Market Letter

Market Perspective: Third Quarter 2012

Don't Fight the Fed … or the ECB

by George W. Hosfield, CFA, Chief Investment Officer

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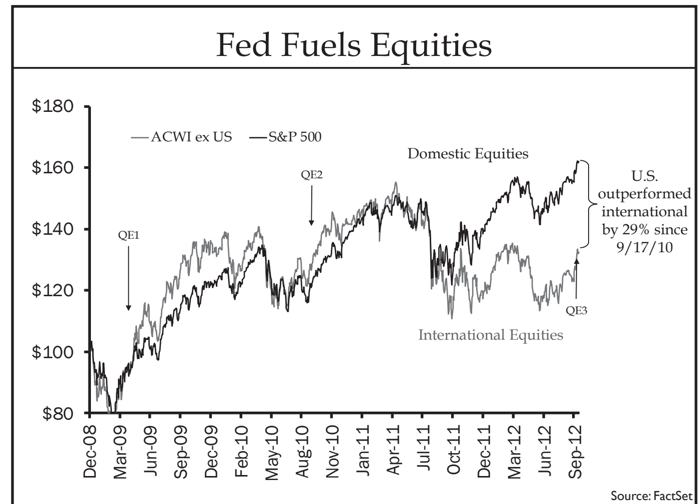
Looking Back

- The pace of economic growth continued to slow across the globe. Uncertainty about fiscal reform domestically has put a damper on U.S. expansion, while austerity measures designed to fend off existential threats to the euro have pushed Europe into recession. In China, growth has succumbed to export weakness and rising wage rates.
- In response to waning economic growth, global central banks have expanded their balance sheets to lower interest rates and support asset prices. The European Central Bank (ECB) has promised quantitative easing contingent upon fiscal reform.
- Increasing global liquidity has helped drive up commodity prices, with gold breaking out of a recent trading range and crude oil prices benefitting from a Middle East "risk premium."
- Despite weaker underlying fundamentals, stocks had a good quarter as U.S. and European equities enjoyed returns approaching double digits.



Looking Forward

- Persistently high unemployment and a tepid pace of capital spending reflect uncertainty concerning both the "fiscal cliff" and election. Regardless of which party wins, we believe that the lame duck Congress will extend most of the Bush tax cuts for one year, and that a "grand bargain" on tax-and-spending reform may be reached next year.
- The U.S. bond market is increasingly being influenced by Fed policy. With Operation Twist continuing until year-end and the Fed's QE3 program set to purchase $40 billion of agency mortgage-backed securities monthly (accounting for as much as 40 percent of transaction volume), yields on 10-year Treasuries appear to have settled into a 1.5 to 2 percent trading range.
- Given Fed policy makers' concern about the moribund job market, we expect highly accommodative monetary policy to persist until the expansion strengthens. As such, we believe that interest rates will stay lower for longer.
- Equity valuations remain supportive, with the S&P 500 trading for 14 times estimated 2012 profits and 13 times next year's estimates. Even with the rally we've seen, the dividend yield on the S&P 500 still exceeds that of the 10-year Treasury.
- We are maintaining the asset allocation strategy outlined earlier this year, remaining underweight international equities, slightly underweight bonds and neutral large-cap equities. Our January 2012 *Investment Outlook* titled, "Must Be Present to Win," remains an apt moniker for the present market environment.

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

Helicopter Ben and the Brave New World of QE∞

by Dean M. Dordevic, Principal

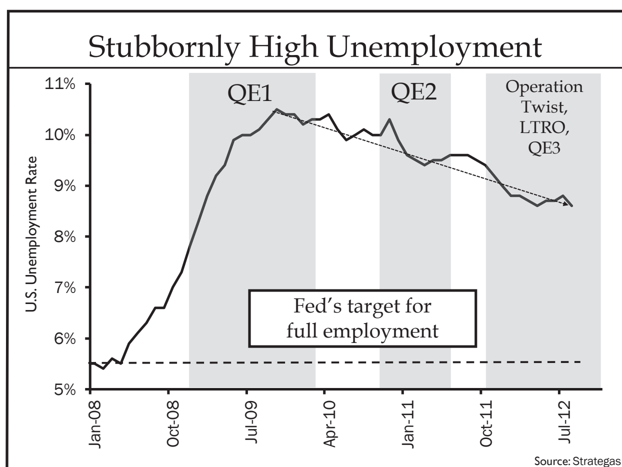
"To Infinity ... and Beyond!!!" – Buzz Lightyear, Toy Story

