First-Quarter US Economic Update
April 2013

Summary of Recent Economic Developments

Economic growth appears to have accelerated in the first quarter of 2013, but it remains modest. Economists forecast 2.1% growth in real GDP in Q1, up from just 0.4% growth in Q4. Although headwinds to growth are diminishing, the US economy remains constrained by deleveraging of debt built up during the credit boom. Slow job and wage growth along with higher taxes restrained growth in disposable income. In turn, real personal consumption expenditure growth is stuck below 2%. Declining government expenditures – while a positive fiscal development – are likely to reduce GDP growth over the rest of the year. Trade should be a small drag on GDP growth this year as well. More positively, the housing market continues to improve rapidly, contributing to higher household wealth and better loan performance. Business investment has also been a bright spot recently, although we anticipate slower investment spending over the next couple of quarters. Similarly, inventory rebuilding should be a major contributor to GDP growth, but only for a quarter to two. Inflation remains subdued. With unemployment still high and inflation below its target, the Federal Reserve kept monetary policy highly accommodative in Q1. Credit conditions continue to improve, and credit demand is growing only slowly. Low rates, improving credit conditions and limited issuance contributed to another good quarter for preferred securities, and we remain cautiously optimistic over the balance of 2013.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	2011:2	2011:3	2011:4	2012:1	2012:2	2012:3	2012:4	2013:1
Real GDP, Chg QoQ (%, SA, AR)	2.5	1.3	4.1	2.0	1.3	3.1	0.4	2.1f
Real Personal Consump Expnds, Chg QoQ (%, SA, AR)	1.0	1.7	2.0	2.4	1.5	1.6	1.8	1.6f
Real Busi Investmt, Eqp & Sftware, Chg QoQ (%, SA, AR)	7.8	18.3	8.8	5.4	4.8	-2.6	11.8	NA
Real Residential Investmt, Chg QoQ (%, SA, AR)	4.1	1.4	12.1	20.5	8.5	13.5	17.6	12.9f
Corporate Profits, After Tax, Chg YoY (%, SA, AR)	11.0	7.8	14.5	9.2	4.4	3.2	-1.1	6.2f
Current Account Balance, Annualized (% of GDP, SA)	-3.2	-2.9	-3.1	-3.5	-3.0	-2.8	-2.8	NA
Federal Budget, 12-mo Def or Surp (% of GDP)	-8.4	-8.6	-8.2	-8.1	-7.9	-6.9	-6.7	-5.8
Unemployment Rate (%, SA)	9.1	9.0	8.5	8.2	8.2	7.8	7.8	7.6
Household Employment, Chg QoQ (000, SA)	-238	759	732	1124	428	526	331	-19
Nonfarm Payrolls, Chg QoQ (000, SA)	628	435	570	787	324	456	626	504
Nonfarm Productivity, Chg QoQ (%, SA, AR)	0.6	-0.1	2.3	-0.7	1.7	3.1	-1.9	NA
Capacity Utilization (%, SA)	76.2	76.7	77.3	77.3	77.7	77.2	77.7	78.5
GDP Price Index, Chg QoQ (%, SA, AR)	2.6	3.0	0.4	2.0	1.6	2.7	1.0	1.7f
Consumer Price Index, Chg YoY (%, AR)	3.6	3.9	3.0	2.7	1.7	2.0	1.7	1.5
CPI ex food & energy, Chg YoY (%, AR)	1.6	2.0	2.2	2.3	2.2	2.0	1.9	1.9
Nominal Personal Income, Chg YoY (%, AR)	5.1	4.6	3.6	3.2	3.1	3.6	7.1	2.6a
Personal Savings Rate (%, SA)	4.7	3.5	3.4	3.7	4.1	3.3	6.5	2.6a
Rate or Spread (End of Quarter)	**2011:2**	**2011:3**	**2011:4**	**2012:1**	**2012:2**	**2012:3**	**2012:4**	**2013:1**
Federal Funds Rate Target (%)	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3-month LIBOR (%)	0.25	0.37	0.58	0.47	0.46	0.36	0.31	0.28
10-Yr Treasury Note Yield (%)	3.17	1.92	1.87	2.22	1.66	1.64	1.76	1.85
30-Yr Treasury Bond Yield (%)	4.38	2.91	2.89	3.34	2.75	2.82	2.95	3.10
Moody's Baa Long Corp Spread (bp)	152	231	227	196	231	190	168	173
10-Yr Interest Rate Swap Spread (bp)	10	19	17	8	13	7	6	16

* Figures are either quarterly or, if more frequent, end of period. f = Forecast[1]; a = Actual through Feb 2013 Source: Reuters EcoWin

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

Economic Outlook

The US economy is starting out 2013 growing more rapidly than it ended last year. Economists expect first-quarter inflation-adjusted Gross Domestic Product (real GDP) to grow by 2.1%[1], although more recent forecasts call for somewhat stronger Q1 growth. For the full year, real GDP is expected to grow by 1.9% and 2.8% in 2013 and 2014, respectively. Those forecasts compare to just 0.4% growth in Q4 and 1.7% growth for 2012 as a whole.

