SPECIAL REPORT

AN ANNUAL PUBLICATION OF FERGUSON WELLMAN CAPITAL MANAGEMENT

OUTLOOK 2009

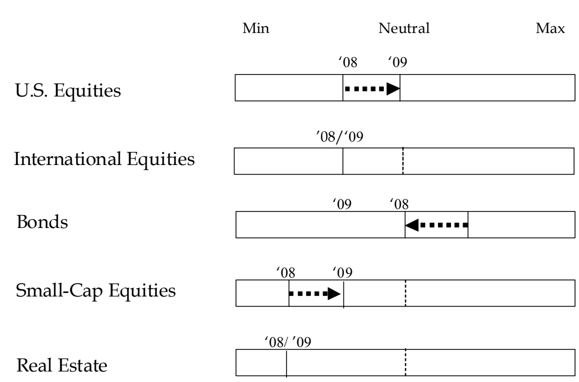
Stemming the Tide BY GEORGE HOSFIELD, CFA

A year ago, we published our 2008 Outlook entitled “Stepping Back From Risk.” The somewhat cautious report listed potential capital market risks as a “significant housing recession, commodity inflation and the possibility of the banking crunch intensifying.” With those concerns in view, we recommended modestly reducing equities, increasing allocation to bonds and emphasizing quality in the selection of all debt and equity securities. However, never in our wildest imagination did we anticipate the severity of the economic storm that unfolded. Amid a virtual credit market meltdown, the U.S. led the world into a recession that decimated equity values across the globe, proving our forecast of mid-single digit equity returns wrong both directionally and by several orders of magnitude.

The fiscal and monetary response from the U.S. Treasury and the Federal Reserve to the crisis has been of unprecedented pace and magnitude. Furthermore, central banks have earned their “lender of last resort” moniker by way of aggressive and coordinated global actions that will ensure that a 1930s-style deflationary spiral will not be repeated. We expect the economy to remain in recession throughout 2009, and with that, unemployment to continue climbing to perhaps 10 percent before peaking sometime in 2010. However, markets historically “climb the wall of worry” and move at least six months ahead of the “real economy.” To that end, ultimately, fixed income spreads will narrow, real estate will bottom, the credit markets will thaw and the investor pendulum will swing from fear and towards a modicum of greed. This phenomenon will likely begin in earnest sometime next year and though we expect positive equity returns for 2009, it is likely to be skewed towards the second half of the year.

Recommended Asset Allocation

2008 vs. 2009



Economic Timeline

2009-2010

- Economy struggles to grow under weight of first consumer-led recession in 17 years
- Confidence and order slowly return to financial system
- Housing market stabilizes
- Capital markets returns are modest

2010-2011

- Economic growth improves and payrolls expand
- Inflation risks rise substantially
- Stocks rise decisively as earning growth improves and valuation expands

Regarding asset allocation, the U.S. was the first to enter recession and the U.S. will likely lead the world out of it. Coupled with a relatively stable outlook for the dollar, domestic returns should be produced that are superior to those abroad. As a result, we intend to keep our focus skewed towards domestic equities. It is our intent to reduce our fixed income holdings and increase our allocation to equities as signs of a thaw in the credit markets emerge. With respect to stock selection, unlike the last cycle (2002) in which more speculative companies led stocks higher, we believe that in a deleveraged and capital-constrained world, higher-quality companies with balance sheet strength and solid free cash flow generation are likely to win this time.

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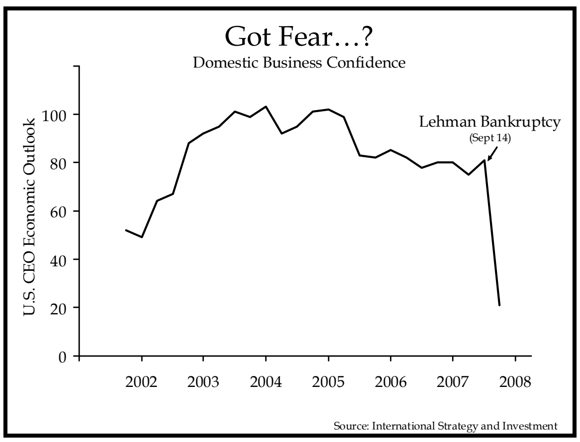
MARKET LETTER
FOURTH QUARTER 2008

