Flaherty & Crumrine

Second-Quarter U.S. Economic Update
September 2021

Summary of Recent Economic and Market Developments

The U.S. economy surpassed its pre-pandemic peak in the second quarter as COVID vaccinations ramped up and many consumers and businesses resumed activities curtailed during the pandemic. Real GDP rose 6.6%, slightly faster than Q1's 6.3% pace. Job growth and job openings rose, and the unemployment rate fell, although it remains elevated. Personal income plunged as transfer payments ebbed, but wage and salary income was strong. Personal consumption expenditures accelerated on renewed services spending. Residential investment declined as homes available for sale remained tight and construction was hampered by shortages. Home prices, however, continued a rapid ascent. Industrial production rose as weather improved and some shortages eased, but ongoing supply chain disruptions and labor shortages remain obstacles to faster growth. Business investment was sturdy despite continued weakness in structures. Government consumption slowed on lower federal spending after surging in Q1, while state and local spending was nearly flat. Inflation rose sharply, prompting the Fed to signal tapering of asset purchases later this year. Despite strong economic growth and much higher inflation, interest rates fell. Credit conditions generally improved further, and credit spreads narrowed.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	2021:2	2021:1	2020:4	2020:3	2020:2	2020:1	2019:4	2019:3
Real GDP, Chg QoQ (%, SA, AR)	6.6	6.3	4.5	33.8	-31.2	-5.1	1.9	2.8
Real Personal Consump Expnds, Chg QoQ (%, SA, AR)	11.9	11.4	3.4	41.4	-33.4	-6.9	1.7	3.2
Real Business Inv ex Stuctures, Chg QoQ (%, SA, AR)	12.4	14.5	17.4	28.1	-25.5	-9.8	0.0	0.3
Real Residential Investmt, Chg QoQ (%, SA, AR)	-11.5	13.3	34.4	59.9	-30.7	20.4	1.1	3.6
Real Private Domestic Final Sales, Chg QoQ (%, SA, AR)	10.0	11.7	6.2	38.1	-32.6	-5.9	1.2	3.2
Nominal GDP, Chg QoQ (%, SA, AR)	13.2	10.9	6.6	38.7	-32.4	-3.9	3.6	4.1
Corporate Profits, After Tax, Chg YoY (%, SA, AR)	42.3	14.7	1.1	2.1	-18.3	-3.8	-0.3	2.8
Nonfarm Productivity, Chg QoQ (%, SA, AR)	2.1	4.3	-3.4	4.6	11.2	-1.8	0.6	0.8
Nominal Personal Income, Chg YoY (%, AR)	2.5	29.5	4.8	6.2	8.6	1.9	3.0	3.7
Personal Savings Rate (%, SA)	8.8	26.6	14.0	14.3	19.3	13.1	7.3	7.3
Unemployment Rate (%, SA)	5.9	6.0	6.7	7.8	11.1	4.4	3.6	3.5
Nonfarm Payrolls, Chg QoQ (000, SA)	1,845	1,554	638	4,025	-13,000	-1,079	590	609
Household Employment, Chg QoQ (000, SA)	754	1,018	2,287	5,443	-13,436	-3,199	505	1,099
Federal Budget, 12-mo Deficit(-) or Surplus (% of GDP)	-12.0	-19.9	-16.6	-15.6	-14.8	-4.8	-4.8	-4.7
Consumer Price Index, Chg YoY (%, AR)	5.4	2.6	1.4	1.4	0.6	1.5	2.3	1.7
CPI ex food & energy, Chg YoY (%, AR)	4.5	1.6	1.6	1.7	1.2	2.1	2.3	2.4
Capacity Utilization (%, SA)	75.4	74.7	74.1	72.1	68.7	73.4	76.5	77.2
Rate or Spread (End of Quarter)	**2021:2**	**2021:1**	**2020:4**	**2020:3**	**2020:2**	**2020:1**	**2019:4**	**2019:3**
Federal Funds Rate Target (upper bound, %)	0.25	0.25	0.25	0.25	0.25	0.25	1.75	2.00
3-month LIBOR (%)	0.15	0.19	0.24	0.23	0.30	1.45	1.91	2.09
10-Yr Treasury Note Yield (%)	1.45	1.74	0.93	0.69	0.66	0.70	1.92	1.68
30-Yr Treasury Bond Yield (%)	2.06	2.41	1.65	1.46	1.41	1.35	2.39	2.12
ICE-BofAML US Corporate Index Spread to Worst vs Gvt	82	91	98	139	155	302	99	120
10-Yr Interest Rate Swap Spread (bp)	-2.6	3.6	0.8	2.5	-1.8	2.5	-2.8	-10.5

* Figures are either quarterly or, if more frequent, end of period. f = Forecast[1] ; N/A = not available Source: Macrobond, ICE, 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 continued to expand rapidly in the second quarter as COVID-19 vaccines became more widely available to U.S. residents, hospitalizations slowed, and many activities curtailed during the pandemic resumed. Inflation-adjusted gross domestic product (real GDP) rose by 6.6% in Q2, slightly faster than the first quarter's 6.3% pace. Growth appears to have slowed in July and August, and forecasts for the second half have moderated. Economists now expect Q3 and Q4 GDP to expand by 5.0% and 5.3%, respectively, down from forecasts of 6.8% and 5.6% a month earlier.[1] Solid U.S. growth is expected to continue next year, with the consensus 2022 GDP forecast currently at 4.2%, little changed from August's estimate.

As expected, the U.S. economy surpassed 4Q2019's level of real GDP in the second quarter. It remains on track to recoup growth lost to the pandemic in the next few quarters, but it seems unlikely to do so by year-end 2021. Rising COVID-19 infections from the Delta virus variant, labor shortages, supply chain disruptions, and higher inflation have been headwinds to the economy in recent months, and they are likely to persist through 2021. As those diminish next year, the current economic recovery should continue at a slower but still above-trend pace and push the level of real GDP above its pre-pandemic trendline (about 2% growth) sometime during the first half of 2022.

Before turning to a review of the major sectors of the U.S. economy, it is worth noting that the National Bureau of Economic Research in July officially set April 2020 as the end of the recession triggered by the COVID-19 pandemic. At just two months in duration, it is the shortest U.S. recession since records began in 1857; a six-month recession from January to July 1980 is runner-up. Although the 2020 recession was short, it was severe, including a 22.4 million decline in nonfarm payroll employment and an 18.0% (not annualized) plunge in real personal consumption expenditures. Of course, COVID-19 cost much more than just lost jobs and output, but we are grateful to close that chapter of this terrible pandemic.

