FLORIDA
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Economic Update

January 26, 2017

PMA
PRUDENT MAN ADVISORS

Economic Commentary

Economic Overview

Much has changed since we last met. The FOMC has increased rates, a new President has been elected and republicans have taken control of both the House and the Senate. Many policy shifts are likely to be in store for the future. While financial markets generally do not like uncertainty, the stock market rallied post-election and bond markets have adjusted to a rising rate environment with an increase in rates across the maturity spectrum. What does this mean for our U.S. economy?

Fueling the equity rally are Trump's proposed pro-growth economic policies including tax reform, fiscal stimulus via lower taxes and increased infrastructural spending, and less stringent environmental regulations. If implemented, these policies could boost economic growth. On the flip side, policies that address trade and immigration issues could restrict domestic economic growth. Going forward, we expect a watered down version of Trump's economic policies to pass. That said, we believe the devil is in the details. Overall, a much needed fiscal stimulus package will likely boost demand and economic growth in the short-term but will likely not address structural issues such as changing demographics, a declining labor force growth rate, and slower productivity.

Economic Commentary

In terms of gauging the overall health of the U.S. economy, third quarter gross domestic product grew at a 3.5 percent annualized rate following a 1.4 percent gain during the second quarter and is the strongest quarterly pace of growth in over 2 years. Underlying data showed positive contributions from consumer spending, net exports, gross investment and increased government spending. Detractors during the quarter included residential fixed investment and imports. Heading into 2017, the World Bank is projecting that the global economy and the U.S will grow at 2.8% and 2.2%, respectively. According to the Bank, risks to global growth include; economic slowdown in major emerging markets, Euro area, Japan and the U.S., increased financial market volatility, heightened geopolitical tensions and declining confidence in the effectiveness of polices to stimulate growth.

Other important economic variables to look at include unemployment, manufacturing, inflation and consumer sentiment. The labor picture remains constructive overall for the U.S economy. The November jobs report showed that the U.S. added 178,000 jobs; which remain close to the 2016 monthly average job growth of 180,000 jobs, but is below the 2015 monthly average of 229,000 jobs. The unemployment rate dropped to 4.6 percent from 4.9 percent in October and is at the lowest level since August 2007. Sectors that contributed positively to the jobs number included professional and business services and health care. According to the Federal Reserve Bank the long-term estimate for full employment ranges from 4.6 to 5.0 percent. This means that the U.S economy has finally attained full employment. Heading into 2017, we expect the labor market to continue to tighten. Further tightening in the labor market will likely result in higher wage growth and rising inflationary pressures.

Economic Commentary

Manufacturing, which accounts for about 12 percent of the economy, continued its upward trend. In November, the Institute for Supply Management (ISM) index rose to 53.2 percent from 52.1 percent in October, while the non-manufacturing index which gauges the service sector increased to 57.2 percent from 54.8 percent in October. Both indices remain consistent and in-line with improvements observed in the global economy. In November, the Markit Global Purchasing Managers' (PMI) indices for manufacturing and services, which tracks business conditions in over 30 countries, posted their highest levels in two years. Generally, numbers above 50 signal expansion. These indicators signal growth in the U.S. and global economies. In 2017 the U.S manufacturing sector may experience contraction driven by a stronger dollar and sluggish demand from abroad. A stronger dollar will make U.S exports more expensive and foreign returns will depreciate in value.

The Federal Reserve has a dual mandate; maximum employment and price stability. While the Fed has achieved its goal with regard to employment, they continue to closely monitor inflation. Consumer prices continue to approach the 2 percent Fed target level. In November, the year-over-year headline Consumer Price Index (CPI) grew by 1.7 percent spurred by higher fuel and shelter costs, while the core CPI which excludes food and energy remained unchanged at 2.1 percent. The core Personal Consumption Expenditure (PCE) price index, remained flat at 1.7 percent and has been below 2 percent for more than four years. While the backward looking CPI and PCE indices inflation numbers remain subdued, forward inflation expectations have inched higher over the past few months. At year end, the 10 year breakeven inflation rose to 1.99 percent, a level last observed in June 2015. Going forward, we believe strength in the U.S dollar and tighter monetary policy will constrain inflationary pressures.

