The Rikoon Group
2218 Old Arroyo Chamiso
Santa Fe, NM 87505

Winter Commentary 2013

The Markets

2012 was a year when government stimulus worldwide fueled unexpected gains. Overall, stock markets globally were up 16.9% with the U.S. Dow Jones Industrial Average returning a moderate gain of 7.26%. European stocks, in spite of the near meltdown of southern periphery countries, were buttressed by the European Central Bank's pledge to provide unlimited funds to its member nations and as a result, the continent's stock markets gained 27% with Germany leading the way with a 29% increase.

Europe's bond market is up 36% since June 2012 for the very same reason. With a concerted and coordinated effort on the part of central banks to allay investor fears of political turmoil and promise to pump unlimited amounts of money into the system by buying what would otherwise be rapidly deteriorating priced assets, has worked to temporarily send all bond values soaring. This strategy, pioneered by the U.S. Federal Reserve Bank in 2008, takes effect by making interest rates plunge. Investors who flocked to bond funds experience a flush of good fortune as their account values rise in proportion to income levels dropping. We have seen the markets reward everyone in 2012.

The topsy turvy nature of the 2012 markets was reflected in the junk bond market's stellar gain, up 18.7%. Junk bonds are rated below investment grade and typically do well in a rising economy. Investment grade bonds returned 10.9%, while U.S. Treasuries gained 2% during the twelve months ending December 31. Risk takers were rewarded by the developed world's printing presses churning out new money with no limits. The default rate on junk bond companies declined almost 50% to its lowest level since 1993. In response to the rising tide of paper money, gold chalked up its twelfth year of annual gains, the longest stretch of positive returns for precious metals since 1920. During 2012, gold increased 6.3% in value. Some of the world's most savvy investors, such as John Paulsen, who called the financial meltdown of 2007 – 2008 and George Soros, who made his fortunes betting against the world's weakest currencies, have on a combined basis, almost $140 billion invested in gold.

U.S. stock market indexes are now approximately 11% below the all-time highs reached in mid-2000 and again in late 2007. Economies growing the fastest in the emerging markets had quite varied results in 2012. The largest developing markets, Brazil, Russia, India and China, lagged the U.S. markets for the third year in a row. They were up on a combined basis around 11%, while the smaller emerging markets of Thailand, New Zealand, Singapore and Indonesia gained an average 23%.

The U.S. dollar remained relatively flat in 2012, and this held true for both industrial and agricultural commodities as well. Oil ended the year approximately where it began, and as a result, U.S. industrial companies and exporters had relatively stable price conditions in which to operate. The Federal Reserve Bank announced its intention to hold interest rates close to zero until U.S. unemployment levels decline to 6.5%. This could be a decade off. We doubt that the Fed and the Treasury will be able to control interest rates for that long.

The Chinese stock market gained 3.2% in 2012 due to a 15% gain in December. The Chinese government controls the largest local companies. Shares and investors are at the mercy of the Communist Party. New leadership took the helm in China during 2012, and they will continue to emphasize the further urbanization, ie. movement of people from the countryside to the cities, as an important driver of China's future economic growth. One elderly individual investor in Shanghai expressed his continued skepticism by stating his feeling that the Chinese stock markets and the local economy have no connection since they are manipulated, and that until the government gets out of the way, he will no longer participate in his nation's stock market. We feel the same way about China's markets.

India is one of the world's largest emerging economies, and its stock market rebounded in 2012 after a terrible year in 2011. The Indian government has put through a series of overhauls which will allow foreigners to invest directly in Indian companies, and they have also cut subsidies for various goods in order to let market forces govern. Brazil's growth rate slowed last year, mostly due to a sharp decline in global commodity prices. Brazilian companies also experienced reduced exports to their largest trading partner, China.

One of the biggest challenges facing investors in 2013 will be the production of income. Individuals who held high dividend paying stocks were rewarded in 2012, but the question remains as to whether this asset class will remain a haven in 2013. Ultra low interest rates will continue to force investors to look for higher yields in riskier assets, such as junk bonds or stocks whose dividend payouts are not covered by the company's production of net income. There is little room for bond prices to increase in 2013 as they did in 2012, and we are likely near the end of a 31 year bull market in bonds.

