Second-Quarter U.S. Economic Update
July 2015

Summary of Recent Economic Developments

After contracting by 0.2% in the first quarter of 2015, economists expect inflation-adjusted gross domestic product (real GDP) to grow by 2.8% in the second quarter and a little over 3% in the second half, slightly above our forecast of 2.5-3.0% for those three quarters. Job growth stabilized in Q2 after slipping in Q1, but wage growth remained stuck at 2%. Personal income grew by 4.4% YoY, but personal spending was muted and probably grew only slightly faster than in Q1. Residential investment was again a standout performer, as home sales and construction activity rose impressively. In contrast, industrial production fell and core capital goods orders plunged, which suggests business investment was weak. Headwinds from trade diminished and should be roughly neutral for Q2 growth after subtracting 1.9% from real GDP in Q1. Inflation held about steady but should begin to drift upward as a disinflationary impulse from last year's sharply lower energy prices recedes. Despite mixed economic data, Treasury rates rose by about 50 bp, returning them to last autumn's levels, as the Federal Reserve suggested it may begin to hike rates later in 2015. Fundamental credit conditions remain favorable, especially for banks, though nonfinancial corporate sector borrowing bears watching. Preferred securities continue to offer an attractive combination of yield and credit quality, and spreads have room to narrow further, which could partially offset eventual higher Treasury yields. We think prospective returns on preferred securities remain attractive for long-term investors

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	2013:3	2013:4	2014:1	2014:2	2014:3	2014:4	2015:1	2015:2
Real GDP, Chg QoQ (%, SA, AR)	4.5	3.5	-2.1	4.6	5.0	2.2	-0.2	2.8f
Real Personal Consump Expnds, Chg QoQ (%, SA, AR)	2.0	3.7	1.2	2.5	3.2	4.4	2.1	3.0f
Real Business Inv ex Stuctures, Chg QoQ (%, SA, AR)	4.0	9.8	1.3	8.9	10.0	4.4	3.0	N/A
Real Residential Investmt, Chg QoQ (%, SA, AR)	11.2	-8.5	-5.3	8.8	3.2	3.8	6.5	N/A
Corporate Profits, After Tax, Chg YoY (%, SA, AR)	4.5	3.4	-11.8	-8.9	-6.3	-6.4	1.9	-1.0f
Current Account Balance, Annualized (% of GDP, SA)	-2.2	-1.9	-2.3	-2.1	-2.2	-2.3	-2.6	N/A
Federal Budget, 12-mo Def or Surp (% of GDP)	-4.0	-3.3	-2.9	-3.1	-2.7	-2.8	-2.9	-2.4f
Unemployment Rate (%, SA)	7.2	6.7	6.6	6.1	5.9	5.6	5.5	5.3
Household Employment, Chg QoQ (000, SA)	272	374	1125	451	360	835	889	408
Nonfarm Payrolls, Chg QoQ (000, SA)	570	651	579	852	712	973	586	664
Nonfarm Productivity, Chg QoQ (%, SA, AR)	3.4	3.0	-4.7	2.9	3.9	-2.1	-3.1	N/A
Capacity Utilization (%, SA)	77.0	77.1	77.8	78.2	78.5	79.0	78.3	77.8
GDP Price Index, Chg QoQ (%, SA, AR)	1.7	1.5	1.3	2.1	1.4	0.1	0.0	1.5f
Consumer Price Index, Chg YoY (%, AR)	1.2	1.5	1.5	2.1	1.7	0.8	-0.1	0.1
CPI ex food & energy, Chg YoY (%, AR)	1.7	1.7	1.7	1.9	1.7	1.6	1.8	1.8
Nominal Personal Income, Chg YoY (%, AR)	2.8	-2.1	3.7	3.7	3.8	5.0	4.0	4.4a
Personal Savings Rate (%, SA)	5.2	4.1	4.8	5.1	4.6	5.0	5.1	5.1a
Rate or Spread (End of Quarter)	**2013:3**	**2013:4**	**2014:1**	**2014:2**	**2014:3**	**2014:4**	**2015:1**	**2015:2**
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	0.25	0.23	0.23	0.24	0.26	0.27	0.28
10-Yr Treasury Note Yield (%)	2.62	3.03	2.72	2.53	2.50	2.17	1.93	2.35
30-Yr Treasury Bond Yield (%)	3.69	3.96	3.56	3.36	3.20	2.75	2.54	3.12
Moody's Baa Long Corp Spread (bp)	170	141	143	135	161	193	195	206
10-Yr Interest Rate Swap Spread (bp)	16	7	12	10	14	12	10	11

* Figures are either quarterly or, if more frequent, end of period. f = Forecast[1]; a = Actual through May 2015 Source: Reuters EcoWin

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

Economic Outlook

After contracting by 0.2% in the first quarter of 2015, economists expect inflation-adjusted gross domestic product (real GDP) to grow by 2.8% in the second quarter and a little over 3% in the second half.[1] That translates to average expected real GDP growth of 2.3% for 2015, weaker than earlier forecasts but better than the Federal Reserve's expectation of just 1.8-2.0% growth. We continue to anticipate 2.5-3.0% real GDP growth in Q2 and over the remainder of 2015, which implies about 2% growth for 2015 overall. While these forecasts vary in their details, they all signal moderate economic growth. We expect the economy will be strong enough to prompt the Fed to begin removing monetary policy accommodation later in 2015 but not strong enough to generate worrisome inflation requiring rapid Fed tightening. We believe the U.S. economic, credit and interest rate outlooks for preferred investors should remain relatively favorable over coming quarters.

Our assessment of major sectors of the U.S. economy follows.

