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Summer Commentary 2013

The Markets

Despite the best half year start since 1999, the world's stock markets have the heebie jeebies. By the end of June, the Dow Jones Industrial Average was up 13.2% year to date, but only after a tumultuous month during which it fell (1.4)%. The mid-cap U.S. index rose 14.7% and the small-cap markets rose 17.3% during the first six months of this year. Due to the perception that the U.S. remains a safe haven, money continued to flow here from overseas and subsequently U.S. stocks far outperformed most other markets.

The index tracking the world's markets, excluding the U.S., fell (0.3)% during this 6 month period. Europe's stock index rose 2.7%, primarily due to the Swiss market which rose 13.3%. Most other European markets returned between (5)% and 5% during that period. The Asia-Pacific stock markets grew approximately the same as Europe, around 2.4% with China losing (11.6)%. Japan's Nikkei index raced ahead 35.6% in local currency terms, due to a dramatic shift in their country's new government's monetary policies which now mimic that of the U.S. Federal Reserve and the European Central Bank.

In the bond markets, the impact of rising interest rates in June clipped all indexes with municipal bonds down (0.48)%, the taxable index lost (0.58)%, and the U.S. corporate high yield bond index declined (0.45)% for the first half of 2013. Mortgage rates rose dramatically and this sent the mortgage rate bond market down (1.25)% over the last year.

The U.S. Dollar rose against most other currencies, with the Brazilian Real falling (10)% versus the U.S., the Australian Dollar down (13.6)%, and the Japanese Yen dropped a precipitous (16)%. The Egyptian pound and South African rand fell (10)% and (18)% respectively, due to political turmoil. Slowing global economic activity resulted in the average price for industrial commodities declining (9.42)% so far in 2013. Crude oil prices have risen to nearly $100 a barrel, up 8.47%, while natural gas continues its slow, methodical rise from its long-term nadir, up 9.04%. Precious metals fell dramatically, with gold prices down (25.75)%, its biggest 3-month decline since gold futures started trading in 1974.

We believe that activity in the bond markets is worth watching much more closely than short-term swings in stock prices. Bonds are more sensitive to changes in interest rates and the true prospects for future economic activity than stocks. Bond traders are extremely focused on these two factors and they have huge positions to sell quickly when they become nervous, which they are now. Individual investors, who poured $1.26 trillion into bond funds over the past 6 years, withdrew approximately 5% of those funds or $61.7 billion during the first half of 2013. Global bond markets dropped (2.9)% in May and June, the most since the inception of this index in 1996. The broad U.S. bond market plummeted (3.5)% in May and June, its worst decline since the two months ended October 2008, when Lehman Brothers went under, ushering in the Great Recession. U.S. Treasuries lost (3.3)% during the 2nd quarter of 2013 for their third straight quarterly decline after a previously uninterrupted 13 year bull market.

Bonds are supposed to provide a safe haven to investors as their stability and yield attract conservative investors. In a swift but sudden shift, both of these attractive qualities have dimmed

but we sense that many investors still have their heads in the sand and are ignoring the warning lights of Ben Bernake's verbal mention of a potential timeline for a shift in Federal Reserve policy. This pronouncement sent the markets down dramatically in June. Most of the market upset has now passed, due to reassuring but disingenuous statements issued by global central bankers. We believe that the introduction of the concept of scheduling when the Fed's support of the economy might be withdrawn was intentional and that there will be several more instances when one or more Fed governors say one thing and the rest of the same organization's spokespersons contradict that announcement. Authorities know they need to plant the seeds of change in monetary policy slowly, so the public can get used to the idea without panicking.

Investor returns worldwide are dependent on central banks' continued injections of cash into domestic stock and bond markets – currently $85 billion a month in the U.S. There are similar sized programs in both Japan and Europe. The recent mention of a pullback in government support upended the markets so much that interest rates jumped higher across the globe. The yield on the U.S. Treasury 10-year rose to 2.485% from 1.63%, almost a 50% rise. Interest rates have declined since 1983 so the transition from a falling interest rate to a rising interest rate environment is something many investors and traders have never lived through. Typically, bonds are priced based on inflation plus a modest return. This means that U.S. Treasuries should be paying over 3%, instead of 2.2%. There may be another 30% rise in rates even if there is no increase in inflation. Central bankers hope that investors will calmly accept an orderly exit of the Fed from supporting the markets. This was not what happened this past June. Everybody wants to be the first one out of the market when bad news arrives but it turns out that no one gets to be first. When the Fed or ECB stop buying bonds, the markets open sharply lower the next day.

