Third-Quarter U.S. Economic Update
October 2008

Summary of Recent Economic Developments

GDP probably contracted in the third quarter as the credit crunch intensified in September. Forecasts for Q3 GDP slipped from +1.2% in August to -0.5% currently.[1] The fourth quarter is looking even weaker as stock markets have continued to plunge in October. Although trade and government spending remain bright spots, employment has fallen to recessionary levels and is likely to limit income growth and pressure consumption. Business spending is also likely to contract. Housing remains weak, although it did show some nascent signs of improvement in Q3. Core inflation was sticky, but overall inflation eased on falling commodity prices, and it should cool further in coming quarters. In response to the weakening outlook for growth, the Federal Reserve cut interest rates by 100 bp in October and sharply expanded the amount of liquidity it provides to markets. The U.S. government also passed the Emergency Economic Stabilization Act, whose centerpiece is the Treasury's Troubled Asset Relief Program. These programs should prevent an uncontrolled credit contraction and help bring private capital back into the markets. However, recession seems inevitable. All of this presents challenges for preferred investors, but we believe preferred valuations reflect a deeper downturn than we currently anticipate.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	**2006:4**	**2007:1**	**2007:2**	**2007:3**	**2007:4**	**2008:1**	**2008:2**	**2008:3**
Real GDP, Chg QoQ (%)	1.5	0.1	4.8	4.8	-0.2	0.9	2.8	-0.2f
Real Personal Consump Expnds, Chg QoQ (%)	3.7	3.9	2.0	2.0	1.0	0.9	1.2	-2.3a
Real Busi Investmt, Eqp & Sftware, Chg QoQ (%)	-2.4	0.0	6.9	3.6	1.0	-0.6	-5.0	
Real Residential Investmt, Chg QoQ (%)	-19.5	-16.2	-11.5	-20.6	-27.0	-25.1	-13.3	
Corporate Profits, After Tax, Chg YoY (%)	8.8	-0.9	-0.2	-0.8	-0.6	1.8	-6.4	11.3f
Current Account Balance, Annualized (% of GDP)	-5.4	-5.8	-5.7	-5.0	-4.8	-5.0	-5.1	
Federal Budget, 12-mo Def or Surp (% of GDP)	-1.6	-1.5	-1.2	-1.2	-1.3	-1.5	-2.3	
Unemployment Rate (%)	4.4	4.4	4.6	4.7	5.0	5.1	5.5	6.1
Household Employment, Chg QoQ (000)	1103	196	-58	173	-49	-242	-78	-636
Nonfarm Payrolls, Chg QoQ (000)	454	328	315	212	241	-247	-214	-299
Nonfarm Productivity, Chg QoQ (%)	0.2	0.0	4.1	5.8	0.8	2.6	4.3	
Capacity Utilization (%)	80.9	80.7	81.0	81.3	81.0	80.4	79.7	76.4
GDP Price Index, Chg QoQ (%)	2.2	4.1	2.0	1.5	2.8	2.6	1.1	
Consumer Price Index, Chg YoY (%)	2.6	2.8	2.6	2.8	4.1	4.0	4.9	4.9
CPI ex food & energy, Chg YoY (%)	2.6	2.5	2.2	2.1	2.4	2.4	2.4	2.5
Nominal Personal Income, Chg YoY (%)	6.4	6.7	6.0	6.1	5.4	3.9	5.7	4.6a
Personal Savings Rate (%)	0.8	1.3	0.1	0.6	0.4	0.2	2.8	1.0a
Rate or Spread (End of Quarter)	**2006:4**	**2007:1**	**2007:2**	**2007:3**	**2007:4**	**2008:1**	**2008:2**	**2008:3**
Federal Funds Rate Target (%)	5.25	5.25	5.25	4.75	4.25	2.25	2.00	2.00
3-month LIBOR (%)	5.36	5.35	5.36	5.23	4.70	2.69	2.78	4.05
10-Yr Treasury Note Yield (%)	4.70	4.65	5.03	4.59	4.03	3.41	3.97	3.83
30-Yr Treasury Bond Yield (%)	4.81	4.85	5.13	4.84	4.48	4.29	4.52	4.31
Moody's Baa Long Corp Spread (bp)	154	155	149	175	208	261	252	354
10-Yr Interest Rate Swap Spread (bp)	47.8	52.8	63.8	62.5	63.8	66.0	70.3	66.5

* Figures are either quarterly or, if more frequent, quarterly averages. f = Forecast[1]; a = Actual through August 2008 Source: Reuters EcoWin

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

[1] August GDP and Corporate Profits forecasts are from the *Survey of Professional Forecasters*, Federal Reserve Bank of Philadelphia, August 12, 2008. September GDP forecast is from Bloomberg, October 24, 2008.

