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## Economic Commentary

December 31, 2001

### Have We Reached the Brick Wall?

The Wall Street spin machine has been relentless in its V-shaped recovery scenario for well over a year. As you recall, the slowdown in economic activity commenced during the 3<sup>rd</sup> quarter of 2000 and as of now has been in recession since March of 2001. Almost every day we have heard that recovery was just around the corner. The latest word is now April. First of all, none of the leading economists and analysts on Wall Street predicted there would even be a recession. As late as the fall of last year many questioned if we were even going to have one. The simple truth is that the broker dealer industry has a huge conflict of interest when it comes to the financial markets. Their livelihood depends upon being able to underwrite and subsequently trade trillions of dollars of equity and fixed investment instruments. The bias is always positive regardless of conditions. We personally know of one high quality economist who was fired from his lofty position because he foresaw trouble ahead and demanded to so inform his firm's clients and customers. The firm's CEO told him that the company is always bullish on America and no one was allowed to forecast recessions. Despite the industries terrible forecasting record it continues to be relied and acted upon by most market participants. It molds conventional wisdom through misinformation and sometimes even disinformation while taking money to the bank every day. Does anyone remember the book Where Are All The Customer's Yachts?

We agree there will be a recovery, but the chances of a V are highly unlikely. One that is shaped like a U, W or L is much more likely under today's worldwide economic conditions. For sometime we have felt that the U shape was the more likely, however, W may be the case, as 9/11 caused a severe drop which may result in a weak mini-recovery followed by another leg down. Obviously, no one knows for certain, however, we feel quite confident that the recovery, when it comes, will be much less vigorous than most expect. Once again, we believe Wall Street will have led investors down the primrose path.

As our outlook for the economy and the financial markets are so much different than the view from the street, we thought it important to enumerate our concerns. Please be advised we do not expect a calamity nor a repeat of the 1930's. What we do expect is a rather long period of slow growth (maybe an average 2%) which will be characterized by continued disinflation and probably deflation, as individuals as well as companies restore their balance sheets. Repayment of debt, which includes bankruptcy, will become the watchword of all economic participants. A normal reaction to conservative financial guidelines will replace the speculative mania of the late 1900's. The greatest stock market bubble in history just cannot lead to the future that is being projected by the conflicted pundits of lower Manhattan.

Yes, there will be new innovations that come along. The entrepreneurial spirit is alive and well in the U.S. We will remain the world's greatest economic and military power, but remember, real growth in assets must come primarily from savings along with some use of debt, but not from debt alone which has been the case since 1995. We need and we expect what Archie Bunker would call another one of those "pauses", in this case a spending pause, a pause that refreshes. This doesn't sound much like Wall

Street does it? Or for that matter, it certainly doesn't sound like the politicians in Washington. What they advocate only extends the problem. What we need to do is solve the problem.

During the high government deficit years of the 1970's, 80's and early 1990's, we were asked time and time again how can we as a country could continue to spend money we didn't have? Our answer has always been as follows: We are the most capitalistic, most free, largest economy in the world and because of that we have huge borrowing capacity. We import more than we export and because of that the world ends up with dollars and these dollars are used to buy our government debt. On the other hand, there is a brick wall out there and at some point in time we will hit it, if things don't change. We didn't and still don't know where that point is, but it's probably a long way out in the future. Well, it never came and, of course, we have been experiencing surpluses over the last several years. That is changing now, but that's not the question that needs to be asked and answered. The question has now become, "how long can U.S. citizens and U.S. corporations continue to create and service their debt?" There is a brick wall in the roadway for these non-government groups and it's our opinion that the wall is within sight.

Ever since the 30's and 40's the Federal Reserve in the public sector and the financial industry in the private sector have combined to encourage and create debt. This form of stimulation, which has increased demand and to its credit (no pun intended) helped extract us from 9 previous post war recessions, must also have at its end a brick wall. That's what we are worried about. We don't believe such stimulation will work this time primarily because the levels of debt are too high. As mentioned previously, debt now needs to be paid. Spending will slow and profits will be difficult to come by. That's the bad news- the good news is that very thing must happen for the economy to ready itself for solid future growth, which is sure to come, but later.

Another major worry is the recent stampede for yield. We will address this in more detail in the bond market section. It all begins with the continuing unabated credit bubble that is adding to the severe debt problem mentioned above. Please note the following:

Money supply (M2) has increased by over a trillion dollars (14%) over the past year. Fannie Mae's total book of business is up \$244B to \$1.539T. At the same time Fannie Mae is laying off most of its mortgage purchases to broker dealers who in turn are selling the mortgages to the public. Freddie Mac also is expanding its purchases rapidly. Let there be no mistake the increasing money supply, which has so many Wall Street firms anticipating a quick return to economic expansion, is coming from this source.

Not only is the real estate mortgage market being force fed by the GSE's (government sponsored enterprises), but public and private debt issuance is setting records. Municipal bond offerings are up 40% from a year ago. It appears as if \$270B will have come to market in 2001. Convertible bond issuance is up 49% over 2000 to \$160B. Asset back securities (year to date issuance) is up 17% to \$268B from 2000's record year. High yield bonds are currently being priced at the low end of price talk. This is a clear indication that the market is cash hungry for yield.

