Plimoth Investment Advisors®

INVESTMENT MANAGEMENT & TRUST SERVICES SPECIALISTS

THIRD QUARTER – FALL 2019

INVESTMENT SPOTLIGHT

"Someone's sitting in the shade today because someone planted a tree a long time ago."
– Warren Buffet

An unremarkable return of 1.7% for the S&P 500 Index in the third quarter masked a roller coaster ride fit for the most adventurous thrill seekers. Equity indices tested new all-time high levels in July, pulled back in a risk-off period that saw capital flood into the safety of Treasury bonds, then recovered strongly. Rising bond prices led to a precipitous pull back in yields and a cautionary inversion in the yield curve with the yield on the 10-Year Treasury dropping below that of the 2-Year. The 30-Year Treasury Bond reached a new historic low yield, temporarily dropping below 2%. Headlines including the dreaded "R word" (recession) quickly followed. Although there is a lack of supporting evidence to say a yield curve inversion leads to recession, such occurrences have been coincident with consecutive quarters of declining economic growth (an average of 18 months out) five of the last six times over the past 50 years. Fortunately, the anomaly proved to be temporary in nature. Stocks regained strength in the final month of the quarter, led higher by previously out of favor value-oriented stocks. When the closing bell rang on the final trading day of the quarter, U.S. equities were only modestly higher from where they started the period.

There was plenty to keep adventure seekers engaged in the rate markets as well. After raising short-term rates nine times in a tightening cycle that began in December 2015, the Federal Open Market Committee (FOMC) dramatically shifted course and cut rates for the first time in over a decade in July, then again in September. A divergence of Committee member opinions flushed out by the ambiguous "dot-plot" of forward expectations kept the journalists busy. They followed around Fed Governors taking to the speaking circuit and clouding the official message from the Chairman with disparate personal opinions. The normally off-the-radar overnight repo market made headlines as well with the NY Fed infusing billions of dollars per day starting in mid-September to mitigate short-term rate spikes caused by a shortage in overnight bank loans.

Beyond the on-again off-again trade war threats between the U.S. and China, the political theater in Washington ramped up further by quarter end with a call for Presidential impeachment. A missile and drone attack on a Saudi oil facility caused a dramatic 20% single-day spike in oil prices that normalized soon thereafter, and the U.S. dollar continued to strengthen as rates around the globe fell further than those in the U.S. With the amount of negative yielding debt around the world (yes… paying governments and companies to borrow money for the promise of keeping it safe and returning most of it at a later date) totaling $15 trillion, even the paltry yields offered by U.S. Treasuries looked quite attractive to overseas investors and U.S. dollars were needed to purchase them. ■

Economic Review & Outlook

Real Gross Domestic Product (GDP) in the U.S. pulled back to a post-recession trend level of 2.0%. Personal Consumption was a critical positive contributor at 4.6%, the highest recorded consumer spending level since 2014. Retail Sales proved to be stronger than anticipated. Business Fixed Investment however, declined modestly for the first time in three years. Companies have been reticent to commit to funding long-term initiatives amid a trade war that changes from one tweet to the next. Declining inventories weighed on economic growth as well, but the pull-back may serve as a positive catalyst in upcoming Q3 growth figures as restocking shelves will require a boost in the production of goods.

The unemployment rate in the U.S now stands at 3.5%, the lowest level since 1969. Despite tight labor markets and the recurring concern cited by business owners of challenges related to filling positions with appropriately skilled workers, wage growth reversed what had been an improving trend in the latest report. After 12 months of reasonable 3+ percent growth in wages (healthy albeit below long-term trend) the September reading ticked down to 2.9%. Whether it was from a modestly rising paycheck or savings, the consumer none-the-less kept their wallets open and credit cards busy.

