STEPPING STONES MANAGEMENT, LLC

Fourth Quarter 2011 Commentary

January 16, 2012

We all have plenty of reasons to celebrate the New Year as 2011 was tumultuous the world over. Beginning with dramatic upheavals in the Middle East our attention was suddenly drawn to the terrible tsunami and nuclear disaster in Japan, severely disrupting the world's third largest economy. The spring months were again consumed by Europe when Portugal became the third country in the region to need a bailout. These increasingly familiar problems were only eclipsed by the shameful political games in Washington DC that resulted in the United States' first ever debt downgrade in August. The downgrade was such a blow to confidence that the S&P 500 declined almost 20% from the post crash high it reached in the spring, bringing us to the subject of this letter, 2011's fourth quarter.

With no respite from the turmoil, October saw more sovereign debt downgrades in Europe and a contagion effect in Asia where China's sovereign wealth fund had to step in to support falling stock prices of that nation's banks. International turmoil and bear markets abroad were not enough however to smother the modest economic expansion in the US that brought better employment statistics and growing corporate earnings. The S&P 500 fought off the international headlines and rose from that almost 20% decline to gain over 11% for the quarter to be flat for the year.

The European debt downgrades destroyed a famous trade put on by former Democratic Senator and New Jersey governor Jon Corzine. The trade destroyed his new employer, MF Global. The financial and political rock star sought to remake the traditional commodity broker serving America's farmers into a mini version of trading superpower Goldman Sachs which he headed in the 90's before entering politics. The company's bankruptcy filing froze the accounts of farmers who used the firm to hedge the volatile prices of the commodities they grow. It didn't matter though as it was subsequently revealed that much of their money was stolen in order to save the trade in European debt on which Corzine staked his reputation. In the congressional hearings that followed, the former US Senator displayed a shocking obliviousness to the financial mechanics of the firm of which he was Chief Executive and whose financial statements he signed in accordance with the strict rules of the Sarbanes Oxley legislation he championed in Congress.

Not spoken about in those hearings was how MF Global gained the coveted position of a Federal Reserve primary dealer giving the firm a key role in the Fed's open market operations and enabling it to borrow at the Fed's exceptionally low rates. MF Global had nowhere near the experience in the government bond market that the 20 or so other primary dealers possess but it was able to gain membership to this exclusive club in February of 2011, less than a year after the influential politician took over the firm. It is stories like this that gave sustenance to the Occupy Wall Street movement that thrilled the media so much in the fourth quarter.

It's a Small World After All

That protest movement also gained traction through Europe as leaders saw their governments fall in Greece and Italy and their leadership replaced with well known European Union officials. Those government turnovers followed ones in Spain, Ireland and Portugal that elected governments advocating austerity. However, the ticking debt bomb was kicked further down the road as officials delighted themselves with ongoing "Merkozy" meetings between the German and French leaders that resemble Oscar night photo ops replete with paparazzi astride red carpets rolled out to meet arriving limousines. The meetings occur regularly but the problems persist. The primary can kicker this quarter was the European Central bank lending over 500 billion Euros to European banks struggling under their large holdings of government debt that the market doesn't want anymore.

One reason that debt isn't wanted anymore is the certainty that Greece is not going to make their bonds "money good" as bankers say. We can only await the consummation of the reported deal to reduce the principle of Greek bonds by 50% and extend maturities. The New York Times reported that a French investment banking team has been hired by the Greek government to convince the hedge funds who own much of the debt to accept the restructuring. The resistance comes from the hedge funds also owning the credit default swap insurance sold by the large banks. The swaps are designed to pay off in the event of a default so they have no incentive to forestall it. The Times reported that the bankers are imploring the hedge funds to accept the restructuring because the consortium of large banks that govern those swaps is going to declare the default to not be a credit event, rendering the swaps worthless. It's like the insurance industry saying their property insurance doesn't cover wind damage after a hurricane. The fact that this deal is taking so long to close suggests the settlement is going to be more painful than is being advertised. And Greece is just a minor part of Europe.

Studying the geographic breakdown of international revenues among the 30 companies that comprise the Dow Jones Industrial Average, I estimated that only 0.23% of total revenues come from Greece. That's the good news from the study where I analyzed the 30 companies' most recent annual reports for any information about international sales and operations. Most companies disclose the percent of foreign revenues and give clues to the distribution on at least a regional basis. I extrapolated things like Wal-Mart's reported international square footage breakdowns to their total international sales. Sales by country for many companies were estimated using International Monetary Fund data to assess relative size of international markets. Greece being so small is good, more worrisome is that almost 15% of the Dow companies' revenues come from Europe (including Russia) and even more come from the Asia Pacific region that is also slowing down. Stock markets across both regions closed the fourth quarter and the year deep in bear market territory. The Dow has always proven to be a good representation of industrial America and these international challenges revealed themselves in the fourth quarter as many US companies cut earnings forecasts for 2012 despite improving US economic data.

