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Commentary
Fall 2003

Market Performance

The third quarter was relatively uneventful from an investment perspective, with the large cap US stock market up 1.4% for the last three months. Year to date, the benchmark Standard & Poor's 500 rose 13.2% in the continued hope that the US economy's fastest expansion in almost four years will eventually be strong enough to create new jobs. The European large cap market did not fare so well, gaining only 2.4% due to anxiety about the strength of the German and French economies. The US taxable bond markets gained slightly with a 1.86% increase. The Rikoon-Carret US stock portfolios gained 10.84% due to our defensive, high dividend orientation, while we were up strongly, 9.63%, in international stocks, Our taxable bond portfolio component gained 4.95%, significantly outpacing the index.

It appears that the expected 3.8 percent growth rate in the economy will fall slightly short of the 4 percent level necessary to encourage job creation. In my last commentary, I wrote about how important that growth is to deal successfully with our country's structural issues in education, health care, electricity, highways, etc.

Recent productivity gains due to the introduction of technology that cuts down on the number of people needed in many businesses have raised the bar on how much growth it takes to spawn new jobs. U.S. worker productivity expansion means that firms are firing workers they no longer need to reach output targets. This helps companies report good earnings but it inhibits new hiring and then the willingness of consumers to spend declines, with good cause: fear they'll lose their jobs, too.
Bush looks like he will be the first president since Hoover to seek reelection with fewer people employed than when he first entered the White House. Payrolls have fallen by 2.6 million since January 2001.

This overhanging pessimism can be good for stocks but bad for working people. Consumer confidence fell in September to its lowest level in six months. Factory orders fell in August for the first time since April and the Labor Department's employment report indicates three consecutive years of factory job losses.

Another symptom of a weak labor market and excess capacity is the drop in the consumer price index. Since the Fed cannot tolerate deflation, it seems clear that the central bank will hold the benchmark overnight bank rate at 1 percent and not raise it until possibly next summer or, a few months after the labor market improves. Overall, people are waiting to see what happens with jobs and how high the deficit will go before fiscal discipline is restored.

Interest Rates & the Economy

In 2002, 200 billion dollars flowed into the economy as individuals refinanced their mortgages. Recently, while visiting with a client, I was told that he had just taken on a new mortgage because his neighbor had said he could get a great rate. “Get a 5 year adjustable rate mortgage (ARM),” the mortgage broker said. “It has the lowest charges and you get the lowest rate.” Unfortunately, individuals who are taking out adjustable rate mortgages are taking on the risk formerly born by institutions.

When interest rates rise, adjustable rate borrowers will be forced to either pay substantially higher monthly payments, maybe more than they can afford, or to sell their homes into what may turn out to be a bad market. One third of all people who refinance their homes use ARM’s. Wittingly or not, if you have a variable rate mortgage, you must believe that either housing prices will go up, that personal incomes will go up, that interest rates will stay down or that there is a tooth fairy.

In fact, the first harbinger of rising rates has already been felt in the bond market, as the bellwether U S Treasury bond had its greatest fall in price in late July 2003 since mid-1987. This is the time to lock in low rates, to sell long term bonds, to exit from some bonds funds and to start saving. Given the size of the government’s debt problems, we all may be asked to pony up some of our savings to bail Uncle Sam out of this mess.

The Congressional Budget oversight committee recently acknowledged that their previous estimates of how much in the hole we are as a nation was woefully inadequate. It is now said that we will be 470 billion in the red this year. If the economy does not grow well over 2% this year, next years shortfall will be higher, or close to 600 billion dollars. As our deficit grows, interest rates will eventually climb.

It would be good to have an investment strategy in place, one that is well thought out and ready if the bond market tanks due to higher interest rates. A recent article in the Wall Street Journal suggested that because bonds were ripe for a fall, stocks now represent a better relative value even though by all traditional yardsticks, stocks remain overpriced. History shows that stocks will outperform bonds if they achieve a real rate of growth of 6%.

If however, we are in an economy that does not grow at 6% or 4% or even at 2% for a long time to come, then we will be in for a hard landing. Hard landings are what used to be called recessions. Business cycles, like nature’s cycles are made up of excess and then droughts. What we are now experiencing is an attempt by powerful people to mitigate the pain and suffering due to market cycles. This is especially important when public election cycles interface with economic ones.

It seems to me that the more we mess with the markets by trying to manipulate interest rates, the more omnipotent we may appear, but the more vulnerable we become when reality resurfaces. One investment strategy to use in anticipation of a hard landing is cash and short-term bonds. We are using some preferred stocks and short term closed end funds along with cash and short-term bonds to accomplish this goal.

