Stepping Stones Management, LLC

Fourth Quarter 2013 Commentary

January 15, 2014

It was a financial panic triggered by bucket shops aligned with the president of one of New York's largest banks attempting to corner the market in a stock. The scheme failed and the Knickerbocker Trust Company collapsed when other banks refused to accept its checks. The failure of a major financial institution spread fear though the industry and regional banks pulled their deposits from the large money center banks. The Panic of 1907 would have been worse if not for J.P. Morgan stepping in to shore up the nation's financial system with his personal wealth while cajoling other bankers to do likewise. This prompted the president of Princeton University, Woodrow Wilson to say "All this trouble could be averted if we appointed a committee of six or seven public-spirited men like J.P. Morgan to handle the affairs of our country." Then John D. Rockefeller's father-in-law led a US Senate commission that resulted in the creation of the Federal Reserve System. A few years later, the new President Woodrow Wilson signed the unpopular Act into law on December 23, 1913. As one of the final acts of his consequential chairmanship, fellow Princetonian Ben Bernanke saw the institution through its 100th birthday in the just completed fourth quarter.

The century prior to 1907 had seen other financial panics, a series of failed national banks and competing currencies. The Aldrich Commission determined that a central bank would bring moderation and supervision to the nation's financial sector. It mostly did through a World War and the Roaring Twenties but even Ben Bernanke admits the Fed made the Great Depression worse. With that knowledge, the chairman has been determined not to repeat those mistakes following the panic that fell on his watch. Bernanke's unprecedented policies have been covered thoroughly in these letters which are published on our website going back to 2008 and where a history of his chairmanship will soon be posted.

2013's fourth quarter saw concern focused on the effects of Bernanke's Quantitative Easing program and how his successor, Janet Yellen, will eventually unwind it. One effect has been the strong stock market which gained 10% in the fourth quarter and almost 30% for all of 2013. The question now is whether those gains can hold once the Fed begins to taper their $85 billion monthly bond purchases this month.

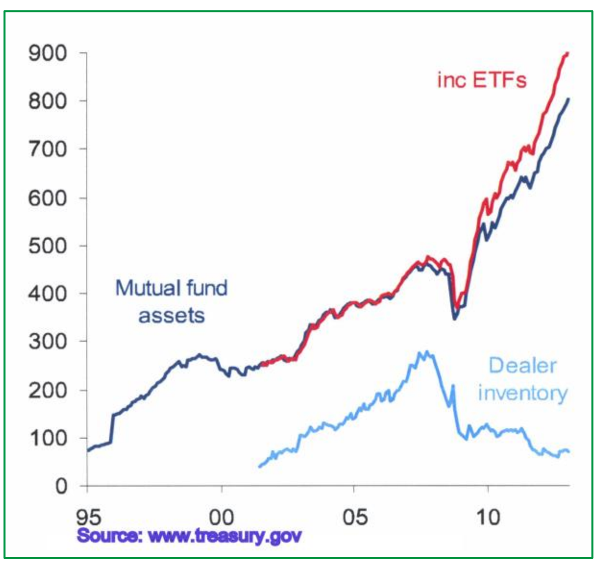
Bubbles, Bubbles, Toil and Trouble

Much of Janet Yellen's Senate confirmation hearings, and debate around the market, addressed whether the stock market is in an unsustainable bubble. Dr. Yellen observed that while stock prices have risen "robustly", valuations still remain within historical ranges. Indeed, interest rates as low as they are now have supported higher valuations but of course it is impossible to know where interest rates would be without the Fed's ongoing interventions.

The fourth quarter saw the Nobel Prize in Economics awarded in part to Robert Shiller of Yale University who devised an alternative way of looking at valuation regarding price earnings ratios. Instead of measuring the current or subsequent year's earnings, Dr. Shiller's Cyclically-Adjusted Price-Earnings ratio averages ten years worth of reported earnings to ensure all aspects of the business cycle are reflected. The Shiller CAPE ratio has been well correlated to stock market returns and is currently as elevated as it was on only a few precipitous occasions; 1929, the late 1990s, and the few years prior to 2008. The laureate says that does not necessarily mean the stock market is in a bubble, it means expected returns over the next ten years are lower, in this case slightly negative. When it breached these levels in the late 90s, the bull market persisted for a while but returns ten years later were in fact negative.

