First-Quarter U.S. Economic Update
April 2009

Summary of Recent Economic Developments

The economy is still shrinking rapidly. Forecasters expect GDP to contract by 5.0% in the first quarter of 2009 after -6.3% in the prior quarter, making the past six months the worst economic performance since 1958. Weakness in the economy was broad-based. Job losses accelerated and the unemployment rate jumped to 8.5%. Incomes shrank. Housing declined for yet another quarter, and home sales and prices fell further. Business investment, capital goods orders, and industrial production plunged. Even government spending probably declined a bit. There were some bright spots, however. Trade probably added at least 1% to GDP growth in the quarter, and personal consumption also staged a modest rebound. More generally, recent data indicate that the pace of the economy's decline is diminishing. In addition, the federal government continued to expand its response to the financial crisis. Congress passed a $787 billion fiscal stimulus package. Treasury added several new programs and provided critical detail on others. And the Federal Reserve expanded its balance sheet aggressively while holding short-term interest rates near zero. These programs and policies should help boost the economy in the second half of the year. In the meantime, loan performance should continue to deteriorate, although that should be at least partly offset by rising earnings power at financial institutions. Although volatility is likely to remain high, we anticipate that signs of economic and financial recovery will gradually accumulate, which should sustain the credit market rally that began in early March.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	**2007:2**	**2007:3**	**2007:4**	**2008:1**	**2008:2**	**2008:3**	**2008:4**	**2009:1**
Real GDP, Chg QoQ (%)	4.8	4.8	-0.2	0.9	2.8	-0.5	-6.3	-5.0f
Real Personal Consump Expnds, Chg QoQ (%)	2.0	2.0	1.0	0.9	1.2	-3.8	-4.3	1.3a
Real Busi Investmt, Eqp & Sftware, Chg QoQ (%)	6.9	3.6	1.0	-0.6	-5.0	-7.5	-28.1	NA
Real Residential Investmt, Chg QoQ (%)	-11.5	-20.6	-27.0	-25.1	-13.3	-16.0	-22.8	NA
Corporate Profits, After Tax, Chg YoY (%)	-0.2	-0.8	-0.6	1.8	-6.4	-7.9	-15.0	-10.5f
Current Account Balance, Annualized (% of GDP)	-5.7	-5.0	-4.8	-5.0	-5.1	-5.0	-3.7	NA
Federal Budget, 12-mo Def or Surp (% of GDP)	-1.2	-1.2	-1.3	-1.5	-2.3	-3.2	-5.9	NA
Unemployment Rate (%)	4.6	4.7	4.9	5.1	5.6	6.2	7.2	8.5
Household Employment, Chg QoQ (000)	-210	146	91	-271	-285	-709	-1691	-2451
Nonfarm Payrolls, Chg QoQ (000)	245	7	500	-338	-458	-624	-1658	-2055
Nonfarm Productivity, Chg QoQ (%)	4.8	7.0	-0.5	2.6	4.7	2.2	-0.4	NA
Capacity Utilization (%)	80.6	80.7	80.6	79.8	78.7	74.5	72.8	69.3
GDP Price Index, Chg QoQ (%)	2.0	1.5	2.8	2.6	1.1	3.9	0.5	NA
Consumer Price Index, Chg YoY (%)	2.7	2.8	4.1	4.0	5.0	4.9	0.1	-0.4
CPI ex food & energy, Chg YoY (%)	2.2	2.1	2.4	2.4	2.4	2.5	1.8	1.8
Nominal Personal Income, Chg YoY (%)	6.0	6.1	5.4	3.9	5.3	3.4	1.3	1.0a
Personal Savings Rate (%)	0.1	0.6	0.4	0.2	2.5	1.4	3.8	4.2a
Rate or Spread (End of Quarter)	**2007:2**	**2007:3**	**2007:4**	**2008:1**	**2008:2**	**2008:3**	**2008:4**	**2009:1**
Federal Funds Rate Target (%)	5.25	4.75	4.25	2.25	2.00	2.00	0.25	0.25
3-month LIBOR (%)	5.36	5.23	4.70	2.69	2.78	4.05	1.43	1.19
10-Yr Treasury Note Yield (%)	5.03	4.59	4.03	3.41	3.97	3.83	2.22	2.67
30-Yr Treasury Bond Yield (%)	5.13	4.84	4.48	4.29	4.52	4.31	2.68	3.54
Moody's Baa Long Corp Spread (bp)	149	175	208	261	252	354	529	491
10-Yr Interest Rate Swap Spread (bp)	63.8	62.5	63.8	66.0	70.3	66.5	35.0	20.0

* Figures are either quarterly or, if more frequent, quarterly averages. f = Forecast[1]; a = Actual through February 2009 Source: Reuters EcoWin

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

Economic Outlook

Economic growth remained sharply negative in the first quarter of 2009. Forecasters expect first quarter Gross Domestic Product (GDP) to shrink by 5.0% (annualized) when it is reported later this month, only slightly better than the 6.3% plunge in the prior quarter.[1] Weakness was broad-based, with most major sectors of the economy continuing to contract at a rapid pace, as we describe in the paragraphs that follow. However, there have been some tentative signs of improvement in more recent data. None of them are signaling growth just yet, but they do suggest that the economy's pace of contraction is slowing. Monetary stimulus is starting to have some impact, consumer spending has come out of its freefall, and fiscal stimulus is poised to rapidly expand in the second half of the year and continue through 2010. As a result, we are cautiously optimistic that GDP growth will turn positive again by the fourth quarter of this year.

Most of the economic trends that we described in last quarter's Update remain intact, as the economy continued to contract rapidly in the first quarter.[2] Among the most dramatic and tangible effects of the current recession has been the rapid deterioration in the **labor market**. More than two million jobs were lost in the first quarter alone, and more than five million jobs have been shed since the start of the recession in December 2007. These job losses have driven the unemployment rate from 4.9% at the end of 2007 to 7.2% at the end of 2008 all the way up to 8.5% at the end of the first quarter (Figure 2). There is a good chance the unemployment rate peaks above 10% before jobs start to grow again.

