

Fourth-Quarter U.S. Economic Update January 2011

Summary of Recent Economic and Market Developments

Real Gross Domestic Product is forecast to grow by 3.3% in the fourth quarter, up substantially from Q2 and Q3. Looking ahead, employment should gradually pick up in 2011, but wage growth is likely to be sluggish, which will keep income gains modest. Consumption also should improve, but a rising savings rate should hold consumption growth below income growth. Business investment should again be a bright spot. Residential investment and commercial construction appear to be bottoming out, removing one of the impediments to growth. Inflation is likely to remain dormant, and the Fed should continue its accommodative monetary policy. However, federal fiscal stimulus is turning to restraint, and state and local spending is still falling. Inventory accumulation is moderating, and the trade deficit is likely to widen again as the domestic economy improves. These will weigh on GDP growth. On balance, we expect moderate growth and low inflation in 2011. The improving economic prospects in Q4 helped to push Treasury yields up but corporate and preferred securities' spreads down, leaving preferred prices little changed during the quarter. Credit quality continued to improve, with strong corporate profits and fewer loan charge-offs and delinquencies. We expect this relatively benign credit environment to persist for some time to come. Regulators kept preferred markets guessing in 2010 and are likely to do the same in 2011, but most of these new regulations have been beneficial to preferred investors. While we cannot expect returns like those in 2009 or 2010, we think preferred securities will again deliver good performance for investors in 2011.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	2009:1	2009:2	2009:3	2009:4	2010:1	2010:2	2010:3	2010:4
Real GDP, Chg QoQ (%)	-4.9	-0.7	1.6	5.0	3.7	1.7	2.6	3.3f
Real Personal Consump Expnds, Chg QoQ (%)	-0.5	-1.6	2.0	0.9	1.9	2.2	2.4	3.7a
Real Busi Investmt, Eqp & Sftware, Chg QoQ (%)	-31.6	0.2	4.2	14.6	20.4	24.8	15.4	NA
Real Residential Investmt, Chg QoQ (%)	-36.2	-19.7	10.6	-0.8	-12.3	25.7	-27.3	NA
Corporate Profits, After Tax, Chg YoY (%)	-10.1	-3.1	0.4	41.9	27.0	26.5	16.2	14.7f
Current Account Balance, Annualized (% of GDP)	-2.7	-2.4	-2.8	-2.8	-3.0	-3.4	-3.5	NA
Federal Budget, 12-mo Def or Surp (% of GDP)	-6.6	-8.9	-10.0	-10.3	-9.4	-9.1	-8.8	-8.6f
Unemployment Rate (%)	8.6	9.5	9.8	9.9	9.7	9.5	9.6	9.4
Household Employment, Chg QoQ (000)	-2502	-844	-1187	-831	992	140	286	-172
Nonfarm Payrolls, Chg QoQ (000)	-2258	-1430	-783	-269	261	570	-91	384
Nonfarm Productivity, Chg QoQ (%)	3.4	8.4	7.0	6.0	3.9	-1.8	2.3	NA
Capacity Utilization (%)	69.6	68.2	70.5	71.6	72.8	74.2	75.3	76.0
GDP Price Index, Chg QoQ (%)	1.1	0.3	0.7	-0.2	1.0	1.9	2.1	NA
Consumer Price Index, Chg YoY (%)	-0.4	-1.4	-1.3	2.7	2.3	1.1	1.1	1.5
CPI ex food & energy, Chg YoY (%)	1.8	1.7	1.5	1.8	1.1	0.9	0.8	0.8
Nominal Personal Income, Chg YoY (%)	-2.4	-2.7	-2.4	0.4	2.8	2.9	3.6	3.8a
Personal Savings Rate (%)	5.6	6.7	5.7	5.8	5.3	6.3	5.7	5.3a
Rate or Spread (End of Quarter)	2009:1	2009:2	2009:3	2009:4	2010:1	2010:2	2010:3	2010:4
Federal Funds Rate Target (%)	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3-month LIBOR (%)	1.19	0.60	0.29	0.25	0.29	0.53	0.29	0.30
10-Yr Treasury Note Yield (%)	2.67	3.54	3.31	3.84	3.83	2.93	2.51	3.29
30-Yr Treasury Bond Yield (%)	3.54	4.34	4.05	4.64	4.71	3.89	3.69	4.34
Moody's Baa Long Corp Spread (bp)	491	283	212	175	160	216	189	164
10-Yr Interest Rate Swap Spread (bp)	20	25	15	13	-2	7	6	9

* Figures are either quarterly or, if more frequent, quarterly averages. f = Forecast¹; a = Actual through November 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

Economic performance in the U.S. picked up substantially in the fourth quarter of 2010. Real Gross Domestic Product (GDP) is forecast to grow by 3.3% in the quarter¹, a full percentage point better than in Q3 – and even that may prove too conservative in light of recent net export data. Many economists who expressed gloom during the summer months are now calling for 3-4% growth in 2011. We were skeptical then and now, and we remain in the “moderate growth” camp (2.5-3% real GDP) in 2011. First, the good news: Employment should gradually pick up in 2011, but wage growth is likely to be sluggish, which will keep income gains modest. Consumption also should improve, but a rising savings rate should hold consumption growth below income growth. Business investment should again be a bright spot, although probably not as bright as it was in 2010. The housing market is not likely to exert much further drag on GDP, and the long slide in business construction spending may be ending. Inflation should remain dormant. Now, the bad news: Federal fiscal stimulus has about run its course, and state and local spending is still under downward pressure. Inventory accumulation is moderating, and the trade deficit is likely to widen again as the domestic economy improves; both will slow growth. Although individual quarters may look dreary or rosy, we think this spells moderate growth and low inflation in 2011. We were not troubled by fears of a “double dip” recession last summer, and we are not troubled by the “growth scare” currently running through the market. The following pages explain why.

