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Fall Commentary 2005

The Markets

The U.S. stock market just can't seem to get it together so far this year. Even though the Dow Jones Industrial average managed a gain of 2.9% in the third quarter, it remains down 2% for the year mostly due to the poor performance of companies that require high energy inputs. The Standard and Poor's 500 was up 3.1% for the third quarter and, because of its inclusion of substantially more energy related companies than the Dow Jones, is up 1.4% so far this year. The technology index had a good quarter, rising 4.6% but it is still down 1.1% year to date. The Rikoon Carret U.S. stock portfolios rose 1.14% during the first nine months of 2005.

The returns on the international scene were quite different. Despite rising oil prices and concerns about a global economic slowdown in China, most major markets outside the U.S. did quite well, and some even rising to their highest levels ever. The Dow Jones World Stock index, which excludes the United States, has, so far this year, gained around 6%.

For the first time in history, the Japanese government will purposefully reduce the size of its influence by privatizing the huge postal system which also serves as a bank and insurance company in that country. A rebound in Japan would have a positive impact for the rest of Asia. Its market roared ahead 17.2% during the third quarter. South Korea and India's markets also rose in similar measure. Even Germany's stock market was up, though it remains under pressure due to political uncertainty, as the ruling government there is about to be replaced.

The European markets were more muted than Asia's. Because taxation makes up such a large portion of their energy costs, the increase this year in the price of oil has had less of an impact there. Analysts have high expectations for European companies, but with consumer confidence weakening overseas, the stock markets representing the major industrial countries in Europe don't have a great prognosis for the rest of 2005.

The Rikoon Carret international stock portfolio gained 2.25% year-to-date. The good news is that the appreciation in stocks overseas was not offset during the 3rd quarter by dollar appreciation, as it had been during the first six months of 2005.

In the bond markets short term rates continued to rise as the Federal Reserve increased the overnight inter-bank lending rate from 1% to 3.75%. That makes for eleven hikes in a little over a year, but they have had little affect on the price of the U.S. 10-year

Treasury bond which is the benchmark for the bond market indexes. Long term interest rates have hardly budged, and the rates earned on junk bonds are still relatively low, a sign of overconfidence on the part of bond market investors.

The taxable bond index had a year-to-date price change of -1.78 %, while the tax-free bond index changed -.45%. In comparison, the Rikoon Carret taxable bond portfolios decreased -.35%, while our tax-free or municipal portfolios gained .06%.

Economic Forecasts

Even though energy prices have gone through the roof, corporate profits have not been adversely affected. The consumer price index has not increased greatly other than for the price of gasoline. It is likely that the Federal Reserve is near the end of its tightening phase and that once it stops raising rates, stocks and bonds will benefit.

A wild card in the big picture of economic forecast is runaway prices in the real estate market. It is estimated that $4 billion has been added to consumer spending due to single family home appreciation. Increased feelings of wealth have kept spending up as the average home price nationwide increased $20,000 over the last twelve months. The Federal Reserve has its eye on this, and it is unlikely that they will end their tightening phase until real estate prices stabilize.

If consumers retrench on spending, the risks for lower rated or "junk" bonds will increase and investors who have been searching for yield in riskier mutual funds are likely to see the principal value of their investments decline. Likewise, investors who have borrowed money, a common tactic used by the real estate investment trusts, would also be at risk.

The Federal Reserve estimates that there is approximately $4 trillion in floating rate mortgages, credit card debt, and student loans all of which would adjust higher if inflation increases beyond current boundaries. In its efforts to stabilize prices, the Fed risks slowing the economy or pushing it into a recession in order to somehow cut down on variable rate debt.

We are amazed that the Fed has had so little influence given the number of rate increases. Neither hurricanes nor oil price spikes have managed to scare US consumers. Commodities have been another area that has seen a large run-up in price. Zinc is near an 8 month high and copper and lumber are both at record prices. Natural gas has approximately doubled since the current chain of events.

As the winter months approach, demand for heat will begin to affect the energy markets. The Federal Government is promising relief in the form of tax reductions on gasoline and economic stimulus packages, but it is unlikely that government can control the rate at which prices rise. The price of gold is up 8.1% for the 3rd quarter and now is trading at an 18 year high. This signals inflation fears. The bull market in raw materials has now run for more than three years and like many others, I consider it to be past its prime.

