

First-Quarter U.S. Economic Update April 2010

Summary of Recent Economic Developments

The economy appears to have grown at a healthy pace in the first quarter, and forecasts for growth over the balance of the year are increasingly upbeat. Inflation-adjusted GDP is forecast to rise by 2.7% in the first quarter, and recent data signal upside risk to that forecast. For 2010 and 2011 as a whole, real GDP is expected to grow by 3.0% and 2.9%, respectively. Employment expanded in Q1 for the first time since late 2007, which drove a small but welcome increase in income. Consumer spending appears strong, with core retail sales up 7.6% annualized in the quarter, though the personal savings rate fell. Housing took a step backward, but we still anticipate gradual improvement in the sector this year. The inventory cycle continues to fuel industrial production, though we think the boost from inventories is likely to level off in the second half of 2010. Similarly, government's contribution to GDP growth appears to be waning as fiscal stimulus runs its course and state and local governments implement sharp cutbacks in spending. Ultimately, we think employment and income will support economic growth in the second half despite the headwinds from fiscal restraint and the end of the inventory cycle. However, we do not think the rate of growth will be rapid enough to put much upward pressure on inflation, interest rates, or credit spreads. As a result, we continue to believe that a well-selected portfolio of preferred securities will deliver attractive returns over the balance of 2010.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	2008:2	2008:3	2008:4	2009:1	2009:2	2009:3	2009:4	2010:1
Real GDP, Chg QoQ (%)	1.5	-2.7	-5.4	-6.4	-0.7	2.2	5.6	2.7f
Real Personal Consump Expnds, Chg QoQ (%)	0.1	-3.5	-3.1	0.6	-0.9	2.8	1.6	2.5a
Real Busi Investmt, Eqp & Sftware, Chg QoQ (%)	-5.0	-9.4	-25.9	-36.4	-4.9	1.5	19.0	NA
Real Residential Investmt, Chg QoQ (%)	-15.8	-15.9	-23.2	-38.2	-23.3	18.9	3.8	NA
Corporate Profits, After Tax, Chg YoY (%)	-3.7	4.8	-15.8	-19.7	-15.3	-9.7	22.8	24.4f
Current Account Balance, Annualized (% of GDP)	-5.2	-5.1	-4.3	-2.9	-2.8	-2.9	-3.2	NA
Federal Budget, 12-mo Def or Surp (% of GDP)	-2.3	-3.1	-4.7	-6.5	-8.9	-9.9	-10.2	-9.3a
Unemployment Rate (%)	5.5	6.2	7.4	8.6	9.5	9.8	10.0	9.7
Household Employment, Chg QoQ (000)	-405	-747	-1833	-2334	-816	-1270	-976	1113
Nonfarm Payrolls, Chg QoQ (000)	-573	-1002	-1955	-2258	-1430	-783	-269	162
Nonfarm Productivity, Chg QoQ (%)	3.0	1.1	2.2	0.9	7.6	7.8	6.9	NA
Capacity Utilization (%)	78.7	74.5	72.7	69.5	68.3	70.6	72.0	73.2
GDP Price Index, Chg QoQ (%)	1.8	4.0	0.1	1.9	0.0	0.4	0.5	NA
Consumer Price Index, Chg YoY (%)	5.0	4.9	0.1	-0.4	-1.4	-1.3	2.7	2.3
CPI ex food & energy, Chg YoY (%)	2.4	2.5	1.8	1.8	1.7	1.5	1.8	1.1
Nominal Personal Income, Chg YoY (%)	4.2	2.5	0.4	-2.2	-2.6	-2.3	-0.4	2.0a
Personal Savings Rate (%)	3.5	2.2	4.7	3.5	4.9	4.2	4.0	3.1a
Rate or Spread (End of Quarter)	2008:2	2008:3	2008:4	2009:1	2009:2	2009:3	2009:4	2010:1
Federal Funds Rate Target (%)	2.00	2.00	0.25	0.25	0.25	0.25	0.25	0.25
3-month LIBOR (%)	2.78	4.05	1.43	1.19	0.60	0.29	0.25	0.29
10-Yr Treasury Note Yield (%)	3.97	3.83	2.22	2.67	3.54	3.31	3.84	3.83
30-Yr Treasury Bond Yield (%)	4.52	4.31	2.68	3.54	4.34	4.05	4.64	4.71
Moody's Baa Long Corp Spread (bp)	252	354	529	491	283	212	175	160
10-Yr Interest Rate Swap Spread (bp)	70.3	66.5	35.0	20.0	24.8	15.3	13.3	-1.6

* Figures are either quarterly or, if more frequent, quarterly averages. f = Forecast¹; a = Actual through February 2010 Source: Reuters EcoWin

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

Economic Outlook

We will keep the text of this Update relatively brief and let the graphs do the talking, as (1) the economy in the first quarter appears to have developed largely as we expected three months ago and (2) our core views remain unchanged. Please refer to last quarter’s Update for a more detailed explanation of many of these points.¹

Inflation-adjusted **Gross Domestic Product** (real GDP) is forecast to grow by 2.7% in the first quarter, and recent data signal upside risk to that forecast. For 2010 and 2011 as a whole, real GDP is expected to grow by 3.0% and 2.9%, respectively.² These forecasts are slightly higher than anticipated a few months ago, continuing the pattern of improving expectations for growth since the trough in the economy around the middle of 2009. As was the case in the fourth quarter, however, much of the strength in GDP is coming from inventories, which are likely to level off in the second half of 2010. Encouragingly, personal consumption expenditures are recovering a bit faster than expected, though this has come at the expense of a lower personal savings rate. Ultimately, we think employment and income will recover soon enough to support economic growth in the second half despite the headwinds from fiscal restraint and the end of the inventory cycle, but the rate of growth will not be rapid enough to put much upward pressure on inflation, interest rates, or credit spreads.

