THE SMITHFIELD Forecast

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For Customers & Friends of
SMITHFIELD TRUST COMPANY

A NOTE FROM THE CHAIRMAN

Everyone in Pittsburgh is talking about the second consecutive brutally cold winter here. Our friends and customers in the Pacific Northwest are sending their condolences and asking us to donate some of our snow. With the coming of spring, I expect all of you to return your focus to the sage words of our esteemed economist, Norman Robertson.

- Bob Kopf

IS THE ECONOMY SPEEDING UP – OR SLOWING DOWN?

Too Much Reliance on the Consumer?

To a degree, the price of oil has tended to dominate the economic news over the past several weeks. At the time of writing, the price of crude oil, as measured by the benchmark West Texas Intermediate, has fallen from around $107 a barrel in June to the latest reading (mid-February) of $50, the lowest in over five years. As a consequence, the nationwide gasoline price has plunged from $3.70 a gallon to the vicinity of $2.20 a gallon. For American consumers, the slump in oil prices represents a significant increase in purchasing power. But while consumers may have additional money to spend, there is little in the way of hard evidence to indicate that, as yet, they are willing to do so. To start with the latest data on retail sales (January 2015) does not suggest that lower gas prices have triggered a marked strengthening of consumer spending. On the contrary, January's retail sales – ex automobiles and gasoline – were barely ahead – 0.1% – of the previous month. True, auto sales have been strong, but in January the annualized sales rate of 16.5 million was essentially the same as it has been since last summer.

Uncertainty and uneasiness about the future could be acting as a constraint on spending. The latest survey of consumer expectations, published by the Federal Reserve Bank of New York, reported that, in 2015, U.S. households anticipated little, if any, increase in income growth, while expectations of spending growth fell sharply from those reported in the October 2014 survey. What these findings suggest is that many households are taking a less-than-upbeat view of prospects for income and spending growth in 2015. Arguably, many families and individuals view the plunge in oil prices as providing a very temporary boost to income. Or put another way, households do not see the windfall from falling oil prices as a substi-

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tute for more substantial increases in wages and salaries. Against this backdrop, it is not surprising to find that a significant number of households may now be more inclined to increase savings and reduce debt rather than boost expenditures. As one piece of evidence, the personal saving rate – personal savings as a percentage of disposable personal income – climbed to 4.9% in December, up from 4.3% in the previous month.

Of late, moreover, most of the increase in retail sales has reflected gains in essential, rather than discretionary, outlays. For example, in the fourth quarter 2014, food services and drinking places, and health and personal care stores, posted solid gains of 8% and 6%, respectively, over the like period of 2013. But sales of the key GAFO* group of stores – a reliable indicator of discretionary spending – were up only 2.5% over the same period of time.

The less-than-robust pattern of non-automotive retail sales seems puzzling in light of, not only lower oil prices, but also an upsurge in payroll employment. On this latter point, the BLS reported that, in January, nonfarm payroll employment posted an impressive gain of 257,000, marking the 11th consecutive month of increases in excess of 200,000. And for the full year, the average monthly increase was 260,000 as compared with 199,000 in 2013. For 2014, as a whole, no less than 3.1 million jobs were created, the largest number for any year since 1999. As might be expected, these substantial gains in employment have been accompanied by an almost steady decline in the jobless rate from 6.6% at the beginning of 2014 to 5.7% in January 2015. At the same time, moreover, a broader measure of unemployment, which includes those working part-time for economic reasons and those marginally attached to the labor force, has dropped to 11.3%, down from a peak of 17.1% in October 2009.

*Department store types of merchandise including furniture and home furnishings, electronics and appliances, clothes and accessories.

In our view, however, these impressive gains in the labor market are not necessarily signaling a sustained strengthening of consumer demand, at least over the near term. As we have noted in previous reports, recent gains in employment have not been accompanied by commensurate increases in wages and salaries. For example, in the fourth quarter of 2014, real after-tax incomes (per capita) were up just over 2.3% over the comparable period of last year. And for 2014, as a whole, such incomes recorded a disappointing increase of less than 2% over the previous year. What has been happening, is that much of the recent increase in nonfarm payroll employment has been concentrated in a number of low-wage industries, including food services and hotel trade, health care and employment services, which accounted for more than 50% of the overall increase in jobs during 2014. Looked at from another standpoint, employment in mid-high wage industries, including construction, manufacturing and financial services, represented just 22.3% of private employment in 2014, down from 45% during the 1960s and 30% as recently as the 1990s.

