YOSEMITE CAPITAL MANAGEMENT

Fourth Quarter 2012 – COMMENTARY

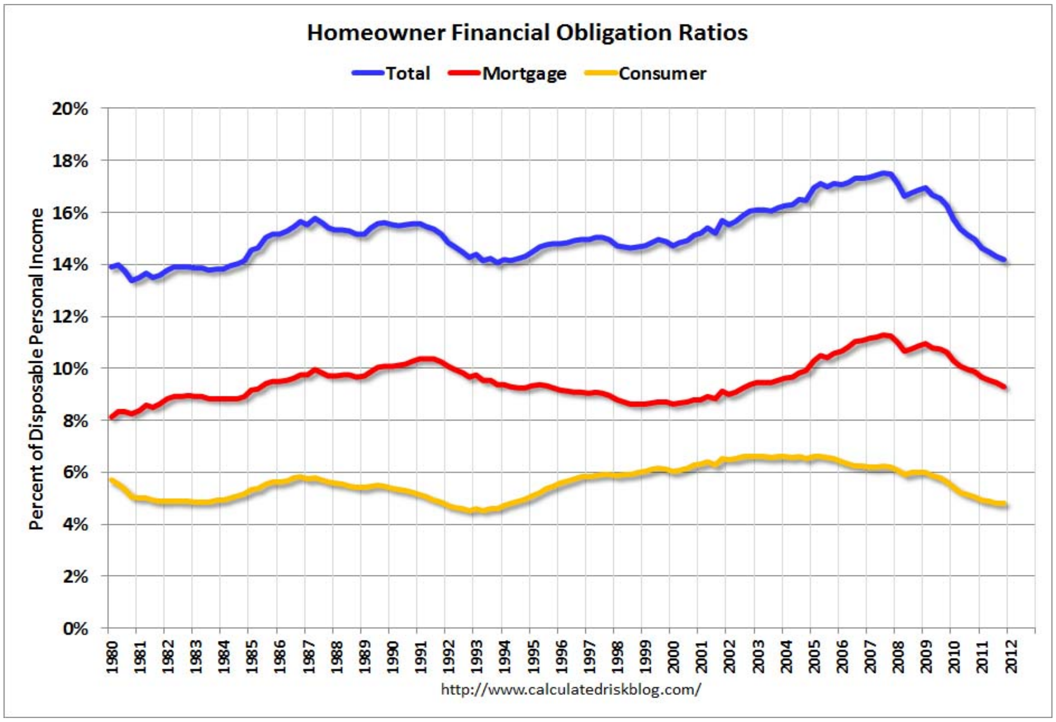
"Many forms of Government have been tried, and will be tried in this world of sin and woe. No one pretends that democracy is perfect or all-wise. Indeed, it has been said that democracy is the worst form of Government except all those others that have been tried from time to time." – Winston Churchill

Successful investors NEVER let their politics get in the way of their investing plan. Too many investors overestimate the role of politics in their investment plan, on the financial markets, and in the economy. The truth is that in the short term of a couple of years, politicians and politics have very little impact on the economy. Indeed, ***the economy usually determines the outcome of an election as opposed to an election determining the outcome of the economy***. Therefore, who is in the White House or which political party controls the Senate or the House of Representatives cannot substantially affect the financial markets in the near term and certainly should not affect one's portfolio decisions. ***Those awaiting the outcome of an election to make investment decisions are potentially making a big mistake***. Politics is primarily about the next election, while proper investing is about the long term.

