Third-Quarter U.S. Economic Update
October 2010

Summary of Recent Economic and Market Developments

The U.S. economy appears to have grown modestly in the third quarter of 2010. Inflation-adjusted Gross Domestic Product is forecast to grow 2.3% in Q3, 2.8% in Q4, and 2.7% next year. Personal consumption growth continues to be constrained by sluggish job formation, stagnant wages, and an ongoing desire by households to reduce debt. Business investment remains solid, though substantial excess capacity may limit future expenditures. Industrial production was sturdy but slower in Q3 in an early sign that the boost to GDP from inventories is waning. The trade deficit probably widened further, although a weaker dollar may lead to some improvement in net exports next year. Federal fiscal stimulus spending is running out of energy while state and local governments continue to trim spending. This backdrop of subdued but still positive economic growth prompted the Fed to change its reinvestment policy on portfolio holdings and to consider renewed asset purchases. Treasury yields fell in response. Meanwhile, rising corporate profits, stronger balance sheets, and improving credit quality pushed credit spreads tighter. Preferred securities' prices rallied. Passage of financial reform legislation and agreement by international regulators on bank capital standards will force banks to take less risk and hold more capital, benefitting preferred investors. The new regulations also will prompt the phase-out of trust preferred securities and usher in substantial changes to the preferred market.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	**2008:4**	**2009:1**	**2009:2**	**2009:3**	**2009:4**	**2010:1**	**2010:2**	**2010:3**
Real GDP, Chg QoQ (%)	-6.8	-4.9	-0.7	1.6	5.0	3.7	1.7	2.3f
Real Personal Consump Expnds, Chg QoQ (%)	-3.3	-0.5	-1.6	2.0	0.9	1.9	2.2	1.6a
Real Busi Investmt, Eqp & Sftware, Chg QoQ (%)	-29.5	-31.6	0.2	4.2	14.6	20.4	24.8	NA
Real Residential Investmt, Chg QoQ (%)	-32.6	-36.2	-19.7	10.6	-0.8	-12.3	25.7	NA
Corporate Profits, After Tax, Chg YoY (%)	-26.4	-10.1	-3.1	0.4	41.9	27.0	26.5	16.9f
Current Account Balance, Annualized (% of GDP)	-4.2	-2.7	-2.4	-2.8	-2.8	-3.0	-3.4	NA
Federal Budget, 12-mo Def or Surp (% of GDP)	-4.8	-6.6	-8.9	-10.0	-10.3	-9.4	-9.1	-8.9f
Unemployment Rate (%)	7.4	8.6	9.5	9.8	10.0	9.7	9.5	9.6
Household Employment, Chg QoQ (000)	-1833	-2334	-816	-1270	-976	1113	214	272
Nonfarm Payrolls, Chg QoQ (000)	-1955	-2258	-1430	-783	-269	261	570	-218
Nonfarm Productivity, Chg QoQ (%)	-0.1	3.4	8.4	7.0	6.0	3.9	-1.8	NA
Capacity Utilization (%)	72.9	69.6	68.2	70.5	71.6	72.8	74.1	74.7a
GDP Price Index, Chg QoQ (%)	-1.2	1.1	0.3	0.7	-0.2	1.0	1.9	1.4f
Consumer Price Index, Chg YoY (%)	0.1	-0.4	-1.4	-1.3	2.7	2.3	1.1	1.1
CPI ex food & energy, Chg YoY (%)	1.8	1.8	1.7	1.5	1.8	1.1	0.9	0.8
Nominal Personal Income, Chg YoY (%)	0.2	-2.4	-2.7	-2.4	0.4	2.8	2.5	3.3a
Personal Savings Rate (%)	5.7	5.6	6.7	5.7	5.8	5.3	6.0	5.8a
Rate or Spread (End of Quarter)	**2008:4**	**2009:1**	**2009:2**	**2009:3**	**2009:4**	**2010:1**	**2010:2**	**2010:3**
Federal Funds Rate Target (%)	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3-month LIBOR (%)	1.43	1.19	0.60	0.29	0.25	0.29	0.53	0.29
10-Yr Treasury Note Yield (%)	2.22	2.67	3.54	3.31	3.84	3.83	2.93	2.51
30-Yr Treasury Bond Yield (%)	2.68	3.54	4.34	4.05	4.64	4.71	3.89	3.69
Moody's Baa Long Corp Spread (bp)	529	491	283	212	175	160	216	189
10-Yr Interest Rate Swap Spread (bp)	35	20	25	15	13	-2	7	6

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

In September we learned – officially – that the recession that began in December 2007 ended more than a year ago in June 2009.[1] The recession lasted 18 months and subtracted 4.1% from real GDP, making it both the longest and deepest recession since the Great Depression. Although the economic recovery since the end of the recession has been lackluster, it is continuing. The U.S. economy appears to have grown modestly in the third quarter of 2010. Inflation-adjusted **Gross Domestic Product** (real GDP) is forecast to grow 2.3% in Q3, 2.8% in Q4, and 2.7% next year.[2] These forecasts are roughly ½ percentage point lower than they were last quarter, reflecting the downshift in growth visible over the summer months, though they now are about in-line with our expectation of low 2% growth in 2H2010 and 2-3% growth in 2011.

We expect that personal consumption growth will be constrained by sluggish job formation, stagnant wages, and debt reduction. Business investment should be solid, but even there it is likely to be limited by substantial excess capacity. Inventory growth is also likely to level out soon. Federal fiscal stimulus spending is running out of energy while state and local governments continue to trim spending. A widening trade deficit may further sap GDP growth, though the recent weakness in the U.S. dollar may signal some improvement in net exports down the road. We do not think any of this indicates a return to recession – although that remains a risk – but we do anticipate that the recovery will remain a sluggish one. Because our economic views have not changed much since our last (extensive) Update, we will keep our comments relatively brief and let the charts do most of the talking.

