THE SMITHFIELD Forecast

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THE U.S. ECONOMY – SLOWING DOWN OR SPEEDING UP?

Focus on Employment

The arrival of spring has brought a mixture of positive and negative news about the economy. To begin with, gains in payroll employment during April and May rebounded to an average of 250,000 from the unexpectedly weak figure of 119,000 in March. However, the employment picture is not quite as encouraging as a quick glance at the headlines might suggest. Of some concern is the lack of jobs in what could best be described as the better-paying industries, notably, manufacturing, construction and finance, insurance and real estate. Thus, during the month of May, job creation in these three major categories accounted for just 13% of the overall gain in payroll employment. And in contrast, job growth in what are predominantly low-wage industries, including health care, social assistance and food services, were 52% of the overall gain in employment. In our view, moreover, these statistics cannot be regarded as either a statistical aberration or a temporary situation which will soon be reversed. Indeed, between 2005 and 2014, employment in the middle-high wage categories fell from 29.8 million to 26.3 million, while those in the low-wage categories jumped from 48.8 million to 54.2 million.

Slow Wage and Salary Growth

The impact of these statistics on wage and salary growth is evident from the fact that, in May of this year, the average weekly earnings of all employees in the private sector were up 2.3% over a year earlier, which, after adjusting for price increases, implies a less than 1% increase in real earnings. Furthermore, on a year-to-date basis, the nominal gain was a 2.4%, which also translates into a real increase of less than 1%. In our judgment, these statistics represent a fundamental change in the labor market in the sense that job growth in the future may well continue to be concentrated among what are essentially low-wage industries. We could be facing an economic environment in which wage and salary increases will continue to lag well behind those experienced during most of the post-World War II period.

Theories about the First Quarter

Be that as it may, the latest employment numbers have assuaged some of the gloom surrounding the first quarter's economic performance as measured by real GDP. According to the BEA, the first quarter's GDP, which was previously reported to have increased at a dismal yearly rate of 0.2%, actually fell at an annual rate of 0.7%. And excluding the large – and probably unintended – buildup of business

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inventories, the decline was a larger 1.1%. The consensus interpretation of this report was that it primarily represented a number of transitory factors, notably, severe winter weather in many parts of the country, the effects of port shutdowns on the West Coast and a temporary decline in energy-related investment spending.

In addition to the view that transitory factors were mainly responsible for the first quarter's weakness, a number of observers have taken the position that statistical problems, particularly those related to the seasonal adjustment of raw data, had greatly exaggerated the weakness in economic growth during the first quarter. What these critics seem to imply is that those reports on economic activity, which are at variance with their own forecasts and expectations, must be incorrect and can, therefore, be disregarded!

Cautious Consumers

Those who contend that the first quarter's performance can be largely dismissed either as a result of temporary factors or statistical noise, argue that a significant rebound in economic activity can be expected over the balance of 2015. Without ruling out this forecast of renewed economic vigor, we are concerned that there are very few signs of a second quarter rebound in spending and investment. To begin with, consumers appear to be keeping an exceptionally tight grip on the purse strings. For example, retail sales in April totaled $436.8 billion, which was almost the same as the previous month and a meager 0.9% above a year earlier. True, some of this weakness can be attributed to the decline in spending for gasoline, which resulted from the recent plunge in oil prices. Indeed, gasoline sales in April were down some 22% from a year earlier. Even so, April's core retail sales, which exclude automobiles, gasoline and building materials, were just marginally ahead of the previous month, while on a year-to-date basis, the increase was a more substantial 3.3%, which implies a small real gain of about 1½%. And finally, sales of GAFO[1] - a reliable measure of discretionary as opposed to essential spending - during April were down slightly from the previous month and, on a year-to-date basis, were virtually unchanged from the January-April period of 2014.

All these statistics suggest that, despite gains in household wealth and employment, along with the improved availability of credit, consumers still seem reluctant to boost discretionary spending and/or go more deeply into debt. As one indication of consumer caution, the personal saving rate jumped from 4.7% of disposable personal income in the fourth quarter of last year to 5.5% in the January-March period of 2015 and, most recently, the saving rate edged upward to 5.6%.

Bearing in mind the slow start to the year, we now expect that 2015, as a whole, will see a mediocre gain of about 2¼% in real consumer spending on goods and services. Thus, even though the underlying fundamentals of consumer spending appear to favor a more vigorous pace of outlays, we remain concerned that the persistence of lackluster gains in wages and salaries, coupled with a wariness about taking on too much debt and uncertainty regarding the outlook for jobs and income, will continue to act as a constraint on consumer demand for at least some months to come.

