First-Quarter U.S. Economic Update
April 2014

Summary of Recent Economic Developments

Unusually cold and snowy weather slowed U.S. economic growth in the first quarter. Economists' forecasts for first-quarter growth in real GDP have fallen from 2.0% in February to 1.0-1.5% currently. Most of Q1's growth shortfall should be recovered in future periods, however, and full-year 2014 forecasts remain centered on 2.6%. Few economic sectors escaped winter doldrums. Even after a healthy rebound in March, personal income and consumption slowed sharply. Home sales dropped back 13% from their summer peak, and home price gains decelerated. Industrial production eased in the first quarter on softer capital goods spending. Import and export growth sagged and the trade deficit widened. Inflation fell. In contrast, job growth held up fairly well, and labor participation improved. Government consumption may have begun to turn upward after years of restraint. We expect better growth in nearly all of these sectors over coming quarters. In response to slower economic growth, interest rates fell during the first quarter even as the Federal Reserve continued to reduce its securities purchases. Credit fundamentals continued to improve, especially at financial companies, although leverage has increased in some sectors and bears watching. Preferred securities posted solid year-to-date price gains. While interest rates in the U.S. are likely to move higher over the next few years, we think prospective returns on preferred securities remain attractive for long-term investors.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	2012:2	2012:3	2012:4	2013:1	2013:2	2013:3	2013:4	2014:1
Real GDP, Chg QoQ (%, SA, AR)	1.2	2.8	0.1	1.1	2.5	4.1	2.6	2.0f
Real Personal Consump Expnds, Chg QoQ (%, SA, AR)	1.9	1.7	1.7	2.3	1.8	2.0	3.3	2.5f
Real Business Inv ex Stuctures, Chg QoQ (%, SA, AR)	3.9	-1.2	7.7	2.3	1.4	2.6	7.9	NA
Real Residential Investmt, Chg QoQ (%, SA, AR)	5.7	14.1	19.8	12.5	14.2	10.3	-7.9	NA
Corporate Profits, After Tax, Chg YoY (%, SA, AR)	5.7	2.0	-0.7	4.5	6.4	8.6	8.0	7.8f
Current Account Balance, Annualized (% of GDP, SA)	-2.7	-2.6	-2.5	-2.5	-2.3	-2.3	-1.9	NA
Federal Budget, 12-mo Def or Surp (% of GDP)	-7.6	-6.7	-6.5	-5.5	-4.2	-4.0	-3.3	-3.3a
Unemployment Rate (%, SA)	8.2	7.8	7.9	7.5	7.5	7.2	6.7	6.7
Household Employment, Chg QoQ (000, SA)	353	515	265	181	682	195	316	1156
Nonfarm Payrolls, Chg QoQ (000, SA)	294	471	642	618	603	515	595	533
Nonfarm Productivity, Chg QoQ (%, SA, AR)	1.1	2.1	-1.5	-1.8	1.8	3.5	1.8	NA
Capacity Utilization (%, SA)	77.3	77.0	77.5	78.0	77.8	78.3	78.4	78.4a
GDP Price Index, Chg QoQ (%, SA, AR)	1.8	2.3	1.1	1.3	0.6	2.0	1.6	1.7f
Consumer Price Index, Chg YoY (%, AR)	1.7	2.0	1.7	1.5	1.8	1.2	1.5	1.5
CPI ex food & energy, Chg YoY (%, AR)	2.2	2.0	1.9	1.9	1.6	1.7	1.7	1.7
Nominal Personal Income, Chg YoY (%, AR)	3.6	3.6	7.9	3.0	3.4	3.9	-0.8	3.1a
Personal Savings Rate (%, SA)	5.6	4.8	8.7	4.3	4.6	5.1	4.1	4.3a
Rate or Spread (End of Quarter)	**2012:2**	**2012:3**	**2012:4**	**2013:1**	**2013:2**	**2013:3**	**2013:4**	**2014:1**
Federal Funds Rate Target (%)	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3-month LIBOR (%)	0.46	0.36	0.31	0.28	0.27	0.25	0.25	0.23
10-Yr Treasury Note Yield (%)	1.66	1.64	1.76	1.85	2.49	2.62	3.03	2.72
30-Yr Treasury Bond Yield (%)	2.75	2.82	2.95	3.10	3.50	3.69	3.96	3.56
Moody's Baa Long Corp Spread (bp)	231	190	168	173	185	170	141	143
10-Yr Interest Rate Swap Spread (bp)	13	7	6	16	21	16	7	12

* Figures are either quarterly or, if more frequent, end of period. f = Forecast[1]; a = Actual through Feb 2014 Source: Reuters EcoWin

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

Economic Outlook

U.S. economic growth slowed in the first quarter as frigid temperatures and heavy snowfall blanketed much of the country from January into March. Economists expect that inflation-adjusted gross domestic product (real GDP) grew 2.0% in the first quarter of 2014[1], although more recent data suggest even slower growth of 1.0-1.5%. For 2014 overall, economists forecast 2.6% real GDP growth, with most of the first quarter's weather-related shortfall in activity made up in subsequent quarters. For now, we are sticking with our forecast of 2.0-2.5% real GDP growth in 2014, but odds are improving that growth could reach or slightly exceed the high end of that range. The Federal Reserve tempered its 2014 real GDP outlook but still forecasts 2.8-3.0% growth.

