MARKET LETTER

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Second Quarter 2009

Recovery?

What "shape" are we in?*

by Dean M. Dordevic

In our last *Market Letter*, we provided our view of the macroeconomic landscape and offered an outline of the shape the eventual recovery will likely take. It was our expectation that this process would unfold in three parts. First, any attempt at recovery would require the global banking system to, in nautical parlance, "right itself." Second, after sopping up some of the massive global stimuli, the financial system, followed by the real economies, would reflate. A period of above-trend growth would follow. Third and finally, the economy would continue to work off the excesses of the last cycle (most critically the "amortization" of the debt overhang) and ultimately revert to sluggish, sub-par growth for, perhaps, a sustained period.

In the past quarter, we've seen a fast-forward version of this recovery process. To wit: Some of the most crucial indicators of the banking system's health such as the "TED Spread" and LIBOR[1] (the moral EEG and EKG of the banking system) now reflect near pre-crisis levels. While the banking system is not heal*ed*, it is heal*ing*. It is no longer in intensive care, but is now comfortably in a recovery room. While credit conditions have not been completely restored to normal levels, a number of widely-followed indicators of financial stress have shown tremendous improvement.

Reflation, or more interestingly, the "reflation trade," is now in vogue throughout the world's financial markets. We noted last quarter that there were tentative signs of this developing theme (i.e., emerging markets like China not making new lows, signs of strength in commodity prices, commodity-sensitive currencies doing well, etc.). In this regard, we have now moved from the anecdotal to the empirical. The Chinese market has advanced 58 percent since March; the price of copper (known among forecasters as the world's best economist, "Dr. Copper") has appreciated 38 percent; and in general, there is hard evidence that investor appetites for risk have increased in the U.S. and around the world. The canary in the coal mine would have to be the emerging world, since they are now the marginal consumers of most of the world's commodities. It appears that after a brief hibernation they, to some degree, have awakened once more.

From our vantage point, events of the last three months unfolded pretty much as we forecast. What surprises us is the speed and momentum of this nascent recovery. There were few, if any, forecasts earlier this year that predicted positive GDP growth anytime in 2009. While not yet a consensus view, the outlook for positive U.S. GDP growth in late 2009 is increasingly likely. To be sure, some of it results from the massive global stimulus that's been injected, but there's more to it.

We see some of this strength is coming from emerging economies. One of the principal differences between this recessionary environment and many other recessions is the ability of emerging market economies to self-finance their growth. In previous cycles, the emerging world was connected intravenously to a steady drip of foreign investment. Once this money drip was withdrawn (often precipitated by financial stress), it took many years for foreign capital and investment to return. However, this historic lag has now largely disappeared.

If you have any doubts about this view, consider that in Washington's frenzy to douse the U.S. economy with stimulus money, it's become very fashionable to talk about "shovel-ready" projects. In the U.S., a shovel-ready

***A modified square root recovery? See next page.**

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project is either very small or, more likely, something that could conceivably begin construction within a year or two at the earliest. But in China, a billion dollar project could start in a matter of months or even weeks! They have the money and they certainly have the will. And absent a regulatory minefield, "shovel-ready" means exactly that in China. Increased appetites for risk that result in investment and production are occurring faster than in previous cycles because of the emerging economies.

Economists love to describe the "shape" of economic recoveries with alphabet letters. We've seen economic recoveries described as the "L" (the Japanese crisis), the "V" (the preferred outcome), the "U" (a combination of the "L" and the "V"), and even the "W" (the double dip). Newest on the scene, and perhaps most apt in our view, is the "modified square root" (see the title of this piece).[2] The square root's path describes a massive global stimulus bringing about rapid and strong, albeit semi-synthetic, global growth and recovery. This is in turn followed by a somewhat drawn-out period of sub-par growth. This anemic growth is the by-product of an ongoing, corrective process as basic underlying economic and financial issues are resolved.

The uppermost bar of the square root sign represents the ballast of systemic debt. We are trying to rid ourselves of it, but truly no one fully understands the scope of the problem or the time it will take to reach some modicum of equilibrium. Still, there are some positive signs, as the consumer savings rate has gone up very quickly and is at its highest point in the last 15 years. The savings rate now appears to be high enough to begin the process of consumer balance sheet repair, but it is not increasing rapidly enough to create additional systemic problems.