Figure 2: Employment Picture Is Grim…

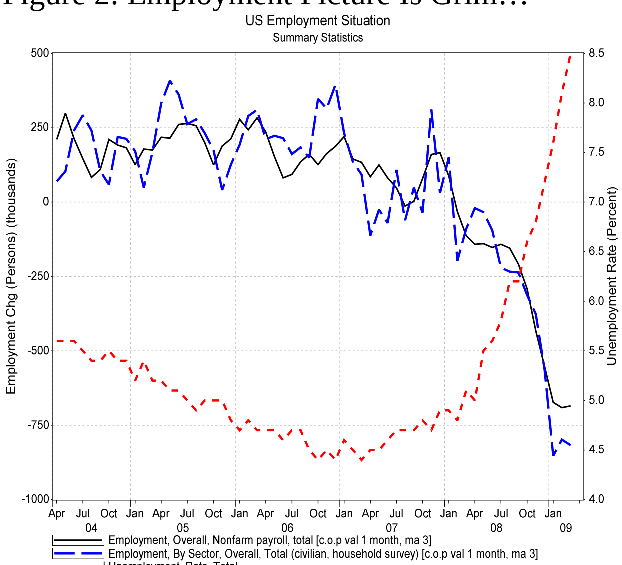
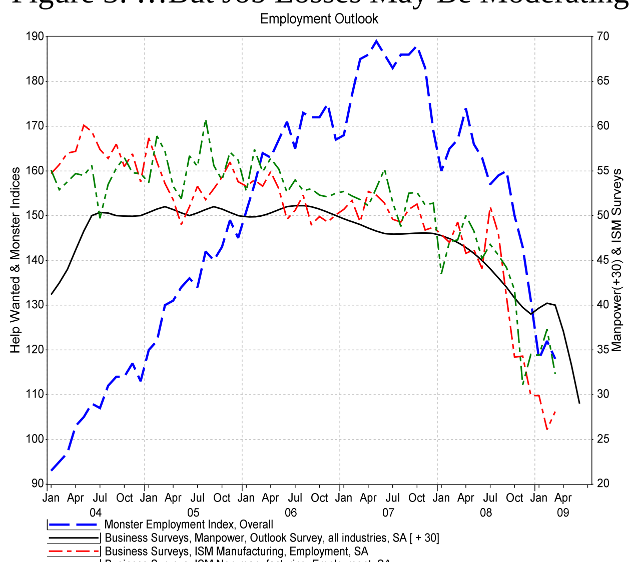


Figure 3: …But Job Losses May Be Moderating



Although the current employment picture is grim, there are some early signs that the pace of decline in the labor market is slowing. The ISM and Monster employment surveys have slowed their descent over the past several months (Figure 3). In addition, the rise in initial jobless claims has slowed in recent weeks while continuing claims have continued to increase. On balance, the data suggest that job losses may be slowing down but that job formation remains weak. This does

[1] Forecast from Bloomberg, April 17, 2009.

[2] See *Fourth-Quarter U.S. Economic Update*, Flaherty & Crumrine Incorporated, January 21, 2009, available at www.preferredincome.com or www.fcclaymore.com.

not mean that the economy is doomed until monthly employment reports turn positive, however. It is normal for the economy to shed jobs even after it begins to climb out of recession (and we certainly are still in recession). The thing we are watching closely is the *trajectory* of the growth rate in employment, which historically has been a reliable indicator of recession entry and exit points (Figure 4). Right now, the growth rate of employment is still falling. Once it begins to turn upward – which will occur when job *losses* start to decline – that should be a good sign that the economy is on the mend. We do not expect so see such a turnaround in the second quarter, but we think the odds are good that it will happen sometime in the second half of the year.

Figure 4: No Signal to End of Recession Yet

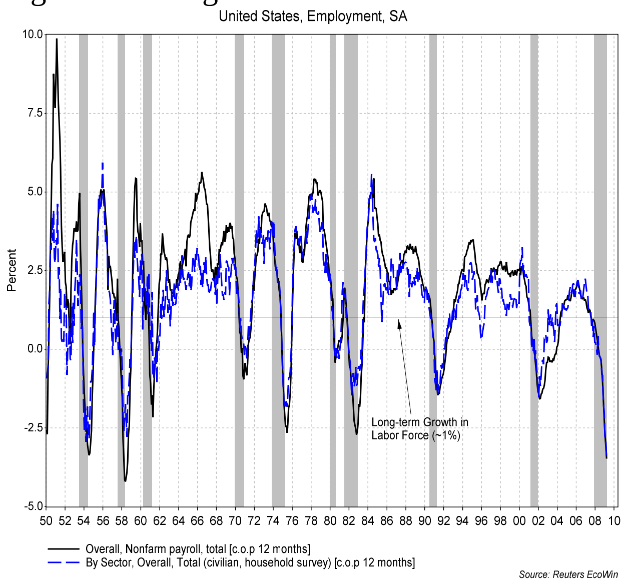
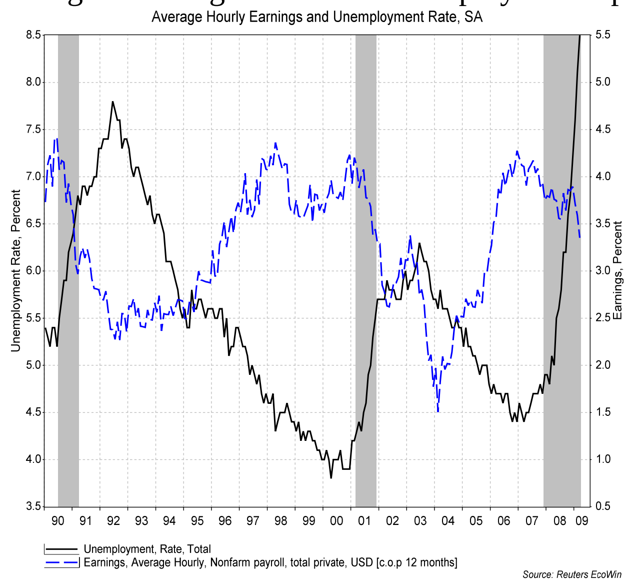


Figure 5: Wages Down as Unemployment Up



As the unemployment rate increased, wage growth slowed (Figure 5). Average hourly earnings were up 3.4% YoY in March, but job losses and a shorter workweek have pushed down income. Nominal **personal income** fell by 1.3% annualized in the first two months of 2009, while the personal consumption expenditure (PCE) deflator rose at an annual rate of 3.7% over the same period. Although lower energy prices probably pushed up real personal income in March, it's still likely to be weak in Q1 overall. Given the near-term wage and employment outlook, personal income does not look very good for Q2 either.