The great hope for the markets is that we grow our economy out of the problem. This is the underlying worldview of our nation's leaders. If they are right, then peace and prosperity will return to part of the world.

Politics & Recovery

Except for rising unemployment, the US economy looks like it is getting better: economic growth is driving the dollar and interest rates upward, but I wonder if it is real? A closer look at the numbers shows that primarily defense spending, tax rebates, mortgage refinancing, and debt fuel our growth.

Government spending had its largest percent increase since 1951, when the Korean War was happening. Consumer spending has also increased, aided by lower income tax rates, rebates, and one time childcare payments. The bad news is that unemployment continues to rise. When hiring begins again, I wonder if the openings will be meaningful, career-oriented jobs or low-wage service jobs.

Stocks have gone up only slightly over the summer while bonds have drifted lower because of widespread anxiety about inflation. Many stock prices are higher due to stupendous profit reports, which look good thanks to the new tax laws. The 2001 & 2003 tax changes allow for paper profits to go up without real growth. Companies also appear to be making more money because they continue to cut jobs. Very few are making more money because their businesses are expanding, which is what is necessary for a sustained recovery. It looks to me like we have been experiencing a bear market rally that is a short respite from a longer term downtrend.

The Presidential race of 2004 will hinge on the state of the economy. Everything possible is being done to ignite "growth" so that the economy looks strong next November. What cost will we end up paying for political meddling in economic affairs? My primary concern is that the government's deficits for 2003, which now tops 450 billion dollars and is estimated to be 475 billion (not including Iraq!) will force a reinflation cycle that will decimate the real estate and interest rate sensitive businesses.

P. T. Barnum said: "You can fool all the people some of the time; you can even fool some of the people all of the time; but you can't fool all of the people all of the time." How will we know whether inflation is back? Don't expect to hear it on the news but rather watch the price of gold, which is up 11 % over the last five months. Are we having a real economic recovery? I think we need to see meaningful jobs created in order to feel that the country is on the right track.

The US Dollar

The US Dollar has recently faired poorly against the European currency, known as the “Euro,” and the Japanese Yen. Most people ignore changes in currency rates but I think it is important for our clients to understand a little more about this important part of the world’s integrated markets. The world’s economy has revolved around the US Dollar for sixty years and many countries formally or informally peg their currencies to the US Dollar.

As we look at the rising unemployment in our country, our weak currency is one major reason why 2.6 million jobs have been lost since 2001. Foreign countries that promote their own weak domestic currency end up having a huge labor cost advantage over high cost and rich currency nations like our own.

US Treasury Secretary Snow recently traveled to China demanding that the Chinese unhook their currency from the US Dollar. If China agreed to this, it would help US companies that export products made here become more competitive. This would save some American jobs but the economic reality of the world’s currency markets will likely preclude this from happening.

What happens when countries export their goods to us and we run trade deficits is that they turn around and buy US Treasury bonds and bills with their surplus dollars. This allows us as consumers to buy more goods and services from other countries at “cheap” prices. We benefit by getting more stuff at the cost of sending jobs overseas.

As a result of this kind of unbalanced circulation of money through the world’s currency systems, foreign governments have become an integral part of the US financial system. Without foreign capital, US interest rates would be much higher than they are and the US Dollar would be much lower than it currently is. Japan recently sold 40 billion US dollars worth of Yen in order to keep its currency cheap. So far in 2003, Japan has spent over 120 billion dollars to maintain a low currency rate, all to protect their domestic jobs.

If countries like China delinked their currencies from ours, the US Dollar would likely fall further and our interest rates would go through the roof as we desperately try to attract capital to finance our nation’s deficits. If interest rates go up quickly, many corporations would be adversely affected. The US’s fledgling recovery would be at risk and global recovery would become problematic.

Higher interest rates used to be a cost of doing business during good times. Companies were able to absorb higher interest costs because they could raise their prices. Today, as more people are unemployed or underemployed, companies are finding they can't raise prices because of competition from manufacturers and service providers overseas.

Higher interest rates hurt people in debt. The US national private-sector debt, as a percentage of disposable income, is 20% higher today than it was 10 years ago. When and if interest rates go up, everyone and every company that is in debt will have to work harder to stay even or possibly just give up and walk away from their obligations.

We believe that the key for our clients is to protect portfolios against inflation and currency risk. Traditionally, stocks were thought to be a hedge against inflation. However, at the price earnings ratio the market sells for today, which is close to 30, stocks seem overvalued. The price earnings ratio when the bear market started on March 31, 2000 was 29.4. There has never been a time in history when investors purchased stocks with price earnings ratios at today's levels, when reviewed ten years later, investors in the stock market indexes made any money.

