Third-Quarter U.S. Economic Update
October 2015

Summary of Recent Economic Developments

After rebounding strongly in the second quarter, U.S. economic growth probably slowed to about 2% in the third quarter as the U.S. economy began to feel the effects of a weaker global economy. A wider trade deficit, slower inventory accumulation and more moderate investment spending probably accounted for most of that slowdown. For 2015 as a whole, economic growth is now forecast to be 2.3%, slightly below 2014's 2.5% pace. Employment gains eased in the third quarter but were good enough to drive unemployment lower. Steady job and wage gains contributed to moderate income growth, which supported personal consumption. Housing remained a bright spot. Industrial production was weak, although orders turned up late in the quarter. Business investment probably slowed along with sluggish production and lower capacity utilization. A wider trade deficit appears to have knocked 0.5-1% off Q3 real GDP. Government spending growth likely remained subdued, particularly at the federal government. Inflation was low and stable. Overall leverage was little changed, but nonfinancial corporate borrowing rose and bears watching. Faced with slower economic growth in the U.S. and abroad, the Federal Reserve decided to leave monetary policy unchanged in the third quarter, and tightening may not begin until 2016. Treasury yields fell, and spreads on corporate and preferred securities widened. Credit conditions remained strong overall, but they weakened at nonfinancial businesses – albeit from very strong levels. We think the U.S. economic, credit and interest rate outlooks should remain relatively favorable for preferred investors over coming quarters.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	2015:3	2015:2	2015:1	2014:4	2014:3	2014:2	2014:1	2013:4
Real GDP, Chg QoQ (%, SA, AR)	2.0f	3.9	0.6	2.1	4.3	4.6	-0.9	3.8
Real Personal Consump Expnds, Chg QoQ (%, SA, AR)	3.0f	3.6	1.7	4.3	3.5	3.8	1.3	3.5
Real Business Inv ex Stuctures, Chg QoQ (%, SA, AR)	N/A	3.5	4.1	-0.3	12.2	5.7	5.4	10.0
Real Residential Investmt, Chg QoQ (%, SA, AR)	N/A	9.4	10.1	9.9	3.4	10.4	-2.7	-8.1
Real Private Domestic Final Sales, Chg QoQ (%, SA, AR)	N/A	3.9	2.0	3.9	4.3	4.2	2.2	3.8
Nominal GDP, Chg QoQ (%, SA, AR)	3.7f	6.1	0.8	2.2	6.0	6.9	0.6	5.6
Corporate Profits, After Tax, Chg YoY (%, SA, AR)	-5.9f	-0.6	4.7	2.7	4.9	-2.6	-7.5	2.8
Nonfarm Productivity, Chg QoQ (%, SA, AR)	N/A	3.3	-1.1	-2.2	3.1	2.8	-3.5	3.5
Nominal Personal Income, Chg YoY (%, AR)	4.2a	4.1	4.0	5.2	4.5	4.2	4.2	-2.4
Personal Savings Rate (%, SA)	4.6a	4.5	4.9	5.0	4.6	4.8	4.9	4.3
Unemployment Rate (%, SA)	5.1	5.3	5.5	5.6	5.9	6.1	6.6	6.7
Nonfarm Payrolls, Chg QoQ (000, SA)	501	692	586	973	712	852	579	651
Household Employment, Chg QoQ (000, SA)	61	408	889	835	360	451	1125	374
Federal Budget, 12-mo Def or Surp (% of GDP)	-2.5f	-2.5	-2.9	-2.8	-2.8	-3.2	-2.9	-3.4
Consumer Price Index, Chg YoY (%, AR)	0.0	0.1	-0.1	0.8	1.7	2.1	1.5	1.5
CPI ex food & energy, Chg YoY (%, AR)	1.9	1.8	1.8	1.6	1.7	1.9	1.7	1.7
Capacity Utilization (%, SA)	77.5	77.5	78.2	79.0	78.5	78.2	77.8	77.1
Rate or Spread (End of Quarter)	**2015:3**	**2015:2**	**2015:1**	**2014:4**	**2014:3**	**2014:2**	**2014:1**	**2013:4**
Federal Funds Rate Target (%)	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3-month LIBOR (%)	0.33	0.28	0.27	0.26	0.24	0.23	0.23	0.25
10-Yr Treasury Note Yield (%)	2.06	2.33	1.93	2.17	2.50	2.51	2.72	3.00
30-Yr Treasury Bond Yield (%)	2.87	3.11	2.54	2.75	3.21	3.34	3.56	3.94
BAML U.S. Corp. Bond Index Yield to Worst vs Govt	172	141	131	138	113	102	111	118
10-Yr Interest Rate Swap Spread (bp)	-5.5	11.3	10.0	11.5	14.3	9.8	12.0	6.5

* Figures are either quarterly or, if more frequent, end of period. f = Forecast[1]; a = Actual through August 2015 Source: Macrobond, Bloomberg LP

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 has been an on-again, off-again affair in 2015. Cold weather and West Coast port strikes helped slow first quarter inflation-adjusted gross domestic product (real GDP) growth to just 0.6%. Second-quarter growth jumped to 3.9% on stronger consumer spending. However, a wider trade deficit, slower inventory accumulation and more moderate investment spending probably slowed growth in the third quarter. Economists now expect 2.0% real GDP growth in Q3 and 2.7% in Q4[1]; if so, that would bring 2015 economic growth to 2.3%, slightly below 2014's 2.5% pace. Our own GDP forecasts are broadly in-line with consensus – and below the 2.5-3.0% growth rate we expected coming into 2015.

