Third-Quarter U.S. Economic Update
November 2017

Summary of Recent Economic Developments

The U.S. economy posted another period of solid growth in the third quarter, despite hurricane disruptions. Real GDP rose by 3.0% in Q3 and 2.3% YoY. Economists expect 2.7% growth in Q4 and 2.4% next year, at the upper end of our 2.0-2.5% forecast. Tax reform currently working its way through Congress could boost our forecast, depending on what legislation, if any, is enacted. Last quarter, employment growth slowed sharply in September due to hurricanes but largely recovered in October. Despite a 4.1% unemployment rate, wage growth remained moderate. Personal income grew at a steady pace, while consumption slowed a bit. Consumption has outpaced income since early 2016, pushing the savings rate down to 3.1%; we expect consumption to moderate and savings to rise over coming quarters. Residential investment slipped but was more than offset by higher business investment. Inventories and a narrower trade deficit added substantially to Q3 GDP, while government consumption was flat. Inflation rose on higher energy prices, but core inflation excluding food and energy remained subdued. Treasury rates edged higher and credit spreads generally narrowed, although they have widened recently in spots. Credit conditions were little changed and remain favorable. With the U.S. economy facing constraints to growth, we expect a gradual pace of Fed monetary policy tightening and modestly higher benchmark rates over the next several years. Despite potential rate headwinds, we think preferred securities remain attractive for long-term investors.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	2017:3	2017:2	2017:1	2016:4	2016:3	2016:2	2016:1	2015:4
Real GDP, Chg QoQ (%, SA, AR)	3.0	3.1	1.2	1.8	2.8	2.2	0.6	0.5
Real Personal Consump Expnds, Chg QoQ (%, SA, AR)	2.4	3.3	1.9	2.9	2.8	3.8	1.8	2.7
Real Business Inv ex Stuctures, Chg QoQ (%, SA, AR)	6.4	6.6	5.3	0.8	0.9	4.0	-5.5	-0.4
Real Residential Investmt, Chg QoQ (%, SA, AR)	-6.0	-7.3	11.1	7.1	-4.5	-4.7	13.4	7.3
Real Private Domestic Final Sales, Chg QoQ (%, SA, AR)	2.2	3.2	3.1	2.7	2.6	3.3	1.4	1.7
Nominal GDP, Chg QoQ (%, SA, AR)	5.2	4.1	3.3	3.8	4.2	4.7	0.8	1.3
Corporate Profits, After Tax, Chg YoY (%, SA, AR)	3.9f	7.8	3.7	14.1	-2.2	-8.0	-4.2	-15.1
Nonfarm Productivity, Chg QoQ (%, SA, AR)	3.0	1.5	0.1	1.3	2.5	0.8	-1.2	-2.6
Nominal Personal Income, Chg YoY (%, AR)	3.0	2.7	3.4	1.6	2.4	2.5	2.8	3.8
Personal Savings Rate (%, SA)	3.1	3.7	3.9	3.2	4.5	5.1	5.7	5.8
Unemployment Rate (%, SA)	4.2	4.4	4.5	4.7	4.9	4.9	5.0	5.0
Nonfarm Payrolls, Chg QoQ (000, SA)	364	562	498	443	716	493	588	832
Household Employment, Chg QoQ (000, SA)	1177	168	889	185	836	-211	1271	1098
Federal Budget, 12-mo Def or Surp (% of GDP)	-3.5	-3.7	-3.4	-3.1	-3.2	-2.9	-2.5	-2.6
Consumer Price Index, Chg YoY (%, AR)	2.2	1.6	2.4	2.1	1.5	1.0	0.9	0.7
CPI ex food & energy, Chg YoY (%, AR)	1.7	1.7	2.0	2.2	2.2	2.2	2.2	2.1
Capacity Utilization (%, SA)	76.0	76.6	75.9	76.0	75.6	75.8	75.4	75.6
Rate or Spread (End of Quarter)	**2017:3**	**2017:2**	**2017:1**	**2016:4**	**2016:3**	**2016:2**	**2016:1**	**2015:4**
Federal Funds Rate Target (%)	1.25	1.25	1.00	0.75	0.50	0.50	0.50	0.50
3-month LIBOR (%)	1.33	1.30	1.15	1.00	0.85	0.65	0.63	0.61
10-Yr Treasury Note Yield (%)	2.32	2.30	2.39	2.43	1.59	1.49	1.78	2.27
30-Yr Treasury Bond Yield (%)	2.86	2.84	3.01	3.05	2.32	2.31	2.62	3.01
ICE-BAML U.S. Corp. Bond Index Yield to Worst vs Gvt	104	112	120	126	138	158	165	168
10-Yr Interest Rate Swap Spread (bp)	-4.5	-2.3	-0.8	-11.3	-14.0	-11.3	-14.0	-8.8

* Figures are either quarterly or, if more frequent, end of period. f = Forecast[1] ; N/A = not available 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

Despite significant disruptions from hurricanes, the U.S. economy grew at a solid pace in the third quarter. Inflation-adjusted gross domestic product (real GDP) rose by 3.0% in the third quarter and 2.3% over the same period a year ago, around the midpoint of our 2.0-2.5% growth forecast for 2017. Underlying domestic activity revealed some adverse hurricane impact, however. Private domestic final sales expanded by a modest 2.2% in Q3 compared to 2.8% YoY. Looking ahead, economists expect 2.7% real GDP growth in Q4, 2.2% for 2017 overall and 2.4% next year.[1]

Currently, a major tax reform bill is working its way through Congress, and it could have a significant impact on economic growth over coming years (though it should not affect 4Q2017 to a substantial degree). Details remain in flux, so it's too early to assess the plan's impact on the economy. Indeed, it is unclear whether a bill will pass at all, given Republicans' narrow Senate majority and divisions among Republicans. Accordingly, we will not attempt to parse tax reform's impact on the major sectors of the economy in this Update. We will simply restate that we believe the current moderate (2.0-2.5%) pace of real GDP growth will soon face constraints absent tax and regulatory reform designed to enhance supplies of labor and capital and boost productivity. Stay tuned.

