

November, and still-high affordability combined with rising employment should further boost sales (Figure 6). In addition, inventories of unsold homes and homeowner vacancy rates are declining. Although construction of new homes is increasing, it remains well below long-term demand for housing (household formation plus home replacement due to obsolescence or loss such as fire or flood). As a result, existing home supply should continue to be absorbed, which should drive both residential investment and home prices higher. Home prices began rising earlier in 2012 (Figure 7), and we anticipate modest but durable increases in home prices over the next few years. In turn, higher home prices should drive further improvement in mortgage loan performance, which is good news for banks and preferred investors. Higher prices should bolster household wealth and, perhaps, consumption. However, at just 2.7% of GDP, even rapid growth in residential investment would make only modest contributions to overall GDP.

Figure 6: Home Sales Up, Inventory Down

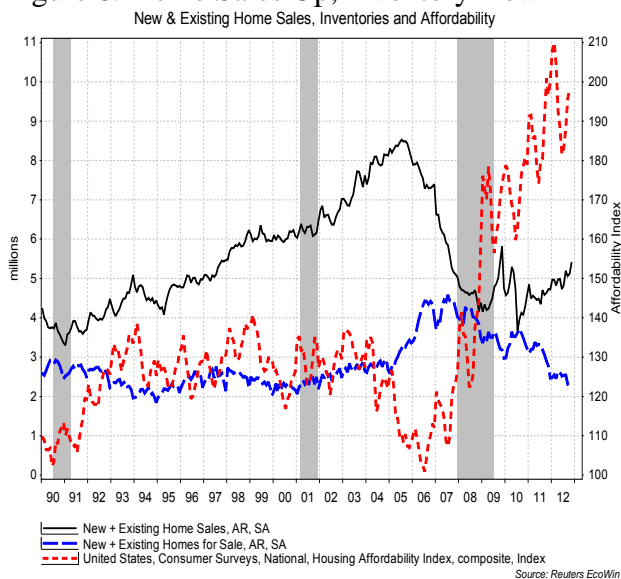


Figure 7: Home Prices Rising Slowly

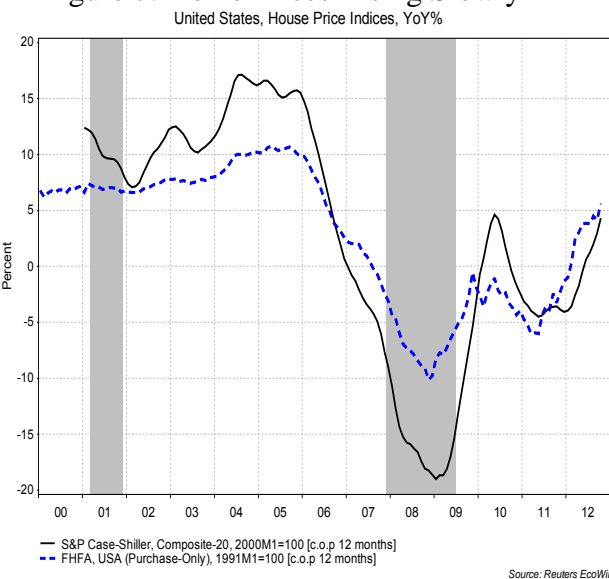


Figure 8: Shipments and Orders Recovering...

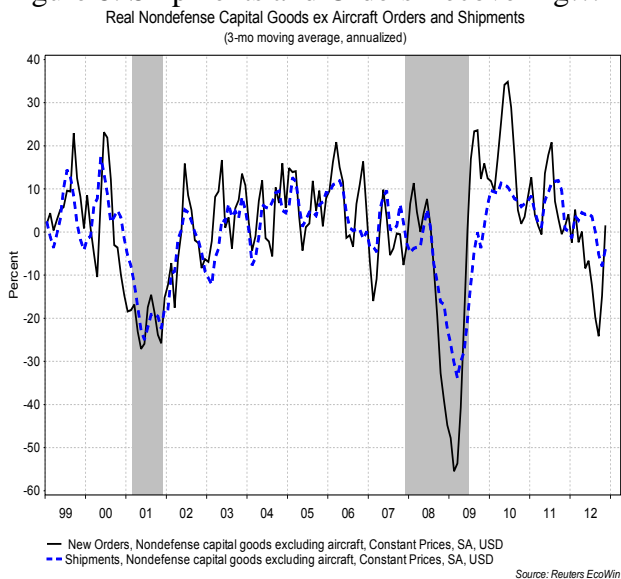
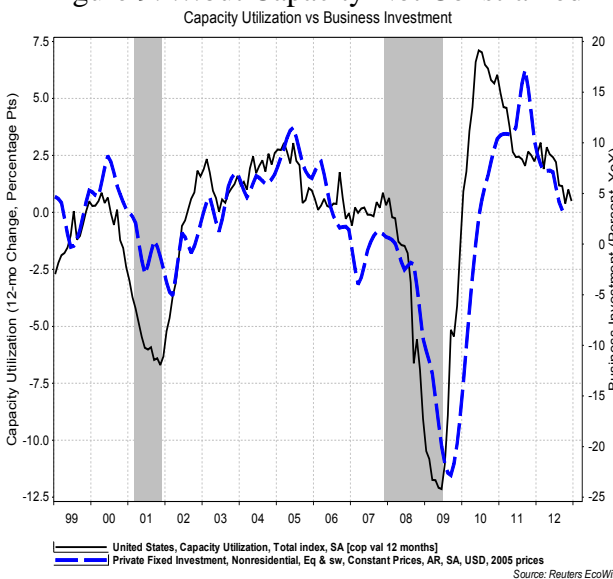


