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Econews

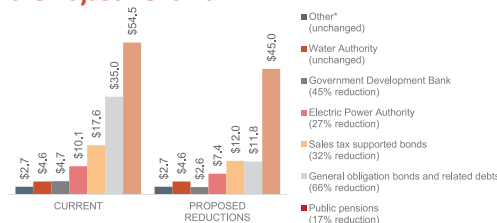
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Puerto Rico The Economy

- Four important developments dominated events during the third quarter of the year: the resignation of former governor Ricardo Rosselló, the arrest of two Agency heads for corruption, the appointment of a new governor, and the filing in the U.S. District Court by the Financial Oversight and Management Board of the proposed Plan of Debt Adjustment at the end of September.
- The new governor faces daunting challenges still unsolved; a public debt of more than \$70.0 billion and \$55.0 billion in unfunded pensions top the list, which is extensive. Plus, Puerto Rico remains immersed in a 12-year recession, with an accumulated contraction in real GNP of 24.6% (up to fiscal year 2018).
- In a nutshell, the proposed Debt Adjustment Plan, if approved, would reduce \$129.2 billion in debts (GOs, COFINA, PREPA, PRASA, GDB, public pensions, and others) to about \$86.0 billion, a 33.4% reduction. The biggest reduction is for GOs and related debts; from \$35.0 billion to \$11.8 billion, a 66.3% reduction. It would also cut the \$54.5 billion pension obligation to \$45.0. Debt service as a percent of government revenue would then be reduced to less than 9.0% from 28.0% currently, from \$82.0 billion to \$44.0 billion over a 30-year period. The Plan ensures that 74.0% of current or future pensions are not cut.

- Given its complexity, and the fact that it will mean that bondholders would take deep haircuts, and some retirees (40.0%) will have their pensions cut by 8.5%, are two highly contentious aspects, the road to an agreement will be long. But, "If approved by at least one class of creditors and the Federal Court, that would almost complete the restructuring of the tax-supported debt." The governor gave her endorsement to the Plan.

Puerto Rico Public Debt Obligations under the Adjustment Plan



Source: The New York Times (September 29, 2019).

Another noteworthy development was the release at the end of September of the Puerto Rico Tax Expenditure Report for Tax Year 2017.² The report presents a breakdown of the tax expenditures or foregone revenues attributable to Act No. 1 of January 31, 2011 (as amended), the Internal Revenue Code for Puerto Rico.

In summary, through four tax regimes – taxes of individuals, corporations, consumption, and other taxes, in 2017 a total of \$20.6 billion in foregone revenues was identified. Of this amount, 80.0% of the special treatment or \$15.7 billion, was granted to companies in manufacturing, with the majority corresponding to non-local companies. Expenditures through Law 20 amounted to \$11.3 million, and in the case of Law 22 \$29.0 million. Attributable to

Sales and Use Tax exemptions (SUT, IVU in Spanish), the amount was \$2.8 billion.

EMPLOYMENT

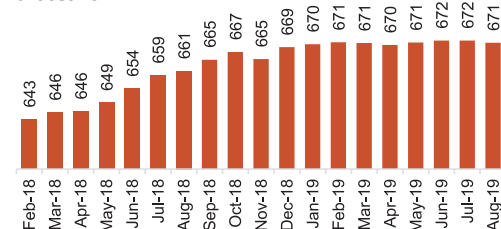
Total employment (Household survey) reached its highest level in August, to 1.0 million, from 995,000 in August of last year. During the first two months of Q3-19 it increased by 4,000 new jobs or 0.5% y/y.

The unemployment rate continued to decrease, from an average of 8.7% in Q3-18 to 7.9% in Q3-19. That number, though, should be viewed with caution, as it mostly reflects fewer persons looking for a job due to emigration.

The employment rate is a more relevant indicator, as it tells the proportion of the population 16 – 64 employed. In the first two months of Q3-19 the rate increased to an average of 38.2% from 36.9% in same period last year, and higher than in July-August 2017 (35.2%).

Private nonfarm salaried employment has improved noticeably after Hurricane María, reaching levels higher than during January-August 2017. The pace of growth, though, has slowed, from 4.5% y/y in Q1-19, to 1.7% y/y in the first two months of Q3-19.

