thoughts

FROM HANSON+DOREMUS

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HANSON+DOREMUS
INVESTMENTS AND PLANNING

'The night is darkest just before dawn. And I promise you, the dawn is coming.'

Harvey Dent - (The Dark Knight)

In my estimation, *The Economist* weekly newspaper (yes, that's how they refer to themselves) is the single best read for world economics and politics. The newspaper favors centrist governments and has little reporting bias and rigorous fact checking. What they said recently in a front page section on America is both unexpected and encouraging.

- America is in a gloomy mood today. According to *The Economist,* 80% of Americans think their children will be worse off economically than they are. Our problems are many: Unequal income distribution, declining life expectancy versus other developed countries, an inadequate safety net, rising nationalist or anti-immigration feelings, and toxic politics. Readers can name many more problems, I am sure.

- But flip the coin over and you find: America makes up 4% of the world's population and back in 1995, was 25% of the world's total economy. Even after the Tech Crash of 2000 and the Great Recession of 2008, America still produces 25% of the world's total output.

- America has a younger population and a higher fertility rate (although coming down) than other rich countries and has a higher share of immigrants as a percentage of the workforce – 17%.

- America has 30% more workers than 30 years ago (Western Europe and Japan have about 10% more) and America's workers have more college education and graduate degrees.

- The typical U.S. worker produces five times the economic value of a Chinese worker, and more than workers in Japan, Canada, or Britain.

- The five biggest corporate sources of Research & Development are all American. We developed the best-selling electric vehicle (Tesla), the hottest smart phone (Apple), and even the currently most advanced AI entrant (ChatGPT, developed by a non-profit now controlled by Microsoft).

- Income per person in America was 24% higher in 1990 than in Western Europe. Today it is 30% higher.

- America is blessed with size and location. It has no major enemies on its borders, enormous natural resources, and the most liquid and deep financial markets in the world.

PLACE YOUR BETS

MSCI stockmarket indices, total return

1990 = 100

Source: *The Economist; Refinitive Datastream* *At April 12th

- And finally, $100 invested 30 years ago in the S&P 500, the index of America's largest companies, has grown to $2,300 today, four times what it would have earned in other developed stock markets.

We are realists here and don't want to sugarcoat America's problems and the fact that we could easily lose our edge in the future. But it is important at times to step back and see our strengths and not just the darkness in the night sky.

- Eric Hanson

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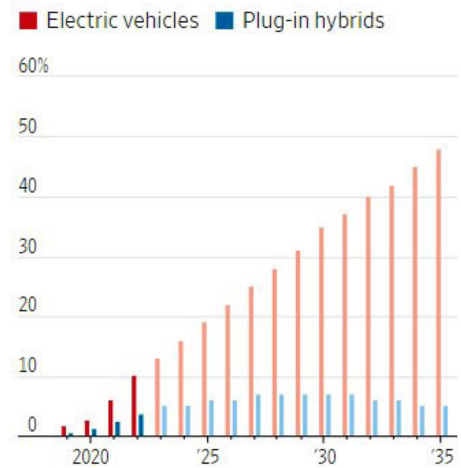
ELECTRIC VEHICLES

By Eric Hanson

“Made in China 2025” accelerates into the passing lane…

In 2015 Xi Jinping announced the “Made in China 2025” initiative. The objective was to move China away from labor-intensive, lower-wage industries to more technology-focused ones.

SHARE OF GLOBAL LIGHT-VEHICLE UNIT SALES



Note: Figures from 2023 are projections.

Source: The Wall Street Journal; Moody’s Investors Service

The Chinese identified 10 priority sectors where it wanted to compete, and dominate. These included semiconductors, aerospace, biotech, AI, robotics, and electric vehicles. Achieving success would mean faster GDP growth and freedom from Western tech company domination.

China over the years has tried to compete in internal combustion engines to little avail. Remember the Hongqi sedan favored by Mao? You probably don’t; it was no world beater.

