STEPPING STONES MANAGEMENT, LLC

Fourth Quarter 2010 Commentary

January 21, 2011

We the People of the United States, in Order to form a more perfect Union, did ordain and establish a new Congress last November charged with rolling back the spending increases of recent years, and not a moment too soon. Media stories are again warning that the United States Treasury could lose its triple A credit rating as our debt service requirements take up a larger share of total tax revenues and our debt outstanding is about to surpass our GDP. The election was the biggest story of the fourth quarter of 2010 and the stock market seems to love the return of divided government and the prospect of gridlock after the most active Congress any of us can remember. The trick now will be for the new republican majority in the House of Representatives to deliver on their promise to roll back federal spending to 2008 levels, which at the time most politicians agreed was excessive. Such a roll back will require staffs in Congress and the Executive branch to be reduced dramatically. The House has already promised to reduce its budget by 5% and I haven't seen any analysis whether that is above or below 2008 levels. For the Executive branch to reach back to that level would require all the new czars to be fired along with their staffs as well as all the new regulators tasked with implementing the legislation of the 111th Congress. It will be interesting to see how the new civil discourse survives the budget battles ahead.

United States of Austerity

States and cities have already been forced to roll back spending as the credit markets make it more difficult to raise deficit financing. The impending municipal bond crisis I have warned about is coming into clearer view. That crisis has been held off for a number of reasons. One is continued stimulus funds coming from Washington DC which get funneled from states to the localities, analysts say that money will run out in the spring. Another backstop has been the Build America Bond (BAB) program that enabled municipal borrows to raise taxable money that the federal government would help to pay back. The taxable aspect made the bonds attractive to the last huge pile of money that has been out of reach to these borrowers, pension funds who enjoy the higher yields without having to pay the taxes. A big chunk of the municipal bonds issued over the past two years have been these BABs and the program expired December 31st. Another source of municipal financing has been bank letters of credit issued in the midst of the financial crisis two years ago. Most of these expire this year and banks facing higher capital requirements from the Dodd-Frank financial regulatory reform will be reluctant to roll over this financing. States and cities have been spending beyond their means for decades and the available pool of municipal lenders appears to be tapping out. Not only are the lenders becoming scarce but the borrowing needs are spiking upwards as unreasonable pension return targets continue to be unmet. Nine years ago, New York City had to contribute $10.5 million annually to its sanitation workers' pension fund, this year it will have to contribute $240 million. The workers thanked their benefactors for this 2000% increase with a work slowdown that left the city paralyzed by a blizzard last month. Even with its deep reservoir of municipal lenders New York City has been forced to fire workers, other cities will have it worse.

The Muckraking Lady

I first wrote about this a year ago and a prominent analyst has joined the fray. Meredith Whitney sounded a precautionary alarm about banks' exposure to mortgage debt before the 2008 crash, in September she sounded an alarm about municipal bonds. Her report, the product of 2 1/2 years and thousands of man hours, highlights good and bad municipal issuers. Her premise is that state and large urban issuers will probably be alright but 2011 will see 50 to 100 smaller issuers default on over a hundred billion dollars in municipal debt. The severity won't be like the mortgage debt crisis with its complex derivative instruments, but she thinks the frequency of smaller defaults will roil the market sending municipal investors fleeing. Her analysis also suggests the nation's largest employer, state and local governments, will need to slash about a million more workers, mostly between now and June when most states see their fiscal year end.

Most of the voices contradicting her are from Wall Street firms that rely on robust issuance and trading of municipal bonds. They love that municipal debt has doubled over the last ten years, growing at twice the rate of GDP. The day Whitney recently guest hosted the morning show on CNBC, a municipal bond dealer took out a full page ad in the Wall Street Journal saying the doomsayers on municipal bonds are wrong because most municipal issuers have sound finances. That is backed up by Standard & Poor's who responded to Whitney by pointing out that 99% of the issues they rate are investment grade. Tell that to investors who got pennies on the dollar for their AAA mortgage bond portfolios. S&P does concede an increase in downgrades over the last year and expects more to come. History tells us that by the time the raters downgrade the bonds, the damage is already priced in.

Those prices are dropping as I write. While Whitney lists all the data points that lead to her conclusion, her premise is strengthened by the counter voices that can't seem to summon more of an argument than "she's wrong". All the while, what I have described as a slow speed train wreck continues. The fourth Quarter of 2010 saw most municipal bond indices fall about 5%, the worst quarter since the first three months of 1994 when Orange County California began to meltdown. Municipal bond investors seem to be more convinced by Whitney's arguments and their own eyes than the Wall Street pros condescendingly saying everything is fine. As investors see the price declines on their year end statements they are selling more municipal bonds which will provide further shock when they get their January statements. Premium bonds are now selling at discounts with yields not seen since January 2009, and the wave of defaults hasn't even happened yet.