So far, economic growth has remained below the threshold required by the Federal Reserve to begin tightening monetary policy. The unemployment rate fell by more than the Fed anticipated entering 2015, but wage growth remained subdued. Moreover, inflation slowed and forecasts of global economic growth weakened. Three months ago, we thought an initial rate hike probably would occur between September and December 2015, with risk that it could be delayed into 2016. We still think the Fed would like to begin normalizing rates with a 25 basis point (bp) rate hike in December. U.S. domestic growth should be strong enough to justify it, but it's unclear whether global economic growth and inflation will cooperate. Whenever the Fed decides to raise rates, it's likely to remove monetary accommodation very slowly. We think the U.S. economic, credit and interest rate outlooks should remain relatively favorable for preferred investors over coming quarters.

Figure 2: Tepid Job Growth & Participation

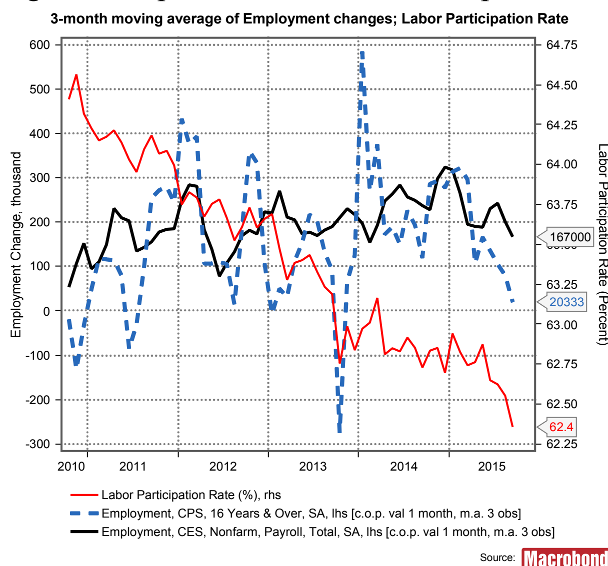
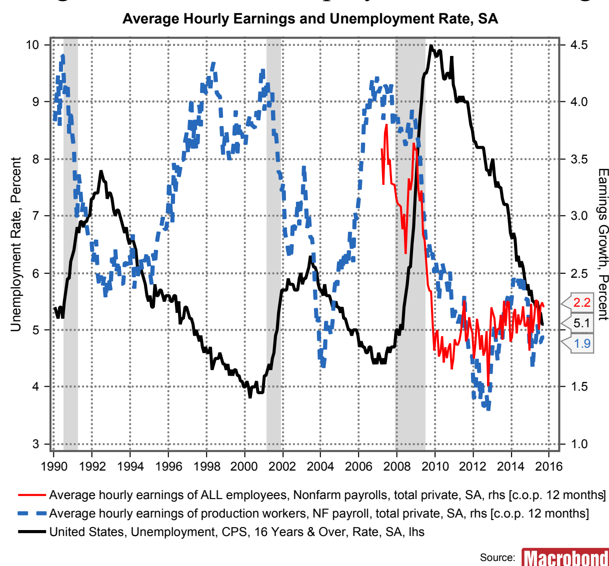


Figure 3: Lower Unemployment, Slow Wages



Labor market conditions ended the third quarter on a down-note but remained strong in absolute terms (Figure 2). After a fast start in July, payroll job growth slowed in August and September, adding an average of 167,000 jobs per month in Q3, down substantially from 231,000 new jobs per month last quarter. Total payroll employment was up 2.0% YoY in September, about where it has been for nearly four years. The household employment survey was even weaker, posting only

[1] Unless noted otherwise, forecasts are from the *Survey of Professional Forecasters*, Federal Reserve Bank of Philadelphia, August 14, 2015 and Bloomberg® *Monthly Economic Survey*, October 8, 2015.

20,000 average monthly job gains in Q3, compared to a Q2 average of 136,000 – although we think the much larger payroll survey provided a more accurate reading of job growth during the quarter. Despite tepid job growth, the unemployment rate fell to 5.1% in September from 5.3% in June because the labor participation rate fell by 0.2% to 62.4%. We expect a downward drift in labor participation due to demographic shifts, most notably, retirement of the "baby boom" generation. However, a strong labor market should pull many employable adults back into the labor force, and that simply is not happening.

Wages tell a similar story. Normally, lower unemployment goes hand-in-hand with faster wage growth (Figure 3). There is usually a lag involved, as is visible in 1992-94 and again in 2004-05, but lower unemployment historically was associated with more rapid wage growth. The impact of lower unemployment on wages in the most recent recovery, however, has been muted. Hourly wage growth has been stuck around 2% since 2010. Slow wage growth is another sign that there is more labor-market slack than implied by today's low unemployment rate.

Although employment and wages could be better, it isn't all bad news. Job growth of 2% combined with hourly wage growth of 2% and a steady workweek translates to aggregate wage growth of about 4%, which is relatively strong given very low inflation. We would like to see faster wage growth, but stronger productivity gains probably need to come first, and that does not appear likely near-term. Productivity growth averaged 2.2% in the post-World War II era, but it averaged 1.2% for the past decade and was up just 0.8% YoY in Q2 (see Figure 11 below). Expect moderate job and wage growth to continue for some time to come.

