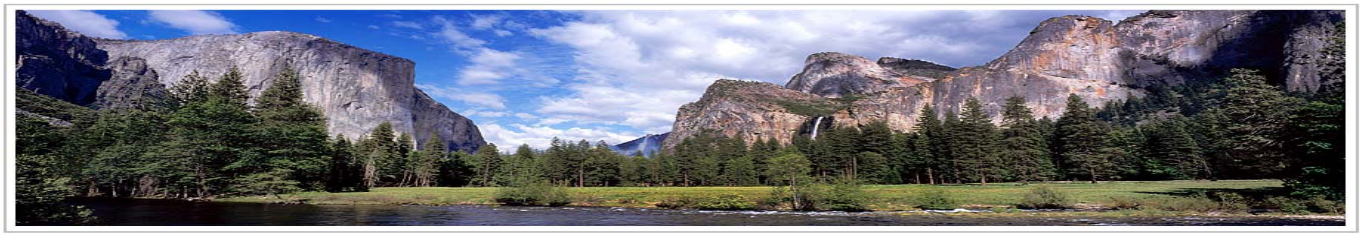

YOSEMITE CAPITAL MANAGEMENT

Fourth Quarter 2011 – COMMENTARY

The two ideas of human freedom and economic freedom working together came to their greatest fruition in the United States. Those ideas are still very much with us. We are all of us imbued with them. They are part of the very fabric of our being. But we have been straying from them. We have been forgetting the basic truth that the greatest threat to human freedom is the concentration of power, whether in the hands of government or anyone else. We have persuaded ourselves that it is safe to grant power, provided it is for good reasons. – Milton Friedman

In the James Bond novels, later made into memorable movies, author Ian Fleming featured a fictional global terrorist organization called SPECTRE, which was an acronym for **SP**ecial **E**xecutive for **C**ounter-intelligence, **T**errorism, **R**evenge, and **E**xtortion. Unaligned with any nation or political ideology, SPECTRE was a vast international commercial enterprise willing to work with any government or other entity for profit, often with a strategy of fomenting conflict between two powerful enemies with the intent of seizing power afterward from the weakened victor.

This sounds a lot like the big investment and commercial banks.

ONE HALF OF THE STORY

Barely three years after bringing the world to the edge of a financial meltdown, big banks have yet again brought the world the specter of economic calamity. This time, European banks are at the fulcrum of the problems.

The situation in Europe is the result of a faulty monetary union that lacks a corresponding political and fiscal union -- a currency crisis with the Euro. The major symptom is a sovereign debt crisis involving several countries in the periphery of the European Union. The trigger is the inevitable default of some sort by the Greek government. Following that is the prospect of contagion since countries such as Portugal, Italy (the biggest economy in southern Europe), Spain, and Ireland are in similar straits.

> The "troika" of the European Union (EU) (led by Germany and France), the International Monetary Fund (IMF), and the European Central Bank (ECB) are scrambling to arrange for bailout funds, possibly with leverage. Their basic goal is to stabilize the European economic system by recapitalizing the banks, lending to nations in fiscal trouble, and buying bonds in the secondary markets. Simultaneously they are pressuring Greece to cut government spending and

increase tax receipts as well as trying desperately to delay restructuring Greece's debt in an effort to buy time in hopes of preventing the aforementioned contagion.

While all of that is bad enough, the problem verges on global mayhem because of large financial institutions that

1) remain too big to regulate
2) made extremely poor lending decisions
3) took on excessive risk via leverage
4) perhaps most importantly, are intertwined with each other on a global basis through derivatives and resulting counter-party risk

The last point simply means that if one large bank goes down, others could follow in a domino effect. Using the threat of economic terrorism around the globe, the banksters are essentially extorting governments to bail them out from the consequences of their actions. SPECTRE would be awestruck.

