

MARKET LETTER



MARKET PERSPECTIVE: SECOND QUARTER 2012

Groundhog Day - European Edition



by George W. Hosfield, CFA, Chief Investment Officer

Looking Back

- Reminiscent of the 1993 film where Bill Murray finds himself repeating Groundhog Day over and over again, global capital markets continue to be held hostage by the rolling sovereign crisis in Europe ... leading European leaders to their fourth make-or-break summit in a year.
- Volatility returned to equity markets as a vivid reminder that the path toward a “solution” in Europe will be neither linear nor quick. With Greece flirting with an exit from the EU, sovereign yields in Spain and Italy at, or near, record highs, – volatility-weary investors continue to place a premium on safety.
- Largely in response to increased investor demand for a “safe haven” from the political turmoil in Europe, Treasury bond yields moved markedly lower during the second quarter. At the same time this “spike” in risk aversion had the opposite effect on corporate bond yields as those rates moved *higher* amidst slowing U.S. economic growth.

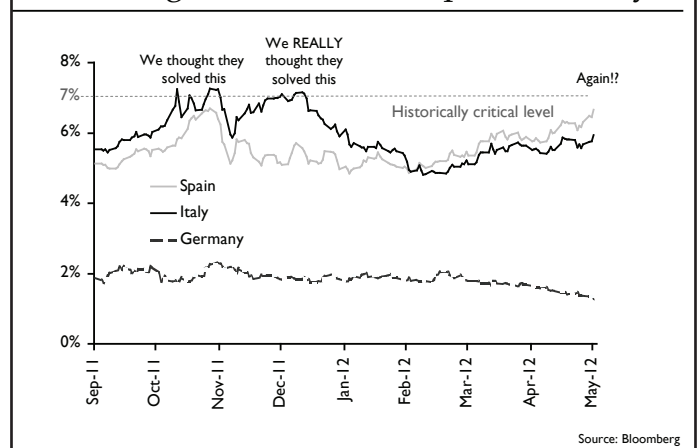
Looking Forward

- As the events in Europe continue to demonstrate, never underestimate the ability of policy makers to find a new way to “kick the can” down the road. Though the Greek elections had a “successful” outcome, we believe that they merely “lived to fail another day.” However, Germany will likely lead the EU toward establishing a closer fiscal union ... thus preserving the 17-member European Union ... for now.
- Widespread political uncertainty, at home and abroad, will dominate the investment climate in the coming months. Angst over the European Union’s fate is likely to persist and despite the inability of the U.S. to confront decisively its own fiscal crisis, the Treasury bond market should likely be the destination for uneasy investors’ funds during these uncertain times. Thus, interest rates should stay low for quite some time.
- The well-documented market risks notwithstanding, with equities underowned and undervalued, there are a host of potential positives for risky assets. Specifically, the potential that soaring Spanish and Italian interest rates force policy makers into action sooner rather than later, that slow job growth prompts the Fed to initiate “QE3” and bipartisan action to address the pending “fiscal cliff,” could all serve as near-term catalysts for equity markets.
- At this juncture, we are comfortable with the allocation strategy that we outlined in our January 2012 *Investment Outlook* titled “Must Be Present to Win.” Recognizing the growth risks around the globe, we remain underweight international equities and neutral bonds and large-cap equities. We are overweight “tactical,” which is a basket of both public and private vehicles (commodities, private equity, hedge, etc.) that collectively have a low correlation to core asset classes.

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Bond Vigilantes Pressure Spain and Italy



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



Hot in Cleveland



by Dean M. Dordevic, Principal

It's halftime, America. And our second half is about to begin. – Clint Eastwood¹

Perhaps we've reached our breaking point and just can't stand to read the front pages of the *business* section anymore. After all, it's been several tortured years of an almost uninterrupted and continuous loop: Europe-Greece-Spain-Portugal-Italy-Ireland-Europe ... *lather, rinse, repeat.*

It's been the same series of articles for quite some time now, and maybe that's why we've found ourselves wandering into – of all places – the *real estate* section. It was in these pages that a string of dots became ever so powerfully connected; namely, that something positive was happening in American manufacturing. Supporting our thesis, venerable economists, International Strategy & Investment (ISI), recently hosted a conference in New York titled, *“Investing in the U.S. Manufacturing Renaissance.”* Though far from a consensus view, this is a developing theme, and it is *not* resident in only one industry or geographic region. U.S. manufacturing is indeed making a comeback.

