

MARKET LETTER

MARKET PERSPECTIVE



SECOND QUARTER 2017



ECONOMICS OVER POLITICS

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With the unemployment rate having fallen to 4.7 percent and headline inflation now above the Fed's 2 percent objective, the U.S. central bank has again raised short-term interest rates. Presuming the U.S. economy continues to make progress, we anticipate two more quarter-point rate hikes by year-end.

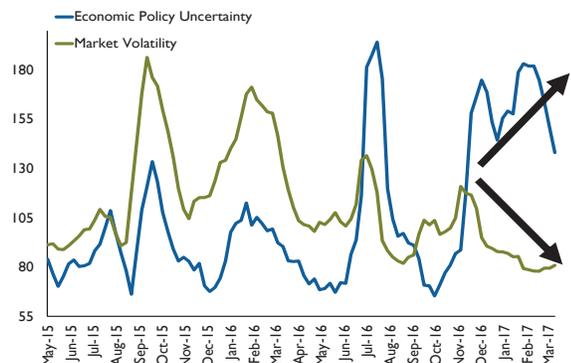
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In dramatic contrast to public anxiety about policy uncertainty emanating from D.C., multiple equity indices have recently posted new highs. Equally notable has been the lack of volatility, as the S&P 500's recent climb was accompanied by the longest run without a selloff of 1 percent or greater since 1995.

Overseas, the economic data has also improved, with European manufacturing activity in the first quarter signaling accelerating GDP growth. In Asia, Chinese growth is slowing but remains stalwart, while encouraging political developments in India bode well for continued expansion of the world's fastest growing major economy.

Markets Responding to the Economy, Not the Headlines



Source: Bloomberg

As new healthcare legislation takes shape in Congress, the timing and certainty of tax reform and infrastructure spending are becoming less clear. But more importantly, consumer and business confidence have soared to 16-year highs amidst moves to reduce federal regulation, spurring healthy spending, employment and manufacturing activity.

Against this global backdrop, we hew to our call for benchmark Treasury rates to climb this year, but not enough to derail the economy or the equity markets. For investors' bond allocation, returns this year are shaping up to be *coupon-minus*.

Corporate earnings will be key to equity investors' success in 2017 and after stalling for the last three years, led by a rebound in energy profits, we believe that S&P earnings will finally enjoy modest growth in 2017. Earnings growth coupled with a relatively benign interest environment should prevent P/E multiples from contracting and support mid-single-digit equity returns. Furthermore, after a multi-year period of negative mutual fund investor flows, we are starting to see investor inflows that should help support equity valuations that are no longer "cheap." If this trend continues, 2017 could be another double-digit year for equities.

Founded in 1975, Ferguson Wellman is a privately owned registered investment advisory firm, established in the Pacific Northwest. As of 2016, the firm manages over \$4.5 billion for more than 760 clients that include individuals and families; Taft-Hartley and corporate retirement plans; and endowments and foundations with portfolios of \$3 million or more. West Bearing Investments, a division of Ferguson Wellman, serves clients with assets starting at \$750,000.

INVESTMENT EXCELLENCE
LIFELONG RELATIONSHIPS

Everything we hear is an opinion, not a fact. Everything we see is a perspective, not the truth. – Marcus Aurelius



THE “C-SUITE EXPERIMENT”

Dean Dordevic, Principal
Alternative Assets and Portfolio Management

“There’s no question that animal spirits have been unleashed post-the election.”

– William C. Dudley, President, New York Federal Reserve¹

Never before in our nation’s history has an incoming administration had so little hands-on government experience. Ray Dalio, legendary investor and head of the Bridgewater hedge fund, calculated that the eight top Trump administration officials (president, vice president, chief-of-staff, attorney general, and Secretaries of State, Commerce, Defense and Treasury) had just 55 years of cumulative government experience, much of which was actually the result of military service. Dalio further noted that the Obama administrations top eight had 117 years of collective experience, while the presidencies of George W. Bush, Bill Clinton, and George H.W. Bush had 80, 101, and 79 years each, respectively.²

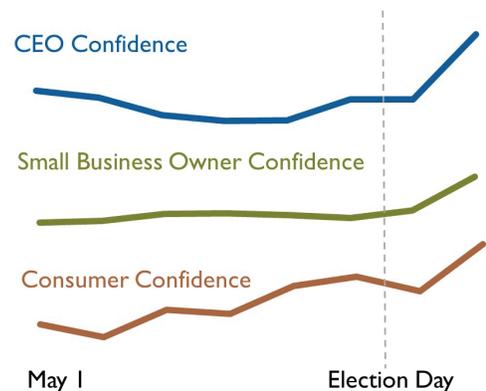
On the other hand, Trump’s top team has a collective 83 years of business experience, this versus President Obama’s administrations’ collective *five years*. Said Dalio, “We are about to experience a profound, president-led ideological shift. This could have a much bigger impact on the U.S. economy than one would calculate on the basis of changes in tax and spending policies alone, because it could ignite animal spirits.”²