Mixed Outlook for Housing

Meanwhile, the recovery in homebuilding activity does not appear to be gathering strength and momentum. True, housing starts in April climbed to a yearly rate of 1,135,000 – the highest monthly rate in seven years. That said, however, the upswing in single-family house construction appears to have run out of steam as indicated by the fact that the annualized rate of permits issued for single-family house construction has fluctuated in a very narrow range since last summer. This level-

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

ing trend of activity reflects, at least in part, a growing demand for rental property as opposed to home ownership. Anecdotal evidence points to a trend toward urban living, notably on the part of retiring baby boomers and the so-called millennial generation. Then too, mortgage delinquencies are still high while the ability to obtain a mortgage is still less easy than it was during the pre-recession boom of 2004-2007. And finally, the steady rise in home prices, at least in some parts of the country, is seen as another contributor to the slowdown in new house sales and construction. Our forecast for 2015 calls for housing starts in the neighborhood of 1,075,000, up from last year's figure of 1,001,000, but a far cry indeed from the average of 1.9 million recorded during the boom years of 2002-2006.

Why the Slowdown in Capital Spending?

Turning to the business investment sector, the recent weakness in real business equipment spending has negative implication for economic growth over the short- and long-term horizons. In the first quarter of 2015, outlays for equipment climbed at a less-than-robust yearly rate of 2.7%, which followed a negligible increase of 0.6% in the final quarter of last year. Looking ahead, one leading indicator of capital spending – orders for nondefense capital goods (ex aircraft) – is not signaling a palpable pickup in orders anytime soon. True, orders in April posted a small but nonetheless welcome gain of 1% over the previous month, but on a year-to-date basis, orders in 2015 are down 2½% from the January-April period of 2014, which, in our view, does not bode well for a marked strengthening of business equipment spending anytime soon. The recent slowdown in business investment spending can be attributed to a number of factors including uncertainties about the economic outlook, the growing burden of governmental regulation and the corporate tax rate, which is the highest of any major country. Against this backdrop, our forecast for 2015 calls for a modest increase of 3-4% in real outlays.

Strength in Nonresidential Construction

Outlays for nonresidential construction are somewhat, surprisingly perhaps, one of the few bright spots in the early 2015 economic picture. Data for the first four months of this year shows a solid 9% current dollar increase in spending over the comparable period of last year. Among the largest year-over-year increases, were outlays for office and commercial construction, which were up 19%, and manufacturing, which posted a boom-like increase of almost 43%. While this upswing is certainly welcome, we should not lose sight of the fact that, in the past, this sector of the economy has often been prone to the boom/bust cycle of activity. One reason for overbuilding is that the long lead times involved in the planning and construction of major nonresidential projects requires projections of long-term demand that, as often as not, are subject to a sizable margins of error. In this regard, the boom of 2007-2008 resulted in a large overhang of unsold and unrented property, which over the following years necessitated major cutbacks in spending. Should outlays over the balance of 2015 continue to rise at a rapid rate, it would, in our opinion, increase the risk of another boom/bust cycle of activity. Assuming for the moment that developers are aware of this potential threat, we see a more subdued pace of outlays over the coming months, especially since we anticipate some cutbacks in construction spending relating to domestic oil exploration and production. For 2015 as a whole then, we expect a solid year-over-year gain of about 7% in outlays for nonresidential construction.

Another Large Trade Deficit

Activity in the other remaining major sectors of the economy will not, in our opinion, make a positive contribution to this year's growth in real GDP. To start with, the recent appreciation of the dollar, coupled with slow economic growth in much of the Euro area, Canada, Japan, China and elsewhere, has already led to a sharp deterioration in this country's balance of trade. In the first quarter of 2015, the annualized rate of real – inflation-adjusted – imports exceeded exports by about $550 billion – the highest quarterly deficit since the second quarter of 2008. On a year-to-date basis – January-March 2015 – real petroleum imports were down 3% but non-oil imports were up over 8%. Most recently, however, the exchange value of the dollar has fallen back from its recent high and, as a consequence, we expect that the international trade deficit over the coming months will be smaller than the near $51 billion figure reported in March. Looking at prospects for 2015 as a whole, we estimate that the real net export balance – goods and services – will approximate $520 billion, up from last year's number of $508 billion. Finally, we doubt that 2015 will see anything more than a very small increase in real government spending on goods and services. In the first quarter of this year, outlays fell at a yearly rate of 1.1% from the final three months of 2014, and for last year as a whole, spending edged downward, marking the fourth consecutive year of decline. This year the odds favor a small – less than 1% – increase in spending, which would mark the first annual rise since the recession year of 2009.