Economic Outlook

After a relatively strong second quarter, real gross domestic product (GDP) appears to have slowed markedly in the third quarter as the credit crunch intensified. In August, the Federal Reserve Bank of Philadelphia's *Survey of Professional Forecasters* showed that economists expected 1.2% growth in real GDP in the third quarter. A more recent Bloomberg survey put the forecast for Q3 real GDP at -0.5%. (Advance data will be released on October 30th.) The outlook for the fourth quarter is even weaker. Recession is now clearly upon us. Previously, we had anticipated a shallow though somewhat prolonged recession. The basis for that view was that strength in trade and relatively sturdy employment and income would support the economy long enough for the housing market to complete its adjustment without pushing the overall economy into a deep recession. That may still be the case, but the intensification of the credit crisis starting in September makes it less likely.

We are not expecting the economy to tip into the next Great Depression, but we do expect a painful recession for at least the next several quarters. As we discuss in more detail later, the U.S. economy is in the process of deleveraging, or paying down debt. Government steps to support the banking system and credit markets should prevent the plunge in economic activity that would be associated with rapid, uncontrolled credit contraction. Nonetheless, the deleveraging process likely will keep economic activity subdued for an extended period. As investors, we have to be prepared for a weak economy, and it is clear that the preferred market is priced for a deep and prolonged recession. While we are far from bullish on the economy, we think it will do better than the market's current fears.

Figure 2: Trade Still Improving, but…

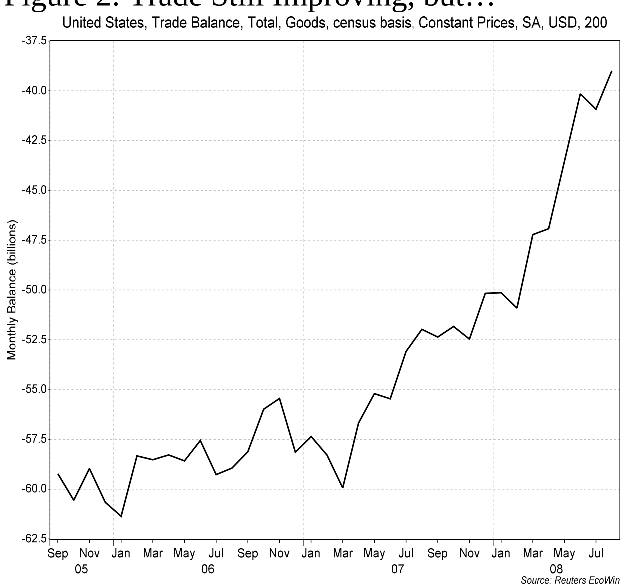
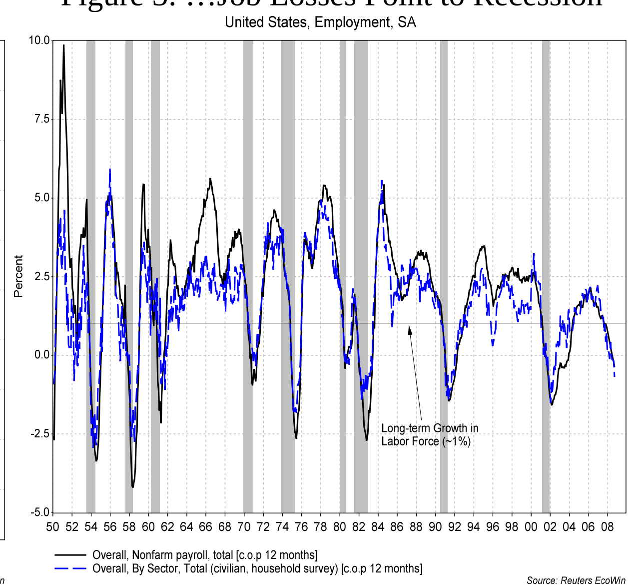


Figure 3: …Job Losses Point to Recession



As usual, we will review the major sectors of the economy, although we will keep it fairly brief. The rapid deterioration in credit markets makes data even from a month or two ago of limited usefulness in projecting the course of the economy. With that caveat, we will start with bit of good news. The **trade sector** continues to add significantly to GDP growth in the U.S. The real trade deficit in August shrank by $4.5 billion from the second quarter average (Figure 2), which implies at least a 2% contribution to Q3 real GDP if the improvement is sustained in September.

We anticipate that the trade deficit will continue to shrink going forward, but with economic growth slowing globally and the dollar strengthening in recent weeks, the pace of improvement is bound to slow.

Government spending is also contributing meaningfully to GDP growth. Real government consumption rose by 3.9% and added 0.8% to GDP in the second quarter. That rate of growth may be hard to duplicate in Q3, since most tax rebates were disbursed in Q2. However, expansionary fiscal policy will clearly help to support GDP over the coming quarters, especially if another package of fiscal stimulus is passed early in the next administration. In any event, there will be an extraordinary need to finance both the increase in the deficit and the various assistance programs aimed at the credit crisis. Treasury's issuance of bonds, notes, and bills is already soaring.

