Bourgeon CAPITAL MANAGEMENT
Investment Counselors

MARKET INSIGHTS

September 2016

Escape velocity: the minimum velocity that a moving body must have to escape from the gravitational field of a celestial body and move outward into space.

- Merriam-Webster Dictionary

My son's best friend is a freshman this year at the University of Michigan studying aerospace engineering. We couldn't be more proud of her and we know that she will accomplish amazing things in her life. Her ambition is to make space travel accessible to all. She plans to engineer a process that makes people feel confident enough to take the risk. Perhaps that's what our business leaders need, confidence in the future so that they can take the risk to expand. US economic growth has been relatively weak since the Great Recession, and business owners lack the willingness to expand despite the fact that interest rates are at historic lows. Many monetary policy leaders around the world are expressing concern that they are running out of expansionary tools. The request for expansionary fiscal policy to be the fuel necessary for our economy to reach escape velocity is only growing louder. We believe that the investing climate remains confusing, and we are being respectful of widening of credit spreads indicating some strain in the financial system. After a slow start to the year, the US stock market was very strong in the third quarter, and we took advantage to shift some holdings. In general we remain slightly under benchmark equity allocations, and we continue to review our investments with a bias to capital preservation and growth at a reasonable price. We raised cash in the third quarter to take advantage of pricing discrepancies that may occur during earnings season.

US Nominal GDP Stuck in a Rut

In nominal dollars US economic growth has remained in a slow-and-steady pace for the past 8 years. This is the slowest consistent level in 50 years. While wage growth rates have recently begun to increase, they are still well below historical levels. No wonder consumers feel like they are stuck in a rut. Central Bankers are doing their best, lowering interest rates to help spur growth.

While there is no doubt that lower interest rates have helped stabilize our economy, companies in the US remain cautious about expanding their businesses. Is this a good time to expand your business? Graph 1 shows that over the most recent 30 years small businesses feel that, except for a brief period in 2014, the past 8 years have been the worst time to expand business. What is holding companies back? The list is long: economic uncertainty, political uncertainty, regulatory uncertainty, and geopolitical uncertainty just to name a few.

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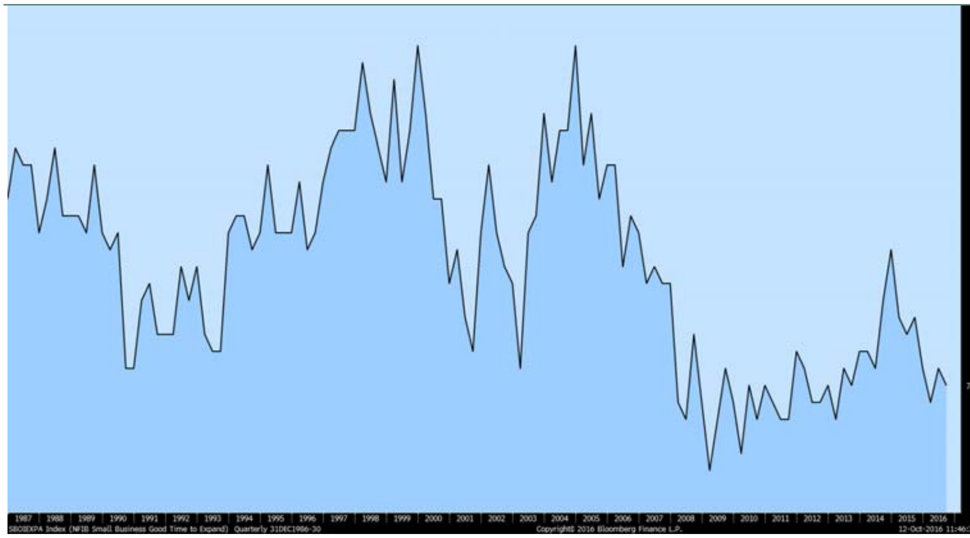
Graph 1
NFIB Small Business Good Time to Expand
1986-2016



Source: NFIB, Bloomberg

"Central Bankers Can't Be the Only Game in Town."

If monetary policy has reached its limits at giving companies the confidence needed to expand, then the other option is to look toward expansionary fiscal policy. IMF Managing Director Christine Lagarde told reporters on 10/8/16 that "We certainly have decided to come out more loudly to say 'Central bankers can't be the only game in town. Let's get on with it, and see some action from the other authorities.'"

Will Fiscal Policy Get us to Escape Velocity?

We don't know if fiscal expansion policies will help our economy reach escape velocity and get itself out of its rut, but isn't it worth a try? Here in the US, fiscal expansion policy could take the form of corporate tax rate reform and infrastructure spending. The good news here is that although the details differ, both political parties support reform in both those areas. The bad news is that we will have to wait until after the election to see what form fiscal expansion may take, if at all. Furthermore, any policy action will likely take several years to benefit the economy.

Thank Goodness for Share Repurchase and Buybacks.

So, if a company doesn't feel confident about expanding its business, what does it do with any excess cash? Apparently it buys back stock and raises dividends. In fact, according to Jonathan Glionna, US Equity Strategy at Barclays, since 2009 S&P 500 total payouts to shareholders, which include dividends and buybacks, have increased by 20% per year. These payouts will reach about $1 trillion in 2016, compared to just $500 billion in 2010.

