

Economic Commentary



Central Plains Advisors, Inc. • 9415 E. Harry Ste 201 Wichita ,KS 67207 • Economic Consulting & Investment Management

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The Tale of Three Scenarios

As we close out 2004 and commence the new year, two very different views of the economy seem to be in the news most every day. From a historical viewpoint, the financial market's expression of these divergent views can be found in the price of the long government bond and the price of gold. Not to be overlooked, however, is that most reliable indicator of the investing public's view of the world, the stock market. At this writing (12/15/04) all three of these markets are telling a different story. The strength in the long government is telling us that the economy is weakening and those who are expecting strong growth and possible inflation are wrong. The move upward in gold usually foretells an inflationary environment at best, or at worst a complete breakdown in the value of the dollar.

The stock market, which had done nothing through October, moved higher through November and December and appears headed for a decent close for the 2004 year. This could be indicative of the Goldilocks economy of old, i.e.

moderate growth and low inflation for as far out as one could see. As a matter of fact, it is quite obvious that leading the stock market move is the individual investor who is back in a big way after having been absent since the bubble blowup of 2000. Charles Schwab reported that their trading activity was up 25%. IPO offerings increased smartly (Las Vegas Sands came public at \$29 and opened at \$44) and mergers and acquisitions came hot and heavy (Sprint and Nextel). One might conclude then, that long

governments say one thing, gold says another, and the stock market says you are both wrong and happy days are here again.

What are we to make of these divergent views? Can they all be correct? Where is the balance? Are

there other considerations that are not being taken into account by all of these markets? You know we believe there well may be (debt) and it's an old story with us, but one that just doesn't resonate with most investors.

In fact, we don't believe a soul on Wall Street pays it any attention at all. If you please, an example: On Saturday morning, December 11th, we were interviewed live on a Philadelphia money talk show. During our recitation, we emphasized the huge amount of consumer debt as being a possible limiting factor as concerns consumer spending. The other participant said "You know, we have heard that for years and yet the consumer continues to spend." Our reply was "Doesn't it just make common sense that at some point huge and growing debt will slow one's spending patterns." We believe his comment of "heard that before" is a typical uninformed answer to an extremely serious problem. Take the "walking the plank" scenario. Just because one doesn't fall into the water after twenty-five steps, does that mean he won't fall when he comes to the end? The first major accumulation of debt was brought about by the bubble stock market that was financed by-in-large by borrowing on common stock. Now an even larger bubble is currently underway in the housing area, once again with the use of debt.

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Why debt, you ask? Let us give you a number through November, which estimates the amount of income lost due to our current jobless recovery.

Unlike past economic recoveries, the current expansion was fueled by extreme monetary and fiscal ease leading to bubbling asset values, rather than the rapid rise in employment and wages that leads to more sustainable growth. For example non-farm payroll employment in the current recovery is up only a paltry 0.9 percent since the official recession bottom in November 2001, an average of only 32,000 per month. This compares to an average increase of about 7.5 percent in other post-war recessions. If employment in the present expansion had risen by that amount there would be about 8.6 million more jobs than there are today, and the average monthly gain would have been about 273,000. Instead, this number has been surpassed in only three of the past 36 months, and as a result, the growth of wages and salaries has been far under the increases posted in the past.

