

Fourth-Quarter U.S. Economic Update January 2012

Summary of Recent Economic and Market Developments

Economic growth in the U.S. improved in the fourth quarter after a weak start to the year. Real GDP is expected to grow by 2.9% in Q4, 1.6% for 2011 overall, and 2.7% in 2012. The labor market continues to improve tentatively, with job growth fast enough to push down the unemployment rate but not (yet) fast enough to push up wages. Personal income growth remains tepid as a result. Personal consumption accelerated in Q4 and should show further improvement in 2012, but continued deleveraging by consumers should keep those gains modest. Home prices finally may be close to stabilizing. Business investment may slow but should remain a source of strength for the economy. Foreign trade had a positive impact on growth in 2011, but it is likely to be a small negative in 2012. Real government spending fell in 2011, and it is likely to be a small drag on GDP growth in 2012. Inflation accelerated in 2011 but finished the year on a softer note, which should continue into 2012. Monetary policy held steady, Treasury rates were little changed, and credit spreads were stable to narrower in Q4. Credit quality continues to improve. Although many risks are visible on the horizon, we think moderate growth, low inflation, and an improving credit environment will benefit preferred securities over time.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	2010:1	2010:2	2010:3	2010:4	2011:1	2011:2	2011:3	2011:4
Real GDP, Chg QoQ (% , SA, AR)	3.9	3.8	2.5	2.3	0.4	1.3	1.8	2.9f
Real Personal Consump Expend, Chg QoQ (% , SA, AR)	2.7	2.9	2.6	3.6	2.1	0.7	1.7	2.3a
Real Busi Investmt, Eqp & Sftware, Chg QoQ (% , SA, AR)	21.7	23.2	14.1	8.1	8.7	6.2	16.2	NA
Real Residential Investmt, Chg QoQ (% , SA, AR)	-15.3	22.8	-27.7	2.5	-2.4	4.2	1.3	NA
Corporate Profits, After Tax, Chg YoY (% , SA, AR)	36.0	36.2	23.3	17.4	10.6	9.4	11.1	8.4f
Current Account Balance, Annualized (% of GDP, SA)	-3.3	-3.3	-3.3	-3.0	-3.2	-3.3	-2.9	NA
Federal Budget, 12-mo Def or Surp (% of GDP)	-9.5	-9.2	-8.9	-8.6	-9.5	-8.4	-8.5	NA
Unemployment Rate (% , SA)	9.8	9.4	9.5	9.4	8.9	9.1	9.0	8.5
Household Employment, Chg QoQ (000, SA)	868	301	207	-124	544	-379	722	683
Nonfarm Payrolls, Chg QoQ (000, SA)	118	543	-137	416	497	290	441	412
Nonfarm Productivity, Chg QoQ (% , SA, AR)	4.6	1.2	2.1	2.2	-0.6	-0.1	2.3	NA
Capacity Utilization (% , SA)	72.8	74.5	75.7	76.8	77.0	76.7	77.6	77.8a
GDP Price Index, Chg QoQ (% , SA, AR)	1.5	1.5	1.4	1.9	2.5	2.5	2.6	NA
Consumer Price Index, Chg YoY (% , AR)	2.3	1.1	1.1	1.5	2.7	3.6	3.9	3.4a
CPI ex food & energy, Chg YoY (% , AR)	1.1	0.9	0.8	0.8	1.2	1.6	2.0	2.2a
Nominal Personal Income, Chg YoY (% , AR)	2.6	3.9	4.9	5.1	5.9	4.9	4.1	3.9a
Personal Savings Rate (% , SA)	4.8	5.8	5.4	5.2	4.9	5.0	3.5	3.5a
Rate or Spread (End of Quarter)	2010:1	2010:2	2010:3	2010:4	2011:1	2011:2	2011:3	2011:4
Federal Funds Rate Target (%)	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3-month LIBOR (%)	0.29	0.53	0.29	0.30	0.30	0.25	0.37	0.58
10-Yr Treasury Note Yield (%)	3.83	2.93	2.51	3.29	3.47	3.16	1.92	1.88
30-Yr Treasury Bond Yield (%)	4.71	3.89	3.69	4.34	4.51	4.38	2.91	2.89
Moody's Baa Long Corp Spread (bp)	160	216	189	164	154	152	231	227
10-Yr Interest Rate Swap Spread (bp)	-2	7	6	9	11	12	19	17

* Figures are either quarterly or, if more frequent, end of period.

f = Forecast¹; a = Actual through November 2011 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 appears to have gained a bit more momentum in the fourth quarter of 2011 after nearly stalling in the first half of the year from the combined effects of higher oil prices and supply chain disruptions caused by the tragic earthquake and tsunami in Japan. For Q4, economists expect inflation-adjusted gross domestic product (real GDP) to expand by 2.9%, lifting the pace of growth in 2011 overall to 1.6%.¹ Real GDP growth is expected to improve modestly to 2.7% in 2012. Although GDP growth in the mid- to high-2% range is hardly outstanding, it would be a good result in light of ongoing deleveraging at home and sovereign debt woes in Europe. Perhaps even more importantly for preferred investors, recession risks in the U.S. appear to be receding, as we believe the following pages will demonstrate.

