Second-Quarter US Economic Update
July 2013

Summary of Recent Economic Developments

US economic growth continues at a moderate pace with low inflation but stubbornly high unemployment. Following disappointing growth of 1.8% in the first quarter, economists expect GDP growth of 1.5-2.0% in 2Q2013, accelerating to 2.3% in 2013's second half and 2.6% for 2014 as a whole. The unemployment rate was unchanged at 7.6% in Q2, but payroll job growth picked up steadily during the quarter and wages and personal income accelerated. Personal spending slowed, however, and the savings rate climbed back above 3%. Housing continues to grow rapidly, with home sales and home prices both up sharply over the past year. Higher mortgage rates will probably moderate but should not derail housing recovery. Business investment is growing slowly but is not likely to accelerate near-term. Industrial production slowed and the trade deficit widened. Government consumption continues to shrink and should remain a drag on GDP throughout 2013. Inflation remains subdued and well below the Federal Reserve's target. Despite sluggish first-half growth, the Fed expects GDP will accelerate and unemployment will decline sufficiently to begin tapering its securities purchases by year-end and to eliminate them by mid-2014. The Fed expects to begin raising the fed funds rate in 2015. Fed guidance prompted a significant increase in fixed-income yields, and preferred securities' prices fell substantially. We expect more market volatility ahead, but improving credit fundamentals and lower prices have increased prospective returns on preferred securities.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	2011:3	2011:4	2012:1	2012:2	2012:3	2012:4	2013:1	2013:2
Real GDP, Chg QoQ (%, SA, AR)	1.3	4.1	2.0	1.3	3.1	0.4	1.8	2.0f
Real Personal Consump Expnds, Chg QoQ (%, SA, AR)	1.7	2.0	2.4	1.5	1.6	1.8	2.6	1.4f
Real Busi Investmt, Eqp & Sftware, Chg QoQ (%, SA, AR)	18.3	8.8	5.4	4.8	-2.6	11.8	4.1	NA
Real Residential Investmt, Chg QoQ (%, SA, AR)	1.4	12.1	20.5	8.5	13.5	17.6	14.0	NA
Corporate Profits, After Tax, Chg YoY (%, SA, AR)	7.8	14.5	9.2	4.4	3.2	-1.1	7.0	5.8f
Current Account Balance, Annualized (% of GDP, SA)	-2.8	-3.0	-3.1	-2.8	-2.7	-2.6	-2.7	NA
Federal Budget, 12-mo Def or Surp (% of GDP)	-8.6	-8.2	-8.1	-7.9	-6.9	-6.7	-5.7	-5.5a
Unemployment Rate (%, SA)	9.0	8.5	8.2	8.2	7.8	7.8	7.6	7.6
Household Employment, Chg QoQ (000, SA)	759	732	1124	428	526	331	-19	772
Nonfarm Payrolls, Chg QoQ (000, SA)	435	570	787	324	456	626	622	589
Nonfarm Productivity, Chg QoQ (%, SA, AR)	-0.1	2.3	-0.7	1.7	3.1	-1.7	0.5	NA
Capacity Utilization (%, SA)	76.7	77.3	77.3	77.7	77.2	77.8	78.1	77.6a
GDP Price Index, Chg QoQ (%, SA, AR)	3.0	0.4	2.0	1.6	2.7	1.0	1.2	1.3f
Consumer Price Index, Chg YoY (%, AR)	3.9	3.0	2.7	1.7	2.0	1.7	1.5	1.4a
CPI ex food & energy, Chg YoY (%, AR)	2.0	2.2	2.3	2.2	2.0	1.9	1.9	1.7a
Nominal Personal Income, Chg YoY (%, AR)	4.6	3.6	3.2	3.1	3.6	8.2	2.8	3.3a
Personal Savings Rate (%, SA)	3.5	3.4	3.7	4.1	3.3	7.4	2.6	3.2a
Rate or Spread (End of Quarter)	**2011:3**	**2011:4**	**2012:1**	**2012:2**	**2012:3**	**2012:4**	**2013:1**	**2013:2**
Federal Funds Rate Target (%)	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3-month LIBOR (%)	0.37	0.58	0.47	0.46	0.36	0.31	0.28	0.27
10-Yr Treasury Note Yield (%)	1.92	1.87	2.22	1.66	1.64	1.76	1.85	2.49
30-Yr Treasury Bond Yield (%)	2.91	2.89	3.34	2.75	2.82	2.95	3.10	3.50
Moody's Baa Long Corp Spread (bp)	231	227	196	231	190	168	173	185
10-Yr Interest Rate Swap Spread (bp)	19	17	8	13	7	6	16	21

* Figures are either quarterly or, if more frequent, end of period. f = Forecast[1]; a = Actual through May 2013 Source: Reuters EcoWin

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

Economic Outlook

US economic growth continues at a moderate pace with low inflation. Inflation-adjusted gross domestic product (real GDP) grew 1.7% in 2012 and 1.8% in 1Q2013. Economists expect GDP growth of 1.5-2.0% in 2Q2013, accelerating to 2.3% in 2013's second half and 2.6% for 2014 as a whole.[1] Despite stronger growth, unemployment is forecast to remain elevated at 7.2% in June 2014 compared to 7.6% currently. Our own forecasts are in-line with consensus in 2013 and slightly weaker in 2014. In particular, we expect unemployment will come down very slowly due to rising labor participation.

