thoughts

FROM HANSON+DOREMUS **JANUARY 2022**

HANSON+DOREMUS
INVESTMENTS AND PLANNING

If you're right more than 50% of the time… you're lying…

Not sure exactly who said this, but they were talking about making predictions. It's just a fool's errand to try to look too precisely into the future. Unfortunately, this is what we all must do when dealing with our investments.

COVID has been a real disruptor to everyone's daily lives but surprisingly not a big disruptor to the stock market averages. The S&P 500 registered a total return of 31.5% in 2019, 18.4% in 2020 and 28.7% this past year. Will our luck run out in 2022? We have already had three great years of gains, valuations are stretched, inflation is heating up, the Fed is about to increase rates, and who knows how bad Omicron, or "Son of Omicron" will get? So, stocks may fall.

On the other hand, consumers are still flush with cash, many investors are sitting on big stock market gains, corporate profits are expected to be up 10%, and wages are rising. So, the market upswing could continue.

Where do we stand? Our crystal ball is too cloudy to know all the answers here. We think it is better to control what we can, not predict what we can't. And what can we control? Jason Zweig recently noted in *The Wall Street Journal* that there are two things we can control -- our habits and our discipline. We can choose an investment strategy that makes the most sense for our age and our risk tolerance, invest in a balance of riskier stocks and less risky bonds, and then – just do nothing. Go sit quietly in your room and exercise extreme sloth. Set it and forget it works.

- Eric Hanson

S&P 500 PERFORMANCE SINCE THE END OF 2020

Source: *The Wall Street Journal*

Hanson+Doremus 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.

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COMPANY UPDATE

By Julie Won

A look under the hood at H+D...

It's been one year since Hanson + Doremus moved to leadership under **Sven Eklof, Art Wright**, and **Julie Won**, and we're pleased to say it's been a successful one. Though **Eric Hanson** & **Anne Doremus** (the H and the D in our logo) stepped down from management at the end of 2020, much about the firm remains the same, and Eric and Anne are still very much with us.

To refresh your memory on the people, **the firm is led by the three partners Sven, Art, and Julie (see photos below).** All have had long tenure at the firm and work directly with clients as portfolio managers and advisors. Sven also oversees firm operations, Art manages marketing and client experience, and Julie heads the firm's investments and research team.

In addition, we have two other excellent portfolio managers working directly with clients: **Alex Watson** and **Liz Ford**. Alex and Liz not only advise clients, but also participate in the firm's investment research and wear several other hats as well. Liz does the firm's bond trading and looks after compliance. Alex is our technology guru and manages everything from cybersecurity to Work-From-Home capabilities.

Jordan Lafayette, Alma Pilausic, and Sarah Cocina do the blocking and tackling that make the firm run. They execute and track transactions, produce quarterly reports, handle requests to move assets, and are the first point of contact when clients need account information. Jordan leads the team, Alma does our stock trading (an enormous number of tickets on some days), and Sarah plays a heavy role in branding and outreach. In addition, Alma helps create client financial plans, while Sarah helps with the investments team's research.

Kristen Audy Rich is the head of Human Resources and our Office Manager. She has been with us 25 years and not only manages HR policies and processes, but also makes sure the bills get paid and the lights stay on. Kristen also lays out and distributes this newsletter.

That brings us to **Eric Hanson, Anne Doremus**, and **Henry Preston**. Most of you know Eric and Anne. Eric founded the firm in 1995, Anne joined him just a bit after, and together they ran the firm for two and a half decades. While both have stepped down from management, they still work part-time with the investments team, and you'll continue to see their "Thoughts" in these pages.

Henry, a new face for many of you, first came to us as a college intern, and fortunately, we got him back after a successful career with the U.S. Marines. Henry has a keen interest in financial planning, and he is working with us part-time while he gets his MBA from the University of Michigan Ross School of Business.

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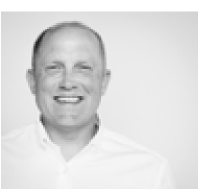
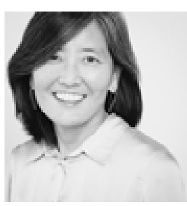
Neither the way we invest, nor the way we work with clients has changed. However, in 2021 we made an unusually high number of investments in technology, systems, and processes to make things run more smoothly under the hood.

Externally, perhaps the most visible change this year has been our **new logo and website** – a big rebranding effort spearheaded by Art and Sarah. The other significant change has been **adjusting to COVID** and a **hybrid schedule,** where we split our workdays between the office and home. The good side of COVID -- if there has been any -- is that it presented opportunities to do things differently but better. Our communications, efficiency, and collaborative spirit all have been elevated as a result.


