THE SMITHFIELD Forecast

A Quarterly Survey of Trends • Seventy Seventh Edition • July 2019

For Customers & Friends of
SMITHFIELD TRUST COMPANY

A NOTE FROM THE CHAIRMAN

As I write this on vacation in Idaho, a cool breeze causes our aspen leaves to shimmer in the morning sun. Trout are ready to hit my fly, and life is good. May all my dear readers have an equally enjoyable summer.

— Bob Kopf

RECESSION RISKS RECEDING

With the trade war back on hold and the Federal Reserve ready to ease monetary policy, the uncertainty that has been holding back economic growth is receding. In our view, it was the triple whammy of tighter monetary policy, higher oil prices and the broadening of the trader war back in September 2018 that set off the deep correction in equity prices late that year. The result was a stumble in the global manufacturing economy that now appears to be finding its bottom. Through a combination of market pressure and government actions, all three threats are now far less pronounced. President Trump and President Xi recently agrees to a truce, similar to the one negotiated at the G20 in Argentina last fall, where tariffs will remain, but trade discussions will resume. The Federal Reserve moved to a neutral position earlier this year, and at its most recent FOMC meeting indicated that it will consider easing – most likely with a 25-basis point reduction in rates in late July. Meanwhile, oil prices have declined to less than $60 a barrel at the peak of summer driving season, despite tension in the Middle East.

In a capitalist economy, it is profits, not jobs, or income or consumer spending – that is the key lead indicator for economic well-being. Profits fell modestly in the fourth quarter and sharply in the first quarter, as firms maintained hiring and produced goods that were unwanted and unsold – resulting in climbing inventories. Growth, as measured by Gross Domestic Production, grew at a solid 3.1% annual rate in the first quarter, after 2.2% in Q4. However, nominal Gross Domestic Income grew only 1.7% in Q1, after 2.4% in Q4. Apply whatever deflator you want to these numbers and you get real income growth near zero. Obviously, most of the correction hit the upper end of the income spectrum in profits and proprietor's income. Now, by reducing hours of

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

412/261-0779
Fax: 412/261-3482
www.smithfieldtrustco.com

factory workers and moderating industrial production, entrepreneurs are reestablishing a profitable environment – which sets the base for further growth. We were particularly heartened by a 0.7% in proprietor's income in May.

Historically, a reduction in employment has set off alarm bells for investors as it often signaled the beginning of a downward spiral, as the layoff of workers by one firm reduced income and thus demand for goods at another company. However, in today's more globalized economy long international supply lines mean that far more of these layoffs happen outside the U.S. That is why readings on the health of manufacturing economies around the world have fallen faster, and remain softer, than in the U.S. China, Japan, Korea, Germany, Italy, the UK and Spain all have ISM readings of below 50 for their factory sectors, while the U.S. has cooled to 51.7. The inventory correction that will dominate GDP results in the second and third quarter (one of which is now in the rear-view mirror) could limit growth to an average of just 1.25% for mid-2019. Indeed, that is the current projection from the New York Fed, with the Atlanta Fed at 1.5% for just the second quarter. But, rather than a concern, investors should see this as good news.

The reality is that service sector indicators remain strong – even in those countries where manufacturing is both larger and weaker than is the U.S. Services even in China – the lowest rung of the global manufacturing ladder – are now more important than goods, whether produced for domestic consumption or export. In the U.S., the health care industry hires 45,000 people each month; professional business services hire another 40,000; leisure and hospitality hire another 25,000 – even during the recent manufacturing slowdown. It only takes 90,000-100,000 new jobs to keep the unemployment rate from rising. With unemployment already near record lows, that means sustained service sector hiring keeps upward pressure on wages and limits the damage to consumer spending – stopping the spiral in its tracks.

We believe investors should be cautiously optimistic about the state of the global economy. The current economic weakness is well understood – not unexpected as back in the third quarter of 2018. Back then, virtually no economist was calling for a recession – or even economic weakness in 2020. Now, firms are trimming additional hours worked, holding the line on wage gains, and postponing capital spending to re-ignite profits growth. Lower long-term interest rates and energy prices are already aiding that process. A decline in short term rates will add fuel to the fire.

The greatest risk now is that markets have priced in too aggressive a path for the Federal Reserve, projecting at least three rounds of ease in the next year. Many are also still expecting positive news on the trade front. We believe that the economy will return to a 2% real growth path by late 2019 -- if the trade truce holds. That makes the three eases priced in by the markets unlikely. Still, there is significant risk that the same blame game that started mid-March will resume later this year as we approach the next face to face meeting at the G-20 in November in Saudi Arabia. We expect the Federal Reserve to ease by 25 basis points in July, disappointing some who expect fifty. For the rest of the Street, that initial ease is likely to be seen as a vindication of their view that more cuts are coming regardless of how the Fed spins the reduction. It might take a lot more Fed jawboning, as well as stronger than expected economic data, before the Street retreats from their current stance. A less aggressive than expected Fed should revive upward pressure on bond yields, reversing their bull rally early in 2019.