Our outlook for the US economy is little changed since last quarter, so we will let the graphs do most of the "talking" in this Update. Economic growth continues to be restrained by deleveraging in the private sector and fiscal policy uncertainty, although both headwinds are diminishing gradually. We remain a little more optimistic on 2013 real GDP growth (2.0-2.5%) than consensus. That modest pace of growth should be fast enough to facilitate further improvement in corporate and household balance sheets and better loan performance while being slow enough to keep interest rates low and issuance of preferred capital subdued on a net basis. Combined with an ongoing regulatory push to increase common equity capital at financial institutions globally, we anticipate continued credit improvement at most preferred issuers in 2013.

Figure 2: Job Growth Mixed…

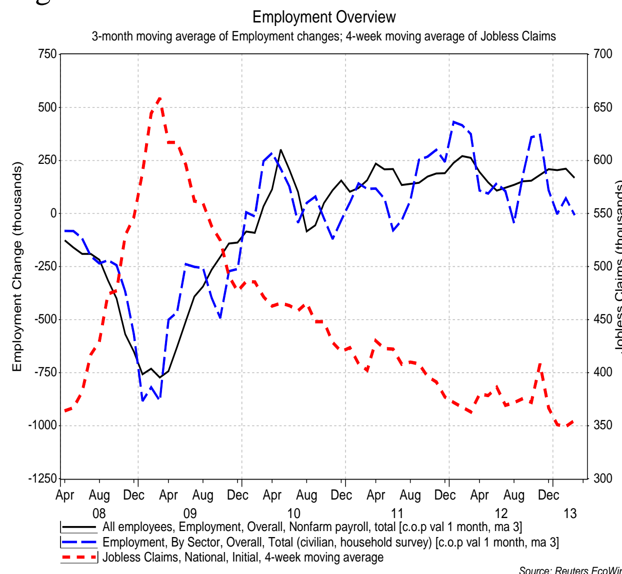
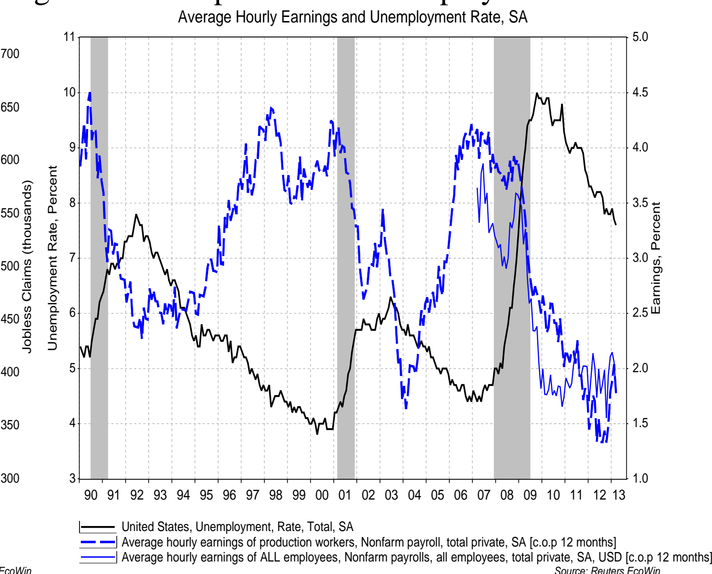


Figure 3: …Despite Lower Unemployment Rate



Labor market performance in the first quarter was a mixed bag (Figure 2). Payroll employment rose by 504,000 in Q1, close to the average pace of job gains over the past several years. However, employment measured by the household survey *fell* by 19,000 in Q1, well below the 2011-12 average. We attribute current weakness of the household survey mainly to its smaller sample size; over longer periods, the two surveys show similar job gains. Moreover, other employment indicators, such as jobless claims (red line in Figure 2) and a rising average workweek, suggest continued modest job gains.

Wage growth slipped (Figure 3). Last quarter, it appeared that wages were accelerating. However, it now appears that the jump in average hourly earnings to 2.1% YoY in December

[1] All growth rates are annualized unless otherwise noted. Forecasts in this Update are from *The Survey of Professional Forecasters*, Federal Reserve Bank of Philadelphia, February 15, 2013 unless otherwise noted.

2012 was driven largely by higher tax rates beginning in 2013, which prompted employers to accelerate some wages into 2012. Wage growth subsequently dropped back to 1.8% YoY in March, about where it was for most of last year.

Despite lower employment as measured by the household survey (which is used to calculate the unemployment rate), the unemployment rate fell to 7.6% in March from 7.8% in December (Figure 3). The reason for the drop is falling labor participation, which slid 0.3% this quarter to 63.3%. The decline in labor participation partly reflects rising numbers of people collecting disability benefits (who are counted as being out of the workforce) and demographics (increasing numbers of retirees), but it likely also reflects poor job prospects. We continue to expect labor participation to increase when jobs become more plentiful and easier to obtain, which would limit, or even partially reverse, the decline in the unemployment rate.[2] That is one reason why we expect the Federal Reserve to keep monetary policy highly accommodative for some time to come.

