

U.S. First-Quarter Economic Update

April 2007

Summary of Recent Economic Developments

The economy likely grew at about a 2% pace in the first quarter of 2007 after 2.5% GDP growth in Q4 – performance that was very much in-line with market expectations beginning the year. Most sectors of the domestic economy slowed modestly, but growth outside of the housing and business investment in equipment and software remains fairly good. Consumer spending remains a source of strength for the economy despite the contraction in housing and jitters over subprime mortgages, and we believe that consumption will continue to hold up fairly well. The trade balance probably continued to shrink on muted import growth and strong exports, although recent increases in petroleum prices will mask some of the fundamental improvement in trade. Employment gains moderated slightly in the quarter, but they were enough to push the unemployment rate down to 4.4%, matching the low point for this expansion. More worryingly, business investment likely fell in the first quarter, and housing continued its descent, albeit at a milder pace that last quarter’s 19.8% annualized decline. Inflation proved stickier than generally anticipated, rising slightly over the quarter and holding stubbornly above the Fed’s “comfort zone.” As a result, the Federal Reserve Open Market Committee left the fed funds rate on hold at 5.25% and retained its inflation-risk bias. Although interest rates and credit spreads displayed some volatility around the equity market sell-off in late February, they ended the quarter only slightly higher than where they began.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	2005:2	2005:3	2005:4	2006:1	2006:2	2006:3	2006:4	2007:1
Real GDP, Chg QoQ (%)	3.3	4.2	1.8	5.6	2.6	2.0	2.5	2.0f
Real Personal Consump Expend, Chg QoQ (%)	4.2	3.9	0.8	4.8	2.6	2.8	4.2	3.6a
Real Busi Investmt, Eqp & Sftware, Chg QoQ (%)	7.9	11.0	2.8	15.6	-1.4	7.7	-4.8	
Real Residential Investmt, Chg QoQ (%)	20.0	7.1	-0.9	-0.3	-11.1	-18.7	-19.8	
Corporate Profits, After Tax, Chg YoY (%)	7.9	3.7	5.7	21.0	17.4	31.0	21.0	13.4f
Current Account Balance, Annualized (% of GDP)	-6.3	-5.8	-7.0	-6.6	-6.6	-6.9	-5.8	
Federal Budget, 12-mo Def or Surp (% of GDP)	-2.7	-2.6	-2.5	-2.5	-2.1	-1.9	-1.6	
Unemployment Rate (%)	5.0	5.1	4.9	4.7	4.6	4.6	4.5	4.4
Household Employment, Chg QoQ (000)	1105	745	333	898	706	520	1020	328
Nonfarm Payrolls, Chg QoQ (000)	793	634	660	755	371	606	531	455
Nonfarm Productivity, Chg QoQ (%)	1.5	3.7	-0.6	3.5	1.2	-0.5	1.6	
Capacity Utilization (%)	80.6	79.2	81.3	81.4	82.3	82.0	81.7	82.0a
GDP Price Index, Chg QoQ (%)	2.4	3.3	3.3	3.3	3.3	1.9	1.7	
Consumer Price Index, Chg YoY (%)	2.5	4.7	3.4	3.4	4.3	2.1	2.5	2.4a
CPI ex food & energy, Chg YoY (%)	2.1	2.0	2.2	2.1	2.6	2.9	2.6	2.7a
Nominal Personal Income, Chg YoY (%)	5.5	6.2	2.6	7.0	6.2	5.7	5.6	5.3a
Personal Savings Rate (%)	-0.5	-0.5	-0.3	-0.4	-1.5	-1.0	-1.4	-1.2a
Rate or Spread (End of Quarter)	2005:2	2005:3	2005:4	2006:1	2006:2	2006:3	2006:4	2007:1
Federal Funds Rate Target (%)	3.25	3.75	4.25	4.75	5.25	5.25	5.25	5.25
3-month LIBOR (%)	3.52	4.07	4.54	5.00	5.48	5.37	5.36	5.35
10-Yr Treasury Note Yield (%)	3.92	4.33	4.40	4.86	5.15	4.63	4.70	4.65
30-Yr Treasury Bond Yield (%)	4.19	4.57	4.54	4.90	5.19	4.77	4.81	4.85
Moody's Baa Long Corp Spread (bp)	162	158	167	165	163	160	154	155
10-Yr Interest Rate Swap Spread (bp)	46.2	46.2	51.9	53.0	64.3	52.8	48.7	54.2

