STEPPING STONES MANAGEMENT, LLC

Fourth Quarter 2009 Commentary

January 22, 2010

One of the winning investment themes of 2009 was buying BRICs, meaning investing in Brazil, Russia, India and China. However the theme that emerged at the end of the year was selling PIGS, meaning reducing exposure to Portugal, Ireland, Greece and Spain. The former countries have an emerging middle class demanding more consumer products as they increase their standards of living. Investors compare this to the post World War II US economy which was one of the best periods of economic growth the world has ever seen. Of course the latter countries emerged long before even the US and are now facing structural imbalances between their public and private sectors. As long as their economies were growing, the governments of these countries continued to provide more services which built up unsustainable government sectors that were funded by growing private sectors. It worked fine until the private sectors stopped growing. It's been quite a while since the tax revenues from those private sectors were enough to fully fund the burgeoning public sectors and the deficits have been closed by debt issuance. However it has gotten to the point where investors are becoming less willing to fund those deficits forcing these governments to take draconian steps to close the gap.

This has happened most starkly in Greece where the budget deficit is close to 13% of GDP despite EU regulations that limit it to 3%. The issue came to a head in December when rating agencies warned of debt downgrades resulting in higher government bond yields and falling stock prices. Investors fear added burdens throughout Europe and have sold the Euro and driven up the value of the US dollar providing a headwind to our stock market which has come to love the declining US dollar. Throughout Europe, austerity measures have reduced income and employment in those government dominated economies. Higher unemployment has led to lower tax revenues and higher social service payments to the unemployed which further burdens those governments in a vicious cycle. Investors can't see the way out and continue to sell assets in those economies damaging even the more responsible governments like those in Germany and France which are in compliance with EU deficit limits. Taxpayers in those latter countries do not relish the prospect of bailing out their counterparts in the PIGS countries.

Our Own Greecy Slope

As a reader of these letters you know I welcome a strengthening US dollar but I would rather it signal a strengthening US economy rather than a flight to quality out of our biggest trading region. It will be even more difficult to export to Europe with a higher currency if those economies are in turmoil. Add to that our own structural deficit problems and it would behoove us to see this as a lesson. Our own federal deficit is close to Greece's level in relation to GDP, and Congress plans to spend even more. The $787 billion stimulus plan passed almost a year ago largely went to state governments that function like those troubled European countries spending beyond their means. Even worse, that money carried strings that required the recipient states to increase their state burdens further in such areas as Medicaid and unemployment insurance. It would have been better to make that money contingent on budget reform in those states like we do with grants from the International Monetary Fund. Large deficit states are finding they have to pay more on the debt they issue as rating agencies cast doubt on their ability to repay. This only adds to the burdens and offsets any austerity measures of their own. Tax increases result in high earners moving to low tax states which erodes the tax base even more. New York State has seen record tax revenue declines in 2009. California passed a $12 billion tax hike in 2009 and received $50 billion in stimulus money but still had to issue IOUs to fund government operations and is facing a $20 billion deficit this year. An interesting statistic is to look at the cost of a one way U-Haul truck rental from states like New York and California to the states with more frugal governments like Texas and compare it to the other way around, it is about triple the price. Like the French and Germans, taxpayers in Texas don't relish the prospect of bailing out profligate governments like those in New York and California. These looming state budget crises are getting more attention as a recent *Financial Times* article highlighted the U.S. state public pension shortfall at $2 trillion. To put that in context, $2 trillion is about $20,000 per American household and that only includes the state pension deficits. Add to that other state deficit spending and the trillions being spent by Washington DC and it could be hard to escape a debt crisis similar to the PIGS of Europe.

The Public Trough

I think the recession that has so damaged the private economy without inflicting such harm on the public sector, has brought the issue to a head. An ever growing government sector has produced positive GDP statistics but the private economy has hardly improved. For the first time in our nation's history government payrolls exceed goods producing jobs and those public sector employees receive about twice the total compensation of their private sector counterparts. That cannot be sustainable and should be a wakeup call to anyone who doesn't want to see a total transformation of our economy but would rather see it get back to its historical entrepreneurial roots. It's that small business sector of our economy that is hurting the most as we can see in the employment statistics. The first Friday of each month brings the non-farm payrolls report and the unemployment rate; the first is based on data received from withheld taxes and the latter from a telephone survey of 1,000 households. The non-farm payrolls data has shown a stubborn trend of job losses with December losing 85,000 but the household survey which better captures small businesses that do not withhold taxes had a much worse decline of 589,000 jobs. Look around your neighborhood and see how many stores are out of business. It's hard to accept that the recession is over as the stock market seems to say.

