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Econews

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Puerto Rico The Economy

- The third quarter of 2016 closed with the first meeting of the [Fiscal Oversight Board](#) (FOB).¹ The board members elected the president, José Carrión and announced the selected governmental institutions that will be under their supervision. The selected institutions include the retirement plans, COSSEC, PREPA, PRASA, the GDB, COFINA, and the central government, among others. These institutions have to submit weekly reports of income and expenditures, as well as monthly compliance reports with respect to their assigned budgets.
- The Board also set specific dates for the Governor to present his fiscal plan and its respective drafts. The final version of the fiscal plan is to be submitted to the Board before the end of the year. For the moment, the Board is expected take a supervisory role, at least until the fiscal plan is presented and approved. Even then, it would only be forced to interfere directly with government operations if the government's revenues or spending fail to meet their estimates. Beginning in 2017, the Board could take a more active role as the fiscal plan is approved and a new administration is in place.
- The Congressional Task Force also began its meetings, as they consider changes to federal laws which limit growth and economic development in Puerto Rico. The Task Force is currently considering several proposals, including a proposed Section 245a. This is a tax incentive for companies to repatriate funds held

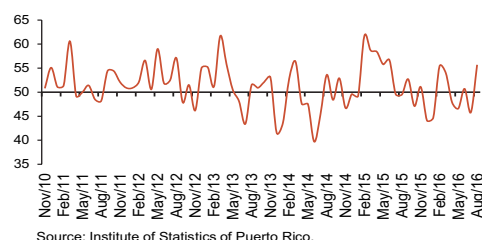
abroad through investing these funds in Puerto Rico. Dividends sent by these firms would pay a low tax rate if such dividends are from Puerto Rico source income. If approved, this could provide a significant boost to the local economy by attracting investment and generating local jobs.

MANUFACTURING

Manufacturing activity increased by over 12.5%y/y in August of 2016, according to the Puerto Rico Statistics Institute's manufacturing Purchasing Managers Index (PMI). While the index contracted in July, it increased to 55.7 in August. A reading above 50 suggests expansion in manufacturing activity, while levels below 50 imply contraction.

During the first two months of the quarter, the index increased 2.4% y/y, as two of its components, the inventories index and that of employment rose 5.0%. The New Orders sub-index expanded to 66.1 in August, the highest value for the sub-index since March of 2015. This could be an indicator of further expansion in manufacturing activity in the near future. Excluding the Suppliers Deliveries sub-index, all other components of the PMI were above 50 in August.

Purchasing Managers Manufacturing Index (Monthly)



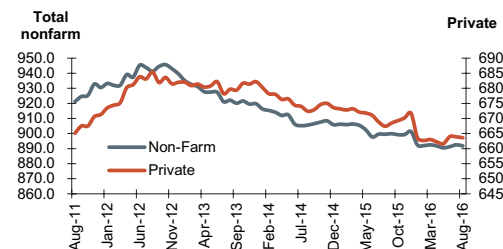
If the section 245a proposal is approved and implemented by Congress it could have a significant impact on the manufacturing sector. According to some [estimates](#), the implementation of section 245a could generate close to 50,000 direct jobs on the Island over the next 10 years.

EMPLOYMENT

[Nonfarm salaried employment](#) continued to decline in 2016 – in fact, more than 11,050 jobs were lost in the first eight months. Total nonfarm salaried employment fell below 892,000 in August, but remains slightly above its historic low in May. The downward trend has been felt in both private and public employment.

Employment is forecasted to continue declining, as the recession deepens in 2017. This is partly due to expected budget cuts by the FOB in an attempt to balance the budget. Budget cuts could lead to layoffs in the public sector, as payroll is nearly half of the Commonwealth's General Fund Budget.

Nonfarm Salaried Employment (In th's)

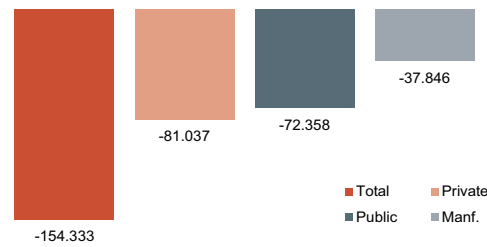


On an accumulated basis, 154,333 nonfarm jobs have been lost since the start of the economic contraction in 2007. Of these, 72,358 were public sector jobs and 81,037 were from the private sector. Manufacturing



accounted for nearly half of the decline in private employment, with 37,800 jobs lost since 2007.

