Market Letter

Market Perspective — Third Quarter 2014

NOT TOO HOT, NOT TOO COLD

by George Hosfield, CFA
Principal, Chief Investment Officer

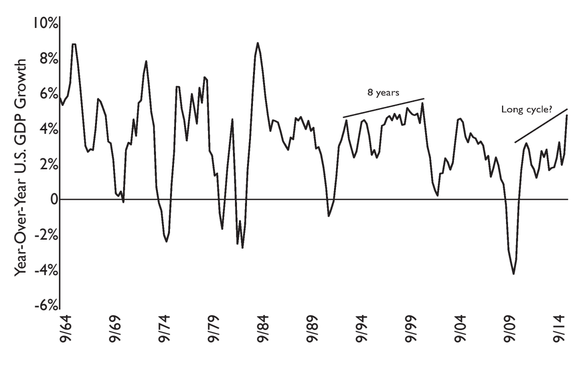
Although stocks are on track to deliver positive returns this year, the ride has become bumpier as investors debate how far and how fast Yellen & Co. will raise interest rates. History shows that equities are more volatile ahead of tightening cycles, but what is different this time around is the notable lack of excess in the stock market or in key commodities, labor and housing. Economic cycles die of overheating, not old age.

While we acknowledge the Fed's plan to normalize monetary policy, a decoupling of economic prospects globally presents interesting dynamics that could give legs to the current U.S. expansion. Europe's economy is near stall speed, Japan is grappling with the economic aftershocks of boosting its national sales tax and China's growth rate is slowing as it unwinds an investment bubble. In sharp contrast, the U.S. economy is poised to grow at a healthy clip, driven by a boom in energy production and a related renaissance in manufacturing. As a result, the U.S. has become a favored investment destination.

Indeed, foreign demand is one reason why benchmark Treasury rates remain low compared to recent history, but the fact that they are above sovereign yields in most other developed nations reflects investors beginning to discount tighter U.S. monetary policy. With fewer dollars likely to be sloshing around global markets, the greenback has surged in value relative to the currencies of key trading partners, providing a degree of optionality for the Fed inasmuch as a strong currency makes imports like oil less expensive. Combined with low unit labor costs and grain prices that have plunged in response to record crops, inflation is unusually benign at this part of the economic cycle.

We foresee the dollar continuing to rise, creating headwinds for investing internationally and within emerging markets in particular. Therefore, we are reducing our holdings of emerging market stocks in favor of additional large cap U.S. equities. Given the inverse relationship of a strong dollar and energy prices, we have also pared energy sector exposure.

Economic Cycles Die of Overheating, Not Old Age



Source: FactSet

Our preference for U.S. stocks versus bonds reflects the former's reasonable valuation and an outlook for continued mid-high single digit earnings growth. In contrast, real yields on domestic bonds remain thin, discouraging the ownership of longer duration issues.

IN THIS PUBLICATION

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

THE UGLY AMERICAN ... REDUX?

by Dean Dordevic, Principal
Alternative Assets and Portfolio Management

Dan: What are you doing?
Jerry: Taking off my shoes.
Dan: Why?
Jerry: Because I run faster with no shoes.
Dan: You can't outrun that bear!
Jerry: I don't have to outrun the bear. I just have to outrun you!

From: "Without a Paddle," Paramount Pictures, 2004

Pity the poor Swiss. They are the avatars of fiscal restraint and perhaps the world's most *prudent* central bankers. The year is 2011 and the Swiss can take it no longer. In the aftermath of the financial crisis, with global printing presses running at full bore, investors regard the Swiss currency as sort of a curious form of *gold with yield*. With the franc soaring in value, money from all over the world pours into Switzerland.[1]

