THE SMITHFIELD Forecast

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For Customers & Friends of
SMITHFIELD TRUST COMPANY

A NOTE FROM THE CHAIRMAN

I am happy to report that I continue to make steady progress toward a full recovery from my nasty bout with sepsis. The kind words of encouragement from many of you have helped me immeasurably in my physical rehabilitation, and for that I thank you.

While no one can say with absolute certainty how I contracted sepsis, it is believed that the bacteria came into me through the interaction of my golf glove with a small cut on my left hand. Golfers beware! My goal is to play tennis before the end of October. Golf can come later, probably without a golf glove.

The one bright spot in this ordeal is that Smithfield operated easily and smoothly in my absence. This proves that our customers will be in capable and competent hands once I am no longer at Smithfield.

Again, thanks for all your support.

— Bob Kopf

IS THE PARTY OVER?

While the turmoil and turbulence that gripped the equity markets in late August has largely subsided, investors are understandably nervous that the bull market for equities that started in 2009 may have come to an end. What happened, of course, was that, between August 17 and August 25, the Dow Jones Industrial Average fell more than 10%, which qualified for the official definition of a market correction. Since then, equity prices have seesawed with gains narrowly exceeding losses. At the time of this writing – September 14 – the Dow Jones Industrial Average has posted a net gain of 4.9% since August 25, which, however, still leaves the Index more than 10% below its most recent peak.

Focus on the Equity Markets

What sparked the tidal wave of selling? Arguably, the proximate cause was a near-collapse – 25% – of equity prices on the Shanghai Exchange, which triggered investor fears that the Chinese economy was facing a major slowdown in overall

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economic activity. These worries were exacerbated by China's decision to devalue the Yuan by 2% on August 11. This move was widely seen as an effort by the Chinese authorities to boost exports and economic growth. However, the decision to devalue the Yuan might well have been designed to persuade the International Monetary Fund that China was moving toward a market-based exchange rate and its currency should be included, along with the Dollar, Yen, Euro and Pound, as a global reserve currency.

Although it can be argued that the equity markets may have overreacted to developments in China, there is no denying that, between 2011 and 2014, China's average annual rate of real GDP growth fell to 8%, down from the astonishing average of 10% during the 30 years from 1980 to 2010. And prospects for 2015 – and 2016 – call for a further decline to 6% or even less. While the growth slowdown is very real, it should be noted that no other country has ever recorded such a high rate of GDP growth as China did for such an extended period of time.

The slowdown in China reflects, at least in part, what is a difficult and often painful transition from an investment-export-led expansion to one which is centered on consumption. Then too, China is facing a number of formidable challenges, including an aging population, a worrisome increase in income inequality, the risk of an environmental crisis and the reliance on exports as a primary source of rapid economic growth. To their credit, the Chinese authorities have recognized the need for economic reforms, including those which would give the marketplace a much larger role in the allocation of resources. That said, these far-reaching reforms, which were adopted in 2013, have yet to be implemented. All in all, one should not dismiss the possibility – or probability – that China's extraordinary record of rapid economic growth has run its course. And since China is the world's second largest economy, it follows that a lengthy slowdown would likely have negative implications for growth, not only in the emerging markets, including Brazil, South Africa and India, but in the global economy as a whole.

Against this backdrop of a slowdown in China, the U.S. economy appears, at first glance, to be gathering speed and momentum. Simply put, the world's two largest economies seem to be moving in opposite directions. In contrast to China, the rate of real GDP growth in the U.S. is apparently on the rise. Thus, in the second quarter of 2015, real GDP in the U.S. climbed at a healthy yearly rate of 3.7%, representing a significant improvement over the dismal weather-related 0.6% pace in the first quarter. Despite the second quarter's rebound in activity, however, we have not changed our view that the underlying trend of real GDP growth in the U.S. is still in the vicinity of 2½% – or less.

How Strong is Consumer Spending?

