

## Fourth-Quarter U.S. Economic Update January 2008

### Summary of Recent Economic Developments

The U.S. economy slowed in the fourth quarter, with economists expecting real GDP growth of about 1%,<sup>1</sup> compared to average growth of about 3% in 2007:H2. Looking ahead, economists now expect just 1.9% real GDP growth in 2008:H1. On the positive side, an improving trade balance should add meaningfully to growth in 2008, and business investment and government spending should also make modest contributions. However, homebuilding is still contracting, and home prices are falling. Consumer spending has held up reasonably well despite the housing malaise, principally because job growth and wage gains remained fairly sturdy. Recently, however, private sector job growth has stalled, and the unemployment rate has increased. Credit distress has spread from mortgages throughout the financial markets, making borrowing more difficult. Slower income growth, declining wealth, and tighter credit standards are likely to dampen personal consumption. In response, the Federal Reserve cut the fed funds rate by 175 basis points, flooded the market with liquidity, and signaled that more is on the way. Credit markets have reacted adversely to growing recession risks, and preferred securities prices have fallen sharply – to the point where we now see significant long-term value despite ongoing short-term risk. It probably will be close, but we think the economy will narrowly avoid recession.

Figure 1: Key Macroeconomic Indicators and Interest Rates

<b>Economic Indicator*</b>	<b>2006:1</b>	<b>2006:2</b>	<b>2006:3</b>	<b>2006:4</b>	<b>2007:1</b>	<b>2007:2</b>	<b>2007:3</b>	<b>2007:4</b>
Real GDP, Chg QoQ (%)	4.8	2.4	1.1	2.1	0.6	3.8	4.9	0.9f
Real Personal Consump Expnds, Chg QoQ (%)	4.4	2.4	2.8	3.9	3.7	1.4	2.8	2.6a
Real Busi Investmt, Eqp & Sftware, Chg QoQ (%)	13.0	-0.1	2.9	-4.9	0.3	4.7	6.2	
Real Residential Investmt, Chg QoQ (%)	-0.7	-11.7	-20.4	-17.2	-16.3	-11.8	-20.5	
Corporate Profits, After Tax, Chg YoY (%)	9.6	10.4	21.3	8.2	1.2	3.3	2.7	-4.1f
Current Account Balance, Annualized (% of GDP)	-6.2	-6.3	-6.6	-5.6	-5.8	-5.5	-5.1	
Federal Budget, 12-mo Def or Surp (% of GDP)	-2.5	-2.1	-1.9	-1.6	-1.5	-1.2	-1.2	
Unemployment Rate (%)	4.7	4.6	4.5	4.4	4.4	4.6	4.7	5.0
Household Employment, Chg QoQ (000)	841	750	477	1103	196	-58	173	-49
Nonfarm Payrolls, Chg QoQ (000)	755	371	606	531	427	379	230	292
Nonfarm Productivity, Chg QoQ (%)	2.5	0.8	-1.6	1.8	0.7	2.2	6.3	
Capacity Utilization (%)	81.4	82.3	82.0	81.6	81.4	81.8	81.9	81.4
GDP Price Index, Chg QoQ (%)	3.4	3.5	2.4	1.7	4.2	2.6	1.0	
Consumer Price Index, Chg YoY (%)	3.4	4.3	2.1	2.5	2.8	2.7	2.8	4.1
CPI ex food & energy, Chg YoY (%)	2.1	2.6	2.9	2.6	2.5	2.2	2.1	2.4
Nominal Personal Income, Chg YoY (%)	7.0	6.7	5.8	6.1	6.8	5.9	6.5	6.1a
Personal Savings Rate (%)	0.8	0.5	0.4	0.3	1.5	0.3	0.5	-0.5a
<b>Rate or Spread (End of Quarter)</b>	<b>2006:1</b>	<b>2006:2</b>	<b>2006:3</b>	<b>2006:4</b>	<b>2007:1</b>	<b>2007:2</b>	<b>2007:3</b>	<b>2007:4</b>
Federal Funds Rate Target (%)	4.75	5.25	5.25	5.25	5.25	5.25	4.75	4.25
3-month LIBOR (%)	5.00	5.48	5.37	5.36	5.35	5.36	5.23	4.70
10-Yr Treasury Note Yield (%)	4.86	5.15	4.63	4.70	4.65	5.03	4.59	4.07
30-Yr Treasury Bond Yield (%)	4.90	5.19	4.77	4.81	4.85	5.13	4.84	4.48
Moody's Baa Long Corp Spread (bp)	165	163	160	154	155	149	175	208
10-Yr Interest Rate Swap Spread (bp)	54.0	59.0	53.8	47.8	52.8	63.8	62.5	63.8

\* Figures are either quarterly or, if more frequent, quarterly averages. f = Forecast<sup>1</sup>; a = Actual through November 2007 Source: Reuters EcoWin

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

<sup>1</sup> *The Livingston Survey*, Federal Reserve Bank of Philadelphia, December 10, 2007.

*Economic Outlook*

We'll begin our analysis of the economy with its better-performing sectors, trade and business investment. After years of sapping growth from the U.S. economy, the **trade sector** made a meaningful contribution to growth in 2007. Net exports contributed an average of about three-quarters of a percentage point to real GDP growth in the first three quarters of 2007, or about a quarter of the total 3.1% annualized growth in real GDP over that period. However, judging by the November trade and December ISM data, it appears that the pace of trade improvement slowed in the fourth quarter. The real trade deficit widened from -\$51.2 billion in October to -\$53.3 billion in November (Figure 2). Together, October and November still represent an improvement over the third quarter average, but only a slight one. In addition, both the ISM Manufacturing and ISM Non-manufacturing surveys showed significant declines in their Export Orders sub-indices in December, from 58.5 to 52.5 and from 55.5 to 50.0, respectively (Figure 3). As a result, we expect a somewhat smaller – though still positive – contribution from trade in Q4. Looking ahead, however, the primary factors that brought about this year's trade improvement remain in place. A weak dollar and relatively firm economic growth abroad should help to sustain U.S. export growth, while weakening U.S. consumption and rising import prices should help restrain imports. As a result, we continue to expect trade to be an important offset to weakness elsewhere in the economy in 2008.

