WILKINS
INVESTMENT COUNSEL

2014 SPRING INVESTMENT OUTLOOK

The stock market made little progress in the early months of 2014 as investors, coming off an exceptionally strong 2013, weighed conflicting facts and trends. The government bond market on the other hand has been in positive territory this year despite the tapering program due to weaker than expected economic data. The Fed is now buying $55 billion of bonds per month, down from $85 billion three months ago.

Domestic economic activity has been impacted by severe winter storms in the eastern half of the United States which impeded key sectors such as retail, housing starts and sales, and industrial production. The country's net export position continues to improve modestly as the nation is now less dependent on foreign oil than in recent years. Business capital investment remains sluggish, however, and at a lower level than it should be five years into a recovery cycle as end demand remains weak. Business executives are still cautious on future prospects and discouraged by ever-changing regulations, federal government mandates, and tax policy. Consensus economic forecasts presently call for first quarter real GDP to grow in the 1% area, a figure beneath the already subpar 2% growth in calendar 2013.

Corporate profit expansion continues in the mid-single digit range on an overall basis with top line organic revenue growth being somewhat lower. Foreign profits are also proving challenging for many companies where key operations are in countries with weakening currencies such as Venezuela and Turkey, or in the emerging economies of Brazil, Russia, India, and China which are falling short of expectations for country specific reasons. Foreign profits have faced currency headwinds in general when translated into U.S. dollars.

The Washington political stalemate which generated key headlines and heightened investor anxiety in recent years has abated somewhat this year as the Republican-led House of Representatives joined with the Senate and White House in authorizing a one year suspension of the national debt ceiling without new spending restrictions. The Federal deficit is moving slowly in the right direction and is presently estimated to be near $540 billion for this September fiscal year or just 3% of GDP, down from $680 billion last fiscal year.

Year-to-date market returns (excluding income)

	3/18/14 Price	Change from year-end
Dow 30 Industrials	16,336	-1.5%
S&P 500	1,872	1.3%
NASDAQ Composite	4,333	3.7%
MSCI All Country World Index ex-USA	276	-1.9%

Current Developments and Outlook

The modest economic recovery of recent years is likely to continue throughout 2014 with no obvious catalysts for either faster or slower growth. Extreme economic or capital market distortions which often precede recessions and need to be corrected are not in the landscape either. Consumers are expected to return to more normal spending patterns as spring unfolds, businesses should expand production as necessary, and the headwinds of higher taxes and lower government spending in 2013 have largely been cycled. In addition, household net worth now tops $80 trillion, a new record. Consumption should benefit somewhat from this wealth effect.

New job creation, a key barometer of progress, remains disappointing. The official unemployment rate of 6.7%, down from a peak of 10%, understates the employment problem since there has been a steady decline in the labor force participation rate (i.e., people who are either working or looking for work). This figure is presently at a 35-year low of 63%. Furthermore, many recent job additions have been in lower paying categories such as retail and hospitality. The total number of Americans working may finally reach the previous peak of some 138 million workers from January '08 by mid-year, or 6½ years later. The recovery to previous peaks has historically averaged 2½ years following the previous five recessions, a huge contrast versus the current slow recovery rate. Slow employment growth and modest wage growth directly impacts income tax receipts which are critically needed to reduce the ongoing large government deficit.

Monetary and fiscal policy also present challenges. On the monetary front Chairman Yellen is continuing Ben Bernanke's policy of easy money and nearly zero short term government interest rates. The tapering program where only $55 billion bonds are now being bought each month as opposed to $85 billion previously is still extremely accommodating and adds to the already bloated $4.2 trillion Federal Reserve balance sheet, up from $800 billion in late 2008. In this environment stock investors and speculators are being favored while savers are being disadvantaged by the low rates. The Federal government is also able to finance its growing deficit on exceptionally favorable terms and there is little or no discussion of the implications of carrying the now $17 trillion dollar debt when interest rates return to normal levels. The very real problem facing the Fed is how to unwind these many years of unprecedented accommodation without shocking the system, something easier said than done and something which has never been required before of this magnitude.

Fiscal policy, too, is in unchartered waters. Massive Federal deficit spending of $5.8 trillion dollars over the past five years has not restored the country to its long term real GDP trend line growth of 3% plus. The administration's budget proposal for fiscal 2015 focuses on higher taxes and higher spending with only cursory attention to structural policies which would encourage investment, production, and employment growth. The projected deficit for fiscal 2015 by the CBO is $478 billion, an optimistic figure and one likely to expand thereafter as the cost of entitlements including Social Security and Medicare continue to grow without reform and are joined by higher than anticipated costs from the Affordable Care Act. The latter is suffering from a lower than projected enrollment and notably so among younger Americans who are less expensive to insure for a given premium dollar. In this firm's opinion, fiscal policy and its impact on the broad economy would be on much firmer ground today had the Washington leadership seriously considered the broad reaching tax reform proposals of the bipartisan Simpson Bowles Commission it appointed and then ignored over five years ago.

