Fourth-Quarter U.S. Economic Update
January 2015

Summary of Recent Economic Developments

Inflation-adjusted gross domestic product is expected to grow by 3.1% in the fourth quarter and 2.7% in 2014 overall. Economists expect 3.2% growth for 2015. Employment growth accelerated, with nonfarm payrolls averaging 289,000 new jobs per month in the fourth quarter. The unemployment rate dropped to 5.6%, but wage growth slowed. Personal income and consumption grew modestly, but the savings rate fell as consumption outpaced income. The housing market continued its slow recovery. Industrial production was strong but order growth sagged, and business investment appears to have slowed a bit. The trade deficit was about flat in Q4 but was a mild drag on growth in 2014 overall. That drag was offset by renewed growth in government consumption after years of contraction. Inflation fell, aided by sharply lower oil prices. While U.S. economic growth improved, global growth slowed and yields fell to new lows, driving investors into U.S. fixed-income investments. The Federal Reserve ended its securities purchase program in October and will probably begin to tighten monetary policy in the second half of 2015; we expect the Fed to move cautiously, however. Treasury rates fell and credit spreads widened, and preferred securities' prices generally rose. We expect long-term interest rates to move up in 2015 but be constrained by slow growth and low yields abroad. Credit conditions in the U.S. continue to improve. Although there are numerous risks facing markets, we think prospective returns on preferred securities remain attractive for long-term investors.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	2013:1	2013:2	2013:3	2013:4	2014:1	2014:2	2014:3	2014:4
Real GDP, Chg QoQ (%, SA, AR)	2.7	1.8	4.5	3.5	-2.1	4.6	5.0	3.1f
Real Personal Consump Expnds, Chg QoQ (%, SA, AR)	3.6	1.8	2.0	3.7	1.2	2.5	3.2	3.9f
Real Business Inv ex Stuctures, Chg QoQ (%, SA, AR)	5.2	0.2	4.0	9.8	1.3	8.9	10.0	N/A
Real Residential Investmt, Chg QoQ (%, SA, AR)	7.8	19.0	11.2	-8.5	-5.3	8.8	3.2	N/A
Corporate Profits, After Tax, Chg YoY (%, SA, AR)	2.5	6.0	4.5	3.4	-11.8	-8.9	-6.3	-3.9f
Current Account Balance, Annualized (% of GDP, SA)	-2.6	-2.6	-2.4	-2.0	-2.4	-2.3	-2.3	N/A
Federal Budget, 12-mo Def or Surp (% of GDP)	-5.5	-4.2	-4.0	-3.3	-2.9	-3.1	-2.7	-2.8f
Unemployment Rate (%, SA)	7.5	7.5	7.2	6.7	6.6	6.1	5.9	5.6
Household Employment, Chg QoQ (000, SA)	94	651	272	374	1125	451	360	835
Nonfarm Payrolls, Chg QoQ (000, SA)	618	603	515	595	569	800	717	866
Nonfarm Productivity, Chg QoQ (%, SA, AR)	0.8	0.5	3.6	3.3	-4.5	2.9	2.3	N/A
Capacity Utilization (%, SA)	78.0	77.8	78.3	78.5	79.1	79.2	79.5	79.7
GDP Price Index, Chg QoQ (%, SA, AR)	1.3	1.2	1.7	1.5	1.3	2.1	1.4	0.9f
Consumer Price Index, Chg YoY (%, AR)	1.5	1.8	1.2	1.5	1.5	2.1	1.7	0.8
CPI ex food & energy, Chg YoY (%, AR)	1.9	1.6	1.7	1.7	1.7	1.9	1.7	1.6
Nominal Personal Income, Chg YoY (%, AR)	2.3	2.9	2.8	-2.1	3.7	3.7	3.6	4.2a
Personal Savings Rate (%, SA)	4.9	5.3	5.2	4.1	4.8	5.1	4.5	4.4a
Rate or Spread (End of Quarter)	**2013:1**	**2013:2**	**2013:3**	**2013:4**	**2014:1**	**2014:2**	**2014:3**	**2014:4**
Federal Funds Rate Target (%)	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3-month LIBOR (%)	0.28	0.27	0.25	0.25	0.23	0.23	0.24	0.26
10-Yr Treasury Note Yield (%)	1.85	2.49	2.62	3.03	2.72	2.53	2.50	2.17
30-Yr Treasury Bond Yield (%)	3.10	3.50	3.69	3.96	3.56	3.36	3.20	2.75
Moody's Baa Long Corp Spread (bp)	173	185	170	141	143	135	161	193
10-Yr Interest Rate Swap Spread (bp)	16	21	16	7	12	10	14	12

* Figures are either quarterly or, if more frequent, end of period. f = Forecast[1]; a = Actual through November 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

Inflation-adjusted gross domestic product (real GDP) is expected to grow by 3.1% in the fourth quarter.[1] That would put average GDP growth for 2014 at 2.7%, a little above the top of our long-standing 2.0-2.5% forecast. Economists expect 3.2% growth for 2015, stronger than both the Federal Reserve's forecast of 2.6-3.0% and our own 2.5-3.0% forecast.

Although details differ, most forecasters think 2015 will be a better year for economic growth than 2014. Government consumption is turning upward after years of restraint and should add to growth in 2015. Job gains are gradually improving, and deleveraging by households is slowing. Both should allow for gradual improvement in consumer spending and residential investment. We think personal consumption and business investment will grow a little more slowly than most forecasters and trade will be a bigger drag, but we are mostly in-line with consensus in other areas. 2015 should be another good year for the U.S. economy and the preferred market. Eventual monetary tightening by the Federal Reserve makes it unlikely that fixed-income returns will be as strong this year as they were last, however, and there are plenty of risks that could disrupt these generally optimistic economic and investment outlooks.

