Third-Quarter U.S. Economic Update
October 2012

Summary of Recent Economic and Market Developments

Economic growth appears to have accelerated in the third quarter but remains slower than normal for a post-recession period. Economists expect real GDP to grow by 1.6% in Q3 and 2.2% in Q4, though September retail sales may push Q3 close to 2.0%. The economy added more jobs in Q3 as well, though the decline in the unemployment rate to 7.8% overstates the improvement. Wages are barely keeping pace with inflation, leading to middling income growth. Personal consumption expenditures firmed after slowing in Q2, but we will need to see faster job growth and/or higher wages to make the pickup in spending sustainable. The housing market continues to recover. Business investment likewise is growing, but probably at a slower pace than earlier in the recovery. Industrial output fell slightly in Q3. The trade deficit probably widened and will offset some of the GDP gains from retail sales. Inflation picked up a bit on higher energy prices but remains well contained, at least for now. Europe made progress toward containing its sovereign debt crisis as the ECB offered plans to purchase debt of countries pursuing reform programs. The Federal Reserve eased monetary policy with the introduction of a third round of outright securities purchases. Interest rates remained low and credit spreads tightened as credit fundamentals continue to improve. Preferred securities performed well and market conditions remain favorable, but the margin of safety in the preferred market is diminishing.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	2010:4	2011:1	2011:2	2011:3	2011:4	2012:1	2012:2	2012:3
Real GDP, Chg QoQ (%, SA, AR)	2.4	0.1	2.5	1.3	4.1	2.0	1.3	1.6f
Real Personal Consump Expnds, Chg QoQ (%, SA, AR)	4.1	3.1	1.0	1.7	2.0	2.4	1.5	1.9f
Real Busi Investmt, Eqp & Sftware, Chg QoQ (%, SA, AR)	9.2	11.1	7.8	18.3	8.8	5.4	4.8	NA
Real Residential Investmt, Chg QoQ (%, SA, AR)	1.5	-1.4	4.1	1.4	12.1	20.5	8.5	9.1f
Corporate Profits, After Tax, Chg YoY (%, SA, AR)	16.4	2.1	11.0	7.8	14.5	9.2	4.4	2.0f
Current Account Balance, Annualized (% of GDP, SA)	-2.8	-3.2	-3.2	-2.9	-3.1	-3.5	-3.0	NA
Federal Budget, 12-mo Def or Surp (% of GDP)	-8.7	-9.5	-8.4	-8.6	-8.2	-8.1	-7.9	-7.0f
Unemployment Rate (%, SA)	9.4	8.9	9.1	9.0	8.5	8.2	8.2	7.8
Household Employment, Chg QoQ (000, SA)	-124	544	-379	722	683	1244	381	559
Nonfarm Payrolls, Chg QoQ (000, SA)	461	576	389	383	492	677	200	437
Nonfarm Productivity, Chg QoQ (%, SA, AR)	1.9	-2.0	1.2	0.6	2.8	-0.5	2.2	NA
Capacity Utilization (%, SA)	76.0	76.5	76.3	77.2	78.3	78.4	78.8	78.3
GDP Price Index, Chg QoQ (%, SA, AR)	2.1	2.0	2.6	3.0	0.4	2.0	1.6	1.7f
Consumer Price Index, Chg YoY (%, AR)	1.5	2.7	3.6	3.9	3.0	2.7	1.7	2.0
CPI ex food & energy, Chg YoY (%, AR)	0.8	1.2	1.6	2.0	2.2	2.3	2.2	2.0
Nominal Personal Income, Chg YoY (%, AR)	5.3	6.1	5.1	4.6	3.6	3.2	3.4	3.5a
Personal Savings Rate (%, SA)	4.9	4.6	4.7	3.5	3.4	3.7	4.4	3.7a
Rate or Spread (End of Quarter)	**2010:4**	**2011:1**	**2011:2**	**2011:3**	**2011:4**	**2012:1**	**2012:2**	**2012:3**
Federal Funds Rate Target (%)	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3-month LIBOR (%)	0.30	0.30	0.25	0.37	0.58	0.47	0.46	0.36
10-Yr Treasury Note Yield (%)	3.29	3.47	3.16	1.92	1.88	2.21	1.64	1.63
30-Yr Treasury Bond Yield (%)	4.34	4.51	4.38	2.91	2.89	3.34	2.75	2.82
Moody's Baa Long Corp Spread (bp)	164	154	152	231	227	196	231	190
10-Yr Interest Rate Swap Spread (bp)	9	11	12	19	17	8	13	7

* Figures are either quarterly or, if more frequent, end of period. f = Forecast[1]; a = Actual through Aug 2012 Source: Reuters EcoWin

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

Economic Outlook

It appears that even our downgraded growth forecast of 2.0-2.5% growth in the second half of 2012 that we outlined in our last Update may be too optimistic. Economists recently forecast inflation-adjusted U.S. **Gross Domestic Product** (real GDP) of just 1.6% in the third quarter and 2.2% in Q4, for an average of 1.9% growth in the second half of 2012.[1] Encouragingly, however, September's strong retail sales report may signal Q3 GDP a bit stronger than that forecast, which could push second half GDP back into our own 2.0-2.5% forecast range. Economists expect growth to remain tepid at 2.1% in 2013.

