Thoughts from

Hanson Investment Management Inc.

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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.

Time for Some Heavy Lifting . . .

THOMAS FRIEDMAN, the Foreign Affairs columnist for *The New York Times*, says that America's greatest competitive advantage is the flexibility of its economy and the quality of its infrastructure, rule of law and regulatory institutions. Friedman was recently in India and noted that on the one hand the big new high tech firms have glistening office buildings and twenty something workers with solid Engineering Degrees. But the Indian infrastructure is often in shambles. There are no sidewalks, there are electricity blackouts, the rivers are choked with pollution and the public school system is dysfunctional.

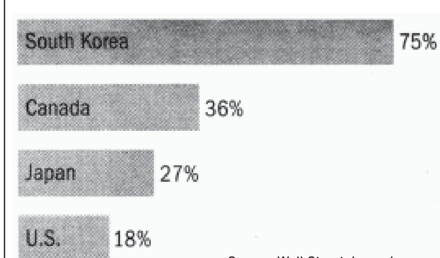
We take our infrastructure backbone here for granted. But it is our jewel and if we let it go it becomes our Achilles heel. We have a state of the art phone system for instance, but have not led the way in the newest marvel, the Information Superhighway. *Take a look at the chart to the right.* Seventy-five percent of South Koreans have broadband Internet connection. 36% of Canadians do also. We are at only 18%. Part of the problem is Korea and Japan are compact, densely populated countries that are easily wired. We are bigger and more dispersed. But so is Canada. When you look at wireless Internet connection we are even further behind the Asians and Europeans. If we don't have the fastest Internet access we will lose out on the latest business applications.

Maybe we need a Manhattan Project for broadband now, similar to what we accomplished with the atomic bomb in WWII. Spend the money to make us competitive.

So far the private sector has done all the heavy lifting. Phone companies and cable companies have battled for leadership here, but their resources are limited. A government push needs to be made. I realize this is a dangerous suggestion. Japanese bureaucrats proved in the 1980's that government is a poor predictor of future technology winners. American bureaucrats would do no better. Should we favor wireless internet connection (Wi-Fi) or the newer wide area wireless connection (WiMax) or

RUNNING BEHIND

Americans are signing up for high-speed Internet access in droves, but the percentage of households with broadband in the U.S. still lags far behind the rates in other countries.



Source: Wall Street Journal

DSL or something we haven't even heard of yet? Who knows. But government needs to get in front here and either spend money or ease regulations or both.

The Economist Intelligence Unit recently a published an "E-Readiness" ranking for the world's sixty largest economies. They assessed the e-business environment including the availability of broadband connection as well as regulation and other features. Denmark came out number one, followed by Britain and Sweden. The U.S. ranked a respectable but lagging 6th. In this hyper competitive World economy we need to do better. High speed Internet connection has to be everywhere – and we need it quickly.

Globalization (Take 1) . . .
Some Wheat and Some Chaff Here . . .

THIS WHOLE OUTSOURCING thing is fostering a lot of hysteria today. I am sorry to be carping on this subject every issue but wherever you turn these days there are stories about jobs lost to low cost countries or jobs just about to be lost.

Twenty years ago the world was a simpler place. (But everything always looks a lot simpler in hindsight!) There were manufactured goods, which are "tradable", and there were services, which are "nontradable". We got used to manufacturing or tradables moving offshore to low cost areas. But nontradables were sacred or so we thought. *But take a look at the chart above.* With the Internet and instant global communications many things we thought would always be done here are now being done offshore. This is scary. When things change rapidly it takes time to adjust. This is where we are now.

JOB EXODUS

Heavily outsourced sectors	Decrease in jobs since 2001
Software publishers (except Internet)	–10.2%
Accounting, bookkeeping, payroll	–10.3%
Telephone call centers	–10.6%
Computer systems design	–14.0%
Computer and electronic products	–24.0%

Source: Fortune

But another problem is the initial figures about outsourcing are somewhat questionable. One of the most widely quoted studies on outsoucing was done by Forrester Research in Cambridge, Massachusetts in 2002. The author traveled to India and also studied the U.S. Labor Department's statistics on 505 white-collar occupations. The report claims that 3.3 million white-collar jobs would be shipped offshore by 2015. The author now says his estimates were just an "educated guess" and that his report has been "hyped". Hyped or not it certainly is all over the place. *Business Week, The Wall Street Journal*, Lou Dobbs and John Kerry have all jumped on these outsourcing numbers with a vengeance.