Figure 2: Trade Improvement Slowed...

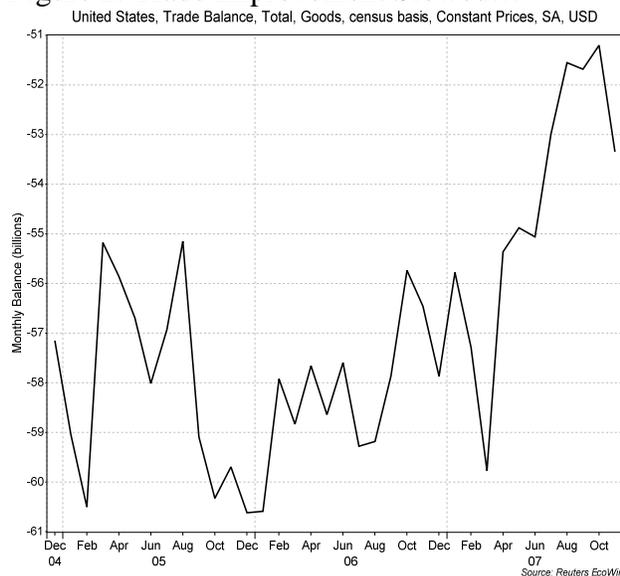
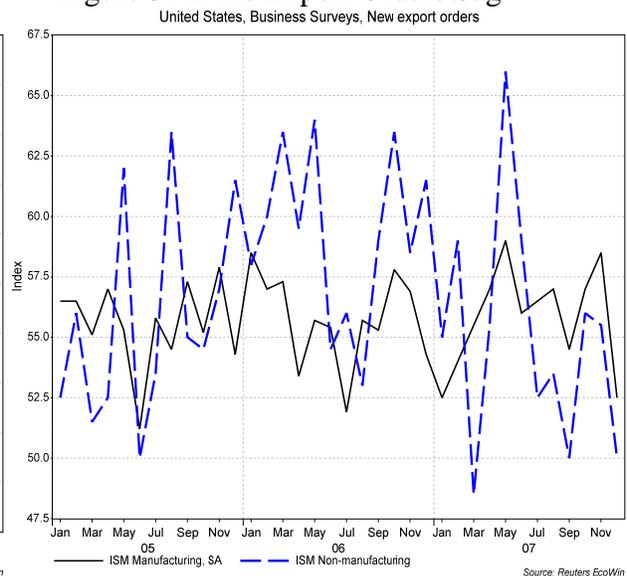


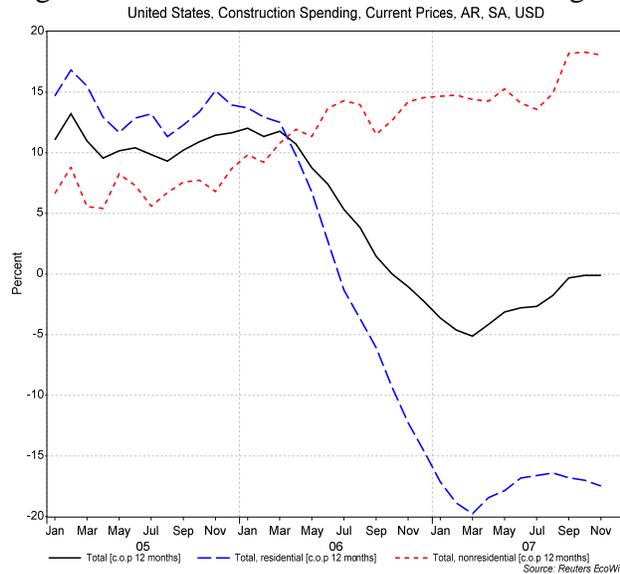
Figure 3: ... As Export Orders Sag



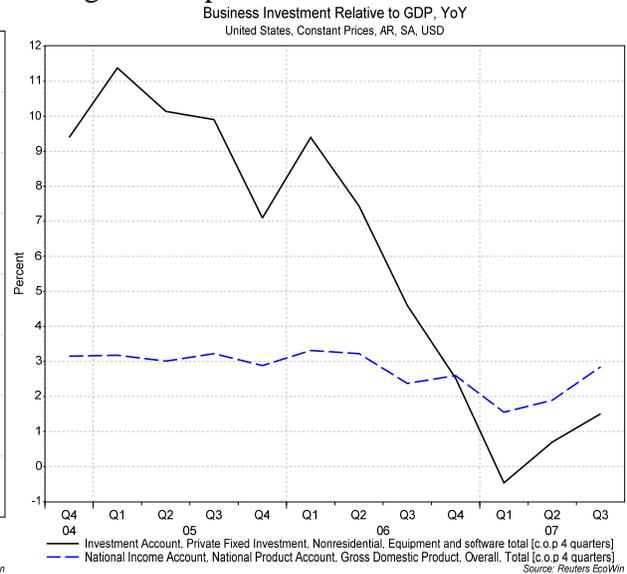
Another sector that should perform fairly well is **business investment**, although the credit crunch skews most of the risks for this sector to the downside over the near term. Businesses continue to spend heavily on structures. Non-residential private construction spending is up 20.4% annualized through November compared to the Q3 average. Total nonresidential construction spending is up 18.1% year-over-year (YoY) in November, completely offsetting the weakness in residential construction spending over the same period (Figure 4). It's a safe bet that nonresidential spending will slow from that pace in 2008, not only because it's clearly unsustainable but also because commercial vacancy rates are starting to increase. So far, the rise in vacancies is not particularly worrisome, but at a minimum it should dampen the enthusiasm for speculative building. Investment spending on equipment and software also should grow

moderately for two reasons. First, businesses should seek to enhance productivity as demand growth slows. Second and perhaps more importantly, real expenditures on business equipment and software over the past year have been fairly restrained at just 1.6% despite much faster (2.9%) growth in real GDP (Figure 5). No doubt that reflects the pessimism surrounding the economy that prevailed over that period (and that was misplaced until recently), but businesses probably will need to catch up on these investments before too long. Moreover, easier monetary policy and proposed fiscal stimulus may make business investment spending more attractive in 2008, both of which should help to drive spending up from its current modest base.

