

Thoughts from

Hanson Investment Management Inc.

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The End of the Innocence . . .

ISTILL HAVE A DOG-EARED COPY of a story on my desk by David Hale, chief global economist at Zurich Financial Services. It is from the *Wall Street Journal* of November 7, 1991 and titled, "The Coming Golden Age of Capitalism". The gist of the story is that prior to the fall of the Berlin Wall the global market economy included 800 million people living in twenty-five industrial countries and maybe another 400 million living in a dozen or so developing satellite economies with large export sectors. With the fall of the Berlin Wall in 1989 and the collapse of the Soviet Union two years later, another 4 billion people or nearly 80% of the world's population re entered the global marketplace.

Take a look at the chart at the bottom. World trade, or the total of all world exports and imports, has been growing at almost twice the rate of world output in the 1990's. Globalization is upon us and the increase in trade is benefiting countries everywhere. Just look at China and how in twenty short years it has lifted more people out of poverty than any country has done at any point in history.

Our recent period of globalization is actually the continuation of something that started much earlier. The first age of globalization occurred in the late 1900's and early twentieth century. Back then countries did not require passports and immigrants flooded across borders without visas. The development of the steamship, telegraph, railroad and eventually the telephone were the New Economy of that day.

Norman Angell wrote a book in 1911 called the *Great Illusion* in which he argued that wars might never occur again because economies were so integrated that fighting would be disastrous for all sides. But that grand illusion came to a sudden end with the First World War. It has taken another 80 years to get back to the second age of globalization.

Now I worry that this one will be brought to its knees by the September 11 horrific attacks. The United States and the rest of the world may stop looking outward and turn decidedly inward. Connectedness and integration may give way to xenophobia, trade barriers and closed borders. Some action is obviously necessary now after the bombings but hopefully we will not kill the goose that bore the golden egg of globalization. It is too valuable to lose.

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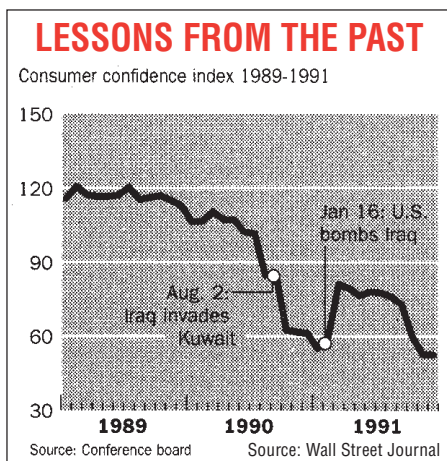
Global Economic Progress

	Growth in World Output	Growth in World Trade
1996	+4.1%	+6.7%
1997	+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 World After September 11 . . . So what about the economy now? . . .

IN A NUTSHELL THINGS ARE WEAK and will probably get weaker. How much weaker? Unfortunately we don't know. Prior to September 11 the economy was already softening. Both manufacturing and the New Economy were declining sharply. Foreign economies had not been much help and do not look to be much help for the foreseeable future. Japan is stewing in its own juices and Europe although doing better is still just treading water.



The last pillar of the economy is the consumer and how the consumer behaves will determine how the economy fares. I know this sounds overly dramatic and simplistic but I think it is close to the truth. Continued layoffs and the consistent drumbeat of poor corporate earnings have so far not sapped the confidence of America's buyers.

The reason is probably the housing market. Alan Greenspan recently noted that households end up spending ten to fifteen cents of every dollar of profit made on a house sale. By comparison they tend to spend only three to five cents of a successful stock sale. Since housing prices have been on a tear for the past five years (see chart in upper right), consumer spending has marched along impressively.

