

Thoughts from

Hanson Investment Management Inc.

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I Stand Corrected . . . But Undaunted . . .

IN THE LAST NEWSLETTER I stated that markets don't mind bad news, they mind uncertainty. And the start of the war removed a big uncertainty. But a *Wall Street Journal* article in late March correctly pointed out that the only uncertainty the start of the war removed was the date of the first shots. All the other uncertainties, the outcome of the peace and the outlook for the global economy, remained just as before. Good point.

David Hale, the Chief Economist for Helix Capital in Chicago, recently discussed in the *Financial Times* the three biggest uncertainties facing world markets today. The first is the possibility of new terrorists attacks in the U.S. The second is the effect the war will have on the U.S. budget and the direction of the dollar and interest rates. (See page 2 for our thoughts.)

The third big uncertainty is the state of globalization. The charts at the bottom show how dramatic the growth in international trade has been since 1960. Recently there has been a sharp slowdown but this is primarily due to the general softening of the world economy. The long-term question is, will geo political events now slow globalization on a more permanent basis?

We are living today in the second great era of globalization. The first lasted from the mid 1800's to World War I. Norman Angell, author of *The Great Illusion* (1910), argued that commercial ties across Europe then were so strong it would be insane for the continent to go to war because it would destroy both the winner and the loser. Well that didn't stop World War I, World War II or the Cold War.

Today globalization could get crippled just as disastrously. I am not betting on it (and hoping very much against it) but supply chains could be affected by the fear of terrorism and political infighting between the U.S., Germany and France could seriously damage trade prospects with our most important trade bloc. Remember imports and exports now account for almost 25% of our economy. This is a one third increase from just 15 years ago. We need trade and we need globalization. This is the big uncertainty to watch.

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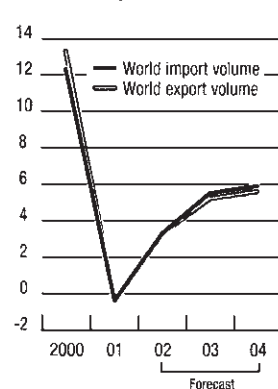
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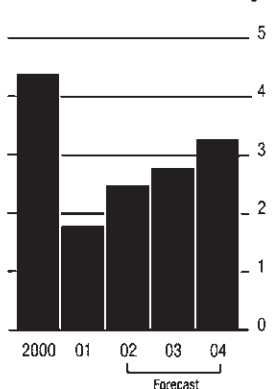
Global trade growth

Annual % change



Global GDP growth

Annual % change



U.S. Interest Rates . . . Priced to Perfection? . . .

THE CHART TO THE RIGHT shows the incredible Bull Market we have experienced in bonds since the early 1980's. Yields have come down and prices have gone up for almost two decades. Are bonds still a good buy?

To cut to the chase, my answer is probably not. You have to start by looking at what causes interest rates to go up and down. Short-term rates are determined by the Federal Reserve. When the Fed buys securities or reduces bank reserve requirements it pumps reserves into the system and pushes down the Federal Funds rate and all other short rates follow. At the moment

imports from places like China are limiting pricing power. But this could change fast. Commodity prices have started to go up and oil prices have jumped. Also the dollar has started to weaken. Foreigners who own a big share of our national debt are going to require higher rates to keep holding dollar denominated bonds.

The biggest question mark in the inflation debate right now however is the U.S. budget. We are in the midst today of the biggest fiscal switch around in U.S. history. We are moving from big projected surpluses to big projected deficits. The Bush tax cuts of 2001 have reduced revenue and the war has pushed up spending. Already the U.S. Treasury is planning on more borrowing and bringing back many of the Notes they stopped issuing three to five years ago. Will we see the long term thirty year Treasury bond again? Probably not. This one was last issued in October 2001. Many feel the Treasury is gun-shy about issuing the 30-year again because it would be seen as an admission that deficits are a permanent part of the fiscal picture.