Figure 2: Job Market Better, but Still Weak

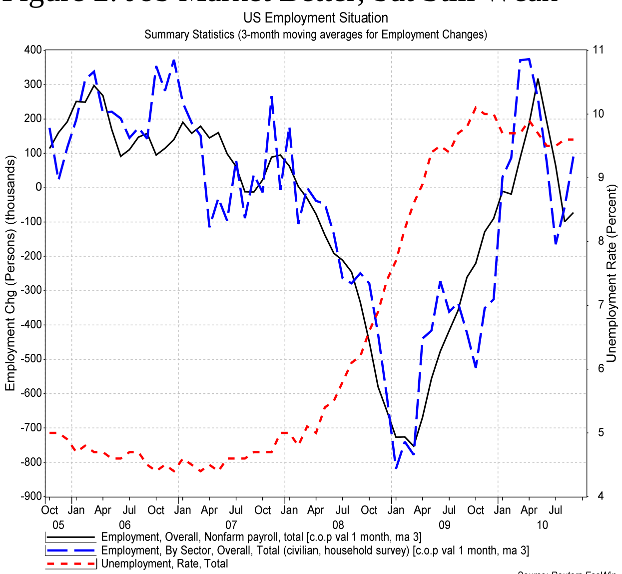
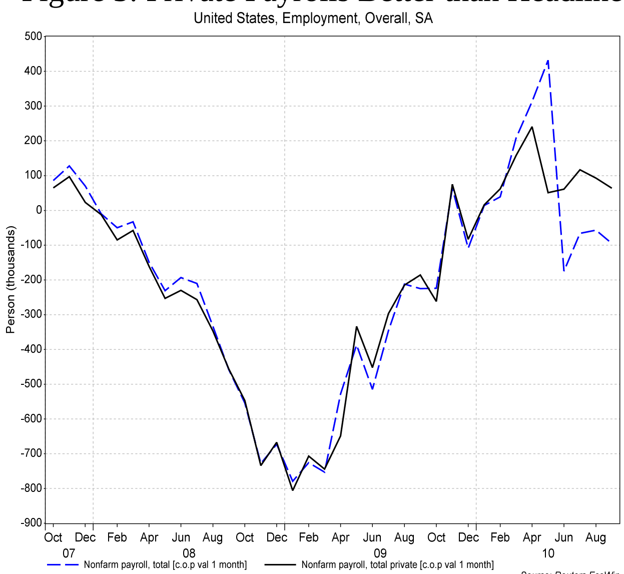


Figure 3: Private Payrolls Better than Headline



The recovery in the **labor market** lost momentum in the third quarter after strong gains in the springtime (Figure 2). Employment as measured by the household survey rose by 272,000 in Q3; that's a bit better than the 214,000 job gains posted in Q2 but well below the 1.1 million jobs

[1] The National Bureau of Economic Research (NBER) is the official arbiter of U.S. recessions. On September 20, 2010, it established the dates of the last recession as beginning in December 2007 and ending in June 2009.

[2] All growth rates are annualized unless noted otherwise. Forecasts in this Update are from *The Survey of Professional Forecasters*, Federal Reserve Bank of Philadelphia, August 13, 2010.

added in Q1. The nonfarm payroll survey of jobs showed job *losses* of 218,000 during the third quarter. The job losses, however, were concentrated in the government sector (largely temporary workers hired for the decadal census), which had boosted government employment earlier in the year. Private payrolls showed relatively steady gains, rising by 274,000 jobs, or roughly the tally shown by the household survey (Figure 3). This is probably a better indicator of the state of the labor market that the overall payroll numbers right now.[3] Employment growth of about 90,000 jobs per month is not enough to lower the unemployment rate, which finished the quarter at 9.6%, up slightly from 9.5% at the end of Q2.

This weakness in job growth reflects both the sluggish pace of economic growth currently and the unusually high degree of uncertainty over the economic, regulatory, and fiscal outlooks. Congress passed sweeping financial and health care reforms this year, and it will be some time before companies understand the impact on their businesses. In addition, we still do not know what Federal income tax rates will be in effect after December 31, 2010. Finally, control of the House and Senate appears up for grabs in November, with opposing sides offering divergent paths for fiscal and regulatory policy. As a result, it is not surprising that businesses are hiring only cautiously. We expect that job growth will gradually accelerate as those issues are resolved and the recovery continues, although unemployment is likely to remain relatively high throughout 2011.

With employment growth slow and wage increases stagnant, **personal income** growth remained subdued (Figure 4). Nominal personal income was up 2.2% in July and August compared to the Q2 average, and it was up just 3.3% YoY. We cannot expect much faster income growth until the pace of hiring and wages pick up – and we do not think that is imminent.

Figure 4: Consumers Spending Cautiously…

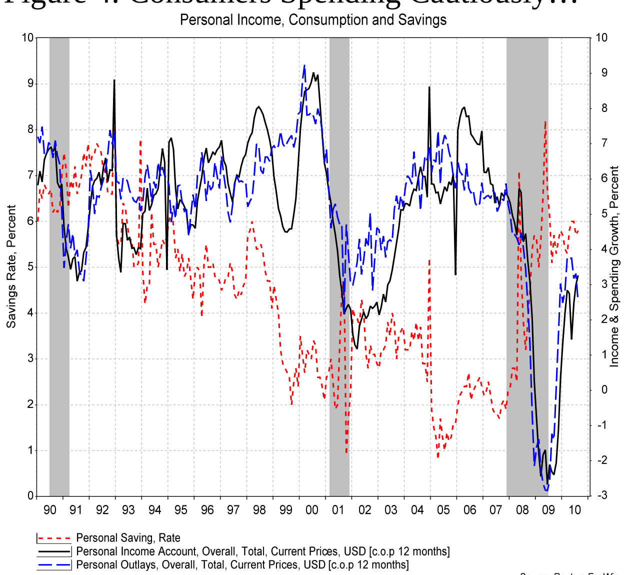
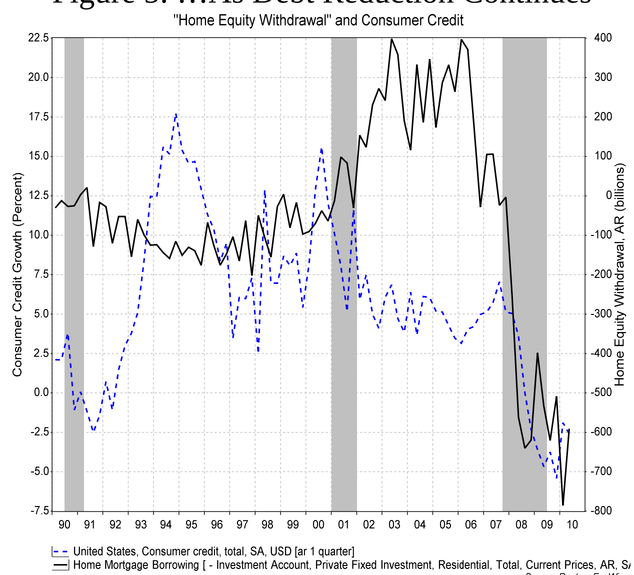


