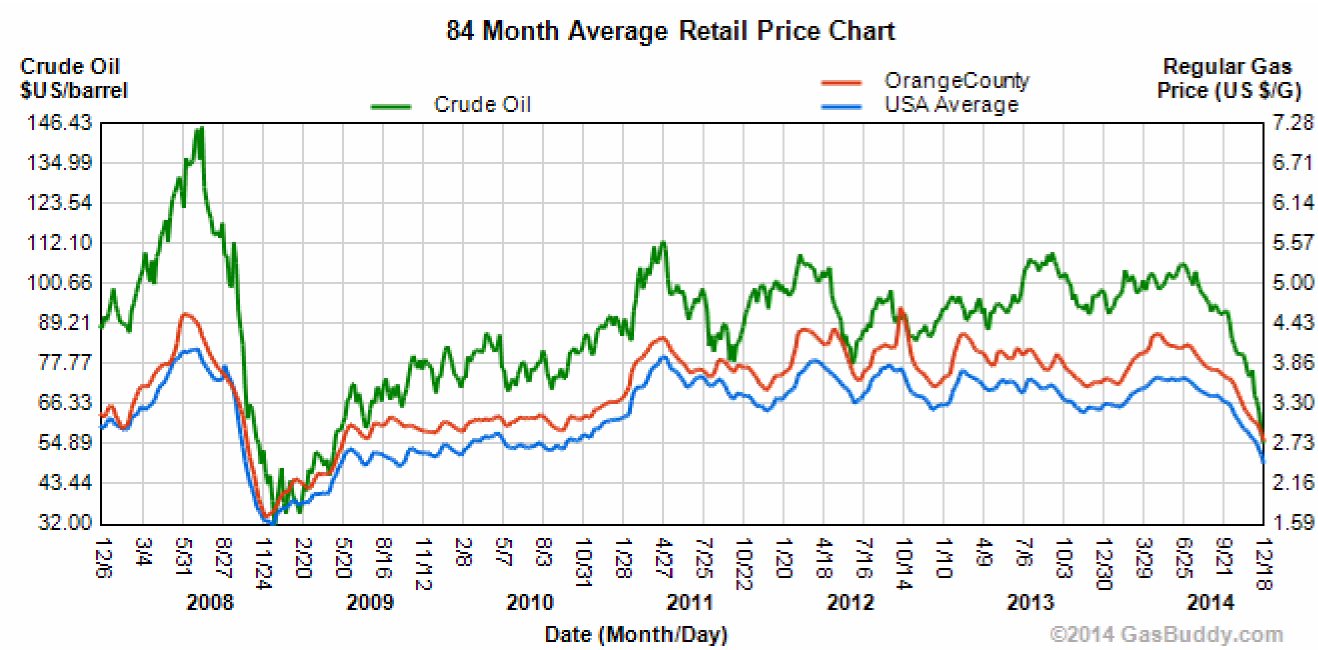
YOSEMITE CAPITAL MANAGEMENT

Fourth Quarter 2014 – COMMENTARY

Be careful what you wish for – you just might get it. – Anonymous

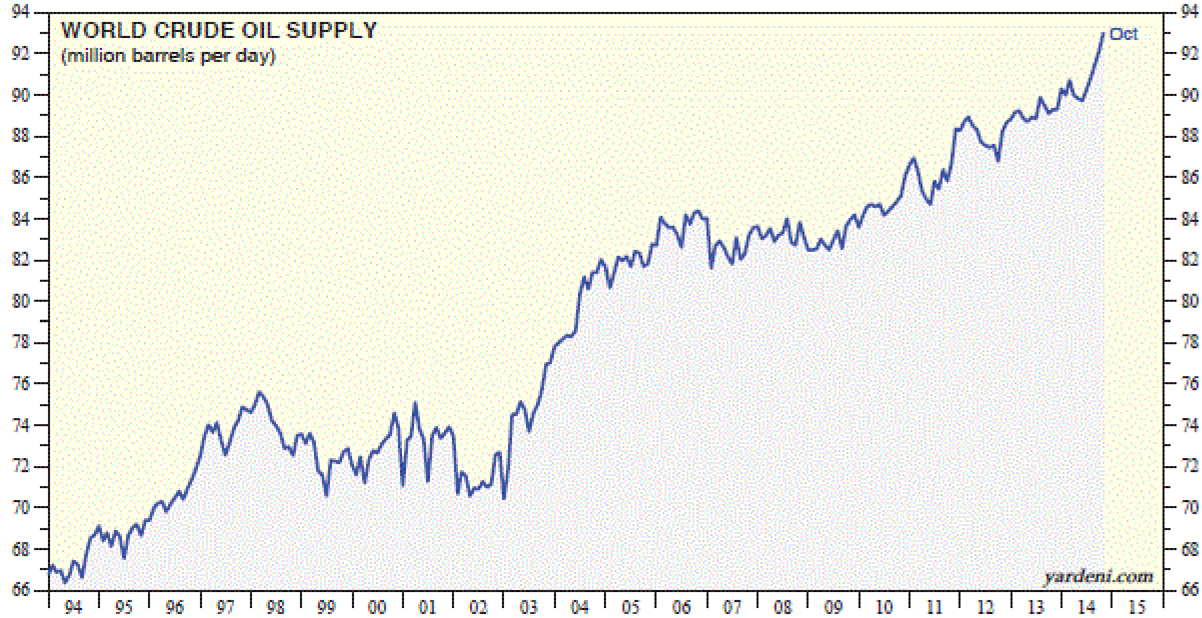
The price of oil has fallen to a remarkable extent, probably far more and far quicker than even the most bearish of oil bears could have imagined (Exhibit 1). As usual with anything in the economy, this is not happening for one reason but is instead due to a combination of supply and demand factors. On the supply side, perhaps most notable is the huge increase in domestic production as a result of fracking technology in Texas, North Dakota, Ohio, Pennsylvania, and elsewhere. The increase has more than offset any loss of global supply due to sanctions on Russia and any lack of production in Iraq or Libya (Exhibit 2 and Exhibit 3). The demand side is a bit trickier to analyze, though productivity gains in the American economy (the world's largest user of energy) play a part (Exhibit 4), as does the reduced demand due to slower economic growth in China and Europe.