Personal consumption expenditures (PCE) probably recovered a bit in Q1 after plunging at roughly a 4% annual rate in real terms in the second half of 2008. Real (i.e. inflation-adjusted) PCE was up 1.3% annualized in the first two months of the year, although weak retail sales in March indicate some downside risk to PCE in the final month of the first quarter. Even if PCE posts a modest recovery in Q1, we are cautious about spending next quarter. We believe that households still want to increase their savings rates, which rose to 4.2% in February (Figure 6). If that continues to be true and personal income remains weak, then personal consumption is likely to fall again until fiscal stimulus spending starts to boost income. Most of that will not happen until the second half of the year, however (see discussion on government spending below), and that means PCE is vulnerable to turning negative again in Q2.

Figure 6: Income & Spending Weak, Savings Up

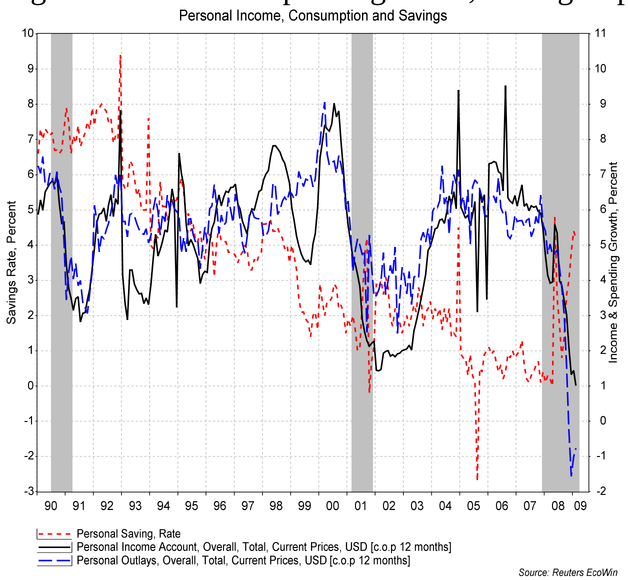
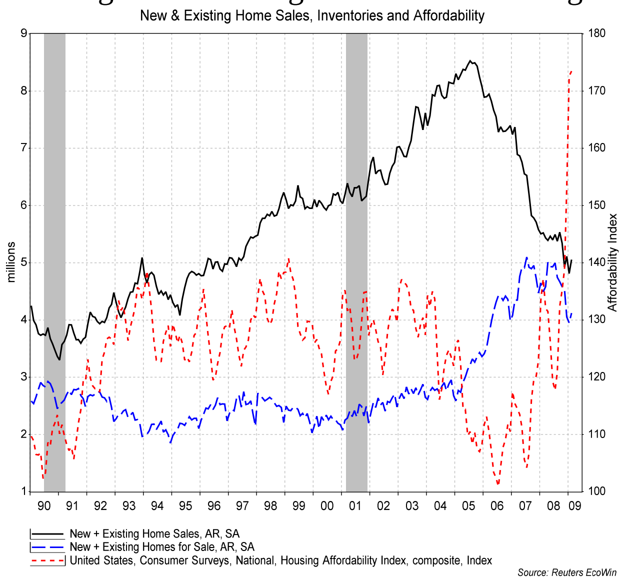


Figure 7: Housing – Soft but Bottoming?



Housing continues to shrink, although there are growing signs that the market is bottoming. Home sales plunged in 2008:Q4 as the financial crisis intensified, sidelining both homebuyers and lenders. However, sales appear to have stabilized at these lower levels (roughly 5 million annual units for both new and existing homes), and inventories of unsold homes have dropped by 873,000 units since July 2008 (Figure 7). In addition, homebuilders are starting to see rising homebuyer traffic and sales, albeit from very low levels. Inventories of unsold homes are still well above normal and suggest that both home prices and residential construction will fall farther. Lower home prices and rising unemployment likely will lead to more foreclosures over the near term, adding to supply pressures. However, lower home prices, low mortgage rates, government homebuyer incentives, and improving availability of mortgage credit have pushed housing affordability to a record high (Figure 7). At the same time, a growing population, little new building, and more than three years of falling home sales signal that there is pent up demand in the housing market.[3] It has not emerged meaningfully yet (mortgage applications for home purchases, for example, remain subdued), and until it does, housing will remain a drag on GDP. However, the recovery in housing may occur surprisingly rapidly once it gets underway.

Business investment is also in a major slump. Real spending on business investment plunged by 28.1% annualized in Q4, and the first quarter is not looking any better. We estimate that real capital goods orders excluding defense and aircraft are down more than 43% at an annual rate over the three months ending in February (Figure 8), and they are down at an even faster rate if we use just the past two months. In addition, shipments have now caught up with weak orders.

[3] There are three important sources of housing demand: household formation, home replacement, and demand for multiple homes. There are about 130 million housing units and 112 million households in the United States. Households have been growing at about a 1% annual rate over the past 20 years, which amounts to roughly 1.1 million households each year currently. In addition, homes have a finite useful life. Some become uninhabitable by natural disaster or neglect while others no longer satisfy current desires and are knocked down. Thus, some of the 130 million houses in the U.S need to be replaced each year. Currently, housing completions are running at about 800,000 units annualized. That's well below the pace of household formation, even before we consider demand for replacement dwellings and additional homes (which we admit is probably negative at the moment). As a result, fundamental demand for housing is rising even before we consider today's record affordability.