But electric vehicles are a “clean sheet” proposition. Legacy car makers and newbies alike have to toe the same starting line to prove their products. The Chinese have gotten out of the gate fast. They are already the largest global electric vehicle market (including plug-in hybrids) as well as the largest maker of these vehicles. I think there are four reasons why they may remain out front.

First, batteries are crucial. Lithium batteries account for 40%-50% of the cost of an EV, and if you can increase the power, decrease the weight, and reduce the cost, you are in the driver’s seat. China has six of the top 10 EV battery makers including CATL, which alone accounts for 37% of the global market.

Second, China does not have the “drag” of a legacy car business. Traditional car companies are trying to keep their big profit models spinning money (think the Ford 150 truck) while at the same time transitioning to EVs, all the while doing it with a workforce trained predominately in gas-powered car technology.

Third, EVs are basically computers on wheels. It is easier for tech companies to transition to making cars than for a car company to become a tech company. Chinese EV companies like BYD, Nio, Xpeng, and Polestar are racing ahead in areas like infotainment, ambient lighting, voice controls, and monthly, if not weekly, software updates transmitted directly to a car’s computer.

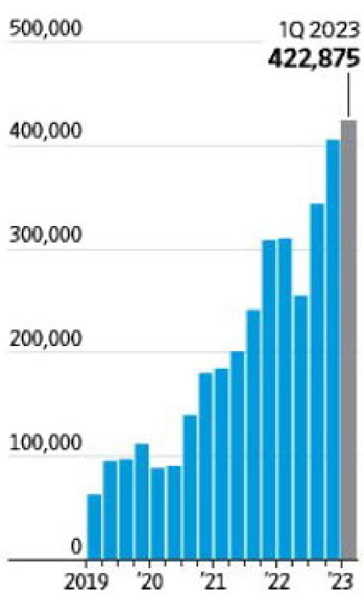
And finally, the Chinese government is supplying subsidies to their car companies faster and more efficiently than governments in the West.

What could derail China’s push into EV leadership? Geopolitics for one. China needs the vast U.S. car market, but China-U.S. relations may prevent this. Protectionism may reign. In addition, car manufacturing is a scale business. With the exception of BYD, Chinese EV makers have to prove they can produce quality models at volume.

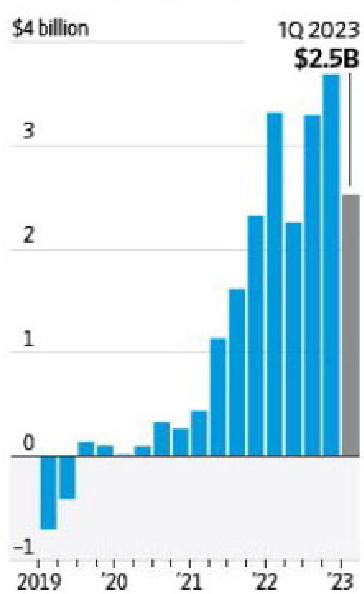
The truly big winner in EVs so far is Tesla. The Chinese are probably its equal in software but not in reputation or sales. The cynic in me sees a China problem for Tesla. China has a long history of inviting in Western tech, only to learn (steal?) their secret sauce and transfer this to local competitors. Forewarned is forearmed.

If the Chinese have benefitted so far from EVs being a “clean sheet” business, others might also benefit. Saudi Arabia, Apple, and Foxconn are all interested in EVs, and all are loaded with cash. And don’t count out the legacy car makers. There are good reasons why they have survived for nearly a century. We are still in the early innings with EVs.

TESLA DELIVERIES



QUARTERLY NET PROFIT/LOSS



Source: The Wall Street Journal; the company (deliveries); S&P Capital IQ (profit/loss)

DEMOGRAPHICS

By Julie Won

The state of U.S. immigration...

