THE SMITHFIELD Forecast

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For Customers & Friends of
SMITHFIELD TRUST COMPANY

A NOTE FROM THE CHAIRMAN

Recently a friend of mine asked me a simple, yet penetrating, question that I had, surprisingly, never received in the nearly twenty years of Smithfield's existence: what factors should one consider in the selection of an investment manager? Following is my attempt to answer my friend's question.

Suitability

The maxim of "one size fits all" certainly does not apply to an assessment of a money manager. Some managers, including Smithfield, provide ancillary services which may or may not be important to a prospective customer. These services could include a role as a fiduciary, tax consulting, coordination of legal and insurance matters, plus risk management.

The obvious inference to be drawn from the weighing of the "suitability" factor is that Smithfield itself is not appropriate for every person. For example, if one wishes to be actively involved in the selection of individual stocks and bonds on a continuing basis, I would refer him or her to a low-cost broker.

Chemistry is vital to the assessment of suitability, though chemistry is admittedly a subjective factor. Try to determine whether the culture, philosophy and personalities of the personnel of the members of the investment firm are in harmony with you and your family. Furthermore, learn how your proposed relationship manager is compensated, what his or her experience is and how many customers he or she serves. Do not be shy about asking for references from current customers and ascertain specifically the level of personnel turnover.

Transparency

Every investment manager pays "lip service" to the concept of transparency, but few really provide it.

If an investment firm engages third party managers, is that firm willing to disclose precisely what the external manager is paid? Transparency should also mean that investment firms must be willing to disclose their cost structure to the customer, to delineate what employees in the firms will be working on the customer's account and to state what services those employees will be performing.

Determine with precision how investment performance is measured and make certain that investment performance is not artificially inflated by the firm's jumping from one "hot" external manager to another.

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Fees

One of the cardinal sins in our industry is the obfuscation of fees. Fees should be simple and be clearly communicated to the customer.

Mutual funds contribute mightily to this obfuscation. The expense ratio in a mutual fund is often a second fee being paid by the customer. While the expense ratio is disclosed in a prospectus, many investors fail to consider or see it.

All fees and any transaction costs borne by the customer should, as stated above, be disclosed.

Conflicts

All investment managers have conflicts of interest. A manager who tells you that his or her business is devoid of conflicts is lying.

In my view the appropriate way to deal with conflicts is to create a business model which minimizes conflicts to the greatest possible extent. We have done this at Smithfield.

A Rule 12b-1 (named after a section in the Investment Act of 1940) fee is charged by a mutual fund to cover promotion, distribution and marketing expenses. Often a portion of the Rule 12b-1 fee is paid by the mutual fund to a broker or other investment advisor for placing the customer into the fund. Rule 12b-1 fees can create egregious conflicts by incentivizing the advisor to put the customer in the fund paying the greatest portion of the Rule 12b-1 fee to him or her. Smithfield takes no Rule 12b-1 fees. While the current Chairperson of the Securities and Exchange Commission, Mary Schapiro, is proposing to reform the Rule, I'll believe it when I see it.

Ask a prospective investment manager how its business model minimizes conflicts.

Conclusion

I hope that the foregoing gives you some food for thought.

— Bob Kopf

DO WE HAVE AN ECONOMY TO CHEER ABOUT?

How does one explain – or rationalize – the recent volatility of equity prices? What are the implications for market activity over the coming months? How have the Congressional elections of November 4th changed the economic landscape?

What's Been Happening?

Looking first at the equity markets, a glance at the statistics showed that, between September 18th and October 15th, the S&P 500 Stock Market Index fell more than 7%, which came uncomfortably close to the figure of 10% that is generally classified as a market correction. Since then, however, equity prices have rebounded with the S&P 500 Index regaining all of the earlier losses. As a matter of fact, the S&P Index is now – November 24 – at an all-time high of 2069.

