Fourth-Quarter U.S. Economic Update
January 2010

Summary of Recent Economic Developments

Fourth quarter inflation-adjusted Gross Domestic Product is forecast to grow by 4.2%, and the economy is expected to continue expanding by 2.7% in 2010 and 2.9% in 2011. Personal consumption is rising, though a desire for higher savings is keeping spending growth modest. Housing continues to recover, with home sales rising, inventories of unsold homes falling, and prices stabilizing. Overall business investment should remain subdued as cutbacks in commercial real estate investment largely offset modest gains in spending on equipment and software. Slower inventory reduction and rising final demand both domestically and abroad pushed industrial production higher. Finally, fiscal stimulus continues to support growth, at least until mid-2010. Despite these areas of strength, the economy shed jobs again in Q4, though we expect to see employment growth soon. With inflation subdued and the recovery only recently underway, the Fed left monetary policy on hold. Treasury rates rose and the yield curve steepened, but credit markets rallied further in response to improvement in the economy, healthier balance sheets, rising savings, and limited demand for new borrowing. We anticipate that loan problems overall will peak in 2010, although commercial real estate loans are likely to continue to deteriorate. We are concerned longer-term about the adverse effects of the federal budget deficit on the economy and interest rates as well as the uncertain impact of impending financial regulation. Nonetheless, we remain cautiously optimistic on the preferred securities market over the coming year.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	**2008:1**	**2008:2**	**2008:3**	**2008:4**	**2009:1**	**2009:2**	**2009:3**	**2009:4**
Real GDP, Chg QoQ (%)	-0.7	1.5	-2.7	-5.4	-6.4	-0.7	2.2	4.2f
Real Personal Consump Expnds, Chg QoQ (%)	-0.6	0.1	-3.5	-3.1	0.6	-0.9	2.8	1.2a
Real Busi Investmt, Eqp & Sftware, Chg QoQ (%)	-0.5	-5.0	-9.4	-25.9	-36.4	-4.9	1.5	NA
Real Residential Investmt, Chg QoQ (%)	-28.2	-15.8	-15.9	-23.2	-38.2	-23.3	18.9	NA
Corporate Profits, After Tax, Chg YoY (%)	6.6	-3.7	4.8	-15.8	-19.7	-15.3	-9.7	21.0f
Current Account Balance, Annualized (% of GDP)	-5.0	-5.2	-5.1	-4.3	-2.9	-2.8	-3.0	NA
Federal Budget, 12-mo Def or Surp (% of GDP)	-1.5	-2.3	-3.1	-4.7	-6.5	-8.9	-9.9	-9.6a
Unemployment Rate (%)	5.1	5.5	6.2	7.4	8.6	9.5	9.8	10.0
Household Employment, Chg QoQ (000)	0	-405	-747	-1833	-2334	-816	-1270	-976
Nonfarm Payrolls, Chg QoQ (000)	-338	-458	-624	-1658	-2074	-1285	-597	-208
Nonfarm Productivity, Chg QoQ (%)	-0.1	3.1	-0.1	0.8	0.3	6.9	8.1	NA
Capacity Utilization (%)	79.8	78.7	74.5	72.7	69.5	68.3	70.8	72.0
GDP Price Index, Chg QoQ (%)	1.9	1.8	4.0	0.1	1.9	0.0	0.4	NA
Consumer Price Index, Chg YoY (%)	4.0	5.0	4.9	0.1	-0.4	-1.4	-1.3	2.7
CPI ex food & energy, Chg YoY (%)	2.4	2.4	2.5	1.8	1.8	1.7	1.5	1.8
Nominal Personal Income, Chg YoY (%)	3.1	4.2	2.5	0.4	-2.2	-2.6	-1.5	-0.3a
Personal Savings Rate (%)	1.0	3.5	2.2	4.7	3.5	4.9	4.8	4.7a
Rate or Spread (End of Quarter)	**2008:1**	**2008:2**	**2008:3**	**2008:4**	**2009:1**	**2009:2**	**2009:3**	**2009:4**
Federal Funds Rate Target (%)	2.25	2.00	2.00	0.25	0.25	0.25	0.25	0.25
3-month LIBOR (%)	2.69	2.78	4.05	1.43	1.19	0.60	0.29	0.25
10-Yr Treasury Note Yield (%)	3.41	3.97	3.83	2.22	2.67	3.54	3.31	3.84
30-Yr Treasury Bond Yield (%)	4.29	4.52	4.31	2.68	3.54	4.34	4.05	4.64
Moody's Baa Long Corp Spread (bp)	261	252	354	529	491	283	212	175
10-Yr Interest Rate Swap Spread (bp)	66.0	70.3	66.5	35.0	20.0	24.8	15.3	13.3

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

Fourth quarter inflation-adjusted Gross Domestic Product (real GDP) is forecast to grow by 4.2%, and the economy is expected to continue expanding by 2.7% in 2010 and 2.9% in 2011.[1] Each of these forecasts is higher than anticipated a few months ago. Recent economic data has shown that the recovery is gaining traction, even though employment continues to shrink. Much of the strength in GDP, however, is coming from fiscal stimulus and inventories. Final demand is improving, but only slowly. This makes the economic outlook for the second half of 2010 fairly cloudy. The current fiscal stimulus will turn to restraint in the second half of the year, and the boost to growth from inventories will probably have run its course by then as well. That will put private final demand (principally personal consumption, investment, and net exports) back in command of the economy. We anticipate growth in these areas, but headwinds are likely to keep the growth rate modest, for reasons we explain in the following paragraphs.

Getting the bad news out of the way first, the **labor market** continues to shed jobs. Nonfarm payroll employment fell by 208,000 in the fourth quarter, while the household survey reported 976,000 job losses. Although these are not good numbers in an absolute sense, the trend is definitely improving, especially in the payroll survey data. After shedding an average of 700,000 to 800,000 jobs per month in early 2009, the current pace of 70,000 (payroll survey) or 325,000 (household survey) job losses per month in Q4 represents major improvement (Figure 2). This also is reflected in the slowdown in the rise in the unemployment rate.

