WILKINS
INVESTMENT COUNSEL

2017 SUMMER INVESTMENT OUTLOOK

Many of the trends that had been in place through the winter months persisted throughout the spring. U.S. economic growth continued at a subpar pace relative to historical standards though it remained at a level sufficient to drive ongoing progress in both corporate profits and the job market. The current economic expansion will begin its ninety-seventh month in July making it the third longest in the post-WWII era lagging only the 106 month boom from 1961-1969 and the 120 month growth phase that lasted from 1991-2001. Compound annual growth averaged 4.9% and 3.6%, respectively, during those periods, and has advanced at an average 2.1% rate so far in the current expansion. Despite only modest economic growth, the job market has continued to improve with the unemployment rate hitting 4.3% in May, a level last seen in May of 2001. In spite of the seemingly tight labor market, however, wage growth has remained disappointing and has only increased modestly above the rate of inflation. This has provided a slight headwind to retail spending and consumer confidence.

The political environment in Washington has remained extremely divided and little progress has been made toward Republicans' plan to repeal and replace Obamacare while no headway has been achieved with regard to President Trump's campaign pledge to overhaul the tax code and guide a substantial infrastructure spending deal through Congress. Not only has the President failed to bridge the divide with Democrats in the House and Senate, he also has had more than a few difficulties finding common ground with politicians in his own party. Nevertheless, investors have continued to focus on events outside of the Beltway and seem unconcerned with the political dysfunction in the nation's capital.

The Federal Reserve has placed greater emphasis on the low unemployment rate and has dismissed recent modest inflation readings as being due to temporary factors. It therefore raised its key short term lending rate last week for the third time in the past six months and for the fourth time in the current tightening cycle. Interestingly, the bond market has remained skeptical of the Fed's logic as longer term bond yields have fallen dramatically this year. At the same time the central bank has raised short term rates by 75 basis points since mid-December, the yield on the ten year U.S. Treasury bond had decreased some 30 basis points. Typically, such a flattening of the yield curve has been a signal to investors to be wary of impending risks to the outlook.

Despite this, stock investors have remained optimistic pushing the markets to numerous record high closes this year. Bolstering investors' confidence, first quarter earnings beat expectations as Corporate America's bottom line increased by an estimated 14% according to FactSet. Importantly, these gains were not all achieved via cost cuts as revenues are estimated to have increased nearly 8% in the quarter, driven by the energy (+34%) and financial services (+9%) sectors. These results have been sufficient to propel markets to substantial year to date gains as shown below.

Equity Markets – 6/21/17

	Index Price Level	2017 YTD Total Return
Dow 30 Industrials	21,410	+9.7%
S&P 500	2,436	+9.9%
NASDAQ Composite	6,234	+16.5%
MSCI All Country World Index ex-USA	276	+12.0%

Outlook

The U.S. economy expanded at a lackluster 1.2% pace in the first three months of the year. The Atlanta Fed's GDPNow forecast calls for second quarter growth of 2.9% so averaging the two quarters indicates that overall growth is continuing in line with the modest pace of the current recovery. While below the historical growth rate of the economy, this increase has been sufficient to lower the unemployment rate to a sixteen year low. Labor market signals are mixed, however, as average hourly earnings of production and nonsupervisory employees rose only 2.4% year over year in May, only slightly above the 1.5% core PCE inflation rate. This is the Federal Reserve's preferred inflation gauge and it has undershot the Fed's 2% goal for fifty-eight consecutive months. Labor force participation rates remain weak and hover near forty year lows. Some debate remains as to whether this is due to the aging U.S. workforce or to the mismatch between workers' skill sets and the qualifications needed in today's job market. It is likely there is truth to both theories although the underfunded status of Americans' retirement savings suggests that some older workers would be willing to re-enter the working world given the opportunity. Regardless, with the number of working age Americans who are not in the labor force near record high levels, it will be difficult to sustainably boost economic growth. It is also difficult to see broad based wage growth meaningfully pick up given a large pool of idle workers. Looking longer term, the Social Security Administration projects no increase in the working age population between 2020 and 2030. This highlights the need for policies to boost labor force participation and to enhance U.S. productivity which remains subpar relative to historical trends.

On this front, the political climate in our nation's capital offers little reason for optimism. With one party in control of the White House, House and Senate it should be reasonable to expect that party to coalesce behind a commonly agreed upon agenda and then to make the necessary concessions to get enough votes from the other side of the aisle to pass legislation to move the country forward. This is not occurring and there is little reason to think this will change any time soon. The Republican plan to immediately repeal and replace the Affordable Care Act has been poorly managed with interparty disagreements looming almost as large as those with Democrats. The nation spent $3.2 trillion on health care in 2015, a 5.8% increase over the previous year, the largest annual gain in eight years. This equaled nearly 18% of GDP, a figure that is set to meaningfully rise in the coming years due both to rising numbers of insured people and an aging population. As of this writing, it is far from clear what legislation, if any will come out of Congress to address this critical piece of the U.S. economy.

In addition to the real world implications for everyday Americans, healthcare overhaul was supposed to provide the funding to allow for a once in a generation overhaul of the tax code. Tax reform that encourages more investment which would boost future productivity and incomes would be a welcome development. Early efforts on this front are not encouraging as there are widely opposing views both within the Republican party and even between key members of the White House team regarding the best path forward. The last time a major rewrite of the tax code occurred was in 1986. At that time, President Reagan benefited from an approval rating north of 60% and had very strong relations with Democrats in Congress having passed a smaller tax bill through a Democratic controlled House during his first term in 1981. Furthermore, he enjoyed the support of a seasoned team of Washington veterans including Treasury Secretary James Baker who understood how to navigate the halls of Congress. President Trump has none of these advantages and is operating in a much more politically divisive time suggesting it might be reasonable to reduce one's hope for major tax reform. A tax bill that simply allows for repatriating companies' earnings held abroad would fall well short of current expectations, but would nevertheless provide a meaningful one time boost to the economy and Corporate America.