Figure 2: Job Market Gradually Improving

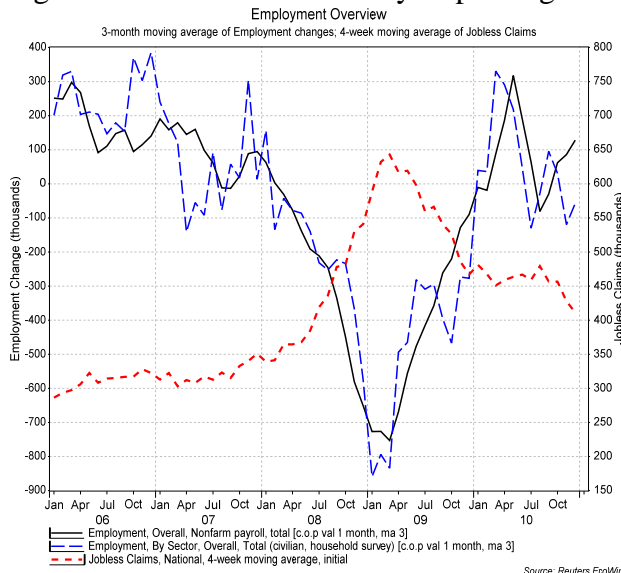
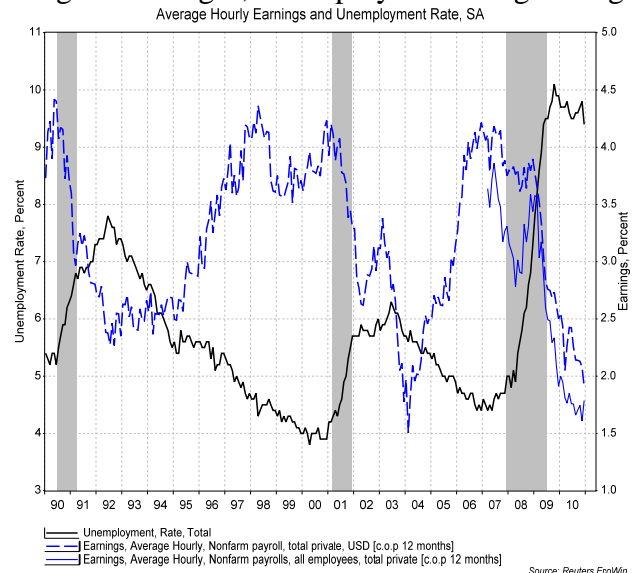


Figure 3: Wages, Unemployment Languishing



The **labor market** is gradually improving, with roughly 1.2 million net jobs created in 2010. Employment figures were distorted for much of 2010 with the hiring (Q1) and subsequent firing (Q3) of temporary government workers for the decadal census. With those distortions now behind us, payroll employment gains averaged 128,000 jobs per month in 4Q2010 and about 94,000 jobs per month for all of 2010. The comparable numbers from the household survey of employment showed job *losses* of about 57,000 per month in Q4 and gains of about 104,000 per

¹ All growth rates are annualized unless noted otherwise. Forecasts are from *The Livingston Survey*, Federal Reserve Bank of Philadelphia, December 9, 2010.

month for 2010 as a whole. With the economy in the midst of recovery and not at a turning point, we think the payroll data provides a better picture of the labor market than the household data – and for the full year, both tell essentially the same growth story. This is corroborated by initial jobless claims, which resumed their downward trend in the second half of 2010 (Figure 2).

On balance, it appears that employers are increasing the pace of hiring. However, the job gains so far have not been large enough either to put much downward pressure on the unemployment rate or to push wages up more rapidly, even though the recession ended 18 months ago (Figure 3). The U.S. civilian labor force has about 154 million members, growing at just under 1% per year, on average. Thus, the economy needs to add about 120,000 jobs per month to hold the unemployment rate steady at a constant labor participation rate. We expect employment gains will accelerate above that level in 2011, but only gradually. If so, income growth and any decline in the unemployment rate will be similarly modest. Along with the deleveraging theme we discuss below, this is a key element in our outlook for moderate GDP growth this year.

Personal income continues to recover slowly from the recession. Nominal personal income is up about 3.8% YoY in November, which translates to about 2.8% in real (inflation-adjusted) terms (Figure 4). For the first two months of 4Q2010, nominal personal income is up 2.8% over the Q3 average. Personal spending has followed a similar trajectory, though the pace of spending picked up in the fourth quarter. Real **personal consumption expenditure (PCE)** rose by 2.8% YoY and 3.7% quarter-to-date through November. Using retail sales data as a proxy for full-quarter consumption, it appears that real PCE will come in over 4% for Q4. Although this is a welcome improvement, it is still relatively weak performance coming out of a severe recession. It reflects a deep cautiousness in hiring and spending that seems to be abating only gradually.

Figure 4: Modest Recovery in Income, Spending

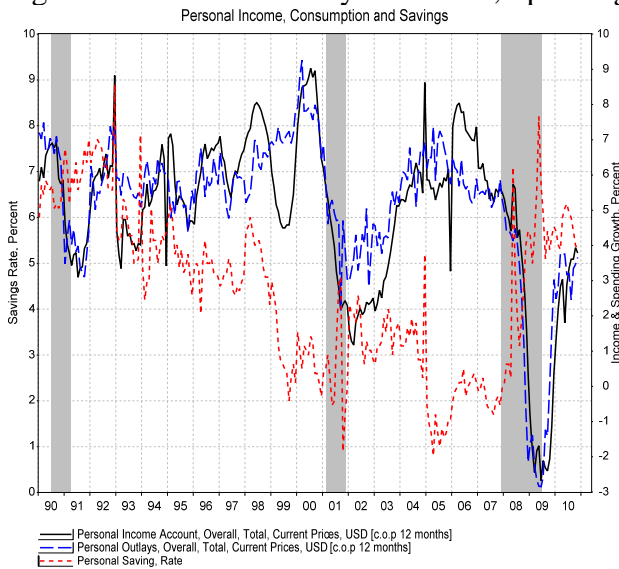
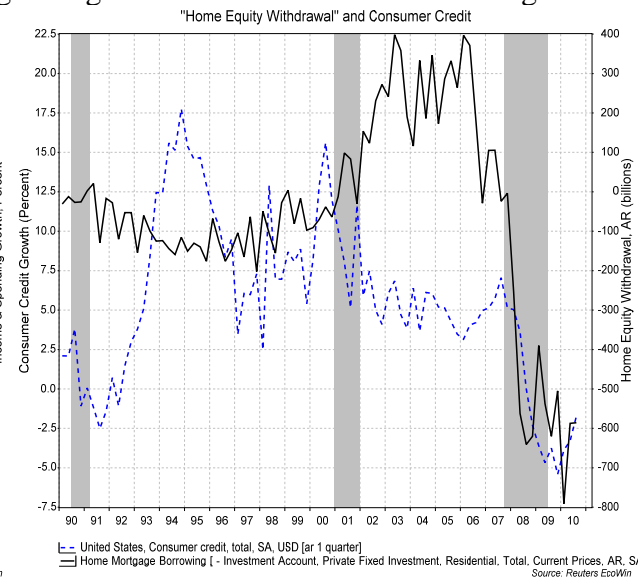


