

## U.S. Second-Quarter Economic Update July 2006

### Summary of Recent Economic Developments

Economic growth moderated in the second quarter: Private forecasters expect real GDP growth of 2.7% in Q2 – putting first-half growth at an above-trend 4.2% – and 2.9% in the second half of the year<sup>1</sup>. With monetary policy finally driving up long-term interest rates, slower GDP growth seems reasonable, although forecasters may still be a little too pessimistic. Reviewing the second quarter, we see that real personal consumption slowed considerably, dropping from over 5% in the first quarter to just 1.8% through May. Housing also continued to decelerate moderately, with unit sales flat and prices up by only 3-6% compared to year-ago levels. The labor market offered mixed signals; wages accelerated and the unemployment rate fell to a new low for the cycle but the two major employment surveys pointed in different directions regarding job gains. Business investment appears to have remained strong, though below the Q1 pace. The core trade deficit improved, which offset some of the weakness in consumption. Inflation accelerated by most measures, prompting the Federal Open Market Committee to hike rates by 50 bp in Q2. Long-term interest rates, which until late in Q1 had largely shrugged off the higher fed funds rate, continued to rise in Q2, albeit by less than the rise in short-term rates. Finally, corporate credit spreads moved sideways, aided by strong corporate profitability and solid balance sheets but hurt by heavy supply and (in places) regulatory uncertainty.

Figure 1: Key Macroeconomic Indicators and Interest Rates

<b>Economic Indicator</b>	<b>2004:3</b>	<b>2004:4</b>	<b>2005:1</b>	<b>2005:2</b>	<b>2005:3</b>	<b>2005:4</b>	<b>2006:1</b>	<b>2006:2</b>
Real GDP, Chg QoQ (%)	4.0	3.3	3.8	3.3	4.1	1.7	5.6	2.7f
Real Personal Consump Expnds, Chg QoQ (%)	4.4	4.3	3.5	3.4	4.1	0.9	5.1	1.8a
Real Busi Investmt, Eqp & Sftware, Chg QoQ (%)	15.5	12.4	8.3	10.9	10.6	5.0	14.8	
Real Residential Investmt, Chg QoQ (%)	2.6	1.6	9.5	10.8	7.3	2.8	3.3	
Corporate Profits, After Tax, Chg YoY (%)	4.4	7.0	4.1	9.9	8.7	14.6	30.5	18.6f
Current Account Balance, Annualized (% of GDP)	-5.6	-6.2	-6.3	-6.2	-5.8	-7.0	-6.4	
Federal Budget, 12-mo Def or Surp (% of GDP)	-3.5	-3.3	-3.3	-2.7	-2.5	-2.5	-2.5	
Unemployment Rate (%)	5.4	5.4	5.1	5.0	5.1	4.9	4.7	4.6
Household Employment, Chg QoQ (000)	314	638	468	1149	685	344	862	722
Nonfarm Payrolls, Chg QoQ (000)	346	631	481	500	464	536	529	325
Nonfarm Productivity, Chg QoQ (%)	1.7	2.0	3.8	2.4	4.2	-0.3	3.7	
Capacity Utilization (%)	78.7	79.7	79.9	80.3	79.1	81.1	81.4	81.7a
GDP Price Index, Chg QoQ (%)	1.5	2.7	3.1	2.6	3.3	3.5	3.1	
Consumer Price Index, Chg YoY (%)	2.5	3.3	3.2	2.5	4.7	3.4	3.4	4.2a
CPI ex food & energy, Chg YoY (%)	2.0	2.2	2.4	2.0	2.0	2.2	2.1	2.4a
Nominal Personal Income, Chg YoY (%)	5.6	9.8	6.2	6.1	6.5	1.9	4.9	5.4a
Personal Savings Rate (%)	1.0	4.4	0.4	-0.6	-0.2	-0.8	-1.5	-1.7a
<b>Rate or Spread</b>	<b>2004:3</b>	<b>2004:4</b>	<b>2005:1</b>	<b>2005:2</b>	<b>2005:3</b>	<b>2005:4</b>	<b>2006:1</b>	<b>2006:2</b>
Federal Funds Rate Target (%)	1.75	2.25	2.75	3.25	3.75	4.25	4.75	5.25
3-month LIBOR (%)	2.02	2.56	3.12	3.52	4.07	4.54	5.00	5.48
10-Yr Treasury Note Yield (%)	4.12	4.22	4.49	3.92	4.33	4.40	4.86	5.15
30-Yr Treasury Bond Yield (%)	4.90	4.83	4.76	4.19	4.57	4.54	4.90	5.19
Moody's Baa Long Corp Spread (bp)	136	127	138	162	158	167	165	163
10-Yr Interest Rate Swap Spread (bp)	45.6	43.0	47.2	46.2	46.2	51.9	53.0	64.3

