YOSEMITE CAPITAL MANAGEMENT

Second Quarter 2013 - COMMENTARY

More money has been lost reaching for yield than at the point of a gun. – Ray DeVoe

As we were just about ready to publish our latest commentary in mid-May, financial markets around the world were jolted by an almost off-hand comment by Ben Bernanke, Chairman of the Federal Reserve, in response to a question about the timing of when the monetary authorities would dial back their latest version of Quantitative Easing (QE). The following week, after the release of the statement from the meeting of the Federal Open Market Committee (FOMC, the entity that determines significant monetary policy) and the press conference with Mr. Bernanke, the markets reacted as if the Fed had dropped a large boulder into a small pond.

An explanation of the mechanics of what happened is fairly easy.

> The merest whiff of QE ending even one minute sooner than imagined caused hedge fund managers to sell their bond holdings and the large amounts of money involved pushed prices down hard and yields up (bond prices and yields move in opposite directions).
>
> This was followed by additional hot money (short term speculators) leaving areas of the markets, perhaps capturing any remaining short term profits or simply driven by computer algorithms that triggered stop-loss selling and kept the downward spiral going.
>
> The commensurate rise in yields re-calibrated the relative value of other assets around the world (common stocks, bonds, currencies, etc.), which caused hot money selling to spill over in other markets.
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> Others, including too many professional investors that should have known better, suddenly realized the excessive risk embedded in their portfolios. They inadvertently had taken a disproportionate amount of risk by owning higher-yielding securities to give them more income. Known as "reaching for yield", this practice forsakes safer fixed income securities (like government and investment grade corporate bonds) for large amounts of junk bonds, high dividend stocks, REITs (Real Estate Investment Trusts), and MLPs (Master Limited Partnerships), and can be ultimately dangerous because of the potential loss of principal that can swiftly overwhelm any higher income. *(Note: There is nothing wrong with owning any of these kinds of securities, but they must be in moderation and never used in that segment of a portfolio designated for safety and stability.)*
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> Then John Q. Public, after reading the headlines or seeing the spectacle on television, entered the fray, and that selling was particularly obvious in the municipal bond market.
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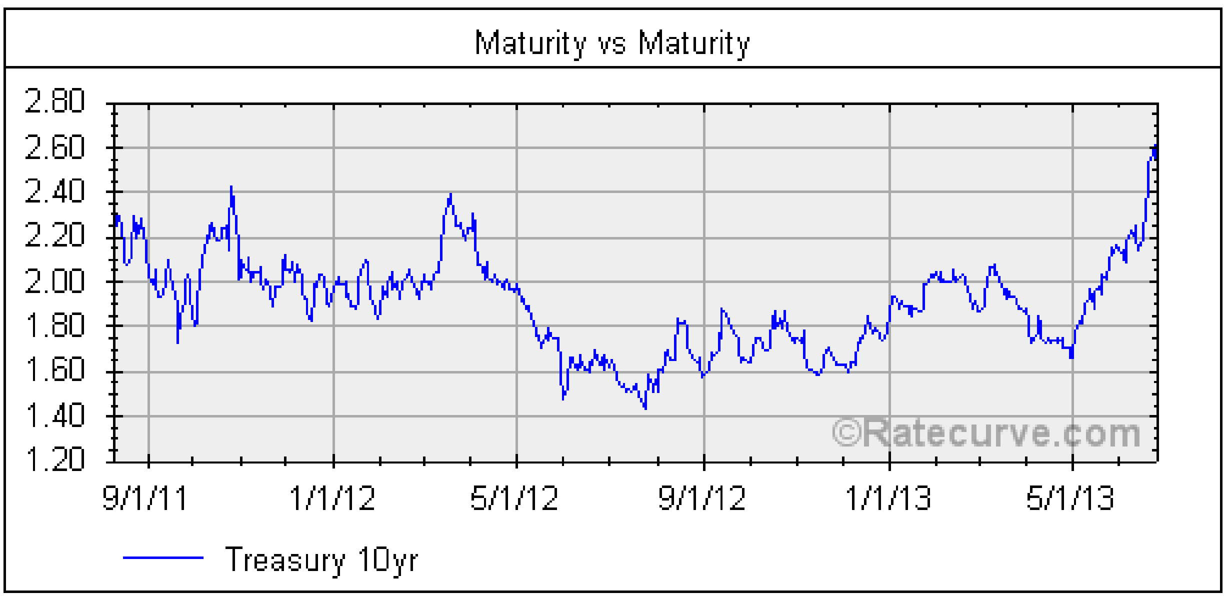
> After a few weeks, the cycle culminated (at least so far) in three days of panic selling in the bond market whereby there were few bids (offers to buy) on bonds across the board.

