THE SMITHFIELD Forecast

A Quarterly Survey of Trends • Sixty Ninth Edition • June 2017

For Customers & Friends of
SMITHFIELD TRUST COMPANY

A NOTE FROM THE CHAIRMAN

Michael Drury and I have been friends for 25 years. An able and articulate economist, Michael has graciously agreed to provide periodic economic commentaries to The Forecast.

Michael began his career at A. Gary Shilling and Company in 1982, subsequently serving as Senior Economist with Allen Sinai at Shearson Lehman Brothers. He then became Chief Economist at McVean Trading and Investments, where he presently serves, in 1992.

Michael is the current Chairman of the Global Interdependence Center, a Philadelphia based nonprofit ("GIC"). GIC brings together renowned academics, business leaders, central bankers and government officials in the promotion of a more integrated global community. GIC hosts 15 to 20 events each year in the United States and around the world.

I hope that your find Michael's first commentary for us to be informative. Since I consider Michael to be an expert on the Chinese economy, I urge you to pay special attention to his observations on China.

There are also a few book reviews in the issue for my dear readers.

— Bob Kopf

THE ECONOMY

As we approach the mid-point of 2017, the global economy is firing on all cylinders with steady economic growth in virtually every region of the world. While the U.S. has been the lead horse - entering its ninth year of expansion - both labor and capital markets are tightening domestically, pushing up interest rates and wage costs and squeezing profit margins. Though we anticipate that the U.S. expansion will continue at the current moderate pace over the next year, multinational firms are likely to expand future production more rapidly in foreign markets where greater slack remains. U.S.

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short-term interest rates will continue to rise in line with the Federal Reserve's stated goal of two more hikes in 2017, holding inflation in check just under 2%. Meanwhile, still easy monetary policy in Europe and Japan, combined with ongoing fiscal stimulus in China, mean solid global demand growth will support a rising tide that raises all boats.

It has taken unprecedented amounts of government aid – which swelled global debt levels – to achieve even these modest rates of expansion. We do not expect central banks or politicians to take away the punch bowl very quickly given the fragility of growth and the simmering anger of the populous with leadership of all stripes. Bottom line, though it has taken years of only gradual improvement, the global economy is now in the sweet spot at the peak of the cycle. The key question now is how quickly will private sector firms take the baton and begin investing in productivity-enhancing technologies to replace governments' borrowing and spending for income maintenance. Actual capital spending – as opposed to plans or survey responses – suggests this process, though positive, will be as disappointing as the expansion has been relative to historic norms. This implies a longer, more slowly developing cycle, which will give firms more time to adapt to rising costs – reducing the chances of a major policy mistake.

Economic cycles are not doomed to die of old age, but as slack dissipates and profit margins narrow, they do become more susceptible to policy mistakes and unanticipated shocks. In the U.S., with 4.4% unemployment and inflation rising to the 2% target, we are the part of the global economy most likely to see profits hit by significant changes from the current status quo in labor and capital markets. Despite discussions of border taxes and tariffs, U.S. borders are still extremely open to international trade. Increasingly, firms will seek to maximize profits by expanding production elsewhere to answer future increases in U.S. demand, which will, in turn, limit the pace of our domestic demand growth.

Recently, expectations of tax cuts, Obamacare reforms and regulatory rollback have all been muted by the turmoil in Washington. Had these promises been rapidly fulfilled, we suspect the economic surge anticipated by the U.S. equity markets would have occurred – leading to faster increases in inflation and interest rates and an earlier denouement to the U.S. and global economic cycles. The tempering in the speed and scale of projected U.S. fiscal stimulus means its positive impulses are more likely to occur later in 2018, just as the current modest pace of Federal Reserve tightening is acting to cool growth and limit inflation. Rather than generating a brief boom, then bust, the new U.S. policy mix may be more boring – but should result in a more sustainable expansion, as during the past six years of government gridlock.

As during the Clinton, Bush and Obama Administrations' first two years, we expect the triumvirate of Presidency, House and Senate will result in some policy progress. In all three cases, the expected loss of majority control at the first mid-term election was an impetus for the ruling party to come to a consensus on new legislation. We expect that the current squabbling will be resolved with a less-than-desired, but still significant, reduction in corporate taxes, curtailing of regulation and reforms to Obamacare. However, these successes are unlikely to impact economic activity or decision making in 2017, and the impact on capital spending will not be felt in the real economy until after the mid-term – though the anticipated benefits will show up in equity markets as passage becomes clear.

