Market Letter

Market Perspective — First Quarter 2014

IN THIS PUBLICATION

SPRING THAW

by George Hosfield, CFA
Principal & Chief Investment Officer

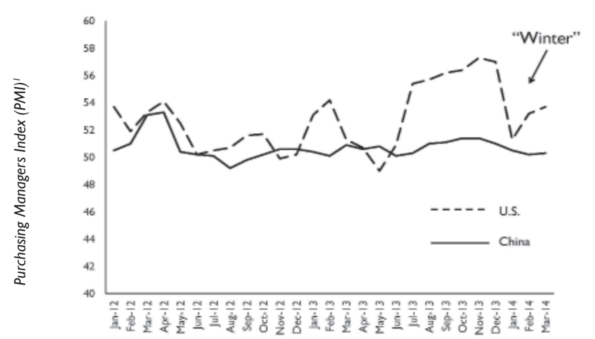
Volatility that was largely absent from last year's markets has returned in 2014, as the cruise control gains enjoyed by equity investors last year are yielding to bumpier roads. An eventful first quarter was headlined by currency devaluations in Argentina and Venezuela coupled with rate hikes in Brazil, India, South Africa and Russia as these key developing nations attempt to stabilize falling currencies and corral rising rates of inflation. While developing world monetary policy has tightened, accommodative monetary conditions remain in the U.S., Europe and Japan. What we see, in a word, is *decoupling*. Divergent policy is evidenced by negative first quarter returns for emerging market stocks contrasted with a modest gain for the S&P 500.

An unusually cold winter has dampened the U.S. economy. As the weather warms up, consumer spending should rebound. As well, our economy has "anniversaried" last year's payroll and income tax increases and, with government austerity beginning to wane, fiscal headwinds are abating. More importantly, U.S. oil and gas production is booming, which is in turn helping to fuel a manufacturing renaissance domestically. The result we foresee is a faster 3 percent rate of GDP growth in 2014, which should boost jobs and help to further narrow the twin deficits of budget and trade.

All of which brings us to the Fed. With Chairwoman Yellen settling in, investors are beginning to discount not only continued tapering of quantitative easing (QE), but also a timeline to the Fed's first rate increase, which could happen within the next 12 months. Because inflation is tame and labor markets retain a considerable degree of slack, we do not foresee aggressive tightening of the money supply once the Fed ends its zero interest rate policy.

A constructive economic backdrop domestically and relatively benign monetary policy offer key support for corporate profits in the U.S. Meanwhile, we observe Europe continuing to make tentative progress in emerging from its economic malaise, hindered to a degree by geopolitical turmoil in the former Eastern Bloc.

The Impact of Winter



[1] PMI - an indicator of the economic health of the manufacturing sector. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

Source: FactSet

Acknowledging the challenged state of affairs internationally, we have reduced our emerging market equity allocation and may further reduce our international exposure in the months to come. We retain an underweight allocation to bonds and continue to manage our fixed income exposure with below average duration.

Founded in 1975, Ferguson Wellman is a privately owned investment advisory firm, established in the Pacific Northwest. With more than 600 clients, the firm manages $3.8 billion in assets that comprise union and corporate pension plans; endowments and foundations, and individuals with portfolios of $3 million or more.

INVESTMENT EXCELLENCE
LIFELONG RELATIONSHIPS

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

CHANNELING DEE HOCK— THE BRAVE NEW WORLD OF CRYPTOCURRENCY

by Dean Dordevic, Principal
Alternative Assets and Portfolio Management

"In theory, there's no difference between theory and practice. In practice, there is." – Yogi Berra

By the late 1950s there had already been at least a dozen attempts to create a universal credit card. While single merchant cards were quite successful, all attempts at a universal card system had failed miserably. Delinquency rates were off the charts, and the cards gave birth to their own new problem - *credit card fraud*. The idea behind a universal credit card almost came to an end[1]. But it wasn't until the early 1970s that a fellow by the name of Dee Hock created the universal credit card system we know today as VISA. Hock fixed many problems and was a big picture thinker. He spoke of the cards not only as a way to get a quick short-term loan, but as a new kind of payment system. In his mind, VISA was an exchange of value on par with, and one that would compete with … cash. The cards could be presented just about anywhere, connecting both buyers and sellers in fiat currencies all around the world.[1] The rest, as they say … *is history*.

