

MARKET LETTER

A QUARTERLY PUBLICATION of
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, 2024, the firm manages more than \$8.4 billion for more than 990 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 \$10 million managed by our firm.

INVESTMENT EXCELLENCE
LIFELONG RELATIONSHIPS

AWAITING THE SCORE



GEORGE HOSFIELD, CFA
*Chief Investment Officer
Director*

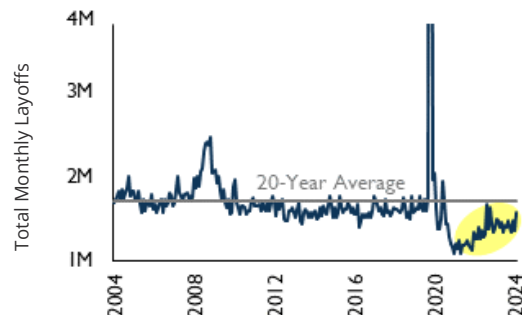
RECEDING INFLATION, renewed profit growth, and the next chapter of Fed monetary policy are proving to be a fortuitous combination for investors. Blue-chip equities have returned 20% year-to-date and, encouragingly, upside participation has broadened beyond technology to include such disparate sectors as financials, utilities and industrials.

The outperformance of interest-rate-sensitive bank and utility stocks coincides with the Federal Reserve cutting short-term interest rates for the first time since 2020. With inflation now approaching the Fed’s 2% target at a time of slowing job growth, our central bank’s focus has shifted to supporting employment and the ongoing economic expansion.

Keeping with the gymnastics analogy that we have utilized this year for what has now become a “soft landing” for the economy, the Fed’s ultimate “score” will depend upon the extent to which it is able to reduce interest rates without causing undue harm to the labor market. It is cutting rates for the right reason -- to promote a full employment economy amid continuing healthy levels of GDP growth. Unemployment remains relatively low and, as the chart shows, while layoffs have trended upward from post-pandemic lows, they remain at below-average levels.

Corporate profits are at all-time highs and if they continue to rise companies are likely to maintain a stable base of employment and capital

Fed’s Focus Has Shifted From Inflation to Jobs



Source: U.S. Bureau of Labor Statistics

spending, which are key supporting pillars of the economy. Against this backdrop, we believe the Fed will methodically cut rates to mid-cycle levels. Although we do not foresee recession anytime soon, 2025 could turn out to be an unusual year in which the economy outperforms stocks.

While lower interest rates typically coincide with higher equity valuations, the market is trading at levels that already appear to be discounting the benefit of the entire anticipated rate-easing cycle. As such, with valuations elevated, we believe that most all of the trajectory of stocks will depend upon companies delivering the earnings investors expect.

To mitigate the effects of a potential earnings shortfall later in the economic cycle, we have been adding to more defensive and interest-rate-sensitive sectors, such as utilities and real estate, while trimming exposure to the more cyclical industrial and financial sectors. We retain our overweight to large-cap U.S. equities and are neutrally allocated to bonds.

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.



AI, REVISITED - NAVIGATING THE CYCLE

KRYSTAL DAIBES HIGGINS, CFA

Vice President
Equity Research



“The skepticism around AI’s ROI today feels a lot like the doubts people had about the internet in its early days. Back then, no one could fully grasp how much the web would transform our lives, and now AI is on the same path. Yes, it might be tough to measure immediate returns, but if history teaches us anything, it’s the

game-changing technologies take time to show their true impact. By embracing AI, we’re not just adopting a tool—we’re investing in a future where human potential gets a major boost and new opportunities are unlocked. Just like the internet became the foundation of our digital world, AI has the potential to do the same, when we approach it with the same optimism and vision.”

— Michael Dell, CEO, Dell Computers

DOUBT AND SKEPTICISM STILL SURROUNDS ARTIFICIAL intelligence (AI). But the skepticism today is different than it was just a year ago. In early 2023, the world was captivated by the capabilities of AI—something that had actually been around for a long time, but not accessible to the public in plain language. Unsurprisingly, fear took center and many worried that AI would take over not only jobs but humanity.

