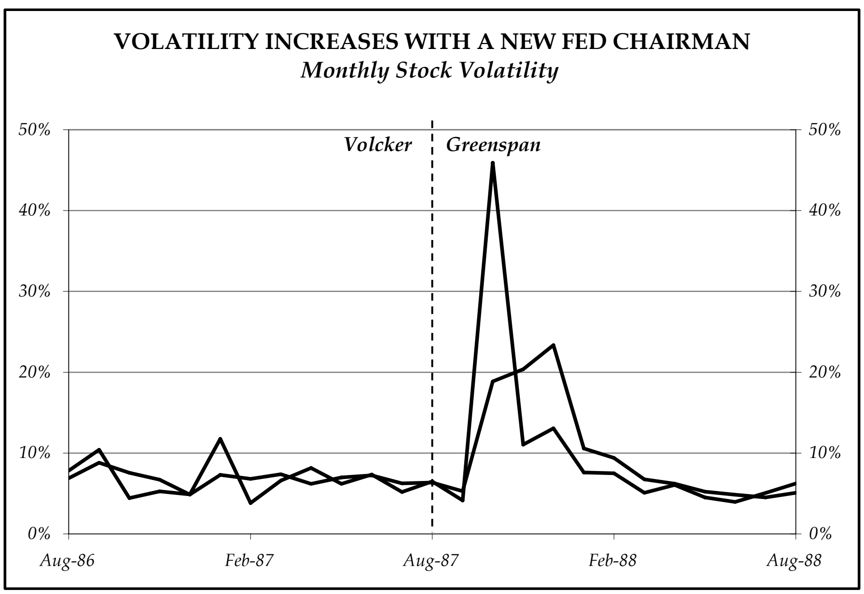
SECOND QUARTER 2006
Cool Hand Luke

On Monday, May 22, Dallas Fed Richard Fisher President said, *"Inflation is running too high for my comfort."* A week before, Richmond Fed President Jeffrey Lacker said, *"The future outlook for inflation may be beyond the borderline of what is acceptable."* Then Kansas City's Tom Hoenig told the Wall Street Journal that he was worried about *"overshooting"* with rate tightening. Michael Moskow, president of the Federal Reserve Bank of Chicago, said that inflation is running at the *"upper end of the range"* consistent with stable prices. The icing on the cake was from St. Louis' William Poole who offered the opinion that a *half-percentage point increase, or a rate cut*, could be in the cards for June.[1]

The most important actor in the movie, Mr. Bernanke, has said that it all depends on the data. But with all the contradictory statements coming from so many Fed mouthpieces … it does bring to mind the classic line, *"What we've got here is a failure to communicate."*



In no less than four weeks, justifiably confused equity market investors voted with their feet. The recent sell off has essentially wiped out the year's gains (approximately 6 percent on the S&P 500). Such dramatic market moves are unsettling and naturally cause one to re-evaluate their investment thesis and strategy.

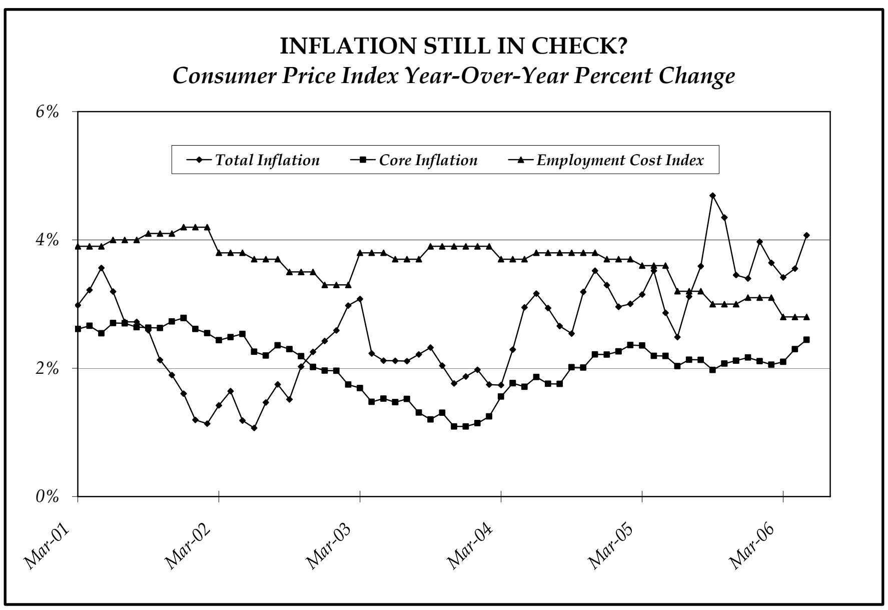
At the beginning of the year, our outlook (see "Getting Paid for the Recovery" Ferguson Wellman Market Letter Q1 2006) was built upon this framework:

- Economic growth (GDP) would slow, but there would be no recession
- Corporate earnings growth would meaningfully decelerate
- Led by commodities, inflation would be up. In aggregate, however, inflation would be contained to acceptable levels
- By summer, the Fed would complete its tightening cycle
- Stocks would outperform bonds
- Business spending will be stronger than consumer spending
- Cyclical and commodity sectors would outperform consumer oriented sectors
- The two "risks" to our forecast were higher than expected inflation and a Fed-induced, "hard landing" (recession)

To date, the macroeconomic environment has very much unfolded as we outlined in our aforementioned forecast. Though we continue to judge the likelihood of an unpleasant surprise with respect to higher inflation and/or recession as the greatest risks to our outlook—at this juncture, we believe we are on track to be rewarded for the significant underlying economic strength that remains.

We are now at an inflection point characteristic of the period just before the end of a Fed tightening cycle. Such transitions (historically) produce significantly increased market volatility as investors react to often-conflicting economic data. The Fed is not immune to this process either, as evidenced by the disparate commentary outlined above. This condition has been exacerbated by the fact that we have a new Fed Chairman at the helm, and Mr. Bernanke must establish himself in the minds of investors as a "hawk" on inflation. It is now important that the Fed exhibit the courage to take its "foot off the brake" before the economy slows too far.

In the markets own version of the film *"Sleeping with the Enemy,"* equity investors are now, somewhat ironically, rooting for economic *weakness.* In some respects this goes against our DNA, but at this point in the cycle, signs that the medicine (i.e. Fed tightening) is working, would be welcomed by investors.



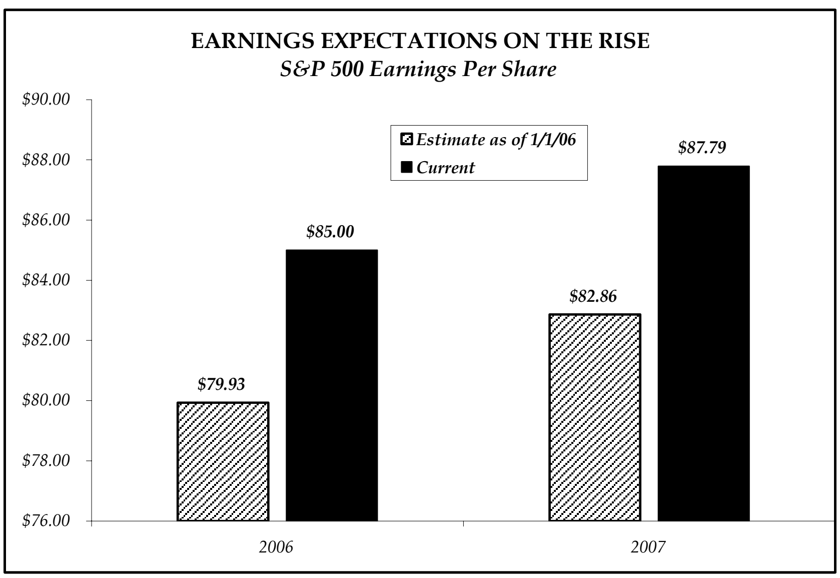
That said, as widely anticipated, the Fed raised rates for the seventeenth time on June 29. More important than the increase itself, was the commentary that accompanied it. The Federal Open Market Committee now appears to have moderated its tone.

While subject to interpretation, the change in wording would imply that a pause in the tightening cycle might be in order. Interestingly, the futures market which was discounting an over 80 percent probability for an August tightening, fell to about a 50 percent probability post this announcement. The "pause that refreshes" will be undoubtedly debated ad nauseum over the coming weeks and months, but as the Fed's own statement clearly indicates, any future tightening will be data dependent. In light of an absence of a more hawkish tone, both stocks and bonds are enjoying sharp rallies as of this writing.

