Economic Update

October 20, 2016

PRUDENT MAN ADVISORS

Economic and Market Commentary

Economic Overview

The U.S. economy continues to experience sluggish growth. During the second quarter, economic growth as measured by the Gross Domestic Product came in at 1.4 percent, a slight improvement relative to the first quarter at 0.8 percent. Growth was largely driven by consumer spending (+2.9 percent), while business investment and government spending detracted from growth at -1.34 percent and -0.30 percent respectively. Thus far, growth during the first half of 2016 is trending below the Fed's long term growth projection of 2 percent. Based on recent economic data, there appears to be soft patches within the U.S. economy but these are not enough to offset the positive fundamentals elsewhere in the economy. For the month of August, the Institute of Supply Management indices which gauge the factory and services sectors posted weak numbers. The ISM Manufacturing Index came in at 49.4 for August vs. 52.6 in July. Readings below 50 signal contraction in factory activity. The ISM Services Index fell to 51.4 in August from 55.5 in July, the lowest level since February 2010. Both indices point to a slowdown in the manufacturing sector stemming from weak business spending and overall uncertainty regarding the global economic growth outlook.

Labor markets continue to show resilience and signal that hiring continues at a decent clip. The U.S. economy added 151,000 jobs in August, below the consensus estimate of 180,000. So far in 2016, payroll gains have averaged about 182,000 per month, lower than last year's monthly average of 230,000, but still more than enough to keep the unemployment rate steady. The unemployment rate was flat at 4.9% and is close to what is considered as full employment. The labor force participation rate was unchanged at 62.8 percent in August. The participation rate is starting to rise, signaling that people feel somewhat encouraged to join the labor force. Although the August payroll report was lackluster, lower numbers of jobless claims and higher number of job openings signal a tightening labor market which could lead to wage inflation and provide an incentive for the Federal Reserve to raise the discount rate.

Economic and Market Commentary

U.S. Consumers remain optimistic. According to a recent report from the Federal Reserve Bank of New York, at the end of second quarter, total consumer debt increased 0.3 percent to $12.3 trillion. This level was 3.1 percent below the record level that was reached during the third quarter of 2008. U.S. households increased borrowing to finance vehicles and credit card purchases. Increased household debt signal that consumers have confidence in the economy. The Conference Board's measure of consumer sentiment rose to 104.1 in September, the largest increase since the recession. Underlying details show that consumers are more upbeat about the employment outlook and neutral on business conditions. Overall, consumers view the current economic environment favorably and foresee growth in the near future. All the above factors suggest that consumers can propel U.S. growth as we approach year end.

Consumer prices increased slightly in August. Headline Consumer Price Index (CPI) rose 0.2 percent and the core CPI, which excludes food and energy rose 0.3 percent on a monthly basis. The monthly increase pushed core prices to 2.3 percent on a year-over-year basis. The Personal Consumption Expenditure price (PCE) index, the Fed's preferred measure of inflation rose 0.8 percent, while the core measure hovered around 1.7 percent on a year-over-over basis. This is below the Fed's inflation target of 2 percent. Another factor that might contribute to higher inflation is an increase in oil prices. Recently, OPEC member countries tentatively agreed to cut oil production to a range of 32.5 to 33 million barrels of oil a day from 33.4. After the news, oil prices surged more than 5 percent. Back in mid 2014, oil prices were as high as $100 per barrel. By February 2016, due to global oversupply prices plunged to $26 a barrel and is currently priced around $48 a barrel. All in all, a sustained oil price recovery will require that demand exceed the amount of supply that is available in the market place.

