WILKINS INVESTMENT COUNSEL, INC.

2013 INVESTMENT OUTLOOK

The year just ended was a particularly eventful one in the capital markets as well as from a political and economic perspective. Despite fears that the U.S. might fall back into a recession, the economy continued its ongoing recovery in 2012. Assuming GDP growth was positive in the fourth quarter of last year the economy has now advanced for fourteen consecutive quarters since bottoming in mid-2009. Two important indicators in particular, housing and the unemployment rate, displayed continued progress throughout the year. While overall economic growth continued in 2012 it did so at a disappointing pace given the stage of the recovery when one would normally expect a more robust advance. Similarly, many foreign economies fell short of expectations with several European nations continuing or entering recessionary periods, Japan experiencing barely positive growth for the year and several emerging market economies, including China and India, growing well below historic norms.

These economic shortfalls had political consequences around the world as many European nations underwent leadership changes as lackluster growth and high unemployment left voters searching for new directions. Meanwhile, the revolving door atop Japan's political system continued as that nation elected its tenth prime minister since 2000. Late in the year China experienced its once in a decade leadership transition as Xi Jinping was named to head that nation in the coming years. It is interesting to note that during a time when the global economy is in dire need of strong leadership many nations have new and untested heads of state. On the other hand, voters in the United States essentially decided to keep the status quo in effect by returning President Obama to the White House and keeping the House and Senate majorities intact. It remains to be seen if this combination can be more effective in the coming years and work in a bipartisan way for the betterment of the nation. One positive development in this regard is this week's agreement on a short term solution to the fiscal tightening that was scheduled to go into effect on January 1st otherwise known as the fiscal cliff. Had the projected $600 billion of tax hikes and spending cuts been allowed to go into effect, the U.S. economy almost certainly would have entered a recession later this year. While this is clearly a helpful near term development it will ensure that the federal government will again post an unsustainably large deficit in the current fiscal year. Disappointingly, the agreement failed to address spending cuts that will be necessary, including entitlement reform, as well as federal debt ceiling limits that will be breached early this year. Both sides of the political aisle are gearing up for a heated debate on these issues that will unfold in the coming months with important implications for investors.

Given all the uncertainty both here and abroad, many central banks around the world have expanded programs to try to nurse ailing economies back to health and provide reassurance to investors. Central banks in the U.S., Europe, China, Japan and elsewhere are implementing unprecedented monetary policies in this regard. While the policies have had limited success in reinvigorating growth they have been relatively successful in enhancing total returns to fixed income investors as falling interest rates have raised prices on existing securities. This process has been particularly successful in Europe where central bank support mechanisms have at least temporarily stabilized several nations' banking industries and sovereign debt markets. Unfortunately, this central back activism has caused new bond investors and those reinvesting proceeds from maturing issues to experience diminished investment opportunities as bond yields fell to multi-decade lows during the year. Another stated goal of certain central banks, including our own Federal Reserve, has been to increase asset prices more broadly. It is believed that the wealth effect from higher asset prices will cause consumers to spend more which will lead to faster growth and improved job gains thus fueling a self-perpetuating recovery. While the evidence suggests that this expected impact on the real economy has not materialized, investors' spirits were certainly boosted in 2012 as most of the broad markets both here and abroad enjoyed above average returns as shown below.

Year to Date Market Returns (excluding income)

	12/31/12 Price	Change From Year End
Dow 30 Industrials	13,104	7.3%
S&P 500	1,426	13.4%
NASDAQ Composite	3,020	15.9%
MSCI ACWI-exUS*	250	13.3%

**MSCI All Country World Index excluding U.S*

Current Developments and Outlook

The broad markets as measured by the S&P 500 enjoyed positive returns in both November and December finishing the year on an uptrend as investors believed that leadership in Washington would prevent us from going over the fiscal cliff. The optimism that a deal would be reached was confirmed earlier this week as the President signed the bill that eventually made it through the House and Senate after much debate. The agreement has been described in the popular press as a tax hike on the wealthy and, in fact, Roberton Williams of the nonpartisan Tax Policy Center estimates that 90% of the tax increases will fall on households with incomes in excess of $1 million. While it has been correctly pointed out that 99% of households will avoid an increase in income taxes, often left unsaid is that approximately 77% of households will pay a larger share of their income to the federal government this year as the payroll tax holiday was allowed to expire. This means all working Americans will revert to paying 6.2% of their income up to the $113,700 limit to fund Social Security, up from the 4.2% rate that had been in effect for the last two years. For a household making $50,000 (near the national median) this will result in an additional tax burden of about $1,000 per year. JP Morgan estimates that this tax increase combined with the tax hike on upper income Americans will reduce 2013 economic growth by 0.5% which would be a headwind to lowering the unemployment rate in the coming year.

