Market View

BIRCH HILL
INVESTMENT ADVISORS LLC

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US stocks continued their strong performance into 2017 and ended the first quarter up 6.1%. Short term interest rates rose while longer rates were generally flat. In March the Federal Reserve raised the federal funds rate another 1/4 of 1% to a range of 0.75 to 1%. Clients are asking us: Why has the stock market done so well?

Financial Markets

In the first quarter the S&P 500 Index of large capitalization US stocks produced a total return of +6.1%. Developed international markets performed slightly better than the US, increasing 7.9%, as the European and Japanese economies showed signs of growth. Emerging markets were up a strong 12.5% building on an improving trend in 2016. The price of oil declined by 3%, ending March at $50.60 a barrel. While OPEC has been disciplined in curtailing output, US oil production has been rising. Active oil rigs in the US are nearly double the number of a year ago, although still below historical highs.

Profits of companies in the S&P 500 Index were down about 1% in 2016 after no increase the year before. Expectations for 2017 are for a 10% increase or more. Some of this anticipated increase is due to a general improving economic trend worldwide plus some expected impetus from proposed corporate tax cuts, fiscal stimulus and reduced regulatory constraints.

Interest rates were mostly unchanged in the quarter. The 5 year US Treasury yield was flat at 1.92%, steady after its rise from less than 1% last summer. The 10 year Treasury performed similarly, closing at 2.39%. The Federal Reserve showed confidence that the economic expansion is sustainable, increasing the federal funds rate by 1/4 of 1% in March. Two, perhaps more, additional increases are expected in 2017.

Market Indicators 3/31/2017

	Total Return	
US Stock Markets	**12 Mos**	**1st Qrtr 2017**
S&P 500 Index	17.1%	6.1%
S&P 400 Mid Cap	20.9%	3.9%
Russell 2000 Small Cap	26.2%	2.5%
International Stock Markets *ETF Returns in US$*		
EAFE Index *(Europe, Australasia, Far East)*	12.4%	7.9%
Japan *(MSCI Index)*	15.1%	5.4%
China *(Xinhua 25)*	17.1%	10.9%
Emerging Mkts Index	17.2%	12.5%
US Fixed Income Yields	**12/31/16**	**3/31/17**
6 Mo US T-Bill	0.61%	0.90%
2 Yr US T-Note	1.19%	1.26%
10 Yr US T-Note	2.45%	2.39%

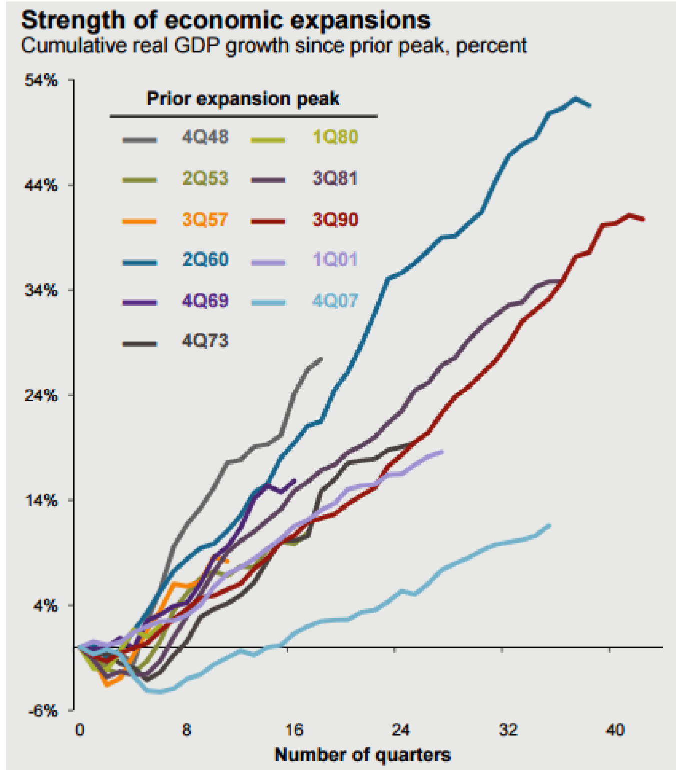
The Economy

The US economy continues to expand at a moderate pace. US Gross Domestic Product grew 1.6% in 2016, down from 2.6% the year before, with the 4th quarter growing 2.1%. This was the eleventh consecutive year of less than 3% growth.

Payrolls have been growing at a strong, steady pace, adding close to 200,000 jobs monthly over the past year. Real average hourly earnings growth is still modest but improving, increasing at a 2.8% annual rate in February. Consumer spending has been healthy, with Personal Consumption Expenditures increasing 3.9% in 2016, versus 3.5% in 2015. Housing has not played its usual strong role in the current expansion, but it is now showing signs of improvement. The rebound in oil prices in 2016 helped the US domestic energy industry and boosted capital spending.

Why is the stock market doing so well?

The US economy has been growing at a moderate pace since the last recession. The chart below shows that while the current expansion (the light blue line at the bottom) is now growing old, economic growth is quite low compared to other post World War II expansions. The US economy may have room to keep expanding before creating inflationary pressures.



Source: BEA, NBER, J.P. Morgan Asset Management. Data are as of 12/31/16

The US economy started to show renewed strength in the latter part of 2016, with 3rd quarter GDP up 3.5%. Average hourly earnings are starting to increase at a faster pace. Simultaneously, growth began to pick up in Europe and developing markets. Two recent Federal Reserve rate increases confirm the view that the expansion is now sustainable. Many economic indicators are showing an improving trend, although these have not yet been reflected in the more recent GDP numbers.

Since the election, investor expectations have been boosted by plans to reduce corporate taxes, lessen regulation and stimulate with infrastructure spending. To some degree, consumer and business sentiment measures have improved, and consumer spending is now trending higher.

Is the rise sustainable?

Worldwide economies are expanding at a faster pace, and corporate profits are expected to rebound in 2017. Stock market valuations appear slightly above the long term trend but are not too stretched. With continued strong job growth, and rising average hourly earnings, consumer spending should continue to grow. These trends were in place before any new legislation from Washington. While stock market drivers are difficult to determine, the markets will likely be disappointed if the anticipated changes are not enacted.

We continue to believe that investors are best served by setting an appropriate asset allocation that meets their needs and periodically rebalancing to target. Allocations should be based on long term goals, investment horizon, and an ability to weather price volatility.

Our role in providing investment advice to you

In the current heightened partisan climate, clients have been talking to us about the effect politics might have on the markets. Our job is to analyze all of the information available to us and to act in a sound, prudent and thoughtful way in exercising investment judgment. We believe our elected representatives have less of an effect on the long term trends in financial markets than most people think. Our focus is on companies that can grow regardless of the political environment. The companies we own have a successful record of adapting to changing circumstances, and Washington politics represent some of those changes.

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