

Thoughts from

# Hanson Investment Management Inc.

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## Want to know who sets oil prices? Try China for starters...

**T**AKE A LOOK at the charts below. Oil is priced at the margin which means the last unit purchased determines the price. And at the margin the big growth now is coming from the developing countries of Asia, like China and India. These two countries do not have large supplies of oil.

Since 1995 oil demand in Asia (ex Japan) has been growing at 4% per year versus 1% in Europe and 2% in the U.S. The chart on the right shows China's net imports of oil since the early 1990's. It has been skyrocketing. Some analysts estimate that by the year 2020 China will have to import 50% of its needs. Most Western countries maintain an oil reserve equivalent to ninety days of imports. China has virtually no reserve so if they decide to establish one, demand will increase even more.

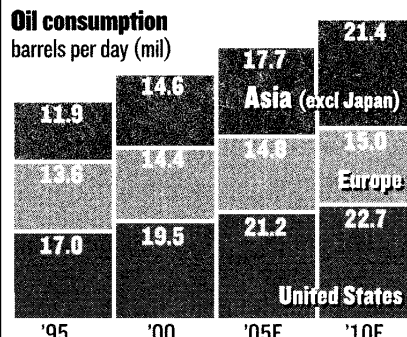
As world economies slow, oil demand will drop off. But the point is, the two big emerging powers, China and India have an almost insatiable demand for oil now and when growth resumes they will put pressure on oil prices. *Forbes* reports that last year 92% of global net growth in oil consumption came from developing countries in Asia, up from 68% in 1999. These countries will continue to grow fast so don't hold your breath expecting oil back at \$10 a barrel anytime soon.

**Hanson Investment Management is an investment counsel firm managing portfolios for individuals and institutional clients. The firm also consults with individuals on financial planning and works with self-directed retirement plans on investment options.**

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### Stepping on the Gas

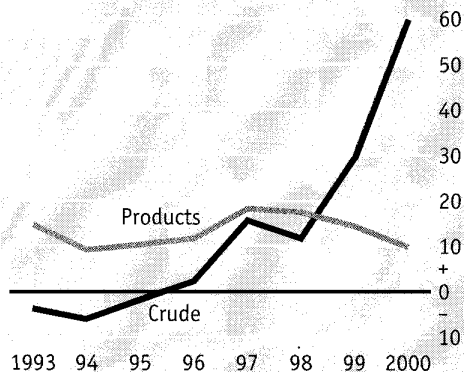
Although Japan's usage is static, the rest of Asia (not American sport utility trucks) is spurring global demand.



Sources: U.S. Energy Information Administration; FACTS Inc. Source: Forbes

### The Cost of Progress

China's net imports of oil, tonnes m



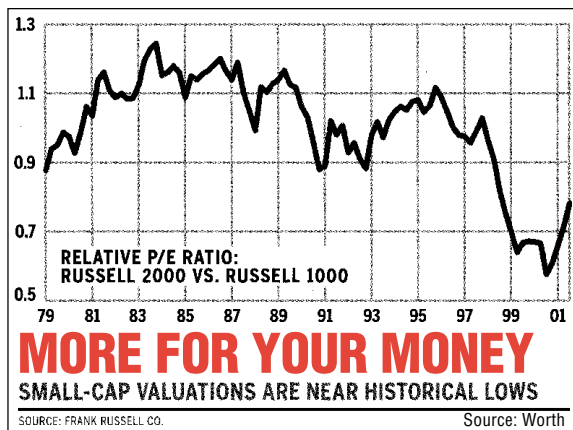
Source: International Petroleum Economics Source: The Economist

# The U.S. Market . . .

## Our Crystal Ball is Back from the Shop! . . .

**W**E HAVE BEEN ASSURED this time it really does work. We'll see. In any case we will soldier on.

One thing we feel pretty certain about now is that the market will behave in the future as it has in the past. This means stocks will go down before an economic slowdown and pick up before an economic rebound. (See chart to the right.) So far in this cycle things are right on schedule. The market turned down in March 2000, about six months prior to the current economic slowdown. Now we just need to know when the economy is going to turn up and we will be all set.



The chart in the upper right shows that market downturns typically have five stages. The first is the premonition of an economic slow down. Then fear sets in. Capitulation is the next stage and then in the fourth stage stock values are at their most attractive and finally, recovery begins. Where are we now? We have certainly had the premonition of a slowdown and also experienced fear. We probably are somewhere between capitulation (when defensive stocks like consumer issues do well) and the real value phase. But we still have not seen earnings stop falling nor have we seen an indication the economy has found bottom.

One of the smartest investors around is Jeremy Grantham founder of Grantham, Mayo, Van Otterloo in Boston. Jeremy is pretty glum today. He feels there are problems both with the

economy and the market. The blow-off in stocks in the late 1990's was so intense and things got so overextended that it will take time, maybe a lot of time, to work off the excesses. U.S. equities will actually have a negative return after inflation over the next 10 years. Pretty pessimistic.