New drilling and completion practices are making it possible to tap the rich shale that resides under select portions of the Great Plains, Gulf Coast, Rocky Mountain West, and even the Mid-Atlantic states. This so-called “shale gas” is now responsible for *one-third* of U.S. natural gas production. These newly rediscovered layers of shale lie a mile or more beneath the surface of the Earth, and can require 100 tons of steel pipes to tap. Led by a boom in oil and gas drilling, the demand for steel (especially specialty steel) is rising once again.²

Indeed, for the steel industry in Ohio, times are changing. Steelmakers are planning to add two million square feet of new production space at a cost of \$1.5 billion. *“We're shipping pipe to drilling operations in Pennsylvania, North Dakota, Texas and ... China,”* said John Wilkinson of United States Steel. *“All over the world.”*²

Three years ago, Timken Mill in Canton, Ohio operated only four days *a month*. Three years later, this plant operates 24/7 and Timken will spend \$200 million on a new 26-story 83,000 square-foot facility. Timken is not alone. United States Steel recently opened a \$100 million 325,000 square-foot mill and an additional 454,000 square-foot mill with their Japan-based partner, Kobe Steel. Vallourec and Mannesmann, a French company, is completing a \$650 million, 1.1 million square-foot steel pipe mill in Youngstown and another 200,000 square-foot mill nearby to thread pipes. *“We haven't had this kind of expansion in steel since the 1980s,”* said Eric Burkland, president of Ohio Manufacturers' Association. *“It's a tremendous turnaround.”*²

The scale of spending in just this one state is truly remarkable—\$4 billion in leasing and an additional \$3 billion in production and transport. *“The new oil and gas play in this region is big, and will get bigger,”* said Robert Chase, chairman of the Department of Petroleum Engineering and Geology at Marietta College. *“We're only scratching the surface right now.”* The trickle-down effect is powerful too. In east and southeast Ohio, where the median household income is less than \$33,000, oil and gas leasing checks in the six and seven figures are amounts their recipients say are ... *“a bit disorienting.”*³

In addition to the boom in the energy sector, manufacturers in the U.S. are benefiting from a laundry list of secular competitive advantages. For one, unit-labor costs (ULCs) are remarkably restrained. By way of example, over the past 30 years, ULCs in the United States have actually declined modestly, while German ULCs have almost doubled in dollar terms. This has occurred against a backdrop where U.S. manufacturing productivity has increased dramatically, and the cost of doing business in many emerging markets has increased significantly. Since the start of this recovery, manufacturing employment in the U.S. has been the strongest of the G-7 countries. The Boston Consulting Group said that after adjustments are made for America's higher productivity, wage rates in Chinese cities, such as Shanghai, are only about 30 percent less than in the U.S. After inventory and shipping costs are layered in, the total cost advantage drops to only single digits.¹

In fact, one of the biggest drivers of this change in relative competitiveness is increasing costs of just about every stripe in the emerging world. In China, there are many market segments where annual wage growth is running at 15

percent. Trucking costs in China's two biggest export regions are almost 60 percent higher than in the U.S. and office rents in Beijing rose 75 percent last year, the fastest globally. Premium office space is now more expensive in the Chinese capital than in midtown Manhattan.¹

Plentiful supplies and the lowest natural gas prices in the world are having a huge impact. More than a dozen chemical makers will expand in the U.S. as a result of bargain-basement energy costs. Exchange rates are helping too. Over the past decade, the Euro has appreciated some 50 percent versus the U.S. dollar. The dollar would need to rise quite significantly for this advantage to evaporate.¹ According to the Economic Policy Institute, manufacturing jobs come with a nice bonus. *Employment multipliers are much higher in manufacturing than in the rest of the economy. Each 100 jobs in manufacturing supports 291 jobs elsewhere in the economy, compared to (only) 154 jobs in business services and retail trade.*

A combination of the aforementioned dynamics has also led many manufacturers to move production back to America. Among them: KitchenAid, Coach, GE, Maytag, Ford, NCR and Coleman. In Tennessee, Whirlpool will build its first new U.S. factory in more than a decade. In addition, foreign companies are moving production to the U.S. too: Volkswagen, Continental Tire, Siemens, Nissan, Toyota and Kia. Even Maserati announced in January that it would manufacture a car in Michigan and Honda chose Ohio as the birthplace for its new ... "supercar."^{4,5}

While *high-cost* nations are benefiting from a long list of developing competitive advantages (narrowing wage gaps, abundant energy, a cheap currency, labor market stability, accounting/legal/economic transparency, liquid capital markets and demographics) there is nothing that ties this package together more completely than the application of superior technology. This revolution has given birth to a new industrial lexicon with phrases like, "networked manufacturing, cluster dynamics, personalized production and bespoke production."⁶

"There's a sense that we are seeing a global manufacturing renaissance," said Jeff Immelt, CEO of GE. This new period has the potential to turn winners into losers and also-rans into champions. It provides high-cost nations with a way back into areas of manufacturing some of them thought they had lost to emerging economies like India and China. "Everywhere I go, re-industrialization is at the forefront of political thought," said Peter Löscher, Siemens CEO.⁶

We believe that the seeds for a U.S. industrial renaissance are in place. The evidence is beyond anecdotal and is both robust and compelling. With this in mind, we will continue to weave this thinking into our portfolios. Representative examples include NRG Energy, which is in part a play on the strong Texas economy and also the shale gas theme. Caterpillar is another example, having closed a Canadian plant earlier this year due to lower unit labor costs in the U.S. There are also many more indirect beneficiaries of this theme like regional financials (Huntington Bank and PNC, which purchased National City Bank back in 2008), and utilities like CMS in Michigan.