Figure 9: ...but Capacity Not Constrained



Business investment probably recovered in Q4 after slipping last quarter. Inflation-adjusted shipments of nondefense capital goods excluding aircraft rebounded modestly in the first two months of Q4, and orders also rose, suggesting higher levels of business investment for the quarter as a whole (Figure 8). We do not anticipate strong growth in investment, however, since capacity utilization has remained essentially flat in 2012 around 78.4%. That does not mean investment will be zero, but businesses tend to invest more aggressively when capacity utilization is increasing, which is not the case today (Figure 9).

Industrial production rose by just 1% in Q4 (Figure 10). Hurricane Sandy caused production disruptions that slowed output. Beyond the impact of Sandy, nonfarm inventories added 1.1% to Q3 real GDP growth, and producers responded to that inventory accumulation by trimming production. Slower inventory growth will almost certainly subtract from GDP growth in Q4, although it is difficult to put a sharp pencil on the amount. More positively, surveys from the Institute of Supply Management point to some recovery late in Q4 at manufacturers and strong growth at non-manufacturing companies (Figure 11). In each of these surveys, a reading over 50 signals above-trend growth.

Figure 10: Industrial Production Slowed

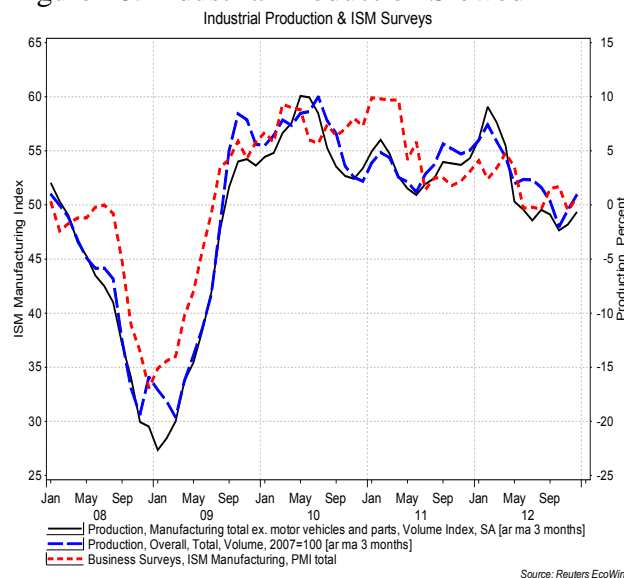
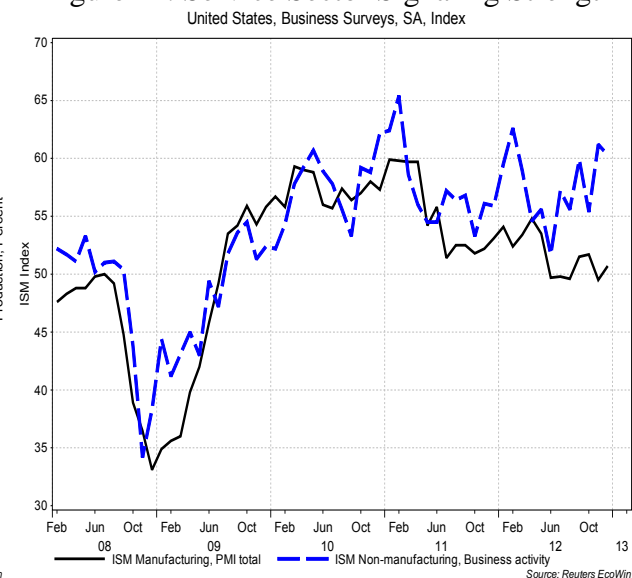


Figure 11: Service Sector Signaling Strength



The **trade deficit** widened in October and November, making it likely that trade will be a drag on GDP growth in the fourth quarter. The real trade deficit ballooned to almost \$52 billion in November, the worst result since 2008 (Figure 11). Production and port disruptions from Hurricane Sandy may have depressed exports in November, which would explain at least some deficit widening. If December's deficit retraces half of its November widening, trade would subtract about ½ percent from Q4 GDP. Looking ahead, we expect trade will have little net impact on 2013 GDP growth overall (slightly positive in H1, negative in H2).

