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Winter Commentary 2006

The Markets and The Economy

2005 turned out to be a mediocre year for most investment classes. Much as we had forecasted, single digit growth in the U.S. stock markets were bested by international markets. The bear market for bonds of all types continued in the face of extremely adverse interest rate conditions.

The Dow Jones Industrial Average of 30 stocks fell slightly during 2005 with a $<.67\%>$ return. The broader Standard & Poor's 500 Composite rose 3% and the technology laden NASDAQ Index gained 1.4%, its smallest move since its inception in 1971. The Rikoon Carret stock portfolios in U.S. stocks gained 4.89% during 2005 while our international portfolios rose 16.86%.

Overseas, in U.S. dollar terms, the Dow Jones European Index of the 50 largest stocks gained 5.5%. If investors had based their calculations on the local Euro currency, these markets were actually up 20.7%! Some of the Asian markets were the best performing of all, with Japan breaking a 20 year record by rising 40% for holders of the yen currency. However, due to the appreciation of the U.S. dollar, the Japanese market only gained 22% for investors based in our country.

The main reason that the U.S. dollar rose in 2005 was that the Federal Reserve increased short term rates, under which banks borrow from the government in order to lend to consumers and businesses, eight times during 2005, ending the year at a 4.25% level. In contrast, the European banks raised their rates only once, to a rate of about 2.25%. As a result, U.S. bonds are paying approximately 2 full percentage points more than European bonds. This difference caused a large scale movement of funds into the U.S. dollar, thereby making it appreciate in value.

Several countries in Asia also performed well, most notably South Korea, Australia and India. Asian equity markets have outperformed others worldwide for three years running. We feel that this rally in Asian stocks is long in the tooth and so are beginning to lighten up on our positions. We recommend against increasing exposure to Asian stocks right now.

In the bond markets, the short term U.S. taxable bond index fell 2.17% on a price basis in 2005, but when one adds in the coupon or interest earned, it gained 1.02%. Tax free bonds fared slightly better, falling .64% in price while gaining 1.45% once the interest earned is factored in. The Rikoon Carret bond portfolios returned 2.24% in the taxable area and 2.32% in the tax free realm.

Going forward in 2006, we expect the Federal Reserve Bank to raise interest rates two more times to a 4.75% level. If this occurs, it will hold back stock performance during the first half of 2006. Once the Fed indicates an end to their tightening, we expect stocks to rally sometime before traders go on vacation in mid-summer. Concurrently, the U.S. dollar should start to fall when the Fed signals an end to rate increases. Given the European and Japanese central banks' desires to

stimulate their economies for political reasons, we do not expect the dollar to fall as much as it did in 2003, which was the last time U.S. interest rates declined.

Overall, economic news during 2005 was not bad. The nation's economy grew at a 3.6% rate while corporate profits rose 14.5%. The market is always forward looking and the current expectations built into today's stock market prices are for slightly slower growth, about 3.4%, while corporate profits are estimated to increase at a 12.5% rate. If there is a small but highly publicized decline in overall economic activity, our expectations for stock returns in 2006 will be in the middle single digits, from about 5% to 8% including dividends.

Energy and health care were the two best performing areas during 2005. Energy stocks rose an average of 34% on a total return basis and health care stocks increased 7.65%. Other than these sectors, the other nine areas in the Standard and Poor's Index either fell or were neutral. In fact, the market, other than energy stocks, fell in absolute price levels during 2005. Our use of alternative investments, including real estate, private placement notes, and natural resources helped our clients in 2005.

One final note on the markets is that we have recently experienced an "inverted" yield curve. This means that short term interest rates are higher than long term interest rates. For example, if short term Treasury Bills are paying investors for three months at a rate of 4.4%, people putting their money to work for 10 years are getting only 4.39%. What does this mean?

Inverted yield curves have marked the beginning of each of the last four recessions. It is likely that as a result of higher interest rates in the mortgage market, real estate sales of existing homes will continue to decline slightly from their peak of early 2005. With oil prices now staying over \$60 a barrel, an increase of over 40% from the price in early 2005, the new reality of the high cost of energy and transportation is sinking into people's thinking. This may play out in a slower economy than most people expect in 2006.

NURTURING THE CREATIVE SPIRIT

I believe that it is unlikely that China, or any other one country, will assume America's place as the number one economic world power, but it is possible that a consortium of creative urban areas around the world will. The most important fuel for economic power going forward will not be oil, natural resources, manufacturing or even computers, but creative workers. By this, I mean people who are trained to be flexible, who are able to constantly learn, who can communicate with many different types of people, and who can multi-task.

