Flaherty & Crumrine Incorporated

Third-Quarter US Economic Update
October 2013

Summary of Recent Economic Developments

US economic growth continues at a moderate pace of about 2% with low inflation. Following improving growth of 2.5% in the second quarter, Q3 real GDP is expected to grow by 2.2% or less before accelerating to 2.6% next year. Job growth remains slow, but declining labor participation pushed unemployment down to 7.2% in September. Personal consumption expenditures probably improved marginally to about 2% in Q3, but October's partial government shutdown and prospects for another budget impasse in January may restrain spending in Q4. Housing remains a bright spot for the US economy, although higher mortgage rates and home prices will probably slow its growth pace over coming quarters. Industrial production improved but orders slowed, clouding the near-term outlook for business investment. Trade probably added slightly to GDP in Q3, and export and import growth is picking up. Government consumption continues to slow GDP growth, but state and local spending may be turning upward. Deleveraging resumed as households and businesses paid down debt. Treasury rates rose and preferred securities' prices fell in Q3, although both have recovered modestly since the Fed decided not to taper securities purchases in September. Credit fundamentals strengthened. We expect markets to remain volatile, but we believe the preferred-securities market has priced in a good amount of risk related to the end of QE3, and we see value in them for long-term investors.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	2011:4	2012:1	2012:2	2012:3	2012:4	2013:1	2013:2	2013:3
Real GDP, Chg QoQ (%, SA, AR)	4.9	3.7	1.2	2.8	0.1	1.1	2.5	2.2f
Real Personal Consump Expnds, Chg QoQ (%, SA, AR)	2.4	2.9	1.9	1.7	1.7	2.3	1.8	2.2f
Real Business Inv ex Stuctures, Chg QoQ (%, SA, AR)	8.3	5.4	3.9	-1.2	7.7	2.3	1.4	N/A
Real Residential Investmt, Chg QoQ (%, SA, AR)	12.2	23.0	5.7	14.1	19.8	12.5	14.2	11.0f
Corporate Profits, After Tax, Chg YoY (%, SA, AR)	12.8	13.3	5.7	2.0	-0.7	4.5	6.4	N/A
Current Account Balance, Annualized (% of GDP, SA)	-2.9	-3.0	-2.7	-2.6	-2.5	-2.5	-2.4	N/A
Federal Budget, 12-mo Def or Surp (% of GDP)	-7.9	-7.8	-7.6	-6.7	-6.5	-5.5	-4.2	-4.1a
Unemployment Rate (%, SA)	8.5	8.2	8.2	7.8	7.8	7.6	7.6	7.2
Household Employment, Chg QoQ (000, SA)	732	1124	428	526	331	-19	772	245
Nonfarm Payrolls, Chg QoQ (000, SA)	570	787	324	456	626	622	547	430
Nonfarm Productivity, Chg QoQ (%, SA, AR)	2.9	1.5	1.2	2.5	-1.7	-1.7	2.3	N/A
Capacity Utilization (%, SA)	77.3	77.3	77.7	77.2	77.8	78.2	77.9	78.3
GDP Price Index, Chg QoQ (%, SA, AR)	0.5	2.0	1.8	2.3	1.1	1.3	0.6	1.7f
Consumer Price Index, Chg YoY (%, AR)	3.0	2.7	1.7	2.0	1.7	1.5	1.8	1.2
CPI ex food & energy, Chg YoY (%, AR)	2.2	2.3	2.2	2.0	1.9	1.9	1.6	1.7
Nominal Personal Income, Chg YoY (%, AR)	4.6	4.1	3.6	3.6	7.9	3.0	3.2	3.7a
Personal Savings Rate (%, SA)	5.4	5.4	5.6	4.8	8.7	4.3	4.4	4.6a
Rate or Spread (End of Quarter)	**2011:4**	**2012:1**	**2012:2**	**2012:3**	**2012:4**	**2013:1**	**2013:2**	**2013:3**
Federal Funds Rate Target (%)	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3-month LIBOR (%)	0.58	0.47	0.46	0.36	0.31	0.28	0.27	0.25
10-Yr Treasury Note Yield (%)	1.87	2.22	1.66	1.64	1.76	1.85	2.49	2.62
30-Yr Treasury Bond Yield (%)	2.89	3.34	2.75	2.82	2.95	3.10	3.50	3.69
Moody's Baa Long Corp Spread (bp)	227	196	231	190	168	173	185	170
10-Yr Interest Rate Swap Spread (bp)	17	8	13	7	6	16	21	16

* Figures are either quarterly or, if more frequent, end of period. f = Forecast[1]; a = Actual through Aug 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

This publication was delayed by several weeks pending release of economic data affected by October's partial government shutdown. We will move quickly through key sectors of the US economy, in part because this is increasingly "old news" and partly because things have not changed much since our last report.

US economic growth continues to plod along around 2% with low inflation. Inflation-adjusted gross domestic product (real GDP) grew 2.5% in the second quarter and 1.8% in the first half of 2013. Economists expect real GDP growth of 2.2% in Q3 and 2.3% in Q4, although more recent forecasts in light of current data and October's partial government shutdown trim those estimates by ¼ percent or so.[1] Economists expect growth to accelerate modestly to 2.6% in 2014 and 2.9% in 2015 before dropping back to 2.5% in 2016. Our own forecasts of 2.0-2.5% real GDP growth for the next several years are broadly in-line with consensus in 2013 but remain a little below consensus – and well below Federal Open Market Committee forecasts – for 2014 and beyond.

