

Economic Commentary



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

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From Crisis to Crisis

The global economy moves from financial crisis to financial crisis. In 2008 it was a U.S. crisis that spread across the planet to both Europe and Asia. What was the cure? There was none. The Federal Reserve, along with Washington, patched over the problem with a Band-Aid, and it has turned out to have made things materially worse. We have had slow to no growth and added trillions of dollars of debt to an already overloaded debt burden. The rate of debt growth has been reduced from 7.6% annually over the 10 years prior to 2008 to 2.3% on an annualized basis during the first quarter of 2011. That is a welcome trend, but we still have a long way to go before our financial house is in order. Really the only sector to have materially strengthened its position has been “big” business. The federal government is in substantially worse shape. The consumer has reduced his debt some \$638 billion since 2007. This has brought the debt to disposable income ratio from 116% to 114% - however, 80% is where it ought to be. They have only \$3 trillion of debt yet to liquidate. Small business (Main Street) is just barely in the game. They have received no help and are burdened with regulations that only a Philadelphia lawyer can figure out. They have no overseas market, therefore are tied directly to the U.S. consumer who is becoming more and more out of the game due to lack of income and, for that matter, lack of a job. Since the first of the year, 480,000 Americans have stopped receiving unemployment benefits with many more to come. Of the 8.8 million who have lost their jobs, only 1.8 million have returned to the workplace.

The current global financial crisis has now shifted to Europe. We are all aware of the Greece problem which, of course, is only the tip of the iceberg. What we are unsure of is the amount of damage that will occur not only with European banks and their central banks, but also those in the U.S. Our too big to fail banks have billions and billions of dollars in both direct and indirect loans to the various European common market banks and sovereigns. God only knows how much in the way of credit default swaps, derivatives, etc. are presently outstanding. It just seems impossible for our best and brightest ivy league MBAs not to take part in all the great investment ideas that come down the pike. The only place where innovation is a bummer is in the financial arena. We have some 25 years or so of evidence to absolutely prove the point. Maybe my old friend Al Wojnolower is right. It has been his position for many years that the banks should be owned and operated by the public sector—but really would the politicians do any better than what we have seen to date?

There is, of course, another area of the world that appears to have a huge bubble that may burst at any time. That is China. It appears that 50% of their GDP is made up of commercial investment. All of this has been done mostly on borrowed money, which has accelerated many times over during the great recession of 2008 and 2009. They now have an inflation problem along with accelerating cost push factors that are lowering profits. They, like the U.S., have a severe income disparity that may lead to serious unrest as time moves along.

Please note that almost without exception the world's economic problems are centered around the issuance of debt. Debt is not considered a problem in the economic model of Keynesians, as it is merely a transfer of money from one sector to another that does not affect aggregate demand. If ever there was a false economic axiom in the whole world this is it. For the first time since the 1930s everyone will soon become aware of the absolutely ill-conceived non-use of the debt factor in economic analysis.

Now to another subject that is all important and well covered by the aforementioned Al Wojnolower, former First Boston Chief Economist and now with Craig Drill Capital in New York. Please keep in mind that Al is of the Keynesian ilk, but his analysis of the "other side" of the debt problem is very valid in the short term.

"More serious from a longer-range macroeconomic standpoint is whether the growth of credit, which is what keeps the wheels of business turning, can be sustained if the budget deficit shrinks. Credit and debt are identical, the opposite sides of the same coin. Neither can exist without an identical amount of the other. Funds received by households and businesses which are not re-spent on the goods and services that make up the GDP have to be recycled through the creation of new credit (and equivalent debt) if the income stream is to be preserved intact. Funds spent on existing assets, or the repayment of debt, are merely exchanges; no value is added to GDP unless and until the funds are used to purchase new production. If the financial system fails to recirculate the unspent funds through new lending, incomes will shrink. And if the GDP is actually to grow, today's increase in debt must exceed yesterday's.

