First-Quarter U.S. Economic Update

April 2008

Summary of Recent Economic Developments

The U.S. economy remained sluggish in the first quarter, with economists expecting real GDP growth of just 0.7%,[1] compared to average growth of 2.5% in 2007. Looking ahead, economists now expect just 1.8% real GDP growth for all of 2008, with the first half decidedly weaker than the second half. An improving trade balance and rising government spending should support growth in 2008, and business investment should also make a modest contribution. However, the housing sector will continue to be a sizable (if diminishing) drag on growth. More importantly, the economy has begun shedding jobs. In combination with declining wealth and tighter lending standards, weakening employment should lead to slower growth in consumption. Although the Federal Reserve cut the federal funds rate by 200 basis points and expanded its liquidity operations, it now seems likely that the economy has slipped into a mild recession. While recession is never welcome, we think it will be mild. The Fed's aggressive actions likely averted a debilitating credit contraction, which since the start of the subprime crisis has been the biggest threat to the economy and credit markets. This should set the stage for the gradual recovery of the preferred market.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	**2006:2**	**2006:3**	**2006:4**	**2007:1**	**2007:2**	**2007:3**	**2007:4**	**2008:1**
Real GDP, Chg QoQ (%)	2.4	1.1	2.1	0.6	3.8	4.9	0.6	0.7f
Real Personal Consump Expnds, Chg QoQ (%)	2.4	2.8	3.9	3.7	1.4	2.8	2.3	0.8a
Real Busi Investmt, Eqp & Sftware, Chg QoQ (%)	-0.1	2.9	-4.9	0.3	4.7	6.2	3.1	
Real Residential Investmt, Chg QoQ (%)	-11.7	-20.4	-17.2	-16.3	-11.8	-20.5	-25.2	
Corporate Profits, After Tax, Chg YoY (%)	10.4	21.3	8.2	1.2	3.3	2.7	3.3	-1.2f
Current Account Balance, Annualized (% of GDP)	-6.3	-6.6	-5.6	-5.9	-5.5	-5.1	-4.9	
Federal Budget, 12-mo Def or Surp (% of GDP)	-2.1	-1.9	-1.6	-1.5	-1.2	-1.2	-1.3	
Unemployment Rate (%)	4.6	4.5	4.4	4.4	4.6	4.7	5.0	5.1
Household Employment, Chg QoQ (000)	750	477	1103	196	-58	173	-49	-242
Nonfarm Payrolls, Chg QoQ (000)	263	618	454	328	315	212	241	-232
Nonfarm Productivity, Chg QoQ (%)	1.3	-1.5	1.6	1.0	2.6	6.3	1.9	
Capacity Utilization (%)	81.2	80.9	80.9	80.7	81.0	81.3	81.0	80.4a
GDP Price Index, Chg QoQ (%)	3.5	2.4	1.7	4.2	2.6	1.0	2.4	
Consumer Price Index, Chg YoY (%)	4.3	2.1	2.6	2.8	2.6	2.8	4.1	4.1a
CPI ex food & energy, Chg YoY (%)	2.7	2.9	2.6	2.5	2.2	2.1	2.4	2.3a
Nominal Personal Income, Chg YoY (%)	6.7	5.8	6.1	6.8	5.9	6.4	5.6	4.6a
Personal Savings Rate (%)	0.5	0.4	0.3	1.5	0.3	0.4	0.0	0.3a
Rate or Spread (End of Quarter)	**2006:2**	**2006:3**	**2006:4**	**2007:1**	**2007:2**	**2007:3**	**2007:4**	**2008:1**
Federal Funds Rate Target (%)	5.25	5.25	5.25	5.25	5.25	4.75	4.25	2.25
3-month LIBOR (%)	5.48	5.37	5.36	5.35	5.36	5.23	4.70	2.69
10-Yr Treasury Note Yield (%)	5.14	4.63	4.70	4.65	5.03	4.59	4.03	3.41
30-Yr Treasury Bond Yield (%)	5.19	4.77	4.81	4.85	5.13	4.84	4.48	4.29
Moody's Baa Long Corp Spread (bp)	163	160	154	155	149	175	208	261
10-Yr Interest Rate Swap Spread (bp)	59.0	53.8	47.8	52.8	63.8	62.5	63.8	66.0

* Figures are either quarterly or, if more frequent, quarterly averages. f = Forecast[1]; a = Actual through February 2008 Source: Reuters EcoWin

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

[1] *Survey of Professional Forecasters*, Federal Reserve Bank of Philadelphia, February 12, 2008.

