Plimoth Investment Advisors®

INVESTMENT MANAGEMENT & TRUST SERVICES SPECIALISTS

THIRD QUARTER – FALL 2018

INVESTMENT SPOTLIGHT

"The longest game in baseball took place at McCoy Stadium on April 18, 1981, lasting 33 innings over eight hours requiring a game halt and restart the following day. The Pawtucket Red Sox edged past the Rochester Red Wings to a 3-2 victory"

The stock market continued running during the third quarter, straight through the milestone of the longest U.S. equity bull market in recorded history. Now what? This question, typically in the form of a baseball game-inning analogy has been posed to members of our team numerous times this year. This is certainly apropos with the Red Sox having finished the regular season with the most wins of any team in Major League Baseball and playing for another World Series championship once again at the time of this writing. While we prefer not to speak in absolutes when making forecasts, when pressed for a number we would say that U.S. equities seem to be comfortably emerging from the seventh inning stretch. We are quick to follow-up however (with tongue in cheek) that this game could very well be poised for extra innings, albeit not to the degree of the "longest game" back in 1981.

While this analogy makes for interesting cocktail party talk, it requires some elaboration to tie in the the extended economic cycle we are currently enjoying (the second longest in history) with the stock market run and evolving interest rate cycle. Read on for more detail of the many factors that guide our view. ■

Economic Review & Outlook

Gross Domestic Product (GDP) in the U.S. was rock solid at 4.2% annualized in the second quarter. The measure of total goods and services produced in the United States was built on a strong foundation of personal consumption up 3.8%, with consumer confidence hitting the highest level since 2000. Small business owners surveyed by the National Federation of Independent Businesses (NFIB) also reported feeling the most optimistic in the history of the survey going back to the 1970s. Business Fixed Investment was strong at 7.3%, led by structural investment, equipment and technological enhancements. While an annualized GDP reading over 4% will be hard to repeat, we remain optimistic about the prospects for U.S. economic growth. As expected, we saw impacts in the third quarter data from the devastation of Hurricane Florence much like past storms. Initial pullbacks in consumption impacting restaurants and other discretionary spending are expected to be offset by purchases related to structural repairs and rebuilding in the final quarter of the year. Despite a slowdown in headline Retail Sales figures released in the third quarter, the critical components which comprise the "Control Group" that factor directly into GDP (excluding restaurants, autos, gasoline and building materials) remain positive.

There is no stronger component of the U.S. economy at present than employment. National unemployment stands at 3.7%, the lowest since the 1960s. Per the latest Job Openings and Labor Turnover Survey (JOLTS), available jobs reached a new record of 7.14mm. The hires-to-openings ratio dropped further to 0.8, the lowest data point

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	Q3-2018	YTD-2018
Consumer Discretionary	8.18%	20.64%
Consumer Staples	5.70%	-3.34%
Energy	0.61%	7.46%
Financials	4.36%	0.09%
Healthcare	14.53%	16.63%
Industrials	10.00%	4.48%
Information Technology	8.80%	20.62%
Materials	0.36%	-2.73%
Telecommunications	9.94%	0.75%
Utilities	2.39%	2.72%

in the history of the survey which began in 2001. The reading indicates that the number of unemployed workers is well below unfilled positions. The voluntary quit rate climbed to a new high as well and wage growth improved at a pace not seen since 2009. Economists continue to wave red flags that such strength should be expected to lead to a spike in inflation, but we interpret the data as squarely in check.

The Federal Reserve's preferred measure of inflation, Core Personal Consumption Expenditures (PCE), is spot on with their target of 2%. The Core Consumer Price Index (CPI) figures pulled back to 2.2% on a year-on-year basis after creeping higher in prior months. The latest headline report at 2.7%, which includes food and energy, had modest contraction in medical costs and apparel prices along with only a slight rise in food costs. Housing and energy prices stand as the exceptions, rising far faster than other components.

Oil prices spiked during the quarter. OPEC initially left production steady while traders speculated that U.S. sanctions against Iran and outages in Venezuela would lead to supply shortages. Production in the U.S. has trended upward however, as would be expected during a period of rising prices, restraining further price increases based on the simple law of supply and demand. Speculators will continually read into global events, particularly in the always volatile middle east, trying to front run short-term price movements, but the longer-term fundamentals don't point to a continuation of a rising price trend in our view.

Standing in stark contrast to the employment situation in the U.S. is housing. The monthly data reports have gone from bad to worse with Existing Home Sales declining and missing estimates for six consecutive months to lows not seen since November 2015. Building Permits and Housing Starts paint a similarly weak picture on a forward-looking basis. The latest report of new mortgages pulled back by a seasonally adjusted 6%, while refinancing applications fell 9%. Average 30-year mortgage rates greater than 5% are weighing on borrowers. Modest inventory levels of lower-end homes available for sale combined with price appreciation well ahead of wage growth are ongoing headwinds. It is difficult to see a sustainable recovery to housing activity without a meaningful price correction.

Despite the challenges within the housing sector, our near-term outlook for the U.S. economy remains positive. The U.S. is leading the developed world in growth and stock market returns which we view as justified. Budget deficits continue to concern us and a seemingly endless supply of headlines from Washington to around the globe need to be considered. After synthesizing the available sea of data points, we remain positive on economic growth based on the core fundamental factors we follow closely and discuss regularly. ■

Bond Market Review & Outlook

The Federal Open Market Committee raised the short-term Fed Funds rate in September by 0.25% to a target of 2.00-2.25%. This was the third rate hike in the calendar year and eighth in the current cycle. It bears mentioning that the Fed Funds Rate now exceeds the Fed's target rate for inflation of 2%. With a fourth rate hike in 2018 widely expected and further increases in the pipeline for 2019, financial markets volatility is likely to be a side product of the Fed's efforts to keep inflation and growth in check. A continued unwinding of mortgage-backed and Treasury bonds from the Fed balance sheet should further stoke the flame of volatility, acknowledging that with this activity no historical precedent exists.

