Fourth-Quarter U.S. Economic Update
February 2017

Summary of Recent Economic Developments

The U.S. economy downshifted in the fourth quarter, capping another year of sub-2% growth. Fourth-quarter real GDP expanded by 1.9%, putting second-half growth at 2.7% compared to just 1.1% in the first half of 2016. For the full year, real GDP expanded by 1.9%, equal to its 2015 pace. Job growth slowed slightly but remains strong, and wages accelerated modestly. Personal income and consumption also slowed a bit, but buoyant confidence should boost spending over the next several quarters. Residential investment rebounded strongly after two quarters of contraction, and home prices rose moderately. Business investment improved after four soft quarters, and a nascent rebound in manufacturing gained strength. We expect gains in residential and business investment should drive better (2.0-2.5%) real GDP growth in 2017. Net exports was a sizable drag on GDP in Q4, and we expect trade will remain an economic headwind in 2017. Government consumption rose modestly. Core inflation was stable, but headline inflation rose along with energy prices. Interest rates jumped on President Trump's surprise election victory, continued expansion, and a 25 bp rate hike by the Federal Reserve. Credit spreads narrowed, but corporate bonds and preferred securities posted negative total returns for the quarter. Credit conditions among issuers of preferred securities were stable or better on balance. Although markets may remain volatile as the Trump administration rolls out its tax, regulatory, immigration, trade and fiscal spending policies, we believe preferred securities continue to offer an attractive combination of high income and credit quality for long-term investors.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	2016:4	2016:3	2016:2	2016:1	2015:4	2015:3	2015:2	2015:1
Real GDP, Chg QoQ (%, SA, AR)	1.9	3.5	1.4	0.8	0.9	2.0	2.6	2.0
Real Personal Consump Expnds, Chg QoQ (%, SA, AR)	2.5	3.0	4.3	1.6	2.3	2.7	2.9	2.4
Real Business Inv ex Stuctures, Chg QoQ (%, SA, AR)	4.3	-1.1	1.8	-4.3	-0.1	6.1	2.8	5.5
Real Residential Investmt, Chg QoQ (%, SA, AR)	10.2	-4.1	-7.8	7.8	11.5	12.6	14.8	13.4
Real Private Domestic Final Sales, Chg QoQ (%, SA, AR)	2.8	2.4	3.2	1.1	1.8	3.3	3.2	2.7
Nominal GDP, Chg QoQ (%, SA, AR)	4.0	5.0	3.7	1.3	1.8	3.2	4.9	2.1
Corporate Profits, After Tax, Chg YoY (%, SA, AR)	12.7f	0.6	-5.8	-6.5	-18.3	-6.0	-2.9	7.9
Nonfarm Productivity, Chg QoQ (%, SA, AR)	1.3	3.5	-0.2	-0.6	-2.4	2.0	1.2	1.1
Nominal Personal Income, Chg YoY (%, AR)	3.5	3.6	3.4	3.6	4.0	4.0	4.5	4.3
Personal Savings Rate (%, SA)	5.4	5.6	5.8	6.2	6.1	5.9	5.8	5.3
Unemployment Rate (%, SA)	4.7	4.9	4.9	5.0	5.0	5.0	5.3	5.4
Nonfarm Payrolls, Chg QoQ (000, SA)	495	636	439	587	846	576	752	570
Household Employment, Chg QoQ (000, SA)	185	836	-211	1271	1098	190	498	723
Federal Budget, 12-mo Def or Surp (% of GDP)	-3.1	-3.2	-2.9	-2.5	-2.7	-2.5	-2.5	-2.9
Consumer Price Index, Chg YoY (%, AR)	2.1	1.5	1.0	0.9	0.7	0.0	0.1	-0.1
CPI ex food & energy, Chg YoY (%, AR)	2.2	2.2	2.2	2.2	2.1	1.9	1.8	1.8
Capacity Utilization (%, SA)	75.5	75.3	75.4	74.9	75.4	76.4	76.4	77.3
Rate or Spread (End of Quarter)	**2016:4**	**2016:3**	**2016:2**	**2016:1**	**2015:4**	**2015:3**	**2015:2**	**2015:1**
Federal Funds Rate Target (%)	0.75	0.50	0.50	0.50	0.50	0.25	0.25	0.25
3-month LIBOR (%)	1.00	0.85	0.65	0.63	0.61	0.33	0.28	0.27
10-Yr Treasury Note Yield (%)	2.43	1.59	1.49	1.78	2.27	2.06	2.33	1.93
30-Yr Treasury Bond Yield (%)	3.05	2.32	2.31	2.62	3.01	2.87	3.11	2.54
BAML U.S. Corp. Bond Index Yield to Worst vs Govt	126	138	158	165	168	172	141	131
10-Yr Interest Rate Swap Spread (bp)	-11.3	-14.0	-11.3	-14.0	-8.8	-5.5	11.3	10.0

* Figures are either quarterly or, if more frequent, end of period. f = Forecast[1]; a = Actual through November 2016 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

The U.S. economy downshifted in the fourth quarter, capping another year of sub-2% growth. Fourth-quarter inflation-adjusted gross domestic product (real GDP) expanded by 1.9%, putting second-half growth at 2.7% compared to just 1.1% in the first half of 2016. For the full year, real GDP expanded by 1.9%, equal to its 2015 pace. Looking ahead, economists expect 2.3% real GDP growth in 2017, in-line with our 2.0-2.5% forecast.[1] Markets, however, appear to expect still-faster economic growth, propelled by hopes for more growth-friendly policies from the new Trump administration. So before examining its major sectors in detail, it's worth thinking about how the new Trump administration might affect U.S. economic growth.

While policy specifics are still being formulated, some of President Trump's policies could benefit economic growth. To start, tax reform could improve economic efficiency. There are too many competing proposals to know what shape tax reform might take, but if the final plan lowers rates and narrows deductions (i.e., broadens the tax base), then it should improve economic efficiency, lower tax compliance costs and promote economic growth at whatever tax rates are enacted.

A reduced regulatory burden on businesses would improve productivity and enhance growth. Although most regulations will remain intact, many can be better targeted, and some can be eliminated entirely. A lighter regulatory burden could lower cost without reducing output and, thus, raise productivity and economic growth.