Figure 11: Trade Deteriorated in Q4

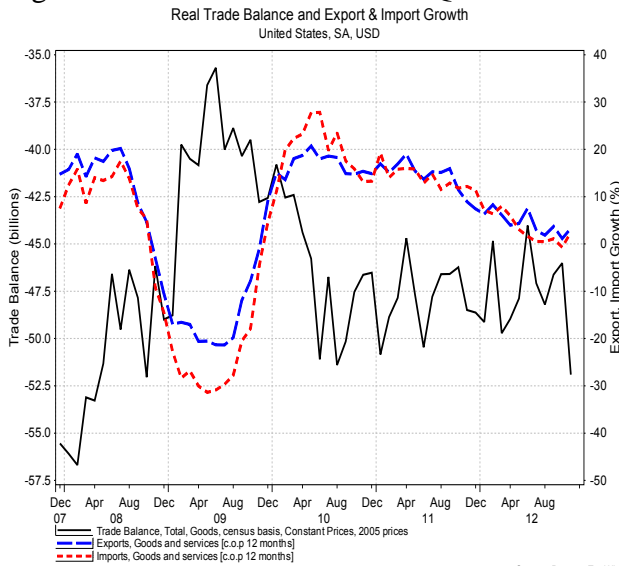
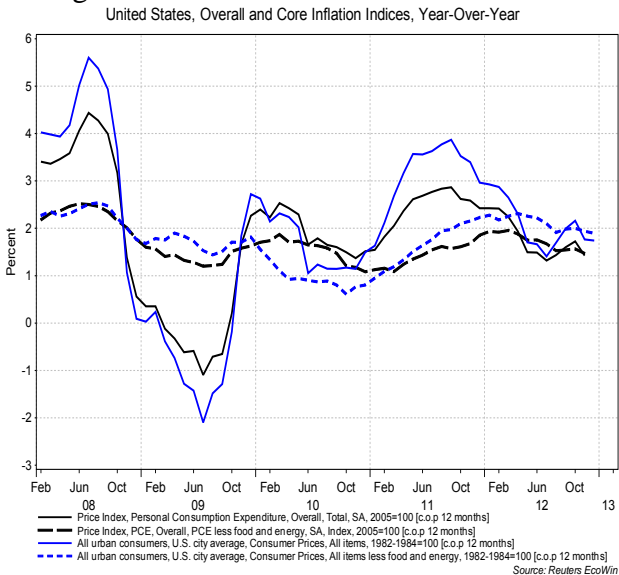


