

Economic Commentary



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Returning to Normal

The economy of the 1990's, in hindsight, was a re-run of the 1920's, only in spades. The final period from 1995 through 2000 was the "blow off years" of a huge investment boom in technology. The recession that followed in 2001 was different than any we've had since the 1930's. However, the Federal Reserve, by "dumping dollars" out of airplanes, kept it short and mild. Mr. Greenspan repeatedly has said how proud he is of the monetary policy that was engineered to prevent another possible economy of the 1930's. By doing so we have created a mountain of debt that is sure to have extremely dire consequences at some point in the future.

The next economic downturn, which we expect is in the "works" right now, is destined to be an "old-fashioned one" in that the consumer will lead us down, as in all post WWII recessions except 2001. The major question becomes, can the Federal Reserve bail us out of this one? Or will the proverbial "pushing on the string" come into play. We suspect it is too early to tell. At some point debt is going to be withheld by lenders and/or not asked for by borrowers. It will happen, but the timing is uncertain.

To refresh your memory concerning the order of recessions we are re-printing the table we have used many times. We believe the order of occurrence in the next recession will be "normal" as opposed to 2000-2001. Keep in mind housing, inventories and consumer spending sometimes happen in a slightly dif-

ferent order. The important difference is the sequence in profits and capital spending investment boom vs. consumer spending. Please note the recent economic news showing that the "normal" is taking place. Consumer spending is slowing (bulls will maintain it is slowing due to the hurricanes) but capital spending is doing better. Watch closely the housing and consumer spending as probable forerunners to an "old fashioned recession." Capital spending along with Katrina rebuilding is creating a spike in long term rates. A "perfect storm" is being created. It is important to understand that the recent increase (spike) in long term interest rates will be transitory. Its root cause is again another inflation scare which has happened at least once a year over the last four. At this stage of the business cycle, the higher these long term rates go, the lower will these same rates be as the recession

is recognized.

From time to time we find on the internet interesting "out of the mainstream" articles which we believe deserve attention. One such was authored by Stephen Church, an investment consultant with Piscatagia Research Inc. The name of his paper is "Consumer Cash Flow" a summary of which is shown on Page 4. He has authored several other pieces which fit in with this paper and are also worthy of your attention. His web site is www.piscatagiaresearch.com. We believe the following items are the important points, which by in large have not come to the thought process of most investors.

1. The world changed after the recession of 1990-91. As part and parcel of Federal Reserve monetary policy strong money supply, growth, and lower interest rates were fostered in

A Different Kind of Recession

(In Order of Occurrence)

"Normal"

"2000 – 2001"

Inflation	Up	Inflation	Down
Tight Money*	Up/Down	Tight Money*	Up/Up
Housing	Down	Profits	Down
Inventories	Down	Capital Spending	Down
Consumer Spending	Down	Inventories	Down
Profits	Down	Housing	Down ?
Capital Spending	Down	Consumer Spending	Down ?

* Two components – interest rates and availability

order to promote economic growth. Commencing after 1992 income based cash flow stagnated and debt became increasingly used to sustain consumer spending. These were the first visible signs of globalization as China was becoming a part of the Asian experience and the pressure on labor costs became acute.