Faced with the "fiscal cliff" at home, recession across much of Europe and slowing growth in Asia, it is difficult to be more optimistic over the near term. We can make a good case for stronger economic growth over a longer horizon if appropriate policy choices are made. However, the need to reduce private-sector debt and, subsequently, public-sector debt is likely to restrain growth relative to prior norms.

We start, as usual, by reviewing the major sectors of the U.S. economy.

Figure 2: Employment Growing Slowly

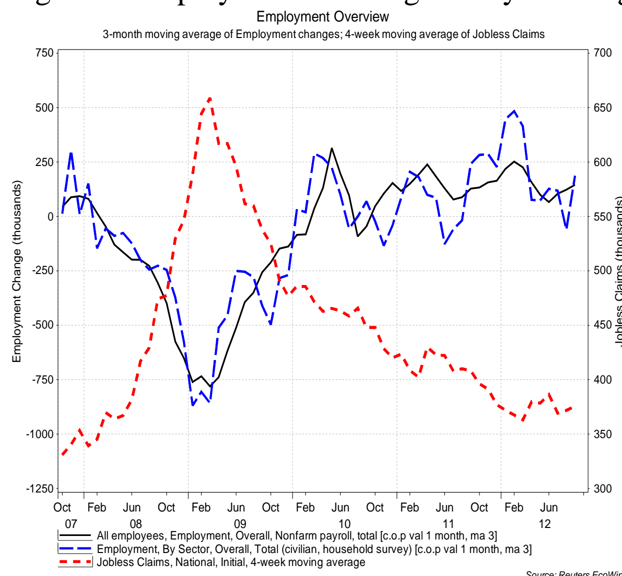
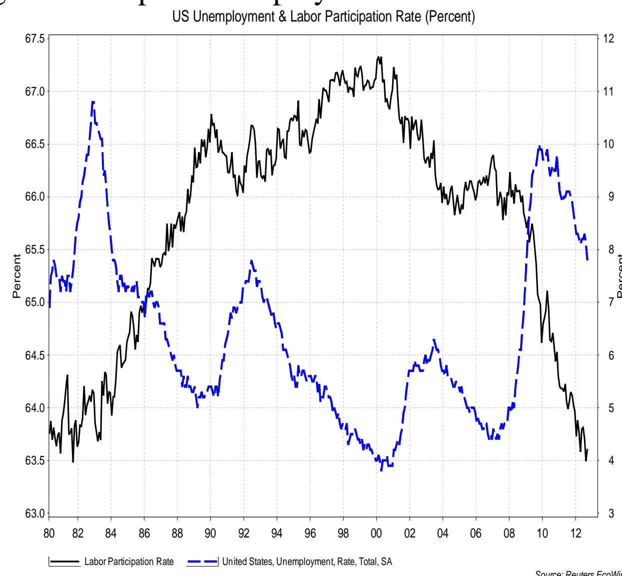


Figure 3: Drop in Unemployment Overstates Gains



The **labor market** improved in the third quarter compared to Q2 but remains relatively weak. Payroll job growth accelerated to an average of 146,000 per month in Q3, up from just 67,000 in the prior quarter. Employment measured under the household survey grew faster, increasing by an average of 186,000 per month in Q3 compared to 127,000 in Q2. Viewed from a somewhat longer-term perspective, however, job growth as measured by each survey appears little changed since late 2010 (Figure 2). Over the past two years, job growth under each survey has averaged about 150,000 jobs per month, which is slow for this stage of recovery from recession. We anticipate sluggish hiring will persist, although we may see some acceleration in hiring if the "fiscal cliff" is resolved adroitly after the November elections.

[1] All growth rates are annualized unless noted otherwise. Forecasts in this Update are from *The Survey of Professional Forecasters*, Federal Reserve Bank of Philadelphia, August 10, 2012.

Despite the sluggish pace of job growth, the unemployment rate has dropped from 9.5% in September 2010 to 7.8% two years later (Figure 3). This is a much larger decline in unemployment than one would expect from either set of jobs data. Some simple arithmetic explains why. The civilian labor force in the U.S. numbers 155 million persons as of September 2012, and it tends to grow by about 1% per year due to population growth, assuming that the labor participation rate remains unchanged. To hold the unemployment rate stable, the economy needs to generate about 120,000 jobs per month. The U.S. economy has done better than that by about 30,000 jobs per month for 24 months, or 720,000 total incremental jobs. That works out to about 0.5% of the labor force. Yet the unemployment rate has fallen by 1.8% over the past two years. The difference is explained mainly by the drop in the labor participation rate from 64.6% to 63.6% over that time.[2] There are a number of possible explanations for this decline, which we will not explore here, but it is unlikely that strong job prospects are prompting people to *exit* the labor force. In fact, labor market strength typically *boosts* labor participation. That's not happening here.

