

# MARKET LETTER

MARKET PERSPECTIVE



SECOND QUARTER 2015



## KEEP CALM AND CARRY ON

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Founded in 1975, Ferguson Wellman is a privately owned registered investment advisory firm, established in the Pacific Northwest for clients with investable assets starting at \$3 million. With more than 646 clients, the firm manages \$4.2 billion that comprises separately managed accounts for individuals and families; foundations and endowments; and Taft-Hartley and corporate retirement plans (as of 3/31/15). West Bearing Investments, a division of Ferguson Wellman, serves clients with assets starting at \$750,000.

**INVESTMENT EXCELLENCE**  
**LIFELONG RELATIONSHIPS**

1. The domestic economy is coming out of its winter funk
2. Rising average hourly earnings and ECI are a precursor to an uptick in inflation
3. At long last, interest rates are starting to rise...in the U.S. and Europe
4. Domestic equities are likely range bound until earnings breakout
5. Contagion risk associated with Greece is minimal
6. Remain overweight equities and underweight interest sensitive sectors and asset classes

Economic growth in the first half of the year was depressed by a severe winter, the west coast port strike and a plunge in oil companies' capital spending. However, these temporary conditions have largely passed and led by housing, the economy is now clearly emerging from its funk. Signs of the rebound are evident in the labor market where unemployment continues to trend down and average hourly earnings are picking up. With labor representing roughly 70 percent of the cost in the economy, finally, the stage is set for interest rates to trend higher.

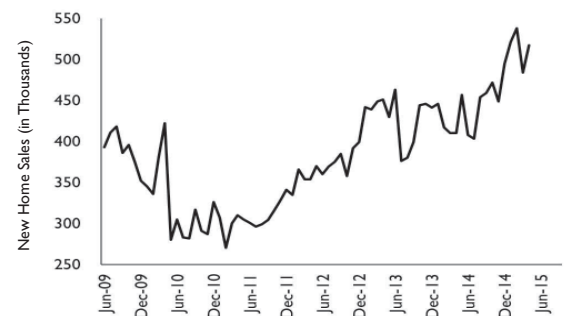
In fact, in recent weeks rates in both Europe and America have increased materially. Domestically, since early April the yield on the 10-year U.S. Treasury has climbed from 1.85 percent to 2.42 percent, while interest rates have also climbed dramatically in Europe. In Germany, the 10-year government bund has climbed from .07 percent on April 20 to .79 percent. Also, the relative yields of European debt

versus U.S. Treasury debt has normalized reflecting the greater credit risk associated with southern European nations.

With the job market improving, retail sales rebounding and manufacturing beginning to perk up, the stage is set for a long expected Fed rate hike in September. In anticipation of rates trending modestly higher, client portfolios have been underweight bonds, REITs and the interest sensitive telecom and utility sectors.

Buffeted by fears of higher interest rates, plunging earnings out of the energy sector and a seemingly endless game of chicken between Greece and its creditors, domestic equities have traded in a fairly tight range for most of the year. Though capital market volatility may be elevated in the coming months as investors digest/discount these factors, borrowing from the famous motivational poster produced by the British Government in 1939 designed to steady public morale as they braced for war, we believe that now is the time for investors to "keep calm and carry on."

## Housing Breaks Out, Economy On Solid Footing



Source: Bloomberg

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



## THE NEXT WAVE

Dean Dordevic, Principal  
Alternative Assets and Portfolio Management

*"The Chinese Communist Party first liberalized labor. Next came the liberalization of land. We're now in the final phase ... the liberalization of money."*

*-- Louis-Vincent Gave, Founding Partner and CEO of Gavekal Dragonomics*

Open any financial newspaper of late and you'll find perhaps a half dozen front-page articles chronicling the long and growing laundry list of issues facing the Grecian economy and their ailing stock market. We'd be the first to admit that Greece is an impossibly lovely country, albeit with a gross domestic product (GDP) on par with that of ... Tennessee. There is another country with a GDP about 100 times larger that has received very little front page ink of late. This, despite a stock market that has been on an absolute tear. It would appear that the old newspaperman's adage, "if it bleeds it leads," is very much at work.

