FOURTH QUARTER – WINTER 2019

INVESTMENT SPOTLIGHT

"Don't just do something; stand there!"
– a cliché turned on its head by, among others, the White Rabbit in Disney's 1951 animated adaptation of Alice in Wonderland

Financial markets in 2019 refused to submit to the dour and cautious outlook espoused by market pundits citing concerns of global economic slowdown, geopolitical and trade headwinds, corporate earnings pullback and the proliferation of negative yielding debt. Asset class returns were favorable to investors regardless of where they chose to deploy capital. The blue Christmas of 2018 is a distant memory following the 2019 holiday season of festive green on the screen. Those who panicked in the pullback of the fourth quarter of 2018 and decided to sit out equity market volatility may have missed the strongest rally in U.S. stocks for some time to come. Rather than overreacting to a (once commonplace) market correction, investors who took the above-quoted advice and relied on their long-term investment strategy faired quite well during the rapid recovery.

Every market pullback of meaningful consequence seems to have a story (or advertisement) of some "expert" making a prescient call of getting out of stocks in advance of a sell off, but I've yet to see a follow-up detailing a similarly well-timed reinvestment back into the market. Attempting to time shifts in and out of stocks based on forecasts and technicals is simply not a practice that holds up over time. Setting out a long-term strategy that includes equity exposure for the long-term has however, proven to be a profitable approach to investing time and again. While there are certainly specific periods in time when U.S. stocks have been lackluster (think back to the "lost decade" for stocks in 2010 bookended by the TMT (technology, media, telecom) crisis and market fallout from the 2008 great recession), the latest equity rally capped a particularly profitable decade for buy and hold investors. The S&P 500 Index and Dow Jones Industrial Average both returned a stellar annualized return of 13.4% over the trailing 10 years, and the technology-focused NASDAQ a more impressive 16.1% for investors willing to implement a long-term strategy through the numerous ups and downs along the way.

The last few months have provided investors plenty of headlines to test their resolve and keep them contemplating the risks and rewards of global markets… escalating Middle East tensions following U.S. and Iranian missile strikes, U.S. Presidential impeachment proceedings amid the myriad of political hyperbole that comes with an election year, a new Prime Minister in the U.K. setting the stage for a more likely exit of Britain from the European Union, a revised trade deal between the U.S., Canada and Mexico and first phase of an on-again, off-again, deal between the U.S. and China, along with ongoing fallout from the catastrophic crashes of the Boeing 737 Max jetliners. It's times like these that I am more thankful than ever to have my Plimoth colleagues as a sounding board as we continually put our heads together to keep all that is happening in context to focus on our key goal of constructing the most appropriately balanced portfolios, continually weighing risks relative to potential returns. ■

Economic Review & Outlook

Real Gross Domestic Product (GDP) in the U.S. in the third quarter was 2.1%, led by strong Personal Consumption that grew at a 3.2% pace. Consumer Confidence remains robust and personal spending continues to be the ballast supporting economic growth. News of the Bloomberg Consumer Comfort Index reaching a new multi-year high is running across the newswire at the time of this writing.

The four-quarter average GDP for the calendar year is on track to edge just past 2%, in line with our base case expectations for growth to be at or around the current economic cycle average for calendar years 2019 and 2020. Recessionary pressures continue to remain off in the distance in our view.

The December Retail Sales report showed strength for the final month of the year, however the prior two months were revised lower. The late surge of the all-important holiday shopping season was not enough to expect fourth quarter GDP to exceed the prior two quarters.

Business Fixed Investment has lagged, and C-Suite Executive surveys continue to reflect a pessimistic view. We continue to expect a resurgence in spending by companies as movement on the trade deal with China advances and more tariff clarity becomes available. A resolution allowing Boeing 737 Max planes back in the air will also add a tailwind to GDP through an increase in inventories and exports.

The Unemployment rate in the U.S. remains at a half century low of 3.5%. Wage Growth was lower than anticipated in the final reading of 2019 having advanced by 2.9% on a year-on-year basis. While the flow through to workers' wallets is below the long-term average of just over 4%, this data point is a one month pull back in a year in which average hourly earnings exceeded an annualized 3% in all prior monthly readings. Over time, a tight labor market is expected to lead to rising wages, but the fact that it hasn't jumped quickly plays more into a "Goldilocks" (neither too hot nor too cold) scenario in our opinion. Recall that as recently as 2018, similar wage growth of 2.9% was cited as a concern for overheating inflation.

