Bourgeon CAPITAL MANAGEMENT
Investment Counselors

MARKET INSIGHTS

March 2017

It's Not What You Say, But What You Do That Counts

As we said in our last quarterly letter, "Strategy is Easy, Execution is Really Hard". The Trump administration was unable to pass the Republican healthcare legislation (AHCA) on the first try. We wish our government much success as it moves on to some of our favorite pro-growth agenda items: tax reform, repatriation, reduced regulation, and infrastructure spending. One would have thought that a Republican sweep would have led to easy Republican victories, but that has not yet been the case. There are many headscratchers out there, as many historical correlations appear to have broken down, at least momentarily. Consumer confidence and wages are up, but retail sales are down. Business confidence is up, but commercial and industrial loans are down. Given the AHCA initial failure, it may be appropriate to handicap the Trump agenda success, especially as valuations appear to be a bit ahead of fundamentals and the Federal Reserve is talking more regularly about withdrawing monetary stimulus. Thus we were not surprised that after an initial rally into the inauguration that stocks have pulled back a bit. However, with the most synchronized global economic upturn in years, we are constructive on the remainder of the year. We took the opportunity of the strong equity markets in the first quarter to raise cash allocations, and will look for opportunities to reinvest in the quarter ahead.

One would have thought that a Republican sweep would have led to easy Republican victories.

One of Trump's major goals was to repeal and replace Obamacare. In fact, it has been a primary goal of the Republican Party ever since Obamacare came into law. But, when it came time to make it happen, the Republican Party was unable to get the votes on the first try. Obviously this calls into question the probability of success with Trump's other agenda items. There are several agenda items that we believe would be stimulative to the economy, such as tax reform, repatriation, reduced regulation, and infrastructure spending. Unlike repeal and replace, many of these fiscal stimulus items carried support by both Democrats and Republicans alike, just in different magnitudes and forms. We remain hopeful that stimulative fiscal change takes place, but recognize that perhaps the magnitude and timing of reform may be less than current market expectations.

One would think that higher business optimism should lead to higher loans.

It seems as though businesses remain exuberant about Trump proposals, but they have yet to put their money where their mouth is. Optimism is up sharply since Trump was elected, but commercial and industrial loan growth has flattened out. Perhaps many companies have already raised cash, when rates were lower, and don't need much more yet. Or perhaps, while they may have stepped up planning sessions, companies realize that there have been many promises made but not yet delivered. They are waiting to pull the trigger.

Table 1
Small Business Optimism Surges
NFIB, 04/15-03/17

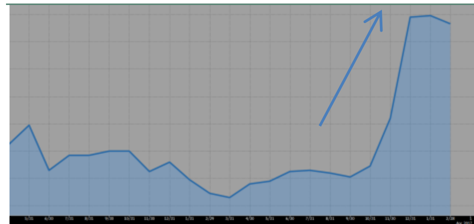
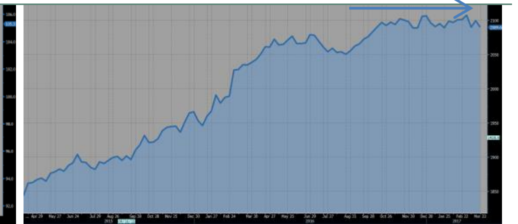


Table 2
C&I Loan Growth Stalls
US Bank Assets and Leases, 04/15-03/17



Source: Bloomberg, NFIB, Federal Reserve

One would think that higher consumer optimism should lead to higher retail sales.

One could say the same thing (almost) about the consumer. Consumer optimism is also up strongly since Trump was elected. Moreover, unemployment is exceptionally low and wages continue to rise at an increasing rate. However, retail sales have been sluggish at best, and auto sales have recently dropped significantly. Are consumers also skeptical about the economy and its potential and taking a wait and see approach? (The only area of consumer spending that is showing accelerating growth at the moment, is homebuilding. Housing starts have had a great start to 2017 and are now almost back to average annual levels.)

