The Rikoon Group
2218 Old Arroyo Chamiso
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Summer Commentary 2008

Overview

In this quarterly discussion, we will look at some of the reasons why fear has taken hold in the financial markets and probe whether the general anxiety which pervades the market has a basis in reality. The ongoing free fall of prices in banking and real estate related assets understandably makes most investors nervous. Reports of runaway price inflation and negative consumer sentiments abound. What is an investor to do?

The Markets

The first six months of 2008 were extremely challenging for most stock markets around the world. The familiar Standard & Poor's 500 index of large U.S. companies lost 12.83% while the narrower Dow Jones Industrial Average of 30 companies lost 14.4%. The technology laden NASDAQ Index gave up 13.55%.

The same retraction occurred internationally but in even greater magnitude. In China, stocks were down 21% during the second quarter alone, and for the first half of 2008, its market declined 48%. Can you imagine how the masses of brand new investors feel there? India has had a 33.6% decline so far in 2008. In local currency, Germany was down 20.6% while France declined 21%.

There were bright spots in the international markets. Canada, our commodity rich neighbor, has risen 4.6% since the first of the year, and Brazil gained 2% due to its success in stabilizing inflation and the strength of its raw material export industries.

The Rikoon Group's stock portfolios' performance outpaced their relevant indexes by a considerable margin.***** Our large U.S. stock portfolios declined 7.7% versus the Standard & Poor's 500 decline of 12.8% while overall, client international equities declined 10.65% versus the global market's plunge of 12.7% and Europe's decline of 17.62%.

*****These numbers represent the core direction of our management strategies. Individual portfolios are managed in accordance with clients' performance numbers reported above.

The composite portfolio's outperformance in the U.S. was due to our emphasis on energy and infrastructure investments while in the international arena, we reduced international exposure near the end of January and then we refocused on Brazil, Japan and mid-sized value companies outside of Europe.

The reasons for the market's decline are many, most notably higher oil prices and continued structural problems in the banking and real estate sectors. Investors worldwide are fearful of higher interest rates and rising commodity prices, a nefarious combination!

Given the extent of inflationary pressure, due to higher energy and food prices, the bond market has been surprisingly resilient. The benchmark U.S. taxable index rose 1.6% on a total return basis over the first 6 months while The Rikoon Group's portfolios gained 1.29%. In the municipal or tax free area, the market rose 1.5% while our portfolios rose 1.24%.

<u>The Economy</u>

One does not have to look far for bad economic news. Lackluster corporate profits, declining consumer confidence, and continued negative reports from large financial institutions have resulted in profit shortfalls. There is a proverbial "wall of worry" in the investing world today. This is the traditional basis on which stock market recoveries occur!

New home prices continue to decline in most of the country. Extremely weak existing home or re-sales and rising mortgage delinquencies have led bankruptcy filings to increase. This is bad news for banks and insurance companies who are having their own credit quality ratings downgraded. This has led to further write offs on the part of many investment firms. The loan problems that first surfaced last summer are not yet fully exposed.

Not all sectors of the U.S. economy are in bad shape. While banks, auto makers, and home builders are suffering, energy concerns, industrial export-based firms, and even some retailers are doing well. No one has declared an official recession yet, and the Federal Reserve still has some unused tools in its chest. The core problem we face is how to keep inflation under control without bringing the economy to a standstill. For the last ten years, this has been accomplished through rapid increases in the value of assets.

The increase in asset prices started with technology stocks in the mid-1990's and then it moved to the housing market in the early part of this decade. Today, asset inflation is present in the commodities area. Commodities are raw materials such as food, oil, copper, steel, and cement. There is a danger in asset inflation when it puts consumers at risk to very high inflation rates in basic goods and services. The normal remedy for inflation is higher interest rates, but with the world's economies already staggering, most politicians and their hired experts are reluctant to prescribe this cure because it hurts.

The meteoric rise in the price of oil weighs heavily on businesses and consumers. Investors are worried that central banks around the world will be forced to raise interest rates to fight rising commodity prices, which is already occurring in Euroland. Global inflation is now running at 5.5%, up from 3.5% at the beginning of this year.

An estimated 42% of the world's population, close to 3 billion people, is currently experiencing double digit rates of price increases. The risks of this are enormous. Runaway inflation (above 10%) has historically been one of the prime causes of political unrest. While we here in America are unhappy paying $4.00 plus for a gallon of gas, people living a marginal economic existence spend a much greater portion of their money on fuel and food. Recently displaced people are most at risk.

The world's economic decision makers face a conundrum: the longer inflation remains elevated, the more damaging it is to the economy. However, efforts to bring inflation down require restrictive monetary policy, higher interest rates and reduced availability of money, both highly unpopular and painful actions. When a country's central bank raises rates and/or reduces the amount of money available, consumer prices go up, and inflation looks like it is being fed rather than fought, at least in the short run. After the initial shock, however, higher rates make businesses price goods and services more competitively and it slims down consumer waistlines.

Inflation plays a key role in making investing decisions. It also greatly impacts persons living off their investment portfolios. As serious as today's inflationary problems are, investors should also be looking at several important areas in which inflation is actually negative, most notably real estate.

In Southern California and Florida, median home prices are down 27% over the past year. Approximately 30% of unsold homes on the market are in the process of some kind of foreclosure. Increasingly, banks and officials are recognizing that downward revaluation of portfolios is still underway. This has led banks to be reluctant to lend money for anything but the safest ventures. The contraction in lending activity will cause the economy to slow for an extended time period, and this is more of a problem than price inflation.

When a slowing economy exists alongside of inflation, it is called "stagflation." In the 1970's, due to rapid oil price increases, a rigid system of foreign exchange, and huge government spending on Vietnam and social programs, inflation spiraled out of control. When the government finally woke up to the fact that is was spending more and making less, it took interest rates going up to 20% to reset expectations and restart a sane economy.

Today, the economy is much more flexible than it was in the 1970's. We produced ten times more in 2007 then in 1973 while using only one-third more energy. Companies do not carry large inventories and most domestic employment is in service industries as opposed to the industrial sector. Increased international competition for goods and services will not allow companies to raise prices the way they did in the late 1970's, so that aspect of inflationary pressure is not really present this time around. Wage inflation also does not exist today because the ability of workers, be they unionized or not, to ask for and receive higher wages is absent. Therefore, two of the three key components of runaway inflation are absent and unlikely to appear. So relax, take a deep breath, drive a little less and read on.

In the 1970’s U.S. financial policy makers were limited to manipulation of short-term interest rates and adjusting the size of the nation’s money supply. Today, there are various ways that the world’s central banks can cooperate and coordinate their monetary policies. Because of this, the political turmoil that followed the oil shock of the 1970’s, with its wrenching dislocation of workers, is not likely to reoccur. No one in the Chinese or the U.S. government wants to face angry mobs of unemployed workers, nor do the ruling families of Middle Eastern sheikdoms wish to be vilified for causing a worldwide depression.

There is no doubt that massive inflationary pressures have been unleashed due to increases in the price of oil and other raw materials. Rio Tinto Group, the world’s third largest mining company, just announced a price increase of almost 100% for iron ore from its Asian steel company customers. Raw material costs are driven by demand and global demand for building supplies will continue to go up.

While the Federal Reserve is talking seriously about possibly raising interest rates, it is unlikely to do so to any great degree. A rise in rates would cause such a shock to the U.S. economy that it would result in further declines in housing values. The Fed is likely going to allow oil prices to creep up along with unemployment and there will be some inflation but not rampant and uncontrolled.

While energy, food, and raw materials continue to up, we will have to continue a marked slow down in bank lending. This deleveraging has a deflationary effect on the economy. As over-extended consumers also tighten their belts, there will be a decrease in consumer lending and the resultant gradual global slowdown will eventually offset many of the inflationary effects of rising food and oil prices.

