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Commentary
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The Markets

The new economy's dancing shoes have finally met the old economy's pavement! Last year at this time, people were speaking about an end to traditional economic cycles. Expectations of 20% returns or more were commonplace. Those who quit their jobs at year end 2000 in order to ride the investment wave to retirement, who believed that new Internet and technology stocks would make them masters of the Wall Street universe, are singing a strikingly different song.

Despite warnings from old timers that nothing goes up forever and that recessions, whether they be soft or hard, are inevitable, most recent investors had no idea that the market could pull back so much and so fast.

In 2000, the Dow Jones Industrial Average was down 6.8%, the S & P 500 companies were down 10.14%, and the NASDAQ index, comprised mainly of technology companies, after rising over 80% last year, declined 40% this past year. This is the largest decline in the stock market since the early 1980's. The NASDAQ's previous record was a decline of 35% in 1974.

Over the last five years an extraordinary string of double digit gains made a mockery of the long-term historical average return for stocks, which is around 11%. Is it any surprise then, that after an 80% + rise in 1999, that a decline of 40% or more would follow? We do believe that there are many positive factors now present that bode well for 2001. If so, the current decline is an opportunity to buy great stocks at more reasonable prices than anytime in the last few years.

For the year 2000, the Rikoon-Carret composite stock market investments in US large companies declined around 8.1%, exactly 2% better than the Standard and Poor's 500 return of negative 10.1%. Our international stocks declined 14.6% in comparison to the international blue chip index's decrease of 15.21%.

For the first time in years, bonds had higher returns than stocks. Our bond portfolios averaged an increase of 6.71%. In the tax-free area, Rikoon-Carret portfolios were up 6.95%.

Economic Outlook

While the market decline rattled most investors, we look out further into 2001 and see several opportunities. For instance, there is the strong possibility of tax cuts now that the Republican agenda is on the front burner. The first and most highly publicized target is the estate tax. Both Republicans and Democrats are in favor of raising the amount that can be passed from one generation to the next. The current level is around $700,000 and it could go up to the 3 or 5 million dollar range. This would allow most Americans to evade the hated "death" tax.

Income or capital gains tax cuts will probably gain Federal Reserve Chairman Alan Greenspan's support. Greenspan is the one who sets interest rate levels between banks and usually he is seen as an astute politician as well as an economic architect. With corporate earnings declining, pressure is increasing for some kind of "Fed" action. Mr. Greenspan has plenty of reasons to reduce taxes. One reason is to cut short the debate on how to spend the budget surplus. Rather than funding pork barrel projects, Greenspan would rather see any excess funds funneled back into "production" financial markets through increased investing. Wall Street would love this! In 1981, when President Reagan introduced his first tax cut plan, Democrats actually tried to cut taxes more than the Republicans, so who knows what might happen. If Mr. Greenspan announces his support for tax cuts, very few people will object. In fact, across the U.S., more people want to see tax cuts than to see the national debt reduced.

Another popular move which, prior to the market's decline, enjoyed bi-partisan support is the Bush Campaign's promise to improve Social Security system's investment performance by investing in stock. Across the spectrum of American society, people are living longer. Without tax increases or increasing investment returns, the U.S. will not be able to pay future retirees the same benefits that current retirees receive.

So, since the living standard of retirees and the stability of public finances are interwoven, there are limited possible moves. One is to raise the age at which workers can retire. Or, the government could reduce the benefits paid to people in higher income brackets. Another possibility, good for investors, is to allow future retirees to put some Social Security money into the stock market for higher returns.

Obviously sentiment is not as strong today for putting some of the nation's retirement funds into the market as it was this past summer. Most long-term advisors argue that this is an especially good time to do just such a thing. During the campaign, George W. Bush talked about moving one trillion dollars from government savings accounts into stocks, which would have a huge positive impact on stock prices.

This positive outlook does not preclude the possibility that the value of many Internet and some marginal technology companies will still go considerably lower. For one thing, there is a traditional fall-off in the sales of technology companies in the first part of the year and we expect that more dot.com companies will go out of business. One of the most highly watched companies in the Internet industry that we feel is in trouble is Amazon.com. We doubt it will *ever* reach profitability. At Rikoon-Carret Investment Advisors our emphasis is on companies that not only make money, but also one's that show an ability to produce sustained and continuously increasing profits from a variety of sources. This means that one-product companies such as Yahoo, E-Bay, and Amazon are not on our radar screen.

