U.S. Mid-Year Economic Update
July 2005

Summary of Recent Economic Developments

Economic growth in the United States remained sturdy in the second quarter, pushing down the unemployment rate to 5%. The economy offered relatively few surprises, although financial markets did: Long-term interest rates fell sharply despite solid economic growth and continued monetary policy tightening by the Federal Reserve; we explore this "conundrum" later in this Update.

Private forecasters[1] expect real GDP growth of 3.0% in 2005:Q2 and 3.5% for the second half of the year, although the recently released trade balance and retail sales reports should prompt forecasters to raise Q2 GDP estimates by 0.5-1.0%. The composition of growth shifted in the second quarter, as the business sector (particularly manufacturing) slowed while consumer spending firmed. Payroll job growth was steady at about 180,000 jobs per month. Trade improvement was a positive surprise, although further improvement in the trade balance will be difficult this year. Inflation pressures eased after accelerating earlier in the year. Still, with economic growth solid and resource utilization rising, the Federal Reserve continued to tighten monetary policy. Finally, corporate borrowing continued around the Q1 pace while strong tax payments reduced Treasury borrowing, leading to wider corporate bond spreads.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator	**2003:3**	**2003:4**	**2004:1**	**2004:2**	**2004:3**	**2004:4**	**2005:1**	**2005:2**
Real GDP, Chg QoQ (%)	7.4	4.2	4.5	3.3	4.0	3.8	3.8	3.0f
Real Personal Consump Expnds, Chg QoQ (%)	5.0	3.6	4.1	1.6	5.1	4.2	3.6	
Real Busi Investmt, Eqp & Sftware, Chg QoQ (%)	21.7	12.0	8.0	14.2	17.5	18.4	6.1	
Real Residential Investmt, Chg QoQ (%)	22.4	9.6	5.0	16.5	1.6	3.4	11.5	
Corporate Profits, Pretax, Chg YoY (%)	20.6	23.3	27.8	19.0	5.8	12.4	15.4	36.2f
Current Account Balance, Annualized (% of GDP)	-4.6	-4.4	-5.1	-5.7	-5.7	-6.3	-6.4	
Federal Budget, 12-mo Def or Surp (% of GDP)	-3.4	-3.5	-3.7	-3.7	-3.5	-3.3	-3.3	
Unemployment Rate (%)	6.1	5.7	5.7	5.6	5.4	5.4	5.2	5.0
Household Employment, Chg QoQ (000)	-156	790	-1	750	369	629	345	1137
Nonfarm Payrolls, Chg QoQ (000)	99	302	531	693	401	569	546	542
Nonfarm Productivity, Chg QoQ (%)	8.6	2.7	3.8	4.1	0.9	2.3	2.9	
Capacity Utilization (%)	75.8	76.8	77.4	77.8	78.0	79.2	79.5	80.0
GDP Price Index, Chg QoQ (%)	1.4	1.6	2.8	3.2	1.4	2.3	2.9	
Consumer Price Index, Chg YoY (%)	2.3	1.9	1.7	3.2	2.5	3.4	3.2	2.5
CPI ex food & energy, Chg YoY (%)	1.2	1.1	1.6	1.9	2.0	2.2	2.4	2.1
Nominal Personal Income, Chg YoY (%)	3.9	4.9	4.9	5.2	5.2	10.0	7.1	6.7a
Personal Savings Rate (%)	1.4	1.2	1.0	1.5	0.5	4.5	0.6	0.6a
Rate or Spread	**2003:3**	**2003:4**	**2004:1**	**2004:2**	**2004:3**	**2004:4**	**2005:1**	**2005:2**
Federal Funds Rate Target (%)	1.00	1.00	1.00	1.25	1.75	2.25	2.75	3.25
3-month LIBOR (%)	1.16	1.15	1.11	1.61	2.02	2.56	3.12	3.52
10-Yr Treasury Note Yield (%)	3.94	4.25	3.84	4.58	4.12	4.22	4.49	3.92
30-Yr Treasury Bond Yield (%)	4.89	5.07	4.78	5.29	4.90	4.83	4.76	4.19
Moody's Baa Long Corp Spread (bp)	191	153	133	149	138	132	130	162
10-Yr Interest Rate Swap Spread (bp)	42.5	40.6	40.0	51.3	45.6	43.0	47.2	46.2

* Figures are either quarterly or, if more frequent, quarterly averages. f = Forecast[1]; a = Actual through May 2005 Source: EcoWin

Legend for all Figures: AR = Annual Rate; SA = Seasonally Adjusted; MA = Moving Average; C.O.P. = Change over Period

[1] Source: Federal Reserve Bank of Philadelphia, *Survey of Professional Forecasters;* data courtesy EcoWin.

