

# Economic Commentary



Central Plains Advisors, Inc. • 200 W. Douglas Ave., Ste. 100 Wichita, KS 67202 • Economic Consulting & Investment Management

April 2010

## Be Resolute & Be Ready

The following is what you must understand if we are going to make it through what we believe is taking place in the world. Of course no one knows the future with perfect accuracy. However, as a fifty-year student of economics and financial markets, we submit that the following are important factors in what is to come:

1. The entire world economy is betting that an increase in sovereign debt can save their respective economies. That may have been true thirty years ago, but piling sovereign debt on top of existing large private and public debt won't work. There is a law of diminishing returns that is currently very much in play. For example, in the U.S., each additional dollar of debt appears to be taking away from economic growth (see chart 1 on page 3). Please remember that we are the best of a bad lot when it comes to economic and political stability. Also not to be overlooked is the fact that we remain the dominant military power if things become extremely critical. For at least the next five to ten years, and probably longer, the U.S. will remain the safe haven for the world. No other market anywhere has the capacity to handle the world's stored and frightened wealth.

2. Chart 2 depicts the Kondratieff Wave Cycle we believe has been in play since 2000. As you may recall, on 6/30/00 we told all of our common stock clients to sell and go to our government bond program (by the way, none of them did). From 2000 to 2009, our Bison Bond I program in government bonds has produced a 5.9% total return net of fees over that period compared to -1.0% for the S&P 500. If we are

correct in our assumption that a Kondratieff Wave Cycle is in effect, one can expect at least another ten years of less than satisfactory economic conditions and volatile markets. As a matter of record, CPAI is in the first percentile of a \$1 trillion fixed-income database for the 19 years (life of the firm) ended 12/31/09. What this means is that we have outperformed 99% of the fixed-income funds in this large database.

Please keep in mind we are pointing out our record not to brag, but rather for you to compare our stewardship to the myriad of others that are telling you to invest otherwise. When hearing or reading about those who have differing investment opinions, always ask for their independent, third-party authenticated performance record. See if their performance is as good as their mouth contends. We have always maintained from analyzing databases of performance numbers that only ~25-30% of those that say they can perform well actually do. Those of us in the investment business are all legends in our own minds.

The long winter phase of the Kondratieff Wave calls for a very defensive investment posture. In hindsight, we will probably find that those who just manage to break even will have done better than most. You see, Wall Street is back to doing the very things that got us into this mess in the first place. Please note chart 3 on corporate profits.

When it became known that "too big to fail" was still in effect, the Wall Street people have been the main factor in the large increase in profits

*As benchmarks for comparison, the indexes used represent an unmanaged, passive buy-and-hold approach. The volatility and investment characteristics of the benchmarks cited may differ materially from those of CPAI. Please be advised that the comparison to the S&P 500 is not an apples to apples comparison, as they are a different class of assets. The account performance figures reflect the reinvestment of dividends and capital gains, and are net of maximum CPAI fees. Past performance may not be indicative of future results and does not guarantee positive returns. The performance results for 1991 through 2009 have been independently compiled by CPAs from information provided by CPAI. Bonds are subject to certain market risks, including loss of principle. The period of 1991-1999 was one of generally rising stocks and bonds. The period of 2000-2003 was one of generally lower stocks, but rising bonds. The period of 2004-2007 was one of rising stocks and bonds. The year 2008 experienced a stock market crash and average bond market. In 2009 there was a strong equity market and positive bond market.*

that we have experienced by selling back and forth to each other. Throughout all of 2009, the majority of the public had not participated in the common stock rally. On examination of the buyers, it appears the major players have been the Wall Street firms, hedge funds, and mutual fund managers. When will this market top out? We don't know, but a wild guess would be when the public gets back in, not being able to withstand the "lost" profits they see everyone else obtaining. Why is it that the public always seems willing and able to become bag holders?

We will be very frank with you—the only reason the common stock market might be "right" is if it is discounting a huge change in the political landscape, away from the brink of European-style socialism.

3. All financial crises have occurred after huge buildups in debt. After the deleveraging starts, history tells us that we will have at least five to seven more years of dismal economic activity. Please note chart 4 that marks how far we have come—or, better said, how little we have accomplished. Those who are projecting hyperinflation just do not understand that debt has to be liquidated first. If we had no debt, money supply would all be "free" so to speak, and adding to that by deficit spending through bond issuance could create a Weimar Republic. Under present circumstances, any price increases in oil or other commodities will only cause reductions in other spending, so that one might pay down debt. No inflation there; it can be only disinflation or, *more probably*, deflation.

4. Why government bonds? We want to be in the highest quality asset available. One could buy treasury bills, but they pay nothing and we firmly believe at these levels long governments yielding above 4.5% are attractive and there is a real possibility that high double-digit capital gains may also be at hand. We enclose here the interim we sent out 3/29/10 in case you missed it.

