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SFGFOA Annual Finance & Investment Seminar

Economic overview: Can we separate the wheat from the chaff?

Carl M. Mastroianni, CFA®, Senior Product Specialist
Thursday, August 18, 2016

➤ A BNY MELLON COMPANYSM



Agenda

- The global environment – a mixed bag
- US economy – slow and steady...wins the race?
- Our investment views for navigating the landscape
- Florida – consistency moving forward
- Conclusions

The global environment – a mixed bag

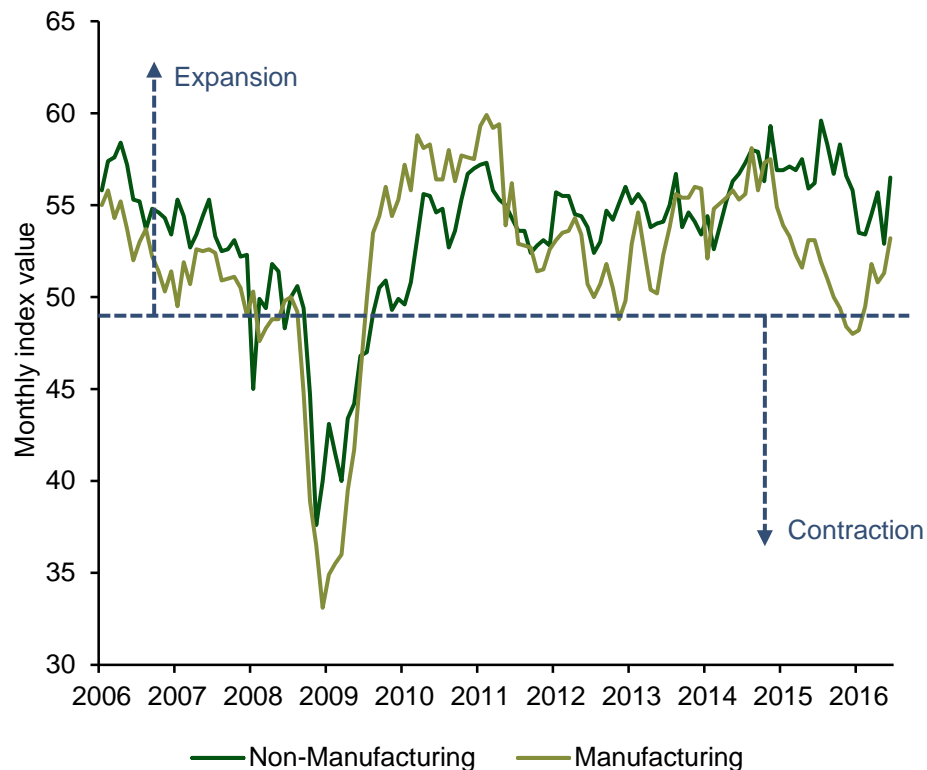
Our view:

Economic and investment themes

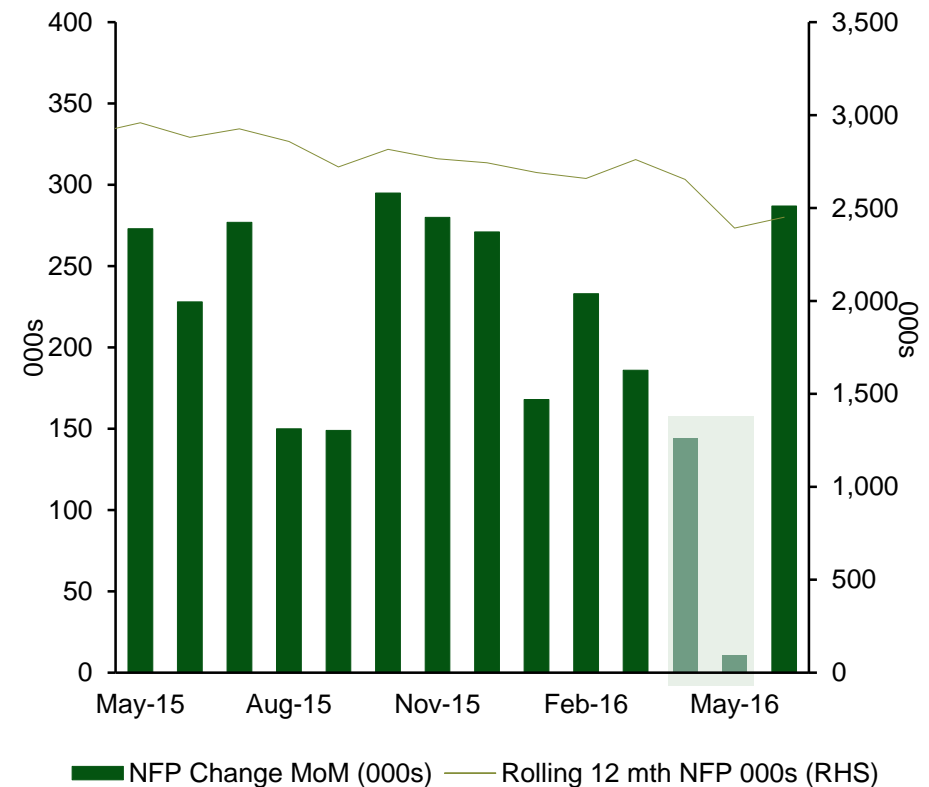
- The result of the European Union (EU) referendum in the UK has had a material impact upon both the economic outlook and financial markets. Growth forecasts in the UK and Europe have fallen, while political and economic uncertainty has risen. US growth is more resilient, but confidence has been impacted
- Inflationary pressure is likely to be muted in the near term in Europe and the US, although we expect inflationary pressure to build in the US over the medium term. The outlook for UK inflation is far less certain, given the contrasting influences of slower growth and higher import costs, the latter linked to sterling depreciation
- The Bank of England is expected to ease monetary policy, likely by cutting interest rates and restarting quantitative easing (QE). Fiscal policy is also expected to be loosened, although uncertainty over political leadership may delay this response
- The Federal Reserve Bank is unlikely to raise rates until the domestic environment improves or international concerns wane. The European Central Bank (ECB) remains biased to ease policy further, potentially widening the scope of its QE program
- The outlook for investment grade corporate bonds is mixed. Although at attractive yield levels given the underlying fundamentals, 'Brexit' concerns will continue to weigh on UK domiciled issuers. The ECB's purchases will help to support credit markets generally, and European markets in particular. The search for yield should also support US credit spreads
- We remain cautious on the high yield market, despite the recent commodity price and ECB fueled rally. Emerging markets are potentially an attractive opportunity given the stimulus measures from China, US Dollar weakness and, in places, improving fundamentals
- Sterling remains vulnerable, despite its already significant depreciation, given the impact of likely future policy responses

Our view: US rate rises pushed further back given global uncertainties

Institute of Supply Management surveys



US labor market (non-farm payrolls)



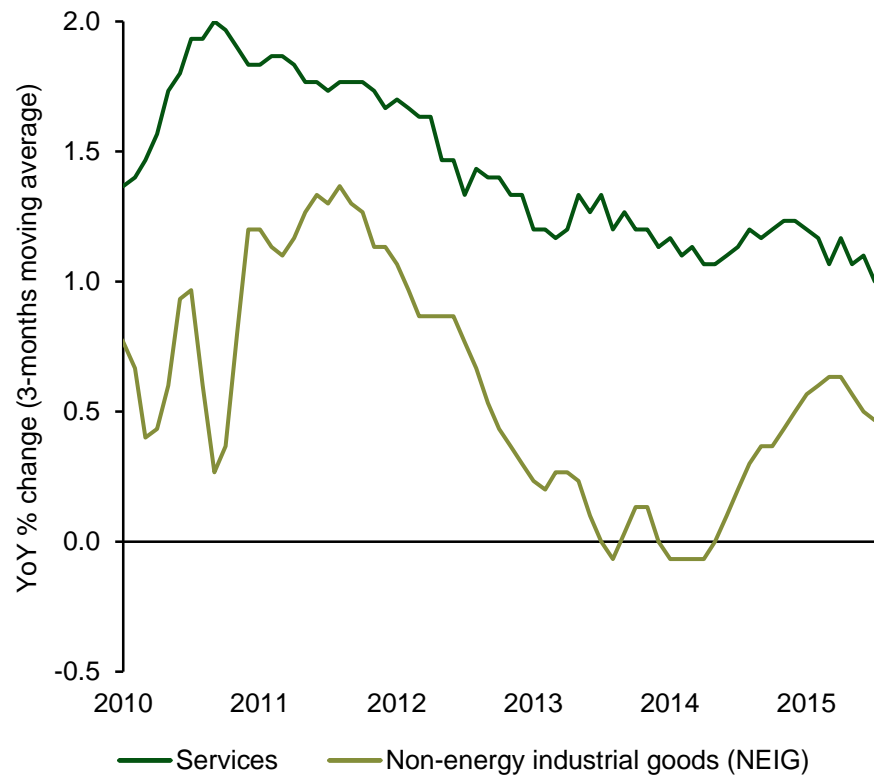
Survey data suggested pick up in activity...

...which conflicted with lower job creation in May

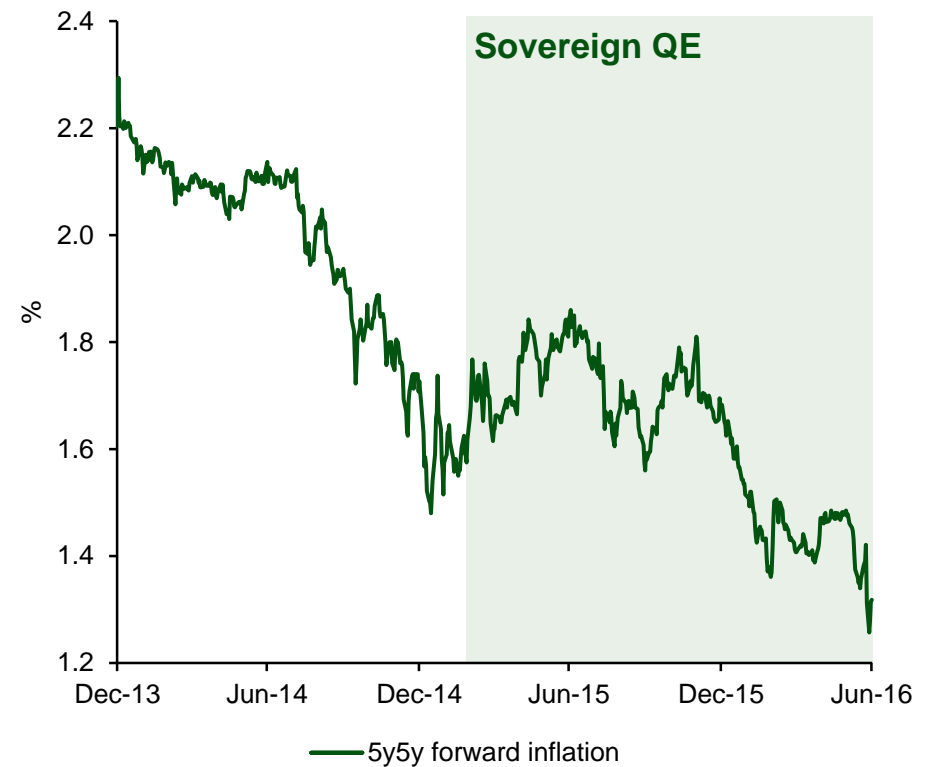
Source: Bloomberg, as of June 30, 2016.

Our view: Eurozone lack of inflation, ECB to continue QE policy

Inflation in services and industrial goods



ECB preferred measure: 5y5y forward inflation



Core measures of inflation remain weak...

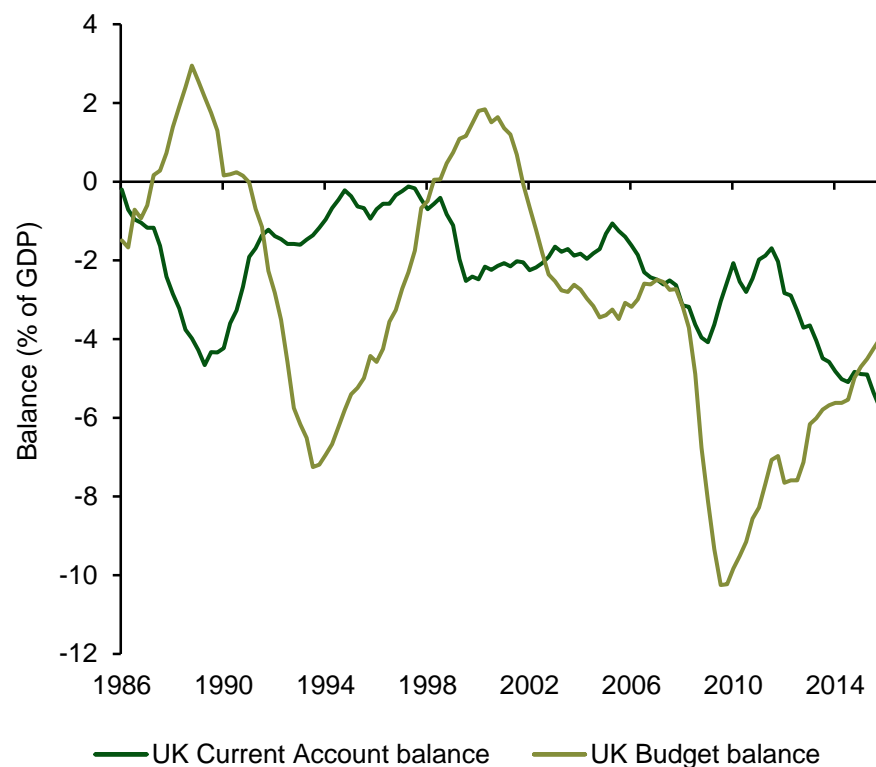
...QE and negative rates not yet enough

Source: Bloomberg, as of June 30, 2016.

