MARKET LETTER

MARKET PERSPECTIVE FIRST QUARTER 2015

DON'T FIGHT THE ECB

George Hosfield, CFA
Principal, Chief Investment Officer

IN THIS PUBLICATION

Founded in 1975, Ferguson Wellman is a privately owned registered investment advisory firm, established in the Pacific Northwest. With more than 706 clients, the firm manages $4.1 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.

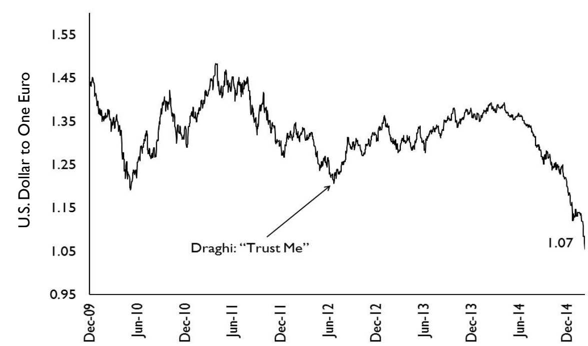
INVESTMENT EXCELLENCE
LIFELONG RELATIONSHIPS

Volatility aside, 2015 is playing out much the way we anticipated. Europe's central bank has graduated from talking about quantitative easing (QE) to actually delivering on it, and with $1.1 *trillion* of bond purchases planned for the next 18 months, markets are taking notice. Euro currency losses have accelerated against the greenback as traders gauge the ultimate impact of a stimulus package equal to 13 percent of the Eurozone's economy.

A materially weaker euro comes at the expense of earnings for U.S. multi-national companies, but is a breath of fresh air for the Continent's exporters and global conglomerates because it makes their products less expensive overseas and boosts the value of foreign profits translated back into euros. Equally, aggressive expansion of Europe's monetary base should stimulate lending and help increase big-ticket consumer durable purchases and capital goods investment. Perhaps in anticipation of QE's benefits to the economy, European "green shoots" have begun to materialize in the form of better-than-expected retail sales and manufacturing activity.

Meanwhile, the U.S. economy retains a firm bid. Notwithstanding the strong dollar's impact on U.S. exports and company earnings, currency strength is boosting the purchasing power of U.S. consumers by dampening the cost of imports, including oil. While low fuel prices aren't likely to persist, an increasingly healthy job market, rising home values and robust stock prices lead us to conclude that consumption spending will continue to spur the U.S. equity market. However, in recognition of an increasingly mature expansion, the Fed will likely pull away from the "Global Liquidity Peloton" by eliminating its zero interest-rate policy later this year. But owing to a muted inflation outlook, we do not expect dramatically tighter monetary policy anytime soon.

Euro Plummets vs. Dollar



Source: Strategas

Early in the quarter, for the first time in five years we modestly reduced our allocation to U.S. large-cap equities and added to bonds. While fixed income yields remain low, a slightly higher allocation to shorter duration bonds should help offset the expected equity volatility that could persist in equities in a later cycle environment. In addition, we are further reducing our large-cap U.S. equity allocation to "neutral" in favor of moving to an overweight in international equities, where we find valuations increasingly attractive in the Eurozone, which is poised to benefit from mammoth monetary stimulus by the ECB.

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

THE MINUS 0.01 PERCENT

Dean Dordevic, Principal
Alternative Assets and Portfolio Management

"The problem with quantitative easing is it works in practice, but it doesn't work in theory." -Ben Bernanke, Former Federal Reserve Chairman, January 16, 2014

Judging by the title of this piece, you might think that we are about to broadly opine on the subject of global wealth inequality or even wealth redistribution. But minus 0.01 percent is actually *the current yield on the five-year German Treasury bond*. That's right, for the privilege of lending your hard-earned Euros to the German Bundesbank, you actually get back *something less* than what you gave them five years earlier. Negative interest rates. Yes, they are here. The "German Bund" - an all-weather, virtually 100 percent "safe" investment now comes with a new feature: *a guaranteed loss*. It goes without saying that five years hence these funds will be *worth even less* after enduring the further insult of five long years' worth of inflation. But who are we to quibble over a few more Euros.

