

# Interim Market Update



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

January 25, 2012

## A REVISIT OF THE FUNDAMENTALS

The financial markets have become a giant casino. One doesn't need to go to Las Vegas to get some action like in the old days. The free enterprise system has been taken over by Wall Street financial engineers, aided and abetted by Washington. No longer do economic fundamentals determine the reasonable pricing of assets in the *short term* (six to twelve months). We see this month after month as the risk-on (stocks and commodities) play dominates and the risk-off (U.S. government bonds) heads south only to reverse in a month or so. If one could use hindsight, he could become richer overnight by playing both sides of the risk trade – or long and short one side or the other. The major problem is that the market is decided day to day by huge pools of capital, primarily hedge funds, using such practices as front running which leaves most of us unable to play the game with any degree of certainty. On the other hand, we believe we have an excellent grip on the fundamentals and they always win out in the *long term* (three to five years). Let us refer again to our 6/30/2000 call when we asked all of our clients to exit the stock market and go to our bond program. The fundamentals have proven us correct and we are not yet through with this allocation; although the day will come when we need to reverse this move. Just as there are only about 25% of money managers who can outperform the stock and bond averages, our discipline has allowed us to be in the upper 5% of bond managers for three decades. There are some who work with stocks and bonds that can trade more often and do well and we say good for them. Lacy Hunt, chief economist for Hoisington Investment Management, has this to say on the subject, as quoted in the January 25, 2012 edition of Gluskin Sheff's *Breakfast with Dave*:

*In economic analysis, there are two things that are important. First and foremost, you have to have some understanding of how the world works and then you have to evaluate the incoming data in terms of the way in which the world works . . . the indicators have to be interpreted in light of a more fundamental structure . . . short-term trading is really dominated by these whole hosts of psychological and behavioral*



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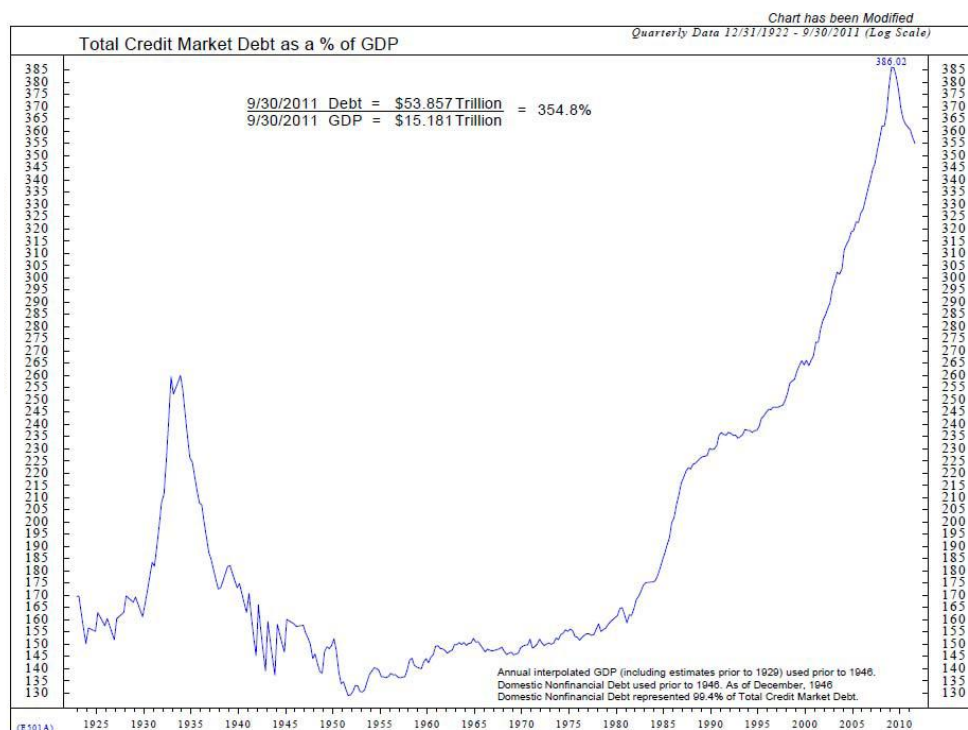


