Second-Quarter U.S. Economic Update
July 2012

Summary of Recent Economic and Market Developments

Real GDP growth slowed to 1.9% in the first quarter and probably did little better in Q2. We continue to expect moderate growth in the U.S., but recent weakness in economic data has caused us to lower our growth expectations for the rest of the year. Most of the news on the economy was weaker than expected. The labor market slowed in Q2 and wage growth remained steady around 2%, leading to sluggish growth in both personal income and consumption. Industrial production slowed as capital goods orders fell and manufacturing sentiment eased. Government spending likely fell again in Q2, and it faces a high degree of uncertainty in 2013. Trade was probably a small drag on growth again in Q2, as we expect for the balance of the year. There were a few bright spots, however. The housing market showed further improvement, and mortgage refinancing activity is increasing. Business investment probably improved in Q2 after slowing in Q1, and it has substantial room to grow when business confidence improves. Interest rates fell, and the Federal Reserve added to its already accommodative monetary policy. Credit conditions continue to improve, and recent bank capital regulations reinforce the strengthening of common equity capital that has been in evidence since the end of the financial crisis. Preferred securities' prices rose. We anticipate preferred securities will continue to benefit over time from low rates, improving credit conditions, and moderate economic growth.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	2010:3	2010:4	2011:1	2011:2	2011:3	2011:4	2012:1	2012:2
Real GDP, Chg QoQ (%, SA, AR)	2.5	2.3	0.4	1.3	1.8	3.0	1.9	2.4f
Real Personal Consump Expnds, Chg QoQ (%, SA, AR)	2.6	3.6	2.1	0.7	1.7	2.1	2.5	1.2a
Real Busi Investmt, Eqp & Sftware, Chg QoQ (%, SA, AR)	14.1	8.1	8.7	6.2	16.2	7.5	3.5	NA
Real Residential Investmt, Chg QoQ (%, SA, AR)	-27.7	2.5	-2.4	4.2	1.3	11.6	20.0	NA
Corporate Profits, After Tax, Chg YoY (%, SA, AR)	23.3	17.4	10.6	9.4	11.1	8.5	2.2	5.3f
Current Account Balance, Annualized (% of GDP, SA)	-3.1	-2.8	-3.2	-3.2	-2.9	-3.1	-3.6	NA
Federal Budget, 12-mo Def or Surp (% of GDP)	-8.9	-8.6	-9.5	-8.4	-8.5	-8.2	-8.1	-7.8a
Unemployment Rate (%, SA)	9.5	9.4	8.9	9.1	9.0	8.5	8.2	8.2
Household Employment, Chg QoQ (000, SA)	207	-124	544	-379	722	683	1244	381
Nonfarm Payrolls, Chg QoQ (000, SA)	-136	461	576	389	383	492	677	225
Nonfarm Productivity, Chg QoQ (%, SA, AR)	1.8	1.8	-1.0	-0.3	1.8	1.2	-0.9	NA
Capacity Utilization (%, SA)	75.2	76.0	76.5	76.3	77.2	78.3	78.5	79.0a
GDP Price Index, Chg QoQ (%, SA, AR)	1.4	1.9	2.5	2.5	2.6	0.9	2.0	1.5f
Consumer Price Index, Chg YoY (%, AR)	1.1	1.5	2.7	3.6	3.9	3.0	2.7	1.7a
CPI ex food & energy, Chg YoY (%, AR)	0.8	0.8	1.2	1.6	2.0	2.2	2.3	2.3a
Nominal Personal Income, Chg YoY (%, AR)	4.9	5.1	5.9	4.9	4.9	4.0	2.9	2.9a
Personal Savings Rate (%, SA)	5.4	5.2	4.9	5.0	4.3	4.2	3.7	3.9a
Rate or Spread (End of Quarter)	**2010:3**	**2010:4**	**2011:1**	**2011:2**	**2011:3**	**2011:4**	**2012:1**	**2012:2**
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	0.30	0.30	0.25	0.37	0.58	0.47	0.46
10-Yr Treasury Note Yield (%)	2.51	3.29	3.47	3.16	1.92	1.88	2.21	1.64
30-Yr Treasury Bond Yield (%)	3.69	4.34	4.51	4.38	2.91	2.89	3.34	2.75
Moody's Baa Long Corp Spread (bp)	189	164	154	152	231	227	196	231
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 May 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

The U.S. continues to grow at a tepid pace, as it has for most of the past two years. Inflation-adjusted U.S. **Gross Domestic Product** (real GDP) grew by 1.9% in the first quarter of 2012. Economists expect growth to accelerate to 2.4% in Q2, although data since that survey was published suggest growth closer to the Q1 pace.[1]

We now anticipate 2.0-2.5% real GDP growth for the balance of 2012, down from 2.5% previously, and most others have made similar or even larger downward adjustments. For now, we attribute part of the weakness in recent economic data to distortions from unusually warm weather and headwinds from higher energy prices (now reversed). As a result, we think GDP growth in the second half of 2012 will improve, although it is likely to remain relatively slow.

This recovery from recession is decidedly weaker than other recoveries since 1970 (Figure 2). Prior to this recovery, GDP growth averaged 3.9% in the three years following recession, including 3.7% growth in the third year after recession. In this recovery, growth has averaged just 2.4% over the past 11 quarters (2Q2012 will be the 12th quarter of recovery) and 2.2% so far in the third year of recovery – in each case 1.5 percentage points below prior norms.[2]

