The Rikoon Group
2218 Old Arroyo Chamiso
Santa Fe, NM 87505

Summer Commentary 2012

The Markets

The last three months have been difficult for the world's stock markets. The combination of European Union turmoil, a slowdown in Chinese economic activity, and continued anxiety about the strength of the U.S. recovery took the wind out of pretty much each and every stock market worldwide. Facebook's initial purchase offering (IPO) turned into another obvious example of how Wall Street institutions are out for their own benefit at the expense of individual investors. Recent investigations into the largest bank in both England and the United States have uncovered facts that show financial industry titans continue to make profits regardless of the fates of their customers. No wonder then that the public's appetite, interest and faith in the fairness of global stock markets is waning.

The Standard & Poor's Index, the 500 largest U.S. companies, closed down 3% during the 2nd quarter. However, it still is up over 8% for the first half of 2012. The Dow Jones Industrial Average, the 30 largest industrial companies dropped close to 2% this quarter but is still positive 5.42% for the year to date. The NASDAQ technology index declined almost 5% during the 2nd quarter but remains ahead 12.5% so far in 2012.

Europe's equivalent of the Standard & Poor's 500 dropped 5.29% during the 2nd quarter but is down only 2.24% for the year. This is quite a feat given the precarious situation of several nations within the European Union. Worldwide, stock markets, excluding the U.S.,declined almost 7% during the last three months but remain up 3.3% in 2012. Emerging markets, most notably Brazil, China, Russia, India, South Korea and South Africa, declined on average around 8.5% during the last quarter but remain up 4.43% for the full six months of 2012. The developed world's stock market price patterns seem almost tied together, a mark of coordinated cross border central bank interference. Asia, less Japan, declined 4.26% in the 2nd quarter but is up 7% for 2012. Japan itself declined almost 5% over the past three months while still gaining 2.7% so far this year. Even China shows the same chart, declining 1.6% in the 2nd quarter but climbing 5.36% overall in 2012.

Overall, investors are still riding waves of monetary and fiscal easing on the part of the Federal Reserve. When the floodgates of easy money close, watch out below! The Federal Reserve, the European Central Bank and the People's Republic of China all announced that they would continue to make dramatic efforts to bolster their banking systems through a variety of mechanisms. Unfortunately, the fundamental problems of unemployment, rising deficits and degradation of health and educational systems are not helped by the draconian efforts made to keep markets steady over the last several years through lowering the cost of borrowing money and loosening the criteria regarding bad loans and collateral.

The increasingly positive correlation or moving together of the world's markets is a worrisome trend as a major slip up in Europe could easily pull everyone down. Investors removed around $44 billion from stock mutual funds during the last 3 months while adding almost twice that amount to bond funds.

Since 2007, one-third of a trillion dollars has come out of stocks and three times that much, about $1 trillion, has moved into bond funds. This is a cautionary sign for people searching for income via mutual funds because these trends look ominous.

Bond markets continue to treat investors well. While the first three months of 2012 were relatively flat for bonds, the 2nd quarter saw positive returns in almost every bond arena. Municipal bonds gained 1.64% to climb a total of 2.8% for the first six months while taxable bonds gained 2.1% from April through the end of June which brought their total for the first six months to 2.26%. Junk bonds or lower quality companies continued to outperform all other U.S. bonds, gaining 2.07% in the 2nd quarter to end the first six months up 5.7%. The only U.S. income oriented investment that lost money during the 2nd quarter were Master Limited Partnerships, primarily energy and infrastructure assets. These declined 2.26% to end the first half of 2012 practically even at a positive .54% return. Investors worldwide continued to flock to the U.S., reducing their exposure to almost all international bond markets except Switzerland and northern European countries. The U.S. continues to be seen as a safe haven whereby our political stability and military strength solicit a feeling of security. This has been the biggest contributor to our bond markets.

Natural resources, energy and precious metals all have had a difficult time so far in 2012. The overall commodity index, which includes agricultural and industrial materials, is down almost 7%. The price of oil has declined 14% so far in 2012 while natural gas is down 5.52%. Many investors who feel that the world's central banks' flooding markets with easy money for the last four years will eventually result in runaway inflation have put much of their stock money in gold, but so far in 2012, gold has been relatively stable in price, up only 2.4%. This spring, agricultural prices have risen, but this will not help U.S. farmers much because widespread drought in the Midwest has sent expectations of corn and soybean yields down considerably. It is possible that France will export more wheat than the U.S. for the first time in a decade.