The Storm Before the Calm BY DEAN DORDEVIC

"Franklin D. Roosevelt was elected President of the United States in 1932 with the mandate to get the country out of the Depression. In the end, the most effective actions he took were the same that Japan needed to take – namely, rehabilitation of the banking system and devaluation of the currency to promote monetary easing. But Roosevelt's specific policy actions were, I think, less important than his willingness to be aggressive and to experiment – in short, to do whatever was necessary to get the country moving again. Many of his policies did not work as intended, but in the end FDR deserves great credit for having the courage to abandon failed paradigms and to do what needed to be done." Ben Bernanke (1999)[1]

It was, simply, a horribly bearish year: A housing market collapse, a global financial market meltdown, and a global recession. An *"annus horribilis"* as Queen Elizabeth II once described a year past. Most of the reasons for the severity of the storms that have blown through the financial markets have been well documented, discussed and are now reasonably well-understood. With that said, we'll use this space to take a look at where we are now, some recent historical economic parallels, and hopefully unearth some keys to divining our future.

At current levels, U.S. stocks are discounting a greater than 40 percent decline in earnings. To be sure, this is a dramatic decrease in profits. The U.S. market has now priced in a typical post-war recession…*times two*; an extended period of deflation is not in sight. We are experiencing a period of painful and pervasive deleveraging. Some aspects of this unwinding have become irrefutably self-reinforcing: Assets are being liquidated, creating declining prices, which in turn brings about more liquidation and even lower prices.



The most recent modern experience we've had with deflation is the Japanese so-called "lost decade." In a research report on the Japanese crisis, strategist Michael Goldstein explains, "What both Japan of the 1980s and the U.S. today had in common were booms in real estate, specifically in land prices. Both countries experienced extraordinary runs that couldn't be explained by existing models. As interest rates came down, prices went up… In earlier cycles, it'd worked the other way… [As prices rose,] people expected less, not more. The longer the story went on, the more credible it became, both to borrowers and lenders."[2] What's interesting is that in both of these real estate cycles the return required by investors over and above the risk-free rate actually declined as prices moved up. In other words, the exceptional appreciation experience made investors expect more return, not less.

An interesting measure of the excess of the Japanese crisis relative to the current U.S. situation is the ratio of the value of land to the size of the underlying economy. While one would expect land values for a country surrounded by water to be high (in some respects the de facto definition of real estate), the peaks that were reached were truly extraordinary. The total value of Japan's land exceeded the value of the country's gross domestic product (GDP) by five-to-one at the bubble's peak in 1990. In comparison, the U.S.'s own ratio peaked at 90 percent of GDP in 2007. Also, the Japanese bubble corrected much more slowly, taking five years for the ratio to meet its pre-bubble level, whereas one-sixth of the appreciation in the U.S. has evaporated in only two years. The bottom line is this: the Japanese land bubble was roughly seven times that of what the U.S. experienced most recently. The U.S. bubble did not inflate as much, and it has corrected more rapidly, though the process is not yet complete. [2]

Japan and the U.S. were also very similar in the use of leverage and debt. Goldstein reports that "[U.S. consumers] were three times as indebted vis-à-vis net worth as their Japanese counterparts. On the other hand, the leverage of Japan's business sector was two-and-a-half times that of U.S. businesses."[2] While the U.S. consumer has much more debt than in Japan, U.S. corporations are in better shape and twice as profitable (with returns on equity twice as high) with half the level of capital usage. U.S. corporations also carry much less debt overall. [2]

Lack of Speed....Kills

While there are many similarities between the Japanese deflation of the 1980s and the current U.S. experience, one thing is abundantly clear. The breadth, depth and—most importantly—the *speed* with which policy is implemented is critical.

In Japan, the policy responses were plodding and timid. Some of this was cultural; a willingness to "save face" virtually guaranteed delay; it took the Japanese nearly eight years to pass a sweeping bailout. "Japanese government and financial institutions realized there was a problem, but they tried to cover it up," said Junichi Ujiie, chairman of Nomura Holdings, Japan's largest investment bank. "The United States has done in months what Japan took years to do."[3] As a result, it took almost a decade for the bubble in land values to reach equilibrium. In terms of stimulus that's been injected into the system, the U.S. has introduced more in two years than the Japanese provided in over a decade.