* Figures are either quarterly or, if more frequent, quarterly averages.

f = Forecast¹; a = Actual through February 2007

Source: Reuters EcoWin

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

Economic Outlook

Economic growth has ranged between 2.0-2.6% since early 2006, and the average GDP growth estimate for the first quarter of 2007 is at the low end of that range. The mediocre overall performance of the economy reflects strength in some areas and weakness in others. On the positive side, **consumer spending** slowed modestly in the first quarter but remains an area of strength for the U.S. economy. Through February, real personal consumption expenditures are up 3.6% over the 4th-quarter average and are up 3.2% over the past year (Figure 2). In addition, preliminary reports from retailers suggest that consumption stayed firm in March. Consumption has been supported by solid income growth of 5.3% nominal (3.0% real) over the past year, and with the job market still healthy (see below) we expect income growth to remain fairly good.

Figure 2: Income & Consumption Solid

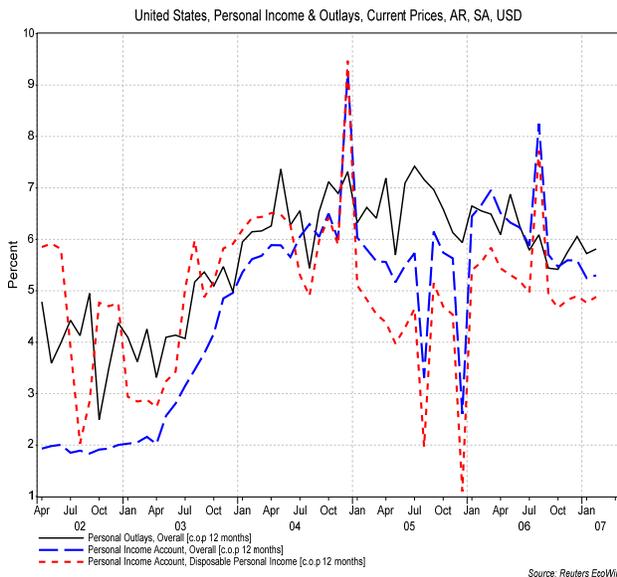
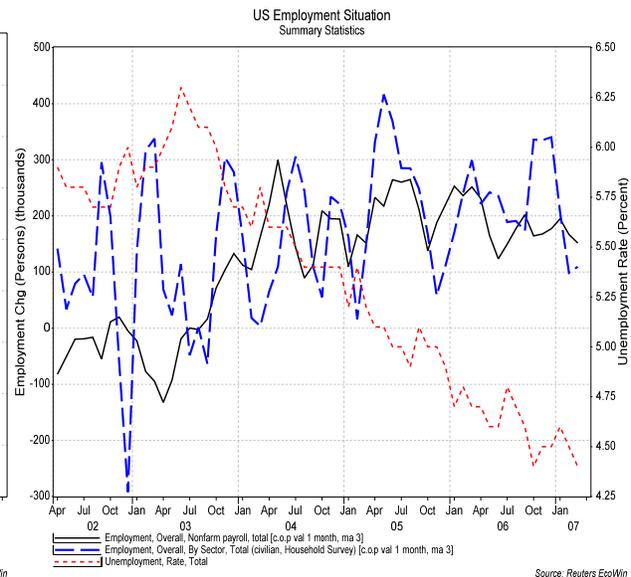


Figure 3: Labor Market Remains Healthy



Trade is another bright spot for the economy. The trade deficit shrank further over the most recent three months, with particular improvement in the core deficit (excluding petroleum). Although it seemed unlikely a year ago, export growth has outpaced import growth nearly four-to-one over the past year ending in January, with exports rising by 10.7% compared to just 2.7% growth in imports (2.6% excluding petroleum). A weaker dollar, modest economic growth in the U.S., and improving global economic growth should keep the core trade deficit on a positive trajectory, although higher energy prices could undo some of that progress.

