Birch Hill
INVESTMENT ADVISORS

Market View

October 2020

The US stock market continued to rebound in July and August before declining slightly in September. For the third quarter, the Standard and Poor's 500 Index returned +8.9% bringing 2020's year-to-date return to +5.6%. The S&P has outperformed almost all other broad indexes, including the Dow Jones Industrial Average, which returned –0.9% for the year-to-date period. Most other important equity indexes have also produced single digit percentage declines this year (see Market Indicators box).

Interest rates were essentially unchanged during the quarter as global central banks continued to provide economic stimulus through abnormally low rates. Since year-end, the 10-year US Treasury yield has declined from 1.92% to 0.69%.

US GDP DOWN, BUT EXPECTED TO REBOUND

The quarterly growth rate of US gross domestic product (GDP) has varied greatly in 2020. The pandemic's economic impact has made early estimates less reliable. It currently appears GDP declined by -5.0% in the first quarter and by -31.4% in the second quarter. Many economists now believe third-quarter GDP will rebound by +20% to +25% with additional modest growth in the fourth quarter. The combined result could be a 2020 decline of only about -5%. The resilience of the US economy is striking, considering 2020's extreme economic disruption.

DRIVERS OF A BIG REBOUND IN STOCK PRICES

Many causes for concern remain. Unemployment is high. The wide distribution of a successful vaccine is still many months away, and medical professionals fear a winter resurgence of the virus. Partisan politics and social unrest are more intense than we've seen in many decades. Why have stock prices rebounded dramatically—up more than 40%—since their March 23 low despite such challenges? We see three main reasons.

1. Anticipation of a vaccine. Stock market investors always look to the future. They're like ice hockey great Wayne Gretzky, who said, "I skate to where the puck is going to be, not where it has been." While most investors

Market Indicators		9/30/2020
TOTAL RETURN		
US Stock Markets	12 Mos	Year-to-date
S&P 500 Index	15.1%	5.6%
S&P 400 Mid Cap	-2.2%	-8.6%
Russell 2000 Small Cap	0.4%	-8.7%
Int'l Stock Markets		
ETF Returns in US$		
EAFE Index (Europe, Australasia, Far East)	0.1%	-7.0%
Japan (MSCI Index)	6.2%	0.5%
China (Xinhua 25)	8.4%	-2.9%
Emerging Mkts Index	10.8%	-1.2%
US Fixed Income Yields	12/31/2019	9/30/2020
6 Mo US T-Bill	1.60%	0.11%
2 Yr US T-Note	1.58%	0.13%
10 Yr US T-Note	1.92%	0.69%

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usually look out six months or so, many have been willing to look past the pandemic to 2021's second half, when they assume we will have an effective, widely distributed vaccine; lower unemployment; and broadly improving economic activity. Currently, some late-2021 relief from the virus seems likely.

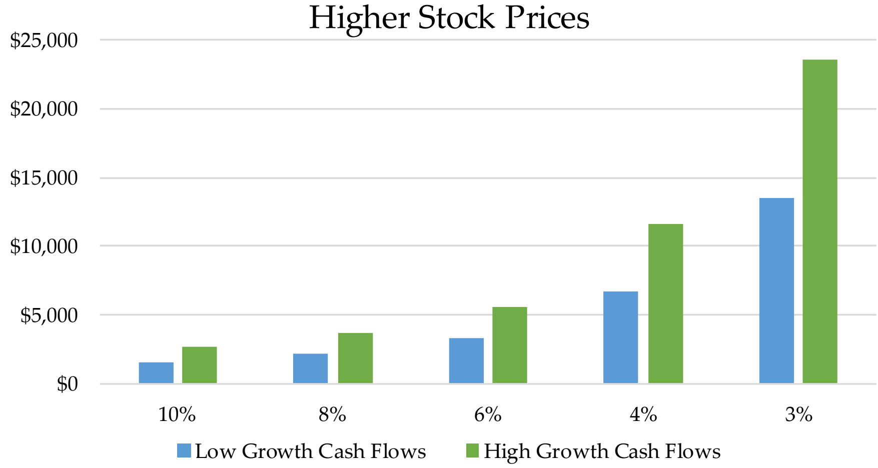
2. Disruption's benefit for some. The stock market rebound has favored a handful of large companies that have benefited from pandemic-related changes in consumer and business behavior. While some benefits could be temporary, others could last after the pandemic ends. For example, consumers who had occasionally shopped online before the pandemic could continue heavy online shopping due to convenience and low prices. Business sales teams that had traveled extensively may convert some meetings to video conferencing after experiencing the ease, effectiveness, and lower costs of virtual meetings.

3. Extremely low interest rates.

The steep decline in interest rates, engineered by the Federal Reserve and other major central banks, has been the biggest driver of the rebound in stock prices. Despite commentators' chatter about short-term drivers, ultimately the value of any company is the discounted present value of all future cash flows that will come from that company.

Analytical investors estimate a company's future cash flows and then apply a discount because earnings received in the future are naturally worth less than current earnings of the same dollar amount. The discount applied to future cash flows is typically based on prevailing and anticipated future interest rates. Therefore, when rates are low, the discount is low. This results in a higher value for the business or its stock.

Lower Interest Rates Result in Higher Valuations of Future Cash Flow Streams and, therefore, Higher Stock Prices



Cash flow streams start at $100. High growth cash flows grow at 25% in year one and decline to 4% over ten years. Low growth cash flows grow 5% annually for ten years. Terminal growth is 2%.

The graph above shows the dramatic changes in valuations as interest rates decline. The changes are more pronounced for the higher-growth companies (shown by the green bars). Interest rates are not the only factors that affect the value of companies and stocks. Still, interest rate changes have a major effect on stock prices; lower rates this year have significantly boosted stocks.

A LONG-TERM PERSPECTIVE WILL HELP INVESTORS COPE WITH A BUMPY RIDE

Unprecedented action by the Federal Reserve has supported stock prices, but major challenges persist—the recession caused by COVID-19, political polarization, social unrest, and the wait for a vaccine. These could contribute to a bumpy ride in the stock market. Despite uncertainty, the US economy remains resilient. Those who continue to focus on the long term will fare best over the months and years to come.

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