While this deleveraging cycle is extremely painful to experience, the pace of change is truly remarkable. Relative to Japan, we're pulling off the Band-Aid in one fell swoop, versus a slow and painful removal: Balance sheets are deleveraging at breakneck speed, the savings rate has escalated faster than ever before, commodity prices have dropped precipitously, massive monetary and fiscal stimulus is in place and growing, stocks in the housing sector are beginning to recover, and the new Obama administration promises a massive stimulus package. What's more, both the Treasury and the Fed have more recently moved into what can only be described as the "shock and awe" pages of the Fed policy playbook. Unlike Japan, our policymakers are not in a state of denial or hamstrung by self-restraint.

The system has taken a massive shock. The policy response, both nationally and globally has been immense. While a deep and painful recession is likely now discounted, a deflationary episode has not. We believe that the Japanese experience with deflation, while not a perfect analogue, offers many keys to what works and what doesn't. Fortunately, this is very well understood by Washington. What is being implemented now is the right tonic, and deflation will be averted. Policymakers at all levels understand that what is needed is a "Rooseveltian Resolve"—the willingness to be aggressive and experiment; in short, to do whatever is necessary.[1]

Recessions, at their core, are all about the reallocation of capital. This is not painless, but it is necessary and comes with the territory. Among other things, what will be evident is that the system will be far less levered. This leverage magnifies "growth" on both the upside and the downside. We should expect a period of reflation, followed by very slow, somewhat anemic growth going forward. There is also the possibility of bone fide *inflation* at some point, but that will be a problem for another day. Sort of like a firefighter fighting a house fire—you don't worry about water damage when the house is ablaze. We should also expect a long period during which the financial system will heal itself. Recovery in both GDP terms and earnings power will be slow. The savings rate will move up steadily and gradually (one percentage point per year for the next several years is likely). We expect to see much more regulation, and perhaps a requirement that financial firms (including rating agencies and auditors) be structured as partnerships, so that the funds they have at risk are their own.[4]

At the moment, we have geared our portfolios for a slow growth outcome. This could change, however, as the impact of the tremendous stimulus takes hold. We will continue to emphasize free cash flow and balance sheet quality in our debt and equity investments.

These times are truly extraordinary. We are fortunate to have in Ben Bernanke probably the foremost student of recent large-scale deflation experienced by any modern developed nation. We think that he understands the problem better than just about anyone, and will avoid many of the mistakes that were made in the past. Perhaps only in the looking glass of history will we know if he is successful—we think he will be.

Sources:
[1] Ben S. Bernanke, "Japanese Monetary Policy: A Case of Self-Induced Paralysis?" *Japan's Financial Crisis and Its Parallels to U.S. Experience*, Peterson Institute for International Economics, Chapter 7, 2000.
[2] Michael L. Goldstein, "The U.S. and the Precedent of Japan's Lost Decade." *Japan vs. the US - The Commonalities and the Numbers*, Empirical Research Partners - Portfolio Strategy, October 2008.
[3] Martin Fackler, "Memo from Tokyo: Scarred by Past Woes, Japan Sees U.S. Bailout as a First Step." *The New York Times*, October 10, 2008.
[4] Dr. Albert M. Wojnilower, "The Economy in Intensive Care." *Craig Drill Capital*, December 12, 2008.

