

MARKET LETTER

MARKET PERSPECTIVE



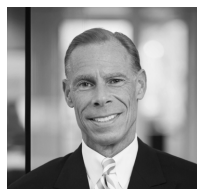
THIRD QUARTER 2015

IN THIS PUBLICATION

Market Perspective.....	1
Weapons of Reason.....	2
Investment Strategies.....	4
Investment Services.....	5
Communication & Education	6
The Last Word.....	6

Founded in 1975, Ferguson Wellman is a privately owned registered investment advisory firm, established in the Pacific Northwest. As of 2015, the firm manages over \$4 billion for more than 700 clients that include individuals and families; Taft-Hartley and corporate retirement plans; and endowments and foundations with portfolios of \$3 million or more. West Bearing Investments, a division of Ferguson Wellman, serves clients with assets starting at \$750,000.

INVESTMENT EXCELLENCE
LIFELONG RELATIONSHIPS



AWAITING LIFTOFF

George Hosfield, CFA
Principal, Chief Investment Officer

Concerns about flagging growth in China and the implications for a global economy already experiencing slow expansion led to a broad equity sell-off last quarter. The correction in the S&P 500 was arguably overdue since the U.S. had gone nearly four years without declining by 10 percent or more.

As the third quarter drew to a close, investors once again witnessed the Federal Reserve abstain from raising rates. Citing global growth concerns against a backdrop of below-target inflation, the Fed's inaction ultimately seems to be more about messaging to the markets rather than anything more pernicious. Simply put, a dovish-leaning Fed doesn't want to further upset an appletart unsteadied by recent volatility in global markets.

Domestically, the economy appears strong. Unemployment is down to 5.1 percent and the latest GDP reading shows 3.9 percent growth, conditions not typically associated with zero interest rate policy. Tightening labor markets are perhaps the best leading indicator of inflation, and, with unfilled jobs now at a 15-year high, our belief is that the Fed will still raise rates this year, likely at the December meeting. However, as the accompanying chart depicts, unlike the last tightening cycle that witnessed a whopping 17 quarter point rate hikes, this time we anticipate a much slower tightening of monetary policy.

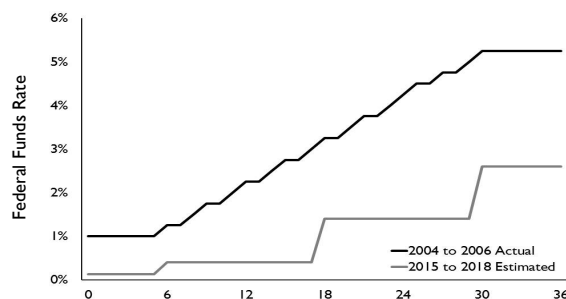
As for China, we have maintained for some time that the law of large numbers and a

"rebalancing" from a manufacturing/investment based economy to a consumption based model will slow its growth. However, we anticipate a slowdown, not a meltdown.

While stocks could remain in limbo this fall as investors await clearer signals from the Fed and China, we are looking forward to a better earnings outlook in 2016. After what we expect will be flat profits for U.S. equities this year amid the effects of a substantially stronger dollar and a bear market in oil, a moderating dollar and higher oil prices should renew earnings growth.

Our thesis of a consumer-led domestic expansion fueled by low interest rates, healthy labor markets and low fuel prices combined with supportive monetary and fiscal policy in Europe and Japan provides a constructive backdrop for equities. Coupled with reasonable market valuations, stocks remain our preferred asset class. In expectation of modestly rising interest rates and rebounding oil prices, we are overweight the financial and energy sectors domestically. Internationally, we are underweight emerging markets in deference to recessions in Brazil and Russia, along with said challenges in China.

