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Fall Commentary 2007

The Markets

The Federal Reserve Bank came to the rescue of the U.S. stock market last month as it delivered an unexpectedly large ½ of 1% interest rate cut. This spurred energy and raw material companies, and they led the stock market's recovery from what was looking like a summer rout. The unexpected magnitude of the Fed's cut in interest rates was sparked by worldwide concerns of an imminent recession, one that looked like it might be precipitated by a crack in the credit market's foundation.

Interest rate reductions allowed the world's stock market to recover from losses sustained in July and August, during which the Standard & Poor's 500 had the largest downward slump in four years. Following worldwide concerted and coordinated injections of money and lowered interest rates, global stock market indexes advanced so mightily that September was the best month for stock in the last ten years. The fallout, both positive and negative, from the Fed's cut in interest rates will be felt for a long time.

Stock market enthusiasts applauded the Fed's action, but many people feel that the Fed's new president, Ben Bernanke, has now placed himself squarely in the camp of those whose main goal is to stave off worldwide recession. The stock market, as measured by the U.S. large company index, the Standard & Poor's 500, gained 3.6% in September but rose only 1.6% during the entire third quarter due to sharp declines in July and August. It closed the third quarter with a year to date gain of 7.65%. The Rikoon Group large cap stock portfolios gained 10.37% during the same nine month period. During the early summer months, we made several portfolio adjustments to simplify our clients' stock holdings, moving from small companies to large ones and changing out several funds. This will allow us to respond more quickly to changing market conditions, as we expect more volatility in the near future.

Energy and raw material companies continued to be our favorite areas. These led the rise in the S&P 500 during the third quarter. If any of our readers are interested in the performance of specific areas, such as metal, commodities, master limited partnerships, hedge funds or any of the other asset classes that we are now using, contact us.

In the international markets, Germany outdistanced the rest of the European Union countries with a 19.17% gain during the first nine months of 2007. England, France, Spain, Italy and Switzerland all under performed the U.S. stock market. However, due to the dollar's decline, most foreign markets beat the U.S., and the composite Dow Jones European Stock Index has gained 15.14% year to date. In comparison, The Rikoon Group's international portfolios gained 16.38% during the first nine months of 2007.

By dealing with the investing public's anxiety by lowering interest rates, the world's central banks risk encouraging leverage and higher inflation down the road. One immediate reaction to the cut in U.S. interest rates was a noticeable continuation in the trend for the U.S. dollar to decline versus most currencies. U.S. Treasuries completed their biggest quarterly rallies in five years on expectations that the Fed will continue to cut interest rates later in 2007.

The bond market's returns for the nine months ending September 30 were mediocre, with the U.S. taxable bond market rising, on a total return basis, 4.13%, while the U.S. tax-free bond market gained 2.55% during the first nine months. The Rikoon Group tax-free portfolio gained 3.55%, while our taxable portfolio advanced 3.51%.

Oil hit a record high of about $80 a barrel and gold reached a twenty-seven-year high, both events being harbingers of future price inflation as well.

The Economy

As the Fed cut interest rates and stock markets around the world rallied, the U.S.'s economy slowed down. Unemployment rose to a one-year high in September while manufacturing levels declined for the third month in a row. Much of this weakness can be ascribed to the precarious housing market which we will explore in detail below. Consumer spending, construction and employment are all contracting due to rising real estate lending costs and falling real estate valuations. These structural factors have not been helped by the cut in interest rates. Further, continued downward pressure on home prices will likely hit the economy in full force during the next several quarters.

While the dollar's decline is good for some U.S. manufacturing companies who export their goods overseas, it is bad for U.S. consumers. Consumer sentiment has declined to its lowest level in three years, and most economists are holding their breath to see, as we go into the holiday season during the fourth quarter, whether anxiety over declining personal wealth as reflected in estimates of home values will impact consumer spending.

The U.S. real estate market is experiencing its most severe setback since the Great Depression. According to the National Association of Realtors, for the first time since the 1930s, year-over-year home prices have declined. No one is sure when this will end due to the increasing likelihood that many of the homes owned by "sub-prime" borrowers will come back on the market due to foreclosures. It is estimated that there are about 3 million "sub-prime" or low credit quality borrowers in the U.S. Analysts think that approximately 40% of those borrowers will not be able to make their mortgage payments as adjustable rate mortgages reset rates over the next three years. This would result in approximately 1.2 million more homes coming onto the market.