Economic Outlook

Consumer spending has been unusually volatile in recent months, driven by unseasonable weather in much of the country this spring. Looking past the monthly volatility, however, it's clear that retail sales have firmed in recent months after slowing earlier in the year (Figure 2). Disposable income growth has slowed due to higher tax payments following the surge in bonus income in December, but we are not overly concerned with this. Consumers are likely smoothing out their spending rather than mirroring the "lumpiness" of bonus income and subsequent tax payments. The six-month moving average of the savings rate has remained fairly steady at about 1.4% – still too low, but an improvement over the sub-1% low touched last year.

Figure 2: Retail Sales Recovering

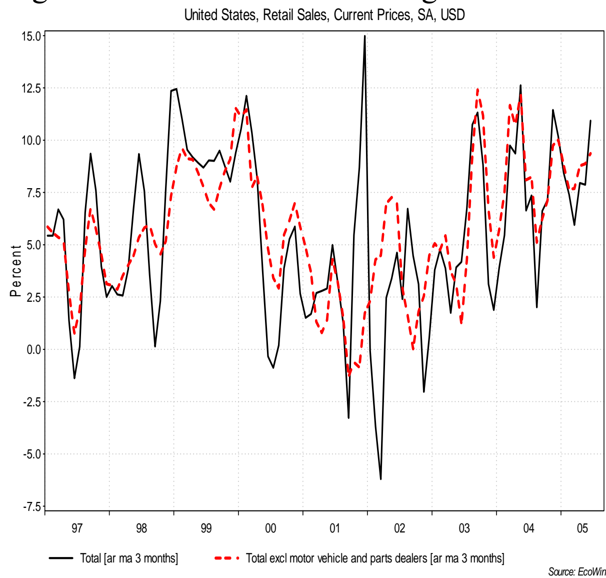
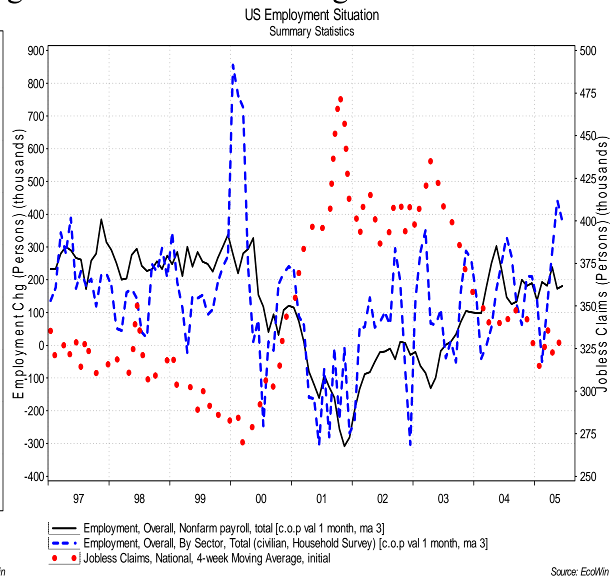


Figure 3: Job Growth Strong



Despite the volatility in the monthly payroll data, the **labor market** has shown steady growth over the past three quarters (Figure 3). Monthly payroll job growth averaged 181,000 in Q2, 182,000 in Q1 and 190,000 in 2004:Q4, well above the roughly 120,000 per month pace necessary to absorb new entrants to the labor market (i.e. job growth necessary to keep the unemployment rate steady). The household survey showed even faster job growth over this period: 235,000 jobs per month over the past three quarters and a whopping 379,000 jobs per month in the second quarter! We pay more attention to the payroll jobs report because it tends to be a less volatile and generally more reliable measure of actual employment. However, the payroll survey, which is used to calculate the unemployment rate, is a good measure of the relative *tightness* of the labor market – and the unemployment rate in June fell to a cycle low of 5%, indicating continued absorption of labor resources. Since labor market tightness rather than the absolute number of jobs has a greater influence on inflation, and since both the payroll and household employment surveys point to a tightening of the labor market, the Federal Reserve no doubt remains concerned about the potential inflationary consequences of ongoing strength in employment.

