Birch Hill
INVESTMENT ADVISORS

Market View

July 2023

UNEVEN EQUITY MARKETS

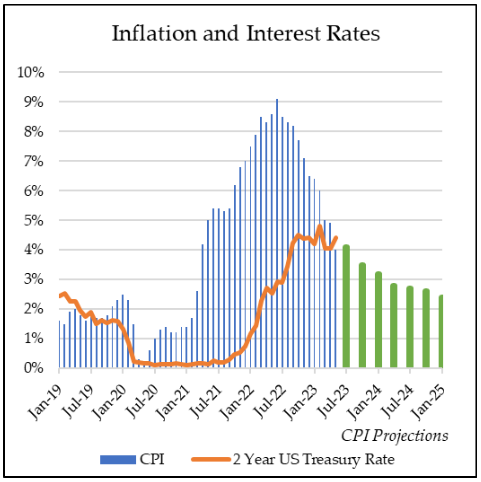
Stocks continued on an upward path in the second quarter. Over the first six months of 2023, the Standard & Poor's 500 Index returned +16.9% while the Dow 30 Industrials Index returned +4.9%. For much of 2023, performance has been driven by a handful of large technology stocks, most of which benefited from enthusiastic interest in artificial intelligence. The S&P 500 Index is capitalization-weighted where the largest companies have a much greater impact on the performance of the index. The equal-weighted S&P 500 Index returned +7.0% in the first six months of the year.

The stock market has "climbed a wall of worry" over the last nine months. Since bottoming last autumn, the Dow has returned +21.7% and the S&P 500 Index +25.9% during a time when many economists expected a recession and the Federal Reserve proved only partially successful in reducing inflation. Even the failure of three regional banks has not deterred stock investors who are looking past the current challenges.

Market Indicators		6/30/2023
TOTAL RETURN		
US Stock Markets	12 Mos	Year-to-date
S&P 500 Index	19.6%	16.9%
DJ Industrial Avg.	14.2%	4.9%
S&P 400 Mid Cap	17.5%	8.8%
Russell 2000 Small Cap	12.3%	8.1%
Int'l Stock Markets		
ETF Returns in US$		
EAFE Index (Europe, Australia, Asia, Far East)	18.6%	12.5%
Japan (MSCI Index)	18.3%	14.5%
China (FTSE 50)	-17.7%	-3.4%
Emerging Mkts Index	0.9%	5.2%
US Fixed Income Yields	12/31/2022	6/30/2023
6 Mo US T-Bill	4.76%	5.47%
2 Yr US T-Note	4.41%	4.87%
10 Yr US T-Note	3.88%	3.81%

THE FED PAUSES

Interest rates moved higher during the quarter. The Federal Reserve increased the fed funds rate by 0.25% in early May to a range of 5.00% to 5.25%. The increase marked the tenth interest-rate setting meeting in a row where the group hiked rates. In mid-June, the Federal Reserve left interest rates unchanged but signaled a high probability of more hikes before year-end. Observers have various theories on why the Fed took this unusual approach to interest rate policy in June. We believe the pause is a result of concerns about financial stresses caused by the rapid series of rate hikes in the last fifteen months.



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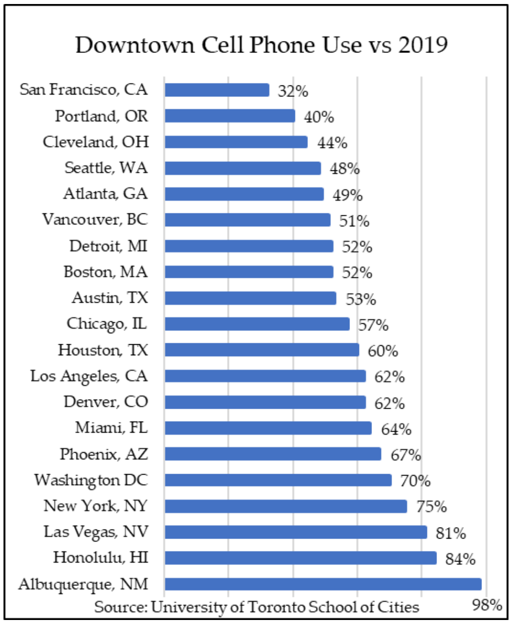
SLOWER ECONOMIC GROWTH AHEAD

The economy appears to be slowly responding to higher interest rates. Inflation, as measured by the Consumer Price Index (CPI), fell to a year-over-year rate of 4.0% in May. CPI peaked in June 2022 at 9.1%. Higher interest rates and other forces will likely slow economic growth in the second half of this year and into 2024. The unemployment rate continues to stay close to recent low levels but several underlying factors have started to foretell higher unemployment in the months ahead. Banks have become somewhat less willing to lend. Mortgage refinancing, which helped bolster many consumers' bank accounts, has slowed dramatically due to higher mortgage rates. Consumers' pandemic-period excess savings are approaching depletion. In October, federal student loan repayments will restart. Thus far, economic growth has defied many recession predictions but slower growth, or mild retraction, in the months ahead is increasingly likely.

WORKING FROM HOME

The combination of reduced demand for office space, higher interest rates and maturing commercial loans could spell additional trouble for smaller regional banks. A recent University of Toronto analysis of cell phone activity in major US and Canadian cities indicates that most downtowns have far fewer people than before the pandemic (see chart) because many businesses continue to allow employees to work from home for at least part of the work week. The typical US office building now has about half the number of people as before the pandemic. As a result, companies are reducing the amount of leased office space. Increased vacancies and declining lease income are pressuring building owners who typically borrow 75% to 80% of an office building's value. Many of these loans, which are held by regional banks, come due in the next two years. Commercial loan defaults have already begun to rise and could grow to be a major challenge for banks. When asked about commercial real estate loans, the chairman of the Federal Reserve recently said he was "watching that situation very carefully."



Source: University of Toronto School of Cities

ANOTHER FINANCIAL SURPRISE?

The sudden failure of three regional banks this year was, in part, the result of rapidly rising interest rates. All three had made poor business decisions over the last several years that left them particularly vulnerable to changing conditions. Only time will tell if other businesses or investors are in similarly precarious positions. Given the prior long period of very low interest rates and the sudden spike higher, an additional significant financial surprise could surface in the months ahead.

EQUITIES COULD MOVE TO THE SLOW LANE

The rate of inflation is markedly lower than a year ago, but still higher than targeted by the Federal Reserve Bank. Slow economic growth and low unemployment have thus far been little affected by higher interest rates. That could change in the months ahead. Challenging commercial real estate conditions could impact regional banks and other loan holders over the next two years. Equities have produced favorable, but uneven, returns thus far in 2023 and could be due for a slower period. With yields higher and inflation heading down, bonds are increasingly attractive.

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