

# OUTLOOK 2015



## RIDING THE GLOBAL LIQUIDITY PELOTON

Macro Strategy and Domestic Equities

by George W. Hosfield, CFA

Principal and Chief Investment Officer

The global economy has shifted gears from synchronized expansion to one decoupled by currency, monetary policy and capital market returns. Treasuries kept pace with global competitors last year despite losing a bid from the Fed, as international investors starved for the yield increasingly absent in European and Japanese credits sought relatively higher fixed income returns domestically. The U.S. economy is now pulling away from the pack and *leading* a race that should produce *rising rates* in the year ahead as the Fed begins *removing liquidity*.

Unlike 2013, last year blue-chip U.S. equity returns hewed much more closely to the high single-digit growth rate of 2014's earnings growth. International investors again fared far worse, registering losses reflecting an increasingly moribund Europe, slowing growth in China and a Japanese economy that has fallen back into recession despite aggressively easy monetary policy. Layer in geopolitical turmoil emanating from the former Soviet Union and what resulted was a notably strong bid for U.S. assets.

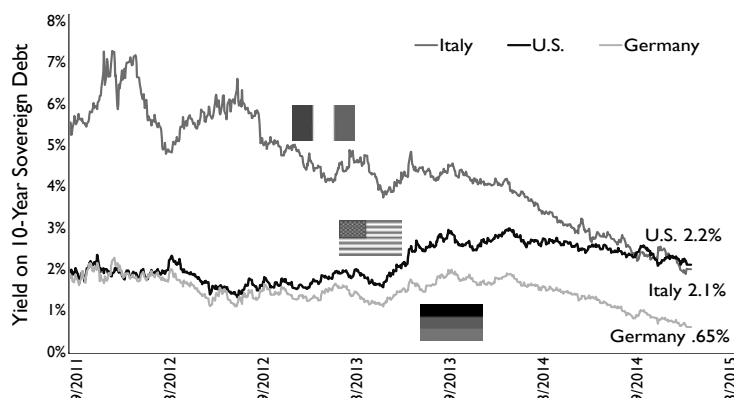
After a slow start to 2014, the U.S. economy increasingly enjoyed the best of both worlds – declining inflation and faster economic growth. While promising to slow the U.S. energy boom, dramatically lower oil prices have produced meaningful savings at the pump and boosted the disposable income of U.S. consumers. In turn, retail sales are up and job growth has accelerated. A U.S. economy gaining strength has coincided with the Fed exiting QE, leaving investors to expect “lift-off” from zero-interest-rate policy sometime in 2015. Thanks to below-target inflation and stable unit labor costs, we are not expecting dramatically higher rates anytime soon.

As the Fed's balance sheet levels off, we believe that an al-

ready strong dollar may continue to rise and incent the purchase of additional goods and services internationally. The resulting export boost for challenged economies overseas should help keep their economies *in the race*. Despite the moderating potential of rising imports and a slower pace of oil drilling, the U.S. economy stands to gain from a healthier consumer and further improvement in manufacturing and capital spending, all of which *benefit* from lower oil prices.

## Liquidity Around the World Pushes Rates Down

Source: Bloomberg Financial Markets



In an environment of low interest rates, which are likely to trend modestly higher, we retain our below-benchmark fixed income duration and preference for U.S. stocks over bonds. After substantial underperformance by international equities in three of the last four years, we recognize that the increasingly compelling valuation of European and emerging market stocks may justify additional investment and a relative reduction in the allocation to domestic equities. As for oil, we think it's oversold and anticipate adding to the energy sector.

### FERGUSON WELLMAN'S INVESTMENT OUTLOOK PRESENTATIONS

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01/22 Bend, OR  
01/27 Portland, OR

01/28 Twin Falls, ID  
01/29 Boise, ID  
02/03 Salem, OR

02/04 Spokane, WA  
02/05 Corvallis, OR  
02/05 Eugene, OR

02/11 Roseburg, OR  
02/18 Medford, OR  
02/19 Astoria, OR  
03/18 Palm Desert, CA

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01/20 West Bearing Investments, Portland, OR  
02/11 Umpqua Private Bank, Seattle, WA  
02/12 Umpqua Private Bank, San Francisco, CA





