FERGUSON WELLMAN

CAPITAL MANAGEMENT

# Removing the Training Wheels

2014 Investment Outlook

# "Beyond the Cliff"

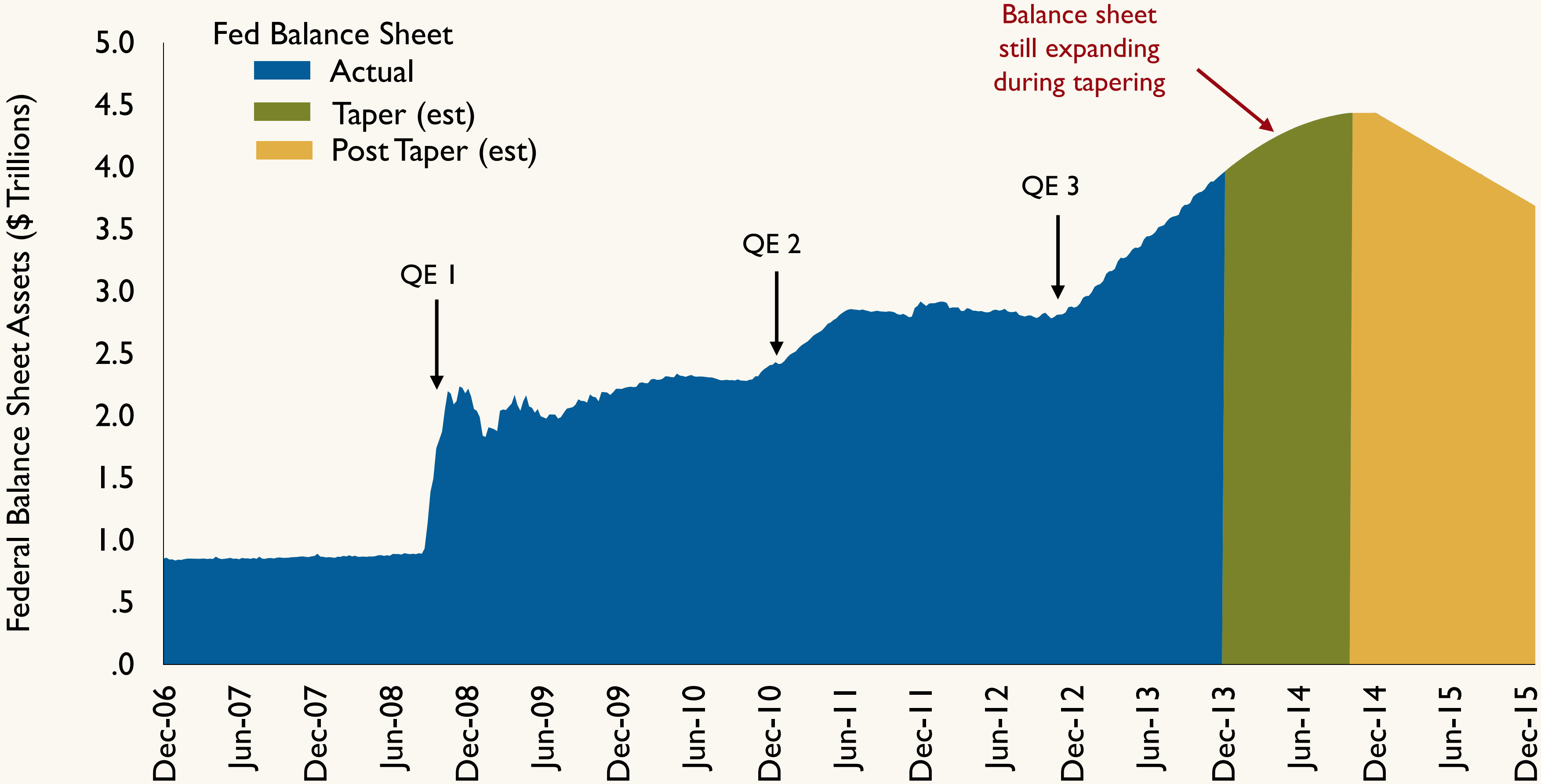
## 2013 Investment Outlook

# "Beyond the Cliff"

## 2013 Predictions Revisited

| | What we said | What occurred |
|---|---|---|
| **Macro Economy** | • Slow improvement in unemployment<br>• An EU recession but no breakup<br>• Sluggish growth across the globe<br>• Growth to accelerate in the second half | ✓ Unemployment rate dropped from 8.6% to 7.0%<br>✓ GDP should be approximately 2% for 2013 |
| **Fixed Strategy** | • Subdued inflation<br>• Rates to trend higher<br>• Corporates offer value | ✓ Total CPI approximately 2%<br>✓ 10-year Treasury rose from 1.9% to 2.9%<br>✓ Corporate bonds outperform Treasury bonds by .66% |
| **Equity Strategy** | • Underweight defensive sectors<br>• Underweight interest sensitive sectors | ✗/✓ Healthcare +41%, staples +26%<br>✓ REITs +2%, telecom +6% and utilities +13% |
| **Asset Allocation** | • Stocks over bonds<br>• Expect to accelerate move away from fixed<br>• Emerging markets over developed | ✓ S&P 500 +32%, bonds -2%<br>✓ Added to equities early in the year<br>✗ Emerging markets -5%, Developing markets +22% |

# Tapering Doesn't Mean Tightening

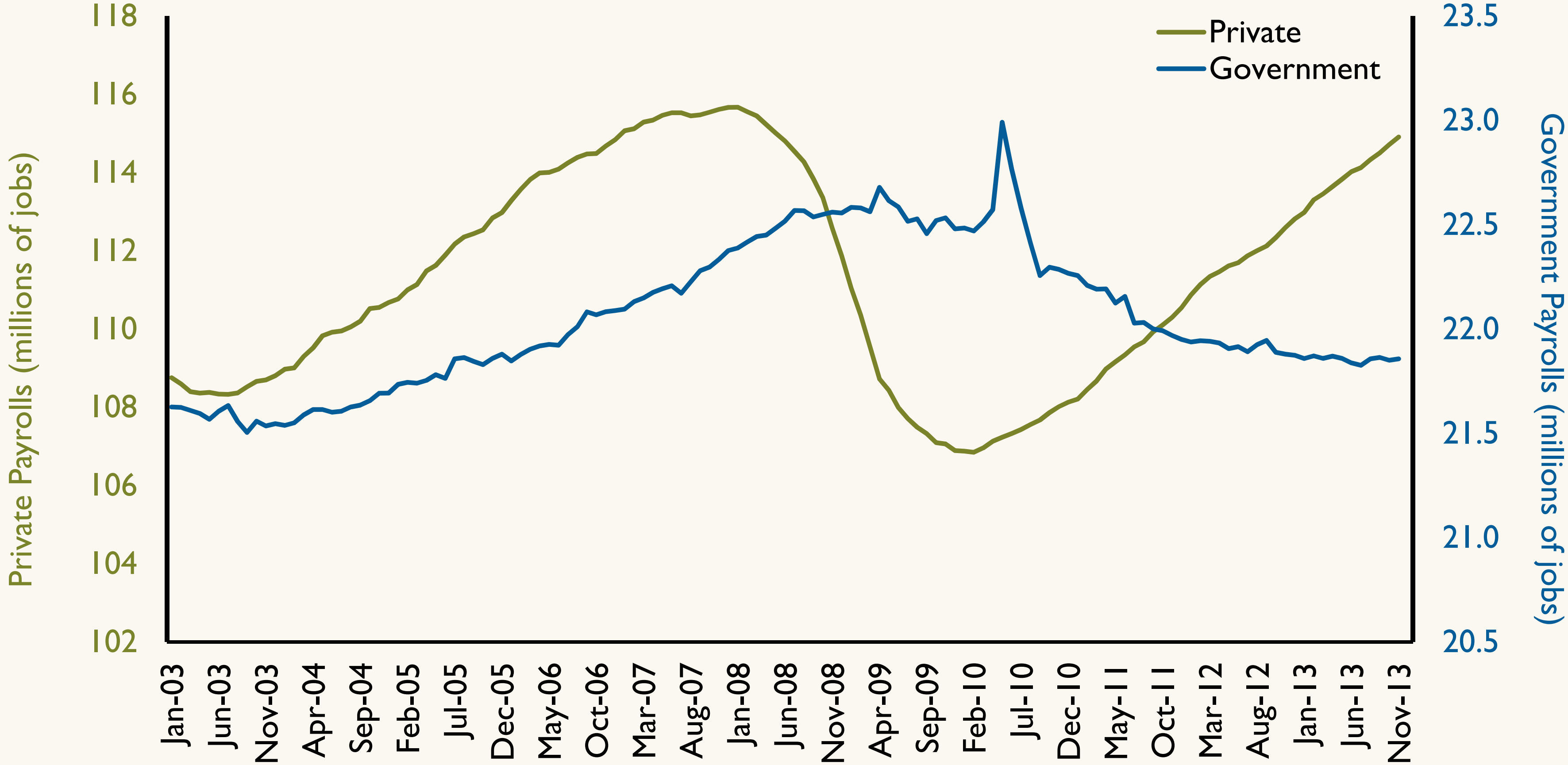



Source: Federal Reserve

- Post-tapering, plenty of money will remain in the financial system
- Through paydowns and maturities alone, the balance sheet will return to 2008 levels in 2019

