Thoughts from
Hanson Investment Management Inc.

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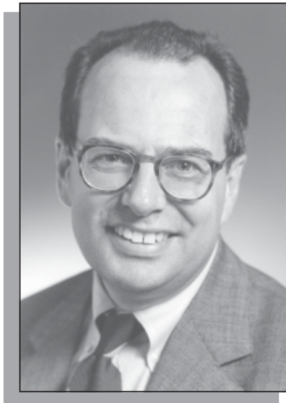

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Hanson Investment Management is an investment counsel firm managing portfolios for individuals and institutional clients. The firm also consults with individuals on financial planning and works with self-directed retirement plans on investment options.

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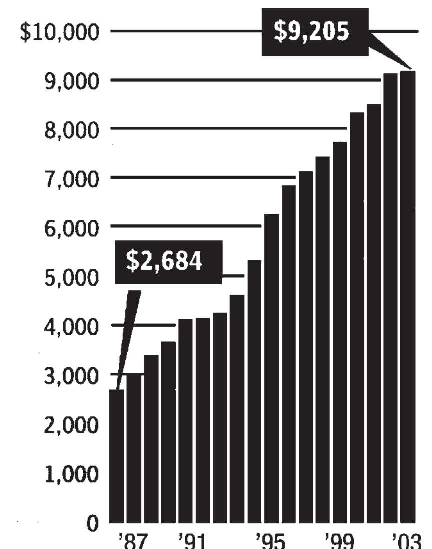
This Is the Wild Card . . .

INFLATION IS STARTING TO heat up today. Energy prices and commodities have already taken off and interest rates will follow shortly. The Fed has indicated as much. The question now is, how will the economy handle higher prices and higher rates?

If you want to know, ask the consumer. Two-thirds of the nation's economic activity consists of consumer spending, so how the consumer goes will probably determine how the economy goes. A number of economists are not optimistic here. One of the most articulate is Stephen Roach at Morgan Stanley. He is amazed at the staying power of the American consumer since 2000. Even in the face of falling stock prices, record indebtedness (*see chart here*), a reduction in saving and a lackluster job market, the consumer has kept spending. But the public may lose steam if we get a significant increase in rates.

The housing market may be the first good test. Rising rates will put some pressure on housing prices as mortgages get more expensive. How much is the question. The Federal Reserve reports that 80% of household debt (mainly mortgages) is at fixed interest rates. So a gradual increase in rates may have less of an overall effect on the consumer than the skeptics fear. Also the job market has picked up recently and this may come to the rescue of the consumer's stretched balance sheet.

The Fed is aware that how it raises rates may be as important as how much it raises them. The more gradual the increase and the more the increases are communicated upfront, the better they will be handled. In August of last year the Fed signaled that interest rates would remain on hold for "a considerable period." Then in early 2004 it said it would be "patient" in raising rates. More recently the Fed stepped up the drumbeat for tighter monetary policy saying rate increases would be at a pace that is "measured." Markets and consumers don't mind bad news. They mind uncertainty. The Fed is working hard to take uncertainty off the table. Our take: rising interest rates will slow things but will be no body blow to consumer spending.



The U.S. Market . . .
Crystal Ball Gazing Time . . .

SO WHAT DO YOU THINK OF the Market now? The Dow and Standard & Poor 500 have gone nowhere this year. The problem seems to be two things. First, the market did well last year and has discounted some of the better economic numbers we are seeing. Second, the market is completely befuddled by what higher inflation and higher interest rates are going to do.

The conventional wisdom is, inflation and higher interest rates are bad for stock prices. Higher inflation means increased corporate costs. Increased costs mean smaller earnings increases and sluggish stock prices. Higher interest rates also deflate the dividend discount models of Wall Street prognosticators. Stock prices reflect the discounted value of the future flow of earnings and dividends. When you discount future earnings by a higher rate you get a lower present value. Ergo lower stock prices.

But conventional wisdom can sometimes be an old wives' tale. History does not necessarily show that higher interest rates or higher inflation are bad for stock prices. Start with inflation. *Take a look at the chart in the upper right.* Real (adjusted for inflation) stock returns have not been that much different whether the inflation rate is +5.4% or +1.3 or even -1.4%.

Mark Hulbert, editor of the *Hulbert Financial Digest*, writing in the *New York Times*, says that investors instinctively believe that companies cannot earn more (in real terms) when inflation is rising. This is just not the case.

The fear today is that as soon as rates go up, stocks will go down. Again history does not support this. *The chart at the bottom* shows that since 1928 there have been eighteen initial Federal Reserve rate increases after at least one rate cut. Stocks have performed well six and twelve months after the first rate increase and in fact have done better than if there had been no rate increase at all. Go figure. One reason may be that rising rates often mean the economy is improving and this leads to higher corporate profits and higher stock prices.

