"It would be irresponsible in the extreme for an individual to forestall a personal recession by taking out newer, bigger loans when the old loans can't be repaid. However, this is precisely what we are planning on a national level."
--Peter Schiff, President, Euro Pacific Capital

Tax and Financial Strategies

WEALTH CREATION STRATEGIES

The Wealth of Individuals
Part 3

In Part 1 (summer 2008 *Wealth Creation Strategies*), we talked about the importance of debt avoidance, stable growth, relative stability in one's personal life and beginning a savings and investing program earlier rather than later. In Part 2 (fall 2008 *WCS*), we discussed the ultimate source of wealth: the protection of property, which fosters the incentive to build savings used to invest in capital equipment. This is an essential component in creating a standard of living that is magnitudes higher than in societies lacking this protection. In this installment, we'll discuss an idea briefly alluded to in Part 1: that increases and decreases in wealth seem to occur in spurts.

Above all, avoid losses

Wealth typically grows or shrinks dramatically over brief periods of time, preceded and followed by periods of relative stability. According to InvesTech Research (www.Investech.com) average annual returns in the U.S. stock market were 9.6% from January 1, 1928 through February 29, 2008 ($10 grew to $15,279). But if you had missed the best 30 months your return would have been 4% ($10 would have grown to only $215). If you'd missed the worst 30 months, you would have achieved a 19.2% rate of return while watching that $10 grow to over $12 million. An analogy can be drawn to biological and human technological evolution, which similarly occurs in relatively short bursts

(which Michael Rothschild in his book, *Bionomics,* refers to as "punctuated equilibrium"). In geek terms, we live in a non-linear world subject to massive discontinuities. In lay person terms, the inevitable happens suddenly at unexpected times, like the one in which we are living.

It is essential to bear in mind that a 90% plummet in value requires an increase of 1,000% just to break even and a 50% drop requires a rebound of 100% to return to square one. This simple mathematical function accounts for the primary rule of great investors: first, lose no principal, a corollary of which is to minimize losses. It follows that we should try to time purchases when investments become dramatically undervalued and sales when absurdly overvalued.

Make it when you can; then relax

My most profitable investments ever were those about which I said, "This is a no-brainer. There is little downside risk and tremendous upside potential." I used these words after analyzing two key investments, one in Bend, Oregon in 1990 and another in Mammoth Lakes, California in 1997. The first involved $1,000 out of pocket for one-half of a $102,000 70-year-old multi-unit residential rental property that grossed $1,750 per month. I figured that even if all the income went toward expenses, I'd come out ok and never have to personally pay more than the interest on the $100,000 loan for which I was liable. It turns out the

property was so old that repairs, maintenance and management costs ate up what was left after the debt payment, property taxes and insurance. Still, when my partner and I went our separate ways ten years later, we each came out with $44,000. Most of the increased value occurred in a spurt from 1993-1997.

The compound rate of return from turning $1,000 into $44,000 in ten years is an extraordinary 46% per annum, made possible only by extreme leverage and one I don't ever expect to repeat.

Let's take a look at what the overall return on my $1,000 investment would have been had I figured at the ten-year mark (when we sold), "I can't find any good 'other' investments. Just get out, pay the tax and stick it into a 5% savings account or bond." Simplifying, my $44,000, while at first shrinking due to taxes, would have grown to about $49,000 by the end of 2008. The overall compounded rate of return over the full 18 years would have been, astonishingly, a bit over 24% per annum, still far better than just about anything else I've ever done with my money. (Because we exchanged into other property, the actual facts are a bit more complicated, but we want to keep this simple.)

Now let's ask, looking at the investment landscape today and seeing nothing better in which to invest, what does my overall return decline to if I end up leaving the funds in savings-type accounts until 2016, another eight years? Let's assume we can't do much

better than 3% with any degree of safety. Specifically, what will my overall compound rate of return be after 26 years, consisting of the first ten years at 46% per annum, the next eight years at 5% annually and the last eight at 3%? The end result is my little $1,000 grows to $62,000, for an average annualized return of over 17%.

When does 23%+5%+3%=11.5%?

