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Fall Commentary 2011

Markets and Economy

Skittish investors pummeled stock markets around the world during the 3rd quarter.
The Dow Jones Industrial Average was down 12%, its largest drop since the first three months of 2009. The corresponding European Stock Index was down even more, declining 22% while Asia's markets decreased an almost equal measure. The Hong Kong markets were down 24% while Japan, still recovering from its spring catastrophe along with a twenty-two year long recession, lost 15% during the first nine months of 2011.

Mainland China's economy, which has been the growth engine for the world's economy, is showing a sign of fatigue as its stock market has fallen 16% while its industrial output has gone from growing 10% to 5%, a rate the West would be happy to experience but far below China's necessary performance to keep its people employed. European government officials are in a quandary about how to make the "PIIGS" nations' problems dissipate. Portugal, Ireland, Italy, Greece and Spain are encountering strong recessionary forces so investors are fleeing those countries. This has created a ripple effect, raising fears among stock investors worldwide. People in Greece are taking their money out of local banks and literally hiding it under their mattresses or sending it out of the country.

Many European bank stocks have lost up to half their value as Europe is going through another version of the 2007-2008 credit crisis. There is little confidence that the European Union can fix its own problems regarding access to the capital markets. If Italian, Spanish or French government bonds are drawn into the morass, action on the part of the International Monetary Fund will be needed to solve the European Union's problems. Please see the article reprinted below from October's New Mexican for a fuller explanation of the "Global Monopoly" game currently underway.

Here in the United States, manufacturing data suggests that exports continue to fuel modest growth for U.S. companies selling overseas. Also, the light truck and SUV industries are faring well as sales were up 20% during the 3rd quarter. This was partially due to the misfortune that Japanese manufacturers experienced last spring as they are just now recovering from the tsunami and its terrible aftermath.

The U.S. dollar strengthened during the 3rd quarter as investors sought refuge in the U.S. treasury market. Our government, no matter how large its deficits, is still seen as the most secure place to keep liquid funds safe. Corporate and municipal bonds made some, but not much money during the 3rd quarter, producing positive gains of 2.53% and 1.37% respectively. For most investors, analyzing the performance of bond markets is confusing. Income oriented investors, who need cash flow to support their lifestyles, continue to be hurt by lower interest rates, even though on

paper their portfolio values are up. Substantial excitement was generated for bond investors when the Federal Reserve Bank came out during the 3rd quarter and announced plans to keep interest rates low for an "extended period of time."

U.S. consumers have found that their take home pay, adjusted for inflation, continues to fall. The Census Bureau reports that the average American household income fell to just under $50,000, the lowest level in more than a decade. The poverty rate in the U.S. rose to 15%, which is a seventeen year high, and the unemployment rate has stayed at a constant 9.1% rate due to anemic job formation and consumer spending.

Due to the stock market's decline and widespread anxiety about the health of the economy, The Federal Reserve recently announced their intention to continue to intercede in the bond markets through a series of planned purchases of long term treasuries and mortgage backed securities to the tune of $44 billion. This form of economic stimulus is targeted to encourage companies to hire more people and on reigniting the moribund real estate market. Our feeling is that it will fail to do so because people without jobs or who are experiencing declining purchasing power as a result of falling real wages are unlikely to go out and look for a new place to live. People are hunkering down and this is making markets and economists worry. At this point, we have to ask ourselves, are stocks cheap?

Some interesting indicators show that if the companies who make up the Standard & Poor's 500 can maintain profits at current levels, the stock market rout that has occurred over the last three months, which erased almost $3 trillion from U.S. equity valuations, has brought stocks down to historically reasonable levels and it is indeed a reasonable time to be buying. During past economic contractions, there has typically been a stock market recovery from these levels of valuations to the tune of approximately 5% over the next six months. Our strategy, therefore, is to buy or add to great companies that are paying handsome dividends.