Real Estate Market. Heading For A Fall?

Even though the real estate market shows classic signs of speculation, few people believe it is in danger of an imminent downturn.

Many investors believe that real estate represents the best investment class today because the median U.S. home price has increased 51 percent since November 2001, and expectations are that it will continue to do so. If you look at a chart of single family housing prices around the United States, it is eerily reminiscent of the stock market in the late 1990's.

From an investment point of view, there is no denying the fact that it is better to rent than to buy today. If you can afford to buy a $400,000 house, you can likely find for the same monthly payment a rental house with a value of $600,000. Renting involves no risk of repairs or maintenance. When people retort that rental money is money down the drain, it assumes that real estate will appreciate. This is an assumption worth examining.

Here are some amazing facts that point to a speculative real estate market. After tax mortgage payments now consume nearly 20 percent of Americans' income. The last time this level was reached was in the late 1980's before a major recession descended upon the country. The housing boom has created up to 40 percent of the 2.3 million jobs added to the U.S. economy since 2001, and since then, real estate appreciation has been responsible for 68 percent of all wealth creation. The easy availability of loan money and the low standards applied to new mortgage loans has created a situation where the amount of down payments is approximately 9 percent! Adjustable-rate mortgages comprise over a third of new mortgages and no-money down, no-principal repayment loans are readily available so almost anyone can afford to buy a home, even people with extremely poor credit histories.

On one hand, this has made the American dream of owning one's own house widely available. The danger underneath this blissful situation is that sub-prime lending, i.e. the percentage of loans given out to people with a high risk of default, is about 17 percent. Consumers who own homes have borrowed $1.62 trillion against their equity since 2001 and spent about half of this amount to support lifestyle decisions. The danger rests upon the event that they are forced to pay it back when real estate values are falling.

Why do people think that real estate has to go up? First, it seems like a more secure investment than stocks and bonds because it is more tangible. Also, investigators tend to project out into the future their experience of the recent past. Almost everyone you meet will say that real estate has done exceedingly well, and they can see many "reasons" why this trend will continue. I am not so sure.

Stepping back and looking at the big picture, there were 2 million new homes built last year, but only 1.2 million new family households were created. The excess housing supply has been soaked up by investors. Currently, The Toll Brothers, the largest luxury home builder in the United States, has a 12-month, $5.9 billion work log of orders. Over time, the demographics of our country do not support such an increase in the housing stock. Neither immigration nor the kind of new jobs being created will sustain the prices of new homes at levels above what a typical family income can support.

What might a correction in the real estate market look like? Housing prices can adjust downward to a gradual slowing or flattening in the rate of appreciation, not just by a sharp drop in prices. This is because real estate is fairly liquid. Many people simply take their homes off the market if they are not satisfied with prices. However, when mortgage interest rates rise significantly, families who have stretched their budget in order to get into a larger home or have made an investment thinking that their retirement would come from real estate appreciation will be forced to sell at an inopportune time, and the selling frenzy will be self-perpetuating.

The Federal Reserve is acutely aware of the problems with overpriced housing markets. But, its ability to maneuver is so severely limited because of its past history of printing money, that the Federal Reserve has no choice but to publicly deny that real risk abounds.

In 1998, beginning with the Russian currency crisis and subsequent Asian currency meltdown, the Federal Reserve and other governments' monetary authorities loosened the gates and flooded the world with easy money. This continued through the stock market meltdown of 2000, the terrorist attacks of 2001, and the subsequent mobilization of military in the Middle East.

An end to easy money will rock the real estate market through rising interest rates. Another real risk is a shortfall of cash flow on the part of borrowers.

The Federal Reserve has some control over short-term interest rates. If there is a disruption to the economy that causes consumers to retrench, the ensuing deflationary shock will not be able to be offset by the Fed's actions. If the housing bubble bursts, people will be reluctant to take on more debt, further slowing economic activity.

Insiders at the Federal Reserve estimate the economy will slow one-fifth of 1 percent for every 1 percent drop in housing values. A normal market correction would be 20 percent, so a drop in real estate prices can create a recession. If unemployment rises at the same time, that would further contribute to an escalating break in housing values. Then, a rush to the exits on the part of impatient investors would create a further downward spiral.

If interest rates stay low, surplus cash worldwide will continue to flow into the United States for investment. This will continue to promote rising real estate values but at the cost of increasing our vulnerability to future economic downturns.