Table 3
Consumer Confidence Surges
Conf. Board Consumer Confidence

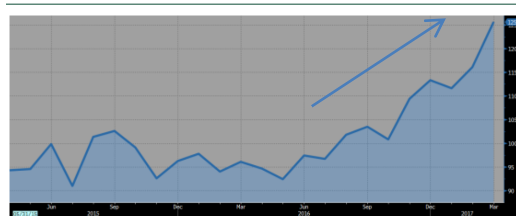
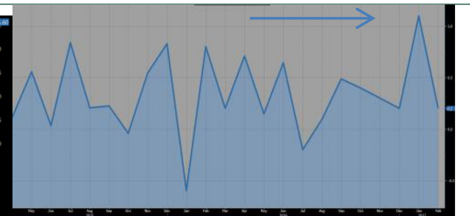


Table 4
Retail Sales Remain Flat
Adj. Retail Sales Less Auto % Chg

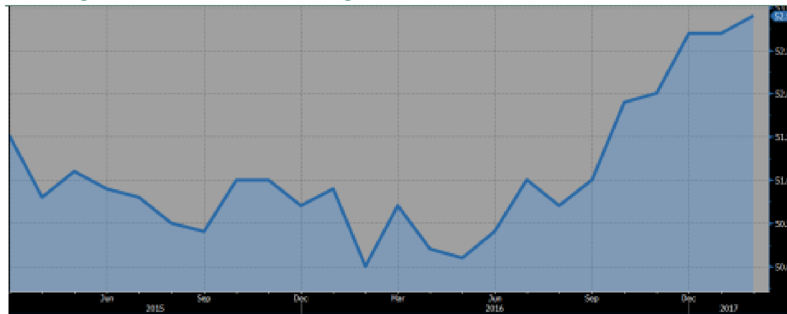


Source: Bloomberg, Conference Board, US Census Bureau

Underneath it all, this is the most synchronized global economic upturn in years.

While some in the US are taking a wait and see approach, looking globally there has been a strong upward movement in manufacturing and economic growth over the past 6 months. Table 5 shows the JPMorgan Global Purchasing Manager's Index over the past two years. There has been strong growth in China and Europe. Add the US to this, and that taken together has begun to put upward pressure on global economic growth.

Table 5
Global Economic Growth Has Been Improving
JPMorgan Global Manufacturing PMI, 04/15-03/17



Source: JPMorgan, Bloomberg

Stock market valuations are relatively high, having already taken note of the expected earnings improvement.

The stock market is a discounting mechanism. This means that investors take note of all incoming information and attempt to make a forecast about the future. They invest using this best guess. Then reality exceeds, meets, or disappoints relative to expectations. The stock market has been very excited about our economic future after Trump, and valuations on the S&P 500 have risen to high levels, implying high expectations about future earnings. Table 6 shows the Price-to-Earnings ratio on the S&P 500 over the past 60 years.

Table 6
Stock Valuations are Relatively High
PE Ratio on the S&P 500 over the past 60 years

Source: Bloomberg

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We believe a risk is how the Fed reacts: It's still two steps forward one step back.

Ever since the Great Recession we have talked about a two step forward, one step back economy. As the economy improved (two steps forward), it has been followed by pulling back stimulus (one step back). From 2007-2014 the Federal Reserve had to add more stimulus, or enter into quantitative easing. Beginning in 2014 the Fed stopped adding more liquidity, and then it began to raise rates. Most recently the Fed indicated that they are beginning to consider taking liquidity out of the sytem by allowing their balance sheet to shrink. How they accomplish this tightening becomes a headwind to growth and potential risk. And how this tightening is offset by fiscal stimulus will be important as well.

We raised some cash and upgraded our portfolio in the first quarter

There was much enthusasiam as we entered Q1. There was optimism in the Trump proposals and there was a relatively benign view of fed tightening. As we leave Q1 there has been moderation in both expectations which we believe is a good thing. We raised cash in Q1 and expect to redeploy in Q2 as opportunities present themselves.

Using 5-year ladder of individual bonds as a way to reduce potential inflation risk

If expansive fiscal policy combined with wage acceleration leads to higher inflation, it is likely that the Federal Reserve will increase its pace of rate hikes. Some investors view a rising interest rate environment as a reason to sell bonds. However, if one utilizes bonds as part of an overall asset allocation strategy to reduce risk in one's portfolio, then the higher yields that come with higher interest rates are welcome. For your portfolios we attempt to reduce inflation and interest rate risk by using a 5-year (short-term) ladder of individually purchased investment grade bonds.

We look forward to speaking with you soon and thank you for entrusting us with the management of your money.

Sincerely,

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