The government debt crisis in Europe is of such a magnitude that there are few market participants who can backstop Europe if the PIIGS countries default. Portugal and Ireland are both now rated as "junk" bonds along with Greece. Because French and German banks own so much of the PIIGS country debt, those nations' financial systems are also at risk and need government help. When governments have trouble borrowing money, everyone gets rattled. It seems that Europe is now headed into a recession, due to the austerity measures at the bequest of Lenders and an overall crisis of confidence in the banking system. The unfolding drama will likely require investors in European bonds to take large losses which will result in diminished access to private lenders. In the latter stages, there will only be government to government loans with less and less entrepreneurial opportunity. Can Southern European nations grow their way out of this mess? The market does not think so and this has sent investors rushing to the United States' markets.

Most asset classes had a tough time during the 3rd quarter. Crude oil and commodities suffered their worst performance since the dark days of the Lehman Brothers collapse in 2008. U.S. stock investors withdrew $71 billion from stock funds and piled into safe investments such as U.S. treasury bills and money market funds, even though these accounts are paying next to nothing in interest, after considering inflation.

Crude oil fell 18%, though gasoline prices at the pump stayed high due to refinery delays in cutting prices. Refiners are quick to raise their prices when crude oil goes up but much slower to adjust downwards. Copper, one of the main materials used for building projects, fell 26%. This has economic forecasters worried because it portends a dramatic decrease in global economic activity. Overall, commodities have fallen 12% in 2011. Real estate investors continue to see prices decline, even though the Federal government is making a concerted effort to lower long term mortgage rates. The Case Shiller index reports that nationwide, residential values have fallen close to 30% from their 2006 apex. The recent dearth of activity in the U.S. new home construction market may indicate that this key industry is in for an extended period of low growth and deflation, i.e. falling prices. These same factors have hamstrung the Japanese economy and kept Japanese government bond yields around 1% for over 10 years. That impacts retirees and decimates savings account investor returns.

The world's economic prospects may be ratcheting downwards as the European crisis intensifies. China is dealing with its own crippling form of inflation, reflected in a terribly overheated real estate market. The U.S. economy is in a low growth mode and the hope is that our economy could surprise us on the upside if there are bigger than expected short term fiscal stimulus programs implemented by the Fed and/or an agreement among members of Congress that would avoid automatic spending cuts slated for this November. This would necessitate a bi-partisan budget plan but even that may not be effective to keep the U.S. economy from going into a recession.

The economies of Western Europe and the U.S. are interdependent and both rely on government stimulus and policy support. European bank liquidity issues could spread to the U.S. and this is why the big U.S. money center banks and investment houses have seen their stock prices pummeled of late. Europe still has the ability to lower its interest rates while we have already used up most of that policy option. This would stimulate some growth within the EU but at the risk of feeding inflation, which the Germans in particular loath due to their experience in the 1930s where rampant inflation helped lead to the rise of Hitler and the Third Reich.

Inflation in Europe rose by 3% over the last 12 months, well above the European Union's target rate of 2% even though European new employment and manufacturing activity remains muted. If inflation continues to rise, it will present EU leaders with fewer policy options in dealing with Greece and the other delinquent nations. Germany, whose jobless rate had fallen to very low levels, has seen its consumer spending levels drop due to worries about the rest of the EU nation's fortunes and reduced exporting opportunities due to the slowdown in China and the US. Spain's jobless rate rose to over 20%. These numbers are from the official reports, which mean that the actual proportion of the population who are either out of work or under employed is much greater.

Our prognosis for the U.S. economy is mixed. We see construction activity and consumer spending remaining at depressed levels for the next 36 months. With government programs to stimulate the economy in their third (and most tired) phase, we do not feel that more debt financing by the Fed will result in enough of an increase in domestic bank lending to produce a meaningful number of new jobs. Unless there is a concerted effort on the part of both political

parties to bring some long term logic and fairness back into the government's role in the economy, which has grown to huge proportions, it will likely be more of the same through the next election: deleveraging on the part of U.S. consumers, a paucity of small business formation, and continued outsourcing on the part of US based companies. We do expect to see continued technological innovation, but none of the above is positive for increased U.S. employment opportunities.