When mortgage debt cannot be paid off for any reason, you have the risk of deflation. Deflation is a dearth of demand, and it represents a serious threat to the world's peace and prosperity.

Once monetary authorities throughout the world decided in the late 1990's to inflate assets in order to assuage the public's anxiety, a real estate boom was inevitable. Now that it is going on, it seems to have no end in sight. It behooves people who are thinking about selling their home or have other real estate property that they need to turn into cash, to start moving in that direction now. In my experience, it is generally better to leave an investment party early rather than late.

Hurricanes Create Another Long-Term Challenge

There are a few factors more important to our national economy right now than the impact that hurricanes Katrina and Rita recently wrought in the South Central United States. It is hard to imagine the magnitude of destruction and the number of lives that will be irreparably changed by these events. Along with the suffering, heroism and sacrifice will come some political fallout and because of this, we may see major changes in economic policies of the current administration. It is clear that many warnings were given to government agencies, as well as the residents of the Gulf Coast, and that funds that were slated to be used to buttress the levees in New Orleans were diverted to military operations overseas.

Looking ahead at the economy in the hurricane ravaged areas of the U.S., the plan is to pump out the water, allow the land to dry and then rebuild the city. I truly wonder whether it will be possible or if it is advisable to try to reestablish the ambiance and real estate values that were washed away when up to 150,000 properties were flooded, making this hurricane the most damaging natural disaster in the nation's history. Stocks, however, were up during the week of the disaster as the markets seem to be predicting that the ill effects on the overall economy will last for only one or two months.

For people directly affected by the hurricane, their misfortune will be longer lived. It is estimated that approximately half of the million or so jobs in the Gulf Coast region will go away. This will be one of the many costs that the taxpaying public will have to cover. The total cost of the disaster is estimated to be 200 billion dollars.

Insurance companies are on the hook for perhaps $50 billion of that amount. The government's recently passed emergency aid program totaled $40 billion, and so the recovery budget is still short by about $110 billion dollars. Through various charities, the public is estimated to meet about $2 billion, or one percent of the cost.

According to an insurance industry information source, U.S. property and casualty insurers have a surplus of about $400 billion out of which they can pay for Katrina's losses. Most people in the affected area did not have flood insurance because it was not available through private insurance companies. The Federal government, through its "National Flood Insurance Program", insured thirty to forty percent of the single family dwellings in the region. This is another cost the public will end up bearing.

Oil and natural gas prices were up because the Gulf region produces about one-third of the oil and one-fifth of the natural gas in the country. If oil prices stay above $60 per barrel, the rest of the country will likely feel it through a slowdown in retail sales.

One question, which looks like it will not get debated in public, is whether it is worthwhile to rebuild New Orleans and other communities on the same sites as before. It is we the people nationwide who will end up paying for reconstruction through higher insurance premiums, higher taxes and lower levels of social services. The alternative, almost unthinkable to many people, is to consider that below sea level real estate, worth untold billions of dollars, might be better off being abandoned because of the likelihood that it could again be destroyed, especially in an era of supercharged hurricanes that have increased both in frequency and intensity.

The costs of environmental cleanup from Hurricane Katrina are likely to be enormous. Given the large number of oil and gas production and processing facilities in the area, experts expect there to be many, many environmental disasters due to the flooding of storage facilities. Will these sites be abandoned without cleanup or added to Superfund sites that require inordinate amounts of time, money and expertise to contain? Is it smart to reconstruct facilities that are likely to be targets for future natural disasters?

The most likely scenario, because it is the one that will invite the least political controversy, is that New Orleans and the casinos along the Gulf Coast will be rebuilt with government aid. New Orleans may well end up looking more like Disney World than the birthplace of authentic American jazz. What can be done to help a million people recreate shattered lives, careers and educations? The issues are those of refugee populations. America has not had to deal with such large scale movements of people since World War II. We were up to the task then and I hope we are now as well.

China – Dancing With A Partner Or An Elephant?

As America focuses on rebuilding from two hurricanes, integrating two new Supreme Court Justices and trying to figure out what the heck the Federal Reserve Bank is going to do to interest rates, the rest of the world moves on. It is fascinating to note how China has recently emerged as a major player on the international free trade scene. Many people believe that China is attempting to position itself as a leader in global investment to counterbalance our economic influence as the world's lone remaining superpower.