Figure 2: Employment Solid but Slowing

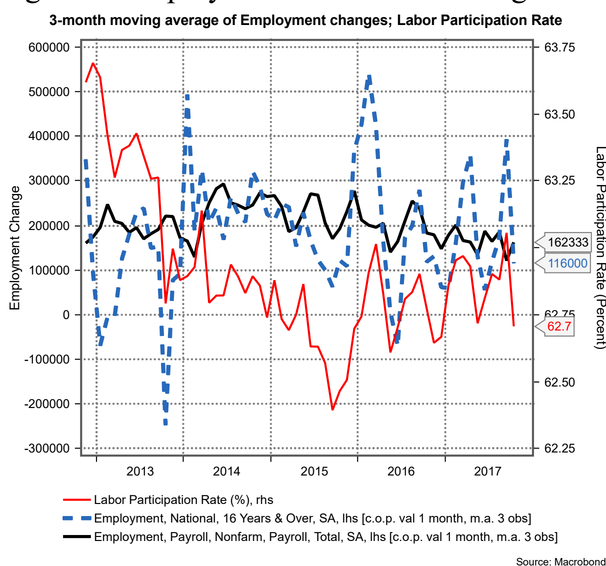
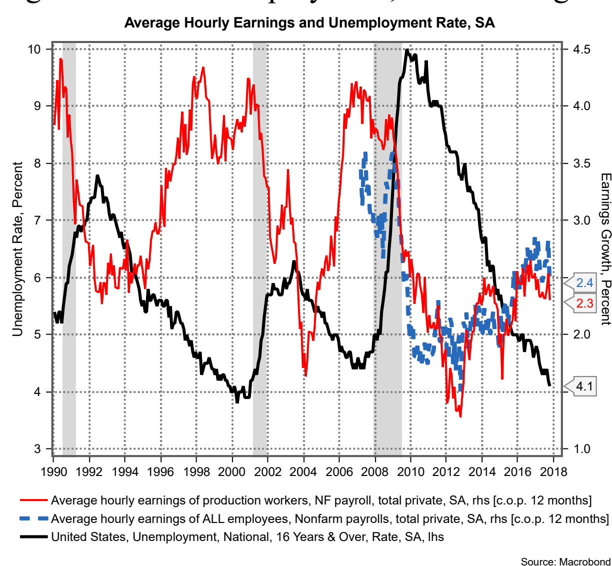


Figure 3: Low Unemployment, Modest Wages



Turning to individual sectors of the economy, the **labor market** remained a bright spot, despite a hurricane-induced slowdown in September. Nonfarm payroll jobs rose by an average of 121,000 per month in the third quarter, down from 187,000 in Q2. Job growth rebounded sharply in October, however, and brought the 3-month average up to 162,000 (Figure 2). The household employment survey was much stronger in Q3 (392,000 new jobs per month) but similar to the payroll survey over four months ending in October.

[1] Unless noted otherwise, forecasts are from the *Survey of Professional Forecasters*, Federal Reserve Bank of Philadelphia, August 11, 2017 and Bloomberg® *Economic Survey*, November 9, 2017.

While the current pace of job gains this long into an economic recovery are impressive, Figure 2 shows that employment growth has decelerated from more than 250,000 jobs per month in 2014 to roughly 175,000 currently. During this time, unemployment fell sharply, as hiring outpaced labor force growth. The unemployment rate now stands at 4.1%, its lowest level since December 2000 (Figure 3). If economic growth continues apace, where are additional workers going to come from? Despite a record level of job openings, the labor participation rate (red line in Figure 2) is little changed from 2014. Moreover, an aging population suggests that participation should decline over coming years, assuming incentives to work (e.g., faster wage growth or lower taxes) don't improve meaningfully. As a result, we expect job growth to continue to slow gradually as the economy approaches full employment.

Wages have been volatile of late, likely due to hurricane disruptions. Wage growth accelerated to 2.8% YoY in September but slumped to 2.4% YoY in October (Figure 3). Truth probably lies between, but it will take a couple months' data to get a better reading. Diminishing labor market slack – represented by a falling unemployment rate – should boost wages in time. However, unemployment has been falling for years, yet wages have risen only modestly. The Federal Reserve wants to see employment expand as much as possible as long as it doesn't threaten too much inflation. Wages are a key data point for the Fed – and they have yet to signal a need for more-rapid tightening of monetary policy.