U.S. population growth has started edging higher again after hitting an alarming all-time low during the pandemic. According to the latest Census data, from July 2021 to July 2022, the U.S. population grew 0.38%. Admittedly, that's still not great – it's one of the lowest growth rates since 1900. But it's better than the extraordinarily low 0.16% growth we saw during the worst of the pandemic. And one real reason for optimism is that the bulk of the increase came from legal immigration into the U.S., one of our best levers for raising long-term economic dynamism.

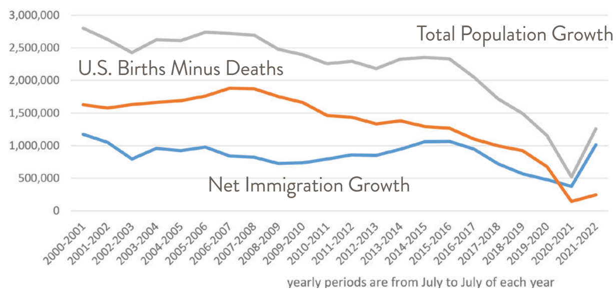
We're still way below where we were a decade ago. Even before Covid, the "natural increase," or the difference between U.S. births and deaths, was declining sharply thanks to both an aging population and falling birth rates after the Great Financial Crisis. While immigration made up for much of the shortfall early in the 2010s, policy changes led to dramatic declines around 2016 (*see chart*). That made the 2010s the second slowest period of population growth in U.S. history – even before Covid brought about excess deaths and crushed migration and birth rates.

Since the low point of 2020-2021, there has been a small recovery in births, but deaths have remained elevated as Covid has stayed with us. It's the recovery in the third element of population growth, immigration, that has been the star of the story. According to William Frey of the Brookings Institution, immigration brought in a million additional people last year while the natural increase, or the difference between births and deaths, added just 245,000.

Immigration matters. Economies need to replenish people as both consumers and workers at an adequate rate, especially as the population ages. Of the three things that affect population – births, deaths, and immigration – immigration is the easiest to manage through policy. Finally, in our current world, where job openings exceed workers, immigration can positively impact labor market and inflation dynamics. Rana Foroohar of *The Financial Times* recently cited a study by the San Francisco Fed that found the sharp drop in immigration after 2017 led to a 5.5 point increase in the ratio of job vacancies to unemployment.

U.S. POPULATION GROWTH

(number of people added)



Source: Data from William Frey, Brookings Institution; chart from Hanson + Doremus

According to the Migration Policy Institute, the U.S. still is home to more immigrants than any other nation in the world. Spanish still is the most spoken second language, but there's also a rich array of other languages being spoken (*see the map*). Finally, immigrants have similar income and education levels to native-born Americans – though newer arrivals are better educated (with a higher percentage with bachelor's degrees compared to native-borns).

Immigration proponents like pointing out that immigrants start a quarter of the nation's businesses even though they make up only 13.6% of the population. *FT* columnist Foroohar says immigrants are risk takers who foster business expansion and alleviate bottlenecks.

Of course, not everyone sees immigration in a positive light – it also can be complex and controversial. But in a world where birth and death rates are hard to control, immigration looks like our best shot at managing the daunting demographic challenges ahead.

MAP OF MOST COMMONLY SPOKEN LANGUAGES OTHER THAN ENGLISH AND SPANISH BY STATE, 2021

Notes: Chinese includes Mandarin and Cantonese, Dakota + includes Dakota, Lakota, Nakota, and Sioux; French includes Cajun; German includes Pennsylvania Dutch and Swiss; and Tagalog includes Filipino. Sources: Migration Policy Institute; MPI analysis of data from the U.S. Census Bureau 2021 ACS for the United States.

U.S. BANKS

By Mark Andrews

What we learned about U.S. banks from first quarter earnings...

