

MARKET LETTER

MARKET PERSPECTIVE  SECOND QUARTER 2019



DELAYED ARRIVAL

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IN THIS PUBLICATION

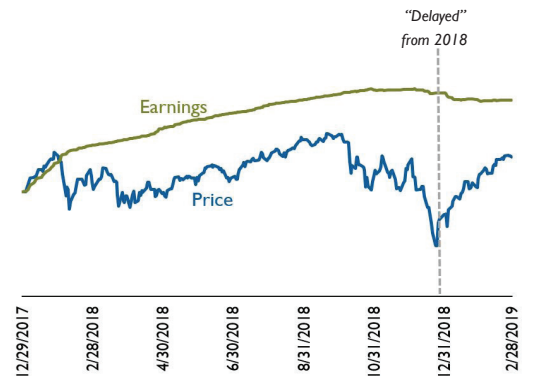
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A turbulent finish to 2018 has given way to a nearly-unchecked ascent for stocks in the new year. Double-digit gains in equities are impressive in their own light but in our view, represent in large part the “delayed arrival” of returns from last year that were interrupted by the fourth quarter correction. As illustrated at right, stock prices that had temporarily decoupled from a still rising stream of corporate profits are now back near all-time highs.

In contrast to fears that the Fed might overdo its quest to normalize interest rates, central bank commentary in 2019 has turned decidedly dovish. Acknowledging that slowing economic growth continues to be accompanied by tame inflation, at its March meeting the Federal Reserve moved to a “neutral” monetary stance.

As the U.S. economic expansion approaches record length, a healthy job market with near record-low unemployment continues to support growth in consumer spending but has yet to produce the type of excessive wage growth needed to tip the scales of inflation. The flip side of this coin is that without materially higher prices to recoup moderately higher wages, profit margins for corporate America are becoming increasingly difficult to sustain. As such, the onus falls on corpo-

Equities Regain Their Composure



Source: FactSet

rate revenues to deliver what have become relatively modest expectations for mid-single digit earnings growth this year.

While equity valuations have rebounded, they are near average levels in the U.S. and remain attractive overseas. Accordingly, we are retaining a “neutral” stance on U.S. equities while continuing to modestly favor international equities.

In a later-cycle economic environment, our equity sector weightings continue to evolve in a more defensive manner across strategies.

Alongside stocks, bonds have rallied this year as well. With yields on the benchmark 10-year U.S. Treasury falling below 2.5 percent, we remain underweight fixed income with a bias to a slightly shorter duration and an emphasis on higher quality issues.

Founded in 1975, Ferguson Wellman is a privately owned registered investment advisory firm, established in the Pacific Northwest. As of January 1, 2019, the firm manages over \$5 billion for more than 830 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



BRINGING BACK THE BOW TIE

Dean Dordevic, Director
Alternative Assets and Portfolio Management

"More than 10 years of free money has rendered the fine art of stock picking as seeming to be somewhat anachronistic and quaint ... a little bit like model railroading ..."

-Jason DeSena Trennert, Chairman and CEO, Strategas Research Partners¹

Twenty years ago, this would have hardly been a consideration. But more recently we've noticed a subtle shift in the attitudes of prospective clients seeking our services asking, "Is it possible for us to own individual stocks?" This question wouldn't have registered in the top five, or even top ten most critical screening criteria years ago, but the thirst to own individual stocks, at least for some, seems to be gaining some nascent traction. For those with especially strong moral and religious beliefs, it can even be a dealbreaker. What's more, the explosive rise in environmental, social and governance (ESG) investing, synonymous with sustainable investing, socially responsible investing, even mission-related investing, has fed this desire as well.

Like the evolutionary biology attached to humans adapting to the drinking of milk, over the last few decades financial markets have become increasingly ... *homogenized and pasteurized*. While equity-oriented mutual funds have been around for decades, nowadays, and with increasing frequency, equity investments are more-often-than-not served to investors prepackaged in the form of so-called ETFs or exchange traded funds. An ETF is essentially a basket that's been filled with an investment. The basket can be filled with just about anything, like all of the large publicly-traded drug companies, for example. In this case, you own *the drug industry* versus an individual company.

