

THE SMITHFIELD Forecast

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For Customers & Friends of
SMITHFIELD TRUST COMPANY

A NOTE FROM THE CHAIRMAN

The daughter of one of our customers told her father recently that she would like to become the Chief Executive Officer of Smithfield Trust Company. When she was asked why this was her wish, she explained that the job was obviously incredibly easy, since the only task performed by the CEO was the reading of books. Based on this issue of the Forecast, with several book reviews from me, I must confess that our customer's daughter may be on to something.

Perhaps the book reviews will assuage any gloom arising from your reading of Norman Robertson's assessment of our economy.

— Bob Kopf

HOW STRONG A RECOVERY?

After four quarters of negative GDP growth – the longest downturn since the Great Depression – the U.S. economy is again on a positive growth track. According to preliminary figures released by the Department of Commerce, real GDP increased at a yearly rate of 3.5% in the third quarter – the largest gain in more than two years. While the turnaround is unquestionably welcome, the improvement should not be overstated. Not only is the recovery starting from a very low level of activity, but much of the third quarter's advance was due to a number of government programs that gave a temporary boost to consumer spending and residential construction. Indeed, the third quarter's rise in real GDP could well give a misleading impression of strength at a time when the underlying demand for goods and services is still quite weak and likely to remain so.

Pressures on Consumers

A case in point is the outlook for consumer spending which in 2008 accounted for 70% of GDP. The strength of consumer spending in the third quarter – real outlays climbed at a yearly rate of 3.4% – primarily reflected increased spending on motor vehicles under the “cash for clunkers” program which, of course, has now ended. Looking ahead, however, the key determinants of consumer demand suggest a rather subdued increase in outlays over the balance of this year – and next. In other words, we do not see the consumer powering a strong economic expansion in 2010.

One reason for taking a circumspect view of the outlook over the coming year is the prospect of a weak job market extending through most of 2010. Of considerable con-

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cern is the rising number of permanent, as opposed to temporary, layoffs. According to the latest official statistics, permanent job losses have climbed to a record 56% of all those unemployed – and a further increase in this ratio could well lie ahead. Many of the jobs recently lost in a number of industries, notably financial services, auto-related manufacturing and construction, are unlikely to return, even as the broader economy continues to improve. And while some employers may soon need to add more workers in response to a firming demand for goods and services, others are more likely to increase the length of the workweek before adding additional employees. In a related development, the rising trend of productivity, while good news for future economic growth and living standards, is likely to retard near-term job creation since it implies that, for a time, firms can expand output without hiring additional workers. Finally, there seems little doubt that the high degree of uncertainty surrounding the strength and longevity of the nascent economic expansion is also likely to curb the demand for labor going forward. While job gains on a modest scale should soon replace job losses, their numbers will probably be insufficient to reduce the unemployment rate, which is expected to remain in the neighborhood of 10% through most of next year.

Aside from the weakness in labor markets, which will inevitably dampen gains in income, the willingness and ability of many households to increase borrowing – and spending – will likely be constrained by the high level of existing debt burdens and the persistence of tight credit market conditions. As a matter of fact, consumers presently appear more eager to pay down their debt as evidenced by the fact that household debt, which before this recession had never declined in any quarter since 1952, has now fallen for four consecutive quarters and is down 5% from its peak. At the same time, consumers have started to rebuild their savings which, as a percentage of after-tax income, has climbed from a little under 1% – early in 2008 – to 3.3% in the third quarter of this year.

Furthermore, if all these negative factors were not enough, gains in consumer spending may also be limited by the recent decline in household wealth. To be

sure, recent gains in home prices and equity prices boosted the net worth of households by almost \$2 trillion in the second quarter of 2009 – the first such increase since the April-to-June period of 2007. This gain, however, still leaves household wealth a staggering \$12.2 trillion below the peak reached in 2007. Even on the questionable assumption of further significant gains in the price of equities and houses, household wealth is likely to remain well below the level of mid-2007 for quite some time to come.

Taking all these factors into consideration, we find it difficult to escape the conclusion that the consumer sector of the economy will likely face strong headwinds in 2010. Our forecast calls for a meager year-over-year gain in real outlays of just 1.7%, which would be about half the average annual increase of 3.4% registered over the past twenty-five years. And looking further ahead, there is, in our view, a distinct possibility – or probability – that, over the coming years, consumer spending will account for a much smaller share of real GDP than the 72% recorded in 2007.

