Thoughts from

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VOLUME 8, NUMBER 1 **SEPTEMBER 2002**

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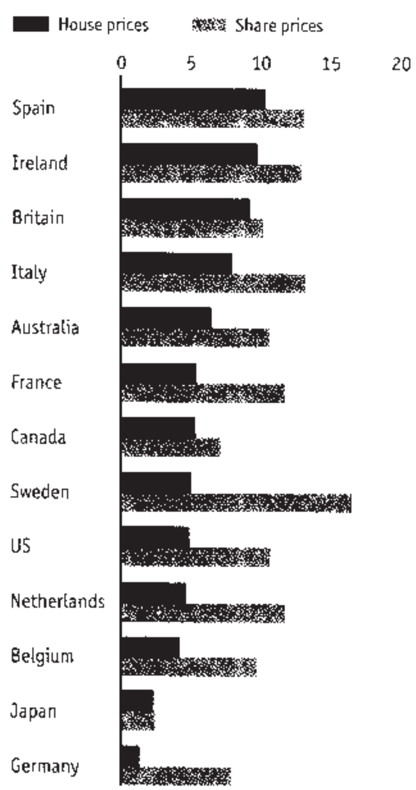
Hanson Investment Management is an investment counsel firm managing portfolios for individuals and institutional clients. The firm also consults with individuals on financial planning and works with self-directed retirement plans on investment options.

Boy When This Shoe Falls, Watch Out . . .

THIS IS WHAT THE BEARS are saying today about the housing market. Consumer spending has been the great pillar of this economy. Nothing seems to stop it. Household stock holdings declined $4.5 trillion between March 2000 and today and still consumers spend. Part of the strength must be due to housing. Housing prices have increased impressively *(see right)* and this has meant consumers feel wealthier; they have more equity in their homes to borrow against and with interest rates low they have the ability to refinance and lower overall expenses.

Equities win

% change 1980-2002 (latest), annual average



Source: The Economist

The Economist's house-price indices

House prices, % change on year ago

	2002, latest	mid-2001
Britain	20.9	9.4
Australia	17.3	8.2
Spain	15.7	15.5
Canada	9.9	4.9
Italy	9.5	8.9
France	8.0	8.1
United States	7.0	9.0
Netherlands	6.4	10.0
Belgium	5.9	5.7
Ireland	5.2	15.1
Sweden	3.6	8.4
Germany	1.6	1.6
Japan	-4.4	-4.1

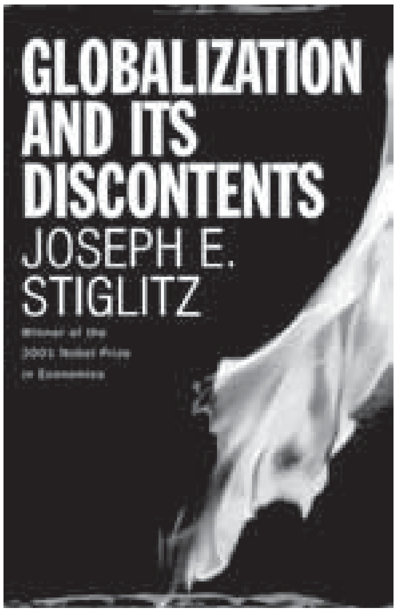
Source: The Economist

Is a crash coming soon to housing? *The Economist* notes that house prices increased 9% in the U.S. in 2001 and 7% so far this year. Have things gotten out of hand? One of the best gauges of the expensiveness of houses is the relationship of prices to average disposable income. *The Economist* notes that this ratio is close to an absolute peak in the U.S. now. But on the other hand Americans seem to be better able to handle housing costs today. Debt Service for mortgages as a percent of disposable income has crept up but only from 6% in 1992 to 7.8% now.

So what is our opinion? Housing has indeed done well recently but there is no bubble. Prices have not gotten out of hand. Consumers will continue to increase their spending albeit with caution and housing will continue to support this recovery. We are still betting against a double dip.

Globalization Update . . .

"If globalization is so good, then why are so many people unhappy?" –Joseph Stiglitz



Globalization and its Discontents
Joseph E. Stiglitz

Norton, 252 pages, 2002
$24.95

IN NOVEMBER 2000 I reviewed Thomas Friedman's *The Lexus and The Olive Tree*. I said then that, "this is the book on globalization". I still think so but globalization has come under such intense criticism since, we need to take a new look at the whole subject.

Globalization is about integration of markets, nation states and technologies. As Friedman says, "it is enabling individuals and nation states to reach the world farther, faster, deeper and cheaper than ever before". The implication here is that free market capitalism can lift a significant portion of the world's population out of poverty. And a second implication is that freedom in the economic arena will also lead to greater freedom in the political arena. Friedman was in Burlington recently and expanded on his thoughts.

