YOSEMITE CAPITAL MANAGEMENT

First Quarter 2016 – COMMENTARY

The stock market has forecast nine of the last five recessions. – Paul Samuelson

RECESSION?

In spite of the fact that the extent of the recent decline of the S&P 500 is nothing out of the ordinary, at least so far, there appears to be great angst among those in the financial news media. Part of the concern stems from many who question if the falling stock market is indicating the domestic economy is headed for a recession.

To get right to the point, ***there is no credible and reliable evidence at this time from economic indicators or the financial markets that the domestic economy is in recession***.

This is not to say the economy is strong and everything is great. Indeed the domestic economy remains weak and many people in the country are not doing well, and there are no shortages of measures to illustrate these points. The economy remains vulnerable to events around the globe as well as to what could transpire within the country's borders. The reality is that a recession could start at any time, including right now, but this is always the case.

Anything is possible, including that a recession starts this year, or next year, the year after next, or in a more distant year. But the question should not be "is something *possible*", but should be "is something *probable*". Fear-mongering is easy, while reasoned analysis is difficult for many.

ECONOMIC INDICATIONS OF RECESSION

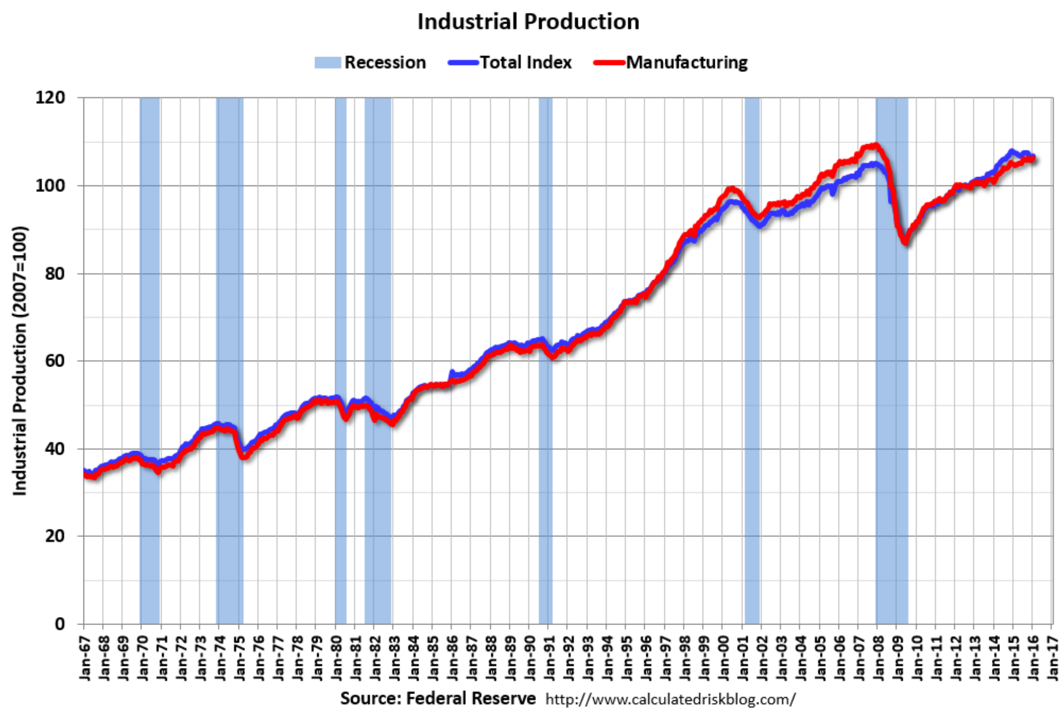
The NBER (National Bureau of Economic Research) is a private, non-profit, non-partisan organization that has become the official arbiter of dating the peaks and troughs of domestic economic cycles. In their words, "a recession is a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales" (http://www.nber.org/cycles/cyclesmain.html).

Of the major economic measures cited by the NBER, only industrial production is showing a very slight decline (see Exhibit 1). All others remain in rising trends (see Exhibits 2, 3, 4, and 5). ***These direct***

measures of the economy in aggregate are why there is at present no reason to believe the country is in a recession.