The Economy

The United States economy is weak but still on a slightly positive trajectory. The latest employment reports show approximately 100,000 jobs are being produced each calendar quarter but at this level the unemployment rate will never come down from its "official" level of between 8 and 9%. We believe the unemployment rate is around 16%, if one includes people who have quit looking for work or who work part time because they can't find full time jobs. Our domestic economic recovery had been led by the manufacturing sector but this part of the U.S. economy has now lost momentum. The nation's industrial output rose at a 2% annual rate which is not enough to generate new jobs or produce enough additional tax revenue to make headway in reducing the federal deficit. The boost that U.S. manufacturing provided from 2009 – 2011 is now fading due to the sharp and prolonged likely recession that Europe is facing and China's focus inwards towards its own domestic consumption. To combat the decrease in U.S. exports, the Federal Reserve Bank announced they would continue using financial levers to attempt to lower long term interest rates, even though we already have the lowest interest rates in memory, and they have not served to help the economy much. Consumers, who account for over 70% of U.S. spending, are struggling with a lack of income growth. The weak labor market along with the aging demographics of the U.S. workforce results in a need for baby boomers to save for their retirement. This bodes poorly for consumer spending trends. Cars and light trucks sold at their lowest pace in two years during the 2nd quarter of 2012.

U.S. indicators point to continued weakness and the decline in new manufacturing orders during the 2nd quarter was the biggest since soon after the September 11th terrorist attacks. Manufacturing in Europe

is contracting for its 11th straight month and at a much more rapid level than here or China. Euro area unemployment reached the highest level on record at 11.1% overall. The “official” jobless rate in Spain is 25%. If there was 25% unemployment in the U.S., Congress would be out of a job and there would be riots in the streets.

Europe remains the economic Achilles heel of the global economy. At the end of June, European leaders reached an agreement to weave their individual country banking regulatory environments together. This will pave the way for cash strapped banks in Spain and Italy to tap Europe’s burgeoning bailout fund directly. There needs to be a unified supervisory agency in place for banks, but this will not be in place until late 2012. Up until this change, troubled banks have to go through their government to get aid, and it is counted as an increase in government debt. The European Central Bank’s guardians have now also agreed to allow private investors, notably hedge funds, to retain their advantageous position as creditors relative to taxpayers, who are the ones who will be on the hook for contemplated bailout of Europe’s troubled banks. The ECB will soon lower interest rates to try and jumpstart economic activity, but so far that measure has not helped. Whether interest rates are lowered or not, the European Central Bank still faces the challenge of having enough new funds to bail out both Italy and Spain. The resources of the current ECB is only 20% of what will be needed. This means Germany will need to pledge its full faith and credit on behalf of its neighboring countries. Private investors no longer trust southern European governments or banks to repay their bonds, so it will take the combined financial strength of all the northern European countries to give southern Europe the respite it needs. I doubt a majority of the voters in any nation would support this plan, but that is the way this is unfolding.

Germany’s Chancellor, Angela Merckel, has so far refused to pledge Germany’s credit to fixing the decaying financial situation of her neighbors. She will insist that all debtor nations follow a strict discipline in order to get a “new” financial union now being formed, one that will likely lead to a political union down the road. Accepting liability for another country’s debts will involve everyone giving up some of their sovereign powers to a centralized bureaucracy. Please see my article below published in The New Mexican 7/3/12 for further comments on this European situation.

The challenge of how to promulgate growth faces the entire developed world. Aging populations, diminished job opportunities for young people, and increasing health and retirement costs all portend slower growth. The emerging market nations, particularly those in South Asia, have totally different circumstances. Youthful populations and low levels of government involvement mean that competitive enterprises have opportunities to spring up. Nations such as South Korea and Taiwan remind me of the energy and spirit of the technology boom era in our country in the 1990’s. Brazil, Russia, India and China, known collectively as “BRICs”, now make-up 20% of the world’s economy whereas they accounted for only 5% less than ten years ago. By 2020, they are expected to make up approximately one-third of the world’s economy and so their stock and bonds should be of increasing interest to investors worldwide. It is not easy to participate in the world’s developing economies. Some emerging market companies trade on U.S. stock exchanges but only the largest and most sophisticated. As individual investors have fled stocks in the U.S., so too have they retreated from owning emerging market stocks. We are focusing in on several countries in Asia and are finding more and more companies that list their shares in the U.S. markets.

One problem with emerging markets companies is that their governments are often majority shareholders and they regularly put national interests ahead of outside investors. Low interest rates in the U.S. and Europe have helped stimulate growth in BRIC countries because they export to the U.S. Prices of emerging market stocks are generally much more volatile than those in Europe and the U.S.

They often jump 50% or drop a similar amount in the span of several months. This is due to the relatively small size of their markets and the lack of solid accounting information on their operations.

