HEMISPHERE CAPITAL MANAGEMENT INC.

Reflections
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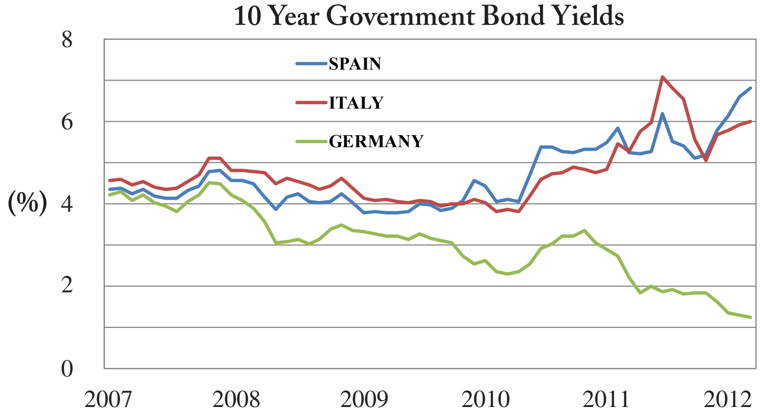
MORE RISK, LESS RETURN
by Rick Riffel

Following four decades of excessive credit expansion, the U.S. experienced a bursting credit bubble in mid-2008. In the aftermath, North American stock markets declined almost 50% by early 2009. Fast forward to the summer of 2012 and North American stock markets, exhibiting strong resilience, have now recovered to their pre-bubble highs.

Over the past four years it is mainly perceptions, rather than actual economic fundamentals, that have changed. There is little doubt that the global economy has stabilized as a result of the actions of many of the world's central bankers, however, much of the fallout from the excessive credit expansion remains. Central bankers have set interest rates at artificially low levels to save overindebted consumers and governments - at the expense of pension funds and individual savers. The consequences of these actions are unknown as central banks have never operated in this manner before. At a minimum, the developed world will confront a very lengthy period of deleveraging.

European policymakers have badly managed the deleveraging process in Europe. On the edge of recession, the eurozone appears to be a "slow motion" train wreck. Diverging performance between the northern economies with high credit ratings (Germany, Netherlands, Finland) and the southern economies with low credit ratings (Spain, Italy, Portugal, Greece) has produced widened differences in political self-interest. Chart 1. highlights the divergence in borrowing rates between the two euro groups.

Chart 1.
10 Year Government Bond Yields



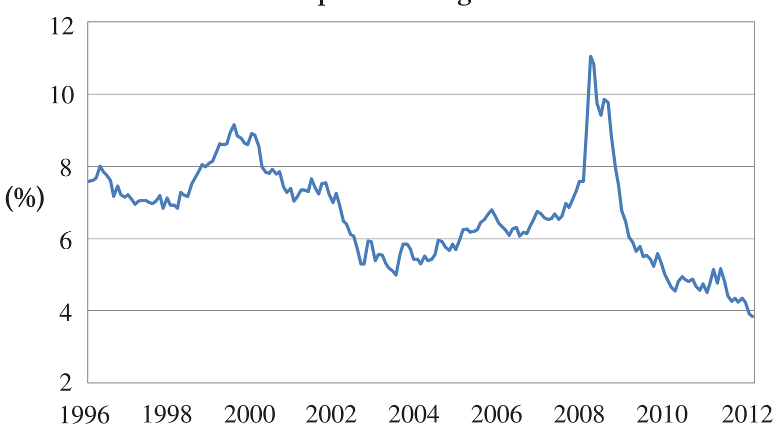
Last year, Germany and France stood in solidarity regarding the future of the euro. Deteriorating financial conditions combined with a change in government in the May 2012 election, have shifted France to the southern camp, leaving Germany more isolated than ever. It is difficult to envision a near-term "solution" to the eurozone situation.

The eurozone economic problems have spilled over to the emerging markets and China in particular. Declining export growth, electricity consumption and material prices (i.e. iron ore, copper, etc.) are evidence of a Chinese slowdown. As China was the recent locomotive of world economic growth, it is very possible that a slowing China could produce a "synchronized global slowdown" between the developed and emerging economies of the world.

Thus far, the deleveraging process in the U.S. has progressed in a more orderly fashion. Much of the U.S. experience has relied on monetary stimulus by the U.S. Federal Reserve. Similar to all central bankers in the developed world, the U.S. Federal Reserve has focused, through various means, on depressing real U.S. interest rates. "Artificially" low U.S. interest rates have provided the confidence to sustain the recovery to pre-bubble levels in U.S. stock prices. In reality, the Federal Reserve appears to be acting as an economic "back-stop" providing support to the financial markets whenever further signs of economic weakness occur. Unfortunately, and probably sooner rather than later, the Federal Reserve will reach the limit as to how much it can help the struggling economy.

By keeping interest rates extremely low, central bankers are attempting to shepherd (or maybe just plain herd) investors into riskier assets. Investors are now confronted with a stark choice. Either remain in low-risk, low-return short-term fixed income investments or be exposed to substantive risk to achieve possibly modest, single-digit returns. The situation is especially critical for retirees. For many pension funds and foundations, the desire for higher returns has translated into increased ownership of very high risk assets such as high-yield corporate debt (often referred to as junk bonds), real estate, private equity and hedge funds.

Chart 2.
BofA Merrill Lynch
U.S. Corporates - High Yield Index



The yield on U.S. high-yield corporate debt acutely illustrates how investors are "desperate for yield". With interest rates so low, yield starved investors are increasingly willing to risk investment in speculative-grade debt for just a marginal pick-up in return. A frenzy of buying in junk bonds has driven prices to record highs and yields to record lows – see Chart 2. Like sovereign debt in the U.S., U.K. and Canada, high-yield corporate debt is more expensive than any time in history, excluding WWII. Safe haven government debt is very overvalued.

Long-term investors can find opportunities in large capitalization U.S. and international companies with strong profit margins, rising dividends and exceptional balance sheets. By keeping labour costs down and investing only when necessary, these companies are able to generate abnormally high earnings and operating margins. Research indicates that rising government debt levels are often supportive of higher corporate profit margins.

Although revenue momentum is slowing, the ability of companies to protect their profitability is more durable than generally expected. This confidence in earnings has translated into higher corporate dividend yields. As can be seen from Chart 3., the dividend yield for the S&P 500 is now higher than the yield on 10 year U.S. treasuries, something that also has not been seen since the mid 1950's, except during the peak of the 2008 credit crisis.

We continue to believe that investors focused on preserving wealth in real terms should invest at least 5% of their portfolio in gold and related assets. Gold ownership is an insurance policy related to central bank money supply and credit expansion, rising government debt levels, global geo-political risks and demand from the growing middle class in emerging markets.

The current investment climate is as challenging as ever. It is our contention that the best returns for investors will likely come from high quality stocks with strong dividends. However, the correlation between stock returns remains very high, implying that diversification offers less downside protection than in the past. Further, given that economic growth in the developed world will remain lacklustre for some time, it is probable to expect an extended period of ultra-low interest rates and a period where returns from stocks and bonds will both be below historic averages. For investors this can only mean more risk and less return.

Chart 3.
10 Year US Treasury Yields vs. S &P Dividend Yields