THE SMITHFIELD Forecast

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For Customers & Friends of
SMITHFIELD TRUST COMPANY

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A NOTE FROM THE CHAIRMAN

Our economist, Michael Drury, has written what I believe to be a cogent analysis of the coronavirus on the economy. He raises several thoughtful questions about its effect on our future. Perhaps most importantly, Michael plants several germs (pun intended) of optimism about the domestic economy for the second half of 2020.

— Bob Kopf

SMITHFIELD SECOND QUARTER

Could NOMINAL GDP increase in the second quarter? (Yes, that is in bold and caps to get your attention.) In the midst of the coronavirus crisis it is often difficult to focus on the positive. Practitioners of the dismal science have produced a wave of dire economic forecasts on real GDP – many around -20% for the second quarter. These are annualized numbers. They mean that volume (inflation adjusted) output will be down -5% in Q2, and then you raise that change to the fourth power (or multiply by four to estimate) and bam you have a terrible number. However, the cavalry is coming via a massive money drop equal to 10% of GDP – with most of that money arriving in the second quarter. Will normal spending fall by more than -10% due to the virus? If not, it is possible that Q2 nominal GDP could be positive, as the money drop offsets the virus effects on income — but not production. The result may be a spike in inflation, as sustained incomes chase far fewer goods and services. Some of the surge in income may be saved, but for most the money drop is to replace normal earnings needed to pay current bills, not a windfall.

For the man in the street, the issue is income – and the $2.2 trillion rescue bill attempts to short circuit any reduction in wages and salaries. First, Treasury will provide every adult with an income under $75,000 a one-time payment of $1,200 – regardless of current work status (smaller amounts phasing out for up to $99,000 in income, double those amounts for joint filers and $500 per child). Second, those unemployed (new and existing) will receive normal benefits, plus an additional $600 per week for up to four months. Eligibility rules are relaxed to include selfemployed contract and gig workers and the benefit period was extended to 39 weeks from 26. Third, small businesses with less than 500 employees can get loans up to $10 million, with any proceeds used to cover payroll becoming a grant. Bottom line, we expect much of potentially lost income will be replaced, maintaining stability for much of the economy (think rents, routine monthly payments, medical coverage), though clearly the brunt of the correction will still fall on discretionary spending, like restaurants, travel and big-ticket items, and on the associated manufacturers. These firms will receive most of the $1.1 trillion in business support loans and payments provided by the bill.

This economic episode is like nothing ever experienced here or anywhere else. Over ten million workers applied for unemployment benefits the first two weeks. In the entire 2007-2010 period, continuing claims rose only 4.2 million. Most of these applicants will earn more in the next quarter than if they were employed! However, another 1.4 million typically young seasonal workers would normally be hired over the next four months, and this is unlikely to happen. They likely do not qualify for benefits. Thus, the monthly seasonally adjusted payroll employment numbers will drop by far more than just the increase in claims. If the surge in joblessness is perceived as brief, most will not exit the labor force, so the unemployment rate could quickly spike over 10%. Bottom line, if the economy remains uncertain, we expect even more money will arrive from Washington. In for a penny, in for a pound. We started the stimulus negotiations at $800 billion -- with a cool 1% of GDP being tacked on at the last-minute to reach $2.2 trillion! Speaker Pelosi is already talking about the next bill. The President favors $2 trillion more for infrastructure.

The next significant decision is when quarantines will be lifted, so that at least part of the economy can return to normal. The economies of Asia started to rebound roughly 40 days after they shut down – quite biblical in this religious season. That schedule suggests that the end of April would be an early date for the US, given our shutdown started mid-March. Many households and institutions will be facing their second rent or mortgage payment and the pressure will be building for a return to normal. If the US follows the Chinese and Korean experience by then the number of active cases should have peaked, as those newly recovered surpass any new illnesses. Europe should have peaked earlier – Italy may have already -- though they may take longer to rebound given the severity of the disease across the continent. Finally, if warmer weather has any impact on the virus, that, combined with a needed relief from cabin fever, may shift sentiment. We are still in early days, but hope springs eternal – especially in the Spring.

