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# Commentary
## Fall 2001

### The Markets

The sharp decline of stocks during the third quarter of 2001 makes it look like we are in for the worst two-year period since 1981-82.  Our country and most of the world were shocked and saddened by the events at the World Trade Center and the Pentagon early last month.  Much has been talked about since then, and many people feel that the future appears more uncertain now than ever.  Before going into the details of our market outlook, it is appropriate to pause, as many of us have, and note that however painful the past months have been, the trillions of dollars in lost wealth pales in comparison to the human tragedy.  The specter of potential disasters that may loom ahead remind all of us of the really important things in life: our families and helping others.  Whatever the costs of repairing and rebuilding the lives of those affected as well as compromised world markets, we feel strongly that people across our country as a whole, and the majority of people in the world, will pull together and something positive will come out of the recent tragedies.

The direct damages from the terrorist attacks are estimated to be between $10 and $15 billion.  Many additional billions could be lost by businesses because of the negative impact all this is having on consumer spending.  In the immediate aftermath of the bombings, our already weak economy and previously nervous negative investor sentiment have catapulted many investors into an unfortunately deep pessimism about our country's future.

That being said, we believe strongly that "the darkest hour is always before the dawn" and that these tragic events are in the process of triggering the "capitulation" phase, which is usually a precondition to an end to the bear market (in which we have been for over a year).  Bear markets often reverse themselves after climactic events, such as the Kennedy assassination in 1963, the Gulf War in 1990, and the terrorist bombing of the World Trade Center in 1993.  The dramatic and now well-publicized retrenchment on the part of consumers has manifested in people delaying travel and putting off big purchases. A delay in business investment is expected to continue as consumer spending has steeply declined. Government revenues will go down as taxpayer incomes decline with the slowing in economic activity.

"Uncertainty causes people to seek information and suspend their judgments and . . . this affects buying behavior" says the Director of Consumer Surveys at the University of Michigan. Many people are now fearful of going to public places, which has the immediate result of deepening the recession. The Persian Gulf crisis in 1991 helped bring on the 1991 recession. Conversely, our nation's entrance into World War II built a national consensus to spend huge amounts of money in order to defeat the Axis powers, which resulted in the boom economy of the 1940's. We sincerely hope we are not on the verge of huge deficit spending on a protracted military engagement.

In our conversations with clients we point to the general pattern of the market: following emotion-driven sell-offs in the wake of catastrophic events, the stock market usually rallies strongly. The chart below summarizes these particulars.

| Event | Date | 1 week | 30 days | 90 days | 1 year |
|---|---|---|---|---|---|
| Pearl Harbor | 12/7/1941 | 4.0% | 3.8% | -2.9% | -9.6% |
| Cuban Missile Crisis | 10/22/1962 | 1.9% | 12.1% | 18.8% | 31.4% |
| Kennedy Assassination | 11/22/1962 | 5.5% | 7.2% | 12.0% | 25.2% |
| 1987 Market Crash | 10/19/1987 | 3.2% | 10.6% | 16.0% | 23.0% |
| Iraq Attacks Kuwait | 8/2/1990 | 2.2% | -9.7% | -14.0% | 3.9% |

Although the American economy has been weakening for slightly more than a year, the economic impact of negative consumer attitudes and conservative business practices might suggest that the recession will be long and deep. However, the Federal Reserve Bank's stimulus should shorten the downturn.

In addition to the Fed's actions, central bankers around the world have also injected a tremendous amount of liquidity into the global markets. This is to reassure investors that national economies are basically sound and that fear should not gain the upper hand as it did in the 1930s. Here at Rikoon-Carret we feel that there will be a W-shaped bottom to the current bear market. The first downward slant, which culminated in the lows seen on Friday, September 21, 2001, was caused by people driven by their emotions into liquidating their entire stock portfolios, fearing the worst was about to happen. Worst-case scenarios range from the start of World War III to continued terrorist attacks, either of which would serve to freeze up and destroy the world's market environments. In addition to emotion-driven selling, we see a good number of very rational people taking reasonable precautions in order to protect their principal.

Retirees and persons close to retirement, who had previously reached a certain desired level of wealth and who had established a threshold amount of capital with which they were comfortable, have seen their portfolios decline below their comfort zone. The Standard and Poor's 500 was down 9 percent last month, 15 percent over the last three months, and 21 percent since the first of this year. Even well-diversified, conservative investors who had only a portion of their money in stocks are now very nervous about the effects of the current bear market on their present and future well-being. While these concerns are well-founded in the short run, markets always run in cycles.

Along with emotional selling and efforts to preserve retirement capital, we are likely to see a certain amount of forced selling due to highly leveraged investors having to unload big positions, like the Bass Family of Texas who were forced to sell $15 billion of Disney stock at a low price. We feel that the market will take a strong upward turn when this first phase of selling is over. The markets seldom fail to respond to the kind of radical cuts in interest rates we are now seeing worldwide without some kind of strong updraft. The most recent example was the coordinated rate cuts in the fourth quarter of 1998 in response to the Russian loan default, after which the stock market rallied 21 percent. When our markets experience this kind of upsurge again, it will be interesting to determine if it is the end of the bear market or just a bear market rally.