Figure 2: Slow Improvement in Labor Market

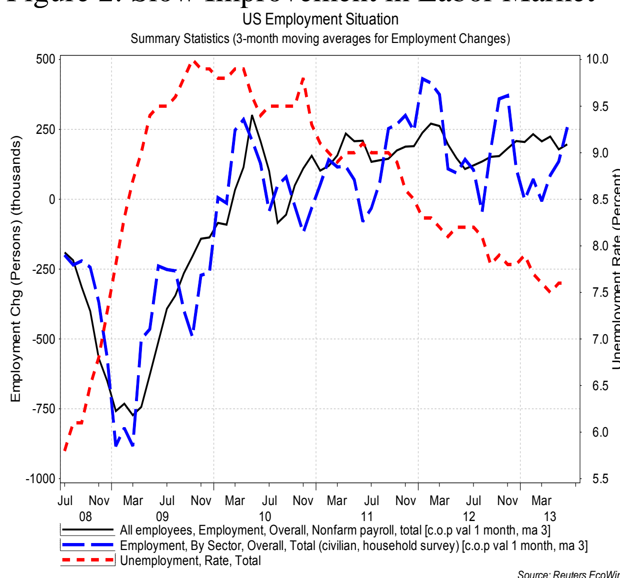
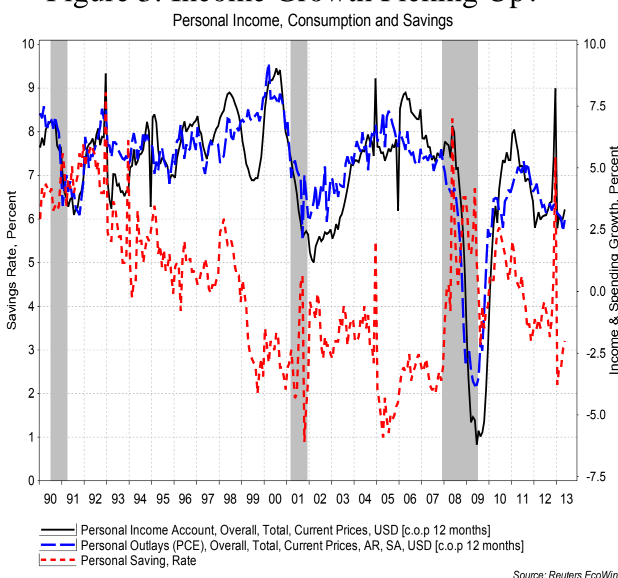


Figure 3: Income Growth Picking Up?



Labor market conditions improved in the second quarter. The unemployment rate was unchanged in Q2 at 7.6% as labor participation (finally) increased. Payroll employment rose by 589,000, slightly slower than first-quarter job growth of 622,000 but better than early-Q2 data indicated (Figure 2). The household employment survey counted even faster growth of 722,000 new jobs, but that was after 19,000 job losses last quarter. We put more faith in payroll survey data currently, when economic activity appears to be relatively steady (i.e., neither slowing nor accelerating sharply). Payroll data indicate gradual acceleration in job growth during Q2. Year-on-year (YoY) payroll growth was 1.7% in June, up from 1.5% in March. Wages also accelerated to 2.2% YoY in June from 1.8% in March. With a steady workweek, that means wage income accelerated from a little over 3% to just under 4%. Although it is still too soon to tell if improvement will be durable or transitory, higher employment and wages could support faster growth in personal consumption expenditures even as savings increase.

Consistent with better labor market performance, **personal income** growth also improved in the first two months of Q2 (June data will be released in late July). Wage and salary income increased 3.7% YoY in May, which pushed overall personal income up 3.3% YoY (Figure 3). Higher taxes blunted disposable income growth (2.2% YoY), but drag from taxes should fade next year.

[1] All growth rates are annualized unless otherwise noted. Forecasts in this Update are from *The Livingston Survey*, Federal Reserve Bank of Philadelphia, June 6, 2013 unless otherwise noted.

