U.S. Second-Quarter Economic Update
July 2007

Summary of Recent Economic Developments

The economy in the second quarter appears to have rebounded from its decidedly sluggish first quarter pace, when weakness in residential investment, inventories and net exports subtracted 0.9%, 1.0% and 0.8%, respectively, from GDP growth. Trade and inventories look much better in Q2, although housing likely will remain quite weak. Economists expect GDP growth of roughly 3% in Q2 followed by 2.6% growth in the second half of the year.[1] In addition to firmer trade and inventories, the composition of growth should be tilted away from personal consumption and toward business investment. We continue to believe that the economy will grow moderately despite headwinds from housing. Inflation is sending mixed signals, with core inflation easing but overall inflation (including food and energy) picking up. Sturdy global economic growth is keeping upward pressure on commodities and thus overall U.S. inflation. With labor markets still fairly tight, it is likely to take some time before inflation cools enough to satisfy the Federal Reserve. As a result, markets now expect that the Fed will leave monetary policy on hold for the balance of the year, and long-term interest rates and credit spreads have moved up in response. This repricing of risk probably has further to run for rates, although still-strong corporate credit fundamentals should limit the amount of credit spread widening.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	**2005:3**	**2005:4**	**2006:1**	**2006:2**	**2006:3**	**2006:4**	**2007:1**	**2007:2**
Real GDP, Chg QoQ (%)	4.2	1.8	5.6	2.6	2.0	2.5	0.7	2.9f
Real Personal Consump Expnds, Chg QoQ (%)	3.9	0.8	4.8	2.6	2.8	4.2	4.2	1.4a
Real Busi Investmt, Eqp & Sftware, Chg QoQ (%)	11.0	2.8	15.6	-1.4	7.7	-4.8	1.7	
Real Residential Investmt, Chg QoQ (%)	7.1	-0.9	-0.3	-11.1	-18.7	-19.8	-15.8	
Corporate Profits, After Tax, Chg YoY (%)	3.7	5.7	21.0	17.4	31.0	21.0	7.2	5.8f
Current Account Balance, Annualized (% of GDP)	-5.5	-6.8	-6.2	-6.2	-6.5	-5.6	-5.7	
Federal Budget, 12-mo Def or Surp (% of GDP)	-2.6	-2.5	-2.5	-2.1	-1.9	-1.6	-1.5	
Unemployment Rate (%)	5.1	4.9	4.7	4.6	4.6	4.5	4.4	4.5
Household Employment, Chg QoQ (000)	745	333	898	706	520	1020	328	-114
Nonfarm Payrolls, Chg QoQ (000)	634	660	755	371	606	531	427	444
Nonfarm Productivity, Chg QoQ (%)	3.7	-0.6	3.5	1.2	-0.5	2.1	1.0	
Capacity Utilization (%)	79.2	81.3	81.4	82.3	82.0	81.6	81.2	81.3a
GDP Price Index, Chg QoQ (%)	3.3	3.3	3.3	3.3	1.9	1.7	4.2	
Consumer Price Index, Chg YoY (%)	4.7	3.4	3.4	4.3	2.1	2.5	2.8	2.7a
CPI ex food & energy, Chg YoY (%)	2.0	2.2	2.1	2.6	2.9	2.6	2.5	2.2a
Nominal Personal Income, Chg YoY (%)	6.2	2.6	7.0	6.2	5.7	5.9	6.1	6.1a
Personal Savings Rate (%)	-0.5	-0.3	-0.4	-1.5	-1.0	-1.1	-0.4	-1.4a
Rate or Spread (End of Quarter)	**2005:3**	**2005:4**	**2006:1**	**2006:2**	**2006:3**	**2006:4**	**2007:1**	**2007:2**
Federal Funds Rate Target (%)	3.75	4.25	4.75	5.25	5.25	5.25	5.25	5.25
3-month LIBOR (%)	4.07	4.54	5.00	5.48	5.37	5.36	5.35	5.36
10-Yr Treasury Note Yield (%)	4.33	4.40	4.86	5.15	4.63	4.70	4.65	5.03
30-Yr Treasury Bond Yield (%)	4.57	4.54	4.90	5.19	4.77	4.81	4.85	5.13
Moody's Baa Long Corp Spread (bp)	158	167	165	163	160	154	155	149
10-Yr Interest Rate Swap Spread (bp)	46.2	51.9	53.0	64.3	52.8	48.7	54.2	67.4

* Figures are either quarterly or, if more frequent, quarterly averages. f = Forecast[1]; a = Actual through May 2007 Source: Reuters EcoWin

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

[1] *The Livingston Survey*, Federal Reserve Bank of Philadelphia, June 7, 2007.