5. With all of the above in mind, we would like to introduce everyone to a new pro-

gram we are kicking off 4/1/10. We call it Bison Equity VII and it will be managed by Freestate Advisors of Overland Park, Kansas. Why Freestate? Why now? Freestate has an economic and market approach very similar to ours. This is very, very important. It does not mean that other equity managers might not also do well—as the old saying goes, there is more than one way to skin a cat—however, to be true to ourselves and to have full confidence in the long-term success of their approach, there must be a common culture in how one sees the economy and marketplace. Please go to their website ([FreestateAdvisors.net](http://FreestateAdvisors.net)) for further information. We are extremely pleased to have made an association with such a fine advisor group. As you know, we manage bonds with a unique strategy. They do the same with stocks.

So, why now? Aren't we bearish on the outlook for common stocks? Yes, we are. But the Bison Equity VII program emphasizes the protection of investor capital during unfavorable economic and stock market conditions. Our new stock program eliminates equity exposure during risky conditions such as today's and invests in short-term government bond mutual funds for maximum safety and liquidity. The new equity program will invest in superior equity asset classes when conditions are much more favorable for long-term stock market performance. So investors who want to participate in stocks when conditions become favorable must be prepared and be in the new program when the trigger is pulled. We expect this to occur some time over the next year or so. We thought the same about bonds in 1981. When the most favorable time for equities comes, the conditions will be such that most people wouldn't touch the market with a 10-foot pole. People will be throwing up in the streets due to their concern over their investments.

Because we always put our money where our mouth is, we have opened an account in this program. We invite you to do the same with some of your equity funds that you may have with other managers or are currently managing yourself. However, we

do not recommend shifting funds away from Bison Bond I, as we have a large potential gain ahead.

If you have any comments and/or questions, please direct them our way. We wish you the very best.

