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Consumer Confidence: A Neutral Indicator at Worst and a Contrary Indicator at Best

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Dear Fellow Investors:

Charlie Munger, the Vice Chairman of Berkshire Hathaway, has said many times that psychology is the most under-utilized discipline in business. He compares the business person or investor, who doesn't have an inter-disciplinary set of "mental models" including psychology, to a one-legged person in a kick-boxing competition. We believe that those using low consumer confidence as a reason to be bearish about US large cap stocks and consumer discretionary stocks are equivalent to one-legged kick boxers.

At the website, The Big Picture, Barry Ritholtz shared his thoughts (Nov. 4, 2011) on the US employment numbers. We have respected the thoughts and research of his firm because they were early in understanding how damaging the housing bubble was going to be on the US economy. However, this time we believe that the trap that the market has laid for investors in the area of unemployment and consumer confidence is well set. We believe that a number of savvy analysts are not "seeing the forest for the trees" when it comes to understanding the history, psychology and the accounting of consumer behavior.

We at Smead Capital Management believe two things about consumer spending and consumer behavior in the US. First, the income statement of US households tells you more about future spending than consumer confidence does. Second, we believe Andy Grove's professor at the City College of New York was right when he said, "When everyone knows that something is so, nobody knows nothing!" In other words, is there an investor left in the world who has not anticipated that it will be years before the US consumer makes a comeback? Consumer confidence is a neutral indicator most of the time and a valuable contrary indicator at extremes.

Let me unpack these two ideas. The Federal Reserve Board has maintained statistics on US households since 1980 measuring the percentage of gross household income required to service household debt. You can view these stats by going to www.federalreserve.gov/releases/housedebt/. There you will see that the real estate and borrowing bubble of the 2000's allowed US households to get to ridiculously high ratios of household debt service (around 14% of income at the peak). This was markedly higher than previous peaks of 12.4% in prior cycles. You will also see that US households have made huge strides since late 2007. These statistics are lagged by three months or more, but you can see that by June 30th of 2011 the ratio had fallen to 11.09%. Assuming that this trend of austerity continues through the next 12 months, the US Household Debt Service Ratio could fall to the low levels of the early 1980's deep recession at 10.6% and in the job-less recovery of the early 1990's.

Think of it like this. Who is likely to spend money and do it more consistently, someone who's in very good shape on their income statement that lacks confidence or someone who is up to their eye-balls in payments but brims with confidence? The unconfident households with room in their income statement will ultimately be part of what we call "pent up demand" for goods and services. The car wears out or the fridge needs replacing or the kids are going to get too old to want to go to Disneyland, so you breakdown and do it. You don't have much confidence, but you can afford the expense.

These facts have been baffling to most stock market participants for nearly three years. In the world of the supposed "new normal", why is everything happening pretty normally among US consumers who are providing great business to McDonald's (MCD), Starbucks (SBUX) and Nordstrom (JWN)? We believe the record-setting low consumer confidence numbers of 2009-2011 and the continuing high levels of unemployment that The Big Picture speaks of have been the reason that the money management community has avoided the consumer discretionary category.

We looked at the correlations between consumer confidence and the stock market between 1977 and 1996. What we found was that there was almost zero correlation and it was a neutral. If you look at the period since 1996, consumer confidence was a valuable contrary signal at extremes and the correlation is significant. Stocks were to be avoided on high consumer confidence and the stock market lows have coincided with low consumer confidence.

Going back to Andy Grove's professor, the logical thing that everyone knows is that US households have a great deal of debt to work off over the next ten years and the US government has a very large amount to deal with itself. Everyone has assumed that the consumer wouldn't be able to lead a meaningful economic recovery until those debt levels come back in line from a historical standpoint. This has resulted in significant under-ownership by professional money managers and asset allocators in the consumer discretionary category. We believe that until the money management community capitulates and buys into the consumer sector that it will out-perform the S&P 500 Index. And we believe that the capitulation will come at dramatically higher consumer confidence levels and we are about as far away from those statistics in early November of 2011 as you can be!

Best Wishes,

William Smead

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