FLORIDA SAFE INVESTMENT POOL

Economic Update

January 28, 2016

PMA
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Economic and Market Commentary

Economic Overview

Finally! The Federal Open Market Committee (FOMC) took the first step toward the normalization of interest rates by raising their target range for the federal funds rate by 25 bps. Although the FOMC removed the uncertainty about the first Fed Funds rate hike, it was quickly replaced by the uncertainty of how quickly they will move rates higher as we move forward. This sentiment was echoed by the Fed in its usual guarded way in the press release following its December meeting. One of the key takeaways from that release was the statement that "the Committee expects that economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate; the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run." While we do not believe this was a "one and done" rate increase, we think economic conditions will lead to a rather slow and gradual path to somewhat higher rates.

Real gross domestic product (GDP) increased at an annual rate of 2.0 percent in the third quarter of 2015, according to the third and final estimate by the Bureau of Economic Analysis. The increase in real GDP in the third quarter primarily reflected positive contributions from personal consumption expenditures, nonresidential fixed investment, state and local government spending, and residential fixed investment. Consumption remained strong in the quarter with consumer expenditures up 3.0 percent year over year. This follows an even stronger increase of 3.6 percent in the second quarter. Overall growth was offset by a negative contribution from private inventory investment. Inventory accumulation in the first half of the year deducted 0.7 percent from third quarter growth, revised up from the initial -1.4 percent estimate. However, many believe inventories still need to be reduced further and this could mean a stronger headwind to future growth.

Economic and Market Commentary

The U.S. economy expanded at a 2.2 percent rate through the first nine months of the year, and the economy is projected to grow at a similar pace in the fourth quarter. If so, the economy will have failed to reach 3.0 percent growth for the tenth straight year, marking the slowest stretch of growth since the end of WWII. Historically, the economy has expanded at a 3.3 percent average rate. Real GDP has averaged only 2.2 percent annually so far during the current expansion, yet the unemployment rate has dropped to 5.0 percent from its high of 10.0 percent in September of 2009. Although a 2.2 percent growth rate for the early phase of an economic expansion may be disappointing by historical standards, apparently it is still fast enough to reduce the unemployment rate and begin to generate moderate wage gains.

The unemployment rate was unchanged in November at 5.0 percent. Payroll additions of 211,000 followed a very strong October revision of +271,000 (the strongest increase this year). Further evidence of a strong labor market can be seen in the October job openings number of 5.5 million (the second highest number on record) and the fact that applications for unemployment benefits are bouncing around the lowest levels in about four decades. All of this indicates we will see even further tightening in the labor market as we move into 2016. The employment situation was one of the key factors that allowed the Fed to raise rates in December, and strong aggregate demand in the economy suggests that unemployment could likely fall faster than the Fed anticipates in 2016.

Headline consumer prices remained flat in November, in line with consensus expectations. Headline inflation is now up 0.5 percent from November of 2014, while the energy index is down 14.7 percent over the same timeframe. Core CPI increased to 2.0 percent year over year and was higher by 0.1 percent month over month. With the drag from lower energy set to fade in early 2016, headline inflation should also begin to move closer to the Fed's 2.0 percent mandate in the medium term.

