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Economic Commentary

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If Nothing Else, Please Do This

If you do not take the time to read Yale economics Professor Robert Shiller's book Irrational Exuberance you're taking a chance on your own financial risk. The two greatest myths perpetrated on the investing public during the 20th century has been the strong advocacy of and belief in:

1. Keynesian Economics (central government planning)
2. Efficient Markets (the market is always correct)

Shiller's book attacks the latter myth. How any casual observer of human society can believe that mathematical formulas can decide such complicated and diverse actions on the part of homosapiens is ridiculous on its face. Yet both of the above myths have been firmly entrenched in the investor psyche for at least the last 70 years. Keynesian economics, although still dominating academia, appears to be declining in influence elsewhere. This is quite a hopeful trend. Efficient markets (much like Keynesian economics) continue to rule the day but are now under very serious question. If the financial markets move in the direction we believe probable over the next several years, both are likely to be discarded.

Economy

Only now are we beginning to hear from establishment economists that the U.S. economy is facing the real possibility of recession. There are, as you know, at least two economic policy groups out there, the media and its academia driven celebrity clique and the laity. The laity, being those of us not anointed by the bi-coastal opinion makers of America, have had and continue to hold the view that a recession is a near certainty. We believe the celebrity group is following the wrong economic model; what they say is affecting economic and market decisions in the short run. However, the long term will be a horse of a different color. Shortly we may see just what color that horse may be. Our guess is it will be red, really red.

In the mean time it is almost impossible to find any bullish economic data. The unemployment rate declined from 4.6% to 4.5% in May, which was seen as a possible positive turning point for economic activity. The reason it was down was because hundreds of thousands of laid off workers quit looking for a job. We have had other hopeful signs. The stock market had a good bounce off the March lows and the housing

market has remained at least firm. The most talked of “good” sign is the consumer who continues to spend more money than he makes. That’s it for the good news. Now for the bad. Inventories continue to be too high and remain under liquidation. Equipment and software spending has declined now for two consecutive quarters along with exports. Exports obviously makes one think of imports. During the first quarter of this year GDP would have been near zero if it had not been for the largest one-quarter percentage drop in net exports ever recorded (exports-imports), which added to the GDP number. In other words, the sharp decline in the purchase of imports by the American consumer is shown as strength in the U.S. economy. You tell me how that works. Let me summarize the good.

1. Unemployment percentage is down but this is not really good because the discouraged workers are excluded from that computation.
2. The housing market is steady but permits have been down for two months in a row. Foreclosures are increasing rapidly. We believe the housing market will go the way of the NASDAQ. It’s a bubble whose pricking time may be close at hand. The force feeding of this market by the GSE’s (government sponsored enterprises) is almost criminal and a price will be paid. By whom? We taxpayers. When? If only we knew.
3. The stock market has rebounded from its March lows. This along with higher long-term interest rates and higher gold prices seem to be telling us a recovery is underway. This we believe is false. We will discuss later.
4. The consumer is still spending, but he has to borrow to do so and the last time we checked, banks like to be repaid.

Now the bad news which involves most everything else including the points mentioned above. The most important bad news is DEBT. We cannot understand why more attention is not given to this concern. Surely it must be the firm and universal belief that the Fed solves all problems. With debt at current levels and growing in absolute terms, as well as in comparison to income and equity day by day, both on the part of business and the consumer, this ever-increasing burden spells serious economic trouble ahead. From time to time one hears that someone somewhere pays heed to this concern. Friday, June 8th, Ben Verwaayen, Vice Chairman of equipment maker Lucent Technologies, mentioned that the telecoms might suffer for another 12 to 18 months. He says, “Only when the debt mountain has been cut will telecom companies start to invest again and prospects for the sector improve”. 18 months would take us into 2003. Never has so much been owed by so many to so few. So few? Yes, because of the consolidation that continues to take place in the financial lending area. One might ask, who is left that is small enough to let them fail? If there are none, guess who gets to pick up that tab.

The world economy, with the possible exception of China and India, is in recession or soon will be. Even in those two countries the economic base is low and percentage gains are not that much money. Also one wonders the accuracy of their figures. The Keynesian economists accepted the Soviet Union’s reported numbers for years, which we know now were false, and openly suggested that central economic planning worked as well as or even better than capitalism. Paul Samuelson, the author of more college economic textbooks than anyone in history, repeatedly praised Soviet economic prowess. He declared that “one of the most profound dilemmas of human society was whether

Soviet political repression was worth the economic gains”. John Gailbraith, a recent Nobel laureate, praised their “great material progress” and attributed much of that gain to the fact that “in contrast with western industrial economies, they make full use of their manpower”. Honestly, that sounds like a remark a less than stellar first year student in economics 101 might make.

