

## How China Gets Things Done...

**C**hina recently halted its exports of rare earths. The move seems to be targeted mostly at Japan a country China has had an ongoing spat with over territorial waters. Rare earths are not something people are very familiar with. But the 17 rare earths are crucial to the production of many products including lasers, disk drives, rechargeable batteries and wind power turbines.

Rare earths are not actually that rare. China has 35% of the world's reserves and produces 95% of the world's output. Lots of other countries however have reserves but for one reason or another have

shut production down. The U.S. for instance has one rare earths miner, Molycorp which closed its production site in Mountain Pass, California over environmental issues. With the problems in China and the jump in rare earth prices it is now trying to re-open the facility but you can imagine the process will be long and arduous due to regulatory and legal roadblocks.

China moves at a completely different speed (i.e. faster) when its national interest is at stake. In the case of rare earths the Beijing leaders are probably thinking, why maximize production (and generate a lot of pollution) to help our foreign high tech competitors when instead we can keep production here at home and nurture our own younger companies.

Now to another example of where China operates at its own speed and with its own rules: In 2007 polysilicon prices soared ten fold in a year. Polysilicon is the main raw ingredient for solar panels, an area where China is eager to grow. Forced to pay high prices to foreign suppliers Beijing declared domestic polysilicon a national priority and within fifteen months Chinese companies were producing one quarter of the world's total output.

Another example: Bullet trains were first developed by the Japanese

and then the Europeans. China has wanted to develop its own high speed train network and in 2004 signed a deal with Kawasaki (Japan) to buy trains and then later to assemble them in China. The deal was so big Kawasaki was forced to transfer valuable train technology to China.

Within five short years China has turned around and "re-innovated" the Japanese product and is competing with Kawasaki offering its own cheaper bullet trains. The Chinese claim they took Western technology, improved it and are offering their own new design. Western companies who often refuse to be quoted for fear of angering their Chinese customers say the Chinese are simply re-packaging Western technology after making some small cosmetic changes.

In any case whether it is bullet trains, solar power, wind power or electric car batteries, the Chinese are moving quickly to dominate all the new technologies. And they are getting there with awesome speed. I still think globalization is a win/win not a win/lose proposition but it is sobering to see how successful China has been taking 'capitalism' and stamping it with its own 'socialist characteristics.'

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### Beijing's State Capitalism Playbook

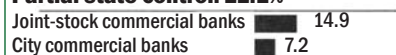
China's government retains control over the levers of the financial system

Share of banking system assets at the end of 2009

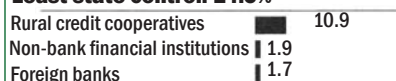
**Full state control: 63.4%**



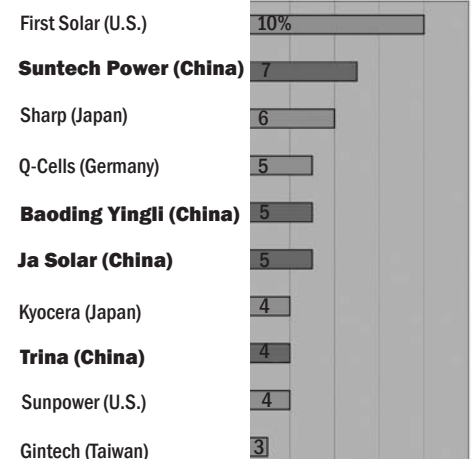
**Partial state control: 22.1%**



**Least state control: 14.5%**



China has aggressively sought green technology  
Market share of top 10 solar manufacturers, 2009



Source: *The Wall Street Journal*

# What the Worries Are Today...

**This summer the big issue was deflation.** The worry was the economy was weak and getting weaker and prices would actually start falling and the economy would slip back into recession.