Economic Outlook

Consumer spending, which has outpaced the growth in GDP since mid-2006, is due to take a breather in the second quarter. Although June data is not yet available, real personal consumption expenditures (PCE) through May are up at just a 1.4% annual rate. Unless June PCE is much stronger than expected – and there is no indication of that from June's lackluster Johnson Redbook Index® of same-store retail sales or auto sales – consumer spending is likely to trail overall GDP growth in Q2. We don't take this as a sign that the consumer is tapped out, however. Income growth remains healthy, with personal disposable income up 5.8% (nominal) and 3.4% (real) over the 12 months ending in May (Figure 2). The unemployment rate at 4.5% remains near its cycle low. Paced by higher stock prices, household wealth probably set another record in Q2, despite softer home prices (Figure 3). And credit remains available for most borrowers. Although consumers certainly face some headwinds – notably declining housing wealth and higher food and energy prices – we believe that consumption remains well supported and should continue to post solid gains beyond the Q2 pause.

Figure 2: Income Up, Consumption Slowing

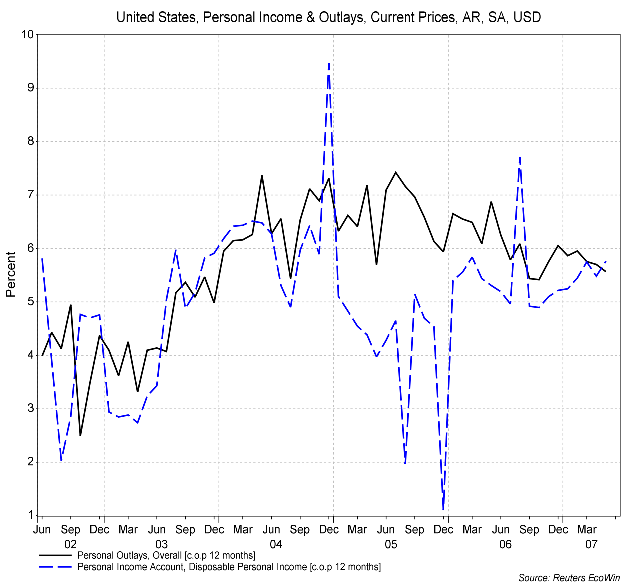
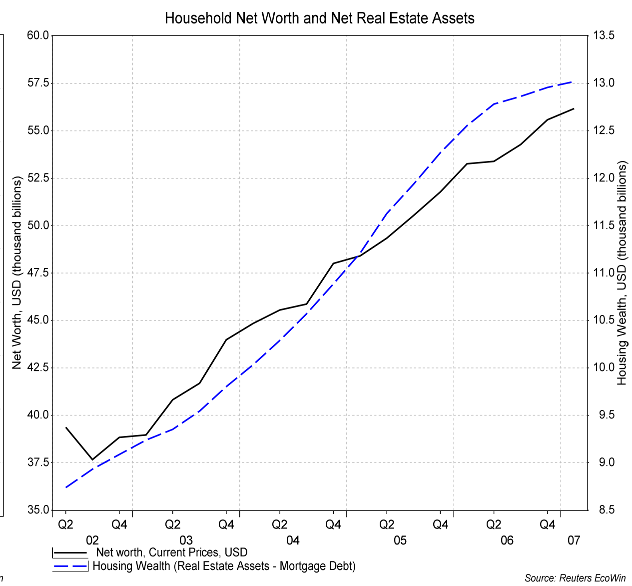


