Birch Hill
INVESTMENT ADVISORS

Market View

July 2019

FINANCIAL MARKETS

US equities started the second quarter by continuing the powerful rebound that began in the last week of December. The market, as measured by the Standard & Poor's 500 Index, set new highs at the beginning of May. Economic growth concerns led to a market sell-off later in the month followed by a rapid rise and new all-time highs in response to the Federal Reserve's signals that further interest rate increases were on hold. For the first six-months of 2019, the S&P 500 returned +18.5%. Stocks of smaller and international companies returned somewhat less. Details are found in the near-by Market Indicators chart.

ECONOMIC GROWTH AND THE TRADE WAR WITH CHINA

In the first quarter of 2019, the US economy grew by 3.1%. Inventory building and a surge in exports, presumably to beat tariff increases, accounted for more than half of the quarter's growth. The Federal Reserve estimates second quarter growth slowed to 2%. Some economists recently lowered their estimates to the area of 1%. Unemployment levels, which remain very low, are being closely watched.

At the end of June, the presidents of the United States and China called for a temporary "cease fire" in the on-going trade war. A permanent resolution of the dispute would be very positive for business confidence and future economic stability.

POTENTIAL LONG-TERM INVESTMENT RETURNS

Modest economic growth, very low interest rates, and somewhat above-average equity valuations suggest investment returns in the next decade will be lower than in the past.

Long-term stock market returns are heavily influenced by the general growth in the economy. Increasing worker productivity (the value of goods produced per hour worked) is a key determinant of long-term economic growth. Productivity growth was historically driven by using more or better machinery or improvements in methods of making products. Today, productivity increases come from sources such as better software and advances in robotics.

Market Indicators		6/30/2019
TOTAL RETURN		
US Stock Markets	12 Mos	Year-to-Date
S&P 500 Index	10.4%	18.5%
S&P 400 Mid Cap	1.3%	18.0%
Russell 2000 Small Cap	-3.4%	17.0%
Int'l Stock Markets		
ETF Returns in US$		
EAFE Index		
(Europe, Australasia, Far East)	1.3%	14.2%
Japan (MSCI Index)	-4.2%	8.7%
China (Xinhua 25)	1.7%	10.5%
Emerging Mkts Index	1.3%	10.7%
US Fixed Income Yields	12/31/2018	6/30/2019
6 Mo US T-Bill	2.56%	2.09%
2 Yr US T-Note	2.48%	1.75%
10 Yr US T-Note	2.69%	2.00%

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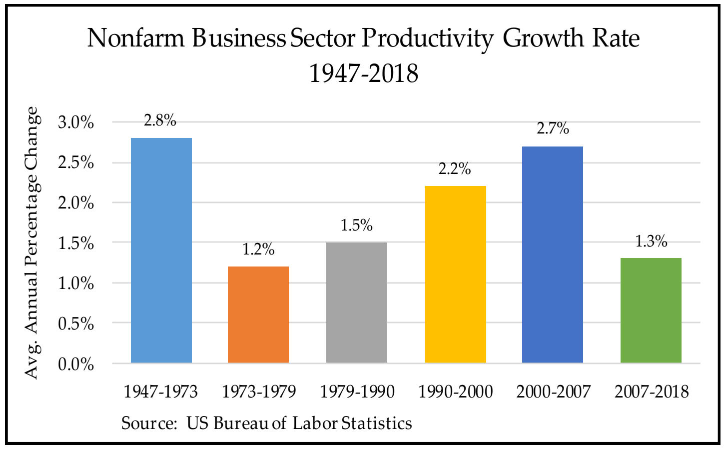
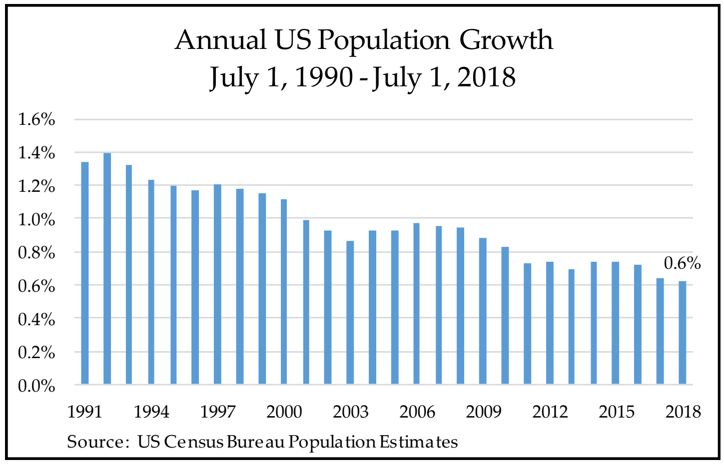
Post-World War II, productivity increased rapidly (2.8% per year on average) for a quarter of a century. After a much slower period, productivity expanded at an annual rate of greater than 2% in the 1990s and then surged close to 3% in the early 2000s. Since the Great Recession, productivity has only nudged along at about 1.3%. The timing of productivity advances has confounded economists. However, it appears we are currently mired in a period of slow productivity growth.



Population growth affects economic growth due to the resulting increase in demand for goods and services as well as the resulting availability of additional workers. Largely due to lower birth rates, the growth rate of the US population has been in a long-term decline. In the 1990s, our population regularly expanded by 1.2% a year. In 2018, US population growth was 0.6%. A change in this trend is hard to envision.



In the fixed income markets, prevailing interest rates and future interest rate changes are the primary determinants of returns. Over the last ninety years, the compounded return from intermediate government bonds has been just over 5%. Currently, such bonds yield less than 1.8%, foretelling low fixed income returns for some time to come.

This sober view of future investment returns could be off the mark for several reasons. One prominent market strategist has put forth an analysis suggesting the stock market is significantly under-valued due to the lower capital intensity of modern businesses compared to businesses of twenty years ago. The theory has at least some merit. Future productivity growth may also turn out to be higher than currently expected. In the late 1980s, economists had low expectations for future productivity growth but productivity surged in the 1990s. The most recent quarterly change in this volatile indicator was a strong 3.4% reading.

Although possibly conservative, given the above factors, investors should expect lower future market returns than in prior periods when stock valuations started at more modest levels or when economic growth factors were more favorable. Historically, investors in a quality portfolio of 70% equities and 30% bonds could expect to withdraw approximately 4% of the market value per year and still keep up with inflation. That sustainable withdrawal rate is now closer to 3%. Investors who rely on regular distributions from their portfolios should incorporate lower withdrawal rates in their planning.

CONCLUSION

Equity markets have moved substantially higher in 2019, completing a recovery from the dramatic decline in late 2018. US economic growth expectations are slowing. In response, the Federal Reserve has halted previous plans to raise interest rates further. We are likely entering a period of subdued multi-year investment returns and investors should plan accordingly.

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