

Economic Commentary



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

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It's Not What They Say, It's What We Say

Unfortunately, the government is not our friend. Even more regrettably, since the days of Franklin Roosevelt, Wall Street has found it necessary to cozy up to Washington in order to secure their franchise and enhance their profits. We call it the “evil axis.” A third party to this evil axis is the Federal Reserve system, which joined the aforementioned two after Paul Volker’s time at the helm. Misinformation by way of myths bordering on propaganda are their tools of trade. It is interesting to us, being old, moss-backed fiscal and economic conservatives, that the two great Fed chairmen were both Democrats—Paul Volker, appointed by Jimmy Carter, and William McChesney Martin, appointed by Harry Truman. So there you have it. We believe that for one to be successful in one’s investments over the long term—let’s say 30 years—it is important to understand how the economy really works and not how the above three say it does. This, of course, means one needs to be out of sync with the consensus a good bit of the time, which is an emotionally difficult task. They have their hands on the mass communication outlets, as opposed to those of us who follow the Austrian economic model who have only a very soft media voice.

They Say/We Say

Consensus

- The consumer is 70% of the economy.
- Debt is unimportant. It only shifts who spends the money.
- Demand drives the economy.
- Government spending has a multiplier effect on the economy.
- Unemployment insurance creates demand, thus economic growth.
- Economic growth always creates inflation.
- Deficits don’t ever matter.
- Large bank reserves lead to money growth and thus inflation. In other words, bank reserves come before loans.

Us

- The end consumer is approximately 35% of the economy.
- Debt is most important. It ultimately must be paid back out of future income.
- Supply comes first. You cannot have demand unless someone produces something, tangible or intangible.
- Recent economic studies indicate there is a negative multiplier.
- Unemployment insurance allows the economy to “run in place.” It does not create growth. There is no multiplier effect.
- Not necessarily. It depends on demand/supply conditions concerning capital and labor inputs.
- Yes they do when debt and deficit are both a large percentage of GDP.
- Money supply increases when growth in loans accelerates. Loans come before reserves. Loan first, obtain reserves later.

How We Got in this Mess

Phase One—1950s through 1970s

Europe and Asia became very competitive after we rebuilt their economies. During that same period, many government agencies initiated in the 1930s and '40s were added to and fostered a strong union movement. Stagflation was the result. American industry became noncompetitive, causing our trade balance to stagnate from surplus, paving the way for deficits.

Phase Two—1980s through 1990s

The watch word for business was cost control and productivity. Labor costs grew less than 2.5% after adjustment for inflation. However, the consumer reacted by borrowing heavily, thus real consumption grew more than the 2.5% cited above. Consumers increased their borrowing and reduced their savings in order to keep up with the Joneses. As a final result, debt has become the problem. Not only that, but the debt incurred went into consumption and not into production except for overseas. Manufacturing jobs went from 19,000,000 in 1980 to 17,000,000 in 2000 to 12,000,000 in 2010. On the other hand, state and local government jobs have gone from 13,000,000 in 2006 to 19,000,000 now. You see the problem? The manufacturing private sector and the public sector have reversed roles—and guess what—it's the private sector that pays for the public sector. So who is in trouble now? The public sector!

Phase Three—2000s to date

Debt continued to accelerate primarily at the consumer level and as of late at the government level. Also as a part of the competitive drive needed by business to compete, mergers and acquisitions activity, which were strong during the '80s and '90s, continued and accelerated in the '00s. Those that didn't merge and acquire purchased their own stock out of the marketplace. All of this, of course, makes domestic companies competitive at home but not worldwide. Also, earnings per share went up due to stock buybacks, but none of this has led to growth in any measurable manner. Debt then, for consumption purposes as well as domestic competitive purposes, along with state and local government debt has added little to our domestic economy. Now this debt must be paid. Thus we have entered the age of deleveraging, as a recent book by Gary Shilling, *The Age of Deleveraging*, has so well documented. We have a small supply of these books and will send you a copy on a first come, first served basis.

