

Economic Commentary



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

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The Correct Belief System

Charles Koch is a legend in his own time. A corporate executive par excellence. As well as one of the greatest corporate citizens the community of Wichita, KS has ever had. Charles' business history was recently featured in the Wall Street Journal of May 6-7, 2006 in an article authored by Stephen Moore. He is a consummate libertarian and a follower of Austrian economics. We like to believe that in a very modest way our company, Central Plains Advisors, Inc., has many of the same attributes as Charles' company Koch Industries. Let us emphasize very modest. We are libertarian in philosophy and follow the Austrian Economic Model in our management of fixed income portfolios. We will use this same model when we once again manage common stocks, if and when they attain more reasonable valuations. As you may recall, we asked all our common stock clients to move to bonds in 2000. Those that did not accepted our resignation. We remain on the sidelines regarding common stocks to this day.

We would like to quote Charles as it pertains to his management of the largest

private US corporation, having \$60 Billion in sales and 80,000 employees. "We couldn't have achieved the profitability we have if we had been a public company. No investor would have been patient enough to allow us to build a firm oriented toward long-term growth and profits. The short-term infatuation with quarterly earnings on Wall Street restricts the earnings potential of Fortune 500 publicly traded firms. Public firms are also feeding grounds for lawyers and lawsuits." He goes on to say, "Regulatory laws like Sarbanes-Oxley will only increase the earnings advantages of private firms." His company recently took over public company Georgia Pacific and he expects many more to come his way. We personally know of some that have. His point with reference to the management of a corporation is the same as ours as it pertains to money management. Wall Street and the regulatory agencies are the nemesis of good long-term performance (profits in the case of Charles) everything is quarter-to-quarter. The long-term is next days quote. One needs to hire lawyers and accountants in a massive CYA effort to keep the Monday morning quarter-

backs and their lawyers at bay. Huge New York firms pay hundreds of millions of dollars in fines in order to obtain billions in commissions and fees. We of more modest size are out of business on any minor violation that might create a whisper in the client base. Most all follow a Keynesian Economic model that is flawed economics at its very best, but is accepted almost 100% by the financial community. Academe wallows in such drivel. It is no wonder that the average investor obtains less than one half of the market indexes while chasing the next hot idea perpetrated on the public by the shills on the Street.

Austrian economics, on the other hand, believes in free markets, human action, and the study of micro as opposed to macroeconomics. It stresses the long-term and individual entrepreneurs as the creators of true wealth and prosperity for all participants. The short-term is filled with chaff; the long-term reflects economic fundamentals. "Econometric" models and other attempts to make the study of economics a physical science are devoid of reality. Humans make markets, not formulas. Although we cannot come any-

where close to equaling Charles' success, we do share his philosophy, economics, and management style. It has allowed us to have arguably the best record in government bond management in the US. We join in the praise of Hayek, Von Mises, Menger, and Schumpeter, who are the true purveyors of solid economic thought. They were right on their prediction of the 30's due to the monetary policies of the 20's and they are right again today. Greenspan was like John Kerry, his analysis at first (with reference to the Great Depression) was right, but later it proved to be wrong. Bernanke was wrong from the beginning.

If one follows an economic model that failed to assess the reasons for the greatest depression in our lifetime, why should one pay any attention today to their assessment of the present economic and financial markets outlook? One should not, although many unfortunately do, as the Keynesian's dominate the financial landscape. In our mind they are the primary reason for poor investment results. This applies both to the investment manager as well as investor.

Recent Trip

On another matter, the principals of Central Plains Advisors, Polly and Don, spent a week recently touching base with

our economic research contacts that have served us so well over the years. The most difficult decision one makes in this business is finding those of superior intellect and market judgment. It is much like finding a needle in the haystack. We at Central Plains are near the top of most performance databases of which we are aware. To stay there is our challenge. We intend to do so. Along the way we met with several clients and prospects. It was interesting to note that our basic values were much the same. It really is true that "birds of a feather flock together."

Current Views

One of the many subscriptions we take is Richard Russell's Dow Theory Letters. The following is from his website of 6/27/06. We believe that Robert Reich could not be more right, and would ask that you read this over and over again. This is our economic environment, and it will determine the markets, perhaps not every minute, not every day, not every week and possibly not every year. The proper consensus will arrive. When it is otherwise as it is today, you buy and hold long-term government bonds. When it arrives, you sell them and that is exactly what we shall do.

