Second-Quarter U.S. Economic Update
July 2009

Summary of Recent Economic Developments

Falling, but at a slower pace than before. That's how we would characterize much of the U.S. economy in the second quarter. Real GDP is expected to contract by 1.5%, better than the 5.5% drop in Q1 – with growth in the forecast for the second half of the year. Payroll jobs plunged by 1.3 million in the second quarter, but that's 37% less than in Q1. Core capital goods orders and industrial production also fell in Q2, but at a substantially slower pace than in Q1. Foreign trade offered a "true" bright spot as the real trade deficit narrowed significantly. In contrast, housing continued to contract, although even there some signs of bottoming are emerging. Likewise, personal consumption probably retreated due to job fears and a sharp rise in the personal savings rate. The unemployment rate rose further. Fiscal stimulus helped boost disposable income, but it provided little lift to spending, though that should ramp up in the second half of the year. Inflation remained mixed, falling overall but moving higher when excluding food and energy prices. Credit markets recovered from depressed levels as hints of economic recovery first emerged and then spread. The banking system began to emerge from crisis mode, as ten large banks repaid their Capital Purchase Program preferred capital and many banks raised common equity capital. The Fed eliminated or reduced the size of several emergency credit programs, and its balance sheet began to shrink. Despite the likelihood that loan quality will worsen over the near term, most preferred prices rallied substantially.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	**2007:3**	**2007:4**	**2008:1**	**2008:2**	**2008:3**	**2008:4**	**2009:1**	**2009:2**
Real GDP, Chg QoQ (%)	4.8	-0.2	0.9	2.8	-0.5	-6.3	-5.5	-1.5f
Real Personal Consump Expnds, Chg QoQ (%)	2.0	1.0	0.9	1.2	-3.8	-4.3	1.4	-0.4a
Real Busi Investmt, Eqp & Sftware, Chg QoQ (%)	3.6	1.0	-0.6	-5.0	-7.5	-28.1	-33.7	NA
Real Residential Investmt, Chg QoQ (%)	-20.6	-27.0	-25.1	-13.3	-16.0	-22.8	-38.8	NA
Corporate Profits, After Tax, Chg YoY (%)	-0.8	-0.6	1.8	-6.4	-7.9	-15.0	-14.7	-16.2f
Current Account Balance, Annualized (% of GDP)	-4.9	-4.7	-5.1	-5.3	-5.1	-4.4	-2.9	NA
Federal Budget, 12-mo Def or Surp (% of GDP)	-1.2	-1.3	-1.5	-2.3	-3.2	-4.8	-6.6	NA
Unemployment Rate (%)	4.7	4.9	5.1	5.6	6.2	7.2	8.5	9.5
Household Employment, Chg QoQ (000)	146	91	-271	-285	-709	-1691	-2451	-691
Nonfarm Payrolls, Chg QoQ (000)	7	500	-338	-458	-624	-1658	-2074	-1308
Nonfarm Productivity, Chg QoQ (%)	7.0	-0.5	2.6	4.7	2.2	-0.6	1.6	NA
Capacity Utilization (%)	80.7	80.6	79.8	78.7	74.5	72.7	69.5	68.0
GDP Price Index, Chg QoQ (%)	1.5	2.8	2.6	1.1	3.9	0.5	2.8	NA
Consumer Price Index, Chg YoY (%)	2.8	4.1	4.0	5.0	4.9	0.1	-0.4	-1.4
CPI ex food & energy, Chg YoY (%)	2.1	2.4	2.4	2.4	2.5	1.8	1.8	1.7
Nominal Personal Income, Chg YoY (%)	6.1	5.4	3.9	5.3	3.4	1.3	0.1	0.3a
Personal Savings Rate (%)	0.6	0.4	0.2	2.5	1.4	4.0	4.3	6.9a
Rate or Spread (End of Quarter)	**2007:3**	**2007:4**	**2008:1**	**2008:2**	**2008:3**	**2008:4**	**2009:1**	**2009:2**
Federal Funds Rate Target (%)	4.75	4.25	2.25	2.00	2.00	0.25	0.25	0.25
3-month LIBOR (%)	5.23	4.70	2.69	2.78	4.05	1.43	1.19	0.60
10-Yr Treasury Note Yield (%)	4.59	4.03	3.41	3.97	3.83	2.22	2.67	3.54
30-Yr Treasury Bond Yield (%)	4.84	4.48	4.29	4.52	4.31	2.68	3.54	4.34
Moody's Baa Long Corp Spread (bp)	175	208	261	252	354	529	491	299
10-Yr Interest Rate Swap Spread (bp)	62.5	63.8	66.0	70.3	66.5	35.0	20.0	24.8

* Figures are either quarterly or, if more frequent, quarterly averages. f = Forecast[1]; a = Actual through May 2009 Source: Reuters EcoWin

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

Economic Outlook

Second quarter inflation-adjusted Gross Domestic Product (real GDP) is forecast to shrink by 1.5% when it is reported later this month.[1] While still negative, that's a big improvement over the roughly 6% annualized contraction in real GDP in 2008:Q4 and 2009:Q1. Forecasts for the second half of the year anticipate a return to growth, with real GDP expected to rise by 1.1%, improving to 2.6% in the first half of 2010. Although these precise forecasts may be off the mark, we believe that their trajectory and scale are correct: The worst of the recession is behind us, but the recovery is likely to be tepid, at least for the next year or so. We explain why as we review the prospects for the major sectors of the U.S. economy in the paragraphs that follow.

