YOSEMITE CAPITAL MANAGEMENT

Third Quarter 2014 – COMMENTARY

Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves. – Peter Lynch

In our Third Quarter 2013 Commentary, we reviewed the role of bonds in a portfolio and explained that

> "A long term plan's broad asset allocation to bonds should not change simply because one believes interest rates have begun a secular rise due to the fact that ***bonds are <u>not</u> a monolithic investment category*** where the question of owning them is a binary yes or no."

We also pointed out

> "The Fed has explicitly stated they are not likely to raise [the Federal Funds Rate] until specific economic data is attained, which by their own projections may not occur until mid-2015."

Through their statements and public speeches, the Federal Open Market Committee (FOMC), the group within the Federal Reserve that is responsible for establishing Monetary Policy of the United States, has essentially guided market participants to expect an increase in the Federal Funds Rate sometime in 2015, depending on economic data as it becomes known. But the Fed has a long institutional memory and they are keenly aware they face a very tricky balancing act between conflicting ideas:

> They don't want to act too slowly and let interest rates stay too low for too long that would let asset bubbles grow (a mistake the Fed made that via unintended consequences was a notable contributor to the Great Recession of 2008-09)
>
> They don't want to act too quickly that they stifle nascent economic growth (a mistake the Fed made in 1938 that partially helped prolong the misery and severity of the Great Depression)
>
> They know inflation is difficult to contain the higher it gets, and they do not want to get burned by failing to act forcefully and timely enough to keep inflation under control (a mistake the Fed made in the 1970's)

FUTURE INTEREST RATES AND INFLATION

So given all of that, what might the country expect for interest rates and inflation? We posit some scenarios that we perceive have higher probabilities of happening based on the key assumptions that the economy continues to grow (even if slowly), domestic employment at least maintains its pace of improvement, inflation remains calm, and, as always, no serious geopolitical events occur (which cannot be known in advance except by conspiracy theorists).

The FOMC is likely to take its first step of increasing the Fed Funds Rate, presently near 0%, sometime between March and September of 2015 to 0.25%.

Further increases will probably follow, but they are not likely to be as rapid or extensive as happened in their last two post-recession tightening periods in 2004-06 and 1994. Until economic growth is more robust, they may strive to keep the Fed Funds Rate near inflation instead of above as they historically have done. Our guess is if the situation progresses smoothly (not a sure bet) the rate could be 2% to 3% within two years of starting the tightening program.

Inflation is likely to increase a small amount, perhaps to the range of 2% to 3%, for the next few years. In fact the Fed wants this to occur. Their target for the Personal Consumption Expenditures (PCE) deflator (Exhibit 1), their preferred measure of inflation, is around 2%, and the Fed has hinted they could tolerate this measure to be a little bit higher to grease the skids of economic activity. The corollary to this is we do not perceive that inflation is on the verge of advancing to the mid-single digits, let alone a repeat of the 1970's out-of-control situation.

Exhibit 1, Personal Consumption Expenditures (Implicit Price Deflator), April 1991 to April 2014

Source: St. Louis Fed

We continue to perceive a fairly benign outlook for interest rates and inflation largely because weak global growth (which caps domestic growth) is likely to continue for perhaps a few more years for two main reasons:

> The Euro zone is wrestling with problems associated with a flawed currency structure that has made their economy stagnant and on the verge of deflation (the most important problems include the need to repair crippled banks and to coordinate monetary policy, fiscal policies, and labor market reforms)
>
> China transitions to an economy that is consumer driven from one led by infrastructure development and in the process China must choose between slower but more stable growth or faster growth that entails risks of excessive credit and subsequent bust

There will likely continue to remain too much slack (underemployment, lack of aggregate demand, plenty of factory capacity, etc.) both domestically and abroad for inflation to advance too far.

MONETARY POLICY TIGHTENING

Since the United States may be on the edge of a tightening in monetary policy, two things are now starting to happen: the parlor game of guessing the exact date the FOMC will act, which we have no desire to play other than just for fun, and the renewed prattling of impending doom in the bond market, which we are eager to dispel because too many charlatans want to create fear and panic so they can sell their product.

The general notion is that when interest rates rise, bond prices fall. The logic is impeccable - but the details are extremely important.