Figure 2: Jobs Rising Again; Strength Unclear

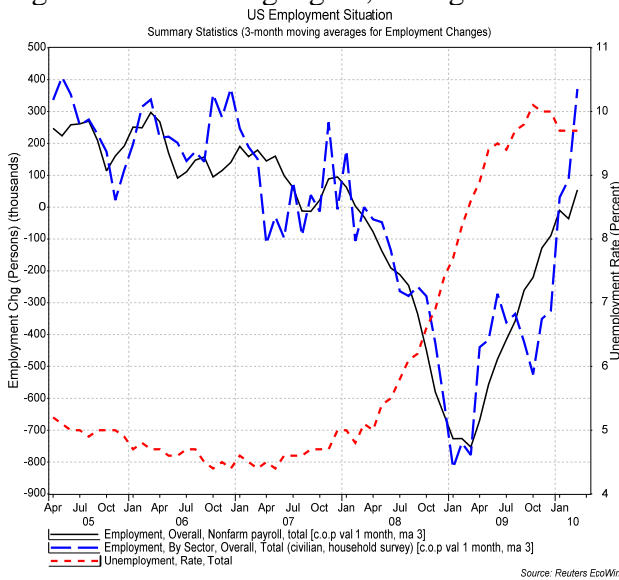
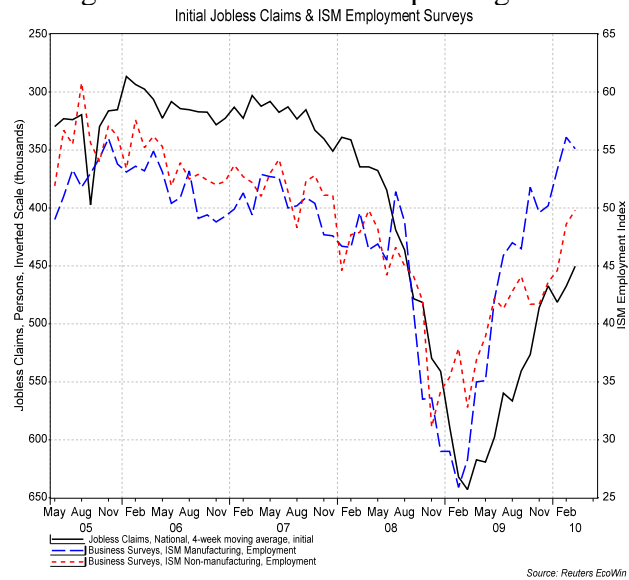


Figure 3: Claims & ISM Improving



Running quickly through the major sectors of the economy, the **labor market** finally added jobs in the first quarter, and the unemployment rate fell (Figure 2). However, the two main surveys of employment, the payroll and household surveys, offer sharply divergent views of the pace of job growth. According to the usually more reliable payroll survey, the economy added only 162,000

¹ *Fourth-Quarter U.S. Economic Update*, Flaherty & Crumrine Incorporated, January 20, 2010; available at www.preferredincome.com or www.fcclaymore.com.

² Forecasts are from *The Survey of Professional Forecasters*, Federal Reserve Bank of Philadelphia, February 12, 2010.

jobs in the first quarter – well below the number needed to bring down the unemployment rate.³ On the other hand, the household survey showed job gains of 1,113,000 in the quarter. To make matters even more confusing, last quarter it was the payroll survey data that looked stronger (it showed fewer job losses). Once again, we turn to data on jobless claims and the employment components of the Institute for Supply Management (ISM) for corroboration. Jobless claims have declined and the employment components of the ISM surveys have rebounded, though in general they are at levels consistent with moderate, not rapid job growth. That’s the same conclusion we reached last quarter, when the signals from the household and payroll surveys were reversed.

We continue to think the economy will add jobs at a moderate pace which, in turn, will support moderate (2-3%) growth in real GDP later in the year. If near-term job growth turns out to be significantly higher, however, then personal consumption in the second half of the year is likely to be higher than we expect, which would support stronger GDP growth, more rapid absorption of excess capacity and, before too long, higher inflation and tighter monetary policy. In short, employment matters a great deal to the outlook. We will be keeping a close eye on it over the coming months.

With the resumption of job growth, **personal income** is now up 2.0% YoY after shrinking for several years (Figure 4). However, high unemployment is keeping wages in check (Figure 5). We expect income growth to improve more meaningfully once job growth begins to prompt wage increases, though that still looks to be a few quarters away. Once again, we are left with the makings of a steady but not especially robust growth outlook.

