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Economic Commentary

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Picking up the Pieces

An amazing thing happened in the later part of the 1920's and is now being repeated some 80 or so years later. Please note the following late 1920's quotes from the most highly regarded financial people in the United States. Irving Fisher, America's most famous economist said, "In a few months I expect to see the stock market much higher than today." This was said two weeks before Black Tuesday, October 29th, 1929. It might be of interest for you to note that Fisher lost \$140,000,000 in the stock market crash. He was one of the founders of econometrics – a much valued, but in our opinion, worthless bit of modeling. The Harvard Economic Society said during the same time frame "a severe depression is outside the range of probability." John Maynard Keynes, the father of macroeconomics and the darling of the Roosevelt administration remained bullish on the stock market and lost 1,000,000 English pounds. As a matter of record, there were only two economists who forecasted the crash of 1929 and the following depression. In February 1929 Friedrich von Hayek forecasted, "The boom will collapse within the next few months." In the summer of 1929, after he turned down a job with Kredit Anstait (one of the largest banks in Europe) Ludwig von Mises told his wife, Margit, that he wanted no part of the position. Why? "A great crash is looming and I do not want my name in any way connected with it." Why are we bringing this up? Isn't this just a piece of history, which has nothing to do with our modern complex economy? Well, Mark Twain said, "history does not repeat itself, but it sure rhymes." This is from where we are coming. The only economic model that forecasted the great depression is saying now that it is likely to happen again. My friends you disregard this warning at your own peril! None of us knows for sure, and one shouldn't bet the farm on its occurrence, however, not to allocate a portion of one's portfolio to those assets that will probably withstand and even prosper under such conditions would be foolish. Please note the following – you think there hasn't been a huge bust in the economy. Think again – more about this concept later.

True Gross Domestic Expenditure

1993-2001

Productive vs. Exhaustive

	1993 – 1999	2000	2001
<u>Expenditure</u>	<u>Average</u>	<u>Amount</u>	<u>Amount</u>
Productive Spending	\$780B	\$1,420B	\$(166B)
Exhaustive Spending	\$370B	\$570B	\$ 430B

Why Are Most All Forecasters Wrong?

The Keynesian economic model doesn't even come close to accounting for all the business activity that takes place in the economy. Because of this, many misconceptions, myths and outright misdirected policies have come into being. It is easy to see why so many "experts" do not understand where we are in this business cycle – they don't have the entire picture and most probably don't even know it. Isn't it ironic that the experience of the 1930's made heroes out of those who were wrong and delegated those

