U.S. Fourth-Quarter Economic Update
January 2007

Summary of Recent Economic Developments

Economic growth rebounded in the fourth quarter as falling energy prices, an improved trade balance, and a resilient consumer overcame weakness in housing and manufacturing. Economists surveyed by the Federal Reserve in late November expected Q4 growth of about 2.5%[1], but a string of firmer than expected data over the past few weeks should push real GDP above 3.0% when preliminary data is released on January 31. Aided by sharply lower fuel prices, consumer spending stayed firm, with core retail sales up 5.8% in Q4, despite a further contraction in housing. Employment and wage gains were also firmer than expected, setting a solid base for income growth and continued consumption. The trade deficit improved dramatically as oil prices fell. Offsetting some of this strength, manufacturing slowed in response to rising inventories and slowing orders. Business investment was mixed, with strong construction activity but soft capital goods orders and shipments. Inflation pressures eased, though the Fed remains more concerned about higher inflation than slower growth. Intermediate- and long-term interest rates moved higher in response to the stronger economic news, but encouraging inflation data limited the extent of the market's sell off. Credit spreads tightened on a combination of solid credit fundamentals and powerful technicals, despite heavy new issue supply.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	2005:1	2005:2	2005:3	2005:4	2006:1	2006:2	2006:3	2006:4
Real GDP, Chg QoQ (%)	3.4	3.3	4.2	1.8	5.6	2.6	2.0	2.5f
Real Personal Consump Expnds, Chg QoQ (%)	2.7	4.2	3.9	0.8	4.8	2.6	2.8	4.8a
Real Busi Investmt, Eqp & Sftware, Chg QoQ (%)	6.3	7.9	11.0	2.8	15.6	-1.4	7.7	
Real Residential Investmt, Chg QoQ (%)	11.1	20.0	7.1	-0.9	-0.3	-11.1	-18.7	
Corporate Profits, After Tax, Chg YoY (%)	4.8	7.9	3.7	5.7	21.0	17.4	31.0	17.1f
Current Account Balance, Annualized (% of GDP)	-6.3	-6.3	-5.8	-7.0	-6.6	-6.6	-6.8	
Federal Budget, 12-mo Def or Surp (% of GDP)	-3.3	-2.7	-2.6	-2.5	-2.5	-2.1	-1.9	
Unemployment Rate (%)	5.2	5.0	5.1	4.9	4.7	4.6	4.6	4.5
Household Employment, Chg QoQ (000)	445	1105	745	333	898	706	520	1020
Nonfarm Payrolls, Chg QoQ (000)	481	500	464	536	529	346	556	407
Nonfarm Productivity, Chg QoQ (%)	3.6	2.3	4.4	-0.1	4.3	1.2	0.2	
Capacity Utilization (%)	79.9	80.6	79.2	81.3	81.4	82.3	82.0	81.8a
GDP Price Index, Chg QoQ (%)	3.5	2.4	3.3	3.3	3.3	3.3	1.9	
Consumer Price Index, Chg YoY (%)	3.2	2.5	4.7	3.4	3.4	4.3	2.1	2.0a
CPI ex food & energy, Chg YoY (%)	2.4	2.0	2.0	2.2	2.1	2.7	2.9	2.6a
Nominal Personal Income, Chg YoY (%)	5.6	5.5	6.2	2.6	7.0	6.2	6.0	5.9a
Personal Savings Rate (%)	0.2	-0.5	-0.5	-0.3	-0.4	-1.5	-0.7	-1.0a
Rate or Spread (End of Quarter)	**2005:1**	**2005:2**	**2005:3**	**2005:4**	**2006:1**	**2006:2**	**2006:3**	**2006:4**
Federal Funds Rate Target (%)	2.75	3.25	3.75	4.25	4.75	5.25	5.25	5.25
3-month LIBOR (%)	3.12	3.52	4.07	4.54	5.00	5.48	5.37	5.36
10-Yr Treasury Note Yield (%)	4.49	3.92	4.33	4.40	4.86	5.15	4.64	4.70
30-Yr Treasury Bond Yield (%)	4.76	4.19	4.57	4.54	4.90	5.19	4.77	4.81
Moody's Baa Long Corp Spread (bp)	138	162	158	167	165	163	160	154
10-Yr Interest Rate Swap Spread (bp)	47.2	46.2	46.2	51.9	53.0	64.3	52.6	48.3

* Figures are either quarterly or, if more frequent, quarterly averages. f = Forecast[1]; a = Actual through November 2006 Source: EcoWin

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

[1] Source: Federal Reserve Bank of Philadelphia, *The Livingston Survey*, December 7, 2006.