Figure 2: Job Growth Strong, but…

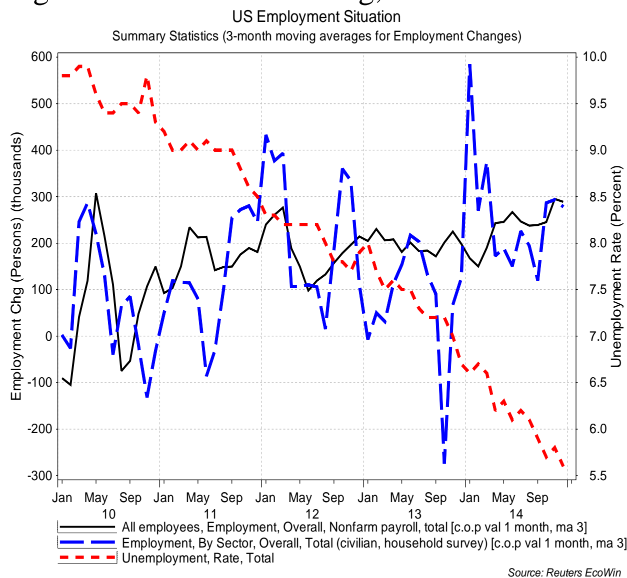
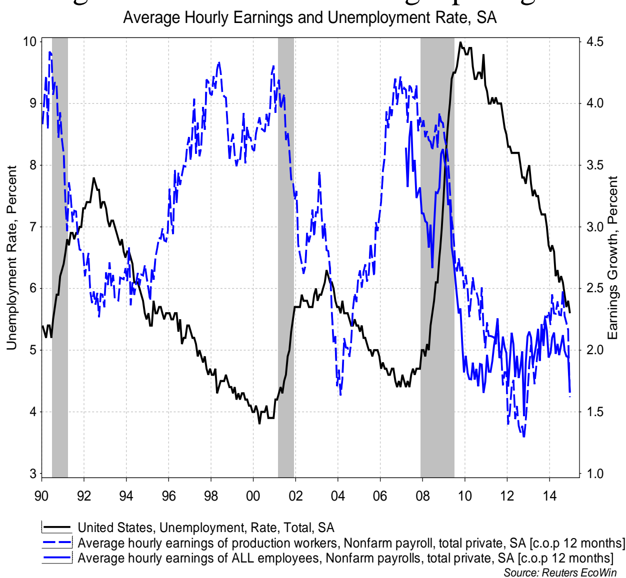


Figure 3: …It Is Not Pushing Up Wages



Labor market conditions improved sharply in Q4. Both payroll and household surveys of employment posted an average of more than 275,000 job gains per month (Figure 2). Initial jobless claims continued to fall. The payroll diffusion index finished 2014 at 63.6, up from 57.2 last year (a reading over 50 means that more firms are hiring than firing), indicating that hiring has been broad-based. The unemployment rate fell to a cycle-low 5.6% in December, 1.1 percentage points lower than year-end 2013. Employment is up about 2% from a year ago, compared to about 1.5% annual growth two years ago. While job growth has not improved rapidly, it has improved materially, and we expect it to continue in 2015.

[1] Unless noted otherwise, forecasts are from *The Livingston Survey*, Federal Reserve Bank of Philadelphia, December 12, 2014 and Bloomberg® *Monthly Economic Survey*, January 15, 2015.

Growth in wages remains slow, however, rising by just 1.6% YoY in December. Although that low reading for December is probably anomalous, wage growth spent most of 2014 bouncing around 2%, pretty much where it has been since 2011, despite sizable employment gains during that time (Figure 3). We have said this before, but it bears repeating: Historically, a falling unemployment rate has been associated with faster wage growth. Today's stagnant wage growth is evidence of labor market slack that is not reflected in the unemployment rate – but is reflected in low labor participation and employment rates. It is unclear when wages will pick up, but we think consumption growth will remain modest and inflation will remain subdued until they do.

Figure 4: Spending Outpaced Income in Q4

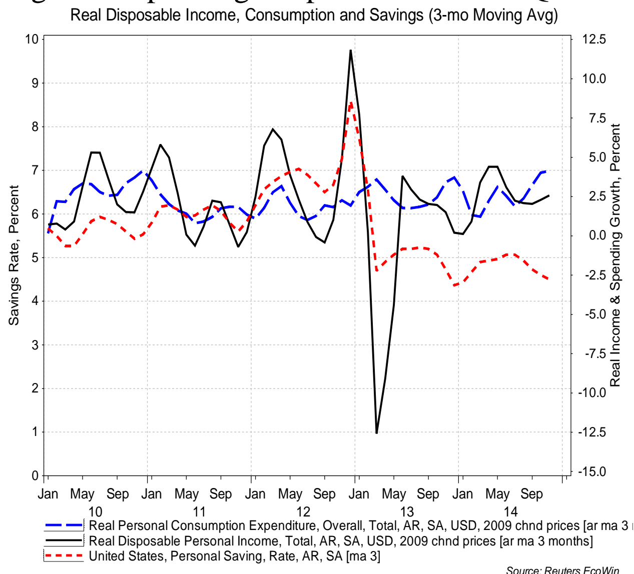
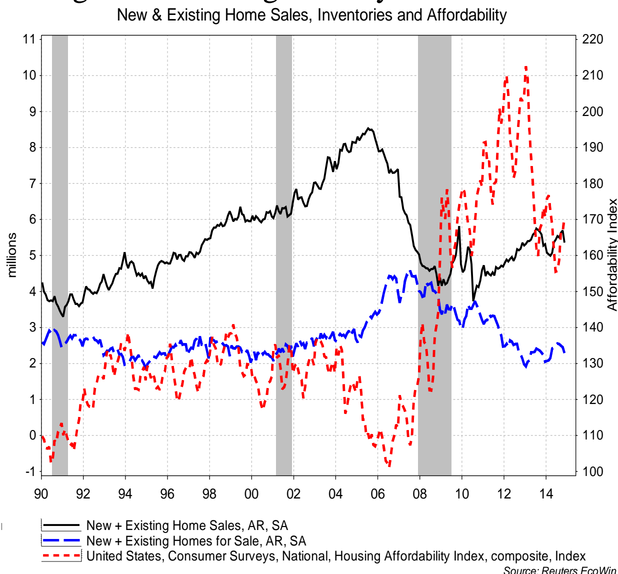


Figure 5: Housing Activity Slowed



With job growth strong but wages soft, **personal income** rose modestly (Figure 4). Through November (latest data available), personal income was up 3.0% over its Q3 average and up 4.2% YoY. After inflation and taxes, real disposable personal income was up 2.6% and 4.1%, respectively. There has been little change in these figures in recent years. We anticipate some improvement in 2015, but progress is likely to be slow.