We estimate that shipments of core capital goods were down 29% annualized over the past three months, and they are down 45% annualized over the past two months.

Figure 8: Orders and Shipments Plunge…

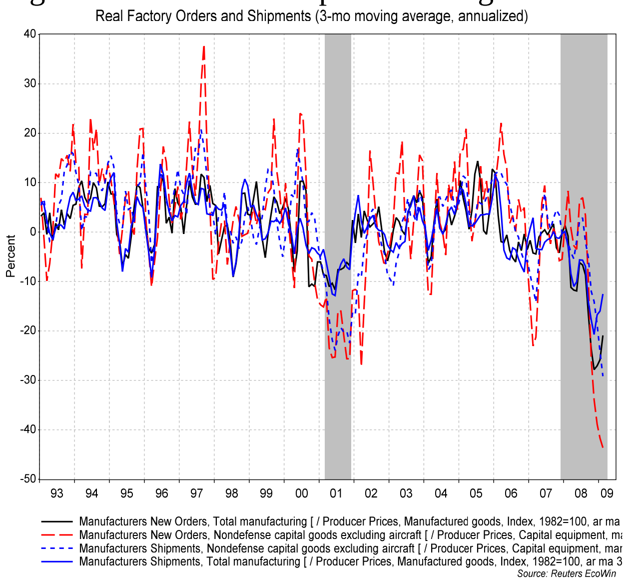
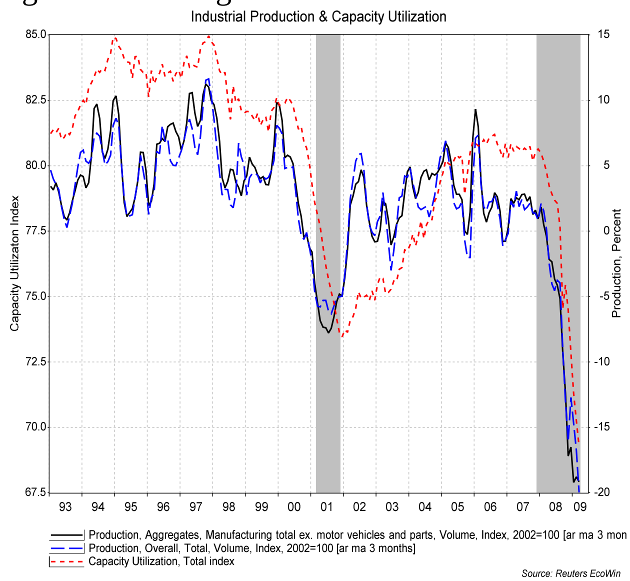


Figure 9: …Along with Production & Utilization



Weakness in business spending is being reinforced by falling **industrial production** and capacity utilization. Industrial production in the first quarter fell by more than 19% at an annual rate, whether we look at total production volume or manufacturing excluding vehicles (Figure 9). As production plunged, capacity utilization dropped to the lowest level on record (data started in 1967). Given substantial excess capacity, it’s no surprise that demand for new investment is severely depressed.

Overall, the only positive thing we can say about these order, shipment, and production numbers is that they are so bad that they cannot continue on such a sharp downward path for much longer. In fact, the Institute of Supply Management (ISM) manufacturing index is pointing to some reduction in cutbacks to production. The index has increased from 32.9 in December to 36.3 in March (readings below 50 indicate below-trend growth). In addition, surveys of New York and Philadelphia manufacturers improved modestly in April (Figure 10). Again, we are not talking about increases in production just yet, merely some moderation in the pace of decline. We continue to look for lower orders and production, since sales are declining and inventories, while falling, are rising relative to sales. Once inventories are in better balance with sales, however, we expect that orders will rise gradually, and production will follow. Fiscal stimulus (in particular, infrastructure projects) in combination with modest gains in consumer spending should provide much-needed support to the industrial sector, and we expect to see stabilization there in the second half of the year. In the meantime, business investment will remain a sizable drag on the economy.

The **trade** sector should be the one bright spot in the first quarter. The real trade balance improved sharply in February after widening in January, as exports rose for the first time in seven months while imports continued to fall (Figure 11). Even if the trade balance retraces half of this improvement in March, it should still add 1% or more to GDP in Q1. More ominously, both imports and exports are down sharply compared to a year ago, reflecting the collapse in global trade. Although we expect that trade improvement will add to GDP growth this year, it is not realistic to think that U.S. exports will grow in spite of a worldwide recession, while imports will shrink. We are happy to take the Q1 boost to GDP from trade, but we are not counting on it going forward.

Figure 10: Business Surveys Turning Upward

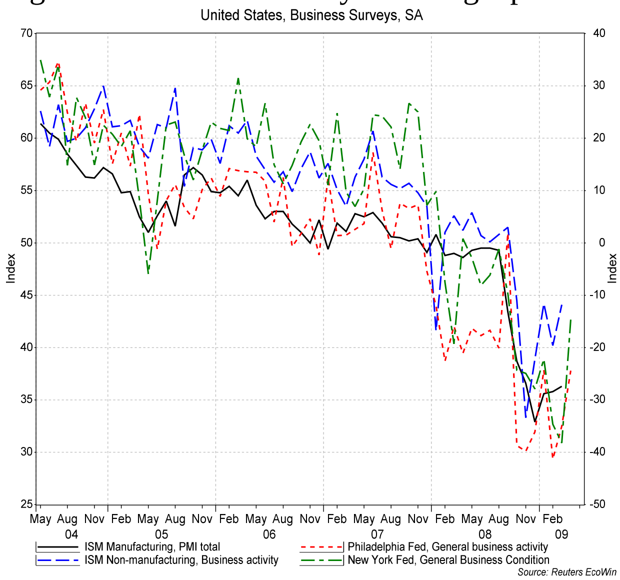
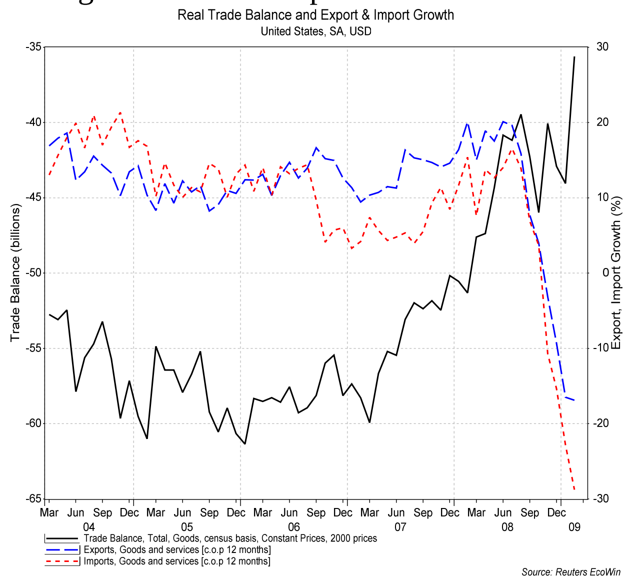


