

Economic Commentary



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

A Critique of the Recent Past

It was in September of 2004 that we took profits in our Bison Bond I program, believing that most of the gain was out of our long treasury position. At year-end 2004 we were able to report an after fee return of 12% for our people who had been with us that entire year. However, at the time of our exit we reiterated to our clients and those others that would listen, that we expected the bull market in long governments to resume in 2005. We remember specifically that we suggested there would be an inverted yield curve before 2005 was over and that we expected to be once again invested long to take advantage of such a move. At year end the inversion did come to pass and we were and are positioned to take advantage of the move. In all candor however, we expected the inversion to come much earlier in the year, signaling a recession or at least a sharp slowdown in 2005. It appears as if this will now happen in 2006. We have always had a history of being early and so it was again. 2005 was another profitable year for which we are quite pleased. Other expectations for 2005 called for the housing bubble to burst, a probable pension fund crisis to occur and the possible demise of both GM and Ford. As things now stand it seems as if all of the above are moving along the track to completion as suggested above. We can continue to hope that none of this takes place, but we certainly wouldn't hold our breath.

On the other side of the projection coin the stock market has done better than we expected. For the second year in a row a Fall rally allowed most of the averages to post a small gain. Earnings were quite good but valuations being much too high did not allow market gains to be anything to write home about. Our returns in government bonds have been fully competitive with common stocks for the last 15 years. If one were to compute the comparable returns on a risk adjusted basis our record would truly be outstanding. One however cannot spend these type returns therefore consider them to be of little value. Longer term results of the raw asset classes since 1924 have been approximately 2 to 1 in favor of stocks. Common stock investors have not been rewarded for the risks they have taken since 2000, which by the way was the year (June 29, 2000) we sold all our stocks and went to bonds. We expect to return to this market at some point in the future, but only after multiplies become more realistic. More about that later when we write about our new programs.

As for a long term look at the short-term rates that the Federal Reserve controls, please note the chart on page 3 taken from the Elliott Wave people. As we have reiterated since 1981 the move downward in interest rates remains well in tact, even at this seemingly late date. This then leads us in to our outlook for 2006.

A Look at the Immediate Future

The forces of deflation remain intense. Probably no one more realizes this than Mr. Bernanke. If the truth were known surely most of those on the open market committee are of the same opinion. Mr. Bernanke, however, has been the only one to vocalize such an opinion that we have noticed. The fear we believe is that such pronouncements would freeze the consumer in place and create a downturn of possibly severe proportion. For PR reasons inflation has and continues to be the stalking house. Deflation has a very negative connotation therefore is mentioned very sparingly. As 2006 moves forward we would expect the economy to slow, corporate profits to stall out, and the Federal Reserve to return to easing interest rates once again. The move by the Fed will come too late to prevent a recession and the jury is out as to the effectiveness of easing once again. Will this be the time that banks and other financial intermediaries will refuse to loan, thus causing the much feared "pushing on a string"? Probably not, but keep in mind without strong income growth and practically no savings it will take another asset bubble and borrowing to propel the economy upward. What will that be? Is it possible that money will flow overseas (say, Japan) creating a stock market or real estate market advance and possible bubble? Japan does appear to be on the mend after 16 years of deflation, low interest rates (0%) as well as equity and real estate market crashes. The question remains in our mind whether we have such a period to look forward to in the US.

To date the Fed seems to have worked its magic, and kept us out of these circumstances. Can they do it again?

Gave Kal Research—Our Brave New World

As you know we have long been fearful of having the “old man disease.” What do we mean by that? Please think back to your younger years – in particular the first job you ever had after leaving school. Do you remember the old timers talking about all the new ideas, products and ways of doing business? Oh, they wouldn’t work they said. We well remember bankers saying that the payment of interest on checking accounts would be the death of the banking industry. The thought of fighting the last war comes to our mind when we hear all the doom and gloom about various deficits our economy is experiencing. This concern led us to read and study the above named book after seeing a rather provocative review in a business report.

Maybe the best \$20 you could ever spend would be to purchase this book. If you are reluctant to purchase it, you may get one free with our compliments if you are one of the first forty to make reservation for our seminar February 7, 2006. A formal invitation is in the mail. If you have not received one, let us know.

The following is a summary of their economic scenario, which we have to admit, makes a lot of sense. It most certainly has accounted for the reason debt has not plowed us under to date. As you know debt has been the single most worrisome thing that has concerned us and has heavily influenced our view of the economic future and financial markets. Basically the author

uses as his lynchpin are the books authored by Alvin Toffler. In particular they make reference to the *Third Wave* written in 1980. As you may recall Newt Gingrich was taken by Toffer to such an extent he recommended the government should supply every student in the US with a computer. The three waves are as follows:

1. Agrarian Revolution
2. Industrial Revolution
3. Post Industrial revolution

It is the latter that we are presently in, therefore a *Brave New World* has developed and most economic thinking continues to revolve around the industrial revolution, which has been exported abroad. Wave one maintained all wealth came from agriculture. Wave two plant and equipment. Now wave three information. The important fact that has taken place with this third wave is the business model. The old model was design, produce and sell. Now the new model is design, produce nowhere and sell everywhere. This model for the US exports low margin cyclical business to emerging markets and retains high margin low volatility design and selling aspects at home. All of the above creates a “new era” in that our economy is less volatile therefore assets are more reliable thus one can afford to pay more for them. At the same time consumers can take on more debt and save less, as the fear of unemployment has become less.