With exports generating over 54 percent of Switzerland's GDP, the Swiss really have no choice. The Swiss National Bank (SNB) will now print francs with abandon. Their monetary mandarins will then buy euros by the bucketful with these newly-minted francs. A line in the sand had been drawn. The franc shall not rally beyond 1.20 to-the-euro-mark, they say. The SNB's balance sheet expands from 23 percent of GDP to almost 83 percent of GDP. Now loaded with euros, their once pristine balance sheet has been sullied. For some perspective, over the very same time frame and after three consecutive rounds of quantitative easing (QE) in the U.S., the Fed's balance sheet expanded from 6 percent to *only* 25 percent of GDP. In the global currency wars, the Swiss became collateral damage.[1]

"Whatever it takes."—Mario Draghi

At the peak of the euro-panic, Irish, Spanish and Greek 10-year bonds delivered spectacular yields of 14.08 percent, 7.62 percent and 37.1 percent, respectively. With the mere utterance of these four important words by European Central Bank President Mario Draghi, yields on the aforementioned *began to melt*, yielding 1.88 percent, 2.33 percent and 5.69 percent, respectively.[1] Even the 10-year bond issued by that stalwart sovereign Slovakia (*yes, Slovakia*) now carries a lower yield than the 10-year U.S. Treasury bond. The important point is this: these interest rates were and are the result of massive liquidity injections by the European Central Bank. Much like our own, these interest rates are indeed *administered*, not market derived. While scholars will for decades debate the efficacy of this Herculean rescue, the system had seized. A compete financial collapse, perhaps even a depression, had been averted.

As we all now know, the process of rescuing the world's financial systems, while not identical, unfolded all across the globe in a very similar fashion. In the aftermath of the financial crisis, global central bankers administered, for the most part, the very same medicine. But these doses came at different times and in varying concentrations. Countries and even entire regions have responded and recovered at *varying rates*. With expansions taking root and in our continual survey of the world for growth, it's apparent that global growth has now become—*unsynchronized*.

While these policies collectively have economic consequences that are both broad and very deep, they reverberate perhaps most powerfully in the largest and most liquid financial markets: the currency markets. On any given day, the value of a sovereign's currency is a function of myriad inputs. But in a world where zero-interest-rate policies, serial attempts at quantitative easing, and competitive currency devaluations are more the rule and not the exception, *everything is relative*. At risk of great oversimplification, it doesn't really matter how fast my economy or my printing press is running. What really matters is *how fast mine is running relative to yours.*

Is the Dollar ... King?

Quietly and somewhat curiously, the U.S. dollar has strengthened of late. The U.S. dollar now rests at a four-year high versus other global liquid currencies. But this being a relative game, the strength is the U.S. dollar is as much a story about the absolute rate of U.S. growth, as it is about *the relative weakness of others*.

With the Bank of Japan's (BOJ) massive effort at economic stimulation (QE more than twice that of the U.S. on a GDP equivalent basis), the Japanese yen has declined in value by almost 30 percent (versus the dollar). With Europe stable, but just now clearly *stalling*, the euro has weakened and appears to be poised for a continued downward adjustment. China too has seen their low-double-digit GDP growth rate cut more-or-less in half. This has put enormous pressure on both the commodity-sensitive Australian dollar and a laundry list of economically-sensitive commodities as well. With both a razor-thin "no" vote on Scottish succession and an upcoming vote on whether or not the UK will remain in the EU, the sterling has been weak too.

With the ECB jawboning and the BOJ still aggressively easing, our Fed is beginning the slow and grinding process—first toward monetary policy normalization and then ultimately higher interest rates. It would make perfect sense that the U.S. dollar would appreciate. "*The theme during the second half of this year is U.S. dollar strength. The (U.S.) economy is growing very strongly, we have (had) a very good set of results, and the (U.S.) central bank will probably be the first to increase interest rates*," said Yannick Naud, portfolio manager at London's Sturgeon Capital.[2] So the strengthening U.S. dollar is the result of both the absolute, and more importantly, the *relative strength* of the U.S. economy. Very significantly too, strengthening U.S. growth and a stronger dollar will make the U.S. an increasingly attractive allocation opportunity for global investors.[3]

Let's Be Franc

In the $5-trillion-per-day market for foreign exchange, incredibly, the U.S. dollar is on one side of nearly *87 percent of all trades*. The United States has the world's largest and most liquid market for Treasury securities. Most importantly, the Fed has clearly demonstrated its ability to be the world's lender-of-last-resort. With this in mind, the so-called "reserve status" of the dollar is not going to go away any time soon.[3]

While a strong dollar is generally bullish, there are negative consequences too. Exports will be more expensive and U.S. products will be less competitive in foreign markets. Money earned abroad will be worth less after conversion into U.S. dollars. However, the flip side of this coin is important as well. Imports will grow cheaper and this will act as an important pulse to counter-balance inflation.

