First-Quarter U.S. Economic Update
April 2012

Summary of Recent Economic and Market Developments

The U.S. economy continues to grow at a moderate pace, restrained by deleveraging, high oil prices, the European sovereign debt crisis and slowing growth abroad. Following growth of 3.0% in the fourth quarter of 2011, economists expect real GDP to by grow 2.2% (or more) in Q1, 2.3% in 2012 as a whole, and 2.7% in 2013. The labor market strengthened considerably in the first quarter, although warmer than usual winter weather likely accounted for some of its good performance. Personal income and consumption growth have remained tepid – around 3% in nominal terms – as wages remain subdued and consumers spend cautiously. The housing market is on the mend, and home prices are likely to stabilize soon. Business investment and industrial production remain strong, although orders have slipped in the core capital goods segment. The trade deficit likely added to GDP growth in Q1, but should be a drag over the remainder of the year. Government consumption remains on a downward trend. Inflation pressures appear balanced, with most inflation indices near the Fed's 2% target. Deleveraging continues in the household and financial sectors, while federal government borrowing is expanding rapidly. Interest rates rose, credit spreads narrowed and preferred securities performed well in the first quarter. Credit fundamentals support further improvement in preferreds over the balance of the year, although the European crisis and other risks may make for a bumpy ride.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	2010:2	2010:3	2010:4	2011:1	2011:2	2011:3	2011:4	2012:1
Real GDP, Chg QoQ (%, SA, AR)	3.8	2.5	2.3	0.4	1.3	1.8	3.0	2.2f
Real Personal Consump Expnds, Chg QoQ (%, SA, AR)	2.9	2.6	3.6	2.1	0.7	1.7	2.1	2.3f
Real Busi Investmt, Eqp & Sftware, Chg QoQ (%, SA, AR)	23.2	14.1	8.1	8.7	6.2	16.2	7.5	NA
Real Residential Investmt, Chg QoQ (%, SA, AR)	22.8	-27.7	2.5	-2.4	4.2	1.3	11.6	6.0f
Corporate Profits, After Tax, Chg YoY (%, SA, AR)	36.2	23.3	17.4	10.6	9.4	11.1	8.5	9.6f
Current Account Balance, Annualized (% of GDP, SA)	-3.3	-3.3	-3.0	-3.2	-3.3	-2.8	-3.2	NA
Federal Budget, 12-mo Def or Surp (% of GDP)	-9.2	-8.9	-8.6	-9.5	-8.4	-8.5	-8.2	-8.1a
Unemployment Rate (%, SA)	9.4	9.5	9.4	8.9	9.1	9.0	8.5	8.2
Household Employment, Chg QoQ (000, SA)	301	207	-124	544	-379	722	683	1244
Nonfarm Payrolls, Chg QoQ (000, SA)	588	-136	461	576	389	383	492	635
Nonfarm Productivity, Chg QoQ (%, SA, AR)	1.2	1.8	1.8	-1.0	-0.3	1.8	0.9	NA
Capacity Utilization (%, SA)	73.9	75.2	76.0	76.5	76.3	77.2	78.1	78.4a
GDP Price Index, Chg QoQ (%, SA, AR)	1.5	1.4	1.9	2.5	2.5	2.6	0.9	1.6f
Consumer Price Index, Chg YoY (%, AR)	1.1	1.1	1.5	2.7	3.6	3.9	3.0	2.7
CPI ex food & energy, Chg YoY (%, AR)	0.9	0.8	0.8	1.2	1.6	2.0	2.2	2.3
Nominal Personal Income, Chg YoY (%, AR)	3.9	4.9	5.1	5.9	4.9	4.9	4.6	3.2a
Personal Savings Rate (%, SA)	5.8	5.4	5.2	4.9	5.0	4.3	4.7	3.7a
Rate or Spread (End of Quarter)	**2010:2**	**2010:3**	**2010:4**	**2011:1**	**2011:2**	**2011:3**	**2011:4**	**2012:1**
Federal Funds Rate Target (%)	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3-month LIBOR (%)	0.53	0.29	0.30	0.30	0.25	0.37	0.58	0.47
10-Yr Treasury Note Yield (%)	2.93	2.51	3.29	3.47	3.16	1.92	1.88	2.21
30-Yr Treasury Bond Yield (%)	3.89	3.69	4.34	4.51	4.38	2.91	2.89	3.34
Moody's Baa Long Corp Spread (bp)	216	189	164	154	152	231	227	196
10-Yr Interest Rate Swap Spread (bp)	7	6	9	11	12	19	17	8

* Figures are either quarterly or, if more frequent, end of period. f = Forecast[1]; a = Actual through February 2012 Source: Reuters EcoWin

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

Economic Outlook

We will keep this Outlook relatively brief, as our underlying view on U.S. economic growth has not changed materially in recent quarters. In a nutshell, growth is being restrained by household and financial deleveraging, elevated oil prices, and fiscal uncertainty domestically and by the European sovereign debt crisis and slowing growth abroad. At the same time, risks of recession and deflation have diminished. This moderate growth environment has allowed companies to boost earnings and strengthen their balance sheets, which contributed to good performance for preferred securities in the first quarter. Although we do not anticipate a repeat of Q1 price gains again soon, improving credit fundamentals and accommodative monetary policy should continue to support preferred securities' valuations.

