

## Third-Quarter U.S. Economic Update October 2009

### *Summary of Recent Economic Developments*

The third quarter should register renewed growth in the U.S. economy. Economists expect 2.4% growth in 3Q09 and continued moderate growth through 2010. That is welcome news, though it does represent a slower-than-normal recovery rate for the economy considering the severity of the recent contraction. Several factors contribute to this mixed outlook. On the positive side, economic activity across all sectors is improving. Job losses have slowed considerably; consumption is up; industrial production has rebounded; global trade is recovering; fiscal stimulus is boosting government consumption; and even the housing market is on the verge of contributing to economic growth. Credit markets generally cheered this economic news, as credit spreads tightened and preferred prices rose during the quarter. Looking ahead, rising savings and constrained credit along with sizable excess capacity suggest that growth in investment and consumption will be limited, which in turn is likely to keep job formation and income growth subdued. In addition, fiscal stimulus will give way to restraint in 2011 and beyond as the government seeks to reduce the budget deficit through higher taxes. This “faster growth now for slower growth later” dynamic should be positive for preferred investors, as long as inflation remains subdued and businesses and consumers repair their balance sheets as we expect. As a result, although credit problems have not yet peaked, we remain cautiously optimistic about the prospects for preferred securities.

Figure 1: Key Macroeconomic Indicators and Interest Rates

<b>Economic Indicator*</b>	<b>2007:4</b>	<b>2008:1</b>	<b>2008:2</b>	<b>2008:3</b>	<b>2008:4</b>	<b>2009:1</b>	<b>2009:2</b>	<b>2009:3</b>
Real GDP, Chg QoQ (%)	2.1	-0.7	1.5	-2.7	-5.4	-6.4	-0.7	2.4f
Real Personal Consump Expnds, Chg QoQ (%)	1.2	-0.6	0.1	-3.5	-3.1	0.6	-0.9	3.3a
Real Busi Investmt, Eqp & Sftware, Chg QoQ (%)	4.5	-0.5	-5.0	-9.4	-25.9	-36.4	-4.9	NA
Real Residential Investmt, Chg QoQ (%)	-29.5	-28.2	-15.8	-15.9	-23.2	-38.2	-23.3	NA
Corporate Profits, After Tax, Chg YoY (%)	-5.3	6.6	-3.7	4.8	-15.8	-19.7	-15.3	-14.9f
Current Account Balance, Annualized (% of GDP)	-4.6	-5.0	-5.2	-5.1	-4.3	-2.9	-2.8	NA
Federal Budget, 12-mo Def or Surp (% of GDP)	-1.3	-1.5	-2.3	-3.1	-4.7	-6.5	-8.9	-9.9f
Unemployment Rate (%)	4.9	5.1	5.6	6.2	7.2	8.5	9.5	9.8
Household Employment, Chg QoQ (000)	91	-271	-285	-709	-1691	-2451	-691	-1332
Nonfarm Payrolls, Chg QoQ (000)	500	-338	-458	-624	-1658	-2074	-1285	-768
Nonfarm Productivity, Chg QoQ (%)	2.0	-0.1	3.1	-0.1	0.8	0.3	6.6	NA
Capacity Utilization (%)	80.6	79.8	78.7	74.5	72.7	69.5	68.3	70.5
GDP Price Index, Chg QoQ (%)	2.3	1.9	1.8	4.0	0.1	1.9	0.0	NA
Consumer Price Index, Chg YoY (%)	4.1	4.0	5.0	4.9	0.1	-0.4	-1.4	-1.3
CPI ex food & energy, Chg YoY (%)	2.4	2.4	2.4	2.5	1.8	1.8	1.7	1.5
Nominal Personal Income, Chg YoY (%)	4.8	3.1	4.2	2.5	0.4	-2.2	-3.4	-2.6a
Personal Savings Rate (%)	1.4	1.0	3.5	2.2	4.7	3.5	4.2	3.0a
<b>Rate or Spread (End of Quarter)</b>	<b>2007:4</b>	<b>2008:1</b>	<b>2008:2</b>	<b>2008:3</b>	<b>2008:4</b>	<b>2009:1</b>	<b>2009:2</b>	<b>2009:3</b>
Federal Funds Rate Target (%)	4.25	2.25	2.00	2.00	0.25	0.25	0.25	0.25
3-month LIBOR (%)	4.70	2.69	2.78	4.05	1.43	1.19	0.60	0.29
10-Yr Treasury Note Yield (%)	4.03	3.41	3.97	3.83	2.22	2.67	3.54	3.31
30-Yr Treasury Bond Yield (%)	4.48	4.29	4.52	4.31	2.68	3.54	4.34	4.05
Moody's Baa Long Corp Spread (bp)	208	261	252	354	529	491	283	212
10-Yr Interest Rate Swap Spread (bp)	63.8	66.0	70.3	66.5	35.0	20.0	24.8	15.3

\* Figures are either quarterly or, if more frequent, quarterly averages.

f = Forecast<sup>1</sup>; a = Actual through August 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*

Third quarter inflation-adjusted Gross Domestic Product (real GDP) is forecast to grow by 2.4%, and the economy is expected to continue expanding by about 2.3% on average in 2010.<sup>1</sup> That growth rate would be slower than normal given the severity of the recession that the U.S. economy experienced in 2008-09. At the forecast growth pace, it will take until early 2011 for real economic activity to get back to its pre-recession level for the economy as a whole; some sectors will take even longer. Nonetheless, sluggish growth is better than recession, and the outlook today is much brighter than seemed possible at the start of the year.

