



# WILKINS INVESTMENT COUNSEL, INC.

## 2012 INVESTMENT OUTLOOK

2011 enters the economic history books as an uninspiring year at best and one of stagnation and missed opportunity at worst. The generally accepted measures of growth/prosperity were disappointing. Real GDP advanced at a subpar rate of some 1.5%, unemployment remained a stubbornly high 8.6% (down only marginally from a year ago), the Federal government deficit totaled an exceptionally large \$1.4 trillion (up slightly from last year), the current trade deficit exceeded \$400 billion, and corporate profit growth decelerated with fourth quarter levels expected to advance a modest mid-single digit amount from prior year. Housing, a major driver of expansions in past recovery periods and the principal financial asset of most Americans, remained generally weak with nationwide prices down 3-4% from last year while consumers paid 3% more for their goods and services as measured by the CPI. Consumer and business confidence was generally weak as the year ended.

Investor confidence in the domestic capital markets and regulation therein was regrettably brought into question once again by the late October bankruptcy filing (11<sup>th</sup> largest in US history and three years after the Lehman collapse) of MF Global, a commodities trading and investment firm, and the disclosure that some \$1.2 billion of client funds remains missing. The firm was headed by Jon Corzine, the prestigious former head of Goldman Sachs, and former United States Senator and Governor of New Jersey. Regulators remain perplexed as to what happened and how laws and regulations protecting separate account assets were skirted. Accountability under federal and state civil and criminal laws remains an open question.

Official Washington and the Executive and Legislative branches of government in particular, practiced hard partisan politics during the year's debates over extending the government debt ceiling and fiscal policy in general. The ongoing mismatch between federal government receipts at 15% of GDP and government spending at 25% is the central policy issue. An opportunity for progress was lost when the comprehensive recommendation of the bi-partisan Simpson Bowles Commission, appointed by President Obama, to reduce the deficit by some \$3.8 trillion by simplifying the tax code while simultaneously altering entitlement benefits was essentially ignored by the President and Congress during the year. The year ended with a bitter confrontation between the President and House of Representatives on the politics of extending a payroll cut for another sixty days.

Recent attention has also turned to the sovereign debt crisis in Europe and the future of the European Economic Union (EEU) and currency. Many European countries including Greece, Italy, and Hungary have spent well beyond their means for years and others including Portugal, Spain, and perhaps France are close behind. It is inevitable that holders of the notably weaker

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sovereign credits will incur principal losses of 50% or more as Greek bond holders have already acknowledged. European banks are major owners of European sovereign credits and a wave of material write downs would dramatically impair their capital base and ability to continue normal lending operations to Europe and the global economy.

Germany, the world's fourth largest economy and strongest Euro country continues to take the hard line that the weaker and poorly run nations must submit to meaningful fiscal discipline, oversight and penalties before additional credit facilities can be given. Finland and The Netherlands, smaller but well run economies, share this view. If an acceptable political solution cannot be found there is a risk of weaker countries leaving the EEU and Europe taking a step backward in regards to its unified ability to compete in today's global marketplace. In recent weeks, central banks including the United States, European Central Bank Authority, Canada, Great Britain, Japan, and Switzerland have stepped in with a market mechanism to help the European banks retain market access to dollars for lending purposes. The European Central Bank also propped up several weak government bond markets as the year ended. Central banks in other geographies including China, Brazil, and Indonesia eased monetary conditions in the final months of the year reflecting their concern that the economic slowdown in Europe could spread to their regions.

These actions buoyed the global stock markets in the final weeks of 2011. The domestic stock market recovered to neutral or modestly positive territory for the year while world markets excluding the US fell more than 15% as shown below:

Year-to-Date Market Returns (excluding income)

	<u>12/31/11 Price</u>	<u>Change From Year-End</u>
Dow 30 Industrials	12,218	+5.5%
S&P 500	1,258	No Change
NASDAQ Composite	2,605	-1.8
MSCI ACWI-exUS*	221	-16.1

\*MSCI All Country World Index  
excluding US

***Near and Intermediate Term Outlook***

Economic prospects for the New Year have notable uncertainty. Consumers (two thirds plus of the domestic economy) did increase their spending in the second half of 2011 but at the expense of their savings which have recently declined. Lackluster job growth, a stubbornly high unemployment rate, and weak residential housing remain potent forces for consumers to contend with, and some 2012 consumption may have moved forward into last year. As noted in recent bulletins, traditional fiscal and monetary policy which normally stimulate consumer spending and the broad economy have been running at full speed (record budget deficits on the fiscal side and sixty year low interest rates on the monetary side) for nearly three years with limited effectiveness. Ed Yardeni, a noted independent economist and investment strategist, cites US policy makers as being "reckless" in both their fiscal and monetary policies of recent years as

short term political concerns have taken precedence over long term economic planning and discipline.

