STEPPING STONES MANAGEMENT, LLC

Third Quarter 2011 Commentary

October 12, 2011

The third quarter marked an important anniversary in American history. It was 40 years ago on August 15, 1971 that President Nixon "closed the gold window" ending the convertibility of US dollars into gold. Henceforth the US dollar became a fiat currency whose value eventually floated freely against other world currencies. The need to shatter the global financial arrangement that had presided since 1944 arose after many nations decided to trade their dollar reserves for the gold we promised. So much so, that we were running out of gold. What followed the delinking to gold was a surge of inflation and 1974's worst recession since the Great Depression. The 40 years since have been an experiment in currencies not backed by anything other than the government's decree that they are the only legal tender. It worked so well for a while that a fractious Europe decided to merge their various currencies into one in 1999 when the Euro was born. This 40th anniversary provided a bookend to that 1971 event as the world monetary system is in turmoil once again, resulting in the third quarter's 14% decline in the S&P 500.

All About the Benjamins

No longer tethered to gold, the Federal Reserve has been free to manipulate the supply of dollars as they see fit in order to achieve their dual mandate of price stability and maximum employment (two objectives sometimes in conflict). The Fed does this through their open market operations of buying and selling Treasury bonds from and to their member banks. If the Fed wants to increase the money supply to stimulate a sluggish economy they buy bonds. This takes securities off the banks' balance sheets in exchange for dollars that they will hopefully lend out to businesses that will use the funds to hire workers and purchase equipment. If the Fed thinks the economy is overheating and threatening inflation as goods become scarcer they will raise rates by selling bonds to the banks which removes dollars from the banking system and discourages borrowing. These decisions are made by the 12 member Federal Open Market Committee (FOMC) which meets every six weeks. That committee is made up of 7 political appointees and a rotating selection of 5 of the presidents of the 12 regional district banks who are selected by their fellow bankers (the president of the New York Fed serves permanently with the political appointees).

A key attribute of the US Federal Reserve system is its independence, they undertake these actions to expand or contract the money supply without any political accountability. The wisdom of this was to shield the value of our currency from the vagaries of the political winds and the desire of most politicians to always have easy money flowing to their constituents. Today's politicians may resent that independence but they must be happy with all the easy money that Ben Bernanke has been showering on our economy since the 2008 financial crash. We entered the quarter wondering exactly what the Fed meant by saying their zero interest rate policy will remain in place for "an extended period"; they answered that question by saying at least until mid 2013. The FOMC also undertook a policy borrowed from the 1960s and named for a Chubby Checker song. In "Operation Twist" the Fed said they will sell some of their short term bond holdings and buy longer term Treasury and mortgage debt in an attempt to get mortgage rates down. With all the money creation, savers find they cannot get any return on their savings unless they go out on the risk curve by eschewing safe investments for riskier ones. What has resulted is the greatest wealth transfer from savers to bankers the world has ever seen. Little noticed about the Fed's mid 2013 timeframe is that it approaches the end of Chairman Bernanke's term in January 2014; maybe he realizes his zero interest rate policy is not popular among America's savers, making his reappointment less likely.

As Ben Bernanke flies his helicopter into the sunset let's look east to how the Europeans do it. Unlike the Fed, the European Central Bank (ECB) has no such political independence and a sole mandate of price stability. It isn't a bank as much as a holding company of the national central banks of the 17 countries that use the Euro. When the ECB decides to undertake a policy, it is those member banks that do the actual open market operations. Each of those national central banks is accountable to its home country's legislature and can only do what the politicians approve which has posed a problem in dealing with the European sovereign debt crisis. The ECB wants a large stabilization fund but they cannot create Euros like the Fed creates dollars, they need each central bank to supply an amount in accordance with the size of their economies. Lest we be distracted by the relatively small Greek economy and the problems it is causing, the ECB needed to enter the market to support Spanish and Italian debt whose market dwarfs that of Greek debt. If those countries face similar problems as Greece, there is no way the ECB can follow the same policies in dealing with them. It has been difficult enough to get all 17 Euro nations to approve the expanded stability fund which will barely be enough to contain the Greek crisis and certainly not enough to deal with Spain and Italy. Not to worry though, Ben Bernanke has told his European counterparts that the US Federal Reserve stands ready to make unlimited dollar loans to European borrowers until year end. Consider this QE3. As a student of the Great Depression, Bernanke has stated it could have been averted if central bankers acted more aggressively so he is stopping at nothing to prevent it from happening again. In doing so he may be causing it to happen again as he discourages current investment with promises of lower rates in the future and forces risk averse savers into unsuitable investments in a quest for return on their savings.