The **labor market** remains very weak and is a key risk facing the economy. However, it now appears that job losses peaked early in 2009 (Figure 2). In the second quarter, nonfarm payrolls dropped by over 1.3 million jobs, the household survey of employment showed 691,000 job losses, and the unemployment rate hit 9.5%. As bad as these numbers are, they are substantially better than those in the first quarter of the year, when nonfarm and household employment fell by 2,074,000 and 2,451,000 jobs, respectively. Similarly, the four-week moving average of initial claims for unemployment peaked at 658,750 around the end of Q1 but has fallen to 584,500 as of early July. These data indicate that the employment situation is improving, but it is still too early to expect job gains. Although job *losses* have slowed, new hiring remains subdued. This can be seen in continuing jobless claims (i.e. number of persons receiving unemployment, as opposed to initial claimants), which are still moving up despite the slower pace of layoffs. It is also visible in statistics on the average duration of unemployment, which hit a new postwar high of 24.5 weeks in June (Figure 3). As a result, the unemployment rate continues to rise, and it will probably peak above 10%, even if the economy grows in the second half of the year as expected.

Figure 2: Job Losses Beginning to Ease…

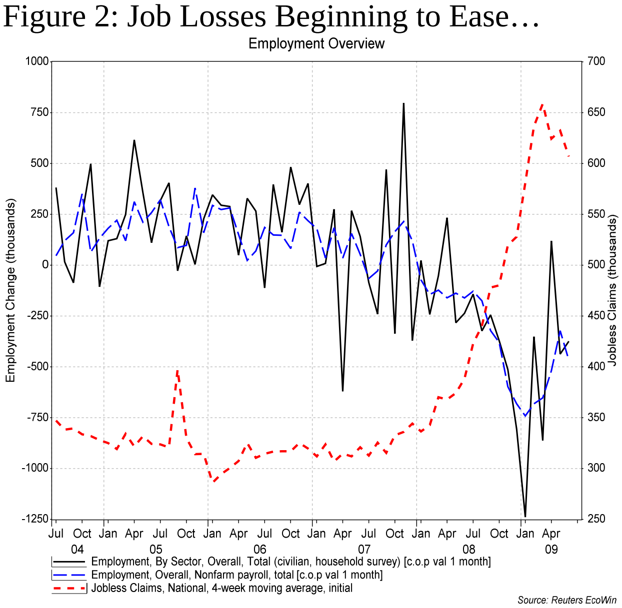
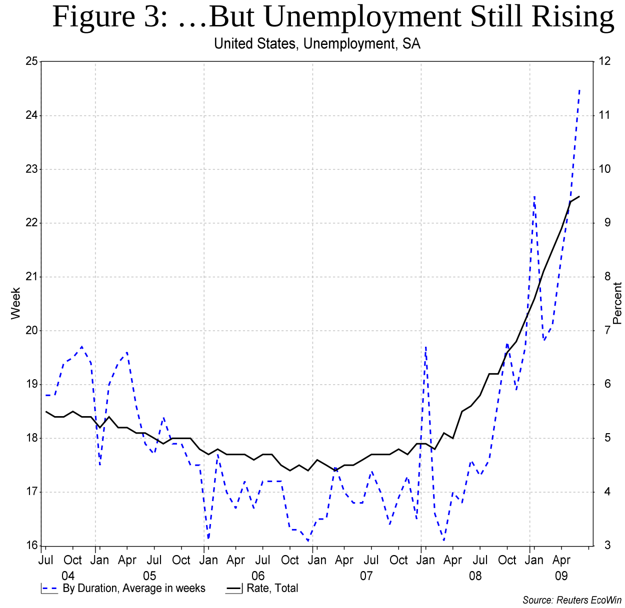


Figure 3: …But Unemployment Still Rising



Weakness in payrolls is putting pressure on **personal income** (Figure 4). Job losses, a shorter workweek, and sluggish growth in average hourly earnings have squeezed wage and salary income, which was flat in nominal terms in April and May after falling in Q1. Disposable income

[1] Forecasts are from *The Livingston Survey*, Federal Reserve Bank of Philadelphia, June 9, 2009.

has surged, however, due to higher government social benefits payments (e.g. extension of unemployment benefits and one-time additional social security payments) and lower taxes and tax credits that are part of the fiscal stimulus package passed in the first quarter. That allowed overall personal income to grow at a 4.3% annual rate in April and May, although their impact on income growth will be short-lived.