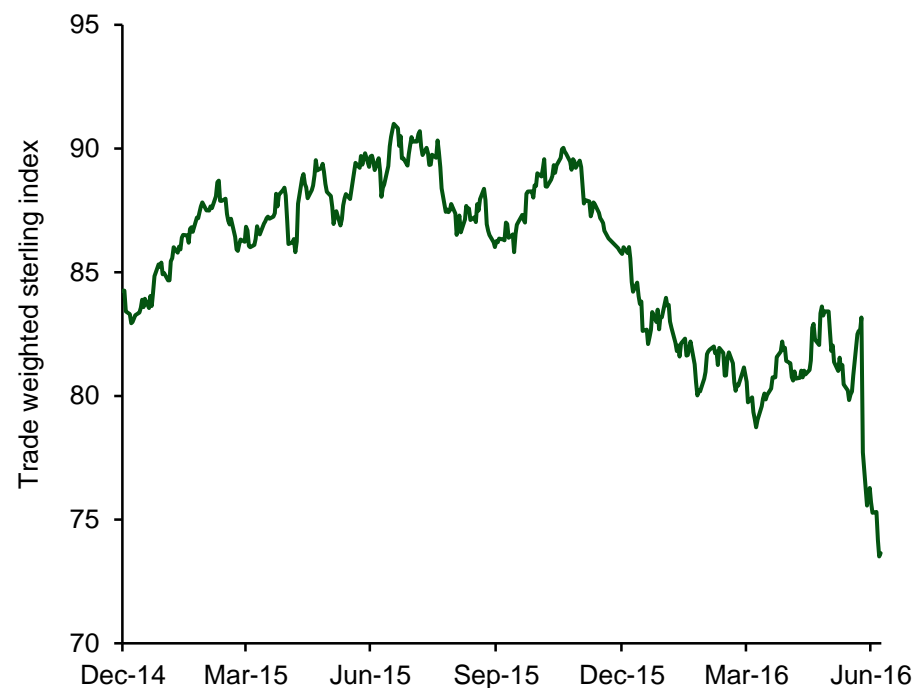
Our view:

UK sterling takes the strain

UK current account and budget balances (% of GDP)



Trade weighted Sterling Index



Significant deficits need to be financed...

...depreciation and QE might help

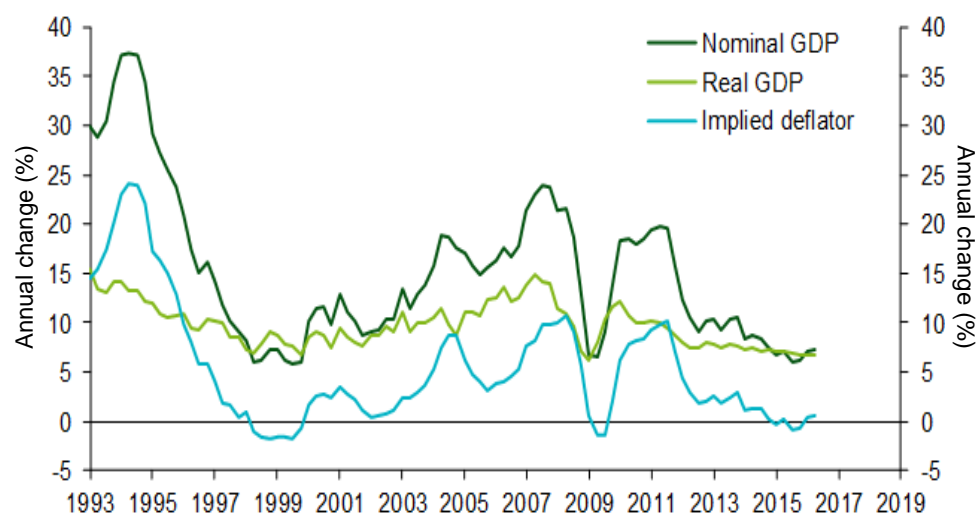
As of June 30, 2016.

Source: Bloomberg, as of June 30, 2016.

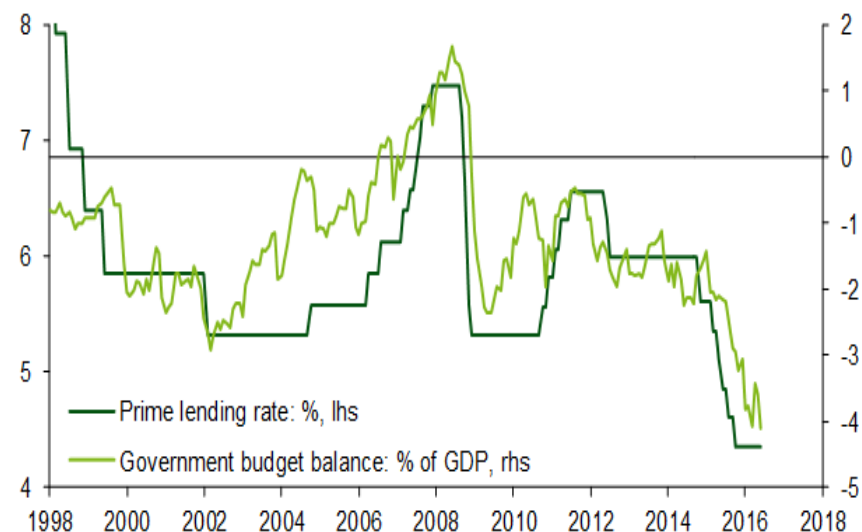
Our view:

China resilient and poised for growth

China: GDP and implied price deflator



China: fiscal and monetary policy



Growth leveling out, while prices may be turning...

...with the central bank continuing to support growth

Source: Thomson Reuters and Insight Investment, as of June 30, 2016.

Source: Bloomberg and Insight Investment, as of June 30, 2016.

Our view:

Oil prices...start of another downturn or temporary respite?

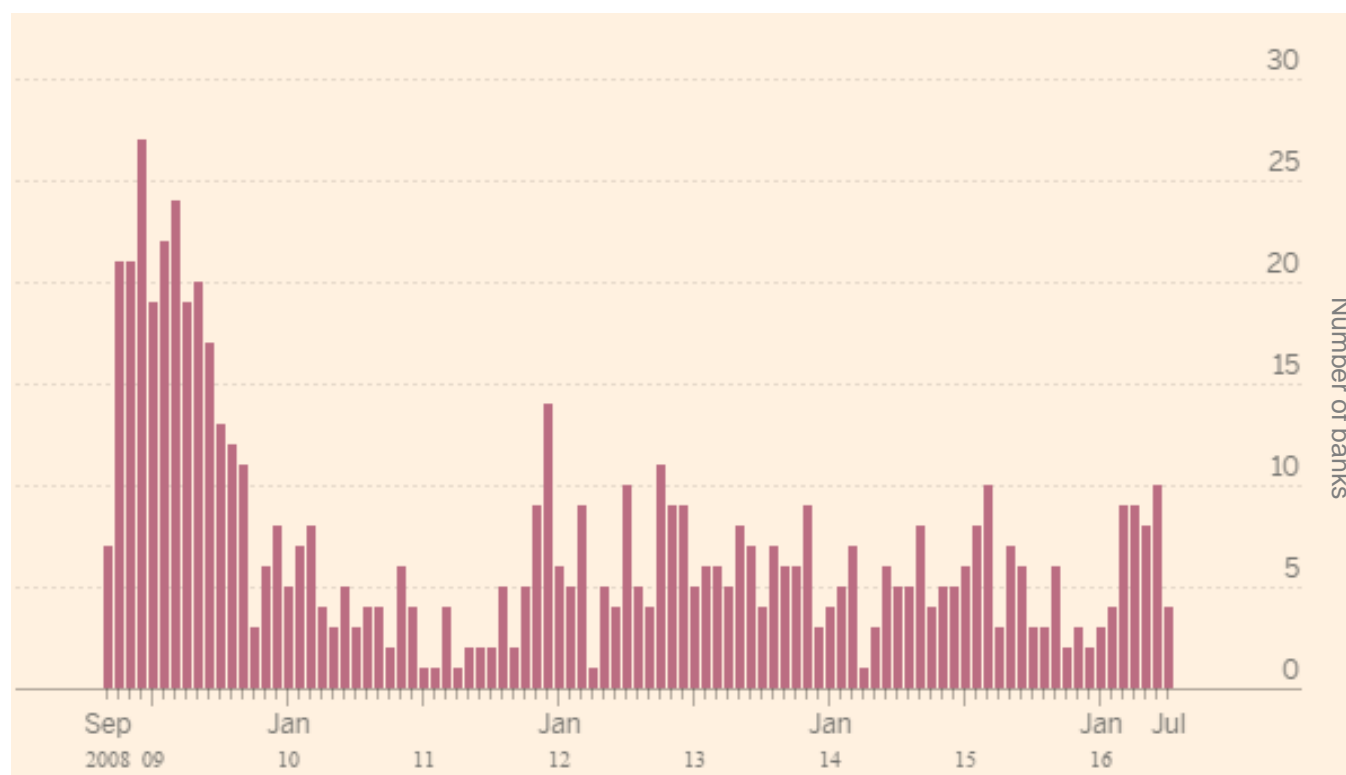


Source: Bloomberg, as of August, 2016.

Our view:

The recent pace of central bank monetary stimulus continues

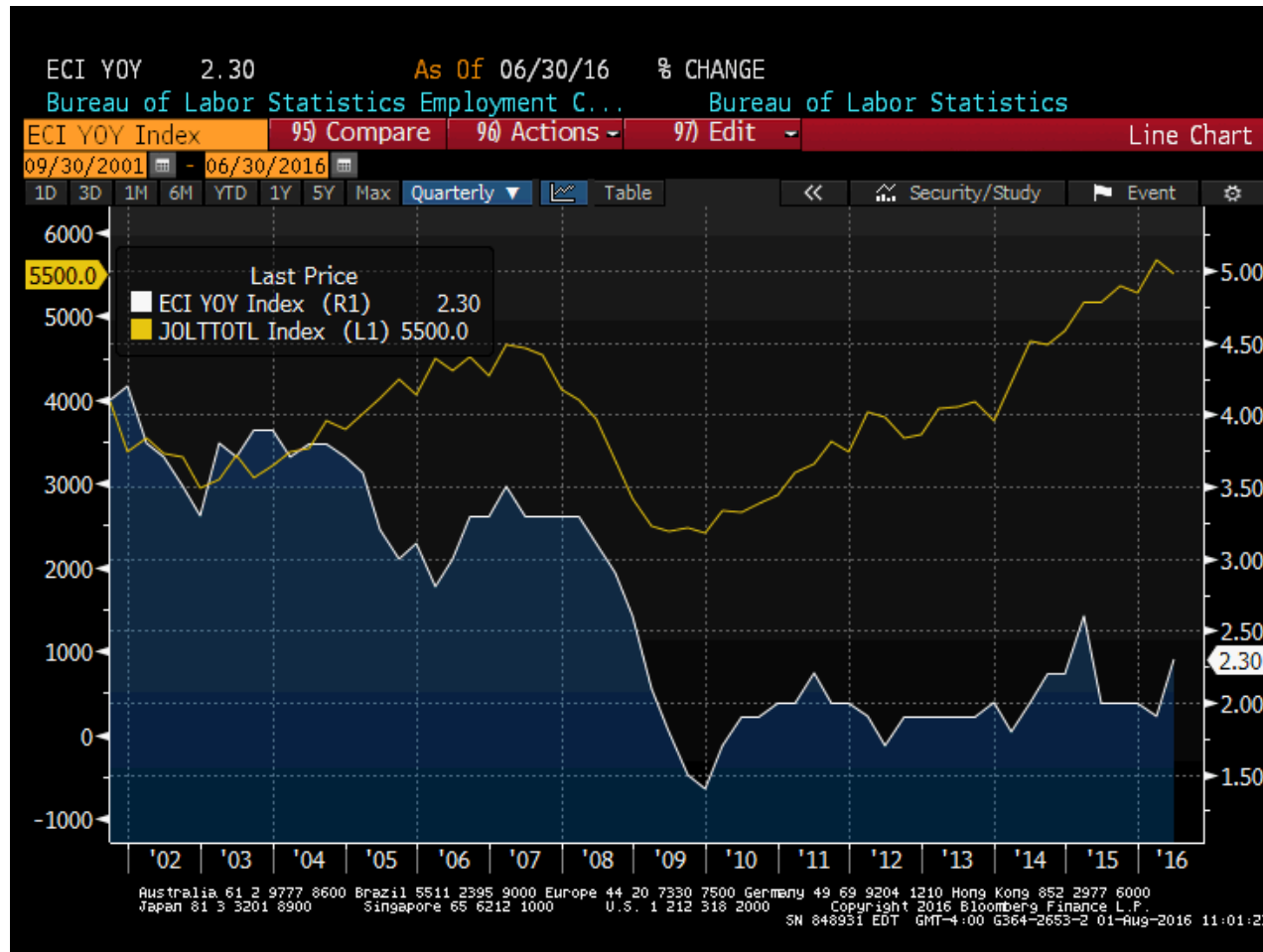
Central banks cutting interest rates – Top 50 central banks



Source: JPMorgan Asset Management, as of July 2016.

US economy – slow and steady...wins the race?

