Y O S E M I T E C A P I T A L M A N A G E M E N T

Fourth Quarter 2015 – COMMENTARY

The future ain't what it used to be. – Yogi Berra

In this Commentary, we cover the following points:

Economic growth in the United States in recent years has been slow due to the credit bust, the inevitable result of a credit bubble. ***Slow growth is normal following a credit bust***.

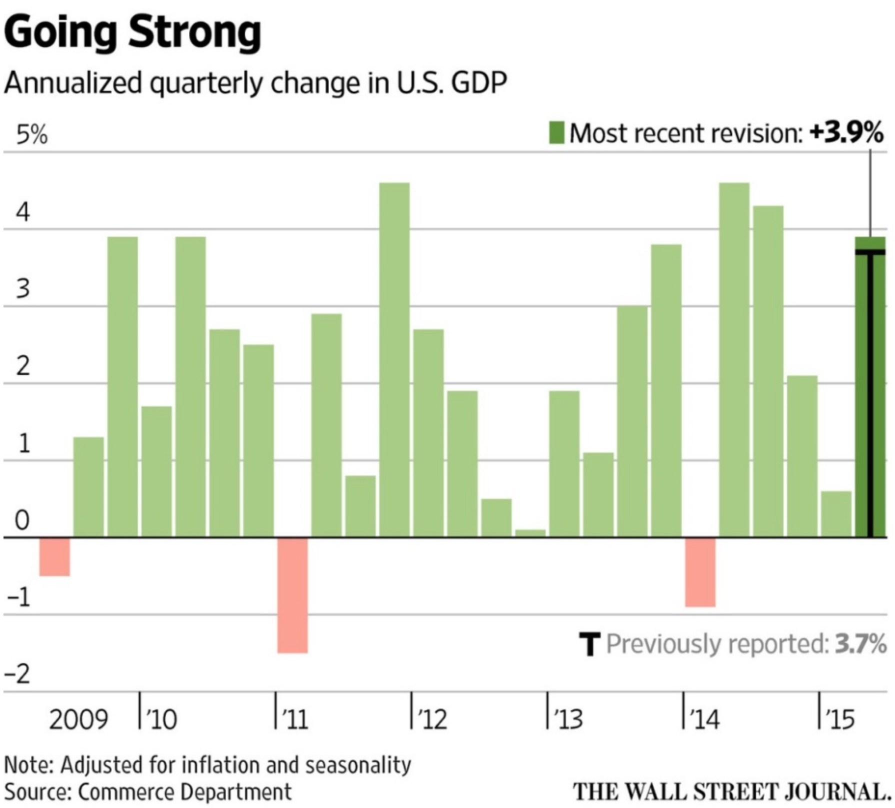
Domestic economic growth in the next few years is likely to remain somewhat slow due to lingering effects of the credit bust, demographics, and the state of the global economy, particularly driven by the situations in China and the Eurozone.

There is the potential for a slightly higher growth rate due to favorable demographics of a rising prime working age population and a rising age 30 to 39 segment that is a key driver of a stronger housing market.

The economy of the United States has grown slowly, averaging about 2.2% per year, in the period of time since the end of the Great Recession in June 2009 (Exhibit 1).

Exhibit 1, Annualized quarterly change in U.S. GDP

Real GDP has averaged about 2.2% since the end of the Great Recession



Source: Wall Street Journal, September 25, 2015

The reason for the slow growth stems mostly from the fact that in 2007-09 the economy did not experience a simple routine cyclical inventory recession, which is a punch in the gut that leaves us temporarily stunned but the pain soon goes away. Instead there was a credit bust, the drying up of free-flowing capital in the circulatory system of the economy, which is a massive heart attack that is fraught with danger unless properly treated with major surgery and requires years to fully heal.