Figure 5: Debt Reduction Continuing



Part of the rebound in spending is being paid for by a dip in the **savings rate** to 5.3% in November, down from 6.3% in June 2010 and a brief peak of 8.2% in May 2009 (Figure 4). We think this relatively minor drop in the savings rate will reverse and move back up over the next several years. We see no indication that consumers are re-embracing debt. On the contrary, deleveraging by consumers is continuing, albeit at a slower pace than during the recession

(Figure 5). If this continues as we expect, then consumption will grow more slowly than income while this adjustment takes place. For example, if the savings rate rises by one percentage point per year over the next two years, then consumption will grow by roughly 1% less than income over that period. Consumers will not increase their savings rates forever, but after 25 years of rising debt loads, we think the adjustment process has further to run, and it will dampen (but not derail) economic growth while it does.

Figure 6: Housing Bouncing Along Bottom...

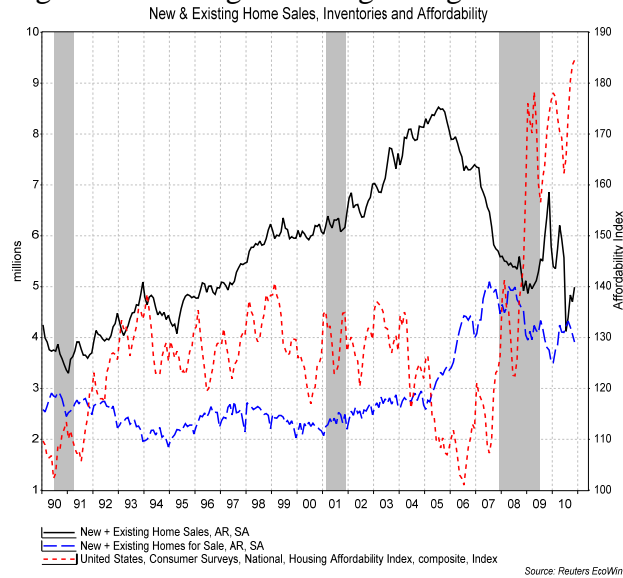
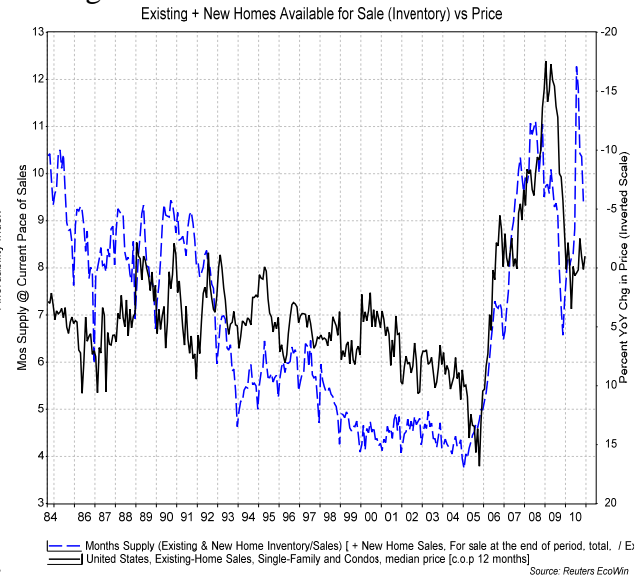


Figure 7: ...But Home Prices Vulnerable



The **housing market** appears to be recovering from the swoon in sales following the expiration of homebuyer tax credits in June 2010. New and existing home sales have recovered to roughly a 5 million unit pace, inventories of unsold homes are falling again, and home affordability is at a record high (Figure 6). We anticipate that housing will have little impact on GDP growth in 2011. On one hand, residential construction activity has fallen so much that there is little downside remaining. On the other hand, there is still excess housing supply in most markets, leading to little demand for new construction. Once inventories clear, housing will provide a big boost to growth, but that is probably a year or two in the future. In the meantime, rising volumes of foreclosures make home prices vulnerable to a pullback. High inventories of unsold homes historically have tended to put downward pressure on home prices (Figure 7). Given already high affordability, we think any further price declines will be limited, but this remains a risk to the otherwise largely upbeat economic outlook.

Business investment should post another strong performance in Q4. Spending on business equipment and software rose 15.4% in Q3. Data on shipments through November give a mixed reading, with continued improvement in overall shipments of manufactured goods but some slowing in nondefense capital goods (Figure 8). On balance, we expect some slowing from the Q3 pace but still good performance from this segment. Business construction spending, which has been falling since late 2008, turned slightly positive in Q4. We are not looking for a commercial construction boom, but it does appear that the long slide is ending. Combining equipment/software and construction, overall business investment should be a big contributor to Q4 GDP growth. We should sound a note of caution for 2011, however. First, capital goods order growth is slowing (Figure 8). Second, business spending has substantially outpaced the rise in

capacity utilization (Figure 9). This suggests that business investment could slow at some point in 2011 as businesses absorb the investments they have made since the start of the recovery. We still think business investment will be an important contributor to growth in 2011, but it's unlikely to be as sizable as it was in 2010.