Figure 12: Inflation Remains Subdued



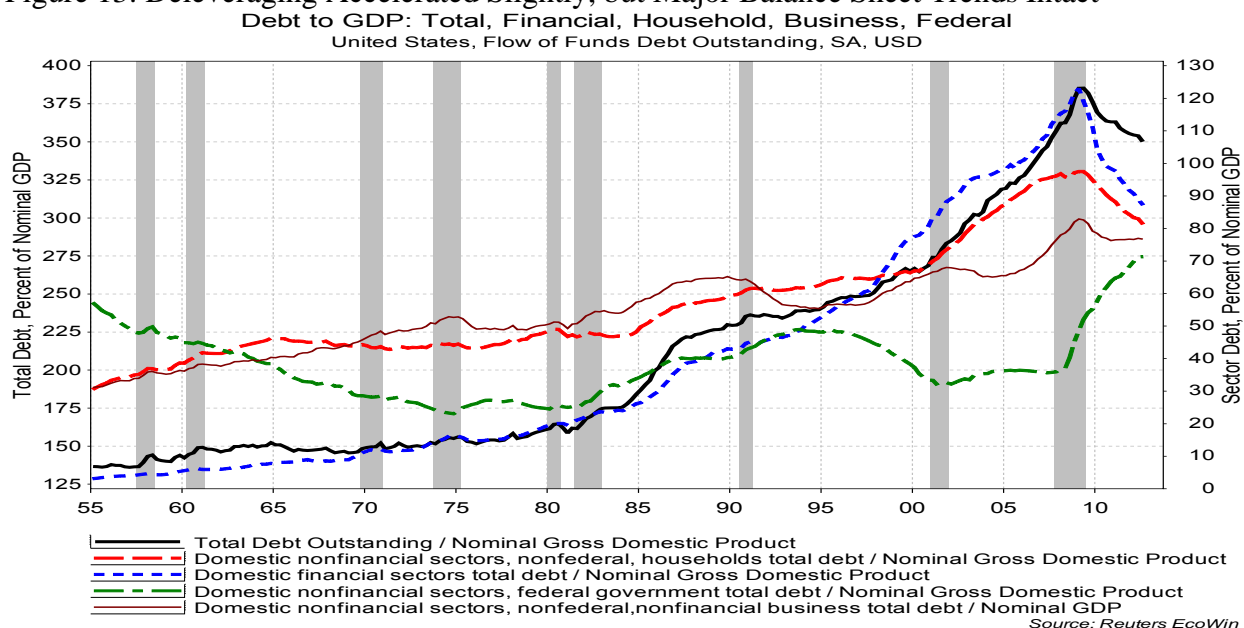
Government consumption probably fell again in the fourth quarter after rising by 3.9% in Q3. Government spending subtracted an average of 0.3% from real GDP in the first half of 2012, added 0.75% in Q3, and probably subtracted at least that much in Q4. Looking ahead in 2013, the trajectory of government consumption will depend upon resolution of the spending portion of the fiscal cliff. For now, the spending sequester that was scheduled to take effect on January 1 has been postponed until March 1. That leaves politicians about six weeks to work out a new spending agreement – possibly accompanied by additional tax revenues. If agreement cannot be reached, the sequester will take effect, and the near-term impact on GDP will be sizable. The Congressional Budget Office (CBO) estimates that the unresolved portion of the Budget Control Act of 2011 (i.e., sequester) would subtract about 1.25% from 2013 GDP growth if it is enacted as currently legislated.

Our political crystal ball has always been hazy, and it is particularly so today given the highly partisan nature of current politics in Washington. Although we felt confident that most tax increases embodied in the fiscal cliff would be avoided, we are much less certain about spending cuts. From an economic perspective, we would like to see (i) modest spending “cuts” over the near term to minimize drag on what is already a slow recovery, (ii) entitlement reform to slow the growth of spending on those programs and (iii) tax reform to enhance economic growth. (We put the word “cuts” in quotations because, except under sequester, government spending continues to increase under every budget proposal currently on the table in Washington. “Cuts” refer to slower *growth* in spending, not lower spending in absolute terms.) At this point, we have no clear idea how remaining fiscal cliff negotiations will turn out. However, it is clear that government spending will reduce GDP growth in 2013; we assume the drag will be somewhat less than 1.25% (CBO estimate under sequester) but greater than zero. We should have a better sense of where government spending is headed by the time of our April Update.

Inflation pressures eased over the course of 2012 as energy prices ended the year about where they began. The consumer price index (CPI) was up 1.7% overall and 1.9% excluding food and energy in 2012 (Figure 12). The PCE deflator was up 1.2% overall and 1.5% excluding food and energy over 12 months ending in November (the latest available data). Inflationary and

deflationary pressures appear balanced over the near term. However, the Federal Reserve's highly accommodative monetary policy raises longer-term inflationary risks.

Figure 13: Deleveraging Accelerated Slightly, but Major Balance Sheet Trends Intact



We will conclude this section, as usual, with a look at broad **balance sheet trends** in the US (Figure 13). Deleveraging in the private sector accelerated slightly in the third quarter (the latest data available), possibly in response to uncertainty over the November elections and looming fiscal cliff. Households and financial firms continue to pare debt rapidly as a proportion of GDP. Most of the decline in debt is in mortgages; credit card debt is about flat, while student and auto lending is increasing. Nonfinancial businesses borrowing edged slightly lower in Q3 but has held roughly steady since late 2010. Given good profitability, low interest rates, strong balance sheets, and ample liquidity, businesses have plenty of room to boost borrowing and investment if and when business confidence improves. Government borrowing continued to rise, albeit at a slower pace than in recent quarters. The current account deficit necessarily shrunk to 2.7% of GDP to accommodate these stronger domestic savings flows. We expect economic growth to remain subdued during this period of deleveraging, which is likely to continue for some time to come.

Market Outlook

Long-term **Treasury rates** rose in the fourth quarter as US economic growth plodded along and European sovereign debt woes eased (Figure 14). The 30-year benchmark Treasury bond rose by 13 basis points (bp) to end Q4 at 2.95%, and it has risen a further 7 bp to 3.02% as of the date of this report. The Federal Reserve left the federal funds rate unchanged at 0.25%.