Inflation pressures moderated in the second quarter, allaying fears of more rapid tightening of monetary policy by the Fed. Importantly, pipeline pressures on inflation generally have eased (see Figures 4 and 5 on the next page). In particular, falling oil prices in April and May contributed to the easing of inflationary pressures, although the rebound in oil above $60 per

barrel threatens to unwind some of that progress. Moreover, continued above-trend growth in the economy eventually will add to inflationary pressures. Although the Federal Open Market Committee ("FOMC") may feel a little more relaxed about inflation today than it did three months ago, it can hardly be complacent given the underlying strength in the economy.

Figure 4: Inflation Stabilizing for Now

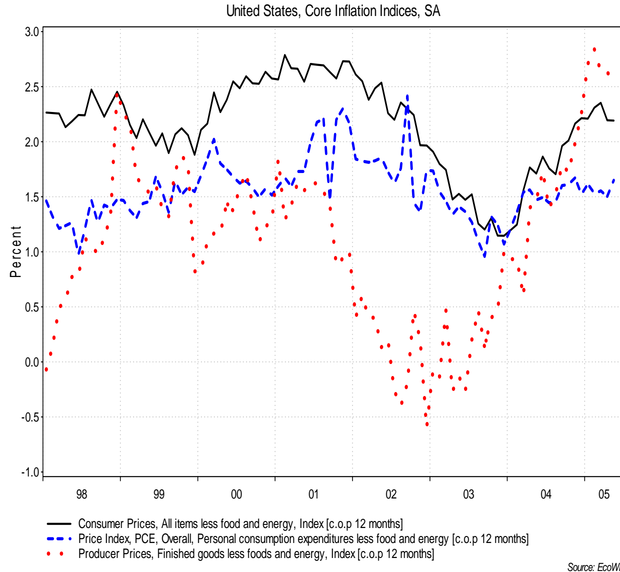
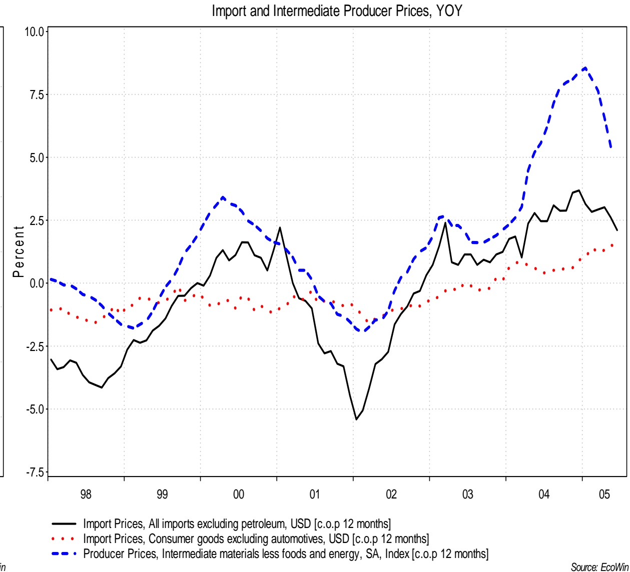


Figure 5: Pipeline Pressures Ease



The **business sector** slowed in the second quarter as rising inventories earlier in the year prompted slower growth in orders and production. Manufacturing activity was hit particularly hard (Figure 6). However, with inventory growth now slowing and business sales picking up, it's reasonable to expect a pickup in orders and production in the coming months. Moreover, the much larger service sector appears to remain on solid footing, with the ISM Non-manufacturing survey remaining essentially stable at a high level (Figure 7). In addition, residential construction continues to be very strong.

