Insanity
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Dear Fellow Investors:

The definition of insanity is doing the same thing again and again and expecting a different outcome. At Smead Capital Management we want to spend most of our time talking about Hall of Fame companies this year. However, we feel we need to comment on the current stock market pullback because in some ways it appears to border on insanity.

A little review is necessary. A near complete panic and financial meltdown was averted by aggressive action on the part of the U.S. Treasury and the Federal Reserve Board in the fall of 2008. The liquefying effects of the stock market sell-off, the flight to quality in Treasury Bills/CD's/money-market funds and low Fed Fund rates set up a very favorable yield curve designed to allow the major financial institutions to earn back the capital lost in the sub-prime meltdown. Sales of discretionary items fell off a cliff in the "reset" and the economy contracted by about 6% in the fourth quarter of 2008 and the first quarter of 2009. Financial sins have been confessed by the Federal Government, State Governments, Financial Institutions, Non-Financial Corporations and on the US Household level. Out of all this came a peak in pessimism in March of 2009 that rivals any "Point of Maximum Pessimism" that we have seen in nearly 30 years in the investment business. A series of highly respected pundits, who correctly anticipated the grief and fallout three years ago, have been granted prophet status in the marketplace and have been singing doom ever since.

As is usually the case, the peak in pessimism coincided with the stock market bottom at around 670 on the S & P 500 Index. The market exploded to the upside and ran into its first minor correction in late June and early July of 2009. The conventional wisdom at that time was that we were having a "Bear Market" rally and that the economy would take years to turn. The highly respected pundits warned us that the economy and financial institutions would take years to heal and that we would do better to buy gold and Treasury bonds.

The market rallied smartly until the end of August as the news on the economy continued to improve and the worst of the problems with financial institutions seemed to be passing. Once again, doubts about the economic recovery created a sharp pullback in the stock market as the pundits expected the economic recovery to disappoint and for this to be a "Bear Market" rally. Everyone knew that September and October are supposed to be lousy months in the stock market. The pundits became more forceful, letting us know that the US economy is never going to lead the world anymore and reminding us that the Chinese economy is the place to be going forward.

Once again the “negative nabobs” were wrong and the stock market in the US rallied to 1150 on the S & P 500 Index through mid-January of 2010. Since then, many of the most popular stocks of the last year in Technology, Oil, Basic Materials and in Heavy Industry are leading another minor correction. The pundits are staring at 5.7% economic growth in the 4th quarter of 2009 (dramatically better numbers than any of the pessimists predicted) and are saying that it won’t last. They are saying that more shoes have to drop in Commercial Real Estate and that financial institutions will take many more years to heal than we expect.

Therefore, we seem to be getting another minor correction in a multi-year bull market in stocks for the same reasons as the ones we’ve already had. We believe this is true because the same logic is being used by the same people in the same way as all the other minor pullbacks. We expect this year to be favorable to owners of good quality, recession resistant US common stocks and to the US economy. Wouldn’t it be insanity to expect anything different?

Best Wishes,

William Smead

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