Late in the Party

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Dear Fellow Investors:

At the annual meeting of Berkshire Hathaway in May of 2006, Warren Buffett was asked to comment on the commodity markets in the US and here is what he said:

"I don't think there's a bubble in agricultural commodities like wheat, corn and soybeans. But in metals and oil there's been a terrific [price] move. It's like most trends: At the beginning, it's driven by fundamentals, and then speculation takes over. As the old saying goes, what the wise man does in the beginning, fools do in the end. With any asset class that has a big move, first the fundamentals attract speculation, then the speculation becomes dominant."

As we now know, the commodity bubble lasted until July of 2008 and ended up including agricultural commodities like wheat, corn and soybeans. I was in Walla Walla, Washington on July 15th in 2008 when wheat peaked out at around $10 per bushel. This coincided with oil hitting an intra-day high of $147 per barrel that same week. The folks who live around the area were benefitting from the fact that Southeastern Washington produces some of the best wheat crops in the nation. Even though the nation was in its deepest recession since 1981-82, you wouldn't have known it by what was happening in Walla Walla. Speculation in commodities ran rampant in the spring of 2008 and drew special notice from the government's main regulatory body, the Commodity Futures Trading Commission (CFTC).

In 1999, a limited number of very smart people invested in the oil business and gold. Oil bottomed at around $11 per barrel and gold bottomed below $250 per ounce. With all the gas guzzlers which were being driven in the US, it was easy to see that at some point we would pay the price. I remember seeing an automobile industry survey at the time which had gas mileage listed nearly last on a list of the 25 most important factors to a car buyer in the US. At the same time, countries were selling gold holdings by necessity or choice. The wise men were buyers in the beginning during the time period between 1999 and 2004.

Buffett's thoughts appeared to have played out when the commodity markets broke in the summer of 2008. Oil dropped to $32 by March of 2009, wheat fell to $2.46 per bushel in October of 2009, and gold peaked at $1003 around March 14th of 2008 and bottomed at $712 in October of 2008. In the past when markets have boomed and busted in that kind of spectacular fashion it took as long as 5 to 10 years or more for those markets to get interesting again. Look at how long it took stocks to recover in the US after the depression and in Japan over the last 20 years. Commodities were hot in the 1970's, but were incredibly dead from 1981 to 1999. It is usually hard to put Humpty Dumpty back together again.

However, there has been an unusual and once in a lifetime phenomena at work in China. It started in late 2008 and it has caused this speculative phase to continue. The Totalitarian Communist Government of China recognized the politically unacceptable downside risk of going through a deep recession. China has the vast majority of its citizens in a position of not yet benefitting from the prosperity of "limited" capitalism. It is one thing to go through a recession when you can vote to "throw the bums out", but it is entirely another one too go through economic contraction when your citizens have no voting power, free speech and freedom of religion.

Once the decision was made to not run the risk of letting the Chinese economy cleanse itself, the government decided to massively increase the money supply and produce GDP growth through legendary construction stimulus..Residential real estate prices soared in China as a result of the confidence and the "easy money" this stimulus created. More than $2 trillion in loans for real estate development was made to special purpose entities at the municipal level to build condos, office buildings and even immense sports stadiums. These loans are equal to one third of the $6 trillion Chinese economy. A Communist Party Official, Yin Zhongqing, and other credible sources have estimated that as much as 70% of these loans will never be repaid. As a result of growing in an uninterrupted way, commodity use in China equals close to 40% of all the commodities consumed in the world each year, even though it is only 9.4% of the world's GDP and 19% of the world's population.

With interest rates low and US investors trained for years to like commodities and trust the growth of emerging markets, the speculative fervor of 2008 was reborn in 2009-11. Speculative positions in major commodities like oil have exceeded those taken in 2008 by more than 50% as reported by the CFTC. We have described this explosive move since 2009 in commodities as "the greatest bear market rally" we've ever seen. Here is how Bloomberg reported the recent speculative activity on July 17th, 2011 in an article titled, Investors Boost Bullish Commodity Bets as Gold Demand Jumped on Debt Woes:

"Speculators raised their net-long positions in 18 commodities by 15 percent to 1.09 million futures and options contracts in the week ended July 12, government data compiled by Bloomberg show. That's the biggest gain since early August. Gold holdings surged the most since September 2009 as prices climbed to a record last week. A measure of bullish agriculture bets climbed the most in 11 months."

Buffett continued explaining speculative phases at the 2006 Annual Meeting this way:

"Once a price history develops, and people hear that their neighbor made a lot of money on something, that impulse takes over, and we're seeing that in commodities and housing...Orgies tend to be wildest toward the end. It's like being Cinderella at the ball. You know that at midnight everything's going to turn back to pumpkins & mice. But you look around and say, 'one more dance,' and so does everyone else. The party does get to be more fun -- and besides, there are no clocks on the wall. And then suddenly the clock strikes 12, and everything turns back to pumpkins and mice."

Therefore, the huge peak in commodity prices in July of 2008 occurred with a few hours left in Cinderella's Ball. The long and spectacular move in commodity prices has turned into an institutional investment orgy in commodity indexes, while gold is the commodity of choice for the speculation of the individual investor masses. Commodities are being taken for "one more dance", very much like college students who keep drinking beer at a party long after intoxication has set in.

At Smead Capital Management, we believe that the clock is very close to striking 12 midnight in commodity prices for three main reasons. First, China's effort to manipulate history and economics with construction spending is being exposed. The inflation occurring in China and the complete recapitalization of the Chinese banking system coming from a real estate crash will cause a deep economic contraction, in our opinion. Second, it has taken so much more speculative firepower to get oil back up to this year's peak at $115 per barrel, compared to how much was required to go to $147 per barrel in 2008. Any good technical analyst would tell you that a lower peak on much higher volume is a “death knell” for a market. Lastly, China must tighten credit aggressively to slow inflation or they are going to see a protest the size of a province, not one contained in a square (Tiananmen 1989).

Commodity over-indulgence, like other out of control circumstances, get the most exciting towards the end and this one is no different from the others in that respect. We think the end of this one will usher in huge revaluations in the capital markets in the US and abroad. Scott Sprinzen, an analyst at S&P, pointed out in a recent report that a significant slowdown in China could cause commodities to fall as much as 75%. His research shows that commodities decline to their cost of production when they fall out of favor. If he is right, they would certainly qualify as “pumpkins and mice”. It all looks to us like time is running short.

Best Wishes,

William Smead

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