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Winter Commentary 2012

The Markets

After an unusual amount of moving up and down, the U.S. stock market ended the year essentially unchanged. The S&P 500 index of our nation's 500 largest stocks was exactly even, before dividends, during 2011 while the Dow Jones Industrial average of 30 stocks gained 5% due to its inclusion of high dividend stocks which investors flocked to as refuge from the markets overall lackluster performance. In Europe, the index of the 600 largest stocks fell 11.3%, which included steep drops in Germany, -14.7 %, France, -17 %, and Italy, -25.2 %. Interestingly enough, the United Kingdom, which embarked early on a fiscal austerity program in 2009 and then, this year opted out of a combined Euro bailout plan, saw its stocks fall a mere -5.6%. British government bonds were the best performing investment in the world last year.

Stocks in the Asia-Pacific region fell -17.4 % with natural resource based economies such as Australia declining -14.5 %, technology and manufacturing economies fell -20 % in Hong Kong, -21.7 % in China and worst off was India which was down -24.6 %. There was nary a bright spot in any stock market in 2011.

On the other hand, bond markets had stellar returns. The U.S. and British Treasury markets did the best while corporate bonds gained in the mid-single digits. Municipal bonds advanced 6.67%, including interest and some moderate price appreciation. Most investors got the majority of their 2011returns from interest or dividends.

The U.S. dollar kept its luster during 2011 as investors fled Europe and moved huge amounts of cash into American treasury bonds and other kinds of dollar backed assets. Hedge funds, who are supposed to be among the most sophisticated investors, lost 5 % on average in 2011 while those focused on stock picking were down 7.2 % on average.

Typical hedges against risk such as gold continued to gain and, even though precious metals prices sank 17% during the last four months of 2011, they still ended the year up 10%. Oil closed slightly higher for the year, up 8%, while natural gas continued its long term decline, falling 32% which is an amazing amount for what looks to be the U.S.'s best medium term source of clean energy. Industrial and agricultural commodities declined 13% in 2011. Interestingly enough, this was the first full year loss for commodities since 2008.

Copper, a widely used indicator of future economic activity, was boosted by emerging market demand early in 2011 but then got slammed by concerns that global economic growth was faltering as problems in Europe became more pronounced. Copper ended 2011 down 23% while corn, which had held up the best of all agricultural commodities, finished the year up a mere 3%, which is 18% below its all-time high hit in June, 2011.

There was tremendous action in the European government bond markets. German “bunds” rallied, making their largest profit in three years as the crisis in southern Europe spurred demand as Germany is considered Europe’s safest investment haven. After 15 European summits in two years, which produced five different bailout plans, investors are still highly doubtful that the EU’s fundamental issues will be resolved. Italy’s bond market just about fell off a cliff, ending the year with near record interest rates slightly above 7%, which is the level most analysts consider to be a sign of impending bankruptcy. Due to heroic efforts, mostly behind the scenes, the European central bank flooded markets with cheap money so that local banks could buy up enough of their new government bond issues to avoid a panic.

As the true cost of bailing out European government banks resurfaces in 2012, we expect German government bonds to come under downward pressure and several countries will have severe funding problems. The German government is in an ongoing struggle with France and southern European countries as to who will pay the cost of keeping the European Union together. Will it be taxpayers, private stock and bond holders, government workers, retirees or future generations?

As European Central bankers announced that they would be buying time for their sovereign nations’ banks to get their acts together, the leaders of the international banks such as the IMF and World Bank headed east to see if the Chinese would supply the needed liquidity. China responded by saying no, it would not bail out Europe but then has proceeded to take advantage of very low asset prices at fire sales to snap up utility and natural resource companies in Portugal and Spain.

The Economy

The U.S. economy, the world’s largest, is showing signs of resiliency and even some slight acceleration, which is good news. The job market in the U.S. appears to be improving, as hiring in December bumped up for the second month in a row. Payrolls climbed by 150,000 workers in December after rising 120,000 in November. Retail sales have been relatively robust and merchandise margins are strong at middle and upper end stores. The U.S. jobless rate has not gone down much but the rate at which new people are applying for unemployment benefits is declining. Manufacturing indicators also show some expansion of industrial activity in the U.S. economy. American manufacturers saw orders increase towards the end of 2011 and spending on construction projects, especially in the multi-family housing market, are on the increase as more Americans choose, or are forced to rent, rather than own.

