MARKET LETTER

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

MARKET LETTER
SECOND QUARTER 2024

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Founded in 1975, Ferguson Wellman is a privately owned registered investment adviser, established in the Pacific Northwest. As of January 1, 2024, the firm manages more than $8.4 billion for more than 990 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 $10 million managed by our firm.

INVESTMENT EXCELLENCE
LIFELONG RELATIONSHIPS

SO FAR, SO GOOD

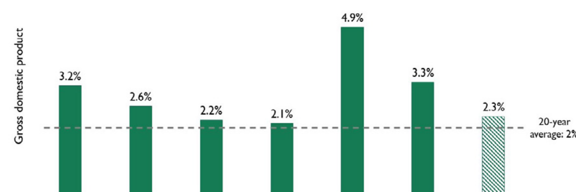
GEORGE HOSFIELD, CFA
Chief Investment Officer
Director

FOLLOWING ROBUST returns in 2023 that exceeded all but the most bullish expectations, blue-chip U.S. stocks are off to a strong start in 2024, generating a full year's worth of returns in just the first three months. Encouragingly, equity participation has now broadened to sectors beyond technology to now include industrials, financials and energy. While some are tempted to compare today's artificial intelligence (AI)-infused narrative with the halcyon days of the tech bubble a quarter century ago, we currently observe significantly more widespread levels of profitability and earnings growth within this key sector.

Artificial intelligence offers the potential for productivity-driven economic gains like those that resulted from the adoption of PCs and the internet in the 1980s and 1990s. The benefits of automating mundane tasks and more efficiently delivering job output are just beginning to be felt but come at a welcome juncture in the economic cycle when labor markets remain tight. Thanks to a gainfully employed U.S. consumer whose spending continues to rise, the U.S. economy has defied expectations for recession despite the Fed's rate tightening campaign, per the chart.

To the title of this piece, our central bank appears increasingly likely to achieve an ever-so-rare "soft landing" for the economy by lowering inflation to near its 2% goal without a recession. Amid strong demand for dining out, travel, and most significantly, housing, inflation has proven stickier around the 3% level. Reassuringly, productivity gains and new housing investment foretell increased supply that should reduce inflation anew, and thus, likely providing the Fed with sufficient comfort to begin cutting interest rates later this year.

No recession in sight



Source: Eikon

Regarding our asset allocation, our overweight of large-cap U.S. stocks remains in place as corporate America appears to have weathered the impact of inflation and is poised for renewed earnings growth in 2024. Nevertheless, we are attuned to the fast start equities have achieved so far this year and remain vigilant of shortfalls in the "goldilocks" narrative that could derail stocks. Accordingly, with bond yields at attractive levels, fixed income is an asset class ripe for additional funding if the economy falters or the earnings picture deteriorates.

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.

THE BUFFETT EFFECT AND THE MAGNIFICENT FIVE

DEAN DORDEVIC

Principal
Portfolio Management

"All five companies have very, very substantial operations and pay handsome dividends, while also buying back shares. Really wonderful partners. I don't have to do anything; we're not done in Japan. I'll be able to say the same thing in five, 10, 20 years …"

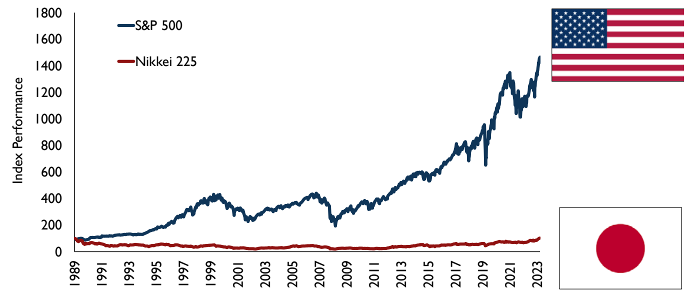
— Warren Buffett, Berkshire Hathaway annual meeting, May 6, 2023

The year was 1989, and Japan was seemingly taking over the world. Japan's gross domestic product (GDP) had grown at a rip roaring 6.7% in the year just past. Sony had recently purchased Columbia Pictures, one of the world's largest film studios for $3.5 billion, and the Japanese property company Mitsubishi Estate took control of New York City's iconic Rockefeller Center. At the same time, the price of land and property in Tokyo reached an epic peak. A massive bubble was being created, and Tokyo's property market became the most expensive in the world. Japan's Imperial Palace grounds were at the time said to be worth more than *all the land in California*.[1]

While few knew it or predicted it at the time, Japan was about to enter its *lost decade*. It was a period of economic stagnation that would last from the early 1990s to the early 2000s and the toll was particularly hard on both real estate and stocks. In 1990, Japan represented nearly 38% of total global stock market capitalization. Valuation at the time was *above* that of the U.S. However, by the end of 2022, Japan's share of global stock market capitalization had fallen to only 6.3%; over the same period, the U.S. share had swollen to a whopping 58%.[2] The Japanese stock market, represented by the index Nikkei 225, peaked in December of 1989 at nearly 39,000. A precipitous decline followed, reaching a low of about 7,600 points in April 2003.[1] However the index would not eclipse its previous peak for *another 35 years* … this having occurred only very recently.