Exhibit 1



Source: GasBuddy.com, December 18, 2014

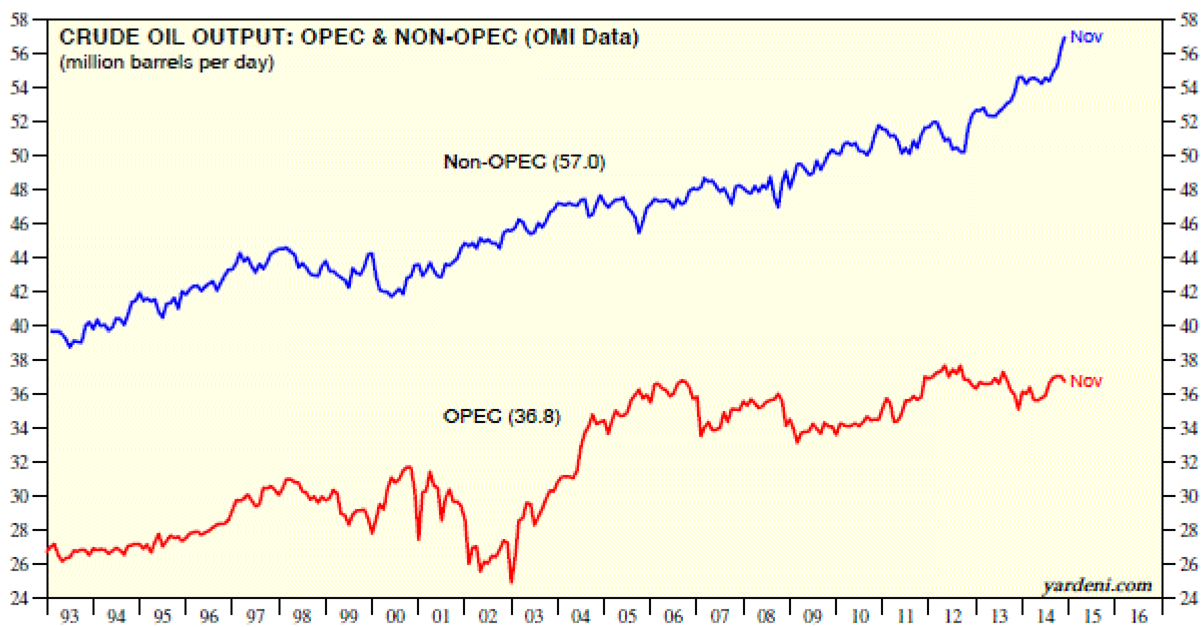
Exhibit 2



Source: Oil Market Intelligence.

Source: Dr. Ed's Blog, November 25, 2014

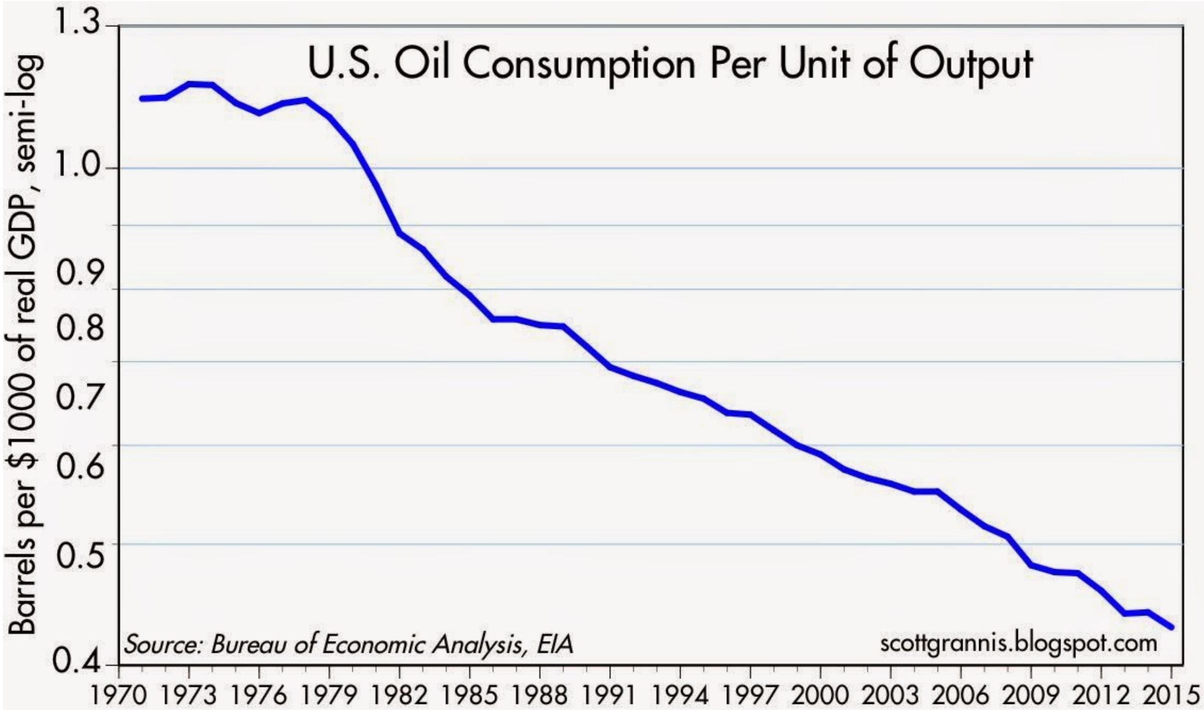
Exhibit 3



Source: Oil Market Intelligence.

