Second-Quarter U.S. Economic Update
July 2010

Summary of Recent Economic Developments

The economic recovery appears to have continued at a moderate pace in the second quarter. Real GDP is expected to grow by 3.8% in Q2 after rising 2.7% in Q1. Economists forecast a mild slowdown in the second half, with growth dropping to 3.3%. We anticipate a larger downshift in GDP to the low 2% area in the second half, but not a double-dip recession. Employment continued to expand in Q2, though the pace of growth slowed over the course of the quarter. Income and consumption growth were subdued, and the personal savings rate rose. The housing market generally benefitted from home buyers taking advantage of expiring tax credits, although stronger Q2 sales probably mean weaker sales next quarter. Business investment remained mixed, with strong spending on equipment and software but weakness in structures. Industrial production turned in another strong quarter as a boost in inventories supplemented higher final demand. The trade deficit widened, and it probably will reduce GDP growth for at least the next few quarters. Government spending likely fell as state and local governments continued to cut budgets and federal government deficit spending eased. Households and businesses continued to pay down debt and increase savings. Markets responded to the outlook for slower growth and limited credit demand by pushing Treasury yields down and corporate and preferred spreads wider. Nonetheless, credit quality generally improved, as corporate profits increased and balance sheets strengthened. We continue to believe that modest economic growth, low inflation, and muted demand for credit should provide a favorable environment for preferreds in 2010.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	**2008:3**	**2008:4**	**2009:1**	**2009:2**	**2009:3**	**2009:4**	**2010:1**	**2010:2**
Real GDP, Chg QoQ (%)	-2.7	-5.4	-6.4	-0.7	2.2	5.6	2.7	3.8f
Real Personal Consump Expnds, Chg QoQ (%)	-3.5	-3.1	0.6	-0.9	2.8	1.6	3.0	2.3a
Real Busi Investmt, Eqp & Sftware, Chg QoQ (%)	-9.4	-25.9	-36.4	-4.9	1.5	19.0	11.4	NA
Real Residential Investmt, Chg QoQ (%)	-15.9	-23.2	-38.2	-23.3	18.9	3.8	-10.3	NA
Corporate Profits, After Tax, Chg YoY (%)	4.8	-15.8	-19.7	-15.3	-9.7	22.8	27.3	25.5f
Current Account Balance, Annualized (% of GDP)	-4.7	-4.1	-2.7	-2.4	-2.7	-2.8	-3.0	NA
Federal Budget, 12-mo Def or Surp (% of GDP)	-3.1	-4.7	-6.5	-8.9	-9.9	-10.2	-9.3	-8.6a
Unemployment Rate (%)	6.2	7.4	8.6	9.5	9.8	10.0	9.7	9.5
Household Employment, Chg QoQ (000)	-747	-1833	-2334	-816	-1270	-976	1113	214
Nonfarm Payrolls, Chg QoQ (000)	-1002	-1955	-2258	-1430	-783	-269	261	621
Nonfarm Productivity, Chg QoQ (%)	1.1	2.2	0.9	7.6	7.8	6.3	2.8	NA
Capacity Utilization (%)	74.8	72.9	69.6	68.2	70.5	71.6	72.8	74.1
GDP Price Index, Chg QoQ (%)	4.0	0.1	1.9	0.0	0.4	0.5	1.1	NA
Consumer Price Index, Chg YoY (%)	4.9	0.1	-0.4	-1.4	-1.3	2.7	2.3	1.1
CPI ex food & energy, Chg YoY (%)	2.5	1.8	1.8	1.7	1.5	1.8	1.1	0.9
Nominal Personal Income, Chg YoY (%)	2.5	0.4	-2.2	-2.6	-2.3	-0.6	2.9	1.6a
Personal Savings Rate (%)	2.2	4.7	3.5	4.9	4.2	3.7	3.3	4.0a
Rate or Spread (End of Quarter)	**2008:3**	**2008:4**	**2009:1**	**2009:2**	**2009:3**	**2009:4**	**2010:1**	**2010:2**
Federal Funds Rate Target (%)	2.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3-month LIBOR (%)	4.05	1.43	1.19	0.60	0.29	0.25	0.29	0.53
10-Yr Treasury Note Yield (%)	3.83	2.22	2.67	3.54	3.31	3.84	3.83	2.93
30-Yr Treasury Bond Yield (%)	4.31	2.68	3.54	4.34	4.05	4.64	4.71	3.89
Moody's Baa Long Corp Spread (bp)	354	529	491	283	212	175	160	216
10-Yr Interest Rate Swap Spread (bp)	66.5	35.0	20.0	24.8	15.3	13.3	-1.6	7.0

* Figures are either quarterly or, if more frequent, quarterly averages. f = Forecast[1]; a = Actual through May 2010 Source: Reuters EcoWin

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

Economic Outlook

The U.S. economy is continuing to recover from the financial crisis. Inflation-adjusted **Gross Domestic Product** (real GDP) is forecast to grow by 3.8% in the second quarter, marking the fourth consecutive quarter of growth. In addition, economists forecast real GDP growth of 3.3% in the second half of 2010 and 3.1% in 2011.[1] We anticipate somewhat slower growth in the range of 2-3% (and probably at the low end of that range) for the balance of the year. In a nutshell, we think personal consumption growth will be constrained by a rising personal savings rate and continued deleveraging by consumers; investment spending will be limited by high levels of excess capacity at businesses and continued oversupply of housing; trade improvement will be slowed by the rise in the U.S. dollar and fiscal restraint abroad; overall government spending will continue to slow; and the boost to growth from inventory rebuilding will run its course. Despite these headwinds, we do *not* anticipate a double-dip recession. We foresee growth in the economy – just at a slower pace than in the first half of the year. The following paragraphs explain these views in more detail.

