improvement account for most of that acceleration, and they are unlikely to repeat such strong performances in 2014.

Turning to an analysis of major economic segments, the **labor market** improved in the fourth quarter, but progress remains frustratingly slow. Payroll employment rose by 515,000 jobs, slightly faster than in Q3 (Figure 2). The household employment survey added just 316,000 new jobs, although that was better than 195,000 jobs added in Q3. Compared to December 2012, payroll jobs grew by 1.6% and household jobs by 1.0%, not much above population growth of about 1%. Labor participation fell to 62.8%, its lowest rate since 1978. The unemployment rate fell to 6.7% in December from 7.2% in September, mostly due to lower labor participation.

Wage growth remains slow despite a lower unemployment rate. Average hourly earnings were up 1.8% YoY in December, compared to 2.1% a year ago when the unemployment rate was 7.9%. Typically, wages accelerate as unemployment falls. This is another indication a recent drop in the unemployment rate overstates improvement in labor market conditions.

Slow growth in jobs and wages translated into slow growth in **personal income**. Overall nominal personal income was up just 2.3% YoY in November (latest data available), and wage and salary income increased 2.2% YoY (Figure 3). Disposable (after-tax) income fared even worse at 1.5% YoY due to higher taxes in 2013, though drag from taxes should fade in 2014. Even with very low PCE inflation of about 1%, subtracting inflation from those nominal numbers means real income growth remains very slow.

Personal consumption expenditures (PCE) grew faster than income, up 3.5% YoY in November (Figure 3), and relatively strong retail sales in December could push Q4 consumption up further. With consumption rising faster than income, the personal savings rate fell to 4.2% as of November, and it probably fell further in December. Rising stock and home prices have encouraged faster consumption; that may continue for a time, but we will need to see faster income growth for it to be sustainable. We expect savings should move up gradually, as it did for most of 2013, during which time spending growth necessarily would lag income growth. We expect real PCE to grow about 2.2% in 2014, a little better than its 2% pace in 2013.

Figure 4: Housing: A Pause that Refreshes?

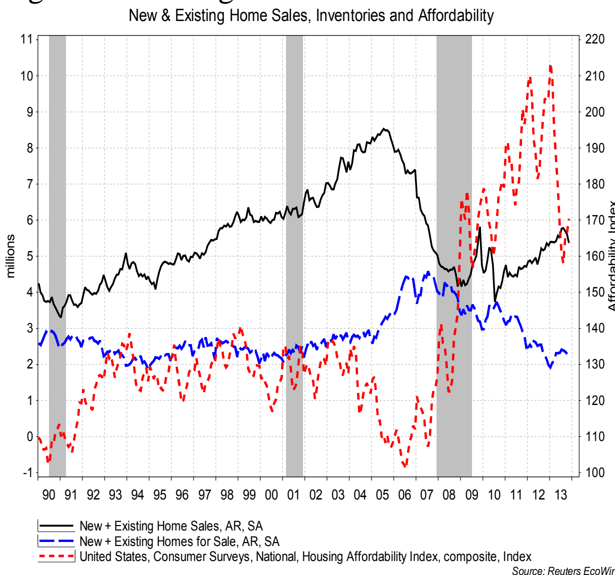
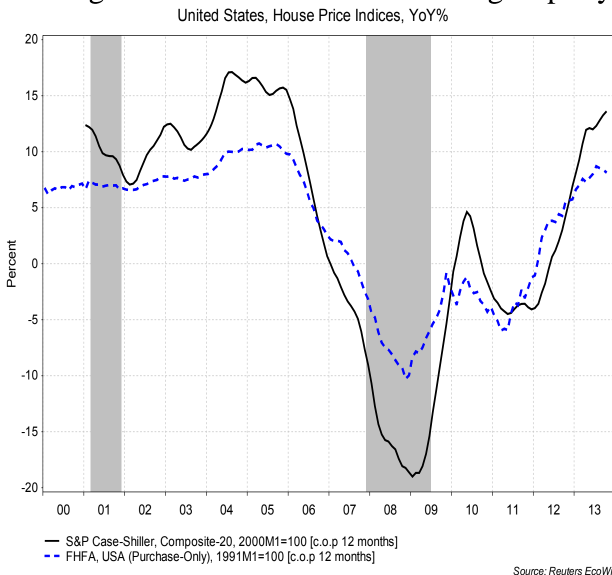


