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Economic Commentary

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Some Random Thoughts & Suggestions

There is a near universal belief in the Federal Reserve being able to cure all cycles economic. After all, didn't they by the use of easy monetary policy keep the recent stock market "crash" from spreading throughout the real economy? Yes they have, but in our opinion, the game is far from over. We believe the odds indicate that the next test of monetary, as well as fiscal, policy is relatively close at hand. Under the guidance of Alan Greenspan, the Fed since 1987 has time after time come to the "rescue" of the economy through the use of monetary policy. The question, however, that remains unanswered has to do with the permanence of the cure. Have we really modified and/or conquered the business cycle for good? Or is it likely that we have only postponed the correction that needs to take place in order to set things straight for the long-term? Our answers are no and yes in that order. Please don't come to the conclusion that we are perma-bears on the economy. That is not the case. What we expect is a long period of slower than normal growth accompanied with investment returns that are quite modest in size.

For example, the near universal disdain for the long government bond at over 5% is systematic of the long held belief that stock market returns are sure to be far superior over the next five years or longer. If one's time horizon is 20 years or so, that belief might be right, but until the structural problems with the economy are corrected, even that period is far from certain.

No economist does a better job of explaining the structural changes that need take place in this global economy than Stephen Roach of Morgan Stanley. No longer can the U.S. economy be evaluated based solely on domestic conditions. Everyone recognizes the new economic environment of globalization, but few do the necessary analysis to obtain a decent view of what it means for us. Roach does. You can find him on the webpage of Morgan Stanley, www.morganstanley.com.

Recently, we have seen data, which is beginning to confirm our economic outlook. For example, the first quarter GDP was revised downward from 4.4% to 3.9%. Now 3.9% is a good number so, at least for now, the economy continues to do well – at least in total numbers. There does remain over consumption on the part of the consumer as well as under investment in private sector. Short-term this is OK; long-term it's a problem. Another interesting group of numbers is year-over-year increases in retail sales. Such huge retailers as Wal-Mart and Target are coming in below expectations – a sure sign, in our opinion, that without the stimulus of tax cuts and mortgage refinancing the consumer is withdrawing from the retail market. Although things rarely go in a straight line, we would suggest softer economic data is in our future.

Let's Talk About Misinformation

The misinformation, which can be so damaging, is the reason why individual investors obtain returns which are much less than the various indices – in both stocks and bonds. Sometimes it seems as if the cards are simply stacked against the investor. It can even seem as if there is a conspiracy of sorts. Let us explain, or at least attempt to explain. The information society, which began with the radio followed

by television and now the Internet, is ready made to give most all a voice in the dissemination of business and market information. The major participants in this are the media, the politicians, and Wall Street firms. There are others, but these wield the most influence and are the ones more likely to influence public opinion.

Rather than expound on the way the media and Wall Street have led us down the primrose path concerning the financial markets, we would like to use, as an illustration, what the media has done concerning news coverage of the Vietnam War and now the war in Iraq. The Vietnam illustration is a matter of absolute fact – Iraq is yet to be determined for sure. The Belmont Club in a piece entitled “News Coverage as a Weapon” dated May 20, 2004, made the following facts known: At the end of 1967, 222 out of 242 provinces had been pacified by U.S. forces. The North Vietnamese has suffered one military defeat after another. The war was all but over, and we had won. Then came the Tet Offensive and everything changed.

Today the media is doing the same with the news coming out of Iraq. Note the following comparisons of casualties:

1. Civil War
 - a. 1st Texas Regiment lost 82% of its people in the battle of Antietan.
 - b. 1st Minnesota lost 82% at Gettysburg.
 - c. 600,000 soldiers lost including both sides.
2. World War II
 - a. British Bomber Command’s chances of survival were less than one-in-four.
 - b. German U-Boats lost 63% of their people.
3. Iraq War to date has lost only a few more than 1000 Coalition soldiers – less than 1/10%.

We would suggest you find the article “News Coverage as a Weapon” on your search engine and read the article for yourself. How is one to know? In our mind, only by looking at the details behind the headlines does one learn the facts. This applies not only to war coverage, but financial markets as well.

We believe the most productive thing an investor can do to improve his/her returns is to become a bookworm and get away from the financial media. As you undoubtedly remember, we have time after time gone after the Wall Street types. There are some 800,000 of them and by in large their research follows the wrong economic model. Their income is derived from selling us securities, which may or may not be to our advantage but certainly is to theirs. Please don’t consider this an indictment of all 800,000. On the other hand, there is absolutely no doubt that they have an enormous conflict of interest. Having been one of those at a time long ago the remembrance of those conflicts remain strongly embedded in our mind. Never ever does one know it all. As a matter of fact, if you think you do, then you are really in trouble. We attempt to keep a constant watch on new studies and theories. The Internet is a great source of information, but of course, it is also a great source of misinformation. A recent book we have just read, entitled “Schizomania” by Jack Lessinger economic professor emeritus of the University of Washington, is yet another attempt by us to understand the economy and the financial markets. It is pretty much a hybrid as far as economic schools of thought are concerned. We would strongly suggest you spend the \$17 or so to obtain his life long study of what causes economies and markets to act the way they do. The following is a review of the book by Michael Nystrom from *World Market Chronicles* dated 7/21/03.