The wave has yet to come but the warnings bells abound. The State of Indiana just passed a law enabling its cities to declare Chapter 9 bankruptcy, which seems to be the kind of law that only gets passed when it needs to get passed. The New York Times has reported that policy makers in Washington DC are working behind the scenes to come up with a way to let states declare bankruptcy and get out from under their crushing debts. The paper says work is going on quietly behind the scenes so as not to disturb the fragile municipal bond market. Another warning bell was a State of New Jersey school bond offering which was cut in half and priced at junk level yields. Traders said the poor demand resulted from Governor Chris Christie making a "rookie mistake" when he said health care costs could bankrupt the state. In the municipal bond world, the chief executive of an issuer telling the truth is considered a rookie mistake. That is indicative of why the SEC has begun investigating the notoriously opaque discloser documents related to municipal issues. One of the arguments the bond bulls make is that current investment grade after tax yields are comparable to junk bonds, an opportunity that should be seized - or a warning that should be heeded.

QE2 Under Water

The Federal Reserve seems to be heeding the warnings. Despite positive economic statistics, including a long awaited improvement in jobless claims, they continue to keep interest rates at "exceptionally low" levels. Market rates not controlled by Fed policy are rising however. The bond rally that ensued when the Fed announced last summer that they would purchase long dated Treasury securities, driving yields down significantly, now appears to be a case of "buy on rumor, sell on news". Since the Fed made their very public first purchases, rates have risen to beyond the point where they were at the initial quantitative easing (QE2) announcement. This is despite the fact that the Fed has bought virtually all the new Treasury debt issued since QE2 set sail. The higher interest rates tell us that the Fed's purchases are being swamped by selling. The health of the banking sector is the responsibility of the Fed but by announcing, almost to the minute, the timing of its purchases the Fed is basically giving money away to the bond traders at its member banks. This is bullish for Hamptons' real estate prices but the increased money supply also drives up the prices we all must pay for life's necessities.

The Fed doesn't give much weight to the higher food and energy prices we are all paying, rather choosing to look at core inflation which is being skewed downward by further drops in home prices. Fed chairman Ben Bernanke said that housing is so bad that it can't get much worse so a double dip recession is unlikely. That same logic says that if home prices do drop further then a double dip recession would be likely and home prices are indeed getting worse as foreclosures pile up; which is why the Fed Funds rate is still close to zero despite rising prices at the pump and the grocery store. Not to worry though as chairman Bernanke told 60 Minutes that he is "100% confident" that the Fed can find the appropriate moment to normalize rates before igniting inflation. Putting such a probability on something that few, if any, of his predecessors have been able to do does not engender the confidence he intended, especially considering that market driven TIPS rates show inflation expectations already above the Fed's comfort zone. In that same interview Bernanke also said the Fed is not printing money. Only the Treasury Department can actually print currency, what the Fed does is credit electronic dollars to its account that previously did not exist. The dollars are created but not actually printed so Bernanke is correct in his assertion but at the expense of his credibility.

Controversy Makes a Market

So who's right, Whitney and Bernanke who see extraordinary threats to the economy, or the stock market that is convinced happy days are here again? We continue to hold excessive cash because stock prices are not discounting these looming threats. The dollar has remained steady when priced against other currencies but is weakening when priced in groceries. Oil prices are again rising towards $100 per barrel which hasn't been seen since the summer of 2008 and we all know how that one ended. If the economy is beset with people who have to spend more on food and energy or lose their well paying government jobs, there will be less to spend on other things like smart phones and restaurants. Inflation pressures are already taking a toll in emerging markets leading officials in those countries to raise rates to reign in economic activity which will mean fewer purchases of things like heavy equipment and enterprise software. While the US stock market gained a strong 10% in the fourth quarter, closing at its high, emerging markets like China and India saw their stock markets begin to roll over. We are still planning to allocate funds to the emerging markets but waiting has been beneficial since last quarter's letter. Commodity prices on the other hand are rising relentlessly, not affording us a pullback opportunity in which to add positions. An economic contraction in the emerging or developed markets would likely result in a commodity selloff which would provide such an opportunity. Recent declines in the price of gold suggest such a pullback could be afoot. We may also get a chance to see what happens to the developed markets when the new emerging markets get a cold.

Most analysts are currently bullish as economic statistics are showing improvement. The index of leading economic indicators is predicting continued improvement but much of that is reflective of the strong stock market. I disagree as many of these statistics showed similar strength in late 2007 and early 2008. Most analysts also disagree with my fears of a municipal bond crisis but such disagreements are what make a market. I have written consistently that I have a problem accepting that the economy is fine when it has been supported by trillions of dollars in government aid and free money from the Fed. Corporate earnings have benefited from all that money which has kept valuations reasonable. It remains to be seen if the economy is on a sustainable path without such aid though. The new Congress promises to rein in spending and they will hopefully do something about the regulatory avalanche that will hit the economy this year. One test of the new Congress will be how they deal with any requests to bailout troubled state and local finances, the media seem to be sinking their teeth into the story already. It will be difficult for new representatives to hold true to their campaign promises in the face of a media firestorm but Americans have made clear their distaste of bailouts and runaway government spending. Any disruptions to the currently complacent stock market from such an exit of government aid will be a welcome opportunity to invest our idle cash as it will signal that one of the last remaining sectors of our economy is finally rationalizing, even if it causes some short term pain. Whether it’s this quarter or next, a reckoning seems to be close at hand and it will be good to get it over with. Until then, 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
fax: 646-619-4804