Private Salaried Non Farm Employment thousand



Source: P.R. Department of Labor, Establishment Survey.

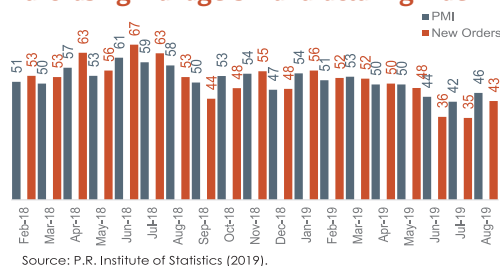


MANUFACTURING

Since April, manufacturing activity, according to the PMI, has been decreasing, with the general index being below its threshold level of 50 (a value above 50 indicates expansion, below 50 a contraction in the sector).

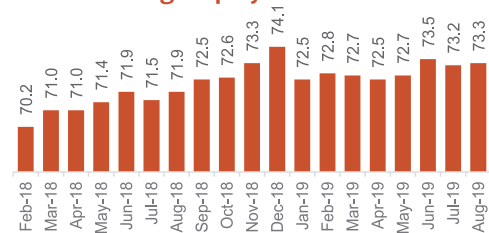
During the first two months of Q3-19, the index averaged 44.1, below its level of 58.5 in the same period in 2018, and below that in 2017 of 49.8. The New Orders component, which points to future manufacturing activity, has been on the downside decreasing to 38.9, from 57.9 in 2018, a 33.3% contraction, and has been the main contributor for the fall in the index. Five consecutive months of decreases in both indexes (General and New Orders) are a troubling sign. Insofar as manufacturing activity in the Mainland has been sliding since August, with its PMI index below 50, decreasing 17.1% y/y in the third quarter, that trend in Puerto Rico could continue in the near future.

Purchasing Managers Manufacturing Index



Employment in the sector, on the other hand, has been moving up. During the first two months of the third quarter, it increased 2.2% y/y to 73,300 from 71,700 in same period in 2018, and higher than in 2017, at 71,800. The pace, though, has stagnated since June, with employment at slightly above 73,000.

Manufacturing Employment



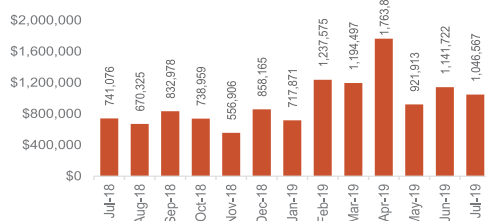
FISCAL REVENUES

Fiscal revenues have risen quite well so far in 2019, led by increases in income taxes and SUT receipts. In the first two month of Q3-19, receipts rose 55.0% y/y, an increase of \$777.9 million, as a result of robust increases

in corporation income taxes and Act 154 receipts. On an accumulated basis, since January and up to July, receipts were \$1.6 billion over those in same period in 2018.

Net Revenues to the General Fund

July 2018 to July 2019



INFLATION

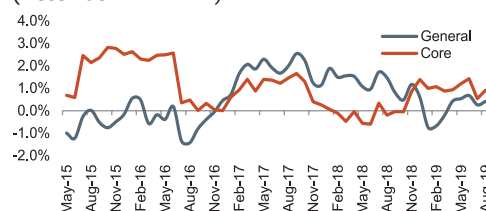
Inflation continued on a moderate path, as both indicators – Headline (CPI) and Core – showed small gains. During the first two months of Q3-19, headline inflation rose an average of 0.3%, a decrease from the rise of 1.3% in same quarter of 2018, but lower than the increase of 0.5% in the previous quarter. Small increase in the food and beverages and electricity indexes, and decreases in gasoline prices, contributed to the lower rise in general prices.

Core inflation (excludes food and energy) rose but at a modest rate of 0.7% from 1.2% in the previous quarter, but an increase from Q3-18, when it increased by 0.03%.

SHORT-TERM OUTLOOK

Headline and Core Inflation

(December 2006 = 100)



There are at least two key issues with potential impacts under consideration in the coming months.

