



WILKINS INVESTMENT COUNSEL, INC.

2011 INVESTMENT OUTLOOK

The economy achieved a modest and uninspiring recovery in 2010 following the severe recession of 2008-2009. Full year real GDP is estimated to have advanced approximately 2 ½%, a figure roughly half of what would be expected in the first year of a normal recovery period.

A number of well publicized factors account for the lackluster progress. Residential housing, an important driver in expansion periods, remains in a weakened state with ongoing mortgage foreclosures and little or no improvement in underlying pricing. New home construction has fallen to a rate of approximately 500,000 units per year and excessive inventory in existing and new home stock needs to be reduced before any uptick is anticipated. Consumer spending, the biggest component of the American economy, remains subdued despite a pick-up in year-end holiday retail sales. The unemployment rate has remained stubbornly high throughout the year and the latest reading (November) stood at 9.8%. Private sector job growth has averaged fewer than 100,000 per month this year, a level well beneath what is required to lower the unemployment rate.

The Federal government has used all the levers at its disposal to stimulate growth following the recession which ended in June 2009. These included a \$900 billion stimulus spending program in early 2009 and an ongoing and unprecedented easy money policy under the supervision of Fed Chairman Bernanke. The former is generally conceded to have been only marginally effective while adding to the federal deficit and outstanding debt. The latter has enabled the banking industry to rebuild its equity capital base at the expense of savers and firmed the pricing of many risk assets including common stocks and commodities. The Federal government also focused on legislating a health care reform package in 2010 which was received skeptically by the American people given the lack of a full vetting and careful review of long term costs and budget implications. The lackluster economic recovery, ongoing questions regarding the Afghan War and a general sense of all is not well, resulted in a “shellacking” (President Obama’s choice of words) for the President and his party in the midterm elections when 63 seats in the House of Representatives changed hands, the most since the 1930’s. Congress reconvened in a lame duck session after the Thanksgiving break to deal with critical income tax, estate tax, and alternative minimum tax issues it had regrettably put off until the last minute. The bill negotiated and signed by the President extends the Bush tax cuts and other tax relief for up to two years and adds an estimated \$800 billion to the deficit over the next ten years. The tax legislation also carries time limits meaning policy makers will be revisiting the issues again soon thereby creating renewed uncertainty.

The stock market finished 2010 on solid ground with an above average 10% plus gain while the bond market achieved similar gains through early November then slid back following the

160 FEDERAL ST., 17th FLOOR ✉ BOSTON, MASS. 02110 ✉ TELEPHONE 617-951-9969 ✉ FAX 617-951-0773

WWW.WILKINSINVEST.COM

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November elections. For the full year 2010, common stocks outperformed bonds while domestic stocks outperformed foreign stock markets as measured by the MSCI all world ex U. S. Index.

2010 Market Returns (excluding income)

	<u>12/31/10 Price</u>	<u>Change From 12/31/09</u>
Dow 30 Industrials	11,577	+11.0%
S&P 500	1,258	+12.8
NASDAQ Composite	2,653	+16.9
MSCI ACWI-ex US*	263	+8.4

*MSCI All Country Index excluding U.S.

The 2011 Outlook

The massive government fiscal and monetary stimulus in place is believed sufficient to sustain economic growth and underlying corporate profit expansion well into 2011. In fact the recently enacted tax package may be a short term stimulant. The federal deficit is projected to remain in the \$1.4 trillion area (9% plus of nominal GDP), the Federal Reserve Bank is holding the federal funds rate (short term borrowing) near zero, and has simultaneously embarked on a \$600 billion government bond buying program dubbed QE2. In simplistic terms, the QE2 program means the central bank is buying (monetizing) nearly half of the year's projected deficit. The conundrum facing investors is the intermediate and longer term consequences of these actions. Many observers have suggested the country's political leadership is "kicking the can down the road" with ongoing programs of fiscal and monetary stimulus rather than letting free market forces bring about the necessary corrective action. Economists of all persuasions do agree that today's fiscal and monetary programs are unsustainable on a long term basis and that severe imbalances and dislocations will result if they are not reduced in scope and returned to more normal levels.

The new Congress to be seated in January will foremost be tested on fiscal policy. Those recently elected to a more conservative House of Representatives and Senate espoused policies of fiscal restraint and deficit management during their campaigns. The basic problem is the mismatch between federal government receipts at 15% of GDP and government spending at 25%, the difference being the annual government deficit. As noted earlier, the higher level of spending in recent years (Keynesian economics) has not had the desired effect on increased economic output, job growth, and revenue creation. This is partially due to the Congressional earmarks program (pork barrel spending) which allows individual Congressmen and Senators to "earmark" funds for their special interests which have little or nothing to do with the wellbeing of the national economy. A lot of deficit spending has been directed to state and local governments which have simply spent the money to continue existing programs without focusing on much needed cost reductions. As one time federal aid is reduced going forward, state and local governments will be required to make hard decisions to reduce spending and large deficits. The cost of the Iraq and Afghan wars has also run up costs with the Afghan endeavor alone costing more than \$100 billion per year. Republican John Boehner, the newly elected Speaker of the House, has indicated he will dramatically reduce earmark spending but profligate ways are difficult to restrain in politics and the proof will be in the pudding. Investors should also be reminded that the last Republican Congress and President, between 2000 and 2006, produced a

massive increase in government deficit spending. The central bank's low interest rate policy has enabled the government to carry more debt with less cost than would normally be the case and has given politicians a false sense of security.