Our point is that the substantial decline in the unemployment rate overstates the improvement in labor market conditions. If the labor market were as strong as what is implied by the drop in the unemployment rate, wages would be accelerating. They are not: hourly earnings are up just 1.8% YoY in September, barely keeping pace with inflation. Moreover, wages have been hovering around that low growth rate for the past three years. Jobs are growing, more people are working and the unemployment rate is gradually declining – but this is not a jobs boom.

Figure 4: Income Growth Sluggish

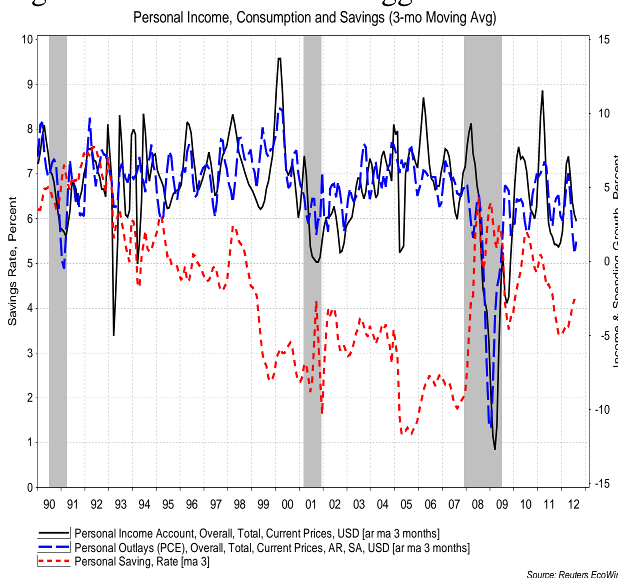
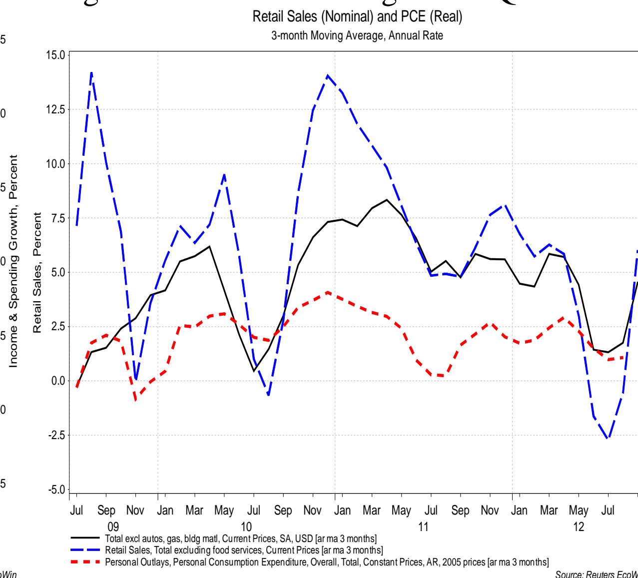


Figure 5: Retail Sales Brighten in Q3



Slow employment and wage growth implies the same for **personal income**. Personal income advanced by 3.5% YoY and 2.7% over the three months ending in August (Figure 4). We continue to anticipate personal income will expand at about a 3% pace until hiring picks up.

Consumers remain cautious in their spending but may be turning a little more optimistic. **Personal consumption expenditure** (PCE) before inflation increased by 3.6% YoY and just

[2] The rest of the difference comes from base effects and labor force growth (the labor force was not constant throughout the period; nor was its growth rate).

1.6% over the three months ending in August, little better than the sluggish pace in Q2 (Figure 4). As a result, the 3-month moving average **savings rate** rose to 4.1% as of August, up from 3.8% three months earlier and 3.4% at the end of 2011. Households continue to reduce debt and accumulate savings (more on that later), which is holding PCE growth at or below income growth. We expect that broad trend to continue for some time to come.

More positively, recent data on retail sales through September point to some improvement in personal spending. Overall retail sales were up 5.5% in Q3 over Q2, and "core" retail sales (excluding automobiles, gasoline and building materials) were up 4.4% (Figure 5). If we subtract 2% for inflation from core retail sales, PCE would be up about 2½ percent in Q3, which is better than the 1.9% estimate baked into economists' Q3 GDP forecast of 1.6%. Although some of the positive impact of higher retail sales is likely to be offset by higher imports, Q3 GDP could come in 0.2-0.3% higher than currently forecast.

We need to be cautious about over-emphasizing the importance of one retail sales report, however. First, retail sales data are subject to sizable revision, and as Figure 5 shows, even after revision they are much more volatile than PCE. Second, as already noted, many consumer goods are imported, so higher retail sales may be partially offset by a wider trade deficit. Finally, September retail sales were probably influenced by the "iPhone effect." Apple's new smartphone went on sale in September, reportedly selling over two million units over its launch weekend. The devices have high retail prices (before wireless carriers' subsidies) and no doubt boosted retail sales in September. Indeed, sales at electronic stores were up 4.5% (not annualized) over the month. While that strong pace of sales may continue in October, it will slow at some point. In short, we are encouraged by improving retail sales data, but we need to see them followed up by employment and income gains to conclude that a stronger consumption trend has begun.

