Bourgeon CAPITAL MANAGEMENT
Investment Counselors

MARKET INSIGHTS

JANUARY 2014

Back to the Future

— Back to the Future was a 1985 Movie about Time Travel The phrase :"Back to the Future" has become common to refer to something from the past being recycled in the present

Investors have gone on a wild ride during the past five years, but it's now time to go back to the future to get into a 'normal' rhythm. During the Great Recession the S&P 500 stock market declined over 50% at its worst. But then in the subsequent five years of deleveraging ending in 2013 the S&P 500 was up 100%. Where do we go from here? In 2009 Bill Gross, CEO of Pimco, explained our situation as the "New Normal" where we would have 3-5 years of muted western growth, high unemployment and relatively orderly delevering. In 2012 Mr. Gross said that the US had morphed into "Paranormal", or into a world with much fatter tails, bordering on bimodal. Deleveraging has occurred now with corporations, consumers, and most recently with the US government. And now as the US Federal Reserve believes that the US economy is strong enough to start the process of removing its extraordinary measures of quantitative easing, we believe that we are going Back to the Future, and we are close to being Back to Normal.

With Tapering of Quantitative Easing, Financial Markets are Getting Back to 'Normal'

In 2007 the US financial markets began to crumble under the weight of massive corporate and consumer leverage. The government and the Federal Reserve stepped in to provide stimulus and cheap money to help ease the pain of the deleveraging cycle that had to follow. Corporations were the first to delever, and this was followed by consumers, and then the US government in 2013. Throughout this process the Federal Reserve continued to supply near zero interest rates and quantitative easing in order to help balance the restraint to growth that was coming from both the private and then government sector. During this time of deleveraging, despite several unexpected shocks to the system, GDP has slowly increased, unemployment has slowly declined, and inflation has remained muted. The Fed has been successful.

2014 begins with the Federal Reserve trying once again to take off the training wheels to see if our economy can move forward without extraordinary assistance. If they can do this, then our financial markets should get Back to Normal. GDP growth should continue to be in the 2-3% range as financial conditions tighten and inflation should stay around the Fed's 2% target. In general we believe this should be good for the stock market through earnings growth and PE multiple expansion, but should weigh on the bond market as yields move back up to normal 3% plus levels on the 10-year US Treasury.

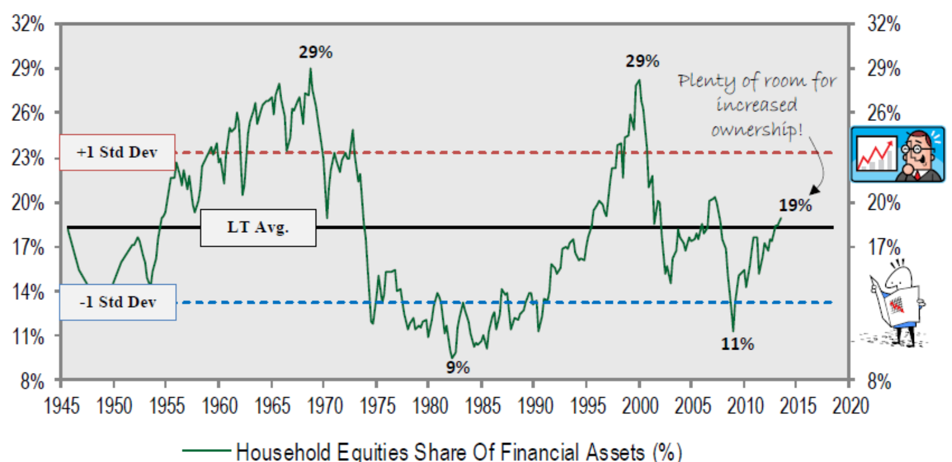
Financial Markets have Rallied on a Return to Normal

Throughout this 5-year period of deleveraging the US stock market has performed brilliantly. During the past 5 years ended 12/31/13 the S&P 500 was up over 100%. For 2013 alone the S&P 500 was up 30%. Meanwhile the Barclays aggregate bond index was down 2% in 2013. The psychology to buy stocks over bonds in this environment has grown. In fact, equity flows into stock funds finally turned positive in 2013, after 12 years of decline. Thus, it appears as if the "great rotation" from bonds to stocks may finally be beginning and has the potential to raise stock prices irrespective of earnings growth.