Figure 2: Job Growth Slowing, not Derailing

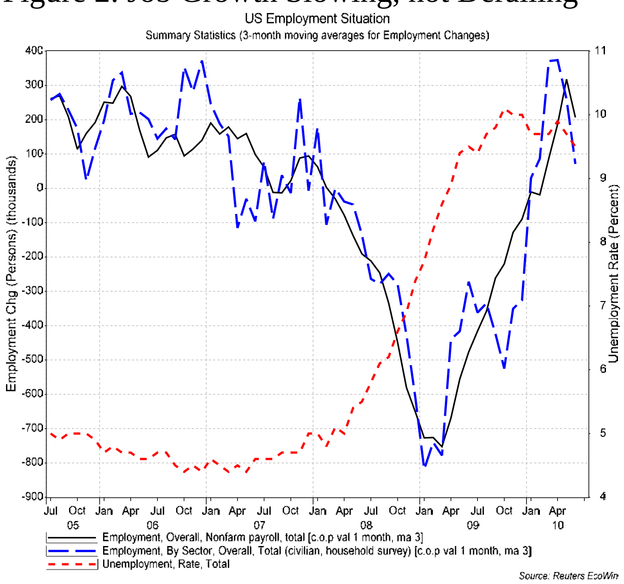
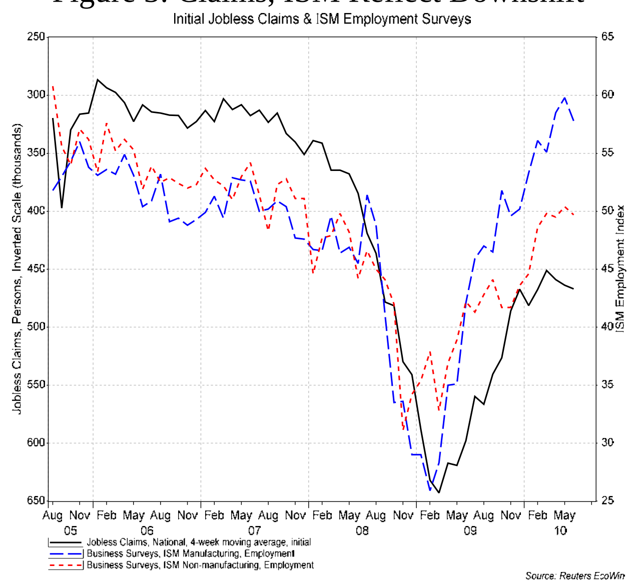


Figure 3: Claims, ISM Reflect Downshift



The **labor market** has been the source of some consternation of late. Monthly employment growth slowed from March (+158,000 private sector jobs) through June (+83,000), and the more volatile household employment survey showed only tepid (+214,000) job growth for the second quarter. In addition, initial and continuing claims for unemployment insurance remain stubbornly high. However, looking at the second quarter as a whole, overall payroll employment grew by 621,000, up from 261,000 net job gains in 1Q10 and job losses of 269,000 in 4Q09 (Figure 2). The unemployment rate also improved to 9.5% at the end of 2Q10 from 9.75% at the end of 1Q10. Given the volatility of the month-to-month employment numbers – along with the continued positive readings from most employment surveys (Figure 3) – we think the longer-term view is the right one. Nonetheless, with the economy facing some headwinds in the second half of the year (including the wind-down of fiscal stimulus and the inventory cycle), employers

[1] All growth rates are annualized unless noted otherwise. Forecasts in this Update are from *The Livingston Survey*, Federal Reserve Bank of Philadelphia, June 9, 2010.

are likely to remain cautious in their hiring. As a result, we anticipate only moderate growth in employment and little change in the unemployment rate over the balance of the year. We do not believe that this downshift in employment will derail the economic recovery, but it probably will limit growth to the 2-3% range for the next year or so.

Sluggish employment growth and only mild wage increases will also keep a lid on **personal income**, which is up only 1.6% in nominal terms over the past year through May (Figure 4). Although rapid job gains in March and April (due in large part to temporary Census jobs) caused personal income to jump by 4.1% in the first two months of the second quarter, job losses (including the end of Census work) in June are likely to dampen personal income for Q2 as a whole. Moreover, as we have emphasized in the past, personal income cannot grow rapidly until employment rises fast enough to drive down the unemployment rate and spur wage increases. It's the "turbo charging" of job gains with higher wages that really accelerates income growth. To date, the unemployment rate has not dropped enough to reverse the downward trend in wage growth (Figure 5). Given our outlook for employment, we don't foresee any meaningful rebound in wage growth this year, which in turn should keep income gains modest.

Figure 4: Consumer Recovering, but Slowly

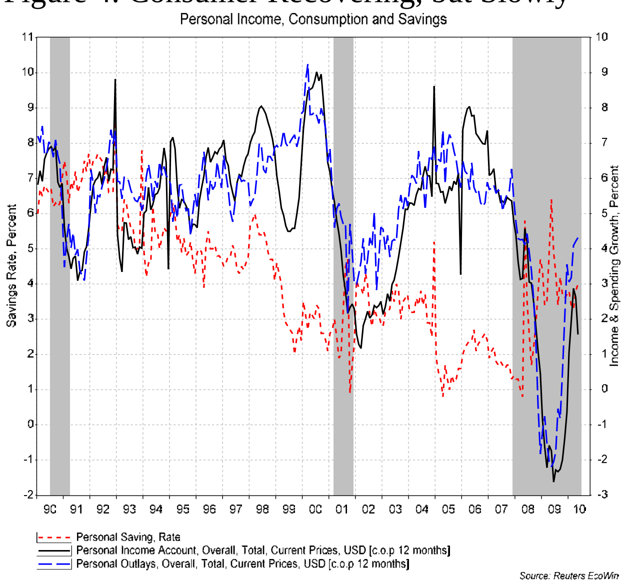
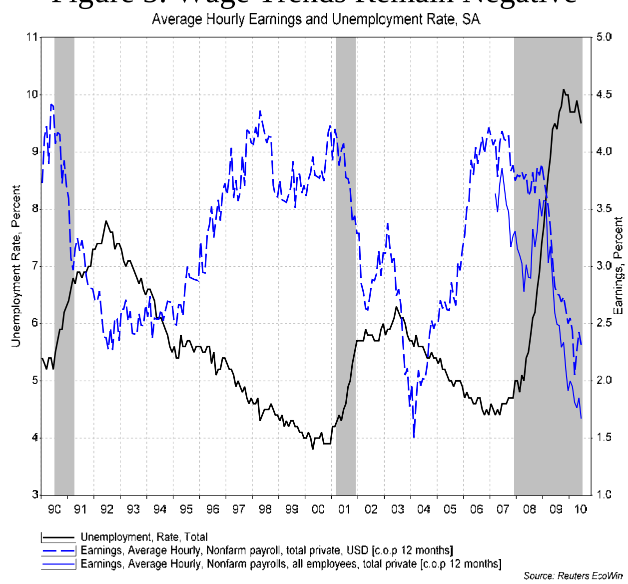


