2018 SPRING INVESTMENT OUTLOOK

In the opening months of 2018, many of the trends that were in place last year continued. Economic growth, both domestically and abroad, appears to be on track to match if not beat 2017's results when the U.S. economy expanded at a 2.2% rate while the global economy advanced at a more robust 3.7%. The ongoing economic expansion has bolstered job prospects as the U.S. unemployment rate in February held at a seventeen year low of 4.1% for the fifth consecutive month. Meanwhile, wages grew 2.6% versus a year ago slightly outpacing inflation. Along with other tailwinds, the above factors provided a sufficient backdrop for Corporate America to record strong fourth quarter results capping a year that saw aggregate S&P 500 earnings grow approximately 12%. Investors anticipate further gains this year with earnings currently expected to improve 19% in 2018. Results this year will be aided by the recently enacted tax cut which may account for 7 to 8 percentage points of that growth and is providing immediate benefits to companies and workers alike.

These solid underpinnings, coupled with prevailing investor enthusiasm, have allowed all three major U.S. stock market indices to modestly extend their gains so far this year as shown in the table below. March 9th marked the ninth anniversary of the current bull market which is now the second longest in history. It has been very rewarding to investors who had the discipline to remain invested since the depths of March 2009 as the S&P 500 has advanced over 300% since that time.

While many of 2017's positive attributes have carried over into the first quarter, there have been a few notable differences in the 2018 investment climate. Perhaps most importantly, interest rates have steadily moved higher with the benchmark ten year U.S. Treasury note now yielding 2.90%, up from 2.41% at the end of December. Short term rates have continued to advance as well, as evidenced by today's hike in the federal funds rate by one-quarter point to a current target range of 1.50-1.75%. Easy money policies throughout the current bull market contributed to stocks' strong gains and rising bond yields left fully valued equities vulnerable to a pullback. Escalating rhetoric out of the White House regarding tariffs put investors on edge as trade war fears rose. A federal spending deal that ensures ever rising fiscal deficits, ongoing acrimonious partisanship in our nation's capital and numerous geopolitical concerns also contributed to increased market volatility in the early months of 2018. These factors resulted in stocks experiencing their first official correction since early 2016 as the S&P 500 fell over 10% from late January into February though it has since recovered some of those losses.

Equity Markets – 3/20/17

	Index Price Level	2018 YTD Total Return
Dow 30 Industrials	24,727	+0.6%
S&P 500	2,717	+2.1%
NASDAQ Composite	7,364	+6.9%
MSCI All Country World Index ex-USA	305	-0.2%

Outlook

The current economic expansion at 104 months is the third longest in history and will almost certainly eclipse the second longest which lasted 106 months from February 1961 to December 1969. Only the 120 month boom from March 1991 to March 2001 was longer. Tax reform will enhance the near term outlook as over 80% of all employees should see an increase in their take-home pay while companies are incented to invest and are bolstering shareholder returns through higher stock buybacks and increased dividend payments. Various estimates suggest that U.S. GDP growth could be boosted by 0.4%-0.7% in 2018 and perhaps a slightly lesser amount in 2019 due to the legislation. Meanwhile, the International Monetary Fund is now projecting that global GDP growth will be 3.9% this year and next due in part to the U.S. tax deal but also to improved economic conditions in both Europe and Asia. A continuation of the current economic expansion can be expected to improve the environment for employees. As it is, the number of working Americans has increased for 89 consecutive months, a record. Indeed, in the first two months of 2018, payrolls have expanded by an average of 276,000 jobs per month, a notable pickup from the 182,300 per month average in 2017. Should the job market maintain this strength, higher wages are likely to follow as employers vie for workers. Increased wages would be welcomed by American workers who have benefited less than the corporate sector in the current expansion as a disproportionate share of the gains have shown up in the form of higher profit margins rather than fatter paychecks. One result of this trend has been a steadily declining savings rate for U.S. households which hit 3.2% in January, down steadily from the average annual rates of 3.7%, 6.0% and 7.2% in 2017, 2016 and 2015, respectively. Rising asset prices may also partially explain why consumers are willing to draw down savings and spend some of their newfound stock market and housing wealth. It is worth remembering, however, that the most recent periods when asset prices were high and savings rates were low were soon followed by the collapse of stock prices in 2000, the end of the housing boom in 2006 and the 2008-2009 Great Recession.

While tax cuts will boost growth, they will also meaningfully increase deficits and add to the long term U.S. debt burden. This is happening at a time when the federal debt to GDP ratio is at its highest level since immediately after World War II. The Treasury Advisory Borrowing Committee, a group of private financial institutions that advise the U.S. Treasury Department, estimates that net federal debt issuance will top $950 billion in the current fiscal year and will likely exceed $1 trillion in the 2019 and 2020 fiscal years. This is unprecedented in a peacetime economy and is even more unusual given that the U.S. is nine years into an economic expansion. It also will likely limit the options available to policymakers to respond effectively when the next recession occurs.