Maintain Asset Allocations at 'Normal' Levels

Investing is a cycle. The bottom of the cycle, when investors are scared and valuations are cheap, is the best time to buy stocks. Your return potential is great, but fear is too large for many to look past. In hindsight 2009 was the best time to buy stocks. It was during 2009 that Bourgeon began to actively increase allocations to equities, and we continued to increase allocations until March of 2013. Today we believe that we are around mid cycle. Investors are starting to want to buy stocks again and valuation multiples have expanded to be at or slightly above historical norms. Thus returns can still be very good, but the risks are also increasing. In March of 2013 we told you that we had reached 'benchmark' type asset allocation levels for our accounts and that we would likely remain around those levels going forward. Thus, our asset allocations are back to 'normal.' Our future sights will be on a cycle peak (hopefully several years away), or a period when equity ownership is back to historical peak levels, valuations are stretched, and short term interest rates are back near 5%. Today, as a comparison, equity ownership is now just back to normal, valuations are about average, and 10-year US Treasuries are only 3%. See Table 2.

Table 2



Source: Cornerstone Macro

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Expect Normal Stock Market Returns Over the Long Run

While the past five years, and especially 2013, have been strong years for the stock market, we can't lose sight of the fact that the long-term average real rate of return (excludes inflation) for the US stock market has averaged 6.5%. Similar to what the above chart shows, in cyclical industries, and in the stock market, over time there is a tendency to revert to a mean. Over the past 5 years the average real rate of return of the S&P 500 has approximated 15%, twice the historical average. Economic headlines as we enter 2014 are of the rosy kind, investor sentiment is bullish, and so it appears as though there is little to worry about. It is at these times when the unexpected, which always happens, can be particularly harsh to stock market returns. Thus, given our prudent nature we are committed to maintaining our asset allocations at levels consistent with each client's specific risk profiles. Some areas of concern for us are the unintended consequences of Fed tapering, potential for deflation in Europe, and continued weakness in China and emerging markets.

Continue to Buy Stocks over Bonds and GARP over Defensive

For the past year we have continued to increase exposure to our GARP-like companies and take profit from those companies where we believe the risk/reward was moving against us. We are still in a relatively low growth environment, so we are looking for stocks that are going to provide us with growth at a reasonable price. If we look at the recent improvement in both the index of leading economic indicators, as well as the ISM Manufacturing Index, it is likely that EPS growth shows some acceleration as we head into 2014. There is even a better than 50/50 chance that we get a resumption of growth on a global basis as well. Our growth themes have remained relatively consistent this year, and have been focused on natural gas, manufacturing, and housing.

Expect Bond Yields To Go Back to Normal and are More Likely to Rise than Fall

After passing on the option to taper earlier in the year, the FED decided to step up to the plate in December. The 10 year Treasury has now settled in the 3% range, approximately double the 1.6% low hit in May 2013. In our opinion the bond market is now almost entirely discounting a complete exit from quantitative easing by the end of this year. We continue to believe that the move in interest rates going forward is more likely to rise than to fall. But with Yellen at the helm it just might rise more slowly, especially if the economy continues with its two-step forward, one step back slow growth movement. Our bond strategy in this environment remains consistent. First, we own individual bonds rather than bond funds. Thus, you know the yield-to-maturity on the bond at any given time. Bond funds, on the other hand, have the potential to trade below net asset value during times of quick redemptions, and the fund, never fully 'matures.' Second, we buy bond ladders with a relatively short duration (under 5 years). Thus every year approximately 20% of the portfolio matures, providing an opportunity to repurchase bonds at the then higher rate, reducing interest rate risk.

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While we have only spoken generically about asset allocation in this report, 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. If your situation changes at any time, 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,

John A. Zaro III, CFA
Managing Partner

Laura K. Drynan, CFA
Partner

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