

Economic Commentary



Central Plains Advisors, Inc. • 100 N. Broadway St., Ste. 130; Wichita, KS 67202 • Economic Consulting & Investment Management

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The Shape of Things to Come

1. What the U.S. needs in order to get back on a path of economic growth is debt reduction and wise investments. The one thing we don't need is additional borrowing and consumer consumption. The fiscal stimulus package can be best used to pay down some of the debt the consumer has been burdened with as a result of his flagrant spending of the past. More consumer spending will just add to the problem. With debt levels accruing interest as each day passes, including Saturday and Sunday, the burden becomes greater and greater. The consumer is in big trouble.

2. America's corporate sector is in fairly good shape. They wasted a lot of money buying their own stock back, but really did not take on an inordinate amount of debt until late 2006 and 2007. By in large, well managed companies should be able to take advantage of the many opportunities that are sure to come over the next five years. Maybe that's the reason the stock market has held up as much as it has to date. The key will be in what they do with their money. Much of it is now going overseas, mostly to China. It's quite possible too much has

gone there as of now. It appears that China has some slowdown coming, at least after the Olympic games have concluded. On the other hand, the weakness in the dollar is making some of the U.S. manufacturing industry competitive again. That being the case, it is much more advantageous for foreign money to invest here, than in the home-grown kind. Still, there will be opportunities for our domestic manufacturers also.

3. The government's position is better than the consumer's, but not nearly as good as our business sector. This does not take into account the large unfunded liabilities not on the books. We assume one can ignore this over the next five years. However, one needs to separate state and

local governments from the federal. The only way for state and local to survive, in our opinion, is to cut costs and reduce taxes. These entities are overstaffed, overextended, and badly in need of reform. Only through applying stringent cost control and reform will any politician stand a chance of re-election.

The federal government, on the other hand, is in relatively good shape. And by the way, it had better be, as the deficits are going to grow by leaps and bounds. One may question our analysis of this matter; however, please note the following tables adapted from A. Gary Shilling's April 2008 INSIGHT monthly newsletter, which give some indication of our relative strength.

Global GDP - 2007

	\$ billions	% of total
Canada	1,425.8	2.7%
France	2,555.4	4.8%
Germany	3,316.3	6.2%
Italy	2,109.8	3.9%
Japan	4,279.6	8.2%
U.K.	2,768.0	5.2%
U.S.	13,779.0	25.7%
Major 7	30,333.9	56.6%
OECD Europe	17,778.9	33.1%
OECD Total	40,289.6	75.1%
Euro Area	12,098.2	22.6%
World Total	53,640.0	100.0%

Source: Organization for Economic Cooperation and Development

Government Debt to GDP (%)
2007

Austria	64.2	Japan	180.3
Belgium	87.3	Luxembourg	13.4
Canada	64.2	Malta	64.2
Cyprus	64.5	Netherlands	53.4
Finland	42.4	Portugal	72.2
France	71.9	Slovenia	27.1
Germany	66.2	Spain	42.8
Greece	103.8	United Kingdom	47.2
Ireland	29.2	U.S.	62.2
Italy	116.9	Euro Area	72.4

Source: OECD and EuroStat

There are many other factors, of course, the above being just a couple. But remember this—although we have treated our economy with little respect through inept public policy, we remain the depository of most of the world's wealth. The Middle East and Asia have a huge stake in our economy. Also having the world's greatest military complex doesn't hurt a bit.