Despite these looming threats, 2009's fourth quarter saw the stock rally continue with the S&P500 gaining 5.5% for the quarter to bring the year's performance to 23.5%. The market was led by technology, basic materials, and the consumer discretionary sectors which can all be seen as inflation plays even though the Consumer Price Index has yet to show much inflation. As good as those returns are, they come in the middle of the range of worldwide returns which were led by emerging markets like those BRIC nations mentioned above. The strongest stock markets in 2009 tended to correlate with the stronger currencies as I wrote about last quarter. With the Federal Reserve providing free money to its member banks the US dollar declined in value compared to most of our trading partners. That free money not only fueled higher stock prices but higher bond and commodity prices too. The CRB index, a proxy for the commodity market, matched the stock market by rising 23.5% in 2009 and the Barclay's Capital Aggregate Bond index managed a gain of 6.37% despite massive new supply of Treasury debt.

Obscene Fat Cats

That Treasury debt supply is a matter I would like to touch on as the media is expounding on the record bank bonuses about to be paid out for 2009. A major factor that is being missed in the reporting is the source of the profits behind these bonuses. Unlike the last two Wall Street booms, these profits have not resulted from intermediating mortgage debt for homeowners or equity issuance for new companies, they have come from funding the unprecedented federal deficits represented by the tsunami of Treasury debt issuance. With China making all too clear that it will not be the source of funds for this debt, the only buyers left who can summon the means to absorb more than a hundred billion dollars on a monthly basis are the major banks who can borrow unlimited amounts through Federal Reserve facilities. With the Fed Funds rate at close to zero, the proprietary trading desks of these firms can print money by accepting the Fed's free largesse, buying the Treasury debt and pocketing the interest spread. Furthermore, this Treasury debt is almost as good as cash when it comes to leveraging it to buy stock and commodity futures which are driving up prices in those sectors. Even if the Fed normalized borrowing rates, the traders would simply bid up the yield on the debt they are buying to insure a profitable spread, and thus a healthy bonus. President Obama's proposal to ban Fed member banks from having proprietary trading desks represents a needed reform but the banks will still find a way to collect their traditional take from intermediating financing for their clients, which in this case is the Federal government. The gargantuan federal deficit is a far greater benefit to these firms than TARP or any other bailout and the only way to stop taxpayers from funding these bonuses would be to reign in government spending. I agree with President Obama when he criticizes these "fat cats" with their "obscene" bonuses but it is his Keynesian policies that are fueling their profits and making The United States government resemble the PIGS mentioned above.

Getting back to the stock market, maybe it is coincidental that the S&P500 and the CRB had identical returns for 2009 or maybe it is because the major bank trading desks were driving both returns. It's impossible to know what those traders are actually buying but we do know that retail investors have pulled money out of equity funds for each of the last five months, so the gains are not being driven by the public getting on board the rally. The retail aversion to the domestic stock market can be viewed bullishly as meaning there is ample fuel for the rally to continue once they do get on board. However the cynic in me sees the rally being fueled by that free Fed money going to the traders' favorite places, stock and commodity futures. The sharp drop in each following the president's trading ban proposal supports this view. Bulls say the rally is being driven by higher earnings expectations but bears say higher costs will offset the higher sales reports. The fourth quarter earnings season was kicked off by Alcoa who did report higher sales but they were more than offset by higher expenses which led to another negative earnings report (aluminum production is very energy intensive.) Intel, on the other hand, reported record sales, aided by the weakening US dollar, which unburdened by rising costs, resulted in record profits. The earnings "reversion to the mean" hypothesis is certainly valid but has not been fully borne out yet which is why I continue to have a problem embracing the rally. Both Alcoa and Intel saw their stocks fall the day after earnings were announced. Indeed, the majority of companies are reporting fourth quarter earnings ahead of expectations but these reports are generally being met with selling. Considering that 2010's market is being led so far by the smallest companies with the highest P/E ratios, embracing the rally is all the more difficult. Recent moves up in jobless claims and inventories may just be zigs against positive zags, but they could indicate a reversal of the improving economic statistics that emerged in 2009. December saw a record number of home foreclosures which you know has been a concern of mine.

Despite my skepticism of the rally, we did participate in it, although our cash position resulted in lagging performance. As I read retrospectives of the financial crisis and stock market crash I am struck by how many say the lesson of the crash is to use stops, which means sell when stocks break below a predetermined level. We did this last February when the major indices broke below their previous lows from 2002. While we did put some money back in at the lower level of March, we ended up riding the rally of 2009 holding excessive cash which resulted in lagging performance. I would prefer to hold that cash for the time being as weakening economic statistics generate fears of a double dip recession which if borne out would result in a better buying opportunity. Although that has not been the best strategy over the past nine months, recent weakness may be confirming it. The just finished decade has been the worst ever in the stock market which makes me all the more grateful for our relationship. As always, I thank you for your trust and thank you for your business.

Yours truly,

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