A key pressing issue is that of additional Medicaid funding for the health reform, which would avoid a potential “Health Cliff” by the end of the year. The federal funds allocated through temporary measures will be depleted soon.

Between July 2011 and September 2019 Puerto Rico received under the Affordable

Care Act (ACA), and after the hurricanes under the Budget Act of 2018, a total of \$6.3 billion in additional Medicaid funds. A block of \$4.8 billion, provided via the Bipartisan Budget Act of 2018, available at 100% federal matching rate, expired on September 30.³ With a return to federal limited funding, and a cap of 55%, after the remaining ACA funds expire, there could be a shortfall of \$1.0 billion in fiscal year 2020, and of \$1.5 billion in fiscal 2021.⁴

In July a bill (H.R. 3631), known as the Territories Health Care Improvement Act, increasing federal Medicaid funding for the territories, including Puerto Rico, moved from the Health Subcommittee to the House Committee on Energy and Commerce of the U.S. House of Representative for consideration.⁵ The legislation provides for Medicaid funds totaling \$12.0 billion for the next four years, and among other things increases the limit on Medicaid payments. The bill is still under consideration, and it is expected that it will be voted on before the end of the year.

A bill was just introduced which seeks to increase the minimum wage to \$8.25 an hour, from the current Federal \$7.50. House Bill 2264 takes one step further the recommendation made in the report from the commission appointed last year by former governor Rosselló, which recommended that an increase be considered. If enacted, Puerto Rico would join 29 states and 3 territories with minimum wages higher than the Federal one.⁶ Such a proposal, though, should be evaluated carefully, for its potential impacts, particularly in the current economic conditions.

Notes:

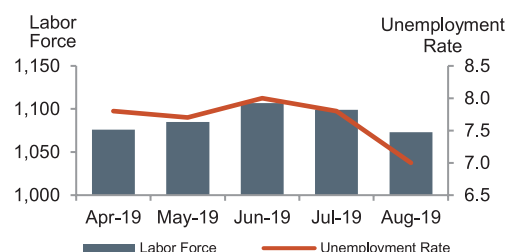
- Brad W. Setser (2019). Is Puerto Rico Back on a Path Toward Debt Sustainability? Follow the Money, Council on Foreign Relations (September 30, 2019). At: <https://www.cfr.org/blog/puerto-rico-back-path-toward-debt-sustainability>.
- Department of Treasury. Office of Economic and Financial Affairs (2019). Puerto Rico Tax Expenditure Report for Tax Year 2017 (September 27, 2019). At: http://www.hacienda.gobierno.pr/sites/default/files/comunicaciones/puerto_rico_tax_expenditure_report_2017_version_final_septiembre_2019.pdf
- McConnel Valdés (2018). Update on the Bipartisan Budget Act of 2018 (February 14, 2018). At: <http://www.mcpr.com/newsroom-publications-Bipartisan-Budget-Act-2018> It allocated \$4.9 billion to increase Medicaid caps for Puerto Rico and the U.S. Virgin Islands for the next two fiscal years. Also, 100% of Federal Medical Assistance Percentage were to be applied to new funds, and \$9.0 billion for housing and urban development projects in Puerto Rico, plus \$2.0 billion to repair Puerto Rico's electrical grid.
- Robin Rudowitz, Cornelia Hall and Barbara Lyons (2019), Medicaid Financing Cliff: Implications for the Health Care Systems in Puerto Rico and USVI. Henry J. Kayser Family Foundation, Issue Brief (May 21, 2019). At: <https://www.kff.org/report-section/medicaid-financing-cliff-implications-for-the-health-care-systems-in-puerto-rico-and-usvi-issue-brief/>
- U.S. Congress (2019). H.R. 3631: Territories Health Care Improvement Act, 116th Congress (2019-2020), Introduced July 9, 2019; Forwarded to House Energy and Commerce July 11, 2019. At: <https://www.congress.gov/bills/116/house-bills/3631>
- Federal minimum wage law supersedes state minimum wage laws where the federal minimum wage is greater than the state minimum wage. In those states where the state minimum wage is greater than the federal minimum wage, the state minimum wage prevails.

