

RIKOOON CARRET
510 Don Gaspar
Santa Fe, NM 87505-2626

Summer Commentary 2006

The Markets and the Economy

The second quarter of 2006 was nerve wracking for most investors. During the first five weeks, the market continued its rally that began in early 2006. But after the second week of May, the markets' gyrations headed downward, and so, by the end of the quarter, the Standard & Poor's 500 had a loss of about 1.2% during the second quarter while bonds remained fairly stagnant. During the first six months of the year, U.S. Large Companies as measured by the Standard & Poor's 500 gained 3.05% while the Rikoon Carret portfolios gained 4.01%. Even the international markets have been battered by adverse macro economic conditions which I will describe in greater detail below. The Dow Jones European Index of the 50 largest stocks has gained 3.35%, an amazingly close correlation with the U.S. market, while the Rikoon Carret International Equity Large Company portfolios gained 7.58%, before fees, during the same 6th month period.

In the bond area, taxable bonds as measured by the Vanguard Short Term Bond Index Fund gained .54%, including interest. Most bond prices continued to fall as the Fed has raised interest rates seventeen consecutive times over the last four years. The Rikoon Carret Taxable Bond portfolios gained 1.18% during the first six months while our Tax Free portfolios have gained 1% versus the Short Term Municipal Bond Market Index gain of 1.2%.

Why the headwinds? It has been more than seven years since Blue Chip stocks as a group have done anything more than move sideways. Technology stocks have suffered worse as they are languishing well below their records of late 1999. While many professionals point to the Federal Reserve as the culprit given the seventeen rate increases noted above, the fact of the matter is that the world economy is slowing down. It has been a long time since the U.S. has had a recession and corporate profits are reflecting a slow down in consumer spending at this time. We depend on global markets and so looking overseas, we note that the Bank of Japan is finally increasing interest rates and making money less freely available as their economy has started to operate at a decent pace. Banks across Europe are raising interest rates and so investors, who have been used to borrowing money at almost no cost and investing in risk or growth oriented assets, are having to pull back.

As interest rates have gone up, bond yields have increased and so we at Rikoon Carret are committing to the fixed income or bond markets for longer periods of time than we have for the last four or five years. The headwinds for stocks ought to create a tailwind for bonds, one much welcomed as it has been a long, hard pull for bond investors over the last several years.

Are we in the beginnings of a bear market for stocks or is this simply a correction? No matter what our thoughts are, clearly the momentum is sideways to down. We look at it as a kind of transition out of high risk growth vehicles and into stable, high cash flow dividend producing companies. For the first time in many years, we at Rikoon Carret have changed our overall asset allocation models to reduce our stock portfolios and increase bonds. We are still believers in long term stock investing but do not see 2006 as likely to show more than a single digit percentage gain for most stocks.

With the end of easy money, investments in speculative areas such as developing countries, industrial commodities, second home and other speculative real estate investments are showing strains. Even gold is off 15% from its twenty-six year high hit on May 11. Some people feel that gold has a chance to double from its current levels because of the unsettling affect of higher oil prices and the wild cards represented by Iran and North Korea. We are not in agreement with this view and do not see gold as acting as a surrogate currency ever again. This is not to say that personally owning some small amounts of gold, especially in coin form, is not a good idea.

Persons whose home loans are based on adjustable rate mortgages are starting to feel some pain. The benchmark 10 year Treasury Note has gone over 5%. While this makes income oriented investors happy, it makes people who have borrowed money on adjustable rate mortgages quite uncomfortable.

Oil prices have refused to fall significantly below \$70 a barrel, and we do not see them doing so for any extended period of time in the foreseeable future. This means that consumers will have to get used to higher costs and one important ramification of this is a slow down in consumer spending. This in turn will impact retail business profits and while not unexpected, the drag on the stock market that this represents is real and likely to be felt for a protracted period of time.

As the United States approaches mid-term elections in November, we will see much hullabaloo about making tax cuts permanent and at the same time, raising some tax levels back to a higher level in order to address the budget deficit and to fund social programs which have been cut over the last several years. The markets tend to be anxious about elections until they happen, and as with the Federal Reserve pronouncements about interest rates, once the results are known, the market will likely shrug off any balanced outcome to November's election process.

We believe that the Fed is pretty close to being finished with interest rate increases as the new Fed chairman has proved his mettle as an inflation fighter. Perhaps he has gone too far and the economy will slow down more than it might otherwise, but given the international flow of money, the actions of the Bank of Japan noted above will probably have more effect on our economy than politicians in Washington. Overall, corporate profits should come in fairly anemic during the rest of 2006, and this, along with uncertainties about international events, means that stock market returns will be muted.