Several nations understand this, but unfortunately, our official policy is traveling in the opposite direction. The fact is that people are the most important resource of any nation, and dynamic people are no longer tied to any single nation because of global mobility. A professor of future trends, Richard Florida, considers creative people to be a new class of world citizens. He points to cities that offer a high quality of life, such as New York City, San Francisco, Paris, Sydney, Amsterdam and smaller nodes of cultural and educational activity, such as Cambridge, England and Iowa City, Iowa as places that recognize the need to attract people with creative energy. Does your town fit this description?

The United States, due to security concerns, has kept many talented immigrants and foreign students out of the United States and decreased our long term competitive advantage. We still

lead the world in producing creative workers in fields such as technology, finance, design, scientific research, communications and entertainment, but the percentage of jobs in our country that relate to these areas is behind that of many other nations. Approximately half of the jobs in the Netherlands, Australia, Sweden, Switzerland, Denmark and Norway are flexible, requiring advanced on-the-job learning and adaptive behavior. In the United States, the number is around one-quarter. Even places in Eastern Europe such as Ukraine and Estonia have a higher percentage of creative based jobs than we do. All of this points to a more troubling threat to the U.S.'s future economic dominance, than does China's emergence as a manufacturing center of the world.

The three basic components which promote creative work are respect for openness, investment in technological infrastructure, and recognition that creative talent is the primary instigator of new business formation. It appears to me that religious ideologies seem to now make an imprint on our long range strategic decisions, thereby decreasing our global competitiveness. This has occurred in the area of scientific research, most notably in respect to stem cells, but also in the way the United States government is treating most non-citizens.

This is demonstrated by a recent decision of the United States Department of Commerce which incited the European Union to challenge the U.S.'s control of the supposedly neutral agency which gives out Internet addresses or "domains". Because of complaints from conservative religious groups and others, the Department of Commerce removed its support for creating a new sector of the internet, to be known as .xxx, for pornographic material. Because this action represents a politicalization of the Internet, other nations are upset and rightfully so.

The Internet is a key to fostering creative workers. If we muddy the water of free exchange of ideas, I daresay we will have to drink from a tainted well. The Internet is already controlled in China. The Chinese government blocks websites that relate to democracy or political views that diverge from the party line. In a similar way, the United States is trying to block certain content which some people feel should be suppressed. The term for suppression of the Internet is called "cantonization". I can't figure out if that refers to Canton, China or Canton, Ohio!

The Internet offers everyone who has a computer and phone lines the opportunity to access information. It has, in some ways, taken the place of offices, libraries, conferences, travel, mail, TV and phone. What the Internet cannot do is provide the opportunities to build personal relationships, which in business, are key.

Where do our best chances lie for producing a creative environment where Americans and others can participate in the exciting opportunities to come? We have examples of what does not work. Silicon Valley has been a magnet for creative people but at the same time, the majority of people in California have watched their economic prospects decline. Take away appreciation in home prices and people are working harder for less benefit. Many service workers, teachers, government employees, clerks, transportation and security employees are struggling to pay their rents. They cannot afford to live anywhere near their place of work. The economic chasm which divides the creative class in California, both in the Bay area and in Los Angeles, is large and getting worse.

The question of how to encourage the propagation of creative opportunities so business can flourish and at the same time afford some kind of widespread social benefit is not impossible. Cities such as Toronto, Helsinki, and Minneapolis/St. Paul that have made conscious efforts to combine an investment in technology and respect for the arts, go along with social support for all workers.

Education and the arts are two basic necessities for promoting the development of creative people. If we want to create a class of new entrepreneurs, the groundwork must be prepared. We see evidence of a contrary movement as the U.S. is dismantling public radio, diminishing support for basic research and the arts, and moving instead towards commercialization of early educational and all cultural functions.

We still seem to have an idea that people with diplomas have better ideas than those that work with their hands. This is clearly not necessarily the case, and in the new world of creative power, it becomes less true over time. The Japanese model of “Quality Circles” has been relegated to manufacturing, but as a basically democratic process whereby workers at all levels are treated equally and each person’s talents and ideas are encouraged to be expressed, the Internet is a perfect means for allowing this type of expression and interaction. We can only hope that we come to our senses and de-politicize our nation’s technology, universities, educational policy, arts and scientific research.

Here are some of the far-reaching themes that I believe will most likely affect the U.S. economic scene for the next 50 years. As you know, I find it hard to envision just how our country can provide for the delivery of adequate health, education and justice to our population as time goes on. We seem largely unable to preserve the ability of people to make a living at small-scale agriculture or manufacturing, things that traditionally have bound citizens in American society together.

