Bourgeon CAPITAL MANAGEMENT
Investment Counselors

MARKET INSIGHTS

April 2016

"Some people see the glass half full. Others see it half empty. I see a glass that's twice as big as it needs to be."

\- George Carlin (1937-2008)

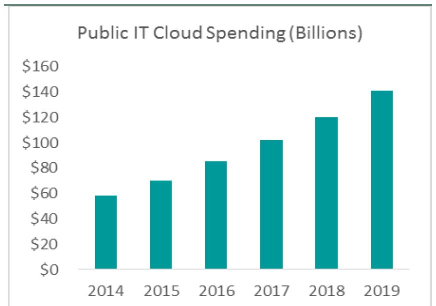
In our last quarterly letter when we said that volatility in 2016 was likely to be high, we didn't expect it to be as extreme as it was during the first quarter. From the beginning of the year through February 11, 2016 the market dropped 10%, and then subsequently rose 13%. The S&P 500 ended the quarter up 1% for the year. From a macro perspective, the world is quieter now compared with a few months ago. Most importantly, as we had hoped, central banks around the world have continued to provide significant monetary stimulus when confronted with growth and deflation fears. In the US, GDP has stabilized, labor markets have stayed strong, and fears of recession have subsided. China has better control over their foreign currency conversations, reducing uncertainty. The dramatic swings in investor perceptions– from glass half empty to glass half full, from deflation to inflation, from bear market to bull market – create pitfalls and opportunities. The two-step forward one-step back process that has marked the US decade long deleveraging process still has to play out on a global basis. Thus it is likely that we will continue to be in a low global growth environment for a while to come and that volatility stays high. We have been focusing our investments on attractively priced companies that provide growth in a low growth world or that provide compelling restructuring stories. As always we work to balance our dual objectives of risk adjusted return and capital preservation.

We see technology as an attractive sector in providing opportunity in a slow growth environment.

Over the past several quarters we have written extensively about things that are weakening, such as global growth rates, oil prices, and China's foreign currency reserves. In this quarterly letter, instead of focusing on the glass half empty, we thought we would focus on the glass half full. If the world is only growing slowly, where should we invest? We believe that in this environment great investments can be made by finding pockets of growth in a low growth world or by finding compelling restructuring stories.

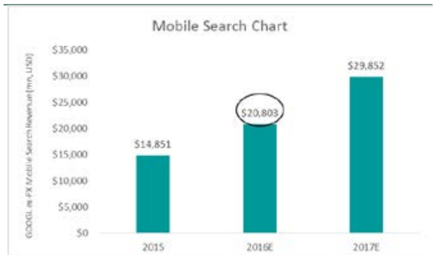
While recognizing that our portfolios are diversified across many industries with many different characteristics, in this letter we are going to focus on one area where we see growth in a low growth world: technology. We have made significant changes to our technology holdings over the past year, increasing our holdings from 11% to 18% of your portfolio. The long-term themes we have focused on have been: cloud services, mobile search and video, mobile payments, and cybersecurity.

Table 1
Cloud Services are growing at a 19% CAGR



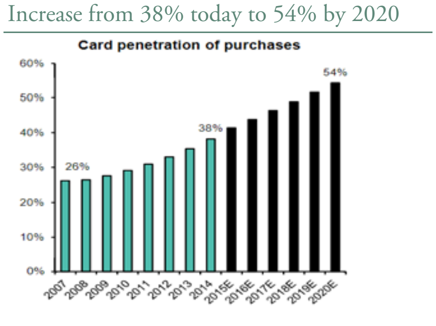
Source: IDC

Table 2
Mobile Search is growing at a 40% CAGR



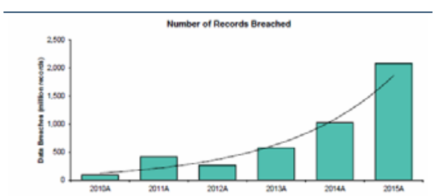
Source: Alphabet

Table 3
Card Penetration of Purchases Could Increase from 38% today to 54% by 2020