Another plausible explanation for the lack of recent income growth is that, during the recent severe recession, many employers, for one reason or another, did not cut wages and salaries. As a consequence, the post-recession increases in employee compensation have been considerably smaller than those reported in prior periods of economic expansion.

Although the BLS reported that, in January, the average weekly earnings of employees on private nonfarm payrolls were up $4.00 over the previous month, it should be noted that earnings in a number of major industry groups, including manufacturing, construction, utilities and information technology, were, in fact, below what they were in November. From our perspective, it would be very premature to conclude that January's increase in weekly earnings marks the beginning of a sustained upswing in wages and salaries. For now we anticipate that this year's increase in real disposable personal income will be in the vicinity of 2.7%, up slightly from last year's gain of 2.4%. As to the outlook for real consumer spending on goods and services, we continue to take the position that the combination of economic uncertainty and modest gains in real incomes will limit this year's rise in real outlays to the vicinity of 2.5%. This forecast, it should be said, is significantly below the near 4% improvement anticipated by many economic forecasters.

Weak Recovery in Housing

Our reservation about the strength of consumer outlays during 2015 extends to prospects for residential construction. The recovery in single-family house construction – which was never very robust – has, for all practical purposes, petered out. Since last June, there has been little or no increase in the annualized rate of permits issued for new house construction. Thus, in January of this year, permit authorizations were at a yearly rate of 654,000 as compared with an average of 647,000 between June and December of 2014. Likewise, there are signs that the upturn in multi-family construction may have run its course. Looking at January of this year, the annualized rate of permits issued for multi-family construction was virtually the same as the average of 377,000 reported between June and December of last year.

There is much to be said for the argument that the housing market is not the same as it was during the years preceding the Great Recession of 2008-2009. From all indications, single-family house construction no longer dominates the market as it did in the boom years of 2003-2006. The rise in house prices, along with a general tightening of lending standards and sluggish gains in income, have all, in varying degrees, contributed to a sluggish demand for single-family houses. The slow recovery in the new house market could also reflect the fact that, according to the Federal Reserve Bank of New York's Survey of Consumer Expectations, "Today's young people are more likely to live in parental households long into their twenties than were young people one or two decades ago. . . .The increasing magnitude of student debt among college graduates appears to be driving young people home and keeping them there." In a related development, one can speculate that demographic forces, notably the rapidly growing number of retired families and individuals, are boosting the demand for rental property. Indeed, in 2014, multi-family unit construction accounted for 39% of all housing starts, up from 22% in 2005. All-in-all, we do not see the underpinnings for a resurgence in new residential construction during 2015. For the year as a whole, we are forecasting that housing starts will approximate 1,075,000, representing a near 7% advance over the 1,006,000 started last year.

Slowdown in Capital Spending

Turning to prospects for business investment, one sees that the recent trend of orders for nondefense capital goods (ex aircraft) is not signaling strong gains in outlays any time soon. Thus, the annualized rate of orders in the fourth quarter of last year averaged $849 billion, a decline of 2.8% from the third quarter average, while real outlays fell at a yearly rate of close to 2% from the previous quarter. It is now possible, or probable, that sizable cutbacks in capital spending by the oil and gas industries are offsetting some part of the planned increases in spending by other industries. While 2015 is not shaping up as anything resembling a banner year for capital spending, we take the position that efforts to improve productivity, reduce costs and replace outdated equipment will be reflected in a year-over-year gain of about 4% in real outlays for business equipment.

Meanwhile, we see continued moderate strength in nonresidential construction activity during 2015. In 2014, outlays posted a solid year-over-year advance of 10.5%, with double-digit increases in four major categories of construction – office, commercial, power and manufacturing – accounting for most of this overall gain. That said, the rate of increase seems to have slowed perceptibly since last spring. In December, outlays were just 2.9% above the May 2014 reading, which, after adjusting for price increases, points to a real volume of around 1%. The leveling out of outlays has primarily reflected higher outlays for office and manufacturing construction but cutbacks in the health care, educational and power categories. So far as prospects for 2015 are concerned, outlays are expected to fall short of the 2008 peak of $409 billion, which, of course, resulted in serious supply-demand imbalances which have taken the better part of five years to correct. For 2015 in total, we look for private nonresidential construction spending to approximate $355 billion, up 5% from the 2014 figure of $337 billion.

