Economic Update

April 28, 2016

Economic and Market Commentary

Economic Overview

A pause in the path to higher rates may be the best way to describe the Federal Open Market Committee (FOMC) position at this time. Since the first step toward the normalization of interest rates in December when they raised their target range for the federal funds rate by 25 basis points to .25 - .50 percent, the expectations for continued rate hikes have decreased. The slide in oil prices in January and February brought the equity markets with it. The ripple effects were felt throughout the industrial sector in the bond market with higher risk premiums required for companies with exposure to energy production. A flight to quality resulted in lower rates on the long end of the U.S. Treasury yield curve. March provided a significant recovery in equity markets along with oil prices, but effects continue to be felt with significant declines in corporate profits.

FOMC chair Janet Yellen expressed some concern with global weakness and has described their stance as greater gradualism. A list of conditions were provided as they consider future rate hikes including 1) Stabilization in foreign economies and their financial markets, 2) Little appreciation in the dollar which hurts U.S. manufacturing, 3) Stabilization in commodity prices and 4) Stronger contribution from the housing sector. The expectation for 2016 is now for two rate increases, but we think economic conditions will lead to a rather slow and gradual path to somewhat higher rates over time.

Real gross domestic product (GDP) increased at an annual rate of 1.4 percent in the fourth quarter of 2015, according to the third and final estimate by the Bureau of Economic Analysis. This revision is higher than the preliminary estimate of 0.7 percent and second revision of 1.0 percent. Household purchases rose at a 2.4 percent annual pace and personal consumption added 1.66 percentage points to growth. Inventories subtracted .22 percent from growth and weak overseas demand weighed on net exports.

Economic and Market Commentary

The U.S. economy expanded at a 2.4 percent rate for the full year in 2015, and the economy is projected to grow at a slightly slower pace in 2016 at 2.1 percent and return to 2.3 percent in 2017. This continued moderate pace of growth will mark the eleventh straight year where the United Stated economy will have failed to reach 3.0 percent growth. This continues the slowest stretch of growth since the end of WWII. Historically, the economy has expanded at a 3.3 percent average rate.

Even with this low rate of growth, the job situation is healthy. The unemployment rate has hovered near the long term goal of 5.0 percent. On April 1st, the Bureau of Labor Statistics released the March employment situation report. The unemployment rate was little changed at 5.0 percent versus a previous 4.9 percent. Nonfarm payroll employment increased by 215,000, a slight decline from 242,000 in February and above 172,000 in January. Employment gains were seen in health care and social assistance, retail trade, food services, and private educational services. Job losses continued in mining.

Overall underlying inflation is slowly rising providing some support for future rate increases by the Fed. Over the past 12 months ending February 2016, the Consumer Price Index for all items increased 1.0 percent on an unadjusted basis according to the Bureau of Labor Statistics. Core CPI which excludes food and energy increased 0.3 percent in February and 2.3 percent over the past 12 months. This is the largest annual increase since May, 2012. Energy continued to be a drag on inflation and its decline more than offset increases in prices for food, housing and medical care. Over the year, energy prices fell 12.5 percent and are down nearly 50 percent from levels seen in 2014.

Economic and Market Commentary

Consumer spending is improving, and the latest figure reported by the Commerce Department was a 0.1 percent advance in February. This follows a 0.5 percent gain the prior month. This was consistent with the forecast and gains may continue as consumers benefit from income growth, steady jobs, cheap gasoline and rising home values. The personal savings rate was 5.4 percent in February which is up from 5.3 percent in January and above the historical average. The wherewithal to spend is present as we have seen savings rates and income levels rise faster than inflation.

One area of concern is an increase in delinquent subprime auto loans. We have seen a boom in auto sales over the past several quarters which may have been fueled by lax borrowing standards. Fitch reported a delinquency rate over 5.0 percent in February for subprime auto loans which is worse than during the Great Recession and the highest level since 1996. There appears to be a strong connection to regions impacted by energy industry layoffs. Losses are below historical averages for borrowers with better credit scores. This is an area that we will be watching to catch any spillover effect.

