Bourgeon CAPITAL MANAGEMENT
Investment Counselors

MARKET INSIGHTS

October 2015

"Life is like riding a bicycle – in order to keep your balance, you must keep moving."

— Albert Einstein

During the third quarter of 2015 global markets declined significantly as concerns of a potential US rate hike were exacerbated by economic weakness from China, Russia, and Brazil. The S&P 500 declined by 6%, the MSCI Europe Index declined 9%, the MSCI Emerging Markets Index declined 18%, and the Chinese stock market declined 28%. Given the recent uncertainty, we thought it would be a good idea to resurrect a concept from 2011. Since 2009 the global economy has moved forward supported by significant fiscal and monetary support. Since then, whenever the world has tried to wean itself off of stimulus – monetary or fiscal – each time it had to ask for more. We compared this to trying to teach our children to ride a bike. Add the "training wheels" and away they go. Take them off and watch them fall. We repeated the process several times before our kids finally got their balance. In mid-2014, because the US had steady growth and falling unemployment, it was time to once again attempt removing the US training wheels by ending QE3. But when we took off our training wheels, we took some air out of the tires of the training wheels for everyone else - Europe, Japan, China, and other Emerging Markets. While the US might be able to ride its bike without training wheels, we are not so sure about the rest of our playground friends. Like all good parents, the central banks of the world say encouraging things - implying that they are there to pump up those tires with fiscal and monetary stimulus if necessary. Yet, the world is now questioning whether or not the central bankers will be true to their word, and the markets are likely to be unsettled until we know the answer. We entered Q3 with relatively high cash balances, and have begun to opportunistically put some of the cash to work while being mindful of the risks.

A relatively strong US economy has allowed us to take off our training wheels.

Who is ready to take off their training wheels? Over the years since the Great Recession, global growth rates have moderated from an average of 4.5% down to 3%, and are now headed even lower. Separating emerging market growth from developed country growth there is a significant change. Emerging market countries, led by China, Russia, and Brazil are slowing significantly from historical high single digit levels. Comparatively the US and other developed markets growth rates have been resilient at modest levels, but have so far been unable to offset the EM decline. Thus overall global growth rates are currently on a downward trajectory. See Table 1.

Table 1
Global Real GDP year-over-year % Change
Using PPP**

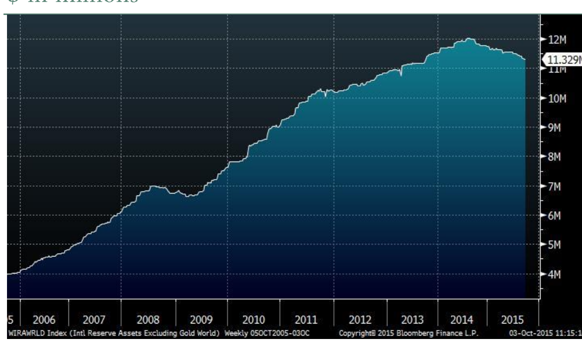
	Weight**	2015:2Q	2015:4Q e	2016:2Q e
U.S.	16%	2.70%	2.80%	3.20%
Eurozone	11%	1.50%	1.00%	1.50%
Japan	5%	0.90%	0.50%	0.50%
U.K.	2%	2.60%	3.00%	3.00%
Other Developed	6%	1.50%	1.00%	1.00%
Developed	**40%**	**2.0%***	**1.8%***	**2.1%***
China	16%	7.00%	6.00%	5.00%
India	7%	6.90%	7.00%	6.00%
Brazil	3%	-2.60%	-5.00%	-4.00%
Russia	3%	-4.60%	-5.00%	-4.00%
Other Emerging	31%	3.60%	3.00%	2.50%
Emerging	**60%**	**4.2%***	**3.5%***	**2.9%***
Global	**100%**	**3.30%**	**2.80%**	**2.60%**

Source: Cornerstone Macro
** Wtd Avg ** IMF 2013Weights*

But when we took off our training wheels, we let the air out of the tires for everyone else.