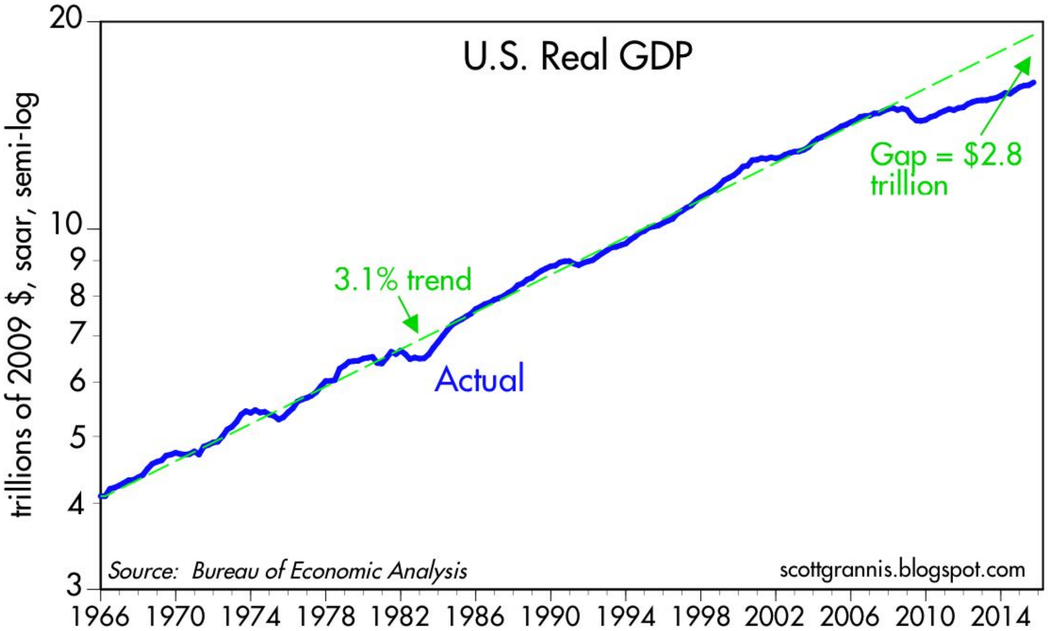
We explained this in our Commentary from First Quarter 2010, early in the recovery. We specifically stated "the pace of recovery could remain painfully slow for a long period" and highlighted "a prolonged period of consumer deleveraging" as a major impediment to future growth.

http://www.yosemitecapital.com/news-commentary/send/2-ycm-commentary-pdf-archive/4-2010-q1-commentary

After a credit bust, which is the inevitable result of a credit bubble, the economy is essentially broken and needs to be reassembled. In this circumstance recovery necessarily takes years and has a drawn out period of below-trend growth (Exhibit 2).

Exhibit 2, U.S. Real GDP

Recoveries from credit busts are slow and require years for the economy to heal



Source: Calafia Beach Pundit, September 23, 2015

Fortunately credit busts are rare in the modern era of the United States, the previous having occurred in the Great Depression in the 1930's. But the damage wrought by such busts highlight the need to do everything possible, from strong business risk controls to sensible regulations, in order to prevent credit bubbles from forming in the first place. This is especially applicable to the banking and finance sector, whose large institutions still remain a clear and present danger to the global economy.

Pundits who lament the current weak recovery expecting a recovery of the type associated with routine cyclical recessions either don't understand economics, don't understand the present situation, or are non-thinking lizard-brained political hacks.

Six years on, a valid question is "What might future economic growth be?" Our bottom-line prognosis is that ***odds favor growth to continue, but the pace is likely to remain muted for at least a few more years***. If things go well the American economy might average a real GDP growth rate somewhere in the range of around 2.5% to 3% per year, with most quarterly reports falling in an annualized rate range of 1% to 4.5%. But to expect a sustainable return to the historic annual rate of 3% or more in the next few years is highly unlikely (though we would be happy to be proved wrong with this positive surprise). This may be disappointing, but be reminded that positive growth is better than stagnation or decline (ask an average citizen of Greece).

There are numerous factors that weigh on the economy and prevent stronger growth. We will focus on three of them and point out some areas of optimism for slightly faster economic growth rates in the next few years:

Lingering effects of the credit bust

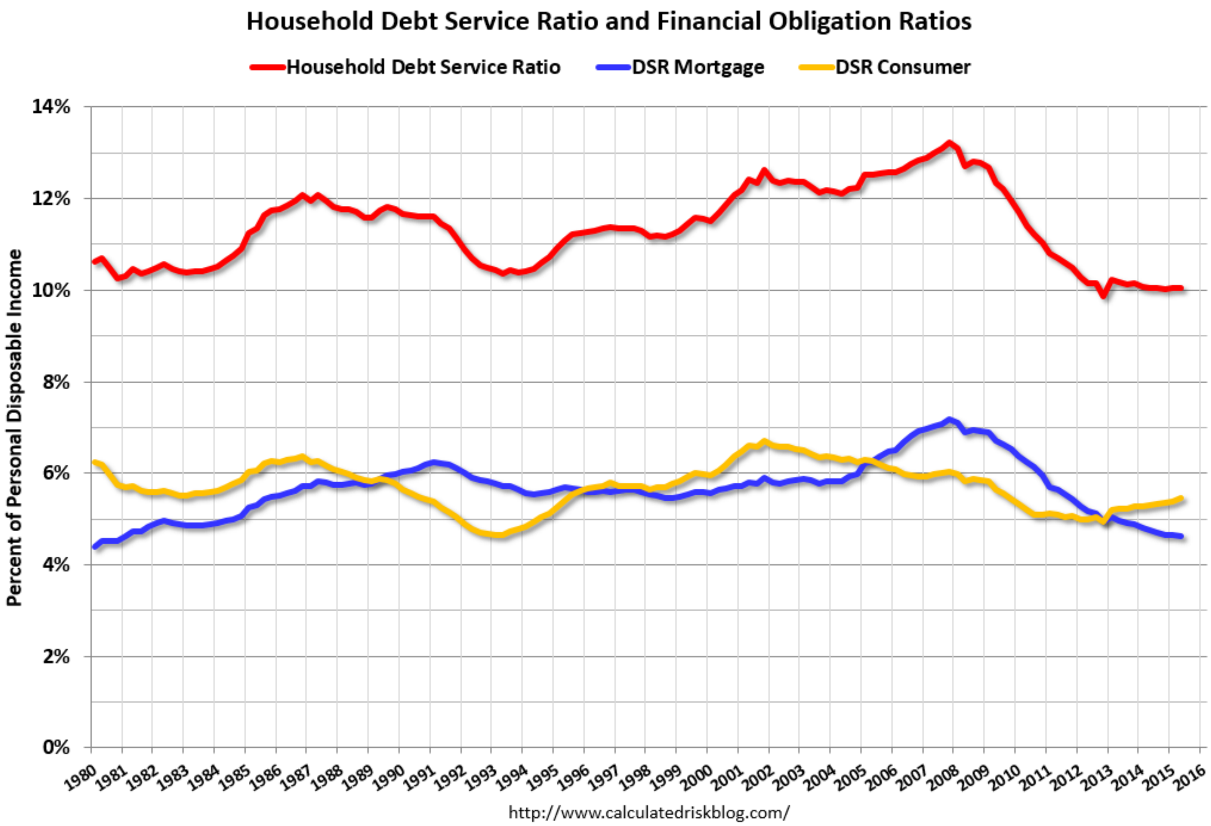
Demographics

The global economy

LINGERING EFFECTS OF THE CREDIT BUST

The good news is that consumers have cut back on their expenses and paid down much of their debt, so debt service ratios (DSR) are down to manageable levels (Exhibit 3). This bodes well for the future because the deleveraging that has been weighing on the economy is mostly, but not completely, finished.

Exhibit 3, Household Debt Service Ratio (DSR) and Financial Obligation Ratios
Debt service ratios (DSR) are down to manageable levels

