MARKET LETTER

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THIRD QUARTER 2009

Synchronicity, Reflexivity, and Fiat Money

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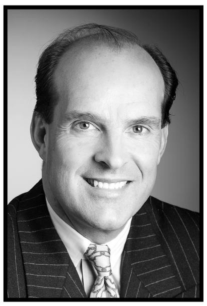
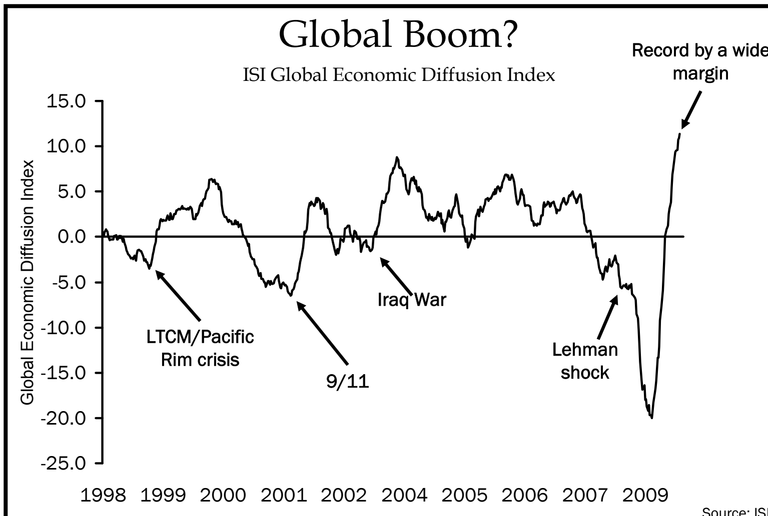


"The error of optimism dies in the crisis, but in dying it gives birth to an error of pessimism. This new error is born not an infant, but a giant." – *English Economist Arthur C. Pigou*

There's an old adage on Wall Street that goes something like this: It's never wise to predict both time *and* price. That "advice" would have served a prognosticator well this past year. Just as summer follows spring, there was never any doubt in our minds that *recovery* would follow *collapse*. What has been quite remarkable; however, is the speed *and* strength of this nascent recovery. We are in the midst of what some noted economists are calling an "*unprecedented synchronized global upturn.*" It now appears that this recovery phase may, in fact, be more robust than previously thought. Why *is* this so, and what are the consequences of such an outcome for investors?



Economic Diffusion Index: *A data series measuring real-time variables such as production, employment, price levels, and orders designed to gauge global output.*

It's been almost three decades since the U.S. economy has experienced anything like our most recent past. The eight-month recessions of 1990 and 2001, in comparison, almost didn't count. In each of these two recessions, declines of just 1.4 percent and 0.3 percent, respectively, barely moved the GDP needle. Michael T. Darda, chief economist of MKM Partners in Greenwich, Connecticut, suggests that we may not fully understand or appreciate the dynamics of what a recovery from the abyss really looks like. He said, "*The most important determinant of the strength of an economic recovery is the depth of the downturn that preceded it. There are no exceptions to this rule, including the 1929-1939 period.*"[1] After the depressions of 1893, 1907, 1920, and 1929, strong growth was the order of the day, not milquetoast recovery. In the first full year of recovery from the Great Depression, GDP (inflation adjusted) surged by 17.3 percent. From a contemporary perspective, emerging from the last - worst secular downturn (1983), the economy surged at quarterly rates of growth ranging from 5.1 percent to 9.3 percent for six consecutive quarters. It wasn't until the third quarter of 1984 that growth finally dipped below 5 percent.[1]

This history is especially interesting, since the data rolling out of the various reporting services are rather stunning. These results are broad based too: Retailers' surveys are the strongest in two years. After having plunged by $14 trillion, consumer net worth has bounced back by $4 trillion, 16 percent higher than in 2000.

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Both productivity and corporate earnings are surging (the elixir for better employment and the key to the sustainability of recovery). From the lows, heavy truck production has increased 58 percent, machine tool orders are up 47 percent, and oil rig counts have rebounded by 11 percent. Even in Detroit, the inventory of unsold homes is now down almost 40 percent from a year ago. More importantly, we are not alone in sharing this good news. Said *The New York Times'* Keith Bradsher, *"Just eight months ago, thousands of Chinese workers rioted outside factories closed by the global downturn. Now many of those plants have reopened and are hiring again. Some executives are even struggling to find enough temporary staff to fill Christmas orders."*[2]