The U.S. economy continues to grow at a tepid pace. Economists forecast inflation-adjusted U.S. **Gross Domestic Product** (real GDP) of 2.2% in Q1 (although warmer than normal winter weather may boost GDP above that level in Q1, with "payback" in Q2) and 2.3% in 2012 as a whole; growth is expected to improve slightly to 2.7% in 2013.[1] We continue to expect growth of about 2.5% both this year and next.

Figure 2: Employment Gradually Improving

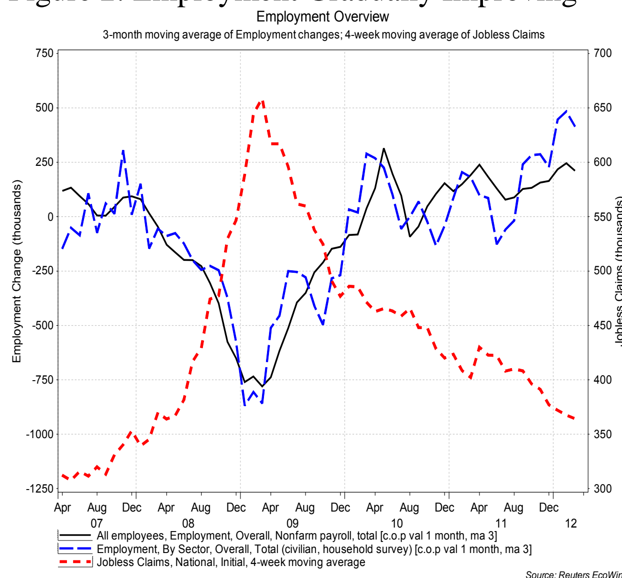
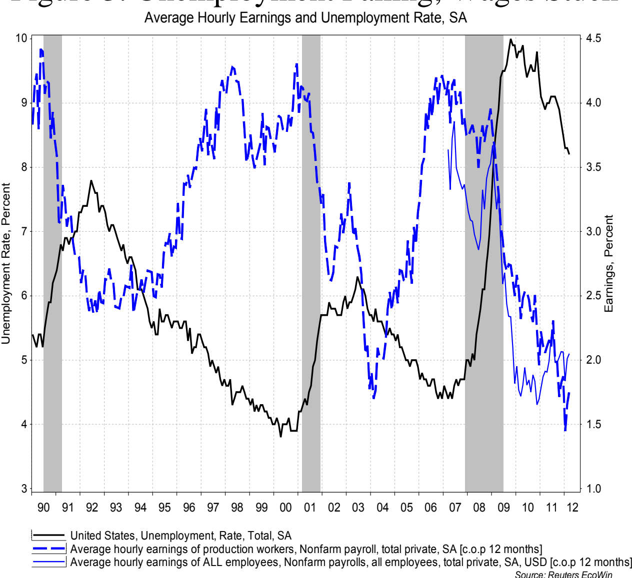


Figure 3: Unemployment Falling; Wages Stuck



Despite weaker than expected results in March, the **labor market** strengthened in the first quarter. Payroll employment rose by 635,000 jobs in Q1, compared to 492,000 in 2011Q4 (Figure 2). Employment as measured by the household survey increased by 1,244,000 in Q1, nearly double the Q4 pace. Jobless claims continued to trend down and are nearing pre-recession levels. The unemployment rate fell to 8.2%, the lowest since January 2009, although wage growth remains stuck around 2% (Figure 3). Unusually warm winter weather likely accounted for some, but not all, of the pickup in hiring. Whatever bump in jobs was caused by warm weather should reverse in the second quarter as temperatures normalize. As a result, slower employment gains in Q2 will not necessarily signal slower economic growth, while continued improvement should be a clear sign of faster growth. We will be watching the employment news closely.

[1] All growth rates are annualized unless noted otherwise. Forecasts in this Update are from *The Survey of Professional Forecasters*, Federal Reserve Bank of Philadelphia, February 10, 2012.

Although the job market is gradually improving, **personal income** growth has remained sluggish. Nominal personal income is up 3.2% over the 3-month period ending in February (the latest data available), little changed from prior months (Figure 4). Unemployment has not dropped by enough to put upward pressure on wages (see Figure 3), and it is not clear that even a further 1% drop in the unemployment rate would do much to push wages up. If so, income growth will continue to depend mainly upon employment gains. We expect job growth will accelerate, but it likely will be a gradual process. Income growth should remain restrained in the meantime.