A recurring theme in this quarter's economic data is adverse winter weather, which reduced economic activity substantially. Much of that activity was simply deferred (e.g., waiting until spring to buy a new car), some was lost due to weather (e.g., restaurant meals not eaten) and some was due to more fundamental factors (e.g., a wider trade deficit). Second quarter growth will almost certainly be better than Q1 as weather improves, and it will probably be better to average Q1 and Q2 to gauge the economy's underlying growth rate. Over coming months, we will be looking to see how economic activity rebounds from winter doldrums and to what extent it was deferred versus lost. Paragraphs that follow will not repeat those points, so expect mostly weak Q1 readings for major sectors of the U.S. economy.

Figure 2: Moderate Job Growth Continuing

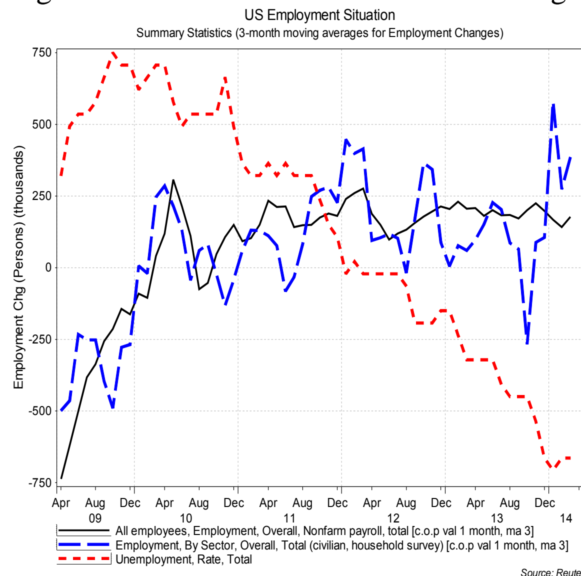
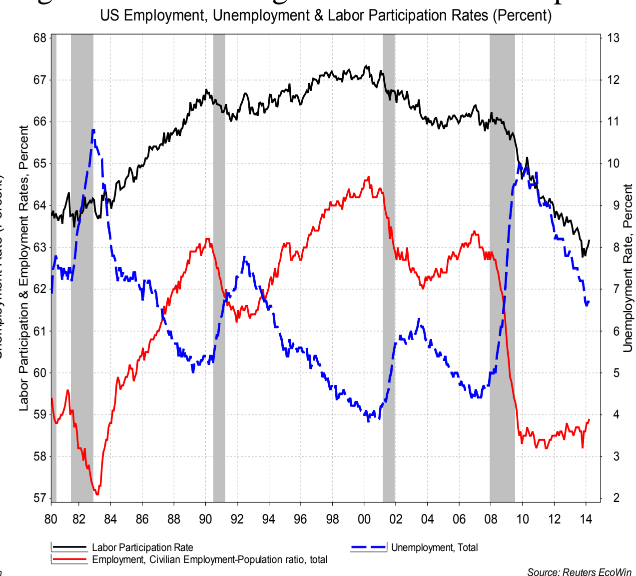


Figure 3: Nascent Signs of Broader Participation



The **labor market** held up reasonably well in the first quarter given adverse weather. Payroll jobs grew by 533,000, down modestly from 595,000 in the prior quarter. The household employment survey showed much faster job growth: 1,156,000 in Q1 compared to just 316,000 in Q4 (Figure 2). While this is an unusually large divergence, over longer periods, these two employment surveys show similar results: For the past four quarters, payroll-survey jobs are up 2.25 million and household-survey jobs are up 2.35 million. Those figures equate to 1.7% and

[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 14, 2014 unless otherwise noted.

1.6% year-over-year (YoY) growth, respectively, which is faster than labor force growth of about 1% (assuming no change in labor participation). If sustained, we should see further downward pressure on the unemployment rate, which ended Q1 at 6.7%, unchanged from last quarter.

There was also some less-publicized good news in recent labor market data. The labor participation rate rose to 63.2% in March from a low of 62.8% in December 2013. Similarly, the employment rate (i.e., the ratio of employed persons to working-age persons) edged up to 58.9% from a recent low of 58.2% in October (Figure 3). These are not spectacular levels historically, but they may indicate nascent progress toward broader employment gains. As we have discussed in prior Updates, we want to see both falling unemployment and rising labor participation to have greater confidence that employment growth will drive faster wage growth.[2]

On that score, wage growth held about steady in the first quarter. Average earnings were up 2.1% YoY in March, slightly better than last quarter but little changed from 1.8% gains in 2009, when the U.S. economy was still reeling from the financial crisis. Moreover, to the extent that weather held down hours worked, it would have boosted hourly earnings for salaried workers. When working hours return to normal, that bump to wage growth should unwind. We expect labor market slack will restrain average hourly earnings growth for some time.