While we all realize that the price of gasoline has gone up, public debate may rage on as to the reasons why and what to do about it. There can be no doubt that the economies of Southeast Asia are demanding more energy, and they are not going to be content to idly sit by watching the U.S. and Gulf states control the world's supply of oil.

Oil is the most important factor for every country's economy. China is targeting two areas of the world so as to increase its influence at the expense of the United States. Surprisingly, the first and foremost of these is Australia. A recent defector from the Chinese diplomatic corps indicated to a U.S. Congressional Committee that China is hoping to drive a wedge between Australia and the United States. Beijing recently signed a contract to buy an Australian liquid natural gas manufacturer in order to obtain natural resources Down Under and to also increase its political influence there.

The new Chinese leader's name is Mr. Hu who came to power in 2003. At a reception of the Australian parliament, he delivered a clear message that China is now ready to be an economic partner with that country. The iconoclastic Australian legislators gave him a standing ovation, whereas the day before, President George W. Bush was derided in front of the same assembly when he delivered a speech focused on terrorism and the war in Iraq.

In addition to Australian natural resources, China has its eyes on nearby Central Asia. The Republic of Uzbekistan recently gave the U.S.A. the boot, giving notice that we need to leave their country and abandon the military bases we have built there as supply points for efforts in Afghanistan. In addition to being strategically important for military purposes, the Uzbekistan and Central Asian region is rich in oil and other natural resources. China recently signed several oil exploration deals with this country and Kazakhstan as part of its efforts to increase ready access to oil production.

The U.S. is responding to this competitive challenge by increasing protectionist measures and invoking more dogma. The recent political reaction against China's oil company's efforts to buy Unocal, which had only very minor assets in the United States, was telling. Because it is a United States based company, our Congress got involved and basically told China's state petroleum company to take a hike. When it is U.S. oil interests at stake, talk about free markets vanishes.

At the same time as they seek expansion opportunities, China's own economy is closed to foreigners for the most part because it doesn't allow for the free flow of information, money or people. The speed with which China works in foreign trade, relative to the U.S., is telling. China agreed to reduce import tariffs on agriculture from above 40% to below 10% between now and 2010. In the United States, special interest groups make it almost impossible for U.S. trade negotiators to offer similar concessions.

Closer to home, China has its eyes on Canada as well. It has entered discussions with Canadian resource owners about developing the huge oil rich sands of Western Canada. U.S. companies have for years refused to get in involved with these projects because of the large capital investment involved. Chinese state controlled conglomerates tend to have a very long-term view, and they can afford to be so minded since they do not have to respond to shareholders' needs for short-term earnings in order to stack prices up or keep management bonuses intact.

China's demand for natural resources such as iron, copper, aluminum and natural gas has strained global prices. China is encouraging its domestic companies, which I believe are hand-in-hand partners with the government, to invest overseas with little regulation. About 135 countries are on a list that Chinese companies can invest in without any extra regulatory oversight. Notable among the names missing from this free trade list are the U.S., Japan and the United Kingdom.

The U.S. is losing influence in Asia relative to the Chinese. Last year, China encouraged the formation of a trading block in East Asia that excluded the United States from its membership. It did include Australia and New Zealand and the first of these members' events will take place in Malaysia around Christmas time.

When American's get past our national anxiety about mortgage rates, inflation, building supply costs and short-term investment returns, we might want to be thinking more about our long-term competitive position in the world markets, vis-à-vis players like China who are disciplined and have an ultra long range focus.

If you think that owning stock in U.S. multi-national corporations will allow us to take advantage of the growth in Chinese influence, think again. For example, one of the most profitable segments in the U.S. economy is the finance industry. Credit cards are among the most profitable of that industry's products. In China, banks such as Citigroup are hoping to take advantage of the increase in the Chinese retail consumer finance market. Here's why this may not happen.

China only has about 50 million people who make more than $5,000 a year. It is only these people who have enough extra income to buy consumer goods. About 30 million Chinese or 60% of those able to make any kind of discretionary purchases at all decided to travel overseas. There are only about 12 million credit cards in circulation in China, and this is expected to double twice over the next five years. This would seem to be a prime opportunity for U.S. and European corporations that have much experience in consumer finance.

