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Fall Commentary 2009

The Markets

Since the inception of last year's unprecedented government stimulus programs focused on the real estate, financial, automotive and consumer credit areas, the party on Wall Street has started back up. The Dow Jones Industrial Average is up 15% for the third quarter, the best performance for a three month period since 1998 and the best July to October period since 1939. Contrary to tradition, the stock market rose in September, a month in which it usually declines. Given the meteoric rise of 25% over the last six months, there seems to be a wave of investors entering the market who believe that the worst is over and there is only smooth sailing and blue skies ahead. This reminds us of the last time the market gained 25% over a six month period, the end of March 1987!

The composite of the largest U.S. companies, the Standard & Poor's 500, also rose 15% during the third quarter and so far this year is up 18%. It is up 56% from the low in March, but remains 32% below its highest point reached in October 2007.

The international markets have outperformed those in the U.S. by a large degree. Large international stocks are up 25.7% with the best performing economies of the world being China, India, Brazil and Canada**.** The developed nations in Europe have had similar government intervention programs to those in the U.S. with their own version of our cash for clunkers program in Germany, France and England. Europe overall, as a market, gained 21.4% during the first nine months and the emerging markets as a whole, including the fastest growing and most populous nations of the world, were up 56.8%.

The bond market has had a stellar 2009 thus far. The taxable or corporate bond index rose 3.97% due to the abatement of fears concerning potential meltdowns. Municipal bond performance, the market that is made up of tax-free bonds, has been even more astounding. Municipal rates for new bonds are at their lowest point in 42 years! Can you believe we are back in the 1950's as far as interest rates go? The tax-free bond market index went up 2.65% through the end of the third quarter.

Our estimate is that approximately 25% of the government stimulus package has been spent to date. This government money has elbowed out private fundraising because the amount of direct issuance of new bonds by corporations and non profits is at an abysmally low level. City and state governments as well as some corporations are finding it very difficult and unattractive to issue new bonds in order to promote growth in their areas. This also makes it difficult for bond investors to find a decent reinvestment rate when bonds held in their portfolios mature. In 2009, a segment of the bond market called taxable municipals, which are sponsored by the U.S. government's Rebuild America

Program funds, became available. These are bonds issued by state and local government and entities with a high degree of safety. Initially, these bonds yielded more than other taxable equivalents, but we have seen tightening in interest rates here as well. Super low interest rates will likely persist for some time, penalizing conservative investors who seek safety in government bonds and government insured deposits. Finding secure and adequate fixed income cash flow through bonds remains a concern as we look ahead to the rest of 2009 and 2010.

The Rikoon Group portfolios have performed well this year. Please contact us if you would like us to email you our latest composite performance numbers.

<u>The Economy</u>

The U.S. economy grew at a 3% annualized rate in the third quarter, which if sustainable, would be very good news. The actual numbers for the second quarter are just out and it looks like the U.S. economy shrank at a 1% rate from April to the end of June.

It is possible that the final three months of 2009 could be filled with good news. Money is cheap, exports are increasing and the continued government fiscal stimulus will add several percentage points' growth to the U.S. economy.

Our sense of the U.S. economy is that American consumers, who have lost up to 40% of their wealth in the last two years, are and will continue to be under extreme duress as their credit card and home equity lines of credit are vanishing. Due to a more stringent banking environment, individual consumers will not be the force that reignites the world's economic growth as has mostly been the case over the last 30 years. The real unemployment rate in America is well over 10% if under employed and part-time workers who would like to, or need to, have full-time work are included in this statistic. The result is that U.S. consumers have no extra income to spend, and the government's programs that spurred car and home sales by subsidizing consumers will start dwindling during the fourth quarter. Only well into 2010 will we know if domestic demand really has been rekindled through this massive government intervention. Without the cheap money, it is likely that the U.S. economy will have a "W" shaped recovery. This means that we will have more bad economic news and another downturn before we emerge into the next sustainable recovery.

Harried and politicized regulators are being instructed to take increasingly harsh positions on bank loan quality classifications. This will force banks to re-capitalize but it is probably already too late for approximately 20% of the banks out there. A recent independent study showed that there were over 3,000 banks that would probably receive an 'F' grade in terms of their loan portfolio quality and management skills.