Personal consumption expenditures (PCE) outpaced income through November (Figure 4). Real PCE was up a solid 3.6% in Q4 through November compared to its Q3 average and 2.8% YoY, although disappointing retail sales in December suggest that consumption eased a bit heading into year-end. Looking ahead, sharply lower oil and gasoline prices, if sustained, should provide consumers with considerable additional spending power. We should begin to see evidence of that in 1Q2015. While lower oil prices are not uniformly good news (see business investment below), they are generally good news for the economy – decidedly so for consumers.

As spending outpaced income, the **savings rate** fell in the second half of the year. It averaged 4.5% over the past three months, down from about 5% at mid-year. We expect that households will seek to boost savings again and that consumption growth will trail disposable income growth slightly as a result.

The **housing market** was mixed in 2014. It recovered from harsh winter weather that started the year, but home sales eased again in November. Total new and existing homes sales posted a 5.4 million unit pace in November (latest data available), up from 5.0 million in March but down

from 5.7 million in October (Figure 5). Inventories of unsold homes dropped a bit but have remained broadly steady for several years. Home prices continue to rise, but at a much slower pace than earlier in 2014. The Federal Housing Finance Authority's home price index was up 4.5% YoY in October (latest data available) compared to 7.4% YoY at the end of 2013, while the S&P/Case-Shiller 20-city home price index slowed even more sharply, to 4.5% compared to 13.4% over respective periods. Home affordability improved, aided by lower mortgage rates and those slower home price gains.

Looking ahead, housing construction remains well below long-term demand (household formation plus demolition of older homes), and excess supply from last decade's housing boom has been largely absorbed. That combined with stronger employment gains should drive above-trend spending on residential construction. We think residential investment should be a bright spot for the U.S. economy over coming years.

Figure 6: Production Strong, Outlook Hazy

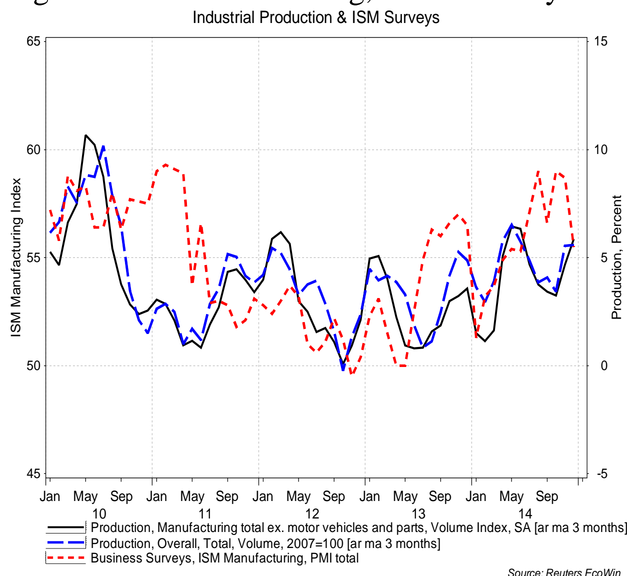
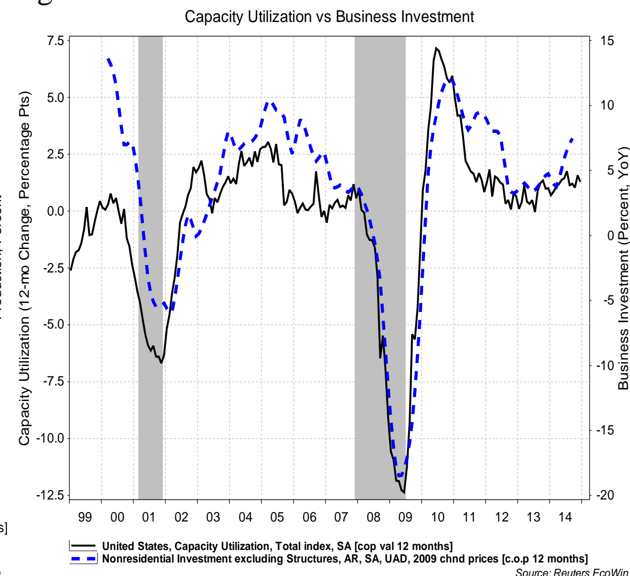


Figure 7: Business Investment Poised to Ease



After a weak start, **industrial production** posted solid gains in 2014, ending the year on a high note (Figure 6). Overall production rose by 5.6 % in the fourth quarter and 4.9% YoY. Manufacturing excluding motor vehicles and parts rose by 5.9% in Q4 and 4.7% YoY. Orders generally outpaced production through the first three quarters of 2014, partly due to strength in aircraft orders, but they sagged in Q4. Order backlogs, which rose rapidly in 1H2014, slowed in Q4. They are large enough to keep production humming for several quarters, but we will be watchful of order growth over coming quarters, especially in light of a somewhat softer Institute for Supply Management manufacturing survey in December (Figure 6).

Business investment remained a bright spot in 2014. Inflation-adjusted business investment excluding structures grew by 9.5% on average in Q2 and Q3, although it appears to have slowed in Q4. We expect more moderate growth in business investment next year, for three reasons. First, capacity utilization increased only slightly in 2014 while investment spending surged, whereas they normally move in tandem (Figure 7). This suggests that business investment is a little ahead of itself and that spending should slow a bit. Second, a surging U.S. dollar (see Figure 9 below) and slower global economic growth are likely to trim export orders and mute investment spending in export industries. Finally, energy producers were substantial contributors to earlier

growth in investment spending. Sharply lower oil prices have already slowed spending by those firms, and we expect further cutbacks in 2015. Although lower energy prices help some businesses, they are likely to react more slowly to good news than energy producers are to bad news. Adding it up, we anticipate 3-5% growth in core business investment (excluding structures) in 2015 – still pretty good, but substantially slower than its recent pace.