Figure 4: Consumption Outpacing Income

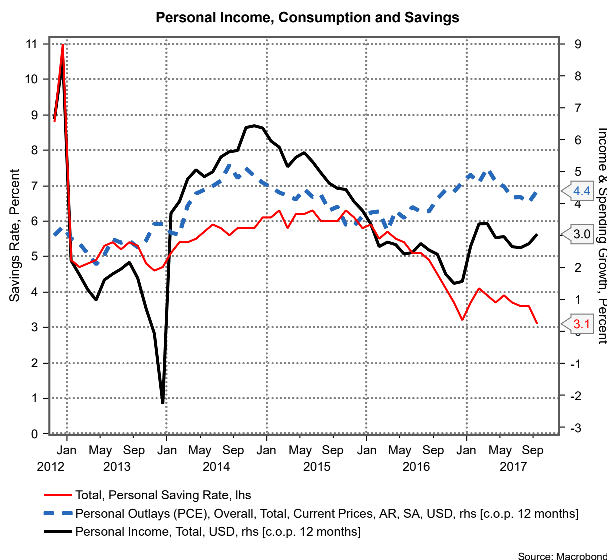
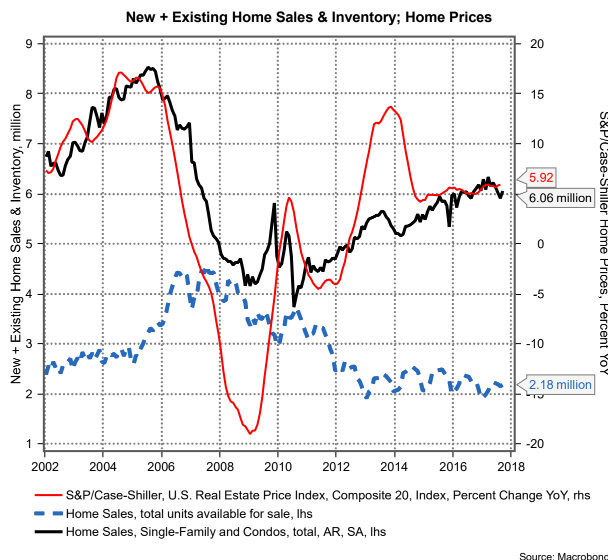


Figure 5: Housing Pauses on Supply, Prices



Slowing employment gains have been offset by slightly faster wage growth and higher investment income, leaving **personal income** growth relatively stable in 2017. Personal income rose 2.8% in Q3 and 3.0% YoY in September (Figure 4). Wages and salaries rose 3.2% YoY, roughly equal to its year-ago pace. Investment income posted a 2.9% YoY gain, far outpacing a 1.3% YoY drop at this time last year. Higher interest rates and a buoyant stock market drove the rebound. This combination of slightly slower employment growth, faster wage growth and modest investment gains should keep personal income growing around its current 3% pace.

Rising consumer confidence and higher consumer wealth drove **personal consumption expenditures** above income growth (Figure 4). Nominal personal spending was up 3.9% in Q3

and 4.4% YoY. Strong consumer spending pushed GDP growth up, but it lowered the savings rate from over 6% in 2015 to just 3.1% in September. While some recent spending represents "emergency" purchases due to hurricanes, consumption has outpaced income growth since early 2016. We expect consumers will need to adjust spending to better match income over coming quarters, which probably means a slower pace of spending.

After a strong start to 2017, the **housing** market paused in Q2 and Q3. New and existing home sales eased to about a six million unit pace in September, as low inventories of available homes and rising prices dampened activity (Figure 5). As a result, real residential investment expanded by only 0.9% YoY in the third quarter, slower than the overall pace of GDP. We view this as a pause within an expansion rather than early stages of a downturn, however. Home construction remains below household formation, and construction (or renovation of existing homes) eventually will need to catch up, which should boost residential investment over coming years.

Figure 6: Manufacturing Set to Rebound

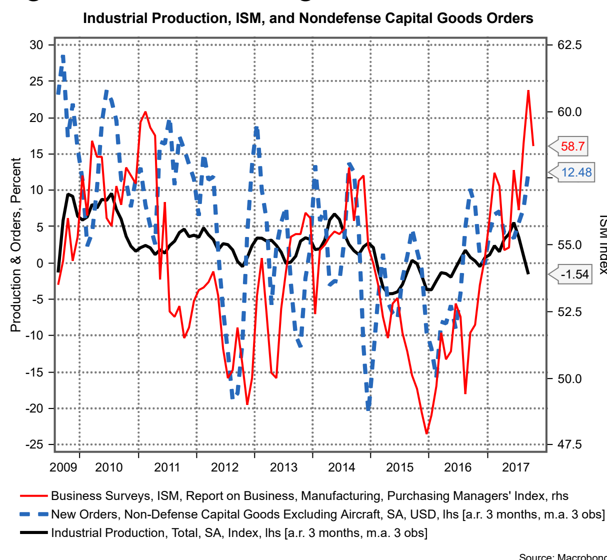
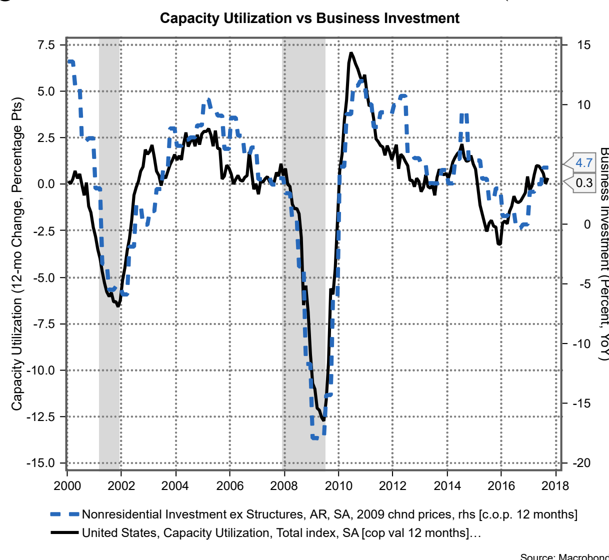