During business expansions, private credit and debt always increase. As some firms and individuals pay off maturing debts, larger amounts of new debt are incurred by others. Growth in self-amortizing home mort-

gages used to be the most sizable and efficient way to accomplish this, but the malfeasance of financial institutions in polluting the market with subprime mortgages has closed this avenue for the foreseeable future. The next-best (but much smaller) channel has been consumer installment borrowing to buy automobiles, but this channel, too, is once again constricted, mainly because of higher oil prices. Business inventory accumulation is another source of self-sustaining credit growth, but such accumulation now seems near its peak relative to sales, orders, and backlogs. The sad outcome is that credit growth to consumers and businesses remains moribund, as is confirmed by the just-published data for the first quarter of 2011.

Nevertheless, the GDP has been expanding — but only because Treasury borrowing and spending has been filling in the gap in private activity. If Treasury borrowing were to diminish without a compensating increase in private debt, the GDP would fall. Presuming an early and substantial resumption of international oil flows and Japanese automotive production, and that any advertised reduction in the Federal deficit is bogus rather than genuine, such a drop in GDP is unlikely to occur soon. But if earnest fiscal restraint is effectuated after the 2012 elections, while monetary policy remains unchanged, a new recession becomes a serious threat.

How are individual private debts repaid? Re-financing aside, private debts are paid from the higher incomes generated by the productive use of borrowed funds. Analogously, public debts, too, can only be retired from the fruitful use of the proceeds. How the return on governmental outlays should be measured and translated into government revenue is a knotty issue. But a society unable to convert such proceeds into the revenue needed to support a growing public debt is self-condemned to economic disintegration. In a different setting and for different reasons, this is the same problem that now faces Europe.

After the Fed ends QE2 at mid-year, hundreds of billions in newly-issued Treasury securities that used to wind up owned by the Fed will have to be absorbed by the public. This is bound, sooner or later, to crowd out purchases of other assets (but which ones?) and lower their prices. Over any short run, money managers who command giant leverage as speculative credit remains cheap and available, as well as foreign central banks investing balance-of-payments surpluses to forestall appreciation of their currencies, can and do take up even larger sums than this. Whenever this herd changes direction, however, longer-term interest rates are apt to flare up. But seeing this, and with unemployment remaining stubbornly high while domestic profit margins are narrowing, those Federal Reserve officials who are now salivating at the prospect of tightening money may back off and delay their picnic. If, in consequence, federal funds appear to be remaining at 1/4% indefinitely, a 3% yield such as currently prevails on ten-year Treasuries may seem, especially when leveraged, high rather than low.”

Why the Long Government Bond?

As you know, we have made a living off of investing in the long government bond. Why, you might ask? First of all, in 1981 we went long from having been in treasury bills for four years. It was more of a gut feeling than anything else. After all we had never seen 15% long rates before and with treasury bills at 20% and the prime rate at 21% it was obvious that a major recession was on its way. Recession equals lower rates. An economy such as it was in the early 1980s could not survive with those kinds of rates.

Second, fast forward to today. Ever since long rates were 7% in the mid 1990s to this very day long government bonds have been the most hated investment by money managers, particularly those who are members of the “equity cult.” Even though rates are now around 4.25% under present circumstances we are in the same environment as

1981. The U.S. economy, as well as the world economy, cannot stand rates that are this high. Why? Debt. It all comes back to leverage. The only sector of the economy that is not overleveraged under present economic conditions is the large company corporate sector. By the way, this is probably the reason PIMCO has shifted their portfolios toward corporate as opposed to government bonds. The major fly in the ointment concerning this is the fact that Washington can tax away at their net worth and put them in the same boat as the rest of us. That worries us.