Figure 2: Employment Trend Improving

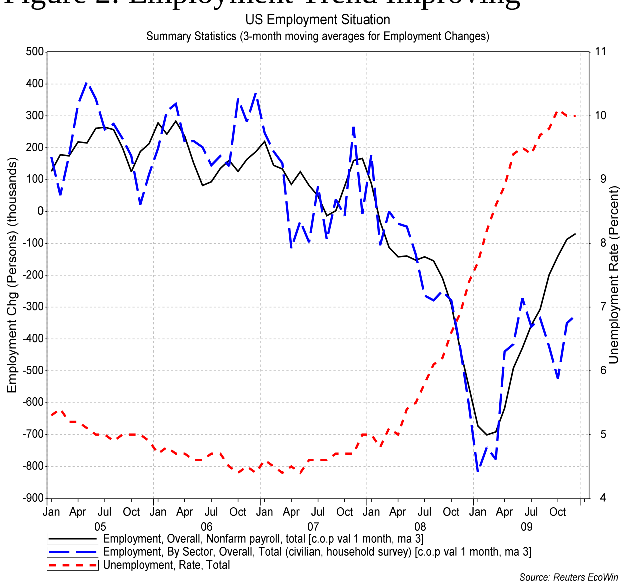
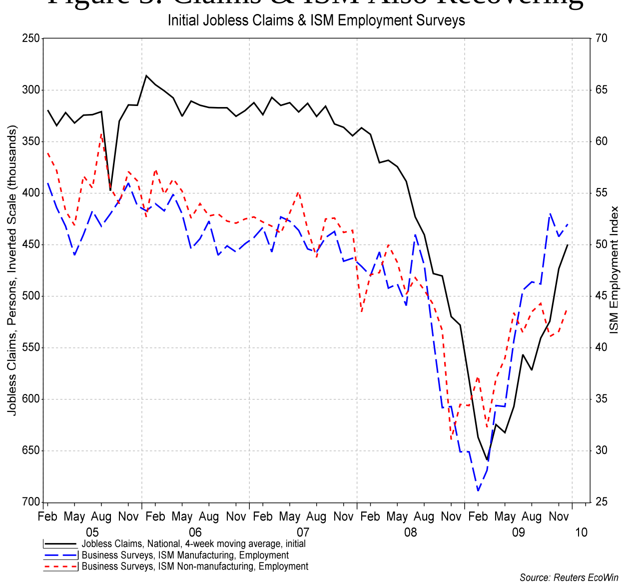


Figure 3: Claims & ISM Also Recovering



The divergence between the two employment surveys is somewhat troubling, however. Because the payroll survey does not capture jobs at new or small businesses in its monthly releases, it relies on estimates of these job gains or losses until more complete data is available six months to a year later. It's possible that the current estimates for jobs from those sources are too high, which would bias the payroll data upward. The household survey avoids that potential problem since it captures employment from all sources every month. However, its much smaller sample size makes it more susceptible to error. Over time, the two series tend to track one another,

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

though the payroll survey shows significantly less volatility (which is why it's the "preferred" gauge of the labor market most of the time). The question at this point is which data set is telling the right story. The payroll data indicate that outright job gains are likely soon. The household survey data indicate that job gains are still a ways off. Confronted with this divergence, we resort to data on jobless claims and the employment surveys from the Institute for Supply Management (ISM). Although not unequivocal, these surveys suggest that there has been greater improvement in employment recently than shown in the household survey data. Thus, we will side with the payroll data and think that job growth should begin soon, although it will probably take until mid-2010 before the economy creates enough new jobs to start bringing down the unemployment rate.[2]

As employment trends have improved, **personal income** has turned upward (it's up 3.0% annualized in first two months of the fourth quarter), though it remains down slightly at -0.3% compared to a year ago (Figure 4). Rising unemployment has kept a lid on wages, as we have seen in other recessions (Figure 5). This combination of slowing wage growth and job losses (along with low interest rates) is constraining personal income. Disposable personal income has fared better due to tax cuts; it is up 3.1% on a nominal basis and 1.5% on a real (inflation-adjusted) basis over the past year. Looking ahead, income growth should improve significantly once employment starts to rise again, not only due to higher levels of employment, but because falling unemployment eventually should result in faster wage hikes.

Figure 4: Consumption & Income Recovering…

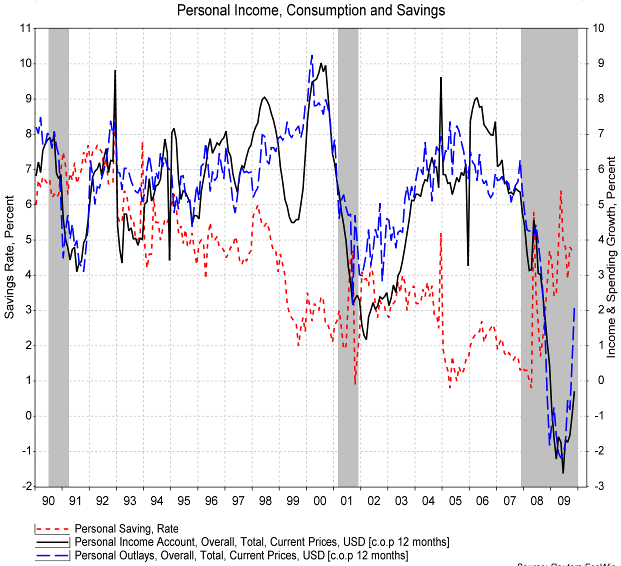
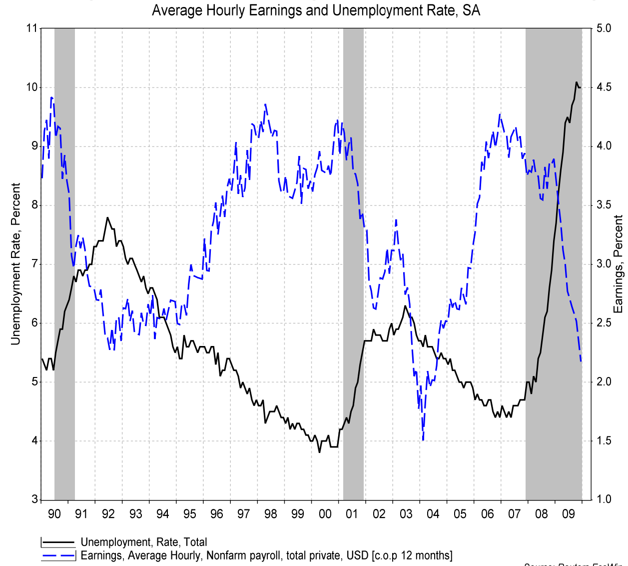


Figure 5: …but Wage Growth Still Falling



Although personal income growth has been weak, **personal consumption** has recovered a bit faster and is up 2.1% YoY in November on a nominal basis. Real personal consumption expenditures (PCE) are up 0.8% YoY and 1.2% annualized in Q4 through November. Judging from the generally upbeat retail sales report, final PCE numbers for Q4 will probably be somewhat better than 1.2% but below the 2.8% growth rate posted in Q3. Because PCE grew more slowly than disposable personal income, the personal savings rate generally trended higher over the course of 2009 (Figure 4). We think that consumers will increase personal savings still

[2] Given growth in the labor force, it takes about +100,000 net jobs per month to keep the unemployment rate steady.

further, which is one of the reasons we anticipate that consumption growth in 2010 will be considerably lower than normal for an economic recovery – a topic we discuss in greater detail later.

