



“Even if you have a so-called statistically significant outcome, which is 95% certain – 95% still leaves 5% you know nothing about.”

— Howard Marks, Co-Chairman/Principal/Co-Founder of Oaktree Capital

When we sat down to write this quarterly letter a few weeks ago, we decided to write about the positive and negative ramifications of the massive share repurchase authorizations made by US companies year-to-date. Interesting but mundane. Since then, every time we pick up our letter to finish it, there has been a new negative headline, and we had to change our focus. First there was Greece and Grexit that wasn't probable and then it was and now probably not. Then there was the Governor of Puerto Rico declaring that the commonwealth's debt is 'unpayable', a comment which also took many investors by surprise. Additionally, China's stock market dropped 30% in a month, losing \$3 trillion of value, an event almost unthinkable a month ago. Finally commodity prices reversed downward with a vengeance. We rebuilt cash over the past quarter as several stocks reached our price targets. Despite the buildup of cash we remain meaningfully invested in equities. While we are constructive on the prospects for equities, we are cognizant that macro risk has risen and we will remain vigilant in putting money to work. We will do so when we feel that valuations appropriately compensate us for the risks we see and the 5% we don't.

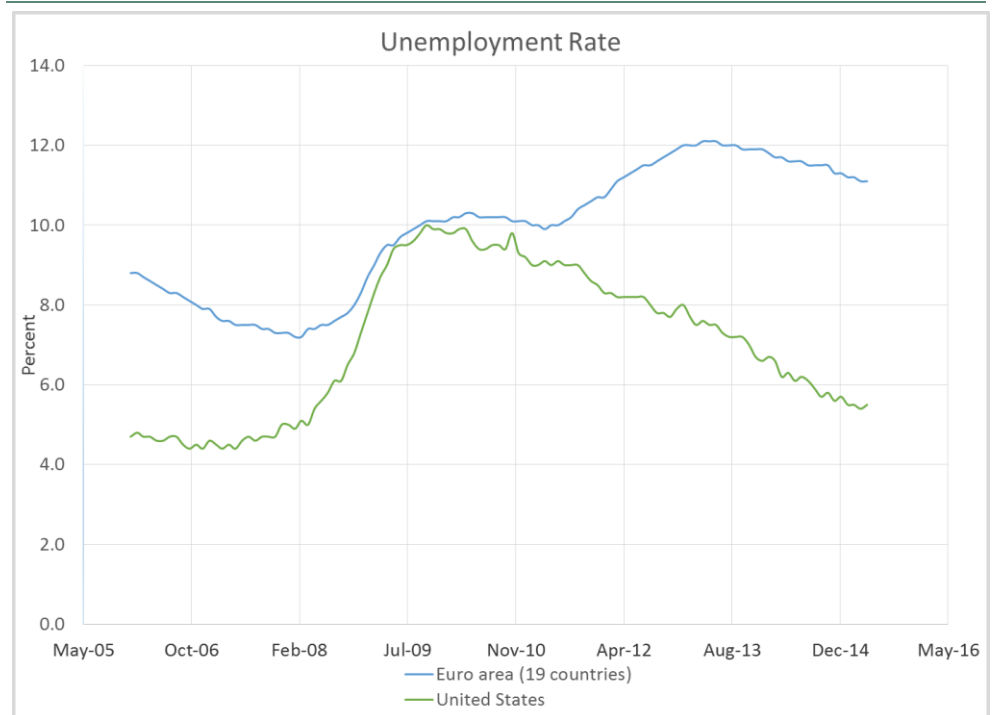
Given that the macro risk/reward tradeoff turned less favorable, we raised cash as stocks reached our price targets and are now able to take advantage of opportunities that may arise.

We started 2015 with a list of macro concerns, and they remain relevant today - the potential beginning of Federal Reserve rate hikes, slowing global earnings growth, weak oil prices, and recessions in Russia and Brazil. Our list of concerns has grown over the past six months – impact of a potential Grexit, China's stock market in a correction, the implications of Puerto Rico's debt crisis, and declining commodity prices. Valuations through the end of June still appeared relatively full to us despite what we saw as increased risks. According to Howard Marks, CEO of Oaktree “It's the job of investors to strike a proper balance between offense and defense, and between worrying about losing money and worrying about missing opportunity.” There is no doubt that the global financial system is significantly stronger today than in 2008, and credit spreads remain well contained. But the degree of uncertainty in the markets has risen, and we don't want to be complacent about risk. Given that we believed the risk/reward tradeoff had turned less favorable we raised cash in the second quarter when several stocks reached our price targets. We look forward to redeploying those funds to take advantage of mispriced investment opportunities when they arise.

