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"We shall never prevent the abuse of power if we are not prepared to limit power in a way [that] occasionally may prevent its use for desirable purposes."
"The more the state 'plans' the more difficult planning becomes for the individual."
--Frederick Hayek (Austrian school economist)

Tax and Financial Strategies

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WEALTH CREATION STRATEGIES

Timeshares Can Make Sense, But Pre-Owned Only Please

Because only a tiny fraction of clients purchase condominium timeshares each year, I've never thought the subject worthy of an article. However, the number who've purchased timeshares has grown. For most people, they've been an expensive luxury. While few clients have thought (or were able) to call me before writing a check while under the intense pressure of the well-rehearsed salesman, every one who did so walked out of the presentation with his hard-earned cash intact. While there is nothing I can do for those who have already purchased, an opportunity, triggered by the economic downturn, may have arisen.

First, however, it may help to understand why timeshares can be so costly. It has to do with simple division.

Divvying things up increases perceived value

Many products become more valuable as they are divided into smaller pieces. Compare, for example, warehouse store-size toothpaste with regular and smaller sizes: you can pay $13 for 40 oz. in five tubes, $4.50 for a 6.2-oz. tube or $3.50 for a 4-oz. travel-sized version. The 4-oz. size costs 20% more per ounce than the 6-oz. size and almost 170% more per ounce than 40 ounces. The idea holds for many staples and food items. If you're going to use it anytime in the next few years and it's not likely to go bad, you are often far better off financially buying in quantity even after taking into account storage and opportunity (what you could have done with the money) costs.

Though in a different league, real estate, too, becomes more valuable this way. Land and buildings become more valuable per square foot when subdivided into smaller components. Everything else equal (adjusting for location and the cost of any improvements, including permits and subdivision fees), a large tract of land sells for less than the totality of lots into which it is divided. Smaller commercial spots usually command a higher lease price per square foot than larger units. Likewise, the more square feet in a house purchased or leased, the lower the cost per additional square foot. An 804 square foot bungalow in Encino Park, California sold, at the peak of the housing bubble, for roughly $550,000 ($684 per square foot), while an 1800 square foot house practically next door in Encino Village sold for $750,000 ($417 per square foot). While the ratio has widened for the time being (I think temporarily), the smaller house currently sells for about $350,000 and the larger one for near $550,000, which is still consistent with getting a lower cost per square foot for a larger home. The same is true to an even greater degree for rents, with the smaller home renting for $1,900 and the larger for $2,500 ($2.36 vs. $1.39 per square foot per month). This accounts for the oft-observed phenomena that you can buy or lease a lot more house at a lower cost per square foot, frequently with far greater amenities to boot.

What is true for space is true for time

The same can be said for time, which a few condominium developers figured out during a period in the 1960s and 1970s when resort prices were depressed. Creative entrepreneurs boosted sales by selling what became known as timeshares, giving birth to a new industry. They also found that by chopping the condo up into 52 pieces they could turn, in today's dollars, a $300,000 condo into one that could be sold for as much as $1 million.

This increase in value ironically translates into affordability for the buyer. Most owners are interested in only a week or two timeslot for a vacation. While owning a $300,000 condo would be an enormous burden from someone who wants it for only a two-week vacation, buying a week or two costs a fraction of that. However, it's a far greater fraction than 1/52nd or 1/26th (which, for a $300,000 condo would be $5,770 and $11,540 respectively). Therein lies the rub—what is great for the developer and, to a degree, good for the buyer is also costly.

One of the great problems with timeshares has been the lack of a resale market. While far easier with the advent of the Internet, reselling still requires a far greater cut in price in percentage terms than that taken by driving a new car off the lot. This is particularly true in recessionary times. But what isn't so good for the reseller may prove interesting for the buyer.

A condominium timeshare resale agent (CA license # 01429320) in South Lake Tahoe, California provided me with comparison information ("deemed to be reliable but not guaranteed and subject to market changes") for similar new and used condominiums, along with current rental rates. The agent, Jana Nelson at Paradise Real Estate (800-996-

2001; cell 916-396-9779; www.timeshare-resale.com) estimates an inside 780 square foot unit at the Tahoe Beach & Ski Club, a lakefront condominium resort condo in South Lake Tahoe, would sell for roughly $275,000 in today's market. The new or "resort" price for a week during high season is about $12,500. A low season week equivalent is roughly $5,500. The average week over the course of a year runs about $9,000. Through the alchemy of divvying up time, the developer and his sales force gets about ($9,000 x 52 =) $468,000 for a $275,000 unit.

