The Rikoon Group
2218 Old Arroyo Chamiso
Santa Fe, NM 87505

Spring Commentary 2012

The Markets

U.S. and global stock markets staged their strongest 1st quarter rally in more than a decade as Europe's Central Bank flooded its market with money backstopped by the Federal Reserve. The index of U.S. industrial stocks ended the first three months up 8.1%, its best performance since 1998. The S&P 500 gained 12% while the technology index, the NASDAQ, skyrocketed 19%, mostly due to Apple's meteoric rise. Stocks in Tokyo, India and Germany also had their best start in several years, in large part due to investors' relief that Europe's debt troubles were not going to engulf the global economy in flames. Greece's "successful" debt restructuring and governmental intervention yielded market action that was relatively calm compared to last year. Central bankers of the developed world continue to force income investors into riskier assets, such as stocks and junk bonds, due to paltry earnings on government bonds and bank deposits.

The U.S. industrial stock index has now had six consecutive months in a row of gains and is close to its record high set in October 2007. As the European Central Bank provided approximately $1 trillion in liquidity to their receding economies, widespread anxiety that Europe's banks would fail and by implication, drag down some U.S. banks abated, fueling robust stock gains in most of Continental Europe.

Contrary to our expectations, financial companies, consumer discretionary and technology stocks have led the way so far in 2012. Despite soaring stock prices, individual U.S. investors have pulled upwards of $15 billion out of the market so far this year. Interestingly, trading volumes and volatility (movement) have diminished markedly since mid-December 2011, which further shows the power of government influence in affecting market action in the short term.

The Japanese stock market gained 19% even though manufacturing activity there has slid. Natural resource economies such as Australia and Canada showed tepid growth in their stock markets, up 3.4%, due to lingering concerns about the strength of the "real" economy worldwide. Germany continues to attract capital, gaining 17.8% during the first quarter while the overall European stock market closed up 7.7%. China's stock market gained only 3% due to concerns about the Chinese financial system and the significant number of bad loans in their economy.

In the bond market, U.S. Treasuries lost ground for the first time in over a year, declining 1%. Investors have moved to higher risk assets such as corporate bonds, which gained almost 4%, and junk bonds, issued by the lowest quality companies, which gained 7% during the first quarter. It's as if investors were rewarded during the first quarter for taking any kind of risk, no matter what the underlying asset or actual prospects are for the long term, and this disassociation from reality puts us on edge.

The Mexican economy is facing several challenges, including an upcoming election and continued debate on the cost of the war on drug cartels, which has taken as many lives in Mexico as the Vietnam War took in U.S. soldiers. The Japanese yen depreciated slightly, assisting that country's exporters. Japan continues to shut down its nuclear energy producers and now, only one nuclear reactor remains active there. The added cost to the Japanese economy of importing all of its energy is enormous and will be an ongoing drag on its markets.

Gold and silver gained 6%, approximately half the return of the U.S. large cap stock market index. Dividend paying stocks, a haven last year for many investors, were among the worst performers during the first three months of 2012. Despite their lower returns, The Rikoon Group's strategy continues to be focused on dividend paying stocks, given our high level of concern in the efficacy of government induced market rallies.

Year to date, natural gas prices continue to fall, down almost 28%, while crude oil gained 4%. Overall, the commodity index for industrial and agricultural goods has stayed relatively flat, but food prices have increased again, following 2011's wrenching market rise. Inventories of corn, soybeans and wheat have now dropped to three year lows, and planting estimates are trailing last year when global food prices rose to an all-time high, triggering unrest across North Africa and the Middle East. The United Nations estimates that grain imports by the world's poorest countries will climb to a record high in the 12 months ending this June. The U.S. is the world's largest producer of agricultural foodstuffs as well as an increasingly large exporter of energy due to increased oil and natural gas supplies.

Our feeling is that the markets are too optimistic about the world's growth prospect for 2012 and complacent about the effects of continued monetary stimulus by central banks worldwide. We believe that individuals should pare their holdings of riskier assets as central bankers look down the road at the extremely high inflationary effects of the creation of $3 to $5 trillion of new paper assets over the last 4 years. Private companies have taken advantage of this liquidity and issued more than $1 trillion of new debt during the first quarter of 2012 surpassing the record set in the late 2000's. The amount of money that needs to be rolled over in 2012 is approximately $3 trillion, just considering Spain and Italy. This year will see one of the first tests as to whether the risk of credit contagion, originating in Iceland, then Ireland, to Greece and Portugal, takes on a proportion that is too large for the European Central Bank to handle.

