

Central Plains Advisors, Inc.

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Economic Commentary

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Slouching Toward Trouble

Ever since Judge Bork's book Slouching Toward Gomorrah writers have used the slouching toward--in their particular areas of influence. We just couldn't resist the temptation to do likewise after hearing chairman Greenspan testimony before Congress several weeks ago. In his testimony he resurrected the Phillips Curve, a long held Keynesian myth, as being the reason for contemplating canceling the official interest rate declines made during the Asian crisis. If you may recall the Phillips curve stated that low unemployment plus a strong economy leads to inflation. This, of course, has not ever been true, and now is no exception, when there is a worldwide excess supply of goods and services. Under today's circumstance inflation does not increase but rather profit margins decline as labor obtains a greater share of the economic pie. That is actually what is now facing the U.S. economy and is a serious threat to future economic growth. Why? Because the multiplier part of the economy is capital spending and it is acutely cyclical. If corporate profits decline then a decline in capital spending is certain to follow. Chairman Greenspan knows this just as well or even better than we, therefore just what is going on?

Greenspan Dilemma

The serious economic problem facing the policy makers in Washington is the fact that most of the activity taking place today is on borrowed money. With the exception of the stock market we have no saving taking place. Not only are individuals spending more than they make but corporations are spending more than their cash flows. The domestic private sector saving rate as a percentage of GDP is - 4%, the worst in recorded history. At the same time, and due to the near Asian and South American economic blow-up, massive amounts of liquidity were pumped into the system. This action apparently signaled to the market that nothing bad would happen economically as the Fed action should solve these problems. Thus consumers, corporations and investors shifted into high gear and we are today in a debt driven economic boom, not seen in 70 years. There also is a stock market mania and they are feeding on each other. Another page of this same book is the never ending Rose Garden statements of Bill Clinton promising new entitlements, huge budget surpluses (there is none - its social security) which again signals no need to save as a larger and larger safety net is being proposed. Also, and maybe we are just too biased, but if there are no consequences to ones actions (as exemplified by the first family) then anything goes - don't worry if it feels good do it. This is a huge problem and Mr. Greenspan has the responsibility to do something to halt this mania which seems certain to result in disaster. Trust us folks it can not go on in this fashion forever and the more it continues the worse it will get. We are on the edge. First of all his stock market warning of late 1996 did absolutely no good. Although his observations about the market were essentially correct the stock market paused only a

day or two before marching onward to its present valuation which is by all reasonable measurers grossly overvalued. As of March this year the Dow Jones is +44%, S & P 500 +65%. NASDAQ +92% and the Internet index +159%. That being the case talking the market down apparently is a no show solution. Let's also be frank, he as well as others and we did not appreciate the high productivity taking place.

What he can do is make up a reason (labor supply) to take away the liquidity that was injected last fall and reduce the growth in money supply. Over time this will work – however it probably will create an inverted yield curve and a recession. By inverted yield curve we mean higher short-term rates and lower long-term rates. In the interim both may go higher (and they have) but the end result will be much lower rates all along the yield curve.

Why you ask would he risk recession by such a policy move? The answer is simple. The alternative would be worse plus it's about the only thing that can be done. Mr. Greenspan wants not to burst the bubble but simply release slowly some of the excess euphoria both in the stock market and the real economy. Please re-read the wealth effect section of the last quarter's economic newsletter. (If you do not have March's economic newsletter please call 888-735-2724) We are not growing too fast so as to cause inflation. We do not have labor costs that are causing problems from an inflationary standpoint. The economy is OK except the stock market is creating an euphoria that is showing up in stock prices and in some areas real estate prices which in turn through consumption borrowing is creating mountains of debt that some day will need to be paid back.

Economy

We expected 1st quarter GDP to be approximately 3.5% and it came in around 4.3%. The 2nd quarter ended 6/30/99 should be in the neighborhood of 3.5% possibly some less. The slowdown is underway of its own devices and could be less than 3% during the next half maybe a lot less due to recent Fed action.

The trouble we seem to be slouching toward is not inflation at least as far as the consumer and wholesale price indices are concerned but rather financial asset prices – the stock market. A sharp drop could be extremely disruptive to the economy. If valuations were reasonable and debt was not large it would make little difference but that certainly is not the case today.

