

# Central Plains Advisors, Inc.

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## Economic Commentary

September 30, 1999

### Down But Not Out

As of this writing 55% of all stocks are down from 1/1/99. 61% of NYSE stock are off 20% or more from their highs, as are 83% of the NASDAQ stocks. To top it off the greatest investor of our time, Warren Buffet, is down 22% since the beginning of the year. Yet, it is absolutely and abundantly clear that if by chance the market averages make a new high the Fed will raise rates again. Regardless of what is said publicly about inflation, **it is not the problem.** The problem is the perception pounded into the public by Wall Street that stocks are a one way street to financial riches. Just think, at this time a handful of highly visible mostly high tech stocks hold the economic future of this country and (maybe the world) hostage to their price movement. Ultimately our heads will be handed to us if we insist on continuing to play the greater fool theory game. There is a brick wall out there and by a stroke of the pen the Fed can send us crashing into it.

Much as been said over the last five years suggesting that we have a new paradigm. Many say the world has changed and the old "rules" don't work anymore. We agree that things have changed but it's not something new. It's an old era returned, not a new one. As Yogi Berra would say, "its de ja vu all over again". We may well be back to the business cycles we had prior to the 30's, as opposed to the post WW II economic experience. It used to be that business contractions developed from over expansions not associated with higher interest rates due to inflation. We do have a recent example during this decade, notably Japan. To date they have experienced a near seven-year recession that was not preceded by inflation and appreciably higher interest rates. We believe that same scenario could happen here. We also believe the Fed privately is seeing the same thing and is hopeful they can let the air out of the indexes slowly in a non-disruptive fashion. The message we think under these circumstances is to be conservative and cautious in the face of seemingly unbelievable and endless prosperity as reported by the financial press. There is no doubt but what the information age high tech explosion has been an extremely positive influence. Standards of living have advanced handsomely. It has been a great economic expansion. The current problem is it takes \$5 in additional debt to increase output by \$1. At some point this debt and the interest there on will need be paid. To date, financing has not been a problem, however, it's interesting to note that as of 6/30/99 there have been more corporate bond defaults than in all of 1998. Could it be that the next "credit crunch" will come from stock price weakness rather than surging interest rates? We say yes but keep in mind most stocks are in decline right now. The median stock is down 4.1% as of 9/30/99. Corporate profits remain the key and they cannot grow at the rates expected when nominal GDP (gross domestic product) is growing at roughly 5%.

As you have obviously observed, the normal section devoted to the economy has been by and large a discussion of the stock market. The reason for this is simply the “wealth effect” which is driving consumer spending. Personal savings rates have historically been 5% post WW II. Since the 1<sup>st</sup> Quarter of 1996, the rate has gone from +3% to -2%, the first negative quarter occurring during 1998. Several things seem to drive excess spending thus causing the savings rate to go negative.

1. **High employment.** All recent entrants to the labor force have probably never saved a dime in their life.
2. **Ample credit availability.** We recently purchased a new car and had to fight in order to pay something down.
3. **Mortgage refinancing.** The Fed has recently brought this to a halt.
4. **The stock market wealth effect.** This is the new Fed target, and we believe the most important reason for the negative savings rate.

In the parlance of sports terminology the Twin Towers of our economic future are negative savings (excessive consumer spending) and the wealth effect (stock market). To accommodate the Twin Towers is a point guard, (the financial industry) which distributes the ball (money) to whomever is desirous. This picture must change, we just don't know when this will happen. The more these things continue in the same pattern, the worse the correction will be.

### **Stock Market**

The technical underpinnings continue to deteriorate, while at the same time the “love affair” with technology stocks continues unabated. There are few if any signs that the public has developed any fear whatsoever concerning the overvaluation of this market. That being the case, the recent 10% decline in the indexes is no where close to being any type of a bottom. It also seems probable that the market will not hit the skids for some time, unless a real surprise comes from out of the blue. This could happen if for example there is a sudden Chinese devaluation. Our sources indicate that China is suffering economically and probably can not keep from experiencing devaluation in order to be more competitive with their goods and services. This would be certain to create a new Asian crisis.