Figure 4: Income & Consumption Slowed…

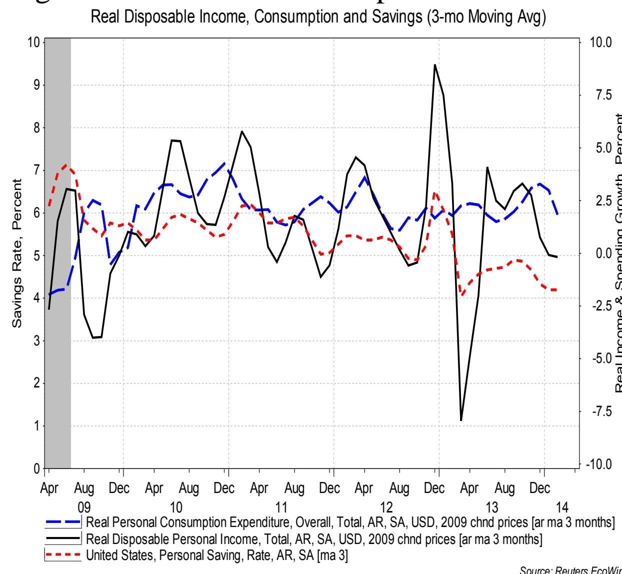
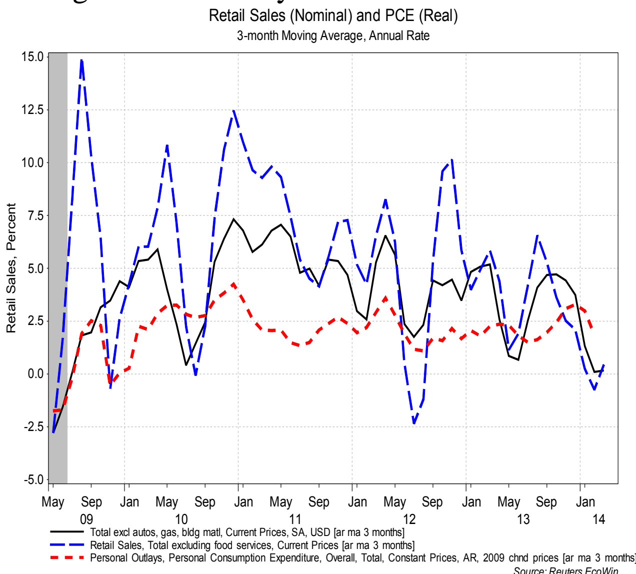


Figure 5: …Led by Weak Retail Sales



Consistent with sluggish growth in wage income, overall **personal income** through February (latest data available) slowed substantially since autumn. Personal income was up 2% in nominal terms in January and February compared to its Q4 average, or about 1% after inflation. Over the past three months, real disposable (after-tax) personal income was essentially flat at -0.2% (Figure 4). Even though hourly wages were flat, income should improve in March due to a 1.1% (not annualized) rebound in hours worked. On balance, we expect growth in personal income to accelerate only gradually this year. Slow wage and job growth are restraining wage and salary income while low yields are adding little to interest income (though they have reduced debt

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

burdens substantially). Proprietors' income is a bright spot, up 6.4% QoQ and 5.2% YoY, but at less than 9% of overall personal income, it is not large enough to move the needle much.

Personal consumption expenditures (PCE) slowed substantially in the first quarter after accelerating impressively in 2013's second half. Real PCE slowed to 1.1% in January and February (latest data available) and 1.8% over three months ending in February (Figure 4). Retail sales drove most of this slowdown. Despite a strong recovery in March, overall retail sales were up just 0.3% in the first quarter, and "core" retail sales (excluding automobiles, gasoline, and building materials) were up 0.2% (Figure 5). Although March PCE data should look considerably better, real PCE will certainly be slower than last quarter (3.3%) and probably slower than forecast in February (2.5%). We anticipate a healthy rebound in PCE during Q2, however.

Despite slower consumption, the **savings rate** edged down and is near its low since the 2008-09 recession ended. We still expect the savings rate to move higher over time, which means consumption must grow a bit more slowly than income. Since income growth is likely to be slow, once any spring rebound in spending has passed, consumption growth should remain modest for some time to come.

Housing market recovery took another step back in the first quarter as adverse weather further curtailed home sales. Total new and existing home sales peaked last summer, reaching 5.75 million units at an annual rate in July 2013. They dropped to just over 5.0 million units in February 2014 (Figure 6). Lower existing home sales explain the entire decline – and then some; new home sales actually rose modestly.

