Birch Hill
INVESTMENT ADVISORS

Market View

October 2022

MARKET PERFORMANCE

The Standard & Poor's 500 Index continued its 2022 downtrend, returning –4.9% in the third quarter. The index has returned –23.9% year-to-date and ended the third quarter below its June lows, even after a sizable summer surge. Thus far in 2022, the market has had three trough-to-peak rallies in the 5%-10% range and two in the 11%-20% range. Such rallies are typical of bear markets and reflect ongoing uncertainty and the push-pull of investor reactions to new economic, geopolitical, and fundamental developments.

THE US ECONOMY

Usually, business cycles take years to play out. However, in 2022, the economy has turned abruptly in only nine months. Early in the year, forecasters predicted robust economic growth near +4%. At the time, concerns centered around record pandemic stimulus overheating the US economy, resulting in high inflation. By late spring, concerns shifted to the Federal Reserve not raising interest rates fast enough to cool inflation and slow the economy. Now, after two negative quarters of US economic growth accompanied by lingering high inflation, investors fear the Federal Reserve may continue to push interest rates higher, causing an increase in unemployment and a US recession. Current estimates call for near +1% US economic growth for the year—a big decline from the earlier estimate of +4%.

EUROPE AND THE RUSSIA-UKRAINE WAR

Europe's support of Ukraine has caused Russia to curtail energy deliveries, hurting economic growth prospects in the European Union (EU). In 2020, Russia supplied 41% of the EU's natural gas, 53% of its coal and 26% of its crude oil needs, according to Eurostat, the statistical office of the EU. Supply disruptions and the war have sent natural gas prices skyrocketing (see chart on the next page).

According to the New York Times and Goldman Sachs, the average European household will likely see this winter's monthly energy bill triple the amount paid in 2021—much more than the 17% heating-bill increase forecast for US homes on average by the National Energy Assistance Directors Association.

Market Indicators		9/30/2022
TOTAL RETURN		
US Stock Markets	12 Mos	Year-to-date
S&P 500 Index	-15.5%	-23.9%
S&P 400 Mid Cap	-15.3%	-21.5%
Russell 2000 Small Cap	-23.5%	-25.1%
Int'l Stock Markets		
ETF Returns in US$		
EAFE Index (Europe, Australia, Asia, Far East)	-25.1%	-27.2%
Japan (MSCI Index)	-28.9%	-26.3%
China (FTSE 50)	-32.5%	-29.0%
Emerging Mkts Index	-29.1%	-28.0%
US Fixed Income Yields	12/31/2021	9/30/2022
6 Mo US T-Bill	0.19%	3.92%
2 Yr US T-Note	0.73%	4.22%
10 Yr US T-Note	1.52%	3.83%

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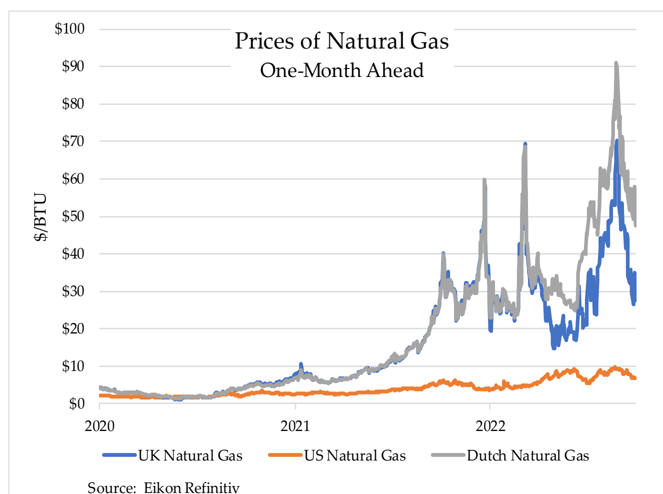
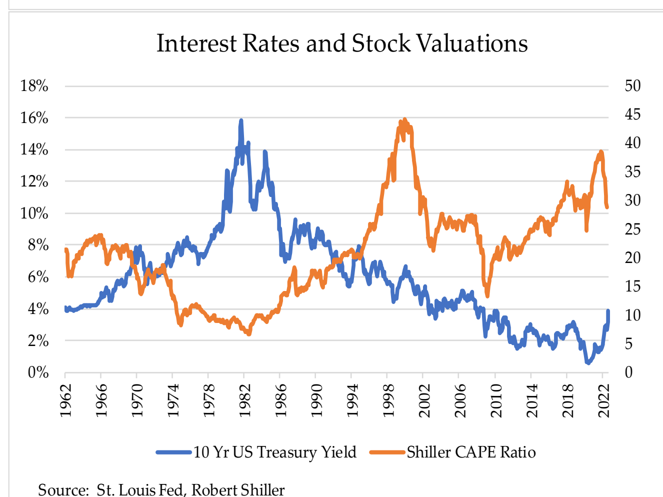
Energy shortages this heating season will likely result in a significant economic contraction in Europe. This would pose a problem for many multinational US businesses and act as a drag on the US economy.



INTEREST RATES AND STOCK VALUATIONS

From 1982 until earlier this year, declining interest rates were a tailwind for equity valuations. As seen in the second chart to the right, the yield on the 10 Year US Treasury note peaked near 16% in 1981, and equity valuations, as measured by the Shiller Cyclically Adjusted Price Earnings (CAPE) Ratio, bottomed shortly thereafter at 6.6x in 1982. Since then, interest rates have generally declined, and equity valuations have increased. Low interest rates make bonds less attractive compared to equities. They also reduce the discount rate at which equity cash flows are valued, which boosts equity valuation levels. Over the last 10 years, the average yield on the 10 Year US Treasury note was an extraordinarily low 2.1%. This helped drive equity valuation multiples to very high levels.

If the Federal Reserve continues to push rates higher into 2023, bonds could become increasingly attractive on a relative basis, resulting in continued downward pressure on stock prices.



EXPECT MORE VOLATILITY AHEAD

There has been no shortage of new developments in 2022 requiring constant recalibration by investors. As old issues have seemingly been resolved, new ones have sprouted rapidly: a waning pandemic, a reopening economy, war, high inflation, rapidly rising interest rates, signs of slowing global economic growth and an energy crisis in Europe. With so many variables in flux, it is reasonable to expect continued market volatility for the foreseeable future. However, volatility cuts both ways. Investors and markets look forward; markets are priced not on current conditions but on expectations of future conditions. If current gloomy expectations prove too negative, markets could move up strongly. We know eventually such a turn will occur. However, the timing of such a turn is unknowable.

CONCLUSION: OWNING QUALITY COMPANIES IMPORTANT AS UNCERTAINTY PERSISTS

This has been a year of rapid changes in the economy and financial markets. Persistent inflation has become an increasing concern, resulting in concerted actions by the world's central banks to raise interest rates. US equity valuations have fallen and may soon become attractive. A turn upward in equity prices will eventually occur, but continued volatility, downward pressure from rising interest rates and possibly a negative surprise make up the most likely path in the foreseeable future. Owning quality companies that can weather an economic storm is very important during this volatile period.

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