Also, as you know, anyone who wants to successfully manage money needs to ferret out the best minds in the business. We have successfully done that over the years. The following are direct quotes from Gluskin Sheff’s economist David Rosenberg in his daily newsletter from May 31, 2011. If there is anyone out there better than he is, we would like to know who; maybe our old friend Gary Shilling. Please note the following:

CHART 2: BOND YIELDS FOLLOW FED POLICY



Source: Haver Analytics, Gluskin Sheff

“So we hear all the time that bond yields are too low, but relative to what exactly? It’s like saying 1,330 on the S&P 500 is ‘too high’ but we have legions of strategists and analysts claiming the market is cheap because when benchmarked against corporate earnings, the P/E ratio is historically low (unless you look at the chart of the Shiller cyclically adjusted P/E multiple—you get a bit of a different story).”

When you benchmark Treasury yields against what is important to them—the cost to carry—then they are actually crazy high right now. That is right. And those pundits that have been so consistently wrong on this for years now collectively suffer from the same ailment—otherwise known as numerical micro-phobia: the fear of small numbers.

What I am saying here is that the yield curve is still far too steep and is now flattening and will continue to flatten. The historical record shows that an ‘average’ yield curve out to the 10-year part of the Treasury curve is 175 basis points. That curve between Fed funds and 10-year notes is now close to 285 basis points (+400bps between Fed funds and 30-year). Bob Farrell’s Rule #1 is about how markets tend to revert to the mean over time, the long end will rally as it becomes evident that the Fed is going to be on the sidelines—at least from a rates perspective—for years.

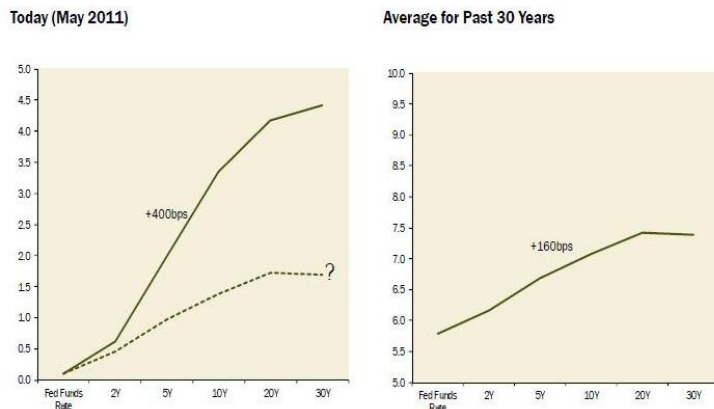
if you have seen the film ‘Too Big to Fail’ (premised on the brilliant book by Andrew Ross Sorkin), you will see what I mean.

Bernanke’s character is played brilliantly (looks too) by Paul Giamatti, and it is so obvious that the Fed Chairman was obsessed with the lack of bank credit and the resulting economic headwinds. Here we are today, in a recovery that so far was built on a lot of straw and sticks, bank lending continues to contract. As the McKinsey report of 2009 clearly illustrated, it takes five to seven years to fully emerge from a balance sheet recession, so we have at least another three years of financial sector debt deleveraging ahead of us.

So what this implies is that in the process of mean reversion, the long end of the Treasury curve will decline in yield rather than the Fed lifting short-term rates. Doing the math, that would mean an eventual re-test of 2% on the 10-year note to get to a fully ‘mean reverted’ 175bps yield curve—the only question is one of time.”

CHART 3: A SUPER STEEP U.S. YIELD CURVE: HOW WILL IT FLATTEN?

United States: Yield Curve (percent)



Source: Haver Analytics, Gluskin Sheff

Final Thoughts

Please keep in mind that the Fed will cap long-term rates as a final move. They will be the buyer of last resort. By that we mean that they will purchase all of the outstanding bonds if need be. Long rates at 4.25% are just as detrimental today as 15% was in 1981. We do not believe it will come to this; however, it is our ace in the hole.

Anybody who really understands Ben Bernanke and has read up on his history all the way back to his upbringing in South Carolina knows that an economic depression is still a scenario that he believes is nontrivial. He understands how fragile the economy is;



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