

## I'm Sorry, I Didn't Catch That...

**W**e may be losing business to the rest of the world but in one area we are still king – language. When it comes to global communication the lingua franca is very much English. Americans can't really take credit for this of course since it is the English who are the originals here. And even the English may be hard pressed to take credit since the English of the global world is more what you might call “globish,” how an Argentine might communicate with a Chinese when they meet in the transit lounge in Dubai. It is estimated today that there are

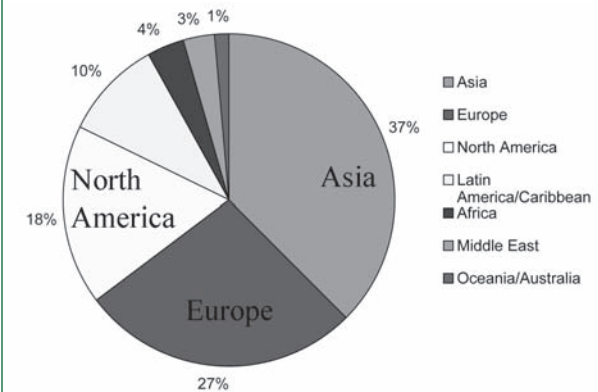
more exchanges in English between non native speakers than native speakers. English has proven itself very malleable in the global world. A lot of what passes for English today includes foreign words, phrases, even whole sentences that make up Chinglish (Chinese English), Singlish (Singapore) and even Indian English (Hinglish).

The upside to being the home of the dominant global language is we can put our feet up and make people come to us. We do not have to learn their language. But this advantage is also a weakness. The more the rest of the world gets fluent in English the less valuable native speakers are who know only English. Even if our mother tongue is the default language of business and travel, global businesses are looking for all-around multi language employees.

China seems on course to be numero uno in many areas today. Will Mandarin Chinese eventually overtake English on the world stage? Possibly but not likely

### World Internet Users

(March 2008)



Source: *When China Rules The World*, By: Martin Jacques; The Penguin Press 2009

anytime soon. Even among Asian neighbors like Japan there is still more pressure to learn English than Chinese. If Mandarin is going to play a greater role as a world language the first place it will show up is the internet. There are now more internet users in China than in either Europe or the U.S. (see chart above). For businessmen dealing in Asia there will be pressure to learn Chinese for no other reason than to keep up on the internet. But keep in mind that Mandarin is REAL difficult, on par with Japanese, Korean and Arabic. Rather than learning Mandarin most Americans will pray for greater strides in computer translation technology.

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### Breaking The Language Barrier In Japan

#### Rakuten

- The online retailer plans to make English its “standard” language by March 2012
- Documents, meetings, even cafeteria menus, are in English

#### Nissan Motor

- Moved to make English common language after entering into alliance with France's Renault in 1999
- Meetings are held in English if non-Japanese staff are present and documents are written in English if non-Japanese staff are copied in

#### Sony

- No official policy, but many top-level meetings and emails are in English
- Potential managers expected to score at least 650 out of 990 on Test of English for International Communication

Source: *The Wall Street Journal*

# It's Still About Risk and Return...

**We are in such a manic investment environment today what with the economy on a knife edge between growth and no growth.** One week the stories are all about slipping back into recession and then the next week when the figures are a bit better, the stories are about how growth is finally taking hold.

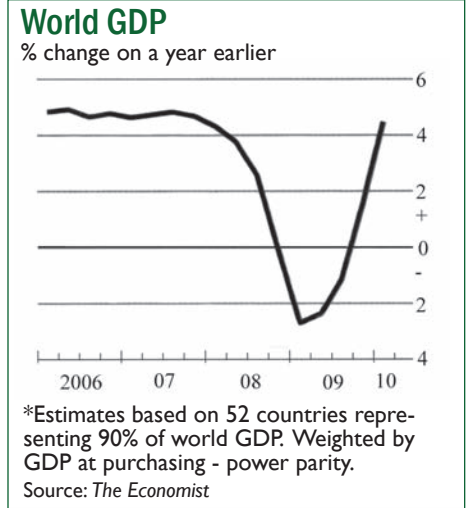
Most recently the stories have been all on the negative side as investors worry about recession and the possibility of a Japanese experience where we go down and just can't pick ourselves back up. The winning investment strategy here is U.S. government bonds. When prices fall for an extended period, interest rates also fall and this means good returns for bonds. And if you want the safest of bonds you buy U.S. governments. I realize there are those who question whether U.S. government bonds are really that safe what with our enormous budget deficit but in the land of the blind the one eyed man is king so speak, and for better or for worse today, U.S. government bonds are still top of the heap.

