The Smithfield
Forecast

A QUARTERLY SURVEY OF TRENDS

Issue No. 95 | July 2024

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A MESSAGE FROM OUR PRESIDENT & CEO

I want to thank our very own Sam Adams for continuing Bob Kopf's legacy of providing a book review for this Smithfield Forecast, let alone a book that Bob would no doubt enjoy. I have spoken to other "Friends of Smithfield" who are interested in providing their thoughts on recent reads. For those who have interest, please email your review to forecast@smithfieldtrustco.com by the 15th of each March, June, September and December.

It is hard to believe that we are now in the second half of 2024. In that regard, please find below our economist's mid-year report.

– Elizabeth J. Poggi

SMITHFIELD THIRD QUARTER 2024

As we pass mid-year, the US economy is beginning to show signs of stress, because inflation remains higher than hoped, the Federal Reserve remains effectively on hold, and the approaching election leaves fiscal policy uncertain. At the very top of the economy, capital gains from an AI driven equity market rally and still escalating home prices have allowed consumers to increase spending out of wealth, sustaining demand for services despite still hefty price increases. Meanwhile, lower income households are no longer seeing wage gains that outstrip inflation – particularly for rent – and are trading down, doing without, and increasingly skipping payments on rent and loans.

Current economic forecasts differ essentially on how one balances the importance of these disparities. In our view, ongoing strength in profits at the top of the income ladder provides sufficient protection against the squeeze on the lower rungs. Thus, we expect that the US economy will continue to muddle through for several more quarters. Yet, while we do not see a recession soon, real GDP growth will continue to cool from the heady pace of late 2023. Critically, the victor in our upcoming elections will determine which of the sunsetting policies – including the Trump tax cuts and Biden child care/Medicare expansion – will survive in 2025. However, simply sustaining the policies favored by either party is not enough to maintain economic momentum, as curtailing any government support will create fiscal drag.

The markets expect the Federal Reserve will leap into action with an easing of monetary policy – to the benefits of asset values. That would sustain the spending of those higher income households who dominate US consumption, but lower interest rates alone would provide little relief for lower end households – especially if strong service consumption kept inflation uncomfortably high. For them, the softening of the labor market has not been due to high rates – but rather to greater competition, from both increased immigration and the rising import penetration that is swelling the trade deficit.

Rising imports may be traced to a stronger dollar, as current US rates are higher than in Europe or Asia, where economic weakness is greater. Moreover, China and Europe are both already lowering rates, while the Fed only discusses that possibility – with declining fervor. The failure of foreign economic policies has generated less of an upturn in the global economy than we had anticipated earlier. This has led many nations – especially China – to depend more on exports to lift their own economies.

Meanwhile, the success of America continues to attract immigrants, legal and illegal – now more from South America's faltering northern economies than from Mexico or Central America. Indeed, the Mexican economy is benefitting from its proximity to the US and easier access under the United States-Mexico-Canada Agreement, becoming a haven for foreign exporters – particularly from China. Immigration has softened wage growth for lower income jobs, eroding some of the Fed's concern about a wage price spiral. Yet, it has exacerbated the shortfall in housing – especially of rental properties – sustaining high inflation, primarily impacting those same households that are competing with the immigrant labor.

We expect that 2025 will have less immigration and stiffer tariffs regardless of who wins the election. President Trump, who narrowly leads in the polls, has made it clear that he will crack down on both. President Biden, who never removed any of Trump's tariffs (why give up billion in revenues?) has already moved to reduce border crossings in response to voter concerns. As either will be a lame duck the day elected, we expect their major concern will be sustaining their sunsetting policies to protect their legacy. Getting anything through Congress – which may remain divided even if one party controls both houses due to internal friction – means defending sunsetting policies will have to be offset by fresh revenues. That probably means more tariffs. Meanwhile, campaign promises are likely to reduce immigration.

Bottom line, we expect suffering low-income consumers will benefit more quickly from changing immigration and trade policies than from a cut in interest rates. Indeed, any tightening of the labor market is likely to keep inflation above target – postponing the starting point and degree of Fed ease. Therefore, the greatest impact of these policies will be on investors, who has been carrying the economy in 2024.