Figure 4: Income, Spending & Savings Steady

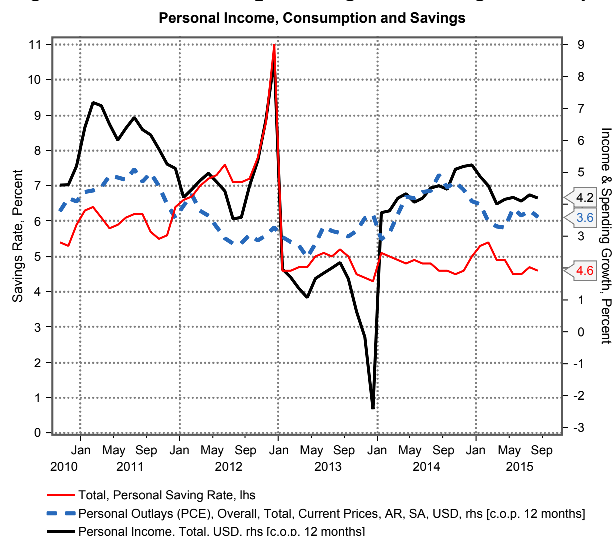
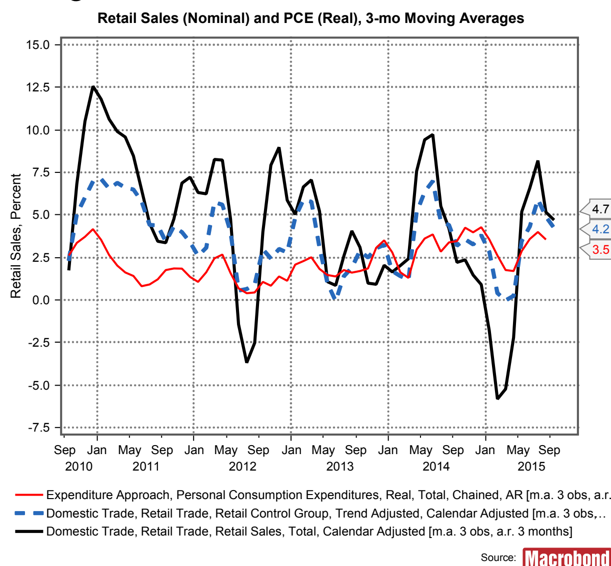


Figure 5: Retail Sales Slower but Solid



With wages and employment growing steadily, if unspectacularly, **personal income** growth remains relatively strong. Through August (latest data available), personal income was up 4.2% YoY, in-line with recent results (Figure 4). Real personal income excluding transfer payments was up 3.8% YoY, not far off nominal income growth owing to low inflation. The current pace of income growth should continue to support moderate growth in personal consumption over coming quarters.

Real **personal consumption expenditure** (PCE) rose a brisk 3.6% in the second quarter and appears to have remained relatively strong in Q3, despite disappointing retail sales in September. For the third quarter, real PCE was up 3.0% through August compared to its second-quarter average and up 3.2% YoY. Core retail sales edged lower in September after two strong months, but they were still up 4.2% (nominal) compared to their Q2 average (Figure 5). We expect real PCE to grow at about a 3% pace in the third quarter.

The **savings rate** was 4.6% in August and averaged 4.7% over the past six months. As shown in Figure 4, the savings rate edged lower in 2015 as consumers spent some of their savings from lower gasoline prices when weather improved. With the savings rate now hovering around its average level of 4.8% since early 2013, we expect that consumption growth will track income growth relatively closely.

The **housing market** has performed well in 2015. Residential investment grew by an average of 9.8% in the first half of 2015 and 8.2% YoY through the end of Q2. It appears to have grown at a similar pace in the third quarter. Total new and existing home sales hit a post-crisis peak of 6.1 million units in July and then eased slightly to 5.9 million units in August (latest data available; see Figure 6). That compares to an average sales pace of 5.8 million units in Q2. Inventories of unsold homes held about steady. Home price gains held firm: the Federal Housing Finance Authority's home price index was up 5.8% YoY in July while the S&P/Case-Shiller 20-city home price index was up 5.0% YoY in July (latest data available for each index), about where they were last quarter. Because home prices outpaced income, home affordability edged lower. We think residential investment will remain a bright spot into 2016, although it is bound to slow from its recent pace of nearly 10% growth.

Figure 6: Housing Remained Strong

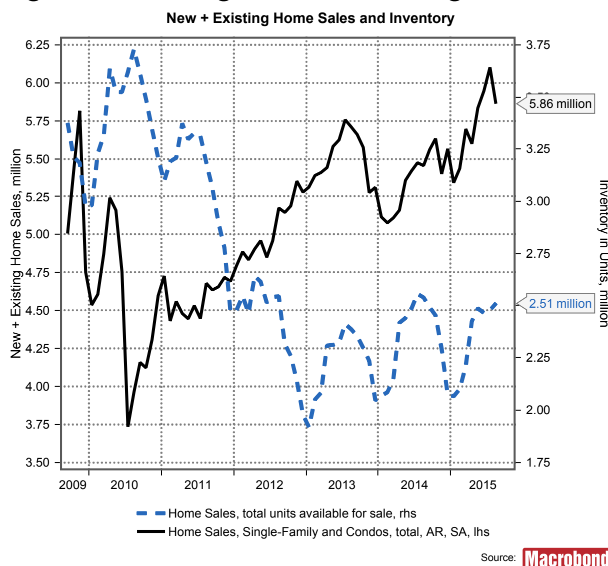
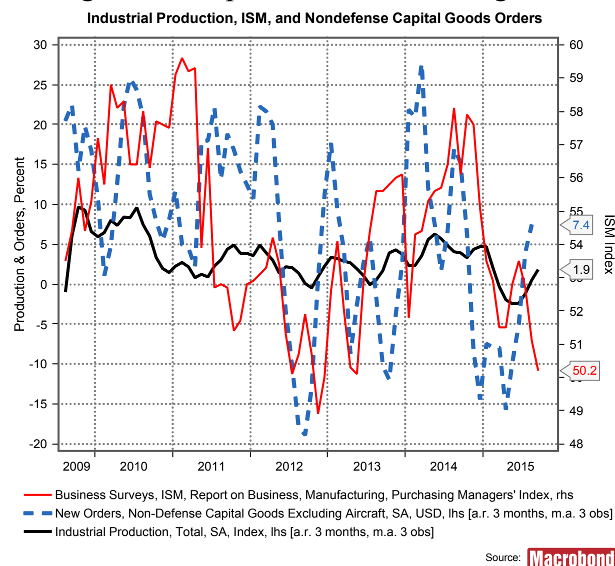


Figure 7: Output Weak but Turning?