Sven Eklof
Partner

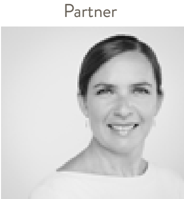

Art Wright
Partner

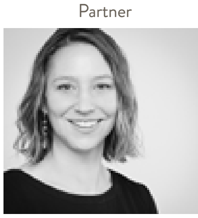

Julie Won
Managing Partner


Alex Watson
Portfolio Manager

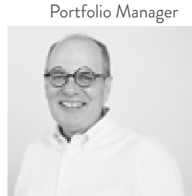

Liz Ford
Associate Portfolio Manager


Jordan Lafayette
Operations Manager

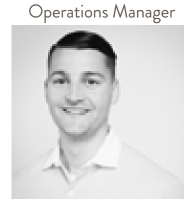

Alma Pilausic
Portfolio Administrator + Equity Trader


Sarah Cocina
Portfolio Administrator


Kristen Audy Rich
Office Manager


Eric Hanson
Founder


Anne Doremus
Senior Advisor


Henry Preston
Associate Portfolio Administrator

SEMICONDUCTORS

By Julie Won

Money is not always enough at the leading edge...

The Wall Street Journal recently reported that two Chinese semiconductor foundries just went under and now are among the nation's six failed chip making projects the last three years. China has thrown billions into building an independent semiconductor industry, but it hasn't been easy. Throwing money at the problem hasn't been enough.

Everyone knows China wants semiconductor independence. Semiconductors are strategic, they are in everything, and everyone needs them. Beijing has committed over $50 billion to support the industry since 2014, and local governments have thrown in even more. But China still is far behind – some say a decade or more. Even if China can design advanced chips – and private companies like Baidu and Alibaba are doing just that – being able to manufacture at the leading edge is a different story. The playbook China has used for other industries – invest, access foreign tech (or the more cynical might say, steal) – hasn't worked here.

China's national champion SMIC (Semiconductor Manufacturing International Corporation) started up over 20 years ago but announced only in 2019 that it would start making 14 nanometer (nm) chips. Meanwhile, the world leader, Taiwan Semiconductor Manufacturing Company, or TSMC, is making 5 nm chips at scale and moving on to 3- and 2-nm. Samsung is hanging in there too. And because each jump in process technology is brutally difficult, money is not all you need. GlobalFoundries,spun out of AMD in 2009, was backed by the United Arab Emirates and had plenty of money, but it gave up at 10 nm in the early teens. It was just too hard, and it was perfectly profitable to hang back and produce less advanced chips.

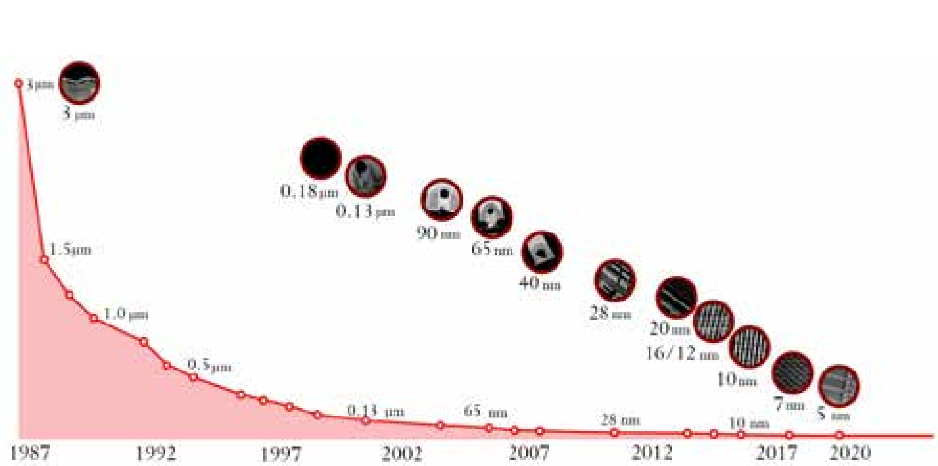
Never say never when it comes to China, but building a whole semiconductor value chain is hard. You need design skills, manufacturing know-how, and semiconductor equipment to make the stuff. But more than that, you need close working relationships with customers and a collaborative ecosystem, where each part of the value chain works closely with the others.

It has taken four decades to get to the ecosystem we have now, and the amazing thing is that there is value (and margin) in each part of the chain. It starts with designers at places like Apple designing chips on EDA or Electronic Design Automation tools – and there really are only two leading EDA companies now. The chip designers need to collaborate closely with TSMC. And TSMC really needs to collaborate closely with equipment makers like ASML. There are only a handful of major equipment makers in the world now, and they might be considered the true arms dealers in the arms race.