Economic and Market Commentary

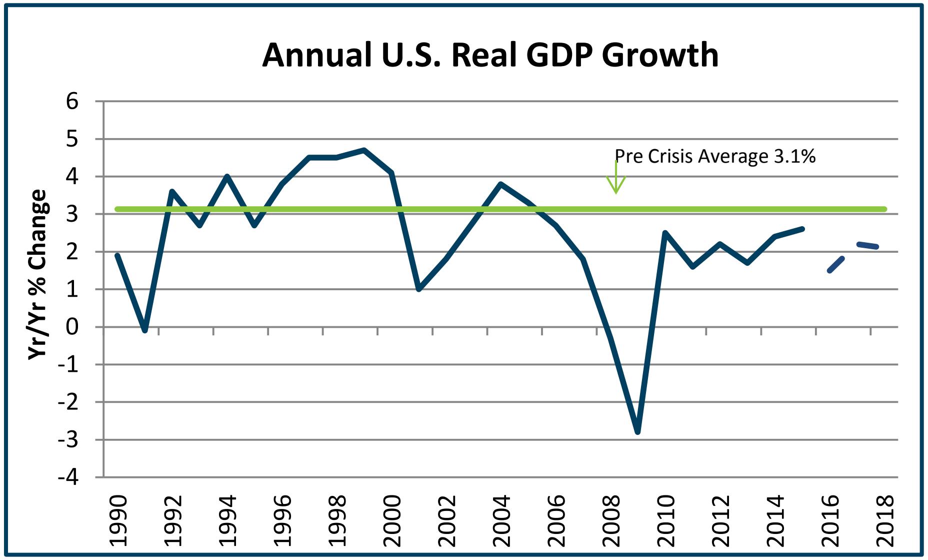
All the above mentioned factors point to a low growth environment with subdued inflation; both of which support further delay in Fed rate hikes. At their September meeting, the FOMC left the federal funds rate target range unchanged at 0.25 - 0.50 percent. In the accompanying statement, the Fed mentioned that rates will likely move upward in a gradual fashion. The Federal Reserve Bank is forecasting a single rate hike this year; two in 2017 and three in 2018. Initially, they were forecasting four rate hikes in 2016 but due to volatility in the stock market, weak global economic data and concerns regarding the impact of Brexit, they postponed rate hikes. Although the Federal Reserve has utilized monetary policy tools to stimulate the US economy, it is important to note that the Fed's influence is limited. Monetary policy as a stand alone tool cannot fully address long term issues such as productivity and population growth. To boost productivity growth and promote the long-run potential of the economy, effective fiscal and regulatory policies should play an important role as well. While the Federal Reserve is responsible for implementing monetary policy, fiscal policy is conducted by the government. The upcoming U.S. presidential elections will determine the trajectory of future U.S. fiscal and regulatory policies. Thus far, both presidential candidates have expressed support for increased government spending, corporate tax reform, higher minimum wages, and changes to pre-existing trade deals. Regardless of who wins the election, it is important to note that there are checks and balances in the system that ensure moderate presidential platforms and overall decisions depend on the eventual composition of the House and Senate.

As we approach year end, primary risks to capital markets include deflation concerns in developed economies, volatility in commodity prices and exchange rates, low productivity growth in the U.S. and uncertainty regarding the timing of when the Fed will again increase short term interest rates.

