Plimoth Investment Advisors®
INVESTMENT MANAGEMENT & TRUST SERVICES SPECIALISTS

INVESTMENT SPOTLIGHT

"Records are made to be broken."
– Proverb

This time last year we wrote to you about the Dow Jones Industrial Average edging toward a major milestone of the 20,000 mark. Amazingly, the blue chip index has since closed above another watershed level of 25,000 in record breaking time. Just as investors began to contemplate the fastest thousand point jump on record from 24,000 to 25,000 in a mere five weeks, the Dow closed above the 26,000 milestone at the time of this writing in an astonishing eight trading days! Similar meteoric advances have occurred with other U.S. equity indices thus far in 2018 with the S&P 500 surpassing the 2,800 mark and NASDAQ breaking through 7,000. The phenomenon is not exclusive to the U.S. as equity markets around the world continue to surge. The MSCI All Country World Index is at an all-time high. With new record highs being shattered on a regular basis, equity markets continue to shake off any cautionary headlines to maintain their steady march higher.

Investor optimism has surged since the 2016 U.S. Presidential election with the S&P 500 posting a positive total return every month since, yet another standing record. With tax reform edged over the finish line in 2017, investors are bullish on the prospects of a lower corporate tax rate leading to higher profitability. The Conference Board Consumer Confidence Index hit a 17-year high last year as the University of Michigan Consumer Sentiment Index approached a 10-year high. Unlike in the previous year, these high levels of optimism are now flowing into consumption and leading to a near-term resurgence in GDP growth.

The pace and magnitude of equity gains left forecasters 2017 estimates in the dust. The recurring question we hear in 2018 is, "can stocks continue their rise further into record territory?" Our short answer is "yes", with continued economic expansion we deem plausible assuming an uptick in wage growth, and continued steady growth in corporate profits. ■

Economic Review & Outlook

Calendar year 2017 started out with an anemic first quarter GDP reading of 1.2% following a weak fourth quarter the previous year, a pervasive trend over the past several years. As in prior years, GDP accelerated thereafter with a healthy 3.1% level of growth in Q2 and 3.2% in Q3. Business investment reaccelerated into 2017 and the consumer reappeared, particularly with their holiday spending. Retail Sales showed significant strength into the calendar year-end with four consecutive months of growth. The November-December shopping season was the strongest on record since 2010. Fourth quarter Retail Sales excluding autos and gas showed the largest increase since 2005. The latest reading on consumer credit spiked in December with the highest monthly increase in 16 years and household debt as a percentage of discretionary income passed 25% for the first time. While a one month figure is far from a trend, we will be keeping a close eye on subsequent reports as signposts of whether our consumption thesis is sustainable. We are comforted that the latest Household Financial Obligation Ratio (a measure of debt service and rent costs as a percentage of income) remains comfortably below pre-financial crisis levels. Continued robust levels of personal consumption, far and away the largest component of GDP, drives our thesis that Q4 GDP should hold up better in 2017 than in prior years. We are also optimistic that the trend of a meaningful shortfall in Q1 GDP will be broken this year as we expect positive economic momentum to carry into 2018.

Unemployment continued to trend lower in the U.S. throughout 2017. At 4.1%, headline unemployment stands at its lowest in 17 years, with levels of slack from underemployment diminishing. A total of 2.06 million jobs were created in the U.S. last year. That is less than 2016, but modestly more than was expected at the beginning of the year. We anticipate that the trend toward lower unemployment has room to continue in the coming year. A key component to our thesis for above trend GDP growth is predicated on an increase in wage growth from the benign levels of 2.5%, driven by a continued tightening in the labor market.

Inflation continued at a subdued pace throughout the year. The Core measure of Personal Consumption Expenditures (PCE excluding food and energy) dipped well below the Fed's target of 2%, muddling through at 1.4% year-on-year change during the summer months before rising to 1.8% as of the last reading through November. Headline and Core Consumer Price Indices (CPI) experienced a similar trajectory throughout the year, with shelter costs pushing the core year-on-year increase through December to 1.8% as well. With a hawkish Fed preemptively raising the Fed Funds rate five times in the current tightening cycle and an 80% implied probability of an additional increase in March priced in by the futures market, we expect inflation to continue at a measured pace.

