thoughts

FROM HANSON+DOREMUS

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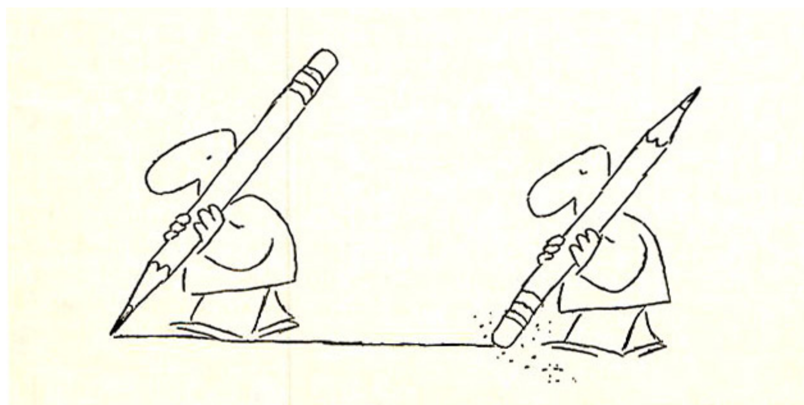
HANSON+DOREMUS
INVESTMENTS AND PLANNING

"Growth comes with chaos, not order"...

Rakesh Jhunjhunwala (1960-2022)

I pay attention to final articles by departing financial columnists. These pieces always cut through the chaff and get right to the kernels of truth that the writer has learned over the years. Buttonwood is the financial column in *The Economist*. Buttonwood refers to the tree where trading was originally transacted on Wall Street.



Source: World Press Review, June 1996, Kandler/ La Nacion/ San Jose, Costa Rica

In July, the writer of Buttonwood (*The Economist* is one of those publications which does not identify its writers) posted her (or his?) final column. What had she learned over the years? In a nutshell, "…there is nothing new on Wall Street." We quoted Fred Kelly, the author of *The Psychology of Speculation* (1930), back in our June letter, "The game is old, but the players are always new." The rhythm of the market never changes. Wall Street is like a pendulum, swinging between hope and greed at one end and doubt and fear at the other.

And we are very "herd like." When I started in the business back in 1972, everyone was chasing the "one decision" growth stocks, companies like Kodak, Xerox, and IBM. They were expensive but it did not matter; their growth was so predictable that even if you paid too much, you would get bailed out as the company posted much higher sales and earnings in the future.

More recently, we have had the "meme-stocks." Remember GameStop, AMC theaters, and Robinhood? Their stock prices soared on hopes that their fortunes might improve or that another investor (a greater fool?) would come along to pay an even higher price. Get onboard now before it is too late! Well, it didn't work.

Rakesh JhunJhunwala is known as the Warren Buffett of India. He started investing with very little in 1985, but by the time he died earlier this year he had amassed a fortune of $6 billion. He traded with some of his money, but his real secret was his steadfast faith in the long-term growth of India and the Indian stock market. He held tight through the ups and downs of the market. His patience paid off with amazing long-term results.

In 1972, when I was just out of college, the Dow Jones Average finally climbed above 1000. Little did I know it would be another 10 years before the market would cross 1000 and never look back. We had a painful decade of stagflation, sky-high interest rates, raging inflation, and little growth. But persistence and faith in the U.S. market paid off. Today, even with a possible recession looming and the market off for the year, the Dow is still over 32000. Big gains for the long-term investor. So be like Mr. Jhunjhunwala – stay the course.

- Eric Hanson

Hanson+Doremus Investment Management is an investment counsel firm managing portfolios for individuals and institutional clients.
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GLOBAL INVESTING

By Eric Hanson

Is China investible?...

This is the question *Barron's* posed recently (10/30/2022). Over the years, China has been a frustrating puzzle not only for foreign governments but also for investors. Look at the growth of the country since 1981 (*chart below*). How could such rapid growth not translate into great returns for investors? Well, growth has not equaled investment profits. The MSCI China Index, which includes 85% of Chinese equities traded in China, Hong Kong, and on foreign markets, has made no real progress since 1990. Some investors and mutual funds have produced positive investment returns but nothing like the growth in GDP.

As usual there are opposing sides to this story. The positive take is, eventually China will mature and be a solid place to invest. China is the world's #1 manufacturer. It accounts for 20% of our total imports. It has developed world class alternatives to Visa and Mastercard with Alipay and Tencent Pay. Consumer income has grown dramatically, and China is the leading buyer of high-end status goods. So just bide your time, say the Bulls.

