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Economic Commentary

June 30, 2002

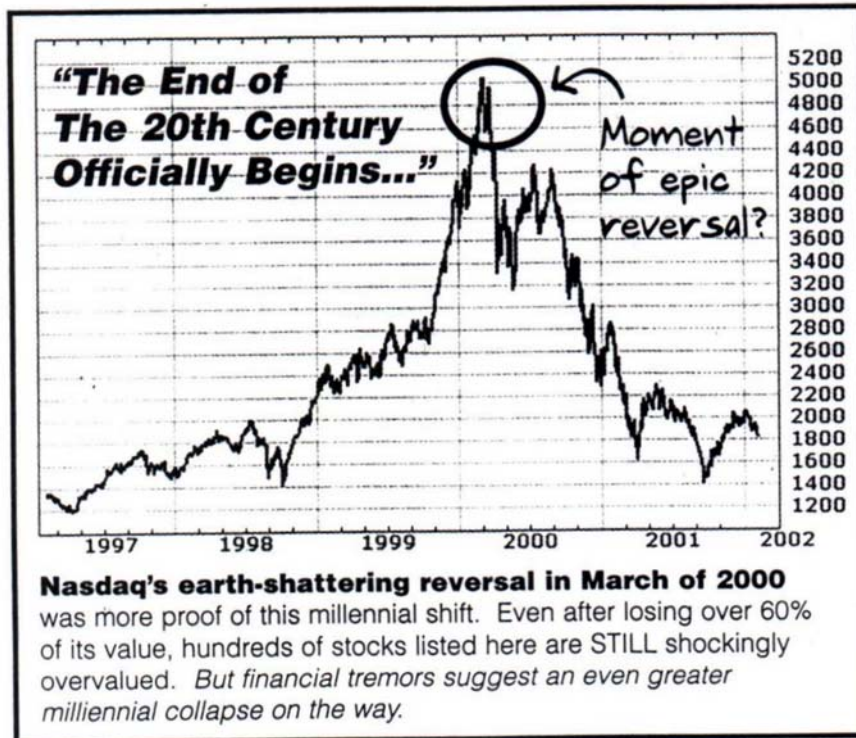
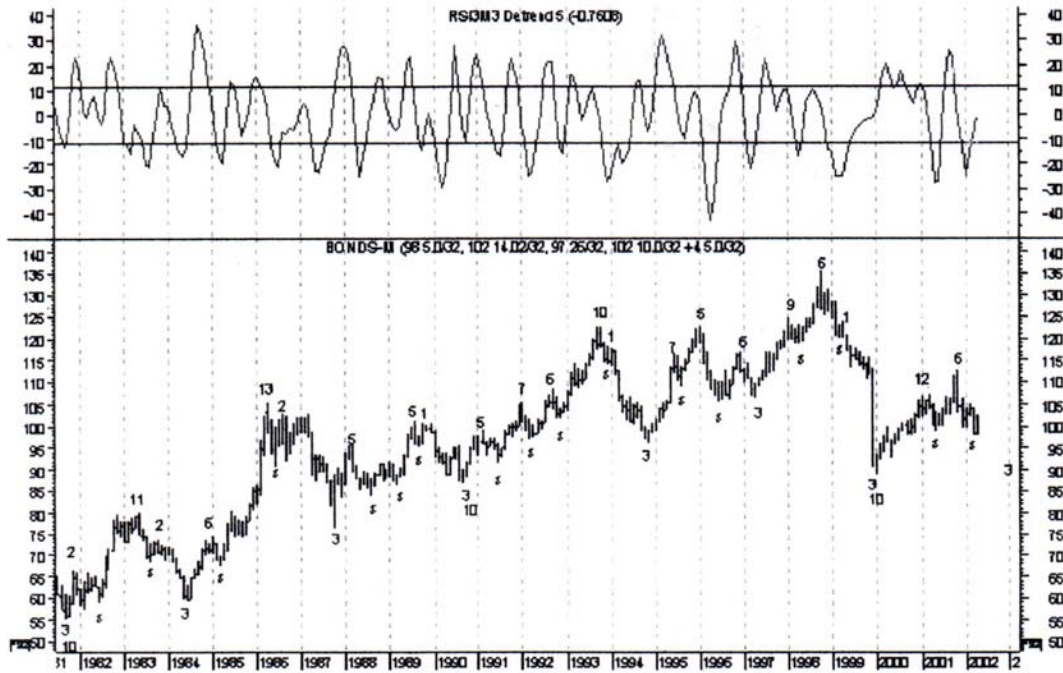
Bubble Bubble Toil & Trouble Revisited