The **labor market** continued to weaken in the third quarter of 2009, and we expect that this will be among the last places where economic recovery will become truly apparent. Payroll employment and initial jobless claims showed ongoing improvement over the quarter. However, companies are still shedding workers, and the more-volatile household employment survey worsened (Figure 2). As a result, the unemployment rate and the amount of time spent unemployed continued to rise. Moreover, businesses remain cautious in their hiring. Both the Monster Employment Index and the Manpower Employment Outlook Survey remain depressed, despite some improvement recently (Figure 3). With the economic recovery just getting underway, heavy emphasis on cost-cutting at businesses, and uncertainty over proposed business taxes and federal mandates for health insurance, employment is sure to lag the recovery. That does not mean that jobs will not be created, but employers will need to feel increasingly stretched before adding workers. We don't expect to see net employment gains for another quarter or two, and those gains probably won't be large enough (at least +100,000 jobs per month) to start bringing down the unemployment rate until the second half of 2010.

Figure 2: Employment Trend Improving...

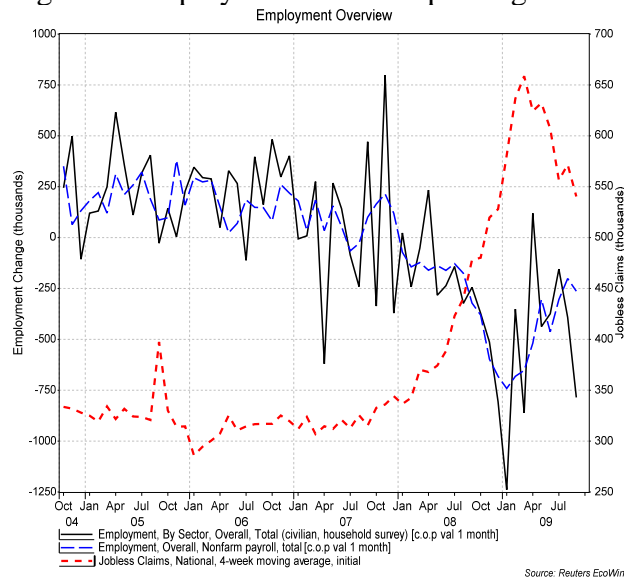
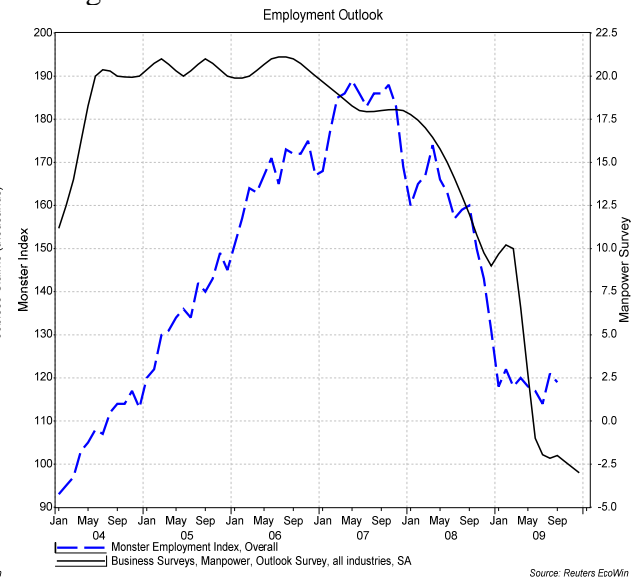


Figure 3: ...But Outlook Remains Cautious

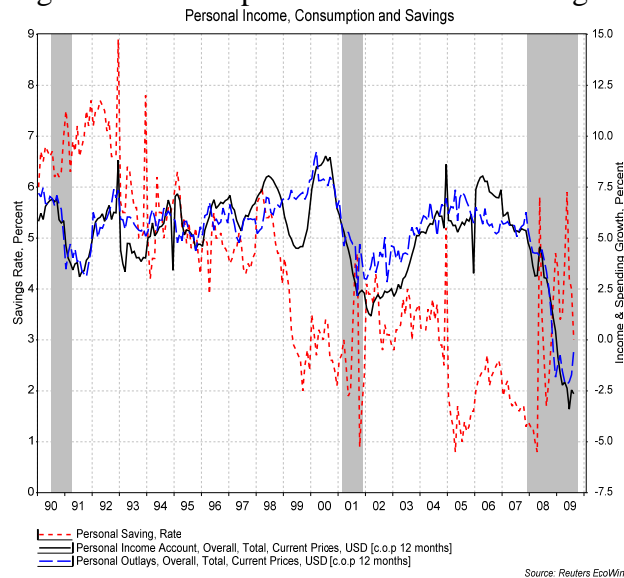


**Personal income** largely mirrors the employment situation. Nominal income so far in the third quarter of 2009 is down slightly (-0.3% at an annual rate) compared to the second quarter, but that is a slower rate of decline than in prior quarters. Employment is shrinking, and wage growth is sluggish. Average hourly earnings were up 2.6% YoY in the third quarter, down from 3.9%