Figure 2: Steady Job Growth…

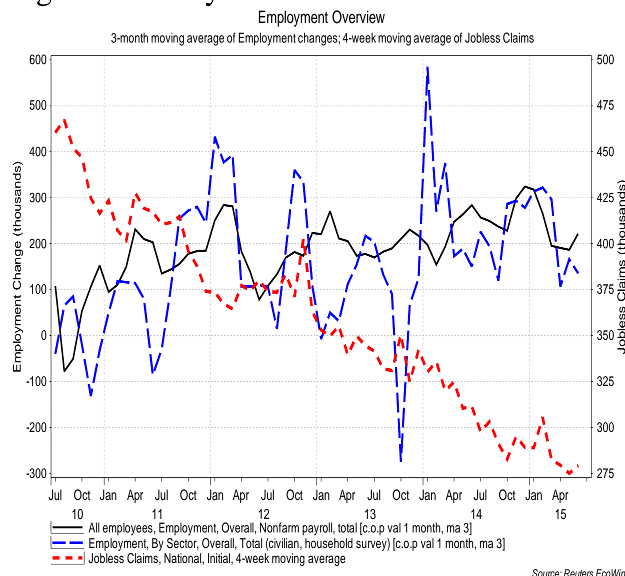
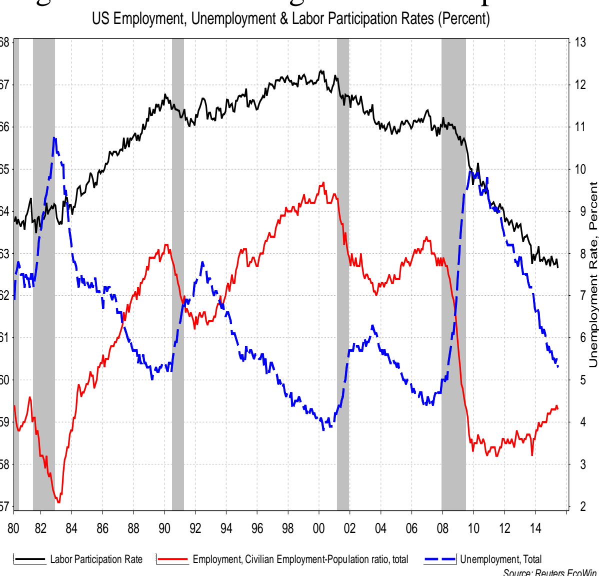


Figure 3: …but Falling Labor Participation



Labor market conditions have been surprisingly steady for several years. Employment gains accelerated in 2014, slowed during 1Q2015 and stabilized again during the second quarter (Figure 2). Employers added an average of 221,000 jobs per month in Q2 according to the payroll survey, up from 195,000 jobs per month last quarter. Total payroll employment was up 2.1% in June compared to a year ago, about where that growth rate has been for several years. The household employment survey recorded only 136,000 average monthly job gains in Q2, compared to a Q1 average of 385,000 new jobs per month. Over 2015's first half, these two surveys recorded very similar job growth of about 210,000 jobs per month on average. Initial jobless claims continued to fall despite a broadly unchanged pace of net job growth.

Other measures of labor market conditions are similarly mixed. Hiring remains broad-based. The diffusion index of employment averaged 60.7 in Q2 (a reading over 50 indicates that more firms

[1] Unless noted otherwise, forecasts are from *The Livingston Survey*, Federal Reserve Bank of Philadelphia, June 10, 2015 and Bloomberg® *Monthly Economic Survey*, July 9, 2015.

are hiring than firing workers). Except for one month at 59.3, this index has remained above 60 since August 2013 – a very strong showing. The unemployment rate fell to 5.3% in June, which is good news, but labor participation was down, which is not (Figure 3). As a result, the *employment* rate (red line in Figure 3) is little changed so far in 2015 after rising steadily in 2014. Employment and labor participation rates remain low by historical standards, reflecting both an aging population and a slower than normal economic recovery. Of course, demographics can't change quickly, and it doesn't look like economic growth is poised to take off either. Expect modest job gains to be a feature of the U.S. economy for some time to come.

After showing signs of acceleration earlier in 2015, wage growth settled back to 2% YoY in June, where it has been stuck since 2011, despite reasonably good job growth and sharply lower unemployment in the interim. As we have said before, a falling unemployment rate has been associated with faster wage growth historically, but we are not seeing that today. However, current sluggish wage growth is reflected in historically low labor participation and employment rates. Since those are likely to remain constrained, it is unclear when wage growth will begin to pick up.