Figure 5: Wage Trends Remain Negative



With employment prospects still weak, growth in nominal **personal consumption expenditure** (PCE) slowed to 2.3% in the first two months of the quarter, although it remains up 4.3% YoY through May. In real (i.e., inflation-adjusted) terms, PCE was up 2.6% YoY and 2.3% quarter-to-date. While we don't yet have PCE data for June, retail sales figures for that month were lackluster. Core retail sales (excluding automobiles, gasoline, and building materials) were up by just 1.5% in Q2 over Q1. The data on PCE is not bad, and certainly it is better than in the spring of 2009. However, it reflects a true sense of caution by consumers – one that is mirrored in weak surveys of consumer confidence. We think this consumer malaise will dissipate only slowly.

The relatively strong income and modest consumption during the first two months of the quarter pushed up the **personal savings rate** to 4.0% in May (Figure 4). It appears that a good portion of these higher savings are being used to pay down debt and build home equity. Consumer credit and "Home Equity Withdrawal[2]" continue to decline (Figure 6). It took households 25 years to accumulate the current stock of debt, and we think it will take a number of years for them to reduce it to a more manageable level. That should keep growth in PCE – and hence growth in real GDP – modest for now.

Figure 6: Consumers Paying Down Debt

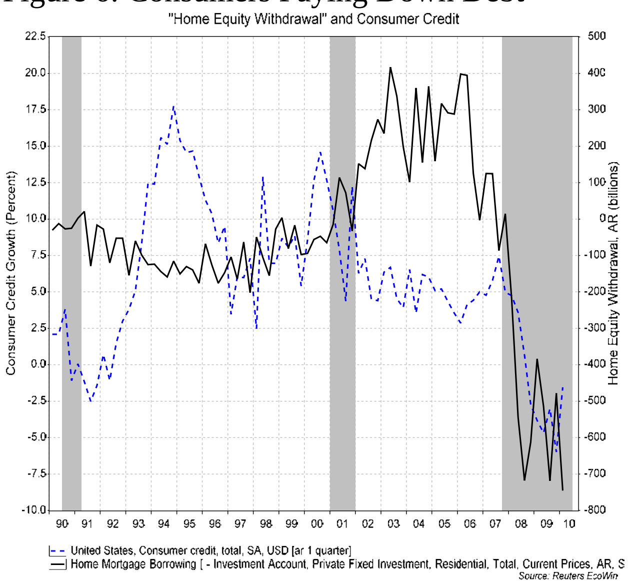
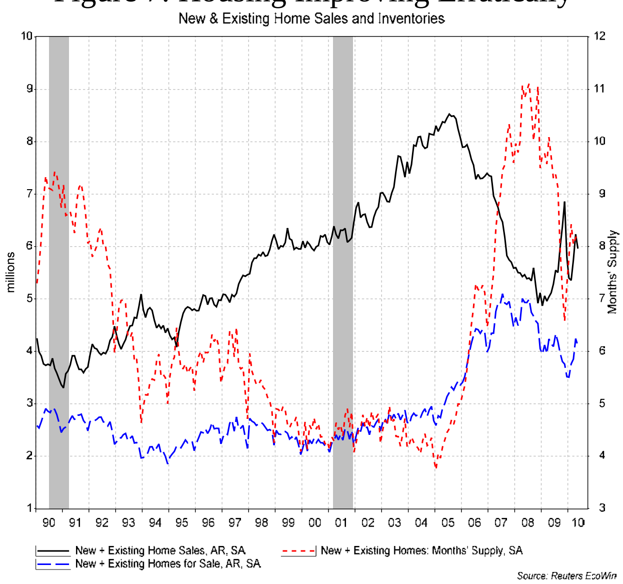


Figure 7: Housing Improving Erratically



The **housing market** was buffeted by the positive and negative effects of temporary tax credits in the second quarter. As a reminder, the Federal government offered certain homebuyers a tax credit for buying a home as long as the purchase contract was signed by April 30 and closing occurred by June 30, 2010. This led to a sharp rise in new home sales in March and April (new home sales are recorded at contract signing), followed by a plunge in sales in May. Existing home sales, which are recorded at closing, jumped in April and May and probably remained high in June, but they too are likely to tumble in July. Similarly, home prices generally firmed during the second quarter, and it's reasonable to expect some slippage in prices next quarter. Nonetheless, housing affordability remains high and inventories of unsold homes – while still high in absolute terms –are declining. As a result, we think home prices will ease in the second half of the year, but we expect the declines will be relatively small. Adding it up, we think residential investment will add a bit to Q2 real GDP growth (after subtracting ¼% in Q1), but then turn negative again in Q3. We continue to view 2010 as a "bottoming" year for housing, with residential investment likely to be flat or only a small negative for GDP growth.

One relatively bright spot for the economy appears to be **business investment**. Expenditures on business equipment and software were up 11.4% in Q1; judging by strong orders for nondefense capital goods (Figure 8), it looks like Q2 spending will be strong as well. The ball and chain on this otherwise bright investment story is spending on business structures, however. Given the current depressed state of commercial real estate, it's no surprise that spending on business structures is falling (-15.5% in Q1), and low occupancy rates suggest that it will be many quarters before this sector returns to solid growth. Putting these together, we think overall business

[2] Home equity withdrawal is mortgage borrowing less residential investment. If HEW is positive (negative), it means homeowners in aggregate are borrowing against (adding to) home equity.

investment will contribute a bit to GDP growth, but with capacity utilization low, we don't anticipate that it will be a real engine of growth for at least another year or two (Figure 9).

