Birch Hill
INVESTMENT ADVISORS

Market View

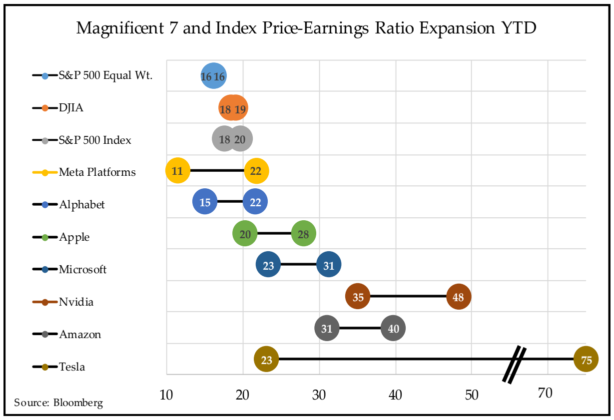
October 2023

STOCKS DECLINE AS YIELDS RISE

US stock prices declined between the second and third quarter of 2023. Year-to-date returns remained strong—the S&P 500 Index returned +13.1%—as stocks held onto the majority of gains achieved earlier in the year. Similarly, bond prices declined as intermediate and longer-term Treasury yields rose. The US 10-year Treasury yield increased to 4.59% from 3.81% in the third quarter as US economic growth proved stronger than expected. Large budget deficits and concerns over the increased Treasury bond issuance to finance those deficits may also be pressuring yields.

CONCENTRATED GAINS

Earnings drive stocks in the long run. Therefore, investors should be cautious when market returns are driven more by changes in valuation rather than earnings growth, as appears to be the case in 2023. Earnings for the S&P 500 Index in 2023 are expected to rise only slightly—$221 per share versus $219 in 2022. Thus, this year's returns for the S&P 500 Index are driven mainly by changes in the multiplier (price-earnings ratio) that investors are willing to pay for those earnings. This multiplier has expanded from roughly 18x at the beginning of the year to 20x at the end of September.



Moreover, much of the gains in index returns and the expansion in the price-earnings multiple have come from a group of stocks that market pundits call the Magnificent Seven. These stocks, which include Alphabet (Google's parent company), Amazon.com, Apple, Microsoft, Meta Platforms (formerly known as Facebook), Nvidia, and Tesla, made up nearly 27% of the overall S&P 500 Index at the end of the quarter but contributed approximately 85% of the year-to-date return. Since 2023's start, the price-earnings ratios for most of these companies have expanded much more than their earnings expectations, as shown in the chart above.

Market Indicators		9/30/2023
TOTAL RETURN		
US Stock Markets	12 Mos	Year-to-date
S&P 500 Index	21.6%	13.1%
DJ Industrial Avg.	19.2%	2.7%
S&P 400 Mid Cap	15.5%	4.2%
Russell 2000 Small Cap	8.9%	2.5%
Int'l Stock Markets		
ETF Returns in US$		
EAFE Index (Europe, Australia, Asia, Far East)	25.8%	6.9%
Japan (MSCI Index)	24.6%	11.5%
China (FTSE 50)	5.3%	-5.7%
Emerging Mkts Index	11.3%	0.9%
US Fixed Income Yields	12/31/2022	9/30/2023
6 Mo US T-Bill	4.76%	5.53%
2 Yr US T-Note	4.41%	5.03%
10 Yr US T-Note	3.88%	4.59%

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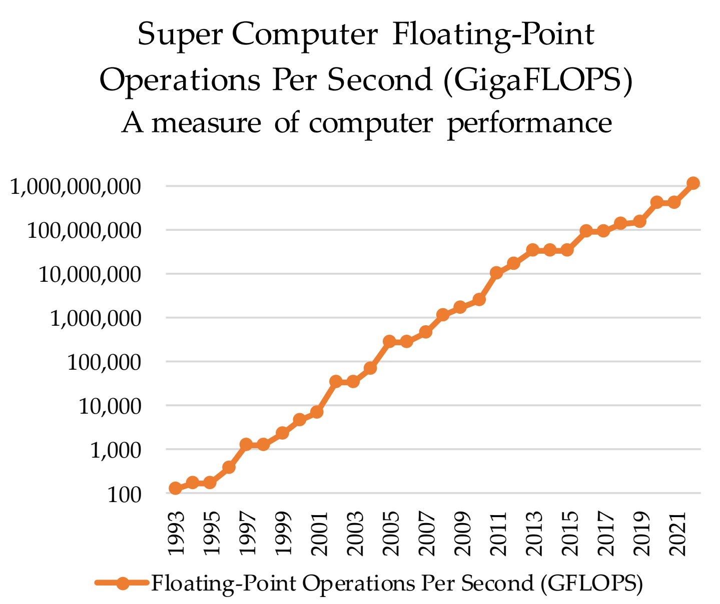
RESILIENT CONSUMER

The US consumer has been more resilient in 2023 than many expected. As the source of nearly two-thirds of US gross domestic product, the US consumer remains a key driver of US economic growth. Moderating inflation and wage growth have boosted spending growth. Household net worth has also increased, due to rising stock and property values. However, there are signs that things are slowing down. The labor market, which continues to be strong, showed signs of softening in August. The unemployment rate ticked up to 3.8%, and job gains slowed. High interest rates continue to weigh on loan growth and the housing market, and they make consumer purchases with financing—such as cars—more expensive. Student loan repayments will resume in October, further crimping discretionary incomes. Higher gasoline prices are another pressure point. While headwinds are building, the US economy is still expected to grow 1% to 2% for the entire year.

IS ENTHUSIASM OVER ARTIFICIAL INTELLIGENCE JUSTIFIED?

Three critical factors that drive advances in artificial intelligence (AI) have recently converged. They are advances in computing power, increases in data, and better machine learning algorithms. Advances in computing power have enabled AI models to function and train at much larger scales. Computing power capabilities have increased tremendously over the years, as seen in the chart to the right. Increases in the amount of data have enabled AI models to train on larger data sets and become more accurate. Improved machine learning algorithms have enabled more efficient training of AI models through approaches like self-training while also better leveraging the increases in data and computing power. Machine learning algorithms are the foundations of AI models and use mathematical methods to extract relationships on a data set (i.e., train) and make predictions based on the results of that training. These three factors have led to breakthroughs like ChatGPT, an AI-powered bot that can “chat” with you to answer questions based on written information provided by you or fed to it by other sources.



Source: Our World In Data

However, these technologies remain expensive. Therefore, beneficiaries today include large, established technology companies with access to computing power, data, technical talent, and resources to invest. As more investment goes into the space, AI should have broader economic and market impacts, such as potentially improved productivity. While we believe enthusiasm is justified over the long term, some stocks may already price in several years of expected progress.

CONCLUSION: STAY THE COURSE

The Standard & Poor’s index has held onto most of the gains from earlier this year, but most of that was driven by valuation changes in a small number of stocks. Treasury yields have moved higher recently on a stronger-than-expected US economy and rising budget deficits. The consumer continues to be resilient, but headwinds are building. AI is an exciting new technological advance that should play out over several years. We believe investors should continue to hold high-quality equity and fixed-income securities in line with their asset allocation targets.

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