\* Figures are either quarterly or, if more frequent, quarterly averages.

f = Forecast<sup>1</sup>; a = Actual through May 2006

Source: EcoWin

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

<sup>1</sup> Source: Federal Reserve Bank of Philadelphia, *The Livingston Survey*, June 7, 2006.

*Economic Outlook*

**Consumer spending** slowed in Q2 from its very rapid pace in the prior quarter. Real personal consumption expenditures (PCE) were up by just 1.8% through May (the latest data available). Some of that slowing in real PCE reflected higher inflation, however, as nominal PCE rose by 6.3%. Core retail sales growth slowed from its double-digit pace in Q1 but still is running around 7% on a nominal basis. These are hardly “weak” numbers, and they indicate that consumers are still spending at a moderate pace. With employment and wages both rising, we continue to expect that consumption will post moderate growth in the second half of the year.

One consumer sector that has clearly slowed down is **housing**, and it has further to go. Both new and existing home sales peaked last summer, and median and average home prices have increased by just 3-6% year-on-year through May from double digit rates in 2004 and 2005 (Figure 2). Nonetheless, prices are still higher than a year ago, and sales remain well above the levels of the late 1990s; so far the housing market is cooling rather than plummeting. It’s too early to call an end to the slowdown, however. Affordability remains poor, and inventories of unsold homes are relatively high and could push prices down more severely (Figure 3). We believe that affordability will improve as incomes rise faster than home prices, and inventories will decline along with that. We expect that will be a gradual process dominated by rising income rather than falling home prices, but this is one of the key risks to the outlook.

Figure 2: Home Price Gains Slowing

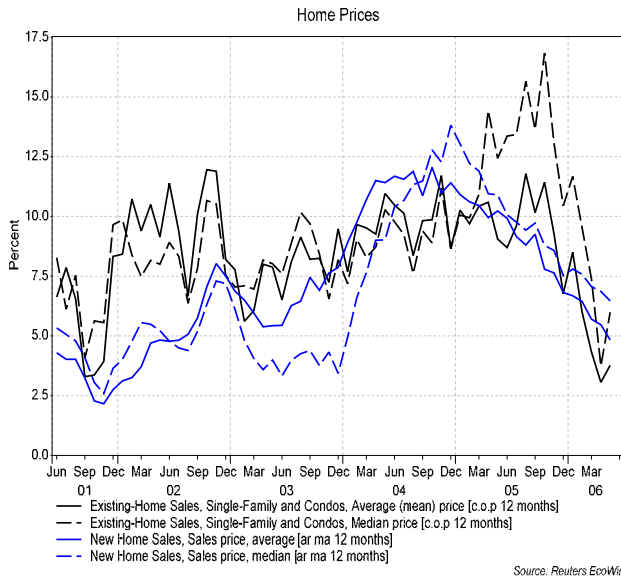
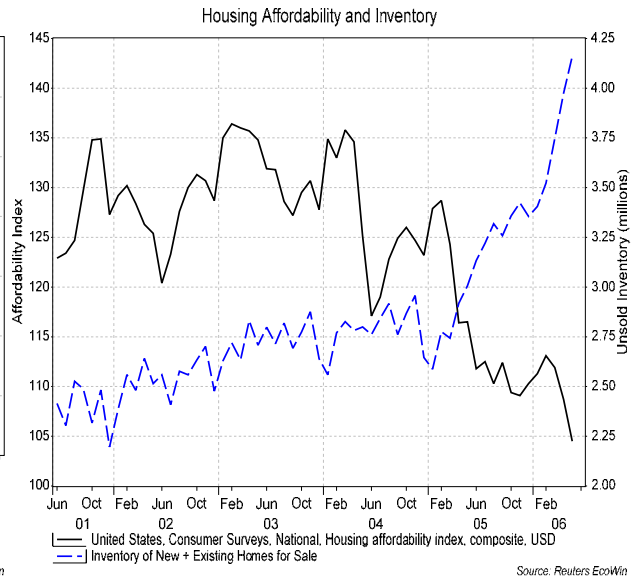