Figure 5: Home Prices Still Rising Rapidly



The **housing market** continues to recover, although its pace appears to be slowing a bit. New and existing home sales are about unchanged compared to a year ago, up 0.1% YoY to 5.36 million units in November after peaking at 5.78 million units (+10.8% YoY) in August (Figure 4). Despite a slower pace of sales, home prices are up 13.6% (Case-Shiller 20-city Index) and 8.2% (Federal Housing Finance Agency Index) YoY in October (Figure 5). Real residential investment was up 10.3% in Q3 and added 0.3% to real GDP growth. Given slower home sales, we anticipate slower growth in residential investment in Q4, though it should still contribute to overall GDP growth. Housing affordability improved slightly in Q4 and remains relatively high historically, but higher home prices and mortgage rates reduced affordability significantly in 2013 (Figure 4). Lower affordability will not derail housing recovery, but it probably will slow future gains in home prices. Looking ahead, we anticipate 8-10% growth in residential investment and home price gains of 5-10% in 2014.

Business investment probably improved in the fourth quarter and should pick up a bit in 2014 as well. Real business investment excluding structures was up 2.6% in Q3, and we expect 3-4% growth in Q4. Capacity utilization rates have moved up in recent months as production has expanded, which should drive higher demand for new investment (Figure 6). So far, increases in capacity utilization are modest, however, so we look for similarly modest gains in business investment excluding structures of about 4% in 2014.

Figure 6: Higher Utilization Driving Investment

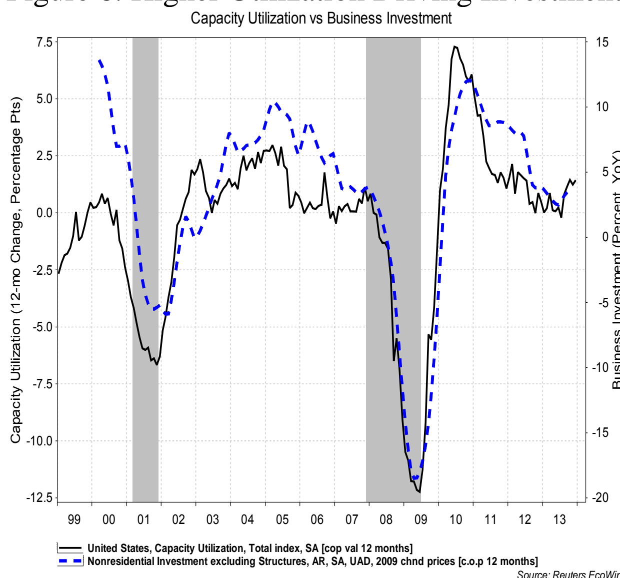
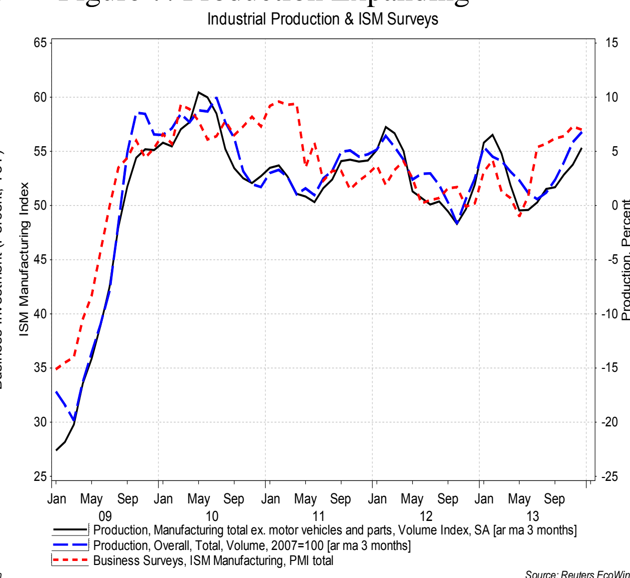


Figure 7: Production Expanding



Five years after the financial crisis caused demand for commercial real estate to fall sharply, investment in business structures may be turning the corner. Industrial production, inventories, and sales are rising and employment is growing (though it remains below its pre-recession peak). Although economic activity has not yet reached a level that significantly strains capacity of current structures, commercial vacancy rates are falling gradually. As a result, investment in business structures began to pick up in 2Q2013, and we expect further growth of perhaps 2% in 2014. Admittedly, this is not a boom, but it helps at the margin.

Industrial production took a roller coaster ride in 2013. Early in the year, production rose rapidly on rebuilding from Superstorm Sandy, slumped around mid-year as those orders were

filled, and gradually accelerated in the second half (Figure 7). Overall industrial production was up 6.8% in the fourth quarter, and manufacturing production excluding vehicles was up 5.3% on the same basis. In addition, the Institute of Supply Management's manufacturing survey points to continued moderate growth over coming months and is consistent with moderately faster investment spending.

