

# THE SMITHFIELD Forecast

*A Quarterly Survey of Trends • Ninetieth Edition • January 2023*

## **A NOTE FROM THE CHAIRMAN EMERITUS**

*For Customers & Friends of*  
SMITHFIELD TRUST COMPANY

Defying the conventional economic consensus as he often does quite successfully, Michael Drury predicts in this issue of the Forecast that there will be no recession in the United States in 2023. We will see.

Smithfield conveys its best wishes to you for 2023.

– Bob Kopf

## **SMITHFIELD FIRST QUARTER 2023**

As the New Year begins, more than half of all economists believe that there will be a recession some time in 2023. We do not. We expect real GDP will slow from its current pace of about 2.8% in the second half of 2022 to its long-term trend – which is about 1.5%, based on productivity and population growth – but not a decline for two consecutive quarters. At the core of the consensus' recession call is the view that one should not fight the Fed, and the Federal Reserve has made it clear that they will tighten and remain tight until inflation has subsided to 2%. Most do not expect that before well into 2024. We do not disagree with the Fed call, but another branch of government – the Congress – has just passed another whopping \$1.7 trillion omnibus funding bill, which lifts spending by over 9% for fiscal 2023. Keep in mind, this bill only covers discretionary spending – and the other \$5 trillion in entitlement spending is being lifted by an 8.7% cost of living adjustment. Bottom line, monetary policy may be tight, but federal fiscal policy – which is the source of income for 25% of US GDP, is not. We believe that mix will allow real growth to remain positive, while inflation continues to slow to the Fed's 2% target by late 2023.

Back at the start of the second quarter, we noted that to kill inflation the Federal Reserve would have to lift overnight interest rates above the level of inflation – not trailing inflation, but the rate projected for the year ahead – to generate positive real rates. Otherwise, businesses and consumers would continue to borrow to buy ahead of expected price hikes. At the time, we (and the market) expected that would happen with 3% interest rates some time in early 2023. In fact, inflation raged due to Putin's war, and the Fed responded with far more aggressive monetary policy, lifting rates to 4.25% in December and projecting a rise above 5% in early 2023.

Smithfield Trust Company  
20 Stanwix Street  
Suite 650  
Pittsburgh, PA 15222-4801

412/261-0779  
Fax: 412/261-3482  
[www.smithfieldtrustco.com](http://www.smithfieldtrustco.com)



Meanwhile, the global food and energy shock cooled growth, as consumers scrambled to adjust spending -- and businesses resolved supply chain issues to increase revenues at higher prices. The result of more supply and less demand was a faster than expected reduction in inflation -- with the CPI rising just 1.0% from August through November, a 3.0% annual rate!

The increase in supply is clearly seen in the far stronger than expected results for real GDP in the second half of 2022, with 2.9% growth in the third quarter and an estimated 2.7% by the Atlanta Fed's GDPNow for the fourth quarter. After reducing output to correct inventory issues in the first half of last year, businesses expanded in late 2022 -- because profit margins were healthy. We expect them to continue to maximize profits in 2023 by sustaining output growth, albeit at a more moderate pace. Recessions typically do not start until firms have suffered deep, year-long, losses, leading them to cut costs.

The Federal Reserve (and many private economists) are worried about a wage-price spiral in 2023, which will hurt margins and sustain inflation. However, during the inflation wave of the past two years, businesses steadily raised prices faster than compensation. Add in subdued hiring in late 2022, which helped lift productivity, and the reduction in unit labor costs has protected margins. The reality is that though businesses are paying more for entry-level and lower-skilled employees in America, they have limited compensation for the top of the income ladder (in part, to adjust for work from home) and are paying far less for imported labor because of the strong dollar. That shift is actually concentrating more of aggregate buying power in the hands of those most likely to spend on US goods and services. We have noted many times that from 2000 to 2018 was a glorious time to be

an entrepreneur, because money was cheap, labor readily available, and regulation relatively lax. For the next several years, demographics, immigration policy, and the new cold war with China are likely to keep low end labor markets tight, while real interest rates appear certain to remain in positive territory, even after inflation ebbs.

While many fear the rapid rise in interest rates, we note that since the Great Financial Crisis (GFC) and the huge money drops in 2020 and 2021, most households and businesses have insulated themselves with far stronger balance sheets. Mortgage rates may be north of 6%, but most households are locked in under 3%. The rise in interest rates after the 2008 recession was the slowest in history because back then debt was an enormous problem -- particularly for those with newer mortgages as home values fell. We believe rates are rising rapidly because the Fed has less influence on business activity than in the past.

Similarly, the oil and price shocks that are driving Europe to the brink of recession are not a worry for the US economy, as we are exporters. The rise in global defense spending is also a lift for the US -- as the world's largest exporter of arms (now that Russia is sidelined). In this year's omnibus bill, defense spending was lifted more than 9% and spending for veterans was lifted by 22%. Virtually all of that increase will fuel domestic output. Historically, war has been good for growth -- and bad for inflation, as the central bank often financed the war. Today, higher taxes on US corporations and wealthy individuals have reduced the need for central bank funding, while military exports are rising as the Middle East benefits from rising energy prices. Thus, war still supports growth -- but the shift in financing reduces savings, putting pressure on asset prices, but resulting in less consumer inflation.

