



WILKINS INVESTMENT COUNSEL, INC.

SUMMER INVESTMENT OUTLOOK 2011

The economy and stock market have made modest progress as 2011 approaches the half way mark. Behind the advances, however, remains considerable turmoil and uncertainty on a number of fronts. Real GDP growth, a key metric of economic gain slowed from the already moderate 2.9% rate of gain in calendar year 2010 to a figure closer to 2% in the first half as housing remained depressed, consumers faced the headwind of higher energy and food costs, state and local government continued in retrenchment mode, and unemployment hovered at a high rate of 9.0%. Corporate profits expanded at a low double digit level on a year over year basis while the Federal Reserve Bank's continuing easy money policy (essentially zero short term borrowing cost) offered no competition from the fixed income market and encouraged investors to move out on the risk curve. Easy money produced sharp rises in many commodity prices while speculation has returned to selected industry sectors such as "social networking" in both public and private market place valuation.

The global scene also saw major change and disruption with popular uprisings across North Africa in Tunisia, Libya, and Egypt, and in the Middle East including Yemen, Bahrain, and Syria. Armed conflict and the potential for a state of ongoing civil war remains a concern in many of these countries. World oil prices have increased with this unrest and the shut-down of Libyan production. Prospects for constructive talks leading to a peaceful solution in the volatile Israel/Palestine area also remain uncertain given unrest and changing allegiances in the region.

As regards the Washington political scene, the significant change in Congressional power following last fall's elections has yet to produce progress on the ever mounting federal deficit and the government reached its current debt ceiling of \$14.3 billion on May 15 and will be short of cash to pay its bills if action isn't taken before early August.

In this environment, the domestic stock market advanced in low single digits while international markets declined as shown in the compilation below:

Year-to-Date Market Returns (excluding income)

	<u>06/20/11 Price</u>	<u>Change From Year-End</u>
Dow 30 Industrials	12,080	+4.3%
S&P 500	1,278	+1.6
NASDAQ Composite	2,630	-0.9
MSCI ACWI-exUS*	258	-2.2

*MSCI All Country World Index Excluding U.S.

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

WWW.WILKINSINVEST.COM

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Current Developments and Outlook

This economic recovery is now two years old and has been more subdued than any recovery period since World War II as measured by the normal yardsticks. Real GDP has grown less than two thirds the normal rate, the number of employed workers is several years away from the pre-recession peak, new claims for unemployment claims remain high, residential housing is mired in a multi-year downturn, and growth in consumer spending (accounts for some 70% of GDP) remains sluggish.

This lackluster record is after massive doses of fiscal and monetary stimulus by the federal government. On the fiscal side, the President and Congress approved a nearly \$800 billion stimulus package in the spring of 2009 and the deficit reached \$1,413 billion in that fiscal year. The deficit declined modestly to \$1,294 billion in fiscal 2010 but according to the Congressional Budget Office is likely to reach a new high of \$1,480 billion this fiscal year. In short, deficit spending or so called “pump priming” has not had the desired effect on growth. The deficit gap remains the difference between the 25% of GDP that the government is spending and the 16 % of GDP the government collects in tax revenues. The ongoing growth in entitlement programs and the cost of financing three foreign military campaigns (Iraq, Afghanistan, and Libya) are major contributors to the spending component.

The large and seemingly intractable federal deficit has set up the political confrontation now unfolding between the Democratic Administration and the Republican controlled House of Representatives where tax laws originate. The House is refusing to increase the debt ceiling (it has been raised 78 times since 1960) and or raise taxes without significant spending cuts. While a compromise will likely be reached before early August, the heated debate will continue through the Presidential election cycle in November 2012 and put other legislative priorities on the back burner.

Compounding the challenge of finding a workable solution to today’s deficit is the ever escalating government spending on health care, some of which is attributable to the President’s showcase National Health Care Reform Bill which barely passed the Congress in early 2010. A recent study noted that the average couple retiring at age 66 this year will receive roughly one million dollars in Medicare and Social Security benefits over their life expectancy while they and their employers will have paid in only half that amount. A new Medicare tax on most sources of income in addition to the traditional payroll tax is scheduled for implementation in 2013 to cover some of the shortfall. Critics contend this will further impede job growth which is critical to expanding government revenues. In this instance we agree with the critics.

Official Washington has more than a full plate in sorting out how ongoing fiscal policy can best be structured to grow the economy while producing sufficient revenues to fund appropriate government spending. European countries such as Greece, Hungary, and Portugal are notable examples of where policy makers have failed in this regard and the restructuring and probable default of some government debt is the likely outcome despite current stop gap measures.