Looking back, one can speculate that the market's selloff in September and October was, in part, related to investor worries about the economic situation and outlook in much of Europe. Of particular concern, were signs of a slowdown in the German economy, which had been expected to lift the rest of the Eurozone, including France and Italy, out of the doldrums. By way of evidence, the German GDP had edged downward (0.2%) in the second quarter of 2014, the first quarterly dip since the opening quarter of last year. Much of Europe, it was feared, was on the brink of another recession, which could well have a negative impact on growth prospects for the U.S. Furthermore, worries about the economic outlook were not limited to Europe, but extended to most of the global economy – excluding the U.S. – which seemed to be growing more slowly than had been expected earlier in the year. As an illustration of this concern, the International Monetary Fund in April of this year predicted a gain of 3.6% in world output for 2014 as a whole. In October, the Fund cut that overall increase to 3.3%, while the projected rise in the output of the advanced economies was lowered to 1.8%, down from the forecast of 2.2% in April.

Fears of a recession-like environment in Europe and Japan were reinforced by the prevalence of flat or declining prices, which raised the specter of deflation and the threat of a deflationary spiral. Notably, the price of oil – West Texas Intermediate – has fallen more than 16% over the past year and is close to a four-year low. At the same time, The Economist's Commodity Price Index shows a year-over-year decline of 3.5% in food prices and a 6% drop in industrial prices, primarily nonfood agricultural products. Another contributor to the decline in equity prices may well have been worries about the risks that the Ebola virus posed to the United States. And finally, it can be argued that international tensions and conflict, notably in the Mid-East and the Ukraine, were, in part, responsible for the gloom on Wall Street.

With the benefit of hindsight, the September/October drop in equity prices was probably out of proportion to the factors that seemingly contributed to it. At issue now, of course, is whether the subsequent rally is warranted in light of the outlook for economic activity and corporate earnings, as well as the unsettled geo-political situation. While investors may still be uneasy about slowing economic growth in the Eurozone, as well as Japan, Brazil, Russia and China, there has been a good deal of optimism regarding the U.S. economy, which, in the view of many observers, is gaining strength and will likely be the engine of growth for the global economy. Most recently, investors were cheered by the news that real GDP in the third quarter of 2014 had increased at a healthy – and better-than-expected – annual rate of 3.9%. Among the major contributors to growth, business spending for new equipment climbed at a robust yearly rate of 10.7%, while real exports increased at a near 5% rate, and real outlays on national defense surged at a 16% rate – the largest quarterly increase in five years.

Interpreting the Numbers

To a degree, however, the volatility of quarterly GDP data has tended to obscure the underlying trend of GDP growth which, over the past three years, has been remarkably stable, posting gains of around 2.2% in 2012, 2013 – and the first nine months of this year. As to what lies ahead, we can find little or no hard evidence to indicate that the underlying trend of real GDP growth is breaking out of the 2-2½% range that has prevailed over the past several years. Notwithstanding the third quarter's solid increase in real GDP, therefore, we continue to see the current economic expansion as disappointing, particularly as compared with those of the post-World War II era. Our view is clearly at variance with what seems to be the prevailing opinion at the Federal Reserve. For example, in a recent speech, John Williamson, the highly respected and well-regarded President of the Federal Reserve Bank of San Francisco, noted "I'll be honest; these speeches get more and more enjoyable as time goes by because the economic outlook keeps getting better and better." One is tempted to ask that, if this is indeed the case, why is the Federal Reserve still holding its policy rate – the Federal Funds rate – at near zero, the same as it was during the severe 2008-2009 recession?