Despite higher disposable income, **personal consumption** appears to have fallen in Q2, likely due to lower wage and salary income and the weak job market. Real personal consumption expenditures (PCE) fell by 0.4% annualized in April and May following growth of 1.4% in Q1. We anticipate another quarter of weak consumption given the labor market malaise, but it should rebound as production – and hence wage income – picks up over the coming months as fiscal stimulus takes root and inventory liquidation slows.

Figure 4: Consumption Down, Savings Up

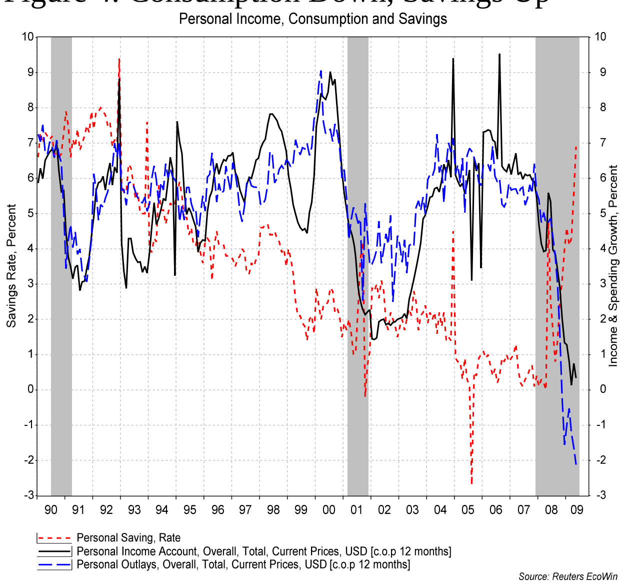
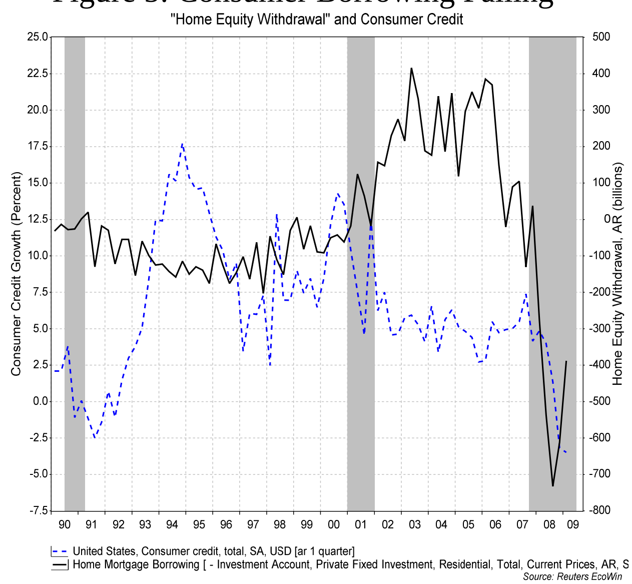


Figure 5: Consumer Borrowing Falling



The positive aspect of strong growth in disposable income along with weak consumption is that the personal **savings rate** has surged. It rose to 6.9% in May, the highest since December 1993 (Figure 4). The rise in the savings rate has been both sizable and rapid, and that's why the recession turned so ugly, so quickly as the financial crisis hit. Although we don't know how much higher the savings rate will go, we do believe the rate of increase will slow as fiscal stimulus and inventory rebuilding cause wages to begin to grow again and consumer sentiment to improve. In turn, that should drive modestly higher consumption, which will reinforce higher production and employment, setting in motion the virtuous cycle of income, consumption, and employment that characterizes economic expansions. In short, we think that most of the drag from higher savings on economic growth is behind us.

Before we sound too optimistic, however, we should emphasize that we believe households probably still want to (or will be forced to) save more than in a normal recovery. Consumers *want* to save more for many reasons. Their wealth has been depleted as market values of financial and real estate assets have fallen by much more than in a typical recession; savings are going to have to fill a good part of that hole. Households are more uncertain about the economy and their jobs, and with credit now much harder to get, households can no longer rely on borrowing to get through a period of joblessness or unforeseen expenses. They now need to save for those things. In addition, many households *have* to save more either because their lenders are requiring that they pay down debt or because new credit is unavailable.[2] We see this in borrowing statistics. Consumer credit is falling, and "home equity withdrawal[3]" has swung from heavy net borrowing to substantial net repayment (Figure 5). We anticipate that this higher-than-normal level of savings will contribute to a weaker-than-normal recovery.

The **housing** market remains weak and probably will continue to be a drag on GDP for some quarters yet, but it finally appears to be approaching a bottom. New and existing home sales have stabilized around a 5 million unit pace since late 2008. Inventories of unsold homes also have held about steady (after declining significantly in the second half of 2008) despite rising foreclosures. Inventories are still elevated and are putting downward pressure on prices, but much-improved affordability is starting to bring in home buyers, and the pace of decline in home prices has slowed. Construction activity is still falling. That won't turn around until the inventory of unsold homes drops significantly, but the pace of home construction is so far below the replacement rate that this sector should be a notable source of economic strength in a year or two.