The prospects for other sectors of the economy appear tepid at best. **Employment** weakened during the third quarter, with payroll and household employment falling by 299,000 and 636,000, respectively. Year-over-year payroll employment growth fell below 1% in late 2007 and turned negative in June 2008. The household survey crossed these thresholds even earlier. Since World War II, this degree of deterioration in U.S. employment has only occurred during recessions (Figure 3). We do not think this will be the exception, especially given the tightening of credit conditions and the loss of wealth that has occurred in recent weeks. However, we remain hopeful that the hiring restraint shown by employers coming out of the last recession (remember the "jobless recovery?") will likewise restrain job losses in this recession. Our best guess is that job losses will accelerate for the next several quarters before starting to moderate in mid-2009, but much will depend upon progress in unclogging credit markets.

Personal consumption probably declined in Q3 as stimulus from tax rebates faded, job losses accelerated, confidence fell, and credit shrank. Through August, real personal consumption expenditures (PCE) fell by 2.3% annualized, and core retail sales fell by another 0.7% (not annualized) in September. Lower energy prices (discussed more fully below) should provide some support for consumption going forward, but probably not enough to offset the loss from housing and stock market wealth suffered by consumers in recent quarters. The personal savings rate remains appallingly low at just 1%. Even without an economic slowdown, we believed that the savings rate would rise.[2] With recession looming, a higher savings rate is virtually certain. As the savings rate moves higher, consumption growth will be constrained. And with PCE representing roughly 70% of GDP, that means the same for growth overall.

Personal income should hold up a bit better than consumption (in fact, that's the only way the savings rate can go up), but job losses are likely to keep income gains fairly small. On the positive side, average hourly earnings are up 3.4% YoY in September, and overall personal income is up 4.6% YoY in August. Both series show slower growth than a year ago, but with inflation likely to drop, they are still respectable. Nonetheless, income and spending growth tend to mirror employment growth (Figure 4), which is likely to be weak. On balance, we anticipate sluggish growth in income, lower consumer spending, and a rising personal savings rate.

[2] See the "Flaherty & Crumrine Second-Quarter Economic Update," July 2008 for a detailed discussion.

Figure 4: Slowing Jobs, Income, Spending

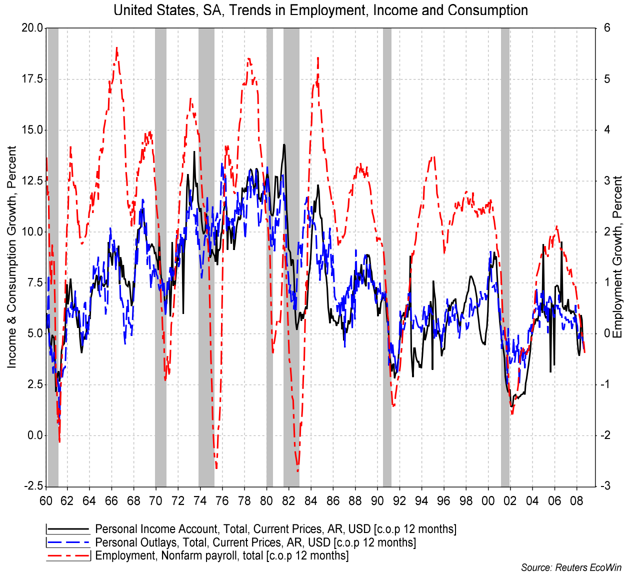
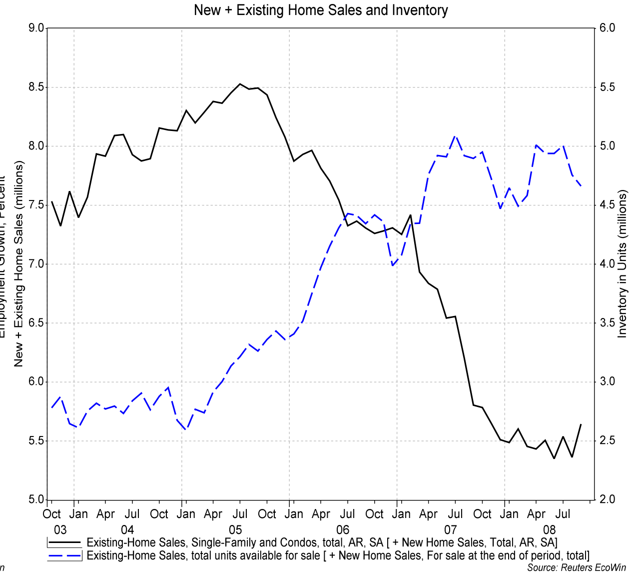


Figure 5: Housing Bottoming?



Business investment was mixed in the second quarter but appears to have weakened in Q3. Spending on business equipment and software fell by 5% annualized in Q2, but spending on private nonresidential structures rose by 18.5% annualized. As financing became harder to obtain, business construction spending slowed by at least two-thirds while shipments of core capital goods fell by 5.2% annualized through August. This should leave investment spending down for the third quarter. Unless credit conditions ease significantly and soon, investment spending likely will fall further in Q4.