Slow GDP Growth Ahead?

What does this rather lengthy discussion of activity in major sectors of the economy imply for economic growth as measured by real GDP? From our perspective, the U.S. economy is now on a 2-2½ growth track, representing a significant deceleration from the average of near 3.5% recorded between 1950 and 2000. What this suggests is that, since the recession ended in 2009, the U.S. economy has entered what we believe to be an extended period of low – 2-2½% – growth in real GDP. For now, the risk of a near-term recession seems relatively small. But there is some danger that, unless decisively reversed, the recent weakness in consumer and business spending could trigger a sequence of events involving cuts in production, the liquidation of excess inventories, widespread layoffs and, at best, a protracted slowdown in overall economic activity.

Low Inflation in 2015

So far as the behavior of prices is concerned, we expect that the inflation rate will remain low, at least for the balance of this year and possibly beyond. As measured by the Personal Consumption Expenditure Index, consumer prices during the first quarter of 2015 were a negligible quarter of a percent higher than they were a year earlier. And for 2014 as a whole, the PCE Index was up just 1.3%. Thus, as defined by the PCE Index, the inflation rate has been running well below the Federal Reserve's longer run goal of 2%, which, incidentally, many observers at the Federal Reserve and elsewhere feel will not be achieved for at least another two years. The low rate of inflation has primarily reflected the recent plunge in oil prices and the appreciation of the dollar, which has reduced the prices of many non-energy imports. Of late, however, energy prices appear to have stabilized and even turned upward, while the foreign exchange value of the dollar appears to have run its course, which implies an early end to price declines in non-energy imports.

Time for a Change in Monetary Policy

Doubts about the near-term strength of economic activity suggest that the Fed will remain firmly committed to the current policy of monetary ease. Expectations that the Fed would raise its policy rate – the Federal Funds Rate – in June have faded in the wake of a weaker-than-expected economic performance during the first few months of 2015. While September is now widely seen as the probable date for the Fed's long-awaited liftoff, a further delay until next year is very possible in the event that the Fed's forecast of a second half rebound in economic growth fails to materialize. That said, we believe that the costs associated with the Fed's seven-year period of a near zero interest rate now exceed the benefits, which, in our view, have steadily diminished and are now few and far between. Arguably, the Fed's policy stance has already reached the outer limits of what can be achieved in the way of economic stimulus with easy money. Despite the Fed's assurances, we see a growing threat to financial stability resulting from a real Federal Funds Rate, which six years after the recession is still well in negative territory.

Threat from Rising Asset Prices

Although consumer prices – as measured by the Consumer Price Index – have shown little or no increase over the past year, asset prices have been rising at a rapid rate, carrying the risk of a speculative bubble. This, if past experience is any guide, would have serious and far-reaching consequences for the economy as a whole. Often ignored or overlooked is that, while consumer prices have only increased 3% since 2012, equity prices – as measured by the S&P 500 Index – have soared almost 47% and home prices have jumped close to 30%. Consider also that, in part reflecting the lure of very low interest rates, corporate bond issuance in 2014 was $14 trillion compared with $11 trillion in the pre-recession year of 2007. Against this background, we tend to agree with those who contend that the Fed should shift its focus from consumer prices to the alarming rise in asset prices. Although a great deal is dependent on the strength of economic activity during xthe summer months, we are guessing that by early 2016 the Federal Funds Rate will be about 1%, which, of course, will still imply a negative real rate of interest. Meantime, the yield on the 10-year Treasury note, which we had expected to be in the 3% zone by early 2015, is still a little over 2% and is now estimated to reach the 2.5% zone by the end of this year or early in 2016.