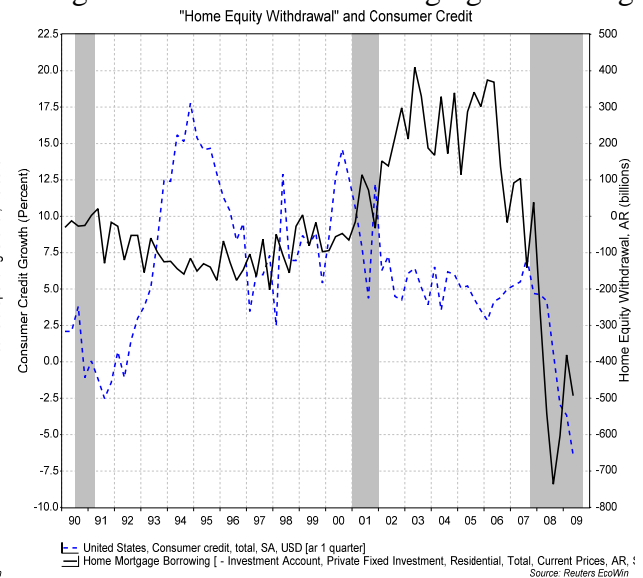
<sup>1</sup> Forecasts are from *Survey of Professional Forecasters*, Federal Reserve Bank of Philadelphia, August 14, 2009.

YoY in 4Q08. That translates into weakness in wages and salaries, which make up a little more than half of personal income. Although transfer payments (Social Security, unemployment payments, and the like) are rising, they are not enough to offset drops in proprietors' income and interest and dividend income. As a result, overall personal income is down 2.6% YoY (Figure 4). We anticipate gradual improvement in these income numbers, but we will need to see both rising employment and faster wage growth before income growth can really take off.

**Figure 4: Consumption & Income Bottoming**



**Figure 5: Consumer Deleveraging Continuing**



**Personal consumption** fared somewhat better than personal income in the third quarter. The government's "cash-for-clunkers" automobile incentive program and some recovery in core retail sales (excluding autos, gasoline, and building materials) pushed real personal consumption expenditures (PCE) up at a 3.3% annual rate in 3Q09 through August, compared to an average of -0.2% in the first half of the year. On a nominal (i.e., not inflation-adjusted) basis, PCE is down by 0.3% YoY after bottoming out at -2.9% YoY in May 2009 (Figure 4).

There are two caveats to the better-than-expected consumption numbers, however. First, the government's auto incentive program (which ended in August) probably accelerated rather than created some auto purchases, meaning that future months' auto sales may be slower than they otherwise would have been. Auto sales data seem to bear this out: August sales spiked to 14.1 million units (annualized), but September sales dipped back to just 9.2 million units, no better than the sales pace prior to the incentive program. Second, rising consumption with stagnant incomes meant that the **personal savings rate** dropped back to 3.0% as of August, down from a recent peak of 5.9% in May (Figure 4).

Offered sizable (and expiring) auto incentives, consumers took advantage of bargains and increased consumption in Q3. However, they also reduced borrowing. Consumer credit continued to fall in the first two months of Q3, while "home equity withdrawal<sup>2</sup>" was negative again in Q2 (Figure 5). We think this deleveraging and the passing of one-time incentives will trump consumption. The savings rate should resume its gradual trend upward. As the economy

<sup>2</sup> Home equity withdrawal is mortgage borrowing less residential investment. If HEW is positive (negative), it means homeowners in aggregate are borrowing against (adding to) home equity.

recovers, we think there will be room for both savings and consumption to rise, but the growth rate of the latter is likely to be muted.

The most remarkable turnaround in the economy can be found in its previously worst-performing sector. The **housing market**, after being a drag on GDP growth since 1Q06, is poised to add to GDP growth this quarter. Residential construction spending through August is up about 1% annualized over the prior quarter. If it does not drop back in September, it will add to Q3 GDP. More importantly, new and existing home sales are rising and inventories of unsold homes are falling. High housing affordability and low mortgage rates coupled with falling inventories have caused home prices in most markets to increase slightly. We are not saying that housing investment will lead the economy to recovery (far from it, in fact), but it does underscore that housing has bottomed and that its burden on the economy should gradually lighten over the coming quarters.<sup>3</sup>

