2004 Economic and Interest Rate Outlook

Note to Flaherty & Crumrine Clients, February 2004

Interest rate anticipation is not and never has been a focus of the investment process at Flaherty & Crumrine. However, we do think about the macro economy and how it's likely to affect the companies and securities in which we invest. We thought it would be useful to share some of those thoughts with our clients, and we welcome any comments you may have.

Conclusions

Implications for Rates

Solid economic growth and a Fed committed to leaving monetary policy accommodative until that growth is assured should translate into higher interest rates in 2004. How much higher they need to rise and when that will happen are unclear. Forward rates already incorporate a substantial amount of tightening over the next two years, and it's not difficult to construct scenarios where tightening could be significantly more or less than current market expectations. The rate outlook will depend upon how the recovery plays out, and we will be attentive to opportunities that the market presents to us, without trying to predict exactly when they will occur.

One prediction we will make, however, is that the combination of economic growth, heavy government borrowing, and low short rates is likely to keep the yield curve very steep by historical standards in 2004. The curve eventually will flatten, but a patient Fed should mean a steep, if not steeper, yield curve.

Implications for Spreads

The credit outlook remains almost uniformly positive, with credit metrics improving and the relative supply outlook supportive of further spread narrowing. However, given the dramatic tightening that has already occurred, we expect that additional spread tightening for the market in general will be limited. That means credit selection will be critical, and it remains our focus at Flaherty & Crumrine.

Implications for Volatility and Hedging

The steep yield curve and monetary policy that is currently focused on just two variables (inflation and employment) present unique challenges to our option-based hedging strategy. Demand for options from a rapidly growing mortgage market has kept option prices firm, while the bond market has settled into a relatively narrow range since August 2003. Volatility is likely to become more concentrated around employment releases, with other economic statistics taking a back seat until Fed tightening is more imminent. In those accounts where we hedge the general level of interest rates, we intend to stick with our time-tested hedging strategy. However, we are likely to manage the hedge a bit more actively this year than in the past in an effort to reduce the cost of hedging.

A Brief Look Back at 2003

The US economy absorbed a variety of shocks in 2003 and turned in solid growth of 3.1% for the year as a whole, with low inflation. War in Iraq, high energy prices, weak equity markets, the threat of deflation, and subdued business confidence held down economic growth in the first quarter of the year. However, expansionary fiscal and monetary policy, a booming housing market, a weaker US dollar, impressive gains in productivity, rebounding corporate profits, and the accompanying rise in household wealth produced strong economic growth in the second half, although employment gains remained elusive. In short, economic growth generally exceeded analysts' expectations. (See Figure 1 for a quarterly breakdown of some of the key elements of the macroeconomic environment over the past two years.)

Figure 1: 2002 - 2003 Macroeconomic and Interest Rate Performance

Economic Indicator	2002:1	2002:2	2002:3	2002:4	2003:1	2003:2	2003:3	2003:4
Real GDP, Chg QoQ (%)	4.7	1.9	3.4	1.3	2.0	3.1	8.2	4.0
Real PCE, Chg QoQ (%)	4.1	2.6	2.0	2.2	2.5	3.3	6.9	2.6
Real Busi Inv, Eqp & Software, Chg QoQ (%)	-0.2	1.2	3.7	1.7	0.5	8.0	17.6	10.0
Real Residential Inv, Chg QoQ (%)	8.7	8.9	4.2	6.8	4.5	4.5	21.9	10.6
Corp Profits w IVA & CCAdj, Chg YoY (%)	16.4	20.5	26.1	8.3	5.3	13.4	24.9	
Current Account Balance, Annualized (% of GDP)	-4.1	-4.7	-4.7	-4.8	-5.2	-5.1	-4.9	
Federal Budget, 12-mo Def or Surp (% of GDP)	0.2	-1.5	-1.5	-2.2	-2.6	-2.9	-3.4	-3.5
Unemployment Rate (%)	5.7	5.8	5.7	6.0	5.8	6.3	6.1	5.7
Household Employment, Chg QoQ (000)	28	247	984	-878	841	373	-29	835
Nonfarm Payrolls, Chg QoQ (000)	-180	-98	-94	-91	-114	-181	77	144
Nonfarm Productivity, Chg QoQ (%)	9.3	1.0	5.9	1.7	2.1	7.0	9.4	
Capacity Utilization (%)	75.6	76.2	75.7	74.9	74.8	74.0	74.9	75.8
GDP Deflator, Chg QoQ (%)	1.3	1.2	1.0	1.8	2.4	1.0	1.7	1.0
CPI, Chg YoY (%)	1.4	1.1	1.6	2.4	3.0	2.1	2.3	1.9
CPI ex food & energy, Chg YoY (%)	2.4	2.3	2.3	2.0	1.7	1.5	1.2	1.1
Nominal Personal Income, Chg YoY (%)	1.7	2.8	2.7	2.3	3.0	2.7	3.5	3.8
Personal Savings Rate (%)	2.4	2.9	2.5	1.3	2.0	2.2	1.5	1.3
Rate or Spread	**2002:1**	**2002:2**	**2002:3**	**2002:4**	**2003:1**	**2003:2**	**2003:3**	**2003:4**
Federal Funds Rate Target (%)	1.75	1.75	1.75	1.25	1.25	1.00	1.00	1.00
3-month LIBOR (%)	2.03	1.86	1.79	1.38	1.28	1.12	1.16	1.15
10-Yr Treasury Note Yield (%)	5.42	4.81	3.60	3.82	3.81	3.52	3.94	4.25
30-Yr Treasury Bond Yield (%)	5.81	5.51	4.67	4.78	4.83	4.56	4.89	5.07
Moody's Baa Long Corp Spread (bp)	230	244	273	267	212	163	191	153
10-Yr Interest Rate Swap Spread (bp)	55.8	57.3	65.9	39.7	44.1	34.4	42.5	40.6