The search for yield or reliable cash distributions continues on the part of investors. Our reading of the situation suggests we still have the majority of a correction in the bond market to experience. Central banks cannot indefinitely expand their influence so the question is how quickly investors bail out once government support leaves the bond market.

As a result of the recent rout in the bond market, many sectors of the stock market that had been leaders due to their steady dividends, such as telecommunications, consumer staples and utilities, lost money so far in 2013. The strategy of looking for high dividend paying stock is one we have championed over the past several years. We are now wary of high dividend paying companies, especially real estate investment trusts, as these sectors seem to be ripe for further declines. High dividend stocks with increased profits that are reinvesting in their own businesses tend to be more resilient, so this is our strategic investment focus at this time.

The Economy

The manufacturing as well as service industries are sending mixed signals on the health of the U.S. economy. The U.S.'s Gross Domestic Product (GDP) looks set to fall from 2012's level of 2.2% to a growth rate of 1.9% in 2013. This kind of moderate growth in the U.S. economy is welcome news for inflation hawks because it means that U.S. consumers have not experienced much of a rise in prices. This is not our personal experience but who are we to question the veracity of government reports. There is increased optimism as consumer sentiment is at its highest level in more than 5 years. Americans are convinced, at least according to the news, that now it is the time to increase personal spending due to higher home values and elevated stock prices. While the real estate economy is extremely strong in some urban areas, notably New York City, San Francisco and Los Angeles, many parts of the country, including Santa Fe, continue to see downward pressure on home prices.

The U.S. seems to have a relatively stable job market, at least for those people who already have jobs. Consumers are making large purchases of durable goods like automobiles, so U.S. car companies are experiencing their most profitable year in over a decade.

While service and manufacturing companies are showing some growth in revenue, they are creating few new jobs. Reports show approximately 187,000 new jobs per month are being created in 2013, somewhat below the base rate of 200,000 jobs considered needed to keep overall employment levels steady. Nonetheless, official statistics show unemployment levels dropping from 7.6% to 7.5%. Our thought is that the Fed's stated target unemployment rate of 6.5% will never be reached, and therefore they will be freed of the obligation to categorically cut back on their bond buying. Consequently, the central bank can then adjust policies stealthily so that the investing public is not aware of what's going on until well after it's done.

There is a sense of unreality in the market relative to the state of the underlying economy. This is in sharp evidence in France where government bonds have had positive returns so far this year even though France's actual economic performance has been dismal. Investors see the easy money policies of the European Central Bank, which is flooding that market with cash, so they buy French bonds because of the lack of available alternative investments in the sovereign government bond world. The shrinking supply of "quality" rated bonds in a market sloshing in cheap money means demand for assets like French bonds will continue. Experts say that fundamentals are not important and when it comes to buying bonds, it's a matter of the best alternatives currently available. This is nonsense.

Bond buyers do not seem to care that France has been downgraded by Moody's and is in risk of further downgrades. The French unemployment rate is officially 10.6%, its highest level in 14 years, but these numbers underreport youth and minority joblessness. France's gross domestic product shrank 0.2% in the first 3 months of 2013. The country is in a deep recession with little prospect of being able to grow its way out. France's debt, as a percentage of GDP, rose to 90% last year from 79% in 2009. 90% is the level from which most economists feel a country cannot recover.

French bonds benefit from the widespread feeling that the Euro will survive as the common currency of most nations in the EU. We feel this is erroneous and that future political events will lead countries such as Portugal, Spain, Italy, Greece, and even France to perhaps stop using the Euro as their common currency, though they will all likely remain in the European Political Union.

