

Thoughts from

# Hanson Investment Management Inc.

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## Our Annual Holiday Gift to You . . .

**E**ACH CHRISTMAS FOR THE PAST FIVE YEARS we have given you a chocolate dessert. We have done chocolate mousse, chocolate brownies, chocolate soufflé, chocolate covered profiteroles and last year, chocolate maple pecan pie. This year we discovered to our surprise we haven't done the granddaddy of chocolate, the chocolate cake.

So it was off to the cookbooks. Since every cookbook writer worth her salt (just a pinch thank you, we're watching our blood pressure) has a recipe for chocolate cake we decided on a bake-off. The contestants: *Loaves and Fishes Party Cookbook* (Chocolate Chocolate Cake) pan-to-pan and fork-to-fork against *Williams-Sonoma Dessert Book* (Devil's Food Cake with Fudge Frosting).

Both recipes got enthusiastic reviews but the final nod went to *Loaves and Fishes*. This Long Island catering and kitchen accessory store puts its recipes to the test every day. The cake is moist and yummy and the cinnamon, coffee and sour cream add just that extra taste. (Hint: we found it needs more time to bake, up to 40 minutes.) Enjoy! Happy Holidays from all of us.

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## CHOCOLATE CHOCOLATE CAKE

½ pound (2 sticks) butter, softened  
2¾ cups sugar  
2½ cups unbleached white flour  
1 teaspoon baking soda  
¾ cup Swiss or Belgian cocoa  
1 teaspoon ground cinnamon  
1 cup brewed coffee  
2 teaspoons vanilla extract  
1 cup sour cream  
5 egg whites

### FROSTING

4 tablespoons butter, softened  
1 pound confectioners' sugar  
¾ cup cocoa  
½ cup water

Preheat the oven to 325 degrees. Butter two 9-inch pans.

In the bowl of an electric mixer, cream the butter and sugar until light. Add 1 cup of flour, the baking soda, cocoa, cinnamon, coffee, and vanilla. Beat at low speed for about 5 minutes, until fluffy. Add the remaining flour and the sour cream. Beat at low speed to blend well.

In a separate bowl, beat the egg whites until soft peaks hold. Using a rubber spatula, fold the egg whites into the chocolate batter. Pour the batter into the prepared pans, and spread evenly.

Bake 25 minutes, or until a toothpick inserted in the center comes out clean. Remove from the oven and cool in the pans.

To make the frosting, beat the butter, confectioners' sugar, cocoa, and water, until very light and spreadable.

Transfer 1 cake layer to a cake plate. Spread the top with frosting, cover with the second cake layer, and spread the remaining frosting over the top and sides of the cake.

Stored at room temperature, the cake will keep for up to 5 days. Yield: 10 to 12 servings.

**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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# The U.S. Economy . . . It's Dusted and Ready . . .

**W**E'VE WHEELED OUT THE crystal ball again and are ready for another year. We haven't always had the best forecasting record but who knows we might get it just right this year. 2003 was a surprisingly good year for both the economy and the stock market. It wasn't straight up, it was more like two steps forward and one step back, but after the 2000 – 2002 market collapse we will take any progress we can get.

Corporate profits are up 15% and 20% this year and the consumer has kept spending especially in the housing area where refinancing rates hit record lows. An especially positive sign was the pick up in business spending. It looks like the bulk of the excess capacity built during the boom years of the 1990's has been worked off.

We look for more progress in the economy in 2004. Corporate profits are projected to be up 12% to 13% and consumer and business spending should continue to move ahead. The big question mark is job growth but the recent data is positive and we see enough hiring in 2004 to keep the economy going.

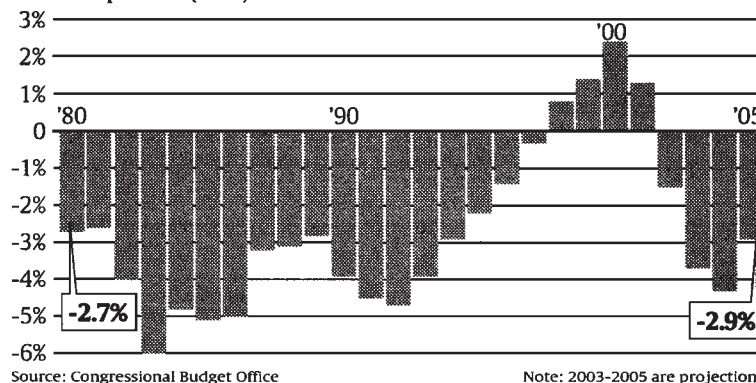
On the interest rate front we think long rates and mortgage rates will inch

up in line with the economy. Not a dramatic increase mind you but still higher rates. Mr. Greenspan has kept the pedal to the floor on short-term rates pushing them to a forty-five year low. The rationale is we need all the monetary stimulus we can get to keep the recovery alive. As conditions improve the Fed will ease off the gas. We wouldn't be surprised to see short rates rise from around 1% today to 2% or even 3% a year from now. This sounds dramatic but we don't think it will jeopardize the recovery.

