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Winter Commentary 2010

The Markets

A remarkable recovery in 2009 brought the world's equity and bond markets back from the eve of destruction thanks to unprecedented and coordinated rescue efforts by the world's governments. After declining 25% to twelve year lows in March 2009, most of the world's stock markets staged an impressive rebound to finish the year with double digit gains.

The broad-based U.S. index of large companies rose 23.5% in 2009 while the NASDAQ technology index gained 44%. In March 2009, they were down approximately 50% from their all-time highs reached in October 2007. Even with the substantial gains experienced in 2009, most stock markets remain approximately 30% below their all-time highs.

More sobering and longer term, the U.S. stock market is down approximately 10% from its level of 10 years ago. Overall, stocks have just ended their worst decade since the 1930's. Contrary to popular wisdom, bonds have outperformed stocks not only over the last 10 years but over the last 20 years as well.

Long-term bonds ended the last decade with an annual return of 8%. This is true for both taxable and tax-free bonds. The 2009 performance of the short-term taxable bond index was up 4.27% and the municipal tax-free index, returned 3.07%. As most investors are well aware, money market interest rates fell close to 0% while CD rates hovered around 1% by the end of 2009.

Overseas, the Dow Jones Index of Europe's six hundred largest companies rose 29% in 2009, its largest gain since 1999. Like U.S. stocks, European stock markets remain approximately 30% below their all-time highs. Many European Union countries are struggling with large amounts of government debt. Greece, Spain and even the United Kingdom are looked upon askance by worldwide investors and are seen as potential credit default risks, much as mortgage and investment banks were in the U.S. during 2007 and 2008. Japan's stock market was up 5.6% while the more narrow Nikkei stock average of the largest 225 companies finished 19% higher. Japan faces many structural issues that the U.S. is looking at as well, but they will be experienced first on that island nation. More to come on this subject in future commentaries!

The best performing stock markets in the world were in the emerging markets. Russia's index skyrocketed 129%, India's market was up 81% and China's gained 80% even though, like the rest of the world, they remain well off their all-time highs touched in

2007 and 2008. Brazil's market has regained the most as it is within 7% of its all-time high reached in 2008.

The Rikoon Group's portfolios were allocated across the world's markets and also heavily invested in alternative areas such as energy and real estate which both experienced rapid rebounds in 2009. For a complete track record of our traditional and alternative investment vehicles, please contact our office and we will provide specific performance numbers on our overall portfolios.

At its current levels, the U.S. stock market, as represented by the Standard & Poor's 500, is selling at a heady 25 times reported earnings, the most expensive level seen since 2002. In large part, the 2009 stock market rally was due to the U.S. government's lending, spending or guaranteeing more than $11 trillion of debt. The Federal Reserve Bank has left its benchmark lending rate near 0% for an extended period of time to stave off a deeper recession/depression. Technology shares led the 2009 rally, followed by raw materials and commodity producers. The price of crude oil advanced 78% in 2009, its biggest annual gain in 10 years. The price of commodities worldwide gained 50% in 2009, its best year since at least 1970, but again, its slide during 2008 more than overshadows its meteoric rise in 2009.

In March of 2009, the Standard & Poor's was selling at 12 times earnings, meaning at relatively cheap prices, and it has roughly doubled in terms of its dearness since then. The U.S. stock market is selling at approximately the same level of value as right before the collapse of New York based Lehman Brothers investment bank. Overseas, the leaders of the markets, notably China, have pushed up commodity prices due to their hoarding raw materials and massive government stimulus programs. All of these factors do not bode well for future advances.

Rounding out the investment picture, oil has risen 210% during the last decade compared to the stock market's decline of approximately 15%. Gold has outstripped even oil, gaining 279% over the last decade. In 2009, gold gained 24%, approximately the same amount as the broad-based U.S. stock market. Lower quality corporate bonds gained 57% in 2009 and 88% over the last 10 years, roughly in line with high quality mortgage bonds and U.S. treasuries. We do not expect that kind of performance to continue and are looking at ways to take advantage of the eventual decline in "junk" bond markets.

The Euro gained a mere 2.5% against the dollar in 2009, though it has advanced 44% versus the dollar over the last decade. We look for this trend to reverse because even though we tend to be pessimistic about the U.S. Treasury's financial condition, Europe's financial future looks bleaker than our own.

The Economy

As mentioned above, the primary ballast supporting the world's markets has been the extremely accommodating policies of central banks around the world. The U.S. Federal Reserve has pledged to keep interest rates low for an extended period of time but we doubt their ability to indefinitely make good on this promise. Our expectation is that the markets will eventually move interest rates up independent of the Federal Reserve's policies when we see the deflationary pressures of global overcapacity in manufacturing and chronic high unemployment begin to abate.