Business investment also looks weak in the second quarter, but the pace of decline in orders and shipments of capital goods has moderated substantially after plunging in the prior two quarters (Figure 6). Our estimate of real orders and shipments of nondefense manufacturing goods in the three months ending in May fell by 14.5% and 24.7% compared to drops of 45.3% and 29.4%, respectively, three months ago. With capacity utilization sitting at record lows, business investment is bound to lag the recovery, but it should be less of a drag on growth going forward.

Figure 6: Orders and Shipments Recovering

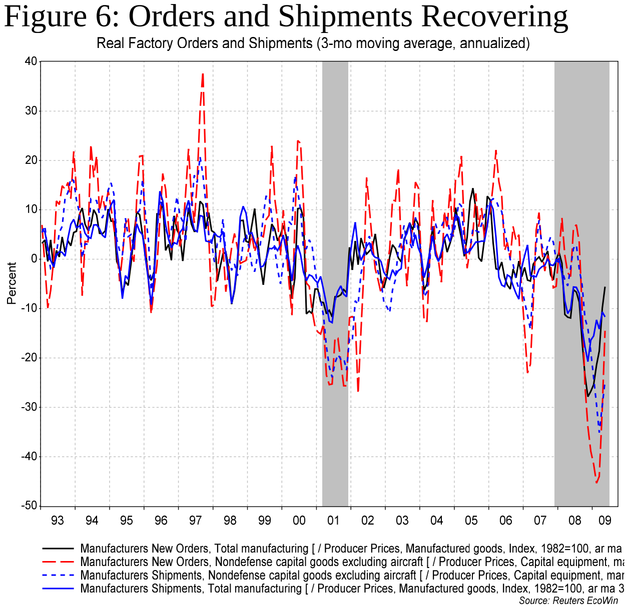
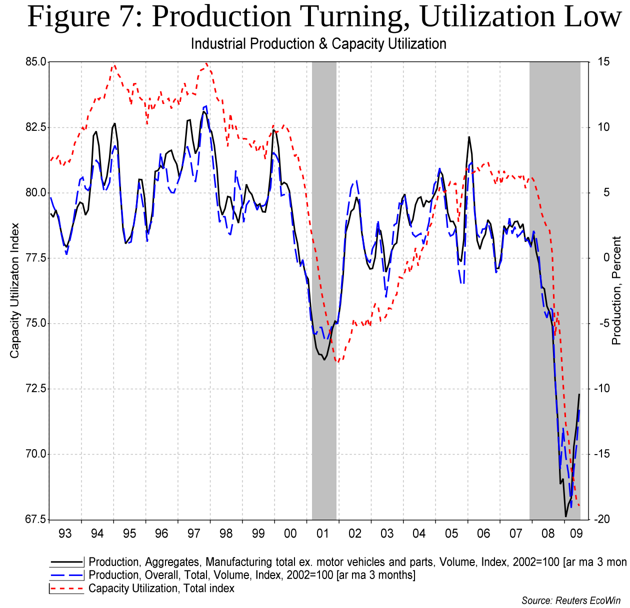


Figure 7: Production Turning, Utilization Low



[2] In aggregate, debt repayment results in higher savings. Also, regular monthly payments on revolving credit and mortgage debt typically involve partial repayment of principal. Thus, if new borrowing is unavailable, then those principal repayments represent additions to savings.

[3] Home equity withdrawal equals mortgage borrowing less residential investment. If mortgage borrowing is greater than residential investment, the resulting "home equity withdrawal" is used either for consumption or for non-residential investment; in hindsight, it's clear that much of it was used for consumption. If mortgage borrowing is less than residential investment, then savings (in the form of housing wealth) is increasing.

It's a similar story for **industrial production**, although the outlook is brighter than for business investment. Production dropped sharply as demand slumped and inventories rose over the course of the current recession, but it fell so rapidly in Q4 and Q1 that is has now begun to recover (Figure 7). Orders are starting to pick up, and inventories are coming down, which means production is bound to increase. Already, the manufacturing production index of the Institute for Supply Management (ISM) has rebounded from a low of 26.3 in December to 52.5 in June. (A reading above 50 indicates rising production.) Overall, business surveys are pointing uniformly toward recovery (Figure 8). With government spending on infrastructure and other projects from the fiscal stimulus package just ramping up, we expect that orders and production should continue to increase over the coming months. Some ongoing inventory liquidation may mute the production rebound for another couple of months, but we do not think it will short-circuit the recovery.

