Flaherty & Crumrine Incorporated

Fourth-Quarter U.S. Economic Update
January 2009

Summary of Recent Economic Developments

The year-old recession intensified in the final quarter of 2008. Economists now expect that Q4 GDP contracted by -6.3%, the worst quarterly growth rate in more than 25 years.[1] Nearly every major sector of the economy was weak. Job losses accelerated, income growth slowed, and personal consumption fell. Housing and business investment were again weak. Even the trade sector, which had supported GDP for the past two years, probably retreated. The lone bright spot was the government sector, where deficit spending expanded sharply. With a large fiscal stimulus package making its way through Congress, government spending should be the primary contributor to GDP growth for at least the next several quarters. Inflation slowed rapidly as energy and commodity prices plunged, sparking fears of deflation. The Federal Reserve eased monetary policy substantially and shifted its focus from the federal funds rate to credit market conditions broadly. Nonetheless, credit markets remained volatile. Short-term markets appear to be normalizing in response to the array of government financial stabilization programs introduced since September. In contrast, long-term corporate bond and preferred spreads versus Treasuries hit record highs in Q4, although most markets have recovered a bit from those levels. Preferred valuations still reflect a deeper downturn than we currently expect.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	**2007:1**	**2007:2**	**2007:3**	**2007:4**	**2008:1**	**2008:2**	**2008:3**	**2008:4**
Real GDP, Chg QoQ (%)	0.1	4.8	4.8	-0.2	0.9	2.8	-0.5	-6.3f
Real Personal Consump Expnds, Chg QoQ (%)	3.9	2.0	2.0	1.0	0.9	1.2	-3.8	-2.2a
Real Busi Investmt, Eqp & Sftware, Chg QoQ (%)	0.0	6.9	3.6	1.0	-0.6	-5.0	-7.5	NA
Real Residential Investmt, Chg QoQ (%)	-16.2	-11.5	-20.6	-27.0	-25.1	-13.3	-16.0	NA
Corporate Profits, After Tax, Chg YoY (%)	-0.9	-0.2	-0.8	-0.6	1.8	-6.4	-7.9	-5.6f
Current Account Balance, Annualized (% of GDP)	-5.8	-5.7	-5.0	-4.8	-5.0	-5.1	-4.8	NA
Federal Budget, 12-mo Def or Surp (% of GDP)	-1.5	-1.2	-1.2	-1.3	-1.5	-2.3	-3.2	NA
Unemployment Rate (%)	4.4	4.6	4.7	4.9	5.1	5.6	6.2	7.2
Household Employment, Chg QoQ (000)	278	-210	146	91	-271	-285	-709	-1691
Nonfarm Payrolls, Chg QoQ (000)	328	315	212	241	-247	-214	-597	-1531
Nonfarm Productivity, Chg QoQ (%)	0.0	4.1	5.8	0.8	2.6	3.6	1.3	NA
Capacity Utilization (%)	80.7	81.0	81.3	81.0	80.4	79.6	75.0	73.6
GDP Price Index, Chg QoQ (%)	4.1	2.0	1.5	2.8	2.6	1.1	3.9	NA
Consumer Price Index, Chg YoY (%)	2.8	2.7	2.8	4.1	4.0	5.0	4.9	0.1
CPI ex food & energy, Chg YoY (%)	2.5	2.2	2.1	2.4	2.4	2.4	2.5	1.8
Nominal Personal Income, Chg YoY (%)	6.7	6.0	6.1	5.4	3.9	5.3	3.3	2.5a
Personal Savings Rate (%)	1.3	0.1	0.6	0.4	0.2	2.5	1.2	2.8a
Rate or Spread (End of Quarter)	**2007:1**	**2007:2**	**2007:3**	**2007:4**	**2008:1**	**2008:2**	**2008:3**	**2008:4**
Federal Funds Rate Target (%)	5.25	5.25	4.75	4.25	2.25	2.00	2.00	0.25
3-month LIBOR (%)	5.35	5.36	5.23	4.70	2.69	2.78	4.05	1.43
10-Yr Treasury Note Yield (%)	4.65	5.03	4.59	4.03	3.41	3.97	3.83	2.22
30-Yr Treasury Bond Yield (%)	4.85	5.13	4.84	4.48	4.29	4.52	4.31	2.68
Moody's Baa Long Corp Spread (bp)	155	149	175	208	261	252	354	529
10-Yr Interest Rate Swap Spread (bp)	52.8	63.8	62.5	63.8	66.0	70.3	66.5	35.0

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

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

[1] Real GDP forecast from Bloomberg; Corporate Profits forecast from the *Survey of Professional Forecasters.*

Economic Outlook

It's official: The economy is in recession and has been since December 2007, according to the National Bureau of Economic Research. Although real Gross Domestic Product (GDP) grew slightly in the first half of 2008, strains in the credit market gradually spilled into the real economy – most notably the labor market – during the course of the year. By the third quarter, the economy was contracting at a 0.5% annual rate. When fourth quarter GDP is reported later this month, forecasters expect the economy to contract by 6.3%, which would be the worst quarterly performance since 1982. The outlook for the first quarter of 2009 is not much better. Although the worst quarter of the recession is likely to be 2008:Q4 or 2009:Q1, it is impossible to say how much longer it will last. We can only point out that recessions do end and that it's as difficult to identify the economic turning point at the bottom as it is at the top while one is living through it. However, it is useful to try, so we will review in some detail various sectors of the economy and financial markets. We will say from the outset that the news is pretty grim, although there are some early signs of a return to more normal credit markets.

The **labor market** weakened sharply in the fourth quarter, shedding more than 1.5 million jobs and pushing the unemployment rate up by a full percentage point to 7.2% in just three months (Figure 2). Job losses were broad-based by industry, with only government, education, and healthcare showing increases in payroll jobs during the quarter. Hourly earnings growth held about steady at 3.7% YoY, although reports of pay cuts have become more widespread in January. Average hours worked fell as firms trimmed output and moved workers to part-time schedules. In addition, hiring surveys and help-wanted advertising show that firms are continuing to shed jobs (Figure 3).