Figure 6: Home Sales Frozen

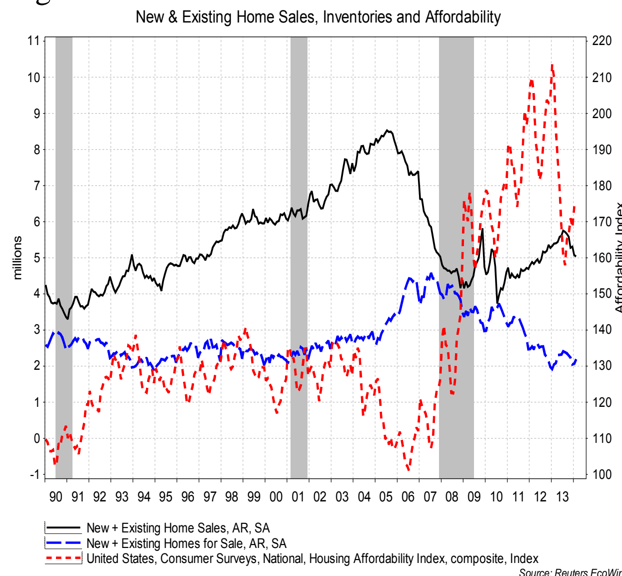
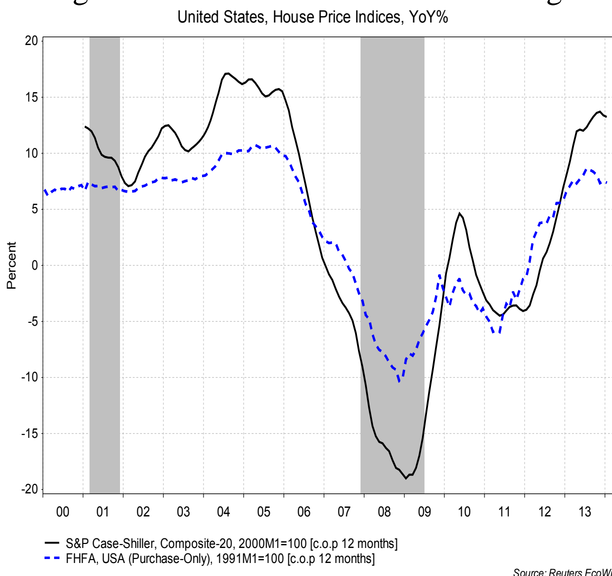


Figure 7: Home Price Gains Moderating



There are a number of possible reasons why home sales slowed. Weather is an obvious one. A relatively low supply of homes for sale is another (see Figure 6). New homes are being built in areas with rising demand and, presumably, limited supply of existing homes for sale; a result is rising new home sales and falling existing home sales in those areas. Lower home affordability is yet another reason for slower sales. Although home affordability is high (i.e., more affordable) historically, it is substantially lower than it was a couple of years ago. Homebuyers may be

balking at higher prices. Indeed, there is some evidence of slower – albeit still rapid – price gains in recent months (Figure 7).

We think residential investment will again contribute to 2014 GDP growth after a weak first quarter. Rising employment and pent-up demand from a severe recession should drive growth in housing for at least several more years.

First quarter **industrial production** was mixed but has slowed since autumn (Figure 8). Utility output was up due to cold weather while manufacturing output was about flat. Orders and shipments slowed (Figure 9). However, the Institute for Supply Management's survey of manufacturing activity indicates stronger activity over coming months (Figure 8).

