STEPPING STONES MANAGEMENT, LLC

Fourth Quarter 2012 Commentary

January 28, 2013

The fourth quarter of 2012 witnessed the most rare yet predictable event known to mankind. On December 21st, the earth and our solar system travelled through the Milky Way in a galactic alignment that happens every 26,000 years. Mystics say it ushered in a New Age but you might think we came through the looking glass instead. It wasn't long after President Obama won reelection that the calls grew louder for the richest 2% of Americans to pay their fair share. Realizing those people are mostly Democrats anyway, the Republicans quickly conceded their no new taxes stance and agreed to higher revenues from those taxpayers. As the quarter wore on, so did the fiscal cliff debate where the President implored the Republicans to accept his stance and then he would consider their positions. With masterful Doublespeak on the part of the Democrats, bolstered with plenty of media Newspeak, the unconventional negotiating tactic worked. The Orwellian "debate" saw the Republicans make a number of concessions while the Senate Democrats never went on record with any position. However it was the Republicans who were portrayed as holding the country hostage as they are in all these now regular Washington crises. As usual, the final bill came out from behind Senate Majority Leader Harry Reid's closed office doors at two in the morning past the deadline and got all the Democrat votes plus most Senate Republicans. They can now all say they didn't know they were voting for all the corporate giveaways and were just trying to avert the latest crisis. The market didn't like the process, as the S&P 500 lost about 1% for the fourth quarter, but it loved the outcome of limited tax increases and continued massive deficit spending. That rally came after the year's end, but 2012 was a good one for the stock market which gained more than 13%.

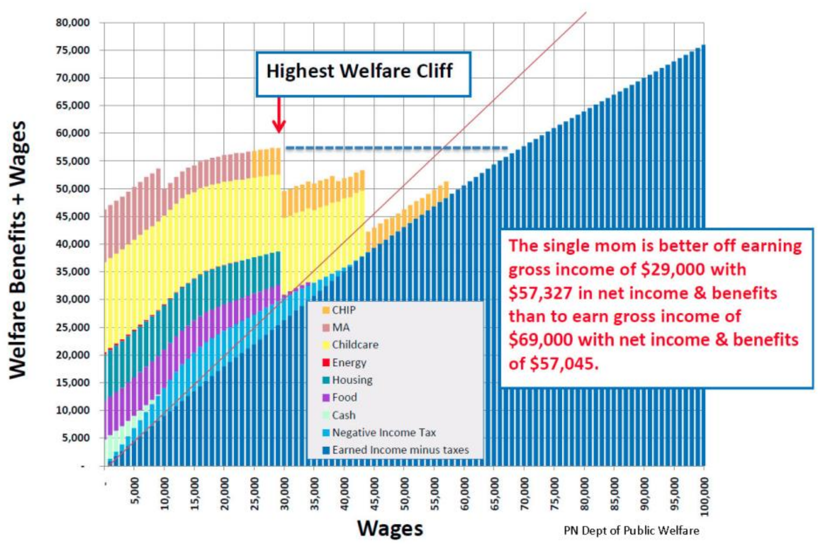
"Never let a serious crisis go to waste"

In his famous quote above, then White House Chief of Staff Rahm Emanuel went on to explain that crises provide opportunities to do things you otherwise wouldn't be able to do. He said it in the context of the financial crisis that enabled the President to sign the 2009 stimulus bill that gave the politicians a trillion dollars to spread around to their favorite constituents. Like most, that one was also written behind closed doors with none of the transparent legislative process the politicians like to say they want more of. But we have all learned by now not to take such Doublespeak seriously. The fiscal cliff was another crisis not to be wasted. The deal raised income taxes on individuals making more than $400,000 per year and with the other hand provided corporate tax breaks worth billions that would have never passed in the light of day.

Windmill credits for Jeffrey Immelt and GE, train subsidies for Warren Buffet's railroads and tax write-offs for Hollywood film producers are just a few of a litany of special interest giveaways. With brazen Doublespeak, President Obama called it a "deficit reduction bill" even though the Congressional Budget Office says it will increase the deficit by almost $4 trillion over the next ten years.