Industrial production was hit hard by cold winter weather and West Coast port strikes in early 2015, and it was walloped again by weaker growth abroad and lower energy investment domestically in Q2 and Q3. It is only now beginning to recover (Figure 7). Overall industrial production rose 2.1% so far in Q3 (through August); even mining, which includes oil and gas extraction, was up 3.2%. Unfortunately, these recoveries don't make up for declines of 2.6% and

13.8%, respectively, in the second quarter. On balance, production is about unchanged both overall and excluding vehicles over the past three months compared to the prior three months.

This would be more encouraging if the Institute for Supply Management's manufacturing survey (red line in Figure 7) were also edging up, but that is not the case. Orders are finally improving, however. Core capital goods (nondefense, excluding aircraft) orders were up 7.4% in three-months ending in August (latest data available), after falling 5.4% in the second quarter. We expect to see manufacturing output begin to turn up over the next quarter or two, although exports are likely to remain challenging for some time.

Real **business investment** rose 4.1% in Q2, considerably better than we anticipated. We continue to take a cautious view on business investment over the next several quarters, however. A steady rise in capacity utilization drove more rapid growth in business investment in 2014. In 2015, capacity utilization growth slowed and then turned negative, while business investment excluding structures continued to grow at a solid pace (Figure 8). We anticipate core business investment (excluding structures) will slow, reflecting little need for businesses to add capacity currently. Investment in structures remains strong, however, and should partially offset weakness in other forms of business investment. We expect overall real business investment growth to slow to 2-3% in the third quarter.

The **trade deficit** narrowed modestly in the second quarter after widening slightly in Q1, but it widened substantially in July and August (Figure 9). Net exports added 0.2 percentage points to Q2 real GDP growth, and we estimate it will subtract 0.5-1.0% from real GDP in Q3. It is also worth noting that import and, especially, export growth has slowed substantially this year, reflecting weaker economic growth globally. Looking ahead, U.S. growth is likely to outpace most of its trading partners over the next year or two; expect trade drag to persist over that time.

Figure 8: Business Investment Likely to Slow

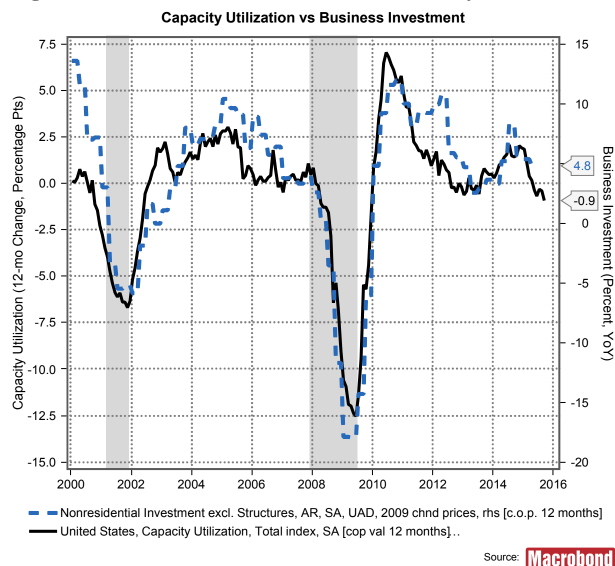
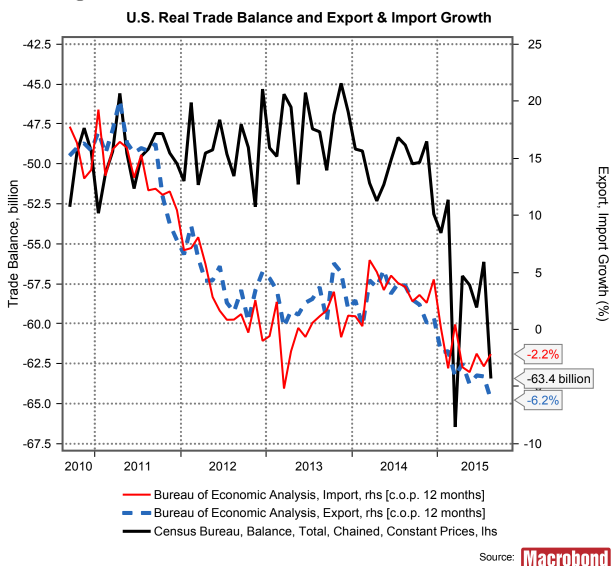


Figure 9: Headwinds from Trade



Government consumption rose 2.3% in the second quarter, adding 0.5% to real GDP growth. State and local spending accounted for all of that increase; real federal spending was flat. Government employment rose modestly (29,000 jobs per month) in the third quarter – again, all at state and local levels – which suggests another modest contribution by government

consumption to Q3 growth. Federal spending is gridlocked and may remain that way until 2017, although some incremental spending might be passed as part of a debt ceiling extension bill in late October or early November. With state and local governments adding most new spending, we expect overall government spending growth to lag GDP growth over coming quarters, but we still expect it to contribute slightly to growth.

