

Economic Commentary



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January, 2008

A Dismal Look at 2008

Introduction

Please pay particular attention to the following economic commentary. We certainly hope the picture we paint does not come to pass; however, most of the ingredients are in place to make it a reality. It's a very gloomy outlook, one that only occurs about every two or three generations. It happens when history is viewed as no longer being important and old time-tested truths are considered obsolete. After all, it's a new era in which science and technology have changed everything. Let there be no mistake: the accumulation of debt—primarily on the part of the consumer—is devastating. Husband your resources. Make sure of the quality of your investments. Pay little or no attention to Washington D.C., The Federal Reserve, CNBC, and for darn sure Wall Street and their 800,000 hucksters. It's best to bet on the turtle and fade the hare.

Puff the Magic Dragon

Please keep in mind much of the profits that we have seen from corporate America have been zero-sum trading gains. The fall of 2007 results for Goldman Sachs were a perfect example. Approximately a year, ago Goldman began shorting the various structured housing securities, while at the same time selling the same kind of new issues to the public. Then came August of 2007, when it finally became apparent that these securities were of little value; thus, the huge write downs by most of Wall Street, except for Goldman. Their short offset their other losses. Inorganic profits, of which trading profits are the most prevalent, can vanish in a minute; organic profits (economic profits) last forever. Much of the heralded profit gains of 2003 – 2006 were inorganic and have gone the way of Puff the Magic Dragon. Now it's back to

reality and the search for real economic profits.

By the way, can you imagine what the size of the government deficit is going to be? The magic federal tax revenue receipts on capital gains over the last few years will probably be gone for a long time. Maybe the only positive cash flow for Wall Street will be tax refunds as we go forward.

Where We Are Now

The banking industry and Wall Street have finally done it. All those rules, written and unwritten, by which the financial community has operated since the Great Depression of the 1930's and the world war of the 1940's have either been changed, overridden, or ignored. Make no mistake about it: we are in the beginnings of a giant debt meltdown that will probably last for many years and spread economic losses and misery in its

wake. To make things even worse, the Federal Reserve has been and is acting in the very same manner as they did during the 1920's and 1930's. What Alan Greenspan called spreading the risk has actually become spreading the losses. We believe it is important that everyone comes to understand just what is taking place in order to properly prepare for the future. Thus, a look back at history is in order.

Look backward and revisit our various quarterly economic commentaries and interim market updates. You will note that we have been consistent and insistent that the lack of income coupled with the taking on of excess debt was going to bring this economy to its knees. It would be our guess that only one in ten, if even that many, have bought into this scenario. When asset values continue to go upward and upward, it makes everybody a supposed expert and a true believer in their ability to make the right investment moves. Even if

one believes a serious recession is possible, they are confident they will know in advance and seek a safe haven in time. We have been on this horse since right before the stock market crash of 2000-2002. We were fooled, however, by the "shadow" Fed and the alphabet credit structures that created the housing and commodity bubbles. We were much too early, but from this vantage point at the end of 2007 and beginning of 2008, we say there is no way the bubbles can continue. Debts need to be paid. The banks don't trust each other. Their loaning standards will become more and more stringent as their capital structures bow under severe duress.

If the truth were known, the financial industry is broke. At least, if you and I owned it, it would be. It, of course, is another institution that is perceived as being too big to fail. The taxpayers of this country, plus the sophisticated big time investment managers, are the losers. The large financial institutions will be stuck with

enormous bad debts (securities) on their books, a la Japan of the 1990's to date. For our banking system, it's workout time for the next decade or so. Slow to no growth is probably in the foreseeable future. We do believe it's within the power of the Federal Reserve to prop up the commercial banking industry. What they cannot do is take care of the losses that are and will be occurring over the next several years.

Great Depression vs. Now

Let us enumerate what public policy was in the 1920's leading up to the Depression of the 1930's. During the Roaring 20's, the Federal Reserve battled a post-WWI recession through strong monetary growth during most of the 1920's. Becoming concerned about excess growth, they slammed on the brakes from 1926 to 1929, which resulted in the market crash of 1929. There was also a short 6-month period during 1927 when they again pumped up the money supply. Many historians say it was

this crash that caused the great depression. In actuality, it was the loose monetary policy of the 1920's, which set up the entire "flapper era" and the resulting depression. Consumer installment debt was initiated during this period. Buying on time became acceptable. Loose monetary policy, loose morals and ethics, and the sharp accumulation of debt characterized the 20's. Excess monetary growth was the cause, and the depression was the result. Does that sound like anything that has just taken place?

