STEPPING STONES MANAGEMENT, LLC

# Fourth Quarter 2014 Commentary

January 22, 2015

"To be, or not to be" said Hamlet, the tragic Prince of Denmark. He was contemplating suicide but his conscience made a coward of him, leaving him to face the "slings and arrows of outrageous fortune" like Fed Chairman Janet Yellen had to face in the fourth quarter. Her predecessor's quantitative easing (QE) policy of creating dollars to purchase US Treasury and mortgage debt was scheduled to finally expire. With a 9% correction in early October, markets attempted to convince the first year chairman to dither like the famous prince and continue the program. When the board met later that month, Yellen showed determination to end the program like Laertes who decisively kills Hamlet as vengeance for his father's death. Markets bottomed before the anticipated Fed announcement and began a surge to fresh highs before finishing the volatile quarter with the S&P 500 4.4% higher. It gained 11.4% for all of 2014.

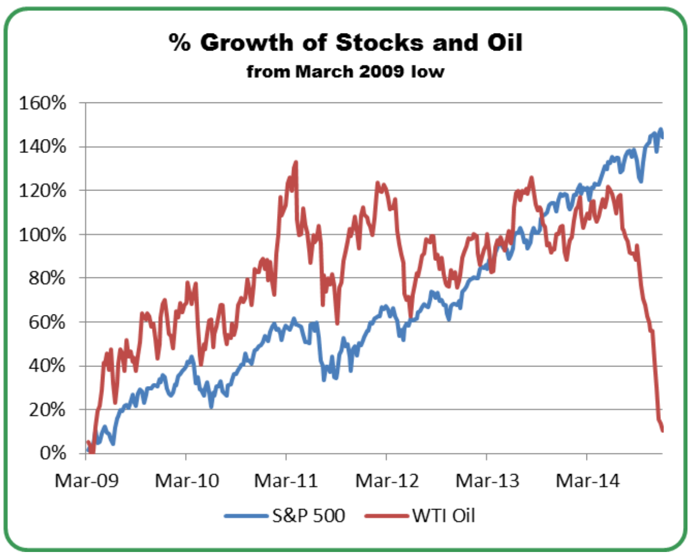
A few days after the Fed finally ended the five year old policy, the Bank of Japan (BOJ) picked up the baton announcing a new round of their own QE including a shift in official assets towards the equity holdings that have become a new facet of modern finance. As mentioned in our 2nd Quarter 2014 letter, for the first time, central banks around the world have become major investors in international equity markets. They have traditionally limited their holdings to their own home country sovereign debt but with interest rates so low, that is a custom now "more honored in the breach than the observance." There has been scant debate on whether or not this is healthy for our financial markets. One can make the case that the central banks are long term holders, but only until they have to deploy their assets for more traditional central bank functions, like the Swiss National Bank (SNB) did last week. The SNB had been one of the more active buyers in international equity markets stating last spring that they were deploying about 15% of their balance sheet into "large, mid- and small-cap stocks in developed markets worldwide." Other central banks had the same reaction to the monetary expansions of the major central banks that have driven international interest rates close to zero. "Madness in great ones must not unwatched go."

Gains from those equity holdings have replaced the interest income that the central banks no longer earn which entices the buyers with the ultimate wallets to further support major stock indices like the S&P 500. The bankers congratulate themselves on the effectiveness of the policy that they need to continuously renew; the BOJ has been doing it since 2001. Bullish analysts say the strong stock market reflects the economy finally regaining its footing and not excess monetary liquidity. That was confirmed by December's report that the US economy grew at a 5% annual rate in the third quarter, confounding analysts who had expected a much lower number. The US economy appears to be improving but note that the new methodology of calculating GDP made the recession of the early 1990s vanish. "Doubt that the sun doth move" and doubt that the economy is really growing at 5%.