Some bright spots in the U.S. economy are increased activity in the energy sector and small manufacturing. American companies are launching exploration programs and looking at ways to restock the nation's energy supply while small industrial manufacturers continue to show growth, particularly in international sales. While this may not get reflected in public market prices, it has resuscitated some employment opportunities in small towns in the industrial heartland which is good news for those communities.

The effect of the upcoming U.S. Presidential race on the economy cannot be overestimated. The Congressional Super Committee charged with cutting $3 trillion from the deficit will be under terrible pressure to make their cuts in such a way as not to inhibit economic growth…how is that for a conundrum? The Supreme Court will review several important business issues, such as mandatory health insurance and affirmative action programs. While we are not optimistic about Congress's willingness or ability to address the structural issues facing our economy, we do imagine no one will stand in the way of the Federal Reserve continuing to stimulate the markets in new and creative ways. While this may not juice up the real economy, it should supply some measure of downside support for the markets over the next 12 to 16 months.

Articles by Rob Rikoon (reprinted from his monthly column in "The New Mexican")

SEPTEMBER, 2011: Think of the current debt crisis in Europe as a game of monopoly. Let's hit the pause button, figure we're at half time, step back and take in the big picture. First, there are two tiers of players, those taking turns now rolling the dice, using what's left of their paper money along with a few houses/hotels already on the board, and those in the background, holding the stash of free money and unaccounted for currency. The numbers are so big that to give a useful perspective, I am going to simplify to the nearest Trillion, (with a big 'T'), which is a thousand billion.

Here's an overview of the players and their positions. First, countries that are in the hole with how much they owe (in Trillions): Iceland(-1/100th), Ireland(-1/10th), Portugal (– 1/10$^{th)}$, Greece (– ½), Spain(-3/4), Italy (-1 ½), France(-4), USA(-15) . There are others, such as the British, Belgians and Eastern Europeans but for the moment, they are irrelevant and on the sidelines. The players with real cash surpluses are: Middle East Oil Producers +6, China + 3, Corporate America +2, U.S. Banks +1.5(this is what they are supposed to be using for loans), International Monetary Fund +1, and the European Central Bank +1/2. All we hear about in the news, relative to the European crisis, are the latter two, the IMF and the ECB, who are both minor players in the scheme of things.

Some facts to ponder: Greece will never ever be able pay off its IOUs; European politics will not allow Germany to abandon helping countries it decimated during WWI and WW II, and the

total amounts owed by European governments and institutions listed above, not including Italy, will wipe out the money already put aside to contain the problem. Here is how our monopoly game gets played out: since Europe is incapable of growing its way out of its malaise or of cutting its budgets enough to make a difference, the IMF can and will get more money from China and the Middle East in order to support the ECB but only by ceding some control to those nations who hold the big pot of money. The IMF and other international conduits for funds to bail out Europe will become proxies for the game's current winners, just as they were, until recently, vehicles for US foreign policy. To the victor go the spoils. In this case, Europe's travails will pave the way for continued expansion of OPEC and China's desire to buttress their military and natural resource gathering capacities. How China and OPEC got to be the winners is another subject but it ain't complicated: they produce and sell stuff which we buy. Their surpluses just about exactly match the size of our deficits.

While China has a homegrown military, the oil producing nations do not. Therefore, they must buy our protection and they do so by funneling their excess capital to fund our deficit which now stands at close to 15 T. We are down in the game, like Europe, but we have a special card to play, our "get out of jail free" asset, which is the US military capability. Our budget hole is getting deeper, to the tune of 1 to 2 T per year. This is the same amount as our annual military budget and ironically, it is also the size of the yearly profits of the oil producing nations. Whether or not any of us philosophically agree with spending money on defense and security, it is the reason why we get to keep playing at the table while racking up more debt. The US dollar is the world's currency not because we back it up with gold but because we do so with guns. The stability that the US military presence brings to the world stage is not unlike that of bouncers at bars or casinos; it enables the game to go on.