Moderate job and slow wage growth translated to only modest growth in **personal income** in Q1 (Figure 4). Nominal personal income growth slipped to 2.6% YoY in February (the latest data available) after surging 7.1% YoY in December. The latter figure reflects both sizable bonus and dividend payments that were accelerated into 2012 in anticipation of higher tax rates in 2013. Income growth slowed sharply thereafter, but we anticipate a return to around 3.5% growth (1.5% growth in employment plus 2% wage growth) once the dust settles around those tax-driven distortions. Similarly, the **savings rate** surged then fell as consumption growth stayed about steady while income moved up and down; we expect it will return to 3.5-4% in another quarter or two.

Figure 4: Income & Savings Rate Volatile

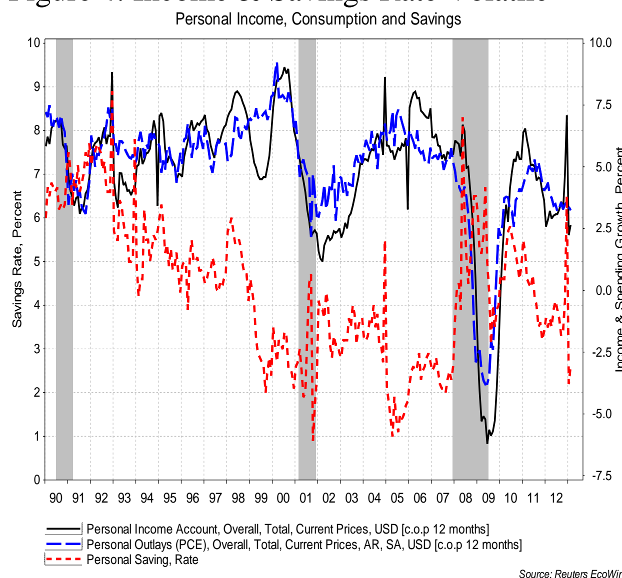
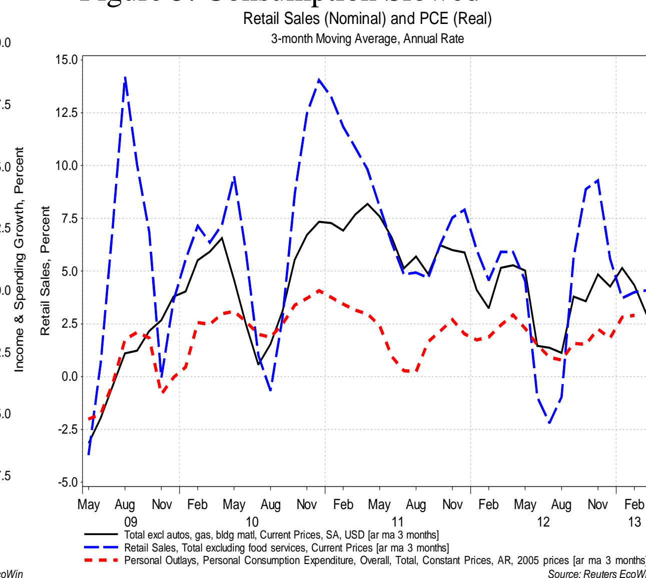


Figure 5: Consumption Slowed



Personal consumption expenditures (PCE) appear to have slowed during the first quarter (Figure 5). Reports on PCE and retail sales early in Q1 were upbeat, but March data on retail sales were weak and included downward revisions to January and February sales that are not yet

[2] See *Fourth-Quarter US Economic Update*, Flaherty & Crumrine Incorporated, January 16, 2013 for a more detailed discussion of labor participation and its impact on the unemployment rate.

reflected in PCE data (to be reported on April 29) shown in Figure 4. The consensus forecast of 1.6% growth in real PCE in Q1 shown in Figure 1, which appeared too conservative a week or two ago, now looks about right. Consumers faced higher payroll and investment taxes coming into 2013, household debt remains high historically (although the cost of carrying it is currently low at today's interest rates), and consumer confidence remains weak. As a result, it is not surprising that consumers remain cautious on spending. Moreover, if the savings rate rebounds as we expect, that will further restrain consumption. We expect improvement in PCE eventually, but it is likely to be slow for at least another year or two.

In contrast to tepid growth in consumer spending, the **housing market** is improving rapidly. Home sales are rising and inventories of homes for sale are falling (Figure 6). As a result, home prices are accelerating (Figure 7). To be sure, home price gains in most markets are modest so far, and home affordability (dashed red line in Figure 6) remains quite high (i.e., affordable). However, the upward turn in home prices has solid fundamental underpinnings, and we expect prices to continue trending upward. That should not only drive construction and ancillary consumer spending, contributing to GDP growth, but it also should bolster household wealth, consumer sentiment and loan performance. Although housing cannot by itself push the economy out of slow-growth mode, it is a welcome tailwind given restraint in other sectors of the economy, especially government spending.