## FIXED INCOME

by Marc Fovinci, CFA, Principal  
Fixed Income Strategy and Portfolio Management

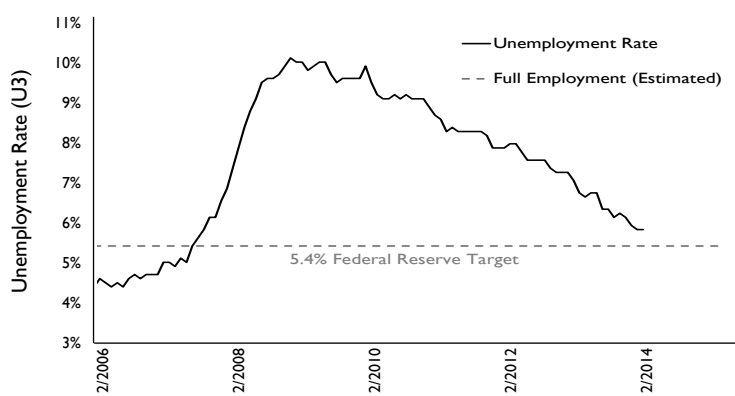
The U.S. financial system, as well as the financial system worldwide, are *awash in money*. Over the last few years, the U.S., Japan and Europe have overloaded their banks with cash, pushing short-term interest rates to zero. In a normal economy, the money would speed up economic growth and bring on inflation, but this cycle has not been normal. The lingering effects of the financial crisis continue to stunt optimism and growth, making the money in the system ineffective (beyond the psychological effect) at creating stimulus. Economist John Maynard Keynes labeled this situation a “liquidity trap;” in other words, no matter the amount of money put in the system, *the economy fails to respond*.

Despite the much-talked-about “Fed tapering,” or the Fed’s gradual reduction of its monthly addition of money to the system, the financial system continues to be flooded with cash. Defying most money managers’ forecasts (including us) of upward-trending interest rates, in fact, interest rates actually dropped last year. First, a harsh winter put the brakes on the growing economy in the first quarter of 2014, pushing interest rates down. After the U.S. economy bounced back, the focus then turned to both a slowing China and Europe and chattering by the European Central Bank of further quantitative easing. To close out the year, oil prices plummeted, hammering away at the expected rate of inflation and again pressuring interest rates downward.

We look forward to 2015 as a year in which these factors move into the past as the financial markets already have priced in a slower economy in Europe and lower oil prices. We anticipate that oil prices will find a bottom and start to rebound in 2015. Without repeated slashes to the price of oil, its impact on inflation will be transitory. The improvement in the economy has been so gradual that it has flown below the radar of consciousness of most Americans. Nonetheless, the labor market is now approaching the full employment rate, which is believed to be 5.4 percent as targeted by the Fed. We anticipate that sometime mid-year 2015 the economy will reach full employment and reassure the Fed that the economy is on firm footing, thus giving the Fed the green light to neutralize those funds and raise the Fed funds rate from near zero to 0.25 percent.

## Steady Employment Gains

Source: Bureau of Labor Statistics



The activity of short-term bonds recently confirms the expectation of a rate hike sometime in 2015. To that end, the yields of two- and three-year U.S. Treasury notes have already moved up in anticipation. We expect long-term bonds to move a similar amount as we get closer to the rate hike. The first rate hike will be a major unwind of the quantitative easing of the Fed and will mark the escape of our economy from its liquidity trap. Many of the effects of the excess liquidity should start to unwind in 2015. Low yields and excess money motivated investors to invest in anything with a higher yield. The challenge for investors has been that high yield bonds have not had high yields, but that is starting to change. This area of the market has already started to sell off, and that will likely accelerate in 2015. Investment-grade bonds should not jump as much in yield; however, we believe a neutral weight or underweight to the lowest quality of investment-grade, BBB-rated, is now appropriate. We continue to overweight single-A rated bonds which enjoy a nice yield above Treasury bond yields and should be shielded from the major impact seen in lower-grade bonds. In this environment, our client portfolios remain shorter in maturity than benchmarks and emphasize investment-grade corporate bonds over agency and Treasury bonds.





## MUNICIPAL BONDS

by Deidra Kryz-Rusoff, Senior Vice President  
Tax-Exempt Trading and Portfolio Management

Last year was another healthy environment for municipalities as municipal bonds delivered 11-straight months of positive performance, and we expect that trend to prevail in 2015.

