**RIKOON-CARRET INVESTMENT ADVISORS**℠
510 Don Gaspar
Santa Fe, NM 87505-2626

Telephone: (505) 989-3581
Fax: (505) 983-8086

# Commentary
## Summer 2003

## Market Performance

The stock market's red-hot spring rally left the Dow Jones Industrial average up 7.7 % for the first half of the year. It was the first time in four years that this average of the thirty largest industrial companies has finished the first six months with a gain. Rikoon-Carret's stock portfolios gained 8.51% during the first six months. The broader S&P 500 index that includes technology and a wider diversity of companies gained 10.76%. Stocks seem to be drifting sideways now after hitting a peak on June 17th. Investors are relieved that the worst seems to be over.

In the international markets, the Dow Jones European Stock Index that includes the fifty largest companies in Western Europe gained 1.39% during the first six months while Rikoon-Carret's international portfolios gained 4.91%. The big question for all stocks remains whether increased, sustainable profitability is around the corner or whether continued anemic global economic conditions will prevail.

In the bond market, corporate bonds continued to gain with low interest rates. The taxable bond market gained 3.91% during the first half while Rikoon-Carret's taxable bond portfolios gained 4.0%. Municipal bonds, with new competition created by the exclusion from tax of some corporate dividends, gained only 1.1%, while Rikoon-Carret's municipal portfolios gained 2.1%.

## The Economy and Politics

Much of this commentary will be devoted to looking at whether the Bush Administration and the Federal Reserve will succeed in their efforts to stimulate the economy. Many intelligent observers of the economy have increasing concerns regarding deflation, which can be described as widespread economic contraction, with rising unemployment.
The question paramount for business leaders is "does deflation, or falling prices represent a greater threat than inflation?" The Federal Reserve Bank clearly thinks so. And this is why interest rates are at their lowest level in 50 years.

The US economy is based on consumer spending and this has so far staved off deflation.

The US government sees its job as one of stimulating our population's consumptive patterns. We are preeminent in marketing. Through exporting our brand of entertainment worldwide we lead the world towards growth at any cost.

Unfortunately, none of our traditional business strengths work well against deflation, as deflation reflects a lack of confidence in the future. Should we or should we not have confidence in the future?

Recent reports show that the US economy has lost over 2 million jobs since 2001, the year of President George W. Bush's first tax reform. The 2003 tax act is supposed to create jobs but it is hard to see how this will happen. We import so many of our basic consumer goods from overseas, and we depend so much on foreign capital to support our budget deficits, it is unlikely that the money being given to wealthy investors will be funneled back into new business investments. There are 10 million people looking for work today in this country, in all regions, and in all professions.

Deflation, if it were merely a reduction in prices, would not be of great concern except that it also means that it is harder for people to earn money. Deflation is particularly hard on people who have debt because each dollar of earnings, be they from profits or wages, becomes harder to obtain. In inflationary times, it makes sense to borrow money because, as prices go up, there is more money to pay off one's debts with successively "cheaper" dollars. In the midst of a deflationary contraction, wages go down and jobs become scarcer. Debt and deflation do not mix well.

Our nation is mired in debt. This is one reason the administration is doing everything it can to prevent deflation. Some tactics being used are: lowering interest rates, increasing government spending, cutting taxes, printing money, and government purchases of bonds in the open market. Will it work? Stay tuned!

Here at Rikoon-Carret, we have been considering what kind of investment strategy does well in deflationary times. The first and easiest step would be to pay off debts. Positive cash flow is the key to thriving during deflation. Real dollars purchasing real goods do well when assets purchased at bargain prices start to appreciate in value. Bonds have done well as interest rates have fallen, though at today's very low interest rate levels, new long-term bonds are not advisable.

Quality medical services, education, and professional services may not be subject to the same deflationary pressures as we see in the price of clothing and consumer electronic devices mass-produced in Asia.

How does the stock market perform during deflationary times? The price of financial assets and real estate assets both tend to fall during long periods of deflation. Assets that throw off a steady source of income are the most valuable. Dividend paying stocks, income producing real estate or real estate contracts with ample collateral are efficient investments during long periods of economic contractions. Most companies lose their ability to raise prices, which negatively affects their profits.

