THE SMITHFIELD Forecast

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The U.S. Economy in 2015 – Prospects and Problems

News that the nation's real GDP climbed at a robust yearly rate of 4.2% in the second quarter of 2014 has been widely seen as a sign not only that the U.S. economy had recovered from the winter doldrums but at long last was gaining speed and momentum. While the second quarter's growth rate was certainly a welcome turnaround from the weather-related decline in the first quarter, we question whether recent events are, in fact, signaling a faster rate of economic expansion over the coming quarters.

From our perspective, the 4.2% annualized growth rate represented an overstatement of the underlying or trend rate of economic expansion. According to the Bureau of Economic Analysis, 1.39 percentage points – accounting for 33% of the growth rate – was attributable to a sharp increase in the annualized rate of inventory accumulation from $35.2 billion in the first quarter of 2014 to $83.9 billion in the second quarter. Excluding the volatile – and difficult to interpret – statistics on inventory investment can provide a clearer and more useful picture of the economy's performance. Looking, therefore, at real final sales of domestic product – GDP less change in private inventories – results in a second quarter growth rate of 2.8%, which although marking a reversal of the 1% decline reported in the first quarter, was below the near 3.5% growth rate posted in the second half of last year.

Constraints on Consumer Spending

The other major contributor to the second quarter's growth rate was consumer spending on goods and services, which accounted for 1.69 percentage points of the 4.2% total. Since consumer spending represents close to 70% of the nation's GDP, it follows that real GDP growth depends heavily on the strength of consumer outlays. While many observers look for a quickening pace of household spending over the balance of 2014 – and into next year – we are concerned that weak income growth will act as a major constraint on future gains in outlays. To say that recent growth of household incomes has been disappointing is, in our view, an understatement. Over the past eight months – January-August – the increase in weekly earnings over the comparable period of 2013 was just 2%, which implied little or no gain in real income. Likewise, the second quarter's gain in real disposable income – a more inclusive measure of household income – posted a weak increase of just 2.5% over the comparable period of 2013. Finally, data just released show that in July real after-tax income recorded a negligible gain of 0.1% over the previous month.

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Expectations of a quickening pace of income growth and spending have been based, at least, in part on recent and prospective gains in employment. In July, the economy added 212,000 jobs, which, although fewer than the second quarter's average gain of 267,000, was nonetheless an indication that the economy was creating jobs at a healthy rate. The employment report for August, however, showed a much smaller than expected gain of 142,000, raising some concern of a renewed slow-down in job creation. While disappointing, a single month's statistic does not constitute a trend. Until such time as more data is available, the August statistic can best be seen as a temporary setback, which is not the harbinger of renewed weakness in the job market.

Disparities in Job Growth

Of more than passing concern is the fact that much of the recent growth in employment has been concentrated in low-wage industries, including retail trade, administrative and support services, health care and social assistance, food services and drinking places. Since March – five months – these four categories of employment accounted for no less than 50% of the overall increase in jobs. At the same time, employment in several industries that in the past provided what were generally regarded as good "middle income" jobs – construction, manufacturing and finance, insurance and real estate – accounted for only 20% of the overall increase in private-sector employment.

Slow Upturn in Consumer Outlays

Bearing in mind that households cannot spend more than they earn for an indefinite period of time, our forecast for real consumer spending calls for limited gains over the balance of 2014 – and into 2015. This view, we believe, is supported by the latest readings on consumer spending, which, by and large, suggest that consumers are keeping a tight grip on the purse strings. True, the annualized rate of car sales has climbed steadily from a recession-low of 9 million in February 2009 to the latest reading (August 2014) of 17.4 million units. But elsewhere it would appear that consumers are either unable or unwilling to spend as freely as they did before the recent recession. In August, retail sales ex autos were 4% above a year ago, which, after adjusting for price increases, suggests a modest volume gain of about 2%. And the estimated year-over-year real increase for the first eight months of 2014 was a weak 1%. As another measure of consumer caution, the GAF category of retail trade, which is a useful indicator of discretionary – or nonessential – spending, has barely increased since late 2011. In July, the latest month for which data is available, GAF sales were a sluggish 1.7% above a year earlier, which suggests little or no increase in volume.