The economy in China is showing some signs of slowing as manufacturing contracted in December as the effect of Europe’s debt crisis decreased demand for exports from China. China is predicting around 8% growth in 2012, down from approximately 10% in 2011.

Elsewhere in Asia, other export driven economies, such as Vietnam and Thailand, who have not yet de-linked their economic health from the West, suffered as the outlook for consumer demand in Europe and the U.S. remains crucial to their economic health. India is a prime example of this as it is experiencing persistently high inflation as well as slowing growth. Recent efforts to do away with government bureaucracy and entrenched corruption met with failure even after hunger strikes by several Indian populist leaders. India’s economy seems to have ground to a halt and their ability to compete with China has been undermined. Japan, after a 20 year slump, is being further hampered by its extremely strong currency. The Japanese government spent close to a trillion dollars to try to force their currency down in an effort to help out their export companies, but to no avail. Despite the natural disaster of last spring and its strong currency, the Japanese stock market finished 2011 down in line with Europe, at around a -17%.

In Latin America, Brazil is one of the strongest economies. Their mineral and agricultural exports to the rest of the world have boosted their foreign currency reserves and allowed them to keep conservative banking rules in place. They also did not suffer the financial industry's tumult over the last several years. Latin America has an expanding middle class who is eager to spend their rising wealth as evidenced by the large number of South American shoppers in Miami and New York. While their local economies are heavily reliant on commodities and investment inflows from the U.S., Europe and China, many South American governments still have room to cut interest rates and reduce taxes which should provide their economy with a buffer against any global economic slow-down.

In spite of all these structural advantages, the Brazilian stock market tumbled 22% in just one month this past summer. Although they have promised to take more responsible anti-inflation measures, it is still too early to see whether the governments in our Southern hemisphere will be able to curtail persistently high inflation expectations that come from their profligate level of public spending.

Globally, investors remain optimistic that U.S. corporate earnings will continue to keep our markets strong. The perceived lack of leadership among politicians everywhere makes it difficult for anyone to be too optimistic. Most Western European nations remain reliant on the extraordinary measures taken by central banks to create money and buttress their consumer based economies. Please keep in mind the fact that the European Central Bank has engineered a bailout of European banks without going through any kind of political approval process. By taking a back route to creating excess money, the ECB has been able to funnel money to their biggest commercial banks, who in turn buy the precarious local government bonds. This cycle creates artificially high prices and an appearance of normality. Italy, Spain as well as the already bailed out countries of Greece, Ireland and Portugal are on this merry-go-round.

Europe is going to experience at least a mild recession in 2012, if not worse. They are only beginning to deal with the difficulties of creating a true union, and the surest sign of their success will be an issuance of common, multinational bonds. The German public is staunchly against taking this next step. Weakening economic performance across Europe will be made worse because of austerities trying to be forced on various countries. Reductions in government spending, increases in taxes, the sale of public assets and contentious revisions to labor and rent laws will turn Europe on its head in 2012. We believe it is likely that Greece and perhaps Ireland will renege on promises made in 2011 in order to negotiate better terms for their domestic economies. Through all of this, the Euro as a currency has held up fairly well. Part of the reason for this is that interest rates in Europe are higher than in the U.S. and this has kept some income investors interested in Europe. Germany will be unable to bear the cost of saving Italy or Spain or France.

The abject rotten state of many large European banks makes U.S. financial companies look like shining stars. We are still averse to holding most U.S. banks, since they have trouble making money on their deposits, their profit margins are declining, and their dividends are low and unlikely to rise. The U.S. economy remains our top choice for 2012, along with some European based international firms that payout stable and good dividends.

The U.S. dollar is experiencing something of a revival due to America's diverse and flexible economy. U.S. factories have been expanding their output for well over two years and earnings for U.S. based companies are expected to continue to rise in 2012. This bodes well for a continued outperformance of dividend paying companies.