Economic Outlook

The U.S. economy continues to flirt with recession. Last quarter we indicated that we thought the economy would narrowly avert recession.[2] Recent weak data have caused us to change our view: We probably will see mild contraction in real GDP before fiscal stimulus nudges the economy back into growth mode in the second half of the year. The bursting of the housing bubble is having broad repercussions. Consumers are curtailing spending and increasing savings, businesses are slowing hiring and investing more cautiously, and investors are seeking less risk and more liquidity. The economy is slowing as a result. Of course, it will be some months before the National Bureau of Economic Research (NBER) reviews the evidence and officially characterizes the current state of the economy. Regardless of what economists call it, however, businesses and consumers are behaving as though a recession is upon us, and that's what really matters to markets and policymakers. The upside of this is that several of the fundamental economic imbalances – notably overinvestment in housing, inadequate domestic savings, and a rapidly widening trade deficit – that have been building up since the turn of the millennium (or earlier) are moving back toward equilibrium. We think these adjustments will hold down growth through 2009 but pave the way for more sustainable growth in the future, assuming that policymakers do not make major fiscal or monetary policy errors. That is a reasonably safe bet in an election year, but we'll be keeping a close eye on Washington next year.

Figure 2: Trade Deficit Shrinking, Erratically

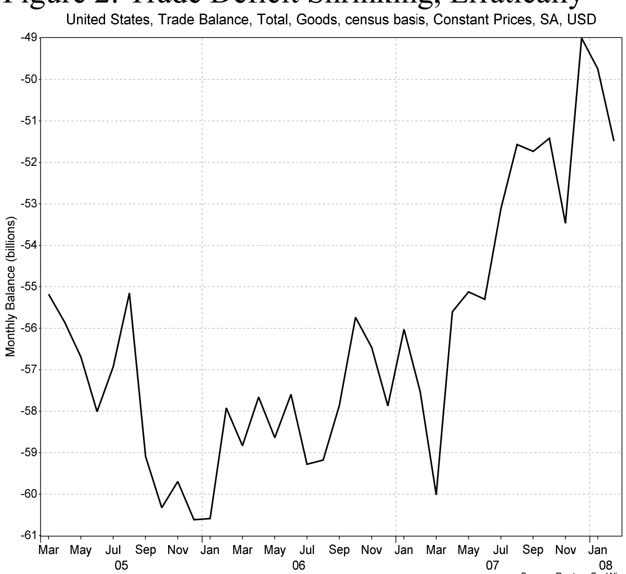
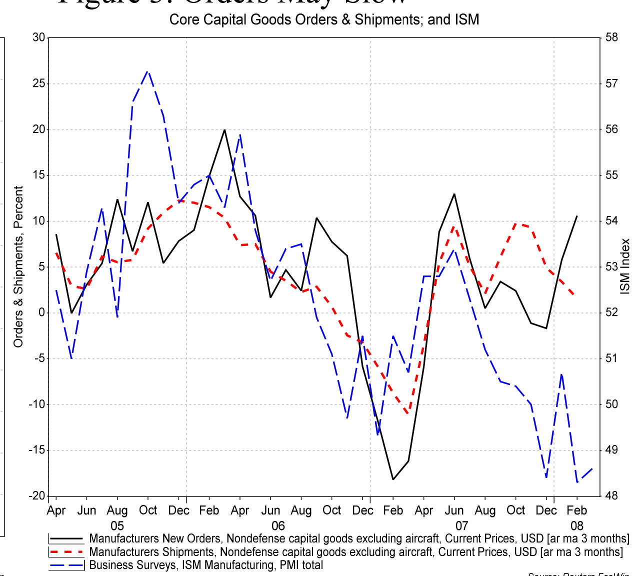


Figure 3: Orders May Slow



We will keep our review of the economy's first quarter performance relatively brief in the wake of our extensive fourth-quarter Update, as the major trends identified then remain essentially intact. On the positive side, the **trade sector** continues to add significantly to growth. In the fourth quarter of 2007, trade added 1% to GDP growth as exports surged and imports slowed. The real trade balance continued to shrink in the first quarter, although an unexpectedly large deficit in February suggests that trade's contribution to Q1 growth will be limited (Figure 2). With global growth currently stronger than U.S. domestic growth and the dollar weak, trade should add to GDP growth throughout 2008. This is evident even in some unexpected places. For

[2] *Fourth-Quarter U.S. Economic Update*, Flaherty & Crumrine Incorporated, January 2008

example, U.S. auto manufacturers are beginning to export U.S.-built cars to foreign markets. That is quite a turn of events for companies that were the poster-children for globally uncompetitive manufacturers only a few years ago, and it suggests that the trade cycle has a long way to run yet.

Business investment, whose two main components are nonresidential construction and equipment and software, added 0.6% to GDP in the fourth quarter. Although business investment should contribute to growth in 2008, it will probably be at a slower pace than last year. Commercial construction spending growth peaked in the fall of 2007. Vacancy rates in commercial real estate are starting to rise, and credit availability for commercial construction has tightened. Both suggest that nonresidential construction spending will slow further, although a lack of prior overbuilding should keep the growth rate positive. We also expect that firms will continue to invest cautiously in productivity-enhancing equipment and software. Core durable goods orders have held up fairly well, although shipments of nondefense capital goods have risen only slightly in 2008 and the ISM Manufacturing index remains near its recent low (Figure 3). On balance, business investment should contribute to growth over the next couple of quarters but at a relatively modest pace.