While GDP growth has come in below the Fed's forecasts, the unemployment rate has declined more quickly, mainly due to falling labor participation. Economists forecast average unemployment of 7.1% in 2014 and 6.6% in 2015. The Federal Reserve's central tendency forecasts are about ½ percentage point lower for each period.

Figure 2: Job Growth Slow, Layoffs Down

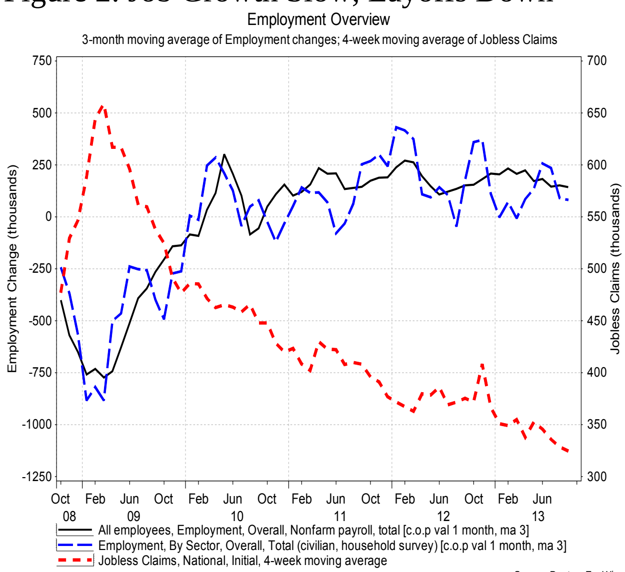
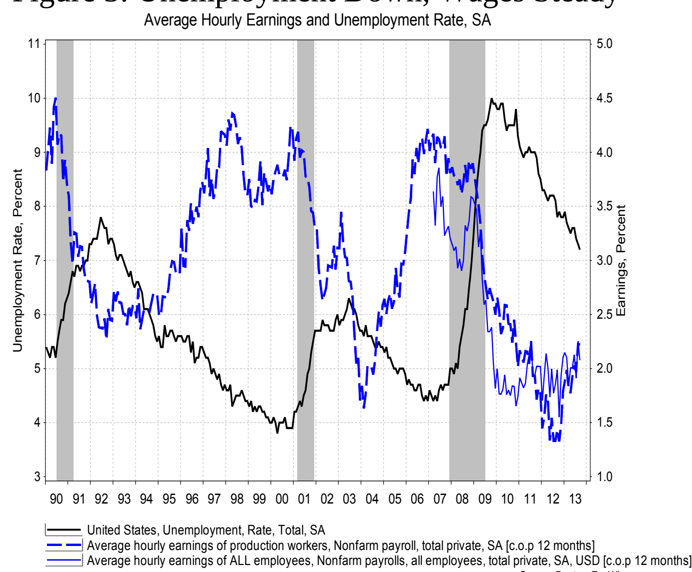


Figure 3: Unemployment Down, Wages Steady



Labor market conditions remain mixed but weakened on balance during the third quarter. Payroll jobs grew by a disappointing 430,000 in Q3, down from 547,000 in Q2. The household employment survey counted even slower job growth: 245,000 in Q3 compared to 772,000 in Q2 (Figure 2). More positively, initial jobless claims continue to fall. On balance, these are not terrible numbers (both employment surveys indicate about 165,000 new jobs per month over the past six months), but they certainly do not point to any acceleration in hiring. Furthermore, labor participation fell to 63.2%, its lowest level since 1978. Despite sluggish job growth, lower labor

[1] All growth rates are annualized unless otherwise noted. Forecasts in this Update are from The Survey of Professional Forecasters, Federal Reserve Bank of Philadelphia, August 16, 2013 unless otherwise noted.

participation pushed the unemployment rate down to 7.2% from 7.6% last quarter (Figure 3). However, as we have emphasized before, falling participation is not a sign of labor market strength.[2] While layoffs are falling, employers remain cautious about adding new workers. Faster job growth, rather than lower unemployment, will be a true sign that labor markets are strengthening

Wage growth held about steady in the third quarter (Figure 3). Average earnings were up 2.1% YoY in September, unchanged from last quarter. Moderate job growth and roughly flat working hours pushed aggregate payroll wages up 3.8% YoY, down from June's 4.2% pace but up slightly from an average of 3.7% over the past year. Labor market slack continues to keep a lid on wages.

Consistent with growth in wage income, overall **personal income** through August was up 3.7% YoY in nominal terms and 2.5% in real terms, although income growth over the past three months was about ½ percentage point slower (Figure 4). We continue to expect around 3.5% income growth for now (1.5% growth in employment plus 2% wage growth), with gradual acceleration next year. The **savings rate** edged up to 4.6%.

