

Economic Commentary



Central Plains Advisors, Inc. • 100 N. Broadway St., Ste. 130 Wichita, KS 67202 • Economic Consulting & Investment Management

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Batten Down the Hatches

The Mess We Are In

It seems as if all the doom and gloom we have been writing about for so long is coming to pass in one form or another. We can't help but believe that a new paradigm is upon us. Of course, the new is really old—as there really is nothing new under the sun. The entire debt built up over the last 25 years is grinding to a halt. It is frightening to witness the financial condition of our banking industry (both investment and commercial), as well as the public at large. We are in just one hell of a mess—a mess that will take years to repair.

The Federal Reserve, as this is being written, is in back-room negotiations with various huge pools of money lenders (private equity and private people) to bail out our banking system. We thought our concern expressed a year ago that there might be \$1T worth of bad debt out there in various hands might have been out in left field, but now it seems low, maybe by half. Our often expressed thought that the banks were broke was a bit of an overstatement, but here again, it seems to be right on target, maybe even understated, if that is possible. Please see Tables 1-3 (located on the last page) depicting level II and III assets and ratios on the books of our large financial institutions. Keep in mind, level II and level III assets are those that have somewhat limited markets as concerns II, and none as concerns III. Their value is basically unknown, but estimated by using some matrix or high falootin' model.

It seems highly probable to us that most in the financial industry are destined to become wards of the state, a la Japan of the 1990's, and yet to some extent even today. All of this, of course, has been brought about through the grand alliance among and between Wall Street, the Federal Reserve, and 436 people in Washington D.C., aided and abetted by lawyers and accountants. Our reliance on government to solve our problems, financial and otherwise, has brought us to this point. Huge changes are in store over the ensuing years. We are trying our very best to figure out just what things will look like tomorrow. It's a formidable challenge. In the meantime, defense is the name of the game. To paraphrase Will Rogers, the return of your money is sometimes more important than the return on your money.

Inflation vs. Deflation

The battle between the inflationists and those in our camp, who believe deflation is on the horizon, continues unabated. What we seem to be having now is inflation in the emerging economies, and some mild spillover in the more mature ones. Commodities have become the hedge for the speculating community, as well as the more sophisticated pension funds and other seeking higher returns. There is no question but what there are fundamental supply and demand changes taking place, which accounts for some of the increase in prices. In economic circles, this is called a change in the terms of trade. However, you have only to look at Chart 1 (located on the last page) to note the parabolic move of recent times. To refresh your memory, oil has gone from \$50 on 1/18/07 to where it is today. Pure and simple, this is another asset bubble which is sure to end in misery. Pension funds led by consultants and their correlation models have once again bagged these pools of investment funds.

We do believe that, in the long-term, everything is set up for inflation to dominate. The world is turning on fiat money and political tinkering, which takes one to that end. Short-term deflation of at least one year—and probably more—through debt liquidation is in the cards—see evidence of this in Chart 2 (see insert). Most of us in our business careers have not witnessed debt liquidation on a large scale. My friends, there will be nothing pretty about it.

Who Can Retire?

We wonder, is anybody going to have any funds to retire on? Homes were once ATMs, now 401(k)s are serving as such. The point is, one asset bubble after another has taken place since 1995. You blow the bubble, extract the money, and move on to the next. Each ensuing bubble needs to be larger and longer in order to clean up the mess left behind. Is the commodity bubble the last to blow? We sure hope so, and it will be unless the financial axis of evil (Wall Street, the Federal Reserve, and Washington D.C.) can dream up another asset to balloon. Fundamentally, our economy is lacking organic growth, and thus income. That being the case, it must come from other sources, and asset price movements are elected. In that game, however, for every winner there is a loser—it's the old greater fool theory in a zero-sum game.

What seems very clear to us is that the world is on the threshold of a troublesome long recession. In our opinion, the U.S. has been in one since the fourth quarter of 2007, but not officially. Dates of recession are rarely known until several years after the fact. The rest of the world has continued to expand; however, Europe is on the verge of recession and some Asian countries are seeing a slowdown, and it's hard for us to believe that all will not be in recession before it's over. We haven't seen anywhere that the business cycle has been repealed for the Asians.

War and Peace

We have recently subscribed to the newsletter of Stratfor, a geopolitical consulting group out of Austin. We have followed them off and on since we were fellow speakers with them during an economic seminar in Dallas in the spring of 2000. The reason for this is our concern that in times like these are ripe for strikes, riots, and wars. These people have a handle on such matters, and we want to stay close to them.

