Birch Hill
INVESTMENT ADVISORS

Market View

April 2021

The stock market's upward trajectory moderated as the Standard & Poor's 500 Index returned +6.2% during 2021's first quarter. Many of the large technology company stocks that led the market's 2020 rebound sat out the first quarter of 2021. Stocks from the previously underperforming sectors of energy and financials shined. As the Market Indicators chart to the right shows, mid-capitalization and small company stocks had a particularly good quarter. The 12-month performance for all equity indexes is impressive. However, those gains include recovering from the market plunge that preceded the period's start.

STOCK VALUATIONS HIGH AT QUARTER-END

Many stocks traded at robust valuations at the end of March. The S&P 500's price/earnings ratio (P/E), many investors' standard measure of valuation, ended the quarter at more than 21.5 times Birch Hill's estimation of pandemic-adjusted 2021 earnings, or about 30% higher than its 25-year average of 16.5. Most other stock valuation measures—such as price to book value, price to cash flow and price to earnings growth rate—are similarly elevated. However, it's not clear how long this boost can last, particularly for lower-quality companies.

LOWER-QUALITY COMPANIES AND LOW INTEREST RATES

While low interest rates have increased the value of good and great businesses, they have also rewarded less-sound investments. Economic-stimulus cash has increasingly moved into speculative areas, such as some initial public offerings, special purpose acquisition companies, many technology companies that have no current or foreseeable earnings and cryptocurrencies. Historically, easy money and low interest rates have fed pockets of speculation that eventually reversed. We suspect the pandemic version of that pattern is well underway.

Federal Reserve Bank Chair Jerome Powell recently restated his 2020 pledge to keep short-term interest rates near zero through 2023. Powell has also said the Fed will allow inflation to move above its stated goal of 2% before raising interest rates. As a result, the yield on securities maturing in the next two years has remained extremely low while inflation expectations are increasing and yields on longer maturities have begun to move higher.

Market Indicators		3/31/2021
TOTAL RETURN		
US Stock Markets	12 Mos	1st Qtr 2021
S&P 500 Index	56.3%	6.2%
S&P 400 Mid Cap	83.4%	13.5%
Russell 2000 Small Cap	94.8%	12.7%
Int'l Stock Markets		
ETF Returns in US$		
EAFE Index (Europe, Australasia, Far East)	45.3%	4.0%
Japan (MSCI Index)	40.4%	1.4%
China (Xinhua 25)	27.2%	0.5%
Emerging Mkts Index	58.8%	3.2%
US Fixed Income Yields	12/31/2020	3/31/2021
6 Mo US T-Bill	0.09%	0.05%
2 Yr US T-Note	0.13%	0.16%
10 Yr US T-Note	0.93%	1.74%

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ROBUST ECONOMIC GROWTH FOR 2021

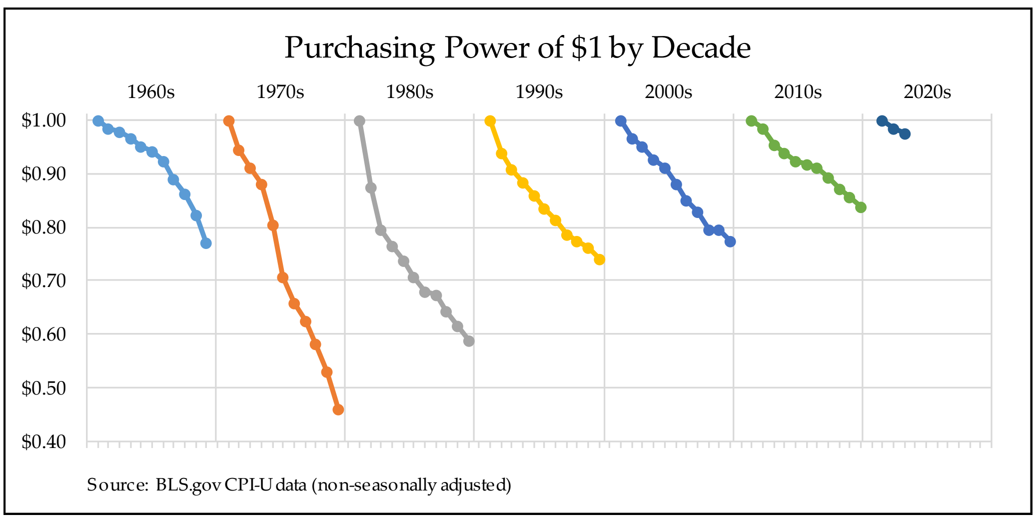
The US economy grew at a rate of 4.3% during 2020's last quarter, the most recent quarterly results available. That contrasts with the economy's shrinking by 3.5% for 2020 overall, due to pandemic-related shutdowns earlier in the year.

Growth expectations for 2021 have steadily moved higher to the current range of 6% to 8%. The first quarter could see annualized growth near 10%. The $1.9 trillion American Rescue Plan, enacted in early March, partly fuels this growth. If passed, a $3 trillion infrastructure plan will add more stimulus. A lack of spending opportunities during the pandemic has resulted in excess consumer savings, now approaching $2 trillion. We believe consumers will spend a large portion of these savings when given the opportunity.

IS LONG-TERM INFLATION COMING?

The Federal Reserve and many economists now expect above-average inflation as the economy reopens and consumers spend more. Recent supply chain disruptions, higher commodity prices and higher wages will move prices up on many goods and services. Sustained price increases are possible, but not certain.

Successful economies generally experience low single-digit levels of inflation. Low inflation provides flexibility for individuals and businesses that is not available when prices stagnate. However, high sustained inflation rapidly erodes the value of consumer savings and can significantly disrupt business activity. As the chart below shows, high inflation significantly depressed the dollar's purchasing power during the 1970s and 1980s.



Economists believe "inflation expectations" are important in understanding past periods of sustained inflation. In theory, when consumers and business leaders widely believe future inflation to be a problem, their behavior changes and the expectation becomes self-fulfilling. This partly explains our sustained inflation of the 1970s and early 1980s, as well as periods of very high inflation overseas.

Breaking a sustained cycle of inflation expectations is very difficult and requires harsh measures that every central banker would prefer to avoid. The Federal Reserve's recent statements that they will allow inflation to exceed the long-term 2% target has caused concern.

The pockets of inflation expected during 2021 could disrupt financial markets. Any signs of sustained inflation or a shift in inflation expectations might counteract the positive effects of the recovering economy on financial markets. The current combination of relatively high equity valuations, strong expected economic growth, low but rising longer-term bond yields and inflation uncertainty are a recipe for financial market volatility in the year ahead.

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