STEPPING STONES MANAGEMENT, LLC

Third Quarter 2012 Commentary

October 22, 2012

Those who have already decided their voting preference may have found obscure points of interest while watching the recent presidential debates. For me, one came with the camera angle from behind the candidates showing President Obama wearing a double vented European style suit jacket, the popular fashion these days, while Mitt Romney chose the traditional American center vent style. Each candidate's choice is consistent with his policy viewpoint where Obama prefers the European social welfare model and Romney the traditional American policies favoring free markets and individualism. Fashion was on the front pages in New York this September as the city hosted fashion week where nineties throwbacks were all the rage. If it's true that high hemlines are correlated with bull markets then nineties fashion could hold good portents too. However, the spring collections were not the reason for Wall Street's almost 5% rally in the S&P 500, nor was the presidential race which saw volatile polls swinging to each candidate's favor. No, in the just completed third quarter, the exciting worlds of fashion and politics were secondary to that usually dry world of central bank monetary policy.

The Great Experiment

In the month of September, the planet's three major central banks undertook massive and unprecedented monetary expansion. Ben Bernanke, who as a professor quipped about solving deflation by dropping dollars out of helicopters, led the US Federal Reserve into the highly anticipated third round of quantitative easing, QE3. The two prior rounds had defined limits, this one does not. Bernanke said the Fed will purchase up to $40 billion worth of bonds each month and will not limit those purchases to the usual Treasury securities but include mortgage bonds like they did with QE2. The new wrinkle is that these purchases will go on for as long as the Fed deems necessary. During his press conference, where he was wearing a single vented suit jacket, Bernanke told critics that his monetary expansion is not to benefit the Wall Street banks who are receiving those dollars but is a "Main Street policy." Main Street is that place where gas costs $4 per gallon and fewer able-bodied adults are employed since the dawn of the dual income family.

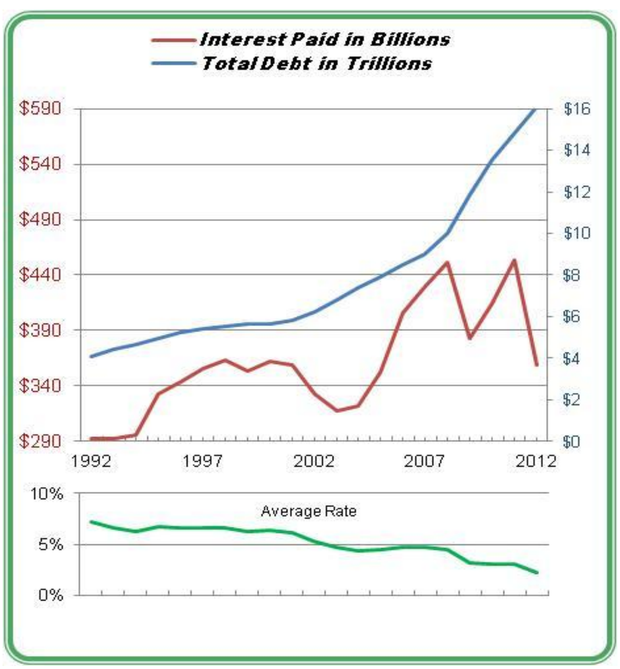
Across the Atlantic, Mario Draghi led the European Central Bank (ECB) into uncharted waters by committing to buy the bonds of countries suffering "a bad equilibrium" in their sovereign debt markets. He acknowledged those countries' culpability in having faulty fiscal policies or no policies at all to control spending, so the ECB insists that any purchases of those bonds follow a request by the subject country and be conditioned on adherence to strict fiscal measures imposed by organizations such as the International Monetary Fund (IMF). In his press conference (no camera angle from behind), Draghi said the conditionality is important because the monetary policy would have no effect if the fiscal policies didn't change. Proof of that assertion can be seen in the stagnant US economy drowning in Fed liquidity that has been flowing for the last four years. The conditionality has been a bridge too far for Spain to cross as of yet but markets rallied on Draghi's comment that the ECB would do "whatever it takes" to preserve the monetary union in its current form. German Chancellor Angela Merkel is also expending considerable political capital with her commitment to the currency union despite protests against austerity across the continent. Those protests provide compelling TV drama but Draghi is daring the speculators that any bets on Euro disintegration will fail in the face of his potentially unlimited bond purchases. That may hold off any bear raids but it doesn't solve the problem of governments providing benefits they can't afford. European austerity which has mostly raised taxes to fund those benefits, has not generated sufficient revenues so eventually Europe will have to find ways to become more productive.

