

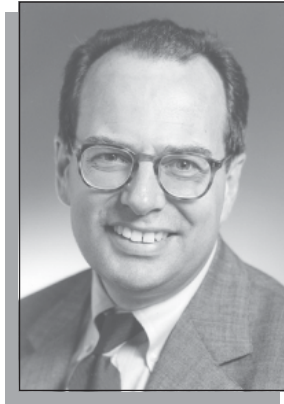
Thoughts from

Hanson Investment Management Inc.

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The Bottom Line . . . Red Ink . . .



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THE WASHINGTON POST in a recent analysis of spending and tax proposals by the two candidates, concluded that the fiscal deficit would be about the same regardless of who gets elected. President Bush would extend all his present tax cuts. Kerry would rescind those for the wealthiest Americans but expand other spending by about the same amount. The result is a deficit of about \$1.3 trillion over the next ten years.

Why should we care? Because deficits do matter. First they increase the national debt, which in turn drives further spending, by increasing interest costs. Second, deficits put the country at the mercy of foreign investors (read Japan and China today) who may or may not buy our bonds in the future. And third, deficits speak to our resolve or lack of resolve to run a sound government. If the world doesn't think we are sound, our dollar could get weak very quickly.

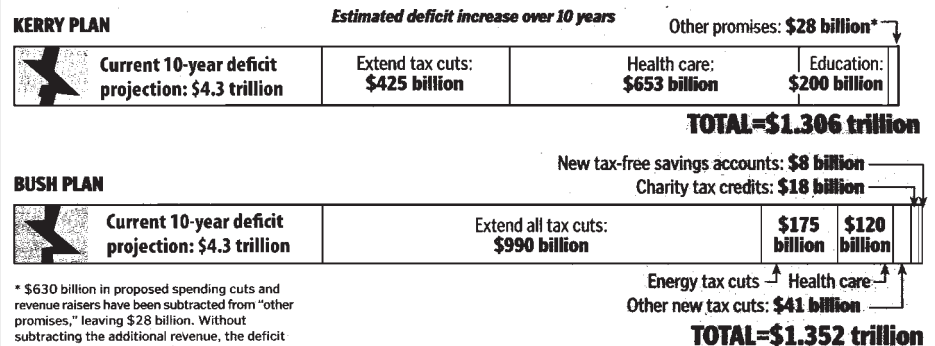
Alan Greenspan recommends bringing back the Budget Enforcement Act as a way to help here. This piece of legislation put tight caps on discretionary spending in the 1990s by requiring that taxes be raised first or funds earmarked before a spending authorization was made. Between 1995 and 1998 while the Act was in effect budget outlays for non-defense spending grew a modest 1% a year.

George Bush has not vetoed a single spending bill in four years while at the same time reducing taxes. The fiscal deficit is close to 5% of GDP now – historically Banana Republic levels. Let's hope whoever gets elected in November gets some budget deficit religion quick.

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.

THE BOTTOM LINE

A Washington Post analysis of tax cuts and spending plans proposed by Sen. John F. Kerry indicates that, over 10 years, the federal deficit would rise under a Kerry presidency by nearly the same as it would if Bush were reelected.



* \$630 billion in proposed spending cuts and revenue raisers have been subtracted from "other promises," leaving \$28 billion. Without subtracting the additional revenue, the deficit over 10 years would total \$2.362 trillion.

SOURCES: Treasury Department, American Enterprise Institute, Kerry campaign

Source: The Washington Post

Our Neighborhood . . . Death, Taxes and . . . Demographics?

THERE ARE NOT MANY things that are certain in this world today. Death and taxes are considered two and demographics may be a third. I know demographics is not an exact science (*see next paragraph*) but still we have some pretty good ideas.