* Figures are either quarterly or, if more frequent, quarterly averages — Source: EcoWin

The Treasury bond market experienced a significant amount of volatility in 2003. Rates rallied strongly in the first half of the year, reaching 55-year lows in mid-June ahead of the June 25 Federal Open Market Committee meeting. Despite the ¼ percentage point cut in the federal funds rate at that meeting, the bond market experienced one of the worst sell-offs in the postwar period, with the yield on 10-year Treasury notes rising by 150 basis points to a peak of 4.6% in early September. The ten-year Treasury subsequently rallied back to finish the year around 4.25%, only about 25 bp higher than its level in early January 2003. In contrast to the volatility in rates, credit spreads marched tighter throughout the year in response to the improving credit outlook, scarcely pausing during the summer sell-off. From near-distress levels in late 2002, Baa-rated long corporate securities tightened by 114 bp over the course of 2003.

Economic & Monetary Policy Outlook

The economy should produce solid growth in 2004, with economists predicting about 4.4% GDP growth on average. Employment and personal income should rebound, although impressive strides in productivity are likely to hold those gains below what we've come to expect in past recoveries. The trade deficit should gradually decline as a result of the falling US dollar and rising US business competitiveness. Housing activity and prices should moderate after several years of sharp growth, but we do not think housing is a "bubble" waiting to burst. Fiscal policy will remain expansionary, with the Federal budget deficit rising to at least $475 billion in FY2004, up from $374 billion in FY 2003. Inflation should remain low, but will gradually increase as employment and capacity utilization rise. Monetary policy will remain accommodative until employment and inflation move higher. Accordingly, the Federal Reserve will not tighten policy before mid-year and may not tighten at all this year, making the interest rate outlook highly uncertain. We explore these points in detail below.

GDP Growth & Business Investment

Coming off strong growth in the second half of 2003, the economic outlook for 2004 appears bright. Economists' forecasts for GDP growth in 2004 are in a range of 3.25-5.25%, with both median and average expectations of about 4.4%. Business investment, particularly in equipment and software, and rising inventories should lead the recovery in 2004. Such investment has been rising impressively (up 8.9% year-on-year through the fourth quarter) as businesses seek to improve their productivity. Possessing little pricing power but facing rising commodity and energy prices, businesses remain under pressure to invest in productivity-enhancing equipment and processes in order to avoid margin shrinkage. As a result, business investment should contribute significantly to growth again this year. Similarly, inventory-to-sales ratios are at historic lows across most sectors of the economy. As demand continues to improve, even a modest recovery in inventories would contribute substantially to production, employment, and growth.

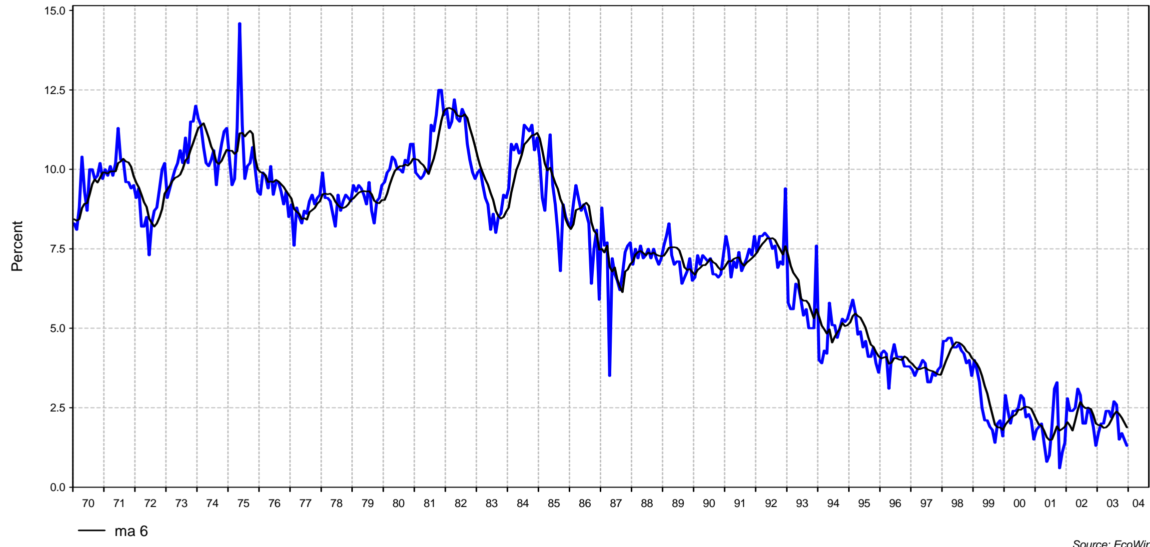
Personal Consumption Expenditures & the Savings Rate

Personal consumption expenditures, which account for 70% of GDP and were up 3.8% Q4 to Q4 in 2003, should turn in a respectable performance in 2004. Consumption in the first half of the year should be robust, aided by expansionary fiscal policy (higher income tax refunds resulting from last year's tax cuts) and accommodative monetary policy (the FOMC is unlikely to tighten policy before mid-year at the earliest). Their trajectory in the second half will depend more on income growth from job formation than on fiscal and monetary stimulus, however.