The **housing market** remains weak but began to show some signs of stabilizing in the third quarter. New plus existing home sales have been running around a 5.5 million unit pace since December 2007 and actually rose to a 5.6 million unit pace in September (Figure 5). In addition, inventories of unsold homes have shrunk in recent months, housing affordability is improving, and the pace of home price declines has slowed. Although the process is painful, lower home prices are starting to attract buyers. However, these nascent signs of improvement may be overwhelmed by the intensification of the credit crisis and the recession it is spawning. Although we believe that the steps the government has taken to stabilize the banking system and provide liquidity to the mortgage market will be successful in maintaining the flow of mortgage credit, the slowdown in the economy probably will keep many potential home buyers on the sidelines and delay the recovery in housing. As a result, we think the recovery in housing probably will not begin until late 2009 or into 2010, about six months later than we previously expected.

Inflation pressures eased in the third quarter even though major inflation indices remained sticky. Core consumer prices rose by 2.5% YoY in September, up 0.1% from the second quarter, and the core personal consumption expenditure (PCE) deflator also continued to trend higher in Q3 (Figure 6). However, as the outlook for the global economy weakened, commodity prices plunged. For example, the price of a barrel of West Texas Intermediate crude oil fell from about $140 per barrel at the end of June to $100 at the end of September and $65 today. Lower commodity prices meaningfully improve the inflation outlook and already have begun to push headline inflation (CPI All-items and PCE overall) lower (Figure 7). More importantly, it has removed the major constraint to more stimulative monetary policy, which paved the way for the recent globally-coordinated rate cuts in the U.S., Canada, and much of Europe.

Figure 6: Core Inflation Sticky…

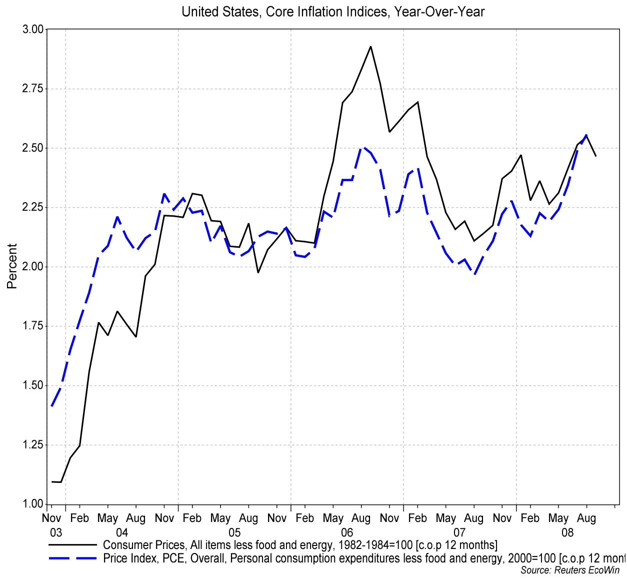
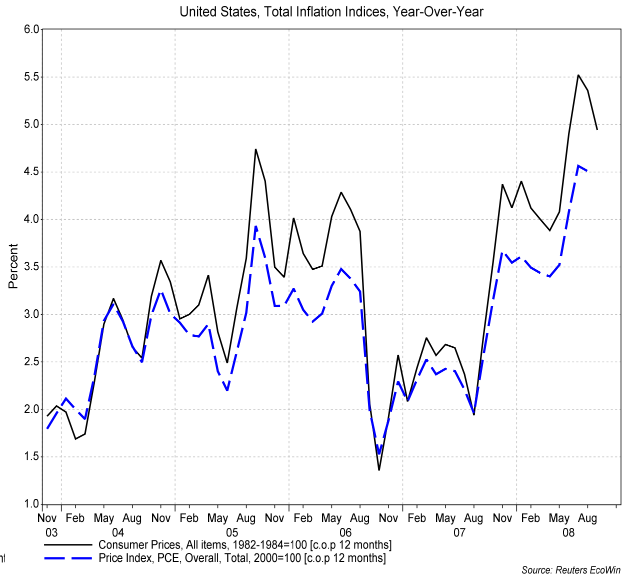


Figure 7: …but Overall Inflation Starting to Ease



Market Outlook

We begin this section with a brief rundown of some of the key credit indicators we follow and an update on monetary policy. We then turn to our outlook for the credit crisis. It is no surprise that the fundamental **credit outlook** has deteriorated as strains in the housing market spread to other parts of the economy. Loan charge-off and delinquency rates, mortgage delinquency and foreclosure rates, and bankruptcy filings are rising (Figures 8 & 9), and all are poised to rise further. This has prompted banks and other lenders to substantially increase reserves for loan losses and to seek additional capital. In turn, this has crushed earnings and put pressure on the prices of financial companies' debt and preferred securities.

At nonfinancial companies, balance sheets remain healthy overall, though leverage and financing needs are increasing. Interest expense has increased and is likely to increase further as the cost of borrowing has risen, but it remains modest relative to earnings before interest and taxes. Long-term debt as a proportion of total borrowings also remains relatively high, which should limit refinancing risk at most of these companies (Figure 10). However, the corporate financing gap (essentially spending less internally generated funds) is increasing as profit growth slows (Figure 11). Although few companies are issuing public debt in today's strained markets, supply should pick up significantly as markets normalize, which will keep pressure on spreads for now.