The Reich piece on the next page is the big pic-

ture. It is not cyclical in nature but rather secular. These are the plain hard facts. China and India along with others primarily in Asia are building their economies from the ground up. They are intelligent hard working people with abundant, almost overabundant sources of labor. They export goods and services and we consume. That will be the way it is until they develop a middle class. At that point worldwide prices adjusted for productivity will become somewhat similar. Until then, the US is under heavy deflation pressure. Within this long secular trend there will be cyclical episodes in which patterns of the past seem likely. That is what is taking place now. For over 4 years those who refuse to understand globalization economics have harkened back to the 1970's and concluded that once again inflation was about to turn us in to a "banana republic". Cooler heads prevailed until the start of this year. The constant drum beat of inflation, inflation, and more inflation finally caused the bond market vigilantes to abandon ship and sell the long end of the curve. The psychology of fear of loss coupled with losing sight of the big picture once again captured the day. Rest assured, however, it will not prevail. The fundamentals are with us and they always win. Be resolute.

Deflation, not inflation, is what Ben Bernanke should be worried about.

By [Robert B. Reich](#), former Labor Secretary under Clinton.

Each generation responds to its own traumatic memory. Ben Bernanke and his Federal Reserve remember the double-digit inflation of the 1970s and are determined to mount a preemptive strike. That's why they're poised on raising interest rates yet again. Bernanke and company have no direct memory of the trauma that haunted the previous generation, the depression of the 1930s.

Each generation, in its determination to avoid the nightmare it does remember, runs the danger of over-reacting, and thereby bringing on the opposite trauma. A generation ago, economic policy makers paid too little attention to inflationary forces then building in the American economy. Eventually, Paul Volcker had to break the back of inflation by raising interest rates sky high. That put the economy into a severe recession. Now Bernanke and company are paying too little attention to deflationary forces building in America and the global economy.

Bernanke fears that today's economy resembles the one that began to overheat the 1970s. But he's wrong. Labor unions today don't have nearly the power they did then to get wage increases. Big companies don't have nearly the power they did then to raise prices. Global wage competition is keeping a lid on American wages, just as global price competition is pushing down on American prices. Meanwhile, fancy computer software is allowing rivals all over the map to erode almost anyone's market share. Who's going to raise prices in this environment?

What's more, there's no reason to raise prices. Productivity has been soaring over the last five years while the median wage has been stuck in the mud. Wages, remember, constitute about 70 percent of the cost of doing business. So how can price pressures be building? Bernanke and company worry the U.S. labor market is heating up. They're wrong here, too. Despite what look like rosy employment numbers, a smaller proportion of the American labor force is employed today than it was in 2000. Millions of people don't show up on the unemployment rolls because they're too discouraged even to look for work.