We are in the midst of a brief recovery in stock prices, but we are trying not to be lulled into feeling that the near future will be a repeat of the immediate past. We have therefore expanded our horizons to include precious metals, inflation protected bonds, floating rate corporate bonds and interest bearing opportunities in markets around the world in order to be diversified enough so that our clients can afford to ignore the daily US Dollar report.

Personnel

In this quarter's newsletter, it seems appropriate to describe in greater detail the current arrangement whereby I am spending a good deal of time in our North Carolina office. I will be in North Carolina approximately 1-2 weeks out of each month. The background to this situation has mostly to do with my wife. Deb spent much of her childhood in western North Carolina and additionally, the passing of both her parents in 2002 set the background for her desire to return to the fertile green countryside there. Three years of drought in New Mexico have not helped her gardening efforts, either!

Early last year, Deb, with the encouragement of some of her long time friends who live in and around Asheville, began looking for a place to try to do some organic farming and husbandry.

Finding a place in the middle of a rural area did not readily provide an educational opportunity for our two high school aged girls, Robyn and Hannah. Through the help of some friends in Santa Fe, Deb found two challenging schools, the North Carolina School of the Arts in Winston Salem for Robyn and the Asheville School for Hannah. Robyn is on a full scholarship for her senior year with a specialty in performing arts, specifically drama. Hannah's school is academically very rigorous, and the students have a fairly formal dress code as well!

All of this change required my involvement and so our office has gone to great lengths to make sure that I am able to stay in constant touch with our clients and continue to make informed investment decisions on all the portfolios. In order to accomplish my management functions from two locations, we have installed a real time computer connection between the two offices. This means that daily, I am online with all of the research capabilities, especially the Bloomberg research terminal, and I have the same access to individual client account information just as if I was sitting in Santa Fe. In fact, my staff feels that I seem to get more research done due to the greater amount of uninterrupted quiet time available to me in North Carolina.

Sometimes, a picture is worth ten thousand words so we have also established a video connection, over the Internet, between the two offices. In this way, we can hold client meetings in our conference room that add the visual aspect. On bad hair days, the conventional telephone conversation works better but it is fun to see how body language and facial expressions add different dimensions to communication!

As we move forward, it is not clear whether Deb and the girls will want to stay in North Carolina for the next school year or return to New Mexico. On my part, I intend to maintain my garden on Old Santa Fe Trail for many years to come. Many of you may remember the yurt we erected in our backyard during our renovations a few years back. It is now serving as my painting studio and instead of training for triathlons and marathons; I am devoting my spare time to the "chapel" painting project, which is coming along slowly. It should be close to completion in three or four years, which is not too long when one considers I started planning it in 1997.

Anyone who is interested in hearing more about any of these projects is most welcome to contact me anytime, either through my cell phone or through the office switchboard. Fairly soon, I hope to join the ranks of the over connected by using one of the new generation color Blackberry or Trios. These allow for real time delivery of wireless text, i.e., email, anytime and anyplace. People in my office are partially dreading that day, as if it isn't bad enough now getting emails from me way before the sun rises. So, feel free to let me know if you have any questions or concerns or if you just would like to talk. I look forward to hearing from you!

Other News

Congratulations to Wendy Havlir who recently accepted the position of Adjunct Professor at the College of Santa Fe. Wendy will be teaching an evening course on the beliefs and practices of Hinduism and Buddhism in January.

Our Quarterly Tea will be at 510 Don Gaspar on Thursday, November 20th at 3:00 pm. We had a terrific turn out last time and we'd love to see everyone there. So bring a friend and come participate in our discussions of the markets, the economy, and geopolitics.

Because the holiday season is quickly approaching, we have already put the next Tea on our calendar! Please join us on Thursday, January 8th, 2004 at our Don Gaspar office.

As we study global markets with our clients' financial well-being in mind, we watch the wide-ranging news events and collectively wish for ways to positively impact the world around us. Last year, in lieu of mailing holiday cards to our friends and business associates, we made donations to the Empty Stocking, Challenge New Mexico, and Heifer International. Again this year we plan to donate to both local and international charities, and although we've tossed some ideas around and done some preliminary research, we haven't made any final selections. We welcome suggestions from our clients because we aren't aware of all worthy causes, especially fledgling ones just getting off the ground. Although we can't extend our "holiday card" fund to help every organization that needs it, we know our part counts and trust we have your support in this endeavor.

And on a final note, enclosed in the packet with your quarterly reports is the statement of our official policy regarding your privacy. Please review it, and if you have any questions or comments, or need anything additional, please call us. We'll be happy to help.