

month last quarter, and initial jobless claims continued to fall (Figure 2). The household employment survey recorded only 160,000 average monthly job gains in Q2, but that was after a January surge that boosted the Q1 average to 385,000 new jobs per month. Over the past three quarters, the two surveys recorded nearly identical job growth; we think the more-stable payroll survey gives a better picture of underlying labor market trends currently. Payroll jobs were up 1.8% in June compared to a year ago.

While some of the acceleration in Q2 payroll jobs is probably “catch-up” from a weak first quarter, there are encouraging signs that most of those gains should persist. First, hiring has broadened: the diffusion index of employment averaged 64.3 in Q2, up from 61.1 in Q1 (a reading over 50 indicates that more firms are hiring than firing workers). Second, the unemployment rate has fallen to 6.1% even as labor participation stabilized this year (Figure 3). This is in sharp contrast to the period from 2010-2013, when the unemployment rate fell but labor participation fell almost as fast. As a result, the *employment* rate (red line in Figure 3) has moved up this year. Although both employment and participation rates remain low by historical standards, the fact that they have stabilized or improved in recent months is an encouraging sign for employment.

Less encouraging is wage growth, which remains stuck at about 2% YoY, where it has been since 2011 despite a 3-point drop in the unemployment rate over that period. Historically, a falling unemployment rate has been associated with faster wage growth. Today’s stagnant wage growth is evidence of labor market slack that is not reflected in the unemployment rate – but is reflected in historically low labor participation and employment rates. That’s why we have been paying as much attention to the latter data as the former, and why we are encouraged by recent improvement in participation and employment rates. At the same time, it is unclear when wages will begin to pick up. Until they do, we think consumption growth will remain modest and inflation will remain subdued.

Figure 4: Income & Spending Recovering
Real Disposable Income, Consumption and Savings (3-mo Moving Avg)

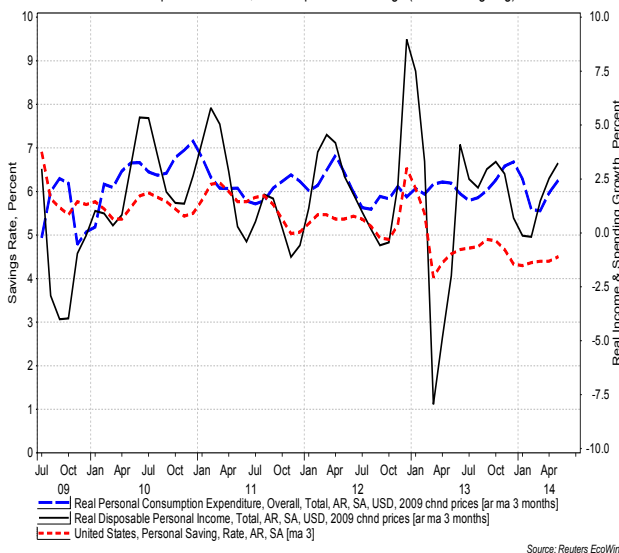
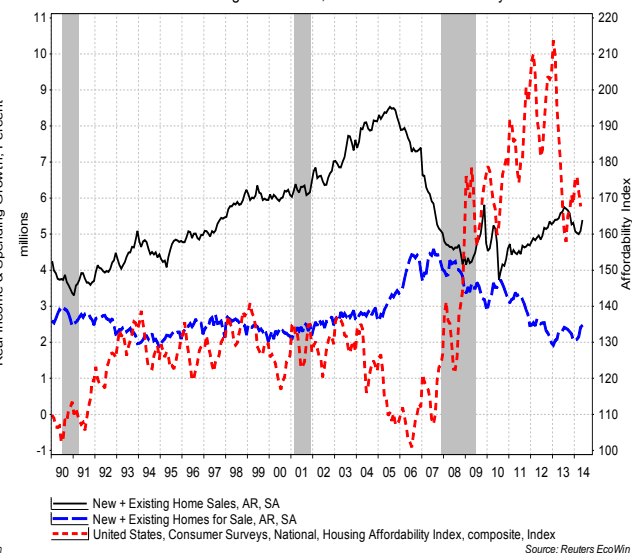


Figure 5: Housing also Bouncing Back
New & Existing Home Sales, Inventories and Affordability



Faster growth in jobs combined with steady, if unspectacular, growth in wages combined to boost **personal income** in Q2. Through May (latest data available), personal income was up 4.2% over

its Q1 average and up 3.5% YoY; it was up 5.1% over the past three months. After inflation and taxes, personal income was up 3.2% over the past three months (Figure 4). Assuming that some of Q2's job gains represented "catch-up" hiring from depressed winter months, we expect slower but still respectable real disposable income gains of about 2.5% over coming quarters.

