

MARKET LETTER

A QUARTERLY PUBLICATION of
FERGUSON WELLMAN; OCTAVIA GROUP and
WEST BEARING



MARKET LETTER
FOURTH QUARTER 2022

IN THIS PUBLICATION

- Bad News Is Good News*..... I
- Energy's Ubiquity and Transition in Perspective*..... II
- Housing High on Low Supply*..... IV

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, Ferguson Wellman's private family office, provides fee-based services for clients with \$10 million managed by firm.

INVESTMENT EXCELLENCE
LIFELONG RELATIONSHIPS

BAD NEWS IS GOOD NEWS



GEORGE HOSFIELD,
CFA
Director
Chief Investment Officer

STOCK AND BOND PRICES

are again probing new lows for the year amid an increasingly hawkish Federal Reserve, whose focus has become taming inflation that recently crested 40-year highs. With history showing that higher interest rates require six-to-18 months to fully manifest their economic impact, the challenge for the Fed is knowing how far to tighten. Housing activity is already slowing amid a doubling of mortgage rates, used car prices have begun to roll over and economically-sensitive commodities like oil and copper have corrected.

Nevertheless, the U.S. economy remains sturdy, with ongoing growth in industrial production, consumer spending and employment. Unfortunately, lower labor force participation and excessive COVID-related stimulus have caused the labor markets to overheat, resulting in excessive demand for employees and elevated wage gains.

An incipient wage-price spiral is the inflation bullseye the Fed is targeting. Accordingly, discerning eyes are on the lookout for what is normally viewed as bad news - recession indicators like layoff announcements and rising unemployment claims - for evidence of softening labor markets that will be necessary in order for the central bank to halt its rate hikes. As Fed Chair Powell recently observed, "Without price stability, the economy does not work for anyone."

The risk for investors is that the Federal Reserve goes too far with its rate hikes, misses the soft landing and precipitates a recession that impairs earnings. While the inverse relationship between interest rates and stock prices largely explains the drop in equity prices this year, we believe the future performance of equities will increasingly be driven by the direction of earnings.

Fed Singularly Focused on Bringing Down Inflation

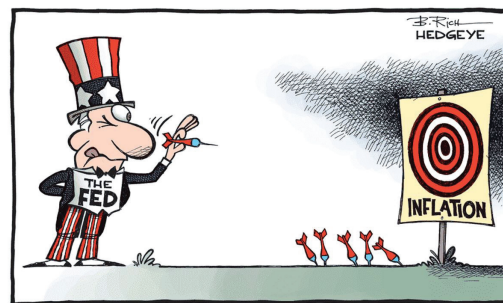


Illustration by Bob Rich

Our belief is that the Fed will succeed in bringing inflation to heel, and with stocks in a bear market having already discounted a high probability of recession, the risk-reward of owning equities is favorable. As such, we remain underweight bonds, overweight income-producing alternative assets, and overweight large-cap U.S. stocks.

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.



ENERGY'S UBIQUITY AND TRANSITION IN PERSPECTIVE

PETER JONES, CFA

Senior Vice President

Equity Research and Portfolio Management



"Without price stability, the economy does not work for anyone."

— Fed Chair Jerome Powell¹

Justifiably, inflation has been the number one, two and three most important topic for investors, economists and Main

Street this year. After being lulled to sleep by inflation confined to a persistent 1-to-2% range over the last 20 years, readings this summer peaked at a 40+ year high of ~9%. Understandably, this has been alarming for all Americans. A combination of zero-interest rate monetary policy, trillions of dollars in both quantitative easing and fiscally enacted pandemic-era stimulus coupled with war in Europe has disrupted supply chains and distorted labor markets which has resulted in a generational surge in prices within economies around the globe.

