The Smithfield Forecast

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For Customers & Friends of
SMITHFIELD TRUST COMPANY

A NOTE FROM THE CHAIRMAN

In this issue of The Forecast I want to express my sincere appreciation for the yeoman efforts of Smithfield Trust Company's Tax Department (and our affiliated accounting firm of Einwag Morrow) in guiding us and our customers through what was an exceptionally brutal tax season. Led by our President, Bill Morrow, our tax personnel worked incredibly long hours, yet they discharged their duties with a high level of competence.

In most trust companies or trust departments the Tax Group is the Achilles' heel of the organization. That is not true of us. I am very proud of our tax people.

— Bob Kopf

ANOTHER LOOK AT 2014

Upside or Downside Risks to Outlook?

After a dismal weather-related first quarter, economic activity in the U.S. is widely expected to strengthen over the balance of 2014 – and beyond. There is little doubt that real GDP growth in the April to June period will be significantly higher than the first quarter's negligible 0.1% rate. In our view, however, this does not mean that the economic recovery, which started almost five years ago, is now picking up speed. Bear in mind that, as economic expansions age and mature, they tend to lose rather than gain strength and momentum. From our perspective, the outlook for the balance of 2014 calls for little change in the underlying trend of economic activity, which we expect to continue on a modest – and sub-par – growth track.

Cautious Consumers

First of all, we doubt that 2014 will be a year in which strong gains in consumer spending will spark a more rapid pace of economic growth. To be sure, household wealth has climbed to a record $81 trillion, up from a recession low of $56 trillion reported in early 2009. Then too, the four quarters ending on December 31, 2013 were the first since late 2008 to record an increase in total debt outstanding.

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According to the Federal Reserve Bank of New York, consumer debt increased by $241 billion in the fourth quarter of last year, the largest quarter-to-quarter increase since the third quarter of 2007. Despite this sizeable advance, however, consumer debt at the end of 2013 was still some 9% below its previous peak of $12.68 trillion recorded in the third quarter of 2008.

All in all, the recent increase in borrowing suggests that many households are now willing – and able – to take on additional debt as a means of boosting spending on goods and services. While the increase in borrowing can be seen as a positive development, we should not conclude that a debt-fueled boom in spending is close at hand. For one thing, many households are still struggling to reduce their debt burden. And for another, memories of the Great Recession are still fresh and, in all likelihood, can be expected to act as a constraint on the use of credit. Of even greater importance, we believe that the near stagnant pattern of income growth will hold back spending in the immediate months ahead. Between the second quarter of 2009 and the first quarter of this year, real after-tax disposable incomes have increased at a feeble yearly rate of only 1.4% which, on the face of it, does not provide much support for an accelerating rate of spending. As another indicator of anemic income growth, the Bureau of Labor Statistics reported that in April the average weekly earnings of all employees in the private sector were just 2% ahead of a year ago which, after adjusting for the rise in prices, implies a fractional gain of less than 0.5%. So far as the outlook for after-tax income is concerned, we are forecasting a near 2% rise in 2014. Although this indicates an improvement over last year's lackluster gain of 0.7%, it does not signal a marked increase in expenditures.

Focus on the Labor Market

Those who contend that 2014 will see robust gains in consumer spending point not only to the strengthening in household balance sheets but to evidence of a stronger job market. True, private job growth in February-April averaged close to 226,000, representing a considerable improvement over the November-January average of 175,000. However, a sizable part of the recent increase in payroll employment has been in low-wage-paying industries which, in turn, has contributed to the lack of growth in household income. Arguably, the labor market has not fully recovered from the severe 2008-2009 recession. For instance, long-term unemployment is still elevated at 35% of all those employed as compared with only 16% in 2007. And while the headline unemployment rate is 6.3%, a broader measure of the jobless rate that includes those who are involuntarily working part-time as well as individuals marginally attached to the labor force* currently stands at 12.3%, down from a recession high of 17.2% but still well above the reading of less than 7% recorded in 2001. Despite these negative comments, we are forecasting that the average monthly increase in payroll employment will be slightly above 200,000 as compared with last year's figure of 190,000.

*Individuals who are available and want a job but are not currently seeking work.