The success of globalization is vitally important to us for two reasons. The first is that globalization is the only viable economic model today and we have to make sure it works. With the fall of the Berlin Wall in 1989 socialism/planned economies crumbled as a legitimate alternative. A second reason globalization needs to succeed is it is so much a part of future U.S. growth. Take a look at the chart in the bottom corner. World trade is increasing at a rate 50% to 100% faster than overall world output. Even after September 11 world trade continues to grow. It is expected to be up 8% to 10% over the next twelve months. As domestic economic growth eventually slows in the developed world due to ageing populations, world trade and the ability to reach new markets becomes ever more important.

Global Economic Progress

	Growth in World Output	Growth in World Trade
1966	+4.1%	+6.7%
1977	+4.1%	+9.8%
1998	+2.6%	+4.3%
1999	+3.4%	+5.1%
2000	+4.7%	+10.0%
est. 2001 (Feb.)	+4.2%	+7.8%

Source: IMF, World in 2001 The Economist

The chart in the upper right shows U.S. imports and exports relative to the whole economy. At the end of World War II foreign trade was only 5% to 7% of our economy. Today it is 20%. And this number does not include the output of U.S. companies offshore that is shipped to third countries. What IBM produces in Japan and ships to Taiwan or Europe is not considered an export from the U.S. and is not included in our GDP. But this production is significant for corporate America and is a direct result of the growth of globalization.

Soaring Imports

►Merchandise exports as a share of gross domestic product spiked to a record high during World War I, and are now running at 7-8%, slightly lower than in 1900. But merchandise imports as a share of GDP peaked at 12.5% in 2000, far above the WWI peak.

Source: Douglas Irwin, *Free Trade Under Fire*
Source: Barrons

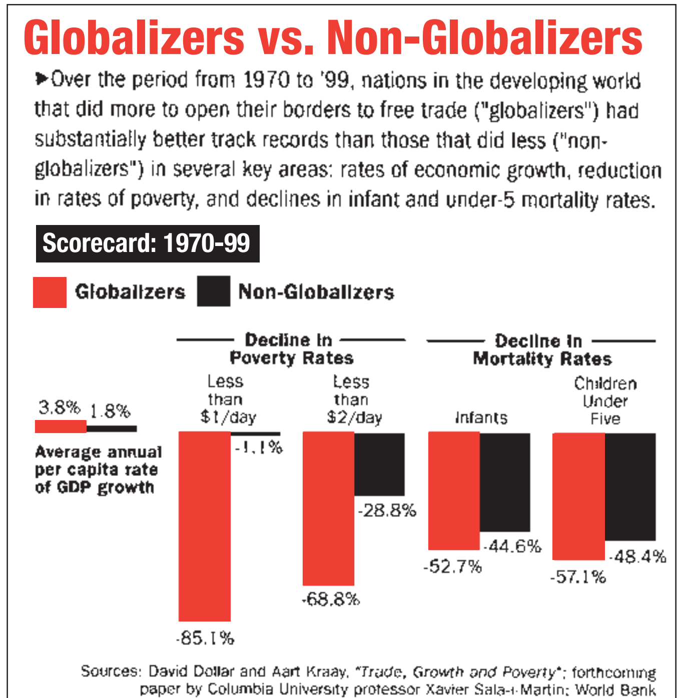
The scary and wonderful thing about globalization, Friedman contends, is that no one is in charge. Can China really control the flow of information within its borders when the Internet is opening everything up? But the scary aspect of globalization is that when problems do spin out of control like in 1997 with the Asian financial crash, there is very little we can do. Joseph Stiglitz in his recent book *Globalization and Its Discontents* agrees that globalization is here to stay and that it has the potential for much good. But it has failed so far. The reason is that those in control, principally the developed countries, have botched it. Technically Stiglitz agrees that there is no global government and no one is in ultimate control but there are institutions of global governance that wield tremendous power and these are the problem.

Two of the most important institutions are the World Bank and the IMF. These were created at the Bretton Woods Conference in 1944 to address the reconstruction of Europe. The World Bank was intended to deal with structural issues such as where money was to be spent for development. The IMF or the International Monetary Fund was to deal with macroeconomic issues of how to get funds or credit to countries in crisis (countries that were “solvent but not liquid”).

John Maynard Keynes, the British economist, held great sway at Bretton Woods. He argued that markets function well but not perfectly. Occasionally governments or international bodies need to step in to right the ship. For instance in recessions governments need to prime the pump and increase overall demand by increasing fiscal spending. At other times countries slide into such crises that they are not able to attract capital on their own and must get the help of organizations such as the IMF (Argentina today).