The federal deficit for the twelve months ending Sept 30th was $1.089 trillion equal to approximately 7% of GDP. This was the fourth year in a row of deficits exceeding $1 trillion and the fourth year in a row with a deficit to GDP ratio over 7%, the highest figure since WWII. The four year increase in total debt equates to about $55,000 per U.S. household. At the end of fiscal 2012, the total federal government debt (including Social Security and Medicare trust funds) equaled $16.07 trillion or 103% of GDP while debt held by the public came to $11.27 trillion or 72.5% of GDP versus only 33.6% only ten years ago. Federal spending now represents approximately 24% of GDP or some 4% above the historic average. It is true that over time the role of the federal government has changed in importance from the increasing function it served during President Roosevelt's New Deal years when Social Security began and on into WWII. Government was expanded again under President Johnson who ushered in the "Great Society" programs including Medicare and Medicaid in the 1960s and continued to grow under the next several presidents. Beginning with President Reagan in the early 1980s the role of the federal government began to diminish in importance and this continued through President Clinton's term. Since then government has begun to grow again culminating in the record deficits of the past few years.

There is a limit to the federal borrowing capacity, however, so a sensible, credible and bipartisan long term plan to raise tax revenue and cut spending is necessary in order to restore confidence that America is on a sustainable fiscal path. Federal tax revenue was up 6.4% in fiscal 2012 and at $2.45 trillion is now close to the record high reached in fiscal 2007. While Congress is likely to propose future changes to the tax code to raise additional funds, it is clear that spending cuts must also be implemented to trim deficits going forward. All together nearly 25% of federal spending goes toward health care, more than double the 10% of the budget it consumed fifty years ago. The Congressional Budget Office predicts this will increase to 33% in a decade. Similarly, Social Security benefits will need to be reduced to return that program to an affordable trajectory. The debate over cuts to these and other programs likely will be quite rancorous in the coming months as will the pending debt ceiling debate. Congress has raised the debt ceiling eleven times since 2001 though, by all accounts, the pending debate will be the most difficult given the partisan attitude in our nation's capital not to mention that politicians from both political parties have a poor track record when it comes to cutting spending. As The Economist (November 10th) recently pointed out, “America taxes itself like a small-state economy, and spends like a big-state one. Add in an ageing population, and it is going broke.”

Despite this longer term reality, in the near term the U.S. is in a healthier financial position than most other nations allowing our borrowing costs to remain low in the global capital markets. Of course, the Federal Reserve has also played a role in this regard as it financed an estimated 75% of the deficit last year with foreign buyers only accounting for 20-25%, a dramatic reversal of recent trends. The Fed now owns approximately one in six dollars of the national debt which is the largest percentage of GDP in history, even larger than during WWII. One unintended consequence of the Fed’s policy is that due to it artificially holding interest costs down it is masking the true cost of the deficit spending of the past several years. As these costs become more apparent over time some very difficult budget decisions will have to be made. Another negative consequence is that, over four years into the Fed’s near zero short term interest rate program, low bond yields continue to harm prudent investors who have experienced significant drops in income from their bond portfolios. It is also highly likely that among the future costs of the current policy will be higher inflation as the unprecedented monetary policy actions will be more than difficult to unwind. A recent International Monetary Fund study looked at twenty-six episodes since 1875 when sovereign debt to GDP ratios topped 100%. It concluded that growth, spending cuts and tax increases were only partially successful in trimming the debt but that easy monetary policy which led to inflation was ultimately a critical part of the cure. There may be other challenges as well in the coming years. As Richard Fisher, President of the Federal Reserve Bank of Dallas, noted in a Sept 19th speech “The truth, however, is that nobody on the committee, nor on our staffs at the Board of Governors and the 12 Banks, really knows what is holding back the economy. Nobody really knows what will work to get the economy back on course. And nobody—in fact, no central bank anywhere on the planet—has the experience of successfully navigating a return home from the place in which we now find ourselves.”

Despite this assessment, there are several positive signs in the current environment. With the fiscal cliff avoided for now, the U.S. economy is expected to continue its slow growth expansion phase which should allow corporate profits to enjoy a modest increase in 2013 over last year’s level. Meanwhile, Europe has temporarily stabilized as European Central Bank President Mario Draghi has committed to backstopping government borrowing in several countries there. Most U.S. housing markets are experiencing improving conditions while private sector payrolls have grown for thirty-four consecutive months. This latter factor has contributed to the unemployment rate steadily falling to 7.8% from 10.0% three years ago. There are even signs that manufacturing is returning to the U.S. as foreign labor costs are rising and other logistical concerns make home grown production more attractive. A key long term planning variable for business leaders with regard to the location of investment spending is energy costs. The recent prediction from the International Energy Agency that the U.S. may overtake Saudi Arabia as the world’s largest oil producer by 2020 has been a factor in some industries planning to invest domestically. Greater energy independence will also benefit budget deficits and the balance of payments which in turn will enhance our nation’s economic strength and international standing.