Economic and Market Commentary

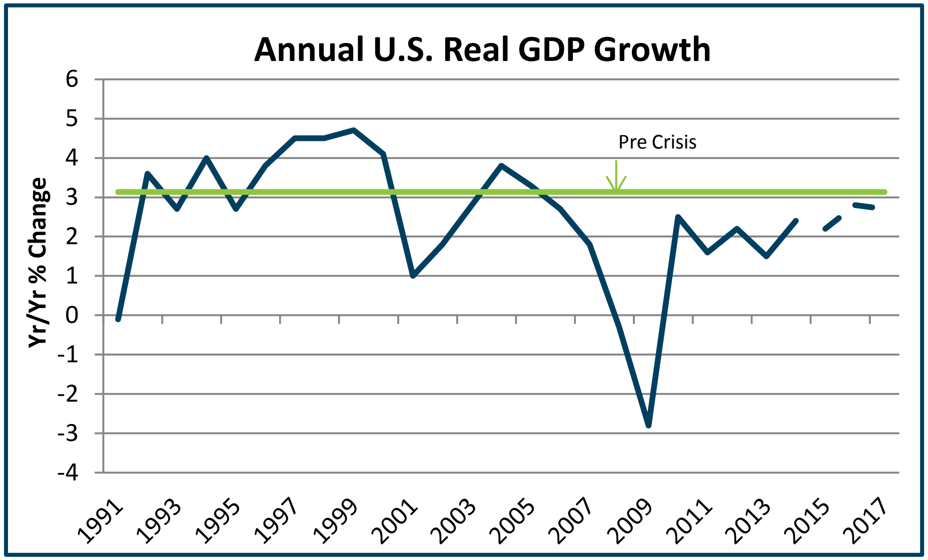
Given household consumption accounts for nearly 70 percent of our domestic economy, let's take a closer look. The consumer is in better shape with income increasing at a faster pace than inflation. November showed a 0.3 percent increase in household income after a 0.4 percent advance in October with strong gains of 0.5 percent in the wages and salaries component. Consumer spending rose 0.3 percent both nominally and on an inflation-adjusted basis as prices were little changed. This is the most spending in three months. Adding to this cushion was cheaper fuel prices. That being said, the consumer continues to pocket most of the savings from lower gas prices and higher wages as indicated by the personal savings rate which inched down to 5.5 percent in November, after reaching a three year high of 5.6 percent in October. This savings rate is high relative to historical standards.

The wherewithal to spend is growing, but the willingness is dampening economic growth. It is a relatively new phenomenon that consumers are reluctant to borrow money to boost their spending. In effect, we have seen consumers spending more in line with income gains. This was expected earlier in the recovery as the availability of credit was nil. However, as we have moved further into the recovery we have seen signs of greater credit availability, but more reluctance on the part of consumers to use their balance sheet to drive higher spending. This is especially true in the housing sector where increased regulation post crisis continues to limit the availability of greater credit backed by real estate.

Economic Outlook

Annual GDP Growth

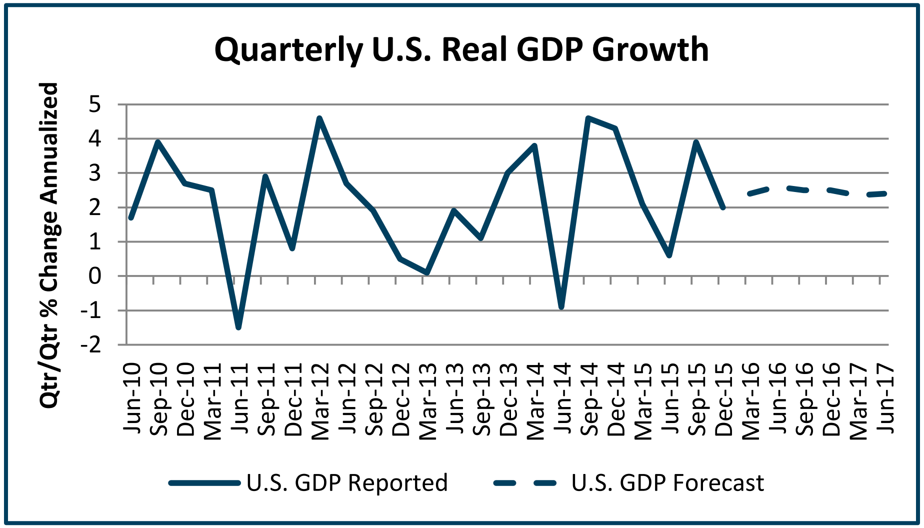
- Full year 2015 likely to come in just above 2%
- Long term growth expected to remain below 3% average
- Recent consumer spending has helped, but strong savings rate has dampened any significant growth
- Slowest expansion since end of WWII



Source: Bloomberg

Quarterly GDP Growth

- Q3 2015 2.0%
- Strong personal spending for 2nd quarter in a row
- Fixed investment and government spending also contributed
- Inventories detracted and may be a headwind for the future



