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Summer Commentary 2010

The Markets

There is a plethora of concerns overhanging investors as the 2nd quarter of 2010 comes to a close. Tumultuous events in Europe have significantly altered the spirits of stock investors around the world. Volatility in the markets drove gold to a record high price, and many industrial commodities sank due to concerns that the global economic recovery is stalling out.

U.S. stocks experienced their first quarterly drop in more than a year as the Dow Jones Industrial ended down 6.3%. The more broad-based Standard & Poor's 500 Index declined 7.6%. On the international scene global markets, excluding the U.S. declined 11.5% while Europe as a whole was down 10.3%. Even China, the locomotive for most growth over the last two years, saw its market slide 26.8% even as government sponsored growth continued.

Many investors fled to bonds, particularly safe bonds, as the U.S. Treasury market gained 5.8% in the first six months of 2010 on a total return basis. Denmark was the best performing developed national bond market, as it returned 9.2%. Germany, the other "sanctuary" country, had its government bond market return 7.1%.

The municipal or tax-free bond market has been plagued by a lack of supply. Even though many states and local municipalities are running larger deficits than ever before, they are reticent to go to the market to borrow money without government assistance. Under the "Build America Bonds" program, the U.S. government directly pays 35% of the interest payments of many municipalities, but in exchange, the bonds that they issue under this program are taxable. This has stood fixed income investing on its head. With bank interest rates hovering near 0%, savings accounts, certificates of deposit, and high quality, corporate and government bonds are all paying paltry rates in the short and intermediate terms.

On the international front, Greece's bonds were cut to junk bond status on June 15 while Spain's government bonds are under review for likely downgrade. A major fear underlying investor jitters is that sovereign nations who came to the aid of their real estate and banking industries are now in precarious financial conditions themselves.

As the market's anxieties mount regarding southern Europe, the Euro currency unit tumbled 15% during the first six months of 2010, its second largest drop in history. Bond returns everywhere exceeded stock returns by the widest margin in 9 years as investor optimism evaporated and a flight to safety ensued. Government officials are not sanguine about prospects for the U.S. economy. The Federal Reserve Bank of Atlanta recently said that the lackluster rebound in employment means the U.S. economy is unable to withstand rising interest rates or a shrinking of the central banks' balance sheet. In other words, the government's extraordinary efforts to flood the markets with liquidity have become essential to maintaining whatever stability now exists in the investment markets and that there is a continued "major downside risk" to global growth. More somberly, the International Monetary Fund and the Bank of International Settlements, the granddaddy of central banks, said in a recent report that the dangers of continued fiscal and monetary stimulus pose "huge future challenges."

Emerging market's stocks also lost ground during the first half of 2010. The index lost 6.1%, and the inherent aversion of those countries to stimulate their domestic economies to allow their citizens to consume more, means that the world economy may be at a standstill for quite a while. The world's past reliance on U.S. and Europe to consume an ever increasing amount of goods is an expectation that is unlikely to be met over the next several years due to increased savings, higher taxes, government cutbacks and chronically high unemployment.

The U.S. real estate market showed a high degree of weakness as new home sales tumbled to record lows after a generous federal tax credit expired. American employers also continue to hire fewer workers than expected. Interestingly, U.S. multinational corporations are showing large increases in profitability, and some professionals feel that this is a time to be buying those companies' stocks. Corporate indicators show the largest advances in profits since 1995 have taken place the last two years due to cutting costs and reducing jobs. The Standard & Poor's 500 is supposedly cheap, trading one-third below its 10 year average P/E ratio based on the last 4 quarters of profits.

The Economy

With crude oil prices declining 9% since March and natural gas losing 17% of its value, since the start of the year, inflation does not seem a concern at the moment. You would never know this by looking at the price of gold as it climbed 13% to reach a record high price of $1,266.50 an ounce. Gold tends to be a reservoir of investor anxieties. The prognosis for the U.S. economy is a 3% rate of growth in 2010, the biggest increase since 2004. Another threat to the economy is the impending rise in tax rates on investment income and on people in high tax brackets. The Bush era tax cuts are scheduled to expire at the end of this year and if that happens, some analysts feel that it will produce a 1% drag on the U.S.'s gross domestic product, reducing growth expectation from 3% down to 2%.

