

You Are Flying Where, On What?..

Some of us of a certain age grew up flying internationally on the great early leading American and European airlines. Names like Pan Am, TWA, BOAC (British Overseas Airways or sometimes better known as, "Better on a Camel"), Swiss Air and KLM. Not much is left of these today.

The long haul international airline business is about to embark on another major overhaul and some new names will rise and a number will fall. To understand all this you had better bone up on your Middle East geography because this is where three of the fastest growing airlines

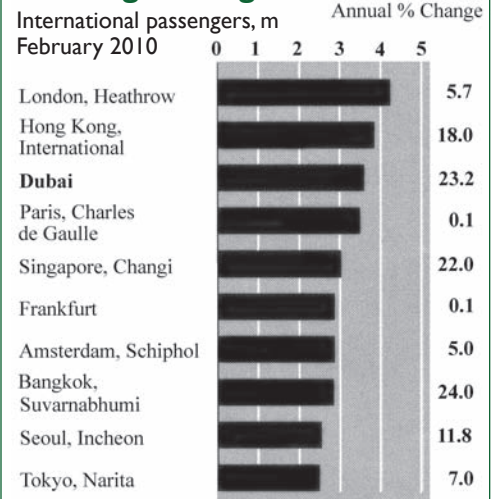
are. The United Arab Emirates (UAE) is a federation of 7 absolute monarchies intricately linked through a common governing body. The UAE sticks out into the Persian Gulf with Saudi Arabia to the South and Oman to the East. Dubai is part of the federation and home to the largest Middle East airline, Emirates. Abu Dhabi is another Emirate and home to Etihad Airline. And close by is a third, separate country, Qatar with its fast growing airline, Qatar Air. Got all this?

The UAE is at a crucial 'pinch point' between East and West. *The Economist* reported recently that 2 billion people live within four hours flying time of the Gulf and 4 billion live within seven hours. In the next five or six years the three Gulf airports of the UAE and Qatar will have more capacity than Heathrow in London, Paris Charles de Gaulle and Frankfurt combined.

Gulf region governments are using air travel as a development tool to bring business and tourists to the region. Emirates in Dubai is the largest customer for the Boeing 777 and these planes can now link the region to any two big cities on earth, non stop. So the next time you fly you may very well find yourself transiting through Abu Dhabi, Dubai or Doha.

It remains to be seen whether the Mideast bet on an exponential expansion of airline capacity will turn out to be a boon or a bust. The region is the largest customer for the new enormous Airbus 380 that can seat upwards to 500 passengers but there are reports that some of the purchase contracts are under pressure. Emirates, Qatar

Climbing the league



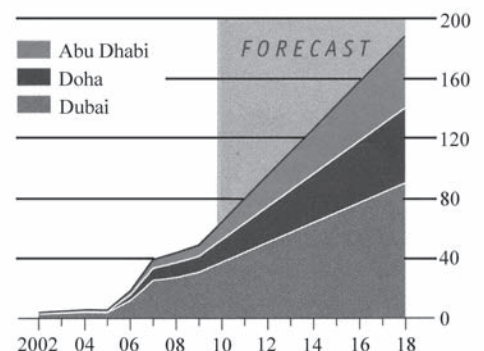
Source: Airports Council International; The Economist

and Etihad may have bitten off more than they can chew right now. There is probably no turning back however and the UAE is going to be a major hub for anyone flying between Europe, Asia and Africa.

The two things that life never runs out of are chocolate recipes and interesting places to visit. So the next time you are off on a world adventure, try an airline you have probably never heard of, transiting through a place you probably can't locate on a map.

Changing places

Capacity at Gulf hubs, passengers, m



Source: Air Transport Intelligence; airlines' forecasts; The Economist

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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.

Wealth Beyond The Dreams of Avarice...

The recent strikes and wage increases in China have gotten a lot of press. One of the big contract manufacturers for iPads and iPhones, Foxconn has just boosted wages 20% to 100% in southern China after a series of wildcat strikes. Other strikes and big increases have occurred at auto parts makers tied to Honda, Toyota and others.

The initial thought is these wage jumps are bad for inflation here in the U.S. since China is the manufacturer to the world and any increase in their costs means an increase in ours. And a second concern is that China's competitiveness will decline and this means a slowdown in employment which means a slowdown in their rapid growth.

