MARKET LETTER

MARKET PERSPECTIVE — SECOND QUARTER 2018

IN THIS PUBLICATION

Founded in 1975, Ferguson Wellman is a privately owned registered investment advisory firm, established in the Pacific Northwest. As of January 1, 2018, the firm manages over $5.1 billion for more than 790 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

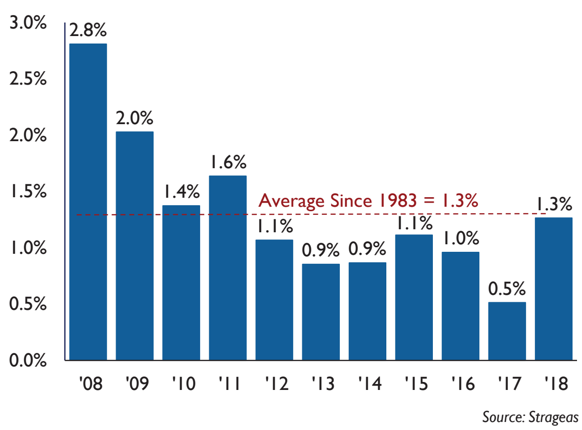
VOLATILITY RETURNS

George Hosfield, CFA
Principal, Chief Investment Officer

The exceptionally smooth ride investors enjoyed last year has returned to a bumpier one in 2018. After a year in which large-cap equities rose every month with minimal fluctuation, a sharp correction that began in February sent the S&P 500 to its first quarterly loss since the third quarter of 2015. As the accompanying chart shows, equity volatility has returned, but only to levels that markets more typically experience.

Volatility Spikes ... To Normal

S&P 500 Average Daily Trading Range



Wage concerns emanating from the January payroll report served as a catalyst for the pullback in stocks and bonds, but we continue to observe relatively stable rates of inflation overall. By the Fed's preferred gauge of prices, inflation remains below its 2 percent target, thus allowing the central bank to continue raising rates in a measured fashion designed to eliminate extraordinary stimulus without killing the expansion.

Tariffs and protectionism are a threat to the ongoing economic expansion, but we see the administration's trade policy as being more bark than bite. Despite a couple uninspiring retail sales reports following a strong Christmas selling season, we believe the U.S. consumer will remain the backbone of GDP growth, benefitting from multi-decade lows in unemployment, tax cuts and a strong housing market that has boosted personal net worth to record levels.

On the corporate side, growth in operating profits and the benefit of lower tax rates are proving to be a powerful combination for earnings, which are now forecast to grow by 18 percent this year. Over nine years into the current bull market, equity valuations are no longer cheap, but because of rising earnings estimates since year-end, price/earnings multiples have actually *declined* so far in 2018.

With regard to asset allocation, owing to less mature economic expansions and relatively attractive valuations abroad, at this time we are overweight international equities. The prospect of modestly higher interest rates tempers our enthusiasm for bonds. As such, we have increased our exposure to "real assets" such as farmland, infrastructure and timberland that provide an attractive cash flow and less correlated returns.

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

NEW SWITZERLAND

Dean Dordevic, Principal
Alternative Assets and Portfolio Management

"The degree to which economists have ignored Bitcoin is surpassed only by the extent to which Bitcoin enthusiasts have ignored economists."
-Wolfgang Munchau, *Financial Times*, March 2014[1]

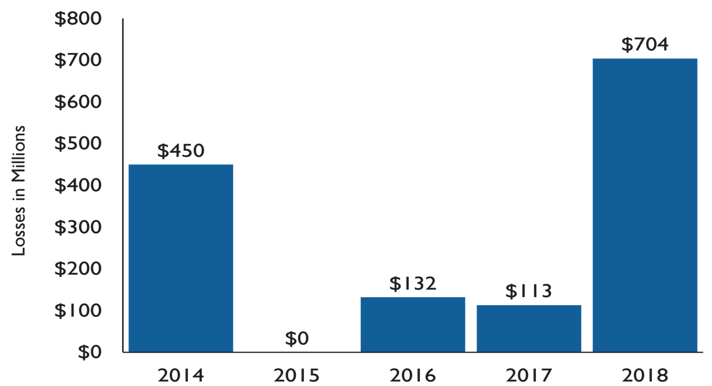
We last wrote about Bitcoin and cryptocurrency four years ago.* We concluded with the quote above, so it's more than fitting that we begin where we left off. The catalyst for our interest back then was the ignominious collapse of Tokyo-based Mt. Gox, then the largest Bitcoin exchange in the world. Mt. Gox suffered from what they claimed was a virtual theft of nearly 750,000 Bitcoins with a value at the time of some $450 million. While the value of Bitcoin plunged to about $600 per coin in the wake of this fiasco, what was truly fascinating to us was that their *value didn't drop to zero*. By our lights, there was a great deal of *information* in that.

