Birch Hill
INVESTMENT ADVISORS

Market View

April 2023

JITTERY MARKETS IN THE FIRST QUARTER

After rising nearly 9% in the first five weeks of 2023, markets gave back most of their gains by early March then staged a recovery into quarter end. The S&P 500 Index returned 7.5% over the first three months of the year while the Dow Jones Industrials returned 0.9%. Unexpected problems at several regional banks developed late in the quarter, creating fears of a wider crisis. Emergency support measures by the federal government have so far restored confidence in the banking system. With inflation still too high, the US Federal Reserve continued raising short-term interest rates. Longer dated Treasury yields declined on renewed concerns of a recession.

CONSUMER SPENDING IS A KEY

Consumer spending, which makes up roughly two-thirds of US gross domestic product, will play a key role in economic growth. JP Morgan estimates that pandemic-related stimulus allowed US households to accumulate nearly $2.1 trillion in excess savings at their peak in mid-2021. By the end of 2022, estimated excess savings had declined to $0.9 trillion. Lower but still substantial savings have helped power strong consumer spending over the past two years, making the consumer more resilient in the face of inflation. Current forecasts call for positive but modest US economic growth in 2023. As households continue spending down excess savings, high inflation and higher interest rates could start to have more of an impact later this year.

INTEREST RATE INCREASES TAKE TIME TO AFFECT THE ECONOMY

The Federal Reserve raised the upper limit of its short-term federal funds interest rate from near 0% in early 2022 to 5% by March 2023. This has been one of the fastest-ever Fed rate hike cycles (see chart on the next page).

Higher rates are affecting some of the most interest-rate-sensitive parts of the economy, such as financial and real estate companies. The S&P 500 financials and S&P 500 real estate sectors were among the worst performers over the last 12 months, with performance of –14.3% and –19.8%, respectively. Other parts of the market and economy have so far held up better.

Market Indicators		3/31/2023
TOTAL RETURN		
US Stock Markets	12 Mos	1st Qtr
S&P 500 Index	-7.8%	7.5%
DJ Industrial Avg.	-2.0%	0.9%
S&P 400 Mid Cap	-5.2%	3.8%
Russell 2000 Small Cap	-11.6%	2.7%
Int'l Stock Markets		
ETF Returns in US$		
EAFE Index (Europe, Australia, Asia, Far East)	-0.2%	9.0%
Japan (MSCI Index)	-3.6%	7.8%
China (FTSE 50)	-5.3%	4.4%
Emerging Mkts Index	-10.5%	4.1%
US Fixed Income Yield	12/31/2022	3/31/2023
6 Mo US T-Bill	4.76%	4.94%
2 Yr US T-Note	4.41%	4.06%
10 Yr US T-Note	3.88%	3.48%

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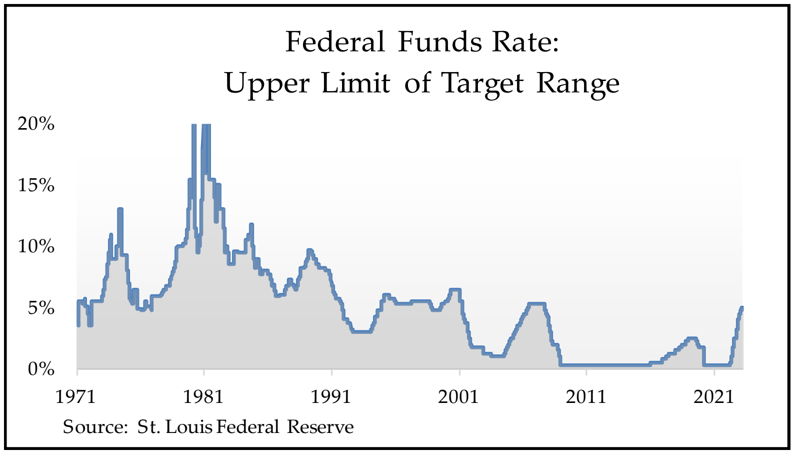
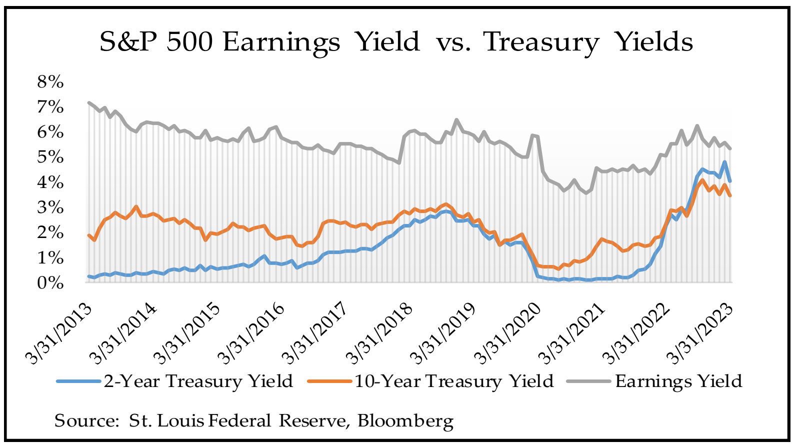
Corporations that took advantage of very low interest rates by refinancing debt obligations over the last decade are somewhat insulated during this hiking cycle because they have locked in lower rates. Consumers who refinanced mortgages have a similar advantage. Therefore, it may take longer for higher rates to have their desired tightening effect on growth and inflation. Problems could arise as debt comes due, requiring refinancing at higher rates. Additionally, if consumer spending strength begins to wane, lower overall spending could lead to lower corporate sales, higher unemployment and potentially higher defaults. A slowdown in lending by the banking sector due to recent problems and higher-cost loans could also weaken the economy. The economic side effects of higher interest rates may be just beginning.



THE SILVER LINING OF HIGHER RATES

Fixed income yields have recently been more attractive than they have been in many years relative to the "earnings yield" on stocks. Not to be confused with dividend yields, the earnings yield on a stock (or index) is its expected earnings divided by the price of the stock (or index). As shown in the chart to the right, the yields on the 2-year US Treasury note and 10-year US Treasury note ended the quarter at 4.06% and 3.48%, respectively. The forward yield on stocks was 5.35%. Investors typically demand a premium over bond yields to hold riskier stocks. With a narrow premium difference in yields relative to history, bonds have started looking more attractive again.



CONGRESSIONAL BRINKMANSHIP

Unless Congress increases the debt ceiling, then sometime in early summer, the US Treasury will exhaust all extraordinary measures to fund the federal government. In the past, Congress has used the debt ceiling and a possible default as leverage to gain concessions, most notably in 2011. Given the persistent political wrangling in Washington, a protracted period of tense negotiating could occur. Ultimately, the debt ceiling will increase, but investors could become nervous during the upcoming political game of chicken.

CONTINUE HOLDING HIGH-QUALITY, CONSERVATIVELY FINANCED COMPANIES

Higher interest rates have begun affecting the economy, causing unexpected problems at several regional banks. Other financial surprises are possible as the effect of the shift in rates continues working its way through the economy. Higher volatility in equity and fixed income markets is likely to continue. Investors holding securities of high-quality, conservatively financed companies with good prospects should feel secure about the long term.

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