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Winter Commentary 2011

The Markets

Investors can thank governments around the world for their help in keeping the financial markets afloat in 2010. It was a year when everything went up after the U. S. central bank, the Federal Reserve, came to the rescue in late August and announced its continuing support for the price of financial assets. The establishment's hope is that these efforts will reignite real economic growth which will in turn create jobs, all of which in turn will help the housing market that continues to flounder.

We are experiencing a classic short-term bull market in all assets (except real estate) due to artificial stimulus with essentially no clue of how the long term problems will be faced. It's as if we have turned the music up so as to dance harder on a ship that is cast adrift. We are attempting to spend our way out of debt. So far, it has worked and the political compromise achieved by the President and Congress in December 2010, extending old and creating new tax breaks has created a positive outlook for 2011 among many investors. The effects of the first bail out were wearing off last summer, and it looked like the markets were going to nose dive so we have entered into the second round of massive government support.

As a result of all these activities, the Dow Jones Industrial Average finished the year with an 11% gain while the technology laden NASDAQ index gained 17%. The Dow now stands approximately 75% above its twelve year low point, hit on March 9, 2009, though it is still 18% below its all-time high reached in October 2007.

Bonds had a decent year, with the long-term Treasury gaining 9.4%, intermediate bonds gaining 5.29% and municipal bonds rising 2.38%. These bond returns compare favorably with 30 month CD rates of 1% and money market deposit rates of 0.2%.

On the international markets, Europe as a whole lost close to 6%, with U.S. investors taking a further hit due to the Euro strengthening against the dollar. The German market, however, was up 18% in local currency terms. Natural resource nations such as Canada and Mexico's stock markets did well at the same time as their currencies appreciated versus ours, further sweetening the pot for U.S. based investors. Sweden was the best performing market of the major industrialized nations in 2010, up 21.4%.

In Asia, China's speculative boom goes on. Building and equipment investment grew 23.5% and is forecast to grow 20% in 2011, far exceeding China's central banks stated desire to put a cap on their domestic bank lending. While China is considered to have had some of the strongest economic results in the world, its stock market fell 14.3% as inflation worries and doubts about the future overcame enthusiasm for the Chinese business juggernaut.

China's economy expanded at approximately 3 times the rate of the U.S. and at 6 times the rate of the European Union. As a result, commodity prices boomed worldwide. Crude oil capped its 2nd consecutive year of gains. There are some investors who feel that commodities such as oil will provide the base for an alternate reserve currency as the dollar continues to drop due to what is looking like an increasingly insurmountable U.S. budget deficit.

Prices of other economically sensitive industrial commodities rose as well. This will present a challenge to emerging markets' central banks in 2011, as they have so far held off raising interest rates despite strong domestic growth and inflationary pressures. One result of the growth in emerging markets wealth creation has been the explosion of gold prices. Gold rose 30% in 2010 to a record high of $1,421 per ounce.

The European market struggled with a debt crisis that began in Greece and threatened other Euro Zone countries due to cross-lending among European banks. Ireland's government had to be bailed out by the European Central Bank due to the deteriorating condition of the Irish banks. Reflecting upon the similarities between Europe's problems and our situation at home, we can see that the crisis in confidence in the U.S. banking system was staved off only by the Federal Government's quadrupling of the deficit from $300 billion to around $1.2 trillion to date. As the Fed pulled out all stops in order to support our consumer economy and to promote the re-inflation of financial assets, it has forced investors, who need income from their investments, to buy higher risk investments such as stocks and low quality corporate debt since high quality government and corporate bonds are paying next to nothing.

As a result of the government stimulus programs and the forcible lowering of interest rates, corporate bonds ended their best two year performance ever in 2010 as borrowers worldwide looked to the U.S. for security. Lower rated debt in the U.S. gained 15% in 2010. These "junk" bond sales are causing lower yields on everything as investors snap them up without regard for the dangers that inflation or another recession would hold. In Japan, which is the largest debtor country in the world, government bonds returned 2.4% in 2010 as the Japanese central bank cut its benchmark interest rate to virtually zero. Globally, all corporate bonds returned 7% in 2010 vs. 16% in 2009. These kinds of high returns are unlikely to be repeated for years to come.

