Growth | Preservation | Partnership
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April 2013

"Two out of Three Ain't Bad"
Meat Loaf

We have been waiting for animal spirits since 2009. When will they come? When will economic growth be something more than just anemic? We don't need giddy growth, but comfortable and consistent growth would be good. We are not exactly sure when that day will be, but we are certainly getting a lot closer. Balance sheets for corporations and consumers now look pretty good. Only the government's balance looks lousy. However, we believe that the stage is set for the government balance sheet to start improving, and that this should lead to better growth ahead. Two out of Three Ain't Bad.

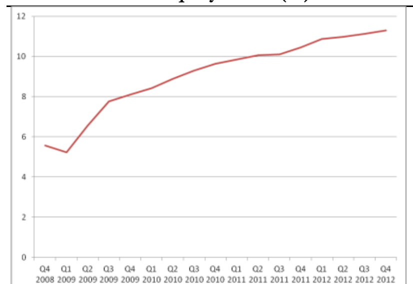
When the Great Recession reared its ugly head, the government stepped in to help. Since corporate and consumer debt was too high, the government helped relieve the burden through stimulus measures and incredible monetary easing. As the government increased its debt burden, deleveraging began elsewhere.

Corporations were the first to reduce their debt. Now, non-financial corporations have over $2 trillion of cash on their balance sheet. In addition, financial corporations have significantly delevered as well. Since the end of 2008, banks have more than doubled their Tier 1 common equity ratio from 5.3% to 11.3% at Q4 2012. (See Table 1.) With 17 out of 18 banks meeting or beating the Fed's most recent stress tests, and a slowdown of the growth rate in capital build up, we believe it is more than likely that banks will begin to lend more aggressively, helping growth.

The consumer was next. According to the Federal Reserve, the household financial obligation ratio has declined 20% since the peak in 2007 and now stands near the lowest levels since 1980. (See Table 2.) Moreover, the net worth of US households has increased 29% since the bottom of 2009 (21% when you exclude stocks).

Thus the stage is set. Corporations have cash. Consumers are feeling a bit better as their debt levels are down and unemployment is slowly dropping. And money is cheap, as interest rates are likely to stay low until employment improves. According to the Federal Reserve, 13 of the 19 FOMC participants during the March 2013 FOMC meeting saw the first increase in the target for the federal funds rate as most likely to occur in 2015. So when will the animal spirits arrive?

Table 1
Financial Balance Sheets Look Good
Tier 1 Common Equity Ratio (%)

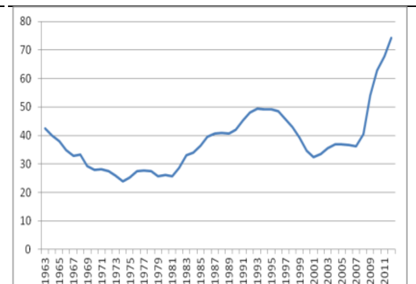


Source: Federal Reserve

Table 2
Consumer Balance Sheets Look Good
US Household Finl Obligations Ratio

Source: Federal Reserve

Table 3
Govt Balance Sheet Still Bloated
US Govt Debt as % of GDP

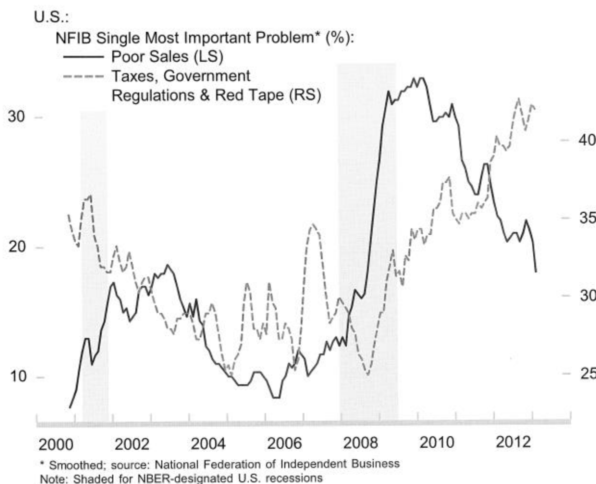


Source: US Treasury

We believe that the final impediment to more meaningful growth remains with the US government and its debt burden. At the end of 2012 US National Debt was 74% of GDP, compared with recent ranges of 30-50%. (See Table 3.) Our government lacks a credible plan to delever, and US Consumer approval rating of Congress is at historic lows. At this stage it seems that we are saying to the government, "We want you, we need you, but there ain't no way we're ever gonna love you."

The lack of a credible plan to delever makes it hard for consumers and corporations to take risk. For example, according to Thomson Reuters, in the first quarter 2013 the number of M&A deals was the lowest since 2003 as companies appear afraid to invest. According to the National Federation of Independent Business, government uncertainty remains the most significant impediment to growth. In 2006 government regulations and taxes was listed as the single most important problem for corporations 25-30% of the time. It has since grown to being the single most important problem 40% of the time. (See Table 4.) Thus, if government had a plan, and business could plan appropriately, then we believe that growth would be stronger than it is today.

Table 4
Corporations Appear Most Concerned about Taxes and Government Regs
NFIB Single Most Important Problem (%)



Source: mrb partners, NFIB

In a perfect world, the government would implement a specific plan to reduce debt. And, we believe that with the consumer slowing, if not outright ceasing deleveraging, that the economic contraction at the federal level can be absorbed. Preferable a little less debt reduction now, and a bit more in the future when the economy is stronger. But in its absence, we will take the debt reduction that we have been given. Expiration of the Bush tax cuts is one way to reduce debt, sequestration another. Still the best way is growth. Going forward we anticipate that our government deleveraging will continue, and that our economy will continue to heal, although the path will continue to be bumpy.

We are making a slight adjustment to our investment strategy going forward. Over the past several years as we have seen macro risk declining, we have consistently used dips to add to equity positions. At this time we are generally at, if not slightly above, benchmark equity allocation for most of our clients. We are comfortable here, and thus at this time wouldn't expect you to see significant additions to equities going forward. While we are optimistic of US domestic growth, we acknowledge that we live in a global world, and that there remain many risks out there. The stock market has been increasing for the past 6

months, and we believe a pause would be welcome. We want to start using pullbacks to transition our ownership to less defensive names to more of those that offer growth at a reasonable price.

During Q1 2013 a widely followed bond index posted a negative first quarter for the first time since 2006. Bonds continue to provide safety with little (or negative) real return. To compensate, our focus continues to be on corporate bonds over government bonds, keeping the ladder of maturity relatively short (under 5 years), and/or buying higher yielding stocks. With unemployment still over 6.5% we are not overly concerned about inflation in the near term. 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 only 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
Managing Partner

Laura K. Drynan, CFA
Partner

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