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## Economic Commentary

March 31, 2002

### The Vigilantes Strike Again

It is extremely difficult to “fight city hall”. In our world, that simply means, it’s nearly impossible to find a way to obtain acceptance of economic truths, when day after day so many report that just the opposite is correct. This they do despite the fact that there is conclusive historical evidence, as well as sound economic theory which backs up Central Plains Advisors position. The most important of these myths are as follows:

1. Growth causes inflation. *Since 1875 the record shows otherwise. It’s a 50/50 proposition – so there is no direct correlation. Other things determine the rate of inflation. Paramount in those determinates are monetary and fiscal policy, government regulation and spending, as well as supply demand factors within the private economy.*
2. Low unemployment (or better-said – high employment) causes inflation. And as an extension of that myth high unemployment is considered a way to stop inflation. *Historical evidence indicates otherwise. Unemployment and inflation were both low during the 50’s and 60’s and both were high during the 70’s. They declined together during the 80’s and 90’s.*
3. Budget deficits cause higher interest rates. *This hasn’t been true anytime in the U.S. other than for short transitory interludes.*
4. Interest rate cuts do not weaken currencies and rate hikes do not make them stronger. *Once again, evidence is contrary everywhere to these long held beliefs.*
5. Devaluation of domestic currencies lead to economic growth. *Name any country that has had lasting prosperity after making such a move.*

These are probably the major myths that persist year after year. It’s the difference between demand oriented Keynesian economics and the classical Austrian supply side view which more accurately describes the nature of economic activity. The simple question to ask concerning which is correct is – does one need to produce before he buys? Nothing starts unless there is production (supply). Supply first, demand later. Did anyone come to the Carney boys here in Wichita and ask that they start Pizza Hut as the demand for pizza was exploding all over the U.S.? Of course not – they took a risk, made pizza and created the demand. As Jude Wanniski would say, “That’s the way the world works”.

Why do we bring up such differences in thought? Frankly it’s in an attempt to keep you and others “hitched” to our bond program. It is a major conundrum that these myths make our program successful, (13.1% returns yearly over the last 27 years) and also what causes us the most difficulty. Let me explain. If it were not for the fact that at least 90% of all the information you as an investor receives (newsletters, television etc...) is Keynesian oriented, we wouldn’t have the opportunity to perform as we have. The reason of course is that this 90% consistently make the wrong moves in the bond market which gives us the opportunity to put new money to work at bargain prices. Then as the proper economic fundamentals bring the results we expect we are all richly rewarded. However, in the mean time your and our resolve is tested day in and day out. These so-called experts absolutely have no clue how this economy really works and why. They perpetuate these myths causing concern and

unfortunately in some cases exhaustion and then capitulation. Please keep in mind we do not have a 1<sup>st</sup> percentile ranking in a \$1.3T fixed income database for 27 years by being wrong. However, we do have periods when our preferred minority position requires forbearance and tenacity. It is the minority position which makes the program work. If the majority accepted our thesis then the “black box” would no longer work its magic. How many times have you seen really black box trading systems blow up when they become the conventional wisdom? It happens time and time again. Unfortunately, most money managers would rather fail conventionally than succeed unconventionally. It’s always easier to run with the big dogs that command the attention and misplaced admiration of the investing public.

On another matter, we are terribly disappointed that President Bush succumbed to the political pressure of raising by 30% tariff duties on steel imports. It is terrible economics and will accelerate the trade war (which started with the denial by the Europeans of the GE Honeywell merger.) The long term net result of this will be a less competitive industry, more unemployment and a smaller world-wide economic pie. The unemployment will occur in the domestic industries which are heavy users of steel and in the long run, the steel industry itself. We think its possible that this will hasten the demise of the auto industry as we know it in the U.S. Is it possible? You bet, look what Ford has had to do right now just to stay competitive, despite the fact that we really haven’t had a bad auto market in years if measured by units sold.