Economic Outlook

Consumer spending recovered in the fourth quarter as lower energy prices helped to boost confidence and free-up some cash going into the holiday shopping season. Real personal consumption rose at a 4.8% annual rate through November, while core retail sales (excluding autos, gasoline, and building materials) posted 5.8% gains on the quarter (Figure 2). In fact, spending outpaced fairly rapid income growth, pushing the savings rate down slightly to -1.0% as of the end of November. Sharply lower energy prices (Figure 3) along with solid job growth and rising wages have allowed consumers to maintain their spending. So far, weakness in the housing market has not filtered through notably to consumption.

Figure 2: Consumer Spending Rebounds…

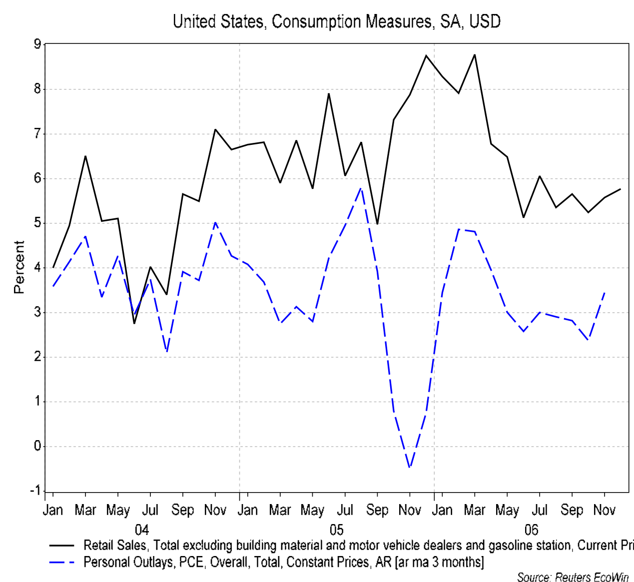
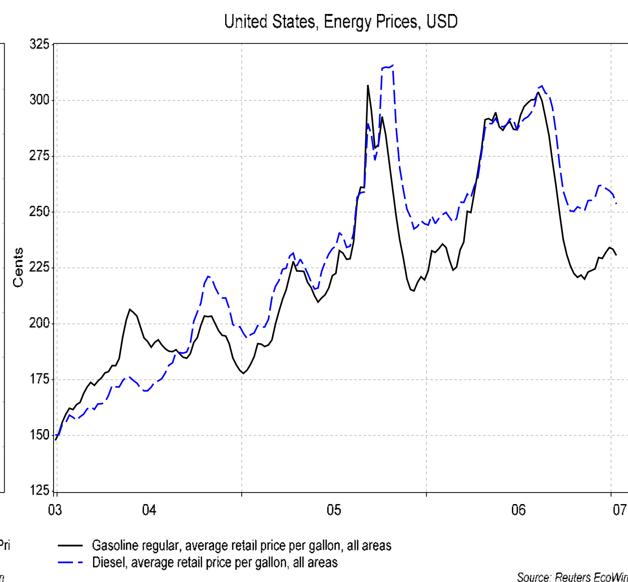


Figure 3: …With an Assist from Fuel



As we discussed in last quarter's Update[2], the ongoing contraction of the housing sector represents the primary downside risk to the economic outlook, since real estate represents roughly 30% of household gross assets and homeowners' equity comprises 20% of household net worth. By all measures, the housing market has suffered a huge contraction. Residential construction spending continues to slide, pulling down overall construction despite surging commercial construction activity (Figure 4). New and existing home sales are down 10.7% and 15.3%, respectively, over the past year ending in November. Inventories of new and existing homes are near the highest levels on record, while affordability is near the lowest (i.e. worst) level in 15 years (Figure 5). Turning to prices, existing home prices are down on the year, and new home prices – while still positive – have eased significantly, with builders offering discounts to pare inventory. On a positive note, home sales and inventories have been broadly stable over the past few months, and affordability has improved due to lower home prices, rising income, and somewhat lower mortgage interest rates. We would not take that as proof that the housing market has bottomed, given today's sizable inventory overhang and still-poor affordability. However, it does appear safe to conclude that the worst of the housing correction is over. Looking ahead, residential investment should continue to be a drag on GDP growth for the next few quarters (and perhaps longer), but in sequentially smaller amounts.

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[2] See the Flaherty & Crumrine Incorporated *U.S. Third-Quarter Economic Update*, October 2006.