Fed Rate Hikes to Be Slower and Lower



Source: Board of Governors of the Federal Reserve System

Everything we hear is an opinion, not a fact. Everything we see is a perspective, not the truth. – Marcus Aurelius



FORTRESS AMERICA ... WHY CHINA'S WOES WON'T MATTER

Dean Dordevic, Principal
Alternative Assets and Portfolio Management

"If somehow China disappeared tomorrow from the map, U.S. GDP growth would fall by about one percentage point. That's not even a recession ..."

-- Paul Ashworth, Capital Economics Chief Economist¹

Greece really is a lovely place. After all, with opalescent seas, wonderful food and superb olive oil, what's not to like? After years of trepidation and turmoil, and just as investors were becoming ever more comfortable with Greece and her many economic challenges - and in what seemed like only a few days - virtually the entire financial media complex boarded the next flight to Beijing from Athens. Greece, which dominated the front pages of the world's most important newspapers for the last several years, has now been replaced by ... *China*.

While the Grecian soap opera of the last three or four years produced its fair share of both hand wringing and not inconsiderable volatility, it failed to produce a bona fide equity market correction (defined generally as a peak to trough decline of 10 percent or more). This is best explained by the simple fact that the Greek economy contributes about as much to global GDP as ... the great state of *Tennessee*.

However, China's woes of late did in fact precipitate text book corrections (or worse) in most of the global markets that matter. This owing, perhaps, to China's place as the world's second largest economy. For the record books, a 10 percent correction (from a previous 52-week high) is something we have not seen now in over four years. This most recent correction is the 41st of its kind in the last 88 years (i.e., since 1927). Importantly, of the previous 40, only 13 came within a year of "predicting" a recession (i.e., two consecutive quarters of contracting GDP growth). So, if you're looking for predictive value from this most recent squall ... you'd be well advised to look elsewhere.²

China's problems are now reasonably well known. In summary, this recent sell-off was born in both Shanghai and Shenzhen, in the wake of the People's Bank of Chi-

na somewhat unexpected "depreciation" (a de-pegging, actually) of the Chinese currency, the yuan. It is well known that China's economy has been slowing - quite significantly, in fact - over the last few years. This as the Chinese government has attempted to alter the complexion of growth from *investment to consumption*.

However, this currency depreciation was taken as a sign that GDP growth was far worse than had been forecast. Why? Because depreciating the Chinese currency would theoretically act to ignite export-related growth for China. This move then took on the unfortunate patina of a central bank's version of a "Hail Mary" pass. Whether or not this is true remains to be seen. Curiously, the global financial reaction was a tad ironic, since the yuan was widely believed by many economists to be somewhat overvalued to begin with. Said Paul McNamara, Emerging Markets portfolio manager at GAM Holding, "The biggest surprise (about China's market panic) was not that China has slowed, but that it has come *as such a surprise*."³

It is worthy of note that in response to queries over China's forecasted rate of growth, and despite their best efforts to stress-test their China GDP models - one venerable Wall Street economics consulting firm (Strategas Research Partners)⁴, couldn't solve for a GDP forecast for China much below 6 percent. If they are in fact correct, this would leave India with the highest global growth rate, albeit at just slightly north of 6 percent. And let's be perfectly clear: a 6 percent growth rate is nothing to sneeze at. For all the harrumphing over the Chinese real estate bubble and their "ghost cities" ... the Chinese will buy some 10 million new homes this year. This is more than *double* the amount of new and existing homes sold in the U.S. in 2014.⁵

But could a slower growing, and potentially more balanced, Chinese economy be a ... *positive for both the U.S. and other developed market economies*?