Economic Outlook

Annual GDP Growth

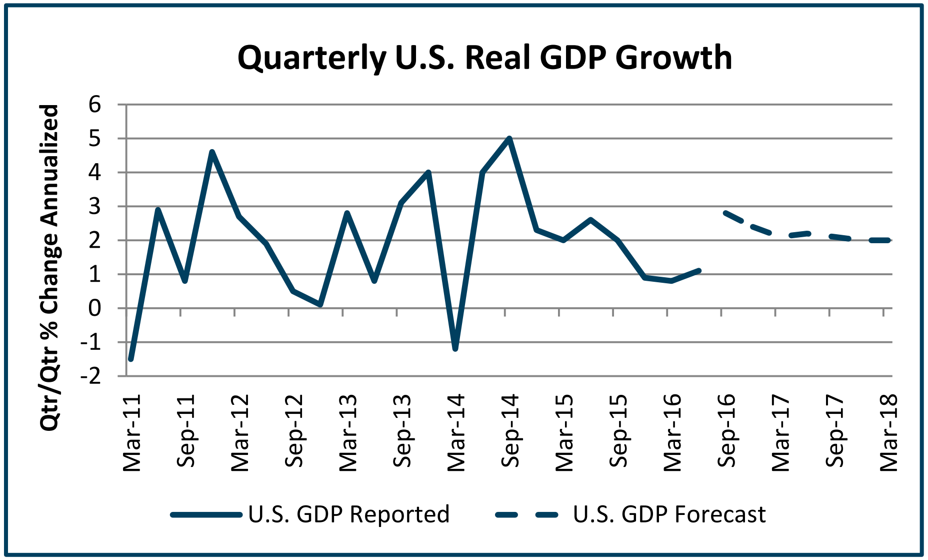
- Full year 2015 2.6%
- Stuck in secular stagnation
- Long term growth expected to remain below 3% long term average
- Business spending and lackluster demand from overseas is expected to be a drag on growth in 2016



Source: Bloomberg

Quarterly GDP Growth

- Q2 2016 1.4% annual rate vs. Q1 at 0.8%
- Q2 revised up slightly from 1.1% preliminary estimate
- Improved personal consumption expenditures, and net exports
- Government spending and private investments declined



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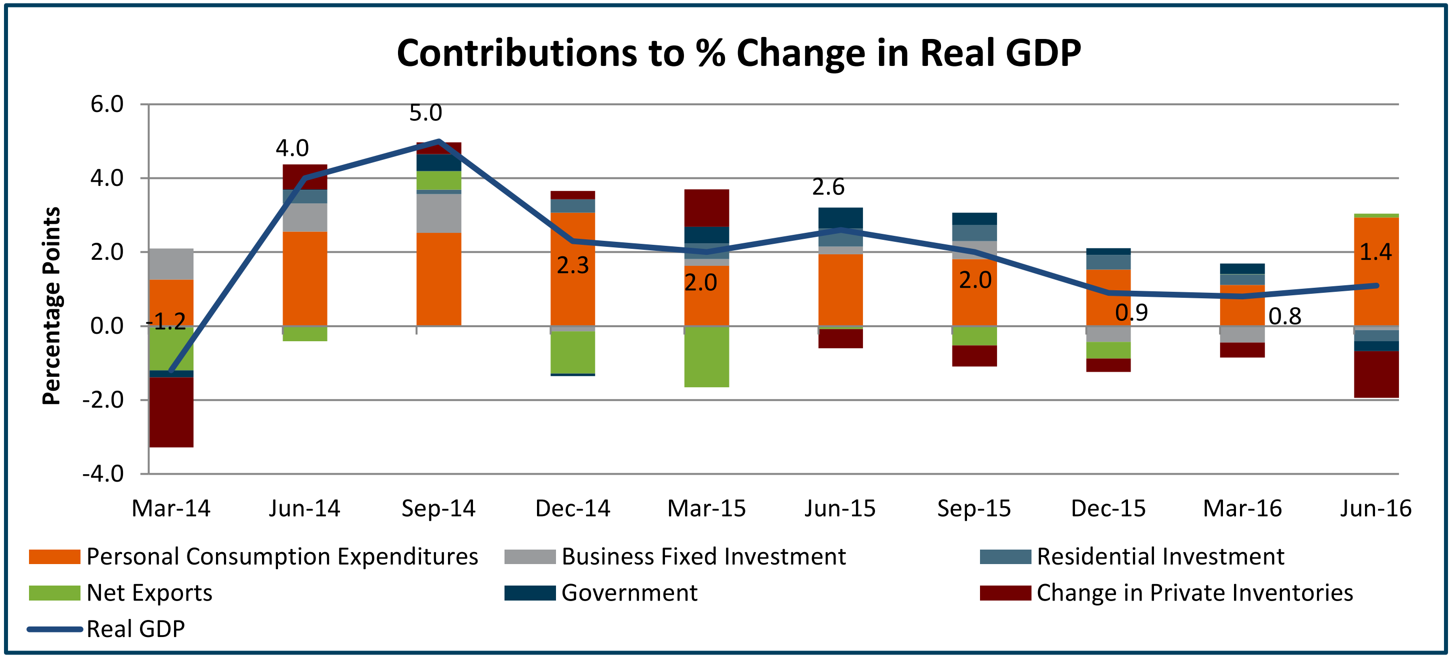
Economic Outlook



