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Economic Commentary

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The Magnificent Mile

There was much fanfare in the media last February as the economy reached and has now surpassed its previous longest expansion in history. The prior record was in the 1960's (106 months) and the present is now 108 months through March just ended. It has been a Mark Twain expansion in that reports of its death have been greatly exaggerated. We reported it dead in 1995 when we had a quarter of less than 1% real growth at an annual rate. In hindsight, the Fed engineered a slow down which lasted only 6 months. Since that time we have had four more years of good growth. Growth which just seems to be etched in stone. *In our opinion this expansion actually began during the fourth quarter of 1982, with the only blemish on the record being the year 1991, which recorded a decline in the GDP of 0.2%. The primary reason for the decline was the spike in oil prices caused by the onset of Desert Storm. Interestingly enough the last three recessions all have had oil cartel action and/or war which created large increases in the price of crude. We wonder – will it happen again this time?*

There are, however, several very disturbing factors which have been ignored by most economists and seemingly all market participants. We have mentioned these in prior newsletters but thought it important that we call your attention to these factors once again.

1. A change in government accounting was (there were several, but this seemed the most important) made commencing in late 1995. Notice the timing. For you conspiracy nuts, keep in mind an election was just around the corner – a recession appeared imminent. This change was made in the manner in which adjustments in the economic data were made for the increase in computer power. The following is a quote from Dr. Kurt Richebacher, a leading Austrian economist. **“This change is at the heart of the U.S. new-paradigm economy. It explains the whole improvement in the U.S. economic performance ever since... including the high real GDP growth and the rise in productivity growth. Consider the following: During the first half of 1999, computer equipment, measured in current dollars, rose \$7.6 billion to \$105.8 billion, accounting for 2.3% of nominal GDP growth. This is peanuts. But the change in computer measurement transformed these peanuts into a super-investment boom of \$87.6 billion, providing 78% of real GDP growth in this half-year. Volume index for computers has skyrocketed to 1,150 while the price index plunged to 20. To put it simply, the exploding computer power, rendered by the 1.2% of the economy devoted to producing computers, has accounted entirely for**

the U.S. economic “miracle” since 1996. Does this make sense? What if a car firm doubles the horsepower of a car and sells it-owing to big productivity gains-at a sharply lower price? Does this increase in horsepower and the fall in price add to economic activity and GDP growth? Everybody would regard this as ludicrous. But that is what is being done with computers. Gross domestic product is supposed to measure economic activity. We think this implies rather more than an increase in horsepower or computer power. To be economically relevant, the increase in power essentially requires a related income flow. But except for the \$7.6 billion actual increase in computer spending, those \$87.2 billion that the statisticians added to the computer component of the U.S. real GDP growth in the first half of 1999 are pure statistical fiction. It suggests “real” growth that has in no way taken place. It’s hard to believe that so many economic and financial experts would let themselves be fooled by such plainly absurd statistics. Some are ignorant of the actual facts. The rest are fooled because of their overwhelming prejudice and wishful thinking.” Can this be right? We have seen other reports on the same subject suggesting that without this adjustment the GDP from (1996 through 1999) would indicate an economy not on fire, but very ordinary in its growth rate.

2. Business profits are another most interesting item which may have some perception, as well as reporting problems. Lower interest rates and lower tax rates account for a large part of the increase from 1992 through 1996. These are not new paradigms created. Since 1997 profits are relatively unchanged. This applies to **total profits** including many companies, as well as the S&P 500 which has had strong profit growth. Much of this growth (S&P 500) has come from using stock options rather than salaries, restructuring magic and other accounting maneuvers. On a per share basis, common stock buy backs have been a major help in reported profits.
3. The build up of debt in the private sector (while the Federal government goes into surplus) has serious long-term implications. In the 1920’s, which many people compare to the 1990’s, it took \$2.00 of debt to obtain \$1.00 of GDP growth. Now it’s running over \$4.00 to \$1.00.

Having said all that, the economy continues to move ahead. The slowdown, which took place through the 1st two quarters of 1999, was quickly reversed during the 2nd half of the year. Much of this may have been Y2K related. It does appear that a new slowdown may once again be in the works. The housing industry is slowing and durable goods orders have now declined for 3 months in a row. These are very cyclical portions of the economy and normally are early indications of a slowdown and/or recession. Being somewhat “gun shy” over previous opinions of a coming recession should render us silent on the matter. However, it doesn’t, because of the Fed’s action which we consider to be a coffin closing move. We believe a recession must and will come if the Fed continues its present course.

