

## The Way The World Works...

I am not going to spend a lot of time on the *chart below*. I think it pretty much speaks for itself and I don't want to insult your intelligence. I will note however if you turn the chart upside down you can get some really good lottery number suggestions! The chart did not appear in some obtuse academic journal or even *Mad Magazine* (I am showing my age) but in the *Sunday New York Times Business* section (7/5/2009). Go figure.

I haven't the foggiest idea what the chart says but if I were to guess it would be, this economy is really impossible to call right now. As they say, it is never a good idea to use the four most dangerous words, 'this

time is different' but we are seeing some things today that we haven't encountered for a long time like the discussion earlier in the year of nationalizing the biggest banks. This makes forecasting even more difficult.

The conventional wisdom is that the economy is forming some sort of bottom now and we will see flat to slightly up performance from the global economy the next year or two. We tend to agree. And the engine driving this train for the foreseeable future will be the Emerging markets (discussed on page 2).

We are not looking for a big jump in inflation or interest rates now nor do we see commodity prices getting out of hand. The consumer still makes up 70% of developed market economies and the consumer is just not in shape to do any sustained buying. Wage increases are anemic,

hours are being cut, unemployment is 9% (and probably double this when you add in people working part time looking for full time work) and debt is still high. And housing is not turning yet. All in all a pretty bleak picture.

What does this say about the stock market? I really don't know but one possibility is we are in for a stop and go market like the late 1930's. Between 1937 and 1942 the market had five rallies of between 12% and 46% and five declines ranging from 10% to 28%. So a lot of energy was expended but in the final analysis the Dow made only slight net headway. This means it is very important now to buy only top quality companies with solid balance sheets and the ability to increase earnings in a slow growing environment. Remember, if the future is uncertain make sure you don't pay too much for it!

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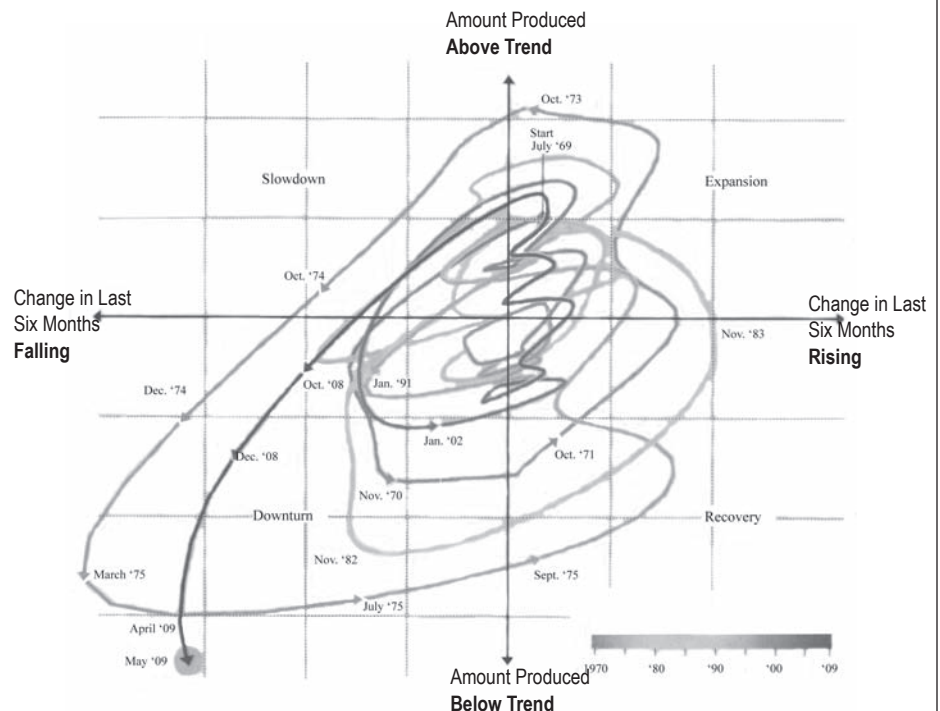


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### Are We Turning A Corner?



Source: *The New York Times*

# This Is Your Mantra For The Future...

You have heard this from us before and also from others that the really big story of the future is going to be the growth in Emerging economies. The last century was ours. We were the fastest growing economy and also the biggest. This century we will cede leadership to the new fast chargers. This doesn't mean we won't continue to be successful or wealthy. We will almost certainly continue to be both. But it does mean that as

integration of the world both in terms of trade and in terms of the rapid movement of information has gone too far and we can't put this genie back in the bottle. We are, for better or for worse in a global marketplace.

