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Summer Commentary 2009

Overview

The end of the Great Recession, which started in the summer of 2007, is not in sight. While stocks rallied during the second quarter of 2009, we expect an extremely slow economic turnaround which will take an extended period of time. The financial markets are no longer dominated by a sense of panic, and many large banks sold new stocks and bonds in order to pay back the government. Smaller regional banks, however, which are the mainstay of small business job-creation and local real estate markets, have already felt the beginning of a second down draft in their fortunes.

We will know that the recession is over when unemployment declines below five percent. It currently is approaching ten percent and so it is extremely unlikely that consumer spending, the biggest component of the U.S. economy, will strengthen significantly. After several decades of decline, the average savings rate of U.S. citizens has increased dramatically from -2% to 6% of earnings. Individuals intuitively sense that while government spending on mega-projects is reaching new highs, the amount of money likely to trickle down into their wallets will be minimal.

Even though some companies have been able to cut labor and supply costs, most corporate earnings reports will show dismal results. Almost no one in the market place is able to raise their prices. It is not only companies that are facing an extended period of hard times. The precipitous change in the financial markets and real estate, along with the attendant rise in unemployment, has created a whole brave new world for state and local governments. Recently, ten state governments were unable to pass their budget due to pressures from declining revenue. With income and property taxes down, a number of state governments have gambling initiatives on the ballots in order to supplement tax revenue. State income taxes on the upper class are likely to rise and federal rates will as well. For all the political drama surrounding many states' fiscal issues, we believe the federal government will, if need be, buttress the financial stability of any government entity who needs assistance.

The Markets

U.S. stocks just finished their best quarter since late 2003. The Dow Jones Industrial Average recovered 29% from its 12 year low, hit on March 9th. The Dow gained 11% for the full three month period ending on June 30th, but remains in negative territory, down 3.8% for the first sixth months of 2009. It remains 40% below its all time high, reached on October 9, 2007. A bright spot in the U.S. economy was technology companies, which saw their index, the NASDAQ, increase 16% year to date. The reason for this gain is that many U.S. technology companies are suppliers to emerging market nations, and some U.S. companies continue to invest in productivity devices such as computers.

Emerging countries stock markets have been the big winners so far in 2009, with natural resource based economies doing the best. Oil posted its biggest quarterly percentage gain during the second quarter of 2009 in two decades. Commodity exporting nations, such as Canada (15%), Australia (6%), Brazil (37%), were big winners. The Asian economies have shown the most strength of all in industrial production. The Hong Kong stock index rose 27%, but India advanced 62.9% and Turkey gained 54% due to strong local consumer demand. European markets faired about the same as the U.S. industrial companies, with the Dow Jones Euro stock index declining 1.8%.

The bond markets were up slightly even though mortgage rates rose during the second quarter. U.S. Treasuries, the safe haven of 2008, fell during the second quarter of 2009 because investors are starting to feel unsettled about earning next to nothing on their money. U.S. Treasuries have lost 4.2% of their value so far in 2009, a sharp reminder that safe is not necessarily secure. The short-term municipal bond market was up 1.7 % and the corporate bond market was up slightly more. The Rikoon Group portfolios have performed well this year. Please contact us if you would like us to e-mail you our latest performance numbers.

The Economy

Recent reports are showing a surge in mortgage delinquencies and foreclosures among prime borrowers, people with good credit ratings. The number of people with money in the bank who simply decide to walk away from their houses has more than doubled during 2009 from levels a year ago. This is a signal that the federal governments efforts to help home owners are failing to keep pace with job losses that are pushing these mid and higher income earning borrowers into trouble. Real estate values continue to decline in many locales, but at a somewhat less torrid pace than earlier this year and in 2008. A similar pattern of less bad news is mirrored in manufacturing and retail sales. So, things are getting worse but at a slower pace, which optimists look to as a harbinger of the eventual recovery.

I believe unemployment will head upwards to 12%, somewhat like the level now seen in some European countries. If the number of people who are underemployed, as well as people who have given up looking for work entirely were counted, it would likely double the unemployment figures. What this means for U.S. investors is that we have to look outside of our country for growth opportunities. It also points to a strategy of looking hard for income producing investments for the next several years. There is no doubt that income tax rates are going to go up, social services are set to be reduced, and we also have a long-term decline in the U.S. dollar to look forward to. However dismal this may sound, the U.S. is in far better shape than England and most of the other European Union Countries.