Inflation remained squarely in check during the quarter and below the Fed's 2% target on its preferred measure of Personal Consumption Expenditures (PCE). The latest Core PCE (excluding volatile food and energy prices) reading came in at 1.6% on a year-on-year basis, right in line with where it had been and meeting expectations. The Core Consumer Price Index (CPI) was also steady at 2.4%. Some have argued that further rate cuts are justified, all the way to zero if necessary, until Core PCE hits the Fed target. We are of the belief that those espousing this highly dovish view should be careful what they wish for on this point. Once a fire gets going, you don't want to be left holding an empty extinguisher, which is the position the FOMC would be in with a zero-rate policy.

Manufacturing by all accounts has contracted in the U.S. The latest ISM Manufacturing Index fell to a 10-year low of 47.8, missing across the board on component estimates with particular weakness in production, backlog and exports. The report drew alarmist recessionary headlines while the detail that the GM strike shutting down plants and vehicle deliveries likely factored into the shortfall was tucked away on a subsequent page. The latest ISM Non-Manufacturing (Services) report was equally weak. The fall to 52.6 is a three-year low. The report raised concerns that slowing is not limited to factories in the U.S. There is no ambiguity from the data that manufacturing is slowing globally, including in the U.S., but the pullback looks more like a slowdown driven by uncertainty about global trade and tariffs than a fully blown production crisis.

	Q3-2019	YTD-2019
Communication Services	2.2%	21.7%
Consumer Discretionary	0.5%	22.5%
Consumer Staples	6.1%	23.2%
Energy	-6.3%	6.0%
Financials	2.0%	19.6%
Healthcare	-2.3%	5.6%
Industrials	1.0%	22.6%
Information Technology	3.3%	31.4%
Materials	-0.1%	17.1%
Utilities	9.3%	25.4%

A pullback in interest rates gave a boost to the housing market. Mortgage applications have been at multi-year highs for this time of year. Refinancing activity rose as 30-year fixed mortgage rates approached three-year lows. An increase in Housing Starts and Building Permits are positive forward-looking catalysts for the sector. ■

Bond Market Review & Outlook

Bonds rallied during the quarter with longer maturities outperforming stocks. The trend of rate cuts around the globe continued and found its way to the U.S. The FOMC cut the Fed Funds Rate twice, in 0.25% increments, in their July and September meetings back to a target rate of 1.75-2.00%. Fed Chairman Powell did his best to temper expectations priced into futures markets of multiple rounds of cuts and future easing measures, to no avail. Rates fell across the curve in dramatic fashion. The yield on the 30-Year U.S. Treasury reached a new record low of 1.98% as

capital flight to U.S. Treasuries drove prices up and yields down. The yield curve inverted across various maturities, some on a temporary basis and some continuing to persist such as the negative spread between the 3-Month Bill to 10-Year Note.

The Barclays Aggregate Index provided investors with a 2.3% total return in the quarter. Treasuries, Municipal Bonds Investment Grade Corporates and High Yield were all profitable holdings for the period, with the safest longer maturity bonds performing the best. Other interest rate sensitive investments such as preferred stocks and REITs were also strong contributors to portfolio returns. ■

	Q3-2019	YTD-2019
Cash:		
FTSE 3 Mo. T-Bill Index	0.6%	1.8%
Taxable Fixed Income:		
Barclays US Agg. Bond	2.3%	8.5%
Barclays Govt./Credit Int.	1.4%	6.4%
Barclays Govt./Credit Long	6.6%	20.9%
BofAML High Yield Index	1.2%	11.5%
Tax Exempt Fixed Income:		
Barclays Muni. 5 Yr.	0.5%	4.4%
Barclays Muni. 7 Yr.	1.0%	5.7%
Barclays Muni. TR	1.6%	6.8%

