

MARKET LETTER

MARKET PERSPECTIVE



SECOND QUARTER 2014

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Founded in 1975, Ferguson Wellman is a privately owned registered investment advisory firm, established in the Pacific Northwest. With more than 650 clients, the firm manages \$3.9 billion that comprises union and corporate retirement plans; endowments and foundations; and separately managed accounts for individuals and families with portfolios of \$3 million or more. In 2013, West Bearing Investments was established, a division of Ferguson Wellman, that serves clients with assets starting at \$750,000.

INVESTMENT EXCELLENCE
LIFELONG RELATIONSHIPS



BACK ON TRACK

by George Hosfield, CFA
Principal, Chief Investment Officer

Although the investment car has struggled much of the year to shift out of neutral, U.S. equity markets are now driving apace to match the 10 percent-type “average” annual return we envisioned at the beginning of this year. What has surprised us is that stocks have reached this point in the road amid falling interest rates. We believe that the Fed’s ongoing albeit tapered purchase of Treasuries, geopolitical risks in Eastern Europe and the Middle East, and surprisingly low sovereign debt yields in Europe help explain this circumstance.

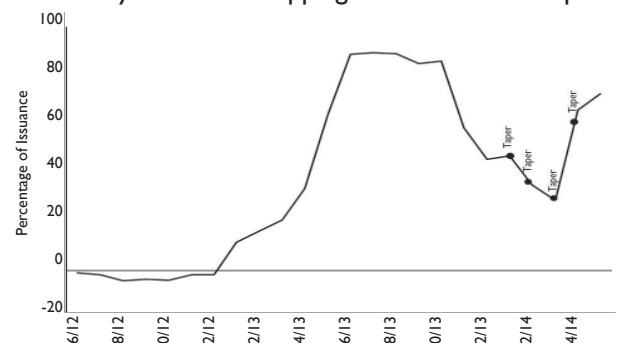
In this environment, longer duration bonds and interest-sensitive equities, such as utilities and REITs, have outperformed. Benchmark 10-year Treasuries are now trading with a yield nearly half a percentage point below where they began the year. However, following the inclement weather that blunted the economy’s pace, yields have begun to increase in tandem with encouraging payroll growth, manufacturing expansion and retail sales growth.

Recognizing the improvement in key economic indicators, the U.S. Federal Reserve has continued to reduce bond purchases and remains on track to complete its program of quantitative easing by this fall. With the end of QE in sight, investors are now contemplating when the Fed will begin to increase interest rates, as well as how quickly the federal funds rate may rise. Timing of the Fed’s first rate hike and the cadence of future increases will depend upon the tenor of incoming eco-

nomics data in general and the inflation outlook specifically. Geopolitical unrest has put a risk premium into oil and housing prices are on the rise, helping push headline inflation to the 2 percent level targeted by the Fed. That said, we do not expect inflation to become a problem. Continued slack in the job market, generationally low labor force participation rates and productivity gains should keep unit labor costs in check and negate the need for aggressive rate tightening.

The Fed is the Market for Treasuries

Treasury Issuance Dropping Faster Than Fed Taper



Sources: Bloomberg, Strategas

Looking forward to the second half of the year, we continue to prefer stocks over bonds. In line with our forecast of faster GDP growth and rising interest rates, we are overweight the economically sensitive sectors of financials, energy and industrials, the latter two of which should be beneficiaries of the renaissance in U.S. energy and manufacturing. Aligned with our call for economic growth to accelerate, we remain underweight duration in bond portfolios and continue to prefer corporates to Treasuries.

