Second-Quarter U.S. Economic Update
July 2008

Summary of Recent Economic Developments

The economy appears to have posted good growth in the second quarter. While economists forecasted second quarter GDP growth of just 0.2% in May[1], more recent forecasts put growth in the 2.0 – 2.5% range. Trade continues to add significantly to growth. Consumption also should post solid gains, supported by tax rebates. Housing continues to fall, however. Although we expect that the drag from housing will gradually diminish over the next year or so, home prices are likely to continue to fall until the overhang of supply normalizes. The labor market softened further during the quarter and now clearly signals recession. As job losses have mounted, wage and income growth have slowed, which should weigh on consumption in future quarters. Inflation accelerated, and it presents the Fed with the difficult task of keeping a lid on inflation while simultaneously trying to rehabilitate the financial sector. We continue to think that the U.S. economy will slip into a shallow recession after the boost in spending from fiscal stimulus fades. That should keep monetary policy on hold through the end of the year, although the Fed is not likely to tolerate a further rise in inflation should that develop. Credit markets traded lower in response to worsening loan performance and heavy capital issuance by financial firms. Despite the short-term risk, we believe that preferreds offer compelling value for long-term investors.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	**2006:3**	**2006:4**	**2007:1**	**2007:2**	**2007:3**	**2007:4**	**2008:1**	**2008:2**
Real GDP, Chg QoQ (%)	1.1	2.1	0.6	3.8	4.9	0.6	1.0	0.2f
Real Personal Consump Expnds, Chg QoQ (%)	2.8	3.9	3.7	1.4	2.8	2.3	1.1	1.9a
Real Busi Investmt, Eqp & Sftware, Chg QoQ (%)	2.9	-4.9	0.3	4.7	6.2	3.1	0.2	
Real Residential Investmt, Chg QoQ (%)	-20.4	-17.2	-16.3	-11.8	-20.5	-25.2	-24.6	
Corporate Profits, After Tax, Chg YoY (%)	21.3	8.2	1.2	3.3	2.7	3.3	4.3	-1.5f
Current Account Balance, Annualized (% of GDP)	-6.4	-5.4	-5.8	-5.6	-5.0	-4.8	-5.0	
Federal Budget, 12-mo Def or Surp (% of GDP)	-1.9	-1.6	-1.5	-1.2	-1.2	-1.3	-1.5	
Unemployment Rate (%)	4.5	4.4	4.4	4.6	4.7	5.0	5.1	5.5
Household Employment, Chg QoQ (000)	477	1103	196	-58	173	-49	-242	-78
Nonfarm Payrolls, Chg QoQ (000)	618	454	328	315	212	241	-247	-191
Nonfarm Productivity, Chg QoQ (%)	-1.6	1.4	1.3	2.7	6.0	1.8	2.6	
Capacity Utilization (%)	80.9	80.9	80.7	81.0	81.3	81.0	80.5	79.9
GDP Price Index, Chg QoQ (%)	2.4	1.7	4.2	2.6	1.0	2.4	2.7	
Consumer Price Index, Chg YoY (%)	2.1	2.6	2.8	2.6	2.8	4.1	4.0	4.9
CPI ex food & energy, Chg YoY (%)	2.9	2.6	2.5	2.2	2.1	2.4	2.4	2.4
Nominal Personal Income, Chg YoY (%)	5.8	6.1	6.8	5.9	6.4	5.9	4.3	6.4a
Personal Savings Rate (%)	0.4	0.3	1.5	0.3	0.4	0.2	0.5	5.0a
Rate or Spread (End of Quarter)	**2006:3**	**2006:4**	**2007:1**	**2007:2**	**2007:3**	**2007:4**	**2008:1**	**2008:2**
Federal Funds Rate Target (%)	5.25	5.25	5.25	5.25	4.75	4.25	2.25	2.00
3-month LIBOR (%)	5.37	5.36	5.35	5.36	5.23	4.70	2.69	2.78
10-Yr Treasury Note Yield (%)	4.63	4.70	4.65	5.03	4.59	4.03	3.41	3.97
30-Yr Treasury Bond Yield (%)	4.77	4.81	4.85	5.13	4.84	4.48	4.29	4.52
Moody's Baa Long Corp Spread (bp)	160	154	155	149	175	208	261	252
10-Yr Interest Rate Swap Spread (bp)	53.8	47.8	52.8	63.8	62.5	63.8	66.0	70.3

* Figures are either quarterly or, if more frequent, quarterly averages. f = Forecast[1]; a = Actual through May 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, May 13, 2008

Economic Outlook

The economy appears to have dodged recession for another quarter, buoyed by sizable Federal tax rebates and continued strength in foreign trade. On the positive side, the **trade sector** continues to improve and has contributed significantly to domestic economic growth. In the quarter through May, the real trade deficit shrunk to an average of $45.1 billion per month from $49.5 billion in Q1, which implies a positive contribution to real gross domestic product (GDP) of about 2% (Figure 2). This is considerably higher than the 0.8% and 1.0% contributions that net exports made to first- and fourth-quarter growth, respectively. We expect that the trade deficit will continue to shrink as sluggish growth in the U.S. limits non-energy imports (and reduce the volume if not the value of energy imports) while relatively strong growth overseas and a weak dollar combine to boost exports.