Our political process does not seem to want to address these issues because decisions are placed in the context of preserving the continuation of current alliances and allegiances and to avoid making hard choices. If we examine our military commitments required to allow our nation’s continued dependence on foreign energy sources, or if we examine the patriotic groundswell for the rebuilding of hurricane-ravaged New Orleans, we find that no one person or party is willing to question the status quo. Our natural propensity to avoid hard decisions carries us into a deeper quagmire.

Just as most politicians’ first priority is to get re-elected, the first aspiration of most employees is to keep their jobs. This is not to say that employees do not want to do their jobs well. However, it is apparent that when a choice is made between doing what is right for others and what is right for oneself, most of us err on the side of self-preservation. We accept this as normal behavior, as human nature. The problem is that our common interest has succumbed to the power of self-interest. Our society therefore languishes, and concern for the public good has deteriorated to the point where economic opportunity is reserved for those who are ultra-competitive, technologically adept, or good-looking.

Perhaps our great experiment with Democracy is over as the power of narrow, single-interest lobbyists far overshadows the interests of the general public. Social segmentation of our population based on race, religion and economic class may no longer allow for a potential leader to rise up based purely on individual merit and constituent endorsement. It costs too much to get elected for almost any office without a party machine or independent wealth.

We have put ourselves, along with the next several generations, into a fiscal straight jacket. Our dysfunctional political system makes the most palatable choice for the short term, a choice that generally turns out to be the most costly in the long term. This strategy has manifested itself in a lower standard of living for working Americans and is evident through higher prices for any “quality” goods or services. Cheap imported food, household goods, and entertainment are

available because they are brought to us by mass markets through global trade fueled by non-renewable resources. In another generation, this sugar-coated retail bonanza will be over.

Many of the problems our country faces can be framed in terms of money; one reason I enjoy discussing these issues. If you follow the money, you find where the power lies. Since moneyed interests are so effective in framing the discussions regarding public policy, they only allow for options that can be controlled by large scaled organizations, be they government, business or media interests. It is easy to feel overwhelmed, discouraged, and even hopeless.

To whom can we then look for solutions to some long term problems such as higher energy and health care costs, environmental degradation, strained public education, and the aging physical infrastructure that surrounds us? Unfortunately, the traditional sources of solutions, government and business, are some of the main culprits in perpetrating and exacerbating the circumstances of our deteriorating situation.

Solutions proposed by our political system, large corporations and mass media rest on spending more resources in order to maintain some kind of status quo, all of which results in steeply rising costs for goods and services of quality. Eventually, this will make living a middle class lifestyle impossible for non-technical wage earners. Except for a few entrepreneurs and those willing to work themselves to the bone, retirement will not be an option for most people.

Opportunities for secure and continuous employment will grow increasingly rare. The promises made by both public and private retirement plans to their older workers are bound to be broken. All kinds of payouts must shrink, from social security to Medicare, due to lower returns and a dearth of good long term domestic investment opportunities. The ever burgeoning dilemma of how to provide long term medical care to an increasing number of people who live well into their eighties is not to be found in public hospitals or institutions, nor are private insurance plans a panacea for those few who can afford them.

Let's use the world of energy as an example of these trends. Gasoline prices have increased and are bound to continue to do so over the next several decades. The U.S. government is not going to be able to do anything about this. No amount of political jawboning or military might can change the fact that demand for oil worldwide will increase dramatically due to emerging middle class consumers in Asia, while the discovery of new reserves will diminish over time due to the finite character of fossil fuel resources. It is beyond the government's capabilities to provide us with cheap oil. It can temporarily assuage our pain by sending tax rebate checks in the mail but there is no reason why private companies should or will lower their prices.

The U.S. economy runs on oil and the wealthiest companies in the world are those that procure, transport, refine and sell to consumers. Oil is power. Countries and companies that control oil can dictate their terms of its exchange. The Saudis and Kuwaitis own or are partners with our major banks, media and insurance companies. It is surprising to many Americans how many so called "domestic" businesses are beholden to foreign investors. Let us recognize that we are no longer a free and independent country since the one major ingredient on which we all depend comes from beneath the desert sands of a far off monarchy.

Looking to the markets or to the energy industry for solutions to rising gas prices has failed in the past. We experienced gas shortages in the 1970's and now again in the mid-2000's, but to what end? Are companies seriously going to put their 8 billion dollar per quarter profits at risk so that the public can sleep better? Can we genuinely expect private enterprise to give a damn about air

pollution or the long term health of the environment when their specific charge from their owners, managers and customers is to keep the gas flowing at all costs?