While personal consumption expenditures, particularly durable goods such as automobiles, were important drivers of growth in 2003, their growth eventually will be constrained by an already low savings rate. In essence, consumers over the past several years have increased spending despite sluggish income growth (a byproduct of the weak labor market) by taking on new debt or refinancing existing debt at historically low interest rates. Although overall financial obligations as a percentage of income are not at alarming levels (owing to low interest rates), consumers are now saving very little of their incomes – just 2.0% on average in 2003 (see Figure 2). That is way below historical averages, and it is bound to climb as the recovery extends and people (think baby boomers approaching retirement) defer consumption

and increase savings. That transition will slow near-term economic growth but permit more rapid real growth in the future. And it is one reason to expect that the rise in interest rates that accompany a rebounding economy is likely to be more subdued than the historical norm.

Figure 2: Low Savings Rate Means Consumption Won't Lead Recovery



Production & Capacity Utilization

Industrial production accelerated over the course of 2003, with the fourth quarter up at a 6.2% annual rate. Surveys of industrial activity, from the Empire State Manufacturing Survey, to the Philadelphia Fed Survey, to the national ISM Manufacturing Survey paint a uniform picture of expansion in the manufacturing sector. Indeed, the ISM overall, new order, and production indices are at or near their highest levels since the early 1980s and point toward continued expansion in the manufacturing sector and sturdy final demand. At the same time, capacity utilization remains low at 75.8%, only a little above the 30-year low reached earlier in 2003. Thus, producers can respond to rising demand by increasing output rather than by raising prices.

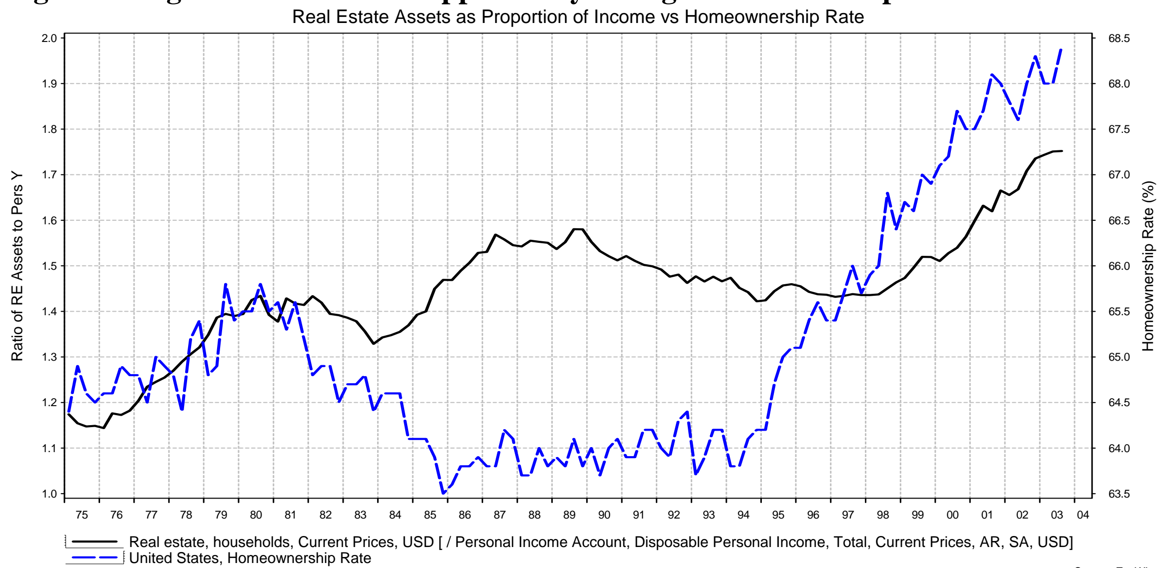
Housing

The housing sector was a source of significant strength for the economy in 2003 (up 10.1% Q4 over Q4) as low interest rates and a rising homeownership rate overcame drag from job losses. Both new and existing home sales hit record levels in 2003, and while they have moderated somewhat from the peak levels of this past summer, sales activity remains brisk. In contrast to the lack of inflation in most other parts of the economy, home prices rose considerably in response to this firm demand, with home prices up 6-9% over the course of 2003, although they have been decelerating recently.