There are a host of other countries in Euroland that have joined the *Negative Interest Rates Club*. Many are not even part of the European currency union. That is, they mint their own currencies. Amazingly, and as of this writing there are some *two trillion in notes and bonds within Europe that offer yields of less than zero*. All German bonds with maturities under seven years yield less-than-zero. Sweden is the most egregious issuer, with negative yields of up to -0.75 percent. Switzerland and Denmark are not far behind.

Prior to 2014, there was little or no research on this subject. The possibility of negative interest rates was rarely if ever discussed - or even contemplated - in academia. There is no professor of Finance 101 who has ever begun her lecture by saying, "*... today class, we are going to learn how to calculate the present value of a stream of future cash flows - using a minus 0.75 percent interest rate ...*" Consequently there is no textbook or even central bank paper that has previously even mentioned this topic.[1] That is, at least prior to this year. If you're thinking that negative interest rates are the moral equivalent of *Alice in Wonderland* for the world of finance, you would be right. But why then, is this happening?

Sometimes, it really pays to be first. In the aftermath of the financial crisis, the U.S. was the first to begin lowering interest rates - bringing them to near zero by early 2009. Ben Bernanke, who is considered to be one of the foremost students of the Great Depression, embarked on an aggressive policy of quantitative easing or "QE." QE had never been tried before, and QE had the potential to do many things and have many effects. But at its core, it would do two things.

First, QE would act as sort of financial market "Drano." That is, during the depths of the financial crisis, there was a minor mountain of paper (bonds) that just wasn't moving. There was no longer a liquid market for these assorted instruments. It would take a "sovereign" (i.e., the Fed) with a printing press, an unlimited supply of ink and an ability to at least theoretically hold these securities indefinitely to fix this problem. Regardless of whether or not the engine (the economy) would ultimately function again without a transmission mechanism (the financial markets), the economy would not get the jump start it so sorely needed.

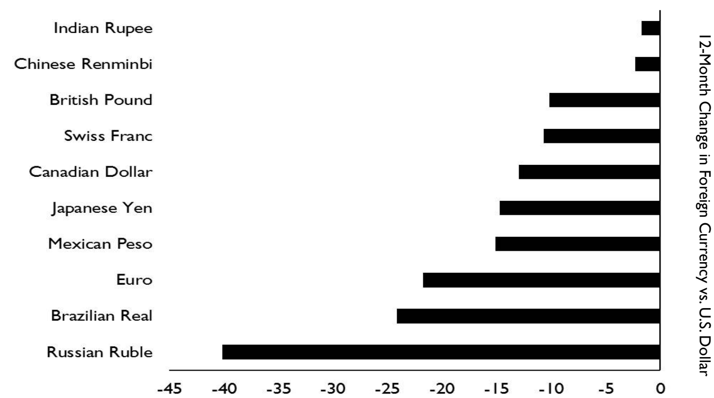
QE "doesn't work in theory" because there is no variable in the myriad equations of the Federal Reserve playbook that can solve for "E." That is, human emotion. John Maynard Keynes once described this dilemma as the challenge of restoring investors' "animal spirits." So the second important impact of QE would be to bolster asset prices. The idea here is that asset prices in general (stocks, bonds, real estate, etc.) would rise from the impact of QE and investors would eventually *feel wealthier*. In theory, investors who felt increasingly wealthy would start to spend and invest once again. It is important to remember that zero interest rates in the aftermath of an epic recession have little or no effect on one's propensity to borrow. The juxtaposition of zero interest rates and recession is often likened to "pushing on a string." In fact, investors are more likely to be reducing debts during those early post-recession years than taking on new loans. But in hindsight, QE did what it was supposed to do. The wheels of finance were lubricated, asset prices gradually rose and the U.S. economy began to grow once again.