The **labor market** also remains fairly firm, although the pace of improvement slowed a bit in the first quarter (Figure 3). According to the household employment survey, the economy added 328,000 jobs, while the payroll survey puts the total at 455,000 jobs. Those numbers generally are below the pace of recent quarters but still exceeded most economists' forecasts. Wage growth eased slightly to about 4% over the past year after touching 4.3% in December, but this still represents fairly good real wage gains. Finally, the unemployment rate fell to 4.4%, equaling the low for this economic cycle.

On the negative side for the economy, **business investment** appears weak. Business equipment and software spending fell by 4.8% in the fourth quarter and probably declined further in the first quarter, judging by the 6.1% decline in shipments of nondefense capital goods excluding aircraft

in the three months ending in February compared to the prior three months. No doubt some of this is related to the contraction in homebuilding (less need for trucks and other construction equipment), though it appears to go beyond just that. Similarly, growth in the manufacturing sector appears to have ground nearly to a standstill based upon survey data from the Institute for Supply Management (ISM). The ISM manufacturing index stood at 50.9 as of March (50 represents no growth), and the key orders and production sub-indices were nearly as weak at 53.0 and 51.6, respectively. Offsetting some but not all of this weakness is business construction spending, which grew by 12.9% over the three months ending in February. Overall, we think business investment will rebound in the second half of the year, but it will probably be a drag on growth in the first half.

Figure 4: Inflation Pressures Return...

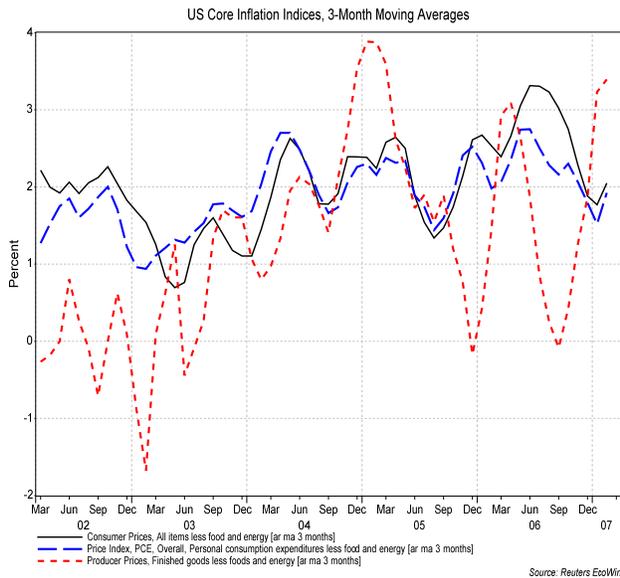
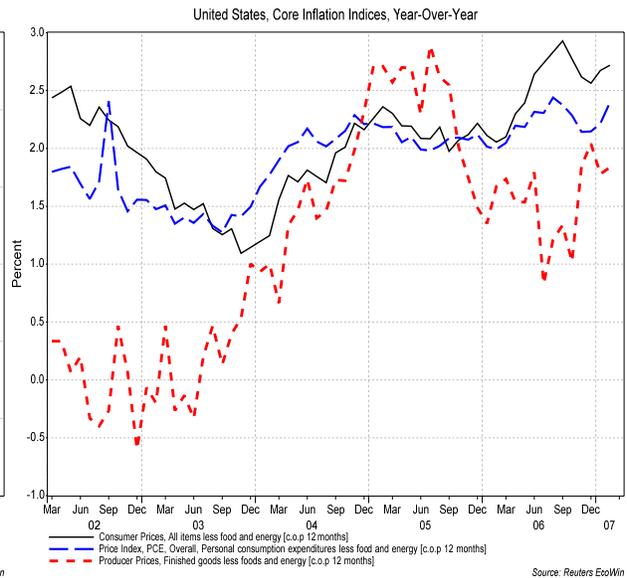