Despite much hand-wringing over the possibility that we are in the midst of a "housing bubble," we do not find evidence for such a conclusion. Yes, home prices have risen faster than personal income for the past three years, but this has been supported by an increase in homeownership from roughly 64% of households in the mid-1990s to nearly 68% now. This is in contrast to the mid-1980s, when home prices rose sharply relative to income even as

homeownership fell, which led to weakness in housing for the following five years (see Figure 3). Moreover, mortgage interest rates have fallen by 40%, or 225 bp, since early 2000, making home ownership much more affordable. We do expect home price increases to moderate this year, due to both higher mortgage rates and some leveling off in the homeownership rate as rental prices decline, and we would become increasingly concerned about the housing sector if such moderation does not occur. However, we don't think housing will be a trouble spot for the economy in 2004.

Figure 3: Higher Home Prices Supported by Rising Homeownership



Foreign Trade

The rising trade deficit has been a source of weakness for the domestic US economy for more than a decade, but the ongoing decline of the US dollar will ultimately generate an improving trade and current account balance that in turn will add to domestic economic growth. After peaking in early 2002, the dollar fell by 8.4% on a trade-weighted basis in 2003, and it continued to decline in January. Currency weakness initially contributed to a further widening of the deficit, which hit an all time wide of almost $43 billion in March 2003. However, it now has begun to turn around, narrowing to $38 billion by November 2003. While those numbers probably overstate the improvement, the weakening dollar and improving global economy have resulted in a notable increase in exports, while import growth appears to be slowing down. Assuming that the dollar does not collapse and generate imported inflation, the adjustment process should result in firmer domestic growth with limited incremental pressure on inflation.

Fiscal Policy

Fiscal policy remains expansionary, with the FY2004 Federal budget deficit projected to rise to $477 billion by the Congressional Budget Office, and with some credible private forecasters calling for a $600 billion deficit. Most of the expansion will occur in the first half of the year, when Treasury pays out high individual income tax refunds resulting from last year's tax cuts. Refunds will be above average this year because taxes were cut in the middle of last year but were retroactive to the beginning of the year. Thus, individuals generally

over-withheld taxes in the first half of 2003, and they will get that money back in the form of tax refunds when they file their 2003 returns over the next few months. Fiscal policy will become slightly restrictive in the second half of the year, but certainly not by enough to alter the course of the recovery.

Productivity

One of the central features of the economy in 2003 was the extraordinary rise in nonfarm business productivity, which increased by 6.2% at an annual rate through the third quarter and by 5.5% per year for the past two years. Moreover, the strength in business investment and increasing globalization indicate that productivity growth should remain elevated, though we should not expect too many more 9.4% increases such as the one in the third quarter.

The strength in productivity has been wonderful news for corporate profitability, which has exploded, and inflation, which has remained stable or fallen. However, it has been bad news for employment growth, since businesses have been able to increase output to meet rising demand without adding workers. Still, these productivity gains have helped to contain inflation despite solid growth, as it raises the potential GDP growth rate (the amount by which GDP can grow without putting upward pressure on inflation, or the sum of population growth – about 1% in the US – and productivity growth). Ongoing gains in productivity, therefore, will allow the FOMC to be slow to tighten monetary policy in the face of strong economic growth.

Employment & Income

Employment growth has been largely absent in the current recovery, although that appears likely to change over the next several quarters. As indicated above, sharply rising productivity has allowed businesses to increase output without adding workers, and indeed nonfarm businesses actually trimmed payrolls by 73,000 jobs in 2003 despite respectable GDP growth. However, at some point the gains in productivity will moderate and employers will begin to add workers. By some measures, that has already begun. Employment as measured by the household survey rose by just over 2 million jobs in 2003; both initial and continuing jobless claims have fallen sharply from their peaks in early- to mid-2003; and even payroll jobs have risen slightly in recent months (see Figure 4). It is difficult to predict when job formation will pick up meaningfully, but it is safe to say that it will pick up eventually.

The reason why employment is so important to (and thus a risk for) the economic outlook is that employment is the primary source of personal income, which drives personal consumption, which in turn is 70% of GDP. Weakness in the labor market led to weakness in personal income growth, which until recently was growing at only about 2.5% on a nominal basis. While it's now up to about 3.8%, it still lags growth in personal outlays by a considerable margin (see Figure 5). Disposable income has done better, posting 4.7% nominal growth largely as a result of personal income tax cuts, and it has supported consumption over the past several years. However, with Federal government finances already stretched, there is likely to be no more room for further improvement in disposable income from lower taxes. Of course, incomes could increase as a result of higher wages rather than higher employment, but wages and salaries are not accelerating: They rose by just 2.4% last year, down from 2.9% in 2002. In short, employment has to rise and the unemployment rate has to fall before we can expect much acceleration in wages and income. Accordingly, rising

employment is critical to the growth outlook, because it will be impossible for the economy to grow at 4.5% *real* for very long if *nominal* income is rising by only 3.5-4.0%. It's no surprise, then, that the FOMC has highlighted employment (along with inflation) as one of two key triggers for monetary policy over the coming quarters.

