



# WILKINS INVESTMENT COUNSEL, INC.

## *SUMMER INVESTMENT OUTLOOK 2010*

The equity markets, having enjoyed a strong and nearly unbroken uptrend since the March 2009 bear market low, changed course in late April as evidence mounted that the V shaped recovery being anticipated by many observers and Wall Street was not unfolding. Hard data bringing about this change in mood included very slow private sector job growth, an ongoing high home foreclosure rate and a generally weak residential housing market, renewed growth in the current trade account deficit, a slow down in retail sales, and continuing high government deficit spending.

In this setting, the stock market has retreated more than 10% from its spring highs with many sectors and industries down notably more. The broad non treasury bond market also weakened as investors have moved away from risk assets they had most recently embraced. The yield spread between investment grade credits and lower quality and or high yield (junk) bonds widened significantly in recent weeks. US government debt, on the other hand, rallied in price as global investors sought safety in the dollar given the serious problems facing many Euro Zone sovereign government credits.

The tragic drilling platform fire and subsequent oil spill in the Gulf of Mexico has been front page news for some eight weeks and the final capping and clean up remains an ongoing issue. The eventual outcome has significant implications for the companies involved, the deep water and coastal environment, and the future of the economically important gulf coast oil and gas industry in a nation already overly dependent on foreign oil.

As summer and mid year approach the indices have given up much of the first quarter gains and now stand only modestly above year end levels. International markets as measured by the MSCI all country, ex US index, continue to lag the domestic marketplace reflecting a range of concerns surrounding foreign economies and markets.

### Year-to-Date Market Returns (excluding income)

	<u>06/21/10 Price</u>	<u>Change From Year-End</u>
Dow 30 Industrials	10,442	+0.4%
S&P 500	1,113	-0.2
NASDAQ Composite	2,289	+0.9
MSCI ACWI-exUS*	228	-6.3

\*MSCI All Country World Index excluding U.S

### *Current Developments and Outlook*

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**T**he economic factors contributing to the spring stock market pullback continue to be operative and suggest an ongoing but modest economic recovery for the balance of this year and into 2011. Job growth is key to the economic outlook and the rate of job growth in the private sector remains disappointing. A solid 150,000 plus jobs need to be created each month to move the current 9.7% unemployment rate down and gains for the first five months of this year have averaged well beneath this figure. Government jobs are expanding as a result of Federal government deficit spending but these jobs lack the multiplier effect of the private sector. Job growth is essential for expansion in consumer spending and tax revenues to finance higher government spending, and sluggish job growth will impede both important metrics. Bank credit also remains very tight for small and medium sized businesses and many businesses which could expand and add employees are not due to the lack of ready bank credit. This reflects an ongoing policy of commercial banks to reduce asset risk and rebuild equity capital following the banking industry crisis of two years ago. Large corporations, on the other hand, have strong balance sheets and cash on hand for appropriate expansion. Economists estimate that some two thirds of job growth comes from the small business sector and expansion in this sector is essential to a solid recovery.

Consumers remain cautious and continue to save more and pay down debt as a result of limited job opportunities, still weak personal balance sheets, and unsettled consumer confidence. This is considered positive for the long term as the economy needs a higher savings rate to support future capital formation but is a short term deterrent to the rate of recovery growth. Capital spending, notably technology oriented capital spending that enhances efficiency and productivity, is growing at a solid pace due to ongoing innovation and the recognition that technology investments enhance long term profitability.

The economic recovery now underway for one year faces several headwinds and challenges. In the fiscal policy arena deficit spending continues at a brisk pace and the health care reform package, passed in the early spring, will prove costly to taxpayers notwithstanding the merits of reform. There is little question about the need for an improved health care system in the United States which spends roughly twice as much as a percentage of GDP on health as other advanced countries while having a notably higher incidence of adult obesity and diabetes and a modestly shorter life expectancy. The so called Medicare Doc Fix is an annual additional appropriation of approximately \$30 billion to keep Medicare payments to physicians and providers from falling as scheduled and the enacted reform bill measures seven years of cost with ten years of revenue. While the major costs of the bill won't be incurred for several years, other federal spending programs and lower than anticipated tax revenues are estimated to result in a \$1.5 trillion dollar deficit this fiscal year, close to last year's recession year record of \$1.7 trillion.

Federal Reserve monetary accommodation, low interest rates, and modest private credit requirements have made massive government borrowings possible. As the government yield curve and general interest rates revert to their historical norms in the future, however, financing costs will rise and squeeze an already overburdened Federal budget. The lessons of Greece and other hard pressed European governments should not be lost on American policy makers. In this regard, Alan Greenspan, a former Fed Chairman whose easy money policies in the 2004-2006 period contributed to the mortgage and banking crisis of 2008, notes in a recent Wall Street Journal op ed piece that drastic action is now required and that "our policy focus (fiscal) must therefore err significantly on the side of restraint." We concur.

As regards taxes, the Bush era tax cuts are scheduled to expire at year end and marginal tax rates as well as dividend and long term capital gains tax rates will rise by a meaningful amount. State and local governments are also raising taxes through a variety of mechanisms to deal with their budget deficits. Economists make the point that taxable income contains an element of elasticity wherein incomes decline (producing less than anticipated taxes) when rates rise and conversely incomes rise (producing more than anticipated taxes) when rates decline. Arthur Laffer, a noted supply side economist of the Reagan era, is currently arguing this point and believes next year's higher tax rates will produce an important slow down in economic activity and even a double dip recession. That outcome seems unlikely to this firm given the slow and steady recovery underway, but it cannot be ruled out.

Two other current developments are worthy of note. First the need for the United States to have a viable long term energy policy that moves the country away from its dependence on foreign oil and towards self sufficiency and renewable resources is a point driven home by the Gulf oil spill and the subsequent Federal government moratorium on deep water drilling. This issue has vexed American Presidents since the first Arab oil embargo in 1973 and seems no closer to solution now than then. Second China with a five trillion plus dollar economy is about to surpass Japan as the second largest economy in the world and be second to only the United States with its thirteen trillion plus economy. China has recently announced it will let its currency drift upward from the dollar to which it has been pegged since mid 2008. This policy should help contain inflation in China, an important internal objective, but will also reduce the local dollar value of the more than \$800 billion in US Treasury Securities it owns, and likely lead China to seek a higher rate of interest on future loans to the United States.

### *Investment Conclusions*

**A** normal correction phase, now two months and counting, is believed to be underway in the domestic stock market. The correction phase is likely to be exacerbated by the slow pace of economic recovery and the growing concern over government fiscal policy.

Corporate profits grew nicely and generally exceeded expectations in the March quarter and should continue to expand, albeit at a more moderate pace, over the balance of the year and into 2011. Consumers are appropriately retrenching and limited job growth suggests a continuation of this trend. Stock investors should continue to emphasize diversified portfolios and buy and hold companies with strong financials and a competitive advantage in the marketplace. Inflation remains restrained on a near term basis and price earnings ratios or market valuations are not currently threatened by higher interest rates. It will be incumbent on corporate profits to continue a solid rate of expansion, however, once interest rates do begin to rise later in the recovery cycle.

Bond investors presently have few if any attractive investment opportunities given the near zero short term interest rate policy of the Federal Reserve. Bond investors are advised to remain patient for the inevitable expansion of bank credit in the recovery period, higher inflation and rising yield curve. These conditions are likely to result in suitable bond investment opportunities for both taxable and tax free investors.

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