U.S. economic growth in the first half of 2017 appears to be growing at a 2.5% annual rate. First quarter growth was recently revised to 1.2%, but the Atlanta Federal Reserve's GDP Nowcast anticipates 3.7% growth in the second quarter. Inventory swings and seasonal adjustment problems are responsible for most of the volatility. Still, the first-half growth pace is a modest improvement on 2016 and exceeds the long expansion's 2.2% average. Traditional early cycle leaders like housing and autos have been losing momentum recently. Late cycle beneficiaries like capital spending and government hiring have been perking up. The transition is far slower than in earlier long cycles as the sheer amount of existing debt has limited the desire of households to augment spending via fresh borrowing - and has prevented the central bank from raising interest rates for fear of sparking a retreat into deflation.

The irony of high debt levels is that they are typically accompanied by exceptionally low rates – how else could one afford it! More and more debt has accumulated slowly over time as inflation and interest rates declined. Moreover, at the end of each economic cycle, nominal rates rose less than the last time because somewhere in the swelling debt pyramid the impact of rising rates caused economic instability. It was the savings and loans that suffered in the late 1980s, Asian borrowers in 1987, technology stocks after Y2K and housing before the Lehman crisis. Since Lehman, Europe has had two episodes of weakness due to Greece in 2010 and 2012, Japan following the 2011 Tsunami and China after its self-imposed corruption campaign in 2014. Existing debt or lack of access to new credit played a role in every tremor. The U.S. Federal Reserve has begun raising interest rates, but far more gradually than in past cycles. They are also talking about reducing their $4.5 trillion balance sheet – but again with an abundance of caution. Bottom line, we expect both inflation and interest rates will continue to trend below the market consensus as debt remains high.

In reality, the U.S. economy has become a sideshow in the recent global economic recovery. Unless unexpectedly rapid passage of new tax policy sparks the slow, but steady, U.S. expansion, the key driver of the current resurgence in global growth will remain fiscal stimulus from China. China was both the cause of the collapse in commodities prices in 2015, as its corruption campaign undermined emerging markets growth, and the source of the EM/commodities rebound as it used central government funds to bail out bad local government debt and funded another round of real-estate-led expansion. The oil industry's collapse, then rebound, in capital investment over the past two years was indicative of the path followed by many commodity producers.

Today, a country's economic growth can be measured by proximity to China. Hong Kong reported its strongest growth in six years in the first quarter. In the same period, Japan grew at a torrid 2.2% annual rate – equivalent to 3.7% growth in the U.S. after adjusting for population growth differentials. Korea is booming despite not having a government until recently. Taiwan grew despite its grievances with the Mainland. The ASEAN is enjoying an export boom to the voracious Middle Kingdom. In Europe, Germany and Northern economies are benefitting from rebounding capital goods exports. For the U.S., the primary effect has been support for the equity market at near record levels despite the fading of the Trump trade. Similarly, the only sign of the China/EM bust in the U.S. during 2014-2015 was the sideways movement for the S&P 500 as a strong dollar hurt the conversion of reported foreign profits.

We expect the Chinese government will continue to support infrastructure-led growth for the remainder of 2017, as they have an important changing of the guard for the Party leadership late in the year and so crave stability. Many are concerned that rapidly rising debt is a precursor to a Lehman like disaster. We have been a regular visitor to China since 2005 and have heard this story for over a decade. The reality is that most of their debt is between government entities or companies that are officially or effectively controlled by the government. Households still have relatively low levels of debt, as does the central government. Moreover, the government has a printing press and virtually all Chinese debt is in yuan between domestic players.

This does not mean there are no problems. Extreme concentration of wealth has exacerbated debt levels as financial intermediation is still in its infancy in China. The purpose of the banking and securities industry is to efficiently reallocate money from those that have it to those than will use it best. Investments could be via equities, but

China's stock market is hardly mature or efficient. Thus, unless the wealthy own everything directly (like Jack Ma), there is going to be a lot of debt. Recently, the government has been encouraging younger party members to lead businesses through private-public partnerships rather than serving in government. In effect, they are filling the swamp by creating a private sector with still significant dependence on government.