Figure 2: Falling Jobs, Rising Unemployment

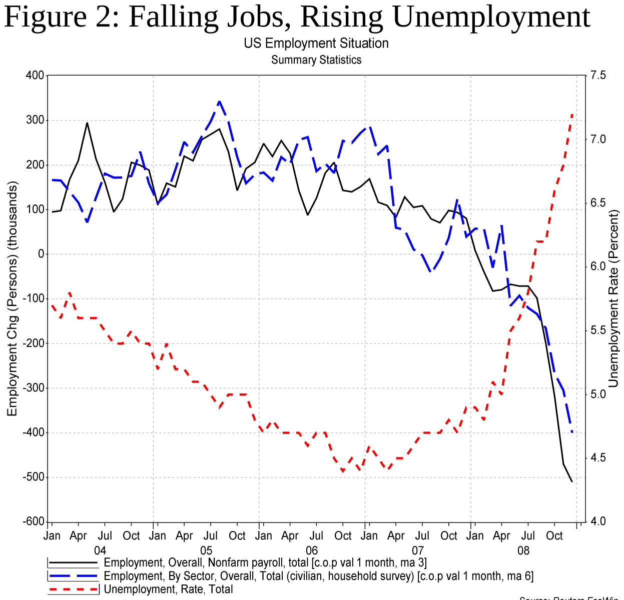
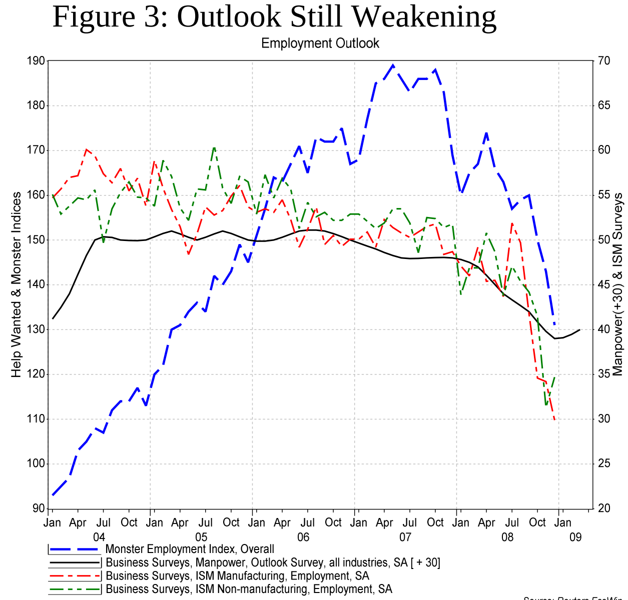


Figure 3: Outlook Still Weakening



Employment is all but certain to fall further for at least the next quarter or two as the economy shrinks. It is worth remembering, however, that employment is a coincident, not a leading, economic indicator. It does not tell us much about where the economy is headed, but historically the employment growth rate has been a reliable indicator of when the economy enters and exits recession (Figure 4). Specifically, recessions have ended when the growth rate in employment turns upward for more than a couple of months after the start of a recession. Although we don't expect that employment growth will bottom soon, we will be watching it carefully as the year progresses.

Figure 4: Keep an Eye on Employment Growth

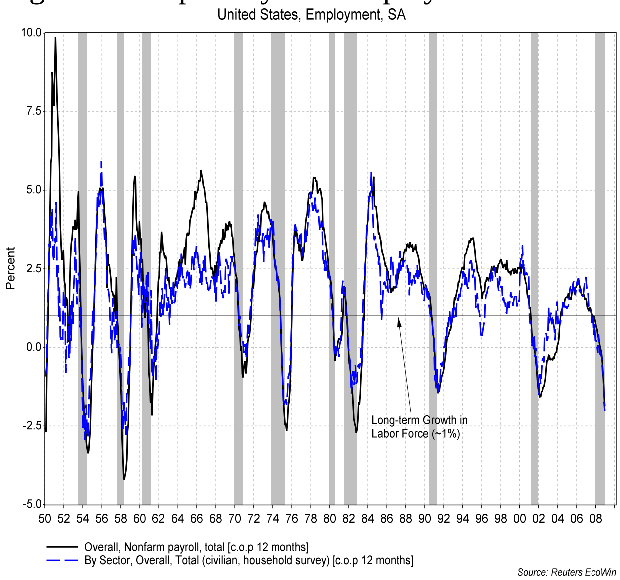


Figure 5: Jobs, Income, Spending Sag

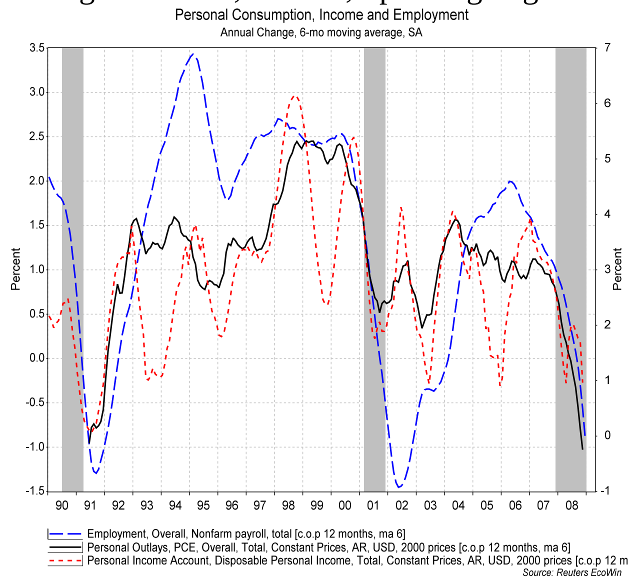


Figure 6: Consumer Confidence Weak

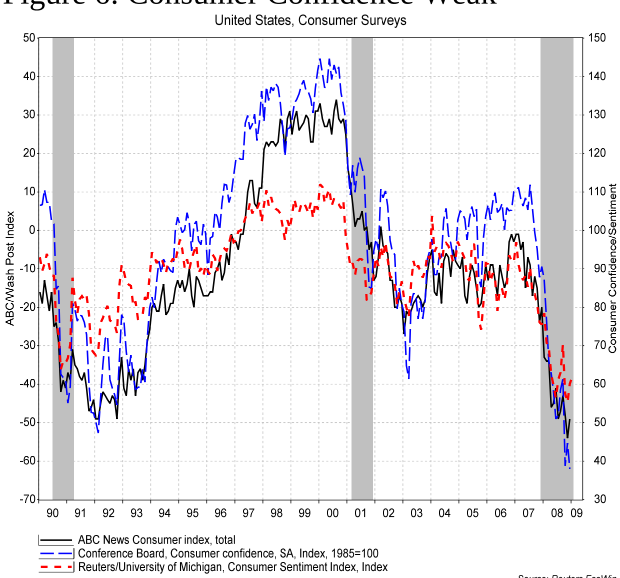
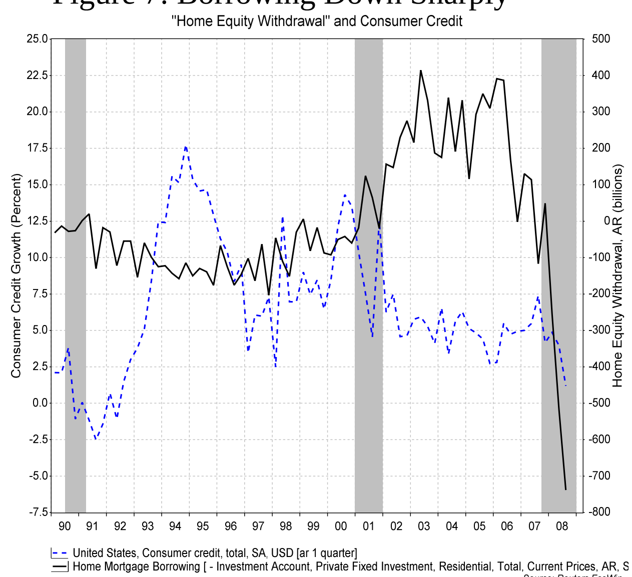


Figure 7: Borrowing Down Sharply



Although hourly wages are still growing at a respectable pace, job losses and declining hours worked caused **personal income** growth to slow significantly in recent months. Nominal personal income growth slowed to 0.5% annualized in the first two months of the fourth quarter and likely slowed further in December. That compares to 3.8% growth YoY as of August 2008. Real income is holding up a bit better, however, as sharply lower energy prices pull down the personal consumption expenditure deflator.