Figure 8: Business Surveys Improving

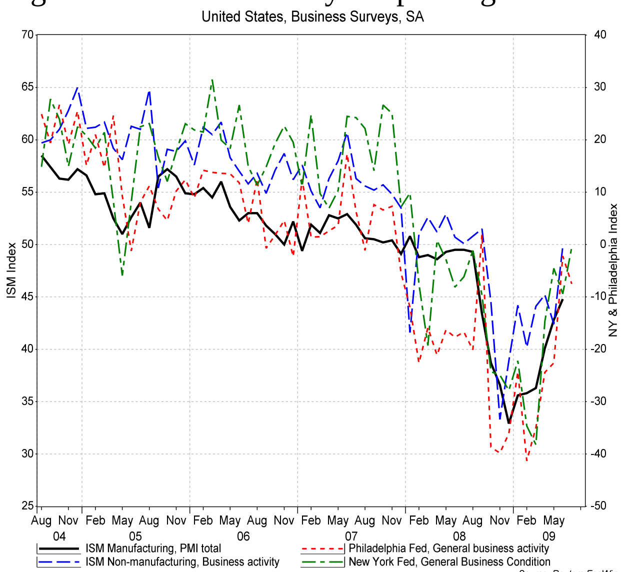
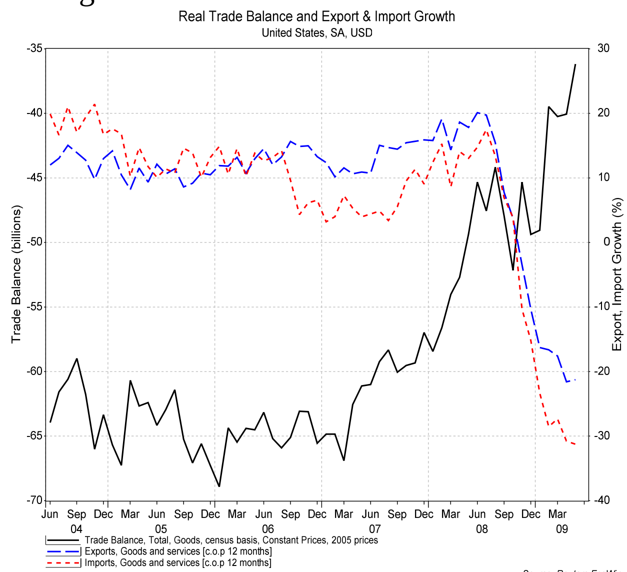


Figure 9: Another Boost from Trade



The **trade sector** seems poised to surprise us with another large contribution to GDP as the real trade balance so far in Q2 narrowed further due to growth in exports (Figure 9). After adding 2.4% to GDP in Q1, if the real trade balance finishes the quarter at the average of April and May, trade should add about 1½ percent to Q2 GDP. We are not sure how much longer this strong trade performance will last, but it's certainly welcome at the moment.[4]

Government spending probably did not have a major impact on GDP in the second quarter, although it is poised to increase sharply in the second half. Fiscal stimulus projects are just

[4] The current account balance is (roughly) the inverse of the trade balance (adjusted for income balances and unilateral transfers, which tend to change fairly slowly). Thus, if foreign investors want to hold more (fewer) U.S. investments, the trade deficit must widen (narrow). Looking at the trade picture from a goods standpoint, we would probably conclude that the trade deficit should widen, at least over the near term, because economic recovery in the U.S. is forecast to arrive a couple of quarters ahead of many of its trading partners. That suggests U.S. imports should recover faster than exports, widening the deficit. However, if investors want to hold fewer U.S. investments (due to concerns over the federal budget deficit, future inflation, slower prospective growth, or whatever), then they will exchange investments for goods and services, shrinking the trade deficit. We don't know how this will play out, but it could mean that the trade deficit will narrow more than "traditional" analysis might suggest.

getting underway, and they will continue through 2010. The federal government disbursed $56.3 billion out of $157.8 billion available to be spent through the end of Q2. Of the $56.3 billion, much was in the form of payments to state and local governments for work on local projects, only a portion of which would actually have been spent by the end of the quarter. We expect that fiscal stimulus will ramp up more meaningfully in the second half of the year.

Figure 10: Overall Inflation Falling…

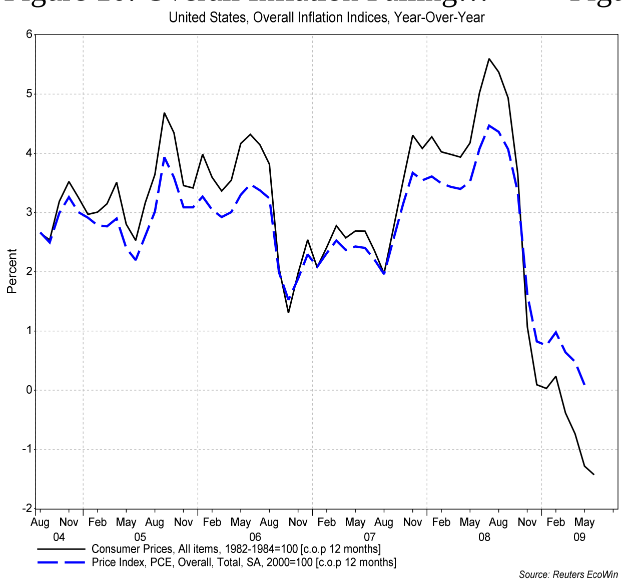
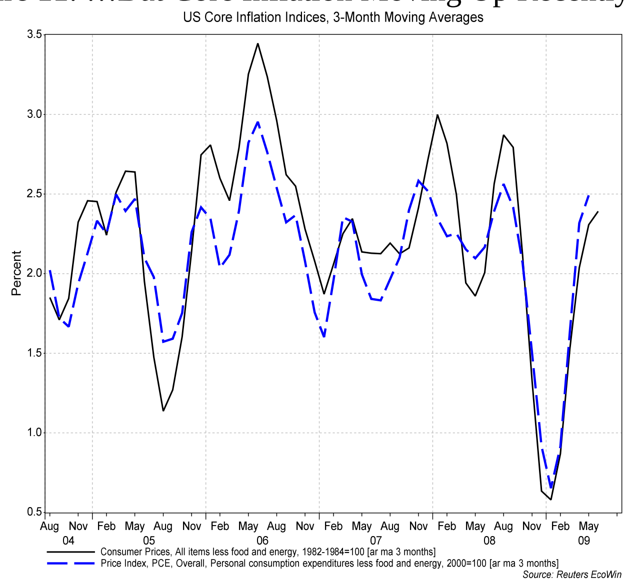