The Fed made several important changes to monetary policy in the fourth quarter. First, it expanded its third round of quantitative easing (QE3) to include purchases of US Treasury securities. Recall that the Federal Open Market Committee (FOMC) introduced QE3 at its September 2012 meeting with \$40 billion per month of unsterilized purchases of agency mortgage-backed securities. It expanded the securities purchase program at its December meeting to include \$45 billion per month of longer-term (4-year and longer) Treasuries. These outright

purchases of Treasuries replaced the Fed’s maturity extension program that concluded at the end of December 2012. The difference between “Operation Twist” and QE3 is that the former did not change reserves and base money (it substituted one maturity Treasury issue for another on the Fed’s balance sheet), while the latter expands them.

Figure 14: Treasury Rates Up, Fed Funds Stable

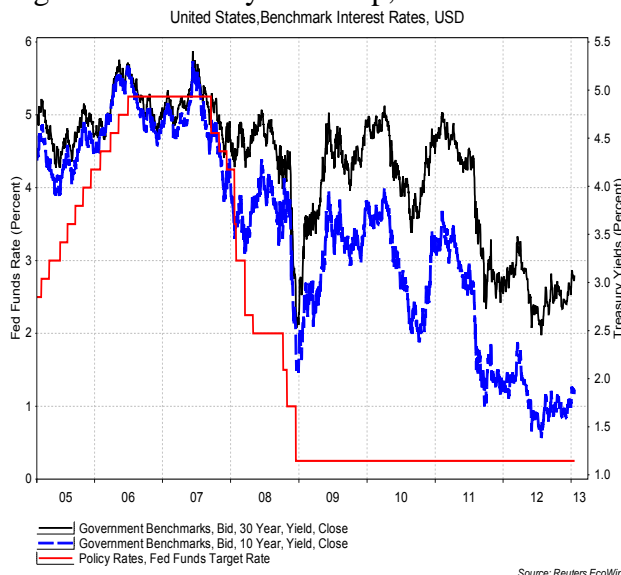
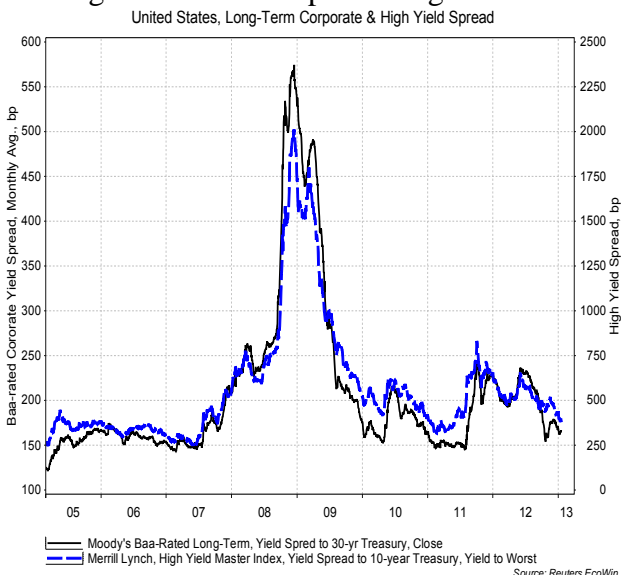


Figure 15: Credit Spreads Tighter



The second important change is the Fed’s communication of its interest rate policy expectations. Previously, the FOMC provided *time-based* guidance for the fed funds rate. For example, the September 2012 FOMC statement reads “[the Committee] currently anticipates that exceptionally low levels for the federal funds rate are likely to be warranted at least through mid-2015.” In December, the FOMC switched to *principle-based* guidance: “[the Committee] currently anticipates that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee’s 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored.” Under the new regime, it is the *unemployment rate* (>6.5%), *inflation* (<2.5%), and *inflation expectations* (“well anchored” – fuzzy but probably recognizable) that matter. Although the FOMC stressed that given current expectations, the old time-based guidance and new principle-based guidance were broadly consistent (i.e., the Fed still feels rates will stay low through mid-2015 or later), the new formulation gives market participants a better sense of the Fed’s reaction function. That may lead to more variable assessments of when the Fed will begin to raise the fed funds rate, but they will be based on observable data rather than on the market’s interpretation of how the Fed views that data. We think it’s a good change. We will discuss its implications for markets at the end of this section.

Credit spreads tightened in the fourth quarter and have continued to edge tighter in January. Long-term Baa-rated corporate bond spreads narrowed by 22 bp in Q4, more than offsetting the rise in long-term Treasury rates. High yield spreads tightened by 56 bp, easily eclipsing the 13 bp rise in 10-year Treasury rates. Preferred securities also performed well, with various preferred indices posting pre-tax returns ranging from +0.7% to +3.3% in Q4.

