Plimoth Investment Advisors®
INVESTMENT MANAGEMENT & TRUST SERVICES SPECIALISTS

SECOND QUARTER – SUMMER 2016

INVESTMENT SPOTLIGHT

"Certainty is the mother of quiet and repose, and uncertainty the cause of variance and contentions."
– Edward Coke

Amid a quarter of generally unexciting, yet steady economic data and little headline news, we were dealt a surprising "curve ball" at the close of June, as Britons decided to leave the European Economic Union in what became known as the "Brexit" referendum. During the two weeks leading up to the vote, polls moved back and forth between "remain" and "leave." Two days before the election, the tide appeared to be turning in favor of the "remain" camp, and global risk markets moved higher in anticipation of a continuation in policy governing the Eurozone. Global investors were shocked by the actual results which revealed roughly 52% of the vote supported a split from the economic union. Global markets sold off sharply the day after the vote, with the panic-driven trade spreading across Asia, through Europe and into the U.S. as markets opened.

The European Union (EU) was officially created by the Maastricht Treaty on November 1st, 1993, yet its roots go deeper back into history when at the end of the Second World War a fractured and battered Europe sought a governance structure to foster development of a new united European Community. The original agreement was centered around energy and materials production and distribution. The European Coal and Steel Community included Germany, Belgium, France, Holland, Italy and Luxembourg. At that time several bureaucracies were created to manage the ECSC and resolve disputes between member nations. Additional treaties were signed during the subsequent decades and membership grew to include other nations, including the U.K. in 1973. In its current state, the EU is a political and economic union between European countries which makes its own policies concerning the members' economies, societies, laws and to some extent security.

Many Britons who voted to "leave" the EU cited a concern that unelected bureaucrats at the EU headquarters in Brussels wield too much power over policies ranging from trade, regulation and immigration. While many would prefer to maintain the beneficial trade components of the Union, they are wary of the loss of sovereign control over many matters of concern. As it stands now, the U.K. will hold elections to choose a new leadership structure which will guide them through the two-year negotiation process required to redefine their relationship with the EU.

So, why did markets react so swiftly? The simple answer is the heightened level of uncertainty this vote has brought about; uncertainty in terms of what the new relationship with the EU will look like, but also the long-term cohesion and integrity of the EU itself. Other nations may choose to follow the U.K. in the months to come. When large events occur, it is the uncertainty concerning unintended or unanticipated consequences that spur panic among investors. After trading sharply lower the Friday following the vote, and the following Monday, equity markets rallied back into the close of the month slightly below the previous week's high. At 2098.86, the S&P 500 is roughly 2 points above the month-opening and 40 points above the quarter-opening level. We expect market volatility to continue to ebb and flow during the summer months as more information and headlines concerning the above referenced relationships hit the newswire. ■

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Economic Review & Outlook

In addition to the generally heightened uncertainty surrounding the U.K. vote, subdued global economic activity suggests the global economy remains fragile, making it even more susceptible to disruptions caused by political turbulence. Meanwhile, in the U.S. the economy continues to follow a similar pattern set over the past several years. The final read on first quarter GDP was 1.1%, up from the original report of 0.4%. Data released thus far from the second quarter suggest a moderate strengthening, but perhaps not as strong as Q2 growth over the last few years.

Manufacturing continues to weigh on aggregate economic activity. Dollar strength relative to foreign currencies, which was only exacerbated by the Brexit vote, continues to weigh on exports of U.S. goods. Capital expenditures by businesses have also been slow, further dampening activity. The service sector of the economy continued to expand at a healthy pace. Accounting for roughly 70% of economic activity, this key component of U.S. growth suggests the economy can continue to grow at a reasonable pace.

Employment data pulled back during the first two months of the quarter, but the June number was well above expectations, quelling some concerns over sputtering employment growth. For the quarter, the average monthly employment gain was 144,000. While slower than the prior quarter, the number was significantly adversely impacted by the May gain of a mere 7,000. Another employment reading issued by ADP suggested a similar average gain, but with far less variability than the Bureau of Labor Statistics report. The unemployment rate closed the quarter at 4.9%, while the labor force participation rate continued to hover around a 35 year low. The underemployment rate remained at 9.7%, still grudgingly high and likely a major contributor to the subdued level of wage growth despite a very low official unemployment rate.

	Q2-2016	YTD-2016
Consumer Discretionary	-0.91%	0.68%
Consumer Staples	4.63%	10.46%
Energy	11.62%	16.10%
Financial	2.12%	-3.05%
Healthcare	6.27%	0.42%
Industrial	1.40%	6.46%
Information Technology	-2.84%	-0.32%
Materials	3.71%	7.46%
Telecommunications	7.06%	24.85%
Utilities	6.79%	23.41%

Consumer spending picked up during the quarter as multiple data points suggested consumers shook off their winter doldrums and began spending some of their “energy savings” on discretionary purchases. We have been awaiting a surge in consumer activity fueled by lower energy prices and steady employment. Whether the Q2 jump in activity is the beginning of a new trend or just a temporary spike remains to be seen. However, given the likely headwinds in the manufacturing sector, stronger consumer spending becomes incrementally more significant in driving aggregate activity.