The problem is that over the years the IMF mission has morphed into a much bigger one than originally intended. New economists who came to the IMF in the 1980s were much less friendly to government intervention and more advocates of letting markets take their course. IMF lending now includes crisis funds and also demands for fundamental economic reforms. These “conditions” include fiscal restraint (balancing your budget), privatizing state owned firms and liberalizing markets including opening up banking and stock markets to outsiders.

For Stiglitz the IMF conditions have been a disaster. One size does not fit all for world economic problems and the magnitude of what the IMF is asking most countries is overwhelming. The Big Bang or opening everything up at once to market forces doesn’t work in countries without a developed rule of law or proper bankruptcy procedures or even a solid idea of how markets work. Stiglitz is much more a fan of the gradualist policies of countries like China, Poland and India.

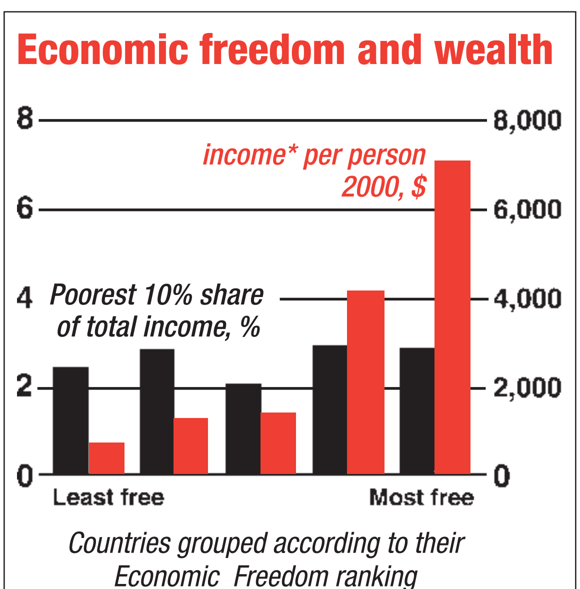


Source: Barrons

What are the solutions to the IMF/World Bank problems? First you need to let the light in. Transparency is limited or nonexistent now. The IMF has its own experts and they have their own agenda and they take very little advice from local leaders. And then there is the problem of the United States. At Bretton Woods we were given great power over the World Bank and IMF. In fact critics today talk of the Washington Consensus where decisions are made by the big three — the World Bank, the IMF and the U.S. Treasury Department. Decision-making needs to be more inclusive. The world is different today than 50 years ago and global governance needs to reflect this.

Friedman has often been characterized as a knee jerk cheerleader of globalization and Stiglitz a critic of the system. I think both are a lot closer to each other than we think. They are realists. Friedman argues that if America really wants the rest of the world’s support, it needs to become a better world citizen. Stiglitz would agree. For instance the two most important export items for the emerging world are textiles and agriculture. America has done a poor job opening its markets to these products while at the same time demanding that the world open its markets to our products. This is hypocritical. The United States also needs to be a better citizen sharing power and decision-making. It and the IMF/World Bank need to listen more closely to the rest of the world and realize that different circumstances require different solutions. Stiglitz laments, “IMF programs are typically dictated from Washington and shaped by short missions during which staff members pore over numbers in the Finance Ministries and central banks and make themselves comfortable in Five Star hotels in the capitals.” Kind of like bombing from 50,000 feet. You never see the faces of those who are affected by your decisions.

Can globalization be a success? I hope so because I am a big fan. The two charts on page 3 show that those countries that have gone furthest in globalizing and in economic freedoms have seen the biggest increase in income even among the poor. Call it trickle down, call it win-win, whatever, globalization can be a wonderful thing when done right. The Stiglitz book is an excellent one for anyone interested in how to tweak the system to get the most out of globalization.



Source: The Economist

Investment Trends . . .
When Will It End? . . .

WITHOUT A DOUBT, the stock market gave investors a wild ride this past summer. Between Memorial Day and Labor Day, the Dow Jones Industrial Average declined 1,441 points or 14.3%. And the sell-off came with a vengeance. Trading volumes during July and August set record levels for a summer period averaging 1.6 billion shares a day. Volatility was also high with the Dow swinging more than 200 points on 57% of the days last summer.