The **trade deficit** widened and subtracted about 0.3 percentage points from 2014 real GDP growth. We are still awaiting December data, but net exports[2] appear to be about neutral for growth in Q4. Gradually improving U.S. domestic economic growth and sluggish growth abroad caused import growth to outpace export growth, although both slowed as the year progressed, which is not an encouraging sign for global economic activity (Figure 8).

Net exports are likely to be a headwind to U.S. economic growth again in 2015. The U.S. dollar appreciated sharply against most other currencies since mid-2014 (Figure 9). Over time, that should slow export growth by making exports more expensive in foreign currency terms. Similarly, foreign goods are cheaper in dollar terms, which should boost import growth. These effects are only reinforced by improving U.S. and slowing foreign growth and by likely tighter monetary policy in the U.S. and easier monetary policy abroad in 2015. Rising domestic oil production (which is likely in 2015 even in the wake of lower oil prices) should only partially offset this. A wider trade deficit could slow GDP growth meaningfully in 2015.

Figure 8: Trade Deficit a Drag on Growth

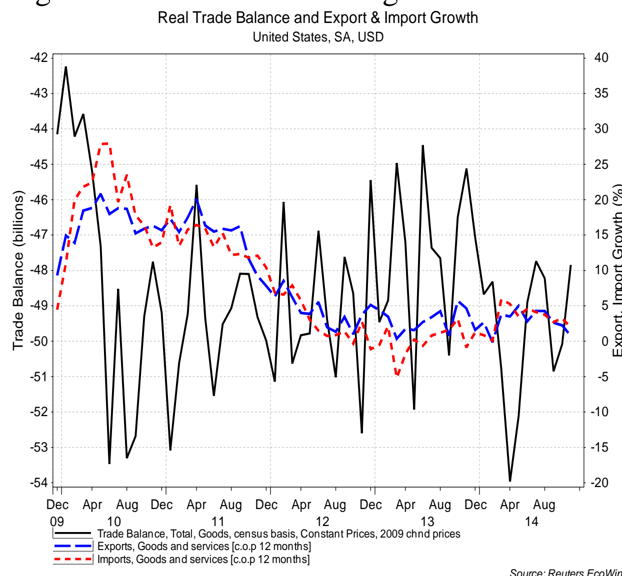
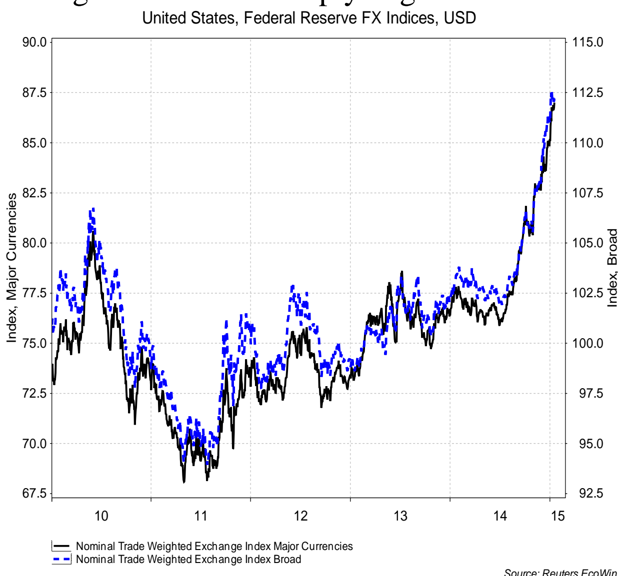


Figure 9: Dollar Sharply Higher



Government consumption finally shifted from being a drag on economic growth to making a modest contribution to it. Overall government consumption added an average of 0.3% to real GDP in the first three quarters of 2014 (it should be similar in Q4), and it is poised to add to growth again in 2015. That compares to subtracting 0.3% annually from growth in recent years. While divided government in Washington is likely to keep federal government spending from accelerating substantially, state and local spending should continue to rise. This shift in government consumption should add ½ percentage point or more to real GDP growth rate relative to its prior trend and is largely responsible for our expectation of faster growth in 2015.

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[2] Net exports subtract from (add to) GDP when the real trade deficit widens (shrinks) compared to a prior period.

