

Troubled Times Ahead

August 7, 2006

It is becoming clearer as each day passes that the US economy is slowing down to a crawl. Everyone is focusing on the Fed's action this week, but in our opinion, the die has already been cast. The Fed should have stopped at somewhere less than 4 ½ %. A federal funds rate of 4 ½ % means the prime rate is at 7 ½%, which is too high for an economy with our level of debt to function in an efficient manner. At a 5 ¼% federal funds rate which we have now, we are looking at an 8 ¼% prime rate, and to make matters worse, there are not many prime customers around. If they move to 5 ½%, which we don't believe they will, matters will become even worse.

The news from the bubble housing market continues to deteriorate. The big question becomes what will be the next asset bubble the Fed can blow? Concurrent with the housing bubble over the last 3 or 4 years has been the commodity bubble. Will either of these bubbles enlarge when the Fed next lowers interest rates? We doubt it. We envision such a weak demand picture, coupled with the raging overcapacity being built in China that deflation will rear its ugly head in a most serious way. Asset deflation, in our opinion, will be the next worry that presents itself and it will probably be worldwide. After asset deflation comes a debt crash with all the attendant problems. Interest rates could go to 1% again and nobody will lend or borrow money.

All of this could be extended to a later day IF the Fed can find another asset to bubble. They seem to be very adept at doing just that, so there could be hope. We at Central Plains just cannot figure what that asset might be.

One interesting wrinkle in the mortgage market has taken place in the UK. They have come up with a quasi equity mortgage, which lets the lender obtain a portion of the expected appreciation thus allowing for a lower interest rate for the borrower. Does that sound like a "top of market" innovation? Maybe, but it might reinvigorate the housing market for a time.

The major problem facing this country is the lack of personal income coupled with unbelievable debt levels. It now takes approximate \$4.5 to create \$1 worth of GDP. The old standard was \$1.4 to \$1. Over the last 4 ½ years real disposable income rose 2.4% compared to 3.1% growth in consumer spending. We used to save some income, now we borrow to maintain our standard of living.

Please note the following two charts. Does this look like troubled times ahead?

