Third-Quarter U.S. Economic Update
October 2007

Summary of Recent Economic Developments

There is an unusually high degree of uncertainty in the economic outlook currently. Pointing to further weakness, the housing market is experiencing another leg down, sparking credit problems well beyond the subprime mortgage market where they began. However, other indicators point to sustained growth, and 3rd Quarter GDP forecasts of around 3% are reasonably strong. Personal income and consumption remain sturdy. Foreign trade is now adding to growth after years of sapping it. Businesses seem to have responded to the uncertainty by trimming new hiring yet generally avoiding layoffs, and they have taken a similarly cautious approach to investment. On balance, these responses by businesses look more like a mid-cycle pause than a prelude to recession. The inflation outlook remains mixed, with year-on-year core inflation rates falling but quarterly rates reaccelerating. The Federal Reserve helped return credit conditions to a more neutral setting with a 50 basis point (bp) cut in the federal funds rate. Credit markets remain somewhat shaken, but fundamental credit quality – with the notable exception of certain segments of the mortgage market – remains healthy.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	**2005:4**	**2006:1**	**2006:2**	**2006:3**	**2006:4**	**2007:1**	**2007:2**	**2007:3**
Real GDP, Chg QoQ (%)	1.2	4.8	2.4	1.1	2.1	0.6	3.8	2.9f
Real Personal Consump Expnds, Chg QoQ (%)	1.2	4.4	2.4	2.8	3.9	3.7	1.4	4.1a
Real Busi Investmt, Eqp & Sftware, Chg QoQ (%)	3.1	13.0	-0.1	2.9	-4.9	0.3	4.7	
Real Residential Investmt, Chg QoQ (%)	0.5	-0.7	-11.7	-20.4	-17.2	-16.3	-11.8	
Corporate Profits, After Tax, Chg YoY (%)	4.1	9.6	10.4	21.3	8.2	1.2	3.3	5.8f
Current Account Balance, Annualized (% of GDP)	-6.8	-6.2	-6.3	-6.6	-5.6	-5.8	-5.5	
Federal Budget, 12-mo Def or Surp (% of GDP)	-2.5	-2.5	-2.1	-1.9	-1.6	-1.5	-1.2	
Unemployment Rate (%)	4.9	4.7	4.6	4.6	4.5	4.4	4.5	4.7
Household Employment, Chg QoQ (000)	333	898	706	520	1020	328	-114	117
Nonfarm Payrolls, Chg QoQ (000)	660	755	371	606	531	427	379	292
Nonfarm Productivity, Chg QoQ (%)	-1.4	2.5	0.8	-1.6	1.8	0.7	2.6	
Capacity Utilization (%)	81.3	81.4	82.3	82.0	81.6	81.4	81.8	82.2a
GDP Price Index, Chg QoQ (%)	3.5	3.4	3.5	2.4	1.7	4.2	2.6	
Consumer Price Index, Chg YoY (%)	3.4	3.4	4.3	2.1	2.5	2.8	2.7	2.1a
CPI ex food & energy, Chg YoY (%)	2.2	2.1	2.6	2.9	2.6	2.5	2.2	1.9a
Nominal Personal Income, Chg YoY (%)	3.4	7.0	6.7	5.8	6.1	6.8	6.3	5.5a
Personal Savings Rate (%)	1.0	0.8	0.5	0.4	0.3	1.5	0.6	0.7a
Rate or Spread (End of Quarter)	**2005:4**	**2006:1**	**2006:2**	**2006:3**	**2006:4**	**2007:1**	**2007:2**	**2007:3**
Federal Funds Rate Target (%)	4.25	4.75	5.25	5.25	5.25	5.25	5.25	4.75
3-month LIBOR (%)	4.54	5.00	5.48	5.37	5.36	5.35	5.36	5.23
10-Yr Treasury Note Yield (%)	4.40	4.86	5.15	4.63	4.70	4.65	5.03	4.59
30-Yr Treasury Bond Yield (%)	4.54	4.90	5.19	4.77	4.81	4.85	5.13	4.84
Moody's Baa Long Corp Spread (bp)	167	165	163	160	154	155	149	175
10-Yr Interest Rate Swap Spread (bp)	55.0	54.0	59.0	53.8	47.8	52.8	63.8	62.5

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

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

Economic Outlook

We'll begin our overview of the U.S. economy with its weakest sector: **Housing**. In one of the more colorful (and accurate) quotes of the year, the CEO of homebuilder D.H. Horton said that the housing market in 2007 "is going to suck, all 12 months." Although the year is not yet over, we are not going out on a limb to say that he is going be proven right. Through August, new and existing home sales nationally have dropped by 14%, while housing starts are down more than 19% over the past year (Figure 2). Meanwhile, inventories of unsold homes (new plus existing) have surged by 28%, pushing combined supply to nearly 10 months at the current pace of sales. To make matters worse, mortgage rates recently have increased, while lenders have tightened mortgage lending standards. Both are likely to further reduce demand for homes. The unsurprising result of higher supply and lower demand is lower prices. Sure enough, home price indices now show that prices are falling (Figure 3), although some markets have been much harder hit than others.