There is a great deal of political pressure for the government to do something about the burgeoning debacle in real estate. The Fed's interest rate cut will not help many people who have more mortgage debt than the value of their house. These people in need will not qualify for the government programs already in place that have strict qualifications to participate. These homes could create a flood of additional houses into a market already saddled with excess inventory.

Estimates are that it would currently take 10 months to sell off all the existing homes on the market. Additional inventory that's likely to come on the market due to pending foreclosures will make it painful for everyone who is trying to sell property. It is possible that the lenders, who will be stuck holding much of the foreclosed houses inventory, will tighten their lending requirements for future loans, thereby offsetting much of the economic gain that normally comes from a Fed interest rate cut.

Global Markets

We believe that financial markets around the world have become so intertwined that economic events in one geographic area will often show up in another. While a U.S. economic slowdown caused by a real estate recession will not affect global demand as much as it would have several years back, Asian economies will need to pick up the slack by encouraging domestic demand. The weak U.S. dollar is allowing many foreigners to shop and vacation here, and cash-flush nations are gobbling up natural resource assets across the globe, creating a boon for investors in commodities.

One of the most fascinating developments in the world is the emergence of the economic power of national investment companies formed by China, Russia and the oil-rich nations of the Mideast. These are fast becoming the new powerhouses of global financial capital.

While U.S. consumers are buying low-cost goods from China, the Chinese have been amassing a surplus of 1.3 trillion dollars, of which about 30% is invested in U.S. Treasuries. The Chinese government owns about 20% of our country's debt with Japan owning slightly more. We are almost minority holders of our own bonds. The interesting part comes when we move to a minority position in our nation's common stock. China is moving forward slowly with an eye to do some more aggressive investing with the rest of their 1.3 trillion dollars. It recently established a 200 billion dollar "sovereign" fund. "Sovereign" means that foreign governments, which are not necessarily democracies, republics or representative governments, have pooled their nation's excess capital in state-owned investment companies. These quasi-government investors invest with very long-term strategic goals in mind. We in the West have little comprehension of the implication. China experienced a political backlash in the U.S. when it tried to buy Unocal, a California based-oil company. The U.S. Congress rejected the sale of a domestic natural resource company to a foreign-owned entity but we may not have the luxury of keeping up barriers to foreign ownership for long.

China was permitted to buy a stake in the New York City based Blackstone Group, which is one of the U.S.'s most powerful private equity firms. An important long-term result of the formation of sovereign funds is that they serve as vehicles for direct investments in overseas companies, gaining access to resources such as oil and essential industrial metals, and establishing footholds in diverse markets.

China, like some of the countries in the Middle East, understands that control of the world's resources is a key to long-term economic stability. It will also leverage their political influence in the world for several decades into the future. China's investment companies' main purpose is to help their state-owned companies expand overseas and to boost the capital of their poorly run state-owned financial institutions. China is using its trading surplus in a deliberate fashion to expand its influence abroad. Eventually, it and other sovereign funds will have a real stake in the developed nations of Europe and perhaps the U.S. as well.

All of this has not gone unrecognized by the world's central banks. The EU Central Bank president recently said that the global economy may suffer if sovereign funds don't act "transparently," that is, disclosing their goals and methods. The European Union and the United States, along with Japan, are responsible for the stability of today's financial markets. The people who are running these sovereign funds from other cultures don't necessarily have to play by the same rules as established by the West. Control, and therefore responsibility, for the multitrillion-dollar daily exchanges of goods and money may pass out of the hands of institutions such as the IMF, the World Bank and the Group of 7 to as yet unknown players.

The stability of the world's markets depends upon close coordination among the major developed nations. There is a concern that if and when huge amounts of capital come to be invested through companies whose motives are not disclosed, future blips in political or financial events could quickly grow out of control. The potential failure of coordinated oversight would yank the rug of confidence upon which global securities markets depend. U.S. investment banks calculate that countries such as Russia, China and the Middle Eastern oil nations could oversee 12 trillion dollars within ten years, which is about the total size of the U.S. economy. In a decade, it's possible that a few foreign funds' financial clout could match the impact of the U.S. Wow!

European bankers and U.S. policy makers are hoping for mediation. This is the best they can ask for, at the moment, because, in the words of Europe's counterpart to our Fed chairman, "when you are in front of entities that are not guiding themselves on free, decentralized decision making, the fundamental choices are limited." Can mechanisms be put in place to ensure that the stability and control of the financial markets of the developed world won't be at risk? We shall see. It is a key question for investors to keep in mind as sovereign funds grow in size and start to wield their economic power in new ways.