Expense control becomes key. The U.S. government wants to stimulate economic activity, which may portend higher national debt levels at the same time their revenue is declining. We are worried!

Deflation creates opportunities for economic power to migrate from one nation to another. China, along with other Pacific Rim nations has large numbers of highly motivated, technically educated, hard working and saving oriented people. Deflation hurts these countries ability to export to the US. China has amassed huge reserves of foreign capital due to their excessive productive capacity and low consumptive patterns however; their ability to wield this power on a global scale has not yet been exercised.

The best medicine for deflation is real economic activity and this is the stated goal for recent trade agreements and tax cuts. Traditional American values, such as frugality, self-reliance and trading with one's neighbors, also would help us deal with deflation.

People who lived through the 1930's remember them as hard, but they also say the friendships and sense of community created by pulling together to deal with deflation was a rewarding, personal experience.

With military events fading from the daily news, many Americans are shifting their focus back towards the markets. Stocks experienced a rally during the 2$^{nd}$ quarter, fueled by significantly lower oil prices. If the strong upswing is a vote that the war on terrorism is over, then the rally will likely fade at the first sign of renewed systemic violence.

The crisis of public confidence in the markets engendered by corporate scandals, plummeting technology prices, and veiled nuclear threats by countries such as India, Pakistan, North Korea, and the U.S could be behind us. The markets need to have a lasting general sense of confidence in the future in order for investors to return to stocks for the long-term. What we have seen is pension funds rushing to fill up on stocks so as to not be out of line with their mandated alterations.

If deflation does not materialize, we face severe long-term inflationary pressures. Any investment that promises a fixed rate of return, especially over an extended period of time, places at risk one's ability to adjust to higher prices in the future. In an uncertain world, the only sensible refuge is diversification.

If interest rates rise, which we think is likely, investors who have locked in low rates are sure to experience regret at buying long-term investments when rates were at or near their low points.

It is possible to protect an income portfolio's value by using "stop losses." One can install standing instructions to automatically sell if an investment's price goes below a certain level. We are now continuously monitoring the target level at which holdings should be sold, and are adjusting and renewing stop losses on a regular basis.

When the U.S. economy starts to exhibit signs of strength, short-term interest rates will likely rise. Other factors that could upset the markets are the U.S. dollar, in which most people in our country have all their savings, continues its decline versus the European currency. This is not an esoteric matter as it directly affects our standard of living.

If the U.S. dollar falls appreciably versus other currencies, it takes more dollars to service the same amount of debt. This is not unlike a reduction in one's credit rating. The worse one's credit rating, the more one has to pay to gain access to funds. So, we are walking on a tightrope between fearing deflation and being hurt by inflation.

It is possible that Iraqi oil could now grease the wheels of market commerce, strengthening the U.S. dollar for some time to come. Our deficits, along with those of Europe, will likely balloon due to the continued economic downturn, increased spending on military arms and security, along with new tax cuts.

Market volatility is a fact of life that is here to stay and should not be a cause for concern. The issue now is deciding if we are in a bear market rally, a temporary rise inside a flat or down long-term trend or in a new bull market.

Many people are ready to believe that the train is leaving the station but a word of caution is necessary. As I wrote earlier, central to a Bull Market is a growing economy.
We believe that it is much more likely that we are in a Bear Market rally, which is a time period when stock indexes move up strongly - often well over 20% - only to later resume their downward march.

Let's look at some basic economic facts: Oil prices are down but not down very much and are still high; Consumers are spending, but only at static levels; Business investment in equipment and technology has not yet reignited to the point where a sustained increase in factory utilization looks likely. The biggest issue, though, is employment. The U.S. economy continues to lose 80,000 jobs a month.

A telling sign for stock market forecasters is whether corporate insiders are buying or selling their own company's stock. This past May, insider selling hit a 2-year high as business executives sought to cash in their stock. This is not a good sign! The bottom line is that corporate profits are going to have to turn up in order to justify people putting money into the stock market.

