



WILKINS INVESTMENT COUNSEL, INC.

SPRING INVESTMENT OUTLOOK 2010

The economic news from the opening months of 2010 would appear to confirm that the recovery which began last year is likely to continue in the near term. To be sure, incoming data has been mixed but, on balance, indicates that the modest economic upturn remains on track. The important consumer sector, which accounts for approximately 70% of GDP, has shown signs of life as retail sales have increased in four of the past five months with gains across a broad spectrum of categories. Improvements in end demand have fueled the ongoing expansion of industrial production which last month notched its eighth consecutive increase. Although this metric reflects activity which represents less than 20% of the total U.S. economy, it is an important bellwether statistic in that it is highly sensitive to changes in the business cycle and therefore often signals turning points in the economy so the recent trend is constructive. Housing markets have stopped declining at the same rapid rate experienced over the past couple of years and some signs of stabilization have occurred. Even the unemployment rate, at 9.7% in February, has declined from its most recent peak of 10.1% in October. Moreover, exports have picked up recently as certain foreign economies have fared relatively better in the near term and Federal Reserve and government fiscal policy remains accommodative. Given these and other factors, the consensus estimate for 2010 GDP growth remains in the range of 3½ to 4%. This, in turn, has led many market participants to believe that corporate profits can expand well in excess of 20% this year.

Not all the news has been positive, however, and several important questions remain in the current environment. Unemployment, while below its peak, remains at worrisome levels and the housing market, even under the most optimistic scenario, will remain challenged for some time. Substantial deficit spending is projected for years to come leading many to conclude that tax rates are headed broadly higher sooner rather than later. Washington politics also remains an issue with unknown outcomes with regard to proposed changes to the important and sizable health care and financial services industries. The government also faces the delicate task of winding down the various stimulus programs in an orderly fashion, a significant undertaking. Globally, too, the picture is mixed as many developed nations are wrestling with several of the same issues facing the U.S., while many emerging markets are confronting their own set of challenges. Recent deterioration in the tone of the rhetoric in the U.S.-China relationship and renewed tensions in the Mideast add to the uncertainty. These and other issues have some investors concerned that the recovery is more tentative in nature than most appreciate and may be short lived. Despite these concerns, momentum has pushed the broad markets higher year to date as shown below. As a further point of reference, we note that the broad market, as measured by the S&P 500, is now up some 72% from its low point of March 9th, 2009.

Year to Date Market Returns (excluding income)

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	<u>3/17/10 Price</u>	<u>Change From Year End</u>
Dow 30 Industrials	10,734	2.9%
S&P 500	1,166	4.6%
NASDAQ Composite	2,389	5.3%
MSCI ACWI-exUS*	246	1.4%

*MSCI All Country World Index excluding U.S.

Current Developments and Outlook

At any point in virtually any economic cycle, there are likely to be sharply contrasting views on the intermediate term outlook so the present environment is not unique in this regard. As our firm weighs all the evidence, we find ourselves identifying with both schools of thought outlined above. As noted, there are several signs that point to a continuation of the economic recovery over the balance of 2010 and we share the view that the economy will make progress this year. That being said, it remains our belief that growth will fall short of expectations and the full year may advance at a rate closer to 2-2½%. Similarly we project that corporate profits, a key underpinning of common stock prices, can grow this year but perhaps at a rate of half what the market expects. On the plus side, corporate balance sheets (outside of the financial sector) generally remain in excellent shape leaving cash available to invest internally, fund mergers, pursue buybacks or increase dividends. However, in light of the very strong stock market advance over the past 12 months, we remain modestly cautious as we ponder the intermediate term outlook.