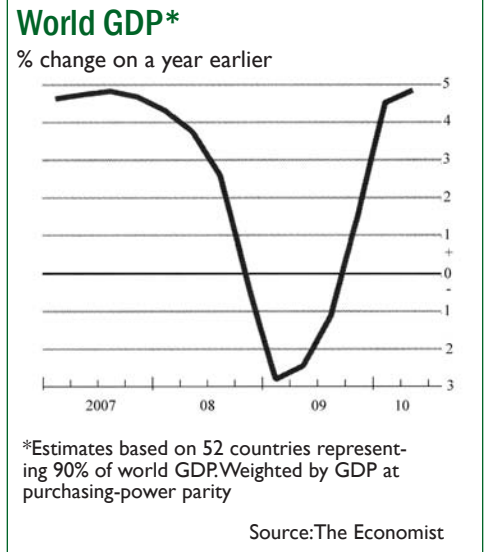
Now things look different. The stock market has been on a mini tear since September and the implication is that folks don't expect a double dip recession anytime soon. Inflation however is now **Worry #1**. The U.S. economy is growing at a moderate rate today but this rate is not enough to do much about the two big problems, high unemployment and the still weak housing market. The optimists say just give the economy some time. It will begin to put on jobs and the housing market will begin to clear from all the foreclosures clogging the sales channel. The pessimists say forget it, a steadily plodding economy is not enough. We need Quantitative Easing (QE II) and a shot in the arm and Mr. Bernanke has taken note and is looking to buy \$600 billion of Treasury debt which should drive interest rates down even further and give banks additional reserves to lend.

The problem is many pundits and foreign observers see QE II not so

much as help to the economy but as additional fuel which when eventually lit will lead to much higher prices. And this means higher interest rates and eventually a sinking stock market. The bond market has bought into this and has actually retreated (rates have risen) even as the Fed has started buying more debt.

Recent Consumer Price data does not show inflation as any immediate problem. Over the past year the CPI has increased only 0.6% the smallest annual increase since record keeping began in 1957. But a lot of consumers are shaking their heads. Look at the increases in energy or many food prices or commodities they say and you get a completely different picture of prices (*see chart below*).

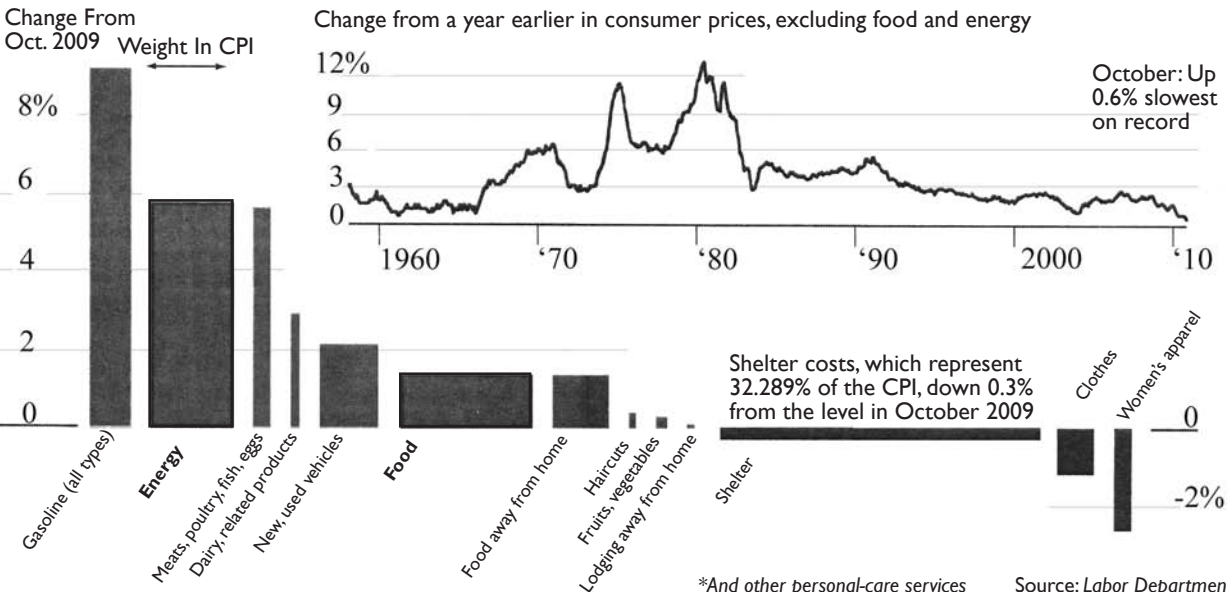
Our take is that we are not going to see a big jump in prices any time soon nor a big a big jump in bond yields. What we are going to see however is what might be called 'biflation' or inflation in some sectors and flat or declining prices in others. The world is set to grow this year and next (*see chart at top*) driven by rapid growth in emerging countries. Prices of things that emerging markets need like oil or iron ore or coal will possibly see price



increases but prices of services that are not traded in global markets or prices of consumer products sold predominately in the U.S. and Europe and where demand is still weak, will stay well under control. If we can continue to get rising corporate profits combined with balance sheets stuffed with cash on the one hand and low inflation and moderate interest rates on the other then the world will be a manageable place. Higher inflation is not at the top of our worry list right now.