Personal consumption expenditures (PCE) grew more slowly than income, up 2.9% YoY on flat spending for the first two months of Q2 (Figure 3). Spending restraint allowed the personal savings rate to increase to 3.2% in May, up from 2.6% at the end of Q1. We continue to expect savings to move up gradually, during which time spending growth necessarily would lag income growth.

We will confess, however, that the personal savings rate generally has *declined* over the past several years. After rising to 5-7% during the 2008-09 recession and holding around 5% in 2010, the personal savings rate dropped below 3% even as households deleveraged (i.e., reduced debt as a percentage of GDP). That deleveraging was slower than it would have been had savings been higher, and it allowed for more-rapid – though still moderate – PCE and economic growth. We have not changed our view that households will deleverage further, but it is possible that they will do so more gradually than we anticipated and that the savings rate will not rise substantially. If so, then personal spending growth would be faster than we expect.

Although the personal savings rate has moved contrary to our expectations for the past several years, we still forecast it to rise from its current low level. We don't think a 3% savings rate is sustainable given increasing need for retirement and precautionary savings in the face of inevitable reductions in federal entitlement programs. Nonetheless, this is a risk factor in our outlook for continued moderate GDP growth over the next several years.

Figure 4: Home Sales Up, Affordability Down

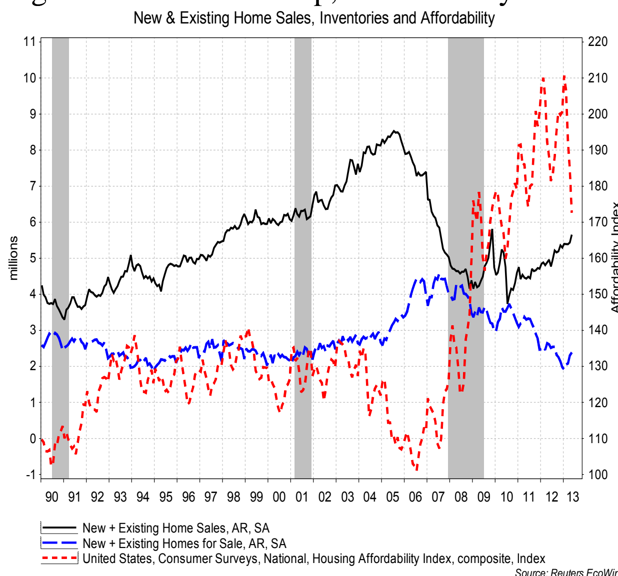
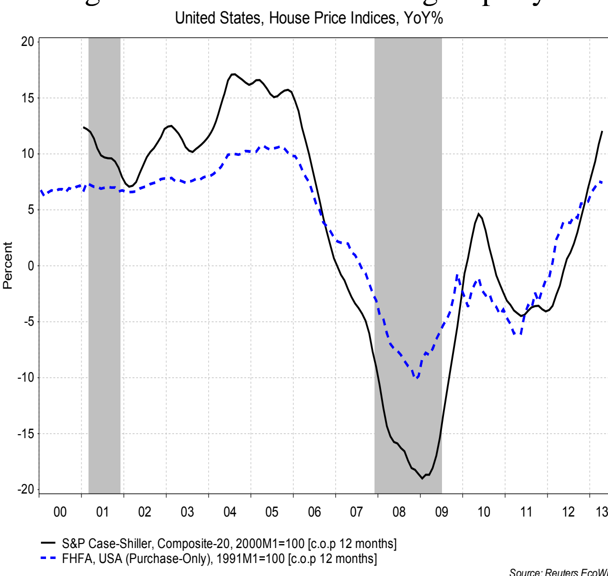


Figure 5: Home Prices Rising Rapidly



The **housing market** continues to improve rapidly. New and existing home sales are up 14% YoY to 5.66 million units in May (Figure 4). Home prices are up 12% (Case-Shiller 20-city Index) and 7.4% (Federal Housing Finance Agency Index) YoY in April (Figure 5). Real residential investment was up 14% in Q1 and added 0.3% to real GDP growth. It likely posted a similar gain in Q2. Housing affordability remains relatively high historically, but higher home prices and mortgage rates (Freddie Mac's 30-year fixed-rate mortgage rate is up over 100 bp from its May low to 4.51% currently) have reduced affordability significantly this year (Figure 4). Lower affordability will not derail housing recovery, but it probably will slow future gains in home prices.

The outlook for **business investment** remains mixed. Real investment in equipment and software was up 4.1% in Q1, and we expect only a bit slower growth in Q2. Capacity utilization rates have held about steady over the past year, which has reduced demand for new investment (Figure 6). Companies still need to invest to replace aging equipment and boost productivity, but current capacity appears to be adequate. With exports slowing and utilization rates steady, there is no pressing need to increase investment spending rapidly.