Everything we hear is an opinion, not a fact. Everything we see is a perspective, not the truth. – Marcus Aurelius



THE "MODI WAVE"

by Dean Dordevic, Principal
Alternative Assets and Portfolio Management

"More governance, less government - toilets before temples."
- Narendra Modi

The election was described as nothing less than a political "earthquake." We're not talking about the stunning primary defeat of the number-two House Republican Eric Cantor, but rather the even more remarkable election of Indian Prime Minister Narendra Modi. Since the British left India in 1947, India's Congress Party has been in power almost exclusively, having governed for all but 13 of the last 67 years. Riding shotgun on the back of the largest voter turnout in India's history (66.4 percent), and for the first time ever, a single party - India's Bharatiya Janta Party (BJP) - achieved a parliamentary majority. In the wake of the fallout from the world's largest election in the world's largest English speaking democracy, *The Asian Wall Street Journal* said, "For the first time ever, India's traditionally left-leaning politics has moved decisively to the right."¹

India, unlike the United States, China, Japan and the European Union, is a country where voters are getting younger every day. India's youth voted for opportunity and growth and an end to the economic sclerosis, statism and rampant corruption of the Nehrus, Gandhis and the once influential Indian Communists. Said Jon Thorn, manager of London-based India Capital Fund, "(Modi) is kind of a Hindu Napoleon, he has a mandate the likes of which nobody has had before, to change pretty much everything. He sees himself - and he has been seen by many - as a historically transformative figure."¹

Modi, the son of a tea seller from one of India's lowest castes, comes from the Indian state of Gujarat where he was credited with working minor economic and political miracles. Modi ran his state of Gujarat with an iron hand while railing against the clumsy central government. Modi was able to cut through India's legendary red tape to allow businesses and factories to grow and expand.² When the government of West Bengal withdrew a request from one of India's largest conglomerates, Tata Motors, to acquire land to build their ultra-affordable car,

the "Nano," Modi personally courted Tata, successfully moving the project, and many jobs, to Gujarat. Canada's Bombardier was able to secure land for an industrial park in a matter of weeks with Modi's help. This was the fastest rollout of a new factory in Bombardier's history. Germany's Duravit AG built a new factory for ceramic tiles and sinks in Gujarat in 2010. Astonished by the speed of Modi's Gujarat government, Duravit AG Managing Director Ashutosh Shah said, "It was a 100-percent corruption-free process. You'd have to experience it to believe it."²

Both the Indian stock market and Indian rupee have moved sharply higher this year in anticipation of a Modi win. On election day, the Indian Sensex pushed through 25,000 to a new all-time high. In U.S. dollars, the benchmark index is now up 21 percent in 2014, its best start in five years, and Asia's top performer. For the very first time, India's stock market has broken into the world's 10 largest, surpassing Australia and even South Korea in total market value.³

Indian Rupee vs. U.S. Dollar



Sources: Financial Times, Thomson Reuters Datastream

Entry into the world's top 10 stock markets is a landmark for Asia's third-largest economy. Prospects for more rapid decision making and approval of stalled infrastructure projects from the central government in New Delhi have led many global investment houses to raise their forecasts for Indian stocks. Rashesh Shah, CEO of Edelweiss, a Mumbai-based financial services group, sees India climbing further up the global market capitalization rankings. "India's markets are going to get much more important globally, and I'd expect them to keep growing (even) faster than the economy as a whole over the next five years," he says.³



India's Market Eclipses Australia



The task before Modi is enormous. India is a country where two-thirds of the population is under the age of 35. To capture India's demographic dividend, Modi must create 10 million jobs per year. This is a pace of job creation that's four times the rate of recent years.⁴ Voter expectations are so high that should a corruption scandal emerge during his watch, all bets will be off.

Cleaning up corruption and igniting growth will be huge tasks in a country the size of India. Modi's critics point out that since his big election victory, his new government hasn't announced anything specific to achieve his lofty goals. To cement their victory, the new government will need to show exactly how it hopes to reduce inflation, dramatically improve India's decaying infrastructure and boost economic growth which is now at its slowest in a decade.⁵

There is perhaps no country on the planet that has reaped more transformational change from the birth of technology and growth of the internet than India. Indians view education with an intensity usually reserved for only the most devoutly religious. Yet for India, a populous coun-

try that will soon surpass China's 1.3 billion people - the birth of the internet has instantly converted this country of highly motivated, well-educated, English-speaking people into ... *an export*. There exists an almost limitless potential for India and her future. Yet what has been so very sorely lacking is a sound political foundation to accelerate this process. The *Financial Times of London* noted, "Modi's ambition is not to be just another leader ruling for five years. He wants to reshape India's political universe."⁶

Whether this is the start of a new bull market for India or just a very extreme case of post-election euphoria is anyone's guess. But with so many of the former darlings of the so-called "BRIC" countries (i.e., Brazil, Russia, India, China) doing relatively poorly, it's certainly good to see this rather significant - and very positive - change at the margin. With the strength of global growth a seemingly perennial question mark, we can't help but think that *India's earthquake* is good for us too.