We think that the credit health of nonfinancial companies remains fairly good. Recession will strain them, but they are facing the prospect of recession with generally clean balance sheets and decent earnings streams. Financial companies face bigger problems, as indicated by rising loan losses and delinquencies. Of course, systemic problems for banks and other lenders translate into problems for the economy as a whole. Without the free flow of credit between borrowers and lenders, economic activity could be severely curtailed. That is why government efforts to diffuse the credit crisis have focused on financial firms.

Figure 8: Loan Problems, Bankruptcies Rising

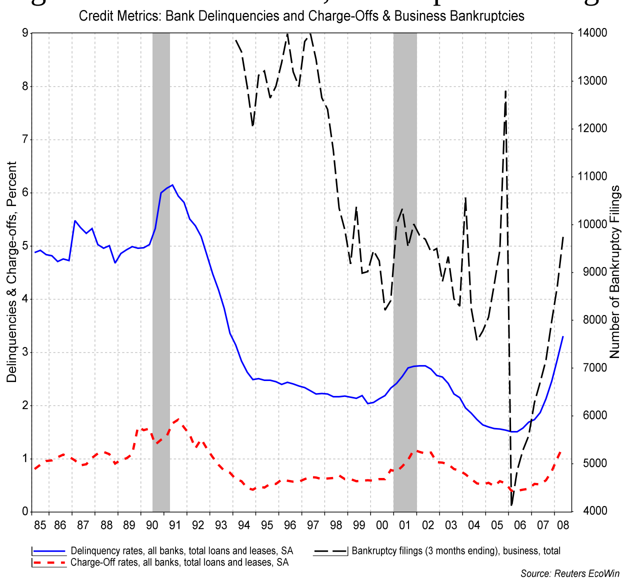


Figure 9: Mortgages Still Deteriorating

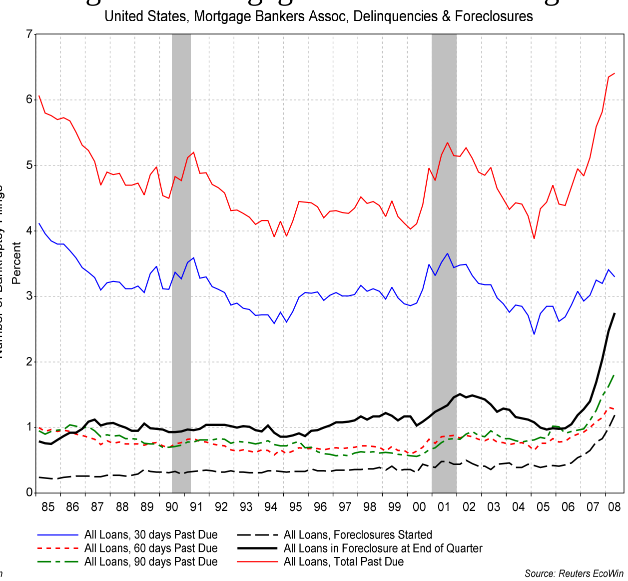


Figure 10: Balance Sheets Generally Healthy…

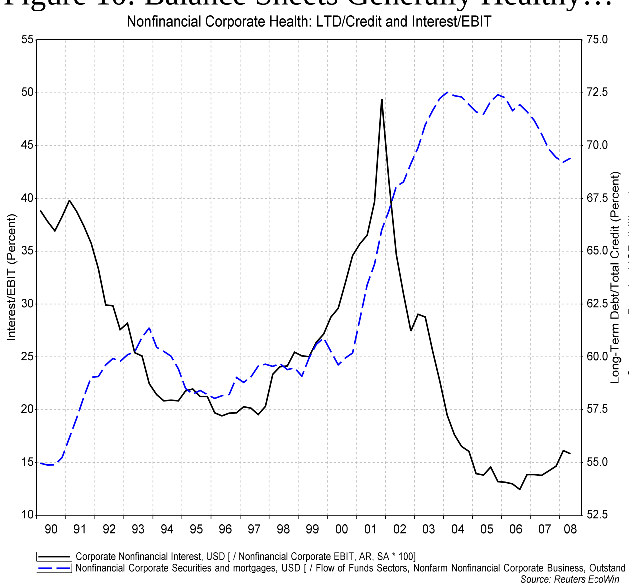
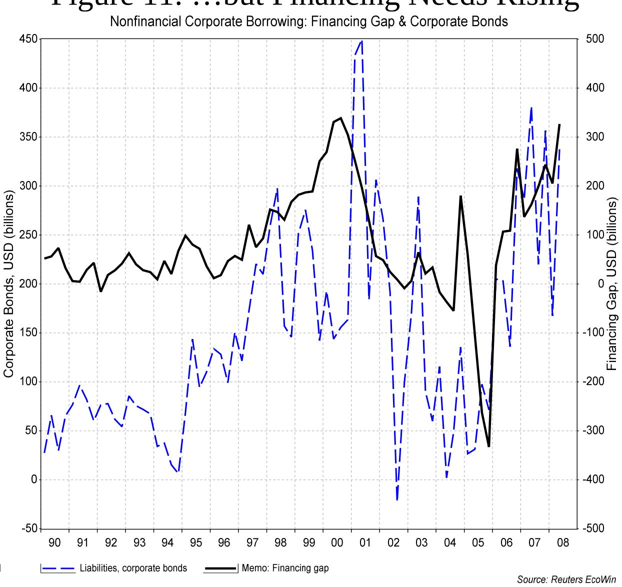


