

INVESTMENT SPOTLIGHT

“It is not by augmenting the capital of the country, but by rendering a greater part of that capital active and productive than would otherwise be so, that the most judicious operations of banking can increase the industry of the country.”

– Adam Smith, 1723-1790

Excesses in life are often not easily or quickly corrected. Generally speaking, the more outrageous the excess, the longer and more severe the remedy. Such has been the case for the U.S. banking system since the recession of 2008 and 2009. Global investors, government agencies, banks, mortgage originators, property appraisers and an all too willing consumer combined to create a housing market bubble, that when popped revealed an overleveraged and inflated market. Borrowers were often unable or unwilling to pay when the house of cards came crashing down. These circumstances revealed other stress cracks in the financial system that began to lengthen and widen in a period of massive credit deterioration. This credit crisis was at the heart of the recession.

At that time, Adam Smith’s advice could not be followed. In fact, so little capital was available that global governments began pumping money into the system in order to prevent an out and out system failure. While a collapse was averted, capital infusions further stressed the balance sheets of most nations, adding to the Sovereign Credit concerns that we now face.

In addition to immediate capital infusions, government regulators, compelled to ensure that these excesses and the systemic crisis they created would not be repeated, began devising and implementing regulatory reform aimed towards protecting consumers and among other things, ensuring sufficient capital within banking institutions. In the U.S. we had the passage of the Dodd-Frank Act, which has broad regulatory mandate across a myriad of financial industry activities intended to safeguard the system and protect consumers. However, many industry leaders believe the increased regulatory burden will crimp our financial institutions’ ability to help stimulate the growth we need to spur economic activity. Overseas, the BASEL III

accords seek to do much of the same by creating a global framework for more resilient banks, which requires increased capitalization levels across the banking system. The question is, will the increase in capital requirements and regulatory oversight impede the much needed private sector investment and risk taking? These efforts appear to contradict Adam Smith’s advice of “rendering a greater part of that capital active and productive than would otherwise be so.”

Given the public outcry against “Wall Street Bailouts”, which interestingly have come from both “Tea Partiers” and “Occupy Wall Streeters”, a thoughtful government response is both necessary and wise. At the beginning of 2012, we can now more easily see some of the hazards that were created from the government activity of the last few years. First and foremost, we still have a significant amount of global financial institutions that are of questionable strength, particularly in Europe. As they have been supported through government funding and credit lines, many have been unable to completely rectify the problems associated with the credit crisis. In addition, global governments have suffered deteriorating credit conditions as the spending necessary to provide capital to the markets and bolster economic activity have left most nations with weaker balance sheets. Finally, more stringent oversight, while understandable given the magnitude of the crisis, may be the very thing that is preventing a full-fledged economic recovery.

In the end, it should be the goal of policy makers to create a regulatory environment that both protects consumers and the economy from dangerous and excessive risk taking on the part of leaders of financial institutions while ensuring that regulations are not so oppressive that they impede the flow of commerce and enterprise that have driven our economic engine for decades. ■

Economic Review & Outlook

While global economic prospects and activity continued to reflect the considerable uncertainties surrounding the European Debt Crisis and the short-term growth prospects in that region, the U.S. Economy continued to demonstrate more favorable aggregate activity. When assessing the current economic climate, the discussion necessarily needs to focus on jobs and more specifically, job creation. The recovery from this past recession has followed a pattern similar to that of recent recoveries, in which employers refrain from hiring until it is absolutely necessary. Accordingly, job growth since the official end of the recession in June of 2009 through the close of 2011 has totaled 1.415 million new jobs. However, more recent employment data has provided some reason for encouragement as over the last 6 months of 2011, non-farm payrolls have increased by 861,000. While the level of job growth is still well below what is necessary for a meaningful and sustainable reduction in the unemployment rate, it appears to have been positive enough to encourage a sharp rebound in consumer spending during the latter half of the year.

Consumer activity faded during the early spring as both a retrenchment from brisk holiday activity, and warnings of a second recession likely combined to dampen consumer enthusiasm. However, during mid-summer, consumer activity started to pick up and continued on a positive trend straight into the holiday season. While expectations were for a mediocre holiday shopping season, early indications suggest a far more robust level of activity with consumers spending far more than expected. While this spending did come at the cost of reducing the savings rate, it was a welcome sign and suggests a reasonable amount of production activity will be required to replenish already lean inventory levels early into 2012.