The **housing market** continued its recovery in the fourth quarter. Total home sales surged to 6.9 million units at an annual rate in November, aided by the homebuyer tax credit passed earlier in the year (Figure 6). Inventories of unsold homes continue to fall and are now at the lowest level since March 2006. Home prices have either stabilized or increased a bit on average, and home affordability remains high (Figure 7). Residential construction spending is turning up after three years of serious weakness. As a result, residential investment should be positive again in Q4 after jumping 18.9% annualized in Q3. Despite this nascent recovery, home construction remains well below the long-term replacement rate. Having turned the corner in 2009, we expect residential investment will contribute positively to GDP growth in 2010. This is certainly good news for beleaguered homeowners – and the economy. Before we sound too bullish on housing, however, we should sound a note of caution. Inventories of unsold homes are still high and could push home prices somewhat lower in 2010. In addition, the rush to buy a home before the November 2009 expiration of the homebuyer tax credit probably boosted sales significantly in the autumn months. Although Congress ultimately extended the tax credit to April 30, 2010, homebuyers did not know this until early November. We expect sales to pull back in early 2010 – as we saw already with new home sales in November – but we believe that the recovery in housing will continue.

Figure 6: Housing Recovery Continuing…

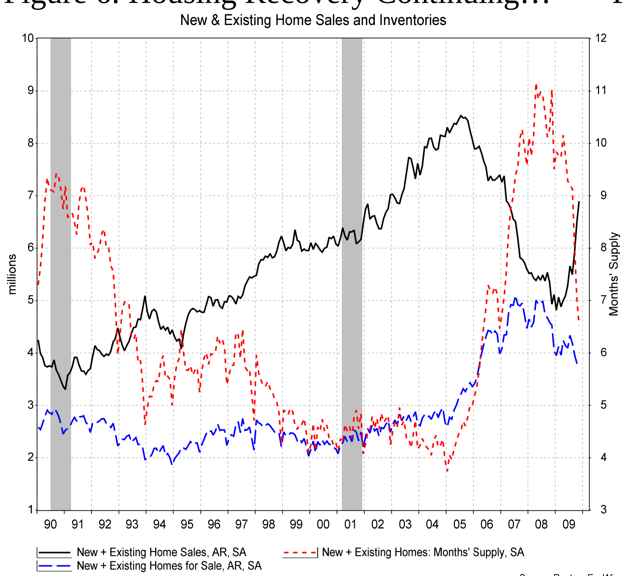
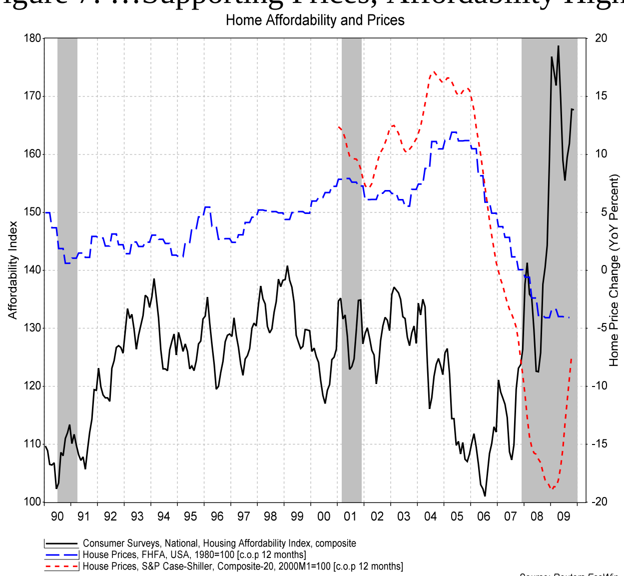


Figure 7: …Supporting Prices; Affordability High



Business investment in software and equipment is improving modestly, but it is shrinking rapidly in business structures (i.e., commercial real estate). Orders and shipments of nondefense capital goods excluding aircraft have rebounded substantially and are back in positive territory (Figure 8). Reports on software spending also point to improvement. Nonresidential construction spending is very weak, however, falling at more than 20% annualized in Q4 – and it's likely to keep falling throughout 2010. We do not think that rising spending on equipment and software will offset falling spending on structures. Relatively low capacity utilization will mean that investment will be subdued until utilization rates rise significantly. In prior recoveries, when growth was stronger than we foresee over the next several years, it took at least four years for utilization rates to hit their prior peak (Figure 9). Even worse, utilization rates in those earlier recessions did not fall as much as they did in the current recession. Businesses will make modest investments to improve productivity, but they will not need to make big investments to expand capacity anytime soon.[3] As a result, we think overall business investment (including structures) will shrink further in 2010.