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*characteristics, which are very difficult to sort out . . . To know when you're moving toward equilibrium and in which direction equilibrium exists, requires this broader understanding of the fundamental economic relationships . . . Yes, and the thing about it is, it's counterintuitive. You might assume that we'd have greater knowledge about the short run and less knowledge about the long run. But in our approach, the only knowledge that we think we have pertains to these longer term fundamental considerations, not to the short-term trading. So we're looking at the world through an entirely different prism . . . trying to sort the short-term noise is an impossible task . . . you cannot react to these short-term swings. If you do that, you'll generally be buying at the wrong time and selling at the wrong time.*

The following are the fundamentals we believe we know concerning the economies of the world which will ultimately determine the value of financial assets within two or three years.

1. The world is awash with debt. Note the U.S. debt number in the chart below.



Adapted from comstockfunds.com



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- 2. Debt is deflationary.**
- 3. Debt problems cannot be reversed by creating more debt, which is what the central banks are doing.**
- 4. Recent research from Reinhart and Rogoff indicates that countries with high debt levels can only grow, at best, very slowly. After all, excess debt created good growth during the 80s and 90s. What debt giveth, debt taketh away.**
- 5. High debt and slow growth lead to tariffs, competitive devaluation, and other tensions.**
- 6. There are already indicators that our exports are topping out as many of our trading partners are in recession.**
- 7. High debt and slow growth make for instability and prone to black swans.**
- 8. We hate to say it, but the conditions we are enumerating have often led to wars.**
- 9. Investors are making their decisions based upon day-to-day headlines. The only headlines that are important are those yet to come.**
- 10. The consumer has only started the process of deleveraging and still has years to go.**
- 11. Final Christmas sales were disappointing.**
- 12. What spending was done came from savings drawdown.**
- 13. Big business is in relatively good financial condition. Small business is suffering and small business creates most of the jobs.**
- 14. U.S. capital spending did relatively well during 2011; however, keep in mind that Uncle Sam allowed a 100% write off which has now declined to 50% for 2012.**
- 15. Most all government leaders around the world have no clue how to address their respective economic problems. We call our president and congress sandbox players.**

**In summary, we see no way that the U.S. economy can accelerate from here. The fourth quarter of 2011, in all likelihood, was the apex of what little recovery we have had. Slow to no growth and probable recession coupled with deflation seems nearly certainty.**



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## A Final Thought

**Please note the following table which details the interest paid on our federal debt. The effective rate of 3% now being paid each year *cannot* accelerate without throwing our debt service completely out of whack. What happens if long-term rates go to 6%? Again, let us repeat some recent comments concerning the Federal Reserve and interest rates. If push comes to shove, they will buy all the higher interest rate bonds (10 to 30 year) to keep that from coming to pass. Also keep in mind that they U.S. is rapidly becoming the safe haven of last resort, which will keep interest rates low.**

### **Available Historical Data Fiscal Year End**

2011	\$454,393,280,417.03
2010	\$413,954,825,362.17
2009	\$383,071,060,815.42
2008	\$451,154,049,950.63
2007	\$429,977,998,108.20
2006	\$405,872,109,315.83
2005	\$352,350,252,507.90
2004	\$321,566,323,971.29
2003	\$318,148,529,151.51
2002	\$332,536,958,599.42
2001	\$359,507,635,242.41
2000	\$361,997,734,302.36
1999	\$353,511,471,722.87
1998	\$363,823,722,920.26
1997	\$355,795,834,214.66
1996	\$343,955,076,695.15
1995	\$332,413,555,030.62
1994	\$296,277,764,246.26
1993	\$292,502,219,484.25
1992	\$292,361,073,070.74
1991	\$286,021,921,181.04
1990	\$264,852,544,615.90
1989	\$240,863,231,535.71
1988	\$214,145,028,847.73

**Adapted from [treasurydirect.gov](http://treasurydirect.gov)**



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