In our line of work we consume information from a firehose. It wasn't always that way; in fact for most of the first three or four innings of our multidecade careers, it was very much the opposite. Information was certainly *not* a commodity and good research was almost semiprecious. Nowadays, we spend a good portion of our days doing *very much the opposite*. We filter and sift, much as one might do at a really good Las Vegas hotel buffet. There's a smorgasbord of important stuff to consume; we just need to quickly determine what is the best and what matters the most. So it does indeed make you sit up and take notice when two of us at Ferguson Wellman, fully independent of one another, focus laser-like on a single sentence. This culled from a mountain of early morning Wall Street research – cut, paste, circulate:

"If all the stock market cared about was Fed balance sheet expansion, then equities should expand ... without interruption and in perpetuity." - Neil Dutta, Chief Economist, The Renmac Group

In late 2002, when he was then *only* a Federal Reserve governor, in a now famous speech, Ben Bernanke invoked an analogy whereby the Fed could engage in a "helicopter drop of money" so as to boost asset values to combat deflation. In fact, Mr. Bernanke has on many occasions highlighted asset-price movements as a measure of policy success.[1,2] As Fed chairman, he has indeed put "his money" where his mouth is, having now initiated three rounds of quantitative easing (QE1, QE2 and QE3). With respect to the latest action, there had been much speculation about what would come next. In their most recent announcement of an "open-ended QE" (QEOE or what some are calling QE∞), the Fed has monumentally changed the game.[2]

With the previous two rounds of QE, the Fed was purchasing *fixed amounts* of bonds (mostly Treasury and mortgage-backed securities) in the open market. The *twist* in this latest round is this: the Fed will now purchase bonds (again principally mortgage-backed bonds) in *unlimited quantities*. Our central bank, unlike many others, has a so-called "dual mandate" of managing both inflation *and* employment. In modern times, for the most part, the Fed has chosen to focus primarily on inflation. Since it now sees inflation as non-threatening, it has chosen to direct its efforts toward employment and job creation.

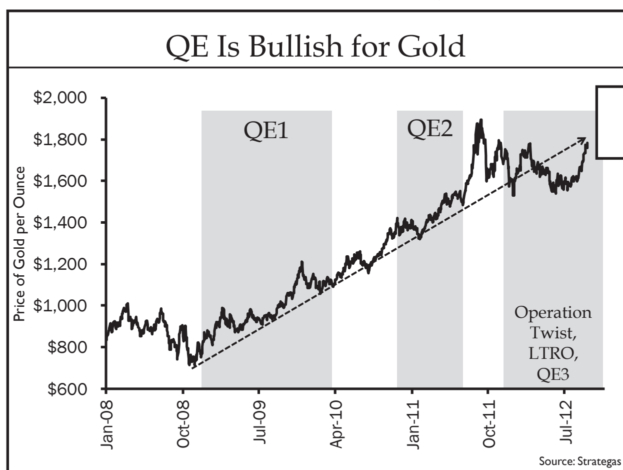


Perhaps more important than the change in emphasis is the *language* that accompanied the Fed's recent post-Labor Day announcement. In addition to saying that it will keep interest rates low (now through mid-2015), the Fed will now not end QE∞ until the labor market has improved "substantially." *If and when* things start to *generally improve*, the Fed will then stop QE∞. In fact, the Fed says that its aggressive policy will be appropriate for "a considerable time *after* the economy strengthens."[1] Wow. What all of this means for financial markets and our portfolios is far from certain. That said, over the short and intermediate term there are some very broad manifestations that seem reasonably likely. However, the much longer-term implications, potential outcomes and even the unintended consequences are, for the most part, unknown.

In the eyes of the Fed, however, this round of QE∞ will be for naught if its effects do not translate to the so-called ... *"real economy."* With this in mind, and at least for the time being, the owners of financial assets are Ben Bernanke's *chosen*. It is remarkable to us that when asked what he looks at first in the morning, Chairman Bernanke has said *"the stock market."* Interestingly, his counterpart in Europe, Mario Draghi (president of the European Central Bank), has had the very same response.

What both central bank heads are attempting in practice is really quite straightforward. They are looking to push investors toward financial assets, (like stocks and bonds), in the belief that higher asset prices will boost economic recovery. They are betting that when folks look at their assets and portfolios, they will *feel wealthier*. In short, they are hoping that the so-called "animal spirits"--that John Maynard Keynes once so eloquently described--will be unleashed into the economy. If you are even a casual consumer of the various financial media, you will have noted the now common phrase or headline "risk on, risk off." This describes the actions of investors as they jump in and out of (perceived) "more risky" or "less risky" assets in tandem with changes in Fed policy actions.

