William Smead
Chief Executive Officer
Chief Investment Officer

China's Command Economy: The Gift That Keeps on Giving

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Dear Fellow Investors,

With Beijing being selected to host the 2022 Winter Olympics, we at Smead Capital took a moment to reflect on China. We concluded that posturing against China's attempt to defy business cycles could be one of the best decisions we have made and could be the gift that keeps on giving. Warren Buffett once observed that you get to make approximately 20 major business decisions in your life. As long-duration common stock pickers, we think what you avoid can be just as important as what you select. In this missive we will share why we tend to avoid companies with major exposure to China, and why that could be a good thing for stock-pickers like ourselves.

Let us share the chronological order of our view of China and the way it has framed the risks in the U.S. stock market since 2008.

1. Not only did China host the Summer Olympics in 2008, but oil prices peaked at around $147 per barrel that same year. We think oil prices peaked under the assumption that China's GDP growth would lead us to 400-500 million new middle class citizens in the world.
2. China began a massive $2.5 trillion fixed investment stimulus program in 2008 on borrowed money and sought to prove that their command economy is insulated from business cycles in the stretch from 2009 to 2011.
3. China's Yuan peg with the U.S. dollar prevented its currency from rising and having the normal slowing effect that would normally follow a boom. There is a reason for it being called a boom/bust cycle.
4. In November of 2010, Caterpillar bought Bucyrus International (a large mining equipment company) for $7.6 billion. In the summer of that year, soft commodities like corn and wheat peaked. Again, all under the assumption of the new 400-500 million middle class citizens.
5. Bill Gates, Warren Buffett and Charlie Munger anointed China with a visit in September of 2010. Investors lauded Buffett and Munger for owning BYD, the Chinese maker of electric car batteries.
6. SBS Dateline shared the story of the South China Mall (The Great Mall of China), an immense orifice without customers or a future in 2011.
7. Jimmy Rogers told Maria Bartiromo on May 14, 2012 to buy a farm or buy a tractor and go into farming. The main reason was to meet the demand from new middle class citizens in China.

Based on these markers, our eight criteria for stock selection and our analysis that everything associated with China was caught up in the 400-500 million person "well-known fact," we have avoided several areas of the U.S. stock market. These included oil/energy, commodities, basic material companies, heavy industrial companies and U.S. multi-national entities that got their best growth between 2000 and 2010 from emerging market economies.

Is it a good idea to continue to avoid companies tied to China as it persists in pretending it is not subject to the recessions and depressions which are part of capitalism? After all, the U.S. grew from an agrarian nobody economy in 1800 to the largest economy in the world by 1900. Its growth of 9% compounded for 100 years suffered through 15 recessions, 3 depressions and the nation even took time out to slaughter 500,000 of its citizens in a Civil War from 1861-1865.

We think the answer is yes. First, China seeks to prove that it is successfully controlling business cycles by announcing what their GDP growth is going to be ahead of time. They have been astoundingly (some think humorously) accurate in doing so. It reminds us of Enron, who would tell analysts at the start of the year what they were going to make in profits, then they would turn to improperly motivated executives and accountants to fudge the numbers and perpetuate the hoax.

The U.S. economy is over 200 years old and we just posted a GDP growth number of 2.3% in the second quarter of 2015. This missed the consensus estimate of 2.6%. Are we really that much less effective or accurate in forecasting with decades more capitalist experience than those who run a Totalitarian Communist government? The answer is no, economics does not lend itself to exacting predictions, especially in the short run.

Second, the debt is gargantuan and growing. It is estimated that the total debt of this 30-year old economy is 280% of GDP, even though individuals have dramatically lower use of debt via mortgages and credit cards. Imagine how much China will spend to make a winter paradise out of the area surrounding Beijing.

Lastly, Kevin O'Leary from Shark Tank was asked about bottom fishing in the oil stocks. He said, "You don't want to buy until grown men cry." Grown men haven't cried when it comes to China. At the end of an era, when a seven to ten-year bear market comes to an end, the bad loans get exposed, the lenders get excoriated, the CEO of Caterpillar writes off the investment in Bucyrus International and the sector becomes a swear word. It appears to us that we are in the sixth inning of a nine-inning game. If we are right, the China economic "miracle" might be the gift that keeps on giving.

Warm Regards,

William Smead