While the mechanics can be understood, the psychology of this situation is not as easy to explain. Did anybody really believe QE would go on forever? Why did some react as if the Fed was going to take some sort of dramatic action, and perhaps imminently, especially when the Fed has explicitly stated otherwise? Why did some take the possibility of an improving economy as a severe negative? Why did so many seem to not even hear how conditional any future Fed actions would be? And perhaps most importantly and egregiously unfair of all, why did the timing of these events have to occur at a time that necessitated us to scrap our original commentary (after hours of work) and cause us to spend more time to write this one?

After the smoke cleared (though we cannot be certain the episode is completely finished), yields have risen to the point where the economy could now be at a higher risk of relapse. For example, the ten-year U.S. Treasury yield went from about 1.6% in early May to a little more than 2.6% at its recent zenith, a large change in a short amount of time. (See Exhibit 1.) This measure is important because many other securities, from stocks to home mortgages to corporate loans, are keyed off this to one degree or another. The suddenly higher rates run the risk of choking off additional economic activity, and this is potentially serious when growth is sluggish in the first place. As a result, the joke could be on those who panicked about the Fed ending QE, because now QE is even more likely to continue, and prudent investors who stayed calm have their portfolios perhaps a bit shaken but basically intact with no permanent damage.

Exhibit 1, Ten-Year U.S. Treasury Yields

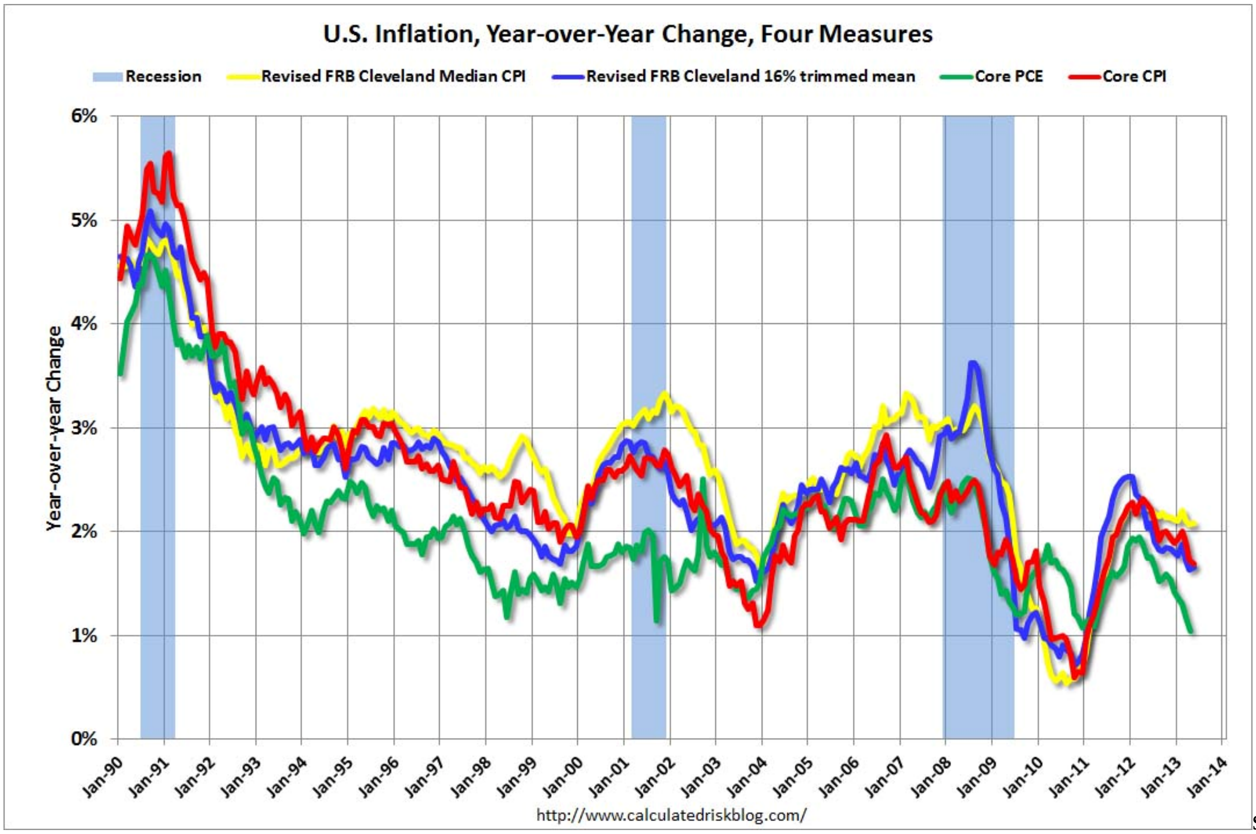


Source: BondsOnLine.com

Many are wondering even more so than usual about what happens next, especially to interest rates, inflation, the economy, and financial markets. Naturally there is also a concern about investment portfolios and whether there needs to be dramatic changes, especially since normally staid bonds have been brought to the forefront.