Figure 8: Orders Point to Stronger Investment…

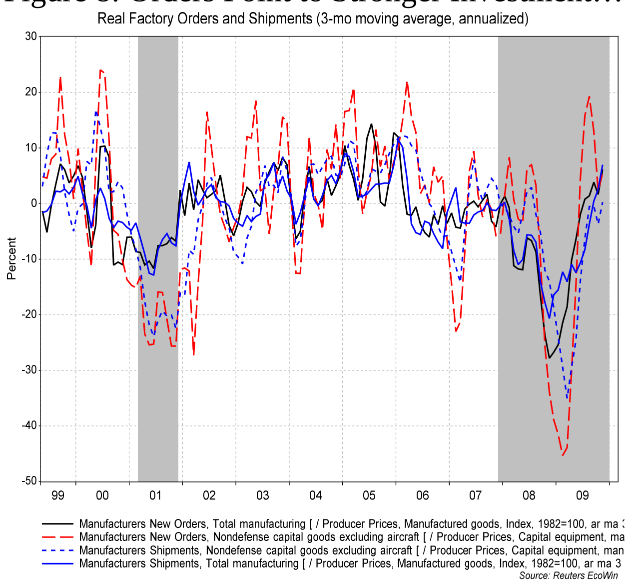


Figure 9: …but Low Utilization a Constraint

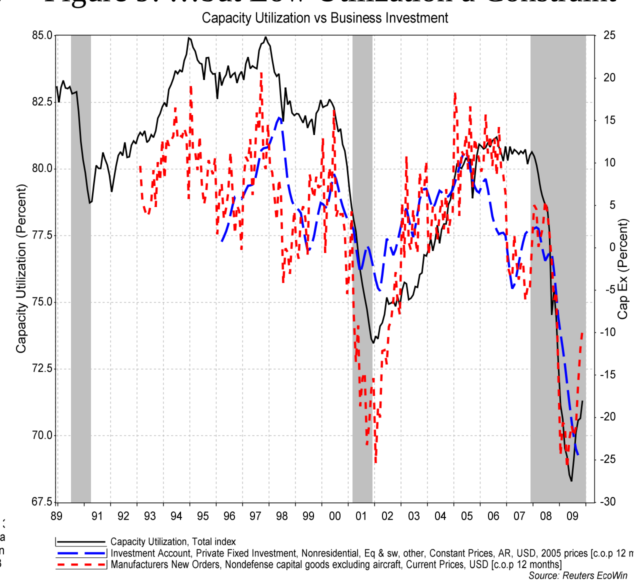


Figure 10: Industrial Production Up

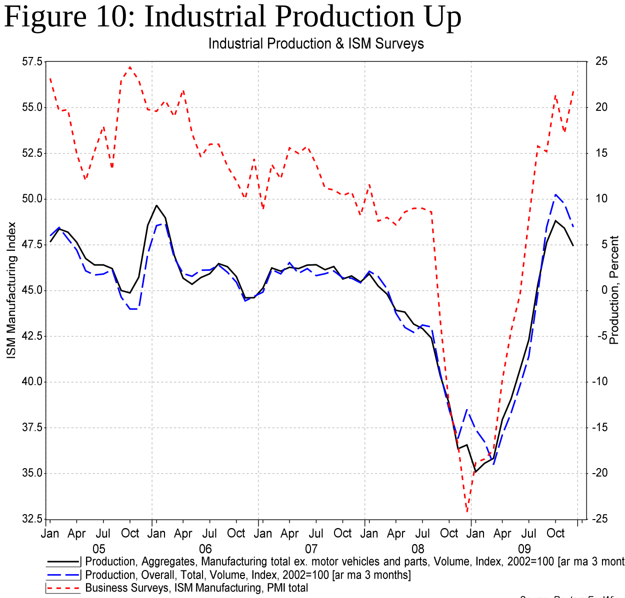
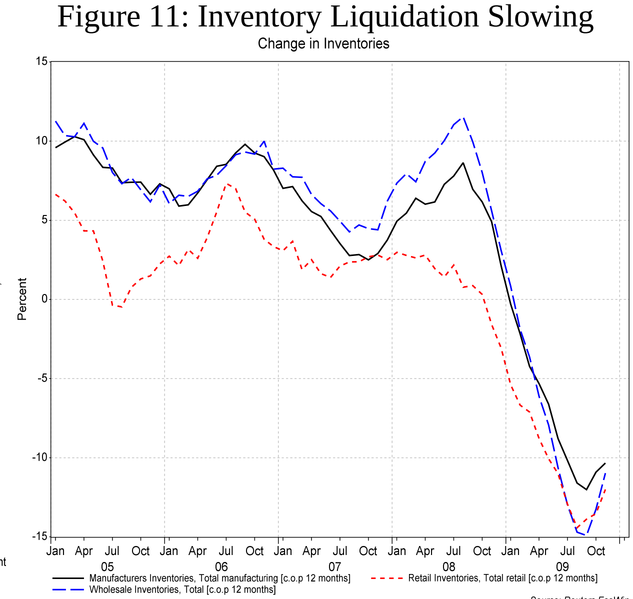


Figure 11: Inventory Liquidation Slowing



[3] Some may argue that low industrial capacity utilization rates overstate the amount of spare capacity in the economy, given that production of goods only represents about one-quarter of GDP. That is true, but there is excess capacity almost everywhere one looks: From high unemployment to rising commercial property vacancy rates to a still-high inventory of unsold homes. There is no reason to expect major investments in these and many other areas until currently available supply is more fully absorbed.

Industrial production rebounded strongly from the lows in early 2009, while the ISM survey points to further gains in production over the coming months (Figure 10). This positive performance is attributable to firmer final demand, both domestically and abroad, and to slower inventory liquidation. Early in the crisis, manufacturers cut production sharply in response to weak demand and made sales out of stock on hand. As a result, inventories contracted sharply throughout the production, distribution, and sales chain (Figure 11). Even as demand recovered, firms continued to deplete inventories. Only recently have businesses begun to slow this pace of inventory reduction, which has meant that production increases have accelerated more rapidly than final demand. This positive "inventory cycle" should run for another couple of quarters, but these cycles tend to be relatively short-lived. When this one runs its course, production will realign with final demand, which we expect will mean a slower pace of production.

The **trade sector** looks as though it will have little net impact on GDP growth in the fourth quarter after subtracting 0.8% from GDP in Q3. Both imports and exports grew in the quarter, indicating ongoing recovery in global trade, while the deficit (through November) was about flat with Q3 (Figure 12). We think the increase in trade activity is more important to the overall health of the economy than one quarter's trade balance. Looking ahead, we expect that the trade deficit will shrink further in 2010 as economic growth outside the U.S. outpaces domestic growth and the lagged effects of a weaker U.S. dollar lead to faster export than import growth.

Figure 12: Imports & Exports Rebounding

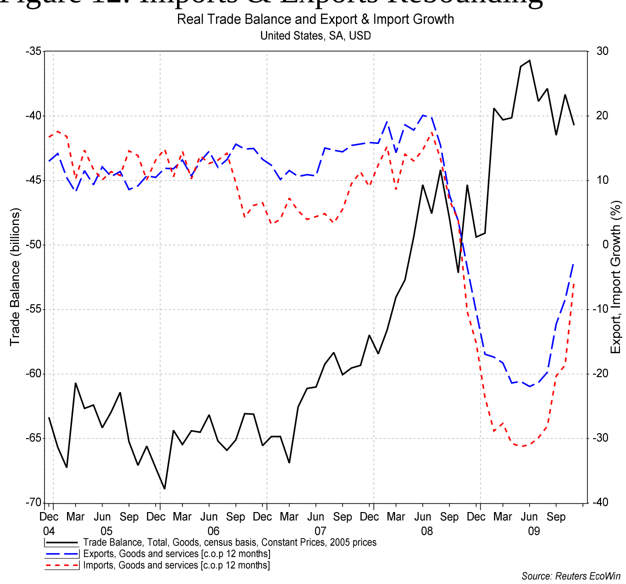
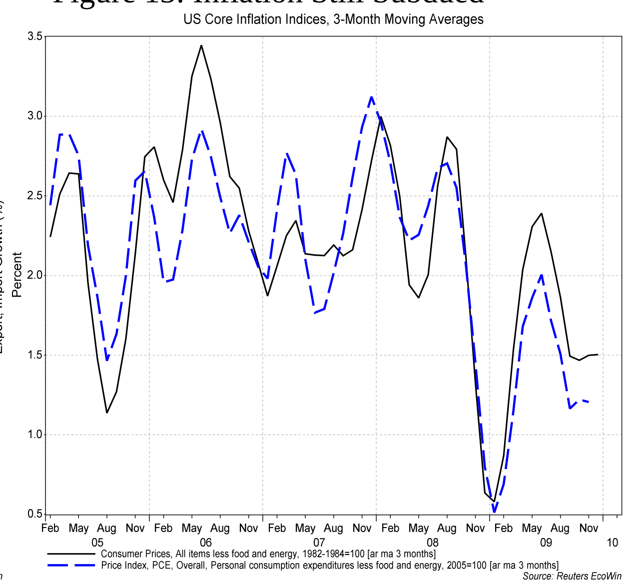