Exhibit 1, Industrial Production

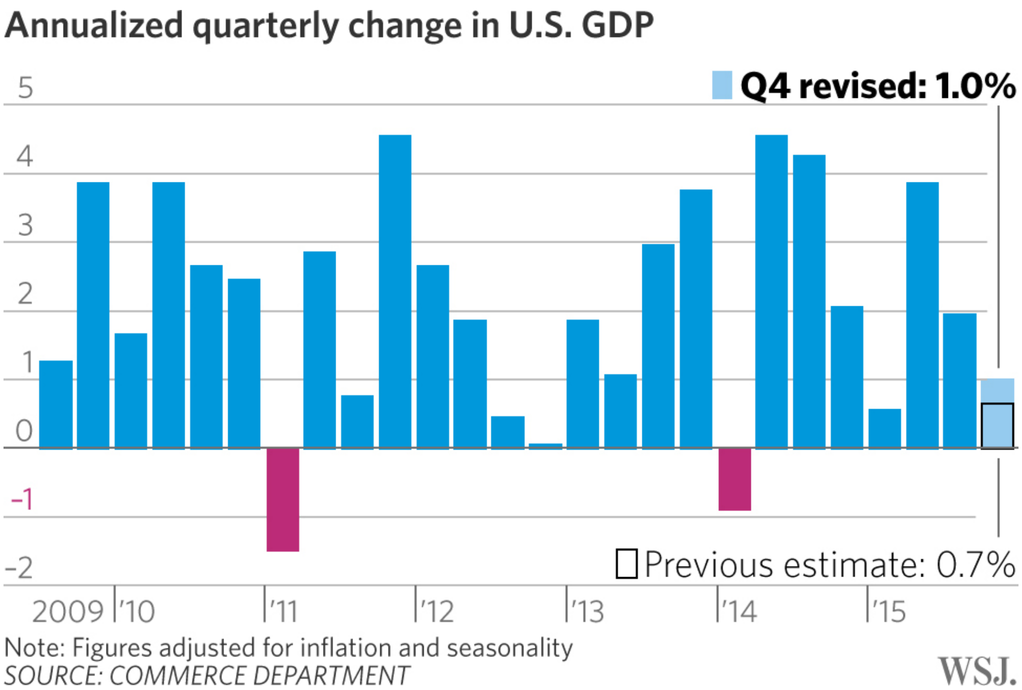
Industrial Production is down slightly from its all-time high, but nowhere near levels indicating a recession