Figure 6: Steady Utilization = Slow Investment

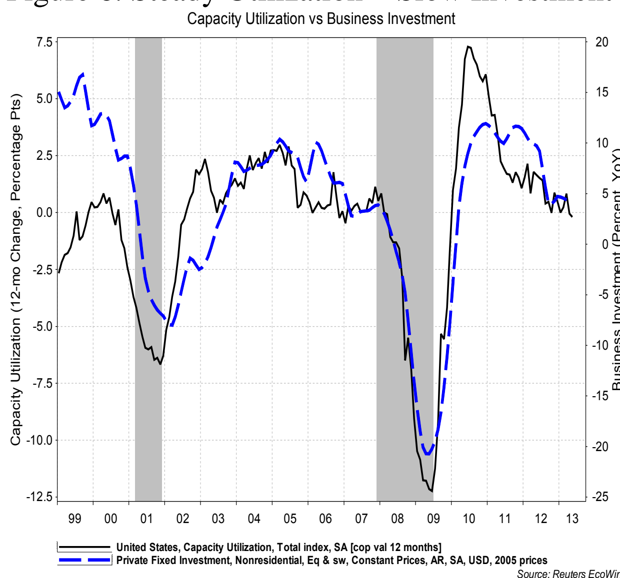
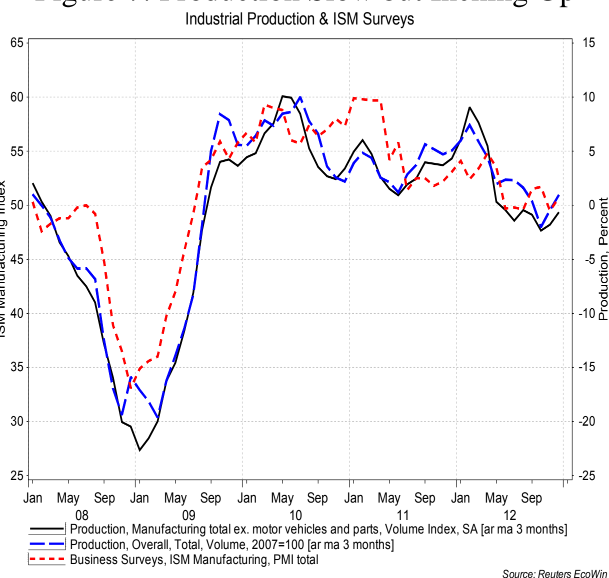


Figure 7: Production Slow but Inching Up



Businesses have even less need for investment in structures, which has remained about unchanged in real terms over the past year. Broadly speaking, business structures are used to house employees (office buildings, stores and factories), make stuff (factories), and hold stuff (warehouses and stores). Employment remains about 2 million jobs below its pre-crisis peak. Likewise, industrial production remains slightly (-2%) below its pre-crisis peak, and goods-producing employment has fallen even more (-15%) as productivity has increased. Domestic sales are growing slowly, and inventory-to-sales ratios have held about steady for the past few years. Economic activity has not yet reached a level that strains capacity of current structures. This is confirmed by vacancy rates for commercial real estate. They have declined with economic recovery, but vacancies have not fallen enough to spur large increases in new building. Eventually, investment in business structures will pick up, but current employment and output trends suggest we are a year or more away from that time.

After a strong start in early 2013, **industrial production** slowed in the second quarter (Figure 7). Earlier strength was partly due to recovery from superstorm Sandy, so it is not surprising that production eased in Q2. Export growth has slowed as well. Exports were a source of strength for manufacturers earlier in the recovery, but it may take some time before that demand builds again. Encouragingly, however, the Institute of Supply Management's manufacturing survey turned up in June, and orders for core capital goods also have picked up a bit. Neither signals an imminent boom in manufacturing, but they do suggest stronger output growth in the second half of 2013.

The **trade deficit** appears to have widened in the second quarter (Figure 8). Net exports subtracted 0.1% from real GDP in Q1. So far in Q2 (through May), net exports have subtracted

about 0.7% from GDP. Economic growth abroad has been slower than expected, with Europe still in recession and growth slowing in developing Asia. Among advanced economies, US growth is comparatively strong, which suggests US exports are likely to grow no faster (and quite possibly slower) than imports. Moreover, trade flows have slowed: Both import and export growth rates are near zero (Figure 8). We expect that trade will be a moderate drag on US growth this year and next.