Figure 13: Inflation Still Subdued

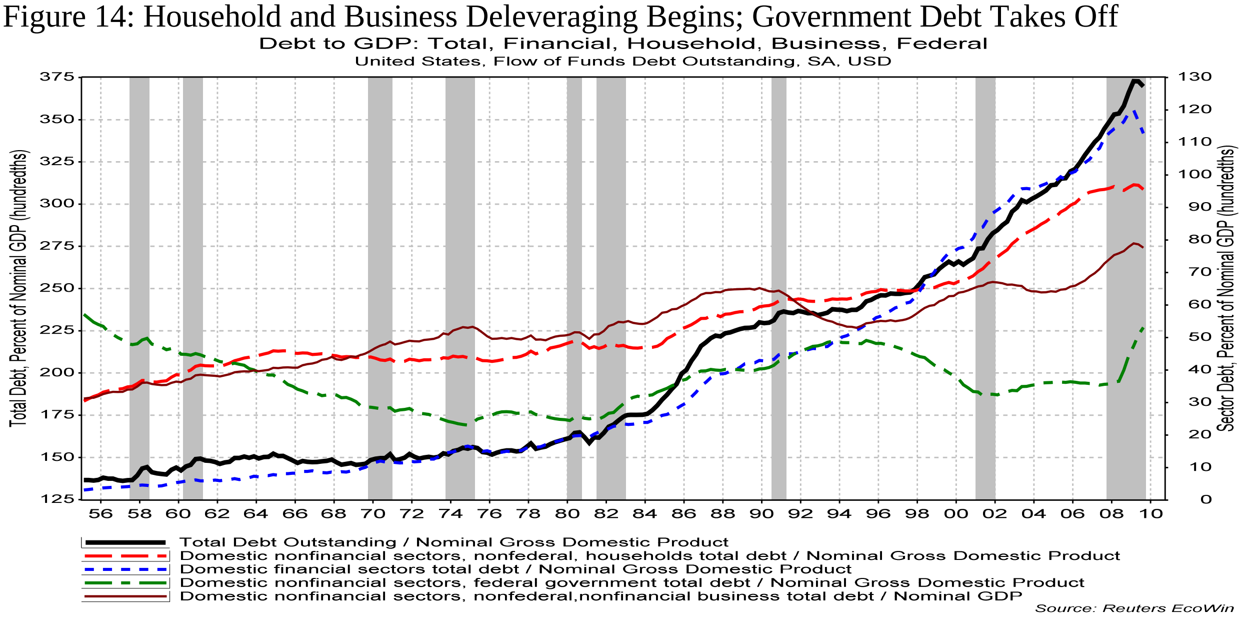


Government consumption probably accelerated in Q4 after adding 0.5% to Q3 GDP as stimulus spending increased. Disbursements under the Recovery Act totaled $257 billion as of 12/31/09, compared to $111 billion at the end of Q3, implying about $146 billion of expenditures during the quarter. That translates to roughly 4% of GDP (annualized). Of course, not all of that will add to growth during the quarter, for three main reasons. First, disbursements do not translate immediately to spending. Second, not all of that spending represents growth: about $55 billion was disbursed in Q3, so "only" $91 billon represents growth in Q4. Finally, state and local governments are slashing their own spending. As a result, much of the federal largesse is merely offsetting cuts elsewhere in the government sector. Nonetheless, it's clear that fiscal stimulus will add to Q4 growth, but we really won't know by how much until the GDP report is released later this month. Looking ahead, however, fiscal stimulus will begin to fade in the first half of 2010 and will turn to restraint in the second half of the year – not because the spending will be finished, but because the pace of spending will slow, and that's what matters for the growth rate.

Finally, **inflation** has remained quiescent in recent months. Core inflation (i.e., inflation excluding volatile food and energy prices) is up 1.5% or less so far in Q4 (Figure 13), and it is up between 1.4% and 1.7% over the past year for the consumer price index and PCE deflator. Overall inflation, including food and energy prices, is somewhat higher at 2.3-3.2% over the past three months and 1.5-1.8% over the past year. The faster rate of overall inflation recently has been driven by higher energy prices as the global economy has improved. Oil has rallied to around $78 per barrel (West Texas Intermediate, as of January 20, 2010) from a low of $34 per barrel in December 2008. Although oil prices certainly can move higher, the rate of increase (which is what matters for inflation) is bound to slow. We believe inflation will remain subdued over the next several years.

Putting all of this together, we believe that the economy will grow modestly in 2010, though probably below the consensus rate of 2.7%, especially later in the year. Growth in the first half of the year will be supported by fiscal stimulus and the inventory cycle, in addition to gradually firming personal consumption, trade improvement, housing, and less drag from business investment. However, fiscal stimulus and inventories probably will no longer be supporting growth by the third quarter of 2010, leaving other sectors to carry the burden of recovery. We think they are up to the task, but the pace of growth they can sustain is likely to be constrained. The main reason for this – and one that we think will be in play for several years – is a desire on the part of businesses and households to reduce leverage and increase savings.

Figure 14: Household and Business Deleveraging Begins; Government Debt Takes Off



As shown in Figure 14, debt-to-GDP for all major types of borrowers in the U.S., except the federal government, turned down in 2009. This follows roughly 25 years of growth for household and financial sector debt and 15 years of growth for nonfinancial business debt. The chart shows that household debt-to-GDP rose from the low-to-mid 40% range from the 1960s until the mid-1980s up to 97% at the peak in 1Q09 – more than a doubling of debt-to-GDP in a generation.

Some of this additional debt was supported by lower interest rates (30-year mortgage rates, for example, fell from over 10% to about 5% currently) and (until recently) lower volatility in the economy.[4] However, it also was accompanied by a dramatic and ultimately unsustainable decline in savings. The personal savings rate fell from around 10% of personal disposable income in the early 1980s to a low of 1.2% in 1Q08, and gross domestic savings (GDP less PCE and government consumption) fell from around 20% of GDP to below 12% (Figure 15). Gross private savings, which includes both households and businesses, fared a little better but shows a similar pattern. Critically, the data show that households and businesses have sharply increased savings and reduced borrowing since the start of the recession. The numbers are particularly striking for consumers. Mortgage borrowing minus residential investment (i.e., "home equity withdrawal") has gone from around +$300 billion (net borrowing) to -$728 billion (net saving) at an annual rate, and consumer credit is falling (Figure 16). Businesses too are saving. The nonfinancial corporate "financing gap" has turned negative, meaning that businesses are generating more cash than they are investing, at an annual rate of nearly $200 billion in 3Q09.