This sounds familiar (aside from the James Bond novels and movies). Behemoth European banks are acting much like their American counterparts did in 2008. Only the names have changed: Landesbank Berlin, Deutsche Bank, Credit Agricole, Commerzbank, BNP Paribas, Societe Generale, Banco Santander, and Unicredit (among others) instead of Bear Stearns, Lehman Brothers, Merrill Lynch, Citigroup, Bank of America, Morgan Stanley, and Goldman Sachs (among others).

THE OTHER HALF OF THE STORY

The banksters around the world have partners in crime, without whom none of their exploits could have happened to anywhere near the extent they did. Their cohorts are the governments of the developed economies of the world, especially the United States. We focus our disgust on the American government because our country was specifically founded on the principles of liberty and justice and is emblematic of freedom around the world, while as citizens we are naturally more familiar with its laws and regulations than those of anywhere else.

Over the course of several decades, the American government condoned the transition from free enterprise to cronyism, from a republic to a corporatocracy, from defending the rights of individuals against government power to providing power to plutocrats and oligarchs at the expense of individuals, and from rewarding hard work by all to rewarding failure in the executive suite. The Executive, Legislative, and Judicial branches all contributed, and both major political parties played significant roles.

Indeed, the federal government aided and abetted the financial institutions the entire way into the credit bubble and protected them through the collapse. By accepting bribes in the form of campaign contributions in return for almost whatever the financial institutions asked for via their lobbyists, politicians created an unholy alliance between government and large corporations.

A very small sampling of American government actions from the long list of lowlights that ignored the law, integrity, ethics, or common sense include:

- Enabling commercial banking, investment banking, and insurance companies to enter each others' businesses and eventually combine
- Allowing derivatives to be unregulated
- Keeping monetary policy too loose for too long after the 2001 recession
- Failing to enforce rules on lending standards or capital requirements
- Waiving the Net Capital Rule (the debt-to-net-capital ratio limit of 12:1) for Bear Stearns, Lehman Brothers, Merrill Lynch, Morgan Stanley, and Goldman Sachs
- Encouraging accounting standards for financial institutions that ignore market valuations of assets
- Barring state enforcement agencies from cracking down on abusive lending tactics
- Failing to supervise regulators

THE CURRENT DIFFICULTIES

As a result of banking megalomania combined with government complicity, the American and European economies face the fallout of a ***credit bubble collapse***. The primary issue is ***excessive consumer debt***, exacerbated by a ***dysfunctional financial system*** and, at least in the United States, a ***constipated residential real estate market***. Until these three main issues are resolved, the economy is likely to remain sluggish for some undeterminable time, which translates to ***slow economic growth*** at best and a naturally corresponding ***persistently high unemployment***.

A weak economy is vulnerable to economic shocks, such as what could transpire from Europe if policymakers cannot find a reasonable solution to their predicament, a slowdown or recession in China, and a geopolitical event (always and everywhere a risk). As a result, the financial markets will likely experience continuing episodes of volatility.

By itself, ***recovery from a credit bubble collapse is longer and slower*** than recovery from more routine economic downturns simply because it takes years for consumers to reduce excessive debt. While repaying debts, people cannot spend in the same manner as in more normal times, which is why economic growth is slow and choppy. In the absence of widespread debt forgiveness or massive injections of liquidity directly to consumers, recovery is a long and drawn out process by necessity. This is a problem of solvency and not liquidity and therefore cannot be resolved simply through loose monetary policy, additional lending, artificially propping up asset prices, or short term fiscal "stimulus" programs.

The other two issues, a dysfunctional financial system and a clogged residential real estate market, are related and are further weights on the recovery that drag out the process. But this is where a prolonged healing process can potentially be made shorter, so this demands major changes by either the companies themselves or by the federal government.

Assessing whether or not the companies will create major reforms is easy: the banksters are probably not going to see the errors of their ways and suddenly develop integrity.

This leaves the country with the federal government to address these two industries. The current dilemma is actually an invitation on a silver platter for a true leader or small group of leaders to step up and make a positive change to the course of the country. Sadly, we are not hopeful about anyone stepping into this void, and not just because the federal government is comprised of too many officials who are corrupt, selfish, and incompetent – they are, but that fact is nothing new. Rather, what is incredibly astounding for an economic superpower is the vast majority of the American political class remains abysmally and woefully ignorant of economics.