Schizomania

Reviewed by Michael Nystrom

The "good life" of twentieth century America was known far and wide to be suburban and consumption-oriented. America was (and continues to be) characterized by a compulsion to put the short run over the long run, the present over the future, the individual over the community, and spending - even if it means going into debt to do it - over saving. But America was not always so, nor will it necessarily continue to be so in the future. The American Dream that we know and love so well is dying - a victim of its own, overwhelming success.

This is the major thesis of *Schizomania*, the latest book by Jack Lessinger, Ph.D., of the Department of Business, Government and Society at the University of Washington. The American Dream is not static, but fluid, growing, developing and transforming over long periods of time, in identifiable cycles. What was generally considered to be the "good life" 100 years ago is not the same thing as today. The future, likewise, will hold a different set of values and beliefs about what is important, valuable and meaningful.

This may seem self evident, but by examining historical data, Lessinger has codified this idea into a model that demonstrates long wave cycles of change in the orientation of American values. The model shows that the full cycle of a dominant value system-or 'ruling mania' as Lessinger calls it-is about 120 years. At any given time, there are two ruling manias in operation, one individual oriented, the other community oriented. When a ruling mania reaches its peak - a new ruling mania is born as its antithesis, and begins to gain dominance as the older one declines in power. At the point when the two ruling manias are of equal strength, we enter a period of Schizomania: A society split between major belief systems, accompanied by a perilous economy prone to depression.

This is where we find ourselves today: Schizomania. As Lessinger writes:

Nearly a century ago, the American Dream promised a consumer's paradise, but the Dream had a fatal flaw - indifference to the long run future of the community. Tomorrow we'll all be dead, went the common sense of the times. Let the future take care of itself.

But the future arrived in a billow of smog and black smoke. The suburbs filled in - they became ugly and congested. Cars and industry spewed pollution. Water became undrinkable. Marriages failed. Children grew into delinquents. Drugs flourished. Education languished. By the 1990's, the Dream had become a nightmare.

The American Dream of the suburban lifestyle is giving way to a new dream of a community oriented, sustainable way of living. The ideal of a suburban paradise is yesterday's craze, and the migration out has already begun. As the exodus from suburbia continues, we'll see a real estate crash large enough to possibly bring on a Second Great Depression, according to Lessinger.

The suburban lifestyle is about consumption, but consumption has led to over-consumption, and that is damaging the world community. We love our cars, but we pollute the air and water by burning fossil fuels, and contribute to global warming with its catastrophic impacts on climate and our biological future. Over-consumption is causing a groundswell of reaction - a countervailing will to live responsibly. As this idea slowly gains ground, old ways of doing things are slowly abandoned.

The emerging, responsible, sustainable way of thinking will require new social and economic machinery to change the way we live, think, teach, buy, sell, work and play. Today over-consumption is built into the infrastructure of our society. This will change over time. As we shift our priorities away from "what's in it for me" to "what's in it for us" (from individual-oriented to community-oriented ruling manias) we will spend less on ourselves and more on the community. This will be a traumatic shock for the economy as we know it.

Lessinger's model is innovative, insightful, and well researched. The book reads easily and is sprinkled with dry wit and humor, but its most important contribution is driving home the key fact: In the long run it is society that drives the economy. From a historical perspective, he examines four ruling manias in America, and gives some interesting predictions and recommendations for the future. He notes that each shift in ruling mania was accompanied by a corresponding mass migration. Anticipating this current migration is a key to recognizing how the future investment landscape is shifting radically. The world is fast changing, and Lessinger's book is a valuable contribution to understanding the underlying trends behind change. This book is a must read for anyone interested in American social history, economics, real estate and investing.

A Final Thought

Take a look at the following analysis of corporate profits. Note the relationship between manufacturing and retail trade profits. Does this look like a well-balanced economy? Not when you consider that manufacturing profits have a multiplier effect, retail does not. Plus, much of retail profits go overseas.

CORPORATE PROFITS (IN BILLIONS OF U.S. DOLLARS)								
	1997	1998	1999	2000	2001	2002	2003	2004 I
NONFINANCIAL	508.4	470.1	461.1	413.4	318.8	334.3	410.0	403.9
MANUFACTURING	209.0	157.0	150.6	144.3	54.0	73.3	96.6	
MOTOR VEHICLES	4.8	6.4	7.3	-1.0	-7.2	-1.0	1.1	
MACHINERY	16.7	15.6	12.4	8.2	3.2	1.5	-2.6	
COMPUTERS	25.3	3.9	-6.5	4.0	-49.4	-18.4	-2.6	
RETAIL TRADE	64.2	66.4	65.2	59.6	71.1	76.7	80.1	

SOURCE: BUREAU OF ECONOMIC ANALYSIS, COMMERCE DEPARTMENT, SURVEY OF CURRENT BUSINESS

Our expectations remain a flattening of the government yield curve (higher short-term rates and lower long-term rates), a disappointing stock market as well as lower prices for lesser quality bonds.

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