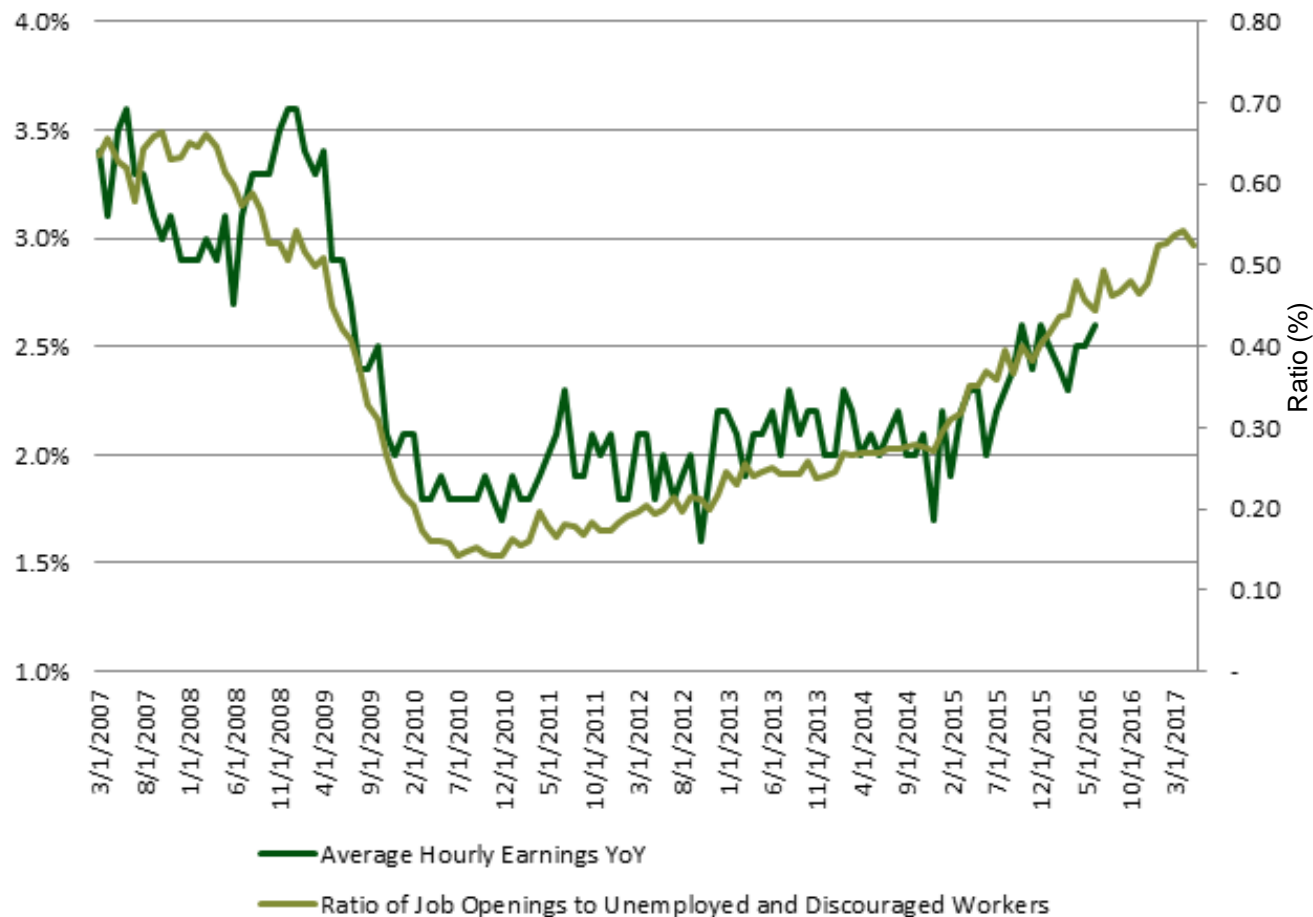
Our view: Employment costs lag job openings, but recovering



Source: Bloomberg, as of June 30, 2016.

Our view:

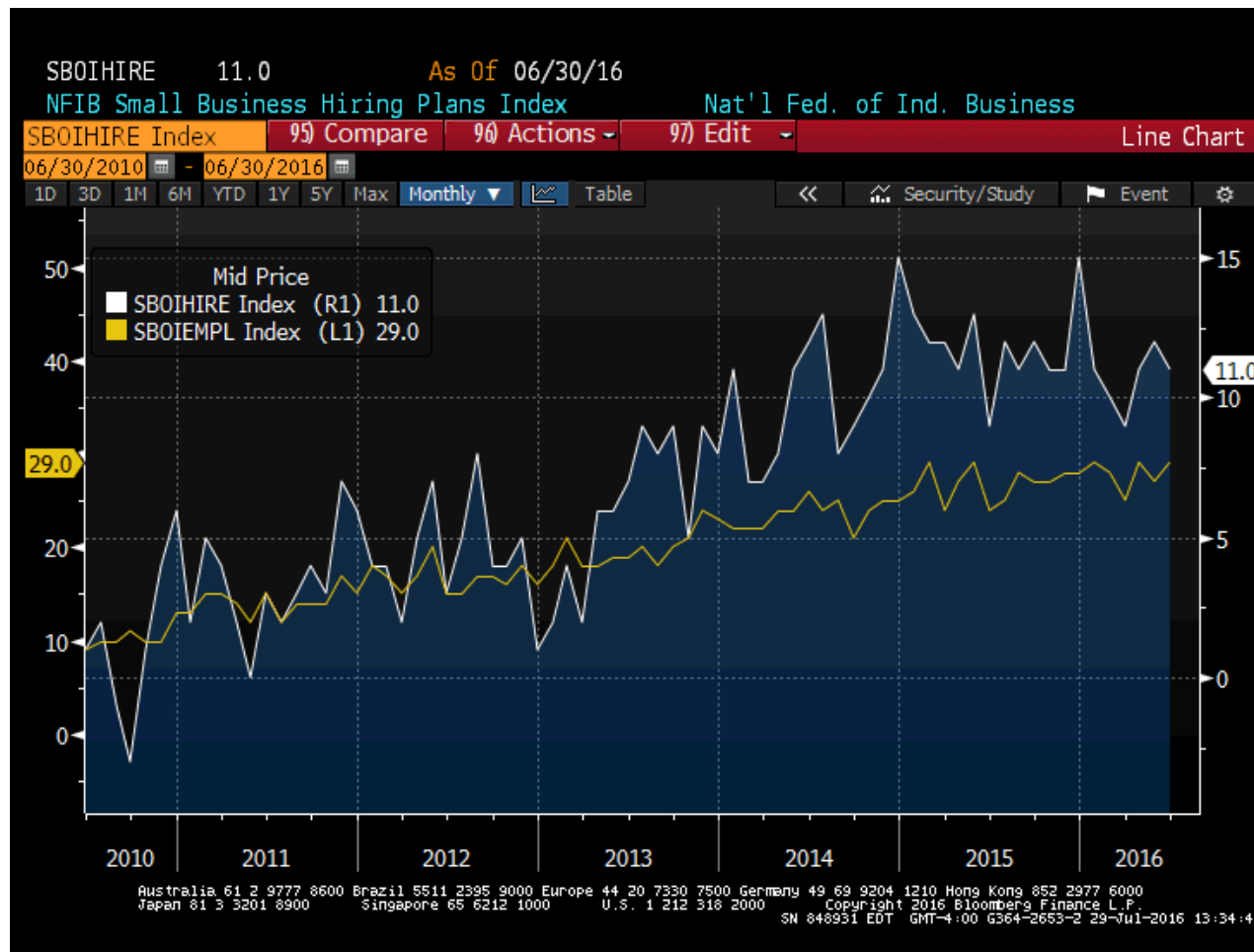
However, increase in job openings does portend higher wage cost



As of June 30, 2016.

Our view:

Small business hiring continues on a generally positive trajectory



Source: Bloomberg, as of June 30, 2016.

Our view: US employment improving...but structural and cyclical impacts

- Although the participation rate remains near record lows



Source: Bloomberg, as of June 30, 2016.

Our view: US housing – the solid foundation getting stronger

- Existing home sales climbed 1.9% in June (5.57 million annualized - strongest since February 2007)
- Spending on home construction and remodeling (fastest pace > three years at the outset of 2016)
- Lean inventory (4.6 month's supply and lowest since June 2001) pushing up prices near record-highs
- Median home price: \$247,700 (up 4.8% from June 2015)



Source: Bloomberg, as of June 30, 2016.

Our view:

US housing – continuing to break new ground...where possible

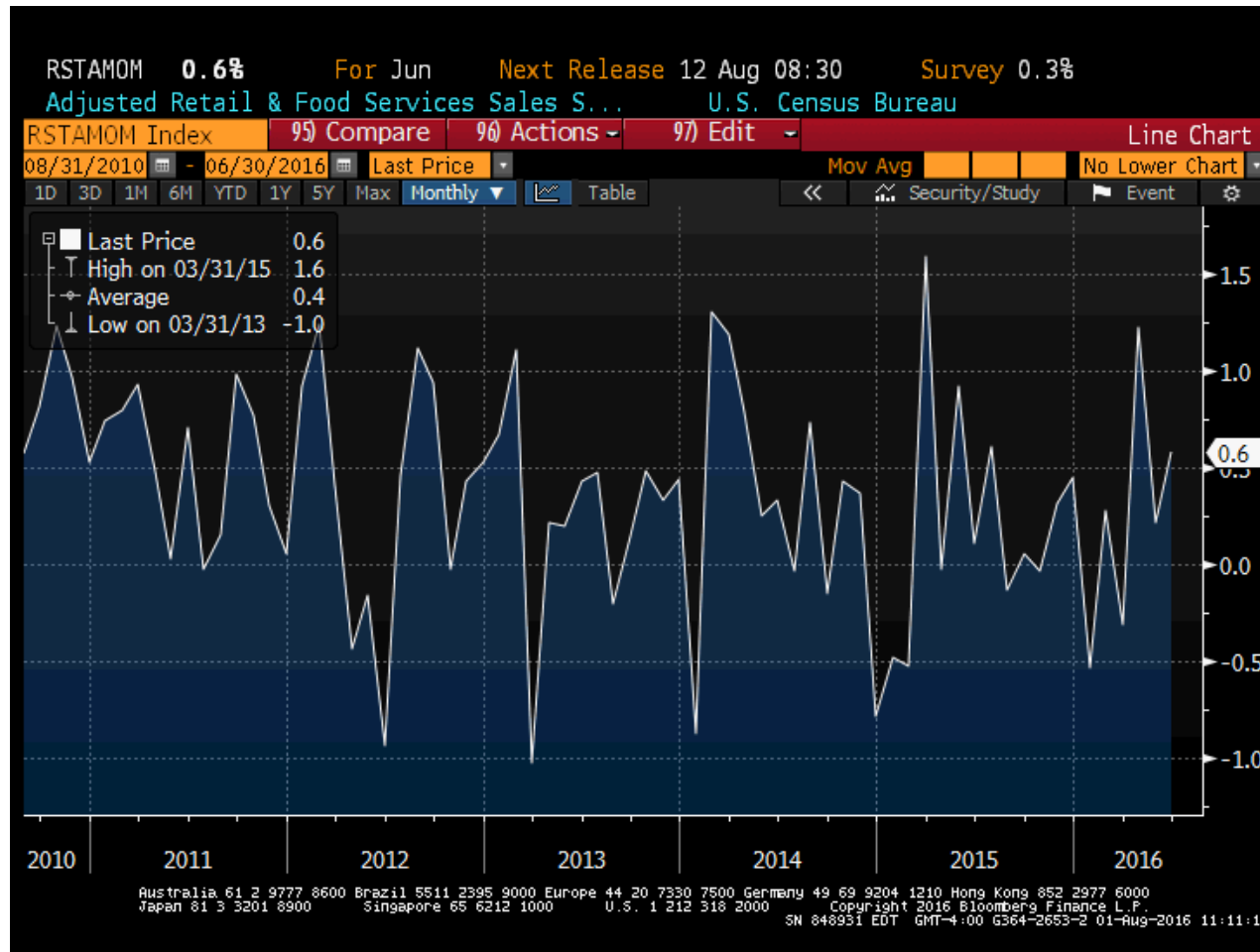
- Single family housing starts up 4.8% in June (1.19 million annualized – most since February) led by the Northeast (+46.3%) and West (+17.4%) regions
- Challenged by land supply and generally still tight lending conditions



Source: Bloomberg, as of June 2016.

Our view:

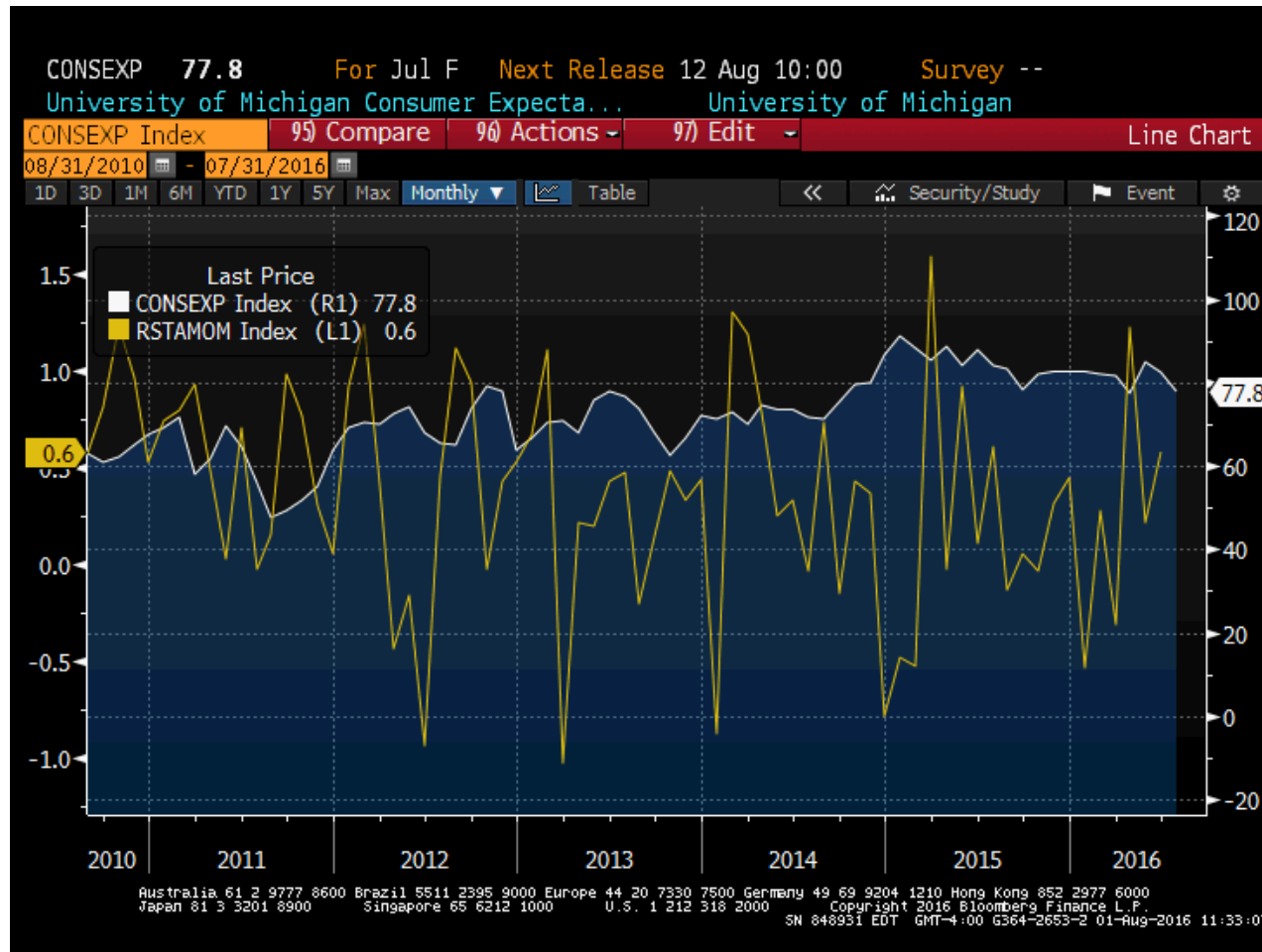
Retail sales depicts a bumpy ride of buying behavior



Source: Bloomberg, as of June 30, 2016.

