



YOSEMITE CAPITAL MANAGEMENT

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COMMENTARY

“Let us never negotiate out of fear. But let us never fear to negotiate.” – John Kennedy

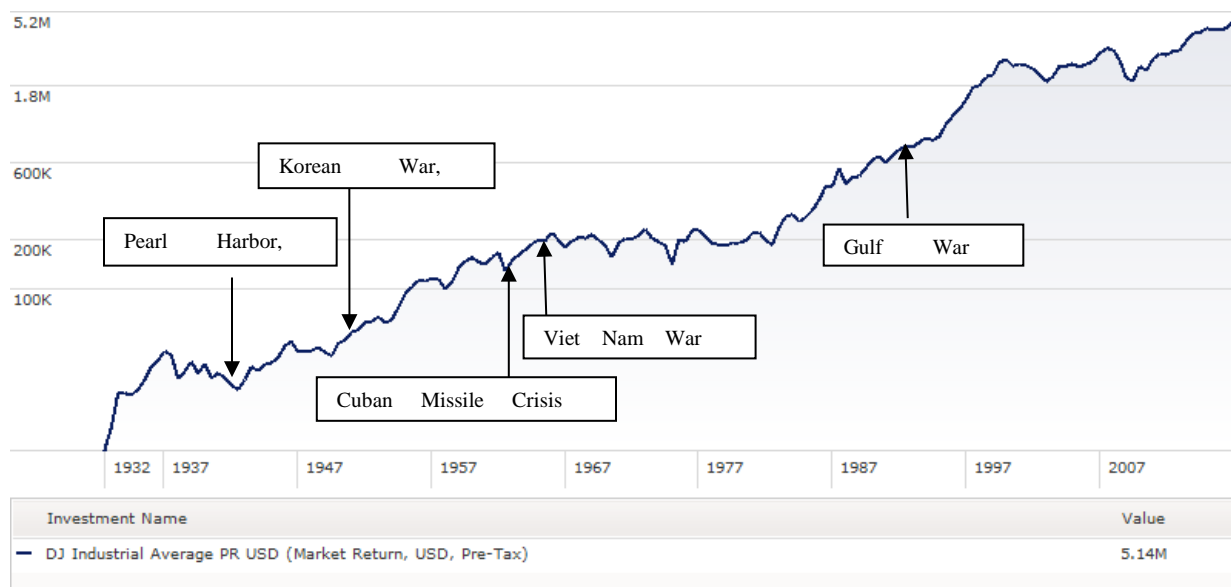
“We are not about to send American boys 9 or 10 thousand miles away from home to do what Asian boys ought to be doing for themselves.” – Lyndon Johnson

The escalation of news from North Korea and the exchanges of threats are unsettling, to say the least. People around the world are very concerned about where this situation leads.

However, the bottom line for participants in the financial markets is that *political and international events may not have much of an effect on portfolios*. This matter on the Korean peninsula, though real and extremely serious, could be yet another of many such affairs. History bears this out as the Gulf War, the Viet Nam War, the Cuban Missile Crisis, the Korean War, and World War II, for examples, had at worst brief and transitory impacts on the broad markets in spite of their severity (see Exhibit 1). Making major portfolio adjustments in anticipation of or in response to these hostilities did not prove worthwhile for all but the very lucky.

Exhibit 1, The Dow Jones Industrial Average (DJIA) Price Return and the Growth of \$10,000 from July 6, 1932 to September 21, 2017

Making major portfolio adjustments in anticipation of or in response to global hostilities is generally not worthwhile as the American stock market advances over the years in spite of various crises



Source: Morningstar

Notes:

Dividends are NOT included, which would have increased the overall returns shown (and reduced declines) throughout the period.

The Dow Jones Industrial Average is a lousy proxy for the American stock market. However, the DJIA is useful for its history prior to 1957 when the S&P 500 went live.

The drivers that always move the financial markets over the long term are the underlying fundamentals of aggregate corporate earnings and interest rates. This is true during war, peace, social upheaval, crisis, calm, disaster, assassinations, etc. Regardless of circumstances, the net effect is that the financial markets ultimately provide cold-blooded verdicts of earnings and interest rates. Beyond the short term, the markets simply don't care per se about politics, global affairs, international relations, wars, terrorism, or whatever else is in the headlines. Thus ***market participants need to keep their politics and current events away from their investment decisions.***

All that said, there are at least two circumstances that would invalidate the aforementioned and cause the financial markets to plummet.

1. ***All-out nuclear war that causes global devastation.*** Because everybody loses everything and nobody wins, finances would become completely meaningless for the survivors, if any, who would be left scavenging for food and water. If this scenario were to unfold, there would be no

benefits to worrying about financial assets and taking preemptive measures. (And for the goldbugs, good luck trying to use your chunk of metal to obtain anything useful.)

2. *A limited nuclear attack that does not escalate into mutually-assured destruction (MAD).*

Because this is unprecedented, it is difficult to guess how much the financial markets would respond. But the drop could be substantial; maybe asset prices would be cut in half, depending on where the event took place. Guam is one thing, a large American city is another.

Of course, this assumes North Korea is the instigator, perhaps because the Kim regime feels trapped in a corner. We would like to think that the United States, China, Russia, and other nuclear powers understand the moral imperative of not using a nuclear weapon and thus legitimizing their use by others, especially a stateless terrorist group that could affect any country.