Figure 3: More to Go for Housing



Economists disagree about the importance of the housing slowdown, however. Some economists expect the slowdown in the housing market to prompt a sizable reduction in consumption, ultimately leading to recession. Others see the housing slowdown as almost a non-event, wherein spending that previously was applied to housing will be applied to other parts of the economy. On one hand, there is no question that borrowing against housing wealth has accelerated consumption and that low interest rates encouraged such borrowing. Indeed, that’s what the Fed’s stimulative monetary policy was intended to accomplish, and the rebound in consumption and the decline in the savings rate offer clear evidence that it worked. However, now that home price appreciation has slowed and borrowing costs are up significantly in recent months (see Figure 11 on page 6), it is reasonable to expect that some homeowners, who might otherwise

have taken out cash in a mortgage refinancing, will decide against additional borrowing to finance current consumption. In addition, with the rapid expansion of mortgage debt and other forms of leverage such as automobile leasing in recent years, households' financial obligations as a percentage of income (the "Financial Obligations Ratio," or FOR) have risen to an historical high of 18.7% as of Q1 (Figure 4). Thus, consumers may not be in the mood or the position to take on more debt.

Figure 4: Household Obligations High...

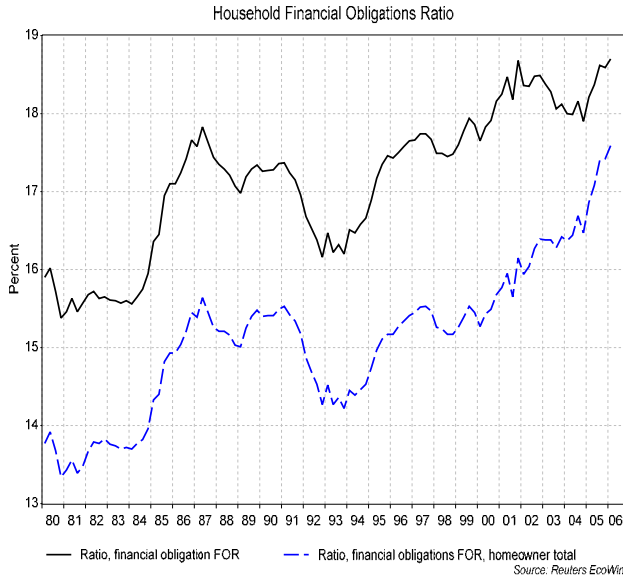
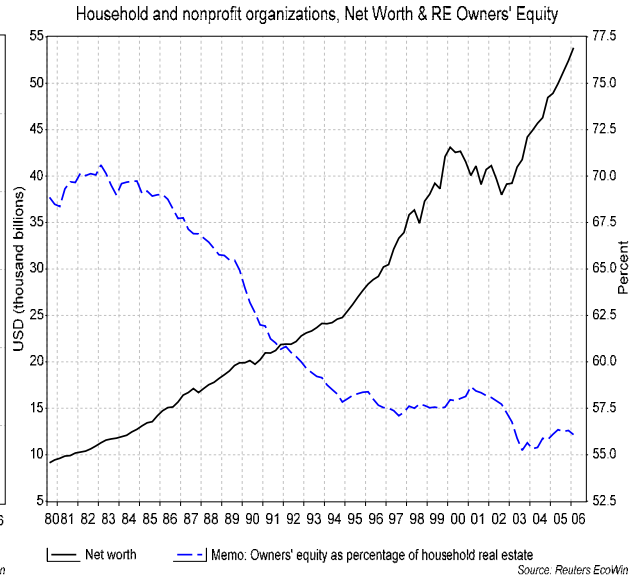