But let's take a look at a "used" price. You get the same unit, but you don't suffer with high-pressure (and often, in my experience, alcoholic) salespeople who may collect as much as 30% of the sales price as their commission (the developer still does well in normal markets). Jana has a high-season week listed for $3,800, or $4,500 including roughly $700 in escrow and title fees. Since the average week sells for about $4,000 all-in, the equivalent sales price for a full year is about $208,000. By purchasing in the re-sale market, you're buying at a discount to the unit's current value of $275,000.

Now don't get any ideas about buying a condo in the form of timeshares for a full year—the weekly maintenance fees and property taxes of roughly $600 will kill you. (Why so much? The fees cover not only the monthly condominium association fee, but also all utilities, insurance, maintenance, furnishings, replacement of furnishings and management.) However, purchasing enough for vacations begins to make sense when we compare the upfront cost plus yearly maintenance fee with renting a comparable unit.

This spot would rent for about $1,600 for a non-holiday high-season week. While I expect deflation over the next several years, inflation could return beginning in the 2013-2016 timeframe. A 50% increase in overall prices would result in an $800 increase for a week's rental and only $300 for a yearly maintenance fee.

The difference between renting for $1,600 per week and owning for $600 per week is $1,000. How many years would it take to pay for the initial purchase? If you bought new for $12,500, it would take about 12 years. Buying used for $4,500 including fees drops this to only four and a half years. These figures do not include opportunity or financing costs, which run a lot more on $12,500 than on $4,500.

What about the high-end? A one-bedroom summer week at the Marriott Timber Lodge in South Lake Tahoe costs about $23,000 new and $9,250 used. You'd think the developer was selling a ($23,000 x 51 useable weeks =) $1,173,000 unit. You'd think wrong. A similar condo in a nice complex would sell for about $360,000. Even used it runs $9,250 weekly, equating to over 30% more ($9,250 x 51 weeks = $471,750 - $360,000 divided by $360,000) than the unit would sell for, but then it's the Marriott. If you're looking for a vacation home at a Marriott, you could do worse. The weekly maintenance fee and property taxes total $929. It would rent for $2,000. You get your initial purchase price plus escrow and title fee costs returned in a tad over nine years.

There are some interesting deals, which is probably a microcosm of what's available worldwide during this economic slump. To get a flavor of what's probably available elsewhere, we'll give a few more examples from the Lake Tahoe region. Used prices, which on average are estimated to be down in the region by 32% from the peak a few years ago, make economic sense. While I happen to think prices could go even lower, I could be wrong.

Breakeven Period for a New v. Used Timeshare, One Week

Timeshare Resort	New "Resort" Price	Typical Resale Price	Estimated Rent, Including Tax	Maintenance Fees & Property Taxes	Estimated Break-even, New, in Years **	Estimated Breakeven, Re-sale, in Years **
Tahoe Beach & Ski Club per text	$12,500	$4,500	$1,600	$548	11.9	4.6
Stardust studio high season	$10,800	$1,800	$1,000	$725	39.3	6.6
Ridge Tahoe Plaza 2 bedroom prime	$22,550	$4,550	$2,100	$884	18.6	3.75
Hyatt High Sierra Lodge 2 bedroom gold (prime)	$33,650	$16,150	$3,493	$955	13.3	6.4
Marriott Timber Lodge 2 bedroom platinum ski season	$42,000	$19,250	$4,812	$1,200	11.6	5.4

** Price divided by (weekly rent minus maintenance fee) = years to breakeven.

While pre-owned timeshares can make sense, new ones rarely if ever do. So, the next time you head off to Puerto Vallarta or other foreign resort and are confronted by the most obnoxious high-pressured salespeople known to civilized man, hand a copy of this to the salesman accosting you. And if he doesn't back off, hand it to his next customer.

The Wealth of Individuals: Part 5
Cash can be King

So far in this series, we've covered the importance of debt avoidance, stable growth, stability in one's personal life and investing earlier rather than later; the protection of property and creation of capital as the ultimate source of wealth; the idea that values of investment-grade assets tend to move in spurts and that it's ok to earn little or nothing for periods of time; and a method of assessing one's tolerance to risk, which can serve to increase the odds of participating in up-moves and avoiding downward ones. In this installment, we'll elaborate on the idea that it's not only ok to earn little or nothing for periods of time, but that such times can yield surprisingly good returns.