Figure 3: Net Worth Still Rising



Trade surprised us by subtracting 0.8% from GDP growth in Q1, mainly due to rising energy imports, but net exports are likely to add to growth in Q2. Although we only have one month of Q2 data currently available, the April real goods balance improved to -$54.9 billion from an average of -$57.7 billion in Q1. Moreover, both the overall and ex-petroleum trade balances have been improving (albeit erratically) since the beginning of 2006 (Figure 4). Since that time, a negative contribution by trade to GDP growth in one quarter has been followed by a positive contribution in the next quarter, with trade adding to growth over the full period. Admittedly, the improvement in trade has not come so much from faster export growth as from slower import growth in response to the slower growth pace of the U.S. economy (Figure 5). Thus, it's possible that trade improvement will slow if the U.S. economy accelerates over the next several quarters. However, we believe that more rapid growth in the global economy and a weaker U.S. dollar (down about 4½% on a trade-weighted basis over the past year) will continue to support U.S. exports and lead to a shrinking trade deficit overall. Although higher energy prices likely will continue to limit the improvement in trade in Q2, the "two steps forward, one step back" pattern of improving net exports should aid GDP growth this quarter and beyond.

Figure 4: Gradual Trade Improvement

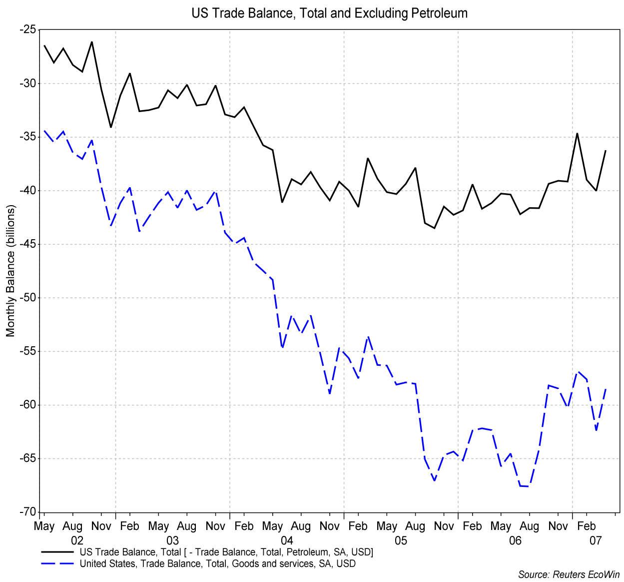


Figure 5: Export Growth Outpacing Imports

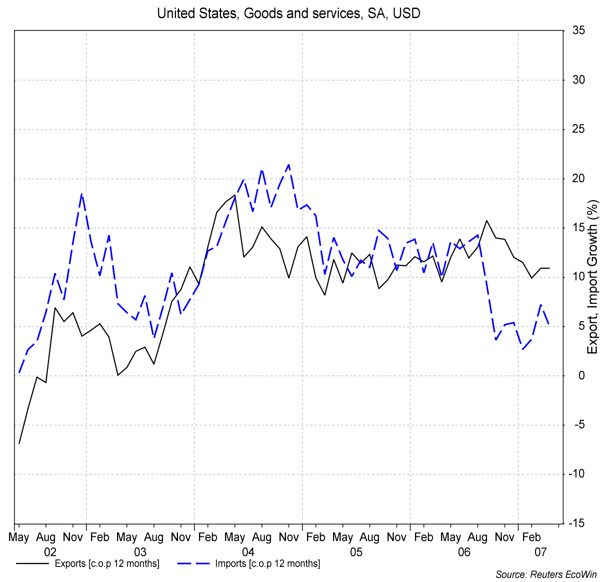


Figure 6: Employment Recovering

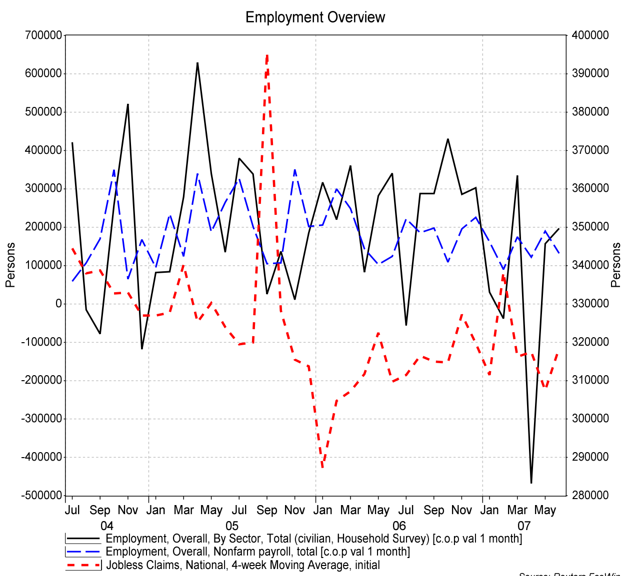
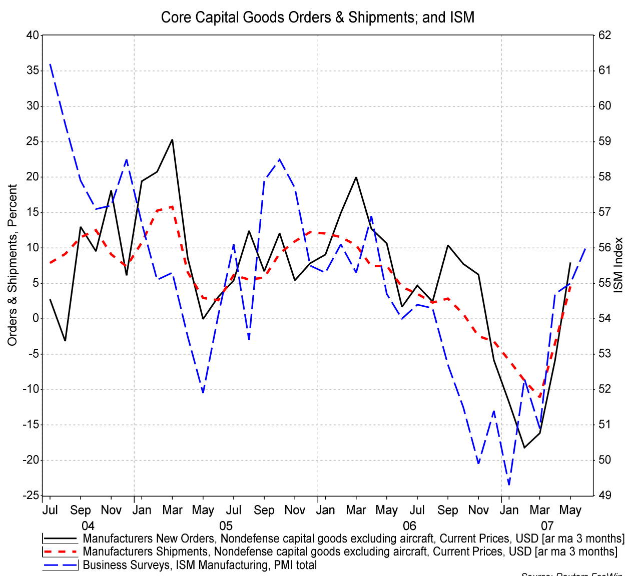


Figure 7: Manufacturing Rebounding



The **labor market** turned in a mixed performance in the second quarter. On the positive side, payroll jobs expanded by 444,000 – slightly more than in Q1. Hourly wages grew at a 4% annual rate during the quarter and are up 3.9% over the past year. The unemployment rate, though 0.1% higher than at the end of Q1, remains near the cycle low at 4.5%. On the negative side, household employment fell by 114,000 jobs over the quarter. The labor participation rate also dipped a bit to 66.1%, and the pool of available labor[2] rose from 11.2 million workers in March to 11.8 million in June. On balance, the payroll survey of employment paints a fairly healthy picture of the labor market, while the household survey indicates some slowing.