The other investment in which I did extremely well was in Mammoth Lakes. I made the case that Mammoth was fundamentally undervalued in an article in the predecessor to this newsletter in August 1996. I purchased an 1100 sq. ft. condominium in 1997 for $70,000 and traded it eight years later for $370,000 net of selling costs. Most of the increased value occurred during the five year period ending in 2004. Figuring an all-cash purchase, the compounded rate of return was a bit over 23% per annum. (Since it was leveraged and there was a bit of net income, the actual return is far too complicated to try and calculate due to the negative effect of having made various subsequent payments toward principal, as well as the positive effect of net rental income.)

By the time we sold in 2005 (which I elaborated upon in the November-December 2005 *WCS*), I had turned extremely bearish on residential real estate almost everywhere and on any real estate in California. It came down to a choice between preserving the ridiculous profits we had earned by trading into something that I could only

hope wouldn't decline in value over the next decade, or selling, paying the tax and sitting tight for what I expect could easily be seven or eight years before prices in California return to a level of undervaluation. After intensive research, we decided to exchange into a commercial building in Tennessee, which we felt had decent fundamental value, partly because we expected a minimum 6% net after-expenses yield (so far we've done a bit better, but I don't expect that to hold over the next few years).

Still, let's say we average only 5% for the ten years beginning in 2006. What's the overall rate of return over the entire 18-year time frame, assuming the 5% earnings compound, the building's value remains the same and the overall net worth grows to (therefore) $603,000? Almost 13% per annum. What if we were to average only 3% in that ten-year time frame? The overall average rate of return would still be a very decent 11.5%

The idea I hope to convey is there are times to go for it, while at other times we should sit back and hope we can earn just a few percent per year, if that. In other words, sometimes capital preservation is essential. During periods of economic distress the focus should be to conserve whatever wealth we have created. Granted, the numbers don't work as well if you start out earning 3% and make the 23% per annum at the back end. Still, there will likely be a time when you earn a "spurt" part way through your investing career. The challenge is to preserve assets so you

have the funds with which to participate when such a spurt occurs.

Here's an example of what you could end up with by being conservative for the next five years, then experiencing a five-year growth spurt followed by taking a conservative stance for another five years. A five-year growth spurt is typical of bull markets in both stocks and real estate.

$10,000 grows at 3% per annum. You've got $11,593 after five years.

$11,593 grows at 20% per annum for the next five years. After year ten, your $10,000 has grown to $28,847. Your average overall annual return was a bit over 11%.

$28,847 grows at 3% per annum during years 11 through 15. After year 15, you've got $36,817, for an overall average annual return of 9%.

You began with $10,000 and ended up with $36,817 after 15 years, while at risk only one-third of the time. The average annual rate of return was 9%. Not bad on a risk-adjusted basis, except for the fact that you don't know in advance which five year period will include a spurt. Here's food for thought: the best times to invest are when you say to yourself, "This is a no-brainer," after markets have turned so ugly most people say they will never invest again, or when you are being paid to wait (for example, by earning 5% in net rental income or cash dividends on stocks). Although there are no guarantees in life, if you stick to investing only at those moments, the odds of investment success are substantially increased.

Traditional IRA-to-Roth Conversions: When is a Conversion Right for You?

I often point out that we should be happy to pay taxes at a 15% rate, especially if we're normally hit with a 25% or higher rate. In fact, whenever we have the opportunity to recognize income and pay tax at the lower rate in lieu of paying at the higher rate at some future date, we should *generally* do so, especially if that future isn't too far off.

This is true even when you don't need the money. After all, you *might* need it. If you're planning to purchase a

home or car in the next several years, rather than taking a chunk of otherwise discretionary income at that time (causing much of that distribution to be taxed at higher rates), consideration should be given to withdrawing it gradually and banking it over the next several years. (I've mentioned this idea on many occasions, including the July-August 2005 *WCS* in an article titled, "Income Averaging: Making the Best of a Low Income Year," available at

www.DougThorburn.com or by simply asking us for a copy.)

Even if you'd prefer to leave the funds in the IRA, you may be *required* to recognize income in future years at a higher tax rate due to **Required Minimum Distribution (RMD)** rules associated with IRAs and other retirement plans. Ultimately, it can be quite profitable to recognize some of that income while in lower tax brackets.