The Federal Reserve provided the stimulus for the market's boom in 2010 by committing to buy $600 billion of U.S. Treasury bonds. We appear to have started down the path of purposely depreciating our currency so that exporting companies benefit at the expense of U.S. consumers. This resulted in interest rates going up slightly since the $600 billion injection which bodes ill for the bond market in 2011 and beyond.

The Economy

The U.S. economy has been buttressed by the tax deal cut in December of 2010 between the Democratic administration and the newly controlled Republican Congress. The losers in the deal are future generations due to the increased burden placed on them by the Federal deficit. The winners are stock market investors and banks who continue to receive support. The consumer market will benefit from roughly $112 billion that will be pumped into the economy during 2011 due to a one year reduction in Social Security tax on wages. It's a novel approach, with Social Security already deep in the red, to reduce its funding as a potential solution. Apparently, a different kind of math operates in higher circles.

Continued low tax rates on income and dividends are a positive for stocks and negative for tax exempt bonds. While financial assets have benefited from the government's activity, there is a broad lack of a "confidence dividend" from either the $600 billion injection or from the huge tax breaks. Consumers continue to hold back from spending on big ticket items like autos and houses, while corporations are still hesitant to hire or pay out dividends due to the uncertainty of what happens when the government stimulus ends. Private individuals and companies tend to have more common sense than governments, as evidenced by the situation in Illinois described below.

Illinois is facing a budget crisis which may be a harbinger of the nation as a whole. States are mandated to balance their budgets. Illinois has a deficit of $13 billion which is roughly half of their annual outlay. It recently missed a $4 billion payment to their underfunded pension plan, and they have $6 billion in unpaid bills. Here are some of the ideas they have come up with for balancing their budget: expanding casino gambling, borrowing $15 billion more, some spending cuts and boosting the state income tax.

Illinois has only about half of the money needed to pay its retired workers and no source to make up the shortfall. They have tried and already used up all the quick fixes that make things look better but didn't actually address any of the real problems. How this story will end no one knows for sure, but the most likely scenario is for the federal government to come in and take up the slack. What are a few extra tens of billions of dollars when the current deficit is more than one trillion? One of the newspaper articles reprinted below focuses on the fact that despite Illinois and other structural problems that we face, investors still feel that the U.S. economy represents a safe and secure bet, especially for stock investing.

The real estate market is of paramount important to the overall U.S. economy. The housing sector is still down significantly, and with a backlog of unsold homes and a dearth of new jobs, the flow of delinquent home loans will continue unabated. Foreclosures have been stymied by some cases of improper paperwork and this will serve to drag out the establishment of a market bottom. Lackluster hiring on the part of corporations has meant fewer demands for office space so commercial real estate is also stuck.

Price declines in some markets have made housing more affordable than at any point in the last 10 years. It is estimated they still have another 10% decline to go. New housing construction is stuck at its lowest level in more than 40 years as the selling prices of resold homes are down about 30% from their 2006 peak.

Banks are still maintaining tight credit standards as their foreclosure efforts will remain at elevated levels for years to come due to the huge backlog of borrowers whose residences are now worth far less than they have outstanding on their mortgages.

Not surprisingly, Washington D.C. has the hottest housing and commercial real estate market, while suburban areas that rely on retail chains and professional jobs still suffer from the excessive construction boom of the 2000's. Vacancies are approximately 15% in commercial properties and construction starts are down from the paltry levels of 2009. The one saving grace is that interest rates remain low because if they were to rise, many commercial borrowers would go belly up.