Figure 15: Private Savings Up; Total Falling

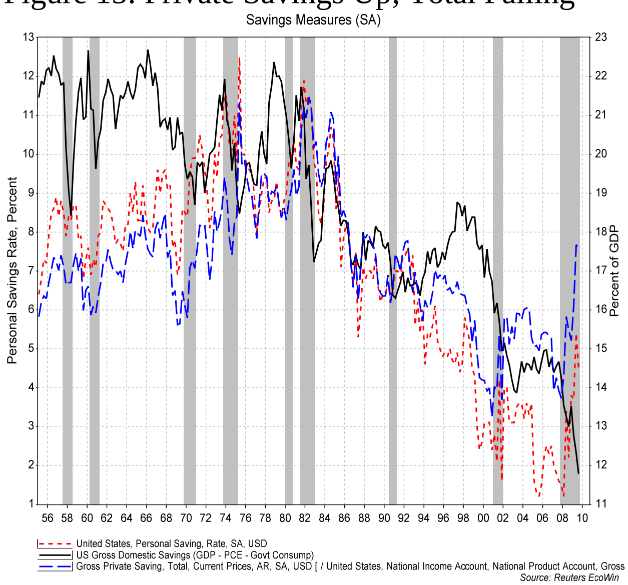
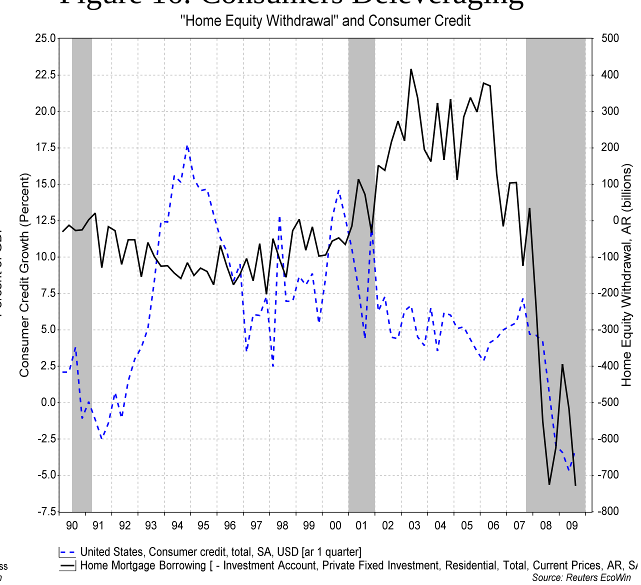


Figure 16: Consumers Deleveraging



In short, the private sector is deleveraging. Given that it took 15-25 years for this leverage to build up, we do not think the adjustment process will be over in just a few quarters; it probably will take at least several years. Savings comes from foregone current consumption. That means GDP growth will be slower over the next several years than it would be otherwise, especially once the inventory cycle and fiscal stimulus stop adding to growth later in the year.

If the private sector is deleveraging and increasing savings, why isn't gross domestic savings rising? The simple accounting answer is that not everyone can increase savings simultaneously.[5] If the private sector wants to save more when investment expenditures are (at best) flat, then

[4] Lower volatility in the economy reduces the risk of borrowing, since it lowers the odds that the borrower will be unable to service or repay debt.

[5] More precisely, savings cannot increase in aggregate without an equal increase in investment expenditures. We have already argued that growth in U.S. investment spending is likely to be slow given excess housing stock and substantial excess capacity. As a result, investment spending cannot currently absorb the rise in private sector savings.

either the government sector or the foreign sector has to save less. We already have noted that the trade deficit is shrinking, but that is not happening fast enough to accommodate the rise in private savings. That leaves the government to "dissave" (i.e., borrow and spend) the difference – and that's exactly what is happening with the dramatic expansion in the federal budget deficit, which is expected to be around 10% of GDP again in fiscal year 2010. As a result of government deficit spending, gross saving is still falling. That is not good, but the alternative – sharply lower consumption and recession – is worse. Therefore, we should accept the current budget deficit as necessary. Ideally, deficit spending would be devoted to infrastructure and other productivity-enhancing projects (i.e., increasing investment) that will generate economic growth and taxes down the road, rather than to current consumption. Investment spending does not seem to be the current focus in Washington, however, so while we might want it, we don't think we are going to get it. In any event, we think these macroeconomic trends and the policy responses to them have important investment implications, which we explore next.

Market Outlook

Interest rate and credit markets moved in opposite directions in the fourth quarter. **Treasury rates** increased across the yield curve, with 2-, 10-, and 30-year rates rising to 1.14%, 3.84%, and 4.64%, up 19, 53, and 59 basis points (bp), respectively, over the quarter. These are still relatively low rates historically, but the higher rates and steeper yield curve reflect the market's expectation that short-term interest rates will increase more than previously thought. As of December 31, 2009, the market was pricing-in 25-50 bp of tightening by the Fed by June 2010, 100-125 bp of tightening by the end of 2010, and more than 250 bp of tightening by the end of 2011. At this point, we do not think economic growth or inflation will be strong enough to prompt the Fed to tighten so rapidly; we see value in longer-term rates as a result.

Figure 17: Corporate Spreads Tighten Further

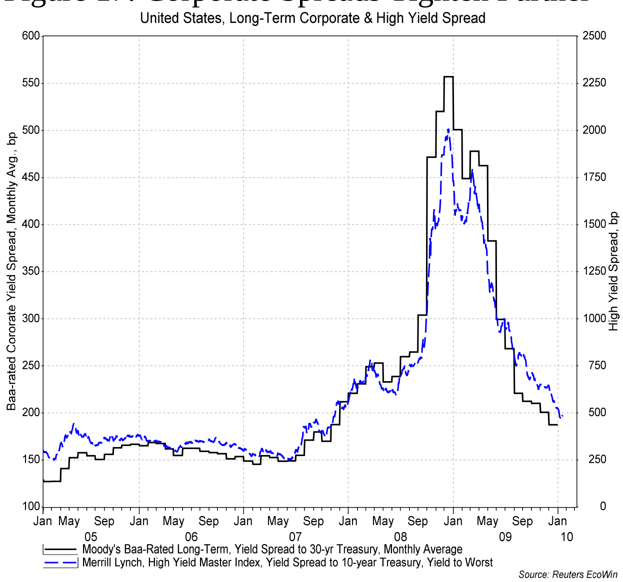
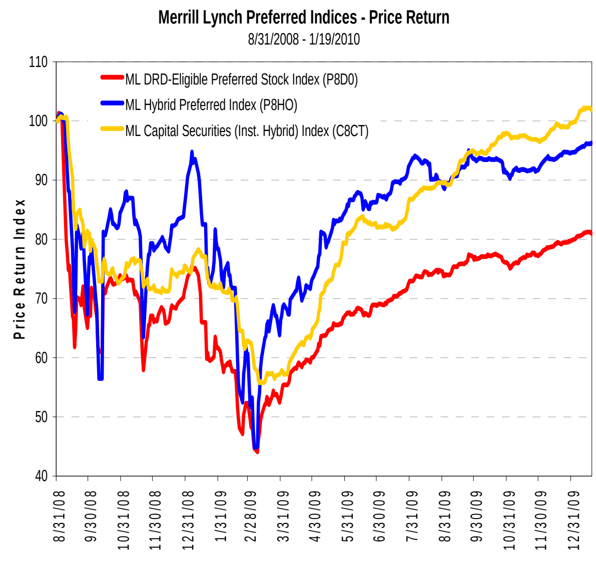