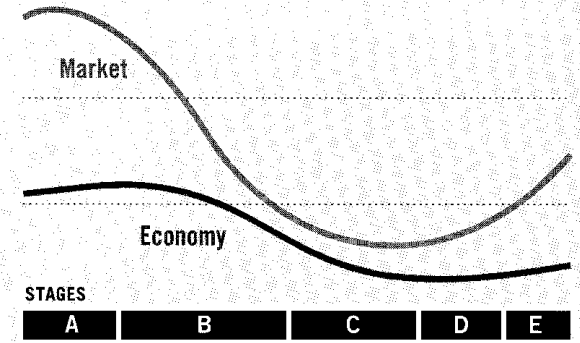
But the good news is Mr. Grantham thinks there are a number of places to seek shelter in the storm. He likes real estate and REITs and

also small cap value stocks (both here and in the rest of the world) and emerging market equities. The average PE of small cap stocks relative to large caps has been falling since the mid 1990's (see chart to the left). This means good returns for small caps when we get the typical regression to the mean. And emerging markets today sell at an average multiple of 8X earnings versus 25X for the U.S. market. Emerging markets had

a checkered record in the 1990s but if the story had been all that good prices would be a whole lot higher today.

We hope Grantham's forecast is right but not too right. We agree it will take time to work off the excesses in the market and the economy. Things could be slow for a few years not just a few months but

### The Phases of the Moon



Source: Smart Money

forecasting a negative return for the next decade is extreme. Too extreme we feel.

We think Grantham's idea of shelters in the storm is on the mark. We like small cap stocks and also defensive issues like REITs. And we even like emerging markets even though we have been accused in the past of being gluttons for punishment in this sector. So we remain 100% invested now continuing to look for solid value ideas. Let's hope our crystal ball doesn't get recalled yet again.

### In the Bear's Den

*A bear market, generally defined as a market decline of 20 percent or more over at least a two-month period, has occurred on average every five years—and has lasted on average about 12 months.*

#### Bear markets since 1956

Duration	% drop	■ Duration in months □ Recovery period in months
Aug. 2, 1956-Oct. 22, 1957	21.6	14.7/11.1
Dec. 12, 1961- June 26, 1962	28.0	6.4/14.3
Feb. 9, 1966-Oct. 7, 1966	22.2	7.9/6.9
Nov. 29, 1968-May 26, 1970	36.1	17.9/21.3
Jan. 11, 1973-Oct. 3, 1974	48.2	20.7
Sept. 21, 1976-March 6, 1978	19.4	17.5/17.3
Jan. 6, 1981-Aug. 12, 1982	25.8	19.2/2.3
Aug. 25, 1987-Dec. 4, 1987	33.5	3.3/19.7
July 16, 1990-Oct. 11, 1990	19.9	2.9/4.3

SOURCE: Standard & Poor's

THE WASHINGTON POST

# U.S. Investing Trends . . .

## Anyone out there on our side? . . .

WHEN I STARTED IN THE BUSINESS 30 years ago stock analysts and investment bankers were entirely separate beasts. An analyst's job was to find solid companies at attractive prices. Investment bankers were there to call on companies to drum up stock and bond deals. There was a solid "Chinese Wall" between the two functions – analysts didn't talk to investment bankers and investment bankers didn't talk to analysts.

Today the distinction has vanished. When companies look to issue securities they want to see a highly rated analyst working hand in glove with the investment banker ready to push the stock before and after the deal. And Wall Street research firms have generally toed the line on this.

The *Wall Street Journal* recently reported on an SEC survey that found that thirty percent of research analysts said they got cheap stock in private companies that they later covered after the companies went public. This is an incredible conflict of interest it seems to us. If you are given low cost options in a private company the chances are pretty good you will do everything you can to help make that company a success.