Figure 6: Home Sales Up, Inventory Falling

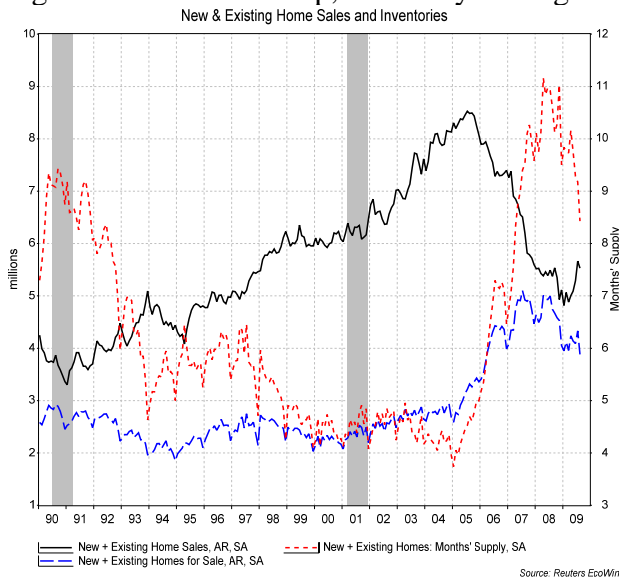
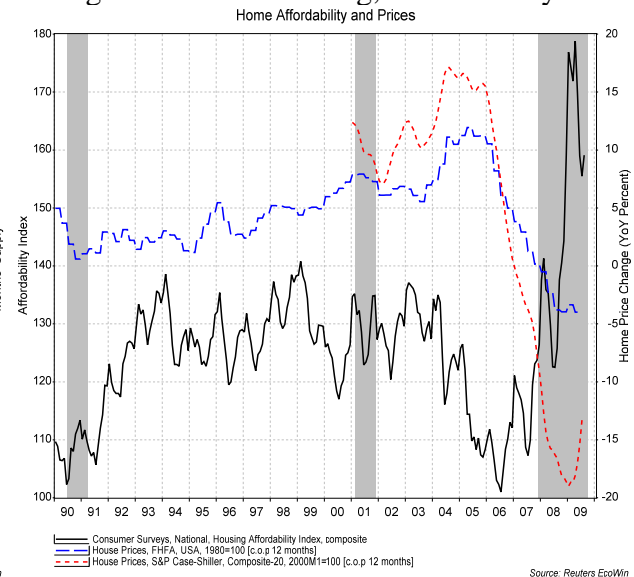


Figure 7: Prices Firming, Affordability Good



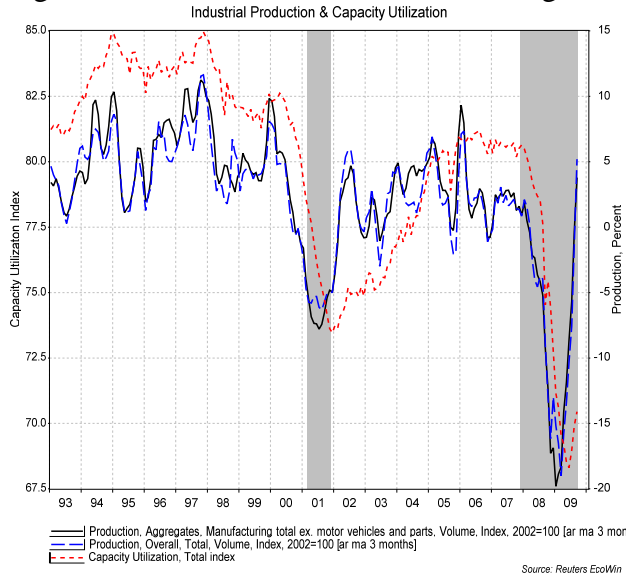
**Business investment** also looks to be on the mend in Q3, although like housing it will take awhile before this sector contributes much to GDP growth. Orders for and shipments of capital goods continued to recover from their swoon in 4Q08 and 1Q09, although for the most part that means just getting back to around flat quarter-over-quarter. The data for **industrial production** looks almost identical, recovering to up modestly from down 20% around the beginning of the year (Figure 8). In addition, business surveys point to further growth ahead (Figure 9). Capacity utilization remains low, however, so investment in new plant and equipment likely will be sparing for now.

The **trade sector** looks like it will be a small drag on GDP in the third quarter. Through August, the real trade balance widened slightly, suggesting that trade may subtract about ¼ percentage point from GDP, although September’s data could easily change that estimate. More important, however, is the fact that both imports and exports are rising again (Figure 10). This is a clear

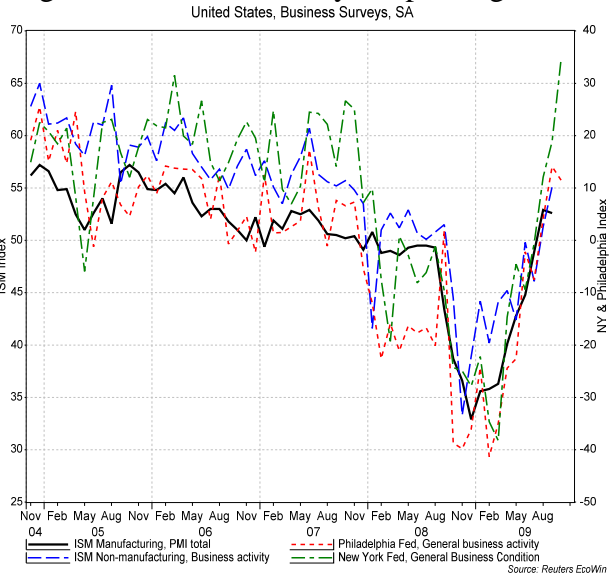
<sup>3</sup> Although residential investment may start adding to GDP as soon as 3Q09, the burden from housing in the form of mortgage delinquencies and charge-offs, impaired credit, and lower housing wealth will weigh on the economy for some time.

indication that global trade is recovering nicely from its collapse around the financial crisis. As trade volumes improve, we expect the real trade deficit to continue to narrow and add to GDP growth, albeit at a slower pace than since the start of the recession.