Figure 8: Industrial Production Sagged…

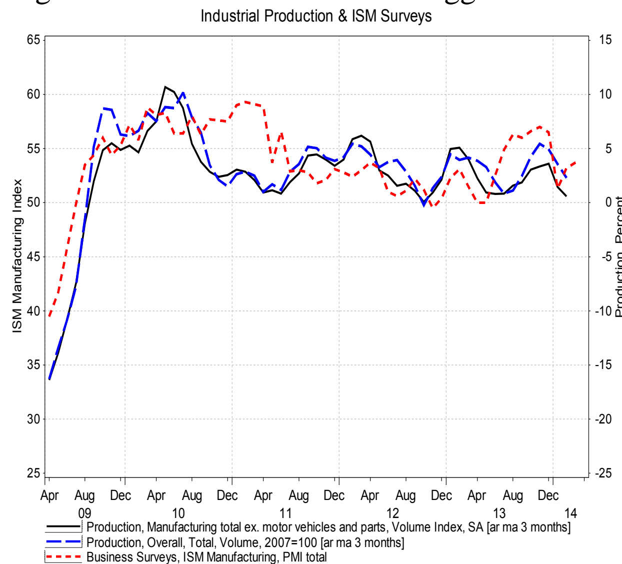


Figure 9: …as Orders & Shipments Slowed

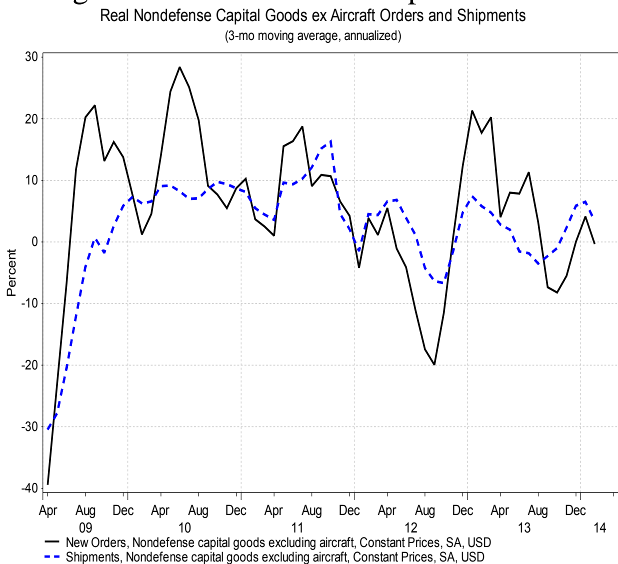


Figure 10: Moderate Business Investment

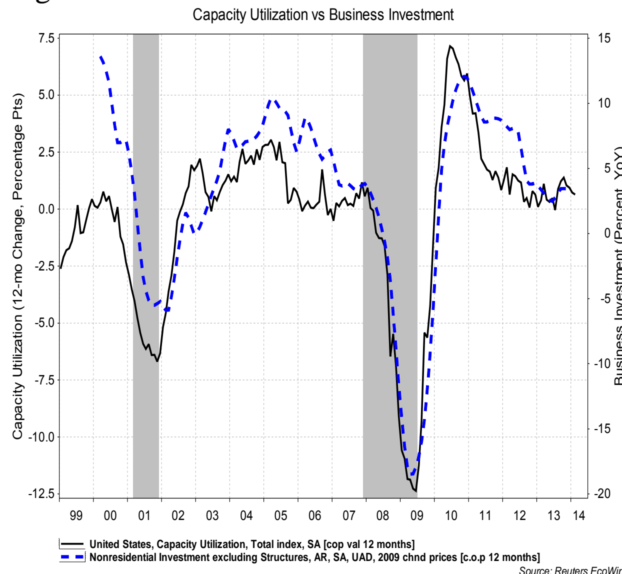
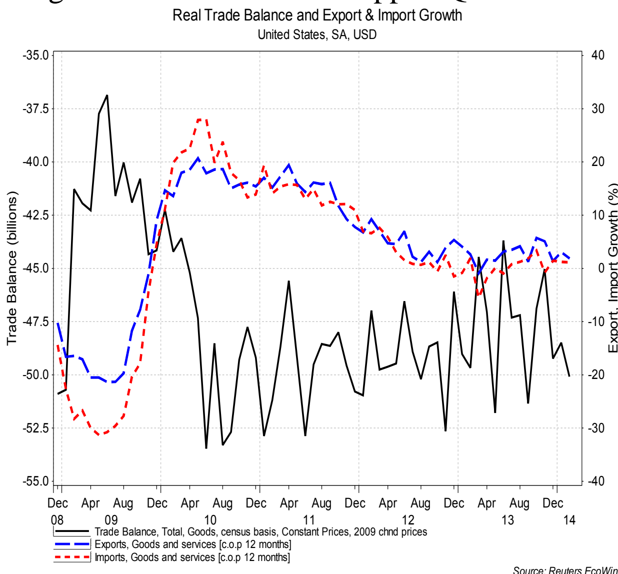


Figure 11: Trade Deficit Sapped Q1 Growth



Business investment has been a bright spot for the U.S. economy. Business investment excluding structures was up 7.9% in Q4 and 3.5% for 2013 as a whole. We expect softer results in the first quarter, but moderately rising capacity utilization suggests that investment spending should grow a little faster than overall GDP in 2014 (Figure 10).

The **trade deficit** added a full percentage point to GDP growth in 4Q2013, but it appears set to give most of that back in the first quarter (Figure 11). If March's real goods balance equals its January and February average, net exports would subtract about 0.7% from Q1 real GDP. Trade flows remain subdued, with slow growth of both imports and exports. We still expect that trade will be a mild negative to growth in 2014. However, improvement in trade balances on petroleum products – a consequence of rising domestic oil and gas production – may be large enough to make overall net exports neutral or even slightly positive for U.S. GDP growth this year.

Figure 12: Fiscal Drag Should Ease in 2014

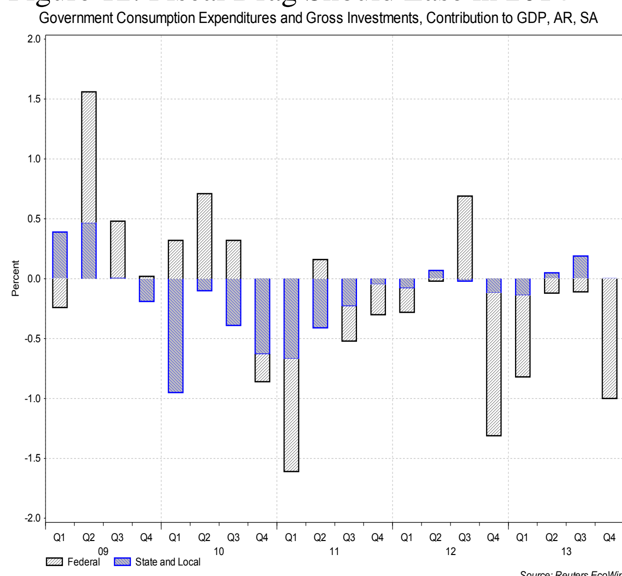
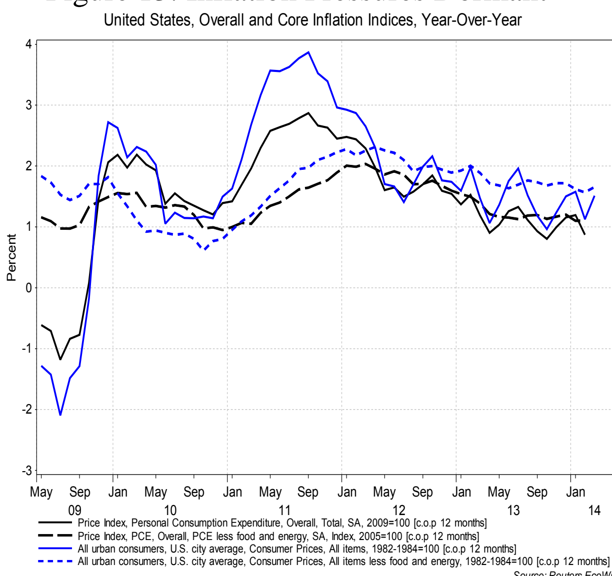


Figure 13: Inflation Pressures Dormant



Government consumption has been a significant drag on GDP growth in recent years (Figure 12). That appears set to end. Economists expect 0.8% real growth in government consumption in 2014, although first quarter government spending may show lingering weakness. State and local spending has already turned up, and the federal government's budget for fiscal year 2014 calls for (a little) real spending growth for the first time since 2010. In addition, Congress passed a debt ceiling extension that should last until at least March 2015, removing one potential catalyst for business uncertainty and market volatility.