Source: Calculated Risk, February 17, 2016

Exhibit 2, Real GDP

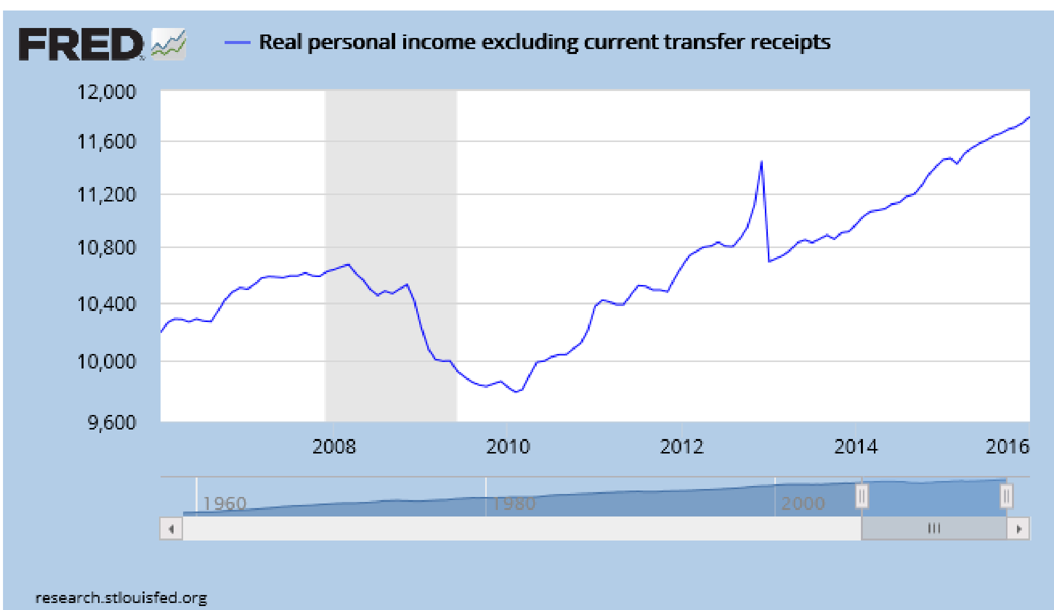
Real GDP remains positive, even if low



Source: The Wall Street Journal, February 26, 2016

Exhibit 3, Real Income

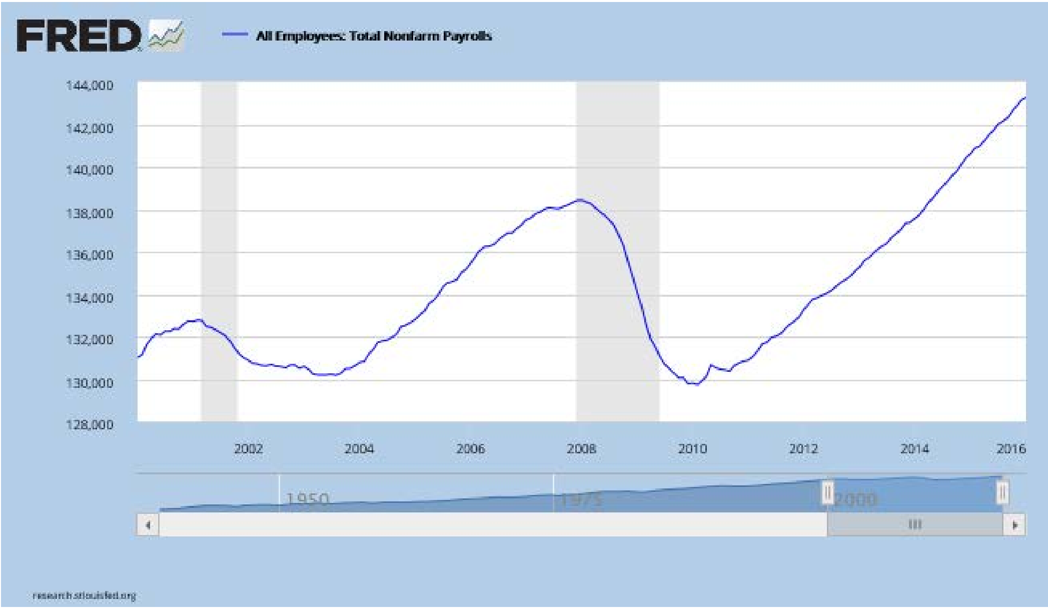
Real Income remains in a rising trend



Source: St. Louis Federal Reserve, January 1, 2016

Exhibit 4, Employment

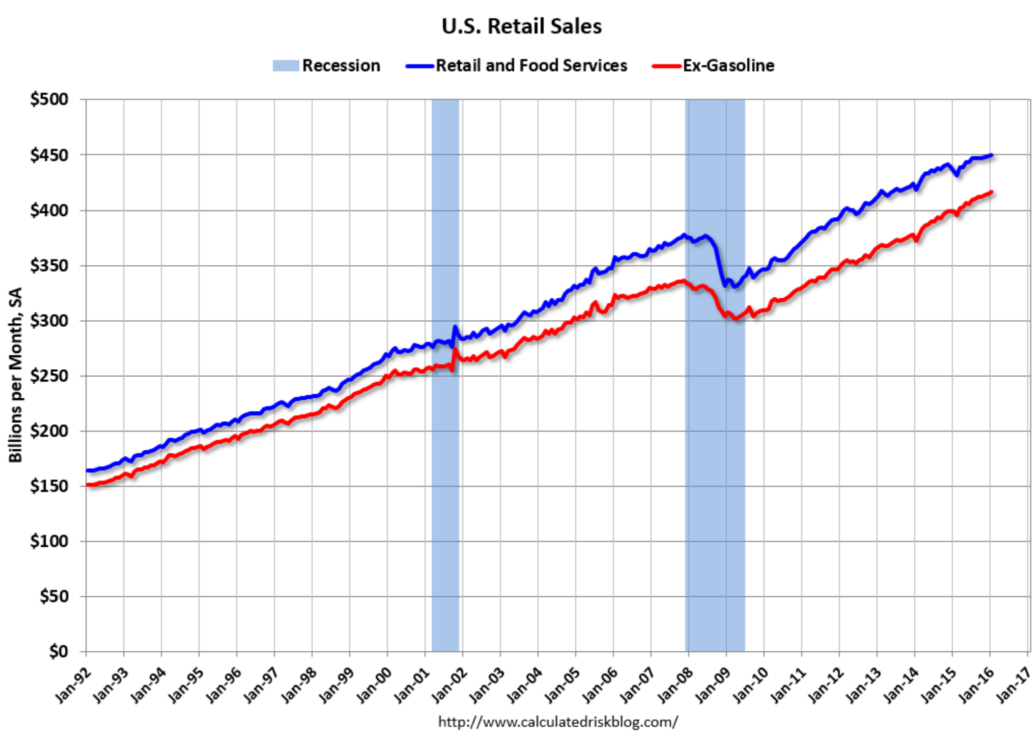
Employment remains in a rising trend



Source: St. Louis Federal Reserve, January 1, 2016

Exhibit 5, U.S. Retail Sales

Retail Sales remains in a rising trend



Source: Calculated Risk, February 12, 2016

All economic measures such as the ones above reflect the past. The US economy is complex, and all measures are subject to revision as additional data is reported. This is one reason why the NBER makes its official announcements about peaks and troughs on a delayed basis, sometimes more than a year after the fact.

This means whenever the economy does turn into recession or recovery, it is impossible to tell in real time. Many have tried to create real-time models to gauge the current status of the economy, but there is not a model widely accepted to be consistently accurate and foolproof. This leads to the problem where any measure that suggests “bad news”, especially when “proved” by a past correlation with a recession, is often loudly trumpeted in the financial news media and elsewhere on the internet. They all seem to forget the following:

> Focusing on one item while ignoring all others is cherry-picking data to support a biased narrative
>
> Every cycle is different to some extent
>
> Merely having a message or a microphone does not automatically confer authority on a subject that is worth heeding

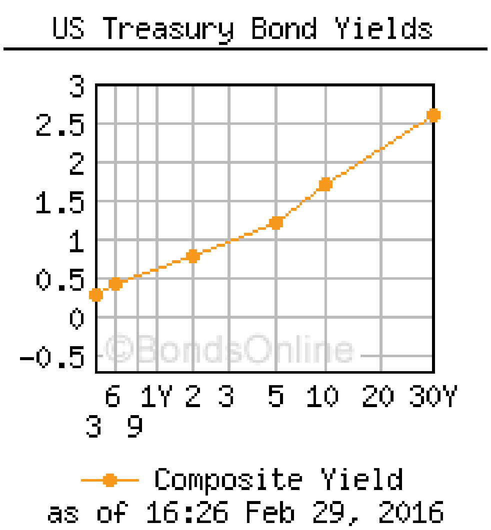
FINANCIAL MARKET INDICATIONS OF RECESSION

Because the financial markets often anticipate future events, many have imparted them with the ability to anticipate the future direction of the economy. Many times this is correct, but many times it is not.

