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

Winter Commentary 2014

The Markets

2013 was the best year for the stock market since 1998, right before the .com crash. All major stock indexes advanced because of the world's central banks' massive stimulus programs. The Standard & Poor's 500 rose 29.6% while the NASDAQ index of tech and smaller stocks jumped 38%. Japan's index of large companies surged 57%, its biggest gain since 1972, due to the Bank of Japan's abrupt reversal of its long-standing tight monetary policy. The total Dow Jones world stock market index, excluding the United States market, rose only 13.3% due to emerging markets stumbling somewhat during the past year. Germany's DAX index gained 25%, France rose 18% and even Spain's stock market rose 21% in 2013.

The aggregate US bond market index lost 2%, on a total return basis, its first decline since 1999. Longer term treasuries fell almost 12% due to an increase in interest rates, especially for mortgages. This increase is the first of many likely steps the Federal Reserve will have to take to pare back its unprecedented monetary easing efforts. US investors pulled $80 billion out of bond mutual funds during 2013, surpassing the previous record of $62 billion in 1994. The short to intermediate part of the bond market, where we at the Rikoon Group invest, gained .47% in the municipal area and .06% in the taxable area. The best performing portion of the bond market were junk bonds, which continued to attract investors hungry for high interest-bearing instruments. Rates on bank Certificates of Deposit lingered around .3%, while money market deposits continue to pay almost nothing, a meager .02%. It is conservative savers who are picking up the tab for the Federal Reserve's largess.

Commodities investors struggled for a fourth consecutive year due to lackluster economic growth worldwide. The Dow Jones Commodity index fell 9.6% in 2013. Industrial Growth in China, the world's largest user of commodities continues, but at a less robust pace than the past several years. Aluminum and steel are in abundant supply worldwide with iron and copper set to join them as new production comes online in Third World countries. The same thing is true for agricultural commodities, where US farmers have planted record acreage, probably overly so, to take advantage of previously high prices for corn and wheat. Even oil and gas prices came down in 2013, due to the surge in US production brought about by the boom in shale drilling.

Precious metals such as gold fell for the first time in 13 years. Gold had its largest annual decline in 32 years, approximately 28%, as investors in stocks of gold and gold mining companies fled this asset class. Interestingly enough, individual investors in China and India both continue to be strong buyers of the actual precious metal, so that the cost of buying coins has not come down much, if at all. Alternative investors and hedge funds did not see their portfolios rise nearly as much as the overall stock market. The average hedge fund gained approximately 6% during 2013. Silver fell over 36% while platinum declined a mere 11.78%!

The market for initial public offerings was hot in 2013. The average new stock offering was priced expensively, close to the same levels as in early 2007 before the financial crash. New offerings raised the most money since 2000 and about two thirds of these new companies are losing money, reminiscent of the height of the IPO market of the late 1990s. From a long-term perspective, the price-earnings ratio on the Standard & Poor's 500 is 40% above its long-term trend. We believe that trends always return to their mean which gives us pause when thinking about putting new money into the stock market today. In 2013, about 75% of the rise in stock market prices was due to a jump in the enthusiasm exhibited by investors and not by profit growth of the company itself.

The Economy

With very easy monetary policies in place for some time now, short-term interest rates continue to hover around zero and the plan going forward is for Fed Chairman Ben Bernanke's successor, Janet Yellen, to keep enough liquidity available in the system to keep interest rates at their current low levels well past the end of 2015. Despite the fourfold expansion in the central bank's size, these policies have failed to produce the economic response needed to bring the world's economy back on a steady growth track.

The US economy has grown at a paltry 2.2% rate since the recovery began in mid-2009, far short of the 4 to 5% rate typical of past recoveries or even the economy's long-term average annual growth rate of 3.5%. While the past quarter's growth rate looks good, relative to recent experience, it primarily reflects a jump in inventory because real final sales grew at a lackluster pace, under 2%. The Labor markets continue to disappoint economists' hopes and as a result, consumer spending grew at a less robust pace during the third quarter than the second. Business spending on equipment and software also fell and going forward, government spending at all levels is expected to be flat to down so there is likely going to be no jumpstart coming from these sectors in 2014.

The housing market experienced firming prices in 2013, with home values in 20 US cities rising the most in seven years. This was partially due to a reduction in the inventory of foreclosed properties on the market and overall, the supply of homes for sale is way down. The net result is that prices have been pushed up, even though higher mortgage rates have served to offset some of this upward momentum. The average rate for a 30 year mortgage is now around 4 ½%, compared with 4% earlier this fall. New construction activity in residential areas is strong as builders try to keep up with the demand for both rental and owner occupied dwellings.