Judging by the sheer number of Google searches, we are going to assume in these pages that you have at least *heard* of the so-called cryptocurrency, more commonly known as "Bitcoin." But in case you haven't, Bitcoin is a truly new form of payment system. It is not connected to any single currency or government and allows users to send payments within a decentralized peer-to-peer network. It does not have a central clearing house nor a financial institution backing or clearing transactions. The supply of Bitcoins cannot exceed 21 million (there are currently about 12 million or 57 percent of the eventual supply in "circulation"). More interestingly, fresh Bitcoins are created by "miners" from virtual Bitcoin "mines."[3]

Near the Arctic Circle on a flat lava plain in Reykjanesbaer, Iceland, you will find Bitcoin's mines. More than 100 silver supercomputers reside here, cooled by the bitter Arctic air pumped in from outside. "Miners" from around the globe compete with each other within an open source network to solve complex algorithms. A successful miner is rewarded with a block of 25 new Bitcoins from the virtual currency's network. Since the system is set up to release Bitcoins at a progressively slower rate, it is expected that it could potentially take up to 100 years for the entire supply to be released.[4] But what is fascinating to us about this new attempt at a payment system is not the system in and of itself. What is fascinating is the *motivation* behind it.

Like its very distant cousin, VISA, Bitcoin has also had its share of problems and failures. Most recently the spectacular failure and subsequent bankruptcy of one of the largest Bitcoin exchanges. Earlier this year, Tokyo-based Mt. Gox suffered from what they claimed was a virtual theft of nearly 750,000 Bitcoins with a value of some $450 million.[5] While the value of Bitcoins plunged (losing nearly 50 percent of their value to about $600 coin), what's truly fascinating is that the value *didn't drop to zero*.

In the wake of the Mt. Gox fiasco, the resolve of some of Bitcoin's most ardent supporters and investors (like prominent venture capitalist Marc Andreessen and the Winklevoss twins of Facebook fame) appear to have become only more convinced of its success. Said Cameron Winklevoss, "Mt. Gox's closing underscores just how far the Bitcoin ecosystem has come. The brightest minds in the room are hard at work building a responsible and secure future." Mr. Andreessen adds, "Far from a mere libertarian fairy tale or a simple Silicon Valley exercise in hype, Bitcoin offers a sweeping vista of opportunity to reimagine how the financial system can and should work in the internet era."[6]

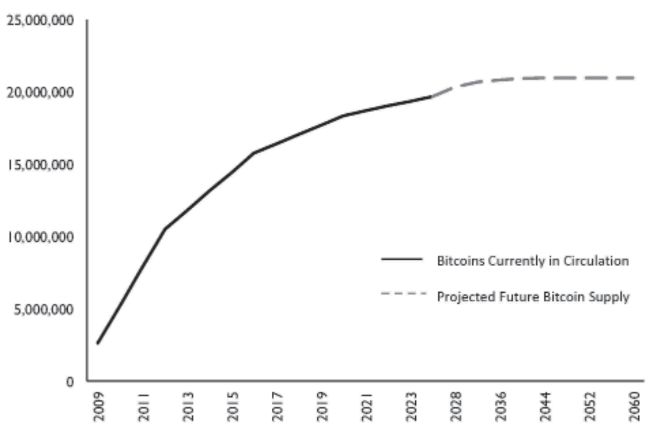
Furthermore, the list of companies that accept Bitcoin continues to grow, now at about 20,000. The largest retailer that accepts Bitcoin is Overstock.com. Others that either accept Bitcoin or plan to accept the currency include: eBay, Paypal and Zygna. Tesla accepts Bitcoin for payment at all of their brick-and-mortar stores.

It would seem that if the *price* of a Bitcoin is at least some indication of the *faith* in it, there appears to be a strong motivation by many for the perpetuation of this wild game. But what exactly - is that motivation?