Personal consumption expenditures (PCE) rebounded modestly in Q2 as weather and income improved. Real PCE was up 1.2% in Q2 through May compared to its Q1 average, not much better than its 1.0% growth rate in that quarter. Over the past three months, it was up 2.4% (Figure 4), in-line with its average growth rate in 2013 but a disappointing result in light of winter weakness in PCE. A subdued pace of spending along with faster income growth pushed up the **savings rate** in the second quarter. It averaged 4.5% over the past three months (Figure 4) and stood at 4.8% in May. We expect that households will continue to increase savings gradually and that consumption growth will trail disposable income growth slightly as a result.

The **housing market** recovered from harsh winter weather, though activity remains below year-ago levels. Total new and existing home sales jumped to a 5.4 million unit pace in May (latest data available) from just 5.0 million in March (Figure 5). Inventories of unsold homes also increased but remain at healthy levels. Home affordability has improved since last summer, when mortgage rates spiked and home prices were moving up rapidly, and they remain affordable from a long-term perspective – though homes are not the bargains they were several years ago (Figure 5). Home prices continue to rise much faster than inflation, but the pace has slowed: the Federal Housing Finance Authority's home price index was up 6.0% YoY in April (latest data available) compared to 7.4% YoY in December 2013, while the S&P/Case-Shiller 20-city home price index was up 10.8% and 13.4% over respective periods. After two negative quarters for residential investment (see Figure 1), we expect a return to moderate growth in the second quarter and beyond.

Figure 6: Production Rebounding

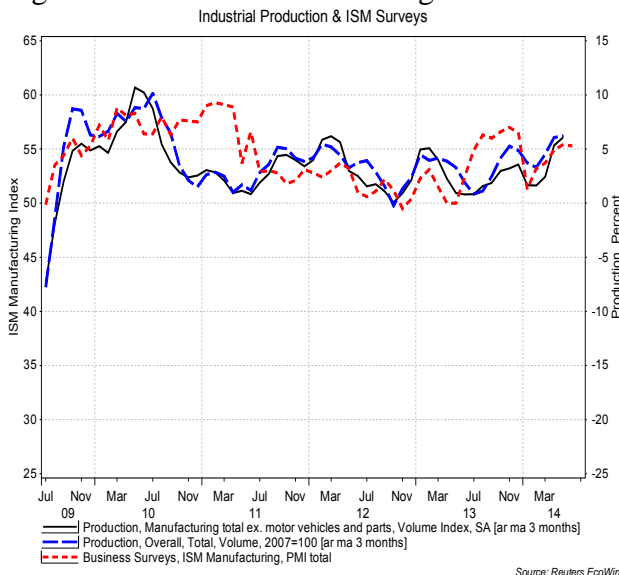
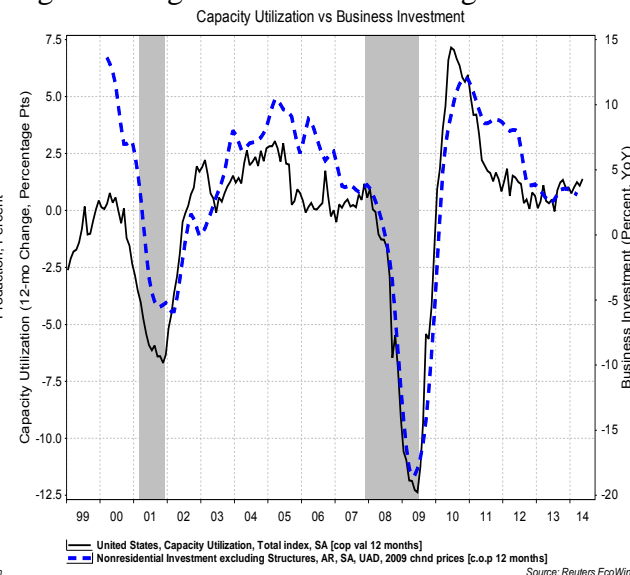


Figure 7: Higher Utilization Driving Investment



Industrial production also rebounded from its winter slowdown. Overall production rose by 6.2% over three months ending in May (latest data available); manufacturing excluding motor

vehicles and parts rose by 6.1% (Figure 6). Orders remain sturdy, and the Institute for Supply Management’s manufacturing survey points to continued, if not accelerating, growth ahead.

