Market View

BIRCH HILL
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US stocks produced attractive but uneven returns in the first nine months of 2016. Longer term interest rates declined, while shorter term rates increased modestly. Many developed nations continue to have sovereign debt trading at negative yields. Low global rates have pushed some investors to "reach for yield."

Financial Markets

Despite numerous questions about economic growth and the upcoming presidential election, the stock market produced attractive returns through the first nine months of the year. The Standard & Poor's 500 Index, Dow Jones Industrial Average and the NASDAQ composite, all posted record high closes during the quarter. The S&P 500 Index and the Dow produced total returns of +7.8% and +7.2% during the first nine months of 2016. Stocks in Telecommunications and Utilities sectors outperformed as investors were drawn to their relatively high dividend yields. Energy has rebounded in 2016 after underperforming in 2015, while the Healthcare and Financial sectors have lagged the broad market this year. Developed international markets underperformed US stocks during the first nine months of the year. Emerging markets produced attractive returns, rebounding from a disappointing 2015.

US interest rates have been volatile. The benchmark 10 year US Treasury Note began the year with a yield of 2.27% and ended September at 1.60%. Renewed concerns about global economic growth caused rates to decline. At recent rates of about 2.2%, core inflation, adjusted for volatile energy and food prices, remains below long term averages.

The Economy

The US economy continues on its path of slow growth. According to the National Bureau of Economic Research, the last recession ended in June of 2009. In the six full calendar years since then, real GDP growth has not exceeded 3.0%. This below average growth continued into 2016 with the economy growing 1.1% for the first six months of the year. The outlook is somewhat stronger for the second half of the year. The US unemployment rate continues to hover below 5%. The labor market has tightened and demand for workers is more competitive, causing wages to grow at an annual rate of about 3%.

The Federal Reserve Bank's Open Market Committee opted not to raise interest rates in September. The Fed increased the Federal Funds Rate to 0.25% from 0% in December of last year for the first time since the recession. The December increase was expected to be the beginning of the normalization of interest rates closer to the historical average of 3%. The September decision followed the pattern of a committee that suggested they were ready to increase rates, only to be sidelined by less than stellar US economic data and global uncertainties. It is still anticipated that the Fed will raise rates at least once before year-end.

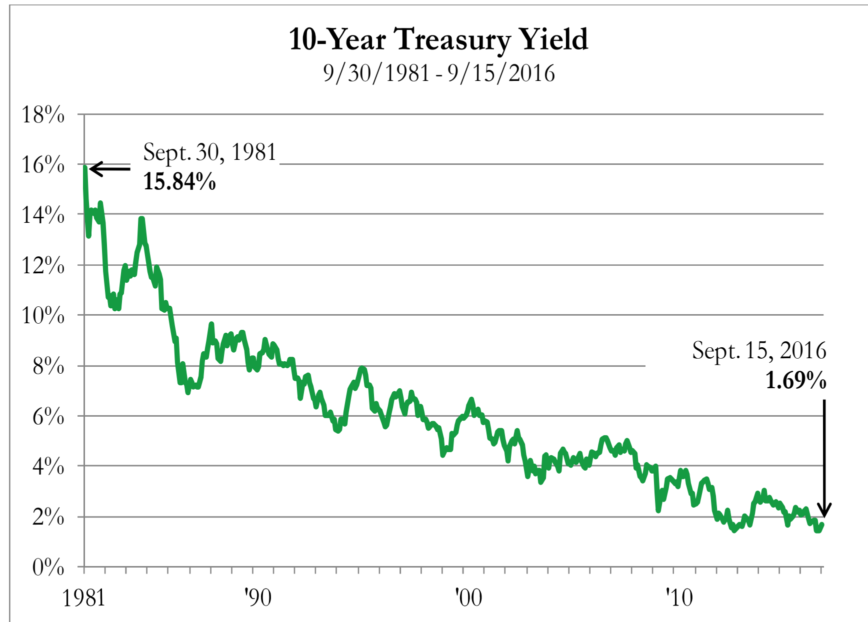
Market Indicators 9/30/2016

	Total Return	
US Stock Markets	**12 Mos**	**Year-to-Date**
S&P 500 Index	15.4%	7.8%
S&P 400 Mid Cap	15.3%	12.4%
Russell 2000 Small Cap	15.4%	11.4%
International Stock Markets	*ETF Returns in US$*	
EAFE Index *(Europe, Australasia, Far East)*	6.2%	2.8%
Japan *(MSCI Index)*	11.4%	4.3%
China *(Xinhua 25)*	10.3%	8.5%
Emerging Mkts Index	16.9%	17.3%
US Fixed Income Yields	**12/31/15**	**9/30/16**
6 Mo US T-Bill	0.48%	0.43%
2 Yr US T-Note	1.05%	0.76%
10 Yr US T-Note	2.27%	1.60%

Presidential Elections

We are faced with a negative political climate and an uncertain election outcome. The media will make many predictions about the best candidate for the stock market. Presidents may have an important short-term influence on certain aspects of the economy and the markets, but there are still many things over which they exercise little or no control. Major policy changes must be enacted by Congress in coordination with the Administration. While markets may react in the short term to election results, we believe long-term investors should not be distracted by the uncertainties of the election.

The "Reach for Yield"



Investors are often drawn to fixed income securities and dividend paying stocks to satisfy their income requirements. Since peaking in 1981 at yields above 15%, the 10 year US Treasury Note continued its 35 year downtrend closing below 1.4% during the quarter. This was the lowest yield on record. While the US faces low interest rates, many other developed countries have engineered negative interest rates in the attempt to stimulate economic growth. The Japanese central bank, which has struggled for years to stimulate growth, recently announced that along with keeping their benchmark interest rates at -0.1% they would also target yield curve control to keep the yield on the Japanese 10 year bond at zero. Numerous European countries continue to have negative sovereign debt yields.

With investors and savers facing low yields from fixed income investments, many have been attracted to high dividend paying equities. The two best performing sectors in the S&P 500 over the last twelve months have been Telecommunications and Utilities. The recent dividend yields in the sectors were 4.6% and 3.4%, respectively. The slow growing Utilities sector now trades at a historically high price earnings ratio of 18 times next year's earnings. This ratio is now higher than the P/E ratio of the faster growing S&P 500.

Other asset types, such as high yield bonds, master limited partnerships and real estate investment trusts, have also attracted yield hungry investors. All of these sectors have risk characteristics that are very different than traditional bonds. A prolonged period of low interest rates can entice investors to make unwise decisions. We continue to believe that investors must be aware of the risks that these decisions entail. In the September 21, 2016 press conference, Federal Reserve chair Yellen addressed the issue:

"...we have highly accommodative policies. And they seem to be necessary for countries to be able to achieve their inflation and employment objectives. And that's characteristic of an environment in which the neutral rate-- interest rates both here and in advanced countries around the globe appeared to be very low. And that is an environment that, if we do have to live with that for a long time, we have to be aware that it does give rise to a reach for yield as individuals and investors seek to, perhaps, take on risk or lengthen maturities to seek higher yields."

Conclusion

We believe investors should stay the course with a portfolio of high quality companies and should not be distracted by ancillary events. With low anticipated fixed income returns, investors should understand the risks that accompany reaching for yield.

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