Figure 2: A Weaker-than-Normal Recovery from Recession

	Real GDP Growth "X" Quarters after Recession End												Average Real GDP After Recession			
Recession End	1	2	3	4	5	6	7	8	9	10	11	12	1st Year	2nd Year	3rd Year	3 Years
Nov-70	11.5	2.3	3.2	1.1	7.3	9.8	3.9	6.8	10.6	4.7	-2.1	3.9	4.5	7.0	4.3	5.3
Mar-75	3.1	6.9	5.3	9.4	3.0	2.0	2.9	4.7	8.2	7.4	-0.1	1.4	6.2	3.2	4.2	4.5
Jul-80	-0.7	7.6	8.6	-3.2	4.9	-4.9	-6.4	2.2	-1.5	0.3	5.1	9.3	3.1	-1.1	3.3	1.8
Nov-82	5.1	9.3	8.1	8.5	8.0	7.1	3.9	3.3	3.8	3.4	6.4	3.1	7.8	5.6	4.2	5.8
Mar-91	2.7	1.7	1.6	4.5	4.3	4.2	4.3	0.7	2.6	2.1	5.4	4.0	2.6	3.4	3.5	3.2
Nov-01	3.5	2.1	2.0	0.1	1.7	3.4	6.7	3.7	2.7	2.6	3.0	3.3	1.9	3.9	2.9	2.9
Jun-09	1.7	3.8	3.9	3.8	2.5	2.3	0.4	1.3	1.8	3.0	1.9		3.3	1.6	2.2	2.4
Average	3.8	4.8	4.7	3.5	4.5	3.4	2.2	3.2	4.0	3.4	2.8	4.2	4.2	3.4	3.5	3.7
Avg excl. last	4.2	5.0	4.8	3.4	4.9	3.6	2.6	3.6	4.4	3.4	3.0	4.2	4.3	3.6	3.7	3.9
Max	11.5	9.3	8.6	9.4	8.0	9.8	6.7	6.8	10.6	7.4	6.4	9.3	7.8	7.0	4.3	5.8
Min	-0.7	1.7	1.6	-3.2	1.7	-4.9	-6.4	0.7	-1.5	0.3	-2.1	1.4	1.9	-1.1	2.2	1.8

Quarterly Real GDP Growth Rate (percent) Source: Reuters EcoWin

There are numerous reasons for this weaker economic performance. Deleveraging and hangover from the housing boom are principal reasons. Government policies also bear some responsibility, although identifying which policies are to blame for suppressing growth and which to praise for supporting it is as much a political judgment as an economic one, and it is something we won't get into here. However, we do not expect the economy to tip back into recession despite the grim attitude of many market participants. The good news for preferred investors is that headwinds from housing and deleveraging are present but diminishing, and companies are operating conservatively, creating a benign environment for preferred securities.

Turning to the major sectors of the economy, the **labor market** slowed considerably in the second quarter, partly as "payback" from unusually warm weather in Q1 that pulled forward hiring from the spring months. Employment gains slowed in Q2 on a seasonally-adjusted (SA)

[1] All growth rates are annualized unless otherwise noted. Forecasts in this Update are from *The Livingston Survey*, Federal Reserve Bank of Philadelphia, June 7, 2012.

[2] While 1.5% may not sound like much, it is more than $200 billion annually on a $13.5 trillion (real) economy, or about $650 extra for every man, woman, and child in the U.S. each year.

basis and the unemployment rate ticked up to 8.2% (Figure 3). However, with weather effects so pronounced this year, it is worth looking at non-seasonally-adjusted (NSA) data as well. While SA data look soft, NSA data on jobs look reasonably strong in recent months, with private payrolls up by 815,000 in June, compared to 84,000 job gains on a seasonally-adjusted basis (Figure 4). Of course this is the typical pattern in the first half of the year, with job losses in January and sizable gains in the following months, and it is precisely what the seasonal adjustment process tries to filter out. Our point is that weather has been unusually warm this year, and it's likely that the seasonal adjustment factors did not fully capture its impact.

Figure 3: Job Market Softer, but …

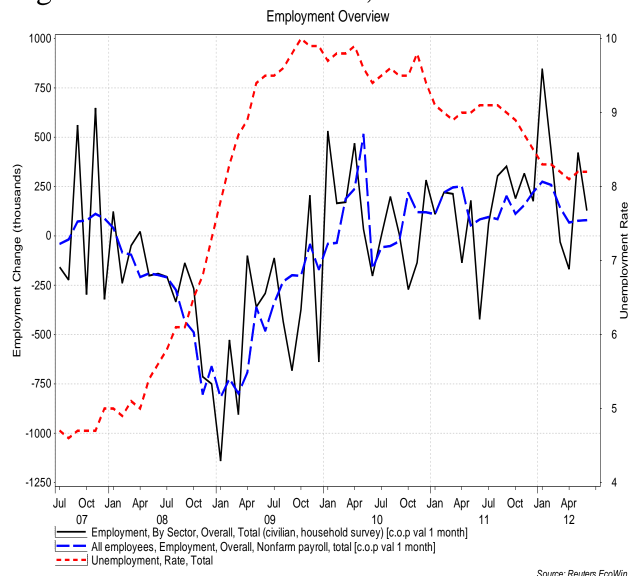
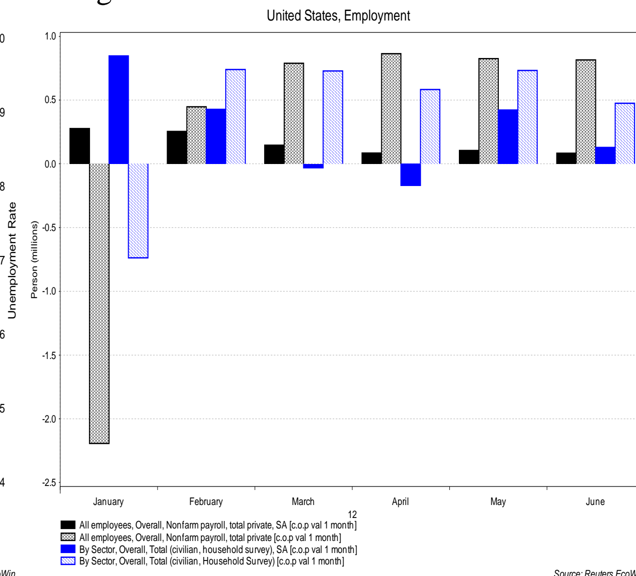


Figure 4: …NSA Data Better than SA



Fortunately, the difference between NSA and SA diminishes in the second half of the year, so we should get a "cleaner" picture of the labor market over the coming months. Unfortunately, business confidence is being restrained by slower growth in Europe due to sovereign debt problems there and uncertainty in the U.S. over the November elections and how lawmakers will confront the "fiscal cliff" next year (more on that later). Since there will not be near-term resolution of those issues, subdued business confidence may restrain employment gains through autumn. We expect job growth in the second half will be fast enough to keep the unemployment rate from rising (about 120,000 jobs per month, or 1% growth in payrolls), but not fast enough to lower it materially.