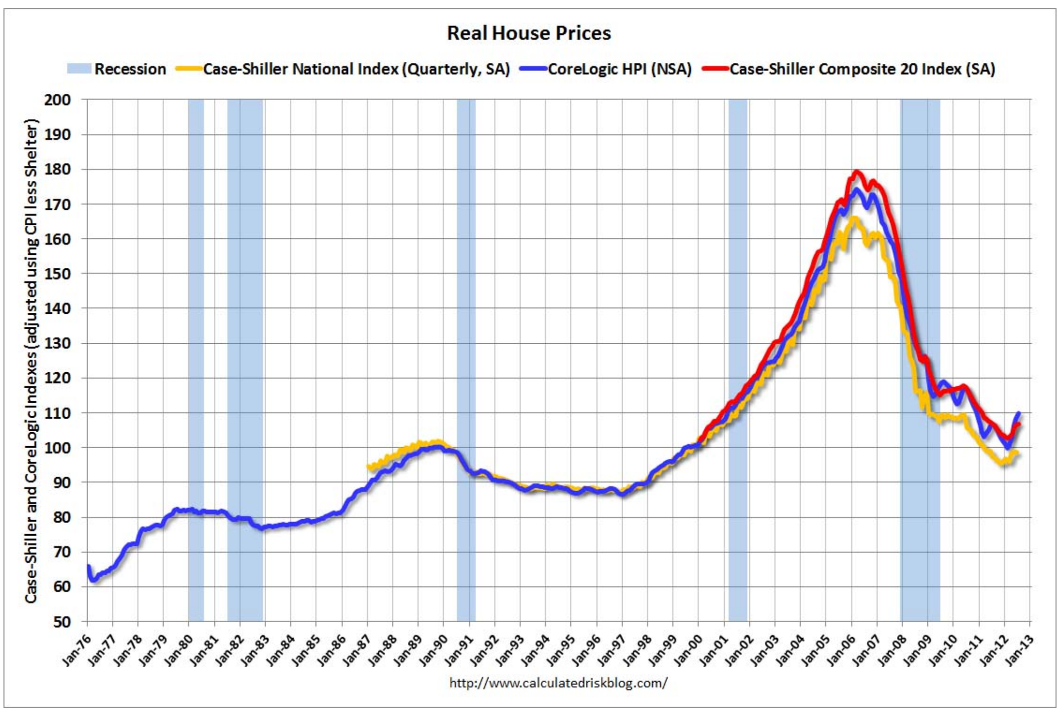
Regardless of who is elected president in November, that person might have great difficulty in resolving even minor issues simply because of rancor caused by a closely divided Senate and two major political parties far more controlled by the irrational extremes of their membership than by more pragmatic moderates. There is also a strong possibility that Congress will be split (different parties having majorities in the Senate and House of Representatives) which will only increase the hurdles.

But even aside from the political environment, there are three major reasons why the short term destiny of the economy is likely pre-ordained no matter who is residing at 1600 Pennsylvania Avenue:

1. **A prolonged sluggish economy is NORMAL after a systemic financial crisis stemming from a burst credit bubble**. In the current situation, the consumer is de-leveraging (paying down excessive debt) and the damaged residential real estate sector is trying to stabilize from its decline. Both of these require time (years) to get back to some semblance of normality and the time required cannot be dramatically accelerated via policy prescriptions. How these two items develop over the next few years, good or bad, will likely be major determinants of how the economy fares.



Source: Calculated Risk



Source: Calculated Risk

2. **The Euro crisis involves structural changes that will likely take years to implement before growth can resume, and these are out of the control of the United States.** We live in a global economy and all major areas of the world are interconnected to one degree or another. Slow growth in Europe reduces their demands for American and emerging markets services and goods, thus limiting growth in production and profits for many American companies around the world.

Source: MacroScope

Source: Pragmatic Capitalism

3. **Neither Republocrat candidate for President understands how the economy works or can correctly diagnose the problems with the current economy.** The incumbent has not grasped that the reality of the economic situation is the aftermath of a systemic financial crisis (which inevitably results in prolonged period of significantly below-trend growth as mentioned in Point 1 above) and not a "traditional business cycle" (where growth usually reverts to stronger numbers within a relatively short time period). Without this understanding he therefore is not capable of proposing a credible economic agenda. This makes him eminently beatable in a period with a weak economy, yet the challenger also fails to grasp that same reality. Furthermore, he offers to merely tinker with large banking institutions instead of proposing a significant overhaul to the financial system to address the root causes of the recent crisis.