Figure 7: Moderate Business Investment (for now)



Although housing has been tepid this year, **industrial production** rebounded nicely until hurricanes struck in August and September (Figure 6). Utility and manufacturing output slumped largely due to hurricanes, although mining output (+6.3% QoQ and +9.8% YoY) jumped as energy prices rose. Looking ahead, orders for nondefense capital goods excluding aircraft rose 12.4% in Q3, and the Institute for Supply Management's survey of manufacturers suggests industrial output is poised to rebound over coming months (Figure 6).

Not surprisingly, **business investment** slowed to 3.9% in the third quarter, down from an average of almost 7% in the first half of 2017. Investment in structures fell (-5.2%), but equipment (8.6%) and intellectual property (4.3%) posted gains. "Core" business investment (excluding structures) rose 6.4% QoQ and 4.7% YoY – higher than we expected and more than offsetting recent weakness in residential investment. However, capacity utilization is up only slightly over the past year, and we think business investment probably does not have much room to accelerate from here once hurricane rebuilding has passed (Figure 8). Of course, corporate tax reform – including immediate expensing of many forms of investment – could boost business investment considerably next year.

Inventory accumulation accelerated in the third quarter, as nonfarm inventories added 0.7% to GDP. As always, inventories can play a major role in quarterly GDP swings, but they tend to balance out over time and are minor players in our long-term growth outlook. We expect that Q3's sizable inventory accumulation will unwind over the next couple of quarters and reduce growth modestly when it does.

Figure 8: Trade Better on Higher Volumes

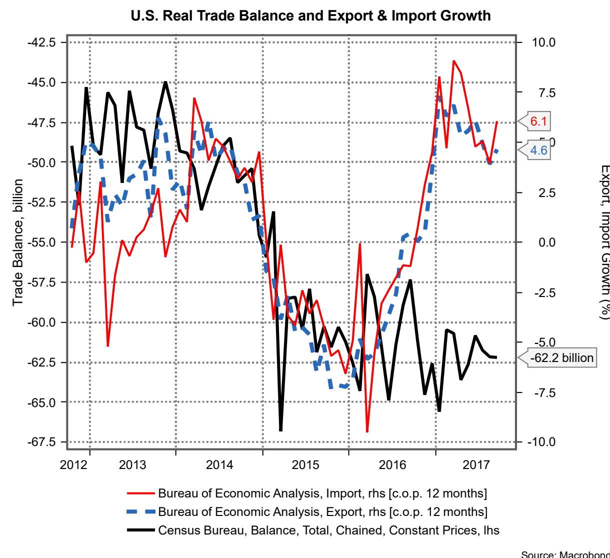
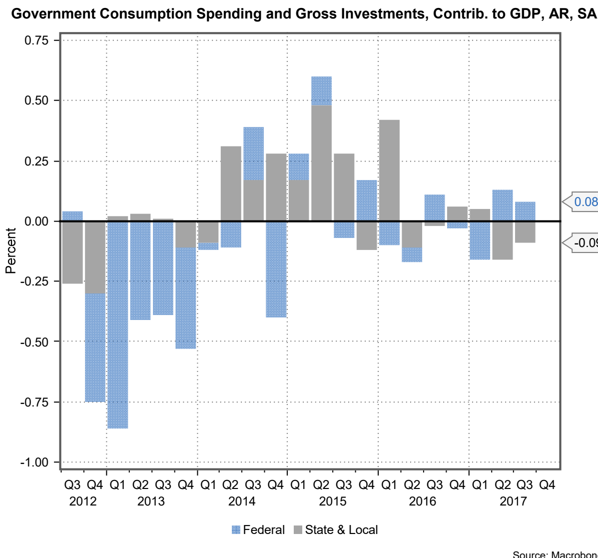


Figure 9: Government Consumption Flat



The **trade deficit** narrowed again, boosting real GDP by 0.4% in the third quarter. Trade improvement added an average of about 0.3% to quarterly GDP growth so far in 2017. Volumes of both imports and exports increased, although the pace of improvement did slow a bit from earlier this year (Figure 8). Global economic growth has exceeded expectations in most regions, leading to higher trade flows, and a weaker U.S. dollar has made U.S. exports more competitive. Trade has performed better than we anticipated (we expected a slightly wider deficit), but we think additional gains will be difficult to achieve – and potentially adverse trade policy remains a risk to the outlook.

Real **government consumption** was essentially flat in the third quarter and has contributed little to growth, on balance, over the past six quarters (Figure 9). Gridlock in Washington has kept spending about flat in real terms, and state and local spending has slowed after a rebound in 2014 and 2015. If passed, tax reform could leave little room for near-term federal spending increases, although that could change over time if reform boosts economic growth. Again, we'll have to wait and see on that.