Figure 4: Income & Spending Hanging In

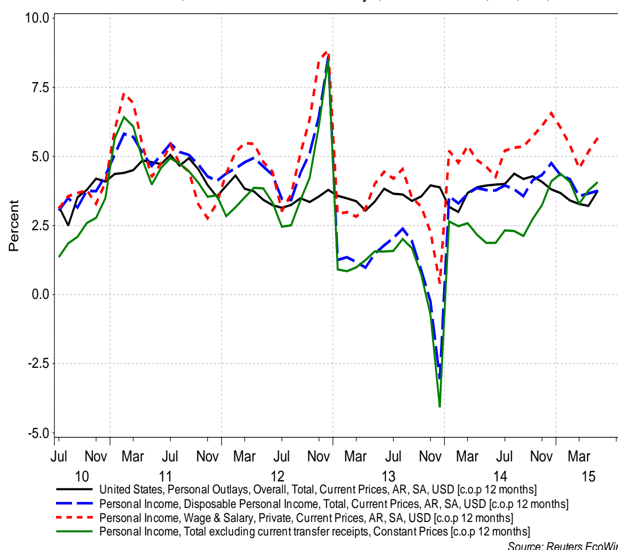
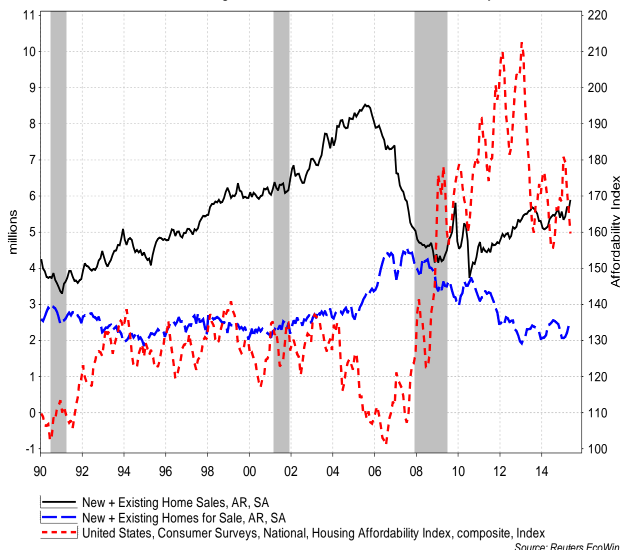


Figure 5: Housing Bouncing Back



Moderate job and slow but steady wage growth combined to boost **personal income** at a respectable pace in Q2. Through May (latest data available), personal income was up 4.4% YoY, led by wage and salary income, which was up 5.7% YoY (Figure 4). Real personal income excluding transfer payments was up 4.1% YoY, which is near its highest level in 2½ years. While income growth would be stronger if wages were rising more rapidly, it is still pretty good, and it should support moderate growth in personal consumption over coming quarters.

Personal consumption expenditures (PCE) probably showed only slightly better growth in Q2 compared to Q1, when real PCE rose by 2.1%. For the second quarter, real PCE was up 2.5% through May compared to its Q1 average, but disappointing retail sales in June suggest that PCE could be a bit weaker than that in June. However, taking a slightly longer view, PCE was up 3.4% YoY, well ahead of its average 2.7% growth rate since 2013 (Figure 4). Of course, most of those gains came in Q3 and Q4 of last year. It remains to be seen whether consumers spend as

freely in the second half of this year, but with respectable income growth and gradually improving confidence, we think real PCE should improve from here.

If consumers decide to open their wallets, they have savings available to support more spending. The **savings rate** was 5.1% in May and averaged 5.4% so far in 2015. While it could move higher over time, a 6-month moving average of the savings rate has ranged between about 4½ and 5½ percent for the past several years (it's 5.3% currently), which suggests that consumers probably would feel comfortable reducing savings a bit. That does not mean consumers *will* reduce savings, only that they *could*, since rising income allows more spending even while holding additions to savings constant in dollar terms.

The **housing market** was a standout economic performer in the second quarter. Despite harsh winter weather, residential investment rose 6.5% in the first quarter, and it should do even better in Q2. Total new and existing home sales jumped to a 5.9 million unit pace in May (latest data available), up from an average of 5.5 million in Q1 (Figure 5). Inventories of unsold homes are relatively low, and housing starts and building permits jumped in Q2 in response to rising demand. Home affordability dropped in recent months (i.e., homes are more expensive), but it is little-changed over the past several years, and homes remain affordable from a long-term perspective (Figure 5). Home prices continued to rise faster than inflation, but the pace of gains slowed: the Federal Housing Finance Authority's home price index was up 5.4% YoY in April while the S&P/Case-Shiller 20-city home price index was up 5.0% YoY in March (latest data available for each index). We expect another strong quarter for residential investment in Q2, and it should remain an economic bright spot throughout 2015.

Figure 6: Production Sagged…

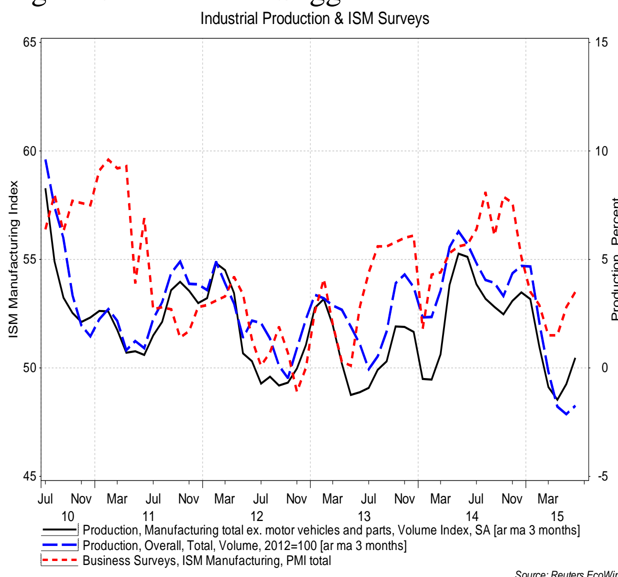
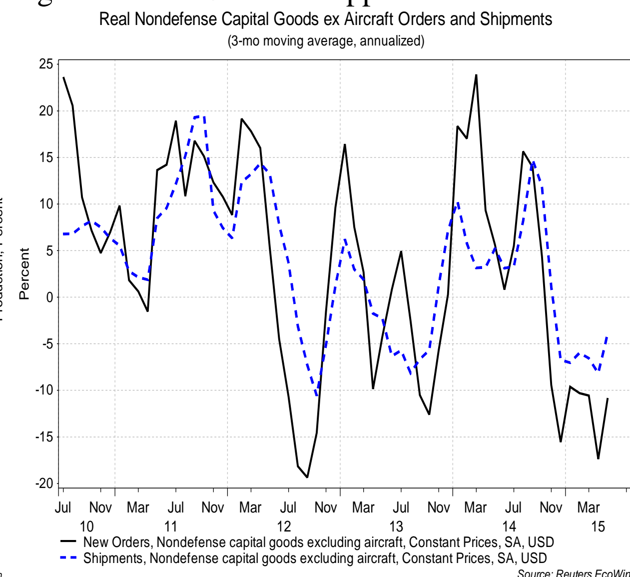