Tighter credit spreads were supported by strong and, often, improving credit fundamentals. Corporate profits as a share of GDP remain near record highs (Figure 16).² Solid earnings and modest capital investment have helped companies strengthen their balance sheets. Interest expense as a percentage of earnings before interest and taxes remains low; long-term debt to total debt is at a record high; and liquidity remains strong (Figure 17). Loan delinquency and charge-off rates are declining across all major loan categories (Figure 18). Finally, household debt burdens continue to decline, especially for homeowners (Figure 19). All of this is good news for credit instruments such as preferred securities.

Figure 16: Corporate Profits Near Record High

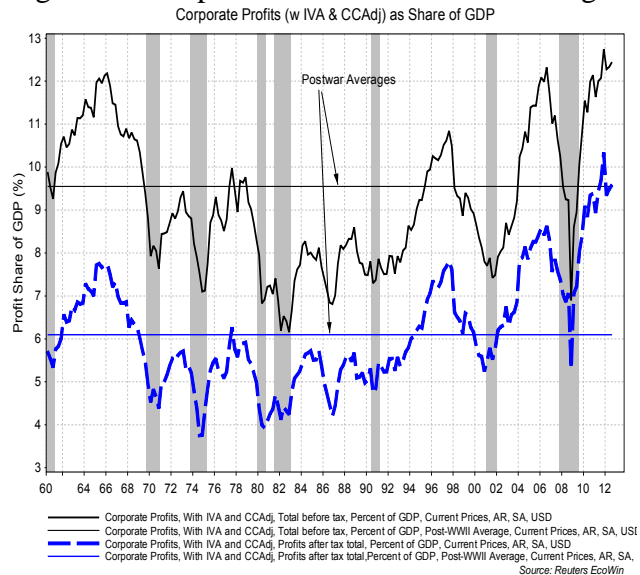


Figure 17: Balance Sheets Strong

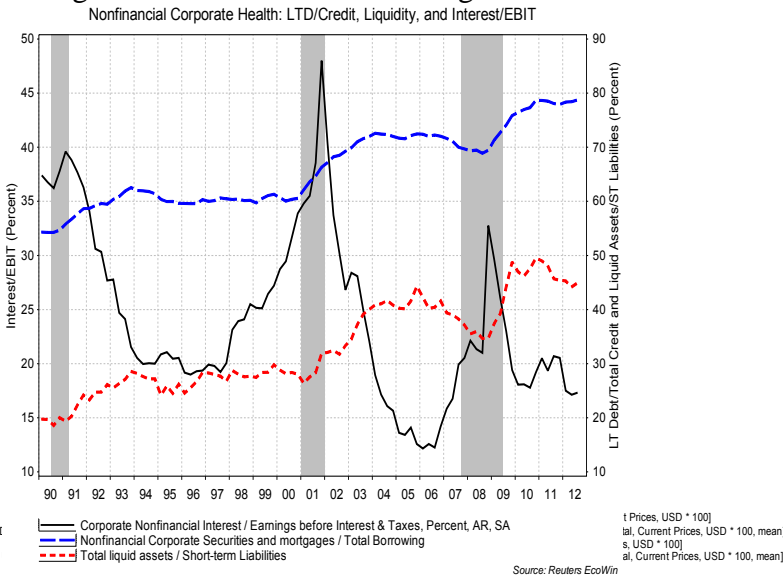


Figure 18: Loan Quality Improving

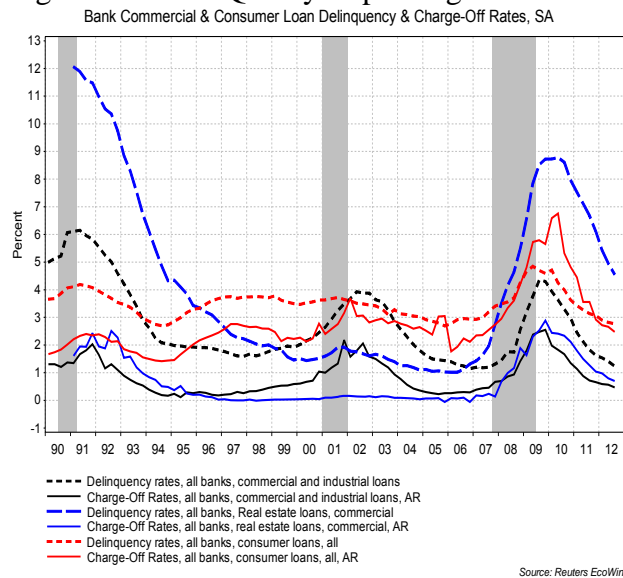
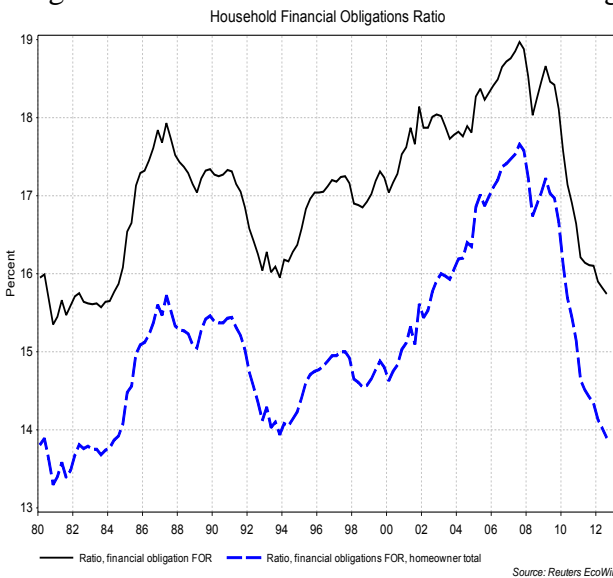