This increase in federal debt is occurring at a time when the corporate debt burden is also cause for concern. U.S. corporate debt now represents approximately 45% of GDP, a level similar to where it stood prior to the past two recessions. As in those periods, lower rated companies have easy access to credit today as evidenced by the fact that stocks in the Russell 2000 (a proxy for small cap stocks) have doubled their net debt in the past five years and it is now higher than it was in 2007. Many deals in the current environment are priced at historically tight spreads relative to risk free Treasury bonds and without bond covenants meant to protect investors. Similarly, half of all U.S. leveraged loans last year were “covenant-lite” according to the Institute of International Finance (IIF), as were 60% of such loans made in Europe.

The IIF reported that total global debt hit $233 trillion at the end of the third quarter of 2017, up 80% versus about $129 trillion ten years ago, divided among non-financial corporate debt of $68 trillion (+92%), financial sector corporate debt of $58 trillion (+80%), government debt of $63 trillion (+87%) and household debt of $44 trillion (+59%). Some $40 trillion of those obligations were extended to emerging market governments, businesses and households, far outpacing growth of those underlying economies. As a result, overall emerging market debt to GDP levels rose to 211% in September, up from 148% ten years prior. Given the interconnectedness of the global financial system, such a rapid increase in indebtedness to these riskier creditors should be of concern to all investors.

As global growth has improved, central banks have begun to normalize policy including today's fed funds rate increase and plans by the European Central Bank to curtail corporate bond purchases later this year. The aforementioned rise in debt levels makes this task more challenging and increases the tail risk of causing negative unintended consequences should central banks remove stimulus too quickly. Such repercussions could easily extend beyond the bond market into the stock market as low interest rates have provided a key underpinning of high equity prices. There is little debate that the era of "free money" has helped inflate asset prices, so it is reasonable to wonder if those high prices can persist as that accommodative policy is removed.

This fear contributed to the market's decline earlier this year as the S&P 500 ended a period of 404 consecutive trading days without a 5% drop in stock prices from the previous high which was the longest streak in history. As noted earlier, this drop became an official correction as stocks ultimately fell over 10%. There has been a notable pickup in volatility this year as well. One such measure is the number of trading days when the S&P 500 has closed either higher or lower by more than 1%. In 2017 this occurred only eight times. Not even three months into 2018, this has already happened seventeen times, a figure that is sure to move higher over the balance of the year. Record levels of margin debt will contribute to volatility as investors may be forced to sell into weaker markets to cover margin loans. Total margin debt hit a record $642.8 billion earlier this year according to the Financial Industry Regulatory Authority (FINRA). With data going back to 1980, Goldman Sachs reported that net margin debt represented a record 1.31% of the total value of the New York Stock Exchange in 2017 surpassing the previous high of 1.27% in 2000 which culminated with bursting of the technology bubble. Should increased volatility create heightened uncertainty regarding the outlook, investors could respond by assigning lower multiples to common stocks. This would likely surprise investors as P/E ratios have increased for six consecutive years. Higher interest rates could prove to be another headwind to stock valuations so the trend in bond yields bears close watching.

At least in the short term, however, there is reason to think that the second longest bull market in history will continue. Optimism in Corporate America remains strong as global growth continues, tax cuts improve near term revenue and bottom line prospects, and many companies benefit from ongoing deregulation. Investors have benefitted from rising stock prices so far this year and have been rewarded with higher dividends too. Through late February, more than one-fifth of all S&P 500 companies have raised their annual payouts in 2018 with an average increase of about 14% according to S&P Dow Jones Indices. Share repurchases should also hit a record this year continuing a streak that has seen common shares outstanding at S&P 500 companies shrink every year since 2010.

Investment Conclusions

Common stocks have been on a historic run for the past nine years and, while the bull market may continue, experience suggests that caution is warranted this late in the cycle. Looking back to the last market trough in 2009, the stock market on a forward price earnings ratio was valued at 9.0x. Since that time earnings have recovered significantly while P/E ratios have also increased dramatically to a current 16.9x. The current ratio is above the fifteen year average of 14.9x implying that future stock market gains will need to come from earnings progress rather than multiple expansion. Notwithstanding the possibility of an economic downturn, it is likely that aggregate corporate earnings should be higher five years from now. We expect the rate of growth, however, will fall well short of that experienced over the past several years. If only modestly higher earnings are coupled with multiple contraction as P/E ratios revert to the average, a likely case scenario over the coming years is that common stocks will provide total returns that are positive but that will fall well below recent history.

This suggests investors should proceed carefully in the current environment. As Howard Marks, chairman and cofounder of Oaktree Capital Management, has noted in his book *The Most Important Thing*, rather than swinging for the fences in search of investing home runs, "risk control is more likely to create a solid foundation for a superior long-term track record." He goes on to say that "requiring good value and a substantial margin for error, and being conscious of what you don't know and can't control are hallmarks of the best investors I know." We embody this philosophy and firmly believe it will serve our clients well for many years to come.

Despite potential intermediate term risks to the equity market outlook, a well selected basket of common stocks is likely to outperform fixed income investments in the coming years. Interest rates have begun what is expected to be a multiyear adjustment phase higher. The Federal Reserve has raised its key short term lending rate by 25 basis points six times in its current tightening campaign, dating back to December 2015, and two or three additional hikes are expected prior to year end. Should this occur, longer term interest rates are likely to move higher as well. In this environment, we will continue to keep new bond purchases focused on the short to intermediate end of the yield curve which allows us to protect capital and reinvest maturing proceeds at higher yields.

March 21, 2018

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