BCM
Growth | Preservation | Partnership
Bourgeon Capital Management, LLC
777 Post Road | Darien, CT 06820
Direct 203-280-1170 | Fax 203-662-1100
www.BourgeonCapital.com

July 2012

Can't See the Forest For The Trees

Every once in a while, it is helpful to sit back and look at things from the 10,000 foot level. We have often used the cliché "Can't see the forest for the trees" during our careers. Typically, the best time to begin to build positions is when investors hated an industry, and vice versa. Buy low, sell high. While our timing is unlikely to be perfect every time, we can glean some interesting information by looking at the historical big picture and applying it to today.

Since 2009 our big picture view has been that the US and world economies would continue to heal, 'muddle through', and kick the debt can down the road for as long as they could, but ultimately move in a positive direction. We do not believe that we will have a repeat of a liquidity crisis in the near-term, although volatility will likely be high. Descriptions we have used to explain our view include "Two-Steps Forward and One Step Back" or "A Tug of War between Fiscal Austerity and Fiscal Stimulus" or my current favorite "Bimodal". In our April 2012 report we alluded to riding a bike with training wheels (i.e. monetary stimulus) and we asked the question. "Can our economy keep its balance and move forward without its training wheels?" It seems as though the answer was not quite yet, but thankfully we are still willing to put the wheels back on if we need them.

So, we sat back and looked at the forest. We reviewed the historical risk/return relationship between stocks and bonds, using data from BCA Research, an independent research firm. In their recent report entitled "Investing in a Low Return World," they compared the real (i.e. inflation adjusted) returns of the S&P 500 to the 30-year real return of Treasury Bonds. Graphs of their findings are listed on the following page.

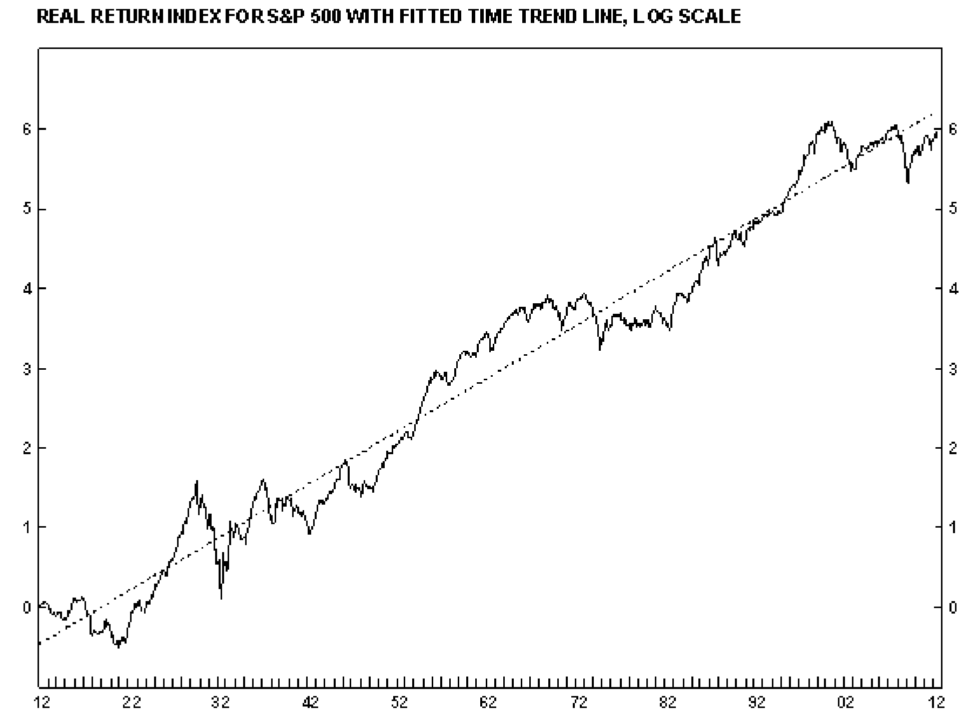
According to BCA, the equity bull markets were from 1920-1929, 1948-1968, and from 1982-2000. The stock bull markets were characterized by rising PE multiples (i.e. increasing confidence), good dividend yields, and real earnings growth of around 4%. The bond bull markets were from 1920-1940 and 1981-2012(?). Bond bull markets were supported by a fall in both inflation and real yields.

With a long run viewpoint, it appears that the real return for the S&P 500 is still below the trend line, thus implying a better relative return over bonds all else being equal (which it never is). On the other hand, the US Treasury bond bull market has primarily run its course. The 10-year Treasury yield is near historical lows and global monetary policy is trying desperately to reflate (there have been over 203 reflationary actions taken by central banks over the past 9 months alone).

