

THE SMITHFIELD Forecast

A Quarterly Survey of Trends • Seventy Eighth Edition • October 2019

For Customers & Friends of
SMITHFIELD TRUST COMPANY

A NOTE FROM THE CHAIRMAN

Having spent two enjoyable weeks in Idaho on vacation, I am now back at Smithfield for the balance of 2019.

A confession is in order. During those two weeks of vacation I paid scant attention to the vagaries of the bond and stock markets, missing absolutely nothing. There is a lesson in this for all of us. Instead of experiencing the euphoria and despair emanating from the rise and fall of the markets, adopt a sound asset allocation policy consistent with your needs, desires and, yes, risk tolerances. Such a policy (developed in consultation with us if you are a customer) will then steady you through market cycles, allowing you to focus on the important aspects of life like family, friends and hobbies, possibly even including Idaho trout fishing.

— Bob Kopf

SMITHFIELD FOURTH QUARTER OUTLOOK

The longest and slowest US expansion in history appears set to continue to expand at its modest 2% trend pace for another quarter, and indeed into 2020 – even as manufacturing growth in the rest of the world battles with recession. The primary cause of the global weakness is the trade war between the US and China, which started over 18 months ago, but erupted last September with the unexpected levy of 10% tariffs on \$200 billion in Chinese exports to the US. The shock of the September announcement led to the deepest sell-off in US equity markets so far in this cycle, hitting bottom on Christmas Eve 2018. But that was nine months ago, and since then much has changed. Firms are no longer in trade paralysis. They are making decisions on how to rebuild their supply chains to deal with a permanently altered tariff world – either by leaving China, or by doubling down on manufacturing there for the Chinese domestic market. It is uncertainty that hurts markets – not unhappiness. Firms may not like the new tariff environment, but they are adapting – and those that adjust fastest will survive and thrive. As the old saying goes -- you don't have to outrun the lion, just the slowest member of the herd.

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We watch Washington closely because policy shifts matter. It mattered when President Trump was elected and shifted to a pro-business stance of deregulation, which helped boost business confidence and hiring. It mattered when he allowed expensing of equipment and advocated for deep corporate tax cuts – which sparked a boom in capital investment and lifted GDP growth over 3% for a year. It mattered when the Federal Reserve steadily raised rates to counter the fiscal stimulus coming at the top of an economic cycle. And it mattered when the trade war started in early 2018, exacerbating the drag on the economy from rising interest rates and energy costs. By late 2018, the burden of 2.5% short term interest rates, \$75 crude oil and a rising tax from tariffs cooled corporate optimism and the economy slowed to near its 2% trend growth rate. To forestall a deeper slowdown, the Federal Reserve has reversed course and lowered short term rates twice to between 1.75% and 2%. Oil prices fell sharply to \$51 in early August before the recent attacks on Saudi Arabia put in a risk premium. Tariffs now stand at 25% on \$250 billion of Chinese exports, but half of the latest 10% on \$300 billion has been delayed during new negotiations.

We expect trend growth in the US because we don't see much more room for new policy adjustments in an election year. Nor do we expect much help from monetary or fiscal policy developments in the rest of the world. Though the Federal Reserve has lowered rates twice, they currently have two dissents from FOMC members who want rates higher and another from one who wants them lower. Meanwhile, the Fed has been pouring money into the overnight markets to push rates lower as a liquidity squeeze spiked borrowing costs around a tax payment date. This suggests that the \$3.5 trillion balance sheet will not be reduced much further, as banks now have far greater need for liquidity than in the pre-Lehman world. That takes one potential tightening tool off the board. Meanwhile, rising labor costs, Saudi oil risks and a return of medical care price hikes all have renewed concerns about inflation,

which reduces the Fed's room for future ease. Bottom line, monetary policy – which has been the workhorse of this long slow expansion – may have reached its limit, here and abroad. Interest rates are already negative in Europe, and China's last bold monetary easing was by 5 basis points. As many have been preaching for some time, it may be up to fiscal policy to lift economies that are threatened by recession.

