Can the US Withstand Higher Short-Term Interest Rates?
March 22, 2011

William Smead
Chief Executive Officer
Chief Investment Officer

Dear Fellow Investors:

In a column online for the Wall Street Journal on Sunday, March 20th, Mark Gongloff wrote that the recent unrest in the Middle East and the earthquake/tsunami disaster in Japan has returned us to a risk on/risk off environment. At the same site under Opinions, Andy Kessler talked about the effect that normalized short-term interest rates would have in an editorial called: "Raise Rates to Boost the Economy". Markets are again dominated by very high correlations and short duration trading patterns during a correction which has knocked about 6 percent off of the S&P 500 Index. As owners of fundamentally sound companies with strong balance sheets, we agree with their observations and would like to expound.

Federal Reserve Board Chairman, Ben Bernanke has maintained very low short-term interest rates to prevent a Depression. He sought to provide wide spreads to our banking system so that their profits would effectively recapitalize our banking system. Simultaneously, he bought US consumers time to repair their balance sheets and income statements. Major banks proved him correct on March 18th by raising dividends and announcing massive stock buybacks. Consumers have shown to be quick studies as they have lowered their Household Debt Service Ratio (HDSR) from around 14 percent in late 2007 to 11.75 percent at the end of 2010. Our research at Smead Capital Management (SCM) indicates that households could be below 11 percent as soon as a year from now. This is a level which spawned five-year economic growth periods in both the 1980's and the 1990's.

The real question is two-fold. First, can the US economic recovery withstand higher short-term interest rates? Second, what investments will investors be happy with when the government is not offering monetary stimulus as a wind behind the back of American businesses and households?

Artificially low interest rates are a friend to capital intensive businesses. When capital is inexpensive, those who need it most, benefit the most. Low rates are beneficial to smaller companies which can borrow at rates normally reserved for only the financially strongest companies. These low rates are the friend of leveraged companies and private equity companies which buy and own companies and use leverage in the process. Lastly, these low rates are the friend of commodity investors and foreign emerging markets who have pegged their currency to the US dollar. Unfortunately, these facts all appear in the rear-view mirror and might be the most crowded multiple-asset class trade this portfolio manager has seen in 31 years in the investment business!

One of the strengths of the US economy is its resilience. This resilience is a by-product of our willingness to trust Adam Smith's "Invisible Hand", which lets the marketplace decide who wins and who loses. The Japanese brought interest rates down and kept them down for 20 years. Their economy and stock market has been terrible. They did this to stay away from washing out the losers and dealing with recapitalizing their banking system. They killed their economy to maintain employment, postpone admitting mistakes and did not allow significant immigration to offset population decline and aging. We are hopeful that the current tragedy might cause them to wipe their slate clean and begin to grow again.

We need to think very soon of taking the training wheels off of the US economy and allow interest rates to gravitate to where the market will take them. We at SCM think it will have the affect of sending the tide out. As Warren Buffett is fond of saying, "It's only when the tide goes out that you learn who's been swimming naked." More normal rates would benefit cash rich companies, savings rich households and present meaningful risk-less opportunity cost to speculative investments. Investments in commodities, emerging market stocks, capital intensive basic material manufacturers and heavy industrial companies have fed off of emerging market prosperity which is appealing in a negative real interest rate environment. Here is how Kessler describes the possibilities:

"But along with a likely lower stock market and failing banks will be several positive effects that will finally kick-start the economy. Oil and wheat and commodities will see a 20%-30% drop in price as speculators run for the hills. This will be a de facto tax cut for consumers. Hiring should restart when businesses see normal short-term rates, most likely 2%.

Similarly, the dollar, suddenly backed by rising interest rates, will start to rise. Unlike those foolish enough to believe that a lower dollar is the path to growth, a higher dollar will lower prices across the board, especially at Wal-Mart—shoes, shirts and sugar. Even better, the companies that are leading the economy, such as Apple and EMC, will benefit from lower costs for memory and storage, as will Google and Facebook stocking their data centers. This price cut on productivity tools will be a good thing for the economy and the real wealth effect.

And even better, despite rising costs from higher short-term rates, surviving banks will lose their fear of rising long-term rates and will start lowering banking spreads, signaling their willingness to lend and fund a real recovery."

As India and China tighten credit and the US lets QE2 die a slow death, we could be on the cusp of the tide change. As interest rates rise, correlations should decline and investment durations will lengthen, in SCM's opinion. When this happens, large, well-capitalized non-cyclical US companies will be gushing free cash flow and won't see demand for their products diminish. When it is obvious that the tide has changed, those who are naked will be exposed and our economy will prosper as we sort out the winners and losers.

Best Wishes,

William Smead

The information contained in this missive represents SCM's opinions, and should not be construed as personalized or individualized investment advice. Past performance is no guarantee of future results. Some of the securities identified and described in this missive are a sample of issuers being currently recommended for suitable clients as of the date stated in this missive and 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.

This Missive and others are available at www.smeadblog.com.