However, Mr. Trump also campaigned on policies that may dampen economic growth. These include tariffs and trade restrictions that raise costs to consumers, increase inflation and, thus, lower living standards. In addition, they typically result in retaliation from countries affected by them, which would lower U.S. exports, employment and income. Consequences may be particularly adverse today, since the U.S. economy relies on a global supply chain, often with few domestic alternatives.

Proposals to restrict immigration also could slow economic growth. Since the U.S. population (before immigration) is projected to begin shrinking within a generation, the United States is going to need immigration to sustain labor force growth. The trick is to better match those we admit with labor demand (particularly in areas where there are clear labor shortages), which should enhance both economic growth and social stability. Although immigration reform could benefit growth if done right, there's a lot of room to get it wrong.

Finally, infrastructure spending could be good, bad or neutral; it all depends on where the money is spent. Even when well-intentioned, infrastructure spending usually lacks price signals, so it's difficult to discern which projects are most needed. Thus, a lot of (politically-directed) infrastructure spending generates low or even negative returns, while every dollar of it would need to be deficit-financed. Mr. Trump aims to avoid those pitfalls through public-private partnerships, though it's unclear what form those would take or if they might create other problems.

Adding it up, we think most of these policies are likely to affect economic growth – and, thus, monetary policy – only at the margin. The U.S. economy still faces constraints from slowing

[1] Unless noted otherwise, forecasts are from the *Livingston Survey*, Federal Reserve Bank of Philadelphia, December 9, 2017 and Bloomberg® *U.S. Monthly Economic Survey*, January 12, 2017.

population growth, an aging workforce, poor educational outcomes for many citizens, and sluggish productivity growth – none of which can change very quickly regardless of government policy. Some of the policies outlined above could improve productivity and growth, while others could detract from them. Moreover, global economic growth remains challenged, and excess capacity in the U.S. and abroad limits potential returns on U.S. investment in many industries. As our real GDP growth forecast of 2.0-2.5% suggests, we anticipate modestly better performance in 2017, but we don't expect the economy will leap to a new, higher plateau of activity.

Figure 2: Employment Growth Slowing…

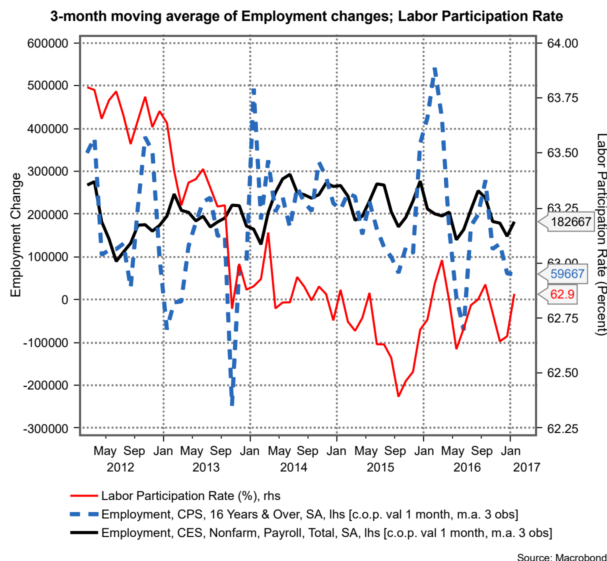
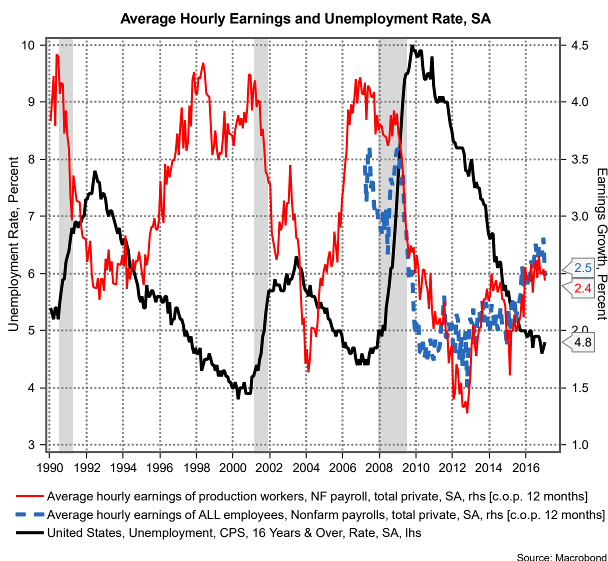


Figure 3: …but Wages Gradually Accelerating



Turning to major sectors of the economy, the **labor market** was again strong in the fourth quarter, although job growth has slowed over the past several years (Figure 2). Payroll jobs rose by an average of 165,000 jobs per month, down a bit from an average of 185,000 jobs per month during 2016's first three quarters but still a strong performance. In addition, the January 2017 payroll report, released February 3, showed faster job growth at the start of 2017. The more-volatile household employment survey showed gains of only 62,000 jobs per month in the fourth quarter, and they were actually down slightly in January 2017. However, both payroll and household surveys posted similar job gains for all of 2016 at 2.16 and 2.08 million, respectively. The surveys showed average employment growth of 1.4% in 2016 (December to December). That is slower than 2015's 1.8% growth rate, which in turn was down from 2.0% in 2014. As labor market slack gradually diminishes, job growth is likely to continue to slow, which will put a bigger burden on productivity improvements to sustain GDP growth.

The unemployment rate fell to 4.7% in December from 4.9% in September and 5.0% a year ago; it ticked up to 4.8% in January 2017. Labor participation fell to 62.7% in December from 62.9% in September and was back up to 62.9% in January; it has been broadly stable since late 2015. We had expected that rising wages would boost labor participation modestly, but so far that has not happened. It could reflect mismatched job skills, higher off-the-books employment, a broader safety net, or other factors in addition to a gradually aging workforce. Low labor participation is another reason to expect a slower pace of job growth over coming quarters. The labor force is growing around 1% annually, below employment growth. That puts downward pressure on an already-low unemployment rate and upward pressure on wages.