Shareowners have reaped the benefit of these actions in several ways. First, the income from stocks in the form of dividends has been greater than that for bonds. For example, the dividend yield on Procter & Gamble at 3.0% is greater than the income yield on its 10-year bond at 2.6%. Second, share repurchase has helped support the stock market. Year-to-date equity outflows of approximately $120 billion have been more than offset by share repurchases, which have totaled $620 billion over the past four quarters.

How Long Can Corporations Keep This Going?

There is debate on how long corporations can continue to fund increasing payouts to shareholders as they have been borrowing money to fund these payouts. The total payout ratio - (dividends + buybacks)/reported earnings – has been greater than 100% for more than two years in a row and 2016 would be year two. In addition, balance sheets are beginning to get stretched.

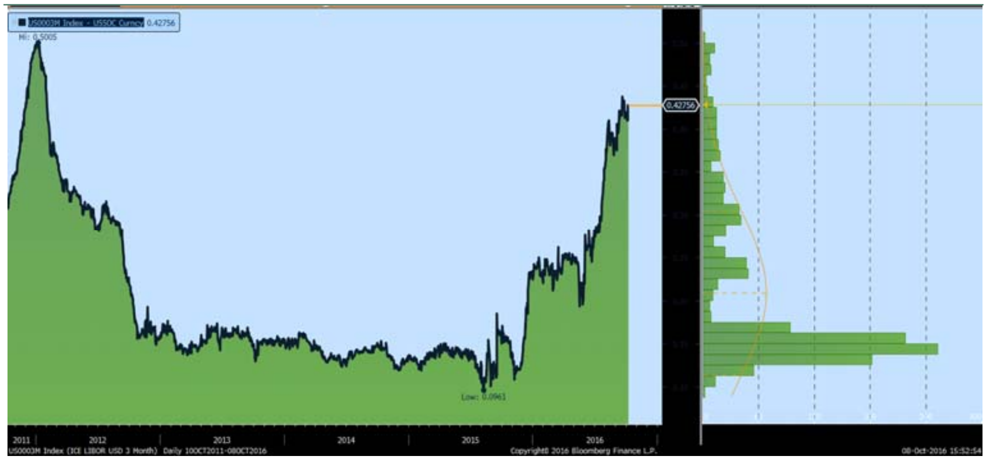
If Share Repurchase Slows, then All Eyes are on the Retail Investor to Buy Stocks Again.

If corporations are no longer able to support stock markets with share repurchase then who will be there to buy stocks? Perhaps by that time consumers will have regained enough confidence to resume investing in the stock market. In August 2016 a survey conducted by Bank of America Merrill Lynch found that cash levels were at almost 6% of portfolios, the highest level in nearly 15 years. In conjunction with this, the AAII Investor Sentiment Bearish Readings have recently gone over 30% after two years in the mid 20% range. BlackRock believes that there is $53 trillion of cash around the world that is sitting on the sidelines. A contrarian might say that once the consumer is confident enough to take risk and invest in stocks, the cash is available and then there could be a strong upward bias to the stock markets.

While Waiting for Expansionary Fiscal Policy, We are Watching Risk Measures and We Don't Like What We See

In addition to our disappointment in economic growth we are watching widening credit spreads with some trepidation. For example, the LIBOR-OIS spread measures the interest rate required for inter-bank lending. When banks become more concerned about lending to each other, this spread widens, and vice versa. This spread started to widen in the beginning of 2016, and has shown a significant widening since the middle of the year. See Graph 2.

Graph 2
Widening Credit Spreads are a Concern
LIBOR-OIS Spread 2011 through 2016



Source: Bloomberg

Maintaining Equity Allocations Slightly Underweight

We have spoken with several credit analysts who believe that this is entirely due to changes in the short term credit markets brought on by recent Dodd-Frank banking regulations. While this makes sense, we nonetheless believe that we should be respectful of this credit metric. What strikes us as more interesting is that the current LIBOR-OIS level is consistent with the level during the European banking crisis in 2011 (but still well below the level during the Lehman bankruptcy). In fact, the iShares European Bank ETF has also fallen significantly since September 2015 and now sits at the 2011 level. Deutsche Bank is currently under stress and the German government has said that it will not provide support. We are continuing to watch the situation carefully and are factoring this into our investment outlook.

In our minds, macro risks have risen, so we continue to monitor asset allocation and investments. We are maintaining a slightly underweight asset allocation, and are diversified in our investments. During the quarter we sold a healthcare stock and an industrial stock as we felt that the risks began to rise relative to our forecasted returns. We also trimmed one of our largest holdings after a strong run. We utilized some of the proceeds to add to existing holdings in life sciences, oil, and alternative investments.

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A Positive of Higher Risk Spreads is Higher Short Term Rates

This year has seen dramatic swings in yields both domestically and internationally. In the US, the 10-year Treasury yield began the year at over 2%, declined to historic lows of 1.4% in June, and has now risen to 1.8%. We were deliberately slow in reinvesting our maturing bonds in Q2, but have since picked up the pace. In addition, given the recent regulatory changes in the very short term credit market, corporate bond yields under 1 year all of a sudden look really good and we have begun to take advantage where appropriate. While good for investors, higher short-term bonds also mean higher funding costs for corporations and represent an effective tightening without the Federal Reserve having to lift a finger.

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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Partner

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