

# THE SMITHFIELD Forecast

*A Quarterly Survey of Trends • Eighty Third Edition • April 2021*

*For Customers & Friends of*  
SMITHFIELD TRUST COMPANY

## **A NOTE FROM THE CHAIRMAN**

Our economist, Michael Drury, has, at least to some extent, tempered his optimism regarding our recovery from the COVID-induced recession. The printing of money in the current environment should, as Michael concludes, generate a heightened level of caution.

— Bob Kopf

## **Smithfield Second Quarter 2021**

### Working Through a Surplus of Stimulus

We have been at the wildly bullish end of the spectrum in forecasting strong growth for all of 2020 and on into 2021 – because of the money. With the passage of another \$1.9 trillion in this third round of stimulus, promises from President Biden that he would propose further aid in April, and a separate bill for \$3 trillion in infrastructure, one has to ask when enough is enough. Clearly, the economy is still far from normal with over 8 million more unemployed now than before COVID. However, the Administration itself estimated that the latest round of \$1,400 checks to households, plus widespread aid to businesses and state & local governments, would lift the economy all the way back up to its previous growth track by the end of 2021. A full recovery in employment was expected to lag somewhat due to productivity gains – but the latest Federal Reserve Summary of Economic Projections has joblessness back down to 4.2% -- below the OMB's 4.4% long run natural rate – by the end of 2022. Is more stimulus needed?

The push for more appears to be driven by political realities, rather than economic need. The \$2 trillion infrastructure bill, which swelled to \$4 trillion before retreating to \$3 trillion, was running into enough opposition interference that discussions of altering filibuster rules have been widespread within the Beltway. Meanwhile, allocating new stimulus via the normal budget process can be achieved under reconciliation rules, which require only 50 votes. Moreover, the infrastructure bill's spending is spread out over 10 years, which would make this year's con-

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tribution paltry in comparison to the \$2.7 trillion in stimulus in 2020 and \$2.8 trillion so far this year. Bottom line, Congress has the votes for budget measures, and they are riding strong approval for both the current stimulus package (who doesn't like free money) and the vaccine rollout. As always in politics, it is best to strike while the iron is hot. Remember, like Biden, each of the last four Presidents was elected with control of both houses of Congress – only to lose one in the midterm elections. Thus, it would appear that more money is coming.

Given we have already been optimistic, we see no reason to gild the lily and are sticking with a 6% growth forecast for 2021, before slowing to 3% in 2022. However, we do think the growth path will be more front loaded now, with real GDP growth in the first half averaging about 8%, before cooling to 4% in the second half of the year. The go early and go big approach to stimulus does increase the risks to economic growth. Long term interest rates have risen more than a full percent from their low point last year as investors push back against the Federal Reserve's *laissez-faire* attitude toward inflation. Indeed, fostering inflation above 2% for at least a year is less a trigger for future monetary intervention than a goal to be achieved as part of the new push for greater equality. After all, inflation is a silent tax on those with existing fixed income assets – which is much easier to enact than passing actual legislation.

One simplistic way to look at the economy is to focus on the “five eyes” – Income, Inflation, Investment, Inventories and Imports. Income and nominal GDP are synonymous, as each individual is paid the value of their output via wages, profits, dividends, interest or proprietor's income. Governments collect their value added (yes, there is some) via taxes and fees. However, excess money printing can distort the economic picture via either inflation or a jump in investments. Clearly, it has

been asset values that have enjoyed the brunt of the impact of the stimulus tsunami so far. However, there is widespread acceptance that consumers will spend out of savings after the economy is fully open. Since current income equals current production, if collectively we are spending out of assets – that is the very definition of inflation, as more money will be chasing the currently produced amount of goods and services.

Inventories and imports are two critical safety valves for the economy, as they offer alternatives to inflation. Where excess demand generated by money printing might generate inflation (in goods or assets), the depletion of inventories is effectively corporate dissaving, as they sell existing goods out of their stockpiles. Similarly, production from abroad can absorb spending power – and the question becomes how and when that money is recycled to the US. A widening trade deficit, as in 2020 and now, suggests it is being invested back into financial assets, which helps provide funding for the government's deficit spending. In this particular economic episode, imports (especially from China) have satisfied a significant part of consumer's demands for electronic goods and furniture as the COVID nesting effect took hold. That is good news for inflation, but for jobs -- not so much. In the second half of the year, it is likely that a combination of inventory rebuilding from deeply depleted levels – especially after this latest stimulus induced spending surge – plus a retreat from imported goods, as consumers shift back to travel and entertainment, should support US job growth at a higher level than suggested by spending alone.

