Plimoth Investment Advisors®

INVESTMENT MANAGEMENT & TRUST SERVICES SPECIALISTS

THIRD QUARTER – FALL 2014

INVESTMENT SPOTLIGHT

"Traders can cause short-term volatility. In the long run, the market must revert to a sensible price/earnings multiple." – Ben Stein

With the exception of the opening 5 weeks of the year, during which the S&P 500 declined by 5.8%, the first half of the year experienced a relatively steady increase in equity values with very low volatility. This is comforting to long-term investors, yet frustrating for short-term traders who need volatility to generate trading profits. We will define volatility as movements up and down in the stock market. Improving U.S. and European economic data, stabilization in the Chinese economy and low interest rates provided the backdrop for positive flows of funds into equities and what's known in the industry as a "risk on" sentiment among investors. Volatility increased and equity markets softened during the month of July as investors became wary over heightening hostility in the Ukraine and the potential adverse impacts of more significant trade sanctions between Russia and Western nations. Volatility dropped again in August, and the equity market subsequently rebounded. Since the end of August, volatility has been steadily on the rise, and equity markets have traded with greater magnitude, positively and negatively.

While long-term investors view this volatility with a certain degree of anxiety, concerned over whether large declines on a particular trading day are harbingers of a more pernicious market downturn, short-term traders relish the volatility as an opportunity to generate trading gains. There is no doubt that headlines have delivered several opportunities to generate fear and its market companion volatility. Between continuing violence in the Middle East, downgrades in global growth forecasts, concerns over Central Bank's ability to foster economic activity and the nightly updates on the status of the Ebola virus, traders have had greater opportunities to generate profit.

We expect the heightened volatility to continue into the end of the year. The current concerns will more than likely continue with the added impact of U.S. midterm elections and the critical early reports concerning the holiday shopping season. While we continue to believe U.S. stocks are trading at a reasonable multiple of earnings, the headlines will most certainly provide enough anxiety to foster enhanced volatility. ■

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Economic Review & Outlook

After posting a 2.1% decline in the first quarter, U.S. Economic activity took a decidedly sharp turn higher during the second quarter, with GDP growth of 4.2%. The unevenness of growth has become emblematic of the recovery, leaving investors and the general public with an uncertain feeling concerning future prospects. Recent economic activity suggests that we may in fact break out of this "two steps forward one step back" economic growth cycle. After a robust 2nd quarter, multiple economic data points suggest the economy continued to grow with significant vigor in the third quarter.

A continuation of strong manufacturing activity provides the brightest hope for continued economic expansion. ISM Manufacturing activity has now

posted 22 consecutive months of growth, with the last 6 months being among the strongest. Unlike other periods of heightened manufacturing activity, this time inventory levels are remaining stable and relatively low, suggesting manufacturing activity will continue.

Technically, the end of the quarter marked the 63rd month of the recovery, 5 months longer than the average recovery post World War II. Many Americans, however, may find the concept of recovery difficult considering that in aggregate they have yet to see evidence of the improvement in their paychecks. While the unemployment rate has dropped from the recession-high peak of 10.0% down to 5.9%, the employment situation remains challenging. The underemployment rate, which tracks those without jobs, in addition to those working multiple part-time jobs or working below their skill level, remains grudgingly high at 11.8%. Meanwhile, the labor-force participation rate dropped to 62.7%, the lowest reading since 1978. What does all this mean? While the employment picture has improved, and job creation has shifted higher in 2014, significant slack still remains in the labor force. As long as this slack exists, employers, on average, will not be competing for labor inputs and wage growth will continue to be constrained.

Previously during this economic recovery, businesses had been hesitant to add both human capital, as measured by employment, and physical capital such as plants, equipment, technology, and other inputs needed in the production of goods and services. On both accounts, businesses now appear more willing

to deploy capital in order to bolster long-term production capacity and improve operating efficiency. Thus far in 2014, not only have businesses hired more, but they have also spent more on building infrastructure. Real non-residential fixed investment increased by 9.7% in the second quarter along with an 11.2% increase in equipment purchases. These are well above prior quarter levels and the general level of investment during the recovery.

