YOSEMITE CAPITAL MANAGEMENT

Fourth Quarter 2016 Part B

COMMENTARY

"Life is what happens to us while we are making other plans." – Allen Saunders

Wrapping up the year is a time for many to wonder if the economy or financial markets are changing or about to change, perhaps even more so when a new president is about to be inaugurated. But rarely do these change merely because the calendar turns, especially considering that new policy directions take time, sometimes years, to have an effect on the economy as a whole.

With that in mind, we convey our thoughts on a few areas that seem to be on the minds of many market participants.

THE DOMESTIC ECONOMY

Domestic economic growth in the next few years is likely to remain somewhat slow due to lingering effects of the credit bust, demographics, and the state of the global economy, particularly driven by the situations in China and the Eurozone.

There is the potential for a slightly higher growth rate due to favorable demographics of a rising prime working age population and a rising age 30 to 39 segment that is a key driver of a stronger housing market.

Our bottom-line prognosis is that ***odds favor growth to continue, but the pace is likely to remain muted for at least a few more years***. If things go well the American economy might average a real GDP growth rate somewhere in the range of around 2.5% to 3% per year, with most quarterly reports falling in an annualized rate range of 1% to 4.5%.

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If these words sound familiar it is because they are from our Fourth Quarter 2015 Commentary. Slow-growing mature economies such as that of the United States generally don't change all that much over the course of one year (with the obvious exception of a shock to the system), so the story still holds.

It's funny that about a year ago there was serious talk about a recession among the chattering classes, which we felt compelled to refute in our First Quarter 2016 Commentary. It's just as funny that today some are anticipating an imminent return to historically stronger "normal" economic growth on the order of, say, 4% annually on average. Growth generally comes from increases in population (via birth rate and immigration) and productivity, both of which are at low levels with no expectation of either being much higher any time soon. The good news is that having a slow-growing economy usually precludes a build-up of broad excesses that typically causes a recession, which means the expansion could continue for some time.

The risks to the domestic economy include overly aggressive monetary policy from the Federal Reserve, poor trade policy such as restrictions on free trade (note that free trade is fair trade and not necessarily provided by a so-called free trade agreement), and, as always, a significant geopolitical event.

THE GLOBAL ECONOMY

China is becoming an accident waiting to happen: slowing growth, property bubble, high debt, huge off-balance sheet financing, dependence on cheap credit, opaque and convoluted financial system, leveraged speculative activity, rising non-performing loans, industrial overcapacity, money-losing state owned companies (kept alive by more cheap loans from state-owned banks and government subsidies), overinvestment in unproductive projects, strict capital controls (even though reserve-currency status requires greater cross-border capital flows), heavy interventions in the currency markets as well as in the bond and stock markets, constantly changing and often unclear rules, no market discipline, etc. (See Exhibit 1)

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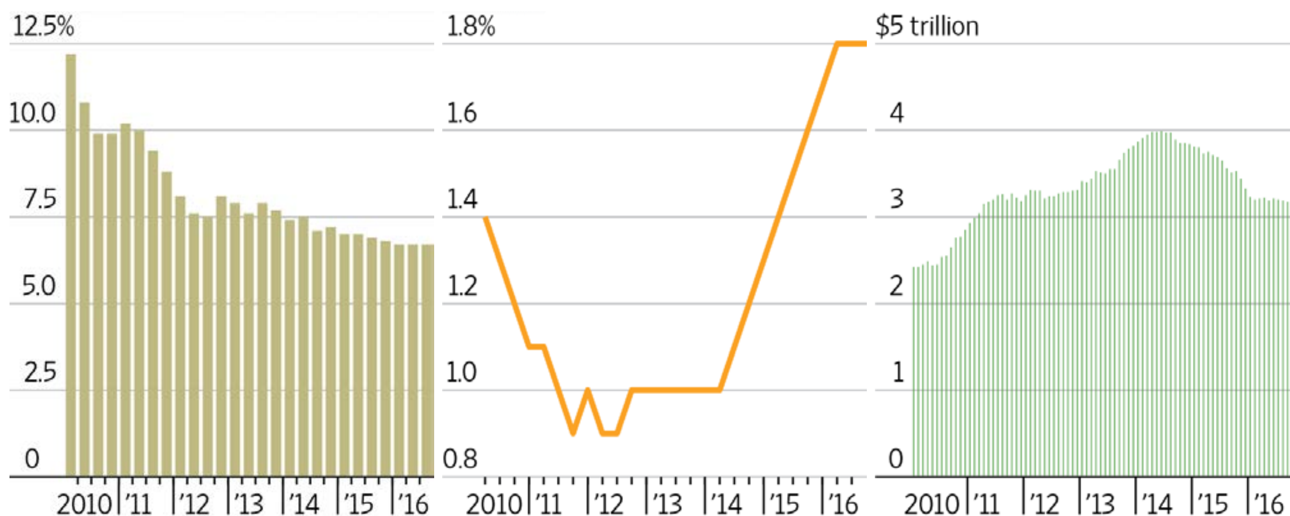
Exhibit 1, Quarterly GDP Growth, Nonperforming Loan Ratios, and Foreign-Exchange Reserves