As the 2012 U.S. presidential primary season unfolds, we may see a split Republican Party, given the divergence between voters focused on economic issues as opposed to those for whom conservative social issues are paramount. While U.S. unemployment remains stubbornly high, especially for young people and minorities, it is possible that the Democrats will not be blamed for the last several years of pain. A continuation of the 4 year old decline in residential real estate market values in most parts of the country will hurt Obama. If the Democrats are able to maintain a solid and unified front versus a split Republican Party, it is possible that the economy, while weak, may not prove to be the deciding factor in the upcoming elections.

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

OCTOBER, 2011: Think of the current debt crisis in Europe as a game of monopoly. Let's hit the pause button, figure we're at half time, step back and take in the big picture. First, there are two tiers of players, those taking turns now rolling the dice, using what's left of their paper money along with a few houses/hotels already on the board, and those in the background, holding the stash of free money and unaccounted for currency. The numbers are so big that to give a useful perspective, I am going to simplify to the nearest Trillion, (with a big 'T'), which is a thousand billion.

Here's an overview of the players and their positions. First, countries that are in the hole with how much they owe, in trillions: Iceland: -1/100th, Ireland: -1/10th, Portugal: – 1/10th, Greece: – ½, Spain: -3/4, Italy: -1 ½, France: -4, USA: -15. There are other important countries in debt, such as Britain, Belgium and Eastern Europe but for the moment, assume they are irrelevant and keep them on the sidelines. The players with real cash surpluses are: the Middle East Oil Producers: +6, China: + 3, Corporate America: +2, U.S. Banks: +1.5 (this is what they are supposed to be using to make loans), the International Monetary Fund: +1, and the European Central Bank: +1/2. Mostly, we hear in the media about the last two, the IMF and the ECB, but as you can see from the above numbers, they are both relatively minor players in the bigger scheme of things.

Some facts to ponder: Greece will never ever be able pay off its IOUs; European politics will not allow Germany to abandon helping countries it decimated during WWI and WW II, and the total amounts owed by European governments and institutions listed above, not including Italy, will wipe out the money already put aside to contain the problem. Here is how our monopoly game gets played out: since Europe is incapable of growing its way out of its malaise or of cutting its budgets enough to make a difference, the IMF can and will get more money from China and the Middle East in order to support the ECB but only by ceding some control to those nations who hold the big pot of money. The IMF and other international conduits for funds to bail out Europe will become proxies for the game's current winners, just as they were, until recently, vehicles for US foreign policy. To the victor go the spoils. In this case, Europe's travails will pave the way for continued expansion of OPEC and China's desire to buttress their military and natural resource gathering capacities. How China and OPEC got to be the winners is another subject but it ain't complicated: they produce and sell stuff which we buy. Their surpluses just about exactly match the size of our deficits.

While China has a home grown military, the oil producing/exporting nations do not. Therefore, they must buy our protection and they do so by funneling their excess capital to fund our deficit which now stands at close to 15 T. We are down in the game, like Europe, but we have a special card to play, our "get out of jail free" asset, which is the US military capability. Our budget hole is getting deeper, to the tune of 1 to 2 T per year. This is the same amount as our annual military budget and ironically, it is also the size of the yearly profits of the oil producing nations. Whether or not any of us philosophically agree with spending money on defense and security, it is the reason why we get to keep playing at the table while racking up more debt.The US dollar is the world's currency not because we back it up with gold but because we do so with guns. The stability that the US military presence brings to the world stage is not unlike that of bouncers at bars or casinos; it enables the game to go on.

<u>NOVEMBER, 2011</u>: Bob Dylan wrote "A Hard Rain's Gonna Fall" almost 50 years ago but most of the Occupy Wall Street crowd is not old enough to remember the tumultuous times of the Vietnam War. That was the last time tear gas was used in the streets against young white middle class Americans. Now, with shrinking employment opportunities from a global and technologically dependent economy along with the prospective burden of somehow shouldering the cascading debt burden coming due from Baby Boomers reaching retirement age and endless government programs to help everyone in need, the movement that targets income inequality and undue influence for the privileged few may be taking root in America's mainstream mindset as the issues raised are real, troublesome and not solved by business as usual.