For example, say you're single, age

62, no longer working, living on savings, have non-Social Security income (pension, rents, interest, whatever) of $15,000 per year and have $500,000 (left) in your IRA. You (wisely, depending on expected longevity) elect to delay receipt of Social Security until normal retirement age—currently 66, when your Social Security income will be $15,000 (about 30% higher than if you had elected to begin at age 62).

You will be required to withdraw almost $20,000 per year from your IRA at age 70 ½. The yearly tax on current income between now and then is expected to be only $600 (dropping to $400 when you reach 65 due to a higher standard deduction). When you begin withdrawing from your IRA, the combined non-Social Security income of $35,000 (the $15,000 you're already getting plus the $20,000 RMD) will take you well into the phase-in for taxing Social Security income. In fact, $11,700 of the Social Security income will be taxable. Your total tax in the first RMD year will be $5,450, which effectively creates a 27% tax on the IRA income.

Given the likely future tax rate of 27% on RMDs, you should consider paying tax on some of the IRA now at a 15% rate. *You could take roughly $26,500 per year and do exactly that before Social Security income becomes a factor.* Since you don't need the money, you may not consider this idea, until you understand the difference between taking distributions now vs. later when Social Security kicks in. Perhaps a chart will help:

Not yet receiving Social Security

Non-IRA, non-Social Security income	IRA withdrawal	Tax	Tax *rate* on IRA withdrawal
$15,000	0	$600	n/a
$15,000	$26,500	$4,500	15%

Social Security kicks in

Non-IRA, non-Social Security income	Social Security	IRA withdrawal	Tax	Effective tax rate on IRA withdrawal
$15,000	$15,000	0	$400*	n/a
$15,000	$15,000	$26,500	$7,340	26%**

*A bit less than pre-Social Security age due to a higher standard deduction.
**   The tax rate when Social Security is added to income ranges in many of these examples from 26% to 28% due to rounding.

Here's an even better idea. Since you don't need the money (and can pay the tax on the withdrawal out of savings), how about converting the funds to a Roth IRA? That way, future gains (should there be any ever again) are tax-free, which is the key idea behind a traditional-to-Roth conversion. You are never again taxed on the funds converted into a Roth *and* never taxed on profits earned inside the Roth (so long as you don't run afoul of the easy-to-meet rules).You pay the tax now at a lower rate, reduce the amount in your IRA that might be subject to higher tax rates in future years and convert all future growth to tax-free status.

Moreover, by reducing the amount in your traditional IRA you reduce the RMDs that begin at 70 ½. To the extent you deposit the funds into Roth IRAs, you also reduce future taxable investment income. In addition, you are never required to take distributions from the Roth IRA and can leave that whole chunk to your heirs, income-tax-free. On the other hand, the funds can be accessed tax-free at any time. Nice.

Advantages of IRA-to-Roth conversions for those in the right situation include:

❱ Converting future growth and income from taxable investment accounts to permanently tax-free status
❱ Paying tax now at lower rates than the rate you may be subject to later
❱ Decreasing future mandatory distributions from IRAs, thereby reducing future taxable income
❱ Leaving retirement funds tax-free to heirs

Even Social Security recipients may benefit

Due to the convoluted rules taxing Social Security, I'm finding that conversions are appropriate even for some Social Security recipients.

An example of someone for whom yearly traditional-to-Roth conversions may work include a married couple in their mid-60s with non-Social Security income of $20,000, Social Security income of $17,750 and deductions totaling $22,000. Due to a recent inheritance, they don't need to draw out of a $600,000 IRA to survive. But should they? Since their tax is zero, of course they should—and convert it to a Roth. Ok, how much?

Now, this is complicated, so try reading this paragraph at least a couple of times. The tax on an additional $5,000 of extra income is only $400. Rational people are more than willing to pay an 8% tax on income, especially if that income can be converted to a Roth, from which all withdrawals (assuming the easy-to-meet rules are followed) are tax-free. The tax rate on

an additional $8,000 (total additional income of $13,000—the original $5,000 plus the new $8,000) is 15%. The total tax is now $1,600. Take another $1,000 (you're at $14,000) and pay an additional tax of $200, which is 20% of that incremental $1,000. Still, not bad, especially when we consider the fact that the mandatory yearly withdrawals beginning in four years will be $22,000, bringing your total tax to $3,960. In other words, that last $8,000 (going from $14,000 to $22,000) increased the tax by ($3,960 - $1,800 =) $2,160, or 27%.