Capital Spending - Slowdown Ahead

As we review the latest batch of economic statistics, the underlying rate of GDP growth is still in the vicinity of 2½%. To be sure, business spending for new equipment has indeed posted strong gains in recent quarters. But one of the key leading indicators of capital spending, is now more consistent with a marked slowing of outlays over the next few quarters. Briefly stated, there has been a leveling out of orders for nondefense capital goods (ex aircraft) since June, which suggests that gains in spending over the coming months will be smaller than those recorded over the past two quarters. As matters now stand, 2014 is expected to see a year-over-year gain of about 5% in real outlays for equipment, and a similar increase is projected for 2015. Likewise, spending for nonresidential construction has shown little or no forward movement since the end of last year. The latest data show modest gains in spending for office, commercial and lodging construction, offset by cutbacks in outlays for power, communication and amusement and recreation.

Tepid Recovery in Residential Construction

Meantime, the housing recovery, notably in the single-family house sector of the market, appears to have run out of steam. Data through October 2014 show permits for single-family house construction posting a slender gain of 1.4% over the comparable period of last year. And more recently, the annualized rate of permits issued for single-family house construction has essentially failed to advance since last June. At the same time, however, permits for apartment construction, although showing month-to-month volatility, have been on a rising trend over the past year. Thus, in contrast to the year-over-year increase of 1.4% in single family permit issuance, permits for apartment construction are up close to 15%. Our forecast for housing starts in 2014 calls for about 1,010,000 units, while 2015 is expected to see a slightly higher volume of close to 1,100,000 units.

Household Income, Employment - and Spending

Turning next to consumer spending, which represents close to 70% of the nation's GDP, many observers are taking the view that the significant decline in gasoline prices will boost consumer spending over the immediate months ahead. Perhaps so. In our view, however, the key determinant of consumer demand is real after-tax income growth, which, in the first ten months of this year, recorded a modest gain of 2.2% over the comparable period of last year. One explanation for the sluggish growth of incomes can be found in the recent pattern of employment. At first glance, the fact that monthly increases in nonfarm payroll employment have averaged 245,000 since last March should mean higher incomes – and more spending. Less encouraging, however, is the fact that gains in low-wage industries, including restaurants, retail stores and health care, accounted for over 50% of the overall increase in employment since last March. What is worrisome is that employment in what can be regarded as moderate- to high-paying industries – finance, construction and manufacturing – has declined almost steadily since 2000

In a similar vein, the average weekly earnings of employees on private nonfarm payrolls during the first ten months of this year were up just 2.4% over a year earlier. After adjusting for inflation, the estimated real increase is a very anemic 1%. Even more striking – and troubling – is the fact that, between 1990 and 2013, real GDP has posted a gain of 75%, while the median household income in 2013 was no higher than it was in 1990 – 23 years ago.

Notwithstanding the weak growth of household incomes, the latest figures on retail sales have been hailed as evidence of a pickup in consumer spending, which, of course, accounts for 70% of the nation's GDP. In this view, recent gains in employment, along with lower gasoline prices, are giving a significant boost to consumer confidence and spending. According to the Commerce Department, retail sales (ex automobiles and gasoline) in October registered a solid 0.5% increase over the prior month. This welcome increase, however, just about offset the decline in the previous month. As a result, sales in October were nearly the same as they were in August. Of some note, was the fact that just two kinds of business – non-store retailing and food services – accounted for virtually all of the increase in nonautomotive sales.

Since month-to-month figures on retail sales can be quite volatile, a three-month moving average of the data can provide a clearer picture of the underlying trend of activity. On this basis, there has been very little forward movement in retail sales (ex automobiles and gasoline) since last June. Similarly, the estimated sales of the key GAFO group*, which, in October, were up a feeble 1.6% over a year ago, has, in fact, trended sideways since the beginning of 2014. All in all, we believe it would be premature to conclude that a significant acceleration of consumer spending is either underway or in the making. We anticipate continued modest gains in real outlays over the balance of this year and a good part of 2015 as well. Looking at the numbers, we expect a 2.2% rise in real consumer spending in 2014 and a slightly larger gain of about 2.5% in 2015.

*Furniture, home furnishings, electronics and appliances, clothing and accessories, sporting goods, hobby, books and music, general merchandise and office supply, stationery and gift stores.

