



“We are at a point in this cycle where there is no longer any excuse if we don’t get economic growth.”

— Thomas Luddy, CFA, Managing Director and Portfolio Manager, JP Morgan

Our careers are largely shaped by our mentors and the experiences that we share with them. One of the smartest portfolio managers we have ever had the honor to work with is Mr. Luddy. He has a way of taking complex information and turning it into an investible thesis that is easily understandable. We recently heard him speak, and in a tribute, decided to quote him in our letter. Mr. Luddy believes that the many excuses used to explain poor growth – from quantitative easing to fiscal drag – are all fading now. So, while admitting that geopolitical risk will always be present, he believes that we no longer have any excuse if we don’t get economic growth. We couldn’t agree more. After a choppy start to the year, the markets had a strong run in the second quarter. While the market never goes up in a straight line, we believe that continued improvement in the markets is justifiable based on the economic momentum going into the second half of 2014 along with our view of reasonable valuations.

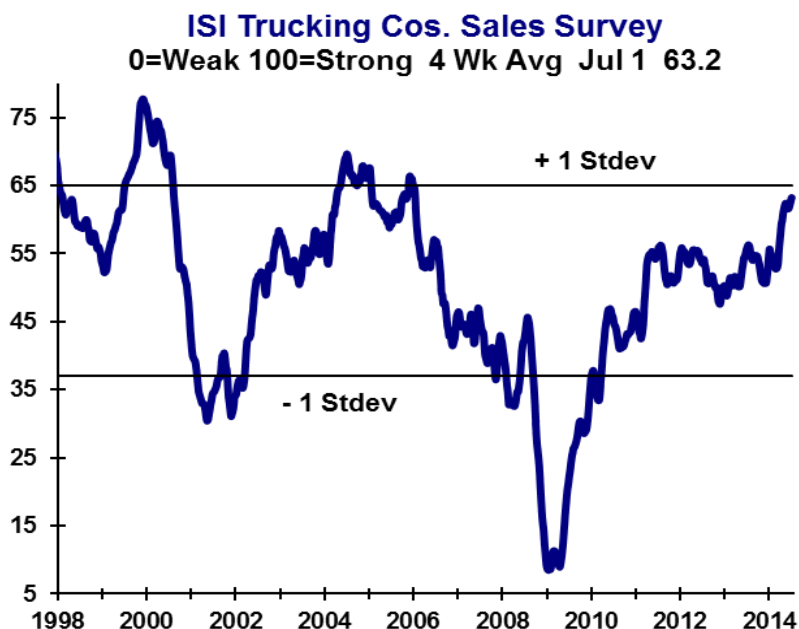
In our opinion, the US economy is on the rebound after weather related Q1 weakness and that valuations are reasonable. We believe that concerns regarding recent weak GDP numbers, falling interest rates, and valuations should resolve themselves as we move through the year.

Economic Growth is on the Rebound

While reported GDP was weak in the first quarter, more current data suggests improvement into Q2. In the first quarter of 2014, annualized GDP declined at a rate of 2.9 percent. This was significantly weaker than expected. The good news is that Federal Reserve Chair Yellen believes that this weakness was a result of ‘transitory factors’ like severe winter weather and that private domestic final demand continued to expand in Q1 and even picked up in Q2. In fact she believes that there are “many good reasons why we should see a period of sustained growth in excess of the economy’s potential,” including a highly accommodative monetary policy, diminishing fiscal drag, easing credit conditions, an improving job market, and rising home and equity prices. We believe a simple way to look at current economic growth is through transportation. One of the real time sources we use is the trucking companies’ sales survey from Oscar Slotterbeck at ISI. According to the most recent data, the trucking industry in Q2 is having the strongest growth since 2006. See Graph 1 below.

Transportation is Strong

Graph 1
Trucking Companies Are Experiencing A Surge in Demand



Source: ISI Group

Interest Rates are being Held Down by Declining Rates in Europe

Interest rates are supposed to rise when economic growth improves, but they have recently fallen. We do not believe that this implies economic growth is weak, but rather we believe that there are other factors at play. The factor that we believe holds the highest weight is that US interest rates have a 92% correlation to German bond yields. So when German yields decline, this puts downward pressure on US yields and vice versa. Thus, when the European Central Bank recently announced that they would provide stimulus to the monetary system, the yield on the German 10 year bond declined, putting downward pressure on US Treasuries. Year-to-date the yield on the German 10 year bond is down 60 basis points, compared with a 40 basis point decline in the US Treasury of similar maturity. On an absolute basis the US 10 year yield is 2.5%, significantly higher than the rate of 1.2% for the German 10 year yield. This spread is the widest that it has been in 10 years.