Figure 4: Residential Construction Sliding

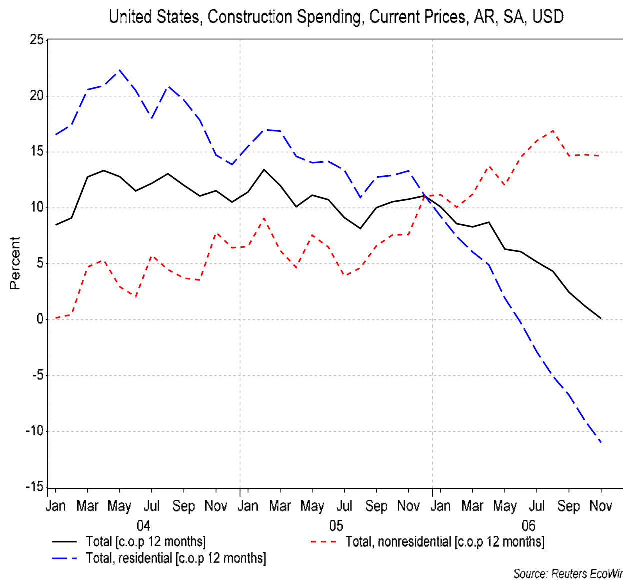
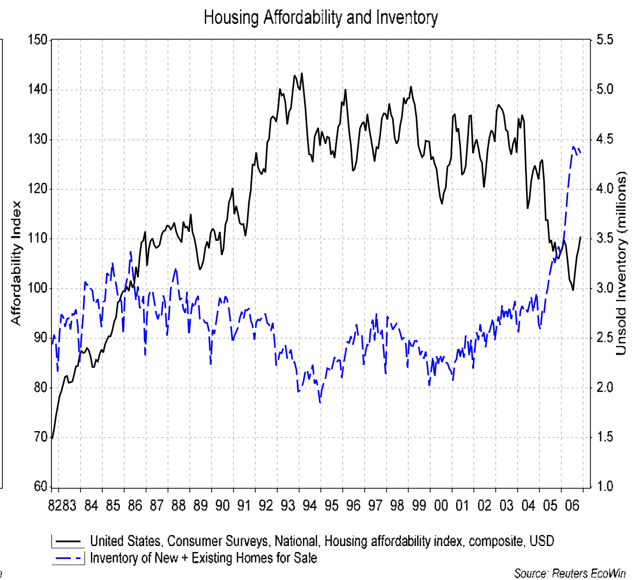


Figure 5: Home Inventory High, Affordability Poor



The **labor market** was a bright spot for the economy in the fourth quarter – though how bright depends upon the data one analyzes. The Household employment survey pointed toward extremely strong employment growth in the quarter, averaging 340,000 job gains per month, while the Establishment survey suggested only moderate job growth of about 135,000 jobs per month (Figure 6). Both of these measures of job growth exceeded the downbeat estimates of economists (or is it "estimates of downbeat economists?") at the beginning of the quarter, but if the Household survey is right, then the economy is much stronger than most people think. Regular readers will know that we have placed greater emphasis on the Household survey for the past few years. This quarter's reading of more than 1 million new jobs, however, is hard to square with respectable but hardly spectacular readings on consumption and output. We still think the Establishment survey is missing a lot of job growth, but not as much as the Household survey suggests in Q4. Even if the Household survey is only half right, however, job growth in the neighborhood of ½ million over the quarter is quite healthy and would continue to put downward pressure on the unemployment rate, which ended the year at 4.5% after touching a cycle-low 4.4% in October (Figure 7). This sturdy pace of job growth will support income and in turn consumption.

Along with the growth in employment and the tightening of the labor market, wages accelerated in the fourth quarter, as they have for most of the past three years. Average hourly earnings are up 4.2% over the past year, about one percentage point higher than a year ago (Figure 7). Wage growth of 4% by itself is probably not worrisome to the Federal Reserve, since that represents real wage growth of about 2% (deflated by the Personal Consumption Expenditure deflator), which is somewhere around the long-term growth rate of productivity and thus not inherently inflationary. For the past few years, real wages have grown more slowly than productivity, which has allowed businesses to expand margins and boost profits and is reflected by the record level of profits as a share of GDP (Figure 15). As the expansion matures and the labor market tightens, it is normal for workers to claim a larger share of business revenues. Indeed, given the concern over the "hollowing out" of the middle class, the Fed is not going to stand in the way of real wage growth. However, the Fed probably is concerned over the *acceleration* in wage gains,

especially with the unemployment rate at or below most economists' estimates of NAIRU (non-accelerating inflation rate of unemployment). Indeed, recent comments from Federal Open Market Committee (FOMC) members indicate that they remain more concerned about inflation than about growth.