Figure 2: Job Market Slowly Improving

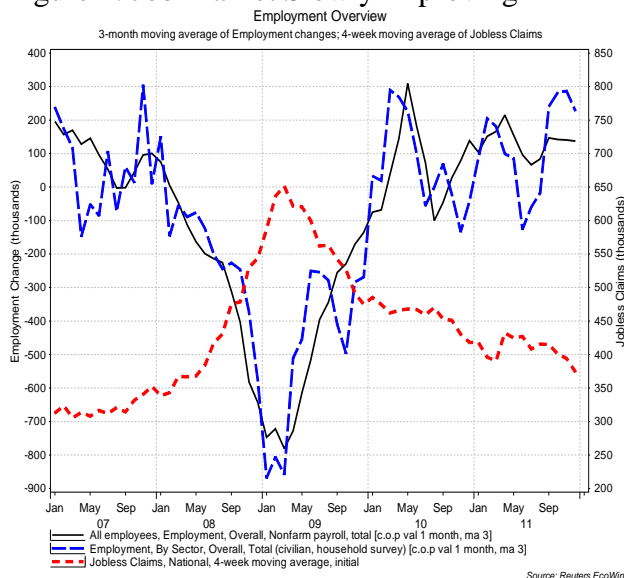
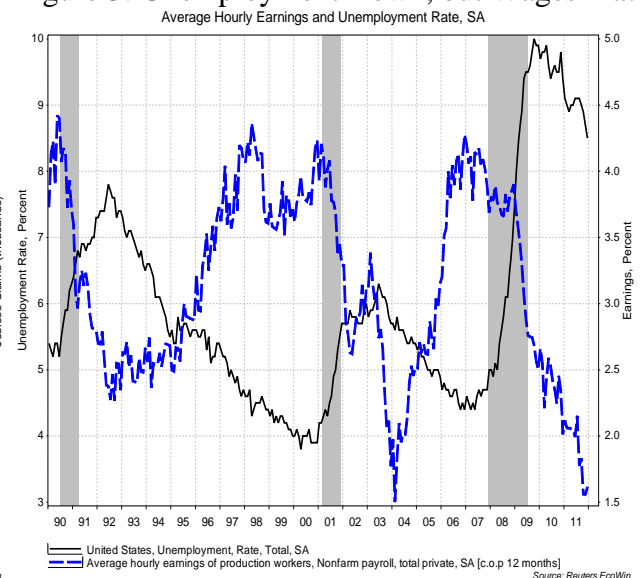


Figure 3: Unemployment Down, but Wages Flat



The **labor market** recovered from its second quarter swoon and turned in a decent, though not spectacular, performance in Q4. Jobless claims have continued to trend gradually lower, indicating a slower pace of job losses (Figure 2). More importantly, nonfarm payroll jobs grew by 412,000 during the quarter, and private payrolls (excluding government employment) expanded by 466,000 jobs. The household employment survey showed even larger gains of 683,000 jobs, which pushed the unemployment rate down to 8.5% from 9.0% at the end of Q3 (Figure 3). Although we do not expect that the unemployment rate will drop by ½ percentage point per quarter throughout 2012, it should continue to decline.

While the job market is improving, wage growth remains subdued given still-high unemployment (Figure 3). This is a good-news, bad-news story for **personal income**. More jobs and rising hours are giving a boost to personal income. However, slow wage growth – average hourly earnings for all wage earners were up just 2.1% in 2011 – is keeping a lid on how quickly incomes are increasing. Nominal personal income was up at just a 1.6% pace over the three months ending in November, compared to 3.9% YoY (Figure 4). The strong job growth recently reported for December should push income growth up a bit, but probably not dramatically.

¹ Forecasts from *The Livingston Survey*, Federal Reserve Bank of Philadelphia, December 8, 2011.

Figure 4: Consumption Outpacing Income

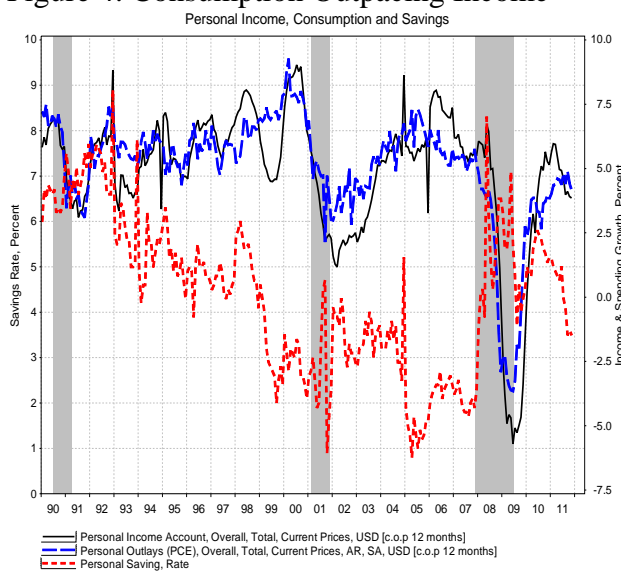
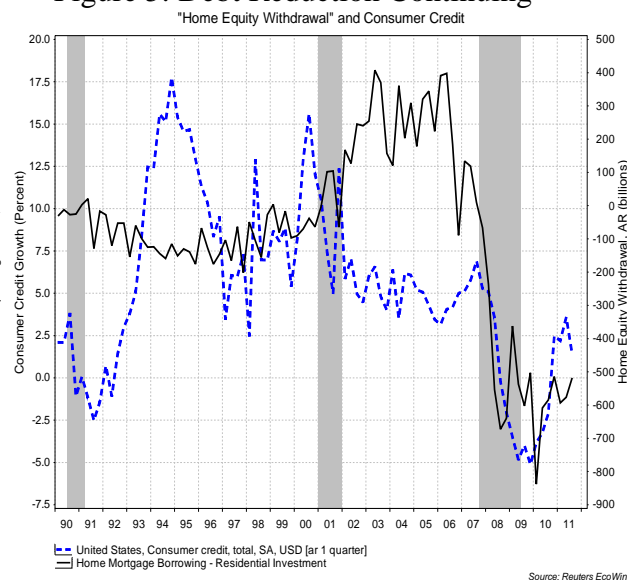


Figure 5: Debt Reduction Continuing



Subdued growth in personal income is one of the things constraining consumption. Nominal **personal consumption** expenditures (PCE) were up at a 4.8% pace in the three months ending in November and 4.3% YoY (Figure 4). Adjusted for inflation, real PCE was 3.5% and 2.3%, respectively. Although personal consumption growth remains modest overall, it still is growing a little faster than income. That has pushed the personal **savings rate** down to just 3.5%.

As regular readers know, we expected the personal savings rate to trend up, not down, in 2011 as households sought to reduce debt and rebuild savings drawn down during the recession. This seemed particularly likely with improvement in the job market. It has not happened, at least not according to the official statistics. Nonetheless, households have continued to pay down mortgage debt at a very rapid pace, and consumer credit – while no longer shrinking – is growing only slowly (Figure 5). This makes us think that income data may be revised up in the coming months, boosting the savings rate. It seems incongruous that income growth has slowed while the labor market has picked up. We suspect that the savings rate has not fallen quite as much as the current data indicate.