Figure 4: Consumption & Income Rebounding

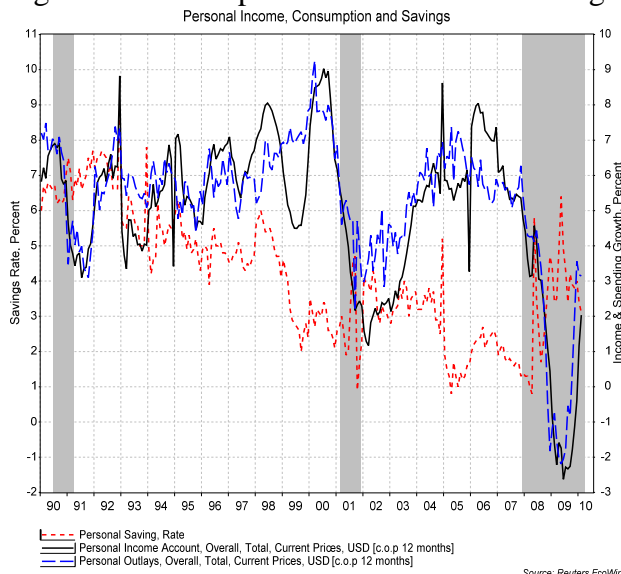
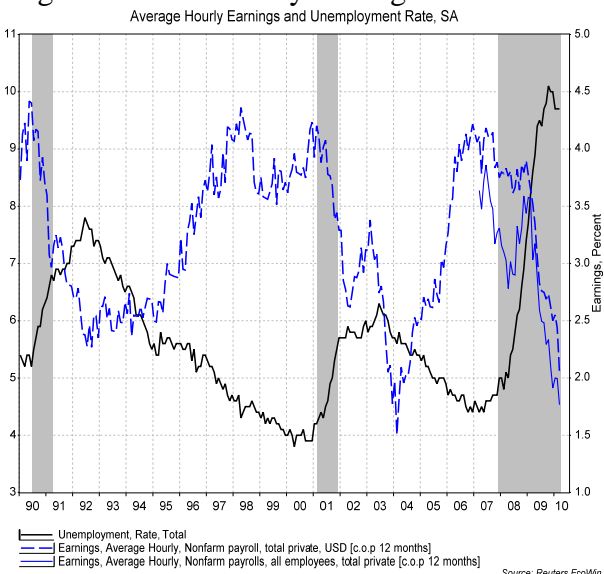


Figure 5: No Recovery in Wages Yet



One area that has shown surprising strength is **personal consumption expenditure (PCE)**. PCE is up 3.1% YoY in February on a nominal basis, and real PCE is up 1.6% YoY and 2.5% annualized in Q1 through February. Moreover, “core” retail sales (excluding autos, gasoline and

³ Given the size and growth rate of the labor force, the U.S. economy needs to add a little more than 100,000 jobs per month to hold the unemployment rate steady, assuming no change in the labor participation rate. If the participation rate increases – as it usually does coming out of a recession – then jobs need to grow even faster to bring down the unemployment rate.

building materials) through March are up 7.6% annualized in Q1 over Q4, before inflation adjustment. That suggests that Q1 real PCE will exceed 3% and contribute meaningfully to GDP.

Of course, this combination of sluggish income and strong spending growth means that the **personal savings rate** declined from 4.0% at the end of 2009 to 3.1% in February 2010 (Figure 4). We do not pay much attention to monthly swings in the savings rate, since it's a residual calculation between two very large numbers (income and consumption) that are subject to substantial revision over time. However, we do believe that the personal savings rate will move higher as consumers reduce leverage – something that is clearly visible in the borrowing statistics we will review shortly. If we are correct in that view, consumption should soon start to grow more slowly than income, supporting our case for moderate growth in the economy overall (PCE is roughly 70% of GDP). If, however, consumers go on a savings-financed spending spree, we'll have stronger growth for awhile but be setting ourselves up for trouble when the Fed tightens monetary policy. This, too, is on our list of things to watch.

The **housing market** took a step backward in the first quarter. New and existing home sales dropped to about 5.3 million annual units in January and February 2010, down about 1 million units from 4Q09, and the supply of unsold homes ticked up a bit (Figure 6). This pullback was expected given the surge in sales owing to expiring homebuyer tax credits.⁴ Nonetheless, home prices are stabilizing – even rising in some markets – and affordability remains near a record high. We continue to expect a gradual recovery in housing over the next several years.

