thoughts

FROM HANSON+DOREMUS | **JULY 2022**

What makes money money?...

I have always been interested in money, not from the standpoint of what it can buy or how we can use it to invest, but from the standpoint of psychology. Money is the ultimate confidence game. The dollar is not backed by anything today. It is worth what it will buy, and we are confident in it as long as we think others are confident in it.

The chart to the right shows the number of dollar bills in circulation and the total value of those bills. I apologize that the chart is a bit dated, from 2016. The total value of bills in circulation today is $2.2 trillion, up from $1.4 trillion in 2016. And the number of $100 bills is now much greater than the number of one-dollar bills. Back in 2016, they were about equal. The dollar is the world's #1 currency, and it is estimated that 70% of the value of all dollars are held outside the U.S. It is also estimated that most of the $100 bills are offshore. I rarely see a $100 bill used here, but outside the country it is much more common to see it in transactions.

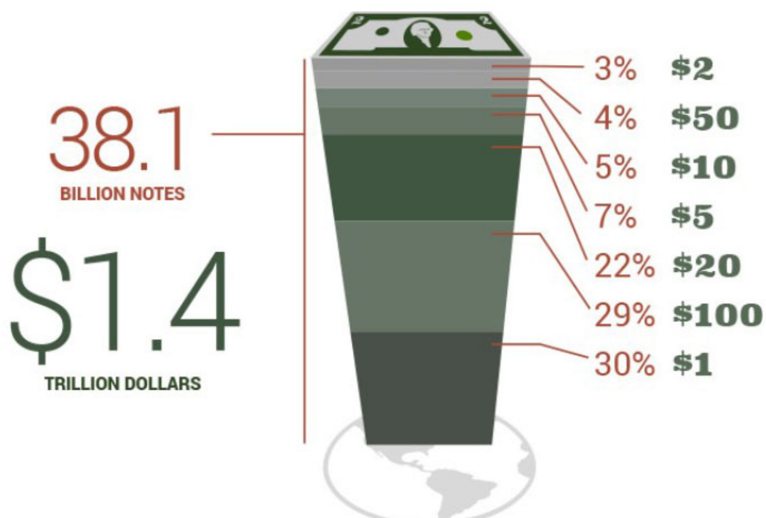
The use of currency in general is in gradual decline today. Sweden is the extreme case. Many banks no longer have cash on site. Everyone uses plastic or cellphone apps. The same goes for China where two private apps, Alibaba (Alipay) and Tencent (Tenpay), use cellphone QR codes linked to funds on deposit to make payments.

Here in the U.S. many older people prefer using cash, but overall only 18% of Americans now favor paying in cash versus 27% in 2016. New York State was concerned enough recently to legislate that retail establishments had to accept cash in addition to plastic, or face a fine.

Other traditional transaction methods are also in decline. Checks seem to be the dinosaur of finance today. Who even knows what the numbers at the bottom of a check mean? (Hint: the 9-digit number bottom left is the bank routing number; the next number is your account number. You're welcome).

So, what is next for money? Some think it might be crypto, which is not corrupted by government control and is protected by blockchain. But after 15 years, crypto has still not proven itself as a medium of exchange (i.e., where can you use it?), and it certainly is not a store of value. It can bounce up or down 50% in just a few months.

HOW MUCH CASH IS OUT THERE



Source: *frbsf.org*

The future of money, I think, may be a China-like system where we will deposit funds with private firms (Visa, Mastercard?) and use phone apps for transactions. Or the Federal Reserve will put in place a digital version of currency where we will have accounts with the Fed to use for transactions, either with cards or phone apps. Whatever the future of money, change will most probably be gradual and also emotionally difficult. I for one will miss leaving my pennies in the jars at check-outs.

- Eric Hanson

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.

802.658.2668
hansondoremus.com

431 Pine Street, Suite 302
Burlington, Vermont 05401

THE U.S. ECONOMY

By Eric Hanson

The ugly, the bad, and the good…

We will deal with the ugly and the bad first, then get to the good. Just look at the chart below right. It gets a lot of people really agitated. Imports have exceeded exports for years, and even though the chart says exports are improving a bit (relatively), we will not get to a balanced state anytime soon.