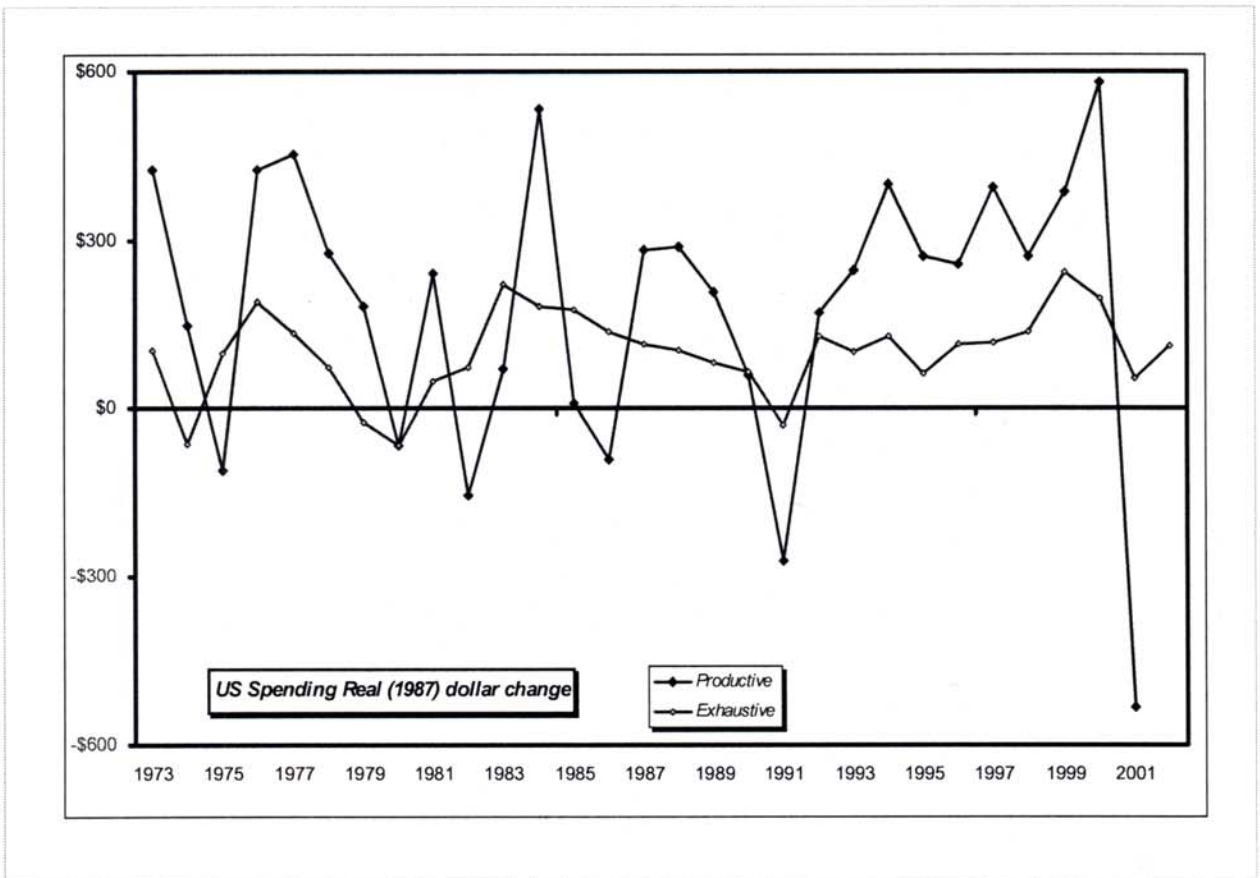
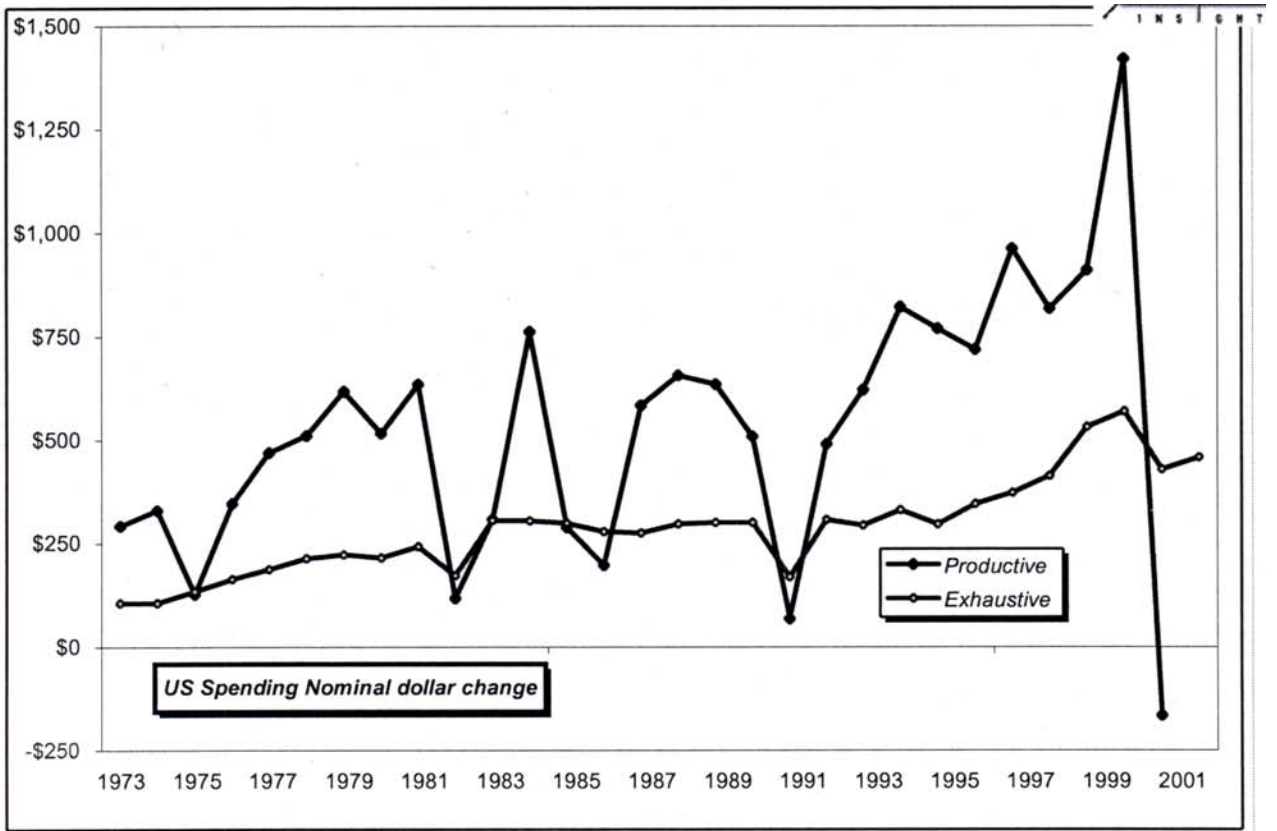
who were right to near obscurity. Keynesian economics rather than Austrian – what a miscarriage – do you think what was taking place during the 30’s (the German heritage of the Austrian economists) had anything to do with this obvious mistake? We don’t know, however, we do know Hayek (who had left Austria for England) was turned down as an economic advisor to the English government because of his nationality. Mises was a Jew and escaped Austria by the skin of his teeth. Whatever the reason, the U.S. came under the influence of Keynes, even though he could not have been more wrong about the economy and financial markets. In our opinion, it still remains today. The great economists are the Austrians with none greater than Hayek and Mises.

