



WILKINS INVESTMENT COUNSEL, INC.

FALL INVESTMENT OUTLOOK 2009

As the fall season draws near, the economy continues to make fundamental progress lending credence to the view that the recession that began in December 2007 is slowly winding down. On many fronts, incoming data reveal that various economic indicators are either showing more moderate rates of decline or are showing outright improvement. It would appear to be only a matter of time before the National Bureau of Economic Research (NBER) declares that the longest recession since the 1930s has officially ended. Granted many important statistics remain well below year ago levels but notable positive trends are evident across a wide spectrum of the economy. Recent releases on manufacturing, retail sales, housing, consumer confidence and jobs are among the many indicators that have shown modest improvement in recent months. The fear and panic that was so prevalent earlier this year has given way to a renewed optimism that a typical post recession recovery is now upon us. While we are encouraged by these positive trends, we remain vigilant as many challenges remain in the present environment including high levels of consumer indebtedness, a weak employment outlook, rising government debt and looming tax increases to name a few. These headwinds are likely to make the present recovery period more challenging than some anticipate. Nonetheless, for now, market participants have taken a more sanguine view and have pushed the broad stock market averages considerably higher year to date as shown below.

	<u>Year-to-Date Market Returns (excluding income)</u>	
	<u>9/21/09 Price</u>	<u>Change From Year-End</u>
Dow 30 Industrials	9,779	11.4%
S&P 500	1,065	17.9%
NASDAQ Composite	2,138	35.6%
Value Line	303	34.3%

Current Developments and Outlook

When third quarter gross domestic product (GDP) data is released for the three months ending in September, it is expected to show a positive quarter of growth for the U.S. economy. This will be a welcome change after four straight quarterly declines which resulted in a peak to trough drop in real GDP of 3.8%. While we won't know with certainty that the recession has ended without the benefit of hindsight, in all likelihood what has been officially the longest, and in some ways, the most painful recession since the 1930s will soon be declared over by the NBER, the official arbiter of economic cycles. Several factors point to a turn in the fortunes of the U.S. economy. Among the various elements that had a positive

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impact on third quarter GDP growth has been the so called “cash for clunkers” program which provided a boost to the nation’s beleaguered manufacturing sector while also lifting consumer spending. The federal government’s support of the housing market via direct purchases of mortgage backed securities and via indirect subsidies such as its FHA insurance program also buoyed that key sector in the quarter. Moreover, the \$8,000 homebuyers’ tax credit has provided a timely and critical shot in the arm for the industry. As of now, this credit is set to expire for home purchases that close on or before November 30th of this year though it is possible that the popular program will be extended beyond that date. The housing market has shown signs of stabilizing in recent months indicating that it will no longer be the drag to growth that it has been over the past several quarters. The Case-Shiller 20 city composite index showed an increase in prices in June (the most recent data available), the first such increase since May 2006. Meanwhile, new and existing home sales trends have improved recently while inventory levels have moderated a bit. Certainly, the ultimate recovery in housing will take many years to complete though we are encouraged that it appears that the process is now underway. Additionally, numerous government programs continue to support the health of firms in the financial services sector. This industry is particularly important as a sustainable economic recovery is highly unlikely to occur without a properly functioning finance industry. Furthermore, the federal government continues to provide other forms of assistance to corporate America, is helping states meet certain financial obligations and has been offering individuals various tax breaks and other safety nets, all of which has had a stabilizing influence on near term growth.

There have been encouraging signs on the employment front in recent months. To be sure, the job market is still challenging though data show the situation is deteriorating at a lesser rate in the summer months. For instance, monthly job losses in July and August averaged less than 250,000. While this is not sufficient to stop the unemployment rate from rising, it is a dramatic improvement versus the average of nearly 560,000 jobs per month that were being lost in the first half of the year.

Another plus is the worldwide nature of the recovery. After suffering through their own recessions, many major foreign economies including Germany, Japan and France showed modestly positive GDP growth in the second quarter while China and several other Asian nations grew their economies at an even more rapid pace. Policymakers both here and abroad would be wise to take advantage of this global upturn to our mutual advantage rather than focusing on increasing trade frictions. Despite growing rhetoric regarding certain protectionist measures, global trade volumes have picked up in recent months, a constructive development for the ongoing global recovery.

Finally, inflation has been subdued which has allowed interest rates to remain at very low levels. This is important given that low rates are supportive of economic growth and, in particular, have been key components of the recent success in the auto and housing markets mentioned above. Very weak capacity utilization rates and ongoing softness in the labor markets suggest that inflation is less of a near term concern. This is expected to provide the Federal Reserve with the leeway to keep the federal funds rate at a low level for some time to come. Indeed, the Fed’s last meeting statement indicated that it is “likely that the federal funds rate would need to be maintained at an exceptionally low level for an extended period.” In addition, the low federal funds rate has had the added benefit of providing the beleaguered banking industry with a

positive yield curve which has been beneficial in helping that key sector begin to recapitalize giving the Fed yet another reason to move slowly in normalizing interest rates.