Figure 11: …but Financing Needs Rising



With the outlook for growth deteriorating and inflation pressures easing, the Federal Reserve eased **monetary policy** and cut the fed funds and discount rates by 50 basis points (bp) to 1.50% and 1.75%, respectively, on October 8. This was part of a coordinated series of rate cuts by the Fed, the European Central Bank, the Bank of England, the Bank of Canada, and the central banks of Sweden and Switzerland. The Federal Open Market Committee (FOMC) cut the fed funds and discount rates by a further 50 bp each on October 29, bringing those rate to 1.0% and 1.25%, respectively. Futures markets anticipate another 25 bp rate cut in December.

In addition to cutting rates, the Fed substantially expanded its existing credit facilities for banks and broker-dealers and introduced two new ones. First, the Fed began offering nonrecourse loans to banks purchasing certain assets from money market mutual funds to assist the funds in meeting rising redemptions. Second, the Fed, in conjunction with the Treasury, initiated a program to purchase commercial paper directly from high-quality issuers as the market for commercial paper began to dry up. The result of these actions has been a dramatic expansion of the Fed's balance sheet (Figure 12). This has served to counteract some of the contraction in short-term lending by private sources.

All this monetary accommodation has led to rapid growth in the **money supply**. M1 is up about 6% YoY after hovering near zero for most of 2008 as FDIC-insured bank deposits have swelled, while MZM growth slowed to about 10% YoY due to redemptions at money market funds (Figure 13). We continue to think these shifts in money supply reflect changing liquidity preferences, not strengthening economic activity. As a result, we don't think this money growth is inflationary; if anything, it may be the opposite. Early in the credit crisis, investors opted for high-quality, short-term assets (e.g. money market funds), so MZM rose quickly. As the crisis deepened in recent weeks and one money market fund "broke the buck," MZM growth slowed while M1 growth surged. The relatively strong growth in both M1 and M2 along with the rapid slowdown in economic activity points to a collapse in the velocity of money. This is exactly what we would expect in fearful markets. Investors and consumers hoard cash and trim spending, so money supply jumps while consumption slows – clearly a disinflationary process.

