

# THE SMITHFIELD Forecast

*A Quarterly Survey of Trends • Eighty Second Edition • January 2021*

## **A NOTE FROM THE CHAIRMAN**

*For Customers & Friends of*  
SMITHFIELD TRUST COMPANY

Michael Drury's optimism about the economy continues unabated, despite the national spike in COVID-19 cases.

I wish all our readers a happy and healthy New Year!

— Bob Kopf

## **SMITHFIELD FIRST QUARTER 2021**

Looking Ahead to a Bright New Year

With the new \$900 billion dollar stimulus package in the books, the outlook for the first quarter and the rest of 2021 is looking bright. The US and global economy had settled into another COVID-induced funk midway through the fourth quarter, as cases started to rise again and lockdowns ensued. Now, the first quarter will benefit from the double whammy of the new stimulus and the advent of widespread vaccinations. We have been more bullish than the consensus all through 2020 – largely due to the tsunami of money released in the \$2.2 trillion CARES Act back in April. The new package provides roughly half of CARES benefits -- with fresh PPP funding, a \$600 stimulus check and \$300 in excess unemployment benefits – for an economy that was merely slowing, not falling off a cliff. The CARES Act amounted to 10% of GDP to offset a 10% drop in real GDP (not annualized) over the first half of 2020. We estimate that pulled US economic output back to just 2% below a year ago by year end. The new stimulus adds another 4% of GDP – which will boost income by an annualized 17% in the first quarter.

Our call has been for near double digit growth in the fourth quarter, followed by a near stall in the first – more than double the consensus forecast for that two-quarter period. The foundation of our outlook now is less about the money (even the new money), than about the need to rebuild badly depleted inventories. While production plunged back in March due to lockdowns, consumption – supported by stimulus checks and stockpiling – fell less, clearing not only store shelves but warehouses as well. As shutdowns eased, consumers were far quicker to return

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than factories, which had to deal with bottlenecks in long international supply chains and difficulty attracting labor when unemployment benefits were so robust. Bottom line, inventories plunged in the second quarter and still have only recovered modestly. In November, even as retail sales slumped -1.1% on weaker Black Friday sales, industrial production at factories was up 0.8% -- and single-family housing starts were the highest since before the Great Financial Crisis. The rebuilding of depleted supplies by businesses is sustaining economic growth even as consumption slumps – and now fresh stimulus should lift spending again in the first quarter.

We expect that the new stimulus will provide a quicker boost to the US and global economies than back in spring – when the vast majority of stimulus was initially saved. First of all, many households are in greater financial difficulty than in March. Secondly, with vaccinations being distributed, there is light at the end of the tunnel. Though the initial goal of the CARES Act was to sustain consumer spending and thus employment, the reality is that the surge in savings provided far more support to asset prices than to jobs. By year end, employment had recovered to down about 5% from a year ago, and wages and salary income was roughly flat, but asset prices – whether for stocks, bonds, home values or many commodities were up by double digits. With household balance sheets so strong, we expect more of the fresh money will flow to satisfy pent up demand once an all clear on COVID re-opens restaurants, travel and entertainment venues.

However, while the stockpiling by consumers last spring led to depleted inventories, the spike in spending on previously foregone services coming this spring is more likely to cause inflation. Service providers are unlikely to ramp up supply as fast as consumers, flush with cash, accelerate demand – because many providers have gone out of business and those that remain need to replenish profits. While sales are certain to rise sharply,

that may require more labor and other rising costs. If demand is as strong as we expect, simply raising prices will move money to the bottom line faster. It is likely to be a while before new competitors are able to enter the market. Moreover, the comparison with year ago prices will make inflation look all the more robust. This inflation may be largely a statistical illusion, but investors need to be aware of the markets' tendency to buy the rumor and sell the fact.

