THE SMITHFIELD Forecast

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SMITHFIELD TRUST COMPANY

A NOTE FROM THE CHAIRMAN

By odd coincidence, three of my current four book reviews involve presidents of the United States. One biography is about Calvin Coolidge, and another deals with Lyndon Johnson. I cannot conceive of two more different individuals on the same planet.

I hope that you enjoy the book reviews and the accompanying economic analysis from the inestimable Mr. Robertson.

— Bob Kopf

The U.S. Economy in 2014 – Pluses and Minuses

The U.S. economy continues to move ahead at a rate which can best be described as sub-par and disappointing. The economy's growth rate in the first half of 2013 was a weak 1.8% – well below the rate that one would expect in the fourth year of an economic expansion. And since the recession ended in the second quarter of 2009, real GDP has posted a gain of just 9%, which was less than half the average increase of close to 19% recorded during comparable periods of economic expansion since World War II. For 2013 as a whole, real GDP growth is estimated at a lackluster 1.7% – considerably below the 2.5% gain that was widely anticipated at the beginning of the year. Indeed the economy's sluggish growth rate has been disappointing to many forecasters including those at the Federal Reserve, who, in March of this year, anticipated that 2013 would see an increase of between 2.3% to 3% in real GDP.

Focus on Long-Term Growth

Is the current economic slowdown a temporary phenomenon associated in part with the severe financial crisis of 2008-2009 and the overhang of debt, or does it represent a more lasting downdraft in the U.S. economy's long-term growth potential? Simply put, has a 2-2½% rate of real GDP growth become the "new norm" for the U.S. economy? In our view, the nation's long-term growth potential has indeed slowed from what it was during most of the post-World War II era. One

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simple way of calculating the long-term trend rate of economic growth is to combine labor force productivity growth with the growth of the labor force. Due in large part to an aging population, the growth of the U.S. labor force is projected to decline over the coming years. According to most projections, the annual growth rate of the labor force between 2012 and 2022 will be about 0.6%, representing a major slowdown from the average of 1.7% recorded between 1950 and 2000. While productivity is relatively easy to define – growth of real output per worker – its measurement is much more complicated. In particular, it is difficult to measure output and productivity in service-related industries which constitute a large and growing share of the nation's GDP.

Between 1997 and 2007, the average annual increase in productivity was a robust 2.9%. Since then however, gains in productivity have been significantly smaller as evidenced by increases of just 0.4% and 1.4% in 2011 and 2012, respectively. As already noted, measurement problems could account for some part of this worrisome slowdown. Other possible factors include a decline in productivity gains from the information technology revolution as well as less spending on high technology equipment. There is also the possibility that a decline in educational standards and work skills might be playing a role in the productivity slowdown. And given the importance of technological change and innovation as a source of productivity improvement, it is disturbing to note that between 2008 and 2012 outlays on research and development increased a tepid 4%, a marked decline from the increase of 23% recorded during the prior four-year period. Likewise, the 12% gain in spending on software between 2008 and 2012 was less than half the increase reported between the 2004-2008 period. Arguably, the effects of this palpable slowdown in spending on what is called intellectual property products could well have a negative impact on productivity for some time to come. In sum, we doubt that annual gains in productivity will rebound to the 2%-3% range anytime soon. Our best guess is that, absent some dramatic technological breakthrough, the average annual increase over the next decade will be in the vicinity of 1.7%. The combination of labor force growth of about 0.6% a year and 1.7% annual gains in productivity suggests that, as a rough approximation, the nation's long-term economic growth potential is now close to 2.3% a year, which would be just about the lowest projection of the post-World War II era.

Labor Market Problems

Meanwhile, our forecast for next year's increase in real GDP is placed at around 2.6% – better than this year's estimated 1.7%, but still not as strong as one might expect for the U.S. economy in a period of expansion. Looking first at outlays for consumer spending – which, of course, account for some 70% of GDP – we do not see the gains in employment and income that would be needed to generate an accelerating pace of consumer outlays. As matters now stand, we expect that monthly gains in payroll employment during 2014 will average about 185,000, representing very little change from the number in sight for 2013. While the unemployment rate has now dropped to 7.4%, there has been very little increase in the employment-to-population ratio since the recession ended more than four years ago. Of considerable concern is the fact that the employment-population ratio is still at a relatively low 58.7%, only slightly above the recession low of 58% and less than the pre-recession rate of 63.4%. Equally disturbing is that, while the official unemployment rate has been cut to 7.4%, there are still millions of workers who have either given up looking for work or are underemployed. If these individuals are added to the official unemployment rate, the jobless ratio jumps to a worrisome 14%.