THE U.S. TRADE DEFICIT SHRANK 1.3% IN MAY AS EXPORTS GREW FASTER THAN IMPORTS

*Note: Seasonally adjusted

Source: *The Wall Street Journal*

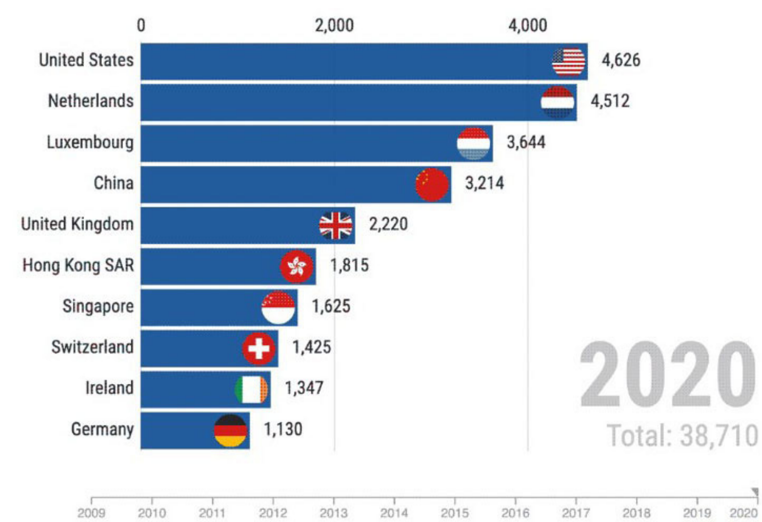
The pessimists are all over these stats… The US doesn't produce anything anymore. We rely on low wage countries for everything. We are more concerned about "where is my container?" than what are we doing to create jobs in the U.S. When we try to "reshore" production, we discover we have lost the domestic supply chain and the skills necessary for production. And what happens if the rest of the world gets tired of holding all the dollars we send them to pay for imports? If mass selling ensues, there goes the value of the greenback.

You would think from all this that the U.S. is going to hell…or worse. Well hold on. The U.S. economy globally is still perceived as strong, and we can do the math to back this up. Foreign Direct Investment (FDI) is what companies do when they invest outside their own country. Think what Caterpillar does when it builds a new factory in Brazil or Asia. Or what a software company does when it sets up a sales office in, say, Europe. And what a natural resource company does when it buys a mine or mineral company in Africa or South America.

And who gets all this FDI? The U.S. is head and shoulders above everyone else in inward FDI (*see chart*). This obviously means global companies think favorably of our market. The U.S. has garnered 26.1% of all inward FDI since 1981, according to Joseph Quinlan, the head Market Strategist and Chief Investment Officer at Merrill and Bank of America Private Bank, who has done considerable work on FDI over the years.

INWARD DIRECT INVESTMENT POSITION

The U.S. took the leadership position as the largest recipient of direct investment in 2019 and maintained that position in 2020. (Top 10, U.S. $ billions)



Source: *IMF.org*

And then there is outward FDI, the amount U.S. companies invest abroad. Here again the U.S. is #1. And it is not primarily companies looking for low-cost labor with the idea of sending production back to the U.S. The bulk of our outward FDI, about 60%, is in developed countries, and 90% of what is produced abroad is sold to the local market. U.S. multinationals are investing abroad primarily to take advantage of foreign buyers. The parent company in the U.S. benefits by employing home office and R&D staff and exporting services to foreign affiliates.

Sales of U.S. company foreign affiliates are significant. They amount to over two and a half times the value of U.S. exports. And none of these foreign affiliate sales are included in Gross Domestic Production (GDP), which includes just domestic production and sales. The U.S. economic machine is still a power.

And just a side note on another country. The Netherlands is a small and sometimes overlooked country. But it is an economic powerhouse. It ranks in the top five in both inward and outward FDI globally. Companies like Royal Dutch Shell, Philips, Unilever, Ahold (supermarkets), ING, ASML (photolithography for chips), and a lot of private real estate concerns have global clout.

STILL NOT ENOUGH

By Julie Won

The state of U.S. retirement savings...

According to a recent survey by the Transamerica Center for Retirement Studies, 69% of Americans said they were confident about being able to retire comfortably. While that doesn't seem like a half-bad number, the other side of the coin is that 31% are worried – some deeply so -- that they won't be able to retire well or at all. In the same survey, nearly 40% of respondents said they felt they hadn't saved enough, and 23% fully expected Social Security to be their primary source of retirement income.

None of these numbers are good, and there are scores of other surveys with more discouraging results. The Federal Reserve's 2021 report on the "Economic Well-Being of U.S. Households" said a quarter of non-retired adults had no retirement savings at all. And investment firm Natixis found in 2021 that 36% of Americans felt they never would have enough money to retire. It ranked the U.S. 17th out of 44 countries in its global index of overall retirement well-being, while the top five countries were Iceland, Switzerland, Norway, Ireland, and the Netherlands.