Figure 5: ...Pushing Up Annual Inflation Indices



Inflation news has been disappointing so far in 2007. Core inflation gauges have accelerated in recent months after falling in the second half of last year (Figure 4). While these pressures have led to only a mild increase in the year-on-year core personal consumption expenditure (PCE) and consumer price index (CPI) measures of inflation (Figure 5), the market and the Federal Reserve have been expecting lower inflation. Moreover, most measures of inflation remain stubbornly above the presumed 2% upper bound to the Fed's "comfort zone" for inflation. Although economic growth has been slightly below potential for the past year or so, little slack has developed. In fact, the unemployment rate of 4.4% is at the low point for the expansion, and capacity utilization is close to the high reached in mid-2006 (82.0% in February compared to a cycle-high of 82.4%). Inflation hardly seems ready to accelerate, given the headwinds facing the economy and broadly neutral monetary policy, but its stickiness is a problem for the Fed.

As it has been for the past year, the **housing market** remains the weakest sector of the economy by far. Although unusually warm weather in December and January and brutally cold weather in February make it difficult to interpret the various housing statistics, it's likely that the housing market is still contracting, although certainly at a slower pace than in the fourth quarter, when residential investment fell by 19.8% at an annual rate. New home sales dropped sharply (3.9%, not annualized) in February after holding about steady for a few months. In contrast, existing home sales rose in February, also by 3.9%! These may simply reflect the abnormal winter

weather noted above. Weak new home sales in February may reflect that month's poor weather, since new homes are counted as sales when the contract is *signed*. On the flip side, strong existing home sales in February may reflect good weather in December and January, since existing home sales are counted when the contract *closes*, typically 4-6 weeks after a contract is signed.

On balance, we expect home sales to continue to decline modestly for two primary reasons. First, housing affordability – while improving – is still poor relative to the norm of the past 15 years (Figure 6). Although home prices have decelerated and incomes are rising, the huge run-up in home prices during the bubble years means that potential home buyers still must spend a significantly larger proportion of income on housing than they did prior to the bubble. It will take a few more years of rising incomes accompanied by flat home prices for affordability to return to normal – although it's possible that an outright decline in home prices will get the job done faster. Second, the inventory of unsold homes is at a record high while home prices have yet to fall very much, if at all (Figure 7). This situation is likely to keep some buyers on the sidelines waiting for lower prices. It's hard to see the housing market (prices or new construction) turning upward until inventories are meaningfully lower. Accordingly, we expect housing to remain a drag on the economy, although that drag should diminish from one quarter to the next.

Figure 6: Home Affordability Still Poor

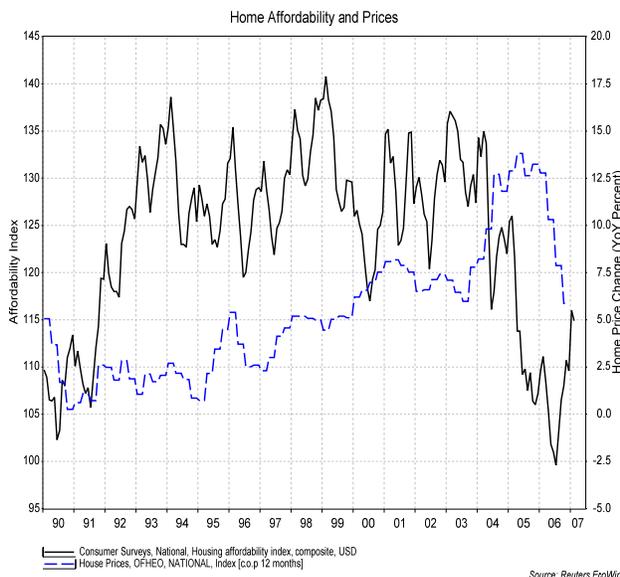
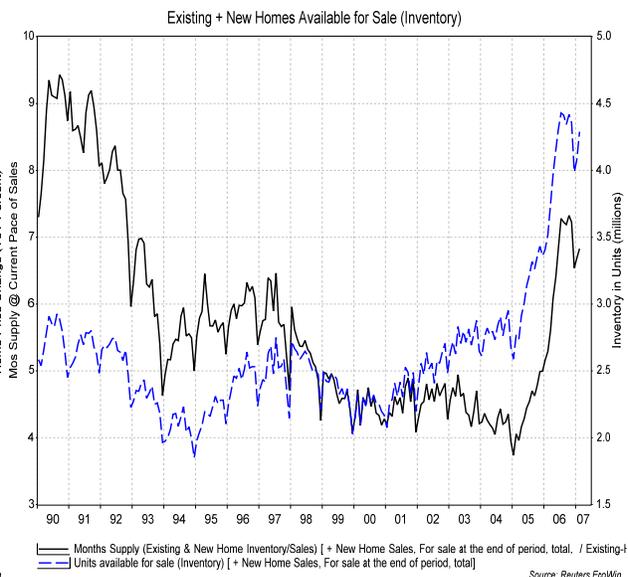