Amazing Rates *

Many of you know that I am winding down my stock market positions built largely in October-November 2008 and March 2009. While I'm not moving completely to cash in the form of .2% yielding money market funds and 2% CDs (I tend to favor more exotic instruments for my personal portfolio), there is nothing intrinsically wrong with a failure to stretch for higher rates. Why?

First, the higher the rate, the greater the risk. Finding an investment yielding 8% is fine, so long as its value doesn't plummet by 28%. Therein lay the problem in risky economic times: there is no guarantee that an 8% payer won't end up in bankruptcy court. In fact, there's no guarantee that such a payer isn't operating a Ponzi scheme, where he ends up in a different court. You really don't want to invest in either scheme, do you?

Second, there are times when 2% is a fabulous return. Consider October 2007 through March 9, 2009, when almost every asset class plummeted in value. Which would you rather have had during that time-frame: stocks, real estate, high-yield bonds or CDs? (For the record, prices of the first three collapsed by 20% to 70%.) **You might be able to buy more. And, your earnings may be greater than you think.**

Third, cash buys more of other assets after they've dropped in value. Consider: you could have purchased twice the average stock, twice the real estate in CA, FL, NV and AZ and almost twice the amount of high-yield bonds on March 9, 2009 than in October, 2007. While no one can time such peaks and canyons perfectly, proper risk management can be used to ratchet up and down exposure in order to avoid most of the carnage of bear markets and reap much of the benefits of bull markets (or bear-market rallies). Another way of looking at this is the bucket of cash normally intended for investment essentially increases in value by 100% (ok, 103% with the interest) during periods of time that stocks drop by 50%.

Fourth, while the bucket of cash intended for expenses and emergencies doesn't do well in eras of consumer-price increases, it does very well in deflationary environments. According to the latest figures the Consumer Price Index has dropped, for the first time since the Great Depression, by 2.1% (and, if housing prices were included, 6.1% according to Mike Shedlock at globaleconomicanalysis.blogspot.com/2009/07/whats-real-cpi.html). Because the purchasing power of cash increased by 2.1% (or 6.1%), uninvested cash earned the equivalent of that rate, while invested cash earned the nominal return plus 2.1%. If your cash is in a taxable account, there's also a hidden tax benefit to a deflationary environment: you don't pay taxes on the 2.1% (6.1%) increase in purchasing power. If you're in a 25% marginal income tax bracket, you'll pay .5% and keep 1.5% plus the 2.1% (6.1%) deflationary "advantage," for a total return of 3.6% (7.6%).

Finally, cash is, for investors, a temporary "parking" place while awaiting the next investment opportunity. As shown in the Wealth of Individuals: Part 3 in the winter 2009 edition of *Wealth Creation Strategies* (www.dougthorburn.com/cmsAdmin/uploads/35-ThorburnWinter08-09.pdf), assets with investment attributes tend to move in "spurts." After a good spurt upward has occurred (the recent bear-market rally, for example), it's best to shift assets to cash so you're not facing an oncoming train. Since we never know the precise dates of those price bottoms and peaks, hedging—buying and selling incrementally—can make sense. (Assessing your personal risk tolerance with the goal of increasing the odds of participating in upward moves and avoiding downward ones was more fully described in the spring 2009 issue at www.dougthorburn.com/cmsAdmin/uploads/36-ThorburnSpring09.pdf.

What is deflation and why cash will likely continue to be King

This installment would not be complete without mentioning what may be one of the great contrarian indicators ever: advertising that one should invest in this or that. Full-page ads touting stocks in 2000 were, for the contrarian, screaming "sell." Full-page newspaper ads lauding real estate in 2005 were one of the great "sell" signals of all time. Ads promoting foreclosures and foreclosure seminars in 2007 were a terrific clue to the idea that foreclosures of that era were just the first round (they were). Currently, obnoxious ads every 20 minutes on talk radio are imploring us to buy gold. This could be one of the great contrarian signals of all time, where we should do the opposite of what is suggested, particularly since gold has already more than tripled from the $283.20 low in 2000 (and where, might we ask, were those radio ads then?).

How can we reconcile the apparent logic of the idea that the Federal Reserve, by pumping up the money supply, is fueling inflation, with the contrarian view that the U.S. is in the throes of deflation, which will result in an increase in the value of dollars and a decrease in the value of everything, possibly even gold?