Figure 10: Fiscal Drag Turned (Mild) Stimulus

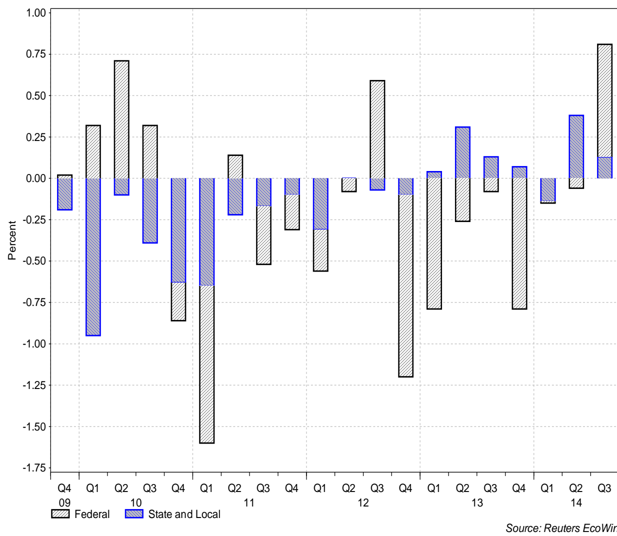
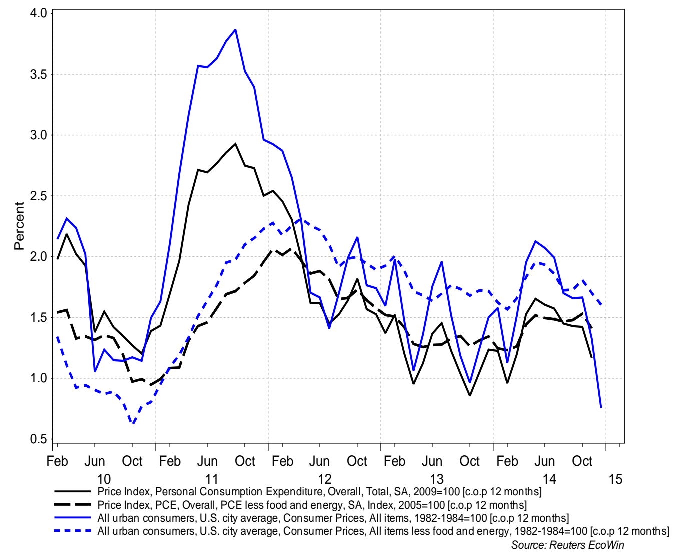
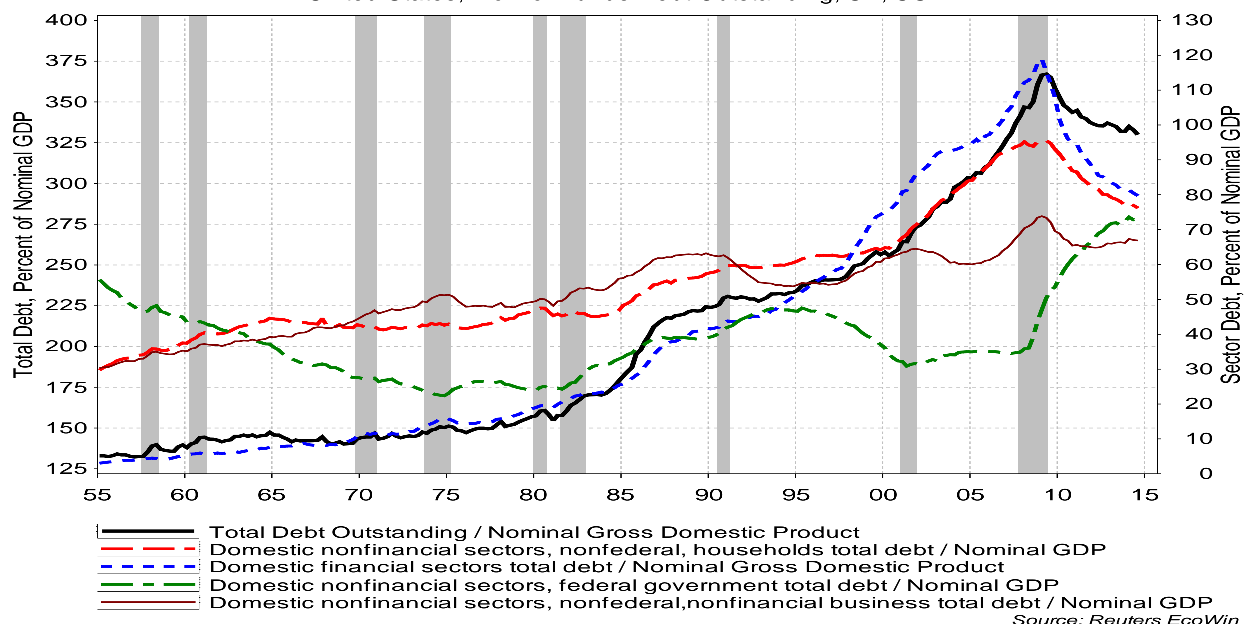


Figure 11: Inflation Slips on Oil



Sharply lower oil prices pushed down **inflation** in the fourth quarter (Figure 11). For 2014 as a whole, the consumer price index (CPI) was up just 0.8% overall and 1.6% excluding food and energy. For 12 months ending in November (latest data available), the PCE deflator was up 1.2% overall and 1.4% excluding food and energy. Money supply growth has not accelerated materially, and monetary velocity was little changed in 2014. Narrow money supply (M1) growth picked up in 2014's first half but slowed thereafter. Broader measures (M2 and MZM) expanded about 6% YoY, more slowly than in 2012 and 2013. Growth in base money slowed as the Fed reduced and then ended its securities purchase program. Although we remain watchful on inflation longer-term, we do not see it gaining a foothold any time soon.

