



WILKINS INVESTMENT COUNSEL, INC.

2010 INVESTMENT OUTLOOK

Challenging and volatile are two words that aptly describe the economy and capital markets in the year just completed. The most severe recession in some fifty years was underway as the year began while the country's financial and banking system was under extreme pressure due to years of easy money, lax regulatory oversight, and excessive risk taking on Wall Street. Many financial commentators were suggesting the country had entered a Second Great Depression similar to the 1930's. The popular common stock indices were in near free fall early in the year and the Dow 30 Industrials recorded a 53.8% decline between October 2007 and March 2009, a decline that exceeded any setback since the very severe bear market of 1929-1932.

Extraordinary measures by the executive and legislative branches of the Federal government, along with ongoing massive intervention and a zero short term interest rate policy by the Federal Reserve Board did, however, shore up the financial system and stabilize the economy. The nation's real output of goods and services was modestly positive at 0.6% in the spring quarter and expanded at a somewhat faster 2.2% rate in the September quarter. The final quarter is likely to be positive and likely beat the third quarter rate of gain as the important Christmas holiday shopping period achieved a moderate improvement over prior year. While a return to growth after six quarters of recession is a positive and has produced significant gains in share prices from the March lows, the level of underlying growth continues to be sub par by historic recession recovery patterns. More than 3.6 million jobs have been lost this year and the unemployment rate stands at a 28 year high of some 10%. Final demand for goods and services remains on the weak side and only aggressive cost cutting has enabled many companies to report higher profits.

Common stock prices are ending the year on a high note but beneath levels of two years ago as shown below:

2009 Market Returns (excluding income)

	<u>12/31/09 Price</u>	<u>Change From 12/31/08</u>	<u>Change From 12/31/07</u>
Dow 30 Industrials	10,429	+18.8%	-21.4%
S&P 500	1,115	+23.5	-24.0
NASDAQ Composite	2,269	+43.9	-14.4
Value Line	309	+36.8	-29.8

The market decline over a two year period puts the ebullience of the year end 2009 rally in perspective and makes the obvious point that much needs to be accomplished in the economy

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and stock market before the very difficult recession period is truly behind investors. Investors in the aggregate are earning lower cash dividends on their investments as dividends paid by S&P 500 companies are 20% lower than a year ago, maturing bonds cannot be reinvested at rates anywhere near the coupons on maturing issues, and money market funds are providing only nominal returns, the lowest in their thirty five year history. It is also worthy of note that in the decade just ended American common stocks recorded a negative 0.5% annual return, the worst showing in the 180 years of record keeping and slightly worse than the negative 0.2% during the 1930's. These poor results reflect in part, the high starting valuations at the beginning of the decade, but they are nonetheless the results.

The 2010 Outlook

The economic outlook for the New Year has far more than the normal amount of uncertainty in that traditional theories of economic recession and recovery seem insufficient to provide a coherent and reasonably predictable pattern of recovery. The near collapse of the financial and banking system in the recession of 2007-2009 and the weakened state of financial institutions and consumers make this recovery period anything but normal. It is fair to say that all sectors of the American economy have been living well beyond their means for an extended period of time and the recent recession has exacerbated the issue. The consensus outlook seems to center around the argument that since the downturn was swift and deep, the recovery will be equally as rapid and strong. This is the so called V shaped recovery pattern.

Our view calls for economic recovery in 2010 but is less sanguine as regards the particulars. For one thing, the consumer sector which accounts for nearly 70% of this country's economic activity, remains in a weakened state reflecting challenged consumer balance sheets (principally lower home values and reduced retirement account balances) and uncertain employment prospects given the 10% and stubbornly high unemployment rate. Jobs were lost in every month of 2009 and it will take the creation of 100,000 per month this year to keep the unemployment rate from going higher. Consumers who had saved little if any of their income in the 2003-2007 period are now saving up to 6% of their income, a number that may very well move as high as 9-10% (fifty year average) in the intermediate future. A higher savings rate means slower consumption and demand in the near term but has the long term benefit of providing capital for future economic expansion. The residential housing market will eventually recover given the very low number of housing starts, but recovery is unlikely this year. A broad sea change as regards consumer activity and expectations is underway and will be an important factor in limiting the scope of recovery.