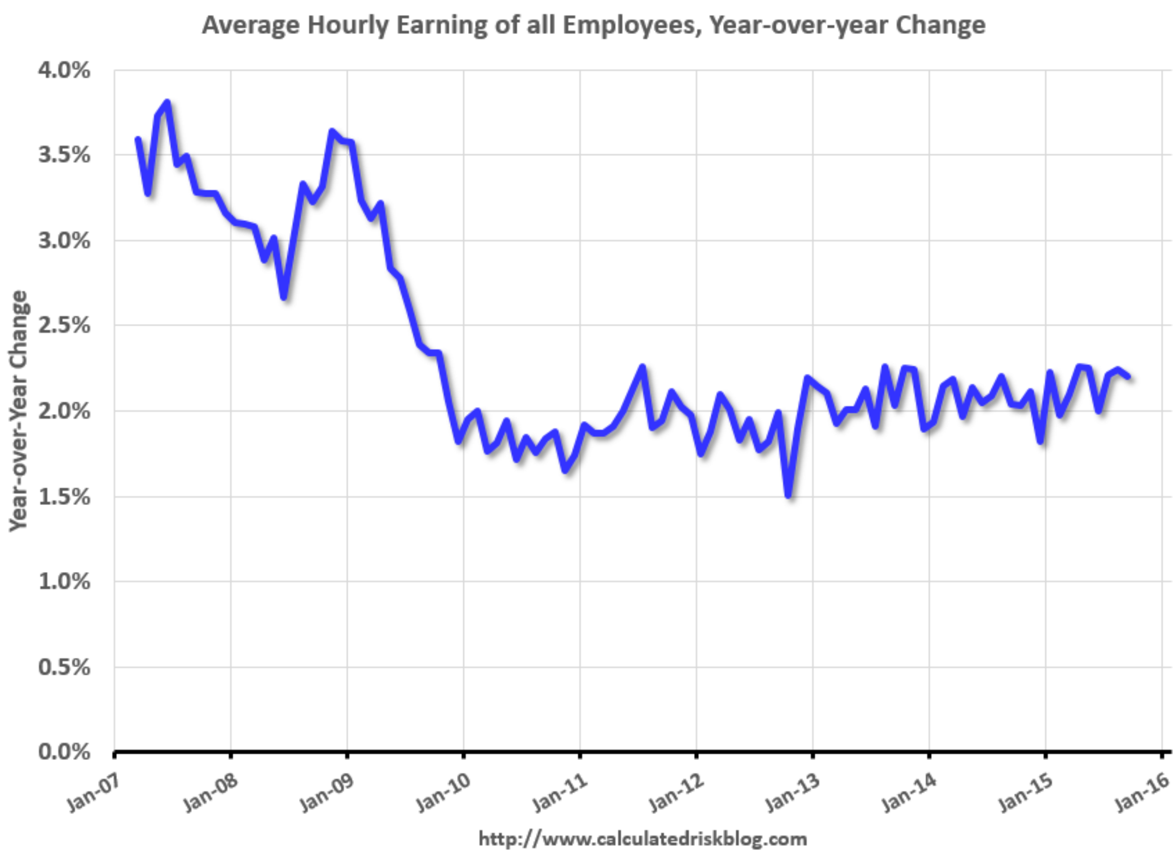


Source: Calculated Risk, October 6, 2015

In spite of lower DSRs, there are still many consumers struggling. Rising student loans are casting an ominous shadow, and in many parts of the country housing prices still have not sufficiently recovered to erase negative equity and prevent foreclosures. Perhaps most significantly, wages, the driver of consumer spending, are growing at an anemic pace for the middle and working classes (Exhibit 4).

Exhibit 4, Hourly Earnings of All Employees

Wages, the driver of consumer spending, are growing, but at an anemic pace



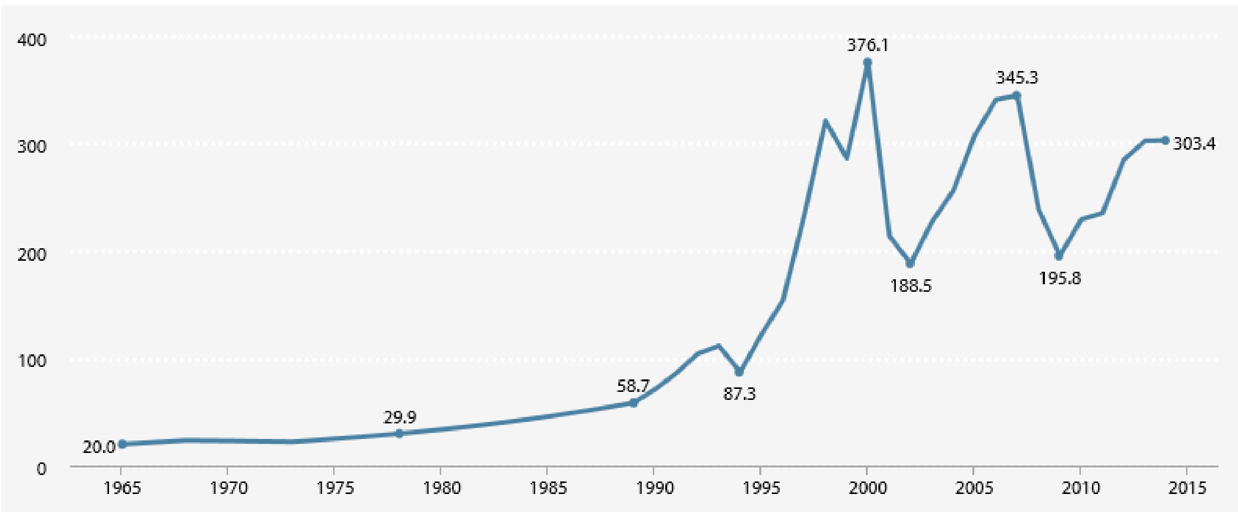
Source: Calculated Risk, October 2, 2015