So said Martin Wolf in *The Financial Times of London*, "One thing is for sure. India has a new game. Pay attention."⁷

Note: At Ferguson Wellman Capital Management we have direct exposure to India through an investment in a diversified emerging markets fund where India is currently an overweighted position. We also participate in a more concentrated manner through our investments in both an emerging Asia and India focused partnership.

Weapons of Reason footnotes and sources:

1. James Grant, "Upside Breakout on Heavy Volume," *Grant's Interest Rate Observer*, May 30, 2014.
2. Geeta Anand and Gordon Fairclough, "India's Moment," *The Saturday Essay, Wall Street Journal*, May 16, 2014.
3. James Crabtree (in Mumbai) and Patrick McGee (in Hong Kong), "'Modi's Mania' Propels India's Stock Market into World's Top 10," *Financial Times of London*, May 22, 2014.
4. Ruchir Sharma, "A Reagan-Volcker Moment for India," *The Wall Street Journal*, May 14, 2014.
5. Shefali Anand, "Doubt's Mount on India Stock Rally," *The Wall Street Journal*, June 12, 2014.
6. Victor Mallet, "India: Modi's Moment," *The Financial Times of London*, May 21, 2014.
7. Martin Wolf, "India's Election Remakes Our World," *The Financial Times of London*, May 20, 2014.



U.S. ENERGY ... AN AMERICAN SUCCESS STORY

by Shawn Narancich, CFA

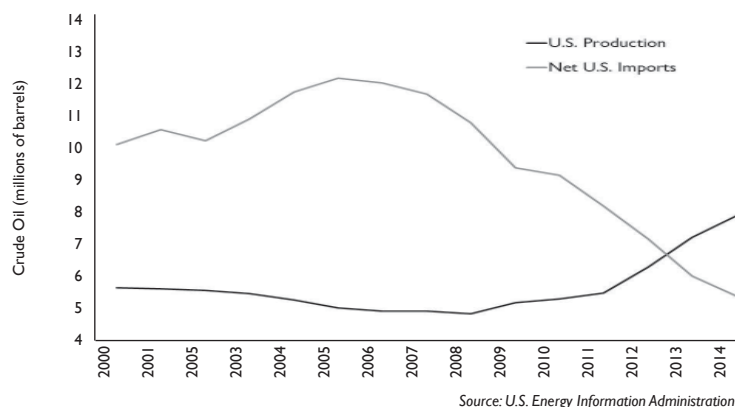
Executive Vice President and Portfolio Management

The ability of American capitalism to spawn solutions to big-picture problems has never been more evident than in the U.S. energy industry, where independent oil and gas companies are rewarding both energy consumers and their shareholders with growing supplies of domestically produced natural gas and crude oil. Natural gas prices of \$4.50/Mcf today are a fraction of the \$13.50 price that taxed the U.S. economy in 2008, and while not as dramatic, \$106/barrel oil today is more than 25 percent below the \$145 price that prevailed six years ago. The high energy prices of 2008 were a contributor to the Great Recession, but amidst those dark days, entrepreneurial capital was flowing to the badlands of North Dakota, bayous of Louisiana and rolling hills of Pennsylvania, helping precipitate a renaissance of energy production that few foresaw. U.S. oil production that bottomed out at an average of five million barrels per day in 2008 is today comfortably above eight million barrels and rising. Natural gas production is also up, with gains limited only by the plummeting price of the commodity (below \$2.00 in 2012) that forced producers to curtail drilling.

