WILKINS
INVESTMENT COUNSEL

2016 SUMMER INVESTMENT OUTLOOK

Uncertainty best describes sentiment in the capital markets year to date. The equity markets experienced a nearly 15% sell-off in the early winter months only to recover and post mixed results as the summer begins.

Key economic data remains uninspiring whether one looks at domestic or international statistics. Real GDP in the United States grew by only 0.5% in the first quarter following a 1.6% gain in the fourth quarter, and even with a spring pick-up the first half gain should be no better than 2.0%. Europe is stalled in the 1% growth area, Russia remains in contraction, Latin America is struggling with recessions in Brazil and Venezuela, Japan is seeking to restore growth, and the Chinese expansion rate continues to moderate. Hence business revenue growth remains lackluster and corporate profit margins are under pressure. Productivity (output per man hour), a key measure of economic progress, fell 0.6% in the first quarter following a 1.7% decline in the fourth quarter. Unit labor costs are rising at a 3% annual rate, impeding profits and discouraging companies from adding workers. Recently reported U.S. job growth of only 38,000 in May was probably an aberration (35,000 striking Verizon workers are one temporary impediment) but is another manifestation of economic uncertainty.

Housing has been one bright spot with solid growth in starts, median prices, and buying intentions. Low mortgage rates have obviously helped. Consumer spending has grown in line with wage gains although the consumer savings rate of 5%+ reflects some caution and is above the previous cycle. U.S. household wealth has recently reached a new high water mark of $88 trillion on the strength of residential real estate and financial assets. Some basic commodities including oil and gold have rallied this year. Oil reflects modest growth in global demand and some reductions in supply. Gold, a traditional safe haven in times of economic and political uncertainty, is benefitting from rising demand and flat mine production.

Federal Reserve Board policy of record low interest rates, contrary to earlier intentions, is no doubt benefitting financial and real estate asset prices while continuing to penalize fixed income investors. Chairwoman Yellen noted recently that the lack of transition to more solid economic conditions weighed heavily on the Board's decision not to raise interest rates at the recent June meeting

Other factors contributing to uncertainty include the barbaric activities of the terrorist group ISIS within broad swaths of the Middle East and now extending to parts of Africa. ISIS inspired attacks in France, Belgium, and more recently the United States are more than unsettling. The 2016 Presidential race is proving to be highly contentious given high unfavorability ratings of the presumptive party nominees, Secretary Hillary Clinton and businessman Donald Trump. The disillusionment of a broad segment of the population with Washington insiders and the political class in general has raised the level of negative rhetoric to a modern day high. Finally, the "Brexit vote" as to whether the U.K. chooses to stay in or opt out of the European Union is to be held momentarily. While an exit vote would be viewed negatively for near term European prospects, serious long term issues remain regarding the long term viability of the economic union and common currency, in any event. All the factors mentioned above contribute to uncertainty which the capital markets generally dislike.

Year to date equity market returns are shown below:

2016 YTD Equity Market Returns (excluding income)

	6/20/16 Price	% Change
Dow 30 Industrials	17,804	+2.2%
S&P 500	2,083	+1.9%
NASDAQ Composite	4,837	-3.3%
MSCI All Country World Index ex-USA	240	-1.1%

Outlook

The direction of the U.S. and global economy are key factors in the outlook. The U.S. recovery period which began seven years ago in June 2009 is the weakest of the post-WWII expansion cycles with real GDP growth never achieving the normal annual trend of 3-4%. In fact growth has been stuck in the 2% area with a number of quarters showing little or even negative progress. This below average showing is despite massive fiscal stimulus and deficit spending of some $7.5 trillion dollars and the most accommodative monetary policy in the history of the Federal Reserve.

Fiscal and monetary policies are the time tested tools government officials use to balance and grow the economy and unfortunately have not produced the desired progress since the last recession. The Federal government debt now exceeds $19 trillion in gross value, a figure larger than the country’s GDP. A deficit has been run each year since 2001, and while the deficit declined from a peak of $1.4 trillion in 2009 to $435 billion in 2015, it is forecast to rise this year and every year thereafter unless adjustments are made (the last budget surplus was $127 billion in 2001). Political leaders of both parties have been reluctant to propose compromise and workable solutions to the deficit issue for reasons of partisan politics. The last serious attempt was in 2009 when the bipartisan Simpson-Bowles commission put forth a program in which all economic interests would contribute something to the solution but the plan fell on deaf ears in official Washington. Slow and uneven growth will continue without substantive reform in fiscal policy.

Federal Reserve Board policy has likewise been very aggressive on the side of monetary ease and interest rates remain at historically low levels. The Fed continues to run a bloated balance sheet of over $4.5 trillion and is reinvesting the interest and principal maturities of its holdings in additional bond purchases. Low interest rates mean the growing deficit can be financed without adding materially to the government interest expense but simply defers the day of reckoning. Hence, the widely used saying “the can is being kicked down the road” and the tipping point will come when normalized interest rates impact the large Federal deficit. On the monetary front, no one can predict future Fed actions, yet it would be politically difficult for the Fed to raise rates between now and the November elections. Hence, easy money is likely to continue for a while and a recent New York Times business section article entitled “The Fed is Learning How Hard It Is to Exit Easy Money” drives home the point.