The authors make the point that the new business model, which they call the platform company, has 4 legs, which are also the pillars of capitalism:

1. Free Trade
 2. Technological Progress
 3. Recurrent Overcapacity in most industries
 4. Ability to move goods.
- The point is that capitalism is

inherently deflationary as long as politicians can keep their grubby little hands off the economy and the above pillars remain in tact.

Most economic observers, including ourselves, have been worried about the trade deficit, which has been growing by leaps and bounds. Our major concern however has evolved around consumer over consumption through the use of debt, while income has been lacking. Mainstream economists though have worried mostly about the trade deficit and the need for foreigners to recycle their dollars into primarily US government securities. The Gave-Kal Research people address this trade deficit problem with the following illustration which backs up our many stated position that this deficit is not near the problem most believe. Again in our opinion the real problem is the assumption of debt and lack of income, which has plagued the American consumer since the recession of 2001.

Gave Kal Illustration

1. Dell sells a computer for \$100
2. They purchase \$470 of items from foreigners
3. They purchase \$200 of items from domestic firms
4. Profits for US companies \$245
5. Profits for foreign companies \$40
6. US GDP increases by \$245
7. US trade deficit is \$470

The question is: Is this a good deal for both parties?

1. For the US, sales are \$900 profits are \$245 margins are 27%. The looks good to us.....
2. Foreigners have sales of \$470 and profits are \$40 margin are 9%. Not bad when you

have no middle class and need buyers for your products. It seems to us that the increase in GDP by the amount of \$245 should be subtracted from the \$470 going abroad when viewing the trade deficit projected for this year should be viewed as a \$384B problem rather than \$800B. (\$225/\$470x\$800B) There is much more to their view of things, which are important, but we will leave it there for now. Again please avail yourselves of this work. We may in fact be at a long lasting turning point, which refuses to be understood by most. Being ahead of curve has always been difficult but extremely rewarding if right.

programs in order to get feel of how they work. Our thinking is that after the long 25 to 30 year bull market in long government bonds is over it will be at a 3% or less yield. At that time we will need to employ a more active strategy in order to obtain capital gains. As the bottom in yields is forming and then subsequently as yields work their way back upward the bullish wind will no longer be at our back. We expect the trend to be choppy for several years before a clear bearish market develops which will allow us to make a long trend commitment. We will want to be able to short the long market and/or move to shorter term securities to cap-

next 5 years or so will be more of the same light. To date in the 2000's we have had a real growth rate of 2.6%, which is below the average post World War II number of 3%. Our guess is that the 2.6% will be hard to achieve on average as we go forward. Globalization is a long long-term economic paradigm. The developed countries are losing their manufacturing strength to the emerging markets of Asia and Eastern Europe. Over the long long term this is good for everyone as a rising tide lifts our boats. In the short run, however, moving from a manufacturing economy which has many multiplying effects to one of service that

| Name | Market Value 12/30/05 | Increase | Strategy |
|----------------|-----------------------|----------|--|
| Bison Bond II | \$ 5,319.25 | 6.40% | Long & Short Governments |
| Bison Bond III | \$ 6,996.41 | 39.90% | Long Government, Precious metals & Cash |
| Bison Bond IV | \$ 6,339.96 | 26.80% | Long & Short Governments & Precious Metals |