Despite efforts by both the Japanese government and their central bank to stimulate the economy and support the country's financial markets with, among other things, ultra-

Rising Sun?



Source: Bloomberg

**Investors cannot invest directly in an index.*

low and/or negative interest rates, the Japanese stock market struggled to regain its pre-bubble levels. The collapse in real estate values was especially devastating. Land prices, which had reached astronomical heights during the 1980s, collapsed leaving behind a trail of economic devastation. Many properties became virtually worthless, and Japan's banking sector was saddled with massive amounts of non-performing loans. The banking sector's inability to lend metastasized into a credit crunch, where it became extremely difficult for businesses and consumers to access financing.

Yet perhaps the most pernicious effect of these collapsing asset prices was that a so-called *"deflationary mindset"* had taken hold. As prices continued to fall, consumers and businesses alike developed expectations for further price declines. This fed on itself, of course, and these diminished expectations discouraged consumption and investment. This was particularly disheartening as individuals and businesses delayed purchases in anticipation of lower prices in the future. A vicious deflationary cycle was underway.

For most of my investment career, Japan has been something of an anomaly in international investing. In fact, despite being a large and important developed market, many broad-brush Asia-focused funds intentionally exclude Japan. So too, many of the indices that track the performance of Asian securities are often constructed as "ex-Japan."

So it came as something of a surprise when in August 2020, renowned investor and chairman of Berkshire Hathaway, Warren Buffett, took a keen interest in Japan. Known for his conservative approach and focus on undervalued assets, Berkshire's regulatory filings disclosed significant stakes in five Japanese companies: Mitsubishi, Itochu, Mitsui, Marubeni and Sumitomo. This would be Mr. Buffett's first foray into the Japanese equity market, and, needless to say, since word got out about his initial stakes in these companies, their share prices have soared. Suddenly, *Japan was hot*.

Looking back, the seeds of Mr. Buffett's interest were most probably planted by the Japanese government back in 2015 with the introduction of the "Corporate Governance Code." These efforts were part of a broader set of initiatives aimed at improving corporate governance and increasing shareholder value in Japan. This code outlines principles and best practices for corporate governance — such as board independence, transparency and accountability — and seeks to improve capital allocation and returns by having companies eliminate cross-company shareholdings, increase dividends and repurchase stock. Exchange operators are placing increasing pressure on companies to comply fully, and those that fall short face potential delisting.

In a homogeneous and largely male-dominated culture, the Japanese government has also been promoting diversity and inclusion in corporate leadership, setting targets for female representation on boards of directors. Many Japanese companies have been appointing women to their boards for the very first time. In addition, shareholder activism, largely if not completely unknown in Japan, has been gaining momentum. The government has openly and actively encouraged institutional investors to exercise their voting rights and engage with companies on governance issues, such as environmental sustainability. The aim here, too, is to hold managements accountable and improve shareholder returns.

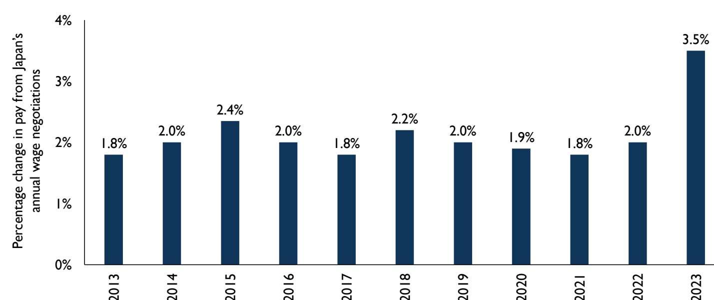
While Mr. Buffett certainly deserves credit for lighting a fire under the shares of Japanese stocks — and he has openly stated his plans to invest more capital in Japan — what forces could propel the market to new highs?

Many institutional investors reckoned that they could ignore Japan in favor of China, which has been viewed as the dominant Asian growth story. However, now that China's investment fate is far more questionable, a steady stream of fund managers and institutional investors have been making their way to Tokyo. Even a small change at the margin in foreign capital flows to Japan could have a dramatic impact on share prices and valuations.