Why does the savings rate matter? Because households need to deleverage their balance sheets and increase savings further. As that happens, consumption growth will trail income growth. If the savings rate really is 3.5%, it has further to rise than if it's really at, say, 5% – meaning that future GDP growth is likely to be slower in the former case than in the latter one. Put simply, consumption and GDP growth are at greater risk if the savings rate is low than if it is high, as we saw in the last recession. For now, we view the low savings rate with some skepticism, but it is a risk factor for the economic outlook and something we will keep an eye on in 2012.

The **housing market** remains stuck in a narrow range, with new and existing home sales currently running at a 4.7 million unit pace² (Figure 6). Nonetheless, the inventory of unsold

² In December 2011, existing home sales data were revised all the way back to 2007. The new numbers show that the housing slump was even worse than originally reported, and the current pace of sales is roughly 700,000 lower as well. More positively, the inventory of unsold homes was revised down by almost 600,000. Looking ahead, we think the smaller supply overhang is more important than the slower pace of sales.

homes continues to fall, and it is now close to its normal range before the housing bubble. Although there is still significant supply that is not reflected in the inventory statistics (particularly homes in the process of foreclosure and homes being held off the market waiting for better times), this smaller overhang of unsold homes has contributed to better home price performance recently. The S&P/Case-Shiller Home Price Index was down only 3.4% YoY in October (the latest data available), compared to -4.5% YoY in May. The Federal Housing Finance Authority (FHFA) Home Purchase Index tells a similar story (Figure 7). Home prices finally may be close to stabilizing.

This is good news not only for homeowners but also for preferred investors. Many banks hold large home mortgage portfolios, and better home price performance should translate into better portfolio performance. As we have indicated before, one of the risks to the economic and preferred market outlook is a renewed housing market decline. That risk – while not eliminated – appears to be diminishing.

Figure 6: Housing Slow but Improving

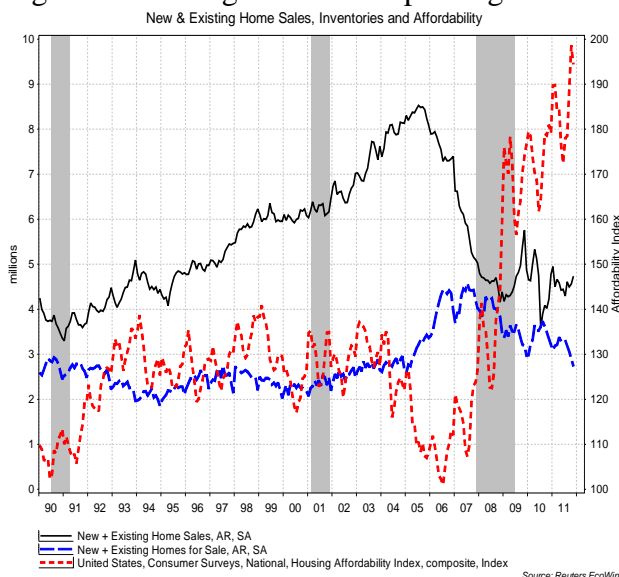
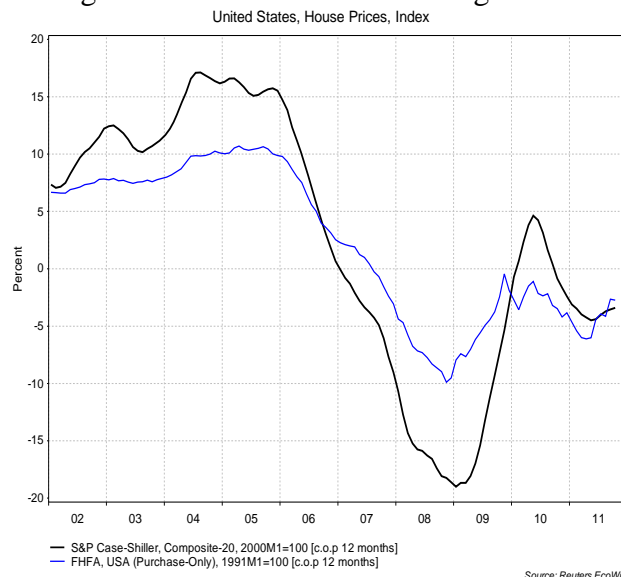


Figure 7: Home Prices Stabilizing?



Business investment rebounded in the third quarter as supply chain disruptions following the Japanese earthquake and tsunami eased (Figure 8). Looking ahead, however, the growth rate of real business investment is likely to slow somewhat, as it recently has outpaced the rise in capacity utilization. This slowdown is visible in the dip in real core capital goods orders and shipments (nondefense capital goods excluding aircraft) in Q4 (Figure 9). Given businesses’ drive to improve productivity, we still expect business investment to grow in the 5-10% range. However, some slowdown from the 16.2% growth rate in the third quarter appears very likely.

Similarly, **industrial production** recovered in the third quarter as supply chain problems eased, but it has moderated a bit since then, with both overall production and manufacturing excluding vehicles production up about 3.7% over the three months ending in November (Figure 10). These growth rates are roughly consistent with current readings from the ISM manufacturing survey. With exports to Europe likely to slow in 2012 – due to both weaker European growth and a stronger U.S. dollar – and other regions unlikely to pick up all of that slack, we expect that industrial production growth this year will remain modest.

