MARKET LETTER

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

MARKET LETTER
THIRD QUARTER 2023

IN THIS PUBLICATION

Standing Eight Count....................... I

Generative AI: A New Era II

Real Estate: In the Midst of a Sea Change IV

Founded in 1975, Ferguson Wellman is a privately owned registered investment adviser, established in the Pacific Northwest. As of January 1, 2023, the firm manages $7.1 billion for 943 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

STANDING EIGHT COUNT

GEORGE HOSFIELD, CFA
Director
Chief Investment Officer

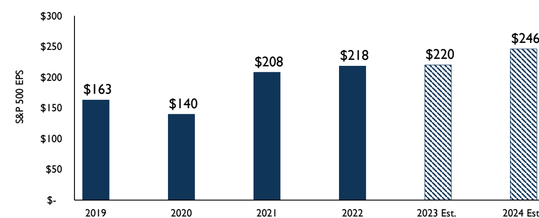
A STRONG FIRST HALF of the year for a small handful of mega-cap, artificial intelligence-themed technology stocks has led the S&P 500 out of a bear market and produced double-digit returns for the blue chip index. However, most other stocks within the index have made little, if any, headway in what has been a historically narrow market amid the Fed's ongoing battle with inflation. That said, with headline inflation having now been more than halved since exceeding 9% last summer, like a boxer who has his opponent on the ropes, the Fed's barrage of rate hikes has inflation teetering.

Five percentage points of cumulative interest rate hikes are beginning to slow the economy, and have dealt body blows to headline inflation. However, the knock-out punch awaits additional slowing in the still-robust labor market, which accounts for the lion's share of company costs. Wage gains remain elevated across broad swaths of the U.S. economy, where price increases are still materially above the Fed's 2% inflation target.

With short-term interest rates now exceeding inflation and banks having slowed lending in response to deposit flight, retail sales growth has all but disappeared and leading economic indicators like unemployment claims are up from recent lows. We are confident the labor market will slow, inducing hiring slack necessary for the Fed to win its inflation fight. Collateral impacts on economic activity have yet to be fully felt, but for now, a still expanding economy continues to defy skeptics predicting imminent recession.

The challenge for companies late in this economic cycle is to maintain their earnings power as price gains moderate, sales volumes slow and costs climb. So far, so good – first quarter profits were better than expected and estimates have been revised upward. As the chart below indicates, earnings estimates are holding steady for the year even as profit margins have moderated.

Earnings Have Been Surprisingly Solid



Source: Eikon

Against this economic backdrop, we have positioned client portfolios for slowing economic growth by emphasizing a higher allocation to healthcare, consumer staples and utility stocks, while reducing exposure to more cyclical sectors like financials, industrials and consumer discretionary. More broadly, we see continuing value in bonds and foresee coupon-plus returns that would merit additional allocation if the economic slowdown becomes something worse. For now, we remain overweight large-cap U.S. stocks and underweight bonds.

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.

GENERATIVE AI: A NEW ERA

KRYSTAL DAIBES HIGGINS, CFA
Vice President
Equity Research

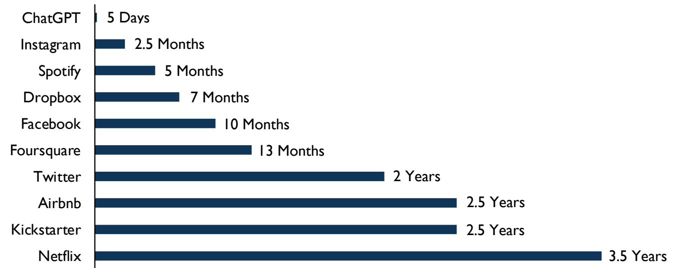
WELCOME TO THE BRAVE NEW WORLD of generative artificial intelligence (GAI). Love it, hate it or frightened by it—the latest evolution of artificial intelligence (AI) has exploded upon us. Although AI technology has existed for many decades, the term GAI, a technology that has also been around for some time, has become a household term in 2023—and deservedly so. GAI is expected to drive seismic, fundamental changes in consumer behavior and business operations. From the creation of new and/or more effective medical treatments, to every student having more access to educational support, to military leaders making more accurate strategic and tactical decisions—the effects of increased productivity and better decisions by consumers, businesses and world leaders are enormous, yet notwithstanding risks.

(R)EVOLUTIONARY

AI is a broad term for technological applications built to understand and respond in ways similar to humans. GAI is a subset of AI, which most have come to know through the Microsoft-backed ChatGPT and Google's Bard. The latest version of GAI exploded onto the scene when tools that could produce human-like responses to seemingly any question became more accessible. While not always accurate, the responses are written in impressive, sophisticated language. Prior to these advanced chatbots, users of GAI would have had to submit data through an API (Application Programming Interface) or other complicated means that required understanding special tools and applications. The ease and accessibility of GAI resulted in ChatGPT reaching one million users in just five days, compared with Instagram at 2.5 months, Facebook at 10 months, and Netflix at 3.5 years.[1]

Beyond the chatbots, GAI can also produce graphics, images and audio. For example, Dall-E is another GAI tool that produces images from written requests. GammaAI is a website that can build a full presentation in under 30 seconds using only a few key words. Durable is a service that builds a website from scratch. And BrandMark is a site that creates logos and marketing related content.