Business investment slipped 1.2% in the first quarter but probably returned to growth in the second. Capacity utilization has edged higher, which suggests more-rapid investment spending ahead (Figure 7). We anticipate mid-single digit growth in core business investment (excluding structures) over coming quarters.

The **trade deficit** widened sharply in the first quarter and appears set to subtract from growth again in the second quarter (Figure 8). Net exports reduced real GDP growth by 1.5% in Q1. If the June trade deficit equals the April and May average, trade will subtract about 1% from Q2 real GDP. With U.S. economic growth strong in comparison to many trading partners, we expect that net exports will be a drag on growth over the next several years. However, we expect its bite will be less severe than in Q1 and Q2 as the deficit widens more slowly (or even partially reverses) in 2014’s second half.² Longer-term, we could see trade adding to GDP as growth abroad gradually improves (helping U.S. exports) and U.S. energy production expands (reducing energy imports and even adding to exports in some areas).

Figure 8: Trade Deficit Widened Sharply

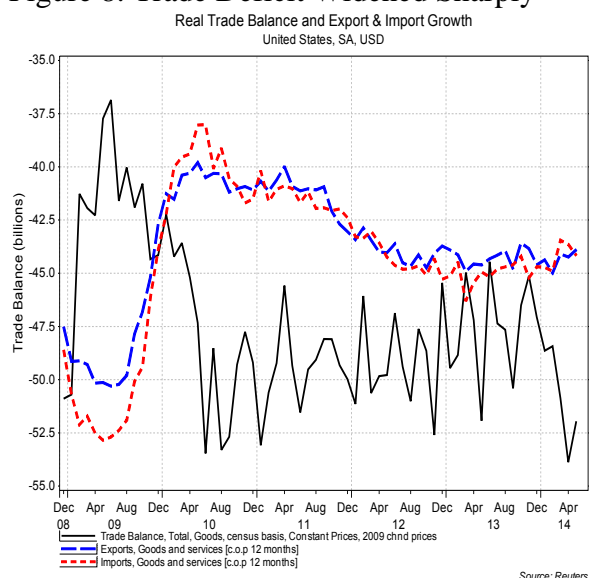
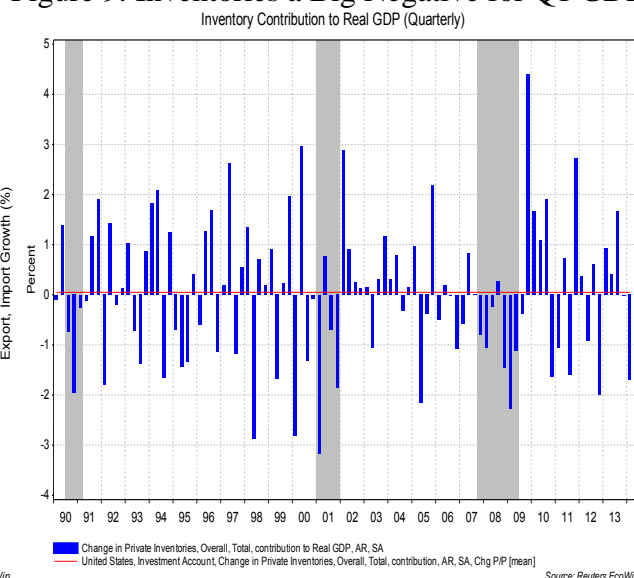


Figure 9: Inventories a Big Negative for Q1 GDP



We don’t usually talk much about **inventories**, but they have played a big, and unpredictable, role in recent GDP reports. Inventories added 1.7% to real GDP growth in 3Q2013, were a negligible factor in the fourth quarter, and subtracted 1.7% from growth in 1Q2014 (Figure 9). For an economy that has averaged less than 2% growth recently, inventories have been a huge factor in quarterly GDP reports.

Historically, inventories have added less than 0.1% to annual GDP growth on average (red line in Figure 9), but they add a lot of volatility to quarterly GDP reports as inventory accumulation accelerates and pulls back. Sometimes, inventories can be an important contributor to medium-term growth. For example, inventory reduction typically amplifies economic weakness in a recession, while inventory rebuilding boosts growth in a recovery. This is clearly visible in the

² Net exports subtract from (add to) GDP when the real trade deficit widens (shrinks) compared to a prior period.

last recession (recessions are shaded gray) and early stages of recovery in 2009 and 2010. In most other times, however, inventories are noisy and largely offsetting. We think that will be the case in 2014, with weakness in Q1 mostly offset by strength in later quarters. It's hard to say if that will happen in the second quarter – we only have data for April at this point – but inventories should be a contributor to growth as 2014 progresses.