With employment declining and income growth slowing, nominal **personal consumption** expenditures (PCE) have fallen. Once again, lower prices have allowed real spending to hold up a bit better, but real PCE is still sagging (Figure 5). Reinforcing the trend toward weaker consumption are consumer confidence and household credit. Consumer confidence has fallen to or near record lows across all major surveys (Figure 6). At the same time, consumer credit growth has slowed to about zero, and home equity withdrawal (mortgage borrowing less residential investment) has plunged (Figure 7). Thus, we have a situation where income growth is slowing, confidence is depressed, and the ability and willingness to borrow is low. We expect weak personal consumption in Q4 and for at least the next several quarters.

If there is a silver lining in these income and consumption trends, it is that the personal **savings rate** is rapidly increasing. Consumers clearly want to build savings, and with income growth slowing, that means that consumption must grow even more slowly or decline. The good news is that the rebound in savings is already well underway. The personal savings rate is up from zero in April 2008 to 2.8% in November. No doubt households will continue to increase savings (hence the desire to offset some of this spending drop with fiscal stimulus), but it is encouraging to see them make such rapid progress.

The **housing** sector took another turn down in the fourth quarter. After broadly stabilizing around 5.5 million unit pace for the better part of a year, new and existing home sales renewed their decline as the credit crisis intensified (Figure 8). Sharply lower housing starts kept the inventory of unsold homes trending gradually lower, but it will mean another big negative contribution to GDP in the quarter. Home prices continued to fall, and at an accelerating pace. Although it happened only late in the quarter, mortgage rates finally fell, and fell meaningfully. The rate on a conventional 30-year fixed rate mortgage is now around 5%, down about 150 basis points (bp) since the summer. This combination of lower home prices and mortgage rates combined to push housing affordability to a record high in the fourth quarter (Figure 9). Eventually, that will drive stronger demand for housing.

Figure 8: Home Sales Plunge Again…

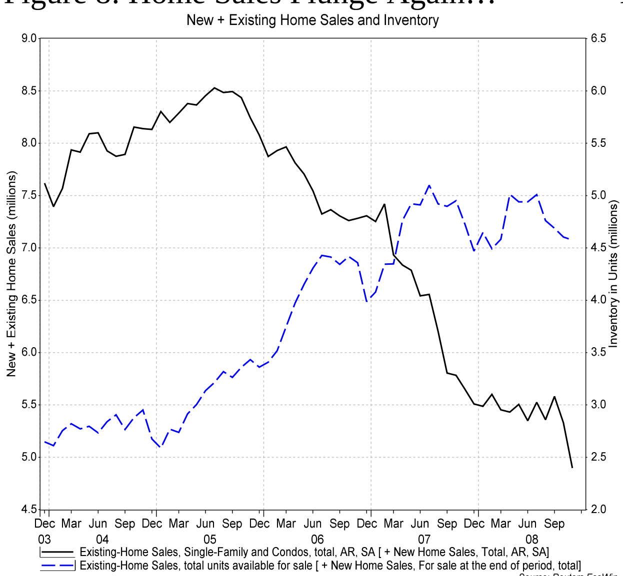
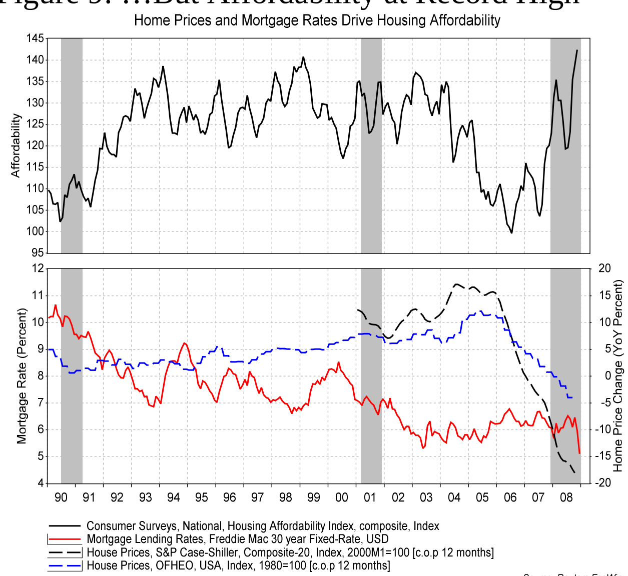


Figure 9: …But Affordability at Record High



The business side of the economy looks even worse than the consumer side. **Business investment** likely fell rapidly in the fourth quarter as the credit crisis and recession intensified. The Institute for Supply Management's manufacturing and non-manufacturing surveys fell significantly, signaling shrinking real GDP (Figure 10). Industrial production also took a nosedive, falling at a 15% annual rate in Q4. Similarly, our estimate of real factory orders fell at an annual rate of 26.8% in the three months ending in November 2008. Shipments fared a little better but were still down by 20.3% on the same basis (Figure 11). Business spending on construction is still rising, but at a slower pace than in recent quarters; it is unlikely to offset weakness in other areas of business investment.