The Economy

The U.S. joblessness rate is holding steady, at least officially, at around 7.8%. This is markedly above the Federal Reserve's targeted rate of 6.5%. The Fed and the European Central Bank have entered uncharted territory by interfering with the normal functioning of the financial system over the last 5 years in order to promote profits at structurally weak banks. In many ways, U.S. and European monetary policies have now entered the arena of politics which is considered a form of interference that eventually inhibits long term investment in much the same way as the Brazilian government trying to achieve social policy ends by lowering utility rates. When governments interfere with prices, the laws of unintended consequences usually follow. In Russia, the government decides where shareholder profits go and in Europe, the weak economies may soon drag down those with formerly good fundamental policies.

The European Organization of Economic Cooperation estimates that economic growth rates for EU members will fall to 1.4% in 2013 from 2.2% in 2012, almost a 30% decline. Much of Europe is mired in a recession. England, who took the lead in implementing austerity measures several years ago, and Germany, whose industrial output continues to be steady, serve as the main engines behind what little positive European economic performance is to be seen.

The U.S. is experiencing a small increase in manufacturing activity due primarily to the housing sector which is starting to rebound after a 4 year period of contraction. Construction equipment and mortgage re-financing showed remarkable strength this last year, especially in the western states, those hit hardest by the financial recession of 2007 – 2008.

Consumers in the U.S., despite the 2% increase in payroll taxes this month, are showing strong resiliency in terms of keeping up their spending levels, perhaps because the Bush era tax cuts have now been made permanent for 99% of U.S. taxpayers. Exports are stable for U.S. companies, and this has allowed corporate profits to continue to advance, albeit at lower annual rates of increase.

Going forward into 2013, we expect that corporations will not be able to continue showing increased profits through cutting costs as payroll and staffing levels have already been reduced to minimum levels. A large amount of corporate cash is still being held overseas, pending meaningful reform of the U.S. tax code.

The much publicized budget and tax deal, made in Congress during the early days of January, will probably allay investor concerns only for a few short months. Most individuals will see tax rates on capital gains and dividends remain the same unless they are in the top 1% category.

More tellingly, the required cost cutting decisions have now been delayed for two or three months in hopes that a new Congress will be able to deal more effectively with long term budget decisions. People with 401K retirement plans will be allowed to roll funds over to Roth IRAs, and the tax generated from this is expected to pay for half of the cost of delaying the real budget decisions for the first quarter of 2013. One big issue facing the nation will be if, how and when to increase the debt ceiling which now stands at $16.4 trillion.

While both political parties did their share of dramatic posturing, the actual deal cut by Congress does not seem too bad or unfair. Estate taxes will go up from 35% to 40% but the lifetime exemption amount remains at $5 million, at least for 2013. One economic impact of the deal is that the growth rate of the U.S. economy is expected to decline from an annualized rate of 3.1% during the third and fourth quarters of 2012 to a 1% level in the first quarter of 2013.

The looming fiscal cliff turned out mostly to be a mirage, in that although capital gains and dividend tax rates increased from 15% to 20% for top earners, by historical standards it is still relatively low. The U.S. remains a bright spot for stable economic growth worldwide, and our tax burden, while relatively high compared to countries in Asia, is still substantially below levels reached earlier administrations. This is a major contribution to the ongoing deficit levels.

Please keep in mind that it is an extremely loose global monetary policy which has flooded the markets with money creating the market's substantial gains during 2012. Easy money has not translated into real economic growth, but rather, just a bulge in asset prices. What has been accomplished is that the weakness of a few players on the global scene has now been transferred to the system as a whole. The relative resilience of the world's overall economy has been reduced, so we believe that future major roils in any one market will have a much wider impact on most others with fewer policy options left available.

Articles by Rob Rikoon, reprinted from his monthly column in "The New Mexican

Money and Politics: November, 2012: People say that money and democracy don't mix well and history supports this conclusion. As far as I can see, money is politics. Whoever comes away with the White House, one thing is for sure: the American people did not really get to exercise their right to choose who will lead them over the next two and four year periods.