We see mostly positives to the recent events not negatives. First, what is happening in China is the same thing that happened in Japan after World War II and later in Korea, Taiwan, Singapore, etc. Countries

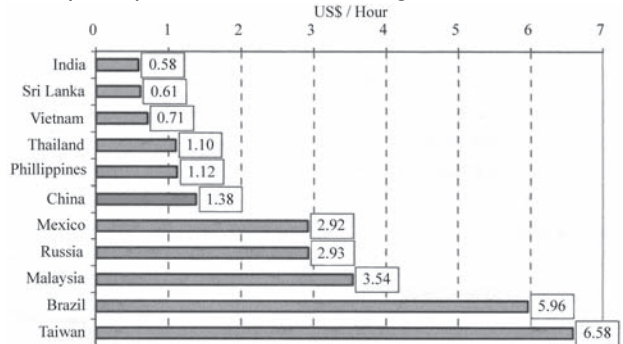
develop, costs and income rise and the lowest value added products get more expensive to make and production moves to lower cost countries. Japan, Korea and Taiwan all moved up the value chain without giving up employment (people get retrained to do higher value things) or income. Now the transition is starting in China and this a positive. Yes, they will lose some employment to Bangladesh, Vietnam and other places but consumer income will rise and this means more sales for both Western and Chinese companies.

Will these wage increases cause big inflation in the U.S.? Not necessarily. Take for instance the iPhone where the full price might be \$300. Chinese labor accounts for less than 3% of this. That's right,

just 3%. The big costs are for the super sophisticated chips made by Samsung in Korea, Toshiba in Japan, Broadcom in the U.S. and Infineon in Germany. As the saying goes, "the value goes to where the knowledge is." The big profits in high value added products are at the front end,

China vs. Other Developing Countries:

Hourly Compensation for Manufacturing Workers



Compensation = wages + supplementary benefits; all data as of 2007; Vietnam data is based on average income while Thailand data is based on average wages.

Source: Morgan Stanley Research CEIC, IMD World Competitiveness Year Book 2009, U.S. Department of Labor, Bureau of Labor Statistics.

the design of the gizmos and its components and the back end, the marketing, brand building and retailing. The costs in the middle, like the Chinese employees putting everything together, are not that significant.

Another way to look at the effects of the wage increases is that China's middle class will grow more rapidly than previously expected and its development will get spread out more evenly. Foxconn workers are not the highest paid workers in the country but their spending will ripple through the economy helping everyone. Also the higher wages in south China and along the coast will spur the migration of manufacturing to western China where pay is 20% to 40% less. Foxconn's next major manufacturing hub is going to be in Zhengzhou in Henan Province in the center of the country.

The growth of the middle class in emerging countries is the big long term gamechanger of globalization. The recent wage increases in China are pushing us along that much faster. Good news.

Minimum wage rates by province, 2010:

Relative to Shanghai (%)



Source: Financial Times; Credit Suisse

“Today’s Common Starting Point is Pessimism”...

This from Robert Samuelson in *Newsweek* recently. His point is we are living in a world viewed as a glass half empty. Not since World War II has a recovery been hobbled by so much poor confidence. The reasons are not hard to find. We have lost about 8 million jobs since December 2007 and it doesn’t appear they are coming back anytime soon. And after a quick start the recovery is slowing now and housing is forming only a saucer bottom at best. Any meaningful recovery here is probably years away. The media is picking up on all this gloom. *Bloomberg Businessweek’s* cover of June 14th featured a growling Bear and the headline, “Grrrrr! What we can learn from the endless pessimism of Wall Street’s biggest bears”. Hard to

make headway when suspicion and pessimism are the norm (see chart to right).

It is interesting however that many pundits are talking the opposite tack. *Newsweek* had a piece April 19 titled, “The Comeback Country – How America Pulled Itself Back From the Brink – and Why It’s Destined to Stay on Top”. And Joseph Quinlan an economist well worth reading and now Chief Investment Strategist at U.S. Trust wrote an Op Ed piece in *Barron’s* (June 7, 2010) titled, “Go Long America”.