Unsettled Outlook for Housing

Meantime, the housing market's recovery from the recent recession has not been as vigorous as many observers had hoped and expected. Despite the attraction of low mortgage interest rates, single-family house construction has shown very little progress over the past year or more. During the first seven months of this year, the number of permits issued for single-family house construction was barely ahead of last year's figure. In fact the reported gain of 0.8% compares with a near 18% increase for permits issued for apartment construction. The striking contrast between what appears to be a near-boom in apartment building construction and, at best, a weak recovery in single-family house construction may indicate a growing consumer preference for rental as opposed to home ownership.

One explanation for the shift from buying to renting property is that the affordability of home ownership has declined in the face of rising home prices and somewhat higher interest rates. While this could well be the case, we believe that weak income growth is acting as a considerable drag on the sale and construction of new single-family houses. A general tightening of lending standards, at least compared with those before the great recession, may also curtail sales of new and existing houses. For the year as a whole, we look for 1,021,000 housing starts, which would still represent a solid increase of 9% over last year's volume. Since we doubt that the negative factors that have impacted homebuilding activity in 2014 will disappear next year, our forecast for homebuilding activity in 2015 calls for little change from this year's estimate. While this forecast may seem downbeat, we believe that a slow and cautious recovery in the housing market is far more desirable than another boom-bust cycle of homebuilding activity, which, in large measure, precipitated the Great Recession of 2008-09.

Needed: More Capital Spending

Turning to the private investment sector of the economy, business spending on new equipment climbed at a vigorous annualized rate of 10.7% in the second quarter of 2014 and was up some 7% over the same period of 2013. So far so good. However, the recent trend of orders for nondefense capital goods ex aircraft – a leading indicator of equipment spending – suggests much smaller gains in outlays over the next few quarters. Over the first seven months of 2014, such orders were up 3.8% over the comparable period of last year, which, after adjusting for inflation, suggests a very modest advance of roughly 2%. Against this backdrop we look for a year-over-year increase in real spending for business equipment of about 4%-5% and a similar gain is tentatively projected for 2015. Essentially, the need to replace outdated and technologically obsolete equipment is expected to keep equipment spending on a rising trend through 2014 and 2015 as well. Despite these positive statistics, the fact remains that capital spending has not rebounded to the extent that it did during prior periods of economic expansion. Anecdotal evidence suggests that continued uncertainty about growth prospects as well as the outlook for monetary and fiscal policies and the regulatory environment are holding back capital spending – and hiring. One other point, since future gains in productivity – and economic growth – are heavily dependent on present-day spending on research and development, it is disturbing to find that, in recent years, there has been a significant slowdown in such outlays. Since 2000 the average annual increase in real R&D spending has been a meager 2.3% – less than half the yearly average of 5.6% recorded between 1960 and 2000.

Cautious Upswing in Nonresidential Construction

At the same time, a rising trend of nonresidential activity is forecasted for 2014 and next year as well. By the same token, there are few, if any, signs that outlays will regain the peaks reached in 2008-09, which, it will be recalled, set the stage for the subsequent collapse in activity. As a matter of fact, outlays for nonresidential building – including office and commercial space – have leveled out since the end of last year. Thus, although outlays in July were up 14% from a year earlier, they were, in fact, essentially unchanged from the level reported at the beginning of the year. One possible reason for the slow-paced recovery in nonresidential building is that activity is still being limited by the overhang of unrented and unsold properties that were built during the pre-recession boom. Furthermore, it is very possible that projections of long-term growth, which underlie most investments in long-term assets, such as office buildings, have probably been revised downward since the Great Recession. What all this suggests is that a series of downward revisions to projections of long-term growth could well be contributing to the lag in spending for most types of commercial and industrial building. Any increase in activity during 2015 will, in our view, be limited to the low single digits.