The **labor market** recovery accelerated in the second quarter. Nonfarm payrolls rose by 1.82 million jobs in Q2 compared to 1.54 million in Q1, and businesses added another 1.29 million employees in July and August. Overall nonfarm employment was 147.2 million in August (Figure 2). Although that remains 5.3 million jobs below the February 2020 peak, labor demand remains very strong. According to the latest job openings report, there were 10.9 million unfilled jobs in July, more than enough to absorb all unemployed persons age 16 and over (Figure 3). Of course, there are numerous frictions to matching employers and employees, including geographic and skill mismatches, generous supplemental federal unemployment payments (now expired) on top of regular state unemployment benefits, or difficulty finding suitable childcare, eldercare, or other assistance that potential employees might need to take a job. As daily activities gradually return to normal and in-person school and care services resume, some of those frictions should diminish. We expect sturdy employment growth for some time to come despite headwinds from COVID-19.

[1] Unless noted otherwise, forecasts are from the *Livingston Survey*, Federal Reserve Bank of Philadelphia, June 16, 2021 and Bloomberg® *U.S. Monthly Economic Survey*, September 10, 2021 and August 13, 2021.

Strong demand for labor prompted faster wage increases. Average hourly earnings in August rose at a 5.7% pace over the past three months and 4.3% over 12 months, even as a rebound in lower-paid leisure and hospitality employment pulled down the average. The employment cost index, which adjusts for compositional shifts, was up at a 3.4% rate in Q2, moderately above its pre-pandemic pace. In addition, anecdotal reports, including the Federal Reserve's *Beige Book*, suggest continued upward pressure on labor costs.

Figure 2: Job Growth Accelerated

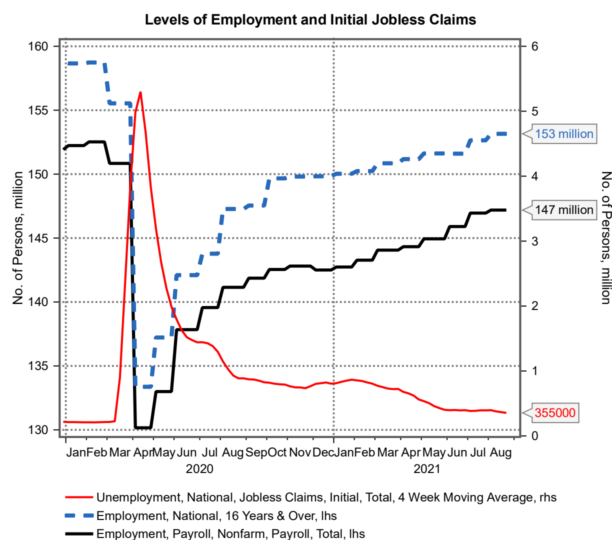
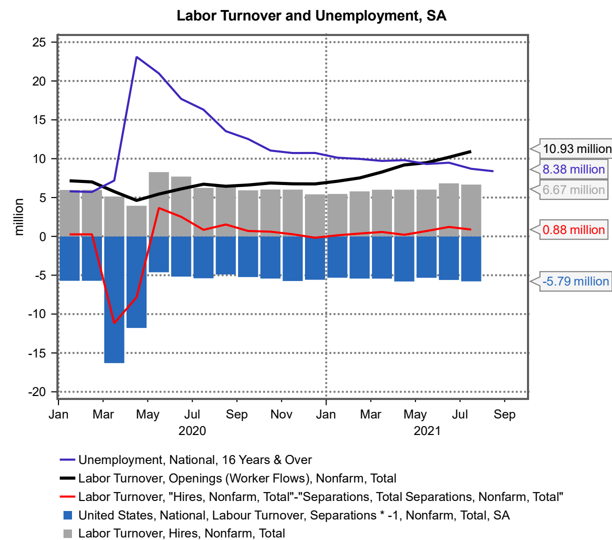


Figure 3: Job Openings Signal High Demand



After surging in the first quarter thanks to fiscal stimulus[2], **personal income** slipped in the second quarter (Figure 4). Nominal personal income fell by 21.8% in Q2 after jumping 56.8% annualized in Q1, although that still left overall personal income in June up 2.3% compared to a year earlier. Transfer payments were to blame; they plunged by 72.6% in Q2 after soaring 181% in Q1 mostly due to one-time stimulus payments. Excluding transfers, nominal personal income rose 9.1% in Q2 and 8.8% YoY in June. Since quarter-end, income was up 1.1% (not annualized) in July, including gains of 1.0% in wages and salaries and 2.9% in transfer payments as new advance child-care payments began. Looking ahead, we expect continued job gains and rising wages will support good growth in personal income.

Despite a sharp decline in income during the second quarter, **personal consumption expenditure** (PCE) accelerated. Nominal PCE rose 19.1% in Q2 and 13.7% over 12 months ending in June 2021 (Figure 4). Adjusted for inflation (the PCE deflator jumped 6.7% in Q2), real PCE rose by 11.9% in Q2 and 9.3% YoY. Nominal spending on goods (23.3%) still outpaced services (16.9%), but that began to shift during the quarter as services spending accelerated while goods spending cooled (Figure 5). PCE slowed in July, up 0.3% (not annualized) in nominal terms and down 0.1% after inflation; but nominal spending on services was up 1.0% while goods was down 1.1%. Many service sector activities that were restricted earlier in the

[2] The Consolidated Appropriations Act of 2021 passed on December 27, 2020 followed by the $1.9 trillion American Rescue Plan Act of 2021, passed on March 11, authorized payments to individual taxpayers of $600 and $1,400, respectively, and sharply raised personal income in 1Q2021.

pandemic are now growing rapidly, especially in leisure and hospitality. The shift from goods to services spending is likely to continue and should sustain good growth in PCE over coming months. Of course, COVID-19 remains a particular risk to the outlook for services activity if a recent increase in infections persists and weakens demand for or prompts new restrictions on service activities again. For now, we are optimistic on consumer spending, but we remain watchful of COVID's ongoing impact.