Figure 10: Inflation Slow and Steady

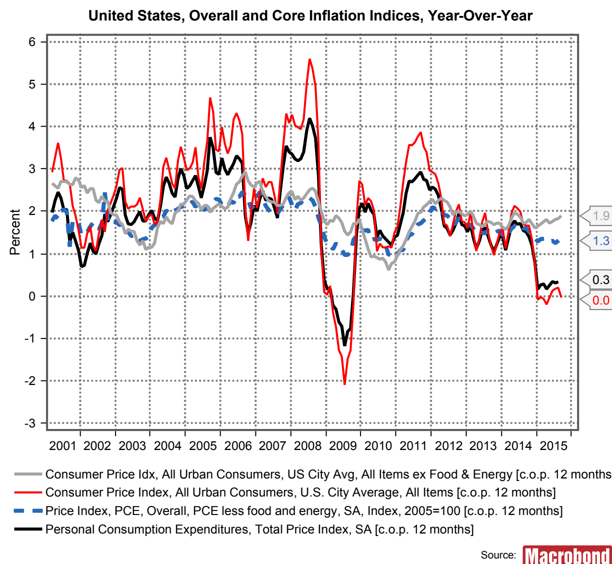
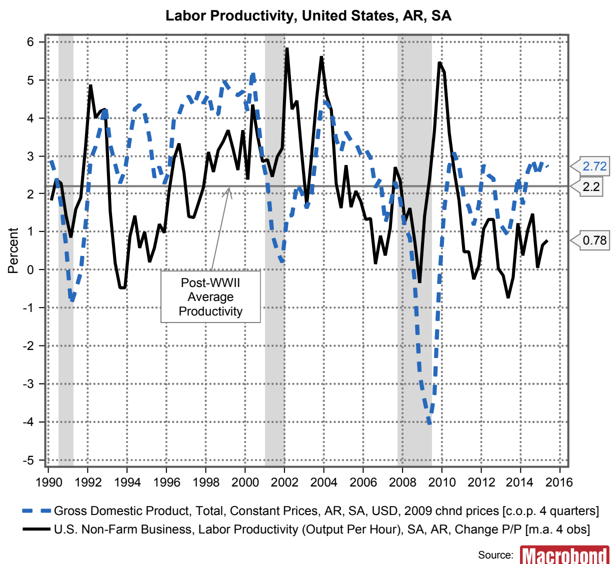


Figure 11: Low Productivity Restraining Growth



Inflation again moved sideways in the third quarter, as it did for most of 2015 (Figure 10). Energy prices retreated after moving up modestly in Q2. For 12 months ending in September, the consumer price index (CPI) was unchanged overall and up 1.9% excluding food and energy. Over 12 months ending in August (latest data available), the PCE deflator was up 0.3% overall and 1.3% excluding food and energy. Falling import and export volumes and a stronger dollar pushed down prices on globally traded goods. Likewise, falling capacity utilization restrained prices of domestic goods. Slow wage growth allowed businesses to limit price increases on services too. The Fed is pacing the room, impatiently waiting for inflation to return.

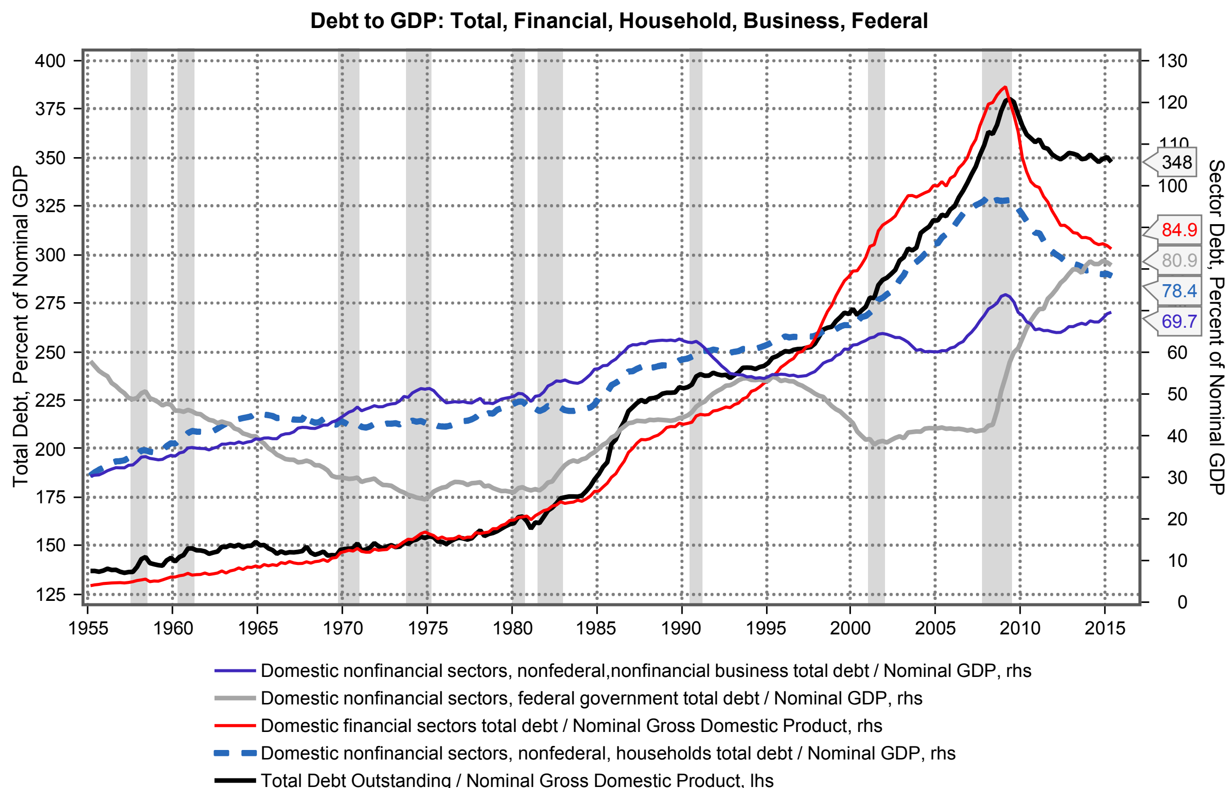
Before concluding this section with our usual review of debt trends, we would like to take a moment to discuss **productivity**. Low productivity growth, if sustained, is a serious long-term economic problem. In simplified terms, domestic economic growth is the product of labor input and productivity. Assuming a stable workweek, an economy's potential growth rate is determined by its labor force growth (in the U.S., about 1% annually) and productivity growth. Long-term productivity growth averaged 2.2% in the post-World War II era; recently it's been running below 1% (Figure 11). If sustained, that would reduce potential GDP growth from over 3% to less than 2%. Although that may not sound like a big difference, it is. Over 30 years with steady 1% labor force growth, 0.9% productivity growth would translate to 1.9% real GDP growth, and the U.S. economy would expand by about 76% overall and 30% per capita. At 3.2% real GDP growth (1% labor + 2.2% productivity), the economy would expand by 157% and per capita GDP would rise by 90%, two and three times better, respectively, than at the lower productivity growth pace. Since labor typically captures a sizable share of productivity growth in the form of higher real wages, wage growth also suffers when productivity growth is low.

