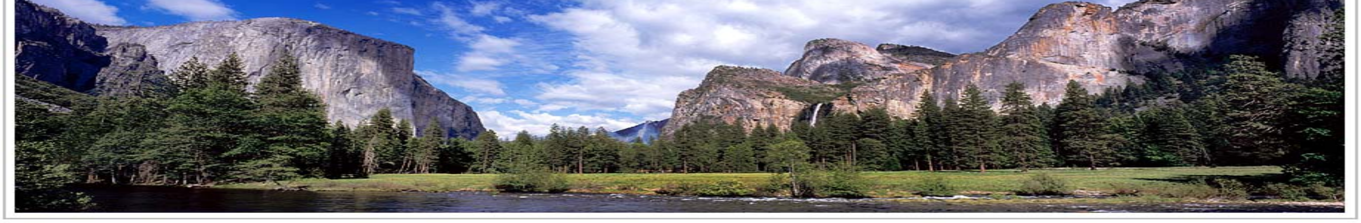

# YOSEMITE CAPITAL MANAGEMENT

## Second Quarter 2010 – COMMENTARY

*Neither a borrower nor a lender be, / For loan oft loses both itself and friend, / And borrowing dulls the edge of husbandry.* -- Hamlet Act 1, Scene 3, 75–77

The fierce economic earthquake that shook the world in 2007-2009 seems to have subsided and the difficult recovery period has commenced. But similar to large physical earthquakes, aftershocks are normal and to be expected. Thus we have the problems emanating from Greece and the fears of contagion to other countries.

The government of Greece borrowed heavily and when the global recession hit, government revenues fell far short of what was needed to make their debt payments. Thus their sovereign debt became subject to default.

When countries face the prospect of sovereign debt default, they have several options, usually used in combination with each other:

Cut government spending

Raise taxes

Print money (thus causing inflation to repay the debt with cheaper currency)

Many people wholeheartedly agree with pursuing the first two options, except for one minor little detail: nobody wants their government programs or benefits cut or their taxes raised, only someone else's. This nasty bit of human behavior naturally leads to heated arguments in the halls of government and riots in the streets, both of which have sadly come to pass in Athens.

The third option of printing money does not exist for Greece because in 1999 they gave up their drachma for the Euro as their currency, which is subject to the supranational European Central Bank (ECB) and over whom individual countries have little influence.

In short, Greece is in a perilous situation.

So why do problems in a small peripheral country in Europe affect the rest of the world and, among other things, contribute to the S&P 500 falling by more than 12% at one point in the space of three weeks? One reason could be that many European banks that hold Greek debt have balance sheets that still hold significant amounts of leveraged subprime debt and are in no condition to deal with yet another distressed asset. Another reason could be that other countries are in a similar situation, notably Portugal, Ireland, Italy, and Spain (which collectively with Greece are affectionately known as PIIGS). Efforts to address the problems from other members of the European Union (EU) (notably Germany) and the International Monetary Fund (IMF) have ramifications that are potentially detrimental to sustaining growth, such as higher taxes, larger deficits, and a falling Euro. The last point is key because faith in the Euro, and the grand experiment that it is, is rapidly eroding. There is also the moral hazard of such bailouts, whereby people are prevented from suffering the consequences of their bad behavior.

As the European scenario unfolds, many are concerned about how far this will impact the financial markets and whether this is the beginning of yet another meltdown. As with almost all serious situations, there can be numerous outcomes across a continuum and no one can know the future for certain. Given the unknowable future, history can potentially be a guide for investors.

Sovereign defaults are actually more common than many realize and they have occurred to world powers as well as struggling countries throughout history (though what constitutes "default" is subject to debate, but that's another topic). More recent examples include the following:

> 1982: several Latin American countries, including Argentina, Chile, Brazil, Venezuela, Ecuador, and Mexico, had a series of defaults
>
> 1994: Mexico faced default that resulted in a massive peso devaluation
>
> 1997: the emerging markets crisis (also called "the Asian flu") affected numerous countries in Asia, including Thailand, South Korea, Indonesia, and the Philippines
>
> 1998: Russia experienced a post-Asian flu debt crisis

Related to these crises or to the events that caused them, the S&P 500 declined anywhere from 7% to 25%, in large part because of fears concerning how far the damage would spread. But even before the storms passed and the end result was not at all clear, the financial markets bolted ahead strongly. Those who panicked and sold after the markets fell then had to decide when to buy and may have missed sizable advances.

History suggests it is difficult if not impossible to gauge the extent of financial crises of any sort. However, usually a calamitous event occurs because excesses reach an extreme and financial connections break. Thus, ***the calamitous event often signals the end of a problem*** and the beginning of repairing the excesses. This is why the financial markets often respond positively and strongly in the middle of a crisis.

We can't say the situation with any or all of the PIIGS has reached a turning point. But we note that corporate earnings in the United States are growing, economies in many emerging markets are (ironically) in reasonable fiscal condition and poised for growth, domestic inflation is for the time being in control, and equity valuations around the world are by many measures at least reasonable. These are reasons why we believe the odds are that the current issues with sovereign debt ultimately will have a limited impact on American investors.

Finally, we remind readers that in our last letter in January we wrote there could be “volatility in financial markets (especially stocks), and constant concerns” that “could cause great angst”. Our thoughts are being played out courtesy of Greece, but we believe this is just an aftershock.

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