Figure 7: …as Orders Dropped



Industrial production was hit hard by adverse winter weather and West Coast port strikes in Q1, and it slumped further in the second quarter. Overall industrial production fell 1.7% in Q2, while manufacturing excluding motor vehicles and parts edged up 0.5% (Figure 6). Mining, which includes oil and gas extraction, was down 12.7%. The Institute for Supply Management's manufacturing survey (red line in Figure 6) recovered a bit, but it remains well below where it spent the second half of 2014. At best, it points to modest growth in manufacturing over coming

months. More worryingly, orders for durable goods were weak. Real orders and shipments of nondefense capital goods excluding aircraft dropped 10.8% and 3.9%, respectively, over three months ending in May (Figure 7). While capital goods orders and shipments are notoriously volatile, these are big declines, and they have been falling for seven months. Sharply reduced investment in oil and gas extraction equipment – and related supplies – accounts for some of this drop and is probably bottoming out. But slower export growth, which is likely to persist given U.S. dollar strength and overseas economic weakness, is also at play. Falling orders probably mean weak industrial output for several more quarters.

Business investment slipped 0.3% in Q1 and probably dropped further in Q2, if slumping core durable goods orders and shipments are any guide. Moreover, business investment ran well ahead of a rise in capacity utilization in the second half of 2014 (Figure 8), driven in part by heavy investment in oil and gas extraction when oil prices were much higher. Since that time, annual capacity utilization growth slowed and then turned negative in March. We anticipate core business investment (excluding structures) will drop in Q2 and for another quarter or two after that. Fortunately, commercial real estate is faring better, and investment in structures should offset some, but probably not all, weakness in other forms of business investment.

The **trade deficit** widened sharply in the first quarter: it subtracted 1.9 percentage points from Q1 real GDP growth (Figure 9). Net exports should be a much smaller player in the second quarter, however. If the trade deficit in June equals its April and May average, trade would be a neutral factor for Q2 real GDP. With U.S. economic growth strong in comparison to many trading partners, we expect that net exports will be a drag on growth over the next year or two, especially if the U.S. dollar remains strong or strengthens further when the Federal Reserve eventually raises short-term interest rates. Longer-term, we could see trade adding to GDP as growth abroad gradually improves (helping U.S. exports) and as rising U.S. energy production reduces energy imports.

Figure 8: Business Investment Poised to Slow

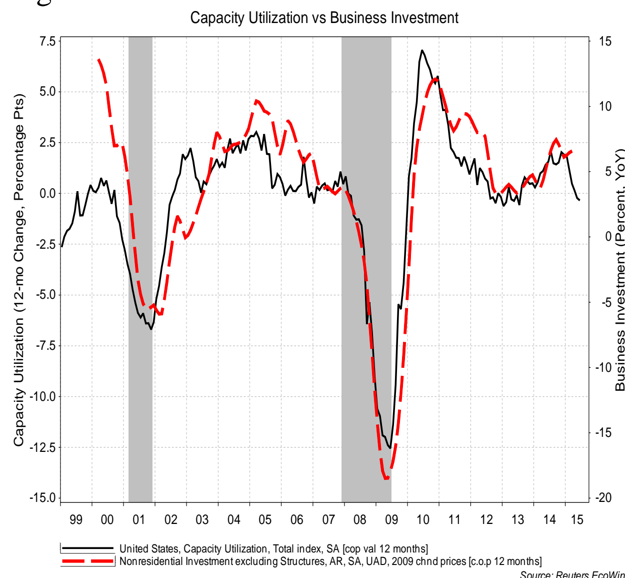
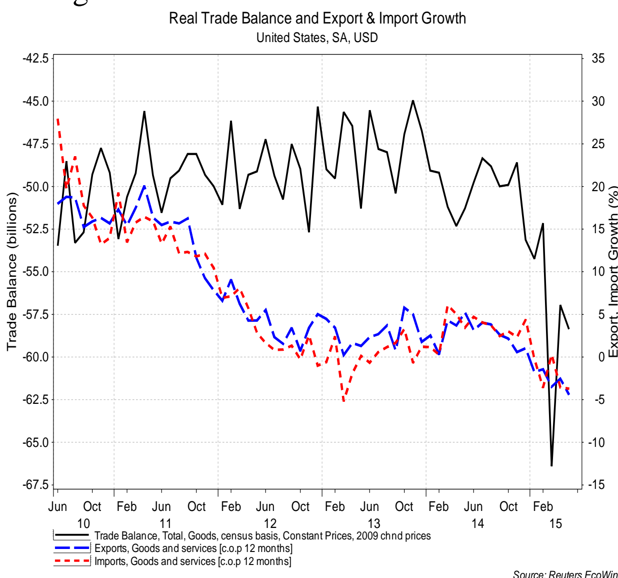


Figure 9: Trade Deficit Back to Neutral



Government consumption was down slightly in the first quarter, subtracting 0.1% from real GDP. State and local spending was down, while federal spending was flat. Government

employment at all levels was virtually flat in the second quarter, which suggests inflation-adjusted spending was probably little changed as well. Although government consumption is no longer a significant drag on economic growth, it probably will not be a major contributor to growth either.