Figure 8: Trade Deficit Wider, Flows Down

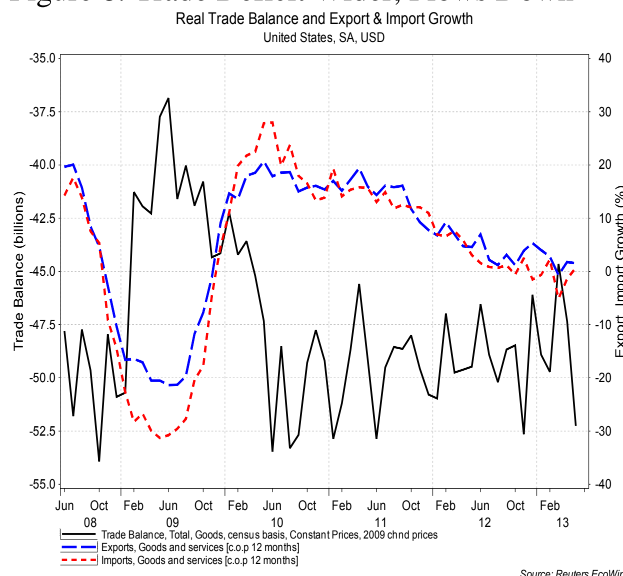
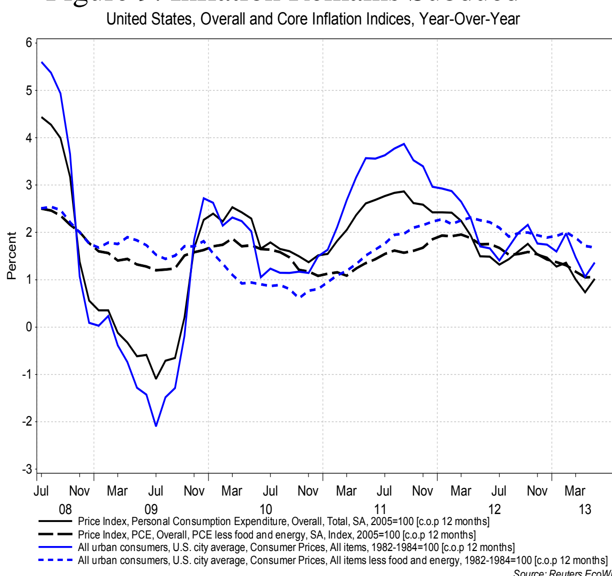


Figure 9: Inflation Remains Subdued



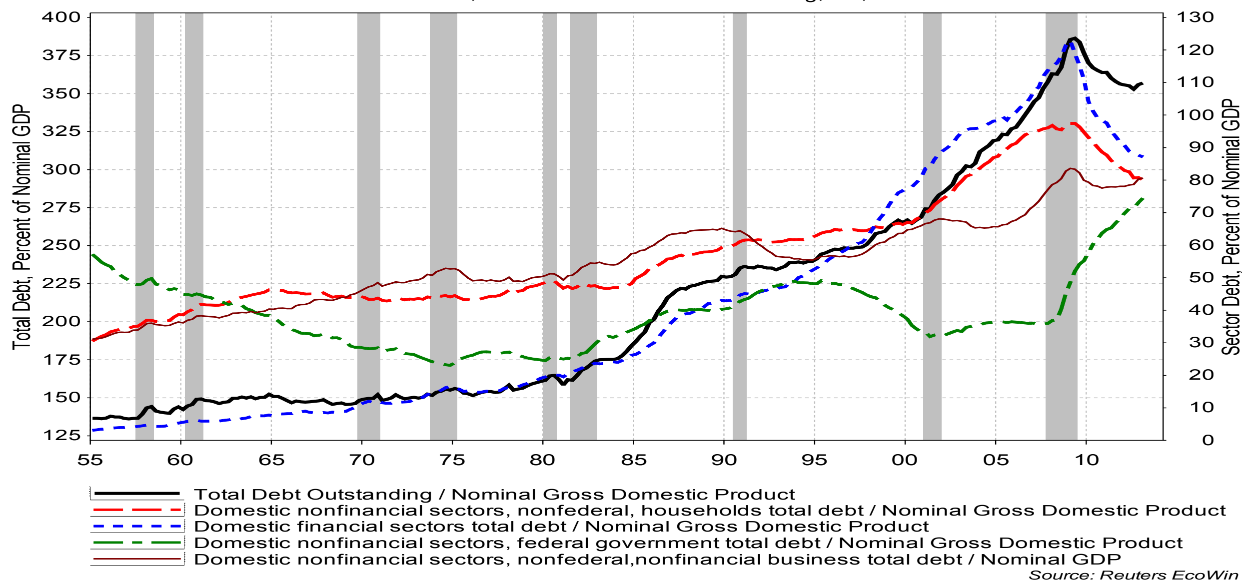
Government consumption almost certainly fell again in Q2 after shrinking 4.8% in real terms in Q1. Federal government spending is constrained by sequester and should contract for all of 2013. 2014 spending will depend upon progress (or lack thereof) replacing sequester legislation with a new spending bill. We aren't holding our breath. Real state and local government spending is falling slowly (-2.1% in Q1). It should turn positive in another few quarters in response to rising tax revenue, which was up 3.8% YoY in Q1. Taken together, government consumption should remain a drag on GDP growth at least through 2013 and possibly into 2014.