Economic growth outside the U.S. was quite strong over the last decade but has slowed in recent years. China, the world's second largest economy at roughly $6 trillion in GDP has seen its growth slow from 10% to about 7% and is being confronted with serious structural problems. These include a highly leveraged and overbuilt real estate industry, excess manufacturing capacity, troubled loans on bank balance sheets, questionable investment products that have been sold to the growing middle class, and the ongoing issues associated with moving millions of people from the countryside to newly built city environments. The government has made efforts to curb real estate speculation through higher interest rates and higher down payments and most recently has allowed its currency to weaken to discourage inflationary capital inflows and speculation. China also recently recorded its first public bond market default which is at variance from its traditional policy of bailouts and loan extensions for troubled borrowers. Another recently surfaced problem is the issue of large copper inventories being used as collateral to finance risky business ventures, a development which is putting downward pressure on worldwide copper prices. In sum, China has serious economic challenges which do not lend themselves to speedy solutions.

The other so-called BRIC countries have issues of their own. Brazil is experiencing notably slower growth, higher inflation, and rising interest rates. India is also in a slower growth mode with banking industry problems in addition to social policy concerns for its one billion plus population. Russia remains highly dependent on its oil and natural gas industry. Its population is declining and it was showing only modest GDP growth before new difficulties with the West over the Ukraine.

The important Eurozone economies have moved beyond recession but growth is uninspiring at the 1% level on a consolidated basis. Several southern European countries continue to struggle with high government debt levels and overly generous entitlement policies that impede a return to higher growth rates. The United Kingdom is doing only marginally better. There are a number of other meaningful foreign economies including Turkey, Venezuela, Argentina, Australia, and Indonesia where weakening currencies and local problems are impeding growth. It is fair to say that foreign economies in general are not going to drive corporate profits to the extent they have in the past.

Investors should also take note of the current geopolitical environment and the implications therein for the capital markets and economy. America's global reach, influence, and power have been in retreat for a number of years. Many observers note that this is leaving a vacuum to be filled by our adversaries and others. The reasons for the retreat can be debated but the adventurism, aggression, and destabilizing actions of others cannot be ignored.

This is clearly the case now that the United States has left Iraq, is becoming the case as it pulls out of Afghanistan, is evident in Libya and Syria, and to a lesser extent in central Africa which has relied more on European powers for stability. Iran's nuclear program, the ever challenging Israeli/Palestinian situation, and Chinese ambitions in the South China Sea are also part of this phenomenon. Russia's current actions in the Crimea and possibly other regions of the Ukraine and Eastern Europe are particularly troubling given the difficulty of constructing meaningful and productive American and European responses. A military response is off the table and economic and political sanctions risk unintended consequences for the fragile economic recovery in Europe and for components of the Western banking system. A weak and/or ineffective response, however, could very well embolden others to push the limits of world order. These conditions all suggest uncertainty will be present, and uncertainty is the one thing the capital markets like the least.

A few thoughts on where the stock market has come from since its low water mark of five years ago and on its current valuation are also in order. Investor sentiment has made a 180 degree turn since that time with the Dow 30 and S&P 500 up 116% and 175% respectively from the March 9, 2009 bottom. Many investors who capitulated at the bottom have become buyers again and have helped push the popular indices to recent all-time highs. Corporate profits and cash flow, key drivers of stock market valuations, have moved nicely higher and net profit margins for the S&P 500 reached 9.8% in last year's fourth quarter, a record level and well above the 20-year average of 7.5%. An eventual reversion to the mean for profit margins, however, implies a much more expensive equity market than meets the eye at the moment.

Examples of excess valuation in highly sought after social media companies are also noteworthy. Facebook, with a market capitalization of $175 billion, recently agreed to purchase the young start-up WhatsApp for $19 billion in cash and stock. This $19 billion valuation exceeds the market capitalization of many well-established S&P 500 companies with thousands of employees and billions of dollars in revenues. WhatsApp by comparison has 55 employees, no marketing or PR staff, and very modest revenues. This deal meaningfully outstrips Facebook's $1 billion purchase of photo-sharing Instagram in 2012. Such a valuation is reminiscent of the dot-com excitement in the 1999 and 2000 period, which ended badly.

Investment Conclusion

Fully valued stock markets are harder to identify than out of favor ones due to the good feelings and momentum they bring with them. A close look at the factors responsible for today's strong market levels and exceptional recovery from spring 2009 raises appropriate questions. Unprecedented monetary accommodation (some would argue it has been a once in a lifetime gift to equity investors) is slowly retreating and a return to anything close to normal interest rate levels will provide competition for marginal investment dollars. Fiscal policy is not a driving force for an accelerating recovery and, if anything, is taking a back seat today to monetary policy. The lack of meaningful new fiscal policy initiatives also leaves this lever constrained by the large and growing federal government debt. Modest corporate profit growth in the United States and globally hence appears to be the path of least resistance. Growing geopolitical risks and concerns are also in evidence.

In this environment our firm reminds clients to maintain long term investment horizons but to also appreciate the importance of keeping a proper balance among asset categories. Selective profits can be taken in common stocks that have become very fully priced and these funds can be set aside as reserves for the inevitable unexpected needs or those times in the market cycle when share prices are unduly low and hence very attractive for long term purchase. Bond yields today remain at unattractive levels and only credit worthy and short term securities should be considered for purchase. These bonds can be reinvested in appropriate laddered maturities when interest rates return to more normal levels.

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