Birch Hill
INVESTMENT ADVISORS

Market View

October 2019

An uncertain global growth outlook and a briefly inverted yield curve held the US stock market close to flat during the third quarter. Interest rates dropped sharply during the quarter before staging a partial rebound. As fears of a recession increase, the resilient American consumer is keeping the economy moving forward.

FINANCIAL MARKETS

The Dow Jones Industrial Average and the Standard and Poor's 500 Index posted modest advances during the third quarter. While there are many economic uncertainties, stocks have performed well so far in 2019. The Standard & Poor's 500 Index returned +20.6% during the nine-month period.

The MSCI EAFE Index of developed international markets returned +13.3% and the MSCI Emerging Markets Index returned +5.4% during the first nine months of 2019. Monetary policy in the Eurozone continues to be accommodative as the European Central Bank lowered the deposit rate to a record low -0.5% in September. The Central Bank also announced the restart of their bond buying program as additional monetary stimulus. Uncertainty surrounding Brexit has contributed to a slowdown in Europe. Short term uncertainties persist in emerging markets as the US and China continue their trade dispute.

US small capitalization stocks underperformed their large cap peers during the first nine months of the year. Small company stocks have underperformed as investors sell riskier stocks in favor of larger more defensive investments.

INTEREST RATES

Interest rates were volatile during the third quarter as concerns about slowing global growth continued. The Federal Reserve cut the discount rate by a quarter of a percentage point for the second time in 2019. The Fed indicated that the current move was an insurance cut intended to stabilize growth and they do not see a recession in the near term.

The yield curve inverted in mid-August when the 10-year US Treasury Note yield fell below the 2-year US Treasury Note. Historically, an inverted yield curve has foreshadowed a recession. The 10-year US T-Note began the year with a yield of

Market Indicators		9/30/2019
TOTAL RETURN		
US Stock Markets	12 Mos	Year-to-Date
S&P 500 Index	4.3%	20.6%
S&P 400 Mid Cap	-2.5%	17.9%
Russell 2000 Small Cap	-8.9%	14.2%
Int'l Stock Markets		
ETF Returns in US$		
EAFE Index (Europe, Australasia, Far East)	-1.0%	13.3%
Japan (MSCI Index)	-4.2%	13.0%
China (Xinhua 25)	-5.1%	2.9%
Emerging Mkts Index	-2.6%	5.4%
US Fixed Income Yields	12/31/2018	9/30/2019
6 Mo US T-Bill	2.56%	1.83%
2 Yr US T-Note	2.48%	1.63%
10 Yr US T-Note	2.69%	1.68%

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2.7% and reached a low of 1.47% during the quarter before rebounding to 1.68%. The 30-year US T-Bond traded below 2.0% for the first time in history. This coincided with the 30-year yield falling below the dividend yield on the S&P 500 Index for the first time since 2009. Many European government bonds trade at negative yields. At the end of August, a staggering $17 trillion of global bonds traded at negative yields. The ripple effect of negative yields in overseas bonds means that investors are buying US Treasuries and keeping the yields low.

THE ECONOMY: CONSUMERS VS. BUSINESS

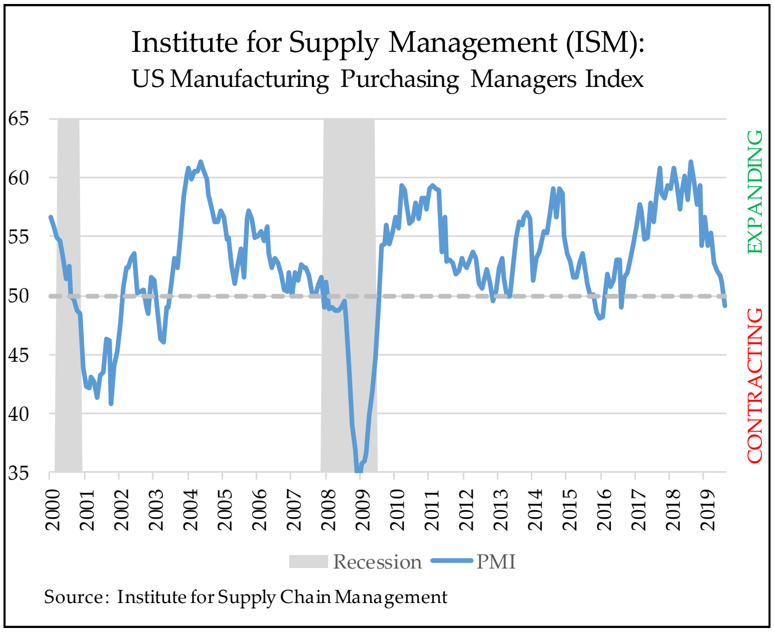
The US economic expansion is now in its 11th year. US Gross Domestic Product (GDP) grew by +2.0% in the second quarter of 2019. The growth was lower than the +3.1% gain in the first quarter. Consumer spending rose while business investment detracted from growth in the second quarter.

US CONSUMER REMAINS STRONG

The US consumer has been driving economic growth despite a manufacturing slowdown. In the second quarter, personal consumption expenditures rose at an annual rate of +4.7%, the fastest rate in almost five years. The US consumer makes up more than two-thirds of US economic activity. Consumers have reasons to feel optimistic, with unemployment low and wages rising. Keeping track of the health of the consumer is important for determining the overall economic picture, but history has shown that it is often a lagging indicator. When consumer weakness shows up in the data, we may already be in a recession.

MANUFACTURING WEAKENING

The picture on the manufacturing side is not as bright. US manufacturing, which accounts for about 11% of the US economy, continues to be held back by the trade war, tariffs with China, and a slowing global economy. In August, the Institute for Supply Management's Purchasing Managers Index fell to 49.1%, the lowest reading in three years. Readings below 50 do not necessarily signal recessionary activity but do imply a contraction in manufacturing activity. As a result of the slowdown in manufacturing, US consumer spending is even more important to keep the economy moving. The current expectations for GDP growth are +2.2% in 2019 and +2% for 2020.



Source: Institute for Supply Chain Management

CONCLUSION

The stock market has held up in the face of numerous headwinds. The US economy is slowing. Conventional wisdom sees a recession occurring in the next year or two. More modest future investment returns are likely, while the underlying fundamental backdrop for stocks remains positive. Low inflation and interest rates have continued to support corporate profits. The long term attractiveness of equities compared to other assets, such as treasury bonds, remains compelling. Markets are hard to predict and the duration of a market rise does not necessarily necessitate a decline. Investors should focus on a long term asset allocation that will help them meet their goals.

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