The European financial crisis is in part a consequence of regulations that allow European banks to hold as much sovereign debt as they like without holding any reserves against those positions. If a bank has to hold reserves against a loan made to a Greek business but no reserves against a loan made to the

Greek government it will be more likely to make the loan to the Greek government. Nobody knows how exposed the European banks are to this sovereign debt and the underlying credit default swaps so a contagion fear has taken over the market and spread to US banks. In early September, Josef Ackerman, the Chairman of Deutsche Bank (the largest bank in Europe's largest economy) told a conference that the situation is reminiscent of the autumn of 2008 and said it is an open secret that numerous European banks would not survive having to mark their sovereign debt to market levels. The importance of this is that he is clearly more worried about his balance sheet than his income statement which means Deutsche Bank is not making many new loans these days. There has also been a large increase in deposits at the European Central Bank which means European banks are leaving their excess reserves at the central bank rather than lending them into the interbank loan market. This will make it even harder for marginal banks to survive a liquidity crisis. We saw that last weekend when the French, Belgian and Luxembourg governments had to rescue Dexia, a lender to municipalities around the world that handily passed the European stress tests in July with an ample 10.5% Tier 1 capital ratio which did not put them in the marginal camp.

Many feel the solution is to harmonize European fiscal policies which would prevent member countries from running such large deficits. As sensible as that is, it would represent a diminution in national sovereignty requiring referenda in all Euro countries which would take years to accomplish. Shorter term prescriptions are for the weak or strong nations to leave the Euro but there are no exit provisions in the treaty that established the common currency. Other short term solutions call for buying the debt of countries that continue to spend beyond their means or injecting funds into troubled European banks like the US did with TARP in 2008. The various countries can't seem to agree on a course of action and the longer it persists, the weaker the world economy is getting.

Government 2.0

Back on this side of the Atlantic, our representatives are locked in a grudge match over whether Washington DC should spend more to rescue our sluggish economy or spend less to rescue our sluggish confidence. The parties did manage to agree to a debt limit increase that does nothing to reduce our national debt and resulted in the first ever downgrade of US Treasury debt. Treasury Secretary Geithner said the downgrade showed "terrible judgment" despite the US having the developed world's worst budget deficit and lacking the political will to rein in spending. While our political leaders become irrelevant, people are demanding action. The Tea Party movement was the first sign of discontent and we have gotten to the point where President Obama's own party has taken the radical step of changing Senate rules to avoid having to vote on his latest stimulus bill.

Spending is clearly a problem but so is an inefficient burdensome government. Beyond the infuriating Boeing, Gibson Guitar and Solyndra stories, there is reason for optimism. Programs under the banner of Government 2.0 are showing government agencies how to use technology to deliver services in a more nimble and cost efficient way and make information more transparent so citizens have access to data and can develop solutions. Washington DC had a contest to encourage citizens to develop smart phone apps that can take advantage of all the information government possesses. One winner developed an app that highlighted bike accidents in the city to alert bicyclists of the danger zones, accidents dropped markedly. Wall Street Journal reporters mined Medicare billing data and found doctors who have billed for unrealistic numbers of procedures, ripping off Medicare and all of us who pay for it. The newspaper is suing the government to open up Medicare records so the public can act as a watchdog over bad doctors. Technology is finally beginning to transform government the way it has industry.