Figure 10: Fiscal Drag Subsiding, not Reversing

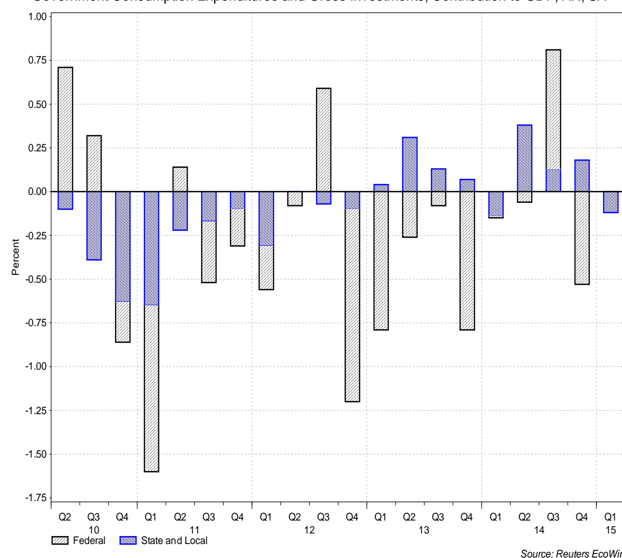
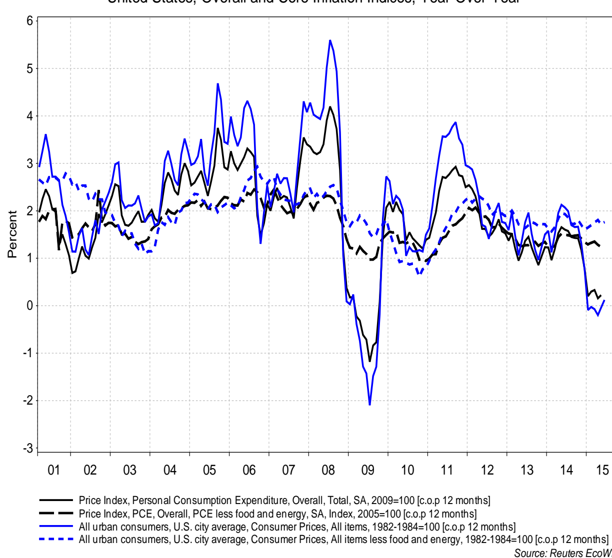


Figure 11: Inflation Stable after Oil Skid

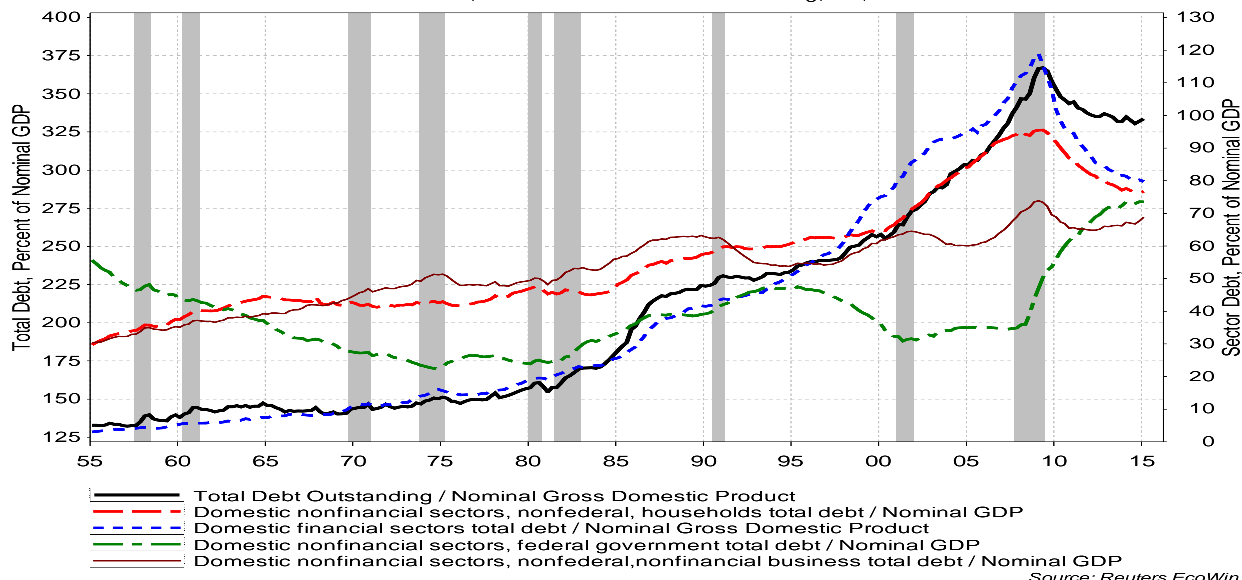


Inflation held about steady in the second quarter after plunging in the second half of 2014 on sharply lower energy prices. For 12 months ending in June, the consumer price index (CPI) was up 0.1% overall and 1.8% excluding food and energy (Figure 11). Over 12 months ending in May (latest data available), the PCE deflator was up 0.2% overall and 1.2% excluding food and energy. It's hard to find much inflation even if one goes looking for it. However, if energy prices remain around current levels, disinflationary impact from last year's energy price swoon would gradually subside in the second half of 2015, and overall inflation should trend up toward core readings. If energy prices rise, that effect would be magnified. Of course, core inflation could fall, but with economic growth likely to be slightly above long-term potential, we do not expect lower core inflation in H2. This should give the Federal Reserve greater confidence that inflation is moving back toward its 2% target.