**Figure 4: Nonresidential Construction Strong**



**Figure 5: Upside for Business Investment**



Government spending also should support economic growth in 2008. We don't normally talk about the outlook for government spending, since it typically does not vary significantly from one year to the next. However, the increasing prospect of fiscal stimulus along with the "automatic" expansion of the budget deficit as the economy slows indicate that government spending may provide important support to economic growth in 2008. It is worth mentioning that recent years of deficit improvement allow for fairly sizable stimulus. The federal budget deficit has fallen to 1.2% of GDP as of the end of the third quarter, down from a peak of 3.7% of GDP in 2004:Q2. Of course, we don't want to see deficits in excess of 3% of GDP again, but with each 1% of GDP worth nearly \$140 billion, that still leaves room for meaningful stimulus without breaking the budget.

Turning to the bad news, **inflation** quickened in the latter part of 2007 as sharply higher food and energy prices pushed the overall consumer price index (CPI) to 4.3% YoY in December and the PCE deflator to 3.6% YoY in November (Figure 6). Those annual inflation rates are close to the peak reached in 2005 and (except for 2005) above anything since 1991. Excluding food and energy, inflation was more subdued, but it still accelerated in the closing months of the year. Core CPI rose 2.4% YoY in December and core PCE rose 2.2% YoY in November, above the top of the Federal Reserve's presumed 1-2% "comfort zone" for core PCE inflation. Firm energy and commodity prices, strong agricultural export markets, and a weak dollar all suggest that inflation will remain sticky in 2008, even if the economy slows. Nonetheless, inflation expectations remain fairly well anchored. The Reuters/University of Michigan 5-year Ahead

Inflation Expectation index was 3.0% in January, in the middle of its range for the past three years. Similarly, the five-year forward five-year breakeven inflation rate on Treasury Inflation Indexed Securities (TIPS) ended the year about where it began at 2.35% (Figure 7). These muted inflation expectations indicate that the inflation credibility of the Federal Reserve remains high, which should give the Fed leeway to ease further if it decides to do so, as we expect.

Figure 6: Inflation Picking Up...

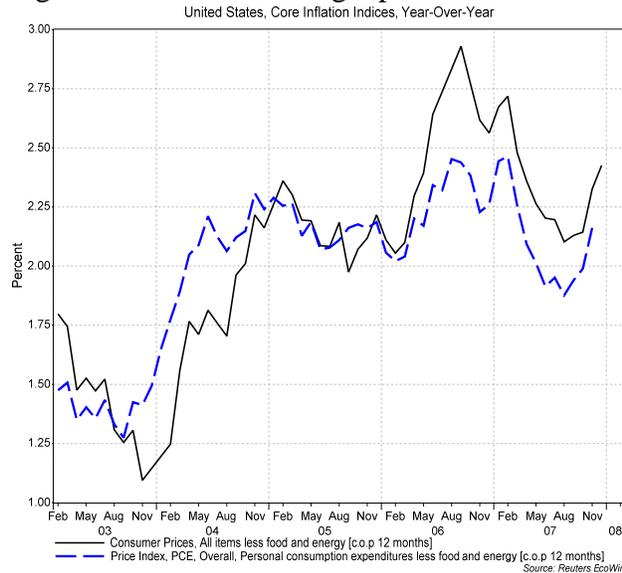
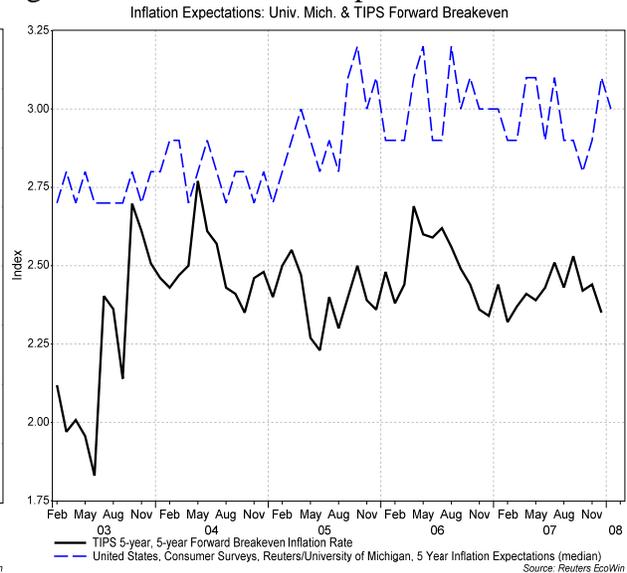


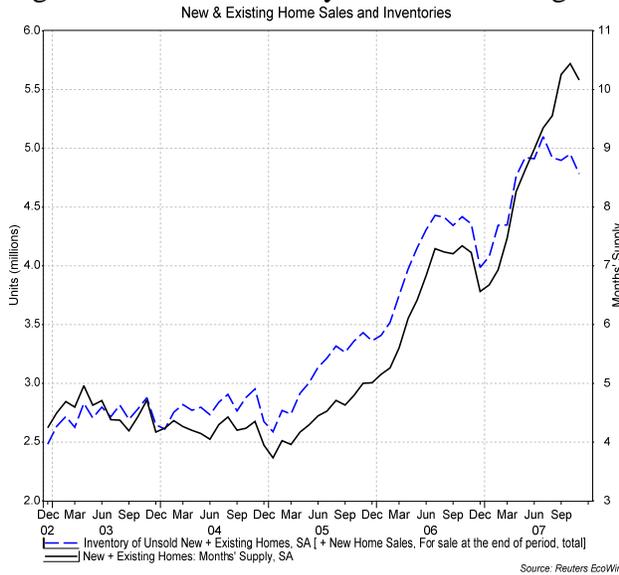
Figure 7: ...But Inflation Expectations Are Not