Among the strongest calls for recession come from Wall Street equity investors, who are hoping – praying – that the Federal Reserve will not only stop raising interest rates, but pivot to lowering some time during 2023. Their desire is clear in interest rates, as the six-month bill offers the highest rate – and they start down from there. Yet, even after the Fed relents, it is not clear rates will fall much. A 2% inflation target and potential 1.5% growth implies 3.5% long term interest rates if the Fed is not interfering. A 1.5% real return on long-term risk-free investments is a far stronger competitor for equity investors than when they could leverage negative real rates for the decade after the GFC. It was fixed income returns that thrived during the initial retreat of inflation after the Volker squeeze – and foreign equities that benefitted from Reagan's open border laissez-faire approach.

The fact that the US economy has been the cleanest dirty shirt in the hamper over the past year – when Europe was sidelined by Putin and China by COVID – has boosted the US dollar to nosebleed levels. As the rest of the world narrows the interest rate gap as part of their own efforts to quell inflation, the dollar should see the same long trend decline that marked the period from the top of the NASDAQ bubble to the GFC. During that period as Europe consolidated around the Euro and China was the belle of the cheap labor ball, it was commodities and emerging markets that outperformed. In the coming decade it seems clear that Europe will again come together against a common enemy -- Russia, while the emerging markets benefit from the need to shift manufacturing out of China. We would argue that even parts of Europe will improve from a shift in US service employment, as work from home transcends national borders.

Bottom line, a lot has changed in the global outlook for investors over the past three years. A lot of changes that were already underway were exacerbated by COVID, and often blamed on the virus. China was already getting expensive for exporters. Europe became dependent on cheap Russia energy to offset rising domestic production costs. Technology was already reducing the need to hire locally for office jobs. It is unlikely the world will ever return to pre-COVID norms. Thus, investors need to reconsider their options in this brave new world. We find the consensus far too concentrated on the recession view for us to be comfortable. Typically, when businesses have been warned that trouble is brewing many months away, they do something to avoid it. We believe that will be the case in 2023 as well – with better-than-expected growth and less than expected inflation the likely outcome.

– Michael Drury

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## **SMITHFIELD TRUST COMPANY BOOK REVIEWS**

### **CHARLIE BROWN'S AMERICA**

By: Blake Scott Ball

Peanuts was arguably the most successful comic strip of the Twentieth Century. Starting in October 1950, it ran in major newspapers for 50 years. This book traces the evolution of Peanuts through those 50 years, and to some degree also serves as a biography of its creator, Charles Schulz.

Because the characters in Peanuts are all children, many people might consider it to be apolitical. The author shows that this is far from true. Through the use of sample strips as well as correspondence to and from Schulz, he shows how the strip reflected the major political issues of the day. At its inception, America was in the throes of the cold war, and the Peanuts characters reflected that in their concerns about the bomb. Later, prayer in school became a hot issue, and there were numerous strips that depicted this controversy.

As the book progresses, Ball shows how the strip relates to other issues, including civil rights, racial integration, the Vietnam War, environmentalism, and women's rights. Starting in the late 1960s, Peanuts could also be found on television in various hour long specials. The first of these was "A Charlie Brown Christmas" which first aired in 1968. Ball discusses the evolution of these specials also.

For anyone who was a fan of Charlie Brown, Lucy, Linus, Snoopy, and the rest of the Peanuts crew (and who was not a fan?), this book will bring back a lot of memories while providing interesting background on how it all came about. I heartily recommend it.

-- Henry Haller, III

### **STEEL CITY: A STORY OF PITTSBURGH**

By: William J. Miller, Jr.

When I first learned of this book, I thought it was an historical account and was a little disappointed when I realized that it was a novel (not that I have anything against novels) and belongs to that genre known as historical novels. However, when I started to read the book, I was far from disappointed.

Mr. Miller describes the events of the late 19th century in and around Pittsburgh by creating a fictional young man, the son of wealthy parents, who lives in Shadyside and after attending Shadyside Academy and Yale, decides to become a reporter for the Pittsburgh Sun (also fictional although this newspaper did exist but not until many years later), much against his lawyer father's wishes. His father is a partner at Knox & Reed (the predecessor of Reed Smith) and represents Henry Clay Frick.

All the major events of this period are covered, the Johnstown flood, the Battle of Homestead, the bitter fight between Mr. Frick and Andrew Carnegie and the birth of U.S. Steel. Woven around all the excitement is the story of a young man growing up, living on the one hand a life of privilege and on the other pursuing his career as a journalist during interesting times.

The book is an easy read and I highly recommend it.

-- Charlie Gross