Figure 10: ISM Surveys Point to Shrinking GDP

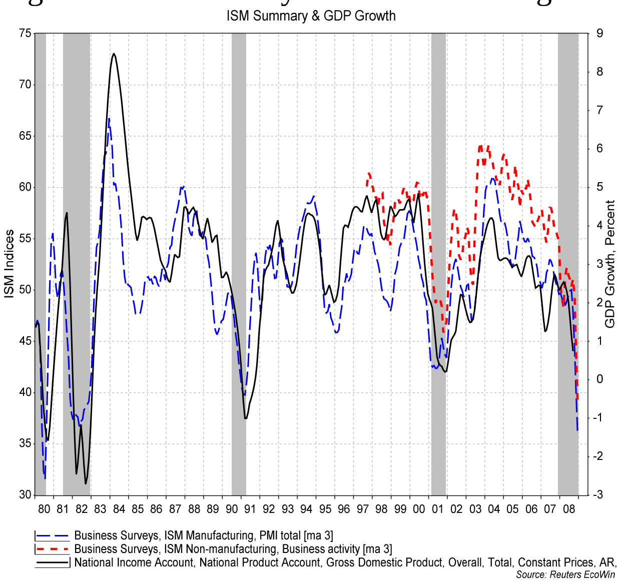
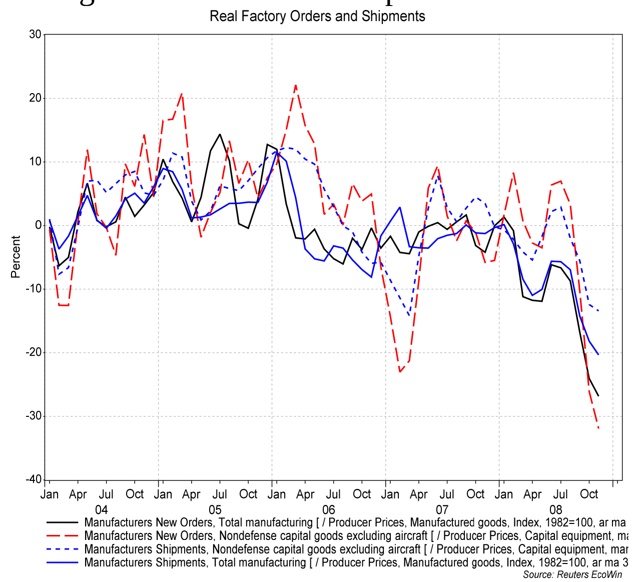


Figure 11: Orders and Shipments Weak



The **trade sector**, which has helped support the economy every quarter since 2007:Q1, will probably subtract from growth in the fourth quarter. The subtraction from GDP probably will not be large (our best guess is -0.5 to -1.0%), but with the rest of the economy shrinking, this change could not come at a worse time. Although trade will not help the economy this quarter, we do not think that trade improvement is over. Despite the poor showing in October, the real trade balance still has shrunk from $54.5 billion per month in 2007 to $44.3 billion per month in 2008 (Figure 12). However, with the dollar rebounding off its lows in recent months, trade improvement is bound to slow in 2009. We do believe that the trade deficit will continue to shrink modestly this year, but it will not be the big support to GDP that it was for most of the last two years.

The positive side of the economy's ledger is pretty short, but there are a couple of entries. First, sharply lower energy and commodity prices have dramatically improved the **inflation** outlook. Overall consumer prices rose by just 0.1% in 2008, while "core" CPI (excluding food and energy) rose by 1.8%. That is the lowest reading for overall CPI since the mid-1950s and the lowest for core CPI since 2004 (Figure 13). We expect similar numbers for the PCE deflators when they are reported later this month. The rapid improvement in the inflation data has caused many market participants to start worrying about *de*flation. Although we do not think the US economy will enter a deflationary period, we cannot completely rule it out. With energy prices plunging and the fed funds rate already near zero, traditional monetary policy loses its ability to stimulate the economy. If prices start falling (as opposed to rising more slowly) but interest rates stop falling (because they approach zero), then real rates rise, which is clearly not a good thing for a weak economy. For reasons that we will discuss in the Market Outlook section, we think the Fed, in conjunction with Treasury and other branches of government, can prevent that outcome.

Nonetheless, the huge and rapid drop in energy prices will pull year-on-year headline inflation indices into negative (i.e. deflationary) territory in the coming months, unless energy prices suddenly rise as rapidly as they did last year – an unlikely outcome. We expect a more moderate decline in core inflation, similar to the one shown in Figure 13. Assuming energy prices stabilize around current (or even somewhat lower) levels, overall inflation should move back into positive territory later this year as the deflationary impact of lower energy prices dissipates.

Figure 12: Trade Improvement Slowing

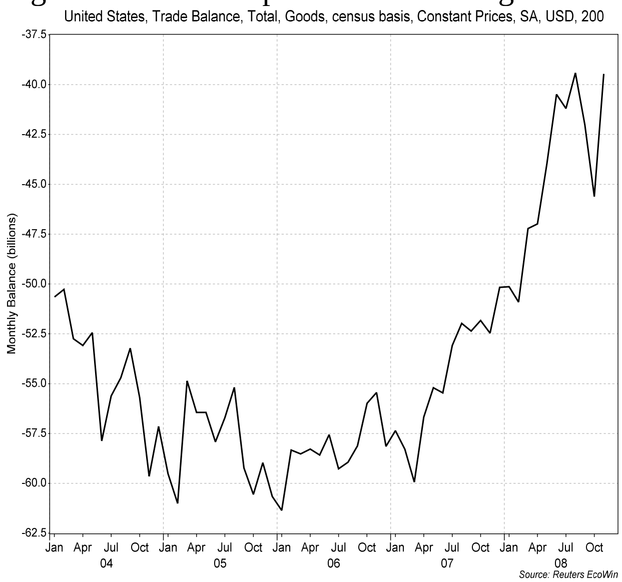
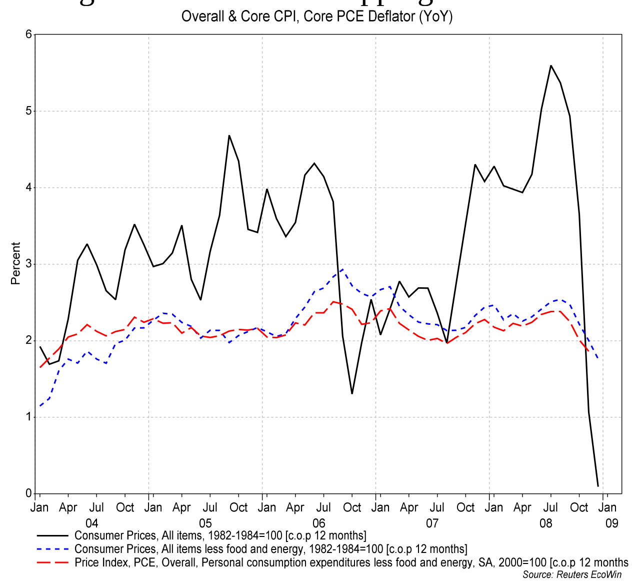


Figure 13: Inflation Dropping Fast



The other positive sector of the economy is **government** spending. As indicated earlier, government is one of the few sectors still adding employees. In addition, government deficit spending is surging, adding "automatic" stimulus to the economy as entitlement spending increases while tax revenues fall. Now, the Obama administration is working with Congress to pass an $825 billion two-year stimulus package of new spending and tax cuts. Even before the stimulus package, the Congressional Budget Office (CBO) estimated that the federal budget deficit would be $1.2 trillion[2], about 8¼% of GDP, in fiscal year 2009. That compares with a deficit of $455 billion in fiscal year 2008. Assuming that the stimulus package passes, that would push the deficit for 2009 at least $1 trillion above the 2008 deficit. This huge expansion of government spending will make the federal government a very large contributor to GDP growth this year. It should offset a significant portion of the decline in private sector spending and allow for a more orderly rebalancing of private supply and demand. However, these deficits eventually will have to be repaid by the private sector, which will slow economic growth at some time in the future. Under the circumstances, we think it is prudent for the government to take out the loan, but we need to recognize that in doing so, we are trading off faster growth now for slower growth later. That has investment implications that we discuss in the next section.

