Dumb and Dumber
October 17, 2011

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Dear Fellow Investors:

Mark Hulbert does a great job of explaining how sentiment works in bull and bear markets. He has examined market statistics and investment newsletter writers for the same 31 years that I have been in the investment business. His analysis shows that bull markets climb a wall of worry and that bear markets decline on stubborn bullishness. Investors buy the dips in bear markets and become more committed all the way down. It reminds me of the main characters in the movie, “Dumb and Dumber”. Lloyd Christmas (Played by Jim Carrey) and Harry Dunne (Played by Jeff Daniels) seemed to compound their mistakes in every pursuit they undertook.

What brought this to mind is the price action of the last week in the US stock market. Stocks have rebounded sharply from the lows of Monday, October 3rd. The rebound has been led by Energy and Basic Materials stocks like Apache (APA), Joy Global (JOYG), Freeport McMoran Copper and Gold (FCX), Schlumberger (SLB) and Caterpillar (CAT). These have been the heart and soul of the BRIC trade for the last 5 to 10 years. The theory is that the growth in China and India will cause immense demand for energy and basic materials. This in turn causes Brazil and Russia to prosper by providing China and India with the energy and basic materials they need. They are not in the BRIC acronym, but you can throw Australia and Canada into that mix.

If you read David Barboza’s columns in the New York Times, you’ll see that a major credit crunch in China is causing all hell to break loose in the world of small to medium size businesses. They are the entrepreneurs in China and they have not received loans from the four largest banks in China which are government owned. The Chinese government’s dictated lending spree of the last three years went to communist party officials at the municipal level, who formed special purpose vehicles to develop condo, office building and other infrastructure projects. Instead, a massive underground lending system has developed where risk takers with cash have sought higher interest rates than the government-controlled banks offer. This money was loaned to businessmen and developers who couldn’t get the cheap financing offered by the government. The borrowers wanted these loans to ride the boom. These small to medium-size businesses operate on fairly thin margins and the slowdown in the world economy of the last six months, triggered by supply chain problems in Japan, has put many of them over the edge.

Thousands of Chinese business owners are disappearing and walking away from their business because they can't meet the demands of the high interest rates and the underground loans they have taken to fund their business. Here is how David Barboza describes the situation in his October 13th piece called, "As China's Economy Cools, Loan Sharks Come Knocking":

WENZHOU, China — The 300 employees of Aomi Fluid Equipment here were delighted recently when the owner offered an all-expenses-paid, two-day trip to a mountain resort three hours away.

The owner, Sun Fucai — or Boss Sun, as he's known — was so insistent that his workers attend that he imposed a $30 fine on any employee who refused the getaway. Nearly everyone went.

Except Boss Sun.

When the employees returned from their holiday, they found that the factory had been stripped of its equipment and that Boss Sun had fled town. "It was entirely empty," Li Heying, a former Aomi worker, said of the factory. "It was like what happens in wartime."

The boss, as it turned out, was millions of dollars in debt to loan sharks — underground lenders of the sort that many private businesses in China routinely use because the government-run banks typically lend only to big state-run corporations.

As China's economy has begun to slow slightly, more and more entrepreneurs are finding themselves in Mr. Sun's straits — unable to meet debt payments on which interest rates often run as high as 70 percent in this nation's thriving unregulated, underground loan system. Such illegal lending amounts to about $630 billion a year, or the equivalent of about 10 percent of China's gross domestic product, according to estimates by the investment bank UBS."

A major credit crunch for businesses is now occurring in China. Its economy, which was built on its businesses having a significant cost advantage over other competitors around the world, is losing its advantage to inflation. As that advantage dissipated over the last five years, China chose to go on the world's biggest building spree. In the process, they have made fixed asset investment an unrepeatable 50-70% of the GDP of the second largest economy in the world, depending on whose estimates you use. Real estate transactions and development is estimated to be 74% of municipal revenue.

In other words, if China doesn't keep on building at the same pace as the last three years, their economy will contract. Therefore, the two-pronged economy of China, exports and infrastructure construction, are both threatened at the same time. Exports are threatened by the underground markets ability to over-leverage small to medium sized businesses and the construction world is over-leveraged on cheap money force-fed into an economy that doesn't need what is being built. There is nobody to rent the condos and too few citizens who can afford a train ticket.