Fundamentally, increasing housing prices have lifted property tax collections and rising employment numbers have strengthened municipal coffers across the nation. In fact, overall tax collections in 2014 were higher than their previous peak in 2008. State reserves and balances have also increased, a sign of improving fiscal health.

Pension funding ratios continued to improve last year, due in large part to the growth in the equity market, with the largest plans averaging over 72 percent funded. However, unfunded retiree healthcare costs of an aging population will put pressure on state finances.

Municipal bond demand has outpaced supply last year, which has contributed to the muni market rally. After having been in “austerity” mode since the financial crisis of 2008, improving budgets and a continued low interest rate environment have encouraged slow reinvestment in capital projects.

Despite further municipal credit strengthening, last year the headlines of large municipal bankruptcies remained. Front and center was Detroit’s general obligation bondholders exiting bankruptcy with \$0.74 per dollar invested. Puerto Rico is now the next big name to battle against default. Despite these well-publicized cases, the total number of bankruptcies is only about 0.25 percent of the total municipal market.

Although municipal bond issuance should increase slightly, we expect this supply to be met with more individuals purchasing muni bonds as they move to shelter their income from ever higher taxes. We expect that municipal performance may soften in a gradually increasing interest rate environment, but believe that municipal bonds continue to be an important part of a tax-efficient investment strategy.



## REAL ESTATE INVESTMENT TRUSTS (REITS)

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

Up almost 25 percent, the performance of real estate investment trusts (REITs) was one of the biggest surprises of the year. Interestingly, REITs were the *worst* performing asset class in 2013 and were the *best* performing asset class in 2014. The reason behind the unexpected price appreciation had to do primarily with falling long-term interest rates. REITs rely heavily on debt financing as part of their business model to purchase real estate. When interest rates go down, the incremental debt funding costs for REITs also declines. The lower interest expense allows REITs to return more cash to shareholders.

Another factor driving REIT performance is the global hunt for yield. Interest rates in most developed markets dropped throughout 2014, and REITs with average dividend yields well above most investment grade bonds proved an attractive source of income for investors.

The underlying fundamentals of REITs have been strong across most segments of the commercial real estate market. Strong employment gains in the economy helped drive demand and lower vacancy rates for office and industrial space across much of the country. In addition, strong demand for space allowed rents to rise throughout the year. The apartment market also enjoyed rising rents as more stringent mortgage underwriting has prevented many people from becoming homeowners. There is also a trend of greater urbanization driving apartment demand where baby boomers, as well as millennials, are favoring an urban lifestyle near amenities as opposed to the suburbs.

After the strong performance they enjoyed last year, entering 2015, REITs are expensive by almost any valuation metric. The underlying values of the real estate assets owned by REITs are relatively expensive as the demand by investors for commercial real estate has driven up prices in many markets. While we believe the underlying fundamentals of real estate will remain strong with the robust economy, the valuation gives us some pause about the sector. As a result, we continue to be underweight REITs in client portfolios.





## DIVIDEND VALUE

by Jason Norris, CFA, Executive Vice President  
Equity Research and Portfolio Management

Capital markets were somewhat schizophrenic in 2014 as economic growth strengthened and equities delivered close to double-digit returns. Despite these factors, interest rates fell meaningfully. The lack of inflation and threat of possible deflation outside the U.S. (specifically in Europe and Japan) served to push rates down. This phenomenon had a profound effect on Ferguson Wellman's *Dividend Value Strategy*\* when entering 2014, we were positioned for a cyclical economic recovery in the U.S. Thus we had underweighted interest-rate-sensitive areas, and emphasizing the cyclical sectors such as energy, industrials and consumer discretionary. The chart below highlights the relative performance of the three major interest-rate-sensitive areas where we were underweight: REITs, utilities and telecommunication versus the broad market.

### Strong Performance by Interest-Rate-Sensitive Sectors\*\*

Source: FactSet



\*\*Interest-rate-sensitive sectors comprise the S&P 500 utilities, telecom and REIT industries. The broad market is the Russell 1000.

As interest rates fell throughout the year, the interest-rate-sensitive sectors performed better for a variety of reasons. First, they typically have a higher nominal yield than the market. Thus, as investors looked for income, they sought out these names. While we focus on yield in the *Dividend Value Strategy*, we also focus on growth. With our market outlook, we thought it prudent to emphasize dividend growth as opposed

to absolute yield. Second, these sectors are typically highly levered and lower interest rates bring down their borrowing costs. This also led to better relative equity performance as these companies cleaned up their balance sheets. As interest rates fell throughout the year, this positioning was a headwind for performance. However, even though capital appreciation was below benchmark, the focus on dividend growth enabled the strategy to deliver increased cashflow to investors of approximately 17 percent relative to 2013.

