

The Rikoon Group
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Summer Commentary 2011

The Markets

As stock prices moved up and down with fervor these last three months, several lingering concerns were swept aside by enthusiastic investors. U.S. stocks shook off an economic downdraft that is reflected in poor employment and worse housing numbers, while the brinkmanship nature of European politics brought Greece's pending default to an anti-climatic intermission. The Dow Jones Industrial Average gained 4% during the last four days of June to finish the first six months up 7.2%. The broader based Standard & Poor's 500 Index lost .4% in the second quarter but still had a 5% gain so far this year. Small company stocks returned 5.6% while gold and silver both lost money during the first half of 2011.

One of the most important questions facing stock market investors is whether or not the Federal Reserve will continue to supply "easy" money which has led to unprecedented low interest rates. It appears that the European Union has banded together to help Greece leap over the immediate hurdle of refinancing its humongous debt. One should not take these pronouncements as a sign that the world economy is back on a roll. Most investors, anxious about Europe stocks imploding, have fled to defensive sectors such as utilities, health care, and consumer staples.

The volume of trading in all asset classes declined dramatically this past quarter. Individual investors are now shunning U.S. stock funds in favor of bonds, despite the fact that bonds are earning practically no interest and risk declining values if interest rates rise. Trade volume on stock exchanges are down 30% and with the U.S. government supposedly giving up its position as the largest buyer of U.S. Treasuries, we can expect more volatility as the year goes forward. Approximately \$26 billion flowed out of stock mutual funds while \$63 billion moved into bond funds from January 1st to April 30th, 2011.

Year to date, U.S. corporate bonds gained 3.1% while government bonds eked out a 1.7% increase. Reported inflation for all items is up 3.6% over the last twelve months while interest rates charged for bank loans have stayed steady at 3.25%. 30 year mortgage rates are now a 4.5% while 15 year mortgages are 3.7%. Adjustable rate mortgages hit a new record low at 3.2% for those home buyers willing to take on the risk of not knowing what rate they will pay down the road.

Investors worldwide rushed into U.S. government bonds, as a safe haven, particularly the short term treasury market, pushing Treasury bill yields down to zero and even into negative territory. This means investors pay the government to take their money. Japan is one of the few other modern countries to experience this weirdness, a sign of economic malaise which has gone on now there for two decades. Low interest rates coaxed big U.S. companies into issuing new bonds. Google sold its first bond ever and Johnson & Johnson staged the largest bond deal in

history. I imagine the insurance companies and pension funds who are buying these ultra long term bonds at ultra low rates will look back with regret that they locked their money away in these securities. If the turmoil in Europe continues, many people think that U.S. Treasury yields could continue to fall, especially if the U.S. domestic economy does not heat up as nervous investors make the “flight to quality.”

The world’s commodities markets closed the first 6 months with price pull backs. Oil ended the quarter down 11% while wheat prices plunged 23%. Silver and gold prices have been stuck in a rut since May while aluminum and zinc fell 6.7%. Observers feel that concern about slowing U.S. and Chinese economic growth, the threat posed by a Greek default and indications that investors and speculators have been stockpiling commodities all contributed to the decline in commodity prices.

Emerging market nations such as Brazil, India and China are all experiencing some degree of economic slowdowns and they therefore have reduced demands for commodities. Brazil has been the worst performing stock market in Latin America so far in 2011 due to its reliance on commodities and its historically poor record of dealing with inflation. Chile, on the other hand, one of the world’s most active mining countries, climbed 3.7% during the second quarter because of higher copper prices.

Notwithstanding commodities weak performance this past quarter, over the past 12 months, corn is up 78%, oil up 26% and copper is 46% higher. Looking back ten years, oil cost \$26 a barrel compared to \$95 today. Sadly for consumers around the world, the price of a bushel of corn has gone from \$2 to over \$6 a bushel. It’s no wonder that gold prices have more than quadrupled over the last ten years!

Asian stock markets lost money during the second quarter as China is trying to engineer a soft landing (planned slowdown in economic activity) so that runaway inflation and their overextended real estate markets don’t crash, driving entire regions into the wall. The Chinese stock market lost 5.7%, Hong Kong dropped 4.8% and India lost 3.1% during the April to June period. Policy makers in China are trying to figure out how to combat inflation without causing mass public protests which would be the likely result of large scale job losses. Nonetheless, the People’s Bank of China has raised its benchmark interest rates three times over the last three months in order to bring inflation under control.