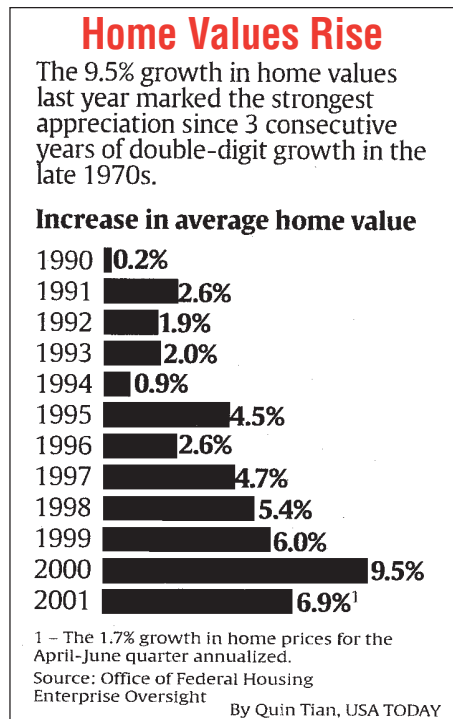
But how much longer can this continue? The chart in the lower right shows the problem. Even before September 11 more people polled by the

Gallup organization were feeling worse off relative to a year ago than better off. Now that the bombings have occurred we could see further deterioration. But things don't have to get totally out of control. The traditional problems of past cycles such as high interest rates, high inflation, a worsening employment picture and a weak housing market are not there this time. We could get a soft landing rather than a sharper one now.

The bigger issue is not the short term but the longer term. The chart in the left hand column shows how consumer confidence reacted to the Iraq War in 1990-91. Initially confidence fell sharply but then recovered when the fighting actually began. Then it slipped again as it became apparent the economy was weaker than previously thought. This is the big question now, how soft will things get and when can we expect the economy to find bottom.

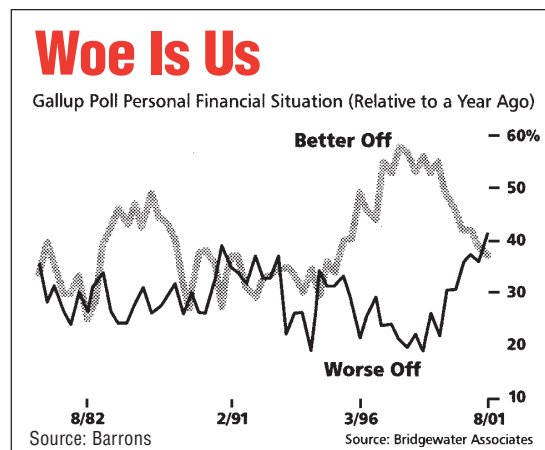
So what is our take on all this? We think there are two scenarios now. The first is that consumer confidence weakens further and the U.S. economy continues to decline. Japan and Europe offer no counterbalance to our fall. Interest rate cuts and tax refunds do not help because this time the problem is not lack of demand but instead over supply. We overbuilt in all the New Economy sectors and manufacturing in general is experiencing overcapacity worldwide. Until these excesses are worked off the economy will stay weak. Under this scenario the stock market and the economy could take years not months to find bottom.

The more optimistic scenario is that the aggressive rate cutting by the Fed, tax refunds and tax rate cuts and the fiscal policy pump priming that will be implemented shortly will give the economy just enough boost to let it find a bottom in 2002. Under this scenario the economy will get the breathing room to work off the excesses in manufacturing and allow the stock market to stabilize



which in turn will shore up consumer confidence.

We tend to side with the more optimistic scenario. We don't see the traditional problems of high interest rates, high inflation or an overly weak job market and we also see a potential silver lining in this incident. The sense of national purpose building today could be a real source of strength. A more unified nation can move quickly to get on with the business at hand and put in place policies that will set the economy up for a much stronger recovery. This is how we are betting.



The World After September 11 . . . So what about the market now? . . .

THE MARKET HAS JUST RE-OPENED and the Dow is down 684 points. By crisis standards this has not been a calamity and in fact this has been a pretty orderly panic if that's possible. Based on the chart to the right the first few days or several weeks of any crisis, things are pretty emotional and prices are often down. But then things turn around. In only two of the twenty-one incidents tracked by Ned Davis Research were stocks still down four months after the initial turmoil. In nineteen cases stocks were higher, and often by a lot. The moral is, don't lose your head even when everyone around you is losing theirs.

Longer term, and we have said this many times, stocks go up for only two reasons. The first is that corporate profits go up and the second is that price to earnings ratios stay stable or increase. Corporate profits will be mixed for the next couple of quarters. But as we say on page two we are betting this is going to be a shallower than expected downturn and we could see some stabilizing next year. Typically stocks turn up six to nine months before a turn in the economy so we could be close to a rebound.