Even for investors, the markets have been significantly bifurcated. The biggest stocks account for the lion's share of equity market outperformance. Indeed, the evenly weighted S&P500 has barely outperformed yields on corporate bonds. Meanwhile, small businesses represented in the Russell 2000 are barely higher than at the start of the year – or since August 2022 – and the National Federation of Independent Business (NFIB) reports confidence remains low. These firms are at the pointy end of the labor cost spear, with little ability to incorporate AI and most exposed to minimum wage legislation. Yet, when tariffs were implemented in 2019 to curtail competition from China, small business optimism rose and the US and global manufacturing cycle started an upturn – which Covid truncated.

We are not advocating for tariffs – which economists widely regard as inefficient. However, today's tariffs are different than during Smoot-Hawley before the Great Depression, or even before the advent of laissez-faire trade laws under Reagan. Tariffs back then were generally to protect a country's industry – and jobs – from direct competition. Today, even high tariffs are unlikely to spur much reshoring – but they will alter the source of imports. Multinationals aggressively seek out the lowest cost labor, lowest taxes, and least regulations globally – avoiding requirements imposed on firms operating in the US. We see today's tariffs as an extension of US laws beyond our borders to influence nations to adopt policies in line with US interests on national security, industrial policies, anti-trust, the environment, and a wide array of other issues. They are like the federal edicts which level the playing field between states – but applied globally.

The approaching election should raise the market's awareness that new tariffs and sanctions are coming. Yet, timing that is tricky, because the market tends to focus on one narrative at a time – and right now the AI theme still dominates. The data dependent Federal Reserve should remain on the sidelines though the election, as even low inflation readings in the next few months will only match last year's performance.

Our mantra has always been that the key lead indicator of a capitalist economy is profits. The narrowness of the stock market's recent success and the pessimism of small businesses worries us. The fact that recent growth in nonfarm proprietors' income has underperformed inflation bothers us far more than that wages have lagged as well. Even high immigration has not loosened labor enough for many small businesses, and wages should rise as the immigration window closes. Still, firms typically need to lose money for a while – and expect it to continue – before they lay off, sparking a recession. Profit growth is cooling, but still positive right now. With the election a pivot point for policy, we expect even challenged firms will seek to hold on through November 5th and the holiday season. The election remains close, clouding our crystal ball, so like the Federal Reserve we will remain data dependent – mining those signals for what they tell us about business leaders' perceptions about the impact of future policy and profits.

– Michael Drury

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BOOK REVIEWS

THE SPLINTERED EMPIRES

By: Prit Buttar

This is the author's fourth book on the Eastern Front of WWI and covers the period 1917 to 1921. The book contains an excellent telling of the story that ends with the three great empires of central and eastern Europe, the Romanovs in Russia, the Hohenzollerns in Germany and the Hapsburgs in Austria-Hungary, all being replaced. It is a fast-paced mixture of military and political history and provides plenty of detail without overwhelming the reader. Attention is given to the conditions inside Russia that led to the fall of the czar, the rise of Alexander Kerensky's Provisional Government ("PG") and the unworkable relationship between the PG and the Petrograd Soviet, e.g., the Soviet's Order Number One, which stated that all orders of the PG's military commission were to be carried out except those that ran counter to the orders of the Soviet. Serving two masters, the Russian Army was doomed to fail, notwithstanding the seemingly callous and detached demands of Great Britian and France for it to continue fighting, presumably to the last starving soldier. Attention is also provided to the backdoor peace deal offered to the Allies by Austria-Hungary, the somewhat farcical negotiation of the Treaty of Brest-Litovsk between the Bolsheviks and the Central Powers, the needless headlong push of German soldiers into Russia's interior, especially while their presence on the Western Front may have been enough to make Germany's spring 1918 offensive a success, and, in a case of history rhyming, the Central Powers, including Turkey, arguing over Ukrainian grain output. The final portions of the book detail the struggles for independence of Finland, the Baltic States and Poland and, interestingly, how the Allies permitted German troops to continue fighting in such countries against Trotsky's Red Army and its domestic allies. In all, the book opens a window into an opaque realm of WWI and will serve as a primer for the calamitous events of the following decades.

– Sam Adams