Puerto Rico Economic Indicators

Employment

	Jun-19	Jul-19	Aug-19	Percent Change Fiscal Year 2018-2019	Percent Change Accumulated year to date
Labor Force (Household Survey, thousands)	1,107	1,099	1,073	-0.6%	-0.7%
Employment (Establishment Survey)	873	863	866	1.6%	2.0%
Private	669	664	665	3.5%	3.7%
Construction	27	27	27	16.8%	9.7%
Manufacturing	74	73	73	2.7%	2.5%
Public Administration	203	199	201	-4.2%	-3.2%
Unemployment Rate (Household survey, %)	8.0	7.8	7.0	-17.8%	-16.5%

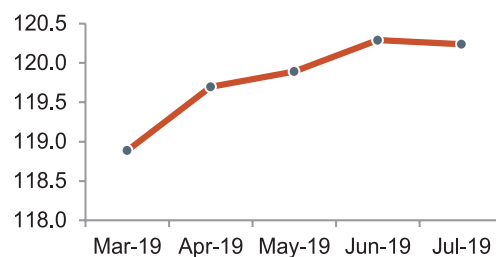
Total Employment
(December 2006 = 100)



Consumer Price Index

	May-19	Jun-19	Jul-19	Percent Change Fiscal Year 2018-2019	Percent Change Accumulated year to date
All Items	119.9	120.3	120.2	0.5%	0.0%
Food & Beverages	131.1	131.0	131.2	0.2%	-0.2%
Housing	114.3	114.4	114.5	0.3%	0.4%
Apparel & Upkeep	88.2	87.6	84.9	-1.8%	-1.5%
Transportation	111.6	113.2	113.2	-0.5%	-2.3%
Medical Care	155.1	155.2	155.1	1.6%	1.4%
Education	117.5	117.8	118.4	2.6%	2.6%
Recreation	113.5	113.4	113.4	-0.2%	0.1%
Other Services	127.5	127.6	127.5	3.2%	3.4%

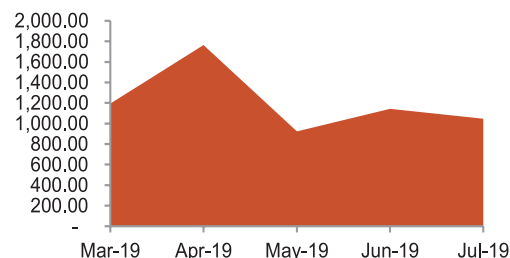
Consumer Price Index



Fiscal Revenues

	May-19	Jun-19	Jul-19	Percent Change Fiscal Year 2018-2019	Percent Change Accumulated year to date
Total Revenues (Mill.\$)	921.9	1,141.7	1,046.6	22.1%	24.9%
Taxes	889.5	1,096.1	1,001.7	21.8%	24.5%
Income Taxes	361.8	546.3	439.0	22.1%	23.3%

Net Revenues to the General Fund

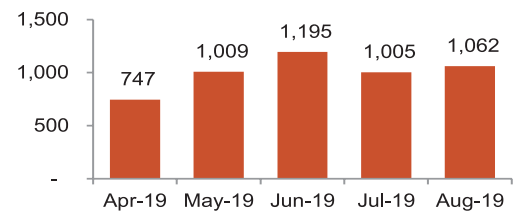


Puerto Rico Economic Indicators

Construction

	Jun-19	Jul-19	Aug-19	Percent Change Fiscal Year 2018-2019	Percent Change Accumulated year to date
Cement Production (Thousand 94-lb Bags)	1,195	1,005	1,062	13.9%	-11.6%
Cement Sales (Thousand 94-lb Bags)	1,117	1,150	1,118	16.9%	-7.9%

