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Economic Commentary

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Before We Start—The 90-90 Prophecy

Tom Peters, in a recent Time article, made the following prediction. “I believe 90% of white collar jobs in the U.S. will be either destroyed or altered beyond recognition in the next 10 to 15 years. That’s a catastrophic prediction given that 90% of us are engaged in white collar work of one sort or another.”

We have no reason to believe that Tom’s prediction will not be the result of the new information economy. Therefore, this is the very reason we are so concerned about the possibility of deflation. Over the long-term, there will be a new paradigm. We are indeed in revolutionary times. Our concern is, that between now and then, public policy may cause the difficult transition Tom expects to happen. The Internet dot. coms are laying off people right and left. It would appear that the bloom is off the rose for now. The natural evolutionary process within a revolutionary economic occurrence is to be expected. Most dot. coms will fail, however those that survive will undoubtedly merge with old economy money to make the long-term dream come true.

Goliath Will Win This Battle

There are visible signs that the economy is commencing a slowdown in economic activity. As we have all seen this before, for a quarter or two, we think very few folks believe this is the real McCoy. That being the case we doubt the Fed is through raising rates. A real catch 22 is taking place. At every sign of economic slowing the stock market advances. This is called “Seeing Over The Valley” and every time it does, (under present Fed policy), they must knock it down. The upcoming elections may suspend rate hikes for a while, but we suspect the market vs. the Fed struggle is not over. Let there be no mistake, the Fed will win this fight. Under normal circumstances, the market action described above makes good sense. However, with over consumption, over borrowing and over confidence in the rewards available from the stock market, the American public is flirting with economic disaster. Due to all of the “overs” described above plus the over exaggerated media coverage, the Fed has a huge challenge to overcome. In their mind they must win now with an almost certain economic thud, but if this does not happen, then a downturn of a more severe nature will occur later.

As you know from our previous newsletters we doubt that this Fed action is the proper policy. Our major concern has been their lack of understanding that we are facing a potentially serious deflation threat. Tight money policy will exacerbate this problem. However we are deeply concerned about the only real inflation around which is in the stock market.

The recent P/E ratio of 30+ on the S&P 500 is just not sustainable. Demographics have undoubtedly played an important part in the elevated ratio. A recent study indicates however that only 35% of the rise can be so explained. If the study is correct, then a multiple of 20 would seem proper under today's circumstances. That leaves the market somewhere between 33% - 50% overvalued.

Before we leave this subject some interesting statistics might be of interest. Our best guess is that barely anyone is happy with their investment performance over the last year or so. This has been an extremely difficult stock market. Before the recent rally, 82% of the common stocks on The NYSE were lower than they were 2 years ago. Maybe you expect you and/or your advisor to have excellent returns during such a period of time. However to have "a bumper crop" when 82% of your land "is hailed out" is a tough assignment. Money is on the move from manager to manager and fund to fund during these times. Unfortunately, it is the human condition. This is why all studies we have seen show that the individual investor always does worse, much worse, than the underlying investments he has owned over time.

Hulbert Newsletters' 20-Year Performance

<u>Newsletter</u>	<u>Annual Gains Through 3-31-00</u>	<u>Us vs. Them</u>
Prudent Spectator	20.0%	72%
The Chartist	18.4%	78%
Value Line Institutional	18.0%	79%
No Load Fund X	16.9%	85%
CPAI (Don Peters)	14.3%	100%
Dow Theory Forecasts	13.3%	108%
Value Line Special Situation	12.6%	110%
The Outlook	12.0%	114%
Market Logic	11.4%	119%
Growth Stock Outlook	11.2%	128%
Six Others	6.6% and Lower	217%

Hulbert Has It Right

We love to cite Mark Hulbert's work which is well respected in investment circles. He is a Kansas boy who has made it big in the big city. In the June issue of the AAI Journal his article entitled How Newsletters Stacked Up Over The Last 20 Years show the above results. Even more important is his opinion of what characterizes the top performers. He says, "The absence of any immediately apparent pattern among the top or bottom performers has inclined me to conclude that there is no one road to riches—or to ruin. A corollary is that no single strategy works best all the time. Even the soundest of long-term approaches will experience short-term periods along the way in which it is out of sync with the market." The only change in the previous chart is the addition of CPAI in the mix. We use bonds only compared to the newsletters which are almost exclusively common stocks.

