THE SMITHFIELD Forecast

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For Customers & Friends of
SMITHFIELD TRUST COMPANY

A NOTE FROM THE CHAIRMAN

While I would like to dissent from Norman Robertson's gloomy view of the U.S. economy, a careful reading of Norman's analysis in this issue of The Forecast certainly does not inspire unbridled optimism. Perhaps the book reviews will divert your attention from the economy.

— Bob Kopf

THE U.S. ECONOMY – CAUSE FOR CONCERN?

Another Slowdown

Why has the economic recovery that started about a year ago failed to gather strength and momentum? Figures just released show that real GDP climbed at a less-than-robust yearly rate of 2.4% in the second quarter, down from 3.7% in the first quarter and 5.0% in the final quarter of last year. And final sales – GDP less the change in business inventories – which is probably the best measure of demand in the economy, climbed at a lackluster yearly rate of 1.4% in the April-June period, representing very little change from the first quarter's 1.2% pace. This slow-paced recovery from one of the deepest economic recessions on record is worrisome since in the past severe economic downturns have been followed by vigorous gains in spending which reflected, at least in part, the satisfaction of large pent-up demands that had accumulated during the recession. On this occasion, however, it is evident that, while there may well be a considerable pent-up demand from consumers and businesses, it has not as yet triggered a significant or sustained rise in outlays.

Less Policy Stimulus

What lies behind this sluggish recovery from the 2008-09 recession? One partial explanation is that the economy is now receiving much less support from fiscal – and monetary – policy stimulus than it did last year. Indeed, worries about the economy's lackluster growth rate have already prompted calls for more government stimulus to propel the economy onto a faster growth track. However, the policy options are now extremely limited and not without considerable risk. Bearing in mind the severity of the nation's short- and long-term budget problems, as well as the public's mounting concern over the explosive growth of federal debt, it is difficult to see the Administration proposing, or the Congress approving, any new large-scale program of fiscal stimulus. And with the Federal Funds rate at near zero, the Federal Reserve's room for additional monetary easing is also very limited. To be sure, the Fed could ease financial market conditions by purchasing long-term Treasury securities. But any further enlargement of the Fed's already swollen balance sheet would risk unsettling the

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financial markets and, in our opinion, will do very little to stimulate the economy. When all is said and done, there is not a great deal that the policymakers in Washington can do to promote a faster recovery from the recent recession.

Are Banks Risk Adverse?

Meanwhile, the persistence of problems in the financial markets, notably the inability of many borrowers to obtain bank loans, is also contributing to the tepid pace of economic expansion. By all accounts, there has been a marked reduction in the availability of credit for small- and medium-sized businesses who in the past, incidentally, have accounted for much of the increase in employment during the early stages of economic recoveries. The continued aversion to risk-taking on the part of many financial institutions is suggested – or confirmed – by the decline in commercial and industrial loans from just over $1.32 billion in December of last year to the latest reading (June 2010) of $1.24 billion.

Weak Job Market

Another factor contributing to the weak economic turnaround is the high rate of unemployment which is having a negative impact on consumer spending. Of mounting concern is the fact that a record 45% of the unemployed have been out of work for 27 weeks or longer while 44% - also a record - are in the category of permanent job losses. These numbers suggest that the labor market is being impacted by structural changes in the demand for workers as well as the usual array of cyclical forces. By way of elaboration, there is marked disparity between the unemployment rate for college graduates (4.5%) and that of individuals without a high school diploma (13.8%) which strongly suggests that a lack of education and required skills are at least partly responsible for a jobless rate which is not far short of 10%. Arguably, the snail-like pace of job creation can also be attributed, at least in part, to the mismatch of skills and educational attainment between those looking for work and those needed by employers. Be that as it may, it is worrisome that a year after the recession ended in June or July of 2009, there has been no increase in private sector payroll employment. One last point. Unemployment that results, at least in part, from inadequate education and skills will not be reduced by the politically popular expedient of additional government spending programs, ostensibly designed to boost the demand for labor.

Is the Administration Helping or Hurting?

