2016 SPRING INVESTMENT OUTLOOK

Financial markets have experienced significant volatility during the first quarter of 2016. The year began with the People's Bank of China (PBOC) guiding the yuan currency lower relative to the dollar, setting off a deflationary panic and a cascading chain of events across global markets. Commodity prices plunged with crude oil falling as low as $26.11 by early February. Stock markets underwent significant corrections and some indices entered bear market territory. The S&P 500 declined 11.5% by mid-winter and was down more than 15% by February 11th vs. its May 2015 cycle peak; non-U.S. stocks were down nearly 28% from the cycle peak in dollar terms (the February bottom in equities coincided with the bottom in crude oil). The flight to safety by investors pushed the 10-year Treasury yield to as low as 1.57%. Credit spreads also widened, especially for energy-related corporates that face mounting financial distress due to the collapse in oil prices. Increasing concerns about a potential global recession arose in many media and economist reports.

While fiscal policymakers continued to sit on the sidelines, monetary authorities once again delivered extraordinary accommodation during the first quarter in response to the financial market stress, continued growth slowdown, and disinflation. The Bank of Japan (BOJ) adopted a negative interest rate policy for the first time ever on January 29th, charging banks a -0.1% rate to park reserves at the central bank. The European Central Bank (ECB) cut its deposit rate to -0.4% at its latest meeting, extended its own QE program, and included corporate bonds as an additional asset it intends to purchase. The PBOC lowered its required reserve ratio and injected additional liquidity into the Chinese banking system. It vowed to stabilize the yuan currency and defend it from speculative attack. Strong credit growth continues in the country. Chinese autocrats also committed to running a higher budget deficit to ensure economic targets are met. Our own Federal Reserve reined in expectations for interest rate hikes throughout 2016 at its mid-March meeting. Currently, the median forecast of the committee is for just two federal funds rate hikes in 2016 compared to an expected four hikes when the year commenced. The response from global investors to such easing has been to pile into even more sovereign debt; the face value of negative-yielding bonds in the JP Morgan Global Bond index is now a whopping $6.62 trillion compared to just $972 billion a year ago.

The inflection across various parts of the capital markets following these central bank policies during the quarter has been surprisingly sharp. The U.S. dollar has declined 5% since mid-January and commodity prices have reversed. Crude oil has rallied 58% to $41 per barrel and industrial metals are up 12% as a group with copper rallying 18%. Iron ore is up 35% despite an ongoing supply glut. The S&P 500 has rallied more than 13% from the February bottom and is now in positive territory for the year. Institutions have fled financials and have rotated into commodity-related/industrial stocks, anticipating that the dollar could eventually be less of a drag on external profits and that interest rates will be lower for longer. Emerging market equities have rallied more than 20% the past eight weeks. Junk bond returns are also back in positive territory for the year after being clobbered at the start.

Gold is usually a portfolio ballast during periods of uncertainty and its price has benefitted from the financial market volatility, additional monetary easing, and sluggish growth during the first quarter. The price of gold is up more than 17% year-to-date and the major indices of gold mining companies are up over 50%.

Unfortunately, not a lot has changed on the economic front despite the violent moves in the financial markets. According to *The Economist*, the world economy grew 2.5% in the last quarter of 2015. Growth has now slowed for

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five consecutive quarters and is at its lowest rate since the beginning of 2013. Monthly data indicates that global GDP growth continues to stall throughout the first quarter of 2016, too. The world is facing diminishing returns from monetary policy and will now need to experience responsible and expansionary fiscal actions if fundamentals are to brighten.

2016 YTD Equity Market Returns (excluding income)

	3/22/16 Price	% Change
Dow 30 Industrials	17,583	+0.9%
S&P 500	2,050	+0.3%
NASDAQ Composite	4,822	-3.7%
MSCI All Country World Index ex-USA	240	-1.1%

Outlook

While the U.S. and global economy survived the extraordinary financial crisis of 2008-09, the world is perhaps a more dangerous place at the moment both politically and financially. The threat of global terrorism is rising and the Middle East is in chaos. The increase in sovereign government debt seems out of control with the U.S. government alone borrowing $11 trillion since 2008 for a total $19 trillion outstanding at the moment on a gross basis. The notional value of the derivatives market (described by market maven Warren Buffett as financial weapons of mass destruction) has risen to more than $500 trillion, according to the Bank of International Settlements, from just $182 trillion in 2008. These magnitudes dwarf the $1.3 trillion subprime mortgage crisis of eight years ago.

The policy response to crisis management and slow growth has been to add even more debt, whether it be in developed economies or emerging ones like China, and make interest rates even lower. An unintended consequence of such action is a misallocation of capital, with the various credit stresses now occurring in the energy sector being one example. Perhaps more egregious is the situation in Europe where some businesses now have banks paying them interest (instead of the other way around) on loans to finance equipment or expansion plans. Has the world been turned upside down? The problem with all this debt is that the world is increasingly paying for things that already have been purchased instead of new items, while economic growth depends on the continual purchase of new goods and services.

Fortunately, the U.S. has yet to experience negative rates and the U.S. banking system is well-ahead of its European counterparts, currently operating at a leverage multiple that is one-third of pre-financial crisis levels. However, the proliferation of negative rates across the globe will likely draw capital into the U.S., supporting the dollar and pushing down longer term Treasury yields. While the dollar has fallen sharply since early February it is likely to find support over the medium term due to growth and policy divergences. The U.S. is growing closer to its longer run potential compared to many other economies, where the gap between the current rate of growth and potential rate is much wider. Closing this so-called output gap in foreign geographies will require additional easing measures. China will also need to manage a deleveraging of its economy, which will require it to eventually depreciate its currency relative to the dollar to a greater degree if it is to implement supportive growth measures to prevent a hard landing. Again, such predicaments have consequences for the dollar and U.S. interest rates.