The money drop is a social and economic experiment of almost unprecedented scale, though it echoes the Chinese stimulus in early 2009, when they injected over 12% of GDP. While the rest of the world collapsed, China had just one negative quarter for nominal GDP (real GDP grew steadily, but you know…), then returned to their earlier running rate. Note, for a centrally planned economy running at over 15% nominal growth, their money drop was effectively just front loading the year's spending. For the US, growing at 4% nominal – with huge deficits already and a massively underfunded retirement era approaching – spending 10% of GDP is a bit different. Still, in stark contrast to the Great Depression, when a lack of income ground the economy to a halt, we now seek to protect everyone's income and hope the economy can rebound as soon as the disease passes. The nation's – indeed the world's -- physical and human capital is largely intact, so a rapid recovery is possible.

In our view, the advent of COVID-19 is a 9/11 or Pearl Harbor moment. It draws a sharp line between the peaceful world that existed before and the massive change and innovation that followed. Pearl Harbor was not the first military event of WW2, nor was 9/11 the first terrorist attack on the US. However, both were horrific wake-up calls that the world had changed, and that everyone would have to adjust. COVID-19 is not the first infectious disease scare of even just this millennium. SARS, MERS, Ebola, Zika, and H1N1 all vied for the title of Disease X, which the WTO had warned was a coming pandemic that would spread through the open globalized economies. Pearl Harbor awoke a sleeping giant, unleashing unrivalled manufacturing prowess – and elevated military spending all the way to Vietnam. 9/11 resulted in TSA and trillions of dollars spent on wars in the Middle East to ensure domestic security. Both led to the building of global alliances and shattered periods of regionalism for the US economy – the recovery from the Great Depression, and the '90s of the Nikkei Crisis/Asian Crisis/Y2K. Globalism has been in decline since the Great Financial Crisis. Will this virus rally the world to fight together -- or will it build walls?

How bad might the virus hit the economy? Recent indicators suggest the manufacturing side of the world economy fell into a normal recession in the past month, as the world still needs many goods. The service side, which normally holds up better, was decimated as much demand for leisure was forbidden. Data from We Bank in China indicates that their economy bottomed at 50% below its normal for four weeks and then recovered over the next five weeks (averaging 25% below normal). That implies China lost 3.25 weeks of output during the first quarter or -25%! Still, if they lost 25% of one quarter and return to normal growth for the rest of the year, they would be down 6.25% from a supposed roughly 6% growth rate – or basically flat -- and it could be even better with stimulus.

What kind of stimulus is important – and China has a bunch of shovel ready projects (it's a planned economy), mostly focused on rolling out the 5G network. China Unicom, China Telecom, and China Mobile are all ramping up investment. China looks to have its entire population converted to 5G by 2025. That implies a whole new level of bandwidth and connectivity – and the foundation for a wave of innovation. Similarly, Congress is discussing an infrastructure bill. Let us hope we are not just going to be rebuilding aging bridges, roadways and transportation systems in a world that has just learned that work from home and home schooling may be the norm in the future.

We do see a world of innovation in the aftermath of the virus. The shift to online retail consumption and delivery has advanced significantly, as many brick and mortar operations are closed – and many will remain so. The same is true of office space, where firms will certainly re-evaluate the importance of having everyone in one place – especially in densely populated areas where rents are the highest. Office space's future may look like retail's does now. Will workers get to write off half their rent (or will firms pay it) if they work from home? There are huge tax implications ahead. Schools are also likely to see substantial changes. Some will make up the time recently lost. Others will not. Summer school, online schools, testing, grades and graduation are all likely to face innovations. And changes may be coming to higher education as well, as its dependence on foreign students faces an uncertain future.

The virus has opened our eyes. The world will never be the same. Was the US more concerned about the virus impact on China or on Europe? That tells us a lot about where economic integration is the strongest. Which nations are best placed to fight future potential pandemics? Does it take authoritarianism – or just scale and a central authority? Will future trade blocs be stronger or weaker? Is China allying with Europe, and isolating the US? A lack of savings and too much leverage was a big reason this massive US stimulus was needed. How will incentives change to limit a repeat? Will weaker firms ever be able to borrow after this? If a borrower came to you needing funds after this massive a money drop, would you lend to them? At what premium? Are higher inflation expectations and interest rates a sure thing? How will P/E ratios react? If inflation is back, will commodities and real estate outperform equities? Will consumers demand lower prices, while labor asks for a growing share of the pie, as households seek to build precautionary balances? Who will gain a growing share of the economy? Bottom line, we doubt we are returning to the pre-virus order. Plenty to think about while we are sitting at home waiting for the virus to break.