> Some interest rates change more than others. For example, when the Fed increases the Federal Funds Rate, the rates of 90-day Treasury bills are likely to increase similarly, but those of other maturities such 10-year Treasury notes and 30-year Treasury bonds could change more, less, or even in the opposite direction. The reason is longer term bonds can be affected more by other factors beyond domestic growth and inflation, such as fiscal policy, global growth, the relationship of the dollar versus other currencies, the geopolitical situation, etc.
>
> Unlike stocks in general, to repeat a very important point, bonds are not a monolithic asset class that reacts in a broadly similar fashion. There are bonds of different maturities, different coupon rates, different quality ratings, and different risks whose prices sometimes act in opposition to each other because they are dependent on different economic situations. As a result, when various interest rates change, numerous bond investment scenarios will play out in dissimilar ways.

Investors also need to remember that rising interest rates can have positive effects. Coupon income and maturing principal are reinvested at higher interest rates, and over time this will very likely offset the effect of any initial price drop in bonds. A key concept to keep in mind is that if interest rates increase, this could very well be the result of increasing growth, obviously a very positive development desired by all good people because of the benefits of more employment opportunities, less need for government social support, and other aspects of a virtuous cycle. Higher economic growth usually leads to higher corporate earnings, which is usually good for stocks if the higher earnings have not already been discounted into the prices. Default risk is reduced, which is a factor that conceptually benefits many corporate bonds. So when the FOMC talks about raising interest rates, this should be interpreted as good news because the economy has much less need for the crutch of monetary stimulus and is actually getting stronger.

WHAT COULD HAPPEN TO BONDS WHEN THE FED TIGHTENS?

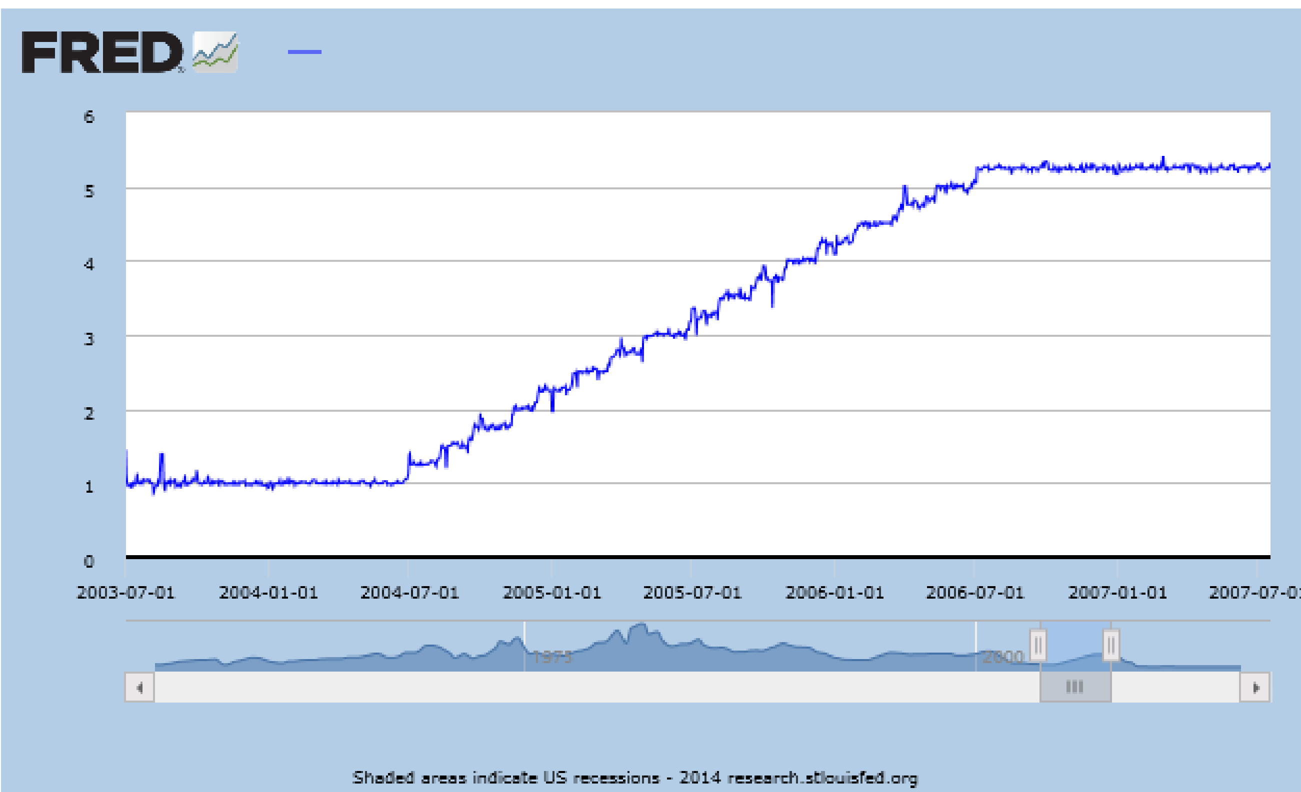
All of this leads to the question that many are asking: What might happen to the bond portion of investment portfolios? Some, but not all, bonds may have an initial price drop of a few percent over the course of a few months. How much of a drop is difficult to determine in advance because much depends on the strength of the economy, inflation possibilities, the rate of change in interest rates, the length of the period during which interest rates change, the action in other financial markets, how the global economy is faring, and other factors.