Emerging markets have taken a substantial hit in 2013, due to political clashes between the increasing numbers of educated but unemployed workers and their reigning governments. Countries like Turkey, Brazil and China are also being hurt by two other negative factors: slowing economies and falling commodity prices. In China, missteps by the central bank, who tried to slow down the overheated manufacturing and real estate sectors, are manifesting as weakness in local economic activity and, therefore, a reduction in exporting opportunities for European and American companies. U.S. trade export data recently showed the second highest trade deficit on record, $45 billion a month, as U.S. consumers, in their optimism, have resumed buying Chinese goods while Chinese consumers, in their pessimism, are pulling back on their purchases of American items.

Approximately $4.2 trillion went into emerging countries' stock markets between 2009 and 2012. Those economies continue to have good performance, collectively they will grow around 4% in 2013, but that is disappointing compared to the extremely high levels of growth, close to 7%, of the past several years. When China's growth rates slow down, it impacts countries as far afield as Australia and Brazil. Brazil is China's largest trading partner and the drop in raw material prices in

2013 has contributed to a slowdown in the Brazilian economy. As Australia exports much of its natural resources to China, it too has been affected.

In India, difficult economic times and stubborn inflation have sent the Indian currency to an all-time low versus the U.S. dollar. Turkey, which has been one of the best performing emerging markets, has been hit by weak demand for its products in Europe, due the ongoing recession. Political unrest in all of these countries will be a factor over the next several quarters, as the benefits of rising stock market prices accrued to only a small percent of the population of these nations. Unlike the U.S., most consumers in the third world do not have retirement accounts so there is little opportunity for workers there to benefit from a rise in their local stock market prices.

As a result of these economic factors, the U.S. dollar is poised to have another period of ascendancy in the world's markets. The slow but steady level of U.S. economic growth distinguishes it from the demographically challenged economy of Japan and the politically challenged Eurozone. Both Japan and Europe are expected to have minimal economic growth as they face severe dislocation of their traditional ways of doing business. Emerging market economies, while growing at a faster rate than the U.S., are prone to the adverse effect of volatile swings in commodity prices. While all this bodes well for the U.S., relative to others, our continued dependence of money pumped in by the central bank means that we too are subject to downward drafts going forward.

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

"Being a Truly Responsible Investor Is Not About Selling Stock": There is a well-meaning movement under way on some college campuses across the country for university endowment portfolios to divest themselves of carbon based energy companies. While the enthusiasm expressed is admirable and the goal of reducing carbon emissions worthy, the means to achieve the end are, in this case, misguided.

Persons interested in socially responsible investments and helping the environment should keep in mind that no one really cares if you sell a "bad company" stock. In some ways, this only makes it easier and cheaper for people who don't share those environmental concerns to gain more ownership. Certainly, this is not the goal of these well intentioned people.

The effective way to influence the policies of large corporations has never been to divest ownership of stock, but to either become actively involved as a shareholder or, better yet, to use the economic power of boycotts. Both of these are long and drawn out processes, as was shown in the highly emotionally and well-publicized campaigns against the abuse of grape workers in California. It took several years for regular people to influence the course of events but they did. Boycott efforts also helped end apartheid in South Africa. If people are willing to refrain from giving even the most indirect economic support to rogue organizations, things will change. For better or worse, this involves personally giving up some comfort and/or convenience.

Companies do not care who their shareholders are, at least on an individual level. If you sell your stock in Exxon, there is someone else ready to buy it, especially if enough people are selling for social reasons and not based on the economic prospects of the company. In effect, divestiture is a "feel good" activity but it accomplishes nothing.

Let me make this point clear by using an analogy. If you live in a town that is highly desirable but you disagree with the policies of the town's government, let's say you decide to sell your property there to express your displeasure. However, the fact is that you are not willing to refuse to shop there, i.e., impose an economic boycott of goods and services provided in the town. So you continue

to enjoy the resources of that place, continuing to visit often. The impact of your selling doesn't hurt anyone; in fact you might be contributing to an increased demand for the town's products, since not only you but the new owners of your property all demand the benefits of the town.

