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Spring Commentary 2011

The Markets

Portugal is the next country in the European Union which looks like it will need to be bailed out. The Federal Reserve continues its unprecedented purchases of U.S. Treasury bills. It is telling that almost all of our country's debt is being purchased by none other than our own Central Bank. This bizarre flow of cheap money has played the key role in fueling the current stock market rally.

While the U.S. market gained over 6%, Europe's combined markets advanced 3.6% and China was up 4.3%. Resource rich countries such as Canada and Australia continue to produce more modest positive gains even though inflation has put a dent in their export driven economies. The Japanese stock market was down 4.6% but before the natural disasters hit, their stocks had rallied substantially and the outlook was quite positive.

Gold and silver's advance has been temporarily stalled with a decline of approximately 4.3% in the 1st quarter. The big winners were oil service and energy stocks given the resurgence of offshore drilling and rising prices due to supply disruptions in the Middle East. The stock market shrugged off numerous calamities during the 1st quarter of 2011 to produce strong results. The Dow Jones Industrial Average gained 6.4% to turn in its best 1st quarter performance in 12 years. It was not a smooth ride. The market was down only two weeks earlier due to political unrest in North Africa and the Middle East and the devastating earthquake and tsunami which hit Japan.

U.S. small caps stocks turned in the best performance, gaining 7.6% but they are still slightly off their record high hit in July 2007. By all investment benchmarks, the party has resumed. In the background, however, the European debt crisis continues to unfold.

Long term home mortgage rates approached 5% during the 1st quarter while 5 year CDs were yielding approximately 1.9%. Money markets continued to eek out a paltry ½ to 1% annual return. Retirees and ultra conservative investors have been the ones hurt most by the government's push to keep interest rates at historic low levels.

The 10 year U.S. Treasury note was earning approximately 3.5% on March 31, which was about where it began the year, so bonds have neither gained nor lost much so far in 2011. Central banks around the world have acted as fiscal shock absorbers by opening up their spigots in response to political unrest, spiking oil prices and supply chain disruption due to the earthquake in Japan. Flooding the markets with money, the Group of 7 (largest industrialized nations) has stabilized currency markets and soothed nerves so investors would not panic in response to these events. Most U.S. corporate executives expect their profits to rise, albeit less rapidly than in 2010, due to continued productivity improvements and lowering labor costs, which is a negative for the labor market. The Euro has surprisingly gained 6% against the U.S. dollar so far in 2011, due to the continued angst that afflicts many of the peripheral European Union nations such as Ireland, Portugal and Spain.

Higher energy and agricultural prices, particularly crude oil which surged 24% in the three weeks beginning mid-February, are likely to slow the global economy for the rest of 2011 due to inflationary pressures. In spite of these adverse winds, stock market investors continue to exude optimism, both in the U.S. and abroad.

Brazil, which has been the major exporting engine in Latin America, has been under pressure due to its strong currency and increasing inflation costs. Mexican companies, adjusting to the ongoing drug war, are benefiting from domestic consumer demand and from higher oil prices. The big question facing investors world wide is: will higher energy and food costs, combined with an end to central bank purchases, toss a wrench into the seemingly strong emerging market economies? If the price of consumer goods and commodities rise overseas, while borrowers in the developed nations like Europe and the U.S. have to grapple with continuing real estate travails and lack of employment opportunities, global growth may grind down into the doldrums. Most investment professionals are very optimistic about continued growth prospects in the emerging market.

The Economy

The important question facing economists and investors alike is whether the steps taken in 2008 to prevent a global financial meltdown are a basis for stable growth or whether further adjustments need to be made. Another way of stating this fork in the road is: will fundamental market forces such as value, productivity and efficient allocation of resources take precedence over government intervention and political support? This is not an academic matter. It will affect what kinds of jobs are created for the future as well determine investment returns on stocks, bonds, real estate and natural resources over the next decade.

For example, banks around the world have been bailed out in various ways. Ireland's banks faced stringent stress tests which resulted in the Irish government taking control of their financial industry. Portugal has suffered a political and financial crisis and will need a bailout within weeks. The European Union's central bank has extended loans to Greece which will most likely never get paid back. Upon circumspection, U.S. investment banks such as JPMorgan and Goldman Sachs were bailed out by the Fed taking near defunct junk bonds as substitutes for real money. These same banks are now being fingered for the collapse of the credit union industry. While the U.S. financial bailout program has enabled banks to generate huge profits, the predatory process of how financial institutions are able to foist mysterious securities on an unwitting public has resumed. Housing bonds backed by mortgages whose repayment is in doubt are back in vogue among investors because the banks can once again sell them free of oversight. Investors have moved back not only into mortgage bonds, but also junk bonds, which are now priced as if they have very little risk over U.S. Treasuries or high quality corporate bonds. These are signs that the basic flows of our financial system that led to the crisis have not been resolved.