The weird part of this (remember, we're talking tax law here) is that once 85% of the Social Security income is taxed, the 27% rate drops back down to 15% for a stretch. We should consider taking advantage of this opportunity via a Roth conversion and "use up" that 2nd 15% tax bracket.

The Social Security income "hump" keeps many people from seeing this as an opportunity, particularly since the 27% phantom bracket continues until a total of $26,000 is converted (creating an additional tax of $1,090 on that last $4,000, for a total tax burden of $5,050). At this point, 85% of the

Social Security has been taxed and now the 15% rate kicks back in. Increase the income—by up to an additional $26,000—and pay a tax of only 15% of that incremental "chunk" of income. If $52,000 of IRA income is converted to a Roth IRA, the total tax is $8,950, which is only $3,900 more than the $5,050 tax on the first $26,000 of the conversion PLUS the original non-Social Security income of $20,000. (Got that? Maybe the chart below will help!)

Tax on Roth IRA conversion assuming $17,750 Social Security, $20,000 "other" income and $22,000 in total deductions, married filing jointly

Total Roth conversion	Incremental Roth conversion	Total Social Security subject to tax*	Total tax	Tax on incremental Roth conversion	Tax *rate* on incremental Roth conversion
$0		$0	$0		
$5,000	$5,000	$900	$400	$400	**8%**
$13,000	$8,000	$4,900	$1,600	$1,200	**15%**
$14,000	$1,000	$5,400	$1,800	$200	**20%**
$22,000	$8,000	$11,840	$3,960	$2,160	**27%**
$26,000	$4,000	$15,100**	$5,050	$1,090	**27%**
$52,000	**$26,000**	$15,100	$8,950	$3,900	**15%**

*   This is meant for geeks. You may be able to ignore this column and grasp the bottom line.

** Note that this is 85% of the total Social Security income, at which point all the Social Security that can be taxed is already taxed. Because of the convoluted tax law, this is the income that creates this mess.

What happens when one spouse dies after mandatory distributions begin? The tax rate on the RMD for the survivor could be 27% from the get-go. Assume that income remains the same, deductions drop to $17,000 and the value of the IRA is $500,000. We'll assume that the RMD begins at $18,000. As you can see, none of the income is taxed at 15%.

Tax on $18,000 RMD, assuming $17,750 Social Security, $20,000 "other" income, $17,000 in deductions and single filing status

Mandatory IRA distribution (RMD)	Total Social Security subject to tax	Total tax	Tax *rate* on RMD
$0	$1,900	$200	
$18,000	$14,750	$5,100	27%*

* Any additional income is taxed at regular tax rates starting at 25%.

While there are too many variables to know the optimal course of action, the odds are this couple and their heirs will be wealthier in the long run if they pay tax on enough income to use up the large expanse of 15% bracket territory above that phantom 27% bracket. The Roth conversion is a perfect way to do this.

Here's an example of a couple that has already begun taking their RMDs. They have non-Social Security income of $41,400 (which includes a mandatory withdrawal of $6,400) and Social Security income totaling $25,600, up to $21,760 of which is potentially taxable. They do not itemize deductions.

Tax rate on couple already taking RMDs

Total non-Social Security income	Total IRA income**	**Incremental Roth conversion**	Total Social Security subject to tax*	Total tax	Incremental tax on mandatory withdrawal *or* Roth conversion	**Tax *rate* on incremental income**
$35,000	$0		$9,200	$2,830		
$41,400	$6,400		$14,670	$4,600	$1,770	28%
$49,800	$14,800	**$8,400**	$21,760	$6,930	**$2,330**	**28%**
$64,050	$29,050	**$14,250**	$21,760	$9,140	**$2,210**	**15.5%**

*   This is meant for geeks. You may be able to ignore this column and grasp the bottom line.
** The first $6,400 is the mandatory withdrawal. The additional amounts are voluntary Roth conversions, but the same principal holds for any other ordinary income including additional IRA withdrawals that are not converted.