Figure 8: Capital Goods Orders Rebounding

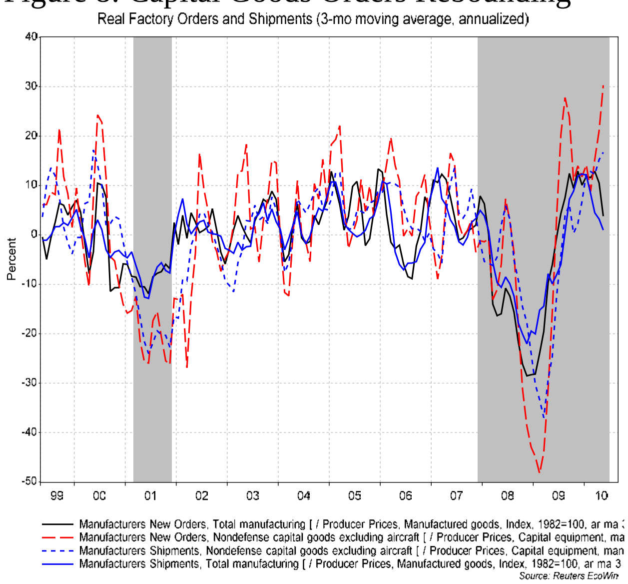


Figure 9: Low Utilization Limits Investment

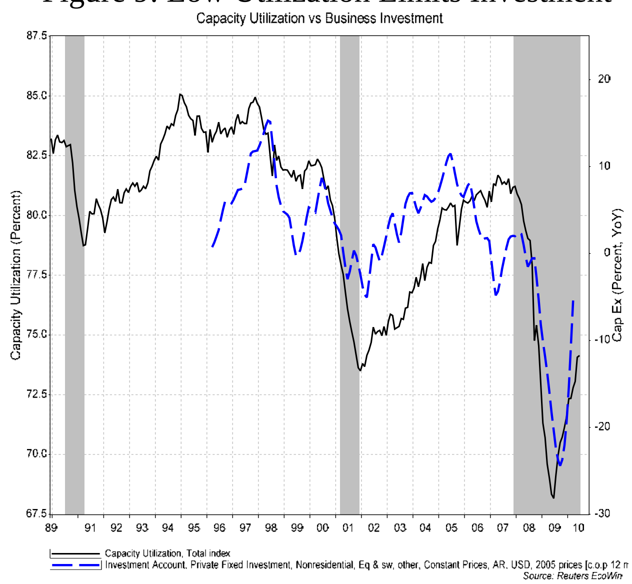


Figure 10: Industrial Production Remains Strong

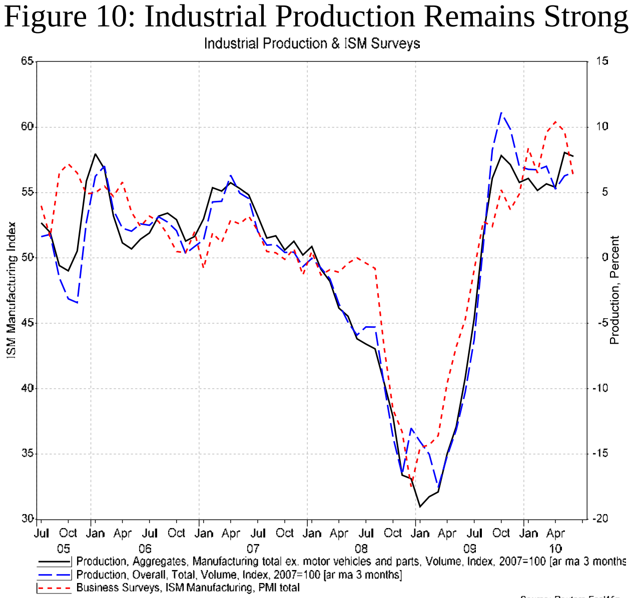
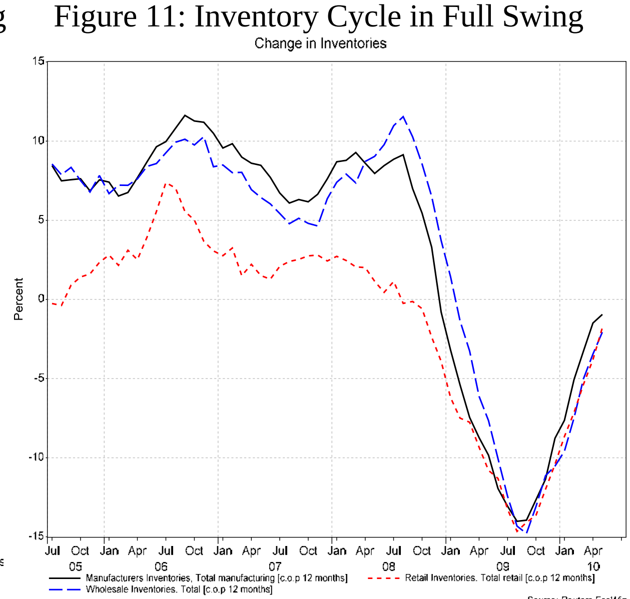


Figure 11: Inventory Cycle in Full Swing



Industrial production remains a major bright spot for the economy. Orders for industrial goods are still up sharply (Figure 8), prompting manufacturers to ramp up production (Figure 10). In addition to moderate growth in final demand, producers are rebuilding inventories after sharp inventory reductions last year (Figure 11). This led to rapid increases in production and has been a major boost to GDP and the economic recovery. However, when producers decide they have added enough inventory to satisfy their needs, production will drop back in-line with the growth in final demand, which remains tepid.[3] This end to the growth boost from the inventory cycle is

[3] Real final sales removes the impact of inventories on GDP. It grew by just 0.8% QoQ and 1.2% YoY in 1Q10.

inevitable, though it is difficult to predict exactly when it will occur. We think it will happen sometime before the end of the year, and it is a key reason why we expect the economy to downshift to a lower growth rate in the second half.