Please keep in mind the overvaluation we speak of is not associated with all stocks. Many smaller, lesser-known companies are selling at very reasonable-price-earning multiples. The problem is their capitalization is too small for the “big boys” to position therefore they are orphans in the market place. This being the case the major market players are concentrating on the same names driving their prices to never before seen levels. Is this a permanent condition? Some say yes--we say no.

## **Bond Market**

Interest rates have been drifting higher for almost a year. It has been like slow torture. The only reason for this is the mistaken fear that strong growth or even any growth will cause inflation. The latest CPI number recorded the lowest inflation in 33 years. The year over year increase in core inflation was 1.9%, the smallest such number since April of 1966. This was greeted with a rally, but soon disappeared as worries about next month's number became the topic of conversation.

All of this means that real interest rates (nominal less inflation) are extremely high. Per Se indication of a buying opportunity. The economic fundamentals concerning inflation remains bullish. Inflation is always the final determinate of interest rate levels, therefore we remain fully committed to the long area of the yield curve. The bond market's poor action is creating a stretching rubber band scenario. When the band is released the upward price action will be spectacular. The purely trend-following bond market participants, who haven't a clue when it comes to fundamentals, will then be our friends. We expect to cash in on their over-reaction on the upside with this happening at some point in the not too distant future. Keep the faith. As in the past, We will prevail!

## **Bond Market Clients**

We are not tax experts by any means, thus it is important that you use your own counsel in regard to the following suggestion. Also please keep in mind this memo applies only to **taxable accounts**.

For those of you who can use a 1999 capital gains loss, it is possible that you may do so by having us sell your position in the Benham 2025 and buy the Benham 2020. After more than 30 days have expired, we can reverse the trade.

### **The risk is as follows.**

If the market continues to decline during the 30 days it will improve our position. If the market rallies we will participate but to a lesser extent. There is no commission and no transaction fee. Longer term we want to be in the 2025.

Please keep in mind when evaluating your portfolio that losses in bonds are much different than losses in stocks. Stock prices can go to zero and stay there, however, high quality bonds (such as US treasuries which we use) do have a final value at maturity. For example the Benham 2025 will be worth \$100 in 2025\* regardless of its market value today. The same is also true of the Benham 2020\* except 5 years earlier. The only real certainties in life are death and taxes however a "bet" made on US Treasuries is about as close as you can get in the real world to a risk free asset.

\* One may determine the ultimate value of ones account by multiplying the number of shares owned by \$100. This will apply at any time if we have you invested in the Benham target funds. Use of other Treasury funds would require a more complicated computation, however the same rule applies.

## A Final Thought

We would like to draw your attention to a recent article in the AAI Journal of September, 1999 entitled "The Folly of Picking Advisors Based on Short Term Results". Mark Hulbert, editor of the Hulbert Financial Digest, authors the article. In summary his study reveals that one must always pick an advisor based on at least 5-year returns. Longer is even better. Short term results, daily, quarterly or even yearly are misleading and many lasting investment mistakes are made based on these less than meaningful numbers.

A copy of this empirical study is worth your time to read. You may get a copy by calling our Wichita office and requesting it.

The numbers in this article based upon Hulberts 20-year equity database are as follows.

<u>Period 1/1/91 – 6/30/99 Results Based Upon</u>	<u>Annualized Total Return</u>
1. Each year investing with the best performer of the preceding year	-36.6%
2. Each year investing with the worst performer of the preceding year	-83.6%
3. Each year investing with the best preceding 5-year performer	+18.2%
4. Each year investing with the best preceding 10-year performer	+21.6%

This difference is remarkable yet many investors continue to let short-term (anything less than 5 years) performance (good or bad) strongly influence their decisions.

## **Don Peters**

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