Figure 4: Income & Savings Rate Up

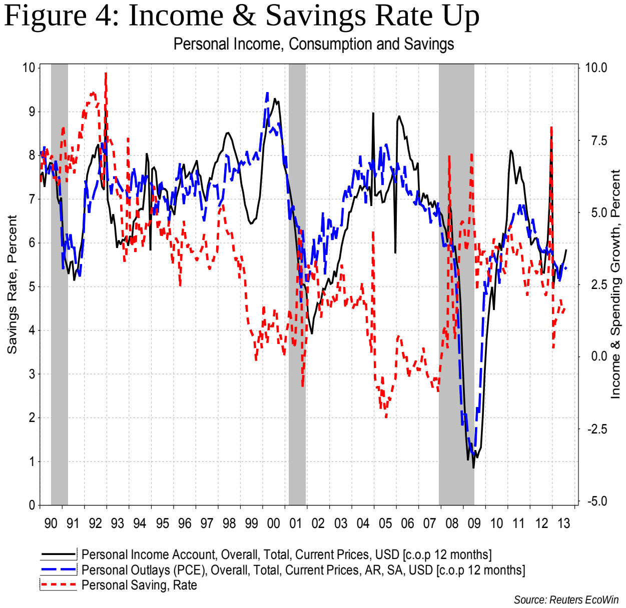
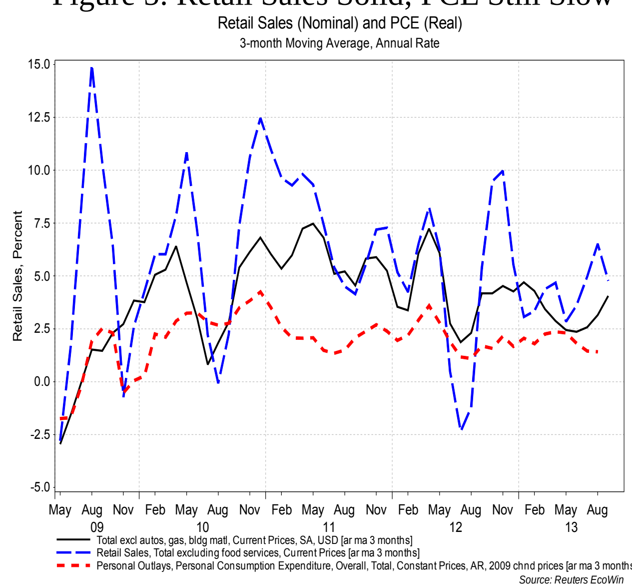


Figure 5: Retail Sales Solid; PCE Still Slow



Personal consumption expenditures (PCE) probably improved in the third quarter after disappointing real growth of 1.8% in Q2, but they remain subdued (Figure 4). Overall retail sales were up 4.5% in Q3 over Q2, and "core" retail sales (excluding automobiles, gasoline, and building materials) were up 4.1% (Figure 5). Adjusting for inflation, core retail sales suggest real goods PCE should be up about 2.3% in Q3, although somewhat slower growth in services should hold overall PCE growth around 2%. Looking ahead to Q4, October's government shutdown restrained personal spending in that month, and continued budget uncertainty may continue to be a headwind to consumption over the balance of the quarter as well. Certainly those concerns have dented consumer confidence, which otherwise has gradually but erratically moved higher since the financial crisis subsided in 2009.

[2] See *Fourth-Quarter US Economic Update*, Flaherty & Crumrine Incorporated, January 16, 2013 for a more detailed discussion of labor participation and its impact on the unemployment rate.

The **housing market** continues a rapid recovery, but we anticipate some slowing in its recovery over coming quarters. Total new and existing home sales moved upward throughout the summer, reaching just over 5.8 million units at an annual rate in August, and inventory of unsold homes remains lean (Figure 6). However, new home sales were down in July and recovered only slightly in August, and pending existing home sales have fallen at an accelerating pace for the past four months. (New home sales are recorded when a purchase contract is signed, whereas existing home sales are recorded at closing, typically 30-60 days after purchase contract date. Pending existing home sales tally those existing home purchase contracts.) These figures suggest the pace of home sales is moderating. In addition, home price gains – while still up substantially from a year ago – have slowed a bit recently (Figure 7).

There are several reasons why housing recovery should slow somewhat. First, interest rates on mortgages have increased substantially since springtime. Freddie Mac's 30-year fixed-rate mortgage rate is currently 4.13%, down from a high of 4.58% in August but up from about 3.5% in March. Second, home prices already have increased a lot, especially in markets that were hard-hit during the housing bust. As a result, home affordability has fallen significantly this year. While both mortgage rates and affordability remain relatively favorable from long-term historical perspectives, it is not surprising that buyers are becoming a little more cautious. We expect residential investment, which has been growing around 13-15% for a year now, will slow over coming quarters. Housing will still be an important contributor to GDP growth, however.

Figure 6: Sales Up but Affordability Down

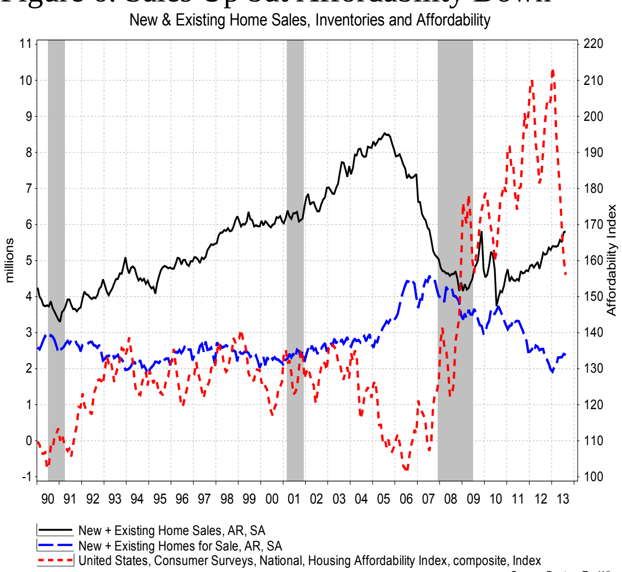
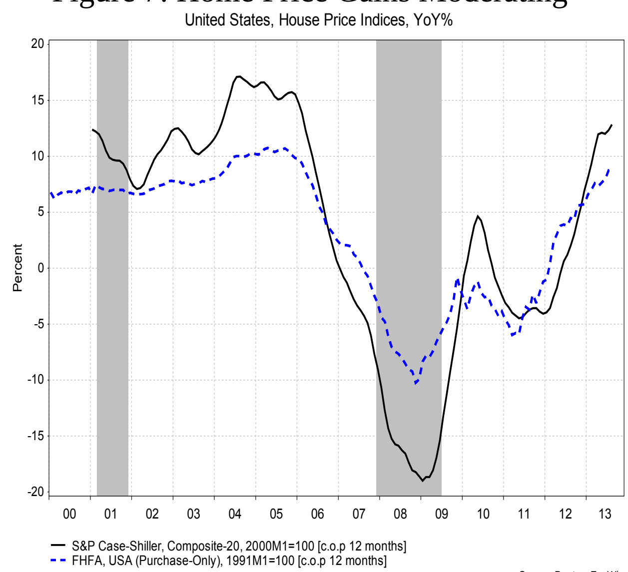


