MARKET LETTER

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Boom and Gloom

"Financial bubbles must be lived forward, even if they can only be understood in reverse."
-- David Ignatius

One of the most widely anticipated financial crises of all time finally boiled over this past summer. Global financial markets are a wondrous and reasonably efficient discounting machine. Yet for some reason it took almost 18 months for the subprime mess to turn into a full-blown financial market contagion. While this is hugely ironic, it is also in many respects a reflection of modern financial "wizardry." In the good old days, mortgages were held and serviced by their issuers, making it a relatively simple task to isolate the provenance of suspect paper. Today, however, mortgages are securitized and then sold to investors. These investors can choose their desired level of risk (and return). In theory anyway, owning a large portfolio of higher yielding uncreditworthy loans is (or was) a safer bet than the individual loans themselves. On the other hand, spreading the risks over literally thousands of investors would also ... *in theory* ... reduce the likelihood that any one investor was overly exposed. So much for theory.

In many respects, one of the principal catalysts of this summer's panic was this lack of transparency. No one really knew where all of the bad loans were. Financial institutions around the world voted with their feet and simply dumped anything they thought might be suspect. However, this credit-related problem quickly became a systemic "plumbing" problem. Central bankers became concerned that the credit markets would not be able to handle all of these fund flows and would simply seize up. However, led by our Federal Reserve Bank, global central bankers came to the rescue, pumping in massive amounts of liquidity to keep the system humming.

It would be foolish to assume that this problem has fully run its course. There will likely be other disruptions (and volatile stock and bond market reactions) as financial institutions disclose their exposure and associated losses over the next few quarters. However, it appears that both Chairman Bernanke and the architecture of the global financial system have preliminarily weathered the "eye" of this ongoing storm.

Wall Street's summer woes were a reflection of what's been happening on Main Street USA for some time now. New foreclosure activity continued to surge this summer, rising 36 percent from July to August, more than doubling from a year ago. In some previously white hot real estate markets, foreclosure rates had soared to stratospheric levels. The National Association of Homebuilders/Wells Fargo Housing Market Index of home builder confidence dropped to the lowest level ever recorded. More than 150 mortgage lenders have either voluntarily quit the industry or filed for bankruptcy. It is likely that the news from this sector of the economy will get worse before it gets better, and as we have said in these pages on more than one occasion, we believe that the residential real estate market is in a protracted secular bear market. Well aware of this, the Fed's decision to aggressively cut interest rates is a good thing. Will it cause the real estate market to come roaring back? No. However, it is quite likely that the Fed's aggressive action will prevent the current real estate recession from becoming something far worse. More importantly, it will provide some "grease" for the wheels of the economic system. The impact of lower rates will be felt across all segments of the economy.

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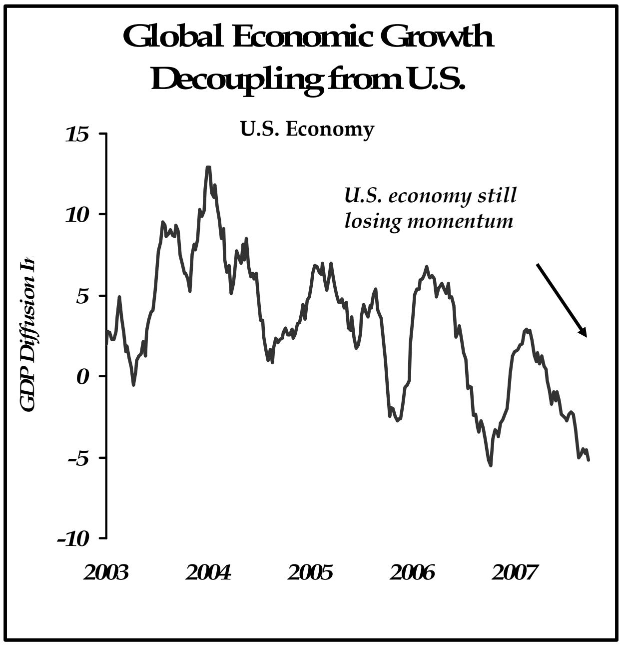
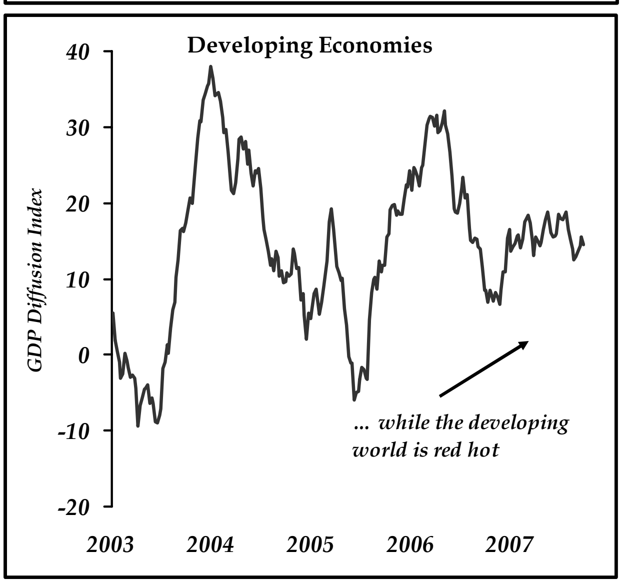
This summer's financial market turmoil is interesting in another context. In any other business cycle, dislocations as large as what we're witnessing would have reliably and predictably brought about generalized economic recession. This doesn't appear to be happening. While the growth rate of the U.S. economy has slowed, it has not fallen off a cliff.