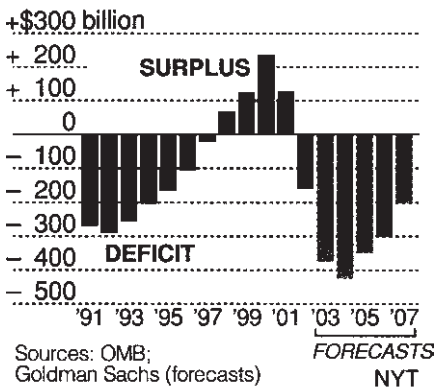
All this possible bad news for the bond market has not scared off investors. *Take a look at the chart in the lower right.* Record amounts of money have poured into fixed income securities. The ten-year Treasury yield shown in the upper right was at 3.8% at the beginning of the year. We are now up to 4.9% and rates could go higher. How does 4.9% look to me? Not that great. Jonathan Clements, the personal investing columnist in the *Wall Street Journal*, made an interesting observation in his March 26 article. He noted that the S&P 500's worst ten-year stretch the last century was 1928 through 1938. The S&P then lost about 1% per year.

10-YEAR TREASURY YIELD



Return of the deficits

U.S. government budget balance; fiscal year to Sept. 30.



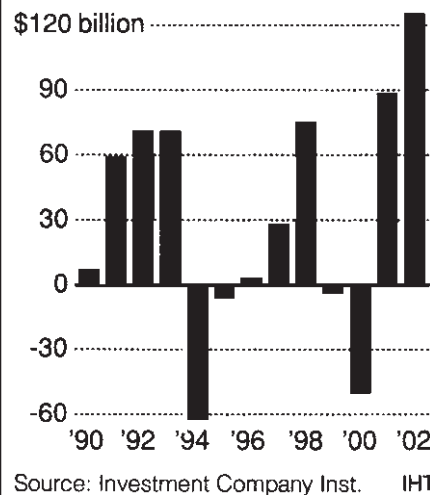
the Fed wants low short-term rates to aid the weak economy and they are getting this. Until the economy shows signs of sustained strength the Fed will keep the pressure on for low rates.

At the long end however interest rates are determined by market forces of supply and demand. Buyers of long-term bonds are concerned about the purchasing power of the stream of interest payments they are going to receive. If they think inflation is going to take a big chunk out of future returns they will demand higher rates as compensation. Right now inflation is low because the economy is weak and cheap prices of

So far this decade we have had three consecutive down years for stocks. How bad would the market have to perform the next seven years for this to rival 1928-1938? The answer is the S&P 500 would have to go up – that's right go up – 5.7% per year between now and 2010 just to get us to the 1928-1938 average. Of course the economy could get worse and the market could move to new lows, but this is not my bet. As for bonds buy them short. The bull market in bonds I think is a thing of the past.

Seeking shelter

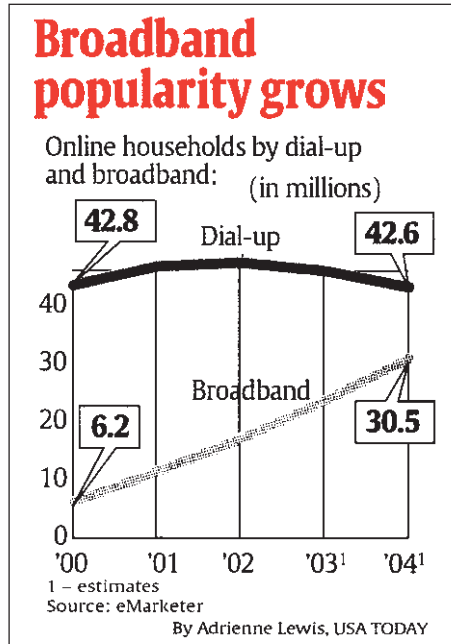
Net new cash flow to U.S. bond mutual funds



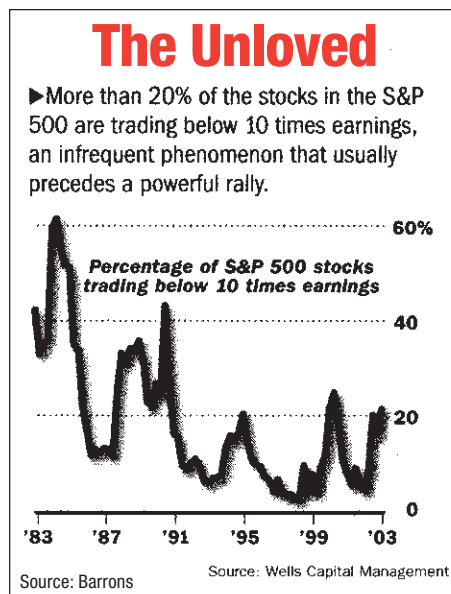
U.S. Trends . . .