The Economy

Wall Street is banking on continued job growth and Central Bank intervention to propel the stock and bond markets higher. The actual per share earnings of U.S. corporations is diminishing compared to last year, especially when one takes Apple out of the equation. The pick-up in U.S. employment has boosted consumer confidence to a four year high, raising the possibility that household spending, which accounts for 70% of the U.S. economy, will be the sustained basis for a cycle of growth.

New applications for unemployment benefits have declined in 2012 to levels last seen in 2008. In fact, the U.S. unemployment rate has fallen by nearly a full percentage point since last December and that is good news. Most of the new jobs are in the service sector but the manufacturing sector in the U.S. also gained 21,000 jobs during the first quarter. Consumer confidence has improved as a result of better employment numbers and this tends to be a self-reinforcing cycle that goes hand in hand with rising stock prices. Unfortunately, housing prices have not yet begun to rise in many markets. Analysts feel that bottoms may have been reached in places like Phoenix and some communities in California that saw property values fall by over 50% from 2007 to 2011.

The U.S. government is looking to unload part of its huge portfolio of houses and large hedge funds are stepping up to the plate with the hopes that they can buy these assets at cheap prices, rent them for adequate cash flow, and wait for the housing market to turn around to sell at a profit.

The aging of the baby boom generation will drive many housing markets for years to come and likely lead to a structural imbalance between the types of jobs available in the U.S., many of which require technical skills and a growing workforce of non-science oriented graduates. Employers with those jobs are having a hard time finding qualified workers. Laid off workers from finance, real estate, construction, and government services industries are not easily trained for technical positions. The consequences of this will be a drop in labor market efficiency, subsequently causing pressure to raise wages for technical workers, while lowering wages for basic service jobs. With automation and new computer technology, fewer overall jobs will be created. Companies will therefore try to pass on higher labor costs to consumers. This, along with rising gasoline prices, will add fuel to the inflationary fires started by the monetary easing of the last several years.

The critical economic news will be coming out of Europe over the next few quarters. The European Union has kicked the can down the road by taking a wide variety of measures to avoid coming to terms with the structural problems in their financial system. While authorities tout improved safeguards and improving credit quality of European banks, the reality is that they are using all kinds of off-balance sheet and creative accounting measures to avoid taking losses. China does the same thing on a much larger scale but because of their controlled economy and captive labor force, no one knows how big China’s problems really are.

Spain is the biggest concern, along with Italy, and they are both now in recession. Unemployment across the board is 23% in Spain. More than half of young Spaniards are out of work. People say that this is the best educated and least employed generation in Spanish history. Both Spain and Italy have more formidable barriers to change than Greece or Portugal. This gives an indication of how hard it will be to fix Spain and Italy’s structural problems.

Most new jobs are created by small businesses. When it is too expensive for small businesses to hire and fire workers, they produce fewer jobs. Spain has extremely onerous labor union requirements and is further weighed down by a housing bubble that is estimated to be five times as bad as that in the U.S. In 2011, housing starts in Spain virtually disappeared and the stock of unsold units in Spain will take at least another four years to clear. To comprehend the size of the Spanish housing problem, imagine the U.S. with 15 million homes for sale. Spanish youth are staying in their parent’s homes well into their thirties and so new household formation, which supports housing prices, continues to decline.

If you walk away from your mortgage in Spain, your unpaid debts follow you. Spanish private citizen debt is three times the size of its government debt, which makes it hard for the government to change the nation's debt overhang. The Spanish government has promised the E.U. authorities that it will increase taxes and reduce spending in order to get the government deficit down to European Union standards. Whether this can be done, or partially done, remains to be seen as their economy is contracting.

There are limits to the ability of European Union's programs to solve basic conundrums of economies such as Spain's. The size of Spain's debt and economy makes the current European Central Bank's rescue fund look woefully inadequate. European governments have spent $1 trillion, half of that in December, 2011, to temporarily buoy up the market for government bonds and save their banks. It has worked, so far, with Europe's stock markets booming during the first quarter, but structural issues remain.

