Birch Hill
INVESTMENT ADVISORS

Market View

July 2022

STOCKS TURN LOWER IN SECOND QUARTER

Stocks fell at a faster clip in the second quarter as inflation continued its upward march and the Federal Reserve reacted by further increasing interest rates. The Standard & Poor's 500 Index returned a negative 16.1% in the quarter. The technology-heavy NASDAQ Composite returned a negative 22.3%. The higher quality Dow Jones Industrial Average held up better, returning a negative 10.8%. Many international markets outperformed US markets due to their heavy weighting in financials and low weighting in technology.

Although bonds outperformed equities in the second quarter, bonds also had a negative return last quarter with shorter maturity bonds outperforming longer maturity bonds. The iShares 1-3 Year Treasury Bond ETF returned a negative 0.5% in the quarter and the 7-10 Year Treasury ETF returned a negative 4.5%. To sum things up, you know it's a bad period for the market when uninvested cash is the best performing asset!

THE FEDERAL RESERVE: STUCK BETWEEN A ROCK AND A HARD PLACE

The Fed finds itself in a tough spot because of a potential conflict between its two mandates: to maximize employment and stabilize prices (i.e., inflation). If they don't raise interest rates quickly, high inflation could become entrenched. But hiking interest rates usually slows economic and employment growth. Moreover, the economies of the US and the rest of the world are fragile because they still have not fully recovered from the effects of the pandemic.

Most economic commentators are focused on two possible economic outcomes. The optimists think the Fed can achieve a "soft landing" by raising interest rates enough to slow inflation but not so high as to cause an economic recession. Pessimists believe the Fed's interest rate hikes will cause a recession—also know as a "hard landing." Soft landings have been rare, and the near-term outcome is uncertain. There is likely to be some additional volatility before the market eventually settles down.

The good news is the stock market looks ahead, and the current uncertainty is already priced into markets. Stocks will likely fall further if we enter a recession, but with the S&P 500 Index already down 20.0% this year, and many of the past two years' best performing stocks down around 70% from their peaks, a lot of the

Market Indicators		6/30/2022
TOTAL RETURN		
US Stock Markets	12 Mos	Year-to-date
S&P 500 Index	-10.6%	-20.0%
S&P 400 Mid Cap	-14.7%	-19.6%
Russell 2000 Small Cap	-25.2%	-23.5%
Int'l Stock Markets		
ETF Returns in US$		
EAFE Index (Europe, Australia, Asia, Far East)	-17.4%	-18.8%
Japan (MSCI Index)	-20.0%	-20.3%
China (FTSE 50)	-25.6%	-6.9%
Emerging Mkts Index	-25.6%	-17.2%
US Fixed Income Yields	12/31/2021	6/30/2022
6 Mo US T-Bill	0.19%	2.51%
2 Yr US T-Note	0.73%	2.92%
10 Yr US T-Note	1.52%	2.98%