Figure 4: Employment Poised to Recover, And Must Do So Because…

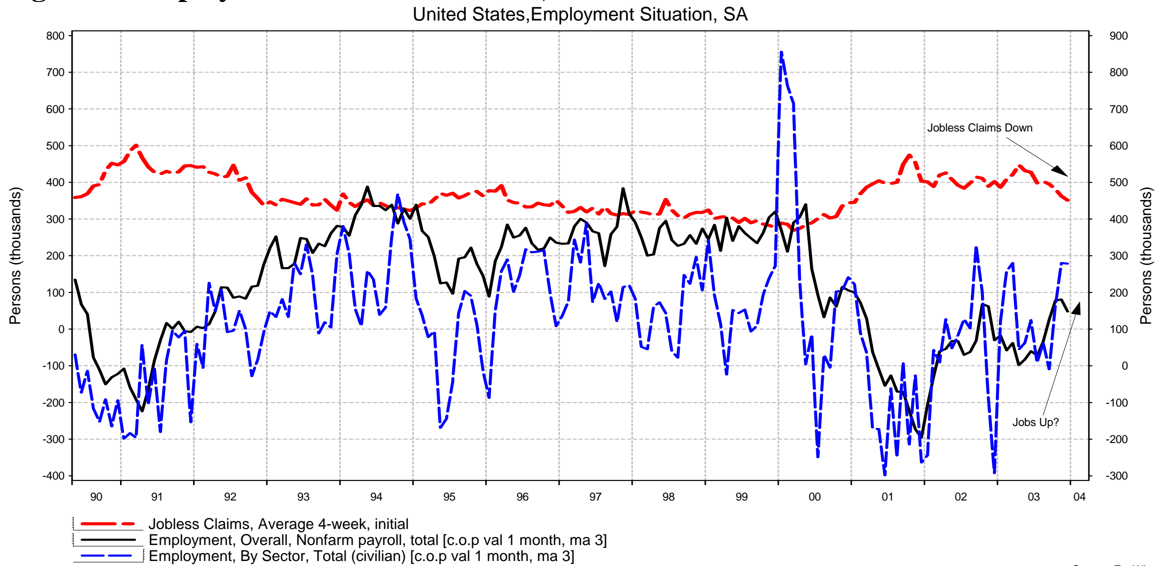
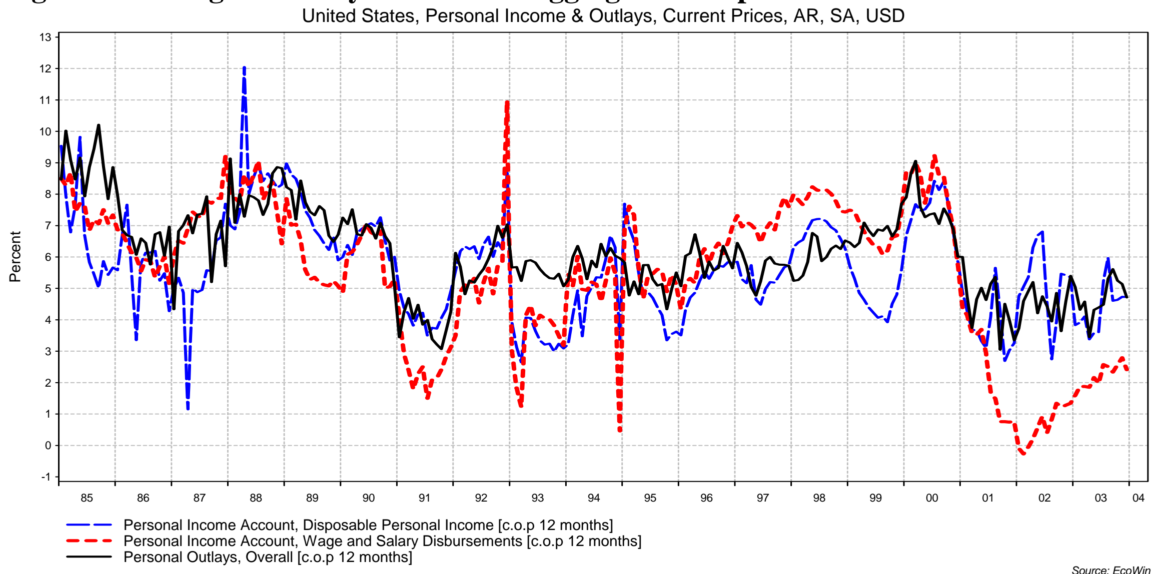