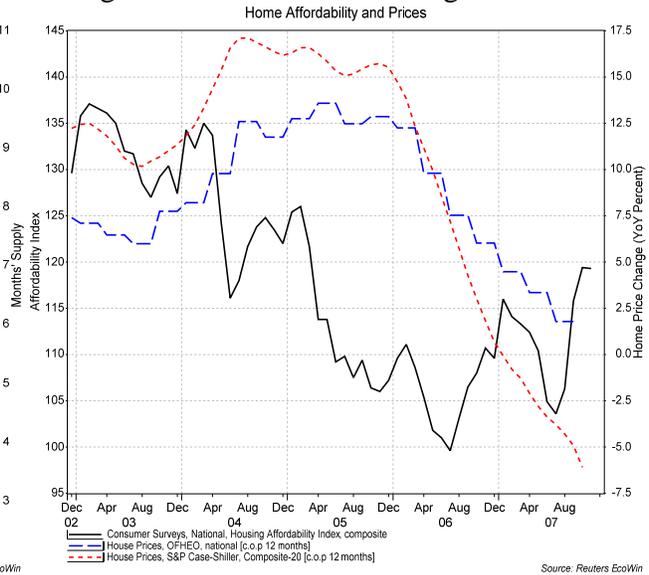
The housing market continues to contract sharply. Residential investment shaved 1.1% off GDP growth in the third quarter, and it likely will cut even more from Q4. Existing home sales were down 20% YoY as of November 2007, and new home sales are off 34.4% on the same basis. Inventories of unsold homes have stabilized since mid-year in unit terms; however, those inventories now represent more than 10 months of supply at the current sluggish sales pace (Figure 8). Even though housing activity and thus mortgage origination has plummeted, the credit crisis has chased many investors away from the mortgage market. Rates on prime, conforming, fixed-rate mortgages have dropped by only about 30 bp since the Fed began easing. Rates on most other mortgages have fallen by less or actually increased, and lending standards have tightened significantly. In short, demand for mortgage bonds has fallen almost as fast as supply, so mortgage rates have fallen little or not at all. As a result, housing affordability has improved only modestly, despite lower home prices (Figure 9). We expect home prices to continue to decline in 2008.

Although we are still far from the bottom in housing, its direct impact on economic growth should begin to wane in 2008, simply because it has fallen so far already. At the peak of the housing boom in 2005, residential investment represented nearly 5.5% of GDP (Figure 10). As of Q3, it was just under 4% of GDP, meaning that residential investment has contracted by 1.5% of GDP, or about 27% over two years. Even if the pace of decline in housing were to show no deceleration over the next two years (the time we estimate that it will take for household formation to absorb the current excess supply of housing), that would represent a further drop of about 1.1% of GDP, or about one-half percent per year. That's not a negligible drag, but by itself it is not enough to pull the economy into recession.

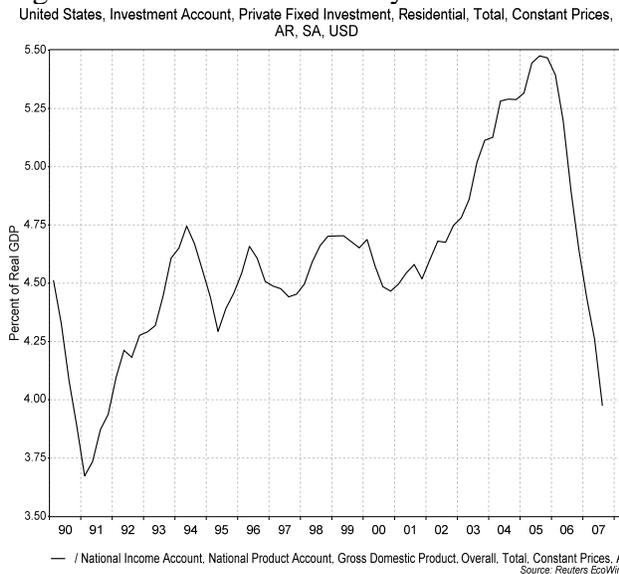
**Figure 8: Home Inventory/Sales Still Rising**



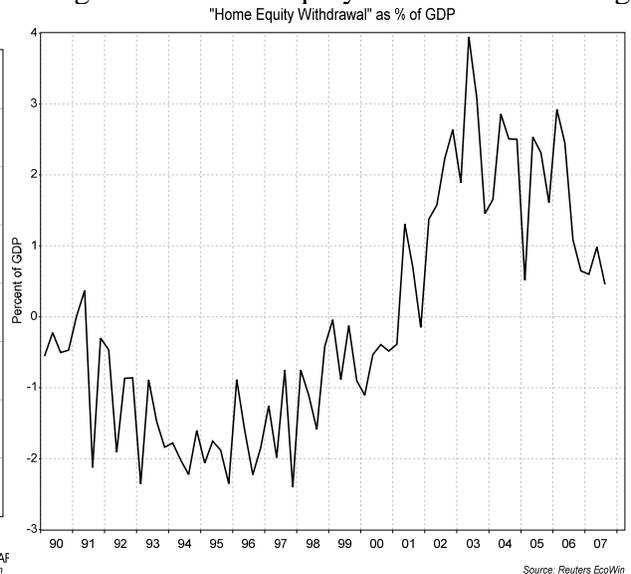
**Figure 9: Home Prices Falling**



**Figure 10: More Than Halfway There?**



**Figure 11: Home Equity Withdrawal Slowing**



Unfortunately, the drag from housing does not end with residential investment. It also affects consumption in several indirect ways. First, with home prices now falling and likely to fall further, housing wealth is declining and probably will continue to do so. In the first three quarters of 2007, gains in stock prices more than offset lower housing wealth, but as stock markets have pulled back from their highs, overall wealth appears to have fallen. As a result, we should expect slower consumption growth, although it's very difficult to predict how much slower.