One reason for our expectation of sluggish economic growth is that we do not see consumer spending picking up much, if any, speed over the coming year. To be sure, some 57% of the second quarter's gain in real GDP stemmed from a marked pickup in consumer spending on goods and services. However, almost half of this increase in consumer outlays was in the catchall category of household consumption expenditures, the most important of which is something called imputed rent for services of owner-occupied housing. In our judgment, the most recent data on retail sales tells a somewhat different story regarding the overall strength of consumer outlays. Consider, for example, the latest figures for the GAF[1] category of retail sales, which is a reliable indicator of the strength or weakness of discretionary, as opposed to essential, spending. Thus, in the June-August period of this year, GAF sales were less than 2% above the comparable period of 2014, which, after adjusting for price increases, indicates an estimated real increase of less than

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

1%. And on a year-to-date basis, the percentage gain over the comparable period of 2014 was a dismal 1.8%, which, in our view, can be taken as a sign of weakness rather than strength in consumer discretionary spending. What these numbers suggest, moreover, is that even though the plunge in gasoline prices may have boosted household purchasing power, it has not, as yet, resulted in the widely anticipated increase in consumer outlays for goods and services.

At first glance, recent gains in employment appear to signal a palpable strengthening of consumer outlays. In August, nonfarm payroll employment, while posting a solid gain of 173,000, was nonetheless below the average increase of 247,000 per month over the prior 12-month period. At the same time, moreover, the widely publicized jobless rate fell to a low of 5.1%, which, in the view of most observers, is very close to the definition of full employment.

Perspective on Job Growth

On closer inspection, however, the employment numbers are somewhat less encouraging. As we have pointed out in previous reports, a significant percentage of recent gains in employment have been concentrated in low-paying industries. On a year-to-date basis – January to August – jobs in the major high-paying industries averaged 27.6 million, down some 4.8 million from the year 2000. In striking contrast, employment in low-paying industries registered an increase of no less than 9.4 million during this same period of time. In a related development, it might also be noted that 51% of the increase in jobs over the past year were in the low-paying industries as compared with 19.3% in the higher-paying industry groups.

One possible consequence of the preponderance of jobs in lower-paying industries is that recent increases in wages and salaries have barely kept pace with the rate of inflation. Looking at the first eight months of 2015 as compared with the like period of 2014, wage and salary increases of all employees in the private sector have averaged just under 2½%, which, after adjusting for the rise in prices, points to a real gain of less than 1%, which, in our view, does not provide much, if any, support for a quickening pace of consumer spending. As a final footnote to the latest report on employment, we might observe that some 37% of the increase in payroll employment over the past year was in just three states: California, Florida and Texas.

Turning to the outlook for 2016, our forecast calls for monthly increases in payroll employment to average 160,000, down from an estimated figure of 200,000 in 2015. Furthermore, we expect that at least 50% of this increase will again be in a number of low-paying industries. As a result, we expect that, for the most part, wage and salary increases in the private sector will be roughly on a par with those experienced in 2015. Looking at the consumer spending component of GDP, we are forecasting next year's increase to be in the vicinity of 2½%, which would represent another year of sluggish gains in consumer spending as well as marking a significant reduction from the average of 3.5% registered between 1955 and 2005. What we are suggesting is that 2016 may be another difficult year for many retailers, with sales of the key GAF group expected to post a modest year-over-year increase of around 2½%. All in all, therefore, we do not see gains in consumer spending as providing much, if any, impetus for a faster rate of GDP growth.

Slow Recovery in Homebuilding

To a significant degree, the sub-par recovery in homebuilding activity can be attributed to a weak demand for single-family houses. On a year-to-date basis, the annualized rate of permits issued for single-family units has averaged 663,000, up 9% from the comparable period of last year, but a far cry indeed from the average figure of 1.5 million recorded between 2002 and 2006. At the same time, the annual rate of permits authorized for multi-family unit construction during the first seven months of this year averaged 486,000, representing a gain of 23% over the like period of 2014. For 2015 as a whole, such permits will likely exceed their previous 2005 peak by a considerable margin.

What seems to be happening is that the demand for rental property is on the rise, largely, it would seem, at the expense of single-family units. One plausible reason for this significant change in the demand for residential property is that demographic forces are reshaping the housing market. Anecdotal evidence suggests that young people – those born between 1981 and 1997 – as well as the growing number of retiring baby-boomers, prefer city or urban living as opposed to home ownership in the suburbs. Another possible explanation is that the rapid growth of student debt – from $480 billion in 2006 to $1.3 trillion in the second quarter of 2015 – is limiting the ability of many young households to purchase a new single-family house.