How is the economy doing? It appears as if a bottom in economic activity has occurred for now. What we have experienced to date is an 18-month downturn in the manufacturing area of the economy, 7/1/00 through 12/31/01. Unlike previous recessions, the consumer has been enticed to continue spending by easy credit, low interest (in some cases no interest) rates, dramatic decreases in prices, plus an unabiding faith in the future as spun by Wall Street. In our opinion we are embarking on a brand new world of deflation that will only be recognized well after the fact. Deflation doesn’t necessarily mean disaster, but it does call for new ways of approaching production and consumption. Our major economic concern at the moment is that the old fashioned recession, of which we have had nine since WW II, has yet to come. The order of the decline to date has been: 1) Capital spending, then 2) Inventories. In the past it has been: 1) Consumer retrenchment, 2) Inventories, 3) Capital expenditures. In other words it would seem logical that this recession might have as its final leg down a consumer spending decline due to high debt levels and weak income growth.

The recent data would indicate that although capital spending has not snapped back we should get a bounce from inventory accumulation. Our most positive forward look is that any recovery we might have will be mild and thus corporate profits will be slow in coming back.

### Stock Market

We have had ten bear markets in the last 50 years. The following are the P/E multiples of the S&P 500 at the bottoms.

When	Multiple	When	Multiple
October, 1953	9.0	May, 1970	13.5
October, 1957	11.6	December, 1974	7.0
October, 1960	16.0	February, 1978	7.3
June, 1962	14.2	August, 1982	7.1
October, 1966	13.2	October, 1990	13.9

To date, the low on the S&P 500 was in September, 2001. That low resulted in a P/E ratio of 37.8. Are we wrong or is there a problem here? The average P/E multiple over the life of the stock market has been 15. The average at market lows have been 11.3X. Does 37.8X seem out of place? Does the future look that much better? Toto, we're not in Kansas anymore!

### **Bond Market**

With the 30-year government bond yielding 5 ½% it simply means real interest rates are twice what they should be. Effectively, the bond market vigilantes, with their full faith in Keynesian economics, are giving us the opportunity of a lifetime to put away non-callable, high quality, default proof assets. To not take advantage would be nearly sinful. This reminds us of the early 1980's when inflation was running at 11% and long-term governments were yielding 14%. Real rates were 3% which made the long bond a good buy. Getting people to buy then was like pulling teeth – why? Because inflation was universally thought to be going higher. Today real rates are twice that and all the smart people are again saying inflation is coming back – Why we ask? Who can raise prices? 1990 and 1991 were the best back to back years in the history of the auto industry and for most of that time the only way cars could be sold were through huge price reductions. Many will say that lack of pricing power may be a problem concerning goods, but how about services – particularly in regard to medical expenses. Many things in the service area are difficult to adjust for value content. For example, if a pill now costs \$2 but does twice the work of a similar pill made years ago and sold for \$1 – is there inflation? NO. Let us give you an actual example experienced by the Peters family since the first of the year. My wife, Connie, had an operation which was exactly the same as one done 25 years ago. The hospital costs were \$17,000 this year compared to \$23,000 in 1977. Why the difference even though hospital costs have accelerated greatly over this time frame? Better procedures and superior products were used in the surgery. My friends, that is what technology does to productivity. Productivity is the key to all things good in the economy. But as far as inflation is concerned the increase in hospital room costs show up in the numbers. This is one of the reasons that the CPI (Consumer Price Index) is overstated by ½ to 1% as it is presently constituted. What do the bond vigilantes believe is going to happen if we have a little more growth and productivity? Is there a chance we are going back to using horses and hand held plows again? The often-repeated answer as to why bond market participants (primarily day to day traders) act as they do is twofold. One, they are by far the least understanding of the economy watchers and two, the primary reason for their making a buy or sell recommendation has to do with what they believe the other traders will do. This past week one of the better supply side economists in the country warned of the possible back up in rates due to “what the other fellow might do”. For trading purposes that makes sense. However, as our model relies on the economic fundamentals and as our discipline has allowed us to have 1<sup>st</sup> percentile performance over 27 years, we shall stick by our guns. We do not believe the recent back up in interest rates will last for any extended period of time. Long interest rates at these levels are not conducive to economic growth. For a look at our updated long-term performance, please note the following page.

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