In the intervening years much, of course, has happened. For one thing, a single Bitcoin is valued today at about $9,000 per coin, reaching an all-time high price of about $19,500 in December 2017. The parabolic rise in the price has spawned a host of imitators. But while the price of Bitcoin has soared, so has the amount of *monies lost* through hacking and cyberattacks on cryptocurrency platforms. Total "investor" losses now total a whopping $1.4 billion. One-half of that amount was lost in just the first two months of 2018 alone. Colloquially, "Gox-ed" is now a verb. While this continued carnage has produced violent swings in the *price* of cryptocurrencies, *demand*, however, remains as strong as ever.

On January 1, 2014, to prevent it from losing its status as a global financial hub, Switzerland signed her name to the "Multilateral Convention on Mutual Administrative Assistance in Tax Matters." A new era would soon begin, with Swiss banking account data handed over automatically once yearly, to countries requesting information for the sole purpose of tax collection. What this meant, in fact, was that the infamous Swiss "Banque Privee," that is, the private bank, banker and secret account with only a number would become a relic of history.

"Thank You, Sir, May I Have Another?"**

Losses Due to Hacks on Cryptocurrency Platforms



Sources: *Wall Street Journal, FactSet*

From a big picture perspective, the world's vast oceans of "black money" would soon need to find a new place to hide. Cryptocurrencies are, of course, a logical choice and even the Swiss are contemplating an "initial coin offering" or ICO. Earlier this year, Johann Schneider-Ammann, Switzerland's economics minister, said that Switzerland wanted "to be *the* crypto-nation." Romeo Lacher, chairman of the Swiss Stock exchange called for the development of an "e-franc" backed by their central bank. Said Lacher, "I believe there would be a lot of upside, we would be strongly supportive."[2]

One cannot study the development of cryptocurrencies and ignore the obvious evolutionary parallels to services like Uber and Lyft. In New York City, for example, for most of its long history the taxi industry has been very tightly regulated. In 1937, New York City created the taxi "medallion" system, where the purchase of a single medallion would convey the right to operate an individual taxi in New York City. In 2013, a NYC taxi medallion changed hands at an all-time high price of $1.3 million. Today, NYC taxi medallions change hands at less than *one-fifth of their value just five years ago*. In the context of the taxi industry, ride sharing is a so-called "first mover advantage" - only on steroids. Uber and Lyft came on the scene so quickly, that regulators were powerless to stand in the way of consumers who had become instantly addicted to a better, cleaner, cheaper service. Eight decades of bureaucracy and regulation could not overcome the development of an app.

Arkady Bukh, a New York defense lawyer who has represented both hackers and terrorism suspects said, "I would call it a money laundering revolution. Governments are way behind the curve when it comes to regulating digital currencies."[3]

We are also quite sure that in places such as Zimbabwe, where inflation can run at 50 percent per month, there are lots of folks who'd just as soon own Bitcoin than the newly minted one-trillion-dollar Zimbabwean note. For the record, *we* would rather own Bitcoin than the Zimbabwean dollar. But one thing is quite clear. If you are an investor in cryptocurrency and the money you're "investing" is not entirely yours, or if your local currency alternative to crypto is far less attractive, your ability to recalibrate your threshold of pain for the possibility of future losses - *is extremely high*.

We will say again now what we said back in these pages in 2014. That is, we admit to having no idea whatsoever as to whether or not these currencies will thrive or even survive. But that said, there are two parts to the cryptocurrency equation: the "bit" or the blockchain and the currency or the "coin." While the coin is currency, or certainly an attempt at one, and although they are joined at the hip, for all intents and purposes the blockchain can be looked at as its own distinct entity. The blockchain is essentially a secure database, or ledger, spread across multiple computers. Everyone has the same record of all transactions, and the cryptography that underlies it allows agents to securely interact while an immutable record is maintained.[4]

Blockchain technology is being adopted increasingly by the global logistics market. Walmart, Kroger, Nestle, Tyson Foods and Maersk Shipping are all using blockchain technology to track goods. The nation-state of Dubai, for example, has declared its intent to make itself the "first blockchain-powered government by 2020." Ubiquitous use of the blockchain could streamline the global real estate industry for example, according to Stephen McKeon, associate professor of finance at the University of Oregon who studies blockchain.[4]

It is also interesting to us that cryptocurrency courses are by far the *most popular classes* on both the baccalaureate and masters level at many universities in America today. So, we hope this effort on our part serves once again as a public-service-message of sorts. At a minimum, it would be our wish that our efforts to inform and educate may make family dinner conversations more enlightened and hopefully more enjoyable. Cryptocurrencies hold the potential to be truly disruptive technologies, and for that reason alone they are worth our time and study.

