Plimoth Investment Advisors®
INVESTMENT MANAGEMENT & TRUST SERVICES SPECIALISTS

FOURTH QUARTER – WINTER 2014

INVESTMENT SPOTLIGHT

"My formula for success is rise early, work late, and strike oil." *– J. Paul Getty*

2014 provided several eye-popping stories that grabbed the attention of investors throughout the year. The early months were focused on Federal Reserve policy and what potential impacts the removal of Quantitative Easing (QE) would have on stock values and interest rates. As QE was drawn down, Fed watchers then shifted focus onto when the Fed may increase short-term borrowing costs. We were then treated to a few rounds of geopolitical uncertainty with Russia leading the charge by taking over the Crimean Peninsula and providing support to Pro-Russian separatists in the Ukraine. Turmoil in the Middle East pushed the Russian incursion out of the spotlight as ISIS terrorists used their social media prowess in the most horrific and brutal manner, displaying beheadings of foreign journalists and aid workers for all to see. We even had the scare of a more widespread Ebola outbreak that has ravaged Western African nations, killing over 10,000 people. While all of these stories were, and to some extent remain, impactful in the short-term, none are more economically impactful than the final story, the precipitous decline in crude prices from a June peak of 107.95/barrel on West Texas Intermediate Crude to 54.73/barrel at year-end.

Prices were on the rise through the spring and into the early summer months as ISIS control expanded across Northern Iraq and concerns over supply disruptions drove prices higher. But the rise was short-lived, and soon the headlines shifted to abundant supply. Several factors led to the supply imbalance, but to be sure, the most impactful was the growth in U.S. energy production. Enhanced mining technologies, such has fracking, have facilitated the extraction of oil and natural gas from shale fields, which were previously economically unviable. With the growth in production and a relatively stable global demand picture, the natural tendency was toward falling prices.

Prices moved down through the late summer months and early fall. The November freefall in prices was a direct result of OPEC's decision to maintain current production levels, and not cut supply to support higher price levels. The OPEC (Organization of Petroleum Exporting Countries) cartel consists of several oil-exporting nations, chief among them, Saudi Arabia. The organization has been able to maintain oil prices at their desired level, which has generally translated into higher prices. However, during their November meeting, the cartel decided to let prices continue to fall. With the additional output created by the U.S., the supply/demand fundamentals for the commodity have changed. During the past 5 years, the U.S. shale oil boom has added roughly 3% to annual global supply. While that doesn't sound like much, in terms of supply/demand fundamentals, it is monumental.

Realizing that U.S. shale oil is far more costly to extract and transport, OPEC decided that lower prices in the short-term were more beneficial to its long-term wealth. The sustained low prices will eventually reduce the supply coming out of the U.S.. Wood Mackenzie, a research consultancy, estimates that the break-even price of American projects is clustered around $65-70 per barrel, suggesting many are vulnerable, especially since these calculations exclude some sunk costs, such as building roads. If oil prices stabilize at $70/barrel, it's estimated that investment will be cut by 20% and production growth for American oil could slow by 10% a year. At $60/barrel, investment could drop by as much as half and production growth would grind to a halt. Current levels of production will continue in the U.S. as most of the well production costs are sunk costs. Investments into new projects, on the other hand, have already contracted.

We expect continued downward pressure on oil prices in the short-term; although, U.S. supply will eventually soften, and prices will begin to migrate higher to a level of equilibrium. If OPEC is successful, that new equilibrium price level should be between $70 to $85 / barrel. ■

Economic Review & Outlook

The U.S. economy showed continued signs of improvement during Q4-2014. The momentum in the manufacturing sector continued from the second and third quarters. Inventory levels also remained lean during this time period, leaving room for continued expansion unlike prior periods of manufacturing strength. The service sector of the economy, which accounts for roughly 70% of economic activity, also continued at a strong pace.

Employment data remained equally healthy. After a dismal January report, employment gains picked up significantly through the remainder of the year. For 2014, the average monthly job gain was 246 thousand, marking the best year of employment growth since 1999. While we continue to see some areas of weakness in the employment data, particularly in the areas of labor force participation and underemployment, the improvement in the employment situation was undeniable.

Housing activity remains somewhat sluggish. Despite falling interest rates and generally stable prices, new and existing home sales growth remains tepid. One reason may be the slowdown in Household Formation. Each year the census bureau conducts a survey to determine how many people left multiple living arrangements to establish their own household. In its March report the survey indicated just 476,000 households formed in the year-ending March, compared with an average of 1.3 million in each of the prior two years. Homeownership among millennials (18 – 34 year olds) has fallen from a peak in 2005 of 17.2% to the current low of 13.2%, which is very consistent with the drop in labor force participation among this age group.

At first, the impact of falling oil prices appeared unambiguously positive for the global economy. But when falling prices turned into a price landslide, potentially destabilizing implications arose. While there are several global considerations, here in the U.S. the rush of development in the shale fields has been a major source of capital expenditures for the domestic economy. Given the current circumstances, one should anticipate a slowdown in expenditures in the coming months, detracting from growth. While incremental consumption should make up for the investment shortfall, it will likely occur at a slower pace, resulting in uneven growth. Once again, we would expect stronger second half activity relative to the first half of 2015.