# Government Following Private Sector

## Job Market Recovery May Accelerate in 2014

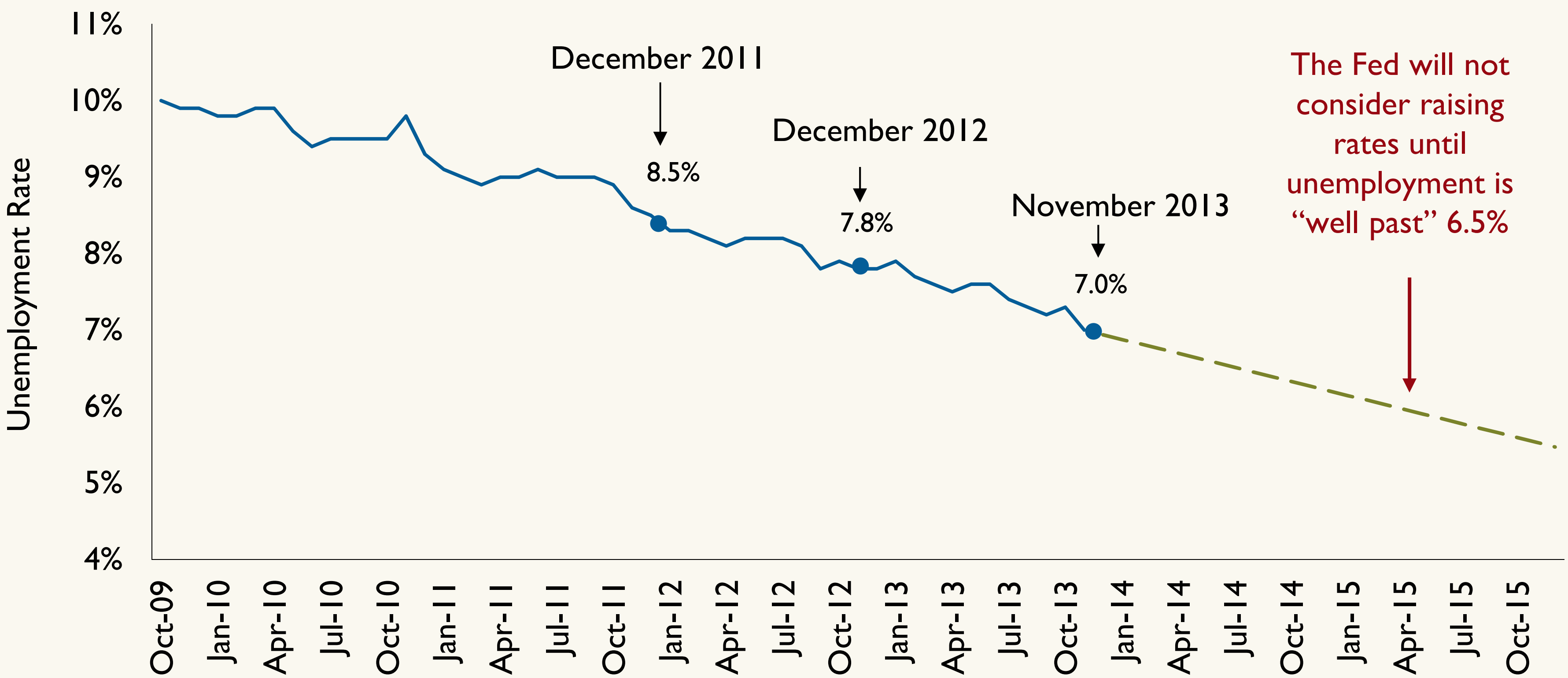



Source: U.S. Bureau of Labor Statistics

- Lackluster economic growth has contributed to sluggish job creation
- We still need 1,290,000 more jobs to get back to the 2008 nonfarm payrolls peak
- Private sector has led public sector by several years
- Government sector is being led by state and local entities
- Improving state and local budgets are constructive for municipal bonds

# Unemployment Rate the Fed's Best Indicator

## Slow, but Steady Improvement Means the Fed is in No Hurry

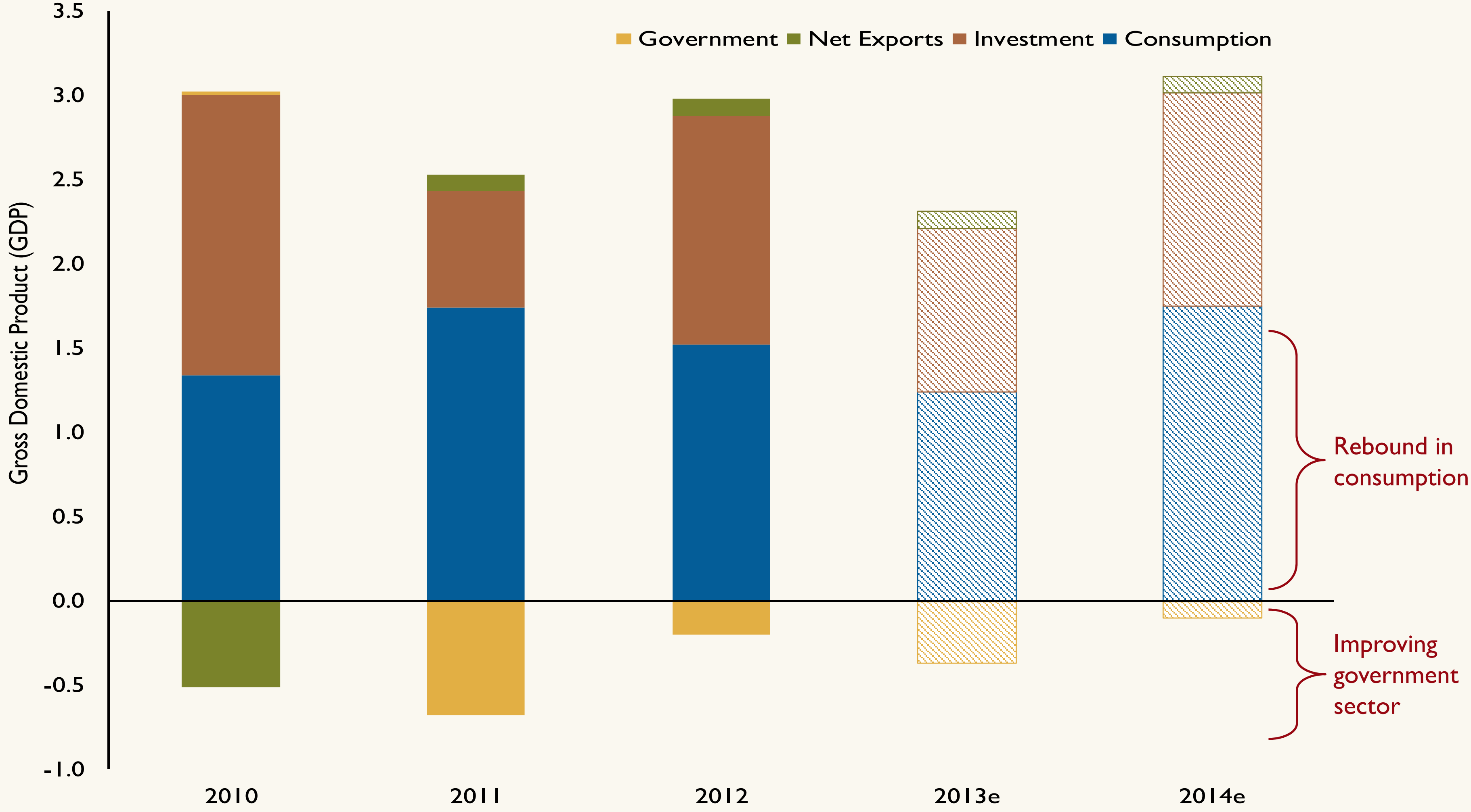



Source: U.S. Bureau of Labor and Statistics

- Tapering continues as long as unemployment keeps improving
- The Fed's timetable is dependent on future economic performance and subject to revision
- Labor force participation[1] stands at a 35-year low of 63 percent

[1]The number of people available for work divided by the total number of working age people

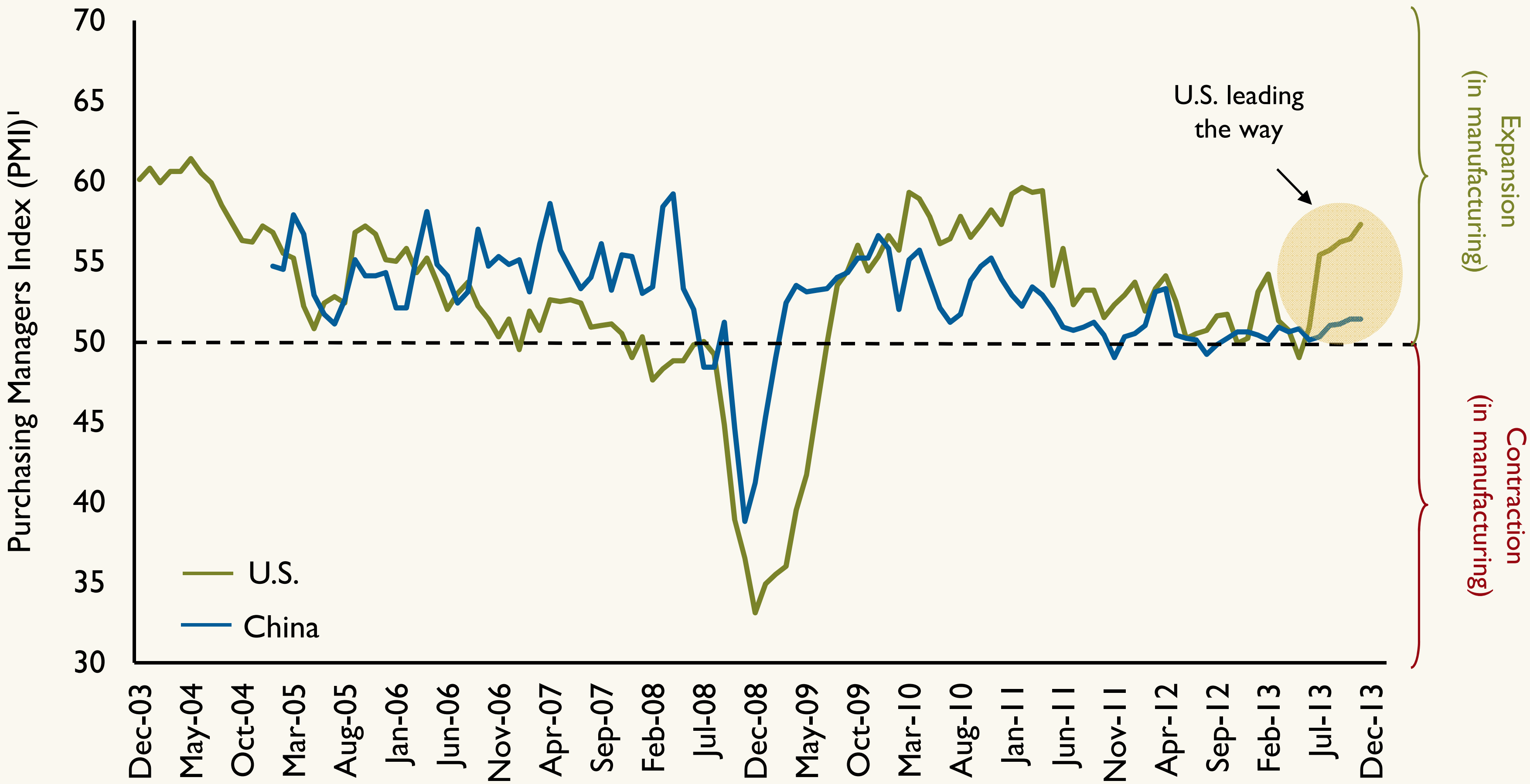
# Economy Gaining Momentum




Sources: BEA.gov, Morgan Stanley, Ferguson Wellman

- Government will provide minimal drag in the year ahead
- Expect acceleration in investment: non-residential construction, technology and general capital expansion