Figure 12: Deleveraging Continuing, but No Longer a Major Headwind to Growth

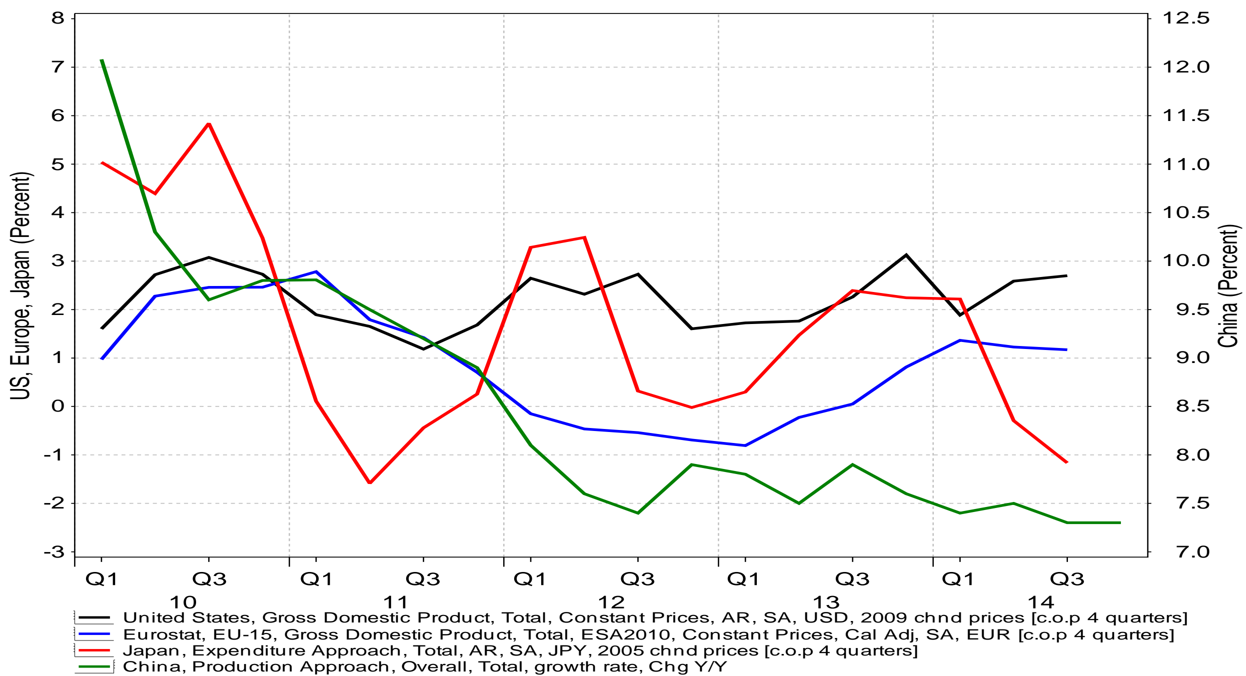


Broad **balance sheet ratios** in the U.S. resumed downward trajectories in the third quarter (Figure 12; Q3 is latest data available). Overall debt-to-GDP declined by 2.8 percentage points to 330%. Household debt-to-GDP edged lower overall; mortgage debt was little changed while auto and student loans again grew rapidly. Financial companies continued to reduce debt, albeit at a slower pace. Nonfinancial businesses held leverage about steady. Government debt-to-GDP rose fractionally.

We expect that overall borrowing relative to GDP will continue to decline gradually. Nonfinancial business borrowing will probably expand further as the credit cycle matures. Similarly, government borrowing is likely to drift upward as government consumption increases. However, other sectors should continue to reduce leverage. We think deleveraging will remain a mild headwind to growth, but it is no longer a major factor in our outlook.

Finally, although this is an update on the U.S. economy, global economic conditions have had and are having a significant influence on U.S. markets. A few words are in order. Economic growth in Europe, Japan and China, among others, slowed as 2014 progressed (Figure 13). Inflation fell globally. Europe and Japan began or expanded quantitative easing programs. China has allowed its currency to weaken versus the dollar. At the same time, geopolitical risks proliferated. Russia annexed Crimea, Islamic State gained ground in Iraq and Syria, and North Korea found new ways to solidify its status as a rogue nation. Global interest rates fell to new lows, and the U.S. dollar surged. Foreign investors poured money into U.S. fixed income investments, and many U.S. investors decided to keep money at home rather than seek alternatives abroad. Lower yields and higher prices for U.S. fixed income securities, including preferreds, were a result, as we discuss below.

Figure 13: Global GDP Summary – U.S. Improving; Europe, Japan & China Slowing



Market Outlook

Long-term **Treasury rates** continued to fall in the fourth quarter, and that rally has extended in January. The 30-year benchmark Treasury yield closed today at 2.40%, down 45 basis points (bp) in Q4 and another 35 bp in January (Figure 14). The 10-year Treasury note yield fell 32 bp in Q4 and an additional 35 bp in January, closing today at 1.82%. These long-term Treasury yields are at or near record lows in the United States.

Figure 14: Treasury Rates Near Record Lows

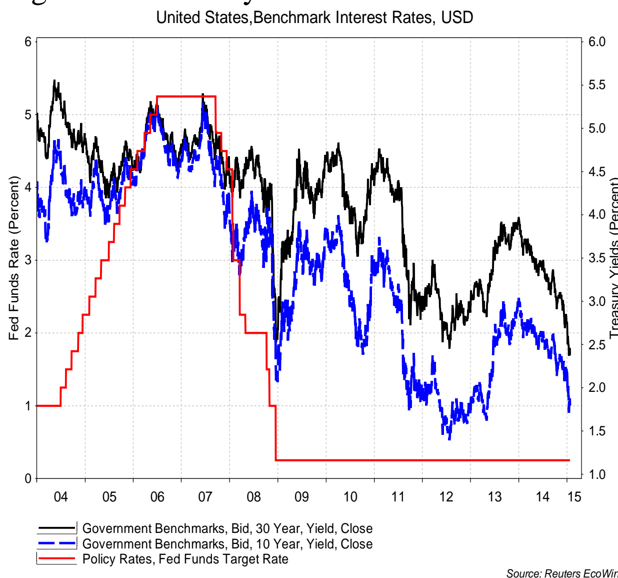


Figure 15: Credit Spreads Wider

Figure 16: Loan Growth Up…

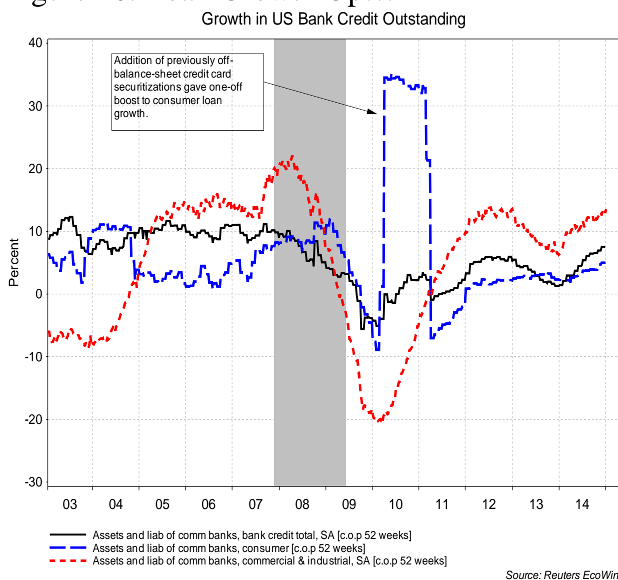
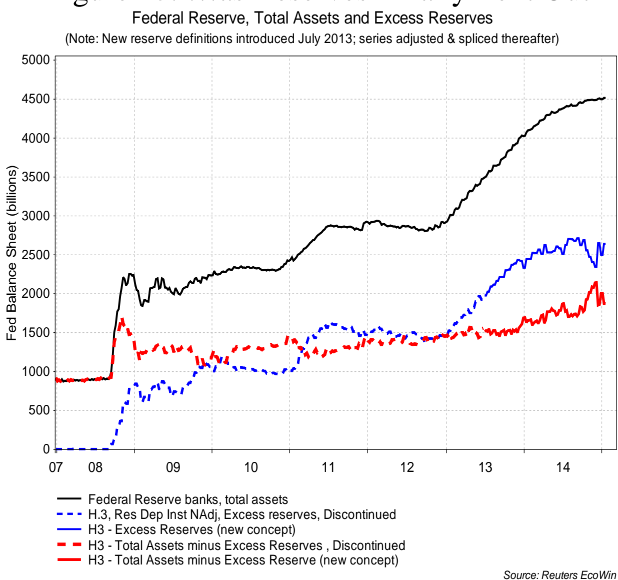