Shifts in Spending

Of more than passing interest are the changes in consumption patterns which have stemmed in part from demographic forces as well as changes in tastes and income. Since the recession ended almost five years ago, the generally lackluster pace of consumer spending has primarily reflected weakness in the nondurable goods – food, clothing and gasoline – and services sectors. Thus, between the second quarter of 2009 and the first quarter of 2014, real outlays on services and soft goods climbed at yearly rates of only 2% and 1.6%, respectively. In striking contrast, outlays for recreational goods and vehicles – which include an array of products associated with recent advances in information technology including smart phones, tablets, I-pads and other devices – have surged at a yearly rate of 11% during this same period of time. As a footnote to the statistics on retail trade, it might be noted that in the first quarter of 2014 non-store retailers – including online shipping – reported a year-over-year gain of 6.6% compared with a 5.6% decline posted by the nation's department stores.

All things considered, 2014 is not expected to be a banner year for most retailers. As one measure, retail sales (ex motor vehicles) and gasoline are forecast to post a 4%-5% increase over last year's performance, while sales of department store-type merchandise** should gain about 3.5% as compared with last year's pallid performance. Looking at the broadest measure of consumer demand, we are forecasting that 2014 will see a year-over-year real increase of close to 2.5% in consumer spending for goods and services – better than last year's gain of 2% but well below the annual average of 3.5% recorded between 1955 and 2005.

Slowdown in Home Building

Meantime, the recovery in new house construction appears to be running out of steam. The trend of permits issued for single-family house construction has not shown an increase since last spring. Furthermore, annualized rate of new house sales in the first quarter of 2014 failed to match the number recorded a year earlier. At the same time, however, permits for multi-family construction during the first quarter surged 23% ahead of a year earlier, marking the continuance of a general uptrend that began more than a year ago and suggesting perhaps a growing demand for rental-type properties at the expense of traditional home ownership. Be that as it may, the demand for single family houses may have been negatively impacted by the slow growth of incomes, as well as price increases in many parts of the country. In addition, mortgage rates, although still low, are generally higher than they were last spring and lending standards are generally much tighter than they were in the years preceding the 2007-2009 recession. In light of recent developments, we have reduced our earlier forecast of housing starts in 2014 and now anticipate a volume of 1,020, 000, up some 9.7% over last year's figure.

**Furniture and home furnishings, electronics and appliances, clothing, sporting goods and general merchandise.

Subdued Recovery for Nonresidential Construction

Turning to prospects for nonresidential construction activity, we look for the continuance of a slow recovery from the severe 2009-2011 downturn. However, spending in 2014 – and beyond – is not expected to regain the peaks recorded in 2008 since the earlier boom-like rate of outlays generated major supply-demand imbalances which contributed to the slump in activity. Since most major nonresidential construction projects require an assessment of the long-term demand for office, commercial and industrial space, there is good reason to believe that the slow-paced recovery reflects, at least in part, a more cautious evaluation of the longer-term outlook. Another factor that could limit gains in outlays over the next year or two is that financing is not as readily available as it was prior to the recession. Weighing all the evidence, we estimate that current spending for nonresidential construction will approximate $318 billion in 2014, up 7% from last year's figure of $296 billion.

Mixed Outlook for Capital Spending

The estimated increase in outlays for nonresidential building is likely to be accompanied by a rising trend of spending for new business equipment. Even though outlays for new equipment have moved steadily upward since the recession ended in mid-2009, the recovery, in general, has been on the slow side with real outlays in the first quarter of 2014 just 4% above what they were seven years ago. As a matter of fact, the ability to spend has not been matched by a willingness to do so. Thus, between 2010 and 2013, capital expenditures averaged just under 78% of funds available for investment as compared with a ratio of 96% for the period between 2004 and 2007. To a considerable degree, the slow-paced upswing in equipment spending can be traced to heightened uncertainty about the fiscal and regulatory climate as well as the short- and long-term outlook for sales and earnings. At the same time, there has also been a significant shift in the pattern of spending for capital goods. Briefly stated, outlays for information business processing equipment – including computers – have outpaced outlays for industrial equipment by a significant margin. Since 2007, real outlays for what might be called high technology equipment have posted a gain of 14% as compared with a decline of 4% recorded for industrial equipment spending during this same period of time.

As evidence of a less-than-robust outlook for equipment spending, orders for nondefense capital goods (ex aircraft), which is a reliable forward-looking indicator of future spending, has shown little, if any, movement since last summer. Based on the relationship between orders and outlays, we do not expect to see much, if any, strengthening of business spending for new equipment, at least through the first half of this year. For 2014 as a whole, we look for a less-than-robust 3%-4% increase over last year's performance.