On a sustained basis, rising stock prices require rising price earnings ratios. The price earnings ratio of the market as a whole is estimated to be between 25 and 32 times earnings. This compares unfavorably with the historical average, which is around 15. In other words, the stock market still looks about twice as expensive as it has been, on average, over the last 70 years.

If the economy continues to exhibit lackluster strength, especially in terms of business spending, then even the low interest rates being promulgated by the Federal Reserve Bank will not help people plunk down money for stocks. In the event that we do not experience a high degree of growth, the borrowing needs of the Federal Government, which is running approximately 400 billion dollars per year, will grow, creating further economic dislocation.

Some very intelligent people have made a good case that the stock market bubble of the late 1990's has been transferred over to real estate and that it, along with bonds, will eventually experience a bust. The Federal Reserve, by setting interest rates low, provided the liquidity necessary for the extraordinary prices paid for stocks up through 2000. Because of the fears that emerged after September 11th, and in order to continuously encourage American consumers to spend, interest rates have been kept low. The hope has been that we will grow our way out of the asset bubbles created by all this extra cash.

The Fed has come out and said in public that it won't raise interest rates because it wants people to spend money. Whether consumers spend money on real goods or buy stocks, bonds, or real estate, doesn't really matter. People in high places realize that if people stop spending money, the economy will grind to a politically unacceptable level.

Statistically speaking, strong positive gains in stocks have never been sustained without rising price earnings ratios, and this has only occurred when the time period of investing starts out with the market at a low ratio. We are currently in a period of high relative P/E ratios so it is likely that the next two decades will see declining, as opposed to rising, ratios. If this is true, the long-term trend in overall equities will continue to be downwards until the P/E ratios come down to more reasonable levels, or until corporate profits go up and stay up! We had some awesome years of high returns in the stock market in the1990's. Anyone who expects a repeat of that performance this decade is likely to be disappointed.

## Personnel Financial Planning

Juliana Henderson

We have some exciting developments on the client service side of Rikoon-Carret. Our web site, www.Rikooncarret.com, is up and running! We are quite pleased with the results and hope that our clients will discover that it provides a convenient way to view their portfolios. It has taken us a little while to get up to speed on the mechanics of the actual web site but now that we have reached a place where it is safe, secure, reliable and easy to use, we are ready to encourage everyone to try it. The procedure is very easy and clients can log on through a secure sign-in and view all their accounts, either individually or as combined family or individual portfolios. The latest industry research, business news, economic commentary and stock quotes are also present so that users can learn more about individual investments in their portfolios.

Please stop by, call or email me and I will be happy to walk you through the learning process.

Jeff Sand

It is beneficial to periodically review one's various insurance policies to determine if they are still adequate, or if they need to be changed or sometimes even eliminated.  We have an insurance policy review program to assist you to ensure that your goals and coverage are still aligned.

Our lives are constantly changing and each change can affect our financial situation. However, during these times of change, we often don't have the time to evaluate the effects on our insurance programs.  A variety of factors may influence the effectiveness of our insurance coverage such as changes in family, career, retirement, lifestyle, health, assets, debt load, inheritance, charitable gifting, estate and tax considerations.

Insurance can be thought of as one way to help ensure that premature personal loss is not compounded by financial loss.  Effective policy reviews on a regular basis can help make sure that the right intentions are carried out with a minimum of cost.

Part of the services available to our clients is that we are able to review your life, disability, long-term care and annuity contracts.  Please call me if you would like to make sure that your insurance objectives are still being met by your current coverages.

Stephen Madeyski

After the stock market plunge of the last three years, many people largely ignored their company retirement plans.  The most common type of retirement plans include the 401(k), 403(b), 457, SARSEP, Profit Sharing Plans and SEP IRA's.  Even under the new tax law, there are still many benefits to consider funding these plans.

First of all, salary deductions for qualified retirement plans come out of pre-taxable income, so your effective taxable income is reduced by your contribution.  Paying less tax is always a good thing!