Figure 7: Home Price Gains Moderating



Industrial production accelerated slightly in the third quarter but orders and shipments slowed. Overall industrial production in Q3 rose by 1.4% over Q2, and production excluding automobiles was up 2.3% on the same basis (Figure 8). Although those results are an improvement over second quarter data, they are still not particularly strong. Forward-looking indicators send mixed signals. The Institute for Supply Management's survey of manufacturing activity does suggest brighter days ahead (Figure 8). However, core capital goods orders and shipments have slowed this year (Figure 9). With federal government spending still in limbo, further production increases may have to wait until sometime next year.

Figure 8: Industrial Production Increased…

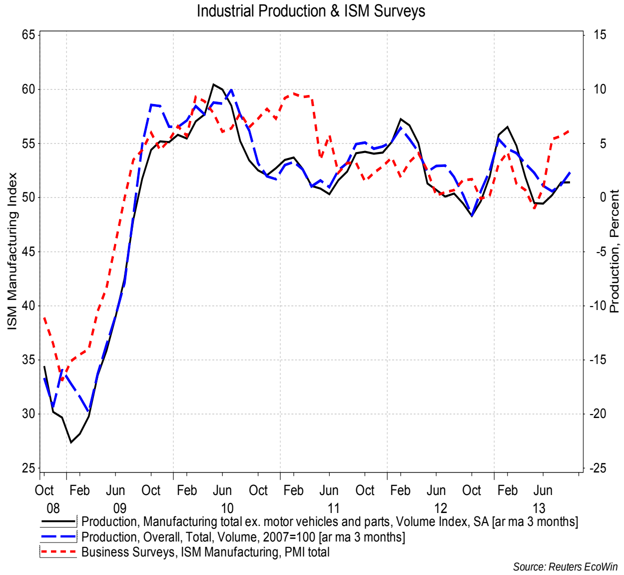
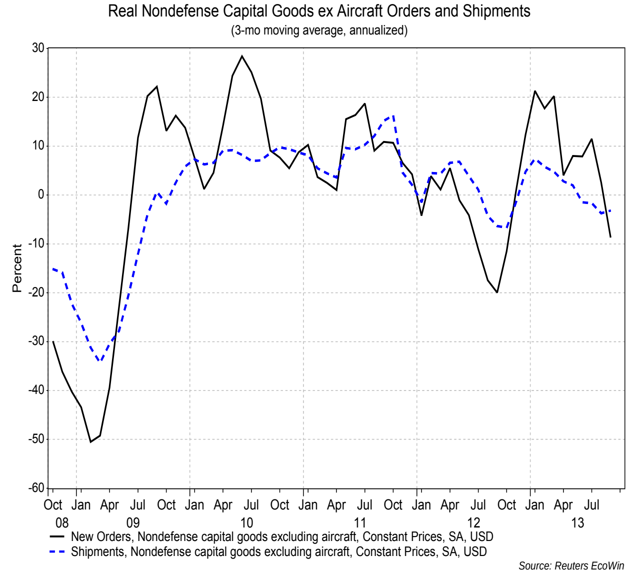


Figure 9: …but Orders & Shipments Slowed



Business investment slowed over the past several quarters (core investment grew 1.4% in Q2, down from 2.3%in Q1; see Figure 1), but moderately rising industrial output suggests that investment spending may be improving somewhat. Capacity utilization has held about steady for the past year, and business investment excluding structures has eased (Figure 10). Companies need to invest modestly to maintain current capacity, but investment tends to quicken when capacity utilization is rising. Although the amount is small so far, capacity utilization has increased over the past several months, which should drive higher investment. We expect that third quarter core business investment spending will be ahead of Q2's slow 1.4% pace. Looking ahead, October's partial government shutdown, continued uncertainty over federal budget negotiations (including corporate tax provisions) and possibility of another partial government shutdown in January will probably slow business investment spending in the fourth quarter. However, we should see modest improvement again next year.