The single-family housing market may also have been adversely affected by the general tightening of lending standards, along with the lackluster growth of wages and salaries and the growing incidence of less-than-acceptable credit scores. The dramatic shift in the demand for residential construction can be gauged from the fact that, so far in 2015, multi-family permits have represented 42% of all permits issued for housing activity, almost double the 23% recorded between 2002 and 2006. Looking ahead, we believe that any increase in the demand for residential construction will continue to favor the rental market. Based on the recent pickup in household formation – last year the gain was 1.9 million – we expect to see some increase in the demand for housing over the coming year. For this year as a whole, we look for 1.1 million housing starts, up some 10% from 2014 and, as a preliminary forecast for 2016, we are projecting a volume of 1.15 million, representing a relatively modest gain of 4½% over this year's estimate.

Weakness in Capital Outlays

Turning to business investment in new plant and equipment, we find little in the way of evidence to suggest that low interest rates are contributing to a quickening pace of capital spending. In the second quarter of this year, for example, real outlays for business equipment edged downward, following a modest annualized gain of 2.3% in the first quarter. Of considerable concern is the fact that forward-looking indicators, notably orders for nondefense capital goods ex aircraft, are not signaling a quickening pace of outlays anytime soon. To be sure, orders for July posted a welcome gain of 2% over the prior month. But looking at a somewhat longer time period – May-July – orders are down 4% from a year earlier, which does not foreshadow an early pickup in spending. One reason for this disappointing performance is the sizable cutback in capital spending by the energy sector of the economy. As one piece of evidence, the number of oil and gas drilling rigs in operation slumped from more than 1,800 in early 2015 to the latest reading of just 848 – the lowest number since January 2003.

The importance of capital spending by the energy sector can be gauged by the fact that, in 2013 – the latest year for which data is available – the mining industry accounted for 14% of all capital outlays, up from just under 5% in 2004. In addition to the decline in spending by the energy sector, we believe that the overall total of business investment has been held down by heightened uncertainty regarding the economic outlook, concerns about the rising cost of complying with a near blizzard of regulatory initiatives and last, but by no means least, a corporate tax rate that is the highest of any developed country. One possible consequence of the recent weakness in capital spending is a major slowdown in productivity, which, since 2010, has increased at a dismally low average annual rate of 0.5%, far below the average gain of 2.4% reported between 1990 and 2010. As we have observed in a number of previous reports, a decline in the trend rate of productivity growth has negative implications for future gains in real GDP – and living standards. So far as the outlook for real business spending on new equipment is concerned, we expect that 2015 will see a small 3% increase over last year, while any increase in 2016 is projected to be in the low single digits.

Little Change in Other Economic Sectors

Activity in the remaining sectors of the economy will not, in our view, have a significant impact on GDP growth either this year or next. To start with, we doubt that the net export balance will make a positive contribution to the nation's economic growth in either this year or next. The recent appreciation of the dollar, combined with weak economic growth in most of our major trading partners, is likely to dampen gains in U.S. exports while giving a boost to imports. As a result, the net export balance, which is predicted to be a negative $540 billion in 2015, is expected to reach $585 billion in 2016. In a similar vein, we expect inventory accumulation in 2016 will be somewhat less than the $105 billion in sight for 2015. During the first half of 2015, private inventories were accumulated at an average annual rate of $117 billion, which, in our view, represented a buildup of stocks in anticipation of sales gains that in many instances failed to materialize. Over the balance of this year and next, therefore, we expect to see the rate of inventory building decline to the level of around $80 billion. Should this be the case, it follows that the change in private inventories over the coming year will have a small but nonetheless negative impact on real GDP. And finally, the improved financial position of many state and local governments is likely to be reflected in a slowly rising trend of real spending over the coming year or more. At the same time, however, budgetary constraints are expected to hold down federal government spending with the result that government outlays in 2016 will post a marginal – about 1% – gain over this year's estimate.

