{PMFA} **Economic perspectives**

plante moran FINANCIAL ADVISORS

4th Quarter 2015

EXECUTIVE SUMMARY

- The final estimate of Q3 GDP indicated that the economy expanded at a moderate 2.0% annualized rate during the quarter. Growth was supported by stronger consumer and government spending, while an inventory drawdown detracted.
- Recent inflation data have been muted, as commodity and energy prices remain depressed. Headline CPI increased a mere 0.5% in November on a year-over-year basis. Core PCE, the Fed’s preferred measure of inflation, remained flat at 1.3% and well below the central bank’s target.
- Long-term interest rates trended upward during the quarter, in anticipation that the FOMC would raise short-term rates at its December meeting. The 10-year Treasury ended December at 2.27%, up from 2.06% to start the quarter.
- The December jobs report built on a recent string of solid results, as the economy added 292,000 jobs, with another 50,000 added via upward revisions for October and November. The unemployment rate held steady at 5.0%.
- Economic growth slowed relative to the prior quarter, but the U.S. economy has continued to advance at its recent 2.0 – 2.5% trend rate on a year-over-year basis. In the wake of the first rate hike since 2006, investors will surely keep a keen eye on the economy over the next several months as they try to determine the frequency and magnitude of future rate increases.

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Economic Dashboard

Gross Domestic Product	Prior Reading	Change	Most Recent
Real GDP QoQ - Q3 (III Est.)	3.9%	⇩	2.0%
Personal Consumption QoQ - Q3 (III Est.)	3.6%	⇩	3.0%
Employment Market			
Unemployment Rate - December	5.0%	⇔	5.0%
Nonfarm Payrolls (Change) - December	252K	⇧	292K
Initial Jobless Claims 4-Week Avg - December	272.5K	⇧	277K
Continuing Jobless Claims 4-Week Avg - December	2222K	⇩	2218K
Inflation			
CPI YoY - November	0.2%	⇧	0.5%
Core CPI YoY - November	1.9%	⇧	2.0%
Core PCE YoY - November	1.3%	⇔	1.3%
Consumer Indicators			
Retail Sales YoY - November	1.7%	⇩	1.4%
Consumer Credit YoY - October	7.0%	⇔	7.0%
Personal Income YoY - November	4.6%	⇩	4.4%
Personal Savings YoY - November	5.6%	⇩	5.5%
Consumer Confidence - November	99.1	⇩	90.4
Business & Production Indicators			
ISM Manufacturing Index - December	48.6	⇩	48.2
ISM Services Index - December	55.9	⇩	55.3
Industrial Production YoY- November	0.3%	⇩	-1.2%
Small Business Optimism - November	96.1	⇩	94.8
Housing Market			
Existing Home Sales - November	5.32MM	⇩	4.76MM
Housing Starts - November	1062K	⇧	1173K
S&P Case-Shiller Price Index YoY-October	5.4%	⇧	5.5%
Leading Indicators			
ECRI Weekly Leading Index - December	131.4	⇩	131.1
Conference Board Leading Economic Index - November	124.1	⇧	124.6

OVERVIEW

"There is nothing wrong with change, if it is in the right direction." – Winston Churchill

In December, a key step toward a meaningful change in the direction of monetary policy was taken when the Fed raised short-term interest rates by 0.25% for the first time since 2006. While the rate hike was widely anticipated by economists and investors alike, it was a critical move toward normalization from the ultra-accommodative era in which interest rates were kept at effectively 0% for the past seven years.

With the first rate hike now behind us, attention has shifted toward the timing and degree of future interest rate hikes. Currently, expectations are for a gradual pace of increase, with rates to remain low (relative to historical standards) for years to come. Ultimately, the decision to raise rates reflects the Fed's view that "economic activity will continue to expand at a moderate pace and labor market indicators will continue to strengthen."