Source: Bloomberg

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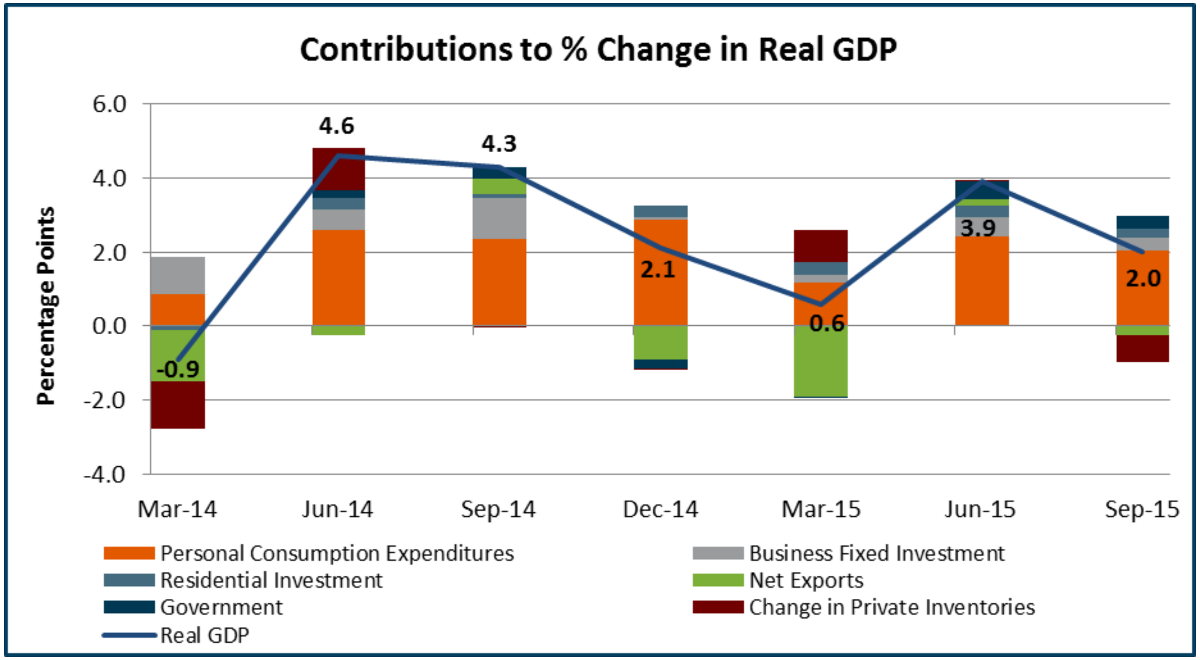
Economic Outlook

