The Smithfield Forecast

A QUARTERLY SURVEY OF TRENDS

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A NOTE FROM THE CHAIRMAN EMERITUS

Having enjoyed a strong and productive working relationship with our economist, Michael Drury, over many, many years, Smithfield Trust Company is delighted to see Michael honored by the Global Interdependence Center with its Global Citizen Award. We offer Michael our heartiest congratulations.

– Bob Kopf

SMITHFIELD FOURTH QUARTER 2023

It has taken the Federal Reserve quite a while, but they have joined the consensus in finally coming around to our point of view. Though pausing in September, the FOMC indicated that one more interest rate hike was likely in 2023, and only limited easing in 2024, with overnight rates expected to end the year above 5% - a half a percent higher than expected in July. The year end rate for 2024 was also lifted 50 basis points to 3.9%. The rationale behind this higher-for-longer strategy was an acceptance by the vast majority of Fed Presidents and Governors that the economy would not have a recession in 2023 or 2024 – and indeed not by 2026 in their view. The Summary of Economic Projections (SEP), which is updated each quarter, boosted 2023 real GDP growth from 1.0% to 2.1%, in admission that the economy has been running hot in the third quarter. Their forecast still implies a slowdown to roughly 1% in the fourth quarter, and their 2024 forecast is 1.5%, slightly below their own 1.8% estimate of sustainable trend growth. Both 2025 and 2026 are penciled in at the potential growth rate – but let's face it, they are just projecting a trending economy after recent misses.

Chair Powell has been adamant that the economic growth must slow to below potential for the inflation rate to slow to the 2% target. In the current SEP, the FOMC collectively sees unemployment rising only slightly from the 3.8% print in September to 4.1% in 2024, as growth slightly underperforms – and then remains there in 2025 with growth at potential. Despite his earlier protestations, this near potential environment still brings inflation down to 2.5% by the end of 2024, then it takes another two years with growth at potential to reach 2%. The Federal Reserve says they are strongly committed to the 2% inflation target, but one wonders then why they would take so long to achieve that goal once they are so close and real growth is well away from recession? Bottom line, we put little stock in this view by committee.

Our view remains that the US, as the suburbs of a global economy, was first to shake off the COVID recession and the rest of the world is only now emerging from their doldrums. Europe may have just tightened for the last time, and the UK recently skipped an expected tightening on a narrow 5-4 vote. Reported annual inflation rates will plunge as the base effects roll off. China, mired in a deep domestic malaise, has been adding stimulus in increasingly large increments, and we expect the recent improvements seen in retail and industrial production to gain traction later this year. The global economy has been in the downdraft of a typical 3-year manufacturing cycle, and 2024 should benefit from a worldwide factory recovery. This recovery will be aided in part by falling prices for goods – especially in dollar terms – which makes them more attractive than still inflating services. That shift should benefit the emerging markets, as investment flows in their direction after a long drought.

Our optimism about the economy managing to grow at potential does not mean that there will not be areas of weakness. We take the Federal Reserve at its word that interest rates will remain higher for longer – and expect that as the economy survives despite 5%+ overnight rates, the consensus will come to accept that short rates may never get close to the 2.5% long run projection in the latest SEP. With real growth running at a 1.8% potential and inflation at a 2% target, we expect overnight rates will cycle around 4% – meaning long term rates are only slightly restrictive at this point. Equity markets and home values around the world are not priced for a return to the interest rate environment that prevailed for decades before the Great Financial Crisis. As businesses must share more of their revenues with labor and pay more for capital or credit, margins will come under increasing pressure. We believe the rising tide of a manufacturing recovery will forestall firms from painful adjustments in 2024 – but 2025 may be a different story. Cycles are not dead; they are just more muted in the global suburbs – both up and down.

As we are now in the fourth quarter, the key question is always about holiday season sales. The fourth quarter faces a number of challenges: from the UAW strike; possible government shutdown; restart of student loans; rising energy prices; and, the fact that we are coming off a strong third quarter driven by spending on entertainment and travel. The FOMC may be right in expecting a setback from recent above trend growth. However, despite rising gasoline prices, they are roughly the same as a year ago – when they were falling from a peak rather than rising as now. We expect the strike and shutdown will be resolved without crisis. A 6-week strike by 50,000 UAW workers in 2019 barely registered on national data although there were significant local concerns. The effect of student loans presents a challenge, but the on-ramp and alternative payment programs were designed to limit the impact – ahead of the election.