Is Slow Growth the New Norm?

From this rather lengthy discussion, we expect that next year's growth in real GDP will not be very different from this year's estimate of 2.4%. But bearing in mind that the economic expansion is now in its seventh year, we believe that most of the risks to this forecast are now on the downside. To date, this has been a subpar economic recovery as evidenced by the fact that real median household income, which in 1990 was $56,800, has fallen to less than $52,000 in 2013. As for the outlook for price increases, we believe that the price index for personal consumption expenditures (PCE) will likely remain below the Federal Reserve's goal of 2% over the balance of this year and a good part of 2016 as well. Inflationary expectations remain well anchored, reflecting the continued decline in oil prices, as well as non-energy imported goods and services. As a matter of fact, the PCE price index excluding food and energy has climbed only 1½% over the previous 12 months. In short, the Federal Reserve's 2% objective will likely remain out of reach for some months to come.

Waiting for the Fed

A comment on monetary policy. As we view recent actions by the monetary authorities, we seriously question whether the Federal Reserve has exercised good judgment in holding to a policy of extreme monetary ease more than six years after the last recession ended. While the Federal Reserve's actions in 2008 and 2009 were instrumental in stemming the recessionary tide and bringing about the subsequent economic recovery, they are now, in our opinion, having adverse effects on the financial markets and the economy as a whole.

To start with, the Fed's policy of near-zero short-term interest rates has forced investors and savers to take on more risks. Between the recession's low point of June 2009 and the most recent peak, the Dow Jones Industrial Average and the S&P 500 have climbed 120% and 135%, respectively, far surpassing the small singledigit gains in real GDP and corporate profits. One can certainly argue that there has been a total disconnect between key – and relevant – economic variables and equity prices. In addition to the danger of a speculative bubble in the equity markets, the Fed's policies could be setting the stage for another boom-bust cycle in commercial real estate. So far this year, outlays for the construction of office buildings have climbed 27% over a year ago and are now within hailing distance of the previous peak reached in early 2008. That level of outlays in early 2008 was followed by an almost steady decline over the next three years as developers struggled to absorb a sizable overhang of unsold and unrented property. Once again, we see a risk of supply-demand imbalances over the coming year or more that might well precipitate another downturn in commercial construction.

Federal Reserve officials frequently claim that they are well aware that monetary policy has its limitations and is not a panacea for whatever seems to be wrong with the economy. And yet, the zeal with which the Fed continues to follow a path of extreme monetary ease suggests that a majority of Federal Open Market Committee members think otherwise.

When will the Fed finally raise interest rates? In light of recent developments in China and elsewhere, many observers are now forecasting that the Fed may not increase its policy rate until December – or even later. In point of fact, however, we believe that the financial markets are attaching too much significance to the Fed's initial interest rate lift-off, which, in our opinion, will have little impact on overall economic activity. Of much greater importance will be the speed and magnitude of future increases in the federal funds rate. That said, we believe the Fed has already waited much too long to normalize monetary policy, and, as we have already noted, continued delay will increase the threat of unstable and disorderly financial markets. Our concern is that the Federal Reserve seems very unsure about what it should be doing. Bear in mind that the timing of an increase in the federal funds rate has been the subject of discussion and debate at the Federal Reserve for close to five years. On the key assumption that the Federal Reserve will finally act before year-end 2015, we look for the federal funds rate to rise to what would still be an abnormally low rate of around 1% by the second quarter of 2016 and 1-3/4% by year-end 2016.

Reflections of the Equity Markets

While the proximate causes of the recent decline in equity valuations were the plunge in oil prices and worrisome economic developments in China, one can speculate that equity prices might already have been on the high side and were, therefore, vulnerable to a selloff. This possibility was reinforced by the research of Professor Robert J. Shiller of Yale University, who noted in a recent article that the cyclically adjusted price/earnings ratio of the S&P 500 had reached 27 in July, well above the average of 17 between 1881 and 2015. While these numbers can scarcely be regarded as statistical proof that equities are overvalued, they can be seen, perhaps, as a warning signal. Be that as it may, recent events have, in all likelihood, shaken investor confidence and complacency regarding the seeming inevitability of a bull market for equities. While no one can say whether the recent correction has run its course, investors should, nonetheless, take a guarded approach to the near-term outlook for equity valuations and recognize that, as compared with the last few years, equity prices will likely be more volatile and riskier.

