Market View

BIRCH HILL
INVESTMENT ADVISORS LLC

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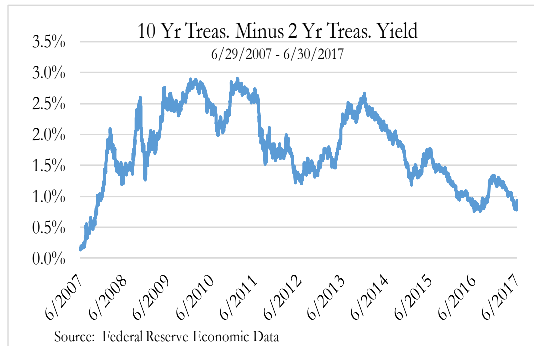
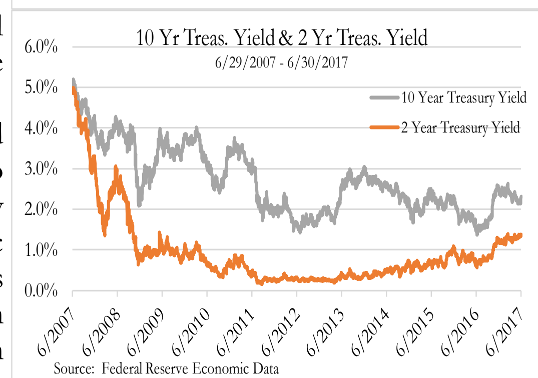
Stock prices continued a steady, low volatility, march higher in the second quarter. With valuation levels somewhat above average, investors may be too complacent. The Federal Reserve seems intent on increasing short-term interest rates even in the face of very low inflation and economic growth. The eventual transition from the current low interest rate period to more normal rates may be painful for less-cautious investors but will likely lead to a period of stronger productivity and economic growth.

Financial Markets

Equity markets continued to produce attractive returns in the second quarter resulting in a very favorable first half of 2017. During the six-month period the Standard & Poor's 500 Index returned 9.3%, the MSCI EAFE index of developed non-US markets returned 14.8% and the MSCI Emerging Markets Index returned 18.8%. US mid-capitalization and small capitalization stocks, which had been leaders for several years, produced more modest returns in the first half of the year.

The US stock market's rise this year has been both gradual and persistent with only brief periods of shallow price declines. Although the US market trades at valuation levels that moderately exceed long-term averages, turmoil in Washington, terrorist incidents in Europe, a decline in the price of oil and continued slow economic growth have not shaken the stock market. Low interest rates, rebounding corporate profits, and slightly higher growth overseas have helped support equity prices. However, the lack of market volatility may suggest investors have become overly complacent.





In mid-June the Federal Reserve Open Market Committee increased the Fed Funds rate for the second time in 2017 to a range of 1.00% to 1.25%. It is generally anticipated that the Fed will increase rates one more time before the end of 2017. However, it is possible the Fed will delay any further increase until the stubbornly low inflation rate increases to at least 2%.

Market Indicators 6/30/2017		
	Total Return	
US Stock Markets	12 Mos	Year-to-Date
S&P 500 Index	17.9%	9.3%
S&P 400 Mid Cap	18.6%	6.0%
Russell 2000 Small Cap	24.6%	5.0%
International Stock Markets	*ETF Returns in US$*	
EAFE Index *(Europe, Australasia, Far East)*	20.0%	14.8%
Japan *(MSCI Index)*	18.8%	10.5%
China *(Xinhua 25)*	18.9%	14.9%
Emerging Mkts Index	22.4%	18.8%
US Fixed Income Yields	12/31/16	6/30/17
6 Mo US T-Bill	0.61%	1.14%
2 Yr US T-Note	1.19%	1.38%
10 Yr US T-Note	2.45%	2.31%