Figure 11: …But Core Inflation Moving Up Recently



Finally, **inflation** remains tame for now, although we still worry about the long-term inflation outlook. Overall inflation fell further into negative territory on a year-over-year basis during the second quarter, reflecting the sharp drop in energy prices since last summer. However, core inflation (i.e., inflation excluding volatile food and energy prices) has been moving up this year as consumption regains some footing, and it should be a warning sign for the Fed. We do not anticipate that inflation will be a problem over the near to medium term, given excess industrial capacity, rising unemployment, tight credit conditions, and cautious consumers. However, there is no doubt that the combination of highly expansionary monetary policy along with massive deficit spending ultimately would be a formula for rapid inflation. We will be keeping a watchful eye on the Federal Reserve to see how it adjusts monetary policy as the economy recovers and on Congress to see if it can deliver some measure of fiscal discipline.

Market Outlook

The improvement in credit markets continued in the second quarter. Money markets, which were first to respond to the vast expansion of government liquidity schemes, in some respects look "normal." The spreads between one-month commercial paper or three-month LIBOR and the fed funds rate are only modestly above their pre-crisis levels (Figure 12). Although the improvement in the long-end lagged that in the short-end of the credit markets, long-term corporate bond spreads also narrowed considerably in the second quarter (Figure 13). We believe the market is signaling that the "crisis" phase of the recession has passed. However, the fact that spreads remain relatively high historically indicates that risks are still elevated, and we anticipate a bumpy ride for the remainder of 2009.

