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Spring Commentary 2009

Overview

The future of our financial system is something that is on all of our minds. While the month of March saw a much welcomed reversal of the previously downward trends in the markets, I believe that most investors are interested in what the prognosis is for the future and how the ground rules are changing before our very eyes.

Successful investing always depends upon an underlying growing economy. Today, in our global economy, we have to consider the effects of the major trends of re-regulation, paying off debt and protectionism when looking at the potential for future market growth.

The activities of the world's governments and central banks are focused on rekindling the fires of an economy based on consumer spending and corporate borrowing. I question the validity of this assumption in a world where most people are looking more for some assurance of security than the allure of rapid growth and profits. If this is so, a continuation of the bull market of the last 30 years is highly unlikely. The various programs now being promulgated by the U.S. government to solicit the participation of private investors in restarting the credit markets and therefore, growth in the United States depends on tremendous government intervention, financing and regulation. We have not seen this kind of state sponsored activity since World War II so that leaves most of us unprepared for what this will feel and look like.

Government controlled economies lead to higher risk, higher volatility, and therefore, lower long-term prices for the majority of investment asset classes. This is because increased government regulation and management involvement at all levels of formerly private enterprises means that investors must be capable of choosing and holding on to correctly priced assets at the time of purchase. Value becomes an essential component of successful investing because computer modeling and portfolio theories that imply stocks always outperform bonds may turn out to be untrue. Long-term investment philosophies of foundations and pensions may well be reversed just as the belief that real estate prices always go up is now highly suspect.

The government's roles in all of this cannot be underestimated. Regardless of which party inhabits the White House, massive government efforts today to prop up ailing manufacturing and financial institutions will require continued financing for decades to come. This intervention will cause severe pressure on the U.S. dollar and will inevitably impact stock prices over the long-run. Investment strategies need to take these likely events into account. It is a sobering message but one that has embedded hope for some kind of stable future economy.

The Markets

After a strong showing in March, the U.S. stock market remained in negative territory for the first three months of 2009. The bellwether Standard & Poor's 500 Index was down approximately 12%, resulting in the longest stretch of quarterly declines since June 1970. It was the worst first quarter performance since 1939. The NASDAQ Technology Index did better, losing just 3% for the first quarter. It also posted its best March performance in history with an 11% gain. For the twelve months ending March 31, 2009, the U.S. Large Company Index has been down approximately 40%, and the EAFE, the International Index for all countries excluding the U.S., is down approximately 47% over the last 12 months.

Since the high point was reached in October 2007, the U.S. stock market is down approximately 49%, while the international markets are down 56%. It would take a doubling of stock prices from their current levels just to get back to where we were a mere 18 months ago. From March 9 through March 25th, the Standard and Poor's 500 surged 18%, its largest 16 day increase since 1982. The Rikoon Group's aggregate portfolios* continued to outperform their benchmarks, and written details and charts of our performance are available upon request.

The bond markets have been essentially flat since the beginning of the current financial market meltdown in June of 2007. For the first quarter of 2009, the Vanguard Intermediate Term Municipal Bond (tax-free) Fund gained 3.05% while Vanguard Intermediate Term Taxable Bond Fund lost approximately -.21%. Over the last twelve months, tax-free bonds gained 2.79% while taxable bonds lost -7.74%.

The Dow Jones World Index, which excludes U.S. shares, fell 12% during the first quarter of 2009 while emerging markets fell just 1%. The Japanese market declined 8% while Canada's commodity driven market was down only 3%. Europe continues to underperform the U.S., with the benchmarks in their major economies falling approximately 15%.

Gold gained 4% during the first quarter of 2009, and silver, which is also an industrial metal, gained 15% after losing value last year. Some commodities, such as copper, rose from their extremely low levels of 2008 due to Chinese demands, while agricultural product prices fell, as did oil in the face of weaker global demand.

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*These numbers represent the core direction of our management strategies. Individual portfolios are managed in accordance with clients' specific investment objectives and constraints.

The Economy

Manufacturing continued to decline in the U.S. For the fourteenth straight month, factories cut production, and this sets a record for the longest decline since the Great Depression. As a result of this and the concurrent decline in retail sales, U.S. companies cut approximately 700,000 jobs in March, making this the longest labor recession in 70 years. Total job losses in the current downturn are estimated to be more than 5 million. Unemployment rose to a 25 year high of 8.5% and we expect it to go over 10% before this period of economic malaise is over. On the real estate front, the National Association of Realtors said the number of signed purchase agreements for previously owned homes gained 2% from January's level. Foreclosures have forced steep declines in prices, and lower mortgage rates are also responsible for this increase in housing sales. The main index of housing prices showed a 20% drop in value from 2008 to 2009 nationwide.