Finally, broad **balance sheet trends** in the U.S. were little changed in recent quarters (Figure 12). Overall debt-to-GDP rose by 1.6 percentage points to 334% in the first quarter (latest data available), in part because nominal GDP fell slightly in that quarter. Nonfinancial business continued to add leverage, although it remains manageable at 69% of GDP. Financial corporation and federal government debt were both about unchanged at 80% and 74% of GDP, respectively. Household debt ticked up slightly to 77% of GDP.

As economic growth revives in the second quarter, these numbers should improve. Nonfinancial business borrowing should slow along with lower investment spending. If PCE growth improves, household debt may increase a bit, but other sectors should return to gradual deleveraging. We think deleveraging remains a mild headwind to growth, but it is no longer a major factor in our outlook.

Figure 12: Deleveraging Slowing; Only Mild Headwind to Growth



Market Outlook

Long-term **Treasury rates** rose substantially in the second quarter as economic growth recovered and the Federal Reserve signaled that it expects to begin raising the federal funds rate later in 2015. The 30-year benchmark Treasury yield jumped by 58 basis points (bp) to 3.12% on June 30; it has dropped by about 6 bp so far in July (Figure 13). The 10-year Treasury note yield rose by 42 bp to 2.35%; it is down by 3 bp since quarter-end. While these were sizable jumps, long-term rates simply returned to their levels of autumn 2014 after a strong rally in December and January, as Figure 13 shows.

Although it left the federal funds rate target unchanged at 0.25% in Q2, the Federal Reserve is edging closer to raising short-term interest rates. At its April meeting, the Federal Open Market Committee (FOMC) dropped an earlier pledge not to raise rates at its next meeting, making a rate hike a meeting-to-meeting decision from that point forward. The FOMC spent much of 2015 preparing market participants for a gradual series of rate hikes. We expect economic activity will be strong enough in July and August to prompt Fed tightening in September, although that could be pushed back to December – or even into early 2016 – if data remain unconvincing. We think tightening is coming, but risk is skewed toward a later move rather than an earlier one.

However, pace of tightening is more important than its start date. The Fed is likely to proceed cautiously, taking time to assess economic and market impacts following each rate hike. We anticipate that the FOMC will increase the federal funds rate by 25 bp at every other meeting (i.e., once per calendar quarter) for 6-8 quarters, with less frequent moves thereafter, eventually bringing the funds rate to 3-3.5%. That's about half as fast as prior tightening cycles, with a lower peak. And, once again, risk is skewed toward a slower pace of tightening over a faster one.

The above pace of tightening is about what markets currently price into forward rates (Figure 13). Accordingly, we think markets have the rate outlook about right after Q2's selloff. Long-term rates should move up gradually as the Fed tightens – and they may "overshoot" when the first rate hike eventually arrives – but we do not expect another sharp selloff from here.

Figure 13: Rates Higher; Forwards About Right?[2]

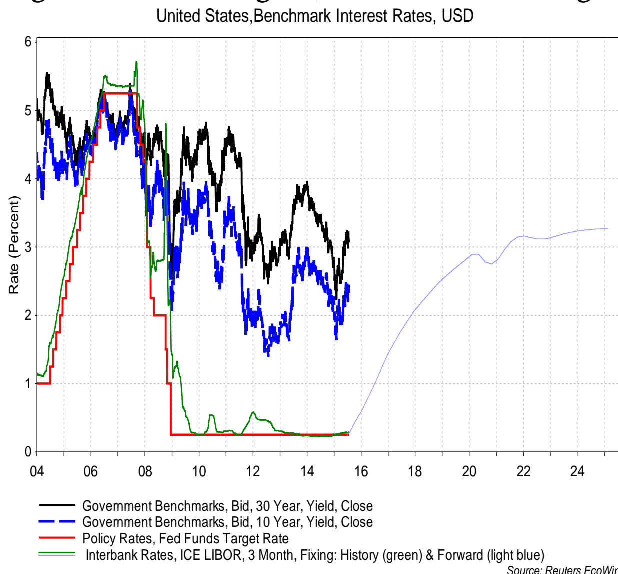
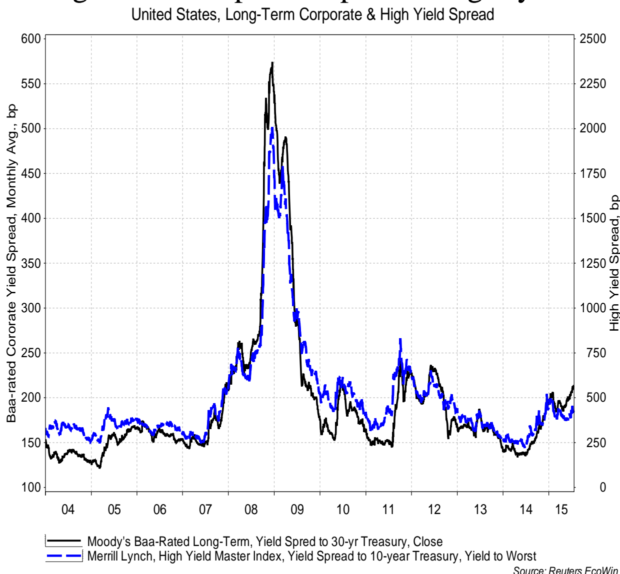