From the incumbent (emphases added) in 2009:

> "The Administration forecast reflects **traditional business cycle** analysis in which a period of weak or negative growth is followed by **a recovery and expansion during which real GDP grows above trend for a time**."
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> *Source: "Analytical Perspectives – Budget of the U.S. Government - Fiscal Year 2010", page 174, http://www.gpo.gov/fdsys/pkg/BUDGET-2010-PER/pdf/BUDGET-2010-PER.pdf*
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> … in 2010:
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> "the Administration's projections for real GDP growth over the next five years [3.8%] imply a recovery that is **a bit** below the historical average [4.2%]."
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> *Source: "Analytical Perspectives – Budget of the U.S. Government - Fiscal Year 2011", page 14, http://www.gpo.gov/fdsys/pkg/BUDGET-2011-PER/pdf/BUDGET-2011-PER.pdf*
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> … in 2011:
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> "The Administration is projecting **a normal recovery** from the recession of 2008-2009"
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> *Source: "Fiscal Year 2012 – Analytical Perspectives – Budget of the U.S. Government", page 9, http://www.gpo.gov/fdsys/pkg/BUDGET-2012-PER/pdf/BUDGET-2012-PER.pdf*
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> … and in 2012:
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> "The Administration projects that real GDP will eventually recover most of the loss from the 2008-2009 recession. This implies a few years of **higher than normal growth** as real GDP makes up the lost ground."
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> *Source: "Fiscal Year 2013 – Analytical Perspectives – Budget of the U.S. Government", page 20, http://www.gpo.gov/fdsys/pkg/BUDGET-2013-PER/pdf/BUDGET-2013-PER.pdf*

From the challenger (emphases added):

> “To bring the unemployment rate back to its pre-financial-crisis level by the end of the next president’s first term would require **real GDP growth averaging 4 percent per year** over that period. That is an aggressive goal, but great progress can be made.”
>
> “If anything, the sharper recession should have produced **sharper growth** in the course of recovery.”
>
> “Greater **transparency** for inter-bank relationships, **enhanced** capital requirements, and **provisions to address** new forms of complex financial transactions are all necessary elements of effective financial reform.”
>
> *Source: “Believe in America – Mitt Romney’s Plan for Jobs and Economic Growth”, pages iv, 15, and 59* *http://www.mittromney.com/sites/default/files/shared/BelieveInAmerica-PlanForJobsAndEconomicGrowth-Full.pdf*
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> “A top adviser to presidential candidate Mitt Romney on Tuesday **dismissed an idea to cap the size of big banks** floated last week by a senior U.S. Federal Reserve official.
>
> Glenn Hubbard, an economic advisor in the Republican camp, said **market forces would keep the size of financial institutions in check** better than difficult and arbitrary government limits on banks judged too-big-to-fail.”
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> *Source: “Romney adviser dismisses capping U.S. bank size”,* *http://www.reuters.com/article/2012/10/16/usa-regulation-banks-hubbard-idUSL1E8LGAS220121016?type=marketsNews*

Both talk about so-called “jobs” plans, making changes to the tax code, treating symptoms, and vague platitudes. But these are merely political pandering and attacks on their opponents instead of bold yet realistic political leadership against built-in risks that were root causes of the recent crisis and possibly the next crisis. Specifically, they put little to no emphasis on restructuring the dysfunctional financial system, a major impediment to stronger growth that unlike consumer de-leveraging and mispriced residential real estate could be addressed by government policy. For example, a worthwhile candidate would work to do the following:

- break up the largest financial institutions
- break up any financial institution that cannot be effectively regulated
- reinstate the affiliation restrictions in the Glass–Steagall Act that were repealed through the Gramm-Leach-Bliley Act in 1999 (this would separate commercial banking, investment banking, and insurance operations)
- limit leverage to a reasonable multiple of a meaningful and relevant measure of solvency
- regulate the derivatives business

- require mortgage lending institutions to keep a significant percentage of loans they generate chosen at random

- allow companies to fail

- prosecute to the fullest extent of the law any company or person that violates statutes of fraud, racketeering, corruption, and other crimes as appropriate

Regular readers might recognize these items from our longer list of "Ideas to Return to Healthy Economic Growth" we wrote in our letter of Fourth Quarter 2011.

Given that these three major reasons are not going to be any different because of who will be inaugurated in January, investors should not wait for the outcome of the election to make major decisions. All else equal, ***the economy and the financial markets do not depend on proper Executive Branch leadership for positive growth***, even though we certainly prefer they be of more help than hindrance.

But ***this is what makes the United States of America a strong country***. Only weak countries or governing philosophies depend on "the right people" to lead them. The nation moves on regardless of, often in spite of, and not because of, who our elected officials are. The United States of America does not have rulers, does not rely on the political class to be its leaders, and does not use government to run its society (including the economy and the financial markets). This is the kind of nation in which to invest. And investing in a country is investing in its people and its institutions and not in its politicians.