Educating America One of the basic building blocks of our economy is the level of preparedness of young people to enter the workforce with relevant skills, a good attitude toward continuous learning and some basic interpersonal abilities. Most of the professionals that I know who are in education believe that our public education systems are under funded and overextended. They almost unanimously dismiss the efficacy of the government's testing requirements under the "No Child Left Behind" Act. Few feel that a system that judges performance based on standardized tests is appropriate and that in many ways it precludes them from providing other kinds of highly needed instruction for young students. Our nation's future business competitiveness is at risk.

It is well known that most very young children are eager students. From extremely early ages, children are able to absorb language, math and interpersonal skills if they are exposed to challenging and individualized curriculums. We know that many problems that afflict America which exact a high economic as well as social cost, such as crime, drug use, and violence, come at least partially from a lack of love, care and attention during early childhood. Good teachers know these things, but the lack of financial support makes it almost impossible to give real personalized attention, except in exclusive private school settings.

The human and financial cost of our improper focus and lack of funding cannot be overstated. It is hard to understand how teachers can receive so much less compensation than that available to people working at similar levels in business or government. What makes us place such a low value on the development of our most precious resource? What would it take to adequately develop our young people to meet our country's present and future needs?

It seems to me that young people between the ages of 13 and 18 exhibit little patience or interest in formal classroom settings. Matching up the various stages of physiological and brain development of children with their educational environment might mean that middle and high school instruction doesn't begin before 10:00 a.m. My daughter sure likes this idea! Doesn't it make sense to start middle and high school classes and programs later, so as to not waste time and effort on the part of students and educators?

Many young people finish school feeling directionless because they have had little hands on experience in the world. Middle and high school students might serve and be better served better by being out of formal classrooms for a good part of the day. Young people are active and exploratory. They would benefit by participating in building projects, nature studies, and community service work. The money we spend "babysitting" capable teenagers is a waste. Boys and girls from the age of 12 or 13 can and should do real work. The kind of learning that takes place through kinetic engagement is much needed by fast growing bodies and minds.

I believe this is one of the reasons that charter schools have taken off. Our tax dollars have traditionally not been put to good use in middle and high schools, but we have grown accustomed to a bad situation. In response to this, many charter schools provide personalized, focused instruction and involve young adults in active learning. The threat

to centralized bureaucratic control is real but healthy. It is competition in the educational marketplace.

If we could figure out how to get the system off the backs of teachers and administrators who now have to spend inordinate amounts of time and energy ensuring compliance with government regulations, more hands on time with the kids and more creative programming for their benefit could materialize. Skill testing ought to take place not to penalize or reward the schools, teachers, or students, but so that individualized instruction can be directed where it is needed with no shame or blame attached.

In Europe, young students are introduced to various trades and technical areas in their early teenage years. We have learned from this example because it is quite common for motivated high school students to take classes at community colleges. Our system of community colleges is quite strong, and it provides the opportunity for teenagers in many communities to expand their horizons with high quality instruction at low cost to taxpayers.

As I look at our nation's shrinking natural resource and industrial base, and note that cutbacks in public funding of education seem to go along with an increasing need for services, I wonder about the ways our tax and political systems have failed us. Schools are primarily funded from revenue and taxation on property. Over the last several decades, widespread real estate investment activity has brought much wealth into the hands of a fairly small segment of the population. This, in my opinion, ought to translate into increased funding for public education. There are many committed and talented teachers who would welcome the opportunity to work in an environment where their skills could be put to work in active learning programs.

The reorganization of schools and appropriate funding of educational programs through revamped taxes are political issues. Where is the leadership needed to take the steps required? That is a question begging to be answered. If we could transform our schools into environments where students can learn at their own pace, be challenged in ways that match their development needs, and ultimately become productive and creative employees, everyone would benefit. It is a question of having the courage to make some bold changes upfront in exchange for a real monetary payoff later.

The fostering of entrepreneurial activities in America depends on students who are better rounded, more experienced in real life work situations and who are confident in their ability to learn on the job. I don't believe we can afford not to look creatively at alternative structures for our young people. Teachers are the best source of ideas about appropriate venues for their student's learning so let's start listening. It would be worth the effort, time and yes, even money in order to enable our collective future work force in these ways.

Iceland Having recently traveled to Reykjavik, Iceland, I observed several ways that Icelanders enhance their own and their many summer visitors' experience of their city. Some of this might be relevant for many American communities where the local economy is based on

services to tourism and the “retirement” community. I believe it is appropriate for us to try to learn how we might integrate the sustainable practices that have been successful for Iceland into our local business development efforts.