Unfortunately, the outlook for robust fiscal stimulus is not apparent either. True, the Trump Administration is talking about new tax relief, but they no longer have a majority in both houses of Congress. An indexation of capital gains is possible without Congressional approval (maybe), but that is a modest boost at best. Internationally, Europe continues to refuse to consider fiscal stimulus, despite the election of Madame Lagarde – long a fiscal stimulus advocate – as the new head of the European Central Bank. The fiscal Scrooge is Germany, despite the fact that their manufacturing sector is currently the most troubled. Though their economy appears to be on the cusp of or actually in recession, we have been frequently reminded recently that the German words for debt and shame are the same.

China has been the greatest source of global fiscal ease recently with substantial tax cuts for business and consumers, a significant reduction in red tape and greater access to credit to help take advantage of tax savings. However, the external burden of higher tariffs and a rethinking of long run China investment strategies has limited their recovery from the 2018 downturn. We do believe China is turning around, with some lift there since February. Still, even they do not think it is enough as they recently announced a new \$100 billion a year residential retrofitting project. They are likely to inject more stimulus to get their economy back to their earlier 6% trend in time for their centennial celebrations in 2021.

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A stronger China is essential to global growth as it drives the ups and downs of the emerging markets cycle. A substantial reason China has survived the trade war so far is through lower commodity costs from emerging markets. For example, as an importer of 10 million barrels of oil a day, the \$20 drop in prices has allowed China to effectively export about \$75 billion of the tariff burden to OPEC. Similarly, their huge \$3 trillion of foreign exchange reserves plus \$1 trillion sovereign wealth fund have appreciated in dollars due to lower interest rates, higher equity prices and a weaker yuan. So lower costs and higher asset values are helping China survive, just like US firms. China's recent modest improvement from ongoing domestic stimulus makes it less likely they will cave in on a broad trade deal involving thorny items, like intellectual property – suggesting that an agreement where they purchase US agriculture and energy goods in return for no more tariffs may be the best deal that will actually be considered.

For investors, the goal now is less to chase advantages created by new policies, but rather to find firms that will squeeze the most out of the more stable policy environment globally. Right now, most corporate leaders are fighting a three front war: with investors who demand both return and stability in an increasingly low yield and volatile world; with employees, who have become more demanding through both wage demands and strike activity than any time since Reagan took office; and with both consumers and governments that want social value along with their goods and services. The result has been very little profit growth over the past five years, with the greatest return to firms coming from asset appreciation due to low alternative yields on interest rates and, hence, higher price/earnings ratios.

Though policy can temporarily lift or reduce growth, right now the trend is the investor's best friend as population growth and productivity still produce steady positive returns – 2% real growth for the US and 3% for the world. Though the US has been enjoying trend growth over the past four quarters (2.1% through third quarter based on average of Atlanta Fed GDPNow and NY Fed Nowcast), there has been a fear of recession – largely based on the assumption that the cycle must eventually end. Rather, we see a number of manufacturing-oriented indicators suggesting that the worst of the trade war is in the rear-view mirror. Philadelphia Fed new orders, housing starts, car sales, and the Chicago Fed National Activity Indicator all suggest an improvement in factory activity recently. We hope they are right, but are happy with just not getting worse. A similar trend is seen in China – but for Europe the downtrend remains. Bottom line, businesses all around the world are dealing with the current economic environment and making the changes they need to continue as profitable investments. The shock of the trade war is over. Unfortunately, the economic healing process may be slower than most desire – for the US and globally.

— Michael Drury

SMITHFIELD TRUST COMPANY BOOK REVIEWS

MY PROMISED LAND: THE TRIUMPH AND TRAGEDY OF ISRAEL

By: Ari Shavit

My daughter Annie was advised to read this book in advance of her four week trip to Israel, a trip her employer The Holocaust Memorial Museum sponsored this summer. She sent it on to me.

I think Shavit taught me more about Israel and Palestine than I have ever known. He's a "liberal" Israelite who is critical of Israel's occupations and settlements in the West Bank and Gaza. He fears for his country's future because of them, and also worries about Iran's growing nuclear presence.

His book details the various chapters in Israel's history, from its 1947 start through its wars with its Arab neighbors. He doesn't spare any punches in describing the exodus of Palestinians from towns in the new Israel of 1947. His chapter on Israel's gaining a nuclear option is almost spooky.

The author questions whether Israel is to foster two states – Israel and Palestine, one state with Palestinians having no rights, or one with democracy and two franchised peoples — assuming it's not gobbled up by its Arab neighbors. I think this is an important book.