Figure 8: Capital Goods Orders High but Slowing

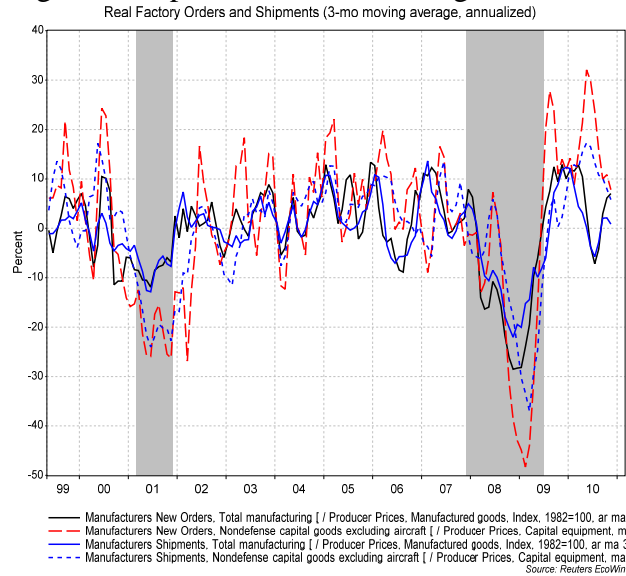


Figure 9: Investment Outpacing Utilization

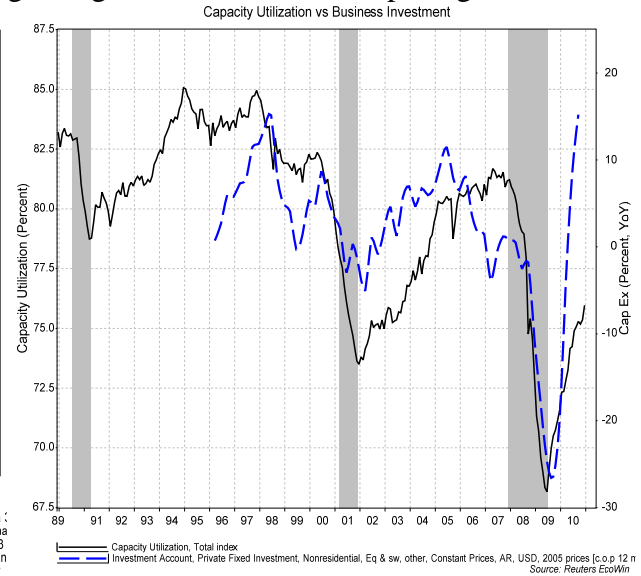


Figure 10: Inventory Accumulation Slowing

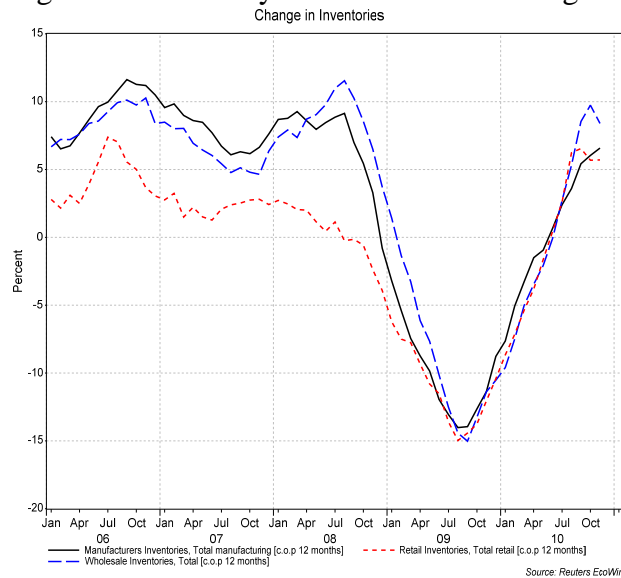
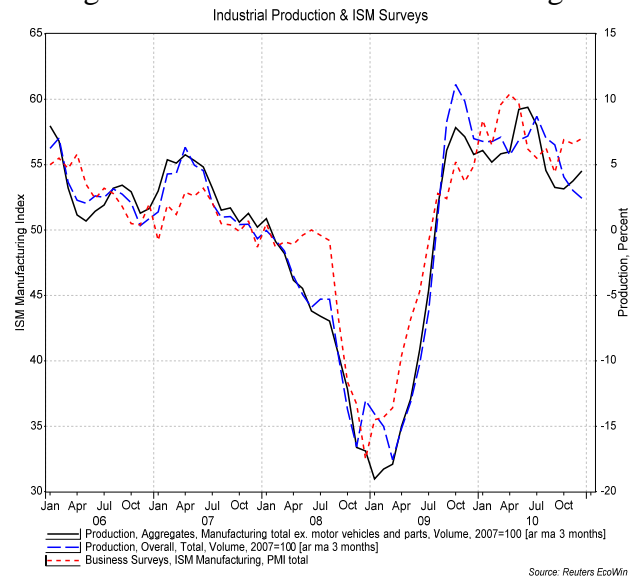


Figure 11: Industrial Production Easing



As expected, the boost to growth from the **inventory cycle** appears to be coming to a close. The growth rate of inventories in manufacturing, wholesale, and retail businesses has begun to level out (Figure 10). To be sure, inventories are still growing given the positive sales environment, but the rate of growth – which is what matters for GDP – has begun to slow. While inventories should again add to GDP growth in Q4, they probably will not be a major factor in 2011. The slowdown in inventory growth is already visible in the **industrial production** data (Figure 11). Production remains sturdy, but it has slowed from earlier in the year when producers had to

satisfy both final demand *and* inventory demand. Looking ahead, production should downshift to meet more the more moderate growth in final demand alone.

Government consumption was an important contributor to the economy in the third quarter, adding 0.8% to GDP growth. Looking ahead, cutbacks to state and local government spending appear to be moderating after sharp budget reductions in the wake of the recession, although spending is still likely to be down on the year. Federal government spending in the form of fiscal stimulus is running out of energy (it probably peaked in Q3) and the new Congress seems determined to cut spending. It is unclear how much spending will be reduced in 2011, but even the Republican House goal of \$100 billion in spending cuts represents only about 0.7% of GDP. We think it is a safe bet that government consumption will be a drag on GDP growth in 2011, though probably only a modest one.