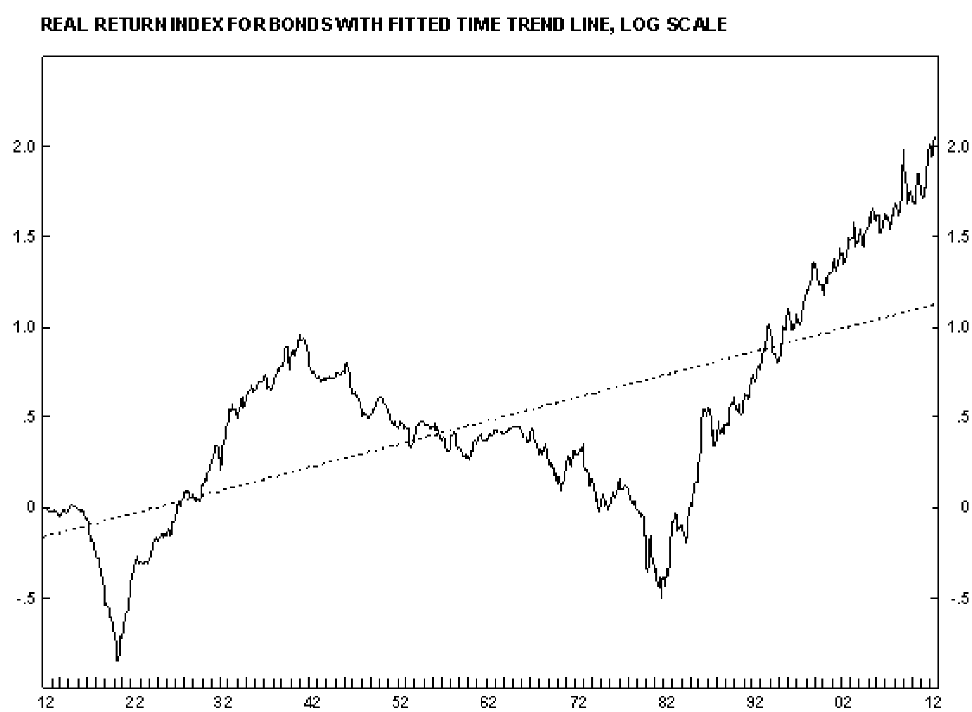
We then tried to figure out stock investor expectations. Are they optimistic or pessimistic? Here we relied on research from Bridgewater. In a June 2012 report they showed that "Today's discounted real earnings growth" for stock prices "is at the lowest levels of the past 100 years." In other words, investors are not expecting much earnings growth going forward. Not expecting much earnings, and trading below trend line, does have the potential to surprise positively going forward.

The forest view looks supportive to buying stocks, but we certainly can't forget about all those trees. There are many near-term concerns out there. First, Europe has serious issues to contend with. The LTRO (Long-Term Refinancing Operation) bought time, but it didn't bring the solution. Liquidity risk is likely 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, and recent economic figures have been

Graph 1
The S&P 500 is Currently Below Historical 100-Year Trend Line



Graph 2
The US Treasury Bonds Are Currently Above Historical 100-Year Trend Line



Source: BCA Research

declining at an accelerating rate. Second, Middle East unrest still remains elevated. Third, the debate on whether or not China will orchestrate a soft or hard landing continues. Finally, here in the US we are facing a severe lack of confidence in our political leaders right at the moment that we are heading toward a fiscal cliff. It certainly doesn't help that Q2 earnings are coming in light of expectations.

Near-term timing still remains a big issue, and global fiscal paralysis is concerning, but for those with longer-term horizons, we continue to believe that using pullbacks to bring equities at least back up to benchmark is the appropriate strategy. We reviewed the equity allocations in our balanced accounts since 2007. We averaged 60% in stocks for balanced accounts in 2007. In 2009 we bottomed out in the 30% range. Currently we have rebuilt to approximately 50%. We see a similar trend in our equity-only accounts.

Given our two-step forward, one-step back view of the macro economy for a few more years to come, we continue to believe that our equity strategy which focuses on quality and stable returns remains relevant. We own some defensive, high-yielding stocks for when the economy is stepping back, and we own some GARP (growth-at-a-reasonable-price) stocks for when the economy is stepping forward. Our year-to-date themes are companies benefiting from domestic growth, housing, and taking advantage of great companies on a pullback.

Bonds continue to provide safety with little (or negative) real return. To compensate, our focus continues to shift to corporate bonds over government bonds, keeping the ladder of maturity relatively short (under 5 years), 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.

While we have spoken generically about asset allocation in this report, we believe that it is a very individual decision. We do our best work for you when we are up-to-date on changes that may be occurring in your lives. If your situation changes at any time, please reach out to us and let us know.

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

Sincerely,

John A. Zaro III, CFA	Laura K. Drynan, CFA
Managing Partner	Partner