# Economic Commentary

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

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## Global Economic Crisis Update: Our Economic Expectations

The current economic downturn can be attributed to excess money creation by the Federal Reserve, Keynesian economics, and human nature. We seem never to learn from history. The Austrians predicted the 1930s and the Keynesians did not. The Austrians predicted the 2008 train wreck and the Keynesians did not. The Keynesians have been wrong time and time again, but their economic model has been accepted by both political parties and promoted by academia. The reason, we guess, is the Keynesians seem always to be "doing something" about a particular problem. In actuality, they have really caused the problem in the first place, then jump in to correct their own mistakes and, at the same time, blame someone else. To watch the political hearings in Washington DC about oil, Wall Street, the automobile industry and Freddie and Fanny is frankly sickening. My friends, any student of the Great Depression will tell you that we are committing now the same mistake made then. Human nature has come full circle. We are in for a long economic period of slow to no growth characterized by deflation in the short run (one to three years), and inflation longer term.

### An Update on Debt

Other than bad economics and the unholy alliance between Wall Street and Washington DC, debt has been and continues to be a dagger in the heart of the economy. Let's take a look at the change in the composition of debt creation calendar year 2007 vs. 3rd Q 2008, on a seasonally adjusted annual basis.

**Issue of Marketable Debt**
**Federal Reserve Flow of Funds**

| Sector Item | 3Q08 | 2007 | Change |
|---|---|---|---|
| Household Debt | -$117.4B | $876.3B | -100% |
| Business Debt | $321.7B | $1,224.2B | -73% |
| Financial | $1,189.7B | $1,762.9B | -33% |
| State & Local | $65.3B | $185.9B | -65% |
| Federal | $2,078.5B | $237.1B | +777% |

My goodness what a change! This is what you might call the de-leveraging of the private sector in this country. The federal government is the only game in town. Almost 60% of all the financing growth during the 3rd Q came from the feds—6% in 2007. If one would take into account that most–if not all–of the financial debt growth came from federal government guarantees, their share would be in excess of 90%. Do you think we might be in a credit crisis? And who do you think might be to blame? There is absolutely no question it is a conflicted, unethical Wall Street group aided and abetted by Washington DC. Accountants and lawyers have been involved on the periphery. It's a toxic mix that has brought main street to its knees. Let's not forget the Federal Reserve let the money supply go wild to save us from ourselves in the 1920s, 1990s, and 2000s—what a terrible stewardship of our country's currency.

We find it very difficult to figure out how in the world we are going to get out of this mess. The consumer has to shed debt—either by payment or default. The payment must come from income now as borrowing by rolling over debt has been shut down. It does appear with short-term rates at 0% and long mortgage rates coming down, some refinancing can take place; however, if we were a commercial loan officer, we would not make long-term fixed rate loans below 6%. Such loans will look good for a year on two but certainly not over 30 years.

### An Update on the Financial Industry

It's quite obvious the financial industry is a long way from being out of the woods. Investment banks, finance companies, and even auto companies are doing their best to become banks, thereby getting permanent financing from the government. If ever there were a more incompetent management group, we don't know where you might find it. Other loans are going to become suspect as this serious recession continues its downward cycle. The banks are afraid to loan, and one can't really blame them. The Fed is pushing on a string, and only some sign of economic stabilization will unlock the loan case.

Please note the following chart, which looks at the bank index stock chart. Since the last half of November, the market has been in transition, not knowing exactly if the worst is over or not. We believe there are other shoes to drop, and would not be anxious to call bank stocks a buy today.


## Update on Wall Street vs. Main Street

Many are attempting to decipher what Wall Street will look like after the smoke from their inept management and downright fraudulent behavior clears. It's clear that there will no longer be any huge investment banks. All are gone. Think about it. Not many years ago, many were partnerships which properly obtained the gains, if any, and succumbed to the losses. Then they went public, as those in the market were anxious to participate in their large profits. The risk and the rewards were shared with the public. However, they knew how to get around that by charging huge executive salaries and enormous bonuses. The next step then was buy, bundle, and sell exotic financial instruments, which shifted the risk to pension funds and other institutional investors, while charging large fees. While this was going on, most of them turned into hedge funds and levered up 20:1 to 40:1, making large profits, sometimes on rather small spreads. Thus was created the largest legal Ponzi mania in the history of mankind.