— Tim Merrill

BACK TO THE LAND

By: C. J. Maloney

This book will tell you just about everything you need to know about the New Deal. It tells the story of Arthurdale, the first Federal housing project in the country. Interestingly, it is almost in our back yard, being located just south of Morgantown, W.V.

The New Dealers believed that the solution to the massive unemployment of the Great Depression was to return people to what they called "subsistence homesteads," on which they could produce all their basic needs on their own land. To this end, they created an agency called the Division of Subsistence Homesteads, and Arthurdale was the first project of the agency. At the time, West Virginia coal miners were suffering due to the reduction in demand for coal after World War I and the subsequent shut down of many West Virginia mines. One of the worst hit was a community called Scotts Run, and it was these people who would be candidates for relocation to Arthurdale once it was completed. Arthurdale became a pet project of Eleanor Roosevelt who apparently even contributed from her own pocket to make it a success. It was overseen by prominent New Dealers such as Rexford Tugwell and M. L. Wilson.

SMITHFIELD TRUST COMPANY BOOK REVIEWS (Con't.)

The book details the overspending, mismanagement, and bureaucratic blunders that have become common in many ambitious social welfare projects undertaken by the Federal government. I could quibble about the writing style which seemed somewhat amateurish; in places it seemed that statements made on one page would be contradicted a few pages later. However, these were mostly minor points, and overall the book tells a powerful story of how projects like this go off the track. It could serve as a warning of Federal overreach, as the plans of today's democratic socialists for reordering society to go far beyond the wildest dreams of the New Dealers.

— Henry Haller, III

THE INCLUSIVE ECONOMY

By: *Michael Tanner*

Michael Tanner is a Cato Institute scholar, and in this book he provides a wealth of information about poverty in America, along with some ideas on how to alleviate it. His first few chapters provide a history of efforts to help the poor, both public and private. Following that he discusses in detail the various theories on why people are poor. Conservatives tend to blame irresponsible behavior and a culture of poverty, while liberals tend to blame structural issues in our society. Tanner seems to believe it is a combination of factors, and rejects the standard approaches of both liberals and conservatives. While government efforts to help the poor have clearly done some good (even the Federal government cannot spend a trillion dollars without accomplishing something!), current programs have reached the limits of their effectiveness. While they help make life more comfortable for the poor, they do little to reduce the overall level of poverty.

Tanner's approach features five policies:

- Reform of the criminal justice system,
- Bringing down the cost of housing through loosening zoning restrictions,
- Reforming the education system to give parents more choices,
- Removing obstacles to saving for the poor,
- and increasing overall economic growth through tax and regulatory relief.

For anyone concerned about the plight of the poor, this is a must read book.

— Henry Haller, III

SMITHFIELD TRUST COMPANY BOOK REVIEWS (Con't.)

GRANT

By: *Ron Chernow*

Ulysses S. Grant is one of our most intriguing historical figures, and Ron Chernow does a good job of capturing the essence of a great Civil War general and revered (and later unfairly discredited) president.

Chernow shatters two myths about Grant. First, he was not the Civil War “butcher” general portrayed by many historians; rather, he was a skilled administrator and tactician who treated the defeated Confederate armies with dignity and compassion. Secondly, as President, he was a visionary leader who made considerable progress in bringing the country together after the Civil War, although his efforts were thwarted by later administrations.

Focusing incessantly on Grant’s binge drinking, Chernow can and does become tedious and tiresome. The reader does not need to know of every instance when Grant consumed a bottle of whiskey.

All in all, this biography paints a sympathetic and worthwhile portrait of a misunderstood giant of the nineteenth century.

— Bill Morrow

A HIGHER CALL

By: *Adam Makos*

Can honor and chivalry be found on both sides of a hideous war? Adam Makos answers the question with a resounding yes.

In December of 1943 Charlie Brown, a 21-year old American pilot from West Virginia, flew a badly damaged bomber out of Germany toward its home base in England. Half of Brown’s crew was wounded or dead, and the plane was completely vulnerable to German attack. Appearing suddenly next to Brown’s bomber was a German Messerschmitt piloted by Franz Stigler, an ace of the Luftwaffe. Convinced that his life was about to end, Brown was shocked that Stigler guided him past German antiaircraft batteries to the North Sea and then to England and safety. Thus the strange, inspiring, incredible and intertwined tale of Brown and Stigler begins.