Growth Forecast for 2015

Activity in the remaining sectors of the economy will not, in our opinion, contribute much, if anything, to real GDP growth either this year or next. Despite quarterly fluctuations, we expect that the trend of real federal outlays on goods and services will be flat through the balance of this year and next. And any increase in state and local outlays will, in our view, be limited in 2015 to a year-over-year gain of about 1%. Given the high level of uncertainty about the outlook, we anticipate that, so far as possible, business firms will keep a tight grip on their inventory positions. As a consequence, we see little in the way of an increase in inventory accumulation in 2015. And finally, the wider-than-expected foreign trade deficit in September serves as a warning that the economic slowdown in many of this country's trading partners is having a negative impact on export growth.
The continued effects of the stronger dollar and sluggish growth in Europe and Japan will likely act as a constraint on export growth in 2015. As a result of these developments, we expect that the net export balance (goods and services) will be little changed from the figure of $460 billion now forecast for this year. Our assessment of the outlook for key sectors of the economy points to a gain in real GDP of about 2.6% in 2015, which, if realized, would represent a modest improvement over this year's estimated gain of 2.2%.

Low Inflation

Up to now, the inflation rate – as measured by the Price Index for Personal Consumption Expenditures – has remained below the Fed's target of 2% and, as a consequence, has been used to justify the continuation of the Fed's low interest rate policy. We are presently forecasting a rise in consumer prices of about 1.5% for the coming year, which suggests that the 2% target will not be reached before 2016. Plainly put, we believe that inflation will remain low for another year – or even longer.

What Will the Fed Do?

What does this outlook for inflation imply for interest rates? At present there is general agreement that the Fed will not start to raise its policy rate – the Federal Funds rate – for at least another six months. On this assumption, we look for a Federal Funds rate of about 1% by the end of 2015. So far as long-term rates are concerned, our latest forecast anticipates the yield on 10-Year Treasury notes not reaching the 3% zone until the fourth quarter of next year. Turning to monetary policy, the Fed has now kept the Federal Funds rate at near zero for six years, while its balance sheet has soared to $4.5 trillion. As we have noted before, the Fed's highly accommodative policy stance, as indicated by the near-zero Federal Funds rate, should not be the same as it was during the severe financial crisis and recession of 2008-2009. In our judgment, low interest rates are now doing very little to stimulate either employment or overall economic activity.

The Political Factor

For now at least, we doubt that the mid-term elections of 2014 will have a material impact on next year's economy. Despite expressions of good will and good intentions, we should not expect that partisan bickering and political stalemate will come to an end any time soon. While we should not, in our opinion, expect too much from the new Congress, the election results of November 4th at least raised the possibility of new legislative actions relating to the Keystone XL pipeline, reform of the corporate tax system and trade agreements with the European Union and other countries.

Meanwhile, the makeup of the new Congress may be more receptive to legislation that could threaten the Fed's independence and, in effect, make monetary policy subject to Congressional oversight and approval. One of the Federal Reserve's more persistent critics – Senator Richard Shelby of Alabama – will likely head up the powerful Senate Banking Committee. As long as interest rates remain at their exceptionally low levels, any legislative action that might threaten or limit the Fed's independence should be regarded as possible but not probable. But criticism of the Federal Reserve and its policies could well increase when the Federal Reserve finally moves to raise interest rates, which is widely expected to occur around the midpoint of next year.

Equity Markets - Can the Rally Last?

Equity investors could face a bumpy ride in 2015. Despite the market's recent impressive rally, we doubt that equity prices can outrun gains in overall economic activity and corporate profits for an indefinite period of time. Up to now, the remarkable disconnect between equity valuations and the major economic indicators can be attributed, at least in part, to the Federal Reserve's unusually accommodative monetary policy, which, in effect, has fueled the almost steady rise in stock prices. However, once interest rates begin to rise, the attraction of equities may start to lose some of their recent luster. Furthermore, continued uncertainty and uneasiness regarding economic prospects in Europe, Japan and elsewhere, coupled with geo-political concerns, could also imply some loss of investor enthusiasm for equities. What we are suggesting is that, unless there is a marked improvement in real GDP growth, coupled with strong gains in corporate earnings, the equity markets in 2015 may be hard pressed to duplicate their recent gains for yet another year.