On This One, Where You Stand . . .

DEFINITELY DETERMINES where you sit. I am talking about the state of the U.S. economy and stock market. The naysayers have plenty of ammunition to draw on here. *Take a look at the chart to the right.* If it is not over



capacity we have to deal with, then it is weak foreign demand or lack of business equipment spending or no new hiring. And if this is not enough there is always the lack of pricing power, the refunding of pension plans at the expense of



earnings and the fact that the housing market may be running out of steam. We are struggling with the excesses of the 1990's to be sure.

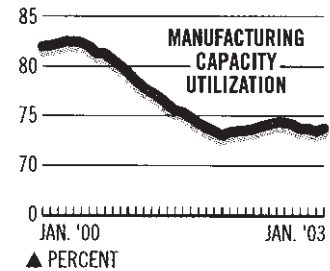
But there is another side to the story. The market has given up a lot of value since March 2000 and many problems have been discounted. Also there are some thin reeds out there signaling recovery. *Take a look at the chart on broadband popularity.* For high tech spending to really revive we need more usage and more killer applications. Broadband is quietly but dramatically gaining acceptance and this may give us the demand we need for more equipment spending.

Barton Biggs at Morgan Stanley is bullish today and paints a pretty attractive picture of the global scene. Here is how it goes. The war ends quickly and the approval rating of President Bush and Tony Blair soar. Pressure builds for a solution in Palestine and Bush and Blair push through (or force?) a compromise that all parties accept. The "Arab Street" grudgingly approves both Iraq and Palestine. With the war over the global economy revives and business spending picks up. Consumer spending continues as the effects of the recent wave of refinancings kick in. Oil prices drop back to the low \$20s and worries about deflation disappear as costs in China increase and pricing power slowly returns.

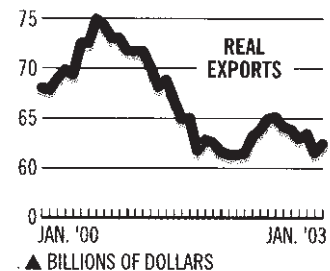
All this obviously requires a lot of ducks to line up just right. I don't buy all of this but I do buy a lot. There is an old adage on Wall Street that "markets make opinions." The stock market has been so glum now for so long, three years and running, that our view of the world can easily take on a negative tinge. The market has discounted a lot of stocks already (*see chart to the left*) and this is not the time to abandon long term investing strategies. The central feature of many investment plans is a diversified portfolio of equities for long-term appreciation. I say stay the course on this one.

MORE THAN WAR WORRIES

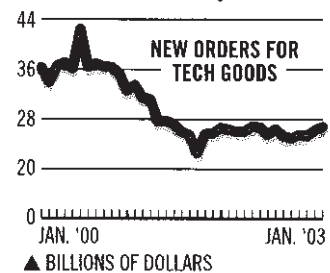
WITH SO MUCH IDLE CAPACITY...



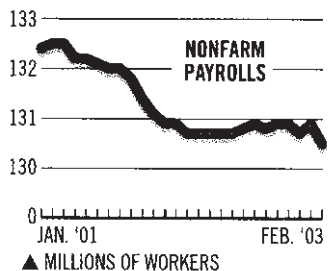
...AND WEAK FOREIGN DEMAND...



...BUSINESSES AREN'T BUYING NEW EQUIPMENT...



...OR HIRING NEW WORKERS



Data: Federal Reserve, Commerce Dept., Labor Dept., Global Insight Inc.

Source: Business Week

Investing Ideas . . .

The Winds of Change . . .