We think that the household survey is telling the labor market story a little more accurately than the payroll survey, but we need to look deeper into the quarterly numbers to understand what is going on (Figure 6). The entire reason for the 114,000 contraction in household jobs over the quarter was a massive (-468,000) drop in jobs in April; since then, household jobs have risen slightly more than payroll jobs (+354,000 versus +334,000) in May and June. Given the sluggish economy in Q1, job growth stalled early in Q2, but it seems to have regained its footing later in the quarter as economic activity picked up. This notion is borne out by the initial jobless claims statistics, which rose in April but dropped again in May and June. We will look for confirmation of this trend in future employment reports, but for now at least we will discount the plunge in household jobs in April as a one-off setback. Job growth – and thus income growth – continues to look sturdy.

Business investment should post solid gains in the second quarter after rising by 2.6% in Q1. Nearly all indicators in this sector are pointing strongly upward. Shipments of core capital goods (nondefense capital goods excluding aircraft) through May are up at nearly a 9% annual rate in Q2, while the same measure for new orders is up more than 13% annualized (Figure 7). Business construction spending also remains strong, up 13.9% annualized in Q2 through May. Finally, after nine months of sluggish growth, the manufacturing sector improved notably in Q2, with the Institute for Supply Management (ISM) manufacturing index rising to 56.0 in June from 50.9 in March. (A parallel survey for the service sector rose to 60.7 in June from 52.4 in March; in both surveys a reading over 50 indicates growth.) With both the manufacturing and non-manufacturing surveys pointing upward in June, business investment should be one of the stars of the second-quarter GDP report.