	Q4-2017	YTD-2017
Consumer Discretionary	9.87%	22.98%
Consumer Staples	6.49%	13.49%
Energy	6.02%	-1.01%
Financials	8.63%	22.18%
Healthcare	1.47%	22.08%
Industrials	6.05%	21.03%
Information Technology	9.01%	38.83%
Materials	6.93%	23.84%
Telecommunications	3.61%	-1.25%
Utilities	0.21%	12.11%

Housing was another area of particular strength in 2017. Above trend new and existing home sales were restrained only by a shortage of supply rather than any drop off in home buyers' demand. Manufacturing was solid as well. Other than short-term weather-related drop offs, manufacturing data reported by ISM and PMI remained well into expansionary territory.

Of the two economic paths we plotted coming into 2017, we found our way squarely down our base case trail of continued (post-2008 recession) trend-line recovery of 2.5% GDP growth. Wage growth proved to be elusive, a factor we cited as having the ability to lead the economy into a period of more normal expansionary growth of 3%. Our base case outlook is more optimistic this year with an expectation of an uptick in wage growth. With the resurgence of the personal consumer and business capital expenditures, along with less incentive for companies to shift production overseas for tax purposes, we are anticipating GDP growth to modestly exceed 3% in 2018. We expect continued innovation and productivity improvements for companies, but not to the detriment of workers, as tightening labor markets should lead to an increase to stubborn wage growth. ■

Bond Review & Outlook

Three rate increases by the Federal Open Market Committee (FOMC) during 2017 and an announcement in the fourth quarter by the U.S. Treasury stating that it would meet much of its new borrowing requirements from shorter maturity debt drove the short end of the Treasury yield curve higher during the year. The 2-Year U.S. Treasury ended the year with a yield of 1.93% and has continued to climb past the 2.0% mark for the first time since the 2008 financial crisis, and more than doubling since the November 2016 election. The yield on the bellwether 10-Year U.S. Treasury remained range bound as anticipated, finishing the year at 2.41%, within 5 basis points of where it started. The spread between the 2-Year and 10-Year Treasury narrowed from 1.25% at the start of 2017 to a historically tight 0.52% at year end. The decreasing spread led to a meaningful flattening in the shape of the U.S. Treasury yield curve.

The FOMC will look quite different in 2018 than the previous year with a new Chair, Jerome Powell, replacing Janet Yellen and four of the seven voting

	Q4-2017	YTD-2017
Cash:		
Citi 3 Mo. T-Bill Index	0.28%	0.84%
Taxable Fixed Income:		
Barclays US Agg. Bond	0.39%	3.54%
Barclays Govt./Credit Int.	-0.20%	2.14%
Barclays Govt./Credit Long	2.84%	10.71%
BofAML High Yield Index	0.41%	7.48%
Tax Exempt Fixed Income:		
Barclays Muni. 5 Yr.	-0.70%	3.14%
Barclays Muni. 7 Yr.	-0.22%	4.49%
Barclays Muni. TR	0.75%	5.45%

seats changing. The plan of a gradual systematic pace of tightening remains in place despite the new faces calling the shots. Bond markets have nearly fully priced in an incremental 25 basis point increase in March, one of three hikes the Fed has telegraphed for this year. The well designed plan for balance sheet reduction began in October 2017 and will ramp up through 2018 until it reaches the maximum reduction cap of $80bn ($60 billion in U.S. Treasuries and $20 billion in mortgage-backed securities) per month in October 2018.

Going forward we are expecting more of the same for bonds. Further increases to short-term rates with more modest yield increases occurring in the intermediate part of the yield curve, known as a “bear flattener” (to potentially augment your cocktail party terminology) is what we anticipate to continue this year in the U.S. We also expect central banks globally to follow the FOMC lead of a measured shift in reducing quantitative easing and moving into a gradual tightening mode within their respective economic cycles. ■

Stock Market Review & Outlook

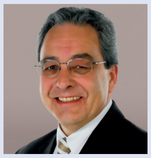
In producing a weekly commentary highlighting economic and market developments for our website throughout the course of 2017, commenting on a new record breaking stock market index high began to seem like the rule rather than the exception. U.S. equity markets broke through the most closing highs of any other year on record and most global stock indices finished the year at or near record levels. The Dow Jones Industrial Average is experiencing its longest consecutive string of monthly gains since the 1950s. The S&P 500 capped its ninth consecutive year of gains with a positive total return in each of the 12 months of 2017, another first in history. These gains were achieved in a period of extremely low market volatility. The index had only eight days of a 1% or greater move in 2017. You’d need to go back to 1964 for fewer, a time when the only thing hotter than the stock market was the release of a brand new line of Ford vehicles known as the Mustang. The standard measure of equity volatility in the U.S. called the VIX Index, often characterized as the investor “fear gauge” posted 22 of the lowest 25 readings in the history of the measure in 2017. The list of shattered records goes on. During this “risk on” environment, many stock markets outside of the U.S. did even better, with emerging market countries leading the charge. The MSCI All Country World Index ended the year at a record high. The “buy the dips” investor mentality was a pervasive phenomenon across most parts of the globe throughout the year.