First, it is important to realize that for all the talk about globalization, the U.S. remains largely a closed system. Over 80 percent of U.S. GDP is generated from ... within our borders. Our exports to China are really quite small. Of China's 20 largest trading partners (measured by exports to China as a share of their GDP) the U.S. ranks 18 which is about on par with Poland and Turkey. So it's hard to make a case that the U.S. would suffer from what



some economists might call an “export shock.” So too, Chinese direct investment is just a fraction of 1 percent of total foreign investment in the United States.¹

Still, from a global macro-economic perspective, we are in fact seeing a dramatic series of reverberations echo through both the commodities and currency markets. We have seen this most intimately with the recent sharp decline in the price of crude oil. However, prices for other important industrial commodities like copper, steel and aluminum have fallen as well. This should be very positive for both inflation and consumer prices both now and going forward. Falling commodity prices transfers income from producers to consumers and consequently acts as a *tax-cut for developed country households*. But China’s reduced demand for commodities is a secular issue that will weigh meaningfully on both commodity producers and emerging market countries and their currencies for some time to come.⁷

China rebalancing towards services and consumption would theoretically play directly into the hands of the U.S. companies. This as China de-emphasizes old-line industries such as steel and tires (that are burdened by overcapacity and essentially export their excesses). In this context, U.S. service-related companies would potentially thrive - boosting companies that sell software, entertainment, internet services, insurance and healthcare related goods and services.¹ The U.S., after all, is largely a consumption-driven economy. Perhaps too much so. But we have a suite of services, products and companies that would very likely benefit from a more balanced and consumption-driven China.

Over the last six years, from trough to peak, the S&P 500 gained some 220 percent. However, until this month, during that time we have had only one correction of 10 percent (summer of 2011). Perhaps we were just overdue. After all, that’s how markets work. But by our lights it is very hard for us to solve the investment equation for

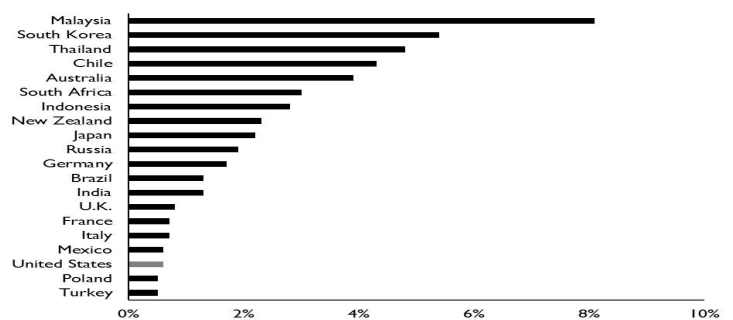
either a recession or bear market at this juncture. At seven years of age, our durable expansion has allowed both consumers and business alike to rebuild and strengthen balance sheets that some have described as near “fortress-like.”

Household net-worth as a percentage of disposable personal income is at its *highest level* since before the recession began. Consumer delinquencies on both credit cards and auto loans are now *near record lows*. Remarkably, the debt-driven excesses that ultimately bring an upswing to a halt are just not present at the moment, now fully seven years post the last recession.

Record corporate profits, low inflation, healthy consumer and business finances all augur for a recovery that is well-positioned for continued growth. These conditions also provide resilience to withstand exogenous shocks, like the latest ongoing drama that now resides in China.

Bull markets don’t die of old age. They are ultimately brought to their knees by elevated interest rates and investor overenthusiasm. Neither pre-condition is even close to being in place currently. Consequently, we believe that this expansion has continued room to run.

Exports to China as a Share of GDP



Source: WSJ Market Data Group, FactSet

Weapons of Reason footnotes and sources:

1. Bob Davis, “China Woes Could be Good for U.S. Economy,” *The Wall Street Journal*, September 9, 2015.

2. “Takes More Than a \$2 Trillion Stock Rout for a Recession Bell,” *Bloomberg News*, September 14, 2015.

3. Roger Blitz, “Global Worries Hold EM Valuations in Check,” *Financial Times of London*, September 2, 2015.

4. Strategas Research Partners, “International Investment Research,” September 15, 2015.

5. Andy Rothman, “What Next? A China Housing Crash?” *Financial Times of London*, August 12, 2015.

6. Diana Choyleva, “Positives of China’s Policy Changes Make U.S. Stocks a Buy on Dips,” *The Financial Times of London*, September 8, 2015.