All this is pretty positive. What could go wrong here? Well three things specifically. The first two have to do with our enormous deficits, the fiscal one (spending exceeds taxes) and the trade deficit (imports exceed exports). At some point investors may look at the yawning fiscal mismatch (see chart above) and see sharply higher inflation down the road. If bond buyers boycott the market, rates could increase a lot sooner and by a lot more than the economy can take. Also, foreigners could sour on the dollar if the balance of payments deficit continues to widen. A sharp unexpected drop in the dollar or a sharp unexpected rise in interest rates could seriously threaten the emerging recovery.

## The deficit is back and getting bigger

After a four-year interlude of surpluses in 1998-2001, the federal budget has fallen back into deficits. The budget surplus/deficit as a percentage of gross domestic product (GDP):

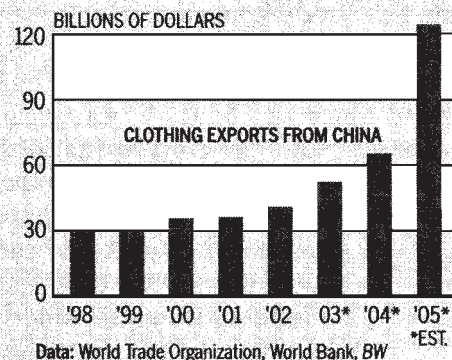


Source: Congressional Budget Office

Note: 2003-2005 are projections  
By Marcy E. Mullins, USA TODAY

The third fear is political. The loss of jobs today to emerging economies (*the chart below is pretty scary*) has many voters irate and politicians scurrying for solutions. One of these is protectionism. Sealing our borders to imports and forcing jobs to stay put sounds logical

## CHINA RISING

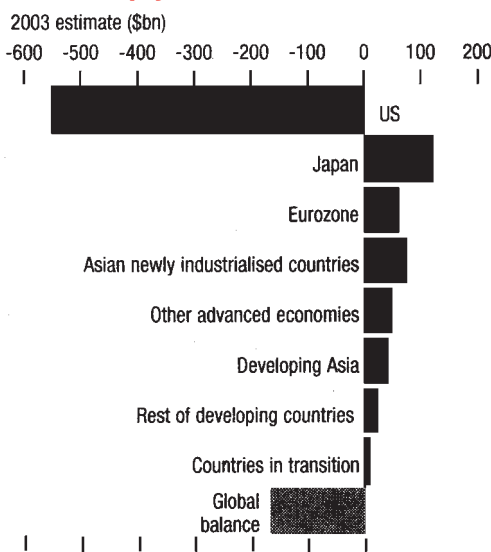


Data: World Trade Organization, World Bank, BW \*EST.

and patriotic to some but it could kill the goose that lays the global egg. We have benefited immensely from globalization and foreign trade and any restriction here could throw the economic engine quickly in reverse.

We are betting that the twin deficits will be manageable in 2004 and that protectionism will not carry the day. The recent Bush Administration decision to back off steel tariffs is encouraging.