Figure 10: Business Investment Muted

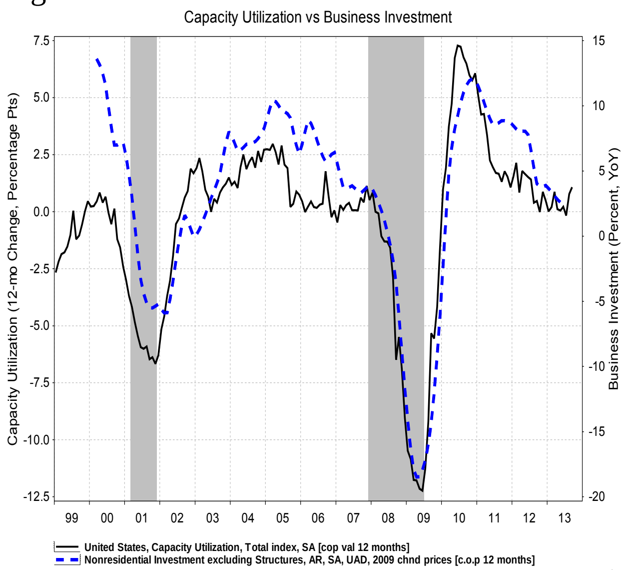
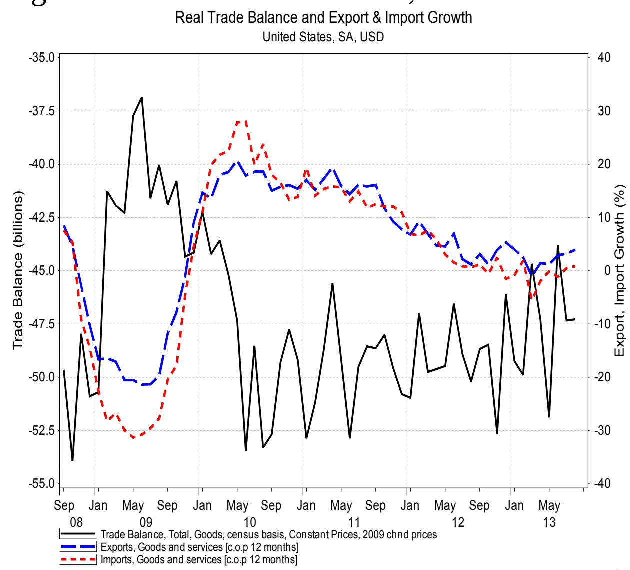


Figure 11: Trade Growth Turns; Deficit Narrows



After reducing real GDP growth in Q1 and Q2 (-0.1% and -0.3%, respectively), the **trade deficit** appears to have added to growth in the third quarter. Assuming September's real goods balance equals its July and August average, net exports should add about 0.1% to Q3 real GDP. Trade flows remain muted, with slow growth of both imports and exports, but their growth rates have turned upward slightly in recent months. Looking ahead, we expect that trade will remain a mild negative to growth on average, at least until economic growth abroad picks up more substantially, but improving trade flows are a small but encouraging sign for global growth.

Figure 11: Government Drag Diminishing

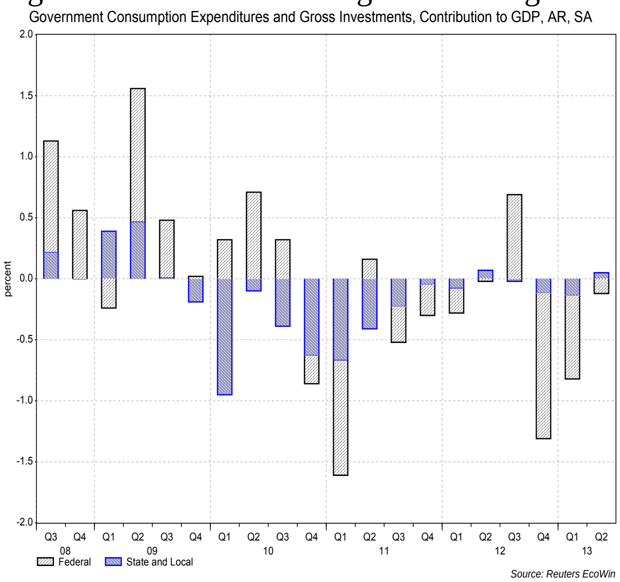
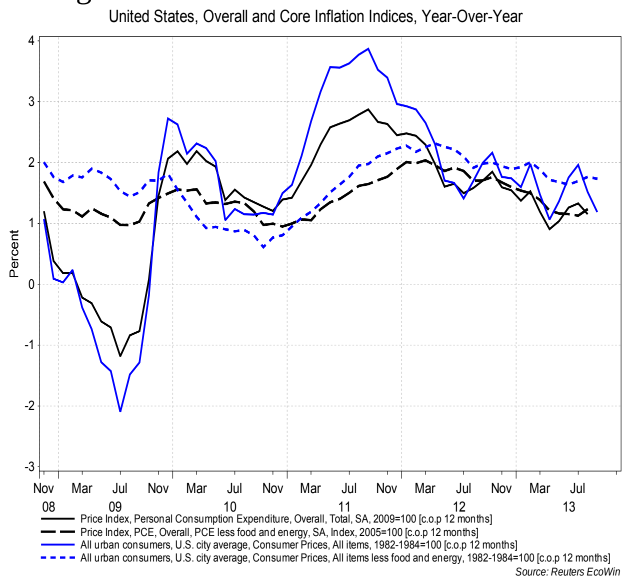


Figure 12: Inflation Remains Subdued



Government consumption overall continues to restrain real GDP growth, although drag from state and local government spending finally ended in the second quarter (Figure 11). In Q2, federal government spending trimmed real GDP growth by 0.12%, while state and local government spending added 0.05%, for net government contribution of -0.07%. Results were probably similar in Q3, but federal government spending in Q4 will be substantially lower due to October's 16-day partial shutdown. Unspent money from Q4 will probably be pushed into next year's first quarter, unless there is yet another shutdown. Further reductions in federal government spending may be forthcoming, depending on budget negotiations currently underway. In the absence of a new agreement, federal spending will fall again in 2014 under sequester rules. At this stage, it is anybody's guess how those negotiations will turn out, but we anticipate that federal government spending will be at least a small drag on 2014 GDP growth.