The slowing economic environment in the U.S., Europe and China has reduced global demand for energy. There also has been an increase in supply, particularly of natural gas, but also in domestically produced oil. This has changed the energy situation in North America dramatically. Mexico is now one of our biggest suppliers of oil, and it also has been one of the best performing stock markets so far in 2012, increasing over 8%. The new President of Mexico, while not in control of the legislative branch of government, says that he plans to privatize the state oil company, Pemex, and implement policies that will contribute to the growth of Mexican industry. We feel there will be some good opportunities to buy individual companies in Mexico.

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

MAY, 2012: "French Elections And The Eurozone" Elections are coming up in Europe and their impact on financial markets cannot be overemphasized. French President Sarkozy appears to be running behind Socialist candidate Hollande and if Sarkozy loses, the French - German alliance that has pushed the European Union forward may tear apart at the seams. The Dutch government recently disintegrated over their financial recovery program. Greece and Spain both face discontented populations that are sick and tired of bearing the brunt of austerity measures that supra-national institutions are intent on imposing.

If the citizens of just one European nation vote strongly enough against the ruling parties, investors everywhere need to beware of the strong likelihood of a major tumult in overseas government bond markets. The current tenuous situation whereby central banks are propping up commercial banks which buttress government borrowing is in danger of falling apart. If this delicate balancing act is upset by a lack of confidence in prospective new European policymakers, there is little doubt that a wave of panic that bond vigilantes might unleash will spill over to European stocks.

Occasionally, someone in a powerful position speaks out with the truth. Jens Weidmann, the head of the German central bank, recently made no bones that all of the measures taken so far in Europe to create financial ties strong enough to pull weaker members out of their morass are inadequate. He went on to state that either governments give up some of their national sovereignty over budget matters or else submit to stricter controls which, if breached, impose severe penalties on the offender. This would have the same effect as the compromise made last fall in the U.S. Congress that states unless there is a budget deal by the end of 2012, all programs, including defense (but not their own salaries) gets cut by some amount.

There are other similarities between our situation and theirs. The European equivalent of our Federal Reserve Bank has swollen its size so that troubled commercial banks and wayward political entities can borrow cheaply and appear to be on sound footing. Our housing agencies continue to eat up billions of dollars every month to keep up the charade. The European and U.S. central bank both keep on printing money so they can buy their own governments' bonds and watering down their standards of asset quality so as to not torpedo the domestic economies by asking people to live within their means. Weidmann put his finger squarely on the place where politics crosses economics by stating that "the idea that the required money (to continue the bailouts) will be created through the printing press (and other tools noted above) should finally be brushed aside….because continuing doing so threatens the most important foundation for a stable currency (economy)….the independence of a (inflation fighting)

focused central bank." European and American politicians have been pushing their countries in the opposite direction.

Individual country by country budget goals, set in 2009 as a condition for the first set of European bailouts, were supposed to be cast in stone and to take effect by the end of 2013. They are already seen as unobtainable and any administration that tries to implement the necessary austerity measures to meet them, whether in France, Greece, Spain, Italy or Portugal, will likely be voted out of office. This is what happened in Holland a few weeks ago and why France is facing a meltdown after May 6th. The German government is committed to fighting inflation by not borrowing and much like the American Tea Party, it is loath to give its national credit card (budget surplus) to the rest of Europe or to indefinitely go on paying the bill for other countries excessive spending.

There are many well-meaning smart people working hard to keep the European situation from spinning out of control. At the same time, people everywhere are tired of earning less and paying more for essential items so their patience with politicians and bankers is justifiably running out. European, American, Japanese and Chinese governments continue to take value away from their citizens by printing money, taking on debt, and avoiding the harsh reality that many old companies and structures need to go away. Listen carefully to candidates and their campaign rhetoric for signs of substance, courage or insight. If you find them lacking, maybe it's time for a new political party.

JUNE, 2012: "Easy Money –Where Do We Go From Here?" Next year is the 100th anniversary of the U. S. Dollar. Before 1913, cities, counties, banks, gold companies, pretty much anyone who pleased was free to issue their own currency. In the Wild West, gold and silver bullion deposited in a vault became the basis on which paper IOUs were drawn up to facilitate local and national commerce. With some frequency, the authenticity of the "real" valuables backing up the paper came into question, causing runs on these informal banks, panic and bedlam ensued.