In theory, the hope for cryptocurrencies is a form of transactional nirvana. Ajay Banga, CEO of Mastercard spoke for many skeptics when he said, "The world is not short of currencies, so what is this currency solving for?"[7] In theory, Bitcoin believers want a currency that could not be undermined by a profligate sovereign. The underlying currency could conceivably grow in value over time since the supply is theoretically fixed and transactions would be global, simple and extremely cheap. Cryptocurrency would also allow for anonymity, just like cash.

Perhaps the most interesting and disruptive impact of a successful cryptocurrency would come from its impact on profit margins. There are legions of companies that have pre-tax margins that are sub-5-percent or less. Many of these businesses transact either the entirety or the vast majority of their revenues through a credit card intermediary, like VISA or Mastercard. But imagine how profitability would change if a company could successfully bypass the credit card intermediaries and keep the 2 percent or so that they take for their service? Profitability would instantly soar. This may be why so many merchants are dipping their toes into these very murky and dangerous waters. If this ultimately works for them, the savings would be huge. Said Antonis Polemitis of Ledra Capital who is head of a family office looking to invest in the Bitcoin arena, "Consumers should rejoice, and money transmission firms like Western Union should worry. Bitcoin is like email, and the other stuff like the post office."[7]

Bitcoin Supply to Taper to 21 Million by 2140



Source: Bank of American, Merrill Lynch

We admit to having *no idea whatsoever* as to whether or not these currencies will thrive or even *survive*. But they hold the potential to be truly disruptive technologies and for that reason they are worth our time for study. We also admit to having no clue as to whether or not Bitcoin is the 21st-century version of email or a modern-day tulip bulb mania. Or, as Wolfgang Munchau said very recently in the *Financial Times*, "The degree to which economists have ignored Bitcoin - is surpassed only by the extent to which Bitcoin enthusiasts have ignored economists."[8]

Bitcoin Currency Symbol

Source: istock.com

The real potential behind Bitcoin is its future potential. Properly executed, it could emerge as an accepted means of transaction, a unit of account and a store of value. But to do that, the acolytes of the world of crytpocurrency must embrace what they had most hoped to bypass, that is, *government and regulation*.[8]

That may very well be Bitcoin's Achilles' heel. Stay tuned.

Weapons of Reason footnotes and sources (from pages 2 and 3):

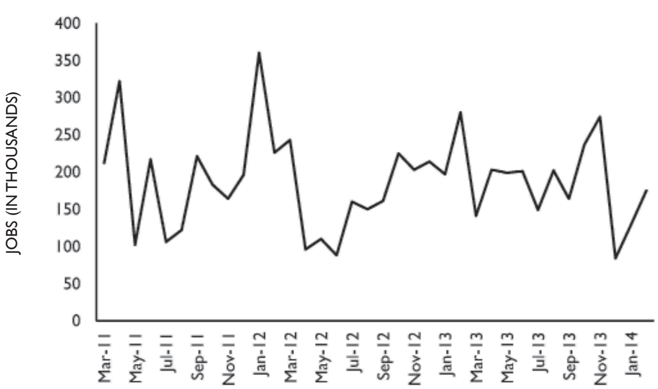
1. "The History of Visa Cards," *History.com*.
2. Joe Nocera, "The Bitcoin Blasphemy," *The New York Times*, February 28, 2013.
3. David Woo, Ian Gordon and Vadim Iaralov, "Bitcoin: A First Assessment," *Bank of America Merrill Lynch*, December 5, 2013.
4. Nathaniel Popper, "Into the Bitcoin Mines," *The New York Times*, December 21, 2013.
5. Ezra Galston, "The Bitcoin Paradox That Undid Mt. Gox," *The Wall Street Journal*, February 27, 2014.
6. Sydney Ember, "A Silver Lining in Bitcoin's Stumble," *The New York Times*, February 26, 2014.
7. Francesco Guerrera, Bitcoin's Crisis is a Turning Point for Currency," *The Wall Street Journal*, February 17, 2014
8. Wolfgang Munchau, "Our Flawed Financial System is Reflected in Bitcoin," *Financial Times*, March 3, 2014.