So how did we get here? The simple answer is that saving money for a distant future is hard, and leaving it up to individuals means it often won't happen. Most people prepare for retirement through 401ks or other employer-sponsored plans, but a 2019 study (Biggs/Munnell/Chen) found that plan balances were less than a third of their potential if participants had contributed regularly from age 30. The main reasons for this tremendous shortfall were the immaturity of the 401k system and inconsistency in employee contributions. The 401k didn't exist before 1978 and wasn't intended to be the primary vehicle for retirement saving -- which means many workers now in their 60s didn't have access to plans early in their careers. Coverage was far from universal, and participation and deferrals have been inconsistent. In addition, two other reasons for saving shortfalls have been "leakage" through participants taking out loans or tapping balances too early, and high fees.

Not all the news is bad, however. Vanguard yearly publishes a report on retirement saving trends, and the most recent, *How America Saves 2022*, strikes an upbeat tone on the 5 million retirement plan participants across Vanguard's business. Plan participation and deferral rates both have moved up the last decade, and so have plan balances. That means we're learning how to make this work. Automatic enrollment -- where employees are defaulted into a balanced investment strategy -- has been a powerful tool for raising participation. In addition, the increased use of target-date funds, where fund selections are dictated by one's age, mean that more participants are invested at reasonable rather than extreme asset allocations.

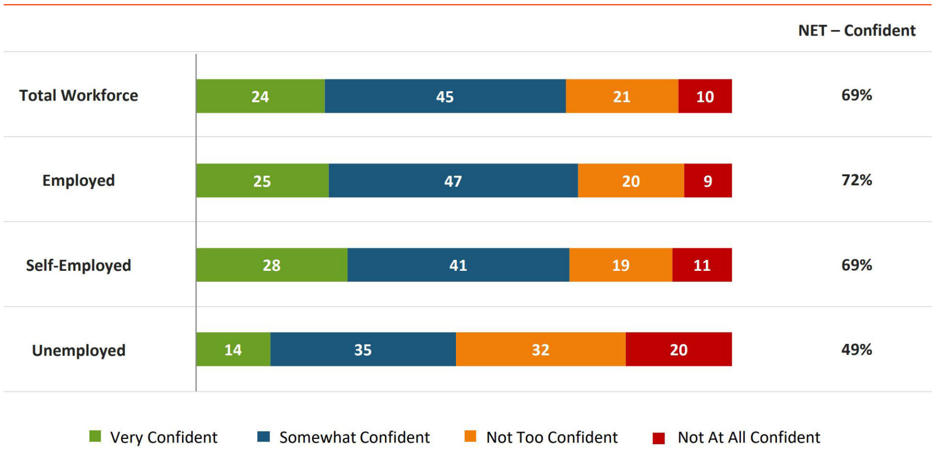
Nevertheless, the Vanguard report reveals that individuals still find ways to sabotage themselves. Nearly a third of Vanguard plan participants did not contribute enough to get their full employer match, which means they left good, easy money on the table. In addition, while excessive trading in and out of assets has stayed reasonably low, the onset of the pandemic in March 2020 spurred a spike in trading activity that likely was wealth-destructive (those who got out of the market likely found it difficult to get back in). Both these behaviors suggest that we have some ways to go on retirement plan design and education. Since we know saving is hard, the more we can get people on autopilot, the better.

ACCOUNT BALANCES BY AGE: VANGUARD DEFINED CONTRIBUTION PLANS, 2021

	Average	Median
All	$141,542	$35,345
<25	$6,264	$1,786
25–34	$37,211	$14,068
35–44	$97,020	$36,117
45–54	$179,200	$61,530
55–64	$256,244	$89,716
65+	$279,997	$87,725

Source: Vanguard, *How America Saves 2022*

HOW CONFIDENT ARE YOU THAT YOU WILL BE ABLE TO FULLY RETIRE WITH A LIFESTYLE YOU CONSIDER COMFORTABLE? (%)



Source: Transamerica Center for Retirement Studies

ECONOMIC TRENDS

By Anne W. Doremus

Predicting the Unpredictable…

Somewhere in the second quarter, the economic narrative shifted to not if we were going to have a recession, but how deep and how long it might be. We decided to take a step back and look at how we got to this point and compare today's outlook to similar periods in the past.