Source: Dr. Ed's Blog, December 18, 2014

Exhibit 4



Source: Calafia Beach Pundit, December 10, 2014

For the American consumer, this is a gift in the form of lower gasoline prices that allows more money to be allocated to debt reduction, saving, or spending on consumer goods (Exhibit 1). (We will leave it up to the reader to make their own judgment as to the most likely choice(s) the average red-blooded American will pursue.)

For many businesses, perhaps most notably the airlines, a significant cut in one of their major costs allows for greater profits, though the timing is usually delayed and the extent will vary depending on any hedges they may have in place that locked in certain prices for a while. If the larger profits are sustainable over the longer term, they allow for several corporate options, alone or in combination, including larger dividends, increased capital investment, higher pay to employees, less urgency to cost-cutting and greater hiring. And whether the larger profits are sustainable or just short term, they also give companies a choice of share buybacks and bigger bonuses to upper management. (We will leave it up to the reader to make their own judgment as to the most likely choice(s) the executives will pursue.)

The same benefits are true for many foreign countries. In particular, China's transition from an investment-driven to a consumer-driven economy will likely be made a bit easier because of lower energy prices. However, this transition will very likely still be difficult and rocky for that country. As a major net user of energy, Europe will also benefit. In particular, for those countries in the Euro-zone any help at all in extricating themselves from the morass of their flawed currency union is welcome and lower energy prices will likely act as a much-needed stimulus.

As a global commodity, oil is traded mostly in American dollars. Falling oil prices have been a more recent contributor to a stronger dollar (Exhibit 5). For Americans, a stronger dollar helps importers, companies with insignificant overseas revenues, and many vacationers to international destinations. A stronger dollar also attracts capital from foreign investors, the bulk of which is usually directed into US Treasury bonds and notes as well as common stocks of large companies (such as those that comprise the S&P 500), which in turn may lead to continued low interest rates and higher stock prices.

Exhibit 5

Trade Weighted U.S. Dollar Index: Major Currencies

Source: St. Louis Fed, December 11, 2014

The combination effects of a stronger dollar and lower oil prices could also help to keep inflation low. Low inflation may allow the Fed to postpone raising the Federal Funds Rate for a while, perhaps into late 2015 or even 2016 depending on how the rest of the situation plays out. Finally, all of these factors combined could lead to real GDP growth increasing from current levels.

So we have lower energy prices, higher corporate profits, a stronger consumer, lower interest rates, higher stock prices, low inflation, and a stronger economy. This sounds perfect!! What's not to like?!?