In addition to conflict of interest

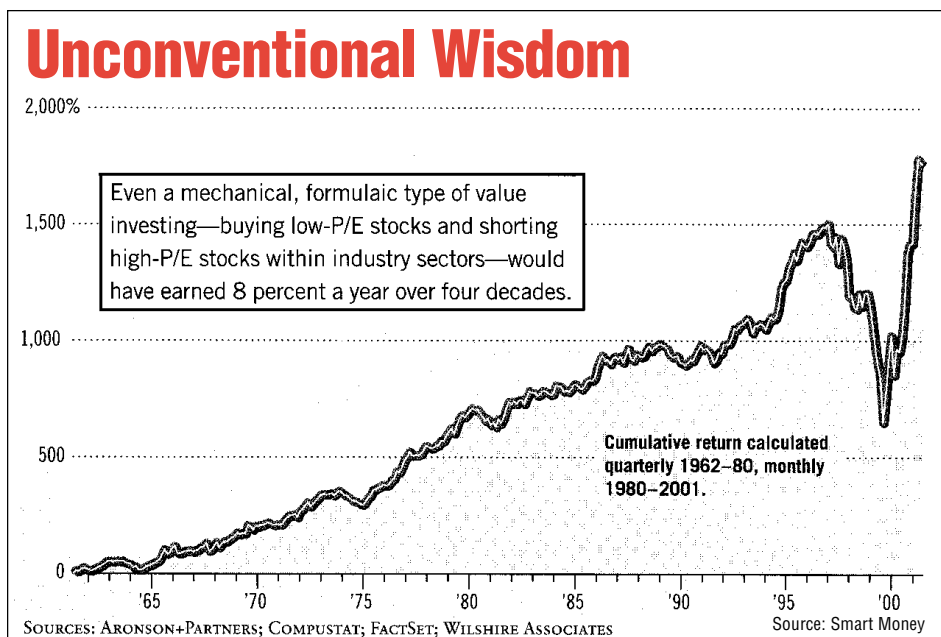
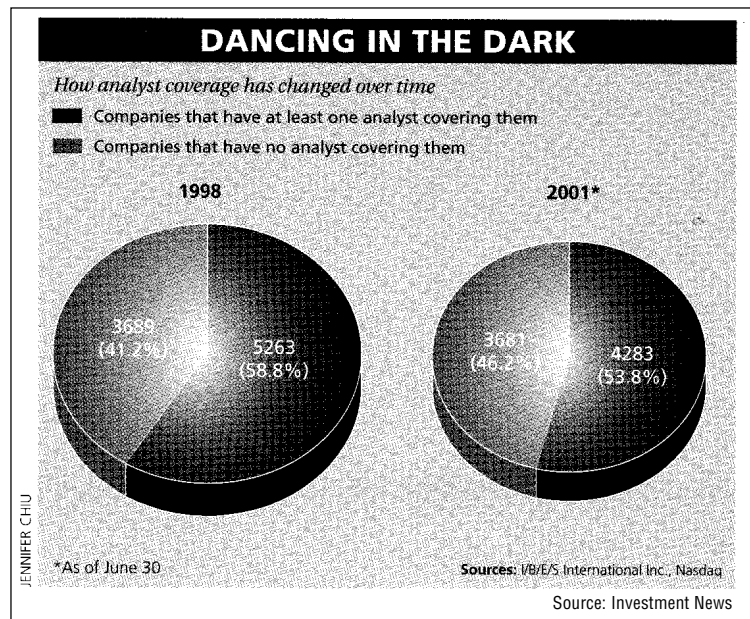
issues there is also the problem that analysts are following fewer and fewer companies today (*chart to the right*). Almost one half of all publicly traded companies have no analyst coverage. The companies that are being shunned are either out of favor, have limited liquidity or have little prospect for investment banking business.

There is an up side to all this however. When you have less analyst coverage you have a more inefficient stock price and this often means opportunity to make money if you get your research right. The new Regulation FD (Fair Disclosure) forbids companies from giving non-public information to large investors before they give it to the public. This will lead, we think, to more

timely disclosure of current operating trends by companies. This is good news for value investors who often are most interested in companies that do not get red carpet analyst treatment on Wall Street.

The chart in the lower left is from *Smart Money*. It shows that value investing has been a consistent money maker in the past. If you had followed a naïve strategy of buying the least expensive companies in every industry and shorting or selling the most expensive companies in the same industry you would have earned 8% per year over 30+ years. The only period where this was not the case was the madness of the high tech boom in the late 1990's. And this is now over.

The blurring of distinction between stock analyst and investment banker is a disturbing trend. We hope it reverses but if it doesn't value investors can still take consolation. What makes a company most interesting is not that it is just about to do a securities offering but that it earns a solid profit, is well capitalized and well managed, and sells at a reasonable price. This has been the successful value formula in the past and should continue to be in the future, with or without Wall Street analyst coverage.



# The Economic Outlook . . . Home Sweet Home . . .

**A**MERICAN'S DEVOTION TO SPENDING is truly an amazing thing. Consider the current economic environment. Jobless claims recently jumped to their highest level in 9 years. Thanks largely to declining stock prices, household net worth fell last year for the first time since 1945. Yet despite the bleak outlook, America's consumers are trudging bravely forward to... the shopping mall.

In past slowdowns, rising unemployment levels quickly led to reduced consumer spending with big-ticket goods often the hardest hit. The current downturn has witnessed no such pull back. Consumer spending has risen at about a 3% annual rate on an inflation-adjusted basis over the last 9 months. Auto sales remain high and homes continue to sell briskly.