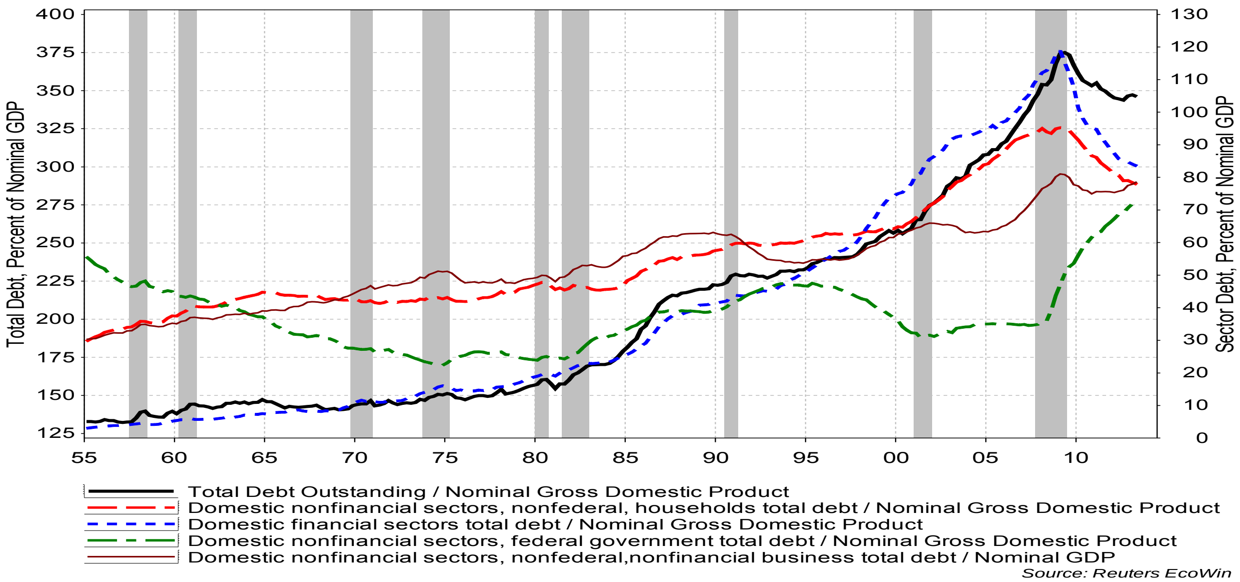
Inflation remains subdued. Inflation measured by the consumer price index (CPI) is up 1.2% overall and 1.7% excluding food and energy over 12-months ending in September. The PCE deflator is up 1.2% both overall and excluding food and energy through a comparable period ending in August (Figure 12). Core PCE inflation probably has edged up enough to allay deflationary concerns at the Federal Reserve, but it remains well below the Fed's 2% long-term target.

Broad **balance sheet trends** in the US resumed their prior trends in the second quarter (most recent data available) after reversing in several key sectors for a quarter or two (Figure 13). Household deleveraging is continuing, albeit at a slower pace than in prior years. Mortgage debt is falling and credit card debt is roughly unchanged in dollar terms (and falling relative to GDP), while student and auto loans are growing. Financial companies continue to deleverage rapidly, though here too the pace has slowed. Nonfinancial business borrowing is rising slowly. However, companies continue to generate more internal cash than needed for business investment. Thus, in aggregate, this additional borrowing is going to share repurchases and to add to existing stocks of marketable securities; the latter increases overall balance sheet liquidity. Federal government borrowing continues to rise, but the pace is slowing here also. The federal budget deficit for fiscal year 2013 will probably be a little over 4% of GDP, down from 6.7% a year ago and more than 10% in 2009. Unfortunately, the long-term outlook for federal debt remains daunting, and Washington appears to have little appetite do deal with it today.

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

Debt to GDP: Total, Financial, Household, Business, Federal

United States, Flow of Funds Debt Outstanding, SA, USD



Across all sectors, debt-to-GDP stands at 346%, down from a peak of 375% in 2009 but still high historically. We believe that private sector deleveraging will continue, albeit at a slower pace than in 2010-12, and that it will remain a headwind to economic growth for some time to come.

Market Outlook

Long-term **Treasury rates** rose in the third quarter as the Federal Reserve moved closer to reducing its securities purchase program (Figure 14). The 30-year benchmark Treasury bond yield rose by 19 basis points (bp) to end Q3 at 3.69%. However, so far in October, the long-bond yield has eased slightly to 3.61% on disappointing economic data and a more uncertain federal budget outlook. As expected, the Federal Reserve left the federal funds rate unchanged at 0.25%. However, the Fed surprised investors by leaving its quantitative easing program (QE3) unchanged. Despite guidance that it might begin to taper its securities purchases, the Federal Open Market Committee (FOMC) made no changes to its $85 billion per month securities purchase program, consisting of $40 billion of agency mortgage-backed securities and $45 billion of longer-term (4-year and longer) Treasuries. Given continued federal budget uncertainty and potential for another partial government shutdown in January, we expect the Fed will refrain from tapering QE3 until its January or March 2014 FOMC meeting.

Looking out over the next few years, we believe the FOMC will continue to be disappointed by economic growth relative to its expectations. (The Fed has consistently forecast higher growth than the US economy has realized since recovery began in 2009.) Currently, the Fed expects roughly 2.5% real GDP growth in 2013's second half, compared to 1.8% in the first half and over the past six quarters. It expects about 3.0% growth in 2014, accelerating to 3.0-3.5% in 2015 before slowing a bit to 2.5-3.3% in 2016. Based on that relatively optimistic growth path, FOMC members' median expectation for the federal funds rate is 0.25%, 1% and 2% at year-end 2014, 2015 and 2016, respectively. Market forward yields are broadly in-line with those medians.