A clue to the conundrum is something that my friend Robert R. Prechter, Jr., has been for years telling subscribers of his newsletters at www.ElliottWave.com to be ready for: a contraction in the value of debt-denominated instruments, or credit. Mike Shedlock ("Mish") explained the problem this creates in his Global Economic Trend Analysis (GlobalEconomicAnalysis.blogspot.com February 19, 2009) by re-defining inflation and deflation as something different from what we usually think (an increase or decrease in consumer prices, which are, instead, an effect). He explained, with emphasis added: "Inflation is a net expansion of money *and credit*. Deflation is a net contraction of money *and credit*. In both definitions, *credit needs to be marked to market*….The mark to market value of credit is contracting faster than base money is rising." ("Mark to market" means that a $500,000 debt instrument on a piece of real estate that has fallen in value to $250,000 should, for this purpose, be priced at $250,000, or even less to account for transaction costs of foreclosing on the underlying asset.)

Prechter and Mish have essentially redefined money as "cash plus the *value* of credit (debt instruments)," which can either be inflated or deflated. Both are saying that the value of the $50 trillion in debt outstanding in the U.S. is collapsing at a far greater rate than the Federal Reserve can possibly print money, which comprises only a few trillion dollars. This is the best explanation for recent financial events, which holds predictive value. Cash could easily continue to be marked up in price relative to other financial assets, including gold, which suggests that gold bugs could be wrong—for now. Rather than suffering inflation, we could experience a continuing deflation until excess debt is wrung out of the system. Cash could, therefore, continue to be King for several years.

* The sub-title and idea on the tax angle came from Brian Whitmer, writing on the subject in the *European Financial Forecast*, an ElliottWave International publication published by Robert R. Prechter, Jr. I'm in debt to Whitmer and Prechter, along with Mike Shedlock, for helping me clarify the ideas presented, as well as to my friend Marty Kreisler for the inspiration in writing this installment.

The California Legislature Tries to Balance the Books on the Backs of Entrepreneurs and Investors

In yet another act of accounting legerdemain that would put private players behind bars, the legislature has made a mockery of the idea behind estimated tax payments, which requires that tax be paid as it accrues.

Non-withheld tax must be paid quarterly in order to prevent penalties. To simplify, under normal rules a taxpayer must pay either 90% of the current year's tax or, as a safe harbor, the equivalent of the prior year tax in four equal installments. For example, if your tax liability was $2,000 in 2008, the "safe harbor" requires that you pay $500 per quarter in 2009 in order to avoid penalties. (The quarterly payments are due April 15, June 15, September 15 and January 15 of the following year.)

These rules were changed for 2009. Those required to pay quarterlies may have noticed an odd arrangement of payments. Instead of mandating that 25% of the tax be paid each quarter, the legislature, in an effort to jigger the budget using accounting gimmickry, front-loaded the payment schedule by requiring 30% in each of the first two quarters and 20% in the last two.

Now the legislature has gone over the top by further monkeying with the schedule. Once again, they attempt to balance the state's books on the backs of investors and entrepreneurs.

For 2010, 30% of the prior year's tax must be paid in the 1st quarter, 40% in the 2nd quarter, zero in the 3rd and 30% in the 4th. Here's how it looks year by year:

State Legislators Again Show Evidence they are Smoking Something: Required Quarterly Payments as Percent of Total Tax

Quarter	2008	2009	2010
1st	25%	30%	30%
2nd	25%	30%	40%
3rd	25%	20%	0%
4th	25%	20%	30%

For Example, if the Prior Year Tax is $5,000, the Payment Schedule for Each Year is:

Quarter	2008	2009	2010
1st	$1,250	$1,500	$1,500
2nd	$1,250	$1,500	$2,000
3rd	$1,250	$1,000	$0
4th	$1,250	$1,000	$1,500

Where there's a calculator, there may be a way

There are a number of exceptions to and ways around these rules.