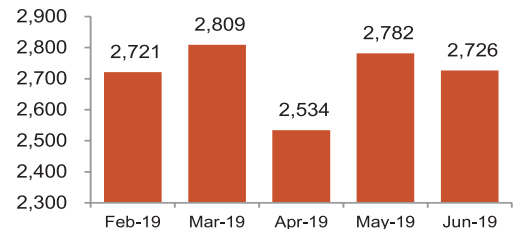
Cement Production



Retail

	Apr-19	May-19	Jun-19	Percent Change Fiscal Year 2018-2019	Percent Change Accumulated year to date
Total (Bill. \$)	2,534	2,782	2,726	1.5%	-3.1%
Department Stores (Mill. \$)	869	943	1,000	2.2%	1.4%
Supermarkets (Mill. \$)	267	276	265	-10.8%	-14.8%
Used and New Autos (Mill. \$)	450	542	515	15.4%	1.2%
Gasoline Stations (Mill. \$)	165	164	112	2.0%	-2.3%
Restaurants (Mill. \$)	167	174	169	-9.4%	-4.0%

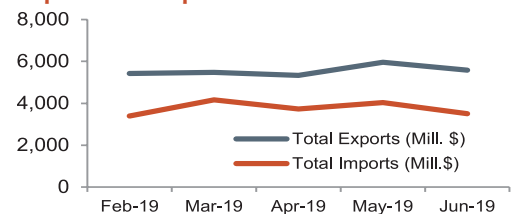
Retail Sales



Exports and Imports

	Apr-19	May-19	Jun-19	Percent Change Fiscal Year 2018-2019	Percent Change Accumulated year to date
Total Exports (Mill. \$)	5,333	5,961	5,580	5.2%	2.8%
Foreign Countries	1,279	1,468	1,295	27.8%	15.5%
Total Imports (Mill. \$)	3,724	4,029	3,511	7.8%	-13.7%
Foreign Countries	1,733	2,037	1,772	19.8%	-10.1%

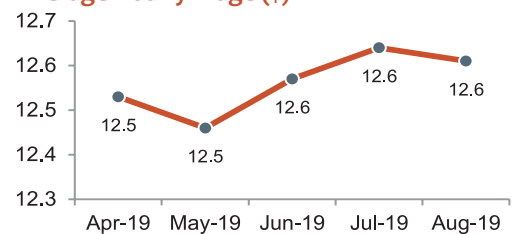
Exports and Imports



Manufacturing

	Jun-19	Jul-19	Aug-19	Percent Change Fiscal Year 2018-2019	Percent Change Accumulated year to date
Weekly Hours (#)	39.8	39.8	39.9	1.2%	3.9%
Average Hourly Wage (\$)	12.6	12.6	12.6	-0.6%	0.8%

Average Hourly Wage (\$)

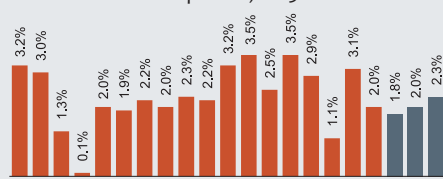


United States The Economy

- Concerns over trade tensions between the U.S. and China, the new tariffs imposed by the U.S. on imports from China, and slowing global economic growth continued to dominate the economic panorama.
- Although, on balance, the U.S. economic outlook remained good, because consumer spending and the labor market remain relatively strong, growth is expected to slow down further in Q3-19 to 1.8%, with a slight rebound in Q4-19 to 2.0%. Economic growth has been above 2.0% in the first half of the year, slowing down to 2.0% in Q2-19, from 3.1% in the first quarter.
- So far consumer spending is carrying the load, and the weakness seen in the manufacturing sector has not yet spilled over into the rest of the economy, but if business spending and exports start to affect employment, then consumers may restrain spending.

Quarterly U.S. GDP

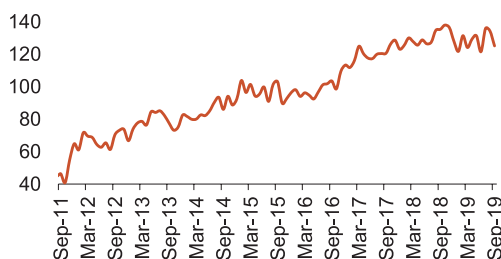
Real Growth and Expected, 2015-2020



Sources: U.S. Bureau of Economic Analysis; Federal Reserve Bank of Philadelphia; Survey of Professional Forecasters, Third Quarter Survey 2019 (August 9, 2019). Seasonally adjusted at annual rates. f = Forecast.