Expensive government programs to stimulate the economy and create new jobs have been disappointing to date. The press has duly reported on too much deficit spending for special interest groups rather than the broad economy, and earmarks (formerly known as pork barrel projects) remain a driving force in Washington politics. Employers in general, both large and small, remain reluctant to hire and expand in the shadow of increasing regulation and higher taxes at all levels of government. Today's flat and uncertain employment picture (a jobless recovery) is in contrast to previous recovery periods where consumers had the wherewithal to spend six months or more after recovery began and was shortly followed by strong job growth. The flat employment picture also means that payroll and income taxes will not be a source of meaningful new government revenue at a time they are needed to reduce the federal deficit.

Corporate profits also drive employment growth and the outlook here is for only moderate gains in 2010 given the uninspiring consumer outlook.

The Federal government is running a \$1.4 trillion deficit, the largest in absolute and relative terms since the end of World War II. The deficit results from spending running at 25% of GDP (\$3.55 trillion) while revenues only account for 15% of GDP (\$2.1 trillion). With a jobless recovery and limited revenue growth government deficit spending and accompanying borrowings will continue at a very high level. The federal government borrowed some \$1.75 trillion dollars in its fiscal 2009 and is likely to borrow that much again in the current fiscal year. Total government debt stands at \$12.1 trillion and last month Congress raised the debt ceiling by \$290 billion, a figure that will carry the government until early March. The capital markets absorbed last year's borrowing at low rates given the Federal Reserve's zero short term interest policy and government support facilities that purchased a lot of existing and new government debt. Government support facilities are scheduled to be less active this year and the Fed is under growing pressure to abandon its zero short term interest rate policy given the record 380 basis points disparity between the three month Treasury Bill and the ten year Treasury Note. This means the cost of financing the deficit will rise as each percentage point increase in borrowing costs equates to an additional \$80 billion of Federal spending. Government financing costs could go even higher if foreign central banks elected to slow their purchases of US Treasury debt. China and Japan presently hold some \$800 and \$730 billion respectively of the marketable \$7.1 trillion in US debt and while it can be assumed they will continue to purchase our debt they are also likely to seek out alternative investment vehicles.

One such vehicle is gold that has served as a store of economic value for over 5,000 years. Western central banks that were active sellers of gold five and ten years ago when prices were in the \$250-\$500 ounce range have ceased their sales and countries with strong current foreign exchange positions have been active buyers. India for example just purchased 6.4 million ounces from the IMF at a then record price of \$1,065 per ounce. China is believed to be in ongoing discussion with the IMF to purchase at least as much and the Chinese Central Bank is reported to be buying all of that country's gold production of an estimated 8.8 million ounces per year. Gold is in strong demand by consumers throughout Asia and the Indian subcontinent and American and European investors have returned to gold as a legitimate investment class in the last year. While no one can accurately predict price changes in a precious metal commodity such as gold, it would seem that the path of least resistance is higher given flat global mine production and expansive fiscal and monetary policies throughout the world that regularly debases the value of paper currency. Gold has served to protect investors against inflation over the years and while inflation may not be markedly higher this year than the 2009 rate of 2.0%, the ongoing monetization of government debt through a variety of mechanisms and the likely return to normal lending practices by the American banking system is likely to result in a higher inflation trend by year end.