Figure 5: ...But Balance Sheets Strong



On the other hand, although the FOR is historically high, it's still less than 20% of total income. In addition, household net worth is at an all-time high, and home equity as a percentage of real estate assets has remained steady to slightly higher in recent years despite the surge in mortgage debt (Figure 5). As a result, the historically high FOR does not appear troublesome. One also has to consider that for every dollar borrowed by one household to support consumption, it must be provided by another in lieu of consumption. This applies even if the lender is a foreigner, since fewer dollars invested ultimately means a smaller trade deficit, which increases GDP. Finally, a softer housing market – which we would define as one where personal incomes increase faster than home prices, not necessarily one where home prices fall outright – will increase housing affordability, allowing homeowners' to allocate income to other forms of consumption *and investment*. Indeed, to the extent that investment dollars are allocated away from improving the housing stock and toward enhancing the productive capacity of the economy, the housing slowdown could prove highly beneficial over the long run.

On balance, then, we believe that the truth lies somewhere in the middle of these two opposing views. A housing slowdown along with higher interest rates will slow consumption over the near term, and indeed we may already be seeing that in the recent consumption data. However, we see offsets in the form of a lower trade deficit and reallocation of investment dollars into more productive sectors, both of which add to domestic growth over time. We will be keeping a close eye on how these themes develop over the coming quarters.

The **labor market** sent mixed signals in the second quarter (Figure 6). On the positive side, the unemployment rate fell to a new low for the cycle (4.6%), and growth in average hourly earnings accelerated to 3.9% year-on-year from 3.2% at the end of 2005. In addition, the household

survey of employment showed that 722,000 jobs were added in Q2 – an average of about 240,000 per month – and jobless claims remain very low by historical standards. On the negative side, the establishment (or payroll) survey of employment showed that 325,000 jobs – about 108,000 per month – were created in Q2, less than half the pace of the household survey and slightly below the rate of growth in the labor force. In addition, the employment components of the ISM manufacturing and non-manufacturing surveys slipped below their 6-month averages in the second quarter, suggesting more sluggish job growth. Most other measures of job demand, including the average amount of time that a person is unemployed (falling), the number of voluntary job leavers (rising), the Monster Employment Index (rising) and the Manpower Outlook Survey (stable), continue to indicate steady-to-firmer job growth. As a result, we are inclined to trust the positive message from the household survey at this time, despite the fact that the payroll survey tends to be more accurate over the long run. Nonetheless, we will be watching the employment situation closely over the coming months.

Figure 6: Uncertain Employment Picture

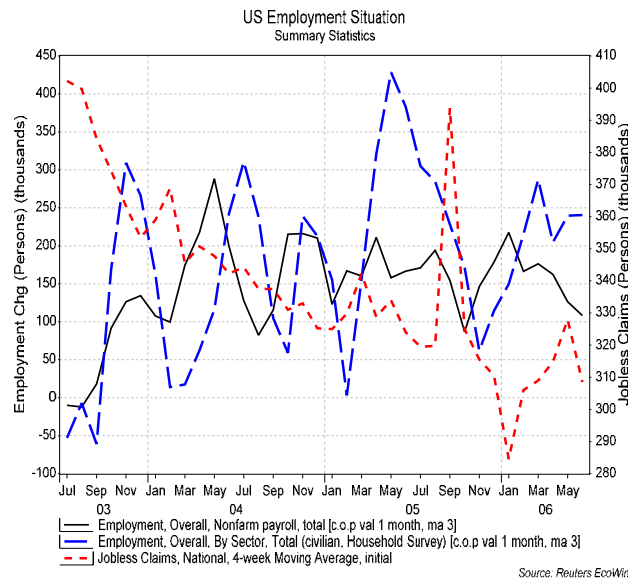
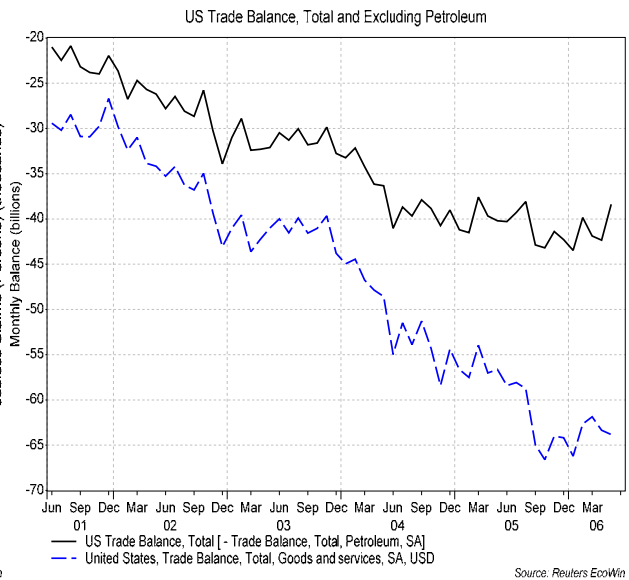