While the consensus remains focused on jobs, income and demand – the big difference in 2023 is the return of supply. Last October retail sales boomed as shoppers rushed out to buy desirable items regardless of price because of fear of missing out. November and December sales were sparse – as inventory was depleted, offerings did not match consumers wants, and there were lots of leftovers from 2022 due to late deliveries. This year, supply has caught up to demand, and prices of goods – especially seasonal favorites like electronics and toys – are falling as the yuan weakens. Travel may still be strong, but it is already likely paid for, as there are few empty seats for the holidays. January 2023 sales soared with a hefty bump in social security payments and other COLAs, but the rise will be a more muted 3.8-3.9% this year. That's enough to maintain potential growth at 2% inflation, but not more.

Bottom line, late 2023 and 2024 are likely to be a period of difficult choices for businesses and households with higher interest rates constraining both supply and demand for credit. Many argue that price hikes of various nature will just be passed along, but we expect any price hike in 2024 will force consumers and businesses to cut back elsewhere. Firms are not going to give raises to help pay your gas bill or interest charges – they will be facing their own! We see 2024 as a wall of worry, enough growth to keep the US out of recession, but not enough to make many feel comfortable. As always, prices will help consumers make decisions – and we expect significant resistance to higher rents and housing costs as it is the easiest way for most households to free income for other purchases. Less rent inflation – indeed, maybe falling rents – should help bring the CPI and the Fed's target PCE deflator down faster than projected in the SEP.

This has been an interesting year, with consumer confidence abysmally low despite a 20% rise in the S&P500, a 3.5% unemployment rate (until recently), above trend economic growth, and a narrowing of inequality as low-end workers benefitted most. The US has been an island of outperformance, as fiscal stimulus offset monetary tightening – and funds from the rest of the world flowed in for safety and better return. Next year will be more challenging for the US as the world enjoys expansion – but multinational corporations should thrive as will their investors. Smaller businesses, domestic services, and those that must compete for internationally traded commodities will be at the pointy end of the spear as a limited money supply is reallocated across a broader range of options.

As always for those who live in the suburbs, to remain there they must be able to keep up with the Joneses. We see 2024 as another year with a rising tide – but it may not raise all boats as competition is likely to become fiercer. Still, one consequence of competition is lower prices – and as inflation remains the biggest worry for most households and businesses, a faster than expected retreat should sustain US expansion at near the potential growth rate. What about 2025? Well, there is an election in late 2024 that will determine a lot of future policies. We will wait until the consequences for the Presidency and Congress are a lot clearer before venturing a guess beyond that horizon.

– Michael Drury

We recognize that every person, family, institution, trust or estate is not the same.

Therefore, we customize every account at Smithfield, regardless of type, to achieve the goals at hand from a fiduciary, investment, and tax perspective.

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SMITHFIELD TRUST COMPANY BOOK REVIEWS

NO TRADE IS FREE

By: Robert Lighthizer

Ever since I was in high school, I was taught that free trade is an unmitigated win-win situation for all countries adopting that philosophy, even those like the United States which have chronic trade deficits. Although I had begun to have some lingering doubts about the wisdom of trade imbalances, I have, after reading Robert Lighthizer's new book, put my old free trade beliefs in the dustbin of discarded thoughts. Lighthizer is an experienced attorney in trade matters and a respected former United States Trade Representative.

Lighthizer's call for Fair Trade, rather than Free Trade, rests on the proposition that Free Trade creates impossible economic and global strategic burdens on the country dealing with persistent trade deficits. These include unemployment and strategic shortages in commodities vital to our sustainable military capabilities.

Saving his greatest ire for China as our trading "partner," Lighthizer advocates a massive decoupling of open trade agreements with China. Cheap TV's are nice, but a sound U.S. military using American generated goods and services is more critical.

Read this book with an open mind. You may adjust your thinking.

– Bob Kopf