The aforementioned positive trends do not necessarily suggest that the U.S. economy has entered another period of uninterrupted prosperity. For instance, the unemployment rate is currently at 9.7%, the highest it has been since June of 1983 when it was 10.1% in the aftermath of the 1981-82 recession. In all, 6.9 million jobs have disappeared since January 2008. With additional job losses expected for several months to come it is likely that the unemployment rate has not yet peaked so it will be some time before the job market returns to a healthy state. In addition, it remains to be seen how government programs put in place to spur purchase of cars and houses impact demand once those programs are allowed to expire. It is quite possible that demand was simply "pulled forward" by the programs and that the payback will be slower growth in 2010 and beyond than otherwise would have been the case.

It is also unlikely that consumer spending will provide the same boost to growth in this recovery that it has previously. For the better part of the past twenty years, consumers have taken on increased debt burdens while watching personal savings rates drop to multi-decade lows. Fortunately this process has begun to reverse and Americans' personal balance sheet repair is under way. In this regard, total outstanding consumer credit (essentially all consumer debt that is not secured by real estate) has been trimmed in each of the past six months, a trend that is expected to continue. This is the longest such stretch of thriftiness since the record seven month periods that were posted in both 1991 and 1943 when the Federal Reserve began tracking this metric. One corollary to this trend is that the personal savings rate has shot up to the mid single digit range in recent months after having briefly dipped below zero a few short years ago. While this is beneficial to longer term sustainable economic growth, all else equal, this does provide less of a tailwind to the near term growth rate of the economy.

Financial conditions remain modestly restrictive as the banking industry needs to focus on repairing its balance sheet and therefore has less capital to deploy. It is also expected that increased regulation and stricter capital requirements will be implemented in due course. Such changes will likely take some time to be put into practice as Washington is presently focused on health care reform but new regulations and a renewed focus on risk management are expected to result in a less leveraged banking industry in the intermediate term thereby reducing overall credit in the system.

Perhaps the critical question facing the economy and capital markets today is how and when the federal government will withdraw the various support programs it has employed in an effort to resuscitate the moribund economy from the worst recession in decades. To this end, the government has erred on the side of caution in providing unprecedented levels of fiscal and monetary stimulus which is predicted to contribute to trillion dollar plus deficits for years to come. The Federal Reserve has already publicly stated that its inclination is to keep rates low for the foreseeable future. The fact that the Fed has sacrificed some of its independence as part of the overall rescue effort makes us more inclined to believe that the current easy money policy agenda will overstay its welcome. This will ultimately prove inflationary and will contribute to a rise in interest rates in our view. Whether investors will be willing to continue to buy U.S. Treasury debt in increasing amounts despite the paltry interest rates being offered remains to be seen. We are very skeptical that this is possible on a longer term basis again suggesting that

higher rates will be forthcoming eventually. We are also concerned that looming tax increases may negatively impact the economy in the not too distant future. The so-called Bush tax cuts are set to expire at year end 2010 and, when combined with other increased burdens being placed on consumers and businesses alike, this could pose a serious threat to the ongoing economic recovery as soon as next year. Economist Arthur Laffer, in a Wall Street Journal editorial (9/22/09), noted the role that rising tax burdens played in contributing to the painful economic setbacks that occurred in the 1930s pointing out that a “government simply cannot tax a country into prosperity.” We agree with that thesis and have concerns that current policymakers in Washington would appear to have forgotten this valuable lesson.

Investment Conclusion

The current resurgence in the market has been based on a continued improvement in the fundamental macroeconomic outlook. As noted above, several recent statistics indicate that the long and unsettling recession appears to be ending. Given this and with the initial stage in the market recovery well underway, the question now turns to the robustness and sustainability of the market’s advance. Corporations, which have cost cut their way to improved profitability, must now show an ability to grow revenues in order to maintain earnings progress that justifies the stock market’s nearly 60% rise since March. This is likely to prove challenging as consumers still face significant headwinds including, most notably, a weak employment picture and high indebtedness. Meanwhile, policymakers in Washington still face the difficult task of weaning the U.S. economy and corporate America off the numerous government programs that have been enacted over the past year. The prospect of rising tax burdens is another impediment to a sustained recovery. Given these concerns, we remain of the view that the market may be particularly vulnerable to the normal pullbacks that are common in most recovery periods though the exact timing of any such downturns is difficult to predict.

We intend to use any such market setbacks as an opportunity to add more broadly to stocks in those accounts where equity ratios are below optimal levels on a long term basis. In accounts where stock ratios have moved to higher than desired levels given the market’s strong advance, we are inclined to selectively pare back those names where stock prices already fully reflect a strong earnings recovery. Opportunities in the bond market are few in number. Most U.S. treasury, government agency and municipal debt remains unattractively priced for buy and hold investors. In due course, this will change and in the meantime we will continue to research and purchase high quality corporate securities where yield spreads appropriately compensate investors.

September 22, 2009

The firm would be happy to provide its current ADV part II filing to any client who requests it.