Figure 6: Housing Market Continues to Improve…

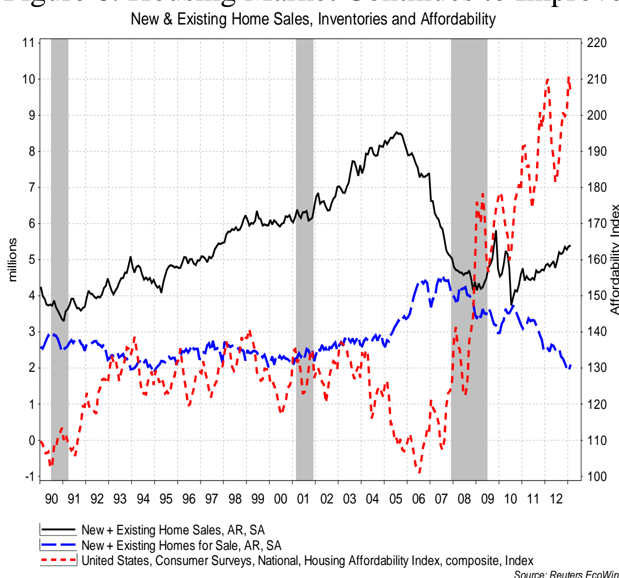
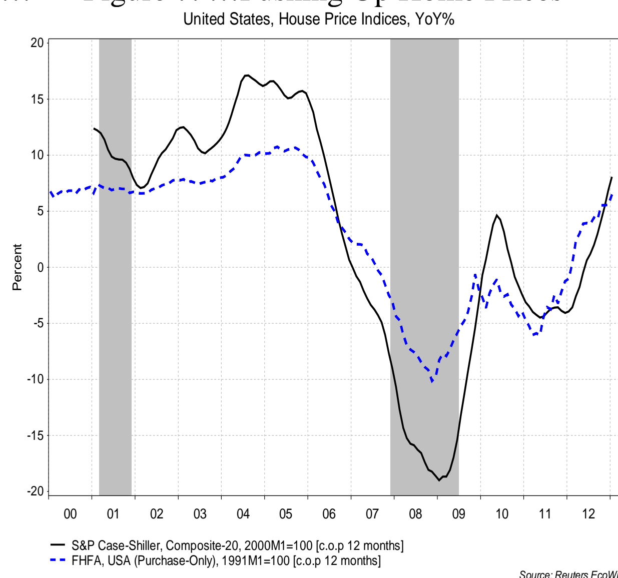


Figure 7: …Pushing Up Home Prices



Business investment rebounded in Q4 (+11.8%) and appears to have remained relatively strong in Q1. Inflation-adjusted shipments of nondefense capital goods excluding aircraft are up about 7% over three-months ending in February (Figure 8). That suggests another solid quarter for business investment. However, investment has outpaced capacity utilization recently (Figure 9), so we are cautious on the outlook for business investment over the remainder of the year. We think business investment will contribute positively to GDP growth in 2013, but we do not think it will be a locomotive of growth as it was earlier in the recovery.

Figure 8: Shipments and Orders Up…

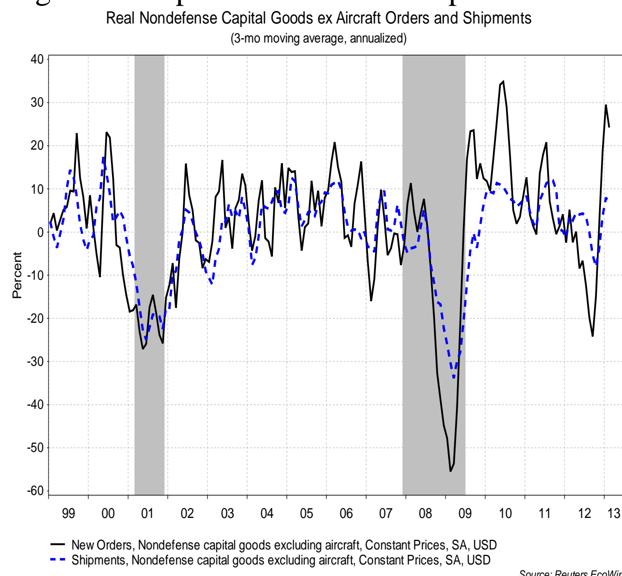
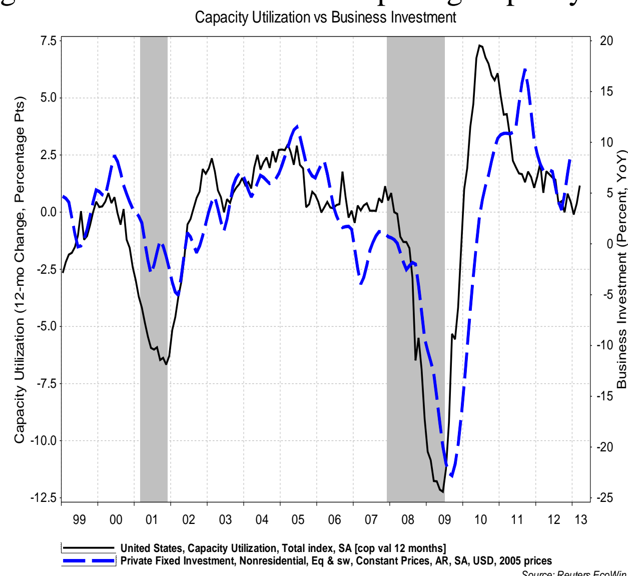


