MARKET LETTER

A QUARTERLY PUBLICATION OF FERGUSON WELLMAN CAPITAL MANAGEMENT

SECOND QUARTER 2010

A-Synchronicity, and the Case for Stocks

by Dean M. Dordevic

"The slump already ranks as the longest period of sustained weakness since the (great) Depression. The economy is staggering under many "structural" burdens, as opposed to "cyclical" problems. The structural faults represent once-in-a-lifetime dislocations that will take years to work out. Among them: the job drought, the debt hangover, the banking collapse, the real estate depression, the healthcare cost explosion, and the runaway Federal deficit."

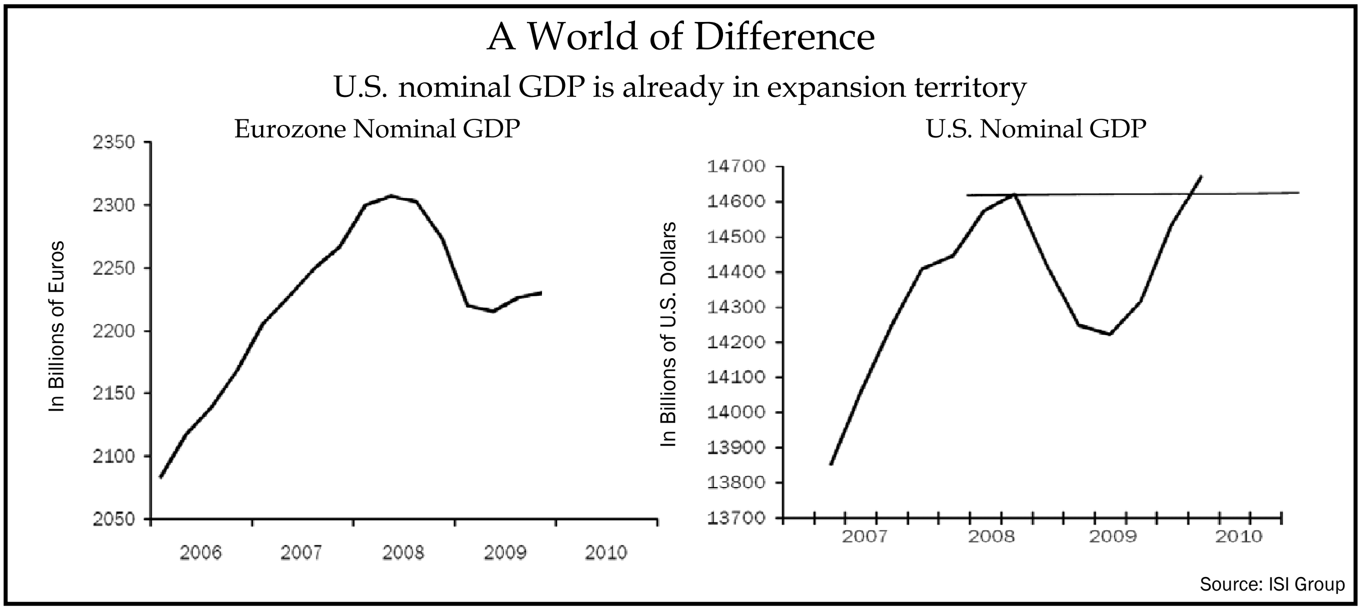
—Time Magazine, September 1992

Mark Twain once said, history doesn't repeat itself ... *it rhymes*. Yet after reading the aforementioned, any reasonable observer could be rightfully scratching one's head. Almost two decades later, this headline could sit on the front page of any American newspaper as an almost "spot-on" analogue to what we now endure. There is also a modicum of curious comfort that comes from knowing ... *it-has-been-almost-this-bad-before*. Though as we now move closer toward the early middle innings of economic expansion, and as the global economy heals itself, *what clues to the future are emerging from the behavior of equities post-crisis?*

At the nadir of the world's brush with financial Armageddon, and in the parlance of the denizens of our financial world more commonly known as quantitative analysts or "quants," almost every risk asset—with the notable exclusion of bonds—reached a correlation of "1." What this means in layman's terms is that all risk assets behaved the same way ... that is, they *all* went down. This was not supposed to happen. While one is tempted to look for exceptions and nuance, in the downturn, risky assets were *highly synchronized*. As economies recover, however, the behavior of risky assets has become less correlated. This could persist for some time, and there are important investment-related considerations that distill from this emerging, and perhaps self-reinforcing pattern.