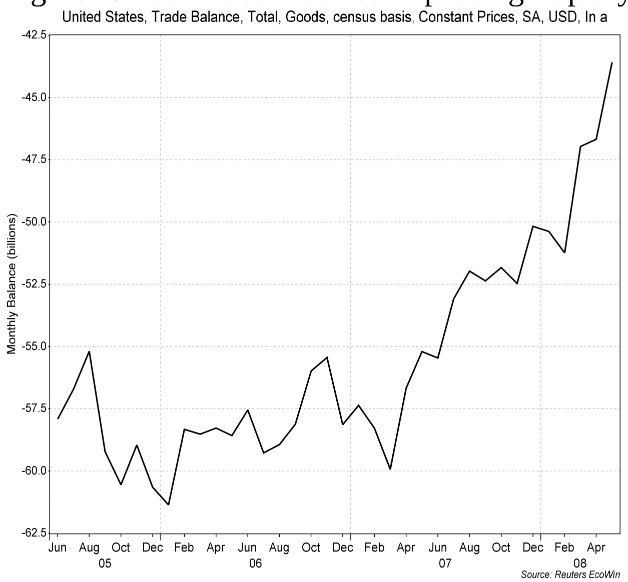


Figure 2: Real Trade Balance Improving Rapidly

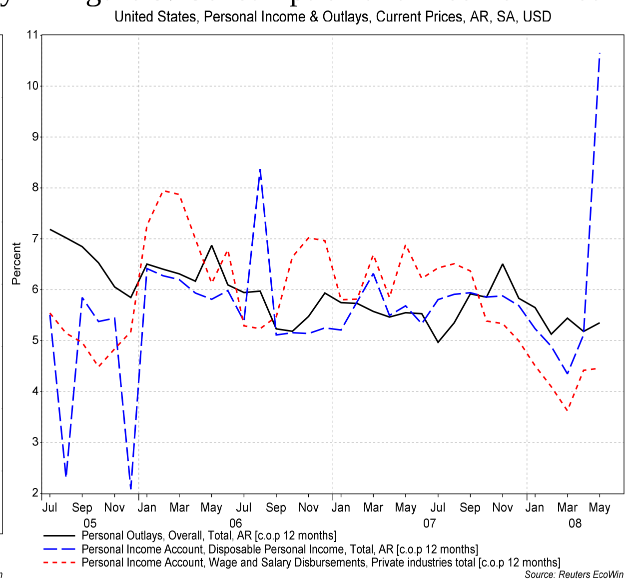


Figure 3: Consumption and Income Mixed

Personal consumption expenditures (PCE) accelerated in the second quarter and should remain relatively firm in the third quarter as well. Boosted by tax rebates, consumers increased purchases in the second quarter at a solid pace (Figure 3). Real PCE is up by 1.9% annualized in the second quarter through May compared to just 1.1% in Q1. Given that the tax rebates only began to go out in May, that's surprisingly good performance. In addition, the advance retail sales report indicates that the pace of sales picked up further in June. Core retail sales excluding automobiles, gasoline, and building materials rose by 7.9% (nominal) at an annual rate in Q2 compared to Q1, the fastest pace in more than two years. Because rebate payments will continue for several more months, the outlook for PCE remains fairly good for the third quarter as well. Although the tax rebates appear to be supporting consumption as intended, their impact will wear off by the fourth quarter. In addition, the credit crunch and shrinking home equity make financing of consumption in excess of income increasingly difficult. That will leave PCE, which represents about 70% of GDP, reliant upon income growth and gains in wealth – and it's hard to be too bullish about either of those.

While trade and consumption turned in strong performances in the second quarter, other sectors of the economy did not do so well. **Personal income** growth has slowed in most sectors of the economy, although the tax rebates have temporarily boosted disposable personal income (Figure 3). Including the tax rebates, overall nominal personal income growth rebounded to 6.4% YoY in May, up from 4.2% YoY in March and about in-line with income growth a year ago. However, components of income that were not affected by the tax rebates grew much more slowly. Nominal wage and salary growth slowed to 4.5% YoY in May 2008 from 6.5% YoY a year ago. Proprietor's income (income from small business owners, excluding farmers) has held up a bit better but still is up just 1.7% YoY. Farm income is doing much better, as one would expect given sharply rising food prices, up 14.2% YoY in May. However, the farm numbers are relatively small: $37.8 billion for farm proprietor's income compared to $5.5 trillion for wages and salaries and $1.0 trillion for nonfarm proprietor's income. Keep in mind that these are nominal figures; after inflation, income growth for most people is barely positive. As a result, it will be hard for real PCE to sustain much growth unless those income trends improve.