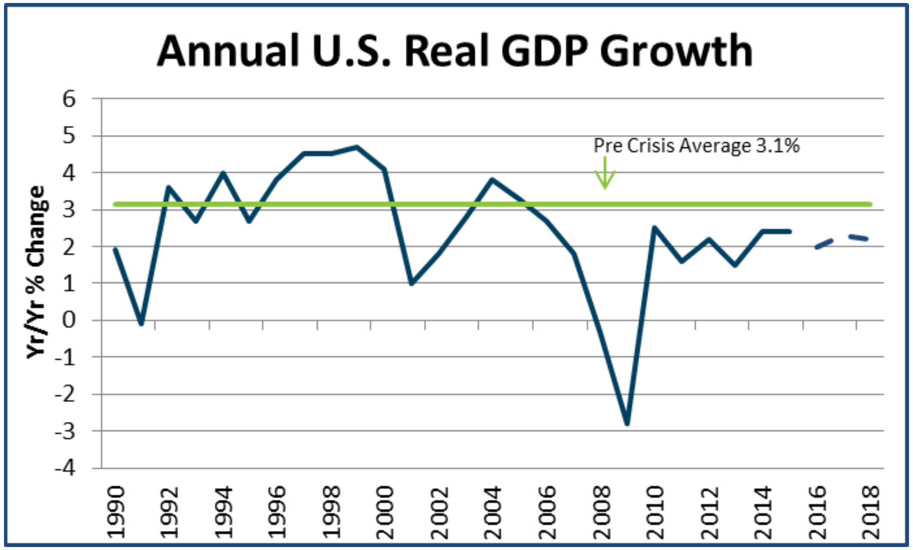
Economic Outlook

Annual GDP Growth

- Full year 2015 2.4%
- Same as 2014
- 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

Quarterly GDP Growth

- Q4 2015 1.4% annual rate
- Revised up from 1%
- Personal consumption expenditures stronger than previous estimate
- Fixed investment slowed
- Government spending and exports detracted



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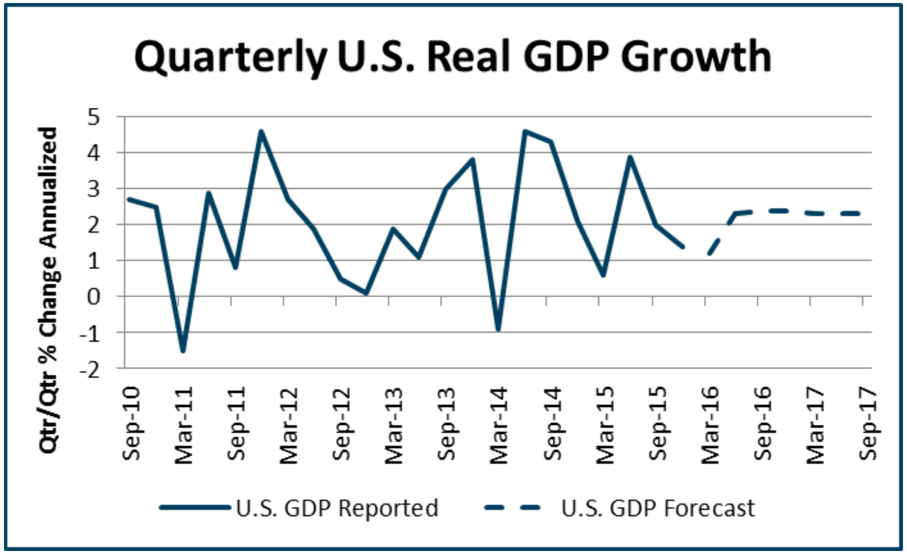

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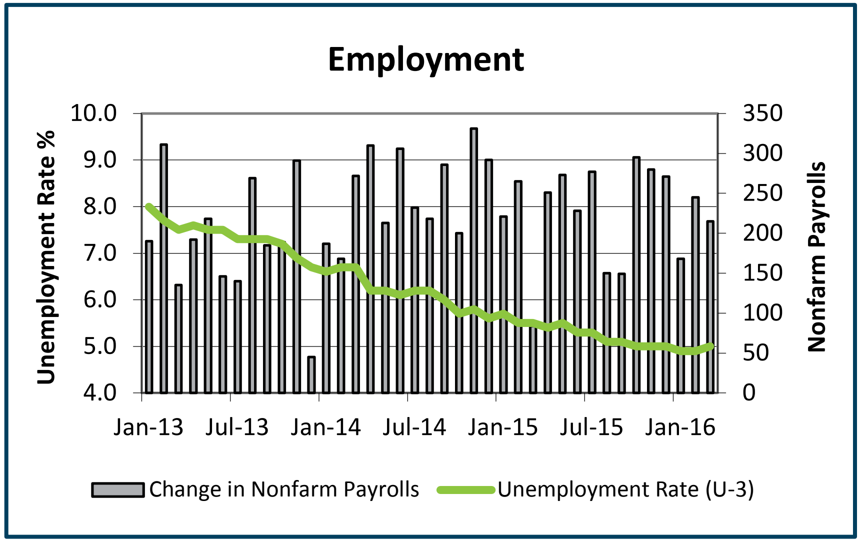
Employment