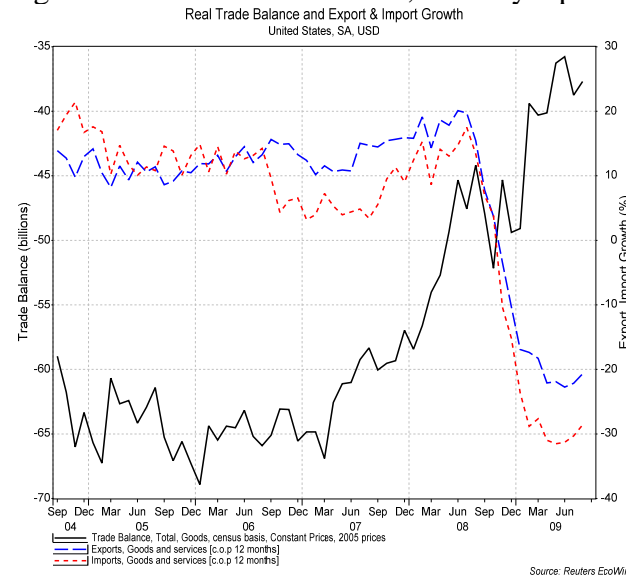
**Figure 8: Industrial Production Recovering**



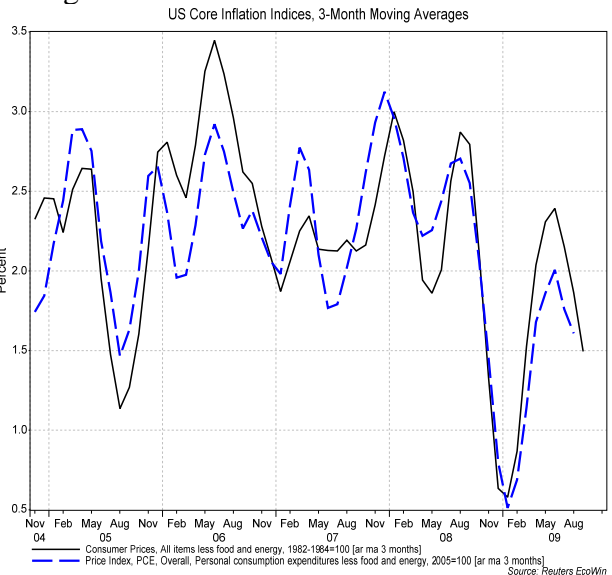
**Figure 9: Business Surveys Improving**



**Figure 10: Trade Deficit Wider, Activity Up**



**Figure 11: Inflation Muted**



**Inflation** pressures remain muted. Overall consumer prices as measured by the Consumer Price Index (CPI) or PCE deflator are -1.3% and -0.5% over the year ended in September and August, respectively. Core inflation readings (excluding volatile food and energy prices) under both indices are less than or equal to 1.5% YoY. They are somewhat above that over the past three months, but are far from alarming (Figure 11). The vast amount monetary and fiscal stimulus that has been applied to the economy continues to make us nervous about inflation. However, given substantial excess capacity at businesses, high unemployment, and much more stringent credit

availability, we still do not see where inflation can get a toehold on a near- to medium-term horizon, though we are watching closely.

**Government spending** accelerated in the third quarter, mainly due to disbursements from the \$787 billion fiscal stimulus bill passed earlier in the year. Most of the tax cuts included in the stimulus package took effect quickly, but spending took longer to ramp up. Through early October, the federal government had allocated \$309 billion of spending and actually paid out \$111 billion. The latter figure is up from \$56 billion as of the end of the second quarter, implying that about \$55 billion was spent in 3Q09. Assuming that cuts in state and local spending roughly offset increases in federal spending away from stimulus spending, then overall government consumption should add about 1.5 percentage points to GDP in the third quarter, slightly more than the 1.3% it added to growth in 2Q09.

The federal government today released the budget deficit for the fiscal year 2009 ended in September. It's a stunningly large number, \$1.42 trillion, though that actually is a little smaller deficit than expected earlier in the year. However, the deficit for fiscal year 2010 is looking even worse. Tax receipts remain weak and are not likely to improve much until income growth picks up (higher personal tax rates are not scheduled to take effect until 2011), although higher corporate profits should increase business tax revenue. Spending continues to rise even without new spending legislation that is currently working its way through Congress. Before adding in any new spending, the Congressional Budget Office forecasts a deficit of \$1.4 trillion in FY2010, about 9.6% of GDP. Unless the economy grows significantly faster than assumed (CBO uses 2.8% real GDP growth from 4Q09 to 4Q10 – a little higher than private forecasts, but reasonable) or Congress puts a lid on spending, the actual deficit probably will be larger.