Figure 5: …As Debt Reduction Continues



Households have substantially increased personal savings (Figure 4) and reduced debt (Figure 5). This greater allocation of income to savings (or equivalently, debt reduction) necessarily means slower growth in **personal consumption expenditure** (PCE). Real PCE in July and August were

[3] With just 6000 temporary census workers still on government payrolls as of the end of September, changes in overall and private sector jobs should start tracking each other closely going forward.

up only 1.6% over the Q2 average and 0.9% YoY, although strong retail sales in September along with upward revisions to prior data should mean that full data for Q3 should be somewhat better than the tepid results for the first two months. Looking ahead, we expect that consumers will continue to increase their savings rate (see the end of this section for our thoughts on household balance sheets), but at a slower pace than seen since the start of the recession. That should allow for somewhat faster consumption growth than seen recently, which in turn will support a faster pace of hiring. This is likely to be a gradual process, however, and it contributes to our outlook for restrained GDP growth.

Figure 6: Housing Drops Post Tax Incentives

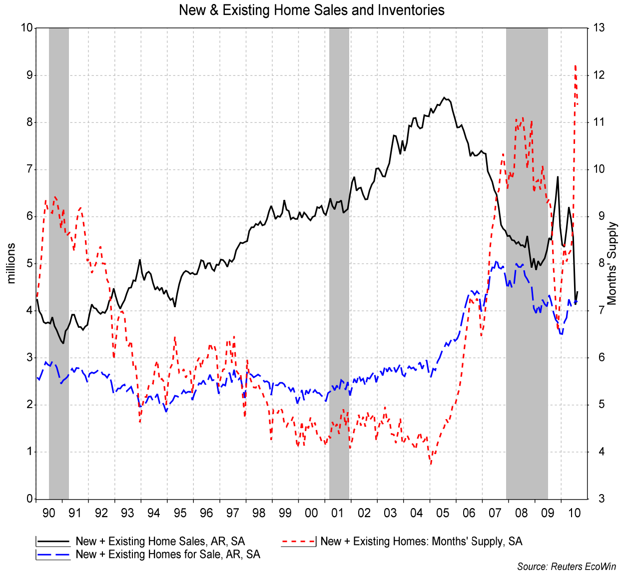
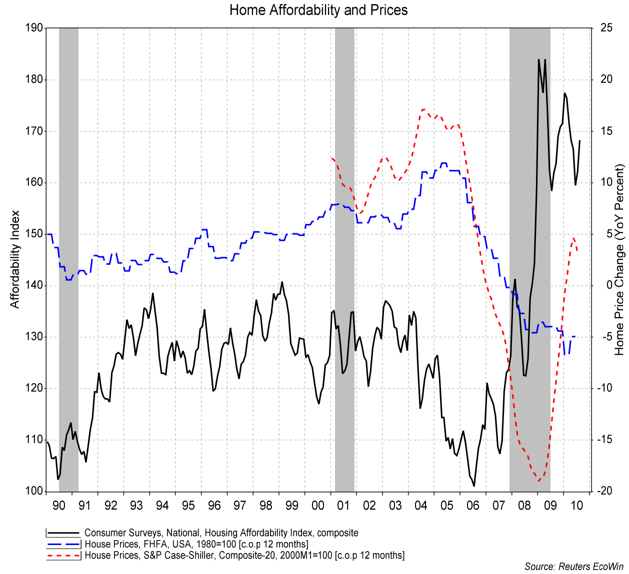


Figure 7: Affordability Remains High



Home sales dropped in the third quarter to the slowest pace since the early-1990s following expiration of homebuyer tax credits at the end of Q2 (Figure 6). This makes it likely that residential investment will be a drag on GDP growth in the quarter after adding about ½ percentage point in Q2. As the pace of home sales slowed, the inventory of unsold homes increased to about 4.2 million units, though it remains well below the peak of about 5 million units. A large inventory of unsold homes combined with sluggish sales means that home prices could turn lower again. However, affordability remains high, new building is minimal, and the population is growing, so we believe any renewed downturn in home prices should be limited (Figure 7). Although housing is likely to be a drag on GDP growth in Q3 and Q4, we should see gradual improvement after that.

Business investment continues to put in a solid performance, although the pace of both orders and shipments moderated (Figure 8). Real nondefense capital goods excluding aircraft orders and shipments slowed during the third quarter but continue to grow at double digit rates. Broader measures of real manufacturing orders and shipments fell, reflecting a slowdown in aircraft orders and shipments. We expect businesses to continue to invest in productivity-enhancing equipment given low interest rates, strong profitability, and cautiousness over hiring. However, the rebound in investment spending has moved well ahead of the increase in capacity utilization (Figure 9), so we should expect the blistering pace of business investment in equipment and software (in excess of 20% annualized for each of the prior two quarters) to slow somewhat. At the same time, spending by businesses on structures (i.e., commercial real estate), which had been falling for about two years, has flattened out in recent months and should be a smaller drag on GDP growth going forward. Adding it up, we think business investment will be a solid and more balanced contributor to GDP growth going forward.