While job growth has had its ups and downs, wage growth remains stuck around 2% YoY, about where it has been for the past three years. Tepid employment and wage growth means that **personal income** growth remains modest, although it has improved a bit on a 3-month moving average basis on the strength of job gains in late winter (Figure 5). Given still-elevated unemployment, we think wage growth will remain slow. If employment grows at a 1% pace and wage growth remains at 2%, then personal income growth should be around 3%, which is its average so far this year.

Slow income growth has kept a lid on **personal consumption** expenditures (PCE). Nominal PCE were up at a 3.9% pace in the three months ending in May and 3.5% YoY (Figure 5). Adjusted for inflation, real PCE were up 1.2% and 1.9%, respectively. The personal **savings rate**

improved a bit from Q1, rising to 3.9%, and we think it will gradually move higher. If so, PCE growth should remain subdued. We simply need to see faster employment growth to generate more income and consumption growth.

Figure 5: Income & Consumption Okay

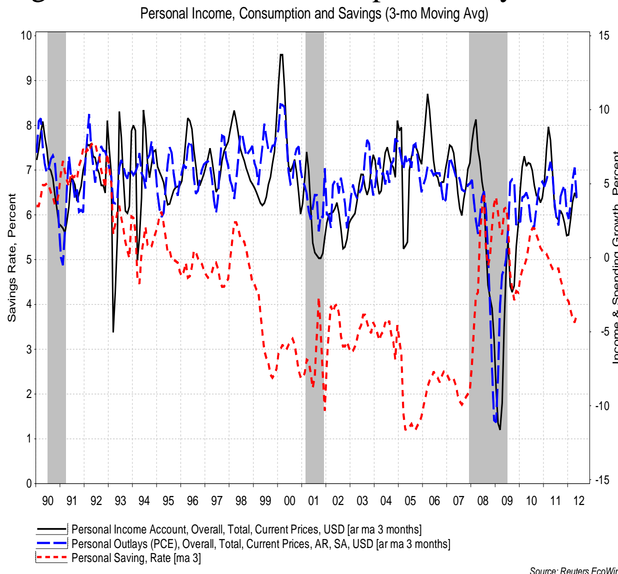


Figure 6: Housing Market Improving

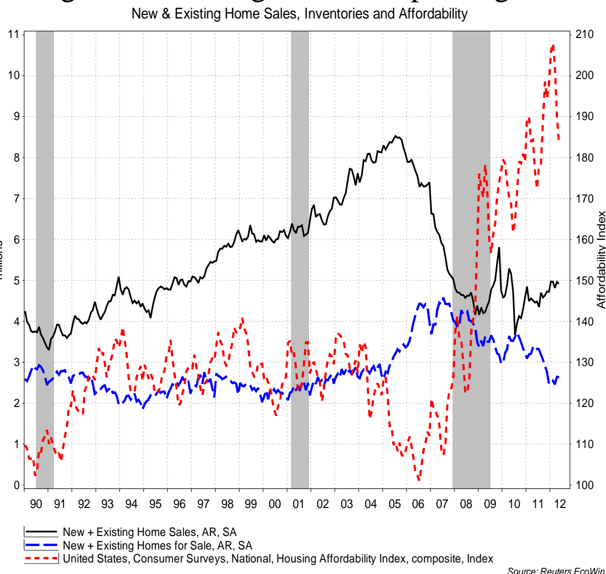


Figure 7: Business Investment Should Recover…

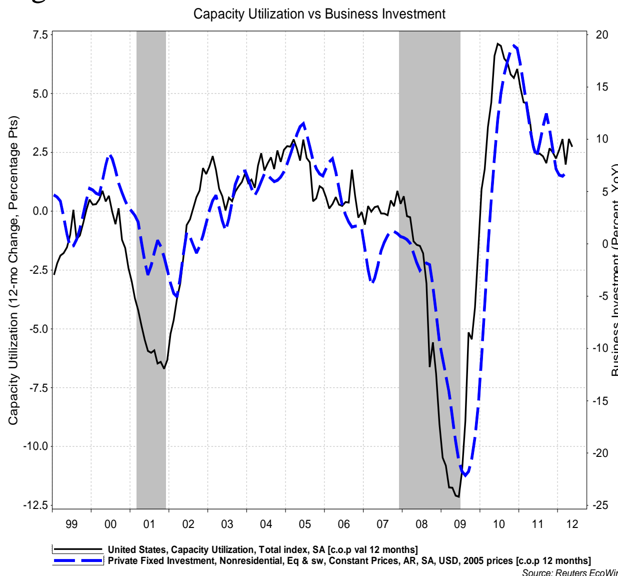
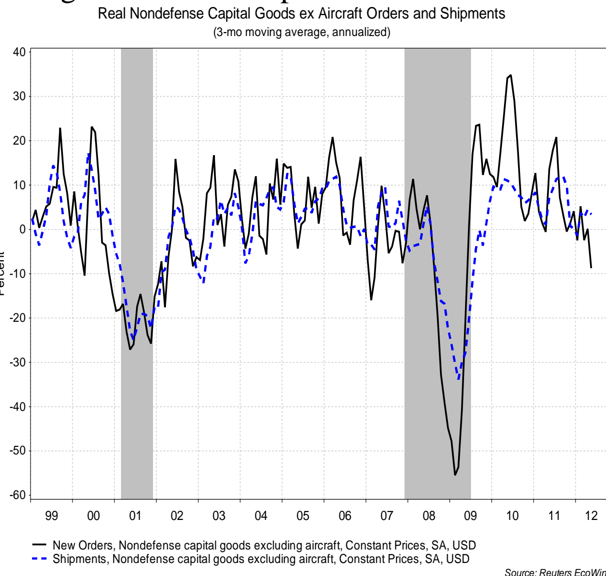


Figure 8: …But Capital Goods Orders Weak



The **housing market** is gradually improving. Sales of new and existing homes are holding steady around 5 million units (Figure 6). Inventories of unsold homes are up slightly to 2.6 million units as sellers responded to improved conditions. Home affordability remains high, although it has slipped as home prices have picked up a bit. The S&P/Case-Shiller 20-city Home Price Index was up 2.5% over the three months ending in April (the latest data available), while the Federal Housing Finance Authority (FHFA) Home Purchase Index rose 5.4% over the same period. This is good news for both homeowners and banks. Although residential investment likely will make

only a small positive contribution to GDP in 2012, it should grow in importance as the housing recovery continues.