Corporate profitability remains a relative bright spot. Earnings growth remains strong, as businesses have been cautious in investing for the future given the general level of uncertainty that remains in the economy. This has been a significant factor in the slow improvement in employment. However, when reviewing data on corporate spending, several data points suggest that companies have continued to spend on infrastructure building

	Q4-2011	YTD-2011
Consumer Disc.	0.8%	4.0%
Consumer Staples	-1.6%	11.9%
Energy	6.4%	2.6%
Financial	-1.0%	-19.2%
Healthcare	-1.9%	10.6%
Industrial	4.7%	-2.7%
Info. Technology	-3.1%	0.3%
Materials	3.6%	-11.9%
Telecommunications	-3.9%	4.2%
Utilities	-3.5%	17.9%

which has helped support aggregate economic activity.

As consumption ramped up during the latter half of the year, existing inventories along the supply chain remained relatively low. All things being equal, we would expect an increase in manufacturing activity early in 2012. In fact, regional and national manufacturing data began to show more solid signs of recovery in the December 2011 data releases.

This was the first quarter in over three years that housing data has actually been trending positively. The late summer and early fall witnessed an uptick in Building Permits, Housing Starts and Home Sales activity. Perhaps the Federal Reserve is finally seeing a positive reaction to their plan of using lower interest rates to incent home purchases. Or perhaps the stability in the employment market has created a confidence among potential home buyers. Maybe the stability in prices over the past year has convinced would-be buyers that the market isn't getting any cheaper for them. It could be that all of these factors are creating an uptick in demand. Regardless, while housing activity remains low, it has taken a more positive trend over the past several months. At the current sales rate, there still exists roughly seven months of supply. While this is still modestly above normal levels, it has improved significantly since market collapse. Should the employment and interest rate environment remain conducive to housing activity, we could be witnessing the beginning of a slow but sustainable upturn in the housing market activity. This would be a welcome and unexpected sign of growth in 2012.

Heading into 2012, there is no denying the positive economic momentum coming out of 2011. This should bode well for manufacturing and production

activity in the early quarters of 2012. Sustainability of this momentum will likely hinge on the evolution of economic activity in Europe. In aggregate, Europe will likely enter an official recession, if one has not already begun. The depth of this recession and duration will dictate how well the U.S. may remain insulated from the European slow down. All things being equal, the dollar should remain relatively strong, making exports more expensive in markets that will likely be experiencing a contraction in consumption. This will provide a macro-economic headwind here in the U.S. In addition, the potential for a “credit crisis” emanating from Sovereign Debt is still very real. Aside from the fundamental economic impacts of Europe, a re-igniting of credit risk concerns could have a more severe and immediate impact on economic

Bond Review & Outlook

While equity investors cheered the positive trend change in economic activity, bond investors appear far less convinced of the positive momentum indicated by the data. Interest rates remained relatively steady during the quarter with interest rates across the yield curve closing within .05% of their quarter-opening levels. Some of this stickiness may be explained by Federal Reserve policy announcements. Their assertions that short-term rates will likely remain close to zero into 2013 likely tied the short-end of the curve down. Meanwhile, on the long-end, the commitment made to keep long-term rates low by purchasing mortgage-backed securities likely assisted in maintaining a lower bias in the long-end of the curve. Finally, global turmoil has driven foreign investors to the safety of U.S. markets. Even though the official U.S. Treasury rating was downgraded to AA+

Stock Market Review & Outlook

After a summer full of worries, equity investors closed the third quarter with a bearish tone as markets fell by 7.03% in the month of September. However, while bond investors didn't take much comfort in the improving economic fundamentals, stock investors were a little more willing to accept the notion that perhaps conditions were not as bad as previously thought.

activity here in the U.S. and within markets. For these reasons, we continue to closely watch developments in Europe, as they will likely drive both our long-term economic outlook and capital markets. ■