Figure 17: …as Reserves Finally Lent Out



The Federal Reserve left the federal funds rate target unchanged at 0.25% in the fourth quarter, where it is likely to remain until at least mid-2015. As expected, the Federal Open Market Committee (FOMC) also ended its quantitative easing program (QE3) in October. That program pushed the Fed's balance sheet just over $4.5 trillion from about $2.8 trillion before QE3 started in September 2012. Much of the Fed's base money creation flowed back to the Fed in the form of

excess reserves, but its "net" balance sheet (total assets less excess reserves) grew moderately in 2014, and bank lending picked up (Figures 16 and 17).

As Treasury yields fell, corporate **credit spreads** widened substantially in the fourth quarter and into January as well (Figure 15). Long-term Baa-rated corporate bond spreads widened by 32 bp in Q4, and they widened another 12 bp to 205 bp as of today's close. Because comparable Treasury yields fell even more, corporate bond *prices* were generally higher. High yield securities failed to keep pace with Treasuries, however. High yield spreads widened by 83 bp to in Q4 and another 33 bp since then. Similar to high-grade corporate bonds, preferred securities' spreads widened but prices rose. A representative Bank of America – Merrill Lynch® preferred securities index posted a pre-tax price return of 0.35% in the fourth quarter and 0.87% from year-end through today.[3]

Bank credit growth moved steadily higher in 2014 (Figure 16). Aggregate bank lending was up 7.5% in the 12-month period ending in December, compared to 2.3% YoY growth at the end of 2013 and 6.5% at the end of 3Q2014. Commercial and industrial loans continued to grow at a brisk pace, up 13.7% YoY at year-end. Even consumer loan growth at banks picked up to a respectable 5.0% YoY pace in 2014.[4]

By driving down interest rates, the Fed's accommodative monetary policy is partly responsible for those more-rapid growth rates in lending. Bank excess reserves were erratic but essentially flat in 2014 even as the Fed's balance sheet expanded (Figure 17). This means that incremental reserves created by the Fed were lent by banks. With corporate and household balance sheets healthy, we think faster loan growth is a positive development for both banks and the broader economy. Nonetheless, we recognize that banks could rapidly turn excess reserves into loans, raising risk of a credit bubble, and we remain watchful for – but do not currently detect – signs that one is developing.

Fundamental **credit conditions** continued to improve in 2014. Corporate profits probably slipped a bit in Q4 but remain near record levels as a proportion of GDP (Figure 18). Corporate balance sheets remain strong: interest expense as a percentage of earnings before interest and taxes is low and stable; long-term debt to total debt is holding near its record high; and liquidity remains solid (Figure 19). Loan delinquencies and charge-offs fell and generally are back to pre-crisis levels (Figure 20). Bank earnings remain modest but balance sheets continue to strengthen. Finally, the "financing gap" shifted into positive territory in 2014, indicating that internally generated funds did not cover capital expenditures. However, nonfinancial corporations' borrowing needs are modest and well below levels that were associated with problems historically (Figure 21). Credit conditions remain favorable for preferred securities.

[3] Index is the Bank of America - Merrill Lynch 8% Constrained Core West Preferred & Junior Subordinated Securities Index℠ (P8JC). Return quoted is price return only; total return, which includes income, is higher.

[4] Overall consumer credit growth is higher, driven by non-bank automobile lending and direct student loans. From all lending sources tracked by the Fed, consumer credit through November (latest data available) was up 7.0% YoY. Credit card debt growth remains subdued at 3.4% YoY in November, though that too has picked up.