Economic Commentary

American consumers remain optimistic. Consumer sentiment improved significantly in November following Donald Trump's presidential victory. The Conference Board's Index of consumer confidence, a gauge of optimism about the US economy increased to 113 in December, above consensus expectations of 109, hitting a 13-year high. According to a statement released by the Conference Board, the improvements reflected a "post-election surge in optimism for the economy, jobs, and income prospects". Underlying data showed older consumers (+35) experienced pronounced optimism compared to younger consumers. Consumer sentiment indicators are key in providing a glimpse of what to expect in terms of spending and consumption habits, which ultimately drive economic growth.

All in all, we anticipate somewhat improved U.S. economic growth expectations. With unemployment at a new cyclical low and inflation approaching the Fed's target level of 2 percent, we expect higher interest rates as the FOMC is likely to pursue additional rate hikes in 2017. As we face an increasingly uncertain world, we expect to see increased volatility in stock and bond markets in 2017.

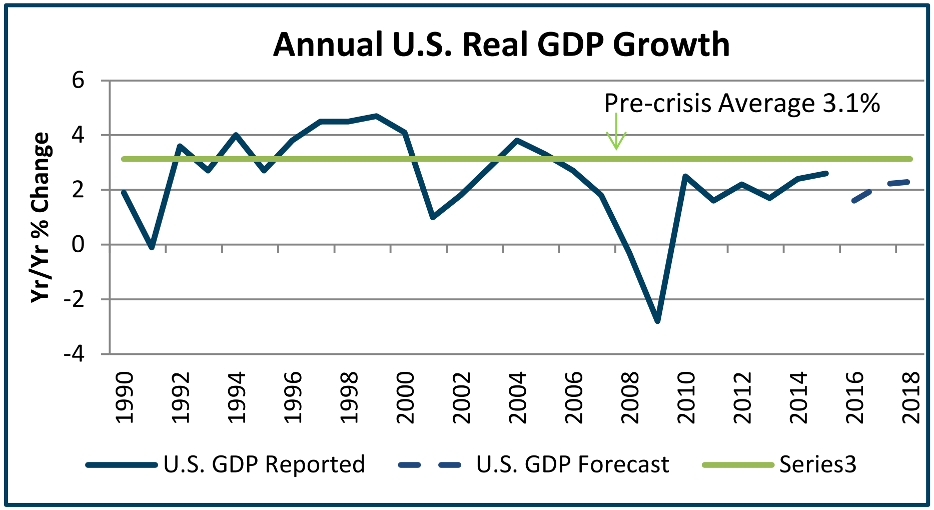
Economic Outlook

Annual GDP Growth

- Full year 2015 2.6%
- 2017 growth expectations are brighter.
- New Trump administration fueling optimism for faster domestic GDP growth
- Proposed tax cuts, infrastructure spending and overall favorable climate for corporate America
- Europe and other international markets are expected to be a drag on global growth in 2017

Quarterly GDP Growth

- Q3 2016 3.5% annual rate vs. Q2 at 1.4%
- Q3 revised up from 3.2% previous estimate