Figure 4: Income Growth Restrained

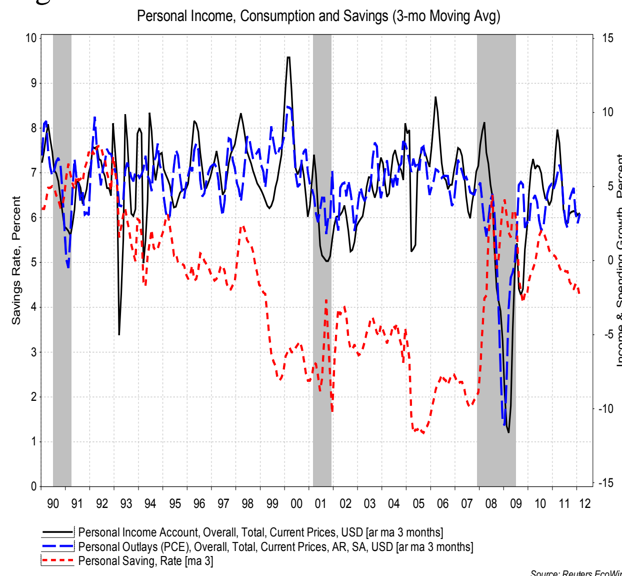
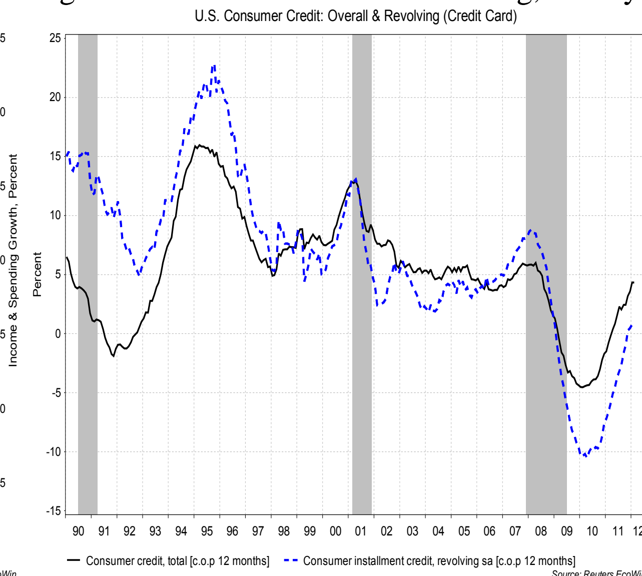


Figure 5: Consumer Credit Recovering, Slowly



Given slow income growth, **personal consumption expenditure** (PCE) also has shown only modest growth. Nominal PCE rose by just 3.1% in the 3 months ending in February, again little changed from prior months (Figure 4). Consumers remain reluctant to borrow to support consumption. Consumer credit is growing again due to automobile and student lending, but credit card debt is up less than 1% over the past 12 months (Figure 5). Finally, higher oil and gasoline prices (only partially offset by lower natural gas prices) pose another headwind to PCE growth, especially if gasoline prices continue to climb through the summer driving season.

The **savings rate** continues to edge lower, but it was revised up considerably for prior periods. This is good news, since we think the savings rate still needs to be higher. When the savings rate rises, consumption grows more slowly than income, resulting in lower GDP growth. The upward revision to the savings rate means that the adjustment will be less negative for growth. However, deleveraging by households will continue to be a headwind to growth for some time to come.

The **housing market** is slowly coming back to life. Sales are recovering gradually, inventories of unsold homes are falling, and housing affordability is at a record high (Figure 6). Residential investment actually contributed ¼ percent to GDP growth in 2011Q4, and warm winter weather makes it likely that housing will add to growth again in Q1. Before we get too excited, however, home prices are still down 3-4% YoY, although the pace of decline appears to be slowing. With home construction running well below the pace of household formation and inventories of unsold homes pared substantially, we are likely to see the bottom in home prices sometime this year or

next. Although it will take a while before housing is again a substantial contributor to GDP growth, we think the drag from housing is essentially over.

Figure 6: Home Sales Up, Inventories Down

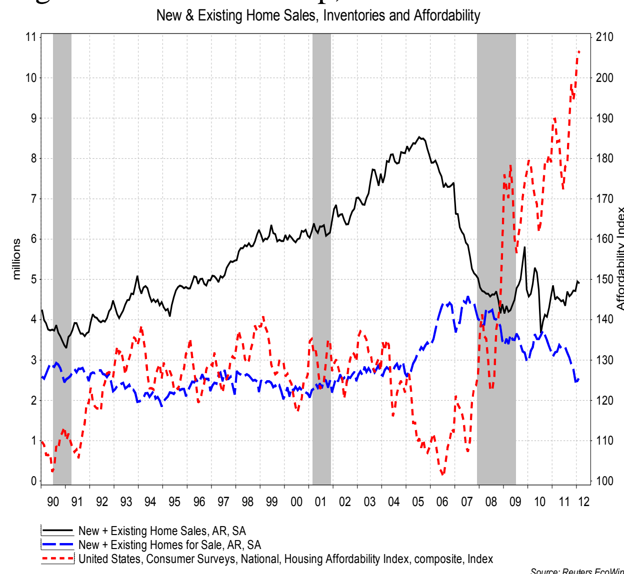
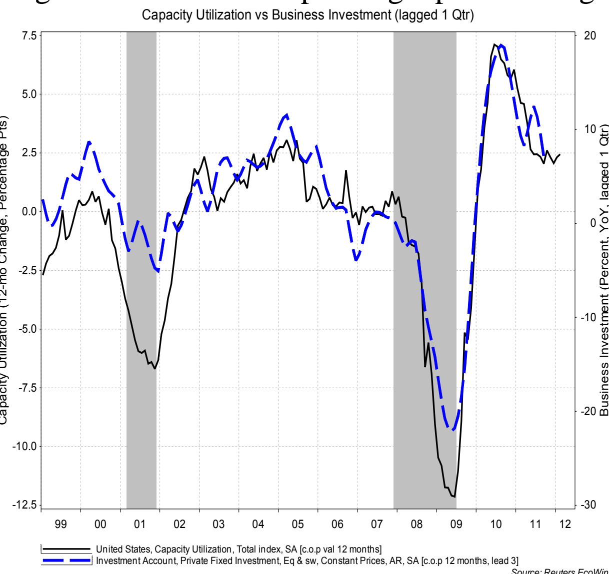