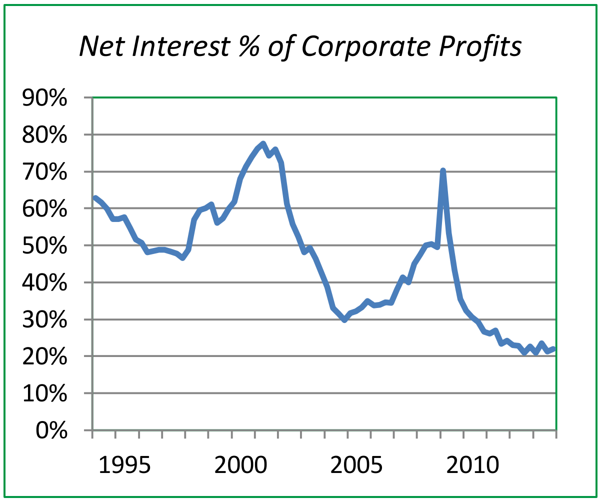
Yellen can also point to lower commodity prices as evidence that bubble conditions have not yet emerged. Money has come out of commodity trading strategies for many reasons but in part because the interest earned on their Treasury security collateral has been insufficient to fund operations. That could reverse as yield is beginning to re-emerge with the Fed's tapering plans. We are not nostalgic for the days of commodity managers burning up our phones with proposals but such turns have historically happened quicker than the Fed's bureaucracy can identify and react to them.

Bubble conditions clearly do exist in the bond market inflated by the almost fivefold expansion of the Fed's balance sheet since 2008. Yields have come down to unprecedented levels with money flowing into the most speculative areas in a frantic chase for return. The nearby chart from a Treasury Department presentation last summer shows the explosion of assets into both



high yield and high grade bond mutual funds and ETFs. Notice that as assets have tripled since 2009, approaching $1 trillion, dealer inventories have been in decline as financial regulations have become more stringent. The Fed has been encouraging these asset flows while at the same time dismantling the infrastructure that may be needed to absorb any reversal. We saw a glimpse of potential trouble last June when the hint of an upcoming taper caused a stampede out of bond ETFs with many trading at large deviations from their net asset values. Although December's announcement of January's taper has not resulted in similar trading to this point, a repeat of those disruptions could force multi asset portfolio managers to meet redemptions by selling equities instead of illiquid bonds; regardless of valuation.

Absent a bond market calamity, and even if not overvalued, the overbought stock market is prone to other unique risks resulting from the Fed's ongoing emergency policies. Corporate earnings have grown despite meager GDP and sales growth thanks largely to lower interest expenses, often even when companies have taken on additional debt to repurchase stock. Compiled with data from the Commerce Department's Bureau of Economic Analysis (BEA), the second chart shows corporate interest expense as a percentage of US corporate profits over the last 20 years. The peaks are the recessions of 2001 and 2009 when profits shrank more than interest expenses. The ratio was over 122% in 1982 but has averaged about 45% since 1994; as of the third quarter it was near its modern day low below 22%.



Quantitative Easing has managed to keep that number in the low 20s since 2011 which shows the meaningful direct effect the program is having on corporate profits. Reversing that significant tailwind to a headwind could be the catalyst that causes historically mean reverting corporate profit margins to fall from their present all-time highs with unfavorable consequences to earnings and valuations.

Other bubble indicators abound. In 1999 at the market top, Warren Buffet said "probably the best single measure of where valuations stand at any given moment" is to compare the total stock market value to GDP. He was explaining why he was bearish at that historic peak when the Wilshire 5000 total market capitalization reached 1.47 times GDP. The ratio got as high as 1.09 at the late 2007 peak and as low as 0.48 when Buffet made his historic purchases in the aftermath of the Panic of 2008. It ended 2013 in red flag territory of 1.15 using expected fourth quarter annualized GDP as the denominator.

