The Rikoon Group
1421 Luisa Street, Suite R
Santa Fe, NM 87505

Winter Commentary 2008

The Markets

As many readers are aware, the final months of 2007 were volatile and extremely nerve wracking for investors in the United States. While the Federal Reserve Bank did begin to lower interest rates, it wasn't enough for Wall Street so the broad Standard & Poor's 500 Stock Index ended up rising a mere 5.49% with dividends in 2007. The Dow Jones Industrial Average of blue chip companies finished 2007 gaining 6.4%. The largest U.S. companies or "megacaps" were the best performers given their sales to international markets.

Both indexes declined during the 4th quarter of 2007, the first time this has happened in 10 years. The Rikoon Group's U.S. large company stock portfolios gained 8.24% in 2007, outperforming both the Dow Jones and the S&P Indexes.

Even though the stock markets ended the year with small gains and larger volatility, the bond market was where the big surprises showed up. The municipal bond market rose 3.8% as investors looked for safety, and the taxable bond markets gained 6.72%. Real estate trusts, preferred stocks, and high yield bonds were buffeted by housing market and mortgage woes. The Rikoon Group's portfolios in the tax-free area gained 4.25% and 5.14% in the taxable area.

A bellwether of future stock market action is the Russell 2000 Small Stock Index. This index usually outperforms the Dow Jones and S&P 500 when the U.S. economy is expected to be strong. The small cap market actually declined 2.7% in 2007 amid worries about an upcoming recession and potential for a substantial upturn in the rate of inflation.

Will the U.S. sink into recession? It depends on inflation and economic activity. If both of these areas bring bad news, we could have a stock market decline of 20% or more from its recent high in October, 2007.

I believe that the Fed will continue lowering interest rates but that this will not likely come to the rescue of the stock market during the first six months of 2008. The economy will probably contract, and bad news from the housing markets will continue through the elections. If it appears that Congress and the presidency will be controlled by the same political party, the markets are prone to head southward.

In the international markets, China and India continued to lead Asia's meteoric rise as investors poured money into these growing economies during 2007. For the first time, China and India are encouraging their citizens to consume domestically produced goods from cars to computers. Our belief is that stocks look increasingly pricey in those markets, and with the global economy threatened by recession in the U.S., it is almost time to reduce stock positions overseas.

The Japanese stock market declined 11% during 2007, and even with their interest rate levels hovering near 0%, economic growth in Japan is almost non-existent. Overall, as measured by the MS EAFE international index of large capitalization companies, the world's combined stock markets rose 8.6%, an average that was reduced by the inclusion in this index of many large Japanese companies. The Rikoon Group's international stock portfolios gained 14.58% during 2007, primarily because we avoided Japan and over-weighted other countries in the world without undue emphasis on China or India.

Restrictions on Chinese investors' capital have been lifted, so the Chinese middle class is now allowed to place funds in Hong Kong and a few other places so that economic (not military) ties between China and its surrounding countries are increasing. China has also just passed its first real labor protection law restricting overtime and providing severance pay. The law is one sign that China is beginning to emerge as a responsible member of the world's economy. We'll see if this trend continues.

In the currency markets, the dollar fell for the second year in a row against the European currency unit or "ECU." It lost 9.5% in 2007 following a 10.2% drop in 2006. Anyone traveling in Europe has surely noticed this phenomenon and it is even worse in the United Kingdom. The U.S. currency also fell versus the yen and against the Brazil real. Currency re-evaluations are important because they are a major determinant of domestic inflation. As our dollar declines, goods that we buy from overseas become more expensive. These numbers do not necessarily show up in government published statistics but they do on our credit cards!

The commodities markets boomed as inflationary expectations, fueled partially by the lowering of interest rates and in part by the meteoric rise in the price of energy, continued unabated. The Bloomberg commodity index climbed 22% in 2007 as oil rose close to $100 a barrel. Gold has jumped to its highest level since 1980 and agricultural commodities reached record levels as well. Expectations are that the U.S. dollar will continue to spiral downward as the Federal Reserve Bank is more concerned with keeping the U.S. out of a deep recession as opposed to fighting inflation. This primarily punishes people living on fixed incomes.

The Economy

The major news in the U.S., as well as in the international economy in 2007, can be summed up in the term "credit crisis." This term refers to the reluctance of institutions and individuals to enter into transactions, no matter how much money they have, because of concern that they will not be paid back. Bank lending, which is supposed to increase with the decline in the interest rate charged by the Federal Reserve Bank and the ready availability of cash, has been severely curtailed due to widespread anxiety regarding the ability of almost all borrowers to repay their debts. The housing market's problems are very serious, but there are a few more widespread problems, not easy to ascertain or understand.

