THE SMITHFIELD Forecast

A Quarterly Survey of Trends • Eighty First Edition • October 2020

For Customers & Friends of
SMITHFIELD TRUST COMPANY

A NOTE FROM THE CHAIRMAN

Our economist, Michael Drury, continues to hold an optimistic view of our economic recovery from the COVID crisis. So far Michael's contrarian analysis has proved to be fundamentally true.

— Bob Kopf

SMITHFIELD FOURTH QUARTER

Our more optimistic view on the economic recovery continues to be reflected in an exceptionally wide swath of rising asset values, as politicians continue to provide substantial income support during these trying times. Investors have seen higher prices for equities, bonds, housing, precious metals, and even industrial materials. The consensus among economists is more pessimistic, as they are focused on the millions of lost jobs. We too regret the unemployment created by the COVID crisis, but our focus is on the outlook for business revenues and profits, which are the key leading indicator and life's blood of a capitalist economy. Fortunately, in this political year, candidates are also worried about jobs -- and voters – so, they have rained down transfer payments and low interest loans on consumers and businesses as near zero interest rates have eliminated concern about rising deficits. The flood of liquidity has lifted incomes, confidence and asset values in diametric opposition to the results just after the Great Financial Crisis a decade ago. Back then fear of deficits limited fiscal spending and put the burden of generating an expansion on the Federal Reserve. Unfortunately, despite flooding banks with reserves, lenders' fear of defaults limited loans to only those that didn't really need the help – generating a limping recovery. Politicians have learned their lesson, with fiscal conservatives an increasing rarity in Washington, while economists appear to remain scarred by their overly rosy forecasts the last time around.

Many analysts fear an abrupt slowdown in growth in the fourth quarter, as the initial wave of income support has faded. While it is true that the $600 a week in excess unemployment benefits expired at the end of July, President Trump mandated a $300 a week extension, which is now being paid out retroactively to August 1st. This pot of money, funded by left over disaster aid, is expected to run out

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

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

quickly. However, both parties appear ready to spend at least another $1.6 trillion, including a minimum of $400 a week in unemployment benefits, another $1200 support check, more PPP, and aid to state & local governments – maybe even before the election is over. In the meantime, consumer spending has continued to rise in August and September despite the lower transfer payments, as indicated by retail sales reports and high frequency data from credit card companies. The combination of workers returning at a faster than expected pace and a declining savings rate, as more confident households spend some of the savings stacked up while income exceeded opportunities to spend, has maintained a rebound in consumption.

We expect that the US economy will expand by a robust 33% in the third quarter, followed by 12.5% growth in the fourth. When we first forecast 33% growth for Q3 over two months ago we were decidedly an outlier. Since then the consensus has moved monotonically in our direction, and we are no longer even the high call with the Atlanta Federal Reserve's GDPNow forecast at 35%. Our optimism is not based on a model, but on the simple observation that hours worked in the third quarter were rising briskly – and now, with September data known, they are estimated up 28%. Normally, in the opening year of a recovery, businesses are more interested in reestablishing profit margins than hiring back employees. Thus, output per hour rises sharply – by at least 6% in the initial year over the past several recessions. Hence, our upbeat third quarter forecast simply assumes that businesses are not hiring unproductive workers. If we assume no further rise in hours worked from the September level, the average for the fourth quarter would already be 3.8% higher than the third. We do believe hours worked will rise, so assuming only a 500,000 gain in monthly employment plus a normal bump in productivity would justify our 12.5% Q4 forecast. We note that in just the first week following the close of the September employment survey, continuing claims for unemployment benefits fell by more than one million. Hopefully, we will have to raise our already optimistic forecast even more -- soon.