Figure 18: Preferred Rally Continues



Monetary policy was largely unchanged in the fourth quarter. The Federal Open Market Committee (FOMC) left the fed funds rate unchanged at nearly zero, and it reiterated that short-term rates are likely to remain low for a "considerable period." The Fed did reduce monetary accommodation at the margin, however. It let a number of special borrowing facilities expire, and it completed its $300 billion Treasury securities purchase program in December. Among the remaining emergency programs enacted by the Fed in response to the financial crisis, only the mortgage and agency debt purchase plans ($1,250 billion and $175 billion, respectively, to be completed by March 31, 2010), the Term Asset-Backed Securities Lending Facility (TALF, set to expire on March 31, 2010 for most ABS and June 30, 2010 for certain commercial mortgage-backed assets) are still growing. Other emergency programs are either shut down or shrinking, reflecting the improvement in capital markets since 1Q09. Perhaps most importantly, most of the reserves injected into the banking system are sitting at the Fed in the form of excess reserves; they are not being lent by the banking system (see below). As a result, money supply growth, which jumped as the financial crisis hit, has settled back to around 5% YoY for M1 and 2% for M2. Neither is cause for concern about inflation.

Figure 19: Corporate Profits Rising

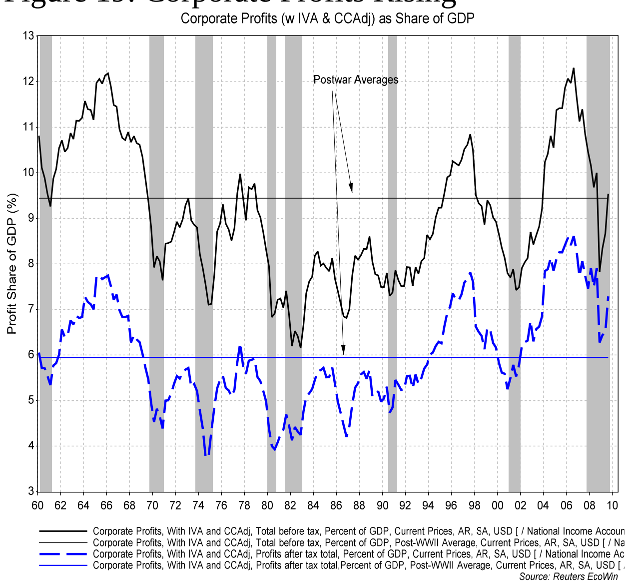


Figure 20: Bank Lending Shrinking

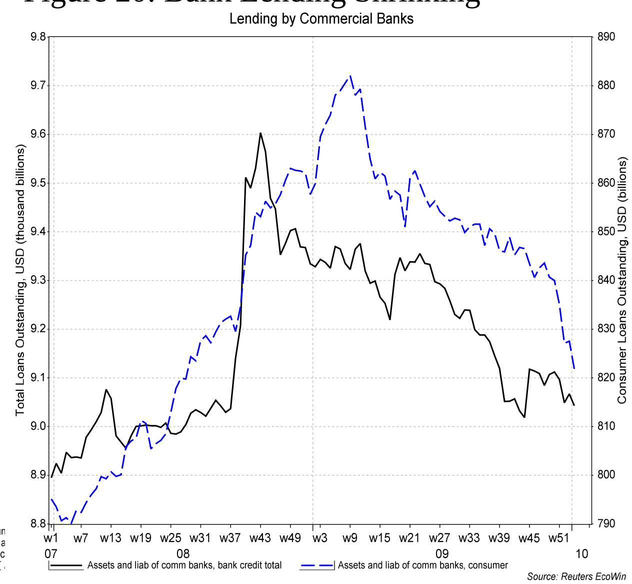


Figure 21: Less Refi Risk, Better Liquidity

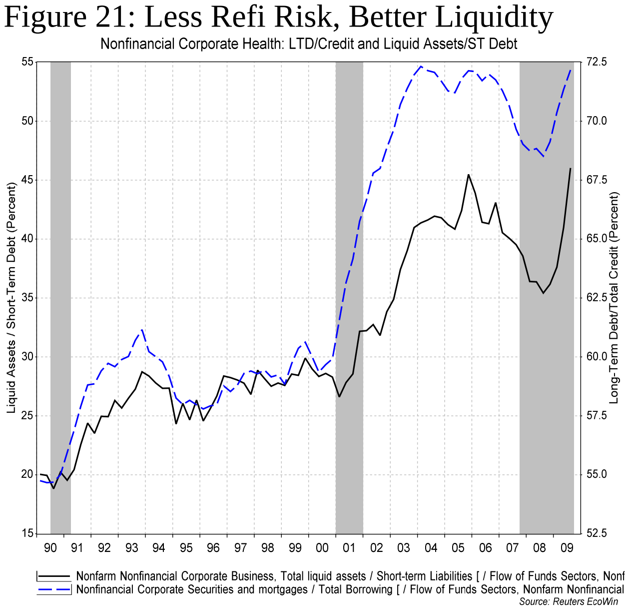
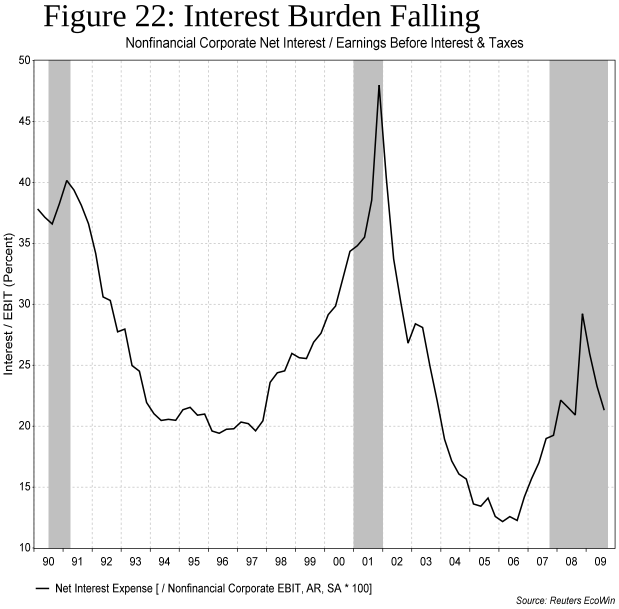


Figure 22: Interest Burden Falling



Although Treasury rates rose, credit markets continued to rally. **Credit spreads** narrowed further, with Moody's Baa-rated long-term corporate bonds tightening 37 bp in Q4 to 175 bp over Treasuries (Figure 17). Preferred securities extended their rally as well (Figure 18). We think the rallies are justified and have room to run further for reasons we'll outline in a moment, though it's clear that the "margin for error" is smaller in the current market than it was in early 2009 when preferred securities' prices were much lower and their yields much higher.

