

# MARKET LETTER

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



## WE'VE LANDED



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*Chief Investment Officer*  
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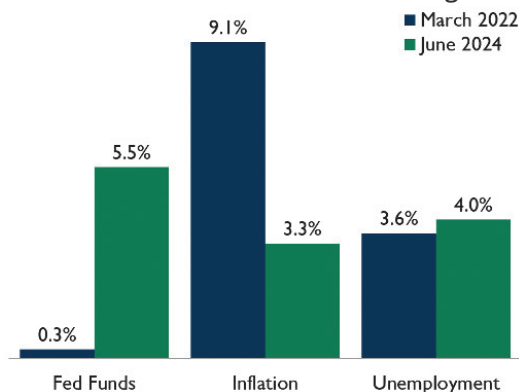
### HALFWAY THROUGH

the year, growth stocks are propelling the S&P 500 to all-time highs amid renewed earnings expansion, even with inflation remaining above 3%. The rush to harvest productivity from artificial intelligence (AI) has put a premium on companies enabling the ensuing applications, shining the spotlight on technology stocks that are once again leading the market. Defying conventional wisdom, the U.S. economy continues to expand despite higher interest rates.

In our 2024 *Investment Outlook* titled "Sticking the Landing," we stated our belief that this would be the year that we would know whether the Fed had engineered a "soft landing," a rare outcome when a central bank raises interest rates and quells inflation *without* causing a recession. As the accompanying chart shows, the Fed has raised rates by over five percentage points since March 2022, achieving substantially lower inflation while leaving the unemployment rate only modestly higher, and near generational lows.

Now, nearly two and a half years after the Fed began its aggressive rate tightening campaign, the U.S. economy is passing through the time lag typically associated with negative economic outcomes. Indeed, U.S. GDP continues to expand, reflecting gainfully employed American consumers that continue to spend as well as higher domestic investment. Accordingly, we believe the Fed has indeed stuck the landing, a feat last achieved in the Greenspan-led Fed of the mid-1990s.

### The Fed has Stuck the Landing



Source: Bloomberg

Acknowledging that inflation has proven stickier at the 3% level, the Fed has yet to cut rates. Given our optimistic economic outlook entering the year, our non-consensus view was that the Fed would deliver few, if any, rate cuts in 2024. Six months later, this prediction is being vindicated. While we may see one or two quarter point rate cuts before year-end, the market is already discounting their impact.

Meanwhile, AI stands to make the economy more efficient by enabling additional output with proportionally less labor—productivity gains that also herald the potential for improving company profit margins and positive earnings surprises. Our recommendation to overweight large cap U.S. equities has been rewarding so far this year, and despite higher equity valuations, we believe this remains the correct call amid expectations for further earnings growth.

MARKET LETTER  
THIRD QUARTER 2024

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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.

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*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.*



# DON'T WORRY, BE HAPPY

**DEAN DORDEVIC**

*Principal*

*Portfolio Management*



*"We're going to have one whopper of a recession in 2023. We know recession is just baked in the cake."*

— Steve H. Hanke, professor of applied economics at Johns Hopkins University and former senior fellow at the Cato Institute<sup>1</sup>

## LET'S FACE IT. IT'S PERHAPS THE MOST WIDELY MISSED

forecast in the last 50 years. So many economists predicted recession for 2023 that these prognostications were treated almost as a forgone conclusion. The economy instead grew at 3.1% last year, a healthy increase over 2022. In fact, this rate of growth was higher than the average for the five years leading up to the pandemic.<sup>2</sup> Many of these forecasts bordered on the draconian and, for some, doomsday was just around the corner. This abysmal performance breathes new life into the now famous quote attributed to John Kenneth Galbraith, *"The only function of economic forecasting is to make astrology look good."*

We're now at the halfway point for 2024 and still no recession. Steady hiring continues to fuel consumer spending and in turn, an economic expansion unlike any the U.S. has seen previously. Employers added a whopping 2.75 million jobs over the last 12 months, including another 272,000 in May. The unemployment rate has been at or below 4% for 30 months. The last time this occurred was during the Vietnam War in the late 1960s and the Korean War in the 1950s.<sup>2</sup> What's more, labor market imbalances appear to have resolved themselves without recession.

In what might amount to a partial defense of our economist friends, there were so many anomalies that distilled from the aggressive fiscal and monetary response to the pandemic that in hindsight, any attempts at economic forecasting might have been rendered mostly, if not completely, useless. There are indeed times on Wall Street when, *"Nobody knows nuttin'."*

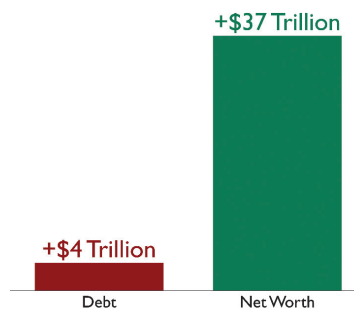
The Fed has done their level best to try to engineer a slowdown and kill the cancer that is inflation. To be sure, their tools are widely understood to be very blunt instruments. That said,

the speed and the order of magnitude of these interest rate increases has been remarkable to witness. Paradoxically, the impact on the financial system from this medicine has been surprisingly benign.