Gary Shilling and CPAI on the Same Page

The following is a direct report of Gary's latest *Insight* paper dated December 2010. Gary is a 36-year friend of ours whom we visit every time we frequent the New York area. The *Insight* documents in exhaustive detail why we continue to believe the long government bond is the premier asset to own. Never has an asset been more hated than it is presently. That's not bad, the lights will come on again sometime in the investor's mind, which is good.

From Gary Shilling's *Insight*:

Treasury Bonds

We've been asked by many *Insight* readers of late, Do you still recommend Treasury bonds? Yes, we do.

- Because we foresee slow economic growth at best in coming quarters and years
- Because the Fed is determined to further reduce interest rates
- Because deflation is looming
- Because Treasuries are the safe haven in a sea of trouble in the Eurozone and elsewhere
- Because China's attempts to cool her economy will probably precipitate a hard landing

—Because the likely price appreciation in Treasuries is in stark contrast to overblown and vulnerable stocks, commodities, foreign currencies, junk securities and emerging market stocks and bonds.

We continue to predict that 30-year Treasuries, “the Long Bond,” will rally from its current yield of about 4% to 3% with appreciation of around 20%. Similarly, a 30-year zero-coupon Treasury would gain 34%. We also expect the 10-year Treasury note yield to drop from the present 2.8% level to 2.0%, but the appreciation would be only 7.2%, largely because of its shorter maturity.

Most observers think our forecast is ridiculous, but then they’ve been skeptics ever since we said that “we’re entering the bond rally of a lifetime” in 1981 when the 30-year Treasury yield peaked at 15.21% in October. As noted earlier, we and Van Hoisington and Lacy Hunt have been about the only consistent bulls on the Long Bond as well as Don Peters of Central Plains Advisors in Wichita and Gary Craig, former Investment Officer for Texas Municipal Retirement System in Austin.

Everybody Hates Them

Almost all other investors despise Treasury bonds, as we discuss in *The Age of Deleveraging*. Stockholders inherently hate Treasuries. Shareholders say they don’t understand them. But their quality has been unquestioned, at least until recently. Treasuries and the forces that move yields are well-defined—Fed policy and inflation or deflation are among the few important factors. Stock prices, by contrast, depend on the business cycle, conditions in that particular industry, Congressional legislation, the quality of company management, merger and acquisition possibilities, corporate accounting, company pricing power, new and old product potentials, and myriad other variables.

Stockholders also understand that Treasuries normally rally in weak economic conditions, which are negative for stock prices, so declining Treasury yields are a bad omen. Those who are more concerned about inflation than deflation also hate bonds, which tend to fall in price as inflation rates rise. These worriers include individual and institutional investors. Wall Street denizens also hate Treasuries, as we learned firsthand while at Merrill Lynch then White, Weld. Investment bankers didn’t want us along on client visits when we were forecasting lower interest rates. They wanted projections of higher rates that would encourage corporate clients to issue bonds immediately, not wait for lower rates and cheaper financing.

Professional managers of bond funds are a sober bunch who perennially fret about inflation, higher yields, and subsequent losses on their portfolio. And if yields fall, they don’t rejoice over bond appreciation but worry about reinvesting their interest coupons and maturing bonds at lower yields. And because of that, Treasuries, unlike stocks, are seldom the subject of irrational exuberance. Their leap in price in the dark days in late 2008 (Chart 87) is a rare exception in a market that seldom gets giddy, despite the declining trend in yields and related rise in prices for almost three decades.

This disdain for bonds, especially Treasuries, continues despite their vastly superior performance vs. stocks since the early 1980s. Since then, a 25-year zero-coupon Treasury, rolled into another 25-year annually to maintain the maturity, beat the S&P 500, on a total return basis, by 7.2 *times* (Chart 87). This is one of our very favorite charts since we have actually participated in this marvelous Treasury bond rally as forecasters and portfolio managers and investors—and we’re confident, despite the remote, infinitesimal, minuscule possibility that we’re wrong, that this rally still has legs.

