

June 23, 2008 Investment Commentary (released July 1, 2008)

## **"A Recession May Be 'Just What the Doctor Ordered'"**

### ***The news continues to be bad – and we must prepare for much worse.***

Every day the worst-case scenario I presented in the April, 2007 newsletter seems closer to becoming reality. In fact, I am pleasantly surprised by how well the economy has held up in the face of all of the onslaughts it has faced; I would have expected inflation and unemployment to already be much higher than it is. I believe this apparent resilience bodes well for the economy over the long term but, as I stated almost a year and a half ago, the ingredients for a significant recession are all there and things grow more ominous by the day.

### ***So what is going on?***

It would be comforting to believe all of our problems are the cause of banks, greedy corporate executives, and government mismanagement. Of course they were partly to blame, but the biggest responsibility lies with us, the American public. No one forced us to pay for large houses, wide screen TVs, and gas guzzling SUVs and pay for them with credit cards and ever larger mortgages. We have unabashedly overspent as we collectively lost track of economic reality. Our "savings" rate has been negative for far too long.

Our buying binge was able to go unabated for quite some time because as we lost fiscal discipline the world financial institutions funded our shopping spree by buying our debt at very low interest rates. As we sent dollars overseas for more products they gave us back the dollars for I.O.U.s. This artificially propped up the dollar and kept interest rates down. As the dollar weakens it is getting harder for us to attract lenders to fund our irresponsible spending. We now have to sell off large portions of our companies and assets (foreigners and sovereign wealth funds buying U.S. banks and real estate) to pay for yesterday's TV, designer kitchens, SUV, and the gas for the SUV.

It should come as no surprise that many of the goods we consume are produced abroad because for our consumption to increase more than our production we have to buy goods someone else is making with money we don't have. Thus we have set the stage for continued weakness of the dollar, and now we must pay for our borrowing by saving and producing even more. There are a lot of dollars and IOUs (treasury bonds) we have sent abroad that must be repaid.

### ***Do you believe in magic?***

To get out of this crisis will require significant and painful steps by the U.S. public and government alike. We must focus on saving and producing real products and services – and not chasing the next alluring way to make a quick buck. Wealth is not created out of thin air by trading stocks, leveraging and employing the magic formulas of hedge funds, or flipping houses. How did all of us count on becoming wealthy by not producing anything and collecting rents from the remaining producers? Where did the wealth come from? *Magic!*

Finally we also believed in the magical ability of the Federal Reserve to avoid any serious recession simply by lowering rates. We believed this so much that we began to lose track of what "tough" times really were and we priced any risk out of the market. Stocks, then real estate became so expensive because rents and earnings will always go up; the Fed had mastered the economic cycle and we could never face a significant recession again.

Our lack of savings also means when bad times come (perhaps very soon) many of us will have no ability to handle unexpected job losses, or even just an increase in gas prices. No safety cushion could spell disaster for many American families. My what a mess we have created!

***Can we save more? Of course!***

The people of China and other fast-growing countries are quickly becoming wealthy *not* from magic. The wealth they have been creating is real, gained through hard work and regulatory easing that has allowed people and corporations to innovate and produce more. They save a lot of their earnings to reinvest in new businesses and productive improvements; in fact they are able to save over 20% of their incomes even though most of them have lifestyles far less extravagant than us. Consider how many immigrant families come to the US and live meager lifestyles and become rich after a decade of saving and investing. Any American can do the same. Let's follow their example!

***Times look tough, but we must stick to a long-term strategy.***

Even though things look bad and could get much worse we should be comforted that Americans have always done well when presented with challenges – that is precisely why the American economy has had a long track record of wealth creation. Technologies and efficiencies will likely lead to more pieces of pie to go around (*real* wealth), even if some have more pie to eat than others. If America's historical trend continues then long-term investors may get bruised tomorrow but we will triumph in the end.

We must remain focused on our savings and investment objectives. Reacting to news and/or emotions is a proven sure-fire way to kill long-term investment returns. Our goal is to not magically create wealth out of thin air by trading over the next 6 months or few years; it is to have more wealth when we need it many years from now.

None of us are true magicians. Neither I nor anyone else can claim to have the clairvoyance to prevent any of us from experiencing losses in a down market while still experiencing all of the gains in up markets. I argue those who claim to be able to magically be able to time the market are selling a dangerous and poisonous illusion.

What I *can* do is keep everyone on a long-term plan that is most likely to be successful over time. I must do my best to keep our eyes focused beyond the immediate (though large) bumps and on the benefits that historically have always seemed to have lain beyond the horizon – just out of our sight.

We need to make realistic choices on personal consumption. We must vote for realistic entitlement benefits we can afford. And we must end the recent fad of blaming someone else for our problems, including the government and "big corporations." It will take a lot of courage for us to make the changes needed to enable America to compete and grow in this global economy and these changes may not be possible to enact until we have collectively experienced a greater degree of pain. If so then a near-term significant U.S. recession may be "just what the doctor ordered." If that is what it will take to effect the needed changes then, as a long-term investor, I say "the sooner the better."

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Mark Daniel Elliott, President  
Elliott Asset Management  
Registered Investment Advisor  
760-845-7854, Direct  
206-222-2772, Fax

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