Figure 8: Capital Goods Orders Slowing

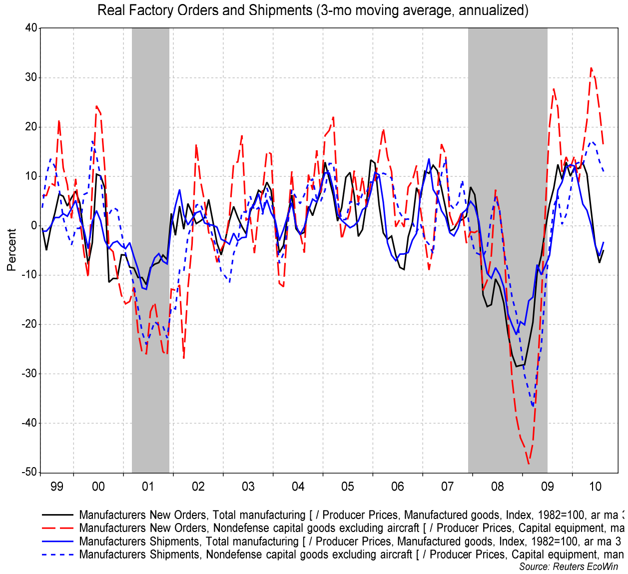


Figure 9: Investment Outpacing Utilization

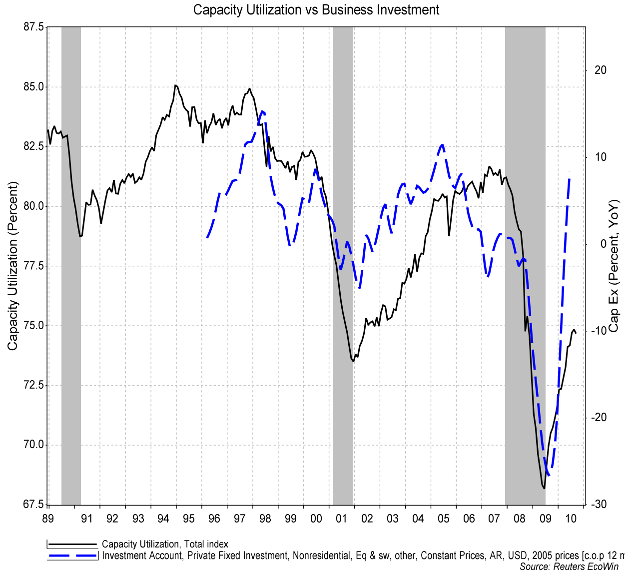


Figure 10: Inventory Cycle Nearing Peak

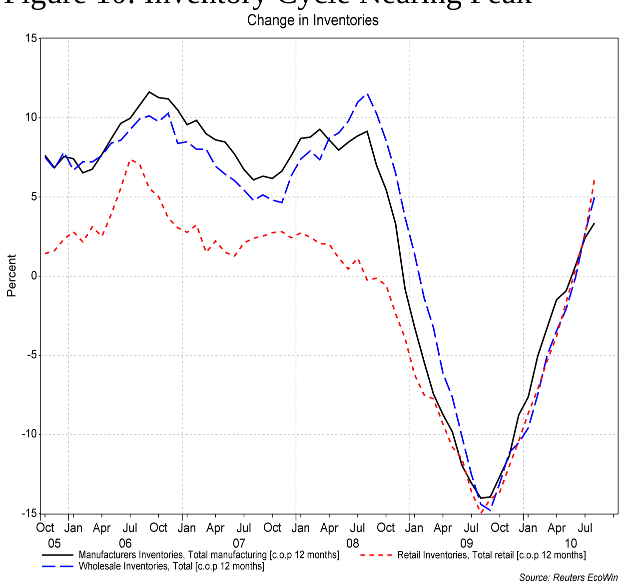
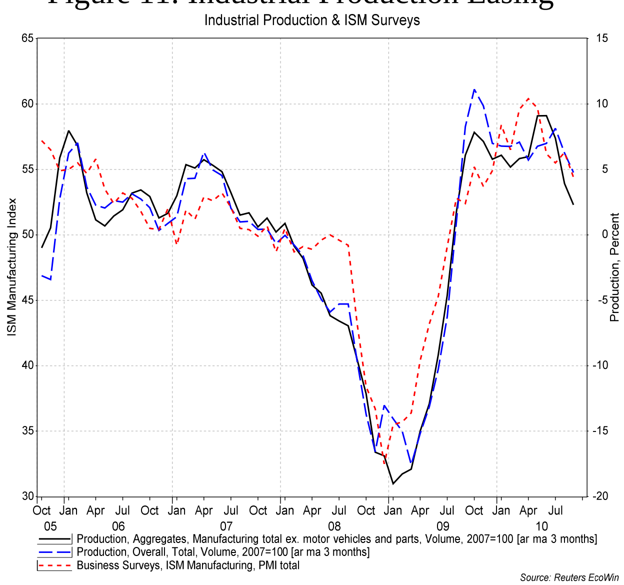


Figure 11: Industrial Production Easing



While the outlook for business investment remains bright, it appears that the inventory cycle is nearing a peak. The rate of growth in **inventories** is almost back to its pre-recession peak (Figure 10). Although businesses probably want to grow inventories somewhat further – inventory-to-sales ratios are up only modestly from cyclical lows – they are going to have to start slowing the rate of increase fairly soon. When that happens, the contribution of inventories to growth, which added 0.8% to GDP in Q2, will drop. Already, **industrial production** and the Institute for Supply Management (ISM) manufacturing survey have slowed from very high levels earlier in the year (Figure 11). Early in the recovery, manufacturers had to produce goods to meet moderately rising demand and to rebuild inventories, causing output to increase rapidly. Now it appears that production is gradually pulling back to levels more consistent with growth in final demand. We know that inventory growth cannot accelerate indefinitely, and we believe the slower pace of production and the already sizable rebound in inventories signal that the boost to growth from the inventory cycle is coming to a close.

The **trade deficit** probably worsened further in Q3, though it certainly will not be as bad for GDP growth as in Q2, when net exports cut 3.5% from GDP (Figure 12). It is an exercise in frustration to try to predict quarterly trade performance, so we generally focus on the longer-term drivers of trade. When the European debt crisis struck last spring while U.S. growth was strong, investors wanted U.S. assets, driving the dollar up and pushing the trade deficit wider. Today, things may be going the other way as the U.S. contemplates additional quantitative easing (see below) in response to slower economic growth and Europe pursues fiscal consolidation. The dollar has weakened again and investors are losing some of their appetite for U.S. investments, which should lead to somewhat better trade performance down the road.