Inflation remains low and has generally eased in 2013 (Figure 9). The Consumer Price Index (CPI) is up 1.4% for all items and 1.7% excluding food and energy prices over the year ending in May. The PCE deflator is up just 1.0% overall and 1.1% excluding food and energy over the same period – well below the Federal Reserve's 2% target. Although excess capacity is gradually diminishing, progress is slow, and we foresee little inflation pressure emerging for several years despite highly accommodative monetary policy.

We will conclude this section, as usual, with a look at broad **balance sheet trends** in the US. Debt-to-GDP increased again in Q1 (latest data available) as corporate nonfinancial borrowing rose and household and corporate financial deleveraging slowed (Figure 10). Federal government borrowing slowed as well, although it continues to expand rapidly. Savings trends represented by these changes are generally what we would expect as economic recovery progresses and financial markets normalize. Government borrowing should slow and, eventually, decline as a proportion of GDP (although that will not happen without substantial fiscal reform). Household borrowing should increase as housing recovers, although probably not as fast as GDP. Nonfinancial

corporations should begin to invest more aggressively. Financial companies are a different story, since they are still responding to higher regulatory capital requirements; they are likely to continue deleveraging for several more years as those requirements are phased in.

Figure 10: Deleveraging Slowed, but Not Moving Back to "Old Normal"



However, normalization of financial markets does not mean a return to credit expansion reminiscent of 1990-2008, which some might call "Old Normal." We expect declining (or at least stable) overall debt-to-GDP in the US for some years to come. Such a credit environment would look less like the 1990s or 2000s and more like the 1960s (preferably the low-inflation early-1960s rather than the rising-inflation late-1960s). It would facilitate modest but sustainable growth and relatively low interest rates. Of course, many things could push the economy off that path, but for now we think that is where the US economy is headed.

Market Outlook

Long-term **Treasury rates** rose sharply in the second quarter as the Federal Reserve outlined its plans for gradually reducing – and eventually removing – monetary accommodation. The 30-year benchmark Treasury yield rose by 40 basis points (bp) to 3.5% on June 30, and it is up another 13 bp so far in July (Figure 11). The Fed left the federal funds rate target unchanged at 0.25%, and it continues to purchase $45 billion per month in longer-term US Treasuries and $40 billion per month in mortgage-backed securities.

Although the Fed did not alter monetary policy in Q2, it did alter market expectations regarding future policy actions. The Federal Open Market Committee (FOMC) anticipates real GDP growth of 3.0-3.5% in 2014, with unemployment falling below 7% by mid-2014 and to 6.5-6.8% in 4Q2014 – considerably more optimistic than economists' consensus forecasts. Based on that outlook, Fed Chairman Bernanke issued updated guidance on monetary policy. The Fed would begin to taper its Treasury and mortgage-backed securities purchases later in 2013, with purchases ending in mid-2014; the federal funds rate would remain near zero until sometime in 2015 and rise "gradually" thereafter.

The Fed's change in policy guidance affected two market expectations: Size of the Fed's balance sheet, and timing and pace of federal funds rate hikes. Whether the Fed's tapering of securities purchases begins in September (earliest likely move) or a few months later (prior market expectations) does not make much difference to its nearly $3.5 trillion balance sheet and, therefore, should not affect long-term interest rates much. Higher short-rate expectations probably play a much bigger role in the market's selloff. However, if the FOMC's economic forecasts are too optimistic – and we think they are even before factoring in any negative impact to growth from higher interest rates – then market expectations for higher policy rates should wane to the extent that economic growth does not match those forecasts. Investors should be prepared for relatively high volatility as markets compare reported economic data to Fed guidance. It is likely to be a bumpy summer for fixed-income markets.