# Expect Growth to Accelerate



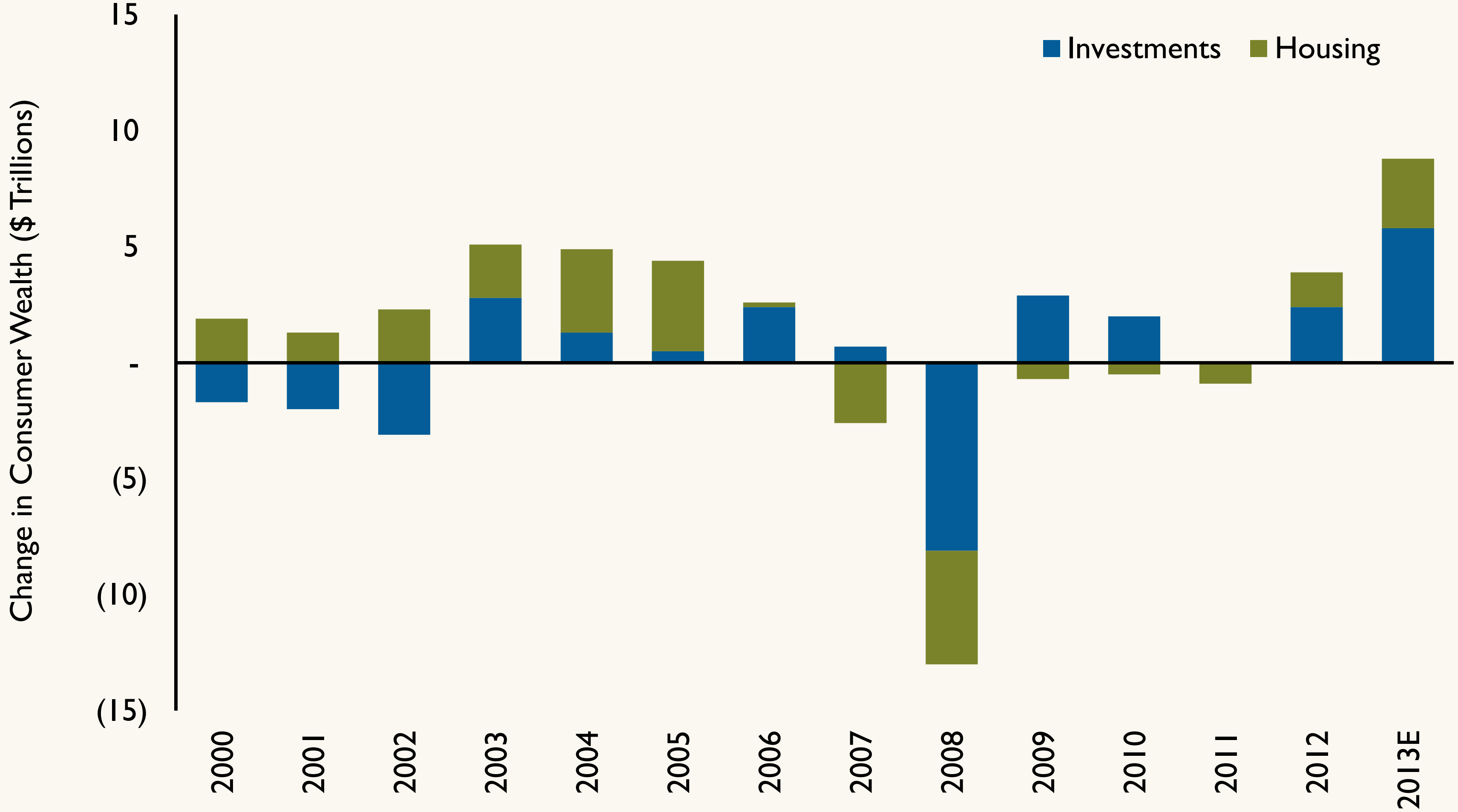

Source: FactSet

- In general, developed economies are experiencing more reacceleration than developing economies
- China appears to have engineered a soft landing, but still a risk to the global economy

[1]PMI – an indicator of the economic health of the manufacturing sector. The PMI Index is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

# The Wealth Effect!

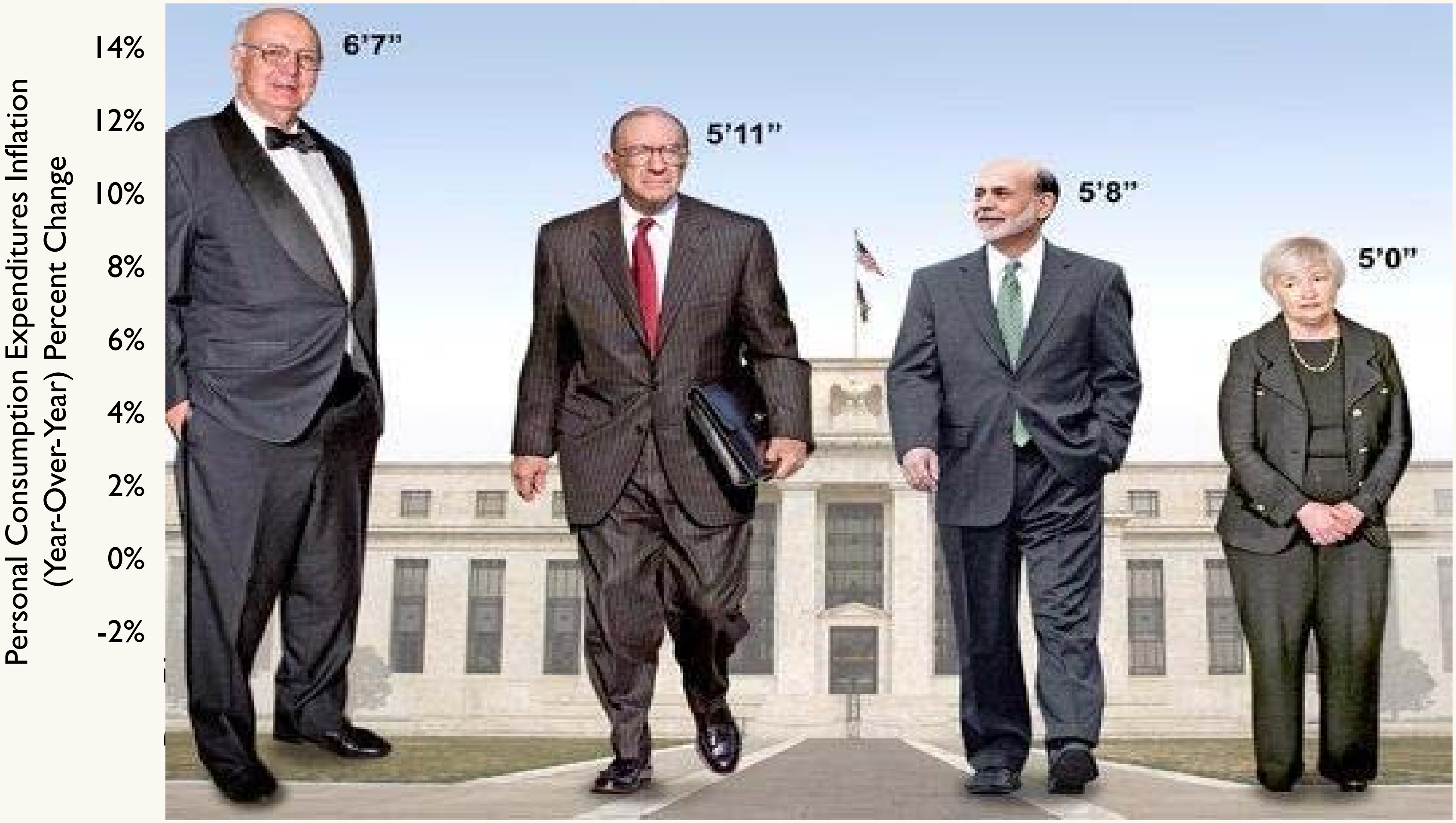
## Household Wealth from Housing and Investments




Sources: J.P Morgan Economics, J.P Morgan MBS Team, Bloomberg, Federal Reserve, Cornerstone Macro Research

- The expected increase in 2013 is likely to be the largest ever, estimated at $8.8 trillion
- Equity returning to homes should allow housing velocity to increase
- Equities up 30 percent in 2013, could lead to an additional .4 percent in consumer spending
- 10 percent increase in home prices leads to an additional .5 percent increase in consumer spending

# The Height of Inflation – The Smaller the Better




Sources: Bureau of Economic Analysis, Barry Ritholtz' blog, "The Big Picture"

- In recent years, the Fed has been fighting deflation, not inflation
- We expect core inflation to move up only to 2.5 percent over the next couple years

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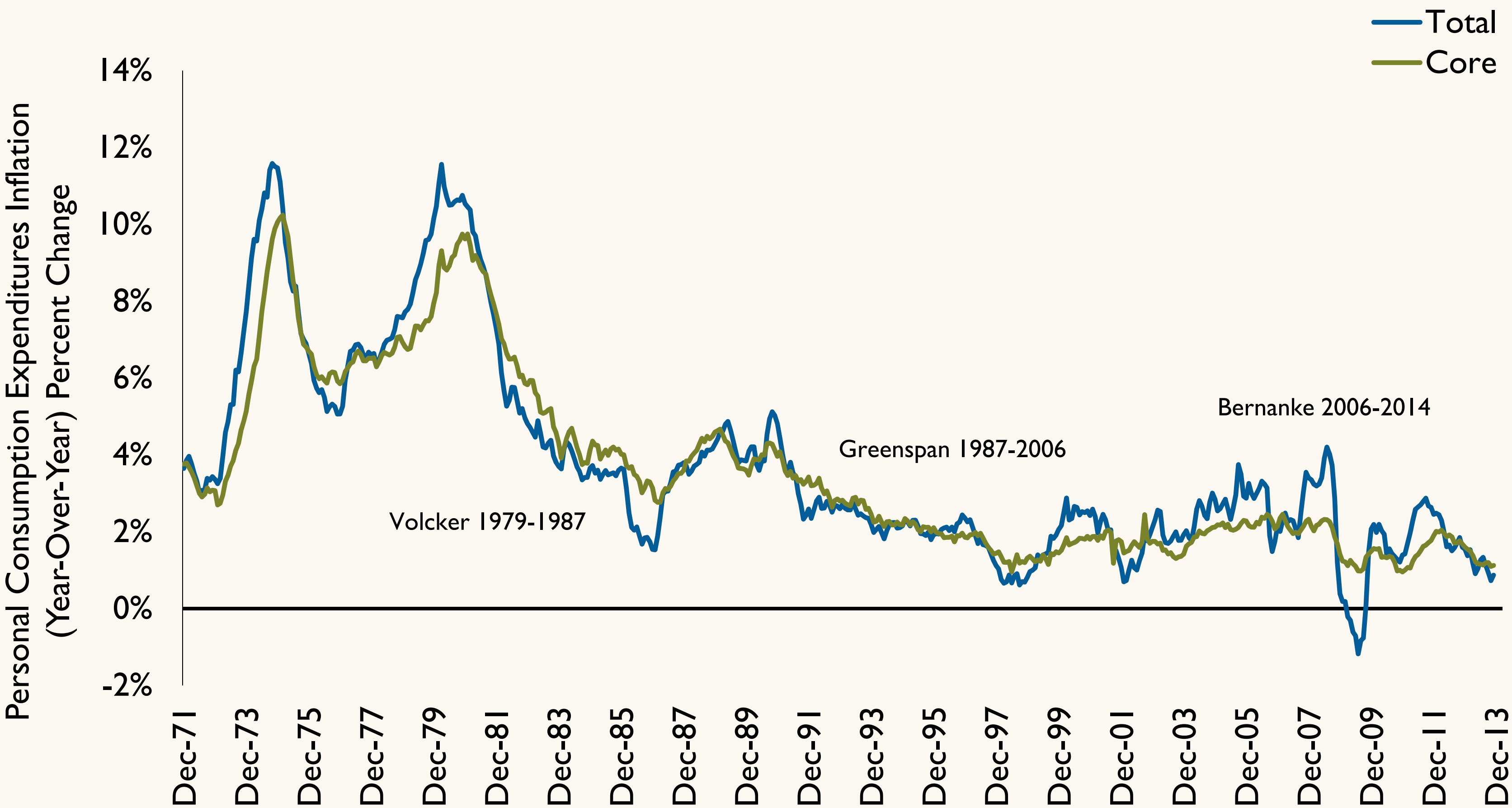