In fact, the UK economy may face a major crisis in their currency in the near future. A predominance of financial companies are located in London, most of which incurred huge losses. As a result, the UK government is being forced to prop up their major banks. Some estimates say that British government debt levels will be almost 100% of their total gross domestic output by 2013. This would spell disaster because to run at this debt level in peacetime is not tenable. The investing public will eventually choose not to buy bonds from governments in this kind of financial condition. By the way, did you know the IMF had to bailout the British economy in 1976?

I believe we can see one possible scenario for the U.S.'s future by watching what happens in England. Brits now expect to face huge spending cuts in social programs, including health care, as well as seeing their personal income and sales tax rates go up markedly. The UK has to sell some of their bonds in the open market. Their own government is buying back a third of the newly issued government bonds in order to pump up their economy. This creates a simultaneous priming of the pump both monetarily and fiscally. Here in the U.S. we are doing the same.

Interest rates have started to rise in England. No one knows how much further support British banks will need and, while there is not widespread panic, it is likely that Brits will see a large and long-term downward shift in their living standards, including visits to the local pub. Formerly considered to be a very tolerant society, some signs of anti-immigration sentiment are appearing.

New Jersey, a state which used to be one of the worst financially managed state governments, recently passed a bill levying higher income taxes on the wealthy and increased charges on tobacco, alcohol and gambling. The residential property tax deduction is being taken away for wealthy individuals, and state employees will shoulder wage freezes or salary cuts. We are likely to see this story repeated in other states.

The impact of this rather sad economic state of the U.S. and Western Europe has not been lost on our international trading partners. The first real sign of a crack in the U.S. Dollar's prominence as the world's reserve currency has now appeared. This is important because as long as the rest of the world uses our money for their trade, it allows the U.S. government, businesses and consumers to finance our debt at a lower cost. If this support is withdrawn, the US will end up paying higher interest rates and higher prices for goods made overseas.

The Chinese and Brazilian governments, as well as other nations who are natural resource exporters, are looking to the International Monetary Fund (IMF) to increase their say over how world commerce transpires during the next several years. China has explicitly stated that they would like a combination of currencies, their own included, to comprise a new world currency called Special Drawing Rights or SDR's. In the long term, they would like this to be the new accounting measure used for international trade. The IMF is about to issue bonds for the first time, and China has agreed to buy one third of the one hundred, fifty billion dollars in bonds which the IMF is planning to sell. The importance of this esoteric arena of international finance cannot be overestimated. It is akin to the world going off the gold standard in 1973. With the Chinese and other natural resource exporting economies staring to flex their muscles, political influence will surely follow.

Summary

We've noted above that income-producing assets are likely to be a focus of many individuals' portfolios going forward. While the economic news is dour, we believe it is highly unlikely that any state or federal governments will default on their debts, no matter how bad the news is in the media. There are buying opportunities in some new issues coming to the market and, due to our view of the likelihood that long-term interest rates will go up within a few years; our strategy is to stay relatively short-term and to avoid bad credit risks. The fear of inflation in the U.S., due to our government's issuance of huge amounts of debt is, I believe unfounded at the present, due to very weak labor and real estate markets.

The new economic world order now taking shape will call for further international diversification, the use of essential commodity based investments, and the ability to move in and out of the market on a relatively short-term basis. We favor quality, high dividend paying U.S. stocks for use inside this kind of strategy. Our firm feels that it is unlikely there will be a new, long-term bull-market beginning for quite some time. There are opportunities to make some money in stocks but they are shorter term in nature.

Article Reprints from The New Mexican

Run Over By Health Care Reform by Rob Rikoon

While Congress beats their (I believe it's a ….) drum, imagine I got hit by a car on the way to the July 4th parade. Wanting nothing but the best care, since I need that knee for the 100 mile endurance race next weekend in Colorado, I tried checking into the hospital but was turned away by a para-adminisitrator who said my insurance card wasn't acceptable to their computer. A Doctor friend of mine sauntered by on his cell phone, waved, but dared not interrupt his lawyer's train of thought, if there was one.