In 1968 the UN Population Division predicted world population, which is now 6.3 billion would grow to at least 12 billion by 2050. Today that estimate is 9 billion. Why the big drop? The simple fact is birth rates are falling worldwide. Conventional wisdom has it that a country needs to reach a certain level of economic development before birth rates fall. This is what happened in Japan, Taiwan, Korea and Singapore. But now rates are falling around the world. Italy has one of the lowest birth rates today at only 1.2 births per woman (2.1 is considered the rate necessary for a stable population). Italy's population is expected to drop 20% by mid century. Much of Europe is in the same boat (*see chart to the right*).

But birth rates are also coming down in developing areas. China has pushed its fertility rate, encouraged to some degree by state arm-twisting, to below that of France. Most surprising is the drop in

births in the Arab/Muslim world. Iran's fertility rate is now 1.9 and Egypt has gone from 5.4 births per woman in 1970 to 3.6 today.

Nicholas Eberstadt a researcher at the American Enterprise Institute notes in a recent article four surprises across the demographic landscape today. The first is the one just mentioned that we are moving rapidly towards a "sub-replacement fertility" rate worldwide. We think of China as a mass of teeming young workers but in reality the country is one of the most quickly aging societies in the world. China is reporting some actual labor shortages in parts of the country as employment grows faster than population (*see chart*). I wouldn't worry about this problem now but the idea of an inexhaustible supply of cheap labor in China is just not accurate.

The second surprise is the unnatural gender imbalances in parts of the world. In China 120 boys are now being born for every 100 girls. This is genetically not possible. What is happening is probably an increase in abortion when girl babies are discovered through ultrasound. Family is extremely important in China and India and an interesting question is what happens in twenty-five years when

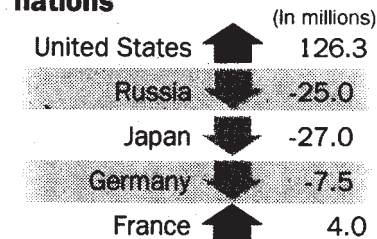
there are too few girls for the marriage market?

A third surprise is that life expectancy may not be increasing anymore but actually decreasing. AIDS is pushing up mortality in parts of the world and alcohol, childhood diarrhea and malaria are factors in other parts. Life expectancy at birth in Russia is now four years lower than it was forty years ago primarily due to alcohol abuse.

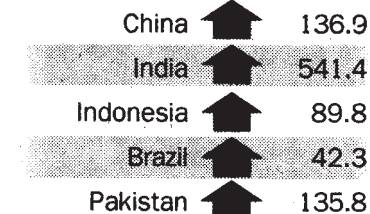
Uneven Growth

Industrialized nations are projected to increase in population at a much slower rate than developing countries as a whole.

Population change from 2004-50 for top industrial nations



Top non-industrial



Source: Population Reference Bureau

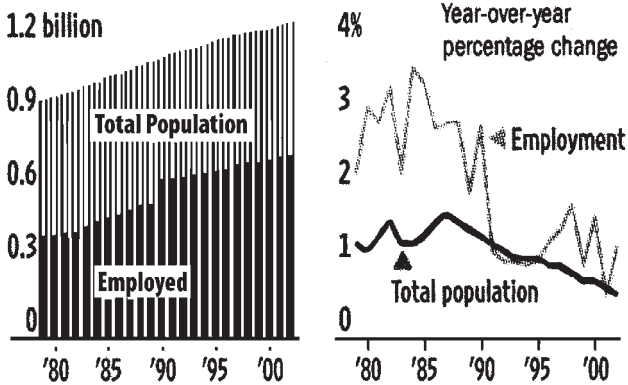
A final surprise is that the United States is the bright spot in the demographic story now. Our fertility rate has stayed close to 2.0 and when you add in legal immigration, our population will continue to expand comfortably in the 21 century.

This is important for a number of reasons. First a growing population means more workers to support those in retirement. Social Security has its problems but the system is a lot better off than if we were experiencing population decline like Europe. A growing population also means faster overall economic growth. We need new consumers to grow and we will have these for the next fifty years.