Figure 4: Income Swings on Stimulus

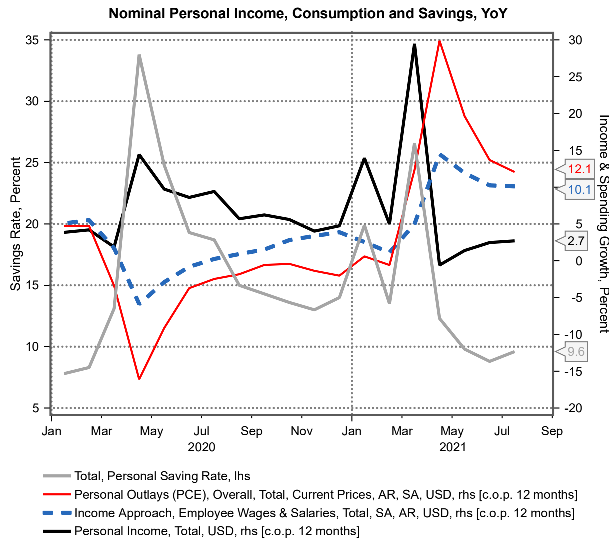


Figure 5: Spending Shift from Goods to Services

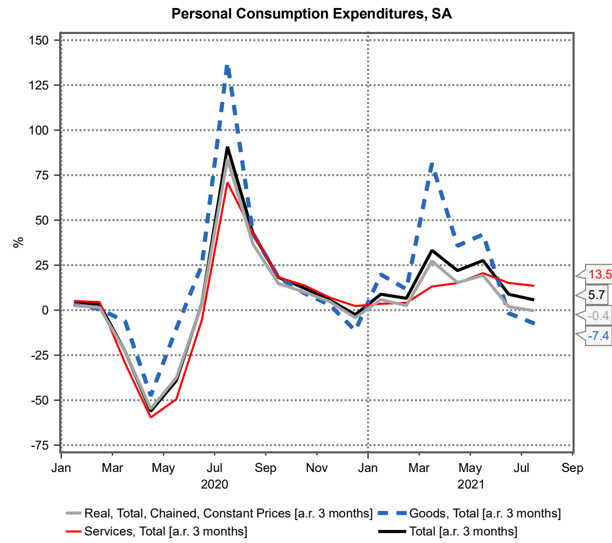


Figure 6: Inventory, Prices Dampened Sales

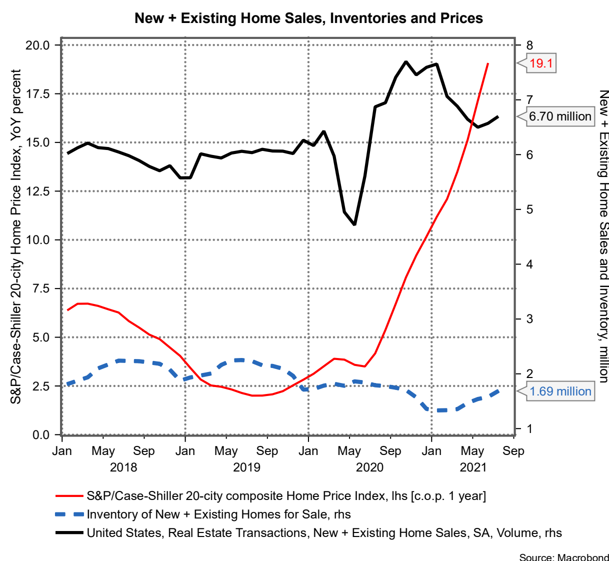
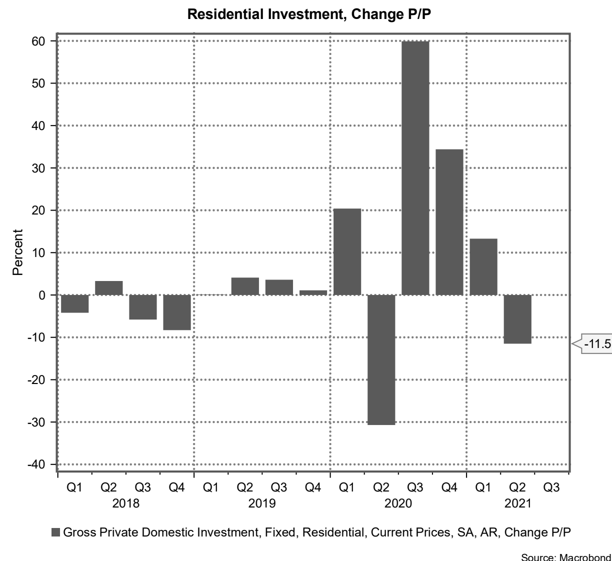


Figure 7: Residential Investment Slipped



Lower income and higher spending pushed the **savings rate** down to an average of 10.3% in Q2 and 9.6% in July (Figure 4). While that is a big decline in the savings rate from almost 27% in March, it follows a similarly outsized gain in Q1 from stimulus payments. It simply took consumers time to spend some of that money. We think rising employment and wages

combined with still-high levels of personal savings mean PCE will remain a source of strength for the economy over coming quarters, although recent rapid gains are bound to slow.

The **housing market** slowed in the second quarter, with both home sales and residential investment pulling back. Combined new and existing home sales averaged a little over 6.5 million units in the second quarter, down from an average of 7.2 million units in Q1 (Figure 6), as low inventory of homes for sale and rapidly rising prices dampened sales. Housing starts fell by 16.3% in Q2 after rising by an equal amount in Q1, and housing completions plunged by 40% as shortages of homebuilding materials and labor slowed progress. As a result, residential investment slipped by 11.5% after three very strong quarters (Figure 7). Low mortgage rates, rising employment and wages, and strong household balance sheets kept housing demand firm, while the supply of homes available for sale remained very tight. Not surprisingly, prices jumped. The S&P/Case-Shiller 20-city composite home price index rose 19.1% over 12 months ending in June, the fastest pace on record. With housing demand firm and some construction bottlenecks easing, we expect residential investment to resume growth over coming quarters – albeit at a slower pace than in 4Q2020 and 1Q2021.

Industrial production picked up in the second quarter as cold weather receded and some shortages eased. Industrial output rose 6.1% in Q2 and added another 0.9% in July, pushing output over three-months ending in July up by 9.4% (Figure 8). It was up 6.6% in July compared to a year earlier. Although the Institute for Supply Management's manufacturing survey retreated from a record high in March, it pointed solidly toward continued expansion at 59.9 in August (50 is neutral). Factory orders also posted strong gains, with overall orders up 12.6% in Q2, and orders for core capital goods (nondefense, excluding aircraft) up 18.6%. Rising orders prompted lengthening backlogs that should keep manufacturers busy for some time, even if consumer spending on goods slows somewhat. Materials and labor shortages eased in some areas and remained acute in others, but rising output signals progress on balance.