Today, a thriving U.S. energy industry owes its success to technologies (directional drilling and hydraulic fracturing) that allow producers to maximize production from basins that were long known to be oil and gas rich, but which had become uneconomical to drill by conventional means. Whether it's the Bakken oil of North Dakota or low cost natural gas from the Marcellus shale in Pennsylvania, producers are capitalizing on the ability to steer drill bits horizontally into the targeted interval thousands of feet below ground. Once the well is cased and perforated, a solution that's 99 percent water is mixed with proppant and injected at high pressure down the wellbore, fracturing the formation and allowing oil and gas to flow. Whereas vertically drilled wells in North Dakota or Texas completed without "fracking" might have initially flowed 100-200 barrels of oil/day in the 1990s, an unconventionally drilled and completed well now commonly produces 10 times as much oil.

Benefits of the U.S. energy renaissance are manifold. As the chart below shows, our dependence on imported oil has waned in conjunction with the surge in production.

A Renaissance in U.S. Energy Production



As well, domestic refineries have boosted their processing of shale oil, producing gasoline, diesel and jet fuel that is now being exported. The net effect is a smaller U.S. trade deficit and faster economic growth. Since 2007, U.S. net imports have declined by 50 percent, with one-third of that improvement attributable to the U.S. energy complex. Labor markets are also benefitting, as energy industry jobs not only pay well, but spawn an above-average level of jobs and economic activity in the surrounding area. Finally, as we observe the turmoil in the Middle East and Eastern Europe, a revitalized domestic energy industry is helping keep a lid on the prices that Americans pay for gasoline, diesel, electricity (which is increasingly generated from natural gas) and home heating (half of which is accomplished by burning natural gas).

At Ferguson Wellman, we recognize the investment opportunities being afforded by the U.S. energy industry, and are accordingly overweight the sector. Our focus is on oil and gas companies that should benefit from reserve development and rising production, with oil service exposure that stands to gain from providing the premium drill pipe and well completion services used by the producers.

Never let the future disturb you. You will meet it, if you have to, with the same weapons of reason which today arm you against the present. – Marcus Aurelius

**EAST AND WEST**

by Elizabeth Olsen
Vice President of Marketing

Bharatiya Janta Party: The second largest political party in contemporary India. The BJP states that their ideology and philosophy is based on “integral humanism,” an idea originally brought forth in a book by the same name which rejected communism and capitalism in favor of attempting to find a “third path” which would ultimately provide a harmonious society by satisfying the needs of the body, mind, intelligence and soul. The party promotes social conservatism, foreign policy based on nationalist principles and self-reliance as stipulated by the Swadeshi movement.

Federal Funds Rate: The overnight interest rate that banks charge each other to meet reserve requirements. The federal funds rate is the most sensitive indicator of interest rate direction since it is set daily by the market.

Gujarat: Known as “the jewel of the West,” Gujarat is a state in the northwestern part of India that is bordered by the Arabian Sea, Pakistan and other Indian states. Gujarat is a religiously diverse state with Hindus, Muslims, Buddhists, Jews and Christians making up the population, but the majority are Hindu. The official language is Gujarati, the native language. Gujarat is one of the major industrial hubs of Indian and is home to some of the largest Indian corporations.

India’s National Congress Party: One of two major political parties in contemporary India, the “Congress,” as it is commonly referred to, has a liberal platform and is largely seen as left-of-center of the Indian political spectrum. According to their website, the INC seeks political, economic and social advancement for

all Indian people by peaceful and constitutional methods.

Indian Rupee: The rupee is the official currency for the Republic of India and its issuance is controlled by the Reserve Bank of India.

Indian Sensex: The Indian Sensex is the abbreviation for the Bombay Indian Sensitive Exchange, the oldest stock index in India. It is comprised of the 30 largest companies in India.

Mcf: an abbreviation for thousand cubic feet. It is a common energy industry measurement of gas volume.

Nehrus: A reference to the Nehru family and Jawaharlal Nehru, the first prime minister of an independent India. The Nehru-Ghandi family is a political dynasty who dominated the Indian political scene for much of the twentieth century. Jawaharlal Nehru was mentored and heavily influenced by Mahatma Ghandi and eventually served as congress president. As congress president, he called for complete independence from British rule and was elected as prime minister.

