The Wrong Premiums

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Dear Clients and Prospective Clients:

At the start of the year, we at Smead Capital Management predicted that 2009 would be like 1988. In the aftermath of the 1987 Stock Market Crash the market thrashed around violently in both directions before settling at the end of the year with about a 10% gain counting dividends. People had to put up with a great deal of volatility to earn that gain in 1988 and we felt that 2009 would look similar. We are halfway through the year and 2009 appears to be 1988 on steroids. The down swings and upswings have already been huge, but the stock market is about where it started the year.

We also have felt that the economy would begin to grow again once we got past the massive "reset" in consumer spending which started in September and October of 2008. Spending figures are typically measured against the prior year. We have continued to believe the year over year retail sales comparisons will be positive in the fourth quarter of this year as compared to the economic coma figures of late 2008. The stock market is an anticipatory vehicle and we expected that the market's rally would begin six to nine months before the economy improved. It did in fact bottom around March 9th or six to seven months before the consumer spending reset turned one year old.

There have been some big surprises for us this year and those surprises are a big part of the market's recent pullback. We believe that the economic "reset" is going to become the kickoff of an era of slower growth and unwillingness on the part of the average consumer to take on debt. In this slow and consistent era we expect a substantial premium to be placed on the companies which perform well despite the new environment and borrowing reluctance. In the prior era, investors basked in the belief that the growth in emerging market countries like Brazil, Russia, India and China would drive worldwide growth, thus placing a premium on the production and distribution of natural resources like oil, basic materials and fertilizer. These cyclical industries out-performed the market from 2004-2008, got clobbered from the second half of 2008 into the new year and came roaring back in the rally off of the March bottom.

If we are right and investors resign themselves at some point to the new environment, the normal premium for strong balance sheets, brand recognition and consistency of customer base should be reestablished. This means lower P/E ratios for cyclical businesses and higher P/E ratios for companies that meet our strict 8 criteria. What normally is highly valued by investors will take its usual place in the hierarchy of common stocks. We believe this current correction in the market is the beginning of a flow of money away from investor attempts to revive the BRIC trade. We expect to move toward a premium for large quality blue chip companies with relatively non-cyclical businesses. We wait patiently.

Best Wishes,

William Smead

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