In summary, third-quarter real GDP growth of 3.0% added up as follows: Personal Consumption Expenditures (+1.62%), Residential Investment (-0.24%), Business Investment (+0.49%), Inventory Change (+0.73%), Net Exports (+0.41%), and Government Consumption (-0.02%). The first three components equal Private Domestic Final Sales, which grew by 2.2% during the quarter and 2.8% over the past year (Figure 10).

Inflation rose modestly in the third quarter, but core inflation remained subdued (Figure 11). The overall consumer price index (CPI) rose 2.2% over 12 months ending in September 2017, largely due to higher energy prices. Excluding food and energy, core CPI rose 1.7% YoY in September,

where it's been since May. The PCE deflator rose 1.6% overall and 1.3% excluding food and energy over the same period. Similar to CPI, overall PCE inflation rose on higher energy prices, but core PCE actually edged down in recent months.

Figure 10: Moderate Growth Continuing

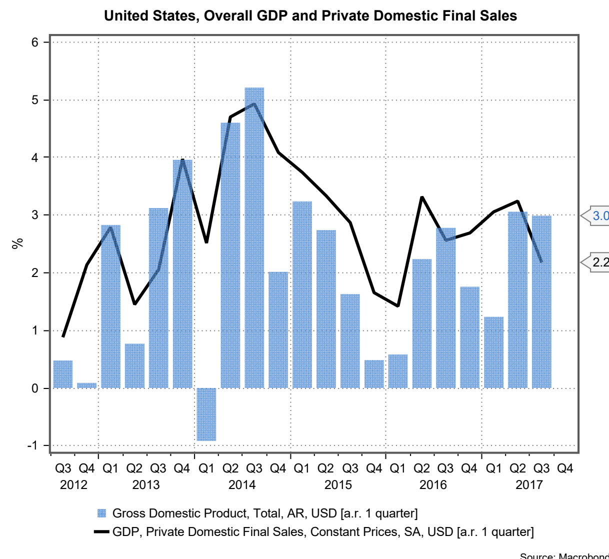
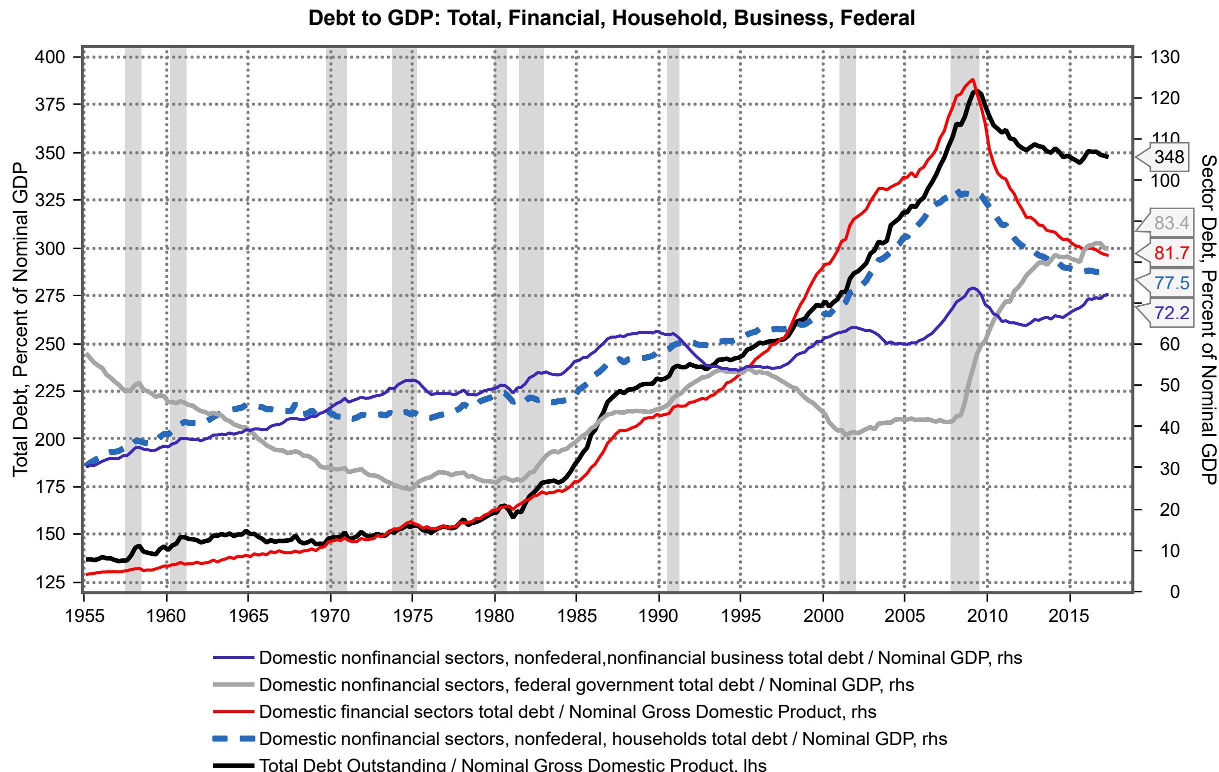


Figure 11: Inflation Mysterious or Just Stuck?