This is because the biggest player in economic terms is the unelected Federal Reserve Board. Congress has never been held in lower esteem by a great majority of U.S. voters and for good reasons. The office of the President retains its prestigious stature but is much diminished in its practical powers. This is due to the pervasive and negative influence that money has on our electoral system. The lack of confidence in our political system results in a real economy that is hobbled by a lack of vision or plan for the future.

Over the last 50 years, the advent of electronic media has impacted the electoral and legislative process so much that public relations, rather than substance, seems to rule most venues that we the public gets to see. It is all the more frightening to see what takes place behind closed doors, where the real negotiations between the Oval Office and Capitol Hill occur. The financial economy, i.e. Wall Street and its beneficiaries have continued to receive great rewards from this privilege driven system.

Influence peddlers exist on both sides of every issue. They work on behalf of powerful players who have money to spend in the "right" places, and they do seem to get their way more often than not, at great expense to the public's well-being. Well placed lobbyists' influence seems to be increasing, as various single issue factions focus on winning elections at any cost and then influencing elected official policies. How can we put the brakes on this deteriorating situation?

Some simple answers to this problem are known and would be easy if voters had some way to go outside the present system to express their desire to reset the democratic process back to "of the people, by the people and for the people". How do we reform the basic way that business is done in the legislature and executive branches of government? First, campaign finance reform that limits the amount of money spent on advertising might allow a sane approach for real ideas to be heard over the current din of P.R. that emanates from party machines. Secondly, term limits are another way to keep entrenched professional politicians and special relationships from overriding the public's interests. The pressure to satisfy donors is ever present when re-election campaigning is always on the horizon. Third, people who hold political office should be prohibited from crossing over the line to receive money from anyone related to their functions as public servants after their service period is ended.

Presently, former politicians often receive large salaries and consulting contracts due to their continued involvement in and influence on matters they dealt with during their tenure as elected officials. This is wrong and markedly reduces the integrity level of our political process. People who run for office and those around them are presented with special opportunities. The largess and inordinately high compensation for minimal work that gets thrown their way would be hard for any of us to ignore.

We could make voter registration easier, rather than more difficult , which seems to be opposite from the way things are going, Highly organized factions who want to reduce the voting population are pushing for a greater level of documentation and voter ID proof. People should be allowed to register to vote when they go to the DMV, file their taxes, pay their utility bills or answer any kind of government request. Why not change Voting Day from just the first Tuesday to the first three day weekend of November? That way, the 50% plus of registered voters who don't normally have the time or energy to vote, due to work, school or childcare responsibilities on weekdays, could participate in elections.

Another way to get around our current dependency on politics as usual is to institute some kind of direct plebiscite process where issues that relate to the public wellbeing can get put to a popular vote via electronic means. Traditional democracies called for citizens to gather and cast their votes directly, not though elected representatives who were subject to tawdry behavior and the corruption that comes along naturally with "power". Given the wide dispersion of technology, especially cell phones, some direct connection could be made on a regular basis whereby simple propositions could be put forth, debated and voted on without money running the show.

The "fiscal cliff" we face over the next several months will be a case study in how well or poorly the current system serves us as a nation. Understandably, no individual wants to stand up and take the heat for advocating making the obviously necessary spending cuts and increase taxes. Maybe our nation's factions will unite in a grand compromise, but if not, voters need to take back power from their representatives as continued inaction by Congress will result in a deteriorating economic outlook. That is not good result for anyone, no matter what their political persuasion!

<u>Fiscal Clouds: December 2012</u>: It's dry, cold and windy here on the ranch, and I am waiting for moisture in much the same way as the stock market awaits action by Congress. Looking at the sky, I see wispy banks of clouds that have not yielded any appreciable precipitation in months. The looming fiscal cliff, which will take us back to the tax and spending system of a decade ago, has companies and employers nervous, unsure of whether to expand or withdraw into the comfort of their huge cash reserves. Business needs a sense of what direction the country is going to take as much as my fields and orchards need water. Sadly, both rain and clarity are both not yet found.

The ski area outside town is not open due to lack of moisture, so its equipment and staff sit idly by. Likewise, individual stock market participants sit on the sidelines while corporations nervously hoard boatloads of cash. Trying to figure out when the skies will open with rain is like trying to predict when the nation's long term direction will become clear. There is no way to know. Life goes on and people make plans. Some believe that this winter season will see the dawning of the Age of Aquarius, bringing hope and a new system of economic interchange. I hope so but am not placing bets on it, nor am I expecting Congress to cut through the fog and give the people a solution to the budget challenges that face the country.