Figure 8: Output, Orders Up; Shortages Ease

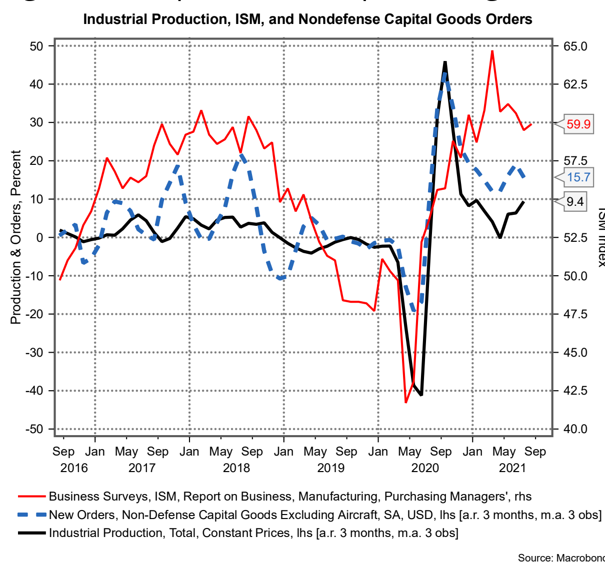
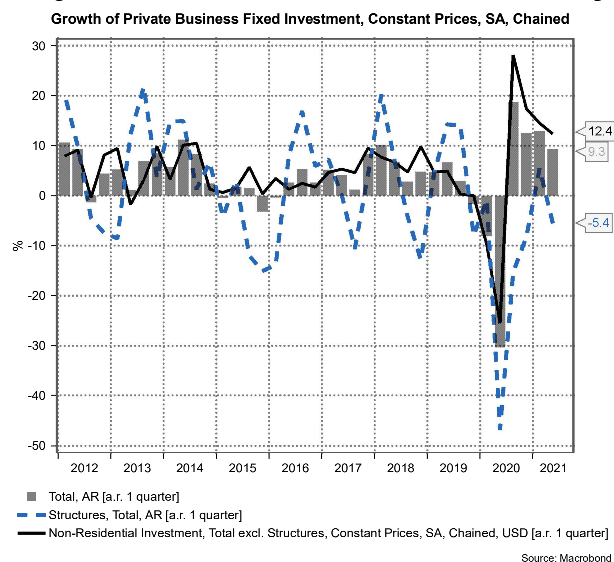


Figure 9: Core Business Investment Strong



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Real **business investment** posted another solid gain in the second quarter as capacity utilization rose. Capacity utilization rose to 76.1% in July from 74.7% in March; it is up 4.6% from July 2020 (Figure 9). Overall business investment rose 8.0% in Q2 and was up 17.6% YoY – but be reminded that 2Q2020 was very weak, making the annual increase unsustainably large. Investment in business structures remained weak, falling 7.0%, but was more than offset by gains in equipment (+13.0%) and intellectual property (+10.7%). With many employees still working remotely, the structures category is likely to remain soft for some time. However, we are optimistic on "core" business investment in equipment and intellectual property. Given that many goods-producing businesses report difficulty hiring skilled workers and a positive outlook on economic growth, investment spending to boost productivity should remain strong over coming quarters.

The **trade deficit** widened in Q2 for the fourth consecutive quarter, albeit at a more moderate pace, and trade volumes remained active (Figure 10). Net exports subtracted 0.2% from real GDP growth in Q2, compared to an average deduction of nearly 2.2% in each of the prior three quarters. Over 12 months ending in July, Imports and exports jumped 22.1% and 24.5%; they are up 12.9% and 3.8% (not annualized), respectively, compared to December 2019, before the pandemic began. A faster rebound in imports reflects stronger economic growth in the U.S. compared to many of its trading partners. Exports have lagged well behind, but they outpaced imports in Q2 and July as growth outside the U.S. strengthened. With much of the US economy's supply chain sourced abroad, we expect net exports to remain a modest drag on real GDP for the balance of 2021, but the worst of it appears to be behind us.

Figure 10: Trade Up; Deficit Wider

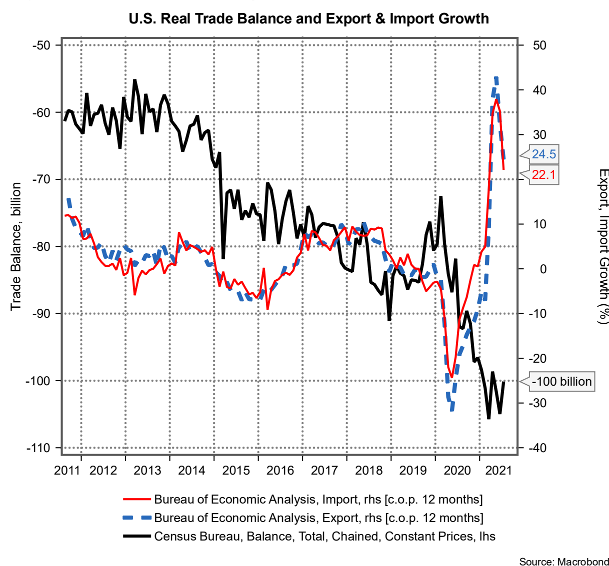
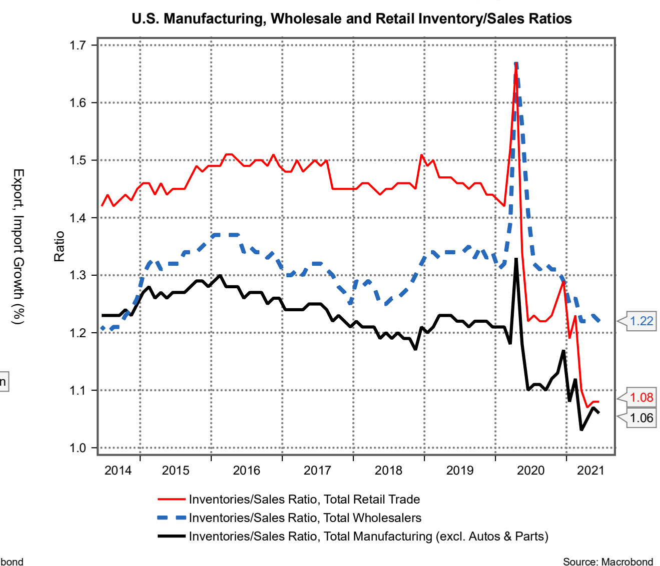


Figure 11: Lean Inventories Support Orders



Despite a sizable increase in output in Q2, sales rose even faster. Businesses once again reduced **inventories**, which subtracted 1.1% from real GDP growth in Q1. Inventories are at or near record lows relative to sales across major goods sectors today (Figure 11). We expect inventories to rebound, adding to orders and boosting GDP, although strength in consumer demand and ongoing supply-chain constraints may delay it for a quarter or so.