Perhaps the one indicator in the financial markets that has a fairly reliable record of predicting a recession is an inverted yield curve where short term bond yields are higher than long term bond yields. ***Today the yield curve is somewhat steep and clearly not inverted, and therefore not indicating a recession*** (see Exhibit 6).

Exhibit 6, Yield Curve

The yield curve remains steep and not inverted



Source: Bonds Online, February 29, 2016

For those who may not be familiar, a yield curve is a measure of the current yields of bonds of different maturities from the same bond category. The most well-known yield curve is that of US Treasury securities.

In general, longer term bonds usually have higher yields than shorter term bonds to compensate for the increased purchasing power risk and credit risk of holding bonds for a longer time. This situation is known as a steep yield curve.

However, there are times where shorter term yields are higher than longer term yields because bond market participants perceive rising risks of inflation and/or default from holding longer term bonds, which is a common situation during recessions. In this case where shorter term yields are higher than longer term yields, the yield curve is inverted. Thus an inverted yield curve is often a signal of a relatively imminent recession.

The problem with an inverted yield curve as an indicator of recession is its timing, as sometimes there is a long lead time and other times the lead time is very short, and in all cases the lead can only be known in hindsight. Nevertheless the yield curve is among the best economic indicators coming from the financial markets.

The stock market usually anticipates all recessions, and this is why many pundits are wondering about a recession. However, ***not all stock market declines indicate recessions***. There have been numerous occasions where stocks have noticeable if not severe declines without a corresponding economic recession. This happened in 2011 (Euro Crisis II), 2010 (Euro Crisis I), 1998 (Asian Currency Crisis), 1987 (market crash, down 22% in one day), and many previous times in history.