Over 2020-2022, the Federal Reserve expanded its balance sheet by buying over $3.1 trillion worth of Treasuries and Mortgage-Backed Securities. This latest round of "Quantitative Easing" was designed to hold down interest rates and keep the economy afloat during the pandemic-induced downturn. On the fiscal side, stimulus bills approved by Congress beginning in 2020 unleashed roughly $5 trillion of support to multiple sectors of the economy. The removal of these expansionary programs, together with the Federal Reserve's recent inflation-fighting move to raise interest rates, are having a tremendous contractionary impact on the economy, corporate profits, and stock prices.

While an economic recession has not been formally declared, we believe there is a better than even chance that we are already in one. First quarter real (inflation-adjusted) GDP contracted 1.6%. The Atlanta Fed's GDP Tracker is now predicting a 1.9% decline in the second quarter. If this forecast proves accurate, which seems likely given the now persistently high levels of inflation, sagging consumer confidence, and higher interest rates, then we have met the commonly accepted, two quarter-decline definition of a recession. Stock prices, typically a leading indicator of economic downturns, have already suggested as much, recently falling into bear market territory.

Fortunately, there are good reasons to believe that any recession we encounter today will not be severe. Jobs are plentiful – the unemployment rate remains a low 3.6%, and there are almost two jobs open for every person who is unemployed. Thanks to rising home prices and relatively low debt levels, consumer balance sheets are in solid shape. Inventory levels, particularly in cyclical sectors like autos and housing, are not extended.

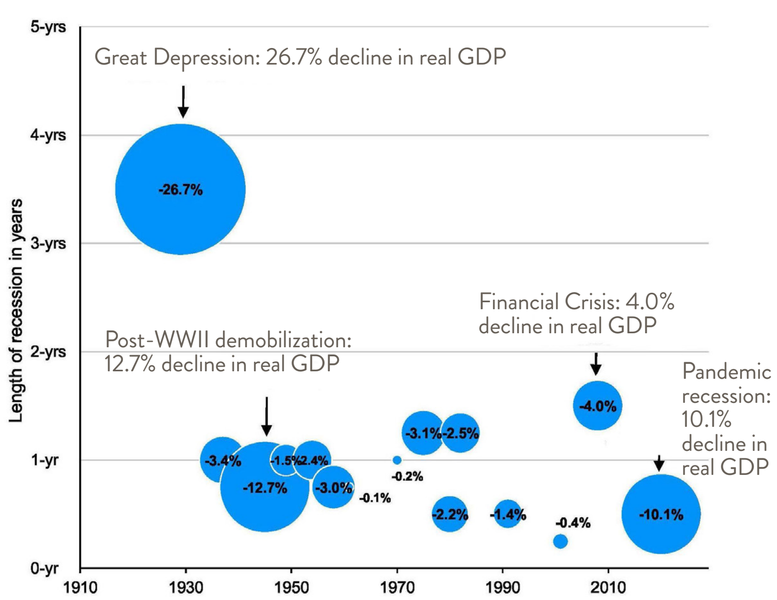
A look back in history can also prove useful (*see chart left*). There have been 15 recessions since 1910. All but one of them lasted less than two years, and the average economic decline (excluding the Great Depression) was 3.4%. Because available data is always backward looking, we may already be well through any downturn.

What does all this imply for stocks? At the risk of making a short-term market prediction (something we typically avoid), there are several reasons to believe that we are not quite done with this stock price sell-off. First, while stocks are now more reasonably priced than they were at the beginning of the year, they are still not cheap. As of June 30th, the S&P 500 traded at 15.9x this year's consensus earnings estimates compared to an historic average of 16.4x. As a group, large-cap growth stocks in particular still appear fully valued when compared to historic levels. Second, analysts' 2022 earnings estimates remain robust; on average they expect 11% year-on-year profit growth in the second half of the year. This rate of increase will be difficult to achieve in an environment where margins are being squeezed by higher interest rates, commodity prices, and labor costs. It's hard to imagine stock prices making much headway when earnings estimates are still coming down.

But pockets of opportunity are beginning to appear. International shares, which have long underperformed their U.S. counterparts, in particular look overly discounted. And for those with a long time horizon, today's prices look far better than they did six months ago.

THE GREAT DEPRESSION AND POST-WAR RECESSIONS

Length and severity of recession



Bubble size reflects the severity of the recession, which is calculated as the decline in real GDP from the peak qtr. to the trough qtr. except in the case of the Great Depression, where it is calculated from the peak yr. (1929) to the trough yr (1933), due to a lack of available data. Past performance is not a reliable indicator of current and future results.

Source: *JP Morgan's Guide To The Markets; NBER; U.S. data are as of June 30, 2022.*