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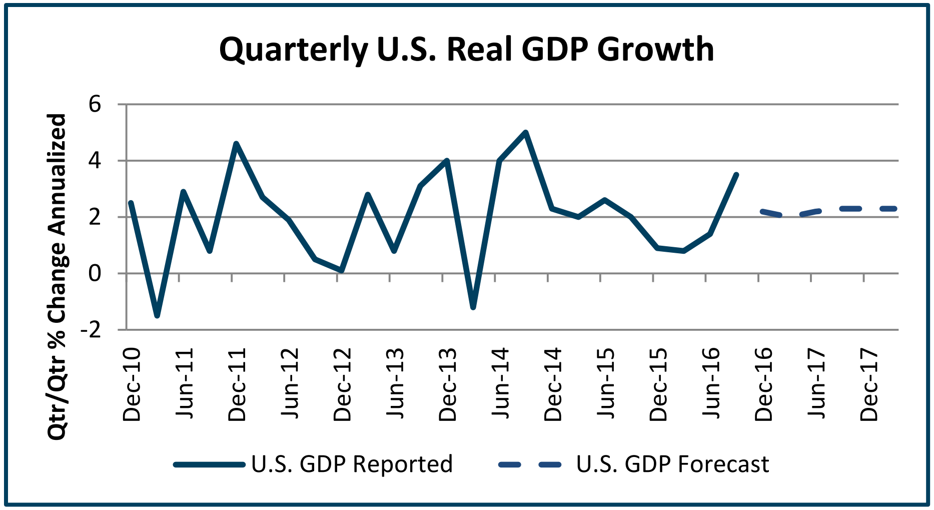

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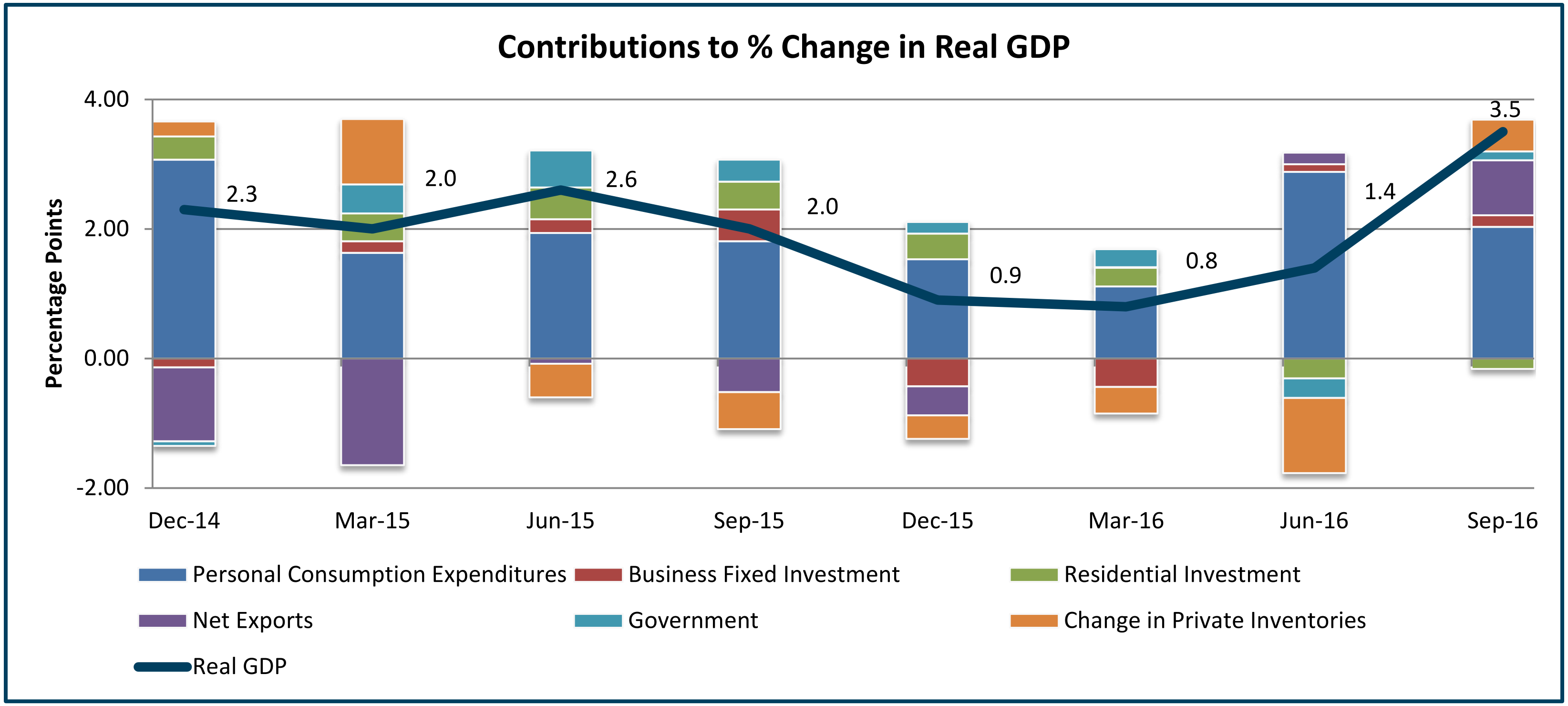
Economic Outlook