Figure 6: Housing Pulls Back

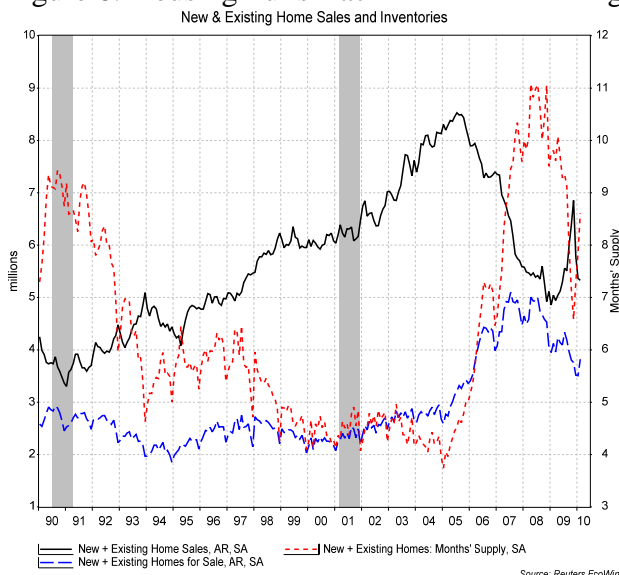
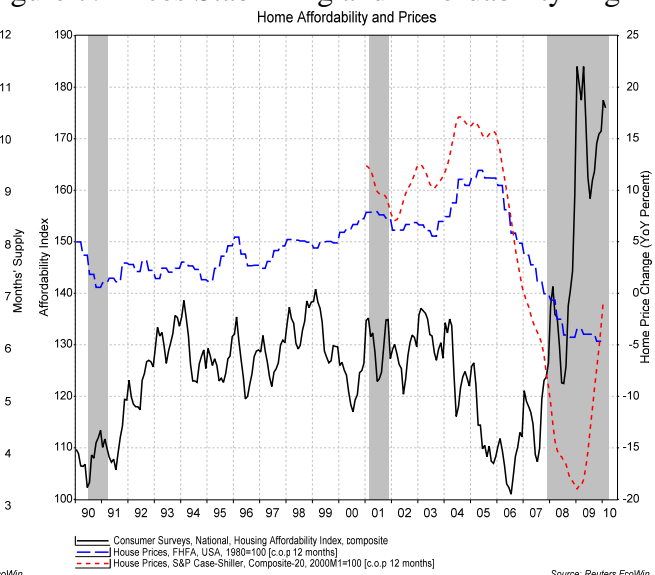


Figure 7: Prices Stabilizing and Affordability High



Business investment continues to be a tale of two sectors. Investment in software and equipment is recovering nicely (+19.0% in Q4), but it is tumbling in business structures (-18.0% in Q4). Orders and shipments of nondefense capital goods excluding aircraft continue to look very strong, up in the neighborhood of 10% annualized (Figure 8). However, capacity utilization remains very low and should keep overall investment spending weak until utilization rises

⁴ Homebuyer tax credits were set to expire at the end of November 2009. Although Congress eventually extended these credits through June 2010, they did not do so until after many homebuyers had already rushed to take advantage of them. As a result, home sales spiked higher in the fall of 2009 and have since dropped back.

significantly, which may take some years. As a result, we think overall business investment (including structures) will shrink further in 2010. That should keep corporate borrowing requirements relatively subdued.

Figure 8: Capital Goods Orders Rebounding

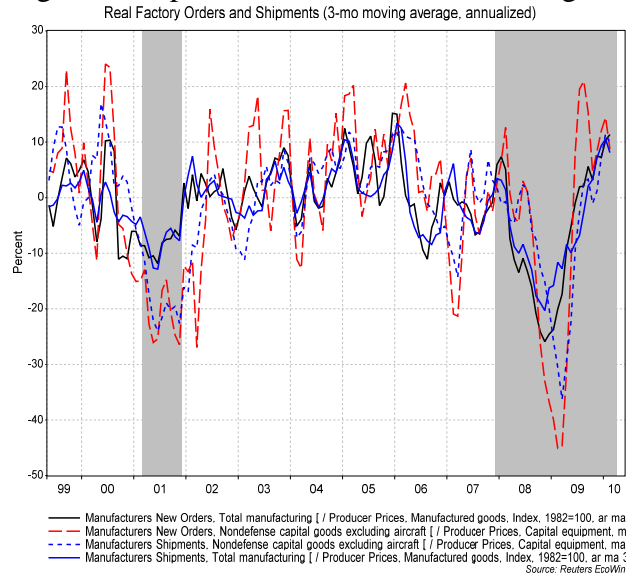
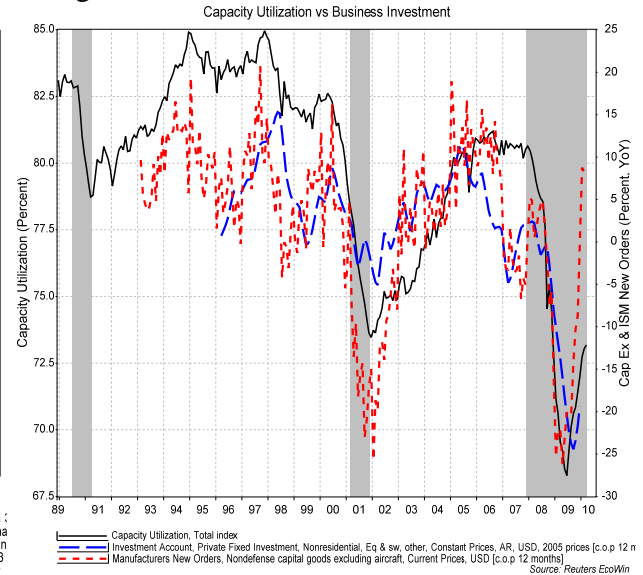


Figure 9: Low Utilization Limits Investment



Industrial production continues to expand at a strong pace (Figure 10). Slower inventory liquidation (Figure 11) is boosting production beyond final demand, adding significantly to GDP. Inventories accounted for 3.8 percentage points of the 5.6% growth in GDP in Q4. We anticipate that the inventory cycle will continue for another quarter or two, but as it winds down, production will drop back in line with the growth in final demand.