Figure 4: Savings Rate Up on Tax Rebates

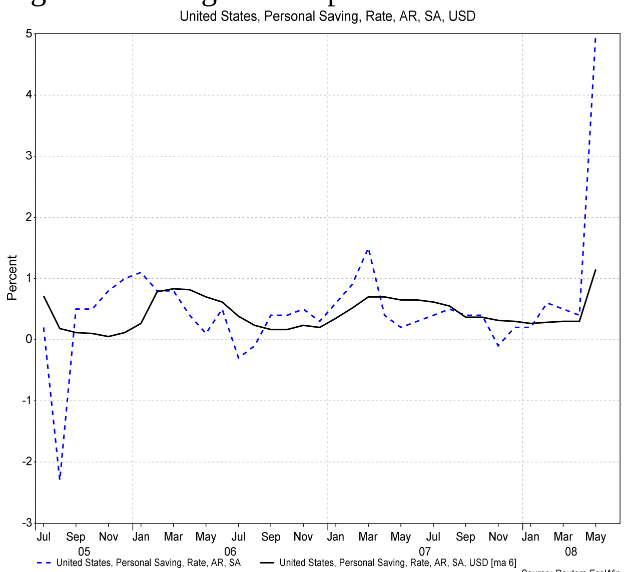
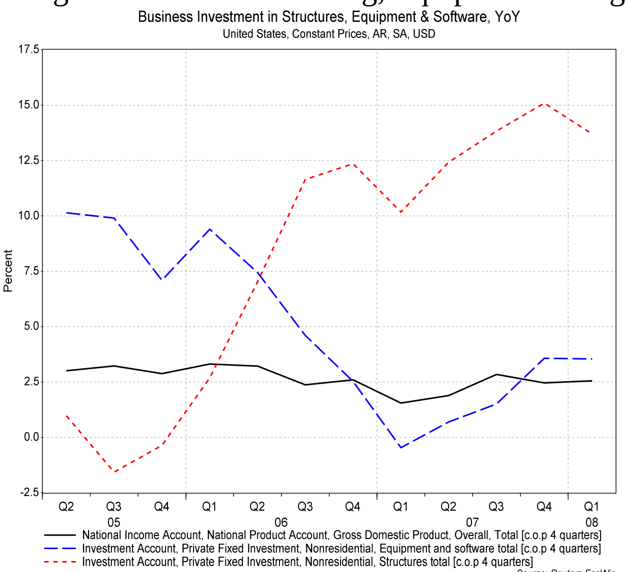


Figure 5: Structures Fading, Equipment Rising



The flip side of these income and consumption trends is that the **personal savings** rate surged as disposable income gains significantly outpaced spending. We expect that the savings rate will drop in the coming months as tax rebates get spent, but we anticipate a secular rise in personal savings from its level of nearly zero over the past several years. There are two main – and related – reasons for this. First, home equity withdrawal has dropped dramatically over the past several years. Lower home prices have reduced owners' equity, and loan standards on mortgages have tightened dramatically while mortgage rates have increased. Thus, there is less borrowing capacity, and it's harder and more expensive to access. Second, prospective homebuyers now need to have a sizable down payment to even be considered for a mortgage loan. Thus, people wanting to buy a home (or trade up to a more expensive one) are going to need to save more than they did over the past cycle. Both of these developments are likely to persist for years to come, and they should help increase personal savings and restrain consumption as a result.

Business investment likely remained mixed in the second quarter following tepid growth of just 0.6% in Q1 (Figure 5). Investment in business equipment and software was up just 0.2% in the first quarter but probably improved in Q2. Shipments of nondefense capital goods excluding aircraft jumped 6.3% in May compared to the Q1 average, which points to fairly strong equipment spending for the quarter. However, judging by the slowdown in nonresidential construction spending through May, business investment in structures probably decelerated from its 1.2% pace in Q1. Putting these together, we anticipate that business investment will do a little better in Q2 than Q1, but it should not be a major contributor to overall growth.

Unfortunately, the news goes downhill from here. **Employment** has weakened considerably since late last year, and it's difficult to see it improving before 2009. Nonfarm payroll jobs shrank by 191,000 in Q2 after falling by 247,000 in Q1. Household employment dropped by a more modest 78,000 jobs in Q2, following 242,000 job losses in Q1. The unemployment rate rose to 5.5% in June from 5.1% at the end of Q1. Taking a slightly longer perspective, both the payroll and household employment surveys show no growth in jobs over the past year – something that has always signaled a recession in the past (Figure 6, gray shaded areas indicate recession). It is possible, of course, that this heretofore reliable indicator of recession will be a false signal this time, but as investors we have to recognize that the odds are against it. We do believe that the trough in employment will be shallower than in prior recessions, however, because employment gains coming out of the last recession were relatively subdued, as Figure 6 clearly demonstrates. Initial jobless claims (new layoffs) remain well below levels normally associated with recessions and support the idea that companies do not have a lot of excess labor. But rising continuing claims (those still claiming unemployment benefits) indicate that workers who are laid off are having a hard time finding new employment.

