

Economic Commentary



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The Return of the 1930s (The 21st Century's Version)

It seems highly likely that a watershed period is underway. In our opinion, it's none too soon. We have been let down by the politicians we have sent to Washington for these many years. They are mostly lawyers, trust fund babies, and other sorts who have no clue how the real world works. What little economics they know is Keynesian in nature, which again has no basis in real life. Do you realize that the economics taught in college does not take into account debt and the use thereof? Now you tell me, how can anyone judge and/or predict the future if debt is not taken into account?

But you know what? The inherent common sense of the average man and woman on Main Street knows you cannot cure a debt problem by incurring more debt. It just can't be done. At present it appears that almost everyone other than the U.S. has come to that conclusion. We, along with China, seem to be the only ones left that want to spend, spend, spend. China, of course, can do so as they have enormous savings from which they can draw. Do we? No we don't. Every penny we throw at our problems, both real and imaginary, has to be borrowed. Every day our compound debt gets larger and larger, and our grandchildren become more and more enslaved to our debt. However, we believe at last the worm has turned. When the U.S. Congress can't extend unemployment benefits you know the game is over—the gig is up—no más! All the deficit hawks wanted in return for voting yes on additional unemployment payments was a cut in other Federal spending—is that too much to ask?

What does this apparent, and rare, season of sanity mean for the economy? It simply means that we are in for a long deflationary period of slow to no growth for at least five to seven years, maybe longer. It will be difficult. There will not be enough jobs to go around until our "little people," through hard work and imagination, come up with new products and services that spark a real, honest-to-

goodness recovery and expansion. It will not come from Washington. We believe they have proven without a doubt that they have no idea how to manage anything. They are the least among us. You may believe this tongue-in-cheek, but we really mean it. Washington should go home for five years and draw half pay. The same should be done with every department that presently exists. The only waiver that might be considered would be the complete elimination of some and the streamlining of the rest. Candidates for elimination would be Education, Commerce, and Energy. We ask you, have any of these three improved anything at all over the last twenty plus years?

What can one expect to achieve in the way of investment returns over this period of time? First of all, a 4% return will look like gold! Double-digit returns are in the vault until the years of government deadwood are weeded out. The stock market will be lucky to return 6% over this period including capital gains. As we expect government bonds to go down in yields over this period, we believe it is possible to make more than 6% with their use. Government bonds have outperformed stocks since 2000 and we don't expect that to change anytime soon. However, please keep in mind that there will be an absolute buy of a lifetime in stocks at some point; probably around 2015. When there is blood in the streets and everyone and his dog have sworn off stocks, the time will have arrived. The equity cult, which has been in force since the 1950s, is slow to die, but die it will and we need to be there when it does.

It is becoming more and more apparent that the "recovery" that supposedly commenced in July of 2009 is going nowhere. The recently revised 1Q10 GDP of 2.7% was one-half of the 4Q09 number, which itself was nothing to write home about. Also, if one were to deduct the inventory build that occurred in the first quarter the gain was only 0.8%. To top it off, there have been two

months of disappointing retail sales, which would indicate that the second quarter just ended could be flat or possibly even a negative number. What is for certain is that to date, if in fact we are having a recovery, it will have been the weakest in recorded history.

With the above in mind, let's review what we have been saying about the economic landscape to get a feel as to why things have developed as they have. Much of what we expected came into being, but we were early as usual. Fiscal and monetary policy out of Washington is mostly to blame for the economic mess we find ourselves in. The shuttle bus between Wall Street and Washington has favored the high and the mighty and left the rest of us to fend for ourselves. Balance sheets must be repaired both on the part of the consumer and governments. When that is done, Main Street should be able to prosper again. The following are points we made during the first six years of the new millennium:

As Concerns Debt

"Please be advised that we do not expect a calamity nor a repeat of the 1930's. What we do expect is a rather long period of slow growth (maybe on average 2%) which will be characterized by continued disinflation and probably deflation, as individuals as well as companies restore their balance sheets. Repayment of debt, which includes bankruptcy, will become the watchword for all economic participants. A normal reaction to conservative financial guidelines will replace the speculative mania of the late 1900's." — QEC 2001.12.31

"We will remain the world's greatest economic and military power, but remember, real growth in assets must come primarily from savings along with some use of debt, but not from debt alone which has been the case since 1995." — QEC 2001.12.31

"The question has now become, 'how long can U.S. citizens and U.S. corporations continue to create and service their debt?' There is a brick wall in the roadway for these non-government groups and it's our opinion that the wall is within sight." — QEC 2001.12.31