Figure 6: Moderate to Strong Job Growth

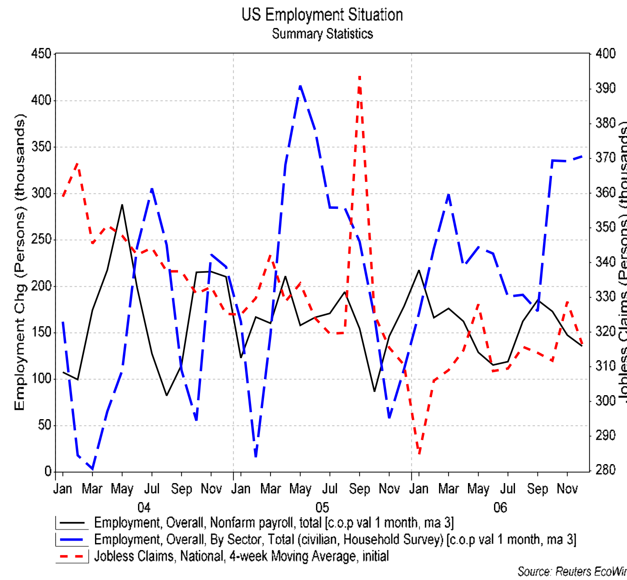


Figure 7: Falling Unemployment, Higher Wages

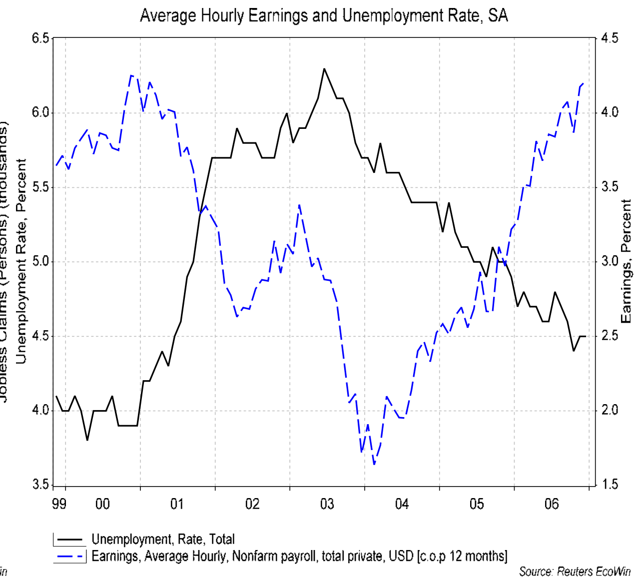


Figure 8: Softer Manufacturing

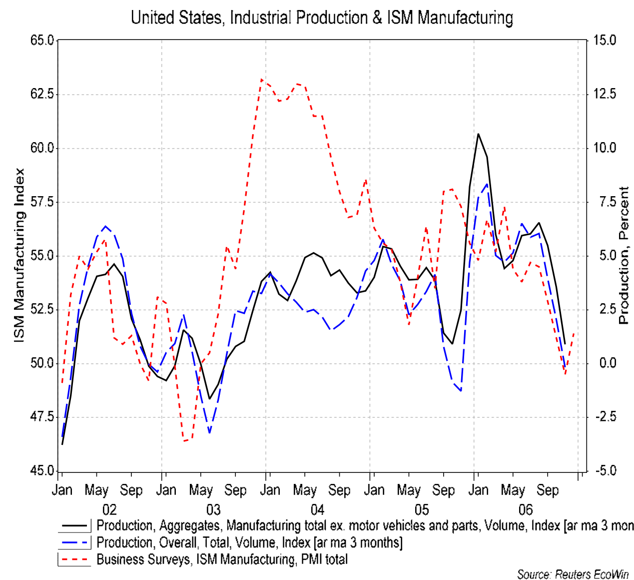
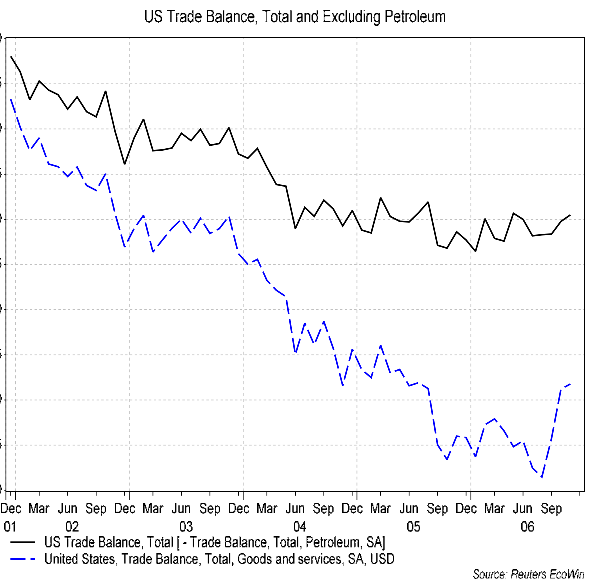