Figure 12: Money Markets Almost Back to Normal

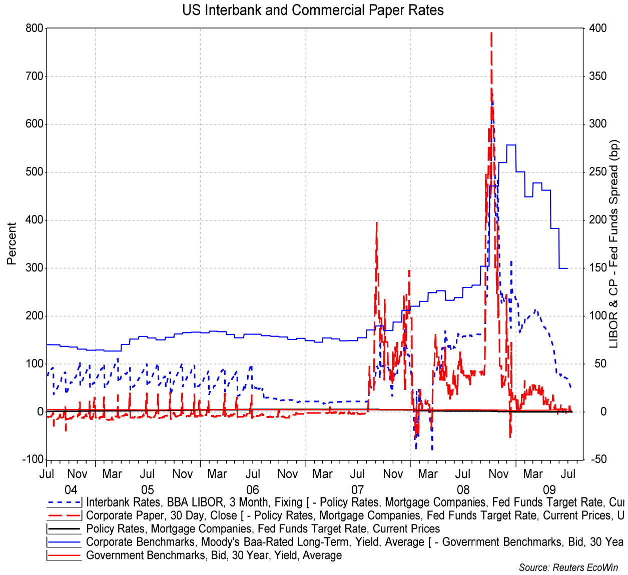


Figure 13: Long-End Catching Up

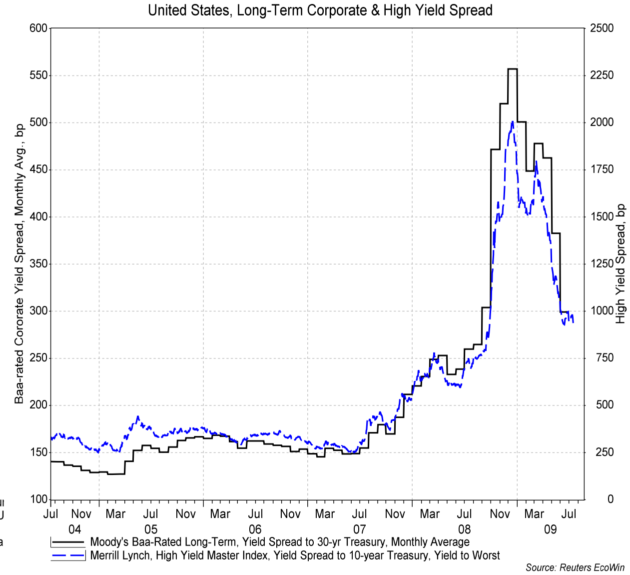


Figure 14: Mortgage Loan Quality Worsening

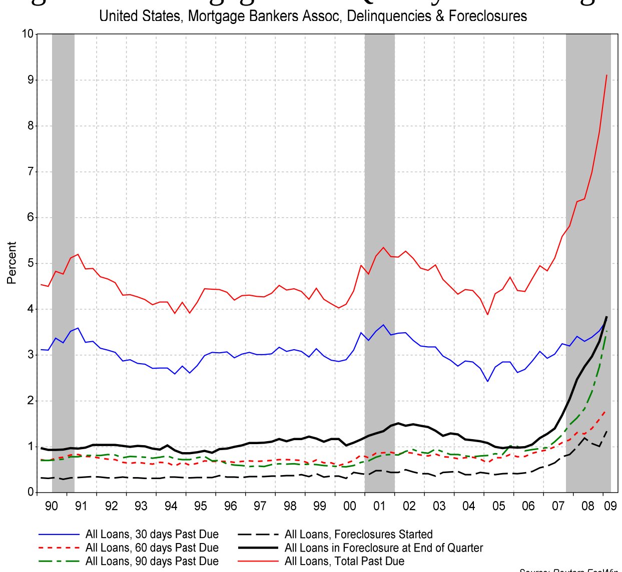
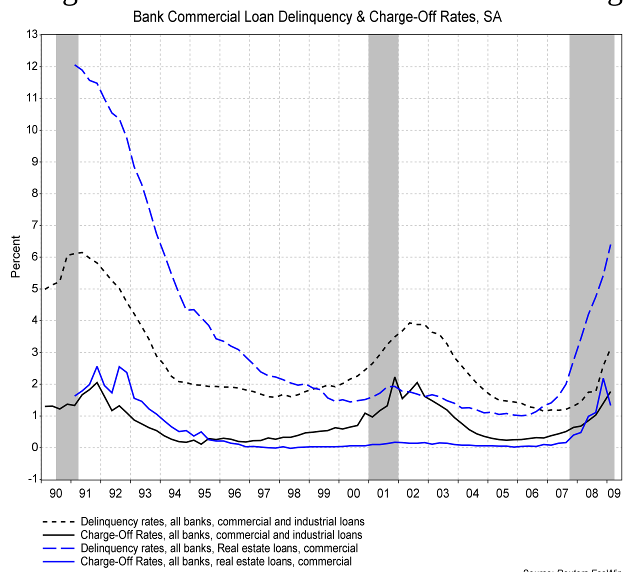


Figure 15: Business Loans Also Deteriorating



While credit markets mostly rallied, loan quality continued to deteriorate in the second quarter. Loan delinquencies and charge-offs are rising rapidly, especially among mortgage loans (Figure 14) but also (for the most part) among commercial loans (Figure 15). This is not a surprise for two reasons. First, credit statistics are reported with a lag. For example, the data in Figures 14 and 15 are as of the end of the first quarter. Second, average loan quality deteriorates due to a weaker economy, but it takes time before the impact on the finances of businesses becomes severe enough to prompt delinquency or default. We think loan quality should bottom out a quarter or two after the economy returns to growth, which means we expect weaker reported credit statistics at least through the end of 2009. As long as the outlook for the economy continues to improve, however, we think markets will look past the poor current credit statistics to stronger earnings and balance sheets next year.[5]

The second quarter was quieter in terms of government programs to address the financial crisis, but there were some important developments. In May, the government released the results of its Supervisory Capital Assessment Program (SCAP) for 19 large bank holding companies.[6] Nine companies passed their "stress tests" without the need for any additional capital, and eight of those subsequently repaid the Capital Purchase Program (CPP) preferred securities issued to the Treasury around the height of the crisis last year. Ten banks were required to raise additional capital ranging from $600 million to more than $58 billion, each of which has either completed its capital-raising program or has announced plans to do so. One of those banks and one other large bank that was not part of the "SCAP 19" also raised sufficient capital to repay their CPP preferred.[7] Many of these recapitalizations involved exchanges of preferred securities into common stock. Although all of the exchanges so far have involved some discount to the par value of the preferreds exchanged, all have been at substantial premiums to market prices prior to their announcements – accelerating the rebound in preferred securities' prices and adding a substantial amount of common equity capital to banks' balance sheets.

The government announced no new programs in the financial sector[8], but it did expand several programs and modify or terminate others. The Treasury expanded the CPP to a small number of insurance companies that own banks, two of which decided to accept government capital. The Federal Reserve's Term Asset-Backed Securities Loan Facility (TALF) got underway in March 2009 and drew increasing participation in the second quarter. The TALF also expanded eligibility and lengthened loan terms for certain commercial mortgage-backed securities. The Fed extended several programs to February 2010, including the Asset-Backed Commercial Paper Money Market Liquidity Facility (AMLF), the Commercial Paper Funding Facility (CPFF), the Primary Dealer Credit Facility (PDCF), and certain portions of the Term Securities Lending Facility (TSLF).