"The economy of the 1990's, in hindsight, was a re-run of the 1920's, only in spades. The final period from 1995 through 2000 was the 'blow off years' of a huge investment boom in technology. The recession that followed in 2001 was different

than any we've had since the 1930's. However, the Federal Reserve, by 'dumping dollars' out of airplanes, kept it short and mild. Mr. Greenspan repeatedly has said how proud he is of the monetary policy that was engineered to prevent another possible economy of the 1930's. By doing so we have created a mountain of debt that is sure to have extremely dire consequences at some point in the future." — QEC 2005.09.30

"As long as the debt machine at the Fed and on Wall Street continues to operate in high gear, this economy will continue to move up in activity and appear to defy the gravity pull of the debt overload. Such build is the Achilles heel of the economy and will eventually bring the economy to its knees." — QEC 2006.03.31

As Concerns Housing

"As the housing bubble fueled by excess liquidity has been the major economic stimulus since 2001 its demise will bring much slower growth in the months ahead. It seems to us quite likely that a financial accident must be in the making. Speculation and leverage are a dangerous mix and we seem to be having it in spades." — QEC 2006.03.31

"So here's the rub in our opinion. The banks today have 62% of their assets in real estate loans, primarily mortgage loans. It is the greatest housing bubble in the history of the world. The reason? For 15 years the Fed managed interest rates in order to make the banking industry strong, and once again aggressive as they were in the 1960's and 70's (this is at least one of the reasons). Their thinking (again in our opinion) was to keep the economy growing as China and India were, and still are, hollowing out our manufacturing industries as well as middle management employees of all kinds. The consequence of all these factors brings us to where we are today after their latest move to raise short-term rates. . . . They knew full well that throughout history, all bubbles burst, and the aftermath can be severe, a la Japan in the 1990's and the U.S. in the 1930's." — QEC 2006.12.31

"Today the consumer is over-indebted in relation to his income. He by far is the weakest link of the economic sectors. The problem is government spending is notoriously inefficient and corporate spending amounts to primarily buying back their own stock. This creates no jobs and the consumer on an income basis is broke! His balance sheet looks good now, but it too will become weak if this

housing break becomes as bad as we think likely.”
— QEC 2006.12.31

As Concerns Autos

“General Motors is on the verge of financial difficulties. They just recently announced a 28% reduction in their whitecollar workers. Please keep in mind on an individual business basis this makes sense, but overall this hurts the economy. On a macro basis this represents a reduction in the size of the economy. Have you noticed that when a company announces a layoff the stock most often moves up in price? This is a prime example of micro over macro thinking, which rewards the short term over the long.” — QEC 2005.03.31

“Other expectations for 2005 called for the housing bubble to burst, a probable pension fund crisis to occur and the possible demise of both GM and Ford. As things now stand it seems as if all of the above are moving along the track to completion as suggested above. We can continue to hope that none of this takes place, but we certainly wouldn't hold our breath.” — QEC 2005.12.31

As Concerns Deflation

“The Fed is fighting the 1970's war of inflationary fiscal and monetary policy. This is a new time and they should be worrying about deflation, which very well may be in our future.” — QEC 2000.03.31

“We believe, and this is certainly not a Wall Street view, that DEFLATION IS THE PROBLEM.” — QEC 2001.06.30

“Do not let the inflation monsters steer you wrong. Deflation is our problem. War is inflationary, but the effects are well in the future. We believe we will know if and when the problem commences festering. It will happen when everyone is convinced deflation is here forever.” — QEC 2001.09.30

“We have been preaching deflation since 1995 (seven long and lonely years). Each day now we are seeing Wall Street economist joining our small but mighty band. It remains, of course, a minority view and that's good for now. Why? It simply means that the best is yet to come. When it becomes the majority opinion we will sell them our bonds. Each day we hear interest rates can't go lower – my friends, we have heard that since 1986 when rates were 8½%.” — QEC 2002.09.30

As Concerns the Stock Market

“In previous commentaries and in various private and public venues we have expressed the opinion that stocks may well underperform bonds over the next several years. We continue to expect this to be the case. We would only caution that less than investment grade bonds may not do that well.” — QEC 2000.09.30

“We expect a regression to the mean in common stock returns over the next three to five years.” — QEC 2001.09.30

“Even at these levels the market [S&P 500] remains overvalued. The index is selling at 32 times trailing earnings and 26 times consensus 2002 earnings (which of course will be revised lower). To reach historical average multiples a 40% decline from here must occur. . . . ‘Fade Wall Street’ has been our mantra since June of 2000 and remains so, even after the decline that has taken place.” — QEC 2002.09.30