Slow Turnaround in Housing

Meantime, the devastating slump in homebuilding activity, which was, of course, a major contributor to the 2008-09 recession in the broader economy, appears to be over. A modest upswing in new house sales has, in fact, been under way since last March. In September the annualized rate of sales was 401,000 units which, although down from the prior month, was nonetheless well above the dismally low rate of 329,000 reported at the beginning of 2009. As the result of rising sales and cutbacks in the construction of new houses, the overhang of unsold units has been reduced from a year's supply – at the prevailing rate of sales – in January 2009 to 7.5 months in September – the lowest such ratio in two years. Reflecting the gradual improvement in market conditions, the annualized rate of new housing starts has increased from 479,000 in April 2009 to 529,000 in October.

So far as the outlook is concerned, many of the expected constraints on consumer spending are likely to dampen the housing market as well. Moreover, the April

2010 expiration of the tax credit for first-time homebuyers could also have a negative impact on sales activity later in the year. Despite the recent firming of new and existing house prices, therefore, we do not expect to see a vigorous or sustained rebound in residential construction during 2010. Our forecast for next year anticipates a volume of about 720,000 housing starts which, with the exception of this year's estimated 570,000, would be the lowest annual volume in over fifty years. What this forecast implies, however, is that, for the first time since 2005, the housing sector will likely make a positive – as opposed to negative – contribution to the growth of real GDP.

Help from Inventories

Next year's economic expansion should also be supported by a steady reduction in the rate of inventory liquidation. Since the beginning of this year, the rapid drawing down of excess stocks has enabled firms to make considerable progress in bringing inventories down to desired levels. Thus, the inventory-to-sales ratio of manufacturing and trade firms has fallen from a 13-year high of 1.46 in December 2008 to a somewhat more satisfactory 1.32 in September of this year. True, the liquidation process still has some way to go before stocks are at or near their pre-recession levels relative to sales. But assuming that, at the very least, final sales have now stabilized, the rate at which stocks are drawn down over the coming quarters is likely to fall well below the annualized rate of \$162 billion and \$131 billion in the second and third quarters, respectively. In contrast to the first half of this year, therefore, when an accelerating pace of inventory liquidation accounted for more than half of the reported decline in real GDP, the declining rate of liquidation expected over the next few quarters will make a positive contribution to real GDP growth.

Mixed Signals on Capital Spending

In the business sector, outlays for equipment and software have stabilized following a six-quarter decline which left spending some 20% below its late-2007 peak. While the end of the downturn is good news, it should not be taken as a signal that a strong upturn is close at

hand. Anecdotal evidence suggests that a high degree of uncertainty regarding the outlook for sales and profits is acting as a major constraint on capital spending plans for 2010. In addition to worries about the strength and durability of the economic recovery, the sharp – and unprecedented – decline in capacity utilization rates is also having a negative impact on next year's planned expenditures. From recent surveys, moreover, it appears that many firms now see only a very limited need to replace or update existing information technology equipment as well as other capital goods that may have been installed during the high-spending years between 2003 and 2007. And finally, unfavorable financial conditions are still cited by many firms as a barrier to increased spending in 2010. What all this seems to imply is that next year's increase – if any – in outlays for business equipment will be small, perhaps in the 2-4% range.

Commercial Real Estate – Cause for Concern

While equipment spending has leveled out, the downturn in nonresidential construction has not yet run its course. In response to steadily rising vacancy rates, declining rental rates and property values, and extremely tight credit market conditions, outlays for office and commercial building have fallen some 21% since the third quarter of last year. With reports from around the country indicating a generally weak demand for most types of commercial property, the number of projects in the planning stage has, in all probability, dropped sharply in recent months. And given the long lead times between the initial planning and completion of major projects, it seems very likely that spending, particularly for office and retail space, will continue on a downward path through at least half of next year. Of particular concern is the impact of the on-going recession in commercial construction on those lending institutions with significant exposure to the commercial real estate markets. What is already happening is that delinquency rates have climbed sharply in recent months and, from all reports, the end of this rising trend is not yet in sight. Against this backdrop, we expect that outlays for all non-residential building, which will likely decline almost

20% in 2009, are headed for another 5-10% drop in 2010, meaning that this sector will continue to be a drag on economic growth in 2010.