One of the interesting things they believe may be happening now is the shrinking of the Axis of Evil so named by President Bush. North Korea has exited this infamous group just recently, and Stratfor understands backdoor talks are going on with Iran, as well as Syria (a second-hand member). We may well have a November surprise, just as we had when Jimmy Carter left and Ronald Regan came to office. It was really Carter who negotiated the hostage release, but Reagan got credit for it. So again, maybe President Bush does the deal, and the new occupant of the White House gets the credit. What comes around goes around. This is just the opposite of what the consensus thinks will occur.

Are Free Markets Gone for Now?

The above leads us to the political situation here at home. Obama is an out and out socialist, and McCain is close behind. Neither one seems to carry strong conservative credentials, as concerns the economy. McCain proclaims to be a fiscal conservative, and maybe he is. The problem is the Federal government is destined to create huge fiscal deficits over the next several years. Why, you ask? There is an economic equation (macro model) developed by

the Levy Institute that always comes into equalization, i.e. government, private sector, and current account balance deficits. By definition, they must balance out. If the private sector reduces its deficit and the current account balances also reduces its deficit, then the government deficit must advance sharply. This means we must have some sort of combination of tax cuts and increased government spending to offset what we see ahead for the economy. It just has to happen. Any public fiscal policy which does not do the above will only make things much worse. We are hopeful that the economic advisors to both parties will see the light, and the campaign rhetoric about tax increases and budget balancing are relegated to File 13. Government deficits should, by our analysis, be large in bad times, but turn to surplus in good. However, it rarely goes to surplus in good times—politicians will be politicians.

We previously discussed government-induced bailouts and the very real probability that we will see many more. The only thing one should add to the socialization of Wall Street is that the Fed must let someone fail. If they don't, the next time the dogs are unleashed, the fallout will be even greater. If your deposits are guaranteed and your loans can be offloaded to third parties without recourse, a perfect motion moneymaking machine of the highest order results. This machine takes on more and more risk until it hits the wall. That is exactly what happened over the last five years. Now, of course, the piper must be paid. Huge profits have now become huge losses. Everybody is suffering, both Wall Street and Main Street.

Financial Markets

The stock market is behaving as we expected. There will be a grand opportunity to buy again, but probably not now. Make sure your equity manager is on top of his game.

A technical event of unusual occurrence has recently taken place in the stock market. The long-term up trend in common stocks since 1982 has been broken—see Chart 3. This doesn't happen every day. Also of note is that based on this occurrence, no money has been made in stocks since 2000. If you may recall, we called on our people to exit the stock market in June 2000. That is one call we are very proud of, but as you know, not one of our clients did so.

Bond markets have been rather slow to recognize the weakness in the economy. Our accounts in the Target 2025 (those in Central Plains Advisors' Bison Bond I program) are approximately flat for the year to date. See Chart 4 for the 30-year government bond. Keep in mind, prices are the inverse of yields.

We do expect stocks to move lower and government bonds to move higher in price. Low-grade bonds are destined to follow the stock market lower. Defaults are moving upward at a fairly rapid pace. Every day, there become fewer and fewer bonds of any quality. As we have warned many times before, check your bonds including municipal bonds very closely; there is trouble ahead for many issues. We believe it is quite likely that the marketplace will soon become anxious to own governments. Large government deficits may be just what the doctor ordered—more bonds for investors as their appetite grows. What a surprise that will be.

Level II Assets Ranked by Dollar Amount		Level II Assets Ranked by Ratio to Total Shareholder Equity		Level III Assets as a Percentage of Shareholder Equity	
Rank	Dollars	Rank	Ratio	Rank	Percentage
1 - Citigroup	1.15 trillion	1 - Merrill Lynch	28x	1 - Bear Stearns	313.97%
2 - J.P. Morgan	1.09 trillion	2 - Bear Stearns	28x	2 - Morgan Stanley	234.88%
3 - Merrill Lynch	1.02 trillion	3 - Goldman Sachs	12x	3 - Merrill Lynch	225.40%
4 - Bank of America	781 billion	4 - Prudential	12x	4 - Goldman Sachs	191.56%
5 - Goldman Sachs	620 billion	5 - Ameriprise Financial	9x	5 - Lehman	171.18%
6 - Bear Stearns	332 billion	6 - Citigroup	9x	6 - Fannie Mae	161.48%
7 - Fannie Mae	321 billion	7 - American Electric Power	9x	7 - Northwest Air	142.02%
8 - Morgan Stanley	304 billion	8 - Genworth Financial	9x	8 - Citigroup	125.06%
9 - Prudential	276 billion	9 - Hartford Insurance	9x	9 - Pridental	119.36%
10 - Lehman	200 billion	10 - Lehman Brothers	9x	10 - Hartford	108.52%
		11 - Suntrust	8.7x		
		12 - J.P. Morgan	8.7x		
		13 - Anadarko Petroleum	8.7x		
		14 - Travelers	8.5x		
		15 - Lowes Corp.	8.5x		

Tables 1-3



Chart 1



Information contained in this commentary is based upon information obtained from sources both external and internal which we consider to be reliable, but the accuracy of the information and the recommendations contained herein cannot be guaranteed, nor do they constitute a solicitation for the purchase or sale of any securities mentioned herein. Information contained in this commentary may not be reproduced in any form without written permission from Central Plains Advisors, Inc.