Figure 7: Record Inventories of Unsold Homes



Weakness in the housing market has had a pronounced impact on **subprime mortgage lending**. In recent months, a number of specialty subprime lenders have filed for bankruptcy, and it's difficult to read the business section of any major newspaper without finding a story about the problems of subprime borrowers or lenders¹. Mortgage borrowing has become more difficult. The most recent Senior Loan Officer Survey by the Federal Reserve (January 2007) revealed that 16.4% of banks surveyed had tightened lending standards on residential mortgages since the fourth quarter, a 25.7 percentage point increase in just three months (Figure 8). In one striking example of such loan tightening, several large mortgage lenders recently announced that they

¹ For a discussion of the impact of subprime lending on the Funds' portfolios, please see the FAQ section of the Funds' web sites, www.preferredincome.com and www.fcclaymore.com.

would no longer accept mortgage applications from a borrower who (1) has a subprime credit profile, (2) wants to borrow 100% or more of the purchase price of the home, and (3) is unable or unwilling to document his or her income. We can only wonder why such applications were *ever* accepted. Nonetheless, folks in that category won't be able to get a mortgage in today's market, and that no doubt will reduce demand for housing and subsequently consumption to some degree.

Figure 8: Tighter Mortgage Lending Standards

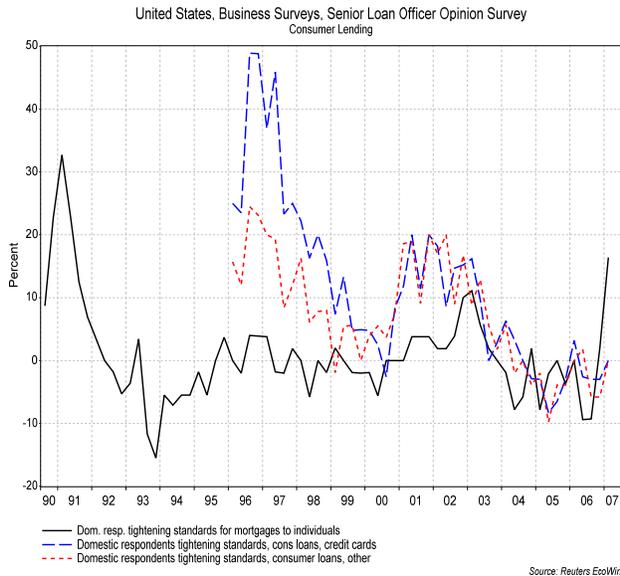
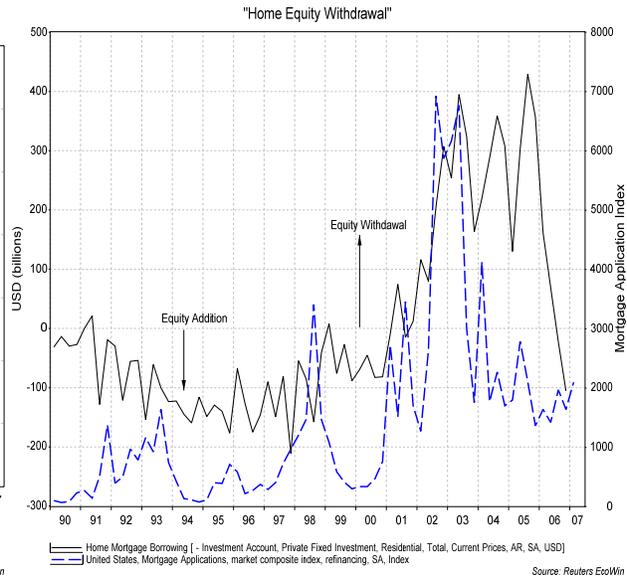