We expect that the prices of long duration and long-dated assets, like stocks and bonds, will rise. With inflation expectations also likely to rise at some point, prices for commodities, such as oil and gold, should rise as well. Against this backdrop, the U.S. dollar will likely weaken (how much is unknown), and the volatility of financial assets should also increase. We would expect stocks with generous dividends to do well in this environment as they would benefit from their yield premiums to bonds as well as their very long (infinite in fact) durations. Large multinationals should do well too, since they can benefit from this policy shift in three distinctly different ways--they benefit from export strength and the positive effects of currency translation from a weaker dollar; they benefit as a long duration asset; and they have historically demonstrated an ability to adjust to inflationary outcomes that might emerge going forward.[2]



By making such unconventional policy part of its everyday thinking, the Fed has added an unprecedented amount of de facto stimulus to the system. The Fed has gone "all in" on job creation (versus its inflation mandate) and believes that the rising prices of financial assets will spur investors to take more risk.[3] The Fed is also hoping that the "wealth effect" takes root and blooms in the real economy, creating jobs and ultimately a virtuous and somewhat self-reinforcing cycle. Of course, this all remains to be seen, and we will remain vigilant in our watch for both the impact of this new and unprecedented stimulus on asset prices, as well as any unintended consequences that may emerge as this process unfolds.

In the meantime, we'd be well advised to heed the advice given to Buzz Lightyear from his good friend, Rex the Dinosaur, *"Buzz, the monkeys aren't working. We're formulating another plan, so … stay calm!"*

Calm indeed.

Weapons of Reason footnotes and sources:

1. Benn Steil and Dinah Walker, "Bernanke's 'Risk-On, Risk-Off' Monetary Policy," *The Wall Street Journal*, September 19, 2012.
2. David Kotok, "The Bible Says …," *Cumberland Advisors Commentary*, September 16, 2012.
3. Justin Lahart, "The Fed Goes all in on Job Creation," *Wall Street Journal*, September 14, 2012.
4. Neil Dutta, "Daily Notes and Economic Report," *The Renmac Group*, September 13, 2012.
5. Jason DeSena Trennert, "An Unshakable Belief in G.O.D (Gold, Oil & Dividends)," *Strategas*, September 21, 2012. (charts)

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

People, Places and Things

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.

Ben Graham: Called the "Father of Security Analysis," Ben Graham authored *The Intelligent Investor: The Definitive Book on Value Investing* in 1949. Graham and fellow Columbia academic David Dodd introduced the concept of 'intrinsic value' and the practice of purchasing stocks at a discount to that value. While starting a successful investment firms and working at Columbia, Graham taught and later hired one of his students: Warren Buffet. (page five)

Gateway cities: Those with an airport or seaport that serves as the entry to or departure from a country. Often these cities serve as international trade hubs. (page five)

Lame duck Congress: A session of Congress after an election and before successors are sworn into office. In the U.S., lame duck sessions are held between November and January. They typically do not occur in countries with parliamentary forms for government. The term "lame duck" originated in 18th century Britain referring the bankrupt businessmen who, due to their loss of power, were rendered "lame" like a shot game bird. (page one)

LTRO: Acronym for long-term refinancing operations, a loan strategy for European banks that was announced by the ECB to help ease the Eurozone crisis. The objective of the LTRO is to boost cash flow in the market and avoid a severe credit crunch or collapse of the banking system. (page two chart)

Phishing scams: Fraudulently obtaining and using an individual's personal or financial information. For example, a consumer may receive an email that appears to originate from a bank regarding an urgent issue, requiring the resubmission of personal information. A "phishing" scam (as in fishing for confidential information) would include a link to a fraudulent website. (page six)

Risk premium: An investor's return above the risk-free rate of return expected in exchange for each additional unit of risk. According to Markowitz portfolio theory, rational investors only accept additional risk if they expect a greater return, which is known as their risk premium. (page one)

Social engineering: Trickery or deception with the intent of information gathering. Defined as an act of psychological manipulation by social scientists, it is now a term used by technology professionals. (page six)

Wealth effect: A theory that the value of investment portfolios rising due to escalating stock prices makes individuals feel wealthy, prompting them to spend. In 1968, a 10 percent tax hike failed to slow down consumer spending. While disposable income dropped due to increased taxes, overall wealth rose sharply because of the stock market, resulting in a consumer spending spree. (page three)

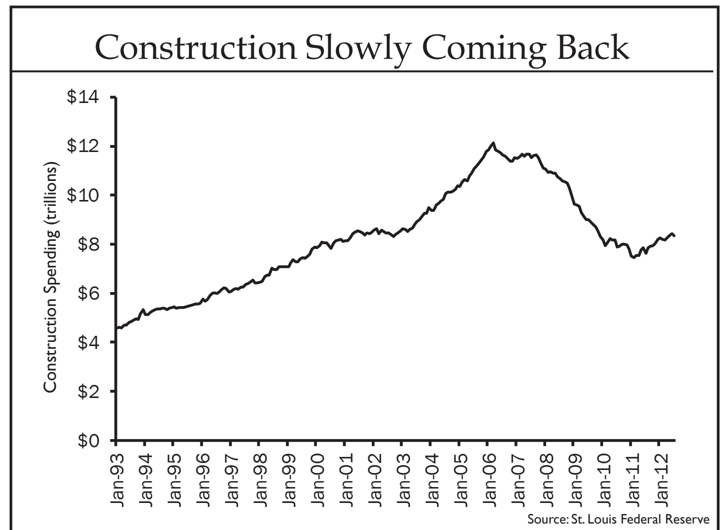
Mindful Reminders sources:
BusinessDictionary.com, CityWire Money, FDIC.gov, Investopedia, ValueWalk, Wikipedia