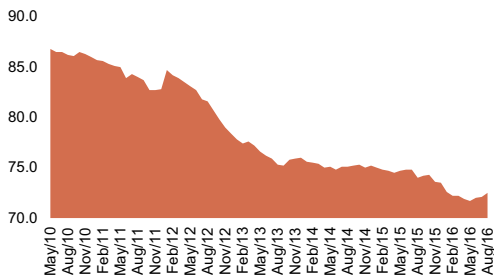
Net Losses in Nonfarm Salaried Employment 2007 - February 2016 (thousand)



Source: U.S. BLS. Establishment Survey. SA = Seasonally adjusted. Note: Reflects revisions from the Census of Population 2010. * Central government, public corporations, and municipalities.

Manufacturing employment increased slightly in the last two months on record, from 72,000 in June to 72,500 in August. Although positive, growth in manufacturing remains very weak. Approval of the section 245a proposal would provide a significant boost to the manufacturing sector and help recover the nearly 38,000 jobs lost since 2007.

Employment in Manufacturing Industries (Monthly, in thousands)



Source: U.S. BLS. Establishment Survey. SA = Seasonally adjusted.

The unemployment rate, has declined by nearly a percentage point in the past year, from 12% in August 2015 to 11.3% in August 2016. As seen before, the decline in unemployment coincides with a reduction in nonfarm salaried employment. This implies that the reduction in the unemployed is not due to job creation, but rather owes to further declines in population caused by a significant increase in migration. Because of this phenomenon, the unemployment rate does not serve as a good indicator of the job market in Puerto Rico.

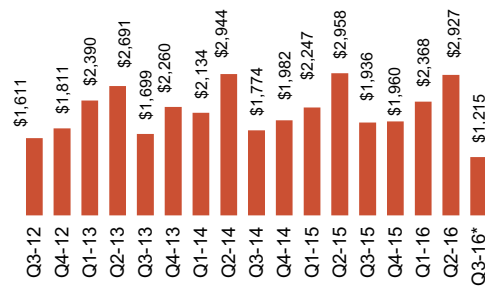
FISCAL REVENUES

Net revenues in the first two months of the third quarter have been above their 2015 totals. The increase in the SUT in the past year was the main factor for the increase in General Fund Net Revenues. On the other hand, income tax revenue from individuals

and corporations decreased in the first two months of fiscal 2017.

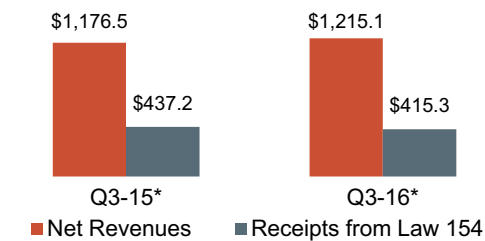
Law 154 revenues have also been below the 2015 total for the first two months of the fiscal year (July-August). The Commonwealth's liquidity issues have continued in fiscal 2017, though to a lesser degree than in fiscal 2016. This was the result of excluding debt payments (principal and interest) from the fiscal year's budget, and thus it is only a temporary measure. The island's government is expected to continue facing liquidity issues in the foreseeable future.

Net Revenues to the General Fund



Source: Treasury Department (2016). *Up until August

Net Revenues to the General Fund

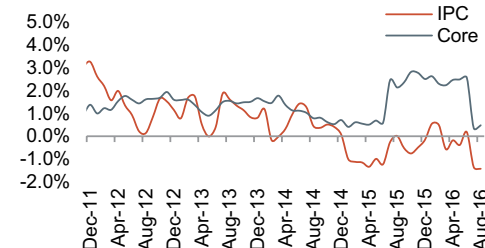


Source: P.R. Treasury Department. *Up until February

INFLATION

After a stagnant second quarter, prices fell by 1.4% in the first two months of the third quarter. This was partly due to declines in electricity, food, beverage, and gasoline prices. While the possibility of an oil price increase in 2017 remains, they are not expected to be substantial. ²

Inflation in Puerto Rico (December 2006 = 100)



Sources: P.R. Department of Labor; Estudios Técnicos, Inc.