Figure 6: Housing Recovery Continuing

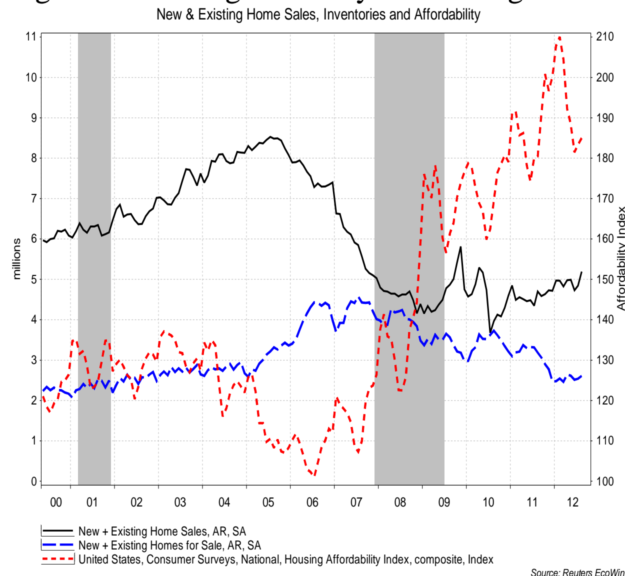
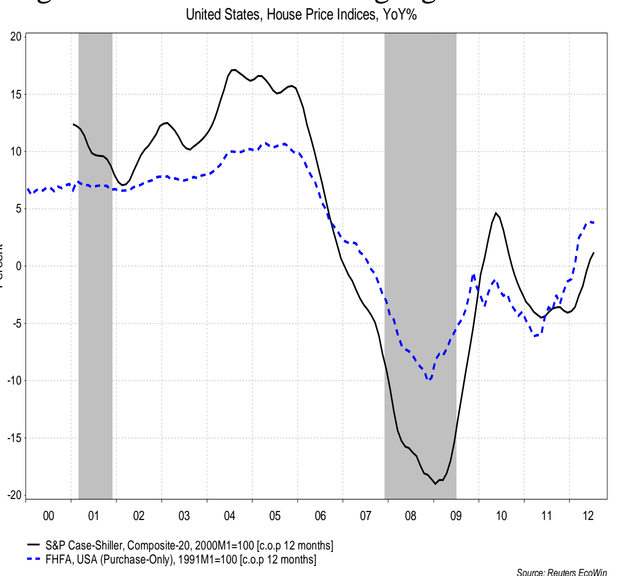


Figure 7: Home Prices Rising Again



The **housing market** continues its recovery and remains a bright spot in the U.S. economy, albeit a small one at just 2.6% of real GDP. Sales of new and existing homes continue to edge higher and are now running above a 5 million unit pace (Figure 6). Inventories of unsold homes have held about steady as the rising pace of purchases appears to be offsetting supply coming back

onto the market. In addition, home prices are now rising on a YoY basis (Figure 7). Price gains are slight and are likely to remain modest in most markets, but this is very good news for underwater homeowners and for banks that hold mortgages on those properties. About the only negative thing we can say about these higher prices is that they have pushed down home affordability from its record, although it remains very high on an absolute basis (Figure 6).

Figure 8: Manufacturing & Order Slowdown

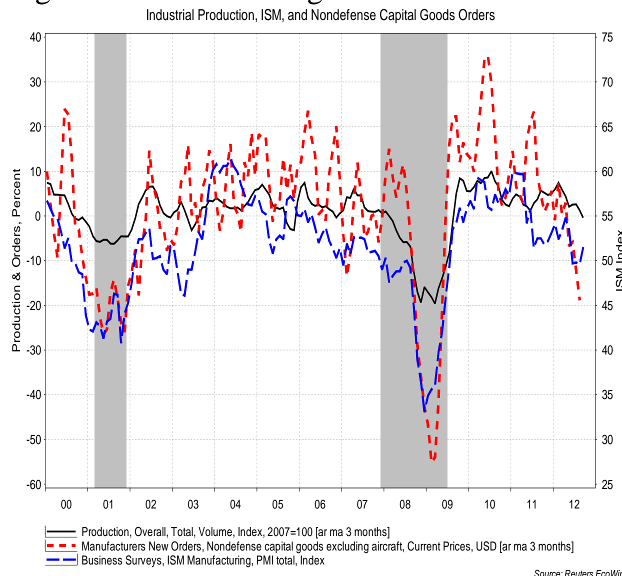
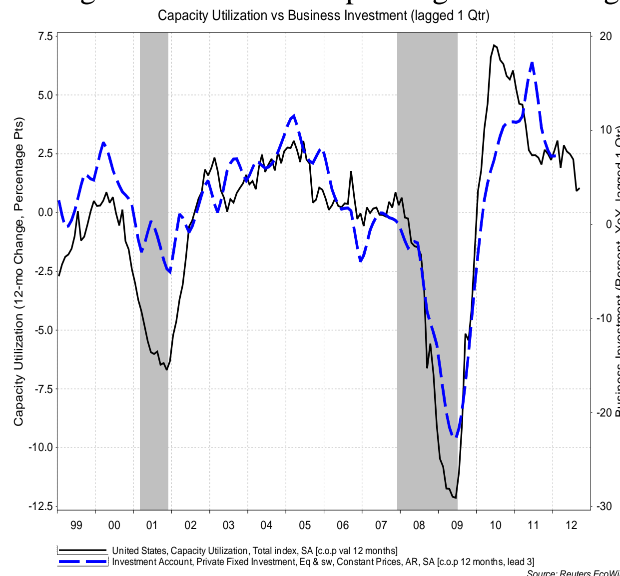