The **trade deficit** likely narrowed in the fourth quarter as export growth improved and energy imports fell (Figure 8). Net exports added about 0.1% to real GDP in Q1 and subtracted an average of about 0.1% over the first three quarters of 2013. Fourth quarter numbers look much better, however: net exports may add 0.8% to GDP, assuming December's real goods balance equals an average of October and November. If so, trade – which we had assumed would be a modest drag on 2013 growth – would add 0.1-0.2%. Again, this is not a big swing in growth, but it helps at the margin.

Looking ahead, our outlook for trade is mixed. Economic growth abroad is variable, with Europe slowly emerging from recession but growth slowing in developing Asia and a number of commodity-producing countries. Among advanced economies, US economic growth is still comparatively strong, which suggests US imports should grow faster than exports, all else equal. However, all else is not equal: US domestic energy production is surging, reducing demand for energy imports and even pushing up US petroleum exports (Figure 9). A sharply narrower deficit in petroleum products is the result (Figure 9). For now, we think macroeconomic trends will roughly offset an improving energy situation, leaving net exports a neutral factor for GDP in 2014. We recognize we may be too cautious on energy, however.

Figure 8: Trade Deficit Narrowing…

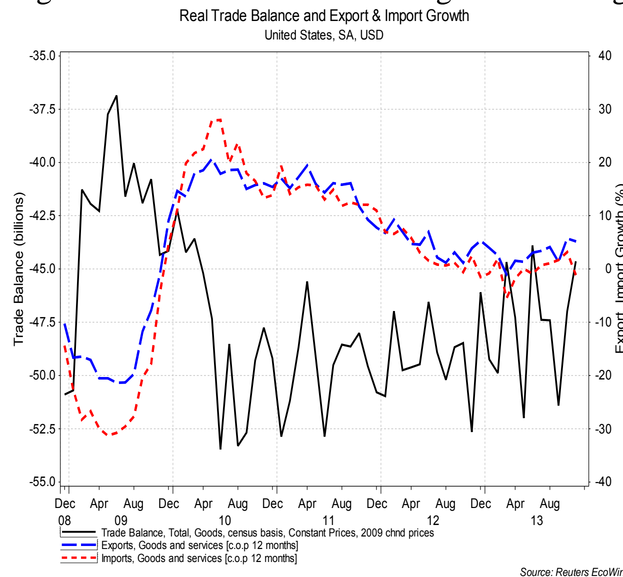
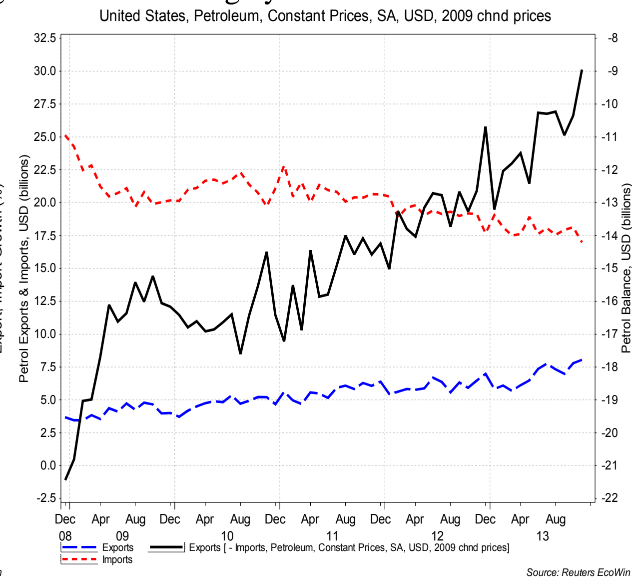


Figure 9: …Due Largely to Petroleum Products



Government consumption probably fell again in the fourth quarter after rising marginally (+0.4%) in Q3. Overall, government consumption added 0.1% to Q3 real GDP growth after three years of fiscal restraint (Figure 10). Federal government spending remained constrained by sequester and was further reduced by a partial government shutdown in October. State and local government spending, however, rose again in Q3 and appears to be heading upward as economic growth and prior spending restraint have improved state and local budget balances.

For 2014 as a whole, government consumption probably will be only a small drag on growth. Federal government spending will be held down by sequester. However, a recent budget agreement increased spending by $45 billion in fiscal year 2014, so federal fiscal drag will be smaller than previously anticipated and should run its course by year-end. We also anticipate Congress will increase the nation's debt limit without too much drama, reducing a source of economic uncertainty that likely hampered growth last year. State and local spending should pick up, but after years of cutbacks, we expect caution will be the norm – for a while at least.