If it feels like we are living in a brave new world it’s because *we are*. More than one client has asked us of late, often using more colorful language, “*What the heck is going on?!*” Being dispassionate, even clinical, is both a huge asset and a hallmark of our craft. We often offer self-descriptions such as, “We are from Switzerland,” or we first and foremost “fly by our own instruments.” At a time when some observers have quipped that, “Rage is the new Hope,” these bromides have served their intended purpose and have helped to sooth some frayed nerves and bruised egos.

While Goldman Sachs famously forecast a 20 percent decline in share prices resulting from a Trump victory, the tale of the tape since election night has been quite the opposite - and remarkable in many respects. The S&P 500 has leapt nearly 14 percent since that wild night, achieving its best four-month-run in six years. Globally, the strength in equity prices has not been confined to the U.S. The all-world indices closed recently at record highs for the first time in nearly two years. In our view, there are three things that are now at work and have coalesced somewhat simultaneously, and have served to buoy the market.

The first is that optimism has improved. This has happened quite dramatically across three important segments of the economy that are easily and reliably measured: consumer confidence, CEO confidence, and perhaps most importantly, small business confidence. In the month post-election, the small business confidence index registered its largest monthly increase since 1986.³

Great Expectations: Confidence



Source: Bloomberg

Some observers have convincingly argued that this surging optimism may be most closely correlated with the prospects for a more relaxed regulatory environment. Small businesses share disproportionate regulatory burdens relative to larger businesses, since they have a much smaller base upon which to spread these regulatory burdens and have little or no lobbying power.

The second important consideration revolves around the prospects for U.S. GDP growth going forward. The average annual growth rate for the 30 years preceding the 2007-2008 financial crisis was 3.1 percent.⁴ The U.S. economy is now, and has for a number of years, been growing closer to 2 percent. What appears to be happening is this: the market is looking at the new administration's proposals and assuming that at least a handful will become reality. These would include a tax holiday to repatriate several trillion of U.S. company profits now residing offshore, a lower corporate tax rate (the U.S. has the highest corporate tax rate in the developed world) and a fairly dramatic relaxation of regulations. While estimates of just what these changes might mean for growth are all over the map and somewhat suspect, what we do know with some certainty is that the incremental benefit to GDP growth is not ... *zero*. A faster rate of growth is not a longshot, and would seem at least to some extent, to be baked in the cake.

Lastly, it appears that the market is *behaving itself*. That is, markets seem to be rising - seemingly in a vacuum - and volatility is *unnaturally low*. This can often be a reason for concern, as low levels of volatility can often presage sharp corrections or even bear markets. But there is perhaps another explanation. Since the financial crisis, virtually every important investor class owns *fewer stocks today* than they did nine years ago. There has been, in fact, a massive secular shift out of equities over the last nine years. These funds have gone almost exclusively into bonds. This is even more remarkable given the fact that stocks have appreciated some 300 percent over that same time period.

Interestingly, the marginal buyer of these shares has been the constituent (index) company's themselves. In the five years that ended Q3 2016, companies in the S&P 500 have retired more than \$2.5 trillion worth of stock. Goldman Sachs' Chief U.S. Equity Strategist David Kostin has

calculated that corporate share buybacks have been the single biggest source of demand for U.S. stocks since the financial crisis, providing a "... *vital pillar of demand at a time when domestic pension funds and foreign investors have largely been selling.*" He further notes that U.S. companies bought back \$644 billion of their own shares in 2016, a new record.⁵

It is also very interesting to us that the investor "euphoria" historically associated with the end of a bull market is largely absent. To wit: in 2015, the last year for which the data is available, cash accounted for a whopping 28 percent of affluent U.S. investors' portfolios. This up from 25 percent a year earlier. Cash holdings are even more robust in the portfolios of affluent investors in both Europe and Asia, at an astonishing 40 and 37 percent, respectively.⁶ Post-crisis, these investors appear to be frozen, and have missed one of the greatest bull market cycles in financial history.