In analyzing the global recovery, we find that growth in manufacturing has been the strongest contributor. This has not translated into many new jobs, but it does help with our balance of trade deficits. Most countries feel that they will grow their way out of this economic malaise by exporting more. Not everyone can be an exporter, however, someone has to import and consume those goods. China's economy may expand 11% in 2010 compared with the 3% expected in the U.S. and Japan. The European zone is expected to grow only about 1.2% in 2010, well below the rate at which new jobs are created and excess funds produced to pay off mounds of government debt. The Chinese government has started to clamp down on the speculative real estate market in its cities, and this has adversely affected its stock market. Unemployment in Europe is now at 10.1%, the highest level in almost 12 years. This is similar to unemployment levels in the U.S. It is difficult to ascertain true unemployment numbers in China as the government fudges most statistics there for its own propaganda purposes. With households in the U.S. holding back on spending and governments starting to talk about cutting their deficits, it is difficult to see what will act as the engine for growth to pull the global economic train in the near future. Investors understand this and so their appetite for risk has diminished over the last quarter, thereby causing the downdraft in the world's stock markets.

As I have written about extensively before, the debt taken on by consumers, real estate purchasers and financial institutions in the mid to late 2000's has for the most part now been absorbed by sovereign governments who forced their interest rates down near zero and flooded the markets with liquidity. A draft European Union document, scheduled for dissemination later in July, suggests that a stress test needs to be performed on banks around the world to assess what would happen if their sovereign governments were to go bankrupt. It is hard to believe that banks in Europe are entering another crisis phase as they did during 2008, but evidence shows they are even afraid to lend to each other and this is an ominous sign.

Most people are aware that it is very difficult for consumers, homebuyers, business owners, and mid-size companies to borrow money from banks these days. It is more difficult in Europe as the banks are terrified of having money outside of their own vaults. Approximately 60% of the world's sovereign (government) debt comes due over the next 3 years and so there will be ample opportunity for investors who are nervous to vote with their feet.

By this I mean that the possibility of investors abandoning particular nations is real enough so that the Bank of International Settlements, the most august of international financial agencies is warning its members that ultra-low interest rates are dangerous to the health of the economy. Ultra-low interest rates, like we see here in the U.S. means that the next time there is a financial crisis, with government coffers almost out of money, the ability to fend off renewed attacks on the banking systems by speculators is limited. By suppressing inter-bank borrowing costs to near zero, many investors are trying to increase their risk taking in the search for higher yields. We see this often when people are fed up with near zero interest rates on money markets and newly issued bonds.

The willingness on the part of banks to recognize their bad loans and to take losses is also blunted by government policies which tend to encourage the banks to bury any bad news that might adversely impact public confidence. The credit crisis of 2007 - 2009 was created by a large increase in demand for mortgage-backed securities which lead to loose lending standards, which lead to many unqualified borrowers getting overextended. The Bank of International Settlements reports that banks should be extremely wary at this time about distorting their markets and balance sheets through politically expedient funding programs which is what they presently are doing with abandon!

Articles from The New Mexican

1) China and the U.S. – Partners for how long?
The U.S. has a symbiotic relationship with China. We need China to finance our debts and they need us to buy large amounts of their manufactured goods. We now owe roughly $17.8 trillion to our creditors and at some point in the not too distant future, we will need to pay a reasonable rate of interest in order to continue to attract the money necessary to service that debt.

If the average interest rate our government has to pay goes up to 5%, which is well below the average borrowing cost since 1980, our nation's total interest payments going out the door each year would equal the total gross receipts the IRS collects from all income taxes. Some economists believe that once interest payments on government debt go above 30% of tax revenue, either the local currency breaks down, interest rates rise to a level that crushes business activity or there is some kind of a default where repayment to creditors does not take place.

In the past, the U.S. was content to be a net importer from other countries because of the political influence it fostered. In Europe, after WWII, we strengthened our political alliances with nations with whom we traded at a deficit so that they would have a real incentive to remain in the fold of the U.S.'s military and markets' network.

China does not fit into our traditional strategy. Because of its extremely large size and the dominant role the government plays there, the Chinese government can essentially force a billion workers to save large portions of their income by funneling all domestic transactions through state-owned banks. This is how China has financed a terrific rate of expansion over the last decade, about 10% annually. In the US, 4% is seen as outstanding growth!

Chinese leaders have long discouraged their citizens to consume. The consumer base in China is about the same size as in France, who has roughly 1/20th of China's population. Therefore, China must export their manufactured goods in order to keep its factories churning, which in turn keeps its citizens employed. This kind of strategy works when there is an endless demand for exported goods, but as the recent global recession has shown, the U.S. no longer serves as an unlimited export market for Chinese companies. The Chinese system will, sooner rather than later, exhibit classic signs of instability. The best indicator of this is that the Chinese residential and commercial property market is greatly over inflated with prices pumped up sky high.