[2] About $420 billion of the projected deficit reflects estimated costs of the government's bailout of Fannie Mae and Freddie Mac and the Troubled Asset Relief Program. Actual costs of these programs could vary widely, depending upon actual defaults and recoveries. In any event, these amounts reflect loss absorption by the federal government rather than true stimulus spending.

Market Outlook

Credit markets continue to operate under strain as problem loans work their way through the system and risk appetite remains subdued, although rapid expansion of the government safety net has pulled most markets back from the precipice they faced in the fall. Business bankruptcies are soaring, and bank loan delinquencies and charge-offs are rising rapidly (Figure 14). Mortgages are the main source of these problems – although other loan categories are also showing rising stress – and there is no sign yet that these mortgage problems are abating (Figure 15). Corporate balance sheets are generally healthy, but the recession is starting to erode interest coverage and financial flexibility (Figure 16). In response, banks and other lenders are tightening their lending standards, albeit from levels that in hindsight were too loose to begin with (Figure 17).

Figure 14: Delinquencies, Charge-offs, Bankruptcies Rising

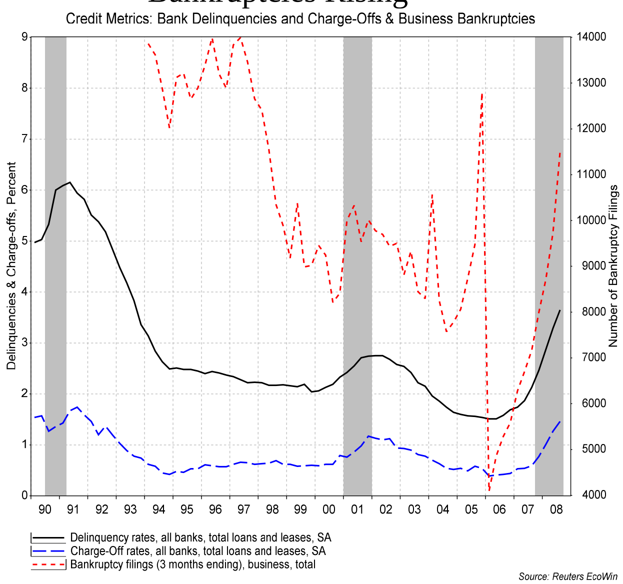


Figure 15: Mortgage Problems Widening

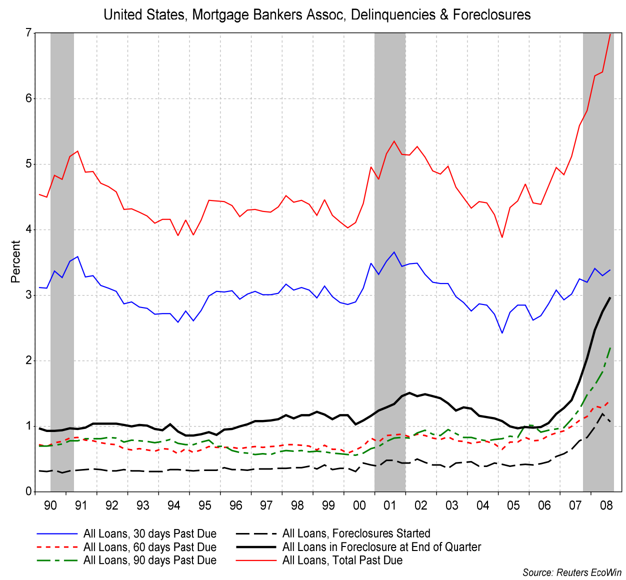


Figure 16: Balance Sheets Healthy, but Turning

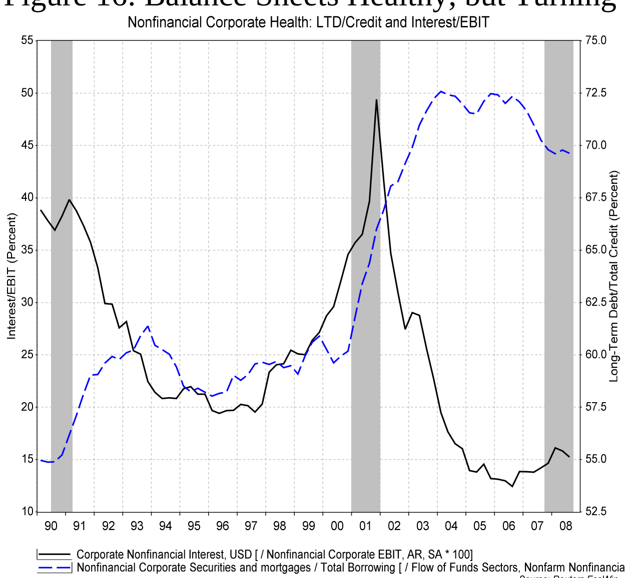
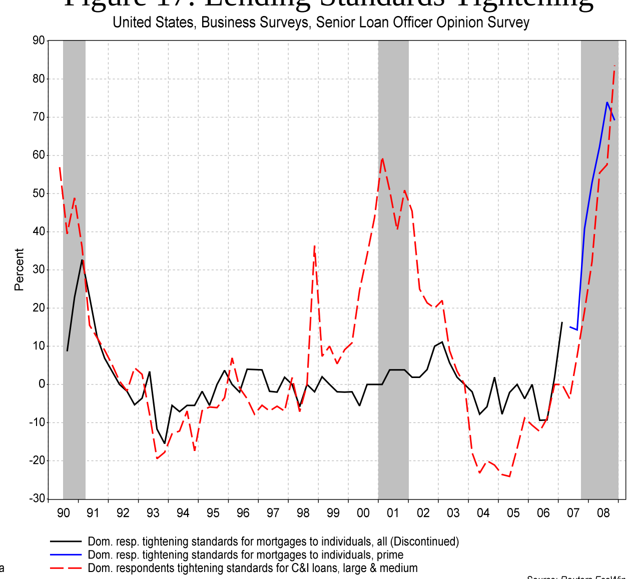
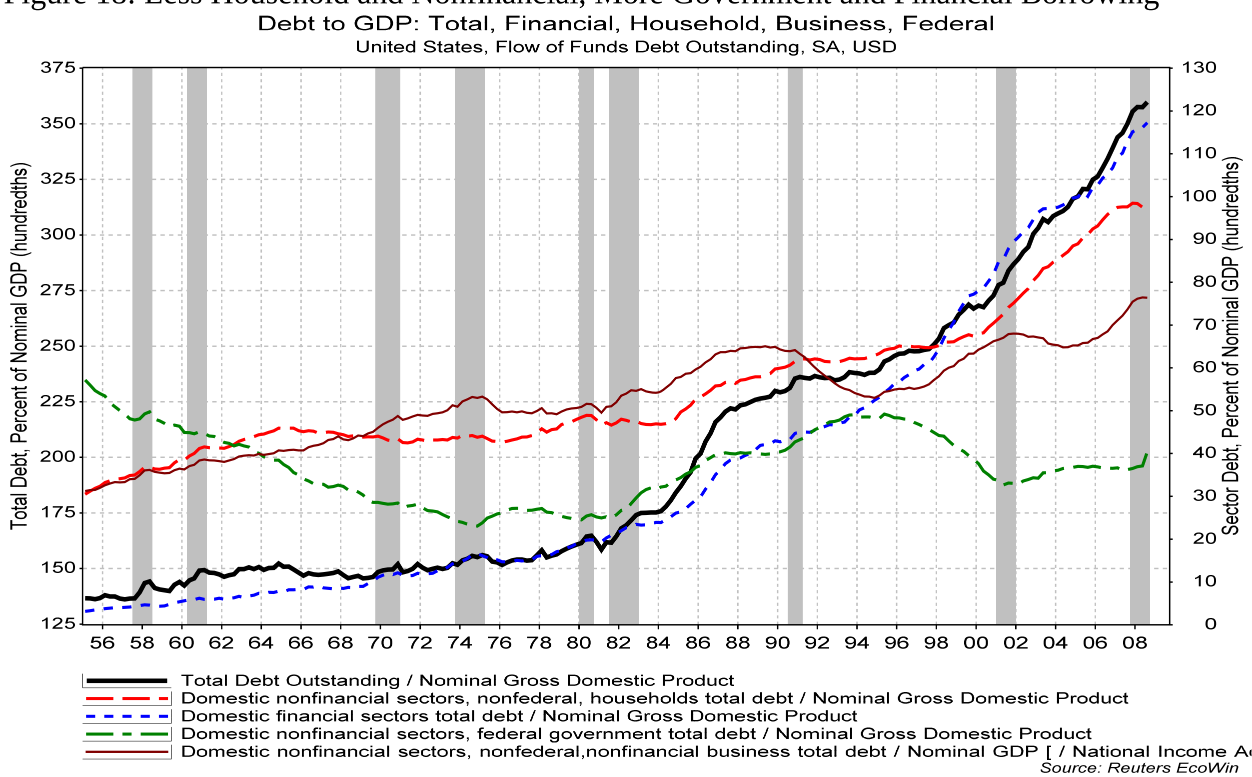


