BCM
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April 1, 2012

"Life is like riding a bicycle - in order to keep your balance, you must keep moving."
— Albert Einstein

During the past six months, the stock market has staged a fabulous recovery, with the S&P 500 total return up 26%. We believe that the most recent recovery has been based primarily on 3 things: significant monetary easing on a global basis, improved consumer confidence, and finally the strong showing of the US banks in the latest stress tests. However, all these wonderful events are now in our rear view mirror. For the past 3 years we have been trying to wean ourselves off of stimulus – monetary or fiscal – and each time have had to ask for more. According to research done by Bridgewater, since the end of the Great Recession, during periods of monetary stimulation, world growth rates have risen by 2%, while during interim periods of monetary inaction, growth fell by 1%. In addition, during periods of monetary stimulation, equity prices have risen by 15-20%, while during periods of minimal or no stimulation they have fallen by 5%. We are entering a period of minimal stimulation, and thus would not be surprised for a pullback. It reminds me of teaching my children to ride a bike. Add the training wheels and away they go. Take them off and watch them fall. We repeated the process several times before our kids finally got their balance. In 2010 and 2011 we tried to take the training wheels off, and both times they had to go back on again. Is the third time the charm? Can our economy keep its balance and move forward without its training wheels?

First, renewed monetary easing globally has been the central bank mantra for the past 7 months. According to ISI, there have been 130 easing initiatives. In our minds, the most important was the European LTRO (Long-Term Refinancing Operation). There had been growing concerns that the European banks were running out of liquidity, and increased speculation that there would be a Lehman-type of liquidity event. We were closely following a statistic that measures stress in the banking system, the LIBOR-OIS spread. Stress levels kept rising throughout 2011, getting closer to 2008 highs, until the first LTRO in December. This was followed by a second LTRO in February 2012, and stress levels have continued to fall. Additional important easing announcements were Operation Twist in the United States, which has helped keep mortgage rates at historic low levels, and also China lowering its reserve requirements to help restart its growth engine. But remember that all this easing will eventually have to be paid off.

Second, the University of Michigan Consumer Confidence survey has risen from a low of 56 in August, back to a level of 76. This is leading to stronger than expected retail sales as well as improved prospects for housing.

Third, the stress tests in the US provided support that the US banking system is strong, even in the face of severe pressure from Europe. Unlike the first stress test in 2009, this test was considered harsh. The assumptions were a severe recession in the United States, a peak unemployment rate of 13 percent, a 50 percent drop in equity prices, and a 21 percent decline in housing prices. In the face of these assumptions, almost all of the participating banks passed, and most have even been able to announce dividend increases and share buybacks.

Are all the risks gone? No. First, Europe still has serious issues to contend with. The LTRO bought time, but it didn't bring the solution. Liquidity risk is off the table, but sovereign default risk still remains. There are 17 countries trying to create a union through forced austerity. It's going to be a difficult and bumpy road, especially with growth initiatives few and far between. Second, war with Iran is a possibility. This has already put upward pressure on the price of oil, which in turn hurts consumer demand. Third, the debate on whether or not China has a soft or hard landing continues. We believe that China will orchestrate a soft landing, but the composition will turn to more consumer consumption rather than industrial growth. And finally, here in the US we are facing a severe lack of confidence in our leaders as well as tightening fiscal policy as we head into 2013.

So, are we ready to ride our bike without training wheels? We think that here, in the US, we are the closest that we've been in a long time. If our confidence wavers, we have Bernanke, like a cautious father, whispering that QE3 is available if we still need it. Unemployment is high but falling, housing is showing signs of life, confidence is up, and our banking system looks strong. In the near-term we see the biggest wild card is oil prices and the potential impact that it has on consumer spending. Going out a year, we will be watching the fiscal cliff hit (Bush-era tax cuts expire, payroll tax cuts expire, sequester cuts begin), and how this impacts our growth. Several economists have estimated that this could lower real GDP growth by 3-5%.

Given this backdrop, how have we changed our investment philosophy over the past quarter? We added to the portfolio early in January, but then decided to take some profit in February. All in all, we remain slightly underinvested relative to individual client target asset allocations. We continue to shift holdings to companies that have a more domestic focus. If, as in the past, there is a selloff as the benefit from monetary stimulus wanes, we still have cash to take advantage of it.

For our first quarter purchases, we focused on companies that are benefiting from domestic growth. We are becoming more confident that a bottom has been reached in homebuilding. While admittedly volatile and controversial, we believe that over the upcoming several years, this will turn out to be a fantastic investment as home affordability is currently at an all-time low, and housing starts and new home inventories are significantly below long-term averages.

We continue to believe that in this two-step forward, one-step back environment we have to remain nimble. Therefore, when we believe that when the risk/reward balance is shifting out of our favor, we have not been shy to take profit.

Bonds continue to provide safety with little real return. To compensate, our focus continues to shift to taking a little more risk in our bond holdings, keeping the ladder of maturity relatively short, and buying more higher yielding stocks. It is a wonderful time to buy a house, as the Fed continues to focus on keeping mortgage rates low to support a housing recovery.

We believe that we are getting closer and closer to the day when the US can ride its bike without training wheels, that it can keep its balance and move forward without stimulus. Once that day comes, we believe the investors who have been on the sidelines should come back. Those that are already in it and prepared should be well rewarded.

We look forward to speaking with you soon and thank you for entrusting us with the management of your money.

Sincerely,

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