Figure 19: Household Debt Burdens Declining



² Although the corporate profit share of GDP could move higher, history suggests it is more likely to move sideways or decline, especially as the unemployment rate falls (prompting higher wages). If so, corporate earnings would grow no faster than nominal GDP, which might be disappointing to common equity investors.

We anticipate some further tightening of credit spreads in 2013 for the same reasons as last year: slow but steady economic growth in the US, low rates on alternative investments, accommodative monetary policy, and sound credit fundamentals. At current spreads, however, there is less room for tightening than there was when spreads were wider. Investors should calibrate their expectations accordingly.

Although credit fundamentals are currently sound, there are some developing trends that could become worrisome if they run too far. First, the corporate “financing gap,” internally generated cash less capital expenditures, is moving from negative (i.e., internal cash greater than investments) toward positive, and net corporate borrowing in the bond market is increasing (Figure 20). So far, most of this additional borrowing has gone toward balance sheet strengthening: raising long-term debt as a proportion of total debt, and improving liquidity. It has *not* contributed to greater leverage in aggregate – though there are certainly examples of companies that have increased leverage substantially. Moreover, a positive financing gap is *normal*. Companies typically do not generate enough cash (net of taxes and dividend distributions) to cover all of their investment requirements. Savings from US households and foreign entities provide funds for those investments. We think the trend in the financing gap is consistent with a gradual return to more normal economic activity.

Figure 20: Financing Gap Normalizing

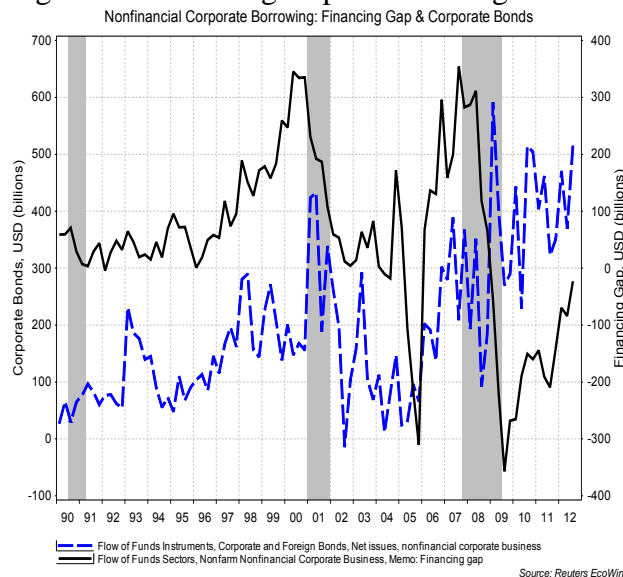
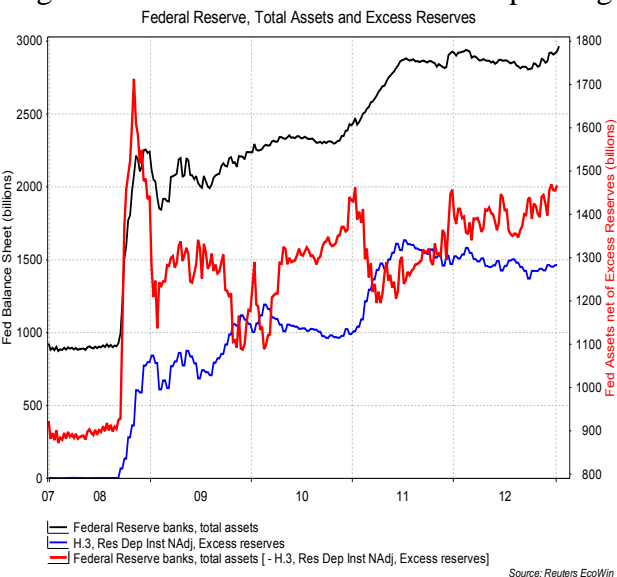