Encouragingly, the Fed eliminated the Money Market Investor Funding Facility (MMIFF) and reduced the auction sizes of the Term Auction Facility (TAF). It also eliminated certain auctions that were part of the TSLF and reduced the frequency of other TSLF auctions. These reductions and eliminations of emergency credit extension are visible in the Fed's balance sheet (Figure 16). They reflect the lower demand for these facilities by market participants, which in turn reflect the gradual normalization of portions of the credit markets. Most importantly, they demonstrate how a good portion – though certainly not all – of the balance sheet expansion undertaken by the Fed will unwind as private markets regain their footing. Reigning in the Fed's balance sheet as the

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[5] One positive aspect to the otherwise bad news on employment is that employee hours have fallen much faster than GDP recently, raising productivity. Higher productivity means that economy-wide corporate profits could fall by less than currently forecast.

[6] See *'Stress Tests' Signal New Phase to Bank Recapitalization*, Flaherty & Crumrine Incorporated, May 11, 2009, available at www.preferredincome.com or www.fcclaymore.com.

[7] The large banks that have repaid CPP preferred are JP Morgan, Goldman Sachs, Morgan Stanley, Capital One, BB&T Bank, Bank of New York/Mellon, US Bancorp, State Street Bank, American Express, and Northern Trust.

[8] Of course, the government played a major role in the automobile industry, orchestrating the bankruptcy reorganizations of Chrysler and General Motors. Neither of these companies are issuers of preferred securities, however.

economy recovers but before inflation takes root will be the critical monetary policy decision facing the Federal Open Market Committee over the next several years.

Figure 16: Fed Balance Sheet Starting to Shrink

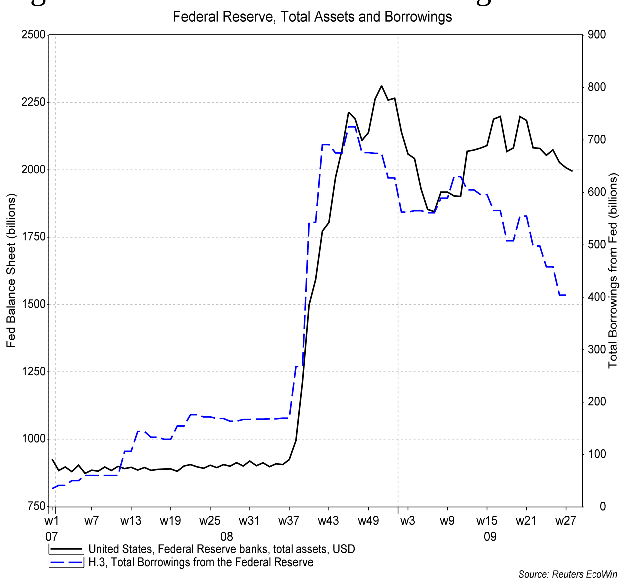
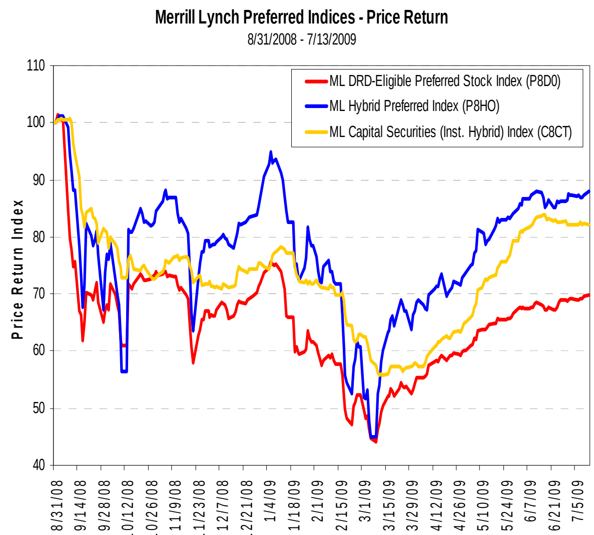


Figure 17: Preferred Market[9] Recovering Too



Although recovery remains a forecast in most sectors of the economy, we see clear signs that the worst of the recession has passed and encouraging signs that growth will resume over the next several quarters. This better economic outlook coupled with supportive government policy, substantial progress on bank recapitalization, and ongoing recovery in the credit markets drove the rebound in preferred prices over the second quarter (Figure 17). Looking ahead, with loan quality in general likely to deteriorate for a while longer and risks to the economy such as rising unemployment and potentially higher energy prices, it will continue to take some fortitude to invest in preferred securities. We expect plenty of volatility – including the possibility of more defaults – in preferreds. However, we continue to see value in preferred securities for patient long-term investors.

Flaherty & Crumrine Incorporated
July 17, 2009

[9] For a description of the Merrill Lynch preferred indices, see *Fourth-Quarter U.S. Economic Update*, Flaherty & Crumrine Incorporated, January 21, 2009, available at www.preferredincome.com or www.fcclaymore.com.