Figure 7: Trade Balance Poised to Narrow



**Business investment** appears to have remained strong in Q2. Production of business equipment was up at about an 8% rate in the quarter through May and was up 11% YOY, and orders for nondefense capital goods (excluding aircraft) are up 9.5% YOY through May. While these data don't quite match the 14.8% growth pace of business investment in Q1, they are still strong numbers. The key drivers of capital expenditure, namely overall economic growth, capacity utilization and corporate profitability, all remain supportive of investment. Moreover, businesses feel compelled to invest in productivity-enhancing equipment in order to protect profit margins given the run-up in commodity and energy costs, which have raised production costs, and an ever more competitive global marketplace, which makes it difficult to pass on those higher costs. We continue to expect solid business investment throughout the year, especially as export growth picks up in the second half.

The **trade sector**, which has long been a drag on the domestic economy, continues its gradual improvement, though it takes a little effort to detect. The overall trade deficit remains enormous at \$63.8 billion for May alone. However, sharply higher energy prices are responsible for all of

the deterioration in the trade balance this year. The non-petroleum trade deficit is actually narrowing after being essentially flat since mid-2004 (Figure 7). A weaker trade-weighted dollar, stronger economic growth abroad, and slightly slower US growth are combining to raise export growth and slow imports, leading to trade improvement. In addition, although the dollar value of US energy imports is rising, volumes are beginning to fall. Thus, once energy prices stabilize (and particularly if they decline), we should begin to see the overall trade deficit narrow. That will contribute to GDP growth, and we think will be an important offset to any slowdown in consumer spending in the coming quarters.

In contrast to the fairly good news elsewhere in the economy, **inflation** took a turn for the worse and has clearly accelerated in the first half of the year (Figure 8). Core consumer prices through May are up 3.8% (annualized) over the past three months, 2.9% over the past six months, and 2.4% over the past year. Similarly, the core personal consumption expenditure index, the Fed's preferred gauge of inflation, is up 3.2%, 2.5%, and 2.1% over the past three, six, and 12 months, respectively. When we incorporate food and energy prices into the mix, the picture is even worse, with the overall CPI, for example, up by more than 4% over the past year. With wages picking up, intermediate prices reaccelerating, and commodity and energy prices still rising, it's no wonder that the Federal Reserve remains worried about inflation.

Figure 8: Inflation Moving Higher...