One example of the loss of financial control of domestic institutions to foreigners can be seen by looking at Britain. The United Kingdom has been for sale since Margaret Thatcher opened the doors of deregulation during the 1980s. Since then, most of Britain's power, water, heavy industry, ports, profitable companies, media, and investment banks have been bought by foreigners.

Recently, a 28% stake in the London Stock Exchange was bought by a group from Dubai. Another group from Qatar purchased an additional interest in Britain's stock market. Over one-third of Britain's economy is owned and controlled by offshore companies.

There have been some immediate benefits to the English, because investor-friendly labor laws and high demand for homes have propelled an unprecedented increase in urban wealth. It is not an unmitigated positive, however. Even though London has now pre-empted New York as a center of world, cross-border banking and foreign exchange trading, it, like the U.S., has lost manufacturing jobs overseas due to outsourcing. I think the most telling sign of Britain's (and eventually perhaps the entire West's) dependence on foreign capital is what happened this summer when the credit crunch hit England's shores early this September.

Anxiety about the high degree of risk hit when Chrysler Corporation's efforts to sell itself failed in mid-July. Soon, all lower quality companies in the U.S. had trouble borrowing short-term money, and then, like a forest fire, the crisis jumped lines and began to impact international money markets. This caused a run on a bank in England, and then other multinational financial firms based in London started having difficulty renewing their loans.

While the fire raged, and before the Fed cut interest rates as noted previously, the Bank of England's governor said he was opposed to bailing out high return-seeking investors by taking emergency measures to flood the market with cheap money. A week later, he changed his tune completely. He also agreed to bail out Northern Rock Bank. I believe that this reversal was dictated by Britain's dependence on foreign capital and that the English long-standing position to not "encourage excessive risk taking which (could) sow the seeds of a future financial crisis" was overturned by pressure from abroad. A former UK official said the bank's troubles were "an amazing example of how quickly pressure can build and overwhelm the financial structure." In this case, so far, global capital worked to protect stability at all costs.

Rob's Narrative

ALASKA: In August, my 21-year-old daughter, Robyn, and I embarked on a journey that we had been planning for two years. Robyn is a senior at the North Carolina School the Arts in the Theater Arts.

Flying into Anchorage, we were amazed at the sight of the setting sun at 11:30 p.m., hitting the snow-capped mountains surrounding the city.

In terms of grandeur, Alaska is to Colorado as Colorado is to North Carolina. If you have Alaska on your list to visit, I encourage you to go there, as it is an experience not to be missed. Anchorage is not much to look at, but as a stepping stone to nearby recreational opportunities, it is well provisioned. We headed north by car toward Denali National Park, which encompasses 6 million acres, roughly the size of the state of Massachusetts.

Arriving in Denali, we experienced typical Alaskan summer weather: intermittent rain clouds and cold, followed by sunshine and delightful warmth. Robyn and I camped out for eight nights, and after our first night in a wet tent, we agreed that she was in charge of the campground and I was to be the trail leader. Each day, we loaded our packs with food, water, maps, compasses, first aid, extra clothing, and rain gear and headed out for a six- to eight-hour hike. Denali is a wilderness area established for the protection of wildlife. Large sections of it have no trails, so one has to forge through the rich tundra and high mountain rocks or follow river beds made of glacial melt. The cold and wet weather did not impede our enjoyment of the Park.

On day four, we set off on a six-hour bus ride for Wonder Lake Campground, 96 miles west of the Park entrance. The bus drivers double as wildlife guides. We saw bears, caribou, wolves and moose from the safety of the bus. Out at Wonder Lake, where no RVs were allowed, there were communal bear-proof food lockers and sheltered picnic tables. Before leaving for Alaska, we thought the keys to bear safety were bear (pepper) spray and bear bells, but the reality was more comforting. It turns out grizzlies in Denali find humans mostly uninteresting, especially compared with the hundreds of thousands of acres of wild blueberries in season during August.

Our first night at Wonder Lake, Mt. Denali—also known as Mt. McKinley—peeked its summit out of the thick cloud cover. The top of the mountain was so high up in the sky, and though we were 30 to 40 miles away, we found it hard to believe that it was rock we were looking at and not a cloud. The next day brought clear skies and a clear view of Mt. Denali, towering 6000 feet above numerous 14,000-foot peaks which serve as its foothills.

After five days of hiking in the western part of the Park, we returned to civilization for a shower and then scooted back south, through Anchorage, to the Kenai Peninsula. We spent one night in Seward, a quaint and historic fishing town, and two nights in Homer, the halibut fishing capital of the world, where we saw halibut that were bigger than Robyn! During our brief sojourn in Alaska, we passed many hiking trailheads which would be great places to return to someday.

