Y2QE
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Dear Fellow Investors:

In 31 years of being in the investment business, I have observed a series of events played out in the late stages of what we call a “well known fact”. By our definition, a “well known fact” is a body of economic information which is known to all market participants and has been acted on by nearly anyone who has access to capital. These well known facts frequently form the basis of a bubble in investment markets. We define a bubble as the massive over-capitalization of a “well known fact”.

A few examples might be helpful. The “well known fact” in 1929 was that new radio, automobile and airplane technology would lead to un-interrupted economic growth and prosperity in the US. We massively over-capitalized the US stock market, forming a bubble. In 1999, the “well known fact” was that the internet would change our lives. We massively over-capitalized technology stocks and large cap growth stocks to form a bubble. Recently, the “well known fact” was that baby boomers would want to retire to the warm weather states of Arizona and Florida. We massively over-capitalized residential real estate and that particular bubble helped torpedo the US banking system.

My observation about these situations is that there are unrelated circumstances each time which perpetuate these “well known facts” long after the massive over-capitalization has occurred. In the middle of 1998, we owned a few large-cap tech stocks. They were fundamentally sound, but had gained maniacal PE multiples. We sold them under the theory that if there is going to be a hurricane in Miami, you don’t want to be in Palm Beach. They weren’t the heart of the tech bubble, but you could see it from there. We spent one year and nine months out of technology stocks while everyone around us was doubling their money on Initial Public Offerings (IPOs) of new tech companies and “lighting the candle” with dot-com favorites.

What perpetuated the love affair with technology stocks long after the prices got maniacal was a boom in the purchase of software and hardware. These business purchases were spurred by fears of what would happen when January 1, 2000 or Y2K came and went. The fear then was that we would have all kinds of business and utility failure in the US because that date would fry the brain of existing computers. A massive amount of money was spent on new technology to avoid this calamity and the earnings growth it caused helped to prod the massive over-capitalization to bizarre heights.

We believe today's "well known fact" is that China is going to become the most successful economy in the world and the movement of one billion Chinese people from rural areas to urban areas will provide unending demand for new infrastructure. This new infrastructure, the story goes, will require a huge part of the raw materials, oil and commodities produced each year in the world. This has caused a bubble in the prices of those inputs and in the common stock prices of any company which is directly or indirectly involved in satisfying that seemingly insatiable demand. Simultaneously, these suddenly more prosperous former peasants will have higher incomes and be hungry. This has triggered an upside panic in the price of major food commodities.

If you have been following our thoughts for the last year, you know that we believe that prices are already out of hand. However, just like in 1998, there has been an outside fundamental which has perpetuated the mania. China has prevented their currency from appreciating during their boom by pegging their currency to the US dollar. By doing so, they in effect are subject to the whims of our monetary policy. We are in the midst of Quantitative Easing II or QE2 for short. Even though China is tightening their own credit to try to get a "soft landing" from their "well known fact" driven bubble, it is undercut by the currency peg to the US. Therefore, QE2 has perpetuated the boom in China, commodities, Oil, Australia, Canada and many capital intensive common stocks like Caterpillar, Joy Global, Rio Tinto and BHP Billiton. This is coming long after they were over-capitalized.

Within 68 days of the Y2K turnover in March of 2000, the tech bubble broke. We believe this China/Commodity bubble will break very close to the end of QE in the US. If QE2 ends up being the end of quantitative easing for the US in this cycle, the clock could start ticking by the end of June.

Best Wishes,

William Smead

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