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

Revisiting Real Estate

by Ralph W. Cole, CFA, Senior Vice President of Research

Real estate has always held a special place in the hearts of investors. It is something tangible that they can touch and, according to the old adage, "You never lose money in real estate." We have seen in the last five years however, that you can indeed lose money in real estate—both in the commercial and residential space. The curse and blessing of real estate is *leverage*. During the good times, leverage amplifies returns, but during the downturns, it can rapidly deplete equity, often leaving both lenders and the owners disappointed.



As an institutional asset class, real estate has many characteristics that we like: yield, inflation protection, professional management and diversification. Legendary investor Ben Graham wrote many years ago about the margin of safety required to make an investment. Just like any other asset, the most important decision is the price you pay for that investment. Real estate is no exception; the cheaper you purchase a piece of property, the better your chances of making money on the investment.

At Ferguson Wellman, we have a long history of investing in publicly traded real estate vehicles known as *REITs*, which offer a very liquid and flexible way of accessing the real estate market. We currently have a constructive view toward real estate for a number of reasons—one being lack of supply. As you can see from the chart, construction spending is still below 30 percent from its peak in 2006, thus leaving those who own quality real estate in a good position to raise rents. This has been particularly notable in the apartment sector and in office space located in "gateway cities."

Another benefit of investing in real estate is its inflation hedge attributes. Specifically, lease contracts usually have escalator clauses that increase rents over time (around 3 to 5 percent per year). In some instances, rents are tied to the Consumer Price Index so in periods of rising inflation, real estate holds its value very well.

Real estate investments can also be acquired through private partnerships, which pool individual and institutional investors to purchase a portfolio of properties. These investments are generally illiquid and longer term in nature, but can offer superior returns. Investing through partnerships allows many of the tax benefits of investing in real estate (amortization and depreciation) to flow through to individual investors. The aforementioned attributes coupled with relatively attractive prices and extremely low cost of capital has heightened our desire at Ferguson Wellman to identify opportunities in this sector for our clients.

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

Investment Services

Planning for Estate Planning?

by Helena B. Lankton, Senior Vice President

Determining if a will or a trust meets important objectives—such as control, predictability, liquidity and direction—are conversations often brought to Ferguson Wellman.

Working with professional partners, such as estate planning attorneys and trust officers, we help start the process by reminding clients that, no matter what they decide, their loved ones are counting on them to create a plan in a clear, fair and tax-efficient manner.

We can also provide value to the process through our resources for organizing the information that will be presented to an attorney or trust officer. Our *Balance Sheet* has the ability to aggregate all assets and provides an opportunity to ponder implications before making important decisions and is often time well spent. All of our services are included in our fees, which help clients maximize their investments on the legal side of the process.

Another way we can help save time and money is through developing specific language that clarifies a client's intention for the investable assets loved ones will inherit. A specific firm can be named or content can be created about preferred investment style, philosophy and process. This strategy helps assure that a client's investment approach is intact, but gives their loved ones the flexibility to select their own manager.

Communication and Education

Protecting Our Clients' Personal Data and Information

by Shawn W. Swagerty, Director of Information Systems

Over the past four decades, the computing landscape has evolved to provide tremendous power and flexibility to the way we serve our clients, conduct our operations, collaborate with colleagues and communicate with the world.

With the exciting evolution of technology, however, new threats have surfaced: risk of information loss and corruption due to datacenter failures, data-stealing malware, social engineering and phishing scams; and new challenges in the mobile space.

The integrity and security of client data is a constant focus of our entire firm. Our electronic communication with our business affiliates (custodians, brokers, etc.) runs only through secure data channels. If we are transmitting sensitive documents to clients, we either upload them to a folder on our secure website or deliver via our secure email service.

Our internal network is protected by firewalls and active protection techniques. Quarterly security audits conducted by an outside firm alert us to any potential vulnerabilities in these defenses. Our data is continuously backed up to a local system that replicates these measures over encrypted channels to secure locations in the Midwest and the East Coast, lest a disaster affects Portland.

We are constantly monitoring developments in the threat landscape, deploying best-of-breed defenses, and educating our staff on best practices in data management and communication. Our clients' trust and confidence in our ability to protect them is of paramount importance to our firm.

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.