Another significant pool of capital exists that could make its way into Japanese shares, and that is funds from domestic households. Japanese households currently hold nearly $8 trillion dollars' worth of cash and equivalents. The Bank of Japan calculates that only 13% of Japan's liquid household assets are invested in equities, an astounding number when compared with more than 40% in the U.S. and 21% in Europe.[2,3] While foreign investors have been enthusiastically pouring money into Japan (with some $43 billion invested in 2023), domestic households have yet to enter the fray in any meaningful way.[3]

Importantly, it is perhaps the vanquishing of *deflation*, and the return of *inflation* after a multi-decade absence that could prove pivotal. Any doubts about the return of inflation were erased most recently when the Bank of Japan raised interest rates for the *first time in 17 years*.

Japan finally gets a raise



Source: Japan's Ministry of Health, Labor and Welfare

So too, and for the first time in a very long while, Japanese workers are seeing pay raises. As companies raise wages, this could in turn reheat consumer confidence. Rising prices should, at least in theory, propel Japan's ever-growing ranks of savers and retirees into the yields readily available in domestic Japanese stocks. After a 35-year drought, it will undoubtedly take some time for domestic investors to trust the tailwinds of their own market.[4] Only time will tell.

Buffett is not alone in his enthusiasm for Japan for we are currently overweight Japan in our international model strategy and, as always, we are on the lookout for additional attractive companies for investment in this newly attractive market.

Sources and Footnotes:

1. Jacky Wong and Nathaniel Taplin, "Stocks for the Long Run: Could Japan's Lost Decades Happen in America?" Wall Street Journal, February 2, 2024.

2. Leo Lewis and Kana Inagaki, "Investors Look to Further Gains as Nikkei Breaks Through 1989 High," Financial Times of London, February 25, 2024.

3. Leo Lewis, "Retail Investors Wary of Backing Japan's Stocks Breakthrough," Financial Times of London, February 25, 2024.

4. Jacky Wong, "Japan Finally Gets a Pay Raise," Wall Street Journal, March 15, 2024.

Our West Bearing logo is inspired by the American bison, an iconic creature symbolizing resilience, grace and the western path to growth and opportunity. Most animals attempt to outrun inclement weather, prolonging their exposure to the elements and, in doing so, weaken their conditions. Only bison instinctively turn to face the storm, often bearing west, to find the quickest path to clear skies.

WHERE DO WE GO FROM HERE?

JASON NORRIS, CFA
Director
Equity Research and Portfolio Management

The equity markets continued their strong run in the first quarter of 2024. Since the stock market lows of 2022, the S&P 500 has rallied over 45% as the Federal Reserve seems to have engineered an economic soft landing. With this recent show of strength, the valuation of the stock market has come to the forefront, with a lot of comparisons of the market today versus that of 1999-2000. The reason for the analogous comparison is because these current strong tech stocks are spurred by the recent development in artificial intelligence (AI) which reminds investors of the dot-com days of the late 1990s. As we have said for some time and have been emphasizing of late is that we do believe it is different this time. First, the technology stocks today are much more profitable than their dot-com peers, and therefore current valuations are more attractive. For instance, the tech-heavy Nasdaq index currently trades at a price-to-earnings (P/E) multiple of 35x, where in the late 1990s, it traded over 100x. For these reasons we believe that the potential downside is much less than what was experienced in the wake of the dot-com crash.

Where do we go from here?

Source: FactSet

Taking a step back and looking at the overall picture of valuation of the S&P 500, the market is currently at the high end of its historical range.

There are a variety of factors that are considered when investors value the market. However, the two primary factors are 1) the current level of interest rates and, 2) expected company profit growth. When interest rates are high and estimated growth is low, investors tend to pay a lower P/E for stocks than the reverse. Some clients are wondering, with the current environment of stocks trading at a P/E above 20x, is the market overpriced? We look and point to earnings growth, with expectations currently forecast to deliver 10% in 2024. We believe this is reasonable, particularly when we consider the economy continues to grow and the earnings growth in the technology sector is a driving force. However, interest rates have increased meaningfully over the last 18 months with the 10-year U.S. Treasury currently yielding over 4%. Historically, a 4% yield on the 10-year U.S. Treasury has resulted in a P/E multiple in the high teens. In other words, we see this not as a flashing a red light, but more like a yellow light indicating caution warranted ahead.

> *Historically, markets have increased 87% of the time during an economic expansion.*[1]

We believe investors are anticipating the market to grow earnings around 10%, and interest rates are expected to remain stable and trend lower throughout the year. With a market P/E currently above 20x, we believe that stocks are priced for this good news. If inflationary pressure starts to increase and/or earnings growth comes under pressure, specifically in the technology space, then we would expect equities to face some headwinds. This is not our base case. However, at current levels, we believe stocks may be more susceptible to weaknesses. While we continue to be slightly overweight to large-cap stocks, we have reduced exposure to the riskier equity asset classes, such as small cap and emerging market equities and have added to fixed income. We believe this more balanced approach is appropriate for 2024 based on our outlook for economic growth and lower interest rates.

1. Goldman Sachs 2024

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