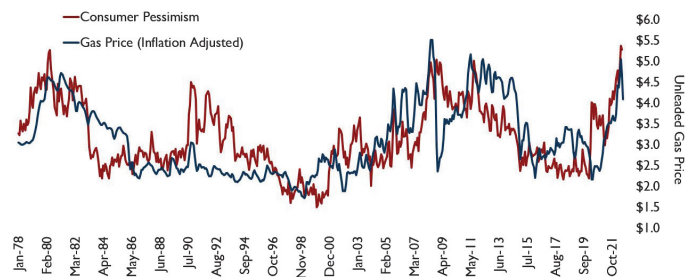
Given the geopolitical landscape, energy prices have become of particular interest for politicians, diplomats, national security advisers ... and perhaps most importantly, American voters.

Energy has touched every piece of the economic and geopolitical narrative this year. To begin, energy price shock has been a major fallout of the war in Ukraine. The day Russia invaded Ukraine, pundits were quick to assume that Russia would weaponize the supply of energy (especially natural gas), if western countries were to enact punitive sanctions. Needless to say, sanctions in unprecedented scale have now been put in place, and Russia has responded by weaponizing energy supply into Europe. Specifically, depending on the country, Europeans, now receive anywhere from 10-to-60% of their natural gas supply from Russia ... and, in retaliation, Russia has toggled the supply of their flagship Nord Stream I pipeline at a rate between 0-to-40% of contractual capacity since the early part of the summer. Deceptive as ever, the Kremlin categorizes this shortfall as a function of unplanned maintenance, rather than retaliation. As a result, German electricity prices have skyrocketed, up more than 1,000% compared to levels a year ago. Mandatory downtime in German factories to ration natural gas has become a reality. Unless something changes soon, it is going to be an exceedingly long and cold winter in Europe. Needless to say, Germany's hasty decision in the

last decade to shutter nuclear and coal power generation has come at the expense of their national security, leaving utility prices at the mercy of the Putin regime – at least for the time being. Whether the history books ultimately record Russia as the third largest fossil fuel producer or, instead, as the de facto energy colony for China, remains to be seen.

Beyond Europe, energy inflation has left everyday Americans appalled by the prices seen at the pump. Although gasoline expenditures are commanding a much smaller portion of wallet share compared to past oil shocks, the psychological impact of pump prices remains astonishingly high. As can be seen in the accompanying chart, consumer pessimism moves in lockstep with gas prices. Frankly, we have difficulty finding a variable that does a better job of explaining consumer attitudes than gas prices ... despite gas expenditures accounting for a relatively small 5% of total consumer spending.

Gas Prices Drive Consumer Psychology



Source: Eikon

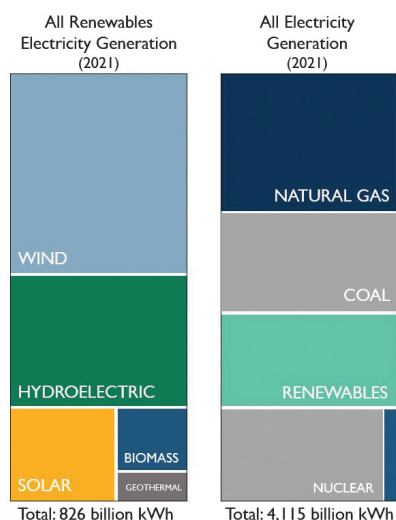
Perhaps not surprising, a similarly high correlation can be found between gas prices and presidential approval ratings.² The current administration has taken note and surely the recent decline in national average gas prices from ~\$5.00 to \$4.00 has been a welcome development for Democrats ahead of the midterms.

Another example of energy headlines dominating the 2022 narrative revolves around the recently passed Inflation Reduction Act. While contrary to the title, the market has interpreted the bill as actually contributing to inflation. This legislation passed in August is acutely focused on incentivizing capital spending to accelerate the transition away from traditional fossil fuels and toward renewable energy sources. For perspective, renewable energy technologies research and development along with renewables capital spending accounted for \$59 billion of investment in 2019. The inflation reduction act provides tax credit incentives that are expected to generate an incremental \$369 billion of renewal energy investment over the next several years.

