Birch Hill
INVESTMENT ADVISORS

Market View

July 2021

MARKETS RISE, LED BY US STOCKS

US equity markets continued higher in the second quarter with several key indexes setting new highs in late June. The Standard & Poor's 500 Index returned +8.6% during the quarter to bring the year-to-date return to +15.2%. Most other indexes produced more modest returns during the three-month period as investors seemed to rotate between sectors in search of undervalued companies. For example, small-capitalization stocks only returned +4.3% and a popular China index returned –0.4% during the quarter.

INFLATION UP, INTEREST RATES MIXED

The personal consumption expenditure (PCE) index of inflation moved noticeably higher in recent months with May showing a 3.9% year-to-year rate of increase. Recent increases have been higher than the Federal Reserve's 2% inflation target, so the Fed has begun to moderate its pledge to keep short-term interest rates near zero through 2023. Pandemic-related shortages, logistical constraints and wage pressures have contributed to the recent spurt of inflation. There are no clear indications yet that higher inflation is here to stay, but the Fed and investors are focusing on that possibility.

During the quarter, interest rates behaved differently across the yield curve. The yield on two-year Treasury notes increased, five-year maturities barely changed and 10-year yields continued to decline from their March 31 level. US interest rates are generally higher than rates in other countries, so some have attributed the increased demand for longer-term US bonds to foreign buyers.

ECONOMIC GROWTH REBOUNDS WITH VACCINATIONS

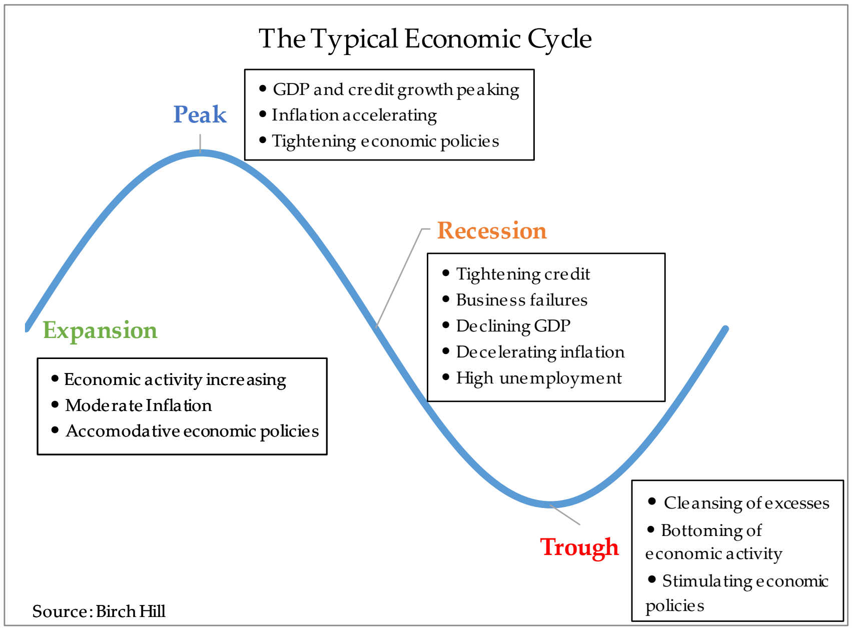
A successful US rollout of vaccinations has led to a resurgence of economic activity. The economy grew at an estimated rate of 6.4% in the first quarter and by greater than 8% in the second. Pent-up demand for goods and services could lead to above-average growth of more than 5% in each of

Market Indicators		6/30/2021
TOTAL RETURN		
US Stock Markets	12 Mos	Year-to-date
S&P 500 Index	40.8%	15.2%
S&P 400 Mid Cap	53.2%	17.6%
Russell 2000 Small Cap	62.0%	17.5%
Int'l Stock Markets		
ETF Returns in US$		
EAFE Index (Europe, Australia, Asia, Far East)	32.6%	9.6%
Japan (MSCI Index)	24.4%	0.7%
China (FTSE 50)	18.8%	0.1%
Emerging Mkts Index	40.0%	7.2%
US Fixed Income Yields	12/31/2020	6/30/2021
6 Mo US T-Bill	0.09%	0.06%
2 Yr US T-Note	0.13%	0.25%
10 Yr US T-Note	0.93%	1.45%

Birch Hill Investment Advisors LLC
One International Place, Suite 770
Boston, MA 02110
Phone: 617-502-8300
BHBoston.com

2021's last two quarters. Massive financial stimulus during the pandemic helped many businesses and individuals survive a difficult period, however, it is winding down. The federal supplemental unemployment benefit of $300 per week will continue through the week of September 6 and could be the last relic of pandemic stimulus.

PANDEMIC FAILS TO REDUCE EXCESSES



The US economy has displayed certain patterns as it has fallen into recession 13 times since the end of World War II. Throughout most of US history, the typical recession occurred after a period of strong growth that encouraged additional borrowing and spending, leading to higher inflation and interest rates. Higher rates eventually caused weaker borrowers to start defaulting, resulting in banks tightening their credit standards. Tighter credit tends to produce even more loan defaults, more bankruptcies and a decline in overall economic activity (see graph). This boom/bust cycle was particularly extreme before the 1950s when the Federal Reserve increasingly intervened to dampen the severity of the cycle.

Nobody likes a recession, but recessions can sometimes play a useful role in improving the long-term outlook for the economy. Recessions are difficult for the unemployed, and frequently for investors. However, the typical recession has the significant benefit of exposing unsound business practices, forcing the closure of weak companies and punishing speculators. This culling is very important because it lays the foundation for a subsequent period of strong, sound growth as successful businesses gain market share and attract the best employees.

The 2020-2021 Pandemic Recession avoided the full culling typical of recessions, which has drawbacks. Although many small businesses closed, at least temporarily, and corporate bankruptcies increased, a flood of government stimulus buoyed the economy, benefiting both solid and unsound businesses. The $5.6 trillion of federal spending and $2 trillion of Federal Reserve monetary stimulus helped to counteract the pandemic's economic shockwaves. However, the excess cash and rock-bottom interest rates caused notable economic distortions, including a surge in housing prices, record-high levels of margin debt and pockets of growing speculation in the financial markets.

BEWARE FINANCIAL FROTH

History suggests that periods of easy credit and low interest rates breed financial problems that must eventually be resolved. This resolution can be greatly delayed by government policies. Investors should resist the temptations of the financial markets' frothy areas and focus on sound, vital businesses that will eventually benefit from a period of economic cleansing.

Gary R. Mikula, CFA   Robert A. O'Neil, Jr., CFA   Catherine M. Kennedy, CFP®   Timothy M. Malloy, CFP®

Brett A. Mirliani, CFA, CFP®, CPWA®   Adam J. Desjardins, CFA   G. Bowen Cook, Jr., CFA   Christopher P. Mikus, CFA