The Federal Reserve has called stubbornly low inflation a "mystery." The Fed has consistently overestimated core inflation in recent years, expecting that a falling unemployment rate would drive up wages and – after a lag – inflation. To date, unemployment has fallen a lot and wages have accelerated a little, but core inflation has barely budged. It is beyond the scope of this Update to delve deeply into this inflation "mystery," but we think a fiercely competitive and increasingly price-transparent global business environment has limited both wage growth and inflation. Profit margins expanded sharply early in the recovery and remain relative high (see Figure 15 below), and producers have been willing to absorb (modest) wage increases rather than risk losing customers by raising prices. This will not go on forever, but it is difficult to say when it will end, especially if productivity continues to recover from last year's doldrums. We think inflation should edge up, but it's likely to be a slow grind.

Finally, **broad balance sheet trends** showed a little improvement in 2Q2017 (Figure 12, latest data available). Overall debt-to-GDP fell marginally to 348%. Household debt edged down to 77.5%. Financial sector debt fell to 81.7% of GDP, about 1% lower than in 4Q2016. It was the only sector that saw a material drop in leverage. Corporate nonfinancial leverage held about steady at 72.2%, although it remains near its financial-crisis peak. Federal government debt outstanding slipped to 83.4% of GDP. However, federal government debt-to-GDP is poised to rise along with a budget deficit that is projected to widen substantially over coming years. Although government debt is likely to increase, it should be stable to lower in other sectors, and we expect little change in overall debt-to-GDP.

Figure 12: Leverage Steady Overall, but Nonfinancial & Government Leverage Edging Up



For now, we remain comfortable with our forecast of 2.0-2.5% real GDP growth in 2017 and 2018. Recent growth has been faster than that, but the U.S. faces a growth challenge as the economy approaches full employment. To maintain output, productivity will need to rise. But with limited need for incremental investment, we don't expect to see a surge in productivity-enhancing investment unless investment incentives change. Finally, consumption, which has outpaced income for several years, should slow to better align with income growth and boost the savings rate. Of course, tax reform may change that outlook. As we said at the outset, stay tuned.

Market Outlook

Financial markets generally continued upward in the third quarter, and preferred securities posted good returns. **Treasury yields** have been tightly range-bound this year (Figure 13). Yield on the 10-year U.S. Treasury note rose by 2 basis points (bp) in the third quarter to 2.32% and increased to 2.39% today. Yield on the 30-year benchmark Treasury also rose by 2 bp in the third quarter; the long bond yielded 2.86% on September 30 and stands at 2.84% today.

The Federal Open Market Committee (FOMC) left the fed funds target unchanged at 1.00-1.25% during the third quarter, although it signaled that a 25 bp rate hike is likely in December. In September, the Fed announced it would begin to scale back System Open Market Account securities holdings purchased during three rounds of "quantitative easing" following the financial crisis. That began in October with a $10 billion per month reduction in principal reinvestments, $6 billion of Treasuries and $4 billion of mortgage-backed securities. The Fed plans to increase

that amount by $10 billion per quarter until it reaches $50 billion per month. So far, markets have taken the Fed's actions in stride. We think a gradual unwinding of quantitative easing is warranted and will be absorbed by markets without a sharp rise in interest rates – although it will add some pressure at the margin. The Fed will continue to evaluate portfolio reductions in light of economic performance and market conditions, and it's much more likely to slow down than speed up the pace of those reductions.

Figure 13: Higher Short Rates, Flatter Curve

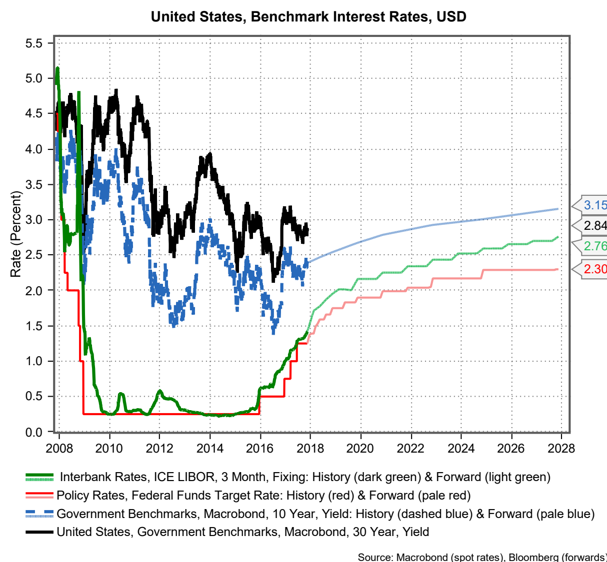
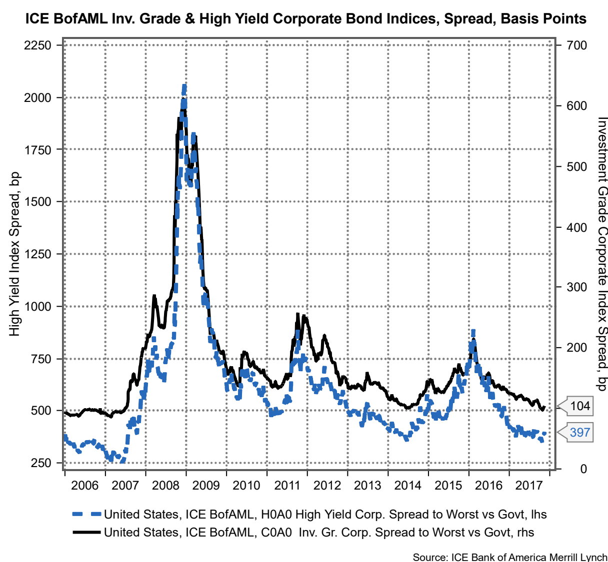


Figure 14: Corporate Spreads Narrower



The FOMC projects moderate rate hikes that would push the fed funds rate, currently around 1.15%, to 2.1% at the end of 2018, 2.7% at end-2019 and 2.8% longer-term.[2] The Fed expects that path of short-term rates will keep the economy growing around 2% after inflation. As illustrated in Figure 13, markets expect less tightening than Fed projections: about 1.75% fed funds at the end of 2018, 1.9% in 2019, and 2.3% longer-term. However, slightly higher market rates and lower FOMC projections have narrowed that gap in rate expectations over recent quarters.