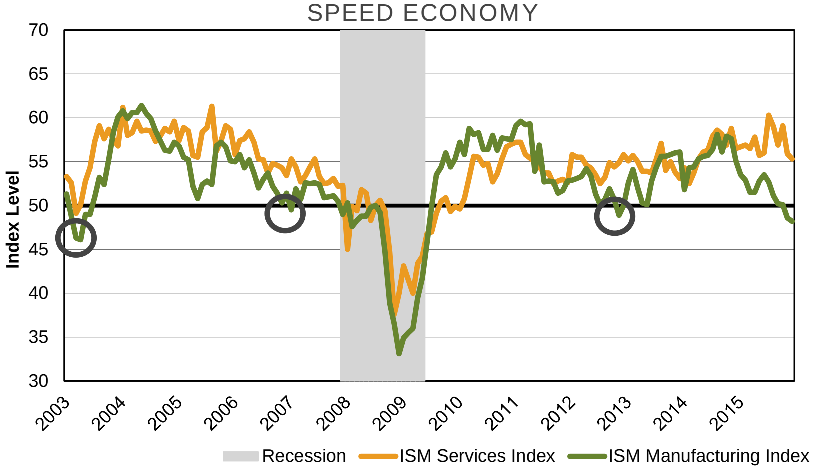
Although the U.S. economy may not be growing at the same pace as in past expansions, economic momentum remains largely positive. Consumer confidence remains strong, supporting consumption growth, the labor market is near (or perhaps at) full employment, and the housing market continues to show signs of strength. On the other hand, inflation remains below the Fed's target, held in check by falling energy costs, and recent manufacturing data have been weak. Against this backdrop, the Fed is faced with the difficult task of normalizing interest rates without jeopardizing the current expansion.

While monetary policy can change in one day, the effect of any change is not fully absorbed by the economy for several quarters. Other changes may transpire over multiple years or even decades. For example, the U.S. economy has become increasingly driven by the services sector, while manufacturing has become less impactful. From 1970 to 2014, manufacturing as a component of U.S. GDP fell from roughly 23% to just 12%. Although recent manufacturing surveys have delivered soft readings (as the chart below illustrates), the services sector has held solidly in expansionary territory. While the recent contraction within the manufacturing sector has created some concern, manufacturing's shrinking contribution to the U.S. economy should help alleviate concerns of an impending recession – particularly given the relative strength of the services sector.

Globally, another shift has been occurring, the transition from export-driven growth to consumer-driven growth for a number of emerging market economies. This trend helps to explain the slowing growth in emerging economies, such as China, where a fast-growing middle class has emerged and begun spending money on things such as healthcare, entertainment, and education, while the manufacturing sector has weakened. This transition can create transitory hurdles to growth, but is expected to be a long-term positive for the global economy.

Overall, the recent rate hike serves as a vote of confidence that the U.S. economy is on solid footing, though much of the rest of the developed world is still lagging, as key central banks abroad continue to ease policy. Recognizing that the Fed's actions have a lagged and gradual effect, policy makers must take calculated risks, and make assumptions about the direction of the economy. As the Goldilocks environment of moderate economic growth and tame inflation persists, the Fed clearly expects continued progress beyond the near term.

MANUFACTURING VS. NONMANUFACTURING: A TWO-SPEED ECONOMY



Source: PMFA, Institute for Supply Management

INSIGHTS

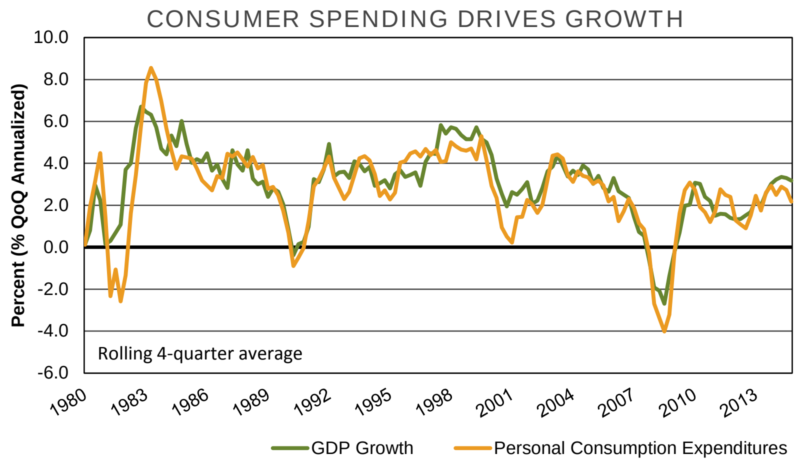
Throughout much of 2015, there has been a growing divergence between the economic health of the manufacturing and services sectors of the economy. While the services sector remains squarely in expansionary territory, recent ISM readings suggest the manufacturing sector has begun to contract.