The pace of **government spending** should not change much in the first quarter after adding 0.4% to real GDP in 4Q07. However, as tax rebate checks go out over the next few months, government spending will accelerate meaningfully in Q2 and Q3. Those checks should help support personal consumption in the second half of the year. Additional fiscal stimulus – from the "automatic" expansion of the budget deficit as the economy slows to proposals to assist homeowners – likely will follow the tax rebates and keep government spending on an upward path for the balance of the year.

The outlooks for the other major sectors of the economy are not so bright. **Housing** remains in a deep recession. Residential investment plunged by 25.2% (annualized) and shaved 1¼ percentage points from real GDP growth in 4Q07. Although the pace of decline probably slowed a bit in 1Q08, housing will continue to weigh on economic growth. Housing starts and new home sales continue to fall and are now 53.5% and 57.5%, respectively, below their peaks. Existing home sales have done a bit better: Sales are down "just" 30.6% from the peak and were actually up in February (Figure 4). Mortgage delinquencies and foreclosures continue to rise (Figure 5), which has caused mortgage lenders to tighten lending standards significantly. In addition, home prices are falling, and falling rapidly in some markets. The S&P/Case-Shiller 20-city Home Price Index has dropped by 10.7% in the past year and 12.5% from the peak in 2006. More encouragingly, inventories of unsold homes have started to decline, although they still represent 9.6 months' of sales – well above the historical average. While mortgage rates have not declined significantly, lower home prices coupled with moderately higher personal incomes have dramatically improved housing affordability. The Housing Affordability Index is now back near the highest (i.e. most affordable) level of the past 30 years, with all of the improvement coming since July 2007.

We draw three main conclusions from the above observations on housing. First, home prices are likely to decline further, given high inventories and tighter mortgage lending standards. Second, lower home prices will reduce household wealth and pressure earnings at financial companies, which in turn will restrain consumption and lending, making for a sluggish economic outlook over the next four to six quarters. Third, as home prices fall and homebuilders restrain output, higher affordability and population growth will gradually absorb the excess supply of homes and set the stage for a recovery in housing. This process probably has two years or so to run – and it will not be painless – but recovery in housing should at least become visible in 2009. [3]