1. Taxpayers can, using the annualized installment exception, calculate the tax they owe monthly and pay 90% of the tax liability in quarterly installments as it accrues. Despite adding to the bookkeeping and tax preparation burdens on small businesses and investors, this method can be worth the price, particularly if the current year's income is substantially lower than that of the preceding year. However, the required payment has been adjusted to correspond to the new estimated tax scheme under the regular method. (As a result, taxpayers using the annualized exception must pay seemingly odd percentages of the total tax in each quarter of 2010: 90% of 30%, or 27% of the tax accrued must be paid with the 1st quarterly payment, another 36% with the 2nd quarterly, no additional amount with the 3rd quarterly and 27% with the 4th quarterly, bringing the cumulative total to 90% of the current year's tax.)
2. Regardless of when withholding occurs, withheld taxes are deemed paid in accordance with the estimated tax payment schedule. This is true even if all of the tax is paid in, say, the last quarter of the year (although for other reasons such a strategy may be illegal, so seek our guidance here). If, for example, $2,000 is withheld in November 2010, following the 4th column in the first schedule above, $600 is deemed to have been withheld in the 1st quarter, $800 in the 2nd quarter, zero in the third and $600 in the 4th.
3. Taxpayers subject to W-2 withholding who must also pay estimates on non-wage income may wish to simply increase the withholding by enough to offset the required estimates. For example, one who pays $2,500 in withholding tax and $3,000 in total quarterly estimates could ask the employer to withhold $5,500 in tax over the course of the year. An employee can file the state equivalent of the W-4, a DE-4, and ask the employer on line 3 to withhold additional state income tax. While the employer is not required to comply with such requests, there is no rational reason for one to refuse. Those who realize late in the year that they may be underpaying could play catch-up by using this method, even having all the additional tax withheld in the last quarter. While this may violate the intent of the law, I don't believe it to be technically illegal so long as the required tax is paid on wage income as it accrues.

It's really just another tax, but what else is new?

Note that this rule is the equivalent of an additional tax on those required to pay estimated tax payments. If you comply, you lose the use of funds earlier than you should have. If you don't comply, you either have to spend additional time tracking income monthly and paying your favorite tax professional to minimize the damage using the "when the tax liability was incurred" rules, or you get hit with penalties on any underpayment of estimated tax, or some combination of the above. Penalties such as these are simply hidden taxes. The state legislature, with the Governator's approval, lied when they included this measure in a bill that included "no new taxes."

In a related act, required withholding will increase by 10% on wages beginning November 1, 2009 and required withholding on bonus payments increases from 9.3% to 10.23% (which is greater than the maximum nominal tax rate for anyone earning less than $1 million). Many taxpayers will simply increase their allowances to counteract the extra withholding, but the legislature is counting on the idea that many will not.

You Generally Don't Need to Pay to Have Your Property Taxes Reduced

Every scam is built around a kernel of truth and fear, including the fear of missing out on an opportunity. The collapse in property values is such a truth, while concern out of missing out on having property taxes reduced qualifies as a fear. This kernel of truth and fear has created new opportunities for con artists and near-con-artists.

The latest come-on is an advertisement that looks like an official-looking document in colors similar to those on property tax bills, making it appear *very* official-looking. Like a typical government document, this "Annual Property Tax Review" from the "Tax Reduction Review and Reassessment Department" (TRRRD) gives a deadline for submission which, if not met, results in a penalty. Under "Notice for [your county] Property Owners," it informs you that "Your property qualifies for tax reduction review. [Since your property was purchased between 2001 and 2009], it is very likely that your assessment could be reduced and you would then begin paying lower property taxes."

They want to be paid to do what will be done regardless, or can't be done

True, but the ad is not being sent only to those who purchased property since 2001. My wife and I received these for our home and office, which were purchased in 1994 and 1985. There is no frigging way we would qualify for a reduction in tax. Yet, they imply it's imperative. "To assure prompt processing return no later than the requested deadline, make check for $167 payable to Annual Property Tax Review" ($187 if not mailed by 8/7/09). They want our money up-front to file a request for a review of values that's worthless because the values are still far above the assessed ones (which increase by only 2% per year).

Furthermore, many county assessors are routinely reviewing values

of most homes that qualify for a reduced assessment. Los Angeles County reviewed every property purchased in the county between July 2003 and June 2008, along with a number of properties purchased as far back as 2000 in the harder-hit areas, resulting in a decreased assessment on a third of a million properties (resulting in reduced assessments averaging $120,000, translating into an average $1,300 reduction in property tax). If your county hasn't acted or you believe they didn't drop the assessment to true value, a "decline-in-value" review is something you can easily request (simply Google "decline-in-value [your] County" and you'll probably find your county's form).

TRRRD's refund policy reads "If for any reason Annual Property Tax Review is unable to prepare for submission to the county for property tax reduction before the [your county] legal deadline, you will receive a refund…." (I thought the name of their company was TRRRD, but I digress.) While they have to do the job (but how would we ever know?), TRRRD keeps the fee regardless of their success in getting a reduction. These scammers count on the fact that many people will fall for their scheme out of fear of being left out and paying higher property taxes than necessary, or a blind trust in (or fear of) the official look of their forms.