Close Watch on Inventories

In the past, an excessive – and unintended – buildup of business inventories has often been the harbinger of a full-scale recession. What has frequently happened is that an unexpected decline – or smaller-than-expected increase – in sales has pushed inventory/sales ratios to levels that exceeded management's targets and triggered a period of inventory liquidation, necessitating cuts in output and employment. Today, business firms appear to be keeping a tight grip on their inventory positions as indicated by the lack of imbalances between stocks and sales. This situation, however, could quickly change and the trend of inventory/sales ratios will need to be carefully watched for any sign that inventories are moving out of line with sales. For now, our best guess is that this year's inventory buildup will be in the $60-$70 billion range, up from last year's figure of $58.3 billion.

To Sum Up…

The remaining sectors of the economy are not expected to make much, if any, positive contribution to this year's increase in real GDP. The net export balance is forecast to be a negative $405 billion, a small improvement over last year's figure of $412 billion, but not sufficiently large to have a positive impact on real GDP. And while the decline in real government spending appears to be leveling out, we are forecasting that 2014 will see a small year-over-year decline in real outlays of less than 2%. Putting all these pieces together points to an increase of about 2.25% in real GDP for 2014. Simply put, we believe that the U.S. economic recovery is well grounded but its speed will, in our view, continue to lack the vigor of prior periods of economic expansion. Along with the prospect of modest growth this year, we look for little or no increase in inflation. From all indications, inflationary expectations are still well anchored which implies that there is little concern regarding the possibility of a near-term increase in the inflation rate. We are forecasting a 1.8% increase in the Consumer Price Index for 2014 as well as a similar rise for consumer prices less food and energy. Likewise, the measure of inflation most closely followed by the Federal Reserve – the deflator for consumer outlays on goods and services – should closely approximate the Fed's 2% target.

Energy Boost to U.S. Economy

No assessment of the U.S. economic outlook would be complete without some discussion of the dramatic changes in this country's energy future. Less than ten years ago, the precipitous decline of U.S. oil and natural gas production suggested a growing reliance on foreign sources of energy for years to come. Of late, however, a series of technological advances have enabled companies to access and extract huge quantities of natural gas that hitherto had been inaccessible to conventional methods of drilling. Innovations in oil and gas extraction have boosted U.S. output of oil and natural gas almost 50% since 2008. In a startling development, which only a few years ago would have been dismissed as virtually impossible, the U.S. is rapidly becoming self-reliant and, before long, could well meet its energy needs almost entirely from domestic sources. Finally, there is good reason to expect that the oil and shale gas revolution will have important benefits for a number of manufacturing industries – and the economy as a whole – over the next 7-10 years.

Monetary Policy – Too Accommodative?

The prospect of a modest/moderate rate of economic growth, low inflation and what is regarded as excessive labor market slack suggests that the Federal Reserve will continue with its exceptionally accommodative monetary policy. True, the Fed's controversial Asset Purchase Program will, in all likelihood, be phased out before the end of this year. But according to recent statements by Federal Reserve officials, there is no intention of increasing the federal funds rate for at least another year. What this means is that, even though the financial crisis and recession ended several years ago, the Fed's key policy rate will be the same as it was during the depths of the last recession. Put another way, the circumstances that dictated the Fed's zero interest rate policy have long since passed and surely monetary policy should also reflect the change in economic conditions.

From all indications, it would appear that the Fed continues to hold the view that pumping more money into the economy will necessarily bring about a further improvement in the labor market. In our judgment, however, the Fed's ability to lower the jobless rate is limited by the fact that technological change and innovation, along with globalization, – over which the Fed has little or no influence – are responsible for a good deal of today's unemployment.

As a result of the Fed's policy, bank reserves have skyrocketed from $45.4 billion in August 2007 to the latest reading of almost $2.7 trillion, while the Fed's balance sheet has ballooned from $851 billion to $4.3 trillion over a similar time period. Consider the inflationary implications of a situation in which banks begin to utilize their massive reserves to accommodate a rising loan demand from their credit-worthy borrowers. Another consequence of the Fed's low interest rate policy has been that investors, including a significant number of retired persons, have been forced to seek higher rates of return other than those available on short-term money market instruments and longer-term Treasury securities. Of concern is that excessive risk-taking by investors seeking higher rates of return can sow the seeds of another debilitating financial crisis. The Fed is now faced with the formidable task of normalizing monetary policy without disrupting the financial markets – and the economy. As matters now stand, we believe that the costs and risks of the Fed's policy of extreme monetary ease are now far exceeding the benefits which are steadily diminishing.