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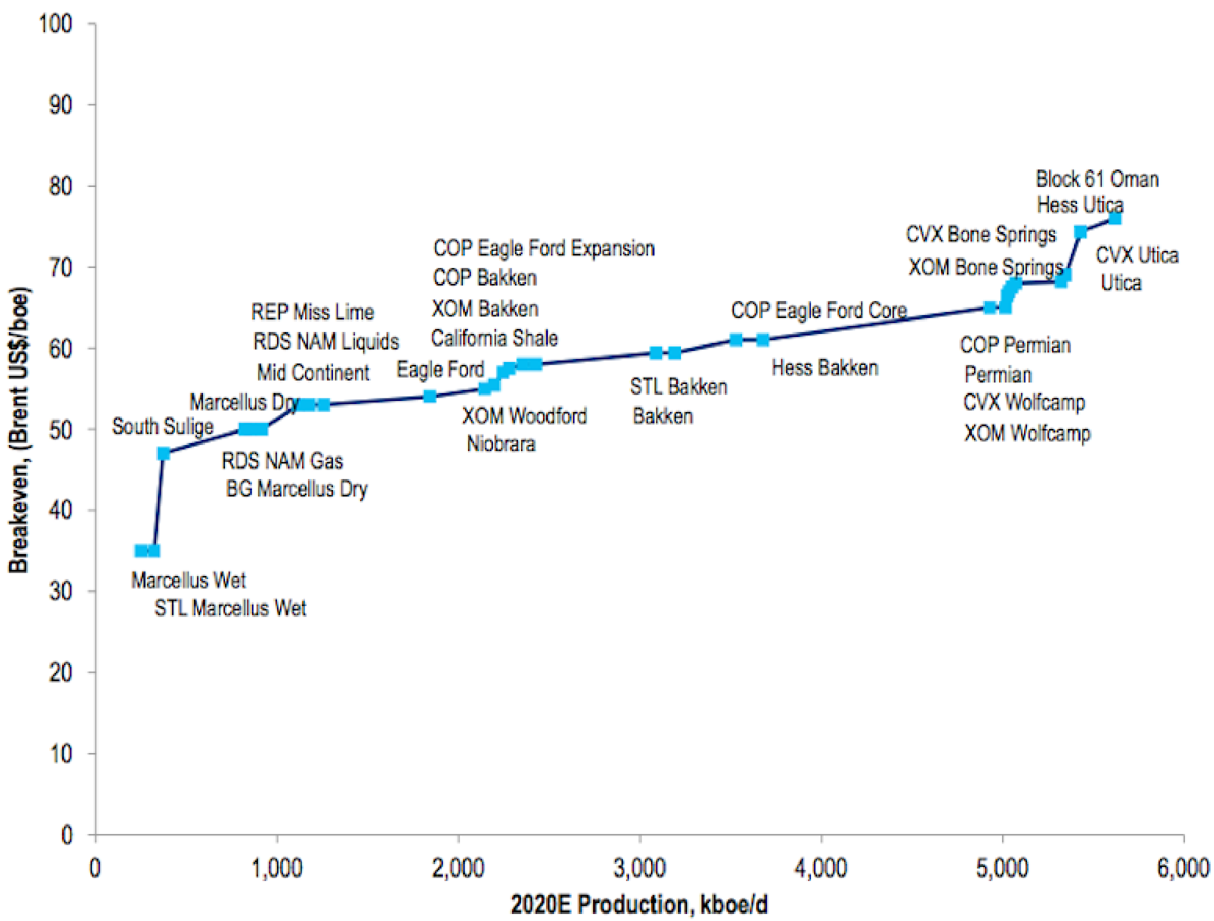
Alas, dear reader, before you reach for that eggnog with your favorite additive to toast what may seem to be a bright new year with the economy reaching nirvana, we must consider the other side of lower oil prices. All things are inter-related, and ***there are consequences to every action***. The lower prices of crude oil could cause cracks in parts of the global economies and financial markets, and the rapidity of the decline could cause those cracks to be more extensive and deeper than if done in a more orderly manner.

While it is true than many benefit from lower oil prices, it is also true that lower prices are a detriment for others. To begin with, understand that all oil fields have a breakeven cost of production (Exhibit 6). If the price of oil stays below that cost, the logical action to take is to shut down production and fire the employees. This in turn will have a ripple effect that spreads to businesses that supply the oil producers, their suppliers, and the ancillary services in the communities where all of this business occurs. Done broadly, oil supply would decrease and unemployment would increase (which may or may not offset employment gains from elsewhere).

Exhibit 6



Source: Business Insider, November 28, 2014

Other industries are also negatively affected to one degree or another. Cheaper fossil fuel prices reduce the demand for solar power and other alternative energy sources. Similarly, demand for new pipelines is reduced as these become uneconomical to build and operate, thus affecting any companies associated with this kind of endeavor.

Stocks of energy-related companies could decline as their revenues and earnings decrease, and this ultimately could be a net drag on the broad stock market indices. Recall that in the 2000-03 dot-com bust, falling technology stocks ultimately had an impact on the rest of the stock market, and a similar phenomenon occurred in the 2007-09 credit bust when declining financial stocks eventually infected the whole stock market (though there were many more factors at play in that era). How much a hurting sector will affect the entire stock market is probably impossible to determine in advance, as it was in all previous such episodes in history and epitomized by the 2007 phrase "the sub-prime crisis is contained".