Figure 10: Industrial Production Remains Firm

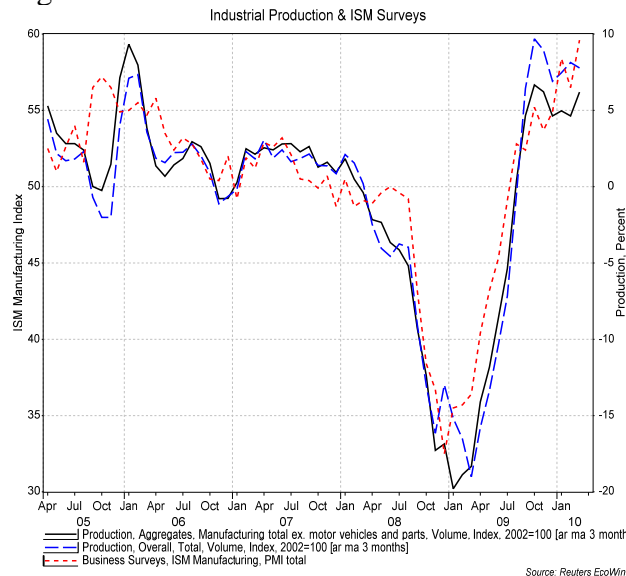
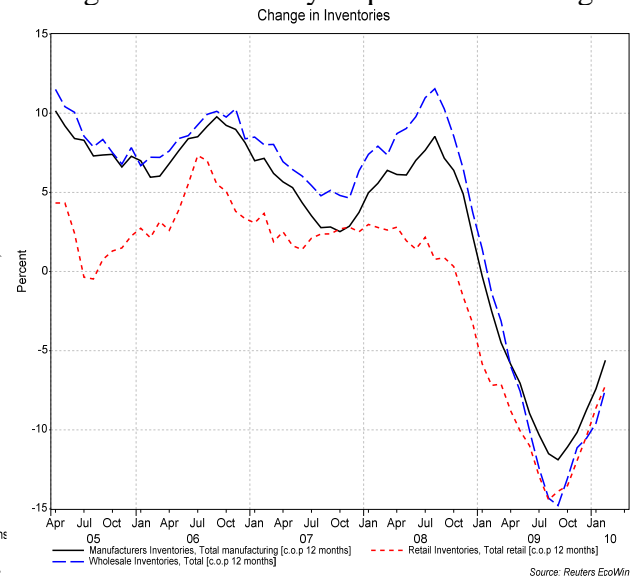


Figure 11: Inventory Liquidation Slowing



The **trade sector** looks as though it will subtract about ¼% from GDP growth in the first quarter after adding 0.3% to GDP in Q4. The recovery in global trade continues (Figure 12), however, and we think rising exports will support a narrowing real trade deficit over the next several years.

Figure 12: Trade Recovery Continuing

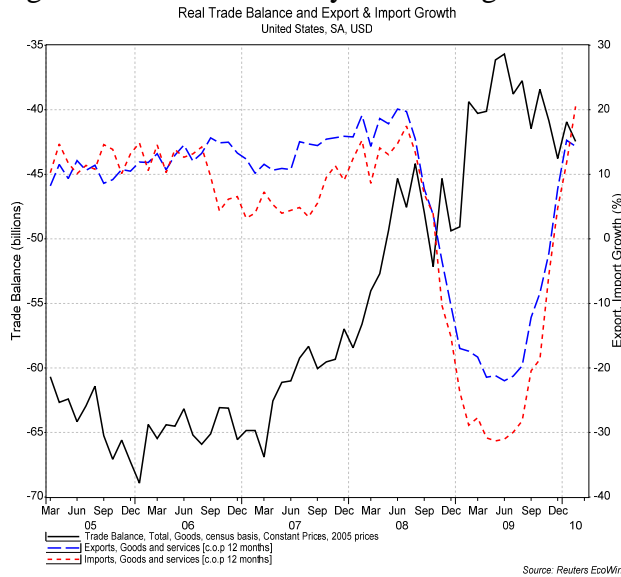
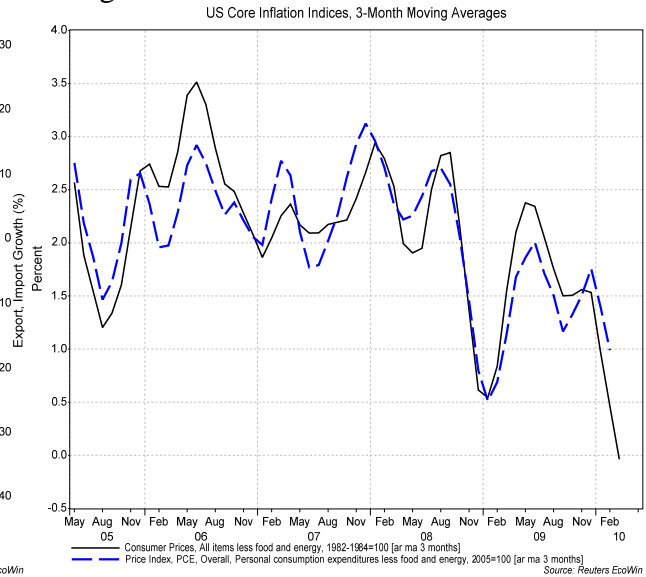