The US is not alone in aggressive fiscal and monetary policies as many countries are pursuing both practices. Interest rates are now negative on over $10 trillion of sovereign country debt which means savers are *paying* to lend their money rather than being *paid* to lend it. The benchmark 10-year German Bund, for example, for the first time in history has a negative interest rate and the average interest rate on all German government borrowings is also negative. Interest rates on short/intermediate term sovereign bonds in France, Italy, Switzerland, the Netherlands, Spain, Sweden, and Japan are also negative. Low and negative interest rates are an anathema to financial service firms which rely on positive earnings from their bond portfolios to pay for their long term liabilities. The large current account surplus in Germany has also contributed to negative rates as there is a surplus of savings to invest, at least temporarily. Insurance companies, in Germany for instance, will quickly see their profitability and ability to meet ongoing liabilities eroded if negative rates continue for a long time.

Bank earnings are also under intense pressure as banks normally earn a positive spread between low cost deposits and higher interest rate investments. The Wall Street Journal also commented on negative interest rates as follows in a recent editorial: "Negative interest rates reflect a lack of confidence in options for private investment. They also discourage savings that can be invested in profitable ventures. A negative 10-year bond is less a sign of monetary wizardry than of economic policy failure."

Current low interest rates in the United States result in a major penalty for savers and speculation in some asset categories including common stocks and real estate. Low rates and bond returns also create major problems for the already underfunded retirement benefit promises of government and private pension plans. State and local pension funds are notably underfunded with the city of Chicago and state of Illinois being notable standouts. Benefit cuts are likely for teachers in Chicago (already has happened in Detroit) as the tax base is simply unable to absorb the costs needed to fund the promised payments. The same can be said for the social security system, a pay-as-you-go operation, where without much needed reform, outflows will continue to exceed inflows and the depositary trust funds holding previous receipts will be depleted.

Debt levels are very high throughout the world and some categories of loans in this country (student, auto, and certain consumer) are challenged and headed to default status. While nothing like the write-downs of housing related debt in the last recession is likely to happen, lenders are expected to incur losses and setbacks. The ratio of global debt-to-GDP has reached a new high of 240% and U.S. corporate debt as a percentage of nominal GDP is at a cyclical high of 45%.

In sum, a meaningful downward correction in bond prices is likely to occur at some point in the future when rates inevitably return to more normal levels. Any price correction would be exacerbated if it occurred during a period of economic contraction. The Federal Reserve Board and many other central banks have left themselves in the vulnerable position of having few policy tools to employ for stabilization should a contraction/recession occur at a time when easy money is the ongoing policy.

We concur with those who believe traditional fiscal and monetary policy tools are no longer working as intended and, given political stalemate within the country, have no immediate prospect of being fixed. Hence economists are left in a dilemma and in uncharted waters as regards the accuracy of future predictions. The best that can be said is that U.S. growth will continue at a substandard rate of no better than 2%, global GDP growth won't be much better, and corporate profits (key driver of common stock prices) will achieve only modest progress. Common share prices are fully-valued (18x forward earnings) by long term historical standards and forecasted growth is modest at best. A good deal of ongoing bullish sentiment is being driven by easy money, which has eliminated the normal competition from bond investments.

The geopolitical front remains a challenge as does the polarized political environment in the U.S. and other countries. The Middle East is as unsettled as ever and regime failure there has spread to South Yemen and Libya. The ISIS threat continues and has been extended to Europe and the United States. Russia and China are also seeking to widen their sphere of influence in their respective regions and have achieved some success. The Eurozone is burdened by the inherent contradiction between a common currency and the lack of political unification and will. Whether this unique economic institution survives or not remains an open question and the possible departure of the U.K. (which never adopted the common currency) may call the question.

Political stalemate has prevented the United States from bringing its outstanding strengths and resources to bear on the problems at hand. As noted earlier, the bipartisan Simpson-Bowles plan for restoring fiscal discipline was dismissed some years ago while its authors continue to argue its merits. The United States has always found the leaders it needed during a crisis and this firm remains optimistic that leadership will emerge to deal with fiscal challenges before the deficit issue becomes truly unmanageable. Sound fiscal policies will also take the pressure off the Federal Reserve as the policy maker of last resort.

American technology also remains a notable strength in the long term outlook and additional breakthroughs on par with the PC revolution, the Internet, wireless communication, and medical advances can be expected. These successes have been exported around the globe and benefitted economies and people everywhere.

Investment Conclusion

The challenges noted above put this firm in a capital protection mode as regards investment portfolios. Solid cash reserves should be maintained to provide necessary liquidity during a period of market setbacks/corrections and simultaneously will provide buying power for long term stock investment opportunities that may emerge. Common stocks with distinctive competence features and an economic moat of protection will continue to be the favored vehicle for long term appreciation and income growth. Bonds are considered to be overpriced as compared with normal conditions and only investment grade short term issues are considered appropriate for new investment at this time.

June 21, 2016

The firm is pleased to announce that David R. MacDougall will be joining our team as a Senior Investment Analyst on July 1. David is a cum laude finance graduate of Northeastern University and holds an MBA from Boston College where he was named a Dean’s Scholar and Executive Fellow. He holds the Chartered Financial Analyst designation and is a member of the Boston Security Analyst Society. He and his family reside in Wenham, Massachusetts.