The reason for this is that there are billions of dollars of commercial mortgages due to rollover in 2011 and 2012. Keeping interest rates low is of paramount importance because many commercial real estate owners would have to walk away from their properties if the rates they are charged to keep borrowing were to go up. Remember that their vacancy rate is up, rent prices are down and the value of the properties is down as well. A rise in interest rates would lead to an inability to pay, and they could not obtain refinancing which would create further job losses, causing further residential mortgage defaults, which would lead to further devaluation of commercial properties and so forth. This vicious downward cycle is the dark side of the self-reinforced boom of the decade ending in 2008.

Commercial real estate problems would saddle banks of all sizes with further loan write-offs, which would once again require the government to step in and bail out the banks. By keeping interest rates low now and for the foreseeable future, the plan is to stave off a repeat of the financial meltdown at almost any cost.

Instinctively sensing the seriousness of the box that the Western world's economies find themselves in, commodity prices went up across the board in 2010 along with food and precious metals. 2010 was gold's 10th straight positive year and also its best performing year ever. Investors are rushing in to buy commodities and metals because they are perceived to be a safe haven from the turmoil of government led intervention in the economy. Cotton and sugar are pricier than they were before the great recession and copper is at an all-time high along with corn and wheat.

These increases in price are due more to speculation from the investment community than actual demand from consumers for these goods. Investors poured $60 billion into commodity markets in 2010 after putting in $76 billion during 2009. If investor sentiment turns away from these kinds of investments, which might well happen if interest rates go up, it has the potential to turn into a very ugly situation.

The world's demand for energy and food is increasing along with population growth and the relative increased affluence in some emerging markets. In November, the United Nations stated that food prices went up for the sixth month in a row while global oil demand was on track to hit an all-time high in 2010. It is expected that the world-wide demand for oil will grow by 1 million barrels a day, to nearly 89 million barrels per day.

On the supply side oil production is going down, about 8% annually, and some are predicting a stable oil price above $100 a barrel in 2011. Natural gas, abundant here in North America, continues to underperform most other commodities. Studies say that the U.S. produces 200 million cubic feet of gas more per day than is used by industry and for residential heating. Natural gas is cheap, clean, and domestic but unpopular with investors.

Articles reprinted with permission from The New Mexican

How the European Union's debt virus might be contagious: It's mighty cold in Iceland but a deeper chill has descended on the people of Ireland. Do you remember the days of old, way back in 2007 and 2008, when the Icelandic banking system capsized? In order to right that ship, the Icelandic government threatened to give the Russians a military base on the southern tip of their island nation. In lieu of that politically unpalatable concession, with the EU's help, Iceland declared its financial institution bankrupt and cleared its decks by forcing bondholders and depositors to bear their share of the $US 85 billion in losses.

While still mired in a recession, Iceland's debt is only a small proportion of its economy now and its export industry and employment prospects are looking good for 2011, so much so that Iceland's stock market was the third best performing in Europe this year. Ireland is going down a different path, one sanctioned by the European Union's (EU) leadership and similar to that taken by the USA: it is bailing out its privately owned banks with public money. As a result, Ireland will be running a deficit for years to come, unemployment there will likely rise above its current level of 13.6% and stay high well into the next decade due to the cost of complying with EU dictates. The winners: bankers, investors and politicians; the losers: taxpayers, workers and retirees.

Defaulting on debts seems dishonorable and if you are someone who lends money or if you need to borrow again in the future, it is an awful thing. However, the pain of default does go away, people adjust to their losses, and sometimes they learn from their mistakes of either borrowing or lending too much to the wrong people and life goes on. Those who suffer are those who were directly involved, the slate is wiped clean and new plans and ventures can begin.

Mandating a solution from the outside, which is what bailouts are, puts off the day of reckoning. While it feels good in the short run, as evidenced by the stock market euphoric reaction to bailout news, it creates long term dependences and interferes with the natural process of establishing viable future business opportunities, the kind that creates jobs and gives direction to a vibrant society . Japan is a good example of someplace where the markets have never had a chance to re-establish themselves after the defacto destruction of their real estate, banking and government sectors in the late 1980s and early 1990s.

