THE SMITHFIELD Forecast

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For Customers & Friends of
SMITHFIELD TRUST COMPANY

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LOOKING AT 2016

In this year-end issue of the Smithfield Forecast, we take a look at prospects for the U.S. economy and the equity markets in 2016.

From our perspective, the U.S. economy is likely to remain on a slow growth track during the coming year. So far as real GDP is concerned, we are presently forecasting a gain of around 2¼% in 2016, representing a small decline from the 2.5% increase expected this year. Despite this forecast of continued expansion in 2016, we believe that the risks are mainly on the downside with odds of a recession in the vicinity of 35%. This may seem an overly cautious - even pessimistic - prediction, especially since the Federal Reserve has, at last, raised its policy rate from zero to the 25-50 basis point range, which would imply that, in public at least, the Fed is confident that domestic demand will continue to increase at a steady and solid pace during 2016.

Other considerations may have also influenced the timing of the Fed's decision to raise rates. One can speculate that, after so many postponements, the Fed could not risk the loss of credibility that might well have accompanied another delay in implementing the widely expected lift-off. Perhaps, too, the Fed was mindful of the risk that its recent policy stance, if continued, would greatly increase the danger of renewed turbulence and instability in the financial markets. As we noted in our September report, the initial increase of 25 basis points will have relatively little impact on economic activity. And since monetary policy works with long and variable time lags, the effects of the latest increase on financial market conditions, and subsequently on the economy, may not be felt for some time to come. Of greater significance than the initial lift-off will be the size and frequency of future increases. On this crucial issue, we expect that the Fed will remain very cautious and move slowly toward the normalization of monetary policy. According to the Federal Reserve's press release of December 16, "The Committee expects that economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate; the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run." Given the Fed's intentions, we are forecasting that the Fed will likely raise the funds rate by quarterly increments of 25 basis points to around 1.50 by the fourth quarter of 2016. An increase of this magnitude implies an exceptionally modest degree of tightening and suggests that monetary policy will remain accommodative through most, if not all, of 2016.

So far as the economic outlook is concerned, the Fed's move comes at a time when some key economic indicators are signaling moderation in GDP growth during 2016.

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True, the labor market has continued to strengthen, as evidenced by the latest statistics, which show that in November nonfarm payroll employment posted a solid gain of 211,000, while the jobless rate held at 5% which is considered to be consistent with full employment. Indeed, over the prior 12 months, the average monthly increase in nonfarm payrolls was a robust and better-than-expected 237,000. At the same time, moreover, the U-6 rate of unemployment[1], which is a good measure of the underutilization of labor resources, has fallen to 9.9%, down from 11.4% a year earlier and not far above the pre-recession reading of just over 8%. These bullish statistics do not, in our view, tell the whole story. Comparing data for the first 11 months of this year with the comparable period of 2014 shows that 53% of the overall gain in nonfarm payroll employment was in low-wage industries, including food services, employment services, retail trade and health care and social assistance. One might also consider that, since the recovery started in June 2009, employment in the mid-high wage industries – notably manufacturing, mining, construction and finance, insurance and real estate – accounted for 28% of total private employment as compared with 58% recorded for low-wage industries.

In our view, there is good reason to believe that the combination of technological change, globalization and demographic forces has played a significant role in the lack of employment growth in the mid-to-high wage industries. One should also note that the geographic distribution of job growth has been very uneven with the South and West regions of the country accounting for more than 60% of the nationwide increase in jobs during 2015.

The lack of job growth in industries offering a middle-class standard of living has been at least partly responsible for the slow growth in wages and salaries which is a key determinant of consumer spending. True, this year's increase in real disposable income will likely approximate a healthy 3.5%. However, the average weekly earnings of all employees on private nonfarm payrolls – which, in point of fact, may be a better indicator of the willingness and ability to spend than the overall rise in disposable personal income – during the first 11 months of this year was up a modest 2.4%, which, after adjusting for price increases, indicates a feeble 1% rise in real purchasing power. One disappointing development has been that the dramatic fall in oil prices has not resulted in any discernable increase in consumer demand for most goods and services.