Underlying or core inflation registered a significant decline in the first two months of the third quarter; the core inflation rate fell from 2.6% in June 2016 to 0.4% and 0.5% in July and August, respectively. ³ Core inflation has registered growth since 2010, a trend which had accelerated since July 2015 but slowed again in July and August 2016. This could be a sign of further weakening of the economy.

OUTLOOK

Over the next quarter, the FOB is not expected to enact significant changes, but rather carry out a supervisory role as the Government continues to prepare the fiscal plan. The Board will perform weekly reviews of the Commonwealth's finances, as well as monthly compliance reports with respect to the approved budget.

The Governor is expected to present the first draft of the fiscal plan in October and the final version of the plan before the end of the year. However, said plan is unlikely to be implemented until 2017, alongside a new administration and legislature. Significant budget cuts should be expected from 2017 onwards, as the FOB begins to balance the current budget and works with the new administration on the fiscal 2018 budget. Public employment could be significantly affected, as nearly half of the Commonwealth's general fund is dedicated to payroll.

Debt negotiations are not expected to take place until a fiscal plan is approved and in place, and could be expected to last anywhere from 1 to 3 years, as a conservative estimate. Any deal reached with creditors must then be approved by the fiscal board.

Key economic indicators, like employment, continue on the downside, and are not expected to improve at least in the short-term. General inflation, on the other hand, will remain subdued, but if oil prices move up considerably by the end of the year or early 2017, that will change. [GDB's coincident index](#) of economic activity remained negative in its latest reading in August, declining 1.0% y/y. It has been in negative territory since 2013.

Forecasts of real GNP growth by Estudios Técnicos, Inc. were revised downward. A contraction of 2.8% is expected in fiscal 2017, while in fiscal 2018, a contraction of 3.3% is expected.

Notes:

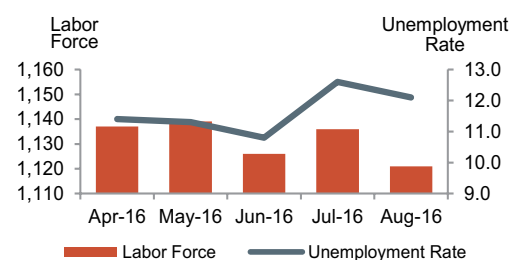
- For a detailed description of the board and of PROMESA, see the June 2016 edition of EcoNews.
- An outlook on oil prices is provided in the Global Outlook section on the US Economy.
- Core inflation excludes the volatile components of the Consumer Price Index, food, gas, and energy.

Puerto Rico Economic Indicators

Employment

	Jun-16	Jul-16	Aug-16	Percent Change	
				Fiscal Year 2015-2016	Accumulated year to date
Labor Force (Household Survey, thousands)	1,126	1136	1121	0.4%	0.7%
Employment (Establishment Survey)	887.6	877.8	880.7	-1.2%	-0.9%
Private	660.4	651.9	653.6	-1.1%	-0.7%
Construction	21.6	21.8	22.1	-13.4%	-11.9%
Manufacturing	71.9	71.6	71.9	-2.5%	-2.9%
Public Administration	227.2	225.8	227.1	-1.5%	-1.4%
Unemployment Rate (Household survey, %)	10.8	12.6	12.1	-9.6%	-2.7%

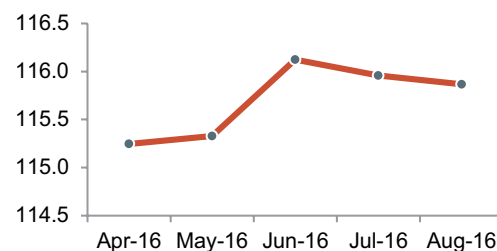
Total Employment and Unemployment Rate
(December 2006 = 100)



Consumer Price Index

	Jun-16	Jul-16	Aug-16	Percent Change	
				Fiscal Year 2015-2016	Accumulated 2015-2016
All Items	116.1	116.0	115.9	-0.2%	-0.3%
Food & Beverages	128.3	128.2	128.9	3.0%	1.7%
Housing	111.3	111.3	111.0	-1.6%	-1.2%
Apparel & Upkeep	93.168	92.953	91.108	1.4%	0.8%
Transportation	108.2	107.6	107.2	-5.6%	-4.8%
Medical Care	148.0	148.3	148.4	3.5%	3.1%
Education	114.8	114.7	114.7	3.2%	2.6%
Entertainment	114.0	113.9	114.1	4.1%	3.1%
Other Services	114.8	114.8	114.9	1.7%	0.9%

