

Economic Commentary



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

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The Return to Normal Remains Elusive

Our present Federal Reserve head is noted for his economic analysis of the Great Depression of the 1930s. Another noted economist, Milton Friedman, also was known for his study of this same period. As a matter of fact, the depression of the 1930s has been studied to death by economists and non-economists of most every stripe. The Keynesian view, à la Ben Bernanke, is the one most accepted even though he once told Milton Friedman, “You are right and we will never let it happen again.” Our study of this period left us with a much different view. In our mind, the seeds of the 1930s were sown in the 1920s through inappropriate Federal Reserve policy of easy money, which led to excessive debt and speculation. What followed was deleveraging, then extremely poor fiscal policy of tax increases and regulation, followed by the anti-business administration of Franklin Roosevelt. We ask you—does that sound something like what is going on today? As Mark Twain once remarked, “History does not repeat itself, but it does rhyme.” Irving Fisher, one of the most prominent economists of the '20s and '30s also did a very exhaustive study of the Great Depression and came up with the following litany of things that occur during such periods of excess debt and the deleveraging that follows: (I) *Mild gloom and shock to confidence, slightly reduced velocity of circulation, debt liquidation;* (II) *money interest on safe loans falls, but money interest on unsafe loans rises;* (III) *distress selling, more gloom, fall in security prices, more liquidation, fall in commodity prices;* (IV) *real interest rises; real debts increase, more pessimism and distrust, more liquidation,*

more distress selling, more reduction in velocity; (V) *more distress selling, contraction of deposit currency, further dollar enlargement;* (VI) *reduction in net worth, increase in bankruptcies, more pessimism and distrust, more slowing in velocity, more liquidation;* (VII) *decrease in profits, increase in losses, increase in pessimism, slower velocity, more liquidation, reduction in volume of stock trading;* (VIII) *decrease in construction, reduction in output, reduction in trade, unemployment, more pessimism;* (IX) *hoarding;* (X) *runs on banks, banks curtailing loans for self-protection, banks selling investments, bank failures, distrust grows, more hoarding, more liquidation, more distress selling, further dollar enlargement.* The order in which each takes place may vary, but most seem certain to take place over the next three to five years, maybe longer.

The process of deleveraging has just begun. Please note the following chart.



Adapted from Steve Keen's Debt Watch

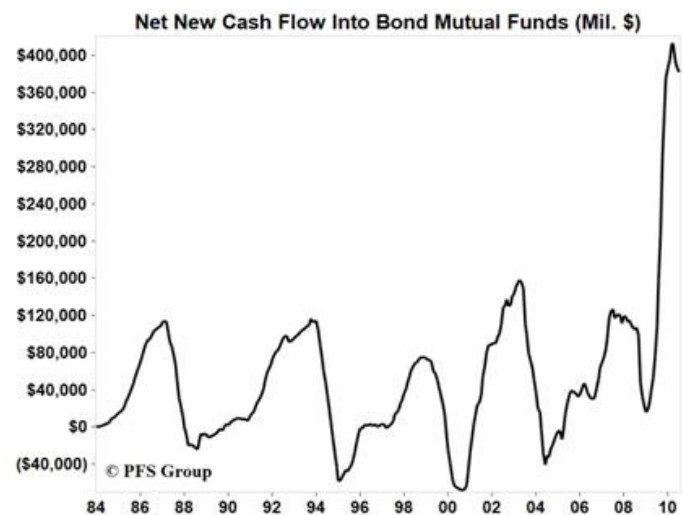
We are uncertain as to just where the point of financial decline will settle; however, we are certain it is much lower than where it stands today. As to taxes, we would guess that at least some of the increases due on 1/1/2011 will not go into effect. If any do increase it will represent a serious policy error which will extend the slow to no growth economy we are presently experiencing. Regulation, which Washington loves the most, is in full swing. Much of it, in our opinion, is not needed and will further enlarge the wedge between producer and consumer. Maybe the worst regulation of all could be the initiation of tariffs (remember Smoot-Hawley of the 1930s). Such a bill just passed the House of Representatives in late September.

Let's now take a look at the anti-business government. The following are some numbers of comparison concerning capital investment in the 1930s and today. As you know, the Keynesians are demand oriented while the Austrians, of which we are one, believe supply (i.e. Capital Investment) comes first. During the 1930s gross private investment fell from 14% of real GDP in 1929 to 1% in 1932. So far during the 2000s it has fallen from 17% in 2006 to 14% in 2010. The decline to date has been less severe, probably due to the stimulus package, which is one major difference between the '30s and now. We hear day after day that the banks won't lend and consumers won't borrow. We hear day after day that America's corporations have nearly \$2 trillion in cash and won't spend it. Why? Many reasons, but paramount to all other is the fear of the future. A rerun of the FDR era is facing this economy head on. Until this changes, we will remain in a slow to no growth mode. What seems to be overlooked by most economists and politicians is that entrepreneurship is the thing that drives the economy and it is savings that fuels it. To quote Gerald Jackson concerning this matter, "Hence a shrinking savings pool means that the number of projects, inventions and innovations that entrepreneurs can under-

take will shrivel thus lowering the rate of capital accumulation and future living standards. This means that attempting to accelerate growth by encouraging consumer spending and government spending will have the reverse effect. This would not need explaining if it were not for the fact that thanks to Keynesianism mainstream economics no longer pays attention to the concepts of the capital structure and the structure of relative prices. Needless to say, capital theory also has no place in Keynesian thinking."