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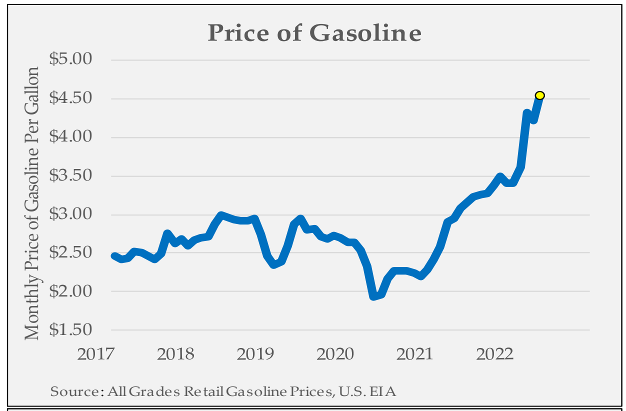
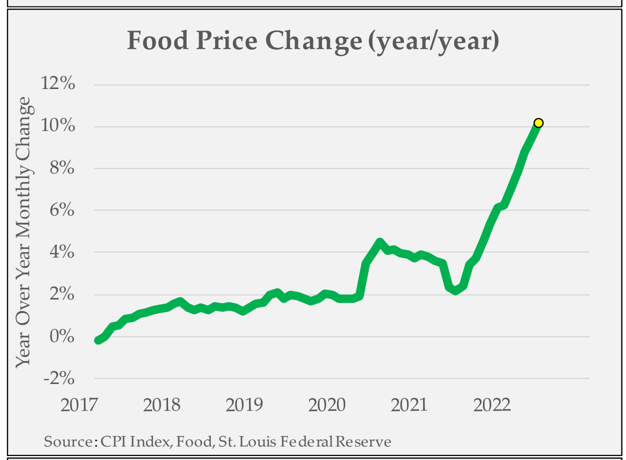
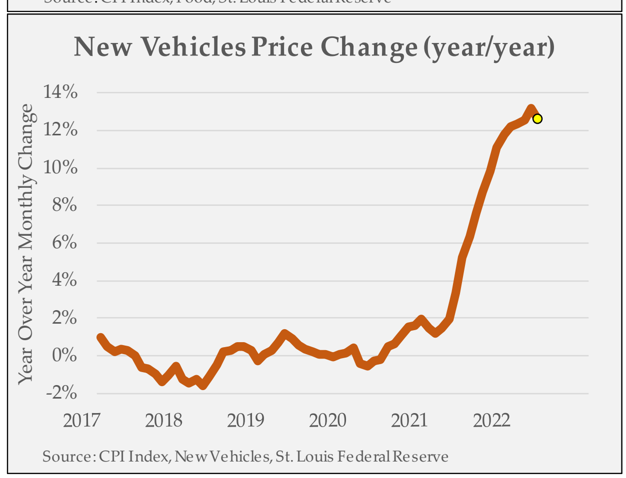
market euphoria has already been removed. One day the market will hit bottom for no apparent reason and then eventually keep trending up. It will be difficult to recognize that bottom, which is why it's important to stay focused on the long-term.

WHY ARE OIL PRICES SO HIGH?

The answer is complicated. The Ukraine/Russia war, Saudi Arabia's unwillingness to increase production, and the lingering COVID-19 pandemic all play roles in the highest oil prices in over a decade. Another large contributor to today's high oil prices is the reluctance of US oil companies to pump more oil. US oil production more than doubled between 2011 and 2019 when new technology suddenly made a number of US oil fields economically viable. Despite pumping so much more oil, most US oil companies were unprofitable during much of this period. The 2020 pandemic caused US oil companies to rethink their strategy; the end result was a commitment to profits over production. US oil fields produced about 3% less in the first quarter of 2022 than in the first quarter of 2019, despite the price of crude becoming more than 70% higher, according to the US Energy Information Administration.







History suggests that production will eventually move higher in response to high prices. Additional US production and an end to the Ukraine/Russia war should moderate prices and lower general inflation.

8.6% INFLATION

The Consumer Price Index (CPI) increased by 8.6% for the 12 months ended May 2022 (the most recent data available). A gasoline price rise of 48.7% (see graph) was a notable contributor, but food, up 10.1%, and new vehicles, up 12.6%, were also very high. None of the major components of CPI fell in price during the past 12 months.

Economists cite increases in underlying employment costs, which increased at an annual rate of 5.7% in the first quarter of 2022, as an important—and possibly durable—contributor to overall inflation. With the unemployment rate at a very low 3.6%, and increasing evidence of the balance of power shifting from management to employees, employment costs may continue trending higher until the next recession.

CONCLUSION: KEEP A LONG-TERM PERSPECTIVE

So far, 2022 has certainly been a tough year for investors, but it's important to recognize how much financial assets have appreciated over the past 10 years. From 2011 to 2021, the S&P 500 Index returned 360%, a 16.5% annual rate of increase. An investor who exited stocks in 2018, when the market fell 4% that year, would have missed gains of 31%, 18% and 28% in 2019, 2020 and 2021, respectively. At Birch Hill our goal is to invest in companies that are capable of weathering all storms to possibly come out stronger on the other side of adverse markets.

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