MARKET LETTER

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Twin Peaks

Real estate and energy. Depending on whether you're a consumer or an investor, an owner or a renter - the twin, multi-year bull market in both arenas have made you either very happy or very sad. We also know of no other slices of our world that are as psychologically vexing. After all, when was the last time you got really worked up over the soaring price of either a gallon of milk or a two-by-four? In our minds, there appears to be a profound change at hand for both of these ubiquitous segments of our economy.

Until 2001-2002, we've never experienced a housing boom during a recession in modern financial history. In fact, during most recessionary periods, the housing market does quite *badly*. The explanation as to why it was *different-this-time*, is complex and beyond the scope of this short paper. However, the "Cliff's Note" version is as follows: the new millennium began with a witches' brew of financial pain. First the dot.com and technology sector collapses, then a recession, and finally a global bear market in financial assets. A full blown mutual fund scandal would materialize shortly thereafter - involving some of the "marquee" names in the industry - virtually guaranteeing to destruction of the last vestiges of confidence in paper assets.

The response of our Federal Reserve to all of this turmoil was a massive easing of monetary policy, resulting in dramatically lower interest rates. Short rates reached sub 1 percent levels, and the 10-year Treasury note (at one point) traded just above an astounding 3 percent yield. Many called this *"The Japanese Response,"* in that it was well known that the Fed had studied the deflation in Japan post the collapse of their economy and financial markets. They concluded that Japan's central bank failed to ease sufficiently post the collapse in order to avoid deflation *at all costs.* The Fed would not make the same mistake. The impact of the massive easing of monetary policy on the real estate market was extraordinary. Much as the Fed monetized the rise in energy prices in the 1970s, the Fed's actions would have much the same impact (in this cycle) on the real estate market. As a result, prices soared nationwide, as the Fed had essentially traded a bubble in technology stocks for a bubble in residential real estate.

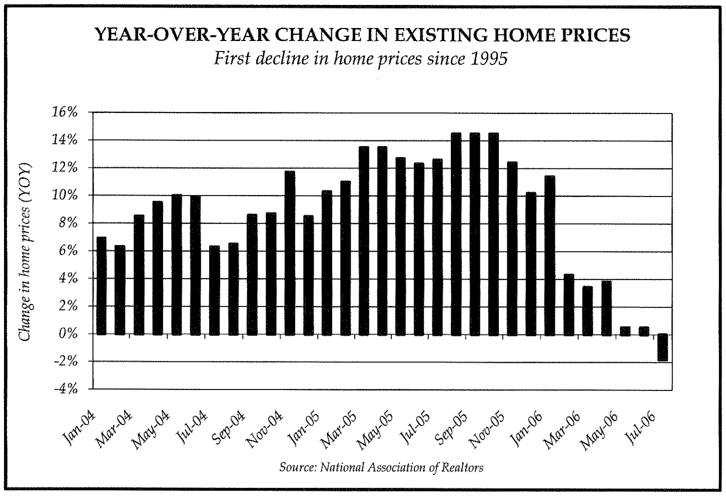
We believe that this bubble in residential real estate is now deflating. In fact, we believe that this decline may be *secular* in nature. As a practical matter, this would mean that prices could decline sharply and may not reach their previous peaks for many years. Or more likely, prices would decline - first extinguishing the speculative excesses - then entering a consolidation phase for an extended period of time. Market equilibrium would eventually be restored as excess inventory is absorbed and supply adjusts to a new level of demand. However, once burned, it will be some time before the "animal spirits" of the speculators return. Therefore, for possibly a lengthy period, returns on residential real estate could be relatively modest.

Evidence of this deflation is now abundant in most geographic markets. In fact, in the most recent reporting period, the National Association of Home Builders market index fell to its lowest level since 1991. Builders are experiencing falling sales, rising cancellations, and increasing inventories. Interestingly, non-prime mortgages were 25 percent of conventional home purchase loans in 2005 versus 12 percent in 2004. Taken as a group, the large publicly traded home builders have walked away from deposits on raw land last quarter. There are even anecdotal reports of buyers walking away from deposits on speculative and yet-to-be-built condominiums.

