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Economic Commentary

September 30, 2000

Times, They are a Changing

As a friend of ours once said (while attempting to sleep with his bride of 30 years on an old fashioned narrow bed in a 2x4 bedroom in Durango, Colorado) “Hold on to the lamp mother, I’m turning over.” This we believe is the state of financial affairs as we head toward the finish of the last year of the old Millennium. The economy is slowing. The “irrational exuberance” of Greenspan fame first coined in a book by Robert Shiller of the same name is coming unraveled. It seems quite likely that the CNBC “new era” “new paradigm” is in the process of being dismantled fiberoptic by broadband. Just as proclaimed new era’s of the past (the most recent being the roaring 20’s) have come to an end, so will this one, either now (quite likely) or tomorrow (for sure). All of the “teeth gnashing” doesn’t necessarily mean the end of the world. Decent free market solutions will take care of the malinvestments which have popped up during these heady times. Human nature hasn’t changed; up-cycles make geniuses of us all. What we are saying is that nothing has changed, the world is circular not linear. We probably need to stop and smell the roses for awhile.

The American experience is too precious and too strong to become distraught. What we don’t need is another Hoover, Roosevelt, Keynes solution to whatever problems we may face. It was their policies that led to the “economic banana republic” lookalike we witnessed in the 1970’s.

Another vanishing aspect of this particular period which seem to be coming to a close, is the use of mathematics in the formulation of economic policies. Please note the following words of an Austrian economist whose criticism of Keynes is not only correct, but classic.

“In a November 9, 1998 Barron’s interview with Gene Epstein, Krugman dismisses Austrian economics as unscientific because it doesn’t employ mathematics. By applying mathematical methods, the mainstream economics that Krugman represents follows the footsteps of natural sciences. The main reason for the employment of mathematical and statistical methods in the natural sciences is to formulate the essential nature of objects. In other words, by means of a mathematical formula the response of objects to a particular stimuli in a given condition is captured.

The same approach is not valid in economics. For economics is supposed to deal with human beings and not objects. The main characteristic or nature of human beings is that they are rational animals. They are using their minds to sustain their lives and well beings. The usage of the mind is not set to follow some kind of

automatic procedure, but rather every individual employs his mind in accordance with his own circumstances. Consequently the human nature is not suitable to mathematical quantification. (Even Keynes had misgivings about using mathematics in economics.) In other words people have the freedom of choice to change their minds and pursue actions that are contrary to what was observed in the past. As a result of the unique nature of human beings, analyses in economics can only be qualitative.

A popular view argues that economics is concerned with numerical issues like the price of a good and its quantity. This in turn, it is held, makes economics friendly towards the introduction of measurement and mathematics. Measurement, however, implies the possibility of the assignment of numbers which can be meaningfully subjected to all of the operations of arithmetic. To accomplish this, it is necessary to define an objective fixed unit. Such an objective fixed unit doesn't exist in the realm of human valuations. There are no constant standards for measuring the minds, the values and the ideas of men.

The use of mathematics in economics poses another serious problem. The employment of mathematical functions implies that independent variables are causing the dependent variable. Thus by stating that consumption is dependent on disposable income the mathematical economist would say that a change in the disposable income will cause a change in consumption.

The magnitude of the change in consumption will be calculated from the equation that the mathematical economist has estimated. Causality, however, is set by the nature of human beings, i.e. that they possess a rational mind. This in turn means that an individual's consumption is not caused by disposable income but by his rational choices. In other words, every individual decides how much to consume and how much to save in accordance with his own goals, and circumstances. Every individual assesses the facts of reality, one of which is his disposable income.”

The above criticism of mathematics applies equally well to that used in the investment business. Efficient markets are about as nonsensical as anything we have ever seen. Yet it is blindly followed by most of the elite in our business. What, for example, is efficient about the manner in which the dot coms were once valued and many others still are? Does anyone ever quote the one man who everyone believes will save the economy and financial markets with his super intellect? Alan Greenspan recently said “What we found over the generations is that the underlying forces which engender economic change themselves are changing all the time, human nature being the sole apparent constant.” Again friends, the world is circular and not linear and no one has been able to carry pie to a final rounded number. You cannot compute the actual area of a circle, and you cannot use mathematical formulas to magically wand the economic future or determine investment results. Even those who have taught us through their economic and investment books that all their scientific dissertations work in the real world are beginning to change their spots. Note the following recent comment of Paul Samuelson, one of the authors of efficient markets. He is now saying (June 2000) that modern markets are micro-efficient but not macro so... he has come half way, and our best guess

is if he lives long enough (he is 82) he will go all the way. “Stocks got nowhere for a score of years after 1968 precisely because from 1942 until 1968 they moved unidirectional. That is not macro efficiency of speculative markets as economic history teaches us.” Believe it or not he says “economies cannot be an exact science.”

Economic Outlook

The NBER'S (National Bureau of Economic Research) leading indicators and the NPM'S (National Purchasing Managers) index continue to point toward weaker business ahead. We would guess that the third quarter GDP will come in somewhere around 2 ½ % real. That would be a dramatic reduction from the near 6% of the second quarter. The second quarter, however, did have outsized increases in inventories and capital expenditures which normally occur at business cycle tops. Could that be? Is the year 2000, 1990 all over again? For the first time since the 1995 slowdown we are beginning to hear the “R” word mentioned here and there in respectable circles. We certainly don't know if a recession is in the cards, but as mentioned in previous commentaries just a slowdown will cause serious earning problems for many. The consensus remains fixated on a “soft landing” which to us appears to be a hope more than anything else.

Debt conditions which began to worry us several years ago remains the wild card in the financial picture. It remains our opinion that the federal government is creating surpluses by overtaxing the private economy. We hear little about this in economic circles. This may very well be the deciding factor in soft vs. hard landing as we enter 2001. The one thing we don't expect is a sudden reemergence of the consumer as the driving force of the economy, as we have seen over the last several years.

Stock Market

The overvaluation that has dominated primarily the tech sector as well as a few others seems to be in the process of being corrected as this is being written. If you may recall in our 6/30/00 commentary we suggested the possibility that the long bull market might be cresting. The question has always been how long can such over valuation last? A very prestigious consulting firm with whom we were discussing our investment philosophy which, as you know, relies heavily upon a free market non Keynesian economic model would just not consider our position worthy of even a casual thought. Keynes, they said, maintained that an irrational market might stay irrational forever. We can only say that they, and many are prevalent in the high profile consulting world, obviously have not learned that human nature (behavioral science) has never changed in lo these many years. The ivory tower and main street have never been farther apart. This schism seems sure to close.

In previous commentaries and in various private and public venues we have expressed the opinion that stocks may well underperform bonds over the next several years. We continue to expect this to be the case. We would only caution that less than investment grade bonds may not do that well.

Bond Market

The action of the stock market is taking the pressure off the Federal Reserve. As long as this market makes little or no headway it would appear that their work is done for now. Short to intermediate term rates under these conditions should move lower as those with liquidity needs may move out a little on the curve with little fear of loss. The long bonds, on the other hand, may back up (already have) or remain flat awaiting clearer indication of economic conditions.

There is also another factor taking place which is working against the long bond. Those who have previously purchased these bonds as a hedge against stocks may be liquidating to cover equity margin calls.

We believe this reversing of the yield curve inversion is a rational move which will be followed by the entire yield curve move downward. High quality bonds of all maturities make sense. Long bonds for investment accounts are particularly attractive.

Economist in the Wind
(Sung to the music of Elton John's *Candle in the Wind*)
by Karen De Coster

Don Peters

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