The mandatory withdrawal of $6,400 is already subject to a 28% tax rate. The couple is in the middle of the phantom 28% territory. Why not move beyond it and take full advantage of what is essentially a second 15% bracket?

For an additional tax of ($2,330 + $2,210 =) $4,540, ($8,400 + $14,250 =) $22,650 can be converted to a Roth IRA, never to be taxed again, reducing mandatory distributions from the traditional IRA and invested where it can grow tax-free long past the death of the owner.

An even more compelling argument for early Roth conversions can be made when we look at the tax rate on a survivor who takes the standard deduction. We'll assume non-Social Security income falls to $21,000 and Social Security income drops to $17,100. RMDs continue and, in fact, increase for a period of several years. Let's assume the survivor needs additional funds of $5,000 to $10,000 to live on, which must be drawn from the IRA.

Survivor's tax rate jumps

Mandatory withdrawal	Additional voluntary IRA withdrawal	Non-Social Security income	Total Social Security subject to tax*	Tax	Incremental tax on IRA withdrawal	**Marginal tax *rate* on incremental IRA withdrawal**
		$21,000	$2,275	$1,545		
$6,400		$27,400	$6,150	$3,090	$1,545	**24%**
	$5,000	$32,400	$10,400	$4,480	**$1,390**	**28%**
	$5,000	$37,400	$14,535	$6,750	**$2,270**	**45%**

*This is meant for geeks. You may be able to ignore this column and grasp the bottom line.

You can see that funds taken after the other spouse dies are subject to a higher tax rate than that $14,250 (or even the $22,650) voluntary conversion while both are alive.

There are many variables to consider before deciding to take advantage of conversions. A potentially crucial one that I haven't discussed is state income tax, which can alter the numbers dramatically. The personal and tax situation of the heirs can influence strategy. If an IRA is left to charity, much of the benefit of conversions may be negated. However, bearing in mind the overall long-term tax cost of IRA withdrawals, early and accelerated Roth conversions should be *considered* by everyone.

Perspectives on the Crash

The historic crashes we have seen in the property, financial and commodity markets come as no surprise to this amateur Austrian School economist and Elliott Wave theorist. As I have been writing in these pages since late 2004, real estate was dangerously overvalued by all measures. The aftermath in stocks is what I meant when I wrote in 2005, "Bubbles do not end well." And since higher prices act as an incentive to producers to produce more and consumers to consume less, the monumental crash in commodities, particularly oil, was no shock either, even if the *speed* of the decline was extraordinary.

I learned in the late '90s that the timing of such collapses isn't exactly predictable. I thought the equity markets were overvalued in '96 (they were) and that they would, therefore, collapse (they didn't). I thought the same thing in '98, when they were more overvalued and *still* didn't crash. When in 2000 I said, "If what I'm seeing now isn't a sign of the peak, I don't know what is," I figured I'd been wrong for so long, why bother saying anything to anyone or even acting on it? One must patiently wait for markets to do what they will eventually do. Investors, including this one, have a

difficult time standing one's ground for so long.

Bearing in mind the history of manias and crashes, I've been extensively reading and researching current events. In the last issue under the heading, "The End of Crony Capitalism," I explained the root of the housing meltdown, which should be read and re-read by those who hope to better understand what went wrong, with the goal of avoiding future catastrophic losses. (The rest of the issue, too, should be re-read to help identify public policy prescriptions that could make things catastrophically worse.) Below, I cite a tiny fraction of quotes from my research, which should help you to better understand the issues. If as a society we expect to pull ourselves out of this mess *and* prevent a similar catastrophe in the future, we need to understand its root cause. As Andrew B. Wilson wrote in his "Five Myths About the Great Depression" in the November 4, 2008 issue of *The Wall Street Journal*: "With the vitality of U.S. and world economies at stake, it is essential that the decisions of the coming months are shaped by the right lessons—not the myths—of the Great Depression."