Figure 5: …Wage & Salary Growth Is Lagging Consumption

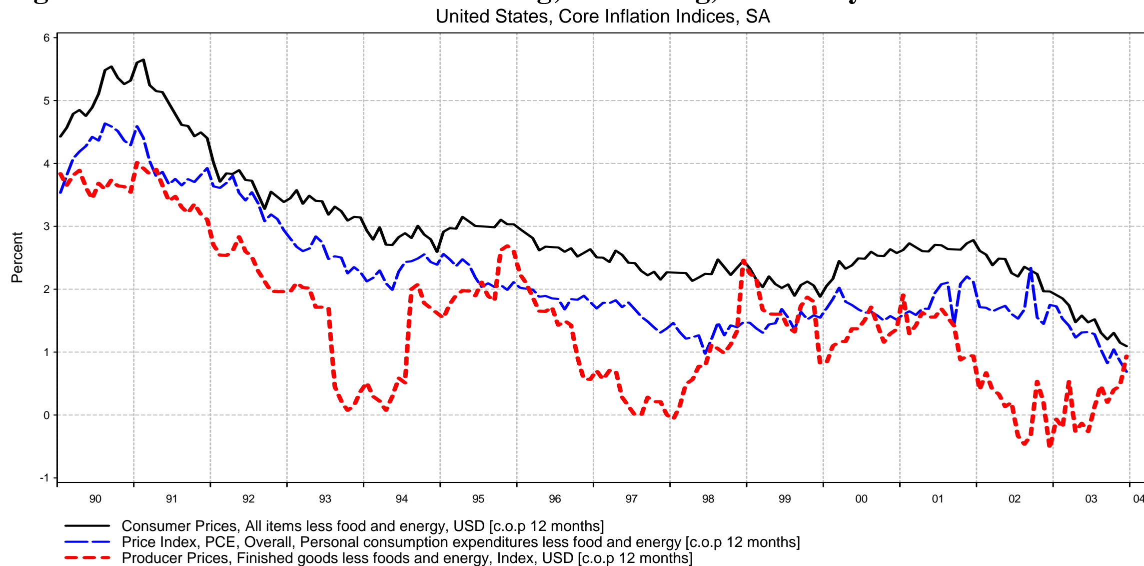


Inflation

Inflation remains subdued at the consumer and finished goods levels despite sharp increases in commodity prices and a falling dollar. The core consumer price and personal consumption expenditure indices were up just 1.1% and 0.7%, respectively, over the past year (see Figure 6). Those are the lowest readings in nearly 40 years, and both have been falling. Farther back in the production pipeline, there are signs of rising inflation as a result of sharply higher energy and commodity prices. Crude and intermediate producer prices were up by 18.6% and

3.3%, respectively, in 2003. Those price increases are being absorbed largely by producers and are not being passed on to final purchasers, however, due to a highly competitive global marketplace for goods and, increasingly, services. Core producer goods prices were up only 0.9% at the finished goods level.

Figure 6: Consumer Inflation Still Falling; PPI Rising, but Slowly



Looking forward, inflation is bound to rise as the slack in labor and capital resources get taken up. How long this will take is highly uncertain, as it depends upon the interaction of a host of factors including employment, productivity, and global capacity utilization. What is clear is that none of these factors is currently a bottleneck that would push inflation higher. The sluggish growth in wages, sharply rising productivity, and a still-low capacity utilization rate point to the conclusion that it will take an extended period of solid growth before inflation rises meaningfully.

Monetary Policy

Monetary policy remains accommodative, with the real federal funds rate hovering around zero, despite 8.2% GDP growth in the third quarter and still-solid 4% growth in the fourth. While this would be unheard of in prior cycles, the Fed has flatly stated that it intends to be "patient in removing its policy accommodation." Because inflation is running at just 1% or so, there is simply no need for the Federal Reserve to make monetary policy preemptive. On one hand, if the Fed waits "too long" before tightening and inflation heats up, it still should peak well below the level in previous cycles. That's not a horrible outcome. On the other hand, if the Fed tightens "too soon," the consequences would be an abortive recovery and deflation that would be extremely difficult to counteract with fiscal policy (given already high deficits) or monetary policy (given that the Fed can push the funds rate only to zero). That *is* a horrible outcome – one that the FOMC, viewing the world from a risk-management perspective, will try to avoid.

The FOMC has highlighted two economic indicators that it considers critical to determining when the period of monetary accommodation will come to an end: employment and inflation. While inflation statistics tend to be relatively stable from month to month, employment

statistics are highly volatile, with different measures often moving in different directions for short periods of time. Thus, although the Fed will need to see 3-4 months of solid employment gains as well as an up-tick in inflation before monetary tightening is back on the table, the market will handicap the odds of such a shift with each employment release. The Fed's risk-management framework puts the earliest tightening at mid-year, and it may take until 2005 before both employment and inflation turn meaningfully upward. Boiling it all down, it seems to us that we're likely in for some interest rate volatility, within a range bounded by a steady Fed. We don't pretend to know when the Fed will move, but we will try to take advantage of any opportunities that the market gives us when policy expectations get overly bullish or bearish.

Credit Outlook

The outlooks for credit and credit spreads remain positive, although the degree of spread tightening seen in 2003 won't be repeated this year. The economic outlook is bright, credit metrics are improving, and companies continue to shore up their balance sheets. Corporate profits are soaring, and external financing needs are declining, while Federal government borrowing continues to rise.

Credit Metrics

Overall credit metrics in the economy are improving. Bank loan charge-offs and delinquencies are falling, as are business bankruptcy filings (see Figure 7). Moreover, debt service for nonfinancial companies continues to decline relative to cash flow (see Figure 8), although there's still plenty of room for improvement. In addition, long-term debt as a proportion of total debt is rising, and short-term assets as a percentage of short term liabilities are rising as well (see Figure 9).