Equipment is a big challenge for China. Trade restrictions keep China from accessing the most advanced equipment, and there is no other place to go. There is no substitute, for example, for what Netherlands-headquartered ASML makes. ASML has a monopoly on something called EUV (extreme ultraviolet) lithography, the process for etching very small patterns onto silicon wafers. It was not easy for ASML to get to where it is, but nobody else now can do what it does. Simplified, its technology involves pulsing molten tin exactly at the right time with a laser thousands of times a second. A series of mirrors and lasers create a light beam that's small enough to etch lines a few atoms wide. These are not regular mirrors and lasers either – only one private company in the world makes those lasers. And by the way, when ASML succeeded, the other big lithography player, Nikon, gave up and dropped out.

So none of this is easy – but not everyone has to be at the leading edge. The chip shortages that you read about in the newspaper for autos and the Internet-of-Things require much less advanced chips. But the few companies who can do what no one else can are extraordinarily strategic – and that is why China and the U.S. are turning semiconductors into a geopolitical issue.

TSMC HAS DRIVEN ADVANCES IN PROCESS TECHNOLOGIES



Source: TSMC

ECONOMIC TRENDS

By Anne W. Doremus

The markets…looking back and ahead…

Two stock market truisms come to mind when I think about last year. The first is that "Markets climb a wall of worry." The continued spread of COVID, rising inflation, and the threat of higher rates all weighed on investors' minds in 2021. The second truism, "Don't fight the Fed," served as a kind of antidote to all this angst. Government support in the form of low interest rates, an ever-expanding Fed balance sheet, and robust federal spending programs helped support both the economy and stock prices last year.

Unfortunately, as we move into 2022 many of the same threats persist. The Omicron virus is dampening economic activity. Inflation continues to gain ground and the path to higher rates seems more certain than ever. In his recent congressional testimony, Fed Chair Jay Powell described inflation as a severe threat to the U.S. recovery and pledged to curb rising prices by winding down the bond buying program and, if necessary, raising interest rates.

What does this kind of paradigm shift mean for investors? <u>Let's start with the bond market.</u> Higher interest rates depress bond prices so a rising rate forecast can't be good news for bond holders, right? Before you jump to sell your bonds, however, it is important to consider two things. First, bond investors have already priced in some of the upward move in rates, with three 0.25% increases widely expected in 2022. Further rate increases are possible if the Fed believes that inflation is becoming entrenched in consumer expectations and the economy more generally. To assess this, Fed officials will be keeping a particularly close eye on wage growth (*see chart below*). Wage gains tend to be "sticky" -- once they rise, they tend not to fall back -- and rising wages tend to cycle through to higher prices as companies attempt to pass their higher costs on to consumers.

Second, it is also important to keep in mind the role bonds play in any portfolio. Traditionally, bonds have both reduced portfolio risk and provided a measure of income. While the income offered today is limited, losses in bonds are nothing like the losses that can occur in the stock market in any given year. Consider that the worst one-year return in stocks over the last 70 years was a decline of 39% while the worst that bonds produced was a mere 8% drop.

<u>When thinking about the outlook for equities, it is important to remember that only two factors drive stock prices in the long term;</u> the growth in corporate earnings and the valuation level (often measured by the P/E ratio) that investors place on those earnings. Let's consider each of these separately. Operating earnings of companies in the S&P 500 gained 72% last year as the economy rebounded from the pandemic-induced decline. While revenue gains contributed, most of the increase came from expanding profit margins. I think the opposite dynamic is likely to occur this year. Revenue gains should mirror a rebound in economic activity, but profit margins will be restrained by rising costs for everything from labor and energy to supply chain disrupted commodities.

<u>On the valuation side, stocks are no longer cheap</u>. At year-end, the S&P 500 was trading at just over 21x forward earnings estimates, well above the 25-year average P/E of 16.8x. Historically, P/E ratios have not been terribly helpful in predicting one-year stock returns but they have proven useful when predicting longer term results. Today's elevated P/E ratio suggests muted annualized returns over the next five years.

The outlook for stocks today is less than exciting but I think there is some reason for optimism. Investors looking to put funds to work will find stocks attractive when compared to other fully valued sectors like bonds and commodities. Further, while stocks *on average* look expensive today, pockets of opportunity can still be found in select areas such as international shares, small cap holdings, and cyclically oriented sectors such as energy and finance.

EMPLOYMENT COST INDEX (WAGES AND SALARIES), PRIVATE SECTOR*

Source: US Bureau of Labor Statistics

*2-quarter annualized percentage change, seasonally adjusted

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