Figure 9: Investment Spending Decelerating



Business investment appears to have slowed in the third quarter after several years of strong growth. Industrial production was slightly negative (-0.4%) in Q3, and orders for nondefense capital goods excluding aircraft have declined sharply (Figure 8). We would be quite worried about the drop in orders in recent months (data is only through August at this point) were it not for the rebound seen in the Institute for Supply Management's (ISM) survey of manufacturers in September. That survey showed an encouraging rebound in both the overall index (51.5 in September versus 49.6 in August) and new orders index (52.3 versus 47.1), which may signal some recovery in manufacturing heading into Q4. Nonetheless, the rise in capacity utilization has slowed, which suggests growth in business investment is likely to follow (Figure 9). We still anticipate that business investment will add to GDP this quarter, but probably not in a big way.

One of the reasons for the slowdown in manufacturing is weaker exports. Both export and import growth have slowed to a crawl, and the **trade deficit** widened in the first 2 months of Q3 (Figure 10). It now appears that net exports will subtract about 0.3% from Q3 GDP after adding that amount in Q2. It is the slide in trade flows (i.e., imports and exports) that highlights sluggish global economic conditions, however. It is simply not possible to read anything bullish into these numbers.

Government consumption has been a drag on real GDP growth for the past two years – coming from exceptionally high levels – as the economy recovered from recession. We expect government spending will continue to subtract from growth as state and local governments seek additional budget cuts and the federal government confronts the "fiscal cliff" next year. However, the government sector added employees in Q3 for the first time since mid-2010, so we may see higher real government spending and a positive contribution to real GDP this quarter.

Figure 10: Global Trade Sliding

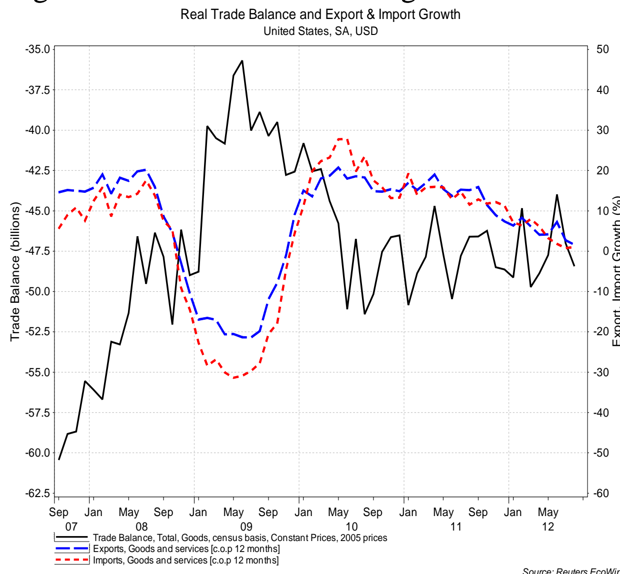
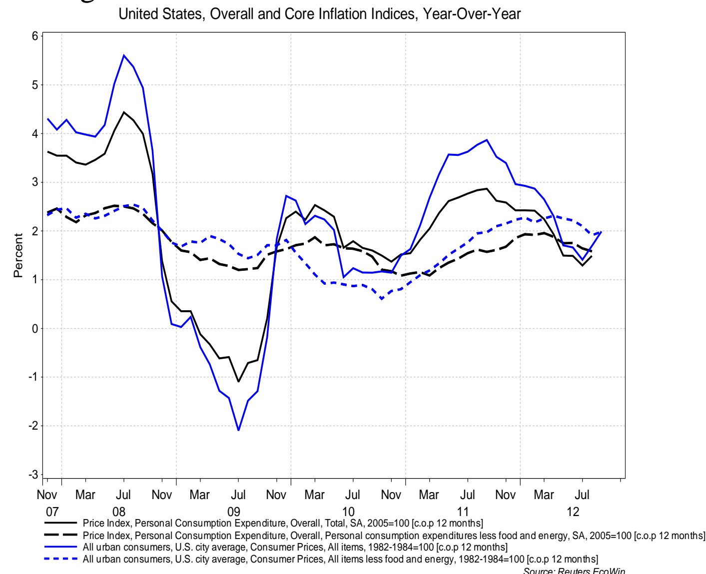