Figure 17: Lending Standards Tightening



The slowdown in the economy and widening of the credit crisis is beginning to become visible in broad segments of the credit markets. We already discussed the sharp drop in home equity withdrawal and the slowdown in consumer credit. We also see weaker household borrowing at the aggregate level in the Federal Reserve's Flow of Funds data. The data is available only with a lag (2008:Q3 is the most recent), but it shows that household (red line) and nonfinancial corporate (brown line) borrowing is starting to fall as a proportion of GDP (Figure 18). While nonfinancial corporate borrowing is fairly cyclical historically, household borrowing has not tended to change much in recessions. This time, household borrowing clearly looks different, which is precisely what one would expect during a credit crunch! While households and nonfinancial companies cut back their borrowing, financial companies (blue line) and the government (green line) are borrowing more. This also reflects the credit crisis. Deficit spending and the Troubled Asset Relief Program (TARP) funding needs have caused government debt issuance to surge, and a sizable amount of borrowing that used to take place in the capital markets is now happening through banks (re-intermediation). Although the time lag makes this data of limited usefulness in anticipating short-term trends, we find it helpful in understanding what is driving financial markets at a macro level. In this case, after a decade of rapid growth, it seems clear that it is going to take more than just a couple of quarters of consumer restraint to bring household borrowing back to a more sustainable level.

Figure 18: Less Household and Nonfinancial, More Government and Financial Borrowing



As the credit crisis has deepened, the Federal Reserve has employed an increasingly unconventional **monetary policy** toolkit. The Federal Open Market Committee (FOMC) cut the fed funds rate target from 2% at the end of the third quarter to 0 to 0.25% currently and the discount rate from 2.5% to 0.5%. The Fed expanded the size of previous lending programs: the Discount Window (DW) and Term Auction Facility (TAF) for banks and the Primary Dealer

Credit Facility (PDCF) and Term Securities Lending Facility (TSLF) for primary dealers.[3] It also introduced new mechanisms to provide funding directly to corporations (the Commercial Paper Funding Facility, or CPFF) and is about to launch a new Term Asset-Backed Lending Facility (TALF) to finance consumer-oriented asset-backed securities. The Fed is purchasing $100 billion of agency debt over the next two quarters, and it will soon begin a program to buy $500 billion of agency mortgage-backed securities. It participated in the government program to guarantee troubled assets at Citigroup and Bank of America.[4] In addition, the Fed has indicated that it is prepared to purchase long-term Treasury notes and bonds if necessary, although with its focus on credit market rates (not Treasury rates) we do not anticipate this move anytime soon. Finally, Chairman Bernanke has indicated that these programs can be broadened and other programs developed to address future strains to the financial system as necessary.

The result has been a dramatic expansion of the Fed's balance sheet, from about $900 billion in the summer to $2.1 trillion currently and down from a peak of over $2.3 trillion in mid-December (Figure 19). The market began calling this "Quantitative Easing," as it is similar to the strategy of the same name employed (with limited success) by the Bank of Japan in battling its long recession in the 1990s and early 2000s. The Fed prefers another name, "Credit Easing," and we think they are right to make the distinction. Success of the program will depend in part on regaining market confidence, and the Fed does not want its efforts associated with a policy that produced dubious results. More importantly, the Fed is focused on improving borrowing conditions, rather than on the quantity of bank reserves (that may or may not be lent). We think it's a key distinction, so we will join the Fed in calling this new phase of monetary policy credit easing.