On a smaller scale, the situation in Portugal is unraveling fast. Greece has paved the way with their "voluntary restructuring" so private investors in Portuguese bonds have got to be prepared for the worst. If a country such as Portugal goes down the same path as Greece, private investors will again be forced to take partial payments on their bonds. If this happens in Portugal, Italy or Spain, these countries will not have access to public markets to fund their governments. They will become reliant on the E.U. and international agencies which are not large enough to alleviate an ongoing crisis. We are therefore pessimistic about the intermediate prospects for Europe. This does not mean that both stock and government bond markets will not continue to rally as long as central banks continue to create money out of thin air.

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

FEBRUARY, 2012: The world is awash in money. You and I may not be personally flush with cash but global central banks are swollen with new-fangled financial instruments more than the great Mississippi river gets after a Louisiana rainstorm. What we are experiencing so far in 2012 is coordinated action on the part of the world's bureaucrats to stabilize topsy turvy economies which threaten to spin out of control.

The world's stock markets are happily celebrating the flood of liquidity which has raised most prices to levels that portend happy times ahead. That is good for people who own stocks: long term investors who can stay the course through muddy waters. The almost inconceivable amount of financing that developed nations' bailouts have created, while allaying fears of widespread panic, has decimated the earning power of savers, retirees living on fixed pensions, insurance companies and bond holders.

Artificially low interest rates are one way that the financial powers that be are able to prop up unsound banks. Another is the shell game whereby problematic governments borrow from international institutions, who then deposit cheap funds into insolvents banks so that private bankers can turn around and buy more of their troubled government's bonds. This is a ruse to paper over the intractable problem that Western nations and Japan spend way more than what we produce. Deficit spending is a powerful way of stimulating an economy but it only works if interest payments on the debt can be made without creating a downward drag on a nation's productive capabilities.

Greece is obviously way past this point, bankrupt by all definitions except the utterance of its sentence. It will soon be under the boot heel of German dictates or else be reduced to waiting for the next olive harvest to trade for heating oil. Ireland, by virtue of its' government capitulating to the European Central Bank and agreeing to pay for the excesses of its banking system, is losing its skilled working age population through emigration to places like Australia. It is too late for the Irish and Greeks to change course. How they got here is a matter of debate: overly generous social programs, bad management, corruption, tax evasion, or some combination of the above. We have our own set of problems.

If the current political paralysis in Washington continues into the next administration and the financial floodgates of money creation remain open, then the "Reaganesque" hope that our domestic economy will somehow "grow" its way out of the hot water we are in will prove delusional. The most likely next economic event will be massive inflation. Inflation is historically the most common way governments get out of their self -generated addiction to chronic overspending. Other methods are war, default, devaluation or austerity. We are trying to debase our currency but so is everyone else so that option is ineffective. Austerity, like dieting, sounds feasible but nobody likes to do it for very long. War is not off the table but it is unpopular. Defaulting is embarrassing and, since investors around the world seem anxious to lend money to us and Germany at close to a zero percent return, what's the point?

One place that money is not going is into new loans for entrepreneurial activity. European banks are afraid to lend to each other or anyone else for that matter. US commercial banks are afraid of their regulators, who simultaneously want no (bad) risk taking but are under pressure to see taxpayer's money ignite some kind of economic rejuvenation. The political cowardly way out of our doldrums is to inflate without informing and that is what we are experiencing now.

When you hear about deflation (prices going down); think of the value of what you own: your house, salary, and interest earnings. Inflation (prices going up) is here in what we buy: movie tickets, medical care, education, and travel. Government statistics are intentionally skewed so that cost of living adjustments lag far behind actual inflation. The price of gold and gasoline are better reflectors of reality than any news release.

Our job is to protect client lifestyles (purchasing power) through this morass of difficulty. As investment strategists, we used to be able to buy good quality US bonds for income and market indexes, mutual funds or large solid companies for growth but now that doesn't cover the risks described above. Energy, income producing real estate, precious metals, and foreign country bonds all take more work to research, track and report upon but they seem essential in today's crazy world. Ben Bernanke, Chairman of the Federal Reserve Bank and arguably the most powerful central banker in the world knows that his actions are creating hardships on traditional investors. I suppose he figures there's no one else better able to bear the burden.

