STEPPING STONES MANAGEMENT, LLC

Third Quarter 2013 Commentary

October 22, 2013

As the fourth quarter got underway consumed by the latest round of Washington, DC shenanigans, the third quarter also saw politics infringe where it has historically remained absent. Fully aware of the drawbacks of our political system, 100 years ago Congress created the Federal Reserve to protect the integrity of the US dollar from the circus that is our nation's capital. Yes, it was back then too. The President was given the power to appoint the chairman and several governors of the central bank, and the Senate was given the power to confirm those choices, but all actions taken by the monetary authority were meant to be insulated from the politicians who by nature will usually prefer low interest rates and easy money. The independent central bank is widely viewed as an integral reason why the US dollar has been the world's reserve currency.

Earlier this month, President Obama made history by nominating the first woman as Chairman of the Federal Reserve. No one questions Janet Yellen's credentials as a world class economist but she is widely viewed as the second choice after the political class shot down the President's trial balloon of nominating Lawrence Summers for the post, another candidate with impeccable credentials. Several issues were identified as the reason why the former Secretary of the Treasury under President Clinton was unsuited for the job including an alleged prickly personality, politically incorrect comments he made while president of Harvard regarding differences between the genders, and his espousal of free market principles in the 1990s. Such political issues have heretofore not come into play in such a nomination. A more salient reason though is his recent comments questioning the effectiveness of the Fed's current Quantitative Easing (QE) policy. At a conference in April, Dr. Summers said "QE in my view is less efficacious for the real economy than most people suppose."

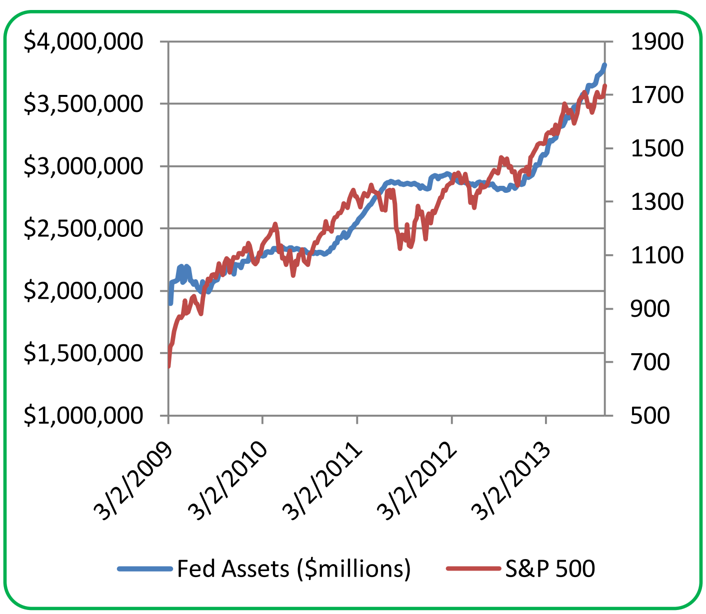
His remarks were not broadcast or reported at the time but when the *Financial Times* reported them in late July the air began to come out of the Summers balloon. Members of Congress made it known that they would not support his nomination for all of those earlier reasons even though none dared say they were against him because they want the easy money to continue. However as explained in last quarter's letter, the QE policy has made the Federal Reserve the single most dominant buyer of the government's debt; the debt that the political class continues to rack up at an unprecedented rate.

NAIRU is Not an African Country

Dr. Yellen's dovish reputation comes from her full support of the current QE policy even though she was reported to have been in favor of higher rates in the mid 1990's. Much of her academic work addresses the economic concept of the "non-accelerating inflation rate of unemployment" or NAIRU, which postulates a full employment level where the Fed should be restrictive when unemployment is below that rate, like in the late 90s, but expansionary when economic conditions exceed it, like now. An added mark against Dr. Summers was his remark in that same April speech that the widely accepted NAIRU rate of 5.5% may be too low suggesting tighter money at a higher unemployment rate. Dr. Yellen has spoken eloquently on the destructive effects of current unemployment trends on workers and families and many believe that the Fed's stated threshold of a 7% unemployment rate before they end QE (separate from actually raising rates or tightening policy) may come down under her Chairmanship, meaning more monetary expansion than previously expected.

Dr. Yellen is on record stating that our current poor employment situation is cyclical rather than structural which means she thinks it can be solved by more central bank easing. However, as these letters have asked over many quarters, why does the situation persist despite such unprecedented policies? To ask the question is to acknowledge the ineffectiveness that Summers suggested.