Well written and fast-paced, the book focuses primarily on Stigler and the horrors of existence in Nazi Germany.

I recommend “A Higher Call” with no equivocation.

— Bob Kopf

SMITHFIELD TRUST COMPANY BOOK REVIEWS (Con't.)

BECOMING LINCOLN

By: William W. Freehling

A renowned history professor at the University of Kentucky, William Freehling shows how the setbacks and failures in Abraham Lincoln's formative years shaped his emergence as the savior of our Union. Professor Freehling's insights are, indeed, brilliant.

Abraham Lincoln's father, Thomas, was, in essence, a loser. Illiterate, Thomas abhorred education and did little to advance the interests of Abraham, who was the converse of his father. Moving beyond Thomas, Abraham became a reasonably successful lawyer and politician, although he managed to lose as many elections as he won. His electoral defeats taught him the importance of caution and the need to occupy the political center. Though Lincoln despised slavery, he muted this point of view and, instead, focused on the need to preserve the Union. He only became the "Great Emancipator" when it was possible to do so without triggering the defection of the southern border states in the Civil War.

In understanding the scores of mistakes and failures in Lincoln's career, I am searingly reminded of Winston Churchill.

There is, at least for me, a stylistic defect in this book. The prose is disjointed, and since the author does not tell his story chronologically, it is often difficult to follow the narrative. Nonetheless, Freehling's observations are highly worthwhile.

— Bob Kopf

THE PIONEERS: THE HEROIC STORY OF THE SETTLERS WHO BROUGHT THE AMERICAN IDEAL WEST

By: David McCullough

Although David McCullough is one of my favorite historical biographers, writing magical tomes about John Adams and Harry Truman, he is, on occasion, able to produce a clunker like "1776." This is, thankfully, in McCullough's highly laudable category.

Led by Manasseh Cutler and a small group of veteran officers of the Continental Army from New England, an intrepid group of land speculators purchased properties along the Ohio River in 1788 and settled there. Facing an environment of natural disasters and hostile Indians, these pioneers bravely opened up the American west with an initial settlement in Marietta, Ohio.

SMITHFIELD TRUST COMPANY BOOK REVIEWS (Con't.)

Cutler was a Renaissance man, a Puritan minister and father of eight children. He graduated from Yale, qualifying for doctorates in law, medicine and divinity, and was especially esteemed by his fellow scientists for his work in botany. However, Cutler's most important accomplishment was his lobbying of Congress to obtain the passage of the Northwest Ordinance in 1787. The Ordinance applied to an immense territory now making up the states of Ohio, Indiana, Illinois, Michigan and Wisconsin, and the Ordinance protected freedom of religion, fostered public education and furthered the fair treatment of Indians. Most significantly, the Ordinance outlawed slavery in the Northwest Territory, despite the allowance of slavery in all of the original thirteen states, thus making it easier and at least possible to abolish that evil institution many years later. When Thomas Jefferson and his allies tried to amend the Ordinance in 1802 to eliminate the exclusion of slavery, Cutler's son Ephraim, a member of the territorial legislature, blocked the amendment. McCullough rightly regards the Northwest Ordinance as equal to the Magna Carta and Declaration of Independence as crucial documents in the advancement of the rights of the individual.

Other pioneers in this fine book are worthy of your attention. You should enjoy learning about unknown, but truly admirable, settlers of the American west.

— Bob Kopf

OHIO'S KINGMAKER: MARK HANNA, MAN & MYTH

By: *William T. Horner*

History generally portrays Mark Hanna as a venal businessman turned politician, serving only his own greedy interests. This book does a very credible job in demolishing that narrative.

It is a common perception that Hanna had a Svengali-like hold over President William McKinley. The truth, well documented by the author, is that the two were co-equal friends and partners. Developed by the Hearst newspapers opposed to McKinley, the puppet master image of Hanna evolved unfairly into a modern accepted fact.

The author goes to great (and excessive) lengths to show how our contemporary media incorrectly compares Hanna to Karl Rove, President George W. Bush's chief advisor. The theme is somewhat interesting but overdone.

The book fails in two respects for me. The writing is average at best, and the reader is given only fleeting glimpses into Mark Hanna's true personality and non-political life.

— Bob Kopf