



Dream to Outperform the Market

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by Bill Smead
of Smead Capital Management

If you dream about investment market outcomes which are already popular in the marketplace, your dreams can turn into nightmares. The Everly Brothers 1958 hit song, "All I have to do is Dream" tells us a great deal about the long-term posture of investors in late 2013 and how dreams can turn to nightmares. On the other hand, if you dream about an outcome which most experts aren't expecting, the rewards can be explosive.

When I want you in my arms

When I want you and all your charms

Whenever I want you, all I have to do is

Drea-ea-ee-ee-eeam, dream, dream, dream

Most institutional and high-net worth investors are dreaming of China's economy becoming the largest economy in the world. They have a vision of seeing 400-500 million new middle class citizens "in their arms" and enjoying "all their charms." Just look at today's wide-asset allocation portfolios and you can see those dreams in emerging market stocks and bonds, commodity investments like gold and oil, expensive high-end residences in places like London and ownership of US companies, which are the most closely connected to the boom in China.

I can make you mine, taste your lips of wine

Anytime night or day

Only trouble is, gee whiz

I'm dreamin' my life away

We believe the problems with the China dream are numerous and are causing investors to be "dreamin' their life away." First, a cab driver in any metropolitan city in the world can recite the dream. It is too popular. Second, the charm comes from no evident cyclical in China's growth story; they haven't had a recession or depression in 30 years! The dreamer assumes something virtuous about the lack of cyclical, but an economic historian knows that economies that are not occasionally cleansed are like an oven which never gets cleaned or an engine which never gets flushed and tuned. Eventually the engine which doesn't get serviced and cleansed will die. Bad investments, failed lending, fraud and graft ultimately cause the economy to stall or breakdown.

Third, plenty of proof exists that there is no connection between the lack of economic cyclical and investment success, including the following chart:

3/31/1960-12/31/2010	
Y/Y % Change of Real GDP	S&P 500 Annualized Gain
> 6.0	-4.6%
0.5-6.0	7.2%
< 0.5	10.5%

Source: Bureau of Economic Analysis, FactSet, Ned Davis Research, Inc. (Further distribution prohibited without prior permission. Copyright 2011 (c) Ned Davis Research, Inc. All rights reserved.), Standard and Poor's.

While China's economy has grown immensely in the last ten years, their stock market has been a losing proposition. Many successful Chinese Nationals set up a parallel life in another country as a backup plan for when the cyclical shows up or the body politic gets over-run by dissent. This shows up in high-end residential real estate prices in large cities around the world with large Chinese national representation like Vancouver, BC and London.

Fourth, the Yuan pegged to the dollar has laid the groundwork for a debacle. It artificially caused a booming economy to not suffer from dramatic currency appreciation which normally occurs when an export-led boom lasts for a number of years. The natural cleansing effects of business cycles are driven by currency valuation today in the same way the gold standard did prior to the Bretton Woods agreement in the early 1970s. If the US dollar strengthens aggressively against a basket of world currencies, the Chinese export machine and property bubble, fed by US easy-money policies, could hit the wall at the same time. Those dreams won't "taste like lips of wine."

To understand this vision, all you have to do is look at what the move in the Yen/dollar trade from 80 to 100 did to various investment markets from October of 2012 to this fall. The investments the China dreamers own have significantly underperformed developed markets since then. We were in Europe for 12 days in early October 2013 and had been in the Far East in 2011 and 2012. The dollar appears massively under-valued when you compare the price of goods and services like McDonald's hamburgers and Starbucks' coffee consumed worldwide. We were paying twice the price in the major cities of Asia and Europe you would pay in New York or Seattle.

Finally, popular dreams which come true aren't useful to the long-duration investor. Dreams of new technologies like the radio and the airplane proved true in the economy and a disaster for equity investors in the late 1920s. Internet visions in 1999 proved true in today's economy, but crushed investors from 2000-2009. Will popular China dreams be any different?

I need you so that I could die

I love you so and that is why

Whenever I want you, all I have to do is

Drea-ea-ea-ea-eam, dream, dream, dream

Drea-ea-ea-ea-eam, dream, dream, dream

What can you dream about which could cause you to substantially out-perform the US stock market if your dreams are correct? Establish a vision of the US economy performing well, and in the process, bringing unemployment rates down to 5.5% while drawing folks back into the labor force who had given up looking for work.

Dream about 86 million "echo-boomers" between 18-37 years of age getting married, having babies, buying houses and buying cars which fit them, a car seat and all their accessories. As optimists, we believe we "need them so" and that the US economy "could die" as a world leading economic power if these Millennials don't reproduce themselves and grow the US population.

Keep visions of the most affordable housing of my lifetime running smack dab into the largest population group gorging on home purchases for the next ten years! Dream about two million housing starts in a single year and a massive rise in wage levels for blue collar employees who practice the building trades or who manufacture and produce home-building inputs. Fantasize about well-capitalized banks and record-low household debt service ratios.

Lastly, dream that this week's (November 5-9, 2103) better than expected GDP number and jobs report are the tip of the next-decade's iceberg. In our opinion, when you are lonely and establish a vision in a logical way, "all you have to do is dream." Whether you agree with us or not, you have to admit that our dream is not popular in the marketplace.

Warm Regards,

William Smead

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