Plimoth Investment Advisors®
INVESTMENT MANAGEMENT & TRUST SERVICES SPECIALISTS

FOURTH QUARTER – WINTER 2018

INVESTMENT SPOTLIGHT

"It's the same old story, same old song and dance, my friend" – Aerosmith

We wish a Happy New Year to all our clients and colleagues. While celebrating with friends and family over the holidays, if you were like us, the topic of financial markets may have come up in conversation. Discussing the stock market started to make its way back to office water coolers, taxi cabs and barber shops in the new year. Market pundits seem to have us talking more as higher levels of stock market volatility have garnered a fair share of headlines thus far in 2019. A question we are beginning to hear more frequently… "Is this the new normal for the stock market?" merits a decisive answer right up front. No. There is nothing "new" about market volatility whatsoever. Perhaps we as investors were lulled into a sense of complacency in calendar year 2017 which we look back on as an environment of 72 degrees and sunny all day every day. From our perspective, market conditions with the S&P 500 Volatility Index (VIX) at or around the long-term average of 20 is just a good old-fashioned "normal" environment for experienced investors.

With this context on market volatility in mind, there were certainly abnormal occurrences in 2018. Having cash as the best performing asset class in a calendar year is unusual, but certainly not unheard of on a short-term basis during a stock market correction, which we had not one, but two, during the year.

Certainly, what is not abnormal is any asset class providing the worst return in a calendar year (such as cash in 2017) moving up to one of the best in a subsequent year. Similarly, the best performing asset class in 2017, emerging markets equities, was the worst performing of 2018. The lesson is as old as investing itself; markets, asset classes, and industries are typically cyclical in nature, making the case for owning a well-diversified portfolio of assets for the long-term.

Geopolitical news led daily headlines across financial publications and media for much of 2018. Issues relating to global trade and tariffs between the U.S. and the rest of the world, particularly China, were prevalent throughout the year. Mid-term elections took place in the U.S. with Democrats taking control of the House and Republicans increasing Senate majority control. Gridlock in Washington gave way to dysfunction and is certainly center stage at the time of this writing as the U.S. government shut down enters a second month with little to no negotiation taking place. The European Union and U.K. have also garnered renewed attention as the Brexit drama, historic defeat in British Parliament and political crisis drags on. The 2019 World Economic Forum taking place in Davos, Switzerland may be best remembered for the number of world leaders who did not attend as they focus on turmoil in their home countries than those who did. ■

Economic Review & Outlook

Gross Domestic Product (GDP) in the U.S. grew by 3.4% in the third quarter, led by robust personal consumption of 3.5%. The drag from trade tariffs was more than offset by a pickup in inventories and government spending increases. Following 4.2% growth in Q2, these are the strongest two back-to-back readings since 2014. We stood by our forecast for 2018 economic growth exceeding 3%, the strongest in the current expansion, throughout the year. With Q4 growth median forecasts slightly north of 2.5%, we are poised to post a 3-plus percent growth figure for the year. The government shutdown will weigh on 2019 growth estimates to an increasing extent the longer the stalemate persists. Beyond the actual dampening effect, visibility into the economy becomes cloudier by the week as government agencies which provide key economic data remain closed. We agree with the consensus view of economists that 2018 may prove to be the peak of earnings growth, but are by no means calling for a near-term recession. 3.4-4.2% quarterly GDP releases are highly unlikely to be the norm going forward, but there is plenty of data to support the idea that a slow and steady march into the longest economic expansion in history will continue. Our base case estimate for 2019 is for a steady, albeit slower rate of growth of 2.0-2.5%, in line with the cycle average.

Labor markets remained tight in 2018 with roughly one job available for every person seeking employment at year end. Headline unemployment ticked up modestly to 3.9% in December from the multi-decade low of 3.7% reported through much of the year. One of the keys to our positive economic growth forecast for 2018, a reemergence of wage growth, came to fruition as well. The anemic range of 2.5% wage growth reported through much of the year (and throughout the current economic cycle) ticked up to 3.15% by year end. This is a positive development, despite still being well off the long-term average of over 4%. For wage growth to continue its upward trajectory, producers will need to gain incremental pricing power to pass through costs to consumers.

