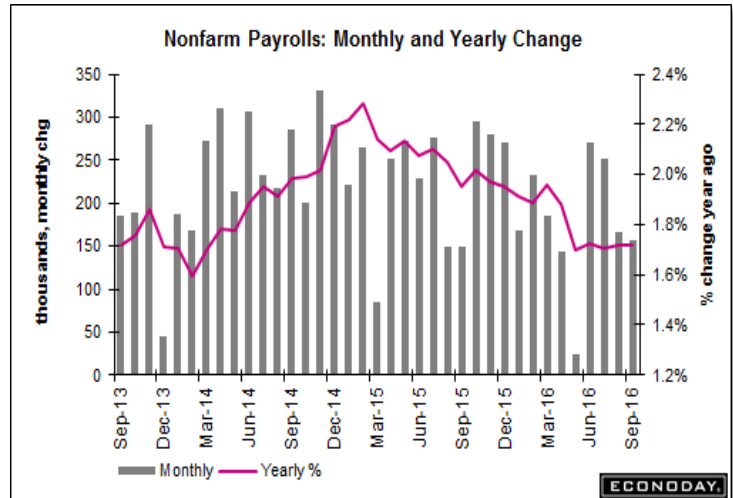


Market Outlook

October 7, 2016

Most of the economic headlines during September were disappointing and show that the U.S. economy is still failing to gain significant sustained traction. The market reports released during September covered critical periods for both the housing and consumption indicators with both registering lackluster results. Production is slow and employment is below expectations, yet many economists are projecting that the Federal Open Market Committee (FOMC) will raise the Federal Funds Rate at their meeting in December.

The Employment report for September was expected to add 168,000 jobs, but the report indicated an increase of 156,000. The August report was amended to show that 167,000 jobs were added (previously reported as +151,000) and the July report was revised to +252,000 (previously reported at +275,000). The three-month average after all revisions currently stands at +192,000 per month (or less than the +232,000 average after August's report). There was some encouraging news in the Household Employment component of the release, as it showed that over 354,000 previously discouraged workers had reentered the marketplace and found employment. The increasing reentry of these workers is one of the FOMC's major policy objectives. The current Labor Participation Rate, a measure of the percentage of eligible workers that hold jobs, rose to 62.9% from the 62.8% level that it had experienced for the past two months. The Unemployment Rate rose to 5.0% from August's 4.9%. The U6 rate (or the under-employed rate – those that are either over qualified for their job or working fewer hours than they desire) remained at 9.7%. Average Hourly Earnings (AHE) rose 0.2% in September after rising 0.1% in August and was weaker than the 0.3% that was expected. Year-over-year, the AHE is at +2.6%, up from the +2.4% in August. FOMC Chair Janet Yellen cites the goal of raising the Earnings Rate component of the Employment report as a priority.



The housing sector reports were also softer than expected. Existing Home Sales fell 0.9% in August after falling 3.2% in July. Compared to last year, the report was 0.8% higher. Prices fell 1.3% after falling 1.4% in July, yet remain 5.1% higher than last year. Supply fell to 4.6 months from 4.7 months in July and remains seriously below the healthy balance of 6-months. New Home Sales fell 7.6% in August following a very robust increase of 13.8% result in July. Some reversal after such a strong July was expected by the market. The prices of new homes fell an average of 5.1% in August. Supply of new homes is at 4.6 months. The supply number suggests that home builders have room to add units to the market, but builders will have to consider that they may be losing some pricing power. The S&P Case Shiller report of home prices in the 20 metropolitan areas indicated that prices were flat in July after falling an average of 0.1% in both May and June. The Federal Housing Finance Agency (FHFA), the entity that analyzes all domestic home prices, showed an increase of 0.5% in July, compared to June's increase of 0.3%. The S&P Case Shiller report is often a leading indicator that shows market changes in the metropolitan areas that will later be experienced over the broader residential markets covered in the FHFA survey. The Housing Starts report showed a decline of 5.4% in August after rising 2.1% during July and Permits also fell 0.4% in August after rising 0.1% in July. Construction Spending was down 0.7% in August after falling 0.3% in July. The aggregate results for the housing market were below estimates for the critical summer season.