Weapons of Reason Footnotes and Sources:

1. Wolfgang Munchau, "Our Flawed Financial System is Reflected in Bitcoin," *Financial Times*, March 3, 2014.

2. Ralph Atkins, "Switzerland's Stock Exchange Chairman Calls for an 'e-franc," *Bloomberg*, February 24, 2018.

3. Brett Forrest and Justin Scheck, "Jihadists See a Funding Boom in Bitcoin," *The Wall Street Journal*, February 20, 2018.

4. Christopher Mims, "Why Blockchain Will Survive, Even if Bitcoin Doesn't," *The Wall Street Journal*, March 11, 2018.

*Cryptocurrency was discussed in Q1 2014 *Market Letter*, titled "Channeling Dee Hock — the Brave New World of Cryptocurrency."
Please email elizabeth.olsen@fergwell.com to obtain a copy.

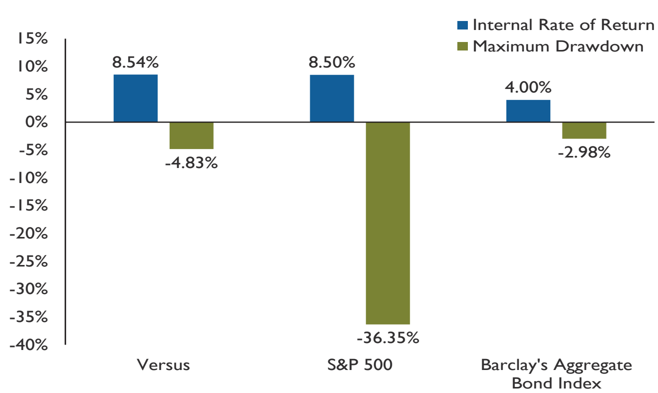
**This quote attributed to the 1978 film *Animal House* distributed by Universal Pictures.

REAL ASSET OPPORTUNITIES

Brad Houle, CFA
Executive Vice President of Research

We have recently begun investing in the Versus Real Asset Fund on behalf of clients. The Versus Real Asset Fund is a mutual fund designed to provide access to private infrastructure, private farmland and private timberland. Private infrastructure includes assets such as cell phone towers and toll bridges. Private farmland is the leasing of agricultural land to grow various crops such as corn or soybeans. Lastly, private timberland is investment in tree farms. All these assets are long-living, income-generating assets. Most importantly, the assets do not act like traditional stocks and bonds in terms of performance characteristics which serves to further diversify client portfolios. While we still believe the economic expansion will continue this year, it is clearly closer to the end of the cycle than the beginning. Late in an economic cycle, adding diversification and income an improve the risk/reward characteristics of client portfolios for an environment of increased volatility.

Investing in Real Assets



Sources: *FactSet*

We have an established partnership with Versus Capital through investing client assets in the Versus Capital Real Estate Fund which has performed as expected. Versus Real Assets Fund offers access to private infrastructure, farm land and timberland investments using a traditional mutual fund structure as opposed to a less-liquid limited partnership. In the past, an investor would need to invest tens of millions of dollars to gain access to top-tier institutional managers. This fund structure is an innovation and Ferguson Wellman has been an early investor in these strategies.

The Versus Fund allows for daily purchases and quarterly redemptions. The reason that Versus shareholders can only sell their shares quarterly is to protect investors from being negatively impacted by the actions of other shareholders. In the event an investor would like to exit the fund, the quarterly redemption procedure allows the manager of the mutual fund to return shareholders' cash in a deliberate and organized way. This decreases the chance of the mutual fund manager being forced to liquidate investments at fire sale prices in the event of stress in the financial markets.

We are pleased to be able to offer this fund to clients as it is a capacity-constrained investment opportunity that is available only to existing Versus Capital clients.

COMMUNICATION AND EDUCATION

We have moved our communication and education section of Market Letter to our website. To access this online feature and to see our industry definitions, please visit www.fergusonwellman.com/investment-terms.

If you would like a printed copy of our Glossary of Investment Terms reference guide, please send an email to info@fergwell.com and we will send it to you in the mail.

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.