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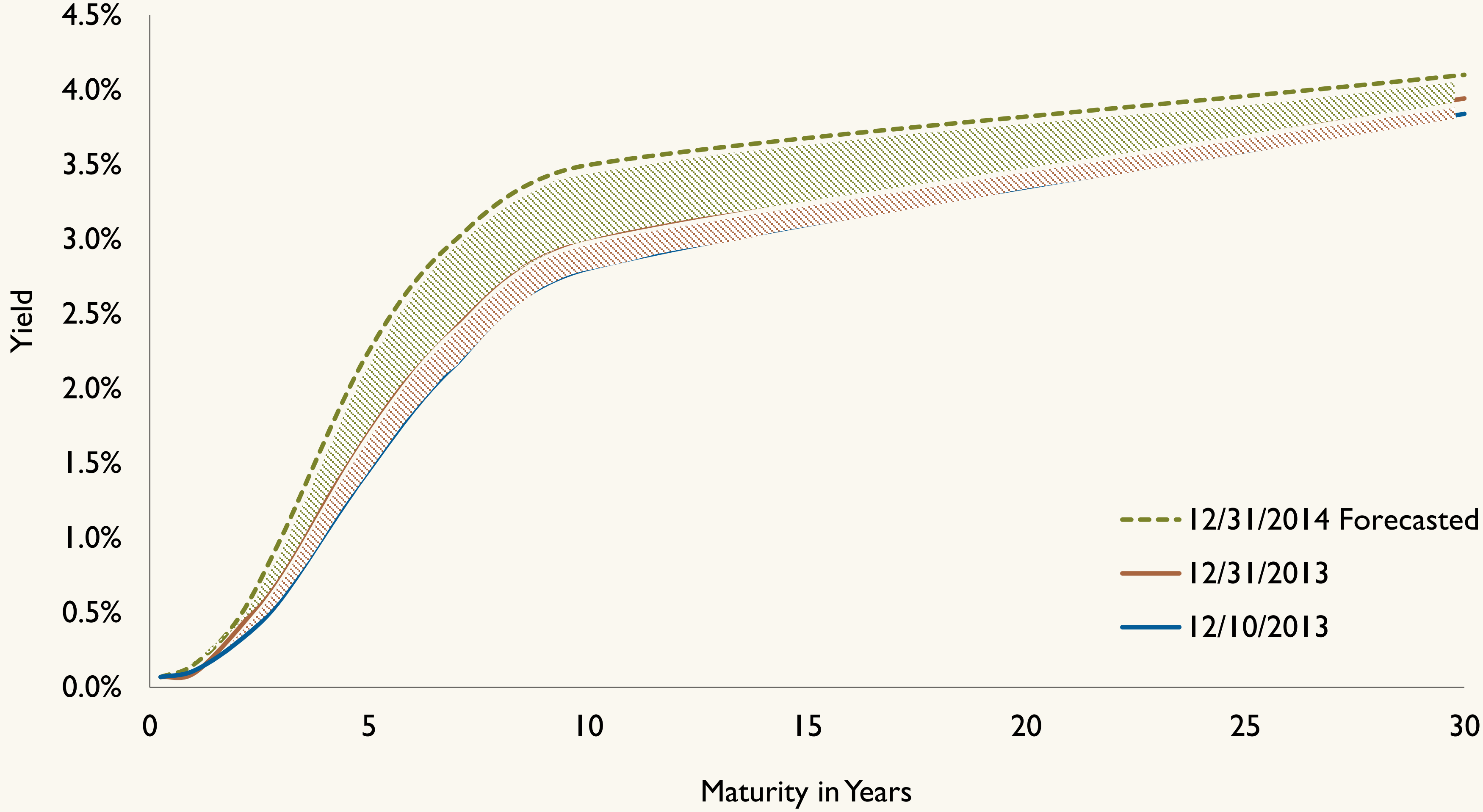
# Rates to Rise But Taper Largely Discounted

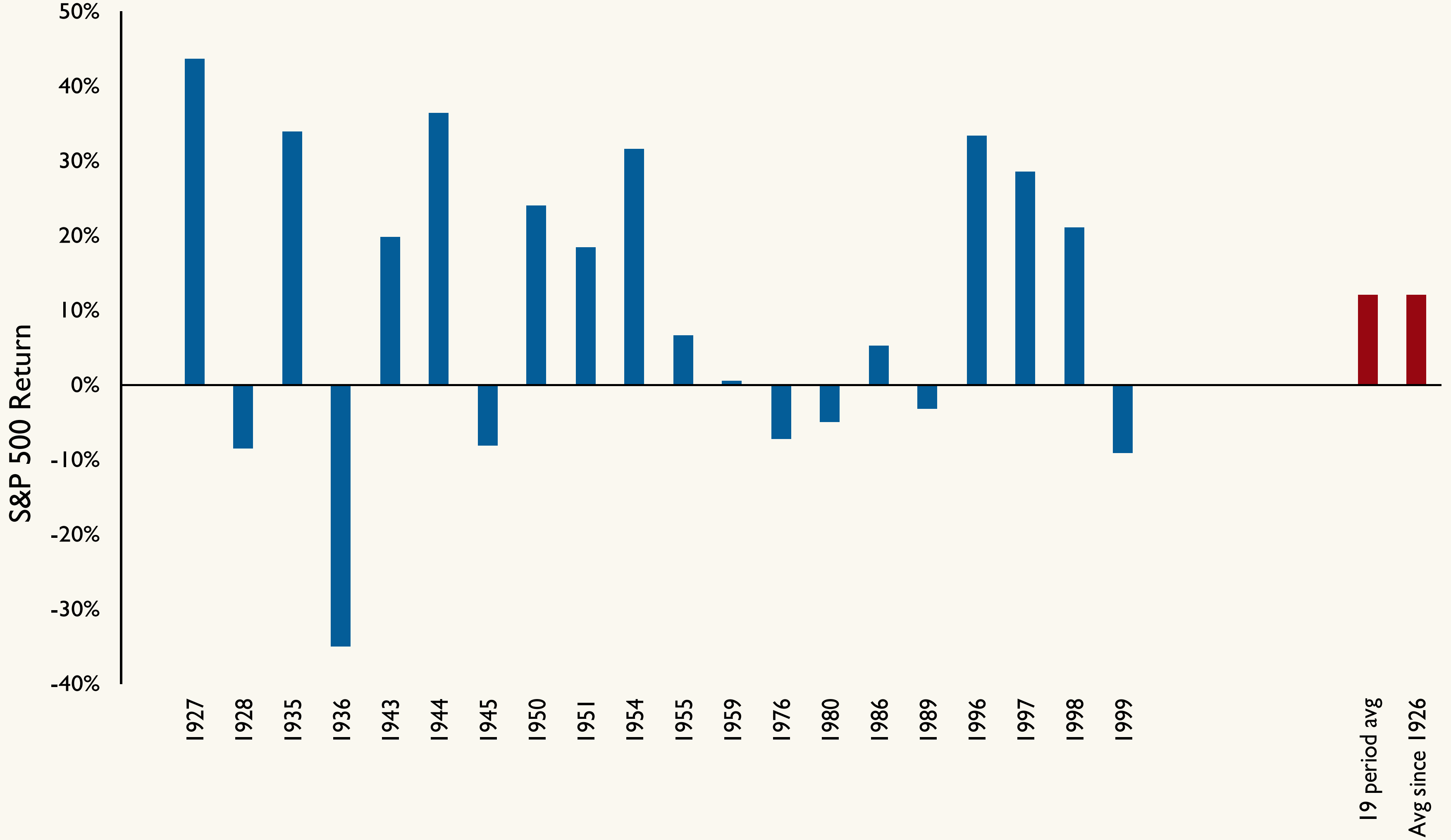



Sources: Bloomberg, Ferguson Wellman

- The Fed's taper announcement causes the market to expect higher rates sooner… but not too soon
- Less of a move in longer maturities means long-run inflation should continue to be tame
- Our fixed income portfolios remain modestly short durations relative to benchmark

# What is Next for Equities … The Average?

## Equity Returns Following a Two-Year Period of Returns over 50 Percent

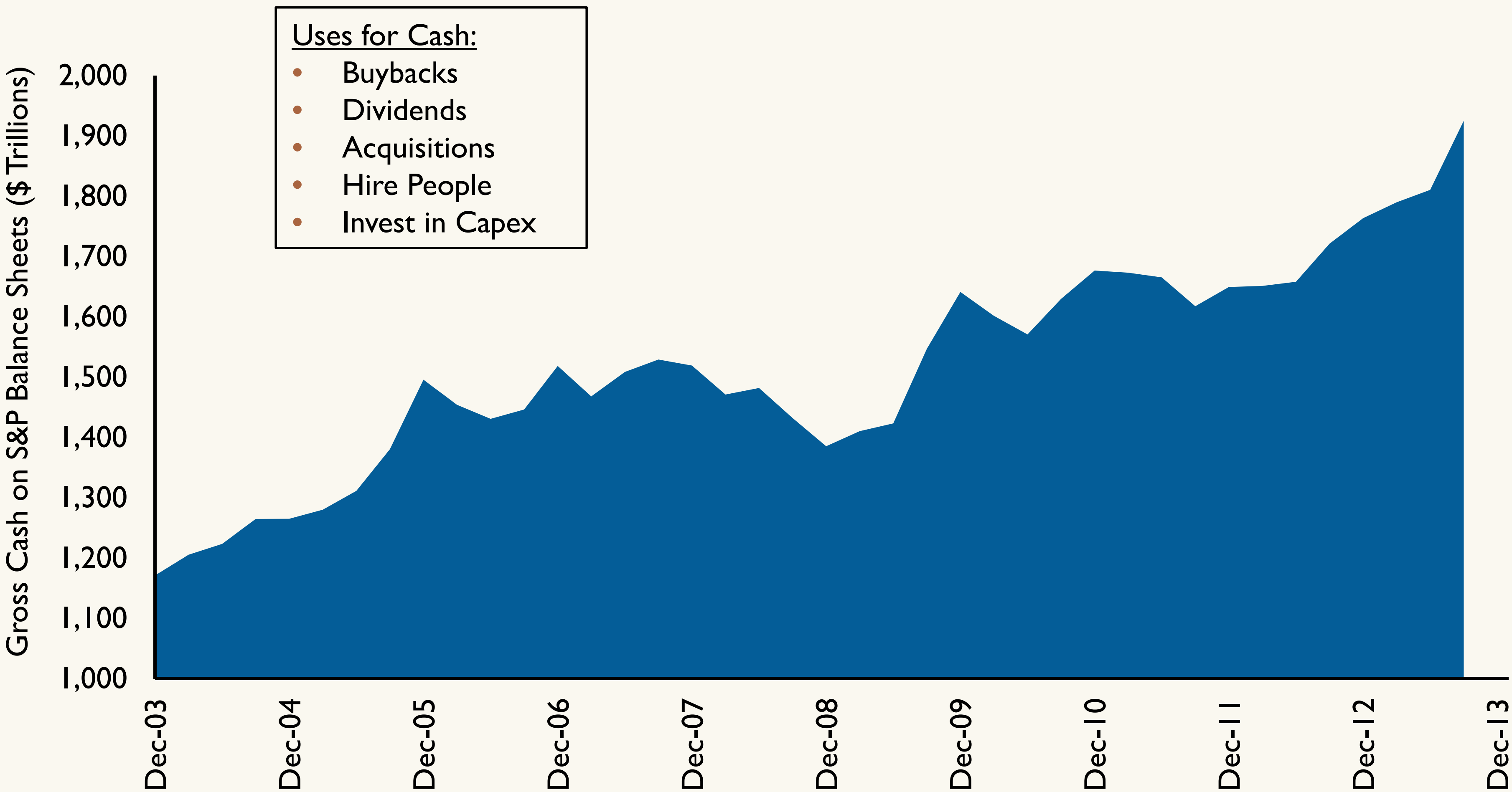



Sources: FactSet, Ferguson Wellman

- After two strong years, market returns back to average annual returns
- Over the long-term, equity returns have been positive two-thirds of the time