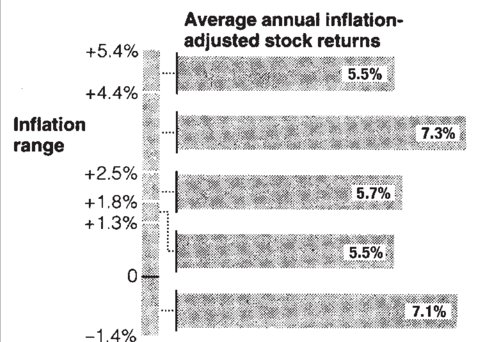
This looks like the case now. Corporate profits increased 15% last year and should be up another 15-20% this year and possibly 10% next year. This is strong stuff. According to Barron's, the S&P 500's price-to-earnings multiple based on operating earnings is now 17, pretty close to the long term average of 15 and far below the late 1990's average of close to 25. I realize we should not compare the late 1990's to anything since we were in an unsustainable bubble then. But still stock valuations have come down and look much more reasonable today.

We are comfortable with the market here and optimistic about stock prices. The US has been "the little engine that could" the last five years. Stephen Roach of Morgan Stanley notes that between 1995 and 2002 the US accounted for an astonishing 98% percent of the cumulative increase in world GDP. This is obviously not sustainable. The rest of the world has to pick up and fortunately many countries are. Japan is coming out of its fifteen-year funk now and China and India are continuing to boom. Europe is weak to be sure but there are pockets of strength. Germany has regained the title of #1 exporter in the world and the expansion of the EU should bring gains to the newly joining countries and lower costs and increased competitiveness to old-line countries.

The Fed will probably start raising interest rates by the end of June. We wouldn't be surprised if the 1% Fed funds rate gets boosted to 2% by yearend and possibly 3% by this time next year. These are big percentage moves but they do not scare us. Remember, 3% was considered quite a low rate just 5 years ago and we think the economy and the stock market will take the increases in stride.

Long-Term Hedge

Stocks performed well during periods of both high and low inflation from 1871 to 2003. Following are the average annual stock market returns during all 30-year periods in that span (1871-1900, 1872-1901, etc.). Those periods were separated into five equal groups, based on the average annual inflation rate of each.

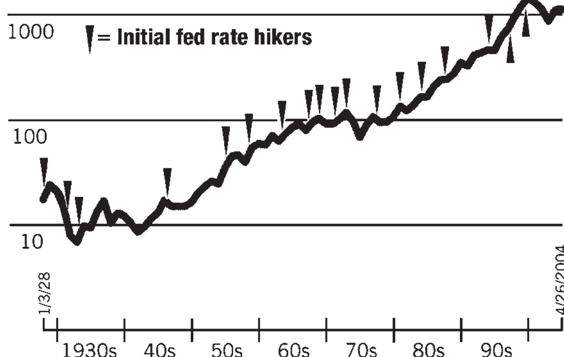


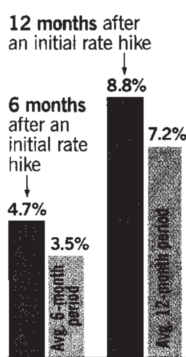
Source: Jeremy J. Siegel, Wharton School of the University of Pennsylvania

The New York Times

The hidden truth about rate hikes

Since 1928 there have been 18 initial Fed rate increases after at least one rate cut. Ned Davis Research found that over time the market has, on average, outperformed afterwards.





Source: Fortune

The Long Term Investor . . .
Get Rich Slowly . . .

FORTUNE MAGAZINE HAS been running a series of articles commemorating fifty years of the Fortune 500. *The chart to the right* got me thinking about long-term investing. I bet most investors have not earned what the S&P has the past 49 years –11.7% a year. Why? Because it is incredibly difficult to stay fully invested and learn to go sit quietly in your room while the world around you boils over. The temptation is to do something, make a trade, time the market, anticipate events. We are hard wired to do this. But resisting this temptation and letting long-term trends play out is the road to stellar investment results.

Five Decades of Astonishing Growth

The recent history of the market may be filled with ups and downs, but over the 50 years since the FORTUNE 500 first appeared the long-term trajectory has been up. The S&P 500 produced a compound annual return of 11.7% during that time. That growth has gone hand in hand with the expansion of the mutual fund industry, which helped bring stock investing to the masses.