	Q4-2019	YTD-2019
Communication Services	9.0%	32.7%
Consumer Discretionary	4.5%	27.9%
Consumer Staples	3.5%	27.6%
Energy	5.5%	11.8%
Financials	10.5%	32.1%
Healthcare	14.4%	20.8%
Industrials	5.5%	29.4%
Information Technology	14.4%	50.3%
Materials	6.4%	24.6%
Utilities	0.8%	26.4%

Inflation continues to be in a comfortably muted place. Core Personal Consumption Expenditures (PCE - excluding volatile food and energy prices) remains well below the Fed's 2% target at 1.6%. In reality, higher services inflation for expenditures such as college tuition, healthcare costs and medical expenses may be a bigger piece of the pie for consumers, while weaker goods inflation continues to restrain this measure. PCE continues to be the Fed's preferred measure so we will continue to pay attention to it, but no matter which data set our analysts review, rising inflation is not a concern for the time being.

Manufacturing continues to be a weak spot in the U.S. economy. The ISM (Institute for Supply Management) Manufacturing Index trended lower throughout the calendar year and weakened further in the December report. While some one-off issues such as California wildfires leading to power cuts and Boeing production halt negatively impacted the data, the ISM reading disappointed by missing consensus estimates month in and month out for the second half of the year. The services segments of the economy continue to outshine manufacturing. Readings from the final report of 2019 strengthened and continue to point to modest growth. The changing of tariffs by the U.S. on Chinese goods over the course of the year (on-again, off-again, revised from 10% to 25% for certain goods) has led to a breakdown in certain relationships of manufacturing and inflation data given the temporary nature of their impact.

Housing data showed signs of incremental improvement through the final quarter of the year. Lower mortgage rates brought more buyers to the table and provided a tail wind to this critical segment of the economy. The Homebuilders Optimism Index now stands at a multi-year high, confidence that is reflected in stronger Housing Starts which peaked at the highest level since 2006 in the final report of the year. ■

Bond Market Review & Outlook

The FOMC (Federal Open Market Committee) cut the Fed Funds Rate three times during calendar year 2019, with the final cut taking place in October to a target level of 1.5-1.75%. The aggressive pace of reductions is a stark reversal from rate hikes only a year earlier. The added stimulus served as a catalyst to bolster investor risk appetite. We are not alone in our expectation that the Fed remains on hold with rate changes for some time to come. They held rates steady in the final meeting of the year with Chairman Powell stating the Committee expected to do so over the next several meetings. His comment that a "material reassessment" of the Committee's outlook would be needed to cut rates further was widely quoted. The projected holding pattern on rates was further substantiated by the updated dot plot of member forecasts as the data shows 13 of the 17 FOMC members expect rates to remain unchanged in 2020.

The bellwether 10-Year U.S. Treasury yield fell over the course of the calendar year, trading in a broad range of 2.78% in January to as low as 1.46% in September before retracing to 1.88% at year end. The yield curve has normalized since our last writing, with a positive spread between long and short-term rates returning early in the fourth quarter.

The Fed has rapidly added back to the balance sheet somewhat below the radar as it has been the topic of far less financial press coverage than the unwinding. Of the more than $350 billion in U.S. Treasuries allowed to roll off over the course of a year and a half, over three fourths of that amount have been added back in a matter of months through short-term U.S. Treasury securities purchases designed to pump liquidity into the money markets. The resulting additional excess reserves of depository institutions has calmed the cash funding markets.

Total corporate debt in the U.S. reached a new cycle high indicating that investors seeking yield in the lower rate environment have been willing to participate in the purchase of new issues. The BBB market (second lowest rating in investment grade) grew to the largest level of debt outstanding in history. Spreads (the premium of yields on corporate bonds over Treasuries) across the spectrum of investment-grade to high yield have pulled in to multi-year lows.

	Q4-2019	YTD-2019
Cash:		
FTSE 3 Mo. T-Bill Index	0.5%	2.3%
Taxable Fixed Income:		
Barclays US Agg. Bond	0.2%	8.7%
Barclays Govt./Credit Int.	0.4%	6.8%
Barclays Govt./Credit Long	-1.1%	19.6%
BofAML High Yield Index	2.6%	14.4%
Tax Exempt Fixed Income:		
Barclays Muni. 5 Yr.	1.0%	5.5%
Barclays Muni. 7 Yr.	1.0%	6.7%
Barclays Muni. TR	0.7%	7.5%

The Barclays Aggregate Index provided investors with a very respectable 8.7% return for the year while the longer duration Govt' Credit Long Index earned a remarkable 19.6% during the period of falling rates. While these returns pale in comparison to the equity market, the ride was markedly smoother. ■

Stock Market Review & Outlook

The S&P 500 provided investors with the strongest returns in six years at 31.5%, driven by red hot returns within the technology sector. Information Technology was the strongest performing sector of the S&P 500 providing an eye-popping 50% return. Eight other sectors had remarkable returns ranging from 25-32% and even the battered Energy sector advanced by double digits. Small cap stocks trailed large and developed international and emerging markets stock returns were below that of the U.S., but with the majority of stock indices closing out the year in excess of 20%, equity investors were well compensated across the board relative to historic returns.