# Corporations May Put Cash to Work in 2014

## Corporate Balance Sheets Are in Great Shape

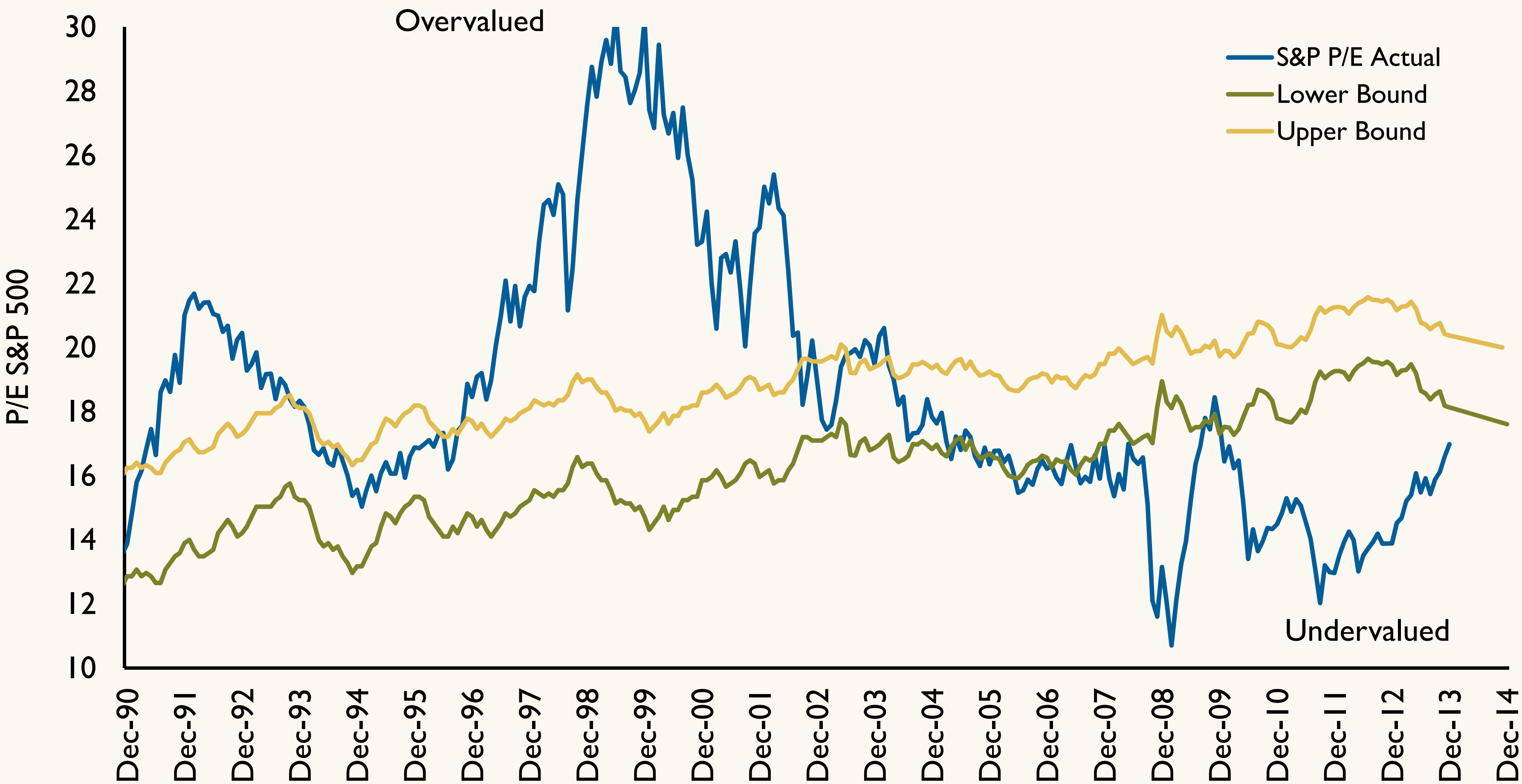



Source: Federal Reserve

- Cash as percentage of assets for corporations near all-time highs
- Large company CFO surveys found that their top two priorities for cash will be dividends and share buybacks
- When selecting stocks, we favor companies growing dividends and reducing shares outstanding

# Stocks Are Not Expensive

## P/Es are Attractive Relative to Bond Yields




Source: FactSet

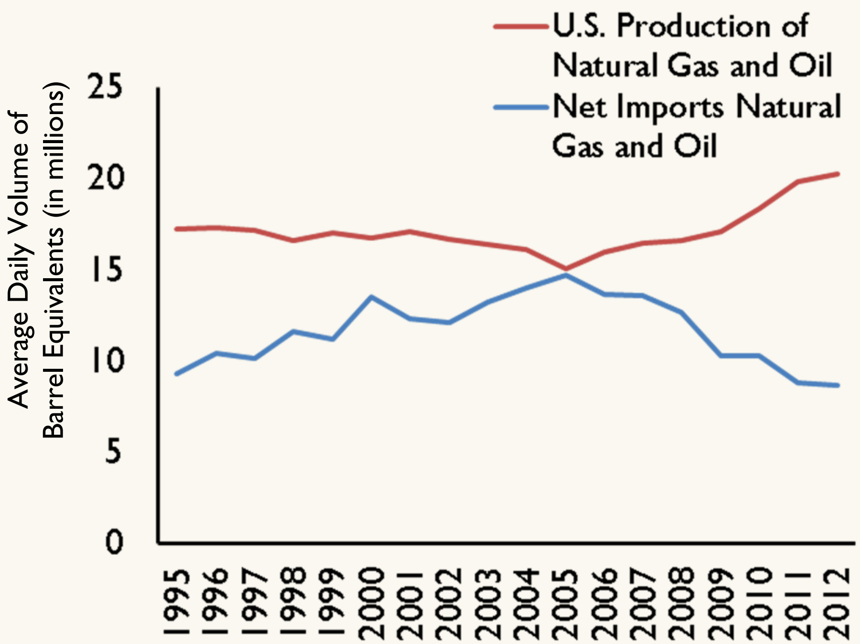
- Multiples[1] are determined by expectations for growth and interest ratios
- P/Es still low relative to bond yields
- Low rates leave room for additional multiple expansion to upper teens

[1]What investors are willing to pay for a dollar of earnings

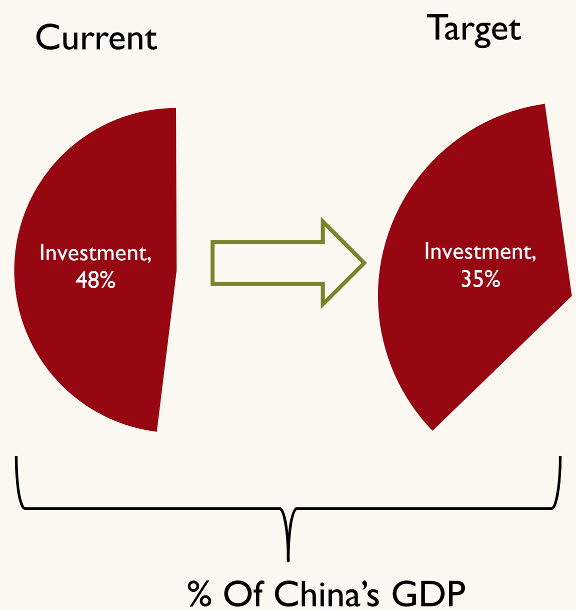
# A Key Tailwind for the Global Economy

## Commodity "Super Cycle" is Over

### More Commodity Supply




### Less Commodity Demand




Sources: ISI, Cornerstone Macro

- U.S. Energy Information Administration projects North American energy independence[1] by 2020 and U.S. in 2030
- Leads to an underweight of the materials sector and an overweight to the consumer discretionary sector globally
- China represents 40% of the world's demand for copper, 43% for steel, 45% coal and 55% for cement

[1]Import only from Canada and Mexico

# Country Allocations

## Global over/underweights

- Many countries benefit from lower commodity prices.
- Lower commodity prices benefit consumers globally

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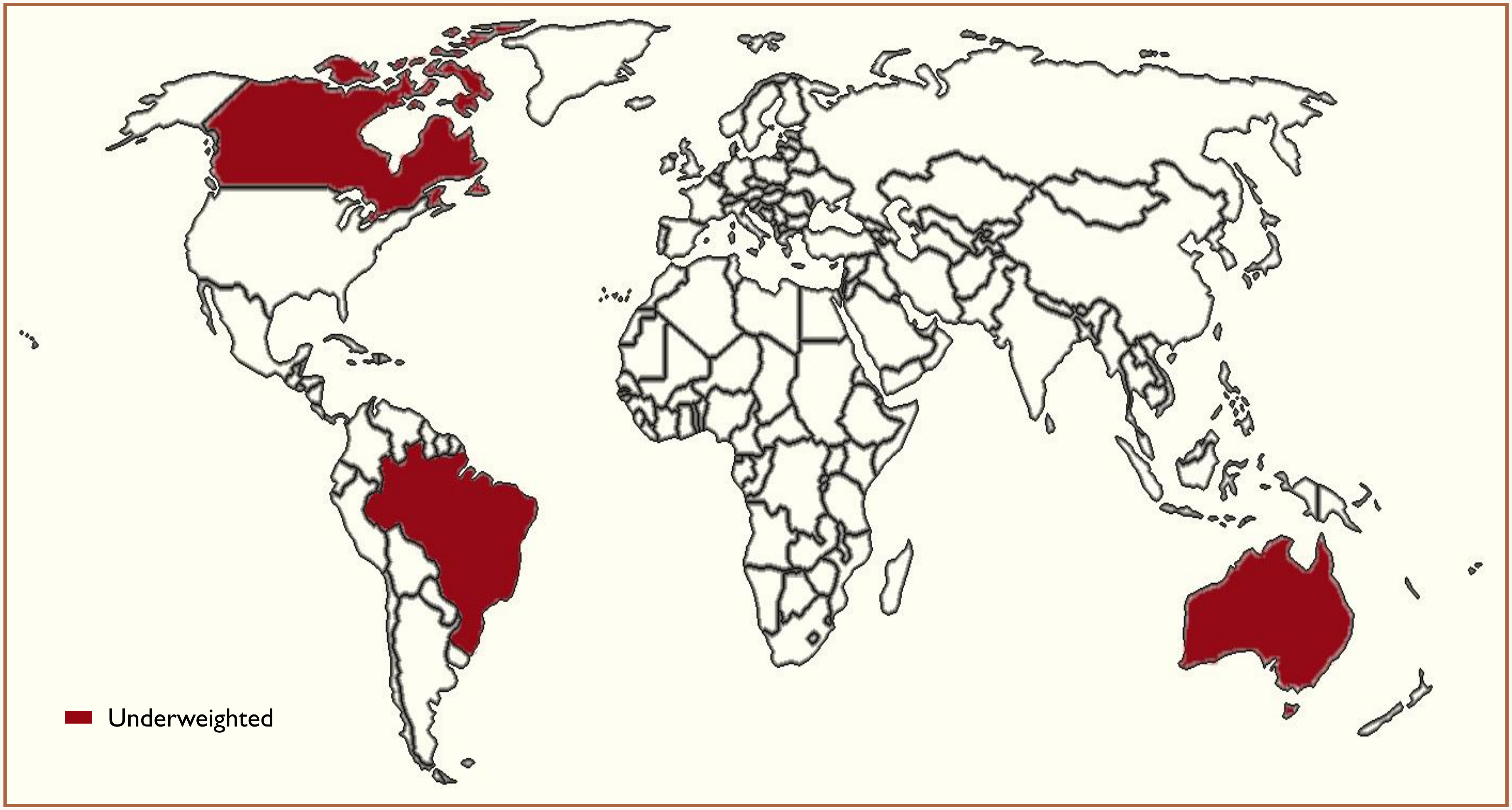
Global over/underweights