7. John Bilton, “China’s Lower Demand for Commodities is not the Whole Story,” *Financial Times of London*, September 2, 2015.



OIL: THE HEALING BEGINS

Shawn Narancich, CFA
Executive Vice President of Research

Our call for higher oil prices has proven to be *early*, but not likely to be wrong. This spring, we observed that U.S. producers had dramatically cut their drilling activity alongside rapidly diminishing cash flow. The chickens are now coming home to roost, as fast depleting shale oil isn't being supplemented by enough new wells to sustain U.S. production. From a cyclical high of 9.6 million barrels/day reached in June, U.S. output is now falling and should exit 2015 *below* the nine million b/d mark. Inasmuch as U.S. production growth helped fuel a surfeit of oil last year, the U.S. supply response now unfolding encourages our bullishness.

While production dynamics have unfolded according to our expectations domestically, we have been surprised by OPEC. Oil prices that began responding positively to falling U.S. investment subsequently suffered an unsuccessful re-test of lows in late August amid rising produc-

tion from Saudi Arabia and Iraq. Since the OPEC meeting last November when the cartel refused to cut liftings, oil production from this 12-nation group has risen by 6.6 percent. Whether or not it was OPEC leader Saudi Arabia's intention to retake market share from the U.S., it clearly has.

Saudi Arabia is the sole source of excess production capacity globally, with its two million b/d equating to just 2 percent of global demand. Accordingly, increasing attention will be paid to the House of Saud and the upcoming OPEC meeting in early December to see whether the Kingdom continues to press its capacity into production or, as we believe, it will stop raising output. Observing that Saudi Arabia's oil revenue has fallen by a third since last November despite its production gains, and that the country is in deep deficit at current prices, Saudi is incented to stop the bleeding.

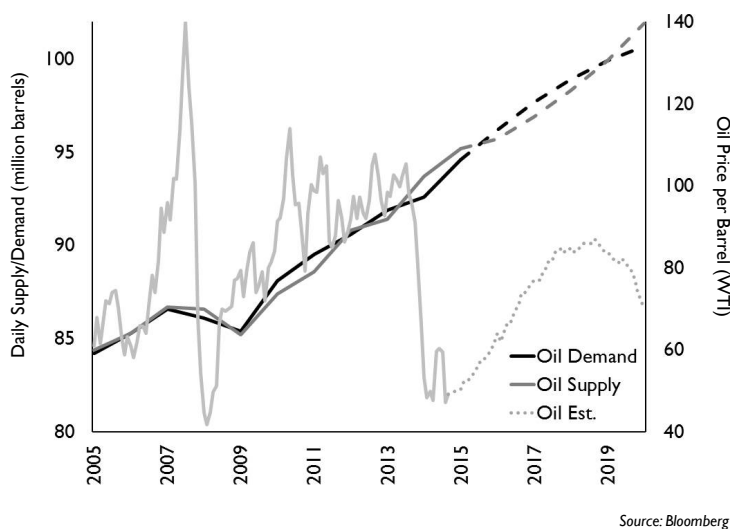
Low oil prices are biting Iraq as well. The central government there has missed payments to the Kurdish regional oil producers as Baghdad runs short of cash amid the ongoing fight with ISIS insurgents. Oil investment is now falling, which leads us to believe that production will follow.

Then there's Iran. Even if sanctions are ultimately lifted, we question whether production infrastructure so long neglected amid a lack of funds is capable of efficiently raising the country's output by as much as expected. Regardless, we believe the world will eventually need this extra oil as production tails off elsewhere.

Meanwhile, U.S. consumers have rekindled their love affair with trucks and SUVs, boosting the demand for gasoline. Internationally, fuel demand is strong in India and surprisingly robust in China. All told, oil demand is robust globally, rising at a 2 percent clip that's been matched just once in the past decade.

