

# Central Plains Advisors, Inc.

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## Economic Commentary

March 31, 1999

### Economy

The Austrian school of economics has won the battle with the Keynesians--with this there is no doubt. The world to some extent and the U.S. in particular are benefiting from the following three "big picture" trends.

1. The Spread of Capitalism
2. The Technology Revolution
3. Government Downsizing

We say the Austrians have won since two of their economic principles are now working as they said they would. Creative destruction is taking place as old industries are giving way to new which is greatly enhancing productivity. The other is Say's (an economist) law which has always maintained that supply creates its own demand. You may remember before Reagan we followed the Keynesian model which postulates that demand creates supply. Maybe it does to a minor extent, but it also brings with it government intervention, higher costs, less efficiency and inflation. Ronald Reagan in 1980, and the election of 1994 has given this country the finest economic policy in seventy years. Paul Volker, Alan Greenspan and Bob Rubin have been our leaders. We owe them much.

While things at home have continued to produce good economic numbers, the rest of the world is not fairing as well. The following are some numbers that are truly eye popping. Fourth quarter real growth rates for Central and South American countries were as follows: Mexico -2.1%, Brazil -6.4%, Chile -7.3% and Argentina -8.6%. Eastern Europe is in recession. Western Europe, including the U.K., is getting weaker. All Asian countries remain in recession with the exception of South Korea. Japan remains hitched to a monetary policy that pegs interest rates rather than supply. Until that changes, Asia will remain weak.

Domestically, real growth in the first quarter will probably be around 3 ½ %, still strong but much less than the 4<sup>th</sup> quarter of 1998. Of more concern to us is the direction of corporate profits. Operating earnings are relatively flat but reported earnings continue to decline. **Such trends will in time lower capital spending which is the most cyclical sector of the economy.**

Our expectations are that the economy will continue to slow as we move forward during the year. Monetary policy continues to accommodate spending which is keeping outright deflation away from our doorstep. This has insulated our economy to date as well as providing the fuel for moving our larger brand name company stocks higher (including the highly speculative internet companies.)

## Economic Impact of Capital Gains

### Wealth Effect    Bubble Accounting    Spending Capital Gains

#### Cash Transactions During The Year

	<u>Investor A</u>	<u>Investor B</u>	<u>Government</u>	<u>Total</u>
Beginning Cash	\$1,000	\$1,000	\$1,000	\$3,000
A sells to B	+ 500	- 500	0	0
B sells to A	-1,000	+1,000	0	0
A sells to B	+1,500	-1,500	0	0
Taxes 20%	<u>- 200</u>	<u>- 100</u>	<u>+300</u>	<u>0</u>
Ending Cash	<b><u>\$1,800</u></b>	<b><u>\$ -100</u></b>	<b><u>\$1,300</u></b>	<b><u>\$3,000</u></b>

#### Beginning and Ending Balance Sheets

##### First of the Period

	<u>Investor A</u>	<u>Investor B</u>	<u>Government</u>	<u>Total</u>
Cash	\$1,000	\$1,000	\$1,000	\$3,000
Common Stocks	<u>500</u>	<u>0</u>	<u>0</u>	<u>500</u>
Total	<b><u>\$1,500</u></b>	<b><u>\$1,000</u></b>	<b><u>\$1,000</u></b>	<b><u>\$3,500</u></b>

##### End of the Period

Cash	\$1,800	\$ (100)	\$1,300	\$3,000
Common Stocks	<u>0</u>	<u>1,500</u>	<u>0</u>	<u>1,500</u>
Total	<b><u>\$1,800</u></b>	<b><u>\$1,400</u></b>	<b><u>\$1,300</u></b>	<b><u>\$4,500</u></b>

### Summary of Results

<b>Market value increased in the private sector</b>	<b>\$1,000</b>
<b>Cash decreased in the private sector</b>	<b>- 300</b>
<b>Cash increased in the public sector</b>	<b><u>+300</u></b>
<b>Net change overall</b>	<b>\$1,000</b>
<b>Stock Market has increased in value by</b>	<b>200%</b>