During the summer of 2014, we adjusted our interest rate call by lowering our forecast for the 10-year Treasury due to global pressures. As fears of deflation and stagnant economic growth increased in Europe, their low rates put a cap on ours. At this time, we made an initial addition of two REITs to the strategy. However, we did continue to maintain our tilt toward dividend and cyclical growth due to the improvements that we anticipated in the U.S. economy. Since that initial investment in REITs, we have not added to our exposure due to concerns over valuation.

As we look to 2015, we expect continued U.S. economic growth, specifically fueled by healthy consumer spending. Inflation should remain low as commodity prices trend lower and the U.S. dollar trends higher. With our expectation that interest rates will move higher with improving growth and Federal Reserve tightening, we are maintaining our focus on the dividend growth. We may also entertain moving some capital back to into the energy sector as we believe that crude oil prices will bottom over the next few months and drift higher throughout 2015 toward \$75 a barrel. Historically, when energy stocks have been the worst performing sector, they are the best performer in the subsequent six months. We will be focusing on balance sheet strength and asset quality when we add to the sector in 2015.

Over the longterm, the goal of the *Dividend Value Strategy* is to deliver a balanced approach that can provide greater income and less volatility than the broad equity markets.

\**Dividend Value* is an all-equity strategy which invests only in dividend-paying stocks. This strategy strikes a balance between dividend growth and absolute dividend yield.





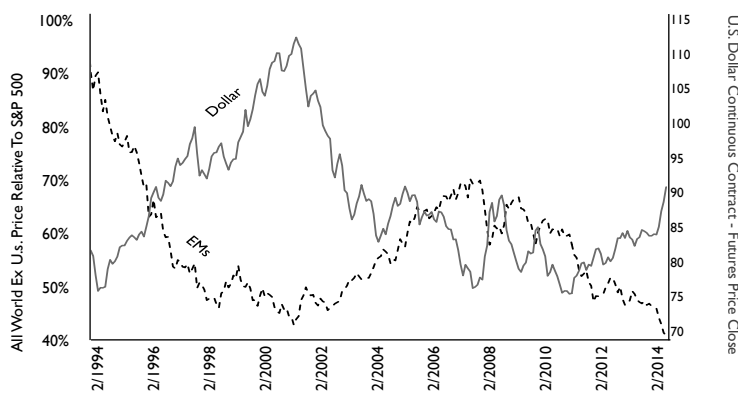
## INTERNATIONAL EQUITY

by Ralph Cole, CFA, Executive Vice President  
Equity Strategy and Portfolio Management

Investing in global markets is inherently a precarious endeavor. While opportunities abound, so do risks that introduce volatility on a daily basis. Today, the primary risk facing U.S. investors overseas is the stronger U.S. dollar. The accompanying chart shows returns of the MSCI All Country World Index ex U.S.\* relative to the S&P 500 over the past 18 years. Bottom line, when the dollar is strong, international markets tend to underperform. One can also observe from this chart that currency swings tend to last years, not months.

### Dollar and Emerging Markets Move Inversely

Source: FactSet



Given this relationship, we moved to neutral in our international allocation and underweight emerging market stocks within portfolios in the fourth quarter of 2014. One of the primary themes of 2014 that we were trying to capture is to underweight commodity-exporting economies and emphasize economies that benefit from lower oil prices. As we enter 2015, we remain underweight Brazil, Canada, Australia and Russia for this reason. At this juncture we favor regions that benefit from lower commodity prices, such as Asia.

India, a country that moved sideways much of the past few years, took off in 2014. We see two reasons for this phenomenon. First, Prime Minister Narendra Modi took office in May of 2014 with the promise of modernizing India's economic system, which was no small feat. Second, India is

an energy-poor country and imports nearly 75 percent of their oil needs on an annual basis. As such, they are a big beneficiary of lower oil prices, which will help keep a lid on inflation.