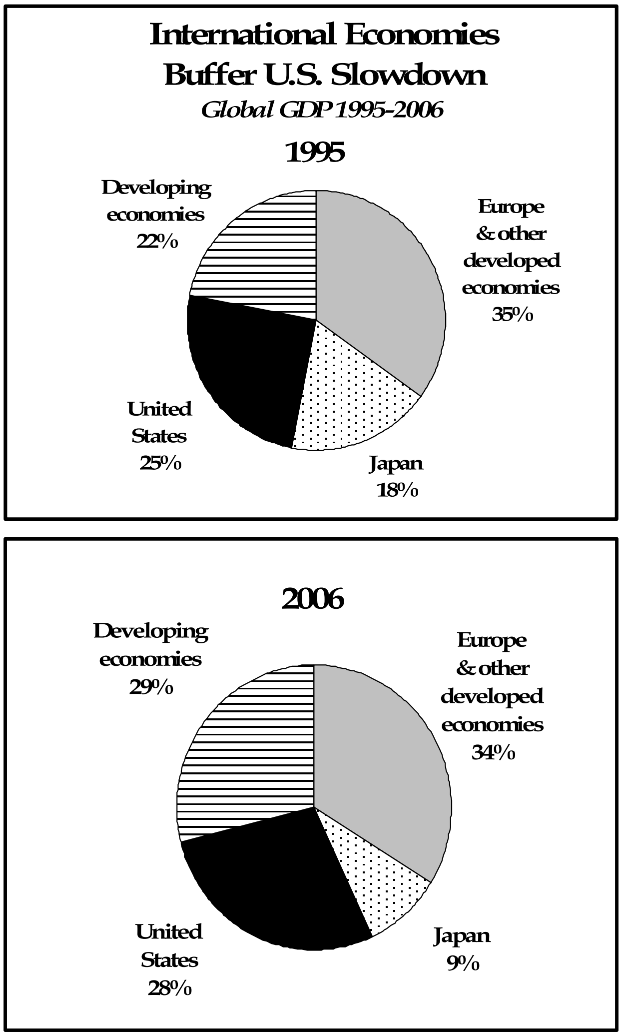


Source: ISI Economic Research

Earnings and cash flows for the majority of U.S. corporations are still quite healthy. For many companies, earnings are actually growing nicely, and in some market subsectors, the real estate mess seems like only a bad dream. Why is this so, and more importantly ... what are the investment implications of this conundrum?

Albert Einstein once said, "*Education is what remains after one has forgotten everything learned in school.*" As students of finance and economics, and observing the behavior of both the financial markets *and* the global economy over this past summer, the wisdom of these words has never seemed more profound. While the long-term records of most economists is about on par with those that choose to forecast the weather for a living ... it seems that economic forecasting has become exponentially more difficult of late. Paradigms are shifting just about everywhere. While the front pages of most newspapers are filled with supremely bearish stories of housing-related horrors, the business pages are brimming with stories of global growth that can only be described as *white hot*. The old maxim that says, *"If the U.S. sneezes, the rest of the world catches a cold,"* is very much being tested at the moment. Perhaps our textbooks created an inherent bias. Could it be that many forecasts harbor a somewhat overly *U.S. centric view of economics*? Whatever the reasons, a decade or more ago an accelerating U.S. housing recession coupled with a consumer led slowdown would have most surely ricocheted rather quickly around the globe. To be sure there has been some evidence of this, principally in the United Kingdom. Yet with the U.S. economy slowing, global growth should be slowing too. Curiously, this doesn't appear to be the case.

Perhaps the best way to understand what's going on is to learn from a boots-on-the-ground manager. Said Jeff Fettig, Whirlpool Corporation's CEO, "*The housing market, we believe, is going to continue to be depressed at least through the middle of 2008. But while industry demand for Whirlpool appliances, such as washers and refrigerators could be down as much as 4 percent this year, sales growth in large international markets has been in the double percentage digits.*" He added, "*Our international business is performing really well. Brazil and Latin America has been extraordinarily strong. Asia, which is still a small part (of the business), has been very strong, and Europe just keeps chugging away, doing a little bit better that what we thought.*"[1]



Source: ISI Economic Research

While the U.S. economy is probably now percolating along at a sub-2 percent (GDP) growth rate, the developing world is growing at more than three times that rate. In fact, when you look at their share of global GDP, developing economies have *now collectively eclipsed that of the United States* (29 percent versus 28 percent, respectively). For the last three years running, global GDP growth has been close to 5 percent. This is the highest level recorded since the late 1960s. The growth rates of nearly 120 countries will exceed 4 percent this year. The reasons for this are now reasonably well known. Two-thirds of the world's population has been unleashed into the global economy. The flow of both information and capital are now virtually borderless, and ironically, the tax rates on capital in many developing economies are lower than our own.