Some of the recent economic malaise can also be traced to a very uncertain economic and political environment which is holding back investment. While some will disagree, we believe that part of this uncertainty can be attributed to the Obama Administration's recent and proposed actions, particularly those related to government spending, health care, regulation and trade policy. Many businessmen perceive the Administration as having done very little to either foster the entrepreneurial spirit or help the U.S. economy become more productive and competitive in the global marketplace. Instead, the Administration is often seen as being intent on pursuing a social and political agenda which is based on the premise that the American people are in need of governmental protection from a predatory, greedy and unstable private sector. There is, we believe, a degree of tension between the business community and the Administration which is certainly not helping the economy regain its health and strength.

Dull Year for Consumer Spending

The less-than-robust economic expansion also reflects the high levels of debt and low asset values in the household sector. With the ratio of household debt to net worth now significantly higher than at any time since the end of World War II, many household balance sheets are in need of restructuring which is likely to dampen spending for some months to come. What we are saying is that the process of de-leveraging – i.e., the paying down of existing debt – points to subdued gains in consumer spending through a good part of 2010. Bear in mind also that, in the second quarter of this year, disposable personal income – a key determinant of consumer spending – was only marginally above – 0.4% – the comparable period of 2009. And at the same time, moreover, consumers can no longer depend on rising real estate valuations to support a high and rising level of spending. And finally, there are signs that consumers have changed their spending patterns in response to the economic and financial turmoil over the past two years. More specifically, the saving rate, which before the recession had hovered around a meager 2.0% of disposable personal income, is now at 6.2%, the highest such ratio for any non-recession quarter in some eighteen years. Needless to say, it remains to be seen whether this rediscovery of frugality is merely a temporary phenomenon associated with the recession or whether it represents a more lasting recognition of the need to increase saving. For now, we see only very limited growth in consumer outlays over the balance of 2010. For the year as a whole, we are now forecasting a slender gain of about 1.5% over 2009 which would represent the smallest increase ever recorded in the first year of any economic recovery since World War II. Such a minor improvement implies that many of the nation's retailers will have another difficult and disappointing year in 2010.

Depressed Housing Market

In the meantime, a sustained recovery from the devastating slump of 2008-2009 has continued to elude the housing market where activity has remained at recession-like levels through the first half of 2010. We can speculate that many of the same factors that are limiting gains in consumer spending are also having a negative impact on the housing market. While new house sales received a temporary boost from the home buyer tax credit – which has now expired – the underlying trend of sales activity has shown little if any improvement over the last year. On the contrary, the latest data (June 2010) shows sales running at a yearly rate of 330,000 which was on a par with the lowest sales rate recorded during the 2008-2009 recession. Just how far the housing market has fallen can be gauged from the fact that in June 2006 new house sales were at a yearly rate of 1.074 million. As might be expected, the construction rate of new houses has reflected the continued weakness in sales activity. Thus, in June of this year, the annualized rate of housing starts was a low 549,000, a far cry indeed from the peak pre-recession rate of over 2.3 million units. Against this backdrop, it is not altogether surprising that builder confidence in the market for new homes has fallen to its lowest level since April 2009. From all indications, the housing market is facing a recession-like environment through most of this year. Given the lackluster rate of home building through the first six months of this year, our previous forecast of 650,000 units for the year as a whole is probably beyond reach. Accordingly, we have reduced the estimate for 2010 of 650,000 units to 610,000 units.

How Much Stimulus from Inventory Building?

Over the past four quarters, a sizable part of the increase in real GDP has reflected a cyclical swing from inventory liquidation to accumulation. As a matter of fact, the move from de-stocking to re-stocking accounted for 60% of the rise in GDP since the second quarter of last year. However, much of the impetus to GDP growth from the rebuilding of depleted inventory positions has, in our opinion, run its course and we expect that any further buildup in stocks over the coming quarters will be on a very modest scale. On the subject of the contribution of inventories to the recent recovery, it is interesting to note that the magnitude of the recent shift from inventory liquidation to accumulation has exceeded any previous inventory cycle of the post-World War II period.