Figure 10: Fiscal Drag Moderating

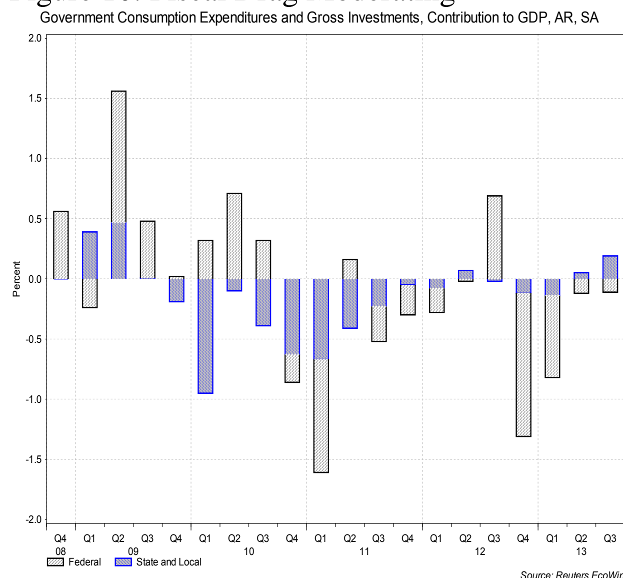
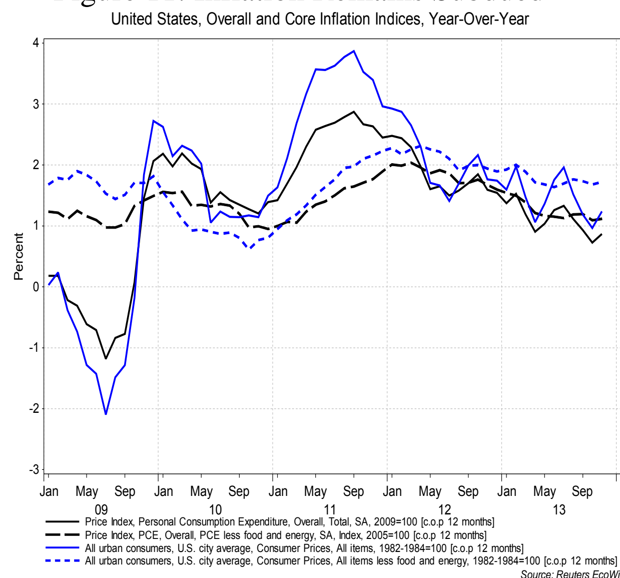


Figure 11: Inflation Remains Subdued



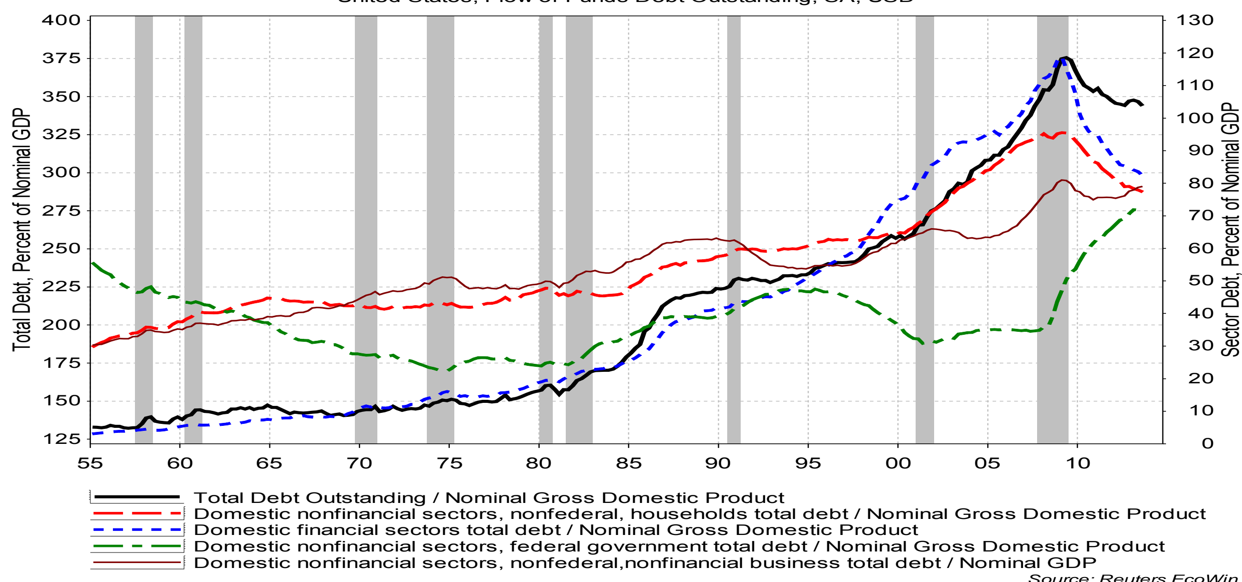
We don't mean to be repetitious, but **inflation** remains low and generally eased in 2013, although overall inflation picked up slightly over the past couple of months (Figure 11). The Consumer Price Index (CPI) was up 1.5% for all items and 1.7% excluding food and energy prices in 2013. The PCE deflator was up just 0.9% overall and 1.1% excluding food and energy over 12 months ending in November – 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 fell again in Q3 (latest data available) as household and corporate financial deleveraging continued (Figure 12). In contrast, corporate nonfinancial borrowing rose for the sixth consecutive quarter, something we are watching carefully. Federal government borrowing slowed as the 12-month trailing budget deficit narrowed to about 3.3% of GDP in December.