Tel 503 226 1444 888 Southwest Fifth Avenue, Suite 1200, Portland, Oregon 97204 2026 Fax 503 226 3647

www.fergusonwellman.com

August marked the first year-to-year median price decline since April 1995, and it was the second biggest in the survey's 38-year history.[1]



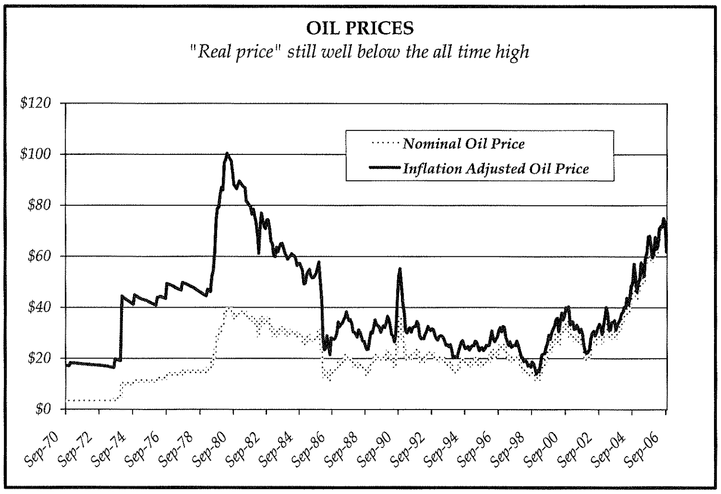
In fact, the data may actually *understate* the order of magnitude of the recently reported price declines. The basis of this belief is that developers are providing incentives to buyers (in the form of free appliances, free trips, paying all closing costs, etc.) that mask the true level of price deflation. Most importantly, the essential questions are: can the residential real estate market deflate in an orderly manner, and what will be the impact of this decline on the economy?

We believe that the national residential real estate market will deflate in an orderly manner. There are four primary reasons for this. (1) Interest rates are still relatively low. While housing affordability has dropped appreciably, for better or worse, non-standard financing will continue to make home financing available to a significant number of Americans. (2) Remarkably, home mortgage equity withdrawals remain at or near an all time high. This is probably more of a developing negative than a positive, but as long as it remains at high levels, the negative economic consequences of a contraction in housing will be deferred. (3) Employment and wage gains are a key underpinning for the residential housing market, and we believe both will continue to advance at a reasonable and sustainable pace. (4) Residential real estate *is different.* People live in their homes. Generally the largest investment that a typical family will make, it is *shelter* after all, and staying warm and dry are powerful motivators to remain current on one's mortgage.

Through diminished employment and consumer spending, even an orderly decline in residential real estate values will certainly impair economic growth. While difficult to estimate, we believe the real estate slump will shave 0.5 percent to 1 percent from the GDP this year through diminished employment and consumer spending. Though painful but not disastrous, we believe the economy will expand by 2.5 percent for the full-year. As a partial counterbalance to negative consequences to a correction in real estate, we believe some relief will come from an *energy market that is also in the process of forming an important intermediate-term top in prices.*

Known as the "Peak Oil Theory," it has provided the intellectual backing for the boom in crude prices and sowed doubts among policy makers about crude's long-term reliability as an energy source. The belief that the Earth is running out of oil is one of many factors supporting energy prices. In early September, a test well (five miles deep) drilled by partners Chevron and Devon Energy successfully pumped crude oil some 175 miles off the Louisiana coast. While the true size of this discovery is not yet fully known, some estimates suggest it may increase our domestic reserves by as much as 50 percent. Although this oil will not reach gas tanks for many years, this find was an important *psychological* wake up call for the energy and commodity markets.

After reaching a peak price of $78/bbl in July (adjusted for inflation, oil reached a peak price of $99.21 in April of 1980) for a variety of reasons, prices have been falling quite sharply of late.



While the bull case is well known, the bear case has asserted itself more recently. In short, we believe that the energy markets have made an important *cyclical top.*

Historically, commodity cycles tend to be notoriously long. In fact, it is not uncommon for a commodity cycle to extend beyond *15 years*. Given the multi-year process it takes to bring on new supply, it is intuitive that these cycles are long-lived.

Furthermore, one would expect new sources of supply to become increasingly *more difficult* to come by over time; if, for no other reason, than environmental concerns becoming more pronounced with each passing day. With this in mind, it is our view that we have reached a *cyclical peak in energy prices.* However, this is occurring within the context of what we believe is an ongoing secular bull market in energy prices. At this juncture, the key questions are: how long will this down-draft last and how do we exploit this as investors?

For the better part of the last three years, we have had an overweight to the energy and commodity sectors. However, over the past few months we have reduced our exposure. We believe that this cyclical bear market in commodities will run its course, but it is *extremely difficult to predict how long it will last.* It could last weeks or months. That said, we watch the energy markets with an extraordinary level of interest, looking for the right *time and price* to again emphasize this sector.

