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Fall Commentary 2012

The Markets

Emerging markets have led global stocks higher this year, capping their longest winning streak since 2007. The world index of stocks has gained 13% so far in 2012 while bonds of all types have gone up 1.3%, on average. In the United States, the broad based Standard & Poor's 500 Index has risen 14.6%, substantially better than the Dow Jones Industrial Average gain of 10%, and both trailing the technology laden, NASDAQ composite 's increase of 19.6%. Large companies outperformed small ones and in particular, biotechnology and bank stocks did the best.

Outside the U.S., the resource driven economy of Canada gained 3% while Mexico, flourishing with low cost manufacturing facilities, gained 10%. Europe as whole, despite its many well publicized problems, had a respectable 9.8% gain in its stock markets, skewed greatly by Germany's outperformance of 22.3%. Asian stock markets gained 7.6%, weighted down by China's decline of 5.1% and Japan's ongoing mediocre economic performance. In other markets, commodity prices advanced 3.5%, driven mostly by higher grain prices resulting from the worst U.S. drought in 56 years. Corn and soybeans reached all-time highs this past summer. Agricultural exporting countries across Europe and Asia have also seen harvest declines. With the additional stimulus provided by central banks around the world, and a decline in the value of the U.S. dollar, precious metals such as gold gained 11% since the end of the 2nd quarter while silver has advanced 25%. Oil prices declined 6.7% so far this year, while natural gas experienced an increase of 11% since January. Market action during the remainder of 2012 will be determined more by political events than anything else. Europe faces a high level of debt refinancing this fall. U.S. election results will determine if the economy drops off the "fiscal cliff "that lies just beyond the end of this calendar year.

The Economy

The most important factor in the health of the U.S. economy is employment. We have had 44 continuous months of unemployment above the 8% level. No sitting president has ever been reelected with unemployment this high, but the Federal Reserve has announced they intend to hold interest rates at near rock bottom levels until the unemployment rate is below 7%. This is unprecedented and potentially a game changer in terms of the election. The 3rd quarter of 2012 saw a small decline in overall manufacturing activity. Nonetheless, U.S. industries are doing far better than most of their peers in Europe.

As mentioned above, the "fiscal cliff" refers to the end of Bush era tax cuts, scheduled to expire at the end of December. It is instructive to know that the top 1% of households in the United States garnered 93% of the nation's growth in income over the last several years. This top 1% faces a 10% tax increase should Congress be unable to renegotiate a new long term budget accord and the fiscal cliff takes place. The top 1% is comprised of 1.2 million households. The bottom 80% of earners in our country, those making less than $100,000 a year, has seen their income drop 2% over the past several years, but they too will see some tax increase.

40% of the new jobs created since February 2010 have an average wage of $15 an hour. This means that the middle class is shrinking. The consequences of this kind of financial inequality will likely be a much longer than normal recession. One organization that tracks social stability puts the United States at a rating of .47, approximately 15% above that considered dangerous, indicating potential social unrest. Here in the U.S., consumers show their anxiety by cutting back on their spending and tightening their belts which further hurts prospects for growth. U.S. consumers are spending, but still below 2008 levels.

The top 1% of Americans has seen their combined income grow by $1.1 trillion. If this were 1979, about 1/3 of that $1 trillion would have been circulated back into the economy, through middle class spending, thereby creating jobs and adding to the nation's output. This would have reduced the unemployment rate from 8.2% to 7%. Due to the income disparity that exists today, most of this $1.1 trillion has gone into the stock and bond markets.

The global economy must expand at approximately 3% per year to create enough jobs for people entering the workforce. 2012 looks to produce 2.2% growth, the slowest pace since the 2009 contraction. This means that in the absence of continued stimulus by the world central banks, the stock and bond markets face strong headwinds. In response to these circumstances, the U.S. and European Central Bank have said they will continue to buy bonds from banks and markets on an unlimited basis to stave off defaults on the part of weaker players. The Bank of Japan unexpectedly expanded its own asset purchase program, and this, combined with the changing of the political guard, is hoped will pull Japan out of its decade long economic doldrums.