ASSET CLASS OVERVIEW

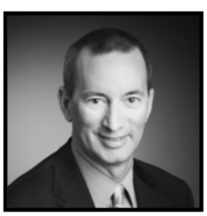
Domestic Equity BY GEORGE HOSFIELD, CFA

The bursting of the housing bubble and a credit crunch that created a prolonged recession last year led to the worst annual return for equities since the 1930s. With this backdrop as we enter 2009, our sector focus is on healthcare, telecom, utilities and technology. The commitment to utility and telecom are primarily defensive in nature, owing to the regulated revenue of utilities and the necessity of communications which provide a degree of earnings visibility that is lacking in most other economic sectors at this juncture. Similarly, healthcare spending should resist a slowing economy, while rising medical needs of aging Baby Boomers offers a secular tailwind. Our bullish view of technology transcends the current slowdown in capital spending, reflecting companies' desire to enhance productivity, address increasingly complex information lifecycle needs and deploy new applications to enhance customer service. Given the unprecedented fiscal and monetary policy actions being undertaken to combat systemic risks to the economy, we are closely monitoring credit markets for signs of thawing that will ultimately impact our sector strategy. To that end, later in the year we will look for evidence of stabilizing home prices and narrowing credit spreads, which would foretell a freer flow of capital and therefore lead us to shift capital to more economically sensitive sectors such as consumer cyclicals, industrials and basic materials.

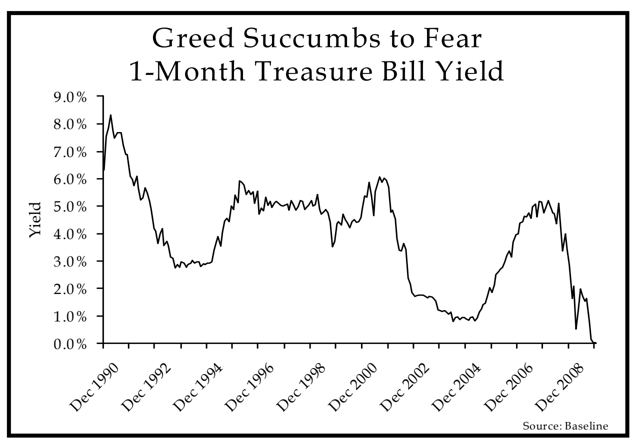
Dividend Value BY JASON NORRIS, CFA

What makes the Ferguson Wellman *Dividend Value* discipline unique is its focus on companies with growing dividends and cash flow, not just "cheap" value stocks. The result is a more robust discipline than many pedestrian value/income approaches. Throughout 2008, we reduced our exposure to commodity stocks, as well as invested in very select financial and consumer discretionary stocks. Looking into 2009, we believe that equity returns will be positive; however, leadership will come from companies with strong balance sheets and cash flow, unlike in 2003 when lower quality stocks outperformed. We will be focusing our efforts in selecting companies that are able to weather this credit crunch and recession. Also, income will continue to be an important component of total return in 2009; thus, with a dividend yield of over 5 percent, the Ferguson Wellman *Dividend Value* strategy is a compelling value strategy.

Fixed Income BY MARC FOVINCI, CFA



Since the bankruptcy of Lehman Brothers, the largest in U.S. history, credit markets have been largely frozen. The financial system is currently on "life support" with the federal government providing liquidity through an alphabet soup of lending facilities. Disarray and uncertainty have led many investors to the safety of U.S. Treasury securities. The desire for safety and liquidity has brought the three-month Treasury bill yield essentially to zero. As the Federal Reserve contemplates buying Treasury securities across all maturities, yields of all Treasuries are now at record-setting lows, making all other bonds look cheap.



The payoff for quality in 2008 was even greater than we anticipated at the start of the year. Now we are looking for opportunities for higher yield without excessive risk. The high-yield ("junk") bond market is too risky. Yields are over 20 percent but with high default risk as the economy continues to shrink. With recent government support, agency bonds now have a stronger implicit backing by the Federal government. We continue to like the agency sector for liquidity, safety and greater yield compared to Treasury bonds. As Treasury yields continue to be low, we will be reducing our positions and adding to investment-grade corporate bonds that appear capable of weathering the recession. Although government efforts to lower mortgage rates will help agency-issued mortgage-backed securities, accelerated prepayments leave us neutral on this sector.

International Equity BY RALPH COLE, CFA

What a difference a year makes. Last year, investors could not own enough emerging markets exposure as the index rallied 32 percent; today, the style is decidedly out of favor, having declined about 50 percent in 2008. Those extremes are the reality of investing today.

As 2008 progressed, we reduced the cyclical exposure and tried to highlight quality and stability. Our best performers for the year were European pharmaceutical companies. Two sectors that are now our biggest overweights are consumer staples and healthcare. We remain underweight material and financial stocks.

