



Grease (Greece) is the Word

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Dear Fellow Investors:

Everything you need to know about today's circumstance in the US stock market is covered in the theme song to the movie, Grease.

*I solve my problems and I see the light
We got a lovin' thing, we gotta feed it right
There ain't no danger we can go too far
We start believing now that we can be what we are
Grease is the word*

You might think that the countries in Europe like Portugal, Ireland, Greece and Spain are the source of the current consternation in the US stock market. We believe that Europe is peripheral to the core issue. American investors have spent the last ten years falling in love with the BRIC trade and feeding an infatuation with the "global synchronized" economy and the "emerging consensus" surrounding global stocks/bonds. They have felt that there is "no danger we can go too far" and they haven't just started believing, they have swallowed this meal hook, line and sinker.

*They think our love is just a growing pain
Why don't they understand, it's just a crying shame
Their lips are lying only real is real
We stop the fight right now, we got to be what feel
Grease is the word*

We at Smead Capital Management think that the love for all things BRIC is a "growing pain". China experts say that we "don't understand" and that "it's just a crying shame". The yield curve is inverting in Brazil and India. China is tightening credit as they deal with all of the usual fallout from acting like you can't "go too far". Inflation, economic inequalities, trouble handling debt and civil unrest are the products of "believing now that we can be what we are".

In our opinion, China's massive stimulus effectively suckered US investors into thinking that their command economy is not subject to the discipline of economics. Instead of participating in the global recession in 2008-09 they shoved \$2.7 trillion of real estate development lending into the system. It certainly made it look like they were still growing 9-10% per year and caused them to keep absorbing a massive part of all the commodities used in the world. This in turn has caused over-confidence in commodity-based countries and currencies like Australia, Canada and Brazil. The Chinese lenders even started using copper as collateral for loans. "Their lips are lying" because they don't want to deal with the political fallout of an economic contraction in a country with no freedom of speech, religion and voting. Here is how Standard & Poor's explained China's predicament on September 26th, 2011:

"Chinese developers face an 'increasingly severe' credit outlook, which may force them to cut prices and turn to costlier funding sources as sales weaken, Standard & Poor's said.

A 30 percent decline in sales may leave many developers facing a liquidity squeeze, S&P said after conducting stress tests of the nation's real estate companies. Most developers would be able to "absorb" a 10 percent sales drop next year, the credit rating company said.

"The worst isn't over for China's real estate developers," S&P analysts led by Frank Lu wrote in a report today. "Developers are bracing themselves for slower sales and lower property prices ahead."

We've seen loss estimates ranging from 30-70% on those stimulus loans. This could set a recapitalization of the Chinese banking system into "motion". Those development loan losses could stop economic growth in China the way a flat tire stopped a jalopy back in 1960.

*We take the pressure and we throw away
Conventionality belongs to yesterday
There is a chance that we can make it so far
We start believing now but we can be who we are*

*Grease is the word
It's got groove it's got meaning
Grease is the time, is the place is the motion
Grease is the way we are feeling*

The US economy grew 9% per year on average from 1800 to 1900. This included 18 recessions, 3 panics and 3 depressions. We even took time out for a Civil War. Our critics say that our belief in business cycles is "conventionality" and that it "belongs to yesterday". They say that each year 25-30 million people will move to the cities of China from the rural areas and that all the empty condos and office buildings will be filled with highly-educated Chinese workers. They argue that the Chinese people will make fantastic consumers and they will ride on high-speed trains and use the world's best infrastructure. They argue that their argument is not over-capitalized.

We argue that this bubble mentality has "got groove and got meaning". It is the same kind of "groove" in 1999 that said, "The internet will change our lives." The internet bubble in Tech stocks chopped common stock investors to bits. It is the same "meaning" as in 2005 that said, "Phoenix and Miami will see a never ending stream of retirees moving down there." Those are two of the nation's worst performing real estate markets over the last 6 years.

Grease was the way teenagers were feeling in the late 1950's and early 1960's. By the 1970's it was a dry, afro hairdo at the discotheque in Saturday Night Fever. Greece is the poster child for how investors are "feeling" in late 2011. We believe the BRIC trade and US investor infatuation with international and commodity-oriented stocks and bonds is in the process of dying. In our opinion, it is time to go back to "conventionality" and leave the BRIC trade before its "time" is gone and investors put their capital in "motion" towards the next great theme in investing.

Best Wishes,

William Smead

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