Monopoly Money Part II
November 23, 2010

William Smead
Chief Executive Officer
Chief Investment Officer

Dear Fellow Investors:

In June of 2009, in a piece called Monopoly Money, (http://www.smeadblog.com/investor-relations/missives/monopoly-money) we argued that increasing the amount of money held in the bank of a Monopoly game will not affect the game unless the players are given more money at the beginning of the game or sometime during the game. For this reason, we felt that those investors (and they were numerous) who were avoiding US stocks out of inflation concerns were making a mistake at that time. In October of 2010, core inflation came in at zero and stocks are higher. Unfortunately for most worldwide investors and asset allocators, another Monopoly game has been played in China. Ben Bernanke, Jim Chanos, David Barboza and Jason Zweig understand this and are explaining it to folks who are willing to listen.

China increased their money supply aggressively in 2008-2010 like the US and many other countries suffering from the "Great Recession". The difference in China is that it is a Totalitarian Communist Government and its Capitalistic economy is built by giving ownership of businesses and real estate development to powerful communist party members and Army leaders. When the increase in the amount of money in their banking system occurred, a simultaneous mandate came down from the Central Government to build homes, commercial properties and infrastructure. In the US, nobody was interested in borrowing the money. The increase in the money supply is only inflationary if it turns into loans and economic activity. The so called "money printing" in the US caused a big decline in interest rates which reduced financial stress on households and businesses. As the media has well documented, it didn't lead to an uptick in lending or economic activity.

China is a completely different story. Jim Chanos provided the following information to Bill Powell at Fortune Magazine recently:

Bank lending in China over the past two years has exploded: *Lending is up 95% year over year in 2009 vs. 2008, and up another 60% through the third quarter of 2010. And off-the-books bank lending to local government finance companies might have been as much as $1.6 trillion from 2004 to 2009.*

They placed money from their banking system into the hands of the folks playing Monopoly. If you've ever played the game, a doubling of the amount of money that the players start with speeds up the process of buying properties and the creation of monopolies. The resulting inflation causes bankruptcy to occur quicker and the game to be expedited. China's developments are designed to keep the façade of uninterrupted GDP growth going. This in turn postpones the day of reckoning when the Chinese people decide if they like the downside of capitalism as much as they like the upside. We call it the BRIC trade.

On top of a development cram down, the Chinese government has also pegged its currency to the US dollar. In Frankfurt on November 19th, US Federal Reserve Chairman Ben Bernanke explained to his audience how disruptive this peg is to international monetary flows and commodity prices. Essentially, economic theory teaches that a country which runs large balance of payment surpluses would see their currency appreciate. This makes their goods more expensive and slows economic growth in a natural way.

By pegging their currency to the US dollar, China has effectively forced the US to pay inflated prices for oil, copper, iron ore, gold and a host of other commodities while they cram down the Monopoly money. We have the commodity prices in the US now which you'd expect from a robust recovery in the US economy and dramatically lower unemployment rates. All the emerging markets which have pegged their currency to ours have effectively hijacked our liquidity. Internationalists want to blame these imbalances on the US money supply increases, because they all want to kowtow to the Chinese government and maintain oddly inequitable business relationships there.

Jim Chanos also kindly pointed out in the November 17th Fortune magazine blog that the monopoly money cram down has reached ridiculous levels. His folks have calculated that 66% of GDP can be tied back to these politically mandated games. Here is what Bill Powell wrote:

Housing prices are down in major cities while supply is growing: *New residential real estate investment alone accounted for 14% of China's GDP in 2009, and housing prices have started to come down, though the overall supply is still growing sharply in 2010. Even Goldman Sachs forecasts a 10% to 20% housing price decline between now and the end of 2011.*

Chanos' firm, Kynikos, also has evidence that the frenzied and somewhat mindless home purchases are seeing a big sales drop from last year. For those of you who got caught in our real estate bubble, the sales drop off preceded the prices collapsing. David Barboza of the New York Times played Toto for us and pulled the curtain back on the Wizard of Oz in China. The Monopoly money has created a number of "Ghost Cities" and empty developments all over China (New York Times article "Chinese City has Many Buildings, But Few People" October 19, 2010).