That being said, a strong dollar has historically been bullish for the stock market. Since the late 1970s, the stock market has performed about *twice as well* during "dollar bull markets" than during "dollar bear markets." Returns are their *best*, however, during periods of U.S. dollar stability.[3]

While a strong dollar is indeed a double-edged sword, on balance, a strong and/or stable dollar carries with it more positives than negatives. It is also very important to realize that currency movements by their very nature (especially large and liquid currencies) can be long-lived affairs exhibiting movements that are often characteristically both glacial and self-reinforcing. This could perhaps create a positive environment for continued global capital flows toward U.S. dollar-denominated bonds and stocks for some time to come.

With this in mind, there are several obvious considerations that shall distill directly into our portfolios. U.S.-dollar-denominated investments should be generally favored. Developed markets will likely provide superior returns relative to the emerging markets, with some notable and important exceptions to be sure. So too we would expect commodities in general to do relatively poorly, with precious metals like gold (often called the "anti-dollar") especially so.

Any traveler over the last decade or more who has visited Europe, the United Kingdom or even Japan armed with a fistful of dollars—returned with a reasonably profound sense of "shock and awe" over the paucity of the greenback's relative purchasing power. We have good news … *this tide may very well have turned*.

Could even a return of the "ugly American" be in the cards? Who knows, even Switzerland might be on our list. We hear it is a lovely place to visit.

Weapons of Reason footnotes and sources:

1. James Grant, "The Balance Sheet That Ate Switzerland," *Grant's Interest Rate Observer*, September 19, 2014.
2. "Dollar Extends Four-Year-High As Gold Drops," *Bloomberg*, September 25, 2014.
3. Liz Ann Sonders, "Million Dollar Question: Is the Dollar's Strength Bullish?" *Charles Schwab & Co. Research*, September 15, 2014.
4. Landon Thomas, Jr., "Buoyant Dollar Recovers Its Luster, Underlying Rebound in U.S. Economy," *The New York Times*, September 26, 2014.

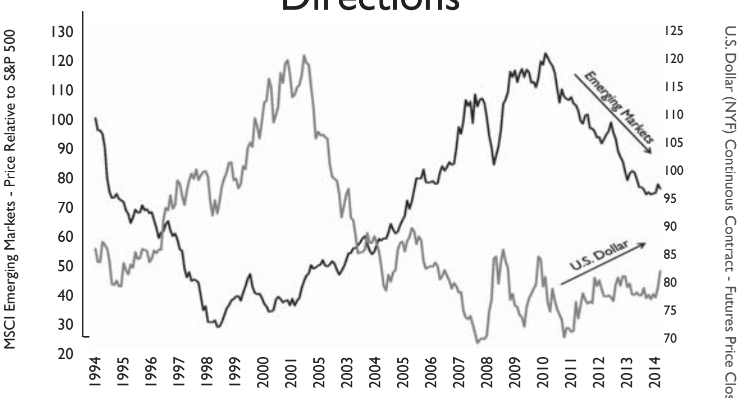
(UN)SYNCHRONIZED GLOBAL EXPANSION

by Ralph Cole, CFA
Executive Vice President of Research

Investing in international markets offers the opportunity to gain access to world class companies in developed and emerging economies. For many international stocks, their domicile isn't as important as their industry group. As portfolio managers we strive to balance both currency/ country risks with finding companies that are positioned well in the anticipated economic environment.

