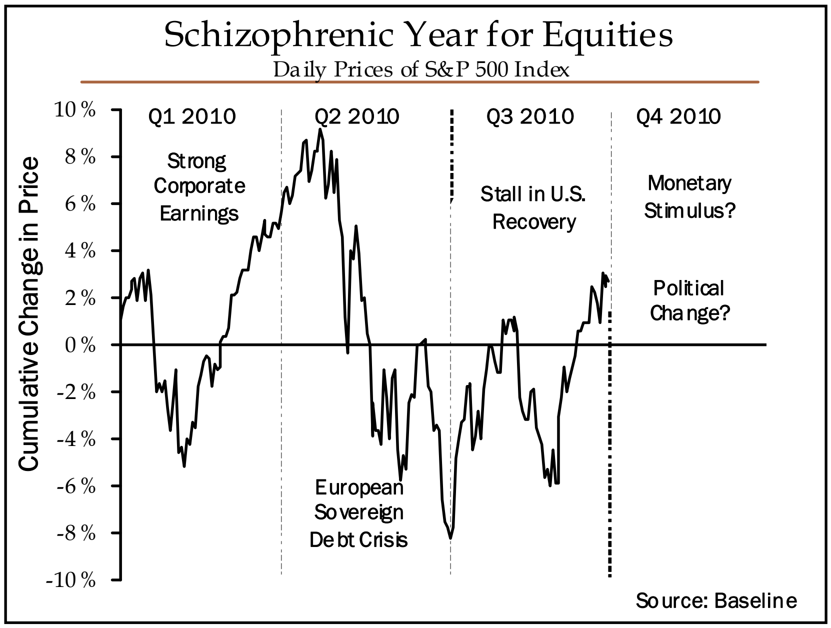
# MARKET LETTER

A QUARTERLY PUBLICATION OF FERGUSON WELLMAN CAPITAL MANAGEMENT

## THIRD QUARTER 2010

by George Hosfield, CFA
Chief Investment Officer

In January we published our 2010 forecast that included a mid-single digit return for equities. In a market that has been buffeted by significant economic cross currents, over the past nine months we have been wrong three times and right four times … and counting.




Standing by our forecast, we are pleased to present a summary of our thoughts on the quarter just completed and what we expect will unfold for the balance of the year. Even though U.S. economic data has been mixed, we don't expect the domestic economy will lapse back into recession, creating a "double dip." For further detail on our fourth quarter views, you may contact us at info@fergwell.com to receive a quarterly email link to our *Investment Outlook* videos, as well as our periodic *Capital Markets Update* emails.

## Looking back …

- Equities rebounded sharply from oversold levels as fears of an economic "double-dip" and concerns over the European debt crisis subsided.
- Also buoying the capital markets was a positive shift in the tone of aggregate economic data. Though many economic indicators have modestly improved since August; unfortunately, unemployment remains persistently high.
- Interest rates took another leg down, which served to drive up the prices of interest-sensitive sectors—such as utilities and telecom—along with real estate investment trusts (REITs) and fixed income securities.
- With interest rates falling and credit spreads narrowing, the longer the maturity and the lower the quality, the better for fixed income performance … a trade that is getting long in the tooth.

## Looking ahead …

- We believe a "soft landing," Washington, D.C. gridlock, and another round of quantitative easing (often called QE2) provides a constructive backdrop for large-cap equities.
- The combination of diminished government spending, a higher personal savings rate and ongoing deleveraging leads us to believe the unemployment rate will remain higher … longer.
- We continue to focus on companies that will benefit from growth in the emerging economies with emphasis upon the cyclical sectors.
- While inflation doesn't look to be a problem in the short term, further wage gains in China as well as diminishing faith in U.S. finances pose risks to long duration investments … given the low prevailing level of interest rates.

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# QE2 and the Square Root Redux

by Dean M. Dordevic, Principal

*" ... The United States government has a technology, called a printing press, that allows it to produce as many dollars as it wishes at essentially no cost … "*

**—Ben Bernanke, November, 21 2002**[1]

In the aftermath of the financial crisis in the early part of 2009, we provided our view of the macroeconomic landscape and offered a forecast and outline for the shape of the recovery to come. We believed at the time that the recovery would look something like a square root sign. That is, the square root's path would describe a massive global stimulus bringing about rapid and strong, albeit semi-synthetic growth and recovery. Eventually this period of "reflation" would be followed by a somewhat drawn-out interval of sub-par growth as the excesses of the last cycle were worked off, principally the amortization of the global debt overhang.

Since the nadir of the market decline (March 9, 2009), the reflation in GDP, corporate profits and stock prices has been profound. Nominal GDP for the U.S. now *exceeds the peak* last seen at the top of the economic cycle in 2007. Since reaching its low ebb of about $59.00 per S&P 500 share, corporate profits are now forecast to reach $83.00 per share in 2010. Stock prices have reflated too, and are now up over 70 percent since the March 2009 low. To date, our square root metaphor has proved to be remarkably accurate. But that's in the past; more importantly *where are we now, and where do we **grow** from here*?