## Core Inflation Slows to Record Low, but to Consumers Prices Still Feel High

Consumers feel the pinch of prices that are climbing faster, like gasoline, and overlook other prices that are declining, or rising modestly. Bars with black outlines show major areas of spending, such as energy, which encompass related subcategories, such as gasoline.



# The New Investment Vehicles...

**The market for ETFs has exploded over the past decade.**

As you can see in the chart at the bottom, today there are over 1,000 ETFs to choose from and over the past 12 months, total assets invested in ETFs have jumped by over 30% to reach just shy of \$1 trillion. ETFs are not only used by individual investors but also by hedge fund investors and day traders. Currently, ETFs account for 25% of the volume on the U.S. stock exchanges.

Exchange-traded funds, or “ETFs,” are investment funds similar to mutual funds, but you can buy and sell ETFs during the trading day just like stocks, versus mutual funds which are purchased at the end of the day. The structure of an ETF is somewhat complex but essentially ETFs are passively managed baskets of securities structured into a “fund” whose assets are looked after by a custodian such as State Street or BlackRock. When an investor buys shares of an ETF, the trade occurs through a market maker who is an approved dealer of the particular ETF. What’s different from a mutual fund is that investors do not have any direct contact with the fund company. Market trades of ETFs by individual investors have no effect on the holdings of the ETF basket. When market makers run out of shares of the ETF, they simply buy shares of all the underlying securities of the ETF in the market and provide them to the ETF manager in

exchange for new shares of the ETF to be given to investors.

The benefit of ETFs is that it provides investors with diversification and often lower operating costs and with more trading flexibility than a mutual fund. It also provides investors with exposure to different facets of the global market including emerging markets, industry sectors, and the commodities market.

But there are risks...such as market volatility, performance tracking error, ETF shutdowns and over-concentrations to name a few. Having said that, there is a place for ETFs in investors’ portfolios. The key is not to get overly excited about the latest and most dynamic ETF options and to focus on the core strategies for diversification. ETFs work best when they provide us with sector or geographic diversification with broad-based index-tracking portfolios. A good example of this is an ETF that tracks the international developed markets index known as the MSCI EAFE index.

The more exotic the sector, the more volatile the ETFs will be due to the lack of liquidity in the underlying securities they own. Broad-based index ETFs can serve as core long-term positions in your portfolio. Market-focused ETFs or industry sector ETFs can be used as add-on pieces to your portfolio in an attempt to add value. More exotic structures include currency ETFs,

commodity ETFs and leveraged ETFs.

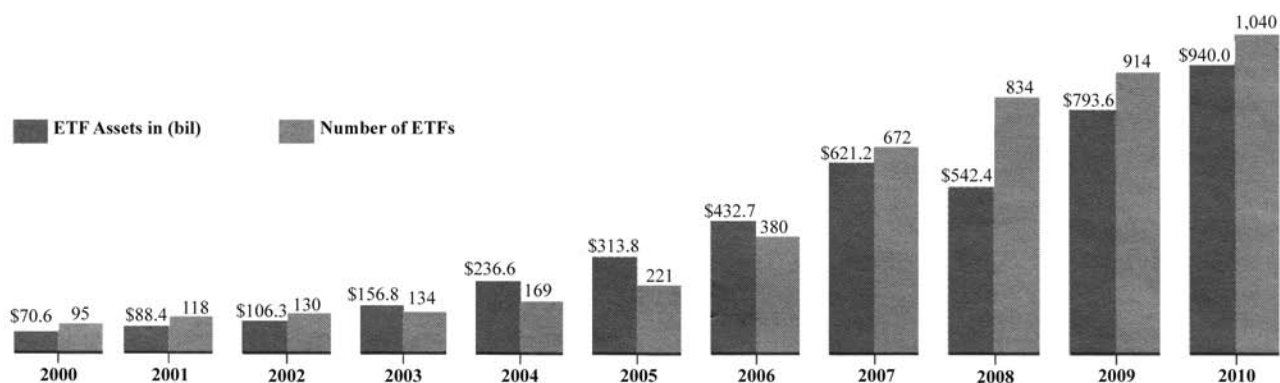
Some investors believe the prevalence of ETFs has made it easier for larger investors to short shares of stocks, adding to the volatility in the market. Some of the more exotic products are purely meant for day traders and hedge funds to provide a hedge for their core positions and as such, some ETFs have more shares sold short than are actually outstanding. While this may seem like a risk, there are restrictions in place which prevent a failure posed by this scenario.

