Watershed Events
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Dear Fellow Investors:

A watershed event is something that happens which serves as a point of division or transition between phases. When Paul Volcker tightened credit in 1981 and President Ronald Reagan stood up to the Air Traffic Controllers the same year, it marked the division between the rising inflation of the 1970's and the disinflationary era which followed. The breaking of the Technology Bubble in early 2000 and the 9/11 attacks of 2001 signaled a new and very difficult decade coming for owners of quality common stock.

We had some very interesting watershed events in Seattle this week. Cy Young-award winning pitcher, Cliff Lee, was traded to the Mariners. Star University of Washington football player, Jake Locker, announced that he would return for his senior season and the Boeing Company successfully flew the new 787 Dreamliner. For a town that is as starved for sports and business success like this one is, these events could signal a new phase.

At Smead Capital Management we see recent events which may indicate a transition or changing phase coming. First, central banks around the world have been buying large quantities of gold bullion. Bloomberg News reports "Central banks, holding about 18 percent of all gold ever mined, are expanding their reserves for the first time in a generation as a nine-year bull market drives prices to a record. The banks will buy 13.8 million ounces (429 metric tons) this year, worth $15.5 billion, for the first net expansion in reserves since 1988, New York-based researcher CPM Group estimates. Gold fell 15 percent that year and took another 15 years to trade again at the same price as central banks from Switzerland to the U.K. cut their holdings."

At the same time, individual investors have gorged themselves on gold bars, gold mining stocks, mutual funds and exchange traded funds which are connected to Gold. I listen to talk radio once in a while and every one of the popular conservative talk shows is pounding advertisements promoting owning Gold. Those same shows were pumping out mortgage commercials in 2006. Where were the Gold ads at $300 per ounce? Hedge fund managers, which as a group are looking for whatever might do well over the next six months, have seen many of their largest and most successful brethren pile into this trade.

It all looks crowded to me and kind of silly in a way. I was on Fox Business with another guest on Dec. 16th who heads a financial firm and he was recommending silver. He liked it because it isn't up to the same inflation-adjusted price as it was in 1980. Why does anyone buy something as a hedge against inflation, which didn't protect you from the inflation that happened the last 29 years?

Second, a city named Dubai in the United Arab Emirates has defaulted on billions of dollars of debt it used to build spectacular commercial and residential real estate; a veritable Las Vegas in the Middle East. In a piece written by the Gerson Lehrman Group for Reuters News Service recently, the writers pointed out that this debt default could be a Lehman Brothers event as it pertains to emerging markets.

Dubai is one of the seven Sheikhdoms that make up the United Arab Emirates, a federation that collectively controls a significant percentage of the world's oil reserves as well as nearly $1-Trillion in Sovereign Wealth. The GLG Group sees three main risks in this default. They felt the projects had become divorced from economic demand. The event reminds everyone that emerging markets carry dramatically more risk and lack transparency. Lastly, it makes you wonder how much you can trust these sovereign wealth funds and how well these "hedge funds" of the Middle East are doing in their asset allocation.

The third watershed event is the Copenhagen Climate Summit. In 1898, a huge pollution problem existed in the major cities of the world. The leaders of London, Paris and New York gathered to figure out what to do about all the horse manure polluting their once great cities. In the New York City area alone, 100,000 horses were dropping 15 to 20 pounds of manure per day. Think of all that manure on a typical summer day of 85 degree heat and 80% humidity. Much like today at Copenhagen, the problem at that time was about to be solved by the marketplace and individual profit motive. From 1900 to 1925, we went from selling 4000 automobiles in the US to 3.5 million and most of the people in New York went from moving people and goods by horse to combustion engine. At SCM, we believe we are in a 10 to 20-year period in which the demand for crude oil and gasoline could drop like hay and feed grain did from 1900 to 1925.

So how are these three events tied together? We believe that investor interest in Gold, Oil, Emerging Markets, and short-term trading are all interconnected. U.S. and international investors got ridiculously over enamored with the US stock market and technology stocks in the late 1990's. Thanks to those very high valuations, US stocks were doomed to ten years of poor performance. The most avoided markets in late 1999 were prepared to do relatively well. Those were Oil, Gold, Commodities and Emerging Markets. The only people making any significant money in the US stock market in the last decade were trading in and out of the market or in the stocks of companies which benefitted from higher Oil, Gold and Commodity prices or Emerging Market demand for their products. Wealthy investors went to hedge funds to get access to these markets and short-term trading strategies and equity mutual funds managers tried to emulate what they were doing by turning their portfolios over every year searching for an answer.

Therefore, these events could signify that a new phase is coming. If history is any guide, the new phase will see the most out of favor sectors produce the best performance over the next ten years. What countries are the most out of favor? Japan and the United States are the most unpopular internationally. What currency is the most out of favor? The US dollar is everyone's dog to kick. What are the most unpopular investing style and the most out of favor sector? Buying and holding U.S. large capitalization quality common stocks hasn't been this unpopular since 1982.

We could transition for awhile as the US stock market adjusts and a new phase is spawned by today's watershed events, but we are excited by the long-term implications.

Happy New Year,

William Smead

This Missive and others are available at www.smeadblog.com.