

# THE SMITHFIELD Forecast

*A Quarterly Survey of Trends • Seventy Second Edition • April 2018*

*For Customers & Friends of*  
SMITHFIELD TRUST COMPANY

## **A NOTE FROM THE CHAIRMAN**

In the last issue of The Forecast published in January, I suggested that volatility in the equity markets might accelerate. That suggestion was certainly understated. Although I am clearly not Nostradamus, I am reluctant to make any new negative predictions on the off chance that they might prove to be true. As an alternative, I will simply wish all our dear readers a very pleasant and happy late spring.

— Bob Kopf

## **SECOND QUARTER ECONOMIC MUSINGS**

As the US economy starts the second quarter the markets see a competition between the good news about deregulation, repatriation, tax cuts and spending stimulus against the bad news of trade wars. In our view this is no contest. The stimulus from tax cuts and the recently passed spending bill are several hundred billion. All the tariffs proposed so far are less than \$40 billion and they are being reduced as negotiations with NAFTA partners, Europe and others proceed. Even the Chinese trade restrictions are about tariffs of 25% on \$50 billion of goods (\$12.5 billion), not tariffs of \$50 billion – a critical distinction.

In our view, the new \$1.3 trillion spending bill is a game changer – because it will supercharge the potential of the tax cuts. As a result of the two, we expect US GDP will be growing at least 3.5% over the year, rather than the bland 2.2% path expected before this legislation. Inflation is sure to breach the FOMC's 2% goal, lifting nominal GDP to 6%. In the short run, that kind of growth is self-reinforcing and covers a host of sins – including trade wars. Eventually, tighter monetary policy will rein in the exuberance, but that will take at least four hikes this year and the threat of at least that many next year – even if they never occur. We sympathize with those who see this stimulus as unnecessary at the top of an economic cycle – but this is not a question of right or wrong as much as IS! There will be a period of very strong (maybe even exceptionally strong) growth before higher rates and inflation end the cycle. It is far too early to call the next recession. First, we must try and estimate how high this tide will be.

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Even before the tax cuts and spending hikes, the economy was grinding higher. Productivity growth improved to a tepid 1.5% annual rate over the past six quarters, which when combined with 0.7% population growth generated a 2.2% potential. The economy was growing right at potential, so there was little price pressure even though we had achieved full employment. That boring steady state was likely sustainable for many more quarters.

The tax cuts injected a new motive for businesses to expand the economy, as increased earnings (along with expensing) would incentivize capital spending. However, history strongly suggested a substantial part of corporate gains would go for stock buybacks, dividends, mergers & acquisitions, or to pay down debt. Even if it hit the real economy, it did not have to be in the US. Despite lower tax rates, the US is still less attractive than the emerging markets for investment. We estimated that the \$1.5 trillion in tax cuts over ten years would produce \$300 billion in freed income in 2018. However, we expected only one third would actually find its way into the real economy, lifting growth by 0.5% to a 2.7% pace in 2018.

The new spending bill changes our outlook dramatically, as the \$150 billion hike in outlays will be spent, spent quickly -- and almost entirely in the US. Where the tax cuts provided motive, the spending hikes create opportunity -- and we expect action is imminent. These higher appropriations are for FY2018, which has only six months to run. They equal 0.75% of GDP and would lift growth by 1.0% at an annual rate over the next three quarters, before fading into 2019. The focus on defense, infrastructure, veterans, and border protection means there will be little import penetration. Bottom line, tax cuts plus spending hikes suggest 3.7% growth in Q2 through Q4 of 2018.

A soft first quarter indicates that it is just too early for the effects of the tax cuts and spending hikes to be reflected in economic data. Households didn't see more money in

their paychecks until mid-February. Corporations are playing wait and see, especially if they are multinationals who might be impacted by NAFTA and recent trade measures. We hope those clouds will clear with major announcement from both the US and China in early April. While the financial markets gyrate on every announcement, CEOs take much longer to act. As we often say, no one runs into a dark room fast.