The **trade deficit** appears to have added substantially to GDP growth in the fourth quarter. The real trade deficit shrunk sharply in October and November on lower imports (Figure 12). If that improvement holds in December, net exports could add about 1½ percent to Q4 GDP! Sadly, this improvement in the trade deficit is likely to prove short-lived. As U.S. economic growth improves, the trade deficit is likely to widen gradually again on rising imports. Moreover, the U.S. dollar remains the world’s primary reserve currency. As countries seek to increase foreign exchange reserves, they need to hold more dollars. In aggregate, the most likely way to do that is to sell more goods to the U.S.², which means a wider trade deficit. As usual, there will be lots of quarterly volatility around the trade balance, but the trend probably will be for a wider deficit. That will present a modest drag for GDP growth later in 2011.

Figure 12: Trade Deficit Narrows Sharply

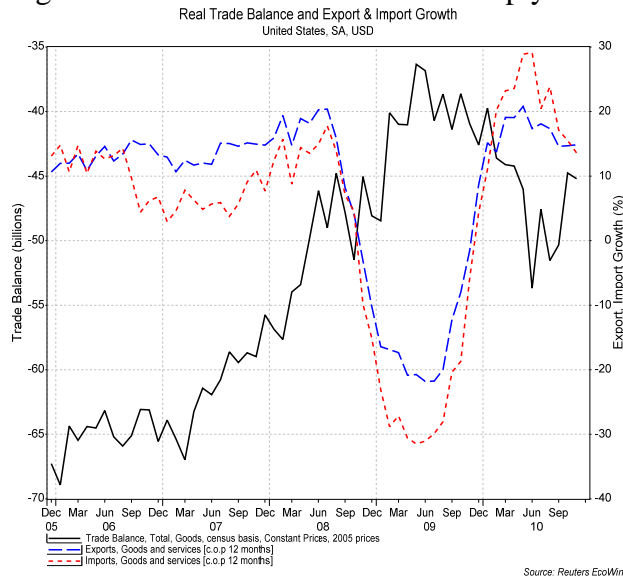
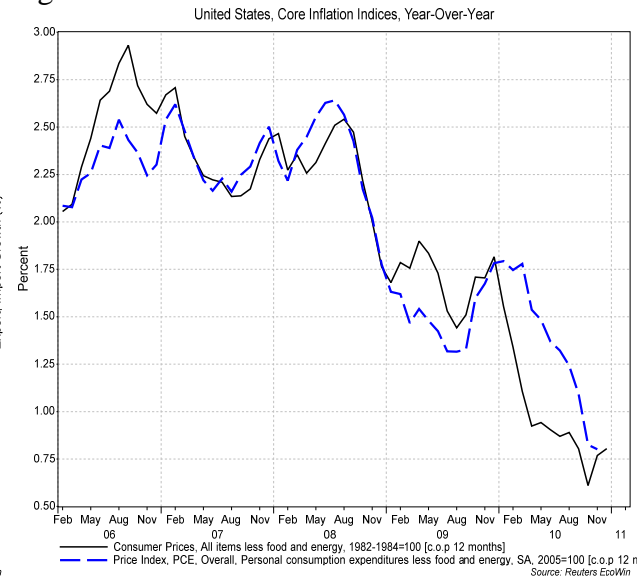


Figure 13: Inflation Still “Too Low” for the Fed

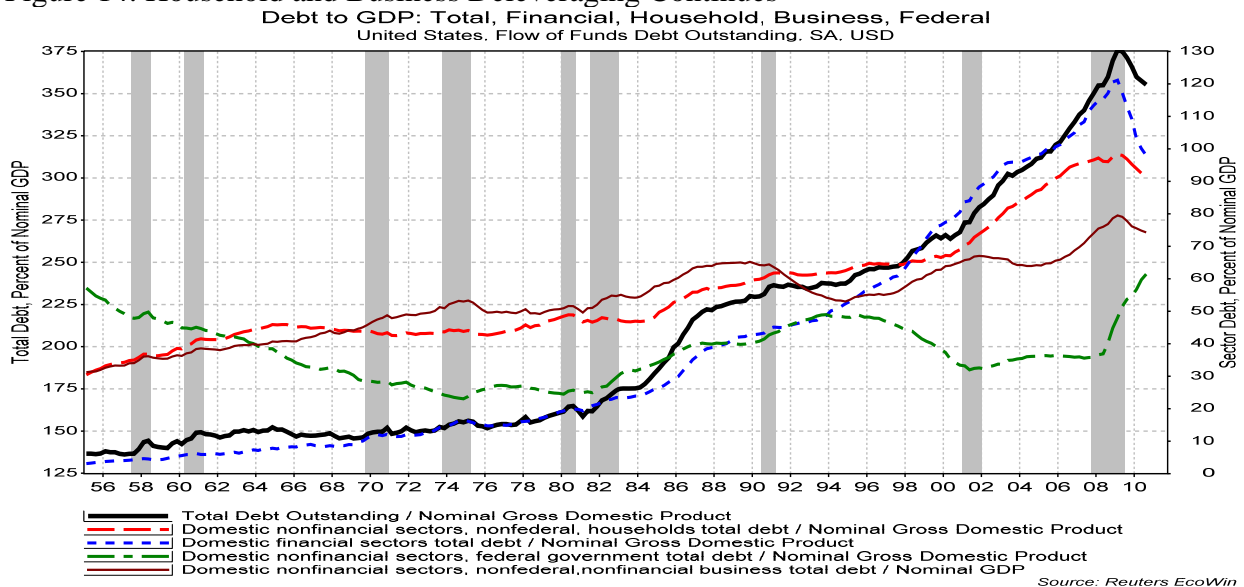


Inflation remains subdued, although rising energy and, more recently, food prices are putting some upward pressure on overall inflation indices. The all-items consumer price index (CPI) rose

² The other ways to increase foreign dollar holdings are reductions in unilateral transfers or a reduction in the income balance on investments. Unilateral transfers are relatively small and are not driven by short-term economic factors. The income balance (what the U.S. earns on its foreign assets minus what foreigners earn on their U.S. assets) probably will turn negative at some point given the growth in foreign dollar assets, but that will not happen soon.

by 1.5% in 2010, while the CPI excluding food and energy rose by just 0.8% (Figure 13). The PCE deflator, the Federal Reserve’s preferred measure of inflation, is up 1.0% overall and 0.8% excluding food and energy for the year ending in November (the latest period available). Given high unemployment, low capacity utilization, and strong productivity growth, these core (i.e., excluding food and energy) inflation indicators are likely to remain low – too low for the liking of the Federal Reserve. That has implications for monetary policy that we discuss in the Market Outlook section below.