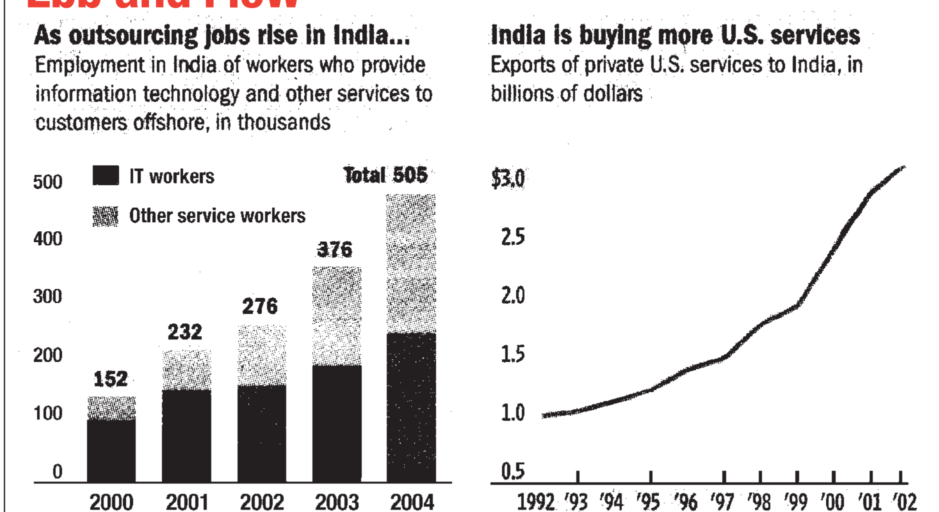
Another widely quoted report was done by International Data Corp in Massachusetts. IDC surveyed <u>eight</u> executives at technology service companies and then estimated that 23% of all white-collar tech jobs would be filled offshore by 2007. IDC now admits its methodology was "a little wobbly".

This is not to say that jobs are not going to go offshore. Many are. But the hysteria around this issue is overdone as is the belief in any wild number out there. Robert Samuelson writing in *Newsweek* notes that American multinationals today look very similar to the way they did twenty-five years ago. Back then 78% of global employment of American multinationals was in the United States. Today it is 73%, not that different. Capital spending by U.S. multinationals also remains very concentrated here and when you look at global production, 77% of U.S. multinational output is in the U.S. compared to 75% twenty-five years ago. So let's be real here. Some jobs will always be moving offshore in this global economy. But jobs will be coming here too. Infosys, the Indian software company and a big beneficiary of outsourcing, has just hired 4,000 employees in North America to service clients. Outsourcing does not spell doom for the U.S. economy or for the service sector. Some jobs will shift but historically we have ended up with more high value added jobs than we started with.

Outsourcing is also leading to a big increase in foreign purchases of U.S. services *(see chart below)*. When the Indian government recently let the contract for computerizing the national tax department (the single biggest IT contract in the country's history), a U.S. company won.

Daniel Drezner writing on outsourcing in the May/June issue of *Foreign Affairs* notes that the benefits of outsourcing are diffused while the costs are very concentrated. It is easy to see and feel the pain of lost jobs. It is not so easy to see the long-term effects of stronger companies, higher value added jobs and lower prices. Right now all we see, or more accurately all we fear, is the loss of jobs. Eventually we will see the other side.

Ebb and Flow



Sources: National Association of Software and Service Companies of India; Commerce Department

Source: Wall Street Journal

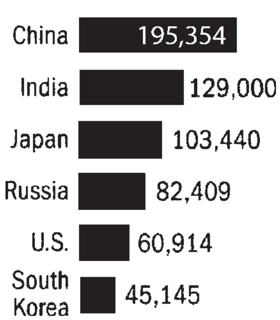
Globalization (Take 2) . . .
This Is What Really Worries Me . . .

THE U.S. CAN EXPORT high tech and white-collar jobs without fear, as long as it maintains leadership in its core strengths. But there are some disturbing cracks in the armor today. *The New York Times* recently reported that America's dominance in science is ebbing. For instance the share of industrial patents issued to Americans now stands at just 52%. Almost half of all U.S. industrial patents are now issued to foreigners.

The Physical Review, the top physics journal reported that America's share of total physics papers has slipped from over half to just 29% last year. Nobel Prize trends are the same. America's dominance is slipping.