Figure 6: Manufacturing Slowed…

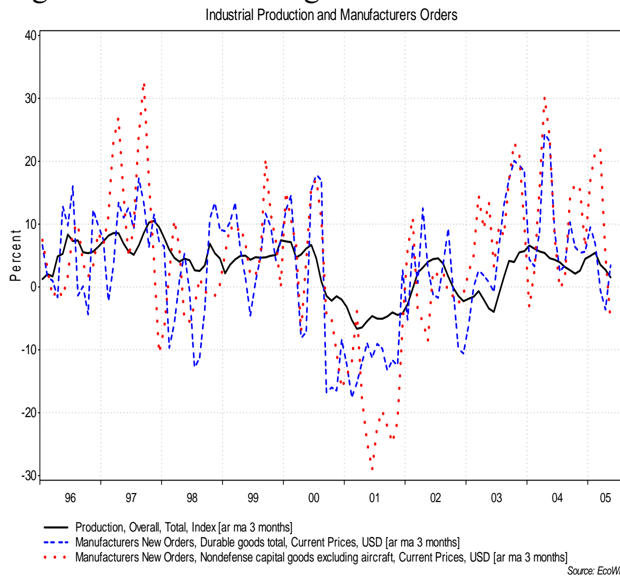
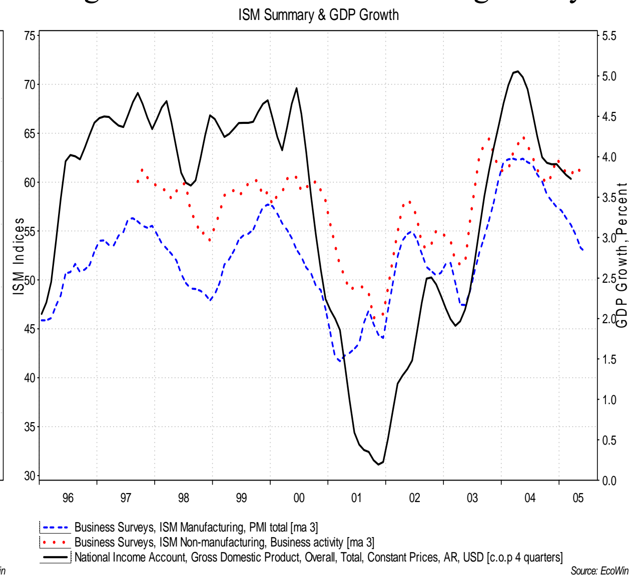


Figure 7: …But Services Holding Steady



The **trade sector**, which has been a major drain on economic growth, staged a sharp turnaround during the three months ending in May (the most recent data available). This implies that, barring a large widening of the deficit in June, trade should add about 1% to GDP growth in the second quarter, compared to subtracting 0.6% in Q1. Although the narrowing of the trade deficit is certainly welcome, we do not expect much further improvement over the balance of the year. In fact, the deficit will probably widen again in response to strong U.S. economic growth. The simple reason for this is that exports have to grow more than 50% faster than imports to stabilize the deficit at its current level; that's a tall order if U.S. economic growth remains above the global average. Should trade improvement persist, however, it's likely that the Fed would respond to faster domestic growth (absent the drag from trade) by tightening monetary policy faster or longer than the market currently anticipates.

Market Outlook

The outlook for **credit spreads** continues to develop in-line with our expectations. As we noted earlier, business investment should remain sturdy given solid economic growth, a competitive global marketplace, and low financing costs. Indeed, corporations have begun to step up their borrowing, as shown by rising commercial and industrial loan and non-financial commercial paper volumes (Figure 9) and rising corporate borrowing generally (Figure 10).

Figure 9: CP and C&I Loans and …

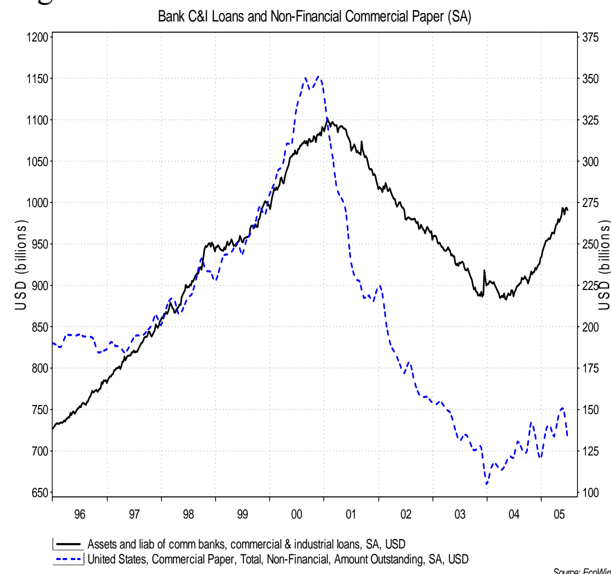
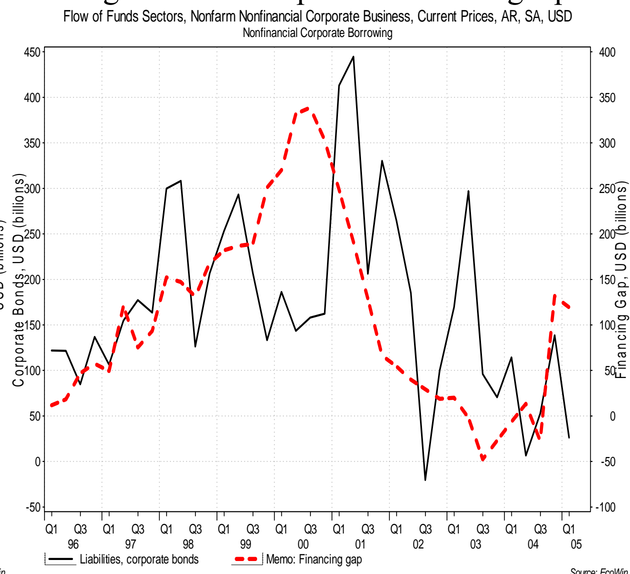