Optimism about the outlook for consumer spending is based in varying degrees on the increase in net worth of households from $55 trillion during the last recession to the latest reading of $85 trillion, and, as we have just noted, the solid 3½% increase in real after-tax incomes. Even though the fundamentals of consumer spending look solid, the fact remains that retail sales have, to say the least, lacked sparkle. During the first 11 months of this year, for example, retail sales, ex motor vehicles and gasoline, were up a modest 3.3%, which, after allowing for price increases, points to a real gain of barely 1½%. And looking at the same categories during the past three months – September-November – the year-over-year gain is even less, at 3%. Likewise, sales of the key GAF[2] group of stores posted a slender increase of just 1.8% over the like period of 2014. And over the past three months the advance of 2% is still extremely low by historical standards.

All things considered, we do not see a significant strengthening of consumer spending during 2016. Monthly gains in payroll employment are, in our view, likely to subside to the 140,000 zone, while wage and salary increases are expected to remain in the 2-2½% range. Our forecast for 2016 anticipates another weak 2% rise in GAF sales and a slightly larger 3% gain for core retail sales. And, in our view, car sales in 2016 will only marginally exceed the 17.4 million in sight for 2015. Finally, from the standpoint of the GDP component of consumer spending on goods and services, we expect a year-on-year

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1 *Includes part-time workers who want full-time jobs, as well as discouraged workers and, of course, the narrower conventional measure of unemployment.*

2 *Firms that specialize in department-store types of merchandising, including furniture and home furnishings, electronics and appliances, clothing and accessories, sporting goods, general merchandise, office supply, stationery and gift stores.*

gain of 2.6%, down from the 2.8% anticipated for this year.

Meantime, housing construction is having its best year since 2007. Indeed, anecdotal reports suggest that, in some parts of the country, supply constraints are hampering the construction of new homes. Arguably, the combination of extremely low mortgage rates, along with a sizable increase in household formation and strong gains in payroll employment, has served to bolster the demand for new residential construction. This year, permits for single-family house construction will likely approximate 685,000 units, the highest for any year since 2007. Even more striking, perhaps, the number of permits issued for apartment and condominium construction will likely set the record for any year since 1987 – exceeding the previous high of 473,000 in 2005.

In recent years there has been a dramatic shift in the composition of the housing market as evidenced by the fact that multi-family construction now accounts for 36% of all housing starts as compared with just 20% as recently as 2010. Looked at another way, there has been a significant increase in the demand for apartments and condominiums, largely, it would seem, at the expense of single-family house construction.

Turning to prospects for 2016, we expect to see some further improvement in the housing market. But given the fact that house prices are rising more rapidly than incomes, while future employment gains are likely to be significantly below those recorded in 2015 and mortgage rates are likely to be on the rise, we expect that any increase in housing starts will be less than the 10% in sight for this year. In sum, our forecast for 2016 looks for housing starts to be in the neighborhood of 1,170,000 units, up about 5% over this year's estimates.

To date, the economic recovery that started in mid-2009 has been marked by a generally lackluster pace of business spending for new equipment. The numbers show that gains in real business spending for new equipment during the current economic expansion have lagged well behind increases recorded in previous economic recoveries since World War II. In the third quarter of this year, real outlays were 16.5% above their previous cyclical peak in 2007. At comparable stages of previous economic recoveries since World War II, real business spending was up an average of 53% above their previous cyclical peaks.

There are several plausible explanations for the recent weakness in capital spending. These include a heightened degree of economic uncertainty, high corporate tax rates, an ever-increasing regulatory burden and considerable concerns about the long-term outlook for sales and profits. In addition, however, the large-scale reduction in oil and gas drilling activity associated with the recent plunge in oil prices is also having a negative impact on overall spending. Often overlooked is the fact that, in 2013 – the latest year for which data is available – the mining sector accounted for 14% of all capital expenditures, marking a significant increase from the 5.5% ratio recorded in 2004.