Perhaps most interesting of all is a very simple set of facts. As the financial crisis worsened and as thoughts of deep recession were replaced by the prospect for an economic apocalypse, shelves were stripped bare. In essence, a macroeconomic "9/11" mentality took hold and as a result, inventories, the jumper cables of economic recovery, are now astoundingly lean. Executives at Chrysler, for example, said recently that inventories are the lowest anyone can remember. If we were to see an *inventory replenishment cycle only* (more or less devoid of incremental organic growth) inventory restocking alone would result in GDP growth of about 1.5 percent over the next year. That's a pretty good base upon which to build a more than decent recovery scenario. Coming off the apocalyptic lows, it's not a stretch to assume a similar contribution (1.5 percent) from housing, and even relatively minor contributions of one-half of one percent each from both autos and global trade. That math would put GDP at 4.0 percent for the full year, with exactly *zero contributed from all other economic sectors*.[3] Just four months ago, a baseline forward-looking GDP forecast of 4.0 percent would have seemed far fetched indeed.

Several years ago, George Soros famously coined the term "reflexivity." The term essentially suggests that markets can and do create their own reality. That is, while markets anticipate recovery, they can also act to bring it about. Said James Grant, author of *Grant's Interest Rate Observer*, *"One year ago, the Wall Street liquidation stopped commerce in its tracks. Today's bull markets are helping to revive it"*[1] The previously "un-financeable," like the major airlines, have returned to the credit markets, as has leasing for some of the auto makers. There are also considerable sums of money looking to be invested. In the week just past we saw $60 billion in mergers and acquisitions (a $3 trillion annual rate of change).[4] A partial list: American Airlines raised $2.9 billion; Goldman Sachs agreed to sell a $1.4 billion holding in Sanyo Electric to Panasonic; Blackstone agreed to buy 50 percent of Broadgate for $3.4 billion; General Motors is planning an IPO next year to repay some its government bailout loans; Dell is buying Perot Systems for $3.9 billion; Unilever buying Sara Lee units for $1.9 billion and Xerox plans to purchase Affiliated Computer Services for $6.4 billion. In summary, capital markets have reopened and "animal spirits" appear to be returning in force.

All of these developments would be supremely "un-interesting" if strong growth was, in fact, the consensus view on Wall Street and therefore fully discounted in share prices. Thankfully it is not. At the moment, the median 2010 GDP forecast by economists is only 2.4 percent. This would suggest that there remains substantial *upside risk* to the very moderate expectations for recovery anticipated by the consensus. Notably, nearly 70 percent of all economic reports so far this year have been above consensus. A gulf in expectations appears to have developed, and is, in our humble opinion, an exploitable, investable event.

Readers of our last missive will no doubt recall our view predicting a recovery that looks something like a square root sign (if perhaps modified). We continue to view this as the most likely outcome. Additionally, we harbor no illusions about the amount of debt that remains in the system (toxic and otherwise). This debt will need to be amortized, and will undoubtedly weigh like ballast on the system for many years to come. Some have even likened this bounce to a "sugar high." Not entirely an inappropriate metaphor. What's more, we've set new all-time records as far a money printing is concerned. The sheer amount of money that's been printed is astounding. Just in case you're keeping score, some $1.2 trillion in the past 12 months. This is inherently problematic. So much so that about a month ago, Fed Chairman Ben Bernanke wrote a half page op-ed in *The Wall Street Journal* just to assuage the fears of the bond market on the printing frenzy. More recently, the Fed has begun talks with bond dealers about withdrawing the unprecedented amount of cash injected into the financial system. This is good, although it is highly unlikely that they would begin withdrawing funds anytime soon. Their challenge is to withdraw this liquidity without impacting the recovery, and *before* it sparks inflation. Said Tony Crescenzi, market strategist of Newport Beach, California-based PIMCO, "*The timing is not now for the exit strategies to begin ... talk of exit strategies will all seem very preliminary and conditional upon evidence that the economy is moving toward a self-sustaining and self-reinforcing condition. The proof of that will be some improvement in the labor market picture.*"[5]

After World War II, the U.S. adopted the Bretton Woods system. This pegged the value of the U.S. dollar to 1/35th of a troy ounce of gold. The U.S., in turn, promised to redeem dollars in gold to other central banks. This system ended in 1971 when, as a practical matter, there wasn't any longer enough gold to escrow all of the money in circulation. Since then, a "faith based" or "fiat currency" system has been implemented. The name is derived from the Latin word "fiat" meaning ... *let it be done*. In a fiat monetary system, there is no real limit to the amount of money that can be created. It is, for all intents and purposes, unlimited.

"You know that Krugerrand we bought in 1980? Well, pop a cork. We just broke even."

