THE SMITHFIELD Forecast

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For Customers & Friends of
SMITHFIELD TRUST COMPANY

A NOTE FROM THE CHAIRMAN

On behalf of the Smithfield employees and shareholders, I wish all of you a happy, healthy and prosperous 2012. For those of you who are our customers, I hope and anticipate that our emphasis on sound and prudent asset allocations will take care of the prosperity part of the equation.

— Bob Kopf

THE U.S. ECONOMY IN 2012

Fears that the U.S. economy might be headed for another recession have receded in the wake of evidence pointing to sustained economic expansion over the immediate months ahead. But while the recovery does seem to be on firmer ground than it did a few months ago, we do not look for a palpable strengthening of economic activity in 2012. Simply put, the less-than-vigorous expansion that has been under way since the summer of 2009 is, in our opinion, likely to continue for another year. Thus, our forecast for the U. S. economy in 2012 calls for a growth rate – as measured by real GDP – which is only a little stronger than the anemic 1.8% rate now projected for 2011.

Constraints on Growth

Why is the growth of real GDP likely to remain on the weak side for a third straight year? One reason is that even though the recession ended more than two years ago, the negative effects of the debilitating financial crisis of 2008 have not entirely dissipated and, in our view, are likely to restrain economic activity over the coming year. Then too, the rapid – and unsustainable – growth of the federal debt has all but ruled out the adoption of stimulative fiscal actions designed to boost the lackluster rate of GDP growth. Recently, fiscal policy actions are now focused on deficit reduction and the urgent need to put the nation's fiscal house in order. As recent events have shown, however, the implementation of a credible deficit-reduction program requires a considerable degree of political will and courage which, up to now, has been conspicuous by its absence. The failure of the Joint Select Committee on Deficit Reduction (the Super Committee) to reach agreement on a workable deficit reduction plan, while not exactly a surprise, can be seen as a dispiriting example of the extent to which the political system has become polarized – and, it seems, dysfunctional. From our perspective, economic policy decisions are being dictated by rigid political ideologies that are precluding compromises over actions that are needed to put fiscal policy on a responsible and sustainable course over the coming years.

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As the result of the Committee's inability to reach an accord, the Budget Control Act of 2011 requires a cut in spending of, at least, $1.2 trillion over the years between 2013 and 2021. While these cuts have been designated as "across the board," it is important to point out that the Social Security, Medicare and Medicaid programs have been specifically excluded from the Budgetary Act. At first glance, a spending reduction of $1.2 trillion spread over ten years may seem relatively small since it would represent less than 3% of the $44 trillion projected for total federal spending during this ten-year period. However, excluding expenditures on the entitlement programs and net interest payments on the debt, the percentage rises to almost 10%, which could constitute a sizable drag on economic growth.

In our view, the adoption of a fiscal strategy which can address the need to bring down the deficit without increasing the risk of an economic setback may be beyond the reach of the nation's politicians, especially in today's contentious political climate. More specifically, the House and Senate appear deadlocked over questions relating to the extension of the payroll tax reduction which is scheduled to expire at the end of 2011. At the time of writing, the House has rejected the Senate's proposal to extend the tax cut for just two months. At first sight, extension of the tax cut for another year can be seen as a wise and prudent move since it would avert the danger of an excessive dose of fiscal restraint at a time when overall demand is far from robust. However, what might seem to be a relatively easy decision has been complicated by the need to avoid a further enlargement of the nation's already swollen budget deficit. Some way must be found to pay for the tax cut extension before it is likely to win congressional approval. Once again, a deeply divided Congress may find it difficult to reach an accord on matters relating to taxes and spending.

Up to now, the recovery has been held back by weak consumer spending and a severely depressed housing market. And looking ahead, we do not see 2012 as a year in which powerful gains in consumer demand and residential construction will spark a return to a more rapid pace of economic growth. To be sure, many retailers have reported better-than-expected sales on "Black Friday" and have expressed considerable optimism regarding sales during the crucial holiday season. Arguably, however, some part of the recent increase in spending can be attributed to consumers taking advantage of bargain basement pricing in many stores. Be that as it may, we doubt that consumer spending is about to play its traditional role as one of the main engines of economic growth.