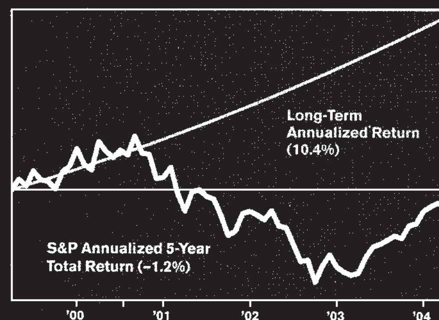
	1955		NOW
S&P 500	45.48		1126.21[1]
Market cap of the NYSE	$207.7 billion		$17.8[1] trillion
Mutual fund industry	1 million	accounts	250 million[2]
	100	funds	8,000
	$2.5 billion	assets	$7 trillion

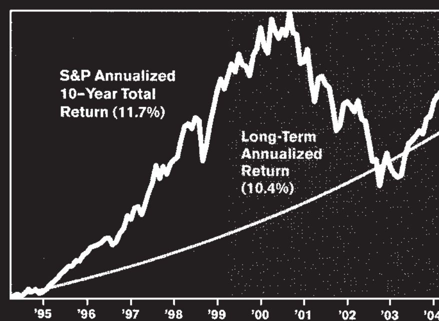
[1]3/31/04. [2]Mutual fund figures are for 2003.

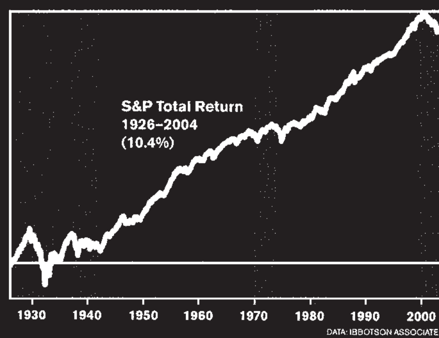
FORTUNE TABLE/SOURCES: BLOOMBERG, NYSE, PROFESSOR JEREMY SIEGEL

Back on Track

The past five years look pretty disheartening (top). But over 10 years, the market is right on trend (middle). And long periods when stocks go nowhere, like the one we've just seen, are few and far between (bottom).







Source: Smart Money

The past ten years is a good example of why investors have such a hard time. The markets soared in the late 1990's only to fall sharply between 2000-2002. *But take a look at the ten-year picture in the middle of the chart to the left.* When you smooth things out over a full decade you find your annual return is right where the long-term averages predict, 10% plus a year. But how many investors bought during the hysteria of rising prices only to sell at the 2002 bottom? A lot I think.

How can investors do a better job managing their money? Focus on three important things. **The first is Discipline.** Know what kind of investor you are and then practice it. We are value investors here. We buy securities that are selling cheap relative to earnings and assets. Why low PE? Because the market is all about expectations. A high PE stock has lots of expectations built in. When things go wrong prices can fall sharply. And when things go right well, the price has already been bid up. Low PE stocks on the other hand have few expectations built in. If things continue to go wrong there are not many disappointed investors left to sell. And when a positive surprise comes along, the price can move up rapidly.

Second, stick to your guns. Don't deviate from your strategy. Low PE stocks did not do as well as technology in the late 1990's. The temptation was to jump ship and invest in those 'New Economy' ideas that earned quick money. Bad idea. You have to have the courage of your convictions to stick with a sound strategy during the inevitable periods of underperformance.

The third secret is patience, gobs and gobs of patience. You don't earn a 49-year record overnight. It happens slowly. When I started in the investment business in 1971, the average professionally managed portfolio had a turnover rate of 20% a year. Today the average equity mutual fund turns over 100% a year. That's right, 100% a year – and that's just the average! How can you be a long-term investor and sell on average nearly every stock in your portfolio every year? It doesn't make sense. Well actually it does. Humans need to "do something" when times get tough. Psychologists call this the "illusion of control." Patient investors, however, recognize this for what it really is, an illusion.

Discipline, consistency, and patience are easy to talk about but very difficult to put into practice. That's why a 49-year record like the S&P is such a monumental achievement.

The Global Economy . . .

The Impact of Higher Oil Prices . . .

LAST WEEK I STOPPED driving my kids to school. While they consider me hard-hearted, the real reason they now take the bus has to do with my pocketbook. A year ago, filling up my tank cost about $28. Today, a trip to the gas station costs me almost $40. This rather staggering increase got me thinking. Will the rapid run-up in oil prices derail the nascent global recovery?

Oil prices, which recently hit a peak of $42 per barrel, have doubled since December 2001. The rebounding global economy is principally behind the price advance. China, with its projected 9% growth in GDP, has become a driving force in oil markets and represents fully half of the expected increase in demand. In this year alone, China plans to install 42 gigawatts of generating plants or about the same as the UK's entire installed capacity. US and Chinese efforts to build up their strategic petroleum reserves are also contributing to the recent price gains.

