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Spring Commentary 2013

The Markets

The first three months of 2013 delivered an unexpected boon to investors in the U.S. stock markets. The Dow Jones Industrial average rose 11.25% while the broader based Standard & Poor's 500 gained 10.03%. Technology stocks lagged slightly, returning 8.21%. The European markets were up slightly at 2.02%. Japan has been the biggest surprise so far this year, with the Nikkei Index rising 19.27% in local currency terms, but only gaining 9.92% for U.S. investors as the Japanese yen declined precipitously versus the U.S. Dollar.

The bond markets had mediocre results with U.S. corporate bonds returning a meager 0.18% on a total return basis which includes interest received plus appreciation. The municipal bond market produced about the same results, advancing .23%. While interest rates are still stable, many investors are getting anxious about when the Federal Reserve will end their bond buying program. This has prompted a huge influx of cash into the shorter end of the bond market where the Rikoon Group's portfolio has been focused for quite some time. Mutual fund investors are exiting bond funds and replacing them with stocks at a rapid rate.

Commodities posted their worst quarter in three years with the Dow Jones Commodity Index declining 1.1%. Weakening prices for commodities is generally a forward looking indicator that sluggish economic growth is on the way. Gold declined 4.78% while oil advanced 5.9%. One unexpected movement was a 20% increase in the price of natural gas.

The U.S. stock market has barreled ahead but not without creating a good deal of anxiety on the part of cautious investors who are trying to figure out when the Federal Reserve Bank will start to reduce its purchases of government debt. The Fed has essentially doubled its pace of bond buying from last year and has now been joined by the Bank of Japan, who joins the club of easy money central banks. The Bank of England, the Swiss National Bank and to some degree, the European Central Bank are all aligned with these policies so we see a torrent of cash coming into stock markets worldwide. One analyst wrote that there is a "TINA" factor at work, meaning "There Is No Alternative" to stocks, which is a fine state of affairs!

Suffice it to say that blind faith in central bank policies is not a time tested way of making money. When the Federal Reserve ends its easy money policies, if the economy is not strong enough to pick up the slack and replace the $85 billion a month now flowing from government coffers into the markets, a substantial obstacle to further stock market gains beckons.

Junk bonds, or below investment grade bonds, which offer yields of 5% or better, have performed very well due to investors ignoring risk in search of income. High yield bonds were the best performing category of fixed income during the 1st quarter of 2013, advancing 2.7%. They are now hitting their all-time highs, so our strategy is to anticipate a junk bond market decline once interest rates start to rise.

The current bull in stocks is a story where the fundamental performance of companies does not justify their current high prices. The market has gone way past anticipating what the economy is or

may realistically produce in the near future so it appears to be riding along atop the wave of the Fed's easy money policies. Corporate earnings growth is not robust enough to project future profits that would justify the current elevated market level.

As stocks benefit from easy money policies, the public is being drawn into the stock market. Many 401K and small investors who pulled out of the market in 2008 and 2009 are now buying and this could supply the needed momentum for the market to rise so long as interest rates do not go up. Even as most generalized indexes have hit new highs, the Dow Jones Transportation average has not. This is a traditional sign that something is amiss. Transportation companies, like Fed Ex, are good indicators of the future level of consumer spending so this is a cautionary sign.

Real estate markets have firmed up, with home prices appreciating in much of the United States. Prices rose by 8% in January, 2013 from a year earlier; the largest gain in over 6 years. The twenty largest U.S. urban areas all posted annual price increases, due to robust housing demand, while the number of homes actually for sale is going down.

Ultra-low mortgage rates are helping some owners qualify for larger mortgages without increasing their monthly payments. Another important development is the supply shortages in new or almost new homes. There are several reasons for this, the first being that many homeowners who are underwater are unwilling to sell at prices that remain far below where they bought. Homebuilders, typically able to anticipate and plan for an increase in demand by building more new homes, have added little new inventory so far in this "recovery" since they were burned 5 years ago. Finally, a growing number of home purchases are being made by institutional investors who are looking for rental properties. Several of the largest hedge funds in the U.S. are now the biggest owners of single family houses in the U.S.

Professional investors have picked up foreclosed or other distressed properties en masse in order to rent them out. Rental rates are rising in many markets, more so than most consumers' incomes, so low and middle families are getting squeezed out of the market by these institutional investors. Phoenix, Las Vegas, Atlanta, Florida and California are the markets where residential prices dropped most in the late 2000s and now they are the places where price and rental rate increases are the greatest.