We are not alone in facing this conundrum. Emerging powerhouses China, India and Asia all have their version of the 99% versus 1% great wealth divide. India is experiencing several internal civil wars fueled by the inequality of distribution of benefits of their economic progress and China had 180 thousand "mass" protests last year, mostly due to the grinding down of traditional sustainable livelihoods in rural areas by centralized industrialization. Europe's inability to grasp the scope of necessary changes to their society make their current negotiations on the restructuring of Greek and other troubled nations debts unfocused on anything but short term fixes. European banks are going to become permanent extensions of their governments, like ours were temporarily during the worst days of 2008 and 2009. Our culture has a better chance than most of addressing fundamental problems of inequality since our country is supposed to be based on equal access to basic rights of the individual.

It is easy to make fun of some of the characters camping out in America's urban parks, and most may well take off during the coming winter months, but the basic mechanisms by which our financial and government systems have operated over the last 65 or 70 years are strained and their ability to function going forward is severely in doubt. I am not predicting we are in for a crash or a depression or any other cataclysmic event, but given the unmanageable size of our debt, the lack of productive opportunity for our young people, and the widening gap between words and deeds on the part of all politicians, something has got to give.

There are many great ideas floating around about how to fix America's problems but they all require large changes in the status quo. Here are some of the best solutions that can all be accomplished through the legislative branch, regardless of the politics and ideologies of this or the next President or any Supreme Court Justice personality. First, remove the right of corporations (or any other form of organization) to citizenship, i.e., prohibit them from attempting to influence the electoral process or law making by Congress via money or persuasion. Then, undo all efforts to make it more difficult for U. S. citizens of any race, location or past history (including felons) to vote. We need as many participants to make this democracy work again.

Second, throw out the current byzantine method by which different people, industries and regions are segmented via taxation and apply a simple, fair method under which all income and receipts on the part of individuals is taxed the same. Why should people in Texas pay no state income tax while here in NM we pay 5%? Why should NYC residents be taxed 3 or 4 times more than people in Alaska? We all belong to the same country, enjoy the benefits of common protections and eventually rise and fall together. Why should entrepreneurs in energy be given better breaks than people in retail? Why should farmers get payments and not taxi cab drivers? Wipe the slate clean and start over.

Third, and closest to the hearts if not the minds of the 40% of Americans who sympathize with the Occupy Wall Street movement around the country, dismantle the obscene financial system that puts tens of millions of dollars annually into individual's pockets, people who produce little of value for the country. I know (and like) some of these people. They are basically great salespeople with some talent for manipulating numbers. They have convinced the country, through their influence and charm, to turn over a good part of its future to their operations. The financial industry has, over the last 30 years, been able to combine traditional deposit taking and lending with trading its own money, mixing risk taking activities with advice giving and also going to town selling whatever products in can to its customers. This is what put the financial system in such trouble a few years back. Breaking up these organizations and requiring keeping these disparate and contradictory business in totally separate legal entities with no cross ownership is the way to go.

Finally, everyone knows that the government has promised way more in future payments and services than it can deliver, given the amount of money coming into the Treasury. Let's step up to the plate and acknowledge reality and remove the false sense of security that we have grown used to by assuming someone is going to take care of us in our old age. The concept of sustainable community may be one way to go forward after the inevitable debt crisis that protesters around the world instinctively sense lurks in our collective future.

DECEMBER, 2011: This month, I will describe how investors can join with local enterprises as a complement to their traditional stock and bond investments. People who have bank CDs, mutual funds, stocks or been burned by salespeople pushing one product or strategy over another often yearn for someplace tangible to put their money. Many of us want to deal with people who we can look in the eye. After a decade of Enrons and Madoffs and banks that have done nothing but enrich their executives at the expense of shareholders, it's no wonder that the disenchantment and frustration that pervades our political system carries over to the financial world.

Matching excess money (capital) with productive opportunities (investments) is what investing is all about. In addition to the public markets where registered securities are sold, there are private markets where consumers contract with entrepreneurs , in this case truck gardeners, so that during the summer months investors receive a steady stream of vegetables instead of cash dividends. The common name for this arrangement is Community Supported Agriculture (CSA).

Most people don't know where their food comes from or how much work goes into producing it. As long as you can go to the supermarket and buy whatever you want, there's no pressing reason to make such inquiries. But, if you are one of the growing numbers of people who are passionate about where their food originates, what goes into growing it and what it takes to get it to the kitchen table, you may have an interest in joining a CSA or an expanded version of it that I will describe below. The rest of us may just want a backup source in case our grocery store can't get the goodies we like to consume.