Figure 9: Much Narrower Trade Deficit



Business investment was mixed in the fourth quarter, with strong construction activity but soft demand for capital goods. As shown earlier, nonresidential construction spending continued its surge, with private spending up 18% year-on-year through November (Figure 4). However, shipments of nondefense capital goods (excluding aircraft) rose by only about 2% in the quarter, and orders fell. In fact, the broader manufacturing sector clearly slowed in the fourth quarter. Industrial production over the three-months ending in November was unchanged compared to the prior three-month period – a sharp slowdown from the 5-10% growth pace earlier in the year

(Figure 8). Similarly, the ISM Manufacturing Index, the single best gauge of industrial activity in the U.S., slid sharply in the fourth quarter, although it rebounded a bit in December (Figure 8). At this point, the slowdown in manufacturing seems to be an early and limited response to some modest inventory accumulation. If demand both here and abroad remains firm as we expect, then manufacturing should pick up again in a quarter or so.

The **trade sector** offered unequivocally good news for the economy, as the trade deficit narrowed by more than $10 billion from August to November (Figure 9). Most of the improvement, as expected, came from lower energy prices, but the core (ex petroleum) deficit also shrunk modestly. Export growth has been impressive, up 13.4% over the past year, while import growth slowed to just 5.2%. As a result, trade will add significantly (at least ½ percentage point) to GDP in the fourth quarter, barring a sharp turnaround in December's balance, which won't be available for another month.

Figure 10: Inflation Pressures Ease Further…

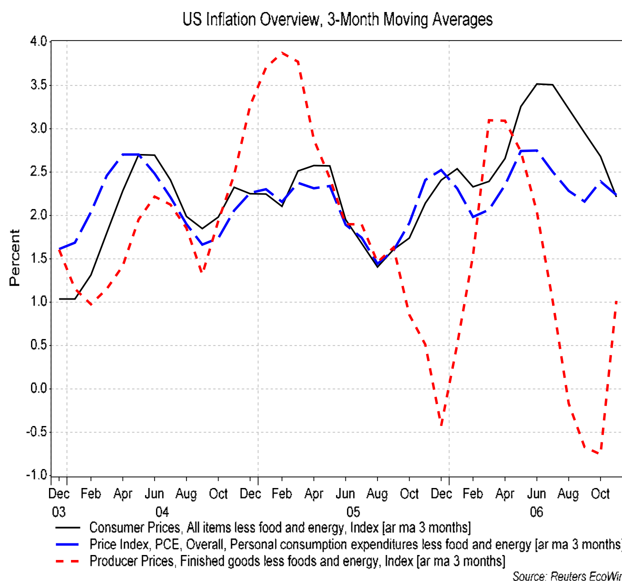
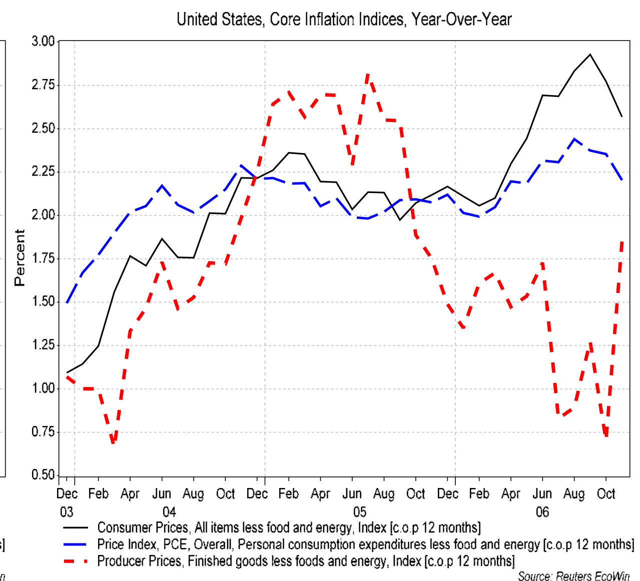


Figure 11: …Pulling YOY Inflation Lower



Inflation generally eased in the fourth quarter although core producer prices rebounded from a fall earlier in the year. Nonetheless, core inflation – whether measured on a three-month moving average basis or on a year-on-year basis – remains above the top of the Federal Reserve's "comfort zone" of 1-2% (Figures 10 and 11). If the economy continues to grow modestly below potential (between 3-3½%) for the next several quarters, as appears likely, and monetary policy remains broadly neutral (which is where we think it is now), then the inflation rate should gradually decline. Indeed, that is the Fed's forecast. If, however, growth is stronger or inflation is stickier than the Fed currently expects, then the Fed may either need to tighten monetary policy further or leave the fed funds rate at 5.25% for longer than the market currently contemplates.