Authorities are very concerned about spiking interest rates because this could potentially put an end to the housing recovery. Real estate valuations tend to drive consumer confidence levels which are a determining factor of overall national spending. The Federal Reserve hopes its commitment to keep short-term rates low for an extended period of time will keep a lid on other interest rate levels and they have succeeded thus far. Investors are well aware that other than pushing up stock prices, the central banks' easy money program is having little impact on the real economy.

The primary reason the expansion of the government's role in the economy has failed to produce much real growth in the economy is because banks are reluctant to lend. There is an ocean of liquidity available in the coffers of financial institutions that are gun shy, due to their recent brush with bankruptcies and increased regulatory supervision which reinforces their bias towards timidity. The Fed has the luxury to forestall any future anti-inflation activity , such as raising interest rates because deflation is more of a concern at this time. In spite of the adverse effect on bond investors, until pricing power returns to labor and businesses and commodity shortages are seen again, the Fed and other central banks can continue their money creation and pumping activity.

The International Monetary Fund has revised downward its estimates for global growth in 2014. India, Brazil and Mexico are expected to experience a fall in economic activity due to the slow but inevitable curtailment of cheap liquidity on the part of the United States Federal Reserve Bank. In addition, competitive constraints, infrastructure shortfalls and slowing investment on the part of developed world investors are also creating severe deflationary forces, especially in Europe. There, as in Japan, and eventually in the United States and China, an aging and declining working population, lower economic output, more competition from the globalization of production to lower labor costs countries, growing economic and trade protectionism, declining real incomes for much of the population, income polarization, and declining government spending will be deflationary forces for the next several decades. All of this tends to make consumers wary of spending.

While interest rates continue to be driven lower in Europe and Japan to offset these deflationary forces, investors expect stock markets to continue to rise, even in the absence of sales volume growth. One of the few areas where spending is increasing is in the purchase of productivity enhancing devices which allow companies to increase their profit margin. The unemployment rate has officially been falling in the US because of declining labor participation, which means that fewer people are looking for work so statistics paint a rosier picture than what actually exists. Of those people who are working, about three quarters are earning less, in real terms, than they were 22 years ago.

The one quarter of the population who has seen their incomes rise since 2008 have gained substantially while the rest of us have lost ground. The only year when the top 1% of the US population took home more of the nation's paychecks than they do today was in 1928!

This portends a major shift in the US, both economically and politically. With housing, business spending, government outlays and exporting companies unlikely to promote future employment opportunities, the consumer is the only remaining engine for future growth. Unfortunately, people who are living on retirement income, who are renting and seeing their costs go up, and those who depend on pensions are unable to look ahead to better economic conditions. The traditional expectation of the younger generation in the United States that they will be as well, or even better off than their parents, is fast disappearing.

The American dream of moving from working class to middle-class to potentially upper-class still exists, but is becoming more elusive for most people. There are several implications of this structural shift in which middle-class fortunes are shifting downwards. The decline of traditional employers such as large corporations and the creation of agile, virtual workplaces puts individuals at a disadvantage to corporate employers. While this may be increasingly efficient and beneficial for corporate profitability, it is likely that in the near future, a large part of our population will not be able to afford to consume what is produced, thus laying the groundwork for potential social unrest.

One of the working assumptions of the market system has been that everyone will benefit from growing productivity and efficiency; that “a rising tide will lift all boats”. This may be true for those who own securities and gain from rising stock prices, but people who are not able to accumulate financial assets are likely to fall further behind, both in terms of education and opportunity. The United States’ position as the major geopolitical power rests on our inclusiveness as a culture which may be at risk. Because the problem is so large and conventional solutions so inadequate, the repetition of the old and tired Democrat – Republican political debate will likely not suffice to address the underlying issues.

Recently, I penned several articles pointing to ways for America to return to its roots as a fertile place for entrepreneurs, using potential revisions to the health and education systems as examples. If you read the articles reprinted below, keep in mind that my intent is to stimulate discussion and not to forge political compromises. The New Mexican, our local newspaper, has decided not to suffer my foolish writing any longer and so my tenure as a writer for the local rag is coming to a close.

Articles by Rob Rikoon, reprinted from his monthly column in “The New Mexican”:

“Government Shut Down” -The hullabaloo resulting from last month’s federal government’s partial shutdown showed us that Congress has finally gone over the edge, devolving into never ending adolescent theatrics as opposed to coming to some kind of adult compromise. By demanding that appropriations for funding Obamacare be removed from the budget, the ultraconservative wing of the Republican Party knew that it would precipitate a stalemate and that the legislature’s primary job of passing a budget would be impossible to fulfill. These politicians are, I assume, intelligent people, not outright dolts as would be easy to conclude from their actions so there is something more going on behind the curtains.