While an inherently passive investment, even active managers are constructing entire portfolios out of these financial LEGOs. This has occurred to such a degree, that for legions of investors the ownership of common equity has become a sterile, even clinical exercise. To a very significant degree,

investors have become increasingly *detached* from the *value* they seek. Price and value are joined at the hip, of course. But when they become *divorced from each other*, unintended consequences can gradually precipitate that are both subtle and profound.

Looking back on the post-financial crisis decade, there are two related themes that stand out. The first is the emergence of the so-called "risk-on, risk-off" paradigm. This lexicon describes investors who are in fact making only a *binary decision*. That is, to either *own risk* or *own safety*. In this case, "risk-on" is typically defined as buying stocks and "risk-off" as moving to cash or bonds. By our lights, this came to pass with the assistance of the Federal Reserve as they unrelentingly *drove interest rates to zero*. By doing so, the Fed had created an environment where "riskless" investments (cash and bonds) were being made increasingly less attractive, therefore driving investors into stocks, or "risk." Investors weren't buying ... *Apple per se*, they were buying "stocks." So, as a curious byproduct of these policies, equities had become, or had been reduced to ... *a commodity*.

The other theme that played out during this cycle was that investors of all stripes *were net sellers of common stocks for the past decade*. This was very much the case for both individual and institutional investors alike. Individual investors *have largely sat out* what has been a 10-year bull market. This is a remarkable, and unfortunate response to two bear markets inside a decade whose 50-percent declines created a profound distaste for "risk." Ironically, the principal *buyer at the margin* have been *companies repurchasing their own shares*. American companies were only too happy to sop up these attractive shares. Compounding the problem has been the simple fact that some of the most exciting and innovative companies (e.g., Uber and Lyft) are *private*.³ In short, this has been the *most hated bull-market of all-time*.

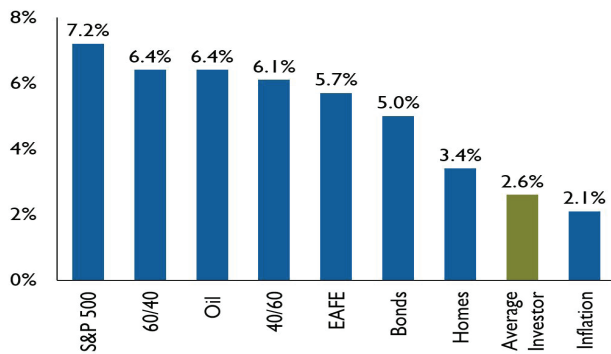
For the 20 years ended 2017, the S&P 500 has compounded at a rate of 7.2 percent per year. While that might not sound like a lot, it is. At that rate you double your money every 10 years. So, over 20 years one million becomes four. Astonishingly, the average investor hasn't earned anything close to that figure. Estimates show that individual investors have earned rates of return of only about 2.6 percent over that same time period.² Their returns barely beat inflation and

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

were only *one-half the returns* earned from the relative safety offered by bonds. As such, in our view the *commoditization* of equity ownership has *irreparably changed the behavior of unwitting investors*.

We believe that for *our investors*, there is enormous value in knowing *what you own and why you own it*. Owning individual shares is the key to this exercise. Why? When volatility and uncertainty reign, as it does all too often ... it's all too easy to sell *stocks*, that is your *commodity*. But it's so much harder to part with your shares of say ... *Apple*. When what you own is only a number, a *price* that is ... one's notion of *value* is completely lost. And remember this powerful math. The stock market is the only market on the earth where people flee the 50-percent-off sale. If you missed the 40 best days, over the last 20 years, you would have *lost money in the stock market*. Those days almost always come after the point of maximum pain.

