Birch Hill
INVESTMENT ADVISORS

Market View

January 2019

Increased uncertainty caused equity markets to end the year on a weak and volatile note. US economic growth is healthy but fragile as headwinds develop and the risks of a slowdown increase. We discuss the effects of the rapid growth of corporate debt. Although hard to do in difficult markets, we believe the discipline of adhering to long term allocation targets will benefit investors in the long run.

FINANCIAL MARKETS

Volatility returned to the stock and bond markets last year. The S&P 500 Index of large company stocks produced a negative investment return of –4.4% after a sharp and rapid –14.4% drop from a new high in late September. Large growth company stocks dominated in the first part of the year but more defensive, value-oriented stocks began to outperform on a relative basis later in the year. International stocks also declined in 2018 and underperformed the US markets.

Short and long term interest rates rose from unusually low levels early in the year as evidence of healthy economic growth mounted. Federal Reserve rate hikes helped push the 6-month Treasury bill from 1.53% at the start of the year to 2.56% at year-end. The 10-year Treasury note rose from 2.40% to a peak of 3.24% in early October. Then, as concerns of a slowdown increased, interest rates on mid– and long-term term bonds began to drop. At year-end, the 2-year Treasury note yield dipped below the 6-month bill and the 10-year bond yielded 2.69%, only slightly greater than short term rates. Some observers believe this flattening of the yield curve may presage the next recession.

THE ECONOMY

Boosted by low interest rates and strong employment, US Gross Domestic Product last year likely gained about 3.0%, the highest rate of growth since 2005. Corporate profits benefited from this growth and with the help of the corporate tax cut earnings of companies in the S&P 500 surged an estimated 20%. However, weak economies overseas and a push to raise interest rates by the Federal Reserve increase the likelihood of a slowdown this year. Political turmoil in Washington and trade tensions between the US and China and between the UK and the EU have intensified the uncertainties. In a recent Wall Street Journal survey economists expect GDP growth of about 2.5% this year, and earnings growth is currently estimated to slow to about 6%.

Market Indicators		12/31/2018
	TOTAL RETURN	
US Stock Markets	4th Qtr	Year-to-Date
S&P 500 Index	-13.5%	-4.4%
S&P 400 Mid Cap	-17.3%	-11.1%
Russell 2000 Small Cap	-20.2%	-11.0%
Int'l Stock Markets		
ETF Returns in US$		
EAFE Index (Europe, Australasia, Far East)	-12.6%	-13.8%
Japan (MSCI Index)	-15.2%	-14.1%
China (Xinhua 25)	-7.7%	-13.3%
Emerging Mkts Index	-7.6%	-15.3%
US Fixed Income Yields	12/31/2017	12/31/2018
6 Mo US T-Bill	1.53%	2.56%
2 Yr US T-Note	1.89%	2.48%
10 Yr US T-Note	2.40%	2.69%

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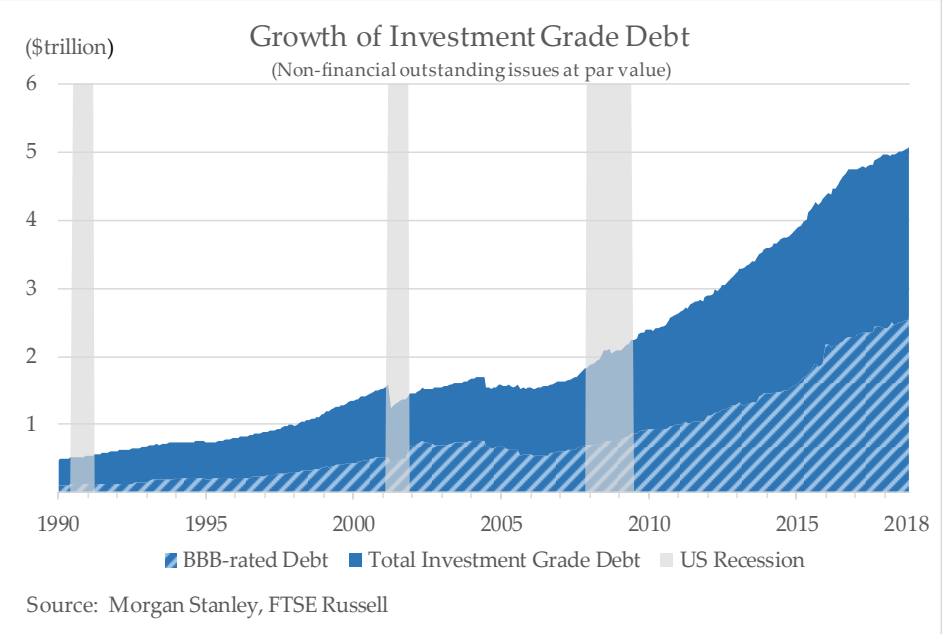
GROWTH OF CORPORATE DEBT



The economic recovery since the 2007 financial crisis is due in part to the Federal Reserve's policy of keeping borrowing costs low. Unusually low rates successfully encouraged corporations to issue debt which in turn added substantial stimulus to both the economy and the stock markets. Over the last decade, total corporate debt outstanding from non-financial companies increased nearly 40% and now account for about 45% of total US Gross Domestic Product, higher than during the Dot-com bubble and about equal to levels just prior to the bursting of the housing and credit bubble in 2007. Much of this growth came in the form of bonds rated BBB, which are at the riskier end of the investment grade spectrum. As illustrated in the chart nearby, BBB-rated bonds have grown almost 4-fold since 2008 and today account for about half of the total investment grade market, up from 35% ten years ago.

Our concern is that higher interest rates, rising costs and slower global growth could now become a strain on companies that issued these riskier bonds. While default rates have not yet increased, bank regulators and the Federal Reserve recently highlighted the emerging economic and market risks posed by the rapid growth of lower quality debt. In a recession, downgrades of BBB borrowers to BB or lower (i.e., speculative, non-investment grade quality) would lead to declines in bond prices and higher borrowing costs. These dynamics would affect not only investors holdings these loans but also the broader economy by choking off the stimulus that played a key role in the recovery from the financial crisis. Furthermore, most of the increased debt was used to fund acquisitions, dividends, and stock buybacks which helped to drive the stock market's 10-year rise. As the debt surge unwinds, this tailwind for stocks will likely subside.

Notably, today's debt burden largely falls on institutions, mutual funds and pensions who hold the bonds, not banks or financial companies who have generally been under strict regulatory scrutiny since the financial crisis and whose balance sheets are relatively strong. Problems with financial institutions are always more concerning for the economy as a whole.

Tax scam alert: As tax season approaches, clients should be on the alert for fraudulent emails impersonating the Internal Revenue Service. In a recent notice, the IRS warned of a surge of emails claiming to be from "IRS Online" that carry an attachment labeled "Tax Account Transcript" or something similar. The attachment is bait to entice the reader to open documents containing damaging or infectious software.

CONCLUSION

Market volatility has increased as economic and corporate earnings growth transitions to a slower pace, possibly even into a recession. Shifts to higher quality securities with more defensive characteristics may reduce volatility. Although hard to do in difficult markets, we believe the discipline of staying close to long term allocation targets will benefit investors in the long run. As always, we welcome your thoughts and comments.

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