STEPPING STONES MANAGEMENT, LLC

Fourth Quarter 2015 Commentary

January 21, 2016

"Look up here, I'm in Heaven!" is the opening line of David Bowie's off Broadway production, Lazarus, which premiered earlier this month two days before the artist's death. Known for innovating the world of music, Bowie revisited the theatre as a creative way to say goodbye as he lost his battle with cancer. Many of the retrospectives on his unique life include his innovation in the financial world too. In 1997 when Forbes magazine estimated his wealth to have peaked at close to $1 billion, Bowie wanted to realize more of the value from his song catalog without parting with "his babies." The answer was to securitize the royalty stream into a ten year bond. He raised $55 million in a private transaction on a bond rated triple A by Moody's. It was before digital downloads ravaged the record industry and although the bond was subsequently downgraded almost to junk, it paid off at maturity.

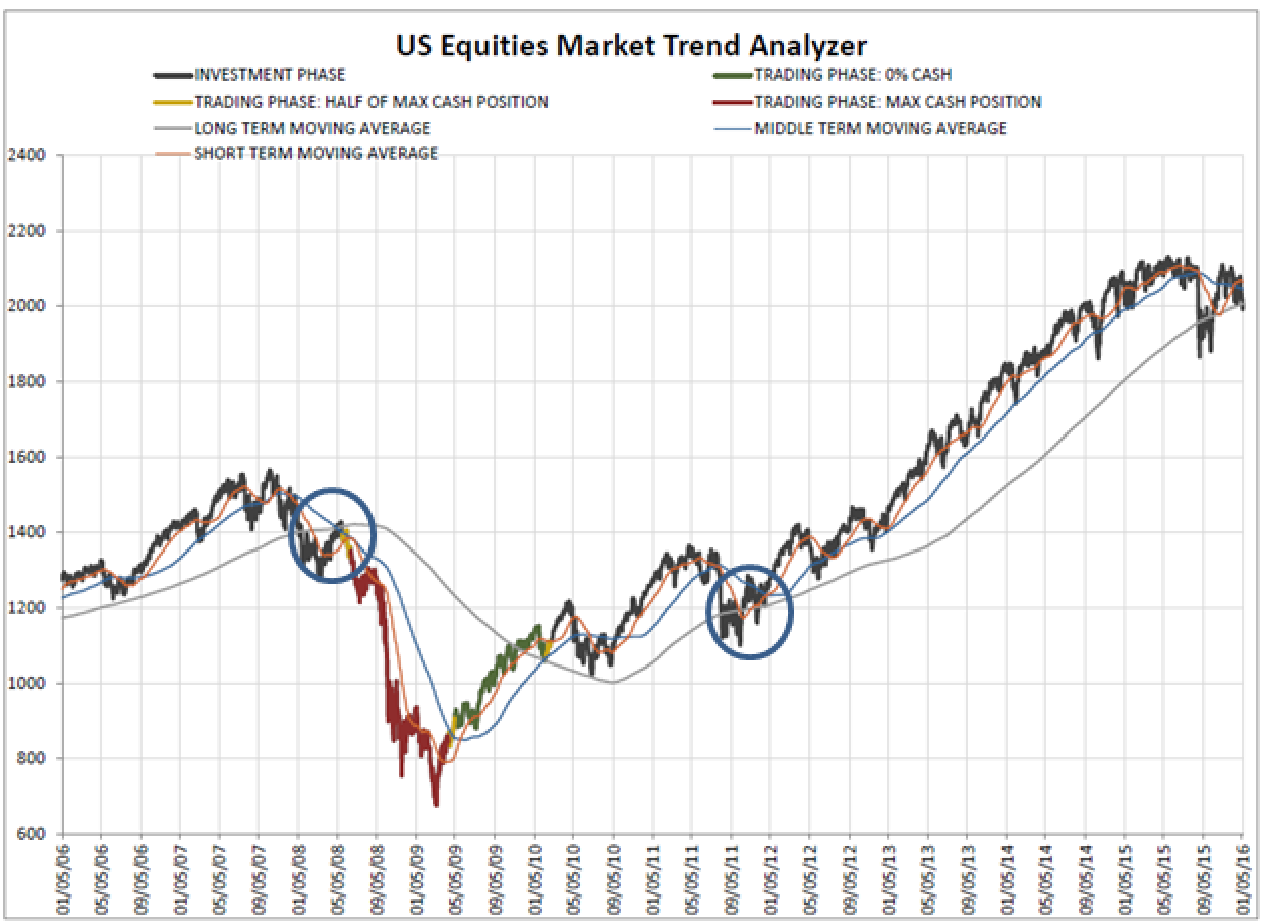
The successful experiment led other musicians and film studios to follow Bowie's example and even athletes have gotten in on the act by securitizing the expected income over their future careers. Ever creative financiers are proposing similar vehicles to help students pay off college loans by sacrificing a portion of their future earnings. It is the kind of financial innovation that truly aids the intermediation of capital rather than the typical kind that makes our markets more complex for the benefit of expensive algorithms.

