Bourgeon CAPITAL MANAGEMENT
Investment Counselors

MARKET INSIGHTS

JULY 2013

"I don't want to go from Wild Turkey to 'cold turkey' overnight."

— Richard W. Fisher, President of the Federal Reserve of Dallas

It's the beginning of summer, and a time for graduation parties, pool parties, and a golf game or two. It's certainly not our favorite time to write a quarterly letter, especially when the stock and bond markets are uneasy. But then we remembered that we had written about this story already in April of 2012. No need to reinvent the wheel, its déjà vu.

The following is a repeat of what we wrote in our April 2012 quarterly letter.

Déjà vu: The Fed Has Been Trying to Reduce Stimulus Since 2010

"During the past six months (through April 2012), 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 stimulus. 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?"

What do we have to change in order to make this paragraph valid for today? Not much. First, the markets are up "only" 14% in the past 6 months. Second, this is the fourth time that the Fed is attempting to dial back stimulus. Finally, and perhaps most importantly, the US economy is much stronger today, riding on the backs of the housing and energy markets.

"I don't want to go from Wild Turkey to 'cold turkey' overnight." We Should Believe the Fed

In May 2013 the Federal Reserve Chairman, Ben Bernanke, reintroduced the idea that stimulus wouldn't last forever. His words sent the stock and bond markets into a correction. The stock market dropped 5% from its highs at the worst of it, but still managed to be up 3% for the quarter. However, high yielding stocks are down 10-30%. The bond markets have taken the situation more seriously; the yield on the 10-year bond has risen from 1.7% to over 2.5% almost overnight. In essence, the Fed has tightened without having to do anything, and has had a chance to sit back and watch. They didn't like what they saw. Since the rout in bonds, most Federal Reserve committee members have tried to calm the markets. A very dovish Fed official, Bill Dudley said "Financial stability is a necessary prerequisite for an effective monetary policy". Even the hawkish President of the Dallas Federal Reserve, Dick Fisher tried to calm the markets with his statement "I don't want to go from Wild Turkey to 'cold turkey' overnight". But it appears that the market isn't listening yet.

We believe that the markets should be giving both our economy and the Fed more credit. Given historical Fed decisions, the thought of dialing back on stimulus shouldn't be a surprise. The Fed has been testing the market's appetite for it since 2010. Perhaps it's the thought that today we are closer than ever to a change in policy and that this carries risk – risk that Ben will get it wrong and push the economy back into recession. Regardless, we believe that Mr. Bernanke is willing to put our training wheels back on if the economy falters. As he has argued, the data will dictate the policy. The Fed has been true to its word from the beginning. We have no reason to doubt them.

Economic Growth is the Key

If economic growth continues even in the face of stimulus reduction, an event we believe is probable, it would be an incredibly powerful positive for the US economy, and the stock market. It would mean that the healing process is in its final stages. Perhaps it would provide more confidence for corporations to spend their cash and take on a bit more risk. Or perhaps M&A activity would resume.

Unfortunately we won't know the results of this latest Fed experiment for a few more months. Until that time we expect the stock markets to be choppy, moving sideways.

Continue to Sell Expensive Defensive Stocks and Buy Growth-at-a-Reasonable Price

To prepare for this stimulus reduction, we have been modifying your portfolios for years. Since 2009 we have actively sought to increase stock ownership, attempting to buy on dips. Most clients are currently slightly above benchmark levels. Then earlier this year, we told you that we were making a shift in our stock strategy, to reduce our defensive exposure and increase growth oriented stocks. Thus, when high dividend yielding stocks with limited growth started to look expensive, we would sell and reallocate those funds to either dividend growers, or stocks providing growth at a reasonable price (GARP). We still believe that areas of secular growth are housing and natural gas.

Our Strategy to Own Individual Laddered Bonds Mitigates the Risk of Price Decline

Contrary to the past 3 years, clients are suddenly worried about the risk of bonds in their portfolios. Bonds have been hurt more than stocks over the past few weeks. The 10-year treasury yield has risen from 1.7% to over 2.5%, almost overnight. This is an unprecedented move, and the speed with which it occurred took us, as well as others, by surprise. However there are at least two positives that come from this. First, given that the Fed Funds Rate remains effectively at 0%, we now have a nicely positive sloped yield curve which is indicative of a growing economy, typically a positive for stocks. Second, while bond yields have climbed, inflation expectations have fallen. Thus, for the first time in several years bond purchases are actually providing a real rate of return. Unfortunately, with the positives comes at least one negative. When yields rise, the price of the bond falls. Our bond strategy provides some protection from this in two primary ways. First, we own individual bonds rather than bond funds. Thus, you know the yield-to-maturity on the bond at any given time. Bond funds, on the other hand, have the potential to trade below net asset value during times of quick redemptions, and the fund, never fully 'matures.' Second, we buy bond ladders with a relatively short duration (under 5 years). Thus every year approximately 20% of the portfolio matures, providing an opportunity to repurchase bonds at the then higher rate, reducing interest rate risk. Finally, even though mortgage rates have risen almost 100 basis points in the past month, housing affordability remains near an all-time high. It is still an excellent time to buy a house.

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,

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