At the time of writing, we see no evidence that a quickening pace of capital spending can be expected any time soon. During the first 10 months of 2015, orders for non-defense capital goods, ex aircraft, a forward-looking indicator of capital outlays, were some 4% behind the comparable period of 2014. This year, real business spending on new equipment will likely post a gain of about 3½% over last year's performance. Even assuming that capital spending for the energy sector begins to level out over the immediate months ahead, we doubt that 2016 will see anything much better than a modest rise of between 3% and 4%.

With respect to other sectors of the economy, the outlook, in our view, points to little or no positive contribution to GDP growth. The recent appreciation of the dollar, combined with sluggish growth in Europe, Asia and elsewhere, strongly suggests that the trade sector will be something of a drag on GDP growth in 2016. The net export balance (goods and services) is estimated at a negative $585 billion, up from this year's forecast of about $535 billion. In a similar vein, the pace of inventory accumulation is also forecast to be a negative factor in next year's economy. During the first two quarters, there seems to have been some overbuilding of inventories, probably reflecting a

degree of over-optimism regarding the near-term outlook for sales. As a consequence, the annualized rate of inventory building declined from an average of $113 billion in the first half of 2015 to $90 billion in the third quarter. As businesses endeavor to realign inventories with sales, we expect to see further cutbacks in the annualized rate of inventory building to the $50-$60 billion range in 2016, which implies that this sector of the economy will likely make a negative contribution to GDP in 2016. As a small offset to these negatives, we see an increase of about 1.5% in real government spending, primarily at the state and local level. In response to varying degrees of improvement in their fiscal positions, we look for an increase of about $180 billion - or about 1½% - in state and local outlays as compared with this year.

Implicit in all these numbers and forecasts is the persistent weakness in the manufacturing sector. Since the recession ended in June 2009, the increase in manufacturing jobs has represented just 4.7% of the gain in private employment and, in November, manufacturing production was essentially the same as it was eight years ago. It remains to be seen whether real GDP growth can rise much above the 2% zone without some considerable improvement in the manufacturing sector, which, in our view, is not on the near-term horizon.

Up to now, the Fed has been frustrated in its effort to reach its 2% target for inflation – as measured by the deflator for personal consumption expenditures (PCE). Over the first ten months of this year, the PCE was up a negligible 0.2%. And excluding the volatile food and energy component, the reading at 1.3% is still below the Fed's target. These barely positive inflation rates have reflected not only the continuing decline in energy prices but the fall in import prices, which has resulted from the recent strength of the dollar against most major currencies. Bear in mind also, that inflation expectations – which are at their lowest level in years – have a considerable impact on spending decisions and hence on the actual rate of inflation. Simply put, the low level of inflation expectations is in fact contributing to the low actual rate of inflation.

The Fed evidently hopes and expects that the forces which have been heavily responsible for holding down the inflation rate, notably the plunge in oil prices and falling import prices, will soon dissipate. Right now, however, there are few, if any, signs of an early pickup in the inflation rate. For example, the Commodity Price Index published by the International Monetary Fund is no less than 96% from its previous peak, and is 0.7% below its previous low point set in the recession years of 2008-2009. All things considered, we see 2016 as another year in which the inflation rate falls below the Fed's 2% target. Our forecast for next year calls for a 1.5% increase in the Personal Consumption Expenditures Deflator.

Our economic forecast is probably not one that will likely favor the equity markets in 2016. Slow economic growth suggests that corporate profits will do well to register a modest near 3% gain, which, however, would mark a reversal of the near 1% dip expected this year. In our view, moreover, the upcoming presidential election campaign, which might well be rancorous and divisive, is more likely to have a negative than a positive effect on the equity markets. What we are suggesting – not forecasting – is that equity investors may face another bumpy ride in 2016. True, there is little or no agreement as to whether equity valuations are too high and are vulnerable to a possible correction. That said, the risks appear to be on the rise and investors should, at the very least, be prepared for another year of considerable volatility in equity prices. At the end of 2015, equity prices, as measured by the S&P 500 Index, are essentially the same as they were in the closing weeks of 2014. Could the equity markets in 2016 be headed for a replay of their performance in 2015? Time will tell!

— Norman Robertson

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