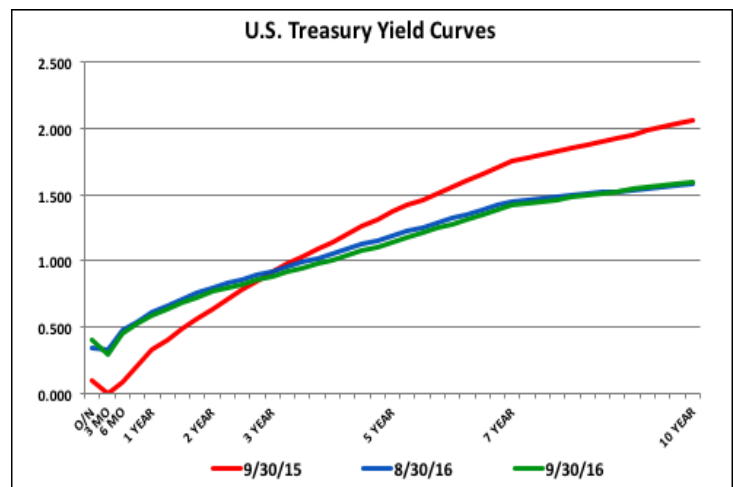
The production and manufacturing sector were slightly better this month. The final report of Gross Domestic Product (GDP) for the second quarter came in at +1.4% which is higher than the 0.8% result in the first

quarter. Business Inventories were flat in July after rising 0.2% in both May and June. The stock-to-sales ratio remains lean. After rising 1.4% in July, Factory Orders rose 0.2% in August. Durable Goods Orders were flat in August after an impressive rise of 3.6% in July. Purchasing managers' assessment of the outlook for production was much more optimistic than they reported last month. In August, both the manufacturing and the service sector purchasing managers reported a decline to just above the 50-level, however both indicators showed improvement during September. The 50-level is the balance point for optimism versus pessimism. Above 50 is optimistic and below 50 is more pessimistic. The Producer Price Index (PPI) was flat in August following a drop of 0.4% in July. The Consumer Price Index (CPI) rose 0.2% after having a flat report in July. Year-over-year CPI is +1.1%. Core CPI, or the results after food and energy numbers are excluded (due to price volatility), posted a +0.3% monthly increase and a +2.3% year-over-year improvement.

On the consumption front, Retail Sales declined 0.3% in August, after rising only 0.1% in July. This report was critical as it included the back-to-school shopping period and usually provides a good indication of how willing consumers will be to spend during the upcoming Holiday season. A decline in this report was unexpected and is cause for some concern. Consumers' attitudes as measured by the Consumer Confidence and Consumer Sentiment reports showed a significantly improved confidence, which could contradict the Retail Sales projections. This mixed read is frequently the case during the late stages of a presidential election campaign as consumers are subjected to continual (mostly negative) scrutiny of economic conditions by the candidates and the media. Once the election is behind us, we should get a more reasonable read of consumer attitudes.

The FOMC met September 20th and 21st and the announcement following adjournment stated that the Fed Funds Rate would remain in the 0.25% to 0.50% range. This was what the market had anticipated, but the division of the votes among the members showed that this vote was not typical (usually unanimous or with only a single "no" vote). This time the vote was seven to three. The statement described household spending as strong and economic risks as "roughly balanced". Many economists noted that these same descriptives were used in the meeting statement just prior to the last Fed Funds Rate change in December 2015. Chair Janet Yellen held a press conference after adjournment and kept alive the hope of another hike before year end. The quarterly projections from the Committee were released in that press conference and showed that members were expecting slower growth, but no downturn through 2019. In the release, it showed that 10 of the 17 FOMC forecasters were projecting one more rate increase in 2016.

Government Security Investment Pool rates rose slightly in September, averaging in the +/-0.38% to +/-0.51 range. After closing August with a rate of 0.61%, the 1-year Treasury closed September at 0.59%. The two-year Treasury closed September at 0.77% or about 3 basis points lower than the August close at 0.80%. The current 2-year yield is 0.834% after the Employment Report. It had reached a one-month high of 0.85% just before the Employment release. Certificate of Deposit rates finished September with the 2-year between 0.95% and 1.10%, or about the same as in July and August. To date, the Certificate of Deposit rates have not been materially impacted by the volatility in the Treasury markets and the offered rates have continued to be attractive. The more immediate concern is that banks will have decreasing capacity for new deposits. We have recently seen a decline in the number of banks responding to CD solicitations and we will soon be approaching tax season where governmental entities experience a large inflow of revenues that will need to be invested/deposited. We are encouraging clients to continue to invest, when possible, and to submit tax proceeds for investment as soon as they are available.



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