The biggest risk to any forecast is the return of the virus. As cooler weather has pushed more activity indoors, including children returning to school, cases have started to rise again in the most northern states. This same pattern is seen in Europe, where the UK and France are experiencing the worst relapse. However, shutdowns are likely to be far more limited in response. In New York City, the epicenter of the worst outbreak globally, the Governor and Mayor are advocating only restricting activity in a handful of zip- codes – effectively making those citizens and their business communities COVID police to protect their jobs and profits. Better information, better protection and better medical treatment all suggest that the next wave of COVID will be treated less dramatically than the first – at least in its impact on economic activity. The shift to work from home and online shopping has reduced social interaction and limited the rapid spread of the disease. Please, wear a mask, maintain separation and wash your hands regularly.

There is a significant upside to even our optimistic forecast, both in the short term and the longer run. Near term, despite increases in industrial production, supply chain restrictions have kept inventories tight. The latest ISM report had business inventories at 47 and customer inventories actually fell a bit to 39 – when 50 is breakeven. We believe that the need to ramp up production even faster than consumption to, first, reduce the inventory gap, and then ultimately to build desired stocks, could add a couple of percent to real GDP growth for several more quarters. At current low interest rates, firms are far more willing to carry extra supplies – especially as many raw material prices are percolating higher.

Longer term, we believe that the advent of COVID has accelerated many trends which were already underway, but will now be adopted far more rapidly as firms try and reduce the cost of doing business. Allowing more work from home, even after a vaccine is available, is the most obvious no-brainer as firms reconsider how much they should spend on office rent. More importantly, workers have indicated that they see the benefit of working from home as equivalent to a 20% rise in income, due to both freed up time and lower transportation costs – not to mention tax advantages in many cities. Firms may not immediately reduce wages, but they are sure to recoup some of the workers' perceived upside as they hire back replacements. Meanwhile, many firms have adopted new technology and introduced new efficiencies that they had been thinking about pre-COVID – but in a strong economy with tight labor markets had been unable to pull the trigger. Like Y2K, COVID has forced many firms to press for immediate productivity gains, as they were often the only path to survival. Unlike during Y2K, the government is lending (quite literally) a helping hand with near zero percent PPP loans, plus other grants and subsidies. Consumers have also adapted with more online shopping and by developing new skills, like cooking and ZOOM connectivity, that will permanently shift their preferences for restaurants and travel. Major decisions, like buying a new home or having a baby, will alter consumption patterns for years to come.

We believe these revolutionary – rather than evolutionary – shifts are likely to result in a faster potential growth rate for the US economy in 2021 and beyond than was expected previously. Pre-COVID, most economists were willing to accept a 2% real GDP growth rate and sub-2% inflation, generating less than 4% nominal growth, as a realistic US growth forecast for many, many years to come. We would have agreed, since our global travels indicated that multinational firms' biggest gains in productivity and sales were going to be found in Asia. Post-COVID, new opportunities to slash costs domestically – and issues with supply chains internationally – suggest that faster productivity growth will return to the US. The adoption of new efficiency will be enhanced by low interest rates and recent equity market gains, which give the biggest players an effective currency to buy smaller firms developing the best and brightest ideas. COVID has been a nightmare, but as Nietzsche opined – that which does not kill us makes us stronger. We look forward to a longer, stronger expansion in 2021 and beyond.

— Michael Drury

SMITHFIELD TRUST COMPANY BOOK REVIEWS

SOONISH

By: Kelly and Zach Weinersmith

Do you ever wonder about the prospects of sending astronauts to Mars? Or what are the chances of generating electricity by fusion power? Perhaps you would like to know how personalized medicine will change health care. The Weinersmiths delve into these and other questions regarding possible future technologies in this quirky little book. While there is considerable scientific background in their analyses, they also employ a great deal of humor in describing the likelihood of the success of any of these future technologies. Interspersed with the text are frequent cartoons depicting the developments being described. They also discuss potential downsides if and when these future technologies come to fruition, as well as how they could change our society. All in all, I found it a fun as well as informative read.

— Henry Haller

THE SPLENDID AND THE VILE: A SAGA OF CHURCHILL, FAMILY, AND DEFIANCES DURING THE BLITZ
By: Erik Larson

Erik Larson tells good tales, whether they be about the Galveston hurricane in 1900, Chicago's 1893 World's Fair, or the sinking of the Lusitania in 1915. He tells another here in his 2020 recounting of Winston Churchill's first year as England's Prime Minister in 1940.