How far have we come since then?! Through federal dictates, the dollar became the only script that was legal and in several steps, control over money was centralized in Washington D.C. under the Federal Reserve Bank in 1935 with the promise that Fort Knox gold would back up the new system. This arrangement gave way, in 1971, when President Nixon removed us from the gold standard, and a new system based purely on government promises was installed. The Federal Reserve tightly control commercial banks who were allowed to issue their own paper: loans and credit, so long as they remained circumspect in the amount and to whom credit was issued.

Under Ronald Reagan's administration, banking was deregulated and the modern financial world was born. Restrictions on the amount and type of credit went out the window. The Savings and Loan industry imploded due to new competition from money market funds, investment banks and other new types of financial service companies. Conservative commercial banks began to trade stocks and bonds while traditional investment houses took in public money so they could share in larger profits while taking on less risk to themselves personally. This helped create the boom financial years of the 1980s and 1990s, the greatest explosion of paper wealth in history.

As everyone knows, the technology stock driven bull market ended in 2000 but the amount of credit continued to expand due to unfettered creation of more and more complex types of financial instruments in relatively unregulated markets. After a brief hiatus, much of this money flowed into real estate and construction, both here and abroad. Good times continued until 2008, when the creators of the new types of credit were seen to be what they really were - stacks (now electronic) of promises that

were good only so long as everyone else in the industry believed they were good. One or two cracks in the system and everything threatened to grind to a halt.

To put this into simple numbers, think of the Old West as a system that created one dollar of paper for every one measure of gold dust deposited in the vault. When the Federal Reserve took over, they allowed staid bankers to create five dollars of loans for each U.S. government issued currency on deposit at the bank. After Reagan, non-bank banks could issue loans and paper securities at pretty much any multiple they wanted and when traditional banks got caught up with the game, the new ratio was twenty to one or fifty to one or seventy to one in the case of Lehman Brothers and Bear Stearns. It's worth noting that the advent of electronic computing power is partially what made the explosion of credit possible to create, sell and sort of track but that is another story.

We now live in a world where the Fed and other central banks around the world want their commercial bankers to go back to something like a 10 to 1 ratio of "government issued currency" to loans or credit. The only way many of them can accomplish this is by trading (gambling) their non-regulated securities accounts or by selling assets. What about the government itself? Its ratio of loans to real money in its vaults is currently about 13 to 1, worse than the standards set up for the banks. This does not include the cost if the unfunded retirement benefits promised government employees or the implicit guarantees that the government has given the banking industry to come home to roost. One estimate is that there are now four times the amount of obligations out there, not reported on anyone's books, as there is in official debt that gets reported to the public. This means the true ratio of "real" money to credit in the U.S. is about 52 to 1 and it is just as bad in Japan, Europe and China.

The reality is that any country with $50 of debt to $1 of real capital cannot work their way out of debt. It can be whittled away by raising taxes and cutting services, as in Ireland, Spain, Portugal, and Italy, but that involves a great deal of immediate pain for the public with very slow improvement in economic results. Countries can try to devalue their currencies, like Japan and the U.S. are doing, but that entails very high costs in terms of depleting national reserves of currency. Devaluation has limited results that benefit mainly the manufacturing sector of the economy and if enough countries try to devalue at once, everyone gets hurt and no one benefits. Defaulting on one's debt is another option, as Iceland has done and Greece may soon follow. This allows one to restart the game after getting sidelined for some period of time during which no credit gets extended and society goes back to barter like system. The other method of working one's way out of a mountain of debt is through inflation. Taxpayer, consumers, investors and working people need to anticipate what an environment combining austerity and inflation will bring. Next month's article will focus on who might be the winners and losers in such an economy.

JULY, 2012: "Will There Be A United States Of Europe" We are in the middle of the European equivalent of the US Civil War (1860-1865). That war, the bloodiest in our nation's history, was fought against the wishes of the vast majority of the public whose opinion was, in retrospect, thankfully ignored. Likewise, most citizens in the countries that make up the European Union (EU) have no desire to give up their national sovereignty or to financially support other people's lifestyle. Nonetheless, pan European bureaucrats have no choice but to advocate for a fiscal and eventual political union in order for Europe to compete in global markets and to avoid repeating the long history of intra-European armed conflict.

Taken as a whole, Europe is the world's largest economy; it makes up 25% of global output and consumes 30% of the planet's annual production. Seven of the 10 most competitive economies are in Europe, and five of its northernmost members account for 25% of worldwide research and development spending every year. European companies whose activities span over several continents are certainly hurt by turmoil in their home country but this hasn't stopped US multinationals from consistently

putting half of their foreign investment into Europe over the last decade, about 70% of that into the northern tier nations. When stock prices drop due to upsetting news out of the EU, we see opportunities to buy high quality, sustainable dividend paying companies that can take advantage of Europe's size, huge reservoir of wealth, advanced infrastructure, and sophisticated and well educated population base.