While a contractionary reading (below 50) in the ISM Manufacturing Index has typically occurred during past recessions, it also commonly accompanies a typical mid-cycle slowdown (as noted three prior times in the past two expansions). Furthermore, strong readings from the services sector paint a more positive picture, as services tend to hold up better during such slowdowns and represents a much larger part of the overall economy.

GROSS DOMESTIC PRODUCT

	Q1 Final	Q2 Final	Q3 III Est.
Real GDP QoQ	0.6%	3.9%	2.0%
Personal Consumption QoQ	1.8%	3.6%	3.0%

- The U.S. economy expanded at a 2.0% annualized rate during the third quarter, as the economy slowed from an unsustainable 3.9% pace of growth in Q2 – a temporary surge on the heels of very weak growth in Q1.
- While a number of factors influence economic growth in the U.S., none has a larger effect than personal consumption expenditures. Consumer spending expanded at a 3.0% rate during Q3. A strengthening labor market, cheaper gasoline, and rising home prices over the last year have contributed to rising consumer optimism and an increased willingness to spend.
- With personal spending representing nearly 70% of GDP, it's not surprising that GDP growth has been strongly correlated with consumption growth over time, as illustrated in the chart to the right.

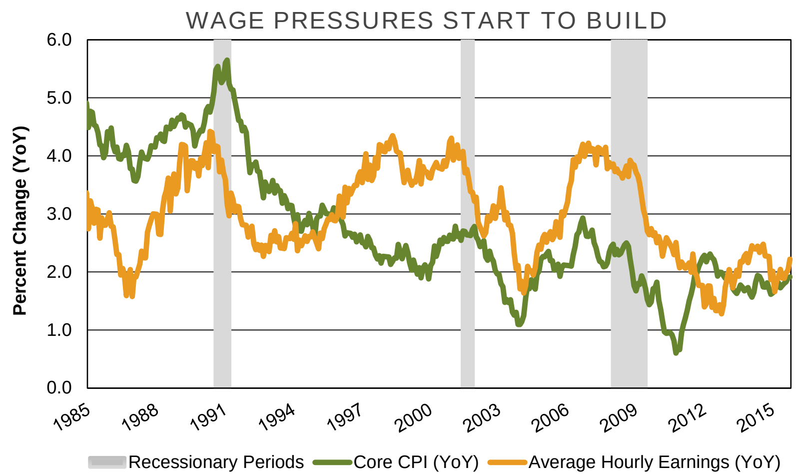


Source: PMFA, Bureau of Economic Analysis

INFLATION

	September	October	November
Consumer Price Index YoY	0.0%	0.2%	0.5%
Producer Price Index YoY	-1.1%	-1.6%	-1.1%

- The Consumer Price Index was flat for the month of November and increased by 0.5% on a year-over-year basis. Core CPI rose 0.2% for the third consecutive month, nudging the year-over-year reading up to 2.0% – its highest point since May 2014.
- Weak energy prices continue to have a disinflationary effect as all of the major energy components within the index have declined over the past year. Some forecasts still call for oil to drop further, but the degree of decline over the past year can't be replicated with prices at current levels, which should mitigate the degree of drag from energy going forward.
- As the chart illustrates, growth in average hourly earnings has often been a precursor to stronger inflation. As skilled labor become scarce, employers must increase wages to attract and retain workers, often passing those higher costs along to customers, particularly in the absence of strong productivity gains. The recent upward trend in wage growth may translate into higher inflation over time.



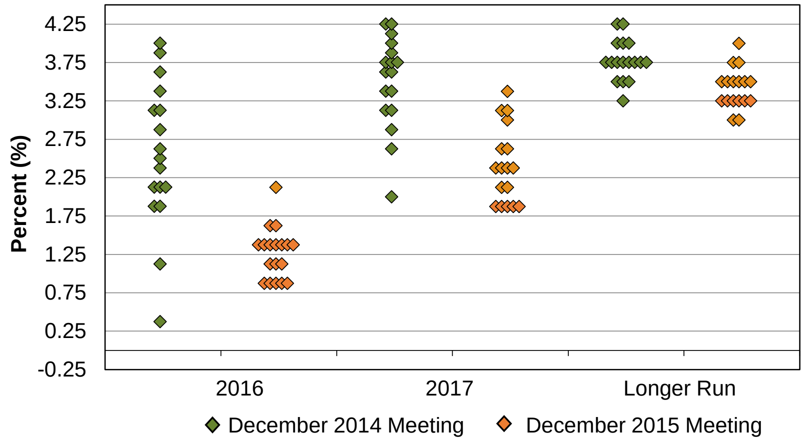
Source: PMFA, Bureau of Labor Statistics