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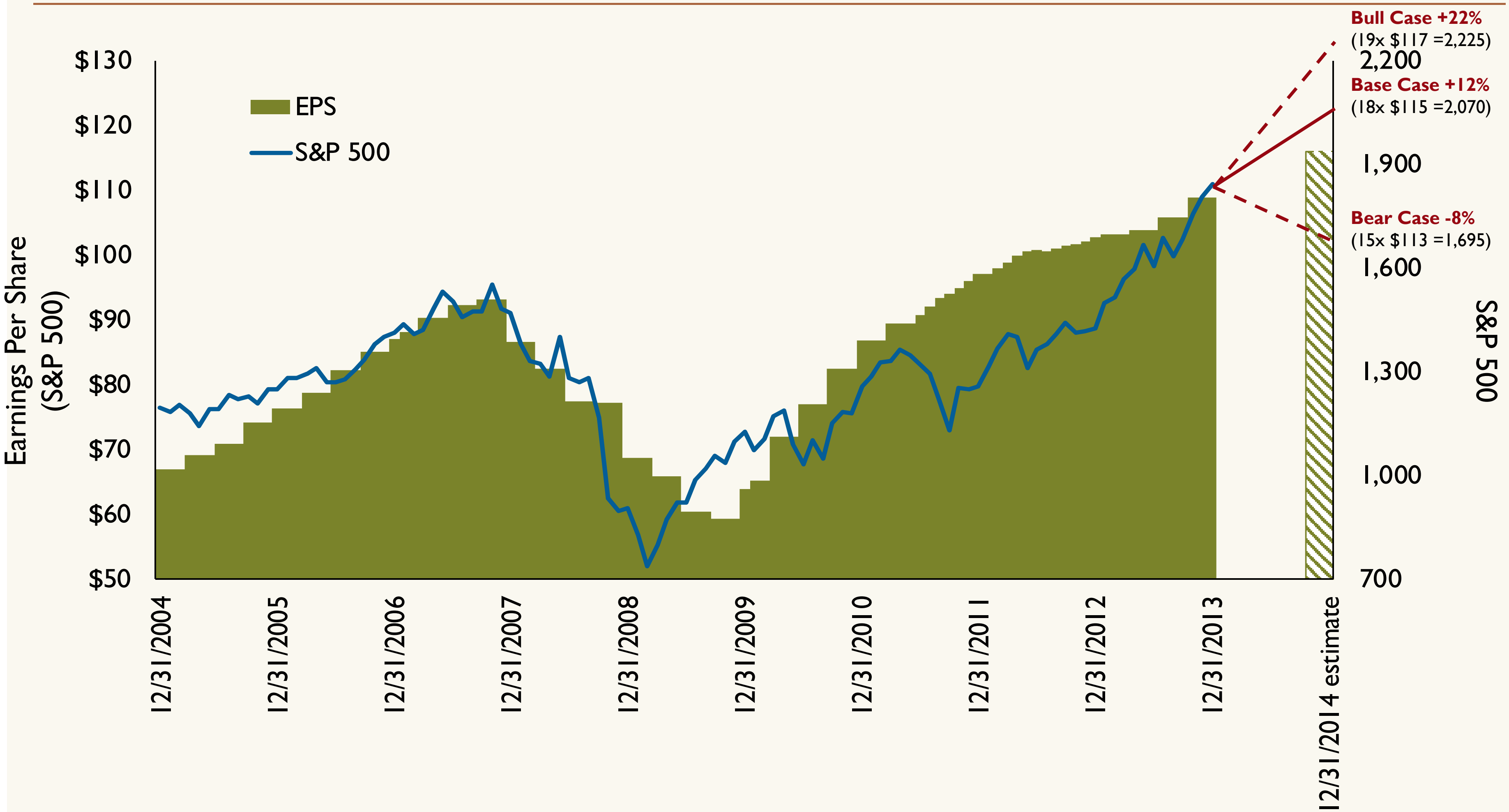
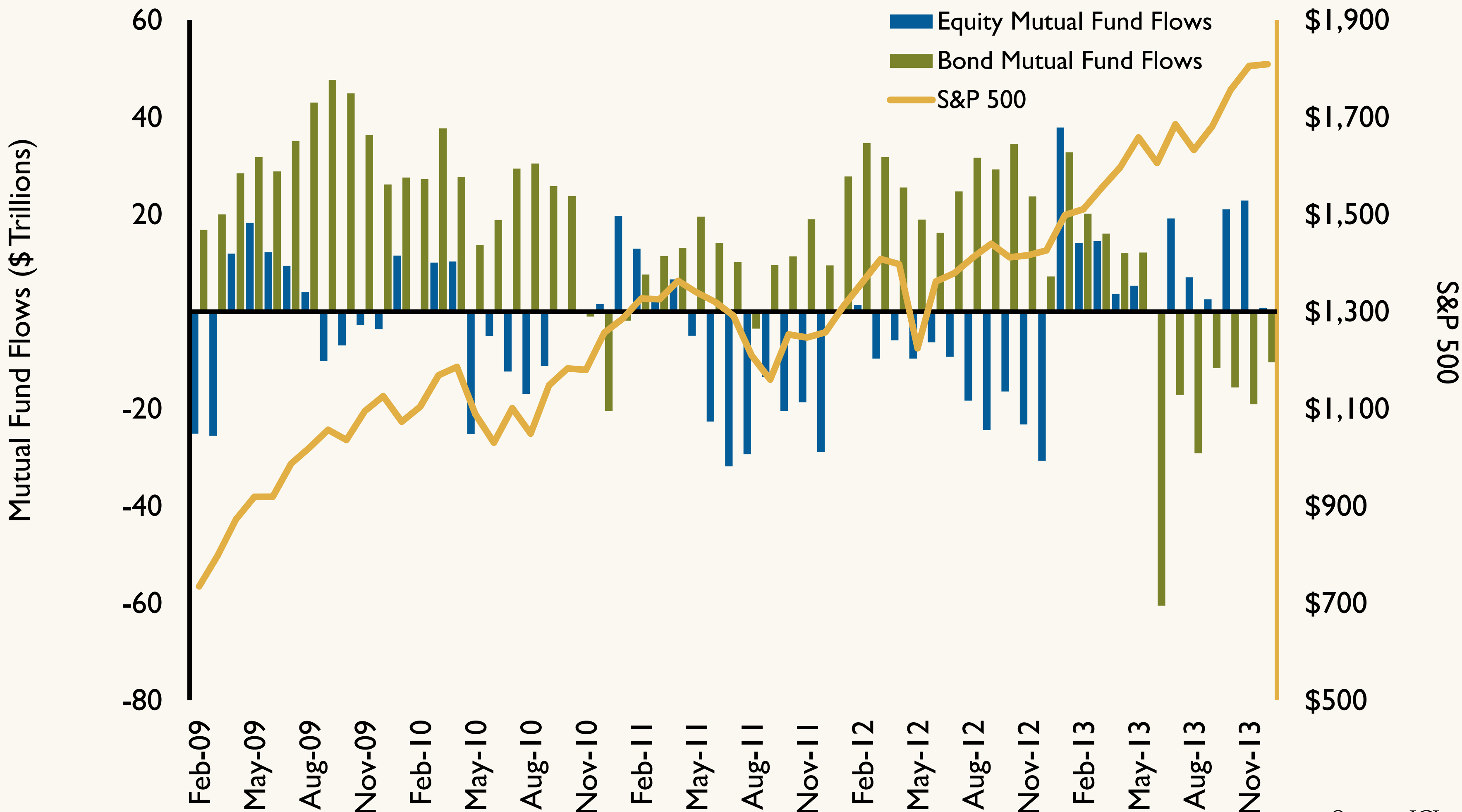
# Earnings Growth Should Propel Stocks Higher




Source: FactSet

- "Base Case" of 7 percent earnings growth provides a 10 to 12 percent total return
- As the stock market approaches "Bull Case" levels we would expect to trim equities