4. The giant Wall Street killing machine has imploded, we believe, for the last time in this long cycle, which commenced in the early 1980's. Yes, the Federal Reserve is pulling out all the stops to prop up this monster with the idea in mind that, over time, they can work themselves out of this mess. Keeping short-term rates low, there is an opportunity to work a spread for income accumulation, but not now! The immediate need is to restore their capital accounts and keep the wolves away from the door. Bear Stearns was

this century's rendition of a run on the bank that occurred almost daily in the 1930's. How can anyone have any faith or trust in Wall Street? What can one believe? Bear Stearns' chairman reportedly spent the critical last days in Detroit playing bridge and smoking wacky weed. What a difference there is between "the greatest generation" and the boomers. Wall Street's 850,000 employees, along with the 950,000 lawyers and 1,400,000 accountants, have stirred a toxic financial mix, which will take years and years to correct—all of this in concert with our friends in Washington D.C. If one wants to survive what we envision to be a huge transition period from the toxic model, which included made-up mathematical formulas and conflicts of interest, coupled with questionable ethics as opposed to one which has the client's welfare in mind, some idea of the future is paramount. We would like to lay out for

you what we think this period of transition will look like. We will keep you updated in future commentaries, and tweak our predictions as events unfold.

Before doing so, we think it's important to realize debt can be very useful—when it's done in a cautious and conservative manner. Up until some time in the late 1980's, debt has always been used to augment equity in building an idea or object. Many mistakes were made along the way, but that will always be the case. In other words, the real economy—let's call it Main Street—drove the financial markets. Recently it has been the other way around. Most action began in the debt financial markets and the real economy either followed or went relatively unaffected. In what some have called a "shadow banking market", money was created out of thin air. For example, a financial institution might sell commercial paper backed by bonds it already owned into the market place. The dollar received from that short-term paper was then invested in, say, mortgage-backed bonds, which were in turn used for backing of another round of commercial paper. And so it goes on and on until someone finally came to understand that this was a Ponzi game, which ultimately finds a less than credit-worthy entity, which would pop the bubble and com-

mence the reversal of the entire buildup. That, of course, is what's going on right now. Through all of this debt creation, the housing bubble was created, commodities have been accelerated in price beyond their fundamental supply and demand relationship, as well as common stocks, which even today remain overvalued.

According to many business analysts, the housing industry, along with its auxiliary industries, accounted for some 40% of the growth in employment and income since about 2003. If one adds in the expansion of the financial industries and adjusts for hedonics and other fancy—or better said, fanciful—formulas that comprise the GDP, most of the growth since 2001 is accounted for.

It is our thought that this “expansion model” is surely dead for now, and frankly we don't see where another of this kind will appear, at least until this one has faded from our memory. It seems time for a “new order”.

In Summary

1. The consumer is dead in the water, having too little income and too much debt. Personal consumption will be flat at best for an extended period of time.

2. Corporate America is in decent financial shape,

but has very little pricing policy, at least at the retail level. We expect many retailers to eliminate redundant outlets over the next three to five years. Carefully financed innovations and technology should lead to slow growth over the period ahead. One of the real bright spots will be exports, which is cyclical, of course, and probably most of all, the agricultural community should be in for a boom. After years of fits and starts, it does appear that the world now has both the desire and means to adopt an American style menu. Herein may occur the next bubble the Federal Reserve can blow, but only down the line as making land loans must surely be the last thing on their minds under current conditions.

3. The Federal government will be a huge spender over the next few years. Much of it will probably be for highways and other infrastructure projects. They may become the employer of last resort. State and local is another matter, as mentioned previously. They will likely get in line at the Federal trough when their revenues will become quite restricted.

4. The entire financial community is in for a giant enema. Frankly, we have little idea how and what shape the financial industry profile might be. Somehow the conflicts of interest and lack of ethics must

be addressed. As mentioned previously, they are—as now constituted—a giant killing machine, preying upon a naïve public, which has been ripe for the picking. Human nature never changes, but surely something structurally must. The financial distribution system is broken. In our humble opinion, Bear Stearns should have been left to go down. Who is going to be next? Do you realize that the leverage used by these huge firms has been anywhere from 20 to 30 times? All of them are targets for the occurrence of the “black swans”. Bear Stearns has seen one, and we believe there are more to come.

We expect the economy to be flat to down over the next four quarters. When we do have a recovery, it will be nothing to write home about. Two percent real growth may be difficult to come by, unless you are willing to accept the “new math”. This new math will be the *real* thing, as opposed to that created by the Ivy League MBAs over the last 20 years.