The overall decline in the world's birth rate and the prospect for a modestly expanding U.S. population is the good news from the demographic tea leaves.

More Back Home?

but the employment rate is anything but steady.



Sources: China Economic Information Network; Goldman Sachs

Global Trends . . .

The Cost of Looking Good . . .

...JUST GOT CHEAPER. The “Multi-Fiber Arrangement” (MFA) is due to expire at the end of the year. The MFA puts limits on the amount of textiles and clothing one country can import from another. Developing countries have lobbied hard to have this overturned. They want access to the big buyers, the US and the EU. Now that changes are imminent, some are finding

producer of cotton and has a well-established textile industry. China and India together may account for 65% of the U.S.’s clothing imports in the future versus 20% now. This is a dramatic change.

Who will the losers be? Some are countries which have prospered under quotas. When America maxes out on what it can import from China, it “quota hops” to new low cost countries like Bangladesh, Mauritius and Indonesia. But these countries will not be able to compete against the biggest players when production gets consolidated to 6 or 7 key countries as is expected. Bangladesh may lose as many as 800,000 garment workers. A real disaster for that country.

America will also be a loser (again) on the production side. Since 2001 we have lost 344,000 textile and apparel workers. Now with the expiration of MFA we may lose another 600,000 jobs. The only good news is this may be our last loss. There will be nothing left to go. The textile industry may be down to 100,000 workers total in the future. Made in America clothing – R.I.P.

The EU is exposed to some of the same competitive risks but may be better protected. Europe is still the world’s largest textile exporter and ranks second in clothing. At the high end – think Italian design and French fashion – they are still dominant in creativity. But at the lower end they will lose jobs.

Some countries are banking on specialty niches. Thailand, a leading silk producer, is hoping their fashion and design sense will see them

through. Central America will benefit from close proximity to the U.S. as will Mexico.

The biggest winners on the import side will be – us. Clothing prices could fall another 20% in the U.S. once the quotas are lifted. A more likely scenario however is the windfall will be shared up and down the supply chain. Clothing sellers like Wal-Mart and big producers like Liz Claiborne may fatten their margins and pass on only a portion of the lower costs.

Fashion will move at a faster clip after the quota changes. A southern China company Luen Thai Holdings is now setting up a 2 million square foot “clothing city” with 4,000 workers. Fabric suppliers, thread people and button vendors all will be in one location. Producers like Liz Claiborne can station design people right on site, try out prototypes and move directly to production. The current system requires endless back and forth FedEx’s and emails. The Holy Grail in clothing is cutting down the time between design and delivery. The best you can do now is a ninety-day turnaround. The Chinese model promises sixty days. Time is definitely money here.

We haven’t heard that much about the sea change about to happen in textiles and clothing, but we will. Get ready for January.

Clothing and textiles:

- Estimated to employ at least 40m people worldwide
- Manufacturing generates trade worth at least \$350bn a year
- More than 30 countries’ exports are controlled by quotas
- Trade barriers have cut world income by \$137bn, according to the IMF and World Bank
- Removal of quotas is forecast to benefit China the most, followed by India
- Bangladesh and other poor economies that rely heavily on clothing and textiles exports will be the most vulnerable to global competition
- US clothing importers expect to buy most of their goods from five or six countries by 2007, down from about 50 today

Source: Financial Times

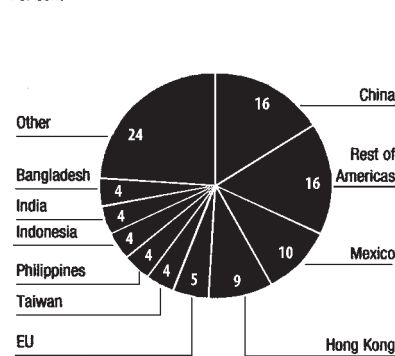
they will be big winners and others are discovering they will be big losers.