A major Oct. 2 *Wall Street Journal* article titled “How to Play Rising Rates” which shows a smiling Ben Bernanke hanging onto the rope of a balloon that’s rising into the clouds. It begins, “Is it time to start positioning your portfolio for rising rates?” A recent Barron’s poll found that 62% of portfolio managers believe equities will be the best performing asset class in the next 6 to 12 months compared to only 3% for bonds and 6% for cash. And 72% are bearish on Treasuries while only 5% are bullish.

The Bond “Bubble”

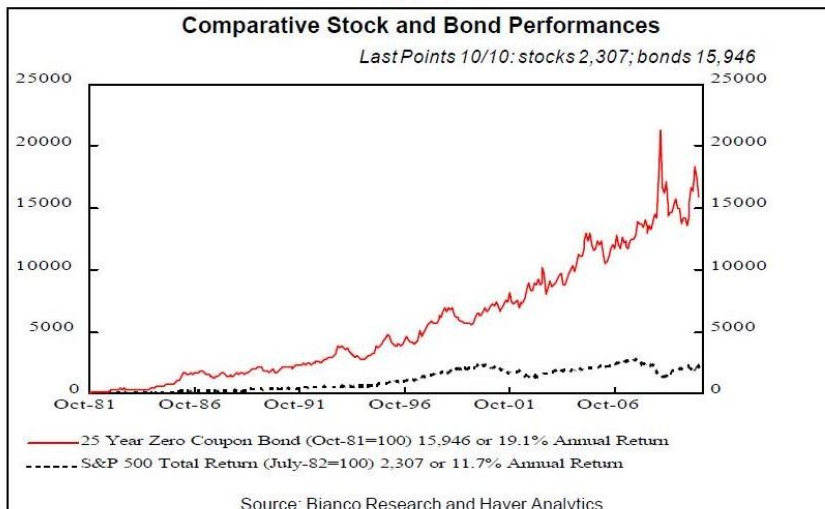
Thoughtful *Wall Street Journal* columnist Jason Zweig, in his Oct. 2 column titled “The Bond Bubble: Are Small Investors Taking Too Big A Bet?,” wrote, “The rush into bond funds, as big as it has been, still leaves many households with surprisingly little exposure to the risk of losses if interest rates raise.” Implicit in this statement is the idea that bond investors only expect the bond yield income as the return on their investment, and any volatility, especially a decline in price due to rising yields, would be an unpleasant shock. But volatility is apparently okay for stock prices, assuming they’re rising.

But what’s the difference? We’ve never, never, never bought Treasuries for their yield. We couldn’t care less what the yield is as long as it’s going down. We want Treasuries for the same reason stockholders want equities—appreciation.

Prof. Jeremy Siegel of Wharton is a congenital hater of Treasuries and lover of stocks. In an Aug. 18 op-ed piece in the *Wall Street Journal*, “The Great American Bond Bubble,” he and Jeremy Schwartz blast Treasuries because the yield on 10-year notes was then one percentage point below the dividend yields on a number of blue chip stocks. Well, shouldn’t it be at a time when stock prices are vulnerable? And unlike Treasury yields, those dividends are not backed by the full faith and credit of the federal government. We saw that decisively when the meaningful dividends of financial stocks evaporated during the 2008-2009 financial crisis.

As we noted in *The Age of Deleveraging*, in March 2006—before the 2007-2009 nosedive in stocks and leap in Treasury bond prices, we were invited by Professor Siegel to Wharton for a public debate on stocks versus bonds. He, of course, favored stocks and we advocated Treasury bonds. At one point, he addressed the audience of about 500 and said, “I don’t know why anyone in their right mind would tie up their money for 30 years for a 4.75 percent yield [the then-yield on the 30-year Treasury].” When it came our turn to reply, we asked the audience, “What’s the maturity on stocks?” We got no answer, but pointed out that unless a company merges or goes bankrupt, the maturity on its stock is infinity—it has no maturity. Our follow-up question was, “What is the yield on stocks?” to which someone correctly replied, “It’s 2 percent on the S&P 500 Index.”

CHART 87



So we continued, “We don’t know why anyone would tie up money for infinity for a 2% yield.” We were putting the query, apples for apples, in the same framework as Professor Siegel’s rhetorical question. And if our forecast is correct, Treasury bonds will continue to outperform stocks (Chart 87).



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