Annualized Returns by Asset Class² 1998-2017



Sources: JP Morgan, FactSet

On Friday, March 1, a number of us at Ferguson Wellman gathered in our office to take this wonderful photo. That date marked the 41st anniversary of our dear departed partner, Roger Van Winkle's first day with our firm and we thought bow ties were a very fitting way to honor both his memory and service. Roger frequently wore bow ties to the office, and in fact some of those pictured were wearing ties he had

bequeathed us. He was a gentleman and "old school" in every sense of the word. Furthermore, Roger was someone who appreciated the *art of what we do* and was an inveterate believer in both the power of markets, and the wealth that could be had from *good old-fashioned stock picking*.

Roger, we miss you, honor you and salute you.



Back: Don Rainer, Nathan Ayotte, Alex Harding, Timothy Carkin, Shawn Narancich, Marc Fovinci, Patrick Yazhari, Blaine Dickason, Michael Garcia, Joe Brooks. Front: Josh Frankel and George Hosfield.



Roger "Rip" Van Winkle spent 20 years of his career at our firm.

He was an accomplished professional whose wit and investment acumen helped shape our firm's culture.

Weapons of Reason Footnotes and Sources:

1. Jason DeSena Trennert, Strategas Investment Partners' Investment Strategy Report, February 22, 2019.
2. Dr. David Kelly, "Making Hay and Fixing Roofs: A Guide to the Markets," J.P. Morgan Asset Management, October 2018.
3. Jason DeSena Trennert and Ryan Grabinski, Strategas Investment Partners' Investment Strategy Report, March 1, 2019.



ARE WE THERE YET?

Blaine Dickason
Vice President, Fixed Income Trading and Analysis

“My colleagues and I have one overarching goal: to sustain the economic expansion with a strong job market and stable prices, for the benefit of the American people.”

- Chair Jerome Powell, March 20th FOMC press conference

With these words, Federal Reserve Chair Jerome Powell began his March FOMC press conference and established a new implicit goal for the central bank beyond their statutory dual mandate to promote full employment and stable prices. As recently as September of 2018, the Federal Reserve’s median projection was for an additional four interest rate hikes in 2019. Trade and global growth fears along with concern about increasingly restrictive monetary policy all contributed to stock market weakness at the end of 2018. Cognizant of deteriorating market conditions, Chair Powell executed what is being called his “dovish pivot” as he suggested the FOMC would be “patient” when considering future rate increases. In a dramatic turnabout, as of the March press conference, there are now NO interest rate hikes projected for all of 2019.

In December of 2015, the Federal Reserve ended its near-zero interest rate policy and initiated the first of what has now been nine 0.25 percent increases to the Federal Funds rate to reach our current range of 2.25-2.50 percent. This has been not only one of the smallest and most gradual of tightening cycles, but perhaps in hindsight may also be noted for how quickly it appears to have reached its terminus.

After a decade of historically low interest rates, it is understandable that the Federal Reserve has aspired to return rates back to “normal,” i.e. higher levels. This would allow them to step out of the policy spotlight while at the

same time give them room to cut rates when needed in the future. Unfortunately for this plan, the goal line has moved and with slowing global growth and tame inflation, their estimate of normal or neutral rates has steadily trended lower and contributed to this policy shift.

Contemplating the End of the Fed Tightening Cycle



Sources: Federal Reserve, Federal Reserve Bank of St. Louis

Upon his nomination to lead the Federal Reserve, Chair Powell was regarded as a pragmatist with the business background to temper the academic prescriptions that may have contributed to past policy missteps. His dovish pivot and the new, lower level of current and projected policy rate should not only be supportive of stock valuations, but will aid the interest rate sensitive sectors of the economy (i.e. housing, industrials) that can have an outsized influence on economic growth. Ultimately, Chair Powell and the Federal Reserve will be graded for whether they can orchestrate an often elusive soft landing for the economy and thus prolong our current expansion.

Our logo features a bronze coin of Marcus Aurelius Antonius, 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 meditations that reveal a mind of great humanity, natural humility and wisdom.