Figure 11: Inflation Pressures Subdued

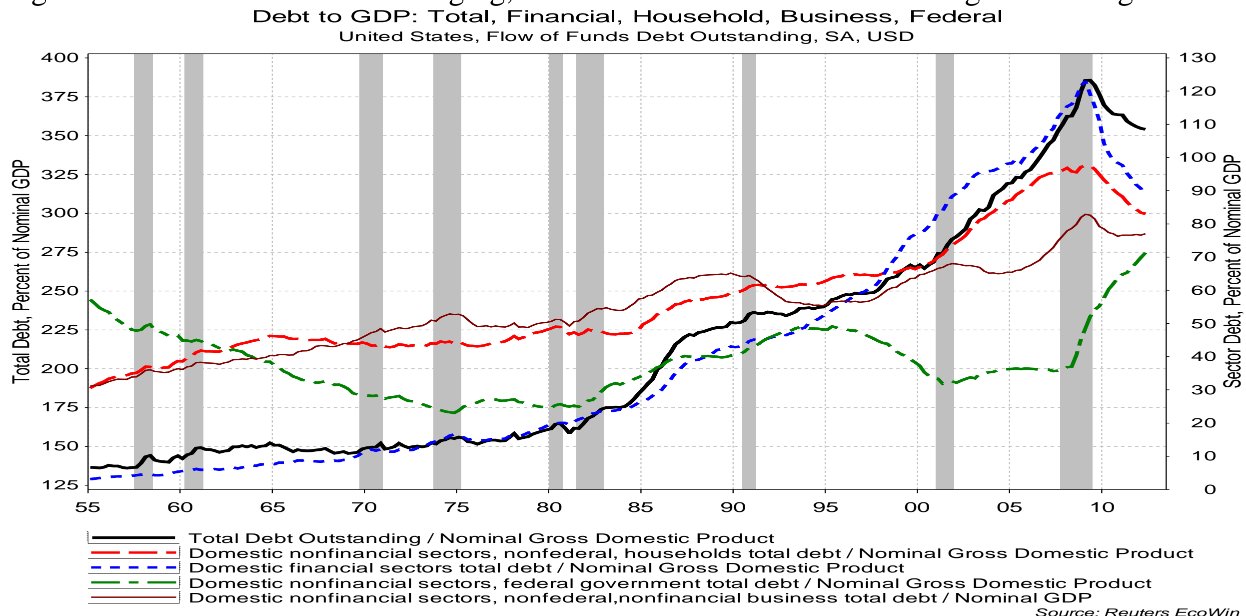


Inflation pressures generally remain subdued, although rising energy prices in August and September have put some renewed upward pressure on inflation indices (Figure 11). Consumer prices were up 2.0% YoY in September, both overall and excluding food and energy. The overall PCE deflator was up 1.5% YoY in August; excluding food and energy, it was up 1.6% over the same period. As we explained in last quarter's Update, we do not anticipate that inflation will increase substantially over the near term. However, we remain watchful longer-term, especially given the further expansion of quantitative easing initiated by the Federal Reserve in the third quarter.

Turning briefly to **developments in Europe**, the European Central Bank (ECB) in September voted to conduct unlimited, sterilized purchases of European government debt in the secondary market, subject to certain conditions. To be eligible for this "Open Money Tap" (OMT), a country must request assistance from the European Monetary Union, agree to reforms and monitoring, and sign and adhere to a memorandum of understanding (MOU) detailing the terms and conditions of the assistance. The ECB will cease OMT purchases if terms of the MOU are not met, as determined by monitors including the International Monetary Fund. The ECB's purchases will be *pari-passu* with other sovereign debt holders, not senior to them.

This is a major, positive step that should encourage countries facing funding difficulty to apply for assistance *and* adhere to its terms. OMT is not a magic bullet. A program country will still need to summon the political will to implement budget, labor market and economic reforms that will reduce borrowing needs and improve prospects for longer-term economic growth. However, OMT assures that a country's finances will not be derailed by debilitating interest costs while implementing a reform program. Markets cheered the news.

Figure 12: Private Sector Deleveraging, but Federal Government Borrowing Still Rising



As usual, we conclude this section with a recap of **balance sheet trends** (Figure 12). Households are continuing to reduce debt (as a proportion of GDP), although the pace of decline appears to be slowing a little. Consumers remain very cautious with credit card debt, where there is near zero growth, and mortgage debt continues to fall. Consumer credit overall (excluding mortgage debt) is growing modesty on strength in automobile and student borrowing. Nonfinancial businesses are holding debt about steady; they continue to generate more cash internally than needed for reinvestment in their businesses. Financial firms continue to delever given weak household and business borrowing. Only the government sector continues to grow its debt; that will not change soon, but as countries such as Greece and Spain have learned, such growth in debt-to-GDP cannot go on forever. As we have said here often, economic growth should remain subdued during this period of deleveraging, which is likely to continue for some time to come.