At first glance, recent consumer trends appear constructive. Data show that both personal spending and consumer savings rates are in an uptrend at the same time consumer debt levels are declining. This is an ideal situation as it allows for the long overdue correction in personal balance sheets to occur while at the same time providing the necessary fuel to boost the economy. A recent Wall Street Journal article (“Americans Pare Down Debt” 3/12/10) lends some insight into the trend. It notes that total U.S. household debt fell 1.7% in 2009, to \$13.5 trillion, the first annual decline since recordkeeping began in 1945. Unfortunately rather than reflecting a healthy consumer, much of this decline is attributed to the fact that a weak job market, coupled with the housing downturn, has led many to default on their mortgages and other debt. From the individual consumer’s perspective, the upside to defaulting is that it very quickly allows one to restructure their balance sheet while putting more money directly into their pocket which can be used to spend, save or pare other debt. However, this has exacerbated the problems in the financial services industry which has reacted rationally by curtailing lending in order to rebuild its capital position. This is all the more important given that a broad overhaul of the sector is pending, one result of which is likely to be higher required capital margins industry wide. According to the FDIC total bank loans outstanding fell 7.4% in 2009, the first annual decline since 1942. Ongoing credit contraction and deleveraging is likely to be a multi-year process and will act as a headwind to growth in the current cycle.

The employment situation has improved dramatically versus one year ago though it is far from healthy and will take many years to fully reverse course given the enormity of the decline. Only 62,000 jobs were lost in the first two months of 2010 as compared with over 1.5 million in the first two months of last year. However, since December 2007 some 8.4 million jobs have

disappeared and total employment in the U.S. today of 129.6 million people is slightly lower than it was in October of 1999 despite that fact that the population has increased approximately 10% during that time. Tax and other incentives to foster development of new industries and to create lasting employment gains would be beneficial, yet there has been surprisingly little progress made in this area to date. Notably, a jobs bill was passed this week but given its limited scope will be only marginally accretive to employment. Due to the weak trends in both bank lending and employment, any meaningful advance in the housing market will be difficult to sustain. Moreover, the potential for another setback in this area is a distinct possibility if the Federal Reserve's purchases of mortgage related debt expire at month end and the housing tax credit ends next month as scheduled. It is more likely that some type of additional support will be forthcoming as it is far from clear that the housing market recovery is sustainable without further government support.

The political atmosphere must always be considered and on this front there are various reasons to have some pause at the present time. The numerous government efforts employed to pull the economy out of the deep recession did achieve that goal. However, one danger that resulted is that certain markets have become overly reliant on that support, as might be the case in housing as noted above, leaving the government with the enormous challenge of trying to seamlessly wean the economy off the various programs that have been put in place. Also, the revenue decline and spending increases which resulted from the recession will be long lasting. Politicians appear to be unwilling to make sensible spending cuts in the face of the massive revenue decline contributing to projected deficits of \$1.5 trillion in the current fiscal year and \$1.3 trillion in 2011 according to the Congressional Budget Office (CBO). Deficits are projected to shrink modestly for a few years after that before returning to the trillion dollar plus range toward the end of the current decade at which time the CBO projects publicly held debt will equal \$20.3 trillion or 90% of GDP. This level of debt, which is significantly financed by foreign investors, will likely become a headwind over the longer term as it will be accompanied by higher interest rates and taxes, constraints to growth.

The health care debate in Washington has taken a decidedly partisan tone and highlights the continued divisive nature of the current political climate. The notion of overhauling an industry which accounts for approximately one-sixth of the U.S. economy using the controversial reconciliation process has proven to be an unpopular method of reform, particularly given that the underlying legislation itself is not favored by a majority of Americans. In particular, there is widespread disbelief that the cost estimates are reasonable reflections of reality and that such a massive expansion of care can be extended in a "budget neutral" fashion. This has led many to conclude, correctly in our opinion, that both direct and indirect taxes and costs will rise for a majority of Americans under this proposal. In addition, legitimate legal challenges are expected as Constitutional and states' rights issues have been raised. As of this writing the passage of any such legislation is still unknown, but regardless of the near term outcome, it is likely that the health care debate and the uncertainty it imposes on the economy will not be completely resolved any time soon.