Chart 1—Adapted from Casey Research

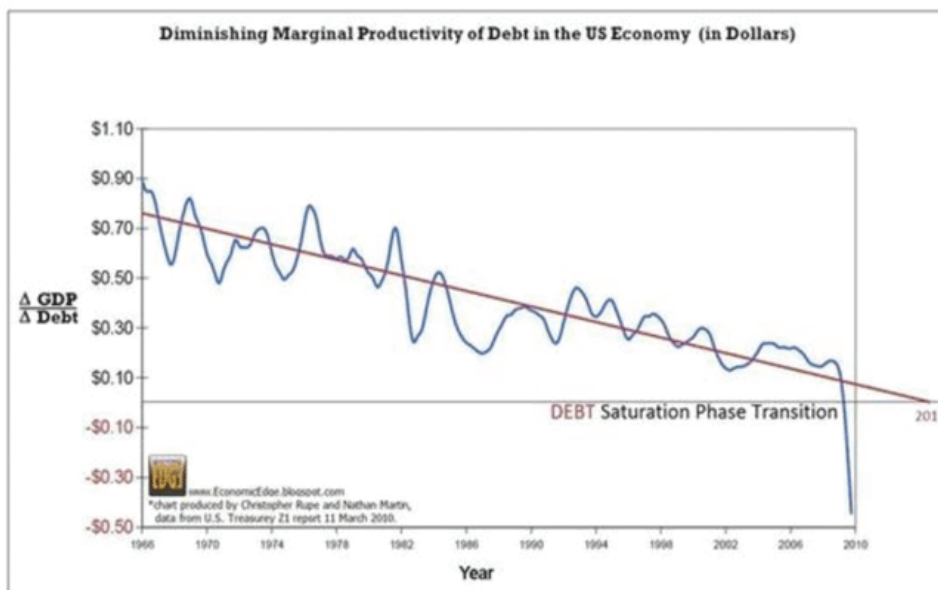


Chart 2—Adapted from FinancialSense.com

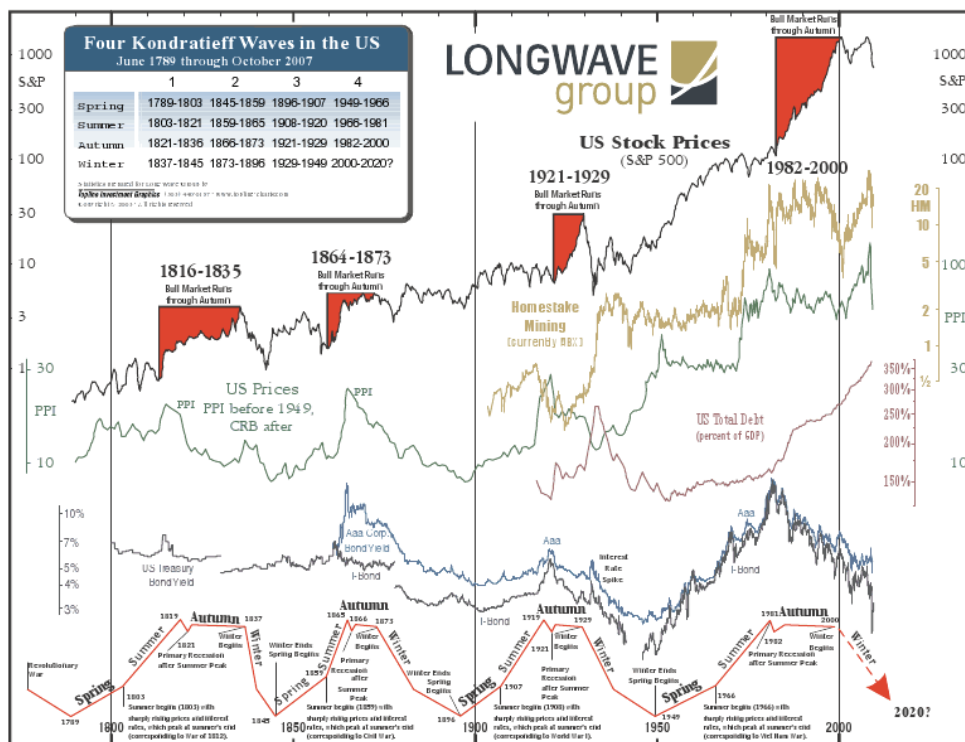


Chart 3—Adapted from Northern Trust

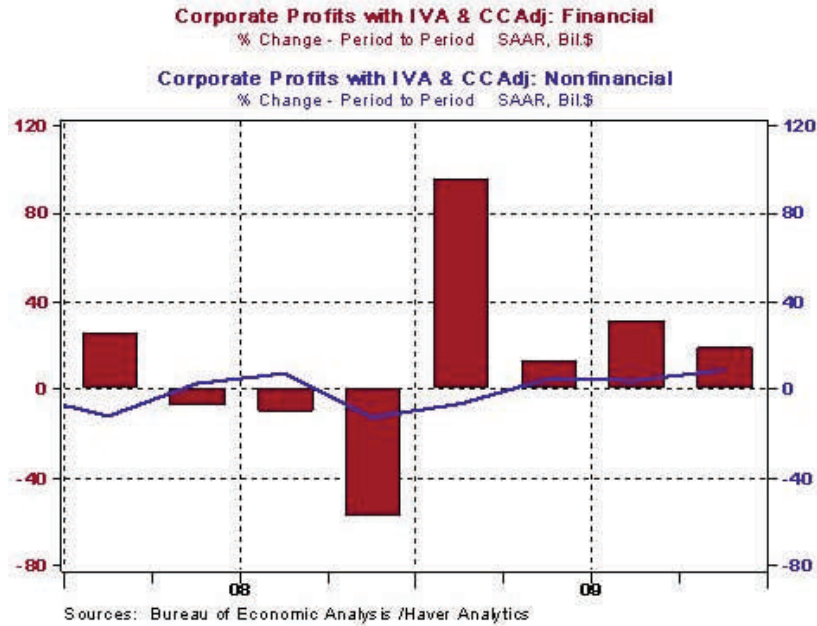
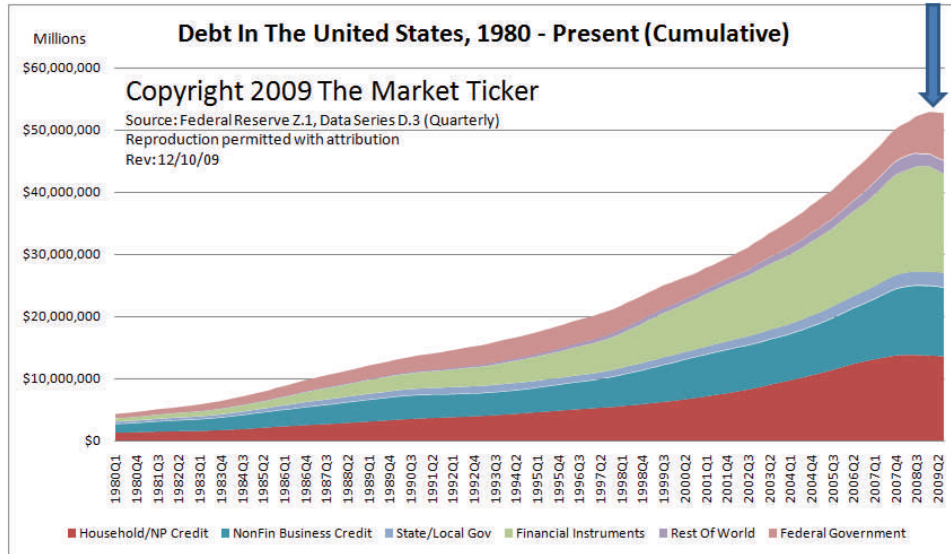


