Bourgeon Capital Management, LLC
777 Post Road
Darien, CT 06820

Main: 203-280-1170
Toll Free: 877-594-2071
Fax: 203-662-1100
www.bourgeoncapital.com

July 8, 2010

"Man is born free but is everywhere in debt"
-The Economist

Last quarter's letter was entitled "Farming at the Base of a Volcano," a play on the challenge of investing in a market functioning in the shadow of significant consumer and government debt. Our letter was prescient. Almost immediately after we finished our letter, a volcano erupted in Iceland. The "PIIGS" sovereign debt crisis in the Euro zone soon escalated as the metaphorical debt volcano spewed heavy ash into the economic atmosphere. This led to a complete reversal in investor perception in just one quarter. From recovery to double-dip, from rising rates to the Fed maintaining 0% rates through 2011, from a 4% 10 year Treasury yield to under 3%, and finally from stimulus to austerity. The risk has flipped in only three months from being too optimistic to being perhaps too pessimistic about the economic recovery. In this quarterly note, we're going to expand on our views of sovereign debt, its ramifications on the economy and investment climate, and the actions we have taken.

Although it is both frustrating and frightening, the renewed attention to debt is healthy and necessary. Rising government debt has been equated to a Ponzi scheme that requires an ever-growing population to assume the burden. We concur. According to the McKinsey Global Institute, total debt (public and private) in the ten mature economies of the world rose from 200% of GDP in 1995 to 300% in 2008. (Federal debt in the USA is projected to reach 94% of GDP in 2010. Historically, it has been around 30% of GDP.) A study recently conducted by Lombard Street Research suggested that each additional dollar of debt is adding less and less to GDP growth. This doesn't bode well for Keynesians who believe the path to recovery is paved with additional stimulus spending. In response to the near-default of Greece, many European countries have announced reductions in spending in order to pay down debt – including Greece, Spain, Germany, and most recently the UK. Now it is our turn. Last week the White House Commission on Fiscal Responsibility and Reform issued its report. Democrats on the panel joined Republicans in suggesting that spending cuts would have to outweigh tax increases if the United States is to seriously tackle its ballooning financial obligation. We believe that the attention currently being focused on the problem is the first step in resolving the issue.

The now-trendy global focus on austerity implies to us only one thing: slower future growth compared with previous expectations. Therefore, we believe the economic recovery will remain moderate and not the quicker rebound the market was discounting in early April. For now, we don't think another recession is imminent, but we acknowledge that the transition between stimulus and austerity is a tricky one, and we are paying close attention to economic reports.

Looking forward, we continue to believe that employment growth is the wildcard regarding the vibrancy of the recovery. With consumers representing 65% of GDP it is foolish to think otherwise. But, in order to get employment rising, we need economic growth. Hence, we believe that the Fed will keep interest rates low. Inflation, which is a concern in China, will probably remain less of a worry in the US and Europe for the next couple of years. However, if government deficits aren't addressed then the risk of inflation rises substantially.

The stock market reaction to the economic data, proposed banking regulations, and political grandstanding, was swift and painful. We believe that second quarter earnings results will be in line with consensus estimates, but we are worried that guidance will be cautious. GDP forecasts for the second half of 2010 and 2011 have already been revised lower to 2.5% and 2% respectively, so the big question is how much of this has been priced into the market? Barron's published an article last weekend highlighting how 13 of the top 25 stocks in the S&P 500 currently sell below 10x earnings. These include BCM holdings of Johnson & Johnson, ExxonMobil, JP Morgan, and Hewlett-Packard. When stocks will mount a sustained advance will probably depend on how successfully the debt crisis is addressed and by a recovery in the jobs market.

We continue to believe that owning businesses generating excess cash flow with a record of deploying it in shareholder friendly activities remains a sound long-term strategy. We have recently added to this a greater emphasis on yields. Equity dividend yields of many stocks now exceed the yields of short term corporate bonds issued by the same company. Additionally, we have been purchasing select REITs, preferreds, and MLPs in client accounts. Earlier in the year we refrained from reinvesting proceeds from maturing bonds because we were concerned yields would rise. As the crisis in Europe unfolded we began reinvesting those funds because we concluded that rates were unlikely to rise over the near term. Laddering bond maturities continues to provide some protection from low rates, but it is becoming more difficult to generate income in the current rate environment.

Lastly, we think it is important to remember that the equity market is a discounting mechanism. It moves ahead of fundamentals. We believe that as the crisis in Europe is addressed, and the US government takes its own debt reduction actions, that the healing process of the last few years will be furthered. Low equity valuations provide support to the market yet we are cognizant that the path to recovery will probably remain bumpy.

We wish you a happy and relaxing summer. Please feel free to contact us with any questions or comments. Thank you, again, for entrusting us with the management of your money.

Sincerely,

John A. Zaro III	JM Sam Nevin, Jr.	Laura K. Drynan
Managing Partner	Partner	Managing Director