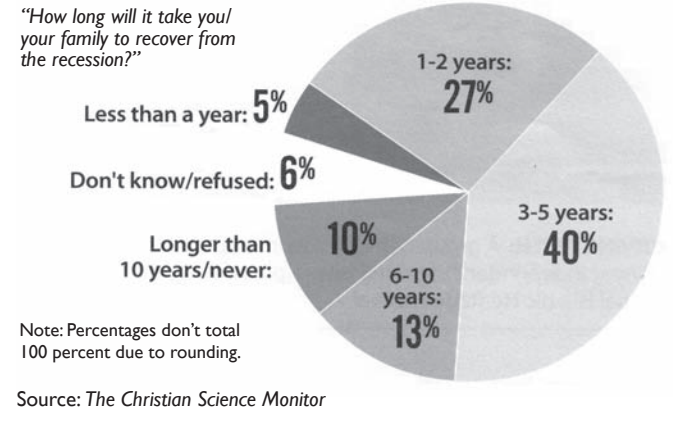
The case for a stronger U.S. starts with the fundamentals. The U.S. with only 4% of the world’s population is still 25% of global GDP. The emerging markets of Brazil, Russia, India and China have increased their share of world output from 7% to 15% since 1995 but it has come out of the hide of Europe and Japan not the U.S. Japan has seen its share of world GDP plummet from 18% to 9%.

And what about export competitiveness? Quinlan points out our share of global manufacturing output has fallen from 22% to just over 17% since 1990. But if you factor in sales of services such as data processing, accounting, medical services and telecommunications, the U.S. is still the largest exporter in the world, topping Germany, 10% to 8½%.

The key to long term GDP growth is pretty simple. If your workforce is growing and those workers are producing more

Many Americans see long recovery period ahead

A recent survey showed 48 percent of Americans say their household financial situation is worse now than before the recession. Here’s how that group answered this follow-up question:

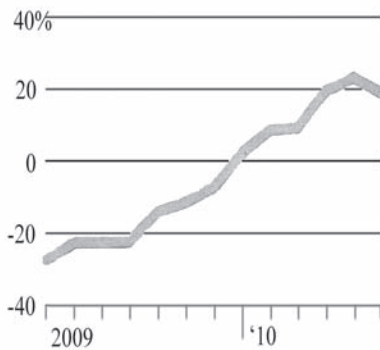


widgets per hour then you are going to see rising GDP. America is relatively well positioned here. Our birthrate is about at replacement levels and when you add in legal immigration you have a growing workforce. This is not the case for much of Europe and Japan. Even China will see its workforce start to shrink in the medium term due to its one child family planning policy.

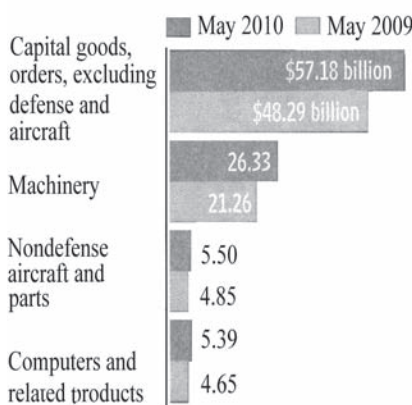
Productivity in the U.S. has been surprisingly strong this cycle as companies have cut costs even faster than declining sales. This is not a great long term solution but companies today are looking at very strong balance sheets and the ability to fund capital spending which is starting to pick up (see chart at left). Some pundits see a ‘New Normal’ for the U.S., characterized by slow GDP growth, a focus on debt reduction and only tepid gains in corporate profits. We are betting on a stronger outcome. Yes, sluggish job growth and a weak housing market are stiff headwinds but a growing world economy will present opportunities for U.S. companies both large and small. And then there is the positive effect of entrepreneurial activity which is not insignificant. Take a look at the glass again. It is not hard to see it as half full.

On The Mend

Year-to-year change in nondefense orders excluding aircraft



Manufacturers’ new orders



Source: Commerce Dept.; *The Wall Street Journal*

Mayhem in Muni Land...

Twenty plus years ago, I started in the investment business analyzing credits like the City of Worcester or the State of Connecticut. I was glad to have this job in the depths of the 1981 recession but it was not exactly exciting work. With few exceptions, municipal finance was pretty straightforward stuff. Towns, cities and various municipal authorities issued debt to pay for long term projects and raised taxes or fees to pay them off. Bond defaults were rare. In fact, the historical cumulative 5 year default rate for investment grade municipal debt remains a miniscule 0.03% compared to 0.97% for corporate bond issuers.