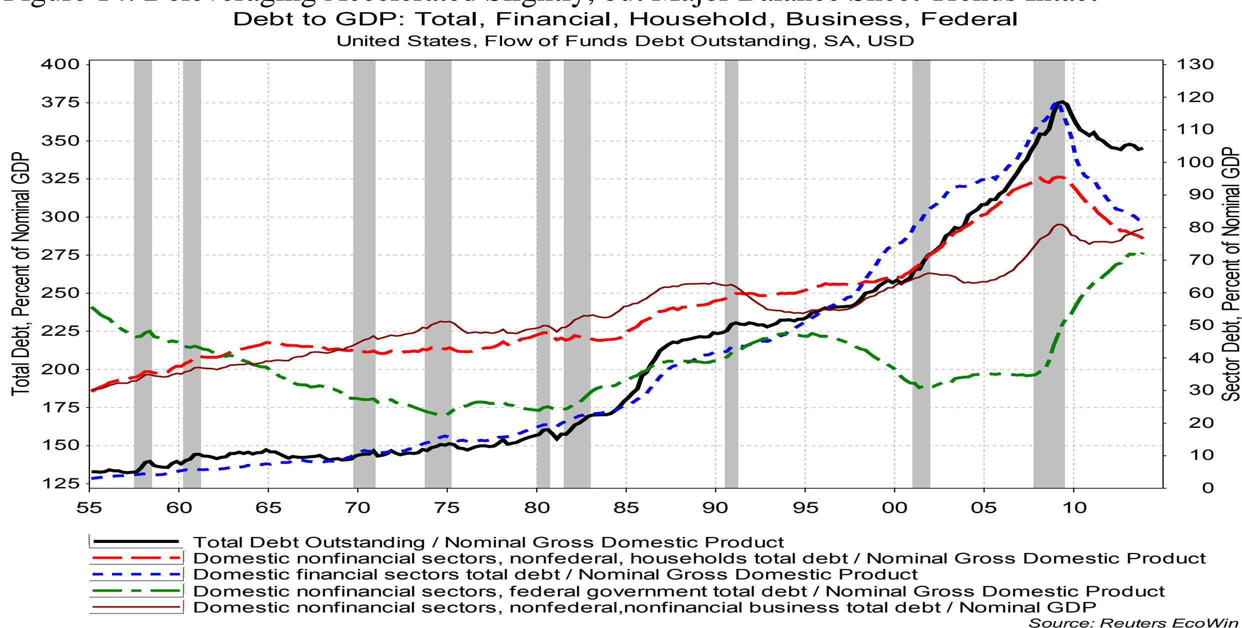
Inflation was steady or lower during the first quarter. The consumer price index (CPI) was up 1.5% overall and 1.7% excluding food and energy over 12 months ending in March, unchanged from last quarter. The PCE deflator edged lower; it was up 0.9% overall and 1.1% excluding food and energy over 12 months ending in February, roughly 1% below the Fed's 2% inflation target (Figure 12). Low inflation should keep monetary policy accommodative well into 2015.

Broad **balance sheet trends** in the U.S. were mixed in 2013's fourth quarter, which is the latest available data (Figure 13). Household deleveraging continued at a moderate pace. Mortgage debt fell and credit card debt was roughly unchanged in dollar terms (and falling relative to GDP), while student and auto loans grew rapidly, each rising about 8.5% YoY in nominal terms.

Nonfinancial business borrowing rose, although, in aggregate, this borrowing has gone to share repurchases and additional holdings of marketable securities. Nonfinancial companies continued to generate more internal cash than needed for business investment. This is good news overall, but it masks marked divergence among companies, with some companies taking on substantial additional debt and others hoarding cash (mostly held as marketable securities). This merits attention from fixed-income investors, especially investors in nonfinancial companies.

Financial companies continued to deleverage rapidly, though here too its pace has slowed in recent quarters. (Deleveraging by financial companies tends to be good news for preferred investors, as the preferred market is dominated by financial issuers.) Federal government borrowing continued to rise, but the pace has slowed here as well. The federal budget deficit dropped to about 3.3% of GDP over the past 12 months, which is about the level at which federal government debt-to-GDP should stabilize. Absent reform, however, the Congressional Budget Office projects that the ratio of federal government debt held by the public to GDP, currently just under 74%, will drop slightly to 72.4% in 2017 and begin rising thereafter.

Figure 14: Deleveraging Accelerated Slightly, but Major Balance Sheet Trends Intact



Across all sectors, debt-to-GDP stands at 345%, down from a peak of 375% in 2009 but still high historically. We believe that overall deleveraging will continue, and it should remain a modest headwind to economic growth for some time to come.

