Bourgeon CAPITAL MANAGEMENT
Investment Counselors

MARKET INSIGHTS

June 2016

"If you are not confused, you don't know what is going on."

\- Jack Welch

Since December of 2014, global equity markets have provided little in the way of positive real returns to investors. The inability of the global economy to respond to unprecedented amounts of central bank easing has resulted in increased uncertainty and heightened volatility. This "economic stalemate" of sorts provides little confidence as to whether the next major move in equity markets will be up or down. Compounding the above, we also find that while history usually provides a sound analytical framework to judge the present, in certain instances we have entered uncharted waters rendering historical relationships less helpful than they have been traditionally. Interest rates have fallen to historic lows yet global growth has not responded accordingly. In fact, 40% of global government bond yields are in negative territory. In those markets, investors are paying the government to hold their money! While we continue to remain cautiously optimistic, given the current level of uncertainty and volatility it is our view that a heightened focus on capital preservation is the most prudent course of action. Thus we are keeping clients close to benchmark equity allocations and are being particularly sensitive to buying stocks at the right price. Our investment focus remains primarily in the US in companies with the following characteristics: franchise businesses with strong management teams capable of providing visible earnings growth in a low growth environment, and/or companies that have the financial wherewithal and management inclination to grow and compound dividends. We will also continue to look selectively at companies going through change as a result of internal catalysts that can provide enhanced return through increased earnings growth, multiple expansion or both.

Since December 2014, the global markets have traded sideways with increased volatility. Global uncertainty, like Brexit, continues to be met with Central Bank Monetary Policy easing certainty. As a result, over 40% of government bond yields are trading in negative territory and valuation on equities has once again become cheap relative to bonds, but expensive on an absolute basis. However, despite the historic low rates and significant increase in monetary supply, global GDP growth rates have continued to weaken. Monetary policy cannot work alone. We hope that the Brexit crisis leads to pro-growth fiscal policies from developed countries in Europe and the US. If not, then at some point monetary policy may become less and less effective. Equity allocations in our portfolios peaked 24 months ago, and we sold 10% of our equities by year-end 2014. Since then we have trimmed holdings when we believed the risk/reward moved unfavorable and added to positions with the opposite characteristics. In these uncertain times, we continue to invest primarily in US stocks (best house in a bad neighborhood) with strong management teams that provide growth in a low growth world, and/or that have above market yields, and/or that have internal catalysts. We were deliberate in our conservative position ahead of Brexit. We have been and remain concerned about a snap back in rates due to continued domestic wage inflation, and would rather own short term bonds than utilities. Not owning utilities was to our detriment in Q2, but given historically low rates, we believe that we will be on the winning side of this trade going forward. Until we have further clarity on the political and economic fallout of Brexit and our own elections, we will continue with this strategy.

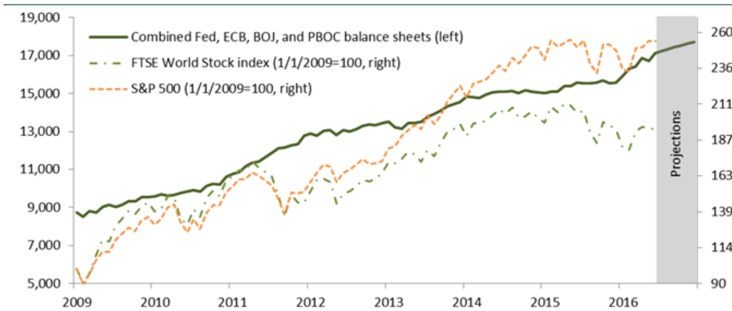
The Global Markets Have Provided Little in the Way of Real Returns for the Last 18 Months with Increased Volatility

Since December 2014, the S&P 500 is up only 2% (5% if you include dividends). This compares with an average annual rate of return of 15% for the prior 6 years. Volatility has increased. Three times during the past 18 months the index has had a significant fall. Twice it fell over 10%, only to recover in a few weeks. After Brexit, the index fell 'only' 4.7% recovering a few days later. From a global perspective, the MSCI All World Index is down almost 5% over the past 18 months.

