Bourgeon CAPITAL MANAGEMENT | MARKET INSIGHTS

Investment Counselors

December 2017

Too Much of a Good Thing Can be a Bad Thing

Said in June 1999 by William Dudley, Chief US Economist with Goldman Sachs

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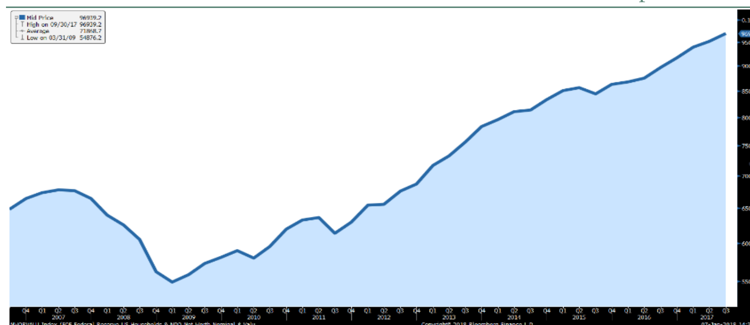
Bourgeon entered Trump's first year as President saying "strategy is easy, execution is really hard". We were a bit cautious in our near-term outlook, but generally favorable for our intermediate-term outlook. While we were correct in trend, we underestimated the magnitude of both outlooks. Politically the Republican Party had a hard time implementing their desired policy. However, we ended 2017 with corporate tax reform which sets up 2018 positively for corporate earnings and share buybacks. The stock market nicely outperformed our expectation for 2017. The S&P 500 was up almost 22% including dividends, and at Bourgeon we were able to more than hold our own. But too much of a good thing can be a bad thing. We spent most of the year looking in the mirror thinking how lucky we were, which led us to "realize and bank" the gains we made. Thus, we ended the year with allocations to stocks about even with where we started. With stock market valuations well above historical averages, interest rates rising, and with capital preservation a major part of our mandate, you should expect our strategy to remain thoughtfully guarded.

Just Look at Household Net Worth!

Trump asks "How's your 401k?" But since only 45% of private sector workers have one, we think you should look at Household Net Worth – which was up 9% over the past year! The consumer is strong and is likely to get stronger as unemployment is at its lowest levels since 2000 and wage growth has started to increase above the 3% level. Early in 2018 18 states and 20 cities will hike minimum wages. In addition, according to the *Washington Examiner*, over 40 US companies have responded to recent tax reform by handing out bonuses of up to $2,000 and/or increases in 401k matches. In general, this is supportive of US economic growth and the stock market.

Table 1
Household Net Worth at $96.9 trillion was 9.0% in 2017 (up 3.7% annually since 2007)



Source: Federal Reserve

Corporations are Entering 2017 with a Tax Tailwind

The Tax Cut and Jobs Act of 2017 was much more about reducing corporate tax rates than it was about reducing consumer tax rates. With corporate tax rates dropping from 35% to 21% (closer to globally competitive levels) and a forced repatriation at hand, it is likely that corporate growth is supported and share repurchase increases – both positive for the stock market. UBS estimates that the tax plan will increase S&P 500 company earnings by 7-9%. This positive news is somewhat offset by the fact that valuations are high, and that the market is potentially already discounting, or anticipating, this improvement.

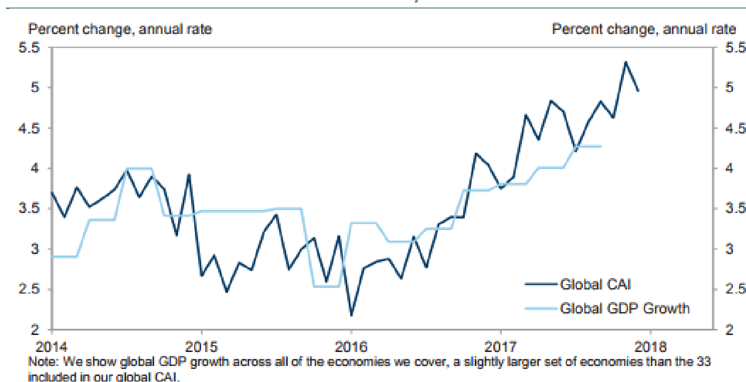
Table 2
S&P 500 Buyback Activity, After a Flat 2 Years, is Likely to Accelerate Further

Source: Standard & Poors

Global Growth is a Monster

It's not all about the United States. Global growth accelerated in 2017. Goldman Sachs Global Current Activity Indicator increased from 4% to 5% over the past year. China, Europe, and Japan all performed better than most analysts expected. Much of this growth was supported by easy central bank/monetary policies. On a global basis, even though the US started quantitative tightening, central banks have added to their balance sheets to keep the economic punch bowl full.