— Michael Drury

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SMITHFIELD TRUST COMPANY BOOK REVIEWS

THE RIGHTEOUS MIND
By: Jonathan Haidt

For anyone puzzled by the inability of people on opposite sides of the political spectrum to communicate with each other, this book will explain a lot. The subtitle is “Why Good People are Divided by Politics and Religion.” Haidt does not make judgments about political opinions, but rather explains what underlies them.

He frames the situation as one of differing moralities. Different people base their morality on differing bases; Haidt identifies six such bases that he calls moral foundations. They are caring (for other people), liberty (as opposed to oppression), fairness, loyalty, respect for proper authority, and sanctity. While liberals base their morality primarily on the first three, conservative morality rests on all six foundations. Interestingly, this results in conservatives being able to understand liberals much better than liberals can understand conservatives, a conclusion that has been borne out in psychology studies.

Haidt also discusses the tendency of people to be drawn into groups, particularly those that share their sense of morality. Add in the phenomenon of confirmation bias, and it is easy to see why many people have become blind to their neighbors’ differing viewpoints. With the extreme polarization in Washington these days, the lessons of this very readable book are especially relevant.

— Henry Haller, III

SMITHFIELD TRUST COMPANY BOOK REVIEWS (Con't.)

PRISONER
By: Jason Bezaian

The head of the Washington Post's bureau in Tehran, Iran, Bezaian was arrested by the Iranian police in 2014 and charged, ridiculously, for spying for the United States. Although Bezaian initially thought that his arrest was a misunderstanding, he ultimately realized that he was being held as a hostage in high-stakes negotiations between the United States and Iran. He spent 544 days in prison, enduring harsh interrogations and varying brutal living conditions. The author, whose father was born in Iran and then moved to California, has a love-hate with Iran itself, and has a nuanced view of Iranian society.

The book has a lively and fast-paced start, but - perhaps inevitably - slows to a more ponderous speed as Bezaian spends a seemingly interminable time in confinement as U.S. efforts to free him falter.

The book is worthwhile, especially when it highlights the authors' complex assessment of the relationships between us and Iran.

— Bob Kopf

SOPHIE: THE INCOMPARABLE MAYOR MASLOFF
By: Barbara S. Burstin

Professor Barbara S. Burstin has written an interesting and informative biography of Sophie Masloff, the first female and Jewish mayor of Pittsburgh.

As the President of the Pittsburgh City Council, Sophie (as she preferred to be called) became Mayor in 1988 by reason of the death of popular Mayor Richard Caliguiri. Sophie was then elected rather easily in 1989 after shrewdly capturing the nomination of the Democratic Party.

Underappreciated and underestimated, Sophie was a successful steward of Pittsburgh's finances in the face of a city struggling fiscally by reason of the massive decline of the steel industry. Sophie, implementing two necessary cuts in the city's wage tax, balanced its budget by courageously divesting Pittsburgh's expensive subsidies of the National Aviary, Pittsburgh Zoo and Phipps Conservatory. Interestingly, those three charities have flourished in private hands.

I remember vividly her voice, famously described as "capable of scraping the paint off a passing car." Read this book to get beyond the voice and discover an important figure in the development of our city.

— Bob Kopf

CHURCHILL: WALKING WITH DESTINY
By: Andrew Roberts

Deservedly, this biography of Winston Churchill has, from most critics, received lavish praise as the best single volume treatment of Winston's entire life. Perhaps so, although I liked Roy Jenkins' yeoman effort over a decade ago.

For me, the strength of the book emanates from its wonderful anecdotes (many of which were new to me) and the author's deft showing of how Churchill learned from his mistakes. This latter strength does, necessarily, cause the narrative to jump occasionally out of chronological order, making it moderately difficult to follow, but the emphasis on this theme is, on balance, highly worthwhile.

I confess to a bias in favor of my friend, Paul Reid, who finished the third volume of William Manchester's The Last Lion. Paul is a better writer than Roberts, but Roberts' effort is definitely worthy of your undivided attention. An added bonus is that the weight of this nearly 1,000 page tome will add muscle tone to your arms.

— Bob Kopf

CATCH AND KILL
By: Ronan Farrow

Reading the overwhelmingly positive reviews of this book by Mia Farrow's son, Ronan Farrow, I asked for it for Christmas. I would have preferred a lump of coal.

This book focuses on the sordid exploits of Harvey Weinstein and a slice of society for which I have little use. Even most of the victims generate contempt rather than sympathy. Disjointed, Catch and Kill ends with a big thud. Unless you want a depressing peek at a depraved part of society, do yourself a favor and give this one a pass.

— Bob Kopf