At the Margin
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Dear Fellow Investors:

I've always felt very fortunate to have received a solid education at Whitman College in Walla Walla, WA. In Micro- and Macroeconomics, we studied marginal supply and marginal demand. In calculus, we learned the mathematics surrounding the rate of change occurring *at the margin*. We learned that producers and their competitors produce until marginal profit moves to zero. What was so important about the things which happened *at the margin*?

We at Smead Capital Management have been pondering the interview Jim Chanos did with Charlie Rose on April 12, 2010. He explained to a very frustrated Mr. Rose that the seeds of a credit driven bubble in the commercial and residential real estate markets in China are about to burst. This will happen, he explains, despite the best efforts of the communist government to combat the bubble and ultimately deal with the effects. In this "treadmill to hell", Chanos shows that the bubble in real estate there is as egregious as the subprime bubble we had in 2005-07 in the US.

However, to make money from these phenomena unwinding, Chanos is not placing most of his bets against Chinese companies. When asked by Mr. Rose what he is “selling short”, Chanos said, "But probably more importantly from an investment point of view this has implications for the people selling stuff to China, commodity, people – anything that are selling things to people who put up high-rise buildings, cement, glass, copper. That’s where you’re going to see probably a step function down in demand – steel, because right now it’s all going to China.” To understand why he is shorting commodities and commodity producers to benefit from a dramatic slowdown in GDP growth in China, you have to understand how important demand *at the margin* is to the market price of copper or steel or oil. Un-interrupted GDP growth in China and India has been at the forefront of investor confidence in commodities and emerging stock markets. Therefore, at the margin, massive quantities of worldwide capital are committed to these investments. This commitment is tied to un-interrupted growth and could disappear very fast. Chanos says, "And then there’s this precarious tipping point where suddenly you can’t sell a project. And then it’s just as if everyone from the port side of the cruise ship goes to the starboard side of the cruise ship all at once.”If institutional investors felt that marginal demand for commodities was going to be impacted by an economic slowdown in China, you could get an outsized move down in commodity prices. Like when the tech stock bubble died, you’d suddenly had no bid.

We at SCM can give you two recent examples of similar phenomena. From 2001-2005 in Phoenix, you could see how the residential and commercial real estate booms were affecting the overall economy *at the margin*. We estimated that as much as 30% of the economy of Phoenix was tied to the building, financing, selling and maintenance of commercial and residential real estate. Prior to demand disappearing *at the margin* in 2006, there were an amazing number of vehicles floating around the highways with contractor logos on the side. Today, you have to look vigilantly to find logo-laced trucks associated with the building and maintenance of homes. The Phoenix economy cratered when home prices cratered and commercial properties followed right behind.

In the fall of 2008, toxic loans on the books of the major US financial institutions created a panic and total stock market meltdown. At the margin, retail sales fell 10% on a year over year basis by the end of 2008. In turn, we believe these purchases not being made *at the margin* triggered lower sales and profits at companies all over the country. Massive nationwide layoffs ensued as producers, distributors and retailers adjusted to the change in demand. The unemployment rate in the US rose from around 5% in 2006 to over 10% in 2009. Most folks didn't lose their job, but *at the margin* everyone's behavior was impacted by the folks that did. Remember, the vast majority of everything that went on in the US economy in 2008 did go on in 2009, but *at the margin* everyone moved to the other side of the boat.

Chanos claims that 50-60% of the GDP of China is tied directly to residential and commercial real estate. When investment capital sees a slowdown in construction, it will cause the same kind of loss of confidence in the commodity and emerging market thesis, *at the margin*, which we saw in Phoenix in 2006-07 and we saw in the US economy in 2008-09. As in everything in economics, some will benefit and some will lose. We like US large capitalization recession-resistant "quality" stocks as defined by our eight criteria and would avoid commodities, commodity producers, commodity exporting nations and construction-related heavy industrial companies. Remember, most of what went on before will still go on, but *at the margin* is where the confidence is set or lost.

Best Wishes,

William Smead

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