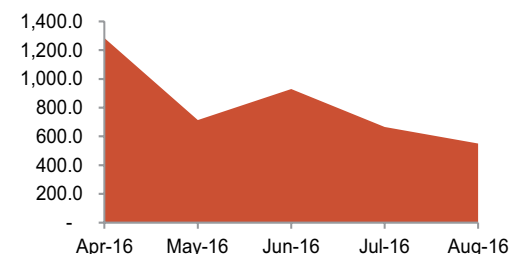
Consumer Price Index



Fiscal Revenues

	Jun-16	Jul-16	Aug-16	Percent Change	
				Fiscal Year 2015-2016	Accumulated year to date
Total Revenues (Mill.\$)	928.5	665.1	550.0	4.8%	3.1%
Taxes	898.1	633.2	502.5	3.4%	2.9%
Income Taxes	419.1	256.5	187.3	-9.4%	-9.5%

Net Revenues to the General Fund

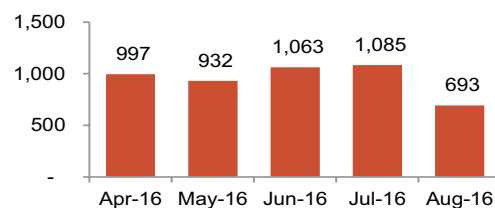


Puerto Rico Economic Indicators

Construction

	Jun-16	Jul-16	Aug-16	Percent Change Fiscal Year 2015-2016	Percent Change Accumulated year to date
Cement Production (Thousand 94-lb Bags)	1,063	1,085	693	-3.8%	-6.3%
Cement Sales (Thousand 94-lb Bags)	1,026	921	1,018	-11.5%	-13.8%

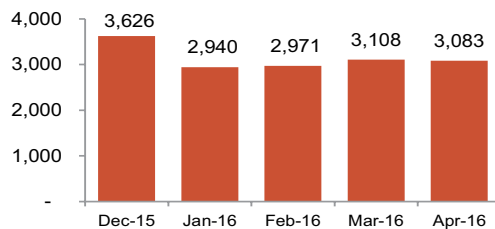
Cement Production



Retail

	Feb-16	Mar-16	Apr-16	Percent Change Fiscal Year 2015-2016	Percent Change Accumulated year to date
Total (Bill. \$)	2,971	3,108	3,083	-2.8%	-2.56%
Department Stores (Mill. \$)	464	495	482	-2.3%	-0.18%
Supermarkets (Mill. \$)	451	465	468	2.5%	2.92%
Used and New Autos (Mill. \$)	295	305	305	0.9%	5.49%
Gasoline Stations (Mill. \$)	403	411	431	-13.9%	-15.28%
Restaurants (Mill. \$)	350	366	351	2.2%	3.14%

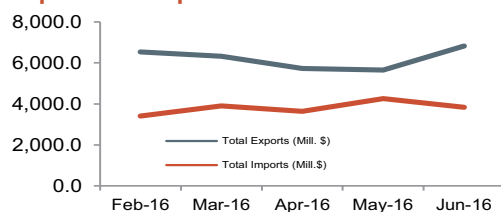
Retail Sales



Exports and Imports

	Apr-16	May-16	Jun-16	Percent Change Fiscal Year 2015-2016	Percent Change Accumulated year to date
Total Exports (Mill. \$)	5,725.9	5,651.2	6,823.0	3.6%	2.8%
Foreign Countries	1,109.7	1,141.4	1,785.3	-4.3%	-4.2%
Total Imports (Mill. \$)	3,634.4	4,258.3	3,840.6	0.2%	4.8%
Foreign Countries	1,622.5	2,194.9	1,930.2	-7.9%	-1.8%