Market Outlook

The Federal Reserve left the fed funds rate unchanged at 5.25% in the fourth quarter as it did in Q3, and it's widely expected to leave rates unchanged again at the January 31st FOMC meeting. Long-term Treasury yields traded in a narrow range, ending the quarter less than 10 basis points (bp) higher than where they started (Figure 12). The yield curve remains inverted, though slightly less so than at the start of the quarter. Currently, the market is pricing in one or two rate

cuts by the Fed in 2007, beginning around mid-year. This represents a bit less aggressive easing than the market anticipated last quarter, but it still reflects a relatively bearish outlook for the economy.

Figure 12: Little Change in Long Rates

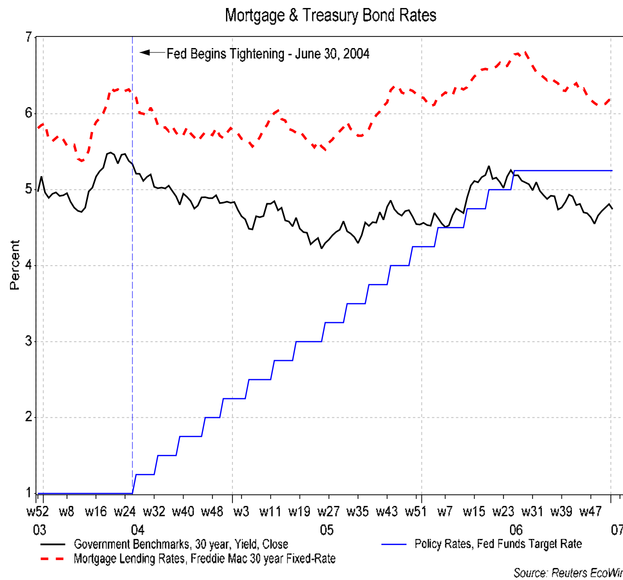
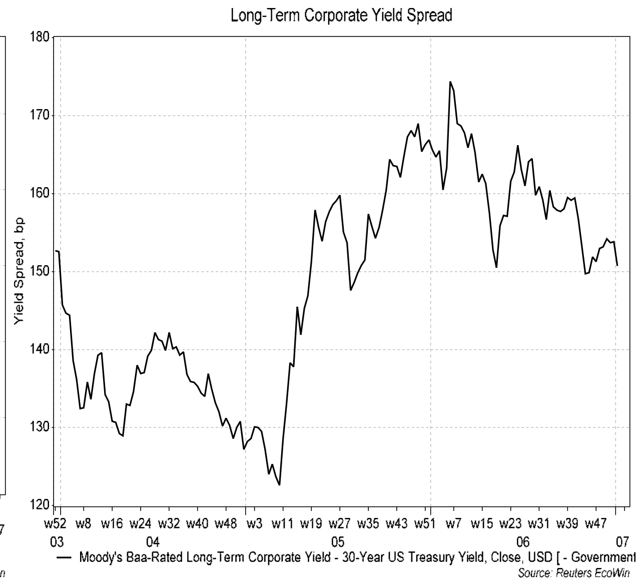


Figure 13: Slightly Tighter Credit Spreads



Our outlook for interest rates and monetary policy is essentially unchanged from last quarter. We see three main scenarios. The first, and in our view the most likely, scenario is that the economy will handle the housing slowdown and bounce back to at- or above-trend GDP growth again in the second half of the year. In this scenario, inflation would ease somewhat further over the next several quarters, but not by enough to prompt the Fed to ease monetary policy. As the rate cuts expected by the market fail to materialize, intermediate- and long-term interest rates would increase moderately and the yield curve from 3-months to 30-years would steepen.

Scenario 2 is a broader housing-led slowdown, which could prompt the easing by the Fed that the market anticipates. We view this as the next most likely scenario. In it, the Fed would likely need to cut rates by more than the 50 bp or so that's currently priced into the market. This would steepen the yield curve significantly, although we still see only limited room for long-term rates to fall from current levels barring a sharp drop in inflation.

Under Scenario 3, the economy grows faster than expected, fueling inflation, and the Fed would need to tighten rates further to bring inflation under control. Since tightening in this scenario would be driven by renewed inflation, rates could turn sharply higher. The yield curve would invert further, but it would probably steepen first as long rates unwind the easing that is priced into today's rates. We don't see Scenario 3 as a major risk for 2007 given the headwinds from housing and the ongoing globalization of large swaths of the economy, but we can't entirely rule it out. As always, we are not betting on any one of these scenarios. The Funds' "safety net" hedging strategy allows us to focus on value in the preferred market and not worry too much about the general level of interest rates, knowing that the hedge is designed to protect the

portfolio if long-term rates rise significantly while imposing only a modest drag on performance should long-term rates fall.