It is also critical to note the Federal Reserve is unlikely to move at all in 2021 – or 2022 – to quell any increase in inflation. For better or worse, the Fed has adopted the view that their earlier policy of raising rates to stem potential inflation may have abetted the spread of inequality, by denying those at the bottom of the skills ladder an opportunity to move up as the labor markets tightened. The lack of inflation at extremely low unemployment rates recently has shifted the Fed to a “whites of their eyes” philosophy, so monetary policy will not tighten until inflation is actually above their 2% target. Given the lags in how fast monetary policy gains traction – averaging two years by most estimates – that suggests inflation will spend quite some time above their target before it is eventually reined in.

We do not see runaway inflation anytime soon, but we do express the view that we are in 1968 – when inflation and fiscal policy were seen as solutions to already rising debt levels and inequality. The world moves faster today than a half century ago, so the 70s may be closer than they appear in the sideview mirror. With interest rates already so low, and business leverage at extremes after a decade of borrowing at low rates following the GFC, any rise in rates – whether from inflation or real rates – will be unfriendly to financial assets. Stocks, bonds and center city real estate all suffered in the 1970s and we see a rhyming -- if not repeating -- of that scenario in the years ahead. Suburban real estate and hard assets, which act as a store of value, did very

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well during inflation's heyday – even before it got anywhere near double digit rates. The recent shift away from cities – particularly by Millennials – is reminiscent what sparked the building boom of the 1970s. Residential construction is a particularly leveraged, domestic and commodity-intensive industry -- making it a trifecta for inflationary pressure.

The global environment points toward higher prices as well. China is moving into greater isolation as they lick their wounds from the trade war. With 5% plus domestic growth and a \$16 trillion economy, they have less need to sell exports to a world that is barely growing. As the world's largest importer of commodities, they have shifted to a stronger yuan policy to boost their buying power. Supply chains will be shifting away from China, as much more for security as for cost, helping lift other low-income Asian nations (and Mexico). Bringing another several hundred million people at the bottom of the skills ladder into the global economy promises a reprise of the commodities boom early in the millennium when China was in that position. After the Great Financial Crisis, most growth was still in China, but their average income was high enough that it was services, not goods and commodities, that saw the greatest growth.

The world's experience with COVID has shattered many earlier norms, which means entrepreneurs and investors need to think outside the usual boxes to be successful. Developments like work from home, tele-learning, tele-medicine, delivery logistics and more are redrawing the competitive frontier. As the world's most creative and market driven economy, we believe the US has a comparative advantage that will support a higher trend in productivity and growth post-COVID than the snail-like growth before. Firms no longer need to look abroad for cheaper labor, as the domestic commute no longer limits their selection. The importance of location is being rethought – with consequences for taxation, real estate values, labor cost, and naturally – politics. The relief from the twin depressants of the Spanish Flu and WW1 led to the Roaring '20s. We are just looking forward to a not boring 2021 after a long COVID-induced pause in our normally hectic travel schedule over the past year. We hope you all enjoy a bright and happier New Year.

— Michael Drury

*The information and data used in the preparation of this report were obtained from public or private sources deemed to be reliable, but Smithfield Trust Company does not guarantee their accuracy. All opinions or predictions expressed herein are subject to change, without notice to the reader, based upon prevailing political, economic or securities markets conditions. The material in this Forecast was prepared in early January 2021 and is based on information available at that time.*

## **SMITHFIELD TRUST COMPANY BOOK REVIEWS**

### **MIDNIGHT IN CHERNOBYL**

*By: Adam Higginbotham*

This is a story of stupidity at the highest levels, or possibly more apt, what occurs when the reputation and supremacy of the State is more important than the lives and safety of the people the State is supposed to serve.