The fourth quarter of 2015 marked a seminal point in the most historic financial innovation of all time, the Federal Reserve's extraordinary policies following the 2008 financial crisis. After guiding markets to expect interest rate normalization since 2013's "taper tantrum," the Fed finally began the process by raising the overnight lending rate to a range above 0.25%. Unlike the disruption we experienced before the expected hike in September, the eventual action in December was met with a yawn. It seemed that all of Janet Yellen's "forward guidance" did the trick and the well prepared stock market enjoyed a 6.45% fourth quarter gain in the S&P 500 which declined on a price basis by almost 1% for all of 2015. Maybe the Fed's experiment was a success like Bowie Bonds, it certainly has its imitators around the world, but the first annual decline since 2008 sent a winter chill through the relative calm. The New Year has rung in with choruses of "Fed error" as the stock market has suffered its worst annual start in history. Many are saying the central bank acted prematurely but as these letters have consistently expressed, the error was not normalizing years ago.

Market shows its FANGs

The apparent smooth sailing to normalization was credited to the central banks in Europe and Japan picking up the Fed baton with their own quantitative easing programs to keep international financial markets liquid. Below the surface was a different story as the broad market performance was hidden behind the FANGs, the stocks of Facebook, Amazon, Netflix and Google. An equal weighted portfolio of those four stocks returned over 25% in the fourth quarter and almost 80% for the year. Enough to maul all the bears in the rest of the market where the average stock has begun the new year more than 20% below its high, the definition of a bear market. If not for the FANGs, the S&P 500 would have fallen much more in 2015 as weakness spread beyond the energy sector still reeling from persistently lower prices. The Dow Theory warnings discussed in last quarter's letter are flashing brighter as the transportation and utility sectors continued to underperform the industrials. The FANG portfolio, valued like a late 90s tech stock, is down by double digits so far this year forcing many to ask if this is the end of the bull market. It is definitely the end of the catchy moniker as Google marked the fourth quarter by changing its name to Alphabet.

Hays Advisory, who manages some of our clients' assets, has a unique quantitative method to address that question. Specifically they ask whether we are in the early stages of a bear market like 2008 or the late stages of a correction like 2011. Hays developed their Market Trend Analyzer displayed on the chart below after 2008 and made the right call to remain invested



through 2011. They also gain confidence from having reduced exposure to zero before the current bear markets in commodities and international equities. It may be hard to make out all the colored lines but the dominant one is the S&P 500 since 2006. It is colored black, yellow, red or green depicting the appropriate level of investment. Yellow warns to basically sell half and red says to go to all cash. After such an event, the model will turn green indicating to invest the maximum amount to take advantage of the typically sharp bounce back before turning black to signal a regular investment posture. The colors depend on the various moving averages whose exact timeframes are proprietary. The difference between the 2008 and 2011 circles is that the blue middle term moving average crossed below the gray long term average in the former but not the latter. The Hays analysts explain how bear markets take time to develop and it would likely take most of the first quarter for those moving averages to cross; so they remain on guard with elevated cash levels but still mostly invested.

The answer to the bear market vs. correction question may lie in the fourth quarter earnings reports coming out mostly this month. Sharply reduced expectations have set the bar so low that even declines are met with praise. Our July letter warned of accounting tricks reminiscent of the tech boom that were masking declining earnings and the mask has since come off. Looking at the Dow Jones Industrial Average, the 30 companies that comprise the index reported aggregate declines of more than 7% in sales, net income and earnings per share in the third quarter of 2015. The energy sector dragged those numbers down but Apple's standout performance and an extraordinary gain from Merck boosted them. Taking out the three outliers, all three categories were still negative. The passage of time didn't help as the fourth quarter is expected to see declining earnings in six out of ten equity sectors. Bloomberg says this will be the worst earnings season since the third quarter of 2009. That was after the kitchen sink quarter in the depths of the financial crisis when companies throw every expense they can find into an already horrible report. As bad as earnings have been in recent quarters, we have yet to see that financial officer capitulation that usually occurs in the depths of a recession.

We expect to see that phenomenon play out first in the energy sector which was the worst performing group again last quarter. A ray of hope was that the energy stocks performed better than the underlying commodity prices. A warm autumn in the northeast drove natural gas prices lower and Iranian oil coming back online further depressed the oversupplied crude oil market. The two energy positions in our fully invested Equity ETF strategy were down again but the other eight positions all gained in the fourth quarter, even the gold miners. The best performers were the semiconductor and currency hedged Japanese ETFs which helped the portfolio gain about 2% for the fourth quarter but could not overcome an annual decline of about 15%. We never thought it would be easy to normalize the world's largest monetary expansion so we have maintained excessive cash levels; the sour start to this year does not surprise us although the unrelenting devastation in the energy markets does.