The Economy

Reports out of the labor markets have been relatively good with employers across the United States hiring more. Despite some increase in hiring, only 14% of the U.S.'s largest metropolitan areas have more jobs now than they did five years ago. Of those fourteen markets, six are in Texas and hiring there is due primarily to increased activity in the oil and gas industry. Jobs in Washington D.C. and Charleston, SC have increased due to the military and government service sectors while growing health care expenditures and university jobs have helped towns such as Salt Lake, Pittsburgh, and Knoxville. Take note that manufacturing jobs are not on the reason behind recent employment gains.

Nationally, there are now 3 million fewer jobs than when employment levels peaked in early 2008. While industrial production has grown twice as fast as the U.S. economy as a whole, the actual size of the manufacturing industry labor force has not increased. While some new factories have been opening, the number of closing factories dwarfs those opening so the net number of manufacturing sites is still going down. Manufacturers have added approximately 500,000 jobs to the economy since early 2010 but 5.7 million factory jobs were lost from 2000 – 2010 so now there are 5 million less jobs in manufacturing than there were thirteen years ago.

Manufacturers are also importing more of their component parts and selling less finished goods overseas. This is shown in our widening trade deficit. The difficult part for manufacturers to stomach about opening new factories and creating new jobs in the U.S. are rising health care costs and complex regulations that make it costly to establish or expand operations here. Manufacturing was one of the first industries to experience a rebound in activity after the financial meltdown because it was greatly aided by the weak U.S. dollar policy of the first Obama administration.

In a similar fashion, other countries are also devaluing their currencies in order to aid domestic manufacturers. Japan, headed by a new central bank leader, is aggressively moving to devalue the yen to make Japanese manufactured goods more attractive. This same policy is being followed by Russia, China, and to some smaller degree, by the European Union.

Strategy

Dispassionately observing the stock market's record levels, we see several long term trends which are sobering. American households lost approximately $5 trillion in the stock market crash at the end of the dotcom era of the late 1990's, followed by a $7 trillion loss of value in the 2007 real estate crash. The tech bubble and the housing bubble are now being followed by what we call the government credit bubble.

The Federal Reserve has increased the size of its debt six-fold over the last 12 years. During the same time, economic output has grown by only 1.7% a year, which is the slowest rate of expansion since the Civil War. Working families have seen their real income drop by close to 10% and the number of people with full time jobs, earning decent salaries has declined by 5 million. We are engaged in a great experiment, bailing out first the stock and then the real estate market with government money. This has created approximately $30 trillion in money that will probably never be paid back. The Fed's easy money policy has enabled the stock market to reach new highs and stabilized some real estate prices. It has not set off inflation because the price for goods and labor has not gone up due to competition from cheap Asian imports and an increasing supply of job seekers.

About half of our nation's debt is held by other nation's central banks. This means that we have little leverage over their currency or trade policies while they have some say over ours. The monumental increase in government debt has been matched by an explosion in the size of the mega-banks, who have the same amount of capital as they did in 2000 but now are three times their former size.

The Fed has promised to keep interest rates down as long as unemployment is over 6.5% or inflation is under 2.5%. It is likely that these statistics, generated by the government, can be kept within these levels for as long as the government wants. We are in uncharted territory as there has never been a time when most of the world's central banks have been extended simultaneously so as to maintain political and consumer sentiment stability. We do not know what the precipitating factor will be for a change, how quickly the change will occur, or what asset classes will perform well when the government credit bubble bursts.

Our strategy to deal with the sword of Damocles hanging over the stock market is to diversify into energy, precious metals, international corporations with strong balance sheets and high dividend flows, and to look for private income producing opportunities. None of these are easy to find so, in the meanwhile, cash and ultra-short bond funds are our preferred vehicles.

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

“Economic Behaviorism”: Being neither Democrat nor Republican, libertarian or conservative, I consider myself a utilitarian, believe that economics trumps politics and that dollars drive most decisions. This is not to say that money is the most important factor in everything but, when it comes to things of this world, people make decisions first and foremost with their pocketbooks in mind.

We can apply this concept to some seemingly intractable problems that exist in society, such as drunk driving or even human trafficking. My proposition is that if we can find some simple, direct and effective financial levers to utilize, it is possible to change attitudes that contribute to the problem. People’s behaviors do change and the world can be a better place through the proper application of money consequences for egregious “anti-social” actions.