Contributions to GDP

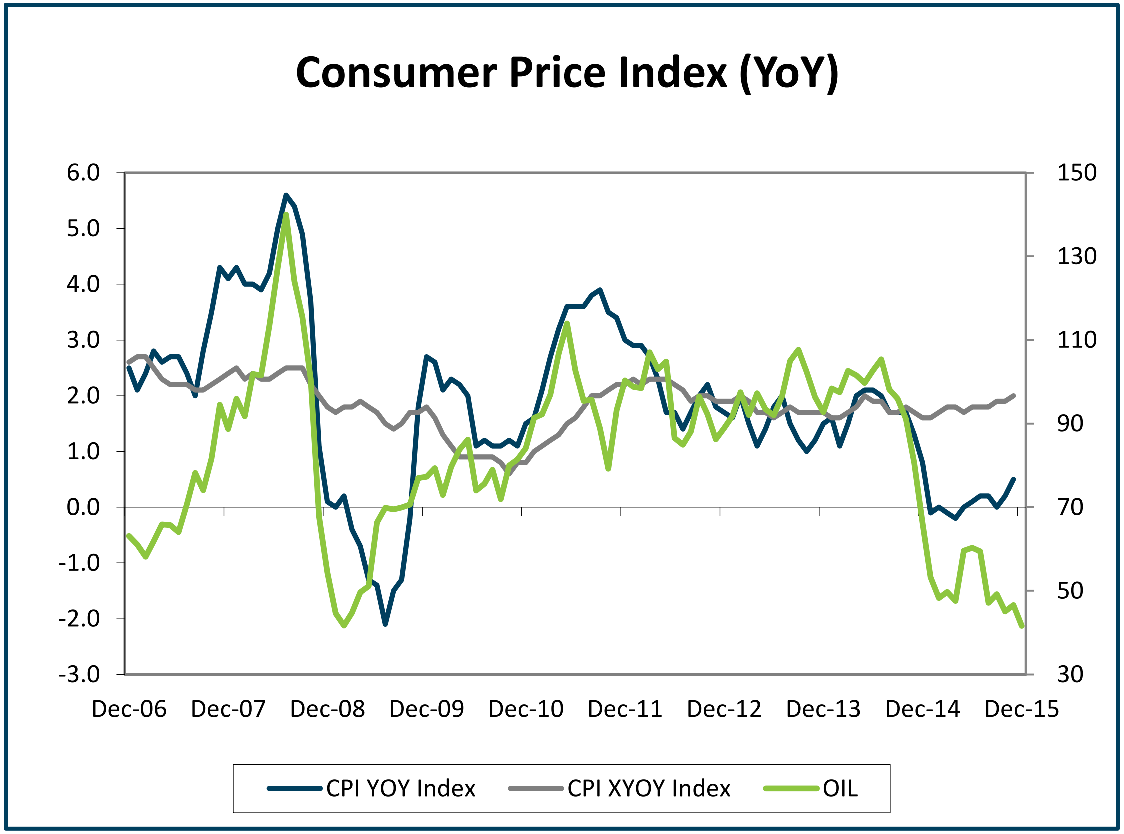
- Consumer spending is key
- Shrinking inventories impacted 3Q GDP
- Net exports have been a swing factor
- Government spending stronger past two quarters
- Business investment also contributing



Source: Bloomberg

Consumer Price Index (YOY)

- Oil prices reaching new lows
- YOY comparisons in energy will have less impact on headline inflation in 2016
- Core CPI remains close to Fed's 2% target rate