Close Watch on Inventories

As matters now stand, we do not see activity in the remaining sectors of the economy making a positive contribution to real GDP. First of all, the rate of inventory accumulation is virtually impossible to predict with any degree of accuracy. In the final quarter of last year, the annual rate of stock building climbed to $106.5 billion, the highest figure since the third quarter of 2010. Unfortunately, what we do not know is whether the increase was planned or whether it was unplanned in the sense that sales and orders fell short of expectations. On the key assumption that most firms will be able to manage their inventory positions in a way that avoids the need for a major liquidation of stocks – and a possible recession – we are guessing that this year's inventory building will be little changed from last year's figure of $79 billion.

Larger Trade Deficit in 2015?

Finally, recent events suggest that net exports will likely be a negative factor in this year's expected increase in real GDP. The recent appreciation of the dollar relative to the Euro and other major currencies is likely to act as a constraint on U.S. exports, while at the same time giving a boost to imports. Furthermore, the prospect of lackluster economic growth in much of Europe, Japan and elsewhere can be expected to curb the demand for U.S. goods and services going forward. In sum, this year's net export balance could approach $500 billion, up from last year's figure of $453 billion.

Growth Prospects for 2015

This review of prospects for major sectors of the economy in 2015 suggests another year of slow to moderate economic growth. Looking at the numbers, we expect an increase in real GDP of around 2.7%, up slightly from last year's gain of 2.4%. That said, we do not see the trend of overall economic activity breaking out of the 2.5% zone that has persisted since the recession ended in mid-2009. So far as inflation is concerned, the decline in oil prices, coupled with a strong dollar, will likely imply an increase in the deflator for personal consumption expenditures, which is below the Fed's target of 2%. More specifically, we see little or no increase in the Consumer Price Index for 2015, as a whole. And excluding the volatile food and energy components, we expect a rise of about 1.7% -- the same as last year.

Federal Policy – Ready or Not Ready for Takeoff

Our views on monetary policy have not changed from those expressed in recent reports. The time has come, if it has not already passed, for the Fed to pull back from its unusually accommodative policy, the benefits of which are now few and far between. However, the Fed seems unsure and unsettled about its next policy move. True, the Fed's asset purchase program ended last October, but the Fed's policy rate – the Federal Funds rate – is still close to zero. Surely, this key interest rate should have already reflected the steady decline in the jobless rate from 10% in 2008 to the latest reading of 5.7%. To a significant degree, monetary policy has been focused on short-term goals – notably those related to the job market – as opposed to the long-term goals of price stability and sustainable economic growth. This emphasis on conditions in the labor market seems curiously misplaced since the Fed's ability to influence employment and unemployment is, in point of fact, extremely limited. We take the position that the trend of employment and unemployment is, to a large extent, determined by forces over which the Federal Reserve has no control. These include an aging population, changes in technology, the effect of globalization and tax and regulatory policy.

In our judgment, the Fed has been probing the outer limits of its ability to stimulate the economy and, as a consequence, its policy of extreme monetary ease is now tantamount to pushing on a piece of string. As a result, too much has been expected of the Federal Reserve in the sense that its policy of extreme monetary ease has been widely seen as some sort of cure-all for the nation's complex economic problems. What this implies is that the U.S. economy has become, in recent years, much too dependent on low or near zero interest rates.

Low Interest Rates in 2015

What are the implications for interest rates of the Fed's widely anticipated policy actions? Despite the Fed's evident hesitation and nervousness regarding the timing of an increase in its policy rate, we believe that mid-year 2015 is still the most likely timing for the so-called lift-off of the Federal Funds rate. By the end of 2015, we expect a Federal Funds rate of about 1%, which would still be extremely low by historic standards. Any delay in raising the Fed's policy rate would, in our view, involve the risk of renewed turbulence and turmoil in the financial markets. As we have commented before, the ability of the Fed to exit from its recent strategy without disrupting the financial markets will be neither quick, nor easy, and, is likely to present the central bank with one of its greatest challenges since World War II. Turning to the outlook for long-term interest rates, the recent decline in yields has necessitated a downward revision to our previous forecast for 2015. We now anticipate that the yield on the 10-year Treasury note will likely remain below 3% through most of the year.