Elsewhere in the Economy…

The remaining sectors of the economy will not, in our opinion, have much, if any, effect on GDP growth. On the key – and questionable – assumption that business firms will be able to keep a generally tight grip on their inventory positions, we doubt that real investment in inventories will make a positive contribution to GDP growth in either 2014 or 2015. Likewise, net exports of goods and services are expected to have little or no effect on GDP growth in 2014 or 2015. This year's deficit of about $450 billion is expected to be followed by a slightly higher figure of $470 billion in 2015. As a matter of interest, it might be noted that the U.S. deficit on international trade and services is running at a yearly rate of close to $510 billion, which reflects a $740 billion deficit on goods offset in part by a surplus on services in the neighborhood of $230 billion. It might be noted that more than two-thirds of the trade deficit is accounted for by two major categories – automobiles and consumer goods. Finally, there seems little likelihood that government purchases of goods and services will boost economic growth either this year or next. While the decline in state and local government outlays appears to have run its course, we expect to see further cutbacks in spending on goods and services by the federal government. Since the year-over-year change in outlays is likely to be small, they too are unlikely to have much, if any, impact on GDP growth.

Slow Rise in Prices

Meanwhile, inflation has yet to rear its ugly head. As measured by the Consumer Price Index, the inflation rate has averaged 2.4% since the beginning of this year. And excluding the volatile food and energy components, the increase was a smaller 2%. Of more than passing significance, the Federal Reserve's measure of U.S. consumer prices – the Personal Consumption Expenditure Price Index – has climbed at a yearly rate of just 1.8%, which is below the Fed's stated objective of 2%. At first glance, the inflation rate is likely to rise in the wake of a further reduction in the margin of slack in both labor and product markets. For now, however, the most recent surveys of inflation show that expectations of inflation over the near – 12 months – term have remained essentially the same since late 2011. The expectation of a low inflation rate could well reflect, at least in part, the intensity of domestic and foreign competition, which could be acting as a constraint on price increases. This year's estimated increase in the CPI is placed at 2%, while the core rate (excluding food and energy) is expected to post a slightly smaller increase of 1.8%. For 2015, we look for a year-over-year rise of 2% both in the Consumer Price Index and the Personal Consumption Expenditure Deflator, which would finally meet the Fed's objective.

GDP Outlook – "The New Normal"

In summary, the economic expansion, which officially started in June 2009 and has already lasted for five years, is expected to continue for at least another year. At present, however, we expect that GDP growth in 2015 will likely remain below the pre-recession average. For 2014, real growth is placed in the vicinity of 2.1% and on a preliminary basis, we are projecting an increase of about 2.6% for 2015. While there is no sign of a near-term recession, we should not forget that the current expansion is now in its sixth year and, if past experience is any guide, could soon become vulnerable to a loss of forward momentum.

Monetary Policy – Time for a Change

What are the implications for economic policy of our economic scenario for 2014 and 2015? In many respects the policy stance of the Federal Reserve is still essentially the same as it was during the recession that ended more than five years ago. To be sure, the Fed's asset purchase program or "Quantitative Easing" is being steadily reduced and will likely be phased out before the end of the year. But the Fed's close-to-zero target range for the federal funds rate, which has been in place since late 2008, is not expected to be increased until some time in

2015. We seriously question the wisdom of a near-zero policy rate in the sixth year of an economic expansion and when the costs and risks are far exceeding the benefits which have steadily diminished in recent months. In our view, the Federal Reserve has been more focused on short-term goals – notably, full employment – than on long-term objectives. An argument can certainly be made that the Fed's emphasis on low interest rates as a means of reducing the jobless rate appears to ignore or minimize the roles played by globalization and technological innovation in the slow-to-recover labor market. A further period of extreme monetary ease will not, in our opinion, eliminate or markedly reduce the degree of slack in the labor market. All in all, we are concerned that the Federal Reserve has lost its way and is unsure of what to do next. What does seem evident, at least to us, is that, one, there is little more that the Fed can do to stimulate the economy and two, that the road back to a "normal" monetary policy is likely to be complex, lengthy and far from smooth.