This is not to say that there will not be battles lost along the way to an integrated Europe. Individual countries may go bankrupt, political events may turn temporarily violent and much money will probably be lost along the way, especially in government bonds. In the end, Germans will end up paying in more and getting less out of their EU membership than others will, such as France, but this is how "federal" governments operate.

A "United States of Europe" will backstop its banks with FDIC- like insurance while a combined budget process and joint bond issuance will drag down Germany's credit rating. All of this will send investor money into our markets and buttress share prices of blue chip American companies. It's not that we have our financial house in order, our total debt exceeds that of the EU, but Americans tend to have a greater willingness to change course and renegotiate contracts through bankruptcy or voluntary reorganization.

When West Germany took on responsibility for resuscitating East Germany after the fall of the Iron Curtain, they did so through privatization, reducing labor union and tenant powers, and by lowering tax rates. It remains to be seen if individual countries in Europe have the will power or stomach to face strong public backlash against the first of these two measures. Presently, they are taking the opposite tack on tax rates, levying new income tax surcharges on upper income people and attempting to add more sales tax on everyone, not great recipes for long term growth. A combined European nation of nations might be able to break the cycle of government largess and financial irresponsibility.

Here in the US, there have been some instructive and positive developments recently, where voters indicated that entitlements promised in former flush times should not dictate the course of the future. The USA retains a global lead in creativity and, if we could combine that with getting our various governments' fiscal accounts in order, a much desired blossoming of employment and investment opportunities would arrive on our shores, probably well before the civil war in Europe is over.

Personnel News

Rob: June was hot and dry here in Santa Fe with zero precipitation. Our sympathy goes out to people and animals displaced by forest fires here and in Colorado. Our company's gardens have languished under the hot sun and insects produced by the extreme weather. In May, I participated in a 50 km trail run through the Jemez Mountains which suffered from last year's fires leaving a fascinating landscape that is slowly rejuvenating itself. Some progress is being made on the egg tempera chapel panels which should be available for public viewing later this fall. My daughter, Hannah (23), graduated from Bard College in May and Robyn (26) continues to find roles in independent film productions around NYC along with her job making coffee and assisting management at the Grey Dog Cafes in lower Manhattan.

Juliana: In May, David and I had a lovely trip to Virginia. We started off by visiting friends in Charlottesville who gave us a great tour of Mr. Jefferson's university and his home. Then, we headed to Williamsburg, where we spent time in that fascinating Colonial town. We ended up at Deltaville with a friend who took us sailing on the Chesapeake. In June, we took a short weekend trip to Seattle to visit

David’s sister and her three children. It was such a treat to be surrounded by green and moisture since our poor New Mexico is so parched.

Jeff: We have an abundance of fruit on the trees in our backyard this summer - cherries, apricots, apples, pears and plums. This is the first time that we have had any fruit at all due to late freezes in the past 2 or 3 years. My wife's vegetable garden is also off to a great start. Summer is definitely here!

Patricia: Everything is pretty quiet in my life, just tending gardens during some pretty dry weather. This spring, I did attend a couple of local Santa Fe fundraisers with a friend. The Horse Shelter holds an annual lunch/silent and live auction out in Cerrillos at the horse sanctuary. Along with a great lunch from Restaurant Martin, we got to see all of the horses who look healthy and happy. They do a great job. I also went to the Feline and Friends fundraiser and spent the afternoon with a lot of other cat lovers.

For folks in the Santa Fe area, we want to offer some names of dependable tradespeople that I have used. We can recommend an irrigation guy, a plumber/drain man, a plumbing company for more complicated work i.e. floor heating and boilers, and finally, a guy that does a great job washing windows. If you are in need of any of these services, give me a call at 505.983.3445 or send an e-mail Patricia.Cody@rikoongroup.com . I hope everyone has a delightful summer!

Emily: So far I’m enjoying the Santa Fe summer with plenty of hikes, lots of soccer and BBQs on the patio. While it looks to be a summer close to home – I’m hoping to get some time out of the office this fall to explore.

Dana: The Santa Fe skies are clear blue and the puffy summer clouds are gathering in the afternoon; a beautiful sight, indeed! I recently returned from a retreat of sorts in Ennis, Montana. I had the opportunity to spend several days exploring Yellowstone, specifically the North Rim of the canyon and the Norris geyser basin. The earth there is truly alive and bursting with energy everywhere you look. I was thrilled to see a mother moose and her little one running across a meadow.

LOCAL TEA & CONFERENCE 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 8, 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 9,** 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.