

# Central Plains Advisors, Inc.

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## Economic Commentary

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### Let's Meet Each Other's Needs

#### Your Need

One of our main themes over the last seven to eight years was that in the coming years (now) there would be a severe income drought. Based upon that projection, Central Plains Advisors, Inc. suggested an investor should make a large commitment to long-term government bonds – non-callable and high quality. Those of you who bought into our outlook have to date been well rewarded. By so doing, one is now in the position to either hold on to the high coupon obtained (say 5%-7%) when buying several years ago, or having capital gains which if realized would allow one to have more principle to invest at current lower rates, thereby retaining their income position. This was and is a strategy to eliminate reinvestment risk, which is always present during a bull market in bonds. Have any of your other investment advisors mentioned reinvestment risk? We bet not. There is more misunderstanding of the bond market than any we know. Maybe better said, there are very few who really understand the bond market; therefore, do not take advantage of what one can accomplish during both bull & bear markets, as well as the one Central Plains Advisors, Inc. now sees approaching in the future.

We are so tired of investment firms talking only about market risk and never reinvestment and credit risk. It illustrates a complete lack of understanding as mentioned above. Central Plains Advisors, Inc. would not be in the bond management business if there was not market risk. We must have market risk to obtain a total return rather than just an income stream. In our opinion, with our approach, credit risk is much more dangerous. Central Plains Advisors, Inc. wants our people to always have the highest quality assets as possible.

Junk bonds (high credit risk) are recommended by many. Our economic analysis tells us that this is an unacceptable risk to take, particularly at this time. While we are addressing risk, there is another important one that needs to be mentioned: comparative risk. Market risk in government bonds is much different than market risk in junk bonds on a relative basis. Also, market risk in government bonds is much less than market risk in common stocks. One needs to carefully analyze and understand different degrees and kinds of risk.

We never question anyone's sincerity, if they are fee based only advisors. There would be no conflict of interest just, in our opinion, a different understanding and knowledge of the bond market. What drives the direction of interest rates is much different than what is generally believed and acted upon.

Your need, we believe, is to carefully sift through the advice given by the myriad of professionals in our business. As is often said, no one knows for certain the future. We all know that. One should never have all of his money in any one program. We all know that. Be analytical, be prudent, and ask for audited past performance returns. There are no guarantees, but surely the above will help.

## **Our Need**

After decades and decades of evidence proving otherwise, most financial market participants continue to believe that in order for interest rates to go lower, the economy must be either in recession or close there to. This is absolutely not the case and simply is not true. Interest rates can recede in strong growth economies – we just went through such a period (1982-2000). There likewise have been many other past examples. Also, during serious recessions interest rates can move much higher – a la 1973 and 1974. Since 1985, there has been no direct correlation between real economic growth and interest rates. The relationship is at best 50/50 over the last 125 years. Why then, do most not know this? They follow the wrong economic model and are prone to revisionist history. They are never confused by the facts.

This market belief is important to our being able to do well. The more this remains the consensus, the more it helps us. Why? Their misread of the market gives us the opportunity to buy and sell at advantageous prices. We cannot over emphasize the fact that (1) the bond market is not what is taught in academe and practiced by most advisors and (2) the Keynesian economic model is loved by all, but lacks a credible record. This is where our needs come to bear. We need for you to withstand the intense pressure that is sure to become even greater from the brokerage community and most advisors and financial planners. We are almost always in a minority position. We need to have those that berate our position, but we need for you to resist what they say – we suggest you ask for their audited record when it comes to bonds.

Please remember the financial secondary markets are a zero-sum game. For every winner there is a loser. If one thinks about it, for every buyer there is a seller. Someone has to be wrong on every transaction made. We must have many who believe we are wrong. It is up to you to make both you and us successful. If the past is any guide (of course, no one knows the future) we will more often than not make the right buy and sell decisions. However, it's of no help to either of us if you cannot stand the down draft when the market goes against us – it always has and it always will from time to time.