Figure 14: Corporate Balance Sheets Strong

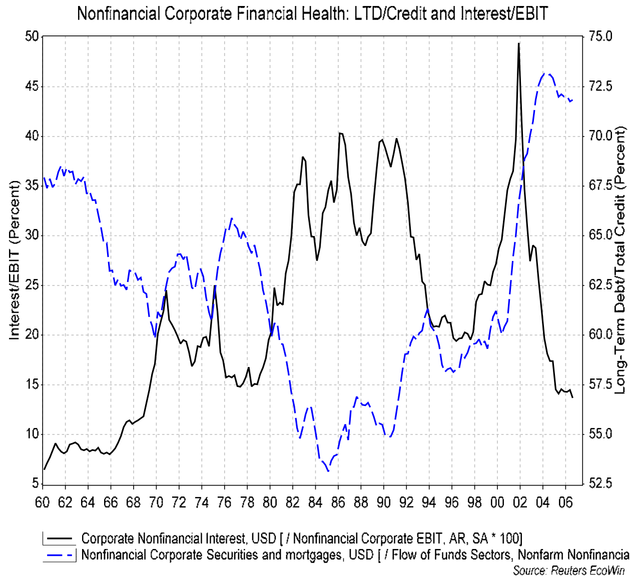


Figure 15: Profits Are Record-Breaking

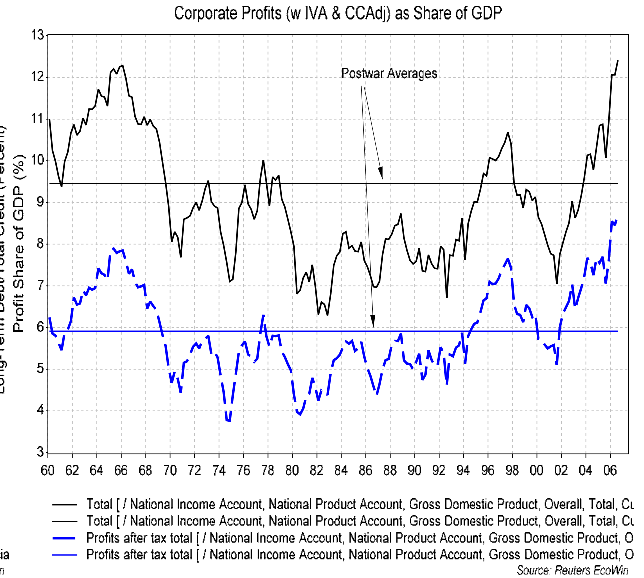


Figure 16: Few Loan Problems or Bankruptcies

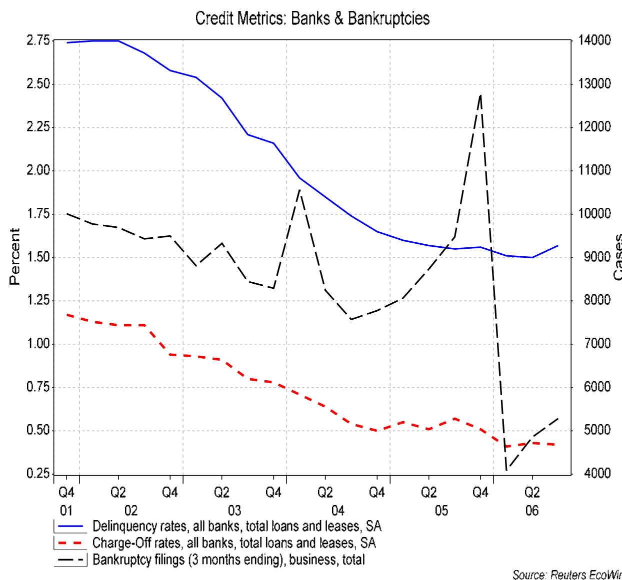
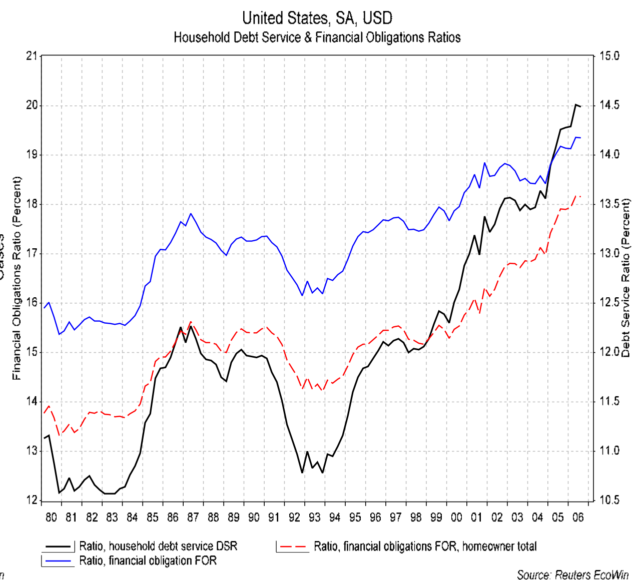


