THE SMITHFIELD Forecast

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For Customers & Friends of
SMITHFIELD TRUST COMPANY

A NOTE FROM THE CHAIRMAN

Our dear readers should note our second installment of wisdom from Michael Drury in this issue of The Forecast. I hope all of you are having an enjoyable summer.

— Bob Kopf

SMITHFIELD QUARTERLY ECONOMIC ANALYSIS

The return to work after Labor Day marks the beginning of the new business year for many companies as they take stock of their situation and plan new strategies for 2018. For most firms, the outlook for next year is likely to look a lot like for every year in the post-Lehman period. Even as we plod through a ninth year of economic expansion with between 2% and 2.5% real GDP growth, there is little reason to suspect that it will accelerate into a boom or subside into recession. The US economy has achieved remarkable, if boring, stability with little volatility in real economic growth, inflation, wages rates, productivity or profits. Businesses are already well prepared for the well signaled likelihood that the Federal Reserve will continue to modestly raise interest rates. Meanwhile, while many remain hopeful, expectation that tax reform will be passed before year end have waned – and tax code changes are unlikely to be a basis for 2018 business strategies. With no significant policy changes in the US, unexpected volatility is most likely to come from events in the rest of the world, primarily transmitted through both the value of the dollar and commodity prices – but with the risk of a black swan event, like the rising tensions over nuclear weapons with North Korea.

Our most strongly held conviction about the global economy currently is that, in the absence of policy developments in the US and Europe, it is the credit tightening in China that dominates the future of the world's economic outlook. China is a heavily industrial economy with a short and violent cycle that takes actual (as opposed to reported) growth from 3% to 9% and back over three to four year periods. It operates much like the US economy did at the same stage of development in the early 1900s. China's growth rate bottomed in late 2015 and appears to have peaked in early 2017. We view the Chinese economy now like the front car of a roller coaster -- already hanging down over the peak of the summit. The descent will gain speed in 2018 as more of their still improving, but lagging, sectors feel the downward drag from growing credit restriction on the leading edge of their economy.

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Policy stimulus across the developed economies remains moribund. In the US, the Federal Reserve is effectively on hold, awaiting some signs that inflation is accelerating -- and a new leader. It is widely accepted that the first already announced moves to modestly reduce the balance sheet will come in September and another interest rate hike is due in December – maybe. The continued downside surprises on inflation through mid-2017 (after the 2016 recovery in oil prices ended) have many on the FOMC frankly confused. With wages still stuck at a 2.5% annual growth rate despite a historically low 4.4% unemployment rate, many Fed watchers are worried that their models are no longer effective. It appears that Fed Chair Janet Yellen's voice remains loudest, calling for another hike in December as the maintaining of the status quo while they await more evidence on what is really happening with inflation dynamics. Meanwhile, speculation about her possible replacement has hit a speed bump as National Economic Director Gary Cohn's criticism of President Trump after Charlottesville leaves the field wide open – including the possibility that Chair Yellen is reappointed.

In Europe, ECB President Mario Draghi is waffling on when accommodation will be removed despite the best performance in the European economy in years. Bottom line, he is charged to maintain stable inflation and, while the risk of deflation is fading, there is no momentum toward higher prices to fight. Meanwhile, German Chancellor Angela Merkel appears on her way to another term in Germany, but her young partner in France is slipping badly in recent polls. Meanwhile, the UK remains mired in the growing reality that Brexit was a bad idea and that they still have no plan.

In Asia, concerns are now more about North Korea than economic. Japan posted stellar 4.0% growth in the second quarter – but still had no inflation – and the 2.1% growth over the past year was mostly driven by trade – which is driven by China. For the still debt fueled emerging markets, the strongest correlation for growth is with Chinese broad money supply. Meanwhile, China announced a record low 9.2% annual growth rate for M2 in July. As a result, the growth rate for home prices in tier one cities – the leading edge of China's cycle – has been falling since the start of the year.

A slowing China has strong ramifications for Europe and Japan, which both appear near the top of their economic cycle. Both are growing at 2.1% annual rates over the past four quarters, just slightly softer than the US. However, because population growth is much slower in Europe – and more so in Japan - both are growing far faster than the US in per capita terms. These capital goods exporters have benefitted from both the US and China reaching full capacity. If China now fades and the US just trundles along, Europe and Japan will both likely slow to below their 1.0% potential growth rates.

While we anticipate that China will slow toward 3% by the end of 2018, the US should remain near its 2.2% trend. We expect the impact will be, primarily, on commodity producers in the emerging markets and capital goods exporters in European and Asia. The US economy's exposure to China is small outside of potentially weaker prices for oil and agriculture products. Meanwhile, the benefits of imported deflation may temper expected Federal Reserve tightening. If our outlook for the rest of 2017 and 2018 sounds a lot like late 2014 leading into 2015, it should. That is the model we are working off. More disappointing, but steady US growth – but with growing risk of a global slowdown.

— Michael Drury

SMITHFIELD TRUST COMPANY BOOK REVIEW

DEAD WAKE
By: Erik Larson

This is the story of the sinking of the luxury British ocean liner, the Lusitania, at the beginning of World War I by a German U-boat in the North Atlantic. Erik Larson is a master storyteller, and he generally succeeds in capturing the personalities on the liner, strange amorality of Walter Schwieger, the German submarine captain, and the carnage and horror of the drowning of over 1,000 passengers.

For me, however, the book falls short as a result of Larson's desire to create a more compelling tale out of a singular event. In doing so, he arguably plays fast and loose with the facts. He makes the reader draw the conclusion that the sinking of the Lusitania, with many American passengers coming from New York to Liverpool, was the primary reason that President Woodrow Wilson decided to have the United States enter the war against the Germans. If this is so, why did the United States wait two years to join the fray?

Larson also promotes the suggestion that Winston Churchill, as First Lord of the British Admiralty in 1915, deliberately left the Lusitania unprotected by the Royal Navy. I asked my good friend Paul Reid, author of the final volume of the "Last Lion" biography of Winston Churchill, about Larson's indictment of Churchill. Paul regards this theory as preposterous, citing the constraints imposed on Churchill as First Lord and the unlucky and bizarre timing of the Lusitania's crossing. Paul looks at Larson as a gifted teller of stories, rather than a credible historian. So do I.

— Bob Kopf