Thoughts from
Hanson Investment Management Inc.

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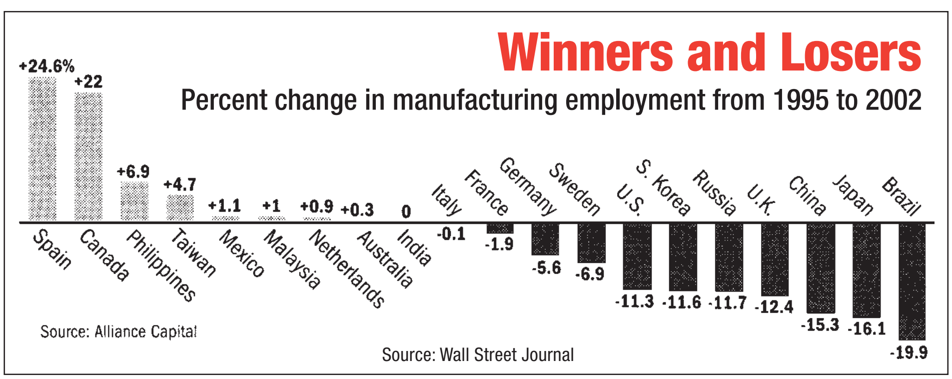
Here Is Something You Won't Believe . . .

CHINA HAS ACTUALLY LOST manufacturing jobs the past seven years. Yep you're right Eric, no one is going to believe that. But keep reading. Subsidiaries of foreign companies now employ 3.5 million workers in China up 3½ times the past decade. Everything made by Mattel, Nike, Gap, Dell and others seems to come out of China, made by newly employed workers. Another 3.25 million Chinese are employed by subsidiaries of Hong Kong and Taiwan companies. So how can the Chinese be losing manufacturing jobs?

The fact is that China has had and still has an enormous state sector that is terribly inefficient and employs millions of workers more than are actually needed. These companies have been bleeding red ink for years but the Central government has refused to allow them to fire anyone for fear of civil disorder. Finally by the mid to late 1990s the red ink got so great that the State companies were allowed to thin down and they did, laying off large numbers even more than the new foreign plants could employ. From 1995 to 2002 manufacturing employment in China fell from 98 million to 83 million a percentage decline even greater than ours. Since 2000 however China has a net gain in manufacturing as new foreign jobs have outnumbered the losses at state companies.

Also factories that are closed in developed countries are starting up in markets like China with fewer workers. It is a fact that even in low cost China companies are doing more with less and employing capital in place of labor. The developed world made the move from agriculture to manufacturing many decades ago and is now well along in moving from manufacturing to services. The Emerging world will be making the same move but in a much more compressed period of time.

Anne talks about jobs in more detail on page 4 but suffice it to say that this is not a simple story of our manufacturing losses being China's gain. The world economy is getting ever more complex and employers are demanding more value added from workers at every level. Value added is more about brains than about brawn. Education and training, not the lowest possible labor cost, will be the mantras for success in this Global economy.



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.

A Globalization Update . . .
"No one is in charge" . . .

THIS IS A FAVORITE QUOTE of Thomas Friedman in *The Lexus and The Olive Tree*, still the best single book on globalization. Friedman's point is that there is no wizard behind the global curtain pulling the ropes. Globalization is developing at its own creative, rapid and baffling pace. Here are some recent examples.

Everything gets outsourced.

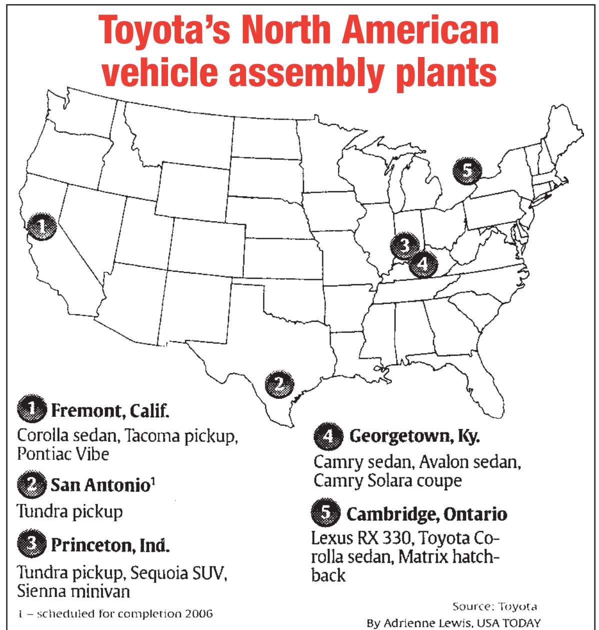
E-Bookers is an online London travel agency serving primarily European customers. The company as you might expect has set up a call center in India to reduce costs. But they quickly discovered there aren't many Indians who speak Danish, Norwegian, Portuguese, etc. So the company did the next best outsourcing thing, they exported the workers to India as well as the jobs. Fifty young Finns, Germans, etc. now work in India earning Indian wages of $6,000 dealing with customers in their home countries, and enjoying the culture of the sub continent for a year or two. This is never going to be an enormous market but it shows the novel twists that globalization takes when necessary.