Today we are faced with a world that is growing at different rates within both the developed markets and the emerging markets. The clear growth leaders in the world today are the United States and the United Kingdom. Which means, among the developed markets, they are the nations closest to raising short-term rates. Higher growth should lead to both higher long-term rates, and stronger currencies in those countries. At the same time, Europe is stagnating with zero growth and near zero inflation. As such, the EU is about to embark on quantitative easing (QE) for the first time. This should lead to a weaker Euro and hopefully better economic growth in 2015. We view this as both a risk and an opportunity. Japan is already undergoing QE in order to stimulate growth and increase the rate of inflation. These actions should continue to drive down the price of the yen.

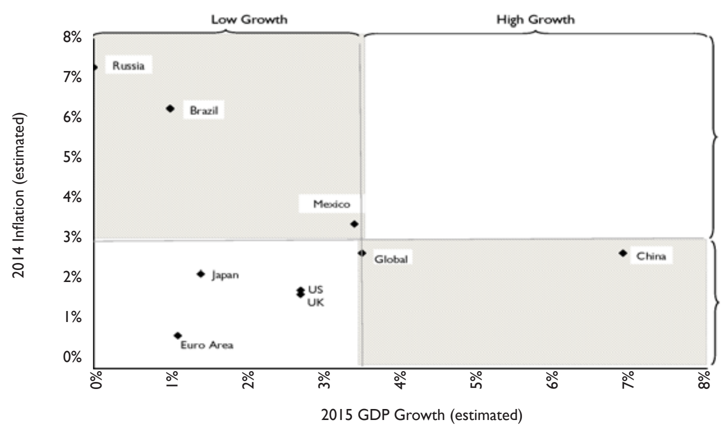
The Dollar and EMs Move in Opposite Directions



Source: FactSet

A stronger dollar presents a formidable headwind for emerging markets. The emerging markets have benefitted this year from lower rates around the world because their relatively high yields have drawn outside investors, which in turn, has lowered their borrowing costs. However, this tailwind is most likely gone for the emerging markets. As U.S. rates rise and the dollar strengthens, global investors are more likely to shift investments away from some emerging markets and into the U.S. Some emerging markets will be able to handle this flow of funds issue; South Korea and China come to mind. This will be especially difficult for a country like Brazil as they continue to struggle with low growth and high inflation. Without solid growth prospects, investors will look elsewhere for opportunities.

The Global Growth



Source: Barclay's

With the expectation that the dollar will continue to strengthen, we have reduced our weightings in both the emerging markets and small capitalization, developed markets. This move reduced our allocation to "neutral" toward international equities in client portfolios. While weak foreign currencies can help countries increase their export business and bolster their domestic companies, it acts as a large headwind for U.S. investors. It is our job to identify stocks that can increase in value enough to justify their country's weaker currency.

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: COORDINATING ADVISORS

by Helena Lankton, Executive Vice President
Wealth Management Committee Chair

It's not too early to start year-end planning to offset realized gains and income where possible. Working with your accountant, we can determine how you are positioned with regard to current tax rates and take appropriate action.

Coordinating with you and your estate planning attorney, we can start making arrangements for year-end gifts to charities and family members well before the December rush. We can also assist in exploring the benefits of setting up a donor advised fund.

As always, anytime you are in touch with one of your professional partners, it's important to ask yourself if any new developments in the past year would warrant changes to important documents. With every meeting, we first check in with clients on evolving circumstances that would impact their established investment goals and objectives. Tax strategies and estate planning documents regarding your intentions may also need to be modified.

For example, many clients are surprised to learn of the impact the American Tax Relief Act of 2012 has on irrevocable trusts. New taxes plus higher brackets on undistributed income make it necessary to review each trust's investment strategy and manage for taxes. For 2014, if taxable income is over $12,150, the tax is $3,140.50 plus 39.6 percent of the amount over $12,150. If a trust is in the top income tax bracket, the top capital gains tax rate of 20 percent applies to net capital that exceed the top income rates for trusts (i.e., the amount above $12,150 for 2014). Many trusts will also be subject to state taxes and the 3.8 percent Medicare surtax on net investment income.

