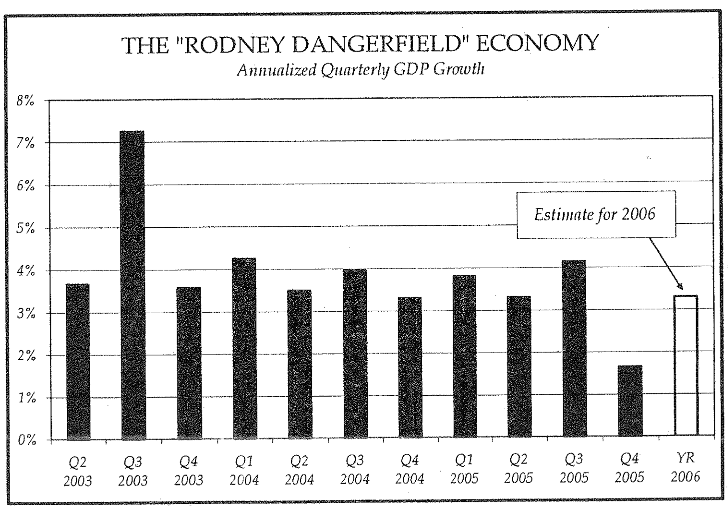
MARKET LETTER
A QUARTERLY PUBLICATION OF FERGUSON WELLMAN CAPITAL MANAGEMENT, INC.

FIRST QUARTER 2006

The Great Depression

In November of 2002, with the economy struggling to get airborne, then Fed *Governor* Ben Bernanke suggested that as a last resort the Federal Reserve Bank could, if so inclined, drop bags of money from helicopters to re-light the engines of economic growth. At the time, this suggestion received a lot of press. Coming from someone on a very short list for the job of *world's most powerful banker,* it should have. Our hunch is that there was a *wink* in there somewhere ... but it did what it was supposed to do. It made us sit up and pay attention. He was reminding us that with very few exceptions, monetary stimulus ultimately works. It goes a long way to frame how bad things were back then, by virtue of the fact that he felt it necessary to remind investors of this simple relationship. Taken in context of the day, his colorful suggestion is not as strange as it might have first appeared. Interest rates were at levels not seen since the early 1960's; the economy was barely alive; and in an election cycle ... there was much debate over not so much the *quality of job creation* ... but whether we would *create any jobs at all.*

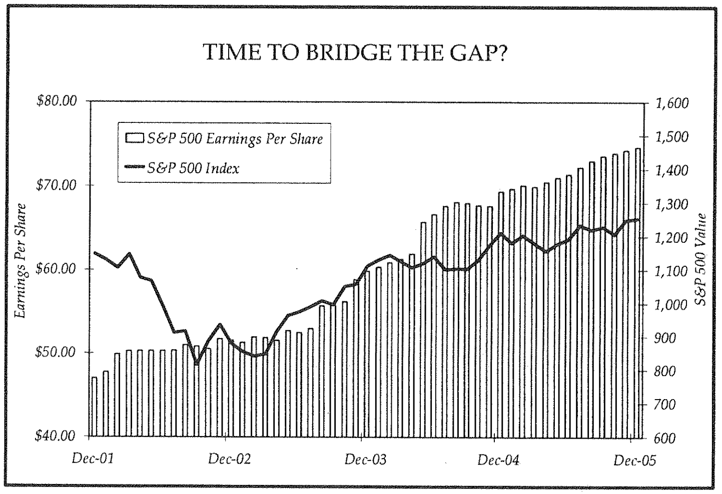
Much has changed since Mr. Bernanke's now infamous statement. For one thing, he is now *The Chairman of the Federal Reserve,* so any vague historical references to aerial bombardment with cold hard cash would take on special significance. With the benefit of hindsight, at the time of his comment, short-term T-bills were sporting Japanese-style rates of just over 1 percent and the Fed had already planted the seeds of recovery. For the record books (while we didn't know it at the time), the recession officially ended sometime toward the end of 2001, and the expansion that followed was, by any measure, a robust one.



Since the end of 2001, the U.S. economy has grown at a compound rate of 3.1 percent. What's more, enjoying double-digit growth for 13 consecutive quarters, corporate profits are now up 70 percent since 2001. In addition, the U.S. economy has since added more than five million new jobs ... more than the next two largest economies, Japan and Continental Europe ... *combined.* Yet with a return of 22 percent over this same period, the equity market reaction to this very good news has been, well ... *underwhelming.*

Though we wonder if Chairman Bernanke, in the context of all that has transpired since, was to opine not on macroeconomic performance but equity market performance (and with a passing glance at the compound returns accrued to the owners of common equity), would *money* still be the weapon of choice? Or would he suggest using something else possibly? Perhaps powerful anti-depressants?

As analysts, we're trained to fly by our instruments. Sure we can look out the window and fly with the best of 'em by the seat-of-our pants. But at the end of the day, we are trained to respect, and more importantly *trust,* the data. Although when the instruments don't square with what we're seeing outside the window, we'll admit to more than a touch of frustration. It would be one thing if this phenomenon was short in duration, but it's not. It's been several years now. The growing chasm between economic performance and stock performance is a puzzle that just can't persist in our view. While far from perfect, it is not an unreasonable analytical assumption to expect some degree of correlation between earnings and equity returns. So we ask ... *when will we get paid for this recovery?*

