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Winter Commentary 2007

The Markets

2006 turned out to be a spectacular year for most of the world's stock markets. The broad based Standard & Poor's 500 Index gained 15.7%, well above expectations. In comparison, the Rikoon Carret stock portfolios in U.S. large companies gained 17.13%. It is interesting to note that the technology laden NASDAQ composite index was up approximately 9.5%, still 50% below levels reached in mid-2000.

Internationally, the Dow Jones Index of the 50 largest European companies gained 10.48% in U.S. dollar terms while the broader based Dow Jones International Stock 600 Index posted an 18% increase. The Asia Pacific index of the largest companies in the Far East gained 15%. For the fourth year in a row, the emerging markets including China and India rose 29%. The Rikoon Carret international stock portfolios gained 22.1% during 2006.

After a 15 year hiatus, U.S. telecommunication stocks finally outperformed the S&P 500 by gaining 32%. Patience has its rewards sometimes, as holders of AT&T and Verizon stock can attest. Energy stocks continued their stampede as they gained 22% in 2006 after annual gains of 29% in both 2004 and 2005. Our portfolios had and continue to have a large exposure to this area through Master Limited Partnerships.

In the bond area, interest rates trended downward for a brief time during the second half of 2006. This was welcome news to investors and had a great deal to do with the stock market's rise during the latter part of this past year. Shorter term bonds, those with maturities of fewer than 5 years, performed the best as their market index gained 3.7% for the year versus the Rikoon Carret, U.S. taxable bond portfolios increase of 7.24%. In the tax free area, the municipal bond market index for short term bonds gained 3% while the Rikoon Carret tax free portfolios gained 3.77%.

Commodity prices for materials used in industry and construction continued to rise while energy prices fell 22% from this past summer's record levels. Gold and zinc prices continued to rise while tin is selling at a seventeen year high.

It is fascinating to think about the reasons behind the continued explosion in the prices of basic commodities. Demand for the world's resources is now coming from many nations in the developing world which is estimated to expand 6.4% in 2007, almost twice as fast as growth in industrialized countries. In China, disposable income for people living in urban areas rose 14%, while in India the number of households earning more than

$10,000 a year is rising more than 20% a year. This means the Indian subcontinents middle class will double in the next 3.5 years.

Over the next 25 years, it is expected that about 1 million people per week will move into towns or cities in developing nations around the world in order to seek higher paying jobs. This will fuel growth in infrastructure spending and consumer markets as people move off the land and onto public transportation. The relevant question for investors is "will this growth continue and are there still opportunities here for U.S. investors?" After a 29% rise in price during 2006, it is hard to feel that emerging markets stocks are still cheaper than developed countries as a whole. India is the most expensive country to invest in, and China is the highest risk. Investment into China related mutual funds now accounts for over half the total foreign investment in Asian markets. Since we here at Rikoon Carret have been investing in emerging markets since the early 1990's, we are cognizant of the extreme volatility of these markets and feel that diversification is important while pursuing these higher risk investment opportunities.

In Europe, merger and acquisition activity along with robust industrial growth has fueled an advance in European stocks. I believe the European stock markets are 10 years behind the U.S. in terms of capitalistic opportunities. The world's largest hedge funds are looking to Europe for wringing out increased profit and efficiency gains. There is merger mania going on in Europe and U.S. investors are eager to look overseas for higher growth potential. We are likely to find it there at least for a while.

The U.S. dollar was basically flat for 2006 versus the Japanese yen, but it declined 11% versus the European Currency Unit (ECU). European banks are starting to raise interest rates and currency traders like to follow higher interest rates. They can now borrow Japanese yen at low interest rates and reinvest in the U.S. at a much higher rate. Our sense is that the U.S. Federal Reserve is now backed into a corner by anemic U.S. economic growth and simultaneous higher inflation. This means they might want to lower interest rates to stimulate the U.S. economy but be unable to do so lest inflation take off out of control, which would send the U.S. dollar on a downward spiral.

Real Estate and the Economy

Since the last U.S. recession ended in 2001, the real estate market has been critical in enabling the U.S. consumer to continue spending. Almost half of the new jobs created since September 11, 2001 has been in the building or real estate related trades. Now that our economic expansion is entering its fourth year, the cooling real estate market presents important risks.

I think most people are aware that there is a buildup of homes and offices for sale now and that the pace of sales is going down, with some price decreases being felt. Real estate, like any other market, has its cycles. What is new today is the extent to which U.S. consumer confidence relies on increasing real estate values and the danger that a precipitous drop in real estate prices might mean for the economy as a whole.

After the stock market crash of 2000 (to 2002), there was a short recession and companies cut back on hiring and spending. Since 2002, job growth in the U.S. has been anemic other than in specialized creative fields, with most jobs being created in the low paying retail area. All the while, U.S. consumers have not paused in our spending, which accounts for 70% of the U.S. economy as a whole.

Often I hear people say "I don't know where people get the money to buy homes, take vacations or luxury goods." The reason is simple. After the stock market bubble burst and the September 11 terrorist attacks occurred, the U.S. government gave big tax cuts, started to spend heavily on military, increased the money supply and most importantly, cut interest rates down to levels unheard of in forty years. As a result of all of this, portions of the economy boomed. In public speeches, government economists acknowledge the need to keep consumers spending, noting it was and is the main way to keep the economy going. One result of this focus on maintaining continued confidence, is summed up in one important word, "inflation".

Inflation has taken root through the Fed lowering rates down to 1%, and leaving it there for a full year. The U.S. economy has kept going through cheap money. As a result, dollar denominated assets such as oil, gold, commodities and real estate, have rallied dramatically. Cheap money has helped consumers aggressively use debt to finance their purchases of automobiles and houses. We are now like someone who has sat down to an all you can eat buffet, eaten too much and can hardly get up from the table.

