Bourgeon CAPITAL MANAGEMENT

Investment Counselors

MARKET INSIGHTS

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The decision of automakers to eliminate the spare tire leaves 30 million people vulnerable at the roadside.

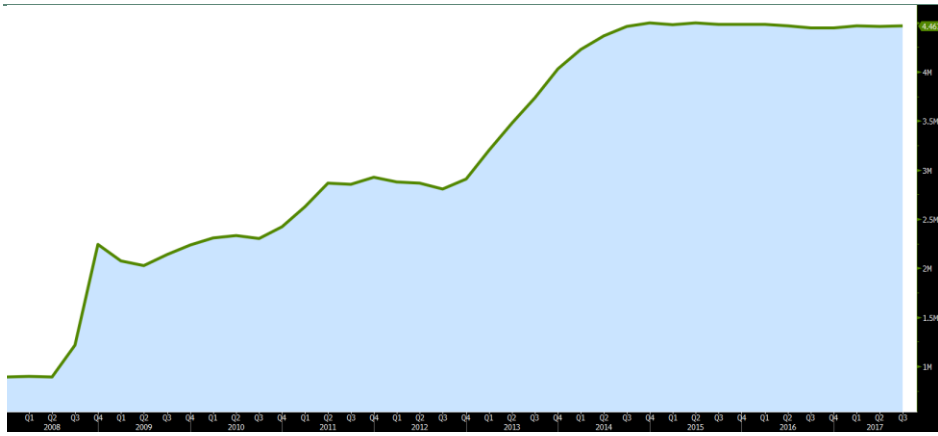
\- AAA

Today's investing environment is uncertain as many things we have relied upon – globalization and monetary stimulus to name a few – are changing and shifting. Our biggest concern at the moment is that the Federal Reserve (followed by the rest of the world) may begin shrinking its balance sheet over the next 6-12 months. From 2009 – 2015 the Federal Reserve used quantitative easing to help stabilize our economy. We called this economic assistance 'training wheels' for our GDP. We took off the training wheels in 2014 when the Fed stopped increasing its balance sheet. The economy has continued its slow and steady improvement. Now the Fed is talking about allowing the balance sheet to slowly shrink. For a while we were hopeful that the Trump Administration would provide a 'spare tire' of fiscal stimulus through infrastructure spending, or tax cuts to offset unforeseen negative impacts. Our confidence in this outcome is waning. So, we are going to call the current environment "Driving without a spare tire." We must rely more on the skill of the Federal Reserve and the resumption of growth in international markets (our biggest positive) to provide economic help should the US get a flat tire. The stock markets have rallied nicely in 2017. We have taken the opportunity along the way to trim some of our outsized holdings as valuations became stretched. Cash remains higher than normal as we patiently look for opportunities to redeploy.

Driving without a spare tire.

In order to keep our economy moving forward since the Great Recession, the Federal Reserve adopted "quantitative easing" whenever the economy hit a pothole. The idea was to provide economic stimulus to the economy. In so doing, the Fed more than quadrupled its balance sheet to $4.5 trillion. See Table 1. For the past several years, the United States GDP growth has been slow and steady and unemployment has been below the Fed's target for over three years. Wage inflation has been increasing, and is now in the 2.50%-2.75% range. While certainly not red hot, it is at the highest level in almost 10 years. There appears to be no reason to keep extraordinary monetary stimulus. The Fed has been talking about reducing its balance sheet for several quarters now, and the drumbeat is only getting louder, and may start by the end of the year.

Table 1
The Federal Reserve has more than quadrupled its balance sheet to $4.5 trillion since 2007



Source: Bloomberg

But we remember the adage "Bad things happen when balance sheets contract." For the past several months, we brushed away these concerns, believing that the Trump Administration might provide some fiscal stimulus to offset some of the monetary tightening. Or, at least be there in case we hit a pothole. But, we are now less confident in the speed and magnitude of any tax cuts or infrastructure spending, and thus must rely more heavily on the skill of the Fed and international growth to offset any unforeseen impacts. We are driving without a spare tire.

The potential for unforeseen impacts is high.