Figure 8: Business Investment May Slow

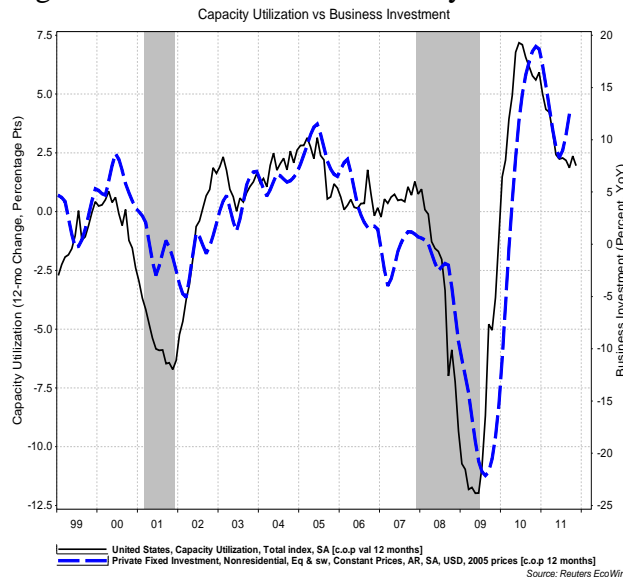


Figure 9: Capital Goods Orders Ease

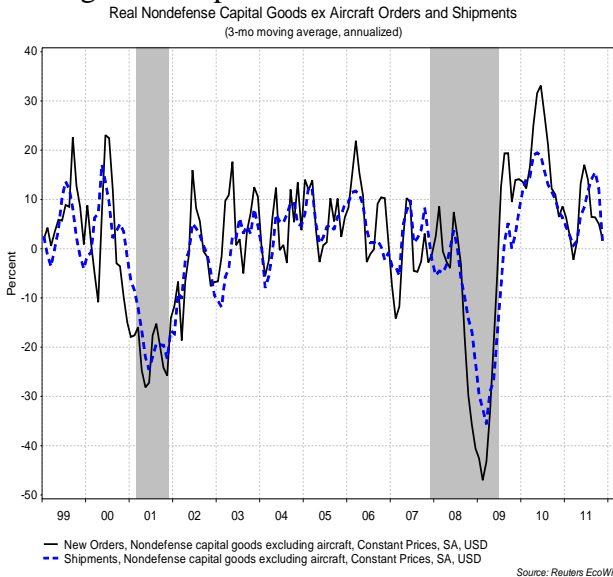


Figure 10: US Industrial Production Moderate

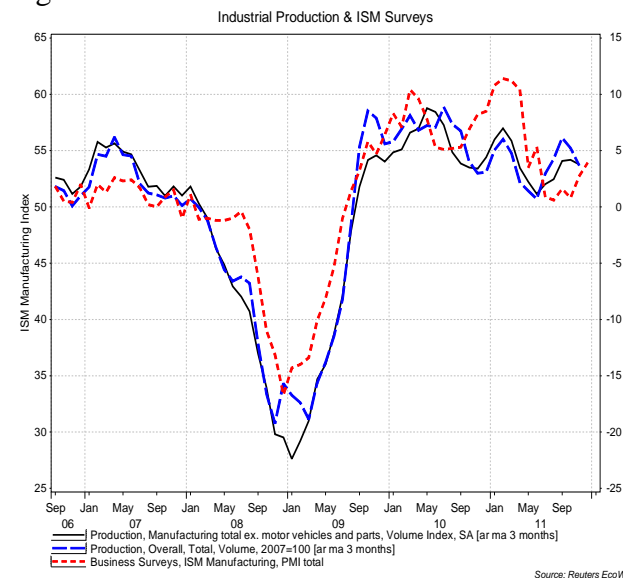
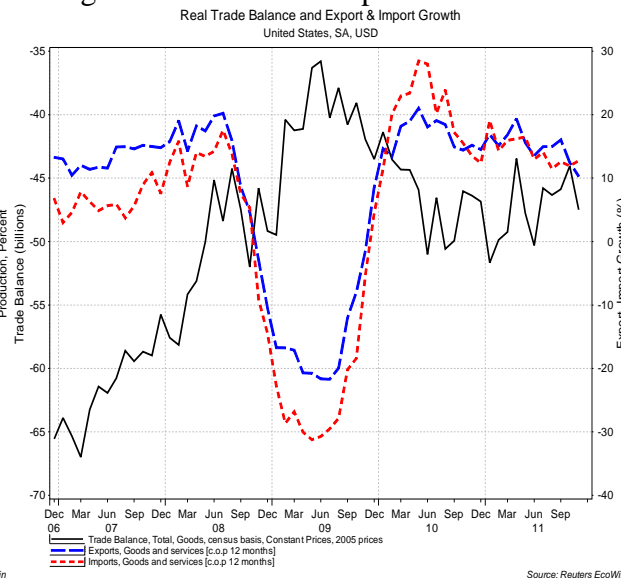


Figure 11: Little Net Improvement in Trade



The real **trade deficit**, which narrowed during the recession and widened in the early stages of the U.S. economic recovery, has moved mostly sideways – with perhaps a slightly improving trend – over the past 18 months (Figure 11). For Q4 as well, it appears that trade will neither add to nor subtract from GDP growth. Looking ahead, the relative growth outlook among U.S. trading partners remains mixed but suggests downside risk to GDP growth from net exports. Growth in the U.S. should be modest; Japan is facing weak growth; Europe is on the edge of recession; and non-Japan Asia and most emerging market economies still look reasonably strong, though slower growth in their key export markets raise growth risks there too. At the same time, U.S. financial assets are likely to continue to benefit from strong foreign demand while the European sovereign debt crisis plays out. If investment flows drive the U.S. current account balance into deeper deficit, then the trade deficit should widen as well. As a result, we think trade will probably be a modest negative for GDP growth in 2012.

Government consumption probably will be a small drag on GDP growth in 2012. Overall real government consumption fell by just 0.1% in Q3 after averaging -3.4% in the first half of 2011. State and local government spending is likely to continue to shrink, though the pace of contraction should slow over the course of 2012, as it did in 2011. State and local governments cut spending much more rapidly than the federal government, and most of those cuts are now behind us. In contrast, real federal government spending is poised for larger cuts. Real federal spending should hold about steady in 2012, but it is slated to fall in 2013 and beyond. Lawmakers were unable to agree on the deficit reduction required by the debt ceiling agreement reached in August 2011. As a result, across-the-board spending cuts will begin in January 2013 – although Congress could reach a new compromise prior to that date. On balance, we do not think government spending will play a major role in the pace of GDP growth this year, but the election is likely to determine the trajectory of government spending thereafter. Figure 12 shows the federal and state and local government shares of GDP for the last 50 years. Readers can make their own judgments about where they would like to see those shares head in the future.