Instead of passing budgets, the Senate has chosen to fund the government by continuing resolutions that pass in crisis situations on voice votes. This enables them to spend 2009's "temporary" stimulus money again year after year without having to cast a vote in support of the biggest deficits in our nation's history. Since 2009, it has been government from one manufactured crisis to the next with each one settled in the same late night porkfest that is applauded by the Newspeakers. The markets experience tumult as the Armageddon clocks count down in the lower right of our TV screens and then burst upwards on a wave of Fed liquidity when the politicians "rise above" their partisanship and agree to another bill with targeted tax breaks and higher spending. The result is a budget that was decried as vastly wasteful at almost $3 trillion in 2008 but in the New Age is declared entirely essential at 2012's level of almost $4 trillion. That trillion dollars buys a lot of votes but also skews the economy in undesirable ways.

In a presentation last summer, Pennsylvania's Secretary of Public Welfare explained the chart reproduced below. The horizontal axis represents an individual's gross wages and the vertical axis their after tax net income including welfare benefits. The red text in the box says *"The single mom is better off earning gross income of $29,000 with $57,327 in net income & benefits than to earn gross income of $69,000 with net income & benefits of $57,045."* The chart is difficult to make out as printed here but I would be happy to forward you a copy of his presentation. You can see where the yellow bars drop off after $29,000 and again around $45,000 of gross income. The colors represent various benefit programs available to that single mom at various income levels, the horizontal dotted blue line shows how that $29,000 salary is comparable to a $69,000 salary without government benefits. Such an arrangement is a powerful incentive for all the middle class families in Pennsylvania earning between those amounts to get a divorce and a part time job so they can spend more time with the kids. At their very best, the benefits inhibit people from taking a better job which would make them worse off; it's a real world example of how government's good intentions produce undesirable incentives. This is why we have trillion dollar deficits even as the President tells the Speaker of the House that we don't have a spending problem. More Doublespeak.



You can't blame the President for not seeing the problem. It doesn't matter that the rest of the world has stopped buying our debt because the Federal Reserve is picking up the slack, a lot more than the slack actually. In the fourth quarter, the Fed more than doubled the amount of their bond purchases from $40 billion to $85 billion per month; they are now buying about 85% of the Treasury issuance. It was shocking to report that number as 60% for 2011 and with all his transparency, Fed Chairman Bernanke has not explained why the improving economy needs such unprecedented support. And of course, all that debt leads to our next crisis not to be wasted.

A Trillion Dollar Coin

The debt limit is one of those checks on the political class so necessary in a government of the people. It's too easy to vote for higher spending, so the law forces the politicians to decide on the record if our next generation will fund it. One idea to get around the limit touches on an obscure law that enables the US Treasury to mint platinum coins of any value. The Treasury Secretary could mint a trillion dollar coin and place it on deposit at the Federal Reserve from which the Treasury Department could borrow to fund the budget. The idea seemed loopy until it was endorsed by the Nobel Laureate economist at the New York Times. Paul Krugman says it is legal and preferable to being bound by the debt limit. Thinking about that $3 can of Coke from last quarter's letter, how long would it be until the local vending machine accepts that coin?

Another option cites the 14th Amendment's exhortation that the "validity of the public debt…shall not be questioned" and calls on the President to simply ignore the debt limit. This addresses the straw man arguments against default that are currently echoing from the summer of 2011. Suffice to say that if the debt limit were not raised, any maturing debt could continue to be paid with newly issued debt because it would not change the amount of outstanding debt, therefore no default would be necessary. It is the interest that adds to the debt, which our government could easily pay out of available tax revenues, especially with rates as low as they are now. Even the Newspeakers are beginning to expose the default threats as hollow. That doesn't stem the flow of Doublespeak portraying the Republicans as "holding a gun to the head of the American people" by not giving the Administration the unlimited blank check it is demanding and refusing to negotiate over. That's been enough for the Republicans to cry uncle and once again give the President what he wants, for a few months anyway. The latest deal to suspend the limit until a defined date in May also provides the Newspeakers an opportunity to reset their Armageddon countdown clocks. At this writing, it remains to be seen whether the Senate Democrats will pass the budget that the House debt extension bill requires.