The Great Recession of 2008 was a global phenomenon and the rest of the world did not respond as quickly with the administration of Bernanke's good medicine. So the U.S. economy emerged from the recession before the rest of the world. QE has now ended in the U.S., and the only question is *when*, and not *if* the Fed will raise interest rates. On the other hand, Japan began its QE experiment (twice as large as the U.S. on a GDP equivalent basis) about two years ago, and the European Union just began its QE process earlier this March. Very much like Japan, the European Central Bank's (ECB) QE will be massive as well. By way of example, it will be buying bonds in an amount equal to as much as *22 times* the net issuance of bonds by Germany. There will be a relatively price *in*sensitive buyer too, buying paper with negative yields up to minus 0.20 percent. There has been much speculation that in the face of such a large bond buying spree, a shortage of bonds could indeed develop.

In some respects, the world of finance is not unlike the world of Newtonian physics. For every action there is - at least somewhere - an equal and opposite reaction. Interest rates that are falling in some countries, and rising or about to rise in others can produce huge adjustments in currencies. That is what we are witnessing right now. With the notion that the Fed will begin raising interest rates sometime this year, and there not being a snowball's chance that interest rates will rise in a good part of most of the rest of the developed world, the U.S. dollar has been soaring - very recently reaching a 12-year high versus a basket of other large liquid currencies. It is important to understand that globally, unsynchronized rounds of QE are forcing interest rates down to zero and beyond, and that in turn is spilling over into the relative values of currencies worldwide. So what then does this mean for our economy and the financial markets?

As a practical matter, the very strong dollar is on balance a positive for U.S. investors. The prices of imported goods will continue to decline, which is very positive for inflation. And despite globalization, the U.S. is still largely a closed system. Fully 87 percent of our GDP happens solely within our borders, which acts to dilute the negative effects of a strong dollar. It is likely that the strong dollar will have more of a negative impact on reported S&P 500 profits however, since approximately 40 percent of the constituent company earnings within the index are derived from non-U.S. sources. So a strong dollar will likely have more of an impact on corporate profits than U.S. GDP.

King Dollar



Source: Cornerstone Macro

On the other hand, foreign capital continues to pour into the U.S. This is because of very juicy (positive) levels of interest rates on our bonds, a rising currency and a relatively strong economy. As such, non-U.S. investor can indeed make money twice. Perhaps this is why U.S. stocks tend to perform well during dollar bull markets. Since the late 1970s the U.S. stock market has performed about twice as well during dollar bull markets than that during dollar bear markets. Returns are best, however, during periods of U.S. dollar stability.[2]

The Great Recession of 2008 pushed the financial system to its firewall, and called for an unorthodox set of solutions. While it is still too soon to judge whether or not QE was a complete success, we were lucky to have had a Fed chairman who wasn't a slave to his institution's dogma or its many formulas. Having a sense of humor during our darkest hours probably didn't hurt either.

Weapons of Reason footnotes and sources:

1. Bill Gross, "Going to the Dogs," *Janus Capital Group, Investment Outlook,* March 2015.
2. Liz Ann Sonders, "Million Dollar Question: Is the Dollar's Strength Bullish?" *Charles Schwab & Co. Research*, September 15, 2014.
3. Cornerstone Macro, Chart and Background Data.

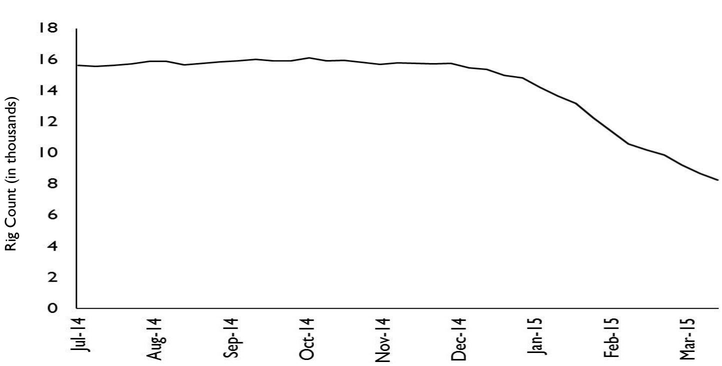
SKATING TO WHERE THE PUCK WILL BE

Shawn Narancich, CFA
Executive Vice President of Research

Much has been made recently of the build-up in crude oil inventories *domestically* and whether the U.S. will run out of storage capacity for the stuff. Against this backdrop, benchmark West Texas Intermediate oil prices are retesting lows beneath $45 per barrel that was reached in January. As markets grapple with rising U.S. production that has not *yet* felt the impact of reduced drilling, we predict that the U.S. *will not* run out of storage capacity and, even more importantly, that oil prices will finish 2015 well above current prices.