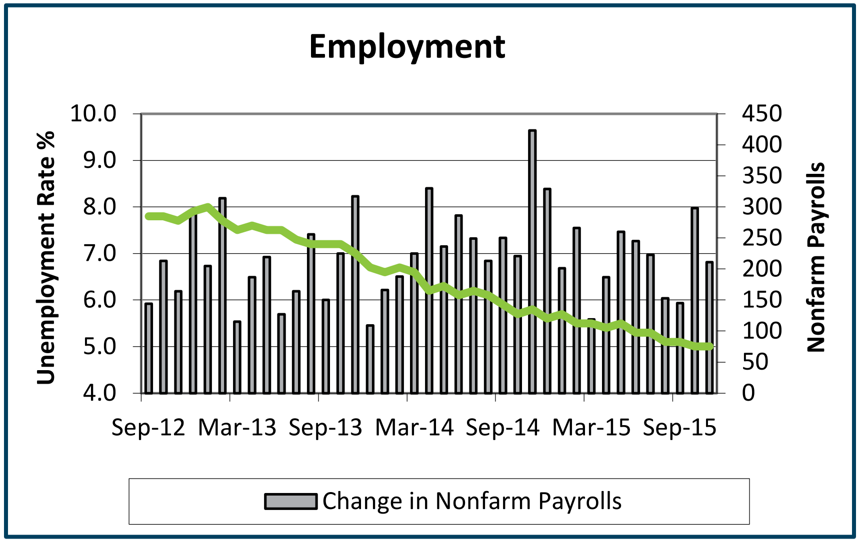


Source: Bloomberg

Employment

Employment

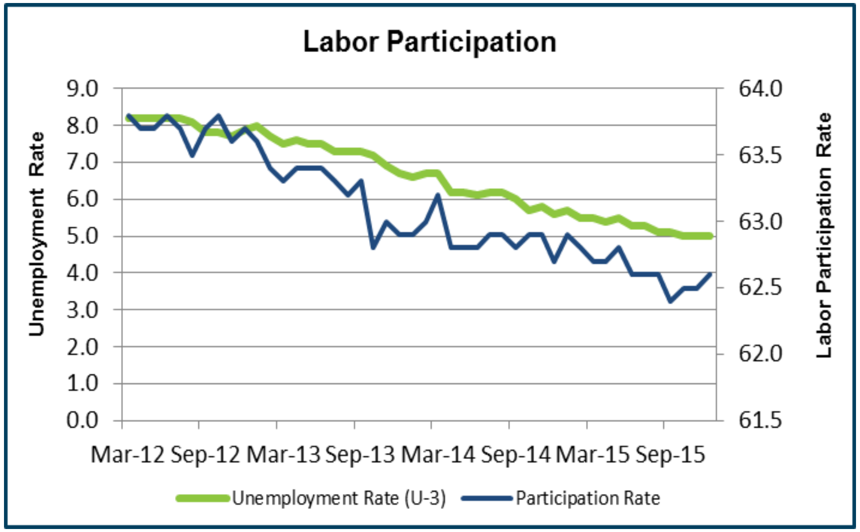
- Payrolls growing nicely
- Continued decline in unemployment expected
- Wage inflation likely
- Key factor in allowing Fed move in December



Source: Bloomberg

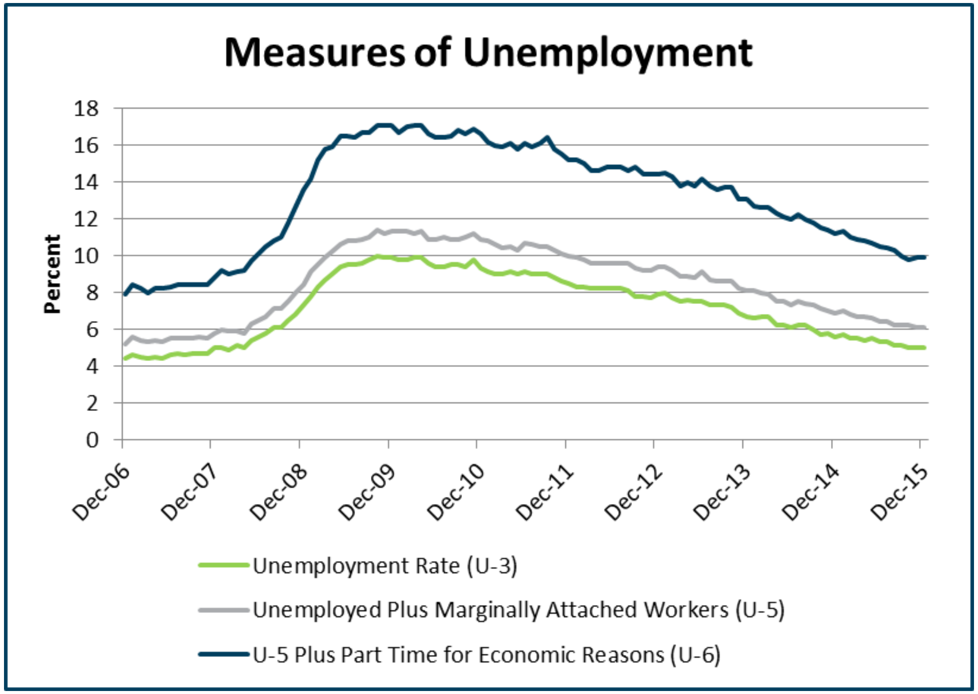
Labor Participation

- Declining participation rate
  - Aging Baby Boomers
  - Younger people delaying entry to pursue advanced degrees
  - Higher disability claims
  - Lower participation by women
- Creates a drag on economic growth