Unsustainable Fiscal Situation

While the Fed has provided a huge pool of liquidity, we do not have a fiscal policy that provides incentives – taxes and regulatory – for business firms to utilize it for job-creating enterprises. Unfortunately, neither the Administration nor Congress appears willing or able to enact measures designed to put the nation's fiscal house in order. To be sure, the deficit has been reduced from $1.4 trillion in 2009 to an estimated $492 billion in 2014. However, the long-term outlook suggests a resumption of large-scale deficits accompanied by a rising tide of federal debt. According to the Congressional Budget Office, the combination of rising health care costs as well as higher interest payments on the federal debt will, under current law, result in trillion-dollar deficits early in the next decade. As a result, federal debt held by the public, which was just under $12 trillion in 2013, is projected to approach $21 trillion in 2024. Bear in mind, moreover, that these projections do not include the possibility of another economic downturn over the next ten years. The Congressional Budget Office also provided projections of expenditures that underscored the dramatic change in federal spending that has already taken place and will continue to do so. By way of illustration, spending on Social Security and major health care programs, which accounted for 4.7% of GDP in 1974, climbed to 9.7% in 2014 and is projected to reach 11.7% by 2024. During the same period of time, defense discretionary spending has been cut from 5.4% of GDP to a projected 2.7% by 2024. And finally, nondefense discretionary spending, which in 1974 was close to 4% of GDP, is expected to be only 2.5% by 2024.

What's Ahead for Equities?

Since 2009, equity prices as measured by the S&P 500 Index have more than doubted which has given rise to concerns about where the markets may be headed over the balance of 2014. Some observers contend that the prospect of continued gains in corporate earnings, combined with a flow of generally upbeat economic news and low interest rates, could push equity prices to new peaks. They also argue that, as long as interest rates remain unusually low, investors will have few viable alternatives to the equity markets. Others are less sanguine, pointing out that the price/earnings ratio of the S&P 500 Index is now at its highest in some four years while the market capitalization of the U.S. stock market as a percent of GDP is close to 120, well below the peak reached in 2000, but still among the highest recorded in recent years. At the same time, they note the lack of confirming evidence that the U.S. economy is gaining – and not losing – momentum. There is also some concern that, since the Fed's financial engineering has been, at least, partially responsible for the recent bull markets in equity, the winding down of the Asset Purchase Program could have negative implications for interest rates – and equity prices.

These conflicting views will likely be reflected in a volatile trend of equity prices as investors grapple with economic uncertainty, corporate earnings that will either be above or below expectations and, in all likelihood, a less than tranquil geo-political climate. What all of these comments suggest, perhaps, is that a cautious and defensive approach to the equity markets will be an appropriate investment strategy for the balance of 2014.

— N. Robertson

SMITHFIELD TRUST COMPANY BOOK REVIEWS

THE GREAT DISSENT
By: Thomas Healey

The First Amendment to the Constitution of the United States provides "Congress shall make no law…abridging the freedom of speech…" Those few words have produced more comment, philosophizing and litigation than any other words in that great document. This fine book by Professor Healey examines how we arrived at our present understanding of free speech by tracing the thought process of Justice Oliver Wendell Holmes, Jr. He had voted in favor of the Government's side in various prosecutions of radicals. Over a period of several years, he was encouraged to consider a more liberal position by various friends: Judge Learned Hand, Justice Brandeis, Professor Harold Laski and Felix Frankfurter.

Finally, in the Abrams case, involving the prosecution of several radicals who had spoken in opposition to the United States involvement in the Russian civil war, he broke with the majority of the Court. His brief dissent captured the idea that opposing views should be tolerated, short of a clear and present danger to the Republic. That view, in which Brandeis joined, later became the view of a majority of the Supreme Court, and is such a commonly accepted position today that we forget that it was not always so.

One need not be a constitutional lawyer to enjoy this well written piece of intellectual history.

