Birch Hill
INVESTMENT ADVISORS

Market View

April 2018

Stock prices ended the first quarter down slightly from their year end values. Price volatility is back, a sharp change from the quiescence of 2017. Short and intermediate term interest rates continue to rise. A negative yield curve, with short term rates higher than long, is a possibility, with the Federal Reserve projecting seven short term rate increases over the next three years, and a yield curve already pretty flat. Below we answer some questions we have been hearing from clients.

Market Indicators		3/31/2018
TOTAL RETURN		
US Stock Markets	12 Mos	1st Qtr 2018
S&P 500 Index	14.0%	-0.8%
S&P 400 Mid Cap	11.0%	-0.8%
Russell 2000 Small Cap	11.8%	-0.1%
Int'l Stock Markets		
ETF Returns in US$		
EAFE Index (Europe, Australasia, Far East)	14.9%	-0.9%
Japan (MSCI Index)	19.4%	1.3%
China (Xinhua 25)	25.7%	2.3%
Emerging Mkts Index	25.0%	2.5%
US Fixed Income Yields	12/31/2017	3/31/2018
6 Mo US T-Bill	1.53%	1.93%
2 Yr US T-Note	1.89%	2.27%
10 Yr US T-Note	2.40%	2.74%

FINANCIAL MARKETS

US equities ended the quarter down from year end, with the S&P 500 Index of large cap stocks declining -0.8% and the Dow Jones Industrials –2.0%. The small percentage decline masks the amount of volatility. The ending S&P 500 Index was 8% below its peak. International developed market returns were generally in line with the US, with Emerging Markets performing better. Interest rates rose with the 6 month US Treasury yield at 1.93% versus 1.53% at year end, and the 10 year US Treasury yield at 2.74% up from 2.40%.

In 2017 corporate earnings, as measured by the S&P 500, were up 10% year over year and are expected to increase by more than 15% in 2018, supported primarily by a worldwide economic expansion and the US corporate tax rate reduction. This tax cut is projected to boost profits for US companies by roughly 7.5%, half the projected 2018 increase. Valuations are still somewhat elevated despite the sharp rise in earnings.

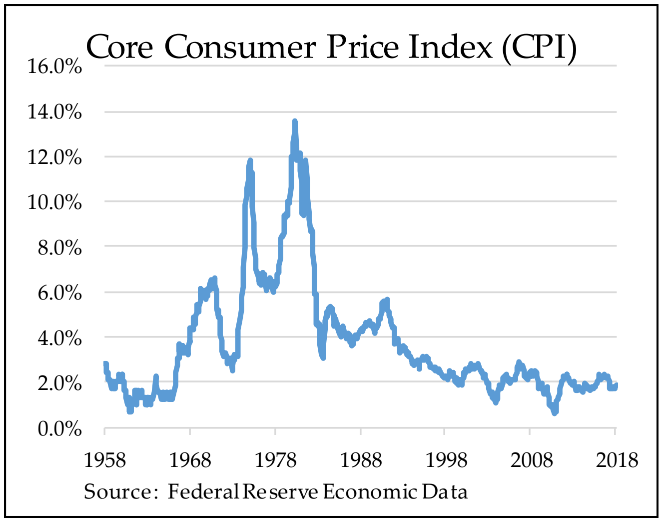
US economic growth has been trending higher, building confidence that the expansion will continue. GDP grew 2.3% in 2017, above the 1.6% for 2016. The corporate tax cut passed at year end is projected to add $1.5 trillion to the national debt, and the recent federal funding limit increase adds another $300 billion. With this recent new fiscal stimulus from Washington, higher near term economic growth is looking more likely.

Birch Hill Investment Advisors LLC
One International Place, Suite 770
Boston, MA 02110
Phone: 617-502-8300
BHBoston.com

QUESTIONS OUR CLIENTS ARE ASKING US

Why are stock prices suddenly so volatile?

Increased volatility is more of a return to normal, rather than an aberration. This year the largest stock market drop, peak to trough, was 10%, versus the average of 14% since 1980. The largest drop was only 3% in 2017. In order to obtain the returns equities can provide, long term investors have to tolerate price volatility.



Why the concern about higher inflation?

Inflation has been running mostly below the Federal Reserve's target of 2% per annum. The intractable high inflation from 1968 through 1981 (see chart) created a host of problems for the US economy, and policymakers do not want to repeat it. The corporate tax cut late in the cycle, increased Federal deficit spending, new tariffs, and a slowly growing labor pool may boost inflation.

Aren't higher interest rates a good thing for investors?

Yes, for those relying on their investment portfolios for living expenses, higher interest rates can be a welcome relief. However, bonds compete with equities for investor dollars, so higher interest rates can hurt equity investors by reducing demand for stocks. Higher interest rates also add to the costs of most businesses, putting pressure on profits. Higher rates may also depress housing and inhibit consumer spending.

When is the next recession?

The flattening yield curve and a Federal Reserve Bank anxious to normalize credit markets may cause short rates to go higher than long ones. Such an inverted yield curve has in the past been associated with economic recessions. Why? Bond investors' willingness to accept a lower return on longer bonds indicates they expect economic weakness, likely a recession. With the current expansion in its 10th year, it clearly is mature.

Should I be concerned about these new tariffs and talk of a trade war?

Yes. Trade is important to the US, and any evidence of escalating tariffs and retaliatory actions can elevate costs for many companies and increase prices for consumers. The claim of "unfair" trade practices has been around for many years, and the most common resolution is with each side making some accommodation. We are inclined to think the result will be the same this time.

CONCLUSION

With interest rates moving up, the stock market volatile and threats of a trade war in the news, the first quarter of 2018 did not lack excitement. 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.

We look forward to your questions and thoughts.

Miner A. Crary, CFA *Gary R. Mikula, CFA* *Robert A. O'Neil, Jr., CFA* *Thomas E. Reilly, Jr., JD*

Catherine M. Kennedy, CFP® *Timothy M. Malloy, CFP®* *Brett A. Mirliani, CFA, CFP®*