In Europe, Germany has been the best performing stock market so far this year due to its increasing prominence in the European Union. The German market seems to be moving in lockstep with the U.S. stock market while the rest of Europe, other than England, has posted a loss so far this year. Germany is a big exporter to China and if there an abrupt fall off in China’s economy, Germany’s markets will be at risk. Germany is one of the few countries with strong domestic employment which has helped its consumers have continued confidence to purchase big ticket items.

The U.S. sub-prime mortgage market fell down a hole this spring as the Federal Reserve started to sell off its huge portfolio of mortgage backed bonds obtained during the financial crisis of 2008 and 2009. The Fed had planned to unload many of its sub-prime bonds but the prices that it

was receiving was so low, they called off any further immediate sales. This won't stop the U.S. Treasury from successfully selling \$51 billion in short term Treasury bills as skittish investors tend to flee to U.S. Treasury's in times of uncertainty.

Facebook is looking to sell its initial public offering (IPO) of stock for upwards of \$100 billion over the next few months. In a similar vein, an online provider of coupons called Groupon, which had a half a billion dollar operating loss last year, may sell its stock for more money than Google did when it went public several years back. Video games, social networking, and shopping online still holds out the prospects of untold riches for some people. Investors should take note that these kinds of stocks with no real assets other than a good idea and name recognition sometimes end up performing rather poorly.

The Economy

The U.S. economy is fueled by five major ingredients. They are housing, employment, manufacturing, oil (energy) and the military, which enables us to be the world's policemen. The U.S. housing market continues to be in terrible shape; even though the U.S. Housing and Urban Development's (HUD) Secretary stated recently that it is a great time to buy houses as "prices are bound to go up in the long run." We note, contrary to his enthusiasm, that the actual selling price of most homes continues to decline. The number of home sales is up over the last several months as some sellers have finally acknowledged that they have to lower their asking price to unload their homes.

The number of housing units for sale has declined due to federal and state investigations into flawed foreclosure processes. This has forced many banks and finance companies to hold delinquencies on their books for far longer than normal. Approximately 1.7 million homes in the U.S. remain on the market, and more will eventually be forced into being sold once these hidden inventories surface.

The commercial real estate market has strengthened in some cities. New York, Washington and San Francisco are experiencing resurgence in commercial values. Many markets in America's less desirable cities continue to see a decline in value, while suburban properties, especially retail malls, are begging for buyers. The banking industry has said that they are interested in lending but we do not see evidence of any sustained upturn in commercial lending activity at this time.

The U.S. employment situation remains precarious. Unemployment is officially around 9%, pretty much where it's been for the last six months. New jobs are being created at a pace of 50,000 to 100,000 jobs per month. It is widely acknowledged that we need at least 200,000 new jobs per month to make any dent in the chronically high level of unemployment. While manufacturing jobs may be increasing, service jobs are in decline.

Manufacturing activity has continued to improve every month over the last two years, although with some hiccups. U.S. exporters are able to take advantage of the declining value of the U.S. dollar in order to sell more goods abroad which has created job opportunities in some industries. While not robust, manufacturing is one of the few bright spots on the current scene.

President Obama recently released 30 million barrels of oil from the U.S. strategic petroleum reserves. As a nation, we consume approximately 19 million barrels of oil per day so the impact of the release is not going to have that much effect. Saudi Arabia and OPEC have given assurances that they will open up their spigots in order to keep oil prices below \$100 a barrel. The price of oil continues to be a cause for concern among those who fear inflation. It is estimated that for every \$10 rise in oil prices, our country spends \$6 billion more a month.

The potential effect of Greece's problems on the European Union's economy and its eventually impact on the U.S. is real but a bit difficult to follow. Greece, which is hemorrhaging money and digging itself into a deeper hole every day, will receive whatever aid it needs from other European Union nations. China announced that it would continue to be a backstop buyer of European Union goods, services and financial instruments. This calmed the world's markets greatly, since China and Saudi Arabia have the world's largest surplus of currency reserves.