— Bob Patton

THE BULLY PULPIT: THEODORE ROOSEVELT, WILLIAM HOWARD TAFT AND THE GOLDEN AGE OF JOURNALISM
By: Doris Kearns Goodwin

Beautifully written, The Bully Pulpit focuses on the initial decade of the Progressive Era at the beginning of the last century. In a sense the book is a series of separate, yet intertwined, biographies chronicling the lives of Theodore Roosevelt, William Howard Taft and the rising new class of journalists called the "muckrakers" (the most notable, in my opinion, being Ida Tarbell) by Roosevelt himself.

Teddy Roosevelt is a true "force of nature," and the author captures his essence quite well.

I actually found William Howard Taft's characterization to be highly interesting, possibly because I knew little about him. A kind and decent man, Taft was a capable public servant and arguably the nicest person to ever have occupied the Oval Office. Smithfield recently sponsored a reception for Doris Kearns Goodwin at the Robert Morris University Speakers Series in Pittsburgh. This event allowed me to ask her why she devoted so much of the book to Taft. She replied: "I couldn't help it. I fell in love with Taft."

Roosevelt and Taft were best friends until politics and unnecessary misunderstandings sadly drove them apart. Their reconciliation late in life, orchestrated by Taft, is, indeed, touching.

The three most prominent women in the biographies, Edith Carrow Roosevelt, Nellie Herron Taft and Ida Tarbell, are fascinating. Nellie Taft was the driving force behind her husband. She suffered a serious stroke at the inception of his presidency, and Taft was never the same.

I recommend this book to you.

— Bob Kopf

<u>DUTY: MEMOIRS OF A SECRETARY OF WAR</u>
By: Robert M. Gates

Robert Gates writes an insightful and sometimes contradictory memoir from the unique perspective of a public official serving as a cabinet member for two presidents from different political parties.

Addressing multiple topics, Gates describes with great candor the fighting of wars in Iraq and Afghanistan, dealing with the Pentagon bureaucracy as Secretary of Defense, negotiating with a Congress which he regarded with unvarnished contempt, counseling presidents with misguided advisors and dealing with a variety of world leaders.

I find Secretary Gates' analysis of the principals in the Bush and Obama administrations compelling.

More philosophically in tune with President Bush, Gates has a great deal of admiration for him. His view of Vice President Cheney is less flattering, yet he regards Condoleezza Rice with affection and respect.

Gates cites several positives about President Obama, yet he criticizes Obama for his aloofness and lack of commitment to our troops. He also pans Obama's choice of younger advisors. Interestingly, Gates admires Hillary Clinton for the most part. He saves his highest level of scorn and ridicule for Vice President Biden, saying that it is remarkable that he has been in public life for over 40 years without ever being right on any major foreign policy decision.

What do I find contradictory in the book? Essentially it is this: in his efforts to be even-handed, Gates praises a Washington figure and then trashes the same person a few pages later.

An overriding theme in the memoir is Gates' love and deep respect for our troops. This is its most redeeming feature.

I liked this book, authored by a highly intelligent patriot.

— Dave Perkins

<u>KILLING LINCOLN AND KILLING KENNEDY</u>
By: Bill O'Reilly and Martin Dugard

Despite the "hype," I avoided reading Bill O'Reilly's touted Killing books, frankly because I assumed that an arrogant blowhard like O'Reilly could not write a compelling historical narrative. My assumption was, to my complete surprise, mainly wrong. Both books read like thrillers with spare and crisp prose, and each reveals some nuggets of information about the assassinated president and his assailant.

<u>Killing Lincoln</u> is the better of the two books, with a less superficial "feel" to it. O'Reilly's depiction of John Wilkes Booth and his co-conspirators is especially good. My one criticism of <u>Killing Lincoln</u> is the devotion of considerable space to the highly speculative theory that Secretary of War Edwin M. Stanton was a part of the conspiracy to assassinate Abraham Lincoln. The truth is that Stanton was devastated by Lincoln's death, and I am confident that he played no part in the assassination.

<u>Killing Kennedy</u> also shines a strong light on the assailant, and it tells much of interest about Lee Harvey Oswald. I like the fact that <u>Killing Kennedy</u> rejects the growing body of thought in this country that Oswald did not act alone or was not involved in the assassination at all.

Both books are relatively short and are easy reads.

— Bob Kopf