More Federal Debt

Unfortunately, there is really nothing new to say about fiscal policy. On the positive side, the budget deficit has fallen steeply from a recession-related figure of $1,412.7 billion in 2009 to $680 billion in 2013 and an estimated $506 billion in 2014. And the CBO is projecting a further decline to $469 billion in the next fiscal year 2015. That said, the news going forward is much less welcome. Assuming that current laws regarding spending and taxation remain unchanged, the CBO anticipates that the deficit will again reach close to $1 trillion by 2024. Moreover, the CBO's projections do not take into consideration the possibility or probability of another cyclical downturn in the next ten years. What they are saying, in effect, is that the U.S. will enjoy 15 years of uninterrupted economic growth, which may be possible but, in our view, not very probable.

In its latest report, the CBO points out that, even though the budget deficit has been reduced, federal debt is still on the rise. According to the CBO's estimates, federal debt held by the public will reach an estimated 74% of GDP at the end of this fiscal year – more than twice what it was at the end of 2007 and the highest for any year since 1950. Unfortunately, the recent decline in the deficit seems to have removed any sense of urgency on the part of the Administration and the Congress to tackle the nation's long-term fiscal problems, which, left unattended, could have serious and far-reaching economic consequences. In the past, fiscal policy has generally been supportive of economic recoveries but today the level of debt has, for all practical purposes, precluded an active role for fiscal policy in promoting a faster rate of economic growth.

Little Change in Interest Rates

Based on recent pronouncements by Federal Reserve officials, little or no change can be expected in short-term interest rates until around the mid-point of 2015. Our best guess is that the second half of next year will see a rise of 25 to 50 basis points, which would still leave the federal funds rate at less than 1%. Long-term interest rates have, up to now, defied predictions of an early increase. For example, the yield on a ten-year Treasury note, which we had expected to be about 2.8% in the third quarter of this year, is presently in the neighborhood of 2.4%. Looking further ahead, we still anticipate that the gradual normalization of monetary policy will be reflected in a slowly rising trend of long-term rates. Thus, in the second half of next year, we still expect the yield on a ten-year note to be in the vicinity of 3¼%.

Issues for Investors

Over the past year – or more – there has been a puzzling disconnect between the trend of equity prices and the economy as a whole. Looking at the period between the second quarter of 2014 and the comparable period of last year, equity prices, as measured by the S&P 500

Index, have posted a substantial increase of some 22%. Over the same time period, however, the nation's current GDP registered a significantly smaller gain of just over 4%. And over a longer time period – 5 years – equity prices are up 113%, far exceeding the much smaller increase of 21% reported for the GDP.

Needless to say, there is much to be said for the argument that investors are more focused on corporate earnings than GDP and other economic variables. Quite so. But in the second quarter of 2014, corporate profits from production were actually down slightly from the like period a year ago. And over the past five years, the increase in corporate earnings was little more than half the increase registered for equity prices.

In our judgment, the magnitude of the disparity between the rise in equity prices and the increase in GDP and corporate profits can be traced, at least in part, to the Fed's exceptionally easy monetary policy that has created a huge pool of liquidity, much of which has been channeled into the equity markets. As we have already noted, the Fed has been pumping money into the economy in an effort to drive down the unemployment rate and speed the pace of economic recovery. One significant consequence of low interest rates has been that many investors have been forced to seek yields higher than those available on Treasury securities, money market funds, CDs and the like. One can certainly speculate that the high valuation on equities can be attributed, at least in part, to an increased appetite for risk on the part of many investors who, with good reason, are confident that the Fed will not raise the federal funds rate until some time in 2015. At the same time, there seems to be a mistaken perception in the equity markets that the Federal Reserve is virtually omnipotent and has the ability to generate above-trend economic growth accompanied by stable prices and low unemployment.

The equity markets' advance is even more remarkable when one considers the possible implications of recent geopolitical events, including chaos in the Middle East, violence in the Ukraine, and strained relations between the United States and Russia. While no one can say, at least with any confidence, that equities are overvalued, the risks, in our opinion, are on the rise. One last comment. What we find most troubling about the short- and long-term economic outlook is that neither Congress nor the Administration seems to have any inclination to address the nation's complex structural problems, which, in our view, are beginning to sap the U.S. economy's energy and dynamism.