So far, the healthy pace of consumer spending has kept the U.S. from falling into recession. Economists today feel a number of factors are supporting the strong spending. First, a string of interest rate cuts by the Federal Reserve has reduced consumer payments on every-

thing from credit cards to mortgages. Falling energy prices are putting cash directly back into consumers' pockets. Finally, real estate markets across the country remain strong. According to the Office of Federal Housing Enterprise Oversight, housing prices rose 8.9% last year, the highest rate since 1979. Take a look at the chart below. For the first time since 1997, homes are American's largest asset.

The combination of rising home values and low interest rates has allowed homeowners to borrow against their equity to pay for everything from vacations to tuition bills. According to consulting firm Economy.com, over \$495 billion in mortgage loans were refinanced during the first six months of this year alone. Further, they estimate that consumers extracted about \$33 billion in cash from these transactions. These amounts are about three times as high as those for the same period last year.

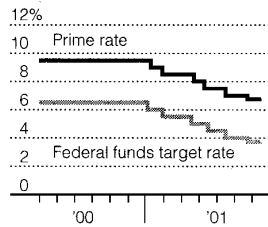
But the downside to this trend is that, in order to maintain spending habits, consumers have taken on unprecedented levels of debt. Mortgage debt today totals approximately 45% of home values, up from 35% at the end of the 1980s. Escalating credit card use has also taken its toll on consumer balance sheets. In 1998 and 1999, consumer credit card debt increased approximately 5.5% a year. By the end of 2000, this growth rate had surged to 12%.

Consumers are also taking on larger mortgages to finance the purchase of bigger, costlier homes. Over the last decade, the median size of a house rose from 5.2 to 5.8 rooms and the cost of financing these homes increased 35% even after adjusting for inflation. Often, affording these larger homes has meant moving further out to less expensive

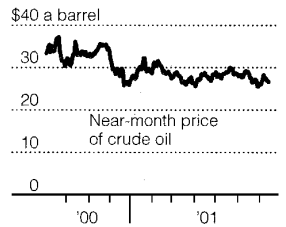
## Will Consumers Keep Spending?

Despite a sharp retrenchment by American businesses this year, healthy consumer spending has kept the economy growing slowly. While some factors might help perpetuate that trend, others might encourage consumers to retrench.

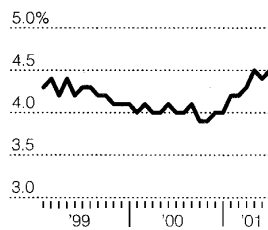
### Interest rates are lower ...



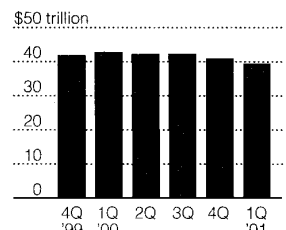
### ... and so are energy prices ...



### ... but unemployment is creeping up ...



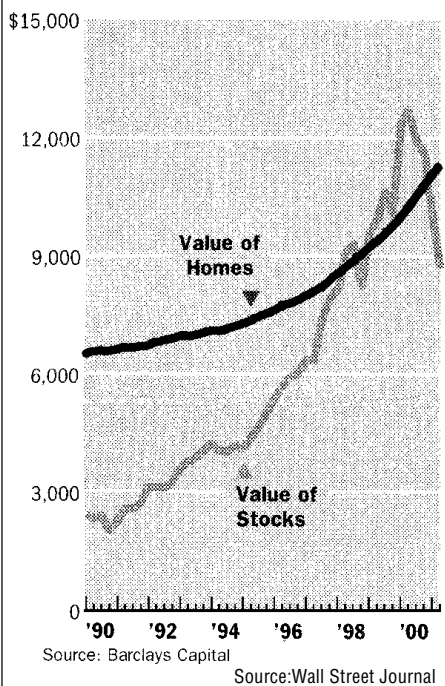
### ... and net household worth has declined.



Sources: Associated Press; Bloomberg Financial Markets; Bureau of Labor Statistics; Federal Reserve Board

Source: The New York Times

## Back Home



neighborhoods and longer commuting times. In 2000, the average commuting time of about 24 minutes was up from slightly over 22 minutes in 1990.

Further, commute times in many rural areas such as New Hampshire and West Virginia exceeded the national average.

Moving forward, a number of factors should help support continued strong spending patterns. First, the recently enacted tax cut will pump approximately \$40 billion dollars into the economy. Energy prices are heading lower and the Federal Reserve seems poised to cut rates further should economic conditions deteriorate.

Today the risk remains on the job front. If layoffs continue at their brisk pace, then consumers will have a tough time maintaining spending levels and paying off now higher levels of debt. To date, Americans have done their part to support the economy. But we won't be out of the woods until Corporate America turns around.

— Anne Williams Doremus