Every year in late winter, U.S. refiners reduce their processing of oil in preparation for peak fuel demand in the summer driving season. However, since early February, utilization rates have dropped more than usual because of high "turnaround" activity and one-time factors like the refinery strike and an explosion in California that took one major refinery offline. With demand for physical oil curtailed, excess supplies have accumulated. Combined with cyclically *peaking* U.S. oil production, a perfect storm for prices has pundits and the financial press conjecturing about the next leg down in prices. We beg to differ.

Always Darkest Before the Dawn



Source: Bloomberg

As striking workers resolve their grievances and go back to work, U.S. refiners are well incented by high margins to expeditiously complete their seasonal maintenance and return throughput to full capacity. We foresee the accompanying renewed bid for oil coming at the same time U.S. oil production is about to roll over as the result of a plummeting domestic rig count. As the accompanying chart shows, producers disadvantaged by low prices and without the cash flow to sustain previous levels of activity have dramatically curtailed their drilling since last fall. In just five months, the number of U.S. rigs targeting oil is down 49 percent.

This precipitous fall-off in drilling *will reduce output*, it's just a question of *when* it begins to show up in the numbers. But when it does (and production from major shale plays like the North Dakota Bakken is already diminishing), the psychology of oil traders so important to near-term pricing is likely to reverse.

Longer-term, we see the marginal cost of oil somewhere between $75 and $100 per barrel. Absent these prices, we do not believe the world can produce enough oil to meet demand – demand that *domestically* has taken off in recent months as U.S. consumers revert to driving the trucks and sport utility vehicles they enjoy. Overseas, oil demand growth should slow in China alongside its slowing economy, but we see an emerging demand driver in India. New reform-minded leadership, courtesy of President Narendra Modi, is beginning to make the country a more attractive destination for investment, which is so dearly needed in an economy lacking the type of infrastructure that could meaningfully boost fuel demand.

In anticipation of higher oil prices, we have moved to overweight the energy sector and have tilted our exposure to the oil and gas producers and their service and equipment suppliers that stand to gain the most as commodity prices recover.

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: HEALTHCARE CHOICES

Helena Lankton, Executive Vice President
Wealth Management Committee Chair

Healthcare insurance is complicated. So is the federal government. When you combine the two, you get Medicare, a complex program that requires careful navigation. Understanding your options and developing a best course of action is something we recommend exploring at least six months before your 65th birthday.

There is an initial enrollment period for signing up for Medicare: three months before you turn 65 and three months after your birthday. If for some reason you aren't able to enroll during that timeframe, you are able to enroll between January 1 and March 31 of each year, which will result in coverage starting on July 31. The downside to enrolling later is that it is likely you will permanently pay higher premiums than if you had signed up earlier.

There is one major caveat to the initial enrollment window as noted above. If you're still working and covered by your employer's health insurance plan at age 65, you may defer signing up to Medicare for as long as you're covered by your employer's plan. This special enrollment period lasts for eight months after you leave your employer's health insurance plan.

Once you have taken the initiative to enroll, decisions must be made on what kind of coverage you need. If you have other types of coverage, make sure you understand how they work with Medicare. Having a grasp of the costs of premiums, deductibles and other costs is essential in your decision-making process. Conversely, it is important to check with your current healthcare providers to ensure that they accept Medicare coverage.

Supplemental coverage and your prescription drug plan adds another layer of costs to the process. In short – the earlier you become informed of your options, the more comfortable and confident you will feel about your decisions.

FOR INSTITUTIONS: STRESS TESTS FOR COMMITTEES

Don Rainer, Executive Vice President
Institutional Services Committee Chair

March 9 marked the six-year anniversary of the bottom of the bear market and the start of the bull market we continue to enjoy today.