“Stocks are overvalued and overowned. We believe the next major move will be down. It is possible that a 1987 market may soon be in our future.” — QEC 2003.06.30

As Concerns the Bond Market

“On a recent business trip we were admonished by the executive of a large pool of retirement funds, to not say that interest rates may go to 3%. ‘Nobody will believe you and you are certain to lose credibility,’ he said. When 30-year governments were yielding 14% in 1980 we projected 8% within 5 years. This indeed turned out to be correct. For sure, most disagreed, but then shouldn't we tell you what we really believe as opposed to conducting a PR program?” — QEC 2000.06.30

“Bonds represent a startling mixed bag as suggested below:

- (1) High yield bonds will suffer. Many will default.*
- (2) Municipal bonds in general will be under pressure. Governments less than Federal will face fiscal problems.*
- (3) Most high quality corporate bonds will be re-funded robbing investors of their capital gains. This will force reinvestment of original principal at much lower rates. For lenders (investors) a typical lose, lose scenario.*
- (4) Short to Intermediate Governments are not attractive. Their prospects are good only for safety.*

(5) Government bonds of long maturity will bring handsome total returns to those with patience.” — QEC 2001.09.30

“Last November if you may recall Wall Street beat the drums for selling government bonds and buying stocks. It started, as we understand, from the pillar of integrity, Merrill Lynch and spread through the brokerage industry. We expect that this will be heard again several times before lows in yields are obtained. Over the last 83 years yields have been lower than today over 70% of the time. The advice emanating from the street is abysmal.” — QEC 2002.09.30

“It must sound like a broken record, but the facts remain the facts. Any bond lesser than AAA quality should not be owned, that includes both corporates and municipals. Do not invest for yield. Invest for total return. The market continues to give one the opportunity to make handsome returns (total returns) in long term governments. Inflation blinded analysts are giving the rest of us an opportunity of a lifetime.” — QEC 2002.12.31

“We are noticing that more and more of the mainstream investment community are coming to the conclusion that bonds just may outperform stocks over the next several years. As you may recall this has been our expectation since early summer 2000.” — QEC 2004.09.30

As Concerns the Economy

“The only economic model that forecasted the great depression is saying now that it is likely to happen again. My friends you disregard this warning at your own peril!” — QEC 2003.09.30

“For some time now we have been lamenting the fact that more and more income and more and more debt is associated with financial organizations as opposed to non-financial. These in our opinion, are vastly different sources of activity. If you will, financial is Wall Street and non-financial is Main Street. Financial sources are really fees to allocate capital and non-financial is the real or ‘organic’ economy that creates wealth through widgets and services by way of productive brains and equipment. Much of the income over the last five years or so that has come from the financial sector (inorganic) is stock and bond trading associated, which is a zero-sum game and in the

grand scheme of things, does nothing to increase the wealth of the nation. . . . Many ask where does all the money go when markets retreat? The answer is nowhere – it’s all a paper fantasy – a one hundred share trade on the downside can literally trim billions off the value of a company’s stock capitalization which includes millions of shares. Again all secondary markets are zero sum games.” — QEC 2004.03.31

“As our manufacturing sector continues to suffer from foreign competition, the slack is being taken up, in many respects, by the financial industry. What’s wrong with that? Two things: (1) The manufacturing sector that has to do with capital expenditures has a huge economic and profit multiplier effect and (2) the financial sector is much more highly leveraged, therefore very much subject to a financial accident.” — QEC 2004.12.31

During the late summer of 2008, we published a paper entitled Investors’ Global Economic Crisis Report. It summarized our thinking since 2000 as it pertained to the economy and financial markets. In truth, the entire story was there to see if only one would look. The problem is that for years Wall Street and its minions have created an equity cult propagated by thousands of market specialists who have enormous conflicts of interest. To stand as one among very few while the entire Wall Street machine has indoctrinated the public for 60 years has been a lonely, but now rewarding task.

Don’t get us wrong, we certainly are nowhere close to being perfect. To understand that more debt cannot cure an economy that is over indebted does not require the brains of a rocket scientist.

If you would care to re-read this aforementioned piece, or read for the first time for that matter, it is available at www.centralplainsadvisors.com, as are all of the QECs referenced in this commentary. If you do not have access to the internet, we would be happy to send you a copy upon request. It’s even more relevant today than yesterday.



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