Commercial real estate is likely to be at the forefront of the news over the next several quarters as the real estate investment market continued to be pummeled during the first quarter of 2009. Most investors are afraid of real estate investments that are funded by any kind of debt since re-financing options are limited given most banks continued reluctance to lend. The next bailout will probably be for commercial real estate companies forced to come to the market for new money, and without government aid, they will be shunned by the banks. This will rival in scope the size of the current difficulties facing the single family residential market. Many people believe that the real estate market is the root cause of the financial doldrums we are experiencing. The two governmental sponsored entities, the Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corp. (Freddie Mac), which together guarantee over half of the nation's mortgages, have seen their delinquency rates shoot to record levels over the past few months. Approximately 3% of their single family loans are delinquent, which is the largest increase in potential foreclosures since data started being collected in 1998. The U.S. government has allocated 60 billion dollars so far to these two agencies, and by the end of this year the remaining 340 billion dollars in credit that was part of the first government bailout package will be pledged. The current ownership and capital structure of these two mortgage market makers are not sustainable. I imagine that once the Obama Administration is done bailing out the banks, it will turn its attention back to the critical mortgage situation.

For the past 50 years, the willingness and ability of companies and individuals to borrow money has been a precursor to any sustained economic recovery. So far, government programs have helped stabilize some credit markets, especially the short-term one where companies and banks fund themselves by borrowing with government guarantees. However, most other credit markets, such as those for lower quality companies, students, auto buyers and credit cards remain stuck. One mainstay of the current effort is to kick-off private/public investment partnerships to spark lending to consumers and businesses.

Despite unprecedented activities on the government's part to lower interest rates, the average 30 year mortgage rate remains at 5%. This is because there is still great skepticism about the inflationary aspects of the current policy initiatives.

The Dollar continued to gain ground in 2009, mostly due to skittishness about the rest of the world's economies and investors' continued preference for cash as opposed to riskier assets. There are storm clouds gathering on the Dollar's horizon. The Federal Reserve stunned the markets by announcing it would directly buy its own debt. This resulted in the worst one-day drop in the value of the Dollar against the Euro in history. This could be a harbinger of the future as the Fed and U.S. Treasury focus exclusively on reigniting the consumer economy and not fighting inflation. Since we are effectively printing money, inflation is the main method used to reduce the cost of the government's debt burden, to the detriment of savers and retirees.

The Future of Finance

Given the many basic structural changes that are taking place in our financial markets, we thought it would be worthwhile to provide an overview of what looks to be coming down the pike. Let's look first at a few structural parts of our system that were supposed to protect investors but which, in fact, contributed to the market's rapid demise. Rating agencies, such as Moody's & Standard & Poor's, are supposed to judge accurately the strength of companies' financial statements and operations and to alert investors to changes in the soundness of a company's competitive position. However, there appears to have been a too cozy relationship between the rating agencies and the companies they were evaluating. As a result, there is great pressure now to have rating agencies be paid by investors. Only large institutions will be able to afford this and so a whole new set of rules, stacked against small investors, is emerging.

Investors need clarity about financial reporting and we rely on the financial accounting standards board to provide this. The recent loosening of accounting standards (April 2, 2009) now allows companies to determine the value of troubled assets on their books. This means that Wall Street has convinced Washington that transparency is not going to be a priority going forward, in much the same way as Japanese banks have been able to hide their problem assets for two decades.

A Summary of the Plan

The Administration's efforts to re-establish lending in the credit markets relies on the pillars of regulation, public/private partnerships and recapitalization of financial institutions as three parts of the Administration's policy.

Regulation of mortgage companies, hedge funds, and a myriad of other non-bank financial institutions is in the works because the sheer size of the non-bank financial players has grown so they are major, yet hidden, players. The complex financial instruments which people refer to now as toxic securities are just one component of this non-bank system of finance. Establishing common standards for their behavior is one key goal of the plan.

The regulation of all these new types of financial institutions will be a daunting task. Will individual investors be protected under the new structures? We don’t know, and it is unlikely that we will be able to find out. In order to solicit the talent of Wall Street, the Administration has struck a bargain with key financial market players, which means much of the investigation and regulation will go on behind closed doors. Again, most individual investors will not know who the weak players are until it is too late to move their money elsewhere.