The Fed's action has caused short-term interest rates to increase in 2017 but low inflation, slow economic growth, and low interest rates in Europe have resulted in declining long-term US rates in 2017. At mid-year the difference between the yield on the two-year US Treasury Note and the ten -year Note, referred to as the 2s-10s spread, was only 0.93% compared to 1.24% at the beginning of the year. Historically, banks and other financial institutions need a 2s-10s spread of at least 1.50% in order to achieve desired levels of profitability. An inverted yield curve, when short-term rates exceed long-term rates, has often been a predictor of recession. Although not yet on the horizon, economists and investors will continue to watch for signs of an economic downturn as the current expansion, now the second longest expansion since the end of World War II, continues.

The Economy

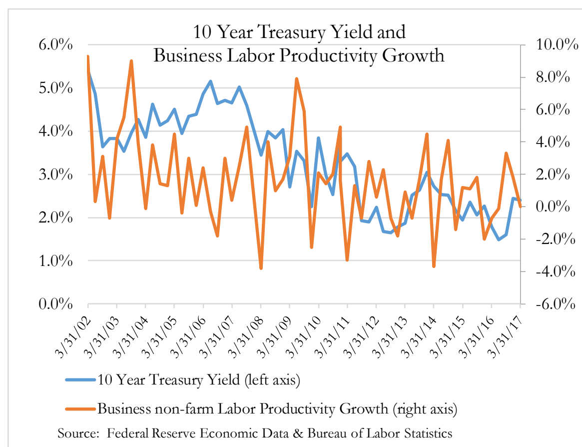
US Real Gross Domestic Product (GDP), an inflation-adjusted measure of economic activity, grew at 1.4% in the first quarter of 2017. In recent years the US economy has followed a pattern of slow growth in the first quarter followed by modest acceleration in the last three quarters of the year. Most economists believe that pattern will continue in 2017 and that the year will achieve GDP growth on the order of 2.2%. The reason for this new pattern is unclear. Some analysts suggest that given heightened political and economic uncertainty many business managers and individuals prefer to start the year cautiously and then become more confident by mid-year. If uncertainty is the cause of first quarter weakness it is doubtful that the new growth pattern will change in the foreseeable future.

Economic Distortions Caused by Low Interest Rates

Although the US Federal Reserve has recently been working to increase short-term interest rates, most rates in the US and in almost every other major country are very low by historical standards. Ever since the credit crisis of 2008-2009 central banks around the globe have launched efforts to push rates lower in an attempt to support the financial system, bail out borrowers and encourage lending in order to stimulate economic growth. This low interest rate campaign was probably instrumental in avoiding a global economic depression. However, abnormally low interest rates have likely caused financial and economic distortions.

Much has been written about the impact of low interest rates on investors. In the search for yield many savers have taken on additional risk in terms of lower credit quality, longer maturities, or obscure financial products. When interest rates eventually increase the soundness of such investments will likely come into question.

Distortions related to low interest rates are certainly not limited to investments. Economists have been puzzled in recent years by the relative lack of productivity growth. The growth of labor force productivity is an essential element in producing higher economic benefits for society. The culprit is generally believed to be low levels of corporate investment in new equipment and technology. Some economists now think that low interest rates are the ultimate cause of low productivity growth as low interest costs make it possible for failing businesses to struggle on much longer than would occur under normal conditions. If a struggling business closes, the remaining, more efficient, competitors increase their business and therefore increase average productivity in that particular industry. Future increases in interest rates will likely lead to a period of losses in certain interest rate sensitive investments and a wave of business bankruptcies. While that period may be painful for some, it will ultimately lead to a sounder economic base and higher productivity growth.



Conclusion

Most sectors of the stock market produced attractive returns in the first six months of the year. US stocks have performed well for several years and are now trading at somewhat elevated valuations. Although short-term interest rates have not yet risen to attractive levels, long-term investors should rebalance portfolios in order to control risk. Taxable investors will undoubtedly incur capital gains during this rebalancing.

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