More Exports - And Imports

The remaining sectors of the economy can be expected to make only minor contributions to economic growth in 2010. Although U.S. exports should benefit from a global economic recovery as well as the recent weakness of the dollar, imports are also likely to rise in response to a stronger domestic demand for goods and services. Since the growth rates of U.S. exports and imports are expected to be quite similar in 2010, our forecast of next year's trade gap is essentially unchanged from the figure of the \$355 billion in sight for 2009. Thus, the net export sector, which in 2009 will make one of the very few positive contributions to real GDP growth, is likely to be a neutral force in the 2010 economy.

Less Support from Government Spending

Finally, the economic expansion in 2010 will be supported by a rising trend of government spending on goods and services. However, the degree of support – as measured by the contribution to GDP growth – will likely be a good deal less than in 2009. Not only has the spending associated with the federal government's stimulative fiscal programs passed its peak, but the ability of state and local authorities to increase spending has been severely constrained by the decline in tax revenues during the recent recession. As a matter of fact, many states facing large budget deficits have been forced to cut spending in 2009 – and may do so again through a good part of next year.

Debt, Debt – And More Debt

What are the economic policy implications of this forecast for 2010? The rise in the jobless rate to 10.2% in October, along with continuing job losses, has prompted calls for new programs of fiscal stimulus to bring about an early improvement in labor market conditions. Already the tax credit for first-time homebuyers has been extended to next April, while unemployment

benefits, depending on the individual state, have been extended from 79 weeks to 99 weeks. But without a credible deficit-reduction program, the implementation of further large-scale stimulus measures would be, in our judgment, extremely ill-advised – and dangerous.

As matters now stand, the Congressional Budget Office has projected a cumulative budget deficit of \$8.7 trillion over the next decade. By way of comparison, the cumulative budget deficit over the preceding fifty years was \$5.1 trillion. These massive – and unprecedented – deficits will further increase the debt held by the public from 41% of GDP at the end of 2008 to a projected 68% in 2019 – the highest percentage since 1950. The unsettling prospect of outsized budget deficits as far as the eye can see, along with a further explosive rise in debt, implies a lower rate of national saving, less investment in new plants and equipment and a reduction in the economy's long-term potential growth rate. There is, moreover, another dimension to the worsening fiscal position of the U.S. government. Briefly stated, the budget deficit projected over the next decade will likely be accompanied by a renewed rise in the U.S. trade and current account deficit which, in turn, will have to be financed with a large and continuous inflow of foreign capital. We cannot be sure, however, that foreign investors will be willing to finance these deficits for an indefinite period of time or on terms that remain generally favorable to the U.S. At the same time, it may not be too farfetched to suggest that this dependency on foreign capital could, over time, limit this country's ability to implement economic policies that are based solely on domestic consideration. Against this sober background, we believe that it's now imperative for the Congress and the Administration to curb their appetites for new spending programs and focus instead on measures, including spending reduction, which will, over a period of years, reduce and ultimately eliminate large scale budget deficits.

More Challenges for the Fed

While much has been written and spoken about the role of fiscal stimulus in bringing about an economic recovery, we believe that without the Federal Reserve's

swift and aggressive response to the economic and financial crisis, the return to positive GDP growth would not have been possible. We should not forget that the Federal Reserve was faced with a major financial crisis which manifested itself in a virtual drying up of the credit supply as well as an upsurge in credit risk spreads and a near-total loss of the financial sector's appetite for risk-taking.

The measures taken by the Federal Reserve to support the economy were innovative and, in many instances, unprecedented. In addition to keeping the Federal Funds rate at near zero for an extended period of time, the Federal Reserve also provided an extraordinary measure of liquidity to the financial system. The size of these measures can be gauged from the Federal Reserve's balance sheet which has ballooned from \$870 billion before the crisis to the current reading of \$2.1 trillion. As another indication of new policy initiatives, the purchase of long-term marketable securities has reached about \$1.6 trillion, representing some 75% of all Federal Reserve assets. In pre-crisis days, the Federal Reserve held less than \$800 billion in securities, virtually all of which were U.S. Treasuries. Today, U.S. Treasury obligations have been cut to the neighborhood of \$450 billion, while other long-term assets – primarily mortgage-backed securities – have climbed from near zero to \$1.1 trillion. From all indications, these initiatives appear to have stabilized the financial markets. To be sure, the financial system cannot be described as functioning in a normal manner. But “normal” should not be interpreted as implying a return to the credit market conditions of the middle years of this decade. From the standpoint of the financial markets, “normal” is likely to mean something very different from what it did in recent years.