The powerful market rally since the November election suggests the stock market has already priced in corporate tax reform. The market has also benefited from first quarter results which were strong as both revenues and earnings posted decent advances adding to investors' confidence. In fact, revenues and earnings recorded their strongest advance since the fourth and third quarters of 2011, respectively. Furthermore, gains were broad based as ten of the S&P 500's eleven sectors grew earnings in the quarter. After five consecutive quarters of earnings declines, S&P 500 companies have now grown earnings for three quarters in a row. This bull market, as measured by the S&P 500, is now ninety-nine months old making it the second longest on record trailing only the 147 month bull market that lasted from December 1987 to March 2000. At the same time, markets are fully valued with the S&P 500 currently trading at 17.9 times projected earnings over the next twelve months, a premium to the thirty year average of 15.1 times. Another indicator that gives us pause is the fact that the gap between S&P 500 operating earnings and earnings as reported according to generally accepted accounting principles (GAAP) is at its largest since 2007. While some deviations from GAAP are legitimate, in the past, when company management teams were overly liberal with their interpretations of accounting rules investors were ultimately wise to remain skeptical.

Federal Reserve policy is another question mark in the outlook. As noted, the Fed raised short term interest rates by twenty-five basis points at its latest meeting earlier this month and signaled that one more hike is likely prior to year end. In addition, the bank announced its plan to slowly wind down its $4.5 trillion balance sheet clearly communicating its intentions in an effort to avoid a repeat of 2013's so-called "taper tantrum" when investors' questions regarding the pace of Fed asset purchases created turmoil in the bond market.

The interest rate outlook is important to stock investors as low rates have provided a key underpinning for equity prices so developments in this area bear watching. In addition, overall debt levels in the economy remain high so any meaningful change in funding costs could have significant implications for the future. Federal government, state government and corporate debt are all notably higher now than when the recession ended in 2009. Under current policy, the nonpartisan Congressional Budget Office forecasts that the U.S. federal deficit will increase every year from 2019-2027. It will hit $1 trillion by 2023 thus adding to what is already the highest federal debt level in our nation's history relative to GDP excluding two years during World War II. Many states, too, are financially stretched which is why the National Association of State Budget Offices projects that state spending will rise by just 1% in 2018, the smallest gain since 2010. Meanwhile, S&P has downgraded the credit rating of fifteen states since the beginning of 2016 versus only two upgrades. Finally, a recent Bank of America Merrill Lynch study concluded that at a time when debt issuance is at a record high level, investment grade corporate debt interest coverage ratios are at their lowest levels since 2010. In our view, the market is underappreciating the risks that higher interest rates would present to these three important segments of the economy.

Other countries around the world continue to grapple with the consequences of having too much debt which will limit global economic growth relative to historical trends. China is a prime case in this regard as its total debt has reached 257% of GDP according to the Bank for International Settlements. This compares to only 152% in 2007 and is well above the current level of 184% for emerging markets overall. This is a key reason why the rate of economic progress in that country has slowed meaningfully in recent years as policymakers shift their focus to a more sustainable level of growth. Credit ratings firm Moody's recently acknowledged China's challenges as it downgraded the country's sovereign debt rating one notch to A1 from Aa3, its first downgrade in twenty-eight years. Puerto Rico offers an extreme example of what can go wrong when a nation's debt exceeds its ability to repay it. Earlier this year the island territory declared bankruptcy with over $73 billion in total debt leaving it up to the courts and its creditors to decide its fate.

Investment Conclusions

In recent *Outlooks*, our firm has recommended a cautious stance regarding the investment climate. The concerns noted above coupled with the overextended valuations in today's stock market suggest that a careful approach will be rewarded over the complete market cycle. While we have remained fully invested and client portfolios have benefitted from recent gains in the market, we have been reluctant to commit meaningful additional capital in the current environment. As successful long term investors, we have an appreciation for history and the lessons it offers.

It is our belief that an investor's greatest advantages are the ability to think for themselves, come to thoughtful conclusions supported by the facts and to remain unfazed by emotion and the so-called conventional wisdom of the day. We always take into account the potential upside of any investment while paying careful consideration to the risks involved. Today's overextended valuations in the face of an uncertain investment climate give us pause. Despite any near term headwinds in the outlook, however, we have faith in the longer term potential of the American capital market system to drive stock prices higher in the years to come. Indeed, even in today's world of stretched overall market valuations we have identified several companies that are selling at appropriate prices for long term investment. We remain well positioned and have cash available in money market funds and short term bonds to take advantage of opportunities that present themselves.

As we contemplate the future, we will embrace the sentiments of successful long term investor Seth Klarman of Baupost Partners who said in his latest year end letter to his limited partners "we will remain cautious and disciplined; we will do our utmost to separate reason from emotion, relying on the former while striving to recognize the latter and hold it at bay." He further pointed out that "successful long-term investing requires unending hard work, great patience, and strict discipline." We wholeheartedly agree and our team will never forget these principles as we work to meet our clients' goals and objectives.

June 22, 2017