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Fall Commentary 2010

The Markets

Small investors continued to exit from U.S. stocks during the 3rd quarter of 2010 and they went on a buying binge for bond mutual funds, gold and emerging market equities. Even though the stock market rallied 10% during the last three months, the Dow Jones stands about where it was six months earlier and is up 3.5% for the year. International stocks rallied in a similar fashion, as Europe's index of its 600 largest companies has gained 2.6% so far in 2010 while the Asia Pacific markets has increased by 6.3%.

Bonds continued to do fairly well, with U.S. Treasury debt returning 2.7%, corporate bonds gaining 4.9%, and high yield, or junk bonds, returned 6.5%. Bonds have been in a bull market since the beginning of the credit crisis in late 2008, so we believe it is unlikely investors will see huge gains continuing in this arena.

In the natural resources markets, due to slackening global demand for industrial commodities, prices have risen about 12% in 2010. This is primarily due to Asian countries stockpiling copper, magnesium, and other industrial materials. Oil gained roughly the same amount so far in 2010, climbing close to $80 a barrel, which is 13% above its 2009 year-end level. Natural gas has fallen 13%, which continues a long-term trend due to a huge oversupply of this form of energy. Gold hit an all-time high of $1300 per ounce during the 3rd quarter of 2010, ending September up 30% for the year to date.

Some market watchers now group the U.S., Europe, Great Britain and Japan together and are calling us HIIC's, or Heavily Indebted Industrialized Countries. Certain investment risks, traditionally associated with emerging markets, are now being associated with these economies. Investors have yanked some $36 billion out of stock markets in the HIIC countries so far in 2010. At the same time, $45 billion has flowed into stocks in the emerging markets known as BRIC's or Brazil, Russia, India and China. These areas are where the population growth is the strongest and where much of future economic growth will occur.

Among the HIIC, Japan is considered to be in the worst shape, followed by the European Union. Japan's level of manufacturing activity is now contracting and while in Europe (mostly Germany) and in the U.S., manufacturing is expanding slightly.

The stock markets sharp rise in September was the best one month performance in over 60 years. Behind this ascent is the fact that corporations have accumulated great reservoirs of cash and many people believe they will start purchasing back their own stock which will provide support in uncertain markets. Investors are also looking for

dividend increases and some pick-up in acquisition and merger activity which would help companies increase their market share. Manufacturing has been the bright spot in the U.S. economy as firms have used their cash hoards to increase spending on equipment which will allow them to refrain from hiring more employees. This does not bode well for the employment market, but it is good for corporate profits.

Another factor fueling the 3rd quarter rebound in stocks was the persistently high unemployment rate. Investors are now bullish because they are expecting the Federal Reserve to recommence injecting funds into the economy, either through purchases of U.S. Treasuries or other mechanisms through which they hope to reflate the economy. The first round of quantitative easing in 2008 resulted in the stock and bond market rise of 2009.

Europe has a bad case of the jitters. Ireland is one country now being targeted by short-term traders and speculators because two of the largest Irish banks recently had to be bailed out again to the tune of $68 billion, which is one-third of the countries economic output. Ireland's budget deficit, along with the cost of servicing this new debt, will soon be ten times more than the European Union's official limit and the biggest in the Euro zones' 11 year history. The Irish government has already undertaken one of the toughest budget cutting programs in Europe so there is little fat left to cut in order to save the money needed to service the increased size of its government debt. Investors are anticipating that Ireland, like Greece before it, will need to seek financial assistance from the European Union and the International Monetary Fund. Similar situations exist in both Spain and Portugal, where anxiety about the levels of their government debt is never far from the surface.

Like many banks in the U.S., one cause of Ireland, Spain and Portugal's suffering is a deep real property value bust which has crippled its banks lenders. As here in the U.S., those governments have stepped in to fix the banks by absorbing their private debt onto the public balance sheet. Ireland had to recently guarantee nearly its entire banking system's liabilities or there would have been a shutdown of the official economy.

European stock markets continue to lag behind the U.S. due to the weak nature of their governments and banks. Studies have shown that banks in one Euro zone country participate greatly in the fate of banks in weaker Euro zone states, so a crisis in Ireland, Spain or Portugal could well touch off a Euro zone wide debacle. We have reduced our European holdings drastically, other than some individual companies which operate globally and are somewhat immune to the European Union's economic prospects.

Given Asia's strong performance, it is interesting to note that China's stock markets declined approximately 19% so far in 2010. Japan is down 10% in local currency. Economists continue to look to Asia to be the engine of future global growth. China's trade surplus allows it to continue to support the U.S. bond market as foreigners added $373 billion of U.S. Treasury debt to their coffers so far in 2010.