Our strongest observation as we enter the second quarter of 2021 is that optimism is currently at a fever pitch – just as pessimism was a year ago. The combination of hefty stimulus and the rapid roll out of vaccinations have lifted outlooks so far that our unchanged bullishness is now merely in the consensus. That shift raises

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our contrarian antennae, and leads us to ask what could go wrong? What concerns us most is the lack of profits net of subsidies paid via PPP and other programs. The final estimate of fourth quarter GDP report showed that nominal output was down only -1.2% from a year ago, and that income (they estimate both ways) was down only -0.2%. Meanwhile, profits were 3.6% higher – despite higher costs for labor, interest, transfers and depreciation. What made it all work out was a 35% drop in taxes net of subsidies – or \$366 billion. Without this government largesse, corporate profits from domestic sources – our main focus for jobs – would have been down -16.5% from a year ago. If the government were to pull back on its stimulus efforts, it seems likely that firms would go back to correcting a profit shortfall the old-fashioned way, by layoffs and cuts in capital spending (which also means layoffs somewhere else). Since this is hardly what the Administration is planning for, we expect there will be more aid in the near term, but this is quickly becoming a case of just kicking the can down the road.

How long can the deficit spending continue? That is more a political question than an economic one. Even at current long term interest rate – which have risen quite a bit over the past year – interest rates on five-year and ten-year notes that are rolling over during the next three years will be anywhere from 25% to 60% lower than the interest rates at which they were originally issued. Thus, interest expense will still be declining even with steeply rising deficits. Clearly, the bond market may not like this and keep pushing rates higher. We have argued many times that if the Federal Reserve insists on near zero short term rates and more than 2% inflation, the ten year should trade above 2%. Thirty-year rates are already there because the Federal Reserve does not buy those as part of its \$120 billion monthly purchases.

Bottom line, we do not believe the Administration or the Federal Reserve is unhappy with the current state of affairs in the economy. The path of least resistance is to do more of what is working – in their view. Whether future stimulus includes more money drops that are 90% saved or targets areas that generate more spending will alter which sectors of the market benefit – or don't. However, in our view, all investors should feel a bit more cautious about the future, given that lack of concern among those that currently run the printing press.

— Michael Drury

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## **SMITHFIELD TRUST COMPANY BOOK REVIEWS**

### **PARIS, 1919**

*By: Margaret MacMillan*

This book tells the story of the Paris Peace Conference following World War 1. Although most people remember this for the Treaty of Versailles setting the terms for Germany's surrender, it involved far more than just that. In a very real sense it created the framework for the rest of the Twentieth Century, and many of its repercussions persist to this day.

The author, Margaret MacMillan, is the great granddaughter of British prime minister David Lloyd George, one of the "big four" who took charge of the conference. The others were the American president Woodrow Wilson, French prime minister Georges Clemenceau, and Italian prime minister Vittorio Orlando. In addition to these four, there were national leaders from all over the world, from as far away as Japan and China. Even Vietnam's Ho Chi Minh made an appearance; apparently he was not given much attention, which may have contributed to the stresses that led up to the Vietnam War 40 years later.

The conference set national boundaries in some of the most troublesome areas of the world such as the Balkans and the Middle East. It was fascinating to read of all the political maneuvering among the leaders of these countries, all trying to get the most territory for their countries. For example, I had not realized that Poland had not existed as a country going into the war. This new country was created out of territories taken from Germany, Russia, and Austria-Hungary, with a great deal of politicking by the concerned players. Austria-Hungary itself ceased to exist, and taking its place were the much smaller countries of Austria and Hungary. The artificial country of Iraq was created at this time, and the stage was set for the territory of Palestine to later become the country of Israel.

Far more was established at this conference than I can touch on in this review. Another part of the history of this time that was new to me concerned all of the border wars going on in a scramble for territory. The "war to end all wars" certainly failed to accomplish that! Ms. MacMillan provides great detail on the lives of all the major players, both military and political, that shaped the results. Reading this book gave me considerable insight into subsequent world events, up to and including world politics today.