The geopolitical climate has also deteriorated recently, notably between Israel and its neighbors and between the U.S. and China, not to mention the ongoing debate in Europe concerning Greece and possibly other overly indebted nations. With regard to the U.S.-China tension, we would hope that the recent strong rhetoric calms down as a trade war and rising frictions are in

neither country's best interest. For our part, U.S. politicians would be wise to acknowledge that many of our current problems are of our own making and that a one time dollar depreciation versus the Chinese yuan will not be a cure all. As noted economist David Malpass has pointed out, "no countries have devalued their way into prosperity." On the contrary, pursuing a weak currency as a policy option carries the risk that resulting capital flows out of the country will overwhelm any benefits received thereby undermining the original intent of the policy. Certainly, China could do more to smooth growing tensions between the two nations and we will watch developments in this area closely in the coming months.

Another unknown is the timing of the Federal Reserve's exit program from its near zero interest rate policy. Consensus wisdom holds that the Fed will not change this strategy until the second half of this year at the earliest. This will likely prove to be correct as the Fed historically waits until a recovery is firmly in place before beginning to normalize short term rates. For instance, coming out of the last two recessions the Fed waited 31 and 35 months, respectively, before raising rates. One potential risk with this plan is that the central bank will wait too long allowing inflation to creep back into the system. In the current environment with high unemployment, weak credit and low capacity utilization this is less of a near term concern, however, it bears watching in the coming quarters. Another risk, particularly in an era when credit demand is weak, is that low rates fuel speculation in asset prices rather than stimulate demand in the real economy and our belief is that this is happening now to some degree in a broad range of asset classes. In this regard, we are mindful that due to the unprecedented nature of the fiscal and monetary stimulus injected into the system during the downturn, prices of many assets were not allowed to find a natural bottom but were artificially inflated to prevent further economic damage. While this hastened the turn in the economy and capital markets, it also may have provided a less than stable foundation for the present recovery. It is simply a fact that major credit imbalances, as experienced in the period leading up to the 2007-2009 recession, take many years to work through the system. Our experience suggests that the capital markets will remind investors of this at some point. Stock market rallies can be strong in times such as these and the current upturn is no exception. We also note that periodic setbacks are equally common and one would not be unexpected in the coming months.

Investment Conclusion

The current investment climate has far more moving parts than is typical coming out of a deep recession resulting in our firm maintaining the "air of caution" that we noted in our *2010 Investment Outlook*. We are mindful that given the particularly cloudy outlook in the present environment, the capital markets are likely to be more vulnerable to any unexpected events which may occur. We also highlight the opinion of Thomas Hoenig, President of the Federal Reserve Bank of Kansas City, as quoted from the March 16th release which accompanied the Fed's decision at its recent policy meeting, who "believed that continuing to express the expectation of exceptionally low levels of the federal funds rate for an extended period was no longer warranted because it could lead to the buildup of financial imbalances and increase risk to longer-run macroeconomic and financial stability." While investors generally remain unconcerned with this risk and with many of the other potential headwinds discussed above, we remind our readers that periods of complacency often end suddenly and without warning.

With this perspective in mind, we will act prudently and at a measured pace as we consider investing client funds. While the broad markets have moved sharply higher, many individual common stocks are still selling at attractive valuations for new investment and we are willing to purchase those issues for clients whose stock ratios are sufficiently low. For those investors whose stock ratios have moved noticeably higher along with the market advance, we are more inclined to take profits in select investments, particularly in cases where the stock price fully reflects intermediate term fundamentals. Patience continues to be required for fixed income investors as bond yields are not especially attractive, particularly for longer dated issues. In time this will change as looming supply and moderately higher inflation will result in more appropriate investment opportunities becoming available. In the meantime, certain high quality, short term issues can be purchased very selectively to provide a higher return than the money market fund alternative.

March 18, 2010

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