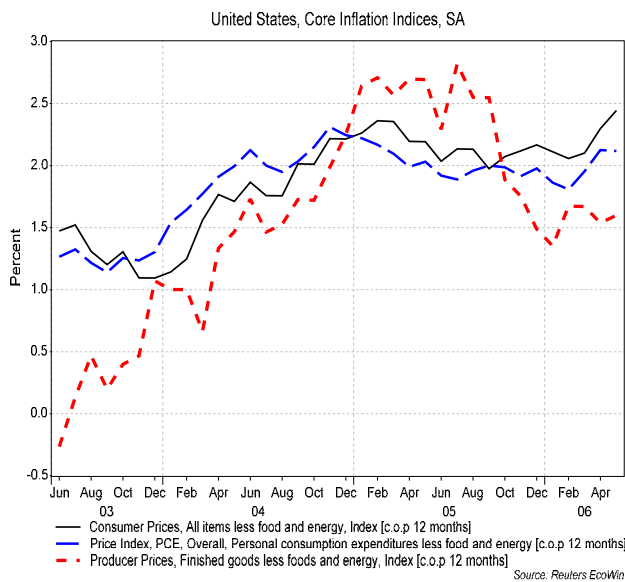
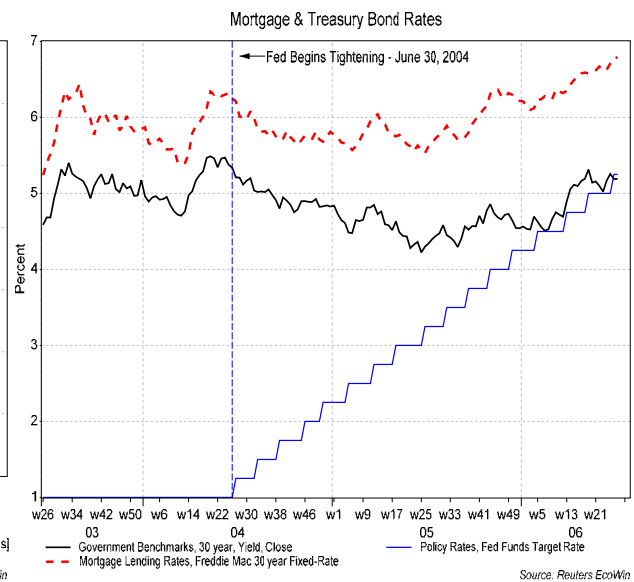


Figure 9: ...Pushing Rates Up



### Market Outlook

The **Federal Reserve** raised rates by 25 bp twice in the second quarter, leaving the fed funds rate at 5.25%, 425 bp higher than when the Fed began tightening in June 2004. This was more than the market had anticipated at the end of Q1, and it led to a broad-based rise in fixed income yields (Figure 9). Moreover, the Federal Open Market Committee (FOMC) has given no indication that it is finished tightening monetary policy. Future rate hikes, if any, will be dependent upon the outlooks for growth and inflation, as shaped by the economic data from one meeting to the next. With inflation now firmly above the Fed's 1-2% "comfort zone" and the

growth outlook still fairly strong, the market is now discounting that the fed funds rate will peak around 5½% in the fall.

It has taken a long time, but the market is finally pricing in a realistic endpoint for this tightening cycle. That's not to say that the FOMC may not have to raise rates above 5½%, since a real interest rate of about 2¼% (5.5% deflated by the 3.25% year-on-year increase in the PCE index) cannot be considered truly restrictive. But it's at least neutral, and if the economy slows modestly in the second half as the Fed and the consensus forecast anticipates, then a final fed funds rate around 5½%, or perhaps a bit higher, seems reasonable.

Long-term **Treasury bond yields** responded to the strength in the economy and the higher-than-expected inflation and fed funds rates by increasing by about 30 bp over the course of the second quarter, although 30-year Treasury rates have dropped by about 8 bp between quarter-end and the time of this writing as tensions in the Middle East have intensified in recent days. Treasury rates across the yield curve remain slightly below the current 5¼% fed funds rate and well below the anticipated peak of about 5½%. This indicates that the market expects the Fed to begin easing policy by the middle of next year. We continue to believe that, although such a scenario is certainly possible, there's a better chance that the Fed either will have to tighten beyond 5½% or will have to leave rates at the peak level for longer than the market anticipates. As a result, we think the risk premiums priced into longer-term Treasuries are inadequate, and we remain cautious on the outlook for Treasuries over the balance of the year. This view has led us to keep the Funds' hedges somewhat tighter than normal. We have realized some profits on those hedges over the course of the quarter, but having fallen into the "safety net" over the past four to five months, we don't want to pay another full "deductible" if rates continue to move higher.

Figure 10: Borrowing Picking Up...