Though I'll be interested in learning from the Churchill fans (if not scholars) who I know frequent these book reviews whether they, like me, will find things here about the man that were not revealed in prior Churchill biographies. Like how he hated to hear anyone whistling! I didn't know that.

I guess, like everything these days, there are indeed Churchill fans and detractors out there, I am most definitely in the former camp though I understand the arguments of those in the latter.

Larson is for sure a Churchill fan. He uses diaries (from one of which Larson came up with the title to this book – which I won't spoil for you but say only that it relates to the Blitz observation), and he uses public documents as his source material. Family members as well as English, German and American very public figures are woven into his story. Remember Harry Hopkins? Larson describes his pivotal visit to England in 1941.

Larson's descriptions of the night-after-night bombing raids and Churchill's regular radio broadcasts to the English people, and the effect on them of those broadcasts as perhaps the best features of this tale (though there are unexpected personal revelations about family members along the way that make the tale down-right juicy).

I guess I better end here. As you can see, I really like this book.

— Tim Merrill

SMITHFIELD TRUST COMPANY BOOK REVIEWS (Con't.)

GODS AND GENERALS
By: Jeff Shaara

THE KILLER ANGELS
By: Michael Shaara

THE LAST FULL MEASURE
By: Jeff Shaara

Readers may recall the middle volume of this Civil War Trilogy; it was made into a TV mini-series in 1993 entitled simply "Gettysburg." Subsequently Michael Shaara's son Jeff wrote a prequel, covering the Civil War up to the battle of Gettysburg, and a sequel, covering from Gettysburg to the end of the war. I have read a great deal about the Civil War, but in none of my previous readings did I gain the insight and understanding of what this war was about that I found in these three books.

All three books follow the same format wherein each chapter tells the story from the perspective of one of the various generals, from both Union and Confederate armies, that are singled out. The authors delve deeply into the minds and motivations of their primary characters. While these are works of fiction, I feel certain that their basis is mostly factual.

A couples of these leaders stood out to me as being of particular interest. Robert E. Lee is featured in all three books. He was clearly a deeply religious man, and believed that God was with him at all times. Contrary to many contemporary critics, his motivation was not to defend slavery, but rather to protect his Virginia homeland from the invading Union army. He had been offered the opportunity to command all of the Union armies, but could not bring himself to take up arms against his people.

Another fascinating character, with whom I was not familiar, was General Joshua Lawrence Chamberlain. At the beginning of the war he was an English professor at Bowdoin College in Maine. Feeling the call of duty, he left that position to volunteer in the Union Army, and was commissioned a Lt. Colonel, second in command of the new Maine regiment. Without out any formal military training, he went on to become one of the most respected leaders in the army and rose to the rank of Brigadier General, despite a bout of malaria and a very serious wound suffered at the battle of Cold Harbor.

A clear lesson learned from these books is that good leadership is far more important in war than numbers of troops, quality of weaponry, or adequacy of supplies. I highly recommend this trilogy to anyone interested in the Civil War and how it shaped our culture going forward.

— Henry Haller, III

METTERNICH: STRATEGIST AND VISIONARY

By: Wolfram Siemann

This book was a real slog for me. The fault lies with me and not the author, who assumes that the reader, unlike me, possesses a rudimentary understanding of the European history of the early nineteenth century.

Derided by many historians as a reactionary monarchist hostile to democracy, Prince Klemens von Metternich is persuasively portrayed by Wolfram Siemanns as a gifted Austrian statesman who dealt with Napoleon skillfully, resulting in the latter's defeat in 1815. Justifiably, the author credits Metternich's balance-of-power "system" of alliances between nation states as laying the foundation for the relatively peaceful nineteenth century.

If you have a decent grounding in nineteenth century European history, I urge you to give this depiction of a dazzling personage – Henry Kissinger calls him the father of realpolitik – a chance.

— Bob Kopf