The Fed's economic forecasts are higher than those of private economists, who expect real GDP growth of 2.6% in 2014, 2.9% in 2015 and 2.5% in 2016. We anticipate 2.0-2.5% growth over most of that period. If we and private economists are right and growth undershoots FOMC forecasts, then both short-term and long-term interest rates should rise more slowly than currently anticipated and long-duration securities should deliver excess returns relative to short-duration alternatives.[3]

Figure 14: Treasury Rates Up, Fed Funds Steady

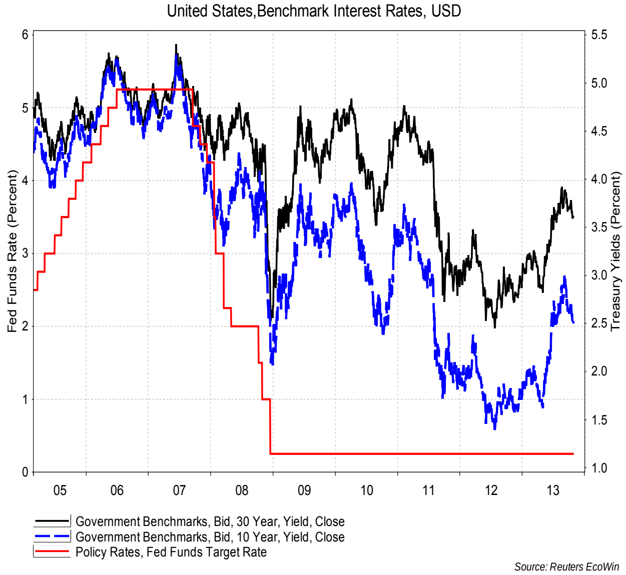
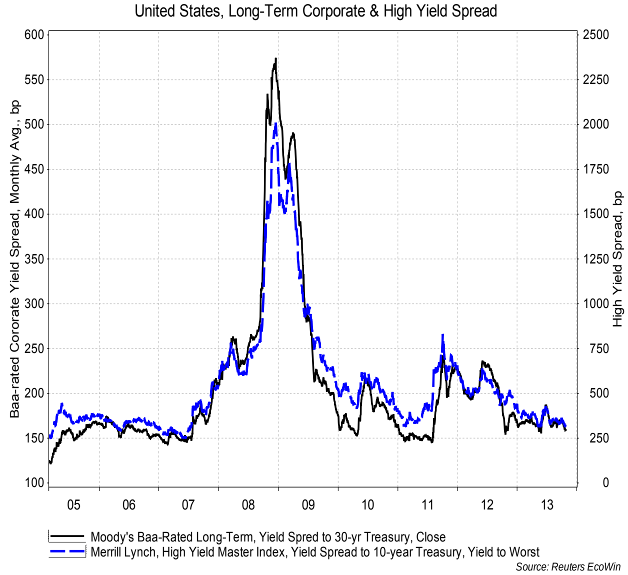


Figure 15: Credit Spreads Mostly Narrower



While preferred securities underperformed, **credit spreads** generally tightened in the third quarter as credit conditions improved and Fed policy remained highly accommodative (Figure 15). Long-term Baa-rated corporate bond spreads narrowed by 15 bp in Q3 to 170 bp, roughly offsetting higher Treasury rates during the quarter; they have narrowed by another 10 bp so far in October. High yield spreads tightened by 45 bp in Q3 to 362 bp and have narrowed by another 45 bp since quarter-end. Fears over rising Treasury rates prompted investors to exit many long-

[3] This does not mean that long-term interest rates will not rise at all; we think they will move up over time. It means that rates will rise by less than implied by market forward yields. If so, then returns on longer-duration securities would exceed those on shorter-duration securities. However, returns on long-duration securities (1) may be less than their stated yields at some point between now and call- or maturity-date and (2) are likely to be more volatile than those on shorter-duration securities.

duration assets, including preferred securities. Preferred securities' prices were sharply lower, with various preferred indices posting pre-tax price returns (*before* income) ranging from -1.3% to -7.1% in Q3, and option-adjusted spreads widened. Preferred index prices have rallied by 1-2% since quarter-end.

Despite QE3 creating roughly $85 billion per month in base money, bank credit growth is actually *slowing*. Overall bank credit is up just 1.6% YoY, well below growth in nominal GDP. Commercial and industrial loan growth remains strong at 8.8% YoY, but loan growth has slowed there too. Consumer borrowing is low and slow at just over 3% YoY, about in-line with nominal GDP growth. With the Fed's foot pressed hard on the accelerator, we continue to watch credit formation for signs of excess, but, so far, we do not see them.

