “quantitative easing”. This plan is a follow up to the prior experiment in buying mortgage and Treasury debt during the financial crisis two years ago. The necessity of what is being called QE2 places the efficacy of QE1 in doubt. These bond purchases have indeed brought interest rates down but historically low mortgage rates have not spurred home buyers to bid on properties. A case can even be made that QE2 is retarding economic activity as potential borrowers wait for the lower rates that will result from more Fed bond buying. If the Fed were to instead raise rates because the positive economic statistics no longer require such an extraordinary policy stance, it could spur waiting buyers to jump in now before rates rise further.

The future direction of interest rates is just one example of the unusual uncertainty that Bernanke is combating. The presence of QE2 also contributes to the unusual uncertainty around the direction of the economy by suggesting the Fed doesn't see the current positive economic statistics as being sustainable. Unprecedented actions by the Fed to push up inflation suggests that deflation is a bigger problem than Helicopter Ben told us could be solved by dropping money from the sky; maybe that will be QE3. If we are in a deflationary period, cash is among the best investments to hold. But with commodity prices rising, inflation can't be too far away and during inflationary periods cash is among the worst investments. By keeping short term rates at zero, the Fed is forcing idle cash to move into risk assets like stocks that pay dividends or bonds that pay interest, if you want your money to earn anything.

Risky Business

Commodities and foreign stocks are other risk assets enjoying investor inflows, which is the risk of the Fed's reflation strategy. Investors can avoid dollar based investments by investing in emerging markets expected to have strengthening currencies or by owning commodities whose values rise as the dollar falls. Either action works against the Fed's objectives of price stability and maximum employment. Our investment in the Gold Miners ETF is up almost 25% in the year we have owned it compared to the S&P500's 10% gain. We regret not yet investing in the India ETF but are satisfied with having waited on a China position, India is up over 25% and China is flat over the past year. There are commodity based ETFs that may also be appropriate for a falling dollar environment. The point is that all of these investments should perform well during an inflationary period but none of them help the economy in general. Investments in innovative companies with growing workforces help the economy but they also carry the most risk in a recession, which has to be contemplated.

The other side of this currency risk regards foreign investment flows. Any developed economy such as ours is reliant on foreign investors who must have faith that not only will their investments perform well but also that the currency is at least stable so any gains will not be offset when converted back to their home currency. The weakening dollar does boost the earnings of US multinational companies but, as I have written previously, no nation has ever devalued its way to prosperity. Nevertheless, major trading regions are attempting to boost exports by weakening their currencies which is creating rumblings of an emergent trade war. The US House of Representatives recently passed a bill, with an overwhelming majority, assessing tariffs on Chinese goods in retaliation for China's alleged currency manipulation. Amazingly, if the bill were to become law, it would be an amendment to the disastrous Smoot Hawley Tariff Act that set off the stock market crash of 1929 and remains on the books to this day.

Our representatives in Congress have done much to burden the economic recovery. Tax rates are one area of unusual uncertainty as everyone prepares to pay more beginning January 1, unless Congress keeps its promise to the middle class. Most analysts believe that some action will take place before the end of the year and the latest buzz is that all the Bush era tax rates will be extended which would alleviate one big threat to our economy. We can only wait for something to happen. Bigger sources of business risk are the two major pieces of legislation passed by the 111th Congress – the health care and financial regulatory bills. I have yet to receive the typical white papers from various law and accounting firms explaining the implications of these new far reaching laws because Congress left most of the details to be written by the executive branch departments charged with overseeing them. As we wait for this to happen, the risk is that these new laws will only be as durable as the administration in power. Future presidents can rewrite these details however they would like without any action from Congress. So once the Department of Health and Human Services and the Treasury Department finish their work, businesses can have confidence that the rules will not change for at least two years. It's hard to make long term plans when the laws you operate under can be changed as easily as the political winds blow. These two bills are a bigger threat to the economy than the looming tax hikes. Financial firms are raising capital instead of lending it and shedding employees from departments that are no longer permitted. Small businesses who have been struggling for years with higher health care costs are now seeing their premium hikes bent upwards which will put many of them over the edge or just lead them to drop their health plans altogether.