Strength in Capital Spending

On a more positive note, we still look for increased spending for capital goods to support a sustained, albeit modest, rise in real GDP during 2010. Even though political and economic uncertainties are still weighing heavily on decisions to increase spending, we are forecasting the need to replace obsolete technologies and enhance productivity will necessitate higher spending for equipment through the balance of 2010. In the first half of this year, equipment spending posted a healthy gain of 15% over the comparable period of 2009. And with orders for non-defense capital goods (ex aircraft) also running 16% ahead of last year's figures, the odds now favor a year-over-year increase of close to 15% in real outlays for capital goods, notably, information equipment and software. Even with this increase, however, it should be noted that outlays in 2010 will still be appreciably below those recorded in the pre-recession year of 2007. Although we take an upbeat view of the outlook for equipment spending, we see little expansion in outlays for new plant construction in light of a still large overhang of unused industrial capacity. We should point out, moreover, that the upswing in capital spending is by no means as strong as the recent rise in corporate cash flow. Thus, the cash flow of corporations – the funds available to companies for investment – reached $1.50 billion in the first quarter of 2010 while capital spending was $1.37 billion, which indicates that the ability to spend has not been matched by a willingness to do so. The size of the first quarter's gap between cash flow and capital spending – $130 billion – was the largest ever recorded for any quarter in the post-World War II period.

Less Optimism on 2010

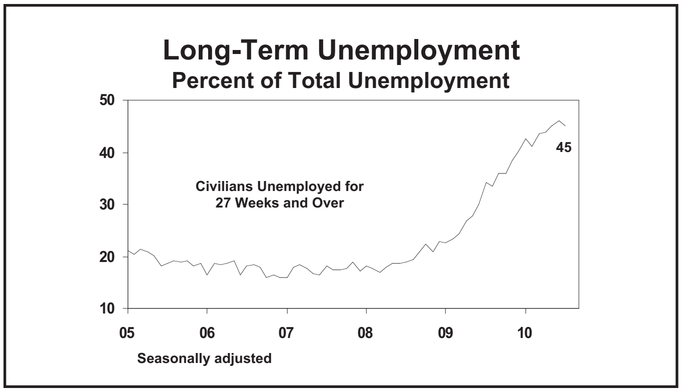
Elsewhere in the economy, the contribution to the growth of real GDP is more likely to be neutral or negative than positive. To start with, the trade deficit is likely to be somewhat higher than it was in the recession year of 2009. So far this year – the first six months of 2010 – the goods and services deficit has totaled $247.5 billion compared with $170.9 billion in the comparable period of last year. For this year as a whole, therefore, we expect that the net export contribution to real GDP could be slightly negative. And finally, with most state and local governments cutting spending and/or raising taxes in response to widening deficits and federal outlays leveling out after last year's $50 billion rise, the public sector of the economy is not expected to make a positive contribution to this year's growth in real GDP. In a recent speech, Federal Reserve Board Chairman, Ben S. Bernanke, highlighted the financial problems facing state governments, "Estimates of states' unfunded pension liabilities span a wide range, but some researchers put the figure as high as $2 trillion at the end of last year." He also noted that the budget difficulties of many states had already forced sizable cutbacks in employment, "…state and local payrolls have fallen by more than 200,000 jobs from their peak near the end of 2008."*

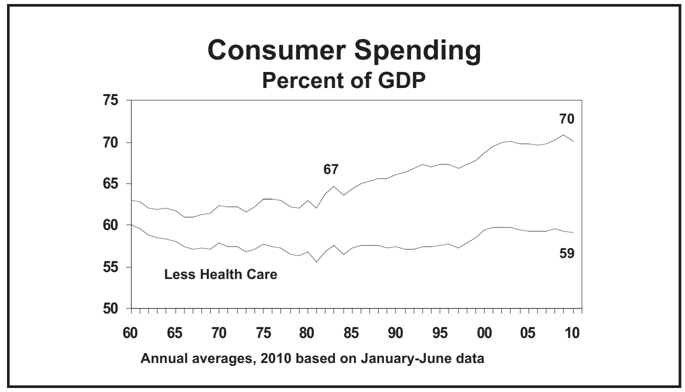
The lack of policy options to stimulate the economy when combined with the strong headwinds that are hampering the growth of private-sector demand suggests that the risks to earlier forecasts of GDP growth are now on the downside. Although we believe that fears of a double-dip recession in 2010 are overblown, we have revised our forecast of GDP growth in 2010 from around 3¼% to the neighborhood of 2.9%. Whether this year's growth in GDP is 3%, 2.8% or some other number, it is evident that recovery from the 2008-09 recession is proving to be a lengthy, complex and increasingly uncertain process.