As a firm, we remain underweight international stocks. Despite having pared our emerging markets exposure in 2008, we continue to own this equity style because we see a great deal of value and growth in developing regions of the world. We are not making any major country bets internationally, as we think sector selection is more important at this time.

Real Estate Investment Trusts (REITs) BY RALPH COLE, CFA

We have been wary of the sector for several years now. We were early to our bearish call in 2006, but in 2007 and 2008 the over-valuation in REITs corrected dramatically. REIT securities actually held up quite well during the first three quarters of the year, only to tumble with the rest of the equity markets during the fourth quarter. Massive debt loads placed stress on the balance sheets of even the best real estate investment trusts. Debt structures continue to be a point of emphasis in our research. Our expectations are for the economy to continue to slow, thus leading to weaker fundamentals in the industry. We favor companies in the most defensive real estate industries, including healthcare and apartments.

EQUITY SECTOR STRATEGIES

Consumer Discretionary BY GEORGE HOSFIELD, CFA

Our outlook for this sector has been quite negative for the last three years. This pessimism has been warranted as soaring commodity prices, plummeting real estate values and leveraged personal balance sheets have seriously impaired consumers' ability to spend. Given this difficult backdrop, what limited exposure we had to this sector has been focused on smaller-ticket, solid cash flow generating industries such as media and leisure. Conversely, we have avoided big-ticket and credit-sensitive industries such as housing and autos. As we look into 2009, with depressed asset values, constrained credit markets and what most likely will be the highest unemployment rate in 27 years, the backdrop for consumer spending is poor. However, in aggregate, consumer discretionary stocks are early-cycle investments, and have been the best performing sector in 12 of the 14 post-war economic recoveries. Recognizing that stock prices tend to lead the "real economy" by approximately six months, our current thinking is that by mid-year it will be time to increase our commitment to this sector in anticipation of an economic rebound in 2010. We would anticipate the purchase of some high-quality retail franchises such as Target, Starbucks, Ralph Lauren and Abercrombie & Fitch.

Consumer Staples BY LORI FLEXER, CFA, AND SHAWN NARANCICH, CFA

During 2008, the consumer staples sector provided a relative safe haven for investors, capturing less than half of the market downturn. As we move into 2009, several new themes have emerged. Foreign currency translation, which had provided a significant tailwind during early 2008, became a headwind as the dollar strengthened. We have tilted our portfolio towards U.S.-centric companies to avoid this earnings drag. Our tilt equally addresses a forecast for a deeper and more protracted recession. Consumer trade-down is also a theme for the sector. Consumers are looking to meet essential needs, but spend less on essential items like groceries and pharmaceuticals. We think this dynamic will continue into 2009 and companies that provide private label products and generic brands will benefit. We are also emphasizing companies with superior balance sheets and ample free cash flow. Sector earnings growth is projected to be positive but slowing, from 12 percent in 2008 to 9 percent in 2009 (versus 6 percent growth for the S&P 500). As signs of broader economic and capital market recovery emerge, funds will flee this sector and returns will likely lag the broader market. These conditions are unlikely to emerge until the second half of 2009.

Energy BY MARK KRALJ

It paid to own energy stocks for the first half of 2008 as speculators drove oil prices to an unsustainable $147 per barrel. But the reality of the decline in global economic growth caused the price of oil to tumble by 70 percent before year-end, taking the energy stocks down by a similar percentage in many cases. For 2009, prices should stay in a $35 to $50 range for most of the year as continued lack of growth in oil demand will be offset by panicked but undisciplined production cuts from OPEC. Ultimately, higher oil prices will require economic recovery leading to renewed demand from the two largest users of oil, the U.S. and China. Until that time, spikes in prices could occur if politically volatile oil producers such as Russia and Venezuela use their oil supply for economic leverage. The major integrated companies and domestic exploration and production companies should outperform in an environment of oil prices that are lower and less volatile in the upcoming year.