Employment

- Unemployment hovering near 5%
- Payrolls still growing, but at a slower pace of 215,000 in March
- Continued decline in unemployment expected
- Key factor in future Fed moves



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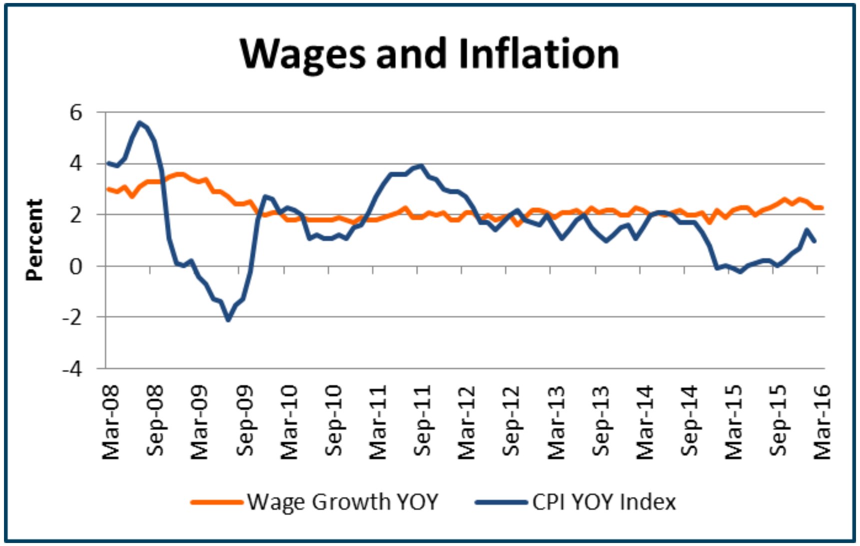
Wages and Inflation

- Healthy wage growth above inflation rate
- Underlying inflation slowly rising supporting future rate increases by the Fed
- Tight job market could contribute to future inflation



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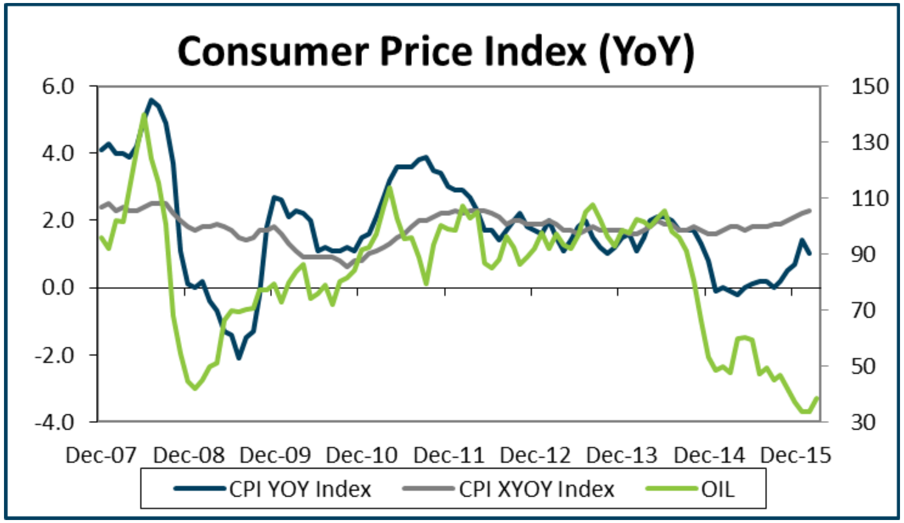
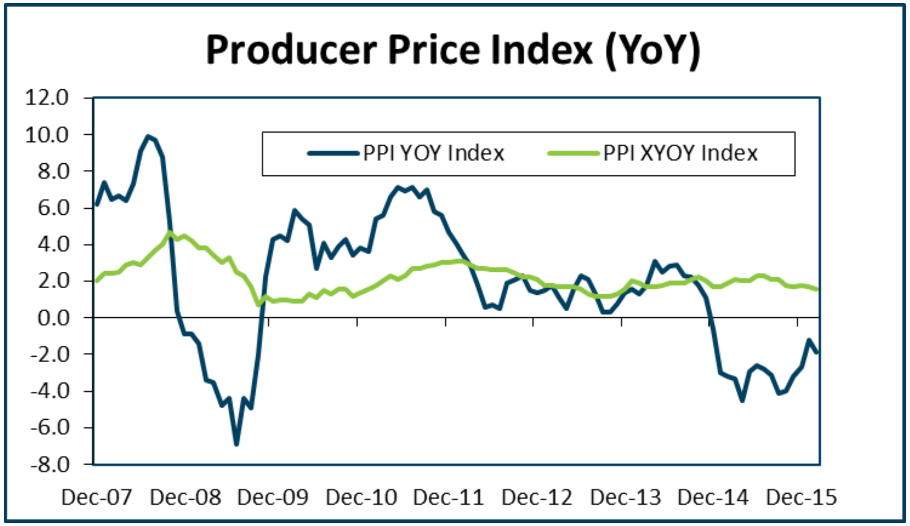
Consumer Price Index (YOY)