With proper planning, some funding, and mostly unskilled labor, we could emulate Iceland’s capital, Reykjavik, where pedestrians, bicyclists and clean energy small bus riders have precedence over private motor vehicles. They have tastefully designed and built walkways everywhere which promote safety and beauty. These involve multicolor raised bike paths, paved and gravel trails with subtle lighting and adequate signage. They crisscross the city allowing people and animals to move leisurely between hotels, restaurants, recreation, shops, museums and nature.

In places where weather permits almost year round enjoyment of great attractions, it seems to me that potholes, intermittent sidewalks and lack of an easy flow between tourist locations leaves too much to chance. Signage, with directions, would be helpful. We could have clean buses in urban areas that offer free shuttle service. City officials and planners should be looking to lead the way in these matters but as always, the question naturally arises as to where the money will come from to put such an integrated people friendly system into place.

Icelanders add flavor to their city’s human byways with outdoor art, which is everywhere. America has many artists who would probably donate, at least on a temporary basis, outdoor sculpture and craft constructions to adorn public spaces. Visitors to Iceland rarely see trash on these alternate people transportation routes as pride and regular cleanups scheduled by volunteer civic groups instill a clean aesthetic sense which permeates the landscape. School groups would get appropriate lessons on civic duty by so participating.

Community gardens in Iceland are sponsored by neighborhood organizations, and they occur in medians and behind the many simple benches that regularly mark the quieter path sections. Due to the common acceptance in Iceland of the existence of “hidden people”, whom we know of as elves, dwarves, gnomes, trolls and fairies, one occasionally bumps up into a wee (little) bit of wilderness right in the middle of town. It would take time to gather the necessary right of ways and to define the specific steps, but besides having a salubrious effect on tourism; the process of putting such a network into place would also build some strong person-to-person and group-to-group community ties.

A common sight in Iceland are out of school students dressed in bright colored jumpsuits, wearing gloves and hats to protect them from the elements, working in groups to continuously enhance and maintain the public greenways and their pedestrian protection devices. The kids there all have summer jobs and the community benefits in so many ways.

Boycotts: Are they an effective tool for change? Speaking of labor, I would like to focus for a moment on the role of immigration in our “free market” economy and a discussion of the use of economic boycotts to achieve political goals.

The United States has obviously been built by waves of immigrants throughout our history. Most of us can trace our roots and know the story of how our ancestors came to

this country. The vast majority of American's sympathize with others who struggle to achieve, through education and assimilation, the language and culture. Our economy is founded on the theoretically "free" exchange of labor, capital and goods. The free flow of capital, or money, is an easy concept for American businesses, as we clearly want access to Asia's capital markets and have no trouble berating governments overseas for closed door policies that shut out our financial service firms.

When we look at the free flow of goods, for example those imported from China, there are calls for tariffs, protective laws and taxes to aid U.S. industries. Most people understand that America's consumers lose under tariffs because prices go up. Eventually, retaliatory action on the part of affected nations would escalate backlashes leading everyone worldwide to a much lower standard of living. This is what happened during the Great Depression of the 1930's.

The issue of free exchange of labor is much more emotionally charged! American industries such as agriculture, construction, and foodservices depend heavily on immigrant labor and much of that labor force lacks official paperwork.

Under current proposals being debated in Congress, illegal immigrants already in the United States would be prohibited from using previously presented false papers in order to continue their employment. They would fall into a black hole as there is no clear cut way for them to obtain legitimate authority to work in the U.S. The mass demonstrations that took place across the country recently had as their goal the legalization of undocumented workers. Whether the current law under debate in Congress ultimately provides this, is uncertain.

Our government is in a tight spot. Advocates of keeping illegal immigrants out of the U.S. garner support from voters concerned about the increased cost of public education and health should these services be extended to a larger population base. There are those who believe that encouraging current and future immigration is essential to the workings of the American economy. Even the new Federal Reserve Chairman, Ben Bernanke, who is a well known scholar of the Great Depression, is greatly concerned. He warns that "growing inequality threatens the U.S.'s commitments to open markets. Our society is based on opportunity, it's based on flexibility in labor markets and product markets, and it's based on open and fair trade. And all of those things are at risk if a growing portion of the population feels they are not sharing in the benefits from those changes."