— Norman Robertson

SMITHFIELD TRUST COMPANY BOOK REVIEWS

MYSTERY LOVERS

I just finished listening (I know, I know, that really isn't "reading") to Alan Bradley's new Flavia de Luce mystery *The Dead in Their Vaulted Arches*. This book is another in the series (he's working on his 7th book) that features a nearly 12 year-old girl in pigtails, an aspiring chemist and a resident of Bishop's Lacey, England who has a nose for murder solving. This one, set in 1951, involves a 10 year-old, World War II espionage case in which Winston Churchill even makes a cameo appearance. These books make for comfortable reads (or listenings).

For those inclined toward mysteries I also recommend, for lovers of Paris (now, who isn't a lover of Paris!) the Cara Black series. Although, she seems to be a mite geographically challenged from time to time, her mysteries deal with murders in the 20 arrondissements (neighborhoods). From *Murder in the Marais* through *Murder Below Montparnasse*, Black describes the adventures of Ame'e Leduc in solving murders with subplots ranging from the WWII past to current issues with Muslim suburbs.

On the other hand, for those who enjoy the Adirondacks, there is Julia Spencer-Fleming's series dealing with the lonely police chief Russ Van Alstyne and the town's Episcopal priest, Clare Fergusson. Together, they solve mysteries in and around a small town on the edge of the Adirondacks. *In the Bleak Midwinter* is the first of the series. She's working on her 9th book now.

I'm sure most mystery lovers have discovered the Cozy Mystery List website (cozy-mystery.com), though I just came across it recently. It's pretty extensive if not all encompassing.

— Tim Merrill

TERMS OF ENGAGEMENT
By: Clark M. Neily, III

Mr. Neily, a senior attorney at the Institute for Justice, argues for what he calls "judicial engagement," which he distinguishes from "judicial activism." By judicial engagement, he means that the courts should take an active role in enforcing the Constitution instead of deferring to the legislature, as they so often do. He is particularly critical of the so-called "rational basis" test, whereby a court will refuse to overturn legislation if there is any conceivable rational basis for enacting it, even if the government attorney does not cite such a basis. He makes a compelling case for how the courts have reversed the fundamental principle of the Constitution; instead of a government whose powers are limited to those explicitly enumerated in the Constitution, we now have a government that can exercise any power not explicitly prohibited by it.

— Henry Haller, III

THE IDEALIST
By: Nina Munk

Nina Munk, a journalist and editor at *Forbes and Fortune* (among others), details the story of Dr. Jeffrey Sachs, a Harvard economist, who felt that he had the solution to extreme global poverty. In 2006, to implement his plan, he raised $120 million, much of it from George Soros. With these funds, he launched his "Millennium Villages Project" in a dozen poverty stricken villages in various African countries. Although considerable benefits were realized at first, the project ultimately failed as realty set in, in the form of culture, corruption, climate and the vagaries of human nature. I would recommend this book as an object lesson in how difficult it is to organize any society from the top down.

— Henry Haller, III

CAPITAL IN THE TWNETY-FIRST CENTURY
By: Thomas Piketty

The most controversial (and interesting) book on capitalism in many years is this book from a French economist. It was translated to English by Arthur Goldhammer and published by Harvard U. Press. His thesis is simple and direct: inequity of wealth in capitalist countries will continue to increase absent catastrophic events such as the period 1914-1945 in Europe.

His data rich argument is based on 300 years of data from his native France, as well as England and Germany. He has about 100 years of data from the United States, much of which has drawn criticism from our economists. It is relatively easy to develop data on income, but data on wealth is problematical. The government doesn't ask how rich we are, except for the estate tax on death, which doesn't include all wealth. And wealth can be in any country of the world, regardless of where on lives.