Around March 1, 2002 we sent our clients and other friends a rather exhaustive “Contrarian View” concerning the outlook for the financial markets. Our purpose, quite frankly, was not only to inform, but also to strengthen the backbone, both yours and ours. It is extremely difficult to swim against the tide. As mentioned many times previously, our ability to deliver 1st percentile performance in bonds over the last 27 years is dependent upon being able to buck the wind. Why? Because, at least 90% of those with whom we compete in the market place are following an outdated economic model (Keynesian) propagated by Wall Street economists whose primary interest is *their* profits, not yours. We now are beginning to witness a small but significant change in the consensus macro outlook for the economy, interest rates, inflation and corporate profits, which has prevailed since the 2nd quarter of 2000. For two straight years all we have heard out of Wall Street has been recovery next quarter, inflation will follow and corporate profits are sure to explode on the upside. *Bond Dealers Pare Forecast For Fed Rate Increases* was the title of a Bloomberg article dated 6/10/02. Probably the most telling quote came from Jim Glassman, senior US economist at J.P. Morgan Chase. “We had been hanging on, thinking that any month now we’d have a strong employment pickup, but the numbers suggest a lack of momentum in the job market”. Stan Shipley, senior economist at Merrill Lynch commented, “We have weak auto sales and tepid consumer spending; with no inflation prospects, the feds are not going to be in a rush to raise rates.” The worm is turning and if we stay hitched we’ll be there for the reward. Another one of our themes has been the expectation that returns on common stocks would become much lower over the next 3 to 10 years. It led us to an admittedly self-serving position that one should consider allocating more to bonds than previously. Not forever, but for now. We continue to strongly believe that Jeremy Siegel, finance professor at the Wharton School of Business, is right in regard to his book Stocks For the Long Run. By the way, we don’t believe in his efficient market theory. Here is his recent direct quote, “We’re entering a world of lower returns this decade and investors are going to have to get used to it.” If one does increase his bond allocation the type of bond that you buy will be very important. Our economic model indicates that anything lesser in quality than direct government bonds will require the assumption of unusual risk.

1999 Revisited

To this very day we have remained puzzled as to why the bond market acted as it did during the year 1999. Based upon the Austrian economic model, it was clear sailing. Or so it should have been. We did know, of course, that there was a flight from bond mutual funds. Net redemptions were quite high. On the other hand, inflation was at bay and the economy appeared to be doing well. It was somewhat of a puzzle. Our thought was that maybe “cocktail talk” turned conservative investors into rank speculators. The latter part of 1999 and the first quarter of 2000 were after all the “tech bubble blowoff”. We now are convinced that this was exactly the case. Please note the following two charts. Of particular interest is the last several months of 1999. Bonds fell like a rock and the NASDAQ went parabolic on the upside. After the NASDAQ had doubled in two years sanity was thrown to the wind. Seeing one’s neighbors (Ken and Barbie) driving a new red convertible evidently was just too much for

those of us who made our money the old fashioned way. The pied piper won. But the game is far from over. We believe the next 3 to 5 years may be our best.



Investment or Consumer Spending Bubble?

Forever, it seems we have been talking and writing about an investment bubble that blew out in 2000. Comparisons have been made to the rail boom of the late 1800's and the auto and radio boom of the 1920's. Again, referring to the “contrarian view”, we made a strong case that the high tech boom was analogist to the hundreds of motor car companies that ended up with three strong companies. The work of Dr. Kurt Richebacher has just about convinced us that the bubble wasn't really in technology, but

rather a huge consumer spending frenzy that in effect has consumed the “seed corn” of our economy. We would like to present to you his thinking. If he is correct, then the slow economic growth we see in the future may be even slower than even we thought. Either way the need for restoration is profound and it’s going to take considerable time for healing.