Given the strength of the US economy it made sense that the US would stop quantitative easing in 2014. But when the US stopped quantitative easing, global liquidity dropped. Graph 1 shows international reserve assets excluding gold for the world over the past 10 years. Since mid 2014, when we ended QE3 this ratio has been declining.

Graph 1
International Reserve Assets Excluding Gold, World
$ in millions



Source: Bloomberg

Who is going to pump up the tires this time?

The decline in international reserves has resulted in a tightening of financial conditions. In a way, it was a form of ‘quantitative tightening’ rather than ‘quantitative easing’. Global GDP growth rates have declined for the past several quarters at a much more rapid pace than we at Bourgeon had been expecting. Ms. Lagarde, the head of the IMF recently said “I can already tell you this: global growth will likely be weaker this year than last, with only a modest acceleration expected in 2016.

If the US is done with quantitative easing, who is left to pump up those tires to improve growth? All the central bank parents are saying the right thing, but it's time for action. As Albert Einstein said "In order to keep our balance we must keep moving." On September 23, 2015 Draghi, the head of the European Central Bank said "We will adjust size, composition and duration of Asset Purchase Program as appropriate, if more monetary policy impulse should become necessary". On Sept. 28, 2015 Japan's Kuroda said "The Bank maintains its policy stance that…it will make adjustments without hesitation if judged as necessary to achieve the price stability target at the earliest possible time." If global weakness continues, we believe that the FED would continue to delay rate hikes and under an extreme scenario, perhaps even consider QE4. While some have given up on the central banks stepping up to the plate, recent history has shown a great willingness to do so, we just don't know the timing.

Ultimately all eyes are focused on China with the hopes of a very large fiscal stimulus program

While more liquidity from Japan and Europe should help, all eyes are really on China since they are the epicenter of the recent global economic weakness. China GDP represents a whopping 16% of global GDP, on par with the US. China is moving from being an industrial led economy to one led by the consumer sector. History has shown that this is a necessary but potentially very painful process that will take time to resolve. It is not inconceivable that China falls into recession before fixing their excesses and emerging victorious. The Central Bank in China has been following a slow and steady drip of easings which so far have not been able to stop the declines. They propped up their stock market, and devalued their currency (something we expect to continue). At the end of the day we think that both China citizens and the rest of the global markets would welcome a very large fiscal stimulus program.

In fact, pro-growth fiscal stimulus programs globally would be extremely helpful

Monetary policy, which has been exceptionally aggressive over the past few years, can only take us so far. Ultimately we believe that the best solution would be if governments around the world implemented more pro-growth fiscal policies to reignite animal spirits.

While a financial crisis is far from our base case, we continue to monitor measures of financial strain.

While it is likely that global weakness could weigh down US GDP, a recession or financial crisis in the US is far from our base case at the moment. But, we are not complacent. We continue to monitor financial conditions and risk spreads both domestically and abroad for signs of extreme stress. So far financial strains have been concentrated in a few emerging markets such as Brazil and South Africa, or in US energy high yield. Otherwise the credit and risk spreads, while elevated, have remained rather tame when compared to 2008/9. Most importantly, the US banking system is significantly stronger today than in 2008.

We continued on our path to opportunistically position our portfolios more defensively.

During this time of unease, we have been busy changing the portfolio to take on a more defensive bias. We had raised cash heading into the third quarter, and have begun to put some of the money to work on an opportunistic basis while being mindful of the risks. From a sector allocation standpoint, year-to-date we have increased our healthcare, financial, and technology exposure while reducing our energy, materials, and industrial exposure. In regards to our energy exposure, we have outperformed on a relative basis, but admittedly our total return is negative YTD through the end of Q3. Our relative outperformance in energy has been a result of owning the higher-quality names, as well as opportunistically trimming or selling several of our MLPs near all-time highs during the first half of 2015. We have confidence that all our energy holdings have strong balance sheets and are some of the best in their field.

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 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.

We understand that in turbulent times there is a tendency for anxiety to increase. As always, we welcome the opportunity to discuss your portfolio and our current thinking with you at any time. 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