Over the next several years, tighter oil markets should boost prices to levels closer to the marginal cost of production, estimated at \$80-90/barrel. Accordingly, we expect our overweight to the energy sector to pay off, particularly for the more cyclically exposed producers and service companies.

Oil Prices Are Going Higher



Never let the future disturb you. You will meet it, if you have to, with the same weapons of reason which today arm you against the present. – Marcus Aurelius



WORKING ON YOUR BEHALF: CLASS ACTION LAWSUITS

Steve Holwerda, CFA

Principal and Chief Operating Officer

While managing your investment portfolio is our primary responsibility, there are other services we provide clients at no additional cost to you as part of your standard management fee. Examples include: managing the effect of corporate actions such as mergers, spin-offs and stock splits; proxy voting on your behalf; and processing class action settlements. Class action lawsuits can be a nuisance, but we want all of our clients to know that we file them on your behalf, if your custodian does not already provide this service.

Although the securities litigation process is lengthy and complex, we have taken steps to manage the process with the goal of collecting distribution payments for you. Our controller works with a third-party administrator firm, Battea, to participate in class action lawsuit claims for any security our clients owned during the class action period. Battea is paid on a contingency basis and only receives a fee if the class action suit pays out.

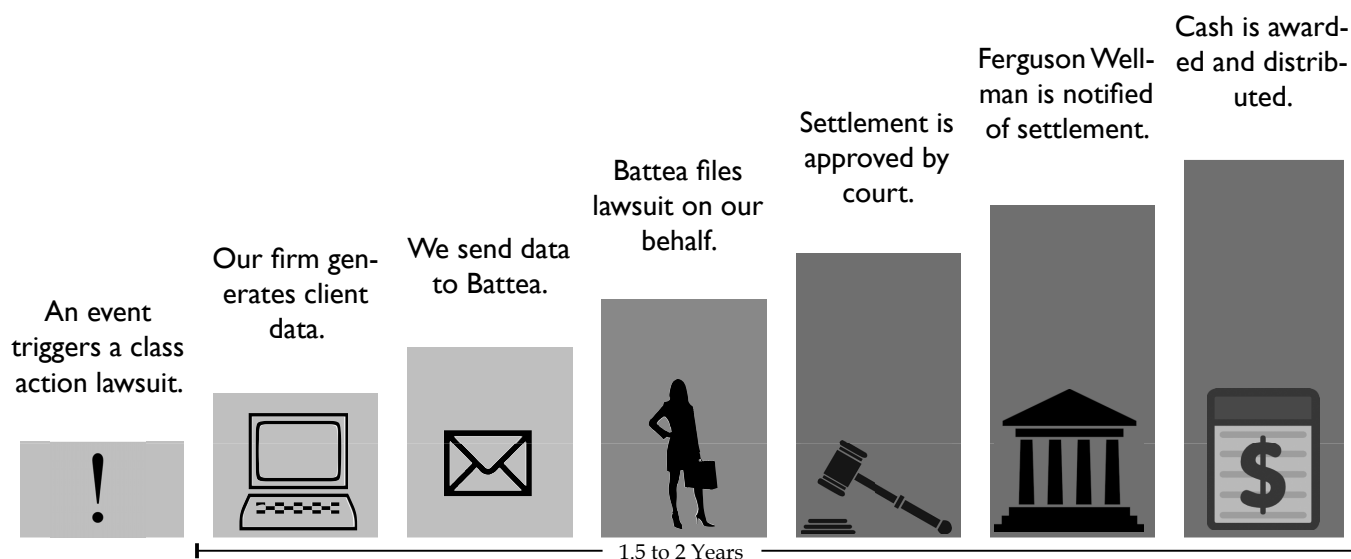
You may have received notices regarding securities class action claims because you have held securities of companies that have gone through the litigation process. The

following graph illustrates the many steps that occur from the time you receive a notice to a possible distribution payment. Also listed below is data showing how many client accounts have been impacted by class action cases.

