The Tough Transition
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William Smead
Chief Executive Officer
Chief Investment Officer

Dear Fellow Investors:

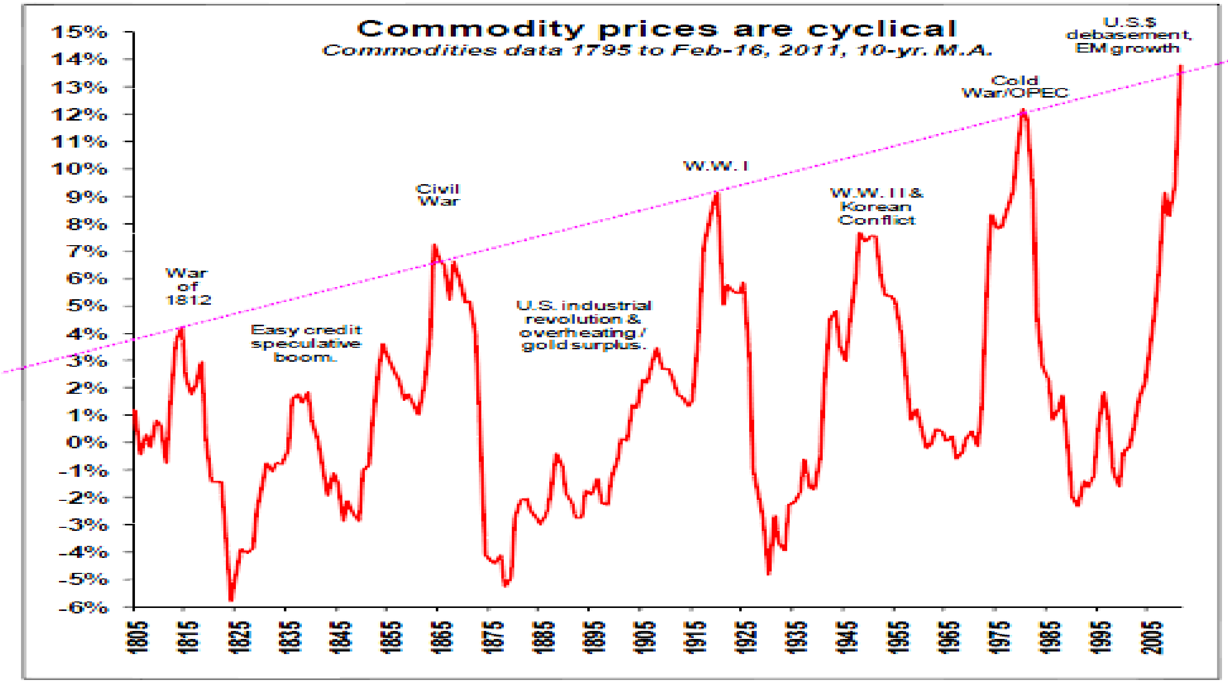
Stock market participants seem to be having a great deal of difficulty handling temporary economic weakness. This weakness is highly likely to be a combination of higher gasoline prices and the disruptions that supply chains suffered at the hands of the Japanese Tsunami. We are not surprised by this temporary weakness and if it hadn't been caused by this combination it would have come to pass anyway.

In our opinion, 2011 is the year that the US economy will move away from export-led growth in manufactured goods. US manufacturers have been the biggest beneficiary of the weak dollar. The Federal Reserve's policy of keeping short-term rates at nearly zero has made capital intensive manufacturing companies the darling of growth in the US economy. These low interest rates have triggered dramatically higher commodity prices in both soft and hard commodities and provided the ammunition to financial advisors, RIA firms and institutional investors to chase emerging market growth. Ironically, most of the emerging market growth of the last three years has been due to higher commodity prices and China's massive construction spending.