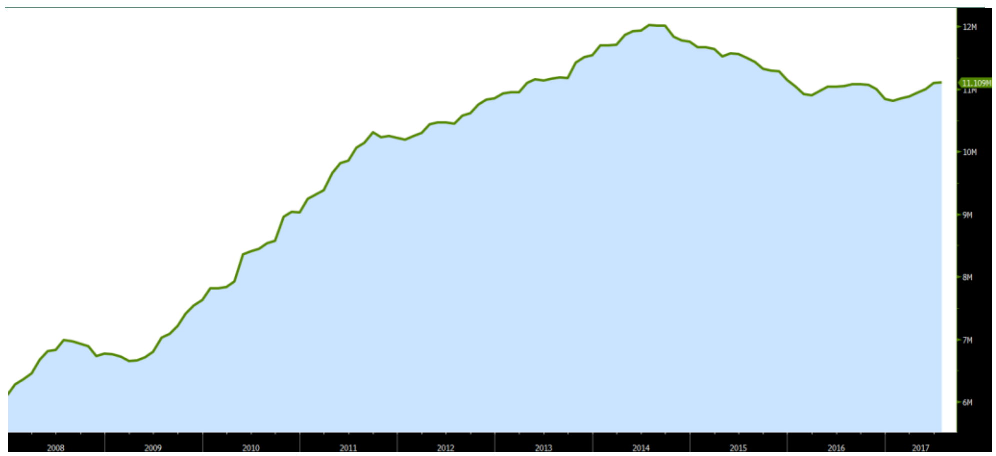
We remain confident in Yellen and her colleagues. So far, they have done a very good job overall in the 10 years since the Great Recession began. We like the fact that the Federal Reserve is openly discussing how and when they might want to reduce their balance sheet. But they have never done this before, and thus the potential for unforeseen impacts on the global economy and markets is higher than normal. On July 11, 2017 Jamie Dimon, the CEO of JP Morgan said "We've never had QE like this before, we've never had unwinding like this before. Obviously that should say something to you about the risk that might mean, because we've never lived with it before." Fed Chair Yellen's term ends February 3, 2018, creating yet another uncertainty depending upon if she is reappointed, or if someone new is appointed in her place.

Resumption of global growth is a nice positive… but too much of a good thing may lead to global tightening.

On the bullish side, global growth is picking up. World growth is expected to rise from 3.1 percent in 2016 to 3.5 percent in 2017 and 3.6 percent in 2018 according to the IMF. The economic surprise index provided by Citibank has recently picked up internationally as well. This is very good news and we hope it continues.

But one can have too much of a good thing. Continued strong economic growth in Europe and Japan may lead those countries to the same conclusion as the US: time to reduce quantitative easing. As Ray Dalio, Chairman of Bridgewater Associates recently said "The directions of policy are reversing. Our responsibility now is to keep dancing, but closer to the exit and with a sharp eye on the tea leaves." Table 2 below shows the combined global central bank balance sheets. It has doubled since 2007. But periods of contraction, such as 2014-2016, were met with stock market declines/weakness.

Table 2
The Global Central Bank balance sheet has doubled since 2007



So many good pros and cons to buy stocks today.

While the potential reduction in central banks balance sheets is our biggest concern and global growth our biggest positive, there are many other pros and cons of buying stocks today. We think Bank of America recently put it very simply in Table 3.

Table 3
The Pros and Cons of Buying Stocks Today

THE BEARS SAY	THE BULLS SAY
Valuations are too darn high	Finally, synchronized global growth
Cycle is long in the tooth	Stimulus will boost growth
The end of easy money	We're in an economic upswsing
Leverage is high and the credit cycle is over	Low interest rates justify higher valuations
Rising wages will crush margins	

Source: Bank of America Merrill Lynch

But, 10 years after the Great Recession, investors are back to neutral.

How do investors react when there is high uncertainty both of plausible downside and upside scenarios? If today is any indication, they do nothing but sit tight. Over the past 8 years, the AAII US Investor Sentiment Survey NEUTRAL reading has risen from 20% to 40%. These are the levels last seen in the mid 1990s – a time of good stock market growth.

Table 4
Investors Describing Themselves as Neutral Has Doubled to 40% in 8 Years
AAII US Investor Sentiment Survey: Neutral

Source: Bloomberg, AAII

We have raised cash as stock prices rose, selling high to buy low.

With all this "neutral" sentiment, the US stock market is up almost 10% this year, higher than historical averages. Breadth is thin, meaning that there are only a few stocks pulling up the averages. Year-to-date, the biggest drawdown we've had has been 2.8%, the smallest since 1995. So in our minds, the probability for a near-term pull back is high. We have raised cash from stocks where we thought valuations were high with the intention of redeploying when opportunities present themselves. Our cash allocations are higher than normal.

From Q1 to Q2, as investors moved from Trump reflation back to deflation, growth stocks once again surged. We took the opportunity to trim some of our oversized positions.

If one utilizes bonds as part of an overall asset allocation strategy to reduce portfolio risk, then higher yields are welcome.

The Federal Reserve has raised rates 4 times since 2015, and the Fed Funds rate is now 1%. We believe that there is more to come. 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 conservative 5-year (short-term) ladder of individually purchased investment grade bonds and then hold to maturity.

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,

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