Figure 4: Home Sales Down

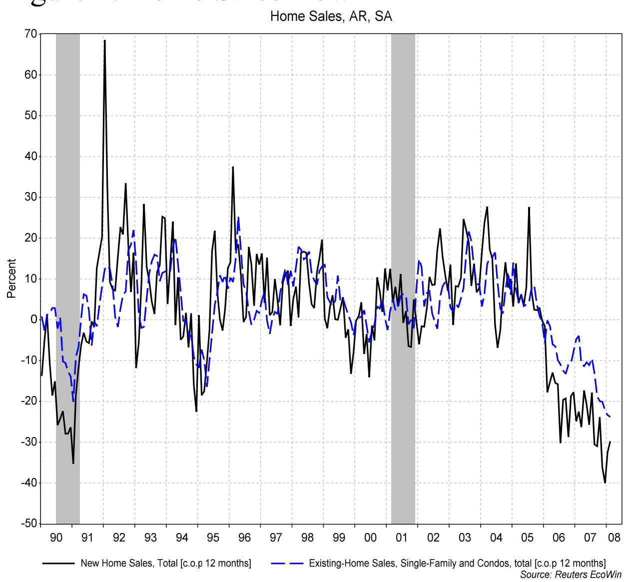


Figure 5: Delinquencies & Foreclosures Up

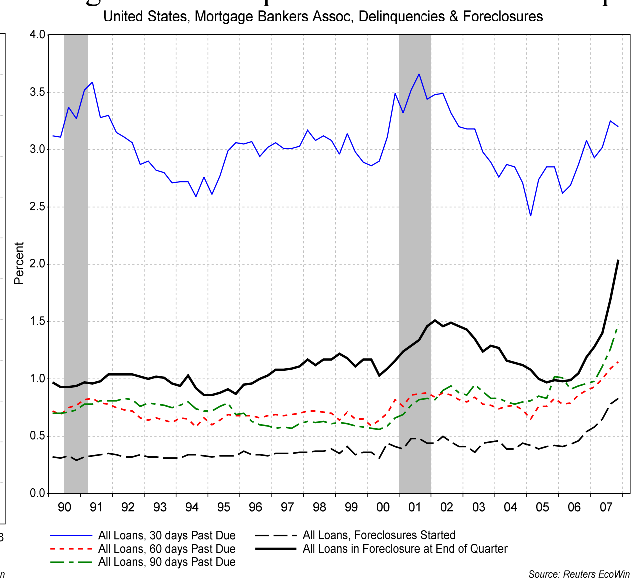


Figure 6: Inventories Starting to Turn Down

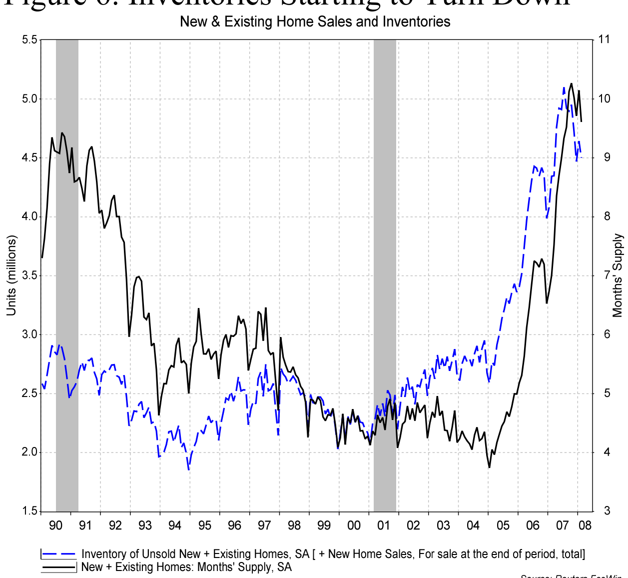
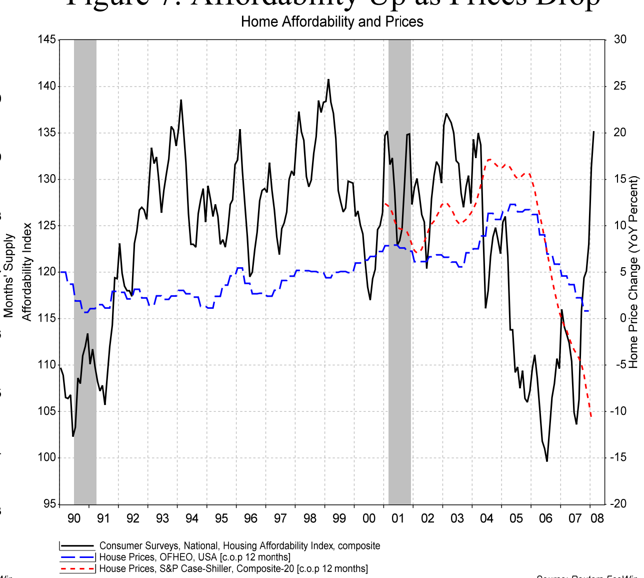


Figure 7: Affordability Up as Prices Drop



The outlook for continued growth in **personal consumption** expenditures (PCE) has clearly weakened over the past quarter. There are three main reasons for this. First, **employment** growth

[3] Why two years to recovery? The number of households in the U.S. was estimated at 114 million in 2006, according to the Bureau of the Census. The growth rate of households has averaged roughly 1% since 1970, which translates to a current growth rate of a little over 1.1 million new households per year. Total home inventories are about 2 million units above the average of the 20-year period preceding the housing bubble. This suggests that the current excess supply of housing will be absorbed in about two years. It may take longer, of course, but it's worth remembering that the recovery in housing is as inevitable as was the bursting of the housing bubble. It's just hard to know precisely when either is (or was) going to happen.

has slowed. In fact, it has turned negative. Nonfarm Payrolls fell by 232,000 in 1Q08 while Household Employment fell by a similar 242,000 jobs. The unemployment rate ticked up to 5.1% – still low historically but up significantly from 4.4% a year ago. As the labor market slowed, so did wage growth. Average hourly earnings are up 3.6% over the past year compared to 4.2% a year ago. Similarly, wages and salaries are up 3.6% YoY compared to 5.6% a year ago. These are not horrible numbers, but they do indicate slower income growth and hence less support for PCE (Figure 8).

Second, household wealth is declining. Household net worth, as reported by the Federal Reserve, dipped slightly in 4Q07. Given that both U.S. stock markets and home prices have declined in 2008, it's virtually certain that net worth has fallen further as well. If consumers are less wealthy, they typically consume less, especially when confidence is falling, as it has been for more than a year.

Figure 8: Slowing Income, Consumption, Jobs

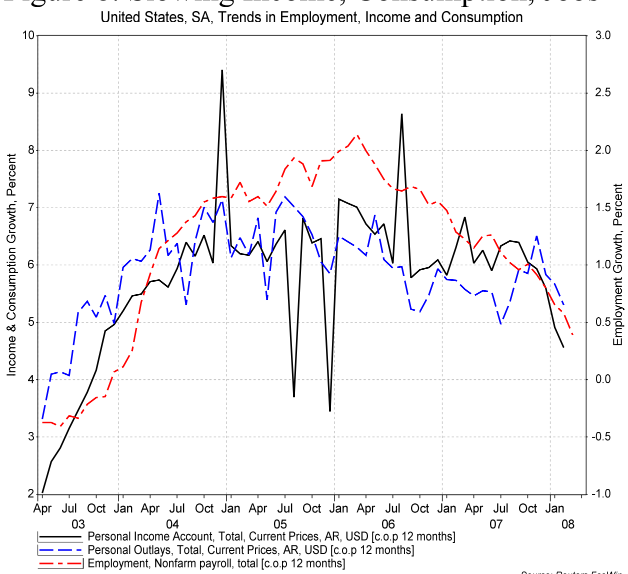
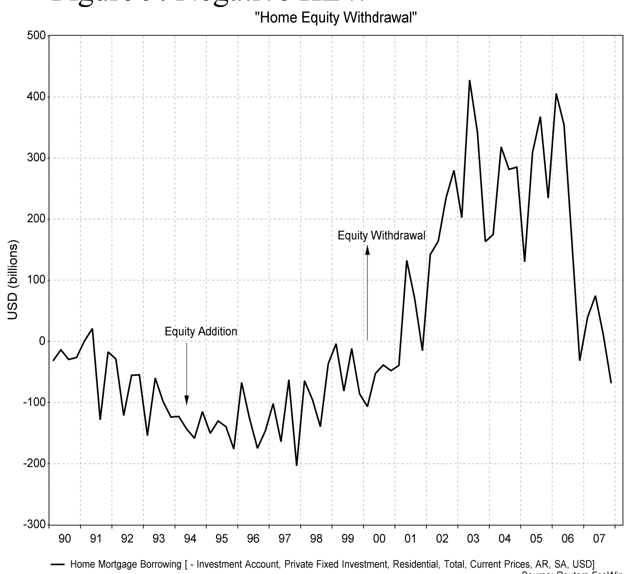


