



July, 2010

Indications of slowing US economic growth and a potential Greek debt default pushed the stock market and US Government interest rates lower in the second quarter. Correcting the credit excesses of the last three decades will take time. The impact of the 2009 Government stimulus package has peaked and future economic growth will increasingly rely on the private sector.

US Financial Markets

After a strong first quarter of 2010, the US stock market retreated in the second quarter. Catalysts of the decline included the financial disruption in Europe and indications of slowing US economic growth. The stocks of large companies declined more than the stocks of mid-sized and small companies during the quarter. This continued a multi-year period of under-performance for large company stocks which now appear to be significantly under-valued compared to smaller companies. Given the growth challenges potentially faced by all companies, large globally diversified firms that dominate their industries are generally more attractively positioned than small narrowly focused companies. Large companies have reduced costs during the downturn and many have substantial cash positions. Interest rates fell during the quarter as the markets concluded that the situation in Europe plus potentially slowing economic growth will cause the Federal Reserve to delay increasing short-term interest rates.

Buying Time to Address Credit Problems

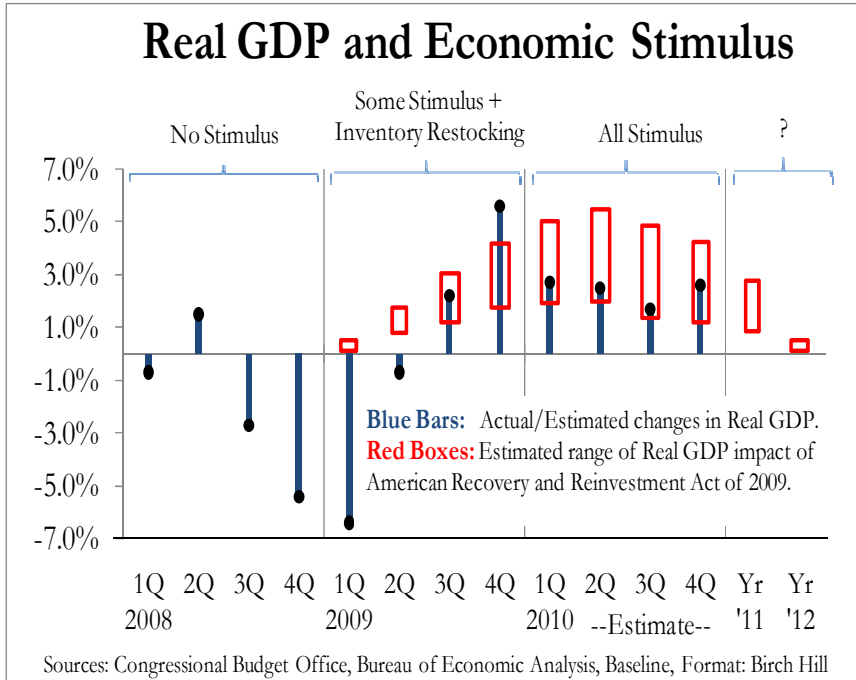
After percolating for months, concerns about Greece's ability to meet large pending debt payments boiled over in April. Greek debt denominated in euro is held widely in other "euro zone" countries and a default would have troubling ripple effects on many European financial institutions. Various plans were developed that would provide short-term support or that would restructure maturing Greek debt. The initial proposals would have cost euro zone countries on the order of €30 billion (about \$37 billion). As market pressures intensified, the scope of the rescue package grew to anticipate problems at other weak euro zone countries. The final plan commits a breathtaking €750 billion (\$920 billion) to purchase troubled debt. The announcement of the plan initially brought a level of relief to European financial markets.

The European plan does not solve the underlying problem of excessive debt levels in weak countries. The plan does buy time by using the higher credit worthiness of stronger euro zone countries (primarily Germany) to support less-credit worthy countries over the next several years. In many ways this is a reasonable, time tested approach to a difficult financial problem. The US has employed similar strategies by supporting "Brady Bonds" issued by over-leveraged countries in the 1980s and by providing Mexican loan guarantees in the early 1990s. In the 2008-2009 financial crisis the US employed variations on this basic strategy many times: to rescue Fannie Mae and Freddie Mac, to save General Motors and AIG, and to support many commercial banks. The troubling aspect of the current period is the need to simultaneously rescue so many large debtors.

Market Indicators 6/30/2010

	Total Return	
	12 Mos	Year-to-Date
US Stock Markets		
S&P 500 Index	14.4%	-6.7%
Dow Jones Industrials	18.9%	-5.0%
NASDAQ Composite	16.0%	-6.6%
International Stock Markets	ETF Returns in US\$	
EAFE Index <i>(Europe, Australia, Far East)</i>	4.2%	-14.4%
Japan (MSCI Index)	-0.9%	-4.9%
China (Xinhau 25)	3.7%	-6.4%
Emerging Mkts Index	17.6%	-9.5%
US Fixed Income Yield	12/31/09	6/30/10
90 Day US T-Bill	0.05%	0.18%
2 Yr US T-Note	1.14%	0.61%
10 Yr US T-Note	3.84%	2.94%

Will we transition from government stimulus to real growth?



The economic recovery in the US and other developed nations remains fragile. Private (non-government) employment levels have continued to increase at a slow pace but the nascent recovery in the housing market now seems vulnerable, particularly with the expiration of the home-buyer tax credit. Over the last year the US economy has benefitted from the strong positive effects of government stimulus. According to Congressional Budget Office estimates, the American Recovery and Reinvestment Act of 2009 contributed first quarter real economic growth in a range of 1.7% to 4.2%. Therefore it appears that government stimulus was responsible for most or all of the 2.7% growth achieved during the quarter. Based on current CBO estimates, it appears that

the same will be true for the balance of 2010 (see the near-by chart). Not counted in the estimates is the stimulative effect of Federal Reserve purchases of mortgage securities in order to lower interest rates, another form of stimulus. CBO economists estimate that the positive economic impact of Federal stimulus spending peaked in the second quarter of 2010.

Conclusion

In response to financial disruptions in Europe and questions about the durability of the US economic expansion, the stock market cooled in the second quarter while interest rates on US government bonds fell. Over-indebted institutions and governments continue to require the support of financially stronger governments. The US economy has derived much of its recent growth from government stimulus. The stocks of large companies are attractively priced compared to those of smaller companies. Very low interest rates present a dilemma for fixed income investors. We prefer to avoid lower quality issuers and longer maturities.

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Birch Hill is pleased to announce that Rina K. Jha, CFA recently joined the firm as an equity analyst. Ms. Jha has worked as an analyst for fifteen years, most recently at Fidelity Management and Putnam Investments. She received her undergraduate degree from The Wharton School at the University of Pennsylvania and her MBA from the Booth School of Business at the University of Chicago.