MARKET LETTER

A QUARTERLY PUBLICATION *of* FERGUSON WELLMAN, OCTAVIA GROUP *and* WEST BEARING

MARKET LETTER
SECOND QUARTER 2022

IN THIS PUBLICATION

Founded in 1975, Ferguson Wellman is a privately owned registered investment adviser, established in the Pacific Northwest. As of January 1, 2022, the firm manages $8.2 billion for 913 clients that include individuals and families; Taft-Hartley and corporate retirement plans; and foundations and endowments with portfolios of $4 million or more.

West Bearing Investments, a division of Ferguson Wellman, serves clients with assets starting at $1 million.

Octavia Group provides fee-based personal financial services exclusively for Ferguson Wellman and West Bearing clients with a minimum of $5 million managed by our firm.

INVESTMENT EXCELLENCE
LIFELONG RELATIONSHIPS

KRYPTONITE

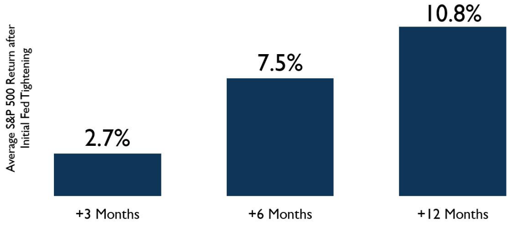
GEORGE HOSFIELD, CFA
Director, Chief Investment Officer

OUR *2022 INVESTMENT* *Outlook* featured a Superman and Clark Kent theme as a metaphor for our belief that the massive fiscal and monetary stimulus during the COVID-19 pandemic that served as a strong tailwind for stocks last year was abating, and that 2022 would bring a transition from this extraordinary capital market environment to something *more ordinary*. To date, concerns regarding inflation and fallout from the heart wrenching events unfolding in eastern Europe have delivered heightened volatility and the first equity market selloff of at least 10% in two years … challenging our constructive thesis for equities this year.

In keeping with the Superman theme, in our annual outlook we also mentioned that the greatest potential risk … "kryptonite"… to our constructive thesis would be unchecked levels of inflation. As such, the Russian invasion of Ukraine and related surge in commodity prices have delayed the peak in inflation, raised its high-water mark and certainly increased the level of difficulty the Fed will have in walking the tightrope of increasing interest rates enough to tame inflation without tipping the economy into recession.

To that end, with near-full employment, record housing prices and robust levels of consumer net worth, the domestic economy is on solid footing. As such, slowing but still positive earnings growth, a Federal Reserve lifting short-term interest rates off the zero bound and a moderating rate of inflation remains our thesis for 2022. Despite understandable concerns to the contrary, a review of market history reveals the initial phases of Fed rate hiking cycles coincide with *rising* stock prices, which are the result of underlying economic strength.

Initial Federal Reserve Tightening Does Not End Bull Markets



Source: Bloomberg
As of 1983 - 2015

Accordingly, we remain overweight to large cap U.S. stocks, while increasing our exposure to defense and agriculture industries therein. While rising bond yields may ultimately reach levels that could spur us to increase our fixed income exposure, we are nowhere near there yet. In the meantime, our redeployment of capital formerly invested in bonds into alternative assets in recent years continues to be rewarding as our positions in real assets (cropland, timberland, infrastructure) and specialty finance not only have provided an attractive stream of income, but they are the only major asset class that have enjoyed a positive return year-to-date.

Our Ferguson Wellman logo is based on a bronze coin of Marcus Aurelius Antoninus, emporer 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 a series of personal writings and meditations that revealed a mind of great humanity, natural humility and wisdom.

FIVE DAYS, FIVE DECADES, AND THE WEAPONIZATION OF FINANCE

DEAN M. DORDEVIC
Principal,
Portfolio Management

"There are decades where nothing happens; and there are weeks where decades happen."

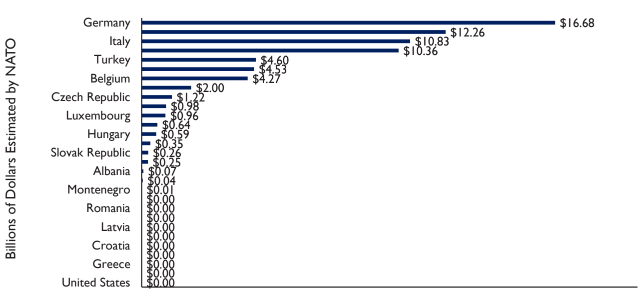
— Vladimir Ilyich Lenin

The now infamous, 40-mile-long Russian tank column was stalled for nearly two weeks. News reports say that these tanks were equipped with fuel, food and water for only three days. Clearly, Russian President Vladimir Putin had expected Russia's "special military operation" into Ukraine to be a short-lived affair. As one television commentator said best, "*It's not a tank column, it's the world's longest mobile prisoner of war camp.*"[1]

In all likelihood, Putin's calculus was that his incursion into Ukraine would go much as it had for him with Russia's annexation of Crimea in 2014. That is, a military operation that lasted exactly … one month, and six days.[2] The fierce resistance from the Ukrainian people, the unwavering resolve of her brave and Churchillian leader, Volodymyr Zelenskyy and the overwhelming and unvarnished opposition from the west, appears to have been a complete surprise.