Figure 12: Trade Deficit Worsening (For Now)

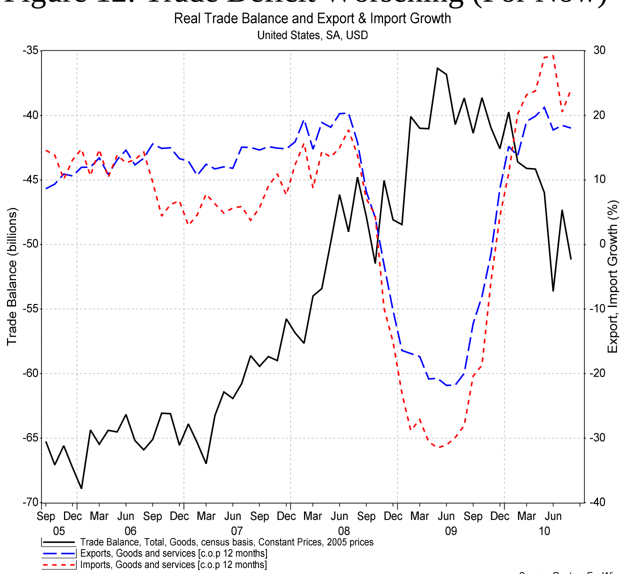
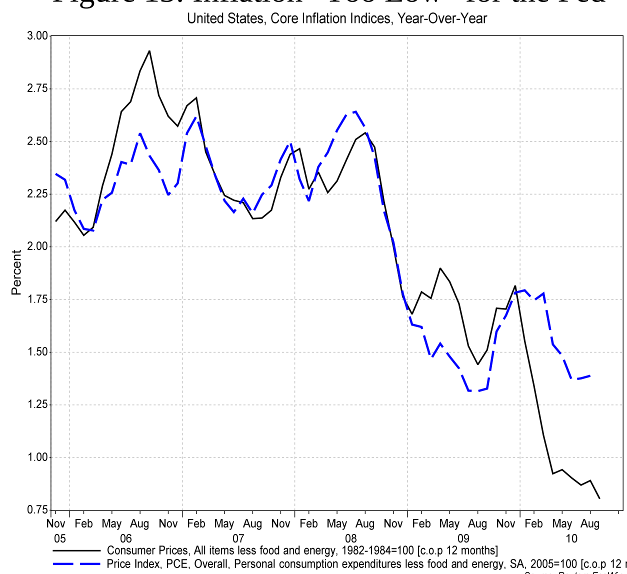


Figure 13: Inflation "Too Low" for the Fed



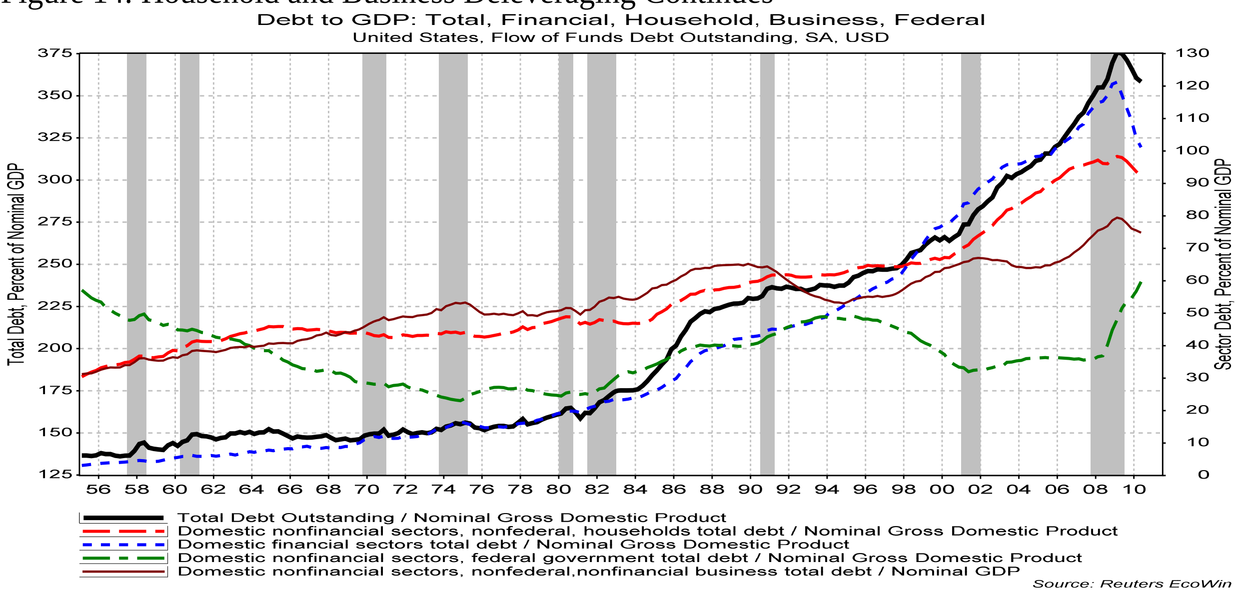
Government consumption has been similarly difficult to predict from quarter to quarter (it added 0.8% to GDP in Q2), but we feel confident that it is headed lower over the next year. Fiscal stimulus probably peaked in Q2 or Q3. That is later than originally expected due to the lack of "shovel-ready" projects last year. However, unless Congress quickly passes another big stimulus bill, which we don't expect, deficit spending should trend lower next year.

The Federal budget deficit came in at $1,294 billion in FY2010 (roughly 8.9% of GDP), compared to $1,415 billion (10.0% of GDP) in FY2009. The improvement in the deficit (if one can call a $1.3 trillion deficit "improved") came roughly equally from higher tax receipts and lower spending. State and local government spending continues to decline.

Inflation in the U.S. remains subdued. The PCE deflator excluding food and energy was up 1.4% YoY in August while core CPI slowed to just 0.8% YoY in September (Figure 13). The Federal Open Market Committee (FOMC) views this as too low, and it is considering another round of quantitative easing to boost the economy and push inflation higher. Although we are confident that the Fed will succeed in generating higher inflation eventually, with excess capacity throughout the economy and lending still constrained, we do not think inflation will move higher anytime soon.