Unsurprisingly, average hourly earnings accelerated. Hourly wages rose 2.9% YoY in December compared to 2.7% in September and 2.6% in December 2015, though they eased to 2.5% YoY in January 2017 (Figure 3). Fortunately, productivity accelerated along with wages. Productivity remains low historically at 1.0% YoY in the fourth quarter, but that's up from just 0.4% a year ago. While there is risk that faster wage growth could drive up inflation, rising productivity supports higher wages without stoking inflation. This should give the Federal Reserve more time to see how the economy responds to its latest rate hike and where the Trump administration takes tax, regulatory and fiscal policy.

Figure 4: Income, Spending Growth Moderate

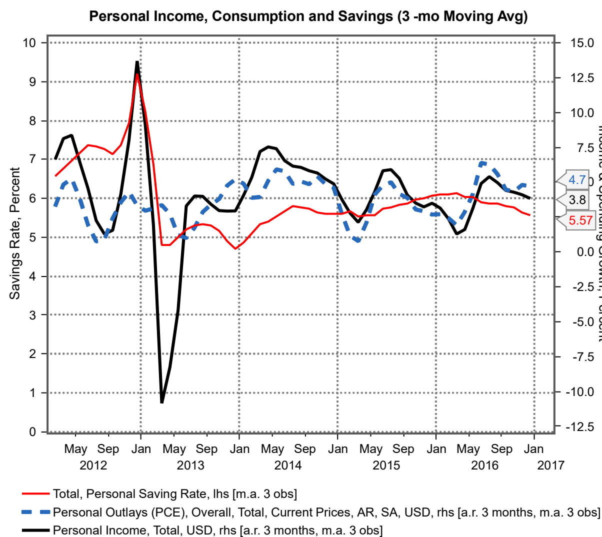
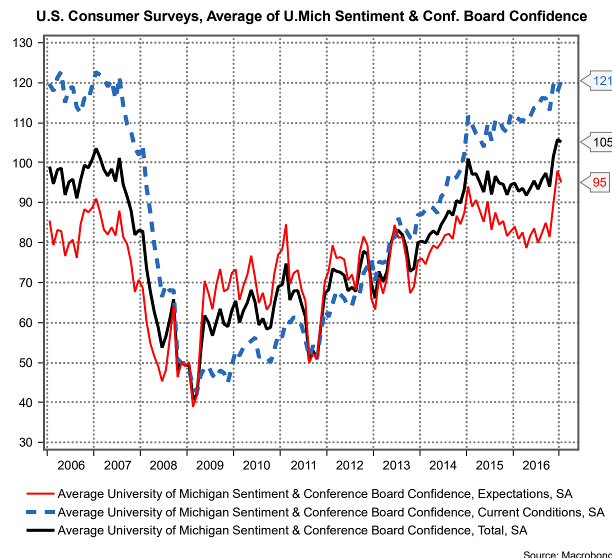


Figure 5: Confidence Up Since Election



Rising employment and earnings helped generate moderate gains in **personal income** in the fourth quarter (Figure 4). Nominal personal income rose 2.8% in Q4 over Q3, and it was up 3.5% YoY in December. After inflation, income was up about 1.6% in Q4 and 1.9% YoY. For reasons we discussed in August,[2] personal income growth has edged lower for the past few years, and we expect that to persist in 2017.

Real **personal consumption expenditure** (PCE) again grew more quickly than income, as rising confidence boosted consumer spending. While consumers' assessment of current economic conditions rose fairly consistently since 2012, expectations lagged (Figure 5). After the November election, however, consumer expectations surged. The gap between current conditions and expectations remains relatively wide, but it closed considerably, and this should support moderate growth in consumer spending over the next several quarters.

For the fourth quarter, real PCE was up 2.5%, slightly below 2016's 2.8% pace. Strong consumption growth combined with modest income growth pushed the **savings rate** down to an average of 5.6% in Q4 from 5.8% in Q3 (Figure 4). We remain unconcerned about this drop given good job gains, rising wages and confidence, and solid consumer balance sheets. Eventually, faster income growth will be needed to sustain current consumer spending, though we would not be worried if the savings rate edges lower for a few more quarters.

[2] See Flaherty & Crumrine, *Second-Quarter U.S. Economic Update*, August 2, 2016.

After two weak quarters, the **housing market** rebounded strongly in the fourth quarter. Residential investment jumped 10.2% in Q4 after an average of -5.9% in Q2 and Q3; it edged up 1.2% YoY. New and existing home sales eased back a bit from their recent peak but still appear to be trending upward (Figure 6). Rising employment, pent-up demand from the housing bust, low inventory of unsold homes and still-good affordability should boost home sales in 2017. In turn, that should encourage new homebuilding and housing upgrades (i.e., residential investment). Home prices continued to rise moderately faster than overall inflation. The S&P/Case-Shiller 20-city home price index was up 5.3% YoY in November (latest data available), which indicates good demand. Although higher mortgage rates may dampen price increases somewhat, we expect housing will be a bright spot for the U.S. economy in 2017.