Post 1929, everything done fiscally was a major mistake. Taxes were increased, wage and price controls were used, tariffs were increased, and counterproductive make-work schemes were instigated. Are we hearing anything like this now? Yes we are! From a monetary standpoint, the Fed did its very best to increase the money supply, but it didn't work. Why? The banks would not lend to each other or anybody else. If the banking industry

won't get in the game, the Fed can do nothing. Is that starting to happen now? Short-term borrowing rates between banks are very high. We well remember banking colleagues of ours that went through the 30's talking about inter-bank loans being 6%, which they said was a sure sign of trouble. Longer-term governments went to an almost 0% yield, as one would expect in a deflationary climate. Generally speaking, a "normal" inclining yield curve is a sign of easy money, an inverted yield curve a sign of tight money; however, tight money can happen two ways: 1) Fed action, and 2) slow to no economic growth causing deflation. The later happened in the 1930's, and we expect that to happen again.

The question now becomes—what will the government fiscal policy be? Will it be much like the 1930's? Probably—after all, politicians will be politicians. We know what the Fed will do. They are now and will be flooding the banks with reserves by buying all the govern-

ment bonds the banks own—which, by the way, are not that many. They are now and will be loaning them money on their other assets to prop up their cash positions in order to take care of any bank runs there may be. Yes, runs on the banks. Just like in the 1930's. Both the U. K. and U.S.A. had some this last fall. What comes around goes around.

Summary

Look out for economic problems to come. It's payback time for those who have believed what has been and is now being preached on Wall Street and validated by Washington D.C. It certainly won't be the end of the world, but it may seem like it. Deflation seems inevitable. As Gary Schilling has projected, it could be the gentle kind that does not cause lasting damage. On the other hand, it could be something much worse. We don't believe that anyone knows for sure. We do not believe the coming recession will be short and shallow, unless there is some way the

Fed can create yet another bubble. What would it be? The only one left is commodities – maybe they can bubble up even more than they already have, but we doubt it. Debt has been a major player in their recent move. Quality assets are the only place to be for now. We hope we are mostly wrong on this outlook, but we wouldn't bet on it and neither should you.

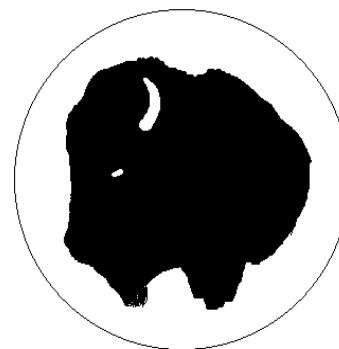
In Closing: How Did We Get into This Mess? (Just Our Opinion)

In our opinion, we may have come to the end of a political and economic phase of American history, which seems certain to completely reshape the landscape of the future. On the political side, we have pandered to the worst of our human nature: something for nothing—taking resources from the productive and giving them to the unproductive, thereby essentially creating a giant dependent reser-

vation, something on the order of 25% of our population. Our economic policy has slowly but surely trended toward European socialism, which destroys much-needed incentives and work ethic. On the other hand, our financial industry has been corrupted by get-rich-quick schemes engineered by ivory tower economists and their mathematical brethren, aided and abetted by the legal and accounting professions, all of whom are using the magic facilitated by the computer.

Since 2002/2003, trillions of dollars have gone into non-productive assets, which—along with other consumptive items—have left us with the highest debt levels in recorded history. At least during the dot-com blow-off, we were left with some productive assets, which can be used to enhance economic growth. Housing is not a productive asset. As a matter of fact, many are finding out now

that it is, in fact, a huge liability. When one borrows money from Asian and Middle East countries to buy consumptive items, who comes out the winner? Wall Street, which is the culprit in this game, is soon to be owned by those who produce and save. Somehow, somewhere, we have to “grow” leaders who will make the tough decisions and get our financial house in order in an orderly manner. If not, others who speak a different language will make the decisions.



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