Inflation remained squarely in check last year. The Consumer Price Index (CPI) through December advanced 1.9% on a year-on-year basis, led lower by a falloff in oil prices. Core CPI (excluding food and energy) was 2.2%, right in line with expectations. The Fed's preferred bogie for inflation, Personal Consumption Expenditures (PCE) expanded by 1.8% and 1.9% for the Core reading. Pricing pressure at the consumer level for transportation, housing, medical costs and apparel were tame. Inflation hawks found little to support their arguments in 2018.

Oil prices fell 38% in the fourth quarter, the worst quarterly pullback since the precipitous slide of 2014. Crude prices reached a four-year high of over $76 in October before sliding off the proverbial cliff. The agreement by OPEC countries to cut production in early December put a temporary and short-term stop to the pain before prices took another leg down. An unexpected waiver on U.S. sanctions on the purchase of Iranian oil along with production increases in the U.S., Russia and Saudi Arabia weighed heavily on the commodity. U.S. crude oil production hit a new record at the time of this writing, approaching 12 million barrels per day. With the U.S. production taps wide open, we aren't expecting much price appreciation anytime soon from the current mid-$50 level.

	Q4-2018	YTD-2018
Communication Services	-13.2%	-12.5%
Consumer Discretionary	-16.4%	0.8%
Consumer Staples	-5.2%	-8.4%
Energy	-23.8%	-18.1%
Financials	-13.1%	-13.0%
Healthcare	-8.7%	6.5%
Industrials	-17.3%	-13.3%
Information Technology	-17.3%	-0.3%
Materials	-12.3%	-14.7%
Utilities	1.4%	4.1%

30-Year fixed mortgage rates that peaked over 5% in the latter half of 2018, combined with strong price appreciation on limited inventory, weighed heavily on the housing market. Housing stood alone last year as an area of economic weakness in the U.S. Data releases went from bad to worse for Existing Home Sales through Starts and Permits. A recent pullback in interest rates and slowing of home prices from an unsustainable trajectory offer home buyers a glimmer of hope in the new year. Manufacturing indices as measured by ISM pulled back modestly toward year-end from record highs while remaining comfortably in expansionary territory. The "bend but not break" environment for manufacturers is analogous to our 2019 outlook for overall U.S. economic growth. ■

Bond Market Review & Outlook

The Federal Open Market Committee (FOMC) raised the short-term Fed Funds rate four times in calendar year 2018 for a total of nine hikes in the current cycle. The target rate now stands at 2.25-2.50%. Perhaps no measure took as circuitous a path over the past year as the expectations for future rate hikes visible in the futures market. Traders followed the lead of the FOMC "dot plot" forecast expecting as many as three additional rate hikes in 2019. These nearly certain expectations of continued rising rates shifted in a matter of weeks to nearly off the table. As the markets softened, so did the Fed's message about plans for further monetary tightening. The Fed language on being "flexible" and "data dependent" struck a more dovish tone, as did comments on balance sheet reduction shifting from "auto-pilot" to more flexible if "necessary". Our base case assumption at present is for the Fed to stand pat on rates for the first half of 2019, perhaps electing to continue with one incremental hike later in the year only if economic data heats up and equity markets prove to be healthy and stable.

Treasury yields fluctuated throughout the calendar year along with risk on/off sentiment. The yield on the 10-Year U.S. Treasury started 2018 at the low for the year of 2.46%, traded at a peak high of 3.23% in the fourth quarter before closing the year meaningfully lower at 2.68%. The spread between the 2-Year and 10-Year Treasury flattened over the course of the year, closing at a historically tight 0.18%.

Returns on fixed income investments, while far less volatile than equities, were certainly nothing to write home about. The Barclays Agg index was flat for the year, short to intermediate bonds provided positive returns of sub 1%, while municipals were not much better at just over 1%. Taking on incremental credit risk into high yield or duration risk with longer maturities pushed returns into negative territory. We continued to focus on high quality bonds on the short end of the curve throughout the year with little to no risk premium available for extending maturity.

	Q4-2018	YTD-2018
Cash:		
FTSE 3 Mo. T-Bill Index	0.6%	1.9%
Taxable Fixed Income:		
Barclays US Agg. Bond	1.6%	0.0%
Barclays Govt./Credit Int.	1.7%	0.9%
Barclays Govt./Credit Long	0.8%	-4.7%
BofAML High Yield Index	-4.7%	-2.3%
Tax Exempt Fixed Income:		
Barclays Muni. 5 Yr.	1.6%	1.7%
Barclays Muni. 7 Yr.	2.0%	1.7%
Barclays Muni. TR	1.7%	1.3%

Stock Market Review & Outlook

A pronounced sell off across risk assets in the final quarter of the year solidified a year of negative returns for equities. The worst Christmas Eve sell off on record was followed by a massive recovery and multiple gyrations later in the week, but the stock market was unable to break out of negative territory. For the calendar year the S&P 500 Index was lower by -4.4%. The riskier Russell 2000 Index of small cap stocks was down by -11.0%. The NASDAQ Composite was unable to hold on to significant gains in technology shares from earlier in the year, ending lower by -2.8%. International equities pulled back more than the U.S. with the MSCI EAFE Index down by -13.8% and MSCI Emerging Markets Index off by -14.6%.