However, a review of the two most recent post-recession tightening episodes mentioned previously may be instructive as a guide because the circumstances are broadly similar: interest rates are at low levels and expected to rise, and the economy is recovering slowly from recession. Be aware that such guidance is not a prediction because, as investors should know, "past performance is no guarantee of future performance" and no two cycles are ever exact. Finally, keep in mind that *the index is not your portfolio*.

2004-2006 Episode

The most recent period of tightening by the Fed was in 2004-2006, when the Federal Funds Rate increased 450 basis points, or 4.5%, from 1% in May 2004 to 5.25% in July 2006 (Exhibit 2). (By the way, this kind of change happens to be much further and much more rapid than we presently expect for the upcoming rate increases.) Because the FOMC had been laying the groundwork for this increase prior to actually tightening, the financial markets anticipated the effects several months in advance. In fact, most of the decline took place before the tightening and the bond market actually increased during the tightening phase (Exhibit 3).

Exhibit 2, Effective Federal Funds Rate, June 30, 2003 to July 31, 2007



Source: St. Louis Fed

Exhibit 3, Barclays US Aggregate Bond Total Return and S&P 500 Total Return, March 17, 2004 to September 14, 2004

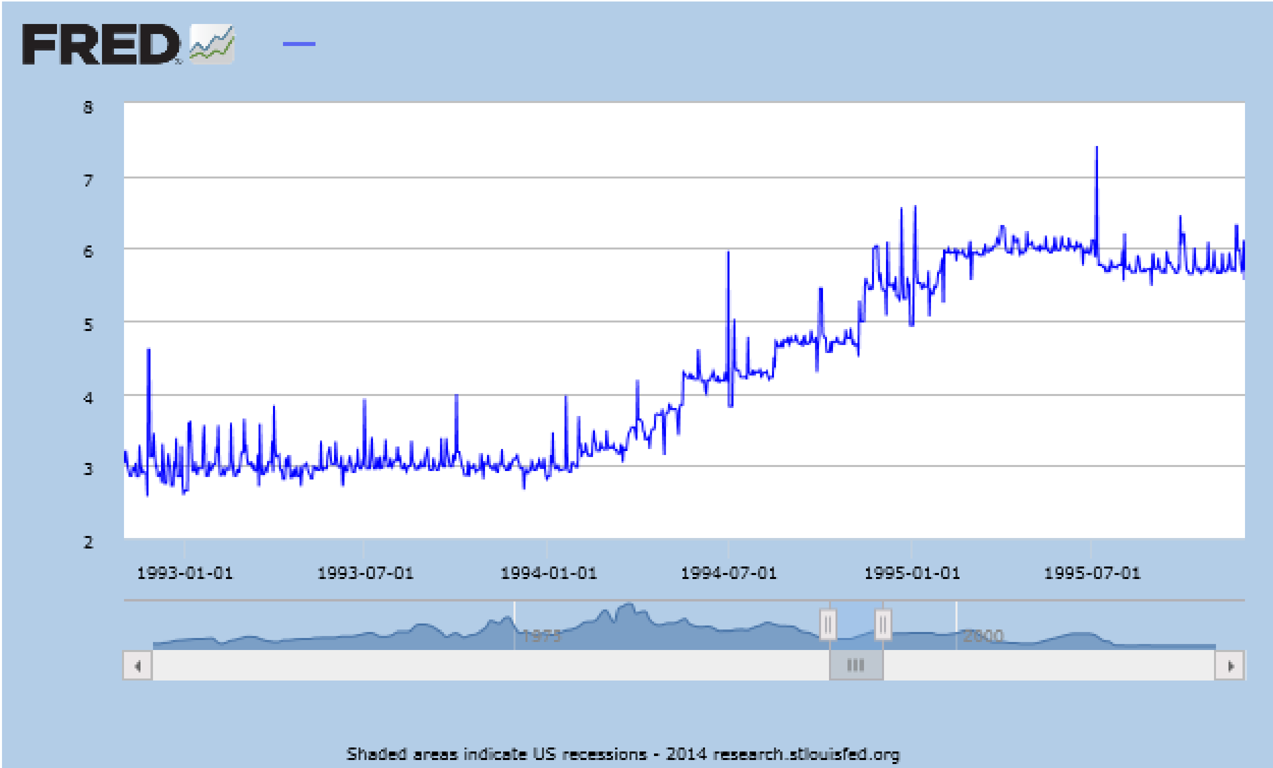
Source: Morningstar

Note that the Barclays US Aggregate Bond Index (the proxy for the broad American bond market) had a drawdown of a mere -4.4% over a period of less than two months. But the benefits of reinvesting at higher interest rates kicked in and those investors who did what they were supposed to do and stuck with their long term plan saw gains with the bond portion of their portfolio just four months after hitting bottom.

<u>1994 Episode</u>

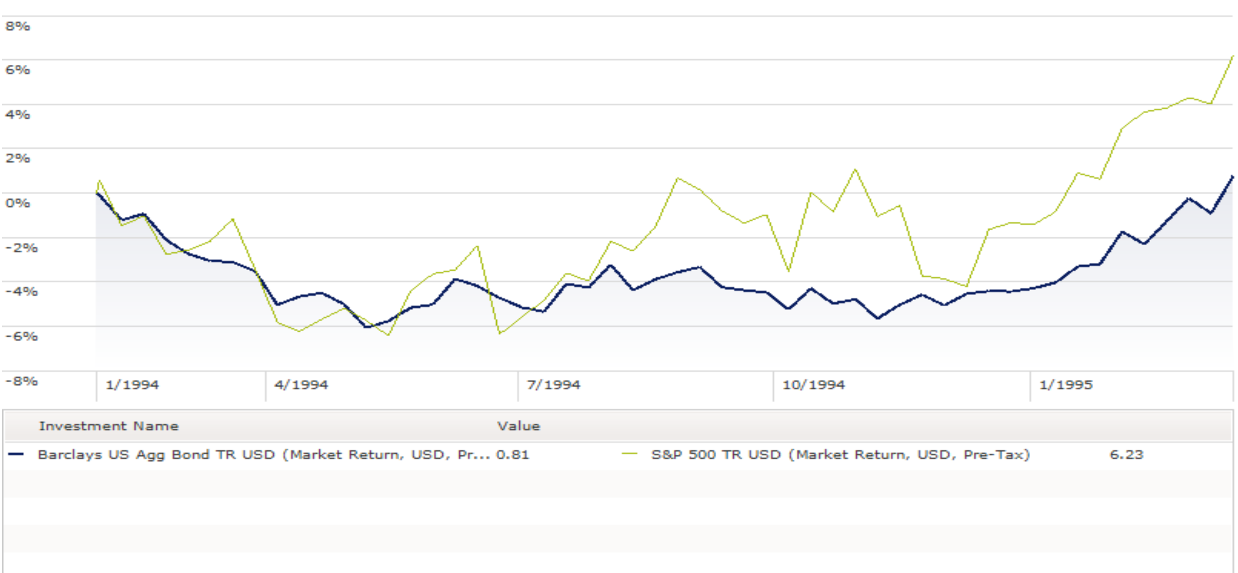
The previous post-recession tightening program occurred in 1994 when the FOMC hiked the Fed Funds Rate from 3% in February of that year to 6% over the course of 12 months (Exhibit 4). At the time the Fed did not convey their thoughts or plans in advance, so the financial markets were surprised by the move and reacted more severely. This led to one of the worst periods for bonds since the Great Depression (Exhibit 5). (The reaction in the financial markets led the Fed, then under the leadership of Alan Greenspan, to begin its policy of communicating future actions because the Fed did not want their actions to be the cause of market disturbances.)

