The Best is Yet to Come

August 24, 2010

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Dear Fellow Investors:

In discussions with clients and prospective clients recently, we at Smead Capital Management (SCM) have argued that the US Treasury Bond market today is the antithesis of 1984. In 1984, 10-year Treasury bonds peaked at 14% with a 4% trailing inflation rate. Back in 1981 the interest rate was higher at over 15%, but it took massive courage to believe that inflation would get tamed. It took wisdom to see in 1984 that the back of the demand-pull and cost-push inflation of the 1970's was broken. In an editorial in the Wall Street Journal dated August 18th, 2010, Wharton Professor Jeremy Siegel reiterates our argument about why today's 2.7% interest rate on 10-year Treasuries could be as dumb an investment as the 1984 rates were smart.

In his article titled, "Great American Bond Bubble", Siegel points out that the fear of deflation and the lack of trust in eventual economic recovery have caused an avalanche of money to flow into bond funds and individual bond purchases.

A similar bubble is expanding today that may have far more serious consequences for investors. It is in bonds, particularly U.S. Treasury bonds. Investors, disenchanted with the stock market, have been pouring money into bond funds, and Treasury bonds have been among their favorites. The Investment Company Institute reports that from January 2008 through June 2010, outflows from equity funds totaled $232 billion while bond funds have seen a massive $559 billion of inflows.

He focused on comparing this bond bubble to the tech stock bubble of 2000. Many tech stocks were trading at 100 times earnings back then and Siegel correctly points out that if you're buying a bond instrument paying 1%, you are effectively paying 100 times pre-tax profits to buy the bond. Are IBM, Johnson and Johnson, and McDonald's, which sold billions of dollars of debt recently, not performing a bit of genius by borrowing money that they really don't need. IBM paid a 1.1% interest rate for three-year bonds, while JNJ and McDonald's issued 10-year bonds at 3.1 and 3.5%, respectively.

The negative nabobs of double-dip recession and Japanese style deflation have been jumping up and down lately as local, state and federal governments have been shedding staff to cover up the beginnings of private sector employment growth. Temporary staffing firms like Manpower are booming, which has historically been a predecessor of permanent job openings to follow. We believe the current economic consternation stems from having stared into the abyss back in late 2008, when we seriously considered a total breakdown of our economic system. We also believe that it is human nature to want the source of our prior problems (in this case excessive household debt) to get eliminated before we can feel comfortable about the future. Here is how Professor Siegel explains these attitudes.

Today the purveyors of pessimism speak of the fierce headwinds against any economic recovery, particularly the slow deleveraging of the household sector. But the leveraging data they use is the face value of the debt, particularly the mortgage debt, while the market has already devalued much of that debt to pennies on the dollar.

This suggests that if the household sector owes what the market believes that debt is worth, then effective debt ratios are much lower. On the other hand, if households do repay most of that debt, then the financial sector will be able to write-up hundreds of billions of dollars in loans and mortgages that were marked down, resulting in extraordinary returns. In either scenario, we believe U.S. economic growth is likely to accelerate.

We argue that the 2% interest rate on 10-year Treasury bonds in late 2008 was a function of not knowing whether we'd have a 1930's style depression. We know that the TARP plan and the work the Treasury and Federal Reserve Board did back then successfully avoided the worst case scenarios. However, there is a large crowd out there that believes there are years of penance to pay for the financial sins of the last 15 years. These purveyors of painful futures don't think the 50% decline in the stock market in 2007-2009 and the changed household behavior (some forced and much unforced) are doing the trick to cleanse the system and prepare us for long-term economic growth. The future agony they self righteously predict assumes that we can't have a long-lasting economic recovery unless Americans borrow money like drunken sailors on leave.

We disagree and can see it in the sales and profit figures from companies we own like Starbucks, Disney, EBAY and Nordstrom. As US Households postpone car purchases, put off trading up on homes and maintain rather than remodel their homes, they keep fixed monthly payments from being added to their income statements. They are saving a good part of these outlays, paying off debt and have money left over to spend on things they want. Those things they want include coffee, movie and TV entertainment, online purchases and clothing/shoes to upgrade their appearance. None of these purchases require installment or mortgage debt.

Therefore, in our eyes, the 2.7% 10-years Treasury Bonds are foolishness. We believe everyone out there avoiding the premier US companies to own those bonds will be looking back at today in the future and asking themselves, "What was I thinking about when I could have bought those stocks back in 2010?" With huge amounts of cash earning nearly nothing in money market funds, savings accounts and a massive amount of money tied up in historically low interest rates in the bond market, we could have a market melt up if the nabobs end up being wrong. We could have a pretty good US stock market even if we avoid their worst case scenarios. We saw an 80% move up in the S&P 500 Index coming off of the 2009 lows, but the best could be yet to come.

Best Wishes,

William Smead

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