One underlying issue is that the Republicans have no effective leadership. Simultaneously, the President is unable to get his directives approved through his own party’s Congressional members, witness his inability to neither mobilize military action in Syria nor win the approval of his first choice, Larry Summers, to be the next Federal Reserve Bank chairman. Both sides can therefore be characterized as aimless. This is not the first time that a vacuum in the American political structure has been taken hostage by a small but extremely focused minority to direct the country’s direction. It happened in the 1850s regarding slavery.

I believe the most important matter at stake is the direction of the country’s domestic policies. Will we try to provide a wide net of care for most people? Will we attempt to build infrastructure? How will the citizenry step up and pay? Higher taxes are as sure to come as is a much lower level of service in health, education and welfare. Both sides have intelligent things to say on this seemingly simple but notoriously devilish matter.

Conservatives want entitlement spending curtailed but no new taxes. Liberals want the reverse. Neither can get their way nor should they! No matter what your views are on social policy, it is a mathematical certainty that taxes will go up and benefits down. The longer we wait to take these unpopular steps, the deeper the cuts will be and the more burdensome the levies will be.

The movement of the nation's health system towards some kind of simplified payer and more universal coverage is inevitable. Obamacare is one small step in this direction and while the quality of care may go down and the costs go up, this is the wave of the future so get used to it. The law was passed, a subsequent election vote was taken confirming the public's acceptance of its implementation, a Supreme Court challenge to its legality was raised and it survived all these challenges. Obamacare is a reality and the Republicans know this, so they must be trying to question the underlying principles involved.

The talks over the debt limit that were negotiated in August 2011 and led to the sequestration process, i.e. cutting equal percentages from all parts of the budget, is now the default methodology for settling debt negotiations. It allows every politician a convenient way out from the dark hole of endless arguing because in the end, without a 'Grand Bargain' (a long term budget and spending framework), everyone's programs lose money every year. There is no one to blame for the cuts so they are politically palatable.

The latest political impasse did not spell an end for the economy nor will the next one. Keep in mind that the U.S. will never knowingly or willingly default on its debt. In fact, the markets' performance indicates that there is no recession in sight and that resurgence in economic output will occur during the first half of 2014. Unfortunately, the future climate for investments is still largely predicated on the actions of the Federal Reserve. They seem to be agonizing over when and how to reduce their bond purchases because they know there is a danger to the economy when they start doing so. They cannot avoid cutting back but they don't want be blamed for putting the country back into a recession so the status quo is in vogue on the financial as well as the political front.

As the Federal Reserve has continuously supplied easy money to the markets for the last several years, it has become a "business-as-usual" policy which is now hard to reverse. It will be difficult to wean stocks from their addiction to this monetary stimulus. There is no doubt that the economy needed bold action in the midst of the financial meltdown of 2007 and 2008 but that is no longer the case.

The Federal Reserve's policy is not going to solve the structural issues facing the economy and everyone knows this but they don't know what else to do to keep the fire stoked. The impacts of keeping the crisis policy in place beyond the appropriate time for tightening are an artificial suppression of market forces, interest rates being kept low and distortion of asset prices upward. This is great for investors as long as it lasts but it is like a rubber band stretched too far, it's going to hurt when it eventually reverts back to its natural shape.

By most accounts, the economy is on firm footing so why is the Fed continuing to press on the accelerator? They are afraid that the Congressional and Executive branches' ongoing philosophic impasse means there will be no forthcoming plan for the country other than what they, as a non-elected body, come up with. It is an abdication of responsibility on Congress's part that it cannot pass a budget or come up with a long-term plan to deal with our debt. It might help if we docked their pay for each day this situation continues or better yet, maybe Congress should just be disbanded and new elections held if they show they are not up to the task at hand. After all, that is what other forms of democracies do when the government in power loses the people's confidence. Wouldn't that be refreshing!

"Dismantling the Wasteful Machine: Part One" - This must be some kind of cosmic joke. It seems like the harder we try to fix our health care and educational systems, the deeper we dig ourselves into a hole. Don't get me wrong, I'm as much a bleeding heart as anyone else in that I think everyone on the planet ought to have decent food to eat, clean water to drink, a safe place to live , books to read, and medicine to take when they get sick. From the looks of it, however, everything is going in the other direction.