In addition, mortgage refinancing continues at a rapid pace and should help support consumer spending. The Mortgage Bankers Association's refinancing application index has averaged 4200, a very high level, in 2012. Improvements in the housing market and somewhat easier lending standards have allowed more homeowners to refinance their mortgages and take advantage of today's low mortgage rates, freeing up disposable income. This is one of the transmission mechanisms through which accommodative monetary policy boosts the economy – a mechanism that was restrained by the housing bust until recently.

Business investment continues to expand, although the pace of growth has slowed considerably from earlier in the recovery. After averaging nearly 10% in 2011, growth in business investment in equipment and software slowed to 3.5% in Q1 (Figure 7). It probably did better than that in Q2, and we expect growth in this segment to improve to 5-8% in response to rising capacity utilization and the ongoing need to modernize equipment. However, although shipments of core capital goods (nondefense capital goods excluding aircraft) have held up, orders have slipped 6.9% over the past three months (Figure 8). These orders are volatile and frequently dip into negative territory only to rebound quickly, but this drop is troubling and will be something to watch over the coming months.

Industrial production slowed but remains positive (Figure 9). Overall industrial production rose 2.3% over the three months ending in May and 4.7% YoY. Manufacturing output rose 2.8% and 5.4% over the same periods. More worryingly, the Institute for Supply Management (ISM) manufacturing survey suggests further slowing ahead. We suspect that nervousness over Europe, weaker export growth, and stock market jitters have suppressed the ISM survey recently, but if it does not rebound at least a couple of points soon, we will become more worried about the manufacturing sector.

Figure 9: US Industrial Production Slowed

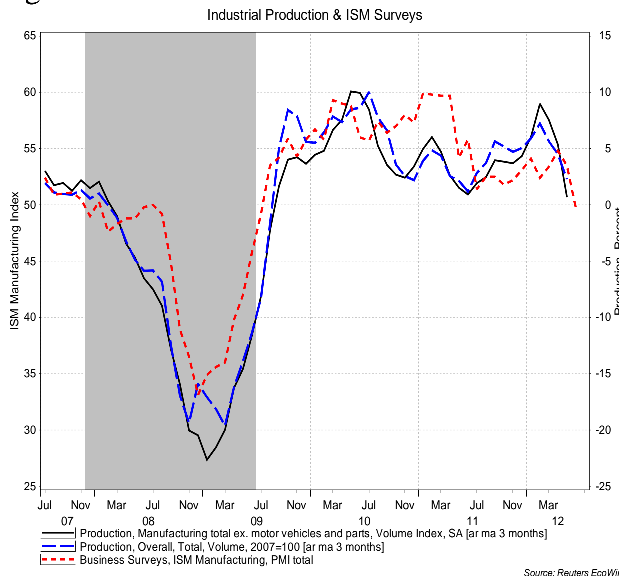
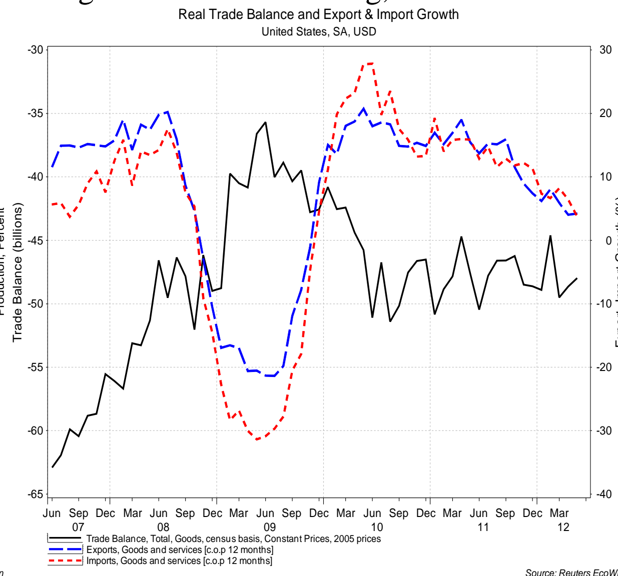


Figure 10: Trade Slowing, Deficit Flat



The real **trade deficit** continues to move roughly sideways, but both export and import growth has slowed (Figure 10). So far in Q2, net exports have been a small (-0.2%) negative for GDP

growth, and we think trade will probably continue to be a modest negative for GDP in 2012. Although U.S. economic growth is sluggish, it is outperforming many other parts of the world. In addition, U.S. financial assets are likely to continue to benefit from strong foreign demand while the European sovereign debt crisis plays out. Both suggest that the trade deficit should remain a modest drag on growth.

Government consumption continues to slide. Overall real government consumption fell by 4.0% in Q1 after falling 2.8% in 2011. State and local government spending continues to shrink, though the pace of contraction should slow since state and local governments generally cut spending relatively quickly in the wake of the recession.

In contrast, real federal government spending is poised for larger cuts. Lawmakers face a "fiscal cliff" in 2013 because they were unable to agree on a gradual schedule for deficit reduction that was required by the August 2011 debt ceiling agreement. As a result, across-the-board spending cuts are slated to begin in January 2013. In addition, the 2003 tax cuts are scheduled to expire at the end of 2012. According to the Congressional Budget Office, the combination of currently legislated spending cuts and tax increases total about 5.1% of GDP in CY2013. While it is virtually certain that not all of these spending cuts will be implemented, and some of the expiring tax cuts may be extended, it is highly uncertain which of them will survive. The November elections (both federal and state) will determine the amount of near-term fiscal drag on GDP and the longer-term trajectory of government spending. They are going to be interesting and important elections.