Lastly, Jason Zweig put the effects all this has on the US stock and bond markets together in the November 20th edition of the weekend Wall Street Journal. His article was titled, "Why Your Stock Portfolio Is Acting Like a Commodity Basket."

Zweig confirms what we at Smead Capital Management have believed for a long time. Our belief is that the mass acceptance and the belief of worldwide investors in the idea of uninterrupted growth in China and other emerging markets have created distortions in the US stock market. These distortions might be bigger and more all-encompassing than the tech bubble. Here is what Mr. Zweig wrote:

Some of the linkages between stocks and commodities are looking bizarre. This Thursday, the monthly correlation between sugar futures and the S&P 500 hit 67%, more than 10 times its level just six days earlier, says Howard Simons, strategist at Bianco Research. That is the third time this year that the linkage between sugar and stock prices surged above 60%—much higher than their long-term average of under 20%.

Another group of commodities—industrial metals—seems to be exerting a magnetic force on some unusual targets. According to global portfolio strategist Phil Mackintosh of Credit Suisse, in recent weeks, shoe manufacturer Nike and fast-food giant Yum Brands both have been moving around 60% in lock step with the prices of aluminum, copper and zinc. Those correlations have roughly doubled since May.

But there is another, less visible force at work, Mr. Simons says. Algorithmic trading programs, or "algos," automatically buy and sell a wide variety of assets based on mathematical models. An algo doesn't know or care why two assets are moving together; it merely is programmed to recognize that they are doing so. As soon as a computer places bets that such a linkage in prices will persist, other traders—computers and humans alike—tend to take note and follow suit. That can be true, Mr. Simons says, whether or not a correlation is driven by fundamental economic factors.

"We've gotten to the Frankenstein point where algos are self-programming, and they evolve to chase these relationships," Mr. Simons says. "That's created a sheer wall of money that is forcing other people's behavior into the same pattern."

We would agree that the use of monopoly money in China and the mass belief in uninterrupted growth in emerging markets has reached the "Frankenstein" or just plain silly stage. We remember how ridiculous investor faith became in the idea that the internet would change our life. Investors didn't know or care when a "dot-com" company would have meaningful sales or profits just like Chinese government officials are not worried about David Barboza's "ghost cities". The Northern Telecom Corporation made up 70% of the market capitalization of the Toronto Stock Exchange at the top of the tech bubble in early 2000. Fidelity's Rising Dividend Fund had a 20% position in tech stocks in late 1999, even though none of them paid a dividend. The bear market that followed decimated technology stocks. How crippled will widely diversified investors be when emerging markets, commodities, commodity-related stocks, heavy industrials and resource exporting country currencies all turn incredibly sour at the same time?

Emerging market monopoly money has had a very damaging affect on the duration of common stock investing. Investors in good quality companies which have very little to do with emerging markets or commodities are being tossed around by high volatility and these high standard deviation price movements. Zweig quoted Howard Simons on this subject:

"The longer your time frame as an investor, the greater your risk tolerance has to be now, because over the short term diversification is going to keep looking as if it's disappeared. It will re-emerge with time, though."

We believe that investors in the BRIC trade are about to find out that what John Maynard Keynes said many decades ago is true. He said: "It (investing) is the one sphere of life and activity where victory, security and success is always to the minority and never to the majority."

Best Wishes,

William Smead

The information contained in this missive represents SCM's opinions, and should not be construed as personalized or individualized investment advice. Past performance is no guarantee of future results. Some of the securities identified and described in this missive are a sample of issuers being currently recommended for suitable clients as of the date stated in this missive and do not represent all of the securities purchased or recommended for our clients. It should not be assumed that investing in these securities was or will be profitable. A list of all recommendations made by Smead Capital Management with in the past twelve month period is available upon request.

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