Figure 7: Investment Spending Up but Easing



Business investment has remained a strong point for the economy. Investment spending on business equipment and software was up 7.5% in the fourth quarter, adding more than ½ percent to GDP. The continued rise in capacity utilization should support further growth in business investment around the Q4 level (Figure 7). Investment spending on business structures should grow much more slowly – it was down 0.9% in Q4 – but warm weather may boost the category in Q1. We remain optimistic on overall business investment spending in 2012.

Figure 8: Production Increasing …

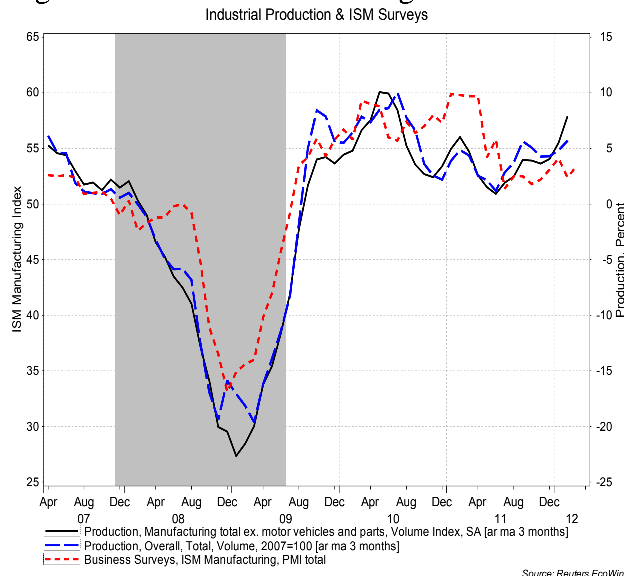
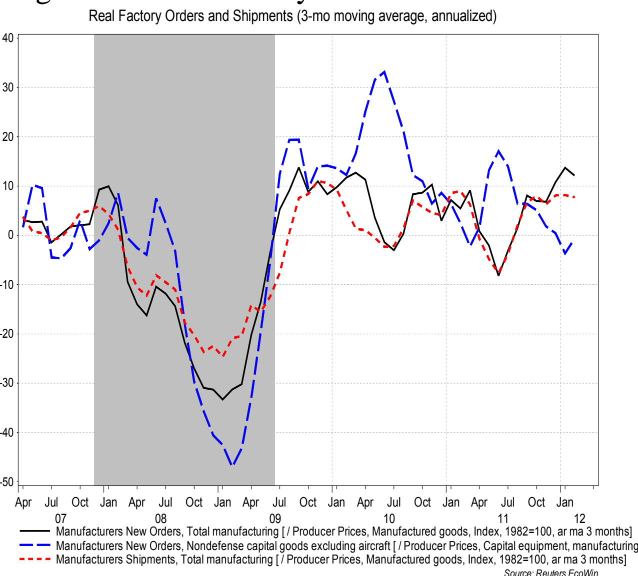


Figure 9: …but Factory Order Growth Mixed



Reflecting the strength in automobile and business equipment sales, **industrial production** has accelerated in recent months. Overall industrial production is up 5.7% and manufacturing

excluding automobiles is up 7.9% in the three months ending in February, even as the Institute for Supply Management's Manufacturing Index edged only slightly higher (Figure 8).

At the same time, factory *orders* for durable goods have been mixed. Overall orders and shipments are growing rapidly, driven by strong orders for commercial aircraft, while orders for core nondefense capital goods excluding aircraft have dipped into negative territory (Figure 9). Meanwhile, order backlogs – including those for core capital goods – are still up at double-digit rates over the past 3- and 12-month periods. Those backlogs should keep factories busy for several quarters or longer. We anticipate core orders will pick up over the coming months, although slower economic growth abroad is likely to dampen export demand for some business equipment. We will be watching those orders closely.

The **trade deficit** has improved on balance since the middle of 2010, adding slightly to GDP growth in one quarter and subtracting a bit the next (Figure 10). For 2011 as a whole, trade added just under 0.1% to real GDP, and that slightly positive trend continued for the first two months of 2012. Looking ahead, U.S. domestic growth should improve compared to last year, while Europe faces recession and growth in emerging markets appears to be slowing. That suggests U.S. import growth will outpace export growth, widening the trade deficit. At the same time, demand for U.S. "safe haven" assets remains high, so financing the current account deficit should not be difficult. As a result, we expect trade will be a drag on GDP growth this year, though probably not by more than a few tenths of a percentage point on average.