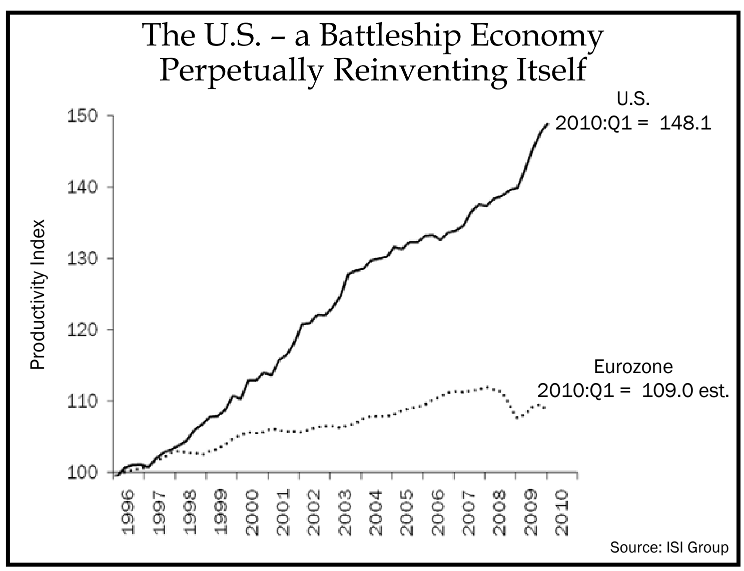
From a 30,000 foot level, the global economy can be divided into two generic categories: developed and emerging markets. Very roughly, these represent two-thirds and one-third of global GDP, respectively. These economies can be further divided into four more specific buckets: the United States, the Eurozone, Japan and other developed nations, and the emerging markets. While the global economy is recovering, the rate of economic growth and the corresponding stock performance in one region versus another has been notably different. Another characteristic of the global financial markets thus far in 2010 is the economic delineation between overleveraged developed economies, and the somewhat healthier emerging economies.[1]

In the developed world, the U.S. is a veritable bright spot. Some of the strongest empirical indicators for the U.S. economy have been, and continue to be, consistent with a sustained recovery. While the U.S. faces significant long-term structural problems, when compared to the rest of the developed world, the U.S. is in reasonably good shape. We are on the cusp of a self-sustaining recovery. It is nothing short of stunning that in the first quarter of 2010, nominal GDP in the U.S. reached an all-time high. It is very likely that real GDP (inflation-adjusted GDP) will reach a new high in the second half of this year. This is remarkable, considering that after the Great Depression, it took over 15 years for U.S. GDP to eclipse its previous peak. So too for Japan; following its "lost decade," it took Japan almost as long, as the post-Depression U.S. economy, to beat its previous high for economic output.



During the crisis, U.S. corporations cut costs and retrenched at an incredible pace. The retrenchment was *four times* what historically occurred in a "typical" recession. As a result, a gusher of profits have spilled forth. It is likely that corporate profits will reach *a new record high in the third quarter this year*. Free cash flow for non-financial U.S. companies is exceptional, as is balance sheet cash which for collective corporate America now sits at a 60-year high. This has resulted in dividend increases, share buybacks, new capital investments, and mergers and acquisitions activity. It is also the precursor to higher levels of employment, which is *the* key to the recovery becoming fully self-sustaining.[2]