Figure 2: Home Sales and Starts Falling

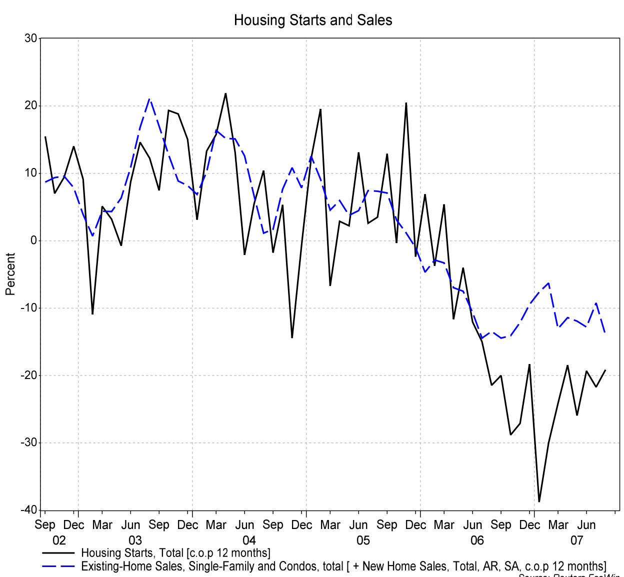
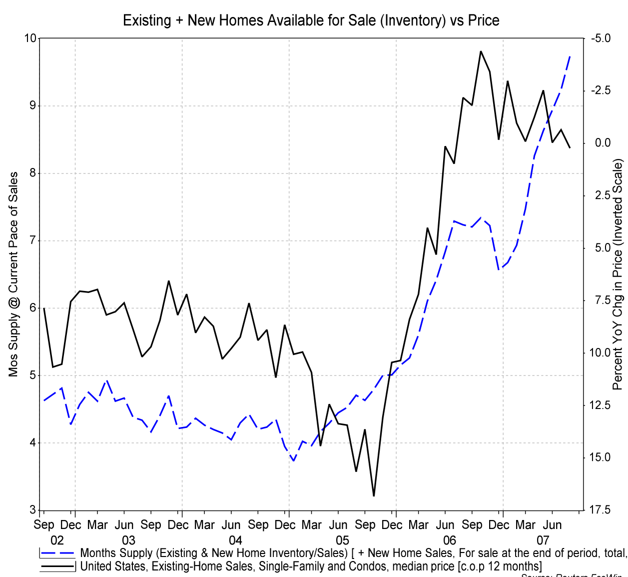


Figure 3: Inventories Up, Prices Down



Houses are important assets for consumers, and there is little doubt that lower housing wealth will reduce consumption from what it would have been without the slump in home prices. But will the recession in housing push the overall economy into recession? In the following paragraphs, we argue that the answer is no. Housing is important, but it represents only 4¼ percent of real GDP. Perhaps more importantly, homes are not an easily traded asset. They are expensive to buy and sell, with significant transaction costs and numerous contingencies to closing. They are impossible to "short," since one can't sell a home without first owning it. And even if a current homeowner decides to sell, he or she needs to live somewhere else.[1] As a result, the correction in the housing market is likely to be an extended process, with prices falling moderately for several years, rather than an abrupt bust. As prices fall and incomes grow, housing affordability will improve, and the housing market will first slow its descent, then stabilize, and eventually begin to grow again. If we are right in our expectation of a protracted

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[1] Of course, the homeowner may move into a rental unit, but someone needs to own that. A home can't be "borrowed" from an owner the way a stock or bond can.

but comparatively "slow-motion" housing correction, the overall economy should be strong and flexible enough to avoid recession, assuming no major fiscal or monetary policy errors from the federal government. We now turn to an assessment of the other major sectors of the economy.

The U.S. **consumer** is a resilient creature, and while its spirits may have cooled, it remains healthy. There is no doubt that consumers are worried: Consumer confidence has fallen substantially (Figure 4). Fortunately, that concern does not seem to extend to consumption, which has remained sturdy. Real personal consumption expenditures are up 4.1% while nominal core retail sales are up 5.7% in the 3rd quarter through August (Figure 5). The likely explanation for such strong consumption is that income growth remains strong as well. Personal income grew by 6.2% over the past year and 5.5% in the 3rd quarter through August. These gains were aided by firmer average hourly earnings, which are up 4.1% over the year ending in September, as well as continued growth in employment. If consumers have jobs and their incomes are growing, they will continue to spend despite weaker home prices – probably at a slower pace than otherwise, but they will still spend.