Our view:

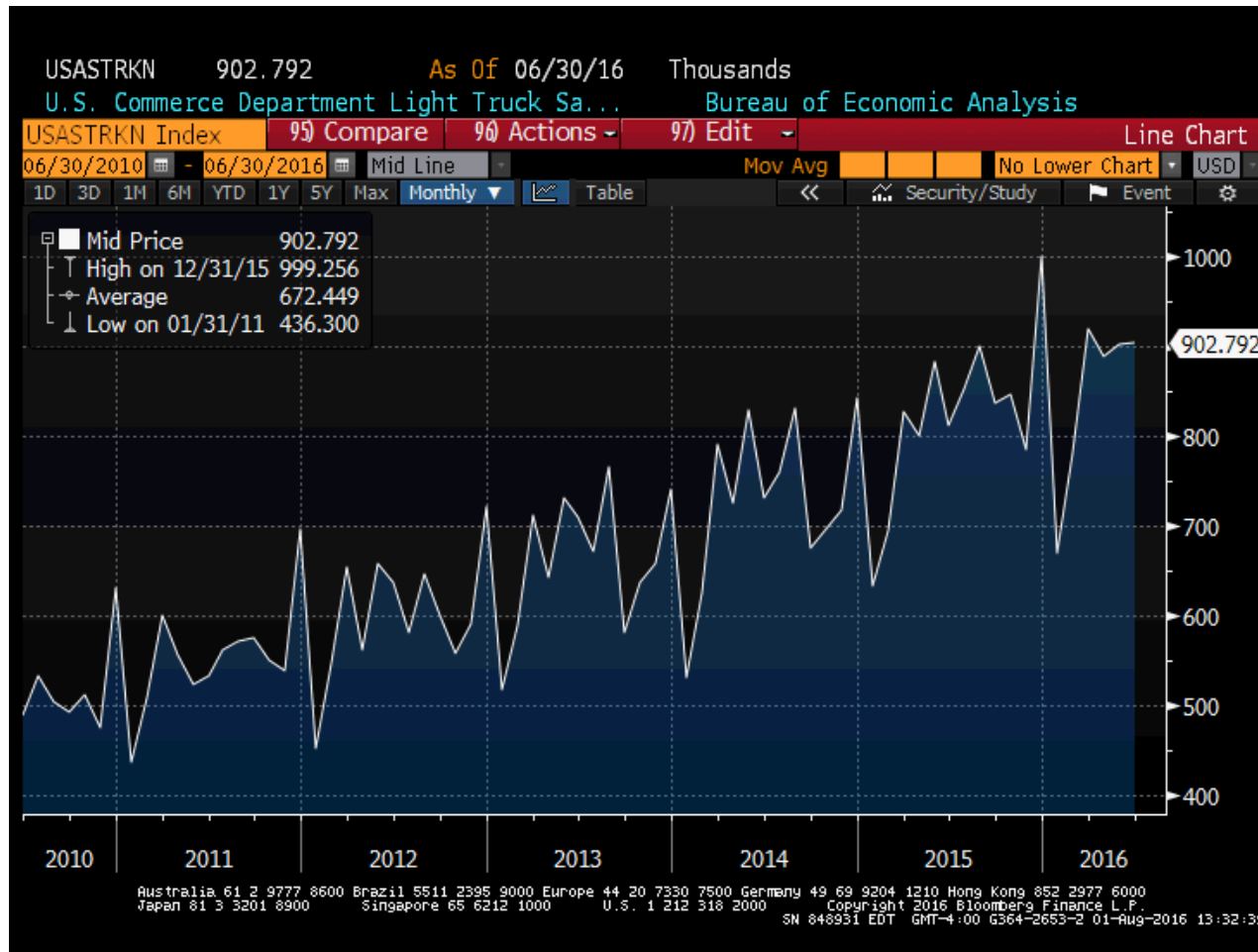
...but may be consistent with downward trend in consumer expectations



Source: Bloomberg, as of June 30, 2016.

Our view:

However, auto sales continue to reflect overall consumer confidence



Source: Bloomberg, as of June 30, 2016.



Our investment views for navigating the landscape

Global government bond markets

Position: Tactical long and short positions taken during the quarter.

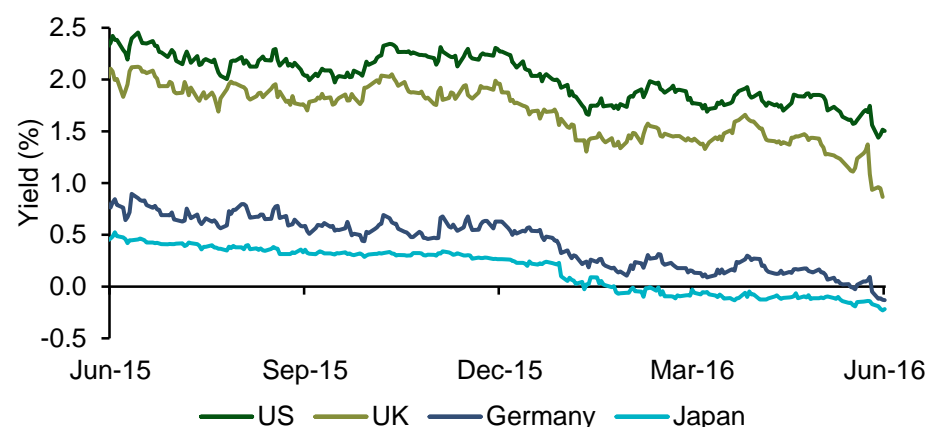
Market: Yields drifted lower throughout most of Q2. The UK referendum vote was the key driver of a sharp fall in all developed market yields towards the end of the quarter.

Gilts outperformed all major markets given lower growth expectations and potentially easier monetary policy.

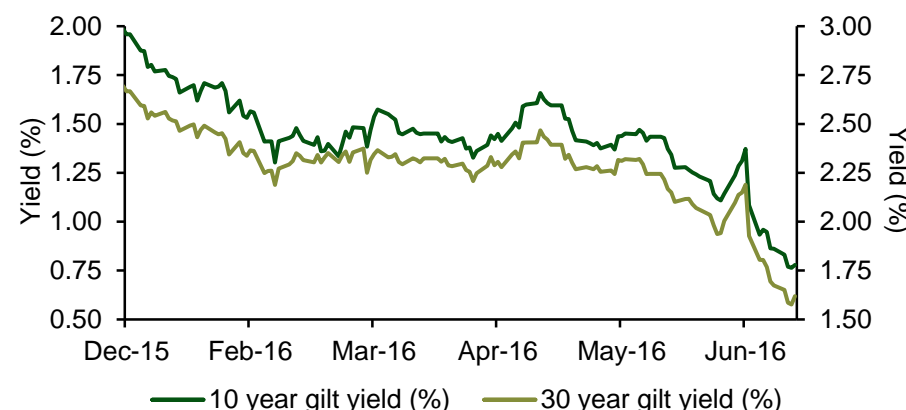
By the end of the quarter 54% of the European bond market was trading with negative yields.

Outlook: The outlook for government bonds is highly uncertain. Prospects of easier policy (UK, EU) are supportive factors, but markets are already discounting a pessimistic economic outlook.

Global 10yr government bond yields



UK government bond yields



Source: Bloomberg, as of June 30, 2016. **Past performance is no assurance of future returns.** Please refer to the important disclosures at the back of this presentation.

Yield curve

Global government bonds

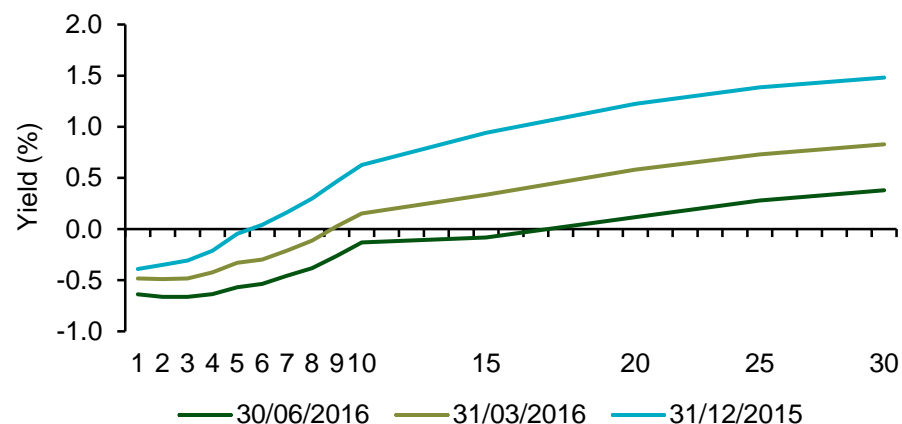
Position: Actively traded, but with a bias for flatter curves during the quarter.

Market: In Europe, the ECB's focus on asset purchases rather than deeper cuts in short term policy rates has driven the outperformance of longer dated bonds, flattening the yield curve.

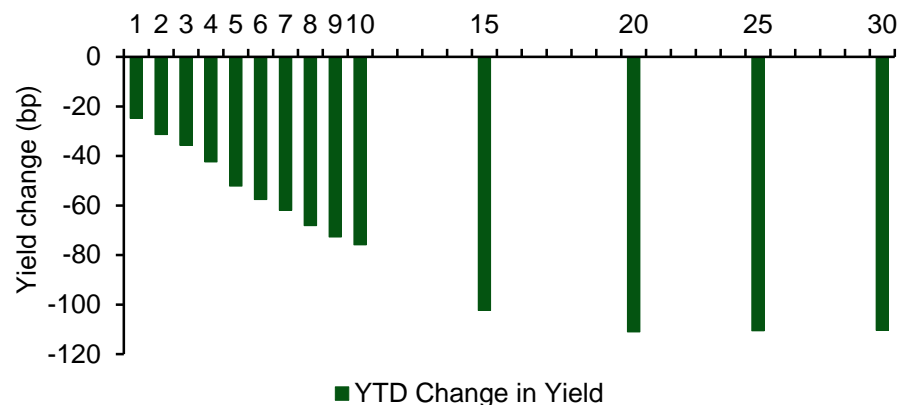
The result of the EU referendum has increased the probability of an expansion of QE, exacerbating the 'bond scarcity' theme.

Outlook: With near term 'bond scarcity' set to remain, the ECB may change its approach to QE purchases. This may mitigate flattening in Germany and support semi-core and peripheral yields (France and Italy especially).

German yield curve



Change in German government yields



Source: Bloomberg, as of June 30, 2016. **Past performance is no assurance of future returns.** Please refer to the important disclosures at the back of this presentation.

Market allocation

Global inflation

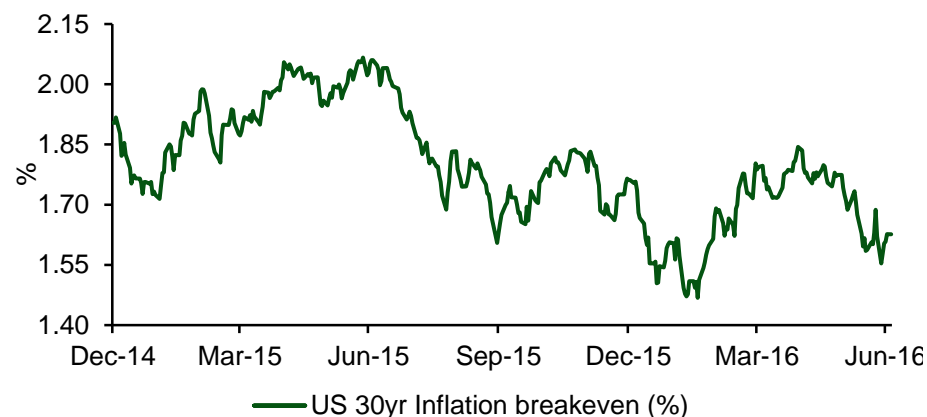


Position: Overweight US inflation linked assets.

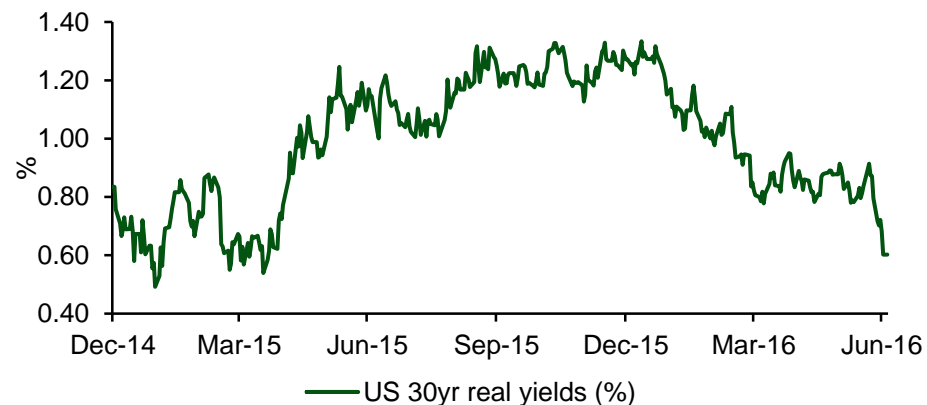
Market: Real yields fell sharply following the UK vote to leave the EU as the US market benefitted from being seen as a safe haven. Uncertainty about the future economic outlook pushed inflation expectations lower, however.