Focus on Productivity

Looking further ahead, future gains in real GDP – and our standard of living – are very dependent on the growth of productivity, which, in recent years, has been extremely disappointing – and worrisome. Largely as a result of technological advances, annual gains in productivity averaged 3% between 1996 and 2004. Over the past four years however – 2011-2014 – the annual improvement in output per hour in the nonfarm business sector has been less than 1%. This disconcerting slowdown, which has negative implications for the nation's long-term growth potential, has been attributed, at least in part, to the end of productivity improvements associated with recent advances in information technology. Whatever the reason, there is clearly a need for economic policy to be focused on the implementation of strategies designed to reverse this discouraging slowdown of productivity growth.

Perspective on the Forecast

The performance of the U.S. economy since the end of the Great Recession in mid-2009 has been considerably better than most of the major economies, including the Eurozone and Japan. Even so, the average annual rise in real GDP since 2009 has been 2.2%, well below the average of 3.4% recorded between 1960 and 2007. Simply put, the U.S. economy appears to be on a much slower growth track than it was before the recession and financial crisis of 2007-2009. We recognize, however, that our forecast of about a 2.7% rise in real GDP for 2015 is lower than what appears to be the consensus forecast of close to 3½%. Forecasts of a better than 3% growth in 2015, however, are very much dependent on a major and sustained advance in consumer spending over the balance of 2015. Our caution regarding growth prospects for 2015 stems, at least in part, from our belief that the U.S. economy is still facing headwinds that, to a large extent, are the legacy of the financial crisis of 2008-2009.

We would also add that, since the recession ended in mid-2009, there has been a persistent tendency of forecasters – including those at the Federal Reserve – to overstate the near-term strength of overall economic activity. On this point, a recent economic letter published by the Federal Reserve Bank of San Francisco noted that "Since 2007, Federal Open Market Committee participants have been persistently too optimistic about future U.S. economic growth. Real GDP growth forecasts have typically started high, but then are revised down over time as the income data continues to disappoint." So much for the accuracy of economic forecasts!

Equity Markets – Will the Advances Continue?

In our November 2014 report, we suggested that investors in the equity markets could face a bumpy ride in 2015. Since then, swings in investor sentiment regarding economic and political developments in Europe and elsewhere, as well as the near-term strength of overall economic activity in the U.S, have been, in large measure, responsible for considerable day-to-day volatility in equity prices. One major question regarding this year's outlook for the equity markets is whether the recent disconnect between overall economic activity, corporate profits and equity valuation will continue for another year. Bear in mind that, even though 2014 saw a negligible increase in corporate profits from current production and a modest advance of 3.9% in current dollar GDP, the S&P 500 Index posted an impressive gain of just over 17%. We doubt that the magnitude of this disconnect between major economic variables and the equity markets will unlikely persist for an extended period of time. While we do not, and cannot, forecast equity prices, we believe that 2015 will be another volatile year for the equity markets as investors react to political tensions and conflict in many parts of the world, as well as mixed signals regarding the outlook for economic activity in the U.S. and elsewhere. While not offering a prediction, there is good reason to expect that any net gain in equity prices during 2015 will be less than the near 20% advances reported last year.

- Norman Robertson

SMITHFIELD TRUST COMPANY BOOK REVIEWS

WHEN LIONS ROAR: THE CHURCHILLS AND THE KENNEDYS

By: Thomas Maier

A worthwhile read for those who love Churchill trivia. This is more about the private lives of the two families and their interactions. Besides featuring Winston Churchill and Joe Kennedy, Maier goes extensively into Jack Kennedy and Randolph Churchill. For me, a true devotee of Winston and having read many of his biographies, I learned a great deal about Randolph for the first time. He became very close to Jack and then Bobby in the 50s and 60s, even being asked to write Jack Kennedy's official biography after the publication of his first, and only, volume of Winston's life. Of course, he never writes it due to his early death (on the same date and at the same age as his grandfather, Randolph).

The best part of the book for me was the chapters devoted to the years of Joe Kennedy's ambassadorship to Great Britain and the interaction with Winston before he became PM and then once he become PM. The parts about the Tyler Kent spy affair in the US Embassy at that time are truly riveting.

By the way, Maier is also the author of Masters of Sex, which has become an HBO miniseries. At times, in When Lions Roar with all the sex affairs of Randolph, his first wife Pamela, Joe and Jack Kennedy and many other characters, I believe that could have been the subtitle of this book.

A little too long at the end but a worthwhile read.

