The Rikoon Group
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Spring Commentary 2010

The Markets

It has been a very interesting first quarter as the stock market has shrugged off doubts about the strength of the economic recovery and political uncertainty in Europe to extend its rally. U.S. corporate profits continued to pleasantly surprise investors even though the U.S. economy overall continues to be battered by high unemployment and sliding residential and commercial real estate prices.

The Dow Jones Industrial Average gained 4% during the first three months of 2010 while the broader based, Standard & Poor's 500 Index rose 4.9%. Both indexes remain approximately 25% below their all-time highs posted in October 2007. On the international scene, China took its first steps to reverse its gangbuster economic stimulus program while Europe struggled with gaping budget deficits and potential political meltdowns due to the plight of the European Union's weaker members on its southern perimeter: Greece, Spain, Portugal and Italy. Most foreign stock returns were below those achieved in the U.S., with France gaining 1%, Germany 3.3%, and the faster growing Asian economies such as Korea and India both flat for the first quarter of 2010.

The Rikoon Group's portfolios did well during the first quarter with our special emphasis on high dividend stocks, real estate companies, energy master limited partnerships and internationally diversified bond portfolios.

While the stock markets continued their foray into moderately positive territory, the bond markets were on tender hooks as the Federal Reserve and other central banks around the world began to talk about how they will end the unprecedented easing of credit and printing of money that they claim helped the world avoid a financial meltdown in late 2008 and early 2009. Investors seem to take government officials at their word that everything (financial) is under control. The world's central banks have yet to credibly show how their domestic economies can sustain themselves without the support of easy money. The large banks literally have been granted license to produce paper profits since late 2008, and this is how the public's concerns have been allayed in regard to the credit worthiness of the large financial institutions.

One of the few places not in danger of meltdown in 2008 and 2009 was China. China's growth rate has been among the best in the world for the last decade, though it now faces structural problems that are endemic to all developing world economies. In China, worries about overheated home prices recently prompted the government to ratchet down on lending for building new housing, as there is already a huge oversupply of luxury apartments. At the same time, there is a shortage of working class residences for the masses of people still migrating from the Chinese countryside to already overcrowded and terribly polluted coastal urban areas.

No one knows what will happen if and when China's growth falls back from its 8% to 10% annual level to a more normal 2% to 4% rate. Maintaining full Chinese employment is so politically important that policymakers there have little choice but to go, go, go for every increasing avenue of production. The Chinese stock markets fell 5% during the first quarter. One of The Rikoon Group's main investment theses for 2010 is that 10% annual growth is inherently unsustainable. China's large financial stimulus program caused its domestic markets to skyrocket in 2009, and many traders point to the fact that Chinese stocks trade at more than 3 times book value and 18 times after tax cash flow compared to U.S. stocks which trade at about 2 times book value and 10 times cash flow. This leads us to believe that there is a strategic opportunity in shorting the Chinese market, that is, buying investments that will make money if the Chinese market declines in the near future.

Most investors and anyone who reads the newspapers is aware that Greece, which is running heavy budget deficits and struggling to refinance its hefty debt, could drag down the entire Euro zone's returns for 2010. Will Greece default? In reality, yes, but publically, the IMF and EU will find ways for the Euro experiment to save face. Investors are starting to look at deep values available in Japan, and we here at The Rikoon Group are searching for large multi-national companies based in Japan who have strong balance sheets and are involved in good long-term growth industries such as described immediately below.

Our sense is that the increasing price of oil, which recently climbed above $80 per barrel, will mean that over the next several decades, most industrialized countries will look to new forms of electricity generation and transportation involving the use of nuclear power and mass rail transit.

The political and economic turbulence in Europe, along with China's tenuous grasp on their overall financial growth scene, has sent investors into the safe haven of the U.S. dollar. We feel this will continue for some time as Japan's demographics progressively get worse, with fewer workers and young people entering the workforce to support the increasing number of retirees. It's interesting how the U.S.'s long history of open immigration has served our economy so well. Whatever one's political stripes, it is clear that the continued influx of working age foreigners into the U.S. population has provided an economic boon to retirees and to the country as a whole.

In the bond markets, despite fears of rising interest rates and uncertain economic outlooks for most countries throughout the world, credit markets held up well during the 1st quarter, and investor confidence remained strong. Worries about Greece and other Southern European nations, combined with concern about increased U.S. government borrowing needs should have weighed heavily on corporate bonds, but investors shrugged off these factors and went out and bought more junk bonds than ever before.

There was $35 billion in new junk bonds issued in March of 2010, outstripping the previous record set in November of 2006. So much for investor memories!

While bonds held up fairly well during the first quarter of 2010, the Federal Reserve continued to create money like there is no tomorrow. It has printed over the last two years enough new money to purchase $1.7 trillion of assets. Some of this money has gone into speculative bonds as people are looking for any way to earn higher interest than the meager returns offered by certificates of deposit or U.S. Treasury bonds. The taxable U.S. corporate bond market increased 1.13% while the municipal market in the U.S. was up .28% during the first three months of 2010. The Rikoon portfolios outperformed their benchmark indexes, and any reader who is interested in the specifics of our performance may contact us for detailed information.

The most important thing for investors to watch going forward are the large sales of United States Treasury bonds which, over the next 3 years, will total approximately $3 trillion. This will be the first place that investor sentiment changes will be apparent, and if there is any advanced clue as to what kind of actions are necessary to protect one's principal, this market will send the signal.

The Economy

As the financial industry is one of the largest sectors of the global economy, unfolding developments in financial regulation are extremely important. We look across the big pond to England to see some of the little forthright analysis being done to assess the cost to the public of having "too big to fail" banks. Despite bank lobbyists and politicians who say that breaking up big institutions is impractical and would lead to diminished economic competitiveness in the host countries, a new paper by the Bank of England states quite the opposite.

According to this august group of scholars, the real costs to society of banks too big to fail taking on speculative loans, trading for their own accounts, and then cutting back normal lending to the utmost degree, has been a materially lower rate of economic growth. They calculate that over the last several years, the world's five top banks were subsidized to the tune of approximately $60 billion. There is no way to effectively regulate these humungous institutions into returning some of that money to the public. Our belief is that the Bank of England is correct in a restructured banking system with a maximum size of 1/10 of the behemoths being both less susceptible to future crises and more able to deliver cheaper and better services to local economies now. This would look a lot like the U.S. banking industry before the Glass-Stiegel Act started to be watered down during the Reagan presidency.

While the U.S.'s economy grew substantially in the 4th quarter of 2009, unemployment has not fallen notably. Every politician and commentator agrees that the economic benefits of this recovery have accrued mostly on the books of banks and financial companies, and they have not trickled down to individuals in the workforce.

With home values continuing to slide in some areas, new construction is also off to its lowest point since 2002. This is a fresh sign that the troubled real estate market remains a sore spot for the economic recovery as a whole. The U.S. government continues to funnel money into highway and infrastructure projects through the Build America bond program which is a great deal for cash strapped states but is eventually another national debt.

While more than 11 million people are still drawing unemployment benefits, there are many people who have given up looking for work. We will likely see job programs being promulgated as election time nears, but this will not help people whose COBRA health or unemployment insurance runs out before then.

CHINA: We here in the U.S. have a close symbiotic relationship with China. We need China to continue to buy massive quantities of our Treasury bonds to finance our debts and to allow us to buy large amounts of their exported goods. Some people feel that a U.S./China conflict is in the making. As the U.S. moves into an untenable position of owing roughly $17.8 trillion in Federal debt, with another $3 trillion in “off balance sheet” obligations, there will need to be a reasonable rate of interest paid so as to attract capital necessary to serve that debt.

If the average interest rate paid goes up to 5%, which is well below the government’s average borrowing cost since 1980, our total interest payments due per year would equal the total gross receipts from all income taxes paid into the U.S. government. Economists believe that once interest payments on government debt go above 30% of tax revenue, the local currency either breaks down or the economic system changes to where its reliance on those supplying capital takes a new format. The current level of our Federal debt and our diminishing capacity to borrow in international markets from people other than the Chinese, Japanese and oil kingdoms is worrisome. China needs us to buy their stuff and is happy to lend us money to do so. But there is an end to this game.

If President Obama makes good on his promise to turn America back into an exporting nation, China will suffer. 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, then in Germany and Japan during the 1950’s, we strengthened our political alliances with nations with whom we traded at a deficit so that they would be kept in the fold of the U.S.’s global, military and capital markets network.

China is a horse of a different color. Because of its extremely large size and near monopolistic society, the government plays the role of sale agent in capturing savings and directing investments. The Chinese economy of today is a phenomenon we have never seen before in the global economy. The Chinese can take the savings of a billion workers and funnel it through state-owned banks to state-linked firms at nearly a zero percent interest rate in order to stimulate growth. This is why China has had such a terrific rate of expansion over the last decade.

The Chinese system works on maximum employment and gaining market share and <u>not</u> profit. There is no thought of profitability because their top three goals are to maintain employment, become a bigger player on the global scene, and to garner control of natural resources for their future long-term use.

Chinese leaders have discouraged consumption on the part of their citizens. The consumer base in China is about the same size as in France, who has roughly $1/20^{th}$ of China's population. Clearly, China under the present system cannot absorb its own products and manufactured goods. It must export them in order to keep its factories churning which in turn keeps its citizens employed. This kind of a strategy only works when there is an endless demand for exported goods, but as the recent global recession has shown, the U.S. now no longer provides unlimited export possibilities to Chinese companies. The Chinese system, therefore, which continues to rely on increasing amounts of loans and unproductive employment, has taken a turn towards instability. The best indicator of this is their property market and their stock market surges of the last several years.

As individuals, the Chinese are no fools. They are practical, hard-working, intelligent people focused on achieving better living conditions for themselves. The Chinese system, run by a military, industrial, political, financial autocracy, has managed to increase the standard of living there considerably. It is possible that their past economic strategy has now taken them about as far as it can go.

If we see a fundamental policy shift towards China on the part of the Obama administration, China will have to face some hard choices. Since the Chinese export 36% of their gross national output, they can't afford to lose their biggest customer. For this reason, many observers are not worried about the Chinese stopping their large purchases of U.S. government debt. In the event of a large scale trade dispute, if the Chinese were to withdraw their capital from our debt markets, analysts think that interest rates in the U.S. would rise about 1%. That is a considerable amount but not deadly. If the Chinese were to find their exports markets in the U.S. closed, they would probably have large scale civil unrest due to factory closings and the like.

Listen closely for upcoming political debates in the U.S. about Chinese trade issues, because if rising U.S. protectionism takes the form of limiting market access to Chinese exporters, something that can be done with the signing of a bill, China will have to figure out how to keep its population employed, either by allowing domestic consumption to increase or by taking more unilateral moves to control more of the world's natural resources. Either way, the Chinese face problems of their own success's unsustainable growth which will eventually collapse due to speculative bubbles or international backlash against Chinese exports. Neither of these scenarios presents immediate threat to the U.S., but when one country has widespread internal unrest, other countries have to adjust accordingly.

Articles from The New Mexican

Rarely do we get to see the likely unfolding of our own future ahead of time by watching another nation. On a national, state and city level, we face crippling budget deficits due to falling tax revenues and increased social program spending. Japan is entering its third decade of sluggish economic activity in economic circumstances eerily parallel to those we now face in the U. S.

Japan's credit rating outlook was recently downgraded because of its high government debt and weak political will. On its current trajectory, it is less than five years away from hitting a financing brick wall. Their government policies call for more borrowing and spending to boost growth. They have a rapidly aging population who is reducing personal spending to cope with anemic job creation and stagnant wages. The political process is incapable of reforming a financial system that rewards entrenched cartels of special interests. Sound familiar?

Japan's debt load as a proportion of their GDP is nearly twice that here in the US but Japanese investors own 94% of their own government bonds while foreigners hold over half of our indebtedness so, in some ways, we are more exposed as a national economic unit. Our military power is clearly superior to all other nations and this gives foreign investors' confidence to continue to lend us funds to operate. Japan has already seen their crushing levels of public debt slow domestic economic growth. They have chronic high unemployment and the stock and bond markets there have had sobering low returns for 20 years.

Many Western European economies are in almost as much trouble. Greece, Spain and Portugal, along with Ireland, the UK and France, are all deep in the red. England's economy is the most heavily dependent on the financial sector but it has a tradition of strong, independent action in addressing financial problems. The other weaker economies will attempt to cope with their downward debt spiral through either hyper-inflation, devaluing their currencies or in some rare courageous instance, by instituting severe austerity programs which are almost certain to cause social unrest and protests.

The next few years are going to be very interesting as Germany and the Northern Sea countries may decide to go their own way, breaking up the European Union so as to be spared the burden of bailing out the offending nations. It may be several years before the pain of running massive deficits in Japan is felt by its citizens but they will have to raise taxes, hike interest rates, or both in order to entice investors to continue to buy their bonds.

All is not bleak on the international front as resource rich countries such as Canada, Australia and the North Sea oil producers are good bets for stability and emerging Asian countries with young, educated and motivated populations are poised for real growth. Back home, the Feds will bail out states that get too deep in the hole but I wonder who will bail the U.S. out when the markets finally decide that we have taken on too much debt? Watching Japan closely may provide us with a sneak preview on where we are headed.

There has to be at least one solid investment opportunity in any market environment and in my way of thinking, energy is the ticket for the next decade or more. Consider the fact that most experts agree the world has used up roughly half of the planet's irreplaceable stock of conventional liquid oil over the last 150 years and the other half will be gone in the next 4 decades. The rate we use oil is accelerating dramatically as countries like China and India come on line as consumer oriented societies. Seems like a no brainer that prices are bound to go up when supplies are declining while demand is increasing.

In considering how to benefit from this long term trend, we have a few small obstacles. First, more than 60% of the world's remaining stock of petroleum lies under the Middle East. Sorry to say, that is one darn good reason our young men and women in the armed forces won't be coming home soon. Here in the US, we use 25% of the daily global consumption of oil but our domestic production capacity has fallen by half over the last 40 years. This trend looks to be irreversible because apparently there are no more Alaskan North Slopes to discover and develop.

The Canadian oil situation is somewhat different because there are huge deposits of unused petroleum buried there. The environmental impact of injecting gobs of water into shale formations in order to entice lower quality oil out revs up when oil is over $80 a barrel. Personally, I can't stomach that trade off. So, what's the answer to our nation's energy needs?

Coal is too dirty and hard to cart around except to industrial plants and large scale mammoth electricity generation facilities. Nuclear energy is poised to make a rebound after 30 years of being on the ropes due to astronomical costs, unsolved long term waste storage issues, and public distrust. Will this change over time as France and China lead the pack in dependence on this high tech solution? Maybe, but I doubt there is much money to be made by investors as ongoing government involvement will cap profits to investors.

My bet is on cost efficient, clean burning, and politically secure natural gas. It fits the bill from a financial and environmental perspective, and given some investment in infrastructure, private vehicles can run on it as our local buses do. Natural gas is very deep in the ground, so it takes a lot of money to get to it, transport it and keep it in a safe form. This is where my firm sees opportunities to make and keep money, no matter what the overall stock market is doing.

Many of my friends are doctors. By and large, they support the Obama bill which is a fulfillment of his campaign promise that health care should be available to all Americans and to accomplish this by taxing the wealthy and providing more services to the working poor.

The freshly signed but still contested plan doesn't do much besides prohibiting insurance companies from denying coverage or booting people out at their company's convenience. They get to charge whatever they want for the privilege of taking on 30 million new customers and so everyone's premiums are likely to continue to skyrocket.

Big drug companies get shielded from more competition from generic drug makers and foreign suppliers in exchange for their promise to refrain from lobbying against these changes. There is no legal malpractice reform, no effort to limit costly procedures during the last phases of terminal illnesses, no incentives for Americans to make preventative efforts, and no increase in competition within the insurance industry.

Doctors will continue to have less autonomy and, except for a few specialists that cater to the wealthy, their paychecks will go down. Hospitals will see their patient populations continue to explode as the absence of national HMOs and fewer doctors in private practice make ERs the main and sometimes the only available location for many people with bare bones or no insurance. Hospitals will therefore have to turn to state and federal subsidies for this very cost inefficient method of delivering health care to the masses.

Insurance companies will maintain control of the system overall because most of the money will continue to flow through their coffers and their continued massive lobbying presence in Washington.

Medical product and service providers will have smaller profit margins, but the increased percentage of the population who will be covered will allow lofty executive pay levels while providing paltry returns to owners of publicly traded stock. The country as a whole will continue its trend of spending an increasing portion of our annual national output on health care, with disappointing results compared with the rest of the developed world.

By the time the bill's provisions get implemented (over the next 10 years), they will probably be different than the recently passed legislation. The Act is a much needed political victory for the president and a practical benefit to uninsured Americans and for that, many are thankful. Is it a first step towards addressing the fundamental problems of a dysfunctional health care system that promulgates runaway spending with mediocre results? I don't think so. Is there much hope that we will not have to take on higher levels of government debt to pay for the newly insured? Not really. The results of the political end run we have just witnessed, while positive from a humanitarian perspective, may eventually be higher interest rates so as to attract capital to fund the nation's deficits.

One certain effect of this long and complicated health care reform process is the government's increased involvement as both a player and referee. Health care, like education, may increasingly be seen as a public service with private options available to the wealthy. Without taking on the insurance companies lock hold on the overall process, taxpayers and small investors will bear the burden of increased costs, reduced services, and lower returns.

We are a fairly passive citizenry because, by and large, our standard of living is still high. Our culture's level of civility could change rapidly if some of the basic goods or services we have come to consider as common rights become the privileges of a few. Decent and affordable health care has become a test of our national character, the results of which are not yet available.

Personnel and Office News

Rob: It has been a great winter for cross-country skiing with approximately 120 inches of snow this winter in the Santa Fe area. In the upcoming months I will foray into Arizona and the mountains of Colorado and New Mexico for some shorter trail runs, enough to get me above tree line but not so much as to impede on exciting gardening and orchard projects in Santa Fe.

Juliana: This winter has dragged on longer than I think is necessary but I was able to escape from the snow for a few days with a quick trip to the Bay Area. A friend and I spent several snow-free lovely days exploring the area. We especially enjoyed the behind the scenes wine tour at Lancaster Estates (Thanks Chris!) and the San Francisco Saturday Farmer's Market.

Jeff: My daughter and I enjoyed all the great snow that we had this past ski season. Stephanie is 14 years old and she greatly surpassed me this year with her skiing skills. She likes to zip down and around all the black diamond runs, whereas, I don't anymore. I am ready for warmer weather so that we can start on some house, landscape and gardening projects.

Patricia: I'm looking forward to working on more gardening projects, including the new raised flower beds that I recently had built at my house.

Emily: I'm heading off on a very rainy trip to Oregon and Washington to visit family and friends. While the weather looks dismal, it could make for excellent skiing conditions. I'm looking forward to seeing a little green and hopefully some spring flowers too! When I return I'll be jumping right in to the spring season of USTA tennis league play. I continue to work on my CFP® study and will finish up classes this fall.

Dana: It has been a quiet and happily uneventful winter with only a recent trip out of town to visit family in the Monterey Bay area. I lost two of my four beehives over the winter. It is my understanding that similar losses are being experienced by other local beekeepers. We are hopeful, however, that abundant spring forage will allow remaining colonies to expand and divide making for healthy and happy hives!

LOCAL TEA & CALL-IN DATES:

Our upcoming tea will be held on Thursday, May 6, at the Ghost Ranch Conference Center in the **Perea Room** at 3:30 p.m. and 6:00 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, Friday, May 7, our quarterly telephone conference call will take place at 3:30 p.m. and 6:00 p.m. The call-in number for both sessions 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.