The ground breaking for the Chernobyl Nuclear Power Plant took place on February 20, 1970. It was to be the greatest nuclear power station in the world. Great fanfare took place on this day. Chernobyl was to be a monument to the supremacy of Soviet planning, engineering and vision. Construction was based on plans approved by the Ministry of Energy and Electrification of the USSR. The problem was that previously constructed, but smaller, plants had demonstrated that there were basic flaws in the plant design. But no one dared to tell the senior authorities that their blueprint was flawed because the State was never in error. Operators of smaller plants were able to jury rig workouts which reduced the likelihood of a nuclear meltdown. The massive scale of the Chernobyl plant was such that the slightest operator error could quickly spin out of control and create disaster. The day construction began, Victor Brukhanov, the plant director who supervised the construction of the plant, knew of the design defects, but did not protest. In the Soviet system, the State was never to be questioned nor its senior operatives challenged. On April 26, 1986 at 4:16 PM, the inevitable happened. The cooling water overheated and turned to steam. This then precluded the lowering of control rods into the core of the reactor which would shut down the chain reaction throughout the core. The reactor utterly failed. The core overheated and blew up, scattering hordes of highly radioactive material into the atmosphere which prevailing winds blew northwest into the Scandinavian countries.

There were a host of contributing factors to this disaster: shoddy construction materials, unqualified workers, especially welders, assigned to critical components of the construction and failure of inspectors to halt construction, because the Party dictated that the plant would be operational by a certain date. The tragedy of the culture of “Never Reporting Bad News” also resulted in the loss of lives of people living in Pripyat, a town close to the plant, who could have been evacuated if a prompt order were given.

The book provides numerous examples of heroism by individual Russians who knowingly exposed themselves to fatal overdoses of radiation exposure in an attempt to minimize the damage from the meltdown. At times, one has to put the book down and relax, because the senseless waste of human life is infuriating.

We are now living in the unreal world of COVID-19, something which apparently could have been significantly limited had the State, China in this case, taken prompt and appropriate measures to limit the spread.

Read this book in the spare time one now has since we cannot go anywhere, do anything, see our distant relatives, etc., etc., etc. It will make one think.

— Mike Daniel

## **THE FEAR AND THE FREEDOM**

*By: Keith Lowe*

World War 2 was undoubtedly the most cataclysmic event ever in world history. In this book British author Keith Lowe attempts to document all of the changes that grew out of the war. His scope is global, covering not only the major participants of the war but also the third world countries that were significantly impacted by it.

His discussions include myths and legends that grew out of the war, technological and medical innovations developed during the war, sociological changes stemming from the war, and, most significant for our time, the geopolitical changes that have occurred. Two major, but somewhat contradictory, trends that emerged after the war were the desire for more global governance, as manifested in the establishment of the United Nations, and increasing nationalism, as manifested in the independence movements in former colonial countries of the third world. The United States was dramatically transformed from an essentially isolationist country to a global superpower and would-be global policeman. The aftermath of the war saw major turmoil almost everywhere in the world as civil wars broke out and large ethnic groups were displaced from their historical homes.

This book was an ambitious undertaking, and I would say that the author largely succeeds in covering the major issues. I am sure that anyone with an interest in the history and meaning of the war will find interesting new information in this book.

— Henry Haller, III

## **ASSAULT IN NORWAY – SABOTAGING THE NAZI NUCLEAR PROGRAM**

*By: Thomas Gallagher*

My good friend Paul Reid (co-author with William Manchester of the Churchill biography “The Last Lion”) and I are firmly convinced that, without Winston Churchill and his creation of a second front against the Nazis, Hitler would have prevailed in World War Two by overwhelming the Soviets, consolidating his hold on Europe and then developing the atomic bomb. Hitler with the atomic bomb is obviously a hideous thought.

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While Allied scientists worked feverishly to catch Germany in a nuclear race, a secret mission was also developed to destroy or cripple Germany's nuclear capacity. This mission created a team, trained in Britain, of Norwegians to sabotage Germany's heavily fortified "heavy water" facility at Vemork, Norway.

Fighting the brutal Norwegian winter and gaining mobility through their prowess as skiers, these Norwegians pulled off one of the most daring commando raids in the history of warfare. A gripping and suspenseful tale, "Assault in Norway" merits your attention without question.

— Bob Kopf