While in the short-term the market can trade on little more than emotion, ultimately underlying company fundamentals drive prices.

With an eye towards a more long-term view, the following are some of the more important considerations to keep in mind:

- ***Valuation:*** The S&P is trading at 14.9 times 2006 earnings and 14.1 times 2007 earnings (our model portfolio is closer to 13.5 and 12.2 times respectively). We have not seen these valuation levels in a decade. However, interest rates were between half a percent and 2.0 percent higher
- ***Sentiment:*** Now consistent with levels that have historically led to market rallies
- *Earnings:* Currently, S&P 500 earnings are projected to grow 9 percent this year (from $76.29 in 2005 to $83.13). In fact, consensus estimates are up 4 percent since the beginning of the year for 2006 (from $80.00 to $83.13) and up 3 percent for 2007 (from $85.00 to $87.79)
- ***Inflation:*** As we expected, commodity prices have remained persistently high. In fact, even with the recent sell off, oil that began the year at $61.00 per barrel is still trading above $69.00. However, of much greater significance is the cost of labor, which has roughly *ten times the impact* on the cost of goods than does raw materials. In this regard, continued productivity gains and the net impact of an excess global supply of labor and capital are serving to keep aggregate inflation in check.
- ***Asset allocation:*** While higher interest rates and the end of the Fed tightening cycle will ultimately present an opportunity to increase our relative allocation to bonds, current valuations support our continued emphasis of stocks.



Naturally, our intellectual curiosity and fiduciary responsibility force us to challenge our assumptions each and every day. As such, we will not hesitate to revise our expectations and opportunistically make portfolio changes.

However, at this juncture, though market volatility has certainly been greater than we had anticipated, we are reaffirming our belief that Fed tightening will lead to a slowdown rather than a recession, and that from these levels, investors with a *cool hand*, will be rewarded.

Footnote:
1. Dr. Ed Yardeni – Morning Briefing – May 31, 2006

Source:
1. International Strategy & Investment – ISI – Background Research

PROFESSIONAL PROFILE – HELENA B. LANKTON

Patience pays off. For proof, just look at the unhurried teaming up of Helena Lankton and Ferguson Wellman. The firm's partners esteemed the accolades Lankton earned in her years as a Bay Area stockbroker. And Lankton, who often met the partners at industry events, respected their reputation. Still, for years the mutual admiration society was, well, muted.

Then, says Lankton, "When I finally decided to make a change, I looked at 20 firms up and down the West Coast. The only one I wanted to work for was Ferguson Wellman—because my investment philosophy fits with this firm, right down the line. "

When she studied the firm and met with CEO Jim Rudd, the decision virtually made itself. "I was reading their annual report," says Lankton, "and when I came to the core values said to myself, 'If they really do eat, sleep and breathe these values, I'm going to be happy.'"

Lankton also shared the firm's commitment to community service. Almost immediately upon relocating to her home state, Lankton joined the board of the Portland Art Museum. She counts herself lucky to have arrived just when art-world powerhouses John and Lucy Buchanan took the helm. "It's been an incredible 12-year odyssey," she reflects.

Helena Lankton with husband Milt at the Portland Art Museum
Photography by Bruce Beaton

"We went from bleeding red ink to being one of the top 25 regional museums in the country."

And, as one of just 46 women among the 650 members of the Arlington Club, Lankton is helping create a top Northwest art collection. She's proud to note that her grandfather's portrait hangs in what she calls the "rogues gallery" of prominent founders. A fourth-generation Oregonian, she's delighted to help preserve her state's art and history.

Lankton spends her days connecting with clients and tracking companies in their portfolios. And, because she enjoys strong relationships with estate attorneys, accountants and other professionals, she's leading the firm's efforts to reintroduce itself.

"I'm meeting with people who *think* they know Ferguson Wellman," she explains. "What they may not know is that we have expanded from a traditional money management firm to a true wealth management firm."

Continues Lankton, "For 17 years we've had no turnover in our senior ranks other than retirement. That's such a solid message, because in this business it's performance *plus* stability *plus* a full roster of services that cement a loyal relationship."

Helena Lankton's family includes her husband Milt, a lawyer at Davis Wright Tremaine, and five sons they share from previous marriages. "The shortest one is six feet tall," she laughs. "When we get together, I call it Helena and the basketball team."