Figure 11: Trade Improvement Sustainable?



Government spending is surging at the federal level, but shrinking state and local government budgets are offsetting some of the strength in overall government spending. Government consumption added only ¼ percent to Q4 GDP, with the federal government adding ½ percent and state and local government subtracting ¼ percent. It was probably neutral or a small negative for GDP growth in Q1. Looking ahead, government spending is poised to increase substantially. Congress passed a $787 billion fiscal stimulus package in the first quarter. It includes tax cuts that will begin in Q2, but the bulk of the higher spending will not occur until the second half of 2009, and most of it will not be spent until 2010. The Congressional Budget Office (CBO) estimates that net government spending will increase by $185 billion (23% of the total program) in 2009, $399 billion (51%) in 2010, and the remaining $203 billion (26%) in 2011 and beyond. These are big numbers, even for the U.S. economy. The amounts represent about 2.6% of GDP in 2009 (assuming that all $185 billion is spent in the second half of the year), 2.8% of GDP in 2010, and smaller percentages in 2011 and beyond. The deficit spending should accommodate the further increase in the savings rate that we discussed earlier.

Of course, this deficit spending is not "free." Greater spending now means higher taxes and slower real growth in the economy later. Adding the cost of the fiscal stimulus to President Obama's proposed budget, the CBO estimates that the cumulative 2010-2019 budget deficit will jump from $4.4 trillion (baseline) to $9.3 trillion, on top of the expected $1.7 trillion deficit in 2009. Of course, these estimates are fraught with uncertainty, including projections on economic growth, military spending, inflation, and may other unknowns. Nonetheless, it is clear that the federal budget deficit is poised to expand dramatically. It is difficult to envision this level of deficit spending without higher inflation and slower real growth longer-term. This is not a near-term worry, but markets ultimately will have to reckon with it. For our purposes, we see a little inflation as a good thing currently, but we will watch it closely as the economy heals.

Figure 12: Overall Inflation Plunging YoY…

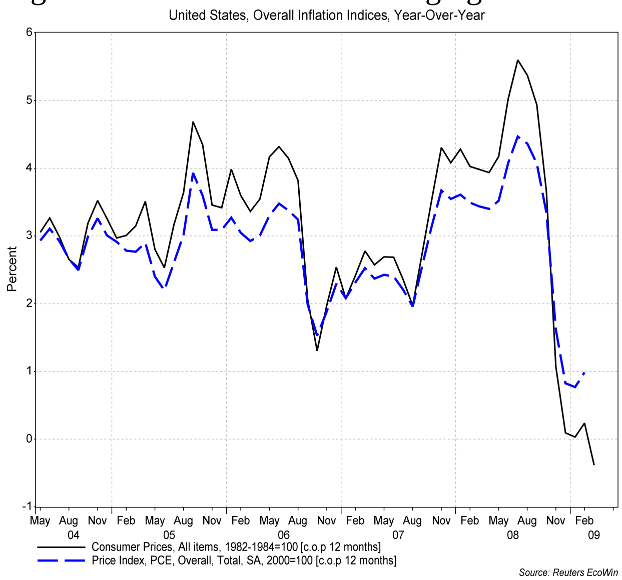
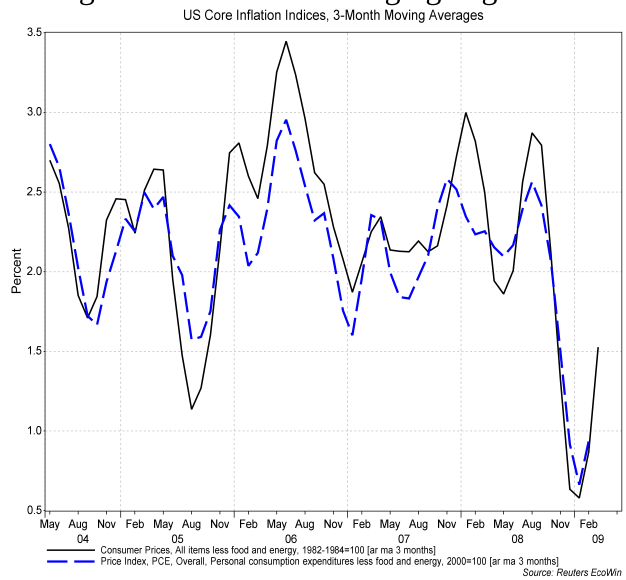


Figure 13: …But Core Edging Higher Now



While we are concerned about the long-term inflation outlook, inflation is not one of our near-term worries. Inflation fell sharply in the fourth quarter and has remained sluggish in the first quarter. Energy prices have continued to be quite volatile, which has caused the headline inflation indices to move around significantly month-to-month, but prices excluding food and energy have been relatively stable. The overall consumer price index (CPI) rose 2.2% annualized in Q1 and fell by 0.4% YoY, mostly due to lower energy prices. CPI excluding food and energy also increased by 2.2% annualized in Q1 and 1.8% YoY (Figures 12 and 13). The PCE deflator excluding food and energy mirrors its CPI counterpart. Although rapid monetary expansion eventually will fuel higher inflation, we think that low monetary velocity coupled with significant excess capacity will keep inflation subdued for now.