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Federal stimulus paused in the second quarter, prompting a modest drop in real **government consumption** (Figure 12). Federal government spending fell 5.0%, and state and local spending rose by just 0.8%, leaving overall government consumption down 1.5% in Q2. With the economy — and consequently, tax receipts — recovering, we continue to expect moderate gains in state and local spending over coming quarters, and Washington is poised to boost spending again, although it is still too early to say by how much.

Summarizing the first-quarter economic situation, sector contributions to real GDP growth of 6.5% break down as follows: Personal Consumption Expenditures (+7.8%), Residential Investment (-0.5%), Business Investment (+1.1%), Inventory Change (-1.1%), Net Exports (-0.4%), and Government Consumption (-0.3%). The first three components equal **Private Domestic Final Sales**, which rose by 9.9%.[3] As noted earlier, this impressive growth pushed real GDP above its prior high from 4Q2019 and is a much better economic outcome than seemed possible in the early months of the COVID-19 pandemic.

Figure 12: Government Spending Paused

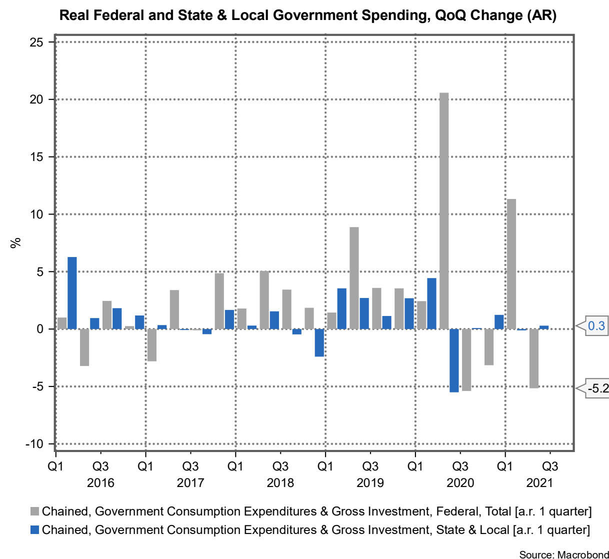
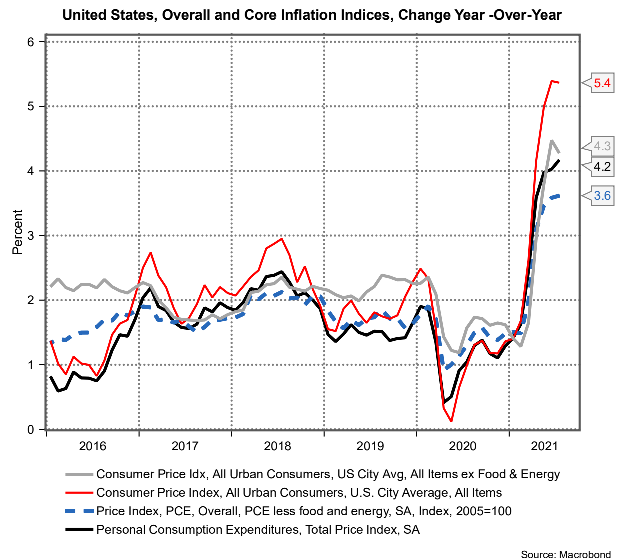


Figure 13: Inflation: Temporary or Sticky?



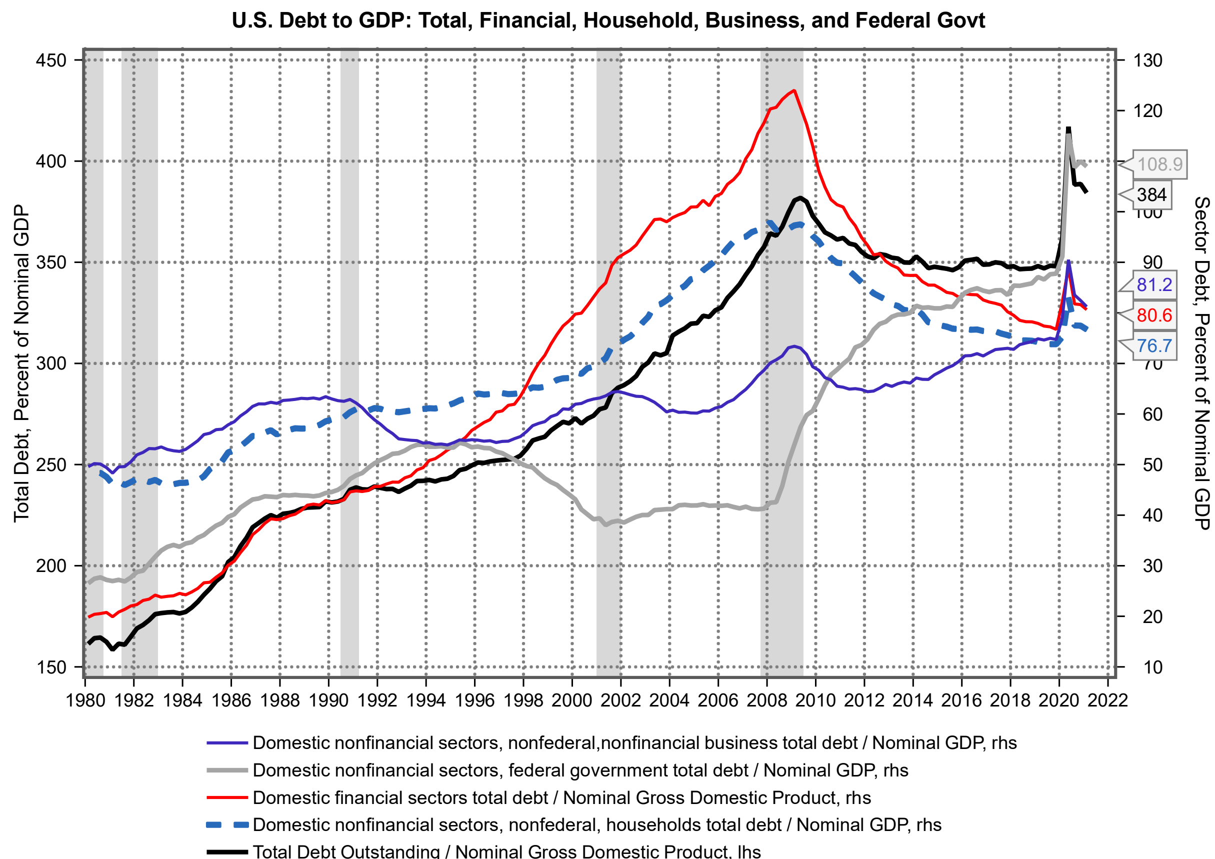
Inflation rose sharply as economic activity expanded in the first quarter and "base effects" from lower prices a year ago rolled into annual inflation calculations. For 12 months ending in July, the consumer price index (CPI) was up 5.4% overall and 4.3% excluding food and energy (Figure 13). The PCE deflator was up 4.2% overall and 3.6% excluding food and energy over the same period. These are the fastest gains in core inflation since 1991. As we explained last quarter, base effects from falling prices last year contributed to these sharply higher inflation rates. However, looking at the past three months, the core PCE deflator was up at a 5.7% pace while core CPI was up 8.1%. Rising wages, shrinking excess capacity, supply shortages and rising input prices remain with us and should keep inflation elevated at least