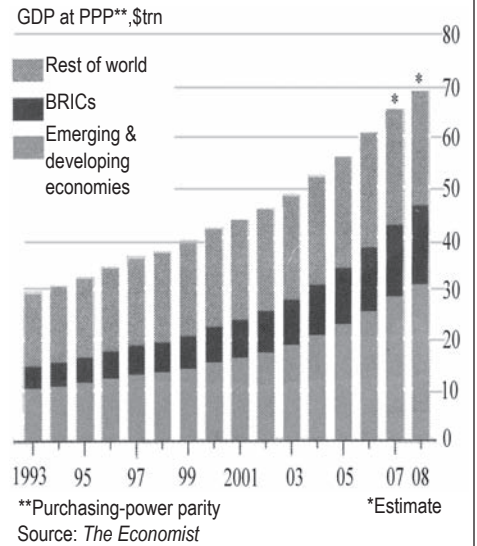
Over the short term the world desperately needs the emerging market engine. *The chart in the left hand column* shows that China, India and East Asia continue to grow rapidly (albeit less rapidly than before) while the developed countries are struggling. If we are going to get out of our present funk in 2010 it will be the newer economies that will add demand at the margin.

U.S. investors are generally underweight emerging markets. Burton Malkiel the author of *A Random Walk Down Wall Street* is a big fan of the newer markets and especially China. He estimates that on a purchasing power parity basis China is about 10% of world GDP. But very few equity investors have anywhere near this percentage invested there. He feels you should have at least 5% to 10% invested in China and our thinking is your total international exposure, both developed markets and developing ones, should be somewhere between 30% and 50%. This is still a quite radical thought for many investors but a very important strategic move for future success we feel.

The most exciting sector in emerging markets is the growing middle class and the increase in consumer spending. *The chart at the bottom right* shows what is happening in just one segment, automobiles. Emerging markets account for about 28% of total car sales today. Within five years this might grow to 50%. In the first four months of 2009 car sales in China actually surpassed car sales in the U.S.

Companies that will benefit from Third World growth include many U.S. and foreign multinationals which have production and sales organizations all over the globe.

## Where The Growth Is



But Emerging market companies are becoming world class in their own right. Acer in Taiwan is now number two worldwide in PC sales and Asustek pioneered the Netbook computer. Huawei and ZTE in China are battling globally in telephone switching equipment, Embraer in Brazil is a force in airplanes, and Infosys and TCS in India are the gold standard in outsourcing. Exciting times indeed for global investing.

## Projections for the global economy

Forecasts for annual change in real gross domestic product.

	2009	2010	2011
China	7.2%	7.7%	8.5%
India	5.1	8.0	8.5
East Asia*	5.0	6.6	7.8
United States	-3.0	1.8	2.5
Euro area	-4.5	0.5	1.9
Japan	-6.8	1.0	2.0

Source: International Herald Tribune

\*Developing Countries

a percentage of the pie we will get somewhat smaller and the rest of the world especially emerging economies will take a bigger share.

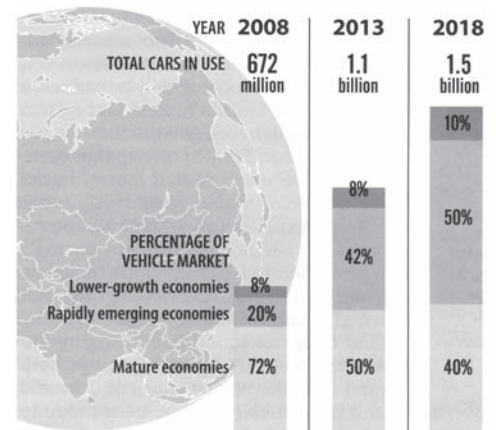
The new growth won't be just in one country or one region but the biggest and most dynamic contributor will probably be Asia. Over the past quarter century 400 million people in Asia have been lifted out of poverty and have moved into the cash economy. *The chart in the upper right* shows that developing economies and the BRICS (Brazil, Russia, India and China) are now almost 50% of the global economy after you adjust for purchasing power differences. Almost 60% of the increase in world output between 2000 and 2008 happened in developing countries.

The growth of the emerging world will not be a straight line. The recent pullback in world trade and the growing doubts about globalization have certainly poured cold water on a lot of forecasts. But we think the

## ACCELERATING SALES

The impending boom in the world auto market

Global demand for automobiles may more than double between now and 2018. One big reason for the growth: Many rapidly emerging economies - such as those of Brazil, Russia, India, China, Malaysia, Mexico, Iran, and Indonesia - are seeing per capita incomes rise to the point where car ownership starts to accelerate.



