

Central Plains Advisors, Inc.

Economic Consulting and Investment Management 9415 E. Harry Suite 201 Wichita, Kansas 67207

Economic Commentary

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Behind the Aggregate GDP Numbers – Trouble!

With 800,000 Wall Street employees shouting one thing (the economy is sound and growing) and only a handful of we Main Street types saying just the opposite, life does get a little lonely. Especially does it seem lonely when three months of hard fought gains are cut by two-thirds in one day. To add insult to injury, the decline actually came before anyone without inside information could act. Such are the affairs of the speculators on Wall Street versus the investors who call Main Street their home. We understand there is an “inquiry” into the conduct of certain trading firms. But we would guess that there will be, if anything, a multi-million dollar fine levied on those who made billions at the public’s expense. What is all this about? On Friday 2, 2004 the Commerce Department announced that there were 308,000 new jobs created in the month of March. When one factors out the striking California grocery workers, the number was twice what was expected. There was an obvious leak and those “in the know” were able to sell before the rest of us had a chance. Why did they sell the long government bond? Employment growth equals business expansion equals inflation. It makes no difference that this is not necessarily the case, but if you are a speculator and doing so on borrowed money, you need to get out first. The truth of the matter is that over the last 7 months or so, we have added approximately 700,000 jobs, which is about 1/3 of what has been created in previous economic recoveries. That’s better than none, but does in no way indicate a robust sustainable economy. It remains our concern that once the tax cuts have completed their work, there will be little left to move this economy forward.

Diverging, for a moment, into those lauded employment numbers, please consider the following from our April 12th Web Buzz: As someone said “We have never seen such a grossly misinterpreted Employment Report in our 30 years in this biz . . .” As it turns out 296,000 of the 308,000 jobs created in March were part time jobs. Not only that, but most all of the jobs were in the service industries, which recorded an \$.08 decline in hourly earnings. Also, the average workweek declined to 33.7 hours; close to the 40-year low of 33.5 hours. This microanalysis of a macro number simply reveals that there continues to be an extremely soft labor market. Just the opposite of what the market thought.

There is a huge lesson here that investors should learn: (1) Markets are not efficient, (2) human behavior is not always logical, (3) headlines are many times misleading, and (4) the devil is in the details – yet many never look to see.

There is not one of us in the world that knows what a day-to-day market is going to do. Good news can be bad, bad news can be good. But the fundamentals do not change. Knowing what they are and having the patience to see them through is the key to above average returns. Everyone worries that if the market is going against them from time to time somebody knows

something they don't. Many times it's not what they know, but what they think they know that creates the counter moves.

We continue to see only slow growth as best for the 2nd half of this year. Debt continues to replace income as the major source of funds in the spending stream – this cannot go on forever.

It might be of interest for you to know that our “lonely” feeling has been reduced by the “switch over” of Dr. Marc Faber to our deflation camp. We have agreed with Marc in all things economic for some time, but have differed as to how this huge asset inflation debt trap would end. We have a copy of his recent comments if you have any interest. He is one of the great independent thinkers in our business and we welcome him as an ally. This is the slow but sure process by which our minority opinion (which gives us the opportunity to buy at good levels) becomes the majority (which gives us the opportunity to sell at equally good levels). For some period of time, the CNBC talking heads have called for higher and higher rates (lower prices for bonds) and higher and higher stock prices. They have been wrong for these years and are destined to continue to be so. For you see, behind the aggregated GDP numbers that everyone loves so much, are micro numbers, which tell a much different story. When it finally becomes apparent to all, it will be too late to position one's portfolio properly. This is the reason we stick to our guns while others might not. Please pay particular attention to the following, which explains that dollars and activities seem to be the same on paper, but when examined carefully are of a much different character.

Organic Income / Inorganic Income

When one assumes debt, there is in the long run only one way of re-paying that debt – with income. Without income, one may restructure for a period of time by issuing long debt to pay off short, but at some point income is the only way to take care of one's obligations. First of all, one could not restructure as above if he didn't have an equity cushion of prior income in his net worth. No cushion, no lender. If one continues to obtain income, then loans will be available, if not, then current income will be called upon to pay off the loan. Game over. Why do we use this really simple Economics 101 example? The answer is that primarily most under the influence of the believed omnipotence of the Federal Reserve have forgotten this basic truth. The following are some numbers developed by Capital Insight Inc., which indicate the seriousness of the amount of individual debt compared to income – it is astounding and exceedingly dangerous. What is compared is mortgage, all household, and household plus non-corporate business debt to pre-tax private sector wages and salaries plus individual proprietors income.