Caution of Consumer Spending

To start with – and this makes rather familiar reading – the weak job market argues against an extended period of strong gains in consumer outlays. Even though the employment situation has shown some improvement in recent months, the number of jobholders in the private sector is still almost six million below the peak number registered in early 2008. At the same time, the fiscal problems of government – federal, state and local – are forcing sizable cutbacks in spending – and employment. Much of the recent decline has been concentrated at the state and local government levels where employment has been cut to close to 640,000 since reaching its peak in August 2008.

True, the jobless rate in November fell to 8.6%, down sharply from the 9.0-9.2% range recorded between April and October 2011. But this encouraging decline was primarily the result of a 315,000 person drop in the labor force as opposed to a major increase in employment. In addition to the 13.3 million persons officially counted as unemployed, there are close to ten million jobseekers who are under-employed – involuntarily working part-time – or have given up looking for a job. In total, there are no less than 23 million persons who are either unemployed, under-employed or have given up the possibility of finding work. Furthermore, more than 40% of those officially classified as unemployed have been out of work for more than six months and, as a consequence, risk the loss of job skills and marketability. Insofar as next year's job outlook is concerned, we believe that uncertainty and uneasiness about the economic and political outlook will keep employers in the private sector from adding substantially more workers than they did in 2011. In the pubic sector, the 2012 outlook points to more layoffs, albeit at a slower pace than that reported in 2011. All in all, we look for

monthly gains in nonfarm payroll employment during 2012 to average about 140,000, while the jobless rate is expected to range between 8.7-9.0% during most of the year.

At the same time, recent gains in household income have been barely adequate to support a rising trend of outlays. For all intents and purposes, real household income (after taxes) has been stagnant since the recession ended in mid-2009 and is, in fact, just 2% above the level reached in the third quarter of 2007 – four years ago. In addition, there has been a significant shift in the distribution of income that could well be having a negative impact on spending. According to the Congressional Budget Office, the 1% of the population with the highest income recorded a 275% increase in average real after-tax income between 1979 and 2007. In stark contrast, 60% of the population in the middle of the income scale reported an increase of just under 40% during this same period of time. Another illustration of the increasingly uneven distribution of income was that, between 2005 and 2007, the after-tax income reported by the 20% of the population with the highest income exceeded the income of the remaining 80%.

We also doubt that consumers will resort to large-scale borrowing as a means of boosting spending on goods and services. From all indications, many households are presently more inclined to pay down some of the debts accumulated in the years before the 2008-09 recession than to take on additional debt commitments. Although the financial position of households has improved over the past couple of years, it should be noted that the ratio of debt to disposable personal income is currently 115, down from the peak number of 130 but still well above the average of 73 recorded between 1970 and 2000. Since, in our view, many households are still overloaded with debt, any increase in borrowing over the coming months is likely to remain on a modest scale. Finally, the latest data on household wealth does not augur well for a marked strengthening of consumer demand. As a result of falling house prices and escalating volatility in equity markets, the net worth of households (September 30, 2011) is still some $8.5 trillion below the peak number of $65.9 trillion reached at the end of 2007. From this discussion, it is not surprising that our forecast of real consumer outlays on goods and services in 2012 anticipates a gain of about 2%, representing very little improvement over the tepid increase of 1.8% projected for this year. In a similar vein, we do not see 2012 as a banner year for most retailers. At present, we are forecasting a gain of about 5% in retail sales (ex autos) which would be somewhat less than the 2010-11 estimated increase of 7.5%.

Slow Recovery in Housing

As already noted, the depressed housing market has weighed heavily on the economic recovery. The best that might be said about the current situation is that homebuilding activity has stabilized, albeit at a level which is essentially the lowest recorded in some fifty years. The housing market's persistent failure to recover from the recession – which ended more than two years ago – is attributed to a rather lengthy list of negative factors, notably the large inventory of unsold and foreclosed properties. Even though inventories have been edging downward for quite some time, there are still roughly 3.5 million unsold new and existing houses that are overhanging the market. In addition, there is a distressingly large inventory of foreclosed and distressed properties. According to one reputable study, 3.6 million loans made between 2004 and 2008 are at risk of foreclosure. What this may imply, of course, is that the number of delinquent mortgages may be on the rise over the immediate months ahead.

Yet another constraint on homebuilding activity is the large number of homeowners whose mortgage presently exceeds the market value of their property and are, therefore, unable to purchase a new or existing house. One can also speculate that the housing market is being held back by credit conditions now much tighter than they were before the downturn started in 2007. As if all these negatives were not enough, it is quite likely that the possibility of a further drop in house prices may be acknowledged as something of a deterrent to the purchase of a new or existing home. Against this somber background, we are forecasting that housing starts in 2012 will approximate 675,000, up from this year's 595,000 but, with the exception of the years 2009-2011, the lowest of any year since 1959.