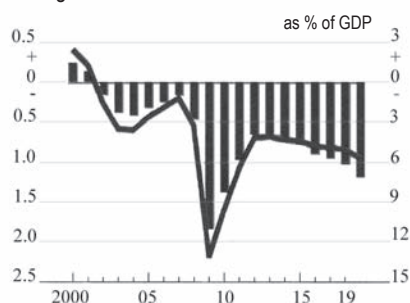
Source: Christian Science Monitor

# The Mother Of All Moral Hazards...

We wrote up Boston investor Seth Klarman and his classic book, *Margin of Safety*, in the last newsletter. Seth spoke at the annual meeting of the Boston Security Analysts Society recently. His biggest fear for the economy today is that the government is creating one enormous moral hazard. A moral hazard is a situation where you behave differently if you are insulated from risk than if you were fully exposed to that risk. If for instance, you thought that the government would bail your business out if you failed then you will

## In a hole

US budget balance:



Source: *The Economist*

probably take more risk than if the government was not behind you and you had to bear all the consequences.

The way the government is jumping in today at every turn with stimulus spending and bailout money, it makes you wonder whether we are on a very slippery slope. Will the government feel it has to step in in every situation from now on? We are already talking about another stimulus package even before the ink is fully dry on the first \$800 odd billion.

The risk of government intervention at every turn is that eventually even the biggest economy in the world runs out of fire power. *The two charts* here show the possible hole we are digging ourselves. The big fiscal deficits will eventually need to be funded by more debt. Relative to Europe and certainly relative to Japan we are not overextended debt wise today. But we could get there

quickly. Bill Gross the bond guru at Pimco Total Return, the world's largest bond mutual fund, predicts the Federal debt as a share of gross domestic product (which is less than 100% today) will balloon to 300% over the next ten years.

Rising debt is not necessarily a big problem if bond buyers are confident in your economy and your growth and are willing to hold your debt. So far, domestic and foreign investors especially Japan and China have been willing to do so. But at some point, "the Emperor has no clothes" and investors might beat a hasty retreat. In the extreme, our debt will become toxic, our currency will sink and our interest rates rise. Did someone say Argentina?

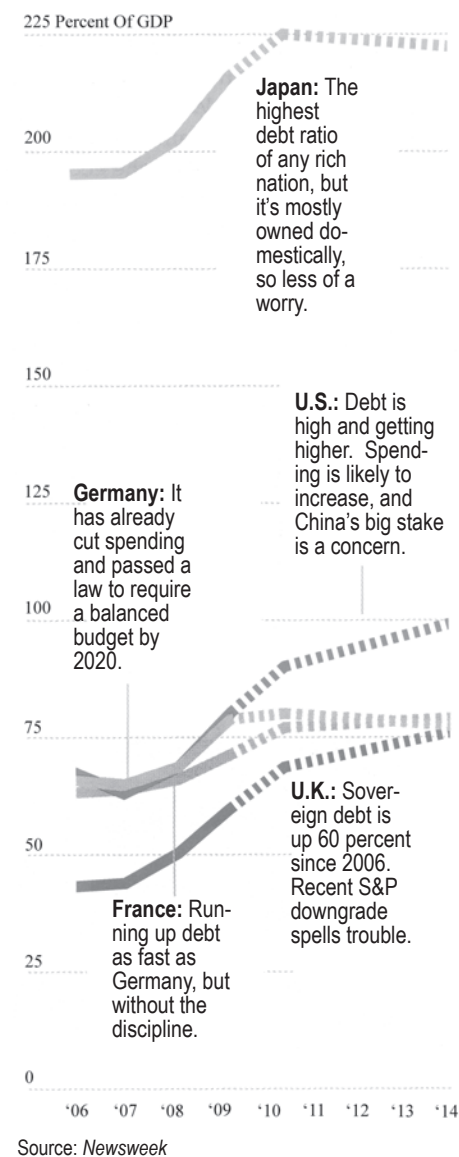
What should be done about all this? One thing would be to come up with brand new revenue sources to plug the gap like the cap-and-trade system for carbon emissions that is being discussed. Or President Obama is talking about a PAYGO plan that requires Congress to pay for new spending either by raising taxes or cutting outlays. But as they say, never ask to see how legislation or sausages are made. Politics is pretty messy and also pretty ineffective when it comes to the biggest issues.