Figure 12: Government Share of GDP

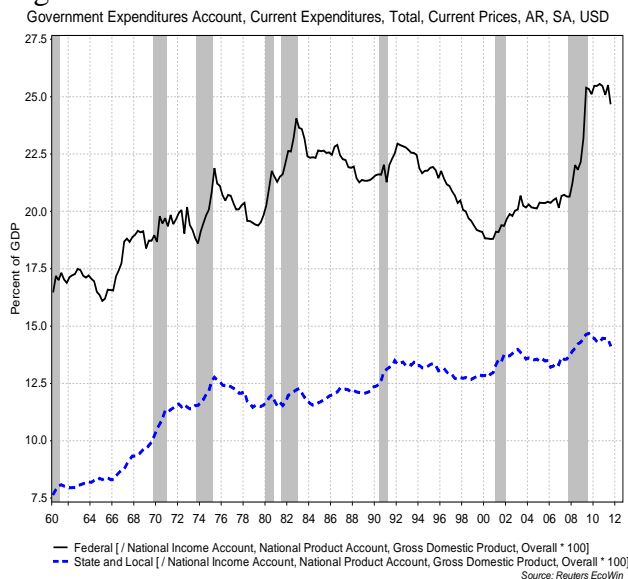
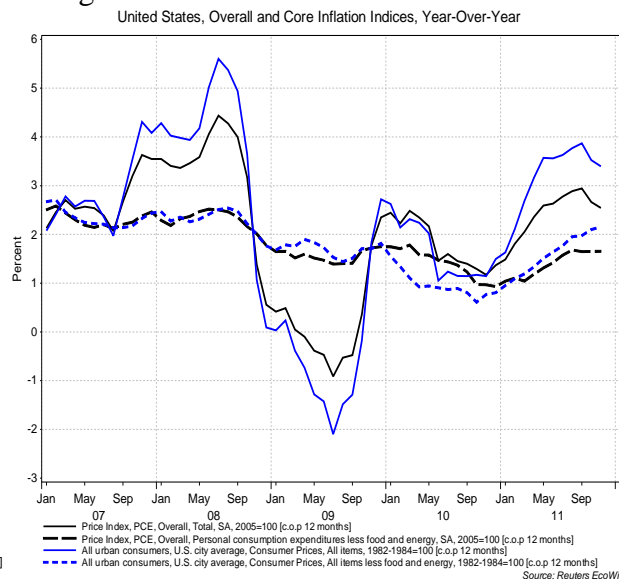


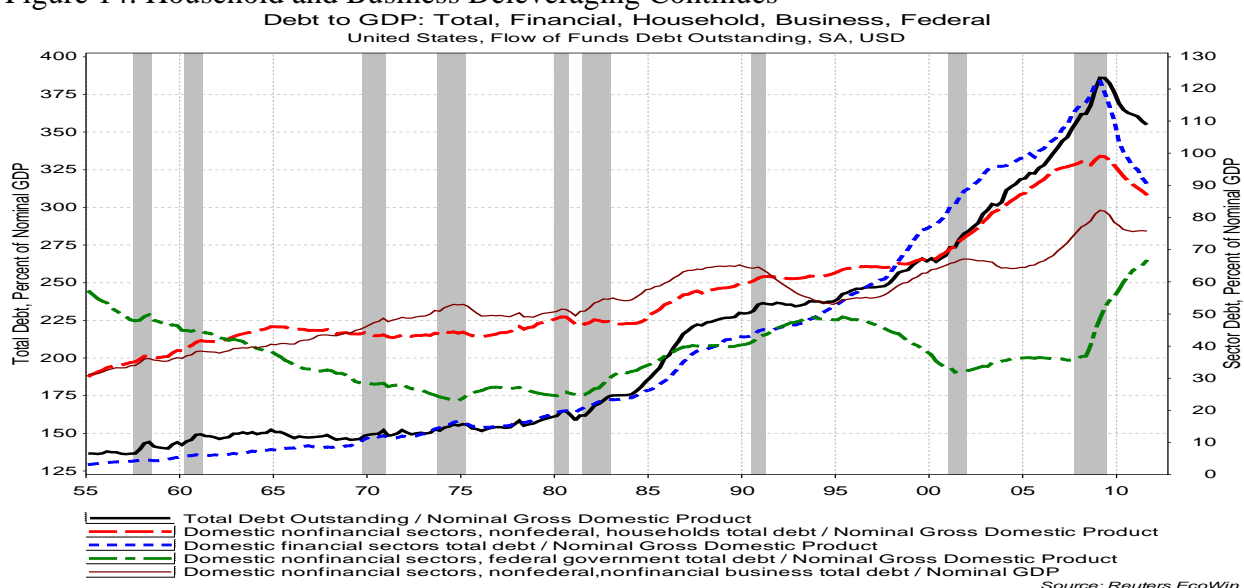
Figure 13: Inflation Pressures Ease



Inflation pressures have eased somewhat on lower food and energy prices, although overall inflation remains above the Federal Reserve’s implicit long-term target of about 2%. The overall consumer price index (CPI) is up 3.4% YoY and the PCE deflator is up 2.5% YoY. Core inflation (excluding food and energy prices) is considerably lower, with core CPI up 2.2% YoY and the core PCE deflator up 1.7% YoY. We expect inflation to remain subdued for two main reasons. First, GDP growth is unlikely to be fast enough (over 3% on a sustained basis) to quickly absorb excess capacity, which could allow businesses to push through higher prices. Second, with households still deleveraging and businesses borrowing only cautiously, monetary velocity is likely to remain low. Until those conditions change, we do not think inflation can gain a strong foothold. As we have said previously, we recognize that the Federal Reserve probably will be late in exiting its current highly accommodative monetary policy and that higher inflation will be the likely result. However, we think that point is not imminent – certainly not in 2012. In the meantime, core inflation should remain subdued.

The **balance sheet trends** that we have described in prior Updates remain intact (Figure 14). Debt-to-GDP continues to fall in the economy overall, led by households and financial businesses. Federal government debt continues to increase rapidly, although the pace of increase has moderated somewhat. As the U.S. economic outlook has improved and balance sheets have strengthened, nonfinancial business debt-to-GDP has flattened out. As the recovery progresses and businesses increasingly see expansion opportunities, we expect to see business borrowing start to replace government borrowing. Financial leverage should continue to fall on tighter regulatory oversight and higher capital requirements. Household borrowing should also diminish on both limited access to mortgage credit and rising personal savings. Economic growth is likely to remain subdued while these debt levels are being reduced, a process that is far from complete.