	Q4-2011	YTD-2011
Cash:		
T-Bill Index	0.00%	0.10%
<u>Taxable Fixed Income:</u>		
Barclay's Govt. Bond Index	0.84%	9.02%
Barclay's Corp. Bond Index	1.70%	8.35%
Barclay's Corp. High Yield Index	6.46%	4.98%
<u>Tax Exempt Fixed Income:</u>		
Barclay's Muni. 3-yr.	0.31%	3.46%
Barclay's Muni. 5-yr.	1.45%	6.93%

	Q4-2011	YTD-2011
DJIA Index	12.78%	8.38%
S&P 500 Index	11.82%	2.11%
Russell 2000 Index	15.47%	-4.18%
EAFE Index	3.33%	-12.14%

during the summer, investors seeking safety showed everyone where they park their money when times get difficult.

Finding value in the bond market remains elusive. Credit spreads remained relatively stable with even the one area that appeared to offer some opportunities, Municipal Bonds, tightening to levels more in line with historical norms. Thus, we continue to position fixed income portfolios with a short-term bias while awaiting better opportunities to purchase intermediate and long-term issues. Generally, we continue to generate more income through new equity investments than new bond purchases. Additionally, Preferred Equities continue to offer attractive yield opportunities. ■

While markets continued to trade with a great degree of volatility, the overall trend had a distinctly upward bias. In addition to the improvement in economic releases, strong U.S. corporate earnings continued to support very attractive valuations for U.S. Stocks. In addition, the low rate environment made high quality / high dividend yield stocks a far more compelling long-

term investment. The Standard & Poors (S&P) 500 closed the quarter with a gain of 11.82%, while the Dow Jones Industrial Average (DJIA) was up 12.78%.

For the year, the S&P 500 eked out a small gain of 2.11%, while the larger companies of the DJIA managed a more convincing gain of 8.38%. Mid-Cap and Small-Cap stocks each posted negative returns for the year as wary investors showed their preference for more established names, many of which rewarded investors with attractive dividend yields. On a global basis, foreign equities could not as easily shake off the fears emanating from Europe. Both developed and emerging markets traded down during the latter half of the year with the EAFE Index (Europe, Asia and Far East) delivering a return of -12.14% for the year. Emerging markets suffered the most, with the MSCI Emerging Markets index down by a hearty -18.42%.

Looking ahead to 2012, we believe markets will continue to focus on Europe and the development and implementation of credible policy geared toward alleviating concerns surrounding Sovereign Debt. Presently, European credit issues present an asymmetric risk to equity markets. Should policy makers effectively address the crisis, then markets may be poised to continue the modest positive trend that closed the year. However, should the situation deteriorate significantly, the downside risk to the market is far greater. Meanwhile, other geopolitical risks are likely to impact investor sentiment throughout 2012. Our biggest concern emanates from the Middle East, where the withdrawal of U.S. troops from Iraq will likely add to instability in the nascent government structure that still is divided along ethnic lines. Immediately to the North, Iran remains an ever-

present threat with recent announcements regarding the successful enrichment of uranium causing heightened concern over Iran's ability to produce nuclear weapons. Finally, the change in leadership in North Korea creates a new wildcard. While some believe an opportunity may exist to open a new and constructive dialogue, King Jong Un remains a relatively unknown commodity.

Given current valuations and our expectation for continued growth, particularly at the outset of the year, we continue to believe that high quality U.S. stocks provide the best opportunity for appreciation, and in many cases superior income generation through healthy dividend yield opportunities. Fixed Income markets will likely trade within the current range, offering neither attractive income opportunities nor potential for appreciation. In fact, investors need to be particularly focused on the potential for rising rates which may erode the value of their invested principal. Money market will likely remain tied to the Federal Funds Rate, which is unlikely to move higher during 2012. This means that investors in bank CD's will have another year of trying to roll over their CD's in a horrible rate environment. ■

As always, we will continue to monitor economic and market conditions to ensure timely and appropriate investment action. If we can be of assistance, please do not hesitate to call us at the numbers provided below.

If you are interested in receiving this quarterly newsletter electronically, please contact Charlene Grogan at cgrogan@plimothinvestmentadvisors.com. We will be happy to take you off the mailing list and add you to the e-mail list.

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