The biggest change at the margin is the government's balance sheet. It would be foolish (if not impossible) to forecast the outcome of this massive balance sheet realignment, but we can at least measure and weigh it.

Probably the best modern analogue to our dilemma is Japan's "lost decade." The metric that matters most is not debt per se, but debt relative to output or GDP. Interestingly, while Japan's economy has been very weak, they have been able to live with a debt-to-GDP ratio three times that of the current U.S. ratio. Yet at the same time, yields on Japanese government bonds (JGBs) have remained at incredibly low levels for many years. While Japan endured more than a decade of anemic economic growth, they also responded very slowly to their crisis as it unfolded. The U.S., on the other hand, responded with great speed, so hopefully we will avoid the same fate.

Total Nonfinancial Debt % GDP

	Govt	Business	Consumer	Total
Japan	195%	177%	76%	448%
U.S.	65%	79%	98%	241%
Eurozone	75%	98%	69%	241%

Source: International Strategy & Investment (ISI) - Daily Economic Report - June 17, 2009

While it's likely that business and consumer debt levels will continue to decline over the next decade, it's a good bet that the government's share of the total debt pie will continue to increase, perhaps significantly. The same thing occurred in Japan after their financial crisis, yet yields on JGBs trended lower for most of that period. Also, for what it's worth, current U.S. debt-to-GDP ratio is about the same as the Eurozone (countries whose currency is the euro).[3] Of course, our experience could be completely different; it's worth noting that the world's second largest economy went through a very similar episode and did not experience soaring inflation or interest rates.

The market has made a very dramatic and rapid advance since its March lows. If nothing more, the bond and stock markets have moved away from discounting something far worse than a deep recession. There are abundant signs of "green shoots" emerging in the U.S. and around the world. It appears that economies are responding to stimulus, some of which is real and some of which is government-induced. However, there are signs that emerging world growth is more robust than previously forecast. The recovery process will likely continue for some time, but we have no illusions about the ongoing deleveraging process and the impact it will have on growth going forward. The pace of economic expansion will eventually find an equilibrium point, and GDP growth will be slow and sluggish for some time to come. We have tilted our portfolios to benefit from the cyclical recovery we are now experiencing.

Sources:
1. TED Spread: the difference between T-bill and Eurodollar interest rates. LIBOR: London Interbank Offered Rate, a bank borrowing rate.
2. Attributed to Jason Trennert, Strategas Research Partners.
3. International Strategy & Investment (ISI). *Daily Economic Report* (June 17, 2009).

Municipal Bonds Remain Secure Investments

by Deidra M. Krys-Rusoff

Due to recent news coverage, municipal bonds have become a growing topic of conversation with clients. Declining tax receipts for states and local municipalities are leading to sizeable government deficits, creating uncertainty for this typically stable investment vehicle. Ferguson Wellman still believes municipal bonds are sound investments for a diversified portfolio. There are a number of measures we take to ensure the safety of our clients' municipal bond portfolios.

A municipal bond's degree of safety depends largely on the sources of revenue available to the issuer. General obligation bonds are secured by the issuer's taxing authority, whereas revenue bonds are secured by the revenues from the respective projects they were issued to finance. The specific type of project is the key to the revenue bond's safety. For example, the revenues associated with providing essential services, such as water and sewer, are much more reliable than the revenues from a special purpose facility like a stadium or aquarium.

With the demise of subprime mortgage-backed bonds, rating agencies have understandably lost credibility with the public; however, history has shown municipal bond ratings to be very reliable indicators of safety. In fact, actual default experience reveals that a single-A-rated municipal credit has essentially the same high degree of safety as a triple-A corporate credit. This is because municipal investors benefit from the high budget priority that municipalities give to payment of bond interest and principal.

In total, municipal defaults are extremely rare, particularly by issuers of general obligation and essential service revenue bonds. According to Moody's, only 41 rated municipalities defaulted between 1970 and 2006, a miniscule 0.049 percent of all issuers.[1] The breakdown of defaults by issuer category is shown in the table to the right.