Figure 16: Corporate Profits Remain Strong

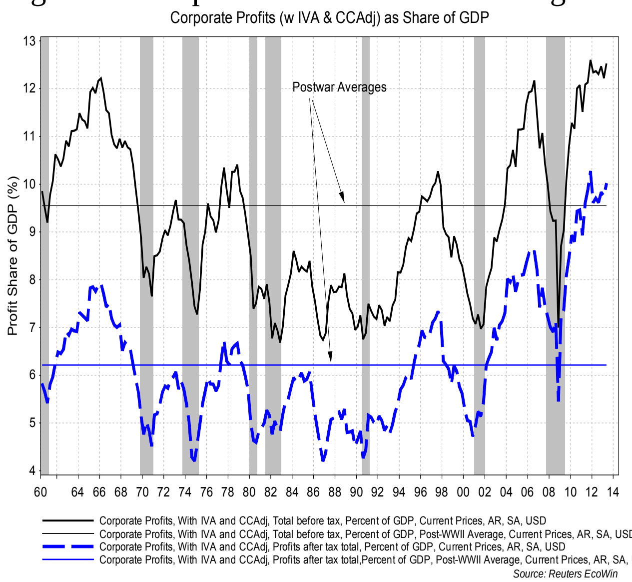


Figure 17: Balance Sheets Solid

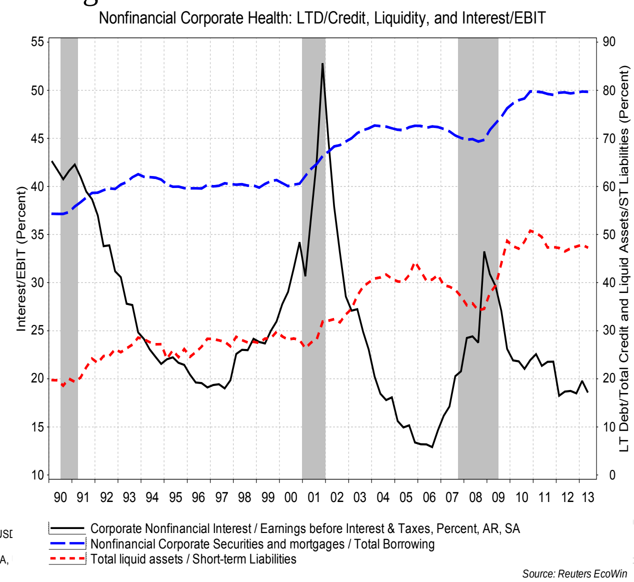


Figure 18: Loan Quality Still Improving

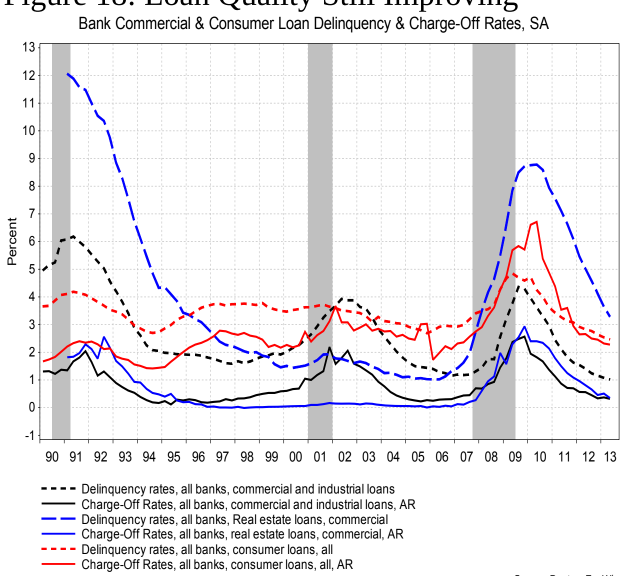
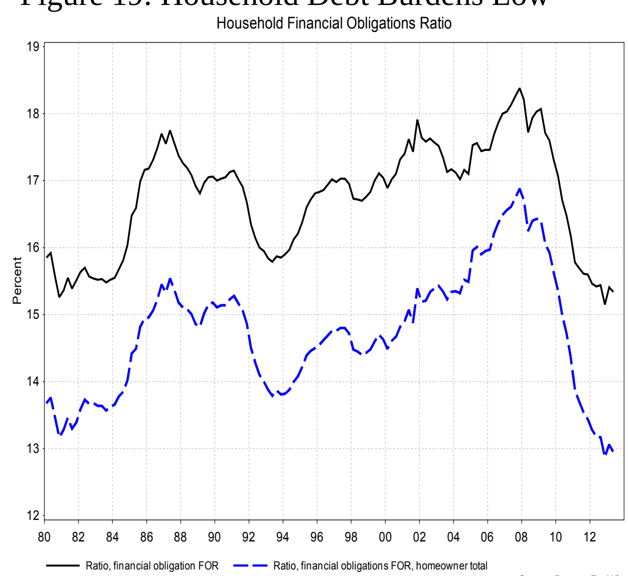


Figure 19: Household Debt Burdens Low



Although many preferred investors did not seem to notice during the third quarter, credit fundamentals continue to improve. Corporate profits as a share of GDP remain near all-time highs (Figure 16). Interest expense as a percentage of earnings before interest and taxes edged lower; long-term debt to total debt is holding at its record high; and liquidity held steady at strong levels (Figure 17). Loan delinquency and charge-off rates are declining across all major loan categories (Figure 18). Household debt burdens have ticked up along with interest rates but remain near the lowest levels in more than 30 years (Figure 19). All of this should be good news for credit instruments such as preferred securities.

Looking ahead, moderate economic growth should provide a constructive environment for preferred-securities investors. We anticipate that economic growth will be fast enough to facilitate continued improvement in corporate and household balance sheets and better loan performance, while being slow enough to restrain inflation and keep monetary policy accommodative for some time. Spreads on preferred securities should recover as fears of further rapid increases in long-term interest rates recede and investors refocus on steadily improving credit conditions. Volatility is likely to remain elevated over coming months, but we believe the preferred-securities market has priced in a good amount of risk related to the end of quantitative easing. We see value in preferred securities for long-term investors.

Flaherty & Crumrine Incorporated
October 29, 2013