Monetary policy under the leadership of Chairman Ben Bernanke has also been challenging. The Fed has pursued an aggressive or easy monetary policy for nearly three years in efforts to

end the recession of 2008-2009 (it did) and restore normal economic growth (it has not). The Fed has ballooned its balance sheet from under \$900 billion three years ago to some \$3 trillion today by buying very low quality housing related debt from the balance sheets of the nation's financial institutions and purchasing roughly one half of the \$100 billion plus of new Treasury debt sold each month in each of the last eight months. Simultaneously, the Fed has kept short term interest rates close to zero in an attempt to recapitalize the equity base of the nation's largest banks while also seeking to stimulate growth and stabilize housing prices.

Negative consequences of these policies include penalizing millions of savers and the elderly who rely on savings accounts and bank CD's for income and encouraging unnecessary speculation in the commodities markets which is inflationary. By contrast, many foreign countries have tightened credit and increased interest rates in the last year to contain excessive demand and inflation in their home markets. Another negative consequence of this policy has been a decline in the value of the US dollar in foreign exchange markets. The US dollar, in fact, when tracked against a market basket of major currencies is at a forty year low. It is therefore not a surprise that gold, a store of economic value for thousands of years and priced in dollars, has recently reached a new nominal high as global investors seek a safe haven from the abundance of US dollars.

The Federal Reserve cannot pursue current policies indefinitely and there is a range of speculation as to when there will be a policy shift to allow interest rates to rise to more normal levels. Chairman Bernanke implicitly acknowledged this in a recent speech when he noted that "monetary policy cannot be a panacea". The most recent inflation data shows both the overall or headline inflation rate running at 3.6%, a level above the Federal Reserve target level with the core rate (excluding food and energy) running at an annual rate of 1.5% but on pace to rise by 2.4% for the full year. In short, the ongoing pick-up in inflation will be taken into consideration by the Fed in setting future interest rates. This firm believes a change to a neutral policy is underway and that with ongoing modest growth there is likely to be an increase in interest rates in the year ahead. One positive from a rising rate environment is that any increase in US rates would also bolster the value of the dollar in global markets, a good thing as the country continues to rely on foreign investors for funding an important part of its capital needs.

Some observers are currently suggesting the US is in for a double dip recession as occurred during President Reagan's first term some thirty years ago. We view this as unlikely, absent a meaningful event shocking the entire system. The more likely scenario would be for continuing modest growth as consumers and governments adapt to today's very challenging conditions and adjust their behavior accordingly. This will mean more savings by consumers and control on spending by government at all levels. Bank loans, which have been flat or down for several years, should turn positive as even modest underlying growth rebuilds business confidence. It should also be noted that a number of foreign economies are growing at rates faster than in the US and Europe, and while many of these economies have their own serious structural and political challenges, they remain a driver of current worldwide growth.

The extended period of low US interest rates poses a major conundrum for investors who need current income and would normally build their bond portfolios (higher yields than stocks historically) to accommodate this requirement. Few if any attractive bond investments exist in the current environment due to Federal Reserve Board policies noted above. Some investors

have turned to higher yielding bond funds and or turned to other higher yielding security products as recourse. Both strategies are fraught with serious loss of principal risk as monetary conditions return to normal levels.

We suggest the following thoughts for investors seeking higher income at this juncture:

- Maintain appropriate liquidity for anticipated near and near/intermediate term needs that will take some pressure off a given current income requirement.
- Keep maturities short and quality high as bond investors are not being paid to take either maturity or quality risk in the current marketplace. Recent record setting sales of high yield or junk bonds at rates attractive to the seller but not the buyer are a red flag in this regard.
- Build stock portfolios around financially strong companies with solid dividends that are adequately financed from internal cash flow.
- Remember that change can, and very often does, occur quickly in the capital markets and that a rapid repricing of today's highly priced and low yielding bond market could create opportunities sooner than many people think.

Investment Conclusions

The capital markets have entered a transition phase, with the stock market taking a normal and appropriate breather from its strong recovery from recession lows in March 2009. Questions regarding the future slope and duration of recovery are being asked while government policy makers seek ways to enhance growth without reigniting inflation. Stock investors should maintain normal equity exposure with sound diversification and a continuing focus on quality. Investors with cash to invest are advised to continue long term buying programs of selected stock issues while paying particular attention to price at time of purchase or entry.

Patience is counseled as regards the bond market and forces are believed to be in place which will produce higher bond yields and hence buying opportunities in the future for both taxable and tax free instruments.

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