



“It is better to be roughly right than precisely wrong”

— Maynard Keynes, 1883-1946

Since mid 2014 we have been using strength to pare back risk positions, and we accelerated this process into the fourth quarter. Over the past six months we believe that the risk/reward profile of the market has become increasingly less favorable. And while we are not outright bearish, we do feel that the likelihood for a correction has increased. First, after seven years of increasing monetary stimulus we are moving ever closer to the time when the Federal Reserve begins to raise rates due to strength of the domestic economy. Historically the start of any Fed tightening cycle due to a strengthening economy has initially led to a correction in stock prices before ultimately resuming a bullish tendency. Second, corporate earnings are vulnerable as growth in many countries outside the US (especially Europe and China) continues to weaken, potentially negatively impacting 30% of the sales associated with the S&P 500. Third, the decline in oil prices to levels under \$60 per barrel could be a destabilizing force for many countries, increasing the risk for geopolitical uncertainty. Finally, from a very broad perspective, valuations are now stretched as the S&P 500 trades at the high end of historical P/E averages. Despite our paring back, we still have meaningful exposure to equity markets, and as always we will continue to look for mispriced investment opportunities.

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The Fed is moving closer to raising rates

In mid 2007 with the initial signs of the Great Recession, the Fed began a monetary easing cycle that has lasted seven years. But as we get closer to meeting the Fed's dual mandate of maximum employment and price stability, 2015 may be the year that monetary policy begins to tighten.

There is no doubt that the US economy is strong and strengthening. Corporate and consumer balance sheets have been repaired. The government's balance sheet is high, but no longer increasing, and has the possibility of shrinking as a percentage of GDP as US growth continues to improve. Domestic GDP has surprised on the upside for several years, even in the face of the recent reduction in quantitative easing by the Federal Reserve. We are sympathetic to those economists who expect that US GDP in 2015 could even accelerate further into the 4% range, a level we haven't consistently seen since the 1990s.

The Federal Reserve has a mandate of maximum employment and price stability. With the unemployment rate under 6% the pressure to increase rates to head off potential inflation rises. But inflation expectations are running at 1.5%, lower than the target of 2%.

Let's take a closer look at inflation expectations. Will the recent decline in oil prices cause the Fed to be concerned about deflation and thus substantially delay any increase in the Fed Funds rate? We believe the answer is probably not. Historically the Fed has looked through changes in food and energy prices and has focused on core inflation metrics, such as the PCE (Personal Consumption Expenditure), and on inflation expectations, which have remained relatively stable. In addition, wage inflation has typically been a better predictor of core inflation metrics. With employment under 6%, the probability rises that wage inflation begins to increase in 2015.

How is the Fed proceeding with the conflicting data? "Patiently." According to the Taylor Rule, a commonly used predictor of Fed policy, the Fed is already late in beginning to tighten. But they are cognizant that if they move too fast they risk derailing the expansion that they have so carefully nurtured. So, the Fed is walking the middle path and moving 'patiently', slowly removing stimulus with QE while proactively assuring the financial markets with their words. The Fed is providing expected dates of liftoff, but lessening the trajectory once they begin. Finally, the Fed is reminding us that they remain data dependent and will put back the training wheels if necessary. This is a delicate process, and one of our colleagues has aptly likened the Fed's situation to landing a plane on an aircraft carrier.

*The start of a Fed
tightening cycle has
historically triggered a
correction*

If the Fed decides to raise rates in 2015 we believe that the risks to Main Street are relatively modest. However, the risks to Wall Street are higher as historically there is a correction ahead of initial rate hikes during an expansion phase. Once the stock markets become comfortable that growth can continue after the rate hikes, the bull market typically resumes.

International Growth is Slowing

While the US economy shows further signs of acceleration, many other economies show further signs of deceleration. Decoupling remains a theme for 2015. In aggregate there has been a recent downside bias on global GDP estimates as both the IMF and World Bank have recently lowered their outlooks. Approximately 30% of sales for companies in the S&P 500 are outside of the US. Thus weakness internationally coupled with a strong dollar could lead to lower earnings for many companies. Most countries are aware of the weakening growth and are trying to turn things around through looser economic policies. We believe that in 2015 Europe, China, and Japan are likely to continue to announce policies to help stimulate their economies, and thus have an opportunity to improve their growth rates going forward.