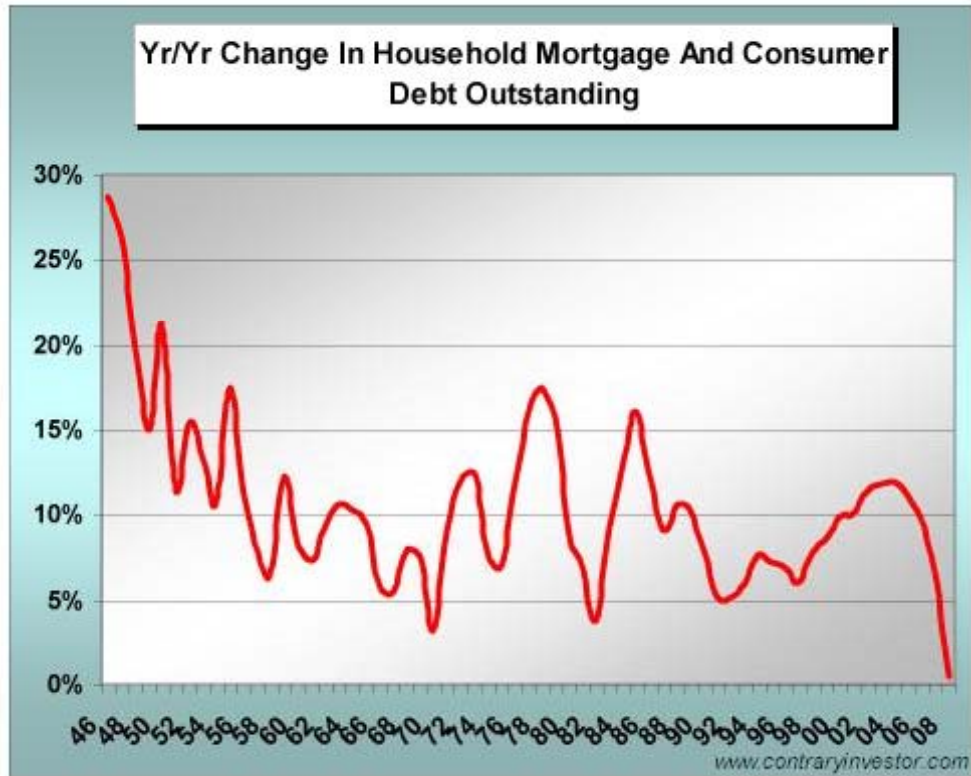
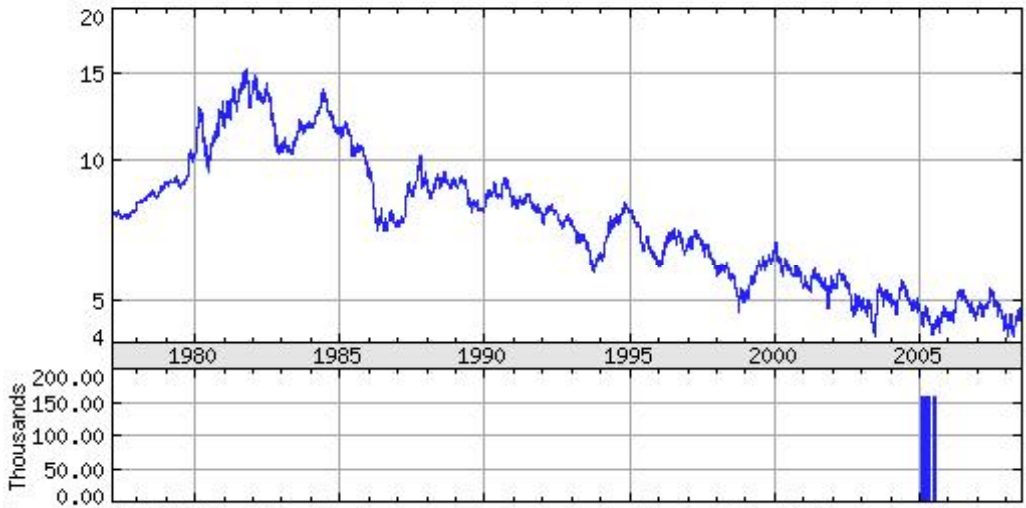


Chart 2



Chart 3

CBOE 30-YEAR YIELD
as of 27-Jun-2008



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Chart 4