The Democrats say we just have to raise taxes. Republicans counter that it is out-of-control spending that is the problem. Just like the old beer ad, 'less filling... tastes great'. *The Economist* newspaper comes down on the side of the Republicans arguing we need to cut spending first before raising taxes. One way would be to raise the retirement age for Social Security and another would be to cut healthcare costs rather than focus as

we now are on the expansion of coverage. Again it's all politics. Our history is that we let things reach crisis proportions before we take action. But the numbers today are really big and if we wait too long we will have a really big mess on our hands before we even get started on the solution. Sorry for the cold shower here. Even eternal optimists like us have to be realistic.

## A World Of Debt

As countries try to shock their economies back to life with big stimulus programs, public debt is skyrocketing. Servicing it will be an issue for some nations, while foreign ownership could limit economic autonomy.



Source: *Newsweek*

# Where Do We Go From Here?..

Investors are questioning a number of well accepted investment tenets today. You have heard them before; diversification limits risk, buy stocks for the long term and, oh yes, stocks provide superior long term returns. This last principle has been hotly debated in the financial press recently. By the end of 2008, the S&P 500 had lost an average of 1.4% over each of the previous 10 years.

Not surprisingly, many investors are now questioning the benefits of owning stocks. Historically, the argument for buying stocks rested on their ability to produce inflation beating returns. This benefit, not offered by bonds or cash, was no small advantage to long-term investors exposed to the risk of rising prices. *And as the chart to the right shows*, stocks have indeed outperformed bonds over the long term.

What can we expect from stocks going forward? Future stock returns will be primarily driven by three factors; the rate of corporate earnings growth, the multiple or P/E ratio that investors are willing to pay for those earnings and the level of interest rates. Historically, the best time to buy stocks has been when corporate earnings are rising and P/E ratios and interest rates are low.

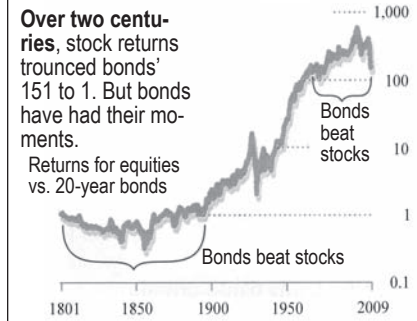
For much of this decade, corporate profit growth was on a roll, increasing at a 15% average annual rate from 2001-2006. But the unraveling of the financial and housing sectors put an end to the easy gains. While the

exact timing of a recovery remains unclear, current estimates suggest that we will not see a sustainable rebound until 2010. Longer term, I suspect several factors will restrain corporate profitability. Much of our recent economic growth was fueled by high levels of consumer spending. Falling house prices and constrained credit put a damper on the consumer sector and likely will for some time. Longer term, rising federal indebtedness and mounting liabilities from social programs will likely direct resources away from more productive ends. The U.S. economy has historically proven quite resilient so I would not count it out yet. But a return to above-average growth will require a lengthy deleveraging process throughout the economy.

On the valuation front, P/E ratios today are at a more reasonable level than they were a year ago. On a cyclically adjusted basis, which attempts to smooth out year-to-year earnings, stocks are now trading at a P/E of around 16. Since 1881, this average has stood at about 18. Stock prices today, on average, do not appear terribly over-valued nor are they at bargain levels.

With little room for P/E expansion and expectations of a muted recovery in corporate profits, the outlook for future stock price gains is below the long-term average. The good news is the return investors are now receiving from dividends, around 3.2%, is better than it has been in years. If

## Stocks vs. Bonds



corporations can grow profits at a relatively modest 3% rate, which we think is possible, and you add that to the return from dividends, equity returns in the 6%-8% level seems reasonable. While below historic levels, these returns could look appealing when compared to bonds which will struggle if interest rates pick up steam.

In the final analysis, predicting future rates of return for any asset class is an inexact science. Fortunately, investment success is less about hitting the jackpot in the market than getting your fundamentals right. This means taking care of what is difficult while it is still easy. Saving more and getting started as early as possible is the real secret (*see below*). Retirement also probably needs to be rethought. Many of us will be working longer although not necessarily at the same clip that we did when we were young. This is not such a bad thing given that we are now living longer and with better health.

## Early-Bird Economics

Here is a model that Vanguard Group, the mutual fund company, has developed to show how to put away less money and still end up with more at retirement. The secret: Start saving early.

Pat starts contributing at age 25, invests \$1,000 a year, and earns 8 percent annual rate of return. He continues this program for 10 years and then stops making contributions. But the savings continue to compound at 8 percent a year until Pat retires at age 60.

Chris also invests \$1,000 a year at 8 percent and he does so for 25 years. But he does not begin his contributions until age 35 - and that delay leaves him with much less money than Pat has at age 60.

■ Year in which \$1,000 is contributed to a savings plan.

□ Year in which no contribution is made to a savings plan.



Source: The Vanguard Group