The bond market is now in a bubble scenario, much like what happened in 1987 and 1994. Many small investors have bought bond funds in order to earn income in the ultra low rate environment without understanding the risks involved. Before the bailouts began in late 2007, the Federal Reserve held about $500 billion in U.S. government securities. By the end of 2009, that number had quadrupled to close to $2 trillion. This massive buying spree on the part of our government in buying its own bonds has helped push interest rates down to generational lows. Investments in money market funds have been penalized as their interest rates have fallen close to zero. This has been one way the Fed has effectively been taxing wealthy individuals who are investors, so as to assist banks recapitalize and start to make profits. With long-term U.S. Treasuries now yielding about 3.5%, the main danger to investors in the bond market is the possibility of rising interest rates. For each 1 percentage point rise in interest rates, owners of U.S. Treasuries lose about 10% of their principal. The typical short-term bond fund stands to lose about 3% if interest rates rise 1%, and perhaps much more if the psychology has a cascading effect with people wholesale stampeding out of bond mutual funds.

The U.S. bond market has been flooded by companies such as Microsoft, IBM, Johnson & Johnson and McDonald's who recently issued huge amounts of long-term bonds at the lowest interest rates seen in decades. Who would buy a 20 year bond paying 2% taxable? It is a mystery! Outside the domestic bond market, investors have put $10 billion into emerging market bonds which have issues of political stability alongside of interest rate risk.

The May 6, 2010 shutdown in the U.S. stock markets were analyzed by Federal regulators who tried to pin blame on the trades of one mutual fund company who chose to sell a large number of "future" contracts (bets that the market would go down) using computer programs. This report is disappointingly superficial and patently political in nature, and a cover-up that protects the big guys. The report says that only half of computer driven high frequency trading firms left the market during the crash and that brokers and exchanges had no culpability. But this is not true. No one was making a market during the blackout period and those firms began making markets again because they had access to information earlier than individual investors.

The report's policy recommendations only lightly touch on how the SEC and other regulators set the stage for this market disruption. They have since then proposed some rules to briefly halt trading during similar circumstances, but this will in no way prevent the kind of manipulation that took place on May 6 from reoccurring. While the technical details are not worth going into, suffice it to say that the regulators did not blame anyone, nor propose any changes in how pricing should function on the stock exchanges. They have merely suggested boundaries under which the market ought to operate during certain short time periods. These will not serve to protect small investors.

The Economy

One major issue plaguing both professional and retail investors is the question of whether we are in a period of deflation or inflation. Typically, deflation hurts companies by

reducing demand, since consumers expect prices to fall and so they cut back on their present purchases. This creates a cycle which leads to job layoffs and causes consumer demand to go down thereby triggering a further downward slide in prices. Inflation increases companies' costs and they generally are not able to build in the increased cost of resources fast enough, so consumers expecting higher prices buy early and on credit if possible. Given the difficulty of obtaining bank loans these days, we believe we are in a deflationary period for real estate, wages and mass produced goods while we think inflation is in place for items like medical and educational services, high-end consumer goods and professional services.

We are undoubtedly in for a period of low official interest rates for some time as none of the major industrialized countries can afford to see another deep recession due to the pressures created by high unemployment and low growth. The U.S., Britain, France and Japan all rely heavily on debt financing, i.e. running deficits, to keep our population calm. No one wants to raise interest rates to combat inflation until it becomes a palpable problem.

The lack of clarity from Congress on estate and income taxes has served to promote a sense of caution on the part of those favoring an extension of the Bush era tax cuts. Our firm is dealing with this situation by looking for high dividend paying stocks which will do well no matter what the tax rate is or whether we are in an inflationary or deflationary environment. We are looking both domestically and internationally and are focusing on companies with dominant market shares and who have sufficient cash flow to continue to pay a dividend even in the event of a recession.

Housing prices have continued to fall, for 50 consecutive months. Approximately 25% of all homeowners with mortgages are underwater in that their mortgages exceed the value of their homes. Many of these people would sell if they could, but because many local banks have been beaten up by their regulators and told to raise their lending standards, only about one-third of people who would like to refinance can qualify. Some people who have cash or other assets to pledge as collateral have refinanced their home mortgage rates to take advantage of the lowest interest rates since the 1950's. Closing fees continue to rise with average closing costs approaching $3,000 per home. Property appraisals have become more conservative, in order to protect and insulate against appraiser liability. The downward spiral in housing prices continues to affect new home construction which is stuck at a very low level.

We expect that residential and commercial foreclosures will rise sharply over the next several quarters and so the bottom has not yet been reached. Lenders already have too much real estate on their books. Large mortgage banks, like General Motors Credit, have been announcing halts in their foreclosure process because now it is a matter of the banks' own financial health that is making them not want to pursue more foreclosures at this time.