The stormy weather of the election season is over. Those earning over $250,000 a year will pay more in taxes and this will create headwinds for the market. Other Americans, the majority of us who work long hours every day to make a living, who pay our taxes in full because the loopholes available to the wealthy are not relevant to us, and who are looking for some kind of eventual retirement, deserve some kind of answers from our government as to what can be done to make things right for our children.

One thing everyone seems to agree on is the need for an educated and trained workforce. The community college system, which has become a primary training ground for people who want to learn new skills in order to get employed, is one answer.

Another simple, low cost way is for employers to provide work-study opportunities in order for young people to get trained and to see if a particular job or area is right for them. It's not easy to find a job now, or for companies to find the right new employees.

At our company, we are looking for a young person who has an interest in people and financial planning; someone who is responsible, responsive and has a career interest in our industry. We are not requiring a business background or attendance at a fancy school. Like most prospective employers, it is more important to us to find a person of character, commitment, industriousness. How do you teach these important qualities in schools?

I know there are other employers out there thinking about expanding and hiring but who will not do so yet because of the lack of resolve in Congress to address our nation's long term financial conundrum. Our elected representatives really do need to get out of the way. As we move into the New Year, high income people will pay more in taxes and maybe lose some deductions like the mortgage interest deductions. One way or another, the income inequality gap in America needs to go down.

While the rest of the world may not be mired down by our brand of Congress, many have more serious structural difficulties than we do, so our markets are likely to be stronger than either

Europe or Japan over the next several years. The good news is that America remains a relatively open society. As a result, their economies are much more bound to social traditions and static than we are. All of this is to say that when you go outside this winter to tend your garden, plant only things which require little moisture and tend to them with care. The same approach to portfolios is called for. As long as the government holds interest rates near zero, beware of advertised income producing products and seek safety through real diversification.

Best Investment is in People: January, 2013: Just before Christmas, I went to one of Santa Fe's established charter schools to speak to a group of high school seniors who are studying economics and how money works. I asked each of them how they would invest $1,000, given current circumstances. I was surprised at how many of the students opted to keep their hypothetical investment funds in a bank savings account or CD; even though they understood that it was an almost sure way to end up losing money. They thought earning a negative real rate of return, given inflation, was an acceptable way to go mostly because it was a sure way to go. While they realized it was a bad option, many of these young people were so suspicious of the market based that it gave them comfort to know they would only lose a little money and not all of it.

Some of the students were aware of the potential benefits of risk taking, either through entrepreneurial ventures such as franchises or starting their own "one person" retail stands. Very few of them seem to be aware that the investment field that I work in has room for creativity. I tried to impress upon them a need to be aware of what is going on around us on the entire planet, from the impact of China's decade's old one child policy on the price of iPods in the US to the impact of the Olympic Games on the economies of places as diverse as Brazil and Vietnam. It is exciting, I told them, that young people graduating from high school all over the world read the same news at the same time, listen to the same music and follow the same fashion trends. Therein lays some kind of investment opportunity!

The risks that we adults worry about, such as having our electoral "knuckleheads" drive us straight towards the fiscal cliff, seemed of little concern to these students. After some discussion about the potential benefits of driving over the "cliff", i.e., forcing ourselves to deal with the mounting problem of their generation's wages going towards supporting my generation of soon-to-retire baby boomers, the excitement and challenge of dealing with the superficial chaos of the markets got less intimidating. Some of the seniors expressed an interest in buying stock in companies that stand to benefit from the coming transitions.

We went on to discuss some social aspects of investing; what is fair in terms of who should receive benefits from government programs, and who might be gaming the system by taking out more than they put in. They seemed to instinctively grasp the corrosive influence of complacency and were willing, or so they said, to endure the short term discomfort of tightening their collective belts in order for the country to live within its means. Why, they asked, didn't the government have the guts to ask people to make sacrifices now in order for their generation to have a brighter future?