The reader may be interested in where he or she fits into the income/wealth distribution. As to income, in the U.S. the top 10% claims 50% of the total income, of which incomes from 10% to 5% of this group have annual income of $108,000 to $150,000; the next 4% incomes from $150,000 to $352,000; the top 1% income above $352,000. The top 1% claims 20% of the total national income. But the elite are in the top .1 of the 1% group, with annual income of $1,520,000 and up. If you find yourself in that group, call Bob Kopf immediately.

Piketty is less concerned about income than wealth. While his U.S. numbers are suspect (he has recently conceded that other U.S. economists' estimates are more accurate, but still prove his point), he believes that the top 10% have 75% of the country's wealth, with the top 1% owning 35%. The next 45% have all the remaining wealth, with none in the bottom 45%.

His conclusion is that wealth inequity will continue to grow, for the reason that capital historically earns about 4% per year, and the economy grows at a rate of 1%. He makes no prediction as to what the end of this century will look like, except to point out that the rate of growth of inequity experienced in the last 50 years, if projected, will lead to such a drastic inequity to be nonsustainable in a democratic society. He offers no solution, other than a tax on wealth, which he concedes makes no sense for any one country to adopt, as it will just cause the wealth to move to other countries.

As a non-economist, I found the book easy to read and understand. And it will lead to many wonderful arguments.

— Robert F. Patton

"SEMISWEET: AN ORPHAN'S JOURNEY THROUGH THE SCHOOL THE HERSHEYS BUILT
By: John A. O'Brien

Founded in 1909 by Milton and Catherine Hershey as a school for impoverished orphans, the Milton Hershey School has an endowment in excess of $10 billion, larger than the combined endowments of Dartmouth, Cornell and Johns Hopkins. The school owns the candy company, instead of the other way around.

John A. "Johnny" O'Brien entered the Milton Hershey School at age three with his slightly older brother, Frankie, under horrifying circumstances. His father murdered their mother and was then imprisoned, although the school did not disclose this to John until his graduation.

"Semisweet" is aptly titled. Many of the events in this autobiography are inspiring. Others are profoundly sad.

The story of Frankie falls into the sad category, although John's efforts to help his older brother are uplifting. Frankie was always different and sensitive. He ultimately lapsed into severe mental illness and was transferred permanently to a mental hospital. Frankie apparently saw the murder of his mother, though he retained no conscious memory of that. One can speculate that this contributed to his illness. The bullying of Frankie at the school made John a crusader against such heinous behavior.

John thrived at the Milton Hershey School, despite a few bumps in the road. He became the president of his class, an all-Pennsylvania football star and class salutatorian. Upon graduation he joined the Class of 1965 at Princeton, where I met him.

At the end of the twentieth century the Milton Hershey School had lost its way by straying from the mission of the Hersheys. Having led an alumni protest against the direction that the school had taken, John then retired from a successful business career, becoming the head of the school he credits with saving his life.

John restored the soul of the school as its head, returning its focus to poor orphaned (or neglected) children. I visited the school as a part of a Princeton reunion near the end of his tenure. In a tour of the campus I privately asked a graduating senior what he thought of "Johnny O", as John liked to be called. The senior stated simply and emotionally: "Johnny O saved my school. In doing so, he also saved me."

There is, in my opinion and John's, a need to clean up the governance of the school by revamping the board, which is plagued by conflicts, greed and undue insularity. Until this is done, all is semisweet instead of just sweet. The Office of the Attorney General of Pennsylvania has jurisdiction over all Pennsylvania charities, including the school. So far the recent occupants of the Office from both political parties have approached the reform of the Board in a fundamentally feckless manner. Political considerations appear to be the culprit.

I am confident that after reading "Semisweet" you will come to admire Johnny O as much as I do.

— Bob Kopf