Public Stress

When middle class people lose their health care coverage their only option is usually their state Medicaid program. These programs are among the biggest stressors on state budgets which still look like the slow speed train wreck I wrote about last quarter. Washington DC came to the rescue in August with a $26 billion blue state bailout enabling the states to postpone the difficult decisions that must be made. If the Republicans take control of one house of Congress next month it will be with a mandate to end bailouts which could bring this train wreck to its culmination. It will be hard for any politician to vote for a bailout of municipal bond holders who are wealthy people looking to minimize taxes. It's hard to summon the fortitude to invest in front of such a possibility but it's becoming equally hard to hold a currency that is being debased which is making those inflation hedges mentioned above more attractive.

Even bigger sources of stress on the public sector are our two major entitlement programs, Medicare and Social Security. Most people born after the baby boom don't have much confidence that these programs will be viable at their retirement and something needs to be done. There has been a lot of talk about raising taxes on the rich but no talk about reducing their benefits. How about instead of taxing the rich more we just give them less? If we tell wealthy people they will have to use more of their own assets to provide for their retirement living, there will more available for those who really need the social safety net. Similar proposals can be brought to our agricultural programs where wealthy farmers collect huge sums from the government for doing nothing, many of them are even members of Congress. The next great political debate should be about means testing entitlements, it needs to happen.

America's Best Days

There is plenty to be pessimistic about. We have been living with zero or worse stock market returns for over a decade. Huge amounts of our manufacturing and service sectors have moved offshore, keeping a lid on American wages. The raw materials we need to live and operate have become scarcer in a smaller world. And perhaps worst of all, the institutions we have invested with our trust have failed us. The good news is that we all know about this and Americans have always been innovative people who solve problems. The winning long term bet has always been that America's best days are in front of us. Before the 1929 crash the Dow Jones Average topped out at 380, 13 years later intrusive government kept it stuck at about 100. The country came together to win World War II and the developing middle class of the 1950's drove a tenfold bull market until big government policies stalled the Dow at about 1000 from 1966 to 1982. Then Americans made clear their desire for a smaller less intrusive government and the Dow went on another tenfold increase for 18 years until the era of big government came back. The country seems to be near that point again and if we can fix the problems we all see, we can free the economy to come up with inventions and innovations that are unfathomable today and will improve our lives in the future.

A member of a seafood industry networking group I'm part of recently asked if anyone knew of a low cost aquaculture alternative to China which has become too expensive. Higher oil prices will only make shipping products across the world more expensive and rising wages in the developing world are already converging with our stagnant ones. A recent NPR report I saw told of call centers coming back to the US where disabled people are manning phones from their homes. Revolutionary telecommunications innovations have brought these highly productive people into our economy. As the weakening dollar drives oil prices higher, natural gas prices have been plummeting. This unusual decoupling of the two energy sources follows the discovery of the Marcellus Shale, a giant natural gas depository under Western New York and Pennsylvania. Like any fossil fuel, there are environmental issues with its extraction but the mammoth supply of low carbon natural gas and the jobs that will come with its development are too good to pass up. The more natural gas prices fall, the more attractive American manufacturing becomes.

As for our discredited institutions, most people can no longer afford ridiculous college tuition rates and are no longer impressed with their diplomas anyway. Wall Street firms are shrinking as retail and institutional clients question whether their products and services add value. Best of all, our political leaders have managed to unite the country behind the desire for smaller government. Only professors and politicians really think it's a good idea to spend trillions of dollars that we don't have. The rest of us are electing regular people to represent us in government. Whatever happens in the November elections, the primary season embodied the spirit of Gettysburg that government of the people, by the people, for the people, shall not perish from the earth.

The run up in the inflation hedges mentioned above happened so swiftly after the Jackson Hole Fed conference that I prefer to wait on some kind of pullback. This was the same strategy that led us to miss so much of the bull market run from March 2009 having only dipped our toes into the market. It's now more imperative to get our cash to work before the Fed destroys its value much further. Waiting for problems to be fixed is fine as long as we are not suffering losses, now we are, even if we don't see it on our monthly statements. I believe the next great tenfold bull market is in front of us, I just don't believe it can begin in earnest until we recognize the costs of the huge fiscal and monetary stimulus that continues to drench the economy. For that reason we will use caution protecting our cash but simply holding money market funds has become less cautious. Turning back to Dr. Seuss, we need to find those bright places where Boom Bands are playing.

Please feel free to call me to discuss various strategies to protect your assets from the devaluing dollar. Until then I would like to thank you for your trust and thank you for your business.

Yours truly,

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