Bottom line, we do not see a lot of stimulative action coming from either the Federal Reserve or the fiscal authorities. That holds for both the US and around the world. In Europe, the combination of already negative interest rates and already high deficit to GDP readings limits policy moves. They would like a weaker currency, but with the Federal Reserve lowering rates and their inability to match (as they are already below zero) their currencies are likely to get stronger. That means that Europe, though already suffering from low inflation, will see imports with even lower prices. That is not good for domestic profits, suggesting capital flight. That might mitigate the rise in European currencies, but it depresses their financial returns. For investors, the outlook for European returns in dollars is still uninspiring. China is likely to continue to ramp up stimulus, especially given the uncertainty around future trade relations with the US. The Party is also determined to put the best spin on the success of Socialism with Chinese Characteristics as an alternative to capitalism during their upcoming centenary celebrations. The trade truce should hold for several months – but the friction between the US and China over whose system is better and who controls future technologies is certain to flare up again and again in coming years.

This month, the current expansion became the longest in US history. It is also the slowest in US economic history. Indeed, if you took a ten-year period from the start of any recovery – even allowing for intervening recessions – the current expansion is still behind. We do not see another US recession on the near horizon – or the far one either, given the greater importance of a stable service sector and the ability to export job losses via trade. US growth is likely to remain low and steady – but investors still have the opportunity to share in the better performance of the broader world economy, either through multi-national businesses or investments in foreign firms. The rising tide that will lift the US boat later in 2019, and on into 2020 and beyond, should be even more pronounced for foreign producers –especially in Asia -- which have suffered more during the recent global economic stall.

— Michael Drury

SMITHFIELD TRUST COMPANY BOOK REVIEWS

THE HOUSE OF THE SEVEN GABLES

By: Nathaniel Hawthorne

"The Wall Street Journal" now has occasional book reviews of "classics," thus inducing me to read this novel, published in 1851, and forced upon me in secondary school. With its old and arcane writing style (well, I am also old and arcane), Hawthorne's novel can go on for several pages in describing a character's momentary thought process, yet I found the novel to be interesting and even captivating at times.

Set in a small New England town, the tale focuses on the intertwined themes of family, good, evil, greed, kindness and, above all, curses. The story starts with a Colonel Pyncheon in the seventeenth century, who covets the land of Matthew Maule. He acquires Maule's land by having him tried and executed for witchcraft, then building a house with seven gables on that land. The house and the Pyncheon family are cursed by Maule at his execution, and the story lurches forward to the middle of the nineteenth century.

My guess is that many of you will not like "The House of the Seven Gables." However, I did.

— Bob Kopf

THE BEST SEVEN YEARS OF MY LIFE: THE UNLIKELY STORY OF AN UNLIKELY CAREGIVER

By: Chad and George Shannon

Reviewing a book written by a friend is a daunting task. What does one do if one does not like the book? Fortunately, for me, George Shannon (and his son Chad) have made my task easy, since I enjoyed reading the story of George and his wife, Carol.

Nearing retirement, George and Carol took a vacation trip to Mexico. Their marriage was somewhat in the doldrums. Close to their return to Pittsburgh, Carol suffered a debilitating stroke. Facing all sorts of uncertainties and doubts about his ability to care for his wife, George resolved to do everything in his power to make Carol's life as fulfilling and fun as possible. He succeeded. The interesting and wonderful aspect of George's new role is that he became a better, more full, humble, and happy man. Despite the sadness surrounding Carol's medical condition, there are many humorous anecdotes in the last seven years of Carol's life. I even know one or two that are not in the book.

I thank George for telling us his splendid story.

— Bob Kopf

SMITHFIELD TRUST COMPANY BOOK REVIEWS (Con't.)

PRESIDENT MCKINLEY: ARCHITECT OF THE AMERICAN CENTURY
By: Robert W. Merry

Arguing persuasively that William McKinley was our first modern president, Robert W. Merry paints a sympathetic picture of our twenty-fifth occupant of the White House. McKinley's accomplishments were manifold and consequential. He presided over incredible pivotal developments: the embrace of the gold standard by the United States; annexation of Hawaii; destruction of the Spanish Empire and consolidation of our influence in the Caribbean; freeing of Cuba; acquisition of the Philippines; adoption of an open door policy in China; and, implementation of a "fair trade" policy by abandoning earlier protectionist trade policies. McKinley quietly and cunningly pushed these policies without caring about who got credit for them, and he achieved his objectives in four years, since he was murdered by a crazed anarchist at the beginning of his second term. His main legacy was the creation of what I would call a benevolent form of American imperialism.

Why has history underestimated McKinley? There is a two word answer to that question: Theodore Roosevelt. Succeeding McKinley as his vice president, Roosevelt was self-aggrandizing, visionary and charismatic. Conversely, McKinley was a solid, yet uninspiring, manager. Roosevelt stood on McKinley's shoulders while deprecating McKinley after his death.

Robert Merry's informative book is in many ways like McKinley himself --- not flashy, but worthwhile.

— Bob Kopf