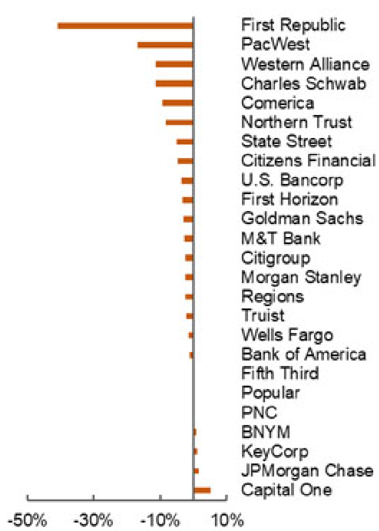
With the banking crisis and collapse of Silicon Valley Bank (SVB) in March, and now First Republic, we were anxious to take a look at the recently reported first quarter bank earnings. The following is a brief summary of what we learned.

1. Deposit flows were not straightforward.

Deposit flight—a bank run—is ultimately what doomed SVB, and this was our first chance to get a bank-by-bank look at how others fared. It turns out, deposit flows were not that straightforward. Most banks experienced deposit outflows, but many pointed out that the declines had little to do with panicked behavior and were roughly in line with projections. Deposits had already been leaving banks as customers looked for higher-yielding alternatives. Money-market mutual funds have seen large inflows as they are able to increase their yield along with the Fed's rate hikes (*see chart, above right*).

Of course, some banks experienced much larger outflows (*see chart, below*), and the stability of deposits seemed to be influenced by many factors including the type and location of its clientele, the diversity of its services, the size of the institution, its asset mix, and the share of deposits that were uninsured (above the $250k FDIC limit). As Bloomberg's Matt Levine explains, deposits are technically short-term funding for a bank in that they need to be paid out to customers on demand, but in practice they are often treated as long-term funding because of the banking relationship and the hassle of switching accounts. What we are learning is the extent to which deposits are short-term and sensitive to information, or long-term and insensitive to information in the current environment. Thus far, it seems, it depends on the bank.

% CHANGE IN DEPOSITS, Q4 '22 TO Q1 '23

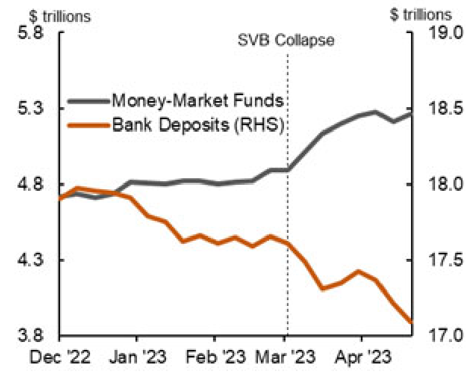


Source: *The Wall Street Journal*

2. Bank profitability has declined.

Current conditions are not permanent, but for now, bank profitability is being squeezed. Banks are earning relatively little on the loans they issued and securities they bought at low fixed interest rates during the pandemic, while they are increasing what they pay to depositors as the Fed raises rates. Additionally, withdrawn deposits have had to be replaced by other, more expensive sources of funding, in some cases including the various—and expensive—liquidity facilities offered by the Fed and the Federal Home Loan Banks. In the extreme case of First Republic, Marc Rubinstein, who writes the Net Interest newsletter, found that they went from funding almost entirely from deposits that cost them 1.4%, to around half their funding coming from these official facilities that cost them around 5.0%.

COMMERCIAL BANK DEPOSITS AND MONEY MARKET FUND HOLDINGS



Source: *Investment Company Institute, FRB H.8*

All the while, they earned just 3.7% on their loan and securities assets.

3. Commercial real estate remains a concern.

Q1 also showed an increase in "provisions for credit losses," or money banks are setting aside in case a loan they've made defaults. The increases were primarily driven by commercial real estate (CRE) loans, given changing office-use dynamics and how expensive it is for borrowers to refinance at higher rates. CRE loans are more highly concentrated at the small, regional banks, and there is some concern about how CRE could pose an additional challenge to these already beleaguered banks.

Beyond those three themes, the main thing we learned was that it is hard to generalize about banks, especially in this environment. There is a lot of nuance related to size, business model, market, funding mix, and asset mix—all of which play a role in the bank's ability to weather the storm and its profitability going forward.