Our big question now is not how much trade wars hurt -- but rather how much of a piling on effect we will get as consumers and businesses watch the government surge in spending lift demand for scarce resources and labor -- raising prices, wages and profits. At the start of every cycle, it is the expansion of the federal deficit that lights the spark of recovery. Typically, that happens with little inflation as there is plenty of excess capacity. This time, the private sector will have to compete with government spending, which is not focused on profits, in already tight markets. Real GDP growth could exceed 4%, but with more inflation and higher interest rates. The big question is how long businesses and consumers who just received a tax cut will keep spending because they feel optimistic.

The counterfactual is that a full blown trade war might dampen the budding boom we expect in the economy. We do not believe it could blunt the impact of so much stimulus. Indeed, small businesses, who deal less internationally, are already ramping up activity. Still, uncertainty about international supply chains could slow the pace of capital investment and limit the piling on effect. That would generate less pronounced economic improvement -- and also less inflation and interest rate hikes -- stretching the duration of this cycle well into 2019.

Bottom line, we believe that the US is embarking on an experiment to see how long we can run our economy in the red. Even at full capacity, higher profits and wages can lead to overutilization of capital and labor for a while. What is

the top end for the economy and how long will it last? What will the backside look like – a blown engine or just a retreat to normalcy? And will we learn new lessons while at the red line that enable better growth policies in the future? We are just starting the acceleration phase now, so strap in. I expect many will be surprised at how fast we can go – for a while. Stay tuned.

— Michael Drury

## **SMITHFIELD TRUST COMPANY BOOK REVIEWS**

### **THE GENERALS**

By: *Winston Groom*

Author Winston Groom's book, *The Generals*, opens up to the reader the life and times of the U.S. army's three greatest generals. Educated to be military leaders, Douglas MacArthur and George Marshall – West Point, and George Patton – VMI, spent their lives in the service of their country. Groom follows each of these men's involvement in WWI through WWII, emphasizing the qualities that made them great: Patton's daring feats while developing advanced tank warfare concepts, MacArthur directing the army in battles dominated by navy forces, and Marshall the brilliant planner and administrator, who was too valuable to be put in harm's way.

Besides the vivid battle descriptions of WWI and II, Groom relates the "between the wars" lives of these mid-ranked officers in the command structure of a sham army itching for action in a yet undeclared war.

This is a fast read about true American heroes with colorful insights into their lives, including Patton's strong sense of reincarnation. Although difficult to command, these three generals proved indispensable to winning the war, and Groom shares with us the road to their success.

— Dave Genter

### **ONCE WE WERE BROTHERS**

By: *Ronald H. Bolson*

This is a compelling story about the holocaust in Poland in WWII. A wealthy Chicago businessman/philanthropist (Elliott Rosenzweig) is attending the gala opening of the Lyric Opera. He is confronted by a pistol-waving man (Ben Solomon), who accuses him of being a former Nazi named Piatek Rosenzweig and shows him a tattoo on his arm from a concentration camp. Solomon is quickly disarmed, as the pistol is not loaded. Rosenzweig tells the police not to send Solomon to jail as he has suffered enough from the war.

A private investigator (Liam Taggart) calls an old friend (Catherine Lockhart), a lawyer in a large Chicago law firm, and asks if she would talk to Solomon. She reluctantly agrees to do so. Solomon wants to sue Rosenzweig for the recovery of property stolen by Piatek from the Solomon family. She will have nothing to do with that, but agrees to talk to him. This begins a long series of interviews in which he describes the travails of Jews in Poland during the war.

Piatek and Ben had been raised by the Solomons as though they were brothers. Piatek's parents were German and had abandoned him. However, after Poland had been overrun by Germany, they come back to Poland to retrieve their son, who does not want to leave. His mother is now a high official in the Nazi party and tells them their son must leave and the Solomons should escape from Poland. She knows what is coming.

Piatek leaves with his parents, reluctantly, and becomes a Nazi officer. He occasionally helps the Solomons as long as he isn't endangered himself. Things go from bad to worse. Papa Solomon is shot by Piatek and Ben is sent to a concentration camp where he is eventually rescued by the Russians.

Gradually we come to believe Solomon's story. How will it all turn out? I won't spoil the story by telling you the ending. You can find out for yourself.