As to the future, Federal Reserve policy is likely to remain on hold well into next year. For now, the Fed is much more concerned about the strength and durability of the expansion than the threat of renewed inflation. Clearly, the Fed sees no need to tighten policy at a time when the margin of slack in the economy is pushing inflation downward, not upward. Most forecasts for next year, moreover, assume a relatively tepid economic

expansion which is unlikely to put upward pressure on costs and prices. Absent an upside surprise in economic growth and/or a palpable increase in the trend rate of inflation, we expect that the Federal Funds rate will remain close to zero through at least the first half of next year – if not longer.

At some point, however, the Federal Reserve's extraordinarily accommodative stance will have to be reversed in order to prevent a reigniting of the inflationary fires. The implementation of an exit strategy will not be easy since it will require the use of unconventional measures, the effects of which on the financial markets cannot be predicted with any degree of confidence. Moreover, it takes a long time – anywhere from three months to two years – for monetary actions to impact the broad economy. As a consequence, the Fed will need to act well before the present-day margin of slack in labor and product markets has been reduced to its pre-recession level.

Cautious View of the Outlook

In sum, we do not look for a robust economic upswing in 2010, but neither do we expect a relapse into recession. While there is clearly some risk of a downturn, we believe that the odds favor a year-over-year increase in real GDP of about 2.5%, which would represent a decidedly weak performance in the first full year of an economic recovery. For many Americans, however, the GDP is a concept which has little relevance to their perception of economic realities. A sizable segment of the public will likely remain unconvinced that the recession has ended until such time as the unemployment rate has started to decline and there has been an accompanying improvement in the job market.

A more vigorous upturn seems unlikely in light of the strong headwinds the economy is likely to encounter during 2010. As we have discussed, a number of negative factors, including a limited availability of credit, a weak labor market, the destruction of household wealth, a large overhang of unsold houses and unused manufacturing capacity, and cutbacks in state and local government spending, are expected to weigh heavily on next year's prospects for real GDP growth. Another con-

straint is the likelihood that the stimulative effects of recent fiscal actions have passed their peak and will now have relatively little impact on next year's economic performance. Aside from these short-term concerns, moreover, there are a number of long-term issues, notably the massive trade and budget deficits, that, unless resolved, will seriously undermine the nation's economic health over the coming years.

What's Ahead for Equities?

Judging by the rise in equity prices since last March – the DJIA has gained almost 50% — investors have been taking an increasingly sanguine view of broad economic prospects for 2010 – and beyond. But with the strength and longevity of the recovery still very much in doubt, we believe that investors would be well advised to temper their optimism with caution. Any investment strategy should, in our opinion, take into account the high degree of uncertainty regarding the economic outlook as well as the unusual number of formidable challenges facing the monetary and fiscal policymakers. One such challenge relates to the phasing out or winding down of the unusually stimulative economic policies recently adopted in response to the economic and financial crisis. Another concerns the likelihood of a jobless recovery in 2010 that will have far reaching political, as well as economic, consequences. And last, but by no means least, the policymakers will have to come to grips with the need for politically difficult and unpopular decisions with respect to government spending and taxes.

In effect, we are having to cope with not just the aftermath of a major recession but the painful consequences of an extended period of economic growth driven by a rapid build-up of debt* which, as a percentage of GDP, has climbed from a steady 140 between 1960 and 1982 to 240 in 2008. When all is said and done, we believe that the time needed to make a full recovery from the 2008-2009 recession will be considerably longer than after previous post-WWII downturns in economic activity.

*Domestic Non-Financial Debt

— Norman Robertson

SMITHFIELD TRUST COMPANY BOOK REVIEWS

THE LIFE OF GENERAL ELY S. PARKER

By: Arthur C. Parker

This is a quirky biography and is probably appealing only to a quirky person like me.