We want to make it absolutely clear that none of this is to suggest that politics is unimportant. To the contrary, ***government has a VITAL role to play in society***. It is crucial that citizens participate in the affairs of government at the federal, state, and local levels, at the very least by voting in every election, because the policies, laws, regulations, decisions, and appointees can and do affect the country and even the world in the longer term.

> The rights we all enjoy as citizens are ultimately what really make our country strong. The fact that anyone can publicly express an opinion about a current office holder and challenger in a negative or positive light is something that most human beings throughout history never could safely do and too many in our own time around the world still can't. We are thankful for this ability and grateful to those who sacrifice so much to maintain all of our inalienable rights, knowing full well losses of rights can be insidious and usually difficult to reclaim when gone.

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For those who want to better prepare themselves for the result (good or bad depending on their preference), we offer an analysis (not a prediction) of what the current data is indicating about the outcome of the presidential election.

> Remember that the United States does not elect its president in a national election decided by a popular vote of the people. Instead, the country has 51 state elections (for this purpose the District of Columbia is considered as a state). From these 51 elections, the president is chosen by a vote of the Electoral College where at least 270 votes out of 538 are required to win. (This is one reason why national polls about voting intentions are irrelevant for trying to determine the ultimate outcome.) For more information, see the National Archives and Records Administration (NARA) at http://www.archives.gov/federal-register/electoral-college/about.html.

There are 42 states where the outcomes are practically guaranteed to one candidate or the other. A tally of these votes reveals 237 for Mr. Obama and 191 for Mr. Romney with less than two weeks before the election. (If they are so inclined, voters in these states can cast their ballot for a third-party candidate without fear of altering the results of their state's election.)

This leaves 9 swing states which by definition could go to either way and where every citizen's vote matters. These are where the candidates are focusing their attention in the final days of the campaign and observers will be attuned to on election night. Those states and their 110 Electoral College votes are Florida (29), Ohio (18), North Carolina (15), Virginia (13), Wisconsin (10), Colorado (9), Iowa (6), Nevada (6), and New Hampshire (4).

The current numbers indicate an easier, but by no means certain, path to re-election for Mr. Obama. Needing only 33 votes or less than one-third of those up for grab, he could obtain a second term with as few as two swing states, the five smallest swing states, or numerous combinations of three or four states. Ohio is possibly a key state for Mr. Obama as the Buckeye state could be the one to push him over the top or cause him to fall short.

Put another way, in order for Mr. Romney to gain the Oval Office he must win at least 79 votes or more than two-thirds of those available. This means he needs victory in a minimum of five of the nine swing states. If he loses Florida he must run the table and get all of the remaining eight states, so obviously the Sunshine state is crucial. If he loses Ohio he must capture both of the two largest remaining swing states and at least four of the remaining six states. North Carolina is likely a critical state for Mr. Romney because losing the Tar Heel state could portend losing most of the other swing states.

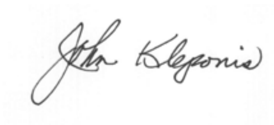
> Interestingly, there are several combinations that could result in a tie, which would cause the outcome to be decided in the House of Representatives where each state delegation has one vote (source: http://www.archives.gov/federal-register/electoral-college/faq.html#no270). This happened in 1824 and 1800.

No matter who gets elected, he could do so by a small margin, perhaps razor-thin, which suggests a contentious term is very possible. Even if Mr. Obama wins all nine swing states to give him a 347 to 191 tally, this would be narrower than his 365 to 173 margin in 2008 and cause him to be only the second president in American history to be re-elected to a second term with fewer Electoral College votes than received for his first term (Woodrow Wilson in 1916 was the first). Such an outcome might not allow him to effectively claim much of a mandate.

The biggest margin for Mr. Romney would be 301 to 237, which would rank as the tenth smallest out of the 57 presidential elections held in the country's history (comparable to the Nixon win in 1968 and the Carter win in 1976) and probably no legitimate claim of a mandate. (Source: (http://en.wikipedia.org/wiki/List_of_United_States_presidential_elections_by_Electoral_College_margin).

There are many assumptions in this analysis, especially that the polls in each state are fairly accurate. But anything can happen in the last two weeks of a campaign that could change the dynamic of the race one way or the other.

Happy voting!



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