Bourgeon CAPITAL MANAGEMENT
Investment Counselors

MARKET INSIGHTS

September 2017

The Dilemma of the Grey Rhinos

A "gray rhino" is a highly probable, high impact yet neglected threat: kin to both the elephant in the room and the improbable and unforeseeable black swan. Gray rhinos are not random surprises, but occur after a series of warnings and visible evidence. In Michele Wucker's book "The Grey Rhino: How to Recognize and Act on the Obvious Dangers We Ignore" she explores why leaders and decision makers keep failing to address obvious dangers before they spiral out of control. As we look across the investment, economic, and geopolitical landscape we are wondering the same thing. Do we ignore the Grey Rhinos? Do we participate with the crowd in a narrow market ignoring valuation? Given that it is our goal to protect as well as to grow, we continue to err on the side of caution and monitor our portfolios for the ever changing balance of risk/reward among the investments that we own.

What is the Dilemma and What are some Grey Rhinos?

The US economy continues to move along at a 2.5% GDP growth level with corporate earnings moving higher and job growth at a historically good pace. The worldwide economy is also showing synchronized global growth and strong international earnings, which in turn has sent many overseas stock markets to new highs. Yet, many investors feel at least complacent if not uncomfortable. Is it the dilemma of buying the leading sectors like technology and the FAANG (Facebook, Amazon, Apple, Netflix, and Google) stocks as they move to historically high valuations? Is it the narrowness of the returns? Or is it the Grey Rhinos which represents the big obvious problem(s) that are right there in front of us but which we refuse to acknowledge? It's hard to put your finger on it. After all, the market is up almost 15% in the US, with other markets around the world up even more. But something seems amiss in all this, and we remember that over time, things revert to the mean.

Grey Rhino #1: The end of easy money

One of the greyest rhinos that we see is the reduction of central bank liquidity that is starting in the US and is likely to spread to the rest of the world over the upcoming year or so.

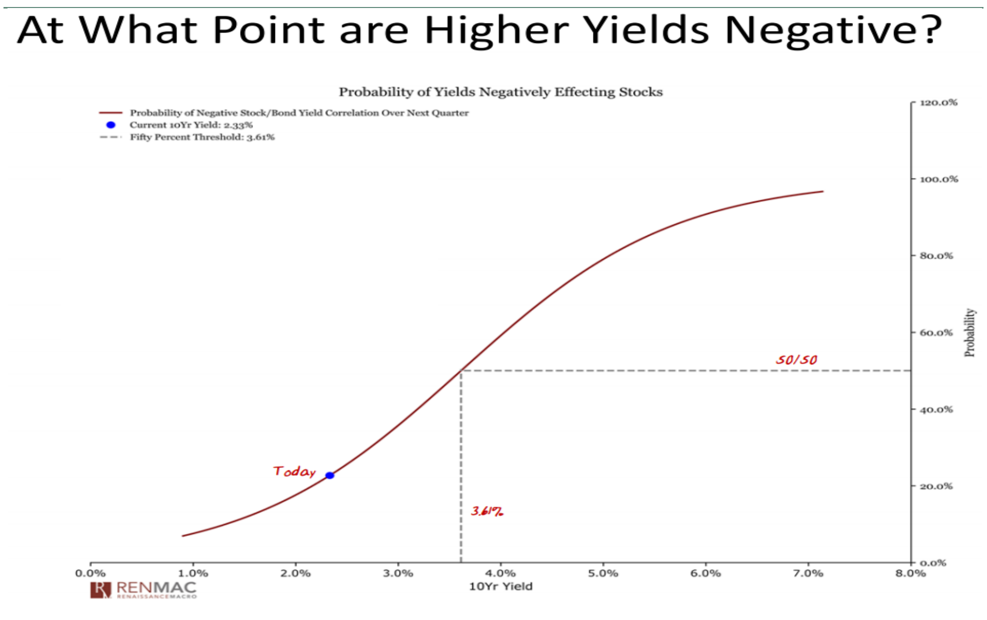
With global economies stronger, central banks across the world are signaling that the past decade of monetary easing is over. The ballooning of worldwide government balance sheets is about to be reeled in. Liquidity, as we have known it, is about to end. And yet, markets continue to move up unfazed.

One argument is that central banks around the world are getting better and better at signaling their intentions. Therefore, these movements get 'built into' expectations and thus are not worrisome to market participants. While we agree in part, we also think that the pain points have not yet arrived. For example, while US central bank balance sheets are going to begin to shrink very soon, expansion is happening elsewhere, and thus GLOBAL liquidity is increasing. Once global balance sheets begin to shrink that is likely to be a bigger concern. We are not sure when this will happen, but Krishna Guha of Evercore ISI believes that this could happen as early as Q3 2018.

Another argument is that 10-year yields are only coming back to 'normal' and still don't have power to weaken growth. What is the tipping point? Jeff DeGraaf of Renmac thinks that the crossover point to consider is a 10-year yield of approximately 3.6%, almost 100 bps higher than today. When you consider that several Fed participants expect 100 bps of tightening between now and the end of 2018, and that the 10-year today is about 2.5%, 3.6% is not really that far away.