We generally expect those trends to continue. Households continue to shed debt, reflecting cautious use of credit cards and tighter mortgage lending standards, although student and auto loans are growing rapidly. Financial companies likewise are deleveraging their balance sheets, but the pace is slowing there too. Banks have spent five years raising capital and shrinking balance sheets, and their recapitalization is nearly complete. Indeed, most large banks already fully comply with more-rigorous 2016 capital standards, and others are making rapid progress toward meeting them. Finally, nonfinancial corporations already have begun to borrow more rapidly. To date, that borrowing has been used to add to financial assets and repurchase common

equity, not to expand capacity. The nonfinancial corporate "financing gap" (capital expenditures minus internally generated funds) remains negative (see Figure 20 on page 10), although not by much anymore. This bears watching but does not yet sound alarm bells in our view. Finally, government debt should stabilize and maybe even drop a bit as a proportion of GDP for the next few years, assuming spending discipline holds. However, as baby boomer retirements accelerate, US fiscal situation will deteriorate dramatically absent reform. Our conclusion is that headwinds to growth from deleveraging are still present – and probably will be for some time – but they are diminishing. This is not the end of deleveraging, but it may be the beginning of the end.

Figure 12: Deleveraging Slowed, but Not Moving Back to "Old Normal"



Market Outlook

Long-term **Treasury rates** rose again in the fourth quarter as the Federal Reserve announced plans to taper its securities purchases. The 30-year benchmark Treasury yield rose by 27 basis points (bp) to 3.96% on December 31, although it has recovered to 3.76% as of today (Figure 13). The 10-year Treasury note yield rose 41 bp to 3.03% as of year-end; it has rallied back to 2.83% so far in January. The Fed left the federal funds rate target unchanged at 0.25%, where it is likely to remain throughout 2014.

At its December 2013 meeting, the Federal Open Market Committee (FOMC) decided to begin winding down its quantitative easing program (QE3), reducing securities purchases from $85 billion ($45b in Treasuries, $40b in mortgages) per month to $75 billion ($5b cuts in both Treasuries and mortgages). In a subsequent press conference, outgoing Fed Chairman Bernanke indicated that the FOMC expects to end its securities purchase program by the end of 2014 but probably not so soon as mid-year. With eight FOMC meetings in 2014, reductions in purchases of $15 billion per meeting would bring QE3 to a close in July; at $10 billion per meeting, the program would end in October or December. Thus, the Fed is signaling it expects to taper purchases by roughly $10 billion per meeting. Chairman Bernanke left some wiggle room, however, noting that the FOMC will respond "appropriately" to incoming economic data.