Part of anemic wage growth is that many can find only part time jobs while others are constrained for various reasons from moving to better jobs. Businesses do not feel comfortable investing for future growth because they perceive risks are too high that such investment might not pay off. Thus there remains the continued vicious cycle of corporations hoarding cash and not investing in plant or people, with the result that wage growth remains sluggish. All of this is why the seemingly low unemployment rate, while welcome, is not a great cause for celebration for the average consumer or the economy.

<*Sarcasm on*> There is some good news on the compensation front, as the executive management teams all around the country have recovered nicely to resume taking their rightful share of the spoils of the economy out of the hides of their employees and customers. Providing outsized rewards to top management is, after all, the one true purpose of a company (Exhibit 5). <*Sarcasm off*>

Exhibit 5, CEO-to-Worker Compensation Ratio, 1965-2014

The concentration of wealth continues to increase



Source: Economic Policy Institute, June 21, 2015

DEMOGRAPHICS

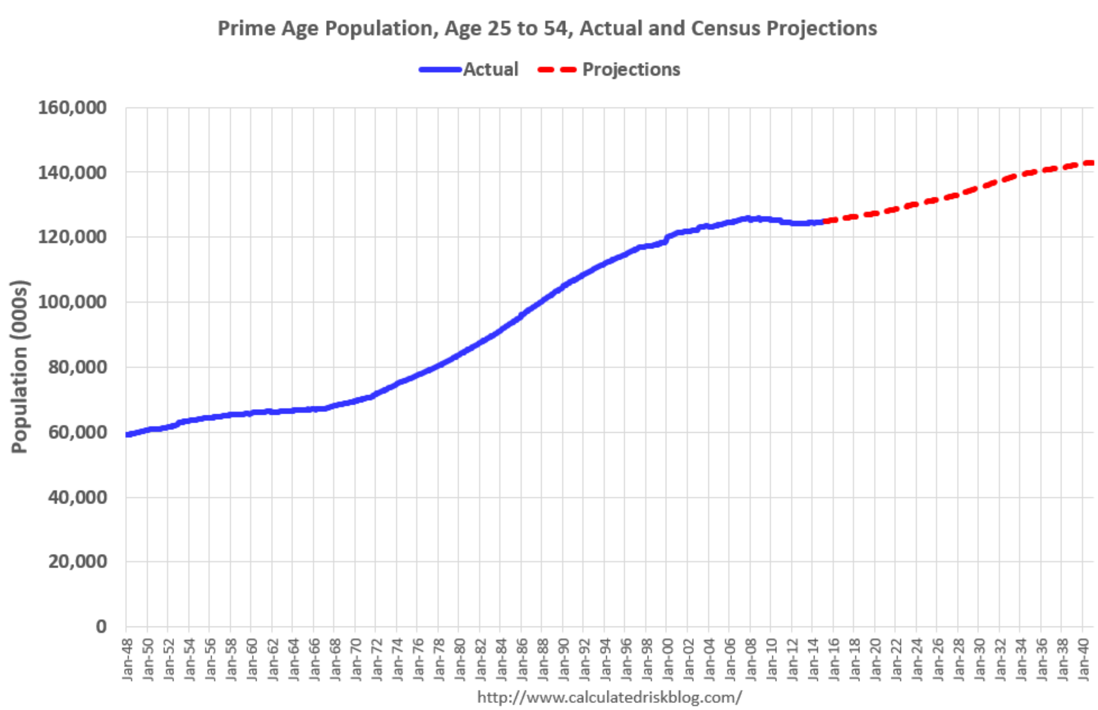
Very broadly, economic growth increases due to the combination of increases in the labor force (via births and net immigration) and higher productivity. Assessing the future size of the labor force is fairly easy because births are known and immigration can be roughly estimated. But future productivity cannot be predicted because productivity gains cannot be controlled and tend to occur irregularly.

The prime working age population of ages 25 to 54 contains a very important subset of the labor force and a key driver of economic growth. This contrasts with the younger cohort that has a high percentage staying in school longer and the older cohort that contains a high percentage that are retired or semi-retired.