Consumer spending has remained relatively steady over the past few years. As the employment picture improved, consumers maintained a reasonable level of consumption, and began using revolving credit more aggressively after cutting back significantly during and after the recession. While not robust, the spending has been sufficient to drive modest GDP growth. After cooling in May of 2013, housing activity remains subdued. Despite record-low borrowing costs, the increase in mortgage rates from the spring of 2013 has sidelined some buyers. Improving prices may have also pushed activity lower, particularly for investors who were snapping up properties at bargain prices for rental income.

All things considered, the overall U.S. economic picture looks stronger than the same period last year; however, headwinds remain. A recent surge in the value of the U.S. dollar will certainly have an adverse impact on export activity in the coming quarters. European economic struggles in the latter half of the summer and elevated concerns from China resulted in a downgrade of the International Monetary Fund's 2015 global growth expectations from 4.0% to 3.8%. ■

S & P 500 Sector Performance

	Q3-2014	YTD-2014
Consumer Disc.	0.26%	0.86%
Consumer Staples	1.95%	7.23%
Energy	-8.62%	3.24%
Financial	2.33%	7.42%
Healthcare	5.46%	16.62%
Industrial	-1.09%	2.87%
Info. Technology	4.77%	14.13%
Materials	0.22%	8.87%
Telecommunications	3.07%	7.47%
Utilities	-3.96%	13.95%

Bond Market Review & Outlook

	Q3-2014	YTD-2014
Cash:		
T-Bill Index	0.01%	0.02%
Taxable Fixed Income:		
Barclay's Agg. Bond	0.17%	4.10%
Barclay's Govt./Credit Int.	-0.03%	2.22%
Barclay's Govt./Credit Long	1.04%	12.97%
BofAML High Yield Index	-1.92%	3.61%
Tax Exempt Fixed Income:		
Barclay's Muni. 5 Yr.	0.79%	3.10%
Barclay's Muni. 7 Yr.	0.96%	5.23%
Barclay's Muni. TR	1.49%	7.58%

The bond market has also seen its share of volatility, particularly during the end of the third quarter. Over the first half of the year, long-term bonds rallied, driving yields lower. Despite the fact that the Federal Reserve began the process of ending quantitative easing, falling global yields drove investors to U.S. Treasuries. The European Central Bank, eager to foster a stronger growth environment embarked on policies similar to those undertaken by our own central bank. This drove yields down on European Sovereign Bonds, in many cases well below comparative U.S. yields.

As the summer months passed, it was clear the Federal Reserve would end quantitative easing by October, with the next question being "when would they begin increasing short-term rates?" Estimates on the timing of a Fed rate increase went from June of 2015 to March of 2015 as more data emerged concerning the firming of the U.S. economy. Short-term interest rates began to rise on these expectations, while the long end of the curve remained low, causing a flattening of the yield curve. Long-term rates began to move higher toward the end of the quarter, but then fell back as concerns mounted over global growth and the potential impact on the U.S. economy.

The Federal Reserve has long used the unemployment rate as a key factor in policy decisions. While the Fed remains committed to using employment data, it appears as though the scope of review has broadened. In the minutes of the last Fed meeting, there were references to continued "slack" in the labor markets resulting from underemployment and weak participation. The slack in the labor market helps keep a lid on wage growth, a key component of inflation. In addition to the slack in the labor market, the Fed also cited concerns over what impacts faltering growth in Europe and the global economy could mean for the sustainability of U.S. growth. Finally, the Fed discussed policy implications on developing nations that have the potential to fuel above average growth, yet require access to inexpensive capital. All things considered, while there is more evidence of diverging opinions among Federal Reserve Governors, the minutes from the last meeting suggest a more dovish Federal Reserve approach, which will incorporate a wide spectrum of data into the policy making decisions. This will not be a binary relationship in which interest rate decisions are pegged to the unemployment rate. As such, we believe interest rates will remain grudgingly low well into 2015. This is bad news for savers and good news for borrowers and investors who were concerned about rising interest rates. ■