"Financial risks are rising in China as an economic slowdown means more bad debt and a shrinking foreign-currency pile"



Source: Wall Street Journal

Long term sustainable growth may be closer to 3% to 4% than the 6.5% targeted by the authorities. As a command economy, the Communist Party leaders of China will prioritize its growth targets at almost any cost, in part to achieve a goal to double China's economy and per capita income from 2010 by 2020. Such growth can go on for a while, maybe even a few more years, but at some point the increasing imbalances are highly likely to cause something to crack.

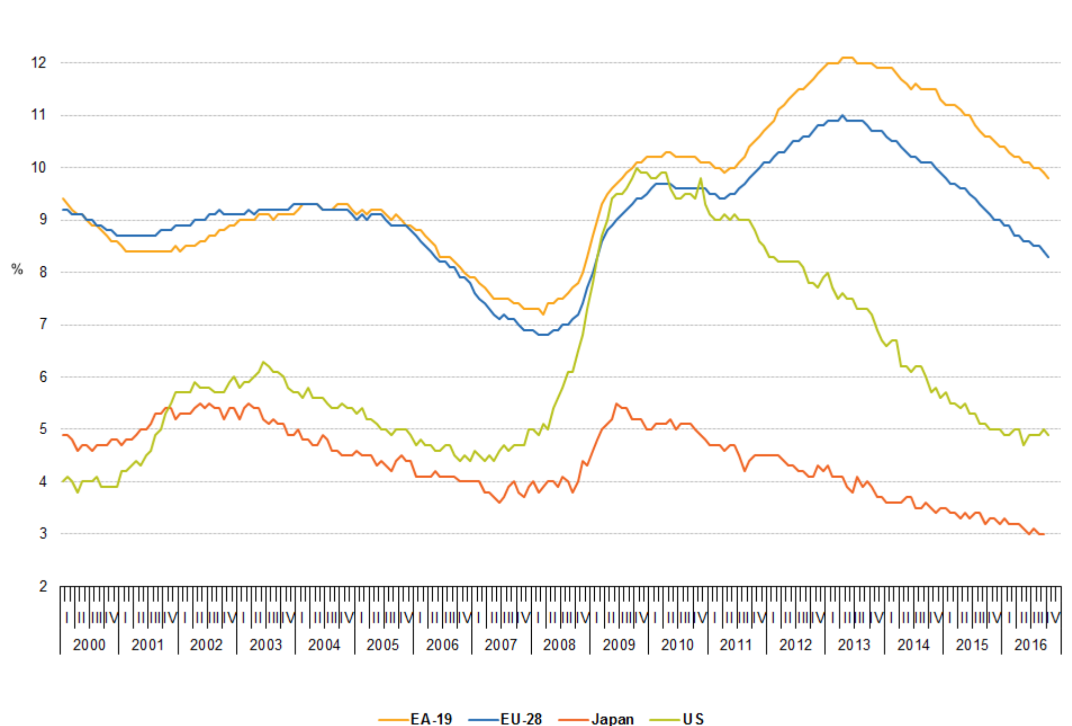
In the meanwhile, the heads of government are managing their economy like a game of Whac-A-Mole, addressing each short term problem individually by diktat as they arise. This lets long term economic imbalances fester, making the country vulnerable to, among other things, a tightening Fed, which contributes to a falling yuan, higher interest rates, and capital flight.

When the situation ultimately gets out of control, the entire global economy will be affected to one degree or another, especially other emerging markets due to China being their biggest customer. The best things China could do for its own economic benefit and that of the world is to 1) accept the reality of slower economic growth and 2) follow its own advice to let market forces have a bigger role in their society. Unfortunately we are not optimistic about either of these happening any time soon.

The Eurozone will remain an economic risk indefinitely until certain structural problems are resolved, especially instituting a central treasury and a complete banking union. Unfortunately these are not likely to be addressed any time soon as there is no political will to do so. Failure to address structural problems could ultimately prove fatal to the Eurozone.

Greece is still a mess and Italy's banks are seriously undercapitalized. Unemployment remains high (see Exhibit 2), with Greece, Spain, Italy, and Portugal currently having official rates over 10%, higher than the United States experienced at the worst point in the Great Recession. The social strains are getting worse as Europe deals with a refugee crisis, a big factor in the unsettling rise of nationalism across the continent.