Our view of a year ago of the continued attractiveness of international markets is one of the areas we missed the mark in our base case. As equity volatility heightened from benign levels, we gradually shifted our attention toward income and away from capital appreciation in the context of total return. Higher dividend paying stocks along with attractively priced preferred stocks offered an added margin of safety we took advantage of throughout the year.

The higher yields offered by Utilities stocks dampened volatility and was one of only a few sectors of the U.S. market providing investors with a positive total return, up 4.1%. Healthcare (another defensive sector) had the strongest returns, up 6.5% in the same period. Despite a significant pullback in Consumer Discretionary stocks in the fourth quarter, the sector held on to enough gains to stay in the black for the year by 0.8%. The previously high-flying Information Technology sector however, finished modestly in the red by -0.3%. Energy was again the worst performing sector in the quarter and calendar year, down by -18.1% followed by Materials off by -14.7%. Fortunately, our average portfolio exposure to these two sectors was quite modest during the year.

	Q4-2018	YTD-2018
DJIA Index	-11.3%	-3.5%
S&P 500 Index	-13.5%	-4.4%
Russell 2000 Index	-20.2%	-11.0%
MSCI EAFE Index	-12.5%	-13.8%

Valuations of U.S. equities became more attractive at year end as a function of both price declines as well as strong corporate earnings. The S&P 500 now trades at a multiple of 17.2x current and 14.7x forward earnings. With the amount of negative spin provided by financial press, it would be understandable for investors to not be focused on the fact that the S&P 500 at the time of this writing has advanced by over 13% since the lows of Christmas Eve. With a multi-year time horizon, we expect to be rewarded over time with a high single digit return for large cap U.S. equities once the near-term peaks and troughs settle down.

Closing Thoughts

Market returns certainly do not move in lockstep with economic fundamentals over short periods of time. While we would describe our investment team more as “students” than “prognosticators” of near-term financial markets moves and economic data releases, we find value in setting our own expectations with a macroeconomic base case on an annual basis. In hindsight, we are pleased to have hit the mark a year ago on a number of areas including: above cycle trend U.S. economic growth, lower unemployment, improved wage growth, subdued inflation, higher corporate earnings growth and modest S&P 500 P/E compression. We would be remiss however to not acknowledge missing the mark on expecting the trend of a shortfall in first quarter GDP to be broken, an increase in U.S. productivity and a continuation of positive U.S. equity returns in line with corporate earnings. The goal of creating a base case however, is not about creating an annual report card. It has more to do with grounding our weekly strategy discussions with core expectations and looking for contrary or affirming data points to help us identify potential inflection points in prevailing trends.

With that description in mind, we begin 2019 positioning for our base case of 2.0-2.5% GDP growth, a stable Fed Funds target of 2.25-2.5%, perhaps rising a quarter of a percent, a range bound yield on the bellwether 10-Year U.S. Treasury of 2.75-3.25% as further economic data becomes available and an S&P 500 experiencing above trend volatility while offering investors with a long-term horizon suitable high single digit returns over time.

We remain convinced that the current economic expansion becomes the longest in U.S. history in 2019. The U.S. economy will continue to grow, even if not at the pace the staunch bulls are hoping for. Corporate profits are unlikely to set new records, but from the phenomenal run they’ve had, there is still plenty of good (even if not great) news to come in our view. We will be vigilant in reassessing our view on an ongoing basis and positioning portfolios with the most optimal asset allocation.

If we can be of assistance to you along the way, 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.

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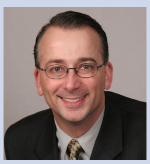

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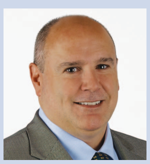

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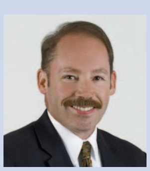

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