Better Year for Nonresidential Construction?

Although the slump in nonresidential construction has bottomed out, there are few signs that a rebound in activity is close at hand. The magnitude of the downturn in this segment of the economy can be gauged from the fact that current dollar spending is still running some 32% below its 2008 peak rate. As noted, however, the downturn does seem to have ended and we look for a gradual improvement, notably in spending for commercial, education and power projects, during 2012. In total, real outlays on nonresidential structures are forecast to post a moderate increase of about 6% over this year's level of activity.

Positive Outlook for Business Equipment

On a brighter note, business spending for capital goods, which has been a source of strength in the 2011 economy, should continue to move upward during the coming year. The year-over-year increase (ten months 2011 vs. ten months 2010) of 11% in nondefense capital goods (ex aircraft) points to further gains in spending through at least the early months of next year. U.S. corporations clearly have ample internally generated funds available for capital spending. According to the Commerce Department, such funds totaled a record $1.85 billion in the third quarter, which represented a hefty 21% increase over the $1.53 billion reported just two years ago. There is, however, some question as to whether the ability to boost investments outlays will be matched by a willingness to do so. Anecdotal reports suggest that a sizable number of firms will be reluctant to significantly increase outlays on new plant and equipment until such time as they feel more secure about the economic and regulatory outlook than they do today. For now, however, we take a positive view of real equipment spending in 2012 and are forecasting a gain of close to 9% which would follow an estimated increase of 11% in the present year.

No Help from Foreign Trade or Government

Meantime, the severe financial stress that is now affecting all levels of government is likely to preclude any increase in real government outlays over the coming year. Our forecast calls for a 1-2% decline over the present year, which follows a similar drop in 2011. Finally, we doubt that U.S. exports will come to the aid of next year's economic growth rate. Of late, the outlook for U.S. exports in 2012 has dimmed in light of evidence pointing to a recession-like environment in much of Europe and slower economic growth in Asia and Latin America. While U.S. exports on goods and services in 2011 will likely post a solid 20% gain over the prior year, it appears that imports are headed for a very similar percentage increase. As a result, this year's trade deficit will likely approximate the $500 billion reported in 2010. Based on next year's outlook for U.S. exports and imports, we are forecasting another deficit of close to $500 billion, which suggests that the foreign trade balance is unlikely to make much, if any, contribution to next year's growth in real GDP. The overall U.S. economic outlook for 2012, we believe that the odds favor a real growth rate in the vicinity of 2%, which, as already noted, would not be very different from the anticipated 1.8% expected this year.

Threat from Europe

In contrast to the forecast of continued growth for the U.S. economy, much of Europe, which has been in the throes of a sovereign debt crisis, appears to be facing a recession-like environment in 2012. Briefly stated, the crisis had its origins in the inability of Greece to make payments on its enormous government debt. The crisis deepened as the borrowing costs of other countries, notably Spain, Italy and Portugal, climbed sharply in response to fears that they, too, would be unable to meet their financial obligations. And the governments of other countries, including Belgium and France, also experienced a rise in their borrowing costs, as something of a financial panic spread through much of the Euro Zone.

Since many large European – and American – financial institutions held significant quantities of bonds issued by these and other European governments, there were fears of major losses that could spark a global financial crisis. Indeed, there were reports of banks refusing to lend to each other, which raised the specter of another disastrous credit crunch.

To alleviate the financial turmoil in Europe and to prevent it from spreading to the U.S. financial system, the Federal Reserve, acting in concert with other central banks, moved to provide adequate liquidity to the global financial system. The central banks' action took the form of a half percentage point reduction in the rate at which they lend U.S. dollars to banks experiencing a shortage of cash. This activity, which may well have averted a full-blown liquidity crisis, was welcomed by the equity markets as evidenced by the near-500 point surge in the DJIA that followed the official announcement.

That said, central banks are essentially powerless to address the complex and challenging issues related to fiscal policy which precipitated the Euro Zone's sovereign debt crisis. Thus, the European Union Summit meeting on December 9, which produced an agreement among the member states to adopt tighter fiscal policies, has been seen as an initial move toward a European fiscal union, which many observers feel is needed to achieve a lasting resolution of the crisis.