Figure 14: Household and Business Deleveraging Continues



Before moving on to the Market Outlook, we will offer a brief update on the European economic outlook. In a nutshell, Europe is on the brink of recession currently, and growth is likely to remain precarious in 2012. The sovereign debt crisis has spread from Greece, Ireland and Portugal to Italy and Spain, which are much larger economies. All five of these countries are in or near recession, and even Germany saw its economy contract in the fourth quarter (although it posted respectable growth of 3% for 2011 as a whole). Spain and Italy already have made sizable cuts to their budget deficits, though more may be necessary if economic growth slows.

Although the situation in Europe is serious, we are now more optimistic that European Monetary Union (EMU) countries are moving both to bring their budgets under control and to enact structural reforms to enable improved economic growth in the future. We have seen meaningful budget cuts, wage reductions, and labor market reforms in the affected countries. These measures will take time to have an impact, and markets are impatient. Indeed, Standard & Poor’s today downgraded the ratings of nine Eurozone sovereigns. However, there is no magic bullet that politicians or monetary authorities can use to defuse the crisis rapidly. While markets are disappointed that authorities have not *solved* the European sovereign debt crisis, we see substantial *progress* toward a solution. It took longer than it should have taken, but policies to respond to the crisis are improving. We are cautiously optimistic that Spain, Italy, and perhaps Ireland and Portugal (Greece is too far gone) will return their public sector debts to a sustainable

path without a need to restructure their debts. This should both support the banking system and allow Europe to avoid a breakup of the Euro, with all of the economic and financial turmoil that would accompany it. Without question, the European sovereign debt crisis is the biggest risk factor facing financial markets currently, and it is something we will continue to monitor and evaluate over the course of 2012.

Market Outlook

Long-term **Treasury rates** held about steady in the fourth quarter as continued worries over Europe offset better economic performance in the U.S. (Figure 15). The thirty-year benchmark Treasury yield dropped by 2 basis points (bp) to end the quarter at 2.89%, though it has risen slightly to 2.95% currently. This is still about 140 bp lower than the 30-year yield at the beginning of 2011. The Federal Reserve left the federal funds target rate at 0.25%, where it has remained for more than three years.

Figure 15: Treasury Yields Down

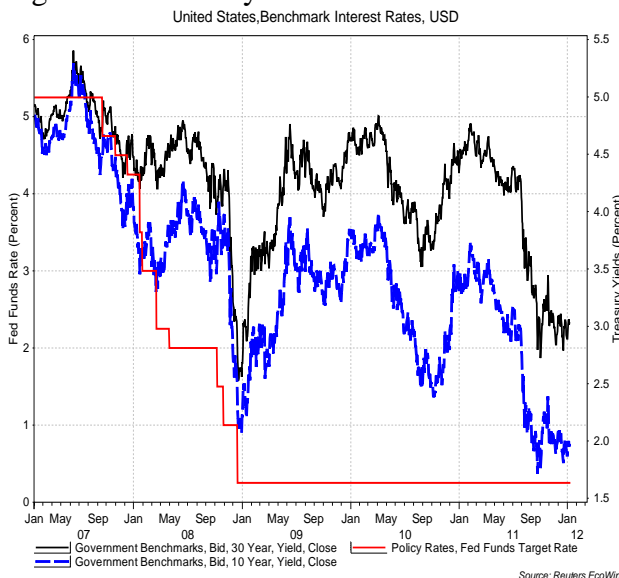
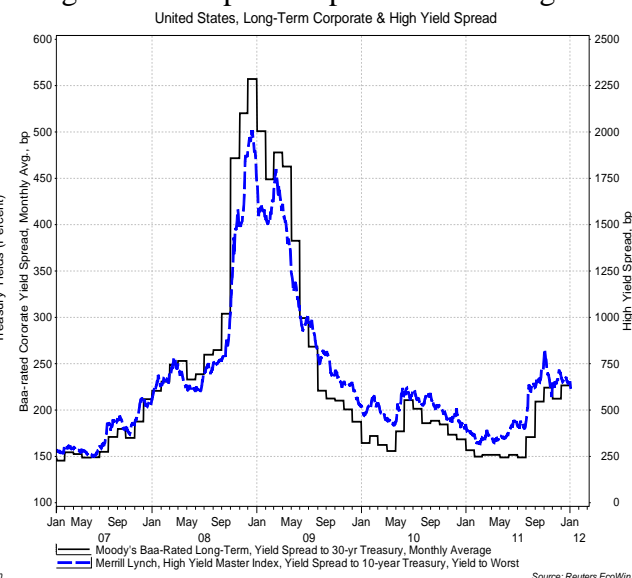


Figure 16: Corporate Spreads Flat to Tighter



The Federal Reserve made no significant changes in monetary policy. It continues to execute “Operation Twist,” selling a total of \$400 billion of 3-year and shorter Treasuries to buy a like amount of 6-year and longer Treasuries. The Fed expects to complete this program in June. It is also reinvesting principal proceeds from its agency debt and mortgage portfolios into new agency mortgage-backed securities. These actions are designed to keep long-term Treasury and mortgage rates low in order to stimulate borrowing and economic activity. Although it is unclear how much these policies are helping the economy, they are making money: the Fed posted net operating earnings of nearly \$77 billion in 2011, which it turned over to Treasury. It’s good to be the Fed!

Credit spreads were stable to tighter in the fourth quarter (Figure 16). Riskier fixed-income assets generally outperformed less-risky ones, a reversal from Q3. Long-term Baa-rated corporate bond spreads were about flat, narrowing by just 4 bp to 227 bp. High yield bond spreads, however, narrowed by 110 bp to 649 bp. Preferred securities’ prices were mostly but not uniformly higher, with prices of DRD-eligible preferred stock and capital securities up 1.6-2.0% and retail hybrid preferred prices 0.6% lower. This mostly positive credit performance was a

welcome respite after a very poor third quarter. Plenty of risks remain on the horizon, however. We expect credit spreads to remain volatile in 2012 but exhibit an overall narrowing bias as credit fundamentals gradually reassert themselves.