What has served as a governor on the rate of money creation is the so-called debt-to-GDP ratio. That is, our government has adjusted the amount of money in circulation relative to our economic output. As you might expect, this ratio has surged dramatically of late, and while it is concerning, we believe that there are some reasons why inflation, or hyperinflation will be avoided.

The truth of the matter is that, our government can pile money to the rafters, but until those funds become the basis for transactions, inflation doesn't result. Economists call this "velocity," and without velocity, there is no true inflationary tendency. In fact, broad measures of the so-called money supply are actually *falling*. This is due to the fact that banks have stockpiled reserves at the Fed. As Peter Coy said recently in *BusinessWeek*, "*... In a healthy economy, banks would take advantage of those reserves to increase their lending. Instead, they're hoarding the money, so the Fed's loose monetary policy isn't resulting in more loans. It's the process of lending that expands the amount of money in the economy ...*"[6]

Being belt-and-suspenders types, we have recently added a *Tactical Asset* class to our portfolio guidelines. This all-purpose asset class bucket could hold, in theory, a variety of low correlation assets and inflation hedges, including gold. Should global central bankers fail to vacuum excess money from the system at the right time, gold would be a primary beneficiary of just such a circumstance.

We believe that a global, *synchronous* recovery has begun. The "bounce phase" of our *square-root-shaped recovery* may prove to be more robust than previously thought. Just as the *waterfall market decline* post the collapse of Lehman Brothers produced its own supremely bearish reality, the powerful bull market that has unfolded around the world is producing its own more positive reality as well. Reflexivity lives. Central bankers have become the lenders of last resort, and provided the system with liquidity when it was desperately needed. Very simply, our banking system cannot survive if everyone wants their money back at the same time. Someone needed to bridge that gap, and someone did. We're in the middle innings now. We also believe that this recovery is not fully discounted in asset prices. Perhaps more importantly, we look to avoid the "error of pessimism." An exploitable and hopefully profitable paradigm has developed. Our portfolios are cyclically positioned for such an outcome.

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FERGUSON WELLMAN AND UMPQUA BANK FORM STRATEGIC ALLIANCE

On September 24, Umpqua Bank and Ferguson Wellman formed a strategic alliance, bringing our core strengths together to serve our clients. We are excited to bring together two solid, healthy companies while maintaining our independence.

How was the alliance created and what does it entail?
Earlier this year, Umpqua was searching for a solution for their money management division. As they consulted with their trusted sources, many felt our firm would be a perfect match for their objectives. We see the arrangement as the best of both worlds: sharing our strengths and staying independent.

Umpqua Bank's CEO Ray Davis with Ferguson Wellman's CEO Jim Rudd
Photo by Cathy Cheney

Ferguson Wellman is Umpqua Bank's exclusive independent investment manager for their high-net-worth clients with investable assets in excess of $2 million. Through this alliance, Ferguson Wellman now has the ability to recommend exclusive private banking solutions, such as loans, lines of credit and bill paying services, to our clients who do not have or are seeking such services.

What is unique about the alliance?
Being Umpqua's exclusive investment manager creates a unique alliance for us. We have not had an opportunity to partner with a company that did not have an existing asset management division before. We have chosen to not collect a fee for recommending our clients to Umpqua's private banking solutions so the arrangement is consistent with our other referral relationships.

How will it benefit Ferguson Wellman's clients?
This alliance enables our firm to continue to do what we do best while growing our business in a careful, prudent manner. This measurable success will enable us to make further investments in talented people and processes that will continue to benefit our clients. Wealth management is one of the fastest growing services we provide, and over the years we have received a number of inquiries about private banking from clients. We will recommend Umpqua's private banking to help clients reach their goals and objectives, but it is not our intention to disrupt a relationship a client may already have with a private bank. Working with Umpqua will enable us to seamlessly provide access to more customized services for our clients through their private banking solutions.

Market Letter Sources and Footnotes:
1 James Grant, "From Bear to Bull." *The Wall Street Journal*, September 19, 2009.
2 Keith Bradsher, "China's Economy is Roaring Back," *The New York Times*, September 18, 2009.
3 "Daily Economic Report," *International Strategy & Investment*, August 25, 2009.
4 "Daily Summary," *International Strategy & Investment*, September 21, 2009.
5 Tony Crescenzi , "Fed Said to Start Talks With Dealers on Using Reverse Repos," *Bloomberg News*, September 22, 2009.
6 Peter Coy, "Shrinking Money Supply Dampens Inflation Fears," *BusinessWeek*, September 21, 2009.

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