At the same time, we do not see a major increase in real after-tax income during 2014. In recent years, the growth of real after-tax income has slowed to a crawl. Thus, in the second quarter of this year real disposable personal income was essentially unchanged from what it was three years ago. And over a longer time period – four years – real after-tax income is up 7%, representing an average annual increase of less than 1%. On a more positive note, recent gains in equity values and home prices have boosted household net worth to a record $70 trillion in the second quarter of this year. While the wealth increase should help support consumer demand, we do not look for a palpable strengthening of consumer outlays over the coming year. We expect that 2014 will see a 2%-2¼% rise in real spending, which would represent a modest improvement over the 1.9% gain in sight for 2013. For the most part, however, the recent weakness in overall spending has been concentrated in services and nondurable goods (food, clothing and energy) which, over the past four years, have climbed at yearly rates of just 2% and 1%, respectively. Likewise, the annual rate of light vehicle sales has rebounded from the recession low of 9.0 million units in February 2009 to the latest – August 2013 – reading of 16.0 million. The highest since late 2007. For 2013, total sales are now estimated at 15.6 million. And for 2014, a figure of 16.0 million should be within reach. In sharp contrast, spending for recreational goods and vehicles has surged at a yearly rate of 11% during this same period of time. In other words, the less-than-robust pace of consumer spending has been very selective as opposed to across-the-board cutbacks in outlays.

How Strong is the Housing Market?

Over the past year, gains in homebuilding activity have been a major contributor to the overall increase in real GDP. Thus far in 2013 (January-July), the annualized rate of housing starts has averaged 912,000, up from the 729,000 pace reported for the comparable period of last year. There are signs, however, that, for now at least, the trend rate of single-family house construction may be leveling out at a yearly rate of close to 600,000. Meantime, gains in multi-family construction have paralleled or exceeded those in the single-family sector of the market. During the first seven months of this year, multi-family start activity registered a substantial 33% increase over the comparable months of 2012. Looking ahead, it may be difficult to replicate gains of this magnitude in 2014. Consider the prospect of higher borrowing costs – mortgage rates have already turned upward – as well as limited gains in income and lending standards, which are considerably tighter than those which were in effect during the last housing boom, we are forecasting that 2014 will see about 1,025,000 housing starts, up from this year's estimated figure of 925,000. In terms of percentage gains, however, the projected 11% increase for 2014 will be less than the estimated 18% advance in sight for this year.

Modest Gains in Capital Spending

Business spending on capital goods has been increasing at a moderate pace through the second quarter of this year. Anecdotal reports, however, suggest that heightened uncertainty regarding regulatory issues, health care costs, monetary and fiscal policy actions – and the strength of future demand – have acted as a constraint on capital spending. Consider, for example, that between 2008 and 2012 the funds available for investment jumped 46% while outlays for equipment recorded a much smaller increase of just 10%. Turning to the outlook, the leading indicators of capital spending are not signaling an accelerating pace of outlays over the immediate months ahead. Notably, the underlying trend of orders for nondefense capital goods (ex aircraft) has shown little upward movement since the end of 2011. As a further indication of only limited gains in near-term spending, capital goods orders during the first seven months of 2013 were up – in current dollars – a very modest 4% over the comparable period of last year. With economic and political uncertainties continuing to act as a constraint on spending, we are forecasting that next year's real increase in outlays for business equipment will be much the same as the tepid 4-5% rise expected for 2013.

