Birch Hill
INVESTMENT ADVISORS

Market View

April 2019

FINANCIAL MARKETS

In the first quarter of 2019, US stocks continued a rebound that began in the last few days of December. As measured by the Standard & Poor's 500 Index, stocks returned +13.7% for the quarter and recovered all but 3.3% from the highs of late September 2018. Small company and international indexes also rebounded. Details are shown in the Market Indicators box to the right.

In late 2018, interest rates declined in concert with stocks, rebounded in January, and then moved lower while stock prices continued to recover. In late March, interest rates dropped further as statements from the US Federal Reserve led many investors to believe the prior policy of gradually increasing rates had been put on hold, at least through the end of 2019.

HEADING INTO A RECESSION?

Concerns about the rate of economic growth and a pending recession have been the principal drivers of stock price swings and vacillating interest rates. The US will certainly have another recession. The timing, however, is uncertain. Given the credit-induced nature of the Great Recession and the probability that very low interest rates have led to unsound financial and business activities during the on-going expansion, the next recession could be somewhat different than most recessions of the modern era. We believe current economic indicators are mixed. Below is a brief list of the major factors.

POSITIVE SIGNALS

Low Unemployment—The US unemployment rate of 3.8% continues to trend near 49 year lows. Currently, there are 7.6 million unfilled jobs in the US and 6.2 million people unemployed.

Attractive Wage Growth—In the last twelve months, not only are more people working but they are earning about 1.9% more, after adjusting for general inflation. This rate of "real" wage growth compares to levels close to zero in the prior two years. With almost 70% of the US economy driven by consumer spending, real wage growth is a strong positive.

Market Indicators		3/31/2019
TOTAL RETURN		
US Stock Markets	12 Mos	1st Qtr 2019
S&P 500 Index	9.5%	13.7%
S&P 400 Mid Cap	2.6%	14.5%
Russell 2000 Small Cap	2.0%	14.6%
Int'l Stock Markets		
ETF Returns in US$		
EAFE Index		
(Europe, Australasia, Far East)	-4.0%	10.3%
Japan (MSCI Index)	-8.4%	8.0%
China (Xinhua 25)	-4.0%	13.3%
Emerging Mkts Index	-9.2%	9.9%
US Fixed Income Yields	12/31/2018	3/31/2019
6 Mo US T-Bill	2.56%	2.44%
2 Yr US T-Note	2.48%	2.27%
10 Yr US T-Note	2.69%	2.41%

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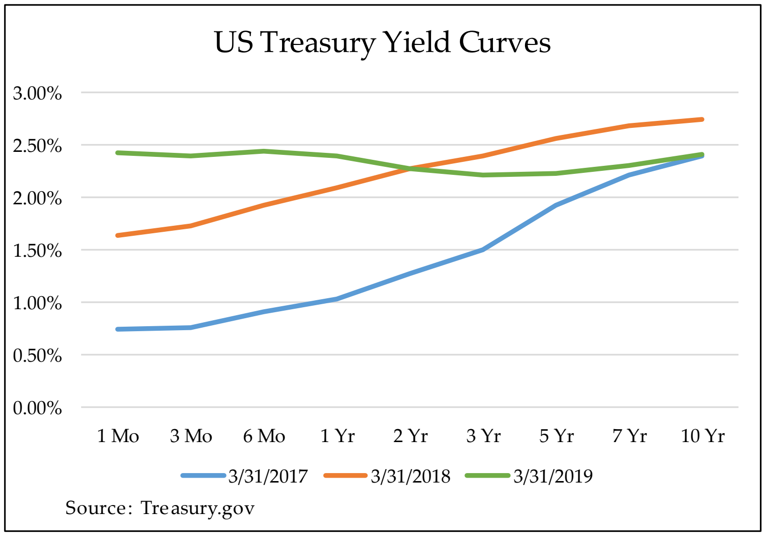
Low Interest Rates on Corporate Bonds—Low interest rates, in general, help support economic growth by lowering the cost of borrowing. When the interest rate differential between corporate bonds and US Treasury securities is small, as it is now, corporate bond investors are anticipating a continuation of favorable economic conditions.

CAUTION SIGNS

Slowing European Economies—The economic growth rate of many European countries has slowed to one percent or less. Recent purchasing managers' data suggests growth continues to slow. In Germany, the largest country in Europe, growth has declined to 0.6%. Italy's economy is already in recession. Slow growth in Europe is a drag on US growth.



Partially Inverted Yield Curve—As illustrated in the chart at the right, the US yield curve is now partially inverted, meaning that longer-term rates are lower than shorter-term rates. Inverted yield curves have tended to presage recessions, frequently by a year or more.

Slowing Industrial Production—The growth rate of various economic indicators has declined close to, and in some cases below, zero in the last few months. While monthly indicators are subject to volatility, industrial production bears watching.

CATALYSTS THAT COULD TIP THE SCALE

Second Quarter Economic Growth—After relatively strong 2.9% US growth in 2018, first quarter 2019 growth is now widely expected to slow to approximately 1.5%. The 35-day US Government shutdown likely reduced the quarter's growth rate by somewhat more than 0.5%. The ongoing trade dispute with China has had a smaller, harder to define, impact. The greatest impact may have come from an exacerbated seasonality, seen since the Great Recession, where businesses and individuals start the year cautiously then resume more normal levels of economic activity in the second quarter. Since 2009, the beginning of the current expansion, first quarter economic growth has averaged only 1.7% versus 2.4% in the other three quarters. A continuation of this pattern in the second quarter would be a positive event.

Outcome of US/China trade dispute—The ongoing trade talks have been a focus of businesses, consumers and investors. We now believe financial markets have discounted a resolution that results in little change. No resolution and higher tariffs would be a clear negative. A resolution that reduces or controls China's unfair trade practices, such as the requirement that western companies reveal certain technology in order to have the right to build facilities in China, would be a clear positive. During a recent speech in Boston, noted foreign policy expert Ian Bremmer said multiple factors convince him that the ongoing talks will result in substantial improvement in China's trade practices.

CONCLUSION

Financial markets have been volatile and subject to wide swings in the last six months, primarily due to mounting concerns of a pending recession. A prolonged period of very low interest rates has likely resulted in certain financial distortions. The next recession will probably trigger various credit-related surprises. A recession is probably many months away, but long-term investors should continue to prepare for a period of more volatility, and, at times, negative market reaction.

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