

# Economic Commentary



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

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## Are the Chickens Coming Home to Roost?

Central Plains Advisors believes that we may be approaching a crescendo from both an economic and a market standpoint. There are hints everywhere, which suggest things are coming to a head. A few examples, if you please.

1 Oil prices are booming and this is bound to either (a) accelerate inflation or (b) bring the economy to its knees. We think the latter, however the market remains unsure. Recent talk of \$105 per barrel, or more, may very well be a self-fulfilling prophesy, but we well remember such talk 25 years ago just prior to a serious 1981/82 recession. In the short-term, anything can happen, in the long-term a recession, a substitution, a new supply, or combinations thereof, can change prices considerably. Oil prices, of course, are only one of the commodities that have been on a tear over the last several years. If ever there was a near 100% consensus in the marketplace, it's been the hard asset move of all kinds of commodities. Particularly heavy in this area has been the hedge funds, which have grown from little to nothing after the Long Term Capital Management

blow up which, as of now, is right at \$1 trillion.

Endowments, pension funds, and other institutional type accounts have amended their investment guidelines in order to hopefully recoup their annual returns using commodities after having been hurt badly in the equity cult move over the last 20 years. This is, in our opinion, a serious mis-read of the economic landscape. There seems to be no appreciation at all of the non-organic build up of demand as the driving force in the world economy. Most all end demand comes from the U.S. and it's being fueled not by income, but by debt. The information bubble of the late 1990's has been and continues to be deflationary—a cost cutting measure of the first order.

2 Non-financial private debt creation (ex-government) is unbelievable. Over the four years ending at 12/31/04, \$5 trillion have been added to existing debt totals. That's on top of \$4 trillion during the previous 4 years. Over 40% of that is mortgages.

The consumer's total debt load is \$10.3 trillion and growing at a rate of \$1 trillion per year. This just must stop! Greenspan and his group of economists consider this not to be a problem as the consumers net worth has advanced sharply. This, of course, is true, but what happens

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when the various markets go down? They do go down from time to time, you know. To top it off, what is not included in these particular debt figures is our domestic financial sector. In 2004, \$802.2 billion was raised and this was the lowest amount since \$805.4 billion in 2000. The year

1997 was the start of the explosion in financial debt. During the years 1992 through 1996 the average increase was \$404.3 billion per year. Do you think there might be a problem if those who loan money are also borrowing money in record numbers? Would it make you nervous to know that there is no savings in this country, and all this money is coming from overseas? All together in 2004,

credit market debt advanced by \$2.71 trillion, 25% of the GDP. Since the recession of 2001 (2002-2004) the increase has been \$7.6 trillion. To that we say “all that meat and no potatoes.” By that we mean all that debt and very little growth to show for it. to use a more modern parlance, “very little bang for the buck.”

3 General Motors is on the verge of financial difficulties. They just recently announced a 28% reduction in their white-collar workers. Please keep in mind on an individual business basis this makes sense, but overall this hurts the economy. On a macro basis this represents a reduction in the size of the economy. Have you noticed that when a company announces a layoff the stock most often moves up in price? This is a prime example of micro over macro thinking, which rewards the short term over the long.

4 Fannie Mae and Freddie Mac, which have been responsible for much of the “housing bubble” are slimming down to size. In many respects, that is a good thing as their “measured” retreat from the exploding housing market may allow it to adjust to less credit fuel. But guess who has come to the rescue? You’re right, the banks. Bank loans increased \$403 billion or 9.1%, a new record