Weak Recovery in Non-Residential Construction

While investment in new equipment should continue on a slowly rising trend through 2014, expenditures for nonresidential construction are likely to remain well below their previous (2008) peak for another year. Notably, as of July 2013, outlays for office and commercial building – including shopping centers – are still some 50% below their 2007-2008 pre-recession peaks. Explanations for this much-delayed recovery include a sizable overhang of unsold and unrented space stemming from the construction boom of 2005-2008, a marked tightening of lending standards for many non-residential construction projects, and in all likelihood, downward revisions to earlier projections of long-term demand. Assuming continued strength in outlays for health care and power-related construction, however, we are forecasting a 2014 increase in the neighborhood of 5% in outlays for nonresidential construction projects. Finally, in the business investment sector, we believe that inventory building will be a neutral factor in the 2014 outlook. From all indications, the high level of uncertainty regarding the outlook has persuaded most business firms to keep a tight grip on their inventory positions. A cursory glance at the data on inventory-to-sales ratios suggests that business inventories are well aligned with sales and, as a consequence, should not pose a threat to the sustained expansion of economic activity.

Outlays in the remaining sectors of the economy are not expected to make a positive – or negative – contribution to the growth of real GDP. Despite the recent strength of U.S. exports – up 3% over the most recent 12-month period – we do not expect much, if any, change in the net export balance for 2014. Thus, the negative export balance is expected to be in the neighborhood of this year's estimated $435 billion. At the same time, 2014 is likely to be another year in which government outlays on goods and services continues to fall in the face of restrictive fiscal policies at all levels of government. That said, we believe that much of the tightening of fiscal policy – notably at the federal level – is, for now at least, behind us, and next year's cutbacks in spending are expected to be less than those anticipated for 2013. All in all, next year's decline in spending for goods and services is placed at about 1%.

Fiscal Policy – Tough Decisions Ahead

As noted, the drag on economic growth from the recent tightening of fiscal policy (sequestration) should be less in 2014 than it has been in the present year. However, this does not mean or imply that the nation's fiscal problems have been solved. To be sure, the federal deficit for 2013 has been cut by $200 billion from the $845 billion anticipated earlier in the year. While this may be encouraging news, it should be noted, perhaps, that the lower-than-projected deficit has resulted from increased tax revenue as opposed to cuts in spending. And looking further ahead, the federal debt is still projected to remain above 79% of GDP, significantly above the average of 39% recorded over the past forty years. It bears repeating that the negative consequences of a high and rising ratio of debt-to-GDP include upward pressure on interest rates which, in turn, is likely to act as a constraint on economic growth. At the same time, a rising trend of interest rates implies a substantial increase in the costs of servicing a large and growing national debt. In addition, large-scale federal borrowing will almost certainly reduce the national saving rate and increase the nation's reliance on the willingness of foreign lenders to absorb a seemingly inexhaustible supply of U.S. Treasury debt. And finally, there is little doubt that a larger federal debt will inhibit the flexibility and ability of government to address future unforeseen challenges – including recessions.

Next Moves in Monetary Policy

Over the past six years, the Federal Reserve has adopted an exceptionally accommodative monetary policy. In addition to pushing short-term interest rates to near zero, the Federal Reserve has utilized a series of unconventional policy tools designed to stimulate the economy. First of all, the Fed adopted a program known as "forward guidance," the object of which was to provide the public with information about the probable future path of short-term interest rates. The second tool involved large-scale purchases of long-term Treasuries and mortgage-backed securities designed to drive down long-term interest rates and thereby quicken the pace of economic recovery.

Of late, "forward guidance" seems to have created more confusion rather than clarification about future Fed policy. What has been happening is that the Federal Reserve has been sending mixed signals regarding future monetary policy actions that have confused the markets. By way of explanation, there have been hints that the time was fast approaching for a gradual unwinding of the asset purchase program. And yet, the Fed has also emphasized that the federal funds rate will remain at near-zero as long as the unemployment rate remains above 6% and the inflation rate stays below 2.5%. More specifically, statements by numerous Federal Reserve officials speculating about the precise timing of a scaling back of asset purchases have, at least in part, been responsible for a shift in market expectations about the outlook for interest rates. Then too, the financial markets interpreted recent comments by Federal Reserve Board Chairman Bernanke as signaling a near-term phasing out of the asset purchase program. Likewise, the release of the Federal Open Market Committee's updated economic projections appeared to indicate a more upbeat assessment of the outlook, which raised the possibility that the Fed's extended period of extraordinary monetary ease might soon be coming to an end.