Table 2
Global Growth Accelerated Sharply
Goldman Sachs Global Current Activity Indicator



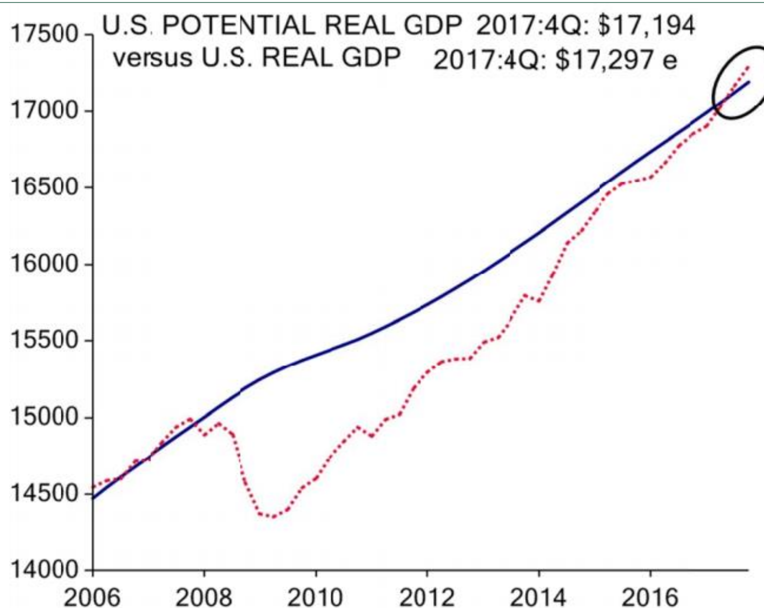
Source: Goldman Sachs

We are Concerned about Having Too Much of a Good Thing

Currently there are many positives, and that makes us cautious. We have always been believers of reversion to the mean, and thus become thoughtfully guarded when we have too much of a good thing, causing the Federal Reserve to tighten financial conditions just when the party gets started.

Happy 10th Anniversary! 2017 marked 10 years since the beginning of the last financial crisis. According to several economists, it takes 10 years to recover from a monetary crisis. It looks like we accomplished that here in the US. Table 4 shows Potential Real GDP growth (in blue) vs. US Real GDP (in red). Our real growth is now above potential. This means that now there is no more 'catch-up' to hope for, and this is typically when forward returns have the potential to moderate.

Table 4
US Economy Reaches Its Potential Output for First Time in a Decade



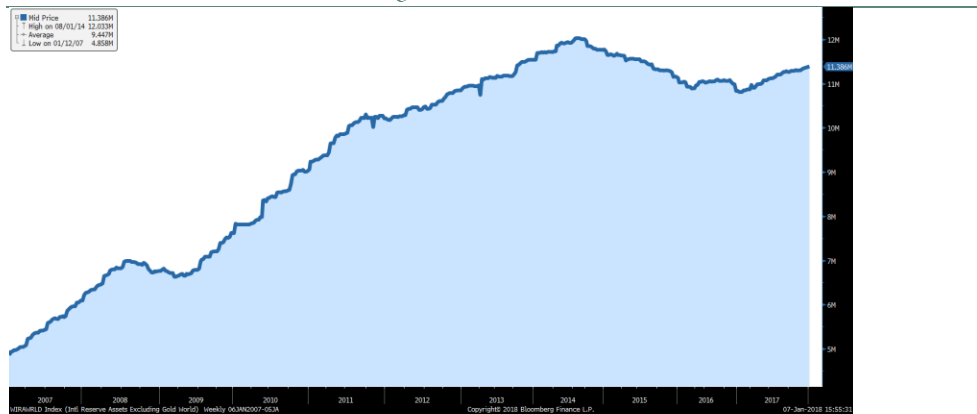
Source: Evercore ISI

Strong growth and low unemployment usually leads to inflation. We have yet to truly see a pickup in inflation. But, with wage growth already beginning to accelerate, and new fiscal stimulus with the tax bill, we think inflation accelerates. This could lead to the Federal Reserve to become more aggressive in rate hikes and put downward pressure on valuation over time.

If global growth stays strong, then it could be that other countries decide that it is time to start quantitative tightening, or raising interest rates. Thus this "punch bowl" could

begin to actually drain. If recent history is a guide, this would lead to stock market weakness. Given public comments and recent global growth trends, we believe that this could begin to happen in the second half of 2018.

Table 5
The Global Punch Bowl Grew in 2017 Despite US Declines
International Reserve Assets Excluding Gold, $ in millions



Source: Bloomberg

We Banked More Profit in Q4

Continuing a 2017 trend, we banked even more profit in Q4. We heard Howard Marks speak a few weeks ago. He summed it up nicely. He sees a market with a high degree of uncertainty, low forward returns, and high valuations. There is pro-risk behavior on the part of those who are seeing high returns in a low return world. In his mind this calls for a cautious approach. We agree.

We Shortened our Bond Ladder Even Further

As the FED has increased short-term interest rates, this has not been followed by an increase in long-term interest rates. Thus the yield curve has flattened. This means that one is getting paid almost the same for a 2 year bond versus a 5 year bond. The incentive is no longer there to add duration, and thus we have shortened our bond maturities even further. We have also sold all of our high-yield bond funds as we do not believe that investors are getting paid enough for the risk.

Looking ahead to 2018, while we are currently enjoying accelerating global economic growth, we remain ever mindful that sometimes too much of a good thing can be a bad thing.

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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Managing Partner

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