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.

It has become clear that both Europe and the United States are working to diminish their reliance on fossil fuels. On one end, only 1% of registered vehicles in the United States are fully electric. On the other hand, roughly 6% of new vehicle registrations in 2021 were fully electric. The share of electric vehicles continues to rise year after year. California, which often sets the precedent for other coastal states, recently enacted legislation that requires all new car registrations in the state to be electric by 2035. Electrical power generation is another example of the shift in energy production. Just a decade ago, solar power electricity generation was rounding error at just one billion kilowatt hours ... And today? 115 billion kilowatt hours. Wind remains the largest source of renewable energy in the United States, and, as a whole, renewable electricity generation has surpassed 800 billion kilowatt hours (chart below), .. and represents about 20% of the total ... which is roughly the same amount generated from coal. While this transition can be evidenced by a multitude of data points, it is a slow process as fossil fuel generated power still accounts for more than half of domestic electricity.³

Composition of Electricity Generation in the United States



Source: Energy Information Agency

Much has been made of the ascension of big internet, technology or the originally coined “FANG” stocks (Facebook, Amazon, Netflix, Google). Without dispute, it has been incredible to witness the growth, innovation and capital market dominance displayed by a select few domestic companies such as Tesla, Apple, Microsoft, Amazon and others. These companies have become so large and ubiquitous, it is impossible to sift through financial media without reading daily articles about different governments conjuring new ways to regulate these entities. It is hard to rebuke that the data, technology, scale and interwoven nature of these companies within society affords them power

never seen before in corporate America. So, how do the collective profits of these companies compare to the largest fossil fuel company in the world? Tesla, Facebook (Meta), Apple and Microsoft generated aggregate net profit of \$45 billion in the second quarter of 2022, while global energy giant Aramco generated \$48 billion of profit. As such, while the inevitable “death” may someday be inevitable ... it is not imminent.

To put an exclamation point on the dominant status of energy in the 2022 economic, geopolitical and political narrative, look no further than the stock market itself. With the S&P 500 continuing to languish, the energy sector has enjoyed a generational upswing. With the exception of the energy complex, every S&P 500 sector is negative for the year, and in many cases by more than 20%. Utilities are in positive territory, and then there is the fossil-fuel-heavy energy sector, up more than 40% and outperforming the broad market by a staggering 60% for the year.

Beyond just fossil fuels, the dominance of energy in the market can be illustrated by looking at clean energy funds. The largest domestic clean energy ETF by assets has appreciated by more than 30% since the day Russia invaded Ukraine. Investors appropriately discount energy scarcity and booming commodity prices as a windfall for those companies producing renewables. Bottom line, all forms of energy production are trading at massive premiums.

Moreover, the energy sector has enjoyed a 154% return since Pfizer received FDA approval for their COVID vaccine. While it may be tempting to extrapolate these returns into the future, the data points below tell a very different story about the energy sector.

- It has underperformed the market by 60% over the last decade
- Its representation in the S&P 500 peaked at 25% of the total in the 1970s
- Its current representation in the S&P 500 is around 5%

In a year mired with generationally high inflation, bear markets and geopolitical turmoil, energy is the common denominator coruscating across all aspects of Wall Street, Main Street and government bodies across the world.

We have seen a renaissance for traditional energy companies and their stock prices over the last couple of years, but if one is to zoom out and take a longer-term perspective, fossil fuel’s share of the global economy is clearly in decline.

1. Jerome Powell, “Monetary Policy and Price Stability” speech, August 26, 2022. <https://www.federalreserve.gov/newsevents/speech/powell20220826a.htm>
2. Kyle Kondik, “Gas Prices and Presidential Approval,” UVA Center for Politics, March 17, 2022. <https://centerforpolitics.org/crystalball/articles/gas-prices-and-presidential-approval/>
3. World Inequality Database, “World Inequality Report 2022,” December 7, 2021. <https://wid.world/news-article/world-inequality-report-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.