Figure 6: Housing Remains Solid

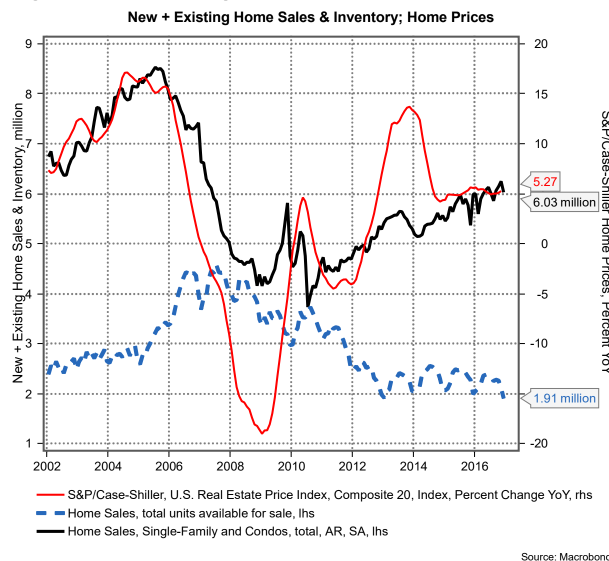
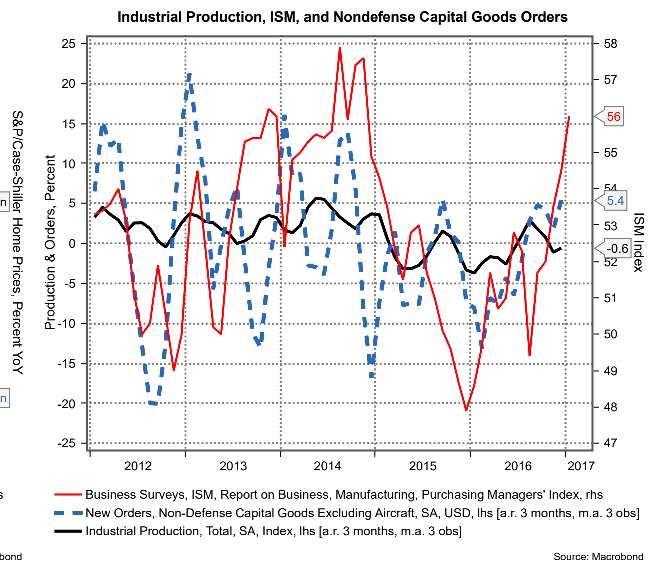


Figure 7: Manufacturing Rebounding



A rebound in **industrial production** that began last quarter mostly accelerated in Q4, although performance varied widely by sector. Overall industrial production fell 0.6% in Q4 (Figure 7) and was down 0.3% YoY. Lower utility output (down 17.0% in Q4) due to warmer-than-normal weather was responsible for the decline. Manufacturing grew marginally (+0.8%), but mining, which includes oil and gas extraction, rose 11.9% in response to higher energy and commodity prices. Moreover, the Institute for Supply Management's manufacturing survey rose to 56.0 in January 2017 from 51.7 in September, a significant improvement in such a short time. Orders for industrial goods paint a similarly optimistic picture. Core capital goods orders (nondefense, excluding aircraft) rose 5.3% in the fourth quarter, a big improvement over the first half of 2016, when orders sagged (dashed blue line in Figure 7). We think continued moderate growth in consumer spending and improved business investment will boost industrial activity over coming quarters.

Real **business investment** rose a modest 2.4% in the fourth quarter and was up only 0.3% YoY. However, capacity utilization is moving up again (Figure 8), and gains in industrial output should boost utilization further. That should prompt greater core business investment (excluding structures) over coming quarters. A rebound in mining as noted above has played an important role in this turnaround – not because we expect another energy boom, but because the bust

appears to have ended. We anticipate modest growth in business investment over coming quarters.

The **trade deficit** was unusually volatile in 2016 (Figure 9). It widened sharply in the fourth quarter in response to better U.S. domestic economic growth, a stronger dollar and reversal of a one-off surge in soybean exports in Q3. Net exports subtracted 1.7% from fourth-quarter real GDP growth after adding 0.9% Q3. Exports (+1.2% YoY in November) and imports (+2.8% YoY) turned slightly positive after spending the first half of 2016 in negative territory. Looking ahead, we expect some improvement in net exports in Q1, but trade will probably be a headwind to real GDP in 2017 overall.

