



WILKINS INVESTMENT COUNSEL, INC.

FALL INVESTMENT OUTLOOK 2011

The summer months of 2011 have seen increased volatility in financial markets as fiscal issues in developed countries find no easy fixes and as recent data depicts a slowdown in economic activity. The appetite for risk assets like equities waned dramatically when the U.S. debt ceiling debate reached a crescendo in late July, with investors further concerned following the August 5th S&P downgrade of the U.S. credit rating to AA+ from AAA. Ongoing issues regarding solvency of a handful of smaller European nations and the broader European banking system have dominated the August and September headlines as policymakers grapple to find the best solution among no good choices. Thus, it's not surprising investors have begun to meaningfully discount potential downside risk to economic growth in equity prices.

While the U.S. did not solve its long term fiscal imbalance despite passage of the debt ceiling bill, concerns are more immediate in Europe. The ability of that banking system to successfully absorb a potential default of Greek debt without the spread of contagion to other troubled countries is an open question. This heightened anxiety is depicted in the 25%+ decline in European equities from the May peak versus the more modest 12% decline in the S&P 500 over the same time period.

Contrary to the media and pundit expectations, U.S. government bonds rallied following the S&P downgrade as investors worried less about the new credit rating and more about the business standstill caused by the debt ceiling debate and its potential impact on near-term economic growth. Bonds are still rallying as the European concerns persist. Investors continue to sell portfolios of financial assets, while storing wealth in issues they deem safe at unattractive rates. The yield on the 10-year Treasury note fell below its late 2008 lows in early September, touching 1.93%, and is currently settling near the 2.0% level. This yield is confiscatory to the holder given the 3.8% year-over-year headline inflation rate reported in the August CPI data, but bondholders appear to be considering factors other than just inflation in their decision to purchase.

Real GDP in the U.S. was weaker than expected in the first half of 2011 at just 0.7% annualized growth compared to expectations for a 2-3% increase. Employment growth slowed and inflation had a meaningful impact on consumer incomes, causing consumer spending to stall. Growth was further impacted by deficit-induced spending declines across many levels of government. On the other hand, S&P earnings grew nearly 18% on a year-over-year basis during the first half, fueled by strong emerging market fundamentals. The loss in economic momentum suggests future profit growth will be less robust, with earnings expected to be up just 5-6% on an annualized basis over first half levels.

The domestic stock market reversed its early-year gains and is down some 12% from its May 2nd peak. Non-U.S. markets are down much greater than the S&P 500, declining 21% from the peak while emerging markets are also off more than 21%.

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

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Year-to-date market returns (excluding income)

	<u>9/20/11 Price</u>	<u>Change from year-end</u>
Dow 30 Industrials	11,409	-1.5%
S&P 500	1,202	-4.5%
NASDAQ Composite	2,590	-2.4%
MSCI All Country World Index ex-USA	224	-14.8%

Current Developments and Outlook

The current economic recovery, one of the weakest in modern times, entered its third year this past summer. Policymakers have had little success at spurring a recovery that finds its own footing, leading to the virtuous cycle of spending, investing, and employment growth as in past cycles. Furthermore, failure to successfully address the root problem of underwater mortgages following the housing market crash and an overleveraged consumer makes the current credit environment less than ideal. Economic growth has stalled at a time when financial stress is increasing due to European bank worries from the sovereign debt crisis, increasing the likelihood of further disappointing and uneven growth. Additionally, environments where government officials dominate the headlines dampen stock valuation metrics, thereby putting the onus on corporate profit growth to fuel continued stock price advances.

The fact that real annualized GDP of \$13.26 trillion in the second quarter of 2011 is still 0.5% below the peak levels of Q4 2007 demonstrates the weakness of the recovery. In a normal recovery there is a snap-back in goods spending at the beginning of an economic cycle, followed by a gradual improvement in consumer service spending, which plays an important role in broadening and extending the recovery since it accounts for almost 50% of GDP and 70% of nonfarm employment. In the current instance, the prolonged weakness in housing and lackluster employment have been substantial headwinds to a spending pick-up in important areas like housing, financial, and business services. Service spending is growing at just a 1.1% annualized rate in the current recovery, significantly below the 2.4% growth experienced from 2004-2007. So when an economic shock like the Japanese earthquake and tsunami in March negatively impacted the more volatile goods spending in the months that followed (especially autos), there was less room for error, causing overall consumer spending to grow at the slowest rate (+0.4%) in six quarters.

The weakness in service spending can be attributed to slower household formation. Since Q1 2007, household formation has grown at just 0.4% annually compared to 1.1% from 1990-2006. Household formation requires a pick-up in the labor market, which has been unimpressive. Additions to payrolls have slowed to an average of 40k per month the past four months compared to the 180k average in the first four months of 2011. Government policies like the new healthcare legislation and financial reform, although well-intended, have created uncertainty for businesses, which remain reluctant to accelerate hiring. Efforts to spur job creation are too focused on propping-up demand temporarily with the hope that new jobs eventually follow. Policies like the 2% payroll tax reduction for employees, which expires at year-end, have been largely unsuccessful at promoting job growth but will likely be renewed for 2012 given it is one of a few pieces of common ground between both political parties. We would prefer to see pro-growth fiscal initiatives that are more permanent in nature and that incentivize risk-taking and new business creation. The most successful recoveries see new jobs being created by starting new companies. Getting permanence and the proper incentives in place will likely require a substantial re-working of the tax code.