Exhibit 2, Unemployment Rates Seasonally Adjusted, January 2000 through October 2016



Source: Eurostat

THE DOMESTIC STOCK MARKET

In the very short term the stock market often seems to flit like a hummingbird from place to place without warning or pattern. Human beings usually over-interpret what these movements might mean, often confusing correlation of events with causation. A common behavioral flaw called recency bias causes people to overemphasize the most recent activity as being indicative of future events.

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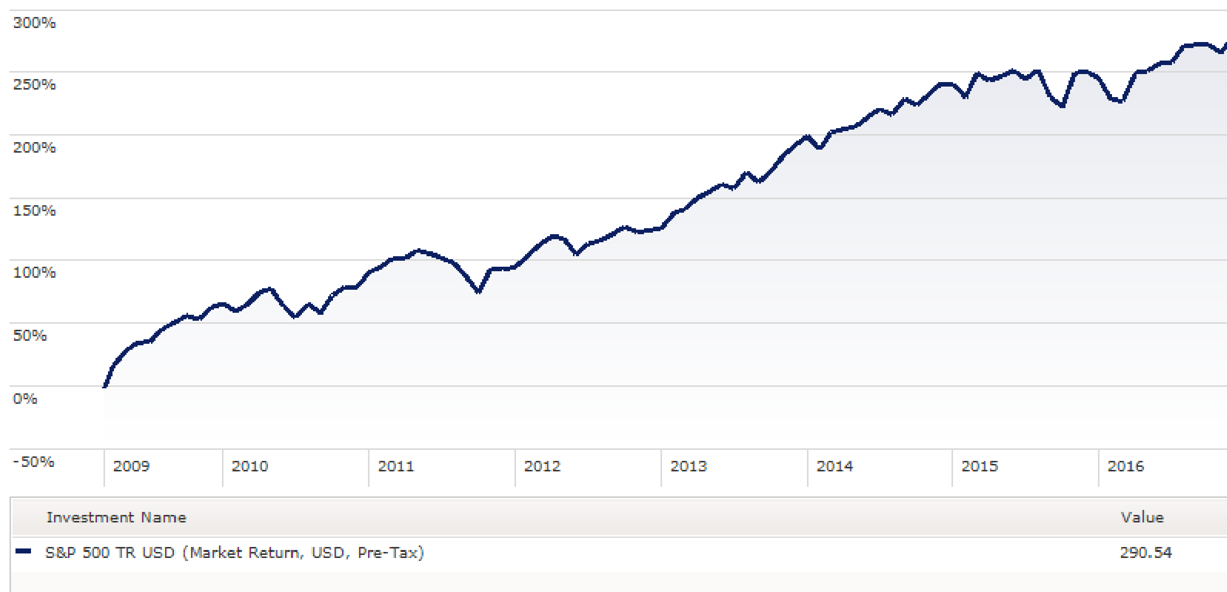
The torrid rally in the domestic stock markets after the presidential election is a case in point. The outcome was a surprise to most observers (including us) and what the financial markets presumably had discounted. A rapid adjustment that occurred over the immediate several days afterward might have been rational, but such moves triggered a buying melt-up that caused many to get excited and jump on the bandwagon.

At the margin, ***the recent higher stock prices could be sustainable with higher corporate earnings***. This could occur IF some regulations are repealed that trigger business investment or a lower corporate tax rate spurs repatriation of overseas cash or additional infrastructure spending increases productivity or any number of other changes take place. But that's a big if as these things cannot simply be declared by fiat to occur the day after inauguration. In the meantime, we give the rally the benefit of the doubt in large part because of the generally positive and potentially improving overall situation for corporate profits and consumer health, which suggests the stock market is transitioning to an earnings-driven market instead of an interest rate-driven market.

However, we question the ***excitement*** about buying into the stock market with money that has been sitting for years waiting for "the right opportunity". ***The time to get excited about the stock market is when prices have fallen and things are scary, not when prices are high and feelings are euphoric***. The greatest opportunity of this generation took place almost eight years ago in 2009 when valuations were low and all hell seemed to be breaking loose. Other times to get excited about aggressively putting money to work were during the Greek crises and any time the stock market pulled back 10%, 15% and even almost 20% (the generally accepted definition of a bear market). The WRONG time to get truly excited about owning stocks is when valuations are high after an almost eight year bull market where the S&P 500, for example, has returned about 300% - which equates to an average return of more than 19% per year! (See Exhibit 3.) This pace is not sustainable and prices may have already anticipated much of the future improvements to the economy and corporate earnings.