Over the last 12 months, the so-called Chinese "A-shares," those that are traded in Shanghai and Shenzhen, are up 140 percent and 175 percent, respectively. Chinese shares that are traded in Hong Kong (the so-called "H-shares") are up only about 30 percent or so over the same time frame. China's stock market is really two different markets: those shares that are traded in Hong Kong and others that trade in mainland China on the Shanghai and Shenzhen exchanges.

Ironically, the Chinese stock market has been rising while China's GDP has been decelerating. Estimated growth rates for China are now in the 7 percent range, and while this is considerably slower than the heady low double-digit growth rates of the last 10 years, China's growth this year will be exceeded only by that of India, with growth estimated at about 7.5 percent this year. Despite the aforementioned, mainland Chinese shares have been strong because of three recent events that have coalesced to ignite this surge.

This past November, Chinese regulators launched the "Shanghai/Hong Kong Stock Connect Link (SH-HK Connect)" which relaxed restrictions that historically split the Chinese markets between shares targeted for local investors and those available for international investors. This link will allow Chinese investors access to Hong Kong listed shares, and foreigners access to the Chinese A-shares that are listed in Shanghai. This new regime has unleashed significant fund flows in both directions. For all intents and purposes, this creates a single "China" stock market that globally ranks as one of the three largest by market capitalization and daily trading turnover. This new link between these exchanges will help diversify the portfolios of Chinese investors, increase trading efficiencies and further the inclusion of Chinese stocks in global benchmark stock indices.<sup>4,6</sup>

Furthermore, on Tuesday, June 9, China took a big step toward joining the global-investing big leagues when global index provider, MSCI Inc., said that it expects to add the Chinese A-shares to its widely tracked Emerging Markets Index. This will generate interest from significant pools of capital as mutual funds and other global investors with assets of about \$1.7 trillion are benchmarked to this index. MSCI said that it expects to add the A-shares when China resolves some market access, clearing and settlement issues. Said John Authers of the *Financial Times of London*, "It's not quite like waiting for white smoke over the Vatican, but for anyone investing in emerging markets, it comes close."<sup>1, 4</sup> The MSCI Index currently has a 26 percent allocation to China; however, these are primarily Chinese stocks that are listed in Hong Kong. Were MSCI to add shares listed on the mainland to the index, the weighing would soar to 40 percent.<sup>2</sup>

More importantly, a decision to add the shares to this important global index/benchmark will result in billions in new investment flows into these markets. While many had expected full inclusion in the index to come on June 9, this delay will likely prompt the Chinese government to accelerate the opening of their capital markets so as to pull forward the date of their full inclusion in the benchmark index.<sup>2</sup>

Lastly, the Chinese government is seeking to "internationalize" their currency, the renminbi. While

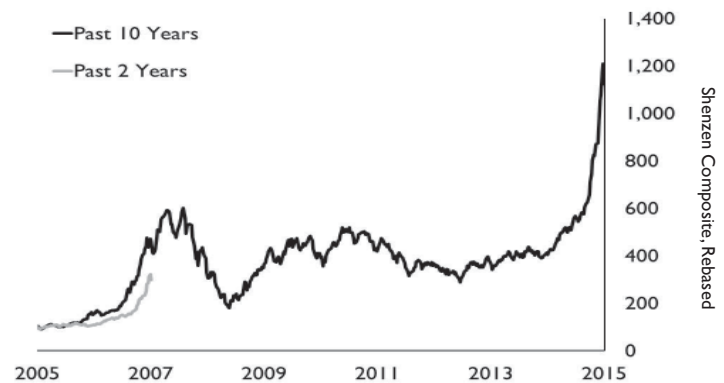


this is a process and not an event, it appears that Beijing is doing everything in their power to make this happen. This coming September, at the International Monetary Fund (IMF)/World Bank annual meetings, the IMF will announce that The Peoples Bank of China (PBoC) will be included as a “participant” country with “Special Drawing Rights” (SDRs). This is a baby step toward China being potentially included in the IMF’s SDR “currency basket.”<sup>3</sup>