The above information is the accounting for the “wealth effect” which has been fueling consumer spending over the last several years. There is nothing sinister about this except it can disappear very quickly if market values decline and/or just quit rising. Note the summary of results. For the economy as a whole, cash is drained from the private sector by the amount of the capital gains tax. Therefore the net purchasing of securities and spending on other items must come from existing savings or current borrowings. It is true that from a balance sheet standpoint the private sector is in a better position, current values are up \$1,000 and cash is down \$300, a net increase of \$700 in wealth. The catch is that the \$700 increase is not in the bank and can disappear overnight. If that occurs then liquidity will be a problem and a virtuous cycle becomes a vicious cycle. Spending that is financed by current income does not carry this possible risk.

Let there be no mistake, we are not putting a damper on this aspect of economic growth. A rising market that creates confidence, which in turn increases spending, is what the capitalistic system is all about. As Sammy Sosa says “is this a great country or what?” If, however, Barton Biggs of Morgan Stanley is correct (and he is one of the great minds of the financial community) stating that “crazy people are buying crazy stocks and making lots of money”, a yellow flag needs to be hoisted. He is the one who said 10 years ago, when the Japanese Nikkei was on a rampage to 40,000 (now 16,000) that the fools were all dancing but the bigger fools were watching. Is that where we are now? The top will probably occur when those of us who are concerned about valuations throw in the sponge and really start to dance, rather than just cutting in when a very attractive partner is spotted.

### Stock Market

The very strong stock market, which celebrated its 4th birthday last November, has moved moderately upward during the quarter just ended. The difficulty, for we who manage mutual funds, is that year over year (April to April) the average stock is down 22% and 75% of stocks are down 15% or more. The advance decline lines (NYSE + AMEX + NASDAQ) actually topped out in October of 1997 and recently made a new low. The technical picture has become weaker and weaker as the market has moved upward. Fewer and fewer stocks are pushing up the averages. It’s been like the 10 little Indians--someday there maybe none. Think of this, since the low in the Dow in October of last year this index has advanced 29%. Six stocks have advanced 72% and the other twenty-four have been roughly flat. So far this year one half of the gain in the S&P 500 has come from only two stocks. During the year 1998 43% of the S&P 500 stocks declined. As this is being written, the average stock on the NYSE is down 30%.

Twenty-five years ago the “nifty fifty” were the beneficiaries of the greater fool theory-- today it may be the index funds which are the outgrowth of modern portfolio and asset allocation theories adapted as gospel by most several decades ago. These funds are being force fed as 25% of mutual fund equity money flows their way.

As we ring our hands about the extremely high valuations, given the stocks that are propelling the indexes as well as the lottery taking place in the internet stocks by the massively increasing number of day traders, we shall from time to time attempt to pick up value where ever it may be found.

### **Bond Market**

The deflationary trend remains well in place despite the upward movement in oil over the last several months. Yes, the price of gasoline will cause the Producer Price Index & Consumer Price Index to move upward. On the other hand this increase will eventually cut spending on other items which will balance this out in later reporting months. That, of course, makes no difference to highly leveraged government traders who must worry day to day what the other fellow is going to do with his position. With inflation for this year destined to be close to 1%, long term government rates should be 3 ½ %, rather than 5 ½ %. That is our future and we urge all to remain hitched to this ongoing, but always erratic yield wagon.

### **Gold Market**

Gold remains the best, but not the only indicator of inflation. It recently declined below \$280.00, a new low since 1984. This may be the precursor to worse economic news in the future. As long as gold stays below \$300.00 we see no reason to become involved in this asset class on a long-term basis. However, short term has promise.

Don S. Peters

### ***INTRODUCING: BILLIE JASO***

Beginning the first of December 1998 you may have heard a different voice on the phones at Central Plains Advisors, Inc. Billie Jaso has come to work for us and is in charge of Customer Services. If you have questions please direct them to Billie and she will get you the answer or set you up with someone who can.

We are rapidly growing at Central Plains Advisors, Inc. and are staffing accordingly to keep up with the inflow of new business. You may hear more new voices in the future.

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