We will conclude this section with a brief recap of **balance sheet trends**, which are shown in Figure 14. Deleveraging is continuing in the U.S. economy overall, with the Federal government the only large borrower to increase debt over the past year. All other sectors, including households and financial and nonfinancial businesses continue to reduce debt. The good news is that the pace of debt reduction slowed a bit. This is good news because if all sectors try to increase savings at once, consumption suffers and economic growth drops. Companies are starting once again to either distribute excess earnings to shareholders (rather than retain them defensively) or invest them in new projects; both contribute to the outlook for sustainable growth. Households continue to increase savings, but at a slower rate than at the height of the crisis, giving greater room for consumption growth. As we have emphasized in prior Updates, we think this deleveraging process has a long way to run, especially for households. The "panic phase" of the adjustment process is over, but deleveraging will restrain economic growth while it plays out. We think this mostly will benefit investors in preferred securities, as we explain below.

Figure 14: Household and Business Deleveraging Continues



Market Outlook

Treasury rates fell again in the third quarter, though long-term rates have risen since quarter-end. Two-year and 30-year Treasury rates both dropped by about 20 basis points (bp), from 0.61% to 0.42% and 3.89% to 3.69%, respectively, at the end of Q3. As of October 18, 30-year Treasury yields had moved up to 3.95% while 2-year rates fell slightly. The lower yields during the quarter were prompted by two developments. First, as we have already discussed, the growth outlook dimmed, leading to lower inflation expectations and higher demand for fixed income investments. Second, the Federal Reserve announced that it would begin reinvesting proceeds from its agency mortgage and debt portfolios into Treasury securities. During the financial crisis, the Fed purchased $1,250 billion in agency mortgage securities and $175 billion in agency debt in addition to $300 billion in Treasury securities. The Fed had been reinvesting proceeds from the

Treasury portfolio into new Treasuries, but it had not been reinvesting the proceeds of the (much larger) agency portfolios. In August, the Fed announced it would reinvest all portfolios' proceeds into new Treasury securities, pushing down their yields.

More recently, the FOMC indicated that it is considering purchasing additional securities in an effort to increase economic growth and lean against the risk of deflation. The Fed has a dual mandate: price stability and maximum sustainable employment. With core inflation below 1.5% and inflation expectations subdued, the Fed can feel reasonably confident that it as attained its objective of price stability. However, with unemployment above 9.5% and job growth too weak to do much to lower it, the FOMC is under pressure to use monetary policy to further support the economy. It seems likely that the Fed will announce additional "quantitative easing" at either the November or December FOMC meetings.

We say "further support" the economy because monetary policy is highly accommodative already; there are nearly $1 trillion in free reserves in the banking system that are available to support lending if demand for borrowing materializes (and banks are willing to extend credit to those borrowers). It's pretty clear that simply adding reserves to the banking system will not do much to help the economy. That's why the Fed is considering asset purchases. If they are large enough, they should push down Treasury interest rates (at least for short and intermediate maturities), which in turn should lower rates for corporate and mortgage borrowers. In theory, those lower borrowing costs would prompt greater consumption and investment, aiding the economy and employment. Of course, the flip side to that story is that lower interest rates mean less income on investments, which would dampen consumption by investors.

Normally, the impact of the former is bigger than the latter, meaning lower interest rates are stimulative. However, many homeowners today are unable to take advantage of lower mortgage rates due to inadequate equity in their homes, and many small business borrowers are unable to access credit. As a result, quantitative easing by the Fed will probably do less for the economy and employment today than the earlier programs implemented (successfully) by the Fed during the financial crisis. This suggests that the FOMC may need to purchase a very large quantity of assets to make an impact. Treasury rates are likely to stay low for a long time.

Credit spreads narrowed in the third quarter, supported by low Treasury rates, high corporate profits, strengthening balance sheets, and improving credit quality. The spread on Moody's long-term Baa-rated corporate bonds fell by 27 bp to 189 bp over Treasuries in Q3, and spreads have narrowed a bit further so far in October (Figure 15). Preferred spreads also narrowed by about 25 bp and finished the quarter around 300 bp over Treasuries for DRD-eligible preferreds and around 335 bp over Treasuries for institutional capital securities (Figure 16). Prices of preferreds rallied. Although preferred spreads are much narrower than at the height of the financial crisis, they remain at or above the high end of their pre-crisis historical ranges.

Fundamentally, credit quality is improving. Corporate profitability is up sharply, not just in percentage terms relative to weak comparable periods last year, but relative to GDP as well (Figure 17). In addition, a healthy portion of these profits are being retained by companies to improve their balance sheets. Interest expense relative to earnings before interest and taxes (EBIT) is falling, corporate liquidity is strong, and long-term debt as a percentage of total debt remains at an all-time high (Figure 18)