Talent Pool

Undergraduate degrees in engineering granted annually:



Sources: U.S. Census Bureau; NASSCOM

Source: Wall Street Journal

Part of this may be we had such a global lead that some loss was to be expected. But still the trend is not encouraging. Today China is taking more and more of the global output of semiconductor chips *(see chart in the upper right)*. Eventually more semiconductor factories will migrate to China to service the demand and more semiconductor plants mean more chip designers moving to Asia. You get the picture. Once you slip in the basic building blocks of science and once you stop producing the scientific leaders of tomorrow *(see chart above)* then power starts to migrate elsewhere.

There is already anecdotal evidence that a reverse brain drain is going on. Graduate students from China, India and Taiwan who studied here and stayed on are now moving back home as growth opportunities develop.

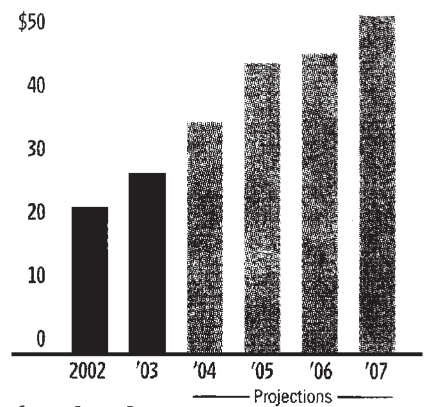
The U.S. is far from lost here however. *Take a look at the chart at the bottom.* China is trying to break into the regional jet aircraft business. These are planes that seat between 50-100 passengers. The problem is they don't have the technology yet. They have to partner with foreigners and in most cases this means U.S. firms. This trend will not change anytime soon.

But China and others are getting smart about closing the tech gap. GE for instance is selling thirteen of its most advanced 9F natural gas turbines to China. Each turbine can produce enough power to serve 300,000 homes. The Chinese have insisted as one condition of sale that GE share some of its most sensitive technology. The company has reluctantly agreed to this even though it means giving up some of the corporate jewels. Fortunately U.S. government rules forbid the sharing of the most sensitive technology here so GE has a way out. But foreigners and especially emerging market countries have figured out how the game is played. They are where the big demand is today and they will continue to press for the latest secrets.

What can America do to preserve its scientific lead? Craig Barrett the head of Intel says there are four things. First, refine K-12 education to ensure that our students compare favorably to international ones. Second, focus on research and development. R&D as a percent of total U.S. production has been in decline for two decades now. We need to reverse this. Third, we need to make sure we have a world class communications backbone *(see page 1 on this)* and fourth, government policy must "do no harm" when scientific and industrial innovation is involved. Good advise on a very scary subject.

Piling up

Sales of semiconductors in China, in billions



Source: Gartner Dataquest

Source: Wall Street Journal

Getting China Off the Ground

International companies providing technology to China's first passenger jet:

Company	*Systems and services*
GE Aircraft Engines	Propulsion
Rockwell Collins	Avionics
Hamilton Sundstrand	Engineering and production support; Auxiliary-power units; High-lift systems
Parker Hannifin	Fuel; Hydraulics
Liebherr Aerospace Toulouse	Environment control systems
Liebherr Aerospace	Landing gear
Honeywell/Parker	Primary-flight controls
Sagem	Flight-deck controls
Kidde Aerospace	Fire protection
EVAN	Waste water disposal

Source: Far Eastern Economic Review

The U.S. Economy . . .
The Honeymoon Is Over . . .

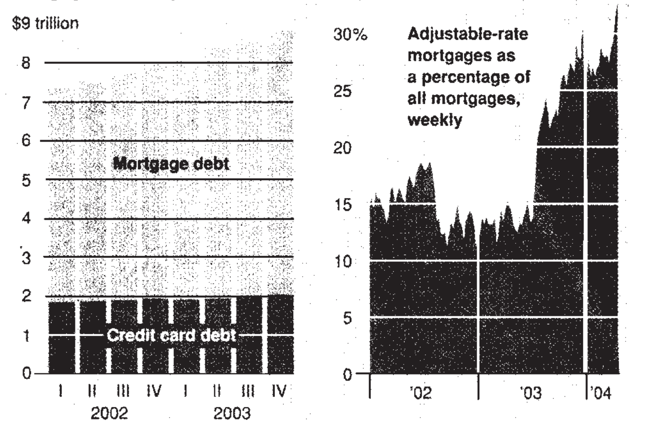
CONSUMERS AND BUSINESSES in the U.S. have had it pretty good the last three years. Over this period, the Federal Reserve reduced interest rates thirteen times in an effort to stimulate a weak U.S. economy. But now things have started to change. The 10-year Treasury bill, which bottomed out at a 48 year low of 3.68% this past March, has crept up to yield almost 4.8% and 30-year mortgage rates are up from 5.5% to 6.1% over the same period of time.