Figure 9: Negative HEW



Third, households have significantly reduced their pace of borrowing as confidence has fallen and lending standards have tightened. Home Equity Withdrawal continues to fall and in fact turned negative in 4Q07, which suggests that consumers are no longer using mortgage borrowing to finance consumption (Figure 9).[4] Separately, consumer credit increased by $138 billion (5.8% nominal, 3.7% real[5]) in the year ending in February 2008, but that is well below the average growth rate (8.1% nominal, 4.4% real) of the past 30 years. Together, these figures point to restrained consumer borrowing.

Weakening employment and income growth, declining wealth and slower borrowing should lead to slower consumption. This is borne out in the data: Consumption growth has slowed to 5.3% YoY in February from 5.7% a year ago (Figure 8). Moreover, real PCE in January and February grew by just 0.8% (annualized), compared to 2.3% last quarter. Although this is a relatively mild slowdown so far, unless incomes, wealth, or borrowing suddenly rebound (not impossible, but

[4] Home Equity Withdrawal is defined as total mortgage borrowing less residential investment. See the *Fourth-Quarter U.S. Economic Update*, Flaherty & Crumrine Incorporated, January 2008 for a detailed discussion.
[5] Discounted using the personal consumption expenditures less food and energy deflator.

not likely), consumption growth is likely to fall further. Adding it all up, it now appears likely that consumption will slow by enough to push the economy into a mild recession, although we still believe this will be a close call.

One positive aspect of the economic slowdown is that the long slide in the personal savings rate appears to have ended. Recessions typically result in higher savings as consumption falls faster than income. With consumer borrowing also declining, the savings rate should soon begin to move higher. This will be necessary in order to accommodate simultaneously the economy's long-term investment requirements and a smaller trade deficit.

The **inflation** outlook is mixed, but we believe that inflation pressures will diminish gradually as the economy cools. After accelerating in the second half of 2007 on higher food and energy prices, inflation has eased so far in 2008. Core inflation has dropped by about 0.2% from its recent peak (Figure 10), while overall inflation has held about steady (Figure 11). Both are higher than the Fed's long-term "comfort zone" of 1-2%, but with the economy slowing, these indices should slowly pull back, even though broad measures of money are growing very rapidly. Normally, we would be gravely concerned by the 16.4% YoY growth in MZM (essentially liquid deposits held at banks and money market funds), but these are not normal times. Individuals and businesses have sought to increase their cash balances as the credit crunch has intensified (in fact, the very process of raising cash has intensified the credit crunch!), which has led to very rapid growth in MZM. This increase is driven by a desire for greater liquidity, however, not by "transactions balances" resulting from surging inflation or economic activity. In economists' lingo, the velocity of money has slowed. As a result, we believe that the rapid growth in money supply is not a harbinger of higher inflation.

Figure 10: Core Inflation Easing…

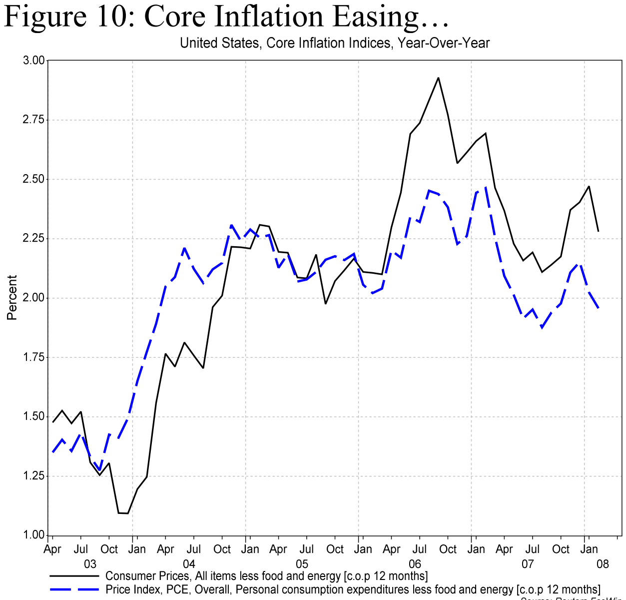
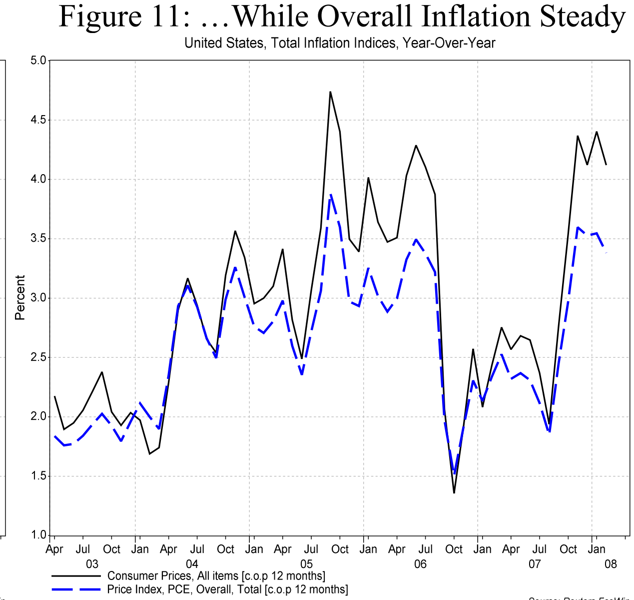


