

# Interim Market Update



Central Plains Advisors, Inc. • 800 East 1st Street Ste 220 Wichita , KS 67202 • Economic Consulting & Investment Management

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## **REMEMBER THIS DAY: 01/31/2007**

Despite the fact that historical evidence says otherwise, one of the unquestioned dictums of economics is that strong growth causes inflation. That being the case, bond traders sell long bonds every time it appears as if the economy is growing stronger. This is always what has given us an edge over the rest of the bond managers in our business. Unfortunately, it doesn't happen every quarter or even every year; but over time it has worked like a charm.

Wednesday, January 31, 2006 the Bureau of Economic Analysis announced the fourth quarter real GDP. It came in at a very strong +3.5%, up from +2.0% during the third quarter. One headline read, "Growth Quickens, Propelled by Consumer Spending". Traders immediately sold the long 30-year government bond. The yield went from 4.96% to 5.00%. Then all of a sudden, just moments later, the market turned around and—as this is being written—the yield is 4.91%. Why? Let us tell you. The price index for personal consumption, which is 70% of the economy, was down 0.8%. Read it again—that's -0.8%. This is the first decline since 1961. Do you remember the 1960's? We had supply side tax cuts, low inflation, strong growth, and low interest rates. Durable goods prices were also down during the fourth quarter of 2006 2.8%, and nondurables down 8.0%. Going the other way, services were up 3.4%. We guess if you use services of any kind, such as lawyers or CPAs, get your hair cut, or have your clothes dry cleaned, you are finding prices in full retreat.

One of the things we have talked about here in the office is the need to once again look at nominal GDP and real GDP in a different way. During the highly inflationary days of the 1970's, one needed to subtract inflation from the nominal GDP to get real or actual growth. If deflation comes as we expect it to, one will need to add deflation to nominal GDP in order to get real GDP.

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Please note the following negative price indices:

<u>Item 4<sup>th</sup>Q 06</u>	<u>% Change from Previous Period</u>
Personal Consumption Expenditures .....	-0.8
Durable Goods .....	-2.8
Nondurable Goods .....	-8.0
Exports .....	-0.3
Services .....	-1.2
Imports .....	-8.5
Goods .....	-10.2
Federal Expenditure .....	-0.1
National Defense.....	-0.5

We have not seen such a broad decline in prices since we can't remember when. Maybe the most startling statistic was the actual reduction in imports—yes, *reduction*—not only in prices but also in total dollars. When was the last time this happened? Things are a-changing my friends; yes, things are changing for the good as they pertain to the value of long-term government bonds. The stock market also fell in love with the GDP number, and especially with the good inflation news. Most everything in the GDP looked very good; however, if one were in the stock market, a whiff of deflation might just be a worry if it were to precipitate a debt reduction cycle. Also, the fact that construction spending was down 0.4% and the Chicago Purchasing Managers Index fell below 50 for the first time since April of 2003 indicates that much of the good GDP number of the fourth quarter might be due to record warm weather in December.

Why remember this day? It just may be the first shot across the bow as inflation worries turn to those of deflation.



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