Birch Hill
INVESTMENT ADVISORS

Market View

January 2022

ABOVE AVERAGE RETURNS FOR US STOCKS

The Standard & Poor's 500 Index had another strong year, returning +28.7%. The higher quality Dow Jones Industrial Average returned +21.0%. Mid- and small-capitalization equities were not far behind (see market indicators table to the right). International equities underperformed US equities. The MSCI EAFE Index of developed country stocks returned +11.5%. Dragged down by weakness in Chinese equities, the MSCI Emerging Markets Index returned –3.6%.

2021 was the third consecutive year of double-digit returns for the S&P 500 Index. Performance over the period was driven by a small number of stocks. Apple, Microsoft, Amazon.com, Meta Platforms (previously called Facebook) and Alphabet contributed approximately one-third of the S&P 500's three-year return. These five companies combined now represent nearly $10 trillion in market value and make up 23% of the S&P 500 index.

STRONG ECONOMIC GROWTH IN 2021–2022

US economic growth slowed in the third quarter due to supply chain issues and a surge in the virus' Delta variant. These headwinds have not fully abated, and the Omicron variant adds additional uncertainty, but fourth-quarter growth is expected to be solid amid strong consumer demand. Most economists believe US gross domestic product grew +5.5% in 2021. The economy in 2022 is also expected to be strong, with growth near +4%. This contrasts with the previous decade's real GDP growth of around +2% annually.

SUPPLY AND DEMAND IMBALANCES

Considering that the economy was recently in a recession, US household balance sheets and income levels are unusually strong. Household net worth is at record highs. The ratio of debt to income is the lowest in 25 years. A strong job market is spurring wages to grow at their fastest pace in decades. Strong consumer demand, combined with supply chain and labor shortage-related production cuts, have resulted in higher inflation. Over time, most of the inflationary factors should moderate, but the labor-related pressures could last some years. Many of the imbalances are due to record amounts of fiscal and

Market Indicators		12/31/2021
TOTAL RETURN		
US Stock Markets	4th Qtr	2021
S&P 500 Index	11.0%	28.7%
S&P 400 Mid Cap	8.0%	24.7%
Russell 2000 Small Cap	2.1%	14.8%
Int'l Stock Markets		
ETF Returns in US$		
EAFE Index (Europe, Australia, Asia, Far East)	2.8%	11.5%
Japan (MSCI Index)	-3.4%	1.2%
China (FTSE 50)	-5.0%	-20.1%
Emerging Mkts Index	-1.6%	-3.6%
US Fixed Income Yields	12/31/2020	12/31/2021
6 Mo US T-Bill	0.09%	0.19%
2 Yr US T-Note	0.13%	0.73%
10 Yr US T-Note	0.93%	1.52%

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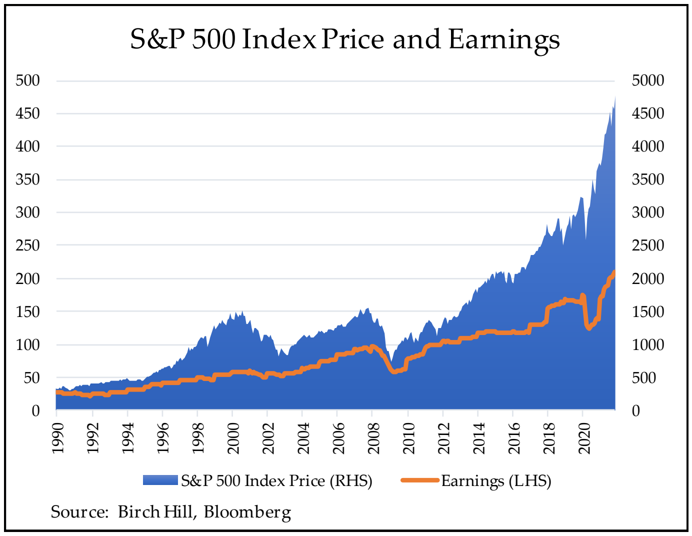
monetary stimulus during the first year of the pandemic. Fiscal and monetary policies will provide less stimulus going forward. The Federal Reserve recently indicated they will end their bond-buying program and increase interest rates at a faster pace than originally anticipated.

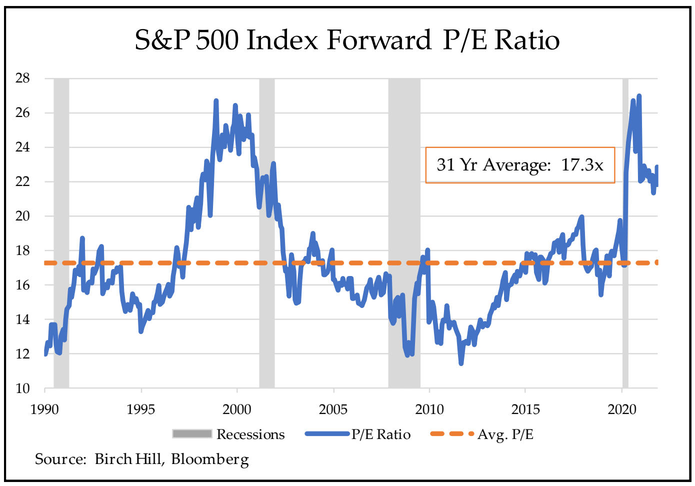
STOCK PRICES HAVE OUTPACED EARNINGS

Over the long term, stock prices tend to rise and fall with earnings. Earnings are the net profits generated by corporations on a per-share basis. Since 1990, stock prices grew +9% annually, and earnings grew +7% annually (see chart to the right). Looking at the past three years, however, stock prices far outpaced earnings growth. Prices increased +24% annually while earnings grew at a +9% annual rate. Such disconnects can happen in the short term and can be a reason for caution. This is especially true if high stock prices reflect exuberant earnings prospects that fail to materialize. Currently, analysts see earnings growing near +9% annually over the next two years, due to a strong US economy. This earnings growth expectation is above the long-term average but does not seem overly optimistic. Whether it justifies current stock prices remains to be seen.



WILL HIGHER P/Es CONTINUE?

The expected +9% earnings growth is a key part of a widely used valuation measure known as the P/E ratio. The P/E ratio is the relationship between a company's stock price and expected earnings. However, it is also influenced by interest rates and investor enthusiasm. Currently, the S&P 500 Index trades at an above-average forward P/E ratio near 21x. The last time the S&P traded in this range was in the 1998–2000 dot-com era. Elevated valuations can persist for long periods if market conditions are just right. But high valuations create vulnerabilities, and changes usually occur when there is a perceived shift in favorable conditions. In the past three years, stocks benefited from a corporate tax cut, record-low interest rates and record fiscal and monetary stimulus. Going forward, all these factors are likely to reverse. While there are still no signs that high inflation is here to stay, sustained high inflation is an additional risk to corporate profit margins.



CONCLUSION: FAVORABLE ECONOMY BUT STOCK VALUATIONS ARE HIGH

US stock markets have posted higher than average returns in recent years. The current economic backdrop looks relatively good, with US households in strong shape. Fiscal and monetary stimulus is likely to be lower in the years ahead. High stock valuations are a key risk. We continue to believe investors should hold a diversified portfolio of high-quality companies that can participate in growth, but also can weather bumps in the road ahead.

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