Figure 14: Corporate Spreads Slightly Wider



Corporate **credit spreads** were mixed in the second quarter. Long-term Baa-rated corporate bond spreads widened by 11 bp to 206 bp despite higher Treasury yields. High yield spreads widened by 2 bp to 430 bp (Figure 14). Both indices are little changed so far in July. Spreads on preferred securities fared better than both corporate and high yield bonds. "Spread to Worst" on a representative Bank of America preferred securities index narrowed by 41 bp to 248 bp in the second quarter; it is 7 bp wider so far in July. Although spreads narrowed, Treasury rates rose, and preferred securities' prices fell 2.2% in Q2, though they rebounded by 0.9% so far in July.[3]

Figure 15: Loan Growth Eased as GDP Slowed

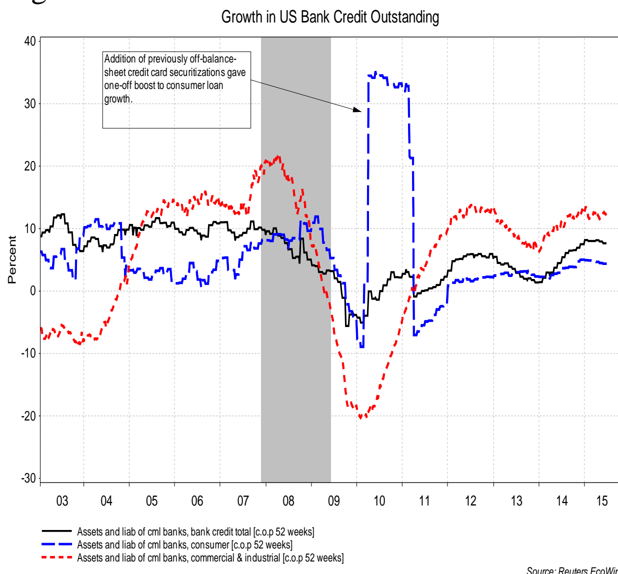
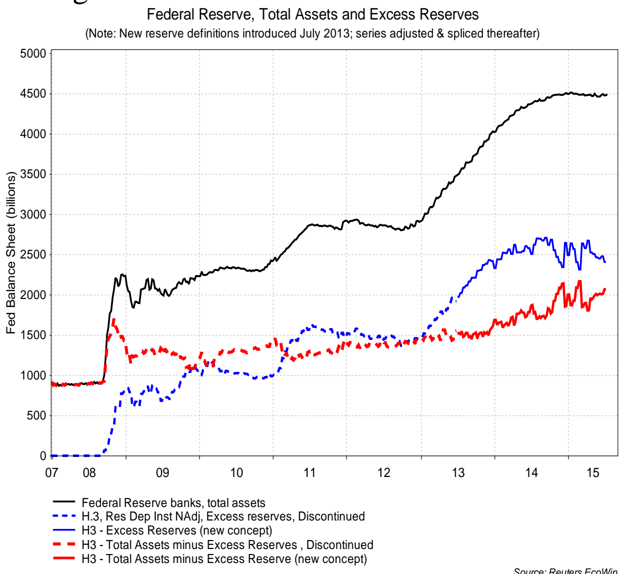


Figure 16: Fed Balance Sheet Flat



[2] Source for forward 3-month LIBOR rates: Bloomberg, LP.

[3] Index is the Bank of America - Merrill Lynch 8% Constrained Core West Preferred & Junior Subordinated Securities Index[SM] (P8JC). "Spread to Worst" is the lower of yield to call and current yield (or yield to maturity for dated hybrids) minus yield on a comparable Treasury security. Returns are price returns only.

Bank credit growth slowed slightly in the second quarter but remained relatively strong (Figure 15). Aggregate bank lending was up 7.7% in the 12-month period ending in June, compared to 8.0% YoY growth at the end of Q1. Commercial and industrial loans continued to lead growth in bank lending, up 11.9% YoY. Consumer loans at banks were up 4.4% YoY.

With the Federal Reserve's quantitative easing program concluded – it ended in October 2014 – the Fed's balance sheet was essentially flat in the second quarter (Figure 16). The Fed continues to reinvest principal payments on its securities holdings into new securities. At some point after rate hikes begin, reinvestment will end, and the Fed's balance sheet will begin to shrink. That may put some additional upward pressure on long-term interest rates, but we think its impact will be mild as long as the Fed does not shrink its balance sheet by aggressively selling securities, something that's highly unlikely over the next several years.