Figure 4: Consumer Confidence Sliding…

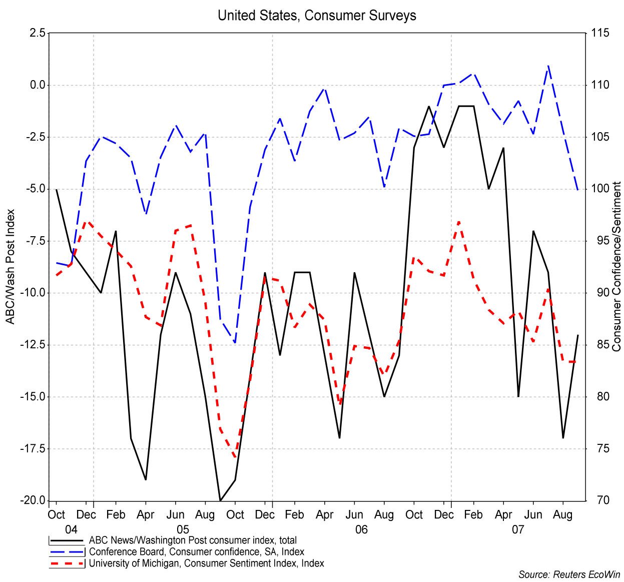
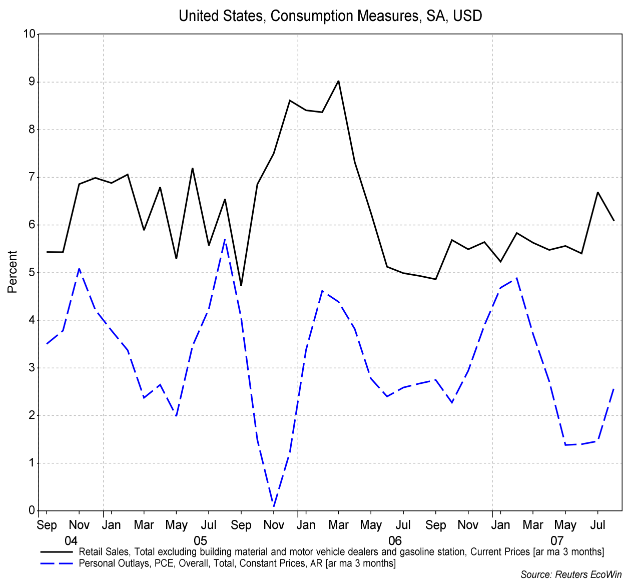


Figure 5: …But Consumption Sturdy



One means of financing growth in consumption that does look to be shrinking is home equity borrowing. During the period of easy monetary policy from 2001-05, consumers borrowed heavily against their homes, presumably to support consumption (Figure 6). This "home equity withdrawal" (HEW) slowed considerably as interest rates increased, home prices deteriorated, and lending standards tightened – but it has remained positive. Assuming that mortgage borrowing returns to a more normal pattern wherein homeowners gradually add to (rather than extract) home equity, this will take some steam out of consumption. However, this source of stimulus has already declined significantly. HEW was $54 billion (0.36% of GDP) at an average annual rate over the past three quarters, down from an average of more than 2% of GDP from 2003 to early 2006. Over that same period, real personal consumption moderated from 3.5-4% to about 3% more recently, suggesting that reduced home equity borrowing helped to slow spending, but did not result in a collapse in spending. With HEW already down considerably, we don't see enough remaining drag from that source to push consumption to recessionary levels.