We continue to think short-term rates will fall between current FOMC projections and market forwards. With inflation subdued and growth constraints looming, we expect the Fed to raise rates more slowly over the next several years than it currently projects. We anticipate the Fed will push its fed funds target to about 2% by the end of 2019, which would put real short-term rates around zero percent assuming inflation edges back up to the Fed's 2% target. Because forward curves already anticipate all but about 10 bp of that increase, intermediate-term rates should rise only modestly – perhaps by 50 bp or so over that horizon. Tax reform and other policy changes could alter that view, but for now we think the interest rate outlook is relatively benign for investors in preferred securities.

Turning to credit markets, corporate **credit spreads** narrowed again in the third quarter. Investment-grade corporate bond spreads[3] started the year at 126 bp and ended the third quarter

[2] *FOMC Economic Projections*, September 20, 2017.

[3] Investment-grade corporate bond spread is represented by the ICE BofAML U.S. Corporate Index[SM] (C0A0) "Yield to Worst versus Government" yield spread series. See note 5 below for definition.

at 104 bp, where they are today. High yield bond spreads[4] narrowed considerably more, starting the year at 439 bp and ending Q3 at 367 bp, although they widened to 397 bp since quarter-end (Figure 14).

Yield spreads on preferred securities followed a similar pattern. Historically, we've used "Spread to Worst" on a broad ICE Bank of America Merrill Lynch preferred securities index as a proxy for preferred spreads.[5] However, because nearly all preferred securities are callable, yield-to-worst often understates economic yield when prices rally strongly, as they have in 2017. Yields on newly-issued preferred securities (priced at par) may give a better indication of yield and spread. In December 2016, five rated U.S. dollar preferred securities[6] were issued with a weighted-average yield of 6.11% and a weighted-average spread to Treasuries of 403 bp. In October 2017, there were nine new issues with a weighted-average yield of 5.09% and a weighted-average spread to Treasuries of 288 bp. By that measure, preferred spreads narrowed by about 115 bp this year, which contributed to their strong performance. For the third quarter of 2017, total return on the ICE BofAML preferred index (+1.48%) fell between returns on corporate (+1.37%) and high yield (+2.04%) indices.[7]

Figure 15: Corporate Profits Healthy

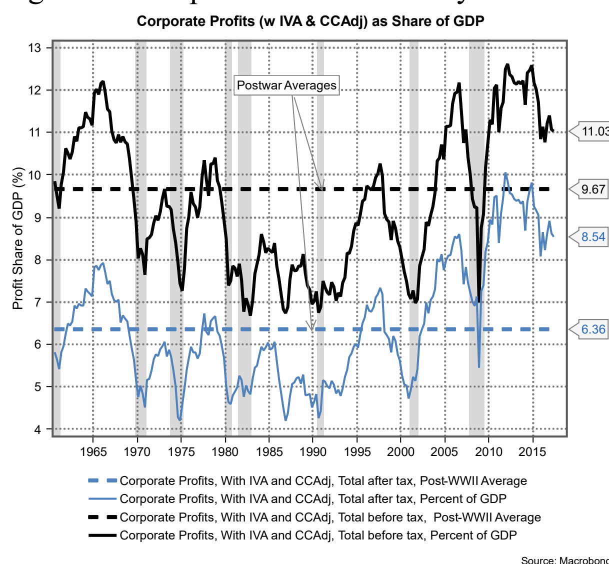
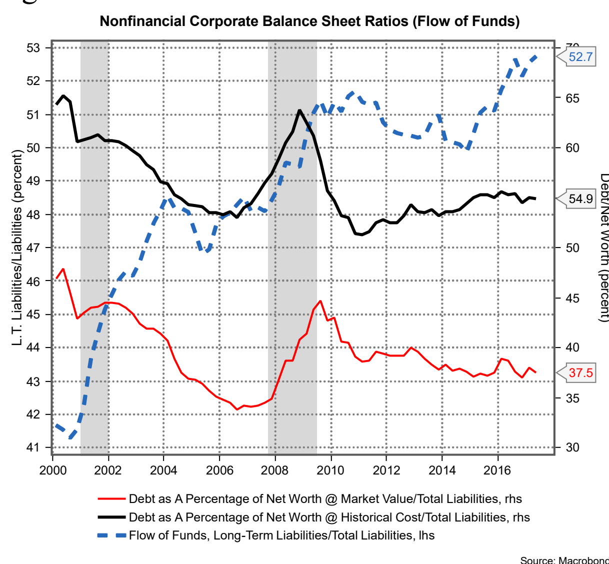