Government consumption was down slightly in the first quarter, subtracting 0.1% from real GDP. State and local government employment rose by 52,000 jobs in Q2, which suggests higher spending this quarter. Federal government employment was flat. On balance, government consumption should be about neutral in the second quarter and turn up modestly in the second half.

Figure 10: Fiscal Drag Subsiding

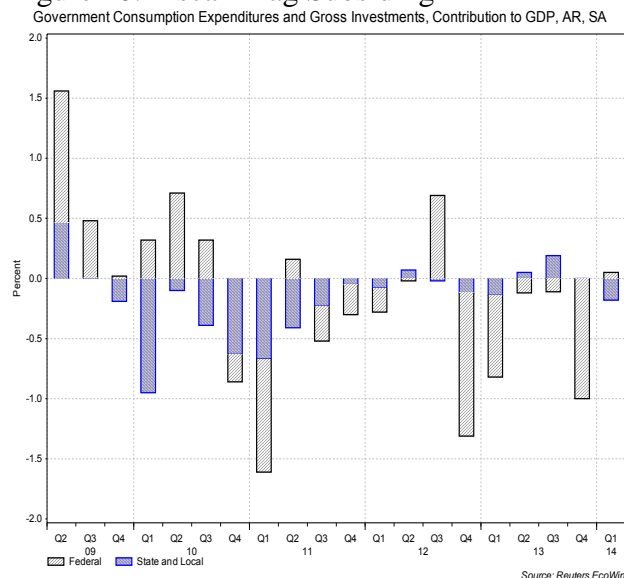
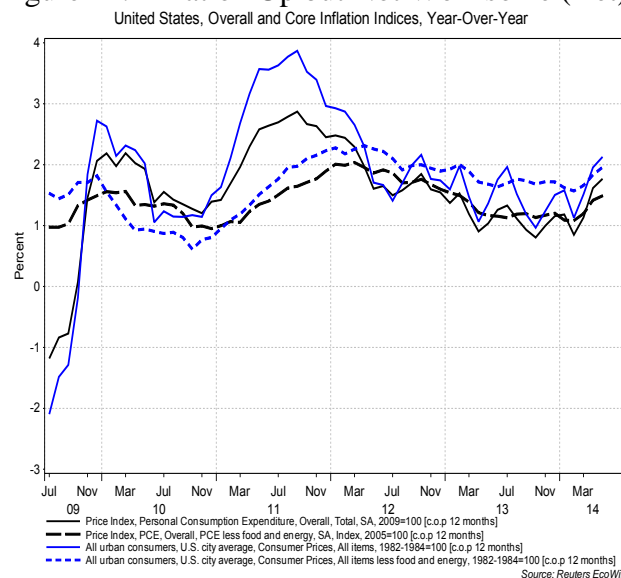


Figure 11: Inflation Up but Not Worrisome (Yet)