Chat GPT —The Fastest Growing User Base Of All Time



Source: Morgan Stanley

TECHNOLOGY FEARS, CIRCA 1921 (AND EARLIER)

While there is much to celebrate about GAI, to no surprise it is also met with a substantial amount of skepticism and fear. Throughout the course of history, almost all major technological changes triggered similar concerns. To that end, it is fascinating to look through newspaper archives from a century ago and see headlines eerily similar to what we have seen of late. Headline such as "Man Devoured by His Machines" and "Unemployment Blamed on New Machines" resonate with many of the stories we see on AI today. From prominent business leaders to local newspapers, there's no shortage of negative AI commentary and headlines being shared in our everyday media feed.

We are certainly not discounting the valid fears surrounding AI. There are potentially serious risks that our society will have to navigate, including copyright infringements, deepfakes (fake photos, videos or audio of real people), amplified biases, violation of privacy laws and much more. As with all technological advancements, governments will have the arduous task of regulating AI in a way that encourages innovation but also mitigates illegal activities and negative consequences.

Ironically, there is actually more risk to halting AI's progress as opposed to not continuing its advancement. To begin, AI is already everywhere. We can use good AI to combat the bad AI—tools that will identify individuals using it for illegal purposes or other nefarious reasons, identify fake content and detect plagiarism are just a few examples. More importantly, AI capabilities are also being developed by governments overseas. Just as it is likely that businesses that don't use AI will be left behind, the same is true for the United States and the West, otherwise we may see outcomes that can be far more frightening.

Innovation Hysteria: We've Been Here Before

THE NEW YORK TIMES,

DOES MACHINE DISPLACE MEN IN THE LONG RUN?

New Studies Cited as Old Argument Is Renewed Over Significance of 'Technological Unemployment'

By LOUIS STARK

WASHINGTON, Feb. 24—Does technological progress, by increasing the efficiency of our industrial processes, take jobs away faster than it creates them? On this question Dr. Karl T. Compton, president of the Massachusetts Institute

labor by 62 per cent as compared with the hand process. In terms of production costs, the reduction in labor time represented a difference in favor of the machine process of at least $3 per thousand of cigars.

"IS THE ROBOT BEGINNING TO THINK?"

view of man and the machine.

MARCH OF THE MACHINE MAKES IDLE HANDS

Prevalence of Unemployment With Greatly Increased Industrial Output Points to the Influence of Labor-Saving Devices as an Underlying Cause

THE NEW YORK TIMES

The Machine Age and Its Effect On the Literary Arts

Mr. O'Brien Undertakes to Gauge Its Impact On the Form and Quality of Our Writing

Man Devoured by His Machines

UNEMPLOYMENT IS BLAMED ON NEW MACHINES

Devices Displace Workers, Smoot Says as Democrats Hit Prosperity Claims.

By RAYMOND CLAPPER.

Source: Pessimists Archive

OPPORTUNITIES

The good news is that past technological advances were actually boons to society. They did not take over humanity, but rather improved productivity which, in turn, gave rise to new industries and opportunities over the long term. In addressing the most frequently cited concerns associated with AI, it is important to note that there is not a finite number of jobs. Rather, history has shown that when technology improves, it leads to higher productivity, lower costs of goods and services and higher profit growth. This benefit then leads to more spending on new business activity, which then leads to greater economic and job growth. Take for example the invention of automobiles, which was one of the most profound advancements. While it initially reduced demand for buggy makers, coachmen and horse breeders, it led to millions of new jobs in the long term. As cars proliferated and evolved, new jobs emerged in oil and gas production, auto manufacturing, engineering, automation, travel, real estate (suburban living), software, electric vehicles—and that is just scratching the surface. In terms of quality of life, it allowed people to travel in a fraction of the time, allowing them to see family members more often, experience new adventures, and live in new areas.

We believe GAI will have a similar long-term impact on new job opportunities and quality of life as did the automobile. While it will initially disrupt the labor market, it could also potentially drive one of the most sustained economic growth periods of our time. Just as with every major technological breakthrough, it is difficult to fathom the creation of new businesses and jobs the further we look out to the future. However, PwC has estimated that by 2025, GAI is expected to create one million new jobs in the healthcare industry and open up new opportunities in machine learning, engineering and data analytics.[2]

INVESTMENT POTENTIAL

As AI continues to improve and become more accessible, demand for AI computing power will continue to grow. Developers are racing to incorporate the technology in existing applications as well as to build new ones. In the most recent quarter, the topic of AI in earnings reports was pervasive, but it wasn't all hype. It came with real value as companies, particularly those driving the AI trends, revised revenue and profit guidance significantly higher against a rather challenging spending environment for businesses. In fact, these AI-enabling companies account for much of the returns we have seen so far this year in the S&P 500.