On a weaker note, the **housing sector** continued to shrink in the second-quarter, and it remains the key downside risk in the economic outlook. Residential construction spending is down by 7.1% at an annual rate in the second quarter through May, compared to -17.7% in Q1. Although the pace of the decline in housing may be slowing, we're certainly not yet ready to call the bottom for housing. The sum of new and existing home sales was down 18.0% annualized in Q2 through May (which posted a 6.9 million unit sales pace), compared to +1.5% in Q1. Partly as a result of the slower pace of sales, inventories of new and existing unsold homes rose to 8.6 months' supply in May compared to 7 months in Q1. Prices are starting to fall too: The median prices for new and existing homes were down 0.9% and 2.1%, respectively, over the 12 months ending in May (Figure 8).

Another factor weighing on housing is affordability. Affordability is a function of three major economic variables: Incomes, home prices, and mortgage interest rates (plus incidentals such as property taxes and insurance). Incomes have been rising at a moderate pace in recent years, while long-term interest rates have been relatively steady. Thus, as home price appreciation slowed following the peak in the housing market in mid-2005, affordability began to improve in

[2] The pool of available labor equals the unemployed (those out of work and actively looking for a job) plus "loosely attached" workers (those out of work and not actively looking for a job, but who would work if offered a job). This is a slightly broader measure of labor market slack than unemployment.

line with income growth. However, over the past quarter, interest rates on adjustable rate mortgages have increased by roughly 25 basis points (bp), while 30-year fixed rate mortgages jumped by about 50 bp. As a result, the national Housing Affordability index is falling again (Figure 9). It's hard to expect home sales to pick up much without better affordability. We think income growth will continue around its current pace, but we don't expect any rapid acceleration. We think interest rates will move modestly higher as global economic growth improves over the balance of the year (more on that in the *Market Outlook* section below). That leaves home prices as the primary means of near-term improvement for housing affordability. With nearly 5 million homes in unsold inventory, home prices are likely to fall further and housing is likely to remain a drag on GDP for at least another year or so.

Figure 8: Rising Home Inventories, Lower Prices

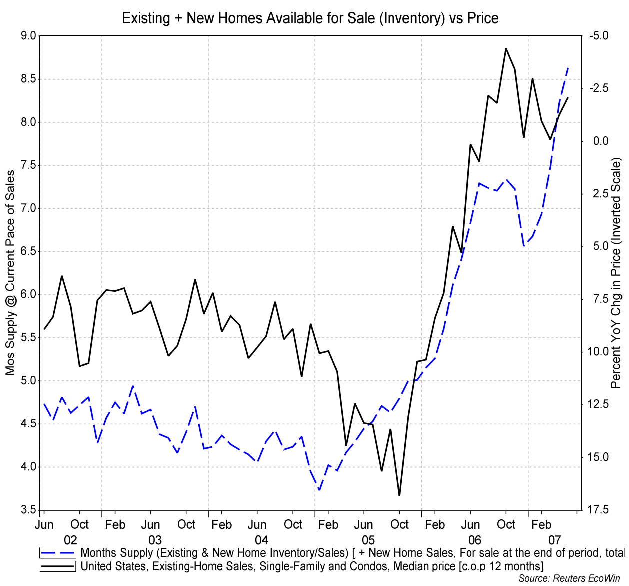
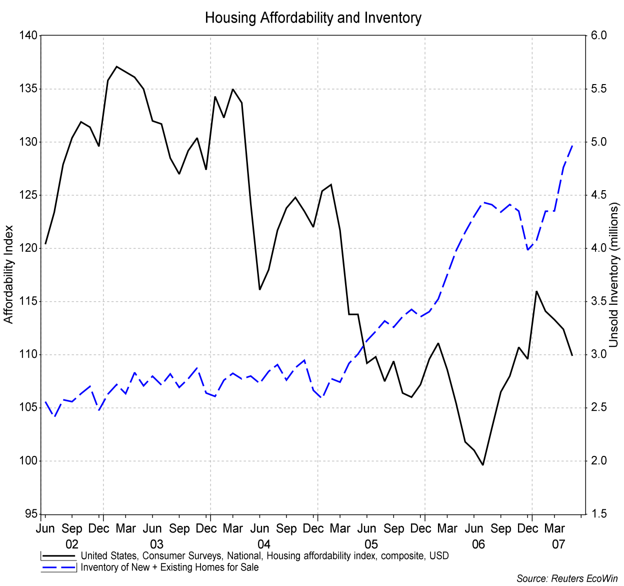