**Uncertain Bubbles**

Hamlet personifies the uncertainty of life and the major uncertainty we face at the start of 2015 is whether stock prices have grown because of the Fed's monetary expansions or have been driven higher by economic fundamentals. The regular financial noise is not as consistent as we would like. The strong 5% third quarter economic growth is confirmed by a low 5.6% unemployment rate but those positive points are contradicted by low incomes and poor retail sales. Indicators of weakness also include fourth quarter earnings estimates that have been coming down over recent weeks. However, in our age of financial engineering, corporate earnings are not necessarily correlated with economic growth. Central bank financial repression has amplified the uncertainty.

The improving world economy since the crisis bottom in 2009 had also been confirmed by higher oil prices despite increasing supply from US shale producers. Although recent events suggest those higher prices were another factor of central bank liquidity. The uncertainty regarding that question was just one more reason why the Fed was ready to terminate the program that they admitted was meant as an emergency measure. Although they did not see any asset bubbles forming, except in very specific instances like biotech stocks, they acknowledged the risk that QE could lead to asset price bubbles. As the nearby chart shows, there was a bigger bubble than biotech stocks as the far more significant price of oil has suddenly given up all of its gains since the spring of 2009. The red line representing the West Texas Intermediate price of oil has been more volatile than the blue line representing the S&P 500 but both had gained about 120% since that 2009 low until the Fed began to taper their bond purchases last summer. That is when the oil price began to weaken even as stock prices climbed higher. The fourth quarter decline in the price of oil was initially attributed to Libyan production coming back online but no analysts predicted the absolute rout we witnessed as the quarter progressed. Oil is now trading below the crisis levels of 2009 which some credit to increased US production and others say indicates a slowing world economy. The American energy renaissance has certainly shifted the supply dynamics of the energy markets but it has been gradually progressing and fully factored in all the estimates of energy prices. The best minds studying the sector thought those prices would remain close to last summer's highs. The energy markets were obviously in a bubble that the Fed completely missed.




There are indications of reduced demand which suggests a weak world economy but even that would be unlikely to cut prices in half. Other commodity prices are also falling, exemplified by the CRB index dropping to levels not seen since 2009. None of these other commodities have seen the supply increases that energy has but nobody thinks the economy has seen demand fall as low as the 2009 crisis.  Reason dictates that the unprecedented monetary expansions of recent years have been a factor in the volatility.  There is no way to be certain, but we should not be surprised to see a drop in other prices that have experienced similar growth over the same period, stock prices being the most obvious.

**Europe's Turn**

Falling prices are ruinous to creditors so markets have been urging the European Central Bank (ECB) to institute a QE policy over the objections of several northern European member states led by Germany.  The objectors express the classical truth proven through history that prosperity does not come from monetary debasement.  ECB Chairman Mario Draghi had preferred to "speak daggers but use none."  Finally this morning he announced Europe's foray into QE that has done such wonders for Japan and the United States; wonders for their financial and government sectors anyway.  Those demanding he join his American and Japanese counterparts say it is needed to forestall deflationary forces from ravaging the European economy even though Japan's numerous rounds of QE have not held off deflation there.  Those who say it is needed to stimulate the European economies ignore that the already low rates in Europe have been unable to accomplish that.  Countries like Spain and Italy currently enjoy long term rates less than 2%, lower than US Treasury debt.  Driving them even lower can be expected to have the same degrading effects on investment that has been experienced worldwide in this era of zero interest rates.  However, Europe's QE will provide more money that can flow into international equity markets.

Switzerland is not part of the common European currency but had been pegging its Swiss franc against the Euro.  That necessitated the SNB to make regular purchases of Euros in the currency markets to offset higher demand for Swiss francs.  The SNB realized it would end up buying most of the Euros that the ECB is ready to create to buy European government bonds.  Funding spendthrift nations is not politically popular in Switzerland so the SNB suddenly announced the abandonment of the peg last week after calling it essential as recently as January 5th.  Their prior commitment had made the Swiss franc a favorite vehicle among currency traders.  This exacerbated the SNB's difficult task of maintaining the peg.  Analysts now say the SNB's credibility has been shaken by the surprising action that caught currency traders on the wrong side of the bet.  Enough retail traders had gotten it wrong that the largest firm catering to them needed an emergency rescue the next day.