Greece's outstanding debt is over 150% of its annual output of goods and services. Anything over 90% is considered to be unsustainable. Every year, Greece spends 10% more money than it takes in as revenue and without a bailout; it will soon be unable to sell its government bonds in the markets. European banks in France and Germany will suffer because they already own a great number of Greek bonds. A failure on Greece's part to sell new bonds through an open auction would cause the price of all outstanding (old) Greek government bonds drop like a stone. This is why the governments of Northern Europe have no choice but to bail out Greece; their own financial systems are at risk if they do not.

We hear rumors that some U.S. money market funds may have cross holdings with some of the same European banks which hold Greek bonds. If Greece defaults on its debt, given the interrelatedness of the banking system and the necessity for implied government guarantees, normally conservative investors such as foreign banks and U.S. municipal governments might get entangled in Greece's morass.

The U.S. budget deficit is a subject that we will hear much about over the next few months since there is an ongoing problem with our nation exceeding its lawful debt ceiling. Democrats and Republicans alike are playing a game of chicken over how much will be cut in government spending and how much taxes will need to be raised in order to save a minimum of \$10 trillion. This is the amount that everyone agrees needs to come off our books over the next ten years. If we do not, it is possible that we will end up in a similar predicament as Greece.

President Obama and the Democrats are suggesting a 3 parts budget cut to 1 part tax increase ratio in order to address the deficit but Republicans, especially Tea Party leaning members, are not buying this proposal just yet. They will reach a compromise before the August deadline for raising the U.S.'s debt ceiling passes. No one wants the government to shut down because then we might not be able to sell our government bonds at the high prices currently received, thus creating a much larger set of issues.

Several states have recently battled their way through these kinds of budgetary issues on a much smaller scaled. Minnesota saw its government shut down because the state legislature and the governor were unable to reach an agreement on a mixture of tax increases and spending cuts. No

one wants to be blamed for a shutdown of the U.S. economy so, as you read and listen to politicians talking about what needs to be done to save our country for the next few generations, pay attention to their votes and not their rhetoric. Most members of Congress are intelligent and capable people, and so, despite their inane utterances in the media, they should eventually move towards a compromise that will not fix the problem but merely kick it down the road for a little while!

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

JULY, 2011: We face the prospect of protracted periods of wildfires here in New Mexico while the rest of the nation looks on, relieved that nuclear waste doesn't reside in their backyards. Similarly, Greece and the European Union as a whole is racked by a tumult of its own, born from decades of political chicanery and financial dishonesty. No one can possibly know which way the wind will blow, towards or away from the stockpiles of above ground drums of plutonium laced debris, nor can we say with certainty if the EU will survive this phase of the dismantling of national identities.

Which meltdown engenders more fear...a release of radioactive particles powerful enough to kill at micro-dosages or the demise of post World War II Europe? For folks here in Santa Fe, already on edge due to smoke and the possibility of evacuations, the ongoing crisis in Europe is as far away as the moon. For Greek, Irish and Portuguese youth demonstrating in the streets, Los Alamos National Lab problems take up as much mental space as Japanese farmers in the Fukushima district do for Midwesterners trying to navigate their breached levee's flood waters.

Being the eternal optimist, I believe there are positive aspects to both situations. Nature cleanses her forests with burns and people who get into financial trouble due to over spending or not enough earnings learn to adjust, adapt and eventually become adept in their new circumstances. It is painful for some but life goes on. The fires will continue until it rains and despite our discomfort, some species will thrive.

Several peripheral European nations will effectively go bankrupt. Until some big changes take place in the laid back Southern European cultures, either Germany will pay everyone's bar tab with the effect of having a pan continent identity formed, or, a split will occur that will separate the industrial North from the agrarian South. Does that not remind you of the issues facing the US in 1860?

Is there a lesson in all this? The dilemma we face is how to determine what resources are going to be devoted to saving and what is likely going down the tubes anyway, be it decades of downed trees and dried underbrush or nostalgic cultures based on high levels of social welfare. It is not a pretty sight here or there. We like to sweep our intractable problems under the door mat of science; figuring nuclear energy's nasty by-products will be dealt with by experts in the industry and a far sighted, caring government. European bankers and politicians believe that basic imbalances in the work ethic and honesty levels, as exemplified by voluntary compliance with tax codes, between various countries can be papered over by bureaucratic institutions and the creation of financial instruments.