Figure 10: Trade Improvement Ending?

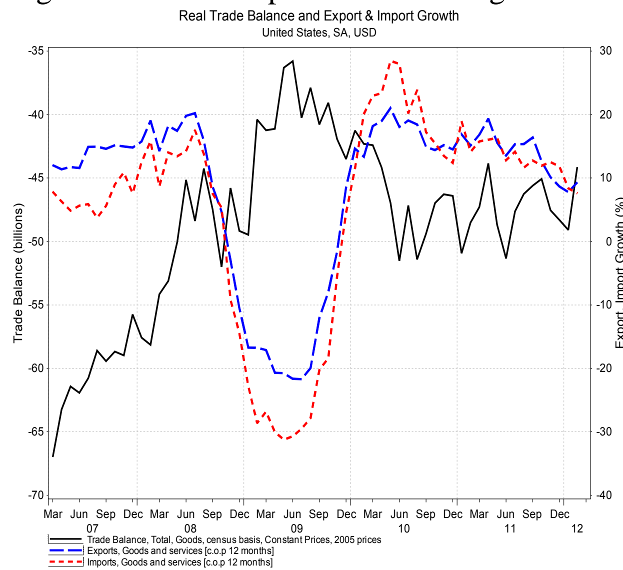
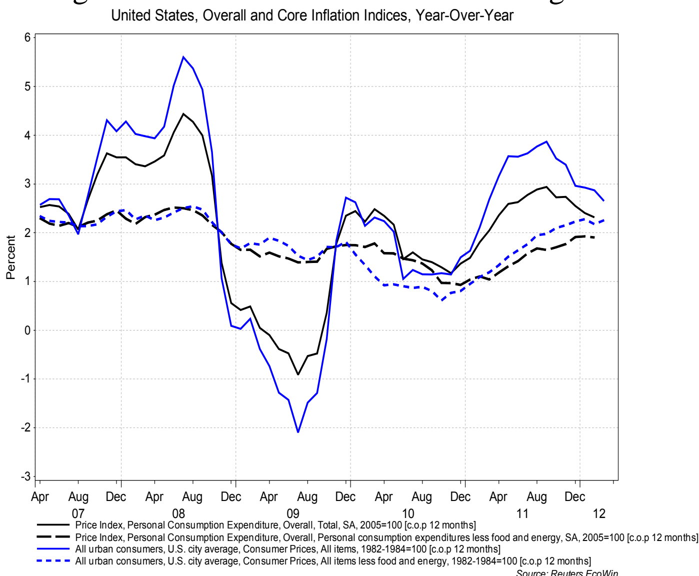


Figure 11: Inflation Near Fed's 2% Target



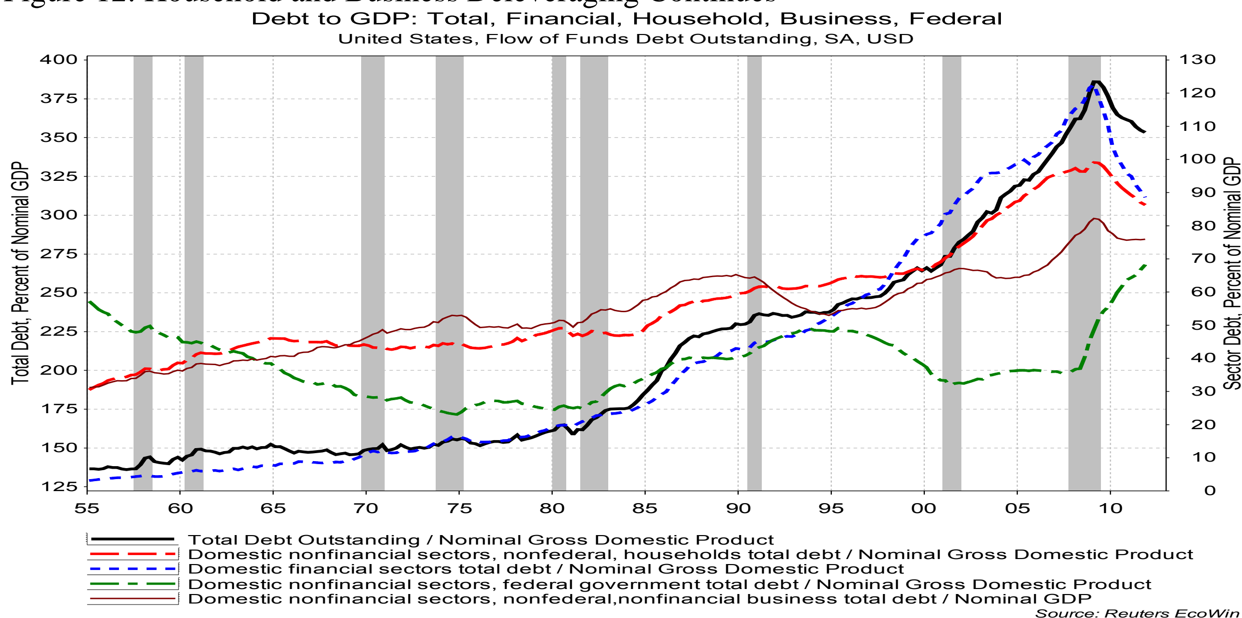
Government spending slowed in real terms in the fourth quarter, subtracting 0.8% from GDP, about 70% of which represented a slowdown in federal government spending. With Republicans and Democrats at odds over the budget leading up to the November elections, it is unlikely that there will be any major changes to taxes or spending this year. We are doubtful that deficit spending will fall by the full 1.6% projected by the Congressional Budget Office (CBO) for fiscal year 2012, but drag of about 1% of GDP looks increasingly likely. State and local spending cuts should subtract another ¼% or so. That sums to a bit more drag from government spending than we anticipated previously. However, the bulk of the "surprise" is coming from higher tax receipts