- Consumer confidence fell in Q3-19, with the Conference Board's index decreasing by 0.6% y/y, and in September it fell considerably by 7.5% y/y, following a slight decline in August. Their assessment of current business and labor market conditions was less favorable, so was their short-term outlook. According to the survey, the escalation in trade and tariff tensions in August had a negative impact, continuing their uncertainty in September.

U.S. Consumer Sentiment Index



Source: The Conference Board.

PRODUCTION

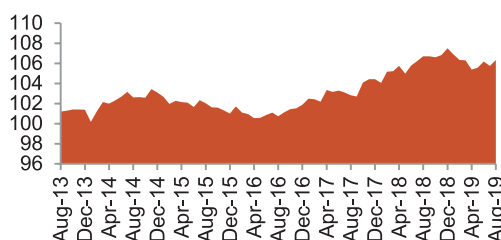
Industrial production (manufacturing), decreased 0.4% y/y during the first two months of Q3-19, although it nudged up in August by 0.5% from July, more than expected, as a result of an increase in machinery and primary metals production.

Capacity utilization, a measure of how companies are using their resources, decreased by 1.7% y/y in Q3-19, but moved up 0.4% in August from July.

The outlook, though, remains weak, amid the backdrop of trade tensions and slowing global economies. Indeed, the results for September of the PMI for manufacturing seems to reflect these developments.

U.S. Industrial Production Index

(2012=100)

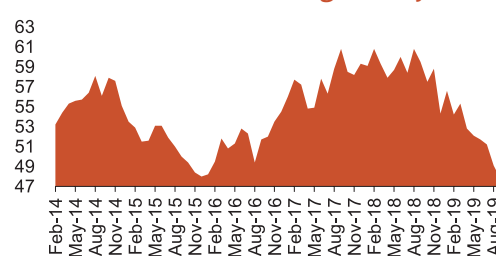


Source: Federal Reserve.

In September, and for a second month in a row, the PMI manufacturing index registered its worst performance, coming in at 47.8%, the lowest since December 2008, a year of recession. This marks the second consecutive month of contraction (a value below 50 signals a contraction in manufacturing activity). Exports plunged amid the escalated trade war with China, with the new export orders index falling to 41.0%, down from 43.3% in August.

For the whole third quarter the PMI index decreased 17.1% y/y, to 49.4%, from 59.6% in Q3-2018, and 52.2% in the previous quarter. The risk is that a slowdown in manufacturing orders could halt the growth of wages and cause job reductions.

ISM Index of Manufacturing Activity



Source: Institute for Supply Management. **Note:** A reading above 50 points indicates that the manufacturing economy is generally expanding, and declining when the reading falls below 50 points.

EMPLOYMENT

Although the economy continued to add jobs, hiring in the U.S. slowed in August for a second month, as employers added 130,000 new jobs in non-farm salaried employment, below expectations, and lower than the 159,000 in July. It should be noted that the new jobs created in August reflect the hiring of 25,000 temporary workers to help prepare for next year's census.

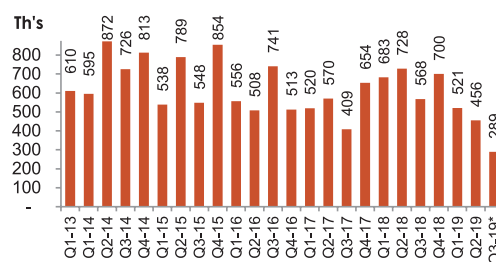
Employment increased the most, as in previous months, in health care and social assistance, and professional and business services, and government. In the first two months of Q3-19 a total of 289,000 new jobs were created, from the 460,000 in same period of 2018. Since February the y/y changes in employment have been negative, after a high of 728,000 in Q2-18.

Employment in manufacturing increased by 7,000 new jobs, lower from the over 8,000 added in the same period in 2018. Manufacturing production has declined for two consecutive quarters.

Although the unemployment rate remained at a historic low level of 3.7% in the quarter, the pace of hiring continues to slow. The employment-population ratio (proportion of those 16-64 years old employed) averaged 63.2%, basically unchanged from the same quarter in 2018.