Figure 8: Business Investment Recovering

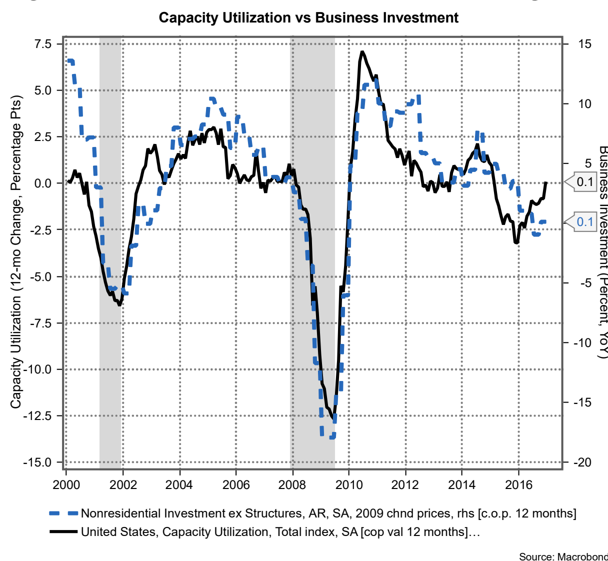


Figure 9: Trade a Heavy Drag on Growth

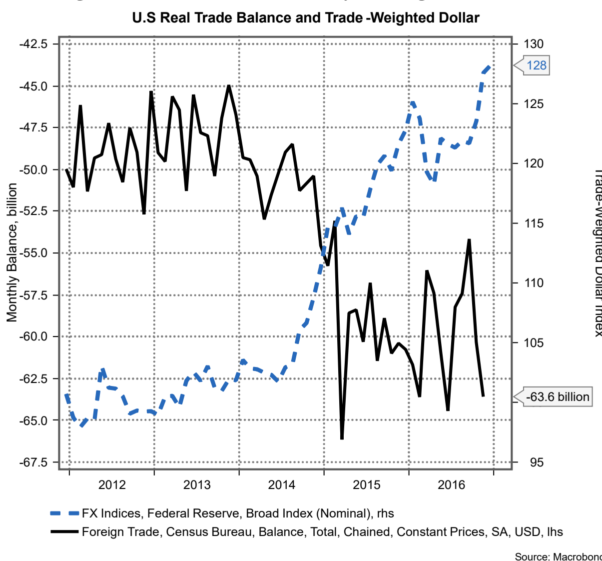


Figure 10: Inventory Rebound About Complete

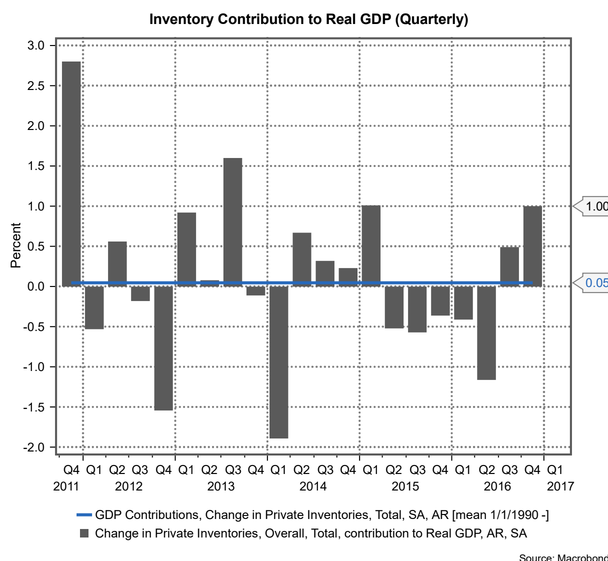
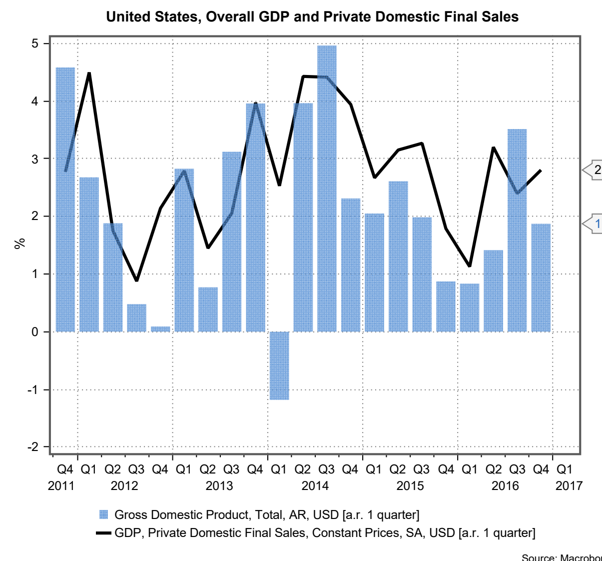


Figure 11: Private Sector Growth Solid



As expected, an **inventory** drawdown in the first half of 2016 was largely offset by inventory accumulation in the second half of the year (Figure 10). Like net exports, inventory growth can

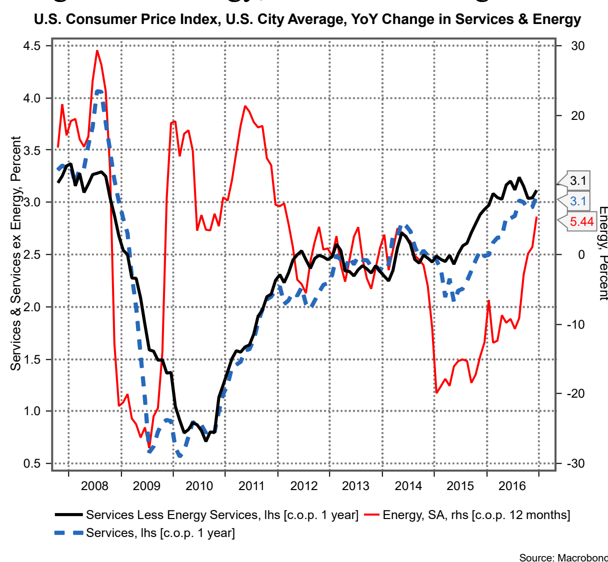
be volatile quarter-to-quarter, although it tends to have minimal impact on long-term growth. We anticipate a little more inventory accumulation in Q1, but we don't expect it to be a big factor for 2017 real GDP growth as a whole.

Government consumption rose by 1.2% in the fourth quarter and 0.5% YoY. Federal spending was down 1.2% in Q4 and -0.2% YoY, while state and local spending rose 2.6% in Q4 and a more modest 0.8% YoY. We expect government consumption will rise a bit less than overall GDP growth in 2017. However, the Trump administration has promised a sizable infrastructure spending program, which could begin to boost spending in the second half of the year, although 2018 probably would receive a larger share of any stimulus. As noted earlier, it's too early to know the impact such a program might have on the economy.

Putting these sectors together, fourth-quarter real GDP growth of 1.9% added up as follows: Personal Consumption Expenditures (+1.70%), Residential Investment (+0.37%), Business Investment (+0.30%), Inventory Change (+1.00%), Net Exports (-1.70%), and Government Consumption (+0.21%). The first three components equal **Private Domestic Final Sales**, which grew by 2.8% during the quarter[3] and 2.4% YoY (Figure 11). Private sector growth was led by consumer spending but was restrained by slow business investment and residential investment during much of 2016. We think the latter two sectors will make a larger contribution in 2017, and they are responsible for our expectation of stronger (2.0-2.5%) real GDP growth this year.