*Junk Bond Spreads are
Low, Implying the
Economy is Good*

Perhaps a better way to use interest rates to view the bond market's perception of economic growth is to look at junk bond spreads, and the current low spread implies an improving economy. In essence we are comparing how much more return investors are demanding in order to hold a riskier asset (junk bond) vs. a safer asset (US 5-year Treasury). When investors are nervous about the economy the spread widens as they demand a higher return for the risk, and it narrows when bond investors are more confident in economic growth. On June 25, 2014, the spread hit a level of 322 basis points, the lowest level in 3 years, and significantly below the 900 basis point reading at the end of 2011.

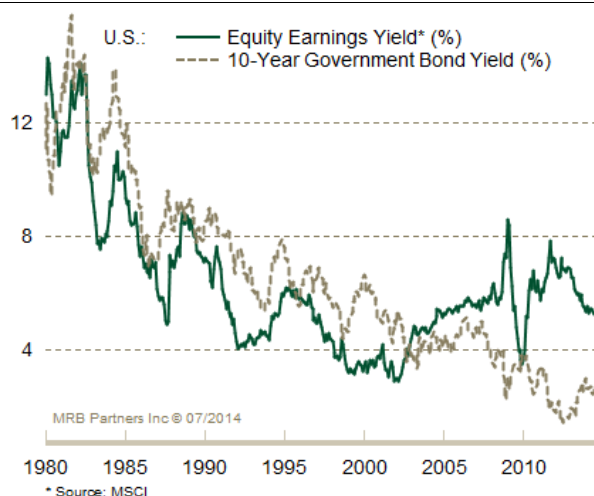
*M&A is the Highest since
2007*

Corporations are showing us that they are more confident about the economy and thus willing to take risk. According to Dealogic, year-to-date M&A was \$1.1 trillion. This is the highest total since 2007. Looking at the information another way, merger volume grew 72% from the second quarter of last year. In addition, C&I loans are up over 10% year-to-date.

*Valuations on an Absolute
Basis are only OK, but on
a Relative Basis they look
Very Good*

From a valuation standpoint, the stock market looks reasonable. On an *absolute* basis we can look at valuations by using price-to-earnings multiples. P/E multiples are a simple guide to measure whether the stock market is undervalued or overvalued. If we look at 10-year history, P/E multiples for the stock market in general look to be expensive. But, if we look at a 25-year chart, P/E multiples are about average. On a *relative* basis, comparing the earnings yield of stocks with bond yields, stocks still look very good. Earnings yield is the inverse of the P/E ratio and shows the percentage of each dollar invested in the stock that was earned by the market. The earnings yield on stocks today is approximately 5%, while the earnings yield on US government bonds is approximately 2%. This is a very large gap and indicates that on a relative basis, stocks are much cheaper than bonds. See Graph 2.

Graph 2
Equities are More Attractive than Bonds on a Relative Basis



*There Will Always be
Risks, So Don't get Too
Far Ahead of Benchmark
Equity Allocations*

Despite our positive outlook for the domestic economy, earnings growth, and the US stock market, it is important to recognize that there still are risks. Because of these risks, we still believe that clients should not let equity allocations get too far ahead of individual benchmarks. Some areas of concern are the unintended consequences of Fed tapering and/or an earlier than expected Federal Funds Rate hike, potential for deflation in Europe, continued weakness in China and emerging markets, and geopolitical uneasiness with Russia/Ukraine/Crimea/Israel.

While we have a positive view of the macroeconomic backdrop, choosing the right companies in the right sectors will become increasingly important as the Fed continues to taper. Our favorite secular growth stories are US exposure over international, housing, natural gas, and manufacturing/industrials. But there are opportunities elsewhere as well.

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

The Fed appears to be firmly committed to tapering quantitative easing, with some bias toward eventually raising rates earlier than expected as long as the labor market continues to improve and they are not concerned about deflation. The 10 year Treasury has settled in the 2.6% range, above the 1.6% low hit in May 2013. We had believed that rates were more likely to rise than to fall this year, but they fell in Q2. As we indicated earlier, we believe that this is tied more to easing by the European Central Bank than an implication of slowing growth. Either way, the decline in rates is helping the Fed to exit QE perhaps more gracefully than would otherwise be the case. We have made no changes to our bond strategy, and continue to 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, which reduces interest rate risk.

While we have only spoken generically about asset allocation in this letter, 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. We enjoy speaking with you and sharing ideas on a consistent basis, and if your situation changes at any time between our regular discussions, 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, CIC
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