Monthly Changes in Employment

(Seasonally Adjusted - Thousands)



Source: U.S. BLS, Establishment Survey. * Up to August.

INFLATION

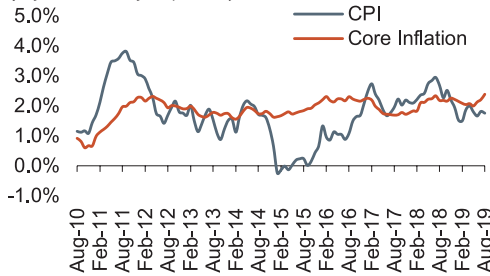
During the first two months of Q3-19 (July-August) headline inflation (CPI) averaged 1.8%, lower than what it averaged in the same quarter in 2018 at 2.6%, and below the Fed's annual target of 2.0%. Lower prices for energy, food and durable goods contributed to offset the growth in services prices.

On the other hand, core inflation (excludes food and energy prices) rose slightly averaging 2.3% in the quarter, from 2.1% previously, reflecting increases in medical care and shelter, and airline fares.

Overall, the CPI is expected to rise to 2.1% in the second quarter, and core inflation could reach 2.6%.¹ So far, increases in prices reflect more those in services and not in durable goods, where the tariffs would show up, but that could change.²

Annual Percent Change in CPI

(Y/y, seasonally adjusted)



Source: U.S. BLS.

INTEREST RATES

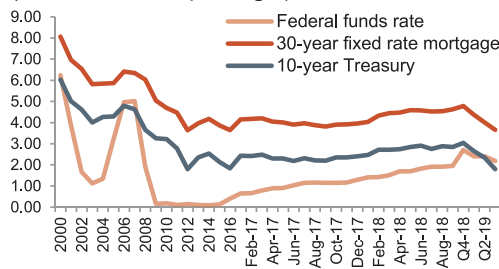
The Fed, after raising interest rates four times in 2018, has dropped them twice this year. At their last meeting in July it lowered the federal funds rate by 0.25 points to a range of 1.75% to 2.0%. The majority of economists expect the Fed will continue cutting rates.³ Their next meeting is at the end of October, where there is the possibility of a fresh cut.

The 10-year Treasury yields, a benchmark for the 30-year fixed mortgage rate, have been falling on concerns about a global slowdown and weak economic activity in the U.S., averaging 1.8% in the third quarter, and are expected to stay below 2.0% for the time being.

Lower rates notwithstanding, business uncertainty will not significantly stimulate business borrowing.

Selected Interest Rates

(Annual and monthly averages)



Source: U.S. Federal Reserve Bank of St. Louis (FRED).

U.S./GLOBAL OUTLOOK

Events by the end of the third quarter pointed to world trade deteriorating rapidly, a development threatening the health of the global economy. Although, so far, according to economists, a global recession is not likely, the downside risks are increasing.

The trade war between the U.S. and China, on the one hand, and the potential absence of an orderly Brexit withdrawal deal before an October 31 deadline with the European Union, are two of the most important contributing factors. Japan and South Korea are also at odds over trade. Plus, just recently, in retaliation for European Union subsidies on aircraft from Airbus, after the World Trade Organization allowed it, the U.S. imposed 25.0% tariffs on \$7.5 billion worth of imports of hundreds of European products. The new tariffs will take effect on October 18.⁴

In its most recent report, the World Trade Organization (WTO) lowered its forecast for trade growth for 2019 and 2020.⁵ It expects world trade of merchandise to rise by 1.2% this year, from 2.6% previously, and 2.7% in 2020 from 3.0%, with increasing downside risks in 2020, as the global PMI new exports index has been trending below its threshold level of 50 since the beginning of the year (as of August), according to the report. Global real GDP growth is expected to slow down this year and in 2020 to 2.3%, with growth in North America (Canada and the US) lower in 2020 to 1.9%.

For the U.S., according to the Survey of Professional Forecasters, slightly weaker growth is expected for the fourth quarter of this year and in 2020.⁶ For Q4-2019, real GDP is expected at 2.0% from 2.2% previously, and in 2020 growth would slow a bit to 1.9% from the 2.0% previously estimated. In 2018 the U.S. economy expanded at an annual rate of 2.9%.