Not only can the latest evolution of AI be potentially transformative to the technology industry, but we will likely see competitive advantages emerge for businesses across all sectors, industries and sizes. From software applications to media advertising to supply chain management and more, those that can identify internal efficiencies and improve productivity should be better positioned to capitalize on profit growth opportunities over the long term.

AI and GAI are powerful tools that can improve work and lives in countless ways. It is important to be aware of the risks, but remember that it is a tool, and like any tool, it can be used for good and evil. We can either fear AI and let it control us, or we can embrace AI and use it to control and improve our future.

1. *Stephanie Roth and Bruno de la Sota, "ChatGPT: The Start of the AI Revolution," J.P. Morgan Private Bank Insights, April 26, 2023.*

2. *Anand Rao et al, "Sizing the Prize: What's the Real Value of AI for Your Business and How Can You Capitalize?" PwC, April 2020.*

REAL ESTATE: IN THE MIDST OF A SEA CHANGE

JOE HERRLE, CFA
Vice President
Alternative Assets

IN THE COMPLEX AND OFTEN-convoluted realm of asset valuation and investment returns, the formula for real estate is quite simple by comparison. Generally speaking, real estate values go down when interest rates go up. It is commonly known that interest rates take about a year to work their way through the vast and circuitous plumbing operation that makes up the U.S. financial system to impact the real economy. However, interest rates have a mainline to real estate within that monetary labyrinth. So, just over five quarters after the Fed began its fastest rate hiking journey in recent history, real estate, on average, has taken its bumps. But it is not all negative in real estate, as some sectors have fared better than others.

Regarding residential real estate, the reason higher rates hurt values is pretty clear. Higher rates mean more expensive mortgages, thus lowering demand for homes. But, in our current environment, higher mortgage rates haven't been able to reduce demand enough to fall in line with supply. One of the lasting impacts of the 2008 financial crisis was a chronic lack of housing supply in the U.S. that is estimated to be between 4 and 6 million homes. We have invested in this high-conviction theme through our alternative investments that we believe be rewarding in the long run. But we are witnessing it play out sooner than anticipated. The most recent new housing starts data revealed that new homebuilding activity jumped almost 22% annually … the most since 2016. This shows that despite an average 30-year fixed rate mortgage of 7.6% today, Americans still desire homes and are financially strong enough to purchase them in this environment.

Conversely, the office real estate sector is paddling upstream into a headwind: higher interest rates combined with the realities of hybrid work arrangements. At Ferguson Wellman, we consider ourselves to be "work from work" company, as in-person interaction is essential for our culture and to drive efficiencies. We know many other companies feel the same way, yet a tight labor market gives employees leverage to have flexible working arrangements. With more employees opting to work from home, many organizations need less office space, and therefore occupancy levels have declined.

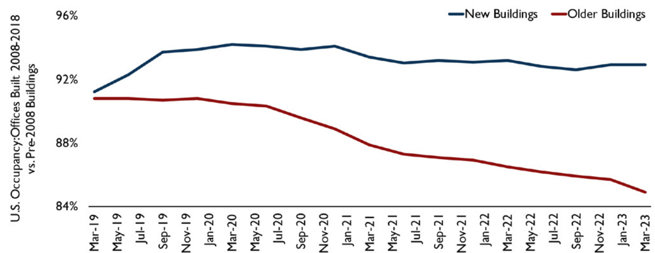
It would be unfair to paint all office real estate with the same brush, as there are idiosyncrasies at the state, city,

U.S. Housing Starts Are Robust

Source: FRED Economic Data

neighborhood and asset levels. Yes, the pain is not over for many older office buildings. However, companies have been downsizing their footprint from older offices and upgrading into smaller floor plans in newer upscale buildings. Essentially, companies are spending a similar dollar amount to be in nicer, albeit smaller, offices. New, highly-amenitized offices demand premium rental rates, even in depressed downtown rental markets such as Portland and Seattle. Through our alternative assets, what little exposure we have to office space is to class A+ buildings in growing areas that can produce higher cash flows from increasing rents. It is clear that work-from-home arrangements are here to stay and will have a lasting, although unknown, impact on the office market. We are in one of the tightest labor markets in history, and employees have unprecedented leverage to work remotely. If we are headed for economic softening, as economists predict, job openings will decline and job losses will grow. This labor market normalization will have more employees returning to the office, whether for job security concerns or employer requirements. Still, the question remains how materially the pendulum will swing back toward in-office work.

Newer Buildings Stand Strong against Office Property Headwinds



Source: CoStar

Disclosures: *Ferguson Wellman and West Bearing do not provide tax, legal, insurance or medical advice. This material has been prepared for general educational purposes only and not as a substitute for qualified counsel who can determine how this information applies to you.*