Figure 18: Corporate Profits Holding Firm

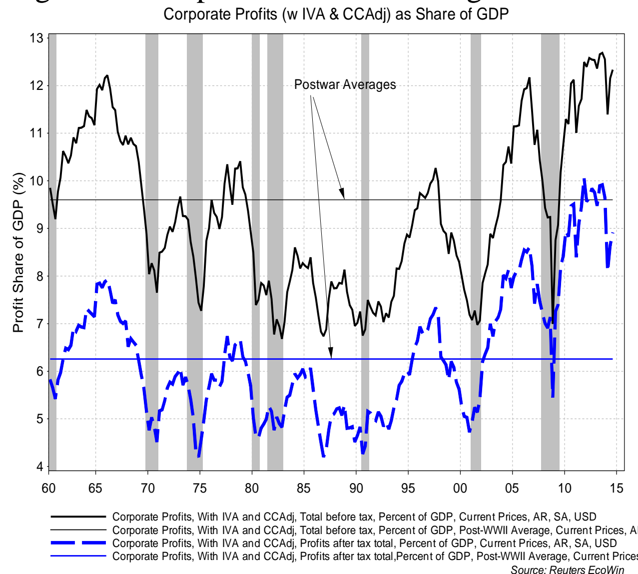


Figure 19: Balance Sheets Remain Strong

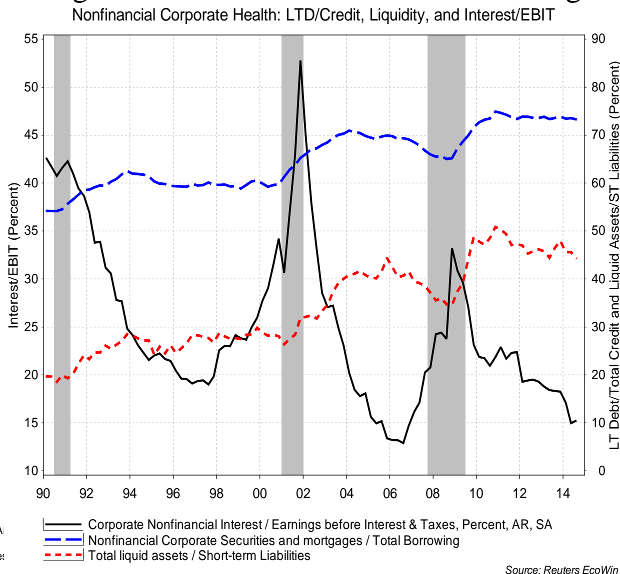


Figure 20: Loan Quality Stable to Improving

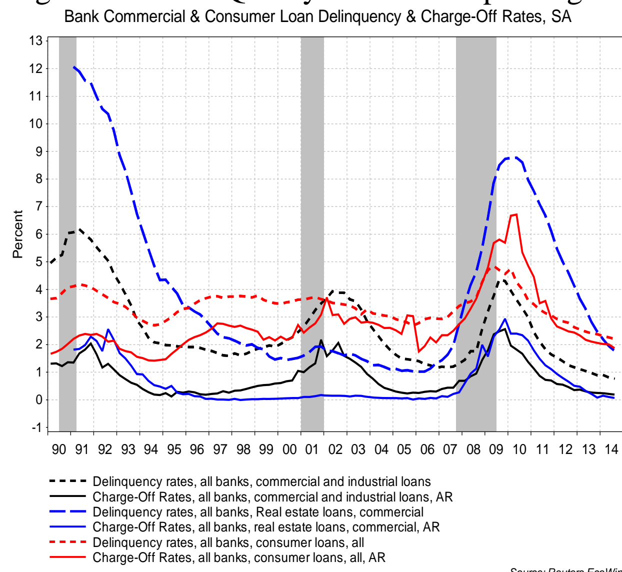
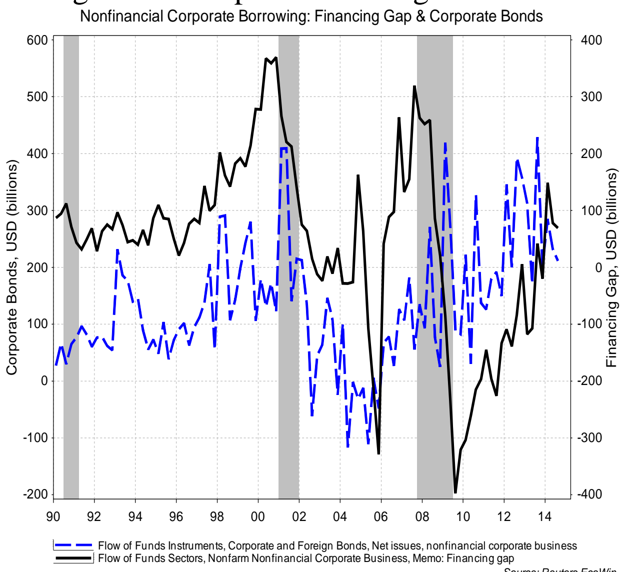


Figure 21: Corporate Funding Needs Low



Looking ahead, we expect U.S. real GDP to expand by 2.5-3.0% in 2015. Private consumption and residential investment should improve, and government consumption should add to growth rather than subtract from it. Employment growth should continue to drive down unemployment, although faster wage gains are likely to remain slow in coming. Despite an above-trend growth rate, we think the output gap will close only slowly. Ongoing excess capacity, low energy prices and falling import prices should keep inflation below the Fed's 2% target throughout 2015.

As it always does, the Federal Reserve will take global conditions into account as it considers an appropriate path for monetary policy in 2015. Global conditions argue for a cautious approach. Indeed, benchmark yield curves imply substantially less tightening of monetary policy than FOMC members projected in December (Figure 22).

Figure 22: Market Forward Rates Imply Less Tightening than FOMC Projections

Term	1/23/2015 Actual	6/30/2015 Expected	12/31/2015 Expected	12/31/2016 Expected	12/31/2017 Expected
Fed Funds Rate (FF)	0.12%	0.13%	0.49%	1.21%	1.63%
FOMC Median FF Projection	0-0.25%	N/A	1.0-1.25%	2.50%	3.5-3.75%
2-Yr Treasury Yield	0.51%	0.79%	1.16%	1.66%	2.03%
10-Yr Treasury Yield	1.82%	1.91%	2.02%	2.17%	2.26%
30-Yr Treasury Yield	2.40%	2.45%	2.50%	2.58%	2.63%

Source: Bloomberg, Federal Open Market Committee (12/17/2014)

We think the market is right that Fed tightening will be more gradual than the FOMC's projections. The Fed should begin tightening in mid-2015, though a later start is more likely than an earlier one. Once tightening begins, however, the Fed is likely to move slowly.

If U.S. or global growth falters, long-term interest rates could fall even further in 2015. However, if international risks recede and U.S. growth improves, both short- and long-term rates should move up – possibly m ore quickly than the market expects. We think that long-term interest rates will rise modestly in 2015 but by less than what would normally be associated with 2.5-3.0% real GDP growth. The interest rate outlook is highly uncertain, and volatility is likely to be elevated.

While interest rates could go either way, credit conditions remain favorable for preferred securities. With preferred securities offering one of the few sources of attractive yield and good credit quality in today's markets, spreads have room to narrow, which should at least partially offset any increase in long-term interest rates that 2015 may bring. More importantly, over a three- to five-year horizon, relatively high dividend yields on these securities can convert modest principal losses into positive total returns. We think prospective returns on preferred securities remain attractive for long-term investors.

Flaherty & Crumrine Incorporated
January 23, 2015

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