These banks will need to be closed or folded into other banks over the next several years. The Federal government's fund to accomplish such actions, the FDIC, is running out of money. It currently only has about ½ of 1 cent for every $100 that it insures. It is estimated that we need about 40 times the amount of the money currently on hand to cover the size of the FDIC's potential losses. This figure will undoubtedly rise as mid and large sized banks with their boatloads of commercial real estate and lending problems come to light.

One arm of the economy that has been pummeled due to the global recession has been commodities and agriculture. As Asia now takes a larger presence on the world's stage, China's national investment fund is ramping up its position in commodities, taking advantage of the global slowdown to negotiate better prices for vast tracts of strategic resources.

China recently purchased portions of Indonesia's largest coal producer, made a substantial investment in a large Canadian mining company and plunked down $850 million for a 15% stake in commodity trading companies that focus on agricultural foodstuffs. China's huge national financial reserves are also being used to take minority positions in natural resource companies around the world. The Chinese autocracy is an economic juggernaut and their ruthless focus on long-term control of resources will likely pay off for them when the world's economy recovers.

While the Chinese are investing in natural resources oversees, they are also attempting to stimulate consumer demand at home since they can see the American consumer giving up our role as the engine of their nation's and the rest of the world's economic growth. Some investors believe that China will lead the world out of its doldrums.

Ever since the Chinese "embraced" capitalism, it has done so in an autocratic and totalitarian fashion. 95% of Chinese international businesses are government owned or controlled. Chinese foreign policy, from the building of hospitals in Africa to the enrollment of Chinese students in universities across America, takes place within a highly planned context designed to strengthen their nation's dominant position in commerce. There are few ways for U.S. investors to profit from this economic juggernaut save for investing in natural resource companies and those that provide essential services that the Chinese cannot clone and reproduce for themselves.

<u>Articles from The New Mexican</u>

Here are adaptations of two articles by Rob recently published in our local newspaper:

1) As most everyone is aware, the U.S. has been running on borrowed money for some time. Thanks to increased output from nations like China, India, and Brazil, we have been able to borrow cheaply and pay back our loans with our own currency which is fairly easy to print. This situation will not last long. The change will come without much warning and the first hints of a vast restructuring of international trade can now be seen.

Even though U..S consumers are saving for the first time in 20 years, we have twice as much debt per person now as we did in 1989, much of which is based on real estate values. The government's ongoing and expanding binge will push our national debt past the point of being sustainable by 2015. Falling tax revenue, the rescue of financially strapped municipalities and states, health care reform and an aging population will undermine hopes that we can grow our way out of the predicament.

With interest rates near zero, investors and taxpayers are being punished alike. As big investment banks congratulate themselves on their handsome bonuses, ill begotten at the least, investors are left to protect themselves. The best strategy I know for most people is to look at high quality corporate or municipal bonds maturing in 5 years or less. By investing in individual bonds that mature with regular frequency, investors can get some relief from the twin vise of low returns and higher taxes and be poised to adjust to an environment where interest rates spin out of the Federal Reserve Bank's control.

The stock market rally we are experiencing is primarily due to massive amounts of money being pumped into the financial system that has no other place to go. Longer term, only companies that are well diversified outside of the U.S. currency stand much chance of successfully dealing with the commodity based inflation sure to come as the world's population grows and becomes more affluent, at least in some parts of the world.

Though price inflation will stay muted for some time due to the global recession, when it returns, precious metals and energy will once again be safe harbors. The US dollar is the ground on which the next international financial crisis will be worked out. The Chinese, Brazilians, Arabs and many other skeptical nations hold lots of U.S. dollars now but they are looking to get out without causing a panic.

A declining dollar hurts American consumers but in such a way as there is no one to blame. It is an inconvenient truth that we as U.S. citizens are constrained by our own government so as to not easily be able to diversify outside the U.S. dollar. You may want to consider investigating how you can diversify your holdings outside of US currency based investments, either through foreign stocks and bonds, commodity vehicles and energy holdings. Don't wait too long to do your homework!

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2) People often ask me how they can make money in this current market. Some of the most common questions include: Is it time to buy real estate? Are the banks over the worst of their problems? When will interest rates go up? How do I my get money to earn more interest but safely?