Figure 21: Fed’s Net Balance Sheet Expanding



Second, bank credit is growing again. It is up 5.1% YoY, about 1% faster than nominal GDP growth. The Fed’s balance sheet is expanding too. This is no surprise given QE3, but what is different from earlier quantitative easing programs is the behavior of excess reserves. After the immediate rush of liquidity provided by the Fed during the financial crisis, the Fed’s net balance sheet (total assets minus excess reserves, shown in red) was little changed at about \$1.3 trillion (Figure 21). That meant that when the Fed injected liquidity into the banking system, it essentially came right back to the Fed as excess reserves. That began changing in 2011, and the Fed’s net balance sheet has expanded gradually to \$1.46 trillion today. This means that some of the Fed’s quantitative easing is working its way into the economy. It’s far from dollar-for-dollar (monetary velocity is still falling), and the pace of loan expansion is not alarming. It is, however, another sign of normalization.

The problem is that *interest rates* are not normal. They have been suppressed by the Federal Reserve's low short-term rate policy and large-scale asset purchases. The Fed is now purchasing long-term Treasuries equal to roughly two-thirds of long-term Treasury issuance. Mortgage purchases are on top of that! That still leaves investors to buy approximately \$250 billion (annualized) in Treasury debt – more than the entire 2007 federal government deficit – but it is clear that when the Fed stops buying, private investors are going to have to absorb a lot more bonds. Higher interest rates likely will be required to attract those investors.

Of course, the difficult part for investors in preferred securities is identifying when tailwinds from sluggish (but not *too* sluggish) economic growth, shrinking preferred supply and improving credit fundamentals start to be overtaken by headwinds from faster economic growth, rising need for capital, and higher interest rates. Have we reached that point? Are preferred securities' prices a bubble about to burst?

Our answer today is “no,” but that will not be the case forever. We think current preferred prices are more a reflection of tepid economic and good credit conditions than artificially-low Treasury rates engineered by the Fed. For now, there is still substantial excess economic capacity (in the US and globally) that should keep inflation and interest rates low. Unemployment remains high, although it is trending lower. Capacity utilization rates have stalled out but are well off their lows. Office vacancy rates remain elevated, but housing inventory is falling. US assets are still attractive to foreign investors seeking liquidity and relative safety, but if our government cannot get its fiscal house in order, investment inflows could turn to outflows. Private sector deleveraging is pushing up savings and dampening demand for debt, but eventually that too will subside, as we already have seen in the nonfinancial corporate sector.

More importantly, the Fed's answer today is emphatically “No!” The Fed's new monetary policy targets of 6.5% unemployment subject to inflation below 2.5% will certainly not be reached in 2013 and probably not in 2014 – maybe not even in 2015 if political leaders make a mess of things in Washington. And even if the economy shrugs off higher taxes and job growth quickens, it is likely that labor participation will increase and slow any decline in the unemployment rate. The Fed is going to keep the fed funds rate near zero for a long time, and it rarely pays to fight the Fed. What happens to QE3 is a tougher call, and December's FOMC meeting minutes indicate there is more debate at the Fed about its appropriate end-date than we previously expected. Nonetheless, we think the Fed perceives the risk of being too early in withdrawing monetary accommodation is greater than the risk of being too late. If so, the Fed should act to keep interest rates low throughout 2013.

Unwinding the Fed's current monetary experiment is likely to be messy and unpredictable. We cannot promise we will get it all right. In fact, we can promise that we will not get it all right. What we will do is follow our credits diligently, seek value, and be faithful students of the preferred market and stewards of your assets. As befits this time of year, we wish you a healthy and prosperous 2013 and thank you for your trust in us.

Flaherty & Crumrine Incorporated
January 16, 2013

© 2013, Flaherty & Crumrine Incorporated. All rights reserved. This commentary contains forward-looking statements. You are cautioned that such forward-looking statements are subject to significant business, economic and competitive uncertainties and actual results could be materially different. There are no guarantees associated with any forecast; the opinions stated here are subject to change at any time and are the opinion of Flaherty & Crumrine Incorporated. Further, this document is for personal use only and is not intended to be investment advice. Any copying, republication or redistribution in whole or in part is expressly prohibited without written prior consent. The information contained herein has been obtained from sources believed to be reliable, but Flaherty & Crumrine Incorporated does not represent or warrant that it is accurate or complete. The views expressed herein are those of Flaherty & Crumrine Incorporated and are subject to change without notice. The securities or financial instruments discussed in this report may not be suitable for all investors. No offer or solicitation to buy or sell securities is being made by Flaherty & Crumrine Incorporated.