Financial Markets

In our opinion the failure of establishment economists to “get it right” is only equaled by the Wall Street analysts recent view of the financial markets. Since the Federal Reserve rate reductions began in January, three very distinct markets have acted in complete disregard of the economic fundamentals. First, we had long-term interest rates (particularly governments) move upward after declining throughout 2000. Secondly, we had the stock market hit a low in March which was followed by a rather sharp rally. Third, lately gold has improved some 10% off its low around \$250.00. These three markets are telling us that a strong economic recovery is destined to commence before year-end and with it another inflationary increase in the U.S. aggregate price level. What is the basis for this view? It can only be the previous mentioned cult-like belief that the Federal Reserve will come to the rescue of the economy and, if necessary, inflate away all the debt that is now in the hands of those whose business it is to lend. But wait a minute, isn't inflation the death knell of stocks as well as bonds? Yes it is. Then why are investors willing to pay anywhere from 30 to 100 times earnings for stocks? The answer to this seems to be as follows. There are two differing Wall Street views of the future. One group is selling long bonds as well as stocks expecting inflation to again become rampant and has employed a bar bell approach – Treasury bills and gold. The other is selling all Treasury issues and buying stocks believing a V shaped recovery is under way and corporate profits will soon move sharply higher.

The clear sign in our rebuttal to both these views is the strong showing of the U.S. dollar. Everybody wants it almost regardless of any other consideration. Lower short-term rates and slower economic growth have not thwarted its luster. And why not? We are with all our faults and problems the strongest and most free country in the world. We think it's possible the rest of the world would pay in order to own our currency. A strong dollar is our greatest asset. It keeps inflation at bay and requires us to innovate to be competitive. However, in the short run it can hurt economically.

We believe, and this is certainly not a Wall Street view, that **DEFLATION IS THE PROBLEM**. The proper investment strategy is to own high quality government bonds, notes and bills, in that order, plus high quality value stocks, and then only those that are not too pricey. Now is not the time to speculate on anything in between. We simply believe that we are facing potentially tough times. Too much debt, too long on the dance floor and too little intellectual thought is going into many investment plans for the future. Emotion and feelings have replaced sound judgement. Even our political future seems somewhat in doubt. We are a country divided. Just think of it, on Monday June 11, 2001, a heart of America jury's verdict of six years ago sent a self confessed man to his death for planning and executing the murder of 168 innocent people. In the same week a New York City jury gave an equally evil self confessed murderer of 213 persons a life

imprisonment sentence. Ten of the twelve jurors said they didn't want to make a martyr of him in the Arab world. Are there no absolutes anymore? Is everything relative?

Stocks

P/E multiples are too high for most stocks as we believe corporate profits will remain under pressure, possibly well into next year. When the upturn comes, the recovery in earnings will be less than currently expected. Value is king.

Bonds

High quality non-callable long dated bonds are a screaming buy. They have been since the beginning of 1995. In light of what we see ahead, they remain every bit as attractive today as they did in '95.

A Final Thought

Frankly, we admit that we did not really believe that both the U.S. consumer and corporate America would go on a borrowing binge, such as we have seen over the last five years. This huge debt expansion was accommodated, of course, by the Federal Reserve and government sponsored enterprises. For what reason we are not certain. Maybe only to keep the music playing. Could it go on a few more years? Yes it could, but the odds each day become less and less. More debt equals (especially without savings) more trouble for the future. But think of it, only by saving and therefore not consuming, can one repay debt. What does that mean for the economy? In the short run--recession, in the long run--non-inflationary economic growth and profits. This we expect to happen, our fear is that the long run above may be longer in coming than anyone now anticipates.

Don Peters

You may have already noticed some new voices at Central Plains Advisors, Inc.

Branimir Gajic is a graduate of Wichita State University, with a BA degree in Finance and emphasis in Bank Management. His role at CPAI includes research and analysis of different financial products in constantly evolving financial markets and their implementation with the Central Plains Advisors corporate philosophy and guidelines.

Angie Heitmann will graduate from Wichita State University, with a BA in Business Marketing and minor in Business Management in December 2001. Her role at CPAI is marketing and database entry of current clients and future prospects. At large she is in charge of updating our Representatives with current literature and materials for their clients.

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