## Balance of payments on the current account



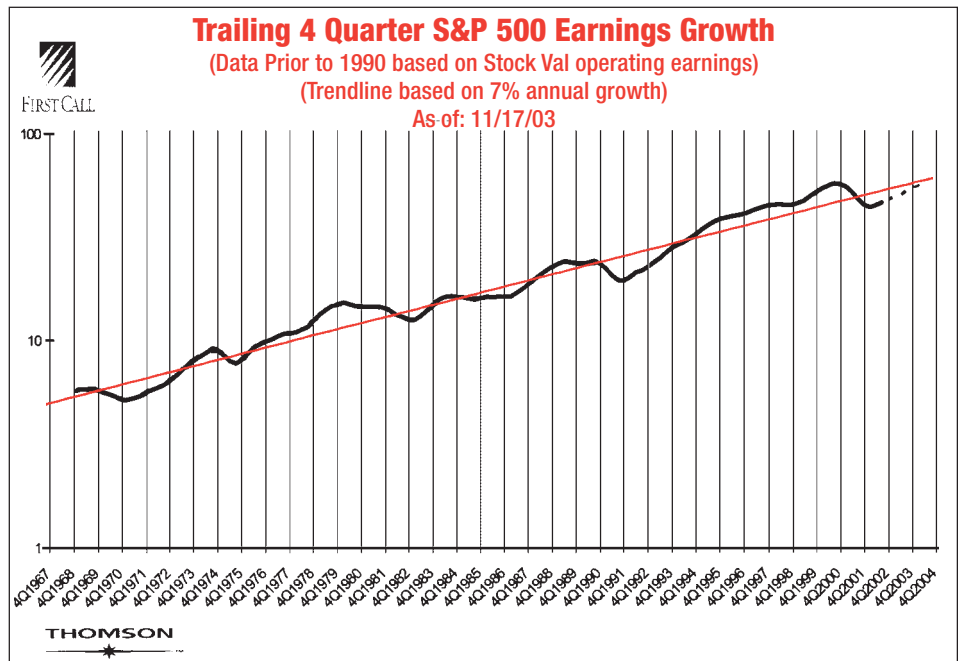
Source: Financial Times

# The U.S. Market . . . Is the Going Still Good? . . .

**Y**ES AND NO. THE DOW JONES Industrial Average is up over 30% since March. Stocks are no longer dirt cheap but even with prices up we think the stock market is a fair bet today. Price to earnings ratios are much lower now than they were at the peak of the bubble in 2000 (*see below*). We realize they are still higher than the average historic PE of 15x earnings. Low interest rates and low inflation explain part of this and corporations are also benefiting from the global market and the greater flexibility of global production.

We are 100% invested in our portfolios now. We don't practice market timing. We buy value ideas, stocks selling cheap relative to earnings and assets, and hold them until they get expensive. Value ideas did not soar with the NASDAQ high tech whiz kids in the late 1990's but they also declined very little in the 2000-2002 bloodbath.

Our investment style is rooted in long-term trends (*see chart in the upper right*). It is a little messy visually but the message is clear. Corporate profits have increased an average of 7% per year since 1967. It is surprising how close to the trend line annual results have been even during the supposed high profit years of 1995-2000. It is also interesting how closely tied corporate profits are to the



economy. GDP is up 7% per year in nominal terms the past 37 years, the same rate as profits.

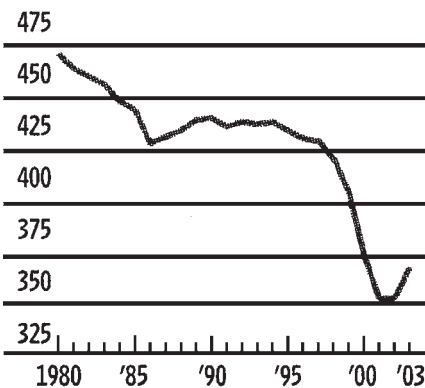
And how about the stock market? It is no coincidence that stocks have tracked right along with GDP and profits. The Dow is up 7.1% per year since Jan. 1968. Add in dividends and you get a total return of over 10%. It is very likely that if the economy and profits go up the next ten years at roughly the same rate as in the past, then the stock market will track right along. But what does next year look like? Who knows. Market confidence is reflected in the price to earnings ratio and PEs are dependent on our gut feelings of fear, greed and apprehension. Who knows how these will play out? It seems better to us to stay focused on identifying inexpensive stocks and let the events of the

moment take care of themselves. Over the long haul we are confident GDP, profits and stock prices will march right ahead.

We are also encouraged that dividends are coming back in favor. For tax and other reasons corporations moved away from higher payouts in the 1990's and emphasized stock buybacks and other activities. Recent changes have lowered the tax on dividends to 15%. More companies are again paying dividends (*see chart to the left*) and those that already are, are increasing them. Good news for 2004.

## Sharing the Wealth

After a two-decade decline, the number of S&P 500 companies paying a dividend has increased slightly this year, to 366.

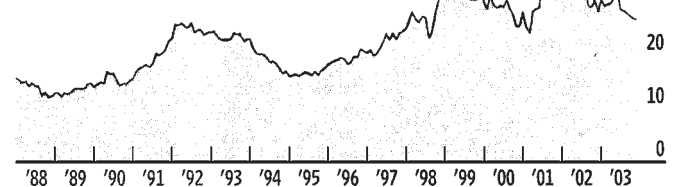


Source: Standard & Poor's

Source: Wall Street Journal

## Will Investors Pay the Price?

As stocks have soared this year, corporate earnings have jumped even faster, pushing down the ratio of price to earnings for the S&P 500 to about 27, as shown below. But that remains well above the historical average of about 16. And because analysts expect earnings growth to slow soon, fears are spreading that stock gains (such as the S&P 500 and the Dow Jones Industrial Average, at right) could suffer as well.