## **Why the “Sermon” Above?**

The long 22-year bull market in bonds (primarily 30-year government bonds) is coming to a close. It was in 1981, with interest rates at 14% that it was apparent to Don Peters that holding 90-day T/Bills for four years was not the position he wanted to continue. Although, in hindsight, everyone can now make that decision, it was extremely unpopular at the time. Don was universally criticized throughout the financial community. After all, bonds had been in a bear market since 1951 (30 years). To turn bullish at the bottom of this bear market was a very lonely call. During the worst part of the bear market, he was in Treasury Bills, as mentioned above. When he went long (30 year bonds) the interest rate was 14%, but the Treasury Bill rate was 18%. He sold away 18% to get 14% - how smart was that? Well my friends, a time will come in the not too distant future whereby Central Plains Advisors, Inc. will sell a 4% or 3% instrument for a 1% shorter-term security. How will that look? The answer to both those questions is darn smart, but you won't be able to tell it from what you will hear on the street. A bear market calls for one type of action, a bull market another and the transition period yet another. We expect the bull market to terminate within the next year or so. Then there will come a three to seven year transition market on the way to a new bear market. Especially at the turning points, we will be even more out of favor with the street than we have over the last few years. The following is what Central Plains Advisors, Inc. envisions and the strategy we expect to employ.

1. Bull market – next several years – infrequent buy and sells.

2. Transition Market – the next three to seven years – more frequent buy and sells.
3. Bear Market – Next seven to ? years – very frequent buy and sells.

As we believe only government interest rates can be projected with any degree of accuracy we will remain invested in these securities. There are just too many factors other than inflation and the state of the economy that bear upon the interest rates of lesser quality securities.

### Economy

Economic activity continues to be anything but strong. That degree of weakness is under considerable debate. Wall Street, which is always bullish, is predicting a rather strong second half recovery for the fourth year in a row. To this we say no – no that is if you believe strong is 5% or above. Even 4%, which appears to be the consensus, seems highly unlikely. Our best guess is 3% tops to a negative 2% at the worst. Keep in mind, when deflation hits, as we believe it will, the mathematics change – note the following:

### 3% Real GDP

1. A 2% nominal plus 1% deflation = 3% real.

Or

2. A nominal 4% minus 1% inflation = 3% real

Or

3. Many other combinations resulting in 3% real.

Government interest rates could be quite different based upon which develops. We simply are in uncharted waters since the 20's and 30's and to make sense of the above "new world" we will need to be particularly introspective. Be careful of what you believe. We would guess that 75% of those who want to attract your attention simply do not have a clue as to what is taking place. As a side bar, this commentary is being written from the St. Rigis Hotel in Aspen. The executives of one of the most prominent mutual fund companies in the world are having a retreat (or something) just below my window. It makes us wonder – where are all the clients spending their summer? In the course of the afternoon and evening, I was able to find out the thrust of their outlook. Oh, by the way, if the some 200 executives were not present, we would have been all alone in the hotel. The featured speaker concluded his comments outside, just as a fierce mountain thunderstorm occurred – lightning, thunder and hail – they were saved by a beautiful white colored tent. The executives were assured that the future was bright, one should hold on to his common stocks and that all of them were being cleansed of their previous sins. Things it seems never change. The symbolism was dynamic. It was as if the skies opened up and the Lord Himself granted absolution to these folks who were buying high tech stocks in 1999 at 150 to 200 times earnings for their clients. The mantra on Wall Street, it seems, is to obtain absolution, pay \$1 ½ B in fines, and move on hawking the next hot item – that's real life in our profession.

Debt and excess capacity remains the U.S.'s, as well as the world's, major economic problem. Again it's not the end of the world, but things are bound to be relatively slow and are destined to remain that way for some time. We ask you: Where is the pent up demand? Has the excess capacity been eliminated? Do the politicians realize what they are doing? Do the captains of industry have a fear for the future? Does organized labor understand they have overpriced their services? The answer, it seems to us, is mostly "no," but before this long economic transition period is over, the answer will be "yes," and the understanding will become greater.

### **Stock Market**

The 5<sup>th</sup> excellent bear market rally seems about over. Stocks are overvalued and overowned. We believe the next major move will be down. It is quite possible that a 1987 market may soon be in our future. Central Plains Advisors, Inc. feels confident of the ultimate direction but haven't a clue as to when. The major rationale as to why one should own stocks is there is no yield in fixed income. Our answer to this is; (1) We know how to get good returns from bonds, and (2) the three great periods of common stock returns in the last 100 years are probably behind us. There will be another, but we doubt it's anytime soon. Sometimes it's better to hold on to what you have, rather than reach for the best yield around.

### **Bond Market**

The commentary on your need, our need, and generally the need to need, fairly well articulates our outlook for the bond market, which has had a small, but significant change.

1. Government interest rates will go lower, but the end is in sight.
2. The return to significantly higher government rates, however, is a long way off. A trading market transition appears likely in the not too distant future.
3. The relatively weak economy will widen spreads, particularly long rate spreads in the corporate and municipal markets, before long. We are not sure when the "fantasy economic rebound" will be discarded, but it will.
4. There will be a time to speculate on lesser quality bonds, but not now.

## Central Plains Advisors

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