As we have mentioned on previous occasions, the risks of the Fed's asset purchase program, including financial market disruptions, are, in our opinion, far exceeding the benefits which, at best, are extremely small. We are encouraged, therefore, by recent statements hinting that the Fed will soon begin withdrawing from its controversial asset purchase program. That said, the transition to a less accommodating monetary policy will not be easy. Essentially, the Fed is faced with the formidable task of reducing its swollen balance sheet that has ballooned from a pre-recession level of $850 billion to the latest figure of close to $4 trillion without sending shock waves through the financial markets. Of concern is the considerable risk that the Fed's sale of securities could trigger a sharply rising trend of interest rates that would have negative implications for overall economic activity. While the Fed claims it has the necessary tools to complete a successful exit strategy, the magnitude of the task is unprecedented in size and scope and will, in our opinion, present the Fed with one of its most daunting challenges of the post-World War II era.

Needless to say, recent developments in the markets have necessitated a change in our interest rate forecast for 2014. At the time of this writing, the yield on a 10-year Treasury note has climbed from around 1.7% earlier this year to the neighborhood of 2.75%. This increase illustrates once again the importance of market expectations in the behavior of interest rates. Looked at in another way, there has been a significant increase in interest rates even though there has been no change in monetary policy. As to the future, we now expect that the yield on a 10-year note may reach a high of 3.85% in 2014 and average about 3.5% for the year as a whole.

Low Inflation in 2014

To a degree, the Fed's easy monetary policy has been facilitated by a continued low rate of inflation as measured by the consumer price index. Over the past 12 months, the consumer price index has increased 2% while, excluding the volatile food and energy components, the rise was just 1.7%. Moreover, the measure of inflation favored by the Federal Reserve – the deflator for personal consumption expenditures – has posted a negligible rise of just 1.1% over the year ended June 30, 2013. The fact that recent readings on this measure of inflation have been below the Fed's target of 2.5% has been cited as justification for a highly accommodative monetary policy. Turning to the inflation outlook for 2014, we expect little additional upward pressure on costs and prices. Inflation expectations still remain well anchored and have changed little in recent months. More specifically, inflation should remain low in the face of rates of resource utilization which, in most industrial countries, are still well below those recorded in the early years of the past decade. Without ruling out the possibility of unpleasant surprises, we are forecasting a near-2% increase in consumer prices during 2014 while, excluding the food and energy components, the rise is expected to be in the neighborhood of 1.5%.

Which Way for Equities?

At first glance the equity markets in 2014 should benefit from a quickening pace of GDP growth – we are forecasting a year-on-year gain of about 2.6%, low inflation and a further rise in corporate earnings which should outpace the expected increase in GDP. That said, however, investors will also have to contend with another year of negative as well as positive reports on the economy, continued uncertainty regarding future monetary and fiscal policies, and, in all likelihood, continuing fears of escalating sectarian strife – and conflict – in the Middle East. The possibility or probability of sudden shifts in market sentiment and expectations suggests that investors should, at least, be forewarned and prepared for what could be a bumpy ride in 2014.

— Norman Robertson

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SMITHFIELD TRUST COMPANY BOOK REVIEWS

THE PRESIDENTS CLUB
By: Nancy Gibbs and Michael Duffy

This is a nifty book. Filled with rich and revealing anecdotes, The Presidents Club describes the complex and often poignant relationships between former and incumbent presidents of the United States.

The "Club" actually had and has some formality to it. At the inauguration of President Eisenhower in 1952, Herbert Hoover and Harry Truman founded the Club. After this founding, Hoover and Truman developed a deep friendship. In his campaign against Thomas Dewey, Truman castigated Hoover as the creator of all the economic ills in the country. Truman then apologized to Hoover, who told Truman not to worry about the attack, implying that he preferred Truman to Dewey in any event.

The warm relationships between both of the Bushes and Bill Clinton are depicted in a detailed and interesting manner. Similarly, Ford and Carter developed a solid friendship, and Nixon was a close and trusted advisor to Clinton.

Not all the relationships between the members of the Club are warm and fuzzy. Nixon worked behind the scenes to undermine Lyndon Johnson's attempt to negotiate an end in Paris to the Vietnam War, and Jimmy Carter tried to sabotage Ronald Reagan's efforts to end the Cold War with the now famous negotiations with Mikhail Gorbachev. Arguably, the actions of Nixon and Carter rise to the level of treason.