*Weakening growth outside
the US could spill over to
weak growth in multi-
national corporations*

The decline in oil prices to under \$60 per barrel could be destabilizing for many countries increasing the risk for geopolitical uncertainty

The Dramatic Decline in Oil Prices Could be both Helpful and Hurtful

Over Thanksgiving week OPEC decided that it would not cut production to defend the price of oil. Instead they decided to let non-OPEC producers “balance” the market through potential production or capital spending cuts. The end result has been a period of ‘price discovery’ as a primarily cash-rich monopoly steps aside to watch where oil finds a bottom. How far oil drops, and how long it stays down will have significant ramifications for the global economy.

The reality is that this is a change in process, and the market is unsure of the end result. The Saudis seem to want a swift and severe price drop that leads to production cuts/capex reduction and/or closure of high cost producers. Oil prices have plummeted from \$100+ to below \$50 in six months. Stock prices for energy companies have fallen with oil. The expectation is that this reduced cash flow expectation will eventually lower capital spending more than what we have already seen and thus bring the market into balance quickly, with subsequent stability by the second half of 2015.

While we have already started to see capital spending reductions (no major defaults yet), it is difficult for us to say with certainty that price stability will happen by the second half of 2015. It could come earlier, or it could come later. For commodities in general, prices usually drop to at least the level of marginal cash cost before finding a base. What is that marginal cash cost level for oil companies? There are many theoretical studies that say it is in the \$60 range, but the truth is that this has been untested in the market for decades. Nonetheless we believe it is a good starting point. As Maynard Keynes said “It is better to be roughly right than precisely wrong.”

A broader concern lies with the fact that the decline in oil focuses investors on what this means for global economic growth and stability. Many economists point out that every \$10 per barrel fall in oil price leads to an increase in GDP of about 20 -25 bps in the US economy as there is more cash in one’s pocket. However, such a precipitous fall sends a very real message that many other economies around the world are weak and that overall demand growth is slower than previously expected. In addition, the longer the price stays weak the more it pressures the economies of several oil producing nations, such as Russia and Venezuela, increasing the possibility of a financial crisis. If we look back at history to the previous seven times where oil declined so precipitously, four of those times, or 60% of the time, it was followed by stock market rallies. While we believe that our current economic situation is closer to

the times when the stock market outperformed, we nonetheless feel that we should be mindful of the other 40% of the time when it was followed by recession.

*With the year-end rally
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Valuations are now broadly stretched

With the year-end rally, valuations of stocks are now broadly stretched. Using the price-to-earnings ratio, the median stock in the S&P 500 currently trades at nearly 18x forward earnings. According to David Kostin of Goldman Sachs, this has happened only 2% of the time since 1976, with the average being 15x over the past 10 years, and 13x over the past 35 years. In addition, historically when the real yield (10-year yield less inflation) has been in the 1-2% range, then the forward P/E ratio has been closer to 13.5x. Over the past 100 years the average real return of the S&P 500 has been 6%, we have averaged 15% since 2009. Add to this a very high Bull/Bear ratio of 3.5:1, credit spreads that continue to widen, and increased volatility and it appears that the risk/reward ratio has become less favorable.

*We believe that the
risk/reward tradeoff has
turned less favorable, and
as a result we have pared
back equity exposure.*

One of your mandates that we take very seriously is to adjust asset allocation levels when we believe the risk/reward tradeoff turns less favorable to help preserve capital. We felt that it was prudent to trim equity exposures as we headed into 2015. Since the middle of 2014 we have reduced equity exposure by 10%, and we have tried to do this in a tax efficient manner. Another mandate that we take just as seriously is to take advantage of mispriced securities. We are active managers, and the same risk/reward focus that we use for asset allocation we also use for individual stocks. While we typically invest with a long-term time horizon and modest turnover, there are periods where we make larger than usual changes to the portfolio, and the fourth quarter of 2014 was one of those times. Even after taking into account our recent risk reduction, we are still meaningfully exposed to stocks.

*The real return on bond
portfolios has been
increasing as short term
rates rise and inflation
falls*

Short term yields have vacillated significantly over the past few months as investors keep changing their mind as to when the Fed may or may not raise rates. Into December 2015 short term rates had risen to a level where we could purchase 5-year investment grade bonds near 2.5%, almost 100 bps above what it was about 2 years ago. Moreover, given that inflation has been declining as oil prices drop, the real return is much better. Conversely long-term yields are being held down by weakness outside the US and a stronger dollar. Thus mortgage rates are dropping and housing is becoming more affordable.

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,



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