Figure 12: Inflation Low but Rising

Figure 13: Energy, Services Driving Inflation

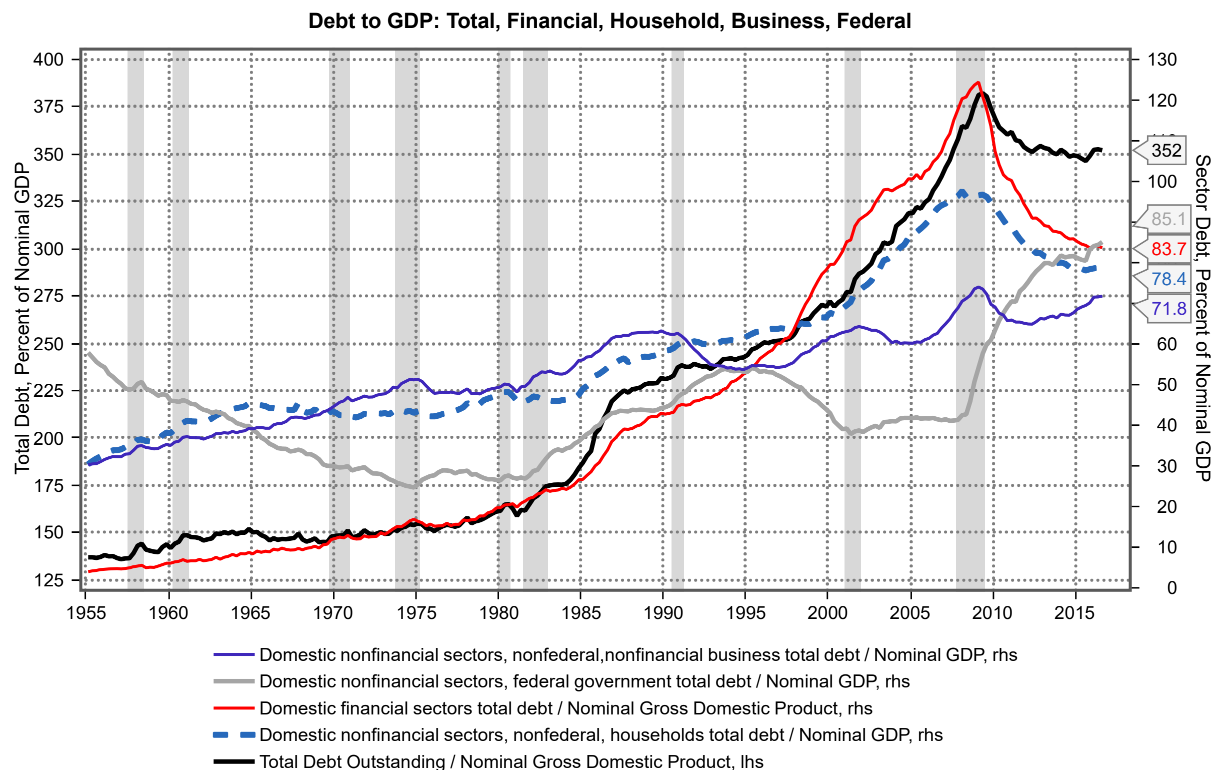


Inflation continued to move higher in the fourth quarter, largely due to higher energy prices (Figure 12). Core inflation was stable. For 12 months ending in December, the consumer price index (CPI) was up 2.1% overall and up 2.2% excluding food and energy. Over the same period, the PCE deflator was up 1.6% overall and 1.7% excluding food and energy. With energy prices stable to higher in recent months, an inevitable "catch-up" of headline inflation to core inflation is nearly complete. We anticipate that core inflation will gradually edge higher, but a rapid acceleration of service prices appears to have flattened out. Service prices overall and excluding

[3] These three GDP components sum to 2.4%, but their combined growth rate was 2.8% because the former rate's denominator is total GDP, which is larger than its subset, private domestic final sales.

energy rose by 3.1% in 2016 and have held around that rate in recent months (Figure 13). On balance, we look for only slightly higher inflation in 2017.

Figure 14: Leverage Steady Overall, but Government and Nonfinancial Borrowing Elevated



Source: Federal Reserve Flow of Funds Report (Z1)

As shown in Figure 14 above, broad **balance sheet trends** in the U.S. held about steady again in the third quarter (latest data available). Overall debt-to-GDP was 352%, up from a recent low of 345% in 3Q2015 but little changed since 2011. Leverage was also about unchanged among households (78.4% debt-to-GDP), and household balance sheets remain very healthy. Financial business leverage (83.7%) continued to edge lower, though most of the deleveraging in that sector appears to be complete. Federal government debt (85.1%) increased as the budget deficit widened, and it will continue to do so absent faster economic growth and/or tighter fiscal policy. Nonfinancial businesses leverage was 71.8% of GDP, up from 69.5% a year ago and a low of 64.8% in 2012.

Although household and financial sector debt appears to be manageable, debt in the nonfinancial business and government sectors is elevated and rising. U.S. high-yield corporate bond default rates were up substantially in 2016: 5.1% in December compared to 2.8% a year ago, according to Standard & Poor's, with the greatest deterioration among speculative-grade energy and natural resources companies. Investment-grade corporate bond defaults remained very low, however. While there is no risk of default on U.S. Treasuries, rising federal debt during an economic expansion leaves considerably less room for fiscal policy to boost the economy when a recession inevitably arrives. Moreover, high levels of indebtedness likely make monetary tightening more potent, which is one reason we expect the Federal Reserve to move slowly in removing monetary accommodation.

Market Outlook

Long-term **Treasury rates** rose sharply in the fourth quarter as Donald Trump won a surprise victory in November's presidential election, domestic economic growth remained sturdy, and the Federal Reserve raised short-term interest rates. The 30-year benchmark Treasury yield rose by 73 bp to 3.05% on December 30, and the 10-year Treasury note yield rose by 84 bp to 2.43% (Figure 15). Ten- and 30-year yields were 2.47% and 3.09%, respectively, on February 3 – little changed from where they ended the fourth quarter.

There were three primary drivers of higher interest rates in the fourth quarter. Most importantly, Donald Trump's surprise victory convinced markets that economic growth would accelerate on a combination of fiscal stimulus, tax reform and lower regulation. The Trump administration simultaneously stoked fears of higher inflation with calls for fiscal spending, more restrictive immigration policy and protectionist (or at least potentially-protectionist) trade policy. Most of the quarter's rise in interest rates occurred after the election.

Second, incoming economic data during the fourth quarter was generally good. While overall real GDP growth was modest at 1.9%, it was mainly due to a sizable drag from net exports. Private domestic final sales rose 2.8% in the quarter, and wages and employment moved up. Although markets may have gotten a little overoptimistic on growth prospects following the election, the economy continued to perform reasonably well.

Finally, the Federal Open Market Committee (FOMC) hinted in September and signaled in November that it was getting closer to raising the fed funds rate target, which it did (by 25 bp) at its December 14 meeting. With rates significantly higher than a couple of quarters ago, market rates now reflect expectations that the Fed will raise rates by about 50 bp (two tightenings) in each of 2017 and 2018, as forward rates in Figure 15 illustrate. As a result, three-month LIBOR forward rates are now 75 bp higher at year-end 2018 and almost 100 bp higher in 2027 than they were in early August 2016. At that time, we thought market expectations for future rates were too low; now we think they are about right – and maybe a bit too high if President Trump's economic policies are less successful at boosting growth than currently expected.