The biggest winner will certainly be China. It has low costs and has become a juggernaut with their rapid response in the clothing business, their reliability and their businesslike attitude. India will also gain even though it has nowhere near the infrastructure of China. Its ports and roads are clogged and its logistics are cumbersome. But it still is a major

Potential winners and losers

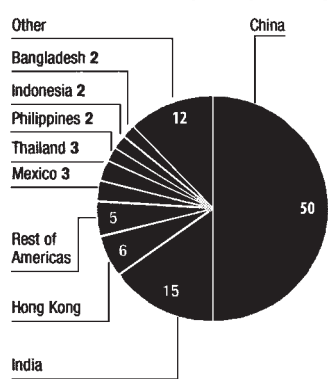
Major clothing exporters’ share of the US market now...

Per cent



Source: WTO, Nordås

...and how they may rank after elimination of MFA[†] quotas (forecast)



Source: Financial Times

† Multifibre Arrangement

The Market Outlook . . .

What to Expect in the Years Ahead . . .

FROM 1982-2000, FALLING inflation and interest rates, helped stocks produce 18% average annual returns. Then, from 2000-2002 stocks fell almost 48% in one of the biggest bear markets in history. This series of events has left many investors wondering what to expect next.

Over the long term, stocks have produced average annual returns in the 10%-11% range. In the absence of other information, it would be reasonable to expect that future returns might approximate this number. But today, a number of strategists think that we are entering a period of lower returns. One proponent of this theory, economist Martin Barnes, suggests that future average stock returns are likely to be almost half historic levels.

To understand his conclusion, it helps to remember that stock prices go up for only two reasons. First, over long periods of time stock prices tend to advance right along with corporate profits. The value that investors place on this earnings growth, often measured by the P/E ratio, is the second driver of stock prices. Higher profits and higher P/E ratios mean higher stock prices.

Historically, corporate profits have grown about in line with the nation's overall output (GDP). Barnes expects GDP to grow at a 5% level (3% real

growth plus 2% inflation) for the foreseeable future. He also believes stiff competitive conditions will keep profit margins in check and prevent earnings growth from exceeding this level.

Barnes further expects that stock prices will get little help from higher valuations (P/E ratios). *Take a look at the chart below.* Today, the stocks in the S&P 500 are trading around 19 times trailing twelve-month earnings. While this lies well below the ratio of almost 30 at the peak of the stock market bubble, it is still above the long-term average of 15. If P/E ratios stay where they are, stocks will advance in line with his 5% profit growth estimate. Add to this the current dividend yield of 1.7% and you get to Barnes' expected average annual return of 6.7%. If P/E ratios contract, then stock returns could fall below this level.

Given this rather anemic return forecast why not bail out of stocks and invest in bonds? Without a doubt, bonds produced strong returns over the last several years. But this price out performance was driven by an unprecedented decline in interest rates. Moving forward, flat to increasing interest rates should temper bond returns.

A number of strategies can help investors navigate a low return environment. First, higher dividend paying

stocks can boost returns when appreciation prospects appear limited. While corporate profits can vary from year to year, dividends are fairly secure. Further, recent tax law changes have lowered the tax on dividend income to the same low 15% rate as capital gains. Thanks to the more favorable tax treatment and investors growing interest, companies are increasingly turning to dividends. Last year alone, 113 more companies added dividends and total regular dividends have grown by almost 20% since the beginning of 2003.

Second, investors can keep a closer eye on investment costs. Buying a fund with a 2% annual operating expense might not have seemed like such a big deal back in the 1990s when stocks were advancing 18% a year. But if your fund is only earning 6% a year, 2% in fees translates into 33% of your overall return.

Finally, if Barnes' work proves accurate, investors will need to lower their return expectations and save more. Unfortunately, Americans tend to be profligate spenders. *As the chart above shows,* the U.S. personal savings rate hit a low of 2% in June of this year. Curbing our consuming tendencies will not be easy but it will help us meet our various investment goals.

—Anne Williams Doremus, CFA