Under Pressure

Analysts say an earnings recession is not necessarily indicative of an economic recession. A technical recession of two consecutive quarters of negative GDP growth would be barely discernable from our new normal of stagnant growth anyway. The Fed points to low inflation and healthy employment statistics to justify raising rates in what they describe as a strengthening economy but the actual money earned by individuals and corporations says otherwise. Many of our letters have highlighted how the dominant economic indicators have become unreliable partly because of the Fed's manipulation of the risk free rate, the most important component of most models. Policy makers congratulate themselves on strong economic reports but stock prices will ultimately follow the earnings reports.

This time is no different as earnings peaked in September 2014 and the stock market peaked last May. The ongoing debate of the bull market is whether it has been fueled by earnings growth or the growth of the Fed's balance sheet. Ben Bernanke used to point to higher stock prices as an objective to drive asset prices higher so the wealth effect would trickle down through the broad economy. Despite record high stock prices, he always needed to keep the liquidity flowing leaving his successor to clean up after the party. These letters, posted on our website, have shown how extremely low rates enable financial engineering like debt funded buybacks and contribute to unsustainable profit margins that have burnished quarterly reports at the expense of underlying corporate health. Low rates have also coincided with depressed levels of savings and investment which are the feedstock of a normally functioning economy. Some Fed governors are raising those points while others call for negative rates to rescue the economy from its latest struggles. Reversing course on normalization would damage the Fed's credibility as they said it would be easy to end their extraordinary policies. Chairman Yellen is finding herself stuck between rocks and hard choices.

The Fed often pointed to international developments in its delays to normalization and would likely reiterate that if they were to pause on their path to higher rates. We agree that the international economy is vital to our domestic economy which gives us one more reason to remain bearish. Recent attention has been focused on the slowdown in China but much worse contractions are happening throughout the emerging markets as dollars borrowed at a zero interest rate are repatriated. The collapse in the price of oil and other commodities that are wreaking havoc around the world are ignored at our peril. Gas prices below $2 a gallon are welcomed by most people outside of the Fed but those prices suggest the prior highs were indeed driven by the policy that has now reversed. It is only reasonable to prepare for similar corrections in other financial assets, meaning a series of painful selloffs producing progressively lower lows over a span of years. As poor as sentiment has become, we doubt many expect such an outcome. A quick selloff of similar magnitude would be preferable to foster the natural rehabilitation that economies usually undergo after a cyclical turn so we hope Yellen remains on course. Our new stagnant normal can be attributed to the deviation from that after the last recession. Fiscal and monetary policies around the world have been hostile to classical economic principles and the lesson of the global economy today is that enlightened elites cannot tame the beast. Steady earnings growth through most of the bull market since 2009 and zero bound interest rates justified record high stock prices but both are beginning to work against the market as the economic cycle inevitably turns.

We have always doubted the Yellen Fed would ride to the rescue of Wall Street and she deserves credit for halting Bernanke's monetary expansions in the fall of 2014. The S&P 500 happened to finish 2015 where it was then and if the Fed enacts more rate increases this year that balance sheet will begin to shrink. Both sides of the debate could be correct by asserting the bull market was driven by earnings growth which was reliant on the Fed growing its balance sheet. Quantitative easing also enabled governments to borrow without cost and since the inflation predicted by classical economics hasn't arrived, many say the policy should be continued. The wealth effect has certainly helped the wealthy but the cost has been the economic deterioration that has infuriated the middle class enough to line up for Donald Trump and Bernie Sanders rallies. The two voices calling for radical change agree on the diagnosis but not the solution, although both appear to admire an activist government. The weakness so far this year may indicate that the market is finally repricing for normalization. We expect each Fed meeting will captivate the markets with volatility surrounding every six week event. Whether the bull has been fed by low rates or strong earnings may not become clear as both represent stakes in its neck.

In the title track from Lazarus, David Bowie sings "By the time I got to New York I was living like a king. Then I used up all my money." He found a creative way to get it back and took financial intermediation in a new direction leaving an admirable legacy behind. The Federal Reserve created a new direction in monetary policy by growing its balance sheet from $800 billion to $4.5 trillion since 2008. We always thought it was too good to be true that central banks could print our way to prosperity and the legacy of their unprecedented policies is coming to fruition now. It isn't looking as smooth as they hoped or predicted, prompting the calls to reverse the normalization process. The calls to reverse course remind me of another recently departed rocker, Glen Frey of the Eagles who wrote in Hotel California, "you can check out any time you like but you can never leave." This is Janet Yellen's real test.

Please call us 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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