Eventually, the markets will cool down as the 200-percent growth cycle that began in 2009 pulls back. Experience has taught us that now is the time for investment committees to review their asset allocation before the market winds change course.

Views on risk and return can be affected by volatility and fear-mongering headlines. We encourage institutional investment committees to take advantage of this period in the market cycle to review investment policies and risk tolerance to ensure that the goals of the organization are agreed upon before the markets shift. An asset allocation study is one tool that can help organizations plan ahead as it uses historical returns to forecast risk associated with different asset allocations. It may predict future returns in support of an organization's mission, spending policies and actuarial assumptions.

Another tool for institutional investment committees is to utilize our *Horizon for Institutions*™ investment forecasting model. Taking stock of historical data of market activity and providing "stress tests" on portfolios enables clients to review possible scenarios and plan a course of action that is not impacted by emotion. This valuable resource can be implemented to help plan for future expenditures and drawdowns, and can be especially helpful when key committee members cycle off boards and committees and new members join.

We value the team approach that we seek to take with our institutional clients and feel it fulfills the mission and obligations of the organization that hires us to manage their assets. These resources are designed to explore potential outcomes and help clients feel confident about the ir strategy at any point in an economic cycle.

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

ALL GREEK TO ME

by Elizabeth Olsen
Vice President of Marketing

Animal spirits: A term John Maynard Keynes used in his 1936 book, *The General Theory of Employment, Interest and Money*, to convey emotions that influence human behavior and can be measured by consumer confidence and trust.

***Global Liquidity Peloton*:** This is the term that we gave to our 2015 Investment Outlook. In it, we state that the global economy has shifted from synchronized expansion to one decoupled by currency, monetary policy and capital market returns. It is a metaphor for what is presently occurring in the global economy. Much like a peloton in the Tour de France, where a group of cyclists rides in a pack but each rider ultimately hopes to break free of the pack to lead the race, many major economies have "ridden" together through the recession and are now employing similar techniques (e.g. quantatative easing) in an attempt to grow their economies. We believe later this year the U.S. will break free from the pack with the Fed eliminating its zero interest policy.

North Dakotan Bakken: A source rock unit that exists in the subsurface of outcrop formation in North Dakota. The formation actually occupies approximately 200,000 square miles that spans Montana, North Dakota and Saskatchewan and Manitoba, Canada. It is named for Henry Bakken, a farmer who owned the land from where the formation was initially discovered. The Bakken was found during oil drilling in 1951 but it is the techniques of hydraulic fracturing and horizontal drilling of late that have caused a boom of oil production since 2000. It is estimated that there are reserves of approximately 24 billion barrels of oil in the Bakken.

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:

Business Dictionary
Bakken Blog
Investopedia
Investorwords.com
Wikipedia

THE LAST WORD FIRST QUARTER 2015

RUDD HONORED BY OREGON STATE UNIVERSITY FOUNDATION

The firm is proud to announce that Chief Executive Officer Jim Rudd has been given the highest honor bestowed by the Oregon State University Foundation. In February, Rudd was honored with the Lifetime Trustee Award at the Destination OSU event in Phoenix, Arizona. This distinctive award has only been given to six other trustees, among them Ferguson Wellman co-founder Norb Wellman. Rudd was named an honorary alumnus by Oregon State University in 2006 and is current co-chair of the $1 billlion capital campaign for OSU. Though he was never a student at Oregon State he has adopted the university since his time as the director of an affiliate of the OSU Foundation at the beginning of his career in the 1980s.

FAULKNER RECOGNIZED BY PORTLAND BUSINESS JOURNAL

Mary Faulkner, senior vice president of branding and communications, has been honored by the Portland Business Journal as a 2015 Woman of Influence. She is being recognized by the Journal in the company of 24 other honorees from around Oregon and SW Washington. Faulkner joined the firm in 2006 and has had a large impact on how our firm utilizes communication and connects with our clients. She is a driving force behind our wealth management and institutional services committees as well as the annual report. In addition to her work at the firm, Mary serves as board chair and founding board member of the Lone Fir Cemetery Foundation and was past board chair of the PSU Center for Women's Leadership.

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.