China's massive construction spending has caused hard commodities to rise in price. Professor Michael Pettis has provided a list of major commodity inputs and showed that many of them saw the Chinese economy use around 40% of what was used in the world in 2010! In turn, US manufacturers of construction equipment, mining equipment and oil-producing machinery have never seen better sales growth and profit margins. Higher soft commodities have produced a "nirvana" environment for US farmers and farm equipment manufacturers. In parts of the Midwest and the farm belts of states like California and Washington, this is the best of times.

The problem for the US economy is that the vast majority of Americans live in states like Ohio, Pennsylvania, New York and Florida. The folks in those states are seeing their gas and food budgets get busted and don't have enough manufacturing or farming prosperity to offset the misery. Or they live in California where the long commutes and debilitated housing market outweigh the farming boom between Redding and Bakersfield in the central part of the state.

Where are we going and where does this transition lead us? First, Barry Bannister from Stifel Nicolaus showed us the chart of rolling ten-year commodity returns over the last 200 years. Commodity prices have never been hotter than in the last 10 years and a glance at the chart helps you see what a statistically freakish point this is! These circumstances have been perfect for commodities. The largest populated nations (China and India) in the world have grown uninterrupted for the last 10 years. Thanks to the massive lending binge in 2009-2010, China skipped the “great reset” recession and their confidence and political necessity have led them to the limits of what an investment-driven economy can do. Even as most of the developed world shrank, the commodity inputs they use in their economy rose to boom levels.



Source: Stifel Nicolaus March 9, 2011 report “World Energy Price, Economic Growth, and the Financial Setting of Agri-Business”

Second, the major credit analysis firms (Fitch, S&P and Moody’s) are reviewing China’s credit rating for downgrades. They are doing this because history has shown that the transition from an export-led economy to an investment-led economy never ends in a consumer-led economy without some recessions and depressions occurring in the process. The US was the most successful emerging economy in history. It grew 9% per year on average from 1800-1900 and we had 15 recessions and 4 depressions during that stretch. It means that the US economy contracted regularly for 100 years and created a consumer economy in the process. It is the opinion of Smead Capital Management that China’s economy will contract in the next two years. For all anyone knows, it could be contracting right now! When China hits the wall, the entire game and worldwide asset allocation will be turned on its head.

According to Standard and Poor’s Analyst, Scott Sprinzen , “A ‘sudden’ slowdown in China may lead commodity prices to fall as much as 75 percent from current levels.” He theorizes that commodities would trade close to their cost of production, which is 25% of the current prices on average. The commodity price decline would be less, Sprinzen says, depending how much the Chinese economy slows down.

All this leads us to a transition to the pent-up demand for everything from cars to homes to travel in the wealthiest nation in the world. The US has 310 million people who have enormous incomes and still are the largest economic engine in the world. These folks have postponed forming households, buying homes and getting on with their life waiting for this commodity boom and religious belief in emerging markets to come to a miserable conclusion. They have worked hard to get their income statements and balance sheets in order and paid for the banking system to get recapitalized. Commodity prices coming down and investments being repatriated could cause a booming domestic stock market and one of the best eras the US dollar has ever had!

How can we say these things and do so with confidence? We will quote the Scottish investor, Hugh Hendry, who said this recently:

"If you want a definition of safe harbour, safe investment, I think it only has safety if it has a degree of contentious nature to it. That's why I worried, there's nothing contentious in wanting to short treasury bonds, there's nothing contentious in wanting to short the dollar… Religion is a function of repetition and a passage of many many years. ***10 years is effectively sufficient to create a cult, a cult of belief, in capital markets****. And we've had 10 years where the dollar has sucked. And the opposite of that, is antithesis: gold has been phenomenal. You have, 10, count them, 10, 10, 10 consecutive up years in gold… it's not contentious. Emerging market is not contentious. The formidable strength of the Chinese is not contentious."*

Therefore, our discomfort and enthusiasm for US consumer discretionary companies, high-quality financials and major medicine makers could lead us to unusual performance relative to other stock market participants over the next 3 to 5 years. It will be because we went to where the tough transition is taking us, regardless of what goes on in the short run.

Best Wishes,

William Smead

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