Figure 1

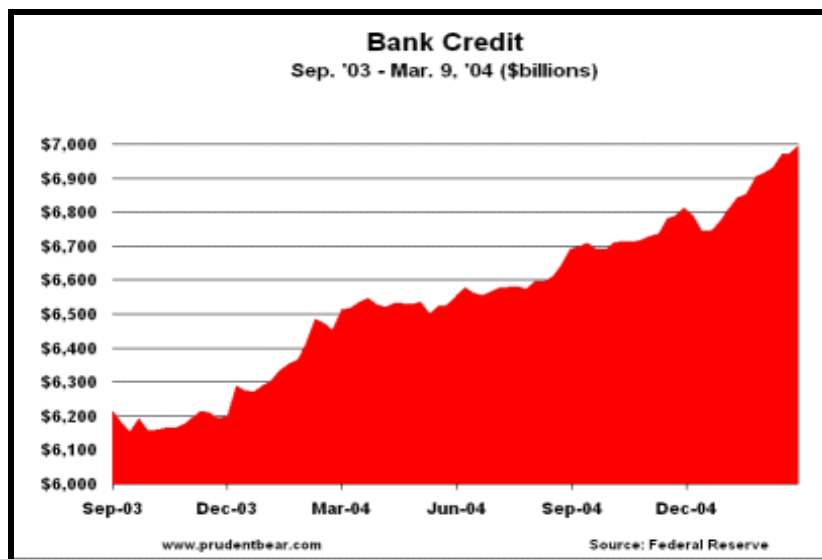
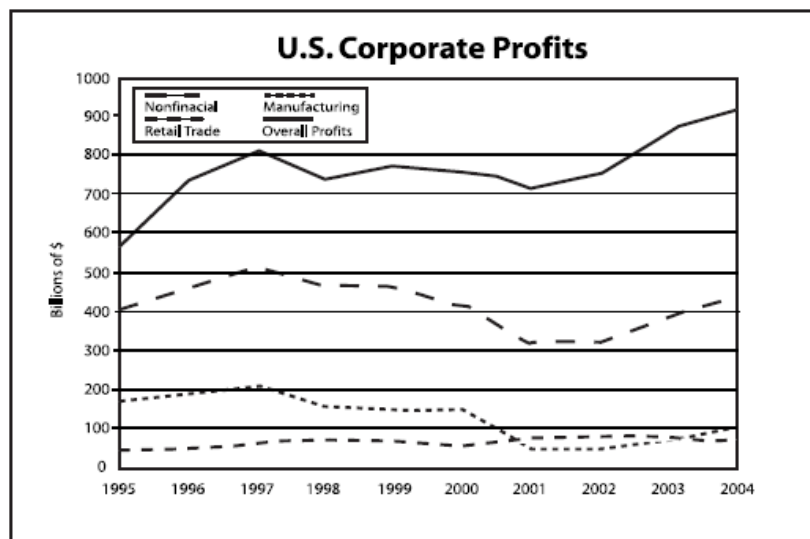


Figure 2



in dollars and the strongest percentage increase since the 2000's of 10.6%. Do you see anything ominous in this? 2000 was the year before the 2001 recession. Do you remember our attribution of the banks being the marginal player in the financial community? Please note Figure 1. Will there be anyone to replace the banks? We don't think so. A move toward a liquidity squeeze may be in the cards over the next several months or

so – at least by this time next year.

5 All the increase in profits since 1997 have been in the financial companies and this does not include GE, GM or Ford among other “banks”. Please note Figure 2. The combined 1<sup>st</sup> quarter 2005 financials have just come out for the likes of Bear Sterns, Lehman Brothers, Goldman Sachs and Morgan Stanley. Figure 3 has some highlights.

Figure 3

Revenues	\$31.6 Billion	29% From 1st Quarter '04
Principal Transactions	\$9.3 Billion	11% From 1st Quarter '04
Investment Banking	\$2.6 Billion	13% From 1st Quarter '04
Commissions	\$1.5 Billion	-2% From 1st Quarter '04
Interest & Dividends	\$14.9 Billion	63% From 1st Quarter '04
Interest Expense	\$12.5 Billion	74% From 1st Quarter '04
Net Income	\$4.2 Billion	20% From 1st Quarter '04

What is the problem? Don't we want Wall Street to be profitable? Yes, but what about Main Street? Answer – little to no increase in profits here. The imbalance we see here accounts for the variance in high scale vs. low scale merchandise sales over last year. Firms such as Nieman Marcus, Nordstrom's, Abercrombie & Fitch, and others have experienced robust sales, while retailers at the middle and lower end have done poorly. Isn't it interesting that several of these high end retailers put themselves up for sale?

The final showdown may be on the way. It's the Austrian vs. Keynesian economic truth test. We just don't believe it is possible for us to come out of this huge debt accumulation period without suffering considerable pain. Never in recent years have we seen such a divided opinion as to the economic future. The sell side Wall Street inflation machine has moved to hedge funds and commodity pools in order to hopefully achieve something north of 5% annual returns. On the other hand, there are some, including us, which

believe deflation is in our future as markets correct both asset and debt bubbles.