For now, we do not think that two years of deficit spending in the area of 10% of GDP will cause problems for the markets. Current Treasury auctions can accommodate these deficits, as they have this year. In addition, a rising savings rate coupled with dampened risk tolerance should drive savers toward Treasury securities. Treasury may need to pay somewhat higher rates over time, but we don't think heavy issuance by itself will drive interest rates significantly higher. However, deficits of this magnitude would rapidly drive total federal debt, which currently stands at just over 50% of GDP, to levels that are politically and economically unacceptable, especially in light of the future funding needs for Medicare and Social Security as baby boomers retire over the coming two decades. Deficits are going to have to come down. How that happens will have important investment implications, which we discuss below.

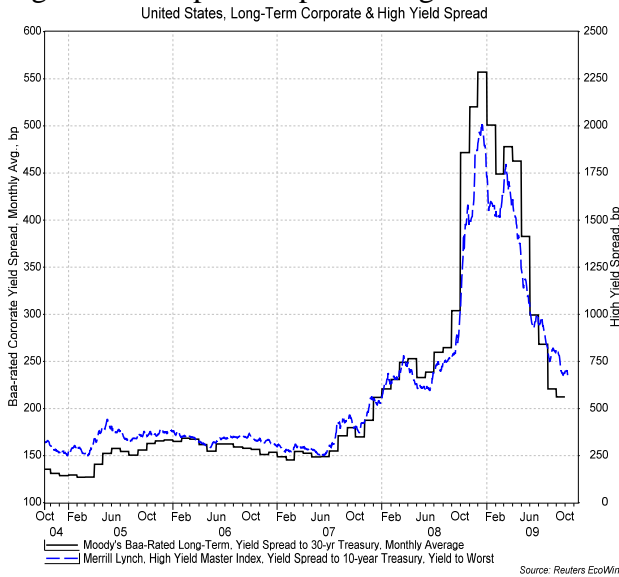
### *Market Outlook*

Credit markets extended their recovery in the third quarter. Money market spreads now are back to roughly pre-crisis levels, and spreads on long-term investment-grade and high-yield corporate bonds have retraced most of the widening of the past two years (Figure 12). This reflects not only the improvement seen in the economy but also the dramatic undervaluation of these assets during the depth of the crisis. Preferred prices<sup>4</sup> also improved, though the recovery started a little later and has not run quite as far as for corporate bonds (Figure 13).

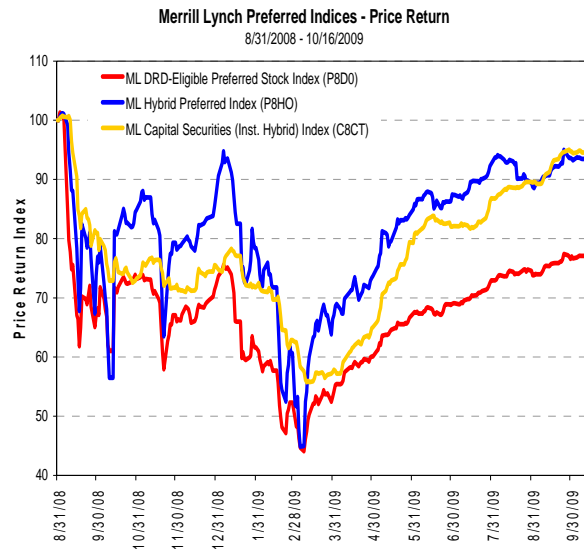
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<sup>4</sup> Preferred prices are represented by three Merrill Lynch preferred indices. For a description of the indices, see *Fourth-Quarter U.S. Economic Update*, Flaherty & Crumrine Incorporated, January 21, 2009, available at [www.preferredincome.com](http://www.preferredincome.com) or [www.fcclaymore.com](http://www.fcclaymore.com).