In only five days, President Putin has changed a lot of minds. Five decades of German pacifism vanished almost overnight. Both Sweden and Switzerland have abandoned their long-held notions of neutrality and they are now acting in concert to punish Putin for the invasion of Ukraine. Europe has come together to crush a common enemy in a way not seen since the fall of the Berlin Wall in 1989, or the end of World War II. The pact between NATO countries, that each member country contribute 2% of their annual GDP to NATO (which until now has largely been ignored), will now be honored and reinforced.

More NATO Allies Will Now Pay Their "Fair Share"
NATO Defense Spending Shortfall by Country



Source: Strategas

> *"Almost overnight, Russia's central bank has been cut off from the west. This renders Putin's vaunted war chest, that is – some $648 billion in externally held, hard foreign currency – useless to him."*

As the largest war in continental Europe since 1945 grinds on, it's becoming increasingly clear that instead of *dividing* western allies as Putin might have hoped, it has forced western European's nations to *coalesce*, and with a force and in a manner that few if any would have imagined.

The sanctions against Russia, which have seemingly come from just about every quarter, have been both broad and deep. While it is a general rule in the world of diplomacy that sanctions designed to hurt ordinary folks are to be avoided – it has not been the case this time. Some of the harshest sanctions have been aimed directly at the Russian economy, their financial sector and by default, the Russian people. Hundreds of multinational companies have either ceased operations in Russia, or plan to exit Russia entirely. Almost overnight, Russia's central bank has been cut off from the west. This renders Putin's vaunted war chest, that is - some $643 billion in externally held, hard foreign currency - useless to him.

So too, the Russian stock market has plunged and bank runs have become commonplace. Russia's infamous oligarchs, with their many yachts, jets and villas in Monaco, are being hunted - and their wealth confiscated - as if they too were war criminals.

The laurel is part of our Octavia Group branding. Octavia the Younger was one of the most prominent women in Roman history. She was respected for her nobility and humility. Octavia was hailed as a "marvel of womanhood" and was a political advisor between her brother and husband. She was immune from the "tutela," which placed in her the unique position of managing her own finances.

At $1.5 trillion, the Russian economy is the world's eleventh largest. Pushing an economy the size of Russia's to the brink of collapse has never been attempted before, with consequences yet unknown to the rest of the world.[3]

How this debacle might be resolved is anyone's guess. There are perhaps dozens of different scenarios that might transpire, rendering any attempt at handicapping these outcomes mostly, if not completely, futile. That said, there's a laundry list of *consequences* that will resonate and distill from the impact of this war. These *themes* will shape our thinking as we move through the balance of the year, and as we allocate precious capital within our various investment strategies. To wit:

Inflation pressures, which were already problematic, have become somewhat more difficult to tame, largely due to the impact of higher commodity prices resulting from the war. Absent a significant pivot with respect to domestic energy policy, prices for carbon-intensive fuels will remain elevated. The pace of interest rate increases, which were, for the very most part, baked in the cake at the beginning of the year, will moderate.

Geopolitical Tension Has Historically Provided Buying Opportunities

Event	Hostilities Begin	Peak to Trough S&P 500 Drawdown	+6 Month S&P 500 Performance
Vietnam War	Summer 1964	-5%	+7%
Gulf War	Fall 1990	-22%	+28%
Afghanistan War	Fall 2001	-21%	+21%
Iraq War	Spring 2003	-14%	+29%
Crimean Crisis	Winter 2014	-6%	+13%

Source: Eikon

The European economy will likely experience - or may have already entered - a moderate recession. On the other hand, the U.S. entered the new year with an economy that was very strong. Perhaps even too strong. However, while the odds of a recession unfolding in the U.S. are extremely low, it's reasonably likely that the U.S. economy will enter a mid-cycle slowdown as we move through the year. Given the torrid rate of growth in many sectors of our economy at the moment, this may turn out to be, as it has previously, a "pause that refreshes." With the so-called "Peace Dividend" having evaporated virtually overnight, the burden of funding NATO's budget will be more widely and equitably shared. This will result in an increase in defense-related spending from NATO's member nations, likely lasting for a decade or more. Investment flows into safe-haven assets will continue to be robust, this especially so for the U.S. dollar, U.S. treasury bonds and dollar denominated assets generally.

It is critically important to remember that over the long pull, riding out these investment storms has proven to be a *very wise and worthwhile strategy*. One year after the bombing of Pearl Harbor for example, the S&P 500 gained 15 percent. Six months after the first bomb was dropped in the Iraq war in 2003, the S&P 500 was up almost 30 percent.[4]

What the adjacent chart shows so very well, is that while these events are quickly discounted in share prices, the associated rebounds are, for the very most part, *equally dramatic*. In many ways this behavior proves the old Wall Street adage that bull markets take the *escalator*, and bear markets the *elevator*.[4]

We all pray for the people of Ukraine and hope this senseless and heinous war comes to an end *very soon*. The terrifying television images that we now witness daily are so very deeply troubling to all of us. We pray for clear heads and steady hands. At the same time, we can't help but be reminded of how very lucky we are to live in this grand experiment we call … *America*.