An internet search turned up no information or ratings of who to use, what was reasonable to do, or where to go so I stayed put. They finally did let me into the ER and ordered an MRI, CAT scan, blood work and psychiatric exam. Gee whiz, all I wanted was to be patched up and sent back to the Windsor Trail.

We spend as much on medical care every year as we do bailing out the banks and are told we have the best quality health services in the world but it ain't so. They say 30 cents of every dollar goes to some middleman somewhere in the Midwest. We may have the best machines and smartest doctors but every time I interact with them, I feel like I have been robbed. Two thirds of Americans are fed up with the current system. 4 out of 5 people who have medical and dental coverage say they would refuse to pay more so that the uninsured Americans could obtain health care.

In Miami, it cost 3 times as much for the same services as in Oregon. Massa(taxa)chusetts is headed to bankruptcy because they tried setting up their own universal health care. We could , and maybe should in part, blame greedy malpractice lawyers, price gouging drug companies, inefficient hospitals and anonymous insurance companies but in the end, we have to figure out what we want as a society.

No matter what tweaks are made to get more folks covered (1 in 6 are presently not), the current private health care system doesn't cut it. About a third of medical costs in the US are spent on the last year of life, much of it in the final months on heroic measures. Are we willing to let our loved ones or ourselves die a few weeks or months earlier than is made possible by medical technology?

If we are to succeed in reforming health care, I see doctors of the future working hard, knowing their salaries will be moderate. Corporate lobbying by drug, insurance and medical professional groups will be banned. Consumers of health care will have access to as much information and choice as we do when going to buy a new car.

The time frame for knee to repair is about a month but mostly I chafe at the expense and ignominy of it all. Woe be to all of us as we Baby Boomers kvetch our way into statesmanship (formerly called old age). The ER waiting room will definitely need a lot more soundproofing.

Is The Recession Over? By Rob Rikoon

The short answer is no but the good news is no one is talking about a depression anymore, that is, unless you are one of the 10% of Americans who are unemployed and then you are likely to encounter a different kind of depression . How will we know when things are getting better? It won't be from reading government pronouncements or following the stock market but by watching the trend in employment numbers.

The economy is still in decline but it is getting worse more slowly. The key to the eventual recovery, and it will happen, is for people to have jobs and to feel secure in the value of their homes because only then will they spend discretionary money. The US consumer is the lynchpin of the global economy. Local housing prices, along with jobs, must show signs of stability before the markets have a firm base from which to rebound. Nonetheless, investors who know what portion of their portfolios they are comfortable with in stocks should keep it there through whatever this downturn has left to go.

How can you anticipate what will happen with inflation, interest rates (for refinancing), or the markets… take it one step at a time. By talking to your friends, you can get a sense of residential sales prices in your neighborhood. Which houses, offices or retail spaces are in trouble? Find out how people are doing at their workplaces. Is anyone hiring?? When you hear the first few cases of people or businesses secure enough to expand or raise prices, you will be able to sense that the recession is over.

Economists like to think they are ahead of the general public's knowledge curve and savvy investors like to think they are ahead of the economists. Some economists, like Nouriel Roubini, are ahead of the curve. He warned of the banking crisis well before it happened. Now, he is optimistic about a few places like South Korea. Check out his site: www.rgemoniter.com for some of the best economic analysis around. We believe that diversifying overseas, especially outside of Europe and Japan, is essential for growth investors over the next decade.

Some investors are ahead of the curve, and even in a long term sideways moving bear market, people can invest successfully. Jerry Grantham, one of the best, has been around the block a time of two and he sees the market as I do, likely retesting its lows of March and calls it slightly overvalued at present levels. We also agree that some companies in the fields of alternative energy and combating climate change will make money going forward, no matter what the general economy is doing, as these are the two biggest economic initiatives of the Obama administration.

More next time about inflation, interest rates, and why the US dollar will continue to enjoy confidence in the world's economy even though the printing presses are going full speed ahead!

In Praise Of Liberal Arts Education And Local Newspapers – Why Bankers Need To Study St. Augustine by Rob Rikoon

What do students of the College of Santa Fe, Sam "the sham newspaper man" Zell and America's bankers have in common? They are all endangered species. As the economy continues to contract, let's look at why it is important to the arts, humanities and future businesses that we promote productive risk taking by young people.