Outlook: A high quality asset offering a positive real yield is an attractive proposition in a world of ultra low or negative nominal yields.

30yr US breakeven inflation



30yr US real yields



Source: Bloomberg, as of June 30, 2016. **Past performance is no assurance of future returns.** Please refer to the important disclosures at the back of this presentation.

Market allocation

Emerging markets



Position: Reduced currency exposure ahead of Brexit, retained exposure to local debt and increased hard currency exposure.

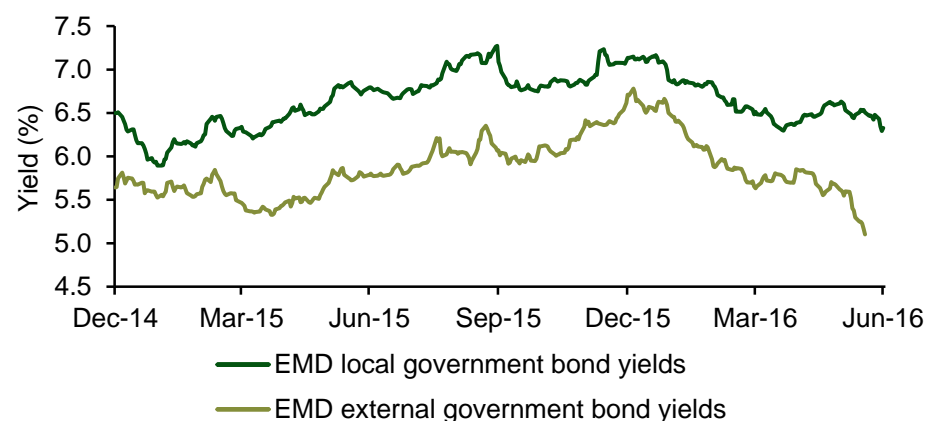
Market: Emerging markets began tentatively, given concerns that Federal Reserve hikes were imminent. With these concerns easing, hard currency debt outperformed, benefitting from investors searching for yield as developed market yields fell to historic lows.

Individual outperformers were driven by structural reforms (Indonesia) as well as the stabilisation in commodity prices (Russia).

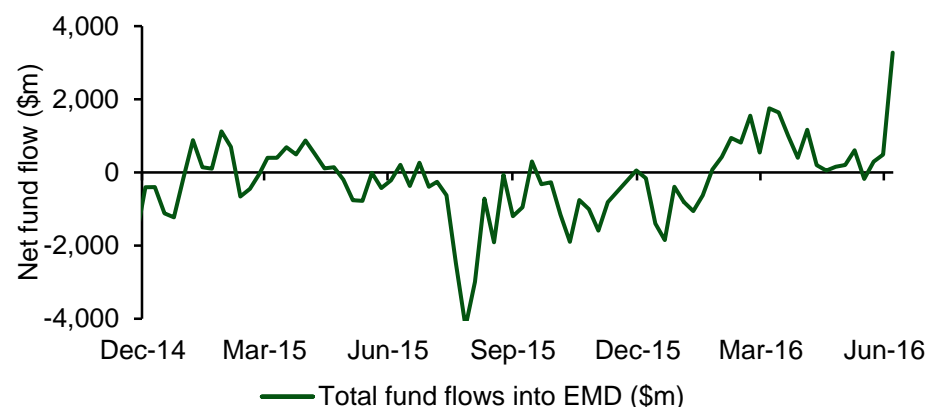
Outlook: Exposure to emerging markets was positive for performance in the second quarter.

With a stable growth outlook, low exposure to the UK and attractive yields, the outlook remains positive. Investor flows are set to continue and should also support markets.

Emerging market debt yields



Fund flows into emerging market debt funds



Source: Bloomberg and JP Morgan, as of June 30, 2016. **Past performance is no assurance of future returns.** Please refer to the important disclosures at the back of this presentation.

Credit and sector strategy

Global investment grade credit markets



Position: Reduced credit risk into the end of the quarter leaving funds with a small long risk position.

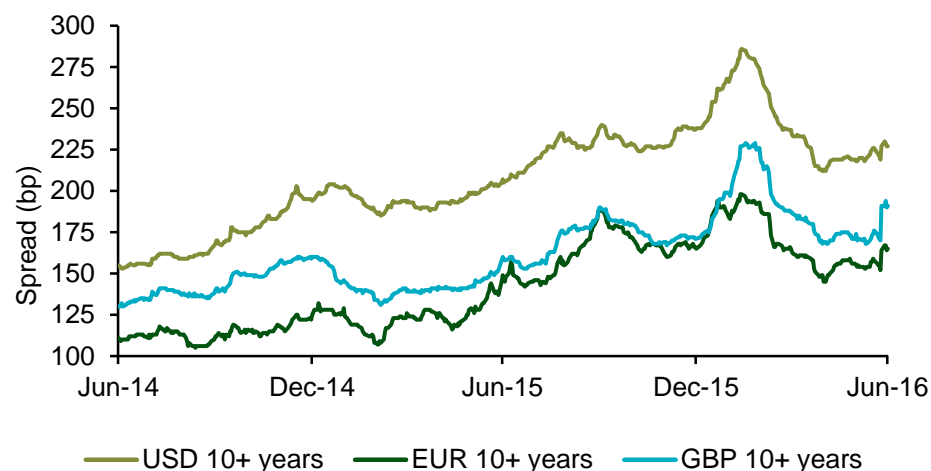
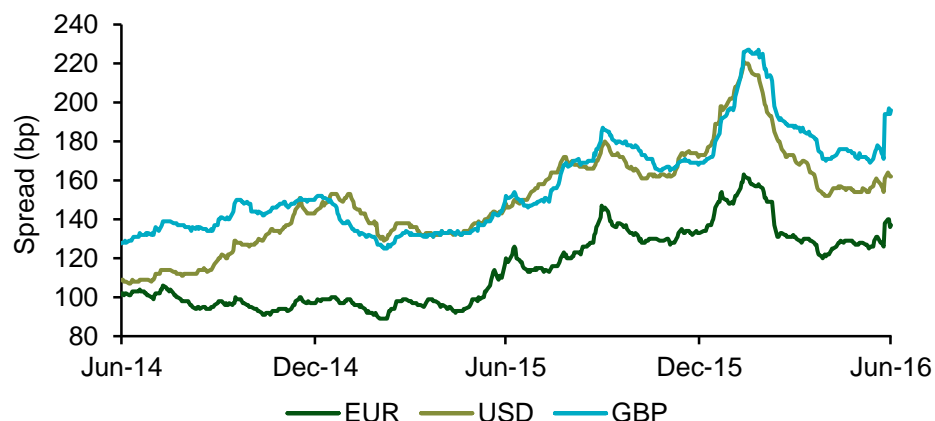
Market: Given the risk of heightened volatility we reduced higher beta positions and introduced downside hedges ahead of the Brexit vote.

We remain overweight longer dated US credit given attractive valuations. European credit remains supported by the ECB buying program.

Outlook: Even with lower growth, credit fundamentals look sound, albeit with a mixed outlook. Although they reached attractive levels given the underlying fundamentals, 'Brexit' concerns will continue to weigh on UK domiciled issuers.

ECB's purchases will help to support credit markets generally, and European markets in particular. The global need for yield should support US credit spreads.

USD, GBP and EUR investment grade credit spreads

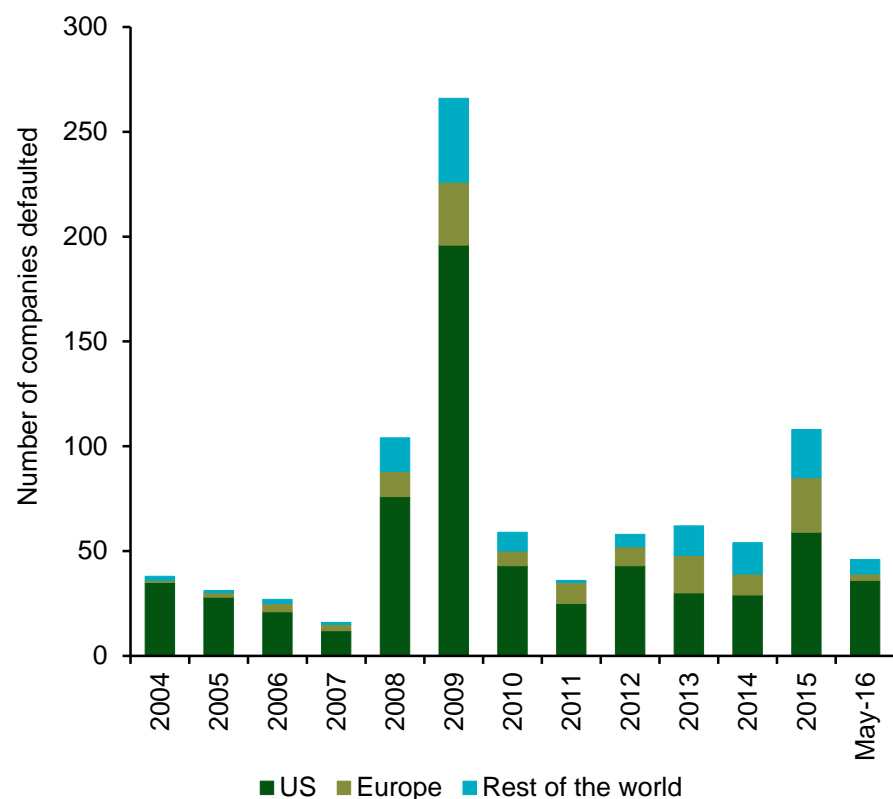


Source: Merrill Lynch, as of June 30, 2016. **Past performance is no assurance of future returns.** Please refer to the important disclosures at the back of this presentation.

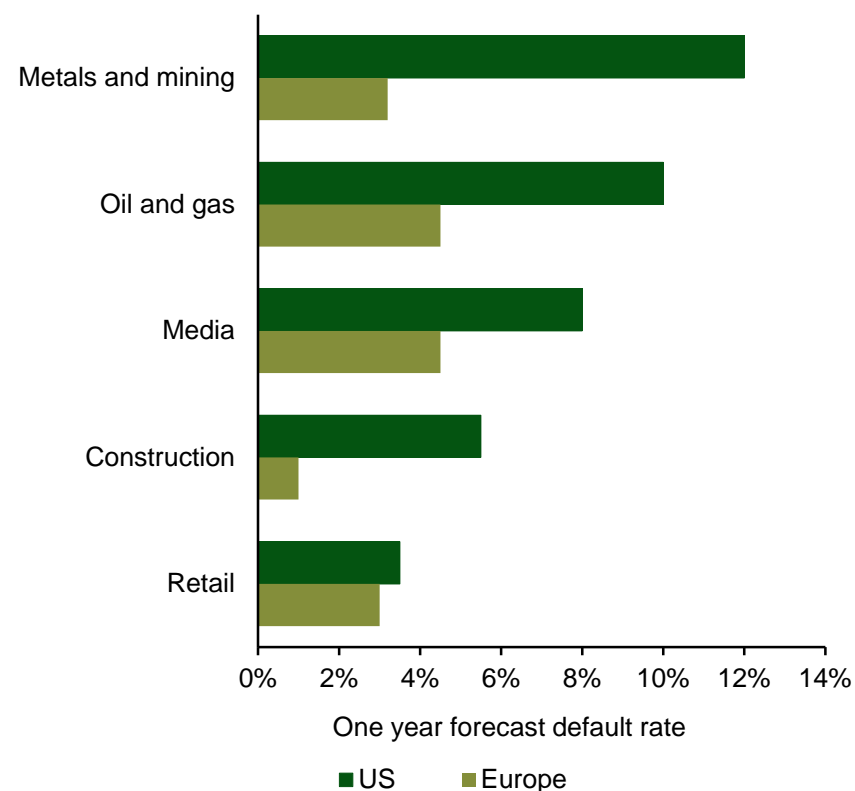
Credit strategy: Default outlook

Corporate defaults likely to continue to rise

Number of company defaults since 2004



One-year default rate forecast by industry



Defaults at highest level since 2008...

...but centred around commodity sectors

Source: Moody's and Insight, as of May 2016.

Credit market outlook

Economic environment

=	Growth	US and continental Europe robust, uncertainty over UK
+	Global excess liquidity	Lower-for-longer

Credit fundamental

—	Leverage	Corporate debt is rising while profits are falling
=	Event risk	Management engaging in shareholder-friendly policies but M&A could create opportunities
=	Defaults	Corporate financing rates at record lows but shake-out in US high yield

Technical

+	Supply / Demand	Consistently supportive amid ECB buying program and negative yields on government bonds
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... but do valuations reflect this?

For illustrative purposes only.

Currency selection

Short sterling position, more pain to come

Position: Short sterling position against US dollars, implemented after the result of the referendum.

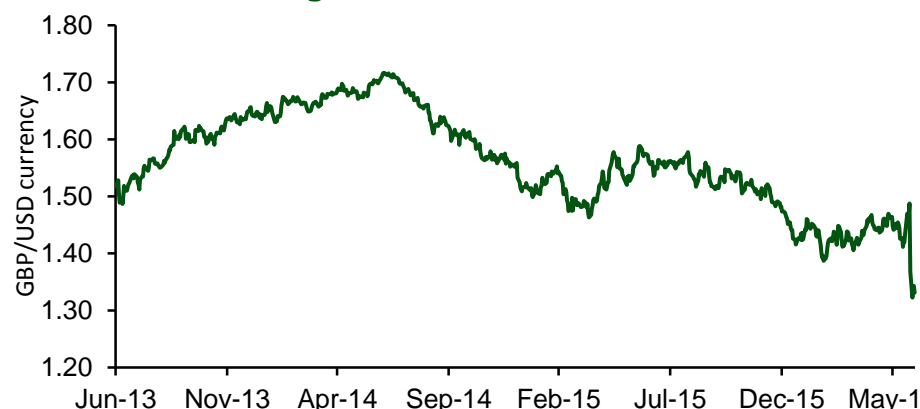
Market: Sterling remained volatile into the referendum, depreciating sharply after the result. Initial market moves reflect interest rate shifts, but have not fully priced in likely policy responses.

