Long Bears

William Smead
Chief Executive Officer
Chief Investment Officer

Dear Clients and Prospective Clients:

In prior missives, we at Smead Capital Management have shared with you that there is a large group of money managers and investors who are counted as bullish, but are actually bearish. These investors own the reflation trade or what we like to refer to as "Peak Oil Mini-Me". Their thesis says that the Federal Reserve and U.S. Treasury are flooding the world with dollars and "printing" money and the only way to take advantage of those facts is to be long oil, gold and other commodities. The current market correction is all about them and the truth behind their thesis.

We believe the truth is that if all that the government is doing causes a rapid improvement in the economy and quickly leads to very high levels of inflation, we've got even bigger problems later on to deal with. We sincerely believe these "Long Bears" are wrong. Their frustration is causing a significant and temporary pullback in the S&P 500 Index. We believe that the U.S. Economy will begin a long slow growth phase beginning in the fourth quarter of this year (Oct. 1-Dec. 31). A year ago the economy went into a coma in September. We have since reset our spending 10% lower than the prior year. This spending cut is much deeper than 10% appears because it is about half of the discretionary spending we do each month. The recovery doesn't occur because of what the government does. Growth occurs because the economic benchmark has been lowered and economic activity is compared to how you were doing in the same quarter of the prior year.

The Federal Reserve's actions and the government stimulus doesn't scare us because of the banks need to replenish their capital. They will return to a good business of lending money to credit worthy people with sizeable down payments. A recent study by Stan Liebowitz in the Wall Street Journal has shown that the number one correlation to foreclosure was the lack of any down payment.

> *The analysis indicates that, by far, the most important factor related to foreclosures is the extent to which the homeowner now has or ever had positive equity in a home. The accompanying figure shows how important negative equity or a low Loan-To-Value ratio is in explaining foreclosures (homes in foreclosure during December of 2008 generally entered foreclosure in the second half of 2008). A simple statistic can help make the point: although only 12% of homes had negative equity, they comprised 47% of all foreclosures.*

This return to normal banking will take three to five years. At the same time, individual households and businesses are going to be very hesitant for years and maybe decades to borrow money. Add it all up and you quickly decide that we will not recover by returning to the foolish lending and borrowing of the last ten years. In our minds this means that we won't reflate the economy. If you don't reflate the economy, the case for oil, gold and commodities go right out the window and will look foolish; especially after last year's oil and commodity bubble burst. History shows that bubble markets are dead money for a long time after breaking, just look at the Nasdaq today compared to the peak of the tech bubble in early 2000.

So who wins in this scenario? The winners will be the "Long Bulls". The "Long Bulls" believe that all the fear of the last 18 months has left the prices of many of the world's best companies far below their intrinsic value. A long and slow economic recovery with an accommodative Federal Reserve could lay the groundwork for businesses with strong balance sheets and wide moats to gain market share. This would allow them to grow nicely from the "reset" of consumer spending levels. It could be a long period without excesses, which are usually created by too much leverage. As the debts of individuals and the government are paid back, an automatic restraint is put on the economy keeping it from overheating. Single-digit earnings growth in a slow economic era could produce price-to-earnings expansion. We believe large quality company shares will be the place to be for the next five to seven years.

Best Wishes,

William Smead

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