The problem with governments however is yields are at rock bottom levels. The five-year Treasury note yields 1.5% and the ten-year, 2.7%. It wouldn't take much inflation to turn these rates into losing propositions. But Americans are glass half empty folks right now. We are looking at a persistently high unemployment rate (see Anne Doremus' page) and are not about to take a lot of risk in our portfolios. But it might just be that what looks like a lot of risk now is actually not that much. For instance the large multinational Blue Chips in the chart to the right have a significant amount of sales outside the U.S. Global growth is bouncing back today (chart in the upper right) and large American companies are taking advantage of this selling all

over the world including the fastest growing emerging markets.

Many multinationals have attractive dividend yields which are as high as or higher than the 10-year Treasury. And whereas Treasury notes pay a fixed rate for the life of the bond, corporate dividends can go up. Of course I realize they can also go down (General Electric is a case in point) but the fact is that many multinationals have increased their dividends impressively. The U.S. consumer price index is up 27% since 2000. Many Blue Chips have increased their dividend 10x this rate.

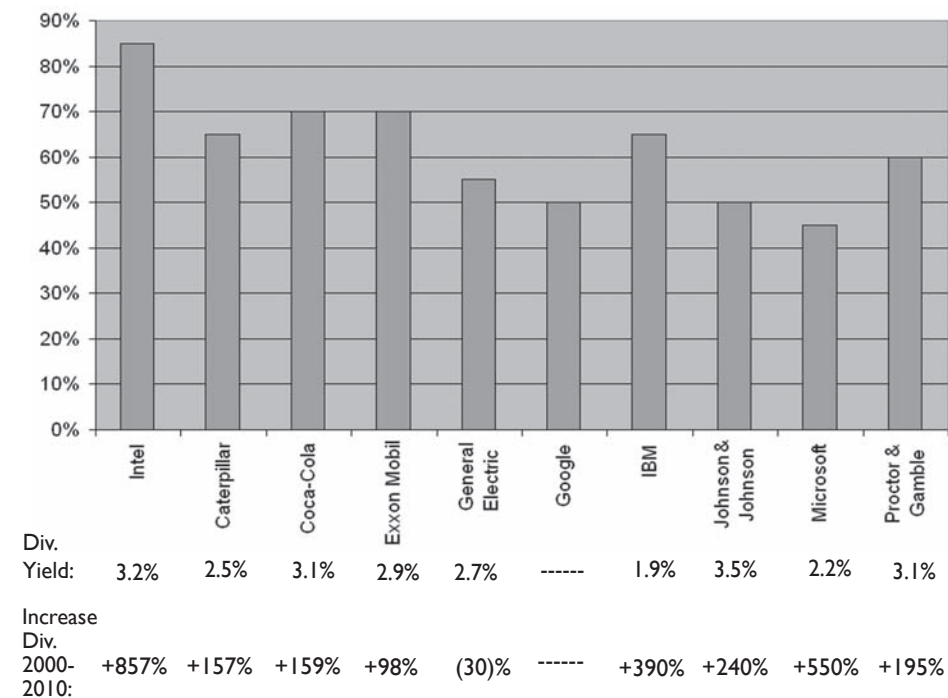
The point is not that the ten stocks listed here are the be all and end all. The point is that it is easy to get scared today and assume you can take no risk at all. The bigger risk might be missing out on the global growth of the next five to ten years. We are not in a boom economy to be sure but it is likely we will see slow and persistent growth here and abroad for some time. This means higher corporate sales and earnings and higher stock prices. Many



solid companies with long track records and steady performance are selling at very cheap valuations today. It's worth asking, where is the better return the next ten years, in a ten year Treasury yielding 3% or a diversified portfolio of solid companies with growing earnings and dividend yields equal to or greater than bonds? I think you can tell where I am coming down on this. Buy fear, sell greed as they say.

## Sales Abroad Drive U.S. Companies

International revenues play a significant role for a number of the largest companies based in the U.S. Add to this a dividend yield and a rapidly increasing one at that, and U.S. Blue Chips look like solid long term investments.