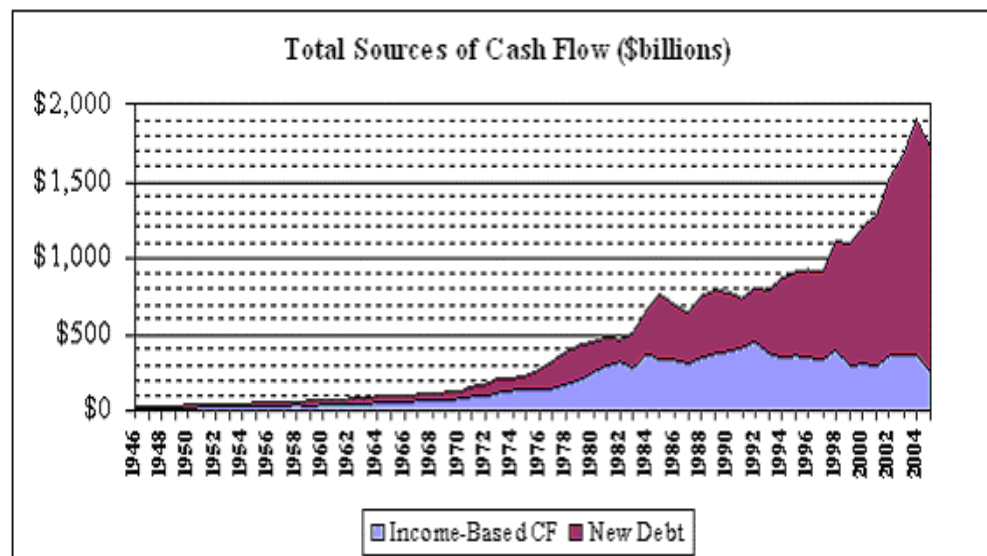
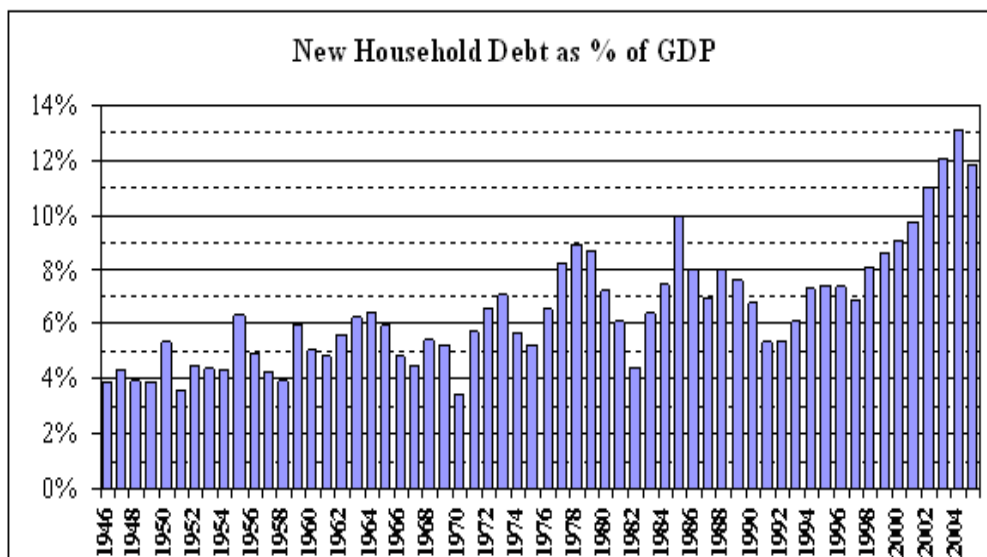
- Household debt as a % of GDP in 1992 was exactly the same as 1947. No problem there, but as the Federal Reserve fought off such things as the Peso problem and the blow up of hedge fund Long Term

Capitol Management, money became more plentiful and available. In 2004 household debt hit a high of 13%, an approximate 150% increase. Big problem here! We do not know at what level debt will need to be liquidated. The rate of growth has not, as of yet, even started to retreat. Again, it can not go on forever.

The \$64,000 question concerning the consumer and his spending habits, which are so critical to GDP growth, is what happens to the economy when on balance income to debt cash flow returns to a one on one ratio

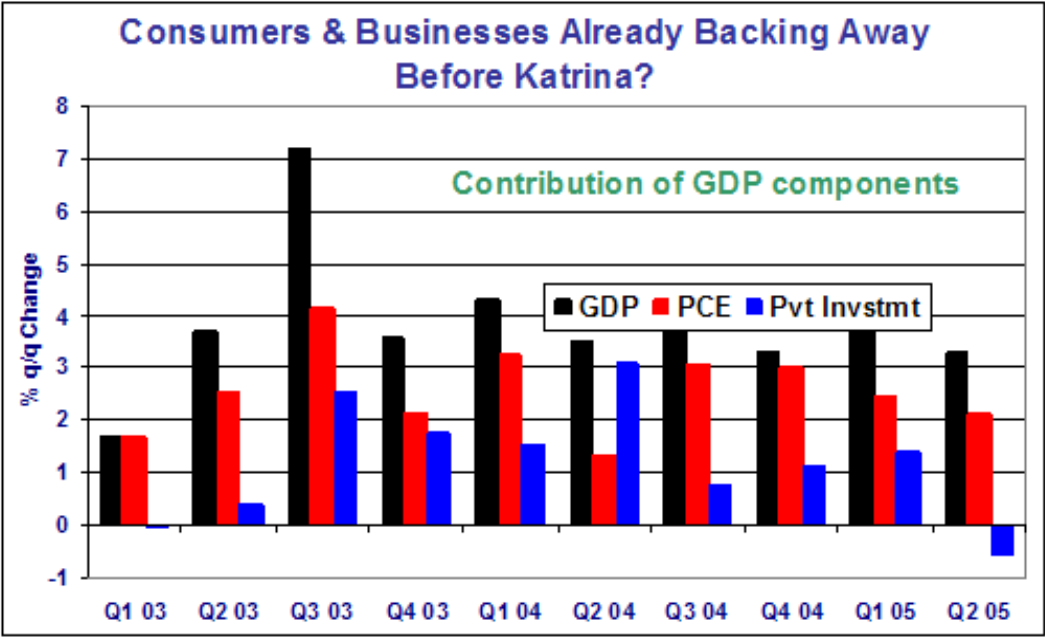
from the estimated one to six ratio in 2005? Obviously, if it happens overnight serious economic dislocations will occur. The second quarter of 2005 noted a decline in domestic non-financial debt. It declined from 9.9% to 7.3% on a seasonally adjusted annual basis. Non federal was unchanged at 8.9%. The consumer reduced his consumer credit from 4.1% to 3.7%, but increased his mortgage debt from 11.3% to 11.5%, overall it was 9.9% vs. 9.6% in the 1st quarter. On a slightly different subject the 2nd quarter of 2005 saw an all time high in domestic financial borrowing.