- Glenn Flickinger

BEING MORTAL

By: Autul Gawande

This Gawande's 4th book and, if not his best, his most important, especially for those of us in our 8th decade, and for our children. Gawande is a surgeon who writes about medicine and its ongoing transformation. In this book, he describes medicine's – nay, our society's – inadequacies in dealing with the end of life.

In a sense, Being Mortal is not for the faint of heart, for Gawande relates the death stories for more than a half dozen of his patients, his friends and even his own father. But, he describes these stories in the context of a medical system programmed to extend life at any cost and using all the latest technologies; and in nursing homes more concerned with safety of its residents than in the quality of their lives. Those negativities are offset, however, by some wonderful descriptions of assisted living communities that know about and care for people, and redesigned nursing homes filled with dogs, cats, parakeets and children.

In the end, and Being Mortal is about the end, hard decision have to be made by families and patients, decisions requiring courage about fears and hopes, and trade-offs that must be made. Our medical profession and our society are in a transition, Gawande opines, as we move more and more toward meaningful assisted living and assisted suicides (Gawande is not a fan of the latter fearing it will militate against society's learning how to improve end-of-life care). Learning how to "let go" he says will not only require courage, and informed decisions that result from greater use of hospice and palliative care, but will allow more people to die at home surrounded by family than in hospitals hooked up to machines or in nursing homes who know nothing about their residents.

I highly recommend this book. It's time.

- Tim Merrill

THE CHURCHILL FACTOR: HOW ONE MAN MADE HISTORY
By: Boris Johnson

Boris Johnson is the Mayor of London, was a Member of Parliament and a journalist. He has been a lifelong Winston Churchill admirer as I have been. Having read many voluminous biographies of Churchill, his wife Clementine, histories of both World Wars in which he was a major player and some of the books authored by Churchill, I hesitated to read Johnson's book, concerned it might be overly favorable to the Churchill legend. To my great surprise, not only is Johnson's treatise very readable, it is a reasonably-balanced argument of the numerous controversial aspects of Churchill's long and productive life.

Johnson presents the positives and negatives (the Churchill factor) on most of Churchill's significant controversial decisions, such as Gallipoli (on the whole a Churchill negative), the Abdication crisis of King Edward VII (neutral), his views on Indian independence (negative), his tenure as Chancellor of the Exchequer and the return of England to the gold standard (negative), his wooing of Roosevelt and deftly bringing the USA into the war (very positive), his decisions on remaking the map of the Middle East (a term he created, the outcomes still reverberate today and Johnson is surprising positive on the Churchill factor) and too many others to review here.

In his most original chapter, Johnson presents a different view of Churchill's decision to destroy the French fleet near Oran in July 1940 out of fear that the fleet would fall into the hands of the Nazi navy. As many other historians have commented, Churchill needed to demonstrate to Roosevelt and the world the steely resolve of his government to take whatever action required to survive alone in Europe. Johnson's original analysis is to link the destruction of the French fleet to the pending Battle of Britain. Johnson believes that, had the French fleet not been destroyed and become part of the Nazi navy, the combined fleet would have been as strong as the British Royal Navy. The combined fleet could have challenged for control of the English Channel in a Nazi invasion of England, regardless of the outcome of the RAF battle for the skies. While he does not present footnoted evidence that Churchill was actually thinking of that in July 1940, it is an intriguing argument for the destruction of the French fleet and could easily have been a factor in Churchill's thinking at the time.

This book is well written and recommended for Churchill novices or Churchill devotees who enjoy reading about a man who impacted history so dramatically in the 20th century, still impacts us today and really did save the world from tyranny in May/June 1940.

- Glenn Flickinger

THE JOHNSTOWN GIRLS
By: Kathleen George

What can be better for a Pittsburgher than a novel written by a professor at the University of Pittsburgh and set in the Western Pennsylvania cities of Pittsburgh and Johnstown?

At age 103, Ellen Emerson is the last presumed survivor of the 1889 Johnstown flood which killed thousands of people. Ellen's mental acuity is still intact when she is interviewed by two Pittsburgh Post-Gazette reporters, Ben Bragdon and Nina Collins. One century after the flood, Ellen convinces Nina that Ellen's twin sister may still be alive, and the plot races forward from there.

The subplots are, for the most part, interesting, and the depictions of our region are enjoyable and accurate.

Kathleen George has crafted a work of fiction worthy of your attention.

- Bob Kopf