Figure 17: Corporate Profits Down in Q1

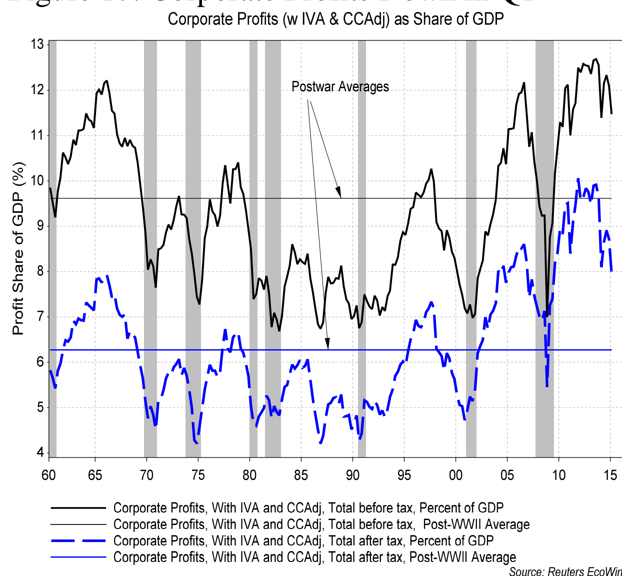


Figure 18: Balance Sheets Remain Strong

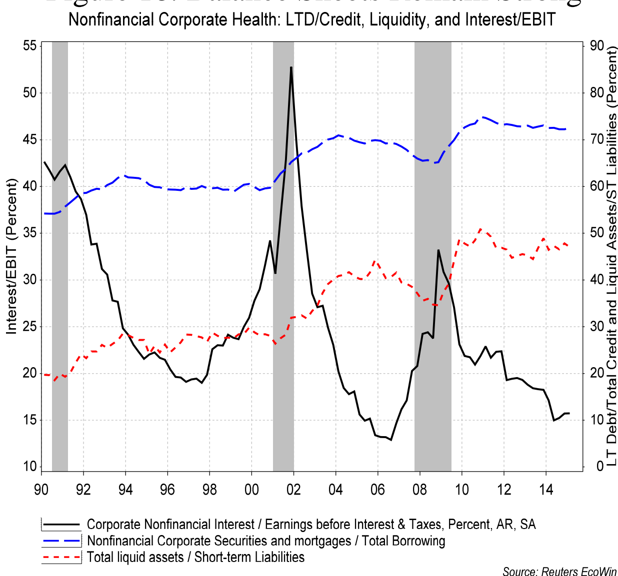


Figure 19: Loan Quality Stable to Improving

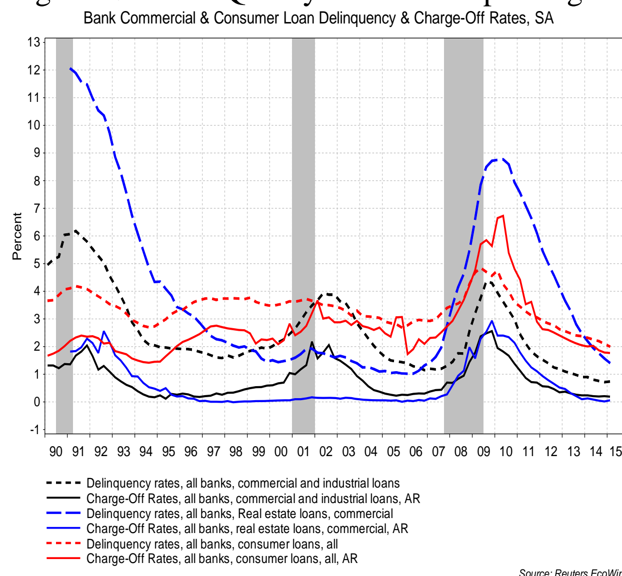
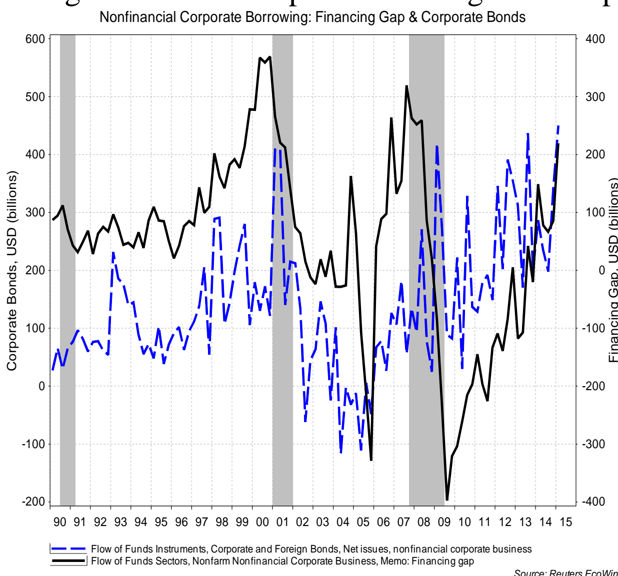


Figure 20: But Corporate Funding Needs Up



Despite economic weakness in the first quarter, fundamental **credit conditions** were mostly steady to slightly better. Corporate profits slipped in Q1 (lower profits at energy companies played a major role), but they remain very high as a proportion of GDP (Figure 17). Corporate balance sheets are 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 18). Loan delinquencies and charge-offs edged lower and are mostly at or below pre-crisis levels, strengthening bank earnings and balance sheets (Figure 19). Bank credit quality, in particular, continues to improve as bad-loan costs drop, lending expands and litigation expenses from earlier missteps recede.

In contrast, nonfinancial corporations saw borrowing needs increase as internally generated cash dropped further below spending on capital investments. This increase in the "financing gap" resulted in greater issuance of corporate bonds by these companies (Figure 20). We suspect that energy companies, whose profits have plunged, are largely responsible for this development. That should fade as their investment spending becomes better aligned with cash flow. However, as we said last quarter, periods of rapidly expanding borrowing generally do not end well, so we will be watching this sector carefully over coming quarters.

Looking ahead, we expect U.S. real GDP growth to accelerate to 2.5-3.0% over the remainder of 2015 as consumer spending picks up and headwinds from government fiscal restraint and trade diminish. Employment growth should continue to drive down the unemployment rate, although faster wage gains may be slow in coming. Despite an above-trend growth rate, we think the output gap will close only slowly, and low labor participation suggests that there is still considerable labor supply available if wage growth does pick up. While inflation should rise as a disinflationary impulse from lower energy prices fades over coming months, inflation is likely to remain low by historical standards. These constraints should keep Fed rate hikes on a slow upward path, which market rates now reflect. Although long-term rates are likely to rise gradually as the economy improves, we do not expect higher rates to shock markets the way they did during the "taper tantrum" of May and June 2013.

Credit quality, while deteriorating in spots, continues to improve at most issuers of preferreds. Preferred securities continue to offer one of the few sources of attractive yield and good credit quality in today's markets, and spreads should have room to narrow further. Higher long-term interest rates may put some pressure on prices of preferred securities, but 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
July 21, 2015

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