due to better private sector growth (outlays are down 0.4% while revenues are up 4.5% in the fiscal year through March). As a result, it does not change our view on overall GDP growth.

The fiscal outlook will worsen substantially next year unless Congress acts. Expiration of the 2003 tax cuts and the temporary payroll tax holiday along with across-the-board spending cuts scheduled to take effect in 2013 imply 3.3 percentage points of fiscal drag on GDP, according to CBO projections. Of course, the November elections could and probably will result in changes to the law that could reduce the amount of near-term fiscal drag. Nonetheless, the uncertainty over how this will play out may restrain growth later in the year.

Inflation pressures have eased since late 2011, although rising oil prices have offset some of that improvement. The consumer price index (CPI) is up 2.7% YoY through March and up 2.3% excluding food and energy (Figure 11). The PCE deflator is up 2.3% YoY through February and 1.9% excluding food and energy. The Federal Reserve appears content to have most of these indices converging around 2% inflation, its unofficial target. With unemployment elevated, wages subdued, and capacity utilization still below the level associated with rising inflation, we think inflation pressures will continue to abate. At the same time, a further rise in oil prices could push the overall inflation indices higher again, and the Fed's extremely easy monetary policy makes it likely that inflation will pick up when headwinds to growth diminish. That is not a risk currently, but it is a yet another risk to the longer-term outlook.

Figure 12: Household and Business Deleveraging Continues



As usual, we conclude this section with a brief recap of **balance sheet trends** (Figure 12). Overall debt continues to fall as a percentage of GDP, paced by still-rapid declines in financial and household debts. Nonfinancial corporate debt is holding about steady despite rising profitability and higher investment spending. In contrast, government debt continues to increase rapidly, although the rate of growth has slowed. We anticipate further deleveraging by both households and financial institutions, probably offset in part by more nonfinancial corporate borrowing as the economy recovers. Economic growth is likely to remain subdued during this period of deleveraging, which is likely to continue for some time to come.

Market Outlook

Treasury rates rose sharply in the first quarter as job growth accelerated, the U.S. economic outlook brightened, and Europe made progress addressing its sovereign debt crisis. The yield on the 30-year Treasury bond rose by 45 basis points (bp) to end the quarter at 3.34%, while the 10-year Treasury note yield rose by 33 bp to 2.21% (Figure 13). Since quarter-end, however, those rates have dropped by 21 and 23 bp, respectively, on disappointing March employment news and renewed worries over Europe. In the short end, the fed funds target rate remained unchanged at zero to 0.25%.

Figure 13: Long-term Yields Up & Down

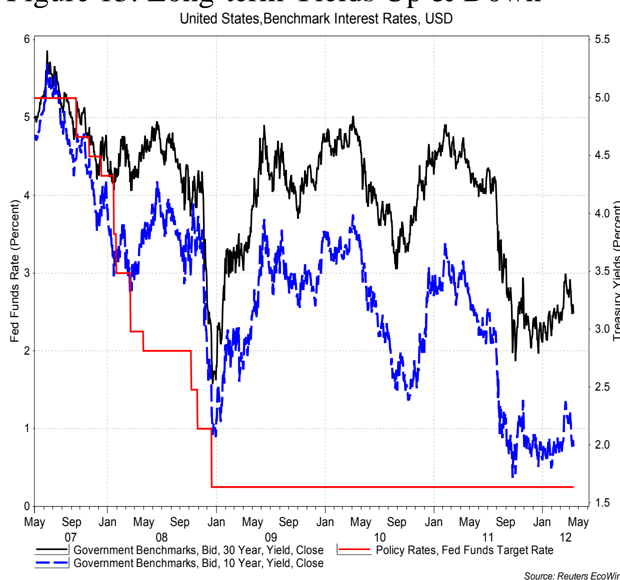
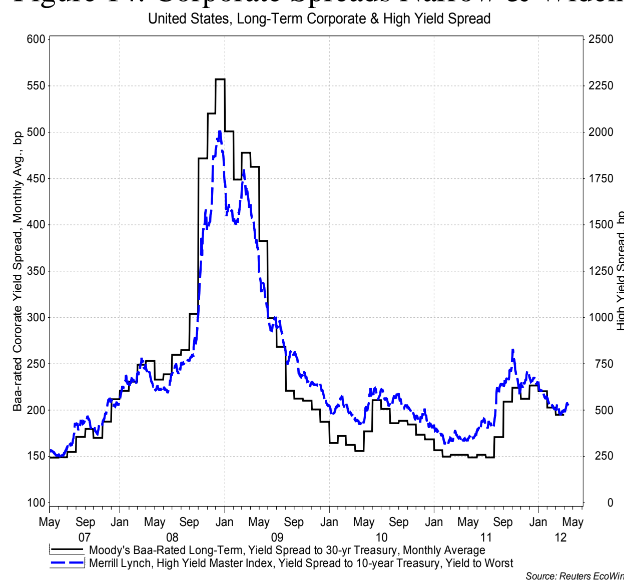