Figure 11: Inflation Pressures Ease

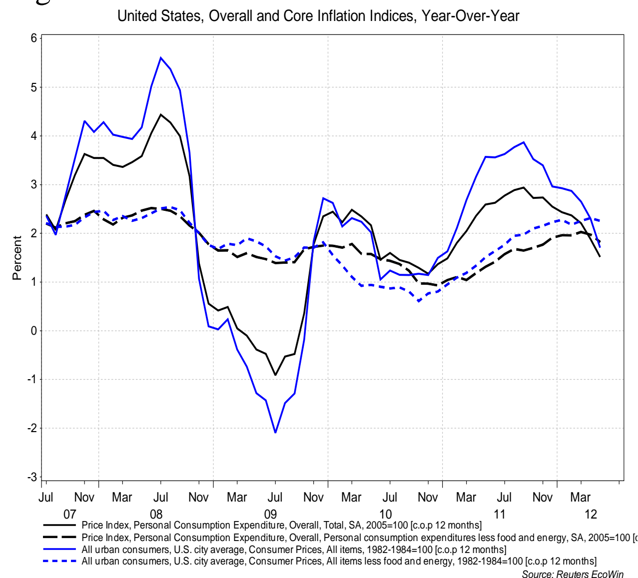
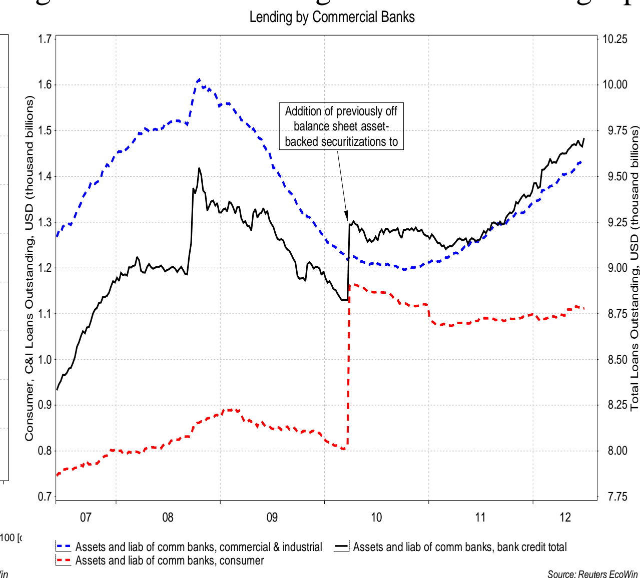


Figure 12: Bank Lending to Business Picking Up



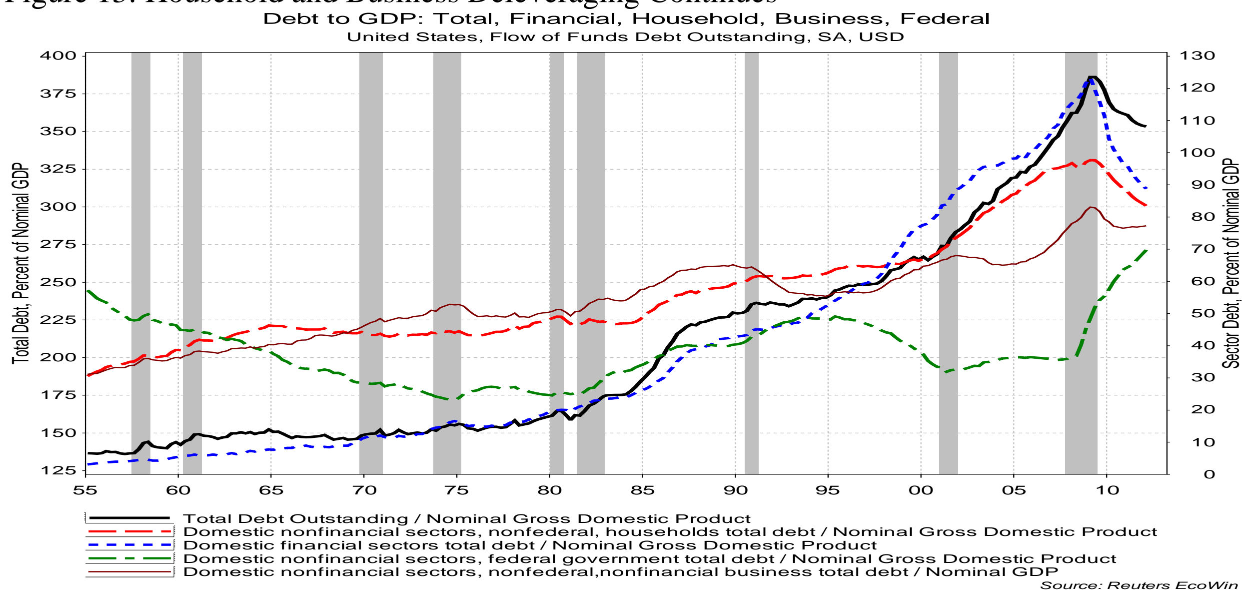
Inflation pressures have eased substantially as energy prices have dropped in response to slower global economic growth. Through May, the overall consumer price index (CPI) is up 1.7% YoY and the PCE deflator is up 1.5% YoY (Figure 11). Core inflation (excluding food and energy prices) is higher but little changed over the quarter, with core CPI up 2.3% YoY and the core PCE deflator up 1.8% YoY.

We expect inflation to remain subdued, but there are risks on the horizon. There are two main factors that have held inflation down despite highly accommodative monetary policy. First, GDP

growth has not been fast enough to quickly absorb excess capacity and thereby allow businesses to raise prices. Second, households have been deleveraging and business borrowing has been modest, resulting in low monetary velocity. Each of those conditions still holds, but business borrowing is picking up even as consumer borrowing remains weak (Figure 12). Much of this business borrowing seems to be for balance sheet improvement (extending maturities and increasing liquid reserves), but it is a sign that monetary policy is encouraging businesses to borrow a bit more freely. For now, we do not see this as having inflationary consequences – and the slowdown in GDP probably has a bigger disinflationary impact in any event – but it is something we will be watching over the next several years.

The **balance sheet trends** that we have described in prior Updates are playing out mostly as expected (Figure 13). Debt-to-GDP continues to fall in the economy overall, led by households and financial businesses, while federal government debt continues to increase rapidly. In each case, however, the pace has moderated from earlier in the recovery. Meanwhile, nonfinancial business debt-to-GDP has begun to move up very slightly, consistent with the increase in bank borrowing discussed above. We expect the overall deleveraging trend to continue for some time to come, and economic growth is likely to remain subdued while it does.