Figure 11: …While Overall Inflation Steady



Market Outlook

Conditions in the credit markets deteriorated further in the first quarter, prompting additional monetary easing by the Federal Reserve. The FOMC cut the federal funds rate by 200 basis points (bp) in the first quarter from 4.25% to 2.25%, and markets expect another 50 bp of rate cuts over the coming months (Figure 12). In addition, the Fed introduced two new programs designed to provide liquidity to the capital markets. Following the near-collapse of Bear Stearns, the Fed on March 11 introduced the Term Securities Lending Facility (TSLF). The TSLF allows dealers to pledge hard-to-finance collateral and receive Treasuries for 28 day terms. A week later, the Fed introduced the Primary Dealer Credit Facility (PDCF), which allows primary dealers to borrow money directly from the Federal Reserve, secured by a wide range of collateral. These moves by the Fed significantly increased liquidity available to market participants, although credit conditions remain challenging. We are impressed by the Fed's creativity and resolve in addressing the credit crisis. Moreover, the Fed has additional tools at its disposal to provide still more liquidity should the economy need it.

Figure 12: Fed Funds Plunges; LIBOR Not So Much

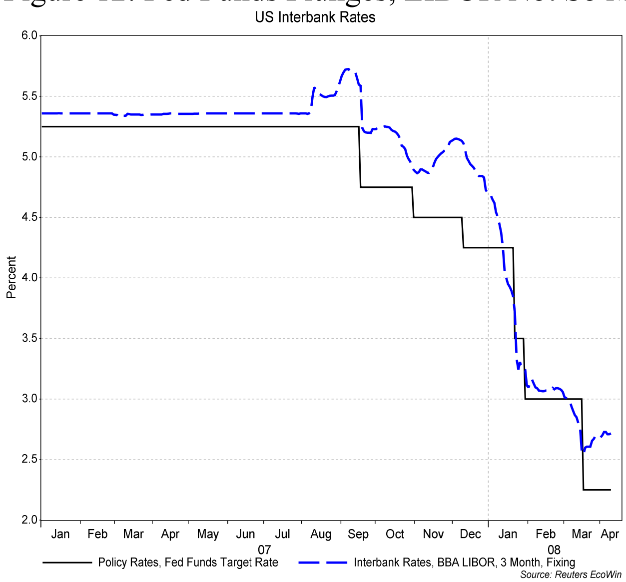


Figure 13: Credit Spreads Wider

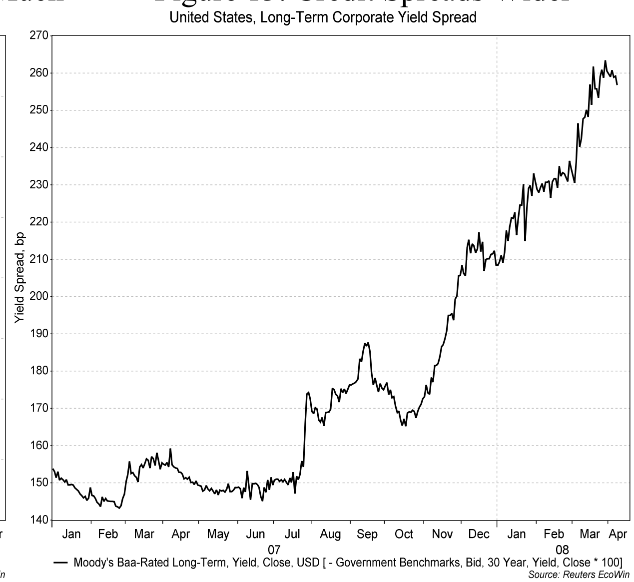


Figure 14: ABCP Down, Money Funds Up