There's a saying attributed to Winston Churchill that, *"One should never let a good crisis go to waste."* As the pandemic set in and policy response grew ever more robust, consumers and businesses took advantage of what they perceived as something close to free money. Businesses issued debt and locked in extraordinarily low interest rates – and consumers did much the same. They were borrowing money to buy homes or refinance mortgages and other debts at generationally low interest rates. As a result, and by the time the Fed began their aggressive campaign to raise rates, private-sector balance sheets were abnormally strong. Consumers and business were in fact somewhat insulated from the negative effects of a much higher cost of funds.<sup>2</sup> Resultantly, the impact on the broad economy of this much higher interest rate regime was significantly diminished.

By way of example, the housing market was probably the very best illustration of this phenomenon. Higher interest rates reduced demand for housing, but to an even greater degree also *sharply reduced the supply* of housing. Homeowners with no mortgage, or with a very low interest rate on an existing mortgage, were either reluctant or unwilling to move.

## Fortress-Like Consumer Balance Sheets



Source: Eikon

\*data as of 12/31/23

Three years ago the average mortgage interest rate was about 3%. That rate today is about 7%, yet the average interest rate on *outstanding mortgages is only 4.1%*.<sup>2</sup> We recall joking a few years ago that these pandemic-era mortgage *liabilities* issued at 3% interest rates would someday be considered "assets." With the benefit of hindsight, this appears to be coming true.

So here we are at mid-year 2024 – still no recession and an economy that just keeps chugging along and defying expectations. It's also important to note that there were

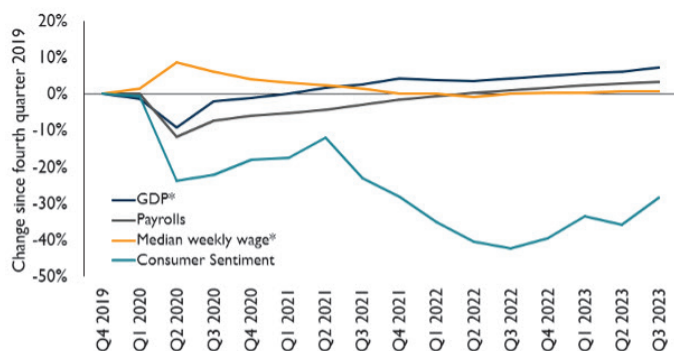
*The laurel is part of our Octavia Group branding. Octavia the Younger was one of the most prominent women in Roman history. She was respected for her nobility and humility. Octavia was hailed as a "marvel of womanhood" and was a political advisor between her brother and husband. She was immune from the "tutela," which placed in her the unique position of managing her own finances.*

forecasts from the economist community for up to *seven interest rate cuts this year*.

A paradox exists in all of this. A durable and growing economy notwithstanding, consumers generally are in a *really bad mood*. In response to a recent *Wall Street Journal* poll, 69% of respondents said the country is headed in the wrong direction. Author and financial writer Kyla Scanlon has dubbed our current malaise a “*vibecession*,” since a majority of Americans incorrectly believe the United States is already in a recession and about half believe the stock market is actually down from last year, although it is up considerably. “*Yes, there’s economic frustration, but these are objectively verifiable facts*,” Scanlon says.<sup>3</sup>

The answer as to why we have this dichotomy appears to rest with two things. The first is inflation. At the risk of great oversimplification, while the price of a cup of Starbucks coffee is not rising as sharply as it once was, it hasn’t gone down either. It’s still going up in price, but just not at the same rate. However, the sticker shock of \$4, \$5, or \$6 per cup just doesn’t go away.

### Why So Glum...?



\*adjusted for inflation

Source: *The Wall Street Journal*

The second is a phenomenon known as *referred pain*. Just as one part of your body can hurt because of injury to another, juxtaposed upon behavioral finance and economics, pessimism about the economy may reflect dissatisfaction with the country as a whole or its direction.<sup>4</sup> On that score, there’s certainly been a lot to fret about.

With an election upcoming, we’ve had more than our share of intensifying political and cultural angst. Add issues with our border and immigration, a war in Ukraine and now another war in the Middle East – you have all the ingredients for a veritable stew of anxiety. Referred pain indeed.

So what’s an investor to do? First, the markets are in a *very different* place than they were a decade ago. There are far more software, technology, healthcare and financial companies resident in the indices than ever before. The percentage of U.S. equity market groups with little-to-no inventory costs has gone from 20% in 1999 to more than 30% today. Accordingly, inventory corrections are less impactful for the broader economy.

So too, the ratio of capital spending-to-sales are down significantly. This since among the largest companies, there are simply far fewer companies engaged in pure manufacturing than ever before. Taken together, companies accounting for 36% of today’s U.S. equity market have greater than 60% gross margins. *This is the highest percentage in history*.<sup>5</sup>

Add to this soup the future contribution to profitability that will inevitably come from the advent of artificial intelligence (AI) and you set the stage for a continuing cycle of robust profitability. Said Adam Parker, founder and CEO of Trivariate Research, “*There is a reasonably high probability that the U.S. stock market will remain expensive compared with history. The bottom line is clear: The U.S. equity market will trade at higher multiples for a long time (since profit) margins are going to be higher in the future than in the past.*”<sup>5</sup>

So, don’t worry, be happy. And most importantly, don’t forget to ... *turn off your TV*.