Overview…

"There was a time long ago when human beings believed that trees caused the wind. They weren't stupid, just ignorant. Today, human beings believe that money is the answer to poverty. They're still not stupid, but they're still ignorant….The question is not, What causes poverty? Poverty is man's natural state. The question is, How is wealth created?....It is created by entrepreneurs who live in societies that … protect private property."
--Edward H. Crane, *Cato Policy Report,* Cato Institute

"When you see that trading is done not by consent, but by compulsion—when you see that in order to produce, you need to obtain permission from men who produce nothing—when you see that money is flowing to those who deal not in good, but in favors….when you see corruption being rewarded and honesty

becoming a self-sacrifice—you may know that your society is doomed."
--Ayn Rand, *Atlas Shrugged*

"In the last 100 years there have only been two fires similar to that of today. The first inferno was in 1929, centered in New York. The second was in 1989, when Tokyo went up in flames. In both instances, rescuers took extraordinary measures. And in both cases, they not only failed to save the economy, they scorched it even more." --Bill Bonner, *The Daily Reckoning*, quoted in *The Contrarian's View*, November 16, 2008

Lessons we should have learned from the Great Depression…

"In an amazing feat of revisionist history, somehow Hoover's interventionist policies have been completely forgotten. It is taken as fundamental that his inaction led to the Depression and Roosevelt's 'heroics' got us out. Unfortunately, since we have learned nothing from history, we are about to repeat the very mistakes that lead to the most dire economic circumstance of the last century…. With Barack Obama now waiting in the wings to conjure a newer New Deal, far larger than even FDR could have imagined, and at a time when we cannot even afford the old one, this will not be your grandfather's Depression. It may be much worse."
--Peter Schiff, *Euro Pacific Capital Commentary*, www.europac.net/#, October 17, 2008

"The guilt for the Great Depression must…be lifted from the shoulders of the free-market economy and placed where it properly belongs: at the doors of politicians, bureaucrats and the mass of 'enlightened' economists. And in any other depression, past or future, the story will be the same." --Murray Rothbard, *America's Great Depression*

"Quite aside from the harm done by specific programs [implemented by both Herbert Hoover and FDR during the Great Depression], the general uncertainty generated by unpredictable government interventions made investors reluctant to make the long-term commitments needed to generate more jobs, more output and more

purchasing power….[which managed] to make the Great Depression worse…."
--Thomas Sowell, "Just don't let Congress 'fix' stock market," syndicated column July 26, 2002

"FDR's policies likely prolonged the Great Depression because the economy never fully recovered in the 1930s, and actually got worse in the latter half of the decade. And we know that FDR got away with it…by blaming his predecessor, Herbert Hoover, for crashing the economy in the first place." --Paul H. Rubin, "Get Ready for the New New Deal," *The Wall Street Journal*, October 21, 2008

"Mr. Bush's staggering 2003 increase [in regulatory spending] of more than 24% was the largest in the last 50 years. If Mr. Obama considers this a record of deregulation—and if current polls hold—America's economy could be in for a very long four years." --James Freeman, "Spitzer and Sarbox Were Deregulation?" *The Wall Street Journal*, October 31, 2008

"No liquidation of bad debt and malinvestment is to be allowed. By doing more of the same, we will only continue and intensify the distortions in our economy - all the capital misallocation, all the malinvestment - and prevent the market's attempt to re-establish rational pricing of houses and other assets…. We are told that 'low interest rates' led to excessive borrowing, but we are not told how these low interest rates came about. They were a deliberate policy of the Federal Reserve. As always, artificially low interest rates distort the market. Entrepreneurs engage in malinvestments - investments that do not make sense in light of current resource availability…. [What the government is doing is] the same destructive strategy that government tried during the Great Depression: prop up prices at all costs. The Depression went on for over a decade. On the other hand, when liquidation was allowed to occur in the equally devastating downturn of 1921, the economy recovered within less than a year….