New Programs

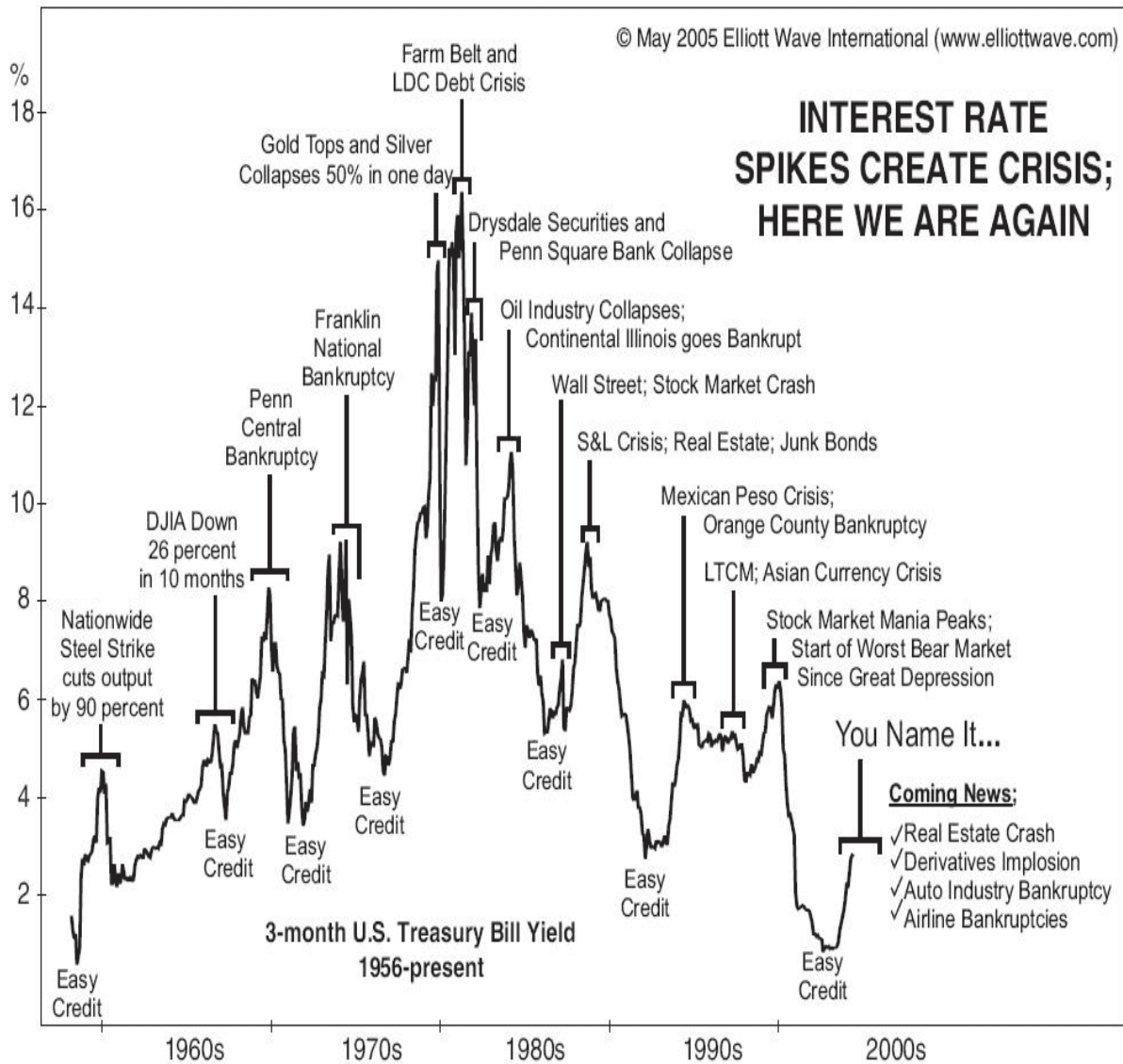
Since April 1, 2005 we have beta tested three new programs for introduction in 2006 using our own money. The results are in and the performance is as shown above. These are before our fee, but after all fees charged by the Rydex no load mutual funds we use. These are raw % numbers (not annualized) for the 9 months ended 12/30/05. These are the programs that we believe will serve us well particularly when the long 30-year government bond reaches that 3% level we have long predicted. Keep in mind that the above returns are for a very short period and may not and as a matter of most certainly will not be achieved as concerns III and IV on a long term basis. We do believe that one should seriously consider placing some new investment funds into on or more of these

ture rising interest rates as deflation rears its ugly head. Please allow us to visit with you about these programs as we go forward this year. Again, we suggest new funds be used. In our opinion the gains to come from long rates going to 3% or even 2% (In Japan they went to 0%) will be greater than the new products at least for now. Obviously no one knows for sure. Our next product to be put in place will be an equity vehicle. The common stock market has been flat for 6 years and very well may become a buy over the next year or two and we want to be ready. We will follow the same procedure as the past using our own money as the beta test to work out the bugs before presenting to you, our clients and friends.

Longer Term Outlook-Economy

We believe the picture for the

has very few simply means slower growth until the rest of the world develops a consuming middle class. At that time we will all be able to compete on more even terms as far as the factors of production are concerned. Our wage rate times our productivity will be equal to their wage rate times their productivity. A somewhat more level playing field should allow all to prosper. Under these conditions growth could accelerate however two things could cause all of this to go away. The first and most worrisome is government intervention such as tax policies or tariffs. The other would be a World War. No once, certainly not us, have the answer to the likely hood of either of these unfortunate events to happen. Human nature being what it is we wouldn't be a bit surprised if something might happen which might derail the rosy future that globalization equalization will promote.



Another cause for slower growth over the next 5 year is the debt structure, which the consuming nations have, primarily the US. The world is in a highly deflationary environment therefore the liquidity created by the Central Banks of the world have not resulted in any inflation except in speculative asset markets, however debts have gone through the roof. There have been two investment bubbles created, one in the US

(technology) and one in China (industries of most every kind). There has also been several other bubbles, housing, construction and commodities, which seems destined to pop along with China's over investment before long.

remain overvalued as well as commodities. Particularly is this so if we have a recession in 2006 which seems possible. The government (high quality) bond market should do well. Watch out for junk.

Longer Term Outlook – Financial Markets

Single digit returns seem the most probable from most assets during 2006. Common stocks however,



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