Birch Hill
INVESTMENT ADVISORS

Market View

January 2018

Stocks advanced to new highs in 2017 as global conditions strengthened. The US economy is healthy but showing signs of maturing. Investors should continue to rebalance portfolios to maintain long term asset allocation targets. We highlight several features of the new tax law changes.

FINANCIAL MARKETS

US equities in 2017 capped a year of strong returns and historically low volatility. The S&P 500 Index of large capitalization stocks returned 21.8%, supported by accelerating global economic growth and strong corporate profits. In a historical first, the Index produced a gain every month of the year and, for the first time in 22 years, it never declined from its peak by more than 3%. The advance, however, was relatively narrow and concentrated in high growth securities: roughly one-quarter of the gain in the S&P is due to just five technology stocks. More moderately priced value stocks significantly underperformed the index. Mid- and small-capitalization stocks produced solid gains but also underperformed. International stocks generally outpaced the US: the EAFE Index of developed markets returned 25.1% and the Emerging Markets Index soared 37.3%.

Short term interest rates in 2017 rose from artificially low levels as the Federal Reserve took steps to rollback its stimulus plan. Longer term rates, such as the 10-year US Treasury Note, remained largely unchanged from the year-ago period. As the economy matures, short and long term rates will likely increase to more historically normal levels.

TAX REFORM

Among the many provisions in the recent tax law changes, several that might affect Birch Hill clients include:

- Reduced income tax rates across almost all income brackets;
- Higher thresholds for the alternative minimum tax. Generally, incomes under $500,000 for individuals and $1 million for couples will now escape the AMT;
- An increased federal gift and estate tax exemption to $11.2 million ($22.4 million for couples). (Separately, the annual gift exclusion in 2018 increases to $15,000.)
- Eased restrictions on the use of 529 College Saving Plans. Up to $10,000 annually may now be used to pay elementary and secondary school tuitions.

Market Indicators		12/31/2017
TOTAL RETURN		
US Stock Markets	4th Quarter	Year-to-Date
S&P 500 Index	6.6%	21.8%
S&P 400 Mid Cap	6.2%	16.2%
Russell 2000 Small Cap	3.3%	14.6%
Int'l Stock Markets		
ETF Returns in US$		
EAFE Index (Europe, Australasia, Far East)	3.8%	25.1%
Japan (MSCI Index)	8.3%	24.3%
China (Xinhua 25)	6.9%	36.2%
Emerging Mkts Index	6.8%	37.3%
US Fixed Income Yields	12/31/2016	12/31/2017
6 Mo US T-Bill	0.61%	1.53%
2 Yr US T-Note	1.19%	1.89%
10 Yr US T-Note	2.45%	2.40%

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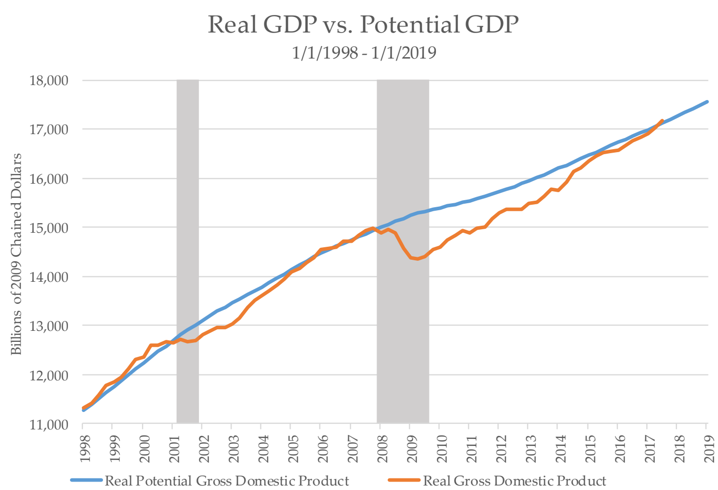
- A new $10,000 limit on state and local tax deductions (property, income or sales tax), a reduced mortgage interest deduction (only up to $750,000 on new mortgage debt), and the elimination of miscellaneous itemized deductions (e.g., home office, accounting and investment expenses). Interest on home equity loans will also no longer be deductible. These changes mean that many taxpayers who previously itemized their deductions may fall under the new standard deduction ($12,000 for individuals and $24,000 for couples) starting in 2018.

THE MATURING ECONOMY

After a decade of uneven gains, economic growth is broadening out, and the economy is entering a more advanced phase. US Gross Domestic Product in 2017 likely gained about 2.5% backed by gains of more than 3% in the second, third and probably fourth quarters of the year. Though not a boom, it would be the first time since 2004 that growth has exceeded 3% for three consecutive quarters. Consumer spending, supported by strong employment and modest wage gains, accounts for most of this growth. In a particularly encouraging sign, business investment spending turned positive in 2017 following several years of disappointing gains and an actual decline in 2016. Many economists expect this new momentum to extend into 2018, buoyed in part by the stimulus from the recently enacted tax cuts. Business spending is central to boosting worker productivity and corporate profits.

In an important milestone, the non-partisan Congressional Budget Office last month reported that by one metric (total economic output) the economy today is running slightly above its full potential for the first time since 2007. Total output is a measure of the economy's potential to produce goods and services based on the supply of people working and how productive they are. As illustrated in the nearby chart, actual output drops below potential during downturns (the shaded areas) and sometimes exceeds potential for a period as the economy matures. In later stages, as workers and resources become scarce, prices and wages often begin to increase and eventually cause the economy to overheat.



Source: Federal Reserve Bank of St. Louis Economic Data
*Shaded bars represent U.S. recessions

While it is impossible to know the fate of today's economy, economists are generally encouraged by the global breadth of the expansion. Economic conditions are reportedly positive in all 35 OECD (developed) countries, with about two-thirds of those experiencing accelerating growth. As a major trading partner, the US should benefit. On the other hand, recent and expected moves by the Federal Reserve to raise interest rates in the US are specifically intended to temper underlying growth. Some economists are concerned that new lower tax rates could overstimulate an already fully functioning economy, adding to interest rate pressures and shortening its life rather than extending it.

In any event, the current expansion, which in its 9th year is already one of the longest on record, appears to have matured into a more advanced phase of a normal economic cycle. While not on the immediate horizon, investors should be alert for signs of the next slowdown.

CONCLUSION

2017 was an unusually strong year for the equity markets and investors should be vigilant in rebalancing portfolios to control risk. Although interest rates are still not at attractive levels, asset allocations should remain close to long term targets. We look forward to your questions and thoughts.

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