Figure 9: Declining Home Affordability



The main question mark for the economy is whether the adjustment in housing occurs quickly (rapidly falling home prices, spillover to the broader economy, and possibly recession) or more gradually (moderately lower home prices, little spillover to the broader economy, and continued – albeit moderate – economic growth). As we have argued in the past, we believe that the latter scenario is more likely, although we acknowledge the risk of the former. We believe that the rebounds in manufacturing and trade should be sufficient to sustain incomes through a relatively brief lull in consumption and that overall growth, while below the 3-4% pace of growth in 2004-06, will continue to be respectable. In fact, in the absence of the problems in the housing market, we would be quite bullish on the economy and bearish on interest rates, but we think that ongoing drag from the housing market will keep the economy in its current Goldilocks state, growing neither too quickly nor too slowly.

Steady monetary policy from the Federal Reserve and moderate economic growth led to somewhat better **inflation** news in the second quarter than the first, although both we and the Fed believe it's too soon to declare victory just yet. Core inflation indicators all fell in the three months ending in May compared to the prior three-month period: Producer Prices (PPI) excluding food and energy rose 1.7% versus 3.1% in the earlier period; Consumer Prices (CPI) excluding food and energy are up 1.9% compared to 2.0%; and the core Personal Consumption

Expenditure (PCE) deflator rose by 1.6% compared to 2.1%. On a year-over-year basis through May, core PPI, CPI, and PCE are up 1.6%, 2.2%, and 1.9%, respectively (Figure 10). All of these indices are either below or close to the upper end of the Fed's presumed 1-2% "comfort zone" for inflation, and they are significantly better than last quarter.

Figure 10: Lower Core Inflation…

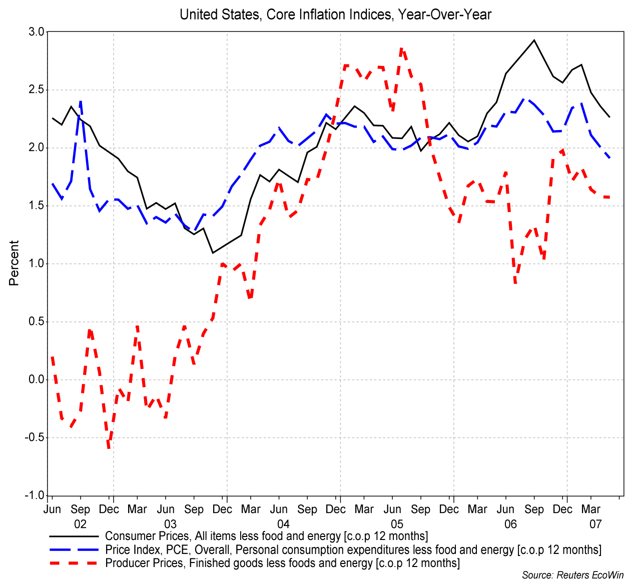
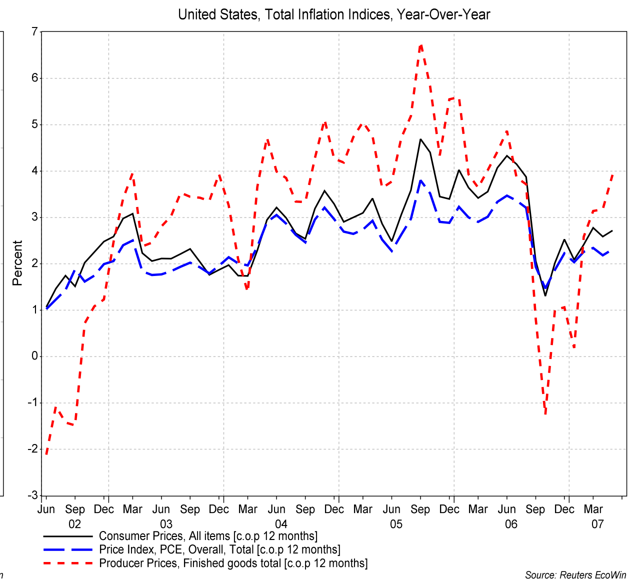


