Courage at the Bottom
Wisdom on the Retest
July 8, 2010

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Dear Fellow Investors:

Somewhere along the time line there are going to be stock market rewards for being in the market for the last 30 years. At Smead Capital Management (SCM) we think that somewhere is coming soon. It all has to do with replacing the courage needed at the absolute lows with the wisdom needed on the retest of those low points.

From the early 1950's through 1981, few things were more assured than the fact that inflation marches ever higher and bond prices march ever lower. Interest rates on 10-year Treasury bonds started at around 2% in 1950 and peaked in 1981 at 14%. When I started in the investment business in 1980, the local brokerage offices ran advertisements touting tax-loss swapping of long-term bonds. If you changed coupon, maturity date and issuer, you could swap to a similar bond and get a big capital loss to use against gains or ordinary income.

Inflation had climbed almost constantly for 30 years and peaked at 13.58% in 1980. Almost all of the respected economists back then thought that inflation and interest rates were going much higher. Therefore, investors kept their bond maturities very short and were more attracted to 3 and 6 month CDs at 18 % or money market mutual funds at similar interest rates.

Since no policy maker or Federal Reserve Board had the constitution to stop the inflation freight train in the prior three decades, it became a "well known fact". Everyone knew that inflation only goes up and bond prices only go down. To buy those T-bonds at 14% you had to bet that Paul Volcker at the Fed and President Ronald Reagan would be willing to absorb massive political grief to break the back of inflation. You had to have massive courage to bet against the crowd of investors and economists to buy at the 30-year bond low and interest rate high.

After living through the worst recession since the 1930's and staring down the Air Traffic Controllers Union in 1981, inflation did get broken as investors became convinced that strong economic growth wouldn't come for years. By 1983, 10-year Treasury Bonds hit 11% and inflation dropped down to 3.22%.

Inflation fears were hard to shake. Economic growth accelerated in 1983-84 and everything we'd learned in the 1970's told experts and Fed policy makers that it meant a reacceleration of inflation was coming. Ten-year Treasury Bond rates soared to 13% and inflation rose to 4.3%. Stop yourself for a moment and think about trailing inflation of 4.3% and 13% on the 10-year bond.

In 1984 you could buy the T-bond at almost the same interest rate as the 30-year high and you didn't wonder whether Volcker and Reagan had the constitution to take the heat. Inflation could rise and your margin of safety left you well covered. It didn't take courage, it took wisdom.

By now you are wondering where I'm headed. In late 2008, investors were scared to death of the possibility of Depression and bid 10-year Treasury bonds up in price to yield 2%. They feared depression and sought what Mark Twain called, "return of my money". Many aspects of the financial markets including commercial paper, money market fund solvency, Libor rates, etc. signaled what Warren Buffett called "an economic Pearl Harbor". The largest US banks were propped up by TARP capital infusions. We all held our breath and were controlled by dire economic worries. To sell your treasury bonds at 2% took huge courage. The depression was averted and the T-bond seller was happy in April of 2010 with the 10-year bond at 3.98%.

A large group of well respected economists have warned profusely since then that our economic recovery is very fragile and that the depression worries are still valid. They forecast double-dip recession and fan the flames of 2008 worst case scenarios.

In our opinion, there is just one problem. The major stress signals of late 2008 are as evident today as the 11% inflation was in 1984. However, the 2008 style fear drove the 10-year bond down to 2.97% last week. No commercial paper problems, ridiculous Libor rates or money market fund trauma. We believe selling T-bonds right now doesn't take courage, it takes wisdom.

We at SCM feel the same thing can be said for common stock owners today. In the fall of 2008 and early 2009 it took incredible courage to buy stocks in an environment where we didn't know that those distress signals would be answered. A buyer on this correction in stock prices is open to the normal risk that you take (which is that you can be underwater for awhile). On the other hand, they don't have to wonder if TARP stabilized the banks, commercial paper markets would reopen and money market funds would stabilize. In our opinion, it took incredible courage to buy stocks in the fall of 2008 and in early 2009 and in early July of 2010 we believe it takes wisdom.

Best Wishes,

William Smead

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