In regular economic news, the U.S. 2007 holiday sales growth trailed last year's by 26% and was the slowest since 2002. The number of insured homeowners more than 60 days late on their house payments continues to rise, and as a result, the entire financial service sector, which includes banks, mortgage companies, brokerage firms, and insurers, lost over 20% of their value in 2007, the most since 1990. Many financial institutions are in such troubled waters that they have turned to foreign investors to shore up their capital base.

Global recession is a possibility in 2008, and the central banks of many nations have joined to attempt to stave off a slowdown. England, Canada and the U.S. have cut interest rates, and the European Central Bank and the Bank of Japan, which wanted to raise their domestic rates due to inflation pressure, had to shelve their plans in order to keep consumer confidence afloat. As a result of rate cuts and a huge amount of new "printing of money," global inflation is now at its highest level in a decade.

The world's economic leaders face the slowing of growth and simultaneous rising inflation. As banks start to write off losses tied to their investments in the U.S. mortgage market, lending may well not pick up no matter how low interest rates go. This "risk averse" climate has never been encountered in the U.S. before but it has held sway in Japan for almost 15 years. Another aspect of the credit crisis, is that confidence in the future, unrelated to the housing market, has also plummeted. During the first seven years of this decade, borrowers, classified as mid to low-level quality corporations and financing companies, were able to get funding to expand production. They too are now having difficulty repaying their loans. The level of anxiety in the world's credit markets, independent of housing, is so great that the Federal Reserve and its counterpart in Europe began selling cash last month to money market funds in the biggest international lending action since the September 11 terrorist attacks. The European Central Bank alone injected $500 billion dollars or one-half of a trillion dollars into its money markets in order to assuage fears that the normal business lending channels are at risk. Beneath the angst is a fear that even high quality borrowers, such as the money market funds that you and I use, could be torpedoed by underlying junk that may be hidden inside of supposedly safe portfolios.

While government banks around the world are lowering interest rates, consumer prices are rising. U.S. consumer prices jumped in the 4th quarter, the most in two years. Inflationary expectations are most quickly and accurately reflected in commodity and gold prices which have gone sky high. It is expected that due to a global high inflation environment, by the end of 2008, no matter what economic conditions prevail, central banks could be forced to tighten policy and raise interest rates, thereby worsening the chance of a deeper recession.

In the United States, the real estate market is the most visible place where consumer expectations of increased wealth have been dashed. Existing home sales are at their lowest since record keeping began, and the median value of a house in the U.S. dropped 4% from 2006 to 2007. Overall, home sales are down 30% from their July, 2005 peak. There is approximately 11 months of housing inventory on hand which means that builders have little reason to break ground on new projects. Sales of new homes fell in the 4th quarter of 2007 to a twelve year low, and the decline in new home construction starts is likely to affect U.S. economic growth well into 2009.

Defaults on privately insured U.S. mortgages rose to a record level in late 2007, adding evidence to the continuing and deepening housing slump. Mortgage insurers are having so many claims that their own credit quality is under review by rating agencies. Like many investment and commercial banks, mortgage and bond insurers are themselves looking to raise additional capital because of anticipated claims. U.S. unemployment levels are fairly stable at slightly under 5%. This is a very important number to watch in 2008, because rising unemployment combined with lower housing values will surely stretch U.S. consumers beyond their limits.

Investor Education

The current credit crunch or “crisis” is a phenomenon that first reared its head to the public in July, 2007, when Chrysler Corporation was being taken private by a group of investment banks in New York. Normally, investment banks borrow money to make their acquisitions. This time, there was not enough investor demand for these high-yielding bonds. Once Chrysler’s bankers couldn’t raise the money to take it private, anxiety about the credit quality of other deals that financed the purchases of large companies by private investors also came under scrutiny. At the same time, the real estate market really started to stagnate as low credit quality homeowners and real estate speculators started running up against increasing interest rates due to borrowing under adjustable rate mortgages. It was a perfect credit storm.

The story continues as banks became reluctant to lend to each other, businesses and consumers. Now, many other groups cannot borrow money. This crescendo has directly affected the prices of bonds. For example, the largest student loan organization in the U.S., Sallie Mae, was involved in discussions to sell to a private investment group that included JP Morgan Chase. Due to the credit crunch, the deal did not happen. Because of this, investors have now become anxious about Sallie Mae’s ability to borrow money for its normal business operations, even though over 90% of its student loans are guaranteed by the U.S. government. Sallie Mae’s ratings, formerly AA, are still investment quality but the bonds are trading like junk. This situation has repeated itself for many companies including Tribune, First Data, General Motors and other strong franchises. 2007 was extremely difficult for the rating agencies, as so many changes in their evaluations of bonds were late that the rating agencies themselves are under scrutiny. All of this activity has created unprecedented volatility in bond ratings and prices which has somewhat impacted many individual portfolios.