Figure 7: Loan Quality Improving and Bankruptcy Filings Falling

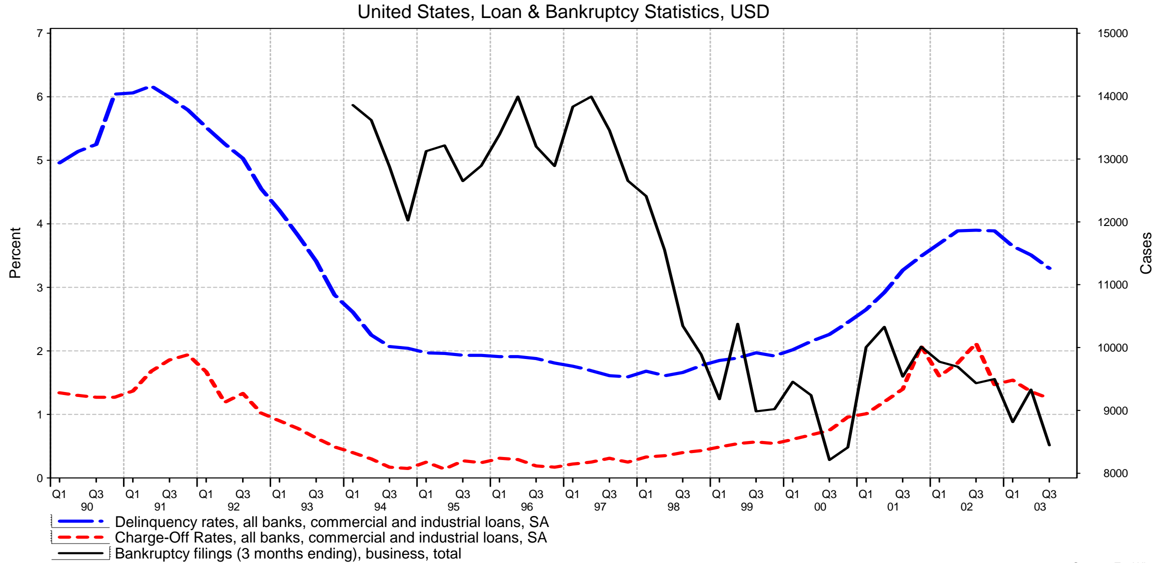


Figure 8: Debt Service Falling

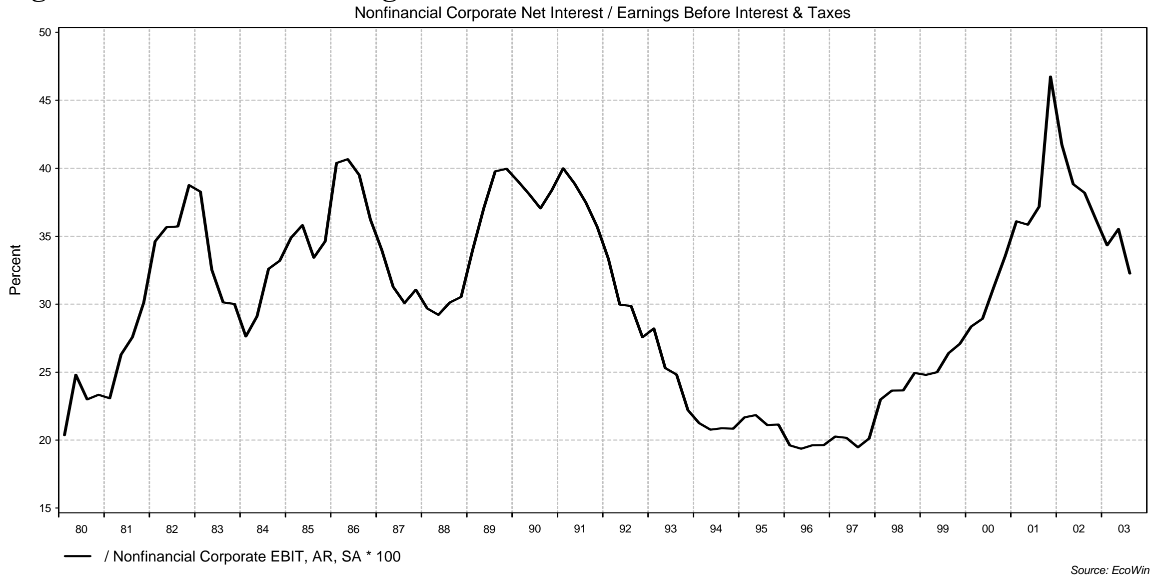
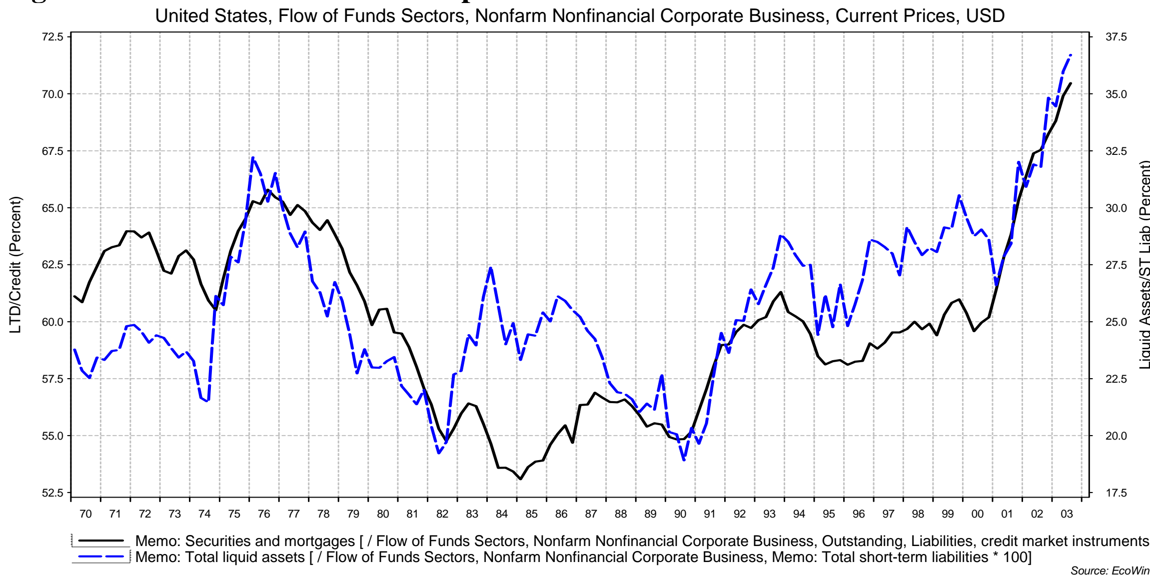