Figure 10: …Corporate Borrowing Up



Meanwhile, the Treasury's borrowing has slowed as tax collections have exceeded expectations while spending has remained contained (at least for now). This combination of rising corporate borrowing and declining federal borrowing has put some upward pressure on corporate bond and preferred securities spreads, though the widening has been limited to date. Still, we have seen increasing opportunities in the securities we buy, and we expect that those opportunities will grow as the year progresses.

Turning to **long-term interest rates,** after three quarters of relative stability, the 30-year Treasury bond yield rallied by nearly 60 basis points (bp) in the second quarter, falling to 4.19% at the end of June; it has risen by 21 bp since then and now stands at 4.40%. The rally came despite another 50 bp of tightening by the FOMC during the quarter, and 225 bp since the Fed began tightening in June of last year. In our Economic Update from April, we anticipated the

higher level of volatility that we experienced, though we did not anticipate that it would come in the form of lower rates[2]. The decline in long-term rates coupled with the rise in short-term rates produced a dramatic flattening of the yield curve. It's worth exploring why short- and long-term rates have moved in opposite directions, and the next several paragraphs will address this **"conundrum."**

As we mentioned above, short-term interest rates have risen as the Federal Reserve tightened monetary policy over the past year. Starting from just 1% in June 2004, the federal funds rate now stands at 3.25% and is likely to move higher still in coming months. In response to firmer U.S. (and global) economic growth and the inflationary pressures that have resulted from it, the FOMC has moved the fed funds rate from a level that was clearly stimulative to one that is closer to neutral. While it's unclear precisely what the "neutral" fed funds rate is, since it depends upon many factors which are not observable in real-time, it's clear – to the Fed at least – that the funds rate is not at neutral just yet.

Normally during periods of Fed tightening, the yield curve flattens as short rates rise more than long rates. However, in this episode the yield curve has flattened dramatically because long rates have fallen even as short rates have increased – an unprecedented development. We have already explained why the Fed has tightened, but why have long rates fallen? There are a number of potential explanations. Analysts have cited the fixed or loosely-pegged exchange-rate régimes in a number of Asian countries and the associated accumulation of dollar reserves as one reason for low rates. When those reserves are reinvested, overwhelmingly in U.S. fixed income securities, they tend to hold down yields on U.S. bonds. More generally, some economists point to a savings glut generated by a shift in income domestically to high savers (corporations) from low savers (individuals) and globally to high-saving nations (e.g. Asia, OPEC countries) from low-saving nations (e.g. the U.S.). Other factors contributing to lower long-term yields include growing demand from pension funds for long duration assets, which better match the liabilities of their defined benefit obligations, the rebuilding of corporate balance sheets, and limited (or even negative) borrowing by businesses. More recently, concerns over slowing economic growth outside the U.S. have pushed global yields lower, particularly in Europe. Finally, technical factors probably contributed to lower yields as well: Many investors correctly anticipated Federal Reserve tightening, but not the decline in long rates, causing some to cover shorts in long-term bonds at higher prices and lower yields.