Likewise, everyone who uses oil is complicit in the carbon emissions dilemma we face. Owning or not owning the stock is irrelevant. The reason for this is the demand for energy is still increasing due to rising affluence in the Third World and the desire of people there to enjoy the same kind of mobility that we in the West take for granted. If enough of us stopped traveling by car and airplanes and changed over to bicycles, if we refused to buy new plastic products and insisted on indefinitely extending the life of all our packaging, carrying containers and the like, if enough of us turned off our electricity except for essential short spells of service, then we would reduce demand enough so that the revenue of offending companies would be severely punished. We would be physically reducing our personal carbon foot prints at the same time. This is what would make a difference.

If a million people stopped buying gasoline, oil industry executives would take notice. Soon, they would try to do something differently to get us to start buying again. I remember when, if you had grapes in your house or in your lunch bag, people looked at you strangely. This wide spread social pressure was so effective in strangling the profits of offending grape growers that after a year or two of poor sales, the owners gave in to the demands of migrant workers for basic improvements in working conditions and other reasonable demands.

Even if only a few people sacrifice their own convenience and comforts, others will take notice. This is how effective social movements are born. I suggest that readers forget about blogging and signing Internet petitions, which are easy to do and therefore easy for people in positions of influence to ignore.

When consumers stopped buying products of companies doing business in South Africa, publically repudiating the names of companies that were doing business as usual, thereby enabling segregation to continue, corporate executives were so financially impacted that they changed their policies. They either withdrew their business operations from that country or pledged to change their employment practices and operations there, eventually forcing the government of South Africa to resign and the whole system totally changed.

Consumers have tremendous power, shareholders very little. It is easy to say we are interested in being "green" while continuing on in an unsustainable lifestyle of travel and consumption. Most of us do just that. How many well-meaning activists who promote investment divestiture have changed anything in their personal lives to reduce their carbon footprint?

One person who has done so and written about the experience is S. Brian Willison. His story, called "Blood on the Tracks", was recently published in the March, 2013, (edition #447) of The Sun Magazine. One of his most interesting conclusions is that to live sustainably, one needs to consume only products made within 100 miles of where you live. This means growing a lot more food locally and reestablishing local handicrafts industries oriented towards functional products (clothing, pottery etc.).

The other means investors have for supporting potential game changing events is through putting some money into emerging technologies that may reduce the impact of carbon based materials extraction, transportation, and use on the planet. This is the cutting edge for America. The risks are high as the great majority of alternative energy companies have had, to date, mostly terrible investment returns. This is the realistic price to pay for trying to make your money do real good in

the world. Giving someone an order to sell a stock is an easy out…way too easy. Do some research, change your buying habits, be an example, enjoy the bike ride!

<u>"The Breakup of the Euro":</u> Once in a while, an investment theme emerges which makes good sense, is not widely held and allows ample time to take advantage of an as yet unrecognized inevitable trend. Having recently traveled to Germany, it was clear to me that the animal spirits of German industrialism and entrepreneurialism are alive and well. The work ethic is intact and German consumers, abounding with optimism about their future and infused with a green sensibility, will propel their economy steadily upwards for the foreseeable future. Crossing the border into the Czech Republic, economic conditions were markedly different, exciting in their own way. The Czechs, though they are not affluent like the Germans, the people there are full of vitality, working and playing hard, exhibiting all the hallmarks of an entrepreneurial culture. In contrast, the French, Spanish and Southern Italian economies are blatantly unproductive.

The central theme here is that while the European Union provides political and military stability, the European currency, the Euro, is a noose around the necks of the flailing economies of those nations mired in a deep recession or depression.   The weak economic countries in Europe: Greece, Spain Portugal, Italy, France, Ireland and several former portions of the Communist bloc are facing a prolonged period of suffering. Because Europe's leaders are unable to publically admit that the Euro is a disaster, these moribund economies are unlikely to emerge from their deeply disadvantaged positions.   A radical reorientation of their economic policies can be implemented most efficiently be effected by delinking the financial policies of the strong nations from the weak. This means the end of the Euro as a common currency.

The reason the Czech Republic is fairly dynamic is that it has its own currency. They never accepted or wanted to be part of the Euro but they still enjoy the benefits of being part of the European Union.   Domestic forces control local interest rates, currency values, government spending, and the regulatory environment. This stands in stark contrast to Italy, Spain and France (and others who use the Euro) where local decisions must be approved by centralized bureaucrats who run the various European Bank mechanisms. These people in Brussels must balance the competing interests of all 18 members and often end up deciding what amount and form of local government activity is to be supported or curtailed.