Market Outlook

Long-term **Treasury rates** fell in the first quarter as economic growth slowed and market participants digested the Federal Reserve's December 2013 decision to reduce its securities purchase program. The 30-year benchmark Treasury bond yield fell by 40 basis points (bp) to end Q1 at 3.56% (Figure 15). The ten-year Treasury yield dropped slightly less: down 31 bp to 2.72%. Both 10- and 30-year Treasury yields are about 10 bp lower so far in April.

The Federal Open Market Committee (FOMC) left the federal funds rate unchanged at 0.25% and continued reducing securities purchases. The Fed's quantitative easing program (QE3) has dropped from $85 billion to $55 billion per month currently. On its current trajectory, QE3 will end in October or December 2014.

The Fed now expects 2.8-3.0% real GDP growth in 2014, down from earlier forecasts of 2.8-3.2% (December 2013) and 3.0-3.5% (June 2013). Those reductions bring the Fed's GDP forecast closer to those of private economists, who expect real GDP growth of 2.6% in 2014. We anticipate 2.0-2.5% growth this year, but odds are improving that growth could reach or slightly exceed the high end of that range.

Interest rates are broadly consistent with an outlook for slowly accelerating economic growth. We expect long-term interest rates to rise moderately and gradually over the next few years, but probably by less than what is implied by current forward interest rates. At the same time, credit conditions should continue to improve, which should support narrower credit spreads and at least partially absorb higher Treasury yields.

Figure 15: Rates Down as Growth Slowed

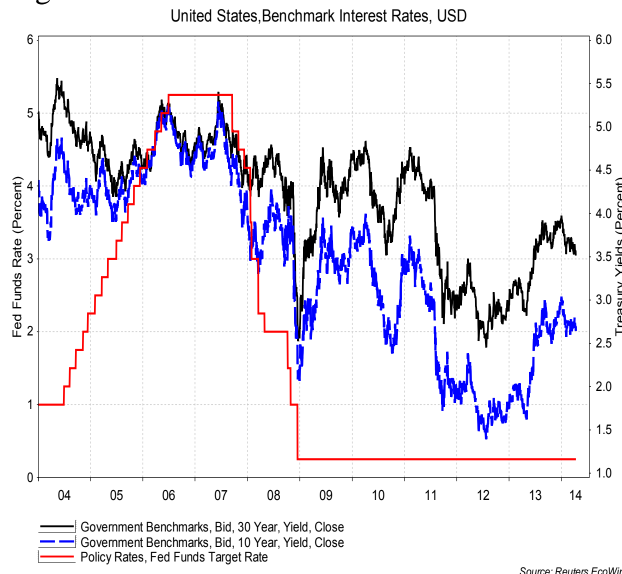


Figure 16: Credit Spreads Little Changed

Corporate **credit spreads** were little changed in the first quarter as corporate bonds essentially kept pace with lower Treasury yields. Long-term Baa-rated corporate bond spreads widened by 2 bp in Q1 to 143 bp. High yield spreads narrowed by 4 bp in Q1 to 261 bp. Both have narrowed by about 5 bp so far in April. Preferred securities' prices rose sharply as Treasury yields fell and year-end tax-loss selling abated. Bank of America – Merrill Lynch® preferred indices posted pre-tax price returns (*before* income) ranging from +2.6 to +6.1% in Q1, and option-adjusted spreads narrowed. Preferred index prices have rallied by an additional 0.8 to 1.0% since quarter-end.

Bank credit growth accelerated to 2.1% YoY during the first quarter, but it remains well below nominal GDP growth of about 4%. Commercial and industrial loan growth is very strong at 9.3% YoY. Consumer borrowing is low and slow at 2.2% YoY, with nearly all of that growth coming from automobile and student loans. With monetary policy still highly accommodative, we continue to watch credit formation for signs of excess. So far, we do not see widespread areas of concern. However, rapid growth in commercial and industrial lending and attendant loosening of

loan covenants that protect lenders are growing credit concerns. Banks will need to manage those risks carefully.