Non consumer sectors of the economy also remain subdued. Capital spending which typically accelerates two to three years into a recovery period (this recovery is now two and one half years old) is growing slowly reflecting a low level of confidence by business leaders who remain concerned over ever shifting regulatory policy and short term tax policies. Official Washington has embraced short term tax policy (as evidenced by the December sixty day payroll tax cut extension) in too many instances making it difficult for businesses to make long term financial plans. With regard to tax rates it should be noted that one year from now Bush era tax cuts expire, preferential capital gains and dividend tax rates will end, estate taxes are scheduled to rise, and a new health care tax will apply to virtually all sources of income. This will put an added burden on consumer spending which will ultimately impact business capital spending.

State and local government spending, a relatively steady pillar of growth for over fifty years, remains in a multi-year decline as governments work to recover from the serious budget deficits of the last recession period. While there are a few bright spots in the budgets of smaller states such as Montana and Wyoming, the large and highly populated states such as California, Illinois, and New York remain in challenging deficit positions. Net exports have been one positive for the domestic economy with rising exports and declining imports but account for a relatively small piece of overall economic activity.

The presidential election year cycle also complicates prospects for new policy initiatives that would improve the growth outlook such as revisiting the findings of the blue ribbon bipartisan Simpson Bowles Commission. The President appears to have staked out an aggressive reelection campaign strategy while his opponents are in a heated debate as to who can best represent their party in the fall election. Strange things have been known to happen in politics, however, and if the economy is lagging and the President's ratings remain very weak come early spring, and while speculative and probably unlikely, he might do as President Lyndon Johnson did in the spring of 1968 and chose retirement. This would leave his party's nomination open to other well-known candidates such as Secretary of State and former US Senator Hillary Clinton. In any event, thoughtful new policy initiatives to deal with the economy and deficit are unlikely to be forthcoming until after the election.

Consensus expectations for economic growth this year have been downgraded for many months. Our best thinking is that full year real GDP growth will approximate 2% with fourth quarter activity "taking" some growth from first quarter 2013 when tax rates are presently scheduled to be a good bit higher. Final consumer and business demand for goods and services remain soft and may limit corporate profit growth to a modest single digit gain. Headline inflation as measured by the CPI may be somewhat less than last year's 3% plus rate. As regards interest rates, Federal Reserve Chairman Bernanke has said clearly that he plans to hold interest rates at current low levels through at least the summer of 2013.

Foreign economies are also likely to face renewed challenges in 2012. Europe is believed to have entered a flat or recession period in the last quarter of 2011 as the sovereign debt crisis impacted lending and business activity across the region. This issue remains unresolved as the year begins and the lack of resolution is likely to produce continuing uncertainty and lack of

economic progress. Emerging economies or the so called BRIC countries (Brazil, Russia, India, and China) also are in a period of slowdown and adjustment. Brazil is taking steps to curtail rising inflation, Russia is facing slow markets for its key oil and gas export business; India is suffering from slower growth and higher inflation; and China has entered a lower growth period after years of excessive credit expansion and rapid growth. The governing Chinese Communist Party also engages in a once a decade leadership change with Vice President Xi Jinping in line to succeed Hu Jintao as party general secretary. This key internal event is likely to take precedence over other pressing matters leaving the Chinese economy more to its own devices than would otherwise be the case.

### *Investment Conclusions*

The stock market discounts (anticipates) forthcoming economic events and ended a severe bear market in March 2009 in anticipation of the economic recovery that began three months later. This recovery phase has been notably strong with the Dow 30 gaining 86% in value since then notwithstanding the below average performance of 2011. If our assessment of modest economic and corporate profit growth for this year is correct, and without the tail wind of sound confidence building government policies, there is little reason to believe the stock market will discount better times ahead. At the same time the broad market is likely to have its moments of doubt regarding the future for reasons discussed above. Hence, above average market volatility and lack of direction would seem the path of least resistance in 2012.

Our counsel to investors at this juncture includes the following:

- Maintain appropriate long term stock ratios with diversified holdings across industry and market capitalization sectors. The challenges ahead can be dealt with in due course and there certainly have been far darker times in the country's economic/political history.
- Continue to focus on issues with strong financial strength, able managements, and growing dividend income streams.
- Hold above average cash reserves to insure ample liquidity for known and possible liabilities.
- Be prepared to buy individual issues that become mispriced during periods of uncertainty and market hysteria.
- Accept today's penalty of below average current income from cash equivalents and short term bonds as protection against substantial price depreciation in bonds when today's historically low government yield curve inevitably returns to more normal levels.
- Invest in equity and fixed income securities directly rather than using the growing number of products created by Wall Street and financial intermediaries that add to fees and often lack a disciplined long term philosophy and/or record.

January 4, 2012

**WE WISH ALL CLIENTS AND FRIENDS OF THE FIRM A HAPPY NEW YEAR!**