First published in 1919 and written by Ely Parker's nephew, this book tells the story of a full-blooded Seneca Indian who becomes General Ulysses S. Grant's military secretary.

Born in 1828 on the Tonawanda Reservation in western New York State (near my birthplace), Parker straddled the white and Indian worlds. A gifted writer, Parker was also a civil engineer who graduated from Rensselaer Polytechnic Institute. During the 1840s, Parker became the leader of the Six Nations, and in 1860 he became friends with Ulysses Grant while using his engineering talents to build a customhouse and hospital in Illinois.

When the Civil War began, Parker tried to join the Union army but was rebuffed, being told by William Seward that this was a "white man's war." Ultimately, however, Parker became Grant's chief aid, was made a Brigadier General and played a significant role in Robert E. Lee's surrender at Appomattox. Grant later appointed him as the first American Indian to serve as Commissioner of Indian Affairs. Parker's efforts to help his people were undermined by unscrupulous politicians who unfairly forced him out of office.

At age 12, I remember attending a speech by the Chief of the Senecas, George Huron, who asked how the Federal Government could take Parker's old reservation to build the Kinzua Reservoir in violation of George Washington's solemn promise by treaty. I agreed with Huron then, and I agree with General Parker, that the treatment of the Senecas was deplorable.

General Parker was a beautiful and articulate writer, as evidenced by his letters. Unfortunately, Parker's nephew did not inherit the General's writing gene. Arthur Parker's biography is disjointed and written in a mediocre fashion.

Since this book is now probably out of print, I will be happy to loan it to you upon request.

— Bob Kopf

THE FIRST TYCOON: THE EPIC LIFE OF CORNELIUS VANDERBILT

By: T. J. Stiles

Cornelius Vanderbilt, the son of a Dutch farmer and English mother, grew up on Staten Island in the early 1800s, became a steamboat entrepreneur and, ultimately, the richest man of his time. Incredibly, by 1877, the year of his death, Vanderbilt's assets equaled one out of every 20 dollars in circulation in the United States. Tough, shrewd, but

essentially uneducated, Vanderbilt was strongly influenced by his mother, Phoebe, who was equally tough. Dutch culture, unlike that of the English, allowed women to enter business. Phoebe became a small lender, and Cornelius watched her avidly. In one instance, a young and recently widowed Staten Islander was unable to meet her mortgage payments as a result of the death of the family breadwinner. As a consequence, Phoebe foreclosed on her residence. What says it all, however, is that the widow was Phoebe's own daughter! Cornelius carried on this tradition, although, unlike the other robber barons like Jay Gould, with a basically honest value system.

T. J. Stiles writes well, and the book is researched to the hilt. Some readers may object to the detailed emphasis on Vanderbilt's financial machinations, but I found it quite interesting that, according to Stiles, Vanderbilt was the first significant American businessman to understand the modern world of paper money and stock valuation based on revenue rather than book value.

I would prefer that Stiles lace his biography with more personal anecdotes about The Commodore, but perhaps they are not available for such a private person. I am also disappointed that Stiles devotes less than one page to Vanderbilt's founding of my alma mater, Vanderbilt University, in a gesture of reconciliation between the North and the South after the Civil War. Aside from these quibbles, I enjoyed The First Tycoon and recommend it.

— Bob Kopf

HORSE SOLDIERS

By: Doug Stanton

Horse Soldiers is the thrilling story of how an outnumbered band of U.S. Special Forces liberated, at least temporarily, Afghanistan from the Taliban shortly after September 11th. The bravery of our men, attacking the Taliban on horseback, is truly incredible, and Doug Stanton's beautiful writing style and ability to capture the individual personalities of our men and women produce a book which is difficult to put down.

Given our current difficulties in Afghanistan, the author also contrasts the successful tactics and methods of the horse soldiers with some of our subsequent blunders. Horse Soldiers is a gripping tale with some profound lessons.

— Bob Kopf

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SMITHFIELD TRUST COMPANY BOOK REVIEWS *continued*

THAT OLD CAPE MAGIC

By: Richard Russo

While on vacation, I made a rare foray into fiction, and I'm glad I did.