**Figure 12: Corporate Spreads Tighten**

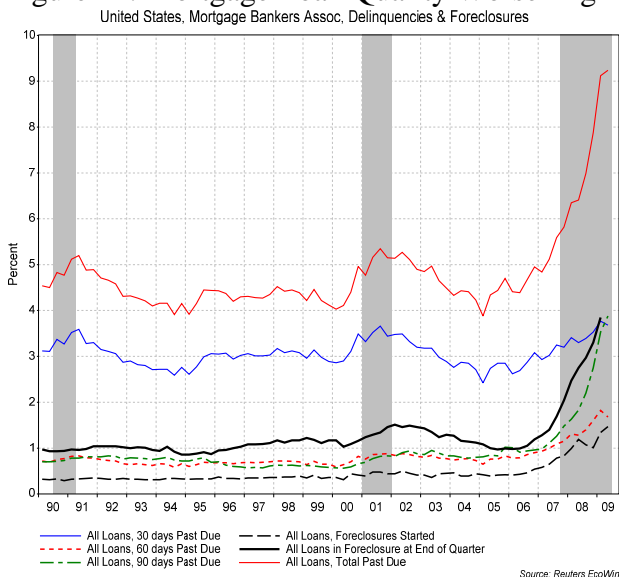


**Figure 13: Preferred Prices Rally**

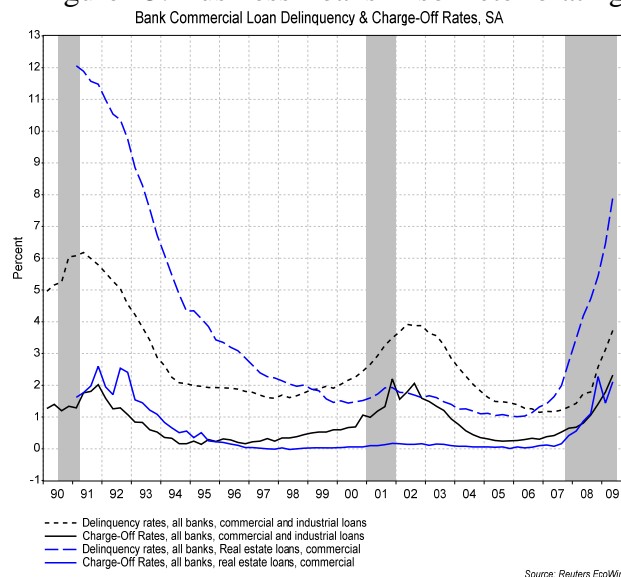


Overall credit quality, however, continues to deteriorate in both the consumer and business sectors. Consumer credit card delinquencies and charge-off rates are still rising, although the increase in these rates has slowed considerably in recent months as the rise in the unemployment rate has slowed. Mortgage credit problems are also getting worse, but there too the rise in delinquency and charge-off rates appears to be slowing as the housing market improves (Figure 14). Business loans, however, still have not shown any real sign of improving (Figure 15). We expect that credit cards delinquencies and charge-offs will peak first – probably in the first or second quarter of 2010 – followed by mortgages and finally by business loans. Elevated levels of provisions and charge-offs will keep pressure on bank earnings for the next few quarters, and we are likely to see more bank failures. However, we believe most large banks now have sufficient earnings and capital to weather the remainder of the financial crisis.

**Figure 14: Mortgage Loan Quality Worsening**



**Figure 15: Business Loans Also Deteriorating**



Monetary policy remains highly accommodative. The federal funds rate is near zero, and the Federal Open Market Committee has said that it plans to keep rates low for an extended period. The Fed's balance sheet, which grew substantially as the government rolled out one program after another to mitigate the financial crisis, has again grown moderately in recent months due to the Fed's ongoing Treasury (\$300 billion) and agency debt (\$200 billion) and mortgage (\$1,250 billion) purchase programs. However, borrowings from the Fed (these are assets on the Fed's balance sheet) are falling. The lower borrowings are a positive sign that private markets are healing. However, continued growth of the Fed's balance sheet is adding to reserves and the money supply. For now, most of those are being held as excess reserves and not being lent. If that starts to change, it could inflate another credit bubble, and the Fed will need to move aggressively to arrest it. So far, however, bank lending continues to shrink (Figure 17).