In the United States, the prime working age population was basically flat over the past ten years. By itself, this suggested that the rate of economic growth was likely to decrease anyway from the prior period, Great Recession or not. The good news is ***the prime working age population has begun to increase again and could contribute to a slightly higher economic growth rate*** (all else equal) (Exhibit 6).

Exhibit 6, Prime Age Population, Age 25 to 54

The prime working age population has begun to increase again



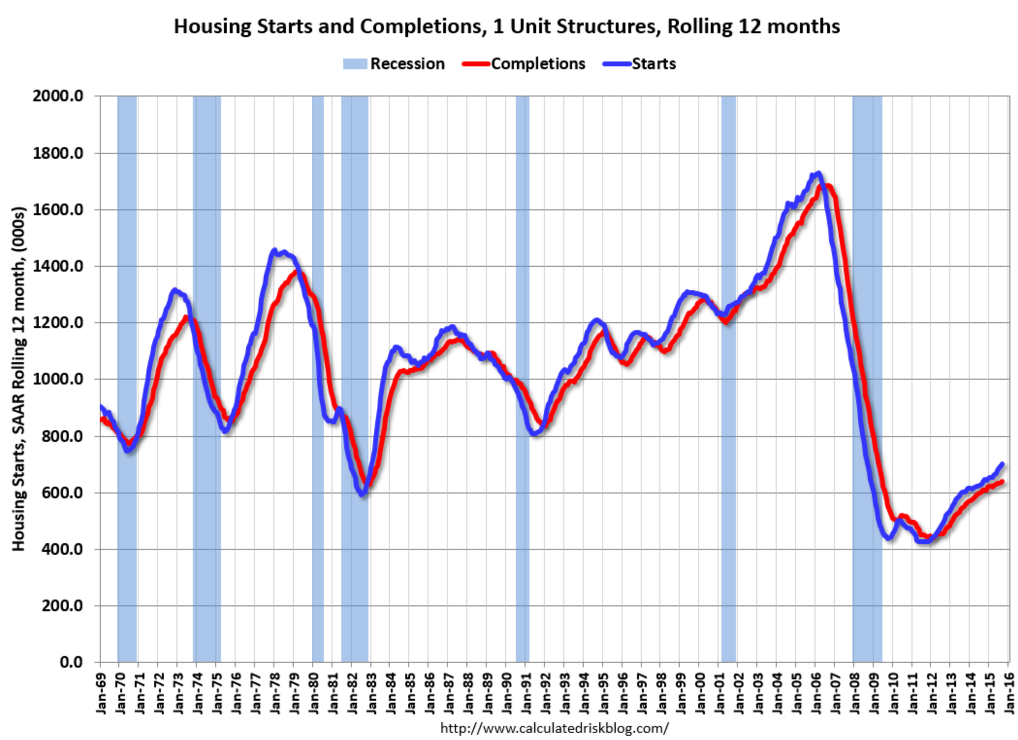
Source: Calculated Risk, May 7, 2015

New residential housing construction, particularly new single family homes, has been a key driver of economic growth in the past. This happened because of the ripple effects of hiring skilled workers to build the houses, the increased demand for supplies for the houses, and buyers of housing spending on furniture and other goods to fill their new abodes. In comparison, sales of existing homes add very little to economic activity.

Construction of new single family homes has been hampered by lack of demand. Millennials are getting married and starting families at later ages than previous generations and have not been forming new households as might normally be expected. Additionally, many have crushing student debt loans that impact saving for a down payment. Lack of demand for starter homes restricts move-up groups and the rest of the housing chain, many of whom themselves are held back by lack of equity as large parts of the country have not benefitted from rising prices. The result is that home builders have built fewer but higher-priced homes. Thus housing starts and completions, a traditional driver of economic growth, though off its lows of a few years ago, remain far below their historical averages (Exhibit 7).