According to the Federal Reserve Bank of Atlanta GDPNow model, first quarter growth in the U.S. is tracking at 1.9%, slightly below the 2.1% annual rate experienced since the end of the recession. Growth in retail sales and overall personal consumption has been less than expected quarter-to-date despite the steady payroll gains. The personal savings rate is currently 5.2% and continues to rise, opposite the declining trend of the previous expansions and a headwind to current spending. Unfortunately, productivity growth also remains weak in the current cycle, growing at just a 0.5% y/y trend compared to the 2.1% average rate from 1980-2007. The trend in capital investment has been flattish since 2012; strong capital formation normally coincides with periods of strong productivity and vice versa. Policymakers need to incentivize investment if the U.S. is to break above the current 2% or so trend of GDP growth.

China plays a very important role in determining global growth and data throughout the first quarter continues to portray a slowdown for the world's second largest economy. The central planners lowered their GDP growth target to a range of 6.5%-7.0% for 2016 in early March. Industrial production, fixed asset investment, and retail sales are all slowing; trade data on exports and imports shows outright declines, which normally occur during recessionary periods. Expectations for other major economies also remain unimpressive with the Eurozone expected to grow 1.0%-1.5% this year and Japan just 0.5% on a real basis.

A supply response seems to finally be occurring in the crude oil market. Domestic U.S. production is down about 5.5% since last summer to approximately 9.08 million barrels per day. OPEC and some non-OPEC members are working towards striking a deal by mid-April to cap production. The extreme bearish sentiment around crude oil prices has given way to a sharp reversal back to price levels seen in early December near $41 per barrel. Oil prices are likely to remain in a range that is still economically beneficial to end users over the next several years, short of a supply shock, unexpected surge in GDP growth, or decline in the dollar. Inventory levels remain at multi-decade highs and cash costs of U.S. shale producers continue to fall.

The Federal Reserve's preferred measure of inflation has firmed with year-over-year gains of 1.7% in January. While the gauge remains below the targeted 2.0% level, prices for consumer services other than energy have been accelerating since mid-2015 and are at rates not seen since the previous expansion. Perhaps the sharpest contrast between hawks and doves in terms of the tempo of future inflation and monetary policy centers on wage growth, which is still below historical average. Both sides can make strong intellectual arguments for the labor market either tightening (hawks) or remaining slack (doves) in the coming quarters, and hence wages either accelerating or remaining stagnant, respectively. How this data evolves could set the pace for how fast the Fed ultimately tightens. Nonetheless, a disinflationary bias may persist over the medium term due to high debt levels, an appreciating dollar, and demographic headwinds.

Our main concern with the equity market continues to be the lack of profit growth as well as full valuations. Trailing earnings for the S&P 500 of about $117 per share have been flat for more than a year due to the headwinds from the energy and material sectors, and profits away from these sectors are probably growing at just a 3-4% rate at best due to currency headwinds and weak global growth. With the S&P 500 trading near the 2,050 level, this puts the trailing price-to-earnings (P/E) multiple near 17.5x earnings, a premium relative to history. This premium valuation combined with modest future growth expectations puts the so-called PEG ratio (P/E-to-growth) of the market above previous peaks. Additionally, corporate buybacks seem to be the sole demand for equities on a net basis as outflows from other market participants selling mutual funds and ETFs continue during the first quarter. S&P 500 constituents are expected to repurchase as much as $165 billion of stock in Q1, bringing the 12-month total above $590 billion and breaking the 2007 record. S&P 500 companies have repurchased more than $2 trillion worth of stock since 2009. We remain skeptical of the present buying as such amounts have historically coincided with market peaks.

We would be remiss if we didn't mention the current political unfoldings. The campaign for the White House has been as volatile as the financial markets themselves during the first quarter, and in our view both parties have been missing the mark with their main economic messages to key constituencies. The bashing of trade ignores the economic benefits generated from comparative advantage and specialization such as lower overall costs for purchased goods, higher global production, higher standards of living, and wealth creation. On the other hand, proponents of income redistribution and attacks on the wealthy are in denial of the necessity to grow the economic pie if society is to become more economically inclusive. The U.S. continues to dominate in entrepreneurship and venture investment; other developed economies are not even close with Europe making just 10% of the venture capital investments that we do and Japan making a mere 4%. A study by the National Bureau of Economic Research (NBER) found successful entrepreneurs realize just 3% of the value of what they produce, while consumers reap the rest, either directly through employment or via social benefit.

Investment Conclusion

We continue to take a disciplined approach to new investment. The current bull market is now more than seven years old, earnings growth is modest, and valuations are extended. Forecasting the future is highly prone to error, but if we had to guess we would not be surprised to see the trendless direction of the equity market continue in the same fashion that has existed since last summer. Volatility is likely to remain elevated and the Fed is expected to raise its short term rate once again in the coming months, which could further drain some of the excess liquidity from global financial markets. The likelihood of a deeper correction seems to be a greater risk than a sustained breakout above the May 2015 highs. A strong move higher would probably require some pro-growth fiscal stimulus in order for earnings to reaccelerate, which does not seem politically palatable at the moment, and it would not surprise us if even more central bank easing pushed stocks into frothier territory. On the flip side, it is impossible to predict if and when one of the many potential downside risks we often discuss with clients becomes a real one and ultimately impacts economic growth and hence stock prices. Thus, our focus on capital preservation continues with new investment a secondary consideration.

March 23, 2016

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