Understandably, AI advancement progressed so fast in the last decade that there were legitimate questions about regulations, threats, deepfakes and cybersecurity among many other issues. Over the past year, reality set in and most began to digest that we are actually far off from AI being able to fully replicate humans, particularly for more complex tasks.

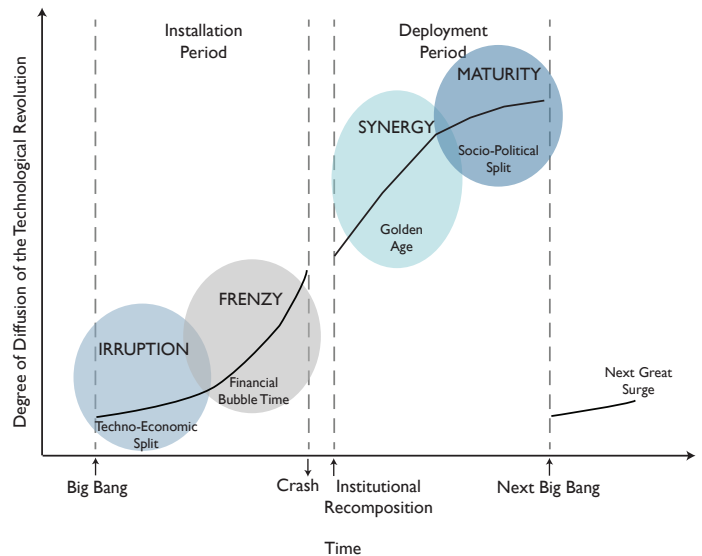
While AI is good at mundane tasks, it has not as advanced as some feared. In fact, the pendulum has swung the other way, and some think it is not transformative enough. Now, a year later, skepticism revolves principally around whether or not AI can truly and meaningfully improve productivity and reduce costs. In other words, can AI produce strong enough return on investment (ROI) that would continue generating the demand and investments to support AI-themed stock prices?

In the last couple of quarters, a debate has evolved among investors and corporations regarding the adoption of AI.

Investors questioned how much longer the largest companies are going to continue investing in advancing AI technologies if consumers are not realizing a decent return (e.g., increased productivity). In our view, many investors’ questions seem to miss the forest for the trees—seeking instant, but perhaps unrealistic, results. The debate around ROI chilled the AI theme that’s been sizzling over the last year. We experienced a sell-off across most AI-related stocks in the third quarter; however, excitement is picking back up as more are realizing AI investments are not just a flash in the pan. Volatility is expected, but what matters most is that the secular trends in this space are firmly in place.

Taking a step back, this isn’t the first time we’ve seen a significant technological advancement that has spurred an abundance of excitement only to be followed by disappointment and volatility. It’s a predictable part of the process when we look at past big technological cycles. They follow an eerily similar path. There are many so-called “S-curve” charts that document the cycle, including the one below developed by Carlota Perez, a renowned scholar in socioeconomics.

Technological Surge Cycle



Source: *Technological Revolutions and Financial Capital: The Dynamics of Bubbles and Golden Ages* by Carlota Perez

It begins with a technological “big bang” that disrupts legacy systems. It is then followed by excitement and investors start eagerly capitalizing on the opportunity by piling into the new space. Once enough investors have piled into the space, a bubble can form that drives price and valuation to unsustainable levels. Eventually, when combined with bad economic news, the bubble deflates rapidly, and a consolidation period occurs around a handful of companies.

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.

Two key events then occur: First, we begin to see new productivity gains that pave the way for new industries and opportunities. Second, those that survive and lead the innovation charge ultimately emerge more resilient and competitive than they were before the bubble. We do not believe AI is a bubble, although there could be air pockets with certain companies catching the AI tailwind. Interestingly, despite the big run up in stock prices, businesses with strong AI-themes have seen their valuations supported since earnings growth has outpaced share prices. Unlike the characteristics of a typical bubble, the AI movement has been supported by strong fundamentals, substantive growth opportunities and leadership from large companies with robust balance sheets pioneering the way.