China therefore faces some hard choices. Since the Chinese export 36% of their gross national output, they can't afford to lose the USA as their biggest customer. They also cannot afford to let their currency appreciate as this would let their competitors in Vietnam and other emerging Asian countries operate at an advantage. If rising U.S. protectionism takes the form of Congress trying to limit US market access for Chinese companies, then China will have to figure out how to keep its large population employed which is no small matter.

We are likely to see Chinese domestic consumption increase somewhat in areas like automobiles and consumer electronics. Watch for continued and successful efforts on the part of Chinese companies to garner control of much of the world's remaining natural resources. They face unique problems generated by their own success stories, which are, in many ways, the reverse images of our society. We are encouraged to spend and consume and the goal, at least as portrayed in our media, is to work as little as possible. The Chinese obsess about saving for the future, getting ahead by working harder and longer, and about obtaining a practical or technical education. This is the makings of a good horse race!

2) Beware of stock market manipulation

May 6th, 2010, was a day that every investor should remember. During a forty minute period that afternoon, the market was in a free fall and many individuals were shut out of their accounts, making trading practically impossible. No price information was available and brokerage firms' phones and faxes were not functioning due to overload.

As a result, price anomalies in many stocks were created when the two largest stock exchanges, the NYSE and NASDAQ, broke down. The breakdown was attributed to a withdrawal of liquid funds by the largest of hedge funds whose role is to make orderly markets in the buying and selling of stocks (market making). Because of their temporary withdrawal from the role of providing liquidity, many pending open trade orders were shunted to small electronic firms whose inner workings are known only to a small group of unscrupulous traders. The results were that those investors without massive computer power were taken hostage by institutions whose business is to take advantage of momentary price differences within imperfect markets, and on May 6th, they had a bonanza.

This is more than a sad and sorry story; it shows how deplorable the stock markets are at their core in protecting the public's interest and puts the future of the stock market in grave doubt. Following the 40 minute black hole period, the NYSE and the NASDAQ made an arbitrary decision to cancel any trade that occurred in that time slot with an error ratio in excess of 60%. This left many small investors who were trying to protect their capital out in the cold.

We now face a critical decision: will vulture institutions be allowed to disrupt markets in the future with their superior information, speed, and large amounts of capital, thereby profiting from actions which are known to be unfair? If so, I strongly urge you to evaluate your portfolio and risk tolerance, because the next time it may be worse.

It was not only individual investors who were harmed by the market makers' failure to do their job, but the companies whose prices were manipulated also felt the effects. Procter & Gamble confirmed that their valid low trade for the day of May 6 was at $56 per share and any other trade level was an aberration due to malfunctioning of the system. Many investors lost their PG stock between $39 and $52 per share. This kind of execution should lead all intelligent investors to question the fairness of the public equity markets. If the stock markets comes to justifiably be seen as a casino with hidden players who have unfair advantages, companies that need to go to the public to raise capital in the future will find a basic source of financing has turned away for good reason, and the competitiveness of our nation will have been dealt a major blow

Congress, the Securities & Exchange Commission and various stock exchanges are now looking to set triggers whereby in the future, trading will stop in individual stocks under certain circumstances so that the travesty of May 6 does not reoccur. Whether or not this will solve the problems or end up causing more is yet to be seen. The public may not be aware of how the technical aspects of what happened on May 6 affected their accounts, but if we complacently let the fox guard the hen house going forward, don't be surprised to wake up one day and find someone stole our nest eggs.

3) The Financial Reform Bill of 2010
It's high time for financial reform but, similar to health care, it's a slippery slope due to the insane amount of lobbying that goes on in Washington. Considering how money and influence get peddled, it's a wonder that any of our elected representatives end up voting for measures that curtail by a smidgen the profitability of the financial giants.

Proprietary trading of speculative instruments by banks, with capital raised from the public coffers, just about melted down the system two years ago. The financial regulatory reform bill purports to restrict this kind of trading to a lower level than is currently allowed. Howls of pain can be heard from restaurants, bars and country clubs around the country but wait, there is a consolation prize for the soon to be deprived elite – they have up to 12 years to implement the new rules. Goldman Sachs, in a recently published report, stated that their funds are due to self liquidate over the next 10 years anyway, so not too much hardship there.

Stockbrokers may be held to a higher level of ethical behavioral standards under the new law but maybe not, another study is all that is called for. Likewise, selling more expensive in-house products and restricting complaints to industry stacked and highly prejudiced panels are topics broached but not tackled head on by the 2,315 page proposal. It is not simply that the industry sponsored arbitrator, FINRA, is anything but a two faced purposefully ineffectual sinking ground for all but criminal violations, its just that the SEC can hardly get its own house in order.

So, instead of having teeth, the package proposes that the SEC do more studies for possible future regulation of itself. Huh? While investors have struggled to get attention from state regulators in areas like the shameful covering up of the meltdown in Auction Rate Securities, FINRA allowed its brokerage firms members to abscond with investors' money by cashing out their own bonds first while hiding the truth from the public. The bill does nothing to address these systemic inequities.

Consumers are supposed to be the big winners under the legislation with a new protection agency and various laws against usurious lending practices. Banks are already figuring out how to shift their fees on debit and credit cards to other areas, so watch your statements, you may soon be assessed with time and out of pocket expense invoices for visiting your local lender.

Aversion to taxation without representation has historical connotations around these parts but what we see now is lack of taxation with undue influence. Many of the travesties played out behind closed lobbyist doors come down to keeping an unlevel playing field tilted in favor of the big, bad and beautiful people. What we see in this bill is nowhere near what the SEC's British and German counterparts know is essential: take away the mechanisms that allow big banks to become bloated with profits made from information not available to the general public. Absent this kind of reform, there is no reason to believe that long term investing in the markets warrants the public's confidence.

Personnel and Office News

Rob: Many regular readers of this commentary have requested reports of my recent running exploits. Of late, I have been reluctant to oblige since my performances have receded into mental obscurity. Now (though I have said this before and reneged), having reached the point where I do not foresee participating in more organized events, here is a brief overview of how these "ultra" marathons (events over 26.3 miles) have played out.

My motivation to do these has always been to get outside with some sense of adventure. Solitude in training and during the events themselves is also important, as the "retreat-like" quality, and opportunity for introspection is a wonderful part of ultras. Beautiful places abound. I have seen parts of Colorado and New Mexico that most day hikers never get to and the high altitude leads to a natural high.

While most ultras involve walking a good deal, all the uphill in fact, the primary emotional overtone of even the best runners is mellow on the outside, burnt on the inside. Still, the question remains. Why endure cold, heat, wind, rain, wet feet, thorns, swollen hands, stomach pain, nausea, high altitude, dizziness, nighttime, and fear of falling? They are a part and parcel of the adventure. Also, the endorphin induced clarity is unsurpassed.

Let me detail how one endures these things through the use of caffeine, ibuprofen, and electrolytes. In addition, there are essential goos (liquid high energy gels) and hydration packs. Also key are high-tech wicking clothing, socks, chafing reduction ointments, shorts and tops of all degrees of warmth, sunscreen, sunglasses, and snow coping apparatus.

Among the many subsequent inconveniences to ultras are also decimated toe nails, various and sundry knee supports, aches and pains. I sometimes wonder, "How many miles does one set of knees have in them?" Well, when I finally hang it up, I hope to have used these appendages to the max!

Perhaps this description sets the stage well enough to go on to the event itself, beginning with a mediocre but much appreciated spaghetti dinner slapped over paper plates in a gym the night before, rising at 3 am to stuff down some stomach settling food, tape feet and drink as much water as possible, so that our “regular” business gets done before the 5 am start. No unnecessary stopping along the trail for the next 14 hours is the goal.

Age is not really a factor. I tramp by plenty of studs in their 30s and in turn, never even see guys in their 60s after the start. Normally I drink little caffeine, but Coke and Mountain Dew work best to wash down salt and special endurance capsules every two hours.

This spring and early summer, I participated in three events. The first was out of Payson, Arizona, along the Mogollon Rim Trail. 50 miles of rock piles and hawthorns piled so densely that there weren’t 25 yards of clear trail the whole way, we started and finished in the dark like darn moles! The race director decreed that no poles were to be allowed so one-third of the way into the event, my hamstring muscle cramped so badly that I couldn’t move a step for 5 minutes. The solution: into the woods searching for sticks to substitute for the trekking poles. I finished under the cut off time, but my hands were torn up from the rough shape of the juniper and alder branches I fastened along the way, as impromptu poles. If you love to hike but your knees hurt, get some good poles!

I am not talkative when running; in fact, I don’t really want to see anyone except so as to know I haven’t lost the trail. The second event I did this year was 50 km in the mountains above Los Alamos which went well except my stomach hurt so badly that my running buddy from Denver couldn’t wait for me to revive. I couldn’t eat any of the food I normally carry except goo, and goo doesn’t cut it for an all day event. The solution: potato chips, PB and J sandwich slices, orange wedges, boiled potatoes with salt, all topped off with Coca-cola and ice. Oh, how we sing the praises of ice. Cold liquid is more easily absorbed than at air temperature. In the Jemez Mountains, the blessed aid station volunteers trekked in ice and from that point on, I was flying to the finish.

At the summer solstice San Juan 50 mile run, my friend Eddie and I met up in Lake City at a client’s beautifully restored cabin. Last year, it snowed during the event for two hours at 12,000 ft, so this year’s drought and hot weather was welcome. Because Ed is so organized, I am not. It was 35 degrees at the start, so we arrive in t-shirts, to traverse creeks. Ed likes to talk and I don’t, so he introduces himself to everyone for the first 10 mile. When we solitaries are forced to bunch together, I get in the zone, Brooklyn forgotten, the markets irrelevant, projects futile, personality a bore on the narrow trail.

We ascend to descend and then ascend again. 13,000 ft of elevation gain. Old mining shacks tell a tough story but we runners are coddled by our equipment and aid stations. There are some tough as nails women out, their big legs determined to finish as many do. I am okay to be out here if my heart gives way, as it occasionally sends signals warning me of my vulnerability. But, no matter, we go on. It’s all about will power and tolerance for pain. How many moments can you enjoy being somewhere you never would otherwise be and will likely never again be?

We come down miles of dirt roads and I feel so good that, at mile 46, I drink a cold beer with a ranching family who has set up a BBQ at their aid station located on one of the private property sections of trail. Amid the aspens and pines, there is not much to remind one of the oil spilling into the Gulf shrimp breeding grounds. High country air, nose bleeding dryness, western independence, we are having fun as the sun starts to set, spinning to run backward the last mile, soaking in the end of a day with no cars or cell phone interruptions.

You can eat whatever you want to when you run ultras, and also however much your tummy can handle. Sounds nice, doesn't it? But is it worth the time, the pain, the junk you put in and onto your body? I don't have any answers, and I don't know if I'll run anymore organized ultras. However, I do know that, like all roads travelled, it is a journey worth taking.

My knees still hurt, my feet are pretty ugly and I am not proud of my race finish times or of the time taken from other pursuits. I am somewhat ashamed of the resources devoured, of the attention of others commanded so I could be indulged on these long trail runs. I am not sure that anything got worked out by participating and maybe overdoing the exercise thing, and maybe it is just another form of immaturity. For better or worse, it may just happen again in another format, because some of us just don't know any better.

Juliana: All work and no play makes for a dull girl! Even though my closet overflows with shoes, my summer goal is to wear them as little as possible.

Jeff: We recently took a trip to southwestern New Mexico and visited Silver City and areas around there. We hiked the Catwalk Trail which has sections of metal walkways that are anchored into the steep canyon walls and there is a suspension bridge over the Whitewater Canyon towards the end of the trail. I am continuing to ride my bike to work. One of the big challenges for bike riding during this season of the year is that goat head thorns seem to be everywhere and they are a terrible menace for bike tires and inner tubes. Even with the precaution of using thorn resistant and self sealing inner tubes, I am still getting lots of practice repairing flat tires and changing inner tubes.

Patricia: So far the summer has been cool enough for me. I welcome that, being comfortable gives me room to think about a vacation. I am thinking of going up to New England after Labor Day. I have several friends and family members to visit so it will probably be a New England tour. Meanwhile I will be here watching the garden grow. If all goes well there will be lots of squash, tomatoes, corn and beans…oh and potatoes, that was the experimental crop this year. So far so good.

Emily: I'm fully enjoying the summer weather. I have been keeping busy with soccer – both playing and watching the World Cup – and trying to get a little tennis and hiking in here and there. No vacations planned, but I'm looking forward to spending some time with my brother and his fiancé when they come to Santa Fe in August to relax a little before their wedding.

Dana: I’m enjoying the summer pace tending bees and garden. I’ve had several trips out of town including one to join up with my California high school boarding mates in Napa Valley. It is a great blessing to have such a wonderful group of old friends. The bodies may age but the hearts get younger!

LOCAL TEA & CALL-IN DATES:

We have decided to change our tea venue from the Ghost Ranch Conference Center location to our Rikoon Group offices at 2218 Old Arroyo Chamiso. The next tea date is Tuesday, August 10 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. Weather permitting, we will gather around our beautiful garden pond so you might bring a hat.

The following Thursday, August 12, our quarterly telephone conference call will take place at 3:30 p.m. 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.