For a battleship economy the size of the U.S., the importance of rising levels of productivity cannot be understated. U.S. unit labor costs are dropping at their fastest pace in 40 years. The last surge in productivity of this order of magnitude came in the late 1990s. Over the past 12 years, U.S. productivity has outpaced the Eurozone by almost 40 percent, or about 3 percent per year.[3] Productivity increases are the mother's milk for higher levels of employment, real gains in income for individuals, and competitiveness for companies. As New York Times columnist and Nobel Prize-Winning Economist Paul Krugman said recently, *"Productivity isn't everything … but in the long run … it is almost everything."*



During the first half of 2010, U.S. equities have been outperforming their developed world counterparts. This makes sense to us, because the Eurozone is battling a sovereign debt problem and a currency regime that is inflexible and cannot respond with country specific devaluations that would act as powerful jumper cables to help ignite recovery.[5] Japan, on the other hand, while not doing as well as the U.S., has been benefiting from its geographic proximity to rapidly growing Asia (although the strong yen has been a stumbling block and has to some degree pinched exports). When compared to their U.S. counterparts, Japanese and Eurozone companies did not move as decisively to cut costs as the financial crisis unfolded. Therefore, the recovery of their profits has not been as robust. When viewed in context, the relative strength of the U.S. versus developed market peers is not surprising.

What counts in our world is not so much the rate change … but the *change in the rate of change*. While the developed world wrestles with the "new normal" and the hangover from the recent crisis, it is the emerging world that provides perhaps the best prospects for the sustainable spark of global growth. As we have discussed in these pages previously, emerging markets are in much better fiscal health, and are benefitting from trade with each other. It is also interesting that their currencies have been relative safe havens.

The shift toward a greater proportion of incremental change in global growth from the emerging world is important and should not be underestimated. Over the next five years, these markets will source over two-thirds of the incremental change in global growth. China alone will account for nearly 30 percent of this incremental growth and India about 10 percent of that total. The developed nations will account for only 35 percent of future incremental demand, down from about 45 percent over the last decade, and almost 65 percent during the 1990s.[4]

We are experiencing an *a-synchronous global recovery*. Going into the crisis, the developed world had overleveraged bubble economies that are now deleveraging. The emerging economies, generally speaking, had positive trade balances, growing cash flows, and healthy balance sheets. As a result, organic growth in many emerging economies could quickly resume since it is largely (if not fully) self-financed. This is producing both different rates of GDP growth and, to some extent, disparate stock price performance around the world.[5] We believe that this paradigm will continue to *rhyme,* and as such, we have adjusted portfolios accordingly. In the developed world, we continue to like the relative bright spot that is the United States, although we like the Japanese and UK markets less so. We have generally underweighted the Eurozone, and overweighted international portfolios toward emerging world economies. We have also made an extra effort to focus on companies in *developed* countries that *export* to rapidly growing emerging markets.

That said, from a big picture perspective, we view 2010 as a transition year. Capital markets will shift from the "sugar high" of government stimulus and inventory rebuilding to a greater reliance on final organic demand. To be quite sure, this will be accompanied by increased volatility and uncertainty. We also believe that the economy can achieve "escape velocity," that is ... a self-sustaining recovery will eventually take hold. Governments will also need to reconcile troublesome sovereign debt problems, and wean their economies from the elixir of generationally low interest rates. This process won't be easy or pleasant, and given the size and scale of these issues, these problems will be with us for many, many years. However, it is through the prism of history that we know ... resolved, they will be.

After all, it was *almost-as-bad* back in '92.

To view definitions of some terms mentioned in this quarter's *Market Letter*, visit http://tinyurl.com/FWQ12010definitions

Market Letter Sources and Footnotes:

[1] "Is Rate Tightening on the Horizon?," Interview with Dr. Michael Hasenstab, Senior Vice President and Portfolio Manager, Templeton Global Bond Fund for Franklin Investments, *Financial Times*, May 10, 2010.

[2] Empirical Research Partners, "The Big Picture: Aftershocks, Macroeconomic Indicators and the Market: A Test," *Portfolio Strategy*, June 2010.

[3] Bob Doll, "The Bullish Case for U.S. Equities, " opinion editorial in *The Wall Street Journal*, June 8, 2010.