Figure 13: Disinflation at Work



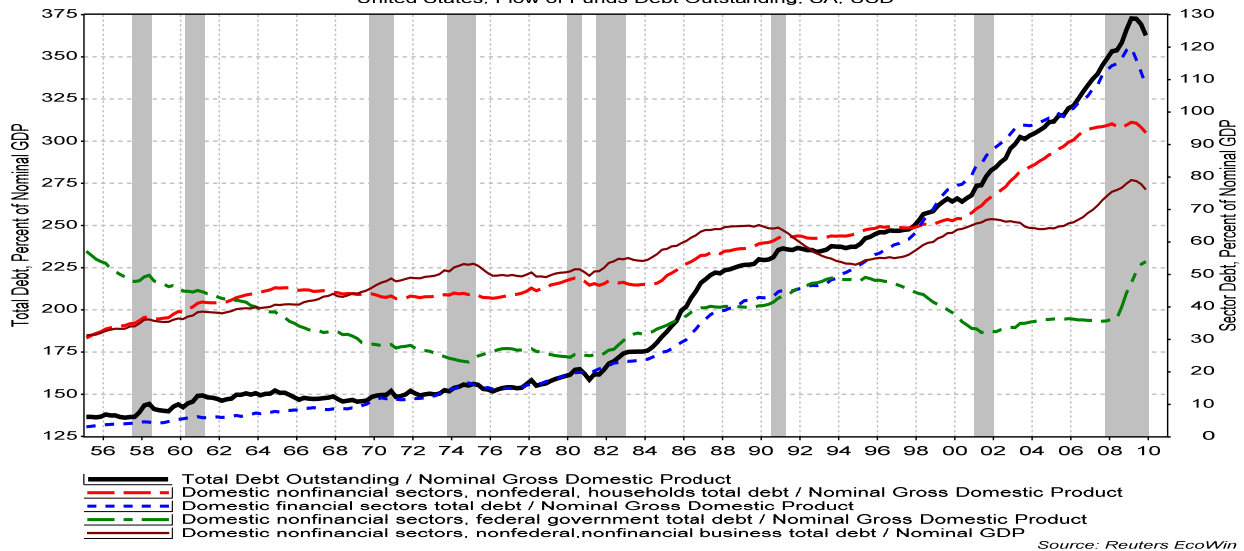
Federal **government consumption** made no net contribution to GDP in Q4 as higher stimulus spending offset lower defense spending, while overall government consumption subtracted ¼% from Q4 GDP as state and local governments enacted spending cuts. Federal government disbursements under the Recovery Act totaled \$314 billion as of March 31, 2010, compared to \$257 billion at the end of Q4, implying about \$57 billion of expenditures during the quarter. That is less than the \$146 billion disbursed in Q4, which means that fiscal stimulus may actually reduce GDP growth in Q1. We can't say this with any precision, because money that is *disbursed* during a period is not necessarily *spent* during that period. Nonetheless, the disbursement figures do suggest that the growth impulse from last year's fiscal stimulus package is waning, even though less than half of the total funds have been disbursed. Couple this with ongoing cuts in state and local government spending, and it appears likely that overall government consumption will be a drag on GDP growth in Q1 – and probably for 2010 as a whole as well.

Finally, **inflation** continues to ease. Core inflation (i.e., inflation excluding volatile food and energy prices) over the past three months fell to 1% annualized for the PCE deflator and zero for the consumer price index (Figure 13). For the past year, those indices are up just 1.3% and 1.1%, respectively. Overall inflation, including food and energy prices, is somewhat higher at 1.8% (PCE) and 2.3% (CPI) over the past year, due mainly to higher energy prices. We believe core inflation captures the disinflationary forces currently at work in an economy with substantial excess capacity. We anticipate subdued inflation over the next several years.

Adding it all up, we continue to anticipate fairly strong growth of 3% or more in the first half of 2010, slowing to the low-2% area in the second half. Stronger growth in employment over the next few months would brighten the outlook for the second half, while no growth or a resumption of job losses would be ominous. In addition, GDP growth could be stronger than we expect if consumers draw down savings (as they did in Q1), though we would question its sustainability in that case. We think it's more likely that consumers will resume gradually increasing their savings and reducing borrowing, which will dampen consumer spending and GDP.

While there is volatility in the month-to-month data, households and businesses are deleveraging (Figure 14). We continue to think this process will last for several more years, perhaps longer for the household sector. If that's correct, it should lead to a period of relatively slow growth, low borrowing, and low interest rates. While somewhat painful to live through, the balance sheet repair enabled by this period of higher savings should result in more sustainable growth going forward.

Figure 14: Household and Business Deleveraging Continues; Government Debt Soaring
Debt to GDP: Total, Financial, Household, Business, Federal
United States, Flow of Funds Debt Outstanding, SA, USD



Although private sector balance sheets are improving, the federal government's balance sheet is deteriorating rapidly. As we explained last quarter, we believe this is necessary for now. However, as the recovery begins to generate higher tax revenue, the government needs to begin to get its deficit spending under control. Our outlook does not assume we will get much near-term spending discipline out of Washington (we think stronger tax receipts will do most of the deficit-reduction work over the near term), but how the government ultimately brings spending into balance with taxes remains one of the key uncertainties in the longer-term outlook.

Market Outlook

As they did in the fourth quarter, interest rate and credit markets moved in opposite directions in the first quarter, although the changes in each were comparatively modest. Long-term **Treasury rates** rose by 7 basis points (bp) to 4.71% during the quarter, but shorter maturity Treasuries saw little change or small declines in yields. Monetary policy was essentially unchanged as the Federal Reserve left its fed funds target at 0-0.25%. As of March 31, 2010, the market was pricing in about 50 bp of tightening by the Fed by the end of 2010, down significantly from 100-125 bp of implied tightening at the end of 2009. The market also reduced its expectation of tightening next year, but only by about 10 bp; the market is now pricing in about 240 bp of tightening by the end of 2011. We continue to believe that slower growth and low inflation will keep the Fed on hold longer than the market currently expects.