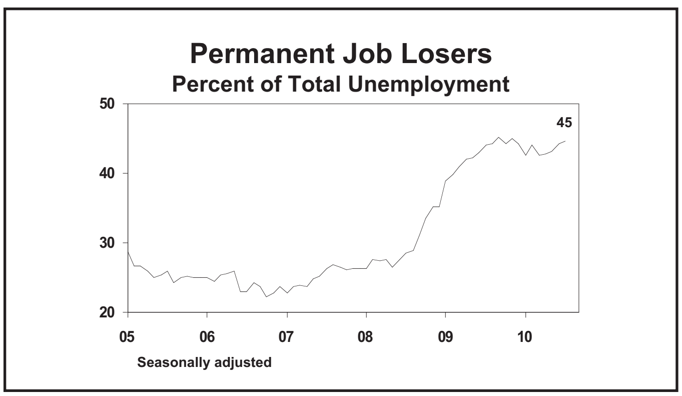
Against this backdrop of a highly uncertain and unsettled economic outlook, we do not see the makings of a strong or sustained uptrend in equity prices over the immediate months ahead. The volatility which has characterized the equity markets in recent weeks is likely to continue as investors are confronted with mixed signals on the economy – and corporate profits. True, the better-than-expected reports on corporate second quarter earnings have been the source of recent gains in equity prices. But given the expectation of what might best be described as a limping recovery, it may be difficult for many companies to replicate their strong second quarter performance over the balance of 2010. Against the backdrop of uncertainty and anxiety about the economy, we believe that the level of risk associated with equities will likely remain high for some time to come.

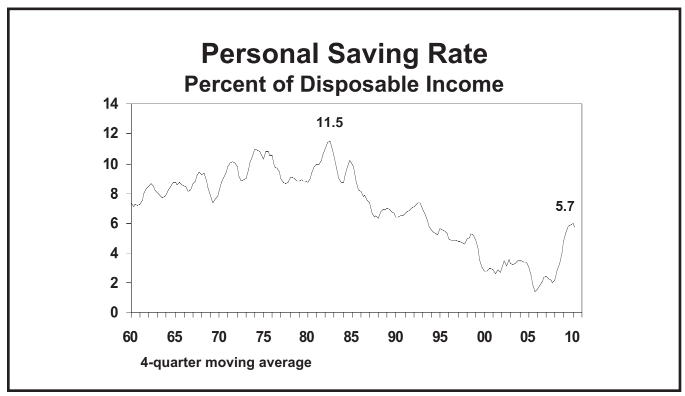
— Norman Robertson

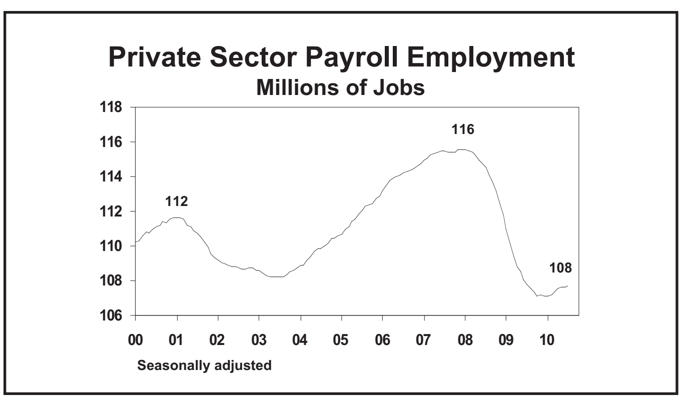
* *Ben S. Bernanke (2010), "Challenges for the Economy and State Governments," speech delivered at the Annual Meeting of the Southern Legislative Conference of the Council of State Governments, Charleston, South Carolina, August 2.*