Figure 13: Household and Business Deleveraging Continues

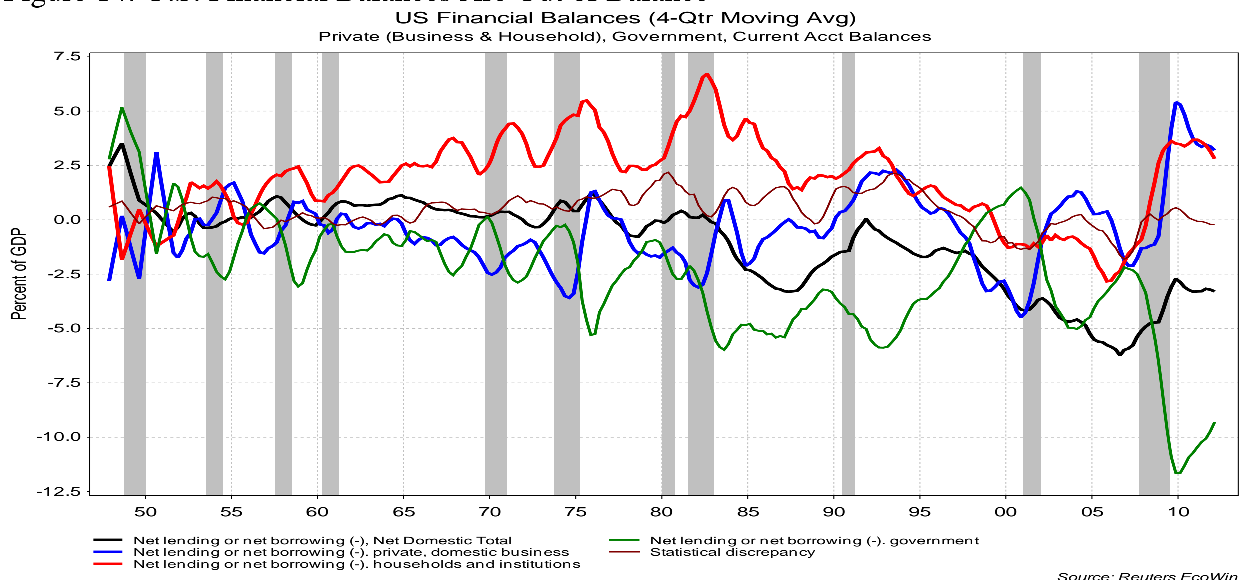


Taking a slightly different perspective on these same concepts, we can see how broad financial balances (savings) respond at various points in the economic cycle. The savings pattern usually runs as follows (refer to Figure 14). During recession and the early phases of recovery, households (red line) and businesses (blue) cut spending/investment and increase savings (financial balances increase), governments (green) do the opposite and the current account balance generally improves – meaning net domestic sources of savings (black) increase.[3] As the recovery matures, households increase spending and slow the accumulation of savings, businesses borrow to expand, and government deficits shrink (borrowing decreases). The current

[3] Since savings must equal investment in aggregate, the sum of these broad balances (private, government and foreign) must equal zero, after including a statistical discrepancy, since measurement is never perfectly accurate.

account balance can go either way, depending upon relative growth, investment flows, and what happens to domestic savings.

Figure 14: U.S. Financial Balances Are Out of Balance



Looking at Figure 14, we can see that households ran a savings deficit for nearly a decade, from the dot-com boom through the housing boom. That's a key reason why the process of deleveraging is going to take a long time for households. Businesses retrenched heavily in the recent recession and are still behaving quite cautiously – but, on a positive note, there is a lot of room for them to increase investment when the environment looks favorable – especially at today's low interest rates. As we have already discussed, foreign investors are likely to want to increase holdings of U.S. financial assets, pushing the black line (net domestic savings) down. If businesses and households remain cautious, that may be difficult to reconcile with government finances, which are way out of balance. It is going to take a number of years to realign them unless the growth outlook improves. That will be a key challenge for our political leaders over the coming years.

Before moving on to the Market Outlook, we will offer a brief update on the **European economic situation**. Conditions in the Eurozone have deteriorated in Q2 as markets questioned leaders' resolve in solving the sovereign debt crisis. The root of the problem is that Europe's desire for expansive (and expensive) government services is at odds with many member countries' ability or willingness to pay for them. Economic reality eventually will win out, but populist policies threaten to delay reforms and increase economic risk in Europe and elsewhere. Most European economies are now in recession, and market sentiment has weakened considerably. Fiscal austerity will keep peripheral countries (Greece, Ireland, Italy, Portugal, and Spain) in moderate to severe recessions through the balance of 2012 and into 2013.

Longer-term growth in Europe will depend upon both budget discipline (to defuse the sovereign debt crisis) and structural reforms (to raise potential growth, reduce unemployment, and increase the tax base). Although they have more work to do, the peripheral countries have made significant – and painful – progress toward those goals.

Importantly, European policy makers have made stability of the banking system a priority. Banks were required to meet stricter capital requirements by the end of June, and virtually all major European banks are in compliance with those requirements. The mostly smaller banks that were unable to meet capital requirements will receive state aid. The European Central Bank has provided ample liquidity to European banks, including roughly €1 trillion of 3-year term loans – with the possibility of more if banks need it. These steps have helped stabilize the banking system, which has helped European preferred securities' prices. Deposit flight from the periphery to core EMU banks remains a risk, however, as permanent firewalls have yet to be erected to contain it.

Despite worsening of the crisis in recent months, we think Europe will muddle through and stay together as a currency union. Faced with walking off a cliff or taking a responsible (albeit difficult) path, we think political leaders will choose responsibly. Our clients' investments in European preferred securities earn attractive yields and are concentrated in what we believe are the strongest issuers in the region. We recognize, however, that the politics and economics in Europe are difficult to read, and we expect continued volatility ahead.