It used to be regular order for central banks to surprise markets.  Providing forward guidance is a new concept in monetary policy largely developed by Janet Yellen.  She has argued that giving markets advance warning can alleviate the disruptions that often follow changes in policy.  In the case of the SNB's peg, the forward guidance gave the impression that the trade was guaranteed and durable and thus created even more disruption when it was inevitably withdrawn.

Having moved beyond QE, the uncertainty about the Fed now regards when they will normalize their zero interest rate policy (ZIRP).  Yellen had stated it would be a "considerable period" after the end of QE before that would occur, leaving markets to define what those two words mean.  At her yearend press conference the Fed chair replaced the phrase saying the board would be "patient" before raising rates.  An emotion is even more difficult to quantify but Yellen said it would be at least a "couple of meetings" until such action would be taken.  That guided expectations for the hike to come this spring but market futures are currently predicting it will not occur until the end of this year.  Someone is going to be wrong.

The enhanced uncertainty has driven financial markets "mad as the sea and wind when both contend which is the mightier." It is the most volatility we have seen since the second round of QE ended in 2011, which led Ben Bernanke to expand the program. "Frailty, thy name is woman!" cry the markets who want similar succor from Janet Yellen but her rhetoric sounds more like she "must be cruel, only to be kind" and wean investors off the extraordinary monetary expansions. She gives no indication that there will be a QE4 which means we are about to find out how much stock prices have been supported by the Fed.

The Stepping Stones fully invested Equity ETF strategy remained in a defensive posture. Strength came from the utilities, China, consumer staples and semiconductor positions but was offset by our overweighting in energy as well as weakness in the gold miners ETF. We were as surprised as anyone about the precipitous drop in energy prices and see current valuations of those positions carrying a better risk reward profile than the general market. The gold miners are performing counter to the market as expected so their weakness in the fourth quarter has shifted to strength so far in 2015. On net, that strategy declined by -1.9% in the fourth quarter and -1% for all of 2014.

As we look for method in the market's madness, bullish analysts remind us that years ending in five and the third year of presidential terms have a reliable record of generating strong gains. However, the January barometer is also a reliable indicator which said last year should have been negative and this year looks even worse. Gold has been rallying even as the dollar is strengthening. The uncommon action comes from an oversold condition and gold being a safe haven from the turbulence we are seeing in stocks. The move down in interest rates even as the Fed ended QE is also unexpected. So many models have been rendered obsolete that it reminds us of Hamlet telling his friend "There are more things in heaven and earth, Horatio, than are dreamt of in your philosophy." Searching for truth through all the noise, we agree with Janet Yellen that the drop in energy prices "is certainly good for families," as she said in December. "It's like a tax cut that boosts their spending power." She said the positives from lower energy prices outweigh the negative economic effects on the vibrant energy sector. There have been layoffs at energy companies but even worse at the major Wall Street firms whose poor earnings announcements have been accompanied by layoffs totaling in the tens of thousands. "One woe doth tread upon another's heel." That old economic indicator, Dr. Copper, has also broken down and is approaching its 2009 lows. We have enough doubt regarding the US and world economy to maintain our cash and defensive positions like utilities and consumer staples that have performed so well for our portfolios. Even as the ECB joins the QE parade we see the end of the US program as the biggest factor facing the stock market. So as Janet Yellen says "sweets to the sweet! Farewell" to QE, we do not expect it to be the smooth ride that her forward guidance expects to deliver.

Please feel free to call to discuss any of your financial concerns. Until then and as always, thank you for your trust and thank you for your business.

Yours truly,

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