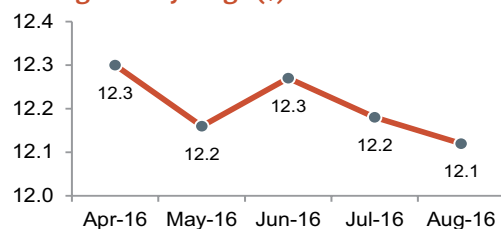
Exports and Imports



Manufacturing

	Jun-16	Jul-16	Aug-16	Percent Change Fiscal Year 2015-2016	Percent Change Accumulated year to date
Weekly Hours (#)	40.7	41.2	40.9	-1.7%	-0.1%
Average Hourly Wage (\$)	12.3	12.2	12.1	-7.1%	-6.4%

Average Hourly Wage (\$)

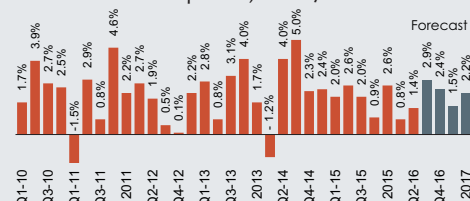


United States The Economy

- The U.S. economic outlook is healthy but not robust. That's because real GDP growth will be below the 2-3% ideal range (1.5%). Unemployment will continue at the natural rate (5.0%), and there is not much inflation.
- At the end of the first half of this year the U.S. economy registered an average real GDP growth of 1.1%, from 2.6% in 2015. For the third quarter just ended real growth is expected to reach 2.9%. Forecasts for the second half expect real GDP growth to average 2.7%, on the expectation that consumer spending will remain solid, and that business and residential investment will rebound, with monthly job creation to be sufficient to lower the unemployment rate.

Quarterly U.S. GDP

Real Growth and Expected, 2010-17



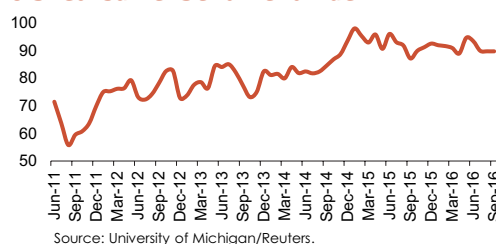
Sources: U.S. Bureau of Economic Analysis (2016); Blue Chip Economic Indicators (September 10, 2016). Seasonally adjusted at annual rates.

- Nevertheless, there are serious structural problems, some of which are becoming more negative. For instance, eleven million Americans spent half their income on rent in 2014 - a record high, according to the annual *State of the Nation's Housing Report* from the Joint Center for Housing Studies of Harvard University. The general rule of thumb is that you shouldn't spend more than 30.0% of your income but with rents rising faster than wages that's impossible for many. Also, the country's labor participation rate - the share of the workforce in employment or looking for a job - is low. Currently it stands below 63%, the lowest level since the 1970s. Another problem, according to the IMF, is that the *middle class in the U.S.* has declined to its level 30 years ago, with poverty increasing. Related to the latter, working families haven't seen a raise in decades. Many are living paycheck to paycheck. According to a recent survey by the

Federal Reserve, nearly half of all American adults [couldn't scrape together \\$400 to cover a financial emergency](#) such as a health problem or a car that needed fixing.

- However, consumer confidence moved up again in September, according to The [Conference Board's index](#), and is now at its highest level since the recession. U.S. consumer's view of present-day conditions was more positive, as they became more upbeat on the labor market, following a summer of lackluster performance on spending. Facing elections in November they still rate and foresee economic expansion in the months ahead.

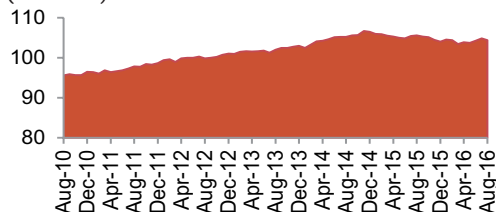
U.S. Consumer Sentiment Index



PRODUCTION

U.S. Industrial Production Monthly Index

(2012 = 100)



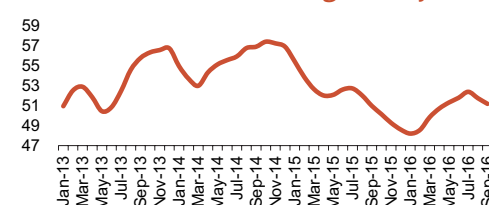
Industrial production declined 0.9%/y/y during the first two months of the third quarter, after rising 0.3% in the second quarter, according to the *Fed's indexes*.¹ It had recently picked up after declining for much of the last 18 months but continues to struggle to shake off the dampening effects of weak global demand, a strong dollar, low oil prices and slow growth across the broader economy. Industrial production has essentially been in a recession. A rise in industrial production would have been a positive sign for the economy, signifying that the major backbone of the economy is driving economic growth. However, the weaker performance of this index is showing that the U.S. economy hasn't seen sustainable growth.