The IMF’s SDR basket is essentially an exclusive collection of global currencies that form a special reserve asset. Every five years, the IMF reviews the composition of the basket, which currently includes U.S. dollars, yen, euros and sterling. This would eventually lead to the Chinese currency becoming more freely convertible, and the renminbi would ultimately become more widely used in international trade and cross border flows of funds.<sup>3</sup>

China’s last two waves of both labor and land liberalization were both long lasting and reverberated powerfully all around the globe. Our hunch is that the liberalization of Chinese money and finance could stir the clay pot in much the same way. We would also be the first to admit that we have no special insights when it comes to assessing the degree to which China’s market is in bubble territory or not. We will also freely admit that we are not comforted by the fact that according to the Chinese zodiac, 2015 is the year of the sheep. However, we are comforted by the fact that we choose to hire experts in this space to make these determinations for us (see the following note). That being said, and as the adjacent chart demonstrates, China’s bull markets can be long-lived and quite volatile affairs. Superimposing this most recent move upon the last ... does give one pause.

## Bull or Bubble ... ?



The chart depicts Shenzhen composite for the last ten years with the last two superimposed on the 2005-2007 time period.

Source: FactSet

In thinking about China and her soaring markets, John Maynard Keynes’ infamous quote was never more apropos. He said, “Markets can remain irrational ... longer than you can remain solvent.”

*NOTE: Ferguson Wellman Capital Management has direct exposure to China through an investment in a diversified emerging markets fund. China and Hong Kong are currently its largest portfolio position at 20.1 percent as of March 31, 2015. This represents a modest underweight versus its China/Hong Kong benchmark weight of 23.1 percent. We also participate in a more concentrated manner through our investment in an emerging Asia and China-focused limited partnership.*

## Weapons of Reason footnotes and sources:

1. John Authors, “Full Weight of MSCI’s A Shares Decision Will Depend on Beijing,” The Financial Times of London, June 4, 2015.
2. Carolyn Cui, “China Near to Joining Influential Stock Index,” The Wall Street Journal, June 10, 2015.
3. John Dizard, “An International Renminbi will create a ‘Chinese World,’” The Financial Times of London, June 7, 2015.
4. Neil Gough, “MSCI to Add China Stock to Indexes,” The New York Times, June 10, 2015.
5. William Kazer, “China Sets Its Sights on Joining the IMF’s Special Currency Club,” The Wall Street Journal, April 6, 2015.
6. Kinger Lau, “SH-HK Connect: New Regime, Unprecedented Opportunity,” Goldman Sachs, China Strategy, September 11, 2014.
7. James Mackintosh, “The Short View – China’s Bubbles Compared,” The Financial Times of London, May 12, 2015.





## RISING RATES

Brad Houle, CFA  
Executive Vice President of Research

With the threat of deflation receding to the background in Europe and the European economies crawling out of a deep dark recession, interest rates have begun to climb. Perhaps most dramatically, in Germany where government bonds had negative yields for maturities for as long as nine years in April and are now positive. Investors finally determined that it is a foolish investment to pay a debtor for the privilege of loaning them money.

Another dramatic normalization of the global fixed income markets was a more rational repricing of credit risk in sovereign debt. For a time, the debt of the United States yielded more than all developed countries, other than Greece. To find countries with bond yields higher than the United States one needed to look to countries that require vaccinations for visitors. The debt of the southern European coun-