Some employees are fortunate enough to have their employer match some of their contributions – this is the best deal that you can get, as it is basically free money.  If you are not able to contribute the maximum allowable amount to your retirement plan, deduct at least the minimum to get the company match!

The third reason to contribute as much as possible to retirement plans is because the money is able to grow tax-deferred until you retire.

As there are serious financial penalties for early withdrawals, it is best to let the money grow, and psychologically, since it is money you don't think of as yours, right now, it usually doesn't get spent and helps you save for retirement.

When you change employers, make sure you roll your current plan over into an IRA account. We can help with that so let us know when the occasion arises.

Rebalancing your plan among asset classes is very important. The large decline in the stock market has reduced the percentage of equities in many retirement accounts, so it is a good idea to rebalance the portfolio at least semi-annually to ensure you have an allocation that best suits your investment objectives.

For the self-employed people, there are a host of different types of retirement plans available. Please call me and I will be glad to help you consult with your Accountant or Tax Professional to guide you towards the best plan.

The IRA (Individual Retirement Account) should not be forgotten. In the lower income tax brackets, your entire annual contribution may be tax-deductible, but even if it is not, contributions are tax-deferred like company plans. At higher income levels, contribution amounts are phased out.

Here is a short list of the annual Benefit Limits for 2003:

| | |
|---|---|
| 401(k), 403(b), 457, SARSEP<br>(Catch-up Contribution if over 50 years old) | $12,000<br>(+$2,000) |
| IRA or Roth IRA<br>(Catch-up) | $3,000<br>(+$500) |
| Defined Benefit Plans (most advantageous for Self-Employed) | $40,000 |

## Staff News

The past several months have held some exciting events for the employees at Rikoon-Carret. Juliana Henderson and her husband attended the Highland Games, a reunion for people of Scottish decent. It is difficult, but not impossible, to imagine Juliana’s husband, David, in a kilt, in which we are told he regaled the crowd.

Beth Humphreys discovered a local reading group focusing on the works of James Joyce. This author was the subject of Beth’s Master of Arts dissertation at St. John’s College when she completed the graduate program in Western Philosophy. Jeff Sand has completed his certification in several areas of insurance, notably medical, health, annuities, and long-term care.

Wendy Havlir recently returned from Bali, where she visited her boyfriend who currently works in Micronesia, assisting their government to rewrite the constitution and prepare the national budget. Wendy will be volunteering in an archaeological dig that will be taking place at the Palace of the Governors in downtown Santa Fe. According to Wendy’s sources, this could be the most significant exploration for historical artifacts around Santa Fe in the last 200 years!

Patricia Cody has improved the quality of life here at Rikoon-Carret by starting a small vegetable patch in our patio area. She has raised lettuce and tomatoes and all visitors here admire the flowers and plantings in our front yard, all evidence of Patricia's handiwork.

Stephen Madeyski has completed four of five sections of the Certified Financial Planning program: Insurance, Retirement Planning, Tax Analysis, and Investments. Some time this fall, Stephen will complete his formal course of study with the Trust and Estates module.

The big news in Rob's life is that his two daughters, Robyn, 17, and Hannah, 14, have both been accepted at extraordinary educational institutions located in North Carolina. Robyn will be attending the North Carolina School for the Arts, in a nationally acclaimed senior year-only performing arts program. Hannah will be attending the Asheville School, founded in 1900, which has a concentration in the Classics. Hannah's volleyball team participated in the National Junior Olympic Championship Tournament in Atlanta in late June where her team had a great experience. Rob will be visiting the family in North Carolina frequently and Deb and he have set up a small office there so that Rob can work just as hard while visiting his family as he does at home.

## Events

Our next Quarterly Tea will be held at 510 Don Gaspar on Thursday, August 28th at 3:00 pm. The last meeting was a great success with some exciting interchanges between participants and staff. As always, we invite you to bring any friends you feel may be interested in this lively discussion of the markets, the economy, and geopolitics.

It has been extremely hot and dry during the last several weeks and we are looking forward to the seasonal monsoons, which we hope begin soon. We send our best wishes to all of our readers for a rejuvenating summer!