Turning to **credit markets**, corporate spreads narrowed, with the Moody's Baa-rated Long Corporate spread narrowing by 10 bp to 160 bp over Treasuries (Figure 15). Preferred securities

rallied as well (Figure 16), with preferred spreads to Treasuries narrowing by 30-60 bp since year-end. Although preferred securities' spreads have recovered most or all of their widening during the depths of the financial crisis, they remain at the wider end of the historical range excluding the crisis period.

Figure 15: Corporate Spreads Tighten Further

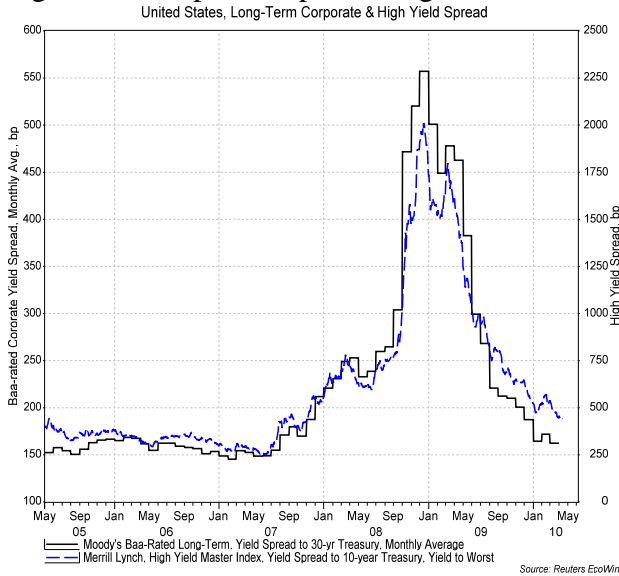


Figure 16: Preferred Rally Continues

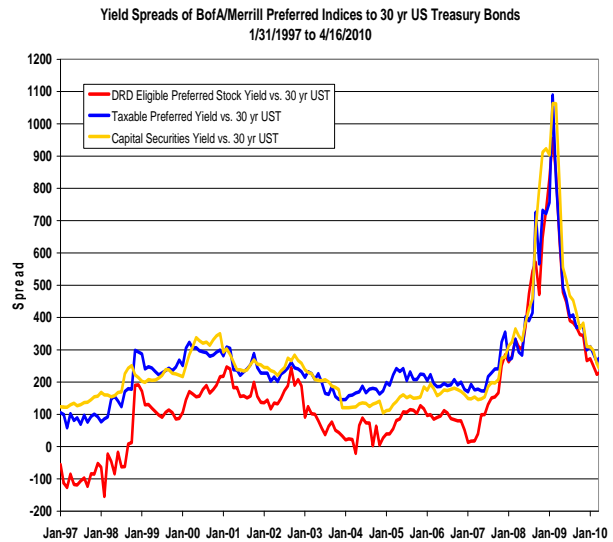


Figure 17: Corporate Profits Rebounding

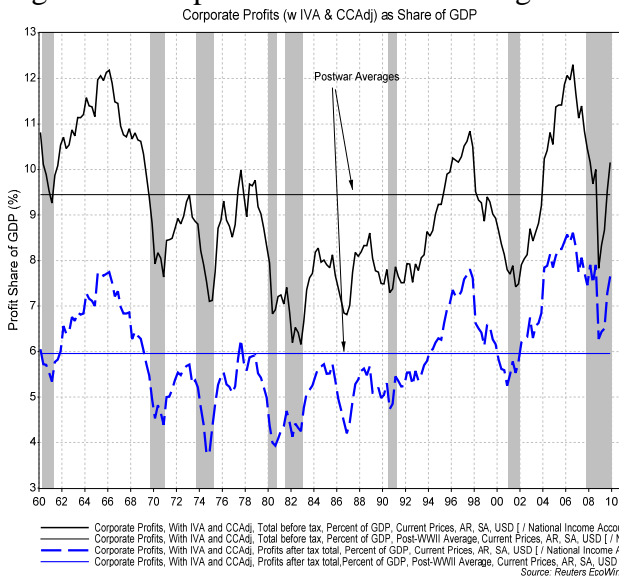
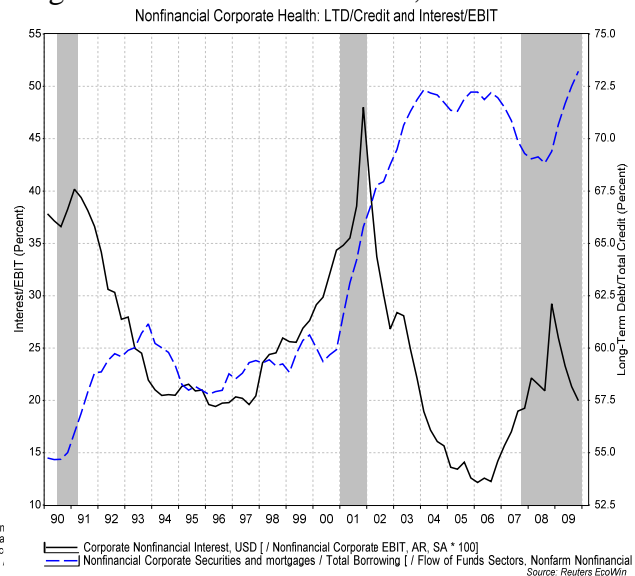


