MARKET LETTER

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FERGUSON WELLMAN, OCTAVIA GROUP *and*
WEST BEARING

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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, 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

BALANCING ACT

GEORGE HOSFIELD, CFA
Director
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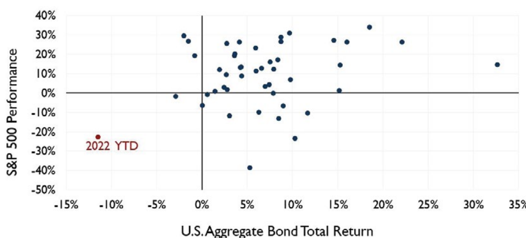
THE FED'S MISSION TO bring inflation under control through increasingly aggressive rate hikes has taken its toll on stocks this year. With the benchmark S&P 500 index having dipped into bear market territory late in the second quarter, a time for reflection is warranted. Since 1945, bear markets on average have taken about a year to go from peak to trough and have declined on average by 33%, and in turn, have required two years to get back to even.

While volatility in equity markets is not unusual, a combination of poor stock and bond performance is. As the chart below shows, there have only been two years prior to 2022 in which both stocks and bonds lost money in the same year, and in both cases the downside was modest compared to the significant losses bond investors have incurred to date.

Stock/Bond Return:
2022 Is a Year Like None Other



Source: Bloomberg

The extraordinarily poor returns for bonds this year is the result of long-term interest rates set by the bond market ascending faster than the Fed's rate hikes. Accordingly, housing markets are beginning to feel the effect of higher mortgage rates that have almost doubled this year.

Nevertheless, the U.S. labor market remains robust with twice as many job openings as there are unemployed. As well, consumers are flush with cash, the banking system is well capitalized, and corporate earnings remain strong. Combined with a still positively-sloped yield curve, the likes of which has never preceded a recession in the past 50 years, we are left to conclude that if a recession were to manifest in the near term, the economic contraction is likely to be short and shallow.

Though it is impossible to predict an exact market bottom, and volatility is likely to remain elevated in the months ahead as the Fed battles to tame inflation, with the market selloff, stocks are already discounting two-thirds of a typical recessionary pullback. In addition, given that bear markets historically precede significantly above-average equity returns in the years to follow, this is not the time to sell stocks.

To that end, client accounts remain positioned to navigate an inflationary environment by maintaining a minimum allocation to bonds and an overweight to large-cap equities and income-producing alternative investments such as cropland and timberland.

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

GRAVITY AND THE EVERYTHING BUBBLE[1]

DEAN M. DORDEVIC
Principal
Portfolio Management and Alternative Assets

"Interest rates are to asset prices what gravity is to the apple. When there are low interest rates, there is a very low gravitational pull on asset prices. Over time, the most important item in determining valuations are interest rates..."

— Warren Buffet[2]

Well, sooner or later it was bound to happen. That is, tighter credit conditions and higher interest rates. It goes without saying that we have been living in a very strange world for the last two or three years. This has served to render most post-pandemic crystal balls even more suspect than usual. That said, we're in the throes of a pervasive and all-encompassing adjustment to higher interest rates. Virtually all asset classes have been negatively impacted in some way, including bonds which are traditionally *the very safest asset class*. But, across the risk asset spectrum, the most speculative assets have been hit the hardest, while the least speculative have been treated more gently.

For the very most part, however, and throughout history market reactions to regime changes tend to be quite similar. Declines are often reasonably short in duration, although reliably sharp and quite painful. Perhaps most significantly, they act to change investor psychology. This, since short, sharp, powerful drawdowns tend to scare the living daylights out of just about everyone. However, these events serve a very important purpose: that is, excesses accumulated during the preceding period are *rapidly cleansed* from the system, and the foundation then begins to *gradually build* for the next cycle. Lather, rinse, repeat.

In the early stages of the pandemic, and so as to avoid economic catastrophe, we experienced both monetary and fiscal stimulus ... *in extremis*. We've written in these pages previously about the response by the Federal Reserve (Fed) at the onset of the pandemic. Ironically much of what the Fed accomplished so quickly was the direct result of their yeoman's work in the aftermath of the 2008 global financial crisis (GFC). As the pandemic took hold, the Fed dusted off their GFC playbook, and implemented (for the very most part) the same game plan, but this time on steroids. The Fed's COVID-era stimulus was about four times as large versus the GFC and administered in only weeks instead of years. As a result, interest rates fell to zero ... and stayed there.