"The only thing we learn from

history, I am afraid, is that we do not learn from history."
--Congressman Ron Paul, "My answer to the President," September 25, 2008, via email

"Central government planning did not work in the Soviet Union and it will not work here. Only free market forces are capable of sorting through the mess. Political meddling will make the problems worse….There will certainly be a great deal of economic pain. Companies will go bankrupt, banks will fail, real estate and stock prices will keep falling, and many people will lose their jobs. However, government action will not prevent any of this. At best, it will merely delay the inevitable, but only at the cost of increasing the severity of the underlying problems, thus making their ultimate resolution that much more painful to endure…."
--Peter Schiff, Euro Pacific Capital Commentary, www.europac.net/#, September 26, 2008

"One would be hard-pressed to say that the financial fallout from this latest money meltdown will have less damaging consequences for the average person than would have been incurred under a gold standard….Sound money would go a long way toward eliminating the distortions that pervert financial decisions and credit allocations."
--Judy Shelton, "Loose Money and the Roots of the Crisis," *The Wall Street Journal*, September 30, 2008

"The theorem of the economic impossibility of socialism, which the Austrian economists Ludwig von Mises and Friedrich A. Hayek discovered, [states that] it is impossible to organize society, in terms of economics, based on coercive commands issued by a planning agency, since such a body can never obtain the information it needs to [efficiently coordinate the allocation of resources]. Indeed, nothing is more dangerous than to indulge in the 'fatal conceit' to use Hayek's useful expression—of believing oneself omniscient or at least wise and powerful enough to be able to keep the most suitable monetary policy fine-tuned at all times….The reintroduction of a cheap-credit policy at this stage

could only hinder the necessary liquidation of unprofitable investments….It could even wind up prolonging the recession indefinitely, as occurred in the Japanese economy, which, after all possible interventions were tried, ceased to respond to any stimulus…." --Jesus Huerta de Soto, "Financial Crisis and Recession," *Daily Article*, Ludwig von Mises Institute, www.mises.org October 6, 2008

"At the current rate of repair it will take 62 years for [U.S.] bridges to be brought up to date. But it won't take six decades to fix them because the government doesn't have the money; it will take that long because our political leaders don't prioritize. Too often they choose ribbon-cutting ceremonies at sports complexes over repairing bridges." --Robert Poole, co-founder of the Reason Foundation, "Stimulus Shouldn't Be an Excuse for Pork," *The Wall Street Journal*, December 10, 2008 [Ed. Note: this is the trouble with government allocation of capital and socialism in general. Rather than allocating capital where consumers want it, it's allocated where politically expedient, where pork buys votes.]

And the debt rolls on…

"Politicians and the media have characterized delinquent homeowners as troubled victims of predatory lenders, unsophisticated, helpless and struggling. The truth is that these 'unsophisticated' borrowers have gamed the system on the way up by accepting 100% leverage to potentially reap the upside of further housing appreciation, a one-way option kept alive by making monthly mortgage payments….These same borrowers are simply allowing the options to expire as worthless by defaulting on their mortgage loans. They are now gaming the system on the way down by waiting for a government bailout in the form of significant debt forgiveness."
--David Mahoney, letter to *The Wall Street Journal*, October 31, 2008

"The government got into the business of encouraging and then forcing lending institutions [via the Community Reinvestment Act and aided by the U.S. Department of

Housing and Urban Development regulations] to make mortgage loans to people who could not pay them back. What we ended up with is a failure of government…." --Harvey Golub, former CEO of American Express, "Getting Out of the Credit Mess," *The Wall Street Journal*, December 9, 2008

"The sad reality is that we borrowed and spent our way into this crisis, and we are not going to borrow and spend our way out of it."
--Peter Schiff, *Euro Pacific Capital Commentary*, www.europac.net/#, October 10, 2008

"…The taxpayers had nothing to do with either side of the mortgage transaction. If the house's value appreciated, believe you me the overleveraged homeowner and the overly aggressive bank would never have shared their gain with the taxpayers….Now enter the government [which] doesn't create anything; it just redistributes. Whenever the government bails someone out of trouble, they always put someone into trouble, plus of course a toll for the troll….If you don't believe me, just watch how Congress and Barney Frank run the banks. If you thought they did a bad job running the post office, Amtrak, Fannie Mae, Freddie Mac and the military, just wait till you see what they'll do with Wall Street…."
--Arthur B. Laffer, "The Age of Prosperity is Over," *The Wall Street Journal*, October 27, 2008