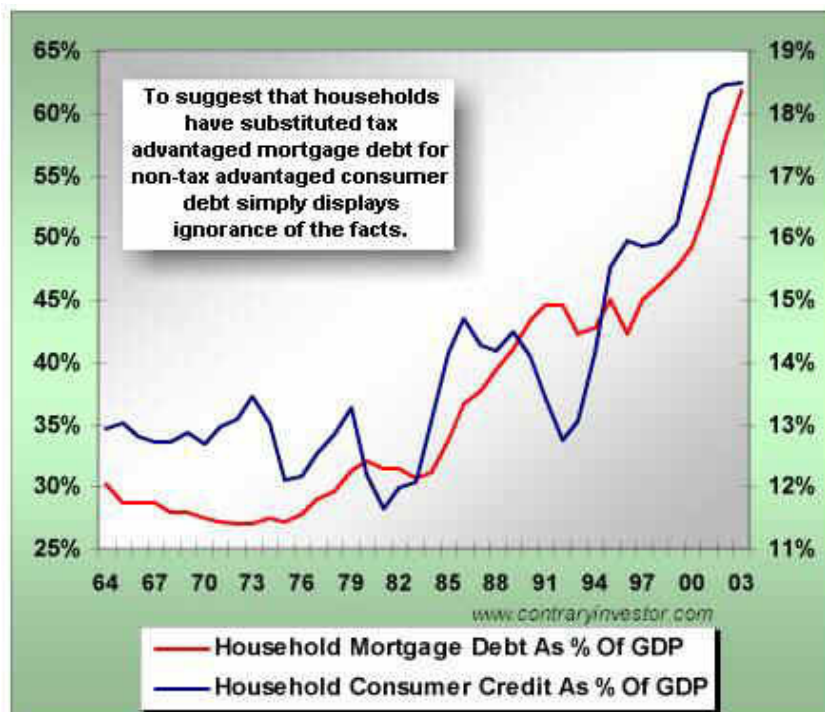
(www.comstockfunds.com)

By our rather crude mathematics, 8.6 million workers at \$25,000 per year amounts to an annual loss in wages of \$215 billion. Despite this lack of income, consumer spending has been good and the purchasing of new homes has been nothing less than spectacular. How can this happen at the same time that personal income is so weak? Debt

is the answer and it has been made possible due to (1) low interest rates, (2) home asset inflation, (3) reductions in required down payments, and (4) other innovative terms such as interest only, various organizations that loan the down payment, variable rates, etc., etc . . . Some say mortgage debt is not a

The same things are being said today about the housing market that were said about the stock market bubble of the late 1990's. That being that we are now in a "New Era," and so on. The most legitimate argument against our bubble thesis is the net worth of those who are owners of these homes. Note the following numbers

Figure 1



problem – much of it is substitution for nondeductible consumer debt, but note Figure 1.

Let's be honest about this housing bubble we have been talking about for several years. To date, we have been wrong if your understanding is that to prove a bubble you must have a concluding bust. We have not come to that point as yet, but let's call upon common sense again.

as of 9/30/04.

. . . Household Assets increased \$805 billion during the quarter. This is the eighth consecutive quarterly increase in asset values, whereby Assets have increased a noteworthy \$9.85 Trillion (21%) to a record \$57.0 Trillion. And with Household Liabilities up "only" \$259 billion during the third quarter (10.3% rate), Net Worth jumped \$546 billion to a record \$46.7 Trillion. And although Assets (up 20.9%) and Liabilities (up

20.4%) have increased approximately the same percentages, Household (including Non-profits) Net Worth is up \$8.1 Trillion, or 21%, over the past two years.

Since the beginning of 1997, Household Liabilities have surged 89% to \$10.3 Trillion, while Assets have inflated 60% (to \$57TN). The seductive magic of Asset Inflation and Bubbles has witnessed Net Worth inflate an astonishing \$16.5 Trillion, or 55%. There should be no mystery behind the boom in consumption, especially luxury goods and virtually everything at the “upper end.” (www.prudentbear.com)

Our answer to this is the same we used in combating the nonbelievers in the stock market bubble, i.e. assets, after being purchased, become a zero-sum game as they pass from hand to

Does anyone remember the late 1980's Savings and Loan debacle?

We have answered the other consideration about the asset market divergent views of the future, that being unprecedented use of debt. We believe this is certain to be the driving economic force for 2005. The near unanimous economic outlook of 2005 is just more of the same: real growth of 3 ½ - 4%, somewhat higher interest rates, 7-10% increase in corporate profits, and a higher stock market. But then, when has it been any different? No one ever predicts anything other than something akin to the above – unless in private. The debt matter seems extremely important to us and makes us believe that next year will be much

gives one an idea as to the growth in various sectors of debt since year end 1996.