Richard Russo's novel features Jack Griffin, known as Griffin, an acerbic professor of English at a small New England college. With a wife and daughter who are underappreciated, to say the least, Griffin has entered his middle age crisis phase. He is a mass of contradictions and a psychological wreck, yet he is also, at bottom, appealing.

Griffin's problems stem, fundamentally, from his relationship with his divorced parents, both snobby academics who taught in a Midwestern university but loved Cape Cod. His mother is a royal pain in the ^{***}, but she is also incredibly perceptive and cruelly funny. Griffin's failure to accept the fact that he has "become his parents" gives rise to some wonderful comedic moments, coupled with good doses of pathos. The author's deft and understated writing style prevents the story from lapsing into an excessive parody.

For me, an eerie aspect of the book is that Griffin's mother reminds me in many ways of my own mother, although I am never a royal pain, am I?

— Bob Kopf

MELTDOWN: A FREE-MARKET LOOK AT WHY THE STOCK MARKET COLLAPSED, THE ECONOMY TANKED AND GOVERNMENT BAILOUTS WILL MAKE THINGS WORSE

By: Thomas E. Woods, Jr.

Thomas E. Woods, Jr. is a disciple of Ludwig von Mises, the free-market Austrian economist. In Meltdown Woods makes, convincingly, a scathing attack on the Federal Government and Federal Reserve, showing why these bodies created the current crisis. In essence, Woods argues, the Congress, the Executive and the Federal Reserve, ruled by political and not economic principles, did not and do not let market forces operate to burst artificial bubbles in the housing and other sectors.

Although I am not an economist, I question Woods' recommendation to abolish the Federal Reserve. The Fed, it seems to me, may be a necessary evil in a complex and intertwined global economy. Is not the better answer to keep the Fed and staff it with people like Paul Volker, rather than Alan Greenspan?

Please read this book.

— Dave Perkins

OLD SOLDIERS NEVER DIE: THE LIFE OF DOUGLAS MACARTHUR

By: Geoffrey Perret

Douglas MacArthur was, arguably, the most controversial soldier in American history. Well researched, Old Soldiers Never Die explodes many of the negative myths about MacArthur, but it also excoriates him for his many personal failings. The strength of the biography is its balance and highly readable prose.

Vain, brave (his exploits in World War I are amazing) and highly intelligent, MacArthur had very serious lapses in judgment. An example of the lapses is having a 16-year old mistress in the Philippines and then bringing her to Washington after returning to the United States. His insubordination regarding President Truman was inexcusable, although Truman is also portrayed by Perret as petulant and lacking in judgment.

MacArthur's relationship with Dwight Eisenhower is explored in considerable detail, beginning with Ike's role as MacArthur's subordinate in the Philippines. MacArthur had political ambitions after World War II, and we can all be happy that Eisenhower, rather than MacArthur, realized his political goals. (See the review of Ike elsewhere).

Perret does a splendid job of describing the dominant figures in MacArthur's life in a brilliant and colorful light: Pershing, Hoover, Roosevelt, Truman, Hirohito, Marshall and MacArthur's immediate family. I recommend the book to you.

— Bob Kopf

IKE: AN AMERICAN HERO

By: Michael Korda

The son of pacifist Mennonites, Dwight D. Eisenhower ironically left Kansas for West Point in 1911 and, ultimately, commanded the largest expeditionary force in history. Michael Korda's highly readable biography of Ike, focused primarily on his military career rather than his presidency, is arguably what my friend Dave Perkins calls a hagiography --- i.e., an overly worshipful depiction of a person. Having said that, I do think that there is so much to admire about Eisenhower that the praise is not misplaced.

Tough, shrewd and ambitious, Ike had the unique ability to handle difficult people like MacArthur, Churchill, Patton and Montgomery without straying from his long-term goals. He was an extraordinary administrator, and history has not given him his due as a military strategist.

Korda devotes a substantial part of the book about the strains on Ike's marriage to Mamie and his relationship with his English driver, Kay Summersby. While the author lets the reader draw his or her own conclusions about whether Ike had had an adulterous affair with Summersby, the evidence certainly points to that.

As I point out in an accompanying review in *The Forecast*, we were certainly fortunate that Ike, rather than MacArthur, emerged as our leader. Michael Korda's insightful biography shows this brilliantly.

— Bob Kopf