Commodity ETFs are examples of funds that are more complicated than simply holding the underlying asset. They actually invest in “futures,” or derivatives that forecast potential prices of commodities in the future and as a result, the performance of these ETFs doesn’t track the underlying commodities well.

Even more controversial are the leveraged ETFs, which are designed to move two to three times the daily change in their underlying indexes by utilizing financial derivatives. The tracking error here is pronounced and the funds have in some cases not done a good job for investors. Despite the risks in ETF investing, broad-based market index ETFs have had success and have tracked their respective indexes well. As with any investment, it helps to do your homework and understand the structure and visibility of the ETF before investing.

## A Booming Sector

More than 1,000 exchange-traded funds exist, covering everything from emerging-market stocks to energy to U.S. blue chips and Treasury bonds. Through October, ETFs pulled in a net \$89 billion in assets this year.



Source: Barron's, Blackrock; Bloomberg

\*Through Oct. 31

# The Road (Blocks) Ahead...

**T**here is no shortage of opinion today on how to cure the economy's ills. Many argue that a lack of jobs is the real issue. Address this problem, they say, and it will be smooth sailing from then on. Others disagree claiming that housing is the root-cause of the current economic malaise. While this debate may seem esoteric, any effective policy response to the current economic downturn must start with an understanding of the interplay between job creation and housing.

The importance of jobs is easy to understand when you consider that consumer spending drives two-thirds of our nation's economic activity. Increase employment and you not only boost consumption but you put a dent in the level of home foreclosures. But housing's central role should not be ignored. Historically, recoveries in the housing and construction industries have helped pull the U.S. out of recession. And structural changes to our economy make a healthy housing market even more important today. Historically, American workers spent the majority of their careers at one or two jobs. Under these circumstances, owning one home for a long period of time made sense. But today, an average worker can expect to hold 7-10 jobs over their career. As a result, owning

a home that you cannot sell now has real economic costs. According to a recent IMF study, between 0.5% and 1.5% of the nation's current 9.6% unemployment rate may be due to workers' inability to sell their homes.

While achieving a sustained housing recovery will go a long way to improving the economy, this will be no easy task. Over long periods of time, real estate has produced returns in line with or slightly above inflation. But in the early part of this decade, a combination of low interest rates and easy lending policies created a bubble of epic proportions (*see chart above*). After adjusting for inflation, real estate prices have fallen by about a third from their 2006 peak. And while there has indeed been a recovery over the last twelve months, concerns are mounting that the upward trend in prices may be waning.

So what will it take to get real estate prices moving steadily upward? Today, over 11 million homeowners owe more on their mortgages than their properties are worth. With no "skin in the game," this group is increasingly foreclosing on their homes. Dealing with this massive wave of foreclosures is proving difficult even under the best of circumstances. Creative solutions, most of which involve some form of direct or indirect

government funding, include loan refinancing to forgoing principal. But today we are not operating under the best of circumstances. There are growing concerns that in the rush to process millions of mortgage loans, financial institutions produced shoddy loan documentation. Thanks to paperwork flaws, everyone along the chain of ownership from mortgage originators to mortgage bondholders is having a hard time determining who owns what. And without a clear understanding of title transfer, creditors cannot foreclose and lenders cannot initiate refinancing options however creative. Fortunately, as the *chart to the left* shows, our housing problem is very much a regional one. In Arizona and Nevada over half of mortgages are "underwater." But prices are rising in some areas of the country. In our own Burlington, Vermont, the median price for sales of existing homes rose 18% in the recently completed third quarter. Communities such as Boston and Los Angeles too continue to see generally upward trends in both sales and prices. The problems remain largely focused in the Sun Belt states of Florida, Arizona, Nevada and California. A broad economic upswing will not be possible until the foreclosure mess is unraveled and the housing market recovers in these key markets.

