



STEPPING STONES MANAGEMENT, LLC

Third Quarter 2015 Commentary

October 15, 2015

The recently completed third quarter reminded us that financial markets entail risk even as the Federal Reserve continues to pursue its extraordinary monetary policies adopted during the financial crisis seven years ago. The third 10% stock market correction since the bull market emerged in 2009 came after a record stretch of time without one. However, the volatility was minor compared to the Black Monday crash of October 19, 1987 which convinced President Reagan to establish the President's Working Group on Financial Markets. Comprised of the Secretary of the Treasury and each of the Chairmen of the Federal Reserve, Securities and Exchange Commission and the Commodity Futures Trading Commission, their goals included enhancing the integrity of our financial markets and maintaining investor confidence. They were so effective over the following decade that the Washington Post referred to the group in 1997 as the Plunge Protection Team. They would be called upon the next year when the collapse of Long Term Capital Management and the Asian currency crisis rocked international markets. The US economy sailed through those events as the fruits of their labors seemingly defeated the business cycle and brought us "The Great Moderation." Their star status was marked by Bob Woodward's biography of Alan Greenspan titled *Maestro* and Time magazine's February 1999 cover featuring him with Treasury Secretary Robert Rubin and deputy Lawrence Summers as "The Committee To Save The World." At the turn of the century, the world was truly enamored with America's financial system.

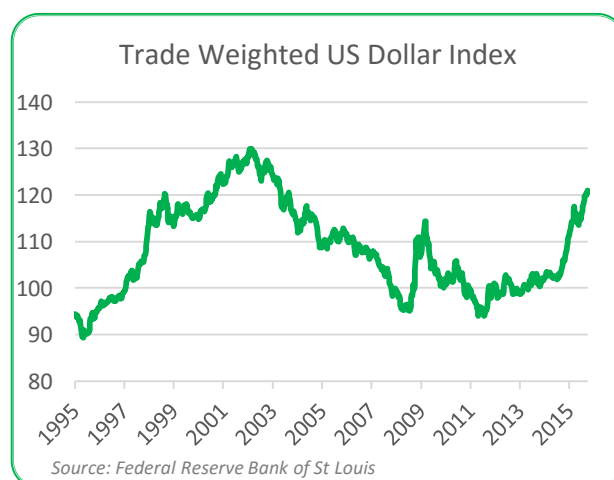
By then, our top engineers were taking advantage of technology and data analysis to devise new complex financial instruments to smooth the natural volatility of a market economy. Such derivative products enable manufacturers to better manage their supply chain and farmers to lock in prices on crops to be harvested in the future. The instruments work fine until they don't. In 2003 we learned that broadband and carbon futures were among many of the scams run out of Enron. The subprime mortgage products designed to offload risk became vehicles to enhance risk beyond manageable proportions in 2007. The role played by financial derivatives in the two financial disruptions of the new century led former Fed chairman Paul Volker to quip in 2009 that the most important financial innovation of the preceding twenty years was the automated teller machine. Maybe it's good that those financial engineers were not building bridges and buildings. Volker's point rang true in the third quarter beset by volatility from massive unwinding of hedge fund bets as Chinese authorities devalued their currency and the Fed prepared markets for the first interest rate increase since 2006. Financial and political tumult throughout the world drove the US stock market down by more than 12% before rebounding partially to end the quarter almost 7% lower in the weakest quarterly performance since 2011.

Special FX

The two other corrections of this bull market were answered with additional quantitative easing (QE) from the Federal Reserve but now the central bank is guiding markets to expect rates to be normalized off their zero interest rate policy (ZIRP). They passed on the opportunity at their July meeting but the minutes released in August showed the board preparing to pull the trigger in September on the long awaited interest rate liftoff. The release of those minutes and China's surprising currency devaluation several days earlier led to a massive unwinding of one of this market's favorite trades, the dollar carry trade. It was a volatile reaction sending the Dow Jones Industrial Average down by more than 500 points on two sequential days including a several minute 1,000 point flash crash on August 24th.

As bad as it was here, it was worse in China despite herculean efforts from that country's plunge protection team. Skeptical Chinese journalists were arrested, corporate insiders were banned from selling stock, and the government forced brokerage firms to buy shares. The measures seemed to finally take effect after the climatic selloff on August 24th put the Shanghai Composite more than 40% below its peak. The Chinese market is currently forming a bullish pattern after the Fed decided against raising rates last month encouraging money to flow back into the dollar carry trade.