Figure 11: …But Higher Overall Inflation



This is clearly good news for the Fed. Nonetheless, we remain cautious about extending these near-term trends very far into the future. First, after a year of relatively sluggish economic growth, core inflation has come down only modestly – and growth is poised to pick up again, not only in the U.S. but globally. Second, although core inflation indices have moderated, overall inflation (including food and energy) has not. Over the past year, overall PPI, CPI, and PCE inflation are up 3.9%, 2.7% and 2.3%, respectively – all higher than at the beginning of the year (Figure 11).

Economists focus on core inflation because it has been a better barometer of overall inflation; food and energy prices are much more volatile than core prices – they are much more likely to go up *and down* than other goods prices. However, when food and energy prices are rising consistently faster than core inflation, as they are today, it is harder to wave them off. More to the point, if businesses and consumers get used to the idea of persistently rising food and energy prices, it is easier for businesses to pass along those price increases and for consumers to accept them, and the Fed does need to worry about that. Having sounded the alarm, we note that inflation expectations and TIPS breakevens[3] have increased only slightly in recent months. It's clear that consumers and investors are not terribly concerned about accelerating inflation. We are not either, but our confidence on inflation stems more from the view that the Fed will leave monetary policy on hold (or possibly even tighten further) to keep inflation from accelerating than from the notion that inflation will fall in response to sluggish economic growth.

[3] The TIPS breakeven is the difference between the "nominal" yield on standard fixed-rate Treasury securities and the "real" yield on Treasury Inflation-Protected Securities (TIPS) of equal maturity; it represents the market's expectation of consumer price inflation to that maturity date.

Market Outlook

As it has since June 2006, the Federal Open Market Committee (FOMC) in the second quarter left the fed funds rate at 5.25% and retained an "inflation-risk" bias in its statements on monetary policy. Unlike recent quarters, however, long-term Treasury rates moved higher, rising by about 40 bp in Q2 – and by a further 20 bp so far in July. With growth prospects improving, the market has been forced to abandon its view that Fed easing is around the corner. Market prices now imply that the Fed will leave monetary policy on hold into 2008. Long-term rates increased while short-term rates were unchanged, causing the yield curve to steepen. Term premiums remain unusually low, however: The yield on the thirty-year Treasury bond (even after the backup in yields through July 6) is still only equal to the fed funds rate at 5.25%. That compares with an average yield spread of about 90 bp (long Treasury yields higher than fed funds) from mid-1995 to the beginning of 2000, a period when monetary policy was relatively stable (fed funds ranged from 4.75% to 6% – see Figure 12). We would expect term premiums to be lower now for a number of reasons – in particular, the credibility of monetary policy and global savings are much higher now – but we still expect them to be *positive*. As a result, we continue to expect that long-term rates will move modestly higher over the coming quarter.