Figure 19: Fed Balance Sheet

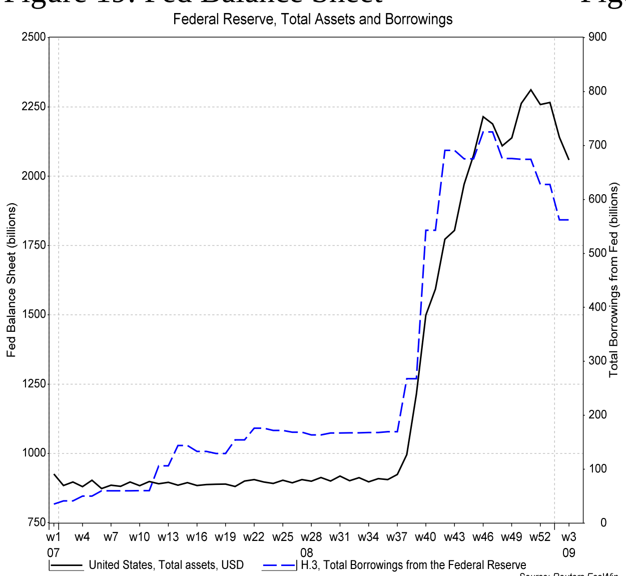
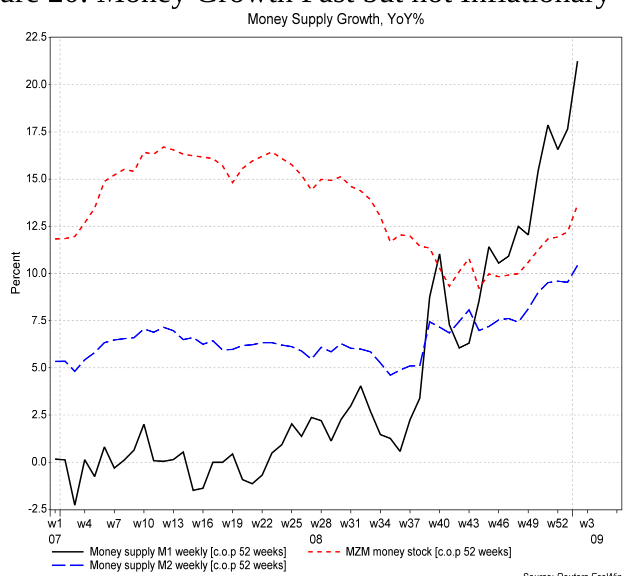


Figure 20: Money Growth Fast but not Inflationary



3 The FDIC has also supported banks with new programs. It participated in the government guarantee of certain assets at Citigroup and Bank of America and is standing behind billions of dollars of newly issued bank debt.

4 This is an interesting and potentially very powerful use of the TARP, because it substantially leverages the funds remaining in the program. By taking a senior position in the guarantee (the bank and then the Treasury and FDIC take first and second losses on the guaranteed assets), the Fed is able to extend the government's guarantee well beyond the direct capital committed by the TARP.

Under credit easing, the Fed provides financing to classes of creditworthy borrowers who are otherwise unable to access the credit markets on reasonably economic terms. In doing so, it supports the functioning of financial markets, preventing a collapse in borrowing and economic activity. This allows time for the economy to regain equilibrium. It will not prevent necessary contraction of borrowing and economic activity, but it should prevent a painful overshoot to the downside, which would be the likely outcome in the absence of these policies.

In addition to a bigger Fed balance sheet, credit easing has resulted in fairly rapid growth in the money supply (Figure 20). We have discussed this in prior Updates, so we will not spend a lot of time on it, bit it's worth repeating that we do not view the current growth in the money supply as inflationary. It merely reflects a sharp decline in the velocity of money brought on by the desire of businesses and households to hold higher liquid (i.e. money) balances, as well as rapid growth in excess bank reserves. Once the economy regains its footing, the Fed will need to slow the growth in the money supply, and we believe they will – probably not at precisely the right moment, but in time to prevent a sharp rise in inflation.

The varied government programs to support financial markets have helped to move short-term funding markets back toward normal. After surging in the fall, spreads on 3-month LIBOR (interbank borrowing) and 30-day commercial paper rates to the target fed funds rate have largely normalized (Figure 21). LIBOR rates remain wider than their earlier norms, but clearly indicate progress. The same cannot be said about long-term credit markets. Corporate debt spreads have come down a bit from their recent highs, but they remain much wider than normal (Figure 22).

Figure 21: Money Markets Normalizing…

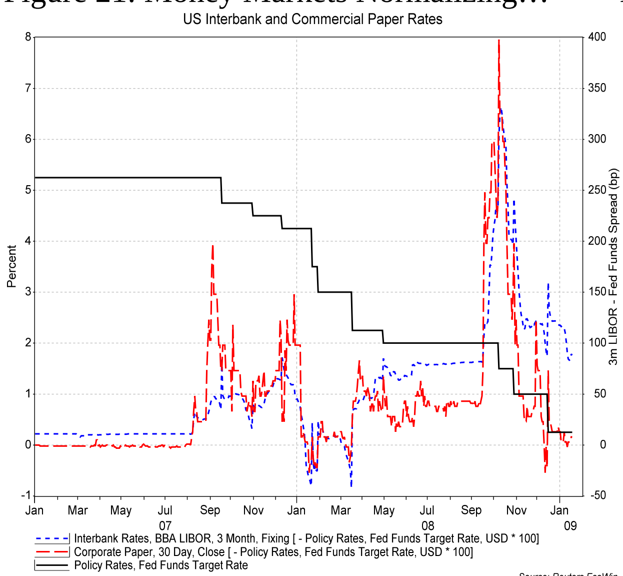
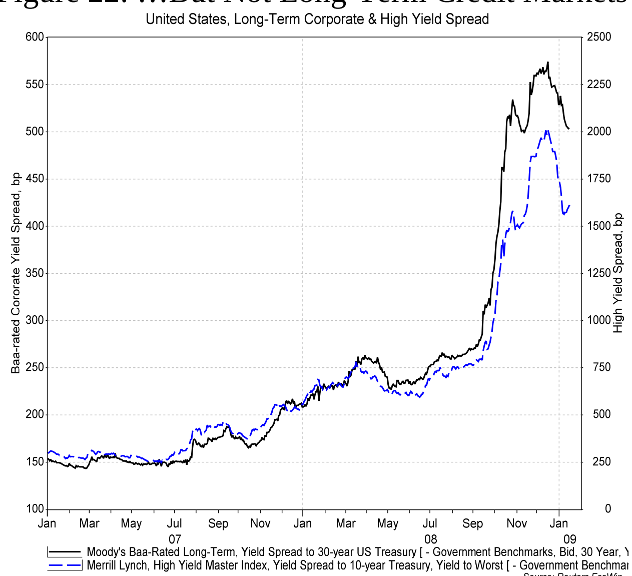


Figure 22: …But Not Long-Term Credit Markets



With all of these crosscurrents, preferred securities prices and spreads remained volatile. Figure 23 shows the price return since the intensification of the credit crisis in September on three Merrill Lynch preferred securities indices representing preferreds eligible for the dividends received deduction (DRD), $25 par retail taxable preferreds, and $1000 par institutional capital securities.[5] Figure 24 shows the long-term yield spreads on the same indices versus Treasuries.

[5] See the Appendix for a description of the indices.

These graphs show that while preferreds remain volatile, they are also exceptionally attractive compared to Treasuries historically.