INTEREST RATES

Treasury Yields as of	12/31/14	6/30/15	12/31/15
3-month	0.04%	0.01%	0.16%
2-year	0.67%	0.64%	1.06%
10-year	2.17%	2.35%	2.27%

- Long-term interest rates trended upward during the quarter as investors anticipated a December rate hike from the Fed. After briefly dipping below 2% in October, the 10-year Treasury yield ended the year at 2.27%.
- As widely expected, the FOMC increased the targeted range of the federal funds rate from 0%-0.25% to 0.25%-0.50% in December. The Fed's decision marked the first rate hike in nearly a decade and ended a seven-year span of zero interest rates.
- The updated "dot plot" from the Fed showed little change in policymakers' expectations for the path of short-term rates over the next several years. However, expectations have shifted materially in the past year, as most FOMC members have lowered their estimates for 2016 and beyond. Even with those adjustments, Fed expectations remain higher than the expected rates being priced into the markets.

FED FUNDS RATE EXPECTATIONS LOWER



Note: Each diamond indicates the value (rounded to the nearest 1/8 percentage point) of an individual participant's judgment regarding the appropriate level of the federal funds rate at the end of the specified calendar year or over the longer run.

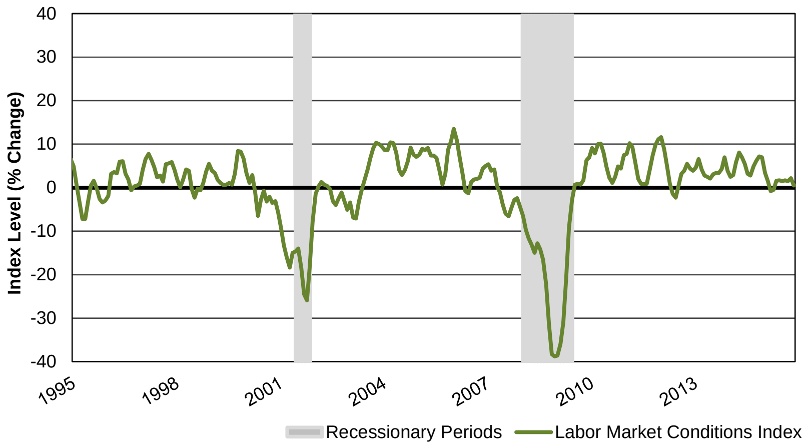
Source: PMFA, Federal Reserve

EMPLOYMENT

	October	November	December
Unemployment Rate	5.0%	5.0%	5.0%
Nonfarm Payrolls (Change)	307K	252K	292K

- The labor market continued its strong showing in December, building on solid advances in October and November. Nonfarm payrolls increased by 292,000 in December, while estimates for October and November were revised upward by a combined 50,000 jobs.
- The unemployment rate was unchanged at 5.0% for the month. A modest uptick in the labor force participation rate resulted in an estimated 466,000 individuals entering the workforce.
- Labor market conditions have been generally positive since 2009, but particularly over the last few years, with solid nonfarm payroll growth and a declining jobless rate. Another gauge of the labor market, developed by Federal Reserve economists, is the Labor Market Conditions Index. The index includes 19 factors, such as the hiring rate and hourly earnings, providing a broader view of labor market conditions. This index has had positive growth over the last 5 years and currently remains in positive territory.

LABOR MARKET CONTINUES TO TIGHTEN



Note: The Labor Market Conditions Index measures 19 individual factors that influence the labor market. Positive growth indicates that labor markets are improving while a negative value implies market weakening.

Source: PMFA, Federal Reserve

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Sources for the Economic Dashboard include PMFA, Bureau of Economic Analysis (BEA), Bureau of Labor Statistics (BLS), U.S. Department of Labor, U.S. Census Bureau, Federal Reserve, The Conference Board, Institute for Supply Management (ISM), National Federation of Independent Business (NFIB), U.S. Department of Housing and Urban Development, National Association of Realtors, Standard & Poor’s (S&P), and the Economic Cycle Research Institute (ECRI).

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