Figure 11: Treasury Rates Up Sharply

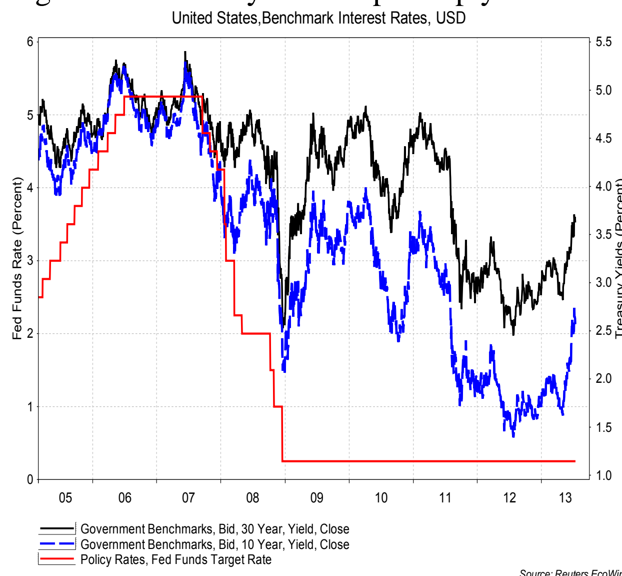
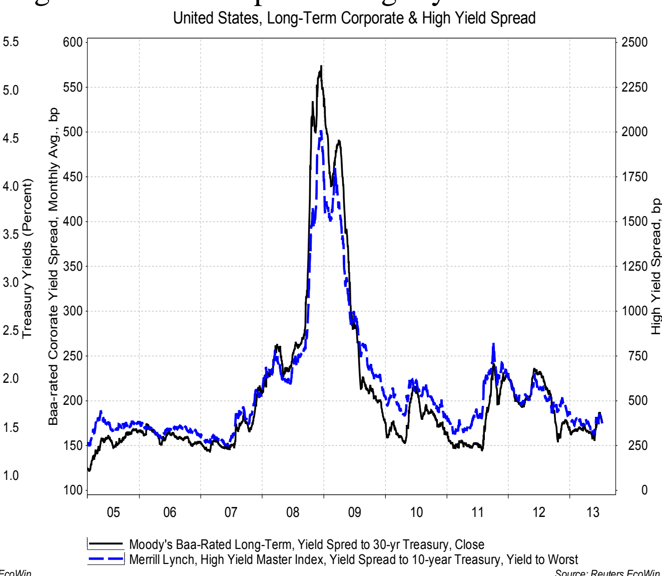


Figure 12: Credit Spreads Slightly Wider



Although we expect US economic performance to lag the Fed's forecast, we do not expect that Treasury rates will return to prior lows. The Fed has made it clear that it wants to end quantitative easing (QE). That is more important to market psychology than precisely when tapering begins. Banks' excess reserves already exceed $1.3 trillion; the Fed does not need QE to encourage more bank lending. The FOMC's guidance pushed risk premiums upward. Barring substantially weaker economic growth, we expect them to remain higher than they were prior to that guidance. Paradoxically, this is good news *prospectively* for investors in longer-term fixed income securities, including preferreds. It means a steeper yield curve, more positive carry, and a decent chance that short-term rates remain lower for longer than they would have had interest rates not increased prior to faster economic growth that the Fed forecasts.[2] In turn, that means investors may earn higher positive carry for a longer period.

Credit spreads widened in the second quarter, adding to pain from higher benchmark Treasury yields for long-term credit investors. Long-term Baa-rated corporate bond spreads widened by 12 bp to 185 bp on June 28 but tightened back to 176 bp so far in July (Figure 12). High yield spreads widened by 30 bp to 407 bp on June 28, but they subsequently have retraced all of that

[2] Higher rates tighten financial conditions, which – if not offset – should result in slower economic growth.

widening. Prices of preferred securities fell almost 4% during Q2, and they have dropped roughly 0.6% more so far in July.