The **trade sector** has swung from an important source of GDP growth in the past several years to a probable drag on growth, at least for the next few quarters (Figure 12). On a fundamental basis, the U.S. dollar has strengthened as U.S. economic growth has outpaced many of its trading partners. That raises the price of and weakens demand for U.S. exports, while it does the opposite for imports – leading to a wider trade deficit. This deterioration in the trade balance is being reinforced by concerns over sovereign debt in Europe, which have driven global investors to "safe-haven" U.S. financial assets. When this happens to a country, a widening trade deficit (or shrinking trade surplus) is all but unavoidable.[4] Although we expect that worries over Europe will subside gradually, it's likely to take some time. The trade deficit is likely to reduce U.S. growth in the meantime.

Figure 12: Trade Rebounding, Deficit Worsening

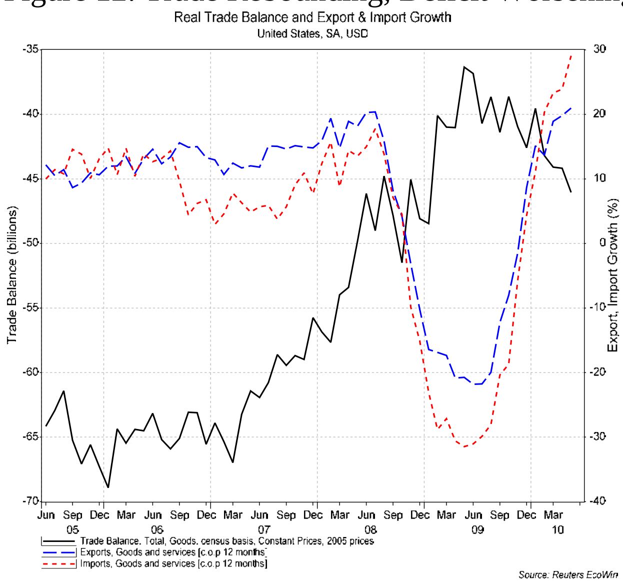
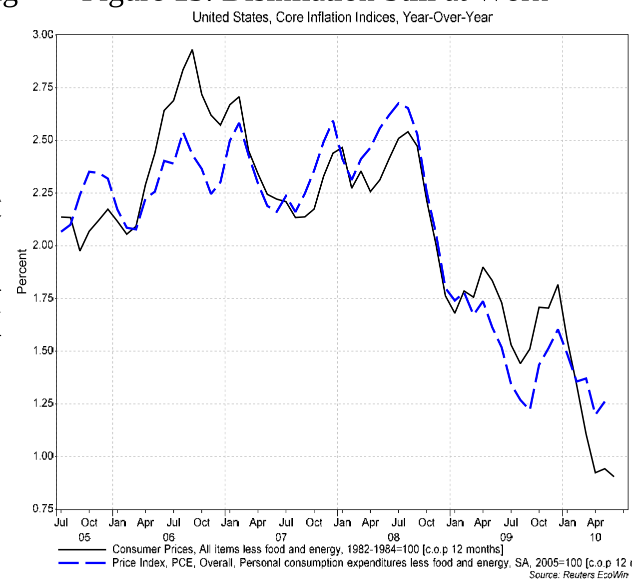


Figure 13: Disinflation Still at Work



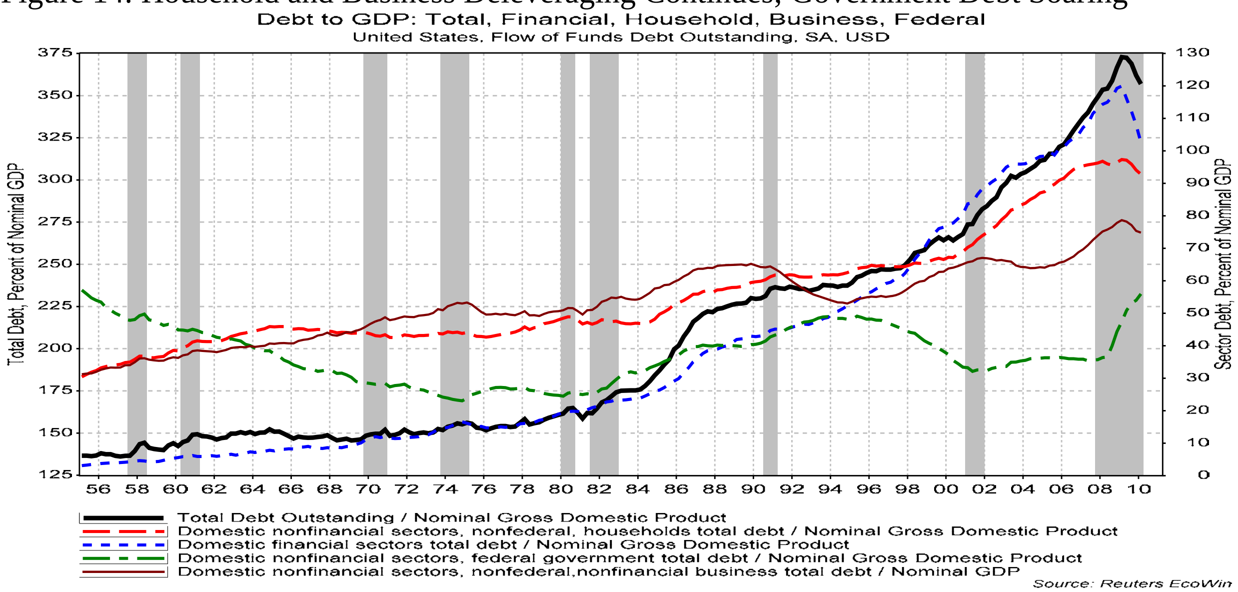
The outlook for **government consumption** remains mixed in the second quarter, though it too will turn down in the second half of the year. Federal fiscal stimulus likely added to growth in Q2, but cutbacks in state and local budgets probably more than offset it. This was the case in the first quarter, when federal spending added 0.1% to real GDP growth while state and local government spending subtracted 0.5%. Looking ahead, state and local government woes are continuing, current fiscal stimulus is waning, and Congress is struggling to assemble sufficient votes to pass additional fiscal stimulus measures. All of this argues for slower government consumption, and it's another key reason we expect the growth rate of the economy will downshift in the second half of the year.

