# The Biggest Bear Market Rally of All?
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Dear Fellow Investors:

At Smead Capital Management we remember how most stock market participants screamed "bear market rally" in the summer of 2009 as the US market exploded to the upside from the March 2009 low. They were referring to the phenomena whereby a major rally follows a bear market, retraces some of the prior decline and attempts to suck most investors back into the market involved. These "sucker" rallies are debilitating because they heap agony upon agony for those who end up getting caught twice in the same secular decline.

Oil prices rose from $11 per barrel in 1999 to $147 in 2008. This massive price increase caused a move in gasoline prices from $1.00 per gallon to $4.00 back in July of 2008. It triggered the biggest worldwide recession since the 1930's and what we refer to as the "great reset" in the US economy. In the depths of the 2007-09 recession, oil declined to $32 per barrel. The price of oil rebounded with the US economy to the $80 per barrel level by 2010.

In April of 2011, oil moved up to $115 per barrel from $90 on the back of turmoil in the Middle East. Nervousness about oil supplies superseded the appearance of "demand destruction" in the US. Most statistics indicate that the heaviest user of oil and gasoline in the world, the US, has reduced consumption for the last 3.5 years. All you have to do is look at the sales results at US auto dealers and check parking lots to see that Americans are gravitating toward high mileage vehicles and are modifying their behavior and travel choices.

In his book "Oils Endless Bid", former oil trader, Dan Dicker, explained what has happened to oil trading over the last 20 years. A huge set of new participants evidenced themselves in the oil markets in 2008 and have dramatically increased their presence in 2011. These are non-economic oil traders. They come in the form of commodity indexes which are heavily weighted in oil (usually 30%) and exchange-traded funds (ETFs) where quick trigger finger investors can chase the popular short-term momentum they foresee.

What are some of the characteristics of a "bear market" rally and how does the oil market fit into this thinking? First, more effort has less effect. Back in April of this year, the Commodity Futures Trading Commission released statistics indicating that there was a much bigger speculative position in the oil futures market when oil hit $115 per barrel this year than there was at the peak in oil prices in 2008 at $147. In other words, a great deal more effort was being put toward bidding up the price of oil at $115 in 2011 than it took to get the same market to $147 in 2008.

Second, the long-term case or "well known fact" as we like to call it becomes universally accepted. In this "bear market" rally there are two widely accepted long-term cases. Peak oil theory is the belief that all of the oil in the world is known and peak production is very soon. In this logic, higher future demand outstrips supply and prices soar. Malthusians like Jeremy Grantham and numerous Texas oil barons support this theory. The other universally accepted long-term case is emerging market economic growth leads to demand hugely outpacing supply. We call this the "more people" theory. China has seen uninterrupted growth of around 10% per year for 20 years without any significant economic contraction. Those that champion this long-term case believe that the command economy executed by a totalitarian communist government has divorced this country of 1.3 billion people from the laws of economics and economic cycles.

Third, the largest pools of money, institutional investors, get completely committed to these themes and make a dramatic move toward the "bear market" rally. We have attended two institutional confabs in the last six months and unless we missed something, most institutional investors have greatly increased their exposure to oil in the last three years. They've done this through commodity indexes, equity managers over-weighted in oil stocks or buying Master Limited Partnerships (MLPs) in the oil patch. They have also increased their bets on emerging market countries like Brazil and Russia. Brazil and Russia are big oil-exporting nations.

Fourth, financial advisors buy in. It seems very remarkable to me that in my 31 years in the business that there is the most complete symmetry among major wire-house advisers, registered investment advisory firms, money manager consulting firms and bank trust departments. They are all advocating the same basic asset allocation advice which over-weights speculative asset classes like commodities, emerging markets and foreign exposure which have contributed to the bear market rally in oil.

Lastly, in "bear market" rallies, something causes the investing herds to ignore what comes next in the future which could form the long-term case. My econ professor use to say that economics is like physics, for every action there is an equal and opposite reaction. This time the equal and opposite reaction comes in the form of the next transportation technology. A walk through history is required at this point. In the mid 1800s, US folks travelled exclusively by horse drawn wagon. After the Civil War, a big push west was made by the railroad system to allow for long trips. By 1900, the environmental damage of horse manure reached the critical level. In New York City, over 100,000 horses were dropping 15 to 20 pounds of manure each day. In 1900 there were 4000 automobiles purchased in the US. By 1925 the number was 3.5 million. This eliminated the manure problem and destroyed the market for oats and hay.

Other industries have seen this same kind of movement. Craig McCaw envisioned a world where the telephone wouldn't be attached to a wall. He laid that vision out in 1989. Slowly the wire-line phone business is dying and his vision is reality. Many newly formed households don't put in a phone line.

High oil and gasoline prices are expediting the move to the future of transportation. The world is awash in oil and the best customers of oil producers are making a permanent move away from gas guzzling vehicles. If you are not taking the race on hybrid and electric technology seriously, you are making the same mistake investors made on oats and hay or the wire-line telephone business. We believe that in 15 years non-hybrid or non-electric vehicles will be in the minority and charging stations will displace gasoline stations.

In the meantime, any proof that "Peak Oil" theory and/or an interruption in China's economic growth could see Oil drop closer to its cost of production around $50 per barrel. Scott Sprinzen, an analyst with Standard & Poor's, put out a major note recently which argues that a meaningful slowdown in China could trigger as much as a 75% drop in commodity prices. Nothing is more tortuous than getting caught long a widely held belief or "well known fact" when the investment it leads you to gets its comeuppance. If that were to happen, gasoline could drop to $2 per gallon and those who got sucked into the rally the last two years will have to gravitate to another theme. The places to go are the countries and companies which would benefit from lower oil prices and would enjoy a rotor-booster to consumer confidence.

In summary, allow us to repeat our thesis. We believe the rally in oil to $115 is possibly the biggest "bear market" rally ever and we advise folks to protect their capital from that possibility.

Best Wishes,

***William Smead***



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