Figure 9: …but Investment Outpacing Capacity



Industrial production rebounded following Hurricane Sandy, but the Institute for Supply Management's (ISM) survey of manufacturing suggests that output growth is poised to slow in the months ahead (Figure 10). Some of the recent rebound in production reflects inventory rebuilding as producers replenished stocks used for repair and replacement of property damaged by Sandy. At this point, we don't have a good read on how much inventory rebuilding will add to Q1 real GDP, but it could be sizable. (Inventory depletion subtracted 1.5% from real GDP in Q4.) We expect production to drop back to around 3% growth once the impact of inventory rebuilding has run its course.

Figure 10: Industrial Production Rebounded

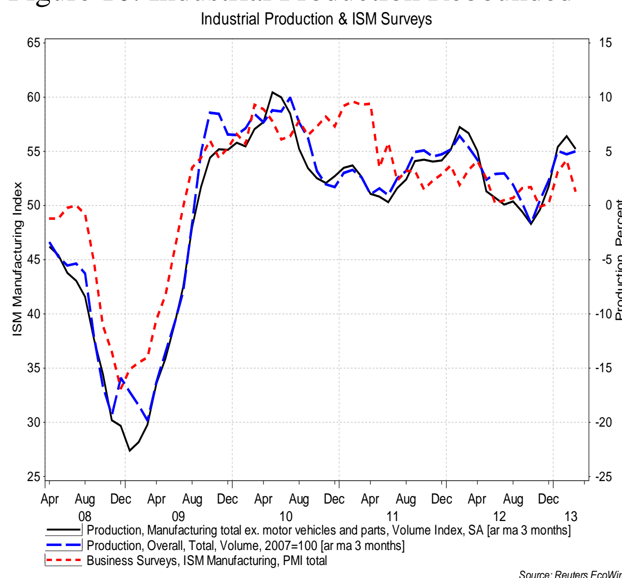
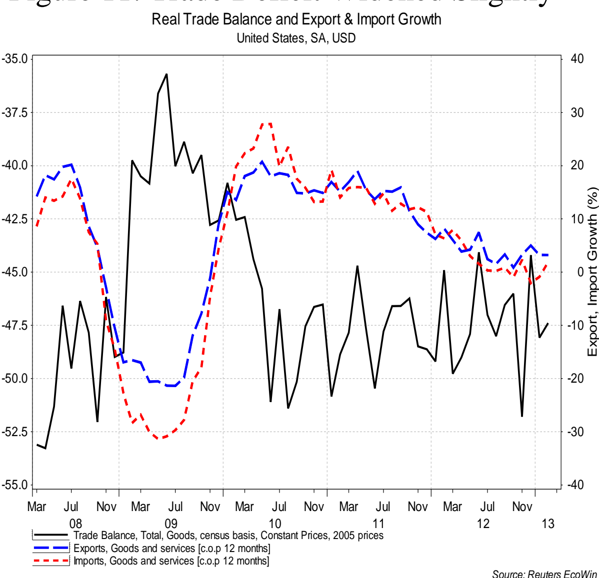


Figure 11: Trade Deficit Widened Slightly



The **trade deficit** surprised us by widening in January and February (Figure 10), making it likely that trade will be a small drag on GDP growth in the first quarter, probably in the range of 0.1-0.2%. If so, trade will probably be a small negative for 2013 GDP growth overall, as we expect

further trade deficit widening later in the year as the pace of US growth quickens relative to its trading partners. We do not think trade will be a major negative for the US economy, but it is another headwind to growth.

Figure 11: Government Spending Slowing

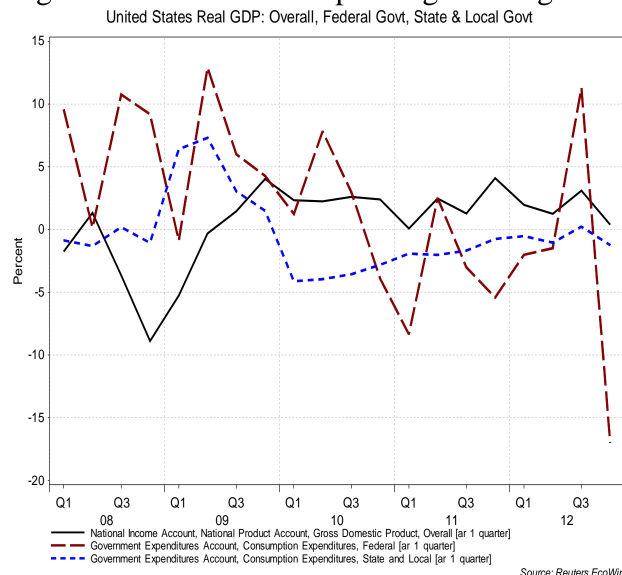
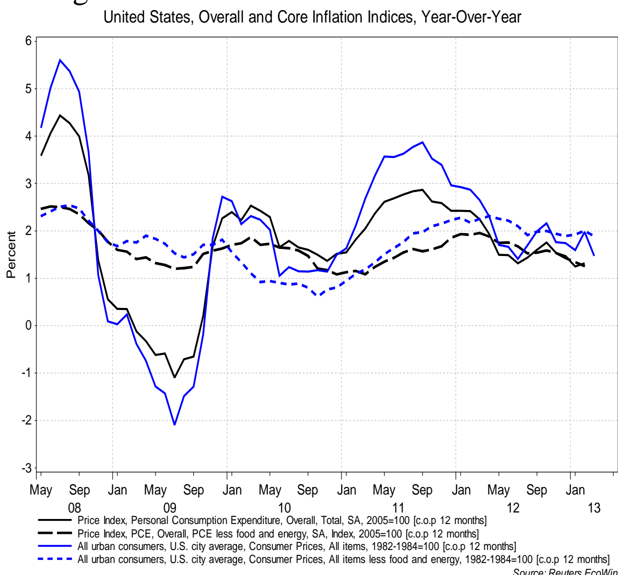