ZIRP enables hedge funds to borrow dollars for almost no cost and invest in emerging markets. The most popular destination had been China with its positive yield on cash deposits and an appreciating currency making the trade even more attractive. The dollars pouring in over the last six years funded expansions in China's industrial sector whose companies built huge stockpiles of all kinds of commodities. Brazil was a similar favorite with the hot money flowing mostly into its energy sector. James Grant, editor of *Grant's Interest Rate Observer* has pointed out how ZIRP has ironically contributed to the deflation the Fed is fighting as supply gluts have driven prices down to the 2009 crisis lows. Selling the borrowed dollars and buying emerging market currencies has strengthened the latter while weakening the dollar. US multinational corporations benefited as a weakening dollar makes their products cheaper abroad. Our [October 2012 letter](#) told of Brazil's finance minister calling the American QE policy "selfish" to which Ben Bernanke responded that the emerging markets should embrace the stronger currencies resulting from his policies.



He had a valid point. History is clear that economic prosperity is correlated with a strong currency. The Federal Reserve Bank of St. Louis compiles a trade weighted index reflecting the dollar's value versus our trading partners. You can see on the chart how our last economic boom correlated with a rising value of the dollar in the 1990s. The plunge protection team of those days was unambiguously clear that a strong dollar was in the national interest and the world took notice. The strengthening dollar this year is seen conversely as a harbinger of

deflation and a threat to the earnings of multinational corporations. The recent upward spike is a function of the world's other central banks undertaking their own QE programs as the Fed winds up ours. A stronger dollar is worrying the Fed but it shouldn't. The economic struggles for most of this century should be lesson enough that the benefits from a weaker currency are more than negated by the consequences. Coinciding with that downward slope in the dollar's value this century has been the median US household income which has plunged to its lowest level since 1995.

International investment flows tend to avoid a country with a depreciating currency because investment gains will be lost when converting back to their home currency. In the weeks after China reversed its long term policy of currency appreciation, their plunge protection team was forced to defend the yuan in markets that came to expect further devaluation. The frantic effort to support the currency as the hot money flowed out reportedly cost China about \$200 billion of their estimated \$1.2 trillion hoard of US Treasury debt. The situation looks worse in Brazil where a steep recession is coinciding with a collapsing currency and political scandal. The good news is Brazil has become a popular destination for Americans to travel for cosmetic surgery and if you have any thoughts on attending next summer's Olympics in Rio, it is a good time to book. QE may not have done much for the US economy but it created booms in the emerging markets which are now crashing as the dollar carry trade gets unwound. The Institute of International Finance, a global banking association, says this year will see the first net outflow of capital from the emerging markets since 1988. Reiterating a now common theme in these letters, these are not normal times.

It is also not normal to have nine out of ten positions lose value over a calendar quarter but that happened to our fully invested equity ETF strategy. Our two energy positions, the China fund and the gold miners were all down more than 20%. The currency hedged Japan fund lost almost 15% and the semiconductor position was down more than 10%. Europe was better along with the value and consumer staples positions which declined about in line with the broad US market. Our utilities fund was the standout gainer adding more than 5%. The portfolio of ten ETFs declined by about 14% on a price basis in the third quarter and is down a little less than that for 2015 thus far.

The decision against liftoff in September followed by the poor employment report on October 2nd provided a reprieve suggesting the data on which the Fed depends signal further easy money ahead. Bad news being interpreted as good has sent prices of the most popular carry trade instruments higher to begin the fourth quarter signaling "risk on" again. We can expect the hedge funds will ride ZIRP until the next threat of higher rates when they will again bring markets close enough to the brink to make Yellen blink. As he works the talk show circuit selling his new book, Ben Bernanke is taking credit for the supposedly healthy economy brought about by the policies that his successor is unable to terminate.