Price to earnings ratios are still high based on the overall market (see chart at bottom). They have come down a lot this year but then again they had a lot to fall after the mania buying in the

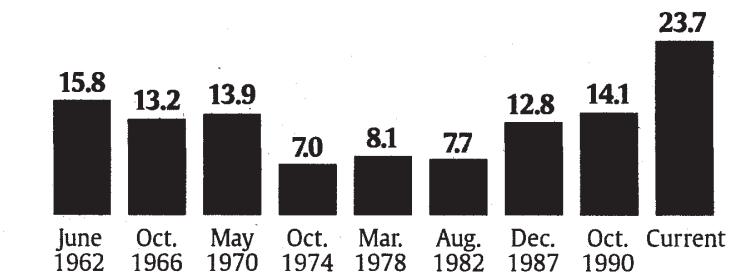
late 1990's. If you ex out the New Economy stocks and high tech the average PE now is below fifteen. This looks very reasonable to us.

Our take is that it is too late to sell now and any further emotional decline in the market is an excellent buying opportunity. The important thing to stay focused on today is your focus. A psychologist at Harvard has found that when stocks are volatile, groups of investors with access to lots of news earn less than half as much as investors with very little access to news. This is not an argument for the head-in-the-sand school of investing. It is simply an argument for keeping the waterfall of information on CNBC or the local news in perspective. Don't panic with the herd but instead stay focused on your long-term needs and the strategies that will get you there.

The Stock Market is an interesting and frustrating mix of economics and human emotion. Stock prices as Ray Devoe a long time stock commentator has said, are only indirectly related to economics. Stocks prices are a function of human fear, greed and apprehension all overlaid on a business cycle. This is one of those moments when both emotions and economics are running high. My best advice is to stay focused on your long-term investment strategy, stay well diversified and stay calm. Don't just do something, sit there.

Pricey Market

Despite hitting a new bear market low Friday, the price-to-earnings ratio of the Standard & Poor's 500 index is still pricey compared with valuations at prior market bottoms. S&P 500 P-E¹ at the start of past bull markets:

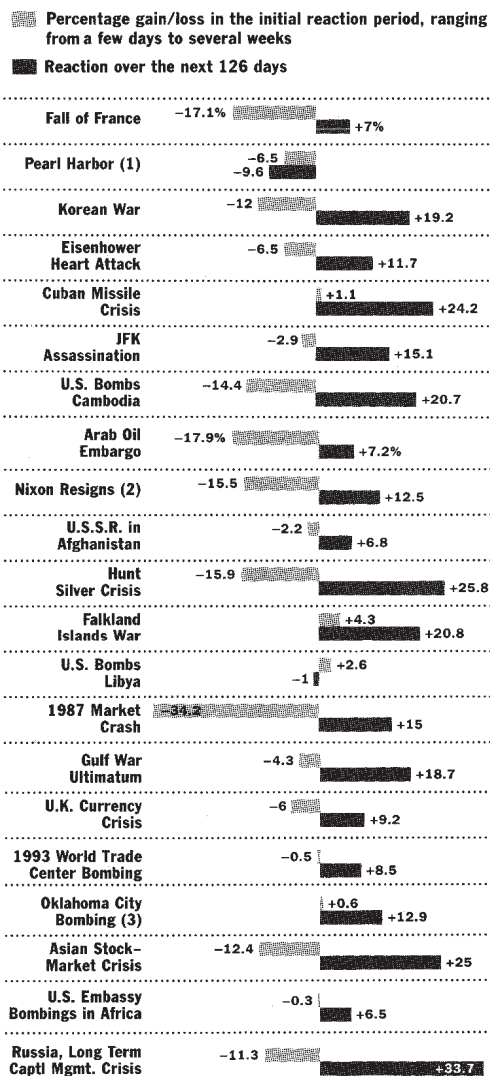


¹ - based on trailing 12-month earnings
Source: InvesTech Research

By Adrienne Lewis, USA TODAY

The Stock Market in Crisis Mode

Crisis events, Dow Jones Industrial Average performance in the period immediately after crisis events and 126 days after the initial reaction period: in percentage terms.