Figure 13: Corporate Profits Near Record High

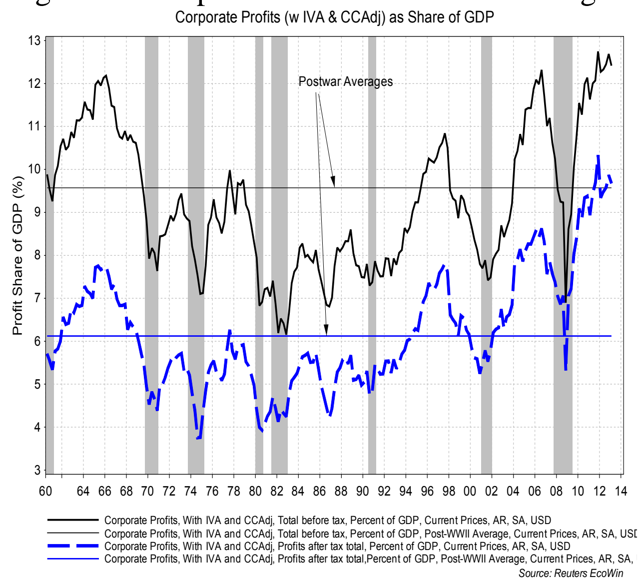


Figure 14: Balance Sheets Strong

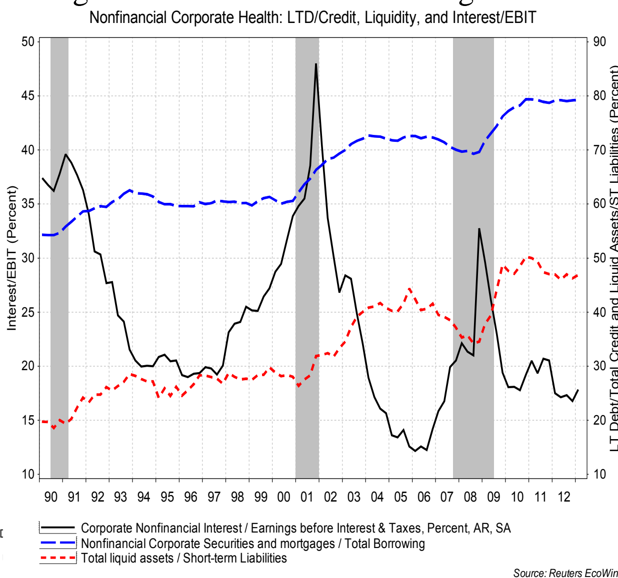


Figure 15: Loan Quality Improving

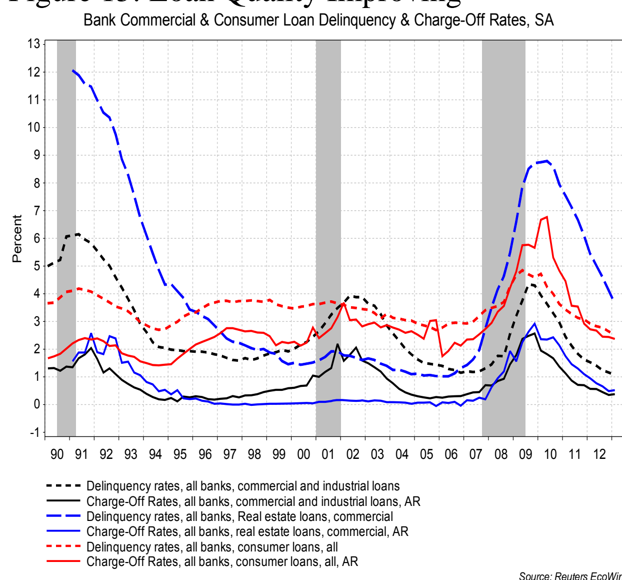
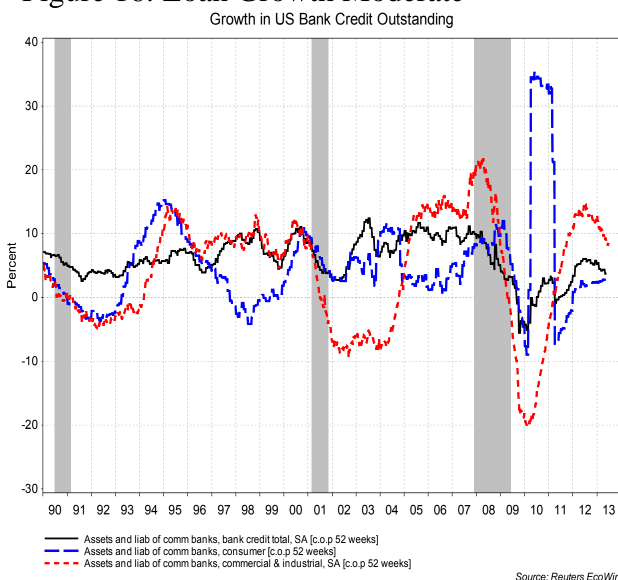


Figure 16: Loan Growth Moderate



In contrast to poor price performance on long-term credit securities, fundamental credit conditions generally continue to improve. Corporate profits remain strong (Figure 13). While it is starting to edge higher as corporations increase their borrowing, interest expense as a percentage of earnings before interest and taxes remains quite low; long-term debt to total debt is holding near its record high and contributes to low refinancing risk at these companies; and liquidity remains very strong (Figure 14). Loan delinquencies and charge-offs are stable at low levels or falling, in turn strengthening bank earnings and balance sheets (Figure 15). These improved conditions have prompted banks to increase lending. Overall bank credit is up 3.7% YoY, led by strong corporate lending (+8.5%) and constrained by sluggish consumer lending (+2.4%) (Figure

16). This generally modest pace of lending reflects both caution by borrowers and tighter underwriting standards by banks. We don't expect either of those tendencies to fade quickly.

As regular readers of this Update know, we long have cautioned that unwinding of the Fed's highly accommodative monetary would be messy and unpredictable. Unfortunately, we were more right about that in recent weeks than we would have wished. We are never happy about losses for our investors. However, lower preferred prices and higher yields have improved prospective returns. We continue to anticipate that moderate economic growth and improving credit fundamentals will benefit preferred securities. Their recent selloff should help us deliver attractive returns to long-term preferred investors even as the Fed's quantitative easing policy comes to a close.

Flaherty & Crumrine Incorporated
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