CSA type operations collect money; say $500, in the late winter or early spring, in order to buy seeds and hand tools and start delivering goods from the time the first radishes come up through when the last squash and pumpkin harvest take place in the fall. It's great. You get to eat a bunch of stuff you might never buy on purpose but it does take time to clean, cook and compost the volume of produce that comes if the year's harvest is bountiful. Also, you don't get to gripe if there's a draught, swarm of locusts or other pests end up feasting on what was supposed to be your repast. One lesson of sustainable investing is that the natural cycle comes with risk and events that lie well beyond human control. After a season or two of crop failures, you might become a more patient stock investor.

Let's postulate a good year for our local CSA, and you're happy with the produce. Now we take the CSA concept and expand on it. If a few people quadruple down on the upfront money, and with $2,000 from each participating family, the local farmer can buy a greenhouse. We now have entered into a contract for fresh vegetables year round for three years, not just one. A bigger investment yields a larger return over a longer period of time. You are now getting to know this farming family better and might go out and see the place yourself. If you are loving the connection, you might plunk down $10,000 to get a bunch of your meat, dairy and fruit from this farm over a 5 year time frame. We are now approaching the concept of functional community.

If you move away, too bad, the farmer gets to keep your capital. If the milk cow dies, everyone shares in the tough luck. A savvy sustainable agriculture operator will figure out how to get you the promised goods because they need you as much as you need them. Increasing investor capital contributions up to levels where farmers can buy their land , pay off high interest mortgages, or get a tractor will incentivize them find creative ways to offer aging baby boomers (and their dependents) things like fuel, shelter, transportation and other components of country living.

Combining sustainable agriculture with long term care might be a good alternative to traditional retirement communities. This could be a boom industry for the next several decades and it might serve as an employment opportunity for an entire generation of 18 to 30 year olds who can't find jobs.

Personnel News

Rob: Santa Fe was the grateful recipient of some early winter storms that left our ski areas with some of the best snow in the West. Rob was not out playing in the woods much this fall and early winter, given his renewed emphasis on the painting project of egg tempera panels on display in the studio behind the office. Daughter Robyn's (25) picture from the movie set of "Cold Weather" was featured in the "Oscar" section of the January 1, 2012, New York Times. And Hannah (22) is finishing up her senior year at Bard College near Rhinebeck, NY.

Jeff: I have been keeping busy with some house projects as we decided to change and swap around our guest room, office room and music room. Rather than just move furniture, we inevitably come up with ideas like "well let's retexture and repaint the walls, and change the drapes" etc. I hope all this ends soon. I have not been snow skiing yet but plan to very soon.

Juliana: Emily and I have been trying to walk at least 30 minutes every day at 2:30 PM, right after the market closes. If anyone would like to join us on these daily walks, we would love to have your company so stop by around 2:30 any day!

Patricia: The last several months of 2011 were spent with family and friends. For Thanksgiving, I hosted dinner for my siblings and several close friends. It was an unusual pot luck of turkey and East Indian fare and ended with several rounds of Yahtzee, the game where everyone tells each other how they should play. You tell how a person runs their life by how they play Yahtzee. For Christmas, I spent a few days in San Francisco with my son, his girlfriend and her family. It was quite a gathering with lots of good food that the kids had been preparing for several weeks and it was warm in San Francisco. Soon gardening will begin again, at least indoors. I am renewed and ready for another season. Think moisture!

Emily: 2011 seems to have flown by! And to add to the year-end chaos, I bought a house. 2012 is sure to be full of getting settled in – hopefully my Kitty will like the new neighborhood - and the inevitable projects that come with home ownership.

Dana: As I contemplate the last few months, my mind quickly goes to a wonderful hike I took with a dear friend around the Marin Headlands in November. It was one of those magical days where San Francisco simply sparkled beyond the Golden Gate and the Pacific was so smooth a mighty arm could have skipped a stone to Japan. While there, I stopped by the Marine Mammal Research Center where rescued sea creatures from up and down the coast are brought for rehab. It's a good thing they have going there. Lots of heart!

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 15th, 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 16th,** 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.