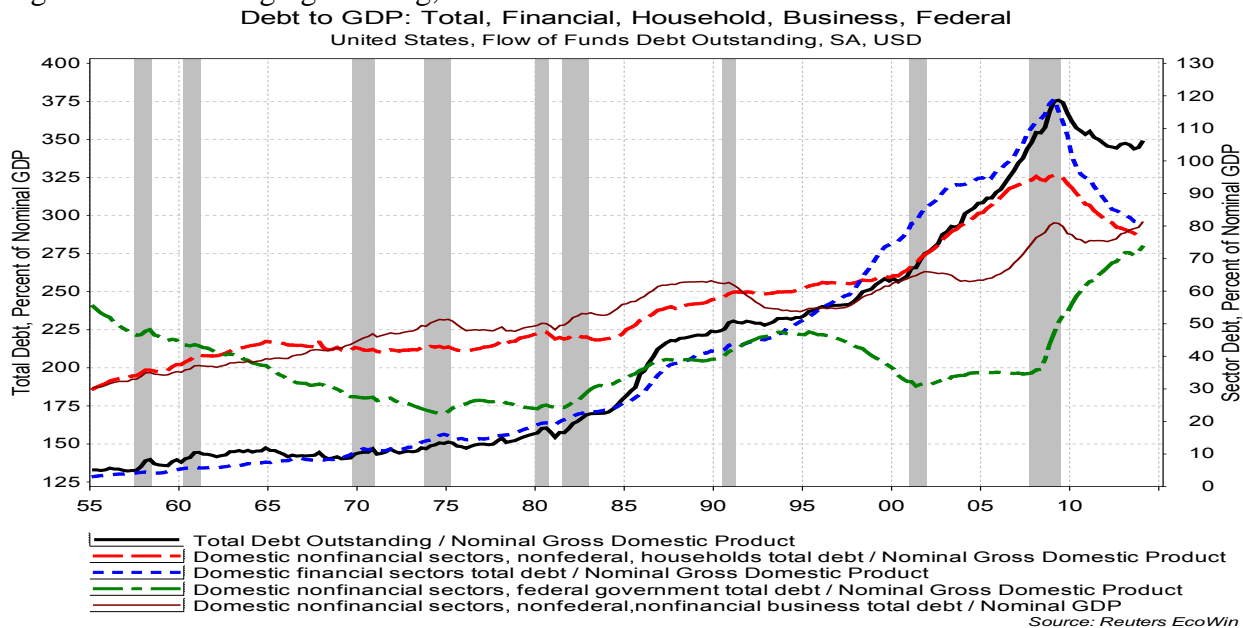


Inflation accelerated in the second quarter after weakening in 2013 and early 2014. For 12 months ending in May (latest data available), the consumer price index (CPI) was up 2.1% overall and 2.0% excluding food and energy (Figure 11). Over the same period, the PCE deflator was up 1.8% overall and 1.5% excluding food and energy. Although we remain watchful on inflation, we are not concerned about its recent uptick. Narrow money supply (M1) growth accelerated in 2014, but broader measures (M2 and MZM) have grown moderately – in fact more slowly than in 2012 and 2013 – and growth in the monetary base has slowed as the Fed reduced its securities purchase program. We think it is not coincidental that inflation picked up as the economy bounced back from winter doldrums. Inflation should settle back as growth stabilizes in the second half of 2014, and it's still a long way from the Fed's 2.5% "threshold of concern."

Finally, broad **balance sheet trends** in the U.S. deteriorated in the first quarter, mainly due to lower GDP during the quarter (Figure 12). Overall debt-to-GDP rose by 4.5 percentage points to 349%. Nonfinancial business continued to add leverage, reaching a new high of 81.4% of GDP. While corporate balance sheets remain healthy and debt burden is low (see below), we are watching this closely. Household balance sheets held about steady, and financial companies managed to deleverage marginally. Government debt rose slightly to 73.9% of GDP.

As economic growth revives in the second quarter, these numbers should improve. Nonfinancial business borrowing will probably pick up – hopefully not too rapidly. However, other sectors should return to gradual deleveraging. Deleveraging remains a mild headwind to growth but is no longer a major factor in our outlook.

Figure 12: Deleveraging Slowing, but Still More to Come



Market Outlook

Long-term **Treasury rates** fell again in the second quarter. The 30-year benchmark Treasury yield declined by 20 basis points (bp) to 3.36% on June 30, about where it is trading today (Figure 13). The 10-year Treasury note yield fell 19 bp to 2.53%; it too is little changed since quarter-end. The Fed left the federal funds rate target unchanged at 0.25%, where it is likely to remain well into 2015.

The Federal Reserve continued to wind down its quantitative easing program (QE3), reducing securities purchases to \$35 billion (\$20b in Treasuries, \$15b in mortgages) per month from a peak of \$85 billion per month when the program was in full swing. The Federal Open Market Committee (FOMC) is likely to reduce purchases by \$10 billion per month at its July 30 and September 17 meetings and then make a final \$15 billion cut to the program at its October 29 meeting. That should put the Fed’s balance sheet just shy of \$4.5 trillion, up from about \$2.8 trillion before QE3 started in September 2012. The FOMC may move faster or slower if economic conditions warrant a change, but we doubt they will.

Benchmark yield curves imply slightly less tightening of monetary policy than FOMC members projected in June. We think that’s appropriate given (i) slower Q1 growth than anticipated in June and (ii) a consistently over-optimistic growth outlook at the Fed over the past few years. We expect that interest rates will move gradually upward – probably by a little less than implied by today’s yield curve, but up nonetheless.