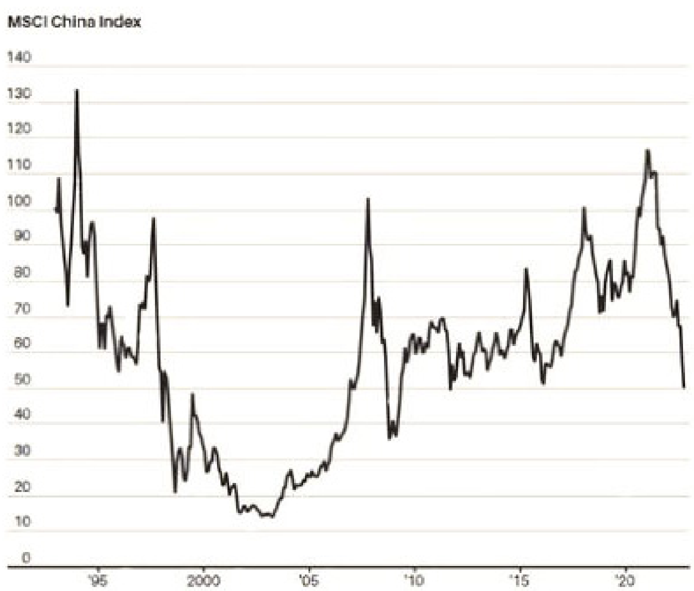
And while you are waiting, just remember how cheap Chinese equities are. Price-to-earnings ratios today are lower than at any time the past decade.

But the Bears say this is all hopes and dreams. China has shifted dramatically under Xi Jinping and this will continue to with his reappointment to another five-year term (and possibly reappointment for life). The newly configured Standing Committee of the Politburo, all Xi loyalists, is not likely to shift towards favoring private business and investors. Xi has chosen ideology over economics. He sees the private sector as a threat to the Communist Party, and without the Communist Party, there is no way of holding the country together. Just look at the chaos in Russia after the fall of Communism, he cautions.

Xi today is reemphasizing state-controlled businesses over the private sector, internal security over personal freedoms, and top-down directives over letting markets decide. The old political bargain, that we will let you do whatever you want to make money as long as you do not challenge the authority of the Communist Party has changed. Now the deal is, do not challenge the Communist Party and oh by the way, we will also make the rules for the economy.

CHINA COULD EASILY BREAK YOU

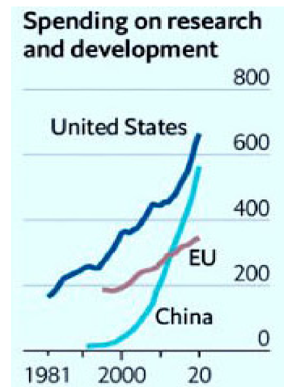
Streetwise: Before being lured into thinking the Chinese stock market is a bargain, consider that it has only sporadically rewarded investors over the past 30 years. With Xi Jinping's unpredictability, U.S. investors risk losing everything.



Source: *Barron's* and *Bloomberg*

CHINA KEEPS GROWING

$bn at purchasing-power parity



Source: OECD, Pitchbook; *The Economist*

We admit we have been guilty in the past of being overly bullish on China. It is such a large and growing market. We are now more skeptical but, like in a fancy restaurant, we are still tempted to at least look at the dessert menu. The Chinese have a saying, "The mountains are high, and the Emperor is far away." There are some sectors of the economy and market that are under the radar and less likely to be targets of government crackdown. One example might be Yum China, the operator of KFC and Pizza Hut restaurants in China. Profitable, and also quiet.

The biggest immediate problem for China is its zero-Covid policy. The economy will be stop and go until zero-Covid is resolved. The government is now making noises about loosening its pandemic policy. Any real change here will be a big positive for the stock market. But we recommend, "Trust but Verify." Wait to see results, don't anticipate changes. Investors have been burned before.

PERSONAL FINANCE

By Art Wright

The yields, they are a changin'...

Inflation is high, currently at levels not seen in over four decades. The Fed's target for inflation to ensure balanced growth in the economy is 2%. Much like Icarus, inflation is soaring way too close to the sun for the Fed to feel comfortable about our economic outlook, and they are moving aggressively to fix it.

The most influential tool the Fed has is the control of short-term interest rates. When inflation is too high, like it is today, interest rates increase to encourage individuals and businesses to change financial habits, essentially prioritizing savings over borrowing.