Figure 17: Record Corporate Profits

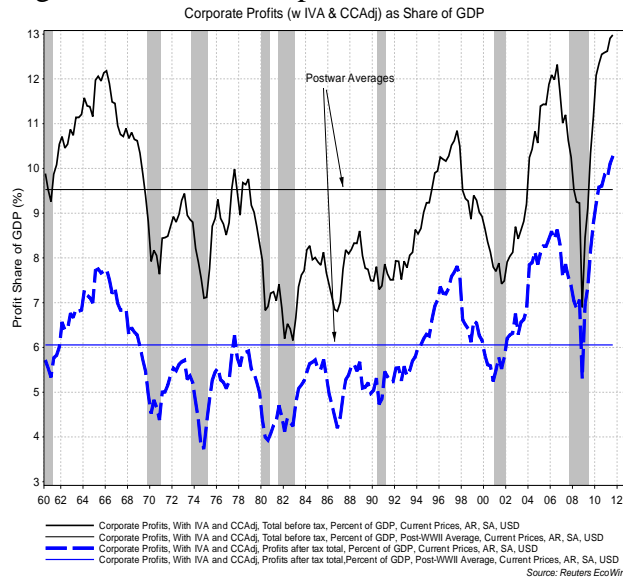


Figure 18: Low Debt, Strong Balance Sheets

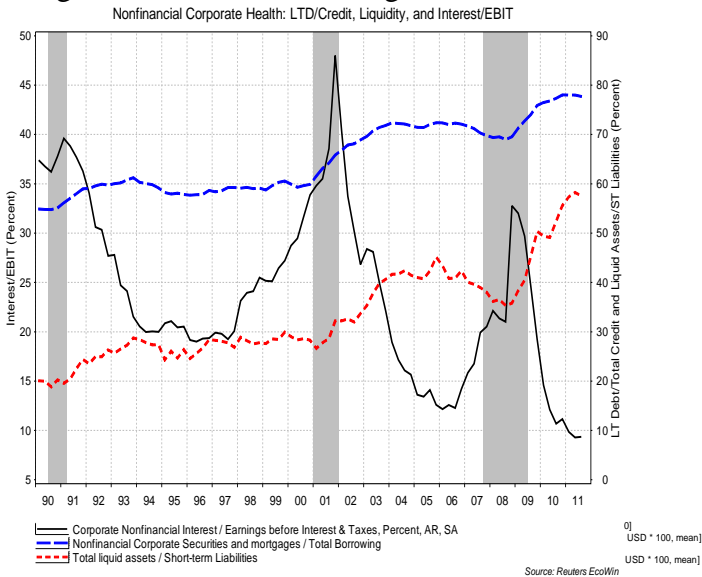


Figure 19: Commercial Loan Quality Improving

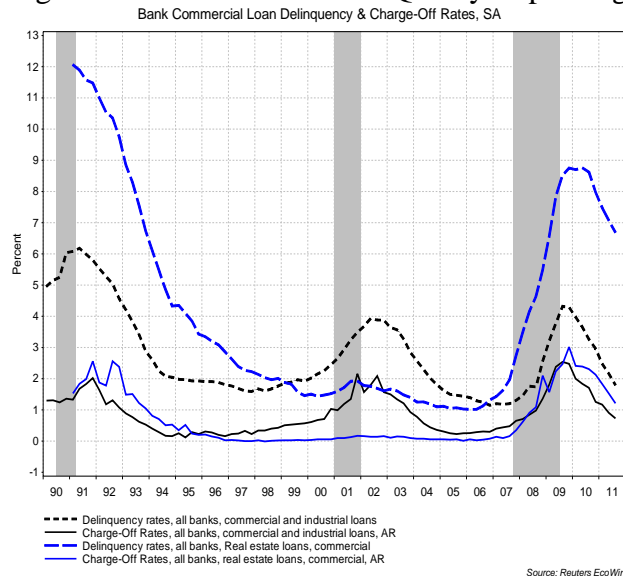
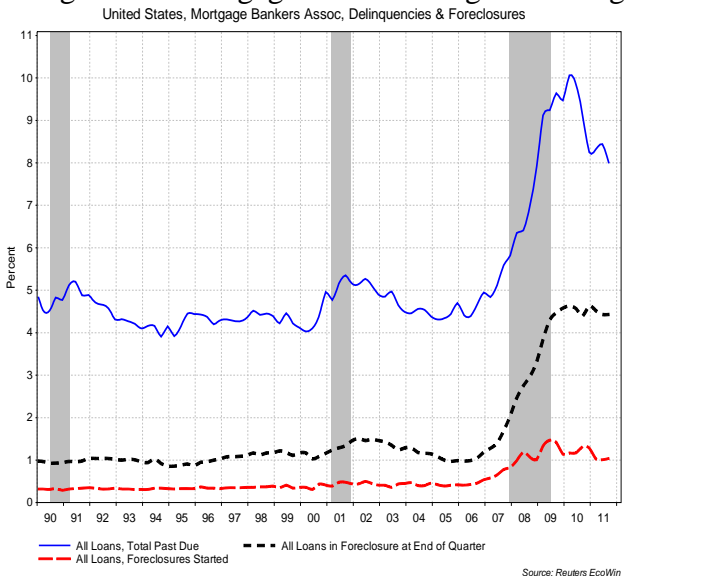


Figure 20: Mortgage Problems Big but Easing



The story on fundamental **credit quality** continues to improve. Corporate profits hit another new high in Q3 and should rise further in Q4 (Figure 17). Interest expense relative to earnings before interest and taxes is at a record low. Corporate liquidity and the proportion of long-term debt to total debt are at or near record highs; both reduce short-term funding risk (Figure 18). Commercial loan delinquencies and charge-offs are falling (Figure 19), and corporate bond default rates continue to drop. Mortgage loan delinquencies are falling, although foreclosures remain elevated (Figure 20). Business bankruptcy filings continue to drop. As we survey a broad range of credit statistics, nearly all of them are improving.