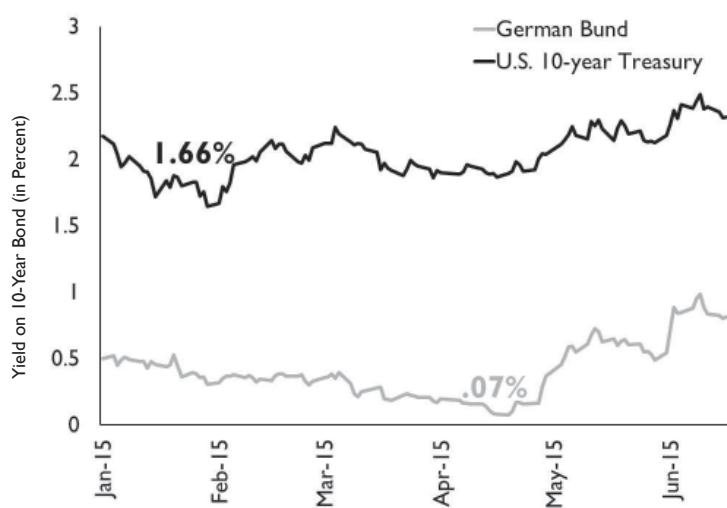
tries Portugal, Spain and Italy now yields more than the United States. The level of yield on a bond should be commensurate with the credit risk associated with the debtor.

The interest rate increase in the U.S. is in response to an improving economy and a labor market that is moving toward full employment. Full employment is a concept whereby the rate of unemployment drops to a level that employers have to start competing for employees. At 5.5 percent unemployment we are approaching full employment and this is one of the reasons the Fed is set to raise short-term interest rates sometime this year. This will be perhaps the most talked about rate increase of all time and the market has been anticipating this event which can be seen in the yield curve. Short treasury bonds have increased in yield in anticipation of a higher federal funds rate.

While we were certainly early with our call for higher interest rates, it now appears the movement to higher is at hand. Ultimately this is good news; the economy is strong enough and the Fed wants to tap the brakes to keep it from overheating. It is also good news for investors and savers as they have been starved for yield for an extended period of time. If interest rates were to rise sharply in a short period of time it would be potentially damaging to the markets and the economy. We do not anticipate this happening as inflation remains in control and despite recent moves higher in global interest rates, low absolute yields will keep our interest rates from rising too much and too quickly.

We have been anticipating this change in rates for some time and have positioned client bond portfolios to be defensive. This has been accomplished by having a lower than market duration and we anticipate reinvesting bonds that mature at higher interest rates.

## At Long Last, Rates Are Starting to Move



Source: Bloomberg

*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*



### FOR INDIVIDUALS: IMPORTANT COVERAGE

Helena Lankton, Executive Vice President  
Wealth Management Committee Chair

The insurance industry is known for its marketing strategies – from an actor with a baritone voice to a talking gecko. Policies for auto, home and life seem to take the lead and rarely do we hear about umbrella policies.

Although we all hope that nothing significant will happen, the basic aspects of the lives we enjoy leave us exposed. If you drive a car or boat, for example, or have frequent house guests, a swimming pool or a hot tub – a personal umbrella excess liability policy may help reduce your risk of liability in the event of an accident. Your children or pet could inadvertently harm someone. Contract workers and domestic staff in the home could be a risk and even joining a nonprofit board could expose you to liability more than you may think.

Attorneys who represented affluent families in liability lawsuits have reflected on two trends that seem to create more exposure and vulnerability for the wealthy. First, frequency of filings tend to increase during bear markets and a slow economy. Second, if multiple parties are potentially liable from an accident, the plaintiff's attorney may pursue a strategy of only suing the wealthiest defendant rather than all parties involved.

Compared to the expense, the amount of coverage an umbrella policy can provide makes this an important topic to discuss with your insurance provider. The first step in determining your exposure is to assess your overall net worth. An umbrella policy that protects these assets is critical and having an insurance professional review all of your policies to establish a cohesive plan is an important part of planning. Not having the right policy in place could be the largest financial risk facing you and your family. Mitigating this risk will increase your peace of mind.



