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Economic Commentary

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Clueless in New York

Being an old CPA, it's interesting from time to time to attend some of the various Kansas Society of CPA meetings. Several years ago, at a meeting here in Wichita, a young CPA made a presentation to the group concerning investment management potential as a business for CPA's. As a part of his presentation he presented a glossy beautifully colored long-term chart of the S&P 500. He proudly pointed to the upward movement from 1925 through 1999. In doing so he asked the question, "Do you know why the market has done so well?" Being somewhat of a big mouth, I answered that the stock market had been force fed by the popularity of index funds. He very quickly said "No" and pointed to 1933 on the chart. "The reason is the SEC has made the market safe for investors." Hello! This in our mind illustrates perfectly the mentality which caused the greatest economic and stock market bubble in the world's history. It started in the 1950's with academe at the University of Chicago proclaiming the virtues of modern portfolio and efficient market theories. This in turn was picked up by the financial community and expanded ad infinitum. Everything became so simple. Why? Just look at this overpowering mathematical formula and the Nobel Prize winners who were authors. It must be right. Consultants to the huge pension funds R squared the world. Everything fit into a box. Ideas opposite the conventional wisdom were cause for excommunication. All of the sudden investing became an exact science. Economic projections were made by computers and the world was changed forever – HOG WASH!

John Nash, "A Beautiful Mind" who claimed he overthrew all economic thinking since Adam Smith, actually overthrew nothing. Ludwig Von Mises knew the Nash equilibrium well before Nash was born. What Nash did was change the thinking of the economic orthodoxy of his and our time – namely Keynesian economics. He did shed light where much was needed. Keynesian economics, to this day, sorely needs additional light shined its way.

Economy

The second quarter real GDP came as quite a surprise. The 1.1% real growth wasn't even half of what the consensus blue chip economists had predicted. Now everyone is lowering the projections for the future just as they have done repeatedly now for over the last 2 years. Someone has said economists are the best lagging indicator in the world. They just don't have a clue. My friends, we are in for a long difficult period of time during which debt needs to be worked off. We don't know how many times it needs to be said. DEBT IS DEFLATIONARY!! It must and will be liquidated in one manner or another. The malinvestment created over the last half of the 1990's will take many years to overcome. Again, it is not the end of the world. But inflationary growth is as dead as a doornail. We can't pump enough money into this economy to get it rolling again at anything like 3 ½ - 4% on a sustainable basis. It is true that refinancing of homes will provide some cash flow to consumers. This will help, but there is a huge bubble being built here just as there was in stocks, and when it breaks we hate to think of where things will go from there. As a public policy initiative what we need more than anything else are huge tax cuts – both corporate and personal and NOW!!! But what are the politicians worried about?

Either someone getting rich or a huge government deficit. Washington let us tell you – we need both! We need it now! Hoover and Roosevelt regulation and demand initiated policies were the problems in the 30's and here we are 70 years later and the same type of thinking still prevails. Do we ever learn? The political parties are fighting over who can do the worst – why not instead fight over what we can do the best?

Our thought of a W or L recession remains probable. Inventory rebuilding appears to be coming to an end. Housing appears to be close to the top. Zero interest car sales may be leading the U.S. auto manufactures close to bankruptcy. The airlines all need new owners. One could go on - retailers are in for serious problems. The increasing sales at Walmart and Target are not good news. Savings are beginning to increase, which is great for the long term, but bad for the short. But be ye of good faith – this too shall pass. Cleansing the ruckus years of 1995 – 2000 (a truly Sodom and Gomorra era of unbelievable irresponsibility) has led to this current condition. Less is more. Values are better than ill-gotten riches and sanity will return. Some of my father's ministerial tendencies pop out from time to time. Thanks dad!, I think.

In summary we believe the recession continues and will not return to above average growth for several years. Things could change and we shall watch closely. But for now, that's the situation.

Stock Market (S&P 500)

Even at these levels the market remains overvalued. The index is selling at 32 times trailing earnings and 26 times consensus 2002 earnings (which of course will be revised lower). To reach historical average multiples a 40% decline from here must occur. Maybe today's state of affairs calls for something better than a 15 P/E but we doubt if it's 26. We had a nice rally off of Julys lows but that is over now. In our opinion, over the next year selling into rally's will be much better than buying. "Fade Wall Street" has been our mantra since June of 2000 and remains so today, even after the decline that has taken place.