Much attention has been given to the debate over national health care reform in recent months. Health care accounts for approximately 16% of this country's \$14.2 trillion GDP and has been rising at an alarming above average rate for many years. This country spends more on health care in absolute dollars and per capita than do other developed countries and yet has higher infant mortality and somewhat lower life expectancy than its peer group. House and Senate versions of "reform" legislation have been passed in an unusually vitriolic debate and await conference

committee work in January before a final bill is sent to the President's desk. While the outcome is uncertain as this is written and the legislation is lengthy and difficult to understand, neutral observers suggest that meaningful cost savings are unlikely to be achieved in the current effort and that increased costs and hence deficit spending will result from the greater accessibility provisions in the legislation. Hence, health care, a major sector of the US economy remains in a confused and somewhat uncertain state.

State and local governments that in normal times have been a force of expansion in the economy are in very difficult financial straights. The economic downturn has reduced revenues and proportionate expense reductions have not been forthcoming. Legislated tax increases to offset the revenue decline have proved counterproductive in many cases. California and New York in particular are learning that higher income and hence higher taxed citizens can and will change state jurisdictions when they perceive the tax burden as being unfair and poorly conceived. State governments are projected to run a combined deficit as high as \$350 billion in 2010, and some amount of this money will have to be borrowed in the bond markets. One solution is for the Federal government to ease requirements for so called mandated programs and California is said to be in negotiations with Washington to have as much as \$8 billion of annual spending mandates removed. State and local governments are in a necessary multi-year retrenchment program as are consumers. It is also conceivable that the Federal government, driven by a combination of capital market constraints and electorate mandates, could find its credit fully extended and also enter a period of multi-year belt tightening.

On balance, the economy is likely to grow in the New Year but at perhaps half the consensus forecast rate of 3-4% in real GDP terms. This translates into corporate profit growth in the 10% plus rate rather than twice as much in a normal recovery period. The current year is also a mid term election year and the debate is likely to become heated and personal as to which political philosophy is best suited to deal with the serious economic and national policy issues at hand. Additional national resources are also being committed to the Afghanistan war campaign and the wisdom of that escalation remains an unanswered question. In short, the relief rally experienced in 2009 as the recession wound down may be replaced by worries over the difficult challenges ahead and the multi-year economic retrenchment at hand.

Investment Conclusions

While this year's outlook notes a number of challenges in what would otherwise be a healthy second year of an expanding economy and bull market, we counsel investors to focus on time tested strategies that will bring long term success notwithstanding the immediate background environment.

We offer the following strategic suggestions in this regard:

- Remain focused on the long term merits of one's investments and not on short term trends that have become popularized by the financial press, asset allocators, hedge funds, and Wall Street. Don't be caught up in the day to day emotional swings of the marketplace, this simply does not matter over longer periods of time.

- Understand the underlying fundamentals of one's investments whether an equity as represented by a common stock or a credit instrument as represented by a bond.
- Seek out common stocks with a sustainable and growing cash flow that will lead to growing shareholder dividends over the years.
- Maintain appropriate cash reserves for unanticipated needs and avoid investments with excessive financial leverage and debt.
- Don't try to time the market but be cognizant of valuation levels in an investment when it is made.

Given these thoughts, we enter the New Year with an air of caution given the sharp run up in common stock prices over the last nine months and our view that recovery will be more subdued and struggling than is believed to be the case. Our common stock accounts are generally fully invested (newer cash accounts being an exception), however, since many leading companies could be purchased at notably attractive prices last Spring. No one area of the economy is deemed particularly attractive for new investment at this juncture, although companies that provide value added products and service to the consumer and industry at large are to be favored. Leading health care stocks are generally selling at a discount to the broad market given concerns over the impact of health care legislation and may show relative strength as concerns abate. Multinational companies with a strong international presence will likely benefit from the expanding global economy while it is probably premature to expand positions in the financial service sector.

The New Year is likely to bring sound bond purchase opportunities to investors who have resisted the urge to chase yield by lowering their credit standards and extending maturity, and have solid cash reserves on hand. Government, corporate, and municipal bonds are likely to offer attractive valuations for investment as the year progresses.

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