Figure 9: Less Home Equity Borrowing



Even before the tightening of mortgage lending standards, the rate of growth of mortgage borrowing had been falling in response to the slowdown in the housing market. It will probably fall further in coming quarters. Many analysts believe that this slower pace of mortgage borrowing in turn will lead to slower consumption and economic growth – and perhaps to recession and monetary policy easing by the Federal Reserve. This view is based on the belief that much of the strength in consumption over the past few years was based on “home equity withdrawal,” which is defined as the amount of mortgage borrowing in excess of residential investment. As the theory goes, this “extra” mortgage borrowing was used for current consumption rather than housing investment, and as it inevitably winds down, so will consumption – and the economy along with it.

We are more optimistic. Although home equity withdrawal will surely fall (it actually turned negative in the fourth quarter of 2006; see Figure 9), we do not think consumption will suffer a fatal blow. First, mortgage borrowing is still *borrowing*; people don't spend mortgage proceeds as if they were winnings from the lottery. The decision to borrow against a home rather than sell financial assets or take out an unsecured consumer loan is a financing decision. It does not drive the decision to consume in the first place. Second, for every borrower there is a lender. To the extent that mortgage borrowing decreases (and does not increase in another form), that increases consumption elsewhere in the economy². We are not arguing that a tighter mortgage market and weaker housing prices don't matter. They do: tighter mortgage requirements effectively increase

² Admittedly, this is not a one-for-one substitution. Lenders tend to have a lower propensity to consume than borrowers. That's especially true for foreign lenders, who effectively have financed much of the growth in mortgage lending via the current account deficit. Nonetheless, higher income enables higher consumption by that lender.

the cost of borrowing, and lower housing prices reduce wealth, both of which should reduce consumption, all else equal. Our point is that all else is not equal. Stock prices have increased, pushing aggregate household wealth up to record levels despite the housing bust. And higher mortgage rates mean more income to individuals and institutions that hold them – income that is available for additional spending. There are offsets to falling home equity withdrawal that are likely to limit its impact. So far, the economic data bear this out: Home equity withdrawal has fallen sharply since the middle of 2005, while consumption has slowed only slightly.

Before moving on, it's important to address one major caveat to this story. If credit tightening moves beyond subprime and other risky mortgage loans and turns into a general tightening of credit conditions, the risks to the economy would increase significantly. The U.S. economy's health depends critically upon the free flow of capital to its most productive sectors. A reduced flow of capital into housing is positive for the long term growth rate of the economy – as long as that capital flows into other investments that increase productivity, create new jobs, and generally raise living standards. If that process of capital allocation is short-circuited, whether through misguided government policy or higher risk aversion by businesses and consumers, growth would slow and recession probably would not be far off. Fortunately, such a general tightening in credit does not appear likely, and it's certainly not present today. Creditworthy consumer borrowers can still get loans at reasonable rates, and corporate credit spreads remain narrow by historical standards.