Following the expiration of the homebuyer tax credit in April 2010, efforts to revitalize the housing market have been too small to make an impact. Thus, it is not surprising that annualized existing home

sales of 4.67 million in July were nearly 20% below the stimulus-induced levels of spring 2010. The problem of negative equity continues to persist. According to CoreLogic, about 23% of U.S. homes have negative equity totaling some \$750 billion. Banks have tightened mortgage lending versus year ago levels due to the absence of a broad government-coordinated effort to address the bad mortgage debt and increasing regulatory burdens being imposed on them, preferring to grow their portfolio of government securities instead of their mortgage book. Overall loan growth at commercial banks is flattish on a year-over-year basis and has fallen at a 2.3% annualized rate since the end of 2007, far from the 10% annualized growth in credit experienced from 2003-2007. Thus, the current deleveraging environment continues to be a meaningful headwind to the economy.

Monetary policymakers have begun to admit the limits of their influence, becoming more vocal on what their fiscal counterparts ought to do to pick up the slack. Chairman Bernanke, in his recent Jackson Hole speech, said “most of the economic policies that support robust economic growth are outside the province of the central bank”. The Fed’s experiment in quantitative easing (the so-called QE2 bond-buying program), which increased the Fed balance sheet by some \$600 billion, fell short in driving respectable growth and reducing unemployment. Although not explicitly stated by the monetary authorities, QE2 was likely intended to stabilize housing values and lift stock prices in an attempt to increase consumer wealth, operating on the premise that consumers will spend more if they feel wealthier. Unfortunately, housing prices are down 5% over the past year and stock prices are flat compared to the levels of mid-November 2010 when the program began. In addition, the excess liquidity created by QE2 resulted in speculative buying of commodities, leading to higher consumer price inflation, which lowered real incomes and served as an unintended headwind to first half growth. Given these trends, the Fed committed to maintain its zero interest rate policy until mid-2013, but not without dissenting by some members of the open market committee. While an expansion of the balance sheet similar to QE2 is unlikely to occur in the near-term due to higher inflation, the Fed will probably extend the duration of its portfolio of government securities by reinvesting maturing bonds further out the yield curve in an attempt to keep mortgage rates near 4% and spur some debt refinancing. On the margin, this should have the positive effect of lowering consumer debt service and freeing-up cash for either additional debt reduction or discretionary spending.

Perhaps the greatest cause of current volatility in the financial markets is the ever-changing news regarding the European sovereign debt crisis and the potential banking issues that could surface should one of the troubled nations default on its debt. The solvency of Greece is a particular near-term threat. The troubled nation received a second bailout from Eurozone members in July at a €109 billion price tag after agreeing to additional austerity measures. There is still €54 billion remaining from the first bailout, of which the country is awaiting an €8 billion tranche to be approved and released from the so-called troika of the European Union, European Central Bank (ECB), and International Monetary Fund (IMF) by the end of September to pay government salaries and pensions. The problem is that the Greek leaders have failed to meet many of the guidelines required to release the new funds. Authorities have been slow to cut government workers, collect taxes, and reduce spending overruns so the Greek budget deficit is set to reach 8.2% of GDP by year-end as compared to an initial target of 7.4%. Leaders and citizens in other EU countries (particularly Germany) are beginning to balk at this “muddle-through” approach of adding more debt on top of existing debt to maintain Greek solvency. This solution falls short in generating the economic growth necessary to enable the country to successfully service its obligations over the long-term. Complicating the issue is the potential for contagion in other troubled countries with high debt loads like Italy and Spain if a Greek default were to occur. Several bond market sell-offs in those nations have already forced the ECB to step into those financial markets as a large buyer of Italian and Spanish government securities to stabilize prices. Furthermore, European banks hold a meaningful amount of the debt of these troubled nations and are experiencing short term funding pressures. According to Bloomberg, the eight largest U.S. money market funds halved their lending to German, French, and U.K. banks over the past 12 months and stopped financing Italian and Spanish financial firms. Central banks have stepped-up their liquidity efforts to ensure bank funding is adequate and that bank lending continues. There are no easy solutions to the crisis and ongoing market volatility is likely in the months and quarters

ahead. An eventual outcome will probably see leaders take a more unified fiscal approach (albeit with political consequences), while instilling discipline on those governments with weak finances, and will almost certainly have monetary authorities in Europe continuing to be reluctant participants in financial markets for some time.

Investment Conclusions

We see the near-term risk of a full-blown recession as a low probability since indicators such as inventories, production, employment, the yield curve, and real interest rates are not at the levels that preceded prior recessions. Rather, the economy remains in a state of wait-and-see, unable to mount a full and normal recovery on its own. That is not to say that an eventual write-down of European debt couldn't cause a decline in growth for a quarter or two if credit flow is temporarily disrupted (a risk that is partially discounted by the recent decline in stock prices). However, policymakers in this "era of intervention" would do all in their powers to quickly address the symptoms of a shock in an effort to stabilize the credit environment. What is eventually needed is an economic "reset" to set the stage for longer lasting growth, which would encompass entitlement reform, broad deficit reduction, and a re-writing of the tax code. However, such dramatic policy will almost certainly be on hold until the 2012 Presidential election passes.

What is apparent to us throughout history is that the direction of the stock market doesn't necessarily follow the direction of the economy. Company fundamentals are often unique, generating impressive returns even amidst the dullest of markets. That is why we have always recommended a disciplined long-term approach that does not attempt to time the market. We believe buying and holding a portfolio of high quality companies with a dominant product or service, strong balance sheets, able management teams, growing international exposure, and disciplined capital allocation is the right strategy for generating and protecting wealth. Many of the enterprises we follow on a daily basis have dividends yielding 3-4%, a meaningful contribution to income in the current low yield environment. Furthermore, market corrections present opportunities to commence buying programs in new growth ideas that we find particularly appealing on a secular basis, and the recent correction was no exception. For fixed income investors, we continue to stress patience. Those investors with high cash levels should be opportunistic when a bond market correction does occur, emphasizing short maturity and high quality issues in the meantime.

9/21/11