Bourgeon CAPITAL MANAGEMENT
Investment Counselors

MARKET INSIGHTS

January 2016

"Our greatest glory is not in never falling, but in rising every time we fall."

- Confucius

After a brief hiatus, several negative Q3 trends reasserted themselves by the end of Q4, resulting in global stock markets ending the year on a weak note. The S&P 500 declined 0.7%, and MSCI All World Index declined 4.3%. Several headwinds have increased: China's growth continues to slow leading to controlled devaluations and stock market support, the US raised rates for the first time in 10 years with more potentially to come, credit spreads domestically have widened, and geopolitical tensions have been exacerbated by decade low oil prices. However, in the face of these headwinds, the world continues to take action steps to counteract the situation: European Central Bank and Bank of Japan balance sheets continue to expand, China has announced significant fiscal stimulus measures, the US fiscal budget is stimulative for the first time since 2010, and low commodity prices are reducing costs for many countries. We will continue to monitor how the pros and cons balance out. Irrespective of the conclusion, we think that investors should expect more volatility in 2016 as the debate precedes the data. We have not been idle. During 2015 we kept equity allocations below benchmarks, reduced commodity exposure in the portfolios while increasing technology, healthcare, and financials. As we move forward, with valuations becoming more attractive, we will continue to selectively look for opportunities to put cash to work, balancing our dual objectives of risk adjusted return and capital preservation.

Global growth rates are weakening, what's a country to do?

Since our Q3 2015 quarterly report, global economic growth has continued to weaken. Within the developed world, the US is seeing slow and steady growth, and Europe is slowly improving. But this is being overshadowed by economic weakness from China, Russia, and Brazil. On January 7, 2016 the World Bank cut its 2016 global growth forecast from 3.3% to 2.9%.

Ever since the Great Recession central banks around the world have met weakening growth and deflationary pressures from weak commodity prices with monetary and fiscal stimulus. The major central banks have inflation and/or employment goals and targets, and thus are compelled to act when these goals are not being met. The complication this time around is that the US Federal Reserve is reducing stimulus while most other major countries are increasing it.

China is managing its transformation from an industrial led economy to a consumer led economy. Historically this is a painful but necessary process. Monetary and fiscal stimulus abound.

China is 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.

China is not without tools to make the transition less painful. Their central bank has been following a slow and steady drip of easings. China has recently upgraded its rhetoric and now says that it wants 'Foreceful' fiscal policy. According to Don Straszheim of EvercoreISI, since the middle of 2015, China has implemented 70 new fiscal stimulus measures, and the budget deficit is projected to be 4% of GDP, the largest in at least 15 years. The fiscal stimulus spending represents 2.2% of GDP. China continues to prop up their stock market. Finally the delinking of the yuan vs. the US dollar (and subsequently linking to a global basket of currencies) is a good thing for China, allowing devaluation, causing their exports to become relatively more attractive. We expect that the devaluation will be just as controlled as the appreciation was during the past few decades. The unintended consequence of these actions has been capital flight, causing China to sell its foreign reserves, and implement new controls. The result of selling foreign reserves tightens global liquidity, offsetting some of the stimulus. The adjustment period aside, ultimately this will help improve China's competitive positioning, speeding up their transformation.

Monetary policy in Europe and Japan are solely focused on keeping inflation at target ranges, so if deflation persists, expect more stimulus, not less.

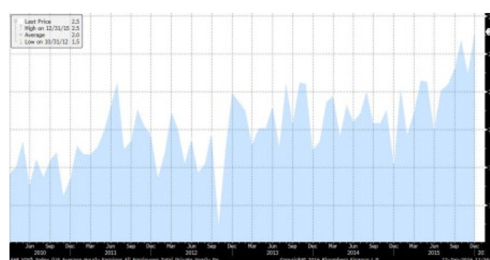
Europe and Japan are not meeting their inflation targets, and have recently increased their balance sheets, providing significant stimulus. In December, the Bank of Japan's balance sheet was up 30%, and the European Central Bank's balance sheet was up 29%. It is the expectation of Ed Hyman at Evercore ISI that both balance sheets will be up 30% in 2016. The good news is that we have started to notice some stabilization and even improvement in several European economies, but if inflation remains weak, we would expect even further monetary stimulus.

But with unemployment down to 5%, the US is tightening as emergency measures are no longer deemed necessary.

Compare and contrast the massive stimulus moves from Europe, Japan, and China with the United States. The US economy has been slow and steady, growing, expanding, and creating jobs. Unemployment has fallen from over 13% to 5%, exceeding its employment goals. In 2014 the US stopped quantitative easing and in December 2015 the Fed raised rates for the first time in 10 years as emergency measures were no longer deemed necessary. Ultimately the reason that the US Federal decided to raise interest rates, even with global uncertainty and deflationary pressures, stems from the strength of the US economy and the historical relationship between higher wages and inflation. Increase in average hourly earnings has had an

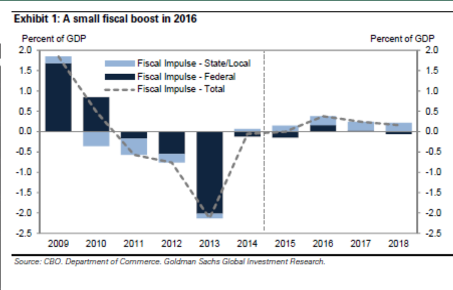
upward bias since the middle of 2015, something one would expect with the unemployment rate at a low 5% level. See Table 1. In addition, it has historically been the Fed's view that lower oil prices are stimulative to our economy. While this has yet to fully take effect on our economy since the consumer has decided to increase its savings rate to 5.5%, we do expect a fairly robust consumer in 2016. Plus the US budget for 2016 is modestly stimulative, the first time since 2010. See Table 2.