Bonds of energy-related companies could also be affected, with perhaps the most serious damage done in the junk bond market. The unanswerable question is about where any secondary damage will occur, which means any bank or hedge fund that may implode as a result of holding too many of those securities or derivatives associated with them.

Globally, the economies and government budgets of some countries are extremely dependent on the energy sector. A sampling of these countries includes Saudi Arabia, Russia, Iran, Iraq, Venezuela, Libya, and Algeria. Saudi Arabia could hold its breath longer than most due to its established infrastructure, oil reserves, low cost of production and large foreign currency reserves, but others cannot. A sustained drop to lower oil prices could have a devastating effect on the people of those places via higher unemployment, cuts in government services, and, depending on other circumstances, civil unrest. All of these could have ramifications that affect the rest of the world. This is especially disconcerting where those in power are pushed against a wall and believe their only response to save their countries - and in reality themselves - is some sort of military adventure.

The stronger dollar also exacerbates the economies of many emerging markets even if they don't rely on oil, especially those who have debt denominated in foreign currencies, have insufficient foreign reserves, or have economies dependent on exporting commodities. High inflation and/or recession are very real possibilities for those countries as lack of internal growth combines with their customer countries facing slowing growth or worse. And this is on top of the known fact that China, a huge customer base for many emerging countries, is guiding itself to slower growth and therefore lower demand.

To bring these possibilities full circle, American exports are at risk when people in other countries are in no position to buy them, and therefore this becomes yet another factor that could further restrict domestic growth. Recessions in foreign countries are a further inducement to offshoring more labor and capping the nascent reshoring movement, which obviously limits wage growth, employment gains, and therefore domestic growth.

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We do not present all of this to scare you. Rarely is anything associated with the economy or financial markets a strict either/or proposition. ***Reality is usually somewhere in the great middle***.

In the commodities trading pits, there is an adage that "the best cure for high prices is high prices" or the alternate "the best cure for low prices is low prices". This is a way of saying that extreme prices cannot continue indefinitely and that one way or another the world will adapt and prices will eventually reverse to a range that is more moderate. Remember the fears of just a few short years ago about "peak oil" and how oil was easily going to cost $200 a barrel? Now just a bit later the world has an oil glut and there is talk of $40 oil. How and when adaptations occur and when and to where prices change are usually not predictable with a great deal of accuracy. Until these happen there will be casualties along the way, but when they happen the consequences will be dissipated.

> As an aside, the fact that economies eventually adapt to changes in supply and prices of commodities is a major reason why, as history demonstrates, ***a long term position owning commodities in a portfolio is a horrible idea***. Note that this is very different than a short term speculation that occasionally under specific circumstances can be worthwhile.

None of this has to mean disaster for investment portfolios. To any extent that people believe the last six years in the markets were normal (they were not!) we suggest that market participants ***lower their expectations*** to more realistic total returns. Remember that portfolio returns that average in the mid to high single digits will still meet realistic long term goals.

We suggest that volatility could increase, in part simply because for the past three years the S&P 500 has had abnormally low volatility and this aspect will simply revert to normal. Consider that ***high volatility is an investor's friend*** because the market is merely providing opportunities to make portfolio adjustments.

Finally, somewhere in the future there will be a bear market, whether it stems from the current circumstances or something else, and whether it is next year or the year after or several years from now. Regardless of when it occurs, bear markets are a fact of life and have **always** been a part of the investing landscape. We may or may not be able to avoid this, but we do know that this country has a 100% record of recovering from any such beast and we firmly believe this record will stay intact. Thus the long term direction of the American financial markets very likely remains upward.

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All of us at YCM wish you and your families a very Happy New Year. Indeed, we as individuals will reach for an eggnog (with or without an additive) and have our own private toast to you, our clients and friends.

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We remind clients and friends that all of our commentaries are available on our web site (http://www.YosemiteCapital.com/News-Commentary). As always, please contact us if you have any questions.

John Kleponis, CFA

Chief Investment Officer

Paul H. Heckler

Managing Director

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