Hulbert also says, "There is one characteristic that I have discovered that does distinguish the top performers: discipline. They were willing to stick to their strategies during the discouraging interludes in which they were lagging the market or even losing money. In fact, I think that the importance of discipline may be the most important lesson to emerge from my 20 years of tracking investment newsletters. It is what keeps us from dumping a good long-term strategy because of short-term under-performance. Without discipline, we are all too likely to dump a strategy at the wrong time, and then compound the problem by jumping on the bandwagon of a winning strategy, just at the time it is about to lose its "hot hand."

Economic Outlook

If the weaker economic numbers do ignite the stock market again, then even higher interest rates will be coming our way. If the market stays relatively flat, then economic growth will likely continue to soften. It has been the capital gains that have fueled consumer spending. Either way we don't see any other outcome at this time. The final result will be slow to no growth later this year or next. Growth moving from almost 5% to 3% will put profits in a tailspin. 1% or less will launch deflation. Pricing power is non-existent. Inflation is not a problem.

Again, now that the Fed is on this track, we believe the die has been cast. The hope for a soft landing (a la 1995) could happen again, but we believe one shouldn't "bet the farm."

Stock Market

We believe it is entirely likely that the great bull market of the last 17 years is coming to a close. Total returns in the neighborhood of 10% to 12% are more likely in the future. Over the next year or two they may be somewhat less. It's not out of the question that negative numbers will come to pass. Over the very long run, common stocks will remain the asset of choice. 50% to 70% allocation in stocks makes sense, however, there is a time and place for most everything and over valuation remains a problem.

Bond Market

On a recent business trip we were admonished by the executive of a large pool of retirement funds, to not say that interest rates may go to 3%. “Nobody will believe you and you are certain to lose credibility”, he said. When 30-year governments were yielding 14% in 1980 we projected 8% within 5 years. This did indeed turn out to be correct. For sure, most disagreed, but then shouldn’t we tell you what we really believe as opposed to conducting a PR program? Haven’t we seen enough of that over the last 8 years?

We expect a 3% coupon for long governments sometime during the next 3 years. There are things that can change this outlook, but none are in play at this moment. We shall watch carefully, but as of now 3% is our prediction.

We believe it is important for you to know that over the 5 years ended 3/31/00 we have left our portfolio of bonds unchanged. We did this very same thing for the 4 years ended 12/31/80. The following are our results for these two periods.

	<u>Don Peters</u>	<u>Lehman Govt/Corp Index</u>
5 years ended 3/31/00	13.7%	7.1%
4 years ended 12/31/80	12.2%	1.0%

Our reasoning today: Deflation probability
Our reasoning before: Inflationary probability

During the intervening years we have averaged some two and one-half moves a year. Why have we done what we have done? **DISCIPLINE!** We follow an Austrian Economic model and it works. Sometimes it says to hold’em. What it doesn’t say is to worry about what everyone else is doing. A recent 14 year study by Dalbar found that equity investors earned 5 ½ times lower average returns than a simple buy and hold strategy. Our 25-¼ year record in bonds earned returns 1 ½ times the index. 1 ½ doesn’t seem like much but note the following.

\$100,000.00 @ 13.7% over 25 years = \$2,477,480.00

\$100,000.00 @ 9.3% over 25 years = \$ 923,643.00

The difference between 13.7% and 9.3% isn’t 4.4%, it’s 47.3%!!!!

Don Peters

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