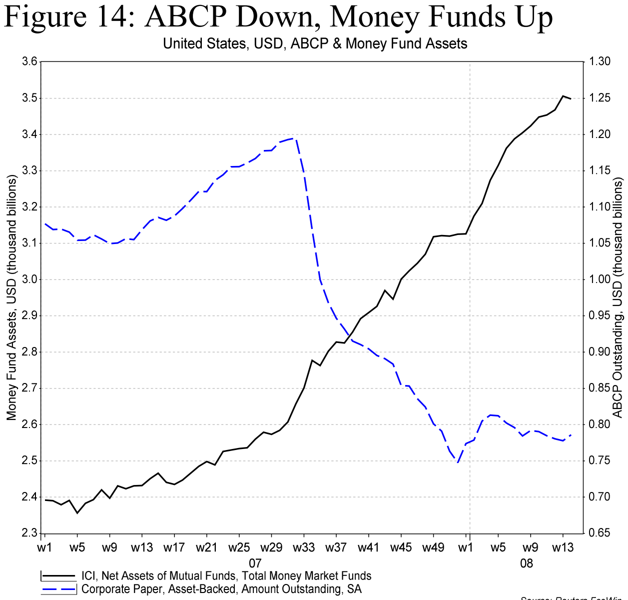
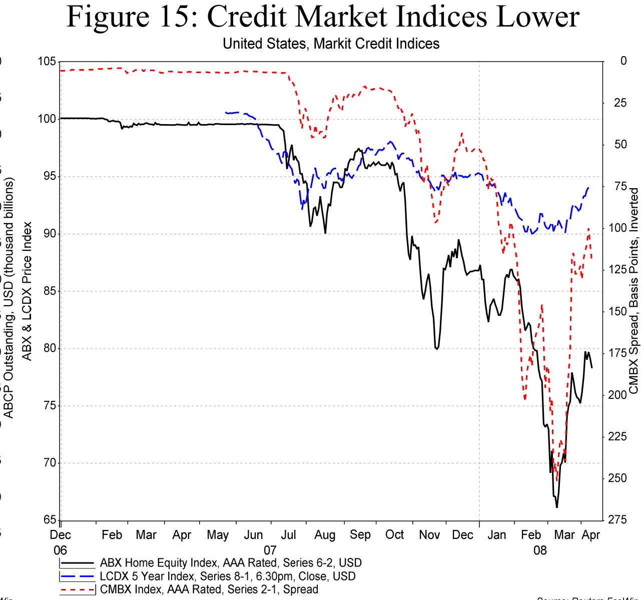


Figure 15: Credit Market Indices Lower



Despite the Fed's efforts to contain the damage from the credit crisis, continued deleveraging pushed credit spreads wider during the first quarter, although they have tightened somewhat in

April (Figure 13). Preferred securities, particularly those issued by financial companies, performed poorly. In fact, the yield ratio of preferreds to Treasuries is at its highest level relative to Treasuries since the 1970's, which is as far back as our data extend. Risk aversion across the credit markets remains high, as can be seen by declining borrowings of asset-backed commercial paper, rising balances at money market funds, and lower prices/higher yields on a broad range of credit market instruments (Figures 14 and 15). It is worth noting, however, that market prices and sentiment have improved since mid-March following the Fed's efforts to extend liquidity to non-bank entities.

The **credit outlook** continues to be mixed. Nonfinancial corporations remain strong, with low leverage, good liquidity and strong interest coverage (Figures 16 and 17). A recession likely will pressure earnings at these companies, but we do not anticipate that default rates at nonfinancial companies will rise to worrisome levels.

Figure 16: Liquidity High, Coverage Strong

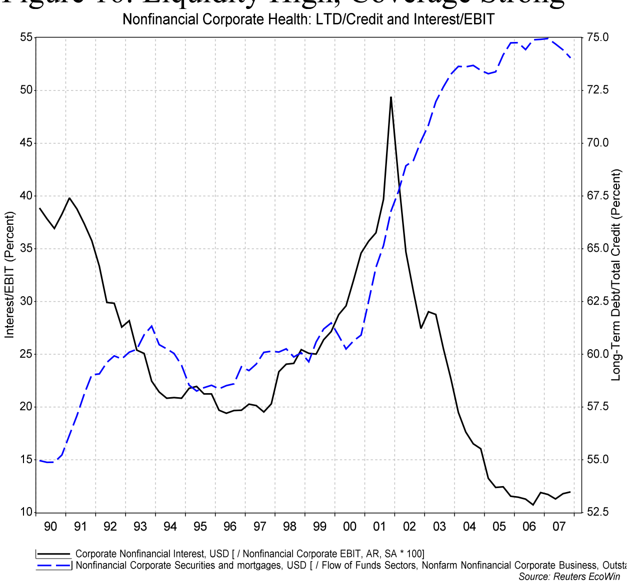
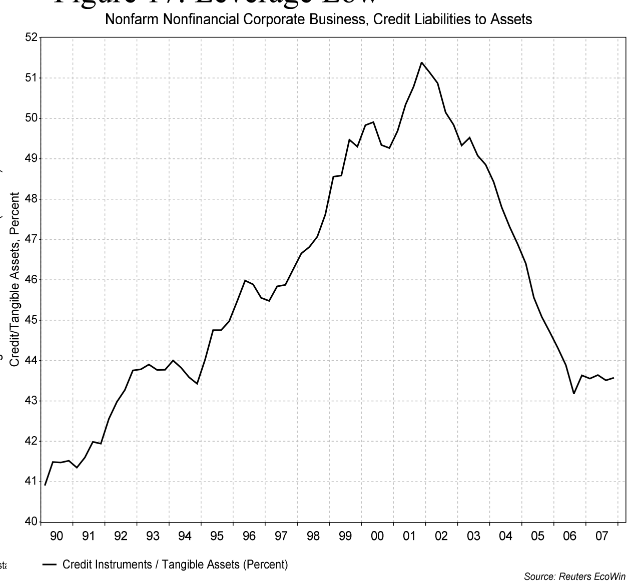