As credit fundamentals have improved, banks have both eased lending standards and increased lending modestly. Lending standards have loosened for larger commercial borrowers and even credit card borrowers, although mortgage lending standards have yet to ease materially (Figure 21). More importantly, bank lending has been rising since the middle of 2011 (Figure 22). Commercial and industrial (C&I) loans have shown the largest increase, but consumer lending is also edging higher, largely from automobile loans. This rebound in lending is modest to be sure, but it suggests that businesses and even consumers are feeling more secure, and maybe even a little bit optimistic. In addition, the rise in lending should help support banks' net interest margins, which have been under downward pressure since the recession due to slack loan demand. Of course, we have to watch out for any sharp acceleration in lending that might signal a bubble emerging somewhere in the economy or a buildup of inflationary pressures. For now, we are encouraged by this nascent recovery in lending.

Figure 21: Lending Standards Easing

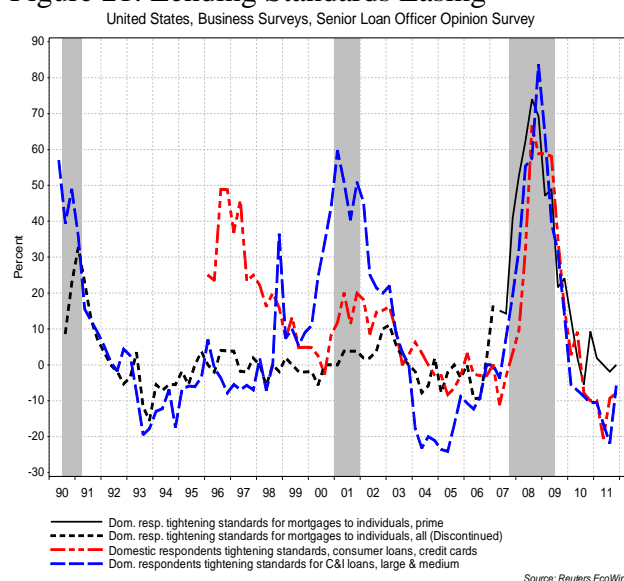
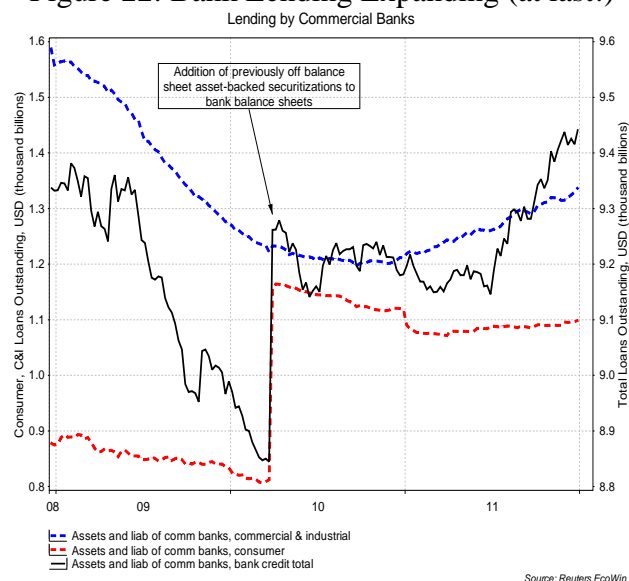


Figure 22: Bank Lending Expanding (at last!)



Moving from a macroeconomic perspective to a sector perspective, we see continued credit improvement in the major industry sectors relevant to the preferred market. As we have discussed, problem loans at banks are falling. Earnings at banks are likely to remain under some pressure given falling net interest margins, rising costs of regulatory compliance and, for some banks, mortgage-related litigation. However, we think this will be offset by greater balance sheet strength and more-focused, lower-risk business operations.

Insurance company credit fundamentals remain healthy and business volumes generally have remained good. Property and casualty companies have had to pay sizable claims on recent natural disasters, but their balance sheets are very strong and premiums are rising, which should allow them to recover losses relatively quickly. Life insurance companies are facing some earnings stress and balance-sheet volatility, but most have comfortable capital cushions and solid earnings streams that can weather those near-term headwinds.

Electric utilities demonstrate strong balance sheets and moderately rising earnings. As preferred investors, we are satisfied with strong fixed-charge coverage and 9-10% return on equity, which is what we see at a number of utilities. Other sectors, including real estate investment trusts,

pipeline, energy, and industrial companies show similar stable or improving credit profiles. Of course, we need to remain vigilant to emerging risks in all of these industries, but for now their credit trajectory is generally positive.

There are only a few new **regulatory developments** to report since our last Update. We are still waiting for final regulations from the Fed required by Dodd-Frank financial reform legislation. At this point, we have stopped trying to forecast when they will be released, but we trust that will happen before they go into effect on January 1, 2013! Until the regulations are finalized, we expect bank issuance of preferred securities to be light.

Electric utilities face new clean-air regulations over the next few years. The two most important are the Cross State Air Pollution rule (CSPAR), which regulates sulfur dioxide and nitrogen oxide, and the Mercury Air Toxic Standards (MATs), regulating mercury and hazardous air pollutants. CSPAR was to have taken effect on January 1, 2012, but it was stayed by a U.S. District Court. The issues should be remedied later this year. The MATs rule goes into effect on January 1, 2015. In both cases, utilities will need to upgrade or close facilities to meet the new rules. These regulations will result in considerable additional capital spending, but the amounts will be manageable and are not likely to change the credit profile of the industry materially.

Putting all of this together, we foresee moderate economic expansion in the U.S., accommodative monetary policy and low interest rates, continued deleveraging by households and financial businesses, progress in but probably not total resolution of the European sovereign debt crisis, gradual improvement in credit fundamentals, and a reasonably constructive regulatory environment. We anticipate preferred securities will benefit over time from these positive developments.

As always, there is risk that events will play out differently than we currently foresee them. In fact, it is nearly certain that they will. However, we believe preferred valuations currently offer a meaningful margin of safety for adverse outcomes. Moreover, we are constantly evaluating the risks that confront our preferred holdings. As the world changes, so will we.

We wish you a healthy and prosperous 2012.

Flaherty & Crumrine Incorporated
January 13, 2012

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