Oil in 2008: A Tale of Two Halves

West Texas Intermediate Crude

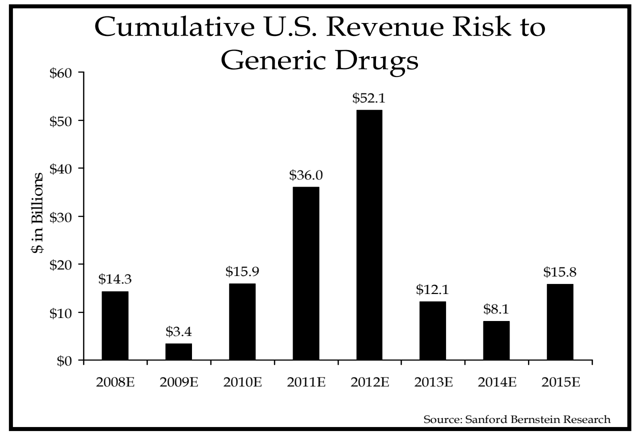
Source: Baseline

Financials BY RALPH COLE, CFA

While 2008 proved to be a seminal event in the financial world, not much changed in our financials strategy. How do you invest when the industry is crumbling around you? Quality, transparency and management teams were themes that carried the day in our portfolios. Quality, to us, meant companies that did not have to rely on emergency outside funding to meet their obligations. As the year unfolded, we consistently saw companies tap the markets for very expensive capital at the worst times. One of the benefits of investing in individual securities is knowing what you own. We did not buy the AIGs of the world because we could not properly evaluate all the exposures these types of financials had. Most important during this crisis was owning quality management teams. During times of financial turmoil, an investor wants managers that have historically treated shareholder funds with care.

While financials may indeed find bottom in 2009, we will not be early to the party. We continue to focus on the insurance industry and high-quality banks that we feel will be winners exiting this crisis.

Healthcare BY DEAN DORDEVIC AND JASON NORRIS, CFA



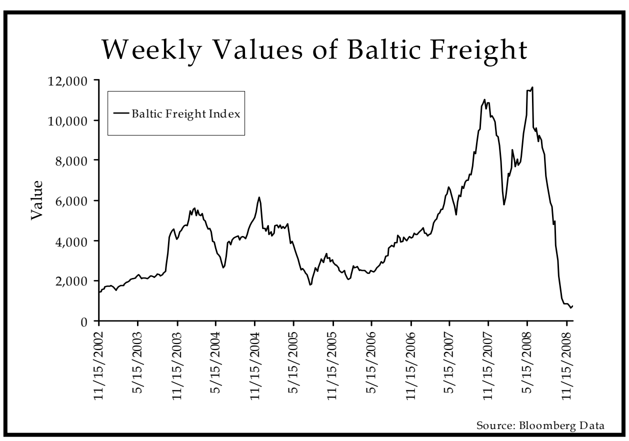
Cumulative U.S. Revenue Risk to Generic Drugs

The healthcare sector should continue to experience better relative performance than other sectors of the economy as long as the recession persists. Throughout 2008, we focused the portfolio on medical technology stocks and away from the large-cap pharmaceutical area. Concerns over generic competition and the election kept us away from the industry. This led to mixed results as the large-cap pharmaceutical stocks held up better than the healthcare industry in general due to trough valuations and high dividend yields.

We still foresee generic competition being a key risk to pharmaceutical stocks in 2009, but several large-cap drug companies generate strong cash flows, have healthy balance sheets and possess attractive pipelines. We would be looking at these names to increase exposure. Outside of drugs, we are focusing on areas less exposed to discretionary spending.

Industrials and Materials BY JIM RUDD, RALPH COLE, CFA, AND JASON NORRIS, CFA

Central governments around the world are beginning to address the global economic slowdown with massive fiscal spending programs. Significant stimulus packages are in the offering not only in the U.S. and China but in other countries including Russia, Germany, Spain, the U.K., Australia, Argentina and Taiwan. We've noted that a key component in these stimulus programs is some form of infrastructure spending. While details are scarce, we believe these programs have the potential to provide some growth until general economic conditions recover in 2010. We are cognizant that many of these multinational companies are dependent on global growth, particularly in emerging economies, to achieve the earnings leverage they enjoyed a year ago. While we believe trading opportunities will arise during the year in many emerging economies, we think the U.S. will emerge from recession sooner than the rest of the world. One element many U.S. companies will have to contend with in 2009 is the possibility of a strengthening U.S. dollar that will mitigate some price advantage American companies have enjoyed in years past. We agree with the general direction of consensus earnings estimates for industrial stocks, foreseeing a low single-digit earnings decline in 2009.