Figure 9: Balance Sheets Under Repair



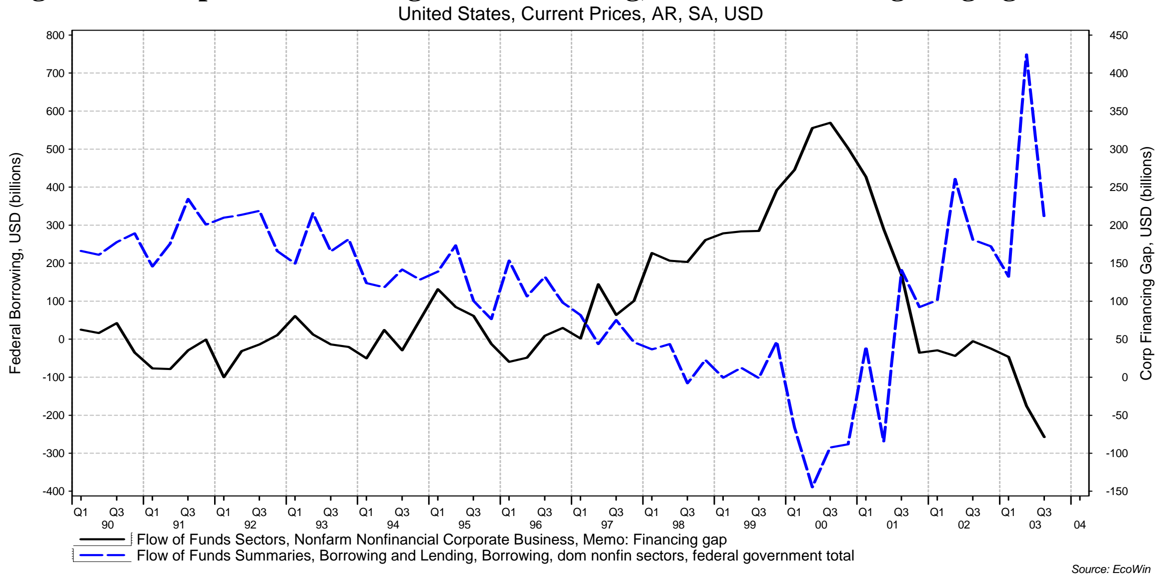
Corporate Profits

Corporate profits staged a stunning recovery in 2003. Profits in the third quarter of 2003 were up by 25% versus the year-earlier period, pushing the profit share of GDP above 10%. While Q4 numbers are not yet available, positive earnings surprises continue to run well above negative surprises, pointing toward another good quarterly profit figure. With demand rising steadily, productivity surging, and wage growth subdued, profits should continue to increase strongly throughout 2004, although not at the Q3 pace. The profit rebound gives companies the capacity to shore up their balance sheets, and we are keeping a close eye on the credits we own to make sure that happens.

Supply

One of the consequences of the bursting of the "New Economy" bubble is that business significantly reduced capital expenditures after 2000. At the same time, as businesses have shed workers, raised productivity and generally become much more profitable, their cash flows have improved. As a result, nonfinancial companies are now earning more cash than they are reinvesting in their businesses, and the financing gap[1] has turned negative (see Figure 10). This may seem at odds with the heavy corporate bond calendar witnessed in 2003. Upon inspection, it turns out that corporations have been borrowing term funds in the corporate bond market in order to (a) pay down commercial paper and bank loans and (b) acquire financial assets. These steps have improved corporate liquidity and should mitigate the impact on spreads as capital spending increases over the course of the year. When we assess the relative financing needs of corporations and the Federal government, the Feds are almost certain to increase their borrowing by more than will nonfinancial corporations. That's positive news for corporate spreads to Treasuries and an important reason why we remain optimistic on corporate and preferred securities.

Figure 10: Corporate Financing Needs Declining, Federal Borrowing Surging



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February 2, 2004

[1] The financing gap is defined as capital expenditures less the sum of internally generated funds and an inventory valuation adjustment, as calculated by the Federal Reserve.