Earlier this summer, following Chrysler's failed attempt to obtain financing, the Rikoon Group reduced its overall U.S. equity positions by a sizeable amount. In December, when the Fed was about to cut interest rates ¼ of 1% instead of ½ of 1% as the market was demanding, we again reduced our equity positions. Both of these macro asset allocation changes turned out to be justified, at least so far, but they have resulted in substantial realized capital gains for 2007 in taxable accounts. Normally, we try to offset gains with tax loss harvesting, but due to our comparatively strong 2007 performance in stocks, we had very few losses to take. At the same time, due to the bond market's volatility, we had some chance to trade individual bond holdings.

This created a hectic holiday season for account management and we are hopeful that this volatility will abate somewhat in 2008. Our clients have been relatively unscathed by the credit crisis though many bonds are under price pressure because of the market's unease about credit conditions overall.

Real estate is an ill-liquid market, which means that owners who do not absolutely need to sell their properties tend not to adjust their prices downwards until well into the retraction. We are only starting to see this downward pricing effect take place.

When investors buy with borrowed money, they are leveraged. Banks usually require borrowers to have collateral to leverage themselves, but when the Federal Reserve makes it easier for people to borrow by lowering interest rates and by increasing the amount of cash available in the system, they are encouraging the use of leverage. This is usually what makes the economy grow, and this is the purpose of the government's actions in response to the threat of recession.

A problem arises when the costs of materials such as energy and natural resources skyrocket. Investors then have higher costs, and along with higher mortgage expenses, have the need for assets to increase in value in order to keep the game going. This is what made housing prices increase so much from 2002 to 2007. People fled the stock market after the technology crash and put money in real estate. It looked so good that investor greed led many to borrow money in order to make more money. Therein lays one seed of the current subprime housing debacle that will continue to unfold in 2008.

Using this same process of using borrowed money, many companies have taken on more debt than they should have, and investors in search of higher yield supported this process. As in housing, we are now seeing a retrenchment of prices in those low quality bond investments.

Many banks, which lent money to low quality homeowners, real estate investors or businesses, now are unwilling to make many loans at all. The behemoths of the banking industry, like CitiGroup, and the investment banking world, Merrill Lynch, have been forced to write down the value of their portfolios so much so that they have had to go overseas to get outside investors to shore up their own financial base. The net effect of this is that ownership of some large American companies is starting to pass to overseas investors.

Vast amounts of wealth are accumulated by Middle Eastern and other sovereign nations due to their control of certain natural resources, primarily oil, meaning that foreign countries now have capital to lend. As a nation, we have large borrowing needs. This co-dependence has and will continue to enmesh the U.S. in complex relationships that will affect our ability to control our own destiny in political, military and environmental spheres.

As the U.S. election season unfolds, there will be a latent and sometimes blatant power struggle between Wall Street and Main Street. Wall Street has controlled most of the U.S.'s political and economic decisions since the early 1980's with a correspondingly large share of wealth flowing to the financial sector. Because the focus of our nation tends to be more on short term financial results, rather than long-term structural issues, we may get help in the short run from financiers based in the Mid-East. In the long run, however, I think a major readjustment of global power is in the making. Stay tuned!

Personnel News & Updates

At the present time, Rob is not participating in any organized races as he is fairly content to travel on mountain trails solo on average once a week this winter. He is also making slow progress on his egg tempera "chapel" with the occasional assistance of his daughter, Hannah, who has just finished her course work in massage therapy in Ithaca, NY.

Jeff: I have been looking forward to this new ski season; however, since it has been so cold here in Santa Fe, I haven't been brave enough to go yet. I am sure that I will get out there sometime, but I don't mind admitting that I'm waiting for warmer temperatures before I'm willing to venture out of my warm home. My daughter's school will be skiing every Monday in January at Sipapu and so I am hoping to join her for one of their ski days.

If you haven't converted your Schwab information from paper to paperless and would like to do so, please call Patricia and she'll help you with that.

The next tea date is Thursday, February 14 at the Ghost Ranch Conference Center, 401 Old Taos Highway. There will be a gathering at 3 p.m. and another one at 5:30 p.m. in the Perea Room. Please let us know if you'll be joining us at either time.
Thank you!