The Federal government's stimulus programs continue to pour money into the economy but they are slated to end during 2010. In Europe, investors are demanding that individual countries raise taxes and cut public spending, a combination that will hurt their extremely fragile economies. Britain is in very bad shape and failure to secure true financial reform within the next 12 months could place Britain's triple A credit rating in jeopardy. It is worthwhile to pay attention to this drama because our country could be next in line for this kind of treatment. The European Central Bank would like to raise short term interest rates, but if it moves too fast, it will snuff out the economic recoveries only now beginning in weaker countries, like Greece, but if they move too slowly, countries such as Germany with strong economies could see high inflation.

In the emerging markets, China has fudged its economic numbers and managed to stimulate its economy through massive government infrastructure spending. A better long-term solution to China's trade issues would be to stimulate domestic growth. On the other hand, Indonesia and India have successfully transformed their economies by allowing domestic consumers to play a key role. Both of these nations have successfully completed democratic elections during 2009 which lends credence to their long-term stability as market economies.

In the U.S. real estate market, the government has been able to bring down mortgage rates by purchasing over $1 trillion in mortgage backed securities, which is where local lenders put mortgages once they are made. The program is supposed to expire in March 2010, and when it does expire, we feel that interest rates could rise by a full percentage point.

The government's efforts to restructure delinquent mortgages have been an abysmal failure with only 31,000 people receiving permanent adjustments of their mortgage. The number of struggling homeowners is mounting, with one in seven homeowners either in foreclosure or delinquent on their payments. Nearly one in four owes more on their mortgage than their homes are worth, leaving less and less incentive to continue paying on their mortgage.

While residential real estate problems are well recognized, those plaguing the commercial property markets are just beginning to become apparent. In New York City, the amount of available space to lease has increased so much (about the amount equivalent to 16 empty 40-story office towers) that landlords have dropped rental rates by up to 30%.

In 2010, we are likely to see many banks fail due to their holdings of commercial real estate mortgages. The typical resale value of a commercial mortgage is approximately 50 cents on the dollar. There is approximately the same amount of money at risk in commercial mortgages over the next three years as what the government has already spent in the residential mortgage market. If the Feds decide to support commercial real estate in the same way as they have done for personal residences, there will be a doubling up of the government's commitment to borrow money.

The increase in unemployment and the lackluster real estate markets have been at the center of the worst economic downturn since the 1930's. Borrowers defaulted on 61% of the loans which were modified, and it is likely that home prices will continue to decline, albeit more slowly, for several years. Other obstacles to a housing recovery include unemployment, an eventual expiring tax credit for home buyers, as many as 10 million additional looming foreclosures and a plan to tighten lending standards at the Federal Housing Administration. What is needed for a real housing recovery is an increase in private sector lending for the purpose of small business formation.

At the moment, however, the private sector is borrowing less and consumers who are looking ahead to retirement are feeling that after a quarter century of borrowing, they need to shift from spending to saving. We expect over the next 10 years the U.S. savings rate will go back to traditional double digit levels and that consumers will no longer depend on their stock portfolios to provide for education and retirement. The importance of this shift has not yet penetrated through to Wall Street.

The days of drawing down one's equity from home ownership to fund consumer spending are gone. Most of the baby boom generation understands that it needs to save more for retirement and that the time to do so is now, while they have jobs. No one is expecting large pay increases and most people are preparing for substantial drops in income levels as they get older.

While the major banks in the U.S. and overseas have been bailed out, smaller banks in the U.S. still have excessive exposure to faltering commercial real estate as described above. We believe that Washington will support these banks, just as they will support the many states and municipal governments which are starting to run out of money. This impending financial debt squeeze will present buying opportunities for investors.

As the media is filled with news of economic recovery, there will be many claims that we have gone past the worst of this recession and are climbing back. This may be true temporarily, but we question whether the rise in economic activity is sustainable. The limited economic growth the U.S. has experienced during the third and fourth quarters of 2009 and likely to continue during the first two quarters of 2010 has been due to the massive fiscal and monetary stimulus.

Personal incomes have been falling, unemployment mounting, and many employed people have had involuntary time and wage cuts. The great theme of this next decade is going to be the de-leveraging or paying down of debt on the part of individuals and increased leveraging, or taking on debt, on the part of governments. As additional stimulus becomes politically necessary in 2010, probably termed as "job creation" funds, the economy will sputter along at a low rate. Stocks will waffle in and out of slightly positive or negative territory. Most overvalued markets, including emerging markets and commodities, will take hits in their prices.