Even though consumer spending has maintained economic activity, we did not create meaningful numbers of new jobs in this four year recovery. We now have strong inflationary pressures on all goods, especially education, medical services, and materials. We have, as an economy, become overly dependent on the perception of wealth that real estate represents in our personal lives. Normally, a robust economy drives home sales and prices up. We have had the opposite situation where robust real estate activity has driven what would otherwise be a lackluster economy.

About 70% of American families live in their own homes. In 2004, when interest rates were at their lowest, about $250 billion dollars per quarter were withdrawn by Americans based on home values and put into consumer goods. By some estimates, people's withdrawals from the equity in their homes have been responsible for about 75% of the growth in the U.S. economy over the last four years. This is untenable.

Despite some recent signs of stabilization in activity, I do not believe we are anywhere near the bottom of the real estate market decline. Housing starts have gone down and inventory of new homes awaiting sale remains very high though optimism in the real estate trades and on the part of individual home sellers continues unabated. This is normal. It is easy for individuals to ignore reality when faced with adverse real estate market action. Historically, new home sales drop by 50% over a four year period in a bear real estate market. As housing activity has now dropped only by 20%, we likely have a ways to go. What does this mean for the economy as a whole?

If the economy decelerates due to the public's changed perception of their real estate wealth levels, other sectors of the economy are due for a sharp retrenchment. This may well impact the prices of stocks. Transportation companies are reducing their outlooks for 2007 and holiday retail sales for the Christmas season of 2006 were well below expectations. Durable goods orders have been falling for two months in a row and four of the last five months have seen a decline in orders. Durable goods are considered to be a long term sign of optimism or pessimism.

Manufacturing indexes are hovering somewhere between a recession and anemic growth while mortgage foreclosures, the statistic most closely tied to the low quality, high risk credit area of the real estate market, have been accelerating. I expect to see interest only and variable rate mortgage holders get reset to higher interest rates. This will likely create higher bankruptcies and foreclosures over the coming twelve months. Automobile sales have fallen off considerably and Ford is closing about 1/3 of its manufacturing capability.

Real estate value increases created a large part of the economic activity of the last four years and if this underpinning is removed, retail activity and consumer spending could finally grind down, after years of overextension. It is not too early to look out to the 2008 elections. Consumers are voters and consumers' perception of their own state of financial security is probably the most important factor in how they vote.

Traditionally, incumbent administrations have generated economic activity by cutting interest rates. Unfortunately, we are at present hamstrung in our ability to cut rates since inflation is clearly on the rise and the value of the U.S. dollar is so inimitably tied to U.S. interest rates. Our foreign creditors such as China will not stand for a free falling dollar and so our ability to lower interest rates is curtailed by our lack of financial discipline.

Personnel News

Rob has settled into a regular training schedule of running 50 kilometer trail runs every other weekend. Over the last quarter, he has run/speed hiked up Mt. Mitchell, Mt. Pisgah and Cold Mountain in North Carolina as well as Glorieta and Thompson Peaks, Santa Fe Baldy and Puerto Nambe around Santa Fe. During a recent trip to New York City, he got out on the Appalachian Trail in Upper Westchester and lower Rockland counties and found the trail there to be quite challenging. Rob's mother, Helen, moved into a multi-level care facility in New Rochelle, New York and she is doing quite well in her new setting.

Juliana has encountered a similar situation with her family as she spent 10 days recently in North Carolina with her mother, Kirby, who is a sparkly, energetic and fascinating person. Juliana is traveling with her mother and one of her mother's friends, age 84, to Canyon Ranch in Tucson next month. Juliana is building her core strength in the back of the office during some lunch hours with a trainer who comes in and makes her lift weights while balancing on air cushion rollers!

Jeff has already gone skiing once to enjoy the recent snowfall in Santa Fe. His daughter, Stephanie, is now 11 years old and so she has declared that she is ready to switch from skiing to snowboarding for this season. So far Jeff isn't sure that he will also try to make the switch himself from skis to a snowboard. Jeff's wife, Barbara, recently chose to finish her tenure as a professor of museum studies at the Institute of American Indian Arts College. She is pursuing other interests in the art and museum fields and she is researching starting a child care facility in Santa Fe.

Dana's children, Evan and Alice, continue to thrive. Her son, Evan, is a student of economics at Denver University while Alice, a sophomore at Santa Fe High School, continues her long standing efforts in the dance field while performing in biannual productions of the company, Moving People Dance Theatre.

Patricia continues her work around the office and house and was instrumental in researching the office's holiday season gift program. This year, in lieu of sending Christmas cards, Rikoon Carret donated money to kiva.org. Kiva is a very interesting organization that enables you to choose and directly sponsor a small business owner in the developing world.

Upcoming Events and Notices

At this time of year, we make all of our clients aware that an updated ADV, Part II form is available. This is the Securities and Exchange disclosure form which outlines our trading, research and marketing practices. Please let us know if you would like a copy of this sent to your home or office. We also want to make sure you are notified that the Rikoon Carret privacy statement is available upon request, fulfilling yet another government requirement!

Our next gathering of friends, clients and the community will be held February 12th. We are changing the format and place so please read this section carefully. Instead of holding our get-togethers at the office, we have decided to rent a slightly larger space with more parking at the Inn on the Alameda in Santa Fe. We will have two sessions so that people who work during the day can come and attend in the early evening talk. We will be discussing the markets, the economy and world politics. Please mark your calendars for February 12. The first 1.5 hour session will begin at 3 p.m. and the evening session is planned to begin at 6:30 p.m. If you could let us know if you will attend, it will help us prepare refreshments and our famous "tea and cookies" gourmet service!