Solutions to the fiscal dilemma will entail more innovative thinking by White House leadership than has been demonstrated in the last two years. If history is any guide, there is comfort in the fact that President Kennedy, a Democrat, pursued new approaches to restore growth in 1960 as did President Reagan, a Republican, some twenty years later. Both were successful. Important work has recently been done by a bipartisan deficit reduction commission chaired by Democrat Erskine Bowles (former chief of staff to President Clinton) and Republican Alan Simpson (retired U.S. Senator from Wyoming). The commission's report recommended a \$3.8 trillion deficit reduction program that would broadly simplify and change the tax code while simultaneously altering entitlement benefits. While the eighteen member commission did not get the required fourteen votes necessary to make the report a specific proposal to Congress, a solid majority backed the report and many of its ideas will likely be brought forward in the new Congress. The absolute need to address the deficit challenge is highlighted by Bowles who said "the era of debt denial is over, and there can be no turning back" while Simpson added "We sign our names to this plan because we love our children, our grandchildren, and our country too much not to act while we still have the chance". The mettle of our democratic country's problem solving ability will be tested during the debate to come.

Monetary policy is perhaps a greater risk to near term economic growth and stability than current fiscal policy. The Federal Reserve Board has followed very aggressive policies since the early fall of 2008 in efforts to stem the impact of recession and hasten recovery. Short term interest rates have been held near zero and the Fed's balance sheet of securities has expanded dramatically from \$800 billion plus two and one half years ago to approximately \$2.3 trillion today with an additional expansion of \$600 billion as the QE2 program is implemented by the spring. Mortgage backed securities and debt from the failed quasi-public agencies Fannie Mae and Freddie Mac account for nearly \$1 trillion of these assets and are not worth their stated value due to the continuing housing slump and underlying weakness in property collateral.

One ever present risk of aggressive monetary policy is higher inflation. While official government figures show the current CPI annual rate at 1.1%, the figure is no doubt understated given the actual market basket of goods and services purchased by consumers. In addition, low cost money is again encouraging financial speculation in commodities such as oil, for example, where the six month run up in price from \$75 to \$90 per barrel is not justified by ample supplies and inventories or modest final demand growth. Bank lending, a key component of money supply, fell during the recession, but is growing again and is likely to accelerate as the economy expands in the New Year. In short, a very large money supply base could very quickly be competing for a limited supply of goods and services thereby driving up the cost of most things and requiring immediate Federal Reserve restraint (taking away the punch bowl). Knowing when and how much restraint to apply is always the question and the current Board's proclivity to err on the side of easy money suggests outsized inflation and instability could step in before corrective measures are taken.

Current Federal Reserve policies of ease are also in contrast to global trends where many central banks are reimposing monetary restraint and higher interest rates. This is true in natural resource

economies such as Australia and Canada and emerging growth economies like India, China, and Brazil. A pattern of rising global rates puts increased pressure on the U.S. dollar thereby making additional purchases of U.S. Treasuries by foreign central banks less attractive. Many have argued that the U.S. which professes a strong dollar policy to be, in effect, following a de facto weak dollar policy to stimulate exports. Ultimately interest rates will rise in the U.S. either as a function of official policy, market forces, or some combination of the two and the bond market is expected to suffer a long overdue correction of some magnitude.

Our best estimates call for a continuation of growth in 2011 but with an ongoing high federal deficit and a notable risk of higher inflation and interest rates by year end. A pleasant surprise would be constructive action between Pennsylvania Avenue and the Congress on recommendations of the bilateral deficit reduction commission, but the political fighting and rigidity of the major political parties make this a long shot.

Investment Conclusions

The stock market has recorded two above average years in a row and the economy is making steady if uninspiring progress. Simultaneously the nation's elected leaders have yet to address in a comprehensive fashion the serious issues of overspending and entitlements that lack the necessary financing. The continuing large deficit, weak U.S. dollar, and absence of growth oriented innovative economic policies would therefore seem likely to serve as a sea anchor to the stock market and the generally expected positive news of corporate profit growth and rising dividends in the New Year. We remain comfortable holding a diversified portfolio of well financed growth companies with global expansion opportunities. At the same time the path of least resistance suggests that interest rates will be rising and bond returns may again offer competition for the stock investor's incremental dollar. Tax exempt bonds will be issued in much larger numbers than in recent years, thereby pushing up supply, marking down prices, and making for more attractive purchase opportunities than have existed for some time. Many bond investments appear overvalued as the year begins and these include intermediate, longer maturity, and low quality issues in particular. The sovereign bonds of the weaker countries (Greece, Ireland, Portugal, Spain, Italy) in the European Monetary Union are under continuing pressure and are likely to incur permanent capital losses several years out as current credit support facilities run their course. In addition it is the view of this firm that many international stock markets, having received massive cash inflows over the last eighteen months, are well ahead of themselves, and are due for a normal correction, particularly when one considers prospects for less heady growth in a number of foreign countries where inflation and interest rates are rising.

We also take the annual opportunity to remind clients that investing is a continuous marathon that should focus on the truly long term objectives and strategies and should avoid the popularized short term trends promoted by Wall Street and the financial press. The New Year will have its share of surprises, good and bad, while the long term offers the thoughtful and patient investor solid return opportunities.

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