President Obama clearly has good intentions in trying to extend health care to people who have been disenfranchised from or disqualified out of the system. However, he has been unable to implement a real solution which would be a universal single-payer system. It looks like some people who already had decent healthcare coverage through individual or company coverage are going to end up with a much more expensive, time-consuming, and burdensome paperwork process than before. This is the inevitable result of imposing a national political conundrum over and on top of what is essentially a local issue.

The same thing is true for the various educational testing and teacher evaluation movements being imposed on public schools throughout the country over the last decade. The No Children Left Behind Act of President Bush may have been well-intentioned, but it seems to have turned into a drag on both teachers and students. More national standards are on their way and no one is enthusiastic about their impact on how well our children will be prepared in public school settings. The costs of administering these programs in trying to make people from various cultures and regional traditions all look and act the same as far as test-taking ability is money down the tubes. Probably more important is the wasted energy and opportunity cost that children will be subjected to as centralized bureaucracies continue to gain power over local schools.

On the bright side, we may be rewarded with the feeling that the education provided to minorities in neglected school districts will improve or that sick people who used to end up in crowded lines at the emergency room in public hospitals across the country have a better chance at getting and staying healthy. It is too soon to know if there is any substance behind this feeling, but at least we are doing something. But are we? My take on both of these important sectors of our economy are that things are actually getting worse in terms of the value we receive for our dollars spent than ever before.

New Mexico ranks last among the 50 states in terms of child welfare. Our taxes are in the medium range relative to other states, so why is our actual performance in service delivery so poor? My answer is that we as a state have become too dependent on federal aid and are suffering the consequences of decades of relying on outside help. The people who settled our state and built homes and ranches here were able to raise and support generations of resilient and self-reliant people with multiple vocational skills. This has mainly gone by the wayside as we have had to focus on complying with federal guidelines to qualify to receive outside funds. I believe we are seeing the same phenomena throughout the country when it comes to complying with the new Affordable Care Act, which is something that I support in concept, but am greatly disenchanted with in practice.

There are some people who need federal intervention to gain access to healthcare. A better interim solution would have been to create a national pool akin to the New Mexico one that provided an insurance option to those unable to get it elsewhere. The great majority of Americans are perfectly capable of determining on their own who to go to and how much to pay for their health care. In the same way, we know who the good teachers are and how to teach our kids to read and write and do arithmetic given the chance to hire and fire locally. Without going in to the issue of unions, I believe that freedom of choice and the obligation to pay as we go would serve ourselves and our children well, if applied to the education and health arenas.

New Mexicans rightfully pride themselves on our quality of life as we enjoy great expanses of nature and can recreate outdoors for much of the year. There are people and events here which are the envy of other states. They rightfully garner our state a proud reputation as home to artisans, musicians, and writers from multiple cultural traditions. While we have this to be proud of, large segments of our state's population remain mired in poverty with little hope of escape. A healthy dose of self-reliance, combined with the option to opt out of federal programs would go a long way towards alleviating our problems. Next month, I will explain how this can be done and the benefits that New Mexicans might receive from a totally new approach.

"Dismantling the Wasteful Machine: Part Two" - In last month's article, I talked about the benefits of retaking local control of the educational and health systems. Here are my ideas of how to do that and why the New Mexican economy would benefit from reducing its dependency on government mandated methods of obtaining health care through federally designated channels. While you may find many of these ideas overly simplistic, impractical, cruel, or simply disagree with the philosophy expressed herein, I believe that given adequate resources, most Americans can and will figure out on their own what best serves themselves and their families.

Practical necessities call us to take some drastic steps because these two basic building blocks of our society are failing us. The declining quality and increasing cost of both systems' current operation are telling us that unless we try something radically different, health and education levels of the general population will inhibit rather than promote the welfare of us and our children for decades to come.

Let's start with the health system because we all have to deal with it one way or another. No one is particularly happy with the way healthcare is now provided unless you are so wealthy that you can ignore the whole insurance game. We have a three-tiered system in this country where the richest get the best, working folks get burgeoning hassles, higher prices and less service, and the poor use the emergency rooms at great expense to the rest of us.

Given the political power vested in maintaining the status quo, the way things are going' health insurance companies will probably end up like the big banks: too important to the system to be allowed to fail. As we have largely off loaded the delivery of healthcare into the hands of corporations, the US has fallen further behind most of its competitors in the global economy in terms of quality outcome per dollar spent. We spend a much larger portion of our national economic output (estimated to reach 20% within a few years) in delivering an inferior product to our citizens than just about any other industrialized nation. The U.S. system is broke and not even the President can fix it.

Here's the first part of my solution: take all the funds we pay in taxes budgeted for any kind of health services and divide it by the number of people in the country. Give everyone a health care debit card with a beginning balance of some portion of their personal allocation of national healthcare dollars, maybe half, and then let each person decide on their own who, where, when and how to spend it. The other portion of the national budget of healthcare dollars would then go to provide "free" preventative care, basic prescription and emergency services on a decentralized basis.