Figure 17: Corporate Profits Remain Strong

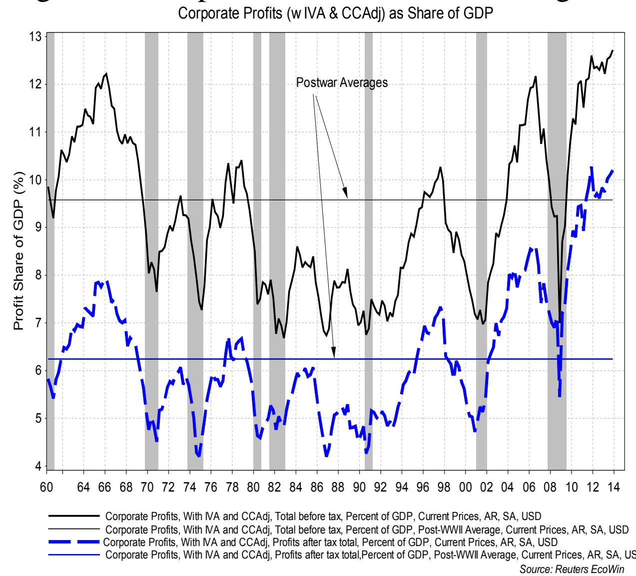


Figure 18: Balance Sheets Solid

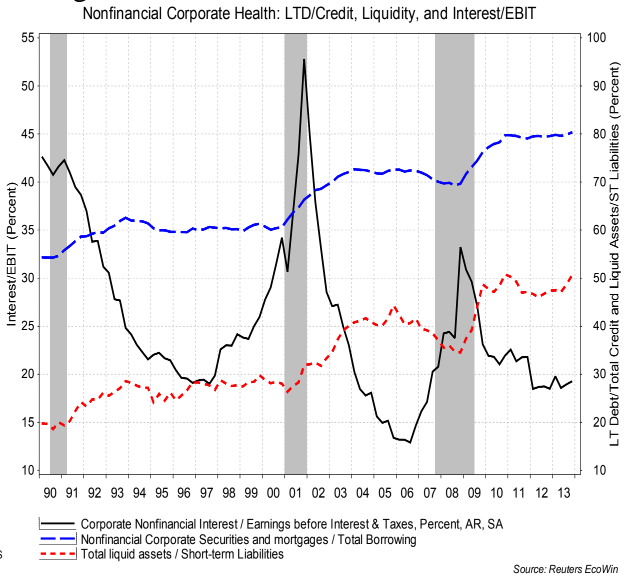


Figure 19: Loan Quality Still Improving

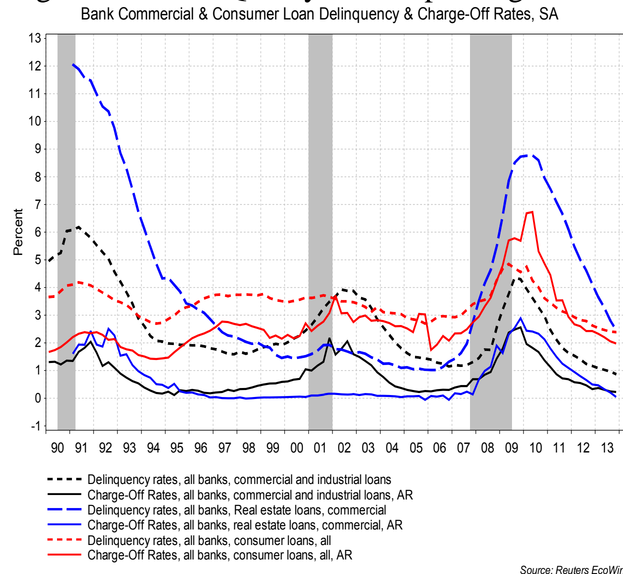
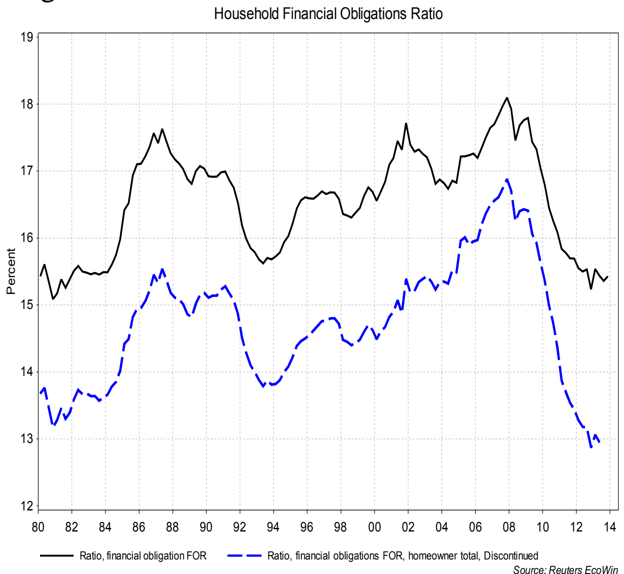


Figure 20: Household Debt Burdens Low



Despite specific areas of concern, broad credit fundamentals continue to improve. Corporate profits as a share of GDP posted all-time highs in 4Q2014 (Figure 17). Interest expense as a percentage of earnings before interest and taxes held about steady at a low level; long-term debt to total debt is holding at its record high; and liquidity moved higher from an already very healthy level (Figure 18). Loan delinquency and charge-off rates are declining across all major loan categories (Figure 19). Household debt burdens have stopped falling since interest rates rose in the middle of 2013, but they remain near the lowest levels in 35 years (Figure 20). And at financial companies, regulators continue to push companies to hold more and higher-quality

forms of capital, especially common equity capital. Improving economic growth should reinforce most of these trends and support narrower credit spreads on preferred securities.

Looking ahead, moderate U.S. economic growth should provide a constructive environment for preferred-securities investors, even as interest rates move upward over the next few years. We anticipate that economic growth will be fast enough to facilitate continued improvement in bank and household balance sheets and better loan performance, while being slow enough to restrain inflation and keep monetary policy accommodative for some time. We think this argues for narrower credit spreads on U.S. preferred securities over coming quarters, which should at least partially offset higher Treasury yields.

More importantly, preferred securities offer relatively high yields compared to most other fixed-income investments such as corporate bonds. Over a three- to five-year horizon, dividend payments on preferred securities can turn modest principal losses due to higher interest rates into positive total returns. Volatility is likely to remain elevated over coming quarters, but we think prospective returns on preferred securities remain attractive for long-term investors.

Flaherty & Crumrine Incorporated
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