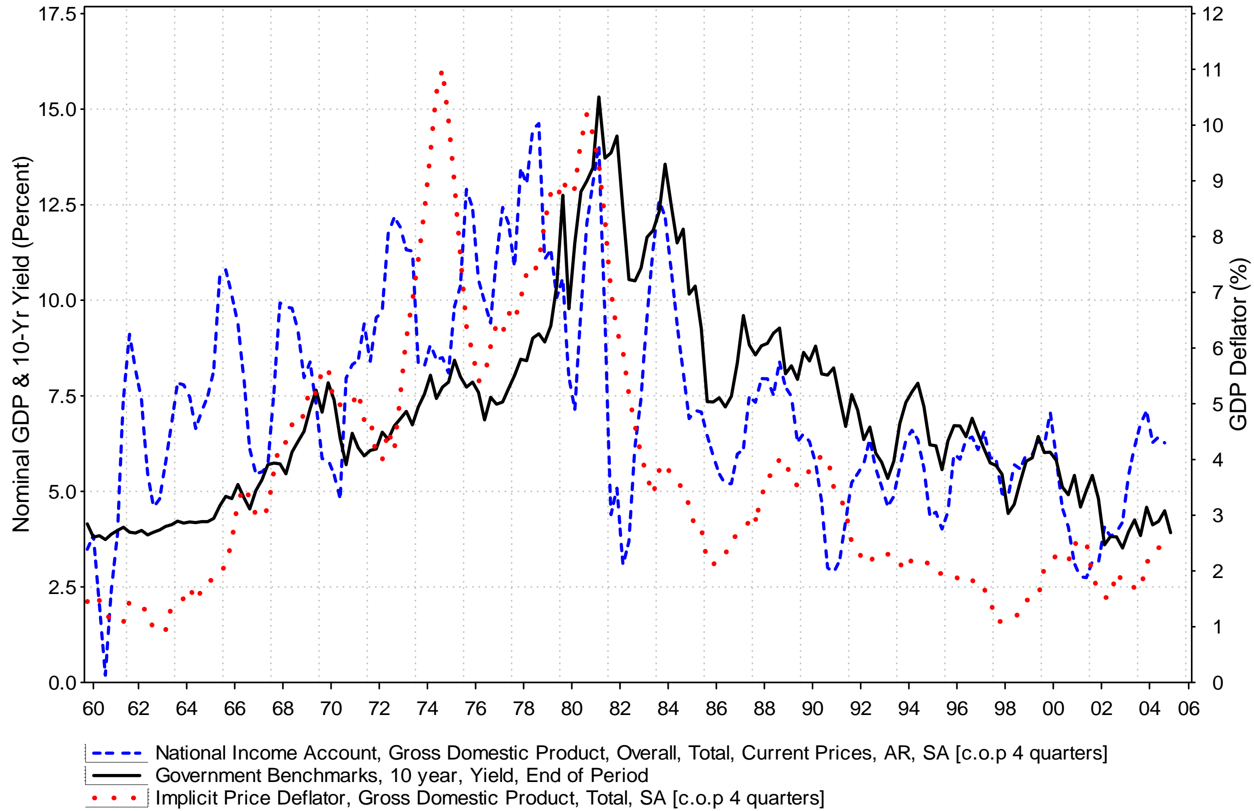
All of these explanations are plausible and all in some way probably contributed to the decline in long rates since the Fed began tightening. In fact, several are complementary and so may have reinforced one another (e.g. export-driven growth policy of a foreign nation → U.S trade deficit, slower U.S. growth → reserve accumulation by foreign nation, reduced investment demand by U.S. corporations → purchases of U.S. fixed income assets, lower corporate bond issuance → lower long-term rates). In short, we should expect that long-term rates will be lower relative to growth and inflation than the historical norm. This is clearly shown in Figure 8 on the next page, which plots 10-year Treasury rates versus nominal GDP and inflation. While the relationship between nominal GDP (i.e. GDP expressed in current rather than inflation-adjusted dollars) and interest rates is not a tight one, it's not surprising to see that interest rates and nominal GDP growth do bear some relation to one another.

---

[2] Of course, that's the reason why we don't try to anticipate the direction of interest rates: It's very hard to do consistently! Instead, we hedge consistently, recognizing that the hedge should protect the value of the portfolio if and when long-term rates rise significantly.