Finally, because the economy's "speed limit" is lower, the Federal Reserve has to adjust more quickly to changes in output, which increases chances for monetary policy mistakes.

We are not policymakers and don't have a prescription for raising productivity growth, but fiscal, and regulatory policies have to play a major role. The U.S. cannot meet its Social Security, Medicare and other entitlement responsibilities – not to mention military and domestic spending priorities – with sub-1% productivity growth. We are not optimistic that these policies will change for the better over the coming year, although there is a chance of reform in 2017 and beyond, regardless of who wins the White House.

Finally, broad **balance sheet trends** in the U.S. were little changed again in the third quarter (Figure 12). As GDP growth recovered from adverse winter weather, overall debt-to-GDP edged lower to 348% in the second quarter (latest data available), about where it has been for three years. Leverage was steady or lower in each broad borrowing category except nonfinancial businesses. Leverage there remains manageable at 70% of GDP, but it has trended higher when others sectors have reduced leverage, and it bears watching.

Figure 12: Debt Stable but Elevated; Growth at Nonfinancial Corporations Bears Watching



Although it is down from its peak, overall debt-to-GDP remains high historically. Low interest rates and moderate economic growth make current debt levels easy to support. However, substantially higher rates or slower growth could strain borrowers. We do not think recession is likely over the next several years, but we know one will arrive eventually. Similarly, the Fed is likely to remove monetary policy accommodation very slowly to avoid a rapid increase in aggregate borrowing cost, but it knows that a long period of low rates fosters its own problems;

rates are going to rise eventually. Finally, recognizing these risks, borrowers should continue to gradually reduce leverage over time. The Fed's zero interest rate policy has delayed but probably not erased that trend. Although not a major feature of our outlook, deleveraging should be a mild headwind to economic growth – and interest rates – going forward.

Market Outlook

Long-term **Treasury rates** eased in the third quarter as global economic growth slowed, oil prices fell and the Federal Reserve decided to hold the federal funds rate steady. After jumping by 58 basis points (bp) in the second quarter, the 30-year benchmark Treasury yield dropped by 27 bp to 2.85% on September 30, and the 10-year Treasury note yield fell by 31 bp to 2.04% (Figure 13). Both are roughly unchanged so far in October.

After signaling to markets that a rate hike was approaching, the Federal Open Market Committee (FOMC) again decided to leave the federal funds rate target unchanged at 0-0.25% at its September meeting. While U.S. domestic economic activity was strong enough to prompt Fed tightening in September, global growth prospects waned, oil prices slipped, the U.S. dollar rallied and the trade deficit widened. To top it off, employment growth slowed in September and Q3 GDP growth probably softened, making it likely the Fed will keep policy on hold again at its October 27-28 meeting. It's possible that economic growth will be strong enough over the next several months to prompt the FOMC to begin raising rates in December, but risk remains skewed toward a later move rather than an earlier one.

Overall, our thoughts on Fed policy from last quarter's Economic Update have not changed much, although global economic developments may further slow the Fed's timetable for policy tightening. The Fed should proceed cautiously, taking time to assess economic and market impacts following each rate hike. We still 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 it would not take much for the Fed to decide to go more slowly, especially over the next several quarters.

Figure 13: Rates and Forwards Lower

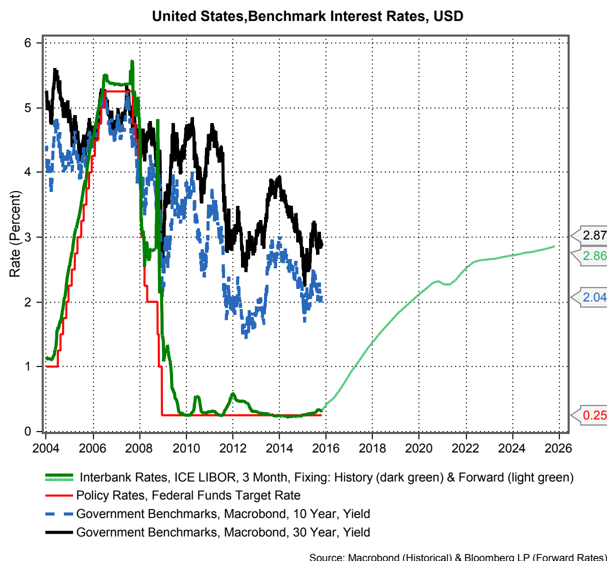
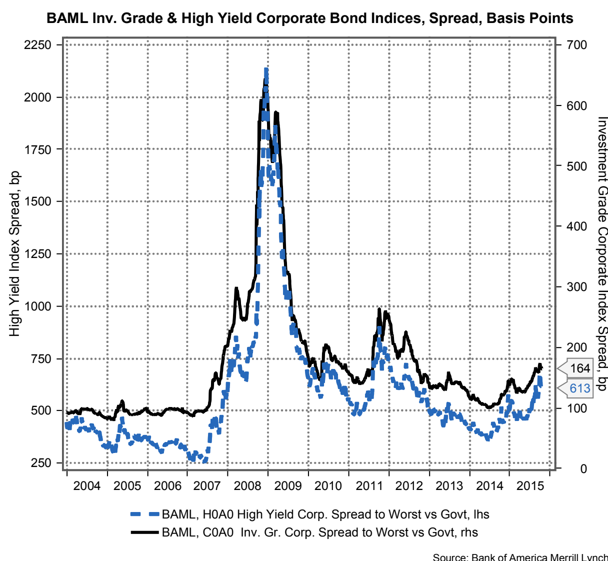


Figure 14: Corporate Spreads Wider



As investors adjusted to that new outlook, interest rates fell and forward curves dropped. Forward rates are now a little lower than our outlook, but rates do not need to rise much for them to align with our view. Accordingly, we continue to expect gradually rising, albeit volatile, long-term rates but no major market sell-off, which should be a relatively benign interest-rate environment for preferred securities.