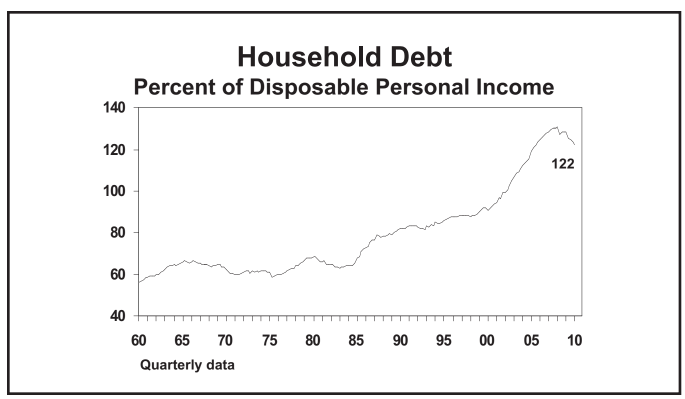

Long-Term Unemployment
Percent of Total Unemployment
Civilians Unemployed for 27 Weeks and Over
45
Seasonally adjusted

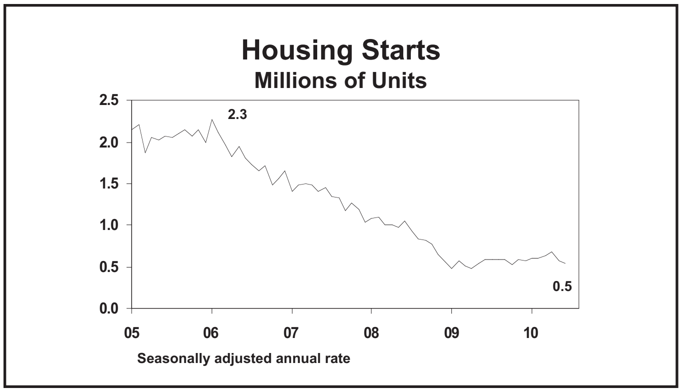

Consumer Spending
Percent of GDP
70
67
59
Less Health Care
Annual averages, 2010 based on January-June data

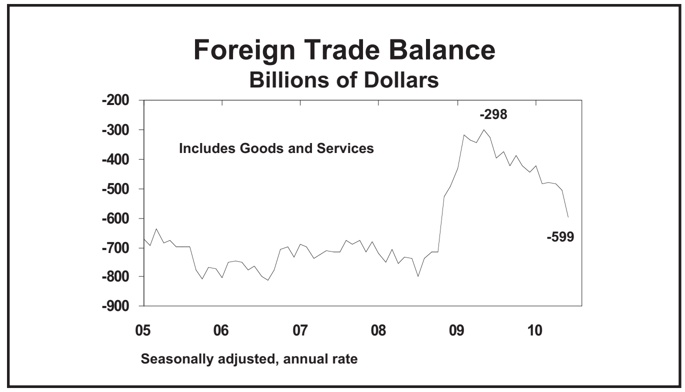

Permanent Job Losers
Percent of Total Unemployment
45
Seasonally adjusted

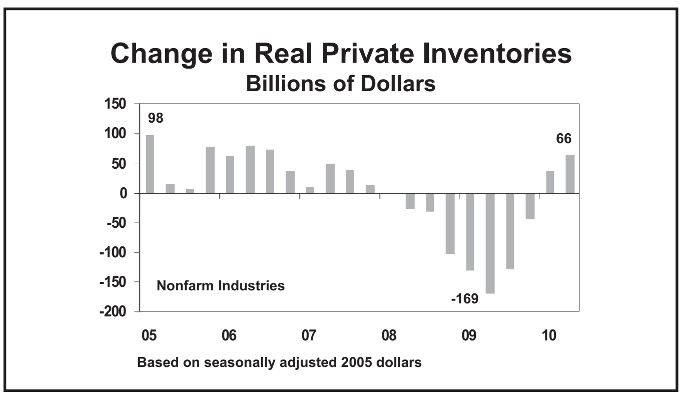

Personal Saving Rate
Percent of Disposable Income
11.5
5.7
4-quarter moving average