Another factor lowering consumption is reduced home equity withdrawal (HEW) by mortgage borrowers.<sup>2</sup> As we explained in detail in the Third-Quarter U.S. Economic Update, HEW has been falling since early 2006 and is now around ½ percent of GDP (Figure 11). That is down

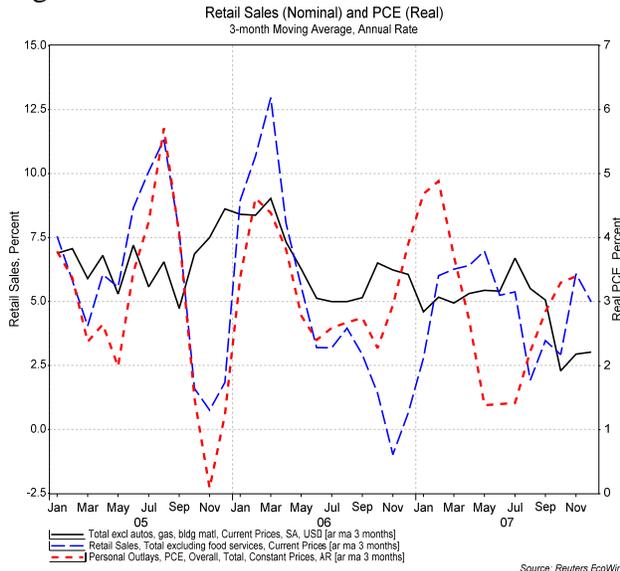
<sup>2</sup> Home equity withdrawal is defined as total mortgage borrowing less residential investment.

from nearly 4% of GDP at the peak in 2003 and 2.9% at the beginning of 2006. Prior to the housing boom starting in 2001, HEW was around negative one percent of GDP. In other words, homeowners generally added to home equity at the rate of about 1% of GDP, roughly what one might expect in the normal case where homeowners gradually pay down their loan balances over time – rather than borrowing against home equity for other purposes. Of course, not all HEW went toward consumption. No doubt some went toward the acquisition of financial assets or other investments. Nonetheless, even if we assume that (a) HEW returns to -1% of GDP over the next two years and (b) all of the reduction in HEW results in lower consumption, then consumption would be reduced by three-quarters of one percent of GDP per year. Again, this is a meaningful drag on growth, but still not enough to generate a recession in the absence of other shocks. Importantly, it also should make a positive contribution to increasing the personal savings rate.

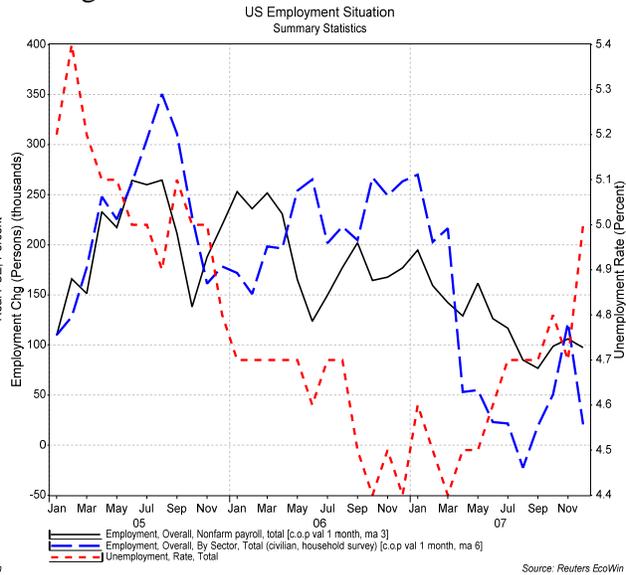
Given these crosscurrents, the most uncertain, not to mention the largest, sector of the economy is **personal consumption** expenditures (PCE). Through November 2007, the news was very good. Real personal consumption expenditures were up by 3.7% compared to the third quarter average, and nominal overall and core retail sales (excluding autos, building materials, and gasoline) were up 8.3% and 6.0%, respectively. However, retail sales figures released on January 15 revealed sluggish sales in December and downward revisions to prior months' data. As a result, overall and core fourth quarter retail sales now show growth of just 4.8% and 3.0%, respectively (Figure 12). That represents a substantial slowdown from the November pace and probably will result in a roughly proportional decline in real PCE growth to between 1½ and two percent for the quarter.

Looking ahead, we continue to think that the employment situation will be the key to consumption. If consumers have jobs, they will spend, especially when wage growth is strong. However, employment data have turned notably weaker over the past several months and, if sustained, could prompt consumers to curtail spending. Continuing jobless claims have been trending higher since late 2006, although initial jobless claims have not. Neither has increased as much as it did leading up to prior recessions, but the rise in continuing claims clearly points to a slower pace of hiring. Nonfarm payroll job growth also has slowed to fewer than 100,000 jobs per month in Q4 from more than 250,000 jobs per month in 2006:Q1 (Figure 13). The slowdown in household employment has been even more dramatic, falling from 280,000 job gains per month in 2006:Q1 to 16,000 job *losses* per month in 2007:Q4. It's worth noting that the household employment data was highly volatile in 2007, but even if we average job growth over the second half of the year to limit the month-to-month volatility, household job gains still amount to just 20,000 per month (Figure 13). As a result, the unemployment rate rose to 5% as of December 2007, up from a low of 4.4% in March. Much of the weakness in the household data was in employment for workers age 24-years and younger, who may have reacted to fewer job opportunities by going back to school for additional training. However, even excluding those younger workers, the unemployment rate for workers age 25-years and over increased from 3.3% in October 2006 to 3.9% in December 2007. At the same time, indicators of hiring such as the Conference Board Help-Wanted Index, the Monster Employment Index, and the Manpower Outlook Survey all point to weaker labor markets. With the exception of initial jobless claims, all of these data are consistent with a slowing labor market.

**Figure 12: Sales Pace Slowed in December**



**Figure 13: Job Market Has Decelerated**



Although job growth has slowed, wage growth has been relatively firm. Average hourly earnings are up 3.75% from a year ago in December, slightly above the 3.6% gain in the overall PCE deflator and comfortably above the 2.2% gain in the core PCE deflator.<sup>3</sup> Thus, real wages are still growing despite slower employment growth. This may reflect relatively little excess labor at employers, which also would explain the comparatively small increase in initial jobless claims. Employers hired fewer workers throughout the current expansion compared to prior recoveries, so even as new job formation slows we may be seeing both stickier wages and fewer layoffs. If so, consumption could remain more resilient than in previous slowdowns marked by widespread layoffs. In particular, personal income should hold up better, and indeed personal income grew by a respectable 6.1% (nominal) in the year ending in November, even though employment gains peaked more than a year ago.