Lets Look At Some Numbers

The following information was put together by Sean Corrigan and Judi Matthews of Capital Insight, an Austrian economic believing investment management group in London. These numbers are illustrative of the Keynesian problems. From the Bureau of Economic Analysis one finds these numbers from two different classes of economic data – GDP and input-output. There is no secret to all of this. It’s available to anyone, but it seems only the Austrians pay attention. Since 2002 figures are not available, the year 2001 is used. The reason being that the input-output data comes from tax returns and are slow to be compiled.

Gross Domestic Output		\$17.3T
Add Imports		<u>1.4</u>
100% Business Revenues		\$18.7T
Less Profits	1.5T	
Depreciation	0.9	<u>2.4T</u>
Business Costs		\$16.3T
Add Capital ex spending		1.2T
Total Business Activity costs		<u>\$17.5T</u>
Personal Consumption Expenditures		\$7.0T
Business to Personal		2 ½ or 71% / 29%

How often have you heard how important consumer spending is compared to business? According to the GDP numbers business is the 4th largest sector and the consumer is 1st, but under this analysis business to business spending is 2 ½ times larger than consumer spending. This is the reason all (almost all) of the economists are saying happy days are here again even though business owners don’t see it. This is the reason no one is hiring – they, the business owners, have not seen an upturn of any significance even though the GDP numbers are looking better. The Austrians characterize these spending patterns as productive and exhaustive: business-to-business spending being productive and consumer spending exhaustive. Think of it in this manner, productive spending produces profits and wages. Exhaustive spending produces nothing that creates wealth. In some respects the wealthy invest, the poor consume. That’s the way the world works. At some point in time when consumer spending crowds out productive spending we are in a heap of trouble. In that regard, please look at the following charts:



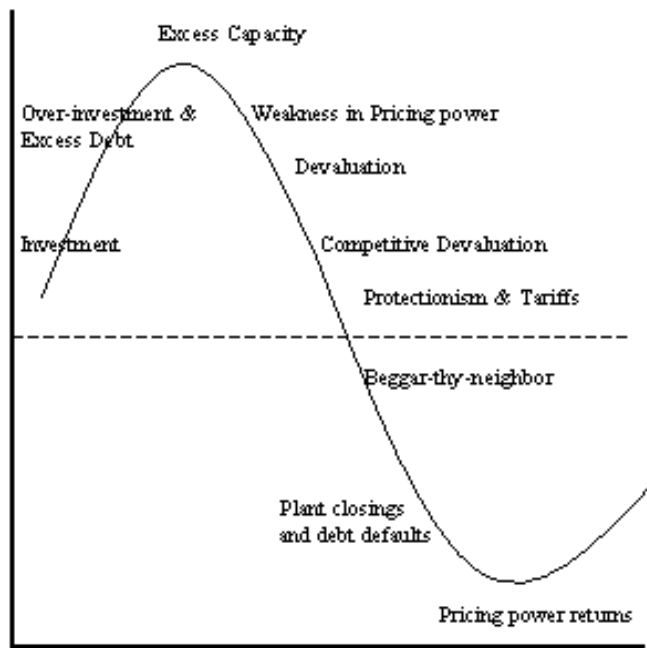
If the sector of the economy that creates the profits and wages that allow the consumer to have the where with all to buy contracts, where does that leave us? The answer is in a deflationary environment, which will take years to mend.

What To Do Now

We believe it is smart to sell when someone wants it and buy when nobody does. That to us characterizes the stock market and the Government bond market today. Keynesians worry about inflation when just the opposite is in store. They see demand being driven by tax cuts and borrowing. They see GDP is growing from 1.4% to 3.3% to maybe 5.0%. They believe the bull market is back in stocks, but you know what? The goose that laid the golden egg is flat on its back and exhaustive spending will soon be exhausted, that's what the input – output dollars are telling us. Don't try to confuse the Keynesians with all this – if they haven't learned by now there is no hope. It is our responsibility to take advantage of their confusion – someone with a clear head needs to be around to pick up the pieces – act now! We are literally eating our young, but we can rebuild it again – so please, act now!

Slip Sliding Along

The Cycle of Deflation



Our Favorite Chart!

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