Don't fight Global Central Bank Expansion

Since the Great Recession, the answer to global uncertainty has been for monetary policy makers to provide liquidity. Brexit was no exception – in fact the Central Bankers were the only ones who seemed prepared to act. They have become very resourceful and creative at developing many new ways to inject liquidity into the global markets. Table 1 plots the performance of the FTSE World Stock index and the S&P 500 relative to the combined balance sheets of the Federal Reserve, European Central Bank (ECB), Bank of Japan (BOJ), and People's Bank of China. There is a strong correlation between the lines. When Central Bank balance sheets expanded, global stock markets improved. When the line flattens, so do the stock markets. Over the past few months the line has increased as significant balance sheet expansion from the ECB and the BOJ have offset flattening in the US and declines from China.

Table 1
When Central Banks Provide Liquidity, Stock Markets Rise

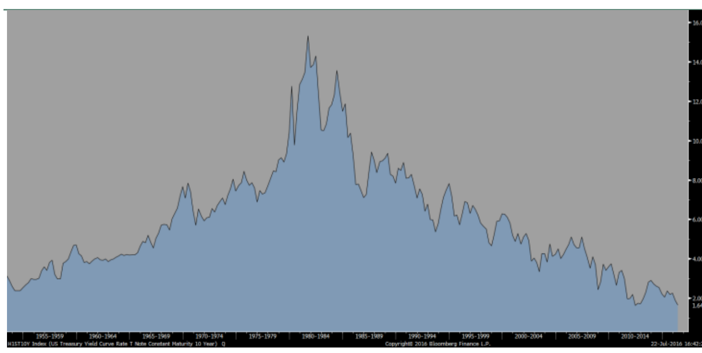


Source: Cornerstone Macro

Government Yields are at Historic Lows

The result of global monetary policy easing has been a steady decline of interest rates. Here in the US the 10-year bond is now at all-time lows. The 30-year mortgage rate in the US is under 3.5%. On a global basis, over 40% of all government debt is trading at negative rates (i.e. investors are paying the government to hold their money). This significant decline in bond yields has led to a significant rally in stocks with high yields (such as utilities and telecom) as investors chase yield. We believe that these stocks have rallied to extremes that could lead them to be vulnerable should US rates rise on rising wage pressures. Table 2 shows the 10-year yield over the past 65 years.

Table 2
US 10 Year Yields are at Historic Lows



Source: Bloomberg

Despite The Strong Balance Sheet Expansion, Global GDP Has Been Weakening: Except in the United States

Ultimately we would like to see low interest rates translate into increased GDP. However, that has not been the case for most of the world. Weakness from China, Russia, and Brazil has more than offset stable growth from the US and recently improving growth from Europe. Given the political uncertainty that surrounds a Brexit divorce, it is likely that European growth weakens as we move forward despite expansive monetary policy.

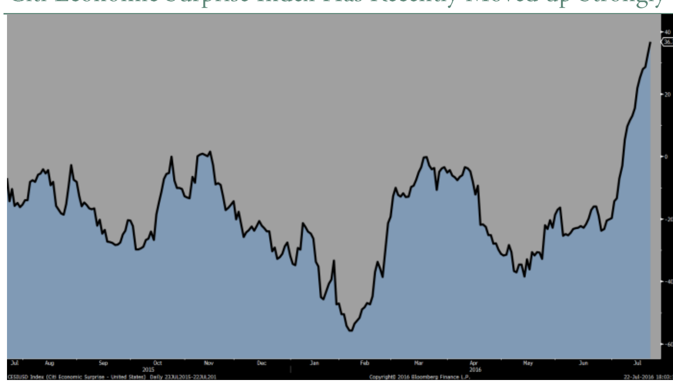
The United States has the most promising economic picture, growing at low double digits. There has been much hand wringing about the US economy and how much it may be impacted by many global uncertainties. Nancy Lazar from Cornerstone Macro has done a nice job outlining the tailwinds and headwinds in Table 3. But despite this handwringing the US economy has continued to forge ahead. In fact, the Citi Economic Surprise Index has risen steadily since the beginning of July 2016, underpinning some of the recent moves in the equity markets. See Table 4.