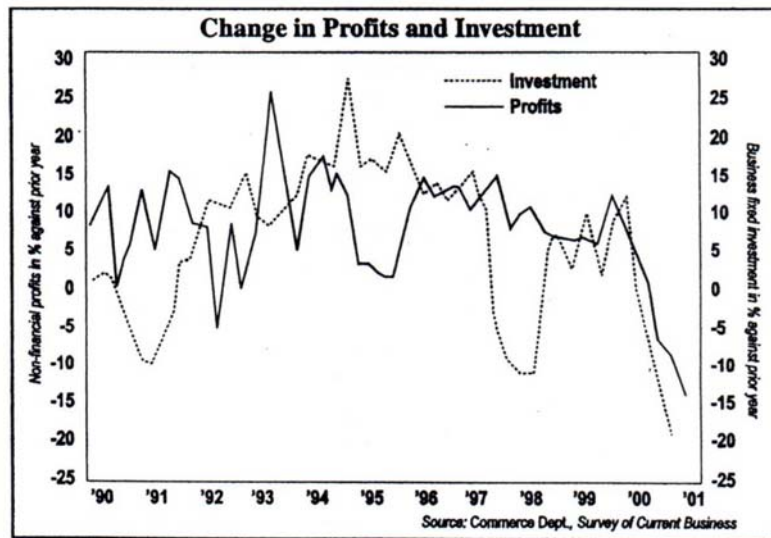
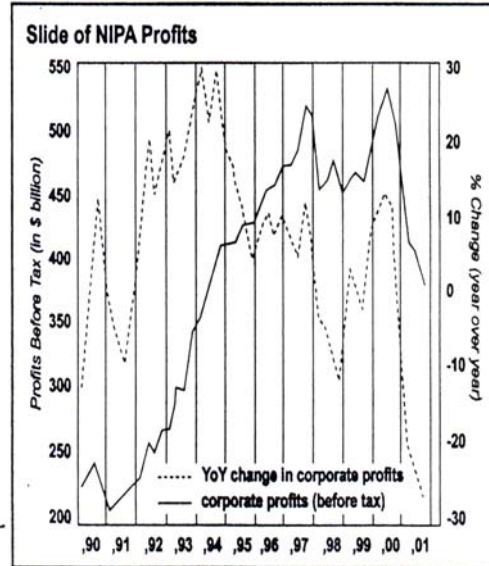
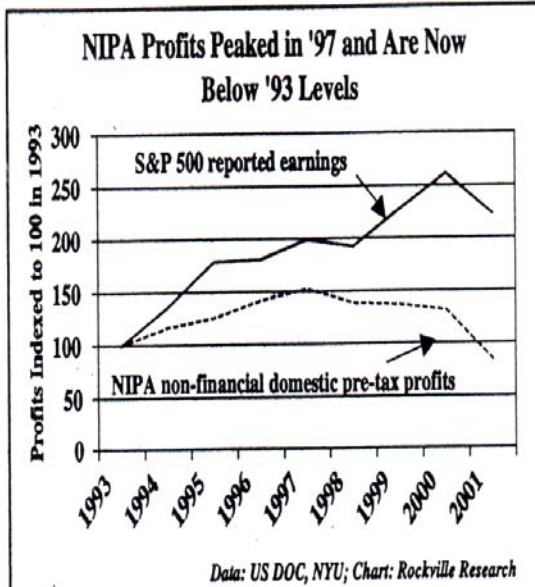
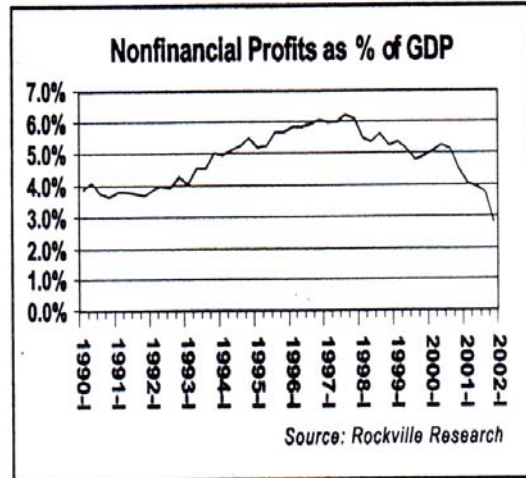
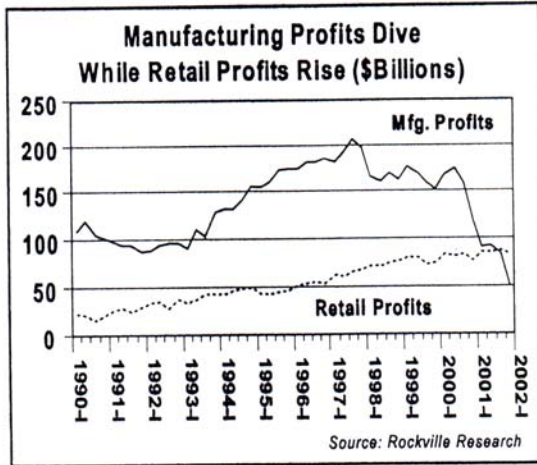
First of all, we all need to understand that the greatest growth factor in the American economy (or any economy) is net investment in what the Austrians call higher production goods. Goods such as machine tools or those for the extraction of raw materials. These are early stage items, which are used in or are a part of final goods, which are purchased by the end consumer. There is a huge multiplier effect here that does not occur at Wal-Mart. Why? The labor content for example of making machine tools is then followed by additional labor that is needed for the final consumption items, and of course storage, distribution etc... When you buy a coffeepot at Wal-Mart it’s all over. The fat lady has sung.