In regards to employment and housing, although layoffs have slowed, new hiring has not resumed in a meaningful way and real wages continue to fall for most Americans. This is in sharp contrast to bankers who have benefited from the government's largesse. The average hourly earnings of workers has been flat for five months and when taking inflation into account, real wages are falling. Fortune 500 companies have been able to increase their earnings, buoying the stock market and raising the sentiment among chief executives to a new high while consumer confidence has tanked.

Sales of existing U.S. homes fell in February and March as it has in 7 of the last 8 months. Many people are moving from home ownership to renting and as a result, apartment vacancies have dropped 25% over the last year. Home ownership has declined from its peak of 70% down to 65% and is expected to fall further. Unfortunately, when the rental real estate industry booms, it doesn't help overall economic growth because there is little new construction called for.

In 1970, working people's wages accounted for ¾ of total U.S. income. Now, that number is closer to 2/3s and the share of income coming from passive investments has risen. The dwindling share of income going to the middle class and the decline in mass consumer spending is evidenced by the fact that 40% of spending can be traced to the upper 20% of the U.S. population. The benefits of the 2010 tax cuts for the middle class have been mostly offset by the rise in gasoline and food prices. There is no doubt that the income gap between wealthy and working Americans continues to widen.

As we look ahead to see what's in store for the markets and economy, we must choose between relying on government intervention, promulgated by Ben Bernanke, which helps large institutions, versus the view that the value of assets has to be based on its long term productivity and ability to generate cash flow. If one believes the government should play a decisive role in markets, then we may be in the midst of a new bull market. Conversely, if one believes that the stock, housing and labor markets all need to be gauged at a price that a willing buyer and a willing seller agree upon based on the long term economic productive capacity of that asset, then we are in for a severe recalibration once the government is forced to exit the market.

Presently, our government has voted to intervene in the markets and to buy assets with the understanding that the government can sell assets back into the market whenever it wants. In spite of resurgent stock prices, corporate returns on invested capital have not increased in a meaningful way, so stock and bond market prices are now artificially high. Our investment approach in the face of these public untruths is to presume that government and investment bankers will eventually get it wrong. Neil Barofski, former Inspector General of the TARP financial bailout program, recently published a scathing critique about the implementation of TARP which he was charged with auditing. Mega banks were saved from collapse and put back into seemingly good positions, but the other two stated goals of the TARP program went by the wayside. TARP was supposed to revise many erroneously structured mortgages that trapped millions of Americans with negative equity on their properties. Regulatory reform that could prevent future threats to the financial system by speculations and machinations on the part of large banks and funds has also been abandoned. Banks are even larger now than they were before the crisis. They control a bigger part of the economy and there has been no progress towards simplification or rationalization of the financial system. Finance is king as it is the driving engine and brains of our economy. Due to the failure of reform, investors' fundamental faith in the fairness, efficacy, and viability of the markets has been severely strained and rightfully so.

All is not bleak. Value investors such as ourselves are inclined to look ahead and save cash for another day. We believe that there are companies which will withstand the likely fall of government bond markets. There are companies with positive cash flow, with real and viable assets that can provide investors with a steady income stream and some modicum of growth. Because we anticipate tumultuous times ahead, positioning oneself to not get burned is critical.

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The Lie Of Low Inflation: We are all living with a big lie called low inflation. With no relationship between our paper money and any real asset, the last few decades have seen a widening gap between what we are told and reality.

Part of my job is to protect our client's standard of living. When financial market activity is primarily based on specialized access to information (hedge funds), massive technology (banks), or just plain misinformation (government statistics), there is a problem. The difficult thing is how to articulate how these lies impact us regular folks.

The truth is, as economic beings, we are experiencing a debilitating loss of purchasing power simultaneous with a seeming inexorable decline of job opportunities. The amazing part is that we are unaware, on a day to day basis, of how this is occurring. John Williams coined a phrase for economic deceit of "Pollyanna creep" and Bill Gross, who manages more bond money than anyone else on the planet , calls the state of our economics (and therefore stock and bond markets) a "haute con job".