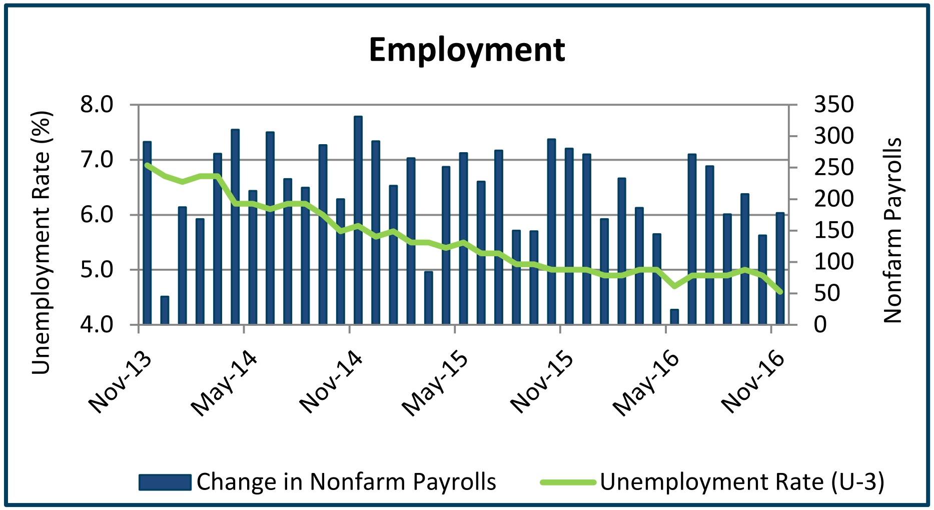
Source: Bloomberg

Contributing Factors to Quarterly GDP

- Personal Consumption Expenditures up 3% annualized
- Net Exports contributed due to a very strong 7.8% annualized growth in exports. Imports are an offset
- Residential Fixed Income investment posted another decline for the second quarter in a row

Employment

- Unemployment rate fell to 4.6% in November
- Payrolls increased 178,000 in November, up from October
- Key factor in allowing Fed to continue increasing rates



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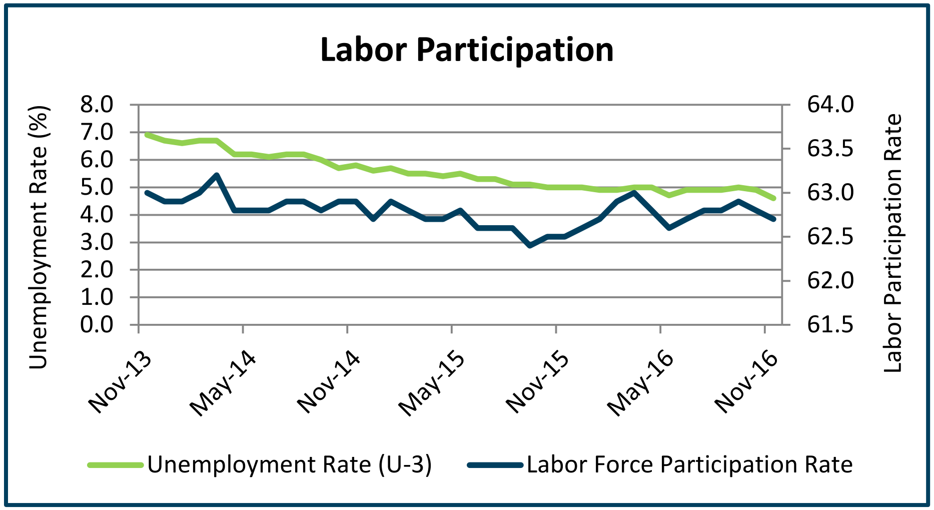
Labor Participation