Figure 6: Job Losses Signal Recession

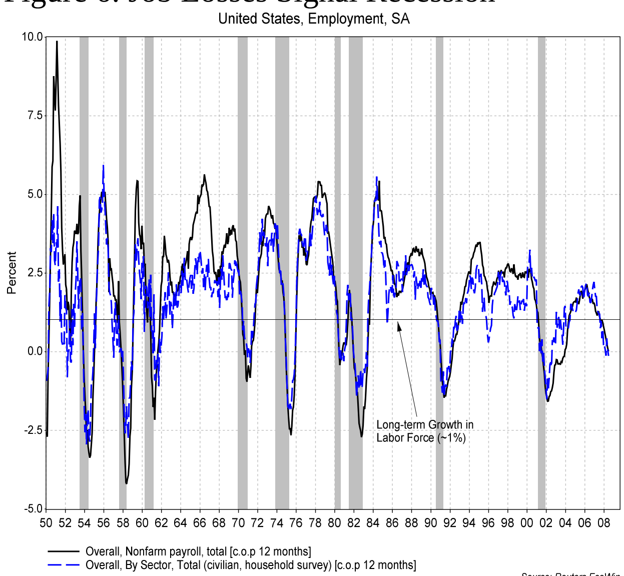
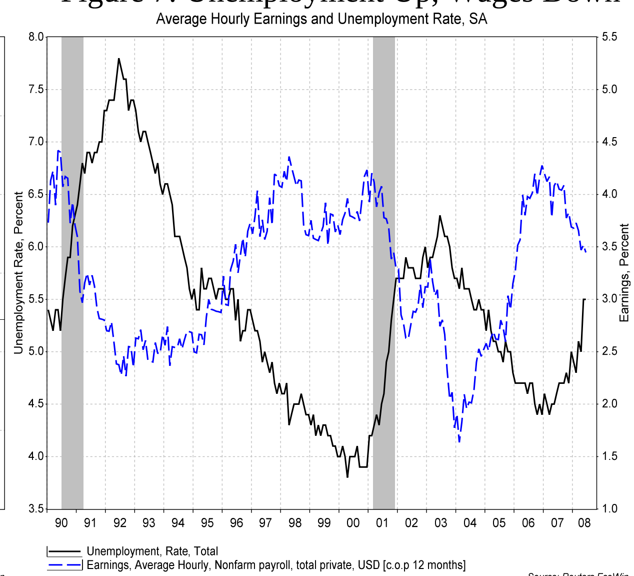


Figure 7: Unemployment Up, Wages Down



As the job market softened and the unemployment rate increased over the past year, wage gains have slowed (Figure 7). Average hourly earnings were up 3.4% YoY in June compared to 4.1% a year ago. Although that is bad news for the consumption outlook, it is reassuring news for the Fed from an inflation standpoint. The Fed has clearly indicated that it will strongly resist a wage-price spiral. Happily, there is no indication in the wage data that the surge in food and energy prices is translating into higher wages. This gives the Fed greater flexibility to pursue monetary policy that is supportive of growth and mindful of the problems facing the financial sector.

Housing remains in a deep recession, although the negative impact on GDP from weaker housing activity is starting to decline. Residential investment shaved -1.1% from GDP growth in 1Q08, compared to -1.25% in 4Q07, even though the pace of decline was about unchanged from one quarter to the next (-25.2% in Q4 versus -24.6% in Q1). The reason for the diminishing impact on GDP is simply that the housing sector is relatively small now after more than two years of rapid contraction. Residential investment was 5.5% of GDP at the peak in 3Q05, but it was just 3.4% at the end of 1Q08 (Figue 8). As a result, a given slowdown in housing activity has a smaller impact on GDP today than it did a year or two ago. More importantly, the pace of activity in the housing sector, while still falling, appears to be getting a little better. Existing home sales have held in a narrow range of 4.9 – 5.0 million units at an annual rate since November 2007, after falling sharply for the prior two years (Figure 9). New home sales have not fared so well, falling from 612,000 to 512,000 (annualized) over the past six months, but the number of new homes for sale has continued to decline. Indeed, single- and multi-family housing starts, which peaked at over 2 million units annually and have fallen to less than 1 million units currently, are now well below the absorption rate (household formation plus replacement dwellings plus net demand for second homes) for housing. Over time, that will reduce the excess supply of housing in the market. On balance, we believe that, although housing will continue to contract, the drag on GDP from the housing sector should diminish over the next few quarters.