Figure 12: Fed Balance Sheet Surges

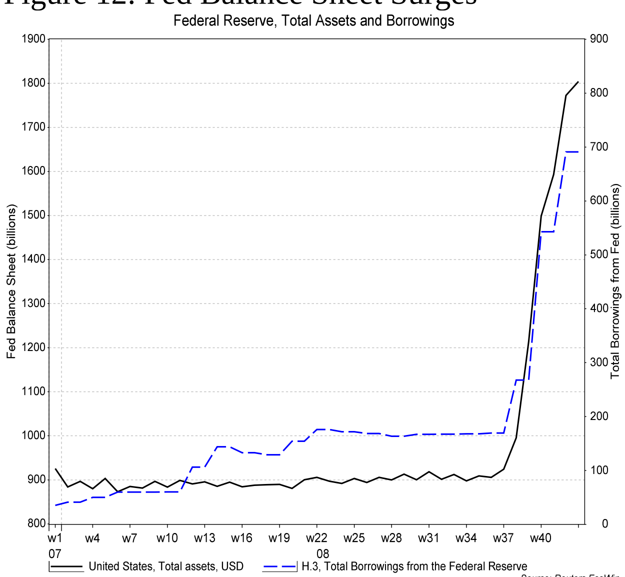
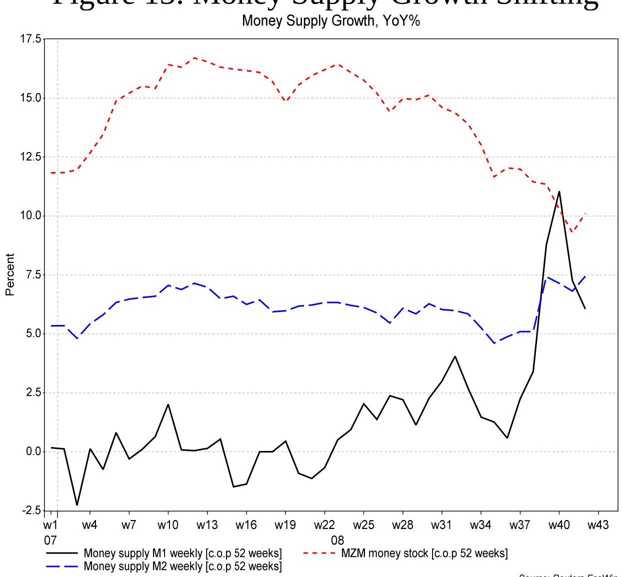
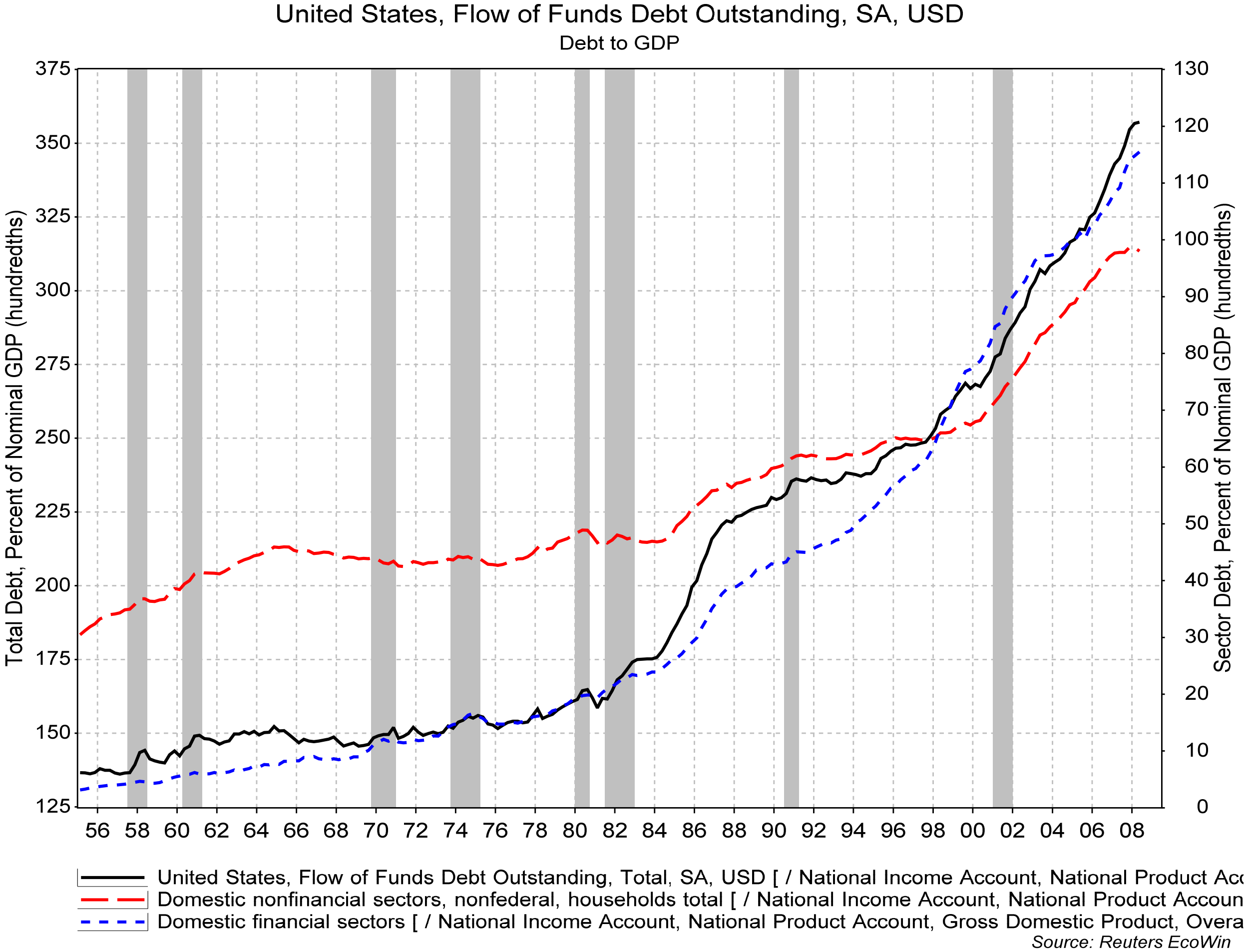


Figure 13: Money Supply Growth Shifting



As we indicated in the opening of this Update, the U.S. economy is in the midst of a profound debt reduction, or **deleveraging**. It took a long time for today's debt levels to be accumulated, and it will take some time for it to be unwound. Debt-to-GDP has been rising for more than 50 years; overall debt started growing rapidly 25 years ago; and household debt took off about eight years ago (Figure 14). At a minimum, the pace of growth in debt needs to slow significantly, but we cannot predict how much debt ultimately will be reduced. While one might look back and conclude that the rise in debt was unsustainable, at least since 1980, it generally was supported by rising net worth, lower interest rates, more moderate business cycles, greater globalization, and financial innovation. Only when asset prices – especially housing prices – began falling broadly did debt levels suddenly become burdensome. We now face a period where debt needs to be paid down and assets sold to pay for it. Net worth will fall as a result. Markets reflect this in lower asset prices, shrinking credit, and falling equity values.

Figure 14: How Much Debt Is Too Much?