Studies show that there are approximately 1.5 to 2 million homes for sale in the country, and this number is growing. Surplus housing inventory could depress prices another 20%

over the next several years. Demographics are also working against real estate prices in that more young people are delaying marriage, and young families are returning to their parents' house to get off the mortgage treadmill while they try to establish themselves. The demographics also bodes ill for the luxury second home market which saw the rise of energy inefficient and high maintenance homes. Construction jobs and associated consumer spending will continue to be constrained by the ongoing real estate market slide.

Against the backdrop of U.S. deficits, the U.S. dollar continued to fall against the yen and the Euro in September. The Federal Reserve is expected to keep short-term interest rates low, given their concern about the pace of recovery and the high level of unemployment. Employers nationwide continue to remain reluctant about adding people to payrolls and commercial bank lending, as noted above, continues to contract. The bright spot in the economy is business spending on equipment and software.

While the Federal Reserve is going to try again to salvage the mortgage spending market, we do not expect the government to stimulate consumer spending or higher employment levels due to the severely restrictive practices of most banks. The Fed can keep interest rates low for an extended period of time and there are other minor tools they can use to try to stimulate the economy, but they are pretty much out of arrows in their quiver. If the Fed is unable to stimulate the economy, it cannot prevent another recession.

In summary, the economic effects of the fiscal stimulus promulgated by the government over the last two years and efforts to reduce stress on the real estate market have probably seen their greatest days. Now it is up to private firms to provide opportunities for ongoing sustainable economic activity. If small business continues to have no access to credit, then the economy will contract as the government stimulus money is eventually withdrawn. Consumer spending, housing and employment are the most important factors in having a sustainable market rally. A revival of small business activity is needed in order for the economy to expand. In its absence, debts will be reneged, employment opportunities will evaporate and people will hunker down to wait for some clarity about the future. The challenge now is to find stable investment opportunities that produce steady income in periods of uncertainty, because in our view, we have not yet turned any corners with confidence.

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<u>Investing in an Ultra Low Interest Rate Environment:</u> Investors are having trouble figuring out how to make a decent income in today's markets. With savings rates next to zero, normally useful vehicles like corporate and municipal bonds are paying such low rates that it's hard to pony up for anything but short-term vehicles.

Retirees living on fixed incomes, such as social security and pension plans, are caught in a bind between extraordinarily low cost of living increases and higher real costs for services. The government seems more concerned about deflation than inflation which means that interest rates and COLA's are unlikely to rise soon. This could change if

enough people get concerned about the possibility of some governments refusing to make good on their debts sometime in the near future.

Wages have stagnated for several years now and I think most people instinctively understand that due to the large numbers of homes that are worth less than are owed on them, real estate prices are likely to fall further as delinquencies among even good quality borrowers rise. This means fewer consumers will feel "rich" and there will be less spending due to anxieties regarding values in the housing market for the foreseeable future.

High quality bonds are now paying 2% for 5 years and junk bonds pay not much more. The junk or low quality market has boomed over the last two years, making it expensive. In a desperate attempt to keep pace with higher real costs of living, investors are flocking to anything that promises a decent income. We caution investors to stay away from junk bonds, long term bonds and annuities. Due to unprecedented low rates of interest rates created by massive and ongoing government intervention, we are in a bond market bubble. Our plan is to stay short term and be vigilant about the prices we pay for income investments. We want to be sure that we know how to exit the market when things start to turn south. The loss of principal is a terrible thing, and so we prefer to err on the side of caution, remembering Ben Franklin's adage "a penny saved is a penny earned."

In most ultra low interest rate environments, stocks do well. We believe that stock returns will range between 10% up to 10% down for the next year or two because most companies depend on consumer spending.

When times are tough for debtors, they are ripe for people with cash to buy certain kinds of private real estate. In local markets, we look for bargain sales of fully leased property which can provide 6% to 12% cash-on-cash return from day one. To achieve these returns, we have to arrange for repairs and get onsite management in place to handle tenants. In the end, if we can stabilize a bad situation that someone else is abandoning, we have the opportunity to turn a rough stone into a gem. There is no way to do this over the Internet. Old fashioned hard work and patience are necessary.

Planning for the Unknown: It's easy to forget what is going on in the Gulf of Mexico. Our awareness of the suffering of many species, both seen and unseen, usually depends on how many images we take in of the catastrophe. Because it has not affected most of our daily lives, even in the cost of gasoline, the BP-Transocean spill somehow seems distant and somewhat irrelevant. The availability of shrimp, our most common contact with the agricultural output of that area, has yet to diminish.

The people who reside and work along the Gulf Coast (and those who vacation there) are seeing their lives changes as 60,000 barrels of oil were released daily into the deep ocean. Something similar in scope could happen anywhere. In New Mexico, it could be a forest fire fanned by extreme winds that engulfs Los Alamos National Labs that causes the release of radioactive waste. In California, an earthquake could suddenly cut off water

and electricity supplies for an extended period of time. If our economic and social lives face massive disruption from causes beyond our control, would we be prepared to cope?