Figure 12: Inflation Remains Subdued

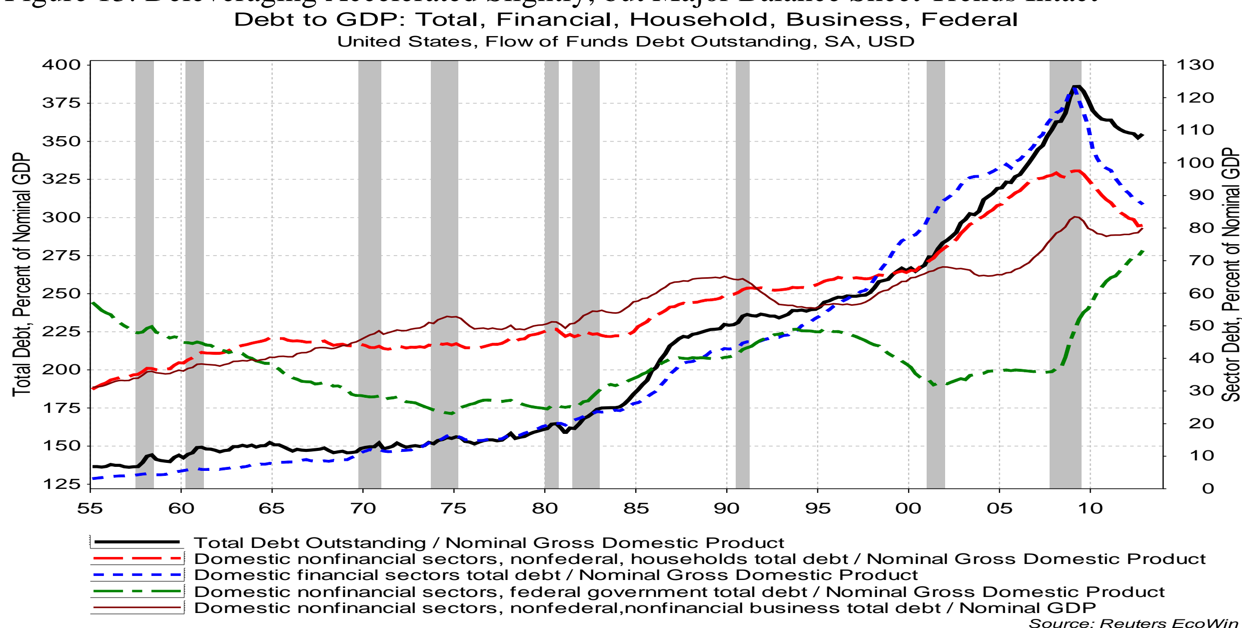


Government consumption probably rebounded the first quarter despite sequester cuts in federal government spending. Defense spending plunged by more than 22% in Q4, resulting in a 1.2% negative contribution from federal government spending to real GDP growth. Much of that drop in spending reversed in Q1, and federal government spending will probably add slightly to GDP in Q1. However, sequester cutbacks will pare federal government spending over the balance of the year. State and local government spending also continues to decline slightly in real terms. Barring a dramatic turn in the political landscape or another economic crisis, government spending will slow in the coming quarters.

We believe markets will welcome government spending restraint, and, although slower government consumption will subtract from GDP growth, we do not anticipate any dire economic effects from these cutbacks. At the same time, sequester does not reform entitlements, which are the principal drivers of the United States' long-term fiscal imbalances. Thus, while markets may take some comfort that Washington is capable of at least a little spending restraint, it has not solved the nation's fiscal problems. This is yet another headwind to faster long-term economic growth.

Inflation pressures remained subdued in the first quarter despite volatile energy prices. Over 12 months ending in February (the latest available data), both overall and core (excluding food and energy) PCE deflators were up just 1.3% (Figure 12). Through March, Consumer Price Index (CPI) inflation was up 1.9% and 1.5% YoY for the overall and core indices, respectively. Inflationary and deflationary pressures appear balanced, although the Federal Reserve wants to push inflation modestly higher. The Fed's ability to engineer somewhat higher – but not too much higher – inflation is one of the key medium- to long-term risks facing investors.