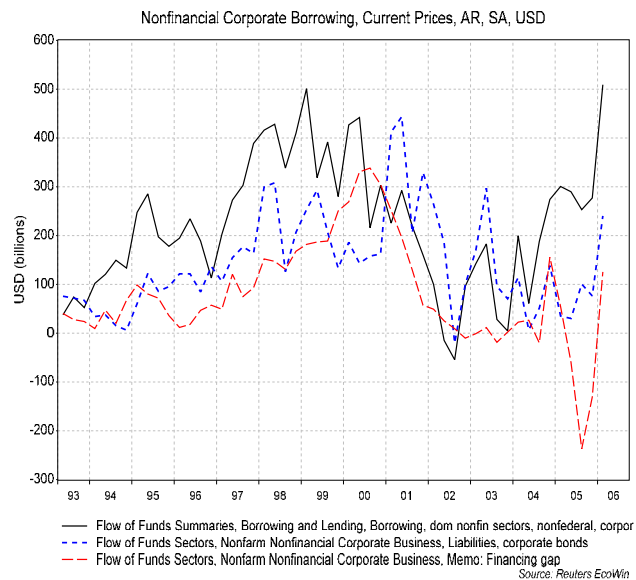
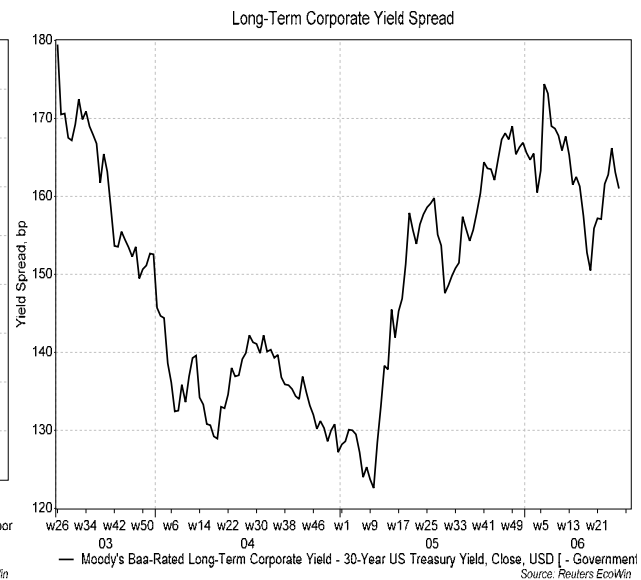


Figure 11: ...But Spreads Broadly Stable



**Credit spreads** moved sideways overall in the second quarter, pushed down by generally solid balance sheets and strong profitability and pushed up by heavy supply and, in the case of preferreds, regulatory uncertainty. Corporate credit health remains excellent overall, although it's

no longer improving, as we have explained in several prior Updates.<sup>2</sup> However, as the economic expansion has lengthened and the period of balance sheet repair has ended, companies have stepped up borrowing (Figure 10), which has led to sizable corporate bond issuance. This has created some spread volatility, albeit within a relatively narrow range (Figure 11).

One area where growth in new issuance has been particularly heavy is in “enhanced” hybrid preferred securities. This issuance came about in the wake of an important change in rating methodology at Moody’s Investor Services early in 2005. Flaherty & Crumrine has discussed the Moody’s changes and the ensuing growth in hybrid issuance at length in other shareholder communications, so we will not repeat that discussion here. Recently, however, the Securities Valuation Office (SVO) of the National Association of Insurance Commissioners (NAIC), the regulatory body charged with setting regulatory capital requirements for insurance company investments, decided to classify certain of these new hybrid preferred securities as common equity, which carry much higher capital charges than preferreds. As a result, some insurance companies have sold from their investment portfolios hybrid preferreds that were or might be reclassified as common equity. This selling – and the uncertainty surrounding the classification criteria used by the SVO in particular and the future participation of insurance investors in the market for “enhanced” preferreds in general – has caused spreads on many hybrid preferreds to widen considerably. Although we believe that the SVO’s classification criteria gradually will become better understood and the NAIC’s regulatory capital requirements probably will be refined to accommodate the enhanced hybrids, the current uncertainty has widened spreads and increased volatility in these issues. As always, we will closely monitor these developments and attempt to take advantage of opportunities as they arise.

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July 13, 2006

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<sup>2</sup> See Flaherty & Crumrine Incorporated, *U.S. Fourth-Quarter Economic Update*, January 2006 and *U.S. First-Quarter Economic Update*, April 2006.