Yields on the bellwether 10-Year U.S. Treasury increased from 2.86% to 3.06% after reaching an intraday high of 3.11% during the quarter. This level looks well behind in the rearview mirror at the time of this writing after having run up to a high of 3.23% since quarter end. The yield on the 2-Year Treasury has more than doubled since the time of the U.S. Presidential election, ending the quarter at 2.80%. Despite some modest steepening during the quarter, the yield curve remains flat with the spread between the 2-Year and 10-Year Treasury ending September at 0.26%.

Returns on fixed income investments have been lackluster but, given the rising rate environment, have performed better than expected. Shorter maturities outperformed longer and higher yielding bonds caught a bid along with other risk assets.

We continue to believe focusing on high quality corporate bonds will best serve our investors; owning bonds with the highest likelihood of return of principal at maturity as opposed to chasing yields of riskier fixed income investments. We are continuing to focus on short to intermediate term bonds because the risk premium to lock up capital with longer maturities remains unattractive. ■

	Q3-2018	YTD-2018
Cash:		
FTSE 3 Mo. T-Bill Index	0.50%	1.29%
Taxable Fixed Income:		
Barclays US Agg. Bond	0.02%	-1.60%
Barclays Govt./Credit Int.	0.21%	-0.76%
Barclays Govt./Credit Long	-0.47%	-5.42%
BofAML High Yield Index	2.44%	2.52%
Tax Exempt Fixed Income:		
Barclays Muni. 5 Yr.	-0.20%	0.10%
Barclays Muni. 7 Yr.	-0.11%	-0.36%
Barclays Muni. TR	-0.15%	-0.40%

Stock Market Review & Outlook

The S&P 500 posted a very solid return in the third quarter, up 7.7% for the period, bringing the year-to-date return to 10.6%. The NASDAQ Composite was equally strong for the quarter, up 7.4% and 17.5% year-to-date. Growth stocks' dominance over value continued with the Russell 1000 Growth Index outpacing the Value Index by a full 13 percentage points through the first three quarters of 2018.

Healthcare stocks rallied in the third quarter driven by rising profits at major drug manufacturers. Strong earnings from some of the largest information technology and industrial companies drove stock returns in those sectors and telecommunications stocks recovered losses incurred earlier in the year. Interest in domestically-oriented small cap stocks waned a bit in the quarter along with sentiment on global trade, but the asset class returns thus far this year remain impressive. International and emerging markets stocks did not fare as well as U.S. equities. Recall that Brexit (Britain's vote to exit the European Union) is still far from resolved and news of financial conditions in Italy continue to worsen. Emerging markets companies with large dollar-denominated debt are facing headwinds from rising rates in the U.S. and a stronger dollar.

	Q3-2018	YTD-2018
DJIA Index	9.63%	8.83%
S&P 500 Index	7.71%	10.56%
Russell 2000 Index	3.58%	11.51%
MSCI EAFE Index	1.35%	-1.43%

Corporate profits in the U.S. continue to impress investors, including us. After eight consecutive quarters of positive earnings growth, the latest earnings season for S&P 500 companies, at well north of 20%, showed continued strength. Despite strong returns in the quarter, valuations for the S&P 500 edged upward only slightly to 20.9x on a trailing 12-months basis due to strong underlying earnings growth. With implied growth surpassing 15%, the forward price to earnings (P/E) ratio is an attractive 17.7x. If earnings keep pace, the bull run looks to have ample remaining legs. That being said, heightened equity volatility like we have seen thus far into the fourth quarter should be expected to be the norm, rather than the exception.

Our near-term outlook for U.S. equities remains favorable given an improved valuation picture thanks to continued strength in corporate profits. Stock buybacks in 2018 are expected to surpass the single year record of $650 billion set in 2007 which serves as an additional ongoing tailwind for stock prices. Despite periodic volatility spikes, we stand behind the positive view of equities cited in previous letters leading up to the milestone of reaching the now longest bull market in history. ■

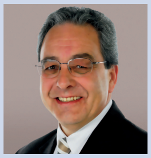
Closing Thoughts

Attention grabbing headlines (also known as “click bait” for our more technology-oriented readers) about pending recession may get reader views, but the message will have to wait in our opinion. Risks of further global trade tensions and tariffs, the renegotiation of trade deals, a revised North American Free Trade Agreement (NAFTA) now known as the United States Mexico Canada Agreement (USMCA) sneaking in under the wire during the quarter, ongoing geopolitical concerns between the U.S. and Russia, China and Saudi Arabia atop a growing list are all factors that may cause another pull back in equity markets. We will continue to keep these factors in mind, and in perspective relative to favorable economic fundamentals, as we manage client capital with a long-term “extra inning” mindset and make strategic adjustments along the way as warranted.

If we can be of assistance to you along the way, please do not hesitate to call us at the numbers provided. And good luck to our hometown Boston Red Sox team. ■

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.

Meet the Plimoth Investment Advisors Executive Leadership Team



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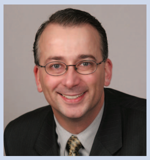

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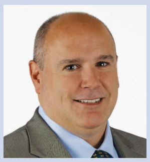

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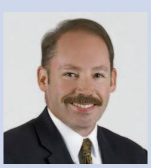

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