When Chairman Bernanke undertook the policy during the Great Recession the rationale was that by lowering interest rates Americans would have an easier time buying big ticket items like autos and homes which would have multiplier effects driving the broader economy. Autos and homes are indeed selling at a faster pace than during the recession but have failed to make much progress beyond pre-recession levels and as we all know, the broader economy has been limping along for the four years since the recession ended. Bernanke defends the policy now by pointing to higher stock prices and suggests that the wealth effect of stock holders feeling more secure should trickle down to the broader economy. This time Wall Street and Washington fully embrace this new form of "trickle-down economics." The nearby chart shows how correct Bernanke is that his policies are driving stock prices higher. The blue line represents the size of the Fed's balance sheet as reported weekly. The balance sheet grows as they create dollars to buy $85 billion worth of Treasury and mortgage debt every month. In March 2009 it stood at slightly over $2 trillion and has grown to almost $4 trillion today. The balance sheet had remained at about $800 billion for the 5 years prior to the financial crisis before its almost 5 fold increase in the 5 years since. The red line, scaled on the right axis, represents the S&P 500 which has risen almost in lockstep with the Fed's



balance sheet. Periods of stock market weakness in those years coincided with periods when the Fed was not expanding the monetary base and prices shot higher when various stages of QE were announced. The decline in the summer of 2011 coincided with the end of QE2 and the US credit rating downgrade but prices came back when Treasury rates actually fell after the downgrade. However, things changed in the just completed third quarter as the balance sheet grew more than ever but the stock market faltered and is now lagging for the first time since 2011. As highlighted in last quarter's letter (available at www.steppingstonesmanagement.com), the volatility that emerged last spring resulted from expectations that the Fed was preparing to taper the rate of their bond purchases.

One of the hallmarks of Bernanke's tenure atop the Fed is his policy of transparency marking a stark contrast from his predecessor Alan Greenspan who kept market participants checking their dictionaries attempting to make sense of his mysterious pronouncements. The third quarter ended up being a departure from that policy in that the market was led to expect a tapering at the September meeting which did not occur. The continued expansion drove the S&P 500 to new highs but the chart shows the correlation between the Fed's balance sheet and stock prices is diverging. So if QE is no longer driving auto or home sales higher, and is not as effective in driving stock prices higher, what is the reason to continue?

TIC, Tock, TIC, Tock…

The answer to that question can be seen in the Treasury Department TIC data which quantifies foreign holdings of US securities. July's release showed that Chinese and Japanese holdings of US Treasuries declined by $42 billion in June. The Fed's QE purchases typically put cash onto the balance sheets of Fed member banks that have been using the extra capital to make loans to hedge funds that drive stock prices higher. Now it is increasingly going to absorb the selling from foreign holders of US debt. Even though the Fed kept the music playing, the world looks to be tiring of all the extra supply of US Treasury notes and the paltry interest rates they pay. Manufactured crises with implausible threats of a US Treasury default will likely worsen those trends.

Chairman Bernanke told a "60 Minutes" interviewer in December 2010 that he is 100% confident that he could raise interest rates in 15 minutes if he had too. His aborted attempt to take a far more modest action in the third quarter proves the folly of that statement. The Fed's mere suggestion of a tapering resulted in a tsunami of bond market selling that resulted in an upward spike of the ten year Treasury rate even while the central bank was buying more debt than was being issued. Far from actually raising rates, the Fed found itself unable to even taper its monetary expansion. Meanwhile the clowns in Congress have milked the latest crisis for all the campaign contributions they could garner before predictably accepting the demands of Washington's big spenders. The crisis is now scheduled to reemerge early next winter so we can do it all again. If a crisis is a terrible thing to waste, then the more crises the better so reset your Armageddon countdown clocks to February 7th. A trillion dollar debt extension used to last a long time, now it only lasts a few months.

You can't blame Congress for racking up ever increasing amounts of debt when the money is basically free. The Fed says the economy is too weak to begin tapering which means any signs of strength are met with selling of stocks in fear that the music may actually come to an end. However a strong economy requires a healthy level of savings and investment and with interest rates pegged at zero there is little incentive to save or invest. The incentives are rather to spend any dollars now before they lose value as their quantity balloons. Supporters of the Fed's QE policy point to Japan where inflation has not emerged despite decades of monetary expansion. Those decades have also coincided with a stagnant economy making that a poor model to follow, except for the clowns who get to spend all the money rewarding their friends. Japanese authorities say they are fighting a war against deflation trying to forestall declines in asset prices but the best way to drive asset prices higher is to incentivize investment. The opposite occurs when interest rates are pegged at zero.

