

Interim Market Update



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

May 2006

The Coming Shortage of Government Bonds

There was a time back in the 80's when the consensus maintained that there was no way that interest rates could go down due to crowding out in the market place caused by large government fiscal deficits. We remember quite well our rather heated argument with Senator Dole in this regard, at a public forum here in Wichita. Of course, the crowd agreed with him. We all know that Senators and Representatives are much more knowledgeable than we mere citizens. Isn't it strange how government people know so much more than we in the private sector?

We, along with a others, Gary Shilling and Ed Yardeni to name a few, beat our fists on the table calling for much lower rates, predicting there could be an actual shortage in government bonds. This shortage never did occur, as the investing public went head long into common stocks. It became conventional wisdom that common stocks could only go up in value and, so they did from 1982 to 2000, despite the crash of 1987. Even the severe decline of 2001 and 2002 did not dim the consensus view that common stocks were the asset de jour. Of course, the major difference between 1982 and 2006 is valuation. Multiplies were less than 10 in 1982 and are approximately 20 today. Despite government fiscal deficits and Americas love affair with common stocks, interest rates did come down with a vengeance, but no shortage of government bonds developed.

The point of this drive down memory lane is not to pat ones self on the back (however, it does feel kind of good), but rather to suggest as Yogi Bera would say, "its not over until its over." In other words, not only are interest rates going to resume their downward trend before long, but there will indeed be a shortage of government bonds in our future. The following, which is contrary to most everything you read in the financial press, is our reasoning:

1. The world economy without strong US consumption will fall into a serious recession. Thus, we must continue to run a trade deficit (imports over exports). *Trade deficit is not a problem.*
2. This means that China, India, Japan and other countries which rely on exports to survive must have us for a buyer. *They need us badly.*
3. The only way they can have us as a buyer is to accept our dollar. Much of those dollars will be invested primarily in US government bonds. If they sell these dollars on a wholesale basis, the dollar value goes down and their goods become less competitive. Then they must lower their prices and reduce their margins, or their economy goes in the tank. The myopic fear of foreigners not holding our dollar and buying our debt is just flat unfounded. That, of course, does not keep the press and others from wringing their hands about this constantly. *Dollars are good.*

Interim Market Update



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

4. If the US is running a budget deficit of ~ \$350 Billion per year and our trade deficit is ~ \$700 Billion per year, one can see that demand is outstripping supply by a two-to-one ratio. *Government bonds are growing scarce.*
 - a. If the US government budget deficit goes into surplus, we may see zero government bond interest rates, and supply will dwindle as demand continues to increase. *Deficits are good.*
5. The final straw in the government bond shortage scenario will be the mad rush to safety by equity owners once they finally understand the stock market is overvalued. The 2001 to 2002 experience should have taught us this lesson, but the love of equities seems to be blind. *Stocks are not good investments all the time.*

My friends, all of the above simply means that if we can resist the temptation to become depressed and jump ship over this recent five-month counter move in interest rates, we shall obtain a superior total return remaining just where we are. *DO NOT CHASE recent performance.*

The markets for, commodities, stocks and government bonds appear close to major reversals in direction. The former two down and the latter-up. The housing market is the key, and it is in serious, but still largely unrecognized trouble. The Fed has raised interest rates way beyond the ability of the consumer to pay. As a final thought, we expect the recently battered dollar to move upward under the economic landscape we expect to see. *Paying off debts requires having dollars.*

Believe it! The Future is ours.



Central Plains Advisors, Inc.

Information contained in this commentary is based upon information obtained from sources both external and internal which we consider to be reliable, but the accuracy of the information and the recommendations contained herein cannot be guaranteed, nor do they constitute a solicitation for the purchase or sale of any securities mentioned herein. Information contained in this commentary may not be reproduced in any form without written permission from Central Plains Advisors, Inc.