The one item we have written about many times in the past that also needs analysis is the huge increase in financial debt. As our manufacturing sector continues to suffer from foreign competition, the slack is being taken up, in many respects, by the financial industry. What's wrong with that? Two things: (1) The manufacturing sector that has to do with capital expenditures has a huge economic and profit multiplier effect and (2) the financial sector is much more highly leveraged, therefore very much subject to a financial accident. Also, its profits in the trading area of secondary markets has little or no benefit to the economy as a whole. In their trading, they provide liquidity and help allocate capital in their investment banking fraction, but they also are the ones responsible for the execution of the bubble markets fostered by the Federal Reserve.

Selected Debt Level Increases

1996 Through Third Quarter 2004 (in Billions)

Year	Total	Corporate	Household	Financial
Q3 2004	\$23,607.5	\$7,671.3	\$9,949.2	\$11,674.1
1996	\$14,391.4	\$4,371.8	\$5,208.8	\$4,866.2
\$ Increase	\$9,216.1	\$3,299.5	\$4,740.4	\$6,807.9
% Increase	64%	76%	91%	140%

hand. As long as the price moves upward, everybody wins, but once the music stops and prices move the other way (which, by the way, has *always* happened in the past) asset values evaporate and the only thing left is debt that must be serviced – debt doesn't know how to just go away.

more of a challenge than most believe.

We have highlighted debt, and in particular household debt (consumer and mortgages), along with a shortage of wages and salaries as being a major headwind to economic growth for 2005. The table above

Interest Rate Outlook

Every year since the recovery began, after the 2001 recession, the consensus has called for higher interest rates – every damn year! As we enter 2005, nothing has changed. Being lonely in our opinion

of lower interest rates has paid off. But will it continue? In our opinion, we just might be approaching a critical tipping point. The accumulation of debt coupled with the below average increase in personal income has to be weighing upon the consumer, which is 70% of the GDP. Another very worrisome trend has been the compression of interest rate spreads. This has come about due to the scramble to obtain yield as the government market and banking community has not provided the yield fixed income investors have seen in the past. Extremely speculative bond yields are right on top of government yields. This is a disaster waiting to happen. What does all this have to do with the direction of interest rates? Please note Figure 2. At the apex of the Sigmoidal Curve, deflation sets in. This will send government bond yields much lower (3% or less). Other yields will undoubtedly spike upward due to the fear of default of first the coupon and then the principal. When will that apex occur? Will there be a huge inflationary scare just before the deflation sets in that will send all yields much higher before the split trend sets in? Note Figure 3 on the trend of the dollar, which the consensus (not neces-

Figure 2

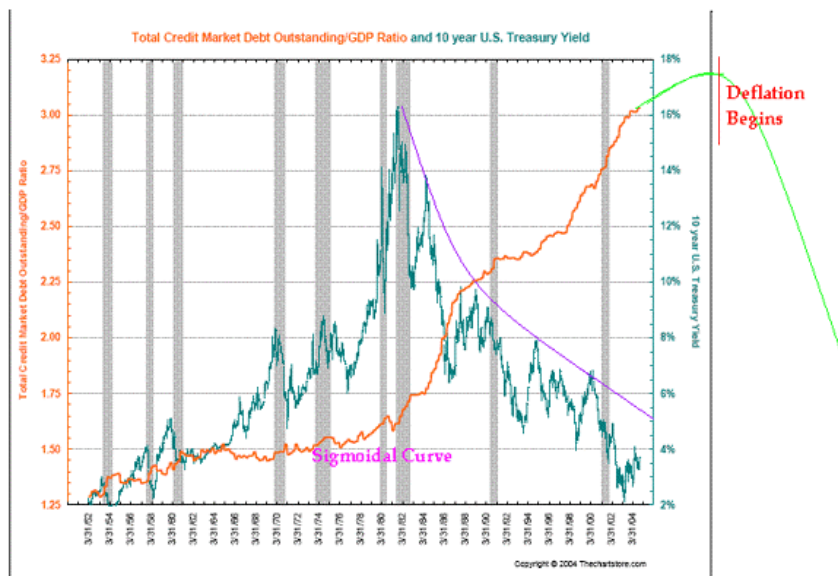


Figure 3



sarily us) believes will create inflation. It is the fear of this scare that has us in cash equivalents. The good news, while we await reentry into the long government bond market, is that the Fed is raising, to our benefit, short-term

rates, which are now 2-1/4% and probably will be 3% by the coming summer.

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