Hit the Reset Button

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Dear Clients and Prospective Clients:

Three years ago Americans were spending all of their after-tax paycheck and were borrowing above and beyond take-home pay to attain a certain standard of living. Most of the money came from loans against home equity or credit cards which were paid off by borrowing through home equity loans or mortgage refinancing. At Smead Capital Management, we think in terms of the U.S. going from a 104% spending society in 2006 to a 95% spending society today. Government statistics show that above and beyond our 401(k) or 403(b) contributions we are saving close to 5% of our after-tax paycheck. In less than a year we have reduced consumption at the household level by 9%. Since Household Consumption has made up 70% of Gross Domestic Product in recent years, this puts a 6.3% drag on the GDP comparisons beginning in early fall of 2008. Notice that the fourth quarter 2008 GDP figure was revised to -6.3%. This is very similar to our estimate of reset spending patterns.

All companies will need to deal with this reset of spending patterns. The U.S. automobile industry is having a very hard time with this reset because auto purchases are a big-ticket item. A $200 to $1000 per month payment doesn’t fit very well into the budgets of the newly reset households. People are holding on to cars for longer than nine years on average and auto repair businesses are flourishing. Auto industry experts talk about a sales level of 9 to 10 million vehicles sold in the U.S. in 2009 which is down from 15 to 16 million vehicles in 2006. It will take time for them to work through this reset as folks naturally err on the side of being overly conservative for awhile.

We like to think about who is being the least affected by the reset in spending patterns or who has put their companies the farthest ahead in adapting to the new patterns. We expect them to be the leaders of the “Next Great U.S. Stock Market” because we believe they will be maximizing their brand and balance sheet strength during the reset and will hit the ground running when we begin to grow from the reset spending levels. The loss of blockbuster drug revenue due to patents running out has forced Merck and Pfizer to flex their balance sheet muscle to buy Schering-Plough and Wyeth, respectively. People have reduced their doctor visits and cut back in healthcare, but it is much less than a 9% cutback. These companies get a huge part of their income from outside the country and the two most populated countries of China and India are becoming wealthy enough to demand the best in pharmaceutical products for the first time in their history.

Starbuck's has adapted with a discount membership card, instant coffee and breakfast value meals. They've closed poor performing locations and cut corporate expenses. Walmart is grabbing market share as it reminds everyone to "Save Money, Live Better." The folks who go to Walmart now, who used to think that they were above the fray, will add numerous spur of the moment purchases once the economy rebounds or stops contracting sometime later this year or early next year. Disney will control more and more eyeballs through ESPN, ABC and Disney Channel because people are staying home and watching more T.V. When advertising revenue rebounds, Disney will have gained market share. They will ultimately pick up customers from less well financed theme parks who fail or downsize as well as movie production companies that no longer get funded. Movie ticket sales are up 16% year over year as we escape to the theatres.

There are many more stories among our companies to tell associated with the new household consumption levels, but we believe our portfolios could take advantage of what the future brings despite this difficult transition from households hitting the spending reset button.

Best Wishes,

William Smead

The securities identified and described in this missive do not represent all of the securities purchased or recommended for our clients. It should not be assumed that investing in these securities was or will be profitable. A list of all recommendations made by Smead Capital Management with in the past twelve month period is available upon request.

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