Manufacturing output remained flat during the same period. Manufacturing output, which accounts for more than three-quarters of all industrial production, fell 0.4% in August.

Capacity utilization edged lower during the first two months of the third quarter, to 75.7% from 75.3% in the previous quarter, declining 1.3% y/y. Manufacturing capacity, though, rose 0.7% from a year ago. It still reflects much slack at factories.

According to the Institute for Supply Management (ISM) *Manufacturing Survey*, economic activity in the manufacturing sector expanded during the third quarter. Its manufacturing index increased 0.4%/y to 51.8% from 51.2% in the previous quarter. Any reading below 50 indicates contraction. Even though the manufacturing industry is a much smaller part of the U.S. economy than it once was, the fact that it is cyclical in nature means the sector is highly influential in cyclical changes. Key components on employment were below the 50% mark, but the new orders index was above that level.

ISM Index of Manufacturing Activity



EMPLOYMENT

The pace of hiring in the U.S. slowed sharply in August after big gains earlier in the summer. The economy added 151,000 jobs in *August* and added an average of 232,000 jobs a month during the summer, enough to absorb the increase in the working-age population and push down the unemployment rate. Total employment gains for July and August, meanwhile, were barely changed. For the two months of the third quarter, the number of jobs created in nonfarm employment (SA) registered a small decline of 0.2% y/y.

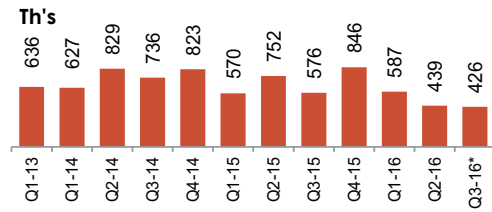
Employment in food services and drinking places continued to lead the increase. Over the year the industry has added 312,000 jobs, followed by social assistance. Employment in manufacturing declined by 12,000 during the first two months of the third quarter, while government (federal, state and county) saw a big increase of 75,000 jobs. Manufacturing represents today 8.5% of total nonfarm payrolls.

The unemployment rate averaged 4.9% in the third quarter, slightly down from 5.2% in August 2015. The employment rate (the proportion of the working-age population (16-64 years) employed) remained at 59.7% in the third quarter, practically unchanged since 2015. The participation rate has remained at

63.0% during the two months of the third quarter, almost unchanged from same period in 2015.

Monthly Changes in Employment

(Seasonally Adjusted)



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

INFLATION

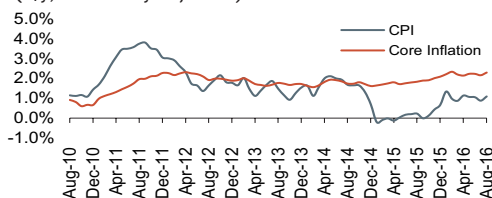
During the first two months of the third quarter, the [inflation rate](#) averaged 1.0% y/y. It has remained at that level since the first quarter of the year, after rising 0.1% in the third quarter of 2015. The rebound reflects increases in housing and medical costs, as energy prices continue on the low side, with the energy index declining 2.8% in the quarter. For the next five months the Consumer Price Index (CPI) is forecast to increase an average of 1.8% y/y.

Core inflation (excluding food and energy) during the two months of the third quarter remained at 2.2% y/y, from the same level in the previous quarter. Core prices are viewed by the Federal Reserve as a better gauge of longer-term inflationary pressure because they exclude the volatile food and energy categories.

Besides the CPI, the other price indexes also showed very low rates of inflation. The producer price index (PPI) showed no change in prices over the past 12 months. The PPI excluding food, energy, and trade increased 1.2% over the last year. Over the past 10 months, monthly inflation has been negative just once, but for all months it has stayed in the relatively low range of -0.1 to +0.3%.

Annual Percent Change in CPI

(Y/y, seasonally adjusted)



Source: U.S. BLS.