As a result of this "coordinated" economic policy, no one country gets quite what they need. Consumer demand, employment opportunities and construction activity therefore continue to contract when they most desperately need growth to stave off domestic political unrest. Currency devaluation and aggressive government spending is the typical recipe to pull a country mired in recession out of the doldrums. This is what is happening in United States and Japan but the European countries whose growth is stymied and who are entering their third year of recession cannot take such actions.

France is the good example of a country with flawed spending, taxation and regulatory policies which will eventually sink their economy unless they delink from the Euro. The markets have not acknowledged this eventuality yet but one day they will!   Portugal, Spain and Italy are on financial life support systems, with transfers from Germany and the Northern European countries needed to keep their big banks afloat and their economies running. Resentment is rising in the northern donor countries as well as in the recipient populations, not a good recipe for furthering the cause of unity!

The Euro was created by bureaucrats with the understanding that it was an experiment. The time will come when those mired in depressions will recognize that they can recover only by having their own currency to devalue. The Euro experiment, at least its first reiteration, will most likely

come to a close. Devaluing one's currency results in factories operating at higher capacity utilization levels, it allows goods and services to be sold cheaper on an international scale, and it narrows the disparity in employment opportunities between countries, reducing the need for emergency and ongoing transfer payments.

The current political situation, which revolves around saving the Euro, makes delinking and then devaluation impossible. This means that countries with chronic deficits and moribund growth prospects will remain ill and that European Central Bank imposed austerity programs will continue to constrict domestic demand, choking off the possibility of growth and continuing the cycle of dependence.

The inevitable endgame has to include abandoning blind allegiance to the Euro. I see no other way out and if this is true, it provides investors with the opportunity to make money. If the Euro in its current form is going to fail, who will suffer and who will gain becomes a key investment question. Hedge funds are generally the first ones to pounce on currencies that are going to implode and then most investors will probably abandon those nation's' stock markets that look like they're going to capsize.

The challenge to investors is to develop both a short and long term strategy that takes into account this seemingly improbable but likely change. It may be portrayed in the media as the end of the world, but in fact, it would serve as an eventual contributor to the long-term stability of various economies which today have no hope of reenergizing themselves. I invite readers to e-mail me if they have ideas of how to take advantage of this possible change and will compile a list of these suggestions and circulate them back to anyone who participates in this process.
Anticipating investment trends is a tricky business and game changing events do not happen often. Taking the U S Dollar off the gold standard and the emergence of OPEC as a force in energy markets were two such examples. The eventual breakup of a single European currency would be a stimulating and exciting development, one worth thinking about well before its ripple effects spread across the great Pond.

"Money and Marijuana": The states of Colorado and Washington face a dilemma about whether or not to collect hundreds of millions of dollars in revenue from the "legalization" of pot. Since it is still a federal crime to possess or sell the substance, a classic state versus national law case is shaping up. Most states currently run budget deficits, with public employee pension plans severely underfunded and social service programs to be cut over time unless something drastic changes. The inclusion of marijuana into the mainstream economy could be just such a change.

In addition to potential revenue received from the taxation of billions of dollars of production, passing untaxed through the underground economy, many states see this as an opportunity to vastly reduce their costs as well. The inclusion of people who break current laws against the possession or sale of pot requires states to build and maintain costly prison systems. It costs as much to keep a prisoner in jail for a year as it does to send someone to a top-notch private university: approximately $60,000 per year.

The allocation of scarce law enforcement resources to pursue marijuana offenses is a fact of life that many top prosecutors and sheriffs' departments recognize. The behind doors debate about when to come clean with the public regarding the absurdity of current laws manifests itself as law enforcement officials turn a blind eye to small scale pot offenses. Still, most people in the criminal justice system recognize that the "war on drugs", insofar as pot is concerned, is not worth fighting.