- Recent uptick in Oil back to $40/barrel
- Core CPI 2.3% for the past 12 months ended February
- Largest core CPI since May 2012
- Energy prices fell 12.5% over the year.



Source: Bloomberg

- PPI measures prices the producers receive on their goods.
- Difficult to get top line revenue growth
- Core PPI excluding food, energy and trade services rose .1% in February and 0.9% year over year
- Gas Index was down 15.1% for the year



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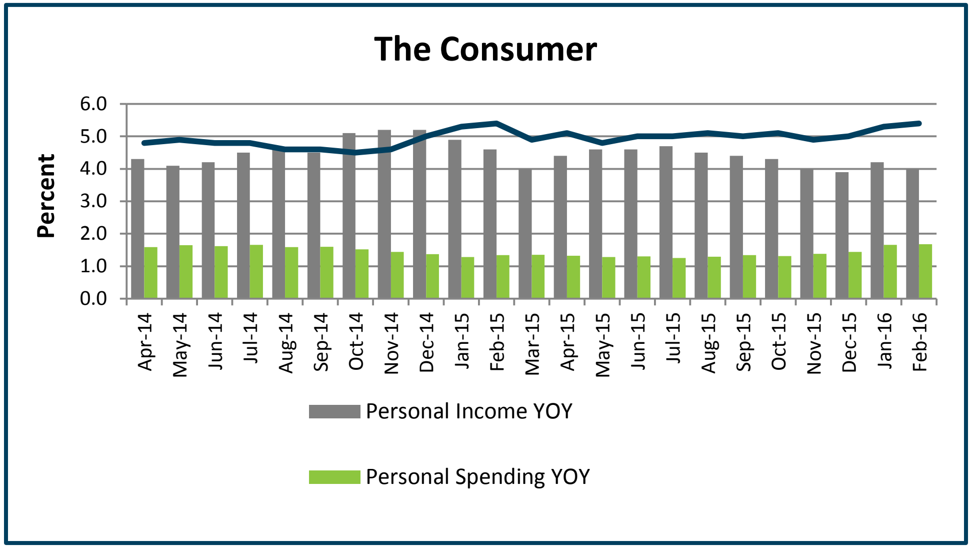
The Consumer

- Savings rate continues to be very strong relative to historical averages and on the rise
- Income growth exceeding inflation and domestic GDP growth.
- Lackluster spending except for autos