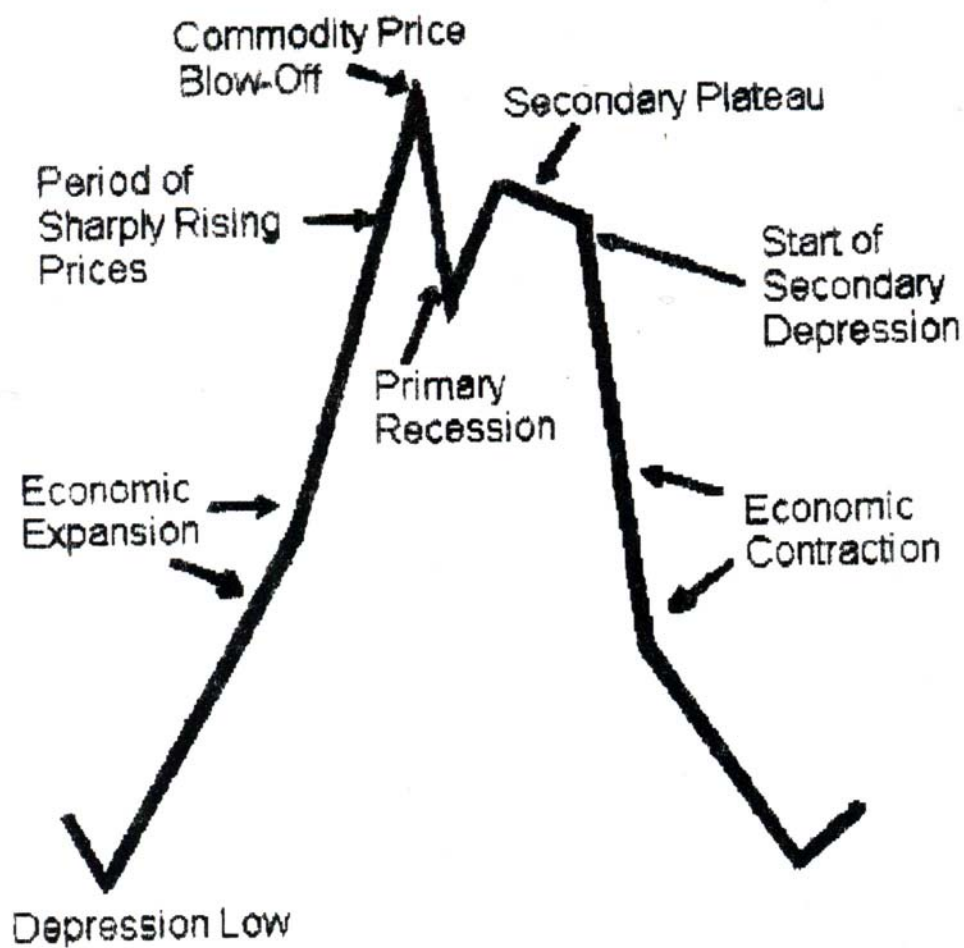
Bonds

The dichotomy continues as government yields are achieving new 40-year lows and lesser quality bonds are doing little if anything. Junk bonds, which are becoming the largest category of corporates through downgrades, should be avoided at all costs. Last November if you may recall Wall Street beat the drums for selling government bonds and buying stocks. It started, as we understand, from the pillar of integrity, Merrill Lynch and spread through the brokerage industry. We expect that this will be heard again several times before lows in yields are obtained. Over the last 83 years yields have been lower than today over 70% of the time. The advice emanating from the street is abysmal. It's only when they decide that rates will never again go up that we should probably make a move. Please don't let our rather harsh language lead you to believe that all of Wall Street deserves our wrath. There are many fine brokers out there, but its just like in the advisor area – only about 30% have a clue as to what's going on.

Deflation – A Final Thought

We have been preaching deflation since 1995 (seven long and lonesome years). Each day now we are seeing Wall Street economists joining in our small but mighty band. It remains, of course, a minority view and that's good for now. Why? It simply means that the best is yet to come. When it becomes the majority opinion we will sell them our bonds. Each day we hear interest rates can't go lower – my friends, we have heard that since 1986 when rates were 8 ½ %. Please keep in mind that a move from

5% to 4 ½ % brings us more gain than a move from 5 ½% to 5%. Put your blinders on, turn off CNBC and enjoy life for awhile. Deflation is the wild card and it's about to be played.



The above is not an upside down W or a couple of dueling praying mantises, but rather a visual description of the Kondratieff Wave named after a Russian economist. As you know Central Plains Advisors are great believers in cycles. Cycles occur because human nature never changes. If you have any interest, there are two great books we would recommend. They are *The Fourth Great Awakening* by economist Robert William Fogel of Chicago University and *The Fourth Turning* by William Strauss and Neil Howe. Strauss is a political observer and Howe a historian and economist. As you can tell by the titles they have a similar scenario but are approached from different angles.

The Kondratieff Wave proclaims that business move in identifiable cycles that vary in length by some 50 or 60 years. The cycle appears to be as follows:

1. 1970's commodities and inflation peak.
2. Primary recession – 1981- 82.
3. 1980's and 1990's were the secondary plateau. Culmination in a final blow off – 1996 – 2000.
4. 2001 was the beginning of an economic contraction which under the Kondratieff theory amounts to a depression.

No one knows for sure if this is the pattern that will follow. A very careful study of the price behavior of economic goods and financial markets appear to meet this pattern almost to a tee. Maybe a depression will follow, but we rather expect a long period of slow economic progress associated with deflation until we can get our economic imbalance of debt reduced. For the first time since the early 1950's, household net worth has declined in 2001 and probably will again in 2002. If the housing bubble is broken we are destined to add several more years to this decline.

Pierre Rinfret

With much pleasure we refer you to web site www.parida.com. This is probably the most straightforward economic and market web page on the internet. Pierre Rinfret is an excellent economist whom we have learned to know over time. For many years he was the chief economist for one of the finest consulting firms in the U.S. – Lionel D. Edie and Co. In later years he headed his own excellent firm. Pierre has retired to Cape Cod, but economics and financial markets are difficult to put aside. Pierre, as you will see has not done so, much to our mutually good fortune.

Pierre and Central Plains Advisors, Inc.'s has been and continues to be on the same page. He was able to get those he continues to advise to leave the stock market several years ago in a very timely manner. He also was kind enough to mention that we did likewise.

There is an interesting pattern that you might note from looking at his web site. Please click on, "They don't get it, do they"? Those who sold were not connected with Wall Street. Wall Street is sell side (they sell-you buy) regardless of circumstances. Those of us whose reputation and financial well-being is dependant upon good performance must do both – buy from Wall Street and sell to Wall Street. When we sell to them they must find another buyer or they also go down with the ship. That's assuming we are right. That's where you, the public, come into play. They would like to have you be the buyer of last resort

You might want to stay in contact with Pierre's web site. He as well as we may be out of step from time to time, but the good news is you will always have our honest, unbiased and well informed opinion. To have followed this opinion in the past would have proven quite beneficial.

Don Peters

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