Considering that the military response to North Korea making such an attack would lead to the destruction of that regime and the country's supporting military infrastructure – and assuming China holds to its statement that it would not defend North Korea in the event they initiated an attack – we ascribe very low odds of this happening. That suggests it makes no sense to prepare portfolios specifically for such an event.

We will, of course, continue to monitor the situation and if necessary make changes to our approach in the markets.

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For those interested, the following is a very brief outline of the situation as we understand it to perhaps summarize what the powers-that-be are facing.

On the surface, events suggest the situation has gotten frighteningly close to someone actually using a nuclear weapon, something the world has successfully avoided since World War II. Underneath, international diplomacy is often unseen and unknown. This is why *public statements from officials in any country should not be taken at face value*, shallow analysis by pundits based only on the headlines should not be trusted, and angry knee-jerk reactions calling for immediate military action based on insults are reckless.

For the United States, there seem to be ultimately two choices to being threatened by Pyongyang: *either accept North Korea as a nuclear power, or go to war*. Washington is adamant about the former because it cannot and should not ignore attack on its territories or its allies, notably South Korea and Japan.

For North Korea, survival of the Kim regime is the only thing that matters. The regime includes not only the Kim family but also a complex web of elites that enjoy a great deal of privileges. Developing nuclear weapons and missiles as a deterrent guarantees their survival and is therefore non-negotiable. North Korea believes they can insist on this path because they have extensive artillery systems spread for miles across the DMZ in position to utterly destroy Seoul in a very quick manner as well as having China and Russia as allies, even though Pyongyang does not completely trust them.

Given that both countries have made absolute conditions, war of some sort seems inevitable unless some sort of diplomatic agreement can somehow be attained.

Regarding diplomacy, the Americans view the past several decades of talks and agreements as failures since the result is that North Korea has or is on the verge of having the very weapons and systems those talks and agreements were to have prevented. Therefore, more negotiating with North Korea is futile.

For its part, the Kim regime will not budge on having the nuclear weapons and missiles it perceives as absolutely necessary for survival as well as end what they view as a constant threat of attack by the United States from troops stationed in South Korea. Therefore, they are not interested in dialogue with the United States.

But the diplomatic situation is even more complicated because there are four more countries involved with direct interests in the region, each with their own competing interests: South Korea, China, Japan, and Russia. And as is often the case in international politics, culture and historical enmity weigh heavily in the calculus. Without full understanding of what all major parties want, disastrous mistakes can occur.

Understanding diplomatic efforts depends on knowing what each country in the region needs and wants, both short- and long-term. A brief list includes the following:

North Korea

Survival of the regime with Kim Jong Un and his family firmly and absolutely in charge

Nuclear weapons and missiles to assure survival, deter foreign aggression, and use as a bargaining tool

Be secure from attacks by the United States and South Korea

Indefinite suspension of joint military exercises by the United States and South Korea

Withdrawal of the United States military from South Korea and Japan

Disrupt the alliance of the United States, South Korea, and Japan

Avoid war with the United States

Become a regional military power

The unification of the Korean peninsula under its control

Have China as a counter to the possibility of foreign aggression

Avoid economic and military dependence on China and Russia

South Korea

Be secure from an attack by North Korea

Prevent the destruction of Seoul and its citizens from the extensive North Korean artillery system spread for miles across the DMZ

Maintain defense partnership with the United States

Continued trade with China as an essential business partner

The unification of the Korean peninsula under its control

United States

No nuclear weapons in North Korea, including an inability for future resumption of development if there is a suspension agreement

No ability of North Korea to attack American territory with nuclear weapons

Assure its own security and that of its allies by maintaining dominance in the western Pacific

Stronger economic and political pressure from China on North Korea

Avoid a land war in Asia

China

Maintain the existence of North Korea as a buffer between the United States and its allies to assure the American military is not close to China's border

Assure no refugees from North Korea

Limit the economic impact from sanctions on North Korea

Avoid radiation fallout from any use of nuclear weapons

Direct talks between North Korea and the United States

Removal of the THAAD system from South Korea

Assure there are no tactical nuclear weapons in South Korea

Prevent a united Korea that would be friendly to the United States

Limit the military capabilities of Japan

Maintain business with the United States

Have North Korea be a constant distraction to the United States

Avoid war with the United States

Become the dominant regional power and eventually a global superpower

Reduce US hegemony in the western Pacific

Russia

Direct talks between North Korea and the United States

Reduce US hegemony in the western Pacific (and in Europe)

Have North Korea be a distraction to the United States

Disrupt the strategy of the United States

Avoid war with the United States

Enlarge its sphere of influence

Be relevant in world affairs

Japan

Be secure from an attack by North Korea

Return of Japanese abductees from North Korea

Maintain defense partnership with the United States

Continued trade with China as an essential business partner

There is, of course, much more to the problem than can be addressed here, including the fascinating histories that significantly contribute to the current complexities and attitudes.

We hope and pray the countries involved can find a reasonable solution before matters get out of hand and a disaster develops. We would much rather spend our time looking for positive opportunities where we can be more certain that things can go right for our clients and their future.

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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 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.