So, while the Fed is using rates to bring inflation down, what are some smart personal financial decisions you can make now as rates increase? Here we'll focus on how rates impact your savings and the rate you'll pay to borrow money.

Interest rates have been at near historic lows for the past 15 years. While low rates have fueled a strong stock market, they have also meant an anemic reward for those looking to save in short-term liquid investments. The days of earning a respectable return on your safe investments are back!

Here are some tenets of personal finance that should always be followed, especially now that interest rates are higher.

The first is an emergency fund. Everybody should strive to have three to six months' worth of expenses in a separate account reserved for those rainy days. Keep this money in an account not linked to your daily money management needs to decrease the temptation to use it for non-emergency purposes.

Furthermore, if you take regular distributions from your investment accounts, it is prudent to have enough on hand to cover 12 to 24 months of distributions.

Building cash for these two purposes is especially relevant given that the probability of recession in the coming year is increasing. We are not saying a recession is guaranteed but rather we recommend proper preparation. Having safe and liquid assets to get you through potentially difficult times allows longer-term investments (stocks) time to recover while ensuring your short-term cash flow needs are met.

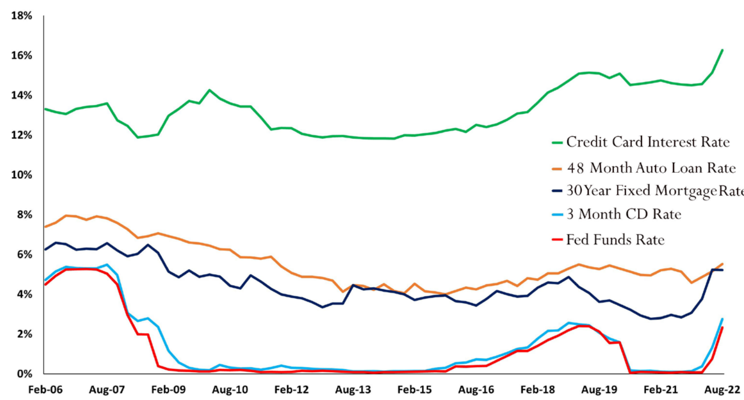
Shop around because not all bank rates are equal. For example, a recent study by nerdwallet.com showed that the average one-year CD offered by a traditional bank was 0.71%, whereas the average one-year CD rate at an online bank was 4.00%. A similar pattern can be seen between rates on savings accounts. So, think outside the bank and know your options.

Also consider a laddered CD or Treasury strategy. You can structure a chunk of money to mature every three months for instance. You can then decide to spend the proceeds or reinvest back into the ladder. This approach gives you the control of a predefined maturity schedule, while earning over 4% on your safe investments.

Now that you are saving more, it's time to talk debt. The same forces at work earning you more on savings are also driving up the cost of debt.

According to the Mortgage News Daily Index, last year the average 30-year mortgage rate was 3.07%. Fast forward to today and that rate stands at 7.21%. To put this in perspective, a $500,000 loan last year would cost you $2,126 per month (principal and interest). Today that same loan means a payment of around $3,397 or an increase of 60%!

RATES ON THE RISE



Source: St. Louis Fed FRED® Economic Data

It's been well documented that cars are more difficult to find today, and cost more. The issue is made worse when financing is required. Much like mortgage rates, the cost to finance has increased substantially over the past year. Unless you absolutely need a new vehicle, it's best not to chase limited inventory and increased finance charges today.

And consider paying off credit cards. Most cards have a variable APR, meaning your rate will go up as the Fed raises rates. According to bankrate.com, the average credit card balance is around $5,500. We advise not carrying a credit card balance past the grace period and signing up for autopay to pay off your balance completely each month, ensuring you pay 0% interest. This matters because, according to creditcards.com, the average credit card rate is 18.94% -- Ouch!

The suggestions here might all seem sensible and obvious, but most people today are not shopping for rates on short-term investments, and many continue to justify incurring debt when making large purchases. The world has changed with rising interest rates. Time to pay attention.

INVESTING FOR THE NEXT DECADE

By Julie Won

Time for a new playbook?...

Old habits die hard, they say, and so it is that investors have struggled to let go of the playbook that triumphed the past decade. Buying the dip in big tech and old favorites worked great in the benign, low-volatility bull markets we had for over a decade. But not this year. Nothing has snapped back quickly or easily, and that has put us in unfamiliar territory. As Dorothy said in Oz, "Toto, I've a feeling we're not in Kansas anymore."

