Bourgeon CAPITAL MANAGEMENT

Investment Counselors

MARKET INSIGHTS

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Buy the rumor, Sell the news?

- Old investing adage

There is an old investment adage: Buy the rumor, sell the news. In effect this means that rumors have one effect on a particular trading instrument's price movement, and news can have an opposite effect. For example, let's say that a company has a "big" new product coming. Investor expectations about the product rise swiftly along with the stock price. Once the product comes to market there are a few things that can happen. First, the product does well, but fails to meet the lofty expectations and the stock declines. Second, the product is a terrible failure, the stock tumbles, and thereafter takes a long time to regain investor confidence. Finally, the product is a massive hit and the stock price continues to rise. Trump winning the Presidency of the United States and the subsequent Republican sweep was a massive surprise. Since that time, stock markets have cheered and there has been a massive shift in stock ownership toward financial, industrial, and basic materials stocks as investors believe that Trump's reflationary policies of tax cuts and infrastructure spending (to only name a few) will be swiftly adopted and work as proposed. In addition, interest rates have spiked as bond investors expect rising inflation as stimulative fiscal policy is added to an economy already at low unemployment. But will Trump be successful in executing his numerous strategies? Will this be the case of "Buy the Election, Sell the Inauguration?" Add to this an increasingly concerning China and foreign relations backdrop, and Bourgeon enters 2017 a bit cautious in our near-term outlook, but generally favorable for our intermediate-term outlook. Over the past quarter we have maintained equity allocations fairly constant, and used tax loss selling to add to new positions in cyclical stocks. For those clients with bond allocations we took advantage of higher interest rates to invest excess cash in short term bond ladders. Going forward we remain ever vigilant to the potential to take advantage of changing risk/reward outlooks and ever mindful that our mandate is for both capital preservation as well as capital appreciation.

Strategy is Easy, Execution is Really Hard

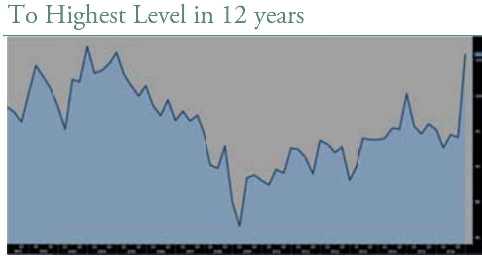
The investing landscape has changed materially since Trump was elected President and Republicans took control of both the House and Senate. Looking through cabinet appointments and tweets, the priorities of the new government agenda have begun to take shape, but still carry the possibility for significant changes and unknown outcomes. Tax cuts and infrastructure spending policies should be expansionary, but how and when remain unknowns. The repeal of the Affordable

Care Act, changing international trade policies, and foreign policy shifts add uncertainty. Trump has no political history and thus there is no baseline to guess on execution success. How much of the good news has the market anticipated already? What increasingly optimistic news is yet to come? We wish our new government much success. But we recognize that strategy is easy and execution is really hard.

Reflation Should Lead to Higher Interest Rates

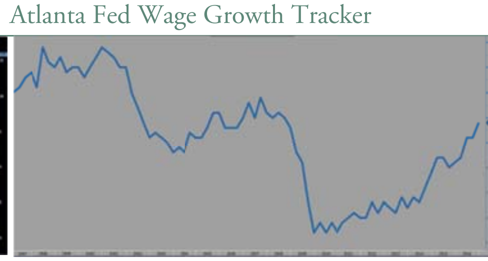
Assuming Trump's success at the reflation trade by reigniting animal spirits and thus accelerating GDP, then inflation has the potential to increase more rapidly than investors had expected. Table 1 shows that after the election small business confidence spiked to the highest in 12 years. This could lead to higher capital spending, higher GDP, and increased unemployment. However, the US currently has the lowest unemployment rate in 10 years and wage growth has already accelerated to the fastest in 10 years to close to 4% (Table 2). Thus hiring at an accelerated pace could lead to even higher increases in wages. Historically rising wages lead to inflation. If inflation does accelerate faster than expected, then the Federal Reserve is likely to react by raising interest rates more quickly. This potential monetary tightening is an eventual headwind to growth, and could offset, to some degree, the benefit of expansionary fiscal policy.

Table 1
NFIB Small Business Confidence Spikes
To Highest Level in 12 years



NFIB, Bloomberg

Table 2
Wages are Rising at the Fastest Rate in 10yrs
Atlanta Fed Wage Growth Tracker



Atlanta Federal Reserve, Bloomberg

China Remains a Wildcard

Twice over the past year liquidity stress in China, and the subsequent significant drawdown of reserves, has been a source of US stock weakness. We enter 2017 with liquidity under stress. As we expect the Chinese currency to continue to weaken leading to the continual liquidation of foreign currency reserves, we are watchful for signs of spillover to the US. The good news is that we have yet to see this, so hopefully this risk is now priced into expectations.

Near-term the Market Could Stumble, But Our Intermediate Outlook for Stocks Remains Constructive

While we would not be surprised with a pullback in the stock market if government execution stumbles, our intermediate term outlook for stocks remains constructive. Except for the US, central banks around the world continue to ease, adding billions of liquidity over the past year to help support global economic growth. We are seeing the benefits in a spike in the Citi economic surprise index, and in the OECD global leading indicator which has recently turned positive. Credit risk measures, such as the Libor-OIS spread, and the BBB spread are improving. While economic expansions don't die of old age, they do die from rising Federal Funds Rates. If the US Federal Reserve feels the need to raise interest rates much faster than expected to combat growing inflation expectations, then the probability of recession increases. While we still believe this is not a near-term concern we are watching the Bloomberg forward 1 year recession probability index which has risen from 10% before the election to 20% afterwards.

We Kept Risk Allocations Flat But Added More Cyclicality to the Portfolio while Making Some Tax Efficient Trades

What to do with the higher uncertainty from all these moving parts? We will do as we usually do, watch the situation unfold, and where we feel the risk/reward has shifted to the negative or positive, we will take action. We remain ever mindful that our mandate is for capital preservation as well as capital appreciation. From a top down perspective, in the fourth quarter we maintained risk allocations fairly constant, but utilized tax efficient trades to add further cyclicality to the portfolio.

Expectation of reflation in a Trump Presidency has led to a significant increase in interest rates in Q4. The 10-year Treasury yield did a round-trip in 2016. On 12/31/15 the yield was 2.3%. It dropped to 1.4% after Brexit, and subsequently ended 2016 at 2.5%. 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

Using 5-year Ladder of Individual Bonds as a way to Reduce Potential Inflation Risk

reduce risk in your 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 on your portfolios 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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Partner

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