Within the S&P 500, the Information Technology sector was a standout winner followed by other more cyclically-oriented sectors including Consumer Discretionary, Materials and Financials. The struggling Energy sector and Telecommunications were the only sectors to decline during the period. Growth-oriented companies provided far more favorable returns than value and large cap companies outperformed small. Small cap stocks, while “only” providing mid-teens returns to investors ebbed and flowed more closely with the swings of tax reform talks in Washington than the overall market.

	Q4-2017	YTD-2017
DJIA Index	10.96%	28.11%
S&P 500 Index	6.64%	21.83%
Russell 2000 Index	3.34%	14.65%
MSCI EAFE Index	4.27%	25.62%

With the U.S. equity market trading at 21.5x on trailing 12 month earnings, well ahead of historical averages, “how much higher can this market go?” is the most frequently heard question from our clients. We are not anticipating further expansion to the P/E (price/earnings) ratio the market is currently trading at, so our answer to this question ties into our outlook for corporate earnings. While we were more concerned about extended market valuations during recent periods of negative corporate earnings growth, we are in fact far more comfortable with U.S. equities now, after five quarters of positive corporate earnings growth. This period included back to back quarters of double digit growth in 2017, the first such occurrence since 2011. With Q4 earnings growth revised projections now calling for another quarter of potentially greater than 10% earnings growth, combined with the catalyst of lower corporate tax rates moving into 2018, we are projecting that the S&P 500 has the potential to grow in-line with these earnings expectations. With arguably the most favorable economic backdrop during the post-recession recovery, 10% corporate earnings growth is expected to lead to another positive year of returns for the S&P 500. Our base case assessment at this time factors in a high single digit stock market return accounting for strong earnings and the potential for some degree of P/E multiple compression marginally reducing valuations. ■

Meet the Plimoth Investment Advisors Executive Leadership Team



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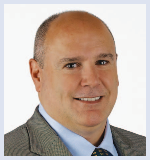

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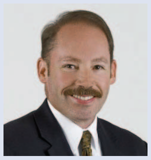

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Closing Thoughts

As with any forecast, our more positive base case assessment for the coming year is not without risks. Geopolitical issues, natural disasters and acts of terrorism; our list of worries is long. One of the critical factors we will be paying attention to as a warning sign of the potential end to the economic cycle is an acceleration in the growth of global sovereign debt, including in the U.S. A rising fiscal deficit gives us pause and could very well be a factor causing us to modify our bullish thesis. A build up in excesses certainly has the ability to end a cycle of expansion. While this is not an immediate concern, the theory that tax revenue can increase, despite lower tax rates, in a period of expanding economic activity (growing the overall pie of taxable revenues) will need to come to fruition. Otherwise the weight of increased debt burden may be the catalyst that keeps newly broken records in the history books for some time to come.

With healthy controlled inflation and a moderate uptick in wage growth, a scenario we see as plausible with tightening labor markets, 2018 looks to provide a strong backdrop for investors. Resilient corporate earnings in this environment, with the tail wind of a decreasing corporate tax burden is key to our thesis for the potential to surpass the longest bull market on record from the late 1980s to the bursting of the tech bubble in 2000. We view this as yet another record poised to fall in 2018. With all Organization for Economic Cooperation and Development (OECD) countries now in some stage of economic expansion, we are anticipating continued strength in equity markets outside of the U.S. in the coming year as well. We will be maintaining an overweight to risk assets and underweight to fixed income securities based on this outlook in the coming year, while remaining vigilant in our ongoing reassessment of this view during our weekly investment team strategy discussions.

Our plan for the coming year is no different than in years past. We will continue to strive to deploy capital on behalf of our trusted partners into securities offering the most attractive risk and return profile. 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.