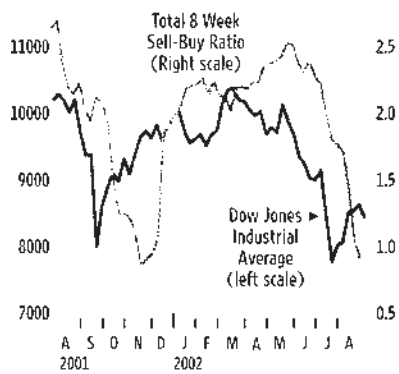
Most investors today are wondering when this roller coaster ride will end. The chart below may help us gauge the market's current condition. This "clock", developed by market strategist Rich Bernstein, illustrates the various stages of investor's earnings expectations. Because earnings growth drives stock prices, this model may also help identify where we are in the market's cycle.

The labels inside the circle indicate the general level of earnings expectations while the outside ones identify investor behavior or sentiment. When earnings expectations are high, for example, growth stocks are favored. As the economy slows, earnings estimates and stock prices decline. When earnings expectations are at their lowest point, only complete contrarians can muster up the will to buy stocks. Finally, as the economy pulls out of recession, earnings estimates are revised upward and growth stocks once again become popular.

Insider-Buying Comeback

Since there may be a small volume of insider trades on any single day, most analysts follow a moving average that tracks insider trades over the prior eight weeks.

Insiders versus the Dow



Sources: Argus; WSJ Market Data Group; Thomson Datastream

Individual stocks

MOST ACTIVELY BOUGHT

	BUYERS	SHARES BOUGHT
FleetBoston Financial	11	57,500
J.P. Morgan Chase &Co.	10	122,700
Computer Associate	9	118,000
Meritage Hospitality Grp.	8	111,188
Korn/Ferry International	7	49,791

MOST ACTIVELY SOLD

	SELLER	SHARES SOLD
Nucor	19	37,267
Vaihl	16	232,800
Material Sciences	14	151,254
HCA	13	454,420
Libbey	13	86,402

*Doesn't include private transactions or over-the counter trades

Source: Wall Street Journal

So where are we today? Bernstein believes the market is now positioned somewhere around 4:00. Earnings estimates have been steadily revised downward over the last year and many stocks are considered "Dogs". But we are not quite at the bottom of the cycle. At market troughs, earnings expectations hit bottom and investors "throw in the towel." This process of complete capitulation, when investors become excessively pessimistic, is what allows the market to finally stage a recovery.

Other tentative signs of a market bottom are also showing up. Stock trading by corporate insiders, CEOs, CFOs and the like, has long served as a leading indicator of market turning points. Take a look at the chart above. Since July corporate insiders have been aggressively buying shares. Over the last three months, 44% of insider trades were purchases up from the 15% low reached at the end of May.

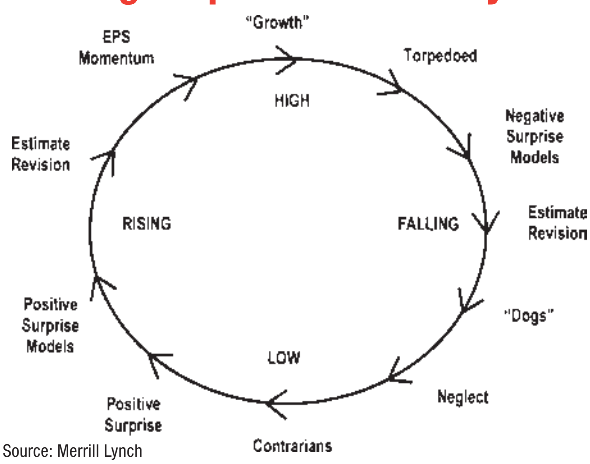
Finally, a number of recently released economic statistics also support a more positive outlook on the market. Last month, the government announced that the federal budget had swung from a surplus to deficit position. Not surprisingly, the swelling deficit is being caused almost equally by falling tax receipts and increased spending. The sagging economy and stock market are largely to blame for the depleted revenue streams while the war on terrorism has blown a hole in earlier spending targets.

OK, this doesn't sound like such great news but from an economic policy standpoint, deficits often provide just the tonic ailing economies need. Consider the recently released employment statistics. Last month, unemployment fell to a five month low of 5.7% with much of decrease resulting from growing federal payrolls. Productivity gains, while below the highs reached in the first quarter of this year, are also holding their own. Gains in productivity are critical to the market's health as they permit the economy to grow faster without triggering inflation.

Evaluating the economy and the market now is tricky business. Looking at the evidence, one could easily see a glass half empty or half full. Market action this past summer certainly suggests that investors see the glass as half, if not completely, empty. Much of this pessimism is warranted with international tensions high and consumer debt burdens growing. But during such periods of extreme pessimism, signs of an upturn are often overlooked.

— Anne Williams Doremus, CFA

Earnings Expectations Life Cycle



Source: Merrill Lynch