Figure 14: Household and Business Deleveraging Continues



The **balance sheet trends** that we have discussed in prior Updates are continuing (Figure 14). Households and financial and nonfinancial businesses are reducing debt, albeit at a slightly slower pace than in prior quarters, while federal government debt is growing rapidly. We think this private-sector deleveraging process still has a long way to run. However, the restraining effects of deleveraging on the economy are likely to diminish over time and do not endanger the recovery. Instead, deleveraging is likely to keep economic growth modest, demand for borrowing low, inflation dormant, and interest rates low. That should create a good environment for corporate profits and credit quality, with positive implications for preferred securities, as we discuss in the next section.

Market Outlook

Long-term **Treasury rates** rose significantly in the fourth quarter. The 30-year Treasury yield rose by 65 basis points (bp) to 4.34% as at the end of Q4, and it has increased by a further 25 bp so far in January. Short-term yields increased considerably less: two-year Treasuries rose by 17 bp to 0.60% at year-end, and its yield is essentially unchanged in January. These sharply higher long-term yields were primarily a result of the improving economic outlook. They also likely reflect the Federal Reserve’s highly accommodative monetary policy and longer-term inflation concerns resulting from it. In addition to keeping the fed funds rate near zero (where it has been since late 2008), the Fed began a Large Scale Asset Purchase program (LSAP), or Quantitative Easing 2 (QE2) as the market commonly calls it, in the fourth quarter. Under LSAP, the Fed will buy up to \$600 billion of Treasury securities through June 2011 (about \$75 billion per month).

Intuitively, one would think that asset purchases would lead to lower, not higher rates! However, Fed purchases of Treasuries really only result in the *shortening* of Treasury debt, not *less* debt in aggregate. Eventually, that borrowing will need to be rolled out to longer maturities. As a result, short-term rates have shown little movement while long-term rates have increased to reflect greater Treasury supply sometime in the future. Of course, the Fed argues that rates would have been higher in the absence of LSAP. That is probably true, though we believe the primary result is a steeper yield curve.³ Nonetheless, long-term Treasury rates should drift a bit lower as the current “growth scare” recedes and the Fed leaves monetary policy on hold. The steep yield curve should push investors into longer-maturity debt over time.

Figure 15: Corporate Spreads...

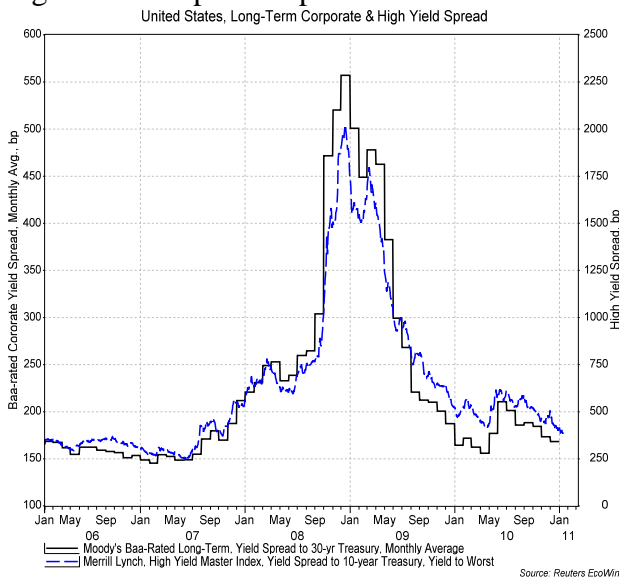


Figure 16: ... and Preferred Spreads Narrower

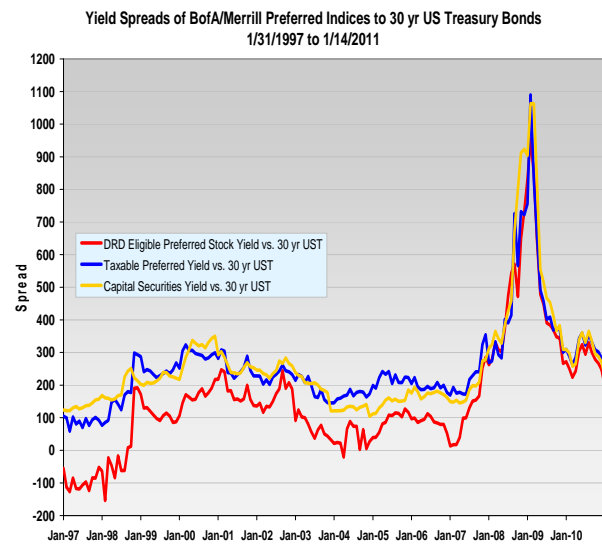


Figure 17: Corporate Profits Surging

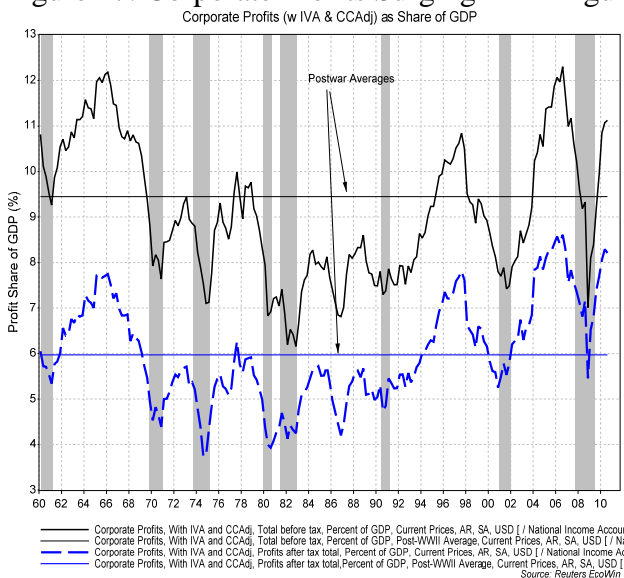
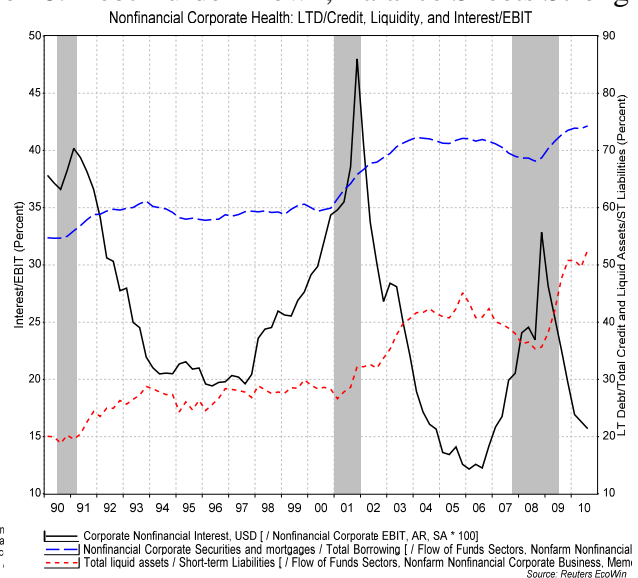