Our economy is stronger today than it was in 2009. Debt levels for consumers and corporations are back to relatively low levels, and both the government and the FED have been reducing stimulus for the past year or more. While not taking off for the races, our economy has continued to chug along at a growth rate around 2%. Unemployment has dropped in half to a bit over 5%. See Table 1. Bank capital ratios are significantly higher and thus are better able to absorb unexpected shocks to the system. Bank lending is strong, up over 7% this year after a strong 2014.

Comparatively the Europe Union also has had improvement since 2009, but not as much as in the US. Both fiscal and monetary policy were not as aggressive compared to the US, and some countries in the Union with the highest debt levels have had to implement levels of austerity that have led to significant unrest (i.e. Greece). Unemployment, has come down slightly overall, but the disparity among countries is large with the most indebted countries remaining stubbornly high. Unconventional monetary easing policies took 5 years longer to implement for legal and political reasons, but they are now in place and Draghi has committed to do ‘whatever it takes’.

Table 1
US Labor Market Has Strengthened Faster than in the Eurozone
Unemployment Rate US vs. Eurozone



Source: Eurostat

So far we have been impressed by how calm the European credit markets have been. We are also watching the retreat in commodity prices on the backs of China's stock market decline for insights into global growth.

During times of crisis we watch how well or poorly the credit markets act in order to give us an idea of possible financial market contagion. While it has been several years since we have had a correction, one should expect equity markets to be volatile. *(In fact, we have not seen a 10% or greater correction in the S&P 500 since 4Q 2011 or almost 1,300 days. This is the third longest period since the Great Depression and the fifth longest period since the 1870s without a 10% or greater correction. Statistically speaking, the odds of a correction are high and rising.)* But when the credit markets suffer, that is the worst type of crisis. We have been very impressed by how calm the credit markets have been given all the recent turmoil and negative news flow. Thus, we are hopeful that Draghi can live up to his promise to contain any credit stress in Europe under worse case scenarios surrounding Greece, but acknowledge that there is uncertainty. In addition to Greece, Puerto Rico now says that its \$72 billion of debt is unpayable. The US Treasury has provided advice to San Juan, but lacks authority to finance a bailout. We are watching to see how this situation is resolved and what role the US government decides it wants to play.

We also follow commodity prices to get an idea of how global growth may be impacted by macro events. Starting June 12 and lasting almost a month, the Shanghai Composite declined precipitously. This resulted in the loss of \$3 trillion of value, over half of all shares being suspended from trading, and financial institutions being required to buy stocks while insiders are not allowed to sell for 6 months. Anticipating some economic turmoil to follow, commodity prices have subsequently retreated, raising some alarm bells about future global growth rates. Second quarter earnings season conference calls will be helpful in beginning to understand how the global economy may be impacted.

Table 2
China's Stock Market Lost \$3 Trillion Dollars in 4 Weeks
Shanghai Composite Equity Market



If global financial markets remain unsettled, it is likely that the FED would delay a rate hike.

Yields in the U.S. continue to vacillate significantly due to changes in the underlying assumptions as to when the FED may decide to raise rates, and to changing expectations of global risk and global growth. While we have been in the camp for the past six months that the FED would likely raise rates sooner rather than later, if the world financial markets remain unsettled due to Greece/China/another unforeseen event, it is likely that the FED would delay their first move. The 10-year yield has been trading in the 2.0-2.5% range of the past quarter. We have been relatively patient with our reinvestment of maturing bonds, attempting to purchase 5-year corporate bonds as close to 2.5% as possible, almost 100bps above what it was about two years ago. Given that inflation has declined, the real return is much better today than over the past three 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
Managing Partner



Laura K. Drynan, CFA, CIC
Partner

Bourgeon Capital Management
777 Post Road
Darien, CT 06820

203.280.1170 | 203.662.1100 -
bourgeoncapital.com
ldrynan@bourgeoncapital.com
jzaro@bourgeoncapital.com

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