We are now somewhere near the hinge point in our square-root metaphor. In other words, we are moving from the *sugar high* of massive global stimulus to real organic demand. Some observers have used the entirely appropriate phrase, *the New Normal,* to describe this next phase of drawn-out, sub-par economic growth.

By our lights, there are five primary issues that require our attention: The current state of U.S. business and consumers; the relative health of balance sheets; non-U.S. growth (especially in the collective emerging world); the impact of global central banks (principally the Fed) on the economy, and the upcoming election. There are positives and negatives inherent in each of these, and to the extent that they tug and interplay with each other, so goes the level of interest rates and the daily change in the equity prices.

For the very most part, U.S. businesses are in great shape. Companies are lean and generating significant excess cash flows. Non-financial companies in the S&P 500 are sitting on a record $2 trillion in cash. If cash balances were to return only to normal levels, U.S. companies would need to part with some $428 billion. One-third of the companies in the S&P 500 increased dividends so far this year.[2] This pile of cash will also ultimately lead to increased mergers and acquisitions. Operating leverage in the system is still very high, and even a mediocre expansion will produce out sized gains in earnings.

It's no secret that consumers are overleveraged and many are unemployed or underemployed. On the other hand, the savings rate has gone up dramatically and the collective consumer balance sheet is improving. In short, reports of the demise of the consumer have been exaggerated.[3]

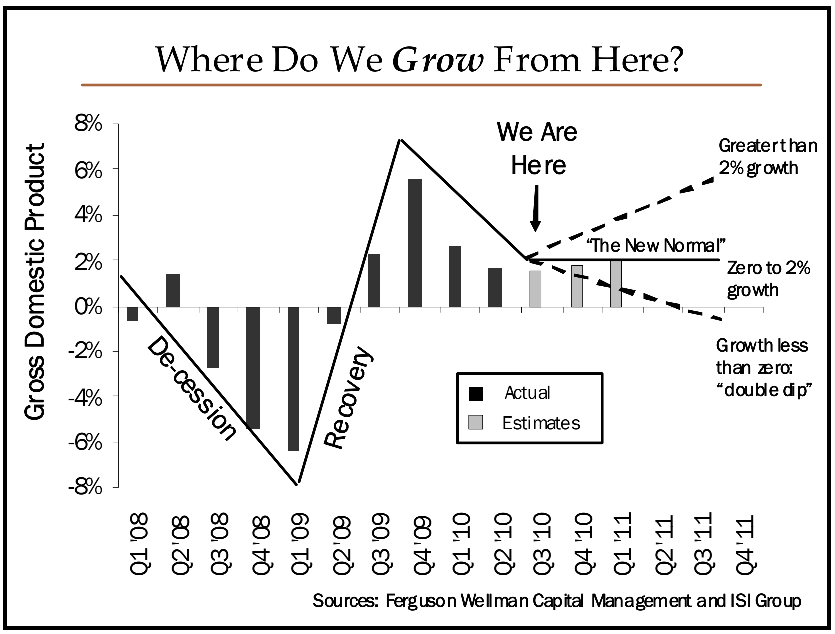
With the collective emerging world now contributing more to global GDP than the U.S., it's important not to adopt an overly U.S.-centric worldview. Emerging markets have for the most part enjoyed: conservative fiscal policies, high savings rates, strong domestic economies and job creation. Unlike most of the developed world, emerging countries did not take on massive amounts of debt and are not overleveraged. Unlike previous cycles, their growth has been largely self-financed as well.

The emerging world has also become increasingly reliant on growing domestic consumer demand. The rise of the middle class has been, and will continue to be, an important source of new growth and economic diversification. All told, these countries have come through the greatest economic crisis since the Great Depression in excellent shape.[4]

To paraphrase Gordon Gekko, *gridlock* is ... good.[5] That is, what history shows us is that markets seem to perform best when neither party runs the show. Political gridlock seems a likely outcome of the upcoming election and the market appears to be discounting the prospect of this event. Regardless of your political leanings, there seems to be a strong sentiment across the land that profligate spending must be checked, and government balance sheets (federal, state, and local) must be repaired.

Despite the aforementioned, there is the possibility that in the not too distant future, the Fed effectively doubles down. That is, in the aftermath of the bursting economic bubble, the Fed adopted an unconventional strategy called quantitative easing, or *QE*. What this means is that the Fed uses its considerable balance sheet essentially as a shock absorber. QE relies on a theory that with the private sector intent on de-levering, some sector of the economy must be willing to proactively lever its balance sheet. Post-crisis, the Fed's balance sheet (once composed solely of U.S. Treasuries), is now an amalgam of "other" credits. With growth relatively weak, and with a truly self-sustaining economic cycle yet to fully emerge, there is speculation that the Fed will begin another round of quantitative easing. This would probably entail buying Treasuries and mortgage-backed securities in an effort to keep interest rates lower for a longer period of time. Some have dubbed this *QE2*.[6]

Generally speaking, quantitative easing is good for financial instruments (both debt and equity). By way of example, when the Japanese central bank began its experiment with QE in the early part of the decade, the Nikkei rose from the 8,000 level to about 18,000 (2003 thru 2007). When this process ended, their market fell steadily back to the 8,000 level (2009). If our markets were to behave similarly, it would portend a monster trade. As *the* foremost student of both the Great Depression and Japan's deflationary lost decade, we think it very likely that *Helicopter Ben* would use all of the tools at his disposal, both conventional and unconventional.