<u>MARCH, 2012:</u> This February, let's imagine a different way to celebrate Valentine's Day by solving our nation's debt problems. President Obama has again proposed a modest restructuring of mortgage debt for a narrow class of people; another tweaking of a broken system. The politics of election year posturing makes progress unlikely on this and most other fronts. Unless faced with imminent crisis, we seem unable to accomplish much in the way of change.

There is a radical but not historically untested way of solving several troublesome issues in one stroke. In the early 6th century B.C., the Greek leader Solon pulled Athens from the brink of economic collapse by forgiving the debts of everyone who had mortgaged their land and who subsequently had to sell themselves and their offspring into slavery. As a result of wiping the financial slate clean, the middle class got a fresh start, trade imbalances were righted, expatriated jobs came home, disenfranchised young people were trained for new industries, and a new order was established. The losses former lenders incurred were offset partially by an increase in their political power in society. This broke a logjam of decision making paralysis much like our own and akin to our own Federal Reserve Bank's flooding the world with money, Solon depreciated the debts of the wealthy by debasing the currency.

As a moderate, Solon refused to follow the wishes of the poor for redistribution of wealth in the form of land. He established a meritocracy that ignored the privileges of the nobly born aristocrats in favor of an annual census of assets and income on which representation in various decision making bodies was based. The repudiation of debts was carried far enough to allow native citizens to resume productive work but not so far as to do away with contract law. In fact, after Solon, the Athenians incorporated a pledge of fidelity to the rule of fiscal responsibilities in the same oath that they swore to defend their democracy. The system changed because under the old way, the power class had lost their ability to enforce contracts. This is exactly where our economy finds itself today in respect to many of its public obligations: health care, retirement, environmental preservation, and employment training to name but a few.

The size of our budget shortfalls and crushing projections of the not too distant future cannot possibly be taken care of by another technology led stock market boom or Reagan-era like period of deregulation. Europe's structural high unemployment will not go away ever under the current system. Corporations can fuel their growth in any number of ways but they are not looking out for the good of the commons. Governments and the banking industries they support are unable to generate economic growth which comes from and by the people.

In the Old Testament, Leviticus 25 states generally that every 50 years the land (and most forms of physical wealth) should be returned to the original owners and all debts forgiven. Both sale and lease prices were based on that fact. The Bible's authors were, like Solon, not immune to class distinctions, as the Levites were singled out to have their town homes returned to them while others were not. Allowing people a chance to start fresh with a clean slate may be the best way to jumpstart a real New Economy.

<u>APRIL, 2012:</u> Energy is one product that never goes out of style. With the world's population increasing and consumers in developing nations' increased wealth, it's hard to imagine how fuel prices can go down. Strangely, that's just what's happened with the price of natural gas, one of America's most abundant resources and a key to our independence from Middle East oil.

Natural gas is one of the cleanest burning fossil fuels around and it can be used not only to produce electricity but also to power motor vehicles. Part of the reason for the fall in prices over the last several years is the increased availability due to new drilling techniques, some of which are considered to be environmentally dangerous. Efforts to get companies to disclose the materials and methods of injection and disposal are underway and this will hopefully lessen the potential negative side effects of gas production.

There are different aspects to the natural gas industry, including pipelines, distribution, retail, exploration, liquefaction and shipping. Some of these operators pay very high dividends which make them an attractive investment alternative to bonds and traditional industrial stocks. Energy companies, in particular natural gas stocks, listen to a different drummer in that they go up and down somewhat independently of the rest of the market.

Investors have the choice of using individual companies, groups of companies that trade as "master limited partnerships", mutual funds or different kinds of indexes known as "exchange traded" funds (ETF) or notes (ETN). Take care when using these relatively new investment vehicles as they can swing wildly in price depending on market sentiment and the fickleness of private computerized trading firms. Being in an exchange traded funds does not mean that you own the actual natural gas itself because in reality, ETFs and ETNs are derivative contracts issued by a financial institution, similar to the mortgage backed notes that blew up in 2008-2009.