The House Republicans say they want to save their negligible political capital for the budget fight that will ensue when the latest continuing resolution runs out and the delayed spending sequesters take effect in March. That will affect the large companies that comprise the stock market and as last April's letter showed, their earnings have become increasingly dependent on that government spending. Our strategy of holding excessive cash has been reflective of the budget fights we are witnessing but it did not accurately foresee the Republicans' inability to curtail spending thus far. 2011 and 2012 saw higher spending levels than the prior year and the White House forecast is for that trend to continue through the end of their timeframe in 2017. The deficit spending has clearly supported corporate earnings but even if the Republicans once again agree to more spending, a problem could arise from the Federal Reserve Board where more members are losing patience with Chairman Bernanke's aggressive policy. The Fed will eventually stop increasing its balance sheet at which point the bond market will resume its vigilante role that helped to keep President Clinton fiscally sound. That could create another crisis even if President Obama gets the unlimited debt ceiling and extra spending he wants.

In a seminal speech on October 1 defending the Fed's unprecedented monetary expansion, Chairman Bernanke said he finds suggestions that current monetary policy enables bad fiscal policy to be "unpersuasive". His speech sets out to persuade us that the Fed is not "monetizing the debt" because that would entail permanently funding the government. He says the Fed is merely buying these securities on the open market and will sell them back to the market at the appropriate time or let them mature. He even points to how it helps the deficit because the Fed remits any interest earned back to the Treasury. Buying $85 billion worth of bonds each month adds up to more than $1 trillion per year. You can decide for yourself about the fungibility of money and whether that trillion dollars going into Treasury securities is funding the debt. Later in the speech, Bernanke betrayed his objectivity when he trotted out the by now worn debt default canard. More recently he said not raising the debt ceiling is like a family trying to save money by not paying its bills. He should know that all the mortgage relief policies of the last 4 years encourage exactly that as no bank will modify a mortgage that is current. If you want a modification you have to stop paying, another adverse incentive from a well meaning government program.

We don't expect the government to stop paying its bills but we do expect the Republicans to stiffen their spines on the next budget reauthorization. Those expectations also include more volatility in a market that continues to become more selective. The last two quarters have seen year over year declines in aggregate earnings but stock indices keep rising, largely driven by institutional money flowing out of low yielding bonds and into stocks. We continue to hold higher than normal cash which rose further in the fourth quarter when Bank of America redeemed its preferred issue. That had done quite well for us and its high interest rate is irreplaceable. The extra cash on the sideline is adding pressure to reinvest but we have yet to see the market acknowledge the deterioration in earnings. That cash resulted in lagging performance for 2012 but our portfolios were spared much of the volatility seen last year. Even if earnings do manage to reaccelerate, we need to be concerned about the growing dissention on the Federal Reserve Board. The exit of the Fed from the Treasury market is sure to be disruptive to interest rates which historically affect stock prices and could rise enough to attract that institutional money back to its traditional place. Bernanke says he will curtail his monetary expansion at the appropriate time but does not explain why the strengthening economy necessitates such massive expansions of an already massively expansionary policy. Despite an improving economy the Fed is dashing what little confidence exists by more than doubling down on its monetary experiment. Further budget brinksmanship in Washington also shakes the confidence necessary for a sustained bull market which becomes even more important at levels that precipitated the last two major bear markets. We are looking to add exposure to the stock market as our overriding concern is a resurgence of inflation; but a recession in the meantime would provide an opportunity to invest at better prices.

In his inauguration speech, President Obama said our country cannot succeed when a shrinking few do very well and a growing many barely make it. Unfortunately, that scenario has worsened under the policies of the last four years. As our government grows bigger than ever, the spoils of that spending increasingly go to those who can afford the million dollar lobbyists to secure their billion dollar subsidies. Eventually it must be paid for and it has always been the middle class that bears that burden, there simply aren't enough people in the richest 2%. Maybe rhetoric won't need to be tethered to reality on this side of the galactic alignment but when I count jelly beans with my kids 2+2 still equals 4. A trillion is more difficult to comprehend but here's a brain exercise. If you had $1 for every minute since that first Christmas 2,013 years ago, you would have about $1 billion which could fund the US government for about 2.5 hours. To get a trillion you would need $1,000 for every minute since then which would fund the government for a few months. The President has made clear he is not considering any of the spending cuts that the Republicans are demanding which should provide plenty of crises in coming months. We still lack the confidence to get fully invested as we expect one of these crises will not be settled in the same Wall Street friendly manner we have become accustomed to. That said, we are prepared to reinvest if we become convinced the party will continue on. For the first time in the New Age, let me say thank you for your trust and thank you for business.

Yours truly,

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