Corporate America remains in a strong position. At the end of September, U.S. companies reported $1.74 trillion in cash and other liquid assets on their balance sheets. This represented approximately 5.75% of total assets, below the recent peak of about 6.25% in early 2010, but up steadily from the 3.75% level recorded in 1990. While both investment spending and new hiring remain below levels that could be described as robust, managements have been willing to increase stockholder dividends and generously buyback their shares at a healthy pace aiding growth in earnings per share. Rolling four quarter average stock repurchase totals among S&P 500 companies have been running at over $400 billion in the past several quarters up from under $150 billion in the second half of 2009. Perhaps somewhat worryingly, however, is that managements’ history of stock repurchases displays only limited success. Buyback activity is edging closer to the highs it reached in late 2007 when that figure totaled nearly $600 billion at a time when the market was at its peak. Looked at another way, according to Standard and Poor’s, since December 31, 1999 S&P 500 companies spent $3.5 trillion on buybacks which was equal to about 25% of their starting market capitalization. During that time, however, the total share count outstanding grew by about 7% as employee stock grants and other factors increased shares outstanding. Share repurchases can represent a strategic use of corporate cash though companies should only invest in their stock if the return from buybacks meets an appropriate hurdle rate and exceeds the return on other uses of the funds. In other words, if management teams overpay for their own shares investors will be disappointed.

Similarly, individual investors must pay careful attention to price at time of purchase to improve their chances of investment success. In this regard, it is worth noting a recent MSCI study which showed that Chinese stocks have returned less than 1% per year over the past 15 years while Latin American stocks have returned over 8% despite China's faster GDP growth rate over that span. Lower returns were the result of starting valuations that were too high as investors initially overpaid for the anticipated growth.

Investment Conclusion

We encourage our clients and friends to take a long term view of the current economic, political and monetary policy landscape. Under this lens the strong market rally of late would seem to be based more on emotion than on underlying fundamental strength. Notwithstanding some of the improvements noted earlier, there are several critical intermediate and longer term challenges that remain unaddressed including slow global growth, high unemployment, questionable sovereign debt soundness and unsustainable fiscal and monetary policies being implemented in many nations around the globe. As long term investors, we continue to believe in the strength and soundness of the capital markets to provide suitable risk adjusted returns. We simply caution investors not to get too carried away in the present euphoria.

Historically, long term stock prices have been driven by earnings growth and we believe this relationship will continue indefinitely. Despite steadily deteriorating fundamental corporate earnings progress over the course of 2012, stock markets marched notably higher by year end with a full year total return of over 15%. This is despite the fact that corporate profits may show a slight decline in the fourth quarter once all the results are finally reported. It also seemingly ignores the fact that it is estimated that over 85% of the profit gain achieved by S&P 500 companies last year came from just ten companies. Typically, healthy stock markets would be experiencing more broad based gains.

As we look ahead to 2013, Wall Street analysts are anticipating earnings growth of 11% according to Thompson Reuters. As stewards of our clients' capital, we endeavor to prudently protect and grow that capital over multiple market cycles on a long term basis. This philosophy drives our process and, as such, often leads us to take a more cautious view of things long before Wall Street has caught on that the game has changed. It is our view that Wall Street is overly optimistic in its earnings expectations for the current year and investors will likely be disappointed if this is the case.

Given the many uncertainties noted in the world today, we are comfortable holding modest excess cash reserves as an insurance policy. Slightly higher than normal cash reserves both protects client capital in the event those uncertainties are manifested in lower stock prices and provides the ability to take advantages of market opportunities that would be present at that time. High quality short term bonds are a suitable place to hold cash that is not required in the immediate future. Despite our near term concerns we share a long term confidence in the capital markets. In this environment, we will continue to own high quality stocks with sound balance sheets and skilled management teams. We will focus on the underlying fundamental factors that drive long term stock returns. We will pay close attention to valuation levels of the stocks we own on our clients' behalf with an emphasis on a long term, low turnover strategy that minimizes both capital gains taxes and transactions costs. We strongly believe that disciplined investors who follow this approach will be pleased over the market cycles that are sure to come.

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