Figure 6: Home Borrowing Normalizing

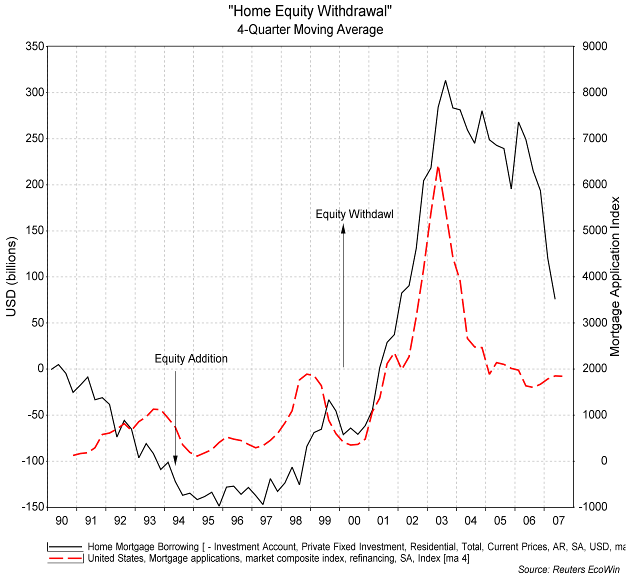


Figure 7: Employment Growth Slows

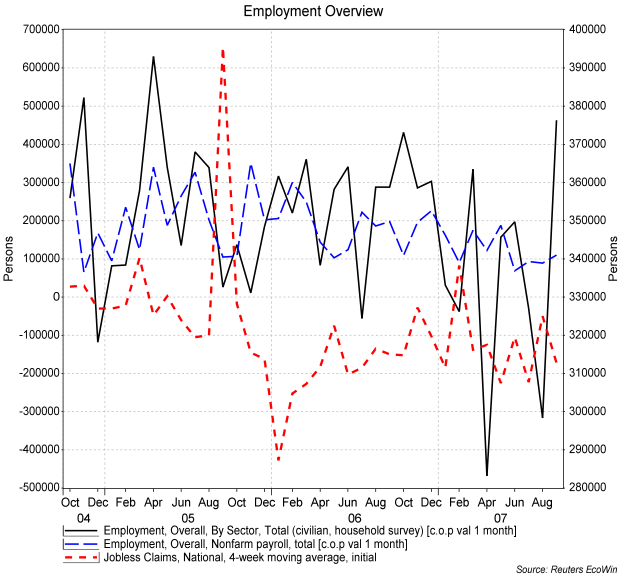


Figure 8: No Surge in Jobless Claims

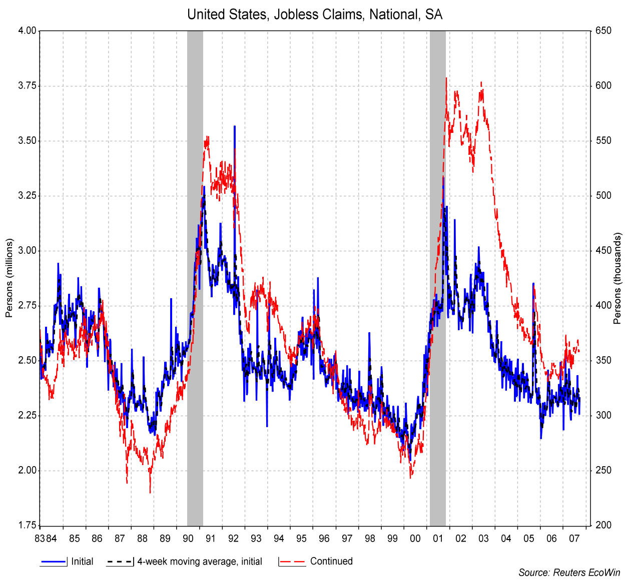
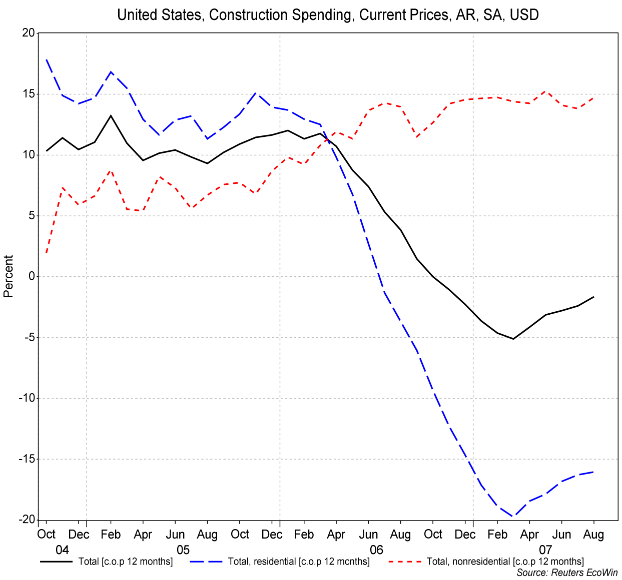


Figure 9: Construction Spending Mixed



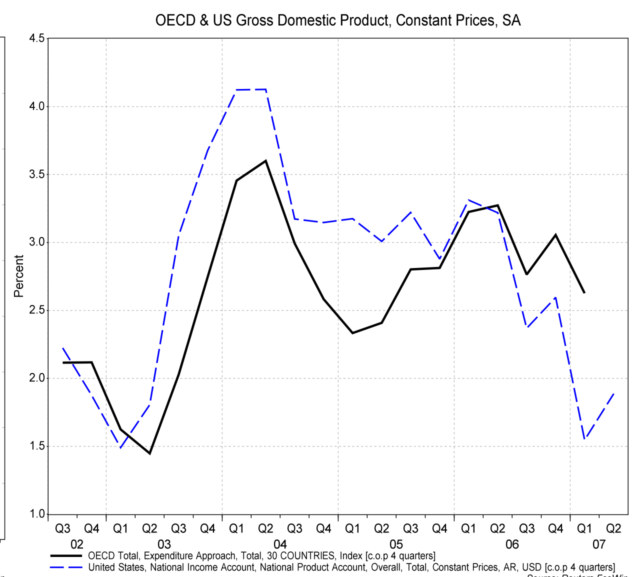
If the key to consumption is income, then the key to income is **employment** – and there the data is mixed. On the negative side, job growth has clearly slowed over the past few months. Nonfarm payroll jobs expanded by 292,000 in the third quarter, down from an average of about 400,000 jobs per quarter in the first half of 2007. The household survey of employment was weaker still, rising by only 117,000 jobs in Q3 and barely offsetting losses of 114,000 in Q2 (Figure 7). As a result, the unemployment rate finished Q3 at 4.7%, up from 4.5% at the end of the second quarter. Finally, help wanted advertising, either through traditional print media or via its major internet competitor, Monster.com, has slowed in recent months. On the other hand, initial and continuing jobless claims remain close to their lows for the cycle and have shown none of the upward drift typically seen before a recession (Figure 8; shading indicates recession). In addition, the ISM employment indices continue to point to modest employment growth. In fact, the readings of 51.7 for the manufacturing survey and 52.7 for the non-manufacturing (i.e. service) survey are slightly above their six-month averages. As a result, we believe that the job market data points more to a mid-cycle pause rather than a prelude to recession.

Business investment was probably tepid in the third quarter as businesses held back on investments in light of credit market turmoil and the swoon in stock prices in August. Shipments of manufactured goods rose by 2.7% at an annual rate in Q3 through August, while "core" durable goods shipments (nondefense capital goods excluding aircraft) rose by 2.5% on the same basis. These are not terrible numbers, but they do suggest that business investment was not a huge contributor to GDP in the third quarter. More positively, commercial construction expenditures remain strong – up 13.3% at an annual rate in Q3 through August. That wasn't quite enough to offset weakness in housing construction (-15.3%), however, and it leaves overall construction expenditures down 1% in the quarter through August (Figure 9).

