Mythical Argument

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Dear Clients and Prospective Clients:

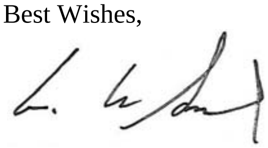
In a recent interview on CNBC, Morgan Stanley Smith Barney Chief Market Strategist Tobias Levkovich talked about the “Mythical Argument” that consumers are never going to spend again. The thesis is that the behavior of consumers will be permanently changed as a result of the depth and length of this recession. In turn, high levels of unemployment could decline doggedly. High sustained levels of unemployment and large over-hanging consumer and government debt could serve as a force field, preventing meaningful real economic growth for years. Leading proponents of this argument are Bill Gross (PIMCO) and Jeremy Grantham (GMO). Tobias argued that their argument is so ingrained in existing portfolio management actions that it just might be a myth. At Smead Capital Management, we believe we are positioned to do well in that environment. We believe our large-cap recession-resistant brand name companies could thrive if that argument holds water.

However, we must constantly harken back to the idea that “When everyone knows something to be true, nobody knows nothin’”. Belief in the “weak economy for years” argument has caused a huge amount of U.S. investor capital to chase commodities and worldwide infrastructure investments. These investors are going where they think the economic growth is going to be and want to protect themselves from whatever inflation comes from the policy decisions made to avert an economic depression and bring us out of this recession. We believe there are some big problems with their approach. First, the BRIC trade or idea that the world will be led by the emerging markets of the world peaked last year (2008) in a bubble. Bubbles take a minimum of 5 to 7 years to correct and many times take as long as 10 years or more to return as a profitable concept. Therefore, if history is any guide, Oil, commodities and emerging markets could be dead money for a number of years.

Second, even if emerging market economies do lead us out of this recession and into a period of prosperity, they may not be a good place to invest. Franklin-Templeton’s emerging market strategist Mark Mobius said on Bloomberg recently that an enormous amount of new shares of common stock will be issued as Chinese companies go public in the next five years. Fast growing nations and their economies can be capital absorbers, rather than capital multipliers. How can this be so? When our nation’s residential real estate markets and economy boomed between 2002 and 2006, capital was drawn away from most stock market sectors. Basic materials, commodities and heavy industrial stocks gained capital and affection, while most other sectors suffered capital withdrawals. Individuals have been massive net sellers of U.S. equities since the peak of the market in early 2000 when they held $10 trillion of individually owned shares. At the recent March of 2009 lows, that figure was close to $5 trillion. The economic growth absorbed the capital and the same thing could happen in China. It happened in the U.S. as we built the railroad system in the second half of the 1800’s. Our nation grew immensely and spread westward, but we absorbed massive capital and much of it never got paid back to the countries like Britain and France which loaned it to us.

I will say the unspeakable. From the “reset” levels of the 2008-09 contraction, consumers could make a consistent comeback as they become convinced that our system will continue to succeed and gasoline isn’t going to cost $4 per gallon or higher. If the idea that American consumers won’t make a comeback is a “Mythical Argument”, what could happen the next few years? Unbelievable profits could come out of the income statements of lean and mean corporations. What would a year-to-year sales gain of 5% do for the profits of Nordstrom, Starbucks or WalMart? How much money could Home Depot make if people quit worrying about their job and the price of gas and started fixing everything that is wrong with the home they want to live their life in? What if all the kids who want to go to Disneyland and Disney World get to go next year? What if you could have a good economy for years without building up debts in the process? What if this cleansing of the last two years really worked and we ended up with one of the best long-term economies we’ve ever had?

Best Wishes,



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