Figure 18: Debt Burden Down, Balance Sheets Strong



³ Most of the Fed’s purchases have been in the intermediate part of the yield curve, from 2- to 7-year issues; relatively little has been in the long end of the market.

While Treasury rates rose, **credit spreads** narrowed for both corporate bonds and preferred securities in the fourth quarter. The spread on Moody’s long-term Baa-rated corporate bonds fell by 25 bp to 164 bp over Treasuries in Q4, and spreads have narrowed a bit further so far in January (Figure 15). Preferred spreads also narrowed by 50-55 bp and finished the quarter around 250 bp over Treasuries for DRD-eligible preferreds and around 270 bp over Treasuries for institutional capital securities (Figure 16).⁴ Spread tightening nearly offset higher Treasury yields. Prices of preferreds ranged from up slightly (capital securities) to down slightly (DRD-eligible) in Q4, with small gains so far in 2011. Although preferred spreads are much narrower than at the height of the financial crisis, they remain near the high end of their pre-crisis historical ranges.

Fundamental **credit quality** continues to improve. Corporate profitability is nearing record highs as a proportion of GDP (Figure 17). In addition, much of these profits are being retained by companies to improve their balance sheets, while new capital expenditures remain modest. Interest expense continues to fall relative to earnings before interest and taxes (EBIT), corporate liquidity is still rising, and long-term debt as a percentage of total debt is at an all-time high (Figure 18).

Figure 19: Mortgage Delinquencies and Foreclosures High but Declining

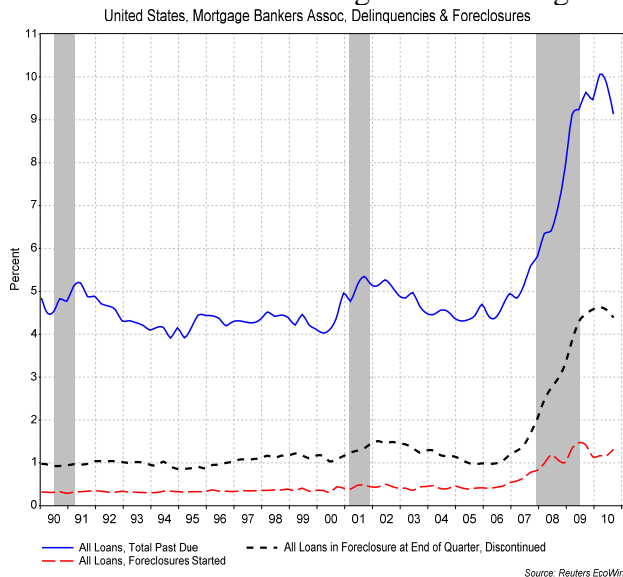
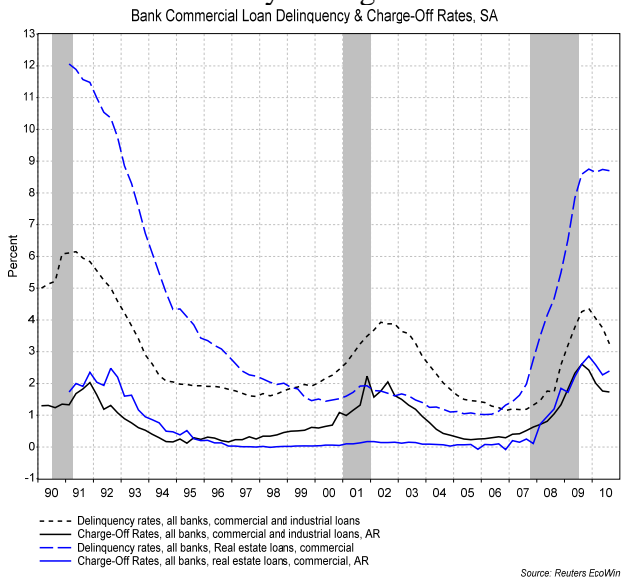


Figure 20: Commercial Loan Problems Gradually Easing



With the economy on the mend and credit quality improving, banks generally have stopped tightening lending standards and have even eased them in some lending categories (Figure 21). Loan demand remains fairly soft, however. Commercial and industrial loans at banks even increased a bit in 4Q2010 for the first time since 2008 (Figure 22). This is good news for the economy and for banks, which are awash in capital and eager to lend to creditworthy borrowers.

⁴ The preferred securities indices referenced herein are from Bank of America/Merrill Lynch. The DRD-eligible index is the 8% Capped DRD-Eligible Preferred Stock Index (P8D0) and the institutional capital securities index is the 8% Capped Corporate US Capital Securities Index (C8CT). Yields and spreads on these indices are calculated by Flaherty & Crumrine Incorporated using data from Bank of America/Merrill Lynch and Bloomberg.