As such, they do not comprehend the problems and understand the underlying root causes. They see only the symptoms and attempt to superficially address them. But as any medical doctor can attest, without a proper diagnosis of the actual disease they cannot prescribe an effective long term cure, and merely treating symptoms might not do any good and could actually cause the patient more harm.

IDEAS TO RETURN TO HEALTHY ECONOMIC GROWTH

Should an effective leader emerge who is willing to take a bold and even courageous course of action, we suggest that implementing even some of the following ideas would demonstrate a better understanding of the problems and return the country and world to healthy economic growth:

- Break up the largest financial institutions so that no single company or small groups of companies can cause systemic risk
- Break up any financial institution that cannot be effectively regulated
- Separate commercial banking , investment banking, and insurance operations into different companies
- Regulate the derivatives business and increase pricing transparency by establishing a central clearing house and standardizing derivatives
- Limit leverage to a reasonable multiple of a meaningful and relevant measure of solvency
- Establish meaningful and relevant measures of bank solvency using actual hard capital available to absorb future losses
- Revise financial reporting requirements of public companies so that investors can more realistically understand a company and its associated risks (marking assets to market, identifying counter-parties, identifying major customers and suppliers, etc.)

- Require mortgage lending institutions to keep a significant percentage of loans they generate chosen at random
- Require stock option awards to be adjusted for stock buybacks and market movements
- Allow companies to fail
- Prosecute to the fullest extent of the law any company that violates statutes of fraud, racketeering, corruption, and other crimes as appropriate
- Claw back all compensation resulting from illegal activities from those convicted of fraud, racketeering, corruption, and other crimes
- Claw back at least three years of compensation from senior executives and members of the board of directors of any firm that accepted government bailouts
- Mandate that those companies still in possession of government bailout money immediately terminate any remaining senior executives and members of the board of directors who were in those positions at the time their company received government bailouts
- Mandate that those companies still in possession of government bailout money pay their senior executives and members of the board of directors government wages until the taxpayers' money is refunded in full and with an appropriate return
- Prohibit corporations and unions from contributing to political campaigns
- Rewrite the tax code to design progressive tax brackets as multiples of the federal minimum wage
- Enact a federal program to rebuild the infrastructure of the United States, including creating a nationwide network of floodwater redistribution, repairing the electric transmission grid, rebuilding highways, updating air traffic control systems, creating regional high speed rail, and expanding local rapid transit
- Establish federal and state employment programs so that government is always available as an employer of last resort
- Prohibit sitting presidents and senators from campaigning for their own re-election and raising funds for political purposes

OUT OF CRISIS COMES OPPORTUNITY

The mere fact that solutions to the current problems do exist is a reason for optimism. More power to implement solutions remains in control of the people, perhaps more than many realize. For examples, all American citizens over age 18 can:

- ✓ Vote in all elections

- ✓ Vote for candidates who are not Republocrats (even 10% of votes cast for minor candidates will send an extremely powerful message against the status quo)
- ✓ Avoid doing business with the big financial institutions

We perceive the financial markets themselves are providing opportunities for participants. For examples:

- ❖ Many can refinance at historically low mortgage rates
- ❖ Domestic stocks have moderately low valuations accompanied by relatively strong earnings growth
- ❖ Corporate bonds have attractive risk/reward combinations
- ❖ Municipal bonds have attractive risk/reward combinations
- ❖ Commercial real estate prices are relatively low

The idea that the people are in control of their fate and that the financial system is not permanently broken are among the reasons why many newly minted millionaires in China, India, Russia, Brazil, and elsewhere seek our shores as a safe haven for their wealth. With their global perspective, perhaps they are more fully aware of the long term possibilities in this country than even many Americans.

The beauty of the United States has always been and remains its resilience from adversity. In spite of its problems, America still has the specter of a bright future ahead.

John Kleponis, CFA
Chief Investment Officer

Paul Heckler
Managing Director