Market Outlook

Stubborn inflation and moderate economic growth persuaded the Federal Open Market Committee (FOMC) to leave the fed funds rate unchanged at 5.25% in the first quarter and to retain its inflation-risk bias. Long-term interest rates were little changed: The yield on the 30-year Treasury bond rose by just 4 basis points (bp) to end the quarter at 4.85% (Figure 10). The yield curve steepened marginally, reflecting diminished expectations of Fed easing, but the market still expects about 25 bp of easing by the Fed this year and 50-75 bp by the middle of 2008.

Figure 10: Long-Term Yields Rangebound

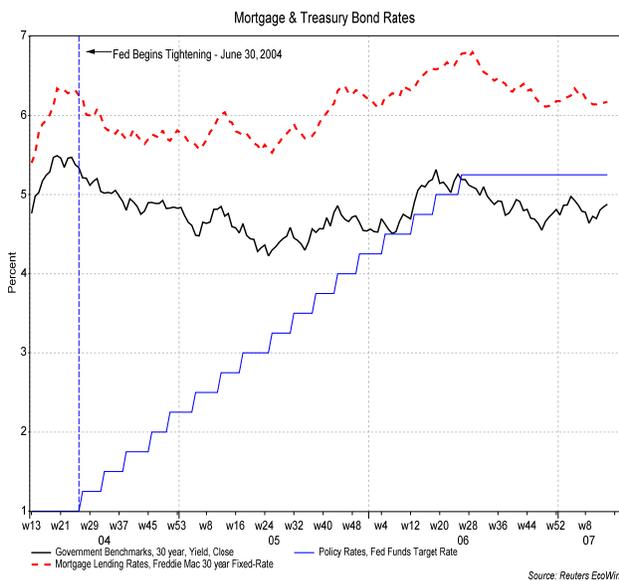
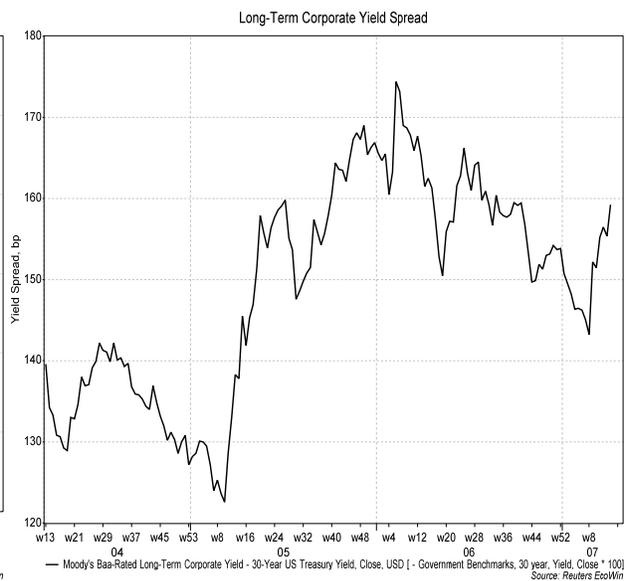


Figure 11: Corporate Spreads Little Changed



Credit spreads were also nearly unchanged, with the Moody's Baa-rated long corporate spread up by 1 bp over the quarter, although volatility did pick up a bit (Figure 11). Preferred spreads also showed some volatility, mainly around the swoon in the equity market in late February and early March, but they too finished the quarter about unchanged.

With few surprises in either the economy or the markets, our rate and credit outlooks (not surprisingly!) are unchanged from last quarter³. Summarizing our main views, we think that economic growth will be strong enough to keep inflation from falling much, which in turn will prompt the Fed to leave the fed funds rate at 5.25% for longer than the market currently expects. As a result, long-term interest rates should gradually increase, and the yield curve should steepen modestly. Credit spreads should continue to be well supported over the near term, but we expect a gradual widening in spreads as corporate borrowing increases and balance sheets become somewhat more leveraged. We are keenly mindful of the growing reach of leveraged buyout funds and the negative credit impact they can have on target companies. Finally, we see recession as the key risk to these views, although we remain sanguine about the prospects for the economy, and we believe that recent economic data has mostly reinforced our thinking.

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³ For a more complete explanation of our views, see the *U.S. Fourth-Quarter Economic Update*, January 2007.