Losing Control

As bulls and bears make their bubble cases, the Fed is carrying out Bernanke's other consequential reform towards greater transparency, which transcends to a policy tool with their forward guidance of interest rates. That guidance says the Zero Interest Rate Policy (ZIRP) for short term rates will stay in place as long as employment is weak and inflation remains below 2.5% . Inflation is gauged by both the Labor Department's Consumer Price Index (CPI) as well as Bernanke's preferred GDP Price Deflator compiled by the BEA. The CPI has a 40% weighting to housing where they try to exclude the investment component of home ownership by substituting home prices with "owners' equivalent rent." Begun in the mid 1980s, the calculation is a function of the interest rates that the Fed has pegged at historic lows. The GDP Price Deflator has a 30% weighting to housing similarly reliant on those rates. Without those low mortgage rates, inflation would be reported much higher which would make GDP much lower.

While interest rates are low and the economy has thrived in the past with far higher rates, there are many cogs in the economic machine that have become reliant on the lower rates that are showing signs of turning. Despite the Fed's massive ongoing purchases, the yield on the benchmark ten year Treasury note has risen for five straight quarters which has not happened since 1999. The risks from higher rates are being overlooked as the market prices in a "Yellen put" expecting any selloffs to be met with aggressive Fed action like Bernanke always provided. Unfortunately, the new chairman will be busy unwinding Bernanke's interventions in a task that will surely outlast her chairmanship, if they are ever fully unwound. Facing different monetary challenges including a board that looks ready to reign in the interventions, Yellen may not be as forthcoming.

The higher rates have not yet enticed any of our fixed income money out of our larger than usual cash positions but we would look to take advantage of a repeat of the June scenario to gain intermediate term exposure there. Emerging markets did not enjoy strong gains in 2013 and valuations look better in the stronger emerging economies but we are reluctant to reallocate cash when the general US stock market is as extended as described. Equity markets around the world are beginning 2014 in poor fashion which is another ominous similarity to 2008. We have yet to add to our gold miners position which is becoming more enticing as a diversifying agent from our other equity positions.

The minutes of the Fed's December meeting show a wide consensus of participants ready to wind down the interventions though they remind us that tapering does not mean tightening. Policy guidance says continued monetary accommodation will be data dependant but the data is so often revised that the Fed's attempt at transparency results in constantly moving benchmarks. At his June press conference, Bernanke said he expected QE would "ultimately come to an end" in early 2014 when the unemployment rate got to 7%, but the tapering hasn't even begun yet with the rate at 6.7%. Fed governors tell us the interventions are necessary to combat a sluggish economy and are not inflationary because most of the newly created dollars have remained on deposit at the Federal Reserve rather than seeping into the economy. This is because the Fed has been paying interest on those balances since October 2008, another unprecedented policy. If the Fed ceased paying that interest, banks would likely seek better returns by making loans, which a normal economy needs. However, Yellen told her Senate confirmation hearing that reducing the rate they pay on reserves could disrupt the money markets which are struggling to remain viable under the Fed's Zero Interest Rate Policy. That begs the question of why not normalize that to relieve the pressure? That would allow savers to once again earn a return which could boost the anemic investment levels afflicting the economy. The Fed has managed to weave a tangled web that strikes at their credibility and detracts from the transparency they seek to provide.

The central bankers are surely doing what they believe is best for the general economy. The unorthodox policies were probably instrumental in keeping the economy functioning after the panic of 2008, but the weak recovery casts doubt on their continued effectiveness. QE's defenders say the recovery would have been worse without the policies but that is impossible to prove and unlikely considering recoveries from other panics have been quicker. It was good to avoid the problems of 1907 but the Fed did not prevent almost as severe problems in 2008 and may be partly responsible for the weak conditions since. Wall Street and Washington are enjoying the cheap money but the rest of America is struggling with lower incomes and no return on their savings. Meanwhile risks are building up as those savings flow into speculative areas which are always more liquid on the way up. Bernanke proudly points to his record low inflation rate among all his predecessors of the last 100 years without noting the reliance on the rates he has driven to historic lows. At 100 years old, the Federal Reserve System is facing many of the same populist criticisms voiced at its founding, mostly as a reaction to these unprecedented policies. History will render the best assessment of the Bernanke Fed, so as his helicopter fades into the sunset, we wish Chairman Bernanke happy flying and we wish the best of luck to Chairman Yellen as she is tasked with cleaning up after the historic party.

We wish you all the best in 2014 and as always, thank you for your trust and thank you for your business.

Yours truly,

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