Volatility has remained muted for U.S. stocks, an unusual dynamic for a year of such significant returns. Stocks “melted up” in a calm fashion with very short-lived sell offs. Volatility spikes abated just as quickly as they appeared. While we anticipate more of these spikes, the idea that investors may continue to step in to erase the dips as quickly as they happen seems to be a plausible expectation.

	Q4-2019	YTD-2019
DJIA Index	6.7%	25.3%
S&P 500 Index	9.1%	31.5%
Russell 2000 Index	9.9%	25.5%
MSCI EAFE Index	8.2%	22.0%

Valuations of U.S. equities stretched into the new year after a long run of positive returns. The returns from 2019 were driven by multiple expansion rather than rising corporate earnings. Said differently, while profitability for companies (as a whole) pulled back modestly, investors willingness to pay increasingly more for $1 of company earnings provided most of the wind in the sails driving higher stock prices, along with an added gust from stock dividends. Corporate Earnings collectively were modestly negative for the year (estimated at -1 to -2%) in comparison to the tremendous acceleration of over 20% in the prior calendar year. The current Price / Earnings (P/E) multiple for the S&P 500 is 21.8x and using forward estimated earnings is 18.7x, making valuations appear somewhat rich relative to historical measures.

Although there was a meaningful disconnect between corporate earnings relative to stock returns over the past two calendar years, over the long-term underlying company earnings are the fundamental foundation driving positive returns for stock investors. All signs point to more positive earnings in the coming year, with consensus in the high single digits at 8 to 9%. As such, we set our 2020 base case for U.S. equity returns at a similar level. Equity markets outside of the U.S., particularly the emerging markets, are becoming more interesting based on relative valuations, although the continued strength of the U.S. dollar remains a headwind to companies domiciled in these countries. ■

Closing Thoughts

Perhaps the key takeaway from all that happened in financial markets in 2019 is that staying invested in equities for the long-run remains the most appropriate strategy. Trying to predict and time year-to-year market gyrations has been counterproductive and quite costly at times. Stock investors (speculators) running for the exits in the fourth quarter of 2018 were left battling the dreaded "FOMO" (fear of missing out) feeling during 2019 as stocks rallied back nearly as quickly as they had fallen and continue to break through new record highs at the time of this writing.

In the end, an allocation to equities for the long-run makes sense across portfolios, with the size and areas of focus dependent upon time horizon and risk tolerance. When all the volatile swings are viewed in retrospect, stocks should be expected to return the level of sustainable corporate earnings they are able to generate over time.

We begin the year of 2020 with portfolios well diversified across asset classes, with modestly less exposure to stocks than the start of last year. Equities are well diversified by sector with a continued underweight to Energy stocks and overweight to Consumer and Communication Services companies. The normalization of the yield curve also gives us more interest in the Financials sector, particularly banks. We have a more modest exposure to small cap stocks given the late stage of the economic cycle, while maintaining exposure to equities outside the U.S. where valuations are becoming increasing interesting. We continue to maintain exposure to preferred stocks and REITs (real estate investment trusts), offering a margin of safety due to the high levels of current income they provide. Selecting the most attractive securities available in these areas is something we continue to spend a good amount of time on. Within fixed income we are maintaining shorter duration, while regularly looking for one-off opportunities in individual corporate bonds in an environment where spreads continue to be tight across credit markets.

You can rest assured that there will be plenty going on behind the scenes of the portfolios under our oversight in the coming year. Overreacting to equity volatility however, is not in the plan or our DNA. What "stand there" looks like at Plimoth is ample ongoing intellectual debate and challenging of our base case set of assumptions while speculators are overreacting. When we decide to "do something" with respect to portfolio allocation changes, the decisions are far from reactionary based on the latest headlines or concerns, but rather meticulously thought through by our team of highly experience professionals and designed to optimize the risk/return equation over the long-term for the benefit of our clients.

We are looking forward to a productive and profitable new decade. If we can be of assistance to you in any way, please do not hesitate to call us at the numbers provided. ■

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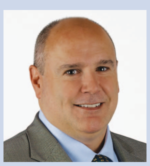
Our weekly market commentary can be found at the "Market Commentary" button in the lower right hand corner.

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

Steven A. Russo, CFA
President & CEO
508-591-6202
srusso@pliadv.com



Louis E. Sousa, CFA
Senior Vice President & Chief Investment Officer
508-675-4313
lsousa@pliadv.com

Edward J. Misiolek
Senior Vice President & Operations Officer
508-675-4316
emisiolek@pliadv.com

Teresa A. Prue, CFP®
Senior Vice President & Head of Fiduciary Services & Administration
508-591-6221
tprue@pliadv.com