Source: Bloomberg

Employment



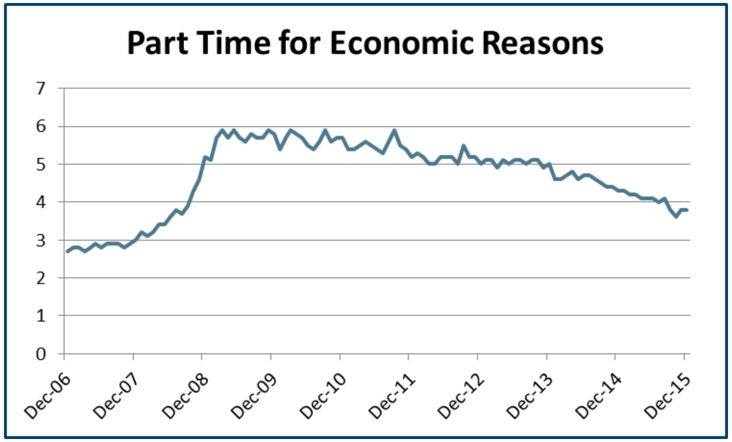
Source: Bloomberg

Underemployment

- All measures of unemployment are declining
- Underemployment remains near 10% and well above pre-crisis levels
  - Marginally Attached Workers
  - Discouraged Workers
  - Part Time for Economic Reasons
- Additional drag on economic growth

Part Time for Economic Reasons

- Difference between U-5 and U-6
- Declining, but above pre-crisis levels
- Lower wages
- Less spending power



Source: Bloomberg

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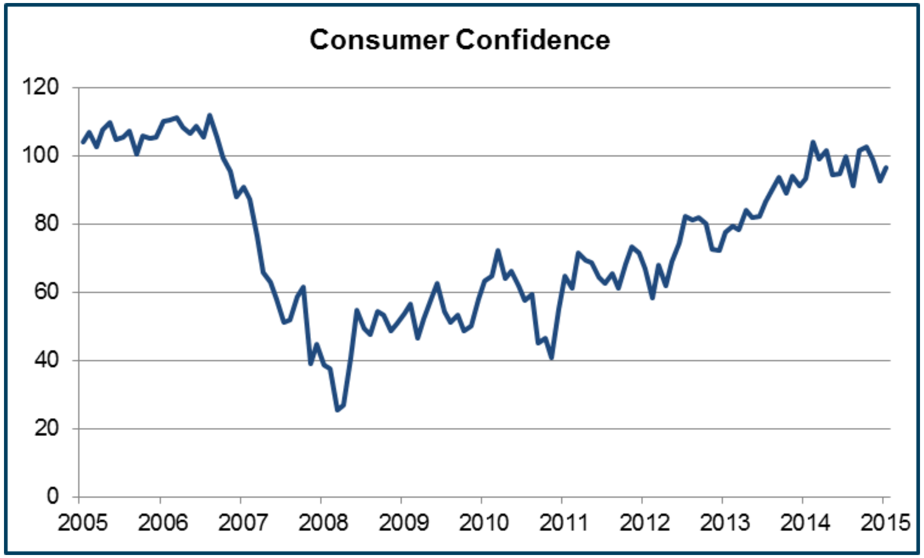
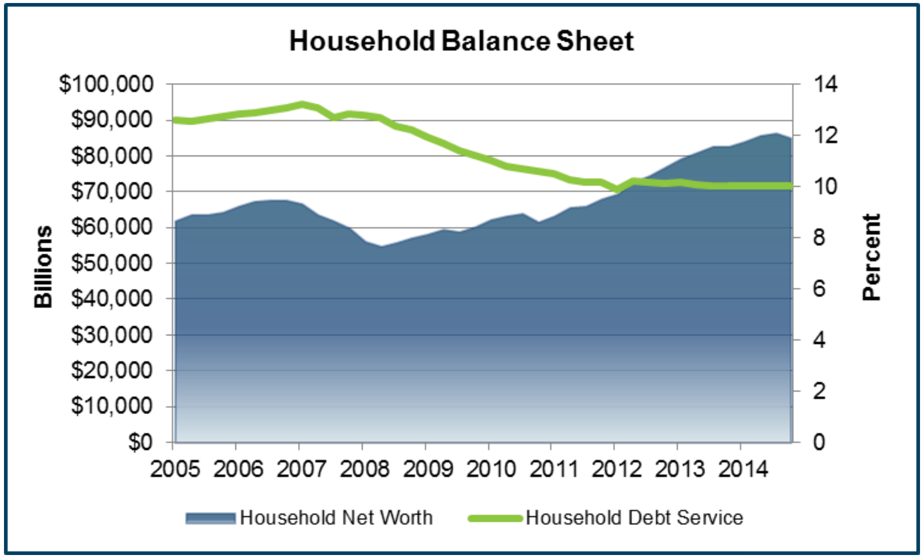
The Consumer