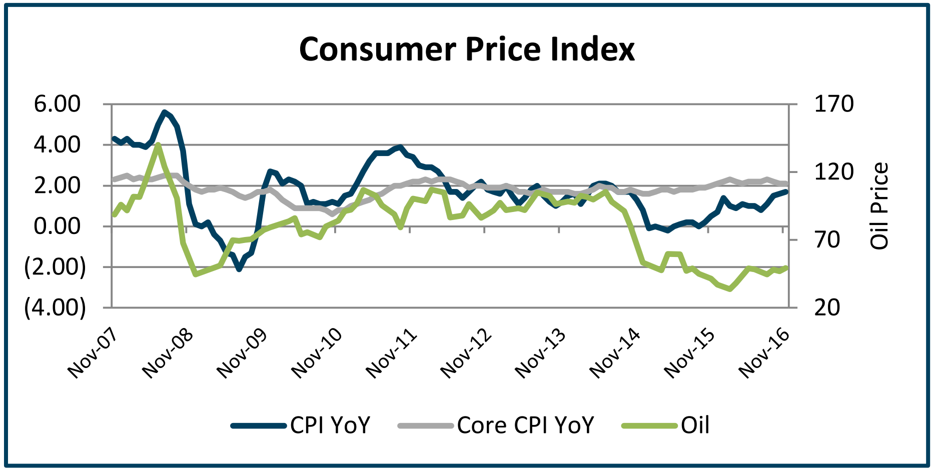
- Participation rate continues to be a drag
- Demographic shifts as well as skills gaps will likely influence going forward



Source: Bloomberg

Consumer Price Index (YOY)

- CPI increased 1.7% over the past 12 months ending November
- Core CPI excluding food and energy rose 2.1%
- Shelter and gas prices were the main contributors. Gas was up 2.7%
- Medical care index was unchanged
- Inflation has picked up, but long term trend is relatively benign
- Forecast has increased somewhat fueling the fed to move
- Long term yields have moved accordingly