Figure 15: Rates and Forwards Up Sharply

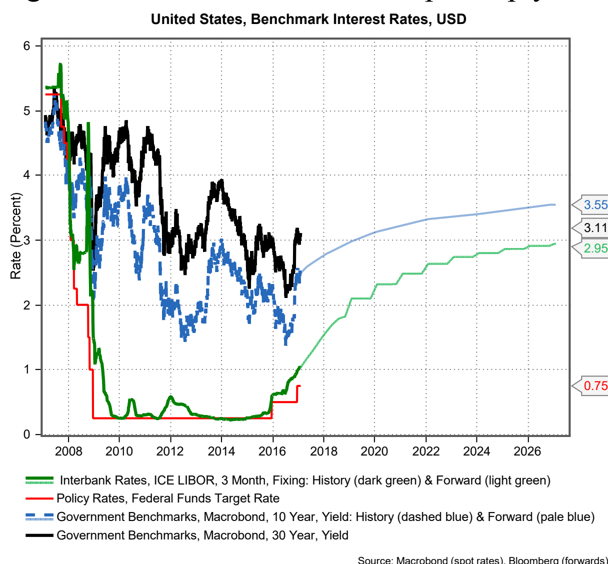
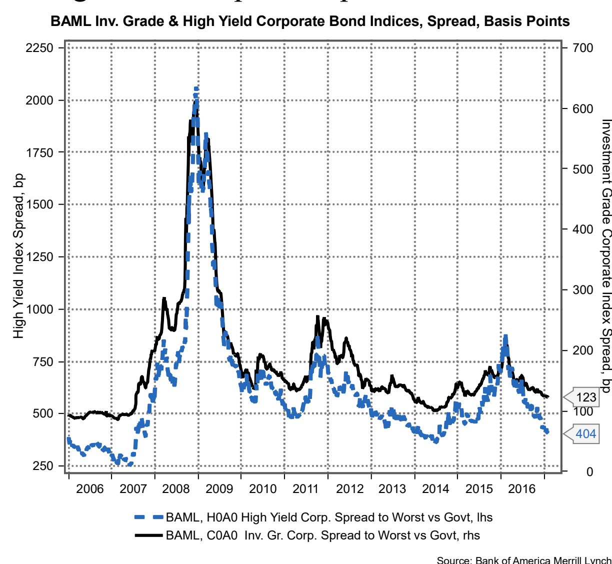


Figure 16: Corporate Spreads Narrower



Corporate **credit spreads** rallied in the fourth quarter and continued to do so through today. Investment-grade corporate bond spreads[4] narrowed by 12 bp to 126 bp on December 30; spreads narrowed slightly further to 123 bp as of February 3. High yield bond spreads[5] did much better, narrowing 71 bp to 439 bp on December 30 and tightening further to 404 bp today (Figure 16). Credit spreads tend to narrow when Treasury rates rise on higher growth expectations, which happened in the fourth quarter. A global hunt for yield that we have talked about for some time continued, and we do not foresee that hunt ending anytime soon.

Yield spreads on preferred securities narrowed modestly during the fourth quarter, but prices were lower. "Spread to Worst" on a broad Bank of America Merrill Lynch preferred securities index narrowed by 10 bp to 310 bp in Q4 and tightened to 300 bp today.[6] Total return on the preferred index (-2.54%) was a little ahead of the corporate index (-2.88%) but substantially lagged the high yield index (+1.88%) during the quarter.[7]

Fundamental **credit conditions** were mostly steady in the third quarter (latest data available). Corporate earnings began to recover over the past several quarters, and they remain high as a proportion of GDP (Figure 17). Moreover, analysts expect better earnings in 2017, in part due to much better performance at energy and commodity firms. Corporate balance sheets remain strong: interest expense as a percentage of earnings before interest was low; liquidity dropped slightly but remains high; and long-term debt to total debt was stable at a high level (Figure 18).

Figure 17: Corporate Profits Recovering

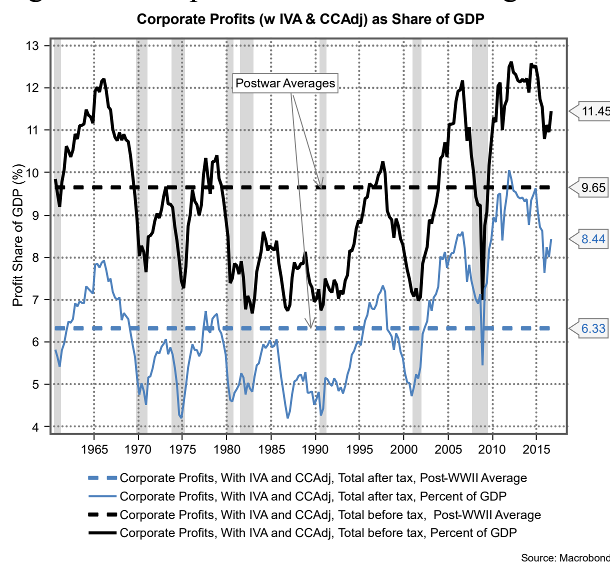
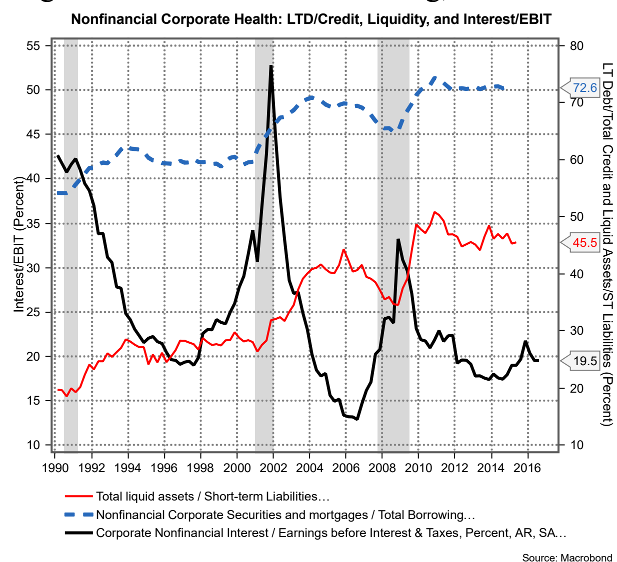