- Consumer Confidence has leveled off in 2015
- Historically correlated with Consumer Spending



Source: Bloomberg

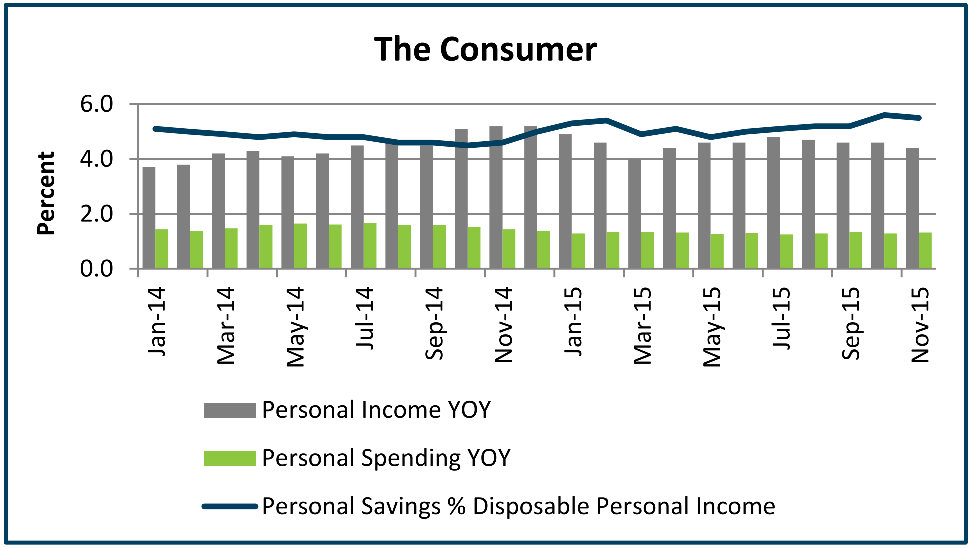
- Household Net Worth exceeds pre-crisis levels
  - Largely due to equity gains
  - S&P Case-Shiller HPI below market peak
  - Wealth reallocation
- Household Debt Service is down
  - Savings up



Source: Bloomberg

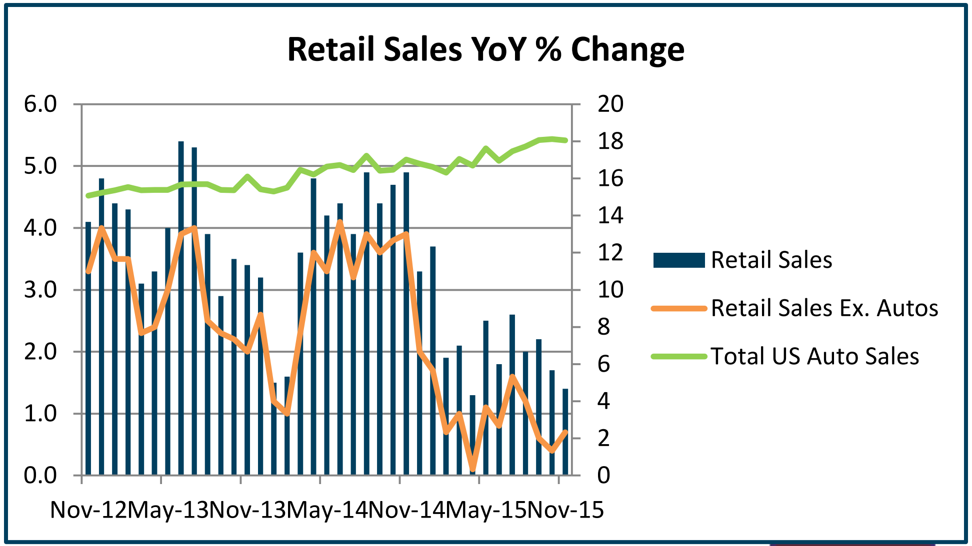
The Consumer

- Personal income is strong
- Lackluster personal spending continues
- Very strong personal savings relative to historical averages
- Consumer reluctance to spend dampening economic growth