Although there is little data available yet for the third quarter, the **trade balance** looks set to continue its improvement. The July real goods deficit narrowed to -\$53.5 billion, compared to an average of -\$55.2 billion in Q2 and -\$59.2 billion a year ago (Figure 10). More current data suggest that the trend in trade improvement continued over the balance of the quarter. The ISM manufacturing survey shows still-strong exports and slowing imports through September. New export orders averaged 56.0 in Q3, down only slightly from an exceptionally strong reading of 57.3 in Q2. Meanwhile, import orders slowed to an average of 53.3 from 56.7 in Q2. This swing toward a narrower deficit is being reinforced by a weaker U.S. dollar and comparatively strong growth abroad. The dollar fell by 6.0% on a trade-weighted basis in 2007 through the end of September, and it is down by an even-larger 8.6% against major currencies. And while U.S. GDP grew by just 1.9% year-on-year through Q2 and 1.5% through Q1, OECD[2] growth was a substantially-higher 2.6% in the year ending March 2007, the most recent data available (Figure 11).

Figure 10: Real Trade Balance Improving

Figure 11: OECD Growth Outpacing U.S.



[2] The Organization for Economic Cooperation and Development; it is comprised of 30 countries in the Americas, Europe, Asia and Australia.

Inflation turned in a favorable if somewhat mixed performance in the third quarter, generally slowing on a year-over-year basis, but strengthening slightly on a quarter-over-quarter basis (Figures 12 and 13). Overall Personal Consumption Expenditure (PCE) and Consumer Price Index (CPI) inflation fell to 1.8% and 1.9% year-on-year as of the end of August, respectively. Core (i.e. ex food and energy) PCE and CPI inflation also declined to 1.8% and 2.1% year-on-year, respectively. Compared to the prior three-month period, however, core PCE rose by 1.5% while core CPI rose by 2.4%. These three-month figures are hardly alarming, but the fact that they are rising suggests that inflation risks remain with us. We continue to believe that global economic strength and a weak U.S. dollar will maintain upward pressure on commodity and energy prices while relatively high capacity utilization and low unemployment will keep underlying pressure on domestic inflation.[3] We don't expect inflation to surge, but we do think inflation will be stickier than many market participants currently expect. Of course, that has implications for Federal Reserve monetary policy, which we discuss below.

Figure 12: Inflation Improving YoY…

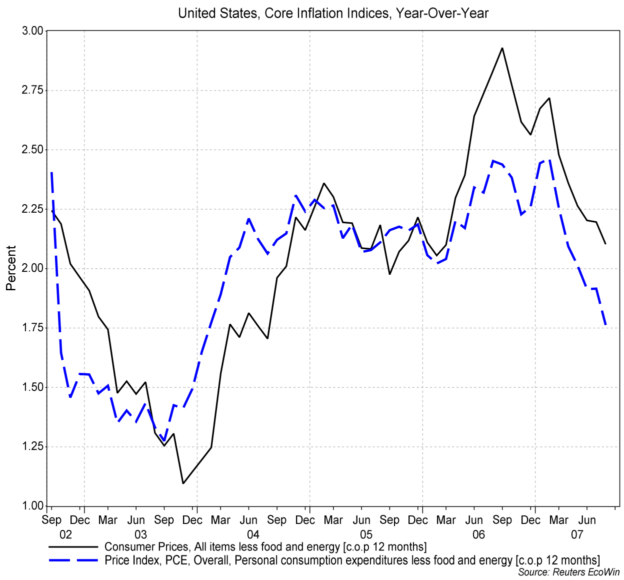
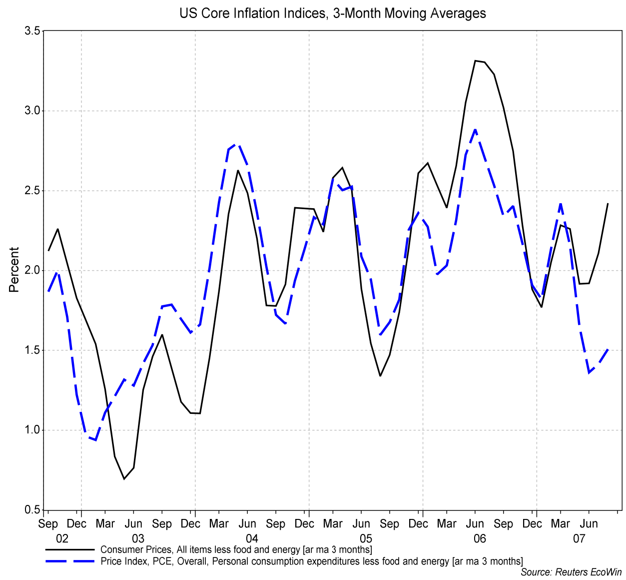


Figure 13: …But Accelerating Recently



Overall, then, the economy looks to have performed pretty well in the third quarter, with GDP growth of about 3%. This is particularly impressive given the headwinds presented by financial markets in August and September. As always, the outlook is murkier. The housing correction has reaccelerated and the impact of higher financing costs due to credit market turbulence has yet to be felt. While easier monetary policy no doubt will help blunt their impact, both will slow the economy. However, we do not believe those headwinds will be strong enough to push the economy into recession. A flexible labor force should keep employment gains in place, supporting income and consumption. Trade improvement looks as though it has much further to run. Finally, business investment should pick up as exports grow, business confidence recovers and credit markets normalize. In combination, these sectors of the U.S. economy should be able to overcome the weakness in the much-smaller housing market.

[3] See "U.S. Second-Quarter Economic Update," Flaherty & Crumrine Incorporated, July 2007.