On our last day, I visited the Alaska USA Trust Company in Anchorage.

TABLE ROCK RUN, NORTH CAROLINA: Over the past eight months, I participated in several trail runs with an informal group that organizes events around Asheville. On September 7th, we left on a huge, granite outcropping called Table Rock on the Mountains to Sea Trail, which is supposed to be well marked! Nine runners—two women and seven men—set out at 6 a.m. after getting very little sleep. We ran along the Linville Gorge, which had experienced a severe fire earlier in the summer.

I was the oldest runner, by about 15 years, but in the middle of the group as far as pace was concerned. Pretty quickly, we became so spread out that at times, I didn't see anyone for a half-hour or more. All went well until the river crossing at the bottom of Linville Gorge. Trail-marking signs were nowhere to be found, so I ended up wading back and forth across the river four times, looking for signs of the others. Eventually two runners came up behind me, and together we stumbled through the woods and found our way, though the folks ahead of us were also lost once they reached the far side of the river. The first eleven miles of trail took four and a half hours to traverse. Due to the extremely hot weather, most of us had prematurely depleted our water supplies, and volunteers took turns running in from the various aid stations to try to find runners who were either lost or out of water.

As I came into the first aid station, I was soaked from the waist down due to difficult and repeated river crossings. Luckily, I had packed extra socks and foot tape, so I managed to dry and refresh myself and go off on the run's second leg, which was 15 miles long.

The trail was beautiful after leaving the fire-scarred area, with fall colors appearing at higher elevations. My three liters of water lasted about four hours, and by then I was within two miles of the second aid station. Two volunteers found me and we started running together. As we passed over a bridge and railroad tracks, we heard voices coming from two different places in the woods. It turned out that two of the faster runners were lost and were wandering without direction. I assisted one, Mohammed, and he and I then proceeded toward the 2nd aid station. We pulled in at around 3 p.m., nine hours having passed since the start. Several people decided to quit, but I wanted to go on until darkness fell.

Mohammed decided to go with me for the final 15 miles. We started off walking and I was grateful that he had a map. The trail markers were wrong in several places, and the maps were also sometimes wrong—but never at the same time! With teamwork, by 7 p.m., we were several miles away from the Blue Ridge Parkway and the finish.

Mohammed and I then came upon a man with a walking stick who turned out to be one of our group. Mark is a Green Beret field instructor, having just returned from a year in Afghanistan. He had been sleeping on the side of the trail and had been awakened by a bear right before we arrived. He seemed a little dazed, so we gave him food and water, and the three of us set off together. A volunteer showed up on the trail at dusk and offered us Gatorade, which was good, since all of us had just run out of water. At 8 p.m., we trucked in, having run about 42 miles, with 10,000 feet of elevation gain. Everyone was in good spirits!

Personnel News

Juliana and Patricia are going to the Schwab 2007 Impact Conference at the end of October. It will be held in Las Vegas this year. Patricia has never been there and Juliana has not been there in a long while. If they don't come back, you know they hit it big!

Jeff’s daughter changed schools this year and she started attending the Camino de Paz Montessori Farm and School which is located north of Santa Fe. In addition to academics, the students care for animals and work at the organic farm. The students sell vegetables and eggs each Saturday at the Santa Fe Farmer’s Market. Jeff recently took a week vacation to just catch up and work on projects at his house – some of those things that he has good intentions to get to, but never seems to. He did lots of miscellaneous small jobs inside the house. Outside he painted wood preservative stain on all the wood decks, so they should all be good for a couple more years. His big project was to finish out a store room that his wife decided needed to be insulated and weather tight. This involved putting in electricity, insulation, drywall, texture, trim and paint. When finished, he said that it looks a lot better than the college dorms and apartments that he lived in.

Dana recently returned from visiting family and friends in the Santa Cruz, CA, area which is also home to her alma mater. She enjoyed Indian summer conditions and numerous walks on the beach. Her son is happily ensconced, when not jetting around Europe visiting other school friends, at the University of Granada, Spain. Her daughter is face to face with the challenges of her junior year at Santa Fe High, wishing she was having as much fun as her brother!

Carole has recently joined The Rikoon Group as a part-time administrative assistant. Of course, she’s also the staff herbalist. Her other life is working with medicinal and edible plants. During the warmer months, she leads groups on outings called “Stalking the Wild Herbs.”

Upcoming Events

The next quarterly tea will take place on Thursday, December 6, at our Luisa Street office. Sessions will be held at 3 p.m. and 6:30 p.m. Please call us at 989-3581 if you plan to attend.