Figure 12: Curve Much Flatter than Normal

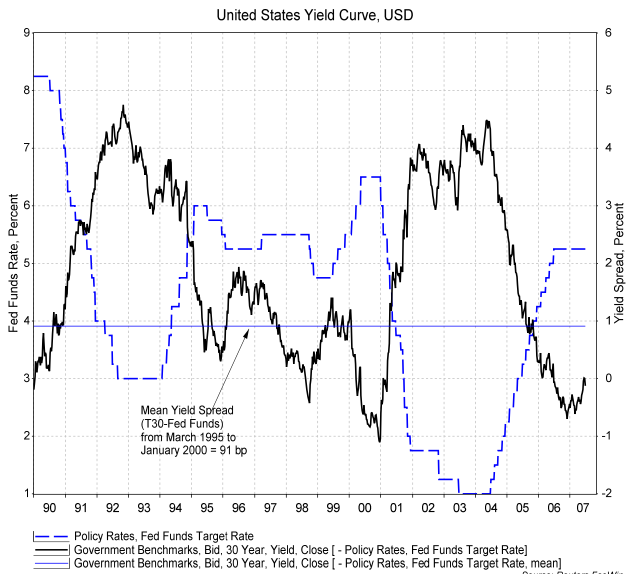
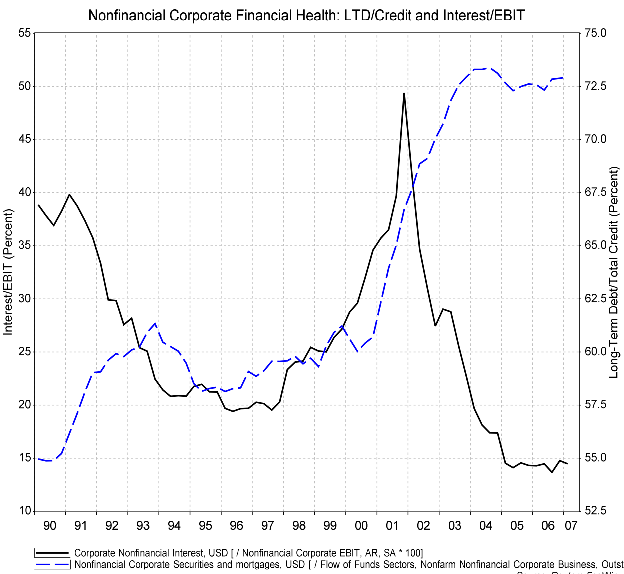


Figure 13: Credit Metrics Still Strong



Along with stronger growth prospects and higher yields, credit spreads mostly widened in the second quarter. Ten-year swap spreads widened by 13 bp, while the CDX North American Investment Grade five-year credit default swap index widened by 4 bp versus swaps and about 14 bp versus Treasuries. In contrast, the Moody's Baa-rated long corporate spread narrowed by 6 bp, although that probably reflects changes in the composition of the index rather than true spread tightening. Lower-grade credits and particularly subprime mortgages performed substantially worse.

Overall, the market seems to be in the process of reassessing risk – duration risk in the case of interest rates and credit risk in the case of credit instruments. We think this process has further to run, especially in rates, but we do not foresee major widening of credit spreads. Although they are no longer improving overall, corporate credit metrics generally remain very strong (Figure

13). Moreover, while not without risk, the economy remains on sound footing, and corporate profits should continue to rise. However, with growth abroad improving more rapidly than in the U.S., the trade deficit is likely to shrink, which in turn will reduce capital flows into the U.S. and may put some upward pressure on credit spreads. On balance, as long as the U.S. economy can avoid recession, we believe that investment grade corporates will perform reasonably well, but we think that credit spreads have already seen their lows for the year.

We think the biggest near-term risk to investment grade bonds and preferreds remains leveraged buyout (LBO) risk. As LBO funds have increased in size, they have the ability – in fact, the mandate – to buy more and larger companies, saddling them with a sizable amount of new debt in the process. Whether or not these deals work out in the long run, they are decidedly bad for existing debt and preferred holders in the short run. As managers, we are spending a lot of time trying to assess LBO risk in the securities we currently own or might seek to purchase in the future.[4]

These investment views are predicated on our expectation that the economy will grow moderately and that inflation will continue to be the Fed's primary concern over the rest of the year. Of course, there are risks to that outlook. Growth could be stronger and inflation higher than we expect; while that probably would not be credit-negative in the short run, it could be in the long run if the Fed were forced to respond to it with sharply higher interest rates, which in turn would increase the risk of an economic hard-landing.[5] On the other hand, weakness in the housing market could infect the consumer and tip the economy into recession, which would increase default risk and almost certainly widen credit spreads. We believe that both of these scenarios are lower probability than the moderate growth scenario, but we recognize that each (or some variation of them) are possible. We will do our best to navigate the Funds through these uncertain waters.

Brad Stone
Flaherty & Crumrine Incorporated
July 6, 2007

[4] For a more complete discussion of LBO risk and its impact on the Funds, please see the FAQ section of the Funds' web sites, www.preferredincome.com and www.fcclaymore.com.

[5] Recall that the Funds' hedging strategy is designed to provide a large degree of protection against a substantial increase in long-term interest rates. Thus, we're more concerned about rising credit risk than rising long-term interest rates in this scenario.