What is going on here? Aren't we in a recession? Are not investors supposed to be risk adverse at such times? It is our opinion that we are actually at the most dangerous period in recent U.S. economic times. As the Austrians would say – interest rates are signaling the wrong message. Why? Because there is a natural rate, one that is set by a 100% free market, which tells financial participants what they should be doing economically. The fed's year long reductions in the federal funds rate have sent Wall Street

underwriters across the country selling lesser quality debt to conservative investors who are starved for yield. With bank's CD's and government short-term debt yielding near to nothing, the stampede is on. That's problem number 1. Problem 2 is the housing industry which is dangerously overdone, and of course, problem 3 is the stock market which is selling at P/E multiples that have no regard at all to economic reality. For example, Barrons says that the S&P 500 is presently selling at 39 times and the 400 at 50 times. At bear market lows 7 to 10 times is the average.

For those who like numbers, please note the estimated increase in financial market debt over the last 5 years. These increases are unprecedented.

### **Financial Debt Growth**

#### **Last 5 years** **Bank Credit**

Governments	\$822 B	+16 %
Commercial & Industrial Loans	\$1,004B	+34 %
Other Securities	\$650 B	+126%
Real Estate	\$1,740B	+55 %
Securities Loans	\$149 B	+78 %
Other Loans	\$449 B	+109%

#### **Other Sectors**

Government Sponsored Enterprises	\$2.13 T	+129%
Asset Backed	\$1.94 T	+158%
Broker/Dealers	\$1.33 T	+137%
Mortgage Backed	\$2.64 T	+60 %

#### **Stock Market**

No one can state our position relative to the stock market better than the following information which comes from Comstock Partners Inc. These are people we have known and followed for over 20 years. One of the original partners, who has passed away, was one of those we knew who wouldn't follow the Wall Street line and left his most prestigious position in order to form his own firm. We quote: "In recent years it has become fashionable in some quarters to denigrate valuation as a tool in gauging the probabilities of future returns in the stock market. A recent study by Ned Davis, however, indicates that ignoring valuation can be hazardous to investor's financial health. Davis looked at price-earnings ratios of the S&P 500 from 1926 to the present, and measured subsequent returns over periods ranging from three months to ten years. In every period, investing when market P/Es were low resulted in significantly higher returns than investing when P/Es were high. For instance, investing when P/Es were 9.3 or under resulted in a three-month gain of 5.8% as compared to a loss of 2.5% when the P/E was 20.2 or higher. Moreover the spreads widened as the time period increased. Over one year, investing at the low multiple resulted in a gain of 13.2%, whereas, investing at the high multiple resulted in a loss of 1.4%. Going out ten years made the disparity in results even more glaring. When investing at a P/E over 20.2, the ten-year gain was a meager 54.1% compared to a much higher 162.4% when investing at a P/E of under 9.3.

This is not to say that valuation is a precise tool to time the market. It does, however, provide investors with the probabilities of achieving various rates of return over different periods. Currently the S&P 500 is selling at 46 times 2001 estimated reported earnings of \$24 to \$25, and 26 times “normalized” earnings of about \$46. If earnings increase at the historical annual average of 6%, earnings in 2012 would amount to about \$87. If we give that a historical multiple of 15, the S&P 500 would come out at 1305 in the year 2012, only 13% above the present level. In the near term, when we look at the late 90’s economic and financial bubble, the record debt levels, low savings rate and vast overcapacity, we believe that the current high market multiple places the market in great danger of a precipitous decline.”

### **Bond Market**

A December 15, 2001 article by Reuters quoted the most successful bond manager in the country (\$229B under management) Bill Gross as expecting good returns from bonds over the year 2002. He, along with us, believe that concerns about the Fed raising interest rates anytime soon is as he says “an exaggeration almost as bad as my claiming to nearly having played Duke basketball”. He also agrees with us that bonds are likely to outperform stocks next year. Where we part company with Bill is in the use of corporate bonds rather than government bonds. He along with most all fixed income managers invest for yield only. As you know, we invest also for capital gains. Corporates do provide more yield but on a total return basis they can’t compare. He does, by the way, believe governments above 5% represent good value.

A paragraph in the same Reuters article hit on what we believe will be the “bear trap” of a lifetime for bond market investors. “With yields on any treasuries now at levels not seen in decades, many Wall Street investment banks are now urging their clients to buy more spread product (inferior quality to governments). This they say should help them improve their performance relative to treasuries as the U.S. economy recovers even if interest rates rise and their absolute levels of performance suffers”. What utter nonsense! ***This is one of those classic moves made by the street which led to our white paper – A LICENSE TO STEAL. Chasing yield by lowering credit standards is a fool’s game. It’s the bond market personification of “all the pigs end up in the slaughter house”.*** As best we can tell, the idea began at Merrill Lynch and trickled down from there. The industry went to their customer’s book and the switch was on. This we believe caused the sharp reversal that occurred in early November. The government long bond went from 4.75% to 5.62%. In hindsight, this will be the “daisy cutter” that will keep the long-term corporate and municipal bond investor from achieving the large capital gains that we see in the future.

What should we do now? We stay the course. Our program achieves the highest rate of income among the highest quality assets in the world. As always, it’s the capital gains that remain uncertain as to how much and when. All of us want to make it happen tomorrow but it’s those that buy into the street stories that make the market. They will come around because we have the fundamentals on our side and guess what-- we will let them own our bonds at the top of the market in price (low in yields) and say thank you very much.

Don Peters

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