Market Outlook

Credit markets continued to contend with a shrinking economy in the first quarter of 2009. For the most part, the trends we described last quarter remain intact. Loan delinquencies and charge-offs are increasing, especially (though not surprisingly) among mortgage loans (Figures 14). Mortgage foreclosures slowed a bit, but that reflects temporary moratoriums on new foreclosures at a number of mortgage lenders, most of which have now been lifted. Interest expense as a proportion of earnings before interest and taxes (EBIT) at nonfinancial corporations is increasing, largely because earnings are shrinking (Figure 15). Net mortgage borrowing (mortgage borrowing less residential investment) remains deeply in negative territory, and consumer credit is still shrinking (Figure 16), driving down total household borrowing even further in the fourth quarter. However, after tightening lending standards sharply in 2008, banks are beginning to ease up a bit. Lending standards are still tightening, but the pace of tightening has diminished (Figure 17).

Perhaps most encouragingly, several large banks, including JP Morgan Chase, Wells Fargo and Goldman Sachs, reported relatively strong earnings in the first quarter of 2009, despite a difficult operating environment and poor loan performance. Rising interest margins and higher trading revenues are gradually overtaking losses on bad loans. This is the natural consequence of reduced excess capacity in financial services.[4] Financial service companies still face many challenges, and many have not yet returned to profitability. However, the expansion of the government's financial stability and liquidity programs (see below) and this recent demonstration of modest profitability at some financial companies have suppressed the rampant (and in our view irrational) fears of widespread bank nationalization that gripped the markets earlier in the year.

Figure 14: Mortgage Problems Getting Worse

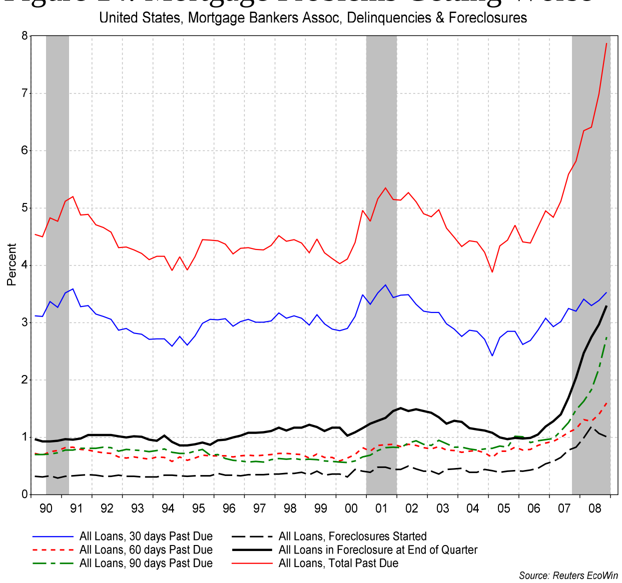


Figure 15: Balance Sheets Starting to Weaken

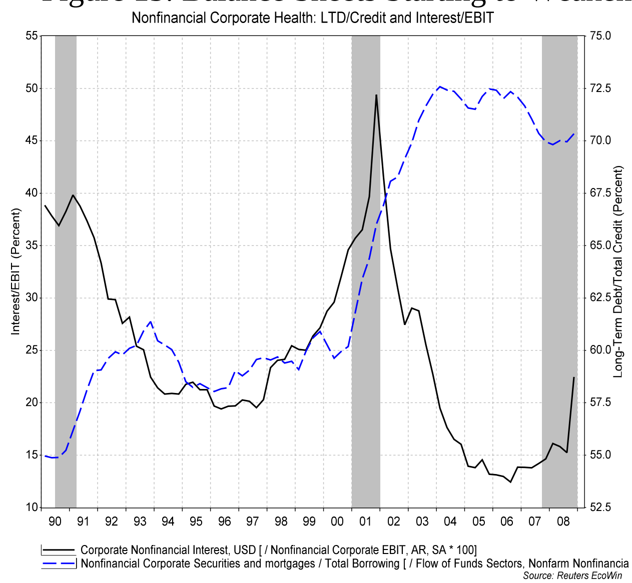


Figure 16: Consumer Borrowing Falling…

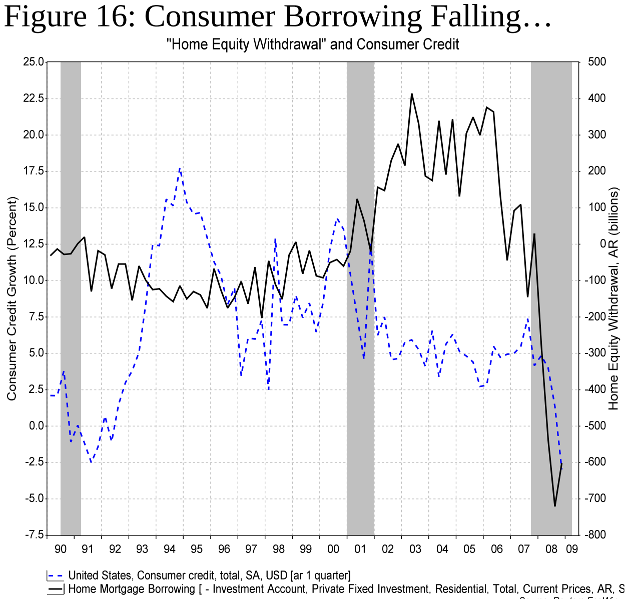
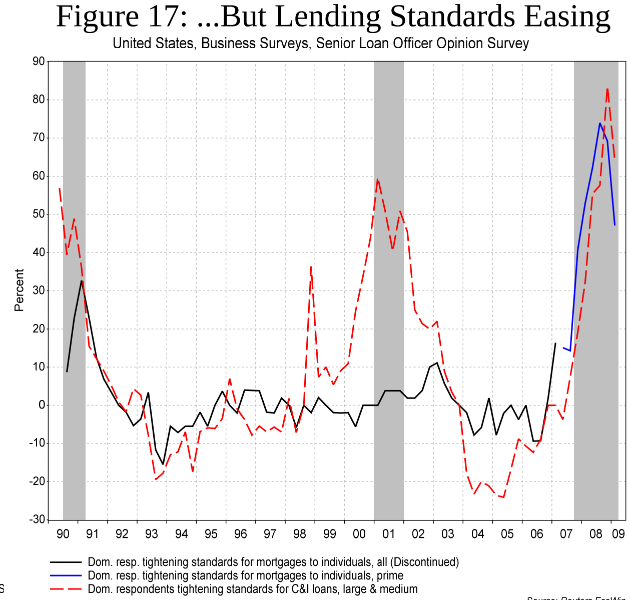