Exhibit 4, Effective Federal Funds Rate, October 31, 1992 to November 30, 1995



Source: St. Louis Fed

Exhibit 5, Barclays US Aggregate Bond Total Return and S&P 500 Total Return, January 31, 1994 to March 15, 1995

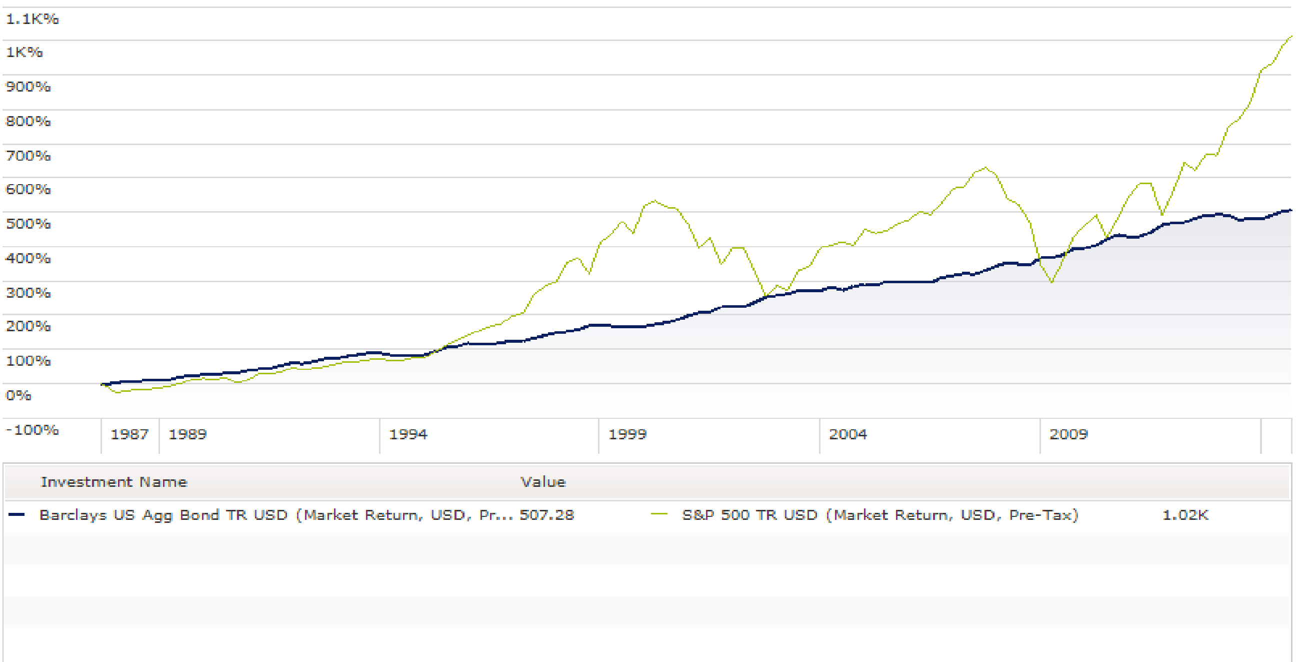


Source: Morningstar

In this case the Barclays US Aggregate Bond Index had drawdown of -6.6% over a period of a little more than 3 months. But as usual in this country, those investors who stuck with their long term plan ultimately saw gains with the bond portion of their portfolio within ten months of the bottom.

Short term negative returns that were made up relatively quickly and followed by gains are depicted in the chart below (Exhibit 6).