— Norman Robertson

SMITHFIELD TRUST COMPANY BOOK REVIEWS

THE CURMUDGEON'S GUIDE TO GETTING AHEAD

By: Charles Murray

This short book of tips from a member of the older generation to those under age 30 is funny yet useful. As a curmudgeon myself, I love how the author tells the younger generation how to act in the workplace, how to speak and write and how to structure one's personal life.

Murray addresses some of my pet peeves in the workplace, including contemporary office dress, language and manners. He is especially adept at highlighting the younger generation's misuse of words. Here are some of my favorites:

- Confusing "disinterested" with "uninterested."
- Confusing "literally" with "figuratively."
- Mistakenly putting an apostrophe in "its."
- Being redundant by writing "general consensus" instead of just "consensus."
- Using "concerted effort" when only one person is involved.

Curmudgeon or young person, you can benefit from the book and be amused at the same time. It does, arguably, get too serious at the end.

— Bob Kopf

THE GENERAL'S DAUGHTER

By: Nelson Demille

Since I finished all of my books on my summer vacation, I turned to The General's Daughter by one of my favorite novelists, Nelson Demille. Stupidly ignoring my wife's advice to burn the book, I proceeded.

The novel begins with a lame set of circumstances surrounding the murder of a prominent general's daughter on a Georgia army base. It never gets better. This is a truly awful book, and I actually wonder if Demille really wrote it. Read, instead, Demille's The Gold Coast, which is a terrific blend of drama and comedy.

— Bob Kopf

<u>YOUNG THURGOOD</u>
By: Larry S. Gibson

This is the biography of Thurgood Marshall in his formative years as a young civil rights lawyer in Baltimore – long before his appointment to the United States Supreme Court.

The beginning of the book is especially good, focusing on Marshall's college years and his subsequent and difficult attempts to start a law practice in the Great Depression. Marshall's successful efforts to compel through litigation the integration of the University of Maryland Law School deserve much scrutiny.

While the biography bogs down somewhat at the end, it is certainly worth reading. If anything, the highlighting of what black Americans had to endure in Maryland in the first half of the twentieth century is shockingly revealed in Larry S. Gibson's depiction of events.

— Bob Kopf

<u>EMINENT PITTSBURGHERS: PROFILES OF THE CITY'S FOUNDING INDUSTRIALISTS</u>
By: William S. Dietrich, II

The late Bill Dietrich, whom I knew and liked, wrote over the years many trenchant articles about Pittsburgh's founding industrialists for <u>The Pittsburgh Quarterly Magazine</u>. Bill's biographical essays have been packaged into this single and highly readable volume.

My favorite portrayal is of H. J. Heinz. Unlike the other great Pittsburgh entrepreneurs, Heinz made his fortune by building the nation's first and greatest branded goods company. Using advertising in a creative and modern way, he expanded his company with obvious concern for his employees and the community. His emphasis on philanthropy is emphasized and appreciated by the author. (Bill Dietrich himself was a highly successful businessman and exceptionally generous in a multitude of charitable activities.) Bill's summary of H. J. Heinz is simple yet accurate.

"[N]o matter how hard one sands the varnish the unvarnished truth about Heinz remains the same – he led a balanced life; he had a human touch. His story is about good products produced by a good man."

I recommend this book.

— Bob Kopf

<u>MR. CHURCHILL'S PROFESSION</u>
By: Peter Clarke

The idea of limiting a Churchill biography to his literary efforts, which sustained a free-spender financially, has appeal, and the author reveals much of interest. However, I feel that Peter Clarke devotes too much attention to the preparation of Churchill's opus, delayed by World War Two, the <u>History of the English Speaking Peoples</u>. Nearly 40 pages at the beginning of the book delve, somewhat tediously, into the origins of the concept of a bond between the English and Americans arising out of their common language and traditions.