Stock Market Review & Outlook

With the exception of January, equity markets moved generally higher during the year through the end of June. Markets slid modestly in July, only to recoup the losses and continue higher in August. After reaching a record high on September 18 of 2,011 on the S&P 500, equity markets began to move with much more volatility and took a decidedly sharp bearish tone in the process. For the month of September, the S&P 500 lost 1.55%, bringing the quarterly return down to +0.63%. The sharp increase in volatility was notable as investors had become accustomed to low volatility and steadily rising markets. To be sure, equity markets are by nature volatile, sometimes more than others. What we have begun to experience now, while

disconcerting, is not to be unexpected; rather, prolonged calm is the exception to the norm. While we are not surprised by the increase in volatility, we do seek to understand the rationale of the uptick and determine whether or not it is driven by factors that may adversely impact the real economy, and thus our valuation assumptions concerning the equity market.

As mentioned earlier, the increase in volatility can be attributed to several factors both economic and geopolitical. The struggles of the European economy and the ECB's efforts to promote growth and fight deflation are at the front of the line with respect to real economic concerns, while China remains a close second. On the geopolitical front, the tensions between Russia and the Ukraine remain atop our list of concerns, as trade sanctions imposed will no doubt suppress activity in regions that are still struggling to promote growth. The spread of ISIS across Syria and Iraq remains a constant reminder of the unrest in the Middle East, and potential adverse impacts on energy markets.

At the beginning of 2014 we characterized the equity markets as fairly valued vis-à-vis earnings, and thus anticipated equity market appreciation consistent with earnings growth. Through the end of September equity market performance was consistent with these expectations. We continue to believe the equity market is "fairly valued" and maintain an upward bias for equities. However, we recognize that periods of "fair value" markets tend to be more susceptible to headline risk, of which we have no shortage of now, or in the near future. We expect equity markets to continue to trade with a heightened level of volatility into the final quarter. These worrisome headlines will battle with the next round of earnings which should provide some reason for optimism based on analyst forecasts.

	Q3-2014	YTD-2014
DJIA Index	1.87%	4.60%
S&P 500 Index	1.13%	8.34%
Russell 2000 Index	-7.36%	-4.41%
EAFE Index	-5.83%	-0.99%

Should some of these items of current concern intensify in the coming months, and have a substantial adverse impact on global growth, then the presumption of "fair value" will need to be re-assessed. At this point, we are viewing the current volatility and market pressure as a normal component of a bull market that "consolidates" from time to time, then moves higher. ■

Introducing Jeffrey Carter

Jeffrey Carter
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Plimoth Investment Advisors is pleased to announce the addition of Jeffrey Carter to the Investment Management Team. Jeff brings over 23 years of experience in the financial services industry to his new position as a Vice President Investment Officer. He has extensive experience guiding client investment strategies in both foreign and domestic equities, as well as in regard to fixed income, emerging markets, and other investment strategies.

We are all very excited to welcome Jeff to the Plimoth Investment Advisors team and are confident he will provide our clients with the highest possible level of investment expertise.

Closing Thoughts

While we remain generally more optimistic about t he domestic growth picture, we cannot discount the impacts of overseas activity. Europe remains mired in a battle to simply avoid falling back into recession while Asian economies remain tied to Chinese growth prospects. We are also anxiously awaiting the results of mid-term elections which will most certainly set the political climate here for the next two years. Finally, we are not at a loss for geopolitical issues to consider: Russia, Ukraine, ISIS and China to name a few.

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 contact us. ■

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.