HOUSING HIGH ON LOW SUPPLY

JOE HERRLE, CFA, CAIA
Vice President
Alternative Assets



When it comes to the housing market today, the general refrain seems to be, "What goes up must come down." It is also apparent why market participants feel a general sense of unease. The U.S. National Home Price Index is up over 10% through June 2022, while year-to-date, equities are down over 17%, bonds are down over 12% and even gold (the "safe" haven) is down 8%. Further, interest rates have been marching higher for over a year, but housing has yet to correct. So, as many are wondering, what's the story here?

Increasingly this year, there have been signs that the housing market is slowing. We first started seeing declines in sales volumes and homebuilder sentiment, and more recently, this has begun weighing on home prices. The simple reason for this softening is affordability. The sharp increase in home values and the rise in mortgage rates have made housing the least affordable in decades. Compared to a year ago, the average new home price increased 7.5% while average 30-year fixed rate mortgages rose from 2.86% to 6.29%. The result: Monthly mortgage payments on the median U.S. home for sale increased 45% over the last year.

Housing Affordability Worsening



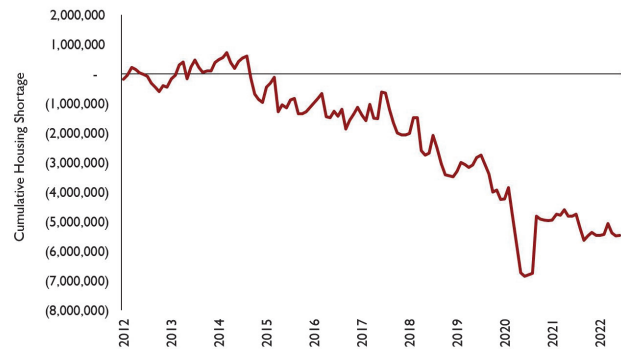
Source: Federal Reserve

Such a run-up in price can cause one to try and draw parallels to the subprime mortgage crisis. We hesitate to utter the four most dangerous words in investing, "This time it's different." However, there are a few marked distinctions that give us confidence this is not another 2008. Excessively relaxed mortgage underwriting fueled the housing bubble of 2007-2008, with many borrowers able to take out mortgages they could not afford. Incongruent

incentives and opacity ultimately led to the rise and fall of the housing bubble. Aside from several regulatory safeguards implemented, the relative financial strength of average borrowers today lends credence that a housing collapse is very likely not in store for the U.S.

As such, near-term signs indicate an unwinding in housing prices and less of a bubble bursting. But we like to focus on the long term, so let's zoom out and look at the bigger picture. The housing market collapse during the 2008-2009 Global Financial Crisis slowed demand for new homes and made builders wary of overbuilding. From 2007 to 2020, new housing starts, a measure of new supply, never rose above 1.5 million annually. This level was widely accepted as the annual supply needed to meet demand through the 2010s. The result is an estimated cumulative housing shortage to the tune of four-to-five million homes.

Housing Supply Not Near Demand



Source: Realtor.com

The existing housing shortage shows no signs of correcting soon. The U.S. needs an estimated 1.7 million new homes annually to reach supply/demand equilibrium by 2030. But recent readings are well below this mark, and it looks like the figure will trend lower. Higher interest rates don't just weigh on buyers: builders will be incentivized to build less, not more. This is the primary basis of our investment thesis around rental housing: As home affordability remains an issue, more would-be buyers compete for fewer rental units. We are seeing this play out in the markets, as rents are now a rising component in U.S. inflation readings. As we position portfolios for the long-term, residential rental housing remains a core component of our alternative investment strategy and plays a role in public equity portfolios.

Disclosures: This material is for informational purposes only. The views expressed represent the opinion of Ferguson Wellman Capital Management and West Bearing Investments; they are not intended as a forecast or guarantee of future results and are subject to change. This material does not constitute investment advice and is not intended as an endorsement of any specific investment.