STICKING TO OUR STORY

by Brad Houle, CFA, Executive Vice President
Fixed Income Strategy and Portfolio Management

Despite the Federal Reserve's tapering of quantitative easing, bond prices were firm in the first quarter, driving down bond yields. Quantitative easing is the purchase of treasury and mortgage securities by the Federal Reserve in an attempt to keep longer-term interest rates low in order to stimulate the economy. Tapering was expected to cause interest rates to rise; however, a confluence of events has kept demand high for treasury securities. Political instability in the Ukraine and the subsequent Russian annexation of Crimea contributed to risk aversion trading which fueled demand for Treasury securities. In addition, fears of a financial crisis and slowing economy in China also contributed to the demand for safe assets. China has had a real estate boom driven by the availability of credit and recently, China had its first ever corporate bond default. With this default, there are fears that more credit defaults are on the way.

Change in Monthly NonFarm Payrolls



Source: FactSet

Domestic economic data has been soft for the last three months due largely to the harsh winter that has caused disruptions in retail sales and employment growth. Monthly employment statics are closely watched by investors and the Federal Reserve and have been particularly anemic with growth in payrolls well below consensus. Weakness in the economic data has been interpreted by some investors as a slowdown in the economic recovery that could lead the Federal Reserve to discontinue the tapering of quantitative easing. However, in a recent statement the Federal Reserve reiterated the view that recent economic softness is simply a function of the weather. In addition, the Federal Open Market Committee raised the median forecast for raising short-term rates to one percent by the end of 2015.

10-Year Treasury Yield

Source: FactSet

Despite some recent soft economic data, we believe the economy will gain momentum as the year progresses. In fact, economic growth could reach 3 percent or more with the absence of the fiscal drag experienced in 2013 and benefit of the wealth effect driving consumer spending higher. If the economy can grow at near 3 percent, bond investors should start to anticipate higher interest rates and an eventual rise in short-term interest rates by the Federal Reserve. As a result, we are cautious on bonds and remain underweighted bonds relative to individual risk tolerance. In addition, bond portfolios invested on behalf of clients are defensively postured in an attempt to minimize price volatility due to an expectation for higher interest rates.

By year-end we believe that the yield on the 10-year Treasury bond will be near 3.5 percent, up from its present level of 2.7 percent which is a level on the 10-year Treasury that more closely mirrors where it would logically trade in the absence of Federal Reserve market intervention.

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

SPEAKING MY LANGUAGE

by Elizabeth Olsen
Vice President of Marketing

Bitcoin: a specific form of cryptocurrency and the first known form of cryptocurrency. It allows users to send payments within a decentralized peer-to-peer network. It adheres to the philosophy set forth in a white paper written by Satoshi Nakamoto, a pseudonym for an unknown writer. Bitcoin only exists digitally and the balances of Bitcoin are kept using public and private 'keys.' These 'keys' are long strings of numerical and alphabetical symbols linked through an algorithm that was used to create the keys. Bitcoin can be exchanged into fiat currency (i.e., dollars) by transferring Bitcoins from a personal account to a third-party account but that is where the risk of hacking and operator fraud can be found.

Bitcoin Miners: individuals, groups and companies that independently own the computer power controlling Bitcoin and participate in the Bitcoin network. Miners verify Bitcoin transactions publicly, which theoretically prevents fraudulent Bitcoin usage. Miners are motivated by mining new Bitcoins and the related transaction fees paid by Bitcoin.

Cryptocurrency: a form of online currency that refers to specifications regarding the use of currency by using foundations of cryptography to create and distribute a decentralized economic system. The first form of cryptocurrency, Bitcoin, was introduced in 2008, but now there are several variations of cryptocurrency in use online all over the world. Cryptocurrencies were created based on the principle that no individual, group or government could abuse or manipulate the currency and its value. Unlike organizations like the Federal Reserve that can produce more units of currency into the system, cryptocurrency has a finite amount that can be produced by the collective cryptocurrency community at a rate that is defined prior to its production and is known publicly to all users.