Our government accurately sees its current job as serving the public by providing support to the giant energy companies so they can compete globally for increasingly scarce resources. Business responsibility extends only so far as the need to project an image of corporate citizenship and protectors of national security. How can we complain about companies who adhere to the marketplace rules we all subscribe to, by taking every action possible to increase share prices for the benefit of their shareholders? In fact, the fundamental combination of government and corporate means has become the definition of a market economy. By many measurements, it has served as a very successful model that has contributed much to world prosperity these past 50 years. The problem, of course, is that our success has led to monumental environmental failure.

There is no question that global warming will exacerbate the pace of suffering and destruction on a massive scale among all living species. It seems inevitable because it is perceived to be a future cost borne primarily by people who do not wield the power to otherwise make substantial and lasting changes. It is a glaring but unspoken failure of our economic system. We all shoulder responsibility for this deteriorating social compact by participating in a consumer driven society where our lifestyles are supported by effortless, cheap, and convenient ways of doing things, largely with our blessing.

The mass media formerly played the role of representing the public's interest in these matters. However, it no longer serves as a platform on which the public can discuss options regarding what responses could be made to the increasingly tight supply of oil. The media companies rely on advertising to stay alive and advertising ties directly to energy consumption. Because of corporate affiliations, editorials cannot seriously rally the public to consider radically different approaches to energy use.

Since we must face the fact that there is no visible leadership or moral compass present in either business, government or the media, what viable alternative might there be? In terms of energy, the most likely solution is going to be nuclear energy because it can largely be kept out of the public eye behind a veil of belief that it is technologically safe and carefully regulated.

America faces a quandary in the energy arena just as it does in medical services. Under the present trajectory, only the very rich will be able to afford a quality of life that we all know is possible. This sets the stage for social unrest, which is unacceptable due to the disruption it causes in commerce. Further control of information, limitations on travel, increased surveillance, and higher consumer taxes are therefore likely outcomes.

I believe that there are non-traditional resources we could draw upon to deal with the looming fiascos. Local communities, organized as friends and affinity groups are the key, all of these structures avail themselves of the most traditional source of assistance: the extended family. There are models of success among these communities which describe skills and training methods that work, as well as viable communication models. And interestingly enough, there is a rich folklore and growing body of stories relating how these creative entities have come into being, replete with coherent value systems that adapt well to the dangerous and unpredictable world we all face. Developing investment strategies to correspond to these circumstances is a daunting challenge!

Personnel News

Rob: The Ironman Triathlon on November 5, 2005 in Panama City, Florida, went well. It was a long day for me, about 12.5 hours. I was grateful to suffer no injuries or technical mishaps and a good time seemed to be had by most of the people who I passed and by the equal numbers of people who passed me along the way. The next upcoming event is the Mt. Taylor Quadrathlon, which is a road bike, run, cross-country ski, and snowshoe race from the town of Grants, New Mexico, at 5,000 feet, up to the summit of Mt. Taylor, at 11,500 feet and back down again in late February. Let's hope we get some snow by then!

Juliana: I visited both coasts this autumn. First I went to North Carolina to visit my mother and to catch up with old College roommates. I also spent a day with Rob visiting his farm and checking out the NC office. For Thanksgiving, David and I went to Catalina Island, CA with David's family. Catalina Island is known for it's "star gazing" and I was quite excited to spot Diane Keaton and John Kerry (not together) all in one weekend!

Jeff: I went skiing with my daughter and her cousin on January 1st at Ski Santa Fe. There were only limited runs open and those were only available through the assistance of snow making machines. It was a fun outing but we still need lots more snow or this ski season is going to be disappointing for lots of folks. I know that I can always go further north to chase the snow if necessary, but I just always prefer the convenience of being able to ski right here in Santa Fe.

Patricia: I would like to remind everyone that their Schwab trade confirmations and statements are now available online at Schwab Alliance.com. I will be happy to assist anyone with this process. I would also like to remind you that our updated ADV is always available upon request. Please be sure to leave plenty of time for your 2005 IRA contributions. If you should be mailing it on April 17, remember that it will need to be sent directly to Schwab in Orlando or taken to the Albuquerque Schwab office.

Dana: I have settled nicely into my new house and am enjoying the change of perspective that a move brings. This is much easier to say after the fact! I am now the "front office" person at Rikoon Carret, so if you haven't met or spoken to me before, chances are that you will soon.

Upcoming Events

The next tea will be held on Thursday, February 16th, from 3 to 5 p.m. at the Rikoon Carret offices in Santa Fe. Please join us and if you could RSVP, it would be appreciated.