One of the most profitable businesses for these still very connected comrades is interest rate arbitrage. Funds can be borrowed directly from the government or depositors at low official rates and re-lent via wealth management products at higher market rates. There are often several layers of debt through a variety of intermediaries before funds get to an actual user. Thus, reported debt levels exaggerate true non-financial sector borrowing. Unfortunately, data quality and accurate market segmentation (many reportedly non-financial companies also lend) make China debt issues quite opaque. There may be a crisis someday, but the Party has a lot of say in when that day will come (it is not a market economy), and it won't come before the Party changeover.

Still, China is coming off the boil as there is no longer a need to stimulate further. Meanwhile, the success in generating another building boom has soaked up low-cost labor and made further foreign investment in China less desirable. The Chinese are responding to rising labor costs and horrible demographics by buying more capital goods from Japan, Korea, Taiwan, Germany and (with a push from Washington) the U.S.. Meanwhile, less costly producers in Mexico and the ASEAN are stealing market share. China is supporting the shift to the ASEAN as they are exporting their considerable experience in infrastructure development via the One Belt, One Road program.

All these developments suggest that global economic output will continue to move to lower cost producers – and that there is plenty of still relatively cheap money to facilitate that process. It is hard to see an imminent and sustainable spike in inflationary pressure with so much liquidity and economic slack still available around the world. We do expect local prices to rise where economies are the hottest. After all, it takes high prices in New York to encourage movement to Cleveland or Memphis. It is when prices are rising even in these lower cost areas that the cycle is most vulnerable. We do not see that happening yet – or until well into 2018. Slow, but steady, development is the most likely path for global growth.

— Michael Drury

SMITHFIELD TRUST COMPANY BOOK REVIEWS

THE SECRET WAR: SPIES, CYPHERS AND GUERRILLAS 1939-1945
By: Max Hastings

A noted historian, Max Hastings, has written a well-researched tome about the espionage efforts before and during World War II by the United States, the Soviet Union, Britain, Germany and Japan. While there are multiple themes throughout the book, the most interesting is that espionage is often overrated. Many intelligence officers are mediocre recruits, and even good intelligence is rejected or overlooked by superiors. Although the spying efforts by the Germans and Soviets often produced good results, the paranoia of Hitler and Stalin caused these results to be ignored or discarded.

The famous British code-breaking of German communications from Bletchley Park is, of course, a positive espionage contribution. Perhaps the most noteworthy and war-changing event was orchestrated by an odd and often-ignored U.S. naval officer named Joseph Rochefort. Studying the Japanese intercepts in June of 1942, Rochefort concluded that the next Japanese attack would take place at Midway. His superiors finally believed him, and U.S. planes sank four Japanese carriers, turning U.S. fortunes in the Pacific.

Alas, despite these nuggets, Hastings' admirable work failed to make a readable book for me. With many characters with funny names (I should talk!) from five different countries, the book had a scattered and somewhat disjointed quality.

— Bob Kopf

KING PHILIP'S WAR: THE HISTORY AND LEGACY OF AMERICA'S FORGOTTEN CONFLICT
By: Eric B. Schultz and Michael J. Tougias

My brother Silas recommended this book to me. It deals with a 17th century conflict about which I knew nothing.

King Philip was the leader of the Wampanoag Indian tribe in New England. His father, Massasoit, negotiated a peace in 1622 with the Pilgrim colonists, and that peace lasted after his death until 1675. In general, the peace disintegrated due to the greed and treachery of the colonists, who gradually took over more and more of the Indian lands. Ultimately, Philip declared war, and the resulting conflict was vicious on both sides, with the highest percentage of civilian and soldier deaths in our history. The conflict winds down in a grisly fashion with the colonial soldiers killing King Philip and parading through Plymouth Colony with his head on a pike.

I wish that we knew more about the character and personality of Philip, but that defect is hardly the fault of the authors. The diary of Mary Rowlandson, a colonist kidnapped by the Indians, does indicate that Philip treated her with kindness and dignity.

The book is oddly structured. The first and third parts chronicle the war and all its horrors, while the middle details information about battles and related sites. I submit that the middle can be skipped unless you are a New Englander.

I am happy to loan the book to an interested reader.

— Bob Kopf

HILLBILLY ELEGY
By: J. D. Vance

As many of my dear readers know, I am not normally apt to focus my attention on bestsellers. I am glad I made an exception in this case.

Hillbilly Elegy tells two parallel and intertwined tales. The first is about the author's formative years in Appalachia – first in Kentucky and secondly in Middletown, Ohio. The other is a sociological analysis of the horrible dysfunction and hopelessness of the white lower class in Appalachia. Both tales are thought provoking, sometimes funny and often disturbing.