Adding it all up, we think that real personal consumption will continue to grow in 2008, although the indirect drag from housing that we described earlier likely will push it down to 1-1½% in the first half of 2008 compared to 3.0% in the year ending in November 2007. After six years of economic expansion that may feel like recession to many consumers, but strength in the nonfinancial corporate sector, government spending, and trade should keep economic growth in positive territory.

Before moving on to the market outlook, we'll add one final long-term thought on housing. As dire as things look now, the housing market will emerge from its current malaise. The U.S. population is growing at roughly a one percent rate. That works out to about three million people being born in or moving to this country each year. Given an average household size of 2.6 persons, that means that the U.S. creates more than one million households per year, each one requiring a place to live. The combination of slower housing starts and rising numbers of households will absorb the excess supply of housing in time, probably within two to three years. It may take a little longer or it may happen sooner, but it will happen. We think the U.S. economy and financial system has the strength to survive in the interim.

<sup>3</sup> Year-over-year changes as of November 2007.

*Market Outlook*

Faced with sharply tighter credit conditions as the credit crisis spread beyond the mortgage market, the Federal Reserve continued to ease monetary policy in the fourth quarter, cutting the fed funds rate by an additional 50 bp to 4.25%. Early in the quarter, credit concerns prevented much of the Fed’s rate cuts from feeding into market rates; money market rates such as LIBOR and the commercial paper rate declined, but by much less than the fed funds rate. As a result, the Fed, along with other central banks, introduced a Term Auction Facility (TAF) to provide term loans to financial institutions looking to fund otherwise difficult-to-finance collateral. These actions succeeded in reducing the logjam in the money markets, and market rates have since fallen even faster than the fed funds rate (Figure 14).

However, concerns over slowing growth and rising loan losses prompted further credit spread widening and equity market weakness in January. The Fed responded on January 22 with an intermeeting cut of 75 bp in both the fed funds and discount rates, which now stand at 3.50% and 4.00%, respectively. Looking ahead, markets expect a further 25 to 50 bp rate cut on January 30 and a fed funds rate of 2.00% when the Fed completes the current easing cycle in the second half of 2008. That would represent cumulative easing of 325 bp, more than what the Fed delivers during a mid-cycle pause but somewhat less than the typical easing in a recession.

Figure 14: Interbank Rates Normalizing...

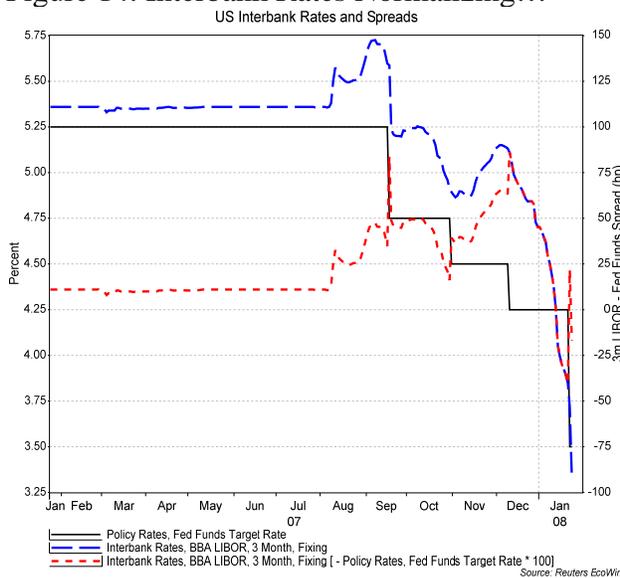
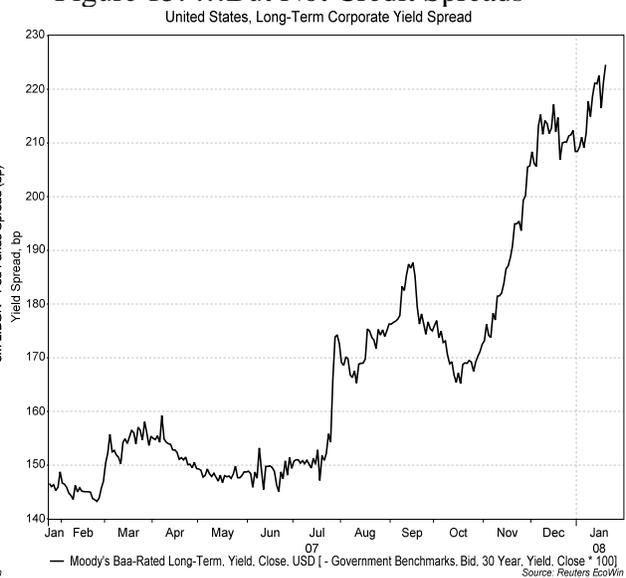