We also like Singapore, as this City-State has positioned itself as the banking capital of Southeast Asia. While the Singapore banks do business in China, they are not state-owned enterprises and their accounting is seen as some of the best in the world. Singapore benefits as inter-country commerce keeps gaining speed in that part of the world and their banks have positioned themselves at the center of most cross-border transactions. Singapore is also home to a number of technology companies that benefit from Apple's supply chain.

Despite a Euro that continues to weaken against the dollar, we have overweighted Europe in international portfolios. One way to take advantage of a weaker Euro is to invest in companies that sell to the U.S. A prime example are European pharmaceutical companies who benefit from a strong dollar, because they produce goods in Europe and then sell them to the U.S. This allows for improved profits as the dollar rises. Finally, European equities currently have lower valuations than their U.S. counterparts and as the European Central Bank implements QE, we expect the economies of Europe to begin to rebound next year.

Though volatile, there are numerous opportunities around the world which will benefit from central bank stimulus and continued growth in the U.S. economy.

*\*The MSCI All Country World Index ex U.S. Investable Market Index (IMI) captures large, mid and small cap representation across 22 of 23 developed market countries (excluding the U.S.) and 23 emerging market countries. With 6,099 constituents, the index covers approximately 99 percent of the global equity opportunity set outside the U.S.*





## ALTERNATIVE INVESTMENTS

by Dean Dordevic, Principal  
Alternative Assets and Portfolio Management

Over the past few years, we have developed relationships with some outstanding managers in private equity, distressed debt and real estate. In addition, we have forged alliances with select hedge fund managers and highly specialized mutual funds. We continue to search both nationally and internationally for new alliances that are attractive and appropriate for inclusion in select client portfolios.

Below is a brief summary of the offerings that we have chosen to participate in as of December of 2014.

### Alternative Investments\*

**Asius Fund** is focused on China, India, Korea and Southeast Asian (Asean) countries. This fund gives unique access to local managers in these respective markets. Nearly three quarters of the fund is invested in China and India to benefit from the economic rebound in India and revival of the A-share market in China.

**Cube Global Multi-Strategy Fund** is a high conviction, London-based global fund-of-hedge-funds. Cube expresses strong macro views by investing in hedge funds with few primary return drivers. In addition, Cube employs a beta management overlay, with the goal of mitigating volatility. Emerging Asian and African markets have been consistent themes in Cube's funds making up 17 percent of the portfolio as of November of 2014.

**Neuberger Berman Absolute Return Multi-Manager Fund** combines the structural advantage of a mutual fund with a roster of high quality hedge fund managers. The fund delivers true hedge fund strategies within the context of a greatly reduced fee structure. In addition, the fund has the flexibility to go both long and short. Performance suffered earlier in the year in response to the repatriation debate, but remained on par with hedge funds even though this is a daily-valued, highly-liquid mutual fund.

### Illiquid Alternative Investments

**Acorn NW Real Estate Fund** is an Oregon-based real estate fund that targets high quality multi-tenant retail centers, medical offices and business parks. Acorn closed on its first portfolio purchase in late 2013 with the acquisition of a medical property, Northwest Center for Orthopedics and Rehabilitation. A second property, Sunset Oaks Medical Plaza, was purchased earlier this year.

**Hatteras Global Private Equity Partners II** is a global fund of private equity funds that closed earlier in the year. The use of exchange-listed private equity and a fund purchased in the secondary market have resulted in healthy first-year returns.

**Keystone National Private Equity Fund II** was our first investment with Keystone. This fund is a traditional private equity fund-of-funds which recently finished its investment period and is now generating distributions. As of the third quarter, more than 65 percent of contributed capital has been returned to investors.

**Keystone National Private Equity Funds III, IV, and V** are distressed credit-oriented funds. Fund III has finished its investment period and has returned 42 percent of contributed capital. Fund IV has not yet finished its investment period and has had more than 20 percent of investor cash returned. Fund V, which closed last year, is fully committed.

**Keystone Recovery Partners II** was a specialized fund that purchased Chapter 13 bankruptcy claims. Through prior funds Keystone created an institutional platform for purchasing claims. The fund closed in 2012 and has already returned more than 40 percent of contributed capital.

**Vista Ridge Diversified Fund** is a traditional private equity fund-of-funds. The portfolio is now fully committed and has been self-funding since 2011. More than half of contributed capital has been returned. Vista Ridge has achieved extremely strong returns on invested capital.

*\*May not be appropriate for all investors. The appropriateness of an investment strategy will depend on investor's circumstances and objectives.*