Table 3
Tailwinds and Headwinds for the US Economy

5 Tailwinds	9 Headwinds
1. Lower mtg rates	1. Declining U.S. Business Confidence
2. Healthy domestic corporate profits	2. Brexit uncertainty
3. Healthy U.S. consumer balance sheets	3. Eurozone slowdown
4. Rising trend in household formations	4. China/EM slowdown/recession
5. Broadening impact of the Mfg Renaissance	5. Washington political uncertainty
	6. Widening BAA spreads
	7. Declining U.S. multinational profits
	8. Unwinding of U.S. energy boom
	9. Geopolitical turmoil

Source: Cornerstone Macro

Table 4
Citi Economic Surprise Index Has Recently Moved up Strongly



Source: Bloomberg

Fiscal Expansion Policies Would Be Nice but Investors and Companies are Uncertain

The idea behind monetary rescue policies is that they provide time for fiscal policy to fix the underlying problem. With the increasing divisiveness of global politics, investors and companies are increasingly uncertain as to the future. Thus, the desire to take risk declines. The addition of fiscal stimulus to provide some guidance and confidence to invest for economic growth would be helpful. Some suggestions might be infrastructure, healthcare, environment, internet, cybersecurity, or perhaps most interesting a reform of the corporate tax code to make us more competitive on a global basis would help. If Brexit creates a willingness of fiscal policy makers around the world to act to help support economic growth then this would be a good outcome to a difficult problem.

Will the Recent Balance Sheet Expansions be Enough to Move our Markets Forward?

Only time will tell if this recent balance sheet and monetary expansion "at all costs" will continue to be enough to move our markets forward. Ultimately it comes down to earnings. Are earnings growing – either through increased demand, increased price, reduced cost, or share repurchase? The earnings outlook for the US is back end loaded, and now supported with better oil markets. July earnings season so far has been fairly good.

Valuations are high

Equity valuations, such as Price-to-Earnings multiples are high in absolute terms, but relative to bond yields, they are attractive. In fact, the dividend yield on stocks is now higher than the yield on the 30 year bond (a very rare occurrence). We continue to wonder what happens if/when bond yields begin to rise again? Wages in the US continue to increase, and are now rising at a 4% rate, the highest in at least a decade. Historically wage inflation leads to general inflation. The Fed will be watching these developments closely and will have to weigh potential domestic inflation against global uncertainty.

We are Watching Risk Measures and So Far So Good

While it is still in the early days, we continue to watch for financial stresses after the shock of Brexit, and so far so good. On the periphery there have been some real estate investment trusts where trading was halted due to illiquidity. Credit risk spreads overall seem to be well contained. We are being most mindful of liquidity risks in European banks and we are watching the trading of the largest European banks. The price of the European Bank Stock ETF (includes 600 banks) has fallen in half over the past year.

The 10-year Treasury is at Historic Lows

There is no place to hide. With 10-year yields at historic lows, investors are chasing yield at any cost. Many prominent bond investors including Gundlach and Gross believe that we are in a bond bubble. We believe there is a risk that with wages growing at an increasing rate, the Federal Reserve may begin to increase rates faster than people expect. We have been and remain concerned about a snap back in rates and continue to believe that a short term bond ladder remains the best course of action. We have been deliberately slow in bond maturities after Brexit as we believe that interest rates should increase from these very low levels based on continued improvement in the US economy and increases in wage inflation.

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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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