For most of these students, meaningful work is more important than making a lot of money. It surprised them to hear me say that a skeptical attitude towards the establishment and low respect for institutional wisdom are tools in the professional investor's belt. One of my points was that if we can't deal with our debt ceiling as a nation, how can we face the future confidently as individuals? As a result of the difficulties that loom large in their eyes regarding their personal employment prospects, alternative lifestyles loom large in their eyes.

We talked about other how other countries have already faced the breakdown of their traditional economies. Iceland thumbed its nose at European bankers and threatens the security of NATO by using the prospect of leasing a naval base to Russia as a bargaining tool. Icelanders ended up throwing their own bankers in jail instead of giving them bonuses. As a result, it is now one of the few growth economies in Europe. They were pariahs in the international community for a while because investors from southern Europe, who sought ultra-high and "easy" returns in Icelandic bank deposit accounts, were thrown out in the cold and told they couldn't withdraw their funds. That is one aspect to risk, and I told them everything has its own brand of risk.

The world is not necessarily a fair place, we reckoned, and so talked about alternative stores of value in things like gold, jewelry, and artwork. I advised them to learn through experience what they as individuals have a passion for, since investing in themselves remains the best method to put hard earned investment dollars. "Trust your instincts", I encouraged them, and "watch out for hidden fees and anticipate taxes". "Most of all, try not to be lulled into thinking you are smarter than the next guy" because that probably has little bearing on whether or not you succeed in long term investing. Together, we decided while that the future may hold formidable and sometimes frightening challenges, it is bright for those who choose to see it that way and on that note, we entered the New Year!

Personnel News

Rob: With my younger daughter now located in Northern CA on one of the oldest family owned organic vineyards, I was able to get out to the west coast twice this Fall just in time to come back to arctic conditions here in Santa Fe. Robyn was in NYC for Hurricane Sandy and with true risk taking fervor, she decided to take her chances and was fortunate that her 15 year old Prius remained unscathed by both flood waters and felled trees on the streets of the Lower East side of Manhattan. We had an informal open house here at the office on December 21, the Winter Solstice, to show the "chapel", which is as yet not totally finished. With the cold has come some moderate snow, enough to engage in one of my favorite recreational past times: cross country skiing.

Juliana: I spent Christmas with my brother and his family in Salt Lake City. My mother, who lives in NC, age 89, braved the chaos of air travel to join us. On Christmas day we headed up little Cottonwood Canyon to go snow shoeing…Mom too! It was nice to be surrounded by family as I spent the first holiday season without David.

Jeff: I attended my 40th high school reunion in Phoenix a few months back and it was a lot of fun. Most of the people I could recognize right away but I needed a little assistance with some. A few of their stories and adventures were something else. It's been great to stay in contact with some of those old friends now by phone and email.

Patricia: Now that the holiday season is past I begin to notice the days getting longer and start to think about gardening once again. This year I hope to focus on just a couple of varieties of plants. I will be attending a Retreat in February at Asilomar Retreat center in California. It is right on the beach and I am looking forward to the change of scenery. I spent Thanksgiving in San Francisco with my son and his fiancé . We toured the local Green Gulch Farm Zen Center. The garden supplies the Center and the Greens Restaurant in San Francisco.

Emily: The anticipation of the 2012 year coming to an end with many uncertainties in tax laws meant very busy times around the office. In anticipation of the mad rush, I was able to sneak away for a trip to Boston in early November to hit the historic sites. I'd never been to Boston and it wasn't at all what I expected, but I enjoyed beautiful weather, lots of walking, great food and local brews. It was a snowy and quiet holiday season for me in Santa Fe and I look forward to what 2013 may bring.

LOCAL TEA & CONFERENCE CALL-IN DATES:

The next tea will be at our Rikoon Group offices at 2218 Old Arroyo Chamiso in Santa Fe. The date is **Wednesday, February 6, at 3:30 p.m.** Please bring a friend or anyone you think would benefit from participating in this open ended review that Rob hosts quarterly in regard to the markets and the economy. The next day, **Thursday, February 7,** our quarterly telephone conference call will take place **at 3:30 p.m. MST**. The call-in number is: 218-936-4700 and the Access Code is 425993#. Please email us before the call if you want Rob to respond to your particular questions or areas of interest