Insane Clown Posse

Of course when the clowns are not rewarding their friends, they are punishing their enemies which seem to include influential voices that disagree with the unprecedented policies. One example is James Dimon, the Chairman and CEO of JP Morgan Chase, who has criticized current fiscal and monetary policy. Despite being a standout manager whose bank remained profitable through the 2008 financial crisis, Dimon has seen the bank subjected to endless investigations and lawsuits from federal authorities. The latest stem from wrongdoing on the part of Washington Mutual and Bear Stearns, two failed institutions that JP Morgan Chase was urged to rescue in 2008. Dimon's world renowned risk managers apparently did not have the foresight to demand indemnification before answering government's call. Now the bank has had to take charges to cover the lawsuits causing it to report a quarterly loss for the first time since Dimon took over at the end of 2005. The third quarter also saw Standard & Poor's argue in federal court that they are being unfairly prosecuted for their ratings on subprime mortgage securities due to their 2011 US credit rating downgrade. They make a good case in that no other credit rating firm has faced similar prosecution despite issuing the same top ratings on the same securities. Small business also appears to be an enemy of the state that smothers them under endless regulations. The latest proposal from the Securities and Exchange Commission is to require small brokerage firms to purchase liability insurance to protect against customer complaints. This contradicts the principle of limited liability for corporations whose customers can choose to avoid doing business with small companies.

But the clowns claim to know better than the people so they continue to appropriate more of the economy under their control. The beginning of the fourth quarter marked the launch of the Affordable Care Act passed in 2010 and despite 3 years and an estimated $500 million to build the website (more than Facebook spent in its first 6 years), it has been worse than the train wreck predicted by Democratic Senator Max Baucus who worked so hard to pass the bill. The few people who have been able to log into the system have found policies that cost far more than they are currently paying with deductibles that exceed a reasonable level of expected annual health care expenditures. The young and healthy that are so vital to the system are instead incentivized to forgo insurance and pay cash for their healthcare. In the event that they contract an unaffordable disease, they can get insurance then because it now cannot be denied due to a preexisting condition. Widespread reports of security flaws in the online healthcare exchanges further incentivize the technologically savvy to stay away. The most likely outcome will be more uninsured people not less. When we hand over one sixth of our economy to be managed by clowns, we should not be surprised that we have to pay more to get less and unintended consequences overwhelm any derived benefits.

Despite the headwinds, the market marches higher. Our portfolios were most impacted in the third quarter by the 27% rise in Chesapeake Energy rebounding from its fall last year. The Gold Miners ETF also looks to be establishing a bottom having risen about 2% in the third quarter. Those gains offset weakness in IBM which has continued into this quarter after the company reported its sixth straight quarter of revenue declines. Most of our accounts lagged the 4.7% quarterly rise in the S&P 500 but are positioned for more risk than is currently being factored into the equity markets. Like Warren Buffet, we are fearful when the market is greedy.

The mantra of the markets has been "don't fight the Fed" as the Yellen appointment and the end to the latest Washington clown brawl has driven stock indices to new highs. Our large cash position has been a regret but we are still reluctant to commit more funds to a market whose underlying fundamentals remain weak. Simply buying because the Fed is printing could prove to also be regretful when the business cycle inevitably turns to recession and a divided Federal Reserve Board has no more answers. The disastrous rollout of Obamacare only reinforces our view that when government is taking over more of the economy, prosperity usually remains elusive. That is the lesson of the 1970s and 2000s and proven further in the opposite economic booms of the 1980s and 1990s when government encouraged free markets. Big government appears to have worked for a few years as the US has been the best alternative in a messy world but that world is showing signs of losing its affection for our markets.

As the blue clowns celebrate their recent pummeling of the red clowns, they may come to regret not negotiating a one year delay in the health care plan that will have its most adverse impacts on their young voter base who are finding out that health care is not free and government managed health care looks worse than the alternative. Bullish managers point to a win-win scenario where either earnings improve or the Fed keeps printing. We foresee a different scenario where in the post World War II era, recessions have occurred about every 5 years which means we are about due for another and the Fed has little left to combat it when it eventually arrives. Furthermore, their financial repression will mask the warnings of an impending recession as price indicators are skewed by their unprecedented monetary policy. Being forced to fly blind and with so many economic incentives in the wrong direction we are inclined to maintain our larger than usual cash position.

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

Yours truly,

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