

Interim Market Update



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October 2005

Ben is Our Friend

October 28th, 2005

The US Treasury Market sold off sharply with the news that President Bush had nominated Ben Bernanke to be successor to Alan Greenspan. Why? Because the perception is that he is a dove on inflation. We all know inflation is the death nelly to interest rates as the market requires higher nominal rates in order to compensate for the decline in purchasing power. This perception comes from his oft-repeated statement that if necessary the Federal Reserve will dump money out of airplanes in order to halt deflation. Also, he has suggested that the Fed should target inflation, in other words help foster inflation in case deflation was on the horizon. All of this came about after a Fed study examining why Japan became entangled in a 15 year recession and outright deflation that resulted in 0% real interest rates. The study concluded that Japan did not act quickly enough to prevent, or even recognize at all, the huge real estate and stock market bubble that created the debt that led to deflation. We believe this study but, and this a big but, the study itself was at least 5 years late. Somewhere around 1995 would have been the time to restrain the creating of these bubbles by the Federal Reserve through appropriate monetary policy.

Here is our take on Mr. Bernanke's appointment and the outlook for the economy and interest rates. Again we repeat that we are talking only about interest rates on government securities. Other lesser quality interest rates seem certain to advance sharply due to their inherent risk. We believe he understands that debt and deflation are the major risks to this economy. We are not certain he understands that the deflation horse is out of the barn, but we believe he will be quick to aggressively lower rates at the first sign of consumer weakness that will lead to a recession. We expect this weakness to show up not long after his term of office begins early next year.

The simple facts, and the reason why we have over the last 14 years been able to return superior relative returns, are that inflation is not the problem. Deflation is what lies ahead. Wall Street and most money managers remain ensconced in the 1970's when debt was low and the increase thereof was available to keep everybody buying ahead. Debt today is unbelievably high and any little event could bring the consumer to his knees. Maybe high oil prices will be the event. Maybe the crash of the housing market will do it or possibly one of the highly leveraged hedge funds will go down. The lesson that needs to be learned is that once again Wall Street's misinterpretation of the facts will result in our ultimate gain. Stay resolute and do not let the inflation hawks lead you astray. Long-term treasury bonds are very attractive at these levels.

All the best,

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