So too, was the size and speed of ... *fiscal* stimulus. Money poured from Washington into just about every quarter, like water from a firehose. Former Fed Chair Ben Bernanke once suggested that in the most extreme circumstances, the U.S. Treasury could "*drop money from helicopters*" if necessary. This earned him the nickname, "*Helicopter Ben*." Bernanke's quip was quite prescient in hindsight since in practice this is more-or-less ... exactly what transpired. As a result, this massive liquidity injection leaked into asset prices of every stripe. While most assets inflated in price, the biproduct was far from uniform. As a result, investors' speculative juices were stirred, and so as not to let this go to waste, a host of new investment vehicles emerged, some of which were, and are, highly suspect.

> *"Inflation is always and everywhere a monetary phenomenon, in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output."*
>
> *—Milton Friedman, Ph.D.*

The iconic economist, Milton Friedman, Ph.D., said famously, "*Inflation is always and everywhere a monetary phenomenon*." A theory no more, Americans are living Dr. Friedman's forecast today. The monetary stimulus that we've witnessed more recently has ignited a course of inflation not seen in the last 40 years. With the consumer price index (CPI) now running north of 8%, the Fed has had no choice but to raise interest rates and tighten credit conditions quite considerably. For the Fed, reducing the level of inflation from its current level to something more in line with the Fed's target of 2.0-2.5% will not happen overnight.

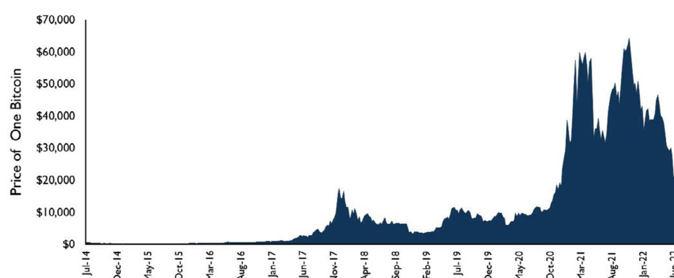
CLEAN UP ON AISLE THREE

The laundry list of speculative assets that accumulated over the last few years is both varied and quite long. This ran the gamut to include the somewhat more sober, special purpose

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.

acquisition companies (or SPACs), to non-fungible tokens (NFTs), meme stocks, and, of course, a panoply of cryptocurrencies. At their November 2021 peak, the collective value of cryptocurrencies topped some $3 trillion. More recently a so-described, "dark crypto winter" has set in. Roughly two-thirds of that value has now evaporated. Despite this epic wipeout, many cryptocurrencies remain that are highly suspect. Astonishingly, there's even one coin that attracted billions - relying solely on the full faith and credit of a *Japanese Shiba Inu dog*. In defense of both the dog and her founding software engineers, "Dogecoin" was, after all, originally created as a joke. You can't make this stuff up.

Cryptowinter



Source: Eikon

While much has been made of *digital* money of late, precious little ink has been spilled on the state of real ... *analog* money. Backed of course, by the full faith and credit of the U.S. government, rather than a dog in Tokyo. Data from the Fed shows that U.S. households have accumulated nearly $18 trillion in cash and cash equivalents. Interestingly, cash holdings rose across all wealth cohorts. The wealthiest 10% of Americans now hold 32% more cash than they did two years ago, and astoundingly, those in the bottom half of the wealth spectrum hold 45% more cash. This record cash hoard could very well serve as a cushion as higher levels of interest rates cool the economy.[3]

Consumers Are Flush

Source: Federal Reserve

During the pandemic years, there was also a parallel boom in a wide variety of growth stocks. While some did have bona fide earnings, many did not. Most were valued not on their earnings (since there weren't any) but on multiples of their sales/revenues. A leap of faith, to say the very least. We have, of course, seen gut wrenching boom-and-bust cycles in this space before. If you're of a certain age, you'll never quite forget ... mylackey.com. But we're not quite sure what's more remarkable this time around — the more recent spectacular declines in price, or the astonishing gains that preceded them. While these types of shares are not our bread-and-butter choice for investment, this behavior was not limited to NFTs and crypto & company. This speculative pulse was indeed pervasive and infected most every corner of the market.

We have lived with "easy money" for quite some time, and it is perhaps the *duration* of this loose-money interval that has given birth to the most pernicious problem for the Fed to resolve: The Everything Bubble. The Fed's zero interest rate policy (or ZIRP) resulted in many assets (and asset classes) that have inflated well beyond their reasonable or intrinsic valuations. Higher interest rates are the tonic - providing Mr. Buffet's "*gravity*" to restore financial market equilibrium. This ongoing adjustment is both worthy and very necessary, and for better or worse — occurring with some deliberate speed. Band-aids are always best removed quickly.

