

Economic Commentary



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

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1930s Redux

Current Status

Several things must be perfectly clear (to use a phrase from the President that put the final nail in the coffin of the U.S. dollar) to almost anyone who is paying attention to all the goings on in the U.S. economy, and that is we are in the modern equivalent of the 1930s economic depression. This is a point we have been harping on really since about 2000. One cannot see it as vividly as one could have in the 1930s depression (1929-1941) due to the safety net that has been provided by the taxpayers of the U.S. to one another. As things stand today, nearly 50% of the U.S. population is on some type of government program. Nearly 50 million people are on food stamps. And on it goes. If counted in the same manner as in the 1930s, the unemployment number is 16% and we expect it to become higher as we move into recession.

This current depression simply is not like any other recession we have had post World War II. Most of them were what economists call inventory cycles. During the boom period optimism becomes quite high and one expects sales to continue to accelerate. Many times inflation heats up as the hoarding occurs in the inputs needed to finish the final product for sale as they become scarce. One of the mandates of the Federal Reserve is to maintain stable prices, therefore interest rates are increased and the boom comes to a close. This is not the case this time around. We are having a balance sheet recession caused primarily because of too much debt. What is needed to rectify this condition is to deleverage. Debt must be

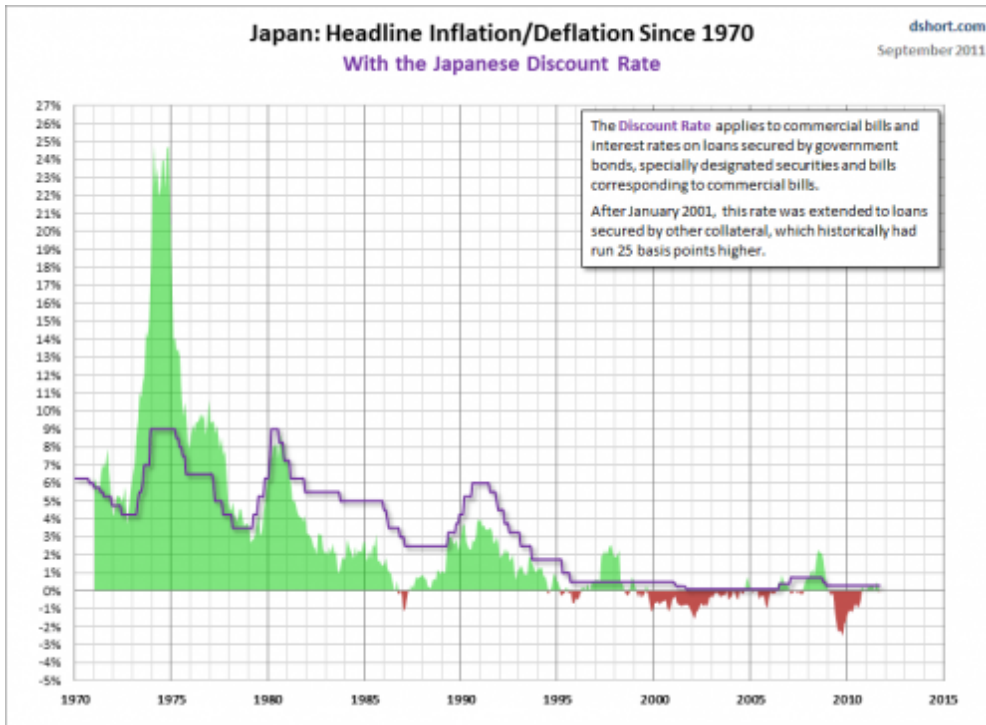
liquidated before the economy can become structurally sound again. Nothing else will do. In the process, assets must be liquidated and savings increased. This means less spending and thus less GDP. This is a good thing in the long run, but is bad news in the short run. More borrowing and/or more taxing will not solve the problem. It will only add time to the final date of cleansing and will likely increase the severity of economic decline.

As we have said many times before, at the present time we have excess of everything except brains. For example, it is estimated that we have roughly \$1 trillion of excess capacity in the economy—what economists call the GDP gap. Do you realize that we have not added anyone to the labor force over the last ten years or so? Not one! To make it even worse, in arriving at zero we added public sector jobs and lost private sector jobs—remember that private pays for public. How is that working out for you? Washington has no clue. The best thing they could do is stay home and give back their salaries.