The best part of the book is its examination of how Churchill's writing funded his rather lavish life style. Without this substantial income one wonders if he could have afforded to stay in public life. It is also interesting to see how Churchill cleverly structured his work and its timing to reduce his tax burdens. This may be an ode to tax lawyers.

If you're a Churchill nut, this will have some appeal.

— Bob Kopf

CHURCHILL AND THE KING

By: Kenneth Weisbrode

The relationship between Winston Churchill and King George VI is fascinating and is explored in depth.

There were profound differences, yet many similarities, between the two men. Churchill was flamboyant and avidly sought the office of prime minister. Shy and stammering, the King reluctantly ascended to the throne. Both men had difficult childhoods with difficult parents, and each was a fierce patriot.

Initially, King George VI preferred Lord Halifax to Churchill as Neville Chamberlain's successor, and Churchill tried to block the abdication of King George's brother, Edward. Despite this rocky beginning, they developed a deep and moving friendship and, acting as a cohesive team, led England through an incredibly difficult period.

My only muted criticism of the book is its seemingly heavier emphasis on Churchill, but perhaps this is because I read so many books on Winston and knew little of the King.

You should find this to be to your liking.

— Bob Kopf

CHURCHILL – THE STRUGGLE FOR SURVIVAL

By: Lord Moran

This is an abridgement, published in 1966, of Lord Moran's diaries which pertain to Winston Churchill.

Lord Moran became Churchill's personal physician in 1940 and attended him until his death in 1965. Moran's (also known as Dr. Charles McMoran Wilson) task was certainly not easy.

The publication of these diaries created an immediate firestorm. Churchill's family was outraged, and many physicians and leading English medical journals charged Lord Moran with a violation of the Hippocratic Oath by revealing confidential medical information about a patient. Lord Moran's defense was that such revelations are acceptable in the case of a great historical figure after his death. I am not sure how I would arbitrate the issue.

As for the substance of the diaries, there are many interesting anecdotes and insights here. While many historians criticize Lord Moran for certain inaccuracies, there is no doubt that Churchill relied upon him, and Moran's revelations about Churchill's medical conditions and habits are important in understanding much about the essence of Winston.

I enjoyed the diaries.

— Bob Kopf

THE BOYS IN THE BOAT
By: Daniel James Brown

This is one of the best books I have read in many years. Though it is about The University of Washington's nine-man crew in the mid-1930s, the story transcends sports, reflecting the triumph of the human spirit over adversity.

The members of the Washington crew stood in sharp contrast to their typical competitors from the Ivy League schools. All were poor. The chief protagonist, Joe Rantz, came to the University from a background of heartache and grinding poverty. His mother died when he was quite young. His father and stepmother abandoned him at age 15, yet he supported himself and graduated from high school with honors. He then catches the eye of Al Ulbrickson, the Washington crew coach, and joins the team.

The journey of the crew to the 1936 Berlin Olympics is not easy. The race, and the Nazis' underhanded attempts to sabotage their gold medal, will capture your attention.

This is a must read.

— Bob Kopf

BRING UP THE BODIES
By: Hilary Mantel

The most virulent criticism from one of my book reviews arose out of my negative reaction to Hilary Mantel's Wolf Hall. Keeping that in mind, I approached this novel with some trepidation.

Bring up the Bodies is a sequel to Wolf Hall. Set in the Sixteenth Century, both books are fiction based firmly on fact. Wolf Hall deals with the execution of Thomas More, who is shown, unexpectedly, in an unfavorable light. Bring up the Bodies focuses on King Henry VIII's maneuvering to execute Anne Boleyn in order to allow him, inexplicably, to marry the shy, dull and unimpressive Jane Seymour. Both events surrounding the executions are viewed through the eyes of Thomas Cromwell, Henry's chief advisor, a powerful and self-made commoner. While history normally paints Cromwell as a monster, he is treated with considerable sympathy here.

This book is short and more tightly written than its predecessor, and I liked it. Mantel tantalizingly refuses to answer whether Anne Boleyn was actually unfaithful to Henry (with her own brother, among many others, according to rumor). This adds to the suspense of her trial, prosecuted by Cromwell, and subsequent execution.

— Bob Kopf