Figure 21: Lending Standards Easing

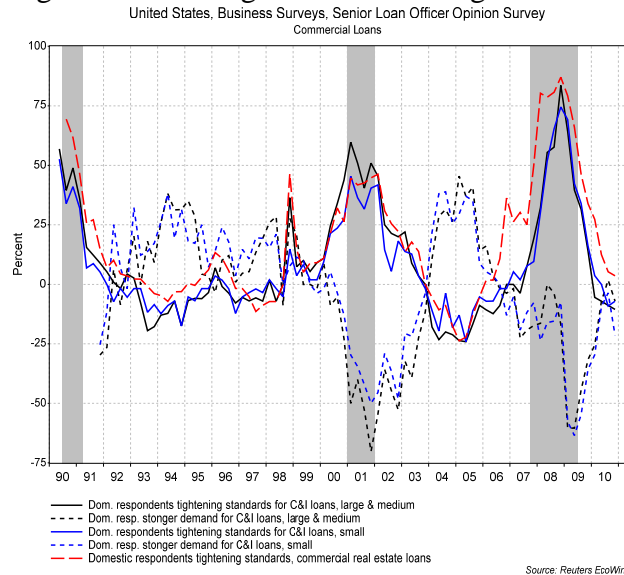
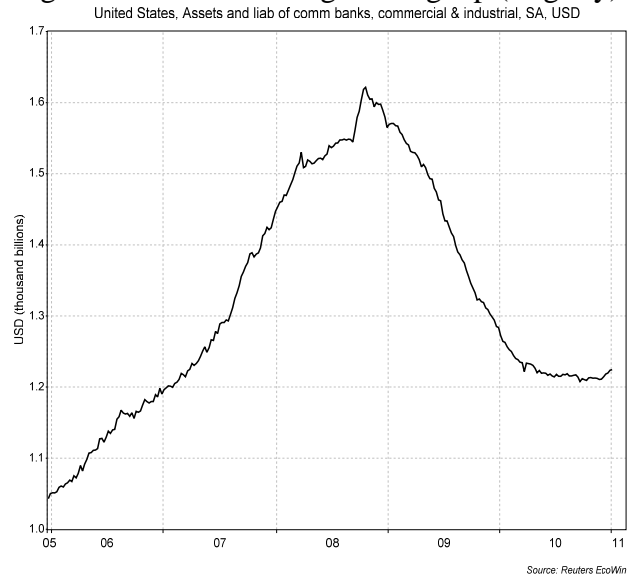


Figure 22: Bank Lending Picking Up (Slightly)



This improving credit backdrop is reflected in lower delinquency and charge-off rates on bank loans. Residential mortgage delinquencies and foreclosures are falling, albeit from very high levels (Figure 19). Commercial and industrial loan charge-offs and delinquencies also are trending down, although commercial real estate loans are still showing signs of strain (Figure 20). This improvement in overall loan performance has allowed banks to set aside smaller provisions for loan losses, contributing to stronger bank earnings. Combined with low dividend payouts and limited share repurchases, banks are rapidly rebuilding common equity capital, which has helped to drive preferred spreads tighter. We expect this generally favorable credit environment to continue for some time.

Turning to **regulatory matters**, bank regulators are busy shaping new capital rules in the wake of the financial crisis. The Basel Committee on Banking Supervision released its final guidelines on bank capital standards. In a nutshell, banks will be required to hold significantly more capital when the new requirements are fully phased in, a process that will begin in 2013 and end in 2019. Tier 1 common equity capital will increase from a current minimum of 2.5% to 7.0% including a capital conservation buffer.⁵ Including preferred capital and several additional capital buffers could push the Tier 1 minimum to 13% or more for systemically important banks. These higher capital requirements – especially the requirement to hold significantly more common equity capital – are a clear positive for preferred securities.

Along with this higher capital requirement, Basel regulators also imposed a requirement beginning in 2013 that all regulatory capital instruments, including preferred securities, be capable of absorbing losses if deemed necessary by regulators. The loss absorbency requirement can be met through the specific terms and conditions of the instrument *or* through the bank resolution regime in the bank’s country of domicile. In the U.S., it is important for outstanding

⁵ Most banks already hold considerably more than the current 2.5% regulatory minimum, and many U.S. banks already meet the fully phased-in Basel standards. We do not anticipate that U.S. banks, in aggregate, will have any trouble meeting the new capital standards, although some individual banks will need to raise a significant amount of common equity capital.

DRD-eligible bank preferreds whether or not the resolution authority granted under the Dodd-Frank financial reform legislation meets the Basel loss absorbency standard. If it does, then most traditional (i.e. non-trust preferred) bank preferreds will remain eligible Tier 1 capital under the new Basel standard. If it does not, then banks will need to replace many of those preferreds with preferred securities that specifically include loss absorbency language. Fortunately, it appears that U.S. bank regulators will have sufficient resolution authority under Dodd-Frank to meet the requirements of the Basel capital standards, although we will need to see final U.S. rules before we can say that conclusively. Furthermore, European banking regulators have proposed a bank resolution regime which, if enacted, might allow many outstanding European Tier 1 hybrid securities to retain capital eligibility.

While much is going on behind the scenes, there has been little U.S. bank regulatory news since the passage of Dodd-Frank in July 2010. Domestic regulators are busy conducting studies that will be used to shape the final rules required under the Dodd-Frank legislation. There will be a steady stream of rule making in 2011, though we may have to wait until late in 2011 before we have a full understanding of what features preferred securities will need to have to qualify as regulatory capital. In the meantime, issuance of bank preferreds is likely to be exceptionally light, which should help push preferred spreads tighter.

We remain optimistic on preferred securities in 2011. Economic growth in the U.S. should be fast enough to allow continued credit improvement but not so fast as to push interest rates or inflation higher. Demand for credit should remain modest while higher savings and accommodative monetary policy will keep the supply of credit ample. We anticipate moderate further spread tightening and slightly lower Treasury rates, with relatively few preferred defaults or dividend deferrals, which should deliver “dividend plus a bit” returns on preferred securities overall. Given the recovery in preferred prices already experienced, however, it is highly improbable that preferred returns will be as high as they were in 2009 or 2010.

Regulatory uncertainty no doubt will cause some volatility during the year, but the new regulations ultimately will drive banks to hold more and higher-quality forms of capital, benefitting preferred investors. New issue supply should remain relatively light. Of course, this is not to say the market is without risk, but we expect investors will move past those worries and continue to support the preferred market in 2011.

Flaherty & Crumrine Incorporated
January 21, 2011

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