This brings us back to the US. Most of the US economy's recovery has been held hostage by incredibly high commodity prices. We have had the worst and deepest recession since 1981 and the deepest depression in construction since the 1930's. On a per capita basis, home building is at 70-year lows! This means that demand for copper, steel, iron ore, cement, coal and oil are way down from four years ago. We are using the least amount of gasoline since 2000 and the least oil since 1996.

We have been struggling to recover against a back drop that includes record high input prices. At the same time, energy costs and demand for food in China and India have made Americans pay much higher prices for food and other goods. All of these facts stem from the demand coming from China and the faith that has been placed in the idea that their economy is not subject to normal business cycles. David Barboza's article is proving them wrong:

"That tycoons in a city known for its savvy entrepreneurs are running scared has raised concerns that private business, a vibrant part of China's economy, may be losing steam — while exposing the high-risk, unregulated financial system on which so many of the nation's small and medium-size businesses have come to depend.

"There have always been people running away because they couldn't pay their debts," said Wang Yuecai, general manager at Wenzhou Yinfeng Investment & Guarantee, which guarantees state bank loans when small businesses are lucky enough to get them. "But recently, the situation here has gotten much worse."

Last week, Prime Minister Wen Jiabao and a delegation of top officials, including the head of the nation's central bank, visited Wenzhou, promising to get official banks to lend more to small companies and to crack down on underground lenders that charge high interest rates.

And on Wednesday, China's state council, or cabinet, announced a series of measures aimed at helping small businesses with tax breaks and new lines of credit.

Beijing no doubt worries that similar problems could surface in other parts of the country.

"This is not just happening in Wenzhou," said Chang Chun, who teaches at the Shanghai Advanced Institute of Finance. "Some companies borrow from the state banks and then lend into the underground market. Many are doing this type of arbitrage."

Thanks to research done by Kynikos Associates LP and its founder, Jim Chanos, we believe that many of the premises used to create faith in the idea that China's economy won't suffer normal business cycles is unfounded. For example, many China apologists argue that 25-30 million people will move each year to the cities from rural areas and support the added infrastructure. I don't know how to say, "If they build it, they will come" in Chinese, but that is the theory. Chanos argues that Kynikos research found 8.5 million people migrated in 2009 and a total of 118.7 million since 1998. However, all that movement is predicated on jobs being available in the cities and that is predicated on the building boom continuing along with those entrepreneurial businesses surviving. It sounds so much like the retiree migration that was anticipated in Miami, Phoenix and Las Vegas in 2005 and we all know how that myth worked out.

Michael Pettis has provided us statistics that which show what an unusually large part of the world's commodities have been used in China in recent years. This was backed up this week by a report which puts China as having 1.9 million metric tons of copper stockpiled at the end of 2010. This is equal to all the copper used each year in America. The credit crunch for small to medium sized manufacturers included them using copper as collateral for loans.

We have argued for three years that commodities are ridiculously over-priced and have argued that China has to have a deep recession/depression if it wants to become a major and sustainable world economic power. We believe this is all unfolding before our eyes, yet US hedge fund, institutional and individual investors are buying every dip in the commodity markets and playing the same risk-on trade that worked in 2009. Hulbert would say that their dogged bullishness is a bad sign for contrarians.

Wenzhou is one of China's many manufacturing metro areas. Barboza relied on research from Wang Tao, a UBS economist based in Hong Kong. Here is how Tao and Barboza show the current circumstance:

"As long as China's economy was racing along at an 11 percent growth rate, small companies could hope for enough business to stay a step or two ahead of their underground creditors. But there was little room for error.

Now, businesses here and elsewhere in China are being caught short because the national economy has begun to moderate a bit, to a projected 9 percent rate by year's end, in response to government-imposed measures to fight inflation and let air out of the real estate bubble.

Ms. Wang, at UBS, said the slowing economy and weakening exports would hurt many small Chinese businesses. Already, according to a recent survey by the city's small-business council, one in five of Wenzhou's 360,000 small and medium-size businesses have recently stopped operating because of cash shortages."

This means that 72,000 businesses have recently been shut down in just one city in China. A major credit crisis and recession/depression is in the offing, in our opinion. Yet US investors continue to pursue the BRIC trade all the way down. This is why the investor behavior reminds me of the movie, "Dumb and Dumber". We believe the next great bull market in US stocks will not be led by the best performing sectors of the last ten years, because leadership in energy, basic materials and heavy industrial can only come from uninterrupted growth in China. If China can continue its charade, we believe the US economy will continue to suffer. If not, the seeds of US prosperity will be watered and fertilized by lower commodity prices.

Best Wishes,

William Smead

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