Figure 23: ML Preferred Index Price Returns[6]

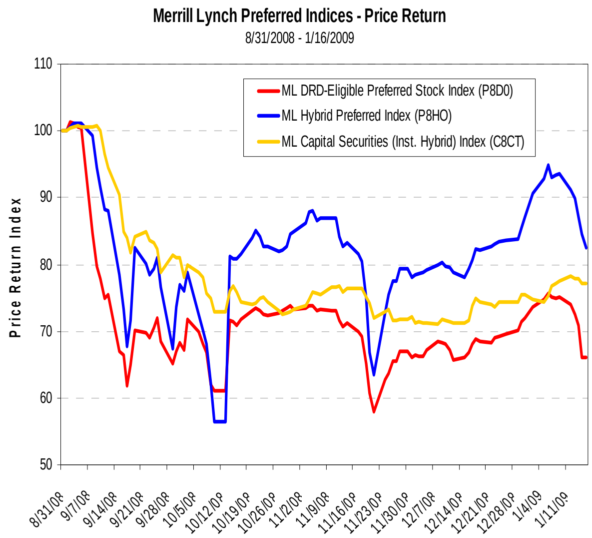
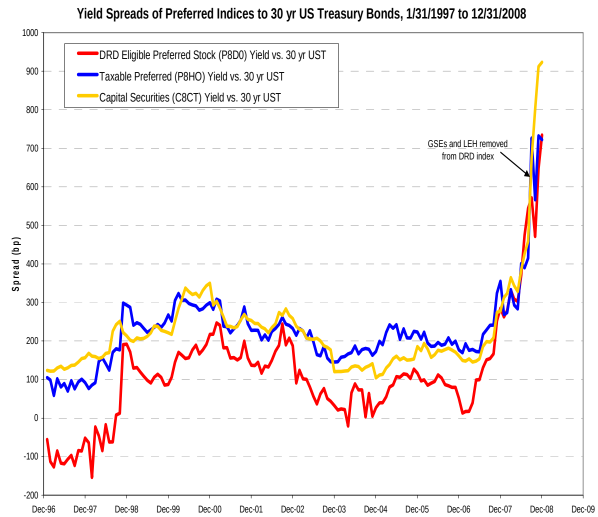


Figure 24: ML Preferred Index Yield Spreads[7]



We take away several key **investment implications** from this discussion of the economy, fiscal, and monetary policy. First, loan charge-offs are going to increase, since they tend to lag changes in the economy. Businesses and households don't default *in anticipation of* a slower economy, they default *because of* a slower economy. Since economic growth slowed sharply in the fourth quarter, we can expect defaults and charge-offs to rise over the coming months. Higher charge-offs and loan-loss provisions are going to keep pressure on bank earnings for at least the next several quarters. More positively, we think there is reasonable hope that mark-to-market losses diminish going forward, given how aggressively banks have reduced positions and how much market prices have fallen already. Nonetheless, we think it will be difficult for preferred markets to rally strongly until investors can reasonably anticipate some improvement in loan quality, something we do not expect over the next quarter or two.

Second, both fiscal and monetary policies are geared to smoothing out the necessary correction in the economy and avoiding a painful overshoot to the downside. They cannot and will not prevent the correction from happening, but they should sharply limit the risk of economic collapse. By trading off faster growth (i.e. less contraction) over the next several years for slower growth in the future, government policies are likely to reduce both the probability of default and the return on equity. We think this should be positive for debt and preferred securities, but it may not be for common stock.[8]

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[6] Price returns indexed to 100 as of 8/31/2008 and are calculated daily through 1/16/2009. Source: Merrill Lynch.

[7] Yield spreads are calculated monthly through 12/31/2008; YTM for C8CT after 6/30/2007 calculated by Flaherty & Crumrine using index member data and pricing provided by Merrill Lynch.

[8] Although a lower ROE is bad for equities, lower discount rates are good. If government policies are successful in lowering borrowing (i.e. discount) rates, then the net impact on common stock is ambiguous.

Third, weakness in the economy has further to run. Of course, financial markets already reflect that view; what is unclear is whether markets reflect too much or too little pessimism about the economy. In the preferred market, we estimate that prices discount even greater default experience than occurred during the Great Depression.[9] We expect a difficult recession, but we do not expect another Great Depression. Thus, our outlook for a weak economy over the next year or so does not dim our optimism for preferred securities over a longer time horizon.

Surveying the economic landscape today, we see excess capacity and falling demand as households and businesses shift from borrowing to saving, either voluntarily or because credit is no longer available or affordable. In such circumstances, it is easy to project self-reinforcing economic weakness far into the future. We think that would be a mistake. Recessions happen either due to policy blunders, market excesses, or both. They end when the resulting imbalances are corrected – in other words, when fundamental (not policy- or mania-induced) demand and supply are again in balance.[10] Markets are correcting rapidly, if painfully. The economy is correcting as well, and we already see signs – such as a sharply higher savings rate – that this process is well underway.

As preferred investors, then, we are cautiously optimistic. Over the near term, the market is very risky, as the recent volatility in preferred prices clearly indicates. Over the long term, we believe preferreds are very attractively valued. We believe that value ultimately will overcome fear of risk. Accordingly, we are seeking to purchase when others are forced to sell and being particularly selective in the credits we buy. But we are proceeding.

Flaherty & Crumrine Incorporated
January 21, 2009

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[9] See *Preferred Valuation after the TARP*, Flaherty & Crumrine Incorporated, January 5, 2009; available at www.preferredincome.com or www.fcclaymore.com.

[10] Of course, another way to end a recession is to inflate another bubble (think dot-com bust followed by housing and credit boom). We think policy makers have had enough of bubbles for now, so we expect more of an old-fashioned demand-driven recovery rather than a bubble-driven one.

Appendix: Index Descriptions

The indices are: Merrill Lynch 8% Capped DRD-Eligible Preferred Stock Index (P8D0), Merrill Lynch 8% Capped Hybrid Preferred Securities Index (P8HO), and Merrill Lynch 8% Capped Corporate US Capital Securities Index (C8CT). P8HO is a subset of the Merrill Lynch Fixed Rate Preferred Securities Index that contains all listed, subordinated constituents of the fixed rate index with a payment deferral feature. The fixed rate index includes investment grade DRD eligible and non-DRD eligible preferred stock and senior debt. P8D0 is a subset of the fixed rate index that contains fixed rate preferred securities which qualify for the corporate dividends received deduction and are issued by U.S. corporations and government agencies. C8CT is a subset of the Merrill Lynch Corporate All Capital Securities Index that contains investment grade fixed rate or fixed-to-floating rate $1,000 par securities that receive some degree of equity credit from the rating agencies or their regulators. All three indices have the issuers capped at 8%. All index returns include interest income and do not reflect any expenses. They are presented on a pre-tax basis and are calculated on a month-end basis. In addition, the index returns are unmanaged and do not necessarily represent any investment products managed by Flaherty & Crumrine Incorporated.