[4] Kevin Swift, "Emerging Markets are the Key to Sustained Economic Recovery," *Chemical Engineering Progress*, February 2010.

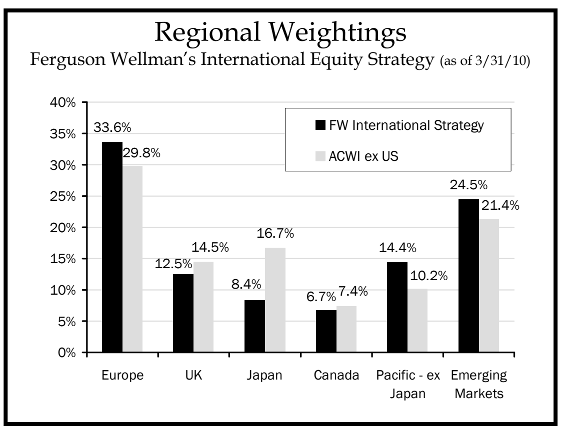
[5] "Paul McCully Discusses Pimco's Cyclical Outlook," *AdvisorAnalyst Views*, April 15, 2010.

Improving Our International Benchmark

This year, Ferguson Wellman will change its international benchmark for all client portfolios to the Morgan Stanley Capital International (MSCI) All Country World Index excluding U.S. (ACWI ex US). Most client portfolios were benchmarked to MSCI's European, Australasian, Far East (EAFE) Index or Standard & Poor's ADR Index.

A Better Benchmark for Our International Focus

ACWI ex US is much broader than our current EAFE index. For example, emerging market countries will be in our benchmark, such as China and Brazil. It also eliminates our concern that Canada wasn't represented in the EAFE index's developed or emerging markets. More importantly, this new index will better enable our clients to judge our performance versus the benchmark. We felt that not having emerging markets in the benchmark resulted in our clients' inability to compare their quarterly performance on an "apples-to-apples" basis.



Our International Process

Ferguson Wellman has a five-person team that develops and manages our *International Equity* strategy, which includes investments in companies with exposure to both developed and emerging markets. In our rigorous process, we begin with resource allocation where we actively overweight and underweight countries and sectors represented within ACWI ex US Index. We then look for stocks that are industry leaders either globally or "in-country." Each stock purchased must meet our criteria for relative valuation versus its peer group and country markets. Every position in the portfolio has a published price target and an equally strict sell discipline to help control risk.

Our *International Equity* is one of 13 strategies we manage, resulting in customized portfolios designed to address our clients' investments goals and objectives. As the global economy continues to shift and evolve, we will seek out more investment opportunities that benefit from these economic conditions.

The Value of Collecting and Connecting

Each quarter, we highlight an investment-related topic in hopes that it will trigger conversation with our portfolio managers. Last quarter we encouraged clients to revisit their investment and retirement goals through resources we've created that compare outcomes of various scenarios. By taking these steps, clients can feel confident that their plans are aligned with their current financial strategies. Moving forward, we encourage clients to take planning one step further by organizing and updating all pertinent information.

Our ***Electronic Safety Deposit Box*** document gives ***individual and family*** clients the framework they need to complete this important work. Information can be added manually or electronically, and can be stored on Ferguson Wellman's secure server or anyplace that will give clients accessibility and peace of mind. This seven-page document covers everything you need to consider and serves as a checklist for connecting with your accountant, attorney, private banker and trust officer. It's a wise move to get all of your professional partners together annually, along with your portfolio manager, to review your documents and ensure that all of your planning is complete. Planning these meetings in ***early fall*** is ideal—long before the holidays and tax planning season.

It's something we all plan to do someday, but prolonging the collection of important information can have serious consequences in the event of a death or an emergency.
– Lori Flexer, CFA

For our ***institutional clients***, we are happy to share our disaster recovery plans with your executives. Helping clients preparing for the unexpected can go beyond navigating a bear market. Having a contingency plan to access pertinent documents and resources in the event of a natural or manmade disaster is also important in planning for the future.