Meanwhile, supply has failed to keep pace with the growing demand for oil. To date, poor returns and a reluctance to allow foreign development have prevented many producing nations from making necessary oil infrastructure investments. In addition, new reserves are simply becoming harder (and more expensive) to find. Today, the world consumes about 80 million barrels of oil per day (bpd). OPEC supplies about 26 million bpd of this total. Only 2 of the 11 OPEC members, Saudi Arabia and the United Arab Emirates, claim excess capacity and this is estimated at a rather modest 2 million bpd. True, new reserves in remote places like the Caspian Sea or Russia are being considered. But getting those reserves out of the ground and to market is proving expensive and difficult.

Limited refining capacity is also contributing to the current high cost of gasoline. After two decades of consolidation, the number of refineries in the US has fallen from 301 to 153. Stiff environmental regulations and poor returns have also thwarted investment in new refining capacity. Today, refiners are operating at well over 90% of capacity and the US is forced to import about 10% of its refined gasoline demand.

Finally, experts estimate that as much as 20% of oil prices today are unrelated to the supply and demand factors discussed above. Fears of further terror attacks on oil producing countries and political instability in Saudi Arabia are fueling higher prices. Analysts estimate that a $8-$10 risk premium is built into the current $40 per barrel price.

History tells us that oil price "shocks" should not be taken lightly. A rapid run up in prices has preceded each of the 5 recessions since 1970. Oil price increases impact economies in two ways. Inflation can ignite as producers raise prices to cover increased costs. This is what the Fed is keeping a close eye on today. Second, higher costs dampen economic growth. *Take a look at the chart above.* A recent survey by BIGresearch showed that at least 56% of consumers polled would reduce their spending when gas prices exceeded $1.75 per gallon.

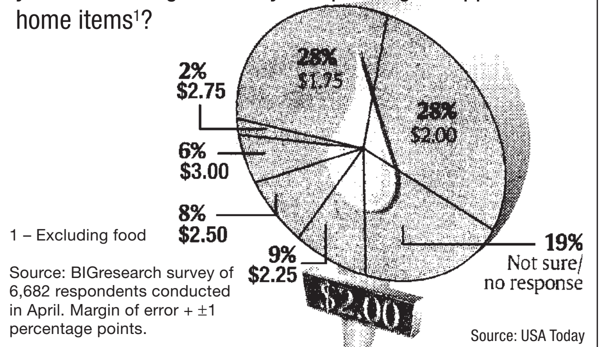
Experts are mixed on whether current prices are high enough to do significant economic damage. *As the chart below shows,* oil prices on an inflation-adjusted (real) basis are not that high. Further, while oil prices are up dramatically over the last twelve months, they are up a more modest 38% from the average level that has prevailed since 2000. Finally, oil today has a smaller impact on the US economy than it did in the 1970s and, thanks to petroleum reserves, we are better able to manage supply disruptions.

Oil prices are just one piece of the economic puzzle. The recent rise in oil prices will undoubtedly temper economic growth. But my guess is that it will take a more significant and prolonged price hike to derail the current economic rebound.

— **Anne Williams Doremus, CFA**

Higher gas prices curtail consumer spending

What price per gallon does gasoline have to reach before you start cutting back on your spending for apparel and home items[1]?

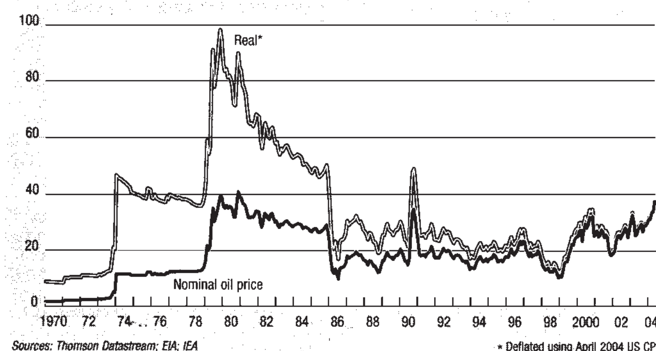


1 – Excluding food

Source: BIGresearch survey of 6,682 respondents conducted in April. Margin of error + ±1 percentage points.

Source: USA Today

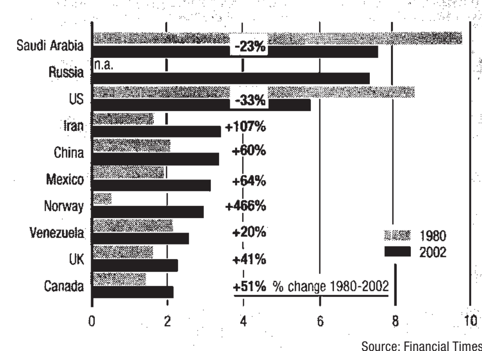
Oil price ($ per barrel)



Sources: Thomson Datastream; EIA; IEA

* Deflated using April 2004 US CPI

Top oil producers (barrels per day)



Source: Financial Times