A similar offer comes from the folks at "Property Tax Reassessment." It shows an assessed value of our office-house at $161,445, with a "proposed assessed value" of $121,084. The precision of the numbers seems remarkable until you bring out the trusty calculator and find that the "proposed" reduction in value is exactly 25%–which happens to be the identical percent reduction on the homes owned by three different clients who received the same offer. It informs us that if we do not qualify for a reduction, our "service fee" will be immediately refunded. My question is how long will they be around to issue you that refund? We called their toll-free number and asked. While the operator didn't have a neat answer, she was at least upfront in emphasizing that we could seek such a reassessment ourselves.

If you have any question about similar letters or offers, please talk to us. A quick phone call, email, fax or letter can save you from becoming victim to offers that you should simply ignore.

An Audit Story

IRS agent Daniel Reeves, who got Swiss bank UBS to agree to a $780 million settlement of a criminal tax case and turn over the names of some 250 UBS account holders, recently stated: "Our goal is not to audit every person in the United States to make sure they pay their taxes. Our goal is to audit those who deserve to be audited."

If only Agent Reeves ran the IRS.

The most intense audit I've recently experienced was of a self-employed person, who was first audited for 2005. The only change was a reduction in the allowable square footage for a home office. A follow-up audit for 2006 focused only on that office space deduction, which was reduced in accordance with the 2005 results. The 2007 tax return was selected for examination and the IRS intent was, as in 2005, to audit the entire business.

In a letter to the auditor, I suggested that it would be unproductive for the IRS to spend its limited resources again auditing this individual. The deduction for the home office was consistent with that allowed in the prior two audits. I tactfully explained a few items on the return that might raise eyebrows. While agreeing not to audit every expense, the auditor insisted on examining income and two specific categories of deductions.

After my client spent yet more time justifying the numbers and the auditor took several hours to examine the latest records, a decision was rendered: there would be no change to the tax. I didn't say "I told you so," but I think the auditor heard it.

My Favorite Financial Blogs and Sites

I subscribe to about a dozen financial, economic and real estate blogs via www.google.com/reader. The top two for anyone with an interest in real estate or the economy are:

1. www.doctorhousingbubble.com The Dr., who covers real estate especially in the Golden State, is a terrifically entertaining writer.

2. globaleconomicanalysis.blogspot.com This is Mike Shedlock's (known as "Mish") blog. He is an excellent writer, compiler, economist and financial guru.

I also check out a number of web sites once a week for new postings. The top two are:

1. hussmanfunds.com ("Weekly Market Comment"). This is John Hussman's letter. While the mutual funds he runs didn't catch the monster bear (IMHO) market rally since March, he wasn't caught in the downdraft either. He is a former Obama supporter who is distraught over what he views as a gigantic bailout for undeserving bondholders, which he thinks will result in a massive net decrease in potential operating earnings for stocks for at least the next decade (with corresponding decreases in the value of companies across the board).

2. www.europac.net ("Peter Schiff's Economic Commentary"). In my view, Schiff is the most politically dead-on economics writer anywhere. However, please bear in mind that having a good grasp of economics doesn't necessarily translate to an ability to predict the direction of stocks. (The reverse holds true as well. While Jeremy Grantham has, in my view, a poor understanding of economics, he has a sterling track record in predicting overall market direction.)

Those who find a site particularly interesting might benefit from reading the last few years of archives.

I subscribe to a half dozen stock market advisories and publications. The top ones for me are those published by Robert R. Prechter, Jr. While comprehending the intricacies of his Elliott Wave Theory is not easy, those with an interest might wish to check out all of Prechter's offerings at www.ElliottWave.com. If you've got a lot of assets to protect or moderate-sized assets you'd like to see grow, you should show an interest.

More Thoughts on the Economy

Debts on assets that have shrunk in value far below the amount of the debt are far from being fully liquidated (i.e., bankrupted, foreclosed, or sold for less than the debt, which wipes out the equity holder and partially wipes out the creditor). As suggested above in the Wealth of Individuals: Part 5, this greatly reduces the odds that the collapse in prices of stocks, real estate or commodities such as gold and oil is over. As Bill Bonner put it in www.ContrarianProfits.com:

"It's a depression. And it will remain a depression until this huge pile of debt accumulated over the last quarter century has been paid down. Until businesses and banks that are no longer viable have gone broke and been restructured. Until consumers have real money to spend – not just more credit. Until those things happen, there is no way for a genuine recovery to take place."