Market Outlook

The third quarter was an eventful – and often painful – one for fixed-income investors. The quarter began with long-term rates continuing to increase as evidence of strong GDP growth in the second quarter became increasingly apparent. (GDP for the second quarter eventually posted a well-above-trend growth rate of 3.8 percent.) However, rising mortgage delinquencies and defaults and declining home sales quickly prompted fears of sizable credit losses at banks, broker/dealers, insurance companies, and other financial institutions. Limited disclosure regarding the holdings of subprime and Alt-A mortgage investments – both in whole-loan form and more importantly in the form of structured securities such as residential mortgage-backed securities (RMBS) and collateralized debt obligations (CDOs) – by those institutions only made matters worse. Investors, fearing that financial institutions would be subject to sizable losses on mortgage securities, fled corporate and preferred issues in general and financial issues in particular for the safety of Treasuries. At the peak of the credit market fears in early September, 30-year Treasuries yielded 4.64% while 2-year Treasuries yielded just 3.85%.

Credit spreads exploded. The CDX North American Investment Grade five-year credit default swap spread, which ended the second quarter at 40.1 bp, hit a wide of 82.4 bp on August 3 and ended the third quarter some 22 bp wider at 62.2 bp. The higher volatility (HVOL) credit index performed even worse, starting the quarter at 101.5 bp, widening to 194.4 bp, and ending the quarter at 162.6 bp. New issuance of corporate and preferred securities virtually ground to a halt.

Figure 14: ABS CP Market Turns to Bank Lines

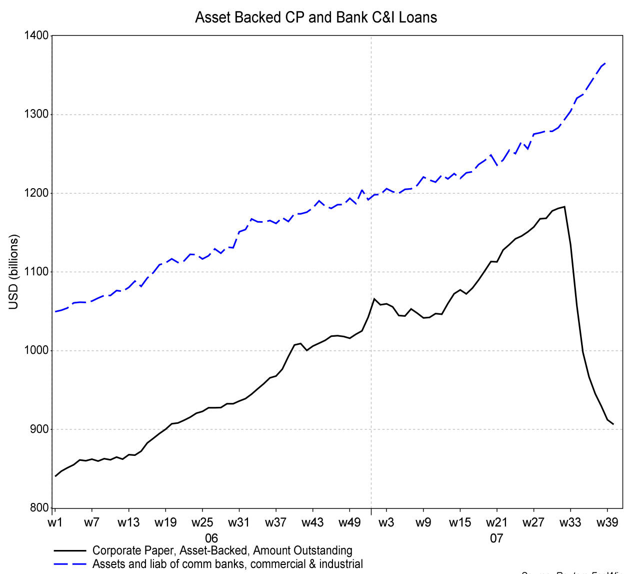
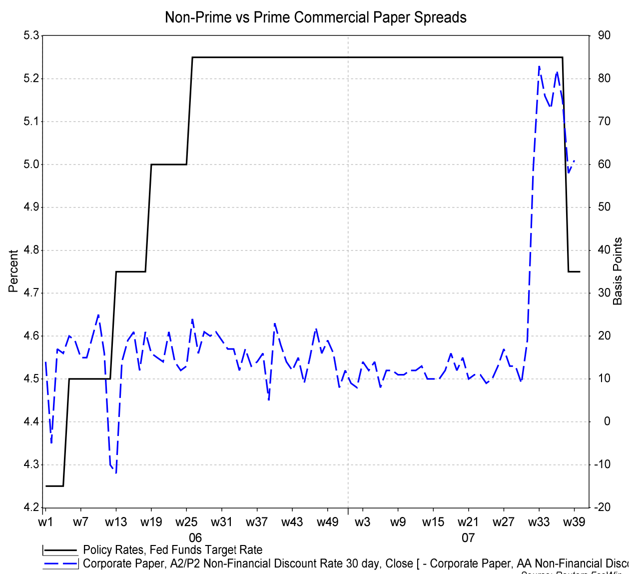


Figure 15: CP Spreads Show Strains



Perhaps most worryingly from the Fed's perspective, the market for commercial paper – especially asset-backed commercial paper – experienced a severe contraction along with higher borrowing rates (Figures 14 and 15). Many commercial paper "conduits" that were routinely used to finance longer-term assets such as mortgages, credit-card receivables, auto loans and the like found it more expensive or even impossible to roll over their obligations. While the asset quality of the issues backing these conduits generally remained sound, investors were not willing to take any chances and headed for the exits. In most cases, that forced issuers to tap backup financing facilities provided by banks, expanding bank balance sheets at a time when money markets were already stressed. In other cases, commercial paper investors were unable to redeem their holdings and had their maturities involuntarily extended, which further reduced the risk appetite of money market investors.

Leverage compounded these problems, as it always does. In recent years, leverage has gradually permeated the financial markets, from the growth of hedge funds and leveraged buyouts to the creation of structured investment vehicles (SIVs), CDOs, and other leveraged financial products. All of these rely on borrowed funds that are subject to crises of confidence. When the crisis arrived, liquidity dried up, borrowing costs increased, and leveraged investors were forced to unwind positions. That put downward pressure on prices, which prompted further losses and additional liquidation. Prices entered a downward spiral until valuations reached compellingly cheap levels, at which point new investors arrived to take advantage of the depressed prices. Of course, a good chunk of the leveraged investors' capital evaporated in the process.