Decoupling: a situation in financial markets where the return on two asset classes deviate from their expected or normal patterns of correlation. Decoupling occurs when two different asset classes that usually rise and fall in unison begin to move in opposite directions, such as one increasing in value and the other decreasing in value.

Fiat Currency: currency whose value originates from government regulation and law. The value is based upon the relationship of supply and demand rather than the material from which the currency is based, i.e., an American dollar.

Mt. Gox: Mt. Gox is an online exchange company for Bitcoin based in Tokyo. Its name is an acronym that stands for "Magic: The Gathering Online Exchange." It originally began as a site where players of the game "Magic" could trade cards but eventually became an exchange for Bitcoin that handled approximately 70 percent of all Bitcoin transactions by 2013. However, after several instances of security breaches, Mt. Gox was forced to file for bankruptcy protection in Japan and in the United States in 2014.

Supercomputers: one large computer or a collection of computers that acts as one machine and performs at the highest operational rate of power and speed. Supercomputers are used for specialized applications that require intense amounts of mathematical calculations, such as predicting weather patterns.

Yield Curve: A line graph that plots the yields of similar bonds by maturity.

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:

Bank of America Merrill Lynch
Business Dictionary
Computer Hope
Ferguson Wellman's Glossary of Investment Terms
Investopedia
The New York Times
Webopedia
Wikipedia

Let not your mind run on what you lack as much as on what you have already. – Marcus Aurelius

Investment Services | First Quarter 2014

FOR INDIVIDUALS

by Helena Lankton, Executive Vice President
Wealth Management Committee Chair

As students head toward their high school class graduation, they are also moving that much closer to their college years. Parents and grandparents benefit from the flexibility, control and tax-deferred growth that 529 College Savings Plans afford.

This savings vehicle not only supports long-term planning and preparation for students, but it also removes these assets from your taxable estate. Owners of the plan are able to retain full control over the account and have the right to take back the money back at any time.

We can work with your accountant and estate planning attorney to determine the best strategy for you and your family. The gift of education can be one of the most meaningful investments you make to future generations.

FOR INSTITUTIONS

by Don Rainer, Executive Vice President
Institutional Services Committee Chair

As a registered investment adviser, Ferguson Wellman is regulated by ERISA, which describes "prudent expert standard" for a fiduciary. ERISA recognizes managers in two categories. The first is a 3(21) fiduciary, which does not have discretion over plan assets directly, but exercises a certain level of influence and must meet a "standard-of-care."

Ferguson Wellman falls into the second category, a 3(38) fiduciary, which has discretionary control and ultimately makes investment decisions on behalf of the client in accordance with their investment policy guidelines. By having discretion through this higher standard, our clients have direct access to decision makers regarding their investments – something meaningful and constructive for trustees, board members and committee members who have been entrusted our firm with their assets.

The Last Word | First Quarter 2014

NEW BEGINNINGS

In recent months, we welcomed three new executive associates to Ferguson Wellman: Beth Harding, Lauren Krygier and Erin Rosenbladt. Beth works with Lori Flexer and Scott Christianson, Lauren works with Mark Kralj, and Erin works with Nathan Ayotte and Brad Houle. Prior to joining Ferguson Wellman, Beth and Lauren came from the investment industry and Erin managed an orthodontics office. Addressing clients' needs, working collaboratively with other associates and creative problem solving are key functions of positions with Ferguson Wellman.

Please join us in welcoming our new associates to the Ferguson Wellman team. You can find their biographies and contact information on our website.

CONVERTING OUR DATA

The accuracy of our client data and efficiency of our office systems is a top priority. To that end, we are in the process of upgrading the technology that manages and stores our client information. The improvements we will have with this technology is contingent on the accuracy of the data. Our executive associates check in with clients often to confirm that their contact information is accurate – from individuals and families to board members and trustees. Should you notice that your contact information is not accurate or you anticipate a change in the future, please do not hesitate to contact your portfolio manager or executive associate with any updates.

Our logo features a bronze coin of Marcus Aurelius Antonius, 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.