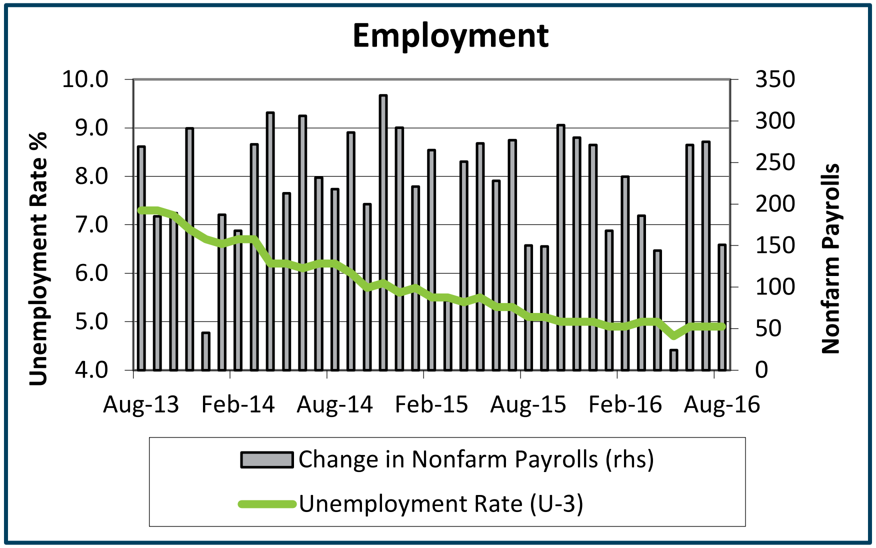
Source: Bloomberg

Contributing Factors to GDP

- Personal Consumption Expenditures drove growth in Q2
- Business Fixed Investment declined slightly
- Private Inventories has been a detractor
- Net Exports no longer detracting

Employment

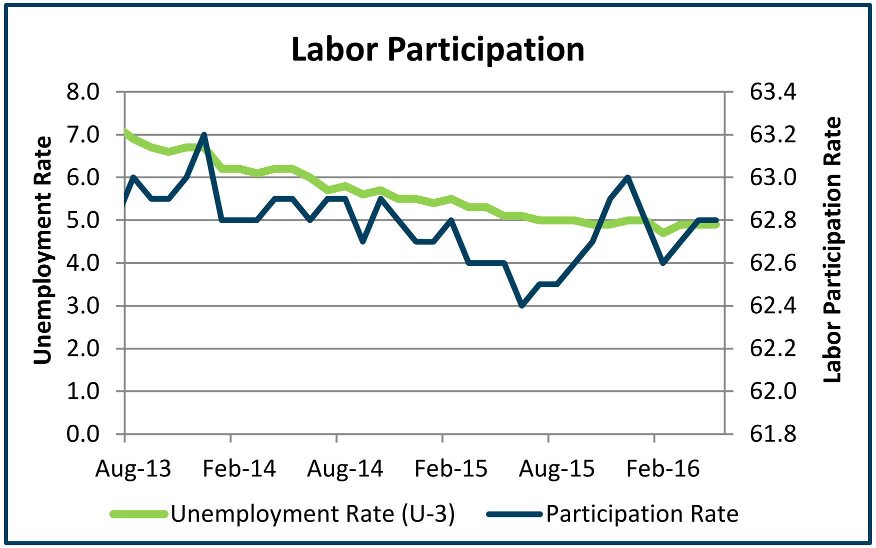
- Unemployment rate steady at 4.9% in August
- Payrolls grew a meager 151,000 in August versus 255,000 in July
- Summer average job growth is in line with 4Q 2016
- Key factor in allowing Fed to move