Figure 17: But Heavy Consumer Debt Loads



Credit spreads narrowed slightly in the fourth quarter, despite heavy supply from issuers. There are a number of reasons for this. First, as the preceding set of graphs illustrate, corporate financial health remains excellent. Overall nonfinancial corporate interest expense as a proportion of pretax earnings is at the lowest level since the 1960s, despite the resurgence of leveraged buyouts (Figure 14). Long-term debt, which does not need to be rolled over frequently, as a proportion of total debt remains near record levels (Figure 14). Pre-tax corporate profits are at the highest level as a share of GDP since the 1960s, and after-tax profits are at a record high

(Figure 15). Moreover, nonfinancial companies are hardly borrowing any money at all in the aggregate. Strong profit growth and disciplined capital spending have limited net borrowing to less than $40 billion (annualized) through the first three quarters of 2006 – very small relative to a $13 trillion economy. In short, companies have never been healthier or more liquid.

Likewise, bank balance sheets remain strong. Although loan delinquency rates have increased slightly, they are up from a very low level historically. Loan charge-off rates have held steady at record lows, and bankruptcy filings are near historical lows as well (Figure 16). More worryingly, household financial obligations are near historical highs (Figure 17). As we have argued in the past, much of this is a natural result of greater economic stability (output, inflation, and interest rates) and the broadening of credit markets. However, with less accommodative monetary policy (i.e. higher short-term interest rates) and a somewhat slower economy, we are bound to see some stress in the consumer sector. Solid job and income growth among consumers and strong capitalization at banks should prevent a broad deterioration of consumer and bank credit quality, but lenders with poor underwriting standards are likely to feel some pain in 2007.

In addition to those "fundamental" positives for credit spreads, we believe that "technicals" also account for some of the strength in credit markets. The inverted Treasury yield curve is one such technical. Hedge funds and many other financial institutions make a living on "carry," or the difference between the return on one asset and its cost of financing. When the yield curve is positively sloped, those investors can earn positive carry by buying higher-yielding long-term securities and financing them with short-term borrowings. There's risk in such trades, of course, but lots of leveraged investors do them. When the yield curve is inverted, as it is now, that income stream is cut off, so leveraged investors look for another carry trade. The corporate bond and preferred markets still offer positive carry, since the credit curve remains positively sloped (i.e. the spread to Treasuries is higher on long-maturity corporates than on shorter ones). Moreover, the development of the credit default swap (CDS) market offers built-in financing for leveraged investors. This positive carry has attracted a significant number of hedge funds and other investors into the corporate and preferred markets, increasing demand and driving down credit spreads.

Another important technical in the market is the huge current account deficit carried by the U.S.[3] The deficit must be financed by foreign capital flowing into US markets. Foreign investors also are faced with relatively low yields and an inverted yield curve in Treasuries and have sought higher returns. Over the past few years, they have become increasingly comfortable with U.S. credit markets, and demand from those investors has increased.

Looking ahead, we think that both the fundamental and technical credit strengths driving tighter spreads in the corporate bond and preferred markets will persist through 2007, although they are likely to diminish as the year progresses. We expect the yield curve to steepen a bit, which may pull some capital from corporates back toward Treasuries and swaps. A tight labor market and rising wages are likely to trim the unusually high level of corporate profits, reduce the profit share of GDP, and increase the need for external financing. As profit growth slows, companies may add leverage to their balance sheets in order to enhance shareholder returns, adding to the

[3] Perhaps the current account deficit qualifies as a "fundamental" given its persistence; nonetheless, it has brought a large new investor base to US credit instruments.

supply of corporate bonds and increasing credit risk. Continued strength in the economy (and rising labor costs) should prompt companies to step up capital expenditures, increasing corporate bond supply. A lower trade deficit will narrow the current account deficit, reducing foreign demand for US credit instruments – although we think this will be marginal, meaning that foreign demand will *increase* only a little less rapidly than it has in the past. Finally, merger and acquisition activity in general and leveraged buyouts in particular are likely to increase in 2007, driven by slower organic earnings growth and the freshly-filled coffers of LBO funds.

We believe these themes will play out gradually, and none of them are likely to reduce demand for or increase the supply of corporate bonds and preferreds over the near term, so we remain positive on credit spreads for now. But we think 2007 is going to be an interesting and perhaps a transitional year for credit markets. Moreover, some of the themes we outlined may develop more rapidly than we now expect. Change often brings opportunity. As always, we will work hard to be on the right side of it.

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January 12, 2007

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