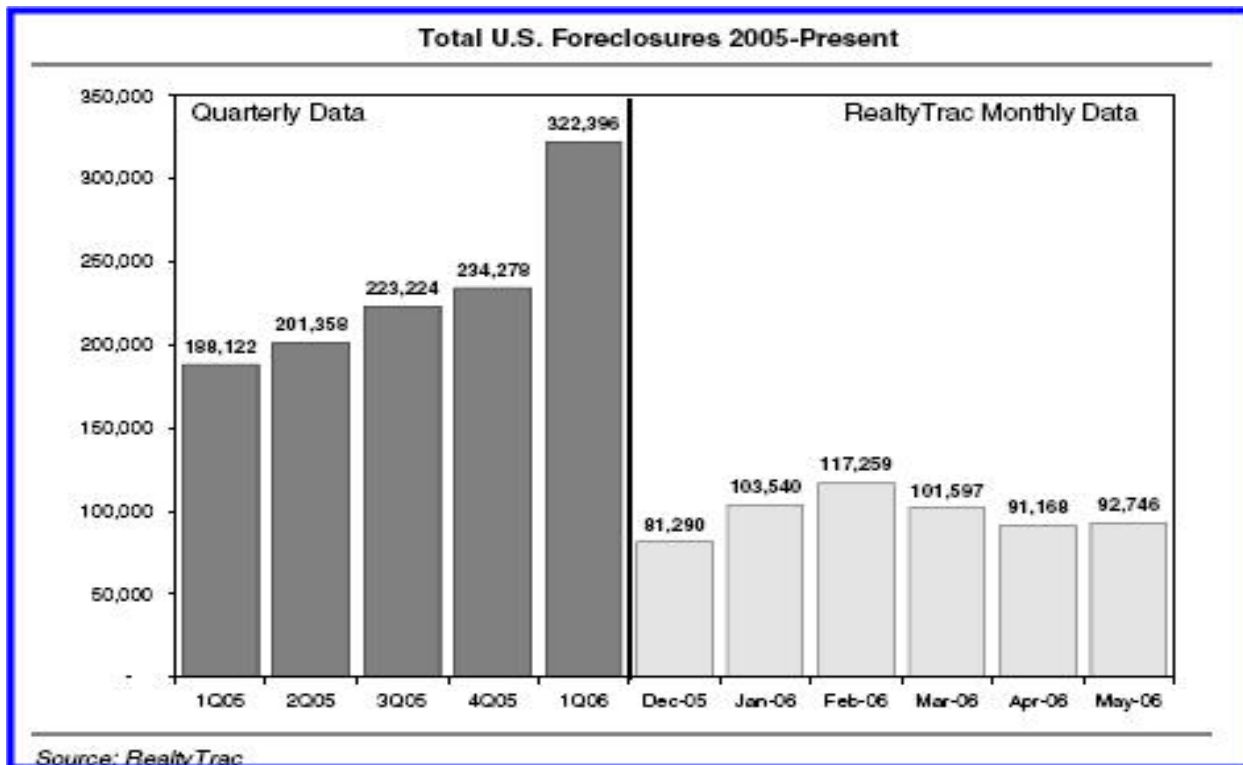
The price increases we're now witnessing are not due to excess demand over limited productive capacity, which causes inflation. They come mainly from soaring prices for energy and raw materials. These commodities are being bid upward because of China's rapid growth, but take a closer look and you see something else going on. Much of the increase in commodity prices is being driven by speculators who expect prices to continue to rise. In other words, part of what we're seeing are speculative bubbles. Such bubbles can burst any time. The fact is, the global market is glutted with productive capacity, and that's not chiefly because of the huge gains in American productivity. If you really want to see a glut, take a look at China.

If anything, there's too much capacity relative to demand. This is a recipe for deflation. Prices can begin to drop because buyers hold off, expecting further price decreases. It happened in Japan in the 1990s. It's already starting to happen in certain housing markets in the United States that had been red-hot but are now cooling so fast home prices are dropping. Deflation is often accompanied by stagnant or falling wages, which make it harder for consumers to afford to buy. Look what's been happening to American wages.

The Fed and other central bankers around the world are raising interest rates because they're fighting the last war. But they already won that war. Inflation is no longer our biggest threat. They ought to be worried about the war before the last one, and the specter of deflation. They're in danger of losing that war even before they know they're in it.

Robert B. Reich is co-founder of The American Prospect. A version of this column originally appeared on Marketplace.

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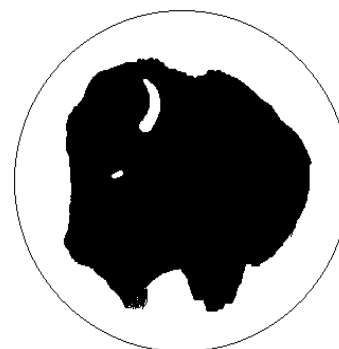
Housing is the Key

Lagging real incomes and heavy borrowing, primarily by using one's home as an ATM machine, has placed the US consumer in serious financial shape. Borrowing to sustain one's standard of living can go just so far, especially when consumers are spending the wealth as opposed to the creating the wealth. The spending of ones equity in his home has the effect of liquidating room- by- room ones place of habitat. The American consumer is becoming homeless. This is serious business. Housing prices in many respects have the character-

istics of the stock market. After its original creation (house being built, company being capitalized) the market is subject to the laws of supply and demand. For every seller there must be a buyer. Wealth can be decimated in a heartbeat by a marginal seller. Many times the weakest among us is the seller in a down market. In an up market, which we have had in housing, the top is created by that same weak marginal buyer who has seen all his friends get "rich" and just had to join the fray.

The aforementioned top is in. Please note the above

chart depicting the change in the housing market place.



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