Figure 15: Corporate Spreads…

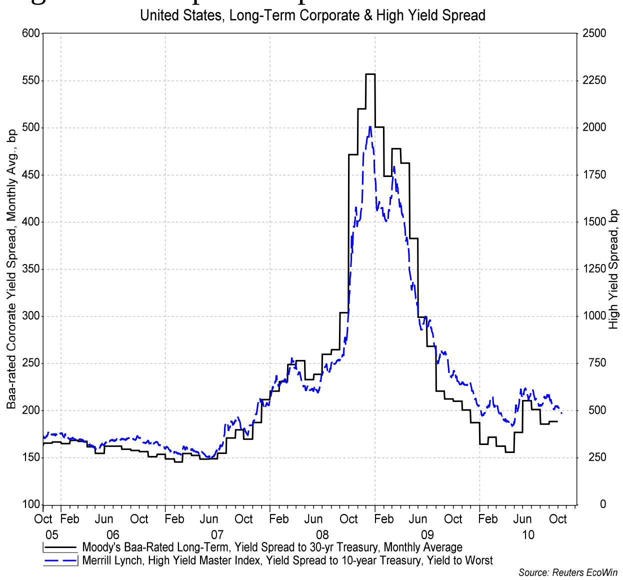


Figure 16: … and Preferred Spreads Narrower

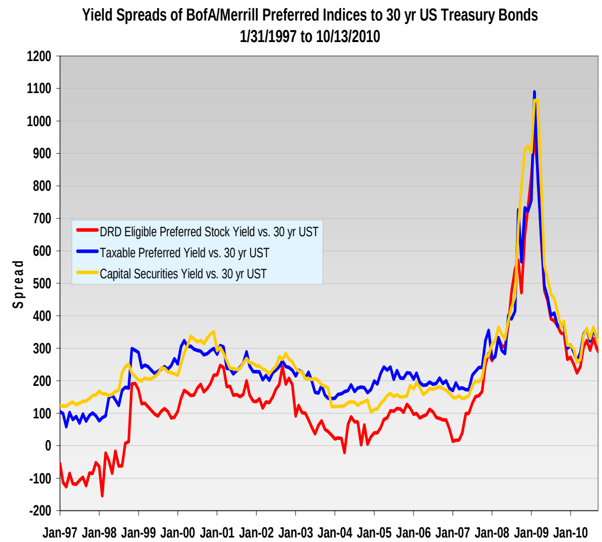


Figure 17: Corporate Profits Surging

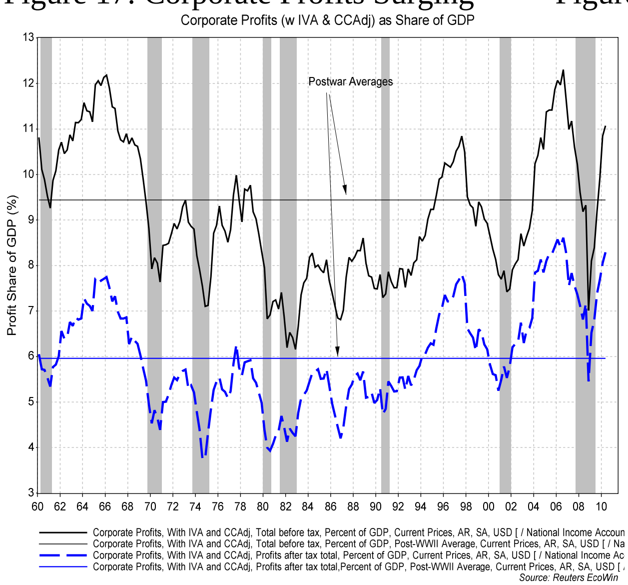
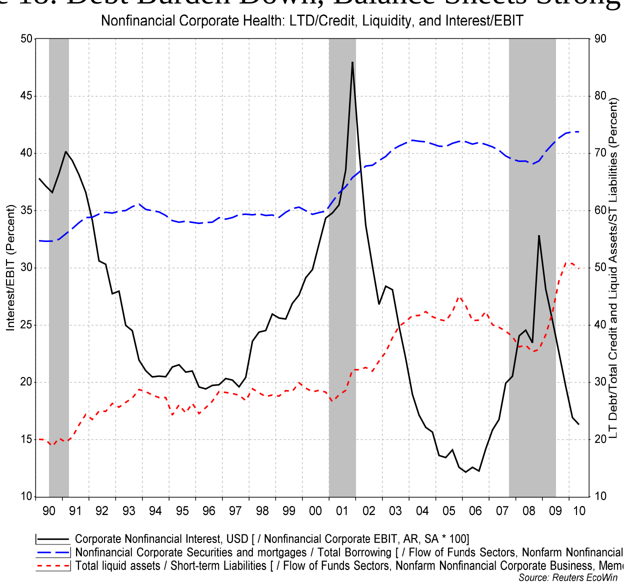


Figure 18: Debt Burden Down, Balance Sheets Strong



At the same time, underlying **credit quality** on loans is improving. Mortgage delinquencies and foreclosures – while still extremely high – have started to decline (Figure 19). Although at least part of the decline in foreclosures is due to documentation problems in the foreclosure process, the drop in mortgage delinquencies is probably "real." Lower delinquencies have been a result of the stabilization in home prices and stronger (if still unimpressive) job formation. Looking ahead, we think home prices could come under some renewed downward pressure (bad for delinquencies), but moderate job growth should continue and eventually accelerate (good for delinquencies). Given that many (most?) of the really bad mortgage loans are already delinquent or defaulted, we think that delinquencies should continue to trend down. That's good news for banks and for the economy in general.

We see the same pattern of fewer loan problems in commercial and industrial loans and (more tentatively) in commercial real estate loans (Figure 20). Delinquencies have dropped sharply for commercial and industrial loans, and they are holding about steady at a high but not record level for commercial real estate loans. Charge-off rates have declined for both categories of loans. However, with delinquencies running well above charge-offs for commercial real estate loans, we suspect charge-offs will turn up again in that category before long. Nonetheless, better loan performance across almost all bank lending categories is visible today. That is leading to reduced provisioning for loan losses and stronger earnings at banks. Combined with low dividend payouts and limited share repurchases, banks are rebuilding common equity capital rapidly, which benefits investors in preferreds.