The economic effect of legalization on marijuana users and producers would be profound. Patients suffering from conditions for which cannabis has been shown to be an effective treatment would benefit from lower prices and a more readily available supply as sources multiply and diversify. Regulating the production and distribution will face logistical challenges, as current illegal marijuana producers are a wily lot and their cash society benefits local businesses to a great extent, especially during harvest season. The businesses that grow pot legally would adapt and likely become larger, employing more people.

Clearly, the use of cannabis needs to be restricted in much the same way as alcohol, with similar penalties in place for driving under the influence or underage use. Experts are divided on the question of whether or not legalization will increase use overall. The studies I looked at show an expectation of a short-term spike in marijuana use after a change in legal status followed by a leveling off at current consumption rates.

The frequency and type of ancillary criminal acts surrounding the current growing scene, from robberies to serious violence including shootings between rival growers, is expected to dramatically diminish after legalization. Many small growers will go out of business and in at least one community that I know of, that will put a lot of young people back into the job market.

New Mexico is neither a leader nor a laggard in regard to its attitude towards marijuana. The State's board that deals with medical uses has been fairly progressive. Our Republican governor has, like many of her party's political peers, stepped back from the public debate and learned to live with the fact that marijuana is part of the mix of substances that need to be controlled but not prohibited from the mainstream of public life.

It makes sense to legalize cannabis, because like alcohol, it is not going away. Its use is widespread across social and economic classes and the cost of partially enforcing laws that a broad cross section of America does not believe in is essentially throwing away. Why not have states collect money from regulating and taxing it, rather than wasting money unsuccessfully trying to prohibit its use? At the same time, we can require students to get educated about marijuana's potential beneficial and harmful aspects. This seems to depend on who uses it, at what age and under which circumstances. We have a responsibility to face the reality that pot is here to stay, just like our fiscal deficits. Maybe the solution to the two issues is one and the same?

Personnel News

Rob: Much of my time the last several months have been spent traveling. In between meetings, I had the opportunity to participate in a few trail events which all went well, especially as I focus more on the wonderful landscape and staying safe during these outdoor adventures. The "chapel" project continues, much to my chagrin, given that it was supposed to be done 6 months ago! The girls are well: Hannah is in residence at the Frey Organic vineyards in northern Mendocino County, CA, working there and enrolled in a 9 month long Natural Herb Study Course. Robyn is in Brooklyn, NY, involved with various and sundry film projects.

Juliana: Patricia and I planted a lovely sunflower and cosmos garden right outside my window so I now have a riotous colorful site to look at all day long. The cool greenery makes the hot weather and fires seem far away. In July, I am heading to Blowing Rock, NC to see my mother who, at age 89 ½, is going strong. Not only will the mountains be cool and damp, I can also have some real grits!

Jeff: My wife is the gardener at our house and this summer she has become an absolute zealot about water conservation. In addition to implementing some gray water strategies inside the house, she

declared that she was no longer going to water our two grass lawn sections. So we recently replaced them with artificial turf. It turned out great and everyone really likes it a lot – even the dog. Another benefit is that when the dog rolls and plays on the turf now she doesn't get filled with dead grass, which she would previously bring into the house. What a mess that was.

Patricia: This summer thus far has certainly been a gardening challenge but, then I think I always say that for one reason or another. June always seems to be the make it or break it month and with the "monsoons" coming later each year, the challenge of keeping the garden from drying up and blowing away is greater. Things are doing nicely now and I am very grateful to a new watering system in the vegetable garden. We have a very capable irrigation guy, so if you ever need help, I will be happy to pass along his name. There are big doings brewing in my family this fall but more on that next time.

Emily: This summer seems to be flying by without the joys of hiking and other fun outdoor activities due to forest closures from the fires. None the less, I'm keeping plenty busy and looking forward to a large Zinn family reunion in just a couple of weeks.

Chelsea: So far this season, I've been enjoying my first summer with the Rikoon Group and the particular beauty of Santa Fe in the summertime. My young German Shepherd, Job, and I have been enjoying spending more time out of doors and it's hard to say which he likes better, the warm sunny days or cool Santa Fe evenings. Personally, the cooler hours might be my favorite, and I've found that my back porch at sundown makes a great place to read!

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 14th, 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 15**, our quarterly telephone conference call will take place at **3:30 p.m. MST.** The call-in number is: 626-677-3000 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.