S & P 500 Sector Performance

	Q4-2014	YTD-2014
Consumer Disc.	8.74%	9.68%
Consumer Staples	8.15%	15.98%
Energy	-10.68%	-7.78%
Financial	7.25%	15.20%
Healthcare	7.48%	25.34%
Industrial	6.76%	9.83%
Info. Technology	5.24%	20.12%
Materials	-1.80%	6.91%
Telecommunications	-4.16%	2.99%
Utilities	13.19%	28.96%

While the U.S. macro-economic picture looks more stable than at any time since the 2007 recession, the global picture is more problematic. Economic expansion in China appears to be stabilizing between the 7 to 7.5% range, which is well below the more recent growth rates. The softer environment has negative implications for other surrounding emerging Asian economies. Weakness in commodity prices has an adverse impact on many emerging economies across Latin America. Russia, which is also dealing with trade sanctions related to the aggression in the Ukraine, faces steep economic challenges with the decline in oil. Finally, Europe continues to be mired in a no-growth environment that the European Central Bank is attempting to revive. As if they needed additional challenges, the European Union is also facing more sovereign debt concerns related to the upcoming Greek elections at the end of January.

While we believe the U.S. economy is poised to regain a sustainable growth rate of roughly 3%, there are headwinds abroad that will periodically cast doubt on not only global growth, but how long the U.S. can continue on a growth trajectory that is running in the opposite direction of our major trading partners. ■

Bond Market Review & Outlook

The U.S. bond market remains somewhat of an enigma. Despite historically low interest rates, long term yields fell even further during the year. While the Federal Reserve was removing quantitative easing, rates continued to fall. This fact defied expectations as most analysts believed rates would rise as the Fed removed liquidity. We have previously referenced the impact of falling global rates on the long-end of the yield curve, and we believe these downward pressures will continue to impact our interest rate environment in 2015.

The Federal Reserve has also indicated that they will begin to raise short-term interest rates should economic conditions continue to suggest the economy has reached a point of sustainable growth. Most analysts believe this will occur sometime in the middle of 2015. At this point, we concur. As we anticipate manufacturing and employment to continue growing at more recent trend levels, we believe the Federal Reserve will have the necessary rationale to take more restrictive policy actions.

We anticipate a continued upward bias on short-term interest rates with long-term interest rates being constrained by more global policy actions. Given these circumstances, a flat yield curve with higher rates on the short-end and stable to slightly higher rates on the long-end are in store for 2015.

Nonetheless, buying long-term bonds in this environment remains very risky. With rates at these historically low levels, there is an ever-present risk of sharp movements higher. While we do not anticipate this for 2015, global economic circumstances can shift markets quickly, leaving a potentially over-bought bond market susceptible to loss. As a point of reference, who in the middle of 2014 would have expected a 50% decline in oil prices? And yet, that's exactly what happened. ■

	Q4-2014	YTD-2014
Cash:		
T-Bill Index	0.00%	0.03%
Taxable Fixed Income:		
Barclay's US Agg. Bond	1.79%	5.97%
Barclay's Govt./Credit Int.	0.89%	3.13%
Barclay's Govt./Credit Long	5.60%	19.31%
BofAML High Yield Index	-1.06%	2.50%
Tax Exempt Fixed Income:		
Barclay's Muni. 5 Yr.	0.09%	3.19%
Barclay's Muni. 7 Yr.	0.82%	6.09%
Barclay's Muni. TR	1.37%	9.05%

Stock Market Review & Outlook

The volatility at the close of the third quarter continued into the fourth quarter. By mid-October, the S&P 500 bottomed at 1,862, 7.3% below the market peak one month earlier. The market recovery was equally as swift, regaining all of the losses, and closing at 2,018.05 by the end of October. Volatility died down in November as markets moved steadily higher. But volatility returned in December. During the first two trading weeks, the S&P 500 dropped 4.95%, only to recover most of the decline by the end of the year. For a year that witnessed low volatility for most of the time period, the final quarter was far less tranquil for long-term investors. For the quarter, the S&P 500 gained 4.93%, contributing to an annual return of 13.69%.

On a sector basis, high yielding and defensively oriented utility stocks dominated the quarter, and consequently the year. Healthcare stocks were next, followed by the Information Technology sector. The biggest loser was obvious: the decline in oil prices

	Q4-2014	YTD-2014
DJIA Index	5.20%	10.04%
S&P 500 Index	4.93%	13.69%
Russell 2000 Index	9.73%	4.89%
EAFE Index	-3.53%	-4.48%

trounced energy stocks for the quarter, making it the only negative performing sector for the entire year. Pricing competition among wireless providers made Telecom the second worst performer, followed by Materials stocks that suffered from the price weakness in commodities.

On a capitalization basis, large cap stocks finally took a leadership role followed by their mid and small capitalization brethren. Growth stocks outpaced value stocks for the year, leaving their 3-year returns almost identical. International markets broadly underperformed relative to the U.S., as the MSCI EAFE (Europe, Asia and Far East) Index lost 3.53% for the quarter, leading to an annual loss of 4.48%. ■

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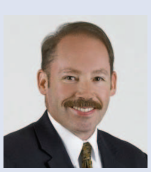

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Closing Thoughts

For 2015, we continue to see an environment in which domestic equities can continue to improve at a rate consistent with earnings growth, somewhere in the mid-single digits. However, we do believe some of the late-year equity strength may pull down potential returns in the New Year. Given our current fair-value trading range, we also expect enhanced volatility in the equity markets. Traders will likely be very reactive to global events and economic data releases in the coming months as there is little "cushion" in equity market valuations. Fixed income will remain a port of safety amid periods of market choppiness, but offer little for the long-term investor other than safety. Foreign equity markets will remain challenged for regionally specific reasons, but may provide areas of opportunity should global growth stabilize and the ECB become successful in getting the Eurozone moving in the right direction.

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.