Figure 16: Fed Balance Sheet Expanding Again

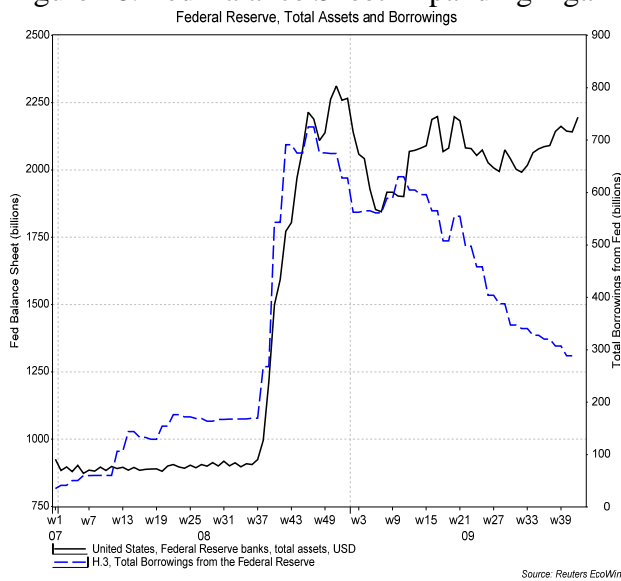


Figure 17: Bank Lending Shrinking

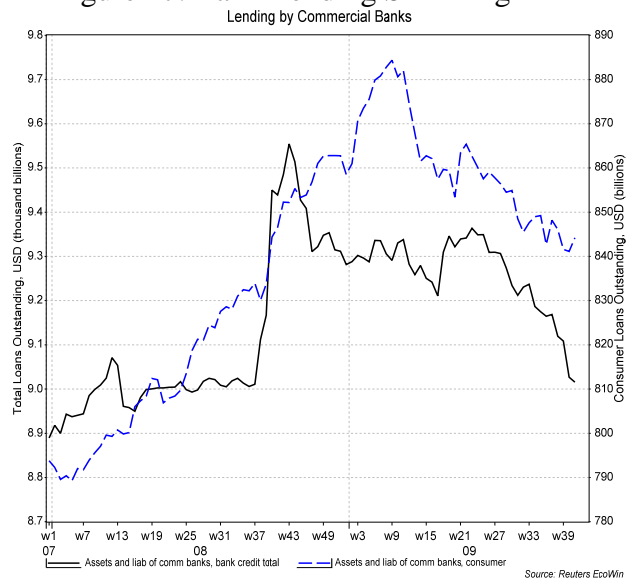
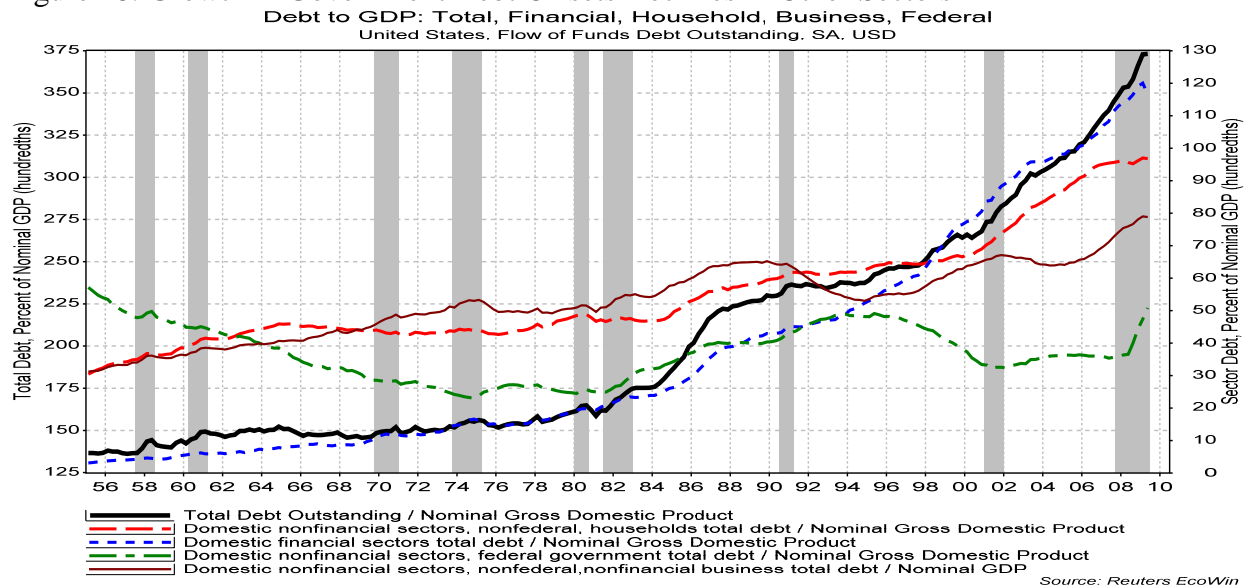


Figure 18: Growth in Government Debt Offsets Declines in Other Sectors





Looking at the recent economic and financial data as a whole, it's worth pondering whether the data point to a strong recovery – stronger than currently forecast. Many sectors of the economy have rebounded sharply from the lows seen earlier in the year, and in sectors where activity is still shrinking, it's generally happening at a much reduced and sequentially improving pace. Financial markets have also recovered sharply, though for the most part not fully, from the depths of the crisis. Our view is that the early stages of this recovery probably will resemble a typical V-shaped recovery. As the economy moved away from the brink of collapse, activity rebounded from unsustainably low levels. Industrial production, for instance can't decline at a 20% annual rate for very long, so as the economy stabilized, production turned from huge cuts to growth quite quickly, and it's probably on its way to higher output if the ISM surveys are any indication. Aside from the employment data, most important economic indicators show similar if somewhat less dramatic rebounds.

However, during the boom period, output capacity grew to accommodate consumers and businesses whose consumption derived in part from access to very easy credit. With economic activity now sharply reduced by the recession, we think it will take a fair amount of time for that capacity to again be fully utilized. In the meantime, investment in housing, business structures and capital equipment should be subdued. Businesses and consumers are increasing savings and cutting back on the use of credit (voluntarily or otherwise), and they will consume less than they did previously as a result. This will not be a permanent development, but it will persist until businesses, consumers, and their lenders feel that balance sheets are healthy again.

That balance sheet repair process will take a few years at a minimum. How much longer it takes will depend how quickly the economy grows, which in turn depends in large part on government policy. We know that the current level of deficit spending is not sustainable. We also know that cutting federal government spending, while not impossible, is extremely difficult. Certainly, the prior administration had no stomach for it, and the current one is pushing for still more spending. Thus, businesses and consumers will face higher taxes. Despite assurances to the contrary out of Washington, those taxes will slow economic growth – even if the spending those taxes support turns out to be relatively efficient and non-inflationary, and much of it will not. Within this framework, we simply cannot envision a growth rate for the economy approaching that of the last recovery (more than 3%), even though it may achieve that higher growth path for two or three quarters.

This need not be bad for investors in preferred securities. In fact, it may be a good thing as long as the path to sustainable fiscal policy avoids debt monetization and inflation. A slow-growing economy with strong consumer and business balance sheets, prudent lending, a large public-sector presence, and moderate interest rates would likely be a pretty good environment for preferred investors. We wouldn't choose this slow-growth policy ourselves, but we don't make the policy. We do react to it, however. At the moment, we think preferreds fit nicely into the outlook, and we remain cautiously optimistic.

Flaherty & Crumrine Incorporated  
October 16, 2009

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