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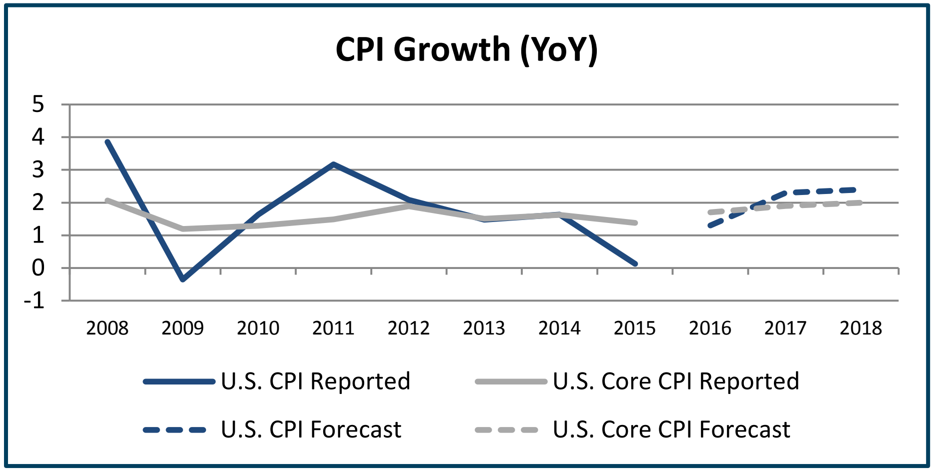
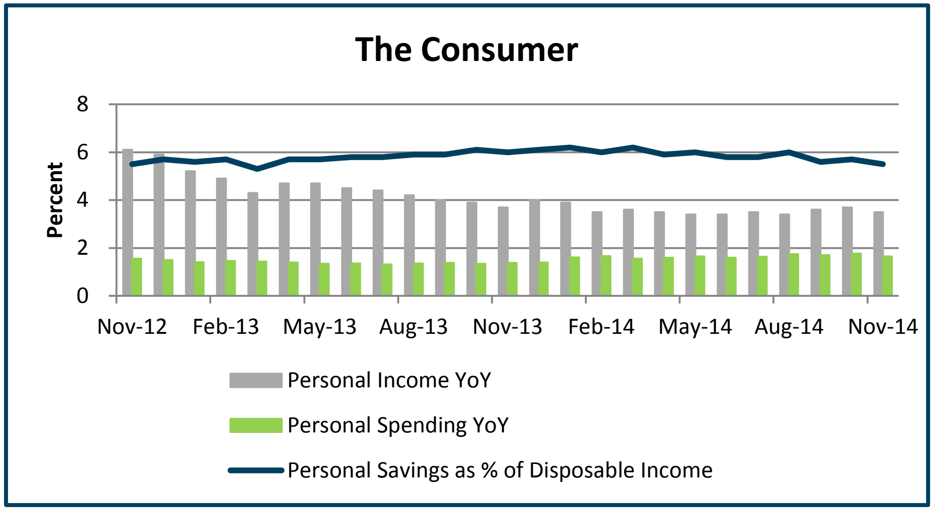


Source: Bloomberg

The Consumer

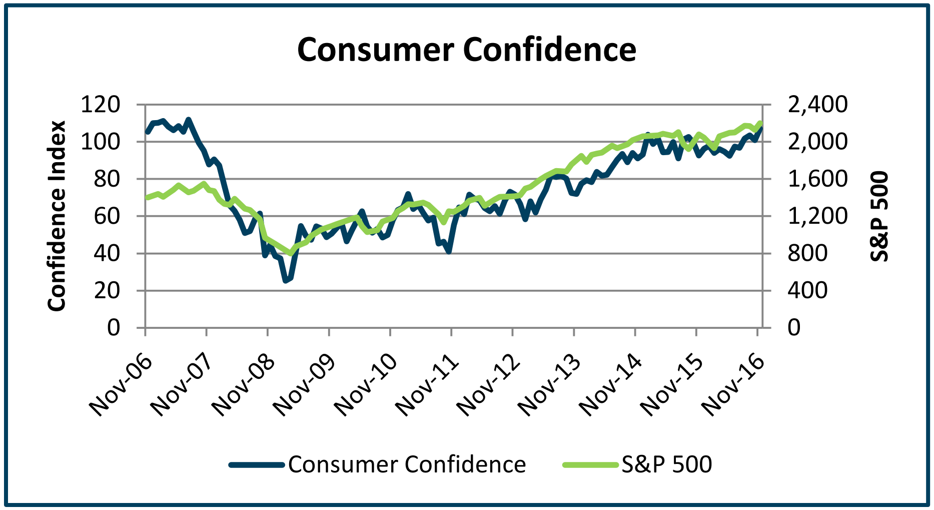
- Personal Income grew at 3.5% YOY in November vs. 3.4% in August
- Personal Savings down slightly to 5.5%
- After tax and adjusting for inflation, wage growth is not keeping pace



Source: Bloomberg

Consumer Confidence

- Does the stock market drive confidence, or confidence drive the stock market?
- Confidence is on the rise and nearly back to pre-crisis levels
- Stronger labor market
- Improving wealth effect from stock market, housing and savings



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