Exhibit 7, Housing Starts and Completions, 1 Unit Structures

Housing starts and completions remain far below their historical averages

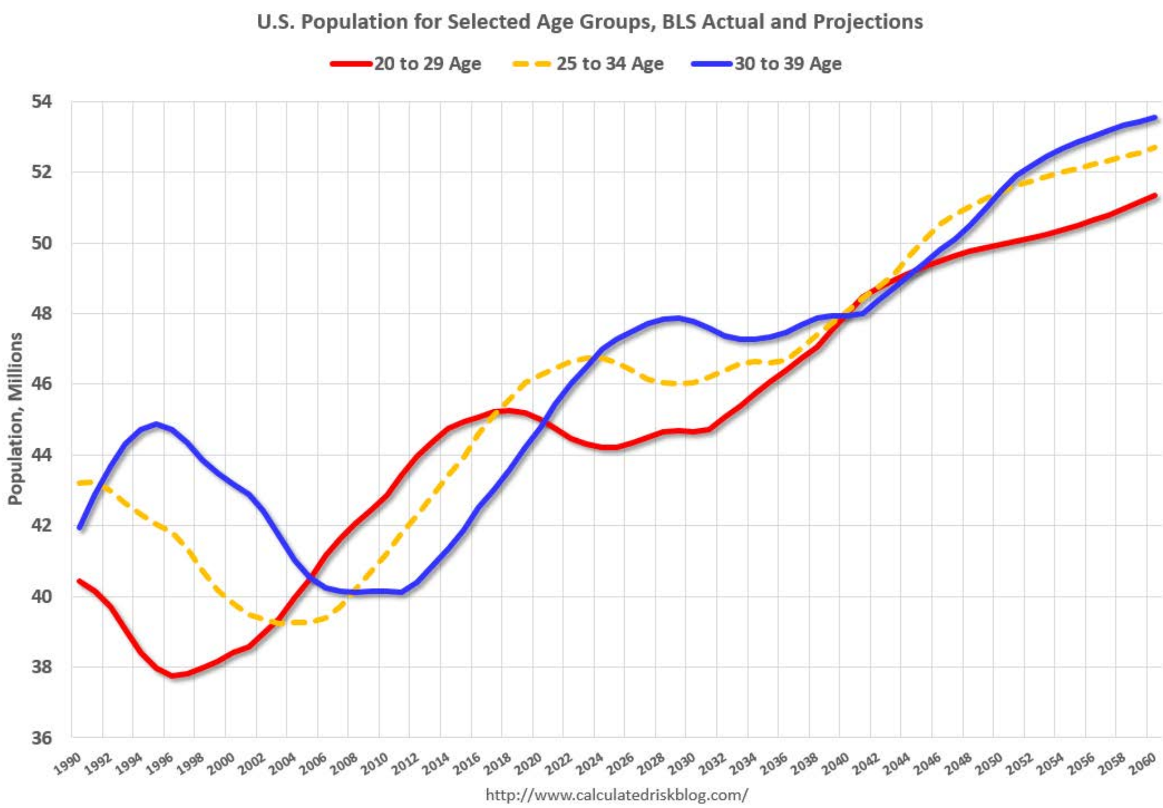


Source: Calculated Risk, October 20, 2015

For single family homes, a key demographic is the 30 to 39 age group. As this group grows, demand for starter and move-up homes increases as the delayed effect of starting new households dissipates. The good news is this segment of the population is growing and is expected to continue to grow substantially for the next 15 years or so. ***A growing 30 to 39 age group is likely to cause single family housing construction to increase and thus contribute to a slightly higher economic growth rate*** (Exhibit 8).

Exhibit 8, U.S. Population for Selected Age Groups

A growing 30 to 39 age group on housing is likely to cause single family housing construction to increase and contribute to economic growth



Source: Calculated Risk, October 8, 2015

(We acknowledge the excellent work of Bill McBride at Calculated Risk (http://www.calculatedriskblog.com/), particularly for his insight on the housing markets, his astute presentation of data, and his appreciation of the role demographics plays in the economy.)

THE GLOBAL ECONOMY

The world is very interconnected and getting more so all the time. What happens in one part of the world affects the rest of the world to one degree or another. This means there is no way to completely escape economic troubles occurring elsewhere.

China has a slowing economy, though exactly how much is difficult to say because the official numbers are very likely not accurate (some estimate their actual growth rate is potentially only half of the reported figures). No matter what the real numbers are, with slower growth comes less demand for input, which in China's case means raw materials of numerous commodities. With less demand comes lower prices for those commodities, and this has an obvious effect on the fortunes of companies that sell that raw material as well as those countries whose economy is based on or heavily influenced by those businesses (primarily emerging countries but also Australia and Canada, which happens to be the largest trading partner of the United States). Naturally those companies and countries will react and do what they need to do to survive and these actions affect the relationships between currencies and of course the prices of industrial commodities traded in the global markets (oil, copper, iron ore, etc.).