Voters came to the ballot box last November ornery and angry. For at least half the country, the unexpected outcome offered little to no comfort or solace, and, if anything, hardened already inflamed feelings on both sides. Intentionally or not, they did vote for a form of generic change that we've never experienced before. Turning over the keys to the "C-Suite" crowd is a great experiment. No one can say with certainty whether a former CEO or CFO will be any better for our great nation's future than a former Governor or Senator. Whether or not this experiment will be good for our country and economy is, and will remain for some time, an open question. But we will happily admit that we are often humbled by the markets, and this is one of those times. What we do know is that there appears to be an important and powerful shift in the *psyches* of business people.

Weapons of Reason footnotes and sources:

1. Irwin Neil, "Why the Markets are Defying Forecasts of Gloom and Doom," *New York Times*, March 2, 2017.
2. Gillian Tett, "Trump Team Unleashes Animal Spirits," *Financial Times of London*, January 6, 2017.
3. Landon Thomas, Jr., "Small Business' Hopes are Up," *The New York Times*, March 13, 2017.
4. Edward P. Lazear, "How Trump Can Hit 3% Growth - Maybe," *The Wall Street Journal*, February 28, 2017.
5. Robin Wigglesworth, "ETF's Curb Gains from Stock Repurchases," *The Financial Times of London*, March 2, 2017.
6. Ralph Atkins, "Higher Rates Will Remove the Need for a Cash Comfort Blanket," *The Financial Times of London*, February 15, 2017.



FLOW OF FUNDS FROM EQUITIES COMING BACK?

Jason Norris, CFA
Executive Vice President of Research

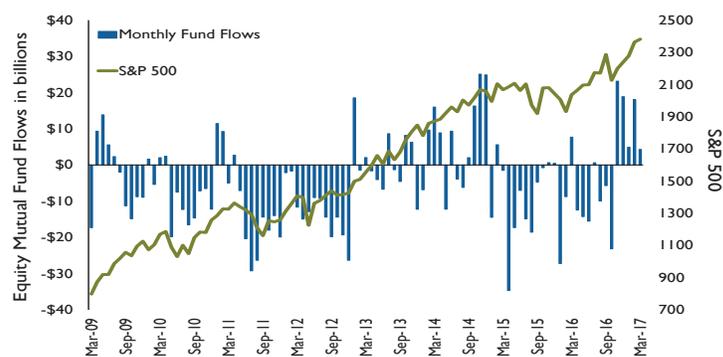
We recently celebrated the eighth anniversary of the bull market. Since then, U.S. stocks have been the best performing global asset class yet they have been the least loved. From March 2009 until the election of 2016, investors have pulled over a half a trillion dollars out of U.S. equities ... yet equities have appreciated by some 300 percent. This outflow can be seen in the accompanying chart that highlights the monthly fund flows in and out of U.S. domestic equity mutual funds and ETFs.

So why have stocks been rallying when investors have been selling? The answer: company buybacks. Bernstein Research estimates that companies have announced over \$500 billion in share buybacks in the U.S. last year, which is down from \$650 billion in 2015. Shares outstanding for Large Cap U.S. companies are hitting record lows. With company margins at record highs, and cash generation remaining healthy, we expect this trend to continue. Fi-

nally, if there is a repatriation holiday for U.S. companies to bring back the \$2.0 trillion of cash held overseas, these buybacks will continue.

Since this bull market has been unloved by individual investors, we are often asked if it still has legs. We believe it does as since the election, investors have purchased over \$65 billion of U.S. stocks. This is only slightly more than 10 percent of what was sold. Therefore, even though we believe the market is near fair value, we have an upside bias as investors look to chase returns.

Investors Return to Equity Market



Sources: FactSet and ICI



Coupon-minus: The amount a bond earns when considering the yield-to-maturity less some loss of market value caused by the increase in interest rates over the course of the year.

Flow of Funds: The net of all cash inflows and outflows from one type of financial asset to another. Flow of funds measurements only share redemptions and share purchases. Investors watch fund flows to gauge investor sentiment within a particular asset class, sector or the market as a whole.

Price-Earnings Ratio: A company's current price compared to per-share earnings. A high P/E means investors anticipate future higher growth. If a company is losing money, it will not have a P/E ratio.

Tax Repatriation Holiday: A tax reprieve which gives U.S. multinational corporations a one-time tax break on money earned in foreign countries to incentivize them to transfer money back to the U.S.

In an effort to provide clarity and explain industry-specific terms, we have included these definitions. For additional resources, you may contact us at info@fergwell.com for a copy of our Glossary of Investment Terms.

Sources:
Business Dictionary
Ferguson Wellman
Investopedia
Wikipedia

Never let the future disturb you. You will meet it, if you have to, with the same weapons of reason which today arm you against the present.
- Marcus Aurelius