INTEREST RATES

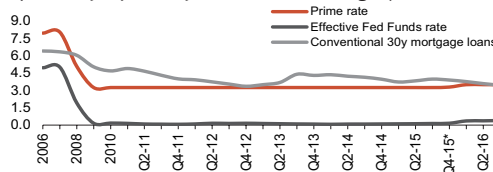
Since the first increase of its target rate last December, the additional increases scheduled for this year have not been adopted. The one contemplated initially for September was postponed at the most

recent meeting of the FOMC (Federal Open Market Committee). Fed policymakers voted 7-3 on September 21 to hold steady the target rate for overnight lending between banks at 0.25% to 0.5%. The decision to leave interest rates unchanged was influenced by low inflation and fewer workers returning to the labor force.

Analysts expect an increase in December, as the U.S. central bank signaled that the case for an increase later this year had strengthened. According to [economists polled by Reuters](#), there is a 70% likelihood of a rate hike in December.

Selected Interest Rates

(Monthly, Quarterly and Annual Averages)



Source: St. Louis Federal Reserve Bank (FRED). * Fed's benchmark rate increased in December. ** Up August.

U.S./GLOBAL OUTLOOK

According to the most recent forecast update from the International Monetary Fund [IMF](#), global GDP (Gross Domestic Product) would slow to 3.4% from 3.5% in 2016, reflecting the aftermath of the U.K. Brexit referendum. The global growth forecasts for 2016 and 2017 were both marked down by 0.1 percentage points relative to the April 2016 WEO, to 3.1% and 3.4%, respectively. The outlook worsens for advanced economies (down by 0.1 percentage points in 2016 and 0.2 percentage points in 2017), while it remains broadly unchanged for emerging market and developing economies.

China still leads the pack, despite the news of a slowdown, remaining the single largest contributor to world GDP growth. Real GDP growth this year is expected at 6.6% and 6.2% in 2017. With the IMF expecting 3.1% global growth this year, [China would contribute nearly 39.0% of the total](#).

For the U.S. economy, the outlook for growth over the next three years looks slightly weaker than that of three months ago, according to 40 forecasters surveyed by the [Federal Reserve Bank of Philadelphia](#). The panel expects real GDP to grow at an annual rate of 2.6% this quarter and 2.3% next quarter, and 2.2% in 2017. In August, the FRBP's [Fed Coincident Index](#) showed continuing slowing of the economic rate of growth.

Overall, "[Growth prospects](#) for the global economy continue to weaken, and recent events such as the Brexit vote, terrorist attacks around the world, and the upcoming US presidential election are

creating elevated levels of uncertainty for businesses."

World Economic Growth: Historic and Outlook

2010 - 2017

	2010	2011	2012	2013
World GDP	5.4%	4.1%	3.4%	3.4%
Developed economies	3.1%	1.7%	1.2%	1.4%
Euro Zone	1.9%	1.6%	-0.7%	-0.5%
U.S.	2.5%	1.6%	2.3%	2.2%
Developing economies	7.5%	6.2%	5.1%	5.0%
China	10.4%	9.3%	7.8%	7.8%
Latin America & Caribbean	6.0%	4.5%	2.9%	2.9%
Puerto Rico*	-3.6%	-1.7%	0.5%	-0.1%

	Forecasts			
	2014	2015	2016f	2017f
World GDP	3.4%	3.1%	3.1%	3.4%
Developed economies	1.8%	1.9%	1.8%	1.8%
Euro Zone	0.9%	1.7%	1.6%	1.4%
U.S.	2.4%	2.4%	1.5%	2.2%
Developing economies	4.6%	4.0%	4.1%	4.6%
China	7.3%	6.9%	6.6%	6.2%
Latin America & Caribbean	1.3%	0.0%	-0.4%	1.6%
Puerto Rico*	-1.7%	-0.6%	-2.2%	-2.8%

Sources: International Monetary Fund (2016). World Economic Outlook Update (July 2016); U.S. BEA (2016); Blue Chip Economic Indicators (September 10, 2016); P.R. Planning Board (May 2016); Estudios Técnicos, Inc. * GNP and fiscal year. f = Forecast

The World Trade Organization cut its [forecast for global trade](#) growth this year by more than a third at the end of September, reflecting a slowdown in China and falling levels of imports into the United States. The new number of 1.7%, down from their previous estimate of 2.8% in April, marked the first time in 15 years that international commerce was seen lagging the growth of the world economy, the trade body said.