Maybe the experts are right and all we need to do is cooperate, coordinate and consolidate until there is one benign governing body looking after the planet. I wish that where each one of us sits on these issues mattered and that how we cast our ballots or spend our dollars really had an impact on public policy. For now, the making of fire fighting decisions, whether concerning forests or finances, is an opaque and inefficient process whose success depends mostly on luck and whose progress is managed by public relations. Another approach would be the practical application of holistic wisdom on a small scale, like everyone putting out their own campfire or paying their bills with earned income. It's an old fashioned view but one that does not go out of style.

JUNE, 2011: People often ask me how they can make money or find a job. My first reaction is to inquiry if they would consider starting their own business. It is my belief, based on experience, is that it is unnecessary to rely on other people to create financial opportunities as long as the drive to succeed is there along with a willingness to put up with some hardships for a while.

Most folks consider themselves hard working and if you don't, there is no need to read further. If you want to live in a place of your choice, have the freedom to come and go as you please and don't mind the anxiety of not knowing where your next dollar will come from, I highly encourage enterprising people, especially young ones, to try it out on their own, at least part time. Look around and observe how many people need help coping with their busy stressful lives. What can you do to make things easier for others?

Let's take it as a given that everyone has some talent or skill in an area that others would find useful. An aspiring entrepreneur should be able to see these needs and figure out several ways to satisfy them in a way that helps others save time or money. Slices of everyday life that most people could use some help with are: yard work, house cleaning, shopping, book keeping, organizing, childcare, eldercare, repairs, and maintenance. Then there are the less routine but normal events, such as dealing with sickness, entertaining, education, vacations, etc., all of which call for some extra effort and expense on the part of households.

What barriers prevent people from starting their own ventures to meet the needs that their neighbors and friends exhibit with some regularity? The main inhibitions have to do with covering the costs of starting up and creating a disciplined schedule that allows time to accomplish the goal. What information do new businesses need about taxes and regulations? Not a heck of a lot if they start with themselves as the only worker and are operating in a way that is honest, safe and respectful. After a new business takes off is the time to get professional help in setting up systems to cover these important bases. Start up enterprises can't afford the time and money to pay outside people to do anything but the most essential support tasks, if there are any, other than serving your chosen target customers.

One thing to be ready for is extremely long hours and a sacrifice of regular vacations. Making do with cheap or free space and arranging to have minimal rent and utilities overhead, often best provided by family and friends, are common ways that new companies save money. This allows them the time and energy to devote to their passion: the fledgling firm. It is not rocket science but sacrifices need to be looked at square in the eye. If you have the guts to take the plunge, you

will find excitement inside of drudgery, new friendships growing out of your supplier and customer relationships and perhaps eventually a self supporting lifestyle.

Look around and you will see for yourself examples of successful entrepreneurs. For the most part, they started with practically nothing, took a passion for something they believed filled a need of others, and, over time, fed their aspiration with ample self confidence and support from a few people who believe in their new direction. Every family yields someone who can start their own business. It could be you.

MAY, 2011: It's easy to complain about how bad things are. Between the wars going on in the Middle east and radiation spreading from Japan, global warming and local drought, government deficits and businesses closing, stagnant housing prices and family members looking for work, it's darn hard to feel optimistic about the future.

Nonetheless, I find my natural optimism reflected in a recent study by global consulting firm McKinsey & Co. Faced with hard facts about the decline of our nation's transportation, energy and social infrastructures, I applaud these smart folks' efforts to define potential areas where we can hike up our pants and get back to work improving our nation's future prospects.

It's all about people and how can we put our precious human resources to creative and productive work without destroying the environment. In the very near future, demographic and natural resource trends will require that we figure out how to organize and accomplish the tasks of life in a radically different way than how we approach them now. Technology will impact, but not solve, our present headaches in healthcare, education, travel, and work. What will?

By international standards, our society overpays and underachieves in most of its schools and medical facilities. Value lost is in the trillions of dollars annually. Twenty percent of our economy is devoted to these two underperforming areas and when combined with the rest of various government service sectors, over half of America's efforts are sliding downhill. Who is doing better than us and why? Let's take what we can learn from them and apply it here.