[4] The current account represents the net foreign assets of a country, and it must equal the sum of the trade balance, net factor income, and net transfer payments. If foreign investors acquire U.S. financial assets over a certain period, the current account will be in deficit for that period. Since factor income and transfer payments tend to change only slowly, a rising current account deficit necessarily means a rising trade deficit. As long as foreign investors view the U.S. as a "safe haven" and buy U.S. assets, the trade deficit is likely to widen, reducing U.S. GDP growth.

Inflation remains subdued. Overall inflation as measured by the consumer price index (CPI) is up 1.1% YoY in June, while core CPI (excluding food and energy) rose by just 0.9% over the same period. High unemployment is keeping a lid on wages. Low capacity utilization is preventing producers from raising prices. Tight standards for new lending are preventing much of the monetary accommodation engineered by the Federal Reserve from working its way into the economy. And a stronger U.S. dollar is pushing down the price of imported goods. As a result, inflation cannot gain a foothold, and core inflation continues to drift lower (Figure 13).

Finally, the balance sheet trends we have highlighted in prior Updates are continuing (Figure 14). Households are paying down debt. Lending is shrinking, and financial companies are deleveraging – a trend that will only be reinforced by new financial regulation. Nonfinancial businesses are reducing debt and increasing liquidity. In general, business has a notably small appetite for borrowing. The offsets to this private sector deleveraging have been the widening of the U.S. budget deficit and (until recently) shrinking of the current account deficit. Looking ahead, there appears to be growing resistance to additional deficit spending, which may make it difficult for the public sector to offset the private sector's desire to increase its savings. At the same time, foreign investors seem to want to buy U.S. assets, which will push the current account deficit wider. If so, that means (i) private sector deleveraging needs to slow down, or (ii) economic growth has to slow.[5]

Figure 14: Household and Business Deleveraging Continues; Government Debt Soaring



Adding it all up, we expect a combination of the two. We do believe that the rapid increase in private sector savings visible since the start of the recession should ease as the recovery continues. Higher employment and improved confidence will gradually prompt households to spend more and businesses to invest more, reducing the growth in net private sector savings. But it's too early to believe that businesses and households will say "mission accomplished" with respect to reducing debt and increasing savings, especially with high levels of unemployment and

[5] See the *Fourth-Quarter U.S. Economic Update*, Flaherty & Crumrine Incorporated, January 20, 2010 for a more detailed explanation of the interaction of public sector savings, private sector savings, and the current account, available at www.preferredincome.com or www.fcclaymore.com.

excess capacity. If the countercyclical offsets to this (government deficit spending and trade improvement) start to move in the other direction, as we expect, then somewhat slower economic growth will be the result. We continue to anticipate that the relatively strong growth rate of about 3% in the first half of 2010 will slow to the low 2% area in the second half. While that's not a stellar growth rate, it should be a benign one for investors in preferred securities, as we discuss in the next section.

Market Outlook

Treasury rates fell sharply in the quarter ended June 30, with 30-year yields down by 82 basis points (bp) to 3.89% and 2-year yields down by 41 bp to 0.61%. The decline in yields was driven by the slowdown in U.S. economic growth visible over the course of the quarter and by mounting concerns over sovereign debt burdens in Europe, which led to "safe-haven" buying of U.S. Treasuries. Rates have moved up somewhat in the weeks since quarter-end, but they remain well below Q1-end levels. Monetary policy was unchanged as the Federal Reserve left its fed funds target at 0-0.25%. Also of note: the last of the Fed's emergency liquidity programs – the Term Asset-Backed Lending Facility – expired on June 30.

As of June 30, 2010, the market was pricing in about 25 bp of tightening by the Fed by the end of 2010, down from about 50 bp of implied tightening at the end of the first quarter. More significantly, implied monetary tightening by year-end 2011 dropped to just 75-100 bp, down from about 240 bp at the end of 1Q2010. At this point, the amount of tightening priced into the market is broadly consistent with our outlook for sluggish growth and low inflation. It's entirely possible that the Fed leaves the fed funds rate on hold through the end of 2011, meaning that the market is *still* pricing in too much tightening. However, given the asymmetry of rates near zero percent, it is rational for the market to price in some increase in short rates, since further reductions are impossible. We think current Treasury rates – while probably a little lower than they should be due to safe-haven buying – do a good job of balancing the risks surrounding the future path of growth.

Figure 15: UST Rally Pushed Corporate…

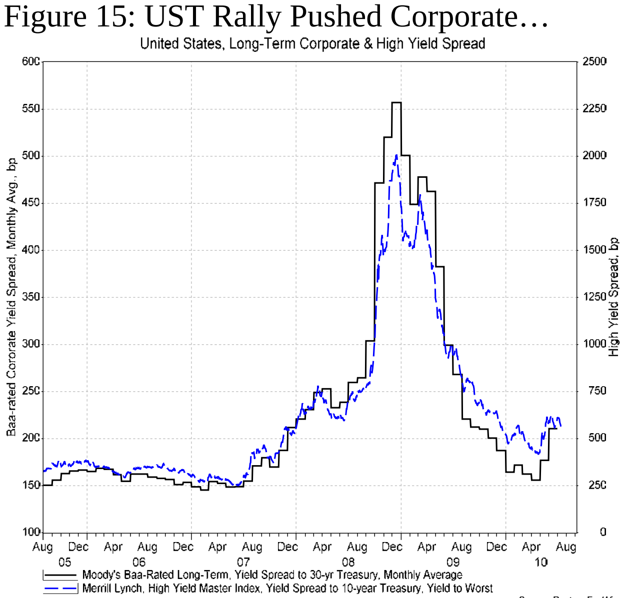
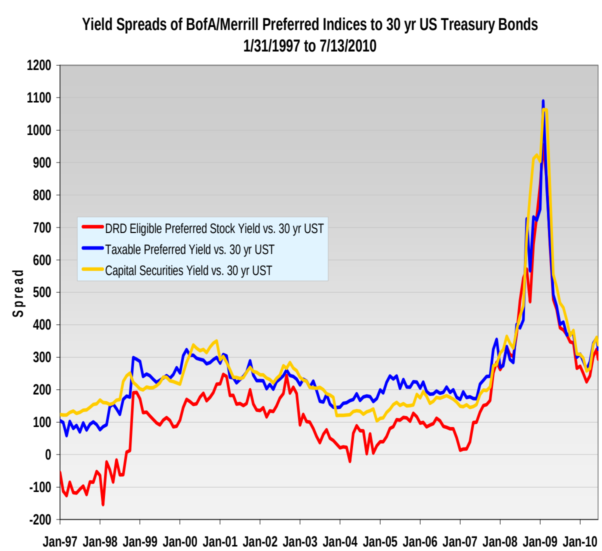