Faced with this seizing up of credit markets, the Federal Reserve eased monetary policy in two steps over the quarter. On August 17, the Fed Board of Governors reduced the discount rate by 50 bp to 5.75% and extended the maximum term for discount window borrowings to 30 days in an effort to reduce elevated short-term market rates and enhance bank liquidity. The Federal Open Market Committee (FOMC) also issued a statement indicating that it was "prepared to act as needed to mitigate the adverse effects on the economy arising form the disruptions in financial markets." This effectively reversed the FOMC's prior inflation bias and set the stage for easing. With credit market conditions improving but still strained, on September 18 the Fed reduced both the fed funds rate and the discount rate by 50 bp to 4.75% and 5.25%, respectively, and the FOMC formally dropped its inflation bias.

Despite our longer-term inflation concerns, we think the Fed did the right thing. Fed Vice Chairman Kohn summed up the Fed's thinking in a recent speech, and we can find no fault with it. He said, "The deterioration in actual and expected financial market conditions between the August and September FOMC meetings changed our view of appropriate monetary policy. Whatever policy path previously seemed appropriate to support sustainable growth and price stability looked too high once credit conditions tightened substantially." Later in the speech he explains that the FOMC "had been holding the federal funds rate at 5-1/4 percent, well above the expected rate of inflation, in part to compensate for what had been very narrow yield spreads and readily available credit." As credit spreads widened, tightening monetary conditions in the absence of any offsetting change in monetary policy, the Fed was able to reduce the funds rate without significantly increasing the risk of inflation. Indeed, benchmark money market rates such as LIBOR are little changed versus three months ago despite the Fed's move. For example, 3-month LIBOR is now around 5.25% compared to 5.36% at the end of Q2, meaning that only about one-fifth of the Fed's 50 bp cut in the fed funds rate made its way into LIBOR rates.

The FOMC's stated intention is to "help forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets and to promote moderate growth over time." Market participants apparently take this to mean that future rate cuts are forthcoming. Futures markets imply roughly another 50 bp of easing by the Fed by spring of 2008. That's possible, but only if the economy weakens or credit markets experience another seizure – neither of which we expect. As a result, we think long-term rates will move modestly higher over the coming months.

Turning to the fundamental **outlook for credit**, the housing market remains the epicenter of credit problems. Mortgage delinquencies and defaults are high, and if our outlook for housing is anywhere near the mark, they are only likely to get worse. Problems are concentrated in subprime adjustable rate mortgages (ARMs) and to a lesser extent prime ARMs (Figure 16). So far, fixed rate loans are performing well, even for subprime borrowers. There likely are two reasons for this. First and most obviously, as the Fed tightened monetary policy over the past several years, payments on ARMs increased along with short-term rates. Second, speculators in houses probably opted for ARMs over fixed-rate mortgages given their lower initial rate. After all, they anticipated rapid home price appreciation and a quick sale, so why not take the lower rate? With home sales sluggish in virtually all markets and prices down in many of the "hottest" markets, these investors are now struggling with higher payments, and many are defaulting on their loans.

Figure 16: Delinquencies & Defaults Rising

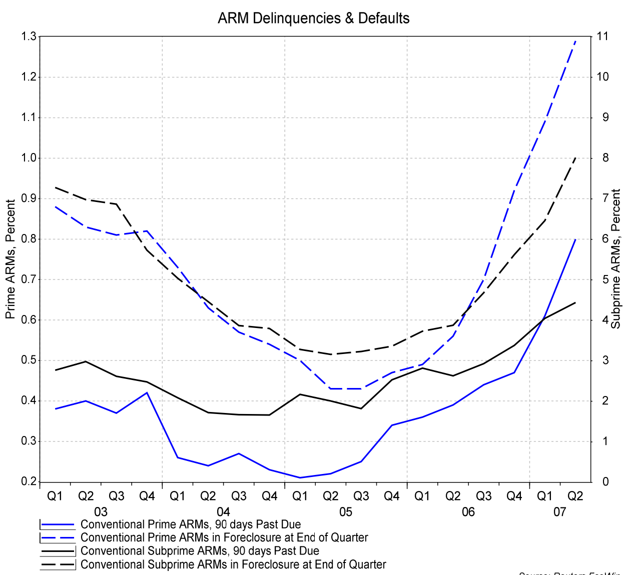
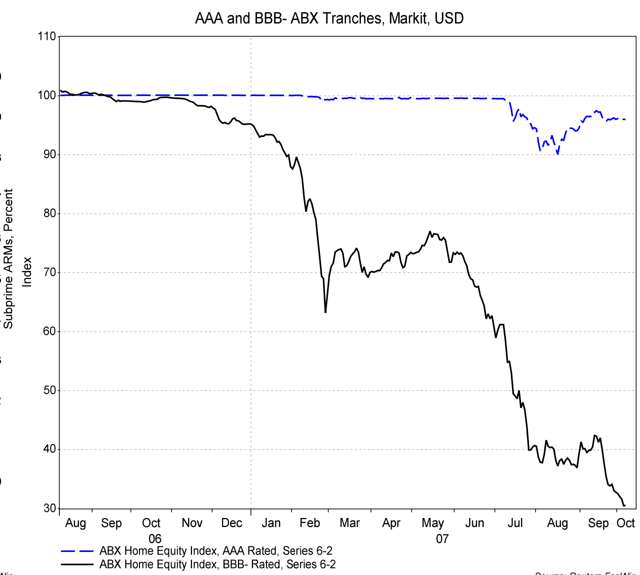