The way we may get to 2% real growth may be 0% nominal and 2% deflation, which results in 2% real. Maybe it will be -1% nominal + 3% deflation, equaling 2% real. In the old inflationary days, the math was 2% nominal *minus* 2% inflation resulting in 0% growth.

What might one expect in the way of rates of return for the next five years? In our opinion, the current low yields will become the high yields of tomorrow. The following might be where things might settle.

S&P 5003% Yield
 Long Govt.....3% Yield
 Long Corp Bond AA .5% Yield
 Junk Bond9% Yield
 Short Govt 1% Yield

Total return numbers, which include capital gains, will depend upon one's skill in selection and timing. It's likely the S&P 500 can obtain 6% total return, and we expect to double the coupon in our Bison Bond I program. The kicker may come from deflation, which could well return an additional 2% in tax-free income.

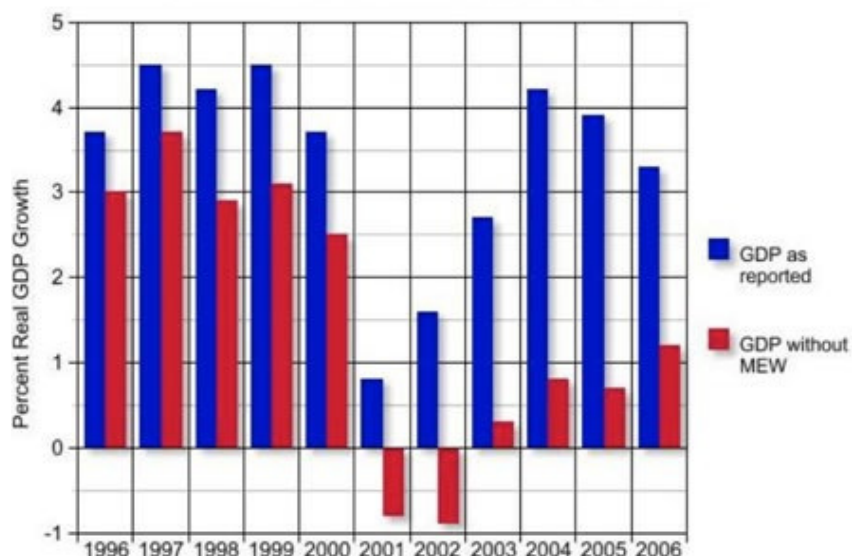
Bison Bond I Estimate
 Total Return Nominal 6%
 Deflation..... 2%
 Total..... 8%

An Almost Final Note

As an almost final note, please view one analyst's idea of what our economy would have looked like if mortgage equity withdrawal had not taken place over the 11 years ended 12/31/06.

As indicated previously, we would suggest that

GDP Growth: With and Without Mortgage Equity Withdrawal

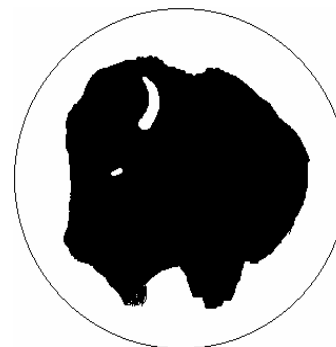


2008-2012 will have a reported GDP possibly somewhat less than the red lines seen for 2003-2006. Again, not much to write home about. Please remember, debt doesn't just go away. Many think the Federal Reserve can magically inflate it away. No way, Jose! The piper must be paid!

what they do, and do the opposite would seem like good advice. The financial community remains in dire straits. Without the banks' participation, growth will be difficult to achieve.

What About Next Quarter?

It would be our guess that the major topic of concern for the July quarterly economic commentary will be about the bust in commercial real estate. It is now gaining momentum on the down side, and this could be the death knell for many a regional bank. Have you ever noticed that bankers in general come in strongly at the top of most cycles? *Watch*



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