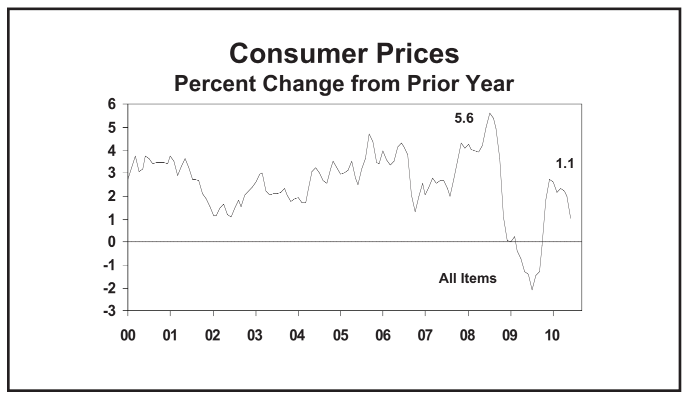

Private Sector Payroll Employment
Millions of Jobs
112
116
108
Seasonally adjusted

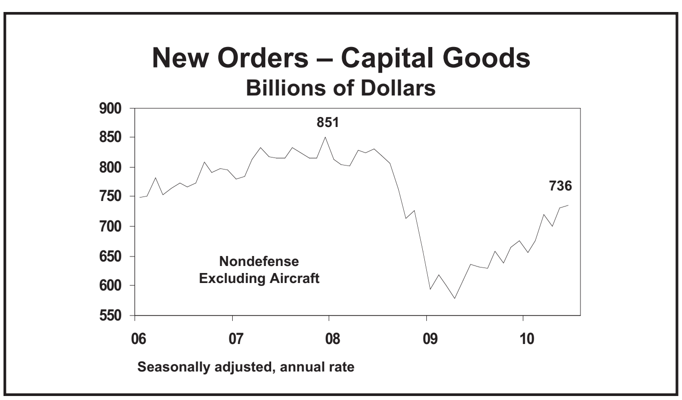

Household Debt
Percent of Disposable Personal Income
122
Quarterly data

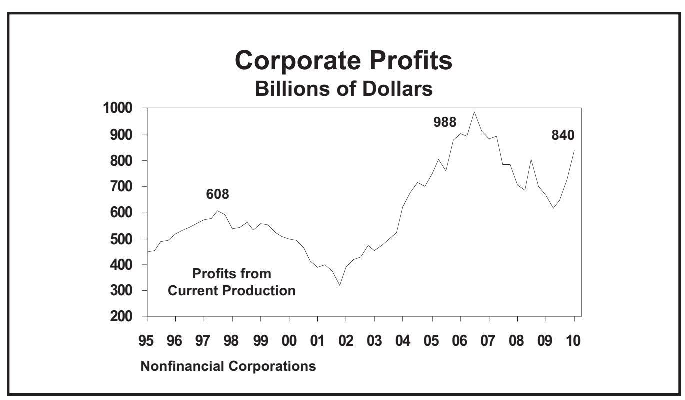

Housing Starts
Millions of Units
2.3
0.5
Seasonally adjusted annual rate


Foreign Trade Balance
Billions of Dollars
-298
Includes Goods and Services
-599
Seasonally adjusted, annual rate


Change in Real Private Inventories
Billions of Dollars
98
66
Nonfarm Industries
-169
Based on seasonally adjusted 2005 dollars


Consumer Prices
Percent Change from Prior Year
5.6
1.1
All Items


New Orders – Capital Goods
Billions of Dollars
851
736
Nondefense
Excluding Aircraft
Seasonally adjusted, annual rate


Corporate Profits
Billions of Dollars
988
840
608
Profits from
Current Production
Nonfinancial Corporations

SMITHFIELD TRUST COMPANY BOOK REVIEWS

The Big Short
By: Michael Lewis

If you share my contempt of Wall Street, The Big Short will reinforce, and even strengthen, your bias. The greed, recklessness and, in the final analysis, stupidity of the Wall Street principals taking advantage of the real estate bubble are nearly unfathomable.

Michael Lewis tells the story of the crash of the real estate markets and mortgage-backed securities through the eyes of the few wise Wall Street outsiders who saw the impending collapse and took advantage of it. This unlikely group of "heroes" did, interestingly, have common characteristics. Each was tough, non conformist, quirky and willing to take on the establishment.