"At long last, nobody wants to lend money to people who won't pay it back. Except governments, of course."
--Thomas G. Donlan, "Where Are All the Capitalists?" *Barrons*, October 13, 2008

"It is naïve for …[Congressman Barney] Frank to defend Fannie and Freddie (the government) by averring that they did not originate mortgages. That is like saying that Jack Daniels did not get anybody drunk; it was the liquor store proprietors' fault. All those loans only got made because Fannie and Freddie defined for the marketplace what characteristics a loan had to have in order to be eligible for purchase by the GSEs [Government Sponsored Enterprises such as Fannie

and Freddie]. Effectively, Fannie and Freddie did make these loans; they just farmed out the dirty work of actually doing the paperwork to banks and mortgage brokers." --Jim Carr, letter to *The Wall Street Journal* October 6, 2008

"Government and mainstream economists have erroneously concluded that the key to reversing the financial free fall can be found in stopping the plunge in home prices. (I would offer the corollary that the key to reducing injuries in auto accidents is to suspend the laws of inertia). But to accomplish the improbable task of re-inflating the housing bubble, the government appears ready to announce a coordinated plan to push down mortgage rates to just 4.5%. Of course, this is precisely the wrong solution to the housing crisis, but when it comes to bad ideas our government has been remarkably consistent." --Peter Schiff, *Euro Pacific Capital Commentary*, www.europac.net/#, December 7, 2008

"The intention of all these daily federal interventions is to keep the credit spigots open so Americans can go even deeper into debt to buy more stuff they can't actually afford….When speaking about the need for an even larger fiscal stimulus package, Barney Frank, chairman of the House Financial Services Committee, said, 'We have to prop up consumption.' He has it backwards. The government has been propping up consumption for far too long, and the best thing they can do now is remove the props so spending can be replaced by savings." --Peter Schiff, *Euro Pacific Capital Commentary*, www.europac.net/#, October 10, 2008

"Anytime you have engines of debt supporting an investment, you will ultimately create a bubble in that area. In past decades, the federal government has created many engines of debt aimed toward greasing the skids for people to buy real estate: Fannie Mae, Freddie Mac, Ginnie Mae, 12 Federal Home Loan Banks and the FDIC [Federal Deposit Insurance Corporation]. The FDIC contributed in an interesting way. It has told depositors they don't have to worry about what their bankers are doing because they are covered with an implied guarantee by the U.S. government. An implied guarantee for an IOU makes the lender [depositor] a lot less interested in looking carefully at what he is investing in." --Robert Prechter Jr., *The Elliott Wave Theorist*, December 19, 2008

"[John] Stossel argues that markets are too complex to manage [by government regulatory bodies]. [Those who responded to him] assume that regulatory power will be used to benefit the broadest number of people. But the regulators may have their own agenda….Even if you give regulatory power to someone who uses it for the common good, the creation of a position with that power will attract those who desire to use it for their own purposes. Mr. Stossel's argument can be stated another way: Give as little power as possible to those who can use it to disrupt your life." --Brady Elliott, letter to *The Wall Street Journal*, October 28, 2008

Final thoughts…

"Manic markets are akin to people abusing 'speed.' In foregoing sleep, amphetamine [addicts] disrupt the healthy ebb and flow of consciousness that is required to healthy long-term functioning, just as manias disrupt the ebb and flow of prices that is required for healthy long term advance. Like manias, amphetamine abusers perform abnormally well for awhile….until they crash. When they crash, they reach a state worse than the one they were in when they began the abuse, just as a market does after a mania." --Steve Hochberg and Peter Kendall, *The Elliott Wave Financial Forecast*, October 15, 2008

Judging by the chart below, there is still tremendous downside risk. Note that until 1995, major stock market peaks generally coincided with dividend yields a bit over 3%. In 1995, yields dropped below that level and stayed there until October 2008. Based on the last 90 years of market history, a long-term market bottom may not be in place until yields reach 7%. Between now and then, there may be plenty of up and down action--but the long-term trend appears to have reversed in 2000. (Disclosure: I am currently 30-40% invested in stocks, but nimble.) Chart courtesy of Robert R. Prechter, Jr., Elliott Wave International, www.elliottwave.com.

STOCK MARKET vs. DIVIDEND YIELD