Figure 8: Housing Drag Should Start to Slow

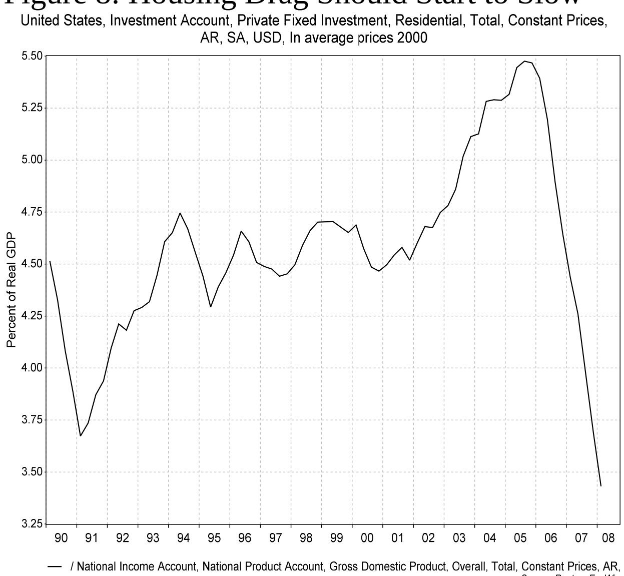
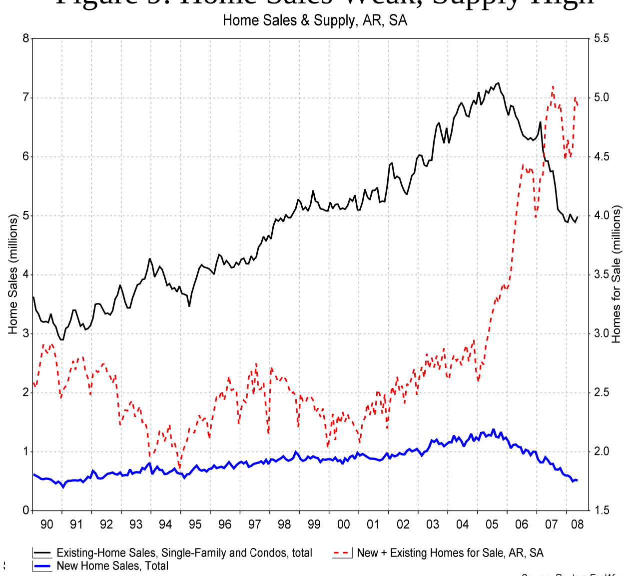


Figure 9: Home Sales Weak, Supply High



While the majority of the slowdown in housing activity is likely behind us, home prices and housing wealth have further to fall. Inventories of unsold homes remain very high, and many homes that were previously for sale have moved to the rental market. Most of those will come back to the for-sale market as conditions improve. High inventories (both on the market and waiting in the wings), sluggish demand, and tighter financing terms can mean only one thing for home prices: They are headed lower. We don't know how much lower they will go, but until supply and demand are in better balance, we're confident that the direction is down. This is not good for housing wealth or consumer confidence, and it's another factor likely to weigh on personal consumption when fiscal stimulus wears off.

Inflation remains higher than almost everyone, especially the Fed, would like. Food and energy prices as measured by the PCE indices remained on an upswing in the second quarter, rising by 5.7% and 27.5%, respectively, at an annual rate over the past three months. This kept overall PCE inflation elevated at 3.9% (annualized) for the past three months and 3.1% YoY. However, the PCE deflator excluding food and energy eased a bit to 1.8% over the past three months and 2.1% YoY. Inflation as measured by the consumer price index (CPI) showed more acceleration, and no doubt is worrisome to the Fed (Figure 10). Overall CPI in June jumped to 5.0% YoY and 7.9% over the past three months, while CPI excluding food and energy rose by 2.4% YoY and 2.5% over the past quarter. Except for the last figure, all of these represent meaningful accelerations over the prior quarter. As we discuss in the next section, the Fed appears willing to live with these higher inflation numbers for now, but we think the Fed has little tolerance for any further rise in inflation.

Figure 10: Inflation Worrisome

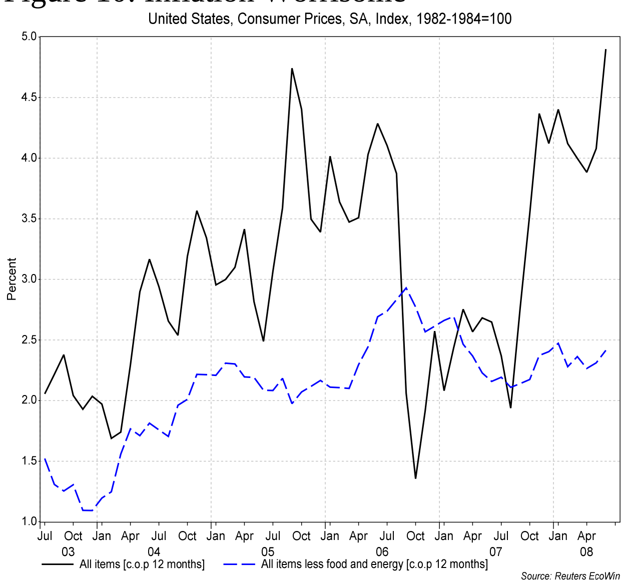
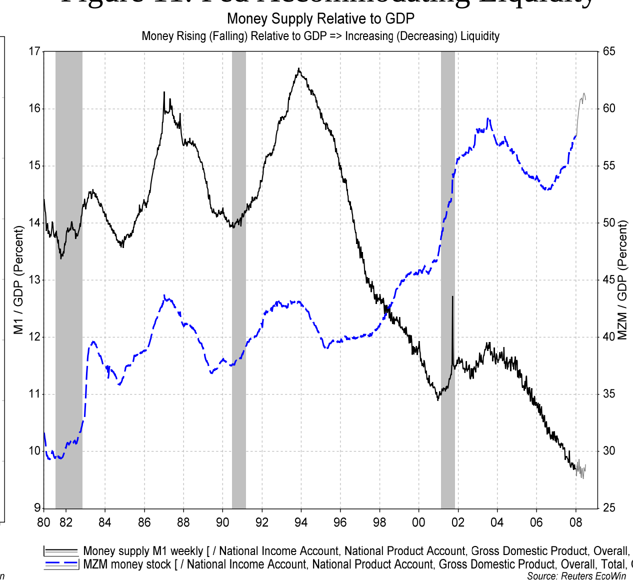