The Germans know how to manufacture through small, family owned factory networks, so why not go there and copy what works? The Danes, the Swedes and the Dutch all know how to keep their people healthy without going bankrupt. We can figure out how they are organized and what it will take to get rid of the inefficient morass we call "managed" health care. Why should we continue to let insurance companies control our nation's health system?

McKinsey estimated the U.S. will face a shortage of over two million skilled laborers in the next ten years. Is this possible with real unemployment rates around 20%? It is because we do not have a system of vocational/technical training or apprenticeships for the nursing/ health care fields or for the analytical jobs that are already out there. Why not? The community college system we have is a great place to start and should be expanded upon.

Large scale investment in local technology and infrastructure are essential but who is going to pay to fix the roads, mass transit, and high speed broadband penetration? Google just announced they are going to rewire Kansas City, at no cost to taxpayers, because they have the money on

hand to do it and they can profit by increasing market activity there. London charges higher tolls to commuters who use certain roads at certain times. China spends twice what we do every year to increase their dominance in the solar and alternative energy fields. I wonder what Exxon and Chevron are doing with their annual profits of roughly the same amount.

Getting bureaucrats out of entrepreneurs' hair is another way to increase opportunities for motivated people with talent and to foster job growth. There are 50 different sets of legal rules that promote lawyer and doctor cartels, using exam and registration requirement to keep practitioners restricted to a one small part of our country. These are state sanctioned monopolies that shut out competition, increase prices and stifle innovation. At the same time, we need to look at how other countries have done away with the onerous overhead costs, including malpractice suits, so we can free up resources to do productive work.

Please don't misunderstand me, I don't believe that legislating or litigating leads to real solutions. Take energy efficiency: we know that cars can be made that go further on less fuel than they do now and that all of us waste energy by doing nonessential things with our vehicles. Would most Americans trade less comfort and higher fuel costs for a cleaner greener sustainable environment? Probably not, if asked to do so one, but as a group, if everyone made the change at the same time, I bet we would. Making sacrifices used to be an American tradition, its how all of our immigrant forbearers came here and got established. I think we have it in us to do it again!

Personnel and Office News

Rob: Despite this past winter and spring's lack of rain and almost no training on my part, I participated during mid-May in a slow 50 kilometer trail event traversing the now burnt hills above Los Alamos. Gardening and slogging away on the "chapel" take up most of my spare time. For a quick view of these egg tempera panels in process, please see our company web site, "rikoongroup.com". Go to the "publications" page and click on the "art video" tab. In the rear of the land behind the office, we are growing compost in numerous beds that take up space between our fruit trees. Stop by for a tour!

Jeff: We have started some landscaping and gardening projects at my house for the summer. There are still lots of projects waiting for me on the "to do list" as well, like repair a block fence that has shifted due to tree roots, take down a large tree that was damaged from the cold temperatures this past winter, and so on. As my personal commitment to community service, I continue to perform music of the 20's, 30's and 40's at various senior centers each month. Now I even have a few other musicians that join me occasionally which makes it even more fun.

Patricia: This has been a terrible year for gardening. I have learned that when conditions are dry the insects rule. So this year it's all about going with the flow. Other than the garden I am involved in some online courses on diet and nutrition, one of my interests. This September is when I will go on my holiday to Scotland. As it draws closer it seems that time is flying and I am getting pretty excited.

Emily: I'm happy to report that I successfully passed the Certified Financial Planner exam that I took in March. The wait for results seemed like an eternity but it was a great relief to find out I

passed on the first try. I'm glad to have it behind me so I can spend more time playing outdoors this summer.

Dana: It's a quiet summer with few plans. I'm enjoying the family of quail that comes to visit in the mornings outside my kitchen window. There are 11 little ones. They move like a school of fish in their parent's wake and cluster in the shade of a currant bush. At least once a day I replenish the feeders and birdbaths hoping to make their lives a bit easier in this summer's hot dryness.

LOCAL TEA & 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, August 10th, 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 August 11th, our quarterly telephone conference call will take place at 3:30 p.m. MST. The call-in number is: 218-936-4700 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.