— Bob Patton

## **POLITICAL TRIBES**

*By: Amy Chua*

The internal dynamics in countries can often be understood through consideration of the ethnic and political "tribes" within the country. However, this is largely ignored by our political leaders, according to author Amy Chua, which results in dramatic failures in foreign policy. She explains how this has occurred in Vietnam, in Iraq, in Afghanistan, and in Venezuela. What I found most interesting though was her discussion of the politics in this country, and in particular the surprising victory of Donald Trump in the 2016 Presidential election. Although this took our governing elite by surprise, Ms. Chua explains that a consideration of the "tribe" of white working class Americans makes this outcome quite understandable.

— Henry Haller, III

## **BECOMING LEONDARDO**

*By: Mike Lankford*

There are two biographies of Leonardo da Vinci in current circulation. One is by the well-known biographer Walter Isaacson, and the other by Mike Lankford. Several of my friends opted for the Isaacson version, and I chose Mike Lankford's. Having heard my friends use the adjective "tedious" in describing Isaacson's tome, I think that I made the correct choice.

A renowned artist, scientist and musician, da Vinci was a late bloomer, born in 1452 out of wedlock. His mother was quite possibly a slave, and because of his modest beginnings, little is known of the young da Vinci. While the author fills in the gaps with speculation, the speculation seems reasonable to me. I normally do not like Lankford's style of writing, since he uses great slang-filled prose with, as I have said, heavy doses of speculation. Yet, for some totally unexplainable reason, Lankford's writing resonates with me. He really does seem to understand Leonardo.

While acknowledging da Vinci's genius, Lankford does not put Leonardo on a pedestal. Da Vinci's maddening inability to finish projects, his development of instruments of war despite his pacifism, and his focus on self-preservation at the expense of others are all profiled interestingly in the book.

I hope that Mike Lankford's quirky and non-scholarly profile of one of history's great geniuses works as well for you as it does for me.

— Bob Kopf

## **ARTHUR VANDENBERG: THE MAN IN THE MIDDLE OF THE AMERICAN CENTURY**

*By: Hendrik Meijer*

Born in 1884 and first seated as a Republican Senator from Michigan in 1928, Arthur H. Vandenberg was arguably the most influential U.S. senator in the last century with the possible exception of Lyndon B. Johnson. Initially a mid-western isolationist, Vandenberg eventually embraced an internationalist foreign policy, crafting a bipartisan approach to foreign policy with Presidents Franklin Roosevelt and Harry Truman. Most historians now credit the bold Marshall Plan advanced by Truman as saving Western Europe from the scourge of Communism. Without Arthur Vandenberg there would have been no Marshall Plan, as this book so vividly and objectively documents. Vandenberg also had an enormous role in the creation of NATO.

While Vandenberg did put the common good of the country ahead of his partisan interests, he was far from perfect. He had an affair with Mitzi Sims, the wife of a British diplomat, and this tryst harmed his marriage for some time and probably led Vandenberg to abandon his presidential ambitions.

Hendrik Meijer has given us a well-written biography of an interesting man in an interesting time. One can long for the emergence of some Vandenbergs in our current political environment.

— Bob Kopf

## A COLUMN OF FIRE

By: *Ken Follett*

A friend of mine persuaded me to step aside from my normal reading of historical biographies to fiction, although his recommended fiction is, at least in part, based on fact.

“A Column of Fire” is the third volume in Ken Follett’s “Kingsbridge” trilogy. Beginning in 1558 and set in England, Scotland, France, Spain and the Netherlands, the book moves beyond the Middle Ages to Elizabethan England. Two families, the Willards and the Fitzgeralds, are the central characters in the novel, which highlights the fierce antagonisms between the Catholics and Protestants in England and France. The most appealing characters are those espousing religious tolerance. The villains, who are wonderfully bad, are religious extremists.

Ned Willard, a moderate Protestant whose family loses everything by reason of Catholic extremism, becomes a devoted aide to Queen Elizabeth. The love of Ned’s life, Margery, is a deeply religious yet tolerant Catholic who has an intriguing journey. Pierre Aumande, an advisor to the French royalty, commits atrocity after atrocity to enhance his standing with the royal family.

Follett does an excellent job of character presentations, and the interactions of real and fictional parties are cleverly done. The plots and subplots are easy to follow, and the storytelling is eminently worthwhile. A word of warning: “A Column of Fire” is very, very long.

— Bob Kopf