Bond Market

The bond market has been extremely good to us this year. It seems that the more government debt the Treasury floats, the more investors want.



Adapted from FinancialSense.com

Do you remember when the bond bears said the excess supply of treasury issues would destroy the market? Not too many years ago we made the comment that there may well be a shortage of government securities as the demand will accelerate due to safety concerns. Where would the demand come from? We said from common stock owners, and this has been the case if mutual fund flows are any indication.

Now, how about the future? We see nothing in the mix that will change the direction of

even lower government bond long-term interest rates. There is no inflation. There is no meaningful recovery and another recession seems to be right around the corner.

However, we believe that less than quality bond interest rates are much too low. We would encourage those who are holding such to lighten their position. This is the area of the bond market that might be in a bubble. The rush to get higher rates now carries with it considerable risk. In our laddered bond accounts we had purchased a good number of corporate bonds of 'A' quality during the first several months of 2009, but have now sold them all and have moved back into governments. Long governments are where good total returns will be attained over the next year or so. It probably could be much longer.

As concerns common stocks, we felt it important that you hear from our partners at Freestate Advisors in Overland Park, KS. As you may recall, we sold all our common stock holdings in June of 2000. During the period since then we have concentrated our efforts on the economy with special emphasis on interest rates and the bond market. Needless to say, we agree fully with Freestate's equity market outlook.

Freestate's Investment Commentary

As most readers know, Freestate Advisors is joining forces with Central Plains Advisors. At Freestate we think our expertise in investment portfolio management is an excellent complement to Central Plains Advisors' expertise in bond investing. In this commentary we will try to give readers an understanding of Freestate's approach to investment portfolio strategy in today's economic environment.

Perhaps the most important thing that has brought Freestate and Central Plains Advisors together is our common approach to investment strategy. Both firms rely on a deep understanding of the current economic

environment to drive investment strategy.

Most readers probably think it is just common sense to let an understanding of the economic environment drive investment strategy. Well, to paraphrase Will Rogers, when it comes to creating investment portfolio strategy, common sense ain't so common.

As odd as it might seem, most investment advisors simply ignore the current economic situation when creating investment strategy. And a whole generation of individual investors has also been told to ignore the current economic environment when they create their personal portfolio strategy.

This is because the "buy and hold" approach to investment management has been the conventional wisdom for many years. The buy and hold approach says that investors will do well if they buy a diversified portfolio of stocks and bonds, ignore current economic conditions and hold onto that portfolio through thick and thin. Over the long haul, according to the theory, returns will be good and portfolio diversification will minimize investment risk.

And if you look back at investment results for the last 100 years you find that the "buy and hold" strategy has worked – about 45% of the time. What the "conventional wisdom" has failed to realize is that the buy and hold portfolio strategy only works during periods of favorable economic conditions. And today isn't one of those periods.

The buy and hold strategy works when the economy is enjoying a long period of both price stability and economic strength (e.g. 1982-2000 or 1948-1966). As you just read in Don's commentary, we are not in the midst of one of those periods – we have price deflation and economic weakness.

The reality is that it hasn't been a good period for buy and hold since 2000. And based on studies of the aftermath of financial cri-

ses, it's not likely to be a good economic period for another six to ten years. This means that investors need to adapt their portfolio strategy to these conditions.

There are two portfolio management tactics that are critical in today's conditions: 1) portfolio investment risk must be actively managed and 2) an investment portfolio has to include assets that focus on "absolute return" strategies.

While past performance is no guarantee of future results, these two strategies have provided both higher returns AND lower risk of loss over the last 33 months. Since the beginning of 2008 Freestate's clients have had positive returns without suffering any periods of significant loss.

By comparison, the stock market has lost about 20% with its largest loss being more than 50% at one point. A "moderate risk" portfolio of stocks, bonds and cash has lost about 5% since the beginning of 2008 and incurred a 30% decline at one point.

In future commentaries we will have much more to say about managing portfolio risk and utilizing absolute return assets. For now, we will cover how portfolio risk management is achieved in the stock market. The approach to stocks in today's environment is fairly straightforward: You buy stocks for your portfolio when they are cheap. You sell (eliminate) stocks in your portfolio when they are expensive.

Despite what you might be hearing from so called "investment experts," the stock market today is very expensive. This means that equity risk is high and expected returns over the next ten years are relatively low. Actively managing portfolio risk right now means that investors should be steering away from owning stocks.

To be clear, we aren't saying that the stock market can't go higher from where it is. In fact, the Federal Reserve is actively supporting high asset price levels with the promise of additional monetary stimulus. But high prices and poor economic conditions have always been a deadly combination for long term stock market returns. It would be foolish for investors to succumb to the thought that "this time things will be different."

Successful investment portfolio management in today's environment requires patience and perseverance along with the right portfolio strategies. Going forward, you will be hearing much more from us regarding effective investment portfolio strategies. In the meantime, you can reduce your equity exposure and start practicing patience and perseverance while we wait for stock prices to become cheap enough to interest us in owning them once again.



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