Issues for Equity Investors

Not surprising perhaps, the uncertain and unsettled economic and financial outlook has produced widely differing opinions as to where the equity markets may be headed. There is no question but that the trend of equity prices has outpaced most, if not all, measures of economic activity. Over the past three years, the S&P 500 Index has climbed 47%, while the current dollar GDP registered an increase of 7% and, even more significantly, corporate profits recorded a gain of less than 2%. There has also been a considerable rise in the cyclically adjusted P/E ratio of the S&P 500 Index – as calculated by the well-known expert Professor Robert Shiller of Yale – from its long-term average of 16.8 to the latest reading of 27.3. Whether or not the equity markets are becoming vulnerable to a sell-off, many investors may feel that, given the Fed's low interest rate policy, they have little choice but to continue buying equities. But the present level of equity valuations, along with the disconnect between the equity markets and key economic variables, and last, but not necessarily least, the still unresolved Greek crisis, which is threatening the very survival of the Euro system, suggest that a defensive rather than aggressive approach to the equity markets might be the appropriate investment strategy for 2015.

- Norman Robertson

SMITHFIELD TRUST COMPANY BOOK REVIEWS

SNOW & STEEL: THE BATTLE OF THE BULGE, 1944-45
By: Peter Caddick-Adams

Another book about the Battle of the Bulge.

Granted, it was the largest, most important, most costly battle in terms of casualties ever fought in any war by the U.S. Army. The history had been covered in scores of books for nearly 70 years. Is there anything new to tell?

Yes, it turns out this book does have some new revelations. First, unlike previous histories, *Snow & Steel* spends most of its pages from the German point of view. The first third of the book is devoted almost solely to the development of the origins of the strategy from Hitler's mind than from the Nazi senior commander's point of view and how they made it into a practical battle plan, at least in Hitler's view. That mindset was clearly impacted by their desperation as the Russians closed in from the east and the Allies from the west. Second, the author delves into deep detail about the failure of the U.S. Army intelligence community and how it was taken totally by surprise on December 16, 1944. The author focuses on the differences in the various intelligence officers' personalities, their jealousies, the past personal battles and the widely varying opinions on the capacity of the German Army to mount a large offensive. All of those factors dramatically contributed to the intelligence failure. Finally, as Caddick-Adams tells the story, which was spread over a very large geography, he informs us of many current day museums located at or near the historical battle sites throughout the Ardennes.

At 700 plus pages, this is a heavy, in-depth history, which can be dense, and at times a difficult read, but in the end contributes to the knowledge of this great battle.

- Glenn Flickinger

BOYS IN THE BOAT: NINE AMERICANS AND THEIR EPIC QUEST FOR GOLD AT THE 1936 BERLIN OLYMPICS
By: Daniel James Brown

I recognize that this book was already reviewed previously, but if you are like me, sometimes a refresher is worthwhile, especially from the perspective of someone an additional generation removed from the Great Depression. I happened to read this on a long week of flights recently, and found it gripping enough to help me fight through the jetlag and plow through it in short order. The most appealing aspect to me about this book, rather than the focus on the actual Olympics, Hitler, and the medal race itself, was that the lead up to it was engrossing enough to almost make you not want to see the months and years prior to the summer Olympics come to an end. Most of us will never experience witnessing a high performance eight-oar crew regatta, let alone work in the shell, but Mr. Brown did such a wonderful job of weaving together the hardships of Joe Rantz and his fellow Depression-era boatmen that it was both exhausting and enthralling reliving their experience. There is something that draws me to the tales from this time, perhaps because they really don't make people like this any longer when you think about everything Depression-era youth endured just to survive, let alone find a way to master a craft and perform at the highest level possible.

- Robert Y. Kopf, III

KILLING PATTON
By: Bill O'Reilly and Martin Dugard

The *Killing* series of books written by this duo has proven to be commercially successful, and having read two of them, I understand why. Time tends to skew one's memory of history, so reading *Killing Lincoln* served as a great update and refresher on the events surrounding the end of the Civil War and Lincoln's assassination shortly thereafter, and had me eager to delve into the Patton chronicle. This book did not disappoint, either. Despite knowing the outcome of the events in the 1940s, the storytelling approach was engaging and the pace constructed much like the race to Berlin. George S. Patton was clearly a larger-than-life figure, flawed in many ways (which the authors tended not to dwell on in tremendous detail), yet fearless and driven. There is no doubt that his style and tactics were extremely influential in the outcome of WWII, and his relationship with the rest of the Allied leadership strained at best. Unclear to me is whether or not the war ends the way it did without him; his ego would suggest he was the reason for victory. Upon finishing this, it piqued my curiosity enough to review WWII history from the Band of Brothers perspective (101st Airborne), which does provide an offsetting perspective, and reminds the reader that the collective Allied team won, not one division. The events surrounding Patton's death in Europe are curious enough to have me wondering whether or not this was a sinister plot or simple accident. This story is worth your investment.