The Administration’s basic position is that the U.S. government will put up whatever money is needed in order to protect the solvency of the large banks. It is estimated that there are over 3 trillion dollars in losses on the banks’ books of which only one-third, or 1 trillion dollars, is being addressed at the current time. In exchange for using public money to refinance these “private” institutions, the U.S. government will essentially take managerial control of the banks while publicly shunning the term “nationalization.” There will be new standards set for lenders and borrowers. Eventually, much to Wall Street’s dismay, severe constraints on bankers’ executive compensation will be imposed, such as the case already in Japan and parts of Europe. Executive compensation or pay is a lightening rod for the public’s outrage. Wall Street is working overtime to keep the government’s hands out of their executives’ wallets. It is difficult to have free markets without unlimited upside for individuals. And, unfortunately, the financial restructuring will not address many of the income dispersion disparities that have occurred over the last 30 years. Financial institutions will no longer be allowed to speculate with their capital, and the government will mandate the types and amount of lending to be done by the big banks. To implement these changes, the regulatory system will balloon and the red tape that borrowers will face will be daunting.

All companies who have federal insurance or who take federal money to get through their current difficulties will be subject to strict rules and procedures. The government will eventually try to show its commitment to stem foreclosures on individual homes, but the process one will need to go through to get government loans will be long and arduous. For many small investors, it will be tempting to participate but frustrating.

The re-regulation of financial institutions is only one of the first steps in reversing the belief that private enterprises can solve public problems. It will likely be several years before we know if the government’s effort to promote more stable economic practices is going to be successful.

The complex financial instruments created over the last decade by non-bank finance companies promoted risk taking and helped inflate the real estate market, and are unlikely to come back in our lifetimes. While the excesses of the last 25 years get worked off, lending for real estate and business purposes will languish.

Most people are worried about the level of government debt we are taking on, but there are very few people looking at the long-term effects of how the restructuring proposal of the financial system takes place. The Chinese government is one long-term player. They recently made a blunt statement that unless the U.S. puts its financial house in order, they will be looking to diversify their holdings of U.S. debt and U.S. dollars. This warning was quickly glossed over by all parties concerned, but there will be a price for all the current government proposed programs. The choices are rampant inflation, permanent decline in the value of the U.S. dollar, possible government default, or sharply lower long-term U.S. consumption and much higher U.S. savings notes. Right now, all the government is trying to do is cue up a new song so people come back to the dance floor. No one is talking about what to do once the dance is over.

Most of Wall Street's answers and input into the financial restructuring plan is based on the assumption that we can go back to a period where consumer spending and business borrowings ignite and drive economic growth returning investor confidence to the stock and credit markets. From our perspective, that economic game plan is a dead end.

The government has a plan to gain access to private sector expertise through its public/private investment partnerships. Here is a recent article I wrote for Santa Fe's **The New Mexican** about this partnership initiative.

The Great Financial Reform Act of 2009 is coming but don't hold your breath that it will provide relief to working Americans. It will re-regulate much of the financial industry but promises not to publish the results of its investigations. It also wants private capital from hedge funds, insurance companies, investment banks and pension funds to buy unwanted assets from troubled commercial banks and is offering generous terms to investors who do so.

Here's the basic of the plan: Let's say a bank paid $100 for an asset. Their auditors were saying that the asset is worth $40, but that was before last week's announcement by the national standards board that politics trumps accounting honesty, The Reform Act proposes to let the bank sell that asset for $70 to a private investor who puts up $5 in cash along with U.S. Taxpayers who put up another $5 in cash. The Federal government lends the other $60 for the purchase at a very low interest rate. The government does not get its $60 back if the asset end up being worthless.

This is a great deal for the private investor but a burden for taxpayers. Here's why: An investor buys 10 of these $70 assets by putting up 10x$5 or $50. The government does the same and in addition issues 10x60 or $600 in loans. 8 of the 10 assets make good and are sold for $100 and 2 go totally bust. The profits are split equally and so the private investor gets 8 times $15 in profits for a total profit of $120 less her $10 loss on the two bad ones for a net combined of $110, which is a $60 profit plus the return of her $50 investment. The government makes the same $60 in profit as a 50% partner but it loses $120 on the two bad loans so it is out $60 on its $50 investment after taking the two loan losses. Simply put, private investors put up 5% of the money but get 50% of the profit. Does that sound fair?