Of course the real problem with our budget deficit revolves around the big entitlement programs growing at an unsustainable pace. There are several ways to fix Social Security with a combination of a higher retirement age, lower cost of living increases and means testing the wealthy. The power of American ingenuity can also solve the problems of Medicare and Medicaid by introducing consumer choice into the health care market rather than delegating almost 20% of our economy to government appointed bureaucrats. If consumers are given incentives to consume health care more wisely, doctors will have incentives to offer their services at lower rates to gain market share. Other issues like medical malpractice reform and coverage for pre-existing conditions can be legislated without the total government takeover passed in 2010.

Markets always beat bureaucrats. Could government panels have come up with the iPod or any of the other indispensible and revolutionary products that Steve Jobs envisioned, produced and sold? Jobs was a pioneer on humanity's constant march forward employing tens of thousands in his own company and supporting countless more in businesses that build on the Apple platform. He built the world's most valuable company without government subsidies or in accordance with any centrally planned industrial policy. He did it by picking himself up after failing and following his dreams and intuition. He was a truly inspirational figure and a stick in the eye to those who say Americans don't make anything anymore.

If it's darkest before the dawn maybe we have another recession in front of us before these problems get solved. Entering the third quarter, our eyes were most fixed on the German economy and whether it would keep Europe and perhaps the rest of the developed world out of recession. It looks like those hopes were dashed. Most analysts say the United States will likely avert a recession which means there is risk of lower US stock prices if those hopes are also dashed. For now our economy looks to be trending along at a slow but positive rate. The only country with more excess housing than the US warrants attention though. Empty Chinese cities that can be seen on YouTube cannot be good for China's banking system. The sharp drop in commodity prices in the third quarter suggests the Chinese economy is cooling more than expected. Nobody seems to expect a full blown recession in China so that also poses a risk that it may eventually get priced in. Most markets around the world have already reached bear market territory and continued sliding. The S&P 500 reached that designated 20% decline for a few hours but has not closed below it. Our cash has provided a buffer to the downturn and we even made some money from our position in the volatility index. That vehicle did not perform as expected but we did manage to exit with a modest gain from our cost basis and a very nice gain for the quarter. We took advantage of the August decline to enter a position in Chesapeake Energy, a leader in the natural gas fraccing boom. This technology will enable the United States to become energy independent with clean burning natural gas reserves that rival the energy potential of Saudi Arabia's oil fields. It's one of today's most exciting economic stories and it isn't getting proper media coverage. We are currently carrying the position at a loss but plan to add more shares at these lower prices. Other positions on our buy list are getting closer to execution as the market approaches the low of July 2010 that I wrote about last quarter.

All in all we see this decline opportunistically having expected problems like the market is facing today and prepared for them by holding excess cash. A full blown recession in China was not part of our analysis though, making that the biggest risk. Wall Street economists who say China will be able to engineer a soft landing lack credibility due to their firms' exposure in China but simply taking price signals from falling commodity prices may be relying too much on vehicles easily whipped around by speculators trading leveraged positions. A short term solution to Europe's banking crisis and the way the market and economy react to that will provide a window into the underlying health of the world economy. Clarity out of China's state controlled information sources is too much to ask for however. On the positive side, there is the possibility of something big coming out of the congressional super committee attempting to cut $1.2 trillion from our budget over the next ten years. Bold reform of our entitlements and tax system could make the difference to those politicians' reelection chances and a bipartisan solution has already been identified by President Obama's deficit commission from 2010. Don't count on it, but don't be surprised if the Washington conventional wisdom of eternal gridlock is wrong. A return of confidence will unlock many trillions of dollars currently squirreled away in zero interest savings accounts providing a stimulus that no politician could match. You can't blame a guy for dreaming.

Once the world economy gets back on solid ground the whole question of fiat money will be a topic for discussion. Many voices call for a return to the US gold standard but something that worked 40 years ago may not be applicable in our current age of leveraged funds around the world trading the metal in violent swings. However, some kind of price rule would go a long way to restore confidence to our currency that is currently managed on an ad hoc basis by 12 people. There are plenty of ideas out there but they will need to wait until the world economy gets through this latest crisis, which will likely result in even more monetary creation. We are sleeping comfortably through this turmoil with our large cash position but looking forward to the sun coming up again on the US economy. We have gradually begun to position our portfolios for those brighter days that lie ahead. 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