Figure 17: ...But Lending Standards Easing



[4] The most dramatic capacity reductions came from the departure of numerous large firms from the market, including Bear Stearns, Washington Mutual, Lehman Brothers and Wachovia. Of course, many of these firms' businesses were absorbed by other institutions, but they still involved substantial elimination of poorly-performing or duplicative businesses. Overall capacity in financial services has fallen significantly as a result of these and other moves by financial service companies.

In response to these worsening economic and credit conditions, the federal government continued to expand its array of financial stability and liquidity programs in the first quarter. Although the Federal Reserve left the federal funds rate unchanged at near zero, it expanded several liquidity programs, resulting in significant growth in its balance sheet (Figure 18). The Fed added $100 billion and $750 billion, respectively, to its previously planned purchases of $100 billion of agency debt and $500 billion of agency mortgage-backed securities. It also announced and launched a program to purchase $300 billion of Treasury securities. Both programs are aimed at providing additional liquidity directly to credit markets and helping to hold down interest rates, particularly mortgage rates. The Fed launched and expanded the size of its Term Asset-Backed Securities Lending Facility (TALF). It will now lend up to $1,000 billion through this program, and it broadened the types of collateral that can be pledged in the program to include commercial mortgage backed securities (CMBS) and non-agency MBS.

Figure 18: Fed Balance Sheet Growing Again

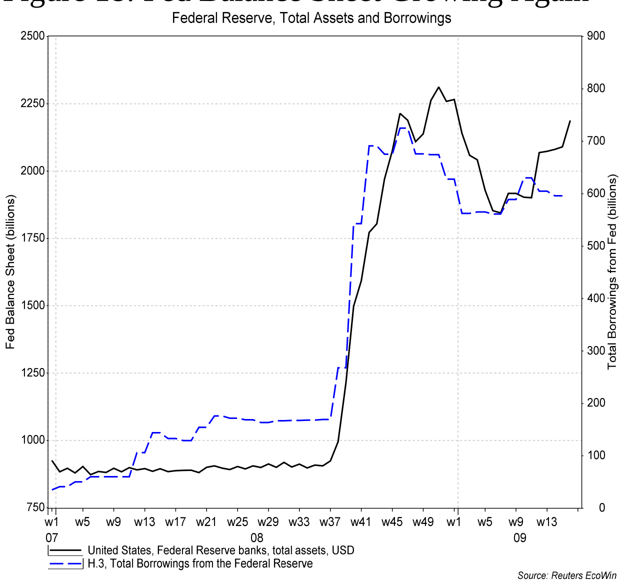
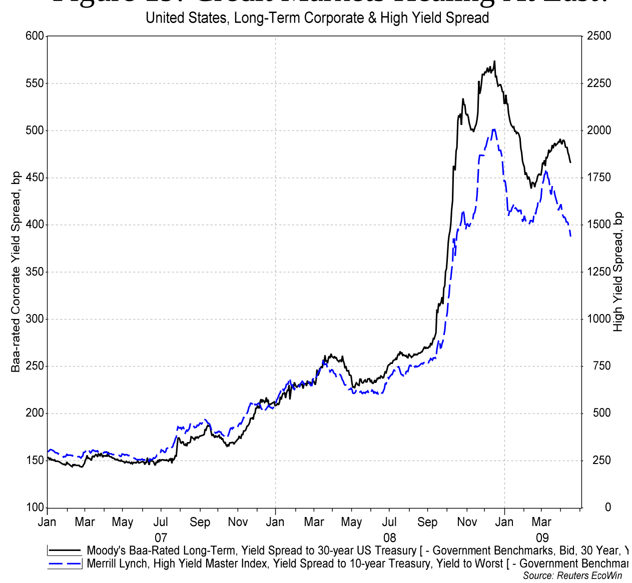


Figure 19: Credit Markets Healing At Last?



Not to be outdone, the Treasury announced an important reworking of the Bush administration's Troubled Assets Relief Program (TARP). First, the Obama administration changed the name of these financial relief efforts to the Financial Stability Plan (FSP). The program allocated $50 billion for mortgage relief and $55-100 billion in expanded government financing (via the TALF) of student loans, credit card and auto loans, and small business loans. It also committed an unspecified amount of money to the Capital Assistance Program (CAP) for banks. This new program, which is similar to the earlier Capital Purchase Program (CPP), offers additional preferred capital to banks that can be converted to common equity at the request of the issuing bank. CAP capital, which comes with stringent financial and governance requirements, will be provided to systemically important banks that regulators determine need it and to other banks that apply for and are approved to receive it.

Treasury also announced details of its Public-Private Investment Program (PPIP). The PPIP seeks to purchase $500-1,000 billion of legacy loans and securities from eligible financial institutions. It consists of the Legacy Loan Program (50% private capital, 50% Treasury capital, FDIC leverage up to 6:1) and the Legacy Securities Program (50% private capital, 50% Treasury capital plus debt financing equal to 100-200% of capital; certain assets may be available for

TALF loans as well). Treasury anticipates committing $75-100 billion to this program, with the balance of financing coming from private sources, the FDIC, and (potentially) the Federal Reserve.