An orderly transition from a European confederation to a United States of Europe may take place without bloodshed but not without some degree of suffering. Our progression from being the undisputed leader of the world to acknowledging the fact that we are now one of several "co-operative" partners on the world's power stage will also, I hope, happen relatively peacefully. It's hard to maintain a good attitude when you lose, be it at a board game, in the stock market or in the more important matters of life. With some variety in our sources of self-esteem, I believe we can make a good go of it.

AUGUST, 2011: What a great opportunity we now have to see the inner workings of the intertwined worlds of government and finance. As the debate rages on about our nation's debt, people are horrified about how dysfunctional our system seems to be and mystified about how we got here.

It's true. Congress is acting like a gang of moody schoolchildren spoiling for a playground scrap because most of its members are beholden to special interest groups or party obligations that prohibit them from exercising their native intelligence and ability to compromise. We are polarized because of intrusive technology and the ingenuity of the best and brightest strategists who hone in on demographic information and voting patterns in order to intimidate independent thinkers. Even Dennis Kucinich, normally an astute critic of conventional thinking, can turn in public and blame peripheral players like the bond rating agencies for the ills of government budget excesses. How absurd!

Everyone knows a temporary measure will be put into place to raise the debt ceiling because both parties fear being blamed for a service shutdown like the one recently incurred by the state of Minnesota. The fact that we live beyond our means is not lost on anyone. The question at the heart of the debate can be simply stated as: is government involvement part of the solution or part of the problem when it comes to the health, welfare, education and conduct of its citizen's lives?

Great theorists and strong leaders do not abound in a world where personal lives are under microscopic examination and instant feedback can be generated to discredit any point of view. We just don't seem to have the luxury of letting time take its due course without some form of human meddling.

Relax: the US is not going to default on its debt. We own the biggest money printing press in history backed up by the strongest military ever placed on the planet. However bad the shape of our finances are, we still trump the hands held by most other nations except Oil Exporters and China. The markets have been exceptionally calm through this and not just because Wall Street has moved to the Hamptons for the brutally hot summer.

However our elected representatives get over the present budget hurdle, the ongoing dilemma of our nation's course will not be solved. In much the same way that Europe has sidestepped a meltdown over Greece by generating enough public confidence in their combined governments so that everyone can go on for a while, we will hobble down the road of pushing structural reforms off until after the next election. If President Obama has a second term, we will see if he has what it takes to face the entitlement issues that have eventually sunk empires throughout history.

We have what it takes to tighten our belts and collectively make do with less. Our children know how to work cooperatively and they are accepting of cultural differences in ways that will allow them to speak Mandarin or Arabic as well as live and work in places most of their parents would find uncomfortable. The political nonsense that we witness daily around the nation's budget is really a side show. The superficial deals that will be cut and then re- cut many times are not nearly as important as the undercurrents of changing expectations on the part of our citizens, who no longer expect the system to work, nor the readjustment of global finical clout, which is definitely moving out of the Western hemispheres   Hold onto your hats and enjoy the ride!

<u>JULY, 2011</u>: Buying stocks is so much easier than buying real estate. Whenever the market goes down, all that is required to make it bounce back up is a news conference in Washington or an optimistic report out of New York. It almost makes my job of managing money as an investment advisor a piece of cake. We are well into our second decade of market intervention, ostensibly undertaken out of a good hearted desire to keep folks from suffering too much.

Many believe that a majority of Americans vote based on their pocketbooks, which may best be represented by how much a gallon of gasoline costs or what their retirement accounts are worth. My view is that the largest determinate of how confident people feel in their financial future is

the value of their home and other real estate. What leads to solid home values is the multi-billion dollar question presently in front of economists.