All of the above was the result of typical human behavior—first greed, and now fear. Almost everyone was in on it as the bubbles grew ever larger and larger. Red flags were everywhere, but Washington DC was in on the deal, obtaining below-market loans and huge political contributions. The thousands and thousands of stock and bond brokers, investment advisors, and consultants believed in Wall Street research and multi-colored PowerPoint presentations. Most had–and still have–major conflicts of interest. Also, the verification of their expertise was backed up by academic studies that, in reality, make no sense at all.

All in all, the Wall Street business model is just plain awful—it must change if we are to have a good and solid economic and financial recovery. What we have now is socialized banking and socialized auto operations, with more to come. Our biggest fear is the overkill that will most certainly come from the new administration. The old one was bad enough. We have the real possibility of becoming a European clone where innovation and the risk-assuming entrepreneur will get shut out of the new economic model. As an indication of what is coming, we are already seeing articles by financial journalists blasting free market economics and the Chicago economists of Friedman ilk. We too have been critical of Friedman and other Chicago economists, but not because of their free market philosophy. We wholeheartedly believe in free markets, and little to no government interventions. What we do criticize is their belief of efficient markets, which have many an investor wishing they had never heard of common stocks. Human nature being what it is, people will most certainly call for more government intervention, thus–in our opinion–permitting more weakness in the economy over a much longer period of time. Present fiscal and monetary policy is designed to further create more of what got us into this mess in the first place.

In our original report, we presented Dalbar's study on the average investor's annualized returns for the 20 years ended 12/31/07. They are, as follows, for mutual fund investors.

**Dalbar Study**

| Asset | Annualized Total Return |
|---|---|
| **Equity (Stocks)** | **4.48%** |
| **Fixed Income (Bonds)** | **1.55%** |
| **S&P 500 (Stock Index)** | **11.81%** |
| **Lehman Aggregate (Bond Index)** | **7.56%** |

There appear to be many reasons for the poor performance of individual investors. In our opinion, most of them have to do with behavioral traits (human nature), which haven't and probably won't change over time. It's just the way we are wired. Also as mentioned previously, the delivery system of Wall Street is seriously flawed with conflicts of interest. Hopefully that will be addressed.

The update for this study will be most interesting when it is done later in 2009. The 2008 market for most assets was an unmitigated disaster. It seems only government bonds stayed out of the slaughter.

Please note the chart in the next column, which depicts the last several months of 2008 30-year government bond yields. Remember, prices go up when yields go down. We, of course, were committed to long government bonds the entire year of 2008, until early in December when we took profits—note the circle on the chart. That's where we got out. If you might remember, we mentioned several years ago that our ace in the hole was the Fed buying long-term government bonds. We said we would let them have ours when that took place, and we have!


## An Update on Globalization

Not much to report here. The ongoing globalization is a very long-term paradigm. The developed economies (will witness an extended period of slowing, while the emerging markets (e.g. China, etc.) are certain to move upward. However, because of the world-wide severe recession, most of them are in for a retrenchment and Chapter 11-like reorganization before this secular trend redevelops. In the long run, as emphasized in our Investors' Global Economic Crisis Report, the whole economic environment will benefit.

The only caveat to the above grim short-term (two- to three-year) recession and longer-term bullish assessment is what takes place in the various political capitols of the world. For example, will we have mutually destructive tariffs, devaluations, capital controls, etc.? If so, the light at the end of the tunnel may well be a train. When it comes to correct fiscal and monetary policy, it's not what we don't know, but rather what we do know that isn't true that causes economic problems.