What will break the cycle of debt deleveraging? First, it's helpful to simplify the problem to attempt to identify some broad solutions. Think of the economy from a balance sheet perspective: Assets must equal liabilities plus equity (net worth). If asset prices fall while liabilities are (mostly) fixed, then equity value drops, and it does so at a leveraged rate. In an attempt to preserve equity, owners sell assets in order to pay down liabilities, so that equity becomes less leveraged. This puts downward pressure on asset prices, which further reduces equity, and prompts more selling, especially if risk appetite is falling at the same time. This continues until (1) sufficient assets are sold to bring leverage down to a level where owners are willing to accept the risk inherent in the assets, (2) new equity capital comes into the market to support the current level of leverage, or (3) liabilities are reduced to the underlying value of the assets (as happens in bankruptcy). Given the complexity of the economy, it probably takes some of each for the system to reach equilibrium again.

Using this framework, we can assess the impact of the various programs that the U.S. government has put forth to address the credit crisis. Early on, the Federal Reserve provided liquidity to banks and later broker-dealers, who represent the most important financial intermediaries in the economy. This facilitated the conversion of assets to cash, which was then used to pay down liabilities. Fed liquidity lubricated the gears of the capital markets, but it did not directly address any of the three things that are necessary for equilibrium. For awhile, that appeared to be enough, but as asset prices continued to decline and new capital failed to flow into the markets (in fact, it was flowing out as investors tried to reduce exposure to risky assets), the credit crisis intensified sharply in September and October.

Governments both here in the U.S. and abroad responded aggressively, if occasionally belatedly, to this broadening and deepening of the credit crisis. In the U.S., the Emergency Economic Stabilization Act of 2008 increased the limit for FDIC deposit insurance from $100,000 to $250,000. Subsequently, the FDIC announced programs to insure non-interest bearing bank deposits of any size as well as new senior unsecured bank debt issued prior to June 30, 2009 and maturing by June 30, 2012. These guarantees directly support the liability side of banks' balance sheets.

The Treasury's $700 billion Troubled Asset Relief Program (TARP) takes aim at both the asset and equity portions of banks' balance sheets. Although it is still a few weeks away from being operational, the TARP's asset purchase program will offer to purchase troubled assets from banks. These purchases will be made at market prices, but probably not at the fire-sale prices available in today's highly risk-averse market. This will help to support asset prices, will aid in price discovery on these hard-to-value assets, and should reduce some of the forced selling evident in today's market.

The second part of the TARP is the Capital Purchase Program (CPP), which provides direct capital injections to eligible banks in the form of preferred shares and warrants[3]. Perhaps the most important aspect of the program from the perspective of preferred investors is that the government's investment is *pari passu* with (i.e. equal in seniority to) most outstanding tax-advantaged preferred stock, and it is actually junior to most fully-taxable preferred securities, which comprise most of the preferred securities markets. Nine large banks already have committed to taking $125 billion of this capital[4], and another $125 billion is available to other banks on a voluntary basis. We anticipate that many banks will strengthen their balance sheets through this program. In combination with the sizable extension of government guarantees on bank liabilities, banks should able to fully leverage this additional capital. As a result, the TARP CPP should help to support lending and will give banks a greater ability to hold on to loans through the credit cycle (rather than dumping them at fire-sale prices). It also removed a huge threat to the preferred market: That systemic government support might come at the expense of existing preferred investors, as was the case at Fannie Mae and Freddie Mac.

Additional programs are in the works to help homeowners modify (i.e. reduce) their mortgage debt to avoid foreclosure. Because such programs are difficult to scale up quickly – they must be administered properly to avoid encouraging homeowners who are current on their mortgages to walk away from them – they will take more time to make a difference in the current crisis. However, taken as a whole, the programs now in place and under consideration address each of the things needed to regain equilibrium in the credit markets: Asset price support, liability guarantees and reductions, and equity injections. We do not think the government can support the markets single-handedly, but its recent moves have been both more comprehensive and more

[3] For a detailed summary of the TARP program, please see the FAQ section of the Fund's web site at www.preferredincome.com or www.fcclaymore.com.

[4] Citigroup, Wells Fargo, J.P. Morgan Chase, and Bank of America/Merrill Lynch will get $25 billion each; Morgan Stanley and Goldman Sachs will get $10 billion each; Bank of New York Mellon will get $3 billion; and State Street Corp will get $2 billion.

investor-friendly than before, especially for preferreds. We think private capital will start to flow back into the preferred market as a result.

If we are right, the economy will not avoid recession, but it should avert depression. We recognize that risks are high in today's markets, and most investors have suffered substantial losses on their preferred investments. However, all the selling we have described has pushed preferreds down to historically low prices and high current yields. As we have explained elsewhere, defaults on a portfolio of preferred securities can approach and in some cases exceed the default rates experienced during the Great Depression while still earning a return equal to Treasuries.[5] We fully anticipate recession. The preferred market is pricing in Depression. Acknowledging there is risk, we have never seen such extraordinary opportunity in the preferred market.

Brad Stone
Flaherty & Crumrine Incorporated
October 29, 2008

[5] For additional information and important disclosures, see "Thoughts on Preferred Valuation in a Turbulent Market," September 2008, available on the Fund's web site at www.preferredincome.com or www.fcclaymore.com.