Corporate **credit spreads** widened in the third quarter as corporate debt issuance increased (see Figure 20 on the next page) and worries over slower global economic growth pressured spreads. Investment-grade corporate bond spreads[2] widened by 31 bp to 172 bp, about equal to the decline in Treasury yields. High yield bond spreads[3] fared much worse, widening by 156 bp to 665 bp (Figure 14). Spreads on those indices narrowed by 8 bp and 52 bp, respectively, so far in October. Yield spreads on preferred securities fared a little worse than corporate bonds but much better than high yield bonds. "Spread to Worst" on a broad Bank of America Merrill Lynch preferred securities index widened by 40 bp to 308 bp in the second quarter; it is unchanged so far in October.[4] Perhaps more relevant to investors, price returns on those preferred and corporate indices were both down 0.6% in the third quarter, compared to -6.5% for the high yield index.[5]

Figure 15: Loan Growth Slowed Slightly

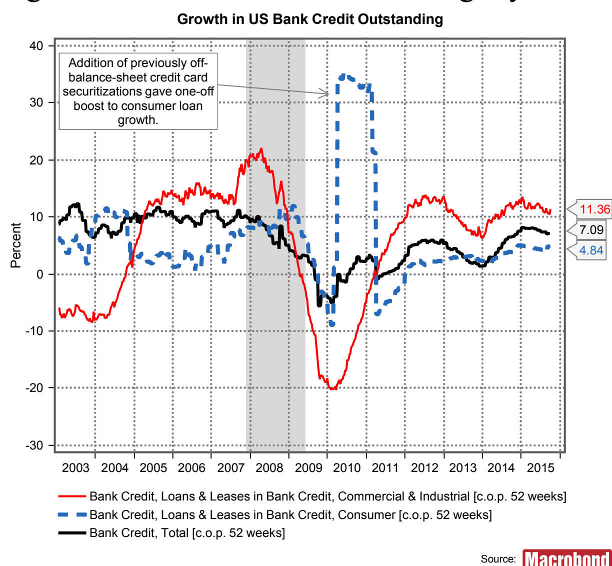
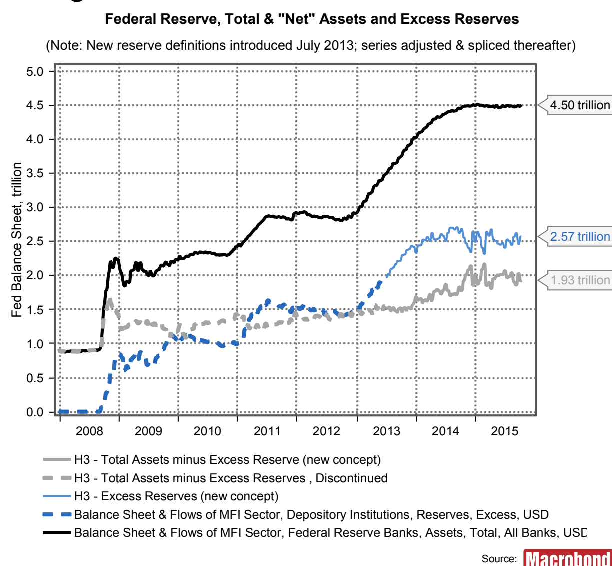


Figure 16: Fed Balance Sheet Flat



Bank credit growth slowed slightly in the third quarter but remained relatively strong (Figure 15). Aggregate bank lending was up 7.1% in the 12-month period ending in October, down a bit from 7.5% in 4Q2014. Commercial and industrial loans continued to lead growth in bank lending, up 11.4% YoY. Consumer loans at banks accelerated slightly and were up 4.8% YoY in October.

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[2] Investment-grade corporate bond spread is represented by the Bank of America Merrill Lynch U.S. Corporate Index℠ (C0A0) "Yield to Worst versus Government" yield spread series. See note 4 below for definition.
[3] Below-investment-grade corporate bond spread is represented by the Bank of America Merrill Lynch U.S. High Yield Index℠ (H0A0) "Yield to Worst versus Government" yield spread series. See note 4 below for definition.
[4] Preferred index is the Bank of America - Merrill Lynch 8% Constrained Core West Preferred & Junior Subordinated Securities Index℠ (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.
[5] Price return includes price change only and does not include income; total return, which includes both, is higher.

The Fed's balance sheet was nearly unchanged in the third quarter (Figure 16). The Fed continues to reinvest principal payments on its securities holdings into new securities, but it is no longer buying securities with newly-created reserves. Excess reserves (blue line) and the Fed's "net" balance sheet (gray line) were more volatile but little changed on balance. Banks are not rushing to lend excess reserves, so this base money remains parked at the Fed rather than circulating in the economy.