Fiscal Drag

Bernanke's memoir titled *The Courage to Act* recounts the 2008 financial crisis and justifies his unconventional actions in the eye of that storm. He says nothing could have been done to save Lehman Brothers but ignores the moral hazard created by the Bear Stearns rescue which led the market to expect similar treatment for Lehman. That criticism is easy with the benefit of hindsight

so our disagreements focus on the actions Bernanke's Fed took after the crisis. Fears of runaway inflation may not have been realized but neither have the Fed's objectives which gradually move with the poor results of their policies. Bernanke told "60 Minutes" in 2010 that the Fed has been "very, very clear that we will not allow inflation to rise above two percent or less" and that they "could raise interest rates in 15 minutes if we have to." Now Yellen says 2% is not a ceiling but an objective. A seemingly unattainable one as the Fed's preferred inflation measure excluding food and energy registered 1.8% year over year in August and 1.9% in September. A tenth below target is still too low for Yellen's Fed. The current 5.1% unemployment rate was once thought to be far below a level requiring monetary accommodation but our economic indicators have become so unreliable that the Fed knows the employment market is much weaker than that statistic suggests. The labor force participation rate falling to the lowest level since women entered the workforce almost 40 years ago is more telling.

Failing to recognize the distortions caused by almost a decade of suppressed interest rates, Bernanke points the finger of economic blame at our political leaders who refuse to confront the structural problems vexing our economy; an easy mark. Unsustainable entitlement programs are pushing taxes higher and the regulatory state has kicked into overdrive. Government dictates regarding health care, finance, energy, labor, internet services and the environment have fundamentally changed our economy. Regulations have become so vast that virtually everyone is guilty of some offense to the point that our nation of laws has become one where the law is arbitrary and capricious. Starting even an ordinary business now requires thousands of dollars to be spent on consultants and lawyers before any business gets conducted and forget about getting a bank loan; risk is heavily penalized under Dodd-Frank regulations incentivizing the banks to focus on Treasury debt instead of commercial loans. That helps the government spenders who find ample demand for all the bonds they need to issue. Since our modern plunge protection team supposedly fixed things after 2008, more US companies are dying than being born each year. In forty years of data, Gallup had never reported that happening until what has now become an eight year streak.

Bernanke is right when he says the economy is suffering from lower productivity due to decreased levels of investment. Record low interest rates surely contribute to that reduced investment activity as much as taxes and regulations do. Investment requires savings but low rates have shrunk the pool. Established companies with access to financial markets have benefited from the Fed's easy money mostly by borrowing to repurchase stock to mask their shrinking businesses rather than investing to make them grow. Unfortunately, productivity enhancements have generally come from firing workers. All the financial engineering has not been enough to hide another quarter of declining earnings as America's multinationals are catching the economic flu spreading worldwide which our doctors seem incapable of curing.

That's not for lack of effort. Yellen maintained ZIRP at their last meeting because the economic outlook in her words remained "quite uncertain," as if the future is ever certain. She almost fainted while giving a speech several days later reiterating her expectations of the long awaited interest rate liftoff before year end. The bond market disagrees and currently predicts that to happen in mid-2016 or later. At her press conference, Yellen responded to a question about adopting a negative interest rate policy (NIRP) calling it "one of our main policy options" if further accommodation were to become necessary; at least one of her board members thinks it will

be. Early this month the US Treasury sold a three month bill at a zero interest rate for the first time ever. The poor employment report issued October 2nd and subsequent disappointing economic reports now have the market preparing for NIRP rather than liftoff from ZIRP.

Our new normal of low rates and stagnant growth has consequences beyond the destruction of US savings. As bad actors take advantage of an increasingly volatile world, the developed world finds itself unable to use our most powerful weapon. Economic sanctions restricting access to our markets are often threatened but rarely undertaken lest the burden tip our economy into recession. The result is more political disruption which metastasized in the historic refugee crisis that emerged this summer. It is not only Syrians and Libyans flowing into developed Europe. We are also experiencing it on our hemisphere as third world Latin Americans seek the relative stability of developed North America. They are coming at least in part to escape the wreckage caused by the heavy hand of government that is also smothering the developed economies, only to a lesser extent.

Despite the best intentions of our plunge protection teams, most of the world appears to be in recession and another quarter of declining US corporate earnings suggest we will not be immune. That may hold the answer to whether the summer selloff was a correction or the beginning of a bear market. The volatility suggests the moderation of recent years will be proven false when the Fed does eventually normalize their policies. It is futile to expect when that will come since their heightened rhetoric of recent quarters has been proven empty. Maybe they are trying to hold it all together until the party claiming to oppose activist government takes over, then the ensuing recession can be blamed on them. We always thought the end of the Fed's extraordinary monetary policies would be more disruptive than they told us to expect. We see the current monetary mess as an argument for a return to free markets rather than enlightened elites deciding on optimal prices. We are not going to wait for Fed certainty before allocating our larger than usual cash positions but we are going to wait for better earnings reports or more compelling valuations.

Please feel free to call with 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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