Proppant: A solid material, such as treated sand or manmade materials such as high-strength ceramic bauxite, that is used to hold fractures open after hydraulic fracturing treatment. Proppants are thoroughly sorted to provide the proper conduit for production of fluid from the reservoir to the wellbore.

The Tata “Nano”: The Nano is a micro-car that was heralded as the most affordable new car in the world. Tata is an Indian company and the production of the Nano was intended to appeal to India’s burgeoning middle class as an alternative to motorcycle transportation.

In an effort to improve clarity and prevent industry-specific terms, we have included these definitions for your information. For additional resources, you may contact us at info@fergwell.com for a copy of our Glossary of Investment Terms or visit our blog at blog.fergusonwellman.com for more definitions.

Communication and Education Sources:

BBC
Business Dictionary
Ferguson Wellman’s Glossary of Investment Terms
Fortis BC
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Wikipedia
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Let not your mind run on what you lack as much as on what you have already. – Marcus Aurelius



FOR INDIVIDUALS: KNOW YOUR BENEFICIARY

by Helena Lankton, Executive Vice President
Wealth Management Committee Chair

We often discuss areas beyond investments to encourage our individual clients to take action on important issues. According to attorneys we collaborate with, clients may be diligent in keeping their estate planning documents current, but may forget the important step of ensuring that beneficiary designation forms are up-to-date. Many of our clients have a significant amount of their wealth in various IRAs that we manage on their behalf. It's critical to complete these forms in a manner that reflects your intentions and takes income tax and estate tax implications into consideration. We can help you start the process and also coordinate with your accountant and attorney.

In the coming months we will be distributing our first wealth management publication, which is designed to cover topics beyond investment management in greater detail. Our first focus will be on decisions regarding Social Security.



FOR INSTITUTIONS: WATCH THE SPENDING

by Don Rainer, Executive Vice President
Institutional Services Committee Chair

Policies established by institutions regarding spending is a key component to investment management. The spending policy is a key driver in establishing asset allocation and investment policy. Drawdowns based solely on annual income used to be the norm, but working off of total return is a better practice today. Another best practice is averaging the spending rate over multiple quarters or years to smooth out the market impact on the organization's mission spending.

Trustees are tasked with supporting the mission and their stakeholders. A solid spending policy can help accomplish both. We have tools and experience in this area and we are happy to support our clients in that process.



COMMUNITY LEADERSHIP

In June, Steve Holwerda assumed the role of board chair for the University of Oregon Foundation. This leadership position supports strategic goals for the university's stability and growth. The foundation manages a \$600 million endowment and plays a critical role in the university's funding. Holwerda has also chaired the boards of Portland Business Alliance, Boys and Girls Club of Greater Portland, Elevate Oregon and Lake Oswego Schools Foundation.

Steve is one of seven professionals in leadership positions with nonprofits this year. This past month, Marc Fovinci was elected president of the Rotary Club of Portland. Other employees include: Lori Flexer as chair of the

Friends of the Children Foundation and Helena Lankton as board chair of the Columbia River Maritime Museum. Josh Frankel, senior vice president of West Bearing Investments, is current president of Oregon Club of Portland. Mary Faulkner is in her second year of chairing the Lone Fir Cemetery Foundation and Don Rainer will become chair of the Lane Community College Foundation in September.

Joining boards of nonprofits is encouraged at Ferguson Wellman. As the investment manager for more than 60 foundations and endowments, board involvement gives us another opportunity to understand challenges facing the nonprofit world. Through boards, we also benefit from working with professionals in other industries who may share new approaches to strategic planning and problem solving.

Our logo features a bronze coin of Marcus Aurelius Antoninus, Emperor of Rome from A.D. 161 to 180. According to historian Edward Gibbon, he was the only person in history in which "the happiness of a great people was the sole object of government." Marcus Aurelius was the author of meditations that reveal a mind of great humanity, natural humility and wisdom.