Source: Bloomberg

Labor Participation

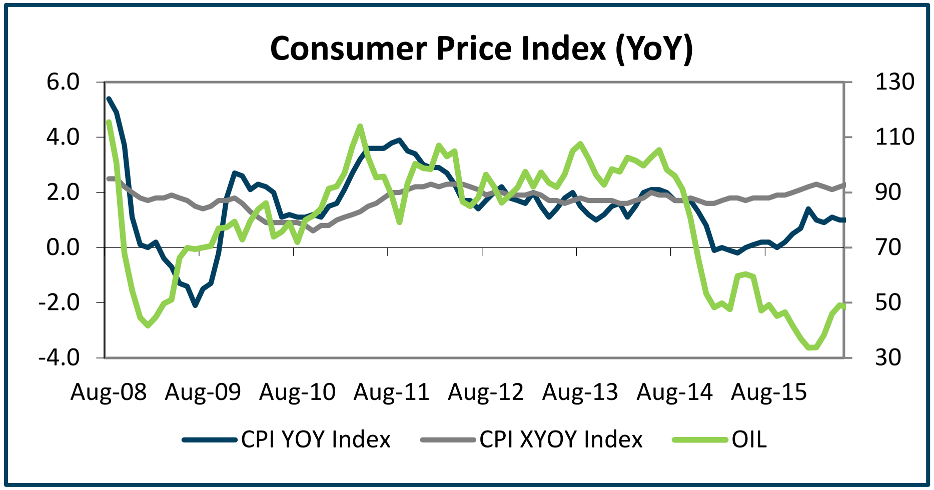
- Aging baby boomers impacting labor participation rate
- Skills gap contributing to lower participation rate
- Increased use of disability claims and extended schooling also contributing



Source: Bloomberg

Consumer Price Index (YOY)

- CPI increased 1.1% for the past 12 months ended August
- Core CPI excluding food and energy was significantly higher at 2.3%
- While oil prices have recovered, energy prices have declined 9.2% over the past 12 months
- Inflation remains tame overall
- Forecast remains within the Fed's target range through 2018
- Low long-term bond yields have very little inflation built in
- Medical care and housing costs have risen 3 – 5 % over the past 12 months



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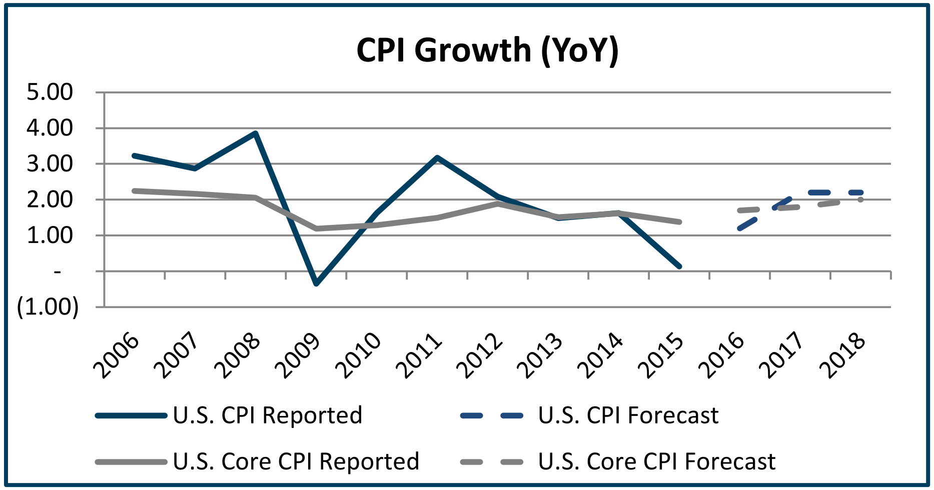