The US dollar reversed its gains from Q1 as weaker labor data reduced expectations for most immediate interest rate hikes from the Fed.

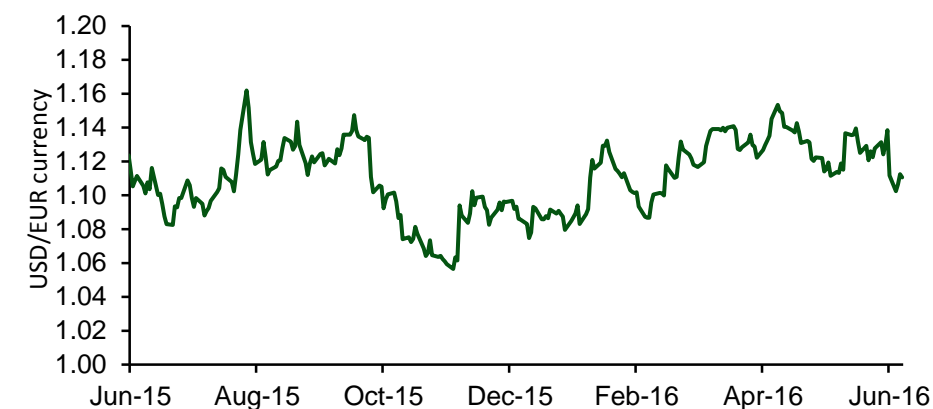
Outlook: Sterling faces several headwinds; lower growth, lower rates and is less attractive to foreign investors. The depreciation should help exports and may be necessary to help fund the UK's significant current account deficit.

The US dollar may be range bound in the near term, given US rates are on hold and the higher uncertainty will drive a flight to quality.

GBP/USD exchange rate



USD/EUR exchange rate

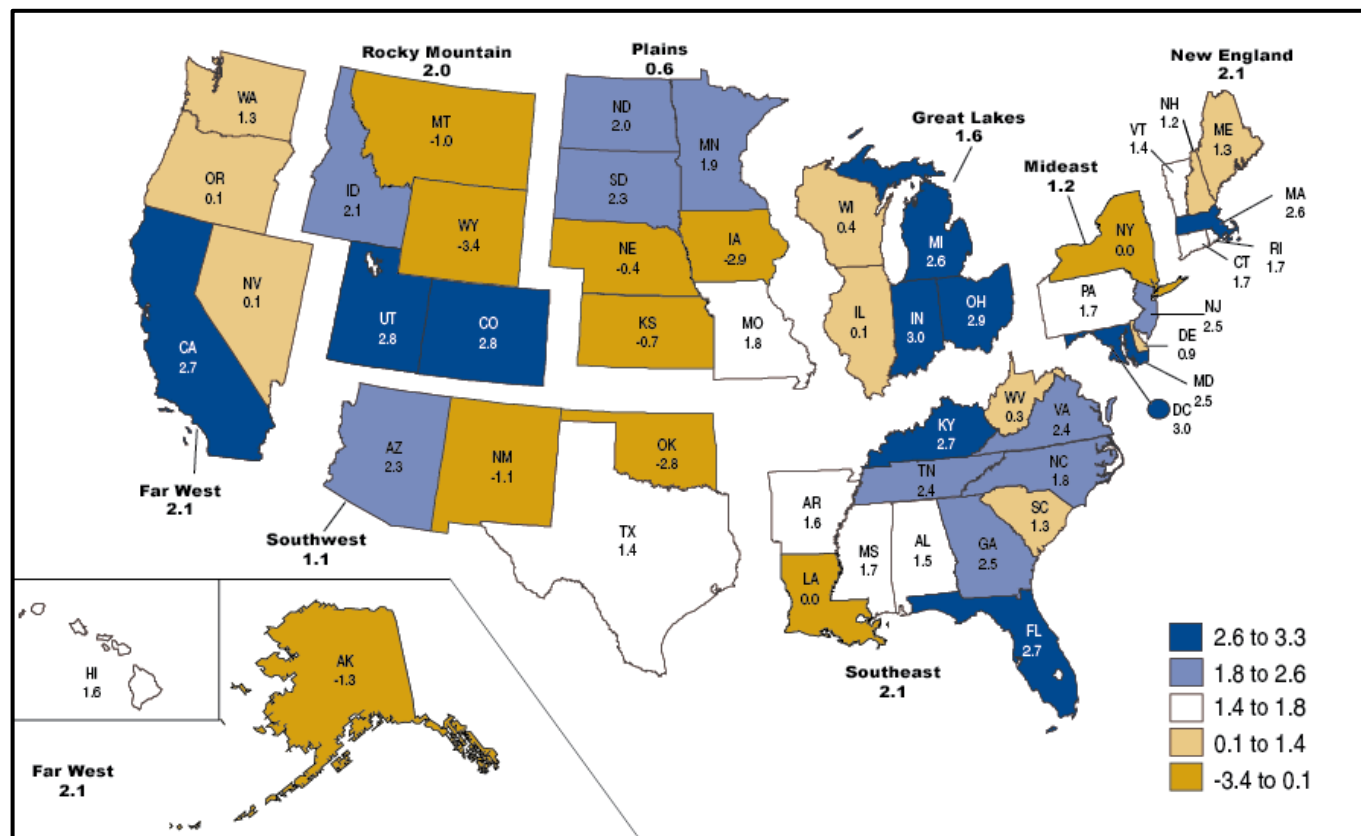


Source: Bloomberg, as of June 30, 2016.

Florida — consistency moving forward

Our view: 2015 US state growth — Florida in the top ten through Q4

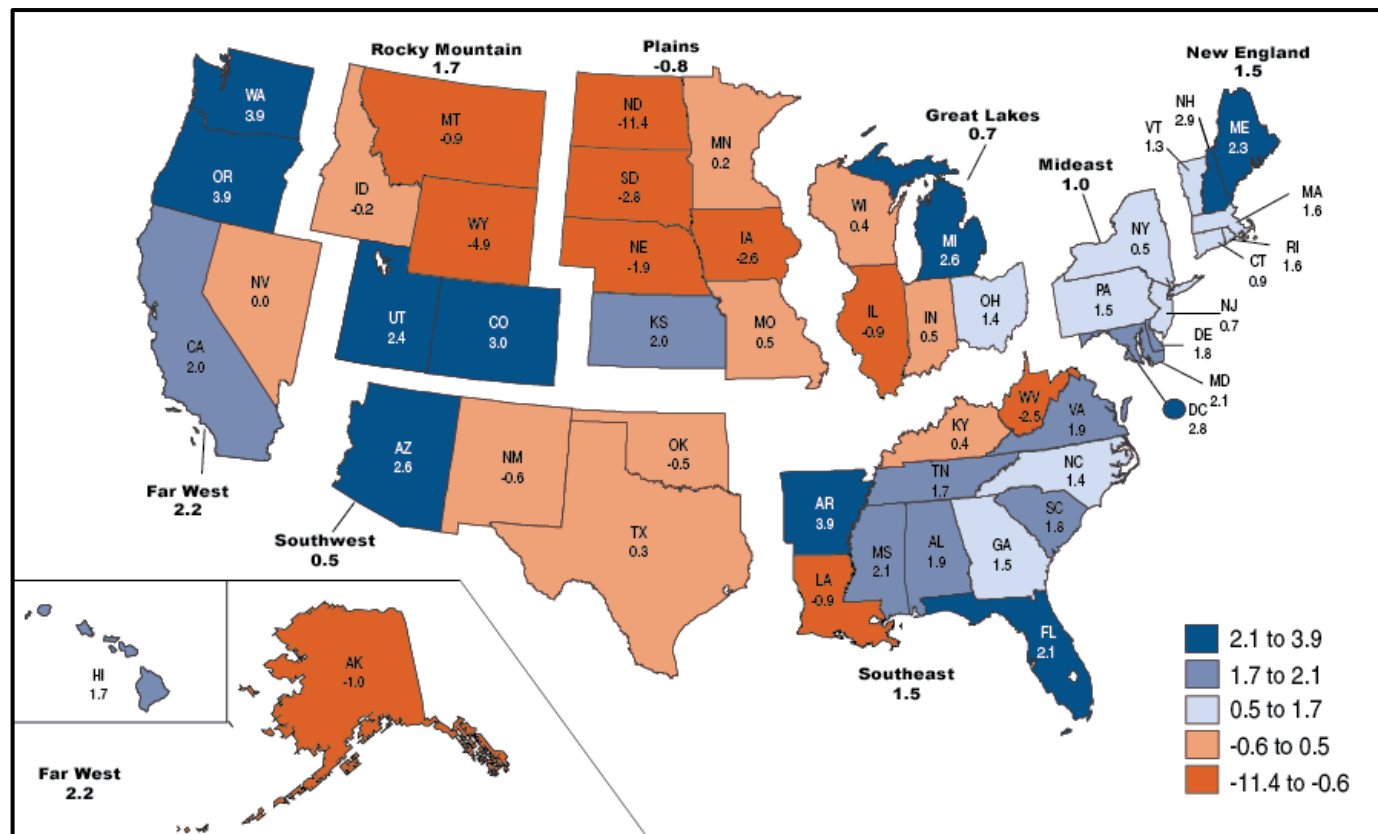
Percent change in Real GDP by state, 2015:III-2015:IV, seasonally adjusted at annual rates



Source: US Bureau of Economic Analysis, as of December 2015.

Our view: 2016 US state growth — the trend continues on track in Q1

Percent change in Real GDP by state, 2015:III-2016:I, seasonally adjusted at annual rates

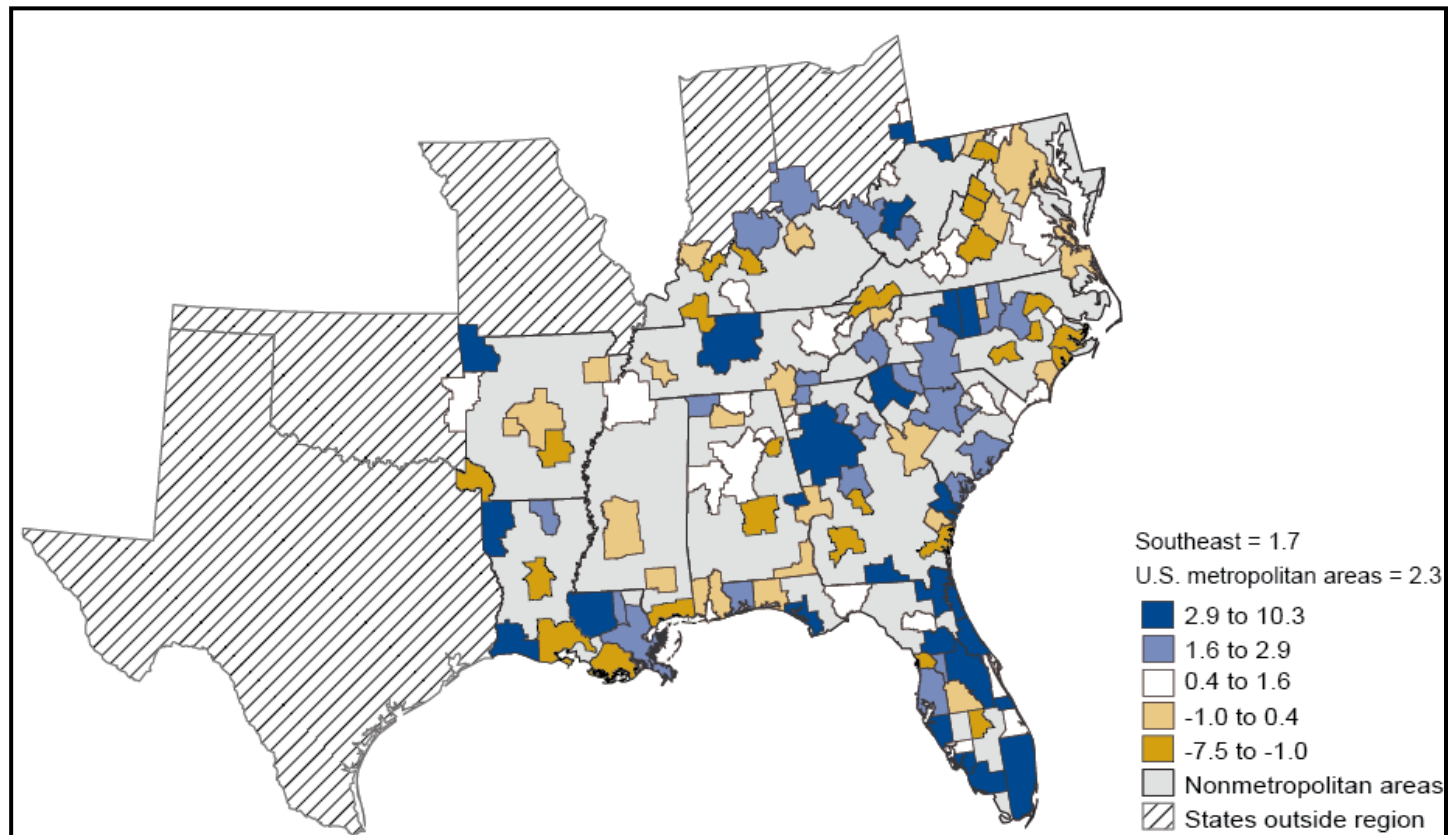


Source: US Bureau of Economic Analysis, as of March 31, 2016.