Figure 16: … and Preferred Spreads Wider



Source: Bank of America/Merrill Lynch; F&C calculations

Credit markets showed mixed results. Corporate and preferred securities' spreads to Treasuries widened on the quarter as credit instruments could not keep pace with the strong rally in Treasuries (Figures 15 & 16). Prices posted either small gains (corporates) or losses (preferreds) for the quarter, though both remain higher year-to-date.

Figure 17: Corporate Profits Strong

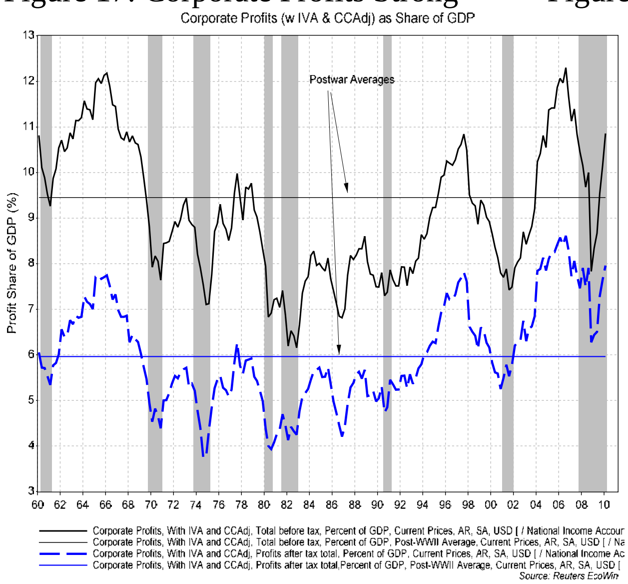


Figure 18: Debt Burden Down, Liquidity & Term Up

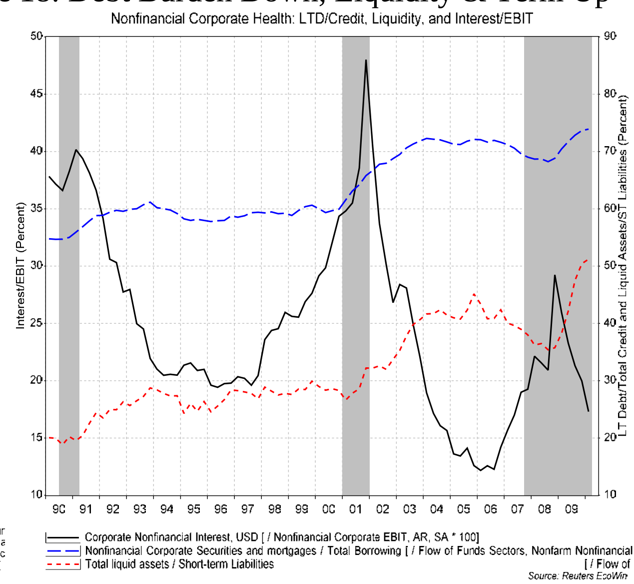


Figure 19: Consumer Loan Delinquencies Down but Charge-Offs Still High

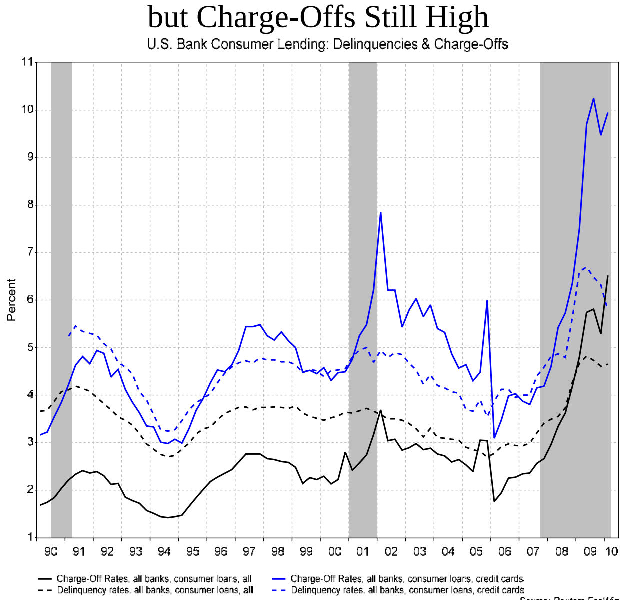
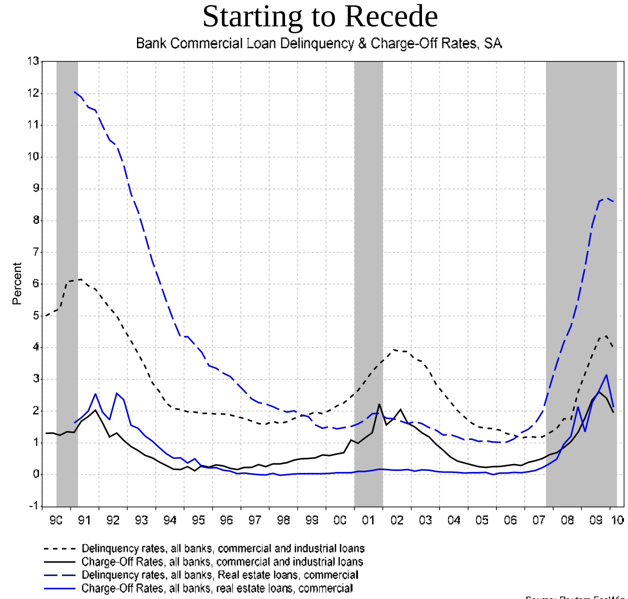


Figure 20: Commercial Loan Problems Starting to Recede



Credit quality continued to improve on a fundamental basis, although problem loans remain elevated. Corporate earnings are strong, with profits up 27.3% YoY in Q1 and expected to be up by more than 25% YoY in Q2. This has pushed the profit share of GDP back up near pre-crisis levels (Figure 17). Corporate balance sheets continue to improve. Interest expense as a proportion of earnings before interest and taxes (EBIT) is falling, liquidity is rising, and long-term debt (which is not subject to frequent rollover risk) as a proportion of total debt is increasing

(Figure 18). The financing gap remains negative, indicating no net need for borrowing by businesses.