# When Will the Average Investor Return to Stocks?

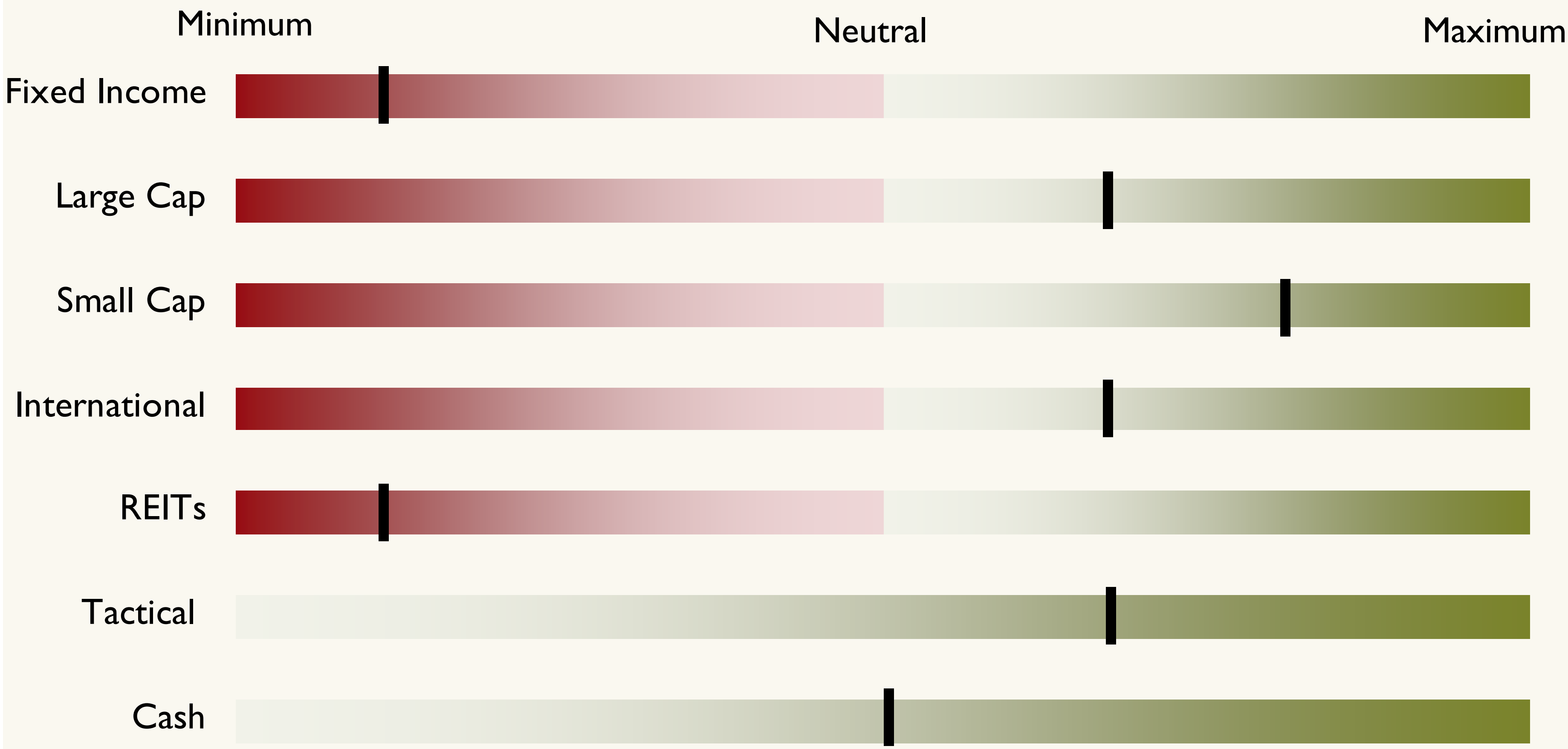



Source: ICI.org

- Equity ownership as a percent financial assets is currently 19 percent, historically peaks around 30 percent

# Target Asset Allocation

## Most Likely Next Moves – "Removing the Training Wheels"




- Favor equities over fixed income
- Anticipate reducing beta sometime in the first half

# 2014 Capital Market Outlook

**Macro**

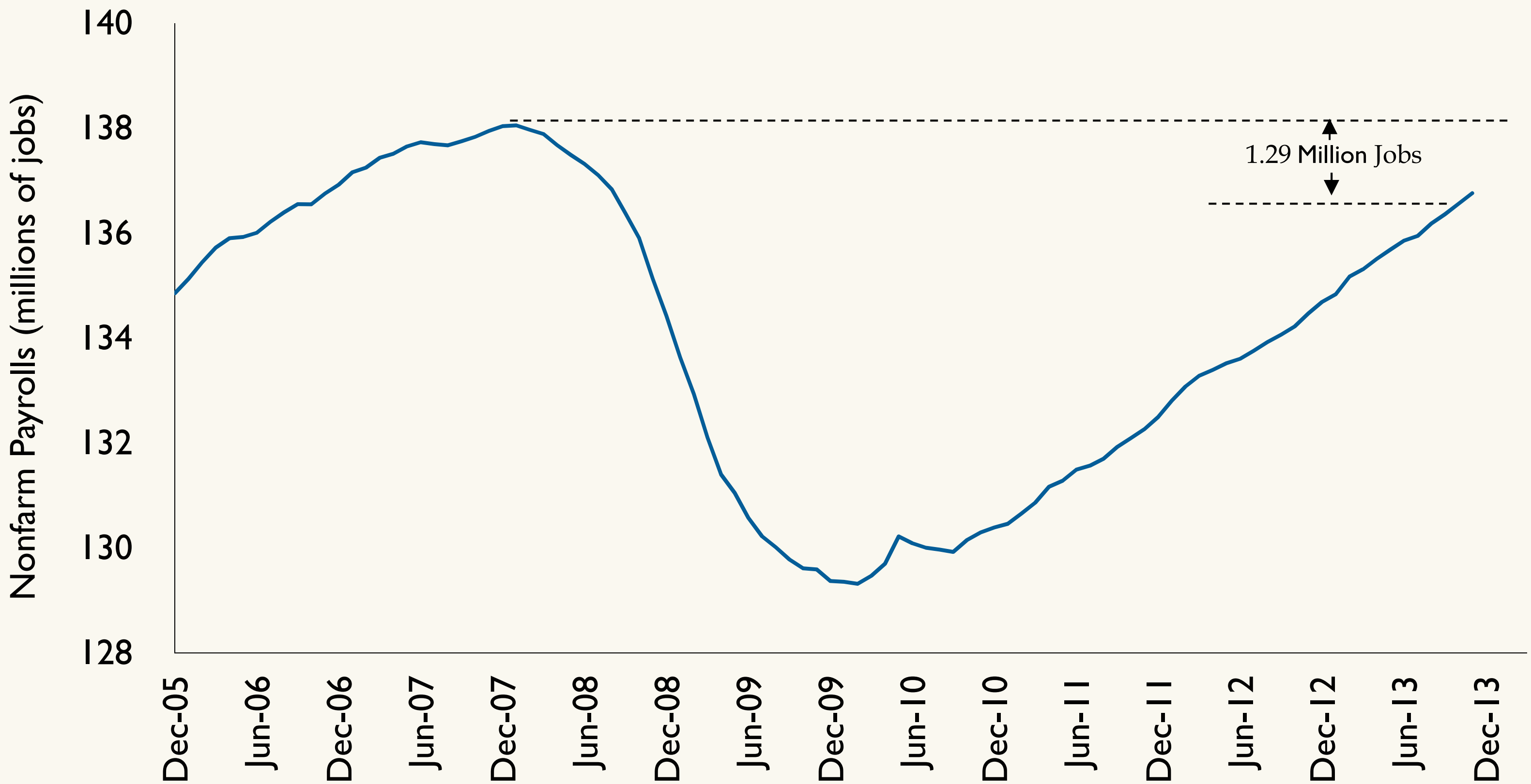
- Expect interest rates to trend modestly higher
- "Wealth effect " should help to fuel U.S. economic growth
- Improving economic backdrop and fund flows are favorable for equities
- "Average" return for equities and flat to negative returns for bonds

**Risks**

- Higher interest rates adversely impacting housing
- China's growth slows more than expected
- Europe's debt and growth problems return to the headlines

# A Long Grind

## Job Market Still in Recovery Mode

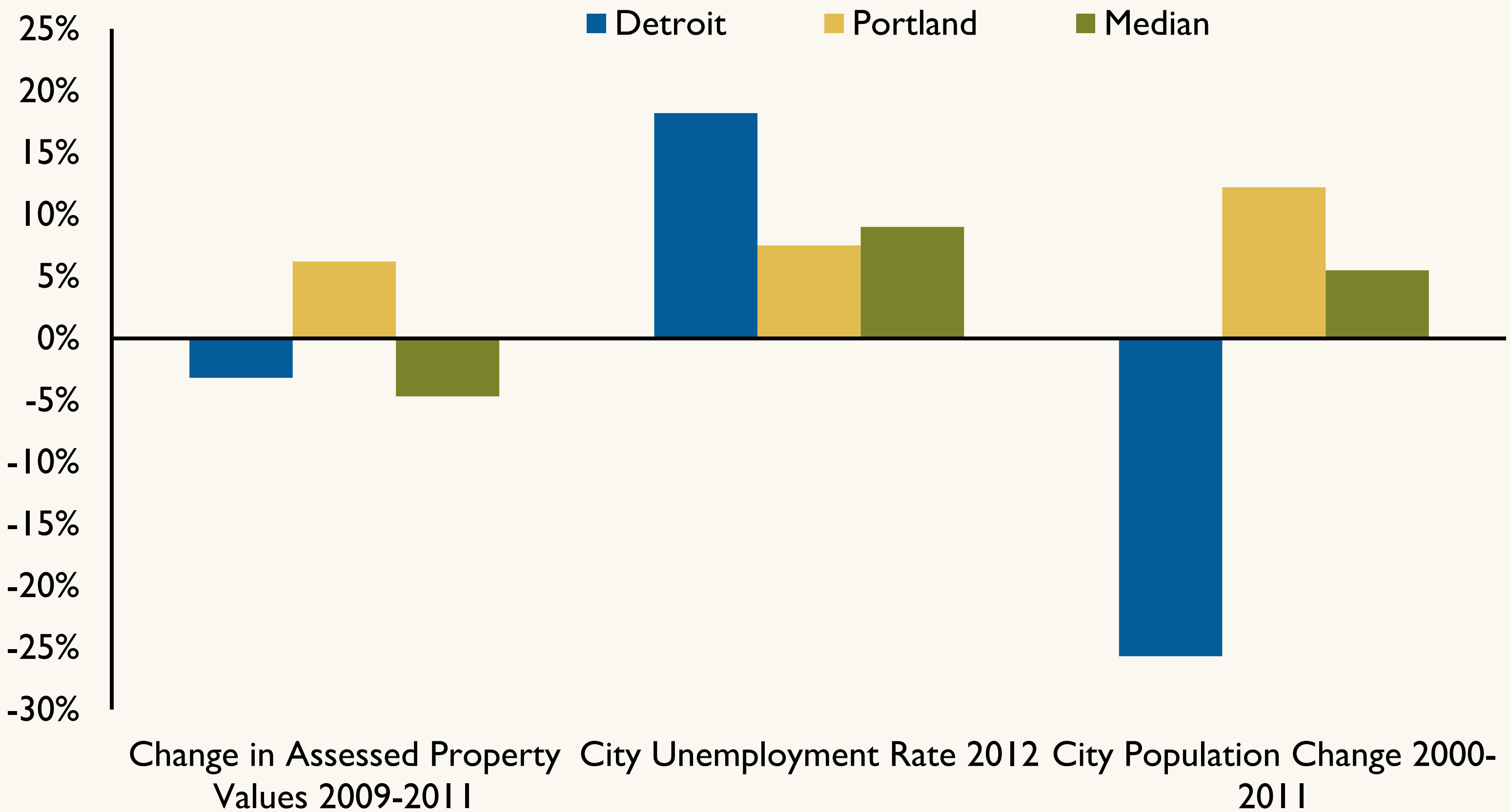



Source:

- Lackluster economic growth has meant lackluster job growth
- Four years later, we still need 1,290,000 more jobs to get back to the 2008 peak
- Fed "easy money" policies will be with us much longer