Attainment of a fiscal union, however, may be much easier said than done. Imposing far-reaching programs of fiscal restraint is never easy or straight-forward since they, inevitably, encounter strong opposition from those who, over the years, have benefited from generous increases in a broad array of social welfare programs. After years of excessive, even profligate, spending, the Euro Zone's crisis countries are now having to enact painful programs of fiscal reform – and austerity. One lesson that can be learned from recent events in Europe and elsewhere is that there are well-defined limits to the extent that governments can resort to increased borrowing as a means to maintain their increased spending.

In our judgment, however, the attainment of quick and substantial reductions in the fiscal deficits of heavily indebted countries may be beyond the reach of elected politicians who are sensitive and responsive to the public's mood. In our view, therefore, attainment of a fiscal union in Europe, while a laudable objective, faces some formidable political and economic hurdles that will be difficult to overcome. For example, the adoption of a fiscal union or compact will presumably require the establishment of a supervisory entity to ensure that members adhere to the provisions of the union. What is at issue here is the willingness of countries with democratically elected governments to surrender some of their cherished political and economic sovereignty to some supranational authority. Without over-dramatizing recent events, the future of the Euro Zone hangs in the balance.

Outlook 2012 – Modest Improvement

To sum up. The prospect of limited gains in consumer spending and a very fragile recovery in the housing market points to a less than vigorous expansion over the coming year. The Federal Reserve, we believe, has done all that it can to promote a stronger economic recovery, while the need to put fiscal policy on a sustainable long-term course has, for all practical purposes, eliminated the possibility of stimulative fiscal actions. And we are not persuaded that the agreement reached at the December 9 meeting of European leaders has resolved the financial crisis in Europe, which, in our view, remains a potential threat to the U.S. economic recovery. As we observed at the beginning of this report, next year's real economic growth is not expected to be very different from the 1.8% in sight for 2011. Specifically, we look for a GDP growth rate in the neighborhood of 2.25% and an inflation rate – as measured by the Consumer Price Index – of about 1.5%. Short-term interest rates are expected to remain at their present level through much, if not all, of 2012, while those at the long end of the market are expected to climb about 50 basis points with, for example, the yield on the 10-year Treasury rising to the neighborhood of 2.50% by the end of next year.

Challenging Year for Equities

What might be the implication of this economic scenario for the equity markets? We are guessing – not forecasting – that 2012 may closely resemble the volatile and trendless pattern of equity prices recorded during 2011. Bear in mind, as 2011 draws to a close, the level of equity prices – as measured by the major indices – is essentially the same as it was a year earlier. Giving consideration to the likelihood of a relatively slow year for economic growth, much smaller gains in corporate profits to those reported in 2011, a lingering sovereign debt cri-

sis in Europe and considerable political uncertainty in the U.S., one can, at least, entertain the possibility that, at year end 2012, the DJIA and the S&P 500 may be within a very few percentage points of those reported in December 2011. Once again, we stress that this is a guess not a forecast!

Whatever the economic outlook, we wish all our readers a happy, healthy, prosperous and stress-free year.

— Norman Robertson

The information and data used in the preparation of this report were obtained from public or private sources deemed to be reliable, but Smithfield Trust Company does not guarantee their accuracy. All opinions or predictions expressed herein are subject to change, without notice to the reader, based upon prevailing political, economic or securities markets conditions. The material in this Forecast was prepared in early-December and is based on information available at that time.

SMITHFIELD TRUST COMPANY BOOK REVIEWS

Dreamers of the Day
By: Mary Doria Russell

This novel, set in the early 1920s, tells the story of Agnes Shanklin, a 40 year old schoolteacher from Cleveland, Ohio, who inherits a small fortune allowing her to take a life-changing trip to Egypt and the Holy Land. Now free from her domineering, but now deceased mother, she is on a trip which fosters her personal awakening and causes her to have significant and interesting interactions with Winston Churchill and Lawrence of Arabia.

While I certainly did not dislike this well-written tale, I would categorize this, as what my wife would call, in a non-disparaging way, a "chick" book. Still, there is much to commend here, including the interesting literary trick of having the protagonist speak to the reader as a decedent.

I am curious to see what others think of the novel.

— Bob Kopf

In The Garden of Beasts: Love, Terror, and an American Family in Hitler's Berlin
By: Erik Larson

Here is non-fiction which reads like fiction.