World Merchandise Trade Volume and Real GDP Growth 2016 - 2020

	Forecast				
	2016	2017	2018	2019	2020
Volume of world merchandise trade (a)	1.7%	4.6%	3.0%	1.2%	2.7%
Exports					
Developed economies	1.0%	3.6%	2.1%	0.4%	2.2%
Developing economies	2.3%	5.6%	3.5%	2.1%	3.4%
North America	0.3%	4.2%	4.3%	1.5%	3.6%
Real GDP	2.4%	3.0%	2.8%	2.3%	2.3%
Developed economies	1.6%	2.3%	2.2%	1.7%	1.4%
Developing economies	3.8%	2.3%	2.2%	1.7%	1.4%
North America	1.6%	2.3%	2.7%	2.2%	1.9%

Source: World Trade Organization (October 1, 2019), table 1, (a) Average of exports and imports.

Notes:

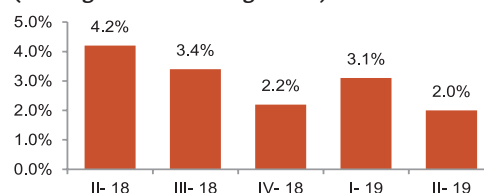
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United States Economic Indicators

GDP

	III- 18	IV- 18	I- 19	II- 19
GDP (% Change From Preceding Period)	3.4	2.2	3.1	2
Private Consumption	3.5	2.5	1.1	4.6
Fixed Investment	1.1	3.1	3.2	-1.4
Residential	-3.6	-4.7	-1	-3
Non-Residential	2.5	5.4	4.4	-1
Government Spending	2.6	-0.4	2.9	4.8
Exports	-4.9	1.8	4.1	-5.7
Imports	9.3	2	-1.5	0

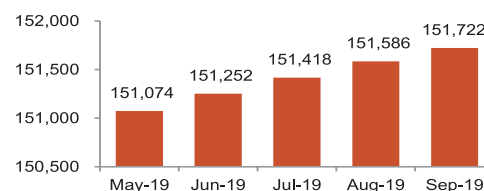
Gross Domestic Product (% Change From Preceding Period)



Employment

	Jun-19	Jul-19	Aug-19	Sep-19
Employees on Non-Farm Payrolls (SA) (Thousands)	151,252	151,418	151,586	151,722
Change (%)	0.1%	0.1%	0.1%	0.1%
Goods Producing	21,104	21,100	21,101	21,106
Change (%)	0.1%	0.0%	0.0%	0.0%
Service Industries	130,148	130,318	130,485	130,616
Change (%)	0.1%	0.1%	0.1%	0.1%

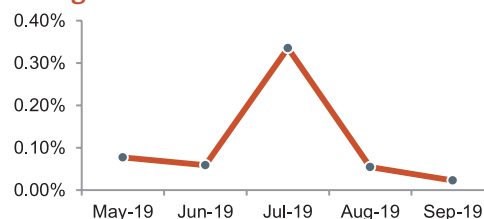
Employees on Non-Farm Payrolls (In thousands)



Consumer Price Index

	Jun-19	Jul-19	Aug-19	Sep-19
CPI - All Urban Consumers (1984=100)				
Change from preceeding month	0.1%	0.3%	0.1%	0.0%
Change from preceeding year	1.7%	1.8%	1.8%	1.7%
CPI - Less Food and Energy				
Change from preceeding month	0.3%	0.3%	0.3%	0.1%
Change from preceeding year	2.1%	2.2%	2.4%	2.4%

Change in CPI



Interest Rates

	Jun-19	Jul-19	Aug-19	Sep-19
Effective Federal Funds	2.38	2.40	2.13	2.04
Three Month Treasury Bill (Constant Maturity Rate)	2.17	2.10	1.95	1.89
Prime Rate	5.50	5.50	5.25	5.15
Ten Year Treasury Bond	2.07	2.06	1.63	1.70
Moody's Seasoned Aaa Rate	3.42	3.29	2.98	3.03
30-Year Conventional Mortgage Rate	3.80	3.77	3.62	3.61

Selected Interest Rates (3month T Bills)