The problem is that there are so many Western and other Asian companies vying for Chinese business that the profit margins have basically evaporated. Retailer credit information on Chinese consumers is practically non-existent and must be gathered on a personal, verbal basis. U.S. and European companies are spending a great deal of money to penetrate the market in China, but many experts feel that what might have been good elsewhere is not necessarily going to work well in the Chinese market.

Foreign banks are prohibited from dealing with Chinese individuals until the end of next year. With the onset of the 2008 Olympic Games in Beijing, optimists are hoping that the Chinese will get hooked on credit cards, much like Americans have. As China expands its influence in economic ways, political power will surely follow. For this reason, investors may want to shy away from Taiwan and towards Australia. Putting money directly into China's stock market is a game for brave or foolish investors, but to ignore that region of the world in your stock portfolio is to settle for less than optimal performance.

Personnel News

Rob recently participated in the 2005 Smoky Mountain Adventure Race which included orienteering, mountain biking, trail running, whitewater canoeing, repelling and night navigation. His next and last event of the year is the Panama City, FL Ironman Triathlon to be held November 5, 2005.

Juliana went to the annual Charles Schwab conference called IMPACT 2005 held this year in Seattle. We're pleased with the information she gathered about alternative trust companies, new trading techniques, and she picked up information on several alternative growth and income funds opportunities. Of course being Juliana, with a special whim for travel, she arranged her itinerary so that she could take the Coast Starlight train along the California coast. She called us from the train and said, "I'm watching whales outside my window!"

Jeff has been busy outside of Rikoon Carret work, working on his house. He has completed construction of the portal on the front of the house which matches the portal he built on the back last summer. With all that work, he occasionally has a minor mishap, but the four stitches in his finger right now are from a different activity. He and his daughter, Stephanie, went to a fishing event for children, and with all those fishhooks flying, we thought that he got hooked. The truth be told, Jeff owns up to filleting his finger along with the fish. We will miss his guitar playing while he heals. Also, Jeff has been a featured speaker at the Renesan Institute for Lifelong Learning and has started riding his bike to work on Fridays. So far, he's cut his bike commute time in half, so he'll be joining Rob on those 100 mile races ….well, maybe not!

Patricia took a vacation in September, and although she says that the best part was the few days she stayed home and puttered around her yard in Albuquerque, she really becomes animated when she talks about her hiking in Utah. Patricia was truly captured by the beauty of Utah and is recommending it as a destination. She spent most of her time in Chaco Canyon, Canyon de Chelly, and camped out in Bluff, Utah. She says that if anyone is interested in where she was, they should read Tony Hillerman's *A Thief of Time.*

Beth is traveling to the Ozarks in Arkansas in October for her grandmother's 101st birthday. Her grandmother says this birthday is better than last year because there was just too much pressure in turning 100 (she was mentioned on the *Today* show, and she received letters from the president and the governor). Whenever she would run errands in town (because she's a very spry 100-year-old), people kept promising to come for her 100th party. She kept saying "What party?" because there wasn't one planned – really! This year it will be just family, including her grandmother's 89-year-old niece from California.

As of this writing, Dana has sold her house and bought another for herself, daughter, Alice; beagle, Henry; and cat, Dash. When all the craziness of moving is behind her, she plans to spend more time volunteering for Moving People Dance Theater, a fabulous local dance company where her daughter performs. As for herself, Dana recently joined the African dance tribe at the Santa Fe Railyard on Monday evenings. She says the live drumming really makes the class, and that no one cares whether you know what you're doing or not, which is a good thing!

Upcoming Events

The dates for the Client Teas for the rest of this year are for Santa Fe: October 27th and December 12th, both held on Thursdays. The teas begin at 3:00 p.m. and conclude at 4:30 p.m. The tea for our clients in North Carolina will be held on November 10th, also at 3:00 p.m., at the office in Asheville at 196 Pearson Drive.

We are hosting a conference of independent investment advisors here in Santa Fe the third week of October. We are honored to act as hosts to the principals of companies from all over the nation, and in addition to the meetings, we have found some delightful things for our guests to enjoy in Santa Fe during the beautiful month of October.

Again this year as in years past, we ask for your understanding that we will make donations to local charities in lieu of sending holiday cards to clients and associates. Although each year that we do this we feel the significance of the need, this particular year seems especially important because of the many demands made on charities right now. We would like to know of any charities you favor. In the past our clients have made us aware of some interesting charities, so please call if you have any suggestions.