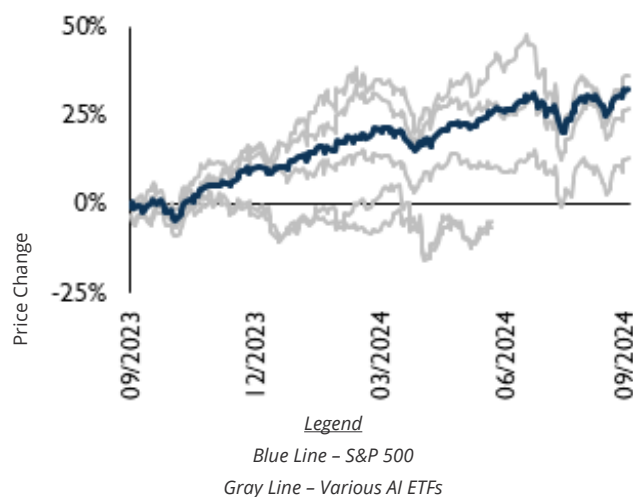
Not So Fast

As it pertains to the current AI mega investment cycle, we believe it is still too early to produce the ROIs investors are seeking. While we have a tool we can now use to ask questions and receive answers the same way a human would respond, the deployment of generative AI is still in its infancy. We are in the midst of seeing large language models, such as ChatGPT, improve significantly in the near and long term. Hence the need for more efficient (less costly) semiconductor chips that allow machine learning to improve. For reference, the largest hyperscalers are currently each buying approximately 100,000 chips, but this number is expected to grow 10-fold over the next several years.

“The companies that are pioneering new technologies, developing groundbreaking applications and enabling the broader adoption of AI are the ones that are likely to capture the most value over the long term.”

The infrastructure to further advance AI still needs work. The building blocks of AI, such as robust infrastructure, data collection and talent are still being formed. One of the biggest hurdles facing the industry is the ability to supply the energy to power AI data centers. The U.S. power grid is aging and underfunded, and AI is going to increase demand dramatically in the next decade. In fact, Goldman Sachs estimates that our energy consumption will increase by an average of 2.5% every year until 2030—and AI is expected to make up about a third of that demand. While it doesn't seem like much, some utilities

Price Changes of Selected AI ETFs in the Past Year



Source: FactSet

Disclosure: Investors cannot invest directly in an index.

are having to double their demand forecasts for the next five years. In Texas, the state's grid will need to support 152 gigawatts of demand on peak days, which is double what it can handle today. This is coming at a time when outages are becoming more common given the increased occurrences of extreme weather, as well as the rapid shift toward the electrification of transportation and buildings.

Not all AI Investment Opportunities are Created Equal

The potential returns from technology cycles are alluring; however, it's important to maintain a discerning perspective. The AI landscape is vast and complex, and not all AI-related investments will yield similar returns.

In fact, when looking at the S&P 500 index, which has a greater concentration of AI stocks relative to some exchange-traded-funds (ETFs), the index has performed better than most ETFs this past year. This divergence is due to a few AI-driven businesses vastly outperforming the rest of the cohort. The index weights of these companies are larger than what you would own in an ETF. Moving forward, we expect to see the divergence continue between the winners and losers as time passes. The companies that are pioneering new technologies, developing groundbreaking applications and enabling the broader adoption of AI are the ones that are likely to capture the most value over the long term.

As we navigate the AI cycle, it's essential to maintain a long-term perspective. The true value of AI will be realized over time, as its technology evolves, and its applications become more widespread.

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.



FED RATE CUTS: HOW FAR, HOW FAST?

BRAD HOULE, CFA

Principal

Fixed Income Research and Portfolio Management



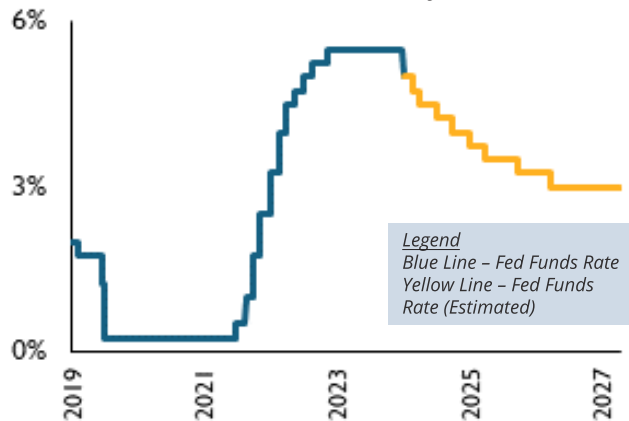
ON THE SURFACE, THE FEDERAL

Reserve’s function seems straightforward with its two primary mandates: full employment and price stability. This means keeping inflation under control and ensuring that unemployment remains manageable.