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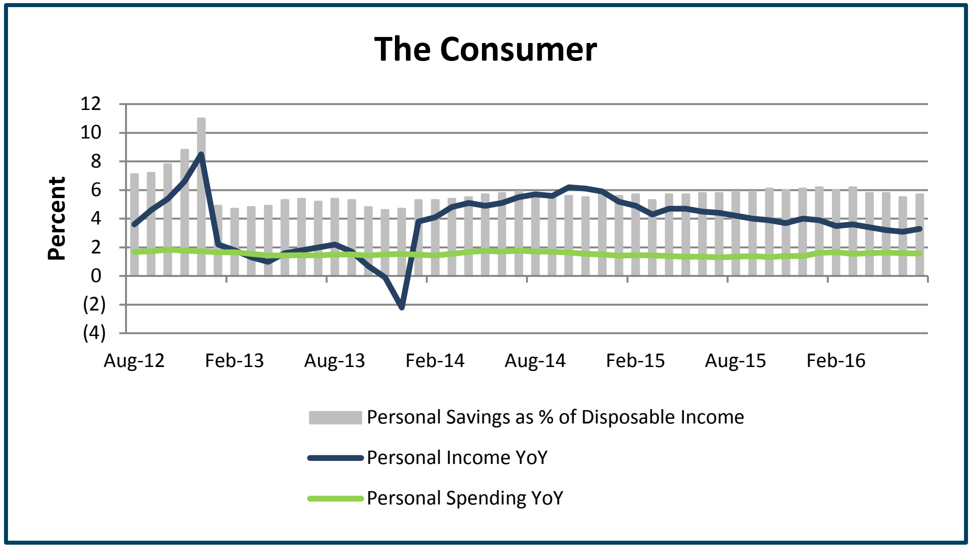
The Consumer

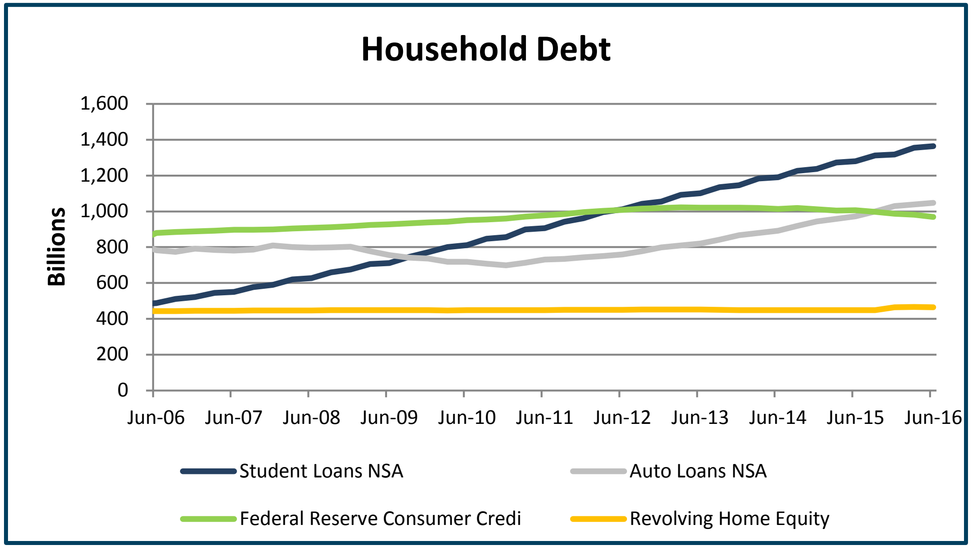
- Personal Income grew at 3.3% YOY in July vs. 3.1% in June, above inflation
- Personal Savings healthy which can support future savings
- Wage growth outpaces inflation



Source: Bloomberg

Household Debt

- Student Loan growth continues at a strong pace and may be holding back spending capacity
- Increase in auto loans show consumers willing to spend on durable goods
- Credit card debt showing signs of growth



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