Figure 14: Corporate Spreads Narrow & Widen



During the first quarter, the Federal Reserve made one substantive change to **monetary policy** at its January Federal Open Market Committee (FOMC) meeting. It announced that it expected to maintain the period of exceptionally low rates "at least through late 2014," well beyond its prior guidance of mid-2013. This statement kept a lid on short-term rates (e.g., the two-year Treasury yield rose only 9 bp in Q1), but it was viewed with some skepticism by the market given mostly upbeat economic data released during the quarter. Although the FOMC's statement does not *commit* the Fed to leaving rates on hold through 2014, it probably does raise the bar for monetary tightening, which may increase the risk of higher inflation down the road. The yield curve steepened as a result.

Credit spreads narrowed during the quarter, but they have given back some of their gains so far in April (Figure 14). Long-term Baa-rated corporate bond spreads narrowed by 31 bp during Q1, nearly offsetting the rise in Treasury yields. High yield spreads performed even better, narrowing by 155 bp. Over the same period, preferred securities' prices rallied 2.5–4.9%. Since quarter-end, corporate spreads have widened by about 12 bp, high yield spreads widened 39 bp, and preferred securities' prices are roughly unchanged. We continue to expect that credit spreads will tighten somewhat further over the remainder of 2012 as the economy recovers and credit fundamentals (discussed below) improve.

As we have already hinted, **credit quality** continues to improve at U.S. corporations and banks. Corporate profits have extended their record-breaking performance, hitting another new high in

2011Q4 (Figure 15). Profits likely continued to rise in Q1. Interest expense relative to earnings before interest and taxes also sits near a record low, while liquidity and the proportion of long-term debt to total debt remain at or near record highs, reducing funding risk (Figure 16). Loan delinquencies and charge-offs are declining across all major loan categories, with some of them now approaching pre-crisis levels (Figure 17). Declining consumer debt, low interest rates, and rising incomes have combined to push household debt burdens down to levels not seen since the mid-1990s or earlier (Figure 18). Even mortgage foreclosures, while high on an absolute basis, have been falling for a few quarters now. This continued improvement in credit quality has benefitted bank profitability and capital ratios and reduced risk to the financial system. It also has increased the appetite of investors for subordinated debt and preferred stock.