Finally, housing activity remains healthy and inventory levels remain well below long-term averages. Combined with a rate environment that will likely remain very low for much longer than most anticipated only a few months ago, housing should continue to provide economic momentum for the remainder of the year. ■

Bond Review & Outlook

The Brexit vote increased uncertainties in almost every facet of the economy and markets with the exception of one. In our view, the likelihood of the U.S. Federal Reserve hiking short-term interest rates for the remainder of the year is negligible. The uncertainties surrounding the impact on the Eurozone are cause for even looser policy, not tighter. Central Banks across the globe have been pumping liquidity into the financial system for the past year. This as the U.S. Central Bank has been attempting to unwind its monetary stimulus measures. After hiking rates in December, most analysts believe the U.S. would hike rates four more times in 2016. Expectations were reduced after the market volatility that greeted us at the beginning of the year. Now with even more uncertainty, reducing liquidity is likely the last thing the Federal Reserve will do.

The implications are that short-term interest rates will remain at current levels as the Fed will defer any policy changes to a later date when more clarity concerning the impacts of Brexit can be better quantified. We do not anticipate further Federal Reserve action until 2017. The determination will be in conjunction with an ongoing assessment of U.S. and global economic development. Long-term rates, which are driven more by market-based forces, will likely remain range-bound at very low levels as quantitative easing continues across Europe and investors seek the relative safety of government debt, particularly the U.S. Treasury.

During the quarter the 10-Year U.S. Treasury fell 0.30% to close at 1.49%, a level not seen since July of 2012.

Bonds rallied in price as yields fell across the yield curve, providing some of the best bond returns since 2014. ■

	Q2-2016	YTD-2016
Cash:		
T-Bill Index	0.06%	0.12%
Taxable Fixed Income:		
Barclays US Agg. Bond	2.21%	5.31%
Barclays Govt./Credit Int.	1.59%	4.07%
Barclays Govt./Credit Long	6.55%	14.33%
BofAML High Yield Index	5.88%	9.32%
Tax Exempt Fixed Income:		
Barclays Muni. 5–yr.	1.16%	2.32%
Barclays Muni. 7–yr.	1.70%	3.22%
Barclays Muni. TR	2.61%	4.33%

Stock Market Review & Outlook

The S&P 500 index traded in an exceptionally tight trading range during the quarter. Even during the heightened volatility of the final trading days with the large 2-day downward move, the index never moved more than 2.9% above or below the quarter-opening level. We believe the lack of clear direction or momentum is a function of two main drivers; first, investor uncertainty was elevated prior to the Brexit vote as global economic conditions remained mired in a slow-moderate pattern that appears unable to accelerate despite significant central bank intervention. Second, equity valuations still appear to be on the high side. While not in bubble territory, traditional valuation metrics suggest equity markets are pricing in reasonable earnings growth numbers, which if not achieved could suggest outright overvaluation. On a combined basis these conditions leave investors unwilling to drive valuation multiples higher, but at the same time do not warrant excessive pessimism.

Risk-based assets are also facing headwinds in the form of political uncertainty both here and abroad. We have touched on the potential geopolitical fallout associated with the Brexit vote, but here at home we are facing a presidential election that perhaps is unlike any in recent history. The sentiments of the populist vote that carried the day in the U.K. are similar to those of the electorate here who are in many ways tired of the status quo and are seeking a new direction. The strength of unconventional candidates like Donald Trump and Bernie Sanders clearly illustrates a discouraged electorate that is looking for a new direction as well. After the primaries, we are left with two presumptive nominees with very high unfavorability ratings, but for differing reasons. One is considered untrustworthy, while the other is thought to be erratic. The directions these two candidates would take the country are so vastly different, the resulting policies would clearly have an impact on both the short- and long-term market outlook.

Given the heightened volatility and declining interest rates, it was no surprise to see defensive and interest rate sensitive sectors continue their market leadership. The strongest sectors of the quarter included: Telecom, Utilities, Energy and Consumer Staples; while Information Technology, Financial and Consumer Discretionary sectors continued to struggle. European equity markets suffered the most with the Euro Stoxx 50 index declining by 6.20% over the quarter. Southern Europe fared the worst as concerns over Eurozone cohesion hurt the weakest members the most. Emerging markets in Asia held ground during the quarter while Latin America continued to improve dramatically. ■

	Q2-2016	YTD-2016
DJIA Index	2.07%	4.31%
S&P 500 Index	2.46%	3.84%
Russell 2000 Index	3.79%	2.22%
EAFE Index	-1.46%	-4.42%

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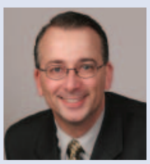

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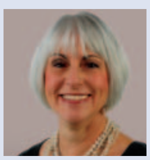

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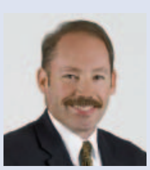

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Closing Thoughts

Defensively-postured portfolios continued to thrive in an environment of heightened volatility. High valuations in equity sectors such as Utilities, Consumer Staples and Telecommunications are driving an overall market valuation that is above average. Meanwhile, cyclical sectors such as Industrials and Information Technology appear reasonably valued. Investors' desire for income has been one of the driving factors behind this rotation. With interest rates unlikely to rise any time soon, and heightened global uncertainty, we do not anticipate these valuations to come under pressure in the short-term.

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. ■

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