The perennially acerbic satirist, P.J. O'Rourke, who sadly passed away only very recently, was for many years the chief of the foreign affairs desk for *Rolling Stone* magazine. In that capacity he spent many years in the world of diplomats, their embassies and the swirl of embassy life. In one of his many clever columns, he made this very astute observation:

"*Each American Embassy comes with two permanent features, a giant anti-American demonstration, and a giant line for American Visas*."

God speed, Ukraine.

Five Days, Five Decades, and the Weaponization of Finance Sources

1. David Jackson and Courtney Subramanian, "Putin Shifts Nations' Neutral Notions," *USA Today*, March 3, 2022.

2. Martin Wolf, "Putin's War Against Liberal Democracy," *Financial Times*, March 2, 2022.

3. Edward Long and Michael Crowley, "With Sanctions, Europe and U.S. Push Russians into an Economic Corner," *The New York Times*, March 5, 2022.

4. Jeff Sommer, "The Outlook: Short-Term Rattle, Long-Term Rebound," *The New York Times*, February 27, 2022.

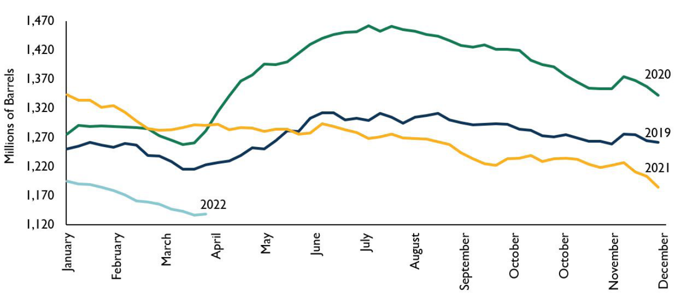
BACK IN BLACK

SHAWN NARANCICH, CFA
Executive Vice President, Equity Research and Portfolio Management

A risk to our call for inflation to moderate in the second half of this year is spiking commodity prices that bleed into "core" prices, causing central banks to act more forcefully in raising rates. Prices at the pump have risen to more than $4/gallon since Russia invaded Ukraine, symptomatic of oil prices that have surged to over $100/barrel in the wake of a U.S. embargo on Russian oil. At play here is the fact that Russia supplies more than 10% of the world's oil. Even before conflict erupted in Ukraine, oil markets were tightening amid a rebound in global mobility that boosted demand and caused inventories to fall.

As depicted in the following chart, U.S. crude oil and product inventories have fallen by nearly 15% since the beginning of 2021, a considerable 205 million barrel reduction.

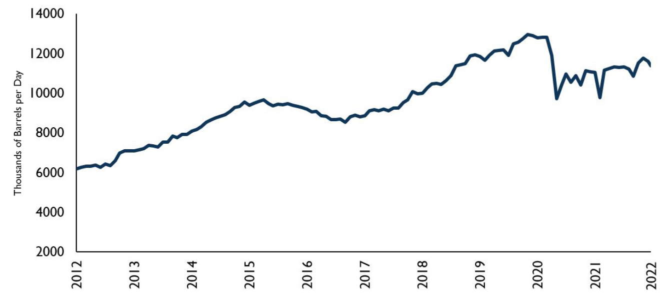
U.S. Crude Oil and Petroleum Product Inventory



Source: U.S. Energy Information Administration

Backstopped by tight oil production, the result of America's shale revolution, the U.S. has become an energy powerhouse well-placed to weather a Russian oil embargo. But despite the ascendency of U.S. oil, the following chart shows that despite an increasingly elevated commodity price liftings are 10% off their pre-COVID highs.

U.S. Field Production of Crude Oil



Source: U.S. Energy Information Administration

An unheralded story is at play. A decade of excessive drilling designed to achieve misguided production goals left many U.S. producers long on debt and short of investor interest. From double-digit levels a decade prior, the U.S. energy sector's market capitalization fell to below 3% of the S&P 500. Confronting a near-death experience hastened by the pandemic and negative oil prices two years ago, U.S. producers pivoted.

As oil prices rebounded, they regained profitability, but instead of spending almost all their cash flow on additional wells, producers repaid debt, started paying meaningful dividends, and have begun repurchasing stock. Newfound capital discipline and above-average oil prices have combined to renew investors' interest in the space — energy was the top-performing sector of the S&P 500 last year and is leading the benchmark index again in 2022.

We believe that global oil flows will adjust to Russian sanctions, but as the chorus grows for more U.S. production, a rejuvenated U.S. oil industry is unlikely to deliver the heady growth of times past. Mothballed OPEC volumes, new offshore production overseas and additional drilling by private operators domestically will provide incremental oil supply and should preclude substantially higher prices.

As new supplies make their way to market and a degree of demand destruction takes hold from consumers' economizing and from rising battery electric vehicles sales, our forecast is for oil prices to drop back below $100 and settle closer to our $70 mid-cycle oil price view. As we are prone to observe, the best cure for high oil prices is … *high oil prices*.