As usual, we will not pretend to be able to make specific predictions about anything in the future beyond what we might have for breakfast tomorrow morning (a piece of toast with butter and strawberry jam, and even that prediction we have to hedge with the possibility of a poached egg instead). But our assessment of the situation remains unchanged: the economy remains positive but slow, with Real GDP Growth in the range of 2% being strong enough to gradually create more employment over time but not strong enough to generate serious inflation. In fact, inflation is not only low but has actually been falling in recent months and the Fed would actually prefer a slightly higher rate to facilitate growth. (See Exhibit 2.) Unemployment remains stubbornly high (the latest figure is 7.6%) while capacity utilization (a measure of tightness or slack in the economy) remains relatively low. (See Exhibits 3 and 4.) All told, this is not a recipe for interest rates to rise much more from present levels. We do not believe at all that interest rates have commenced a death march to high single digits, as apparently some others do (especially those with 24 hours of advertising to sell).

Exhibit 2, U.S. Inflation



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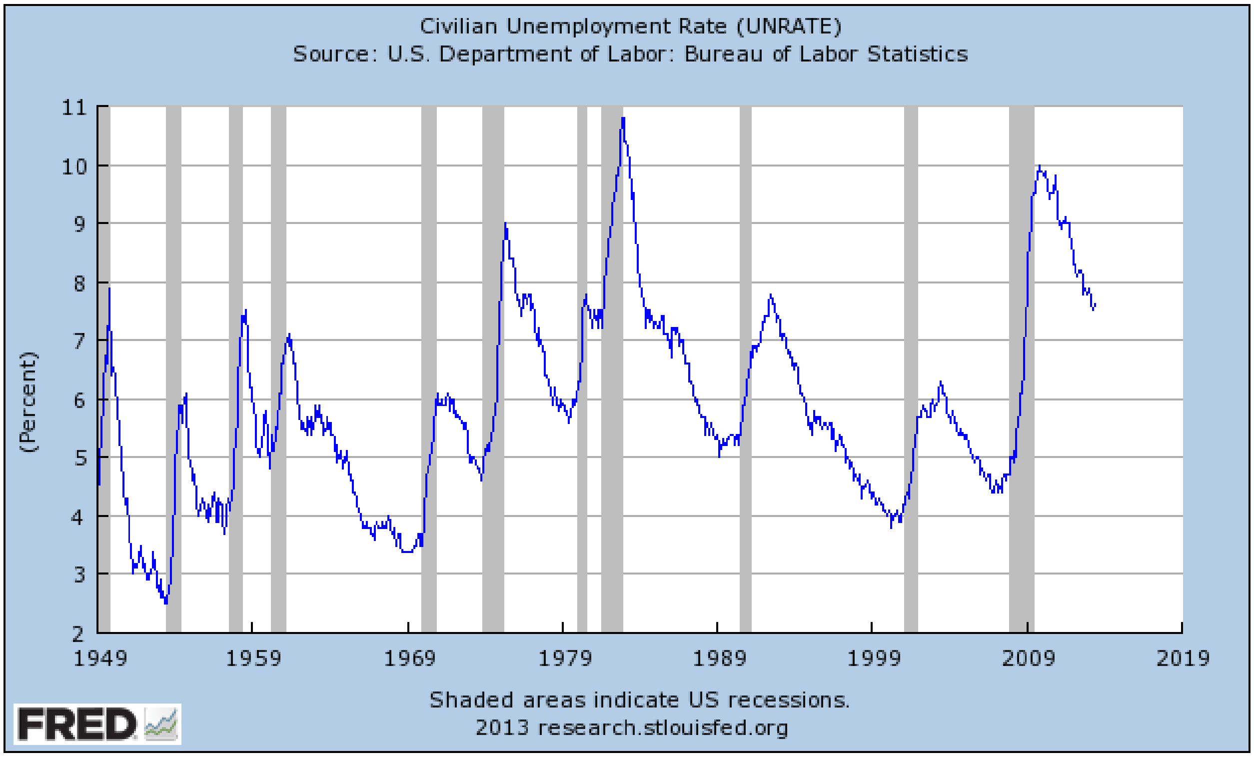
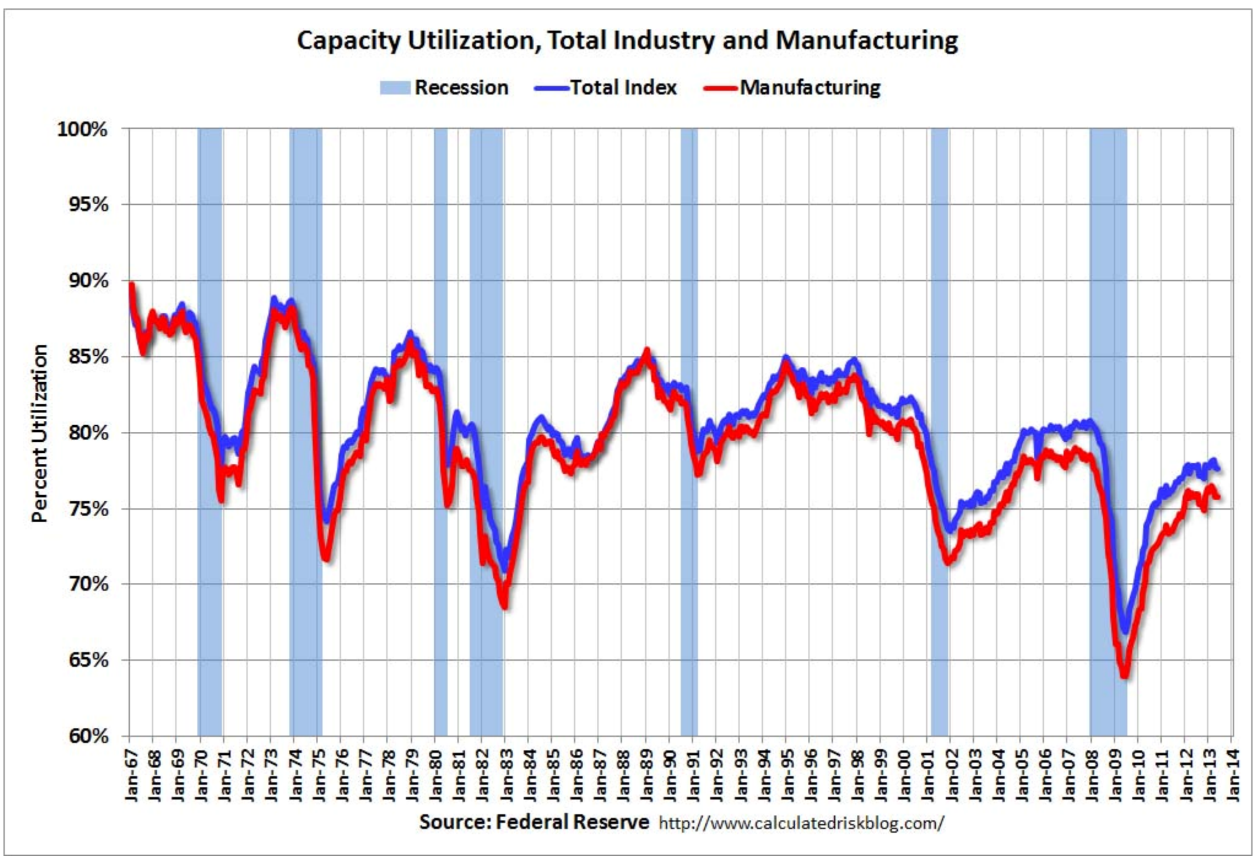
Source: CalculatedRiskBlog.com