While rising interest rates are generally not good news, there are times when this policy makes sense. As economies pick up steam, rate increases temper demand and help keep inflationary pressures under control. This approach, however, is more art than science. Raise rates too much and you risk pushing the economy back into recession. Keep rates too low for too long and inflation can catch fire. This is the tight rope that Alan Greenspan is walking today.

Until now, rising rates have had little impact on consumers. But further increases could spell trouble for consumers and businesses alike. Over the last decade, the economy got used to cheap money. Consumers took advantage of low rates to purchase everything from cars and houses to stocks and bonds. From 2000-2003, household debt climbed at twice the pace of household income. *And take a look at the chart to the right.* Adjustable rate mortgages now represent over 30% of all mortgages outstanding. Interest rate increases will inflict pain on adjustable rate and home equity borrowers as payments start to rise.

Loading up on debt

Encouraged by low interest rates, Americans have borrowed a record amount of money. The growing number of people with adjustable mortgage rates may find themselves in a pinch.



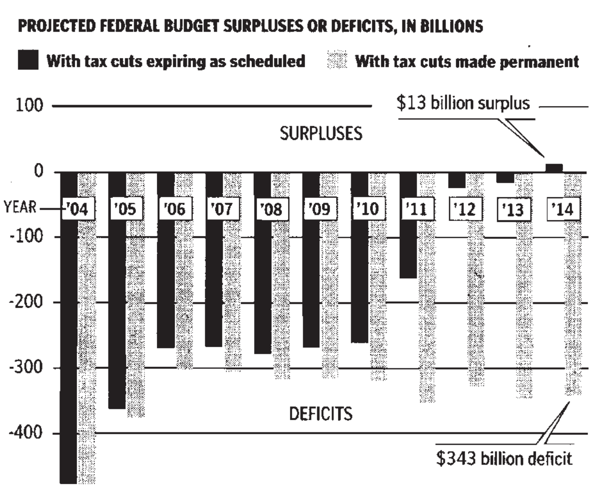
Sources: Federal Reserve, Mortgage Bankers Association

Source: New York Times

On the corporate front, two types of companies will be particularly hard hit by rising interest rates. First, businesses that rely heavily on consumer financing such as car manufacturers could see sales declines. Second, companies such as electric utilities with large amounts of debt on their balance sheets will see profits squeezed as interest costs rise. For both of these groups, the key issue will be whether or not increased demand from the improving economy can offset the increased costs associated with higher interest rates.

Budget Outlook

The federal budget would return to surpluses in 2014 if all tax cuts expired as scheduled, according to Congressional Budget Office projections. But if the tax cuts were made permanent, as President Bush proposes, deficits would continue.



Source: Washington Post National Weekly Edition

Today Alan Greenspan believes that productivity increases and excess industrial capacity will keep inflationary pressures at bay. But troubling signs are emerging. Inflation, which has averaged 3% over the last 20 years, increased at a slightly more than 5% rate in the first quarter. If the Federal Reserve has to step up the pace of rate increases to combat inflation, financial markets could take a tumble.

The course of federal budget deficits will also greatly impact future interest rates. Government statistics now predict a $477 billion deficit this year. While this spending has given the economy a much-needed boost, the consequences of sustained deficits are troubling. Rising government debt requires the country to spend an ever- increasing percent of its budget on interest costs. In addition, a rising debt burden leaves the U.S. at the mercy of foreign governments who buy our debt and increased spending means less money available to fund private sector investment.

As the chart to the left shows, current projections suggest that we may still be able to get our deficits under control. But if the recent tax cuts are made permanent, deficits are likely to remain stubbornly high for sometime. The outlook is especially disturbing considering the prospect of rising federal retirement programs. By 2014, Social Security, Medicare and Medicaid will consume fully 50% of the federal budget up from 40% this year.

The solution to the looming deficit dilemma lies in some unpopular combination of reduced spending and increased taxes. But to quote columnist Robert Samuelson, "Even when problems are widely understood, pragmatic politicians avoid unpopular measures." Let's hope we have the political will to make these choices sooner rather than later.

–Anne Williams Doremus, CFA