Money would impact people’s driving decisions if we make it a fiscal disaster for persons to be caught driving under the influence of alcohol or drugs. While organizations such as Mothers Against Drunk Driving have been effective lobbyists for stiffer legal penalties, these measures have had a fairly limited impact on habitual drunk drivers who continue to get their hands on vehicles that lack physical safeguards such as Breathalyzers.

If drivers register a level of alcohol above an acceptable level, not only should they be immediately penalized by losing their driving privileges, they should lose their vehicles. People can and do drive without licenses. If someone knowingly lends a drunk driver their car, they too should be at financial risk of losing their property.

By establishing a set of intractable procedures under which any serious offense, by a first time or habitual offender automatically, on the spot, loses the use of their vehicles, the incidence of DWIs would go down dramatically. Some police departments are authorized to seize vehicles, impound and then sell them after prior convictions. This is far too lenient a policy to be an effective deterrent. Illegal and dangerous activity that is a direct and ever present threat to innocent people’s lives calls for stronger action. Persons will be tempted to fall into the same behavior need to know that they will lose their vehicles and perhaps other property too upon the first offense.

Drunk drivers could also face the economic burden of wage garnishment, in much the same way that delinquent child support payments are handled. Liens could be filed against offender’s real estate property, if the value of their vehicles or wages is insufficient to reimburse the victims of their offense. Another economic consequence of breaking DWI laws would be to charge offenders with an ongoing obligation to fund future anti-drunk driving enforcement services.

The same concept of implementing economic penalties to affect social behavior could be applied in places where women and children are pressed into bondage. The slave trade is a persistent and ingrained societal ill in many places around the world, not just India, which is currently embroiled in a national soul searching of its traditional tolerance towards abuse of young women. Females are sold into slavery to middle and upper-class households, who should feel the sting of acute financial penalties. This would change the public’s generally complacent attitudes regarding these heinous activities.

For example, families that commission harbor or accept involuntary service from women, once turned in to the police, would have to pay substantial financial remuneration to the persons taking the initiative to report abusive situations. Proceeds from the seizure and sale of residences or businesses that are physically housing abducted persons would provide restitution (not that money alone would suffice) and also fund future efforts to achieve a stated goal of putting an end to this ill.

Graft often stands in the way of implementing these kinds of changes. Once the public is aware of the monetary rewards associated with participating in uncovering and prosecuting people who participate in the slave trade, anyone found impeding enforcement would suffer some economic burden as well as the traffickers. The public sale of offending family properties would serve as a social stigma and provide funding for further enforcement. Once word gets out that informants are well-paid, the complacency that allows these kinds of practices to go on would be rapidly undermined by monetary consequences.

If people can agree that some behaviors are unacceptable, it is not hard to imagine financial methods by which people who create these situations are punished. If we want to end drunk driving and human trafficking, why not make the monetary damages immediate, substantial and inescapable?

These policy suggestions may be unacceptable to people who argue that everyone makes mistakes and why punish someone drastically for what is perhaps only a temporary lapse in good sense. The point is that money talks and people listen when their personal property is at stake. When we collectively decide what kind of destructive actions are unacceptable, we will gain the upper hand on those motivated by their private selfish desires. Having them bear the cost to boot strap the change is key.

“Let’s Get The Tax Code Right To Create Economic Growth”: Our current budgetary impasse involves two issues: taxation and spending. The inability of Congress to agree on a direction of the country is reflected in the Byzantine character of our current tax code. As a result, the United States is falling further behind other developed and even emerging market nations in attracting new business, creating jobs, and being able to adequately gear up for a challenging future.

Everyone realizes we need to pay taxes in order to raise money for common national and local goals such as public safety, schools, etc. For the last 40 years, however, this goal has been overwhelmed by an unwieldy mass of tax legislation generated to further whatever the politically dominant social policy is at the time. Since political views are so mercurial, it is ridiculous to try to legislate and implement long term national strategy through tax policy.

The debate about how much money should be spent on what programs is a wholly different matter than how we should raise the money needed to operate the country. Our overly complex tax code allows lobbyists to insert themselves in the process to get their way without the general public being made aware of what social and economic priorities are being promulgated by these narrowly focused special interest groups.

The amount of wasted time and effort expended to comply with a tax code that even experts have difficulty understanding is estimated to cost in the tens of billions of dollars annually. An even worse consequence is the perverse and unproductive business decisions that many people make in an effort to escape the tax code’s reach. Some high income individuals change their residential location for tax advantages and corporations avoid taxes by keeping their profits overseas. There is no reason why money that's kept offshore should be taxed differently than money earned or kept in the United States.