[3] These three GDP components sum to 8.4%, but their combined growth rate was 9.9% because the former rate's denominator is total GDP, which is larger than its subset, private domestic final sales

through year-end. Whether they become more entrenched or begin to fade next year will be a key question facing monetary policymakers in 2022.

Broad **balance sheet trends** through the first quarter of 2021 (latest data available) show renewed deleveraging compared to 4Q2020 (Figure 14). Overall debt-to-GDP fell to 384% in Q1, compared to 389% in the prior quarter. Even federal government debt fell by 1.1% to 108.9%. Household debt-to-GDP eased 0.8% to 76.7%, while nonfinancial business borrowing dropped from 82.4% to 81.2% in Q1. Financial business borrowing fell by 1.0% to 80.6%.

Figure 14: Private-Sector Debt-to-GDP Falling Again; Federal Debt High but Stable, for Now



Source: Federal Reserve Flow of Funds Report (Z1)

Private-sector debt ratios should trend lower as the economy recovers, although it will take time for them to fall below 4Q2019 levels. However, government debt to fund recent stimulus packages will rise substantially in 2021. July projections from the Congressional Budget Office show federal government debt-to-GDP flattening from 2022 through 2027, but proposed legislation could change that trajectory. The Federal Reserve' purchases of Treasury securities and low interest rates currently make servicing Treasury debt easy, but with the Fed now contemplating tapering those purchases, it may become more difficult. Nonetheless, an elevated savings rate and private-sector deleveraging trends suggest that interest rate pressure remains modest for now.

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Market Outlook

Long-term **Treasury rates** declined unexpectedly in the second quarter despite strong economic growth and substantially higher inflation (Figure 15). The benchmark 10-year Treasury note yield fell 29 basis points (bp) to 1.45% in Q2 and slipped to 1.33% as of September 13. The 30-year Treasury bond yield fell 35 bp to 2.06% in Q2 and closed at 1.91 on September 13. Short rates held steady, leading to a flatter yield curve and market forward rates that were about 45 bp lower than three months ago.

Highly accommodative monetary policy in the U.S. and nearly everywhere else, limited private sector borrowing, and massive savings helped drive interest rates to these lower levels; they remain with us today. However, they are inconsistent with current and prospective rates of economic growth and inflation. As we noted earlier, we believe private sector investment and borrowing will rise and the personal savings rate will decline over coming quarters. And as we discuss below, the Federal Reserve should soon dial back accommodation and eventually tighten monetary policy. We expect interest rates will rise as a result, although it could be several more quarters before those pressures are large enough to push rates up.

Figure 15: Slower Borrowing, Lower Rates[4]

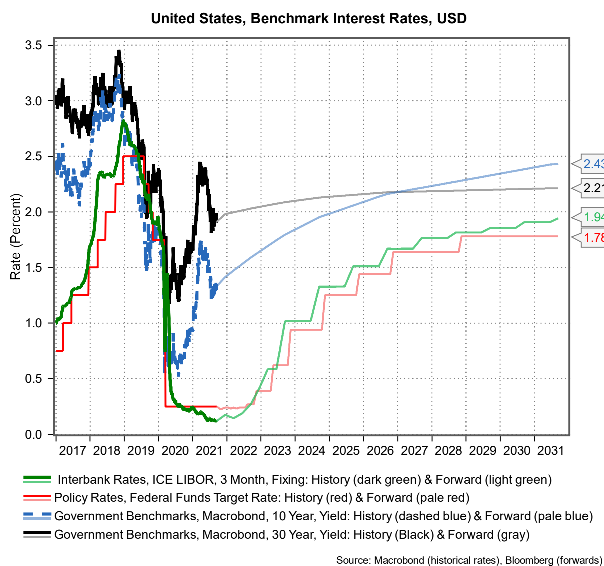
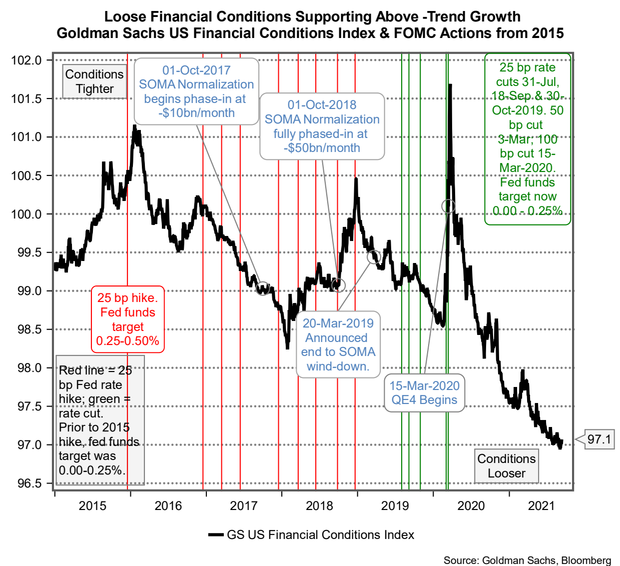


Figure 16: Fed Still Filling the Punch Bowl



As expected, the Federal Reserve left monetary policy unchanged, although it probably is moving closer to tapering its securities purchases. The Federal Open Market Committee (FOMC) held the fed funds rate target at 0-0.25%. It also continues to purchase approximately $80 billion Treasuries and $40 billion agency mortgage-backed securities per month in its System Open Market Account "until substantial further progress has been made toward the Committee's maximum employment and price stability goals."[5] At its annual Jackson Hole

[4] The fed funds effective rate recently has traded about 16 bp below the top end of the FOMC target range. In Figure 15, we add 16 bp to forward rates implied by overnight index swaps (OIS) to align them with historic target rates.