In conclusion, we believe that both the residential real estate market and the energy/commodity markets are in the process of forming cyclical peaks. We expect that the peak in residential real estate prices will be a more long lasting (i.e. secular) problem. However, we think the unwinding of speculative excess in this arena will be reasonably orderly, and that the impact on the national economy will be manageable. We also believe that the bull market in energy is going through an important test of the long-term commodity bull market thesis. Specifically this decline in price is cyclical in nature (in the context of a longer-term bull market in commodities) and ultimately will prove to be rewarding for long-term investors.

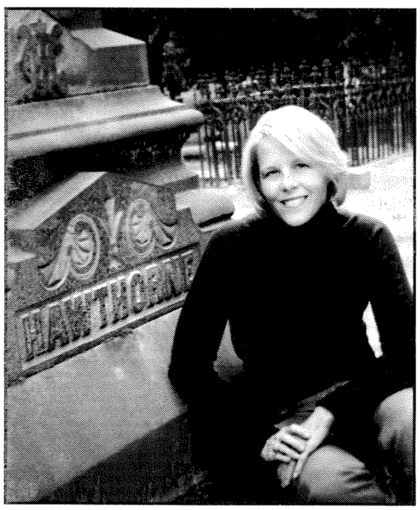
Footnote:
1. Phil Izzo, "Existing-Home Sales Data Show Welcome Correction or Burst Bubble," *Wall Street Journal*, Sept. 25, 2006.

Sources:
1. Russell Gold, "In the Gulf of Mexico, Industry Closes in on New Oil Source," *New York Times*, Sept. 5, 2006.
2. Mike Rothman, "Have Perceptions about Tight Capacity Changed?" *International Strategy & Investment*, Sept. 20, 2006.

PROFESSIONAL PROFILE – MARY A. MILLER

While Mary Miller can handle a crisis like a pro, she's happy to report that her adrenaline level is way down these days. After four years as the communications director for the American Red Cross Oregon Trail Chapter - where she was on call 24/7 to handle media queries and other communications challenges related to the latest natural disaster - her new position at Ferguson Wellman could easily be called the calm *after* the storm.

Since January, Miller has been developing marketing and communications tools to help Ferguson Wellman connect with prospects, clients and the media. It's a post that draws on her long professional experience, in addition to the Red Cross job, six years working on Capitol Hill and three years as public relations manager at an eHealth company called WellMed. "The thread through all my jobs," she muses, "is to excel at communicating *what* you do with what your target audience *expects* you to do. Whether in government, industry or non-profit, it's about building lifelong relationships through applying basic tenets of marketing and communications."



Mary Miller at Lone Fir Cemetery
Photography by Bruce Beaton

Miller appreciates the straightforward nature of her new mission. "What I love about Ferguson Wellman," she says, "is that it really knows its niche. We know what we want to accomplish for our clients and we're true to what we are good at." Her responsibilities range from conducting market research and organizing events to coordinating the development of resources such as *Market Letter* and the firm's *Glossary of Investment Terms.* Miller holds a BA in rhetoric and communications from the University of Oregon and an MBA from the University of Minnesota.

In her spare time, Miller serves as board chair of the Friends of Lone Fir Cemetery, the oldest pioneer cemetery in the Portland area. She believes that cemeteries offer important history lessons. "Many of our early settlers - Asa Lovejoy and Dr. John Hawthorne - are buried there," she explains. "We give tours, host monument repair workshops, and have some great events during the summer and on Halloween that encourage people to get to know Lone Fir Cemetery."

Miller is hoping people look at cemeteries in a new light. "In many cultures," she explains, "people love to visit cemeteries; they're special places. We want to help the public feel more comfortable paying a visit, because once they come to Lone Fir, they love it. They learn about how people lived in the past, which often inspires reflection and perspective on their own lives."

She also serves on the board of Our United Villages/The ReBuilding Center, a non-profit organization that runs a popular building materials center on North Mississippi Avenue. "It's a great organization that deconstructs old homes so people can buy the materials they need at 90 percent less than traditional stores," notes Miller. "That keeps millions of tons of construction debris out of our landfills, and at the same time employs residents of North Portland."

Miller relaxes by snowboarding, doing yoga, and playing golf. Her family, originally from the Midwest, now lives in Lake Oswego, Oregon and Bainbridge Island, Washington.