Figure 13: Deleveraging Accelerated Slightly, but Major Balance Sheet Trends Intact



Broad **balance sheet trends** in the US remain intact, although nonfinancial corporations are starting to borrow more freely again (Figure 13). Deleveraging in the private sector paused in the fourth quarter (the latest data available) as corporations took advantage of low interest rates to increase borrowing. Total debt to GDP rose about 2.5 percentage points to just under 355% of GDP. Financial firms continue to pare debt rapidly as a proportion of GDP, but household borrowing held about steady in Q4. Nonfinancial businesses increased borrowing by about 1.5% of GDP in Q4, a relatively large increase. Most of that borrowing appears to have added to balance sheet liquidity rather than plant and equipment, however. As we have said before, businesses have ample borrowing capacity to boost investment if and when business confidence improves, but we do not think an investment boom is imminent. Government debt is rising, but the rate of increase continues to slow. Although aggregate debt rose in Q4, we think deleveraging has further to run and will remain a modest but diminishing headwind to growth for some time to come.

Market Outlook

Despite larger purchases of long-term Treasuries by the Federal Reserve, long-term **Treasury rates** moved further upward in the first quarter as US economic growth accelerated (Figure 14). The 30-year benchmark Treasury bond yield rose by 15 basis points (bp) to end Q1 at 3.10%. However, so far in April, the long-bond yield has dropped back to 2.88% on somewhat disappointing economic data, returning to a bit below where it started 2013. The Federal Reserve left the federal funds rate unchanged at 0.25% and made no changes to its quantitative easing program (QE3). It is purchasing $40 billion of agency mortgage-backed securities and $45 billion of longer-term (4-year and longer) Treasuries per month on an unsterilized basis. That means reserves added by the Fed's securities purchases are not absorbed (sterilized) by other open-market operations and thus add directly to base money (bank reserves, vault cash and currency in circulation). We expect the Fed will continue QE3 throughout 2013, perhaps beginning to reduce its securities purchases in autumn if growth holds up through summer.

Through these actions the Fed is creating roughly $85 billion per month in base money. Nonetheless, bank lending remains subdued: Total bank credit is up 4.1% YoY, only slightly faster than nominal GDP growth. While the Fed has added a lot of fuel to the economy, so far it is burning pretty slowly. We will continue to watch credit formation closely for any signs of excess, but, so far, we do not see them.

Figure 14: Treasury Rates, Fed Funds Stable

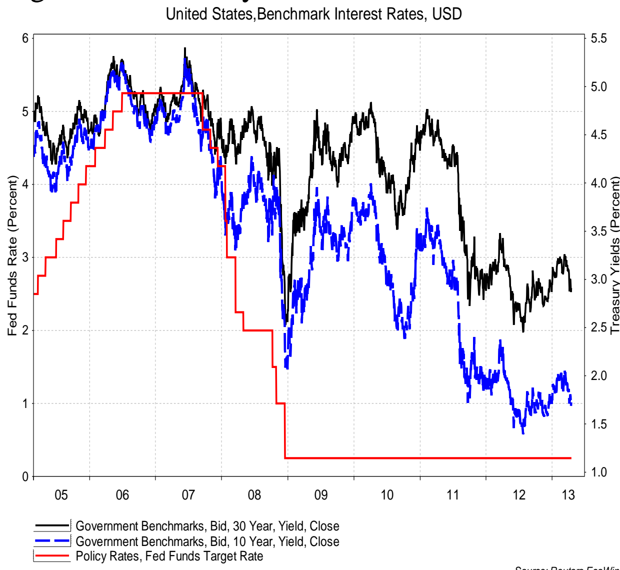


Figure 15: Credit Spreads Mostly Flat

Credit spreads were mostly tighter in the first quarter, although the pace of decline has slowed as spreads have narrowed. Long-term Baa-rated corporate bond spreads widened by 5 bp in Q1 but recovered that widening in April. High yield spreads tightened by 58 bp in Q1 and have held about steady since the end of the quarter. Preferred securities also performed well, with various preferred indices posting pre-tax price returns (before income) ranging from +1.0% to +1.5% in Q1; they have rallied slightly since quarter-end.