The good news for *our* investors is this: as *gravity* takes hold, the financial world is becoming a more reasonable and sensible place. As these excesses are washed from the system, and some semblance of sanity returns, money tends to flow into just the types of stocks that we tend to favor. For example, it's no surprise to us that value stocks of late, and especially those that pay generous and reliable dividends, have been a relative bright spot during this difficult year.

Gravity, it turns out ... can be a good thing.

Gravity and the Everything Bubble

1. *The Everything Bubble: The Endgame for Central Bank Policy*, by Graham Summers, CreateSpace Independent Publishing, 2017.
2. Wikipedia Famous Warren Buffet Quotes.
3. Justin Lahart, "Americans' Cash Hoard Could Cushion a Downturn," *The Wall Street Journal*, June 24, 2022.

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.

BONDMAGEDDON

BRAD HOULE, CFA
Principal
Head of Fixed Income

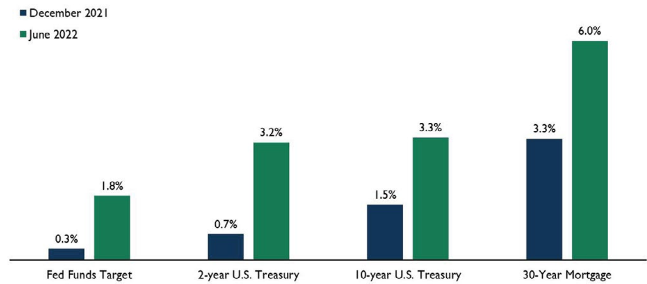
The first half of 2022 has been the worst period in modern bond market history with the previous worst full year being a 3% annual decline that the bond market suffered in 1994. The persistent elevated inflation and the Federal Reserve's aggressive response are the primary culprits for the carnage in the bond market. The fixed returns from bonds are negatively impacted by an elevated rate of inflation. Interest rates climb and bond prices drop as a response to elevated inflation to compensate investors for the diminished value of bonds fixed interest rate payments. Consider this narrative as an explanation of what has occurred:

Source: Bloomberg

You loan a friend $100,000 (this is a bond) and charge them 3% interest because 3% is the going rate in the economy. The agreement is your friend pays you 3% a year interest for 10 years, and at the end of 10 years, they pay back the $100,000. Let's say three years into the 10-year period interest rates have moved up to 5%. Your loan only pays you 3%, which means your loan (bond) is not worth as much as new loan (bond) bought today at 5%. After all, everyone would rather be paid 5% for loaning someone money than be paid 3%. This is exactly what is happening in our economy right now. Interest rates have moved up nearly 2% in the last six months which is a large increase. Existing bonds pay less than new bonds so previously issued bonds are worth less than.

Unlike stocks, ultimately you will get your money back with bonds if they are held to maturity. If bond values decline due to increases in interest rates, it is a paper loss. At maturity, investors get their money back, erasing the interim negative return. Bond returns approach the yield that the bond was purchased at maturity. The silver lining to rising interest rates is that the income generated from bond portfolios will go up as lower yielding bonds mature and are replaced by newly-issued higher-yielding bonds.

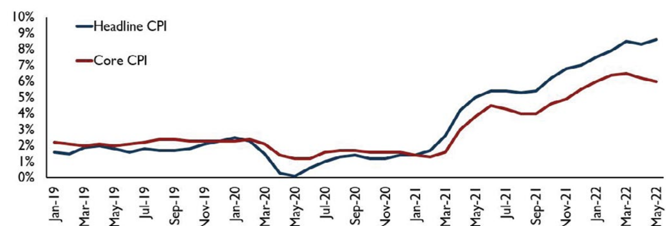
Stocks and Bonds Have Largely Priced in the Fed Tightening Cycle



Source: Bloomberg

Bonds this year can be characterized as return-free risk. Bonds and stocks declining simultaneously is a highly unusual scenario that has only happened twice on an annual basis. As the second quarter of 2022 progressed, bonds began to act more like bonds with Treasury prices rising on "risk-off" days in the equity markets. Despite the painful start to the year for bond investors, we anticipate that the risk mitigation characteristics of bonds will be useful for client portfolios in the future.

Underlying "Core" Inflation Peaked in March



Source: Bureau of Labor Statistics

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