Figure 16: Balance Sheet Ratios Stable



Fundamental **credit conditions** generally remained healthy in the second quarter (latest data available). Corporate profits rose about in-line with nominal GDP growth, leaving the profit share of GDP little changed in Q2 (Figure 15). In addition, third-quarter earnings that have been reported so far look solid. Nonfinancial corporate balance sheet ratios remain sound, and companies took advantage of narrower credit spreads to extend maturities (Figure 16). Debt-to-net worth stabilized on an accounting (i.e., historical cost) basis in 2017, and it continued to edge

[4] Below-investment-grade corporate bond spread is represented by the ICE BofAML U.S. High Yield Index[SM] (H0A0) "Yield to Worst versus Government" yield spread series. See note 5 below for definition.
[5] Preferred index is the ICE BofAML 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.
[6] Includes issues rated BB- or higher by one or more of Moody's, Standard & Poor's and Fitch.
[7] Total return is not annualized and includes both price change and income.

lower relative to market value due to rising equity markets. Finally, interest expense as a percentage of earnings before interest and taxes improved to 18.9% in Q2, largely due to stronger earnings.

While nonfinancial business debt remains elevated, its growth rate slowed in 2017. The financing gap[8] dropped from $121 billion in 2015 to $52 billion (annualized) in the first half of 2017, about flat with last year. With financing needs little changed, corporate bond issuance by these companies also held about steady (Figure 17). Although we do not foresee sharply higher interest rates over the next several years, an elevated level of debt increases nonfinancial companies' exposure to higher interest rates or recession, and it remains a risk factor in our outlook.

Loan delinquencies and charge-offs have been fairly steady at relatively low levels in recent quarters. Delinquency and charge-off rates on commercial and industrial loans declined as last year's problems with energy loans receded (Figure 18). Consumer charge-offs and delinquencies are up slightly from a recent post-recovery trough, but they remain low historically. Despite scattered credit headwinds, bank earnings are up significantly, and their capital cushions remain strong. Bank earnings should continue to benefit from higher short-term interest rates as the Fed tightens monetary policy.

Figure 17: Moderate Corporate Borrowing

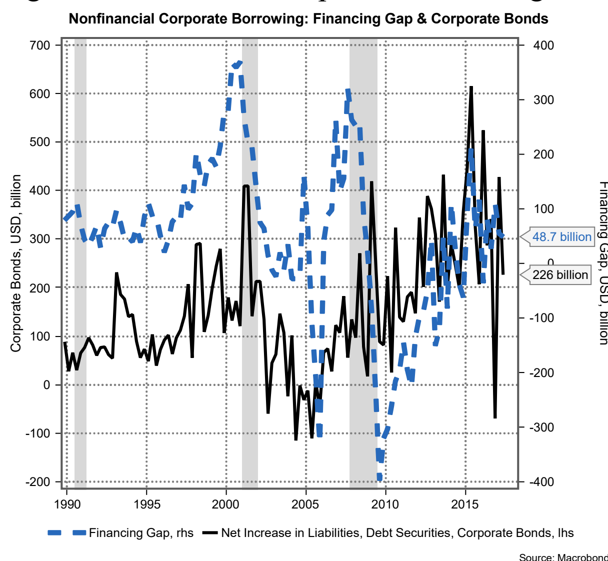
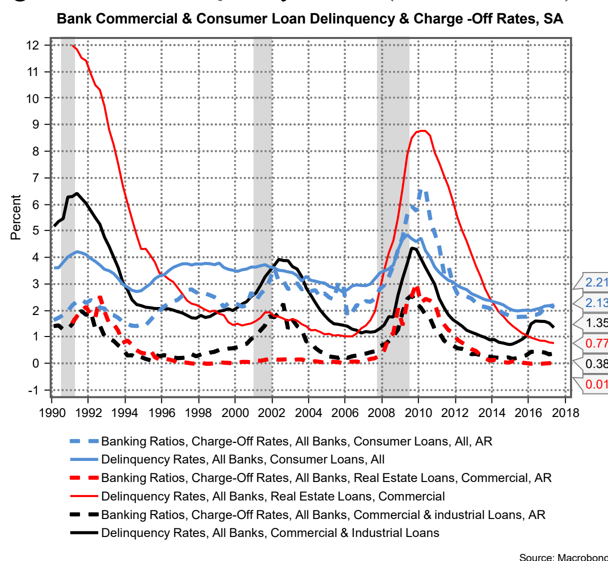


Figure 18: Loan Quality Good (but not better)



Looking ahead, we anticipate moderate 2.0-2.5% real GDP growth and slowly rising inflation, prompting the FOMC to raise the fed funds rate gradually to about 2% over the next several years. This gradual path of tightening should limit increases in intermediate and long-term rates to only slightly more than current forward rates project. Credit conditions also should remain favorable for preferred securities, although modestly higher benchmark interest rates are likely to be a headwind to prospective returns. To date, higher benchmark rates have not had an adverse impact on preferred yields as credit spreads have narrowed. Eventually, higher rates are likely to boost preferred yields, and total returns will fall short of coupon yield when they do. Despite

[8] The "financing gap" is capital investment less internally-generated funds; in other words, the amount that must be financed from external sources such as loans, bonds and equity. A positive number indicates net borrowing (or reduction of financial assets); a negative number indicates borrowing is repaid (or acquisition of financial assets).

these modest potential rate headwinds, however, we think preferred securities continue to offer an attractive combination of high income and credit quality for long-term investors.

Flaherty & Crumrine Incorporated
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