Table 1
Average Hourly Earnings Slowly Increasing



Source: *Bloomberg*

Table 2
There is a Small Fiscal Boost in 2016



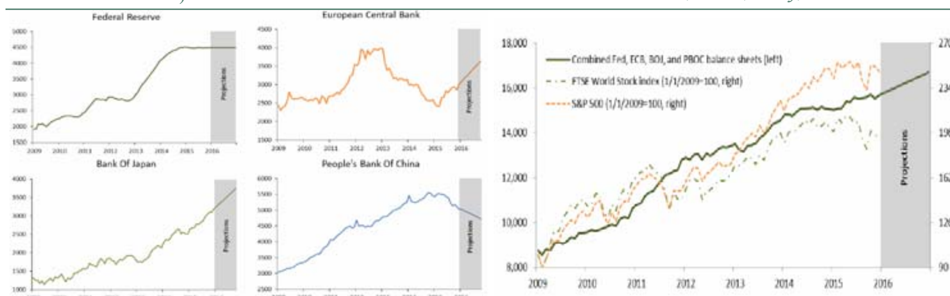
Source: *Goldman Sachs*

How will these divergent forces balance out? If it's not working we expect more commitment, not less.

How will these divergent forces balance out? Many of the recent announcements of stimulus are only just being implemented, and we will need time (six months) to see the results. According to Roberto Perli from Cornerstone Macro, we may get an acceleration of global liquidity for 2016. He took historical and projected central bank balance sheets from the US, Europe, Japan and China and combined them together to conclude that global liquidity still is growing. But what if we don't get economic improvement? The central banks have been committed to their targets for almost a decade now, and we believe that they will continue to stay committed. The US Federal Reserve continues to imply that this will be the lowest and slowest tightening cycle in Fed history. Moreover, who says that the Federal Reserve can't reverse their decision if the data warrants it? They have done it twice since 2008.

Table 2
Diverging Central Bank Balance Sheets
Historical and Projected

Table 3
Global Liquidity Will Still Grow Fast
Balance sheets of Fed, ECB, BOJ, and PBOC



Source: *Cornerstone Macro*

A US recession is not our base case, but the odds have increased over the past few months.

While it is likely that global weakness could weigh down US GDP, a recession or financial crisis in the US is not our base case at the moment. Domestic economic growth continues to be slow and steady with weakness in the manufacturing and energy sectors being offset by improvement in bank loans, wages, and lower cost of gasoline for the consumer. The hit to oil and gas capital spending is perhaps close to an end as rig counts have dropped by 70%, and the rate of decline has begun to flatten out. 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. Most importantly, the US banking system is significantly stronger today than in 2008.

With the debate preceding the data on several trend changes we expect volatility in 2016 to continue.

With so many major long-term trend changes occurring – US tightening and stronger dollar, China global growth declines and deprecation, OPEC removal of quotas, escalating geopolitical tensions – the stock market uncertainties have reignited volatility as we head into 2016. Moreover, with earnings growth estimates slowing, the breadth of the market has narrowed significantly, implying underlying weakness. For example, the S&P 500 Index was down 0.73% for 2015, but the mean performance of all stocks in the Index was down 3.0%. Put another way, despite a fairly modest decline in the Index, 36% of stocks are down 20% or more from their 52-week high.

During 2015 we increased the defensive nature of the portfolios, finding pockets of growth in a low growth world, or compelling restructuring stories.

During this past year, we have been changing the portfolios to take on a more defensive bias. We have been underweight equity allocations for most of the year and overweight cash. From a sector allocation standpoint, for 2015 we increased our healthcare (defensive growth), financial (benefit from high interest rates), and technology exposure (pockets of growth in a low growth world) while reducing our energy, materials, and industrial exposure. We are also favoring self-help/restructuring stories.

In regards to our energy exposure, our belief that the oil market would tighten in the second half of 2015 was obviously incorrect. While we did reduce energy exposure in early/mid 2015, we were not aggressive enough and regrettably we underestimated the Q4 weakness from our MLPs, and we ended the year by doing tax loss selling from several of our energy holdings. We still believe that the cure for lower oil prices is lower oil prices, and with the price of oil under the marginal cost of production for most of the world, the supply/demand balance should improve throughout 2016.

Given the weakness in the industrial sector, we decided to continue to reduce our reliance on general manufacturing and commodities. In our opinion, a potential area of continued growth in the industrial sector was in defense stocks, given geopolitical unrest, and the increase in the US defense budget.

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Welcome to what is likely to be the lowest and slowest tightening in Fed history.

After several months of laying the groundwork and watching incoming data, the Fed increased rates by 25 basis points in December 2015. While the absolute value of the increase is modest, the fact that this is the first increase in a decade is momentus. Moreover, it is the rate of increase from here on out that becomes the question, and the Fed continues to imply that this will be the lowest and slowest tightening in Fed history. Historically an increase in the Fed funds rate due to a strong economy has subsequently led to an improved stock market after an initial few months of hand wringing. This time it is no different as market pundits question whether or not this is a policy mistake, especially given OUS economic weakness. With the increase in the Fed funds rate in December, the short end of the curve rose, while the long end has stayed relatively flat, implying that the bond market is also questioning the move. We stepped up our bond buying in December immediately before and after the rate hike to take advantage of a 5-year investment grade corporate yield-to-maturity rate of over 2.5%. This is the best level we have seen in yield-to-maturity since 2011, and with inflation lower today, the real return is much better.

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
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