Bourgeon CAPITAL MANAGEMENT

Investment Counselors

MARKET INSIGHTS

September 2014

"The Key to Keeping Your Balance is Knowing When You've Lost It."

— Unknown

Several years ago we compared the ending of the very first quantitative easing (QE) program with seeing if the US economy could "ride its bike without its training wheels." Every year since 2010 the Federal Reserve has tried to reduce economic stimulus, and every year it has had to delay taking it off or increase it. For January 2014 we had a great starting point with a strong economic core and good GDP momentum. It has now been 9 months since the US started to reduce QE, and the program is scheduled to be over in October. What do we see? The US economic growth is above trend at over 3%, but the stock markets are nervous, as they historically have been when stimulus ends. Geopolitical concerns top headlines, and growth outside the US is slowing (especially in Europe). Negative headlines dominate the media affecting sentiment. Will our growth slow too? Our economic bike is a bit wobbly. While we currently believe that the US can handle the end of QE (and maybe rate hikes in 2015?), there is always the fear of the unexpected. The FED can always decide to put those training wheels back on, as they have consistently done in the past.

Our economic core is strong and GDP growth has been above trend at a 3% level.

The US core is quite strong, and a pleasant surprise is that most economic indicators have finally reverted back to historical average levels. The three major components of economic growth are solidly back to normal levels and are no longer retrenching. Corporate balance sheets are strong, and banks are very healthy. Consumer debt levels are low, and household net worth is the highest it has ever been. Unemployment has fallen to under 6% from a high of over 13% (wow!). Both consumer and small business confidence is back to historical average levels. Finally, US government annual deficit levels are back to normal. Is our core strong enough?

The US economy has momentum. Real GDP is poised to rise above 3% in four of the last five quarters. Corporations are spending, and the consumer is beginning to step up again as employment improves (nonfarm payrolls have advanced above 200,000 75% of the time over the past year) and as oil prices decline (oil is down 20% in three months). Is this the escape velocity that we need to maintain our balance?

While QE is ending, the FED has repeatedly shown and reminded us of its willingness to put our training wheels back on if necessary

Looking at the components of FED's mandate more closely (maximum employment with stable prices), unemployment has fallen under the 6% threshold, and inflation remains tame due to weak global demand. It was appropriate to begin dialing back the stimulus. A rule of thumb is that the effects of a change in monetary policy take about 6 months to show up in the economic data. We started reducing QE 9 months ago, and while growth has moderated only slightly, it remains above 3%. Will there be unexpected consequences of the removal of quantitative easing? If the answer is yes, the FED has shown themselves to be very data dependent and willing to put the training wheels back on. In a September 17, 2014 speech Chair Yellen reminded us that "even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run."

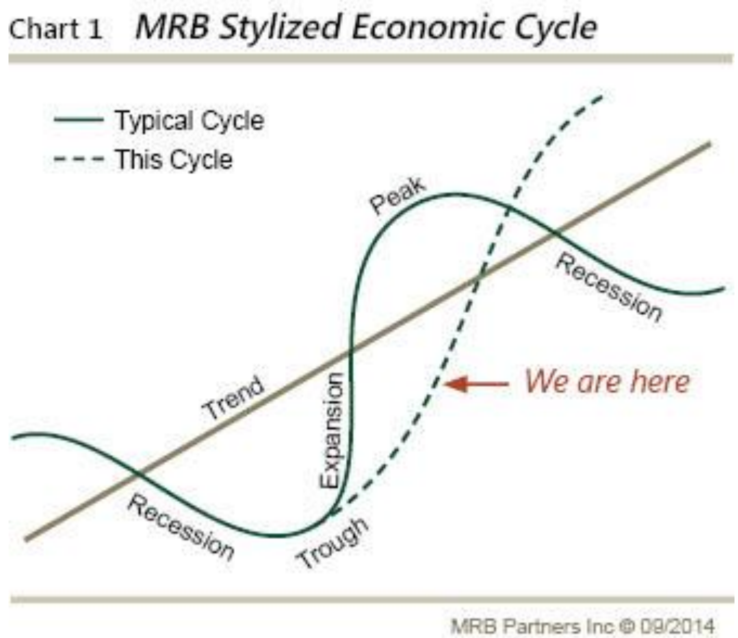
Our domestic economy is strong, but economic weakness outside the US and geopolitical concerns are worrisome.

However, just because the US economy is strong, doesn't mean that there are no outside influences, or unexpected events, that could cause us all to question the stability of the current expansion. The list here is quite long: European economic weakness is currently at the top of that list, but we must not forget Russia/Ukraine tension, ISIS, China slowdown, Brazil woes, UK housing, Ebola fears, etc. Negative headlines are dominating the media affecting sentiment.

Can the US economy decouple from the rest of the world and grow, even if other economies are weakening? This has been the case for the past several years, so we believe it is possible. But the recent rate of decline in Europe does make the path ahead of us more uncertain. (Don't forget that other central banks can decide to add more financial stimulus and put on bigger training wheels.) The positives coming from a weak OUS include: a) Rest of world weakness is helping to counterbalance the upward pressure on our interest rates. The current 10-year Treasury yield is at 2.3%, the lowest since June 2013. This is like a stimulus gift, allowing us to exit quantitative easing more gracefully than would otherwise be the case. b), international weakness is helping to keep inflation tame (ex. oil prices have fallen 20% in the past 3 months), allowing the FED to take its time to reduce stimulus. c) Our currency should strengthen, which historically has been a benefit. The negatives include: a) Our export market could weaken. b) Multinational earnings are at risk. In fact, foreign sales represent over 30% of S&P earnings.

Expect corrections when stimulus is removed, but we believe that we are in a modestly sloped longer than usual recovery.

Even if the US economy is strengthening, what does this mean for our stock market? While linked, they don't always move in tandem. History has shown that since the Great Recession, in periods of stimulus the stock market has grown 15-20%, while in periods of no stimulation the market has pulled back 5-10%. We are in a period of no stimulation at the moment. But history has also shown that as long as economic growth is maintained as rates rise, the stock market eventually powers through until rate levels become overly restrictive (likely a year or two away). While 5-10% corrections are to be expected in any recovery, over the long haul we believe that the foundation continues to be built for a modestly sloped longer than usual recovery. Macro Research Board describes it with the following chart:



Valuations for the stock market remain attractive on a relative basis (i.e. stocks are likely to be a better return than bonds), but only reasonable on an absolute basis. Combine reasonable valuation with a rising list of risks, and we believe that investors should remain close to benchmark risk allocations. This has been our stance since the second quarter of 2013.

We made several changes to the portfolio this quarter and the net result was an increase in cash

During the third quarter we made several changes, adding to positions we want to build, and exiting those that met our price targets or were not performing to our expectations. The net result of these actions was an increase in cash.

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Interest rates have declined on weakening global demand.

While the Fed appears to be firmly committed to tapering quantitative easing, an eventual rate rise remains data dependent. Expect a slower than expected hike if the labor market weakens and if deflation concerns increase. And the reverse holds true as well. The 10-year and the 2-year Treasury yields have recently dropped to the lowest levels in over a year. With employment improving and mortgage rates dropping, this is once again an excellent time to buy a house. We have made no changes to our bond strategy, and continue to buy bond ladders with a relatively short duration (under 5 years).

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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