Given the massive federal red ink which extends as far as we can see, we believe that whatever additional stimulus money is made available in the second half of 2010 will have limited and short term effect. There is some doubt as to the willingness of foreigners to continue to subsidize our debts needed to provide this stimulus, and we see the political and military stability of the U.S. as being one of the few continuing draws that will entice foreign funds into the U.S. As the Fed unwinds its programs to support the financial sector, interest rates will eventually rise dramatically and this bodes poorly for unwary investors.

Overall, our prognosis is for mediocre returns on stocks in the short run and difficult but navigable waters for bonds. We see some short to intermediate opportunity in part due to the likely continuation of temporary deflationary forces. In the long run, the world's increased demand for raw materials and energy on the part of the more vibrant economies of Asia will raise prices in some markets so there will be some positive investing choices at some point in the intermediate future.

Articles from The New Mexican

Now that most investors are comfortable again with the stock market (perhaps too much so!), it would be wise to listen to the words of the head of the Bank of England, Mr. Mervyn King. In a rare service to the investing public he stated, "The belief that appropriate regulation can ensure that speculative activities by banks will not result in failures is a delusion." In short, we believe that the current bills in front of the U.S. Congress to "reform and regulate" are doomed to fail.

Real reform means breaking up banking cartels. The recent rise in the profits of investment banks has brought back resurgence in compensation paid to the big players on Wall Street. Protected against reprisals for their last round of risk taking, they continue to operate legalized gambling franchises with federally insured deposits.

Mr. King's solution for England is to separate the function of trading stocks and bonds from traditional banking which involves making loans and taking deposits. The financial bubbles of 1984-1987, 1997-1999, and 2005-2007 were enabled by the dismantling of basic safeguards put into effect after the manic investment era of the 1920's. In response to that period of protracted contraction, people who created and sold securities were compelled to split off from institutions that handled savings accounts and who lent to businesses, consumers and home buyers.

The skills and risks inherent in brokering investment deals are far removed from what is involved in making good loans. The Glass-Steagall Act, enacted in 1933 and repealed in 1999, was used to provide protection against the persuasive and innovative schemes perennially put forth by the clever and persuasive people on Wall Street. Until something like the Glass-Steagall Act is reinstated, taxpayers will foot the bills for past excesses and current privileges of financiers who portray themselves as essential to our country's well being.

Arthur Burns, formerly head of the SEC, recently berated investment banks for bilking tens of billions of dollars from the public through their lobbying of public officials. Bankers convinced bureaucrats to give them free rein in how the sale of municipal bonds took place. This insured that the banks made large profits through fees which taxpayers never see. To prevent this travesty from continuing, we need to have open bidding and public access to electronic posting of all bond trades, as is done with stocks.

Entrenched interests will forever oppose real reform because they make so much money from the current system. They will prevail as long as they are allowed to hire lobbyists and make political contributions. Have we learned anything from the last two years? I believe we need to put back into the law a strict separation of the stock and bond business from the business of running our economy. The cost of continuing on as we operate now means a further depletion of the commons.

2009 will be a year to be remembered for what didn't take place. We didn't have a system side financial meltdown. Thank you, Ben Bernanke. We didn't have health care reform. Thank you, Joe Lieberman.

What was accomplished in 2009 was to move bad debts off the backs of individuals and businesses onto the broad shoulders of the federal government. In 2010, this will happen again, as the bad debts of states, cities and other public entities must be contained. These injections will be forthcoming even as our national public debt level (141% of GDP) surpasses that of all other countries except Japan, Lebanon and Zimbabwe.

On the bright side, we do have a better image on the world stage. Though neither war is going well, with the price tag for putting one soldier on foreign soil, approaches a million dollars per year, our leaders are honest in stating that the long-term chance for success hinges on local forces stepping into the breach. These odds are slim, but for the moment, violent Islamic Fundamentalism seems to be marginalized across the globe and our energy sources are fairly secure.

The most notable failure of 2009 was the lost opportunity for health care reform. In its current format, drug and insurance companies are the big winners. They get to add 30 million low and moderate income earners to their subscriber rolls as everyone will be bound to buy coverage. No high volume discounts to consumers or international competition for these protected industries, which in turn, only have to curtail their anti-reform media campaigns.

It is true that discrimination against very sick people will no longer be tolerated but the cost of their care will be borne by those who now have good coverage. The public option is out, expansion of Medicare is out, and insurers that are too big to fail are in. The basic problem of health care eating up an increasing share of our national wealth goes on unabated.