Source; WEO, Worldbank, Nilson, Bernstein

Table 4
Cybersecurity Breaches are Growing at an 80% CAGR



Source: Bernstein

Worldwide spending on public **Cloud** services will grow at a 19.4% compound annual growth rate from $70 billion in 2015 to more than $141 billion in 2019 according to International Data Corporation (IDC). Cloud computing means that instead of all the computer hardware and software you're using sitting on your desktop, or somewhere inside your company's network, it's provided for you as a service by another company and accessed over the internet, usually in a completely seamless way. "The cloud" has been a theme for several years, but it is gaining more and more acceptance because for most organizations it should be significantly less expensive to use cloud storage services or run software in the Cloud, all else being equal. In addition, the Cloud provides flexibility and scalability.

Mobile search continues to grow over 40% per year, and **video** consumption now makes up over 30% of the time spent online. According to comScore, in the 2-year period between December 2013 and December 2015, tablet internet consumption grew by 30%, while smartphone internet consumption jumped by 78%. Alphabet's (Google) mobile search grew 41% in 2015 and it is expected to grow over 40% per year for the next two years. According to Morgan Stanley, Alphabet and Facebook drive 85% of US online ad growth. In addition, Facebook and Alphabet (through YouTube) combined make up 70% of the online ad video market.

There is a long-term trend of cash-to-card conversion, as credit cards represent only 40% of total purchases on a worldwide basis. This supports a secular growth trend that could lead to overall credit card payment growth of 11% per year. The addition of **Mobile payments** and Mobile wallets should only accelerate this trend. The scramble to provide a mobile payment platform is on, and Apple declared 2015 the year of Apple Pay. This has subsequently been followed by numerous mobile payment options by banks, financial services companies, and technology companies.

The continued increased use of the Internet, combined with low cost computing power, has made cybercrime more financially rewarding, and as one would expect, the number of security breaches is rising exponentially. There have been several high profile attacks against companies like Target, Home Depot, and Anthem. Even the IRS and the Pentagon have been hacked. Since 2010 the number of records breached has grown at an 80% rate, and this is just for those attacks reported. To fight these attacks, Obama recently requested $14 billion to boost US **cybersecurity** defenses. In addition James Clapper, the US Intelligence Chief has said that cyber ranks highest on worldwide threats to the US. The concept is a simple one. With the ever increasing use of the internet, mobile devices, and big data in our corporate and personal lives, we believe that demand for cybersecurity only increases.

New technology companies with exciting new technologies are emerging every day, and the rate of change in technology has never been greater. Long-term trends often have short-term hiccups, and winning strategies sometimes become losing strategies very quickly. We always ask ourselves, how much should we pay for the growth, and what is the downside risk? As we look to invest in technology we remain mindful of valuation and the balance we must strike between capital return and capital preservation. Our preferred style when investing in technology is to find companies that offer Growth-at-a-Reasonable-Price (GARP). Strong cash flow and a good dividend yield help as well.

Table 5
Wage Growth is Accelerating

Pantheon Macro

From a macro/economic perspective, wage growth acceleration is one of the most important statistics that we have been watching. The real wage growth rate (after subtracting out inflation) is now around 2%, accelerating from recent levels of close to zero. As the unemployment rate has fallen from 13% to 5%, this has begun to put upward pressure on wages. There is some belief that increasing the minimum wage has helped here as well. This is the fastest rate of wage growth in 8 years. It is also very important to note that the participation rate has begun to rise as well. The implication of these two items is that the jobs market in the US continues to improve, and if the growth rate on wages continues to increase that inflation may not be far behind. This implies to us that the Fed should continue to raise rates.

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 momentous. 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. In addition, in February there was significant concern regarding increased default levels in energy high yield as oil prices dropped significantly. This led to overall credit spreads widening, and a great opportunity for us to step up and buy great investment grade bonds at a relatively very wide spreads vs. the US Treasuries. In fact 5-year investment grade corporate bonds were yielding close to 3%., the best level we have seen in yield-to-maturity since 2011, and with inflation lower today, the real return is even better.

Credit market angst in February gave us a chance to buy investment grade bonds at wide spreads vs. Treasuries.

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

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Bourgeon Capital Management
777 Post Road
Darien, CT 06820

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