### FOR INSTITUTIONS: FIDUCIARY RESPONSIBILITY

Don Rainer, Executive Vice President  
Institutional Services Committee Chair

*Fiducia*, the root word of fiduciary, takes its origins from the original contract that bears the same name. Under the fiducia, a person would transfer their property to another on the condition it would be restored and held in good faith. If the property was not returned, the contract holder would be labeled *infamia* and lose legal or social standing. In modern times, fiduciary responsibility is a distinction in the investment industry on how assets are managed and the relationship a firm has with its clients.

Under ERISA rules, those who manage an employee benefit plan must act solely in the interest of their participants and beneficiaries. Investment fiduciaries are classified as either 3(21) or 3(38). 3(21) fiduciaries do not have discretion over plan assets directly, but exercise a certain level of influence and must meet a "standard-of-care." 3(38) fiduciaries have discretionary control and can make investment decisions on behalf of the client according to their investment policy guidelines.

As a 3(38) fiduciary, Ferguson Wellman makes investment decisions on behalf of clients according to their investment policy. For our clients, this means that we shield them from fiduciary responsibility and relieve them from making their own investment choices while also adhering to their directions and acting prudently when choosing investments.

The Labor Department continues its comment period for expanding fiduciary responsibilities beyond registered investment advisors. Currently, RIAs are held to the standard of making recommendations that are in the overall best interest of the client, not just ones that are suitable for the client but may compensate the advisor more than other options. Neither Ferguson Wellman nor West Bearing are compensated by any other company and therefore all decisions are solely in their best interest of their clients.

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



## SPEAKING MY LANGUAGE

by Elizabeth Olsen  
Vice President of Marketing

**Contagion:** Also known as financial contagion, it is a term that refers to the spread of market disturbances from one country to another. This can be observed by following movements in stock prices, bond spreads, currency exchange rates and capital flows.

**“Internationalize”:** the process of increasing involvement of activity in international markets. In regards to currency which is how we referenced it, this term refers to the widespread use of a currency outside of its country of origin for use in transactions between sovereign states. The rate at which it becomes internationalized depends on the demand from oth-

er countries for that currency.

**Renminbi:** the official currency of the People’s Republic of China. The renminbi is legal tender in mainland China, but is not legal tender in Hong Kong or Macau. It is issued by the currency authority of China, the People’s Bank of China. The Chinese character symbol is ¥.

**Special Drawing Rights:** The term that refers to the supplementary foreign exchange reserve assets which are outlined and maintained by the International Monetary Fund. The value of SDRs are based on a pool of key international currencies reviewed every five years by the IMF. The IMFs count SDRs as playing a critical role in providing liquidity to the global economy during the great recession of 2009. The currencies currently included in this pool are the euro, Japanese yen, pound sterling and the U.S. dollar.

*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@fergusonwellman.com](mailto:info@fergusonwellman.com) for a copy of our Glossary of Investment Terms or visit our blog at [blog.fergusonwellman.com](http://blog.fergusonwellman.com) for more definitions.*

## Communication and Education Sources:

Business Dictionary  
International Monetary Fund  
Investopedia  
Investorwords.com  
Wikipedia



## FOVINCI’S SERVICE TO PORTLAND ROTARY

The firm is proud to recognize Marc Fovinci and his dedication to the Rotary Club of Portland as he has stepped down from his post as president of the local chapter this June. Fovinci has been a member of the club for 17 years and previously served as president of the Portland Rotary Charitable Trust. Over the past year the club contributed over \$275,000 to multiple charitable causes such as grants for local nonprofit organizations; domestic violence awareness and prevention; transportation for low-income seniors and families; clean water, literacy, sanitation and healthcare services in other countries, and supporting exchange student programs for adolescents at home and abroad, among others.

## WELCOME TO THE FIRM

Over the last few months, we have welcomed three new employees to Ferguson Wellman: Heidi Goertzen, Peter Jones and Danielle White. Goertzen is our chief compliance officer, Jones is a trading associate and White is the sales and marketing associate. Prior to joining Ferguson Wellman, Goertzen was an investment associate for RVK, Inc., Jones was a client service associate for UBS Financial Services and White worked as an inside sales representative at Arauco North America.

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

*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.*