What would have to change to accomplish this? First, allow anyone with a college or technical degree in the health field to treat the most common maladies, most of which do not require a medical doctor's care. There are nurses, nurse practitioners, naturopaths and all kinds of other alternatively trained people in the healthcare business who can effectively see most people most of the time. No medical malpractice insurance would be necessary because lawsuits against healthcare professionals, at least everyone who acts in good faith, would not be allowed except in cases of fraud, malfeasance, or other criminal acts.

No corporate lobbying should be allowed, as those costs are passed along in higher premiums to patients who have to pay increasing portions of their bills anyway. There would be no mandatory insurance for anyone since the money needed for health care would already be in their pockets or in a no cost clinic. The progressive nature of our tax system would result in wealthier people paying more for the health system than others…too bad. The insurance companies would be taken out of the equation except in cases where people privately choose to prepay against their potential future illnesses, in a way it would work just like life insurance.

At the other end of the spectrum, people with serious diseases or life-threatening injuries obviously need some kind of (catastrophic) care without regard to their financial status. This would be provided by the allocation of some of the general tax collected revenue for healthcare to go to similarly organized clinics for chronic or emergency service. Only the basic form of well-established practices would be offered, like dialysis with as much of the recovery transferred back to the individual as medically possible.

It is partially the bells and whistles of the latest in modern technology and the fear of lawsuits that drives the cost of medical care costs sky high for everyone. Elective surgery would be just that, people would be on their own. Chronic illnesses like diabetes, cancer, heart disease, dementia, all of which require ongoing care would be provided at a base level to prevent huge sums of money being thrown down the tubes by the public through the current system. Individuals would have to figure out and pay for any above baseline services.

Our healthcare system is set up to delay death for as long as possible, even when doing so is incredibly cruel and wasteful. Some religious traditions call for this approach while many ancient and honored ones do not. There is an appalling lack of information about alternative approaches and a paucity of assistance from trained counselors (hospice being a notable exception) available to most patients. Doctors and hospitals therefore end up applying stupendously intense or "heroic" efforts to prolong life by a few hours, days or months, often with little positive effect on the quality of the patient's life. End-of-life care consumes almost half of total annual spending on healthcare in the United States. Both preventative care and chronic / emergency care can be funded with a small portion of the funds spent today if they were taken out of the current system and put in the hands of entrepreneurs. Why do we continue to subsidize the current broken system?

With the dismantling of the health insurance system, the choice for a large majority of medical treatment could happen on a competitive basis. Doctors, nurses, medical technicians would be freed of bureaucratic meddling and allowed to deliver the great care and caring that motivated them to go into the field in the first place. The economic drag of a system based on fear of doing something wrong, as opposed to entrepreneurial efforts to do things right, would filter down into a primarily local industry. This would be good for our health and great for our local economy.

Personnel News

Rob: The last few months of 2013 were filled with excitement, most notably visits to New Mexico by both my daughters and some snow for us to play in! Work continues unabated on the never ending "chapel" project though a landscape commission for a California Ranch beckons in the near future. As we pass through the short daylight time of year, I wish all of you a healthy, safe and peaceful New Year!

Juliana: In November, I went to N.C to celebrate my mother's 90th birthday. She is still running circles around all us and will hopefully continue to do so for a long time. I added solar power to my house this fall and love getting a check from PNM instead of paying them. If anyone is interested, I can highly recommend the company that I used.

Jeff: In October, my wife and I went to San Carlos, Mexico. We got to swim and snorkel in the gulf waters and we ate lots of wonderful seafood in the restaurants. We were able to visit some friends and see their ranch in the area.

Patricia: This year, between Thanksgiving and Christmas, I went to San Francisco to visit my son and his new wife. It was a very nice time to have a quiet visit and get to see them as a couple. We spent a night preparing Red Beans and Rice, revisiting the Wedding in New Orleans last Fall. All else is pretty quiet for me and the garden as we both rest for the upcoming season.

Emily: The end of 2013 seemed to go by on fast forward. I had a quiet holiday season in Santa Fe. There wasn't much snow come Christmas and New Year, so I got out and about to hear festive music and, of course, Farolito walking for some holiday cheer. While I am hoping for a bit more snow to get a little skiing in, I have enjoyed having warmer days on the weekend for being outdoors.

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 5, 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 6,** our quarterly telephone conference call will take place **at 3:30 p.m. MST**. The call-in number is: 626-677-3000 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.