Market Outlook

Long-term **Treasury rates** dropped sharply in the second quarter in response to weaker economic data and growing fears over the sovereign debt situation in Europe. The 10-year Treasury note yield fell by 57 basis points (bp) to 1.64%, and the 30-year Treasury bond yield dipped to 2.75%, a decline of 59 bp (Figure 14). Their yields have dropped by another 14-16 bp so far in July.

Figure 14: Treasury Yields Down

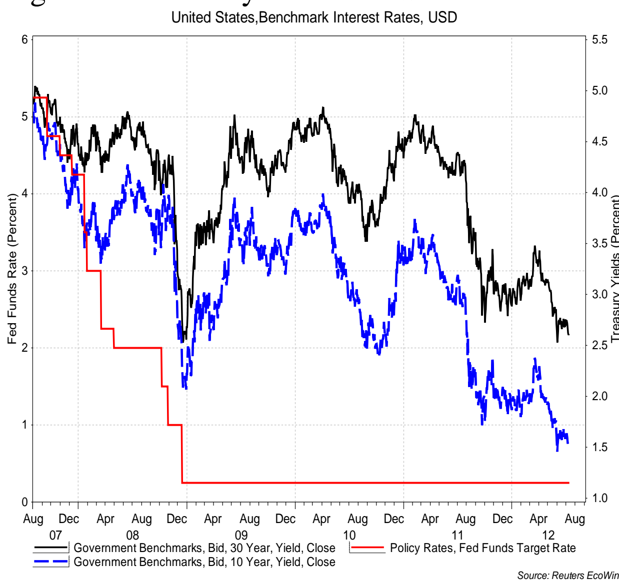
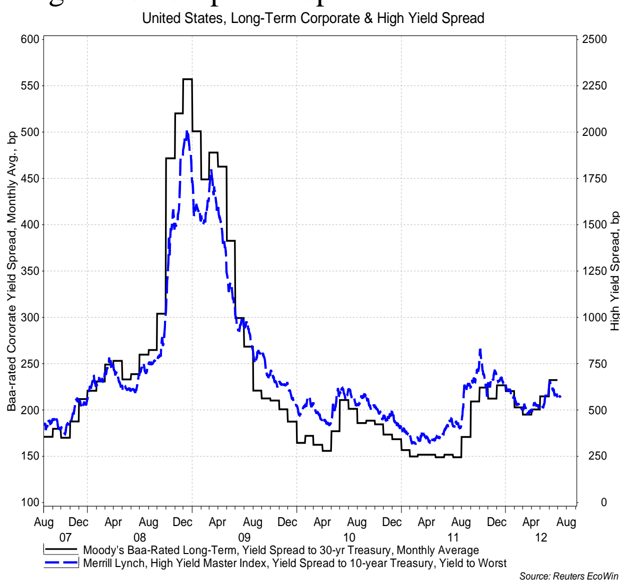


Figure 15: Corporate Spreads Wider



The Federal Open Market Committee (FOMC) left the federal funds target rate unchanged at 0.25% in the second quarter, where it has remained for more than three years. The Fed completed the first round of "Operation Twist" at the end of June, selling a total of $400 billion of 3-year and shorter Treasuries to buy a like amount of 6-year and longer Treasuries. At its June meeting, the FOMC decided to extend the program through the end of 2012. This will result in the purchase of about $267 billion additional long-term securities between July 1 and December 31.

The Fed 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.

Credit spreads were modestly wider in the second quarter (Figure 15), but the decline in Treasury yields still made for higher prices in investment grade corporate and preferred indices. Long-term Baa-rated corporate bond spreads widened by 35 bp to 231 bp, about where they started the year. High yield bond spreads widened by 71 bp to 565 bp, which is still some 85 bp tighter than at the beginning of 2012. Preferred securities' prices were 0.25 to 1.1% higher in Q2. We expect credit spreads to remain volatile in the second half of 2012 but to narrow overall as credit fundamentals continue to improve, especially if Treasury rates move somewhat higher later in the year.