Exhibit 3, The S&P 500 from March 9, 2009 through December 22, 2016
Higher stock prices could be sustainable with higher corporate earnings



Source: Morningstar

We are NOT suggesting the current bull market is facing its demise. While valuations are high, they are not excessive. As indicated earlier, we perceive a recession is not imminent. Therefore we are NOT suggesting anyone should change their longstanding investment plans.

We simply caution that ***expectations of future returns should be reasonable*** and maybe some people need to lower their sights. We suggest mid-to-high single digit returns on average over the next few years. And we always warn that declines could occur at any time for any reason – ***a 10% decline is routine*** - because that is what happens in the NORMAL course of the financial markets.

THE DOMESTIC BOND MARKET

As excited as some are about the stock market, some people are just as worried about the bond market because interest rates have risen in anticipation of the Fed raising the fed funds rate and higher inflation. The problem is this concern has been a broken record during the

entire recovery. (Does the analogy to a broken vinyl record still make sense in an era of downloaded music? Do our younger readers even know what a vinyl record is?)

Maybe at long last a little bit faster growth is upon us. And maybe the slightly faster growth will cause inflation to increase, and with it higher interest rates. And higher interest rates supposedly mean bad news for bonds.

But just as the stock market may have already anticipated much of future improvements to the economy and corporate earnings, the rapid and significant increase in some interest rates may have already anticipated much of the change in future growth and inflation. For example, the benchmark 10-Year US Treasury yield since July rose from about 1.3% to about 2.6% (see Exhibit 4). Certainly this trend could continue for a while, but we highly doubt the recent pace is sustainable for very long simply because we perceive inflation is likely to remain fairly low for some time. At least for now, the yield remains in a multi-year flat, albeit broad, range.

Exhibit 4, CBOE 10 Year Treasury Note Yield Index for Five Years Through December 23, 2016

At least for now, the yield remains in a multi-year flat, albeit broad, range

Source: Big Charts

This leads to the bond market. We remind readers the bond market is much larger than the stock market and is comprised of many sectors, degrees of quality, and lengths of maturity.

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And there are many interest rates. This means that different types of bonds will react in varying ways to changes in different interest rates so that one cannot make blanket statements about the impact on bonds. For example, a portfolio of short to intermediate duration bonds will over time increase the income stream it produces as maturing bonds are reinvested in new securities at higher yields.

Thus the portion of bonds in a portfolio if managed properly can continue to serve the purpose of providing stability, some current income, and a positive total return in many scenarios, even if numerous interest rates rise.

THE FED AND MONETARY POLICY

Our thesis for several years has been that ***the Fed will raise the fed funds rate only at a very slow pace***, which translates to one or two times per year. This thesis remains intact, as we perceive that only slightly faster economic growth and inflation will preclude the Fed from commencing a regime change of frequent or significant rate increases.

The U.S. Dollar Index has been rising since about mid-2011 (see Exhibit 5). But just because the Fed tightens does not automatically mean the dollar will rise, as the episodes from 1986, 1994, and 2004 demonstrate. So far, the dollar has continued to rise with the two recent increases in the fed funds rate. All else equal, a stronger dollar by itself could eventually crimp growth by hurting domestic exports as well as put a cap on inflation, thus potentially limiting the extent of the Fed's rate increases.

Exhibit 5, U.S. Dollar Index (DXY), May 2, 2011 through December 23, 2016

A stronger dollar by itself could eventually crimp growth by hurting domestic exports as well as put a cap on inflation, thus potentially limiting the extent of the Fed's rate increases

Source: Big Charts

Additionally, rising domestic interest rates and a stronger dollar are a de facto tightening of monetary policy for much of the rest of the world, especially many emerging countries. Thus the Fed has to be careful because its actions go beyond borders. The global economy remains fragile enough to the point that a significant portion of the world may not be able to handle too much of a change in monetary policy. The tightening that seems appropriate for the United States could negatively impact other countries to the extent they ultimately feedback and weigh on the domestic economy and financial markets.

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We remind clients and friends that all of our Commentaries are on our web site. As always, please contact us if you have any questions.

http://www.YosemiteCapital.com/News-Commentary

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We wish all of our clients and friends Merry Christmas, Happy Hanukah, and a prosperous New Year!

John Kleponis, CFA
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The S&P500 Index is designed and maintained by Standard & Poor's (a division of The McGraw-Hill Companies), is a free-float market capitalization weighted index that includes 500 leading companies in leading industries of the U.S. economy, and is intended to be an ideal proxy for the total market. This index is calculated on a total return basis with dividends reinvested and is not available for direct investment.

The Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency). This index is calculated on a total return basis with interest reinvested and is not available for direct investment.