As a net importer, to a large extent the United States benefits from lower prices of consumer goods and energy. However, the country is not immune from the ramifications of events in the rest of the world.

> Some sectors are hurt directly by the global turmoil when prices of their products are set by the global marketplace. The obvious example is the energy sector, and reduced earnings and layoffs of domestic companies negatively impact the American economy.
>
> A dollar that is stronger relative to other major currencies reduces sales and earnings of multi-national companies and exporters. This comes home to roost in the form of lower stock prices for those companies and operational adjustments that affect their domestic employment as well as the fates of their suppliers.

Clearly ***a collapsing sector and an overly strong dollar put a limit on the growth of the American economy***.

The Eurozone is a major part of the world economy that continues to have its economic growth stifled due to flaws in the structure of its common currency. At a minimum the structural needs include:

> **A central treasury** with powers to redistribute funds to rectify internal trade imbalances in order to prevent the finances of individual countries from becoming unsustainable. This would be analogous to the way the US government takes in more federal taxes than it spends in states like New York, New Jersey, Illinois, Texas, and California, and essentially redistributes that money by spending more than its federal tax receipts in states like Virginia, Maryland, Florida, Alabama, and Mississippi.
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> For further reading:
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> http://www.frbsf.org/economic-research/publications/economic-letter/2013/december/taxes-transfers-redistribution-us-federal-government-states/
>
> http://www.economist.com/blogs/dailychart/2011/08/americas-fiscal-union?fb_action_ids=10100936796394338&fb_action_types=og.likes&fb_ref=scn%2Ffb_ec%2Fthe_red_and_the_black&fb_source=other_multiline&action_object_map=%7B%2210100936796394338%22%3A10150268276979799%7D&action_type_map=%7B%2210100936796394338%22%3A%22og.likes%22%7D&action_ref_map=%7B%2210100936796394338%22%3A%22scn%5C%2Ffb_ec%5C%2Fthe_red_and_the_black%22%7D
>
> **A complete banking union** with common supervision, a single resolution authority, and common safety nets. This will de-link the financial situation of the national government of an individual country and its banks so that solvency problems of either don't turn into national and regional crises. This would be analogous to the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC) supervising banks and addressing solvency issues as they arise.
>
> For further reading:
>
> http://www.imf.org/external/pubs/ft/sdn/2013/sdn1301.pdf

Until both of these are put in place, the Eurozone will continue to have periodic crises with countries facing government and banking insolvency. Currently the problem child is Greece (that situation is far from over), but it could easily be Ireland or Spain or any other country with out of control deficits and national banks with balance sheets inextricably linked to their national government. ***Places with financial crises every few years do not engender economic growth locally and detract from global growth, including that of the United States through lack of business and related currency effects***.

Note that among the things we did not mention as a driver of increased economic growth is government and politics. This is because politics is generally not a major driver of the American economy. In countries with a freely elected government, ***the economy determines politics, not the other way around***. A government cannot create economic growth, so ***the most important thing that government can do for the economy is to provide a fertile environment for growth to occur***, and this usually means removing impediments for human productivity to blossom. At best, government actions have the potential to increase economic growth at the margin, but not by orders of magnitude.

Demographics and the global economy have far bigger long-term impacts on the domestic economy and set the general tone of future economic growth far more than any set of politicians. If the former suggest that real GDP growth over a few years will be in the neighborhood of, say, 2%, there is nothing a freely elected group of government officials can do to change this to, say, 4%.

This does not mean government affairs are unimportant. To the contrary, government is vital to a well-functioning society. Nor does this excuse poor government policies, which absolutely can detract from economic growth. Some of the things government can do to remove impediments to increased net economic output include:

Better fiscal policy to assure productive use of human and natural resources

Significant tax reform to optimize government revenues and economic efficiency

Sensible laws and regulations to optimize public safety and economic efficiency

Intelligent immigration policy to compensate for a low native birth rate

But any increase in the growth rate resulting from these steps would not be anywhere close to a doubling from the current situation, no matter what anyone says on the campaign trail.

In conclusion, the default mode for the domestic economy is for continued slow but positive growth for a few more years that will likely be uneven, with a bias for slightly faster growth than we have recently experienced. Plenty can go wrong, of course, including the non-zero chance of recession, but that is true in all situations.

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

John Kleponis, CFA	**Paul Heckler**
Chief Investment Officer	Managing Director

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