Source: Washington Mutual Investors Fund; Hanson & Doremus

# Home Of The Red Ink...

You may not realize it but chances are that if you take out a mortgage today the lender you work with will probably end up selling your loan to someone else. These days most mortgage loans are sold to the government-sponsored entities, Fannie Mae and Freddie Mac. In fact, nine out of every ten new mortgage loans are backstopped by these institutions as shown in the chart below. Fannie and Freddie bundle your loan along with thousands of others and sell them to private investors. These are referred to as mortgage-backed securities.

Why should we care? Because Fannie and Freddie stand behind the mortgage backed securities they create and sell, meaning if you default on your payments they still make good on the principal and interest to investors. And since Fannie and Freddie are “quasi” government entities, we the tax payers are in effect standing behind the mortgage market. As you might imagine, this could get very expensive.

Fannie Mae and Freddie Mac were created in 1938 as part of President Roosevelt’s attempt to stabilize the

housing market. They buy mortgage loans from banks and the banks in turn take the cash they receive and make more loans. The idea is to promote homeownership and make it easier for lower-income families to get their part of the American dream.

No one thought much about Fannie and Freddie until the late 90’s when politics entered the picture in a bigger way. We won’t point fingers but pressure was applied to make mortgage loans even more available via less strict underwriting standards. Both the Clinton and Bush administrations deserve blame here.

Sub prime lending became an art form with ever more creative ways to reduce the down payment and make the monthly costs more affordable. The one thing no one counted on was a severe drop in housing prices. By 2008 however things were rapidly unraveling. Many of the risky loans were turning sour as housing prices did indeed plunge and eventually Fannie and Freddie were put into government conservatorship. Both have gone from “quasi” to complete government vehicles. Standards for underwriting new loans have increased considerably since 2008 and it seems that the bleeding from new mortgage purchases has been staunch. However, the sub prime loans made in 2006 and 2007 still account for 25% of the agencies total portfolio and losses here are still significant. Fannie Mae and Freddie Mac have already absorbed \$148 billion in government funds to cover their obligations to investors.

The question now is what to do with the two entities? The recent Dodd-Frank Financial Legislation which has been touted as the most sweeping financial reform measure since the Great

## House Proud

Government mortgage-market support

	Mortgage insurer	Security guarantees	Government-sponsored enterprise
Australia	X	X	X
Britain	X	X	X
Canada	√	√	X
Denmark	X	X	X
Germany	X	X	X
Ireland	X	X	X
Japan	X	√	√
Netherlands	√	X	X
Spain	X	X	X
US	√	√	√

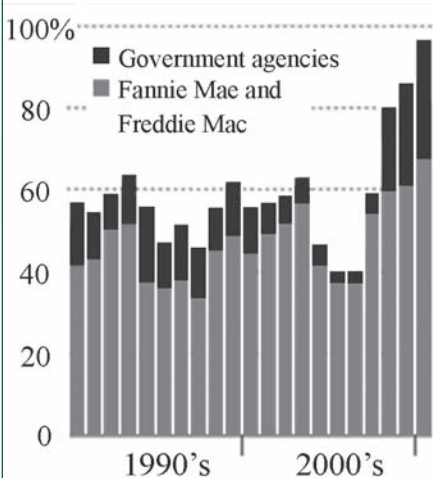
Source: “Alternative forms of Mortgage Finance”, by Michael Lea; *The Economist*

Depression barely even mentioned Fannie and Freddie. No one knows exactly what will be done but within the next year something will have to be hammered out. Conservatives would like to see the government completely out of the mortgage packaging business. Spin Fannie and Freddie off and let the private sector deal with bundling mortgages and guaranteeing them. Others argue that the private market is incapable of fulfilling the role of GSE’s. Government subsidies must be maintained to make housing affordable to moderate and lower income individuals. Where you stand definitely depends on where you sit on this one. You can argue quite persuasively from any number of angles.

One point that is persuasive to us is that a number of other Western countries have approximately the same level of home ownership as the U.S., that is about 2/3 of the population but without extensive government involvement. Canada is one where home ownership is higher than here but there are no layers of GSE’s. Encouraging home ownership is a worthy cause but you have to ask is it worth the price we are paying? When all the dust settles it will not be AIG, Citigroup or GM that costs us the most. It will probably be Fannie Mae and Freddie Mac.