Companies and people who profited from prior lending excesses are slated to pay to play this game. Will the plan revive the U.S. economy by convincing banks to lend once they have sold their 10 assets and now have $700 more in capital? Will consumers and businesses take on more debt? No one knows if consumers have such short memories that they will run out and borrow money to buy new cars, boats or vacation homes but I doubt it. We do know that stock holders in banks, insurance companies and most publicly traded financial firms will get wiped out if financial firms have to declare losses on assets they sell for $70 that they formerly carried on their books at $100. The government may set up a special taxpayer owned bank to hold these $3.6 trillion of losses out of compassion for downtrodden financiers. It would not be out of character of the current proposal.

Summary

The holes in the largest U.S. financial institutions' balance sheets are wide and deep. There is no reasonable way to fill those holes except by using taxpayer money. We are going to see a revamping of the entire financial industry in this process. We also may look overseas for additional capital which will give foreign governments more say in our banking systems.

The International Monetary Fund, which recently was recapitalized on a similar magnitude as the U.S. financial industry, will be funded by China and the OPEC countries. These countries will rightfully ask for more say in how international affairs are conducted. As the U.S. economy gets recapitalized by borrowed government funds, we will face a similar dilemma.

Looking forward, we see future interest rate levels and the U.S. dollar reflecting international investor views as to whether we are on the right path or not. Our firm's game plan relies on diversification outside of traditional assets and the use of quality, short-term, highly collateralized debt as the mainstay of many investors' portfolios.

For any gluttons of punishment who want to read a supplement to this Commentary, it is available via email and covers the following subjects.

1) Is the dollar on its way out as the world's reserve currency?
2) When are wars good for the economy?
3) How is the bank bailout structured and what were the alternatives?
4) What are the likely results of the bailout course being taken now?

Personnel News

Rob: During the winter months, I took a break from trail running to enjoy a few chances to cross-country ski and swim in the ocean on the north shore of Maui. The studio here in Santa Fe is together now, and though it is difficult to find the time to paint, it provides a good balance to the markets. I plan to participate in the upcoming events:
50 mile run in Buena Vista, CO, May 1; 50 mile run in Los Alamos, May 15; 50 mile run in Lake City, CO, June 21.

Juliana: My winter brought on a spate of travel to Winston-Salem, N.C., to see my mother. February's weather was typical of a gray and rainy winter, but in March, all the flowering trees and bushes were beginning to bloom. I have to admit that all the greenness and humidity is a nice change from New Mexico's winds and dryness.

However, after a week I begin to feel claustrophobic and longed to be back in this high desert country.

Jeff: My daughter and I enjoyed the ski season, but now we are anxious for the warm weather to return. With warmer temperatures, Stephanie will spend more time horse riding and my wife and I will start some more gardening and landscaping projects.

Patricia: I schedule a lot of the maintenance and repair at the house and am happy to share with you the good folks I have found to do work. I've found an excellent window washer, especially if you have challenging architecture; a reliable appliance repair service; an electrical contracting and design contractor who did all of our computer network wiring; and a good pest control man. Please call me if you would like information about any of these people. As for my personal life, I spent the winter painting the interior of my house and am anxious to get out in the yard. I have some new plantings in the greenhouse, and at the moment, some glorious orange bouquets of flowers are in bloom. Take a look next time you are by.

Emily: This winter I supplemented my regular tennis with indoor soccer. It was fun playing again, since it had been nearly 8 years since I last played. Now, I am eagerly awaiting the outdoor season to start. This spring we are getting our ducks in line to add a mechanical room and bathroom to our house. Until construction is underway we are sprucing up the garden and doing some interior painting. I'm looking forward to the warmer weather, hiking, camping and maybe even some kayaking.

Dana: Another season of beekeeping is about to commence. I lost one hive over the winter, but the other two are faring well and building up nicely. My daughter, Alice, has decided to follow in her brother's footsteps and attend Denver University next Fall. I'm happy she will not be too far away and that I will get to continue my occasional visits to Colorado. Evan is contemplating post-college life.

General Info: A few months back PBS ran an outstanding program called "The Ascent Of Money" by Niall Ferguson. It provides a clear explanation of the workings of the financial system and the current maze of the world economy. We purchased a copy of the DVD for our office library and are happy to share it with any clients. Please call the office if you would like to check it out for viewing.

LOCAL TEA & CALL-IN DATES:

Our upcoming tea will be held on Thursday, May 14, at the Ghost Ranch Conference Center in the Perea Room at 3:30 p.m. and 6:00 p.m. These stimulating roundtable discussions are a favorite with our local clients who are invited to bring interested guests.

The following Tuesday, May 19th, at 3:30 p.m. and 6 p.m. (Mountain Time) our quarterly telephone conference call will take place. The call-in for both sessions is: **218-936-4700** and the Access Code is **425993#**. Please let us know when you are on the line.