Our view:

2014 Florida intra-state GDP — most coastlines in the top quintile

Percent change in Real GDP by metropolitan area in the Southeast Region, 2014

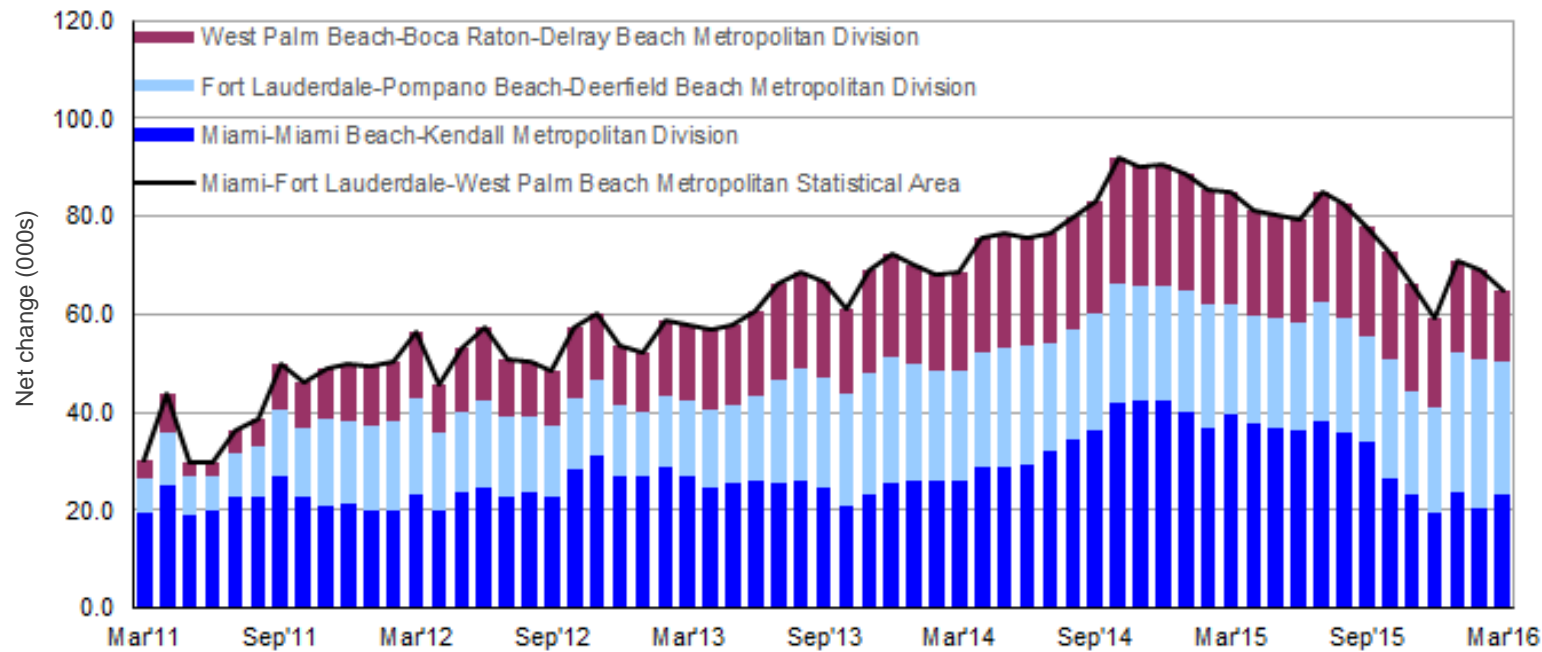


Source: US Bureau of Economic Analysis, as of December 2014.

Our view:

South Florida employment — pulling back from the positive trajectory

Total nonfarm employment, over-the-year net change in the Miami metropolitan area and its divisions March 2011 - March 2016

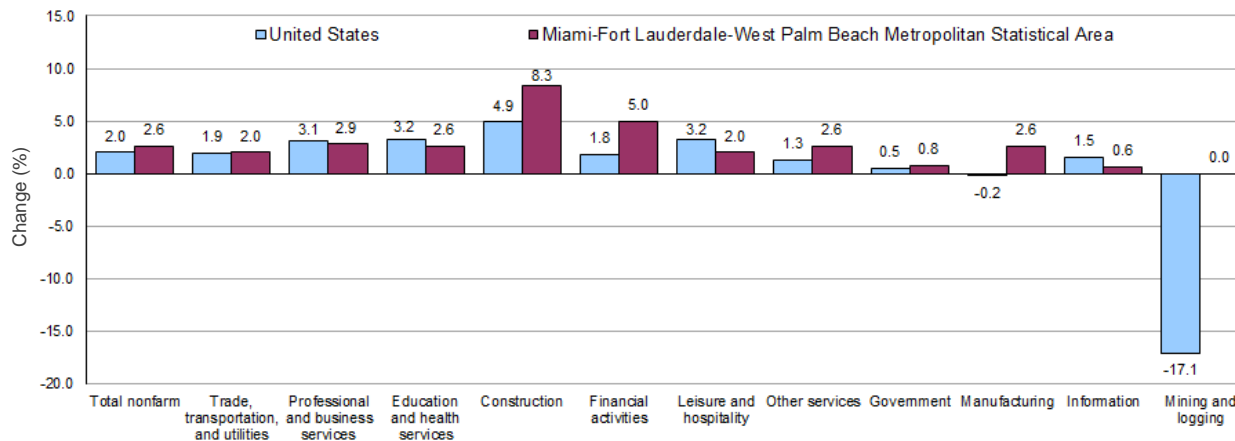


Source: US Bureau of Labor Statistics, as of March 2016.

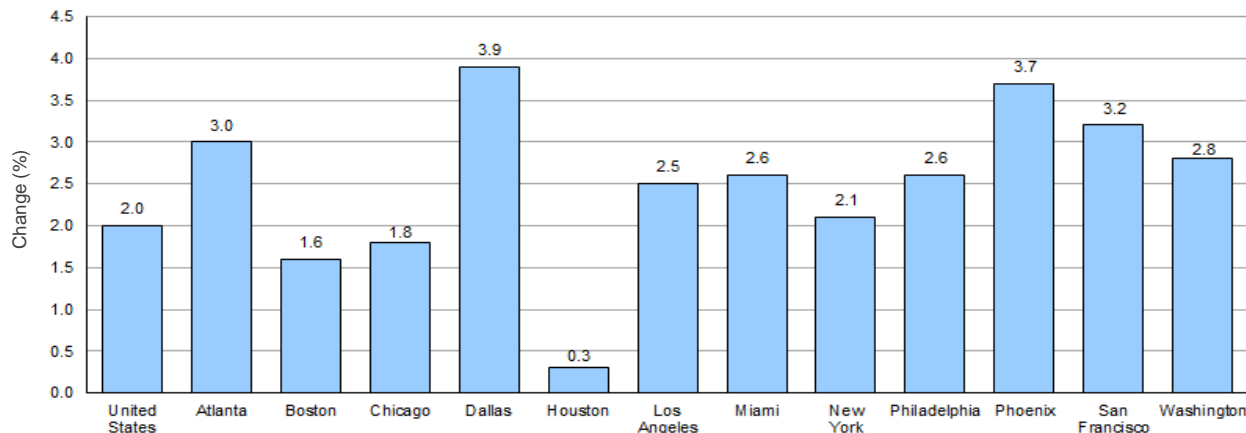
Our view:

Sector and large city employment — construction and Miami among the leaders

Total nonfarm and selected industry supersector employment, over-the-year percent change in the Miami-Fort Lauderdale-West Palm Beach metropolitan area, March 2016



Total nonfarm employment, over-the-year percent change US and 12 largest metropolitan areas, March 2016

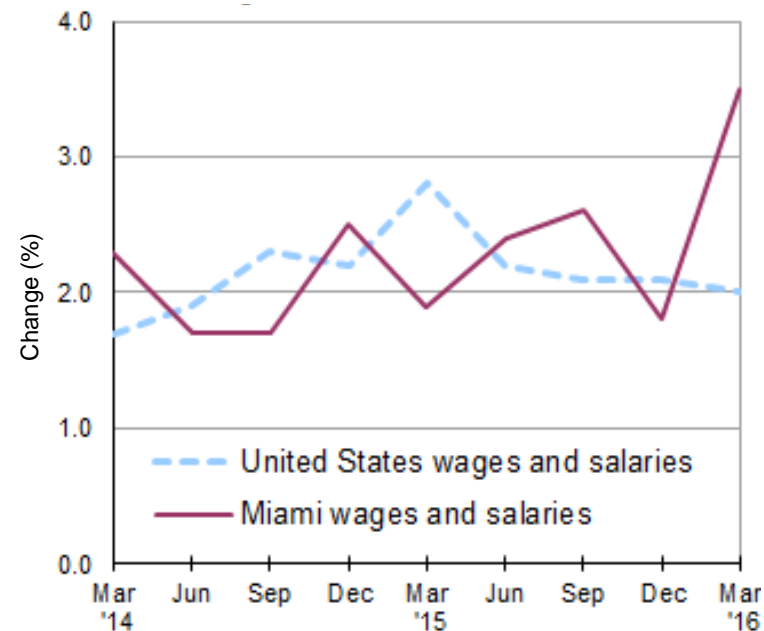
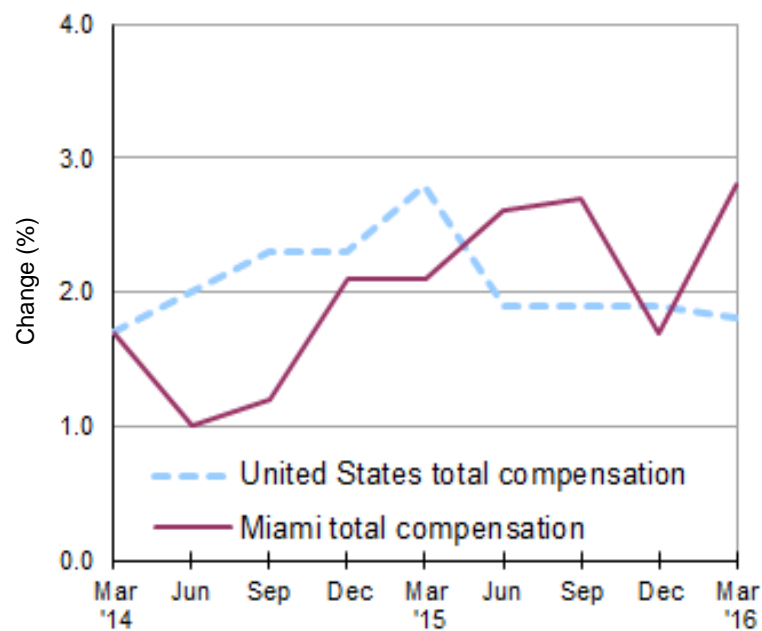


Source: US Bureau of Labor Statistics, as of March 2016.

Our view:

South Florida employment costs are going up

Twelve-month percent changes in the Employment Cost Index, private industry workers, US and the Miami area, not seasonally adjusted, March 2014-March 2016

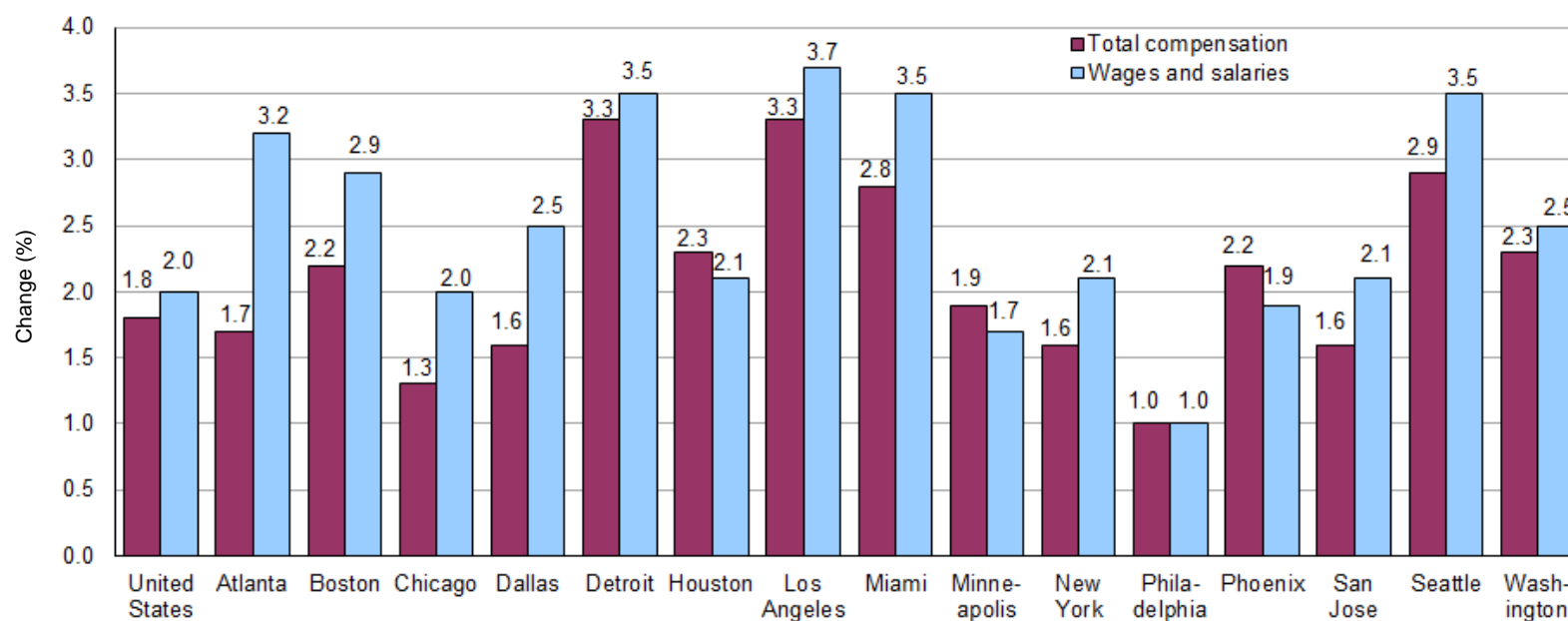


Source: US Bureau of Labor Statistics, as of March 2016.