For a long time, investors had the wind at their backs. We had cheap energy, cheap labor (thank you, China), geopolitical stability, and a U.S. regulatory environment perfectly calibrated, almost exclusively, to generating amazing corporate profits. Of course, above all, we had cheap money, and as *the chart to the right* shows, low interest rates turbo-charged household wealth for a decade. We felt rich. Whether the wealth was real or not, it was an era, as bemused *FT* columnist Sarah O'Connor recently wrote, where flush investors subsidized her cheap Uber rides and 15-minute deliveries of chocolate and beer from Getir.

But all that is over. Covid, then war, mucked up supply chains. Inflation went sky high. National security, energy security, and semiconductor security all got intertwined. And reviled energy stocks started topping beloved tech (*see chart below*).

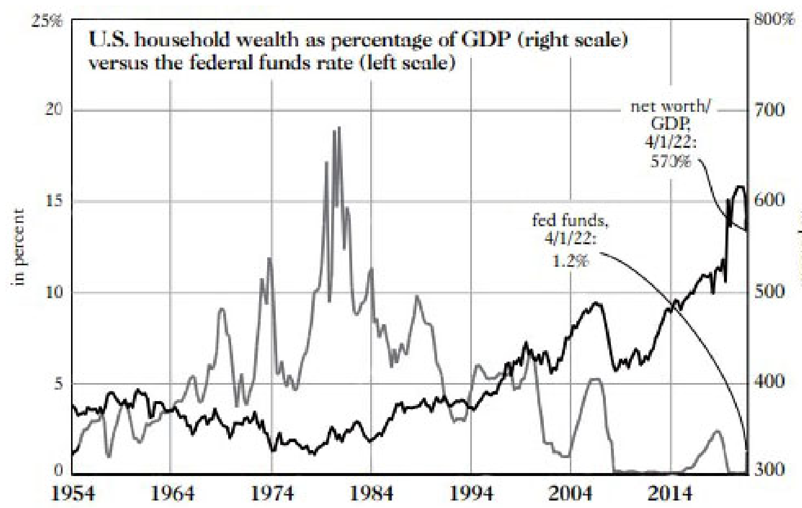
Aswath Damodaran just wrote a long post on Meta -- a mega-META writeup, if you will – where he pointed out that buying Facebook on its first trading day in 2012 at $38 and holding through the end of October at $93 made 144%. That is good, but less than the 181% the S&P 500 made over the same time -- and that doesn't consider the S&P 500's 2% dividend yield.

So how do you invest when you're not in Kansas anymore? For one thing, don't reflexively buy the dip. Investing is going to be a little harder and require some old-fashioned hard work. But the good news is that there are ample opportunities ahead.

One thing we're excited about is that many fine companies will finally get their due as markets refocus on fundamentals like cash flow. We no longer have the tide of low rates lifting all boats, which means that valuation matters again. And while passive indexing remains a sensible strategy for many, opportunities to actively select individual securities look better than they have for years.

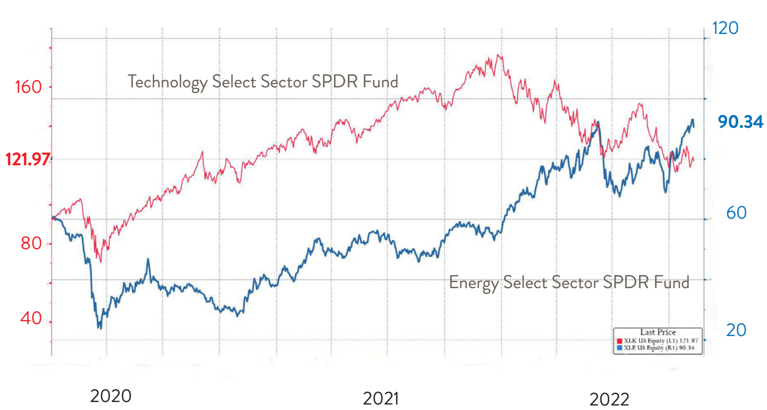
We believe there will be plenty of technology among the winners of the future – but perhaps not from the tech sector alone. Smart *users* of tech, not just makers, could be some of the most exciting companies ahead. Industrials and energy producers – both conventional and renewable – will be among the most tech-intensive. In fact, every company will become a tech company, and those that can better manage enduring supply and labor constraints should generate more cash.

LOW INTEREST RATES DROVE WEALTH CREATION



Source: *Grant's Interest Rate Observer*; Federal Reserve Bank of St. Louis

ENERGY STOCKS OVERTAKE TECHNOLOGY STOCKS



Source: *Bloomberg*

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