More and more, we see instances where ETFs and ETNs trading are under investigation by the regulatory authorities. ETFs and ETNs that are supposed to track the price of natural gas recently rode themselves way up and way down independent of the price of the actual commodity so you may want to find another way to participate in this or other sectors of the real economy.

People often ask me about investing in alternative energy as a complement or substitute for natural gas. The Wilderhill index for renewable clean energy, symbol PBW, was down 48% during the last year, down 32% over the last 3 years, and down 70% over the last 5 years. This ETF owns most of the solar, water, wind, and battery companies that are publicly traded. Why don't alternative energy companies make money for themselves and for investors?

For the most part, renewable energy firms are small and they face crushing competition from Chinese state supported companies. In addition, they need a lot of money to gear up, market and produce for the mass market and it is difficult for them to attract investors without government tax credit program support. While some entrepreneurs may have creative and exciting clean solutions based on renewable energy, only super large entities like GE, Siemens, electric utilities, major oil and car manufacturing companies have the clout to bring clean energy to the market.

Natural gas is a great local source of energy but it takes a huge investment in infrastructure to get it out of the ground and move it to consumers. A large proportion of this clean burning resource lays beneath public lands in the western US. State and local governments hope to use the proceeds from leasing land for gas exploration along with ongoing royalties from gas production to help out their citizens. Much of the benefit of the oil resources that graced our continent up until the 20th century ended up in private accounts. Given the gaping holes in our national accounts, shrinking availability of social services and educational budget woes, perhaps we can do things differently this time around.

<u>Personnel News</u>

Rob: While we endured another very cold but dry winter, indoor activities focused on beginning an end to the egg tempera installation currently ensconced in the studio behind the office. Visits from both daughters Robyn, 25, and Hannah, 23, were welcome respites. They both continue to thrive in the greater New York area. Upcoming outdoor events include the Jemez Mountain 50 miler, a 3 day Southern Colorado day only marathon to see how many 14,000 ft peaks can be summited, and a Fall sojourn to the Grand Canyon for a rim to rim run. Let me know if you'd like to participate!

Juliana: Juliana: In February, David and I had a great trip to Panama to do some birding, snorkeling and general relaxing. We saw 114 species~ I always love seeing toucans and parrots flying above me. But the highlight of the trip was staying at the Canopy Tower, a converted US military observation tower. At dawn, we climbed to the top of the tower to watch the morning canopy activity while sipping our coffee. Quite civilized!

Jeff: We have a new teenage driver in our household (that's a whole other scary subject in and of itself), and so my wife and I decided that we were ready to pass on the old family car and look for a newer car for ourselves. After much research, study and debate we decided that we wanted to look for a hybrid SUV. Our criteria included things we wanted like something a bit bigger but not too big, handle the snow in the winter, reasonable price and low miles. We did extensive searches on the internet and eventually found a vehicle that we both liked, a 2010 Ford Escape hybrid, at a dealership located near Dallas, TX. We contracted with a local mechanic to thoroughly inspect the car and take photos. That went well and so next we negotiated with the dealer and then arranged for the vehicle to be shipped to us in Santa Fe. The car arrived on schedule and we love it. We were very pleased with the whole process as all the arrangements were made by internet and phone.

Patricia: This Spring weather has been glorious for the gardeners. I am enjoying the beginning of gardening season by planting seeds and watching for the asparagus crop to emerge. One more gardening experience I have taken on this year is volunteering at a community garden in Albuquerque. Each participant gets a 30' row for $40 a year. It is interesting to see how each gardener sets up their row. I will be taking a road trip out to Prescott, Arizona this month to visit with a classmate in my Macrobiotics class. It seems that Macrobiotic folks are few and far between. I look forward to seeing you at the tea this quarter when the Holly Hocks are in bloom!

Emily: I have started to settle into my new house although I could use some inspiration for decorating. I am excited to see little things coming up in the garden and trees blooming. No big plans for the spring – lots of soccer – I'm taking a break from tennis this spring but playing soccer here in Santa Fe and in Albuquerque, a conference in Phoenix for continuing education and perhaps a weekend getaway.

LOCAL TEA & CONFERENCE 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 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, May 10,** 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.