# A Tale of Two Cities

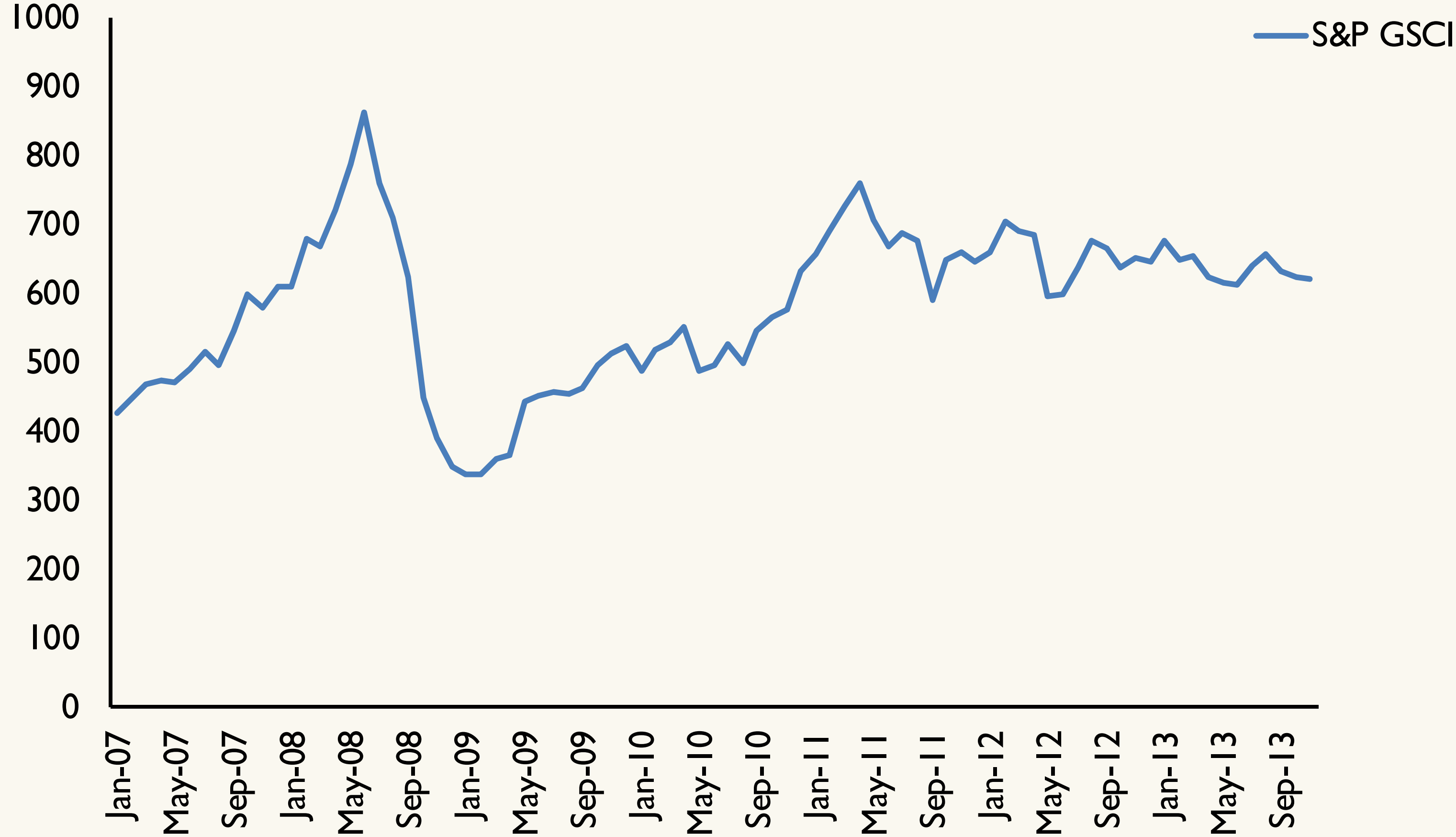
## Detroit is Not a Typical Municipality




Sources: Bloomberg, The Pew Charitable Trusts

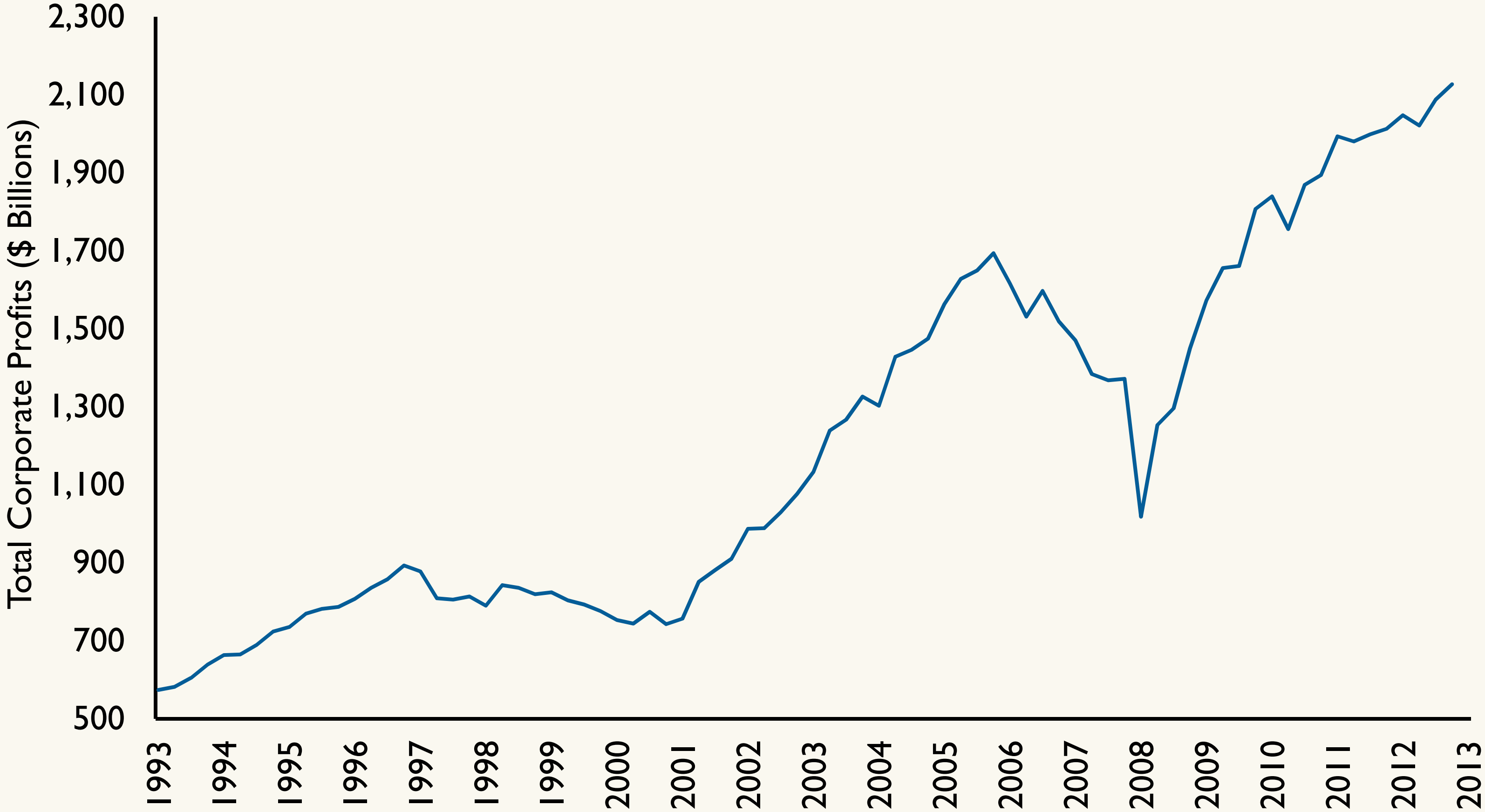
- Detroit's bankruptcy proceedings have made the headlines this year and have inspired fear in some municipal investors
- Detroit has had issues for years and underperforms other cities with declining population and property values and skyrocketing unemployment.
- In contrast, Portland has performed well, with increasing population and property values, and unemployment below the median

# S&P Commodity Super Cycle




Source: FactSet

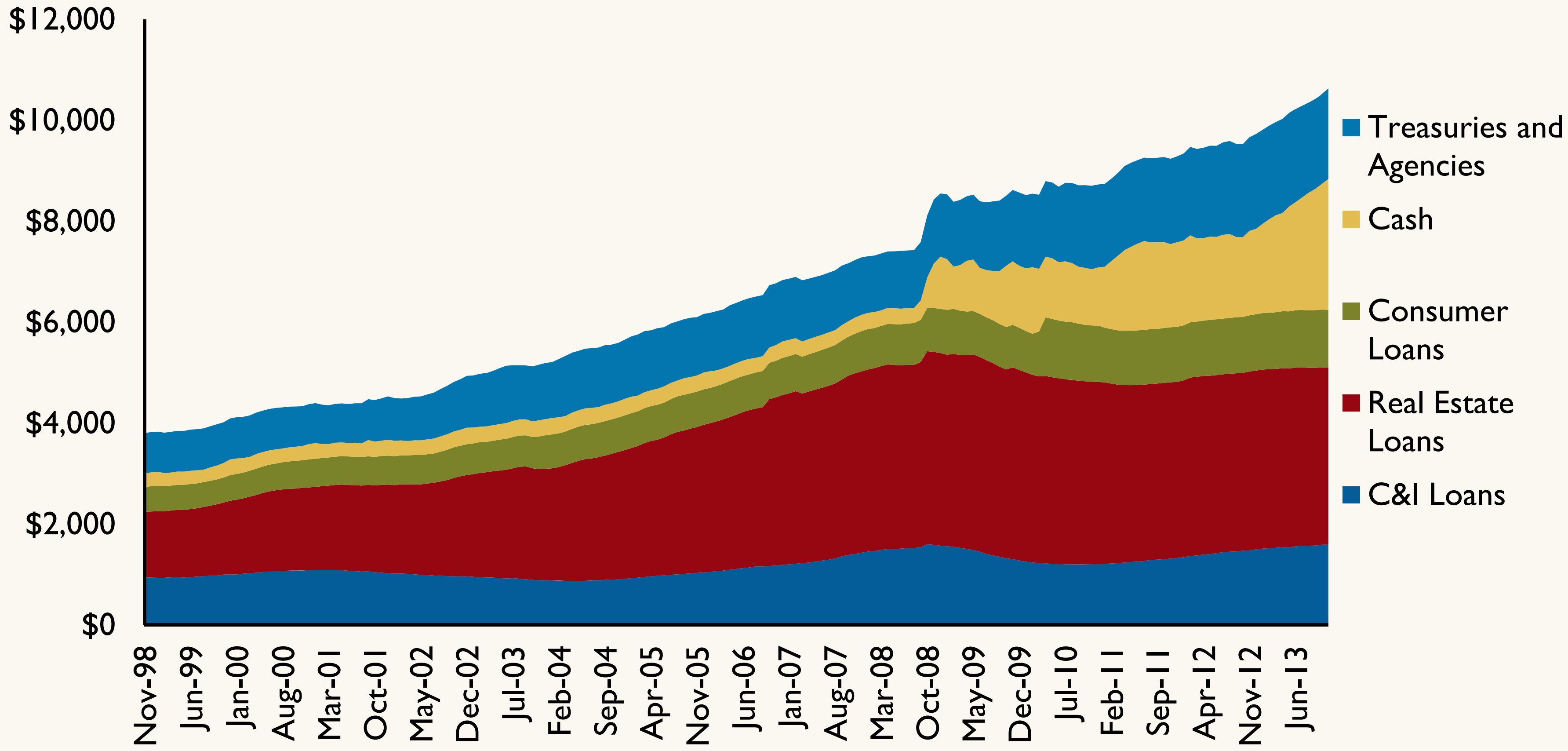
# Profits Are at a Record High




Source: Factset

- While the stock market is marginally higher than prior two peaks, profits are considerably higher, making valuation more reasonable.
- Profits are up from lower interest expense, and improved unit labor costs

# Bank Balance Sheets




Source: