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Summer Commentary 2007

The Markets & The Economy

The first quarter of 2007 was a rollercoaster ride in the truest sense. Following a 3.3% decline in one day, February 27th, the world's stock markets rebounded. It has been a fascinating 2nd quarter. Most of the U.S. and world's stock markets boomed, outperforming analysts' wildest expectations. The Dow Jones Industrial Average rose 8.5%, the S&P 500 rose 5.8%, the U.S. Small Cap market rose 4.1% and the U.S. Technology markets gained 7.5% from April 1 to June 30. Year-to-date, the Dow Jones Industrial is up 7.59% which serves to reminds us that it was in negative territory at the close of business on March 31st, 2007. Year-to-date, the S&P 500 is up 6%, the Technology Index is up 7.78% and the U.S. Small Cap market is up 6.72%. The Dow Jones World Index, excluding the U.S, is up 10.34% after a gain of 6.9% during the 2nd quarter.

The Rikoon Group's portfolios in U.S. Large Company stocks gained 7.47 % during the last six months, while our International portfolios gained 11.98 %. We are pleased with the results so far this year but continue to caution investors not to expect a continuation of these kinds of returns. Why have the markets gone up so much? It is partly due to the fact that interest rates have stayed steady and economic news points to a perfect "soft landing" for the economy. The Fed has therefore not had any reason to raise interest rates because they expect that inflation has been tamed for the moment. Some people are starting to worry that the economy will heat up, eventually causing the Fed to raise interest rates, which will be bad for stocks. But that has not happened yet, and in our opinion, this is not the real latent danger that the markets face.

Another reason the markets have risen dramatically is due in part to the influence of mergers and acquisitions activity. With the S&P 500 posting its best second quarter performance in five years, take note that takeover activity has increased 68% from last year's level to almost $740 billion during the second quarter of 2007 alone! Blackstone, one of the largest hedge funds and a leader in mergers and acquisitions activity, took a portion of its company public on June 21, 2007, in the largest initial public offering in the U.S. in over five years. In what we feel is a telltale sign, Blackstone's stock dropped below its $31 offering price after only three days of trading. We fear the public will once again get left holding the bag by the time all is said and done.

Mergers and acquisitions typically bid up stocks in price because companies are being taken private at higher amounts than they sell for on the public exchanges. Because the "big money people" are under intense pressure to make deals, paying more and more doesn't faze investors when there is a feeding frenzy going on. Increased corporate earnings are the target, so paying an average price earnings ratio for stocks in the middle of their normal band at 16 times earnings seems cheap to M & A firms who borrow money to finance their takeover activity.

One result of mergers is the removal of public shareholders and traditional boards of directors who are friendly to management, and replacement with cutthroat efficiency experts whose sole goal is to cut unneeded staff and unnecessary business lines so as to return the company to profitability as soon as possible. Most takeovers are funded using borrowed money. The low cost of capital, due to fairly low interest rates in the U.S. and extremely low interest rates in Japan, has allowed takeover experts to leverage their bets so now they can target firms of any size. Their goal is to take companies, dismantle them, put them back together in their own image, and sell them back to the public at large premiums.

One caveat is that up until now this market boom has been fueled by cheap money, but buyouts are now costing companies more as low cost credit is starting to disappear. The average purchase price for takeovers in the second quarter rose to 11 times earnings, the highest number in 10 years. Pre-cash flow, or real profit, at targeted companies also fell, while interest expenses rose. This means the quality of takeover deals is going down.

What could go wrong? If interest rates go up, M & A players are in for a rocky time. The recent collapse of two of Bear Stearn's hedge funds, invested in sub prime or low quality mortgages, has not yet run its course. While it is unlikely that the Fed will raise interest rates, currency traders worldwide may force U.S. interest rates higher up as our country may eventually have to compete for capital to continue to fund our twin deficits of balance of trade and national debt.

The bond markets continue to have lackluster returns. During the first half of 2007, U.S. taxable bonds gained 1.89 % while the municipal bond index was up 1.55 %. The Rikoon Group's bond portfolios gained in line with the markets, with taxable bonds rising 1.8 1% while our municipal or tax-free portfolios gained 1.28 %. Our expectation is that with the world economy doing well, the U.S. will be forced to follow Europe and Britain's lead in raising interest rates, even though this poses severe risks to our domestic housing market.

American consumers have finally started to cut back on their spending, partially in step with overall reduced optimism for the U.S. housing market. Several reports show that consumer confidence has slipped but, fortunately, business spending has picked up and seems to be filling the gap so that the U.S. economy continues to churn along at a fairly low but positive rate of growth.

Spending on commercial projects jumped 1% during the last month of the second quarter, and every category of construction spending other than residential showed an increase, mostly driven by the building of factories and utilities. American businesses continue to invest in plant and equipment. The manufacturing sector, in terms of output, has been steady which suggests that productivity growth will continue to aid the economy.

Workers' wages have been rising slowly and the U.S. jobless rate is near a six year low. All of these factors have assisted the U.S. economy and therefore, the markets.

One of the main dangers that threaten the market revolves around residential real estate. We are watching closely the still unfolding story of poor quality mortgages that were made during the heat of the refinancing boom of 2004 – 2006. This time, it is not just the banks who are the culprits.

Bear Stearns, Merrill Lynch, and some of Wall Streets biggest lenders are claiming a bigger and bigger chunk of Main St. U.S.A.'s real property. The value of U.S. homes held by commercial banks and investment firms swelled 53% from a year ago to $2.3 billion, the highest level since 1992.

These institutions do not want to own real estate but they are afraid, and rightly so, that if they try to unload unwanted properties all at once, it would drive the value of their remaining inventory down through the floor. If you live in San Francisco or New York, you may not perceive this phenomenon. Decatur, IL and Cleveland, OH, Detroit, MI and Phoenix, AZ have all seen their share of loans entering foreclosure go up to the highest level in five years.

Late payments on mortgages rose to 14% of all mortgages and the U.S. Realtors Association is forecasting price declines in U.S. homes of 2.4%. Before the third quarter of 2006, prices hadn't dropped since 1993 and measured annually, the national median per homes will likely drop 1.3% in 2007, the first decline since the Great Depression of the 1930's.

Countrywide Financial Corp., the largest U.S. mortgage lender, said it had quadrupled the number of foreclosed real estate properties compared to three months ago. Prices continue to decline in many U.S. housing markets as inventories grow. There are now 536,000 new homes on the market versus the average for the last 20 years of 346,000.

The number of new homes sold at auction, after having been taken back by lenders, surged 67% in May from a year ago. Many individual homeowners will likely decide to hold onto their properties rather than sell them in a rush. This will keep the U.S. market from melting down but will prolong the period of pain well into the future. Hopefully, none of our readers went out and got interest only loans in order to buy rental properties which now are vacant!

The World

International markets continue to outperform the U.S. stock market. England and Germany continue to show the strongest industrial growth and their currencies, as do most others, continue to strengthen against the U.S. dollar.

The Canadian stock market in dollar adjusted terms is up 17% while Australia was up 19%. Why such great returns? It is a combination of robust economies based on natural resources and a weak U.S. dollar. The U.S. dollar traded at a record low versus the Euro and is at the weakest level in 26 years versus the British pound. Both the European and British banks are forecast to raise interest rates soon. This stands in stark contrast to our Federal Reserve Bank, which is handcuffed by domestic real estate problems. If we eventually need to raise interest rates in order to continue to attract capital to finance our national debt and trade imbalance, U.S. consumers are likely to feel the pain immediately.

The U.S. and world markets are now so interrelated that the returns are linked. As the U.S. dollar continues to decline, it makes things more expensive for U.S. consumers and cheaper for foreigners visiting here to shop. There are better growth prospects outside the U.S. and this is one reason why we will continue to see the dollar decline. The only thing that might stem a dollar decline long-term is increased discipline internally in terms of paying down the debt and increased savings rates on the part of the U.S. population. We continue to have a negative savings rate which means that we as a country must continue to borrow from overseas sources.

As the U.S. dollar declines, investors become more concerned about risks in the U.S. economy. England is now being seen as a hub for international finance. Some of the recent investments that we here at The Rikoon Group have made are long term plays on a weakening U.S. dollar, increasing interest rate specials on low quality corporate debt bonds, and we continue to have a large portion of our clients' stock market dollars invested overseas.

Local & Personnel News

As you know, we have become partners with the Sanders, Morris, Harris Group based in Houston, Texas. Our seven year association with the Carret firm in New York has ended. We are very pleased with the research capabilities, technology resources and overall business support that the SMH Group has started to provide us in Santa Fe and in North Carolina.

On a personal note, Rob is taking a break from competitive trail running. There is an ad hoc group in Asheville that organizes runs through the mountains once a month. Rob's daughter, Hannah, recently graduated from Asheville High School and has left for Ithaca, New York, to participate in a six month program in massage therapy. Robyn, 21, is working this summer and taking a class in American Sign Language at Winston-Salem State College while preparing for her senior year in theater at the North Carolina School for The Arts.

Juliana and her husband, David, spent a week on Maui attending a conference on "Investment Trends of the Future." Fortunately, there was also enough time for snorkeling, swimming, and having a great time.

Jeff and his family just returned from a trip to Montana and Wyoming. They attended a wedding in MT and through the generosity of their friends, they were able to stay in a beautiful private mountain reserve area and Stephanie was able to go on several extended horse rides on some exceptional horses and so she was in heaven. Next they headed to Yellowstone Park and went sight seeing, hiking, fishing and white water rafting.

Patricia is busy this summer working on her house. She has tackled an impressive cabinet refurbishing and plans to continue painting the interior of her home.
She is very proud of her son Dylan who has just completed a bike ride from London to Paris. He took part in the opening ceremonies for the Tour de France!
In August she plans a quiet vacation in northern New Mexico. She says" I just want to put my feet up and read a book"

Dana is looking forward to a summer trip to Europe with her children as her son begins a semester abroad in Santander and Granada, Spain.

Upcoming Events

Looking ahead, please note on your calendars that we will be hosting an Open House at our new office location, 1421 Luisa Street, Suite R, on Wednesday, July 25, from 3:00 to 7:30 p.m. Parking is plentiful and we will be offering refreshments along with a tour. Please R.S.V.P. to 989-3581. Furthermore, we have tentatively scheduled our next formal tea on Thursday, September 13, at the Inn on the Alameda. We hope everyone has the chance to enjoy a happy and healthy summer holiday.