Figure 11: Fed Accommodating Liquidity



Before moving on to the market outlook, it's worth taking a brief look at what's going on with the **money supply** figures in light of the sizable easing of monetary policy over the past year. Although the Fed cut the fed funds rate from 5.25% to 2.0% beginning in September 2007, M1 (currency, demand deposits, and other checkable deposits and traveler's checks) has actually *shrunk* relative to GDP (Figure 11). Normally as the Fed eases (mid 1980s, early 1990s, early 2000s), M1 expands faster than GDP as the Fed injects money into the economy in an effort to boost its growth rate. Over the past year, however, this has not occurred.

The blue line in Figure 11 shows the same relationship for MZM (M1 plus savings deposits and money market funds). It has surged since last summer to the highest on record. Bank deposits and money funds increased rapidly as individuals and especially institutions sold risky assets to buy safer, more liquid assets. The Fed accommodated this desire for liquidity by providing banks and dealers with a means to finance the assets that investors wanted to sell. This prevented a debilitating credit and asset contraction, but we believe that it is *not expansionary or inflationary in the traditional sense*. The Fed's liquidity was not used to expand borrowing and lending, which could lead to greater economic activity and higher prices, but rather to increase liquidity balances. We suspect this is another reason why the Fed believes that tighter monetary policy is not yet necessary for inflation or appropriate for the economy.

Judging by recent market behavior, it's appears that the desire for liquidity and safety may have further to run. However, with risky assets trading very cheaply compared to money market rates and Treasuries, at some point the higher returns offered by these assets will outweigh the desire for *additional* liquidity from these already elevated levels.

Market Outlook

Credit market conditions remained strained in the second quarter – despite another 25 basis point (bp) cut in the fed funds rate to 2% on April 30 – and conditions have deteriorated somewhat further in July. Market rates remain well above official target rates: Three-month London Interbank Offered Rate (LIBOR) is about 2.80% today, 80 bp above the Federal Reserve's target for the fed funds rate, near the widest spread since the beginning of the credit crisis more than a year ago. Similarly, the spreads on long-term investment grade and high yield debt over Treasury rates also remain elevated (Figure 12). In addition, lenders continue to tighten their lending standards for loans to both businesses and individuals (Figure 13). To make matters worse, benchmark long-term Treasury yields rose by about 40 bp since the end of Q1 through the date of this report, adding to the upward pressure on mortgage and credit rates.

Figure 12: Credit Spreads Near Wides

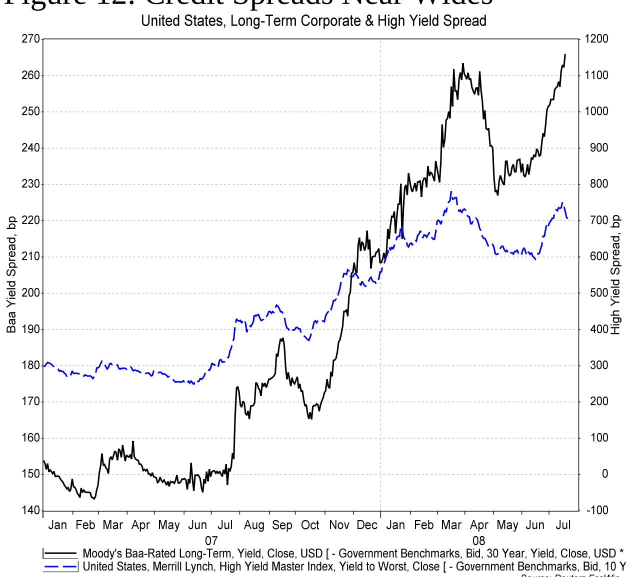
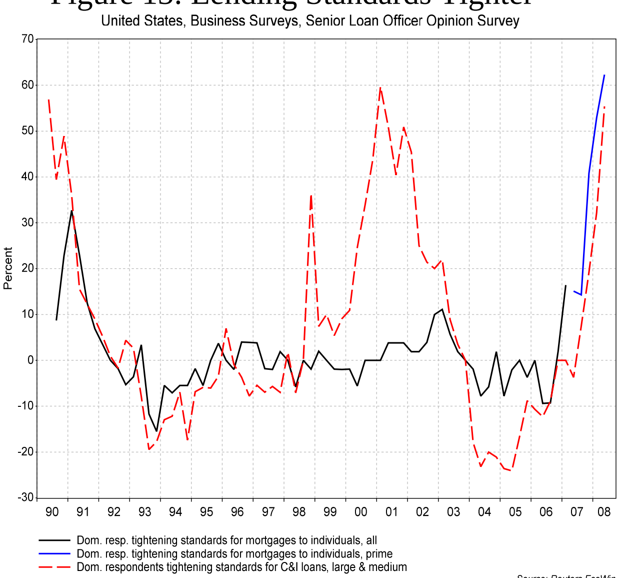