There are many people who continue to be uncomfortable with owning stocks but they are not willing to sell without regaining a certain amount of their "lost" capital. It is a natural tendency to want to recoup some of one's losses before getting out of a stock. In this camp we find many corporate executives who have a large part of their personal net worth tied up in their company's stock. As many good-quality stocks have fallen 50 percent or more, such as EMC, Enron, Cisco, General Electric, and American Express, the effect of having an overhang of potential inside sellers will probably be enough to put a damper on any initial stock market rally.

It is clear is that after two decades of reduced government involvement and spending, the U.S. is on the verge of abruptly reversing course and becoming more involved in many aspects of our lives. At the Administration's request and with the approval of Congress, the $40 billion spending bill passed by Congress in mid-September will now likely be augmented by $17 billion for the military and another potential $70 billion extension of credit to build alternate transportation systems. The Immigration and Naturalization Service is looking for huge budget increases, as is the Federal Bureau of Investigation, in order to implement its proposed new authority to wire tap phones and screen e-mail. Just how far government spending will go is hard to tell, but juxtaposed against corporate retrenchment and layoffs, the future now looks very different than we imagined it just a few short months ago.

It is unclear whether federal officials can even begin to cope with the vast range of information that their proposed new powers would make available. In addition to wire-tapping and Internet monitoring, there would be expanded tracking of foreign students and immigrants. Many of these efforts admittedly will do nothing to stop future terrorist attacks, but may help assuage the high fear and anxiety levels among many people. It is clear that the government knows it must act in order to prevent any further erosion in the confidence of its citizens.

It is usually unwise for anyone to make specific predictions about the stock and bond markets. When all is said and done, bear markets tend to end when there are few sellers left in the game. Once the panic sellers, rational sellers, forced sellers and undiversified sellers are out of the market, there is little left on the down side. Some technology companies are now close to such a position.

We cannot predict when the economy will recover but we are sure that at some point it will recover. The market will already be in a long-term up trend well before the upturn in economic activity occurs. When the fear is mostly gone, and sellers are no longer waiting to see at what point they can bail out, investors who are able to ride through this most difficult period will be richly rewarded for their patience.

To recap the market's action, the blue chip U.S. stock market has declined 21.2 percent so far this year, the NASDAQ or technology index is down 40 percent, the mid and small cap stocks, which began the year with a good showing, are now down approximately 20 percent. The international stock markets, which declined sharply during the days that the U.S. markets were closed, ended the first nine months of the year down 28 percent. They remain in sync with the U.S. technology market, with the German stock market down 35 percent year to date, the British down 22 percent, the Swiss down 26 percent, and the Japanese down 32 percent. The natural resource-based Australian stock market is down approximately 16 percent.

As for bonds, considered a safe haven by many, taxable issues have risen 6.5 percent so far this year, with municipal bonds advancing 2.9 percent. The Rikoon-Carret portfolios have performed closely in line with the markets. Our U.S. large company stock performance is down 21.9 percent, while our international equities declined 28.5 percent. Our taxable bond portfolios have increased 8.14 percent, while tax-free bond portfolios increased 5.48 percent so far this year.

Our large view is that the ability of the world to deal with crisis is predicated on people pulling together to respond to such events constructively. The terrible loss of life on September 11$^{th}$ was well characterized by Barbara Kingsolver, who wrote about this in the September 15$^{th}$ edition of the San Francisco Chronicle. Her daughter brought home a picture of 8,000 people in Tucson, who had assembled all wearing red, white and blue. This sensitive teenager laid her hand over a quarter of the picture, leaving visible more or less 6,000 people, and said, “that many people are dead.”  Kingsolver wrote,

> “We stared at what that looked like – all those innocent souls, multi-colored and tacked into a conjoined destiny – and shuddered at the one simple truth behind all the noise, which is that so many beloved people have suddenly gone from us.  ‘That is my flag, and that is what it means: we are all just people together.’  It is interesting to note,” added Kingsolver, “that in critical times our leaders need most be influenced by the moderating force of dissent.  That is the basis of democracy, in sickness and in health, and especially when national choices are difficult and bear grave consequences.”

## Personal Notes

Due to the terrible loss of life in New York and Washington, it is difficult these days to feel that our personal comings and going have much importance. In our efforts to keep apace with events, all of us here at Rikoon-Carret extend our heartfelt sympathy and offers of assistance to those in need in New York and elsewhere. Our partners at Carret and Company are located in mid-town Manhattan and so were not directly impacted by the attacks on the World Trade Center; however, many of our associates there lost close friends and relatives in the tragedy and to all of them we extend moral and spiritual support.

The rebuilding of southern Manhattan will take place concurrently with the rebuilding of normal business operations in the country as a whole.  We look to our own families and each other for the comfort of local relations and mutual support.  If there are elements of hope and renewal in the aftermath of the suffering, we can begin by taking a realistic view of what we really need.  The staff here in Santa Fe continues to analyze the markets for investing opportunities, and we are available for meetings on the telephone, in person, or via e-mail to assist anyone who wants to review their personal financial plan.  In addition to that open invitation, we will make our next afternoon tea here at our office at 510 Don Gaspar on Wednesday, November 14th at 3:00pm. Refreshments will be served and you are encouraged to bring a friend.  We are sure there will be plenty to discuss, and topics we have yet to discover.  We look forward to seeing you here, and with these efforts we hope to help our clients and friends maintain a healthy and realistic view of our long-term investment strategy.