We are always happy to assist with arranging meetings and coordinating communication with your professional advisors. Giving yourself time to think through what you need to do by the end of the year enables you to make careful decisions and not feel rushed.

FOR INSTITUTIONS: PROCESSING GIFTS

by Don Rainer, Executive Vice President
Institutional Services Committee Chair

As we enter the final quarter of 2014, we are reminded of the dedication of our 60 nonprofit clients as they approach one of their busiest times of year. Due to holidays and year-end tax strategies, Ferguson Wellman and West Bearing process hundreds of gifts in the last few weeks of the year on behalf of our nonprofit clients. These gifts come in the form of appreciated securities or cash to the nonprofits.

Gifts are an important funding mechanism for many organizations. Ensuring that these transactions are processed correctly and producing essential data for those donors is an important service we complete on behalf our clients. When receiving a gift of securities for a nonprofit, it is important to provide the organization with low, high and average prices for the securities on the date of receipt. This is critical information the organization should provide the donor for tax purposes. Following the gifting policy of the organization as it refers to the sale of a gift is equally important when managing the portfolio for the long-term.

Cultivating, accepting and managing the gifting process is sometimes a job that isn't very visible by stakeholders within the organization. It takes a tremendous effort by the development staff to make this efficient and worthwhile for the mission of the organization. We often work closely with the board or finance committee but we would like to take this opportunity to acknowledge the hard work of the development professionals that make this part of the revenue engine work.

We are privileged to work for organizations with a wide range of focus areas such as education, healthcare, social services, conservation and faith-based missions. Through our work with their investment committees, board of trustees and staff, we appreciate the commitment to serving others and working collectively to fill the needs in our communities.

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

ECON EXPLAINED

by Elizabeth Olsen
Vice President of Marketing

Monetary Policy: A strategy chosen by a central bank, currency board or other regulatory institution that determines the expansion or contraction in a country's money-supply. The policy usually employs three tools: buying or selling national debt, influencing interest rates by changing reserve requirements and/or changing credit restrictions.

Reserve Status and Reserve Currency: Refers to the status of the U.S. dollar at present. In general, a reserve currency is one that is held in significant quantities by central banks and governments as part of their foreign exchange reserves. These monies are frequently used in international transactions as a means to pay off debt or as a vehicle to influence a country's domestic exchange rate.

Tightening Cycles: The time frame during which a central bank constricts credit in an economy that is seen as having too much growth or is more affected by inflation than would be prudent. In America, the Fed makes 'money tight' by raising short-term interest rates which then increases the cost of borrowing and reduces its attractiveness.

U.S. Dollar-Denominated Bond: A bond with a price that is quoted in U.S. dollars. It can also refer to a U.S. bond that trades outside of the United States whose coupon payments and principal are paid in U.S. funds.

Zero-Interest Rate Policy or Zero-bound Interest Rate Policy: A concept of macro-economics where short-term interest rates are so low they are near zero. In the circumstance of such low rates, a central banking authority loses the option of further rate reductions to stimulate economic growth.

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
Investopedia
Investorwords.com
Wikipedia

THE LAST WORD THIRD QUARTER 2014

COMMUNICATION RESOURCES

Communication is critical to the relationships we build with our individual and institutional clients. From in-depth quarterly reports regarding clients' investment portfolios to commentary on the economy and capital markets—it's important to us that clients have a solid understanding of the analysis and decision-making behind our investment strategies.

Planning for our *Investment Outlook* season for clients is underway. It will begin in January of 2015 and conclude in March. We will also provide our *Investment Strategy* video for clients who reside in other areas of the U.S. Throughout the year, we communicate to clients how our *Investment Outlook* takes shape in the economy and capital markets—where we hit the mark and where we missed.

Other communication resources we continue to offer clients include our *Glossary of Investment Terms*, which defines terms our clients will find in our quarterly reports and *Market Letter*. For clients who prefer our weekly perspective on market activity, our blog, *To Coin a Phrase*, shares our commentary on news worth noting. You can subscribe at blog.fergusonwellman.com or contact info@fergwell.com and (503) 226-1444 for assistance.

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.

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