Figure 13: Lending Standards Tighter



Credit and interest rate markets have had to contend with two major problems over the past few quarters: Rising credit losses and rising inflation. Over the course of the second quarter and the weeks since it ended, higher inflation prompted markets to abandon expectations of further rate cuts and to price in rate hikes beginning in the fall. Treasury and mortgage rates rose in response. The Fed faces a difficult decision. On one hand, financial markets are still fragile and credit availability is still constrained, making it risky to raise rates. On the other hand, inflation is uncomfortably high and persistent, despite several quarters of below-trend economic growth.

As the Fed weighs these opposing factors, we believe that the FOMC will leave short term rates on hold through the end of the year (and probably until the housing market shows signs of bottoming out). Economic growth should slow as the impact of tax rebates wanes, and recent declines in energy prices should take some of the upward pressure off inflation over the near term. Moreover, we do not think that recent monetary policy has been especially inflationary, as we discussed in the section on money supply above.[2] In addition, the Fed's own rhetoric indicates that it is willing to live with these inflation results for now. However, if inflation accelerates much more from here, the Fed will probably be forced to raise rates, which is one more thing credit markets have to be worried about.

Figure 14: Charge-Offs & Bankruptcies Rising

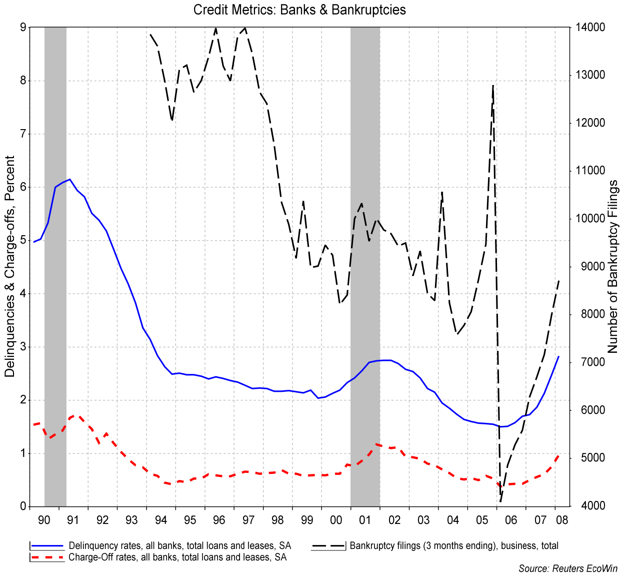
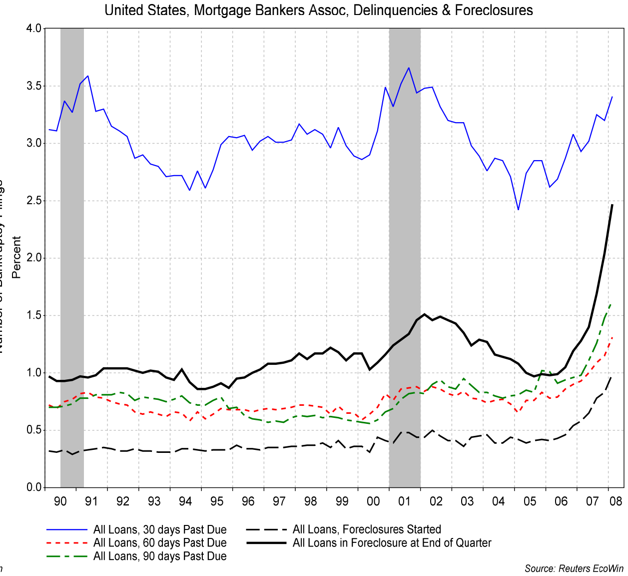