## Public Housing

Share of the mortgage market that is backed by the government\*

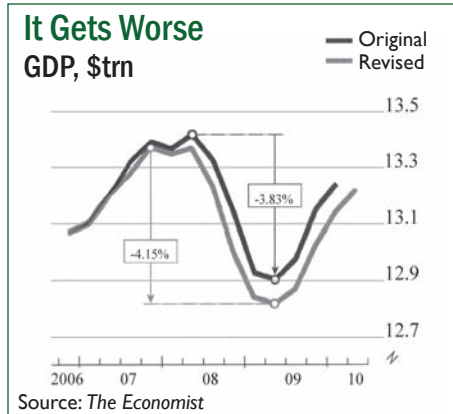


\* 2010 through the first quarter  
Source: *Inside Mortgage Finance*; *The Wall Street Journal*

# It's The Job Market, Stupid...

The U.S. economy has rebounded nicely over the last year. Corporate profits have recovered a stunning 87% of what they lost in the recession and most companies are in fine financial shape sitting on over \$800 billion of cash at the end of the first quarter. Why then do we feel so glum?

The chart below illustrates the cause for our national angst. Despite the impressive rebound in corporate fortunes, companies are simply not hiring. The unemployment rate hovers around 10% and if you include part-time and discouraged workers, the rate is closer to 17%. It is quite common for job growth to lag a pick-up in economic activity as businesses typically wait to see if the recovery is permanent before



changes in the structure of the U.S. economy.

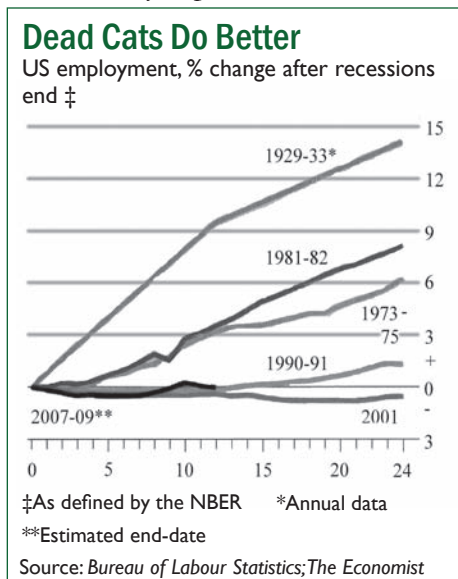
Those in the “temporary” camp point to the fact that recoveries in the housing and construction sectors have historically helped pull the U.S. economy out of recessions. This time around however firms are not hiring due to unparalleled levels of overbuilding. Once the inventory of unsold homes gets soaked up, they argue, new jobs will follow. The almost complete financial sector melt down in 2008-2009 also gets some blame. Many CEOs today, having survived a period when banks cut off the lending spigot, are extra cautious in deploying cash reserves on expansion initiatives. Finally, many complain that greater regulatory uncertainty is thwarting expansion efforts. These issues, while concerning, should not permanently impair the nation’s ability to create good-paying jobs.

Those in the “structural change” camp argue that America is simply no longer creating the kinds of jobs the global economy needs. The rise of stock-based compensation schemes are considered partly to blame. These wide spread approaches to pay fuel a bias toward profit boosting short-term cost cutting initiatives over longer term expansion efforts. Others claim that heated competition from imports

and a growing immigrant work force have weakened the ability of unions to defend high paying jobs. More convincing, is the well documented rise in labor costs here in the U.S. Thanks to escalating health care and other benefit costs, businesses have been increasingly substituting capital equipment for labor (see chart below).

Whatever the cause, it is clear that recovering previous employment levels will take time. Consider the math. The U.S. lost around 8.4 million jobs in 2008 and 2009. The economy needs to create at least 100,000 jobs per month just to keep pace with new workers entering the market and this past July a mere 71,000 jobs were added.

But the picture is not entirely negative. The good news is that we are no longer losing jobs and in 2010 so far, private employers have added around 560,000 new positions. Many of the companies now hiring are benefitting from strong growth outside the U.S. And as a place to do business, the country still has many advantages including a well-established legal system and protections for property rights. Thanks to relatively open immigration policies we are experiencing population growth and maintain a respected system of higher education. The bottom line however is job growth today is going to take years not months to recover.



committing to new hiring. But fewer Americans are working today, a full year into the recovery, than when the recession ended in mid-2009. Compared to previous downturns, the pace of the current job recovery is unusually slow.

The anemic ongoing job reports have most economists scratching their heads. Some believe the job drought is only temporary and due to the specific nature of this last downturn. More ominously, others believe it is due to longer term