Even though corporations are reporting record earnings and interest rates are as low as anyone can remember, there just isn't enough economic activity without a robust housing market to get unemployment down or rekindle consumer optimism, which are the lynch pins of a sustainable recovery. With trumpets flourishing, once more into the breach rides our government by contemplating forced mortgage refinancing at current low rates for everything insured by the government sponsored entities (GSE's), such as Fannie Mae and Freddie Mac , who are the guys that blew it big time 3 years ago and who have been on taxpayer life support since then.

It sounds great but only on the surface. People's mortgage payments would go down, due to a 1/3rd reduction in the amount of interest due. But would they owe any less on their homes? No. If they are out of work or underemployed, will they have a better chance of finding a decent job? No. Would they have more money to spend on big ticket items? I don't think so, given the dim prospects for future earnings, most folks will use the savings to pay off their past due high interest rate credit cards. Does the economy get a boost – not really.

Who pays for the reduction in interest rates? A minor portion gets charged to the banks who can afford it the least so we likely will see more bailouts. Some gets charged back to the government, who owns Fannie and Freddie, and this part eventually shows up in the federal deficit. Private investors who own bonds, i.e., savers and retirees, would take the biggest hit through reduced earnings on their portfolios. Does the real estate market get a boost? No, because although foreclosure sales drop way off, borrowers in bad shape still need to unload their overpriced and over leveraged real estate but they have less incentive to be realistic and cut their asking prices. The result is the housing recovery may be delayed by another 3 or 5 or 10 years. Construction of new homes and remodeling activity will remain suppressed because the status quo will reign.

Buying real estate is a messy business. It is hard to predict future costs of management and maintenance and the hassle factor is high. If the government gets in the business of renting 1 million homes that turn out to be financial losses, it will probably turn into another big hole in the federal budget. Allowing people to fail and start over again is another way of rectifying the problem. If we allow the market to fall freely and find its own bottom, then and only then will new owners appear on the scene. They will do so in order to take advantage of the newly created economic opportunities by investing their capital and time so as to turn bad situations into good ones in order to achieve capital gains. This was the American Way before we got used to looking to someone to save us. Markets are, by definition, brutal. Shielding the impact of its cyclical blows makes things worse for everyone.

Personnel and Office News

Rob: It was a very nice summer here in Santa Fe, hot and dry until August and then rain that turned everything green. With various projects underway in the studio and garden, as well as out on 3 acres near the national forest north of town, I enjoyed a visit from my daughters Robyn, 25,

and Hannah, 22, who are both thriving in New York. There is one more 50 mile run on the docket for this year, in Moab, Utah and then it's time to fire up our newly installed used wood stoves at the office and pray for more moisture this fall and holiday season!

Juliana: I am enjoying our new office chickens, Georgia O'Keefe, Millicent Rogers and Mabel Dodge Lujan. Their "office" is right outside my window and their chucking and scratching around is a welcome distraction from the gyrations in the stock market.

Jeff: We took a trip this summer to Colorado to visit and spend time in some of our favorite spots – Telluride, Pagosa Springs and Wolf Creek. We attended the Telluride Jazz Festival which was a big treat for me. Our summer vegetable garden didn't turn out as well as past years and so we are hoping to do better with our greenhouse this winter. I am still enjoying riding my bike to and from work each day as well as riding to lots of other places too.

Patricia: I am back from my lovely trip to Scotland in September. It was a real vacation to plunge into another culture with such rich history and passion. On my return it became fall here in Santa Fe and time to bring this year's garden harvest to an end. I cannot say this was the most satisfying gardening year. I got to know a lot more about bugs, varmints and disease. It is all part of the gardening process. I hope all you gardeners out there had an enjoyable experience this year.

Emily: I can't believe summer has come and gone so quickly. I had a full summer of soccer and now am settling into a quiet fall and winter.

Dana: The bees have been put to bed for the season. Hot and dry weather through much of the summer made for limited forage and a small harvest. However, the hives remain healthy and I am glad of that!

LOCAL TEA & 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, November 16, 2011 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, November 17, 2011 our quarterly telephone conference call will take place at 3:30 p.m. MST. The call-in number 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.