Bourgeon CAPITAL MANAGEMENT

Investment Counselors

MARKET INSIGHTS

SEPTEMBER 2013

"Plus ça change, plus c'est la même chose."

— Jean-Baptiste Alphonse Karr (November 24, 1808 – September 29, 1890)

We began Q3 believing that there was going to be a change. The Federal Reserve was on the verge of reducing quantitative easing, Larry Summers became a front-runner for Chairman Bernanke's job as head of the Federal Reserve, and the government was going to avoid the budget squabbles of the recent past. However, we end Q3 with the Fed continuing to go full tilt with quantitative easing, Janet Yellen once again is the front runner (and now nominated) for the Federal Reserve Chairman role, and the US government is shut down. I guess "The more things change, the more they stay the same."

The Fed took a "U-turn" and decided that it was not yet time to start tapering. Training wheels are back on and monetary policy remains highly stimulative.

In May 2013 the Federal Reserve surprised us by reintroducing the idea that stimulus wouldn't last forever. Their words sent the bond markets into a sizeable correction. Investors were prepared for a tapering of stimulus by September, but then the Fed surprised us yet again. Rather than change course, they decided to leave everything the same. Bernanke said "We can't let market expectations dictate our policy actions. Our policy actions have to be determined by our best assessment of what's needed for the recovery." Bernanke had to put the training wheels back on. Despite expectations of change, we continue to have an extraordinarily supportive monetary policy to help ensure a longer lasting sustainable recovery.

We believe that there were two reasons why the Fed made a "U-turn". First, they were concerned about the housing recovery. Chairman Bernanke has made it very clear that a housing recovery is paramount for the recovery of the general economy in the aftermath of the Great Recession. After the announcement of potential tapering, mortgage rates rose to 4.6% from an historic low level of 3.2%. This effectively increased the monthly cost of owning a home by at least 10%. Add this to home price increases that had already occurred, and the cost of owning a home with a 30 year fixed-rate mortgage had increased 15-25% in a year. Demand for new homes quickly slowed as prospective homeowners paused to digest, and a prime source for the US economic recovery weakened. Mortgage rates have now dropped down to 4.3%. Second, the Federal Reserve was concerned about the negative impact that could come from fiscal squabbles surrounding the budget and debt ceiling, and thought it was more prudent to continue with support until this passed.

Yellen is once again the front runner to become the next Fed Chairman. As one of Bernanke's closest advisors, she represents monetary policy status quo.

To us, the decision on who could become the next Fed Chairman was more interesting than the decision on taper timing. Given that the US is in much better shape than most advanced global economies, it is our belief that Mr. Bernanke has done a great job, and we don't want significant changes to monetary policy philosophy. We know that Ms. Yellen is the most dovish of all the current Fed presidents, and that it is her expectation at this time that the fed funds rate won't be raised until 2016. Ms. Yellen represents status quo. As we entered the third quarter Larry Summers was discussed as a potential front runner. While his resume is impressive, his views on monetary policy were a bit unknown by the financial community. However, by the end of the third quarter Mr. Summers had withdrawn his name from consideration. The current front runner position goes back to Janet Yellen, a dove.

Washington dysfunction looks like a constant

Finally while we had hoped that Washington would have figured out how to play nicely in its sandbox, we are dismayed that we are suffering through yet another political battle. Our government is now shut down. By mid October we need to make a decision on whether or not to increase our debt ceiling. If agreements are not made, then the US could go into default, which could carry very negative implications for the global economies and markets. The stock and bond markets had expected a quick resolution to the budget and debt ceiling talks, but this positive change from past precedent didn't occur. Every day that this shutdown continues increases the likelihood that the stock market accelerates its sell off. It is our hope that the government will come to a resolution soon, but it is our expectation that it won't happen until the 11th hour.

Status quo looks good: monetary stimulus is supportive, business loans are increasing, GDP is positive, unemployment is declining, and inflation is low.

So the changes many had expected during Q3 didn't happen. And, aside from Washington gridlock, status quo isn't so bad. In fact, status quo looks pretty good, and is supportive of continued gains in the equity market. Monetary stimulus is highly supportive, GDP is positive, North American Homebuilding Index is at its highest levels since 2005, ISM Manufacturing index is at a 2-year high, unemployment is declining, inflation is tame, business loans are increasing, and the Conference Board Consumer Confidence Index is near a 5-year high. And while status quo seems to be the situation in the US, positive change does seem to be occurring around the world. A global coordinated expansion would be a very good thing.

We believe that we are beginning to see the end of a rotation away from bonds and into stocks. Table 1 shows that since 2013 we have seen investors moving out of bonds and into stocks.

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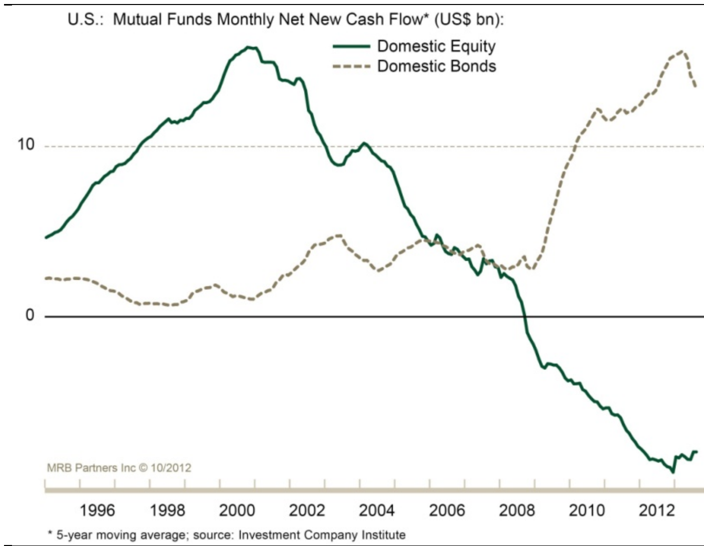
Table 1
Investors are Starting to Move out of Bonds and into Stock



Continue to Increase Exposure to GARP companies: adding manufacturing to our housing and natural gas themes

During Q3 we continued to increase our exposure to GARP-like companies and take profit from those companies where we believe the risk/reward was moving against us. We are believers in the US manufacturing renaissance theme, and we purchased two stocks this month that leverage the positive potential here. In addition we sold sold and trimmed several positions in order to keep asset allocations consistent with goals.

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

The discussion to taper and then not to taper by the Fed was a reminder that we shouldn't be too complacent about stimulus. Thus we continue to believe that the move in interest rates going forward is more likely to rise than to fall. But with Yellen at the helm it just might rise more slowly, especially if the economy continues with its two-step forward, one step back slow growth movement. Our bond strategy in this environment remains consistent. 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.

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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