Source: Wall Street Journal

# Economic Trends . . .

## The Goose That Lays the Golden Egg . . .

THE RECENT ECONOMIC recovery has been unusual. At this point in the average business-cycle upturn, the U.S. economy would have produced almost 3 million new jobs. Instead, a full 21 months into this recovery, 1.2 million jobs have vanished. Not surprisingly, nearly half of the hiring shortfall has come from the manufacturing sector. But the service sector, which now employs fully 80% of the nation's private workforce, has also failed to create jobs.

Companies are, without a doubt, churning out more goods with fewer people. *Take a look at the chart to the right. U.S. productivity, defined as the amount of output per unit of time, surged 9.4% in the recently completed third quarter.* And over the last two years, productivity has gained at an average rate of 5.4%, well above the 3.5% logged in the first two years of recent economic recoveries.

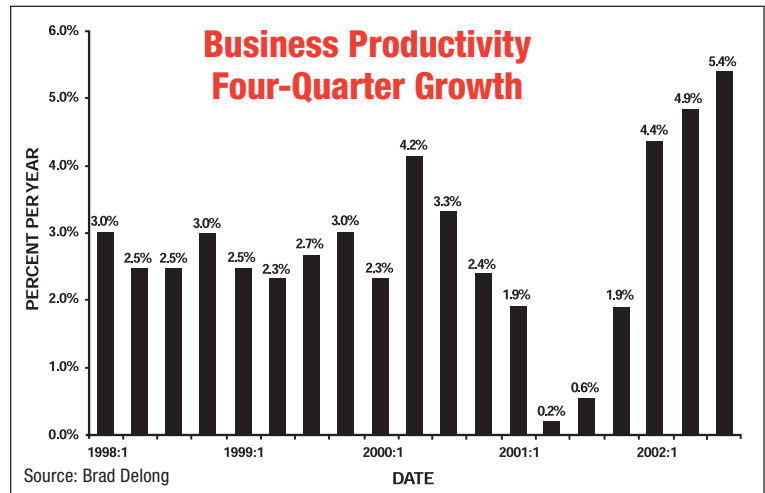
Most economists are cheering the recent results. Productivity growth, after all, is what leads to higher standards of living. Politicians, however, are focusing on the sorry state of the job market and blaming globalization and Corporate America's growing use of overseas labor.

But by making globalization the culprit, they ignore the critical role that technological innovation has played in transforming U.S. labor markets.

In the late 1990s, the U.S. led the world in spending on information technology and telecommunications. Thanks to a booming stock market, billions of dollars poured into everything from web site development to fiber optic cable manufacturing. Unfortunately, as investors soon discovered, many of these investments were written off in the subsequent market meltdown. But significant sums went to fund innovative technologies that are only now beginning to transform business practices.

Consider the following examples. Thanks to the Internet, a shoe company in Des Moines can send design changes to a Taiwanese manufacturer instantaneously. Inexpensive high-speed telecommunication networks now allow a help-desk in India to field service calls for a bank in New York. And at Intel's newest U.S. semiconductor plant in New Mexico, new technology allows the same number of workers to produce 2½ times as many chips as at factories opened just five years ago. As these examples point out, new technologies impact different industries in different ways. In some cases, technological developments are helping companies access cheaper overseas labor markets. But often productivity-enhancing technologies are simply eliminating jobs altogether.

Economic transformation fueled by technological advances is not new. Consider the plight of agricultural workers in the early 1900s and manu-



facturing workers in the 1980s. In 1900, 38% of Americans still worked on the farm. Because of technological advances, today just 2% of U.S. employment is based in agriculture yet we produce enough food to feed ourselves and much of the rest of the world.

Historically, the U.S. has excelled at developing new technologies that become the next source of job creation. But technological innovation is a gradual process whose end-results are not always clear. Consider Amazon's most recent "Search Inside the Book" digital project. With this effort, Amazon hopes to create a digital archive of most of its multimillion-title catalog. Although users will never be able to print out whole books, they will be able to search the archive for keywords and references. If successful, this project will clearly be a boon to Amazon's book selling business. But consider what broader impact the project might have on basic research efforts as scientists and students are able to electronically search the ever-expanding database.

Technological advancements will continue to transform business in unexpected and unpredictable ways. The challenge for any economy today is to remain flexible, innovate and create new products. We have excelled at this in the past and can do it again.

— Anne Williams Doremus, CFA

### More Stuff, Fewer People

Even when factories boomed over the past 15 years, employment trended down.