You may disregard the notices you receive for a security you owned while we managed your assets, as we will file them on your behalf if your custodian does not. Should you have any questions about this service we provide for you, please contact your portfolio manager.

By the Numbers

- Since 2007, **1,280** client accounts have held securities from companies that currently are or have been involved in a class action case
- Presently we are monitoring **38** pending class action cases that could result in distribution payments to clients
- There are **\$1,023,622** potential recognized losses in 16 cases that have been filed. This is not necessarily the number that will be paid
- Since 2007, **1,129** client accounts have received distributions from 102 class action cases
- **\$1,069,923** has been awarded to clients since 2007





THERE'S A NAME FOR THAT

by Elizabeth Olsen
Vice President of Marketing

Correction: A decline or downward movement of at least 10 percent in a stock, bond or commodity market to adjust for an overvaluation. Corrections are generally temporary declines in the said market or asset. A correction is usually of shorter duration than a bear market and can be a precursor but is not always.

Depreciation: A measure of the decrease in the value of an asset over a specific period of time. Also, the gradual decrease in the economic value of the capital stock of a country, company or another entity through changes in the demand for the services or capital in question or through physical depreciation or obsolescence.

Emerging Markets: Countries that have some characteristics of a developed market but do not meet the standards to be thought of as a developed market. The following countries as emerging markets we consider when discussing our portfolios and exposure, among others: Brazil, Chile, China, Egypt, Greece, India, Indonesia, Malaysia, Mexico, Peru, Russia, Taiwan, Thailand and United Arab Emirates.

Export shock: This refers to an unexpected event that affects exports. This can be caused by either economics or exogenous events such as a natural disasters, political events or other outlying occurrence.

Globalization: The process of interaction and integration among the people, companies and governments of different nations which is driven in part by international trade and investment and aided by information technology.

In an effort to improve clarity and prevent industry-specific terms, we have included these definitions for your information. For additional resources, you may contact us at info@fergusonwellman.com for a copy of our Glossary of Investment Terms or visit our blog at blog.fergusonwellman.com for more definitions.

Communication and Education Sources:

Business Dictionary
Investopedia
Investorwords.com
MSCI
Wikipedia



FLEXER HONORED AT PBA EVENT

The firm is proud to recognize Lori Flexer for her recent honor from the Portland Business Alliance. In September, she was honored at the "A Place With No Ceiling" event, which seeks to connect and inspire business women through the celebration of a female executive who has broken through the glass ceiling in her industry and a company for the advancement of its female employees. This year, Flexer was honored along with Intel Corporation. There were approximately 300 people in attendance, including her family, friends and many from our firm. Lori Flexer is an invaluable member of our team and we admire her passion, dedication and professionalism. She leads by example and it is meaningful to us when others also recognize her contributions and talents. Please join us in congratulating Lori Flexer.

SURVEYING OUR CLIENTS

We periodically survey our clients to ensure that we are meeting their service needs. Over the years, we have conducted in-depth client satisfaction questionnaires, with our most recent being in 2011. At that time, we were pleased to report that the majority of our clients responded that their client service expectations had been met, they felt well connected to their portfolio manager, their relationship had remained stable or had improved over the years and that they had or would recommend Ferguson Wellman. We are continually assessing the alignment between a client's short- and long-term goals and objectives. We expect to embark upon this survey after the start of the new year and we thank you in advance for your participation as it is vital in helping us to achieve investment excellence and lifelong relationships.

Our logo features a bronze coin of Marcus Aurelius Antonius, Emperor of Rome from A.D. 161 to 180. According to historian Edward Gibbon, he was the only person in history in which "the happiness of a great people was the sole object of government." Marcus Aurelius was the author of meditations that reveal a mind of great humanity, natural humility and wisdom.