Supreme Moment
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Dear Fellow Investors:

Kairos (καιρός) is an ancient Greek word meaning the right or opportune moment (the supreme moment).

The world of value investing and portfolio management includes mean reversion and patience. Speculative episodes typically go on for much longer than expected. This fact forces us at Smead Capital Management to take a stand by avoiding overvalued common stocks and owning undervalued shares for a period of time before the marketplace chooses to recognize capital misallocation. Everyone would love to make their adjustments at the "Kairos" or supreme moment when that which is over-priced begins to tumble and that which is undervalued starts catching a bid.

We believe that the greatest existing misallocation of capital in the world today is based on over-confidence in the uninterrupted growth of emerging markets. The BRIC trade, as it is affectionately known, has impacted a speculative episode in emerging markets (debt and equity), currencies, precious metals, oil and other commodities, exchange-traded-funds (ETFs), cyclical companies in the heavy industrial and basic material sectors and small/mid cap outperformance. China is 9.4% of world GDP and 19% of the world's population, but as China Business Professor Michael Pettis shared recently, here is China's share of global demand for various commodities:

- Cement demand represents 53.2% of global demand
- Iron ore = 47.7%
- Coal = 46.9%
- Pigs = 46.4%
- Steel = 45.4%
- Lead = 44.6%
- Zinc = 41.3%
- Aluminum = 40.6%
- Copper = 38.9%
- Eggs = 37.2%
- Nickel = 36.3%

Since most equity portfolio managers are all too familiar with career risk, they hesitate to walk away from owning the popular parts of the marketplace. Think of how difficult it has been for us in the last year to be heavily under-weighted energy stocks as they rose 40% in the six months ended Feb. 23, 2011. This was only the sixth time in 70 years that the energy stocks had done that well. How do you indentify the "Kairos" or supreme moment for pursuing the mean reversion that the statistics tell you are inevitably coming?

We use watershed events and the writing/public pronouncements of smart people. In this way we pay attention to the kinds of things which have happened or have been communicated at other major change points. Below is a partial list of recent watershed events:

- Caterpillar bought Bucyrus International
- Glencore (the world's largest commodity trader) is attempting to go public in May
- The Texas State University System announced massive physical gold holdings
- Silver prices went parabolic with the silver ETF trading exceeding the trading on the SPY (S&P 500 Index)
- Cargill is spinning off Mosaic (maker of fertilizer)
- Massive inflows into emerging market mutual funds in 2009-10
- ETF trading dominates exchange volume
- Open interest on US commodity exchanges is higher than at the 2008 commodity peak
- CNBC and Bloomberg devote their TV time to commodities and macro-economic news and thought

We could go on, but you get the idea. On the smart people side of the ledger has been famous short-seller, Jim Chanos, who calls China's use of infrastructure investments as the "Treadmill to Hell". Maintaining economic growth by over-investing in unneeded buildings and infrastructure ultimately leads to the recognition of bad loans and a poisoned banking system. Chanos is no longer alone in his opinions.

The Financial Times has brought forth the ideas of UBS Economist Robert Magnus and Deutsche Bank Strategist John-Paul Smith. Magnus refers to China's investment-intensive growth model and exogenous circumstances as pushing it toward what Magnus calls a "Minsky moment". Minsky warned that the process of leverage always culminates in instability. Magnus asks, "Could China be flirting with a similar outcome?" Here is how he (Magnus) describes what has been going on there:

"What China calls 'total social financing' – conventional bank loans and most other external sources of finance – was still 38 per cent of GDP in the first quarter of 2011, almost as high as in 2009 when China implemented a credit-centric stimulus programme. ***The credit intensity of growth, or the amount of new credit generated for each unit of GDP growth, has risen from 1-1.3 before 2009 to 4.3 in 2011****."*

In other words, it is taking nearly four times as much borrowed money to fuel GDP growth in China in 2011 as it did in 2009. The "Treadmill" has sped up, to use Chanos' metaphor.

John-Paul Smith is more focused on emerging markets in general. He argues that inflation and how it is dealt with in emerging market countries like China will lead to grief. He explains that they are very slow to deal with the inflation problem and are more prone to use government interference in industry. In Smith's view, this will cause US companies to be much more nimble going forward. Magnus backs up Smith by examining where China is in the credit cycle. He argues on an inflation-adjusted basis that China's "real" interest rates are the lowest in 13 years. They are way behind the curve and their catching up process could coincide with the ramp-down of their capital intensive real property binge.

Here is the irony of where we are today. We can't say that this is the Kairos moment or the Minsky moment. We believe that we are seeing the kind of watershed events and comments from smart people which have been seen at other pivotal times in capital markets. Magnus says, “A Chinese Minsky moment would hit global growth and resource markets and shock the consensus.” In our opinion, the risk-reward relationship has worked its way to favoring those of us who are betting that the “Kairos” or “Supreme Moment” is not far off.

Best Wishes,

William Smead

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