***Ebookers** is pitching jobs at its call center in India as a good way for Europeans to see the world.* Source: Wall Street Journal

In the eye of the beholder.

After World War II Japan and then Taiwan were the sources for cheap goods at cheap prices. This changed however when Toyota, Nissan, Sony, etc. moved up the quality ladder. The same transition is happening now in China but at an even faster pace. The question is how high and how quickly can China go. "Made in Italy" has symbolized the highest end of the silk and leather market. If it carried an Italian label it had to be made in Italy. At least until now. The Chinese have been slowly chipping away at this market and Italy has had to face the facts. A number of manufacturers are now talking about a "Marco Polo" plan to move entire factories together to China to reproduce the industrial clusters northern Italy is famous for.

The Japanese are facing a similar quality issue but with a different outcome. The high-end Lexus today is made only in Japan. When Toyota decided to move part of its production offshore the question was where? Interestingly the decision was not to low-cost China but instead to high-cost North America with its threat of unions and quality issues. Toyota is convinced that quality is a state of mind, not physical location. U.S. made Toyotas today are equal to those coming out of Japan and Toyota is betting the Lexus will not slip. Globalization pushes us all.



Source: Wall Street Journal

We bring good things...

General Electric is the benchmark for corporate management and planning. So when they talk globalization people listen. According to Morgan Stanley, GE has announced a "70-70-70" credo whereby it expects in the future to outsource 70% of its head count, and 70% of this will be sent offshore and 70% of this final number will move to India. This would be an amazing re-work of the company. If, say 200,000 of their 300,000 employees are outsourced and 150,000 of these move off shore, then GE might possibly have 100,000 employees in India in the future. They presently have 15-20,000. Wow.

But wait just a second. India may be changing in ways GE is not altogether happy with. The Indian high tech service sector is growing rapidly and the wage bill per worker is up 20% this year because of demand and very high attrition. Wages for the most sought after English speaking Indian software talent may converge to western levels at lot faster than anyone thinks.

China Exports... Jobs?

China's objective is to eventually push fifty of its companies into the Fortune Global 500. Currently they have eleven. Haier, a maker of white goods, has set its sights on 10% of the standard US refrigerator market by 2005. A pretty aggressive target but of course they do have a big wage advantage. So what was Haier's first step when they decided to tackle the US market? Build a $40 million plant in South Carolina! It sounds completely counter-intuitive but Haier argues that the plant will save on transportation and allow them to make model changes more quickly. So go figure. Who would have thought China would be exporting jobs to us!

High Tech Investing . . .
The 2003 AeA Classic . . .

The AeA Classic

THE AMERICAN ELECTRONICS Association hosts a conference each year for smaller high tech companies (generally under $500 million in sales) and the investment community. I attend to get a sense for themes in high tech and also to interview specific companies. This year 190 companies presented over a three day period. Attendance among investors was up 20%, reflecting the better tone to the stock market.

My first observation is that high tech is not cheap today. Four of the companies I saw *(listed below)* are up an average of 65% since the beginning of the year. Granted high tech took a terrific pounding between 2000 and 2003 but still valuations are stretched.

Three common themes struck me as I spoke to companies. First, outsourcing is not just a phenomenon, it is the standard today. Production is moving overseas rapidly. Infocus for instance makes sophisticated projection systems for Power Point presentations, etc. The company specializes in first-to-market machines that are small, light and today, even wireless. Still price pressure from Taiwan and Japan is intense. Accordingly they have just moved all production from Wilsonville, Or. to contract manufacturers like Flextronics of Singapore and Funai of Japan. Infocus doesn't even handle its own logistics anymore. The finished projection units are shipped to UPS in the United States, which handles delivery to the final customer. Infocus and many AeA companies are becoming like Nike, product designers and marketers but no longer manufacturers.

A second theme is the constant search for "disruptive technology". Today's hot product is tomorrow's me-too knock off. The goal of everyone is technology so disruptive and so unique it can maintain leadership for years, not just months. UT Starcom is a U.S. company with significant business in China. Their PAS phone service is similar to cellular but significantly cheaper. It is pitched to Chinese telephone operators as a way to avoid laying expensive hardwire. Instead of copper cable to the house, cheap micro cells are set up to service one town or one small region. Customers can have a PAS phone for ultra cheap local service and a cell phone with roaming capability when they travel. This may be the future for many Emerging markets.

A third theme in high tech is all about productivity. The potential leaps here are truly amazing. ScanSoft for instance is the leading provider of voice recognition systems. This is the "killer application" that is always just about ready to break out but not quite. Well this time it may be ready for prime time. The Dragon voice recognition system is reducing error rates by 10 to 20% per year. When the product finally does take off, productivity gains in transcription, text to speech, call centers with voice recognition and of course, general dictation will be enormous.