The lessons offered up by the events of 2008 are receding from memory. History doesn't repeat itself but the next round of credit default problems will take place in an environment where confidence in some governmental entities is shaken. I don't know if 2010 will be the year of reckoning but watch what happens in Japan and Britain for a review of future events here at home.

Some investors feel that gold is a sensible place to put a great deal of money. It is easy to sympathize with this view, since it plays on well grounded concern that governments are printing unmanageable amounts of new paper money. As contrarians, we recently took some profits out of our gold positions on the supposition that there are a number of reasons why gold can go down from its current levels.

The first is that the price of gold, like petroleum, can be manipulated with a push of a computer button. Hedge fund investors are now the 7th largest holders of gold shares in the world. They have pushed the price of gold higher than it otherwise would be. When there is breaking news that is bad for gold, hedge funds, who are fundamentally short term speculators, will want to get out in a hurry. It is possible for gold to crash much as oil did last year when it went from $150 to $50 per barrel in less than a year due to speculators covering their bad bets.

Gold used to be one of the few ways to protect against inflation. Now, investors can buy several investments that can guard against runaway cost of living increases by purchasing government sponsored Treasury Inflation Protected Securities (TIPS), which adjust to the Consumer Price Index. Investing in natural resources and commodities are other ways to fight inflation. There are also agricultural foodstuffs, natural gas, industrial metals, precious metals and ways to bet that inflation will return. Each investment avenue has its pitfalls so our philosophy is to build a diversified portfolio of inflation hedges that includes gold, but is by no means exclusively made up of gold.

We also believe gold will never again be used as a standard for international trade. There simply isn't enough gold to accomplish the job. Gold as a currency of exchange will be replaced by a basket of commodities. There is a common investment fallacy that the future will be a vague repeat of the past. We believe the government will pay back the 20 trillion dollars or so it has borrowed to date with inflated dollars. When we hear people talk about gold as a panacea, with similar fervor to how they used to describe real estate, our antennas goes up. Keep an open mind about other ways to protect your purchasing power.

Personnel and Office News

We are pleased to announce the launch of our redesigned website at www.rikoongroup.com. Check it out!

Rob: Not traveling much has some real benefits such as more time to plant. Tending trees and clearing trails has supplanted running for the winter. The cold weather has brought a modicum of snow, enough to get out cross-country skiing a few times. Happy New Year to all!

Juliana: This winter/fall was full of family gatherings. In October, I spent 2 weeks in North Carolina, visiting my mother and old childhood friends. I ate lots of barbeque, shrimp and grits, cheese straws and other favorite southern culinary delights ~ I always seem to come back a bit more rotund after each trip! Over Christmas, David and I went to Salt Lake City to visit my older brother and his two daughters. We all went to a Utah Jazz game – a first for me, and I have to admit a pro game is a lot of fun, even for a non-sports person.

Jeff: My daughter and I have already gotten in a couple trips to Ski Santa Fe and plan to do more. I am continuing to ride my bike to work, other than the days when it is too snowy and icy. So if possible, my wish is to have more snow on the ski slopes but not on the roads to interfere with my bike riding.

Patricia: I am planning a trip to Napa Valley this spring to cheer on my son, Dylan, at his first marathon. If any of you are touring bike enthusiasts you might enjoy Dylan's Mission Cycling blog. This is a club he has quite successfully started in his neighborhood in San Francisco. I have the seed catalog out, ready to start ordering for this year's garden. If anyone has any favorites, flower or vegetable, I would be happy to hear about them.

Emily: This Fall I took a much needed vacation to New York City to visit my brother and long time friend. I lucked out with beautiful weather to enjoy Central Park and neighborhood walking tours. The Museum of Art and Design had an excellent exhibit of paper crafts that sparked my imagination for some projects of my own (if I could only find the time). My year ended on a good note with the whole family around for the holidays and I'm getting into the swing of the New Year by starting coursework for earning my Certified Financial Planner designation.

Dana: I am currently recovering from surgery on both feet. The resulting slowdown is not unwelcome as I have lots of quiet time to sit, read, sew or take in the wintry view from the window. In lieu of my usual exercise regimen, I am checking off future hikes listed in the Sierra Club newsletter that I would like to do come the spring and happy feet!

LOCAL TEA & CALL-IN DATES:

Our upcoming tea will be held on Wednesday, February 17, at the Ghost Ranch Conference Center in the **Perea Room** at 3:30 p.m. and 6:00 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, February 18 (Mountain Time) our quarterly telephone conference call will take place at 3:30 p.m. and 6:00 p.m. The call-in number for both sessions is: **218-936-4700** 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.