There are three potential trajectories that could emerge from here. Our economy seems geared to grow at about a 2 percent real rate, sluggish growth that appears to be its stall speed. Growth over 2 percent would *feel* pretty good, growth below 2 percent would be troubling. (see chart)

It seems to us that the weight of the evidence does not support a double dip. There is enough "oxygen" in the system to support growth, and corporations are so lean that profits are likely to continue to spill forth. Corporate balance sheets look terrific, individual balance sheets are in the repair shop, and the government balance sheet looks like it might take another significant hit. Since the emerging world is a distinct bright spot (and a wild card), we could very well experience an upside growth surprise. With the election close at hand, and the markets hating uncertainty, it's entirely possible that *gridlock* ... could be a positive catalyst. Our base case, therefore, is that we avoid a double dip, that the economy grows around 2 percent, and the potential for an upside surprise is a reasonable bet. This *growth surprise* could very well *emerge* from the emerging world.

With this in mind, we have lengthened our bond durations, we prefer export-oriented U.S. companies, and franchises with strong global brands. In short, we want to own businesses with strong free cash flows, fortress-like balance sheets, and a bias toward rising dividends. We prefer emerging markets over developed ones, and companies leveraged to that strong growth over those that are not. And with the potential for another round of QE, we continue to like gold. After all, Mr. Bernanke now has his very own printing press, and we think it's a good bet that he intends to use it ... *again.*

# Year-End Tax Changes

When this publication went to print, Congress was in recess and plans for addressing the expiring tax laws that were enacted in 2003 were still in flux. Any changes to the current tax laws—or inaction by Congress—could impact our individual and family clients' short-term and long-term capital gains tax rates. Dividend tax rates could also rise, affecting the profitability of future security and real estate sales. Although it is unclear what Congress will decide to do, we are following the capital gains and dividends debate closely for our clients.

**Sale of Low Cost-Basis Stock**

Many clients come to us with large holdings in a single security accumulated over a number of years or through an employee stock purchase plan. Deciding *when* and *how much* to sell can be a complex decision with many factors to consider. With the real possibility of higher capital gains rates ahead of us, we advise clients to review their large single-stock holdings and to utilize the tools we have to help them analyze their options. For some clients, it may make sense to sell this year and reinvest in securities with equal or higher return expectations. Our *Low Cost-Basis Calculator* can help clients to review various scenarios so they are ready to act—if or when Congress acts. Your portfolio manager can help you with this process.

***To sell or not to sell?*** *That it what many of our clients are asking themselves this quarter. We have the tools to help you be prepared for what Congress decides to do this year.*
*—Helena Lankton, Senior Vice President*

# Longevity and Continuity

This December, Ferguson Wellman will be celebrating 35 years in business. Anniversaries are important to our firm. Robin Freeman, who has been with Ferguson Wellman the longest of our 39 employees, knows the day each individual started and sends out an email to the firm—resulting in many congratulatory notes, reflections on their first day, and heartfelt appreciation for the contributions and commitments of each employee.

*From left to right: Luz Garcia, Kathi Kimes and Kerrie Young (Sara Calderon Photography)*

This year, Freeman was able to announce the anniversaries of two colleagues who also began their careers during the early years of Ferguson Wellman: Kathi Kimes, who has been with the firm for 30 years, and Kerrie Young, who began 25 years ago. Luz Garcia is celebrating her tenth year with the firm.

All three shared some similar sentiments when reflecting on their tenure. "Thinking back to my very first day, I would have never imagined that 30 years later, I would be with the same firm," says Kimes. "I am very proud to have been a part of Ferguson Wellman's growth and success." All three women also commented on their own personal growth. "My responsibilities have completely changed since 1985," says Young. I started in trading and now oversee the firm's compliance policies and practices." Getting to know clients and celebrating milestones in *their lives* has also been enjoyable. "Over time, we connect with clients beyond their investment needs," says Garcia. "It makes the work we do more meaningful."

*Market Letter* Sources and Footnotes:

1 Ben Bernanke, "Deflation: Making Sure 'It' Doesn't Happen Here," Speech to the National Economists Club, Washington D.C., November 21, 2002.
2 Jonathan Cheng, "Firms Weigh the Options for Those Piles of Cash," *The Wall Street Journal*, August 23, 2010.
3 "U.S. Accelerates in 2011 as Demise of Consumer is Exaggerated," *Bloomberg News*, September 13, 2010.
4 Patricia Riberio, "Emerging Markets: Positioned for Growth in 2010 and Beyond," *International Adviser* , March 2010.
5 "Greed is good," *Wall Street,* director Oliver Stone, performed by Michael Douglas, December 11, 1987.
6 Paul A. McCulley, "When Unconventional Becomes Conventional, *PIMCO 's Global Central Bank Focus*, August 2010.