Figure 18: Debt Burden Down, More L.T. Debt



We remain bullish on credit markets in general and preferred securities in particular, though we are mindful that the “margin of safety” is smaller now than it was when prices were lower and yields higher, for three main reasons. First, corporate profitability is up (Figure 17), while investment needs are low. As a result, corporations simply do not need to borrow much money currently, and we do not think they will until capacity utilization rates are much higher, which we think will take several years. Second, corporate balance sheets are strengthening, with declining leverage overall, falling interest expense relative to earnings before interest and taxes (EBIT),

and a rising proportion of debt that is long-term and, thus, not subject to near-term rollover risk (Figure 18).

The third reason for our bullish credit outlook is that we believe overall **loan quality** is starting to improve for the first time in about three years. Delinquencies and charge-offs on consumer loans already have turned down (Figure 19). Early stage mortgage delinquencies have also dropped, though foreclosures are still rising (Figure 20). Commercial and industrial (C&I) loan delinquencies and charge-offs at a minimum are rising more slowly now, and most of the banks that have reported first quarter earnings are showing stable to lower loan problems in their commercial loan books. All of this is consistent with prior historical experience for loan performance: The peak in consumer loan charge-offs tend to coincide with the high in unemployment, while C&I loan charge-offs tend to peak one or two quarters later. Unemployment peaked in October 2009, so it's not surprising to see loan performance improving by now.

Figure 19: Consumer Loan Problems Peaked

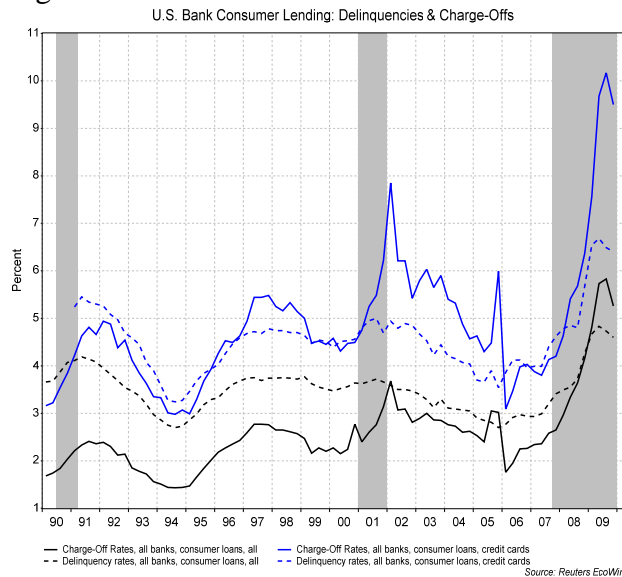
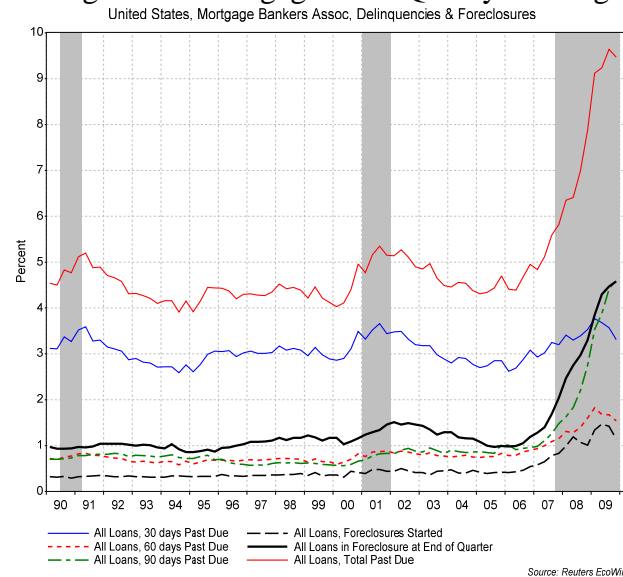


Figure 20: Mortgage Loan Quality Turning?



This is not to say that all banks are “out of the woods.” Although loan problems are starting to come down, they remain high historically. In addition, residential mortgage foreclosures are still rising, and commercial real estate loan losses are also rising. Regulations facing the banking industry may reduce their ability to generate earnings. And some banks’ problems will be too severe to overcome. However, while careful selection is required, we believe that most banks can manage the losses, given their high level of loan-loss provisions, strengthened capital bases, and the improved operating environment. With banks making up a little over 60% of the preferred securities market, the improving health of the banking system is indeed good news for preferreds.

We will close with the same conclusion as last quarter. Household and corporate balance sheets are improving, the economy is recovering, and inflation should remain low. Long-term Treasury rates already reflect relatively rapid Fed tightening and could hold steady or fall if those expectations are not met. We think credit spreads on debt and preferred securities overall should continue to narrow, although not all companies will benefit. As a result, we believe that a well-selected portfolio of preferred securities will deliver attractive returns over the balance of 2010.

Flaherty & Crumrine Incorporated
April 20, 2010

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