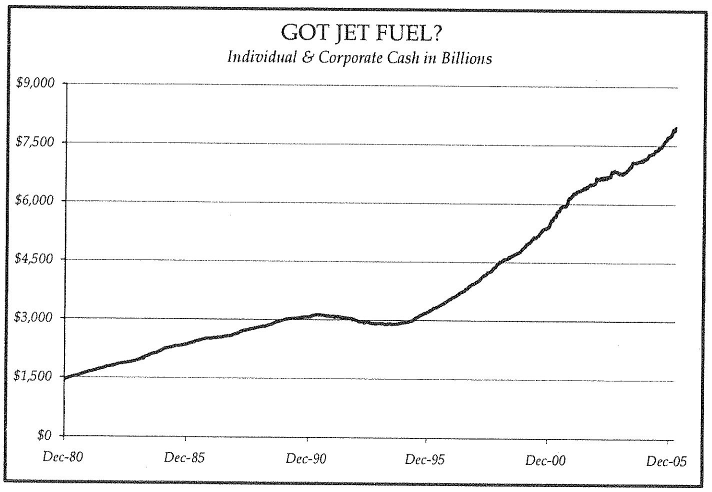


In our world, there are *worries*, and then there are *Worries.* While it is sometimes difficult to separate the two, the former ... *small case worries* are mostly noise. These make for great debates on "Meet the Press" and "Crossfire," but at the end of the day, they really matter very little as far as the major market indices are concerned. The latter ... *large case Worries,* can be significant. These can and do impact one of the critical variables near and dear to our hearts - stock valuation or price/earnings (P/E) ratios. In a metaphorical sense, these *Worries* are really "*bricks.*" Bricks that constitute the proverbial "*Wall of Worry.*" As in the old market mantra that a bull market "*climbs a wall of worry.*" In fact, there are two of these *upper case* worries that have held investors in the palm of their sweaty hands now for some time ... energy prices and interest rates.

In our view, it is ironic that last year's extremes in both energy prices and interest rates have helped set the stage for an improving market tone this year. At the beginning of 2005, with oil prices at $42.00 per barrel (and with the trend in price very much biased to the upside) ... there was a great deal of concern that the spike in price would, at some point, kill the recovery. There was also great concern that this not insignificant headwind, combined with the persistent drumbeat of Federal Reserve interest rate hikes, would collectively become too much for the system to bear. In addition, the devastation brought about by the twin, killer hurricanes and the complete destruction of a significant chunk of our energy infrastructure only served to compound these fears.

But a funny thing happened last year. Despite oil being up 43 percent year-over-year (reaching a peak price of almost $70 per barrel), eight Fed interest rate hikes, and the loss of billions in economic growth as the result of Rita and Katrina ... the economy grew at an astounding 3.5 percent last year. More importantly, investors are coming to terms with the fact that the economy can continue to grow quite nicely in spite of strong headwinds presented by high energy prices.

Interestingly, much of the economic data, prior to the energy spikes of the last few years, predicted this. Energy use per dollar of GDP reached a 25-year low back in January 2002. However it appears that the economic system has successfully completed a sort of "tempering" process. In other words, it seems that empirical confirmation of the economy's vigour was indeed necessary before investors would commit new capital to the equity market. It is also likely that we are reaching the final innings of this interest rate (tightening) cycle. If the last economic cycle is any guide, as we approach the penultimate rate hike, stock performance can improve quite significantly. It is also important to remember that there is a veritable *mountain of cash* (some $7.9 trillion as of the latest accounting) on the sidelines that could serve as fuel for higher stock prices (see "The Cash Buffet" - Ferguson Wellman Market Letter Q4 2005).



In conclusion, we do not believe that the improved tone of the market during the first quarter was a fluke. Rather we believe that the gap between strong economic performance and relatively weak equity market performance is beginning to move closer to equilibrium. This *discounting process* was a cornerstone of our forecast at the beginning of the year. While it is still too early to declare victory in this regard, we think that stocks will continue to play *catch up* with their previously strong earnings performance, resulting in full-year returns in the 8 percent to 12 percent range.

Sources:
1. Remarks by Fed Governor Ben S. Bernanke before the National Economists Club, Washington, D.C., November 21, 2002
2. International Strategy and Investment (ISI) -- related research and statistics
3. Miscellaneous Data Sources: Decision Economics, Wall Street Journal, Thomson First Call

Market Outlook

- Despite higher short-term interest rates, the S&P advanced 4.8 percent, its highest monthly close since January 2001.

- With the exception of telecommunication stocks that were fueled by further industry consolidation, year-to-date, the best performing sectors have been classic cyclicals such as energy, industrials and basic materials.

- Though large-cap equities enjoyed a handsome first-quarter return, they were far from the best performing asset class. To prove that trends can persist longer than reasonable people (ourselves included) would expect; REITs returned 12.8 percent, small caps 12.2 percent and international equities 8.8 percent.

- While we expect slowing U.S. economic growth in the second half of 2006, international growth is projected to remain strong. This growth will be led by a rejuvenated Japan, improving European economies and continued strength in emerging markets.

- The economy is not yet giving the Federal Reserve reason to stop raising rates. The Fed funds rate now stands at 4.75 percent, and we expect at least another hike in May to 5.00 percent. This would become the 16th consecutive increase from the Fed.

- While long-term interest rates have moved up, thanks to Fed rate increases, short-term interest rates have moved up more. The U.S. Treasury yield curve is now essentially flat, with maturities ranging from six-month T-bills to ten-year Treasury notes all yielding about 4.8 percent … a condition that we believe will persist for the balance of the year.

- Rate hikes are starting to impact the housing market and should serve to dampen economic growth. As the economy shows more definitive signs of slowing later in the year, we expect the Fed will cease raising rates.

- Though any further Fed rate hikes will cause a modest inversion of the yield curve, the small magnitude of the inversion will only forecast a moderation in the pace of economic growth, and is not a precursor to recession.