$10/Barrel Oil?
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Dear Fellow Investors:

In the short run, psychology and entrenched beliefs can drive a market or the price of a commodity. In the long run, the laws surrounding supply and demand win out. No current market shows that better than in the market for a barrel of oil. We at Smead Capital Management (SCM) believe today's price of oil is driven by belief in the "Peak Oil" theory, the perception of a very long-term transition to electric/hybrids cars and Oil's use as a trading or investment vehicle to pursue international economic growth and diversification. At SCM we think the day is coming when supply and demand take over. The folks from Cameron Hanover, led by President Peter Beutel, shared on CNBC recently why that is.

The price of a barrel of oil would be closer to $10 if the commodity wasn't traded as an investment instrument, given the record-high levels of U.S. oil inventories, Peter Beutel, president of Cameron Hanover, told CNBC Monday. "I honestly think that if there were no investors using oil as an asset that the price of oil right now would be $10 or $15 or $18, but it wouldn't be anywhere near where it is," Beutel said. "We have so much oil right now, more than we've had in 27 years. Why is it 27 years? Because that's how far our records go back. It's probably the most in 50 or 100 years," he added. Part of the reason the price of oil is currently above $74 a barrel is because of a belief in the economic recovery, Beutel said.

I have been in the investment business for 30 years. Oil peaked at monthly average prices around $40 per barrel in 1980-81. It bottomed around $11/barrel in 1999. Oil peaked in 2008 at a monthly average around $126/ barrel and stands today somewhere around $73/barrel. Like many other investors we at Smead Capital Management have been conscious of "Peak Oil" theory. In his book, "The Prize", Daniel Yergin points out that "Peak Oil" theory has popped up every ten to twenty years since oil was first discovered in Pennsylvania in 1855. Whether "it's different this time" doesn't matter to us because we see a dramatically quicker transition away from gasoline to electric and hybrid automobiles than the average portfolio management firm does. We believe the transition to electric/hybrid vehicles is a 10-15 year process. If you spend much time in Los Angeles or Seattle, you can see the speed of the transition with your own eyes. If you cut demand for gasoline by 25-50% in twenty years, you chop off the "lack of supply" argument which "Peak Oil" is all about.

Much more important to the price of oil today is its use as a way to participate in international economic growth and as a way for asset allocators to use commodities as a way to diversify one's investment portfolio among "non-correlated" asset classes. The "BRIC trade" is a Wall Street slang term for exceptional growth in the world coming from developing nations. The BRIC part of it stands for Brazil, Russia, India and China. Brazil and Russia have

been growing because they are major oil exporters. India and China have become large consumers of oil and gas. China's boom was originally led by exports, but more recently has been led by Commercial and Residential Real Estate construction. It has had one of the longest stretches of uninterrupted growth in modern economic history. The US economy grew from a Gross Domestic Product (GDP) of $476 million in 1800 to $20.56 Billion in 1900, but that growth was interrupted by numerous recessions and depressions/panics in 1807, 1819, 1837, 1873 and 1893. We took time out in 1861-65 to kill 500,000 Americans in the Civil War as well.

Therefore, the Chinese economy is due for a slowdown and recent reports indicate that loan losses at Chinese banks are about to sky-rocket. We believe that as the China economy slows down it will cripple the emerging market demand argument and reduce demand and demand expectations for oil around the world. Brazil and Russia's growth would be immediately called into question since it has been driven by oil exports.

Lastly, the price of oil has moved the opposite direction to the S & P 500 Index from the beginning of the year 2000 to today. By investing in oil and gas common stocks and limited partnerships, natural resource heavy mutual funds, commodity funds and exchange traded funds (ETFs), asset allocators and hedge fund managers have dramatically increased their exposure to oil as an investment vehicle during the last 10 years. In today's highly volatile markets where 3 to 6-month holding periods are considered an eternity, oil is an easy and liquid way to play an economic rebound in the US and world economy. We have one big problem with this approach. THE PROBLEM IS THAT THE DEEPEST RECESSIONS SINCE 1946 WERE PRECEDED BY OIL PRICE INCREASES (1973-74, 1981-82 and 2008-09) AND STRONG ECONOMIC GROWTH IS USUALLY TRIGGERED OR ENHANCED BY LOWER ENERGY PRICES! The US economy grew really well from 1995-1999 and Oil fell significantly during that stretch. We believe that gasoline's importance will be reduced by electric/hybrid cars and that lower oil prices will follow. Those lower oil and gasoline prices will drive consumer confidence in the US. Most of the money we spend on oil and gasoline leaves the country. In the process it damages our balance of payments and weakens our currency. Peter Beutel said it best:

From a historical perspective, Beutel pointed out that the current level of inventories is even higher than when the price of oil was below $20 a barrel. "We've got 50 million barrels of crude more than we had two years ago. We have 176 million of distillate," Beutel said. "When I started in the business back in 1980 we used to think to ourselves: "Gee, we would love it if we had 140 million barrels of distillates to start the winter."

We vote for the law of supply and demand as always.

Best Wishes,

William Smead

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