J. D. Vance, still a self-professed hillbilly, escaped poverty and an environment of drug addiction and alcoholism ultimately to graduate from Yale Law School. His grandmother, who is beyond belief in a good sense, and a female Yale Law Professor are two people Vance credits with his inspiring (but not arrogantly described) ascendancy.

On the sociological front, he does not purport to have all the answers to move white Appalachia out of its rot, and you may find some of his observations to be offensive.

This is a highly readable and important book.

— Bob Kopf

DESTINY OF THE REPUBLIC
By: Candice Millard

Simply put, this is a splendid book, chronicling the life and assassination of President James A. Garfield in 1881 at age 49, describing his demented assassin, Charles Guiteau, and reflecting the incompetent efforts of Garfield's physicians to save his life.

James Garfield was born in rural Ohio in dire poverty. With a clear focus on self-improvement through hard work and education, he became a member of Congress and then a reluctant, yet successful, candidate for President. Garfield was articulate, intelligent and had a clear vision for our country. If he had lived, one can wonder if he could have healed our deep divisions arising out of the Civil War. Although he was an ardent abolitionist, Garfield did not seem to generate fierce antagonisms from the South. Here, in his own words, is Garfield's view of, or at least his vision for, our society:

> "There is no horizontal stratification of society in this country like the rocks in the earth, that hold one class down below forevermore, and let another come to the surface to stay there forever. Our stratification is like the ocean where every individual drop is free to move, and where from the sternest depths of the mighty deep any drop may come up to glitter on the highest wave that rolls."

From the sublime to the ridiculous, the author moves to Charles Guiteau. How such a depraved and pathetic person could have unfettered access to the President is inconceivable in light of Lincoln's murder, yet we had not then learned of the need to protect the Chief Executive.

Perhaps the most maddening message of the book is Candice Millard's conclusion that Garfield's doctors killed him. Though he lingered months after he was shot, Garfield was treated by surgeons – chiefly Willard Bliss – who did not believe, unlike their more advanced European counterparts led by Joseph Lister, in germs and the need for sterilization. Bliss repeatedly inserted his dirty fingers into Garfield's wound in search of Guiteau's bullet. As one observer noted, "ignorance is, indeed, Bliss."

All in all, this is a fascinating portrait of an obscure President who was denied greatness by a lunatic and medical malpractice.

— Bob Kopf

TEN RESTAURANTS THAT CHANGED AMERICA
By: Paul Freedman

This book, albeit perhaps of more interest to the foodies among us, is an interesting description, not only for the 10 featured restaurants, but also about our culinary history since the mid-19th century.

For instance, do you know that McDonalds, and all the other large hamburger chains, came to us from White Castle (how many of us remember them?) by way of Howard Johnsons? Or, why Coney Island hotdogs are so named? Or why French food defined the best of American restaurants for 150 years, but doesn't today?

Thus, Freedman's book is far richer, I think, than just his descriptions of his ten restaurants. He starts with New York's Delmonico's back in the 19th century and concludes with Alice Waters' Chez Panisse in Oakland, California. Only Sylvia's (New York City), Antoine's (New Orleans) and Chez Pantisse remain open, but all of us will remember HoJos and, maybe, Schrafft's. This is a rich book, not only for those interested in food, but also a history of dining in America.

— Tim Merrill

WITNESS TO THE REVOLUTION
By: Clara Bingham

For anyone who lived through the 60s, this book will bring back a lot of memories. It covers the period starting with Woodstock in 1969 through September of 1970. This period marked the peak of violence and protests from that turbulent period. The anti-war protests and the civil rights movement were both regularly in the headlines at that time. What I found particularly interesting is that she presents this history in documentary form, based on interviews with many of the people who were involved in the events of that time. The book consists of a series of excerpts from those interviews. We hear from Bill Ayers, Bernardine Dorn, Daniel Ellsberg, Jane Fonda, Timothy Leary and other radicals of that era. We also hear from a couple of the students who were wounded at Kent State, from a couple of police officers and an FBI agent, as well as a few staffers from the Nixon White House.

The media today tells us that the country is extremely polarized politically. This book reminds us that this degree of polarization (or worse) existed 50 years ago. We survived that, and, hopefully, we can survive today's as well.

— Henry Haller III