Figure 17: Leverage Low



Financial companies, which comprise more than 75% of the preferred market, are a different story. These companies have suffered very large write-downs – in excess of $200 billion through 4Q07, with more on the way in 1Q08. These losses have strained capital, which has both heightened credit concerns and prompted sizable issuance of preferreds and other forms of regulatory capital. The result has been lower preferred and common equity prices. Despite the fact that preferreds are now a very expensive form of financing, companies have continued to issue them because common equity is even more expensive. The common stocks of many financial companies are now trading below book value. Assuming that companies expect historical returns of about 15% on book equity going forward, issuing common stock below book value implies a cost of capital in excess of 15%. Under the circumstances, issuing preferred at 8, 10 or even 12 percent looks attractive if the company needs the capital and the common stock is cheap. Because earnings at financial companies are likely to remain weak and more capital is likely to be needed, we expect to see a lot more preferred issuance.

The credit crisis has taken a heavy toll on financial companies and preferred securities, but is the worst behind us? As we explained in last quarter's Update, we believe the biggest risk facing markets and the economy is a deepening recession driven by credit contraction. The scenario runs something like this: Rising loan delinquencies → credit fears by investors → deleveraging and demand for liquidity → asset sales → lower asset prices → mark-to-market losses → weaker capital bases at financial institutions → reduced lending → slower economic growth or recession → rising loan delinquencies, and the cycle repeats. We have experienced all of these things (to varying degrees) over the past nine months. In the credit markets, the deterioration in credit quality – particularly in mortgages – is clearly a critical factor in the selloff. However, deleveraging has been a more insidious if less quantifiable cause for lower prices. In fact it ultimately may be responsible for greater losses at financial companies than actual defaults on mortgages, leveraged loans, and the like.

Although capital markets in many parts of the economy have replaced banks as lenders, they face the same fundamental liquidity constraint that a bank faces: Not everyone can cash out at the same time. Just as the Bailey Building and Loan from "It's a Wonderful Life" could not pay off all of its depositors in full in a day, capital markets cannot convert all (or even a sizable proportion of) outstanding financial assets to cash in a short time frame. New investors are required to purchase those assets, and if sellers insist on selling quickly (perhaps because their lenders are requiring it), then prices can fall sharply. The impact is even more pronounced if new investors have a difficult time understanding the value of the underlying securities and thus bid low. It's no surprise, then, that structured securities such as asset-backed CDOs suffered brutally in the selloff. They are hard to understand under benign circumstances, much less when the thousands of underlying loans are changing rapidly. The surprise from the market's perspective was how many of these sorts of securities were retained (and subsequently marked down) by financial institutions, which in turn limited their liquidity in an already skittish market.

Until the Federal Reserve stepped in to provide liquidity to broker/dealers, the only way for the capital markets to gain access to scarce liquidity was to sell into unwilling and illiquid markets or to borrow from banks. While the banks had access to liquidity from the Fed, they had to take on the credit risk of the dealer. That was more friction than current skittish markets could stand, and one dealer (Bear Stearns) ran aground as its liquidity evaporated. Although they came too late for Bear Stearns, the Fed's two new programs to provide liquidity to dealers (the TSLF and PCDF) have had an enormous impact on the confidence of the market. Counterparties, knowing that Fed liquidity is available to the dealers, are once again confident in doing business with them. Markets are unfreezing. Credit is beginning to flow again.

The Fed deserves enormous credit for thinking creatively about how to get liquidity into fragile capital markets and then acting decisively to provide it. Its job may not be over – there are still segments of the capital markets that are not functioning well – but an epic credit contraction, we think, has been avoided.

Although the economy and markets still face many risks, we remain very optimistic about preferreds over a long-term horizon and are even becoming more positive on a short-term horizon. We believe that write-downs at financial companies are peaking. Assets have been marked down to very conservative levels, and many financial companies have significantly reduced exposure to problem sectors over the last six to nine months. They also have taken sizable provisions against future loan losses. Although the rising tide of defaults and delinquencies will increase charge-offs throughout the year, we believe that provisions taken to date along with rising net interest margins at most financial institutions will limit future write-downs. Perhaps most importantly, we think the Fed's actions have allowed the economy to sidestep what could have been a devastating credit contraction. If so, preferred prices should already have reached bottom. We think heavy issuance will keep preferred prices in check for another quarter or two, but we are beginning to detect some light at the end of the tunnel for preferreds.

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April 10, 2008