Figure 18: Balance Sheets Strong, Stable



Loan delinquencies and charge-offs were about flat overall. Delinquency rates on commercial and industrial loans, which had moved up in late 2015 and early 2016 improved a bit, while

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[4] Investment-grade corporate bond spread is represented by the Bank of America Merrill Lynch U.S. Corporate Index[SM] (C0A0) "Yield to Worst versus Government" yield spread series. See note 5 below for definition.
[5] Below-investment-grade corporate bond spread is represented by the Bank of America Merrill Lynch U.S. High Yield Index[SM] (H0A0) "Yield to Worst versus Government" yield spread series. See note 5 below for definition.
[6] Preferred 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.
[7] Total return is not annualized and includes both price change and income.

consumer loan delinquencies and charge-offs edged up (Figure 19). Those shifts roughly offset one-another. As short-term interest rates rose, bank earnings generally improved, and a gradual series of rate hikes should further bolster earnings. Overall, bank balance sheets are very strong.

Figure 19: Loan Quality About Steady

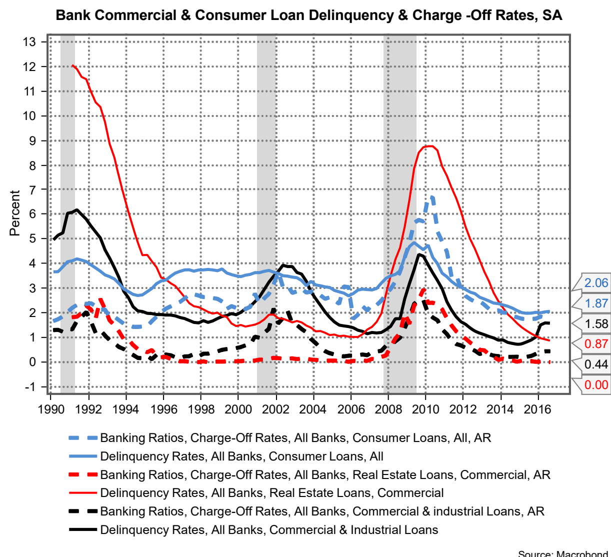
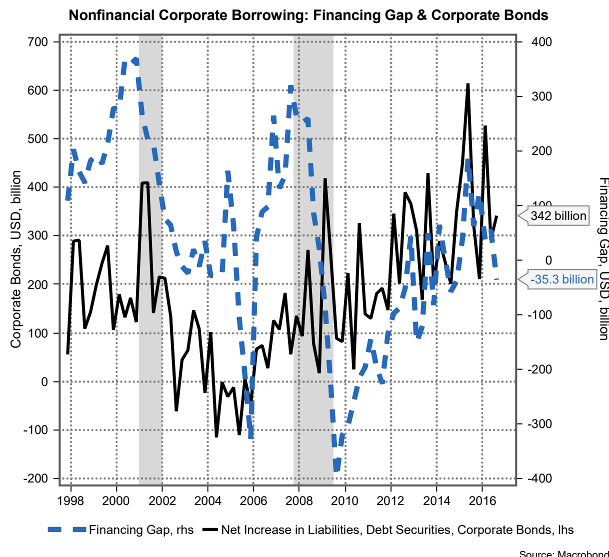


Figure 20: Financing Gap Looks Better



After a worrisome rise in 2015, internally generated cash relative to spending on capital investments (the "financing gap") at nonfinancial businesses improved in 2016 and was actually slightly negative in the third quarter (Figure 20, latest data available). In other words, companies generated more cash from operations than they used to make new capital investments (a negative financing gap) in Q3. Corporate bond issuance by these companies remained relatively high, however. As we have said in the past, we put more weight on the financing gap as an indicator of possible credit excess than bond issuance, because corporations *must* borrow from investors if they do not internally generate sufficient cash to finance investments, while they may issue corporate bonds for a number of reasons. With capital expenditures likely to turn up modestly, we expect the financing gap to turn positive again, though a stronger-than-expected rebound in earnings may blunt that. For now, we think corporate balance sheets generally remain in good shape. We recognize that aggregate debt has increased, however, and we remain watchful.

Looking ahead, we anticipate 2.0-2.5% real GDP growth in 2017 – a little better than 2016's 1.9% pace. Economic uncertainty is likely to remain elevated for at least several quarters as the Trump administration rolls out its tax, regulatory, trade, immigration and fiscal policy plans. Policy uncertainty, tepid global economic growth, and high federal government and nonfinancial business indebtedness should instill caution at the Federal Reserve. We expect the FOMC to nudge the fed funds rate slowly upward, which in turn should limit increases in long-term rates to about what is projected in current forward rates, and maybe less.

Although faster growth and higher interest rates are possible, risks appear skewed to the downside. Trade or immigration policy mistakes by the Trump administration could slow growth. Infrastructure spending could raise the budget deficit while doing little to raise productivity. Tax reform has great long-term potential to boost growth. However, if it can get through a narrowly divided Senate, it would probably add to the deficit over the near term, and it's uncertain how

markets will react to greater Treasury borrowing needs when government debt is already elevated. And regulatory reform, which probably has the greatest potential to boost growth over the next several years, could meet stiff political opposition that might limit effectiveness of those reforms. We hope these fears do not come to fruition, but we see more downside risk than upside risk to our growth and interest-rate forecasts.

Adding it up, we continue to believe the macroeconomic environment is favorable for preferred securities. Credit quality, while vulnerable in spots, remains strong at most issuers of preferreds – especially banks. Higher interest rates could put additional pressure on prices of preferred securities, but we think a nearly 100 bp rise in intermediate and long-term interest rates over the past six months limits that risk over the near term. Moreover, higher interest rates strengthen credit and earnings prospects at financial companies, which comprise over 80% of the preferred market, and they offer us opportunities to reinvest income and redemption proceeds into new investments at more attractive yields. We think preferred securities should benefit from potentially stronger economic growth, offering an attractive combination of high income and credit quality for long-term investors.

Flaherty & Crumrine Incorporated
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