Secondly, we need to understand that supply always comes before demand. Was there originally a huge demand for beanie babies or hula-hoops that caused entrepreneurs to make these items? No. What is it that motivates the making of these items? The possibility of profits. What is it that expands or closes down the operation? Demand or lack thereof. The point is that in a capitalistic society profits are the single most important ingredient to economic growth. If we don’t have it we don’t get it. Come to think of it, that’s true everywhere. Socialistic countries have slow to no economic growth as there is no profit motive. The last point to keep in mind is that GDP numbers are just that – numbers. These measure the total value of goods and services produced and purchased during a given period at the final stage. What is left out are the intermediate stages. This is done due to the possibility of double counting, and there would indeed be some. Estimates made by those we believe have a good handle on economic data say the consumer is not 70% of economic activity but rather 35%. This is yet another illustration that business is much more important than the consumer, but where do you hear that? Only from the Austrians. With the above in mind, let’s chase around some numbers and graphs to ascertain, if we can, what’s happened to what most people believed was a new economic paradigm.

A look at the 1995 to 2000 capital spending items reveal that of the gross amount spent, \$533.2B, as much as \$300.8B may be questionable. For example \$190.8B was hedonic counting (value adjustments) and \$110.0B was a reclassification of software expenses. If one then deducts from the resulting figure \$232.4B ($\$533.2B - \$300.8B$) depreciation charges you end up with \$110B of net new investment. No capital spending boom here! On the other hand consumer spending has reached 70% of GDP - an all time record. We realize there are some inconsistencies in these numbers but it’s obvious that capital spending was not all it was cracked up to be.

Let’s get back to the profits – where did they go and why? This recession has been much different than any other post WWII. The usual pattern was for the economy to overheat on the upside to the point that the Fed raised rates and restricted availability of money. This action would cause the consumer to retrench and incentives to decline, along with housing and then capital spending. Profits were about the last thing to suffer.

How about this time? We know that consumer spending and housing have continued to be strong until recently. Therefore, why the recession? The answer is: extremely weak corporate profits which are hidden in the GDP numbers. Frankly, they have just gone to hell. See the enclosed insert.



It is apparent that profits started their decline some 4 years before the recession. In “normal times” as mentioned above, recessions cause profits to decline. The reasons, we believe, are as follows:

1. **No pricing power – capacity worldwide is enormous.**
2. **Malinvestment in profitless high tech industries.** These are the latest statistics. Profits went from \$23.8B in 1997, \$7.6B in 1998, \$6.2B in 1999, \$3.7B in 2000 and in 2001 a negative \$7.2B. This information comes from the commerce department and is not the amount reported by the companies.
3. **The soaring trade deficit exported jobs and profits to foreign countries.** After all, what private industry earns is derived directly or indirectly from salaries, wages, rent and interest that other businesses have paid as cost of production. To this extent former business costs return to the domestic business sector as revenue. But when one buys foreign goods this flow does not materialize.
4. **Depreciation charges increased during the capital-spending drought. As it is net investment that adds to corporate profits, this increased depreciation becomes a negative.** The reason for this is that business spending on capital investments adds to overall business revenues, but its profit-making peculiarity is that no expenses are incurred until the first depreciation charges set in. From a macro standpoint perspective an increase in net investment equals a simultaneous increase in profits according to Dr. Kurt Richebacher.

Financial Markets

Whether an investment boom/bust or a consumer boom/bust, the results for the direction of the markets will be the same. Stocks remain under pressure and the bond market is a good news/bad news dichotomy. High quality bonds will do well and lesser quality bonds will do poorly. Watch your step out there, we are in dangerous times!

A Final Comment

McKenzie and Company studied U.S. productivity numbers and decided it applied to only 6 industries and Walmart was responsible for most of it. Speaking of Wal-Mart, the other day they announced better than expected same store sales and that led to a 100-point rally on the Dow. Is that good news? No it isn't. People are trading down.

Don Peters

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