Worse, while we stood a chance at a quicker recovery, the powers-that-be have done everything they can to replace the private investment essential to job creation with government "stimulus," which largely consists of bailouts. As John P. Hussman explained in his *Weekly Market Commentary*, www.hussmanfunds.com (June 8, 2009):

"Economic expansions are paced not by major growth in consumption (which tends to be fairly smooth even during economic downturns), but instead by *gross investment* in capital goods, technology and housing, as well as debt-financed durables such as autos. Yet our policy makers have aggressively crowded out private investment through this bailout policy, which allocates good capital to the worst stewards…"

Hussman, who runs the Hussman mutual funds, believes that policy-makers are doing their best to destroy value in the stock market. He writes in his *Weekly Market Commentary*, www.hussmanfunds.com (March 23, 2009):

"The relentless failure to properly respond to this crisis has increased the probable duration of the economic downturn, deepened the likely extent of job losses and de-leveraging, and has lowered the expected level of future profit margins, all [of] which erode the fundamental value of U.S. companies."

The government is even perpetuating the low-down payment problem that was instrumental in getting us into this mess. The Federal Housing Administration (FHA) continues to make loans requiring down payments of far less than even 10%, which flies in the face of everything we should have learned about foreclosure risk (which is far higher with minimal down payments than with larger ones). The results should not surprise us. According to *The Wall Street Journal* op-ed "The Next Housing Bust" (May 4, 2009):

"According to Mortgage Bankers Association data, more than one in eight FHA loans is now delinquent…. Another 7.5% of recent FHA loans are in 'serious delinquency,' which means at least three months overdue."

Policy makers continue to encourage extreme leverage in what is likely to be a failed attempt at artificially propping up the value of assets. Secretary of the Treasury Timothy Geithner, in "My Plan for Bad Bank Assets" published in *The Wall Street Journal* (March 23, 2009), explained that the Public-Private Investment Program (PPIP), which is designed to entice investors into purchasing bad bank assets, will result in:

"Private-sector purchasers [establishing] the value of the loans and securities purchased under the [PPIP], which will protect the government from overpaying for these assets."

Yet Mish explains, in his *Global Economic Trend Analysis* GlobalEconomicAnalysis.blogspot.com (March 23, 2009), what Geithner did not:

"The government has agreed [under the PPIP] to finance 93% of the loan, and it is a no recourse loan. This provision is in place for one reason only: To insure that investors overpay for bad bank assets, at taxpayer expense."

Unfortunately, the lead policy-maker does not, assertions aside, understand how wealth is created. As Ed Crane explains in the *Cato Memorandum* (July 1, 2009):

Barack Obama "recently told the *Wall Street Journal*, 'I am a firm believer in the power of the free market.'….He doesn't understand that Joseph Schumpeter's 'creative destruction' is what makes the free market work. In the free market if you make risky, stupid investments and become insolvent, you go out of business. In the free market, if you make cars that nobody wants to buy, you go out of business. In the free market, nothing is 'too big to fail.' Nationalizing everything in sight wouldn't lead one to think that the president is a 'firm believer' in [free market] capitalism."

Nor does virtually anyone else in Washington, D.C. get it, as proven by their overwhelming support for the "cash for clunkers" program. As *The Wall Street Journal* op-ed piece of August 3, 2009 explains:

The cash for clunkers "subsidy won't add to net national wealth, since it merely transfers money to one taxpayer's pocket from someone else's, and merely pays that taxpayer to destroy a perfectly serviceable asset….By this logic, everyone should burn the sofa and dining room set and refurnish the homestead every couple of years….Let's have taxpayers subsidize the purchase of kitchen appliances, women's clothing, the latest Big Bertha driver….These are hardly less deserving of subsidies than cars, and as long as everyone thinks we can conjure wealth out of $4,500 giveaways, let's go all the way."

All of this should make one concerned over the continued existence of a United States as we have known it. Economist Walter E. Williams, in "Our Problem is Immorality," (www.Townhall.com), explains:

"Do you believe that it is moral and just for one person to be forcibly used to service the purposes of another? And, if that person does not peaceably submit to being so used, do you believe that there should be the initiation of some kind of

force against him? Neither question is complex and can be answered by either a yes or no….The U.S. Congress has established the principle that one American has a right to live at the expense of another American….People who choose to be moral and refuse congressional handouts will find themselves losers….You might as well join in the looting, including the current looting in the name of stimulating the economy. I am all too afraid that a historian, a hundred years from now, will footnote America as a historical curiosity where people once enjoyed private property rights and limited government, but it all returned to mankind's normal state of affairs—arbitrary abuse and control by the powerful elite."