We believe there are two main reasons why credit markets have rallied and are likely to continue to rally over the coming quarters: The economy is growing faster than previously anticipated, and credit metrics are improving notably as corporations reduce the leverage on their balance sheets. We have already discussed the economy's good performance recently, so we'll now turn to corporate health. Corporate profits have turned up (Figure 19), and analysts expect further profit expansion in 2010. Improving profitability coupled with only limited capital expenditures means that corporate borrowing requirements are low. We already noted that the nonfinancial corporate financing gap has turned negative. Similarly, bank lending is shrinking (Figure 20), so borrowing by financial companies remains limited. At the same time, banks have sharply increased the equity capital on their balance sheets, which reduces risk for investors in preferred and debt securities of those issuers. Corporate liquidity and the proportion of total debt that is long-term (and hence not subject to near-term refinancing risk) are improving (Figure 21). Finally, interest expense relative to earnings before interest and taxes is falling (Figure 22). We think the combination of weak private sector but heavy public sector borrowing means credit spreads to Treasuries will continue to narrow.

Figure 23: Mortgage Loan Quality Worsening

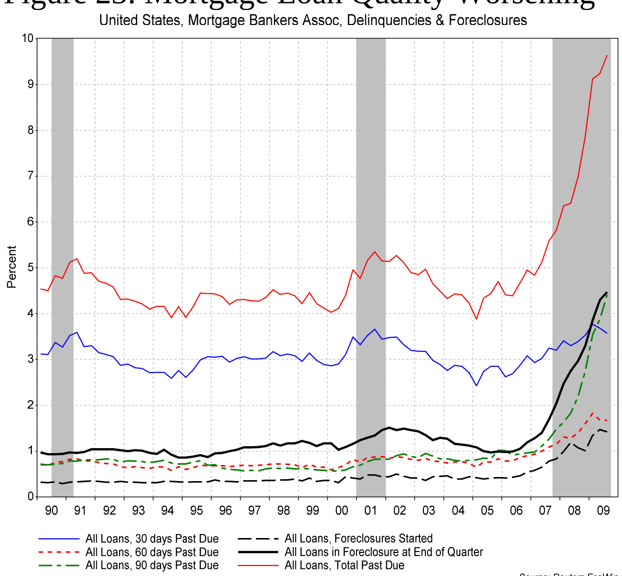
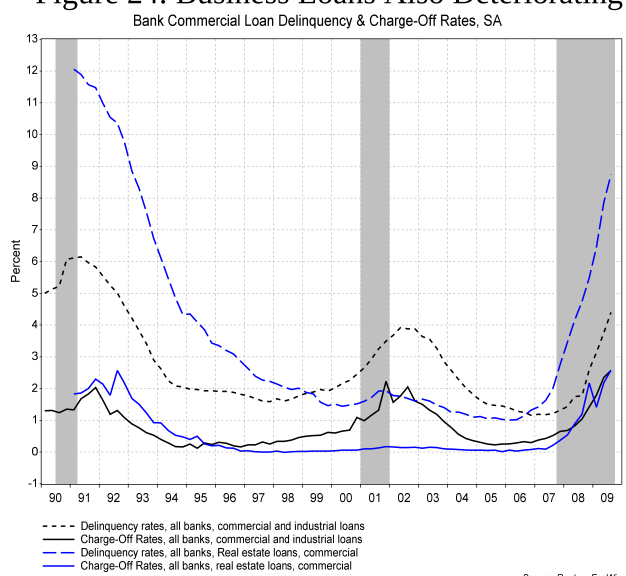


Figure 24: Business Loans Also Deteriorating



This bullish view for credit markets is not without risk, however. **Loan quality** is still deteriorating. Mortgage delinquencies[6] and foreclosures, commercial and industrial (C&I) loan delinquencies and charge-offs, and commercial real estate (CRE) delinquencies and charge-offs are all increasing (Figures 23 and 24). The peak in consumer loan charge-offs tend to coincide

[6] Total past-due loans are still increasing, but there has been some recent improvement in early-stage mortgage delinquencies.

with the high in unemployment, while C&I loan charge-offs tend to peak one or two quarters later. If our economic outlook is correct, we should expect peak losses on consumer loans by the middle of 2010 and on C&I loans in the second half of the year. Residential mortgage loan problems may take a bit longer to peak given current efforts – not all of which will succeed – to prevent foreclosure; nonetheless, we should see residential mortgage loan problems turn down by the end of the year. Commercial real estate lending is generally in the early phase of its loss cycle[7]; we do not expect a turnaround there in 2010.

New regulations facing the financial industry also add risk to the outlook. We believe that, on balance, these regulations should benefit investors in preferred securities by requiring financial institutions to either hold more common equity capital or take less risk, or both. However, with regulations still being formulated, we cannot say with certainty what impact they will have on investors in preferred securities, and they could have a more adverse effect on financial companies' business prospects or capital than we currently anticipate.

As long as the economy continues to recover, markets should remain comfortable that (i) the rise in problem loans is nearing an end, (ii) remaining loan problems are manageable, and (iii) private sector deleveraging can occur in an orderly way – in contrast to the disorderly deleveraging witnessed in late 2008 and early 2009. We need to remain vigilant, as not all companies will overcome their problems, but markets should not face another systemic crisis in 2010.

Our primary concerns surround the federal budget deficit and the need to finance it. While currently necessary, leadership in Washington (from either party) has not offered a credible plan to bring the deficit back to a sustainable level over the longer term. Eventually, markets will force a solution, but we don't expect to reach that point over the next several years. We can expect only modest economic growth until we do.

All of this leaves us with a generally optimistic outlook on credit markets and preferred securities. Company and consumer balance sheets are improving, the economy is recovering and inflation should remain low. In addition, long-term Treasury rates already reflect relatively rapid Fed tightening and could hold steady or fall if those expectations are not met. We think credit spreads on debt and preferred securities overall should continue to narrow, although not all companies will benefit. While we cannot expect another preferred market rally like the one in 2009, we are cautiously optimistic that 2010 will be a good year for investors in preferred securities.

Flaherty & Crumrine Incorporated
January 20, 2010

[7] Commercial construction and development lending is already experiencing very high delinquency and charge-off rates. We do expect absolute loan losses in that segment of CRE to start trending down by the end of 2010, mainly because we expect so many these loans already will have been written off by the end of the year.