Avid is the industry leader in equipment to edit movies and CDs. The big buzz now is a system that allows TV broadcasters to convert film directly to digital format. With the new Avid system you are able to move seamlessly from filming to editing to broadcasting and also to film in one location and edit thousands of miles away almost instantly. 126 stations have acquired the new Avid systems but this is still only 5% of the market.

Productivity growth in the economy has a long way to go if this year's AeA conference is any indication. Smaller high tech companies are robust and healthy today. Balance sheets are strong (note the lack of any debt for the four companies below), and innovation is happening as rapidly as ever. Now if only the stocks were a little cheaper...

The AeA High Tech Conference – A Sampler

Stock (symbol)	Recent Price ($)	% Increase in 2003	($mm) Sales	Price/ Book Value	Debt as a % of capital	Business
Avid (AVID)	49	(113%)	470	11.8x	1%	Digital media editing
Infocus (INFS)	8½	(55%)	550	0.7x	0	Projection Systems
ScanSoft (SSFT)	6	(14%)	112	2.9x	0	Voice Recognition
UT Starcom (UTSI)	34½	(73%)	1,950	4.1x	0	Emerging Markets Telecom

Source: William O'Neil, Company Sources

Global Trends . . .
The Next Big Threat . . .

IT IS PART OF HUMAN NATURE. When things go wrong, we look for someone to blame. This phenomenon is at the heart of a heated debate among economists and politicians today. What is wrong is the weak U.S. employment picture. And who is to blame? Globalization and China in particular.

"This is our son, Eddie. He's just graduated from school and is entering a void this fall." Source: The New Yorker

Protectionist forces in the U.S. are without a doubt gaining steam. Back in March 2002, the U.S. decided to impose tariffs of as much as 30% on imported steel. Then in September, world trade talks in Cancun broke down over differences on issues ranging from agricultural subsidies to financial market reform. And most recently, legislation has been proposed, with bipartisan backing, to slap high punitive tariffs on Chinese exports to the U.S.

The current rise in protectionist sentiment stems from two converging trends. For the first time since World War II, the U.S. has experienced an economic recovery with no job growth. <u>In fact, since the economy bottomed back in late 2001, private non-farm payrolls have actually fallen by 1.2 million</u>. And perhaps more importantly, we are in an election year cycle. Historically, Americans have been first and foremost concerned about jobs and this is a fact no politician can ignore.

In many ways, it is easy to understand the concerns voiced by free-trade critics. Job losses tend to be concentrated in specific areas while the benefits of globalization in the form of lower costs and higher living standards are spread widely and often not evenly dispersed. Consider the case of U.S. steel producers. For years, American steel manufacturers faced with low cost imports, slashed jobs and closed plants. Then in 2002, relief came in the form of import tariffs. By imposing these tariffs, the U.S. hoped to preserve jobs while giving the domestic industry time to consolidate and restructure.

While the tariffs might have helped steel workers, steel consumers were not so fortunate. U.S. prices for steel products ranging from automobiles to washing machines rose steeply after the tariffs were put into effect. <u>A midpoint review of the three-year tariff scheme by the International Trade Commission concluded that the tariffs had cost the economy $980 million</u>. But the real cost of this protectionist measure may yet be felt. Last week the World Trade Organization ruled the steel tariffs illegal. As a result, the European Union has threatened to retaliate with tariffs of up to 30% on more than $2 billion of U.S. exports.

Today, protectionist measures are focusing on preserving service sector as well as manufacturing jobs. Technological innovation and capable outsourcing platforms in China and India mean that many service jobs, once thought immune from foreign competition, can be performed offshore. But a recent study by consulting firm McKinsey once again points out the risks of stemming this tide. In their work, McKinsey found that 2/3rds of the economic benefit from sending jobs offshore flows back to the U.S. economy in the form of lower prices, expanding overseas markets for U.S. products and fatter corporate profits.

History provides further evidence of the dangers of rising trade barriers. Congress, during the economic recession of 1930, passed the Smoot-Hawley Act. This legislation, designed to protect American jobs, significantly raised the level of U.S. tariffs. The retaliatory tariffs and downward spiral in world trade that followed are widely thought to have contributed to the ensuing economic depression.

So how should the U.S. respond to the current complaints of lost jobs? First, there is some evidence to suggest that the current job angst may be short lived. The oldest baby boomers will begin to retire in 2011 and there will simply not be enough workers behind them to fill their jobs. <u>Paul Kaihla, senior writer for magazine *Business 2.0*, predicts that the U.S. will experience a labor shortage of between 5 and 7 million workers by 2010</u>. Labor woes may be today's battle but not tomorrow's.

Until then, the U.S. needs to step up its investment in research and development, education and job retraining. Protectionism is always about preserving the current labor market. Our challenge is, and has always been, to create new labor markets.

– Anne Williams Doremus, CFA