#### Sources and Footnotes:

1. Abigail Ng, “*Steve Hanke Says We’re Going to Have One Whopper of a Recession in 2023*,” *CNBC World*, August 29, 2022.
2. Nick Timiraos, “*A Promised Slump Refuses to Appear*,” *Wall Street Journal*, June 8, 2024.
3. Jeanna Smialek, “*Economy’s Up. People, Down. We Asked Why*,” *The New York Times*, May 31, 2024.
4. Greg Ip, “*The Economy is Great. Why are Americans in Such a Rotten Mood?*” *Wall Street Journal*, November 1, 2023.
5. Adam Parker, “*Profitability Trend Will be a Friend of Wall Street Stocks*,” *Financial Times*, June 5, 2024.



# IS 2024 THE NEW 2008?

**JOE HERRLE, CFA**  
*Vice President*  
*Alternative Assets*



**IT SEEMS THAT ABOUT EVERY OTHER** month, we see a story about a famous office building selling for a fraction of the price it was purchased for just a few years prior. For example, the historic American Bank Building in downtown Portland sold in September 2023 for \$11.5 million, 75% lower than when

it last sold in 2014. Or, in San Francisco, the Salesforce West office tower sold in January 2024 for \$800 million, a massive 60% markdown from its \$2 billion purchase price in 2015.

There is no denying that portions of the office real estate sector are under stress due to higher interest rates and work-from-home adoption. However, it's crucial to recognize the nuances at play before hitting the panic button. First, not all real estate and offices are the same, as so far, the distress has been primarily confined to a subsector of office assets. The second reason we aren't ringing the alarm is that systemically important financial institutions aren't exposed to distressed real estate to the level or extent they were during the subprime mortgage crisis.

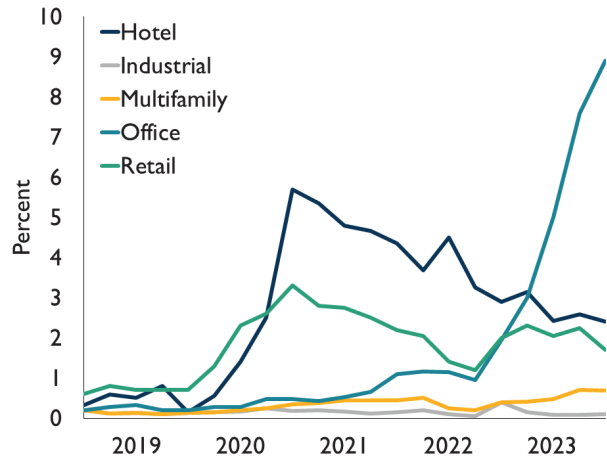
To address the first point, we must note that not all real estate properties are the same. As always, the mantra of "location, location, location" holds true. For example, Downtown Seattle's office market faces challenges, while just a short distance away, Bellevue thrives. Even within downtown Portland, there are blocks that are struggling to find tenants, yet just a stone's throw away, there is very low vacancy. Certain areas, even in a work-from-home environment, will continue to command premium rents. Of course, building class matters, too. A modern building with new amenities, collaborative workspaces and energy-efficient systems will attract tenants seeking a dynamic environment. These "Class A" buildings will weather the storm much better than dated properties on the same block.

As for the second point, the financial system should prove resilient despite negative impacts from the office sector. Even if the entirety of the office market were in distress, the stress on the financial system wouldn't come close to what we saw in the subprime mortgage crisis.

Bank exposure to commercial real estate (CRE) varies by size. The largest 25 banks hold about 30% of CRE loans, but these

loans are only 13% of their portfolio, with office space at an even smaller fraction of 3%. In contrast, smaller banks hold the rest (70%) of CRE loans, occupying nearly half of their portfolios at 44%. However, office space accounts for less than 5% of the loan portfolio on average. While defaults will occur, most of the impact will be felt by a handful of small banks that are overexposed to the office market.

**Income-Producing CRE Loan Delinquency Rates by Property Type**



Source: Board of Governors of the Federal Reserve System

Banks are also likely to be more flexible than they were in the lead-up to the 2008 crisis. This could involve extending loan terms, restructuring payments, or offering lower interest rates – a strategy often referred to as “extend and pretend.” While this approach doesn't erase the underlying issues, it can provide breathing room for both the borrower and the lender in order to reduce defaults.

It is likely it will be a very long time before the office market returns to its former shape, size and dimension. It will take a while to play out, but the market will adapt. Old buildings will be repurposed or renovated, investors will adapt strategies and banks will adjust underwriting standards. The good news, however, is that the risks are currently contained to a subset of office properties. The current situation is fundamentally distinct from 2008 as financial institutions are now largely shielded from systemic risk. Ultimately, we feel confident that this is not a financial contagion event.

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