



Nero (Iran) Fiddles While Rome (China) Burns

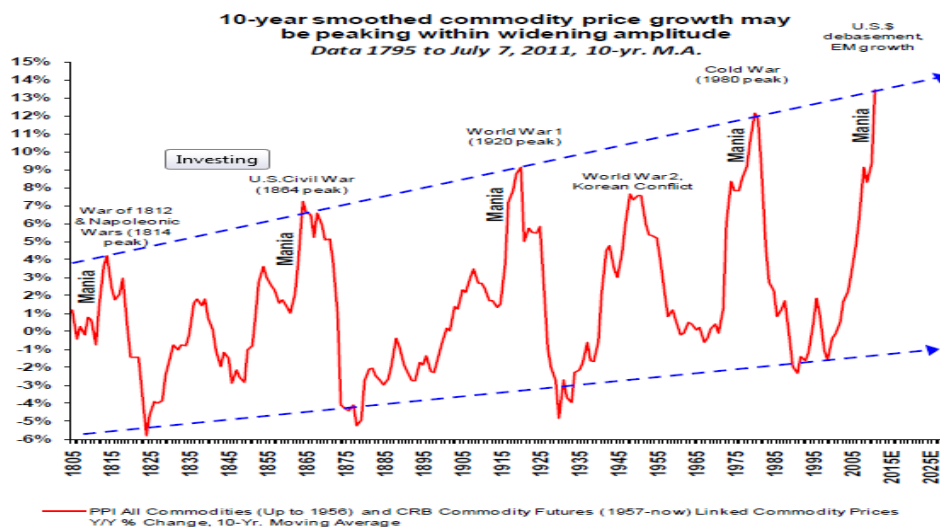
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William Smead
 Chief Executive Officer
 Chief Investment Officer

Dear Fellow Investors:

What is required for a whopper of a secular bear market is for most market participants to believe the positive side of the story all the way down. We at Smead Capital Management believe that all the pieces are in place for commodities to suffer a multi-year bear market which will wipe out up to 70% of peak prices on most major commodities. We have shared the graph below before, but we want to make sure everyone sees the potential for a massive reversion to the mean.



Source: Stifel Nicolaus “Interlocking Structural Challenges: Traction, Unity and Rebalancing”
 July 7, 2011

For commodity prices to revert to the mean in the next ten years and to reach negative rolling ten-year returns requires a massive bear market. Some of the preconditions for a massive bear market in commodities are:

1. Significant over-valuation. Most commodities trade for 3 to 4 times the cost of production.

2. Massive ownership by financial and non-economic owners like Endowments, Foundations, Pension Plans and consultant recommended portfolios.
3. Well identified cheerleaders with great fifty-year arguments (Jim Rogers and Jeremy Grantham).
4. Smart money either short or on the sidelines. Commercial interests have their biggest short positions in CFTC records.
5. Conagra, Cargill and Glencore selling to “bigger fools” at the top. Conagra sold their commodity trading business at the top in 2008, Cargill spun off Mosaic in 2011 and Glencore went public in 2011, both near the top.

We could go on. China is the largest marginal user of commodities in the world at the moment and the largest economy in the world (USA) has been busy teaching itself to use dramatically less of these commodities in the last four years. China’s internal stock market, the Shanghai Composite, the only index which seems to reflect the truth about the immense slowdown occurring in China, made a new low on January 5th at 2148. While China burns, devoted commodity speculators/owners hang their hat on Iran’s effort to flex its muscles in the Straits of Hormuz. Oil is the lynchpin to the commodity markets. It is the biggest single factor in the commodity indexes and has a huge impact in the production and transportation of all the other commodities. Oil and gas production is going wild all over the world and supply is up dramatically everywhere. Oil trades completely uncorrelated to natural gas, even though the process of finding them is deeply intertwined.

We’ve got what we at SCM think is great news for investors around the world. We believe this is Nero’s (Iran’s) last chance to fiddle. In our opinion, the recession/depression coming in China’s economy will break the back of oil prices for decades. Lower oil prices could strip the economic relevance of Iran, Saudi Arabia, Syria and Yemen. The institutional investing crowd will wonder why they got tied up in commodity indexes at their peak of popularity and will spend the next five years moving away from an over-commitment to oil, basic material and heavy industrial stocks. These were nothing more than a back-door play on the commodity boom triggered by the BRIC trade and all of its global synchronization. As we believe that the news will ultimately show that Rome (China) is burning, watch the case on commodities become something that the cheerleaders used to “harp” about.

Best Wishes,

William Smead

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