In previous cycles, developing economies were huge importers of capital. This produced a series of periodic homegrown financial crises. When the externally provided capital was withdrawn, growth would come to a grinding halt. This time around, developing economies are running current account surpluses.[2] As a result, the global economy and the financial system have become far more resilient, and therefore less vulnerable to boom and bust.

We believe that for quite possibly the first time, the U.S. economy is now being bolstered by economic growth offshore. While this summer's market turmoil was unpleasant, it also produced some noteworthy surprises. It appears that global GDP will continue to support profit growth worldwide. Although the U.S. economy is slowing, we do not believe that a textbook recession is imminent. Economies around the world appear poised to continue to grow, and while they too will slow at some point, they will slow from rates of growth much higher than what we are experiencing in the U.S. In addition, foreign growth rates appear to be far more durable than in previous economic cycles.

The investment implications of these paradigm shifts are profound. In short, portfolios should be geared to capitalize on global growth. This means that export-oriented sectors should be overweighted. This would include the energy, technology, materials, and industrial sectors. On the other hand, we recommend only a relatively modest commitment to the consumer and financial sectors since depreciating real estate values could negatively impact consumer spending. There will also be periods when participating in global growth will be more attractive vis à vis domestic companies. We believe that this is the case at the moment. However, direct investment in both developed non-U.S. companies and emerging markets also makes sense, and should be emphasized when appropriate.

Footnotes for Market Letter:
1. Christopher Hinton, "Haven for Housing," *Dow Jones MarketWatch*, September 14, 2007.
2. David Hale, "The Best Economy Ever," *The Wall Street Journal*, July 31, 2007.

Professional Profile: Don Rainer

Last time Don Rainer was highlighted in *Market Letter*, he was the new guy at Ferguson Wellman. Nearly a decade later, Rainer smiles when asked to describe the changes in his job and life. "Well, I'm still handling business development for the firm," he begins, "but now I dedicate considerable time toward managing client relationships. And that baby, Devon, pictured in the last profile we did, is now nine … and his brother Justin is seven."

As his family has grown, so have Rainer's responsibilities at Ferguson Wellman. He continues to handle the firm's relationships with consultants, banks and brokerages, but instead of doing it single-handedly he now manages a company-wide business development effort.

Devon, Don, Lisa and Justin Rainer
Photos by Bruce Beaton

Over the years, Rainer has also developed areas of expertise through addressing client needs. "Looking back, my knowledge base has grown as I've navigated through various issues with our clients," he says. Rainer handles the intricacies of retirement and profit sharing plans, family philanthropy endeavors, and unique needs facing foundations.

Rainer is the first point of contact for several institutional accounts. "I attend quarterly meetings, help review investment strategies – and try to offer some extra value," he says. In one recent example, he invited the firm's healthcare analyst to join the review of a client's healthcare business. "He spoke in depth about how we view that sector from an investment perspective," recalls Rainer, "which let our client see his industry from a new angle."

In addition to handling business development and client services for Ferguson Wellman, Rainer is active in the nonprofit world. He's currently board chair of the March of Dimes Greater Oregon chapter, a trustee for the Oregon Independent College Foundation, and serves on the investment committee of the Lane Community College Foundation.

Outside of work, Rainer and his wife Lisa keep their young sons busy with a steady round of soccer, baseball – and golf. "They love golf!" he laughs. "Sometimes they hit good shots, but the best part is just being out with your kids. You're walking down the fairway and you have time to talk with them. There's nothing like it."

As he reviews his tenure at Ferguson Wellman, Rainer reflects on change and continuity. "We've grown methodically," he comments, "always keeping the needs of our existing clients front and center. We've brought in new people who have amazing expertise and credentials to bolster the firm's investment strategies and services."

At the same time, he notes, "We have remarkable stability. While I've been here, not a single one of our portfolio managers has left." In keeping with that theme of growth and stability, Rainer is one of four managers, along with Ralph Cole, Lori Flexer and Jason Norris, who have been identified by the firm's board of directors to have more significant ownership in the coming years.

Personally and professionally, Rainer is the type who's quick to credit others. "My job," he demurs, "is to promote the members of our investment team. They are the backbone of our company – the pros." And to him, they're more than colleagues. "What's great about this organization," he enthuses, "is that people work really hard – but we also step up and support each other. That's one of the best things about working here."

Sources for Market Letter:
1. Kevin Kingsbury, "U.S. Foreclosures Continue to Surge," *The Wall Street Journal*, September 18, 2007.
2. Rick Brooks, "Home-Loan Report Portends More Pain," *The Wall Street Journal*, September 13, 2007.
3. David Ignatius, "Appetite for Risk -- Subprime Mess Latest Symptom of Financial Ills," *The Washington Post*, September 2, 2007.
4. Francois Trahan, "Portfolio Strategy Report," International Strategy & Investment, September 19, 2007