As the Europeans join the Americans trying to print their way to prosperity, the Japanese Central Bank doesn't want to burden that export driven economy, and the rest of the Asian bloc, with an appreciating currency. They too undertook a new, unprecedented monetary expansion by increasing the size and duration of their prior policy and expanding the types of assets they would buy to include such direct private investments as commercial paper and exchange traded funds. The Japanese policy has been in place for decades begging the question of its efficacy if needed for so long. The central bankers assure us of the necessity of what they are doing and their ability to put on the brakes at the appropriate time, even though their policies have distorted traditional price discovery mechanisms. One such market price signal has historically been the US Treasury yield which is now engineered by Fed purchases across the maturity spectrum, nullifying any inflation warnings it would otherwise send. When someone borrows more than they ever have before, the lenders usually demand a higher rate. With the Fed controlling that price by purchasing about three quarters of the debt, the almost parabolic rise in outstanding Treasury debt is being financed with record low rates which masks the true burden. All this monetary creation has been described by one Financial Times columnist as "the greatest monetary experiment of all time," and he reminds his readers that history has not been kind to monetary experiments.

Finance officials from the world's major economies met recently in Tokyo at the annual IMF conference. With all three major central banks printing at the same time, exchange rates have remained basically stable masking the devaluation in the currencies but engendering animosity from the emerging markets struggling with appreciating currencies from all the hot money flowing into their economies. Brazil's finance minster told the IMF gathering that the Fed's new policy is "selfish" to which Bernanke responded that these countries should embrace the benefits of their stronger currencies. The problem is those benefits are offset by higher commodity prices resulting from all the money flowing into financial assets like oil futures. However, Bernanke isn't printing all this money to weaken the dollar and spur exports, he has no choice as the political class holds him hostage by cutting taxes and expanding government benefits that can only be paid for with his newly created dollars. All the targeted and temporary tax cuts have driven IRS receipts down to about 16% of GDP, the lowest since 1951, making Barack Obama among the biggest tax cutters ever; while expanding benefits have driven outlays to about 24%, a record high except for World War II. When the Fed creates those dollars, its balance sheet grows with the bonds it purchases, to where it has more than tripled since 2008's financial crisis. While a can of Coke cost about $1 then and still does now, if that balance sheet isn't shrunk the same can of Coke will eventually cost $3. Shrinking the balance sheet will require raising rates to an extent never achieved without causing a recession, which is why politicians have historically preferred inflation. The end of the third quarter also marked the end of the government's 2012 fiscal year, the fourth in a row where our politicians produced a deficit above $1 trillion.

Policy Matters

The good news is that 2012's deficit was lower than 2011's as Bernanke's bond buying drove interest rates lower. Interest on our debt came in at almost $360 billion, about $100 billion less than last year with much of it paid to the Social Security trust fund where a new accounting methodology accounts for some of the decline. Putting that in context, the combined amount the government spends on the top 5 cabinet departments other than defense is $339 billion. Dividing that interest cost by the total debt outstanding at the end of the fiscal year, just over $16 trillion, gives a blended interest rate of 2.24%. That rate reflects the success the Fed has achieved in lowering rates as well as the Treasury Department's accounting change and its strategy to skew its outstanding debt towards short term instruments which carry a lower yield. Unfortunately, that strategy requires the Treasury to raise $4 trillion this year to cover the deficit plus maturing debt, another reason for the Fed to keep that market plenty liquid.



The blue line on the chart to the left, prepared with Treasury Department data, shows our national debt outstanding crossing the $16 trillion line. Ironically, that rise has been met with a decline in our annual interest cost as shown on the red line, scaled on the left. The reason this can happen is shown on the green line in the lower chart representing the average interest rate each fiscal year declining from 7.19% 20 years ago to this year's 2.24%. The average rate over that 20 year period has been 5.47% which if it prevailed today would put our annual interest cost at almost $900 billion, exceeding the Defense Department's $700 billion budget. When that rate eventually rises, our outstanding debt will certainly be higher which will drive the annual interest cost far beyond that $900 billion figure. The national debt may not be hurting us too much now, but it will once the Fed ends its monetary experiment. Interest costs will swamp our $4 trillion annual budget with nothing but crumbs left over for our social welfare programs which are also increasing in cost. All this leads the world's largest bond manager, Bill Gross at Pimco, to describe the United States as "a serial offender, an addict whose habit extends beyond weed or cocaine and who frequently pleasures itself with budgetary crystal meth."