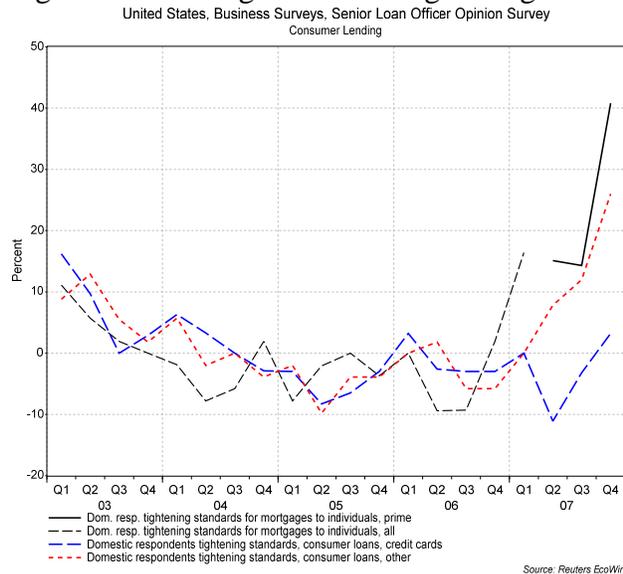
Figure 15: ...But Not Credit Spreads



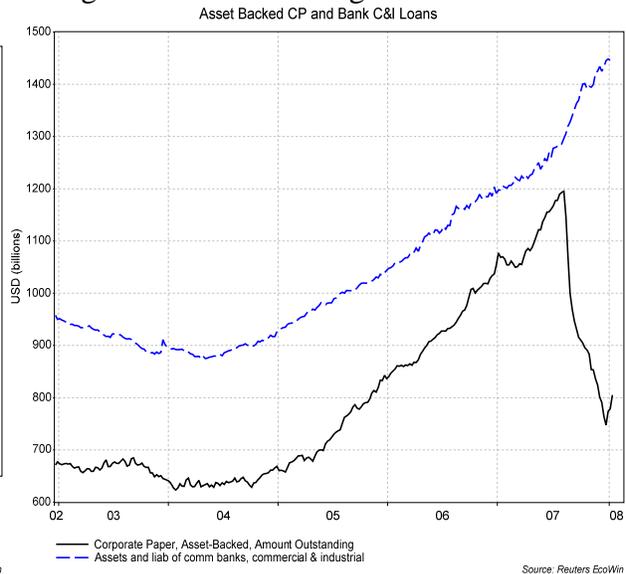
Although market expectations for rates may prove to be too optimistic (i.e. the Fed may ease by less) if the economy avoids recession, we think it is too early to take a bearish view, for two primary reasons. First, we clearly are in the midst of a credit crunch: Credit spreads have moved sharply wider (especially for subordinated investments such as preferred securities), lending standards have tightened, and asset-backed commercial paper has plunged while bank loans have soared (Figures 15, 16, and 17). For monetary policy to be effective in stimulating the economy, market rates – not just the fed funds rate – need to fall. With risk premiums rising, the Fed will need to ease policy more aggressively than it would if risk premiums were stable in order to generate a desired set of market rates. In that sense, the Fed today faces the opposite situation that it did when it was tightening from 2004 to 2006. In that episode, the Fed had to raise the

funds rate by more than the market originally expected because risk premiums fell sharply, offsetting some of the tightening in monetary conditions that the Fed was trying to engineer. With the market now apparently playing out in reverse, we are reluctant to declare market expectations overdone this early in the easing cycle.

**Figure 16: Lending Standards Tightening**



**Figure 17: ABCP Going Back to Banks**



Second, we expect additional deleveraging in the financial system over the course of the next several quarters, and it's hard to know at this stage just how much monetary stimulus will be required to stabilize the situation. Deleveraging can be self-reinforcing; the Fed is well aware of this, and it is trying to adjust policy to prevent it. The reason that broad-based deleveraging is so dangerous is because it affects asset prices, output and confidence. To oversimplify just a bit, if the liability side of the economy's balance sheet (i.e. lending) contracts, so must the asset side (i.e. assets funded with borrowed money). That means lower prices as assets are liquidated and weaker economic activity as asset growth (i.e. output) slows. Lower asset prices and weaker growth then cause lenders to pull back still further, perpetuating the downward cycle. The likely result is that both asset prices and economic activity overshoot equilibrium on the downside – and that's what the Fed wants to prevent.<sup>4</sup> In the current risk-averse environment, the Fed may need to push rates considerably lower to accomplish that goal.

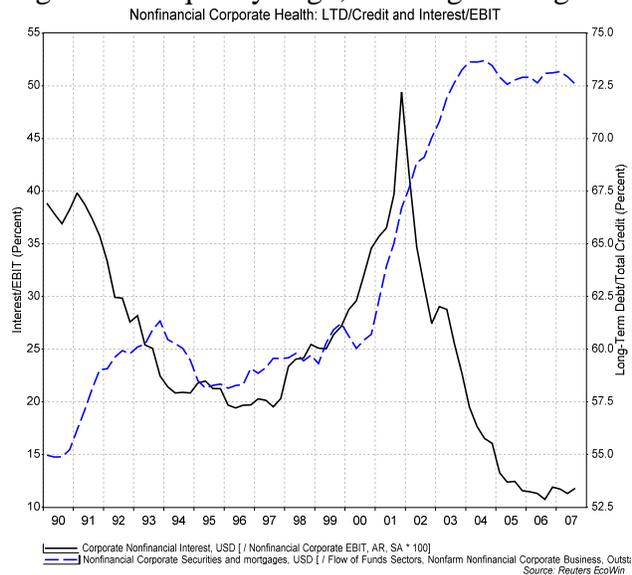
Lower short term rates help to stimulate the economy in several ways. Most obviously, they encourage individuals to borrow money to consume (lower interest rates reduce the cost of accelerating consumption) and companies to invest (lower rates mean more investment opportunities are above the cost of financing them), generating economic activity in the process. Lower interest rates are also associated with a weaker currency, which helps to stimulate exports and restrain imports; the result is a narrower trade deficit and higher GDP. They also aid the financial system by helping to expand net interest margins, since bank borrowing rates tend to

<sup>4</sup> Implicit in this is the assumption that a fundamental imbalance exists that needs to be corrected. In the current situation, there was clearly overinvestment in housing and possibly in leveraged buyouts and other forms of leveraged finance. These imbalances need to correct, which necessarily means lower housing prices and reduced residential investment, among other adjustments. The goal of monetary policy is to allow those adjustments to occur without taking down the rest of the economy along with them.