Figure 16: Profits Strong but Slowing

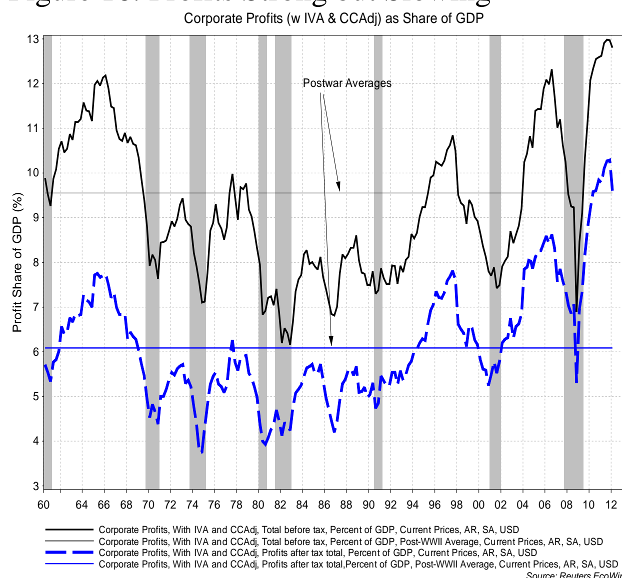


Figure 17: Balance Sheets Strong & Steady

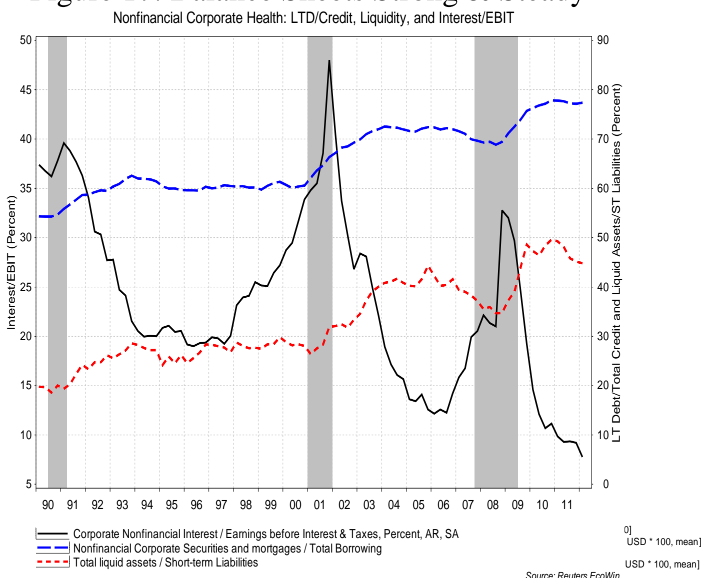


Figure 18: Commercial Loan Quality Improving

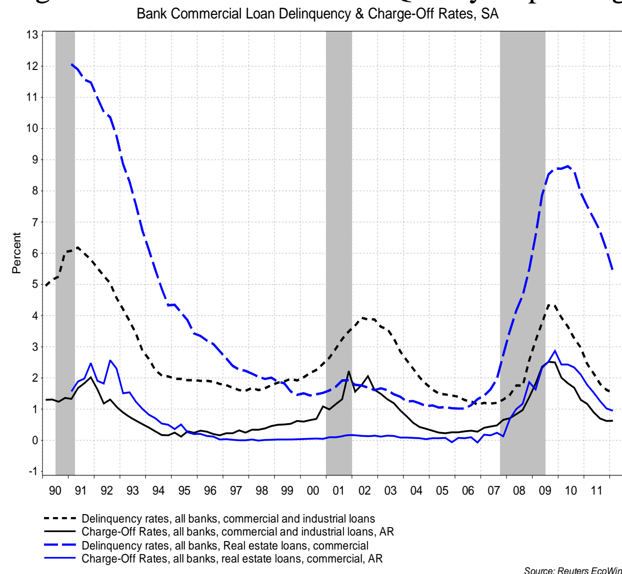
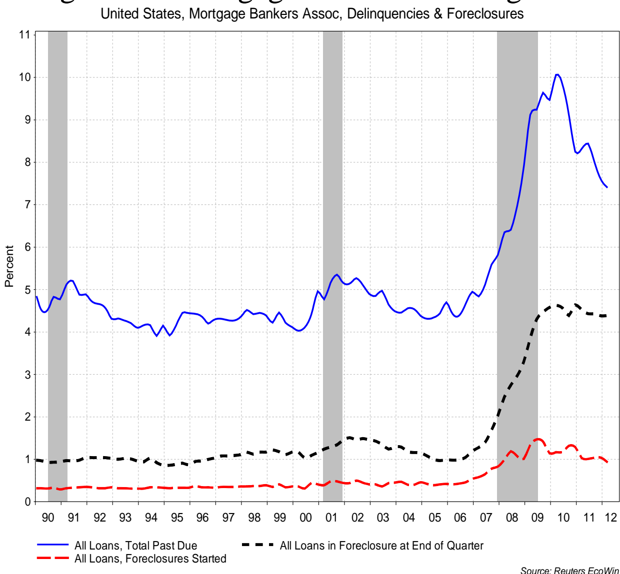


Figure 19: Mortgage Problems Easing



The story on fundamental **credit quality** continues to improve, although the pace of improvement has slowed along with the economy. Corporate profits continue to improve, but in Q1 they dropped below their record high (Figure 16). The pace of growth is likely to slow further in Q2. Interest expense relative to earnings before interest and taxes fell to a new record low in Q1 and probably stayed close to that in Q2. Corporate liquidity and the proportion of long-term debt to total debt remain near record highs; both reduce short-term funding risk (Figure 17). Commercial loan delinquencies and charge-offs continue to decline across virtually all loan categories (Figure 18). Mortgage loan delinquencies are falling, although foreclosures remain elevated (Figure 19). Business bankruptcy filings continue to drop. All of this is contributing to improving credit quality at preferred issuers.

There was one major **regulatory development** in the second quarter. On June 7, 2012, the Federal Reserve released its long-awaited proposed rules on bank capital requirements and calculating risk-weighted assets. We have written extensively on that elsewhere, so we will only summarize the key features of the proposed regulations here.[4]

First, if the proposed rules are adopted, banks would be allowed to count non-cumulative perpetual preferred stock as Tier 1 capital. Income from this traditional preferred stock qualifies for the inter-corporate dividends received deduction (DRD) for corporations and is qualified dividend income to individuals. In addition, most trust preferred securities will begin losing Tier 1 capital treatment in 2013, with full phase-out in 2016. Trust preferred securities that no longer qualify as Tier 1 capital generally will continue to count as Tier 2 capital without limit.

Second, banks will be required to hold substantially more common equity capital under the new capital rules, which closely follow the Basel 3 framework. When fully phased-in, the new rules will require at least 9.5% common equity to risk-weighted assets for a large bank to avoid restrictions on dividend and bonus payments. This compares to the current regulatory minimum of just 2.5% common equity (although common equity capital at most banks is well above that minimum requirement). In addition, there are more deductions from the regulatory definition of common equity for certain forms of capital, which will further increase the amount of common equity capital that banks will need to hold.

Finally, although the proposed rules on risk-weighted assets are quite complex, they generally increase the risk weights applied to assets on bank balance sheets. This means that both the numerator (capital requirement) and denominator (risk-weighted assets) for bank capital calculations will increase. When the dust settles, we expect that large banks will carry roughly double the amount of common-equity capital than they did prior to the financial crisis for a given set of risky assets, adding substantially to the capital cushion beneath preferred securities. From a credit standpoint, the new rules are good news for investors in preferred securities and ensure that present healthy levels of bank capital only get healthier.

Putting all of this together, we continue to expect moderate – albeit slightly slower – growth in the U.S., with limited risk of renewed recession. Growth should be supported by accommodative monetary policy and low interest rates, improved business efficiency, and gradual improvement in housing. It is likely to continue to be restrained by deleveraging by households and financial

[4] See *Implications of Proposed Bank Capital Regulations for Investors in Preferred Securities*, Flaherty & Crumrine Incorporated, July 6, 2012. Available at www.preferredincome.com or www.fcclaymore.com.

businesses, worries over the European sovereign debt situation, and the uncertainty surrounding the "fiscal cliff." Modest growth and low interest rates should support improving credit fundamentals and continue to cause investors to seek out yield. Finally, regulations should encourage banks to operate their businesses more conservatively and with more common equity capital than they did in the past. We anticipate preferred securities will continue to benefit over time from these developments.

Flaherty & Crumrine Incorporated
July 13, 2012

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