Did the recent one day action aid or hurt the cause of immigrants seeking legalization? Are economic boycotts a good or bad thing for our society? Politicians such as President G. W. Bush and New Mexico's Governor Bill Richardson clearly feel that boycotts are an inappropriate expression because it hurts trade. On the other hand, I feel that boycotts are one of the few effective tools available to populist movements. People can express their dissatisfaction effectively with the current system by withdrawing their labor and their capital. If everyone who was concerned with global warming rode bicycles to work and school one day a week, what a difference it might make.

It is interesting to note that employers whose workforce consists mainly of immigrant labor supported the recent demonstrations and made allowances for their workers to attend. This is because they need the continued goodwill of the immigrant workforce in order to be globally competitive.

The reality of our situation is that many jobs would not get done if immigrants were unavailable to fill those positions. We need immigrant labor, yet we resent their potential weight on our social service systems. In much the same way, we resent China for its large trade surplus with the U.S. as we enjoy the benefits of that trade in the form of cheap consumer goods.

Do boycotts work? Looking back at the boycott of firms doing business in South Africa, and the previous successful boycotting of the grape industry in California during the 1960's, it seems that boycotts can and do sometimes work. If there is a clear and concise message, it's that if enough people believe in the actions proposed, and if the desired result can be implemented relatively quickly, then a small number of citizens acting in a concerted fashion can be effective.

This is not at all to say that the issue of immigration will be solved by any one piece of legislation. Due to the timely and critical nature of people earning a living, it is likely that we will see further actions similar to the recent one day boycott.

In consideration of American businesses, the boycott organizers gave employers enough advance notice so that they were able to reduce their operations ahead of time and not incur substantial losses. U.S. labor law protects participation in boycotts and so workers, at least those who are legally registered, are not at risk of losing their jobs.

One thing is for certain, basic demographics are changing, and we cannot escape the economic social trend, the browning of America, which creates the need for further strong-armed actions to establish the rights of people who are part of the most recent tidal wave of immigration. It should be very exciting, at least for those of us who speak Spanish.

Personnel News

Rob: Over the past several months, I have been training intermittently for a 100 mile trail run in Leadville, Colorado which takes place August 19 and 20. In the early part of May, I participated in a 50 mile run in Buena Vista, Colorado which was a lot of fun. I continue to commute back and forth between Santa Fe, New Mexico and Asheville, North Carolina even though both my daughters are overseas this summer. Hannah, 17, is volunteering in Central America, through an international community service project called Amigos de los Americas. She is in a small village called Arenales in the mountains of Honduras with one other American, assisting the villagers to keep their milking cows healthy, teaching English to children and building community public service works. Hannah will be back after six weeks of no iPods, cell phone or any type

of electronic communications. My daughter, Robyn, who is now twenty, visited Israel on a program called Birthright. She is participating with some of the instructors from her school, the North Carolina School for the Arts, in a voice workshop in Arrezzo, Italy later this summer.

Juliana: I recently attended a very informative seminar on stock market strategy and new investment vehicles available to our clients. I was able to spend some time talking with other investment managers and market strategists, gathering information on their investment ideas. The fact that it was at the Broadmoor in Colorado Springs made it even more attractive!

Jeff: I have been able to ride my bicycle to work a couple days a week. Going to work is a bit challenging as there are a lot of uphill stretches but then returning home is a breeze. We have been doing lots of landscaping at my house this summer. We have received many truckloads of topsoil, soil amender, mulch, drought resistant plants and trees and other mysterious things. My wife is the landscape designer and I am the unskilled laborer. However, she did inform me that I am responsible for the drip irrigation system, so I have the front yard completed and the back yard is going to be a lot more challenging. We took our daughter for her first trip to the Grand Canyon in June and I am taking her to a large Sand family reunion in North Dakota in July.

Patricia: I would like to make all of our clients aware that their Schwab confirms and monthly statements are available online now. Some clients will be eligible for discount trading fees if they sign up for all three of Schwab electronic services; e-confirms, Schwab Alliance and e-statements. Let me know if you have any questions about that.

pcody@rikooncarret.com

tel:505-989-3581

fax: 505-983-8086

Dana: I'm enjoying the relief that summer rains have brought that make for milder tempers and easier weed pulling. I spent a recent weekend in Durango on a burgeoning flower and vegetable farm and put in a day of paddling on the Animas River in inflatable kayaks with my daughter. In the interest of minimizing information overload and saving paper on duplicate reports, we will forego the mailing of monthly reports with quarterly reports unless you specifically request them. You can contact me by phone or at dhees@rikooncarret.com. Thanks.

Upcoming Events

The next tea will be held on Tuesday, August 15, from 3 to 4:30 p.m. at the Rikoon Carret offices in Santa Fe. Please RSVP at 989-3581 if you are able to join us.