Being governed by a junkie does not engender optimism. One of the reasons we have been holding excessive cash is because the corporate earnings that have justified the 3 year old bull market are reliant on all this unsustainable government spending, either directly or indirectly. As the budget has been getting squeezed (ever so slightly) the economy's growth rate has been coming down and so have corporate earnings. The third quarter earnings season we are in now is expected to see the first year over year decline in S&P 500 earnings since the recession. Our premise has been realized but the stock market marches higher and Ben Bernanke takes the credit. The old maxim, don't fight the Fed, ruled the third quarter as many of those newly created dollars landed in the stock market. Valuations are reasonable but if profits continue to decline prices will likely follow.

A safe haven in such a scenario could be gold and we continue to hold the Gold Miners ETF which was up almost 20% in the quarter as the market saw these companies as one of the preferred ways to play the Fed's QE3. There are a number of reasons why we prefer the miners to simply buying the Gold Bullion ETF that holds the actual metal. One reason is that the bullion fund is considered a "collectible" by the IRS and does not get the favorable capital gains tax treatment that equities do. Taxes are a secondary reason for any investment though, primary is our expectations of how the vehicle will perform. The gold miners have historically been leveraged to the price of the metal and rise more than the underlying commodity. This has not been borne out over the current rally in gold as the mining companies sell futures at today's prices and forgo the higher ones that follow. This reduces that leverage and keeps them protected against a sudden drop but has also kept them lagging the performance of the bullion. Another reason to own the miners and not the metal is that the metal doesn't pay a dividend, although that has come down like most yields have as higher energy prices make it more expensive to mine. While the miners haven't performed quite as expected, we continue to hold the ETF with expectations of a return to the mean.

Our cash position is looking less safe now with the Fed's unlimited quantitative easing program so we are looking to invest in ways that are protected from a depreciating dollar. One option is the emerging markets where we have been looking for quite a while. Those markets came down sharply in the second quarter but have stabilized and are looking better now. Another area coming down sharply in this earnings season is technology which has impacted our position in IBM that we have been gradually trimming. The stock was up 6.51% in the third quarter but has given that back so far this quarter due to an earnings miss. Bad earnings across the technology sector are making ETFs exposed to those companies more attractive. Technology can be considered an inflation hedge as companies struggling under rising expenses employ it to save money. Energy is another inflation hedge although our position in Chesapeake continues to suffer from weak natural gas prices. Those prices did stabilize and the stock was up a slight 1.45% in the third quarter and has added almost another 14% so far this quarter. Additional positions in the energy space are also being considered as an alternative to Ben Bernanke's depreciating dollars. Where the large cash position helped us in the second quarter it held us back in the third.

The current earnings season is bringing stretched stock prices down as big companies are missing expectations and not sounding optimistic about coming quarters. With the fiscal cliff approaching, managements are questioning where their sales will come from if the government isn't cutting as many checks. History across time and humanity clearly says the market will quickly fill any void left by the lifting of government's heavy hand. If the political landscape looks the same next year as this, we should expect the fiscal cliff to come which means the Clinton tax rates for everyone not just the rich and added Obamacare taxes on top. That combined with the sudden and sharp spending cuts of the sequestration process would be an economic shock which would almost certainly cause a recession but would also stem the current fiscal bleeding, so not all bad. In another scenario where the Democrats hold and gain power, we should expect more government support of the large companies that comprise the stock market and more above average price gains like we have seen, as long as Uncle Ben keeps his helicopter in the air. If Republicans gain control, a recession becomes more likely as spending will be cut and taxes will probably rise to more than 16% of GDP, although it wouldn't be as sudden as a cliff. If any recession is matched by reforms of the big government programs hanging like yokes around the neck of the economy, it could be brief and calm the fears that are restraining the investment so necessary to fuel the next great expansion. That would be the best outcome for the intermediate and long term which could mean more than nineties fashion will be in style next spring. However, the difference between the nineties and now is about an 8% fiscal deficit.

Please contact us anytime to discuss your investment considerations. Until then and as always, thank you for your trust and thank you for your business.

Yours truly,

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