Source: Bloomberg

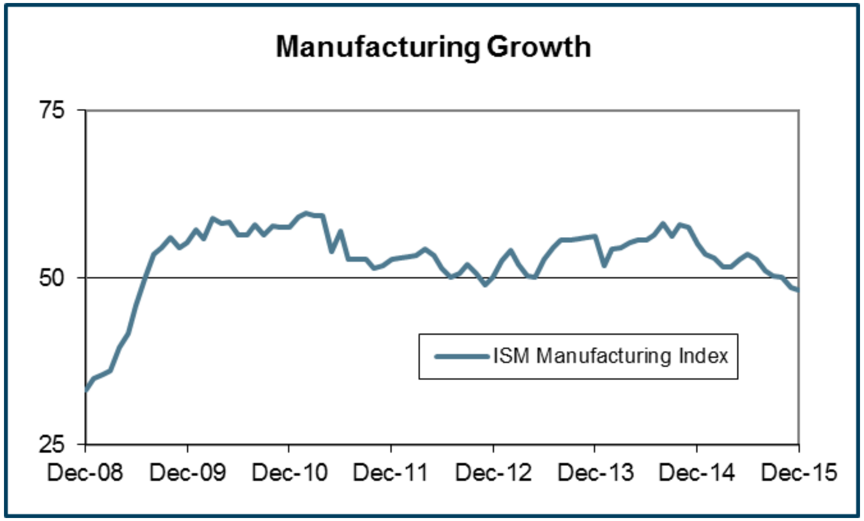
- Overall sluggish Retail Sales, but improvement seen late in December
- Vehicle Sales continue to be strong
- Consumer willingness to spend is key for future economic growth



Source: Bloomberg

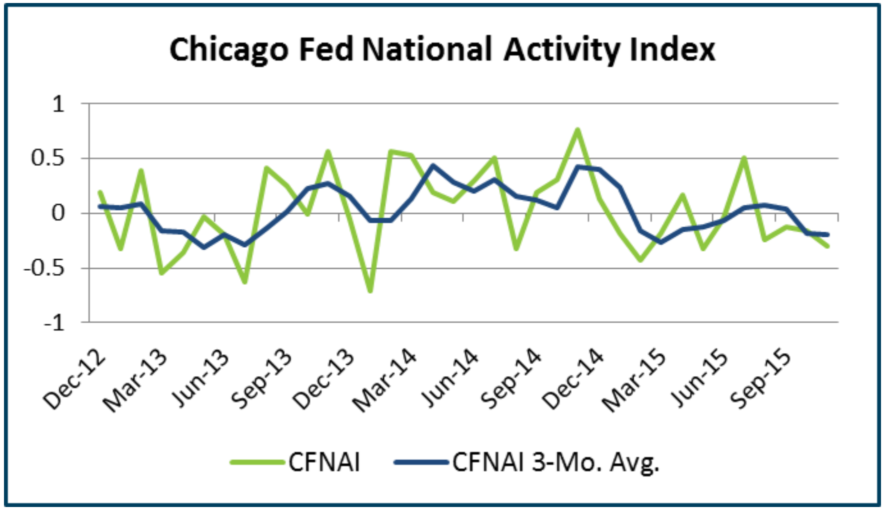
Economic Activity

- A level below 50 indicates contraction
- Contraction in November and December
- Factors include low oil prices and weaker international growth/demand



Source: Bloomberg

- CFNAI is a gauge of overall economic activity
    - Constructed to have an average value of zero and a standard deviation of one
- Negative readings 9 of the first 11 months of 2015
    - A negative reading indicates below trend growth
    - Note that trend growth tends to be positive



Source: Bloomberg

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