Another chart which we believe is telling us a story of slowing economic activity is shown on the following page. Economic growth remains in the 3% plus area, but as documented earlier if it were not for consumers using their homes as ATM's along with huge increases in debt there would be little to no growth.



Final Thoughts

We are beginning to see the end (finally) of the housing bubble. A client of ours in Florida recently overheard a conversation between a new owner and a salesman of a nice home located close to his home on the Gulf Coast. The real estate agent told the new owner that their group of sales people are reducing



vertised energy costs. Unless gasoline prices come down, costs to the consumer will be up approximately 50% in 2006 vs. 2005. The same goes for heating oil. To add insult to injury, liquidity in the hands of the consumer, is at all time percentage lows for the last 60 years. That being the case,

their commissions in order to make sales. That just doesn't happen in a good market. Our guess is that before the salesman reduces his commission the seller has probably reduced his price. The downturn must be well underway. The NY Times recently had an article reporting huge cuts in Manhattan, NY high rise properties. Another report indicated that San Diego's market has gone flat in a month over last month's basis. Remember, housing related cash has been the only thing that has kept the consumer going.

more difficult for one to get his debts eliminated under the new law. Long term pay outs and credit counseling will be hallmarks of many new restrictions. Isn't it uncanny how Washington can perfectly time legislation to become effective at just the wrong time. Do you remember the 1986 Tax Reform Bill? It took effect just in time to drive the final nail into the Savings and Loan coffin. We understand that within this bill there is a provision that minimum credit card payments will go to 4% from 2%. If all the \$2.1 trillion of credit cards outstanding were on minimum payments another \$42 billion per month would come out of consumers pockets for debt service.

it seems to us consumption will bear the brunt of the new "cashless society." Not the one of no checks, but the one of no cash. This is serious business and we see nothing about this coming from Wall Street. Do they not know, or are they the sellers that are keeping the stock market from going up?

Money growth is declining as we have mentioned in previous pieces. This also is a sign that economic activity is trending downward. This will accelerate to the downside, if the housing "bubble" is coming to a close, which seems likely.

Stock Market

The stock market remains overvalued and we expect another down leg to occur at any time.

Bond Market

We would buy long government bonds at their current levels and sell less than A rated long bonds. Spreads are beginning to widen again, however if the stock market breaks severely downward, even less than investment quality bonds might do well for a spell.

The bankruptcy laws in this country change Monday, the 17th of October, 2005. We are sure this will be a piece of legislation that will contain hundreds of pages and clever lawyers will find many loopholes. From what we can tell it will be much

Another consumer problem will be the 2006 reinstatement of AMT (Alternative Minimum Tax). It is estimated that if congress does not extend the Bush tax cuts, AMT revenues will increase from \$15 billion in 2005 to near \$100 billion in 2010. Look out Tiffanys and Nieman Marcus, you may soon be joining Wal-Mart in singing the blues. Yet again another hit to the consumer is the well ad-

Consumer Cash Flow

<u>Cash Provided</u>	<u>2003</u>	<u>2004</u>
"Net Profit" & Non cash items	\$357.3 Billion 28%	\$365.4 Billion 26%
Net Debt (\$459.6B) (\$490.3B)	\$866.9 Billion 71%	\$1044.5 Billion 74%
Total Cash Provided	\$1224.2 Billion	\$1409.9 Billion

Cash Applied

Purchase – Residential	\$572.5 Billion	\$673.8 Billion
Purchase – Savings etc.	\$196.0 Billion	\$277.1 Billion
Purchase – Other	\$373.9 Billion	\$390.6 Billion
Total cash applied	\$1142.4 Billion	\$1341.5 Billion
Increase in Cash	\$81.8 Billion	\$68.4 Billion

Sources:	Personal Income	BEA
	GDP	BEA
	Balance Sheets	FRB

History: Cash provided prior to 1992, 50%/50% net profit and net debt.

Proforma: Cash provided estimate 2005, 14%/86% net profit and net debt.

Observations

1. Borrowing to income 3 to 1 in 2004. Prior to 1992, approximate 1 to 1.
2. Households have to borrow just to pay principal payment on debt.
3. All the growth in total source of cash flow has come from new debt since 1992.
4. Household cash flow in 2005 estimate to be 86%, 6 to 1.
5. This cannot go on forever!
6. Household uses of cash.
 - a. Liquidity needs (M1) little increases since 1993.
 - b. Debt repayment 2% of GDP 1964-1992, 4% of GDP last 4 years.
 - c. Investments- residential 2003-05 only period of over 5% of GDP for reason other than household formation.

Question

How does one reduce dependency on debt, while not destroying the economy?

Hint

What is the one sector of the economy that is doing relatively well?

Answer

Transfer of corporate profits to the consumer through the reductions of prices on goods and services. Which sector of the corporate community is doing the best? Financial. How about loan charge offs, as well as deflation.

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