Figure 17: Corporate Profits Flat but High

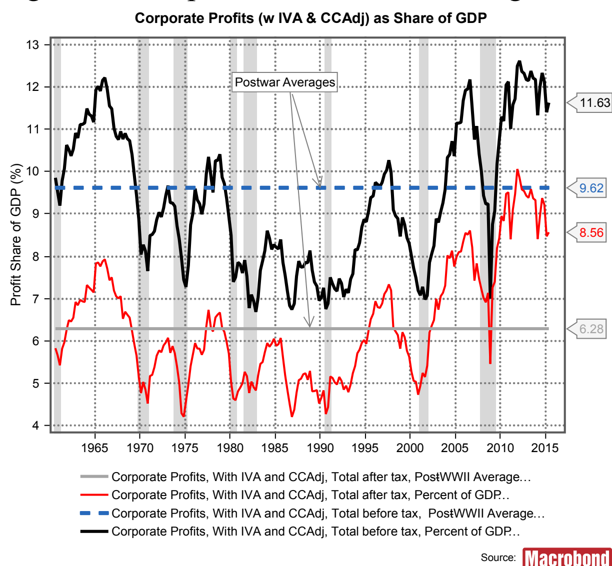


Figure 18: Balance Sheets Remain Strong

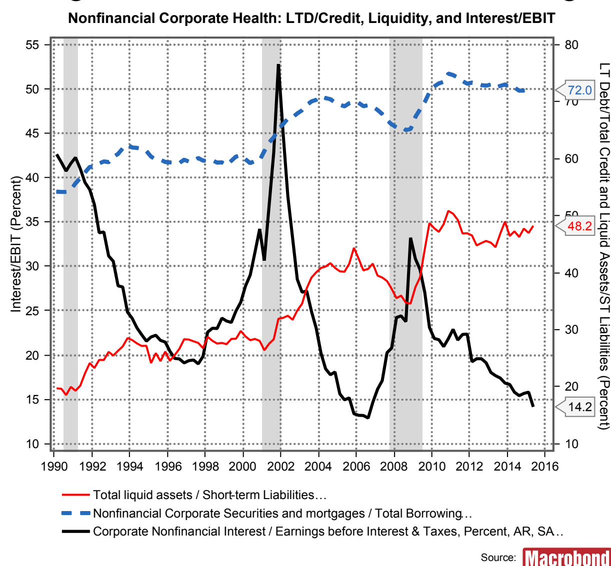


Figure 19: Loan Quality Still Looks Good

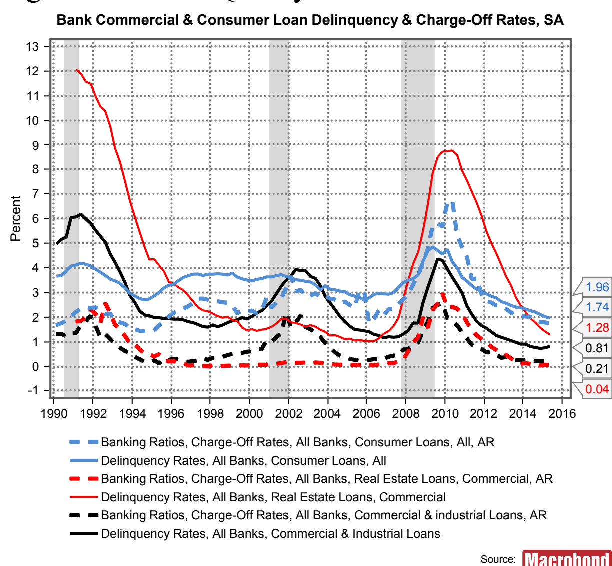
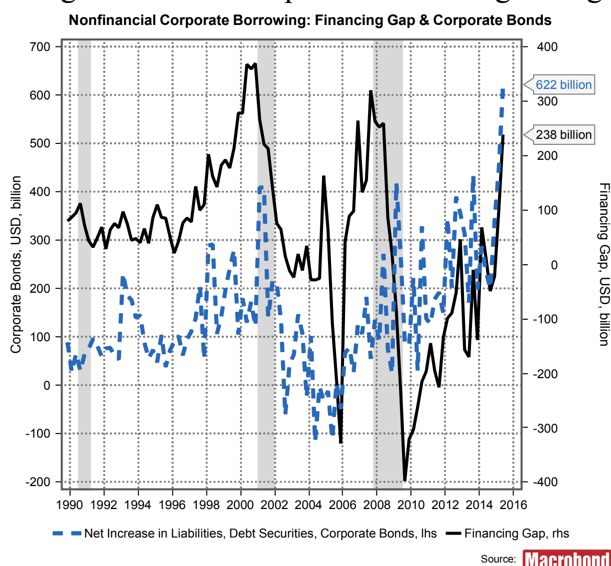


Figure 20: But Corporate Borrowing Rising



Fundamental **credit conditions** were mostly steady in the second quarter (latest data available), but there was some deterioration in nonfinancial corporate balance sheets. Corporate profits edged up in Q2 and remain very high as a proportion of GDP (Figure 17), although they are expected to decline modestly in Q3. Corporate balance sheets remain strong: interest expense as a percentage of earnings before interest and taxes dropped further, and liquidity continued to

improve, However, long-term debt to total debt, while still high, is trending down and could expose companies to greater refinancing risk over time (Figure 18). Loan delinquencies and charge-offs mostly edged lower, although delinquency rates on commercial and industrial loans ticked up (Figure 19). Overall, bank earnings are improving and balance sheets are very strong.

In contrast to this picture of general improvement in credit conditions, nonfinancial corporations increased borrowing as internally generated cash dropped further below spending on capital investments. This increase in the "financing gap" resulted in substantially greater issuance of corporate bonds by these companies (Figure 20). Energy companies, whose profits and free cash flow have plunged, are partly responsible for this development. Merger and acquisition activity has also added substantially to debt. For now, low interest rates and strong earnings make this debt easy to support, as interest-to-EBIT figures show. However, the financing gap has risen to a level that preceded problems in the past, so we will be watching this sector carefully over coming quarters.

Looking ahead, we still believe the U.S. economy can achieve real GDP growth of 2.5-3.0% as consumer spending picks up and headwinds from government fiscal restraint and trade diminish. That will not happen in 2015 and perhaps not in 2016 either. U.S. economic growth will probably be stuck in a 2.0-2.5% range until global growth improves. Employment growth should continue to drive down the unemployment rate, although limited productivity gains and competition from abroad mean wage growth should remain slow. 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 mostly reflect, and long-term rates should rise only gradually as the economy improves.

Credit quality, while deteriorating in spots, remains strong at most issuers of preferreds – especially banks. Preferred securities continue to offer an attractive combination of high yield, intermediate duration, and good credit quality in today's markets; spreads should have room to narrow over time. 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, as they did in the third quarter. We think prospective returns on preferred securities remain attractive for long-term investors.

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