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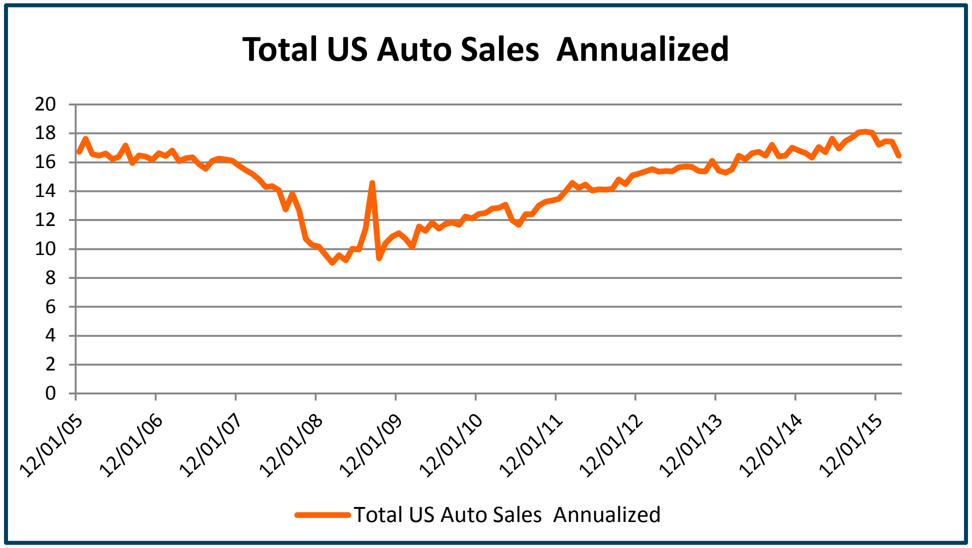
- Auto sales quite strong
- Subprime lending growing due to liberal credit standards
- Delinquencies at 5.2% in February which is the highest rate in 2 decades
- Will there be a spillover effect?



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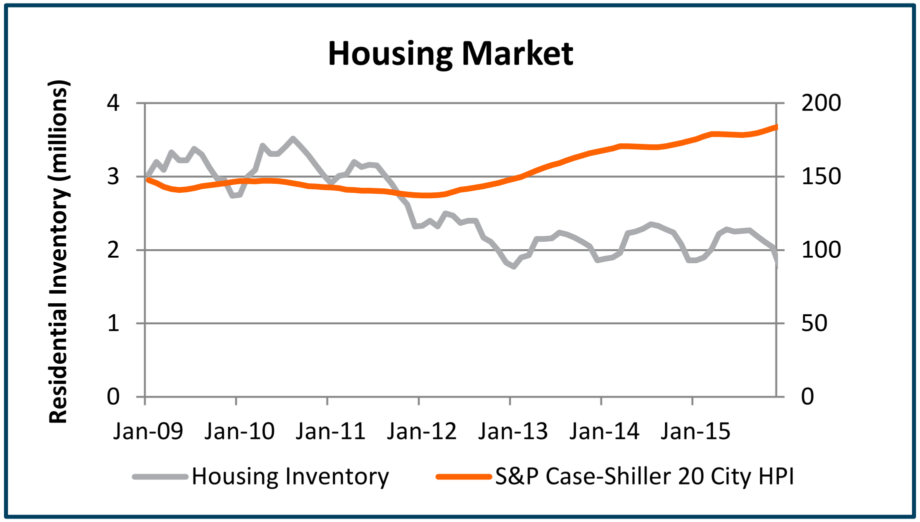
Housing and Household Balance Sheet

- Housing market is improving
- Prices gradually increasing
- Inventory declining



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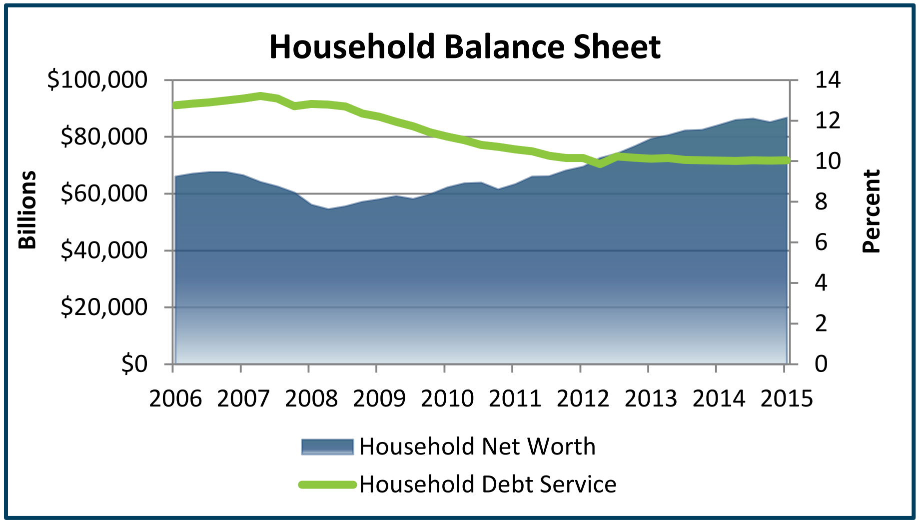
- Consumer balance sheet continues to improve
- Net worth has improved despite a weak equity market early in the year
- Debt service is below 20 year average of 11.4%



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