

Central Plains Advisors, Inc.

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Interim Update

As the Gipper Would Say “There You Go Again”

For the second time this year, government traders (not investors) have given us the opportunity to buy the world's premier asset at unheard of real (ex-inflation) yields. At the close Friday December 7, 2001, which of course is the 60th anniversary of Pearl Harbor, the 30-year government yield was 5.62%. As mentioned in previous commentaries, Hersh Shefrin, author of Beyond Fear and Greed, has explained such irrational behavior as we are now seeing in the bond market by explaining that fixed income participants are “the last to learn”. And so it is.

Let us examine the reasons given for the swift sharp increase in government yields over the last month or so.

1. *The economy is about to turn upward and that means inflation is soon to occur. **Is this true? NO!*** There may be a very mild upturn in the first quarter of 2002, but if so it will be only a rebound from 9/11 and nothing more. Let us say we are wrong about the economy; **does that mean that inflation is going to come back? NO!** Growth and inflation have no positive correlation. It has been that way since 1875.
2. *The war, tax cuts and a stimulus package are sure to be inflationary. **Is that true? NO!*** It's all a pittance relative to the size of government. A WWII type all out conversion from peacetime goods to war goods would do it, after several years, but that is not in the cards as of now.

3. *The government surplus has now turned to deficit and deficits mean higher interest rates. **Is that true? Absolutely Not.*** A government deficit has nothing to do with the level of interest rates. Politicians perpetuate this myth as do Keynesian economists. The most recent example is during the 1980's, when long-term government rates went from 14% to 7% while we compiled the largest deficits in history.
4. *All past recessions since WWII have been halted by monetary ease. This is inflationary and one doesn't want to be in fixed assets under these conditions. **Is this true? Yes and No!*** First, this recession is completely different from any other of the previous nine recessions since 1945. Yes, prior recessions have been halted by Fed ease, but no, it won't this time. **Why?** We have just gone through a classic capital spending boom that occurs once every 100 years or thereabouts. The railroads in the late 1800's were similar to the 1990's in magnitude, and to a somewhat lesser degree, so was the auto and radio boom of the 1920's. The problem is no one lives long enough to see "it" repeated. Therefore, it's not on the radar screen. One could read books but who does that anymore when football and soaps on TV seem so much more important? A recovery, when it comes and it will, is destined to be one characterized by deflationary growth and extremely low nominal interest rates. By the second half of 2002 all will see this difference, but now it is not appreciated.

There may be other reasons that the bond market vigilantes are at it again. For example, just the fact that the upward momentum in rates underway, will cause many to join the crowd. Another cause to action is always the fear that someone else knows something you and we don't. My friends, they do not! Billions of dollars of government bonds are traded each and every day, some say trillions. Traders, not long term investors, are responsible for most day to day fluctuations. Many are heavily leveraged and their day to day decisions are made solely based on what they think the other fellow is going to do. Or maybe a huge bond underwriting is under way and they need to hedge their positions by shorting some other security. That some other security is almost always government bonds. **Why?** They are the highest quality and most liquid fixed asset in the world. A perfect vehicle to use.

A Final Thought

We have been asked time and time again (only when the market moves against us, which is approximately 20% of the time) what will make you change your mind? Our answer – **when economic fundamentals change.** Our discipline will not allow us to disengage just because some economist or

analyst can not or will not stand erect against a prevailing wind. If the truth be known, sell side Wall Street pundits are the perfect competitors to fade.

Just as a dentist gets a call when a patient has a toothache, we receive calls when our investment program is “going the wrong way”. This is human nature and it is to be expected. We welcome the calls, for it gives us an opportunity to have a fruitful dialog.

As we returned from the dentist today, obviously the reason for the analogy, the thought occurred that the practice of prevention might have alleviated the need for our call. With that in mind we took our 10-year record and invested a like amount of money after each down quarter over the 10 years. If one had so done (instead of calling) one would have increased their rate of return from 15% to near 18%. Wouldn't that be a better solution? The question is: will you do that or will we practice better hygiene – probably not – after all we are all human.

Don Peters
CEO/Central Plains Advisors, Inc.

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