— Henry Haller, III

## SMITHFIELD TRUST COMPANY BOOK REVIEWS (Con't)

### APOCALYPSE NEVER

By: *Michael Shellenberger*

The author, Michael Shellenberger, has been an environmentalist all his life. Although he once accepted many of the beliefs of the left regarding the more extreme dangers we presently face, he still has concerns about the environment. In this book he sorts out what dangers are real, and what have been wildly exaggerated.

I felt he does an excellent job of debunking the left's anti-human Malthusian doctrine that we are destroying the planet and are all doomed within the near future. The Greta Thunbergs of the world are frightening children with the threat of global doom if we do not immediately take drastic action. He describes demonstrations he has witnessed, mostly in Europe, in which these fear mongers disrupt normal business activity in order to get attention.

What today's environmentalists seem to ignore are the effects their proposals would have on people in the third world. Shellenberger has traveled extensively in Asia and Africa, and he uses interviews with people there to make his point effectively. For example, he tells of a woman in the Congo who is struggling because wild baboons are eating the produce of her garden. The problem as he describes it is not saving the baboons, but saving them in a way that allows the local people to grow their crops unmolested.

"Climate change" is, of course, the environmental issue most prominent today, and he discusses this at length. His view is that it is real, it is mostly caused by carbon emissions, and it is a serious problem, but not even the most serious environmental problem today. He is highly critical of those on the left who reject the use of nuclear power to generate our power cleanly. Since it is clear that wind and solar will never be completely adequate to provide for our power needs, nuclear seems like the default choice if we are serious about limiting carbon emissions.

My one quibble with the book is that it seemed very repetitious to me. He rehashes the same arguments several times in different chapters of the book. That being said, I found his arguments logical and compelling, and would recommend this book to anyone looking for more information on this timely issue.

— Henry Haller, III

### HERO OF THE EMPIRE

By: *Candice Millard*

If you are at all like me, your usual breakfast routine involves a glass of orange juice and a burned piece of toast. If I were to write about this routine, the description would easily cure insomnia. However, Candice Millard's

writing about my typical breakfast would result in an irresistible page-turner. Not unexpectedly, this talented author has penned a masterful tale of Winston Churchill's capture and subsequent escape from a Boer prison in 1899.

Having lost at age 24 his first elective attempt to Parliament but still filled with overwhelming ambition, Winston Churchill became a war correspondent in South Africa covering the British effort to quell the Boer rebels. Just two weeks on the scene, Churchill, riding on a troop train, was ambushed by the Boers. Acting more as a soldier than a journalist, he was captured and imprisoned. He abhorred confinement and then escaped his captors with a bounty on his head. A combination of luck and heroism led Churchill to freedom beyond the borders of South Africa. His adventures in an escape are chronicled skillfully. Returning to the fray, Churchill then freed the men with whom he was imprisoned.

The lessons learned in his Boer War experience, plus the invaluable celebrity status conferred upon Churchill, propelled him to greater heights in the ensuing century.

The book would make a splendid movie.

— Bob Kopf

## **THE DAUGHTERS OF YALTA**

*By: Catherine Grace Katz*

In 1945 Franklin Roosevelt, Winston Churchill and Joseph Stalin had a fateful conference at Yalta to set the stage for world governance after the then expected defeat of Germany. Assisting Roosevelt and Churchill, the U.S. ambassador to the Soviet Union, Averell Harriman, was instrumental in organizing the conference.

This is the story of three highly intelligent and strong-willed women chosen by their fathers to accompany them to the Yalta Summit: Kathleen Harriman, Anna Roosevelt and Sarah Churchill. Each daughter was fiercely devoted to, and protective of, her father, and each played a critical role in the tense and arguably flawed negotiations of the United States and Great Britain with Joseph Stalin.

The interactions of the three daughters with Stalin are quite engrossing. Fluent in Russian, Kathleen Harriman addressed Stalin in an insightful manner, and Anna Roosevelt's remarkable efforts to hide the condition of her frail and dying father are noteworthy.

I had the pleasure of meeting Catherine Grace Katz at a lecture in Idaho, and she is charming and intelligent. Her well-researched and well-written first book is most worthy of your attention.

— Bob Kopf