## Update: Inflation vs. Deflation

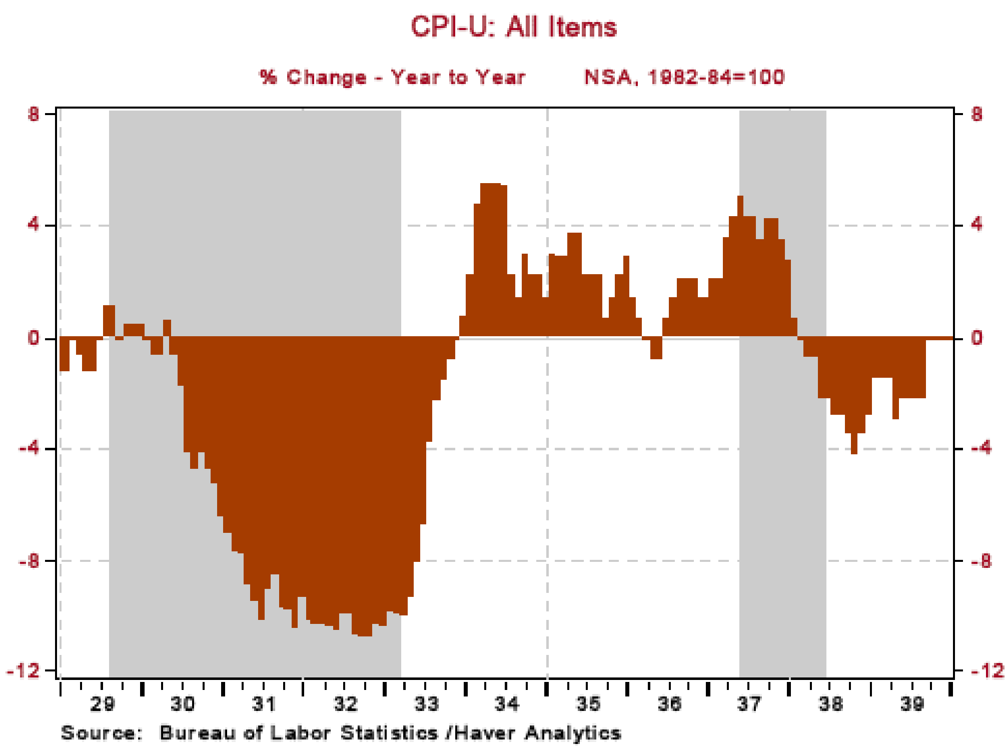
The headlines are currently screaming deflation, and deflation we are having. This, of course, has been our long-held view, and frankly anyone could have had the same opinion if they had just followed the Federal Reserve's flow of funds report. Economic growth based on excessive debt will always succumb to debt liquidations and deflation. It's always just a matter of time.
It is our feeling that we might see several years of deflation— but in the long run, infla-

tion will once again become a problem. Note the following chart depicting the experience of the 1930s .

The timing of these changes, and just when the markets will begin to discount the occurrence, is our mutual challenge. This timing will be difficult, and as a result it has led us to change our no-load mutual fund investment vehicle. No longer will we use American Century's Target 2025. We have used this fund for 18 years, but the long-term trend in lower rates is changing. This fund limits trades, which was all right, as we didn't need to trade often–but in the future this will no longer be the case. Our long-term research and beta testing has led us to use the Rydex no-load government mutual funds as the horse we want to ride. We expect through our fundamental research and technical model to achieve returns consistent with the past. As you know, in our Bison Bond I accounts we are in money market funds. These funds deliver little to no income, therefore are only used to keep from losing principal. Please be patient, we will not be there forever—the wait will be rewarded as it was recently.

### A Final Thought

As we look toward the future, what worries Central Plains Advisors the most is the role of the federal government in our free enterprise system. We appear to be morphing into a China-driven economy—those in Washington DC will decide the winners and losers, who gets off free, who pays the bill, etc. These actions likely will be the start of something akin to disasters. Beware of the knock at the door where someone says "We are from the government and we are here to help you."




**Adapted from SafeHaven.com**

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