Figure 19: Mortgage Delinquencies and Foreclosures High but Declining

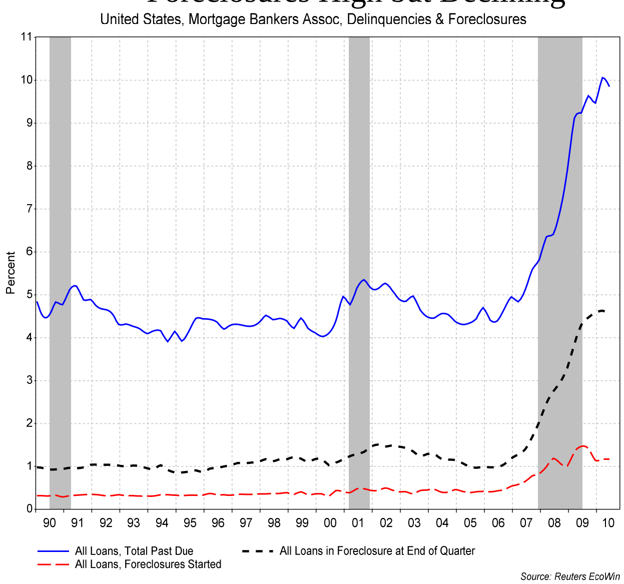


Figure 20: Commercial Loan Problems Gradually Easing

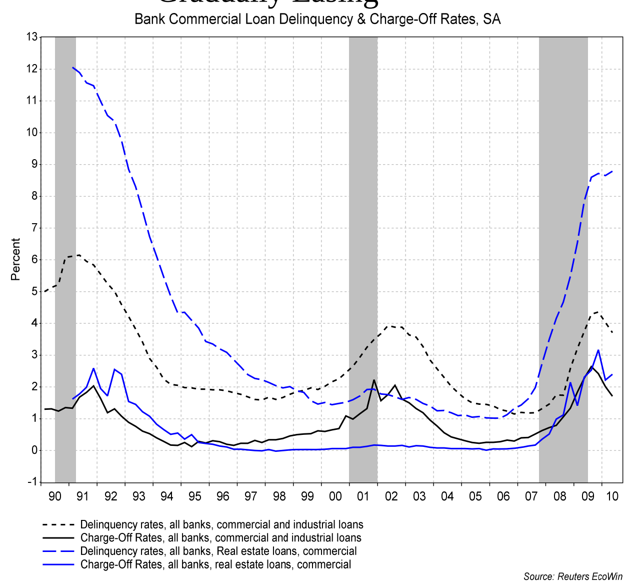


Figure 21: Lending Standards Easier

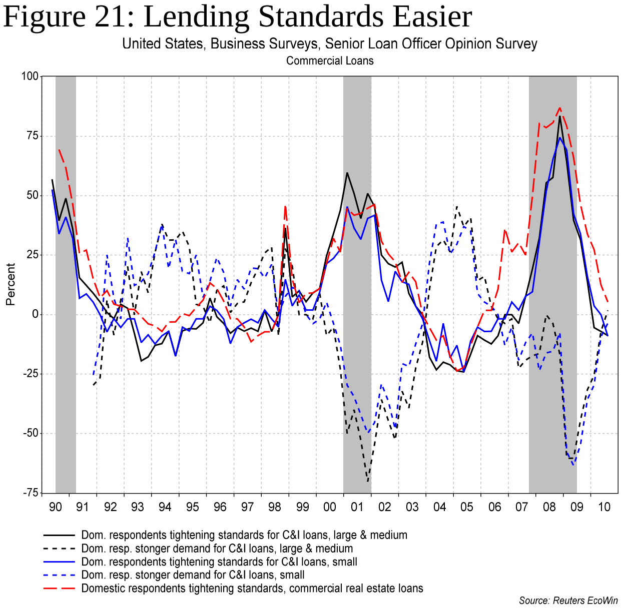
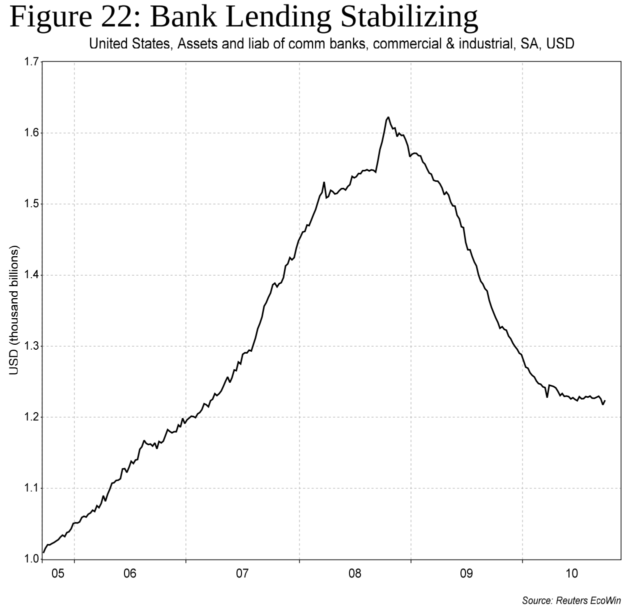


Figure 22: Bank Lending Stabilizing



As credit quality has improved and the economic recovery continues, banks generally have stopped tightening lending standards and have even eased them in some areas (Figure 21). That is not to say that lending standards are easy – they remain tight by historical standards – but they have eased enough and the economy has improved enough for loan demand to move upward. That has lead to some stabilization in total bank lending over the past couple of quarters (Figure 22). Of course, lending is not yet growing, but we think it will over the next quarter or two. That would be a healthy sign for both the economy and bank profitability.

There were a number of important developments in **financial regulation** over the summer. Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) in July and international bank regulators agreed on new bank capital standards (Basel III) in September. We have written extensively on these developments elsewhere, so we will not go through them in detail here.[4] We will only summarize their likely impact on preferred securities. In short, we think (1) banks will take less risk than they have historically and (2) they will hold more capital and higher quality capital to support the risks they do take. This significantly enhances the credit quality of preferred securities.

The new rules also will usher in substantial changes to the preferred market. Most bank trust preferred securities (TruPS) will no longer fully qualify as Tier 1 capital in the U.S. after January 1, 2013. We anticipate that most, but not all, U.S bank TruPS will be called by their issuers at some point during their three-year phase-out period from 2013-2016. It is not yet clear what new form of preferred will emerge to replace TruPS. Regulators are still writing rules required by Dodd-Frank and negotiating the Basel III framework with their international counterparts. It seems fairly clear that traditional preferred stock with non-cumulative dividends and perpetual (i.e., no) maturity will qualify as Tier 1 capital, although it may require "loss absorbency" language to do so.

We think existing preferred issues will benefit not only from the improved credit environment but also from a lack of issuance. Banks – which are the largest issuers in the preferred market – should remain absent from the new issue market until new rules on capital are written. That is going to be an extended process.

With all of these changes afoot, we do not know exactly what the bank preferred market will look like in the future. However, we believe the preferred market will live on. Preferreds have been an important component of regulatory capital at banks, insurance companies, utilities and others for more than a century. They provide a vital and diversified source of capital to issuers and attractive income to investors. Moreover, regulators have carved out a place in the capital structure for preferreds. These developments have created some uncertainty and probably some anxiety in the preferred securities market. We expect that the next several years will offer numerous challenges and opportunities for preferred investors.

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[4] See *Preferred Market Update*, August 27, 2010 at www.preferredincome.com or www.fcclaymore.com and our comment on the Basel Committee's loss absorbency proposal at http://www.bis.org/publ/bcbs174/fac.pdf.