Market View

BIRCH HILL INVESTMENT ADVISORS LLC

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US stocks closed 2016 near record highs. Economic growth picked up in the latter part of the year and expectations are high for new pro-growth policies from Congress. Market volatility may rise as actual legislation is hammered out. Investors should stay the course.

Financial Markets

US stocks reached new highs last month as the economy strengthened and election results increased the odds of a new fiscal stimulus program from Washington. Total return (appreciation plus dividends) of the large cap S&P 500 Index in 2016 was +11.9%, roughly half of which is due to gains since the election. Returns of the riskier mid- and small-capitalization indices were notably stronger. Energy and financial stocks generally lead all the major indices as a result of the rebound in oil prices and higher interest rates. Many industrial stocks, which are sensitive to economic growth, were also strong performers.

Internationally, the EAFE Index of developed country stocks (predominantly UK and Eurozone) gained only modestly last year due to sluggish growth and ongoing political uncertainties including the fate of the European Union in the aftermath of Britain's decision to leave. Emerging market stocks rebounded from difficult conditions in 2015 but face renewed pressures caused by a strong US dollar.

US interest rates rose sharply from depressed levels at mid-year as bankers and investors recalibrated expectations for stronger economic growth and somewhat higher inflation. The Federal Reserve in December raised short term rates by 0.25% which pushed the 6-month T-Bill yield to 0.61%, the highest since 2008. The yield on the 10-year US Treasury Note ended the year at 2.45% up from an all-time low in July of 1.32% and back to levels not seen since 2014. Interest rates are generally still historically low.

The Economy

Economic conditions in the US improved in the second half of the year. Following a sluggish first half, growth picked up in the third quarter of 2016 to an annual rate of 3.5%, the fastest pace in two years. The outlook for fourth quarter and 2017 growth is about 2.5% according to a December poll of economists by the Wall Street Journal. Business spending, while still weak, is showing signs of improvement aided in part by a recovering energy sector. Consumer spending, the largest component of GDP, is relatively healthy and being driven by solid employment and modest, long-awaited wage gains. Inflation remained below the Federal Reserve's target but as noted by the Fed in their December statement, inflation expectations have moved up considerably from year ago levels. Higher interest rates have in part led to a stronger US dollar. While there are many benefits of a strong currency, a potential risk is that exports become more expensive relative to foreign-made goods, a headwind for US manufacturing jobs and US economic growth.

Market Indicators 12/31/2016

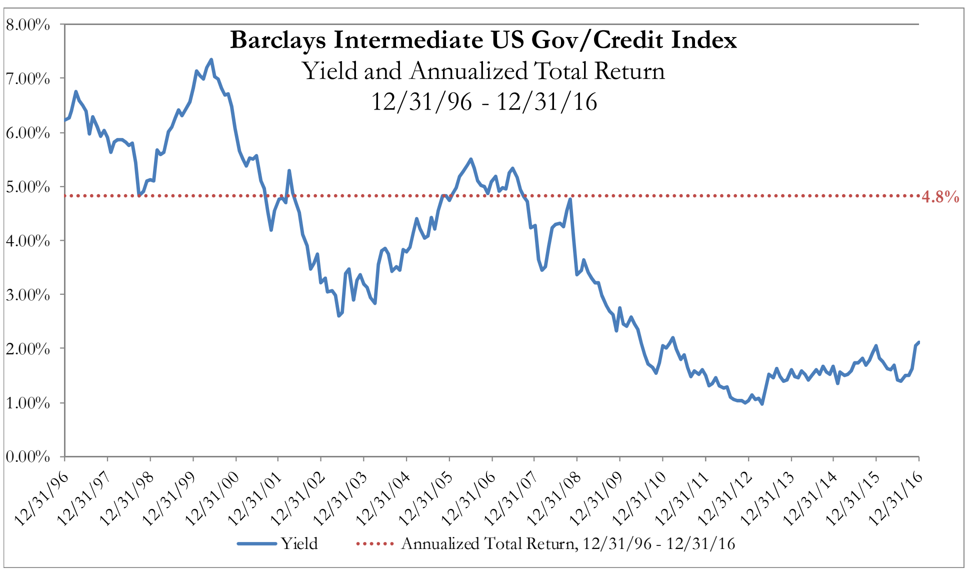
	Total Return	
US Stock Markets	**4th Quarter**	**Year-to-Date**
S&P 500 Index	3.8%	11.9%
S&P 400 Mid Cap	7.4%	20.7%
Russell 2000 Small Cap	8.8%	21.3%
International Stock Markets	*ETF Returns in US$*	
EAFE Index *(Europe, Australasia, Far East)*	-1.4%	1.4%
Japan *(MSCI Index)*	-1.4%	2.8%
China *(Xinhua 25)*	-6.9%	1.0%
Emerging Mkts Index	-5.5%	10.8%
US Fixed Income Yields	**12/31/15**	**12/31/16**
6 Mo US T-Bill	0.48%	0.61%
2 Yr US T-Note	1.05%	1.19%
10 Yr US T-Note	2.27%	2.45%

Navigating the Waters

Donald Trump was elected on a populist platform and Republicans retained control of both houses of Congress, raising the prospect of broad-ranging social and economic policy changes. While Mr. Trump's populist agenda includes many controversial positions, the ones most likely to gain early traction will be those that align with pro-growth Republican interests including tax reform (particularly corporate tax cuts) and infrastructure spending. If enacted, these proposals could boost US economic growth and lead to a long-anticipated (and normalized) rise in interest rates. There are plenty of challenges, however. Congress will need to balance the benefits of stimulus-led growth with the long term costs of higher deficits. Trump's anti-trade campaign rhetoric has not yet advanced as policy but could trigger damaging trade wars especially if similar policies are adopted by rising populist movements overseas.

Based on post-election gains in stock prices and interest rates, investors appear to be optimistic that new successful policies will evolve even though negotiations are just beginning. The financial markets could be volatile while actual policies are fleshed out and publically debated.

How should investors navigate these waters? We believe equity investors will be best served by staying the course, owning a diversified portfolio of companies with strong competitive moats. Such companies have developed high barriers that effectively keep competitors at bay due to cost advantages, strong brands, patents, and other characteristics. Wide moat companies typically have a record of stable growth and above average profitability that enable them to ride through challenging environments. They are the core of Birch Hill client portfolios. Their lower stock price volatility is particularly beneficial to portfolios during periods of change and uncertainty.



Modest interest rate increases backed by slowly improving economic conditions are generally a positive for financial markets but make fixed income investing more challenging. As the adjacent chart shows, declining yields over the last 20 years produced an annualized total return (income plus appreciation) of almost 5% for a broad basket of fixed income investments. Such returns will not be realized in a period of rising rates. Still, depending on individual needs, fixed income investments continue to play a useful role in portfolios by buffering against the volatility caused by equities and to protect the value of a portfolio should economic growth falter. Maintaining a ladder of short maturities provides a low risk way to preserve capital with the opportunity to reinvest maturing securities at higher rates.

Conclusion

Although many potentially impactful policies from the new administration and Congress are being discussed, it is still far from clear which will be enacted. We believe investors should continue to focus on equities of high quality wide moat companies and, where appropriate, a portfolio of short term fixed income securities. We look forward to hearing your questions and thoughts.

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