Set in Berlin in 1933, this book chronicles the tour of duty of William E. Dodd, selected by President Franklin D. Roosevelt to be our ambassador to the Third Reich. Dodd, a mild-mannered history professor from Virginia and then Chicago, was appointed after several other choices refused the appointment. Naïve and meek, Dodd brings his wife, son and daughter, Martha, to Berlin, and the ambassador and his family are initially entranced by the Nazis with their desire to revive Germany. Martha is an equal opportunity nymphomaniac politically, since she has multiple and simultaneous affairs with several Nazis, including the first head of the Gestapo, and a Russian Communist. Ambassador Dodd's, and then his family's, enthusiasm for the Nazis soon turned to disillusionment and then horror as Germany quickly became engulfed into unspeakable violence and terror. Dodd's warnings about the Third Reich to the Roosevelt regime were ignored as the Administration engaged in feckless denial.

My only problem with the book is that none of the characters, even Dodd and his family, is particularly appealing. Obviously, the Nazis are abhorrent, but Dodd's naïveté makes it difficult to feel any sympathy for him and his family even after their views on the regime have moved to the proper point of view. I guess I need a book with a hero or two.

— Bob Kopf

Scorpions: The Battles and Triumphs of FDR's Great Supreme Court Justices
By: Noah Feldman

Of the books I am reviewing for this issue of The Forecast, Scorpions is clearly my favorite, but remember that I love historical biographies and note that U.S. Constitutional Law was my favorite course in law school.

Franklin D. Roosevelt appointed four larger-than-life judges, Felix Frankfurter, Robert Jackson, Hugh Black and William O. Douglas, to the U.S. Supreme Court, where they served together from 1941 to 1954. While all four were committed New Dealers and liberals, each developed his own unique judicial philosophy, and these philosophies clashed in material ways which shaped the development of our constitutional law. Frankfurter and Jackson became allies, and Black and Douglas formed a countervailing faction. The personal relations between the two factions became increasingly poisonous – not unlike four scorpions in a bottle. For example, Black was able, single-handedly, to sabotage Jackson's appointment by Roosevelt as Chief Justice.

Jackson, whose luster faded somewhat as the chief prosecutor at the Nuremberg trials, is perhaps my personal favorite of the four, although I may be influenced by his background. Born in Warren County, Pennsylvania (where I was born and raised), he moved to nearby Jamestown, New York, practiced law as a generalist and became involved with the Democratic Party in southwestern New York. My mother (whose father, Will Walker, was the head of the Democratic Party in the county contiguous to Jamestown and undoubtedly an ally of Jackson) knew and respected Jackson.

The venomous interactions between the four justices are fascinating, and the author, who is a professor at Harvard Law School, does an excellent job of explaining how the justices shaped our history.

— Bob Kopf

The Ones Who Hit the Hardest: The Steelers, The Cowboys, The '70s, and The Fight for America's Soul
By: Chad Millerman and Sharon Coyne

Although I like sports, I generally abhor books about sports. On balance, this book passed muster with a few negatives.

The authors show, in convincing fashion, how the Pittsburgh Steelers saved the psyche and boosted the morale of a region severely battered by the decline of the steel industry. The Dallas Cowboys, self-described as America's football team, are the villains here, and they fit that billing quite well.

It is fair, I think, that the authors' failures to examine the Steelers' fourth Super Bowl win and to have an epilogue on the post-football lives of the key players in the creation of the Steelers' dynasty diminish the impact of The Ones to some extent. Moreover, the comparisons of the tribulations of the U.S. Steelworkers' Union executives to the Steelers' key players are certainly strained. But, it is not bad for a sports book.

— Bob Kopf

The Sixth Man
By David Baldacci

If you like the mystery/thriller type of novel, David Baldacci is significantly superior to, say, John Grisham, whose efforts always begin on a strong note and end with a whimpering thud.

In The Sixth Man, Baldacci brings back Sean King and Michelle Maxwell to assist Sean's old friend and mentor, Ted Bergin, an attorney defending an alleged serial killer. When Bergin is murdered at the beginning of the investigation, King and Maxwell pursue the killer in a suspenseful and entertaining manner. The pursuit leads the protagonists into a web of intrigue involving two competing government agencies working at cross purposes.

This well-plotted novel has a surprise ending which I enjoyed but did not anticipate.

— Bob Kopf