Figure 13: Treasury Rates Up Again

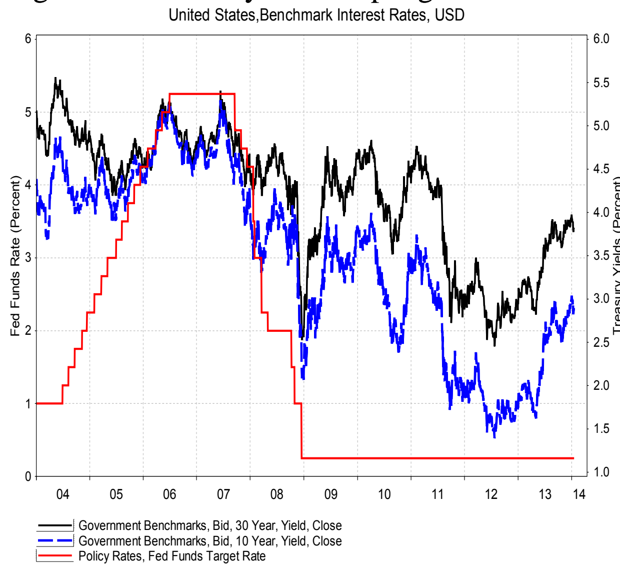
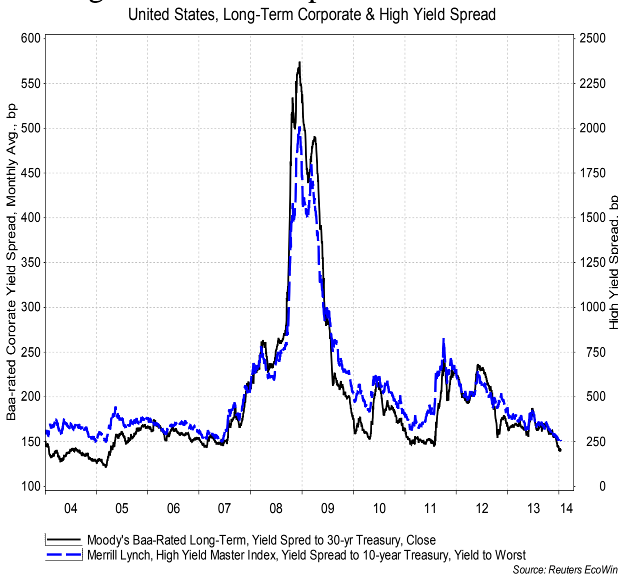


Figure 14: Credit Spreads Narrowed



A $10 billion-per-meeting pace of tapering would mean the Fed would purchase about $140 billion more securities than it would under a $15 billion-per-meeting path. While that's a lot of dollars, economists estimate that an additional $140 billion of Fed purchases would reduce long-term interest rates by about 6 bp. At this point, we think Fed taper is largely priced into markets, and tweaks to its pace should not affect yields too much.

Figure 15: Little Net Expansion from QE3

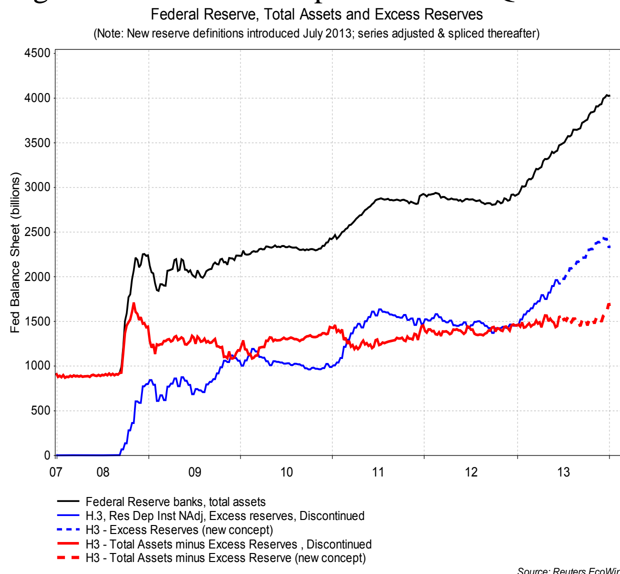
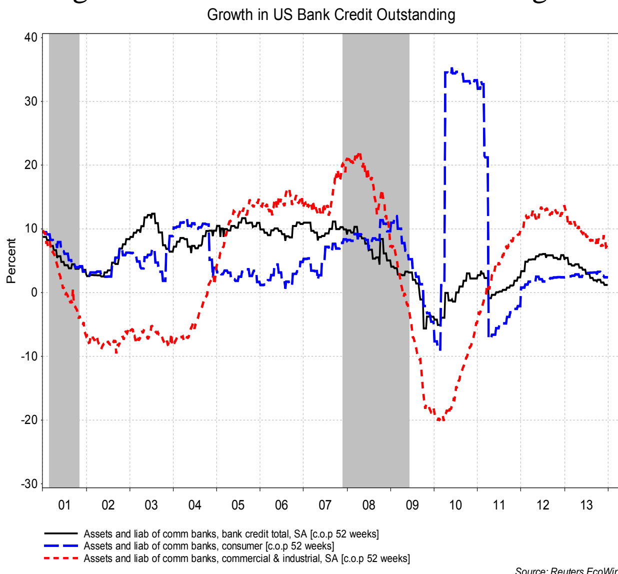


Figure 16: Bank Loan Growth Slowing



The Fed's balance sheet is now over $4 trillion, but most reserves created by QE3 have wound up back at the Fed as excess reserves (Figure 15). The Fed's net assets (i.e., total assets less excess reserves; red line in Figure 15) have barely moved higher since the start of QE3. Other than what's probably a year-end spike, there is no indication that the Fed's expansion of base money is rapidly working its way into the economy. Indeed, bank credit growth is *slowing* (Figure 16). We are watching for signs of excessive credit expansion, but we do not see them today.