The most fascinating hero is Mike Burry, a one-eyed graduate of UCLA and Vanderbilt Medical School, who became bored with medicine. Burry left medicine and proved to be a successful value investor in the 1990s in the middle of the dot-com bubble. Burry has Asperger's disease, which causes him to look at situations through a different, and arguably better, prism. Through pure tenacity, Burry was able to create a market where it became possible to short credit default swaps – hence, the Big Short. Credit default swaps are, in essence, contracts insuring the pools of mortgage obligations packaged by Wall Street. When the real estate securing the mortgages began to plummet, Burry's shorting of the swaps was prescient.

Michael Lewis, who wrote Liar's Poker, another expose of Wall Street, writes well with humor and great clarity. Unfortunately, The Big Short will add materially to your level of cynicism as you see our government bail out the scoundrels who created the financial mess in the first place.

— Bob Kopf

The Definitive Wit of Winston Churchill
By: Richard M. Langworth

Readers of The Forecast may know that I am a great admirer of Winston Churchill. Part of that admiration stems from Churchill's verbal dexterity or, in the words of Richard Langworth, his "ability to associate words and thoughts in an arresting fashion." The book is cleverly arranged so that Churchill's quotations are assembled, in part, by topics. Some quotes are humorous; some are simply sage observations.

Here are some of my favorites:

- Bernard Shaw: "Am reserving two tickets for you for my premiere. Come and bring a friend – if you have one". WSC: "Impossible to be present for the first performance. Will attend the second -- if there is one."
- Churchill referring to his desertion of the Conservatives for the Liberals in 1904, and returning to the Conservatives again in 1925: "Anyone can rat, but it takes a certain amount of ingenuity to re-rat."
- On Stanley Baldwin: "Occasionally he stumbled over the truth but hastily picked himself up and hurried on as if nothing had happened."
- On Aneurin Bevan: "I should think it was hardly possible to state the opposite of the truth with more precision."

This is a great book to read in snippets or all at once.

— Bob Kopf

Innocent
By: Scott Turow

Scott Turow is, in my opinion, the best of the current crop of mystery/thriller novelists. Perhaps this is because, unlike John Grisham, he doesn't write a new novel every few weeks.

Innocent features a likeable, yet flawed, Rusty Sabich, an appellate court judge whose wife, Barbara, is found dead under odd circumstances. Sabich is indicted for murder by a long-standing rival, District Attorney Tommy Molto. The trial takes some unpredictable twists and turns with a believable ending. Turow's depiction of the characters makes this a worthwhile, yet easy, read.

— Bob Kopf

Citizens of London
By: Lynne Olson

A friend of mine, Mike McCann, recommended this book to me, and I am glad that he did.

Lynne Olson tells the story of how three Americans, Edward R. Morrow, John Gilbert Winant and Averell Harriman, helped to push a reluctant United States into an alliance with Great Britain before the Battle of Britain.

Edward R. Morrow, the head of CBS News in Europe, and John Gilbert Winant, the U.S. Ambassador to Britain, are portrayed as idealistic and effective. Olson shows Harriman in a somewhat less sympathetic light, with Harriman being more ambitious and less intelligent.

The romantic foibles of the three Americans are incredible. Winston Churchill's daughter-in-law, Pamela, had an affair with Harriman and then with Morrow. Winant was romantically involved with Churchill's daughter, Sarah. Olson implies that Winston knew of these affairs but looked the other way to allow the three to induce Roosevelt to support the British.

Well written and researched, Citizens of London is an especially powerful tribute to the English and their American champions during the Battle of Britain.

— Bob Kopf

Open
By: Andre Agassi

Although I am a true tennis fan, I actually did not expect to like this autobiography. I was wrong.

Andre Agassi was raised by a lunatic of a father who drove him to be a star tennis player. Abusive, violent and seemingly without any compassion toward his son, Agassi's father planted the seeds for later social dysfunction in Andre. It is, frankly, astonishing that Agassi did not self destruct.

The stress and level of physical exertion required to play professional tennis come across clearly in the book, and one must admire the successful players for their sacrifices. Andre's relationships with the other players, as well as Brooke Shields and Stefi Graf, are interesting. Not surprisingly, Jimmy Connors is a colossal jerk.

You will, I think, have a heightened sense of empathy for Andre Agassi after reading this.

— Bob Kopf