Exhibit 6, Barclays US Aggregate Bond Total Return and S&P 500 Total Return, September 4, 1987 to September 8, 2014



Source: Morningstar

Note how both drawdowns resulting from these tightening episodes have clearly been proven inconsequential over time, absolutely and especially relative to the volatility of the stock market. ***Monetary policy tightening and rising interest rates does not mean bond or stock market Armageddon!***

PERSPECTIVE AND LESSONS

As with almost anything in the financial markets, some perspective is necessary.

> *Declines in the bond market are usually shorter and milder than those of the stock market.* A bad year in the bond market is like a bad week in the stock market. One of the worst drawdown in the bond market since the Great Depression (6.6% in the 1994 example above) was limited and less than a routine annual correction of 10% in the stock market. Those who several years ago scared themselves into positioning the bond portions of their portfolios for higher interest rates by exclusively owning short term bonds or variable rate bonds have cost themselves dearly as the opportunity cost so far has been much higher than their actual gains.

> *Investors are likely to recoup the initial price drop over what could be a relatively short period if they keep their investment time horizon in mind.* Any initial price drop below par (the price at which most bonds are sold when originated) is temporary because bonds mature at par and the proceeds are

reinvested at higher interest rates. There is a loss only if one panics and sells, and in the process wrecks a long term plan over a short term minor disturbance.

Income from bonds continues to be paid out and will eventually increase as interest rates rise. Bonds are usually in a portfolio for income from interest payments and generally not for capital appreciation. The interest payouts are not affected by a price drop, which means the cash flows to a bond investor continue uninterrupted. As rates move to higher levels and as maturing bonds are reinvested at those higher rates, the interest payments paid to bondholders will eventually increase. (The obvious exception to uninterrupted interest payments occurs when a bond issuer defaults, but as stated earlier an improving economy reduces the chances of this happening.)

One key assumption for the aforementioned limited damage to bond portfolios when interest rates rise is that inflation stays relatively low, which is what we expect as we explained earlier. If inflation gets out of control and rises to the high single digits and beyond, the effect on bonds will be more severe than we described. Memories of this occurring in the mid-1970's to early 1980's haunt those who lived through this period and are reasons for the knee-jerk reaction of equating rising interest rates with an immediate need to abandon bonds.

SHOULD INVESTORS MAKE CHANGES TO THEIR PORTFOLIO?

Investors might question if they should sell bonds that could fall in price and buy other bonds or go into stocks or cash instead. The short answer is that trying to avoid small temporary declines are simply not worth the effort, angst, and potential opportunity cost.

There are many reasons for, but perhaps the most important is that no one can consistently predict the future with any degree of precision. The Fed itself does not know exactly when they will raise interest rates. Logically no one else can either. Thus if one sells too soon, as many already have, they miss out on continuing gains that happen in the meanwhile that more than make up for avoiding any temporary declines. If one sells too late, as inevitably many will and possibly in a panic, they may miss out on the market recovery. Regardless of selling too soon or too late or just right, selling requires a second decision of when (and what) to buy at another point in time. Making one such decision correctly has low odds of being effective, so making two such decisions correctly by definition has dramatically lower odds of being successful.

Because there are different types of bonds with different features, as explained earlier, the various segments of the bond market may react in dissimilar fashion. It is not possible to reliably predict the extent of such reactions in numerous bond categories in advance.

As noted, the Fed has been quite clear about their broad intentions and current prices may already reflect at least some of their initial changes in policy. If this is the case, the efforts to avoid small temporary declines are even riskier because the reward (if any) is so much smaller.

Selling bonds and buying stocks with the proceeds may or may not prove worthwhile because stocks are affected by many more and different factors. Most important are corporate earnings and valuations, and we are not aware of any correlation between these two factors and Fed tightening that suggests any sort of reliable outcome. Note that in both the 2004-06 and 1994 episodes, stocks had negative returns that for a brief period were worse than bonds, though as shown were to differing degrees.

These reasons demonstrate the importance of asset class diversification in an investment portfolio. Since no one can know how the future will unfold, the best approach is to invest at least somewhat broadly, let the markets do what they do, let others panic if they must, ignore or preferably take advantage of the short term fluctuations, and adhere to the long term plan. History shows this has worked before and we remain highly confident this will continue to work in the future.

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