Inflation numbers have been under reported for 40 years now, with each successive Administration adding to the mirage. The benefit to the government is obvious, social security payments would be 70% higher than they are today if the figures used to calculate cost of living adjustments were based on the original , common sense methods established in the 1960s. If you feel like you are being screwed but can't quite figure out by whom or how, herein lies one piece of the puzzle.

Other important numbers that we rely upon to know where we stand have also been purposefully falsified. There are six definitions of unemployment now with only the lowest used in the media. Measuring the nation's output has been fudged to the point where the terms recession and recovery have little bearing on most people's experience of employment or investment opportunity.

The net result of these lies is that people understandably and justifiably doubt the fairness of the "system". This is a problem if you are an investor relying on the markets to protect wealth, a retiree relying on fixed payments or a consumer trying to find durable domestic products. When people lose faith in their government and official markets, economic activity starts to move off the books, underground and outside of voluntary tax collection channels. This is normal for under developed nations with little history of multi- cultural participatory democracy.

Most people in the developed world are culturally trained to comply with their government's directives. If we wake up one day and sense that we have been duped, a change of occupants in the White House or Roundhouse will not matter. The severe under reporting of inflation and unemployment is an effort to keep people believing in the status quo without feeling just how fast the standard of living is declining. The over statement of the nation's output growth rate is intended to keep investors optimistic while public deficits mushroom out of control.

I am not quite sure what will give out first, the international money funding our fantasy lives or our tolerance for being lied to. We aren't forced, on a daily basis to feel the pain that may be required to take the cure that reality would prescribe: living within our means and doing what it takes to be sustainably productive.

<u>New Mexico's Legislative Opportunity</u>: New Mexico has a window of opportunity to greatly expand a local industry. Many other state legislatures have already seen the financial benefits of creating and keeping high paying jobs as well as retaining investor capital that comes with expanding the legal definitions of permissible trust options.

Congress's recently enacted a tax bill in late December 2010 which has created a two year boom, 2011 and 2012, for the establishment of certain kinds of trusts, ones that can go on for many generations. In order to take advantage of this, investors have to find states that allow for "perpetual "or "near perpetual" trusts. So far, Delaware has the biggest lead and most favorable tax climate as one of its largest industries is serving business organizations: corporations, LLCs and also trusts.

Trust administration is a clean industry with little downside to their host states. They provide work to lawyers, accountants, bankers, investment advisors, realtors, computer technicians and administrative support staff. The problem is that New Mexico's current Trust law does not yet allow for these new types of trusts. Roughly half the states have already changed their laws to remain competitive in this clean and green industry.

In addition, changing New Mexico's trust tax laws to compete with states like Nevada, Alaska, New Hampshire, would eventually generate much needed tax revenue with minimal cost outlay. The increased cash flow that would come to the State of New

Mexico as a result of expanding these businesses could be used to buttress the state's budget for oversight of the entire financial services industry.

What might prevent an elected official from voting for such an improvement to our state's business climate? Those philosophically opposed to the estate tax provisions of the new federal tax bill believe that families should pay estate tax every time one generation passes assets to the next. The implication of this belief is that successful small businesses and family homesteads ought not to remain in the same hands for decades.

There can be concern that real estate will not change hands and go stagnant or that administering trusts based on current rules might not serve family members as time goes on. These "perpetual "trusts usually have internal committees that oversee investments and they can make amendments to their charter and operations as times change. I have helped set up and participate on several such trust committees on behalf of our clients and up until now, have had to move them out of New Mexico and into Delaware. Due to the high degree of oversight given by the trust committee structure, there is active management and the number of real estate transactions increased in every case.

State senators and representatives have a rare opportunity to do something this session to make New Mexico a player in the field of trust administration. Whatever well intentioned misgivings or natural resistance to change anyone may have, we owe it to our citizens to pass this bill since if we don't, we risk falling further behind in the competition to attract and retain a growth industry of the 21st century.

<u>Advice To Young People Looking For Jobs</u>: Many young people are having great difficulty finding jobs and their employment outlook is bleak. Private companies, along with government organizations, will continue to reduce the number of positions available. People with jobs are looking to stay on as long as they can since the prospects for a comfortable retirement are dimmer than at any other time since WWII.

We are not alone. Europe has faced these circumstances for thirty years, albeit with the aid of a wide social safety net. Now that the net is frayed, given several EU nations piling up of national debt, college education there may soon cease to be free there as it has been for decades. For recent graduates to feel excited about the future and not be dragged down by the pressure of paying off excessive debt, a nation has to have an expanding economy that creates an atmosphere of hope and opportunity.