Debt Type	1991-2000 Average	December 2003
Mortgage	99%	133%
All Household	142%	184%
Household & Non Corp. Business	181%	231%

If one eliminates the income of those financial types who are providing these funds, the ratios would look as follows:

Debt Type	1991-2000 Average	December 2003
Mortgage	109%	149%
All Household	156%	205%
Household Non Corp. Business	198%	258%

The reason for eliminating the providers of the funds is that their income and fees are providing for the leveraging of others and not really creating new wealth. This follows the same principles as eliminating trial lawyers income, which is nonproductive for society as a whole – it is redistribution of existing income, not the creation of new income. Unfortunately for the US economy, more and more income, what there is of it, is coming from non-multiplier sources, which add little to overall growth (financial profits) as compared to economic profits from productive assets that add much to our overall well-being.

For some time now we have been lamenting the fact that more and more income and more and more debt is associated with financial organizations as opposed to non-financial. These in our opinion, are vastly different sources of activity. If you will, financial is Wall Street and non-financial is Main Street. Financial sources are really fees to allocate capital and non-financial is the real or “organic” economy that creates wealth through widgets and services by way of productive brains and equipment. Much of the income over the last five years or so that has come from the financial sector (inorganic) is stock and bond trading associated, which is a zero-sum game and in the grand scheme of things, does nothing to increase the wealth of the nation. While advancing markets are providing commissions and profits increase income statements, higher valuations allow additional borrowing. It becomes a circle. However, when markets move downward virtuous becomes vicious and many times the only thing left is the debt used to play the game in the first place. Many ask where does all the money go when markets retreat? The answer is nowhere – it’s all a paper fantasy – a one hundred share trade on the downside can literally trim billions off the value of a company’s stock capitalization which includes millions of shares. Again all secondary markets are zero sum games. There is a buyer for every seller. There is a loser for every winner. This is why it is so important that one have the economic fundamentals on his side. Through ups and downs and sideways, fundamentals always in the end prevail.

Let’s take a look at corporate America today and estimate the change in character between organic and inorganic (non-financial and financial) today versus yesterday. One of the best descriptions we have seen concerning corporate America today is as follows:

“ . . . With financial assets on their books now in excess of 100% of tangible assets (the latter themselves somewhat flattered by the boost accruing from the upward revaluation of commercial real estate holdings), even non-bank America, Inc. is now little more than a pension fund and vendor finance house with a machine tool in the annexe.” Capital Insight, Inc.

	<u>Profits Share – Financial / Non-Financial</u>
1952-89 Average	18%
Today	68%

However, as most non-financials have a sizeable portion of their profits coming from financial transactions we find that only 30% of all profits come from the real economy and 70% from financial. My friends, this current economy is one giant casino brought to us by Alan Greenspan and his merry men of bubble-makers. Caution dictates quality in all things.

How Does All of This Come to an End?

The Federal Reserve must, over the next several years, move short-term rates upward while not allowing long-term rates to do the same. This is the ace in the hole, which limits (almost eliminates) the downside of our bond program. If things do not develop as we believe, the Federal Reserve will institute “operation twist” just as they did in the 1960’s. Let us explain what we believe will happen, keeping in mind that if we are wrong our downside (in our opinion) is very little as the Fed must act to save the economy from sharply rising long rates. We expect the economy to slow down in the second half of this year. The major reason for this slow down will be the withdrawal of the consumer from the market place. Very slow income growth plus higher and higher debt will limit the consumers’ ability to spend. Maybe there will be additional tax cuts – if so then the slowdown may come during the 1st half of next year. We expect the housing industry to top out even if rates do not move up. Under these conditions, short-term rates might move slightly higher and long-term rates on governments will move much lower. A recession will develop – keeping rates low for some time.

If, on the other hand, the economy does much better than we expect, there will be higher rates all along the yield curve – except we believe the Fed will sell short maturity governments and buy long maturity governments in order to keep long rates from moving up. If they don’t, high long rates will most likely precipitate a severe recession . . . and we mean really severe!

1st Quarter Performance

We’ve enjoyed quite a ride through the first quarter of 2004, ending with a solid 8.48% gain in our Bison Bond I program. Taking a step back to look at the bigger picture, for the last 12 months, April 2003 - March 2004, we have amassed an equally solid 10.96% gain. To expound, that means that despite the “doomsday” fall in bond prices in the second half of 2003, we have still managed double-digit returns. Let this be a lesson that even looking at quarterly performance can be deceiving when evaluating a program’s long-term accomplishments.

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Past Performance is no Guarantee of Future Results