What does all this mean for your portfolio? Bank, brokerage and all financial companies are likely to stay down for awhile. Over the last 10 years, the financial sector grew to make up about 1/3 of the U.S. economy. Financial institutions are essential to the economy and are not going away, so patience is required to weather this storm.

We believe there are very some fine regional banks and small finance firms that will make good long-term investments. As the real estate market looks for a bottom (likely 12 months out), U.S. consumers will ratchet down their discretionary spending. Over the last few years, the U.S. dollar has sunk 50%, making foreign goods more expensive. Until the U.S. dollar recovers, people have good reason to batten down the hatches. Cash can be a good investment in times like these.

Overall demand for services will increase worldwide and so there are good investment opportunities if one is positioned with cash and a long-term horizon during the market's next growth phase. Countries such as Japan, Korea and Taiwan have let their currencies float and then rise against the U.S. dollar so they have both dealt early with inflation and present some solid opportunities for growth investing.

I believe the commonly held assumptions that oil prices will continue to rise, that food costs will spiral out of control, and that company profits will plummet to nothing are mistaken. Private enterprises have always figured out ways to adapt to difficult economic conditions. Companies who have maintained a high level of service and who have a solid financial base will fare well.

There is a tremendous amount of cash waiting to be put to work, ours amongst many others. Internationally, demographics favor investing in new markets and in companies developing new products. While stock share prices do not respond in the short-term to long-run potentials, we believe that consumer and investor sentiment will improve and this provides buying opportunities, be they next week, month or year.

Personnel News

Rob: Besides moving and running at high altitudes, I am slowly getting a studio set up. My daughter Robyn, 22, landed a role at the Guthrie Theater in Minneapolis doing Arthur Miller's play, "A View from the Bridge." It runs September 19 – November 9 and it represents an opportunity for her to earn a stage actor's union card. Hannah, 19, is working in Hot Springs, NC as a licensed massage therapist until August when she leaves to start Bard College as a freshman.

Juliana: I spent a week in June at Atlantic Beach, NC doing nothing but reading, walking, napping and eating Shrimp and Bar-B- Que. It was wonderfully relaxing, restorative and the humidity did wonders for my wrinkles.

Jeff: My daughter attends school at the Camino de Paz School & Farm and this past spring the students had a week off from school in which they had to donate time to an organization for community service. Stephanie chose to spend her time at the Heart & Soul Animal Sanctuary and so, of course, she came home with a puppy at the end of the week. She appears to be a Labrador, Border Collie mix of some sort. Natalie Owings of the animal sanctuary said that she is a New Mexican purebred, meaning "who knows". She is now 5 months old and already weighs 40 pounds. I just hope that she's not part horse as well! Our 2 cats are not too thrilled with the new addition, but they seem to be working things out.

Patricia: I'm planning a trip to San Francisco this summer to visit my son. I am longing for a leisurely boat ride across the bay and perhaps a trip to Napa.

Emily: I'm enjoying my time back in the Southwest. I recently spent a long weekend seeing the sites and hiking at Mesa Verde, CO. My summer looks full with playing tennis, going to the opera and enjoying the mountain sunshine.

Dana: I recently went to Santa Cruz, CA, to visit family. The usual June gloom was non-existent, so I was able to enjoy summer days at the beach. My son is doing a summer internship at a financial company in Aspen, CO, and my daughter is working part-time in the garden at the Rikoon Group's new locale.

News & Upcoming Events

We are settling in to the building that we recently purchased at 2218 Old Arroyo Chamiso Road. General maintenance and landscaping projects will keep us busy for awhile. We hope that you will be able to stop in and see us sometime at our new location.

Our next quarterly tea is scheduled for Thursday, August 14, at the Ghost Ranch Conference Center (Rendon Room) at the corner of Paseo de Peralta and Old Taos Highway in downtown Santa Fe. There will be two sessions, one at 3:00 p.m. and the second at 6:00 p.m., each lasting ninety minutes. Please feel free to bring a friend.