We do believe the Internet will continue to transform the way that business, education, and recreation take place. The two areas in which we feel accelerating strides will be made are hand-held devices and wireless communication. Investors in companies such as Nokia, Southwestern Bell, Tellabs and Vodaphone are poised to make nice long-term gains, especially at today's depressed price levels. Last year's approval of the AOL-Time Warner merger is also significant. After a year of negotiation with the Federal Trade Commission, the merger of these two behemoths will precipitate a total reshaping of how news is viewed, music is heard, movies are watched, and books are read.

No business is going to have an easy time in upcoming years, so we feel that individual stock selection will continue to be an important factor in portfolio management. The AOL-Time Warner merger will make every other company in the entertainment, media, and Internet business take stock of who they really are, who their partners should be, and make them re-examine their future strategy. In the automotive industry, the domestic car companies General Motors, Ford, and Chrysler have now realized they have to totally revamp their business strategy in order to survive, versus the likes of one of our international stock holdings, Toyota, who first entered the U.S. market in 1975. It now has about half the market share that General Motors commands. The gap between the two is getting smaller. Last month, General Motors decided to drop its Oldsmobile line of cars and to close 15% of their manufacturing capacity in Europe. The company plans to reduce overlapping models and assembly lines. As a result, some factories will close. GM aims to cut 10% of its white-collar work force. It aims to take advantage of Mexico and other overseas locations that have lower wage scales than the U.S. General Motors is trying to remake itself. It is being forced to step up its efforts to make money outside of its core vehicle making business, under sharp attack by Toyota.

<u>Japan</u>

Longtime readers of this commentary are familiar with our interest in the Asian markets, especially Japan. The index of Japanese blue chip stocks was down 35% in 2000, in line with the performance of U.S. technology stocks. Japanese investors have had a zero return on their stock portfolios for the last 10 years! Japan is caught in a bind; it must change its basic political philosophy or continue to stagnate.

The basic problem is that Japanese politicians opposed to reform have been able to kill any movement for change. As a result, Japanese consumers have put thirteen trillion dollars in non-productive saving accounts. These pay about 1% in interest and very little of that money becomes available for business to borrow. So the government has had to step in and try to stimulate growth. Japan's national debt therefore has grown tremendously and turns out to be one of the most serious threats to the country's economic health. How did this happen?

Japanese banks have huge bad loans. In fact, they have more bad debt on their books today than they did five years ago. The scope of their problem is much larger than when we faced our own savings and loan crisis several years back. Why does this concern us? Japan is the world's second largest economy. If it becomes vulnerable to destabilizing forces, such as a confidence crisis, the U.S. capital markets could very well be effected. Japanese investors support our government bond market.

One example of the inherent weakness is that politicians in Japan are reluctant to let anyone with money deposited in their banking system lose money. Therefore *all* deposits are insured. This encourages Japanese to continue putting money into unproductive bank deposits. It serves to shore up rotten banks at the country's expense as a whole and perpetuates the national debt crisis.

Japanese debt as a percent of their economic output is the world's largest, surpassing even that of Italy! No one in Japan plans to deal with this problem anytime soon, so only if Japanese consumers take their money out of the banks and use it to fund businesses will things improve. Japan funds its own debt with its huge pool of domestic savings. The Japanese government also owns massive assets such as buildings, roads, and stakes in monopolies such as the phone company. They are reluctant to liquidate these assets in order to reduce their debt, so market forces cannot have their yet needed effects of winnowing out bad business.

As a result, Japanese companies such has Toyota, Hitachi, and Sony have changed the focus of their growth efforts away from domestic markets to focus on other parts of the world.

Developments at Rikoon-Carret Investment Advisors

We have settled into our new office on Don Gaspar Avenue. Along with our renovated building, we are upgrading our computer systems with the help of the Carret office in New York. The technology is now available to allow for instantaneous communication across the country. Our competent technical staff in New York has been out to Santa Fe several times. We are working hard to make a transition to our new system within the next 3 months.

The year 2001 will see the development of an interactive website. Our clients will be able to access their accounts, performance, research, and other educational tools. Another exciting development is a Rikoon-Carret Socially Responsible Hedge Fund. The goal is to have positive returns, even in declining stock markets.

As the winter comes on, the annual quadrathalon at Grants' Mt. Taylor beckons me, although it has been difficult to get out on a bicycle in the sub-freezing weather. So far, for seven years I braved the elements, and hopefully can continue to do so this February. All of us at Rikoon-Carret Investment Advisors wish you a safe and prosperous New Year.