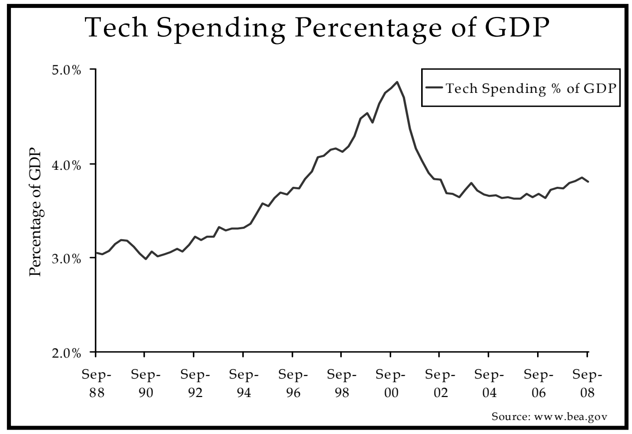
Weekly Values of Baltic Freight

While global growth in 2009 may be hard to find, we are more optimistic, in a relative sense, about domestic growth. We are adjusting our weights to be more U.S.-centric and are focusing on those companies that either benefit from U.S. defense spending, a resumption in U.S. economic growth before the rest of the world, or selected companies that may benefit from an uptick in emerging market economic growth.

Commodity stocks are also very sensitive to global growth. Demand for metals, oil, chemicals, and other basic materials is premised on economic expansion. With the slowdown global economies are experiencing, commodity prices have declined meaningfully. The CRB Index (measuring the overall direction of commodity sectors) is down over 50 percent and the Baltic Freight index (measuring changes in the cost to transport raw materials) has declined over 90 percent since both peaked mid-2008. Earnings expectations for 2009 are also negative, with analysts anticipating a decline of 23 percent. However, we believe that emerging markets and China, in particular, have the potential for more of a V-shaped recovery given the stark choice they face regarding either reflation or political/social dislocation. Thus, 2009 will provide an opportunity to become more aggressive in commodity stocks. However, we are currently positioned more defensively.

Technology BY JASON NORRIS, CFA

Technology stocks underperformed the broad market due to the reduction in business spending, as well as consumer spending on electronics. However, we do not believe that technology spending will go through as meaningful a downturn as we saw in 2001 and 2002. In December 2000, spending in technology reached close to 5 percent of GDP. In this most recent cycle it has been consistently between 3.5 and 4 percent.



Our themes of broadband growth, security, and storage will continue into 2009. One example of the growth in broadband and storage is consumers viewing video online. High quality video is very data intensive; thus, spending on data networking equipment should hold up better than other areas. Storage and security spending are still priorities for corporations. Another attractive attribute of the technology space is cash. There are several high quality, profitable technology stocks that have 15-plus percent cash as a percentage of market value on their balance sheet, and they continue to generate cash flow.

Telecommunications and Utilities BY SHAWN NARANCICH, CFA

Highlighting the sector's defensive qualities, utilities outperformed the broader market in 2008 as the economy fell into recession and Treasury bond yields plunged. Regulated businesses did best, substantially outperforming the independent power producers. Utilities have traditionally grown through rate-based capital spending, with allowed rates of return recouped in electricity or gas prices. However, this model has been upended by the credit crunch. Entering 2009, our focus is on integrated electric utilities with a mix of regulated and wholesale power generators with a reduced carbon footprint. Favored investments are those with strong balance sheets, dependable cash flow, below average capital spending intensity and rate case catalysts.

Telecommunications investors were hurt less in 2008 by sticking with the quality of integrated service providers like Verizon and AT&T. We enter 2009 overweight AT&T based on the belief that market share gains in wireless, an increasing dividend and less exposure to the declining wireline business will produce an attractive total return.

Ferguson Wellman Launches New Website

We are excited to be launching a new website in 2009. The new site provides updated and in-depth information on our firm, strategies and services. We have also enhanced our media and publications viewing platforms, as well as offering a new section for publications available to clients.

Please visit our new website at www.fergusonwellman.com.