Japan-Like

Another comparison we have made for our situation is that of Japan. In that regard, you might look at charts 1 and 2 on the next page. They are just a few potential similarities as we go forward. Japan has had little or no growth since about 1989 along with mostly deflation and low interest rates (that is on quality debt). This is what we are experiencing and, in our opinion, will continue to experience over the foreseeable future.

Chart 1



Adapted from financialsense.com

Chart 2



Adapted from financialsense.com

Of course no two economies are exactly the same due to such things as cultural differences and economic structure. Be that as it may, both countries followed the same monetary and fiscal policies before the downturn

\$30 trillion in the hole.

How is all this debt going to be liquidated? We would suggest that much of it will default, some will be restructured, and, of

as well as their actions to “help” the turnaround. Our people gave them advice they should not have listened to and even after seeing it was the wrong medicine, we took our own advice with the same attendant results—more debt and no help.

Bubble, Bubble, Toil, and Trouble

Tech bubble, housing bubble, but the grandfather of them all is the debt bubble. If one wanted to use only one word to describe the fault of the mess we are in it would be DEBT. We have had a 30 year debt acceleration which has brought the consumer to his knees and the other factors of production close to it. In 1980 our total debt to GDP was approximately 1.6:1. As this is being written the ratio is around 3.6:1. The world has never ever seen anything like this type of debt increase. Before 1980 the 1.6:1 ratio was about normal in historical context. If one were to take 1.6 times our GDP of today, our total debt would be something like \$22 trillion. What is it actually? Over \$52 trillion. Measured in that way, we are

course the old-fashioned way, paid off with cash. The final way, which will come as a last resort, will be to have debt inflated away through deliberate Federal Reserve action. We suggested in one of our recent Web Buzzes that the government will probably handle its debt by issuing 50-year treasury bonds at say 3% and 100-year bonds at 4% and then inflate away the balance. This, of course, would bag the bond buyers; however, what's new about that? Do any of you remember the Series E Bonds of yesteryear?

You might ask us—what happens to us in your various programs that include government bonds? The answer, of course, is that we expect to be out of bonds well ahead of that occurrence. Remember, we (U.S.) are the best looking horse at the glue factory. We will be riding a brand new horse.

As we have suggested many times before, one should be very careful what bonds one holds. Coupon income is almost nil, therefore capital gains are the thing to look for. In our mind, U.S. governments, along with Canadian governments, may be about the only thing to own. High quality corporates are income sound, but most with any coupon above 5% or so will be refunded during this period of time making any gains go away. (Government bonds are not callable. They have to buy them in the open market. We think it's quite possible we will sell our long governments to the Fed when the price is right.) Other sovereign debt may be suspect. Note the following taken from Doug Nolan of Prudent Bear's website:

Back in the autumn of 2009, Greece could finance its massive deficit spending program for two-years at less than 2%. Portuguese yields were about 125 bps and Ireland 175 bps. Spanish and Italian 2-year yields were around 1.5%. The Fed's, ECB's and global central bankers' moves to slash interest rates to near zero were instrumental in the marketplace's accommodation of unprecedented government debt issuance at arti-

cially low yields. The European "periphery" markets were part of the expansive Global Government Finance Bubble. And the market perception that monetary policy would ensure ongoing low sovereign debt service costs was instrumental in the market disregarding – and mispricing - credit risk throughout the eurozone. Even last spring, after the Greek crisis' initial eruption, markets held to the assumption that policymakers would sustain low sovereign borrowing costs and insulate bondholders from significant losses.

Not only has monetary policy fostered the rapid expansion of government debt at artificially low rates, it has also set the stage for a very destabilizing change in market perceptions. Particularly after many years of interventionist policymaking (throughout the protracted private credit boom), the markets naturally turn complacent when it comes to debt crisis risks. Yet as Europe is confronting these days, there are limited available options when crisis finally arrives at sovereign debt's doorstep. At some point, fiscal and monetary stimulus comes to the inevitable end of the road. At some point, markets say "no más," "não mais," "non piu" or "no more."