[5] Board of Governors of the Federal Reserve System, FOMC *Meeting Statement*, July 28, 2021.

symposium in August, Fed Chair Powell stated that he and most Committee members judged that the "substantial further progress" goal has been met on inflation but not yet on employment and that "it could be appropriate to start reducing the pace of asset purchases this year."[6] In addition, the FOMC's most recent "dot plot" from June showed Committee members expected the fed funds rate to remain near zero through 2022 but penciled in 50 bp of rate hikes in 2023. The FOMC will release updated projections on September 22.

Figure 17: Money Supply Up, but Not Crazy

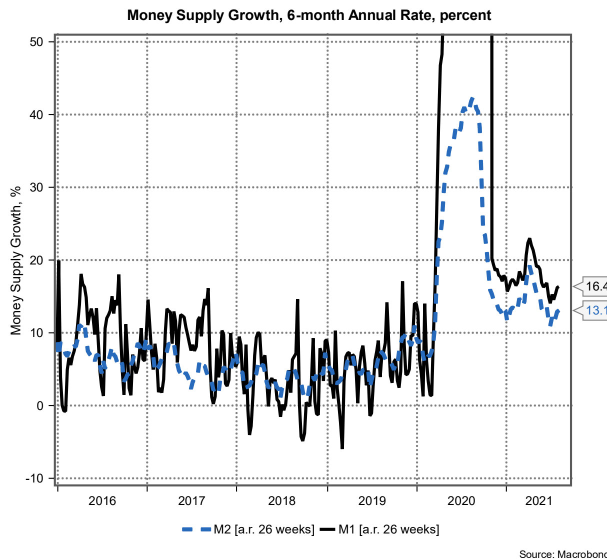
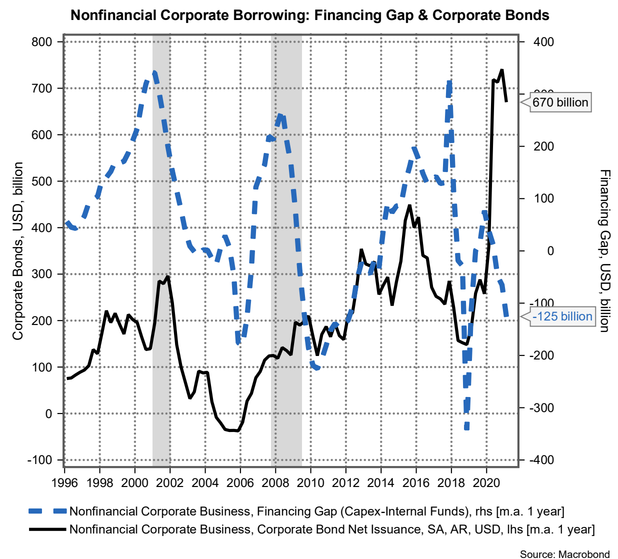


Figure 18: Issuance Outpacing CapEx



Highly accommodative monetary policy has kept financial conditions very loose and helped buoy markets. Financial conditions are currently the easiest on record (Figure 16). Easy Fed policy helped spur rapid money supply growth (Figure 17). Note that the spike in money supply last year resulted from a change in bank reserve requirements for deposits. The Fed eliminated deposit reserve requirements in March 2020, which meant reserves held for that purpose suddenly were included in money supply, exaggerating their growth rates, especially for M1, which exceeded 1800% during the 6-month period following the change. (We have limited the y-axis to 50% make more relevant movements visible.) Current 6-month growth rates of 16% for M1 and 13% for M2 are high but consistent with the Fed's objective of raising inflation to its 2% long-term average target. Nonetheless, there is substantial fuel available to sustain inflation at a level the Fed could find unwelcome, especially if the labor market remains tight and final demand remains strong — a combination that could allow producers to pass through higher labor costs and begin a cycle of wage and price increases. We do not expect a 1970's style wage-price spiral, but the Fed may be too optimistic that recent inflation gains will prove only temporary.

Nonfinancial corporate businesses took advantage of ample liquidity in financial markets to boost their own liquidity and prepare for greater capital expenditures (business investment) ahead. Net nonfinancial corporate bond issuance over the past four quarters ending in March

[6] Jerome Powell, *Monetary Policy in the Time of COVID,* August 27, 2021.

(latest data available) was $670 billion according to the Federal Reserve's Flow of Funds (Z.1) report (Figure 18). That is well ahead of what was needed to finance capital expenditures net of internally generated funds (the "financing gap"). Most of that corporate bond issuance wound up on corporate balance sheets in the form of financial assets, which rose by about $550 billion since 4Q2020. While we expect the financing gap to turn positive again (i.e., companies will spend more on business investment than they generate internally) as the economy grows and competition shrinks margins, businesses should not need to deluge corporate bond markets with debt. That could limit upward pressure on corporate bonds spreads when capital expenditures accelerate.[7]

Figure 19: Spreads Reflect Outlook, Borrowing

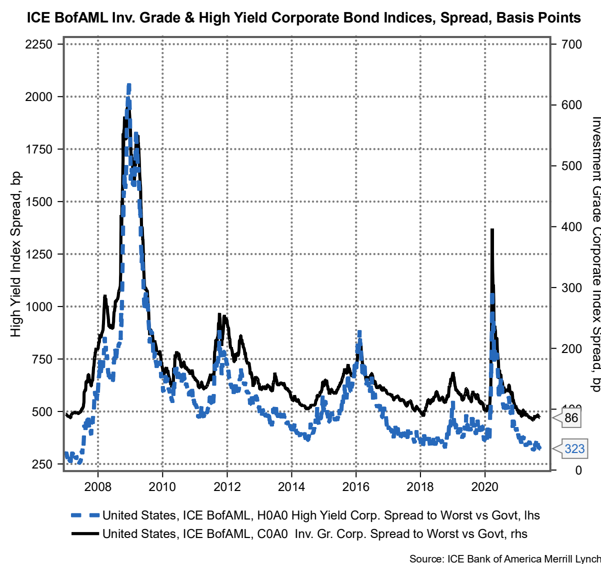
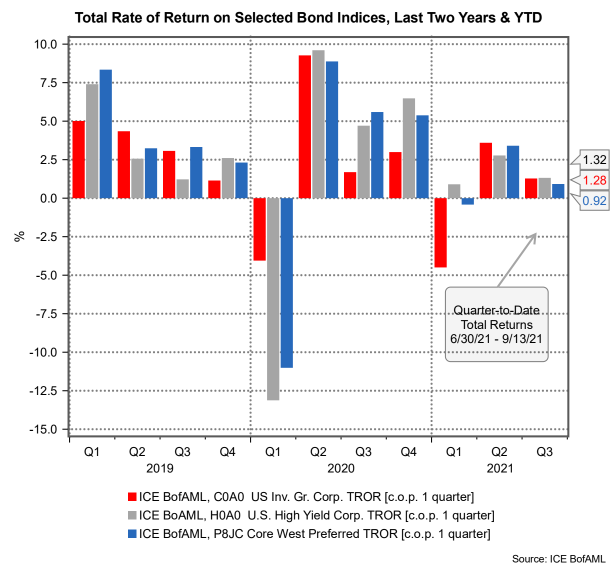


