We’re Off to See the Wizard

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Dear Fellow Investors:

We're off to see the Wizard, The Wonderful Wizard of Oz.
You'll find he is a whiz of a Wiz! If ever a Wiz! there was.
If ever oh ever a Wiz! there was The Wizard of Oz is one because,
Because, because, because, because, because.
Because of the wonderful things he does.
We're off to see the Wizard. The Wonderful Wizard of Oz

In October of 2010 we explained in a missive called “The Wizard of Oz” that investors had put too much confidence in the ability of a group of Chinese National, US-educated economists to manage the China economy. Back then the curtain was pulled back to reveal that these planners were attempting to be significantly more prescient and accurate in their monetary and fiscal policy than the US Federal Reserve Board and Chairman attempt to be. Thanks to the writing of Ambrose Evans-Pritchard in “The Telegraph” on May 13th of 2012, we can see just how successful the Wizard has been in perpetuating the myth that China can be the first major world economy to defy business cycles.

The piece in The Telegraph is called, “World Edges Closer to Deflationary Slump as Money Contracts in China.” Here are Evans-Pritchard’s key points:

1. Real M1 deposits—a leading indicator of economic growth six months or so ahead—have contracted since November of 2011. They are shrinking faster than at any time during the 2008-09 crises and faster than Spain.
2. China’s electric output--watched religiously by bears--slumped in April. It is up just 0.7% over the last year. State investment in railways is down 44% and Highway construction has dropped 2.7%.
3. The Yangtze shipyards tell the tale. Caixin magazine said eight of the 10 largest shipbuilders in the country have not received an order since January 1.
4. Housing sales slumped 25% in the first quarter. This has since fed into a drastic fall in new building and floor space under construction fell 28.3% in April. (Alistair Thornton from IHS Global Insight)

Despite these chilling facts, the media seems to find experts on the China economy who think all that is needed is to go visit the Wizard. It makes you think that if you ask them why they'd say, "because, because, because, because, because…". If this were happening in the US, the media and the best thinkers in the money management world would be screaming "bloody murder". In China, the media doesn't seem to have the ability or freedom to report what is happening on the ground. And the US money management community is up to its knees in investments which play to "suckling on the bounteous teat" of uninterrupted growth in China. They all want to believe that there is an "All-knowing Oz" who can push a few buttons in China's economy and cause the 8-10% growth that is needed to make it all work out. They believe that because of all the "wonderful things" that have gone on in China over the last 20 years. We compared it in last week's missive to standing in a bog, with mud half way up your thigh. Here is a list of categories which we believe are "all twisted up in the game" with China:

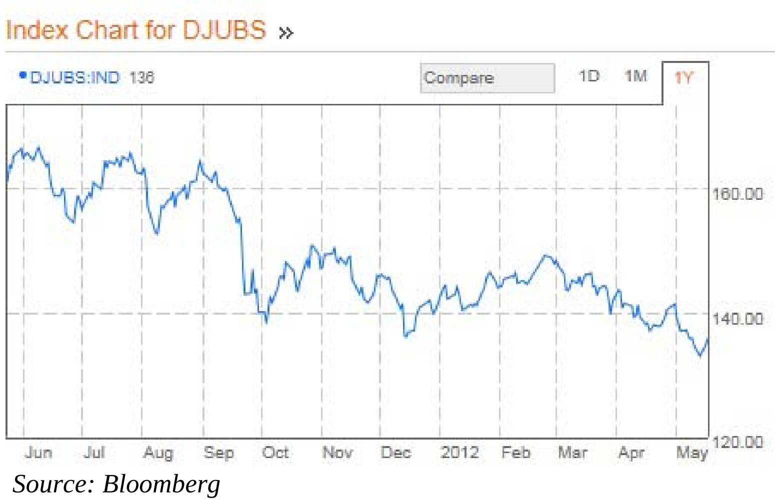
Emerging Market Stocks and Bonds—If China has a meaningful economic contraction (recession or depression), we believe US investors will flee the category.

Commodities—Michael Pettis from Peking University showed us in early 2011 that China has been using 40% of many of the major commodity inputs used each year in the world (diesel fuel, copper, iron ore, etc.). Any sizable decrease in commodity use by China could lead to a debacle in the price of commodities like Oil, Gold, Grains, Copper and Cotton.

Sovereign Debt and Currencies of Commodity Exporting Nations—Australia, Brazil, Canada, Indonesia and others are huge net exporters of commodities to China. If China gets a cold, these commodity exporting nations could get pneumonia. Major bond funds, which have been craved by US investors in the aftermath of the 2008 meltdown, are loaded with the bonds of these "suckling" countries. The US had a budget surplus when we were booming in 1999 and now we run huge deficits. We thought our Wizard, Alan Greenspan, could overcome all of our economic misallocations in the early 2000's. It's never more than a mortal and intelligent man who stands behind the Wizard's curtain. Will it be any different in these commodity exporting nations when the boom in China turns into a bust?

The S&P 500 Index and the US "High Quality" Trade—the energy, basic materials and heavy industrial sectors in the US have been "suckling" on China. Their profits could disappear in a China recession. Examine where the companies you own get their revenue outside the US. If it is from China, Brazil, Australia, Russia and others who are intertwined with this trade, beware. In the opinion of Smead Capital Management, highly cyclical companies are not "high quality" because in their down cycle they are capable of bleeding red ink.

Now that we've told you what not to do, it is only appropriate that we tell you what to do. We believe that the decline in commodities (which started one year ago according to the chart below of the Dow Jones/UBS Commodity Index) will be an enormous stimulus to the US economy. We believe the benefits of that economic stimulus will coincide with some significant improvement in housing and blue-collar employment. Lastly, we believe that domestically- oriented US companies and those which buy commodities and sell brands will be the big winners. Did we mention to quit believing in Wizards?



Source: Bloomberg

Best Wishes,

William Smead

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