Some people decide what and when to make major purchases based on tax considerations and many new jobs are part time or outsourced because of the tax burden associated with having regular career employees. The misallocation of resources in our country that happens through people’s understandable efforts to comply with or get around the tax code could be reversed by a drastic reduction in the number and scope of the tax rules along with an enormous simplification of

how it is implemented. For example, a simple tax structure that doesn't provide for any deductions or credits would make people decide what to do with their money solely based on the merits of the proposition. Tax rates could still be progressive, in the sense that people and companies would still pay higher rates as their earning levels go up.

There are many entrenched beneficiaries of the current tax code who will howl at the suggestion that there be no further breaks for having a mortgage or giving money to charities. I believe that the markets, including the real estate, stock and job market, would all be greatly enhanced by the free flow of money when tax avoidance is no longer a prime motivating factor. Non-profit organizations, who now market donations to their organizations as a means of avoiding taxes, would do as well or better when they are supported by individuals and companies who can make decisions about what to do with their money completely independent of tax formulas.

Other suggestions are to do away with deductions for contributions into retirement plans, for taxes paid, and that there be no tax credits given for spending money in any way. People who can afford to save for retirement should not have any special benefits over those who cannot as it only serves to widen that divide. Why should certain pieces of equipment or business activities be paid for by the general public? This is essentially the net effect of tax credits and deductions.

People should spend their money based on the direct benefits they receive and will do so if taxes are dropped from the deliberation process. There is a simple way to administer a fair tax system that promotes growth. Set a level of taxation on all business and personal income (be careful not to tax the same money twice) and then free people up so they can make economic decisions based on bettering their own futures. A tremendous amount of long term thinking will come into play, unsullied by silly tax rules.

Tax rates should be at a level, for individuals and for companies, which produces the amount of revenue that we decide as a country to spend. Everyone, no matter whether they are young or old, single or married, should pay at the same rate. Capital gains, interest income, salaries, carried interest, rents, royalties; any kind of income at all should be taxed in the same fashion, no matter what its source.

Companies should be taxed the same no matter how or where they are organized, or what business they are in. Energy companies do not deserve special income tax breaks because we, the people, should not have to support oil drillers or, for that matter, alternative energy companies. If a company can't make it on its own, they should find something else to do or team up with another partner who has capital to invest for growth. The system proposed here is neither based on debt nor reliant on tweaking the law every two years.

If citizens want the government to raise additional revenue, without an ongoing national televised spectacle that wastes valuable time and effort on endless arcane debates, we can simply adjust the tax rates to whatever level are needed without redoing what should be a fair and simple system. Let's move the tax code out of the political arena and into that of sensible economics.

"From Shirtsleeves To Shirtsleeves In Three Generations": The second part of our national debt dilemma is government spending. In many of our own lives and most of America's well managed companies, we have had to downsize and make choices about where and when to spend our hard earned cash. Studies show that American families and businesses are well into a long term trend of deleveraging, i.e., reducing debt levels. The question remains, how can we get government to take the same kind of difficult step and just say "No" to non-essential expenditures? This is where our political system falls short.

At the present time, Congress is deadlocked, unable to come up with a long term plan to solve the nation's runaway spending problem. The problem is on both sides of the aisle. Everyone involved acknowledges the need to spend less but there seems to be no politically acceptable way to consciously downsize the number or size of government programs.

Take spending on medical care, which consumes 26% of America's gross national product. A March 4, 2013 article in Time magazine by Steven Brill, titled "Bitter Pill: Why Medical Bills Are Killing Us" pinpoints hospitals, labs, drug companies, medical device makers and insurance charge masters as the source of the problem of runway spending on healthcare. Obamacare, while achieving some worthy social goals, does nothing to address the fundamental out of control spending dictated by the structure of America's current medical system. How do we say "no "to the exorbitant prices levied by companies for products deemed essential to health?

Gridlock in Washington over the last two years on making decisions has resulted in across the board cuts to Federal spending, which is not going to bring the budget deficit under control since the debt ceiling was just raised again to avoid a government shutdown. It also does not set the stage for an honest discussion of who is going to suffer the effects of the inevitable hard choices that need to be made. We know that an increase in the retirement ages along with an across the board reduction in benefits and services to most Americans are necessary steps. Once we are informed of the truth, we can adjust and move ahead with the business of trying to grow the economy.