Stock Market

Our view toward this asset class is obvious from the above comment on the economy. When Barbara Streisand makes 89% in one year in the stock market and Warren Buffet loses almost 15% one needs to look at his hole card. Come on now. The point is Barbara is an amateur and Warren is a proven professional. We are in dangerous territory. It's important to once again talk about numbers. For the year ended April 30, 1999, the average stock was down 22% and 75% of all stocks are down more than 15% from their 52-week highs. As of May 1999 67% of all stocks on the NYSE were down 20% or more. 52% were down 30% or more and 39% were down 40% or more. Yet we would venture to guess most believe that stocks continue to throw off huge gains. The reason

for this is the unsophisticated journalistic hype given the stock market over approximately the last 5 years. We have been experiencing a stealth bear market and very few have taken note. Even many of those of some sophistication have yet to see the light.

In our opinion on aggregate earnings are headed downward and the stock market at best has only limited upside potential. We are, however, ready and willing to change our opinion if our research tells us otherwise. In such markets there are winners, but the number of late have become smaller and smaller.

Bond Market

It has always been our opinion that one should put his money where his mouth is. With that thought in mind twice since the first of the year we have increased our personal bond positions – once by over 100% and once by approximately 40%. Why? Because the decline in the price of government bonds has created an opportunity of unusual long-term value. If we have additional declines in price (increase in yields) we will do so again. The entire move since the first of year has been due to an irrational fear of inflation. There has not been and there will not be any sustainable increase in inflation above the 2% level. If that is true then the long government bond yield should be no higher than 4 ½ % and even lower (3 ½ % - 4%) if deflation creeps into the picture. Today it's a little above 6%. Such a move will create high double digit returns.

Our approach to the management of bonds has always been based upon the economic fundamentals. From time to time on a short-term basis we suffer, i.e. the two middle quarters of 1987, the first quarter of 1996 and the first two quarters of 1999. Out of 98 quarters (24 ½ years) we have had 5 more than “normal” downside (in percentage) returns. All to date have been outstanding buying opportunities. We believe this again will be the case. At today's level one will obtain a 6% return from here if things remain the same. If rates go to 4% over the next two years one will obtain a total return approaching 25% per year. The risk reward ratio is a little better than 4 to 1 in what we believe is the highest quality asset in the world.

In today's parlance its time to get one's game face on. Don't let the myopic fear of loss, which along with greed, are the investors worst enemies take hold. The force (fundamental economics) is with us.

A Final Thought

To those of slightly advanced years (yours truly included) the major concern is always that you are like the “old geezer” you remember who always thought the world was coming to an end, a la bear market and depression. Sewell Avery of Montgomery Ward was the poster boy for that in the fifties as Sears spread across the country after WWII and Avery stood pat expecting a depression at any moment. This has always been something that has worried us and we have attempted to guard against such becoming a problem. At times we feel like Sewell Avery as we explore the debt problems facing the average US citizen. What is different however is that Avery in the late 40's and 50's was looking backward to the 30's and expecting a rerun. What do we see now as we look backward? A stock market boom of unprecedented proportion and an eight-year

economic expansion. Bill Clinton raves that “the surplus is the hard earned product of our fiscal discipline” That of course is untrue and if one looks at the figures, it is obvious that the Federal government is balancing its books on the back of US taxpayers who each day are going further and further in debt. While the individual gets deeper and deeper in debt, our corporations are expanding supply where little is needed and to boot borrowing to do so.

The final thought is that one should be very careful with ones investment funds. We are in potentially dangerous waters.

Don S. Peters

INTRODUCING: LINDSEY MALITO

Last commentary we introduced you to Billie Jaso and stated you may hear different voices in the future. Lindsey came to work with us to assist Billie and Polly with customer accounts and inquiries. We welcome her as an integral part of CPAI.

<u>Year 2000 Readiness Disclosure</u>
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In the third quarter of 1998 Central Plains Advisors, Inc began the task of preparing for Y2K. Our plan began by retiring all old computers that were not compliant. We have replaced them all. Both our hardware and software are all Y2K compliant. These systems include our administration and accounting offices.

At this point we made inquiries to all the custodians with which we deal and they responded with written documents disclosing their readiness. The majority of them stated they were compliant or had plans to be so by mid-1999. Central Plains Advisors, Inc intends to monitor those venders and stay abreast of their goal to be Year 2000 compliant.

The security and exchange commission (SEC) has required each Registered Investment Advisor to submit a Y2K ADV. They required this in February of 1999 and an update in June of 1999. This document informs them of our readiness for the year 2000.

We at Central Plains Advisors, Inc have done all we can to prepare for the Year 2000. Although we do not anticipate any problems we have all client records on file as a hard copy and, if needed, will be able to accomplish business the old way, with a pencil, paper and calculator.

Thank you

Central Plains Advisors, Inc

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