Figure 15: Delinquencies & Foreclosures Up



Although there are many reasons why credit-related financial assets, have fallen so significantly, we will focus on four important ones for preferreds. First, credit risk clearly has increased, most obviously in subprime mortgages but also across all categories of consumer and commercial lending (Figures 14 and 15). With home prices still falling and the job market weakening, delinquencies and defaults are likely to continue to climb. Second, companies have turned to the markets to replenish capital in the wake of heavy losses. Capital issuance by financial companies totals more than $330 billion since the start of the credit crisis in the third quarter of last year, covering about three-fourths of the total losses of $450 billion reported so far. Third, as discussed earlier, many investors either chose to or were forced to reduce borrowings and increase liquidity. Thus, secondary market players were looking to sell securities even as primary issuance was heavy. All of this supply had to compete for scarce investor dollars and depressed prices for outstanding issues. Fourth, equity values for financials have fallen dramatically, limiting the desire or ability of companies to raise the common equity capital that would help support preferred prices. That is not to say that companies have not issued common equity – they have – but it's clear that they would have issued more common and less preferred equity had common stock prices been higher.

[2] This does not mean that we don't think loose monetary policy can be inflationary. Rapid money growth from 2001-04 clearly contributed to rising inflation from 2003 onwards. However, the fact that M1 is shrinking while MZM is surging suggests that monetary policy is not the fuel behind the recent rise in inflation.

While second quarter reports for financial institutions are not yet complete, it appears that credit-related write-downs declined in the second quarter after surging in 4Q07 and 1Q08. We use Citigroup, which has suffered sizable losses in recent quarters, and JP Morgan Chase, which has weathered the credit storm relatively well, as representative examples. The table below shows that mark-to-market losses on structured finance, leveraged loans, and other securities peaked in 4Q07 for Citi and 1Q08 for JP Morgan. Subsequently, they diminished as the companies either sold off those positions or marked then down to very conservative levels. However, charge-offs have increased sequentially over the past four quarters as delinquencies and defaults have risen due to stress in housing and, to a lesser extent, the economy overall. It is important to note, though, that the pace of deterioration (i.e. the quarter-to-quarter increase) in charge-offs appears to be slowing a bit. Provisions for future loan losses are more subjective than charge-offs, so there is greater variation there. Both banks took provisions for loan losses that were significantly in excess of charge-offs for the respective quarter. That is a clear indication that banks think loan losses will get worse before they get better. The pattern for regional and community banks is similar, though their securities-related write-downs are much smaller.

$ millions, pretax	2008 Q2	2008 Q1	2007 Q4	2007 Q3
Citigroup				
Charge-offs	$4,400	$3,800	$1,560	$780
Loan-loss Provisions	$7,200	$6,000	$5,410	$2,980
Securities Write-downs	$7,123	$13,530	$17,551	$1,830
JP Morgan Chase				
Charge-offs	$2,130	$1,906	$1,429	$1,300
Loan-loss Provisions	$3,455	$4,424	$2,542	$1,785
Securities Write-downs	$1,101	$2,566	$1,300	$1,300

While the next several quarters are likely to remain very difficult for banks, there is some good news in these higher loan-loss provisions. First, higher provisions give banks a larger cushion to absorb losses, which protects us as preferred investors. Second, once banks feel provisions are consistent with expected charge-offs going forward, they will fall back to be more in-line with charge-offs. Although we anticipate that charge-offs at banks will rise until a quarter or two after the housing sector bottoms (probably sometime in 2009), provisions should peak somewhat earlier, especially if the pattern of slower increases in charge-offs persists for the next couple of quarters. This could give an important boost to earnings and should help to buoy common stock valuations. Since common equity is an important potential source of capital that is junior to preferreds, firmer equity values are also good for preferred investors.

If the outlook for charge-offs at financials is still negative, why own preferreds at all? The simple answer is that valuation is highly attractive today. The average money center bank preferred is trading at a price of 90 cents on the dollar and a current yield of 8.9%, more than double the yield of about 4% on a 10-year Treasury note currently. Assuming that prices and reinvestment rates remain constant and that there are no defaults, after ten years the preferred investment would return 1.62 times the Treasury investment. To equal the return on the Treasury, more than one-third (38%) of the money center banks would have had to default on their preferreds over the ten-year horizon, with zero recovery on default.[3] The valuations on regional bank preferreds are even more compelling. A number of regional bank preferreds are trading around 60 cents on the dollar with 11% current yields. Again holding everything constant and assuming no defaults, regional bank preferreds return twice the Treasury investment. In addition, cumulative defaults would have to be 50% with zero recovery to earn the same as the Treasury over the ten-year horizon. If we believe that the preferreds rally from 60 up to 80 cents on the dollar after ten years, then cumulative defaults can be as high as 55% and preferreds still break even with Treasuries. While there certainly will be some bank failures over the next decade, we don't think the numbers will come anywhere close to half of all regional banks or 38% of money center banks. Risk premiums on these preferreds are simply too high. Of course, there is no guarantee that market prices cannot go lower, but we believe that current prices on preferreds offer compelling valuation for long-term investors.

Brad Stone
Flaherty & Crumrine Incorporated
July 18, 2008

[3] This analysis assumes that defaults occur at a constant rate over the ten-year horizon.