Keynesian's Last Stand

We find it difficult to understand the thinking of the Fed. First of all, the Fed, in effect, has said too much growth is bad. What is wrong with breaking the four-minute mile? Is being better actually worse? Since 1875 inflation and high growth has occurred simultaneously 50% of the time. Only 50%! It would seem to us that if the correlation is not positive or negative then one should look for other causal factors concerning inflation. Secondly, the Fed said wage costs were certain to cause “cost-push” inflation. This is a Keynesian notion and is flawed. Wages do not lead inflation, they follow. The next problem was productivity. First Mr. Greenspan said it couldn't last forever. However, rather than slowing it has increased. Now he is saying that high productivity is bad. Why? Because it leads to higher profit prospects, therefore higher stock prices, which in turn creates excess demand before supply has a chance to be created. This is yet another version of the wealth effect. One or the other of the above reasons have been given for the five interest rate increases over the last 15 months. What were the inflation numbers for last month? On a core basis +0.2% CPI and +0.3% PPI. If you take cigarettes out of the PPI number, the increase was zip, zero, nada!!! Ten years ago approximately 50% of the people smoked, today only 20%. The more you tax (and raise prices) the less you get.

The Fed is fighting the 1970's war of inflationary fiscal and monetary policy. This is a new time and they should be worrying about deflation, which very well may be in our future.

Stock Market

The stock market, which appeared headed to correcting overvaluation that has occurred over the last 3 years, turned on a dime and has taken the S&P 500 to a new high. It looks like a long-term slugfest between the Fed and stock market participants. We find it difficult to bet against the Fed. On the other hand, the forces of the new paradigm seem to have the firepower to keep the ball rolling. We are participating in this market as we have in the past, but not sleeping well at night, and keeping our finger on the trigger – please don't tell our illustrious president. If you will recall we mentioned the influence of lower interest rates on corporate profits during this expansion. Now the opposite is occurring. The business sector, as well as the consumer, is “neck deep” in debt. The Fed will, we believe, win this game of chicken – just when, we do not know. On the other hand, maybe they will throw away their Keynesian defunct relationships and let the economy grow. Is it possible this is what the market is telling us? The Fed used every possible reason for raising interest rates to kill the stock market but with no avail. Maybe the Fed will change stripes and join the supply side (Austrians Economists) who started this expansion during 1983 in the first place.

Bond Market

For the eighth time since WWII we have an inverted Treasury yield curve. During four of those times, we later experienced a recession. On this basis there appears to be a 50/50 chance. We believe, however, due to the Fed continuing to raise interest rates in the face of this inversion, the chances are somewhat greater. Please keep in mind a recession is not needed to have lower rates. Whenever you get the feeling that maybe inflation is just around the corner, remember two things, the world wide capacity for producing automobiles is 36 million and at best, we sell about 17 million a year. And also when a consultant asks you to pay \$300 an hour for his services you can find a consultant on the internet just as competent in India for \$10 or less.

Interest rates on the short end are headed higher and on the long end (Treasuries mainly) are going lower. The chances of a credit crunch are very real before this is over. Keep your eyes peeled for a major bankruptcy as there are close to \$100 Trillion of derivatives slopping around this global economy. A financial shock of some magnitude is certain to create a market with no bids.

New Director of Marketing

Central Plains Advisors, Inc has appointed Sam R. Peters to be the firm's director of marketing as of February 1, 2000. A native of Kansas, Sam and his three children, Kelly, Evan and Molly, returned to Wichita after having lived in Prescott, AZ for the past eight years. Sam has extensive background in market research, market development and sales. His most recent position was as director of business affairs for Tom Whittaker's Granville Associates, Inc. and Windhorse Legacy organizations. Whittaker achieved a world's first when he became the first disabled person to climb Mt. Everest in May 1998. Sam was responsible for developing the positioning and marketing plans behind Whittaker's corporate speaking, documentary film, non-profit foundation and event sponsorship endeavors. We are most pleased to have him affiliated with our firm.

Don S. Peters

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