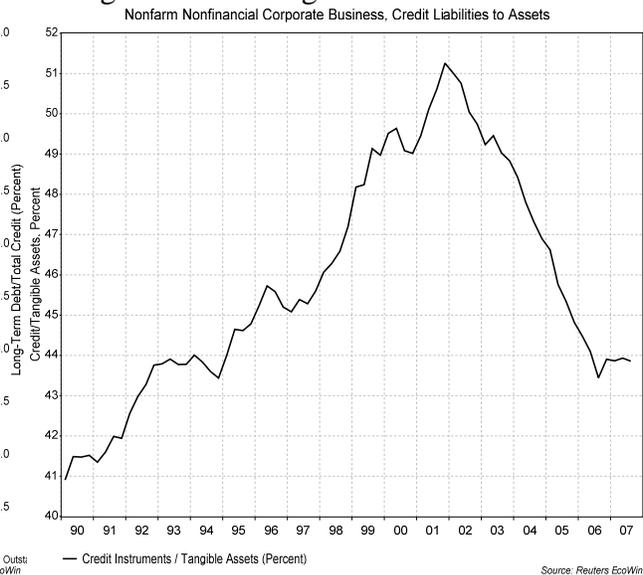
fall more rapidly than corporate and consumer borrowing rates, especially when risk premiums have expanded, as they have in today’s markets. However, the housing market – one of the main channels for monetary policy historically – probably will not respond much to the current easing cycle. Adding it all up, we still think monetary policy works, but with housing out of the picture and risk premiums elevated, the Fed probably has to ease more than normal to keep the economy out of recession.

For the Funds, this is mixed news. On the negative side, high risk premiums mean relatively high interest rates and low prices on preferred securities. In addition, a steeper yield curve and higher volatility make hedging the Fund’s interest rate exposure more expensive. Beginning in the third quarter of 2007, the Fund modified its interest rate hedging strategy as prices on preferred securities largely disconnected from Treasuries and interest rate swaps. Because the correlation between preferred securities prices and benchmark interest rates has diminished, we have reduced the size of the hedge, which has lowered its cost. As preferred markets begin to trade more normally (that is, as correlation increases), however, we anticipate increasing the size of the hedge as well. If the yield curve remains steep and rates continue to be volatile, hedging costs eventually will rise again. On the positive side, lower short-term rates should translate to lower cost of leverage, which should help support distributable income. The higher risk premiums that we have discussed so far have prevented auction rate preferred yields from declining much (and in some instances they have increased meaningfully), but we expect that those yields will gradually come down if the Fed continues to ease as we expect. We anticipate that risk premiums will also eventually decline, though the market probably will want to see more evidence that the Fed is successful in keeping the economy out of recession before risk premiums can come down meaningfully.

**Figure 18: Liquidity High, Coverage Strong**



**Figure 19: Leverage Low**



Turning our attention to the fundamental outlook for credit, we see a similarly mixed near-term picture but a considerably more positive long-term outlook. On the positive side, nonfinancial corporations remain quite healthy. They have relatively low leverage, strong liquidity, and solid interest coverage (Figures 18 and 19). Slower economic growth likely will cause some

incremental strains at nonfinancial corporations, but overall we think those strains will be modest.

However, the corporate financial sector, which constitutes the largest sector of the preferred market and where consequently the Fund has significant holdings, suffered sizable losses over the second half of 2007. Life insurance and property and casualty insurance companies generally have avoided most of the problems facing other financial companies, but banks, finance companies, financial guarantors and broker-dealers have been significantly affected because of their direct and indirect exposure to the problems in the housing and structured finance markets. Many of these companies have taken sizable losses on securities and loans (mostly mortgage-related, along with smaller losses in leveraged loans, asset-backed loans, and various other obligations) held in their portfolios. Most of the losses so far have been mark-to-market losses rather than charge-offs due to actual defaults. That is an important distinction for investors because market values should reflect the market's estimate not only of current but also of all future losses due to defaults. Markets today are highly risk-averse, so risk premiums are very high. In turn that means market prices incorporate high expected loss rates – possibly substantially higher than ultimately will be incurred.<sup>5</sup>

This has several implications. For the economy, changes in wealth (in this case, mark-to-market losses) normally have a significantly smaller economic impact than realized losses (actual defaults). If so, the economic impact of defaults may take some time to play out, allowing time for easier monetary policy to nudge the economy away from recession. However, because today's mark-to-market losses are concentrated at financial institutions, we recognize that these losses may prompt these institutions to cut back their lending, which would increase the downside risks for the economy. Of course, the Fed recognizes this as well, and it's one of the reasons for easier monetary policy.

For financial companies, we think that the fourth quarter will represent the peak in mark-to-market losses. We fully expect that loan delinquency, default and charge-off rates will continue to increase during the first half of 2008. Until those rates stabilize, we suspect that there will be further write downs. However, because loss expectations are already so high, we think that incremental write downs will be much smaller than those in the fourth quarter. What will mark the end of write-offs, and hence the beginning of recovery for financial companies? In short, we think that market expectations for *future* losses probably will not improve materially until *current* losses come in lower than expected. We don't know precisely when that will occur or if the recovery in preferred securities prices will coincide with it, but we think it will be in 2008 and that it will mark the fundamental turning point in the credit cycle for financials. Until then, we retain a cautious near-term outlook on the preferred securities of financial companies.

Having sounded that cautionary note, we believe that the financial issues in our preferred portfolios remain fundamentally sound. Banks, broker-dealers, and most other financial companies came into this credit cycle very well capitalized. Even after sizable losses over the past several quarters, they remain well capitalized and have solid business franchises. Of course, some companies had to raise additional equity capital to maintain their financial strength, but (a) they were willing to raise the capital and (b) the market was willing to give it to them. Although

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<sup>5</sup> For example, some banks have written the value of mezzanine asset backed CDOs down to zero. They may indeed be worthless, but it's clear that only upside remains on those positions.

we do not rely on it when making our credit decisions, this willingness to raise capital during a period of stress provides an important incremental level of credit protection for our preferred holdings.

Although we admit that we worry about some holdings more than others, we believe that the overall credit quality of the portfolio remains sound. Put simply, we think that current preferred securities prices more accurately reflect the fear and illiquidity of today's credit markets than the fundamental creditworthiness of the issuers. It may take some time, but we are confident that preferred securities prices will reflect more of their creditworthiness eventually. In the meantime, we are watching the credits in the portfolio carefully and doing our best to take advantage of dislocations in the market.

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