	$ millions	% OF TOTAL
Dow 30 Annual Sales:	***$2,473,313***	
United States	*$1,383,854*	*56.0%*
Other Americas	*$209,767*	*8.5%*
Europe	*$361,493*	*14.6%*
Asia Pacific	*$392,087*	*15.9%*
Middle East & Africa	*$124,547*	*5.0%*
Estimates by country:		
China	*$116,091*	*4.7%*
Japan	*$96,747*	*3.9%*
Canada	*$60,152*	*2.4%*
United Kingdom	*$58,800*	*2.4%*
Germany	*$55,142*	*2.2%*
Brazil	*$50,622*	*2.0%*
Mexico	*$49,884*	*2.0%*
France	*$44,375*	*1.8%*
Italy	*$34,357*	*1.4%*
Australia	*$31,103*	*1.3%*

Noticing that the two banks in the Dow, Bank of America and JP Morgan, only get about 20% of their business from outside the US suggests that much of the Asian boom has been funded by the big European banks. As those banks are forced to shrink their balance sheets, loans and credit lines are being called in, putting further strain on the Asian economies. Assessing the US stock market therefore, we need to not only worry about US companies' exposure to Europe but also the interconnectivity of the new globalized world. This first quarter of 2012 will be pivotal as European governments need to roll over 157 billion Euros of sovereign debt. Italy needs to roll more than 53 billion before the end of March and was unable to fully roll only 8 billion in December. Many European banks will also need to refinance large maturing debt issues in the first quarter which doesn't leave too many buyers for all the sovereign debt. Mario Draghi, the new chairman of the European Central Bank, is resisting pressure to abandon the rules and print Euros like his counterpart Ben Bernanke has done in the US. These looming debt refinancings are enough of a worry to keep our excessive cash reserved for now. Even though the US economy is improving, the US stock market relies on over 40% of its business from these troubled economies throughout the world. While there is value in our market, our bet is that prices will look better when all the European debt comes due later this quarter.

There's No Place Like Home

The improving US economy was best exemplified by 200,000 new jobs reported for December. The report showed strength in the industrial, retail and health care sectors of the US economy and a decline in the unemployment rate to a still too high 8.5%. The strength in retail employment may not be sustainable as holiday sales failed to meet expectations and most were the types of jobs at transporters like UPS and FedEx that might not outlast the surge in holiday internet sales. The expansion of health care jobs is likely a function of the expansion in Medicaid spending as Obamacare takes effect. More middle class workers are getting their healthcare through government programs as private insurance costs more than their stagnant wages can bear. It's the expansion in manufacturing jobs that is most bullish for the economy and one driver of this trend is the fracking boom in oil and gas production. This domestic energy production is creating jobs not only in the actual extraction process but also in all the secondary support industries like steel pipe production that is bringing steel mills back to the Rust Belt. As good as the growth in these well paying jobs is, so is the falling price of now plentiful natural gas. And since much of the natural gas is difficult to export, the United States becomes a more attractive destination for foreign manufacturers looking to outsource production, especially with the world's most productive workforce and a now strengthening dollar.

Our position in fracking company Chesapeake Energy was entered in the summer swoon and has lost value as natural gas prices have declined further. Deals the company has struck in recent days to share in their properties confirm our investment thesis and will help reduce the debt the company took on to acquire the sites that are beginning to produce so much energy. One deal with French oil giant Total is to develop sites producing liquids such as propane that can help make the United States an energy exporter again. We plan to add to our initial position at these lower prices but the charts are not yet telling us to rush in. Plans to enter positions in emerging markets and add to commodities are also being discouraged by negative technical trading patterns. Conversely, increasing exposure in large US dividend payers is looking more urgent as their charts are among the strongest but we want to wait for the European debt refinancings and see what knock on effects are sustained throughout the international financial system. When financing gets tight, stocks are the easiest asset to sell.

We kept our cash and added some Tums to go along with the sharp quarterly rally. We aren't going to try to time the extreme volatility the market has undergone over the last few years. Where that cash was a benefit in the third quarter, it was a detriment in the fourth. The opportunity of a 10% percent quarterly rally slipped away and our portfolios were basically flat for the quarter and the year compared to the S&P 500 which gained 11% for the quarter and was flat for all of 2011. Quarterly declines in Chesapeake Energy and the Gold Miners ETF were offset by gains in IBM and the Bank of America Preferred. None are candidates for sale although we have trimmed overweighted positions in IBM considering slowing international markets and an announced management succession.

The durability of the US economy in the face of these international pressures is impressive. After several subpar years, demand has gotten pent up and things need to be replaced. The economy is displaying its natural tendency to grow. Although there is clearly value in the market at current prices it doesn't mean they won't get cheaper. The longer the sovereign debt issue persists the more likely it becomes a calamitous event. That said however, similar problems have been solved without too much disruption. There are solutions that have been identified but the political will has not coalesced around any yet. Instead, European finance officials are focused on assigning blame to one another like our politicians do in Washington DC. Of course here at home we are entering a year where all the politicians will be telling us how awful the other guy is and having every incentive to get nothing done. The 2012 election will be a clarifying event and if pro business policies become politically popular the market could begin to discount the enactment of those long overdue solutions. We are bullish on the year but bearish on the first quarter, until those debt refinancings anyway. Please feel free to call us to discuss any of these issues more fully. 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
www.steppingstonesmanagement.com