Figure 8: Disconnect between Ten-Year Treasury Yields and Nominal GDP Growth

United States, Nominal GDP vs 10-year Treasury Yield



One interesting observation from the graph above is that yields tended to be below GDP growth prior to 1980 and equal to or above GDP thereafter – except for the past several years when yields barely increased in response to stronger growth. There are a number or hypotheses about why rates were below GDP in the 1960s and '70s, but it's clear that inflation over those two decades rose significantly. Since much of that inflation was unanticipated, investors did not charge a sufficiently high inflation risk premium, and so rates tended to be below (inflated) nominal GDP – something economists call money illusion. As inflation dropped in response to much tighter monetary policy in the late 1970s and early 1980s, but with inflation still very much in the mind of investors, yields remained high in the '80s even as nominal GDP growth declined (though real GDP recovered following recessions in 1980 and 1981-82). In other words, investors demanded a high inflation risk premium given the experience of the prior decade, and that risk premium declined only gradually. By the mid 1990s, Federal Reserve inflation-fighting credibility was well established, the inflation risk premium had declined significantly, and 10-year rates tracked nominal GDP for the following five years. Bringing the story to the present, we find that rates have significantly lagged the pickup in economic growth. While higher inflation could explain a little of this (money illusion again), the gap between nominal GDP and interest rates has increased by much more than inflation, so it's clear that other factors – some of which we discussed above – have been suppressing long-term rates.

The next question is how much below "normal" should long rates be? While the question is impossible to answer precisely, with the gap between 10-year Treasuries and nominal GDP

growth at more than 3¼ percentage points and inflation expectations subdued, our qualitative answer is, "smaller than it is today." We believe that most of the factors holding down interest rates will diminish over time. First, with rates low, corporate bond spreads tight and economic growth solid, corporations now are able to make investments that are likely to exceed the cost of capital. Thus, on a cyclical basis, we expect that U.S. corporations will begin (and in fact already have begun) to borrow again, increasing the demand for credit. Second, domestic savings will decline as employment expands and wage pressures increase, shifting income from corporations to lower-saving wage earners. Finally, the accumulation of dollar reserves (savings) by foreigners cannot go on without limit. After all, the reason one saves is to support consumption at a later date. Eventually, foreigners will decide that they have enough savings – or at least enough dollar savings – and will begin to spend them. While that probably will not happen over the near term, its inevitability should limit how low rates fall relative to what otherwise would be equilibrium.

The last question we will address on this topic is will long rates fall even if the Fed continues to tighten monetary policy? While this too is not clear-cut, we believe the answer is no. First, the curve has already flattened dramatically. While it's possible that long bonds will continue to rally despite further tightening by the Fed, with the fed funds rate now approaching the level where the market expects the fed to stop tightening (between 3 3/4 and 4%), the possibility that the Fed may need to tighten beyond that point should soon cause long-term yields to rise along with short rates. Put simply, if the Fed keeps tightening and bonds keep rallying, soon investors would earn higher yields on less volatile short-term instruments than on more volatile long-term bonds. In particular, managers of foreign reserves, who have no explicit long-term liabilities to fund, may shift investments to short-term instruments if their yields rose above those of current holdings. In addition, as we have already noted, demand for borrowing from corporations appears to be picking up.

Putting all of this together, we expect that short-term and long-term rates will move more closely together – at the very least, in the same direction! – going forward. If so, then higher short-term rates (which increase the cost of leverage) would result in higher long-term rates, which would improve the return on our hedges if long-term rates rise significantly. Alternatively, if long-term rates decline again (reducing the return on our hedges), we expect that short-term rates also would decline, which would lower the cost of the Funds' leverage. As a result, we believe that the market will reestablish some of the balance between the cost of leverage and the cost of hedging[3] that has been largely absent over the past year.

Brad Stone
Flaherty & Crumrine Incorporated
July 15, 2005

© 2005, Flaherty & Crumrine Incorporated. All rights reserved. This document is for personal use only and is not intended to be investment advice. Any copying, republication or redistribution in whole or in part is expressly prohibited without written prior consent. The information contained herein has been obtained from sources believed to be reliable, but Flaherty & Crumrine Incorporated does not represent or warrant that it is accurate or complete. The views expressed herein are those of Flaherty & Crumrine Incorporated and are subject to change without notice. The securities or financial instruments discussed in this report may not be suitable for all investors. No offer or solicitation to buy or sell securities is being made by Flaherty & Crumrine Incorporated.

[3] See the August 2004 Quarterly Report to shareholders for a further discussion of this.