Stock Market Review & Outlook

U.S. stocks broke through to new all-time highs in July then pulled back in a risk-off shift before recovering to sustain a positive total return for the S&P 500 in the quarter of 1.7%. The gains added to already stellar results achieved earlier in the calendar year to a 20.6% return through September 30. The first three quarters of 2019 provided the highest return for the index since 1997. The recovery in the later part of the quarter may best be characterized as a "risk-off" rally as defensive sectors such as Utilities and Consumer Staples were the key drivers. Investors seeking the high dividend yields of utility companies were rewarded with a 9.3% return in the quarter as they were not alone in piling into the shares. The normally plain-vanilla Utilities sector has now outperformed for six consecutive quarters (the best since 1999), driving valuations well ahead of the overall market and their historical averages. The sustainable revenues of Consumer Staples companies (regardless of the economic environment) also attracted investors. The sector provided the second strongest return at 6.1%. The volatile Energy sector (-6.3%) and Healthcare (-2.3%) were negative in the period. The latter pulled back on increasing litigation and regulatory concerns weighing on company's bottom lines. The more cyclically-oriented Materials sector (-0.1%) was the only other segment of the S&P in the red.

	Q3-2019	YTD-2019
DJIA Index	1.8%	17.5%
S&P 500 Index	1.7%	20.6%
Russell 2000 Index	-2.4%	14.2%
MSCI EAFE Index	-1.1%	12.8%

Volatility in equity markets reignited at times during the quarter with steep declines and sharp rallies depending upon the flow of tariff-related headlines or tweets. U.S. Small Cap stocks pulled back in the quarter with the Russell 2000 Index returning -2.4%. Diversification into developed international and emerging markets stocks also detracted value during the period. A devaluation of the Chinese Yuan added additional loops and curves to the roller coaster ride investors in non-U.S. equities experienced.

Despite the higher prices in U.S. large cap stocks coming from multiple expansion rather than corporate earnings (facing difficult year-on-year growth comparisons from a stellar 2018) valuations are not particularly concerning. The Current Price / Earnings (P/E) multiple of 19.5x for the S&P 500 is lower than the trailing 3-year average and in line with historic 5 and 20-year averages. A late quarter rally in value stocks brought them more in line with the return of growth shares for the quarter, but it is far too early to consider the change in leadership a trend. ■

Closing Thoughts

With the third quarter now behind us, we are focusing our attention on the next Fed meeting at the end of October. Market participants are predicting the FOMC will make another 25 basis point cut (as priced in through the futures market). Considering the Fed's dual mandate of maximizing employment and price stability (through a targeted level of inflation) it is hard to see justification in the data for such a move. That being said, the old adage "don't fight the Fed" seems to have shifted to "don't fight the market" and we expect another cut is in the cards shortly.

Unemployment in the U.S. stood at 5% at the start of the Fed tightening cycle in 2015, with benign inflation levels not far off from where they are now. With a now 50-year low unemployment level of 3.5% it is difficult to not pause over the idea of a Fed now engaged once again in quantitative easing. The official Fed-speak describing "cross-currents" in financial markets and "uncertainties" relating to global trade struggles and slowing global growth, while outside the Committee's defined mandate, are certainly logical. If the dramatic policy shift sustains the longest economic expansion in the U.S., you'll hear no complaints from investors. What is not part of the policy language and is a more logical explanation from our view is that the Fed hit the brakes too hard too fast in 2018 with four rate hikes, particularly considering the slow measured pace of the previous five increases. Whether definitively stated or not, rate cuts in 2019 to offset overly aggressive hikes in 2018 have been welcomed by investors. Now if that stubborn yield curve would cooperate the way dusty textbooks sitting on the shelves of graying investment professionals say it should, fixed income opportunities beyond the shortest of the short might become interesting again.

Regardless of whether financial markets are following expected playbooks or not, rest assured our team will be closely monitoring and regularly discussing the most prudent steps to manage risks and capture opportunities on behalf of you our clients. Following the words of Mr. Buffet, we'll be cultivating existing trees and planting some new ones along the way aiming to provide just the right amount of shade. If we can be of assistance to you along the way, please do not hesitate to call us at the numbers provided. ■

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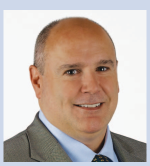

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