Market Outlook

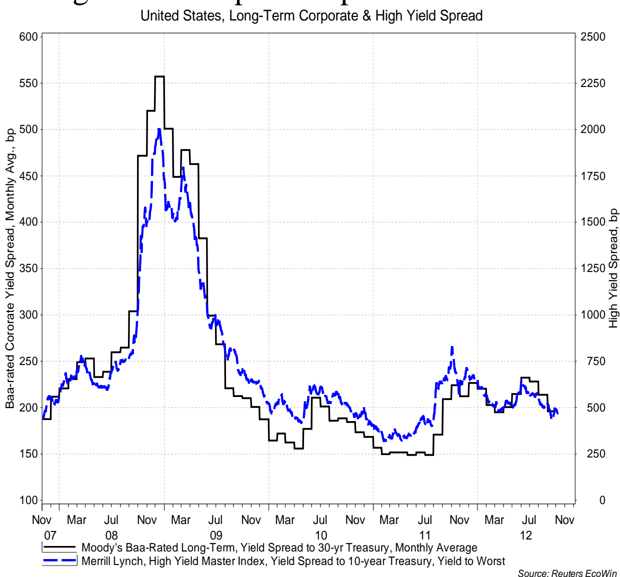
Treasury rates ended the third quarter about where they started as the economy plodded along only a bit faster than it did in Q2. The yield on the 30-year Treasury bond rose by 7 basis points (bp) to end Q3 at 2.82%, while the 10-year Treasury note yield fell by 1 bp to 1.66% (Figure 13). Rates are little changed in October as well. In the short end, the fed funds target rate remained unchanged at zero to 0.25%.

The Federal Reserve further eased **monetary policy** in the third quarter. After deciding in Q2 to continue extending the maturities of its Treasury portfolio ("Operation Twist") through the end of 2012, the Fed in September commenced another round of outright purchases of mortgage-backed securities (MBS). In this third round of quantitative easing ("QE3"), the Fed will conduct unsterilized purchases of $40 billion per month of MBS, with no specified end date. This will expand the monetary base and should put downward pressure on mortgage rates in an effort to stimulate borrowing and investment. Although the Fed's efforts probably will contribute marginally to economic growth, the Fed is facing diminishing returns on quantitative easing

given that mortgage rates are already low and liquidity high. There is little doubt, however, that accommodative monetary policy is driving yield-seeking investors into corporate debt and preferred securities.

Figure 13: Long-term Yields Sideways in Q3

Figure 14: Corporate Spreads Narrowed



Credit spreads narrowed during the third quarter, and the rally has continued so far in October (Figure 14). Long-term Baa-rated corporate bond spreads narrowed by 41 bp during Q3 and have narrowed an additional 19 bp so far in October. High yield spreads performed even better, narrowing by 76 and 21 bp in Q3 and October, respectively. Over the same periods, preferred securities' prices rallied an average of 2.2% and 0.8%, respectively. We continue to expect that credit spreads will tighten somewhat further over the remainder of 2012 as economic growth remains slow but steady, the Fed pursues QE3, and credit fundamentals gradually improve.