There's another term for what Williams refers to in his first question: slavery. And that's immoral.

Why *are* we Doomed to Repeat History?

I have long maintained that the key reason unemployment remained between 15% and 25% throughout the 1930s was because wages, in the aggregate, were far too high relative to productivity and other prices. If you've got 10 apples for sale for a dime each and they don't sell, what do you do? You drop the price. At some price, they will sell. The same idea holds true for labor. If prices of goods and services are dropping by 30% and mass unemployment is to be avoided, aggregate levels of wages must fall by a similar amount.

I have also suspected that government must have somehow prevented wages from falling. I only recently learned that two economists, Harold L. Cole of the University of Pennsylvania and Lee E. Ohanian of UCLA, figured this out and quantified it. In an article in the August 2004 issue of the *Journal of Political Economy*, Ohanian and Cole blame specific anti-competition and pro-labor measures that Roosevelt promoted and signed into law, which allowed unions to set and maintain higher-than-market wages, writing:

"President Roosevelt believed that excessive competition was responsible for the Depression by reducing prices and wages, and by extension reducing employment and demand for goods and services. So he came up with a recovery package that [allowed] businesses in every industry to collude without the threat of antitrust prosecution and workers to demand salaries about 25 percent above where they ought to have been, given market forces….High wages and high prices in an economic slump run contrary to everything we know about market forces in economic downturns…. By artificially inflating both [salaries and prices], the New Deal policies short-circuited the market's self-correcting forces…. Our work shows that the recovery would have been very rapid had the government not intervened."

Many commentators have said we are doomed to repeat history because we fail to learn from it. To my knowledge, no one has ever explained why. We fail to learn from history because of the myths of history as recorded in our books and taught in our schools. Those interested in dispelling the myths of the Great Depression and New Deal should read *The Forgotten Man* by Amity Shlaes, *New Deal or Raw Deal* by Burton Folsom, Jr., and *Meltdown* by Thomas Woods.

How Much Bigger Was this Real Estate Bubble than the Last One?

I've been predicting a 2012 bottom for bubble-area real estate prices since 2005. I based this estimate in part on the fact that the last California peak occurred in 1989 and Northern California bottomed in 1994, while Southern California continued plunging into 1996. Since the current market's peak was 2005-2006, 2012-2013 would be comparable–except that this was a bigger bubble. Therefore, the bottom could come later or, as I'm beginning to suspect more likely, we'll bottom with a "thud." Instead of the saucer-shape typical of real estate bottoms, this one may be more "L"-shaped, with little or no recovery in the lifetime of anyone over age 40.

This comparison with the prior bubble raises an interesting question: how much bigger was this one?

I look at my tax preparation/ financial planning-office house in Granada Hills for price comparisons over time, since I know the numbers for this classic 3 bedroom 2 bath 1680 square-foot tract home in the Valley. I purchased it in 1985 for $106,000. It ballooned to $190,000 in 1989, at which time I predicted a 30% collapse in value. Indeed, it bottomed at $130,000-135,000 in 1996, about 30% lower than seven years before, not counting inflation. It then grew in fantasyland to almost $600,000 by late-fall 2005.

Now, let's adjust theoretical value taking into account interest rates. Long-term fixed mortgages ran about 10% in 1989 and 6.5% in 2006. A buyer could afford to purchase one-third more home for the same payment, which arguably justifies one-third greater valuation (just like a bond). My $190,000 office-house increases in value to about $250,000 in the face of the interest rate plunge.

Inflation ran about 60% cumulatively in the 17-year period 1989-2006 (amazing how much fiat money drops in value in the blink of an economic eye under a regime of relatively mild inflation, isn't it?!). Add 60% to the $250,000 house and we get $400,000.

Although I've been citing its "fair value" as $360,000, if it was worth $190,000 in a prior bubble $360,000 is probably still too high. If "fair value" was $160,000 in the mid 1990s (to which it increased in fairly short order after the 1996 bottom) by this analysis its long-term theoretical value is about $330,000. IMHO, I think it'll bottom at or below $250,000.

Getting back to how much bigger this bubble was than the late 1980s version, adjusting for interest rates and inflation my office-house didn't stop increasing in value at its late 1980s equivalent of $400,000. It peaked at 50% higher. As we have seen, bubbles do not end well. They end badly. The bigger the bubble, the greater will be the fallout. As I wrote at the tail-end of the 2005 series on the real estate bubble, "The repercussions when [the] trend reverses could be a sight to behold."