Perhaps the deep ocean oil well blowout in the Gulf could have been prevented. It seems that ever increasing demand for domestic petroleum combined with sophisticated new technology has created ongoing opportunities for these kinds of mishaps. If BP-Transocean, or the U.S. government had been doing their job properly, perhaps it wouldn't have happened, but experience teaches us that mistakes happen in every sphere of human activity.

If system risk cannot be avoided through regulation, legislation, policies and procedures manuals, technology, or human effort of any kind, how can we possibly protect ourselves? As professional investment advisors, we look at the public securities markets and ask this same question: can our portfolios supply adequate diversification against exogenous risks? The pensioners, stock and bond holder of BP Amoco don't think so, as their previously secure dividend may go away permanently. Can real estate provide security in the form of income producing assets like vacation rentals, retail spaces, homes in historic districts, or commercial offices? When natural disaster or nonfunctioning infrastructure systems threaten, it is unlikely that any one type of asset can insure protection. This conundrum doesn't get addressed by anything less than a robust and radical review of our backup plans. For families, it may mean setting up cooperatives with neighbors. For individuals, it may mean having an alternative way to earn a living. For investors, it means not relying on one company, one industry, or one market for either income or growth.

As we saw in the May 6, 2010 shutdown of the stock market, normal channels that provide liquidity can disappear without notice. Selling stocks can be made impossible in an instant if the market is going down rapidly. Bond issuers, even governments, don't have to pay their debts. It is too large of an issue to cover in this missive. We urge our clients to make some creative preparation for the unknown. Investors can successfully navigate the economic twists and turns that are to come but only if they pay attention to what goes on elsewhere on the planet. We are always trying to learn lessons about how others have adapted to market disruption. In the unseen, deep ocean waters, there are lessons for all of us. One thing we already know is that damage to the environment occurs when individual and corporate profits trump the good of the commons. The oil in the Gulf Stream will not be either apparent or fixed in the short term. Our goal is o plan for the very long haul and not count on the government to provide solutions.

Personnel and Office News

Juliana: I have always wanted to do a barge trip in Europe and this Sept, I finally got my wish. We spend a week on a small barge in Burgundy, exploring the region around Dijon. We then took the train to Aix en Provence and rented an apartment, allowing us to explore that lovely area of France at our own pace. The pace of life, the food and the wine was something that I could get very used to, very quickly so I must confess that coming back to my Trader Joe cuisine has been difficult.

Jeff: This was a terrific summer and I was able to do a lot of biking and hiking. We recently went to view the changing of the fall colors around the Santa Fe ski resort located in the Sangre de Cristo Mountains. We took the ski chair lift up to the top of the mountain and then hiked back down. The views were spectacular. My daughter, Stephanie, is attending the new charter high school, The Masters Program, which is housed on the campus at Santa Fe Community College. High school students can earn college credits when they take some of the dual credit courses that are offered. Stephanie likes to stretch the truth, as usual, when she is asked where she goes to school. She simply says "I go to college" --- obviously leaving out the part that she attends a high school located at the college.

Patricia: This late summer I took a trip to New England and did a three state sweep of Vermont, Maine and New Hampshire. That sounds like a lot but most of New England is probably the size of New Mexico. Most of my time was spent on the Maine Mid-coast. It was great to be around so much water and I particularly enjoyed the small town feeling in the area. The summer has also been filled with much bounty from the garden: Lots of winter squash, tomatillos, Poblano, Green and Jalapeño chili's. Also lots of green tomatoes, Rob pickled those. As garden season winds down I have planned a short trip to San Francisco for my son's birthday. We are celebrating his 37th birthday. Yikes!

Emily: I'm excited to be finishing up with the last portion of the Certified Financial Planner education requirement. With the education requirement under my belt, now the real studying begins for the March board exam. In the mean time I'm trying to enjoy the last bits of warm weather and the changing leaves—autumn my favorite time of year.

Dana: The summer was good to me. The bees recovered from winter loss providing lots of golden Santa Fe Floral honey, and I've had a family of quail at the feeder at least twice a day through spring and summer. My son returned from a six month stint in South America and joined me and his sister on a trip down the Middle Fork of the Salmon River in Idaho with family and friends. And most recently, I returned from my sister's home on Maui where I picked tasty Surinam cherries off the tree every morning for breakfast. I'm grateful and beholden to the bounty our beautiful earth provides!

LOCAL TEA & CALL-IN DATES:

The next tea will be at our Rikoon Group offices at 2218 Old Arroyo Chamiso. The date is Wednesday, November 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.

The next day, Thursday, November 11, 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.