Figure 15: Corporate Profits Remain Strong

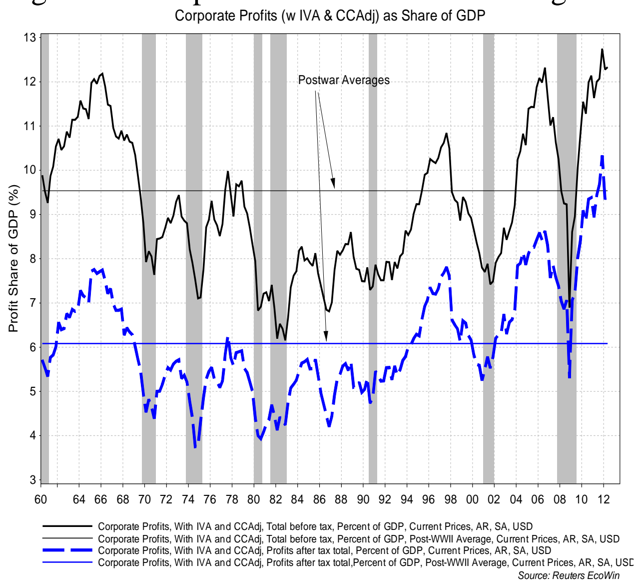


Figure 16: Balance Sheets Solid, Liquidity Off

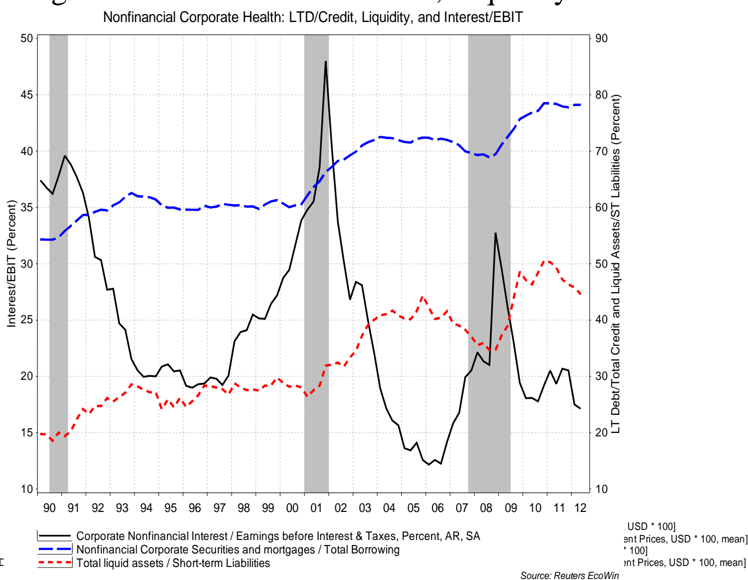


Figure 17: Loan Quality Improving

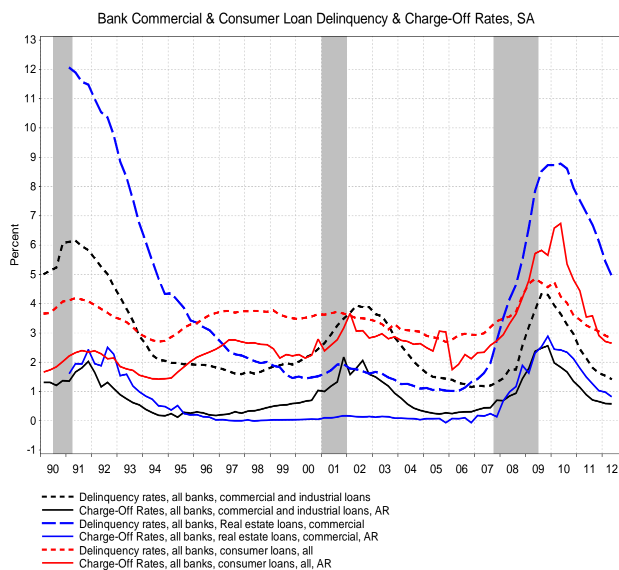
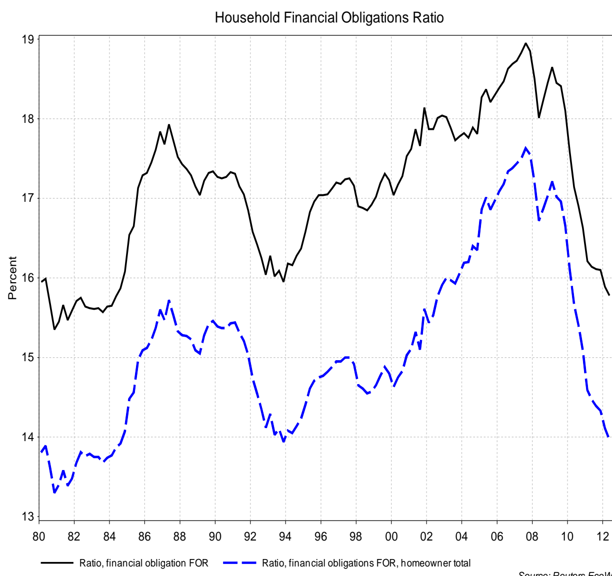


Figure 18: Consumer Debt Burdens Falling



Credit quality continues to improve at U.S. corporations and banks, although the pace of improvement has slowed in recent quarters. Corporate profits have retreated slightly from postwar records, but they remain high by any standard (Figure 15). Interest expense relative to earnings before interest and taxes is falling again, and the proportion of long-term debt to total debt remains near its record high (Figure 16). However, liquidity is slipping at nonfinancial corporations (Figure 16), probably reflecting near-zero returns on cash and cash equivalents and progress made extending debt maturities. We do not think this is worrisome in the context of low rates, strong profitability and improved funding profiles, but we will be keeping an eye on it. Loan delinquencies and charge-offs are declining across all major loan categories (Figure 17). Household debt burdens continue to fall (Figure 18). Improvement in credit quality has boosted bank profits and capital. With relatively little growth in their balance sheets and higher regulatory capital requirements looming, banks' capital ratios have risen sharply. Improving credit conditions have contributed to the strong performance of preferred securities, and we anticipate additional but more gradual improvement going forward.

The U.S. economy, policymakers and regulators have delivered a nearly ideal set of circumstances for investors in preferred securities. Economic growth has been fast enough to generate rising profits and incomes, which, in turn has allowed businesses and households to reduce debt and strengthen their balance sheets. At the same time, growth has not been fast enough to generate demand for much new borrowing, and monetary policy has put additional downward pressure on interest rates, making existing debt burdens more manageable. Finally, regulators have mandated that banks, which are the largest issuers of preferred securities, hold much more common equity capital than they have in the past. Banks have cleaned up their balance sheets and reduced business risk while increasing capital, significantly enhancing the credit cushion protecting preferred securities.

We foresee these favorable fundamental conditions continuing, although we are cautious about how much lower yields on preferred securities can drop. There are many risks that could interrupt

or reverse the gains that preferred securities have enjoyed in recent quarters. How politicians resolve – or fail to resolve – the “fiscal cliff” in the U.S. and the sovereign debt crisis in Europe are just two such risks. Political turmoil combined with rising militarism in the Middle East is another. Adverse or unforeseen developments in these or other trouble spots could cause investors to reevaluate their exposure to deeply subordinated securities such as preferreds. We also anticipate significant new issuance of preferred stock by banks as they redeem trust preferred securities in 2013, and yields may need to move higher to allow the market to absorb it.

We remain optimistic on preferred securities and we continue to find attractive securities to purchase. However, we recognize that our margin of safety shrinks as yields decline. Investors should be aware of it too.

Flaherty & Crumrine Incorporated
October 16, 2012

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