This broad array of government assistance programs, which already had achieved success in helping money markets return to more "normal" levels of activity and pricing, finally began to have an impact on long-term credit markets. Although corporate credit spreads remain volatile and are still much wider than normal, they have tightened materially since the end of 2008 (Figure 19). Long-term Baa-rated corporate bond yield spreads narrowed by about 65 basis points (bp) since the end of the year, and high-yield bond spread tightened by almost 300 bp.

While the direction of preferred securities prices was similar to that of corporate bonds – falling early in the quarter and rallying over the past month or so – most preferred prices remain below their year-end levels, and corresponding yield spreads remain near their all-time highs (Figures 20 and 21).[5] Despite the rally in recent weeks, we estimate that preferred securities continue to price in default experience that is substantially greater than that experienced during the Great Depression.[6] We simply cannot reconcile such extreme default outcomes given the vast expansion of the government's financial stability and liquidity programs, especially when data are now signaling some moderation in the pace of decline in the economy. We continue to believe that preferred securities offer outstanding value to long-term investors.

Figure 20: ML Preferred Index Price Returns

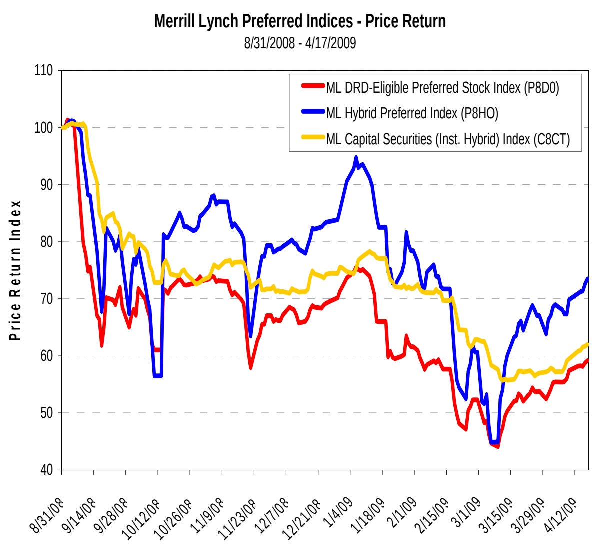
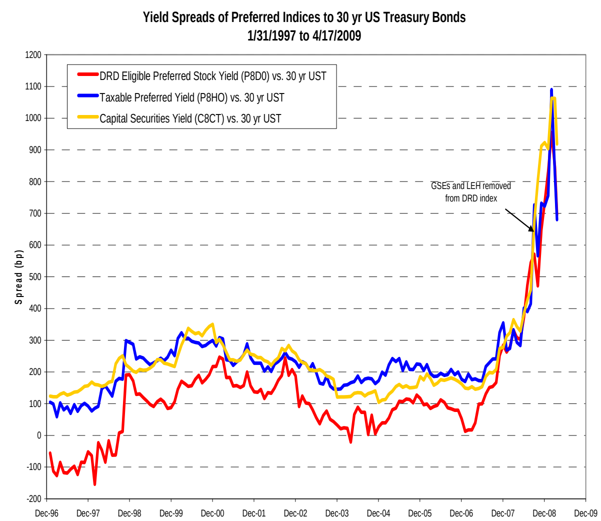


Figure 21: ML Preferred Index Yield Spreads



That is not to say that preferred securities are without risk. Over the long term, defaults overall or in the portfolios we manage could be worse than prior historical maximums. Over the near term, current tentative signs of improvement in the economy could fizzle out, leading to another round of nationalization fears. This could prompt other banks to offer to exchange preferreds for

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[5] For a description of the Merrill Lynch preferred indices, see *Fourth-Quarter U.S. Economic Update*, Flaherty & Crumrine Incorporated, January 21, 2009, available at www.preferredincome.com or www.fcclaymore.com.

[6] See *Preferred Valuation after the TARP*, Flaherty & Crumrine Incorporated, January 5, 2009, available at www.preferredincome.com or www.fcclaymore.com.

common stock, as Citigroup did in the first quarter. In the case of Citigroup, its preferred securities (especially the DRD-eligible preferreds that are the target of the exchange) actually rallied on the exchange offer.[7] However, the value implied by the exchange at the time of the offer was still well below the par amount of the preferreds, even though it was above then-current market prices. Future preferred-for-common exchanges, if any, are virtually certain to involve discounts to the par value of those securities, and terms could be materially worse than those offered by Citigroup. Moreover, we believe that if a bank issues CAP preferred to the Treasury and subsequently converts it to common stock, the odds of a preferred-for-common exchange following that conversion would be high. In other words, if the government provides common equity capital, DRD-eligible preferreds, which are equal in ranking to Treasury preferreds, likely will be asked to do the same, at least to some extent.

Given all of the crosscurrents in the economy, the uncertainty surrounding how government policy will develop, and the difficulty faced by policymakers in eventually removing – and paying for – all of the stimulus that has been put in place, we expect that preferred securities prices will remain volatile. At the same time, we think the long-term trend in preferred securities overall will be upward. There are two main reasons for this. First, the recession should at a minimum lose intensity as the year progresses, and there is a good chance that there will be renewed growth before the year is out. Although we expect that loan performance will continue to deteriorate throughout 2009, since it lags the economy, banks' earnings power is improving. Markets will price in a turn in the credit cycle ahead of actually achieving it.

Second, following a near-collapse in financial markets in September, government policy has been broadly supportive of financial institutions and preferred securities, and its size and scope are unprecedented. The government has demonstrated that it is moving aggressively to avert depression. In some cases, preferred securities holders will need to participate in the recapitalization of troubled institutions (and in cases of receivership, preferred securities likely will be wiped out). However, we continue to believe these recapitalizations will be special situations, not applied indiscriminately across the banking system, as the market seemed to fear in early March. With preferreds still pricing in default rates worse than those during the Great Depression, we continue to see tremendous long-term value in preferred securities currently.

Flaherty & Crumrine Incorporated
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[7] Citigroup stock has rallied dramatically since shortly after the exchange offer was announced. If the stock remains at or above $3.42, it is possible that preferred holders will receive common stock worth par or even more for their preferred shares. There is no assurance that future exchanges, if any, will work out so favorably for preferreds.