Figure 16: Corporate Profits Remain Strong

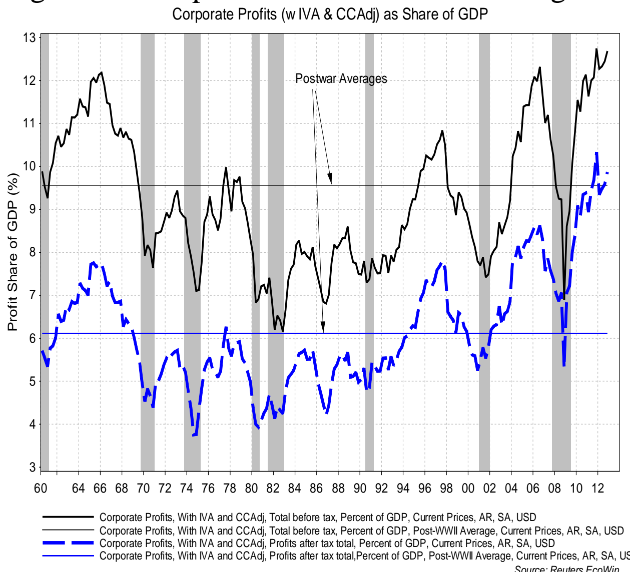


Figure 17: Balance Sheets Solid

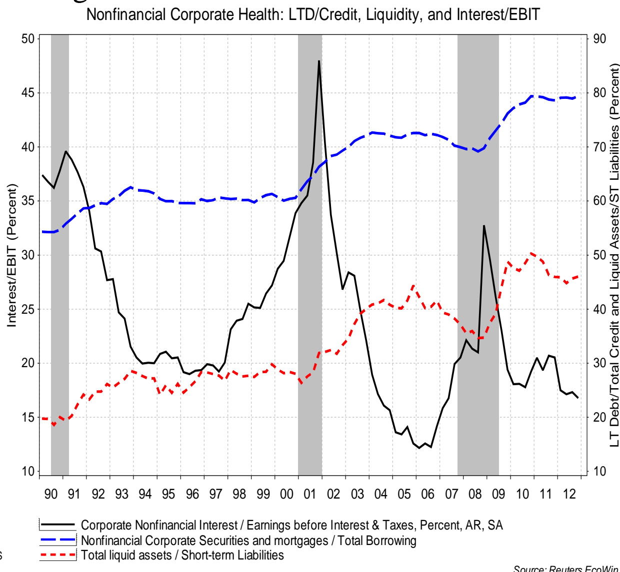


Figure 18: Loan Quality Still Improving

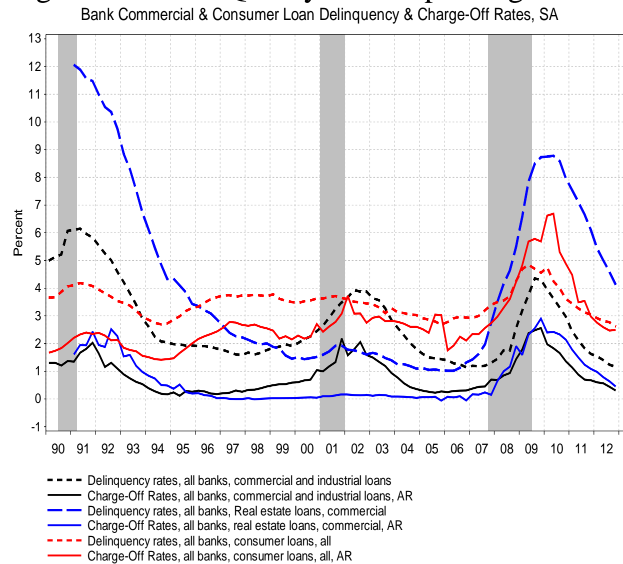
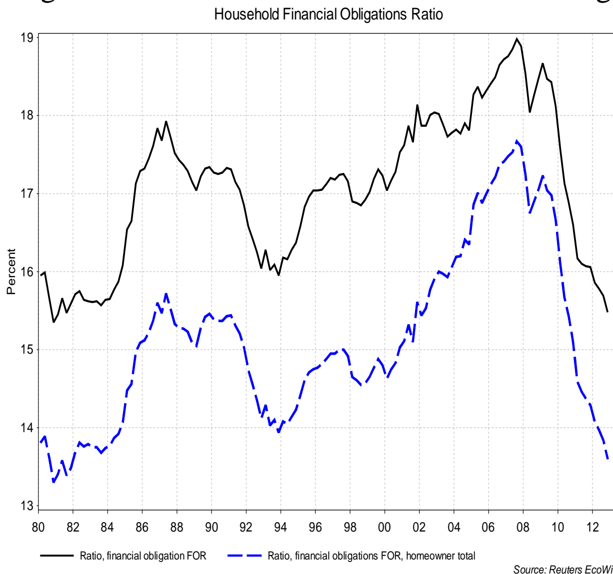


Figure 19: Household Debt Burdens Declining



Tighter credit spreads continue to be justified by improving credit fundamentals in addition to low rates and accommodative monetary policy. Corporate profits as a share of GDP are stellar (Figure 16). Interest expense as a percentage of earnings before interest and taxes edged lower; long-term debt to total debt is holding at its record high; and liquidity increased further from already strong levels (Figure 17). Loan delinquency and charge-off rates are declining across all major loan categories (Figure 18). Finally, household debt burdens continue to decline (Figure 19). All of this is good news for credit instruments such as preferred securities.

We continue to anticipate some further tightening of credit spreads in 2013 for the same reasons we have articulated before: Slow but steady economic growth in the US, accommodative monetary policy, low rates on alternative investments and sound credit fundamentals. We also reiterate our caveat from last quarter, however: At current spreads, there is less room for tightening than there was when spreads were wider, and investors should calibrate their expectations accordingly.

Flaherty & Crumrine Incorporated
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