Piling on additional government debt is then no longer a solution, inaugurating the debilitating and depressing "austerity" cycle. And, as we continue to witness here at home, having the central bank monetize federal debt only worsens market distortions and delays desperately-needed fiscal (and economic) reform. As much as there was an element of certainty in the marketplace with regard to the mechanics of private-sector debt crisis resolution, sovereign debt bubbles and crises just seem to foment uncertainty. Policymakers are destined to look incompetent, while markets will appear fickle and unstable. Meanwhile, fragile recoveries will turn increasingly vulnerable. And throughout, there will be a growing disconnect between what the markets have come to expect from policymakers and what they

can now realistically deliver.

As witnessed in Greece, Ireland, and Portugal, there comes a point where the market recognizes debt trap dynamics and begins to price in sovereign risk. And it is not long into this process of risk re-pricing that the marketplace comes to view huge debt loads as unmanageable albatrosses. This destabilizing process has now commenced with Spain and Italy. Once unleashed, sovereign debt crisis momentum can prove difficult to contain.

Greece is Coming Here

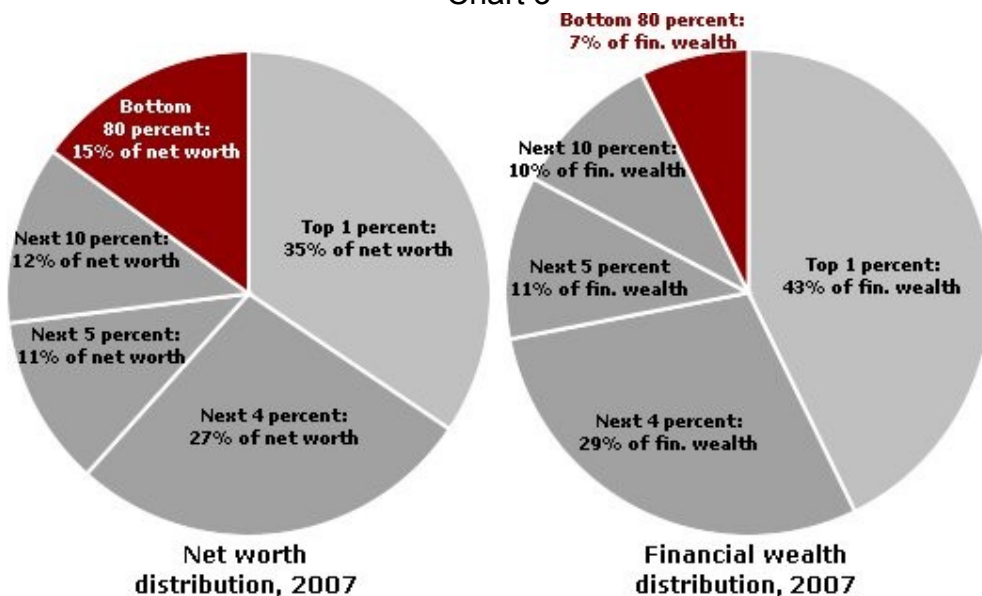
Again, as mentioned in our previous writings, the riots that started in Greece and other European countries are coming to America. They showed up on Wall Street several weeks ago and seem to be destined to spread across the country. It is reported that insider trader George Soros is the money behind this movement. Why is this taking place? One only need to look at chart 3 to obtain at least part of the answer.

These numbers are approximately what they were in 1930 as we entered the Great Depression. When income and wealth distribution is concentrated heavily in one sector, problems seem sure to come. Also, it will be big trouble when class warfare is conducted by our politicians. Ever since the 1930s when the welfare state was created, Washington has pandered to certain areas of our population in order to buy their votes. But when things become tough in the economy, Washington runs to Wall Street with easy money and bailouts in order to restore growth. Once the recovery is well underway, Wall Street and corporate America again become the bad guys. Votes then come once more from the less fortunate, as well as Wall Street which is actually paying ransom not to be punished by onerous laws and regulation. It is a vicious cycle that has been taking place over the last 80 years. However, there is a difference this time—there is no return to growth!

Markets

The stock market remains overvalued. High quality bonds remain good value. Gold is a good hedge against currencies and time marches on.

Chart 3



Adapted from theburningplatform.com



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