Birch Hill
INVESTMENT ADVISORS

Market View

July 2018

US equity markets produced attractive returns in the second quarter. The Federal Reserve increased short-term interest rates. Trade tariff rhetoric escalated but thus far actual tariff implementation has been limited.

Market Indicators		6/30/2018
	TOTAL RETURN	
US Stock Markets	12 Mos	Year-to-Date
S&P 500 Index	14.4%	2.7%
S&P 400 Mid Cap	13.5%	3.5%
Russell 2000 Small Cap	17.6%	7.7%
Int'l Stock Markets		
ETF Returns in US$		
EAFE Index (Europe, Australasia, Far East)	5.9%	-2.8%
Japan (MSCI Index)	9.5%	-2.6%
China (Xinhua 25)	11.8%	-5.7%
Emerging Mkts Index	7.0%	-7.4%
US Fixed Income Yields	12/31/2017	6/30/2018
6 Mo US T-Bill	1.53%	2.11%
2 Yr US T-Note	1.89%	2.52%
10 Yr US T-Note	2.40%	2.85%

FINANCIAL MARKETS

The stock market turbulence that started near the end of January gave way to reduced volatility in the second quarter of 2018. The Standard & Poor's 500 Index produced a modest but positive return of +2.7% during the first six months of the year. Mid-capitalization and small company stocks produced more attractive returns of +3.5% and +7.7% during the period. A stronger dollar and trade war concerns put downward pressure on both developed international markets and emerging markets, which returned -2.8% and -7.4%, respectively.

The Federal Reserve raised short-term interest rates by one-quarter of one percent again in June. Two additional quarter-point increases are expected by year-end. While the two-year US Treasury Note yield increased in-line with the Federal Reserve's action, the ten-year US Treasury yield increased by far less resulting in a further flattening of the yield curve. Most other country's central banks have continued to suppress interest rates.

THE ECONOMY

US Gross Domestic Product (GDP) grew by 2.0% in the first quarter of 2018. Boosted by the reduction in tax rates, GDP is widely expected to have grown on the order of 4% in the second quarter. International trade frictions escalated during the quarter with the implementation of US tariffs on steel and aluminum. There were multiple announcements of reciprocal tariffs and planned future tariffs. World financial markets had only muted reactions to what is now largely a war of words. The consensus believes tariff announcements are simply posturing before trade negotiations. However, the implementation of the larger groups of tariffs would likely have a meaningful, negative impact on markets and on the economy.

THINKING ABOUT THE NEXT RECESSION

Throughout history, world economies have experienced periods of growth followed by contraction. The contractionary periods, recessions, serve to rid an economy of speculative excesses and unsound businesses thereby laying a firm foundation for the next period of growth.

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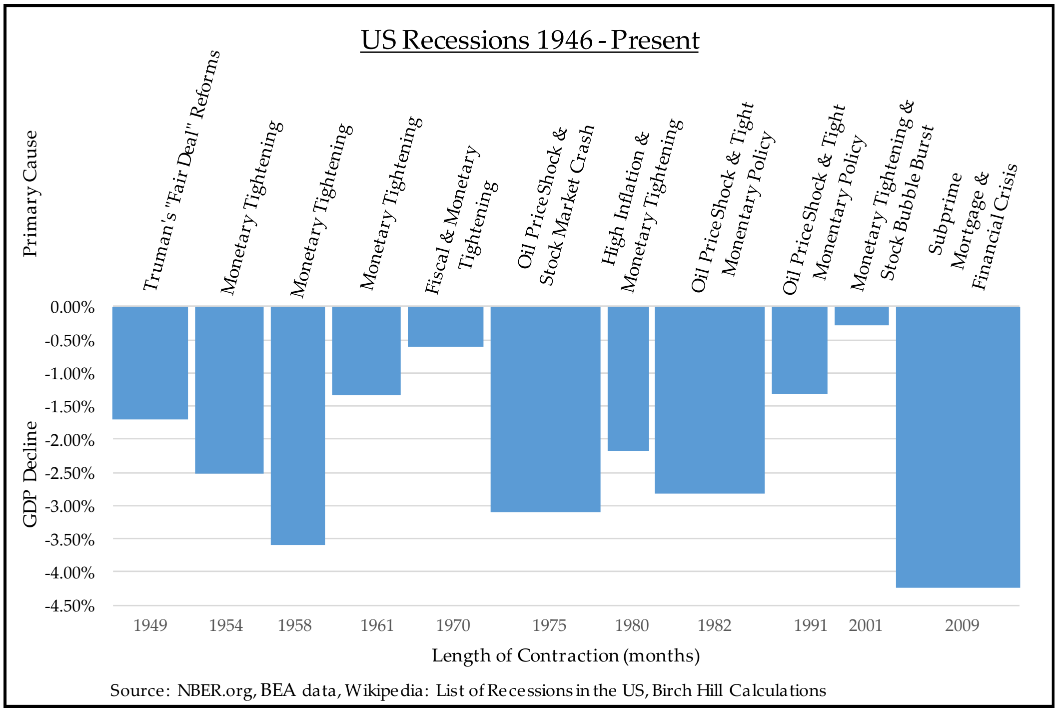
The current economic expansion is 108 months old, almost twice as long as the average post-World War II expansion. While there are no immediate signs of a downturn on the horizon, a growing number of economists believe some combination of higher interest rates and trade frictions could eventually push the economy into recession.



There have been eleven US recessions since World War II. During the first ten, Gross Domestic Product (GDP) declined, on average, by 2.0%. During the eleventh, the Great Recession of 2007-2009, GDP declined by 4.2%. The credit crisis-induced Great Recession was very different than other post-War recessions, most of which were caused, in whole or in part, by Federal Reserve tightening in an attempt to cool an over-heating economy.

US authorities reacted quickly to the 2008-2009 credit crisis with a series of efforts to inject funds into markets, bail out the banking system and, in some cases, rescue individual companies. In order to ease pressure on indebted businesses and individuals, the Federal Reserve reduced short-term interest rates to zero. European authorities were much slower to react, resulting in the eventual need to take even more dramatic action including implementing negative interest rates.

Extraordinary levels of governmental support have now continued for a decade. Most observers believe low interest rates and other governmental efforts allowed the global economy to avoid a more severe downturn. Part of the price paid has been a prolonged period of low economic growth. The current expansion has produced annualized GDP growth of 2.2% versus 4.3% in the average post-World War II expansion.

The nature of the next recession may also be different than most recessions of the last 70 years. The hidden distortive effects of a prolonged period of very low interest rates is an important concern. One possible problem area is the high level of low quality corporate debt in the form of high yield bonds and leveraged loans, which, when combined, now approximate 11% of GDP compared to 9% in 2008. Other speculative areas currently supported by low interest rates undoubtedly exist, but may only come to light during the next recession. Given the facts at hand, it is reasonable to assume the next recession will have an above-average number of financial surprises and bankruptcies. On a relative basis, well-managed, financially sound companies will likely benefit due to the difficulties of their weaker competitors.

CONCLUSION

The recent tax cut boosted economic growth in the second quarter. Escalating trade frictions have, thus far, been excused by the markets as posturing. The Federal Reserve has continued to gradually increase short-term interest rates. The next economic recession is not yet visible but given the potential distortions caused by a decade of abnormally low interest rates, investors should be aware of what may wait beyond the horizon.

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