The FOMC also updated its economic and interest rate forecasts in December. Fed Board members and regional Fed presidents expect real GDP growth of 2.8-3.2% in 2014 and 3.0-3.4% in 2015, well above private economists' consensus forecast of 2.6% and 2.9%, respectively. Despite the Fed's robust growth outlook, the Fed's median expectations for the federal funds rate are 0.25%, 0.75% and 1.75% at year-end 2014, 2015 and 2016, respectively. Market-implied forward interest rates are broadly in-line with those expectations.

We believe the FOMC's economic forecasts are too optimistic. If so, then monetary policy tightening may come later than the Fed's current expectations, and market expectations for higher policy rates should be pushed out as well. Simply put, we think the current Treasury yield curve already incorporates meaningful acceleration in economic growth. We anticipate that long-term Treasury rates will drift higher over coming years, but only modestly and by less than market forwards. We are mindful that there may be periodic "growth scares" that could push rates upward quickly, and investors should be prepared for volatility in 2014. However, we do not think a large, sustained increase in long-term interest rates is in the cards this year.

Credit spreads narrowed in the fourth quarter, largely offsetting higher Treasury rates. Long-term Baa-rated corporate bond spreads narrowed by 29 bp to 141 bp on December 31, and they are little changed in January (Figure 14). High yield spreads narrowed by a whopping 98 bp to finish the year at 265 bp, and they have tightened another 10 bp so far in January. Prices of preferred securities were mixed during the quarter, with retail taxable preferred securities down 1.5% and institutional preferred securities up 1.2%[2]. Since year-end, those indices are up 3.1% and 0.8%, respectively.

Figure 17: Corporate Profits Near Record High

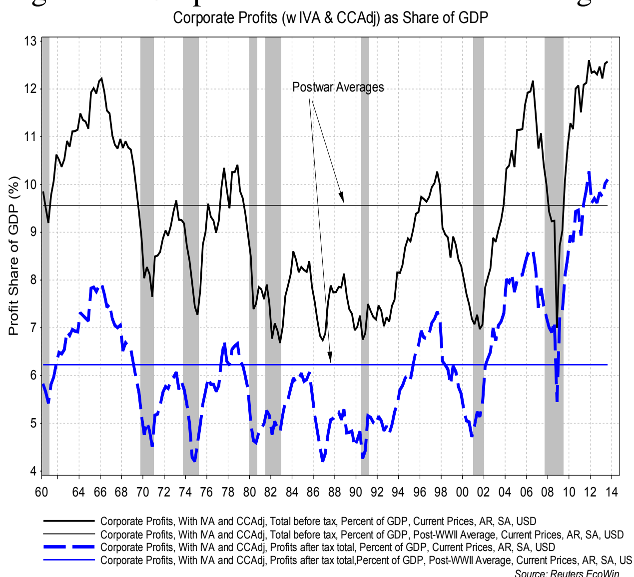
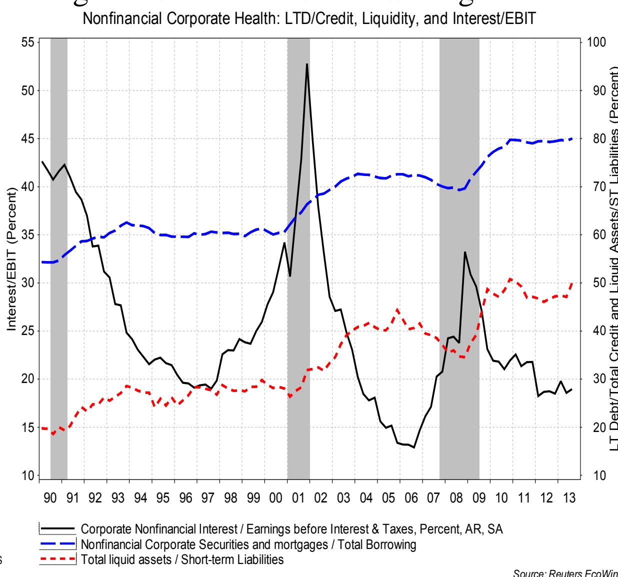


Figure 18: Balance Sheets Strong



[2] The sectors referenced are represented by the Bank of America - Merrill Lynch 8% Capped Hybrid Preferred Securities Index[SM] (P8HO) and BofA - Merrill Lynch 8% Capped Corporate US Capital Securities Index[SM] (C8CT). Returns quoted are price returns only, not total return, which includes income and is higher.