While no one is expecting municipal bond defaults to reach the same level experienced by their corporate brethren, credit quality in the sector is deteriorating. Since last July, 180 issuers have missed interest payments on some \$6 billion of bonds. And unfortunately this period of weakening credit quality is happening at the same time that investors are pouring money into the sector - at last count \$1 billion a week.

So what has changed to make this once sleepy sector the latest area of concern? *As the chart below shows*, over the last fifteen years,

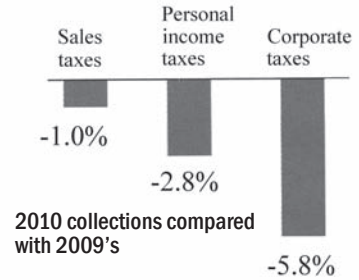
municipal debt issuance has surged. In the face of low interest rates and generally strong economic growth, municipal entities issued bonds to fund an increasingly diverse array of projects. In addition to the standard road and water treatment upgrades, tax-favored funding was used to pay for new dorm facilities and baseball stadiums. Unfortunately, the economics of many of these projects made sense only if tax revenues and user-fees kept rising.

Not surprisingly, the economic downturn is hitting municipalities hard. Declining real estate values, the chief revenue source for most, is lowering property tax collections while higher unemployment and falling corporate profits are hitting personal income and corporate tax receipts. And in the face of declining revenues, demand for services from Medicaid to unemployment insurance, is rising. Federal stimulus funding to the states has stemmed much of the red ink recently. But as these funds dry up, municipalities are looking to cut budgets and raise taxes. Unfunded pension liabilities which have exploded as a result of insufficient contributions, generous plan provisions and poorly performing investment markets, are also wreaking havoc on municipal budgets.

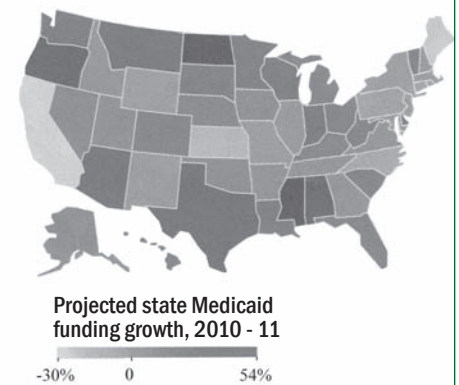
While some states are faring well, North Dakota and oil rich Alaska come to mind, most are under

pressure. Further belt tightening will not be easy. Much spending such as debt payments is fairly fixed. And sacrosanct programs such as K-12 education and Medicaid make up

States' primary sources of income are down...



...and their costs will be rising in areas like Medicaid



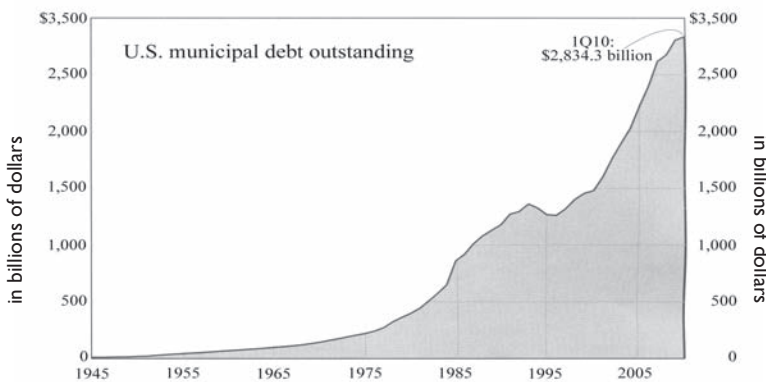
Source: Time Magazine; The Fiscal Survey of States

approximately half of all general fund spending.

So what is a municipal bond holder to do given the rather dismal state of affairs? First, remember that municipal issuers are somewhat unique. Unlike businesses, states and many of their municipalities cannot declare bankruptcy. Also, states cannot be sued by creditors and many constitutions force the repayment of debt. Second, all states (except ironically Vermont) are required by their constitutions to balance their budget each year. This provision has forced state governments to close over \$400 billion in cumulative budget gaps over the last four years.

Municipal finance is going to continue to be a struggle. Further budget cuts are needed and taxes and fees will go up. But it is important to remember that municipal credits, with low default rates, high recovery rates and lower financing requirements, are relatively safe when compared to corporate alternatives.

Money Good?



Source: The Bloomberg; Federal Reserve