One place where this is not happening is Ireland, which is experiencing an emigration of many of its ambitious and bright young people. If this continues, it will take generations for Ireland to recover. Ireland's new government may refuse to pay off its national debts so as to stave off this unfolding disaster. Could this occur in other countries? Here?

For America's next generation to lead productive work lives, I offer some advice:

First, no matter what field you studied in school, find something you can do immediately which is useful to others, is in fairly steady demand no matter what shape the economy is in and that it pays decently. It is best if you can do it part-time and on a flexible schedule so you can develop other opportunities. Examples: cooking, massage, yard maintenance, cutting hair, doing nails, sewing alterations, minor house repairs, childcare, waiting tables, tutoring high school students, and eldercare. Put the word out that you are available every way you can.

Second, pursue your real passion in a creative way by finding a mentor and/or volunteering somewhere people are doing what you would love to do. Apprenticeships of any kind are invaluable, no matter what you end up pursuing. This kind of non-money oriented effort will result in the best kind of networking.

Third, get your expenses down. Trade with your neighbors, friends, and family for as many of your needs as possible. Sign up for a Time Bank in your area. Live with a family by converting a garage, basement, or shed into a hospitable apartment.

Fourth, pay off your debts and don't drink too much. It is impossible to combine partying and work so if you want to stay sharp, schedule some exercise into your routine. Sports are a great way to make helpful friends.

Fifth, take a course in a new field. Artists should take bookkeeping while business majors would benefit from studying psychology and history classes. The reason is that most good jobs require multiple skills, a willingness to take on new things, a positive attitude and the ability to get along well with others from different backgrounds. Traveling to other cultures on a bare bones budget show initiative, resourcefulness and an ability to be self-reliant. Try not to specialize too early as the best employers I know want well-rounded people who are not afraid to try new things.

Once you put together your own multi faceted work life, chances are good you will have already achieved an important slice of the American Dream, which is that your time is your own. Opportunities will appear in unpredictable ways. If you can build your own base, put your heart into what you believe in and apply yourself patiently, career and money will follow.

Personnel and Office News

Rob: Positive events continue to unfold for my children. The film, Cold Weather, shot in Portland, Oregon in 2009, appeared to critical acclaim at the South by Southwest Film Festival in Austin. It was reviewed in the NY Times and The New Yorker. Soon after, Robyn was offered the lead female role in a 3D production of a science fiction script now being filmed in Greenpoint, Brooklyn, NY, with an outstanding cast of actors, directors and producers. Stayed tuned for when that film is available to view. My younger daughter, Hannah, will be working as a waitress and masseuse this summer before she travels to Germany, France and Spain to visit friends who are living abroad. The "chapel" painting project, taking place in our backyard, has seen some small progress towards completion after 13 years of endeavor. We are praying for rain to hit the plains of parched New Mexico.

Juliana: I recently saw a notice that April 5th is the official one day without shoes. I am opting for a full summer of going barefoot!

Jeff: The weather this past winter was unusual in that the temperatures were very cold but there was not much snow. For me, that meant that the snow for skiing was not great, however, that also meant that the roads were pretty clear so that I could ride my bike to work for most of the winter. I just had to use extra warm gear for the ride. Now the temperatures are warming up for spring and I am looking forward to more outdoor activities like biking, hiking and yard work.

Patricia: Things are sprouting up in the garden due to the unseasonable weather in Santa Fe. I spend many of my weekends here working the garden, although it is far from work for me. In the fall I am planning a big trip to Scotland to celebrate my 60th birthday.

Emily: Sunshine, flowers blooming, warmer weather, sowing seeds – Spring is surely in the air, which means windy tennis and the start of soccer season! I'm trying to make the most of it and spend as much time outside on the beautiful days.

Dana: I have been busy selling out last years honey harvest to allergy sufferers. My three hives survived the winter and those bitter cold days we had. They look to be off to a healthy start with the queens rapidly building up the brood nest. The bees are especially seeking water sources to turn crystallized comb honey back into a useable energy source. Don't be alarmed if you see a lot of bees around your birdbaths or ponds. If you don't have a water supply outside, you might consider establishing one to help them and our bird friends out.

LOCAL TEA & CALL-IN DATES:

The next tea will be at our Rikoon Group offices at 2218 Old Arroyo Chamiso in Santa Fe. The date is Wednesday, May 18, 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, May 19, 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.