Interestingly enough, it has made no difference to the markets how much debt we have taken on as a nation because investors worldwide continue to flock to the US to invest their capital in our stocks, bonds, and real estate. Assets on paper have increased in value, which has helped buoy investor confidence, but young people trying to deal with the uncertainty of their financial futures are increasingly putting off starting families or buying homes. This is only part of the price we are beginning to pay for our collective cowardice.

Another consequence of our country's inability to deal with it's out of control spending is the prospect that most people working now will not be able to afford to retire, ever. Older people are taking on more debt while younger people, faced with increasingly more difficult student loans to pay off, have to take lower wage paying jobs because Baby Boomers cannot afford to retire.

As a nation, we continue to spend money that we don't have. Under the present regime, we act like we can simultaneously fix our highways and utility infrastructure, fund public health and education, pay those lucky enough to already have retired their full pensions and maintain an effective military presence. Continuing on this path means mortgaging the nation's future to our creditors, whoever they may be.

As with our personal spending, common sense dictates that we raise the revenues needed to meet government spending levels for essential services and reduce everything else. What is essential and how does this happen? We start a comprehensive public debate that results in a binding, long term plan to specify who is going to get what amount of support from the public coiffeurs. Poor people usually bear the brunt of the pain when the government cuts spending and this is not right. Wealthy individuals, highly paid government officials including members of Congress, and youthful retirees from all forms of government jobs at all levels, including the military, need to give up some of their non-essential benefits. Government subsidies of all kinds can be curtailed as the business of deciding winners and losers in business should not rest in bureaucratic hands.

The "shirtsleeves to shirtsleeves in three generations" saying usually applies to individuals. It means that people who are lucky, smart or industrious can make a great deal of money but their

children, who struggle to preserve that money, and their grandchildren, who end up with far less than their parents or grandparents, are somehow incapacitated by their inheritances. National fortunes, created by favorable geography, ample natural resources and hardworking citizenry, can similarly be squandered.

Maybe technological breakthroughs in medicine, energy or agriculture will obviate the need to tighten our collective belts but I doubt it. The character of a nation is built upon its willingness to sacrifice, a term often used in connection with military efforts but equally relevant today to our fiscal behavior. I hope that we can talk about these issues and decide collectively to share the pain of downsizing in time to help the many species and ecosystems that presently suffer under the weight of our excesses. We do have the ability to change course, as individuals, families and as a country. It's up to those who are most fortunate to bear the greatest share of the burden.

Personnel News

Rob: My children are now split on the East and West coasts. Hannah, 24, is working on the Frey family organic vineyards outside of Ukiah, CA in Mendocino County and attending a series of weekend courses in local plant based medicines (only legal ones). Robyn, 27, recently appeared on NBC's "Law & Order- SVU", as a woman pressed into the slave trade who accused one of the stars on this TV cop show of sexual assault. The episode is called "Undercover Blue". As for myself, it's all work in the office, studio and then outside. It's all good!

Juliana: I saw my first turkey vulture of the year just the other day so spring must be here, along with the wind and dryness. I am off to New Orleans for Jazzfest in early May and I find myself looking forward to the humidity, something we southerners don't usually miss.

Jeff: This past January, I took a big fall when snow skiing and I did a very good job of injuring my wrists and shoulders. So I have been introduced to the world of physical therapy which is humbling and slow. I have had to put my guitar playing and studies on hold until my wrists heal some more. Hopefully I can go back to that in another month or so.

Patricia: Happy Spring! The bird, rabbit and gopher activity around here signals the arrival of spring. Since the short retreat I was on in February, it seems down to the business of house maintenance and now some exterior painting while the weather is still cool. Also on the agenda was reroofing my house which has to be the most expensive, unexciting home expenditure there is, so I spend time up on the ladder just admiring the newness of it. If it rains, I am ready. However, I do have some exciting events this fall….but more on that next time.

Emily: The winter flew by and I'm happy about the increasingly warmer spring weather. I've been unable to play tennis or soccer due to a knee injury but it is improving and I hope to be out there again in a few weeks. As a board member for the Santa Fe Adult Soccer League, I was able to keep busy this winter, implementing a new website for the club and working out the many kinks that have gone along with it.

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 15, 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 16,** our quarterly telephone conference call will take place **at 3:30 p.m. MST**. The call-in number is: 626.677.3000 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.