Our view:

South Florida among US leaders for wage costs

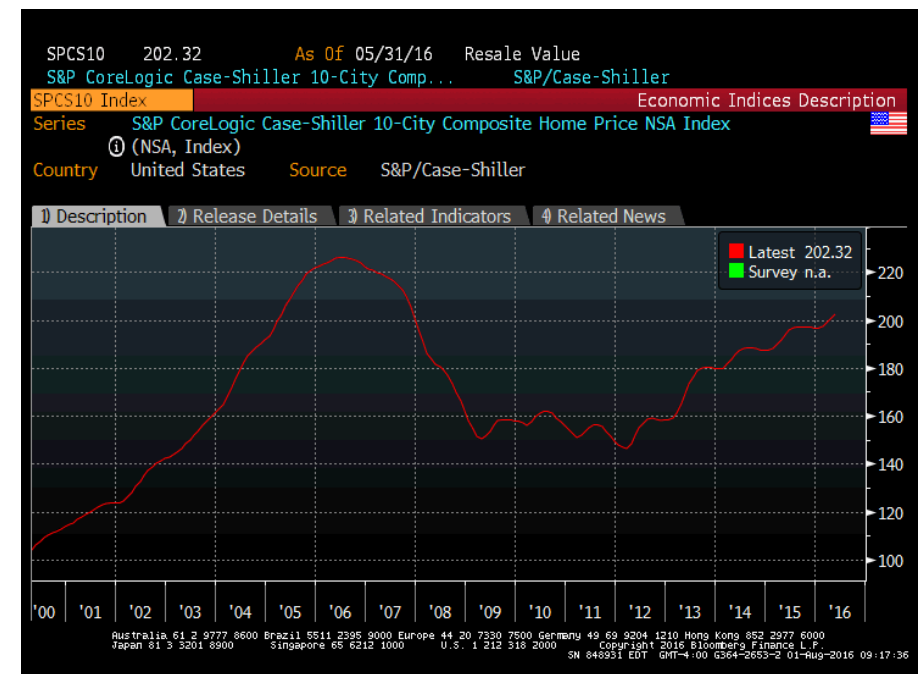
Twelve-month percent change in the Employment Cost Index, private industry workers, US and localities, not seasonally adjusted, March 2016



Source: US Bureau of Labor Statistics, as of March 2016.

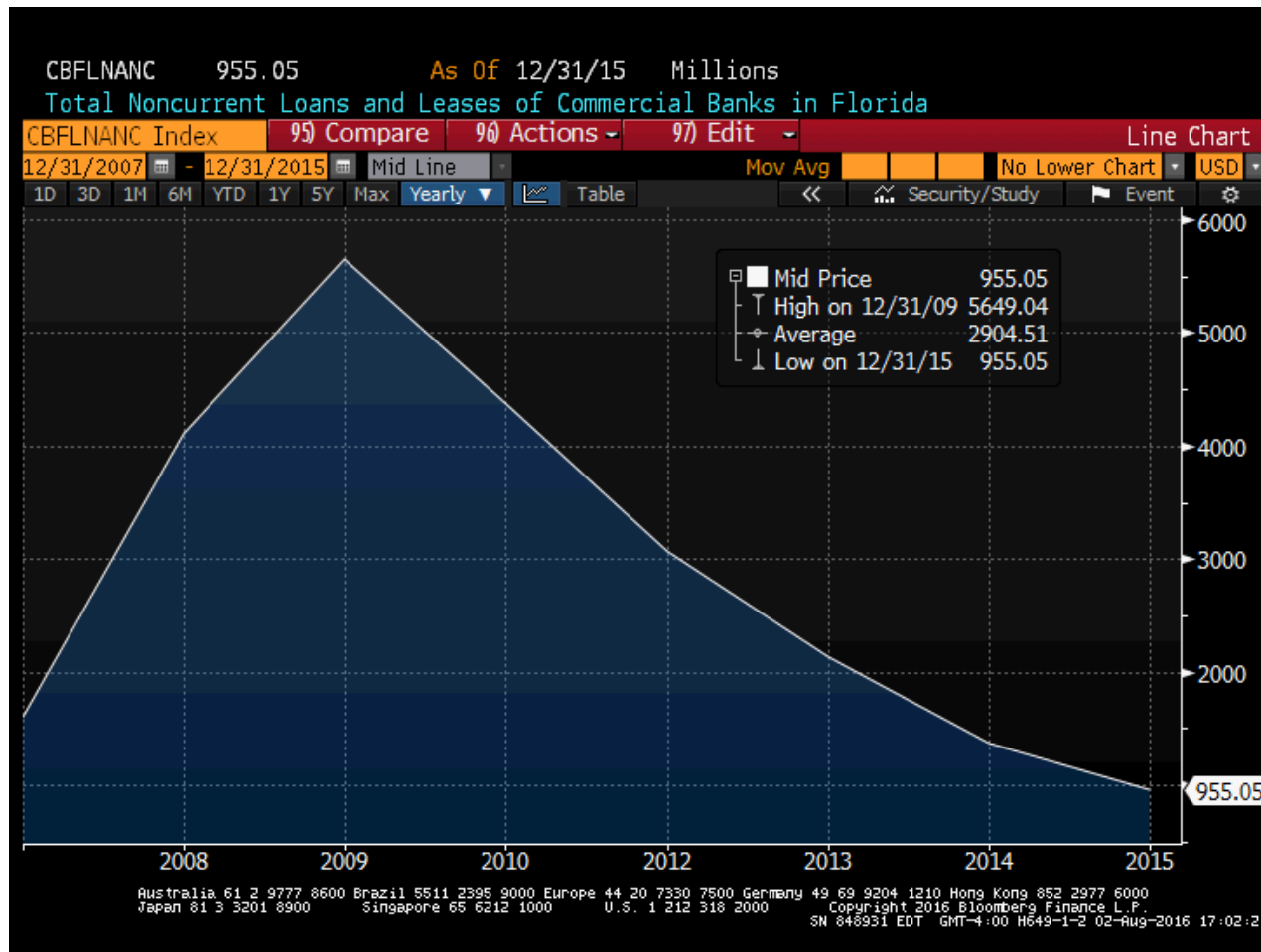
Our view:

Major Florida market house prices follow the national trend higher



Source: Bloomberg, as of June 30, 2016.

Our view: Florida non-performing loans – back to pre-financial crisis levels

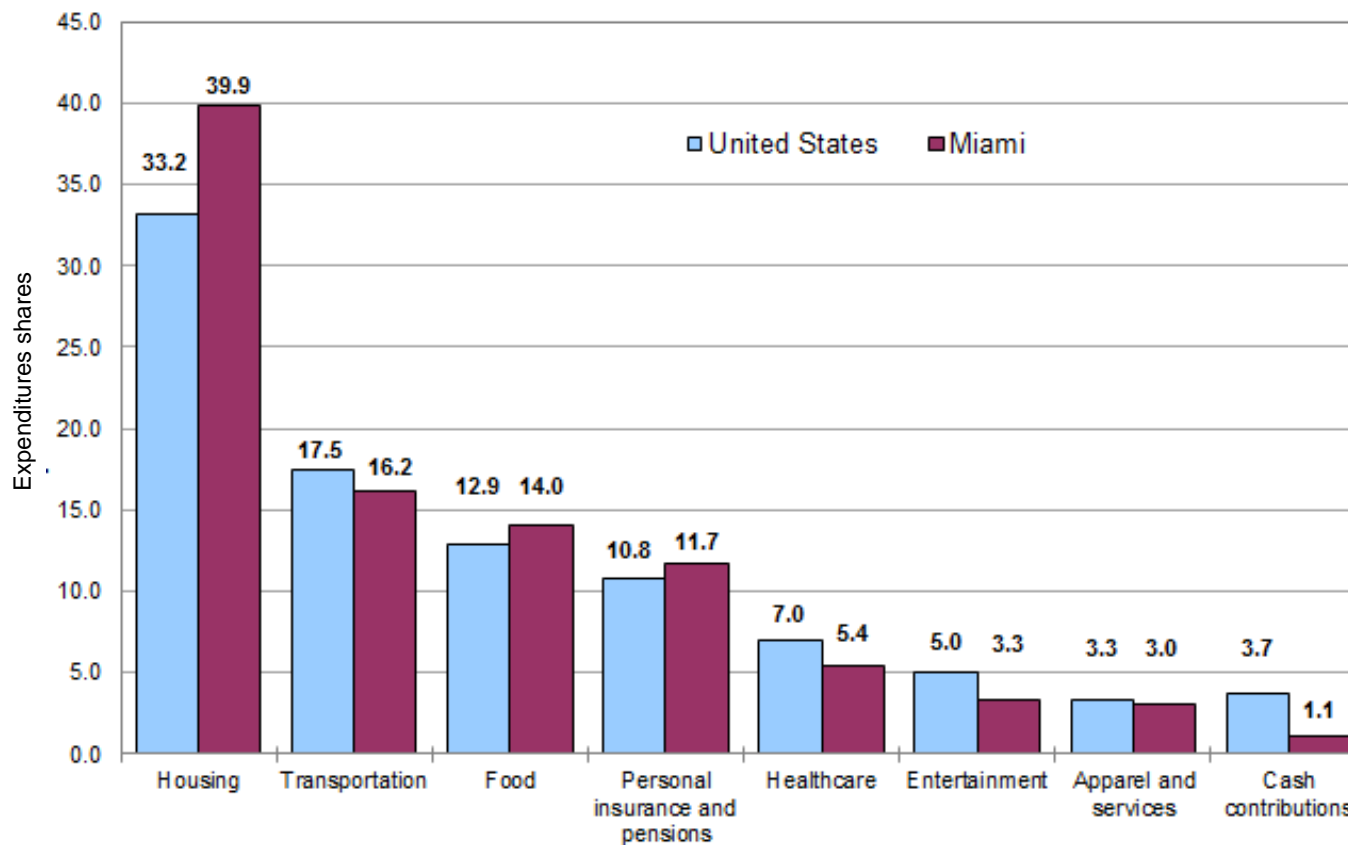


Source: Bloomberg, as of December 2015.

Our view:

Consumer spending – higher spend for shelter from the elements

Percent distribution of average annual expenditures for the eight major categories in the US and Miami metropolitan area, 2012-2013

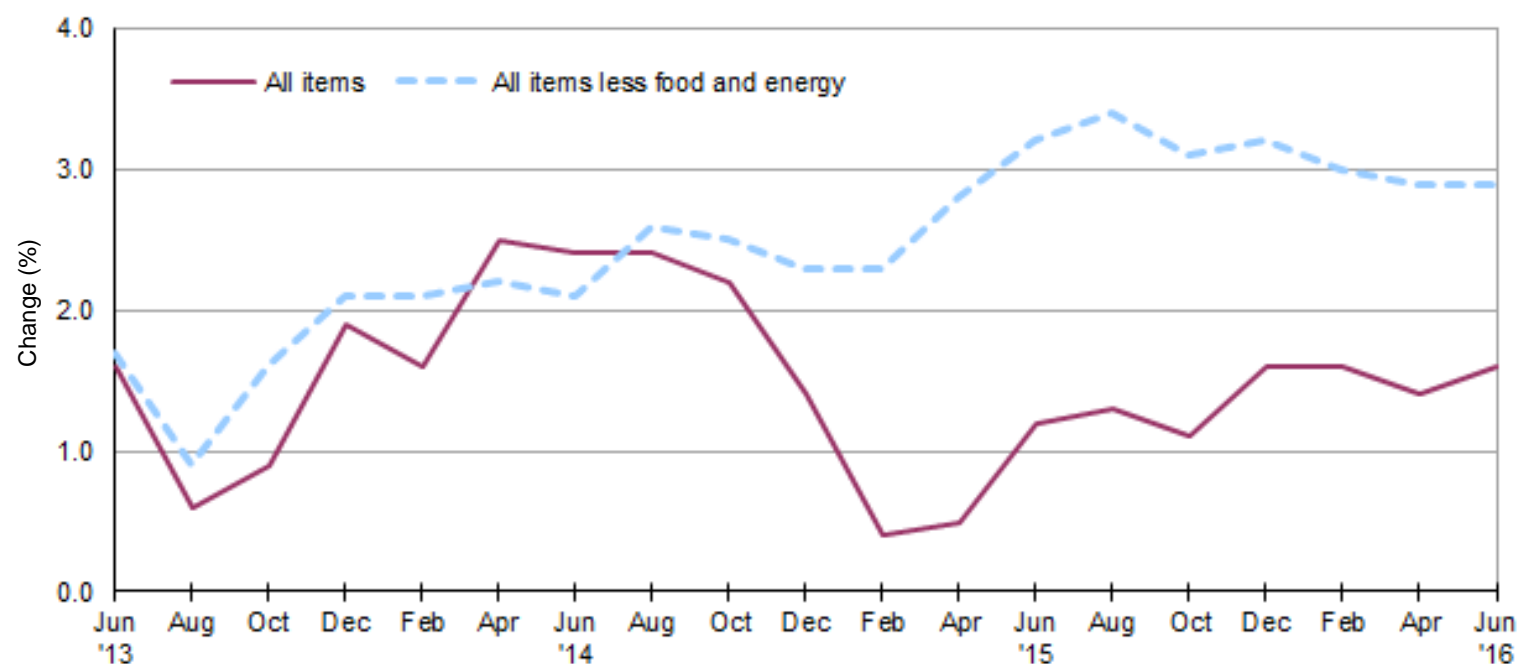


Source: US Bureau of Labor Statistics, as of December 2013.

Our view:

Consumer prices – the impact of energy...however, higher prices elsewhere

Over-the-year percent changes in CPI-U, Miami, June 2013-June 2016



Source: US Bureau of Labor Statistics, as of June 2016.

Conclusions

- US economy is the “best house on a bad block” of major developed market counterparts and could renew the divergence thesis from the outset of the year
- Improving domestic data (e.g., employment and housing) could prompt the Federal Reserve to revisit an interest rate increase by year-end, following similar action from December last year; however, there are mitigating circumstances:
 - Global risk events (e.g., central bank easing, geopolitical actions, “Brexit”)
 - Unevenness of domestic recovery and impending US presidential election
 - Lack of sustained inflation
 - Consumer confidence and tight financial conditions
- History suggests that if inflation is tame, the hiking cycle should be accompanied by flatter Treasury curves and opportunities for tightening credit spreads
- The risk to this thesis is that this time is different
 - Market transition process
 - Rate cycle likely to be slow and uneven
 - Increasing corporate leverage
- Florida consistently moving forward in line with national economic trend, but challenges remain

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