Allowing Irish banks to go under would severely impact the rest of the banks in Europe and somewhat effect those in the US since there is around half a trillion dollars owed betwixt and between. The European Union might fall apart, but as I have previously written, this reiteration of a pan - continent concept may not be up to the task of creating a true United States of Europe. The Irish people would survive; in fact they would be better off long term through a default than under a bailout. The pain would be severe but relatively short. As expected, Ireland decided to take over their banks and so now the Irish people are in for a very long haul under German supervision!

Financial and political leaders worldwide believe that their general populaces are ignorant, soft and gullible. Perhaps we are but when people realize that their housing values, retirement benefits and employment prospects are growing consistently dimmer due to ongoing bailout costs, the rubber may hit the road.

<u>Election Day, 2010:</u> Now we will see if Americans are willing to give the current Administration more time to accomplish the goals laid out in 2008 or if they just want less government overall. President Obama's election was a signal that G.W. Bush's hands off style wasn't working but now many voters aren't sure they like the alternative of unlimited bailouts. This debate is being played out on the international scene with Great Britain opting for austerity, the exact opposite approach to the U. S. Treasury's bet that spending is the way to stimulate real economic growth.

The root challenges facing America are high unemployment and declining real estate markets, both complex and emotional areas. These two problem areas may be ones where more government money and regulations do not help but actually hinder the efficient relocation and retooling necessary for the economy to get back on a long term roll. Let's look at the real estate foreclosure mess now prominent in the media as an example.

Around 5% of all mortgages, around 2.1 million are now delinquent. On average, the last payment made on these loans was 16 months ago. Over half of the mortgages in the U.S. are under Fannie Mae and Freddie Mac, which now are seen as thinly veiled arms of the government. The cost so far to taxpayers for bailing out Freddie and Fannie is $135 billion and they predict this will rise to $260 billion if the real estate market, which is highly dependent on full employment, does not rally soon.

The five largest domestic banks dominate the mortgage servicing business and the recent expose of their paperwork shortcomings has further rattled the markets, both for investors holding mortgage bonds and for prospective purchasers of new /used homes. Since a majority of U. S. consumers' wealth is tied up in their houses, and with no end in sight for a crushing amount of new inventory to hit an already over supplied market, we truly have forces in place for a deflationary spiral in prices. When potential buyers decide to wait for lower prices and they turn out to be right, they impact other buyers, who also delay, driving the market further in the hole.

Can the government prevent the market from hitting bottom? No more than it can control the stock market or the value of the US dollar, but it can put off the day of reckoning as long as taxpayers are willing to shoulder the burden. Local courts are ill prepared to process the volume of delinquent mortgages that will be brought by opportunistic attorneys and delinquent borrowers who see a potential broad loophole. The result will be higher costs for the great majority of homeowners who are not in arrears, through higher title insurance, increased mortgage bank fees and overall a much less liquid system that will make most future transaction onerous.

As we look ahead to a new Congress, it is hard to imagine an end to fractious divisions in our country about taxes and the economy. The Fed is stepping back into the market again by purchasing more government bonds to blow air into a leaking balloon. The bubbles you will see are an overvalued bond market, stubbornly low real estate activity, and an increasingly impatient public that wants to know where its personal opportunity lies. I daresay it will not be in government work.

Reflections for the New Year, 2011: It's great to be an American in the 21^{st} century, considering the alternatives. If we were Japanese, prices on everything from hot pants to hot sauce would be going down monthly, 5% in November alone. That old car you are trying to sell, or the house that shelters it, would feel like the incredible shrinking machine since no one in their right mind would buy anything from you quite yet, given that it will likely get cheaper over time. Your kid's future, if you were unusual enough to have one, would be looking mighty dim, since nobody is hiring or retiring.