There is an old saying that *economics* was invented to make *weather forecasting* look good. That said, we can comfortably predict that this summer, it's going to be ... *Hot in Cleveland*.

Weapons of Reason footnotes and sources:

1. Courtesy International Strategy and Investment (ISI) Conference "Investing in the U.S. Manufacturing Renaissance," The Chrysler Group, LLC, 2012
2. Schneider, Keith, "As Demand Rises, Ohio's Steel Mills Shake Off the Rust and Expand," *The New York Times*, April 24, 2012.
3. Schneider, Keith, "New Value for Land in Rural Ohio," *The New York Times*, June 4, 2012.
4. "A New Chinese Export - Jobs," *Wharton School of the University of Pennsylvania*, April 4, 2012.
5. Davis, David, "Cleveland, Whirlpool get Obama's Eye" *Cleveland Daily Banner*, June 21, 2012.
6. Marsh, Peter, "Future Factories - High Cost Nations return to Manufacturing," *The Financial Times of London*, June 11, 2012.



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



From Savile Row to Dearborn, Michigan



by Mary A. Faulkner, Vice President of Marketing

To ensure that our *Market Letter* is useful and informative, we provide definitions for investment and economic terms mentioned in each publication. Some clients may be learning these terms and phrases for the first time, while others may need some *mindful reminders* on their meaning.

Also-rans: A horse that does not win, place or show in a race. In general, a loser in a competition. (page three)

Bespoke production: Originating from the verb “bespeak,” which means to “speak for something or give order for it to be made.” Historically, the term applied only to men’s tailored apparel and referred to items that were made without a pre-existing pattern. A buyer visiting Savile Row had total control over the fabric used, the features and fit, and the way the garment should be made. Once a fashion-specific term, bespoke now refers to custom specification for many products and services, such as software, finance, luxury automobiles, music, firearms, jewelry, travel and surgery. (page three)

Fiscal cliff: A term used by economists regarding the implications of the expiration of income-tax cuts first enacted under President George W. Bush, the end of payroll-tax reductions and automatic decreases in government expenditures. There is concern that the combined effect of spending cuts and tax increases will be a clip of 3 percentage points from growth if allowed by Congress and the President to occur in 2013. (page one)

“QE3”: An acronym for proposals for a third round of quantitative easing by central banks. Quantitative easing is an unconventional monetary policy used by central banks to stimulate the national economy when conventional monetary policy has become ineffective. A central bank buys financial assets to inject a pre-determined quantity of money into the economy. A central bank implements quantitative easing by purchasing financial assets from banks and other private sector businesses with new electronically created money. This action increases the excess reserves of the banks and raises the prices of the financial assets bought, which lowers their yield.

The term was first used in Japan in 2001. In 2007, central banks applied what was considered the first round of quantitative easing. The term, “QE2” became a common term in 2010. (page one)

Sovereign yields: Yields from bonds issued by national governments in foreign currencies. (page one)

Unit-labor costs: The costs incurred by hiring workers per unit of output. Companies seek to reduce unit labor costs and can do so in a variety of ways. Holding down wages to a minimum level is one approach but high-paying firms often have low unit-labor costs because they attract workers who are productive and rely on technology to ensure that output is high. Henry Ford offered a “five-dollar day” salary to workers at his first factory in Dearborn, Michigan. Although a very high wage at the time, the system of production used by Ford ensured that productivity was also high and therefore unit-labor costs were low. (page two)

Mindful Reminders sources:

Answers.com, Bloomberg, TheFreeDictionary.com, Wikipedia

Let not your mind run on what you lack as much as on what you have already. – Marcus Aurelius



Finding Income: A Pressing Issue for Individuals and Institutions



by Jason D. Norris, CFA, Senior Vice President of Research

With interest rates in the U.S. at historic lows, both individual and institutional investors are struggling to generate income to satisfy their spending demands.

We believe that interest rates will remain lower, longer as the Federal Reserve actively pushes rates down and investors continue allocating funds to this “safe haven” asset class due to economic uncertainty. With rates at historic lows, maintaining purchasing power will remain difficult. Also, when rates ultimately start to rise, investors will see the value of their bond portfolios decline.