Figure 20: Lower Rates Boosted Returns



A strengthening economy, rising corporate profits (up 9.7% for all corporate businesses in Q2 and 42.3% YoY on an after-tax basis) and easier financial conditions continued to push corporate **credit spreads** tighter in the second quarter, bringing spreads to their lows since the global financial crisis. Investment-grade corporate bond spreads narrowed by 9 bp to 82 bp in Q2 but edged up to 86 bp as of September 13 (Figure 19).[8] High yield bond spreads narrowed as well, falling 35 bp to 318 bp in Q2; they ticked up to 323 bp as of September 13.

Spreads on preferred securities fell between those of investment-grade and high yield corporate bonds, although their complex call features make simple spread measures difficult to illustrate. Total rate of return, which incorporates both income and price changes, combines the impacts of credit spread and Treasury yield changes on bond returns. Figure 20 shows total returns on selected ICE BofA indices in recent quarters. In contrast to the first

[7] To the extent corporations sell financial assets to cover a financing gap, that could cause credit spreads to widen. However, it is likely that a substantial portion of those assets would be lower-risk assets such as money market instruments or Treasuries, whose sales should have little impact on corporate bond spreads.

[8] Investment-grade corporate bond spread is represented by the ICE BofA U.S. Corporate Index℠ (C0A0) "Yield to Worst versus Government" yield spread series. "Spread to Worst" is the lower of yield to call and yield to maturity minus yield on a comparable Treasury security. Index data through 9/13/2021.

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quarter, credit spreads and benchmark rates both fell in Q2, giving returns an extra boost. Total return in Q2 on the preferred index[9] (+3.41%) slightly lagged the investment-grade corporate bond index (+3.60%) but outperformed the high yield index (+2.77%).[10] For the year to date through September 13, 2021, the high yield bond index is ahead (+5.07%) as those credit spreads fell most substantially. Return on the preferred index was also strong (+3.92%), while the investment-grade corporate bond index was up slightly (+0.21%).

Figure 21: Bankruptcies Slow as GDP Booms

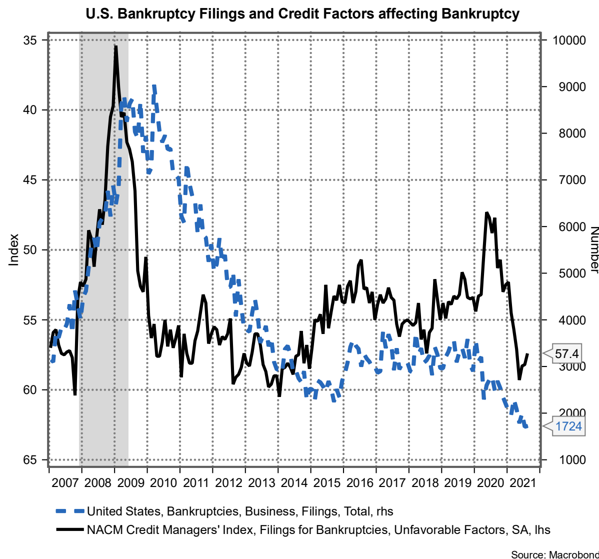
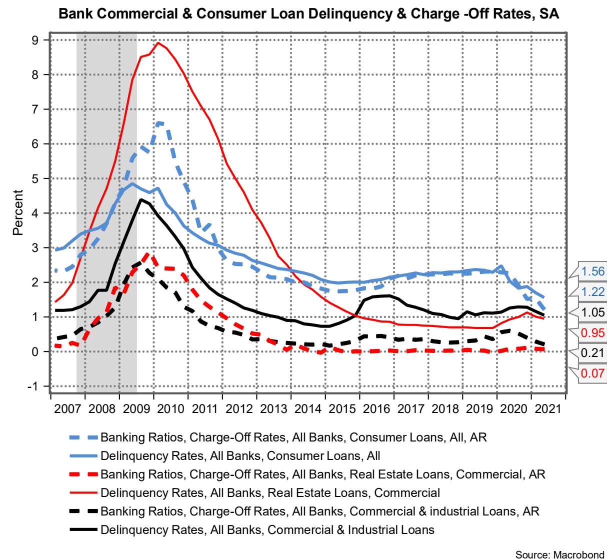


Figure 22: Loan Quality Improving Again



Credit conditions continued to improve in the second quarter. Business bankruptcy filings continued to decline through August, although factors unfavorable to bankruptcy filings as measured by the National Association of Credit Management increased slightly (Figure 21). Bank loan quality generally strengthened in Q2. Total bank loan delinquencies and charge-offs edged down to 1.4% and 0.3%, respectively, both of which are below pre-pandemic levels. Consumer loan delinquencies declined by 0.1% to 1.6% in Q2, while charge-offs fell by 0.3% to 1.2% (Figure 22). Commercial and industrial loan performance improved by 0.1% during the quarter, with delinquencies at 1.1% and charge-offs at 0.1%. Commercial real estate charge-offs remained under 0.1% and delinquencies slipped below 1.0%. A broad economic recovery and accommodative monetary policy have bolstered balance sheets across industries that are major issuers of preferred and contingent capital securities.

Although supply chain disruptions, labor shortages and ongoing challenges from COVID are likely to slow economic growth in the second half of 2021 compared to its first half, we continue to expect above-trend growth through 2022. Indeed, headwinds to near-term growth may produce tailwinds to medium-term growth to the extent they help dissipate inflationary pressure that could prompt more-aggressive monetary tightening and lead to

[9] Preferred index is the ICE BofA 8% Constrained Core West Preferred & Junior Subordinated Securities Index^{SM} (P8JC). Index data through 9/13/2021.

[10] Total return is not annualized and includes both price change and income. Past performance does not guarantee future performance.

recession. For now, we expect healthy credit conditions and moderately higher interest rates over coming quarters, which should again favor fixed-income sectors with higher credit spreads and moderate interest rate risk, including preferred and contingent capital securities.

Flaherty & Crumrine Incorporated
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