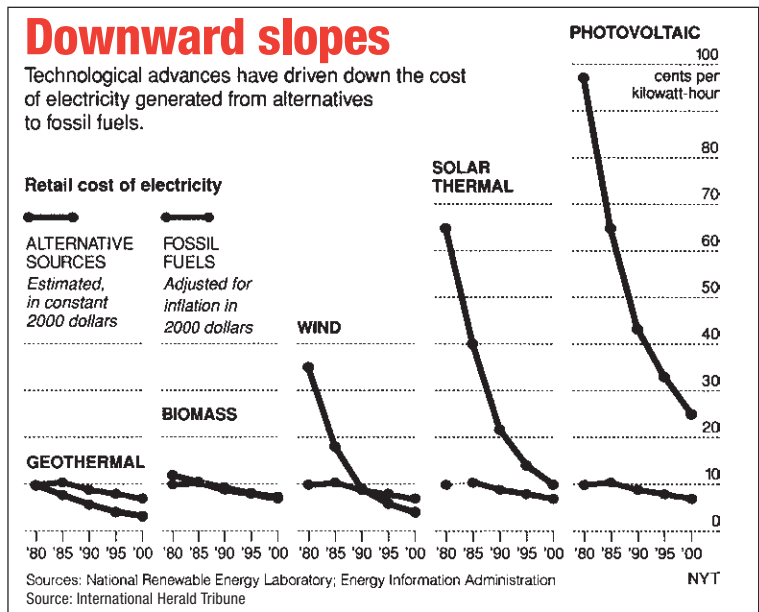
BY NOW, MOST OF US ARE ALL too aware of Wall Street's fickle nature. In the 1960s, small electronic stocks were in vogue. In the 1980s, biotechnology was the rage and in the 1990s Internet stocks were considered gold. Periodically, "alternative energy" companies receive icon status. While broad, this investment sector is mostly comprised of fuel cell, solar and wind power businesses.

Not surprisingly, investors warm up to these companies when traditional energy sources become expensive or unreliable. Remember the 1970s energy crisis or the recent power disruptions in California. But historically, investors have been better off avoiding the stocks. Typically, alternative energy shares have gained on news of technological advances and then sunk as efforts to produce profits failed.

Today, with oil prices spiking to ten-year highs, investors are once again sniffing around these stocks and wondering if this time will be different? For a number of reasons we think the answer could be yes.

First, technological advances have driven down production costs for most energy alternatives. *Take a look at the chart to the right.* Over the last twenty years, retail costs for many alternative power technologies have plummeted. Unfortunately, despite the significant cost improvements, most remain more expensive than traditional fossil fuels. But wind power has managed to drive costs down to competitive levels. For the last 30 years, the cost to produce energy from traditional coal or gas sources has averaged 2½¢ per kilowatt hour (kwh). Since 1980, wind power production costs have dropped from 10¢ per kwh to just under 4¢ today. Without a doubt, federal subsidies and tax credits have contributed to wind's current cost-competitive status.

Typically, I have a hard time getting excited about an industry whose long-term growth prospects depend heavily on government regulation. But today, for both political and environmental reasons, global government regulations are



increasingly supporting wind power development. Currently, the European Union has a goal of obtaining 22% of its electricity from alternative sources by 2010. Great Britain has an objective of getting 20% of its power from alternatives by 2020 and the United States seeks to generate 5% of its electricity needs from wind over the same time frame.

Wind is already a sizable industry. Europe, which suffers from relatively high traditional energy costs, has been at the forefront of wind development. Denmark is currently generating 18% of its electricity needs from wind. Wind provides Germany with a lesser 6% of its total electric needs but the country accounts for almost 50% of Europe's total wind capacity.

Over the last three years, wind capacity worldwide has doubled and prospects for future growth appear strong. Much of this growth should come from the traditionally large European markets but China and the United States look promising too. Merrill Lynch analyst Raymond Greaves expects 4% of global electricity to come from wind power by 2020. This forecast would represent a growth in capacity from 16.5 billion watts to 128 billion.

Historically, capitalizing on wind

power's expected growth has not been easy. Ideally, we like taking a portfolio approach when investing in new, technologically oriented sectors. But the industry is young and today a fund focusing exclusively on wind companies does not exist.

From an individual stock perspective, many industry players are large, diversified companies such as General Electric whose wind operations represent a small part of its business. The remaining "pure-play" investments are typically small firms, manufacturing wind turbines and equipment. Not surprisingly, three of the larger firms, Vestas, NEG Micon and Nordex trade on the Copenhagen exchange. The shares of all three of these companies are down significantly from their 52-week high.

While growth prospects appear bright, it is important to keep in mind the risks associated with new markets like wind power. Current supportive regulations may disappear. Renewal of production tax credits in the U.S., for example, has been delayed over the last year disrupting a whole range of wind power projects. But the long-term players in this business have dealt with regulatory uncertainty before and may now be worth a second look.

– Anne Williams Doremus, CFA