With the economy growing again and balance sheets improving, it is not surprising to see loan quality improving, although loan delinquencies and charge-offs remain elevated (Figures 19 & 20). On the consumer side, credit card loans showed the earliest improvement, and both delinquencies and charge-offs are now falling at most lenders. Residential mortgage delinquencies have been falling for the past few months, though foreclosures and charge-offs are still rising. We continue to expect strain on residential mortgage books through the end of 2010, though the drop in early delinquencies is an encouraging sign for 2011. Commercial loan delinquencies and charge-offs have begun to turn down as well. We expect continued improvement in commercial and industrial lending given the strong recovery in manufacturing and related services. We are more negative on commercial real estate loans, however. While the dip in commercial mortgage delinquencies is welcome news, the delinquency rate remains very high and stands well above the charge-off rate, suggesting that losses remain in the pipeline.

The improvement in corporate balance sheets and in overall loan quality contributed to some loosening in lending standards by banks in Q2. Lending standards for consumer loans were little changed after three years of substantial tightening. Commercial lending standards were mostly flat or even eased a bit in Q2, although standards for commercial real estate lending continued to tighten. Demand for loans also improved, though in general loan demand is still falling (Figures 21 & 22). Nonetheless, the lending survey data indicate that companies gradually are feeling less pressured to pay down debt, and banks are more willing to extend loans than had been the case over the past several years. We think both are important ingredients for sustaining the economic recovery.

Figure 21: Lending Standards Easier

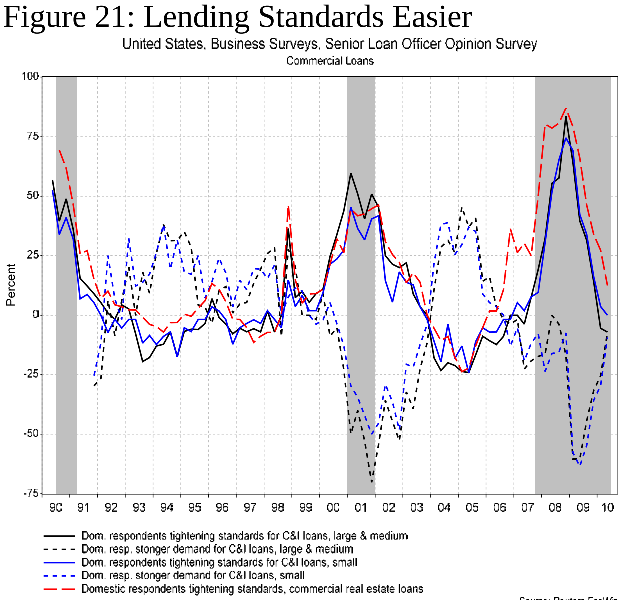
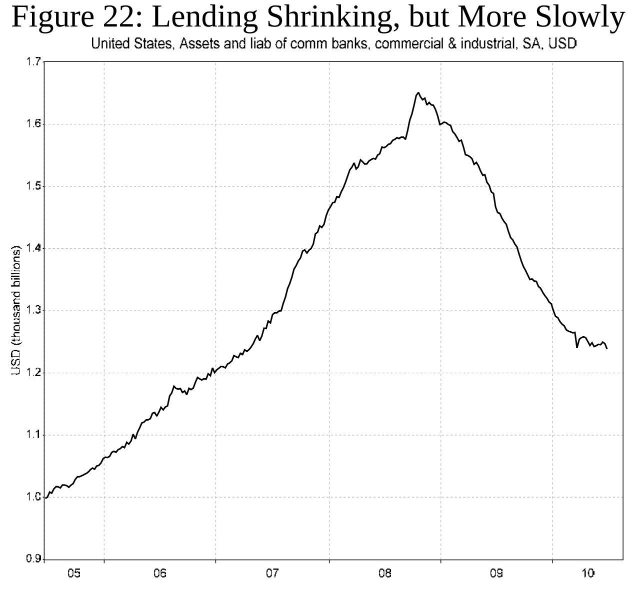


Figure 22: Lending Shrinking, but More Slowly



Finally, late in the second quarter the House and Senate conferees agreed on **financial regulation** legislation. It quickly passed the House, and the Senate passed it on July 15. While it is impossible to assess the full impact of the legislation on financial companies until regulators write the rules that are required under the new law, we think the broad outline is visible now.

Most importantly, the new regulations will require financial institutions to hold more capital (including a larger amount of common equity capital), take less risk, or both. That's a clear positive for investors in preferred securities. The legislation also phases out Tier 1 capital eligibility for outstanding trust preferred securities (TruPS) issued by large financial institutions and eliminates Tier 1 treatment for all newly issued TruPS.[6] There is no doubt this provision will prompt changes to the preferred market, with shrinkage in some areas, expansion in others, and eventually emergence of some new forms of hybrid capital. While the new regulatory regime may generate some volatility in the preferred market, we expect it will offer plenty of opportunities as well.

The economy and markets (so far) are playing out about as we anticipated at the start of the year. The economy has shown fairly good growth in the first half. Inflation has declined and should remain low. Household and corporate balance sheets are improving, and borrowing is falling. As we enter the second half of the year, we anticipate slower growth, but not a "double-dip" recession. We think this should keep interest rates low while continuing to benefit credit markets. We remain cautiously optimistic on the prospects for preferred securities over the balance of 2010.

Flaherty & Crumrine Incorporated
July 16, 2010

[6] See the discussion topics in the May 2010 shareholder letter for more details on the impact of financial regulation on preferred securities; available at www.preferredincome.com or www.fcclaymore.com.