Chart 4—Adapted from Mish’s Global Economic Commentary



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# Interim Market Update

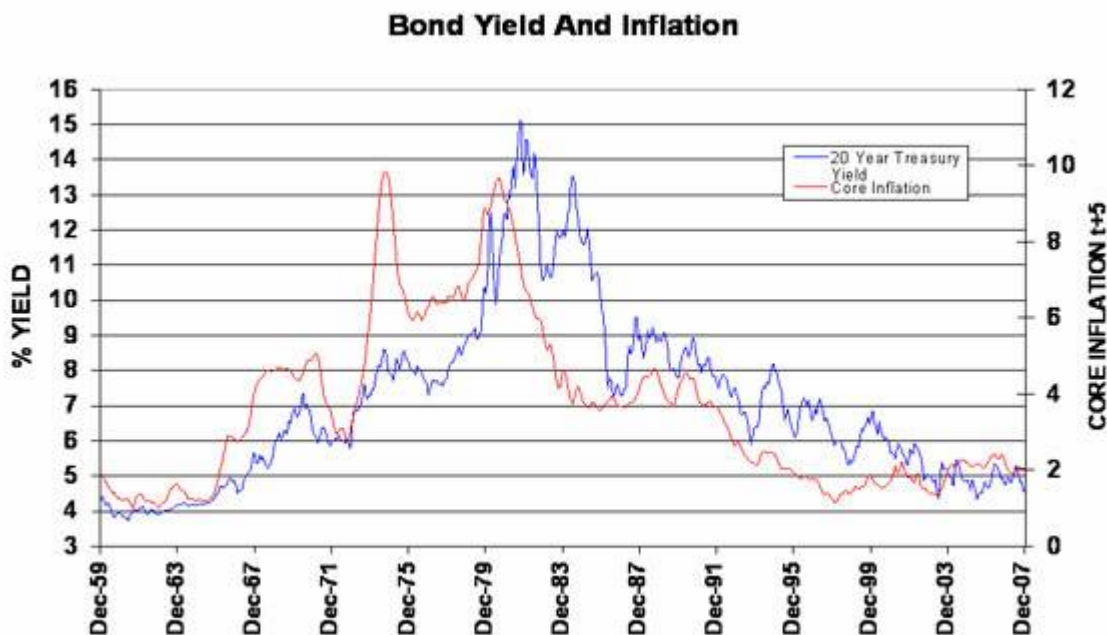


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## MARKET SLOW TO LEARN

One of the most consistent positive correlations in the financial world is between inflation and long-term government bond yields. Many other factors cause changes (noise) from time to time, but, in the final analysis, inflation is without a doubt the primary determinate. Please note the chart below.



Adapted from [FinancialSense.com](http://FinancialSense.com)

Today we seem to be experiencing the reverse of a lag that took place during the 1970s. Note that inflation during the '70s erupted well in advance of the upward move in yields. That, we believe, was due to the lack of inflation during the 1950s and first part of the '60s. The market was slow to understand that the “dogs of inflation” had been unleashed by improper monetary and fiscal



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# Interim Market Update



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policy on the part of the federal government. Today there is a lag in realizing that this time the “dogs of deflation” are being unleashed by – you guessed it – improper monetary and fiscal policy. Inflation is now running at about 1%. If one were to add 2.5% for an inflation hedge (approximately that which has been demanded historically) then 3.5% should now be the yield on the 30-year government bond rather than 4.7%. In addition, the inflation premium will diminish as it will become apparent that deflation will be here to stay for an extended period of time. That’s when a 2% interest rate could become a reality.

Many have asked – and rightly so – why we should own government bonds when the government we have is taking us down the path to financial turmoil. The answer is that the United States is the best of a bad lot. Governments over the entire world are destroying their financial worthiness. As they begin to fall – and they will – the rush to U.S. assets will begin and we will see it flow first into government securities. Why not common stocks? The government can and will take over their businesses if need be. How much of our economic system do they own now? Some say 30%. It can be 100%.

The “recovery” in the second half of 2009 from a real GDP standpoint was 2.2% for 3Q09 followed by 5.6% for 4Q09. The reduction in the decline of inventories has been the major contributor to the snap back in GDP. Personal consumption has been weak. As this is being written, it appears that 1Q10 will see an increase of approximately 2.5%. We believe the 5.6% of 4Q09 represents the high point in GDP growth for this brief “recovery.” Expect a return to negative GDP during the second half of 2010.

It would seem reasonable to think that stocks will soon move downward, while government bonds will finally move higher in price and lower in yield. In our opinion, the countermoves we have experienced since 1/1/09 are soon to disappear.



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