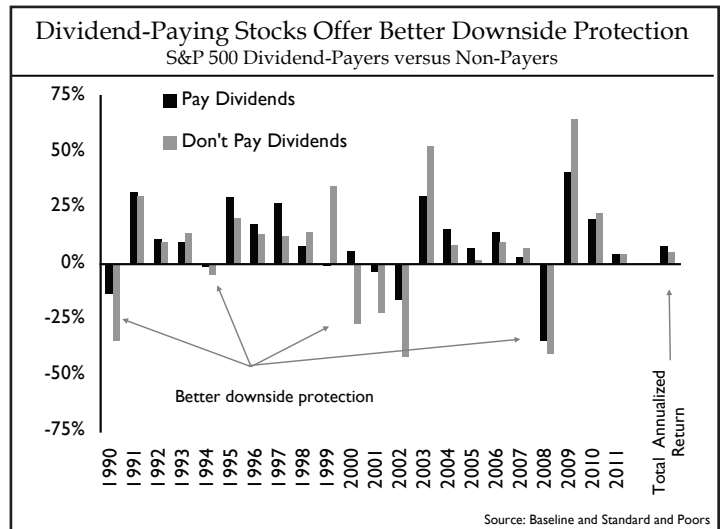
With these issues in mind, what is the best course of action to address short-and long-term income needs? In this environment, we believe investors should increase their allocation to dividend-paying stocks. This approach not only supplements income needs, but also protects against rising interest rates.

This approach to address income needs is not a new concept. For more than 20 years, dividend-paying stocks have been giving investors attractive returns while mitigating some of the broad-market volatility. The staying power of high-quality, dividend-paying stocks is evident in the relative strong performance we have seen over the *last 50 years*.

There is considerable discussion this year about looming tax-policy changes. We do not believe changes in dividend-tax policy will have a meaningful effect on the overall market for a few reasons. First, roughly two-thirds of equities are held in institutional accounts, thus taxes are not a driver. Second, when the dividend tax was cut in 2003, there was not a noticeable benefit to dividend-paying stocks. Finally, when you look at various tax regimes since 1972, dividend stocks have consistently outperformed the S&P 500—even in the face of a 70 percent tax rate.

There have also been concerns about the number of baby boomers retiring and starting to rely more on their savings and investments for living expenses. We believe that this *does not* pose a negative headwind to the equity market, specifically dividend-paying stocks. As individuals live longer, they will continue to need exposure to the equity markets to meet rising costs—specifically healthcare. Anecdotally, we have seen situations where individuals are *outliving* their savings due to increased life expectancy and low interest rates.

Over the last century, dividends have comprised 44 percent of the total return from equities. Though this has not been the case the last two decades, looking forward, we see corporate profitability at record highs, leaving plenty of flexibility to increase dividends. As such, we believe that dividend increases will be robust over the next several years and in turn, a dividend-based equity approach will be a rewarding strategy.



Change makes our universe. Thoughts make our lives. – Marcus Aurelius



For Each Institution – We Serve Many People



by Donald L. Rainer, Senior Vice President

Ferguson Wellman serves a diverse client base in 36 states, with a large concentration in the Pacific Northwest. A majority of our clients are affluent families and in numerous instances, we have had the opportunity to work with multiple generations over the years.

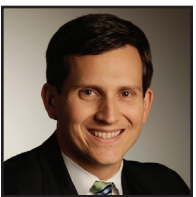
About 40 percent of our assets under management are from institutions. They range from Taft-Hartley plans and corporate retirement plans to foundations and endowments. Our portfolio managers meet quarterly with their investment committee or board of trustees. Between meetings, we answer any questions or conduct analysis on a topic that has arisen from the group.

The length of time trustees and committee members serve vary. Unlike our relationships with families, we may serve an institution for many years, but the people we work with change frequently. Due to these circumstances, our institutional committee has been identifying ways to make the transition of new trustees easier through our investment education and communication on timely economic events.

As the terms of trustees or committee members end, we offer the ability to access our resources should it be useful to them as individual investors or when they serve on the board of another institution. We appreciate their service to our business and philanthropic community, as many of these responsibilities are in a volunteer capacity.



Why We Tweet, Link and Blog



by Shawn M. Narancich, CFA, Vice President of Research

Although social media is standard communication for most companies today, we feel it supports our long-standing belief that *everyone* can benefit from knowledge about investing, finance and economics. Our philosophy is based on the premise that the more our clients understand what we do around these topics—the more inclined they will be to ask questions and articulate their needs.

By following us on Twitter, you will be notified when we have made an addition to our blog, *To Coin a Phrase*. Our *Weekly Market Makers* are posted after the markets close, providing our views of the past five days and what we see on the horizon. LinkedIn is another channel for receiving our communication and education. By using these resources, we are able to deliver information in a way that is most convenient for our clients and friends. Find us on Twitter at @fergusonwellman or our blog at blog.fergusonwellman.com

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.