Figure 15: Corporate Profits at Record Highs

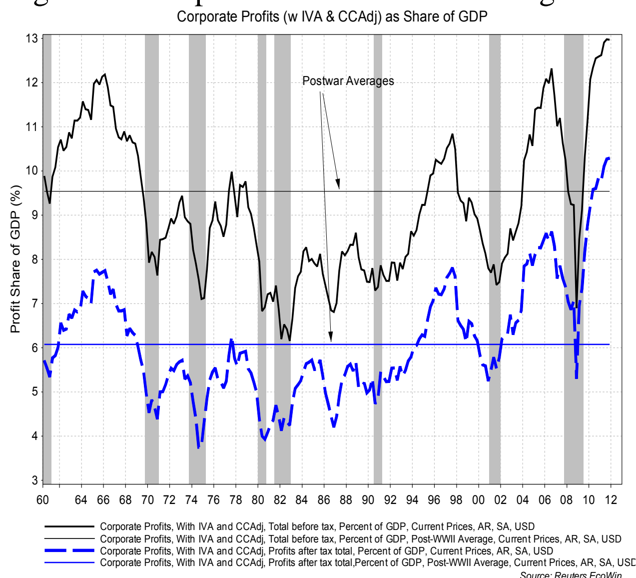


Figure 16: Balance Sheets Strong

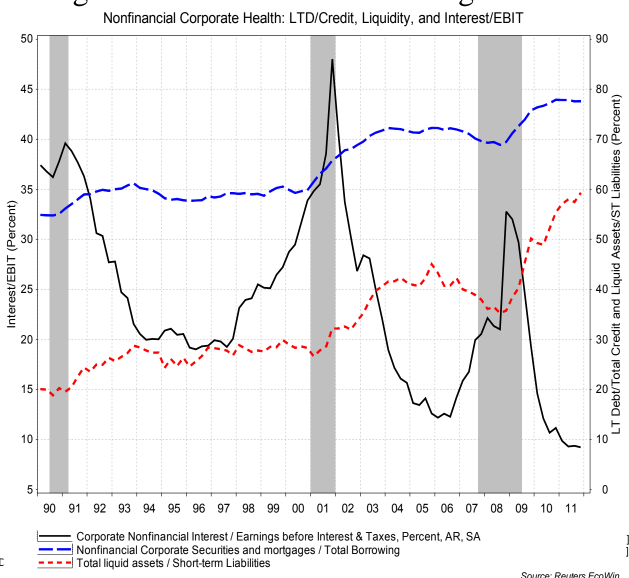


Figure 17: Loan Quality Still Improving

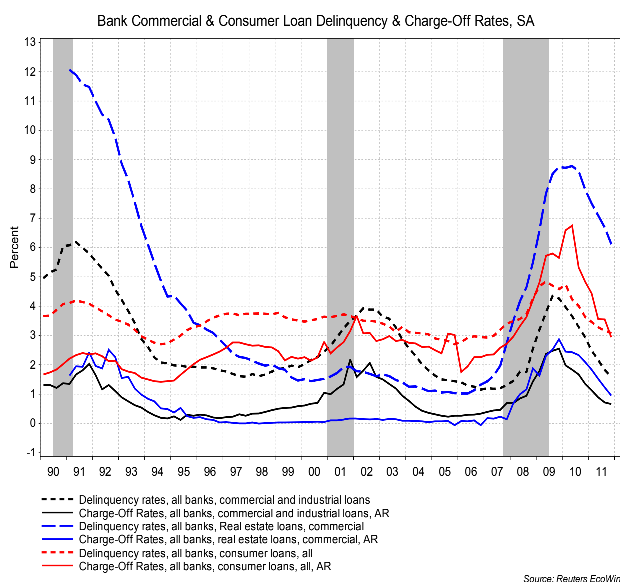
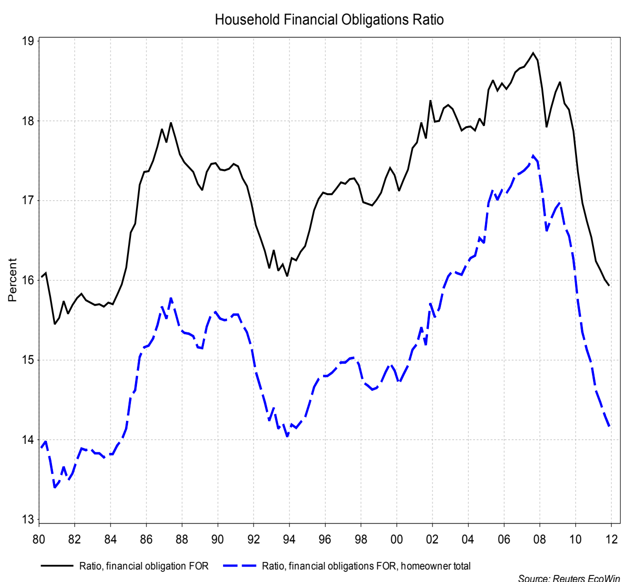


Figure 18: Consumer Debt Burdens Falling



There is little new to report on **regulatory matters**. We are still waiting for bank capital rules that are required under Dodd-Frank. We expect to get them before they are scheduled to go into effect on January 1, 2013, but that is about as firm a date as we can give at the moment. In the meantime, banks are calling high-coupon trust preferred securities under their regular call provisions when the economics make sense. In addition, a few banks have issued traditional DRD-eligible preferred stock, which we and the market presume will qualify as Tier 1 capital whenever the new bank capital rules are promulgated. We anticipate a substantial pickup in bank trust preferred calls and preferred stock issuance after those rules are released.

The Fed concluded its annual Comprehensive Capital Analysis and Review on large U.S. bank holding companies in March. Those "stress tests" showed that most banks have sufficient capital to withstand a severe financial shock (slightly worse than the 2008-09 crisis) between now and the end of 2013. Only four of the 19 institutions "failed" some portion of the tests (meaning capital fell below a mandated threshold at some point over the test horizon), and three of those four were only marginally below Fed minimums in that extreme scenario. Although we don't view these stress tests as definitive, the results show how much capital banks have generated since the crisis, through a combination of equity offerings and exchanges, retained earnings, and balance sheet reduction. Certainly, we think the U.S. banking industry is stronger today than it was in 2007. We are perplexed that rating agencies think the opposite and continue to downgrade many of these companies.

To sum up, we remain moderately optimistic on U.S. economic growth, with real GDP growth averaging about 2.5% both this year and next. This moderate growth environment should allow companies to continue to boost earnings and further strengthen their balance sheets. That, along with improving lending performance, rising household savings and accommodative monetary policy, should contribute to good performance for preferred securities. At the same time, a number of risks are visible on the horizon, most notably (but not exclusively) the sovereign debt crisis in Europe. We think policymakers in Europe are making progress, but there will be bumps in the road. As always, we will do our best to navigate through them while meeting your portfolio objectives.

Flaherty & Crumrine Incorporated
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