Type, Number, and Defaults of Municipal Bond Issuers
Between 1970 and 2006

Type	*Number of Issuers*	*Number of Defaults*
Nonprofit healthcare	>1,400	17
Other state and local	> 6,000	4
Housing	> 2,500	16
Electric power	> 700	2
Private universities and other nonprofit	> 550	1
Public university	> 250	0
Water and sewer	> 1,900	0
General obligation	> 15,000	1

Source: Moody's U.S. Municipal Bond Rating Scale, Special Comment, March 2007, Moody's Investors Service

Of the three general obligation and essential services defaults, only one—Washington Public Power System (WPPS)—resulted in investor loss. With other notable defaults, action was always taken to ensure the security of principal or to repay investors. For example, in 1975, New York State took control of New York City's fiscal operations to avert default on its bonds. During 1994, Orange County's investment losses drove it to default on its debt but within 18 months the county had made all bondholders whole.

Despite the relatively low incidence of municipal bond defaults, we believe in broad diversification as a means to further reduce the risk of loss. Specifically, we limit holdings of any one state's general obligations to 10 percent or less of the total portfolio. In addition, we focus on bonds issued by cities, counties, school and water districts and other providers of essential services to create portfolios backed by varied and stable revenue sources. This commitment to diversification reduces risk even when all the issuers are located within the same state. Thus, clients residing in high-tax states can still have a low-risk portfolio that provides income that is exempt from both state and federal tax.

Historically, municipal bonds are a secure choice for risk-conscious investors. Careful selection and sound portfolio construction provide additional safeguards, particularly during tumultuous economic times.

Sources:
1. Moody's U.S. Municipal Bond Rating Scale, Mapping the Global Rating Scale, March 2007, Moody's Investors Service

Milestone Anniversaries for Ferguson Wellman Employees

Lori Flexer, Deidra Krys-Rusoff,
Jeanene Wine, Steve Holwerda

Anniversary and Start Year

20 years	Steve Holwerda
1989	Mark Kralj
	Ginny Marsh
10 years	Lori Flexer
1999	Mike Knebel
	Jeanene Wine
5 years	Lori Ferraro
2004	Deidra Krys-Rusoff

Mark Kralj, Ginny Marsh,
Lori Ferraro, Mike Knebel

Dow Jones Close and Top Headlines from Their First Year with the Firm

1989	2,753.20
1999	11,497.12
2004	10,783.01

1989 Fall of the Berlin Wall. Friday the 13th "mini-crash": The Dow Jones Industrial Average plunges 190.58 points, or 6.91 percent, to close at 2,569.26.

1999 Fears of the Y2K conversion. Roth IRA introduced.

2004 South Asian tsunami. Martha Stewart begins serving her sentence for insider trading.

Thoughts from the Team

***On their first impressions of Ferguson Wellman*:**

Kralj: "The firm's reputation, personnel and investment philosophy created the exact environment that I had wanted to immerse myself in to offer the best investment service to clients."

Holwerda: "Even though Ferguson Wellman has grown from 12 employees to 40 over the last 20 years, the firm still feels small and family-like."

Wine: "My first day was Ginny's 10-year anniversary. It's hard to believe I'm now celebrating 10 years too."

***On the changing times*:**

Knebel: "The continued growth in financial derivatives and other sophisticated risk management tools has been a major change since I joined the firm."

Flexer: "The capital markets have become much more global and correlated."

***On their relationships and accomplishments*:**

Krys-Rusoff: "Working my way up from a trader, to a fixed income analyst, to a portfolio manager has been a great experience for me at Ferguson Wellman."

Marsh: "Ferguson Wellman's great reputation in the community makes me proud to work here."

Ferraro: "I value the relationships that I have with our clients, and I'm proud of how much I have learned and continue to grow at the firm."

Community Involvement over the Years

Oregon Health & Science University Foundation; President's Council for the College of Urban & Public Affairs at Portland State University; American Red Cross Oregon Trail Chapter; American National Red Cross; Portland Business Alliance; University of Oregon Foundation; Boys and Girls Clubs of Portland; Lake Oswego Schools Foundation; Northwest Taxable Bond Club; Providence Child Center Foundation; Arlington Club; Oregon State University Foundation; Oregon Symphony Foundation; March of Dimes Lewis & Clark Chapter; Friends of the Children; St. Vincent Hospital; Northwest Taxable Bond Club; Operation Christmas Child; Chartered Financial Analysts Society of Portland; Junior League of Portland Glencoe Elementary School; Sisters of St. Mary of Oregon; Portland's theatre community.

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