**Is it Impossible to Achieve Good Investment Returns?**

We continue to be amazed by the lack of good returns achieved by most all participants in the financial markets. It seems as if the only profitable sector of the investment equation is the broker/dealer and his hordes of sales people. Note the recent profit picture of Wall Street reported earlier. Dalbar Associates continually updates their performance findings of individuals and we recently combined their findings of individual returns with those of professional companies to market indexes.

**Dalbar Associates**

**20 Years Ended 12/31/03**

S&P 500 Annual Total Return	13.2%
Individual Investor Annual Total Returns	3.5%

Other recent studies as concerns professional stock and bond managers were as follows: Only 37% of equity managers exceeded the S&P 500 in five-year returns

ended 12/31/2004. Further, only 40% of bond managers exceeded the Lehman Brothers Aggregate bond index for the ten years ended 12/31/02.

There is nothing new in this information at all. We have never seen a period of 5 years or longer that showed anything materially different than that above. As a general rule one must have to say, regardless of one's own high degree of self confidence, that when it comes to investing, individuals do a poor job. But it's also true that approximately 2/3 of all professional managers are nothing to shout about. Good returns are difficult to come by. Obviously, however, it's quite possible. 1/3 of us have proven we can do the job.

Maybe it is the realization of these poor investment results that have most people not wanting to invest a part of their own social security funds. On the other hand, the Federal Government has made only 1.6% over the life of the fund and to boot, they stole the money. It's difficult to believe that most of us could not do better than that.

We believe these low returns are a result of poor information emanating from Wall Street along with behavioral attitudes of individuals which are steeped in emotion as opposed to sound reasoning. Human

behavior seems never to change and many will not own up to the fact that most of us are ill suited to be successful investors. We either think we know more financial matters than we really do or are unwilling to admit to a deficiency we know we have. Our mistakes seem never to be our fault, but if they are, we are quick to find others who have done the same or even worse. Even in the “best of times” its difficult and we think you can tell we believe that we may be close to being in the “worst of times.” We implore you to read the following, which comes from one of the great economic thinkers of our time, Stephen Roach of Morgan Stanley.

### **The Big Squeeze**

“A US-centric global economy continues to run on fumes. In the developed world, the current recovery has been notable for a lack of organic income growth - the wage earnings derived from productive employment. For Europe and Japan, this income shortfall has restrained domestic consumption -- forcing these two economies to rely largely on external demand as their only real source of growth. America has been different: Consumption has boomed even in the face of

subpar labor income growth. Can this anomaly persist?

“The simple answer, in my view, is not for long. America’s income-short, consumer-led recovery is the aberration -- not the norm -- in this Brave New World. It is all about ever-declining personal saving rates, ever-widening current account deficits, mounting debt burdens, and increasingly wealth-dependent consumers. It personifies what I believe is one of the most precarious macro models that has ever existed for a major economic power. It is a model that not only puts pressure on future prospects in the US but also underscores the tensions bearing down on the rest of the world. In my view, income-short growth models are not sustainable - the only question pertains to the circumstances of their demise.

“Strong words, I realize that. But consider the facts: Lagging employment and real wage growth has been a hallmark of the first half of the 2000s in the developed world. Unemployment in Europe and Japan is hovering near-post-World War II highs. The US is in the midst of the weakest period of job creation in modern history -- its unemployment

rate has been depressed by those fleeing the work force. Jobless recoveries have become the norms in most major segments of the developed world. And they persist to this very day.

. . . The endgame is not in doubt, in my view. The American consumer will ultimately cave. It is the only means by which the US will ever “fix” its twin saving and current account problems. It is the timing and circumstances of that fix that we endlessly debate. But the clock is ticking -- especially now as interest rates and energy prices rise. Yet another in a long string of crummy US labor market reports only serves to underscore the obvious: Excess consumption is on a collision course with subpar labor income growth. Courtesy of an unrelenting global labor arbitrage, the “big squeeze” is getting tighter and tighter on the world’s only real consumer.” —Stephen Roach, Morgan Stanley

### **Central Plains Advisors**

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