Figure 17: ABX Indices Highlight Losses



We believe that most banks are adequately capitalized to deal with the delinquencies and defaults in their mortgage portfolios. Many monoline mortgage companies are not, and indeed many of them have declared bankruptcy over the past year. The bulk of these mortgage losses, however, will be borne by investors in mortgage-backed securities, not by the banks that originated the loans. Already, market losses are severe in lower-rated tranches of subprime RMBS (Figure 17), but holdings of these issues by the companies in our investment-grade universe appear to be minimal. Highly-rated tranches of these securities have also suffered mark-to-market losses, but we do not think that many of these issues ultimately will be impaired, given the substantial subordination built into the structures. This is something we are keeping a close eye on, however, as holdings of AAA- and AA-rated RMBS are very broadly held.

Away from the mortgage and housing markets, credit fundamentals remain sound and have changed little in recent quarters. For nonfinancial companies, long-term debt remains high as a percentage of total indebtedness, and interest expense relative to earnings before interest and taxes also remains near historic lows (Figure 18). Although there are losses that will have to be absorbed, credit fundamentals remain generally strong. Most importantly, leverage among corporate borrowers remains modest. Credit market borrowing relative to tangible assets is very low (Figure 19). Finally, one of our major concerns earlier in the year – leveraged buyout activity – has faded along with the increase in rates on leveraged loans and high yield bonds.

Figure 18: Corporate Credit Healthy…

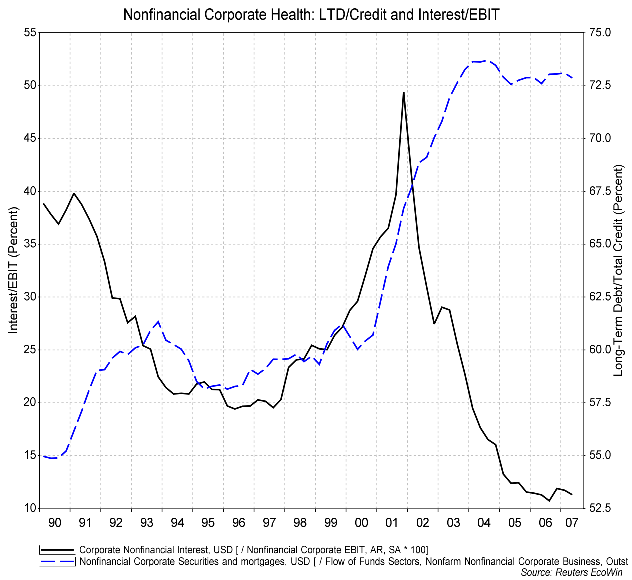
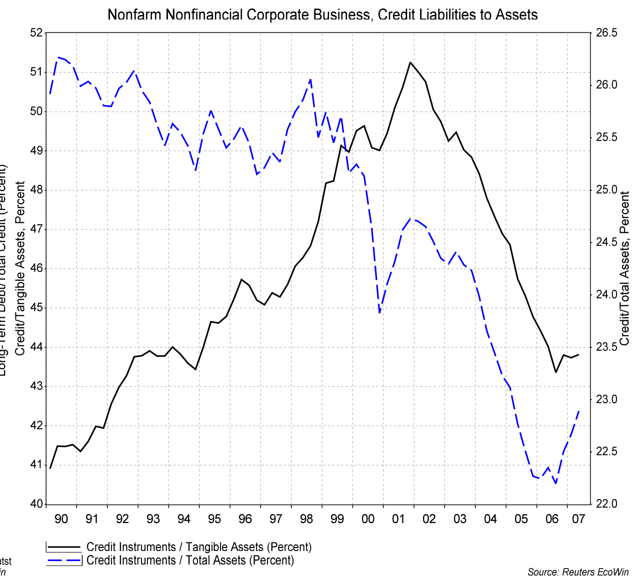


Figure 19: … With Low Leverage



As we hinted earlier, we believe that incomplete disclosure of portfolio holdings by financial companies contributed meaningfully to the sell-off in credit markets. If investors are unable to assess the risks in the companies in which they invest, when crises arise they will assume the worst, causing spreads to widen more than they would otherwise. Many companies have gotten this message and are improving disclosure. As credit-focused investors, we believe that more detailed disclosure will give Flaherty & Crumrine an advantage over our competitors, and we hope the trend toward greater disclosure continues.

As preferred investors, we place a strong emphasis on balance sheet strength for a simple reason: Recessions happen. We don't think one is imminent, but we readily admit that they are very hard to predict. However, we are confident in predicting that, over the life of a 30-year (or longer) preferred instrument, the economy will experience a recession or three. If a company is adequately capitalized, it can survive the recession and even emerge stronger as weaker competitors are acquired or go bankrupt. However, if it is over-leveraged, a company will either not survive or be weakened significantly, neither of which are pleasant for preferred investors. Since we can't avoid recessions, we think we are better off investing in companies with good businesses *and good balance sheets*, even if that means giving up a little yield when things look rosy and spreads are tight. As shown in Figure 19, overall leverage by corporations remains low, though these aggregate numbers mask considerable variation among companies. Our job is to separate the wheat from the chaff. That work is particularly rewarding when – as now – many investors don't take the time to make the distinction.

Brad Stone
Flaherty & Crumrine Incorporated
October 8, 2007