Table 1
At 3.6% 10-Year Yields Could Begin to Negatively Affect the Stock Market

Table 1: "How do we get here? This predicts the probability that the correlation between yields and the market will be negative over the next 65 days. That probability is 50/50 at 3.61% which implies stocks react negatively above that level. We trust math, but are aware of the dangers of precision when applied to markets." -Renmac



Source: Renmac

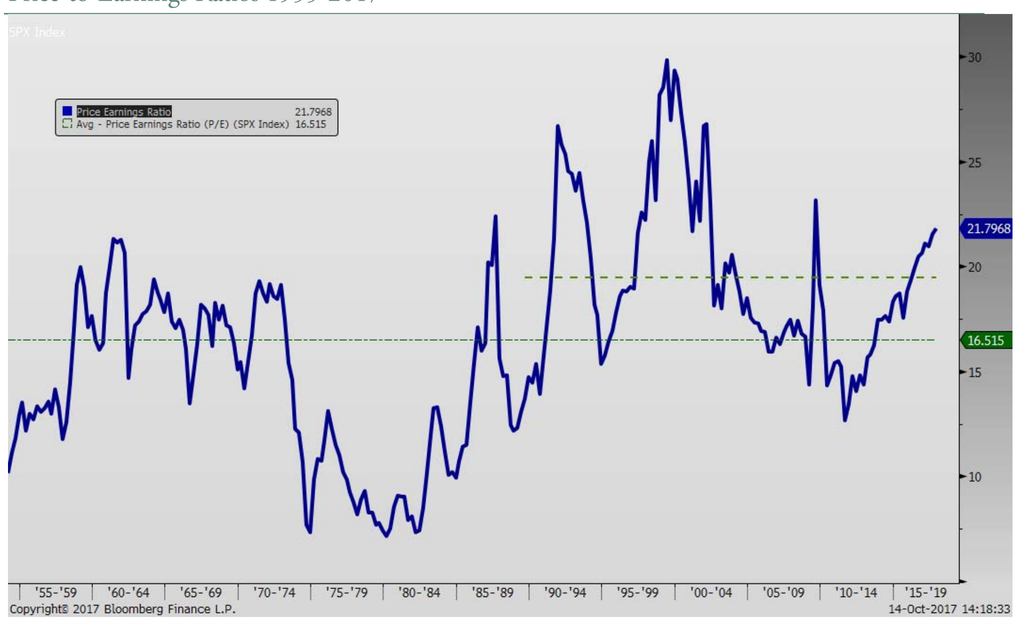
Grey Rhino #2: Geopolitical Uncertainty

We believe that geopolitical instability is another Grey Rhino. Political upsets now appear to be the norm – with Brexit in the UK and an unexpected Republican Sweep in the US last year. The worldwide populist movements are disrupting governments everywhere as countries move away from decades of globalization and freedom of immigration. In addition, issues surrounding North Korea, Iran, and Russia continue to escalate. The rules of the sandbox are changing and thus outcomes more uncertain.

Grey Rhino #3: Valuations

Domestic stock market valuation is our third Grey Rhino. The majority of market research we see today references high valuation and either sees it as a source of worry or something to be explained away due to the "current environment". Average price-to-earnings ratios for the S&P 500 have averaged 16.5x for the past 60 years, and just under 19x for the past 20 years. Today we are close to 22x. While the current level of multiples is high relative to history, the reality is that it can stay this way for an extended time until a catalyst happens. While we can't predict the catalyst, we have always believed in reversion to the mean.

Table 2
Valuations Are Currently Above Average
Price-to-Earnings Ratios 1955-2017



Source: Bloomberg

Adding to the uncomfortable nature of high valuations is the fact that the market is incredibly narrow. This means that the market is going higher because a relatively few number of stocks, such as the FAANGs (Facebook, Apple, Amazon, Netflix, and Google). We believe this adds yet another level of risk.

Dilemma: Should we ignore the Grey Rhinos?

Our dilemma becomes, what to do when faced with these Grey Rhinos? According to Michele Wucker, the worst thing to do is nothing. "I think that's a big reason why gray rhinos don't get dealt with. People are afraid they're going to make a wrong decision about how to fix something, or they're going to get blamed for doing the wrong thing, instead of at least trying to do something. In many cases, you may make the wrong decision about what to do. But that may actually change the playing field. It can shake things up so that you're more likely to get to a better place."

We Err on the Side of Caution

We do our best to acknowledge and take action in the face of Grey Rhinos. We never stop asking questions. We realize that we don't have all the right answers. We try to learn from our mistakes and never get too complacent with our wins. Sometimes we get it right, sometimes not. But we completely agree with Ms. Wucker, that the worst thing to do when faced with a Grey Rhino is nothing.

We have been cautious since the end of the first quarter. Our concern has grown as Congress and the new administration have made no progress on their plans. We have actively taken profit in areas that we think have reached our targets. Year-to-date from a broad perspective we have used the rallies in the stock market to sell into strength, keeping our cash balances higher than normal, and we parked the money in Treasury Bills for a bit of extra return until we found opportunities. You should expect this plan of action to continue.

We Continue to Favor Investment Grade Laddered Bond Portfolios for the Risk/Reward

Bonds remain in the crosshairs of all three Grey Rhinos. Over the past few years we have been approached by several clients frustrated by low yields and asking our opinions on investing in middle market bank loans where the aim is to return 5% annually. With credit spreads at all-time lows (i.e. not being 'paid' for risk) and the illiquid structure, we remind clients that these instruments are more expensive then they initially look. We continue to recommend a short-term ladder of investment grade bonds as the best balance of risk/reward. In fact, with recent increase in short-term rates, we are finding highly liquid 3 year bonds at 2.5-3.0% yields. 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.

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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