Dear Fellow Investors:

As long-duration common stock owners, we at Smead Capital Management don't put much emphasis on predicting the year-to-year movements in the stock market. We expect at least a 10 percent or greater decline during each year and a greater than 20 percent decline at least once every five years. With that caveat in place, we will throw our two cents into the debate about what the US stock market will do in 2013.

An article online at the Wall Street Journal caught our eye on January 1st, 2013 which hypothesized that 2013 might be similar to 1973. The writer, Spencer Jakab, used research on four-year presidential term cycles from Grantham, Mayo, Van Otterloo (GMO) to present his thesis.

It has long been observed that the worst year of those four-year terms for investors is the first and the best is the third. Data going back to 1926 for the Standard & Poor's 500-stock index show the total return of first years has averaged 8.2% while third years reaped 18.7%.

An investor can cherry pick data to no end, but a particularly worrying statistic is the market's return the year after an incumbent has been reelected: a negative 0.3% on average. In contrast, the market has returned 24.9% in the third year of a president's first term.

Here is a quick review. Certainly, we don't dispute that hard medicine is usually swallowed in the first year of a presidential term, because it is the farthest away from the next election. However, for GMO to compare 2013 to 1973 and the writer to not challenge the thesis with the comparative facts, kicks our blood into gear. Our blood is up even though the tax increase and spending cut pill is being handed out in Congress as we speak (January 1).

It is easy for us to remind you what went on in 1973. Dr. John sang “Right Place, Wrong Time,” the nation suffered from years of fighting the Vietnam War, an insidious rise of secular inflation was revving up and lousy stock performance since 1966 had driven institutional and individual investors into the arms of the "Nifty Fifty" stocks of 1972. This was a group of consistently fast-growing companies which seemed to be able to overcome the difficult economic environment. They were so consistent that they were called "one decision" stocks, because portfolio managers felt they only had to decide to buy them and hold forever. Market popularity caused them to trade at 23-100 times profits and their all-encompassing combined market value caused the S&P to trade at historically high levels. Pension plans started 1973 concentrated 73 percent of their investments in US stocks and their participation was tilted heavily toward the "Nifty Fifty."

American dependence on foreign oil was about to explode with the first oil embargo, Nixon's Presidency was about to go down in Watergate flames, and we were about to get the last American out of Saigon. The market fell 14.7 percent in 1973 and 26.5 percent in 1974. Many of the Nifty Fifty fell 80 percent in less than 24 months—right place, wrong time indeed!

Mark Twain has been quoted by us many times as saying, "History doesn't repeat itself, but it rhymes!" The point in his wisdom is to analyze historical situations with similar circumstances to try to discern the mathematically most likely outcome. Here is why we think the GMO thesis fails to rhyme.
First, the common ground is in the first year of a presidential term and first year of a second term. Also, the stock market as measured by the S&P 500 Index rose the year before 1973 and 2013.

Now we will cover the differences. At the end of 1972 US institutional investors were overcommitted to US stocks and particularly large caps. Today, they are as under-committed as we have ever seen them. In 1973, the US was starting a process of becoming the most dependent on foreign oil as we have ever been. This was thanks to two Arab oil embargoes in the 1970’s. Today, America is well on the way to being the least energy dependent in 50 years. We are early in an economic recovery today and they were early in an economic decline in 1973.

The S&P 500 Index traded for 19.1 times after-tax profits on January 1st of 1973 and today trades at 14.5 times after-tax profits. Ten-year Treasury bond interest rates were 6.4 percent in 1973 and are 1.8 percent today. Labor unions were powerful in 1973 and have lost power in 2013. We could go on, but there is a lack of similarity and for that reason there is no rhyme to us.

Is there a year that does look similar to 2013? We think 1985. Ronald Reagan was a popular second-term president. He was ideologically to the right and was intensely disliked by the left. We were early in a lengthy economic recovery period from deep economic problems in the late 1970’s/early 1980’s and Howard Jones had his hit, “Things Can Only Get Better.”

And they did! It was the first year in Reagan’s second term. Oil prices were in the process of moderating after everybody and their brother had poked holes in the ground the prior ten years. A massive population group, the baby boomers, were around 28 years old (on average) in 1985 and about to explode as a major driver of the US economy.

Barack Obama is a popular second-term president. He is ideologically to the left and is intensely disliked by the right. We are early in an economic recovery from deep economic problems left over from 2007-2009. It is the first year in the second term. In our opinion, oil prices are moderating for the next ten years after everybody around the world and their brother poked holes in the ground the last ten years. All of this appears to rhyme to us. According to the Bureau of Labor Statistics, 27.4% of Americans are 18-35. Compared to prior generations this group of 19-28 year olds are running way behind prior groups in marriage, children and home buying. We believe they are about to become a major driving force in the US economy as the catch up to norms.

In summary, we would expect moderately positive stock market activity in 2013 similar to 1985, despite the natural political drag on the market. We believe that 2013 is unlikely to look similar to 1973 and that “things can only get better”.

Warm Regards and the Best of New Years,

William Smead

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