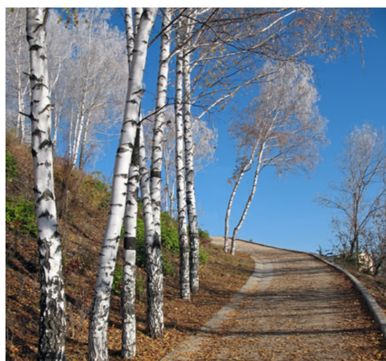
Market View



January 2016

US stocks in 2015 had a bumpy sideways ride but fared better than most other markets. The Federal Reserve raised interest rates for the first time since the 2008 recession but rates still remain at exceptionally low levels. Most global economies remain mired in slow growth trajectories. The US consumer appears to be on solid footings. We address a few client questions regarding oil prices, interest rates and more.

Financial Markets

US stock indices produced mixed results in 2015. In a year marked by a continued slide in oil prices, a strong US dollar and little or no profit growth, investors preferred the relative safety of large US-focused companies. Including dividends, the S&P 500 Index of large capitalization US stocks produced a return of +1.4% and the Dow Jones Industrial Average of blue chip companies returned +0.2%. Mid- and small-cap indices did not fare as well. Stocks of energy and export-focused companies declined broadly, while consumer and technology stocks generally climbed. Most international markets declined, particularly those tied to China's prospects.

With some exceptions, returns from US bonds were positive in 2015. As widely reported, the Federal Reserve in December raised short term interest rates by a modest 0.25% and at year-end some short term rates were at multi-year highs. As shown on the chart below, the year-end yield on the 6-month Treasury Bill was 0.48% compared to 0.12% at the end of 2014. The two-year note yield rose to 1.05%. Long term rates, which are not directly controlled by the Fed, are little changed from a year ago and remain very low. The yield on the 10-year Treasury at year-end was 2.27%.

The Economy

The US economy continues to expand at a slow, uneven pace buffeted primarily by international pressures. Following a weak start, Gross Domestic Product (GDP) growth in 2015 is expected to average about 2.5%, the tenth consecutive year of less than 3% growth – the longest stretch in the postwar era. Nonetheless, this growth has been better than most international developed economies. Consumer spending (the largest component of GDP) continues to increase and remains relatively healthy driven by strong employment gains and modest wage increases. However, business investment spending (about 15% of GDP) declined. According to government estimates, one broad gauge of business activity, capital expenditures excluding defense and aircraft, dropped over 3% last year. Slowing growth in China and the strong US dollar were largely to blame, particularly affecting those companies dependent on exports or with large operations overseas. A strong US dollar reduces revenues and profits earned abroad. Lower energy prices compounded international headwinds by forcing many oil, gas and other commodity companies to curtail operations and cut jobs. These same pressures also kept inflation rates below desired levels. Most economists (as reported by the Wall Street Journal) expect growth in 2016 to continue at about the same pace.

Market Indicators 12/31/2015

	Total Return	
US Stock Markets	**4th Quarter**	**Year-to-Date**
S&P 500 Index	7.0%	1.4%
S&P 400 Mid Cap	2.6%	-2.2%
Russell 2000 Small Cap	3.6%	-4.4%
International Stock Markets	*ETF Returns in US$*	
EAFE Index *(Europe, Australasia, Far East)*	3.3%	-1.0%
Japan *(MSCI Index)*	6.8%	9.2%
China *(Xinhua 25)*	1.6%	-12.9%
Emerging Mkts Index	-0.3%	-16.2%
US Fixed Income Yields	**12/31/14**	**12/31/15**
6 Mo US T-Bill	0.12%	0.48%
2 Yr US T-Note	0.67%	1.05%
10 Yr US T-Note	2.17%	2.27%

Frequently Asked Questions

We love hearing questions from our clients. Recently, questions have focused on the impact of oil prices, terrorist attacks and interest rates. We share our thoughts on the next page.

Will weakness in oil prices derail the US economy? We do not believe so but this is a key question facing economists and investors today. When oil prices began to tumble in 2014 many economists predicted that the drop would be temporary and, while mildly disruptive to the energy sector, fuel savings would be a boon to economic growth. Instead, abundant supplies, weak global demand and a strong US dollar converged to push oil and gas prices down for a second year to the lowest level in over a decade. The result has been a severe contraction in the nascent oil fracking industry which has spread to other related sectors of the economy as loans go sour and orders for drilling and related equipment dry up. US manufacturers, already reeling from lower exports caused by a strong dollar and slow growth overseas, are reporting recession-like conditions.

While the contagion is troubling, the overall economy appears to be weathering the storm. Consumer spending, which accounts for roughly 70% of the US economy, is growing about 3% annually – not as much as originally forecast when oil prices first dropped but enough to offset the contracting energy and manufacturing industries. Rather than spend all of their energy savings, consumers appear to be strengthening their balance sheets by using a portion of the windfall to pay down debt and boost their savings accounts. Supported by rising employment and slowly improving wage increases, the all-important consumer base seems to be on a solid, even improving foundation. Over time, the benefits of cheaper fuel costs should translate more directly into higher consumer spending.

Stock prices barely moved after the horrific terrorist attacks in Paris and California. Why? Despite their unpredictable ups and downs, equity prices in aggregate tend to reflect estimated future profits of their underlying companies. While many factors can impact prices, the market's reaction to an event is often seen as a quick assessment of its economic impact. Immediately after the 9/11 attacks, stock prices declined globally in anticipation of long lasting consequences. The market's response to the most recent attacks would suggest that investors, at least for now, do not see them as major economic threats.

What will higher interest rates mean for investors? Although Federal Reserve officials made it amply clear that future changes will depend on how the economy performs, we do not believe the recent increase presages steeply higher rates as seen in the 1980's. Interest rates then were driven by the Fed's attempts to stamp out rapidly rising inflation. Today, a slowdown in China, abundant oil and a large, low cost, global supply of workers means that the US is more likely battling a period of modest growth and persistently low inflation. The Fed's decision to increase rates is more akin to easing up on the gas pedal than stepping on the brakes. Further gradual increases are likely. If inflationary pressures build when oil and the dollar reverse course, the Fed will likely respond more aggressively.

The rise in rates will be a change for bond investors who have benefited from falling rates for almost three decades. Higher interest rates erode the principal value of bonds and potentially decrease the total return of bond portfolios. Nonetheless, we believe investors should stay true to their long term allocation targets. Bonds add certain diversification, stability and income characteristics which, even in a rising rate environment, can be beneficial for portfolios. Maintaining a ladder of shorter maturities provides more interest income than cash equivalents, while providing the opportunity to invest maturities at higher rates.

For equity investors, continued economic expansion and low inflation in-line with the Fed's goals could be supportive for corporate profits and a tailwind for stock prices. Of course, stock prices are affected by many factors and predicting their short term direction is impossible. Investors should own a diversified portfolio of companies positioned to grow through multiple economic conditions and phases.

Please let us know what's on your mind. We look forward to hearing your questions.

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