U.S. companies have seen their profits grow for almost three straight years now, and this has helped send the stock market up substantially from its twelve year low in March of 2009. The U.S. economy and markets have outperformed Europe and Asia over the last several years, and continuation of the U.S. outperformance hinges on a resolution of the political dilemma described above. Stay tuned!

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

August, 2012: "The LIBOR Scandal" Its summertime and the sweltering streets of New York and Washington are empty of all but those hapless few who failed to make arrangements to get out of town or who have to work for a living. Wall Street is quiet except for the public relations and law firms assigned to dealing with the recent uproar in the press over LIBOR. Very few individuals outside of finance understand what LIBOR is or realize what impact it has on the lives of everyday people.

Here's a hint, if you have money in a bank and are not happy about your paltry earnings rate, you are a victim of the LIBOR manipulation scheme which has pitted you against the large banks and governments who collaborate to keep things "calm". At the height of investor fears in 2008, regulators were guided by political leaders to allow cheating so that the public would not abandon many institutions which were in danger of losing funding from the market. This would have caused a "run on the banks" in much the same way that Spanish depositors presently are withdrawing money en mass from their weaker regional savings and loans, necessitating federal government intervention paid for by taxpayers somewhere, someday.

The banks rigged interest rates for the same self-serving reasons as Social Security underreports inflation: it lowers their cost. A major goal of every elected official is to say that they helped promote growth and the opposite is to be blamed for any "meltdowns". LIBOR was manipulated for profit and this was sanctioned by authorities so the publics' confidence in the markets' stability could be maintained, and so it has been.

This is evidenced by the fact that interest rates have remained steady and stock returns have been positive, though tepid. Nonetheless, we have not seen any major upsets other than in real estate, and there the government has intervened to help temper the downturn. By and large, the Great Bailout of the banks, of which the unfolding story of the LIBOR scandal is part of, has worked. One unforeseen non-monetary cost of public financing of private mistakes has been a loss of faith in the fairness of the public securities markets. This deep seated skepticism is well founded. Eventually, if there is no trust, there is no system and that is a huge problem.

Banks no longer primarily function as conduits of capital to new businesses because they make most of their money playing games with securities and selling stuff for fees. The widespread, behind the scene control of the markets not just for LIBOR rates but of all price levels is one reason this economic recovery is bereft of jobs for the middle class. We saw in 2008 that mispricing by the big investment banking players in mortgages and derivatives ended up as an expense of the taxpaying public while the benefits of government approved borrowing went to private salaries and bonuses This situation continues today due to totally ineffective government mandated "reform" under the hollow Dodd- Frank Act. Bankers do not want the public to know how much they make on trading individual contracts as that would cut into their profits. Without transparency, which means instantaneous, public access to private trading, wealth will continue to accumulate in the hands of those with real time information. The lesson here is that we can't have it both ways: individual investors will get fairness and opportunities for solid long term investments only if the financial giants lose some of their power.

Watergate was a watershed event for politics in the sense that the duplicity of the President was revealed and the power and prestige of that Office has never been the same. The US Congress's ineffectualness to take a leadership role in dealing with our budget deficits is obvious and so everyone knows that swapping out the old guard for the new in November isn't going to make a difference, therefore our current style of democracy is structurally flawed. LIBOR gate may be the event that indubitably shows the complicity of the financial institutions in the decline of fortunes of the middle class. As a member of that industry, I am determined to find ways to get around the inherent negative bias of financial instruments. It involves taking actions that are neither convenient nor totally secure but no one said it was supposed to be easy.

September, 2012: "Real Estate Bottoms" The long and dark protracted downturn may soon be over for home owners. Given the relative calm in the stock and bond markets these past few months, the real estate world looks better and better all the time to investors. Prices have turned a corner in some of the hardest hit cities such as Las Vegas and Phoenix. The Land of Enchantment's statistics, while not as dramatic as our neighbors, are similar.

We may have seen a bottom in valuations and investors are entering the market for both new and existing homes regardless of whether or not banks are extending financing. With mortgage interest rates at record lows, people with sufficient cash are taking advantage of the 25% of home sales which are being sold through some kind of foreclosure process. Americans signed more contracts to purchase existing homes in July in the second half of the second quarter than in the previous two years. Pending home sales climbed 3.4% as home buying comes within reach of Americans who have been renting. Part of the reason for this is that existing homeowners are finally lowering their selling prices.

The Case – Schiller index of home prices in the 20 largest cities climbed in June, the first gain in almost 2 years. Nationwide, home prices increased in the second quarter of 2012 by the most in six years. This is welcome news for people in the construction and related industries. Home prices are still down almost 35% from their peak of 2006 but the slow economic recovery in the US is encouraging potential buyers, especially young adults setting up house for the first time, to take the plunge. This is especially true in the moderate range of the market. A house priced at $200,000, with a mortgage rate of 3.55%, will cost a home buyer approximately $704 per month with some of that being tax deductible. This has caused many renters to consider buying homes.

The government should be pleased with the results of its monetary policy easing, insofar as its effect on potential homebuyers. As we look forward to the fall, the question is how the Fed, the U.S. central bank, will continue to support an ultra-low interest rate environment without going bankrupt. The pending "fiscal cliff", i.e., the automatic imposition of higher taxes and reduced spending, is due to take effect in January of 2013, could bring about an abrupt halt to the increased pace of home sales. Another major question facing real estate markets is how effective any further acts on the part of the government and central bank will be. There is evidence that there will only be a slight beneficial effect of continued central bank buying of securities in the open market. So far, it seems to me that the Feds' efforts to promote higher levels of bank lending to individuals and small businesses have fallen short of their intended goals.

The Federal Reserve cannot remain the main source of support for the real estate market indefinitely. Only sustained consumer demand, which relies on an optimistic outlook for jobs, can produce a long term upturn in housing prices. Local retail establishments and the construction industry will flourish if we can figure out how to create decent employment opportunities for the many talented and motivated young people and displaced workers out there looking for something productive to do. After years clearing the huge backlog of inventory left over from the 2005-2007 boom, maybe whoever makes their way into the White House this fall can ride this momentum and help channel the nation's creative energy in a productive direction?

October, 2012: "The Money Continues To Flow" I feel like we have a bad case of déjà vu. It seems as if we are back in 2005 and there is a party going on in the markets. You know the story of the boy and the wolf, where the crier of danger gets ignored because he has too often repeated his plea for caution. As we enter October, traditionally a month of great volatility in stocks, many cautious investors remain on the sidelines with substantial cash reserves. No wonder, with CD and money market rates close to zero!

Given recent announcements that the intent of the central banks in the US, Europe and Japan are hell bent on promoting higher domestic employment levels at the risk of runaway money creation and eventual inflation, it is appropriate for individuals to consider how to cope with a global environment of ultra-slow growth and the potential that the next meltdown will be in government finance, which means there will be no bailouts. Every public market will be affected- bonds (especially mutual funds), stock indexes, and packaged products such as real estate investment trusts, master limited partnerships, everything that relies on low interest rates.

To put this challenge in context, the European Central Bank has said it will do whatever is necessary to bailout southern European nations who are on fiscal life support. The US Fed is determined, at all costs, to bolster employment and Japan's finance minister stated that they will print money endlessly to promote an end to their 20 years of stagnation. Due to these concerted actions, the world's stock and bond markets have bounded ahead.

Investors do not tolerate earning less than the rate of inflation. We now may be entering a "liquidity trap", which means that people keep large amounts of cash out of fear. Money stops circulating, no matter how much is printed, and government policies meant to stimulate the economy actually end up having little effect on job creation. The velocity of money, a standard measure of circulation, has been falling rapidly throughout the past few years, despite multiple rounds of qualitative and quantitative easing.

This topsy turvy investment environment is unlikely to change soon because the Fed has promised to keep rates low until 2015. Mortgage rates may continue to decline but this will not convince entrepreneurs to take risk and hire more employees. No matter who is elected in November, imbalances in the US such as the mismatch between the skill level of most people coming into the workforce and the technical demands of 21st century manufacturing jobs will remain. If this analysis is correct, it points to chronically high unemployment levels, muted consumer spending, plus a continued need for high government expenditures. As we see in Europe, this is a recipe for meltdown.

The markets have not been bogged down by these concerns because risk assets continue to benefit from artificially low interest rates. Investors who are willing to take risk and participate in the market, but who want to maintain some defensiveness, should find and hold only the highest quality global companies that pay substantial dividends. Telecommunications, pharmaceuticals, diversified manufacturing and energy related companies are our preferred industries because we believe they will continue to produce enough cash to pay out dividends, no matter what happens in terms of government and bank insolvencies.

Where else can investors go? Besides high dividend paying stocks, we believe that investors can find private real estate investments, particularly rental situations that pay high cash flows and are well collateralized. It is important to keep in mind the real estate investments I am referring to here are ones that you (or someone you know and trust) can actually touch and feel on a regular basis. We are not currently in favor of investing in traditional bonds or bond mutual funds, as new bonds are paying in the 1% to 2% range. If the advertised earning rate is higher, watch out! One final suggestion is to look at precious metal stocks that pay dividends. As governments and banks debase the value of local currencies by maintaining an unsustainable status quo, investors need to protect themselves.

Here are some Pollyanna solutions to the problems noted above. If the world's governments did what they say they believe in and cooperated on banning all non-peaceful nuclear work and materials, we could fund a global system of free education and health that would train and put people to work all over the planet. If the world's underground energy resources were considered to be common heritage assets of everyone, we could fund a multifaceted approach to the environmental problems facing the world's population as a whole, with some mixture of materials and technologies, which would also be a great propeller of economic growth.

Personnel News

Rob: Early in August, I traveled to central Colorado to climb some of the 14,000' peaks in the Collegiate range near Buena Vista. Other than traveling for work, family and pleasure to both coasts, I have been happily ensconced in the office and studio, hoping to bring the long standing "chapel" project to an end by Thanksgiving. Robyn was in an off off Broadway play, "Bourbon and Laundry", in September and her movie "Hellbenders" was released at the Toronto Film Festival while she was onstage in New York. Hannah spent the summer with her mother on the farm in North Carolina and is now working at an organic family owned vineyard in northern California, eventually headed to spend a month at a yoga center there.

Jeff: This summer I hosted a house concert for one of my favorite musicians, Jack Williams (www.jackwillimasmusic.com), at our office. We had 38 people attend and so I am very grateful to everyone for the nice turnout. Jack will be coming through New Mexico again in March of 2013 and I hope to do it all one more time. I will put the word out when the date is confirmed. I recently finished one of my summer projects, which was staining all the wood decks and fences in our backyard. It was a large project and took lots of time and I am pleased with the results. It's just one of the many house and yard maintenance projects that seem to come up and demand our attention from time to time.

Patricia: Boy this summer seemed to whiz by. Garden seasoning is coming to a close with some wins and some losses, pretty much the same as any year. For some time off I took a short trip to Tor C for a nice hot springs soak and some down time with my sister. We also took a side trip to Chloride, NM. Chloride is an old mining town that some folks rediscovered in the 1970's and are revamping. You have to go out of your way to get there but it is worth it. Well on to the fall , Balloons and chili roasting.

Emily: Fall seems to have snuck up on me this year. I'm enjoying the warm days, cooler evenings and beautiful yellow all around town, but I'm not sure I'm ready for winter just yet. I had a lovely visit to New York City over Labor Day to meet my niece, who was born in July, and catch some early rounds of the US Open. I'm sure that I'll find myself making more regular trips out to New York to see her grow up.

LOCAL TEA & CONFERENCE CALL-IN DATES:

The next tea will be at our Rikoon Group offices at 2218 Old Arroyo Chamisos in Santa Fe. The date is **Wednesday, November 7, 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 8,** 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.