\- Robert Y. Kopf, III

THE STRATEGIST
By: Bartholomew Sparrow

Our economist, Norman Robertson, is a good friend of Brent Scowcroft, an advisor to our Presidents (except Bill Clinton) from Nixon through Obama. Brent Scowcroft spoke to our Smithfield customers several years ago at the behest of Norman, and I had the pleasure of having dinner after Scowcroft's speech with him, Norman and Churchill biographer, Paul Reid. Since I sensed that I was in the presence of genius, I kept my mouth shut, listened and had one of the most enjoyable dinners of my life.

Given that background, I was eager to read *The Strategist*, the biography of one of our most influential foreign policy experts. A humble and nonpartisan person, Scowcroft is perhaps best described as an honest broker and a foreign policy realist who has been right many more times than wrong.

Scowcroft is at the center of many foreign policy debates over the past 40 years, not the least of which is the second Iraq war, opposed by Scowcroft. Interestingly, the author theorizes that Scowcroft's uncharacteristic public criticism of the war was George H. W. Bush's way of trying to persuade his son to reverse his decision to go to war.

The Strategist is a balanced and nuanced treatment of an underappreciated public servant.

\- Robert Y. Kopf, Jr.

FOUNDER'S SON: A LIFE OF ABRAHAM LINCOLN
By: Richard Brookhiser

Richard Brookhiser is one of my favorite historians. He almost never fails to put a unique slant on his assessment of historical figures, and Brookhiser succeeds in doing so here.

This is not a comprehensive biography of Abraham Lincoln. Instead, it attempts with considerable success to connect Lincoln to our Founding Fathers, especially Thomas Paine, Thomas Jefferson and, above all, George Washington.

Although Paine's irreligiousness initially influenced Lincoln, Lincoln abandoned Paine on that point, as Lincoln became deeply religious near the end of his life. Paine's use of wit and punchy prose did, however, continue to guide Lincoln throughout his political career. Jefferson and the Declaration of Independence played a large role in animating Lincoln's crusade against slavery. George Washington, a man of action and high principle, became Lincoln's lodestar through the trials of the Civil War.

Brookhiser could arguably be criticized for surmising that Lincoln's attachment to the Founding Fathers arose out of his desire for a father figure to replace his father, Thomas Lincoln, from whom he was seriously alienated. I, for one, think that this is an interesting thesis.

You should like the smooth, concise and a highly readable treatment of Abraham Lincoln.

- Robert Y. Kopf, Jr.

FOOTBALL'S LAST IRON MEN
By: Norman L. Macht

Written in 2010, this short book chronicles the epic Princeton/Yale football game of 1934. Having won the national championship in 1933, Princeton was the overwhelming favorite to prevail, but Yale stunned the Tigers 7-0. While the narrative of the game itself is good, the author highlights the importance of a highly publicized sporting event to Americans mired in the middle of the Great Depression.

My father played for Princeton, and he always chastised himself for not blocking a Yale kick in the fourth quarter. Here's a description of the kick:

> "The 15-yard penalty put Yale at the 10. Three plays into the line gained 3. Fourth down on the 7. One minute to play. Roscoe thought: field goal, a chip shot, and an easy 3 points. As they lined up for the kick, Greasy Neale's (the Yale coach) innards tightened. He was having a silent, invisible fit. A blocked kick, he thought, and then an open field for a touchdown run, at best a recovery way up field somewhere with a minute left for Princeton to score. Do nothing. Roscoe. Fall on the ball, and they'll have it on the 7. But Neale was powerless to intervene. Even if he could call time and send in a sub, the man was not allowed to say a word before the play was run.
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> Princeton left tackle Bob Kopf was thinking the same thing: block that kick. The ball was snapped. Roscoe knelt and held it. Kopf faked a blocker and rushed in as Curtin kicked. Kopf could feel the wind of the ball going by his fingertips. Only a harness strapped to an injured shoulder had prevented him from reaching as far as he normally could.
>
> The kick was wide."

My father never told me that a shoulder harness prevented him from blocking the kick. He never made excuses, and this is one reason I revered him so.

I do feel compelled to say that in 1935 Princeton crushed Yale 35 to 7, winning its second national championship in three years.

- Robert Y. Kopf, Jr.