For investors with cash, my response is based on gut instinct and street level experience. Your personal choices should rely on what you can see, touch and know to be true. Because the information presented through corporate media is incomplete and biased, we are forced to puzzle through the contradictory signs of a manufacturing recovery and official pronouncements of confidence versus most people's angst about runaway budget deficits and falling real wages.

On a practical level, each of us knows for ourselves which products are essential and fairly priced. We know whether or not our family plans include luxury cars or expensive vacations. The rising power of Asia, due to its astounding demographic trends, is no surprise; and the technical capacity of India's hundreds of millions of English speaking, hard working citizens cannot be underestimated. These are the trends on which wealth will be created over the next decade.

Our housing and car markets are on life support so they don't make a lot of sense to invest in. When looking at publically traded stocks, ask yourself: if it weren't for government support, would the company have gone down the tubes? Chances are high that the management and culture of many financial firms who were at the heart of the crisis have not changed so don't fall into the trap of thinking everything is OK with the markets.

Consider how you spend your own dollars when thinking of investments. If you were to buy a new computer, what would it be? When you consider your home and transportation fuel sources, how satisfied are you with their sustainability? Are they profitably run? Combining data available to you on the Internet with common sense is enough to find suitable investment opportunities in companies you rely on.

We are a forgetful nation. The traumas of last year, ancient history to some investors, have receded with the allure of quick gains. We are seeing some investors come back into high risk investments like currency speculation, shorting the market, and borrowing to increase the size of their bets. This was standard fare up until 2007 and it is back in vogue.

My advice is to steer clear of companies that rely on government programs and those with poor business practices. Instead, focus on things you know and like to use. After all, they still haven't invented the free lunch.

Personnel News

Rob: I completed the Hardrock 100 mile trail run for the second and last time this summer, picking up a nasty infection and a bit of common sense amidst the 13,000 foot passes of SW Colorado. For pictures of the event, please see Rob's Facebook photo album created by my daughter, Hannah. I continue to fill in the landscape around the office/studio with fruit trees, adding nine varieties of heritage apples specifically oriented to the Northern New Mexico climate.

Juliana: In an effort to keep "all the little gray cells" working, I decided to take bridge lessons this summer. It has been a fun and extremely challenging endeavor. I am still wrestling with the very, very basic concepts and am going to continue to take classes at the community college The next challenge will be to see if I can converse "bridge" at least slightly intelligently with my mother when I visit her in North Carolina. I doubt it!

Jeff: I have been riding my bike each day to and from the office since April. Though the temperature is beginning to turn a bit colder now, I hope to keep riding until the snow comes; or maybe even through the snow too. We had great success with our summer gardens at home and here at the office. That was fun and we had some tasty treats as well.

Patricia: I have spent a lot of my spare time in the garden this summer. We have had wonderful vegetables, and I've made lunch for all of us several times. I want you to know that if you are interested, I have Hollyhock seeds to share and instructions on how to get them started. You can e-mail me at patricia.cody@rikoongroup.com or give me a call. After spending several days in real estate classes catching up on my CE credit, I took a short trip to Pagosa Springs with my sister to relax in the waters and enjoy the Fall weather and colors.

Emily: It's hard to believe Fall is here. I am thrilled to have the contractors gone from our house, but now the challenge of finishing the bathroom interior is upon us as we hope to do most of the work ourselves. I continue to play soccer and tennis as time and weather permit and am looking forward to a trip to New York City in November.

Dana: The summer was punctuated with trips to the east and west coasts. I especially loved Maine and the joy of picking blueberries, feasting on lobster, and finding the resting place of "Dana" ancestors dating back to the Revolutionary War. The latter part of summer was very bittersweet as I helped my daughter prepare to leave for college. The nest is empty now. When I'm feeling wistful, I sit at the window and watch the comings and goings of the bees, their hive-minded activity a soothing balm. Soon their final flurry to make haste for winter will end, and they will cluster within around their communal fire.

LOCAL TEA & CALL-IN DATES:

Our upcoming tea will be held on Wednesday, November 11th at the Ghost Ranch Conference Center in the **Perea Room** at 3:30 p.m. and 6:00 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, November 12th at 3:30 p.m. and 6:00 p.m. (Mountain Time) our quarterly telephone conference call will take place. The call-in # for both sessions 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.