Figure 19: Loan Quality Improving

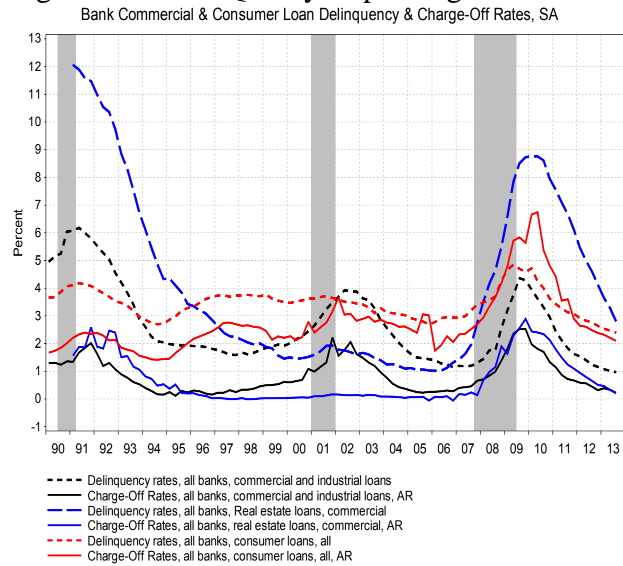
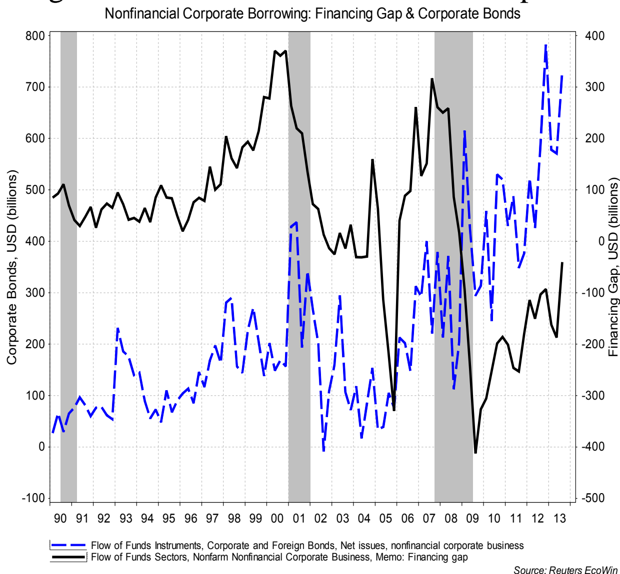


Figure 20: Cash Flow > Investment CapEx



As they have since early 2010, fundamental credit conditions generally continue to improve. Corporate profits are near record levels as a proportion of GDP (Figure 17). Interest expense as a percentage of earnings before interest and taxes is low and stable; long-term debt to total debt is holding near its record high and contributes to low refinancing risk at these companies; and liquidity remains near its record high (Figure 18). Loan delinquencies and charge-offs are falling and, in many sectors, near historic lows, strengthening bank earnings and balance sheets (Figure 19). Finally, nonfinancial corporations, which we indicated earlier have increased borrowing in recent quarters, continue to generate more cash internally than they are spending on capital investments, despite increasing their issuance of corporate bonds (Figure 20). The "financing gap" remains negative (meaning internally generated funds exceed capital expenditures), though it is shrinking. Taken as a whole, credit conditions are highly favorable for preferred securities.

Looking ahead, we foresee moderate economic growth with improving credit conditions. While economic growth is likely to improve over coming quarters, we think interest rates already largely reflect that view. The Fed is going to remove monetary policy accommodation (taper securities purchases) only slowly – and be even more deliberate about tightening (increasing the federal funds rate). Long-term Treasury rates are likely to bounce around this year, but we don't expect them to go up a lot. On the credit front, we remain watchful, as always, for signs of credit excess, but so far we do not see them. By most measures, credit quality continues to improve, particularly at financial companies. We think that adds up to a favorable environment for investors in preferred securities. We thank you for your trust in us and wish you a healthy and prosperous 2014.

Flaherty & Crumrine Incorporated
January 17, 2014

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