As to oil prices, they have remained on the downside, from an average of \$48.71/bb of WTI in 2015, to an average of \$41.12/bb so far this year. The estimate for this year is that the price will average \$42.16/bb, increasing to \$48.13/bb in 2017 (according to futures prices as of writing). Still, there are downside risks that could push prices down. Based on the revised estimates of the IMF for the global economy, the [International Energy Agency](#) estimated in August that demand growth for crude oil in 2017 will suffer from a dimmer macroeconomic outlook, which could mean lower prices.

At their meeting on September 28th in Vienna, the OPEC reached a deal to [limit crude production](#) for the first time in eight years, starting in November. It will push prices up but probably not by much, as the cut would represent less than 1% of total global production from all sources, barely reducing the oil glut.

Notes:

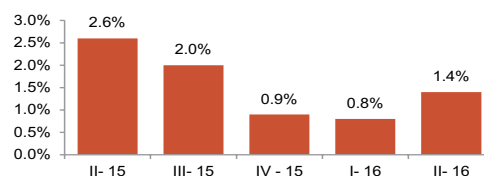
- The industrial sector measured by the U.S. central bank comprises manufacturing, mining, and electric and gas utilities.
- Industrial Production measures the change in the total inflation-adjusted value of output produced by manufacturers, mines, and utilities.

United States Economic Indicators

GDP

	III- 15	IV - 15	I- 16	II- 16
GDP (% Change From Preceding Period)	2	0.9	0.8	1.4
Private Consumption	2.7	2.3	1.6	4.3
Fixed Investment	5.7	-0.2	-0.9	-1.1
Residential	12.6	11.5	7.8	-7.7
Non-Residential	3.9	-3.3	-3.4	1
Government Spending	1.9	1	1.6	-1.7
Exports	-2.8	-2.7	-0.7	1.8
Imports	1.1	0.7	-0.6	0.2

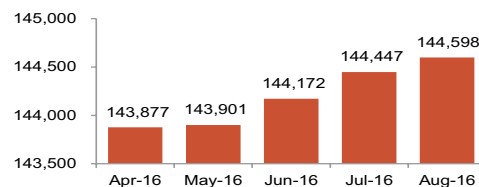
Gross Domestic Product (% Change From Preceding Period)



Employment

	May-16	Jun-16	Jul-16	Aug-16
Employees on Non-Farm Payrolls (SA) (Thousands)	143,901	144,172	144,447	144,598
Change (%)	0.0%	0.2%	0.2%	0.1%
Goods Producing	19,618	19,613	19,624	19,600
Change (%)	-0.2%	0.0%	0.1%	-0.1%
Service Industries	124,283	124,559	124,823	124,998
Change (%)	0.1%	0.2%	0.2%	0.1%

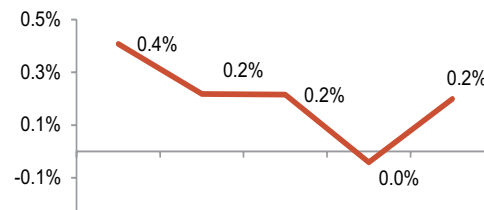
Employees on Non-Farm Payrolls (In thousands)



Consumer Price Index

	May-16	Jun-16	Jul-16	Aug-16
CPI - All Urban Consumers (1984=100)				
Change from preceeding month	0.2%	0.2%	0.0%	0.2%
Change from preceeding year	1.1%	1.1%	0.9%	1.1%
CPI - Less Food and Energy				
Change from preceeding month	0.2%	0.2%	0.1%	0.3%
Change from preceeding year	2.2%	2.2%	2.2%	2.3%

Change in CPI



Interest Rates

	May-16	Jun-16	Jul-16	Aug-16
Effective Federal Funds	0.4	0.4	0.4	0.4
Three Month Treasury Bill (Constant Maturity Rate)	0.27	0.27	0.30	0.30
Prime Rate	3.50	3.50	3.50	3.50
Ten Year Treasury Bond	1.81	1.64	1.5	1.56
Moody's Seasoned Aaa Rate	3.65	3.5	3.28	3.32
30-Year Conventional Mortgage Rate	3.60	3.57	3.44	3.44

Selected Interest Rates