Such events happen because over short time periods stock prices are driven by the emotions of market participants instead of the fundamentals of future corporate cash flows. Any entity that is subject to sometimes extreme manic-depressive emotions, as the stock market is, cannot be and is not a consistently reliable indicator of the health of the domestic economy. Thus we again remind readers that ***the stock market is not the economy***.

The global economy outside of the United States is a different story, especially China and its slowing growth rate. Because China's rate of growth is slowing, there is marginally less demand for inputs in the form of commodities, which in turn affects the economies and markets of its suppliers in emerging markets, Australia, and Canada.

The commodities story is especially acute with oil because of the additional supply provided mostly by fracking operations in North America. As the price of oil falls, marginal producers must shut down. This obviously affects the companies in the energy sector and spreads to their financiers (banks, bondholders, etc.) and suppliers. The concern is why declining oil prices, which are logically good for consumers as enabling them to spend more, has spread to the entire stock market. One major reason stems from the fact that in many oil-producing countries there are sovereign wealth funds that have been tapped to replace their governments' revenues normally received from the sale of oil. These funds raise revenues by selling assets, and the most liquid assets at somewhat reasonable prices are stocks of developed economies. This is why the S&P 500 and the price of oil have moved in lockstep with each other in recent months (see Exhibit 7). This scenario of a high correlation between the two is likely to continue until the price of oil finds a fairly stable longer term bottom.

Exhibit 6, S&P 500 Index and West Texas Intermediate Crude Oil

Stocks and oil have tracked each other tightly in recent months

Source: StockCharts, February 29, 2016

It's easy to say that China's economic growth rate of 6.5% is still enviable even if lower than the recent past. But in reality this growth rate is not at all enviable because it is not sustainable. And it's no secret that China's official numbers might not even be real. The Middle Kingdom has grown by government diktat, with heavy-handed direction from the very top of what is still fervently a one party Communist country, which incidentally has high global economic and military ambitions. As a result, their economy is now dominated by state-owned enterprises (SOEs) that are woefully inefficient, four major banks (Bank of China, the Industrial and Commercial Bank of China, China Construction Bank and Agricultural Bank of China) with large and growing amounts of non-performing loans, a shadow banking system that is focused solely on rewards with seemingly little care about risk, high debt levels throughout the corporate and household sectors of which a significant amount may not be serviceable, and projects that can charitably be described as atrocious mal-investments (ghost cities, empty apartment buildings, unused power plants, steel factories producing far more than demand warrants, etc.). Even the Chinese Communist Party acknowledges the need for reform to address their situation. But the fact is that growth, debt reduction, and reform cannot simultaneously occur to the degree necessary so something must give. All of this speaks to the truth that command economies simply don't work in the long run, both in theory and in actuality (see the Soviet Union, Venezuela, Cuba, etc., etc., etc.).

The Chinese leadership proclaims they want the western-style financial markets to have a bigger role in their society, but it has become obvious they want only the upside and none of the downside, as seen in the clumsy way their government actively regulates and controls their stock, bond, and currency markets, including cracking down on short-sellers, capital flight, and yuan-based foreign investment. The fact is financial markets that are free to work as intended serve a vital role in any society by properly and efficiently allocating capital. But this means letting the downside serve as a necessary purging mechanism and not bailing out those who make foolish mistakes (more western politicians need to accept this fact of life as well). The downside volatility of properly functioning financial markets is an important and necessary feature, not a bug.

Clamping down on symptoms of a problem is ignoring the cause. Failure to let the markets do what they are supposed to do leads to distortions and mal-investments. Eventually the pressure can build up so much that something in the financial system breaks, such as a precipitous currency decline, which then would trigger additional chaos and a financial and economic storm that could choke what little global growth exists.

China would do well to decide that if they ultimately want to have a strong and sustainable economy, they let free markets – warts and all - do their job instead of trying to control their economy and financial markets. If China decides well, the whole world will benefit.

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

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The S&P500 Index is designed and maintained by Standard & Poor's (a division of The McGraw-Hill Companies), is a free-float market capitalization weighted index that includes 500 leading companies in leading industries of the U.S. economy, and is intended to be an ideal proxy for the total market. This index is calculated on a total return basis with dividends reinvested and is not available for direct investment.

The Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency). This index is calculated on a total return basis with interest reinvested and is not available for direct investment.