That said, the Federal Reserve has a rather limited set of tools to achieve these goals. The best tool in the Federal Reserve’s arsenal is to raise or lower the interest rates that banks charge each other to borrow money overnight, which is referred to as the “federal funds rate.” Between March 2022 and July 2023, the Federal Open Market Committee raised the federal funds target rate by a total of 525 basis points. This was the fastest and most aggressive tightening cycle in decades as the Fed attempted to tame the high inflation that emerged in the wake of the pandemic. The speed and magnitude of the rate increases made this tightening cycle unique compared to previous ones in recent history. The good news is that it worked. Inflation peaked at 9% in June of 2022 and has now receded to 2.5%. Price stability has been achieved. In addition, the labor market has cooled but has not yet suffered from outsized unemployment, with last month’s jobless rate quite low by historical measures at just 4.2%. Often, slower economic growth and rising unemployment are an undesirable side effect of the Federal Reserve aggressively increasing short-term interest rates to get inflation under control. This can sometimes result in a cure that is worse than the sickness. Fortunately, a soft landing has been achieved this time and the negative side effects of higher interest rates appears to have been avoided.

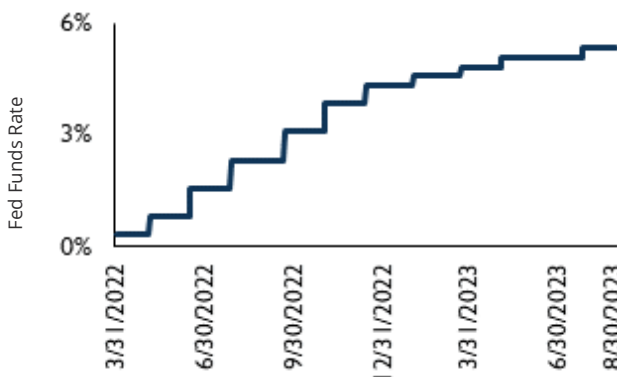
At the last Fed meeting on September 18, 2024, the Fed lowered interest rates by .50%. The Fed has telegraphed it will continue to lower interest rates in the coming months. Normally, the Fed lowers interest rates due to economic softness or a global crisis with economic consequences like we saw with COVID. This cycle, the Fed has the luxury of lowering short-term interest rates because interest rates are simply higher than they need to be. Federal funds futures are contracts on the future level of the benchmark interest rate. Speculators use the futures market to place bets on the direction and magnitude of the Fed’s actions. This speculative trading benefits market participants in that it reveals what the assumed future fed funds rate will be. The predictive value of this data is far from perfect; however, directionally it shows how things will unlikely unfold.

We Expect Short Rate to Decline Methodically



Source: U.S. Federal Reserve

Fed Rate Increases



Source: Bloomberg

As the economic data suggests inflation slowing and the labor market cooling, the futures market has priced in a total of eight additional .25% rate cuts. If you look at the “dot plot” that shows where the Federal Reserve thinks interest rates are going, it is predicting a 3.4% fed funds rate by the end of 2025 and 2.9% at the end of 2026. The speed and magnitude of the rate cuts matters.

We do not anticipate a recession in 2025, as a result the Fed can be deliberate in rate decreases, saving “dry powder” should the economy encounters real economic softness and sharply rising unemployment.

Disclosures: The views expressed represent the opinion of Ferguson Wellman. The views are subject to change and are not intended as a forecast or guarantee of future results. This material is for informational purposes only. It does not constitute investment advice and is not intended as an endorsement of any specific investment. Statements of future expectations, estimates, projections and other forward-looking statements are based on available information and Ferguson Wellman’s views as of the time of these statements.