Things are quite different in China where the opposite set of problems prevails. Everything there is going up in price. Swelling coastal populations live in mega-cities that stretch as far as the eye can see, which is not too far, given the ever present smog reminiscent of Charles Dickens's London. Those folks have got to have tremendous migraine headaches, sitting in 20 mile long traffic jams while rushing around to buy second or third apartments in practically empty buildings. Everyone in China knows that real estate prices never go down.

Our friends in Europe aren't quite sure where to send their kids to school because it looks like their previously "free" high quality university system is headed for a "California like Proposition 13" meltdown. It's hard to believe that students there would riot like it was the 1960's just because they now have to pay to go to college. Why don't they just get a lottery like us? I don't understand what they using all that surplus German money for anyway besides bailing out the Irish banks and the Greek government? Will their piggy banks savings all get spent just to keep Romania from rejoining the Soviet Union?

Heck, let the Russians have their old satellite states back…. it might keep Mr. Putin occupied with things other than throwing his entrepreneurial buddies in jail when they fail to follow his KGB inspired will. You can get a Big Mac in Moscow but I'll bet you a dollar they don’t serve fruit smoothies, garden snack wraps or frozen strawberry lemonades there or in Beijing.

So what if we can’t garner a World Cup match on our soil, they’re messy and our ability to watch from home might get stymied by some unscrupulous media magnate from Australia. I’m happy staying put here in the good ol’ USA, what with the hassle of airport security, customs and bad toilet paper abroad. Nobody can say we still don’t have the best music, movies and military on the planet. Let’s give thanks to our lucky stars to be right where we are. Gimmie a cup of Joe please, Costa Rican is OK.

Personnel and Office News

Rob: My older daughter Robyn, 24, appeared on HBO’s series “In Treatment (week Six of Frances) in late November and she continues to happily live and work in NYC. Hannah, 22, has developed an active interest in all aspects of film while studying creative writing at Bard College in Rhinebeck, NY. My athletic endeavors have given way to developing an organic composting process behind our offices, blending manual labor with trips to the source of various green manures and brown mulches.

Juliana: This winter has been very quiet and uneventful. For that, I am grateful!

Jeff: I am continuing to ride my bike to work most days, except when the weather conditions interfere. We are excited about the new ski season. Stephanie has new skis and boots and I even bought myself some newer “used” skis. Lots of my evening hours are devoted to assisting and cajoling Stephanie with her high school homework. I get to review a lot of the things that I have forgotten about history, science and other things. Fortunately, my math skills are still pretty good, at least by high school standards anyway.

Patricia: I have nothing particular going on. Spending some quality time with my old dog Jake as he moves forward to his transition time. Also, started ordering seeds and putting things in order in the green house. This year I expect to get a lot more productivity from the greenhouse during the winter months when the outside garden is resting.
Looking forward to Spring and some short trips around the southwest.

Emily: I had a nicely quiet holiday season here in Santa Fe with a quick trip to the little town of Ajo, AZ. Unfortunately the weather didn’t cooperate so we experienced the unusual freezing temperatures instead of the mid-60s typical for late December.

Dana: I took a wonderful trip to Guatemala in October. I had lovely quarters in Antigua and enjoyed walking the old city. I made several side trips including one to the Lake Atitlan region. I also traveled north to see the temples of Tikal. It was a very magical overnight with the full moon rising above the jungle. I was sure the growly noises I heard during the wee hours of the morning were that of a jaguar. However, I later learned it was howler monkeys!

LOCAL TEA & CALL-IN DATES:

The next tea will be at our Rikoon Group offices at 2218 Old Arroyo Chamiso in Santa Fe. While we would like to honor several requests to hold the teas elsewhere, Santa Cruz, CA or Brooklyn, NY have been suggested, they remain, at least for now, at our offices in New Mexico. The date is Wednesday, February 9, 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, February 10th, 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.