National banks, like chain restaurants, sprouted quickly but now are frozen by fear. They are not lending because they don't care what might work in the future, they only are allowed to fund what has succeeded in the past. Students who want to explore their creativity are losing venues for much more than vocational training. If our society's nurturing of intellectual curiosity, openness and cross discipline investigation gets relegated to private Internet lines instead of public forums like newspapers which can be read and debated in cafes and classrooms, we all will end up poorer.

There is a strong similarity between reading a hard copy newspaper, getting a broad based education and starting a business: they all require the ability to structure one's time, a willingness to take on unforeseen challenges and a desire to expand one's horizons. I recently visited my two daughters in NYC, who are grappling with these issues, and was struck by the similarity between what both they and our economy need to get going- self confidence, a willingness to make and learn from mistakes and discipline to implement a program based on sustained effort. This is one definition of creativity – both economic and personal.

If readers can't thumb through a physical paper but only access subjects that they specifically search the Internet for, they are unlikely to discover articles that would widen their perspective. Likewise, business students who only study marketing and accounting often bring little to long range planning efforts because it is the ability to synthesize unrelated topics that leads to profitable inventions. Bankers who restrict their analysis to spreadsheets miss the all important human character elements which generally determines if a new venture is going to succeed.

As we turn our attention to the myriad of government programs that aim to forestall mortgage foreclosures, keep the car industry rolling, and reinstate consumer confidence in the economy, we need to have a basis for optimism other than a personal affinity for the nation's Chief Executive. If you believe it is Pollyannaish to have faith in the transformative power of crisis, study the circumstances of the scientific and artistic breakthroughs of the early 20th century. Harsh military and economic realities forced people to band together and develop new systems of communication, cooperation and creative thinking.

I believe we are on the cusp of a period of similar such constructive effort. Let's get rid of the entrenched megabank executives and their political cronies by breaking up "too big to fail" conglomerates into responsive regional players and level the playing field so we can have a new start.

Personnel News

Rob: The spring of 2009 was fairly wet and cool here in Santa Fe but that did not diminish my enjoyment of several trail-running events. The weather has been of great assistance to the new fruit trees and bushes planted around the grounds and we look forward to giving visitors a tour of our garden, pond and growing dome, in which we are raising various herbs and a monster tomato bush.

Juliana: I took a trip to England during the month of May. I was looking forward to visiting the Cotswolds and the Lake District. David was looking forward to seeing the Eric Clayton concert in Manchester. The weather was dry and warm, the flowers were in full bloom and Eric Clapton was incredible.

Jeff: In June, we went "almost" camping. The second day out it started raining and never stopped. We and all our equipment got soaked. My "fair weather" campers declared that they were done and so we went back home to our nice warm beds. We went on day hikes the next couple days. After that we went "hotel" camping and that was much better. I recently built a raised vegetable garden in the back yard for my wife. She really liked the greenhouse that we built last summer and so she requested that we expand to include the open air vegetable garden as well. She has lots of stuff growing already.

Patricia: This summer we have a large gardening project which I am enjoying in my spare time. We have a vegetable garden out in the yard and continue to grow magnificent crops and flowers in the dome green house. The yard and pond is just alive with color. If you have a chance, stop by and see for yourself.

Emily: I'm enjoying the warmer weather and trying to spend as much time outdoors as possible. I just returned from a week in Colorado visiting family and friends and enjoying the mountain air. July and August are looking quite busy with soccer games, tennis tournaments, house projects and family visits.

Dana: I'm enjoying the slow pace around my house and garden. The bees are a bit behind due to the cool rainy weather of June, but I expect them to move into full gear with the advent of hotter days. Fortunately, the rain has provided plenty of forage. At the moment, they especially love the lavender and bee balm.

LOCAL TEA & CALL-IN DATES:

Our upcoming tea will be held on Wednesday, August 12, at the Ghost Ranch Conference Center in the **Rendon Room** at 3:30 p.m. and 6:00 p.m. These stimulating roundtable discussions are a favorite with our local clients who are invited to bring interested guests.

The next day, Thursday, August 13th, at 3:30 p.m. and 6 p.m. (Mountain Time) our quarterly telephone conference call will take place. The call-in for both sessions is: **218-936-4700** and the Access Code is **425993#**. Please let us know when you are on the line.