



**April, 2010**

*The US stock market has staged a remarkable recovery from a year ago with the S&P 500 Index up 70% from its lows. Fourth quarter 2009 Real GDP expanded a very strong 5.6%. These signs of economic strength and confidence come at a time of unprecedented federal fiscal and monetary stimulus. The question is whether this nascent economic expansion can continue as these stimuli are reduced or withdrawn.*

### Financial Markets

The stock market rebound of the last twelve months was driven in part by a recovery in corporate profits. Earnings in 2009 for the S&P 500 companies were off 5% from the year before, less than feared, and the fourth quarter results increased 47% versus a weak prior year comparison. Cost cutting, not revenue growth, was the main reason for the recovery in profits. The 2010 consensus forecast of a 20% increase may prove too optimistic considering the current headwinds:

- A mountain of unsold homes and new home starts off 75% from the highs of recent years,
- The likely gradual withdrawal of fiscal and monetary stimulus, at home and abroad, especially China, and
- An overleveraged consumer focused on reducing debt.

Short term interest rates are still extremely low, with money funds close to zero and one year Treasuries yielding less than 0.5%. Rates on five year bonds are less than 3%, below the average inflation rate of the last 80 years. The spread between low quality debt and US Treasuries has narrowed significantly over the last twelve months, as investors have stretched to obtain higher current yields.

While unprecedented monetary stimulus and federal government deficit spending may raise fears of higher rates of inflation, disinflationary forces are at work as well. A rise in labor costs would be surprising considering the current level of unemployment. Consumer demand is not likely to drive up prices as spending moderates. Also, given the current inventory of unsold homes and, we suspect, a backlog of current homeowners who would be willing sellers at slightly higher prices, a meaningful rise in home prices does not appear in the offing. With a modest economic expansion we expect interest rates to return to more normal levels, but we do not see them driven by significantly higher rates of inflation.

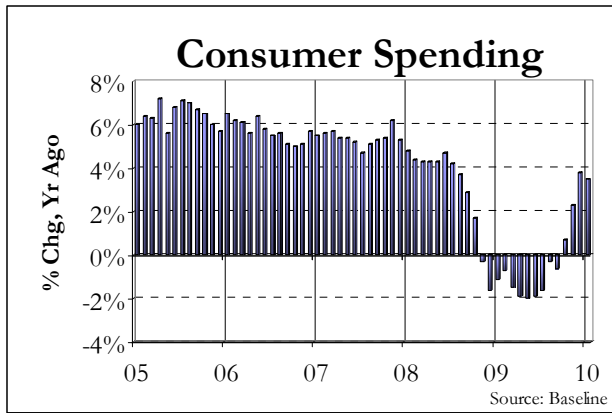
### Market Indicators

	Total Return	
	<u>12 Mos</u>	<u>1st Qtr 2010</u>
<b><u>US Stock Markets</u></b>		
S&P 500 Index	49.8%	5.4%
Dow Jones Industrials	46.9%	4.8%
NASDAQ Composite	58.4%	5.9%
<b><u>International Stock Markets</u></b>	<i>ETF Returns in US\$</i>	
EAFE Index <i>(Europe, Australia, Far East)</i>	53.5%	1.3%
Japan (MSCI Index)	33.9%	7.2%
China (Xinhau 25)	49.7%	-0.4%
Emerging Mkts Index	72.6%	1.5%
<b><u>US Fixed Income Yield</u></b>	<u>12/31/09</u>	<u>3/31/10</u>
90 Day US T-Bill	0.05%	0.16%
2 Yr US T-Note	1.14%	1.02%
10 Yr US T-Note	3.84%	3.83%

### The Economy

Over the last six months job losses appear to have bottomed out. Approximately 8 ½ million jobs have been lost in this downturn, a staggering figure, far greater than in prior recessions. While employment is usually considered a lagging indicator, the higher level of layoffs in this recession may indicate an earlier rebound, as companies find they need to bring back workers to meet modestly growing production and service levels. Overtime hours have increased while nearly 300,000 temporary help workers have been added to the rolls of the employed since last September. These improvements would indicate that payrolls may be expanding soon. We do not need to regain those lost 8 ½ million jobs to keep the economy expanding.

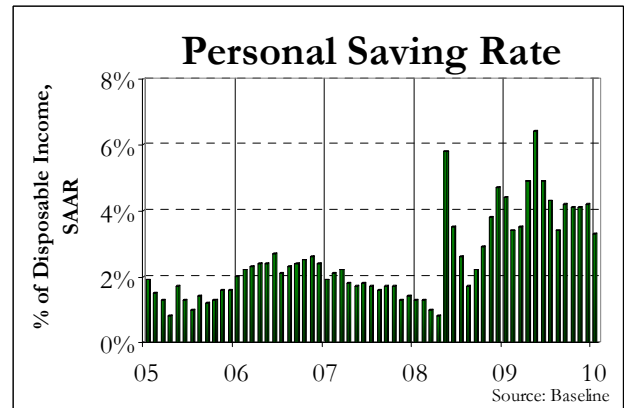
Consumer spending in recent months has increased at a 3% annual rate. While this figure is lower than in recent years, it is an increase nevertheless, and the trend is important. At the same time, the per-



personal savings rate has moved from 1.4% of disposable personal income in 2005 to 4.3% in 2009. If we start to see new workers added to payrolls, and the consumer continues to increase spending modestly while reducing debt levels, the resulting slow growth scenario may be just the tonic for a gradual, sustained expansion. Modest growth with less debt is a much sounder base for economic progress than the high debt consumer economy of recent years.

Some have suggested that we might have a double-dip recession, along the lines of the recession of 1981-1982 that followed the shallow recession of 1980. We would point out

that the Federal Reserve aggressively increased interest rates at that time. Treasury bill rates were in the high teens and the Prime Rate above 20%! The Fed wanted to wring inflation out of the system. Today the Federal Reserve is mostly concerned with economic growth. The current very low short term rates of interest are intended to keep the economy expanding. The Fed is trading cautiously to be sure the recovery is well established before allowing interest rates to return to more normal levels. The resilient US economy has an upwards bias, and another downturn, so soon after the last contraction, while possible, does not seem likely.



### The United States AAA Rating

The Congressional Budget Office projects a federal budget deficit of \$1.3 trillion for the 2010 fiscal year, slightly less than last year but roughly 9.2% of GDP. These deficits are the largest, as a % of GDP, since the end of World War II, and have prompted the International Monetary Fund and Moody's Investors Service to speak out about the need to reduce spending to keep revenues and expenditures in better balance. Moody's ten year outlook cites pressure on the AAA rating as debt service levels grow. The IMF said that maintaining public debt at current levels will significantly reduce potential growth, and noted that unwinding stimulus programs will not be enough to reverse the trend. Entitlement reforms are needed as well.

While we do not think the US Federal Government is on a course to lose its AAA rating any time soon, the challenges are great and bear watching. A return to fiscal responsibility will not be easy, as we are reminded by news clips from Greece showing labor unions protesting wage and benefit cuts. Increased focus on the Federal deficit is beneficial, but it is only a harbinger of the difficult discussions about reducing spending and increasing government revenues. As the baby boomers enter their retirement years, the strain on the entitlement system will only become greater.

### Conclusion

The economy is now on an improving trend. While the sustainability of the recovery is not a certainty, a continuing slow growth recovery seems most likely. We continue to focus on high quality, large cap companies able to withstand difficult competitive times and use their financial strength to increase market share and acquire weaker competitors. We maintain our cautious posture on bonds, keeping duration short and maintaining quality.

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