Exhibit 3, Civilian Unemployment Rate



Source: St. Louis Fed

Exhibit 4, Capacity Utilization



Source: CalculatedRiskBlog.com

There is no need for investors to dramatically change course from a well-conceived long term plan, though tactical changes (those made to a portion of a portfolio take advantage of new opportunities) might be occasionally worthwhile.

> Stocks maintain their role as the provider of long term growth. But with that growth, one can count on them to frequently fluctuate in price, meaning there will be times when stock prices go down. Successful investors understand that this is an opportunity instead of bad news because such downturns, no matter how severe, are not permanent. As a general rule, we currently perceive stocks to be fairly valued (not cheap but not overpriced either) and prices remain dependent as they always are on corporate earnings growth.
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> Even after the latest storm, bonds remain important as ballast in a portfolio by providing longer term stability and income. With rates perhaps close to their ultimate near term highs, we perceive many bonds are now underpriced. Investors who are fearful of higher interest rates need to remember that shorter durations (a measure of sensitivity to interest rates) allow one to re-invest maturing bonds at higher rates.

As is often the case, market disruptions provide lessons for investors. The recent situation brought forth the following among many others:

> Maintain a long term perspective, perhaps decades (even a 65 year old retiree could easily have 30 years in front of them) to keep any short term market disturbances in context
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> Do not react to the news or to short term fluctuations in the markets by making impulsive changes to a portfolio properly designed for the long term
>
> Use broad asset class diversification to spread the risks because the future is inherently uncertain and unknowable
>
> Acknowledge the realities of the current environment and avoid taking excessive risks in an attempt to get something (like higher income) that the markets cannot otherwise provide

As always, please contact us if you have any questions or concerns. In the meanwhile, enjoy the summer. (And tomorrow morning we will enjoy our toast, or maybe an egg, or possibly some oatmeal, or perhaps a bowl of cereal, or …)

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