Source: The Wall Street Journal

Source: Ned Davis Research

The Investing Scene . . . Going Global . . .

MARKET PUNDITS ARE SCRATCHING THEIR HEADS trying to predict the duration of the current downturn. The truth is, of course, that no one knows for sure. So where should investors turn given this rather unsettling reality? One recommendation that is gaining credibility is the old idea of global investing.

The rationale behind global investing is fairly straightforward. Take a look at the chart below. International and domestic stocks do not move in sync with one another. Global investing takes advantage of this. When you combine both types of stocks in one portfolio, you reduce overall risk (volatility) without negatively impacting return.

Unfortunately, while the theory of global investing makes sense, there has been some slippage between cup and lip. Over the last decade, investors fell out of love with foreign stocks as international returns simply couldn't keep pace with the red-hot U.S. market. From 1991-2000, the S&P 500 produced an average annual return of 17.5%. This record-breaking result was more than double the 8.5% return earned by the Morgan Stanley EAFE Index, a widely used international benchmark.

International results were so disappointing in the late 90s that many institutional investors proposed eliminating the sector as an asset class altogether.

A number of factors however are now coming together to improve the outlook for this overlooked sector of the market.

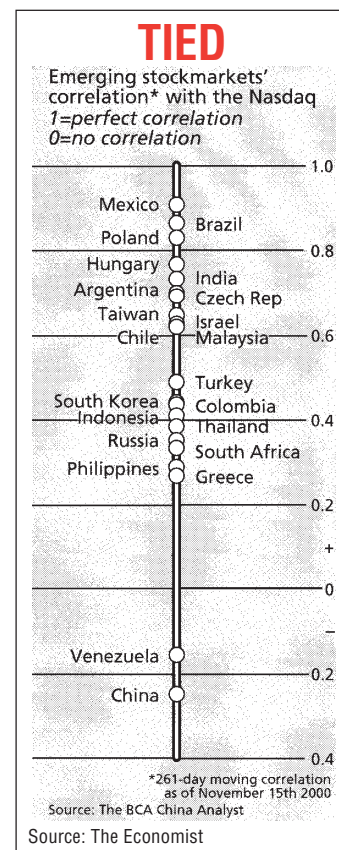
First, even after the most recent decline, U.S. stocks remain expensive relative to their international counterparts. On average, U.S. stocks now sell at approximately 200% of corporate sales while European stocks trade at roughly 120% and Japanese stocks sell at an incredibly cheap average of 70%.

Further, prospects for

long-term economic growth abroad look good. European companies are just beginning to embrace the kind of restructuring activities that U.S. companies underwent in the 1990s and benefits from unification are still unfolding. In Asia, China's economy should see strong growth as that country's growing middle class creates a huge demand for a wide range of consumer products. Opportunities for growth in Japan are improving too as the new administration tackles a number of issues such as financial sector reform.

Finally, the now weakening U.S. dollar should benefit foreign investors. When the dollar strengthens, which it has over the last decade, investment funds are translated into fewer dollars for a U.S. investor. A strong dollar therefore means lower returns for a U.S. investor in foreign stocks and a weak dollar translates into better returns. The dollar should weaken further as interest rates decline and the U.S. economy slows.

Opponents of global investing believe that the diversification benefits derived from global investing are a thing of the past. The increasing connection between economies means that markets around the globe now move more in sync. While recent evidence appears to support this claim, significant benefits can still be gained from investing abroad. Consider the chart above right. While the markets of close trading partners such as Mexico move in line with the U.S., other markets such as China and Venezuela do not.



Like most investment strategies, international investing is not without risk. But great opportunity also resides in the 50% of world stocks traded outside the U.S. Selectively adding international investments to a well-diversified portfolio of U.S. stocks can boost overall returns while reducing risk. This strategy sounds pretty appealing in these current turbulent times.

— Anne Williams Doremus

The Case for Going Global

Year by year, the U.S. and major non-U.S. stock markets can have wide swings in results. But over the past three decades, the average returns from the Standard & Poor's 500 and the Morgan Stanley Capital International Europe Australasia and Far East Index are nearly identical. An allocation of two-thirds S&P 500 stocks and one-third EAFE delivers nearly the same return with less volatility.

Source: Business Week