I commend this book to you.

— Bob Kopf

THE PASSAGE OF POWER: THE YEARS OF LYNDON JOHNSON, VOL. IV
By: Robert A. Caro

Writing his fourth volume about Lyndon Johnson, a masterful biographer, Robert A. Caro, began this tale in 1960 as Johnson unsuccessfully attempts to wrest the presidential nomination of the Democratic Party from John F. Kennedy. Caro then describes Johnson's unhappy time as Kennedy's Vice President, with his shocking ascension to the presidency after President Kennedy's assassination.

I had never known of the searing hatred between Johnson and Robert F. Kennedy. This manifested itself most vividly when Johnson was in a subordinate position to the Kennedys during his time as Vice-President.

Caro rightly extols the virtues of Johnson in guiding significant legislation through the House and Senate after he became President. Johnson was a superb legislative tactician. I am not certain that Caro balances his admiration for Johnson's tactical brilliance with sufficient emphasis on his enormous character flaws. Johnson was, after all, a crook, and even Caro thinks that the Kennedys were about to dump him from the re-election ticket because of his involvement with his aide, Bobby Baker, in some felonious financial activities.

Another mild criticism is the unevenness of Caro's prose. For example, Caro's depiction of President Kennedy's funeral is incredibly moving and beautifully written. On the other hand, in writing about more mundane matters, he uses prose with a lazy and sloppy quality with too much reliance on dashes instead of commas.

All in all, though, this biography is worth your time and attention.

— Bob Kopf

COOLIDGE
By: Amity Shlaes

Like many, I suspect, I knew very little about Calvin Coolidge before reading this biography. My basic impression of Coolidge arose out of a Dorothy Parker quip. Upon being informed of Coolidge's death, she asked "How can they tell?"

Born in Vermont in 1872, Coolidge became a successful Governor of Massachusetts and then Warren G. Harding's Vice-President. After Harding died in 1923, Coolidge became President. A minimalist and a man of few words, he reduced the size of the federal government and, with Treasury Secretary Andrew Mellon, advocated what we now call "supply-side" economics, arguing accurately that a reduction of marginal tax rates can and often will generate increased revenue. While Coolidge never fully grasped the fallacy of the Republican Party's pro-tariff stance, he did usher in an era of political civility, honesty and, Shlaes argues, prosperity. Although he was certain to be re-elected in 1928, Coolidge declined to run.

There is much to admire about our thirtieth President and much to admire about this splendid biography.

I have one quibble about Shlaes' writing style. She uses too many semicolons. I have always suspected that semicolons were a pernicious invention by law schools to teach law students how not to write.

— Bob Kopf

THE PRICE OF JUSTICE
By: Lawrence Leamer

This is a riveting story featuring two of my former law partners, Dave Fawcett and Bruce Stanley, in epic legal struggle against Don Blankenship, the head of Massey Energy and a powerful force in West Virginia politics.

While there are some side legal battles between the protagonists, the central courtroom drama involves a plaintiff, Hugh Mason Caperton, represented by Fawcett and Stanley, asserting that Blankenship had tortiously and fraudulently destroyed Caperton and his company. After obtaining a $50,000,000 verdict in a West Virginia trial court, Fawcett and Stanley seemed to have prevailed. Instead, the story really starts there.

Blankenship and Massey ultimately appealed to the Supreme Court of Appeals of West Virginia. Initially, it seemed that the trial court judgment would be upheld, but Fawcett and Stanley ignored the fact that an election to the Supreme Court was pending. Blankenship donated massive amounts of money to the candidate favorable to him and, in a great surprise, steals the election. The newly elected justice refuses to recuse himself from the Caperton case, and the court overturns the trial court's judgment in favor of the plaintiff. I will not ruin the suspenseful drama except to say that the United States Supreme Court eventually becomes involved.

Although the conduct of Blankenship is, without question, outrageous, the author's portrayal of the players is a bit too "black-and-white" for me. Nonetheless, I am proud of my former partners in their zealous representation of their client, and I think that you will share this opinion in reading a Grisham-like non-fiction thriller.

— Bob Kopf