Birch Hill
INVESTMENT ADVISORS

Market View

January 2020

Last year was a great year for the stock market, and a good year for bonds. The US economy continued to grow, though its growth was on the slow side. While 2019's rate of stock market gain is too good to continue, we have a positive outlook as we enter 2020. We believe that many investors are too pessimistic about the stock market.

US MARKET REMAINED STRONG

In the US, large-cap stocks led mid-cap stocks and small-cap stocks for the year 2019. International stocks continued to lag US stocks.

As growth managers, we noted that value stocks, which have underperformed for a decade, began to show signs of strength versus growth stocks. This trend might continue. However, we continue to prefer growth stocks over value stocks. In our experience, investing in higher-quality growth companies pays off over the long run. Our preference for long-term growth over value also rests on our preference for higher-quality companies. Stocks often fall into the value category because of weaknesses in their earnings prospects or long-term deterioration in their industry.

Bonds had a good year, with the intermediate term bond index returning 6.8% for 2019, and 0.4% for the fourth quarter. While bond yields fell rapidly during 2019's first eight months, they partially rebounded by the end of the year. The 10-year Treasury note, which started 2019 yielding 2.69% and bottomed at 1.47%, ended the year at 1.92%. Interest rates remain near historical lows.

Changes to IRA Rules

The SECURE Act, a new law passed in late December, changes a number of rules governing IRA and 401(k) accounts. The three changes most likely to affect Birch Hill clients: (1) Beginning in 2020, Required Minimum Distributions start the year an IRA owner reaches age 72, up from the previous 70½. (2) Any working individual or their spouse may make IRA contributions regardless of their age. Previously, the age cap was 70½. (3) Inherited IRAs must be drawn down within ten years, not over the beneficiary's lifetime as in the past. This change has a significant impact on anyone using an IRA or Roth as a meaningful estate planning vehicle. Please contact your Birch Hill advisor to learn how the SECURE Act specifically affects you.

Market Indicators		12/31/2019
TOTAL RETURN		
US Stock Markets	4th Qtr	Year-to-Date
S&P 500 Index	9.1%	31.5%
S&P 400 Mid Cap	7.1%	26.2%
Russell 2000 Small Cap	9.9%	25.5%
Int'l Stock Markets		
ETF Returns in US$		
EAFE Index (Europe, Australasia, Far East)	7.7%	22.0%
Japan (MSCI Index)	5.7%	19.3%
China (Xinhua 25)	11.7%	14.9%
Emerging Mkts Index	12.1%	18.2%
US Fixed Income Yields	12/31/2018	12/31/2019
6 Mo US T-Bill	2.56%	1.60%
2 Yr US T-Note	2.48%	1.58%
10 Yr US T-Note	2.69%	1.92%

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ARE INVESTORS TOO PESSIMISTIC?

The stock market declines of 2018's fourth quarter spooked many investors. Let's put that decline in perspective. If an investor bought the S&P 500 Index at the 2018 peak, by the end of 2019, their investment would have produced a return of 13.1%. That's far different than the disastrous scenario that the late-2018 decline conjured in investors' minds.

Rattled by their 2018 experience (and by trade disputes and political turmoil), many investors remain pessimistic about the future for stocks. Let's look at what the economy and stock market valuations suggest for stocks' future.

Great Years in the stock market tend to be followed by Good Years due to the persistance of favorable conditions

Great Year		Following Year
1950	33%	24%
1954	52%	31%
1955	31%	7%
1958	43%	12%
1961	27%	-9%
1975	37%	24%
1980	33%	-5%
1985	32%	19%
1989	32%	-3%
1991	30%	8%
1995	38%	23%
1997	33%	29%
1998	29%	21%
2003	29%	11%
2009	26%	15%
2013	32%	14%
Average	34%	14%
Median	32%	14%

"Great Years" are years since 1945 when the S&P 500 Index returned more than 25%.
Source: Bloomberg. Format: Birch Hill.

SIGNS OF ECONOMIC WEAKNESS MAY BE OUTWEIGHED BY POSITIVE INDICATORS

The economy produced mixed signals in late 2019. Negative signals in the manufacturing sector turned slightly more positive by the end of the year. Housing sales, which had slowed in 2019, picked up in recent months. In the interest rate arena, the yield on the 10-year Treasury, which dipped below that of the two-year Treasury earlier in 2019, moved higher. The late-2019 interest rates moves returned the bond market to a more normal, positive sloping yield curve. A positive yield curve signals continuing economic growth ahead.

The US consumer, who accounts for about 68% of GDP, has continued to spend. Unemployment remains low. Some companies have reported better-than-expected earnings. These positives are reflected in the continued growth of the US economy, with real GDP forecast to grow 2.2% for 2019. The US-China trade dispute has, at least for now, been contained. Recent elections make it clear the UK will leave the European Union, removing a significant element of uncertainty. So far, political disputes in Washington have not derailed the US consumer.

On balance, we don't foresee recession arriving in the near future, despite the current economic expansion entering its eleventh year. This is a positive for the US stock market.

STOCK VALUATIONS ARE ONLY SLIGHTLY ELEVATED

The combination of reasonable stock valuations and low interest rates also offers a reason for optimism. The valuations of US stocks are only slightly above their long-term averages. For example, the 2020 price-earnings ratio for the S&P 500 index is approximately 18 versus a 25-year average of 16.2. There's a similar relationship for mid-cap and small-cap stocks.

Low interest rates, which decrease the appeal of investing in bonds, make stock valuations appear even more attractive. The dividend yield on the S&P 500 Index currently equals the yield on the 10-year Treasury note. Less competition from bonds means more potential for stock prices to rise.

MAINTAIN EQUITY POSITIONS

We believe investors should maintain equity positions equal to long-term allocation targets. We continue to favor owning high quality stocks, with an allocation to bonds that depends on the investor's circumstances.

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