— Norman Robertson

SMITHFIELD TRUST COMPANY BOOK REVIEWS

THE TRAIN TO CRYSTAL CITY
By: Jan Jarboe Russell

This book details the history of America's only family internment camp during World War II. Most people have read of the internment of Japanese living on the west coast, but few know that many Germans and Italians were interned as well. Much of the narrative revolves around the experience of Ingrid Eiserloh, who was 13 at the time of the Pearl Harbor attack. Her father, a German immigrant and an engineer working for PPG in Cleveland, was detained a week later, primarily based on rumors spread by neighbors. Later, after struggling to make ends meet, her mother gave up and agreed to be interned along with her three children in the family internment camp at Crystal City, Texas. There they were reunited with her husband. However, in 1945 they were repatriated to Germany in exchange for Americans being held by the Germans. This was a particular hardship for Ingrid who had been born in the United States and knew not a word of German.

The book reads much like fiction as the author tells the stories of not just the Eiserlohs, but also a various other German and Japanese families in the Crystal City camp. She apparently had done extensive interviewing of camp survivors. My only complaint is that the narrative often shifts too abruptly from one family's story to another. However, she does a good job of describing the daily life in the camp as well as the experiences of those unfortunate enough to be repatriated to their countries of origin. I learned a lot about a dark side of America's World War II experience.

— Henry Haller, III

DANCE OF THE FURIES
By: Michael S. Neiberg

If you are like me, your knowledge of the root causes of World War I is somewhat spotty. I always thought that Europe before 1914 was a tinderbox, with a bloodthirsty general populace eager and ready to go to war. Michael S. Neiberg, a Pittsburgh native who is a professor at the United States Army War College, effectively explodes this notion, arguing that few Europeans had any desire to go to war. Although a tiny group of European leaders had war-like proclivities, the outbreak of such a massive conflict was, in many ways, an unintended accident.

I had the pleasure of having lunch with Professor Neiberg earlier in the year. One of his more frightening observations to me is his belief that the conditions today in Europe parallel the circumstances in early 1914. Look at the Ukraine.

If you are a history buff, grab this well-written book with a unique thesis.

— Bob Kopf

THE CHURCHILL FACTOR
By: Boris Johnson

The current and flamboyant Mayor of London has written an informative biography of Winston S. Churchill. While the author believes that Churchill saved western civilization, Johnson is not shy about citing and analyzing Churchill's errors. Johnson regards Churchill's worst two blunders as his decision as the First Lord of the British Admiralty to attack Turkey in World War I through the Dardanelles and his fierce resistance to Indian self-government.

Johnson's quirky writing style makes this book a lot of fun to read. He uses a lot of words I have never encountered, and I suspect he made up a few of them.

— Bob Kopf

EISENHOWER: A LIFE
By: Paul Johnson

Paul Johnson, the renowned British historian and commentator, has written the "Cliffs Notes" biography of Dwight Eisenhower. The best part of this short book is Johnson's somewhat subjective, albeit positive, conclusions regarding Eisenhower's presidency. Johnson highlights several examples of Eisenhower's deviousness which he skillfully used to obscure his keen intelligence.

For a more comprehensive biography of Eisenhower, I recommend Stephen Ambrose's seminal two volume work.

— Bob Kopf

CALIFORNIA VERSUS FRANCE
By: George M. Taber

This is the true story of the legendary blind wine tasting in Paris in 1976 where French judges chose unknown California wines over celebrated French wines. The tasting changed the world's view of wines from wineries outside France.

Written by the only reporter (Taber was *Time Magazine's* Paris correspondent) at the tasting, *California Versus France* has the compelling elements of a thriller. The three disparate characters who became the winning California vintners are featured beautifully here.

I thank my Smithfield partner, Joe Denski, a true oenophile, for giving me this book.

— Bob Kopf