Figure 13: Treasury Rates Edged Lower

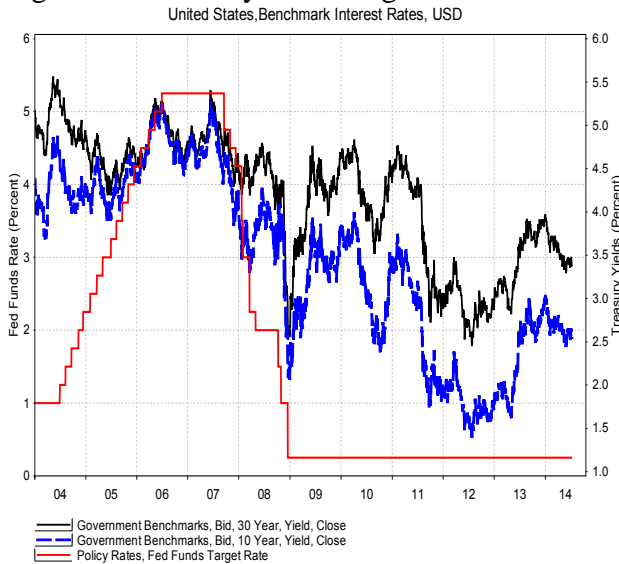


Figure 14: Credit Spreads Slightly Tighter



Corporate **credit spreads** narrowed marginally in the second quarter, slightly outpacing a rally in Treasuries. Long-term Baa-rated corporate bond spreads narrowed by 8 bp to 135 bp; high yield spreads narrowed by 13 bp to 247 bp (Figure 14). Both indices have given back most of those gains so far in July. Preferred securities' prices rose moderately: Bank of America – Merrill Lynch[®] preferred indices posted pre-tax price returns ranging from +2.2 to +3.1% in the second quarter; they are little changed so far in July.³

Figure 15: Loan Growth Up a Bit...

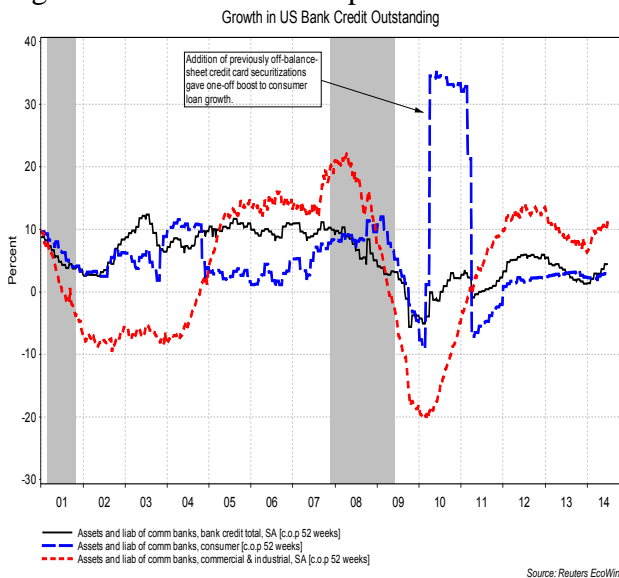
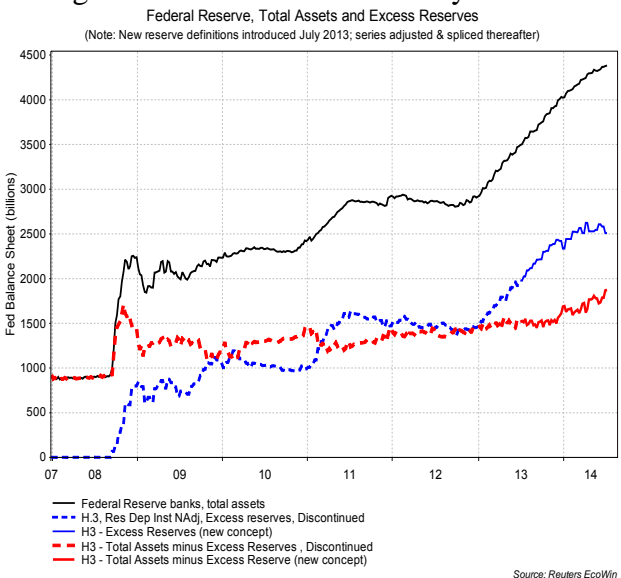


Figure 16: ...as Reserves Finally Leak Out



Bank credit growth improved a bit in the second quarter but remains subdued overall (Figure 15). Aggregate bank lending was up 3.6% in the 12-month period ending in June, compared to 2.9%

³ The sectors referenced are represented by the Bank of America - Merrill Lynch 8% Constrained Hybrid Preferred Securities IndexSM (P8HO), DRD Eligible Preferred Securities IndexSM (P8DO) and US Capital Securities IndexSM (C8CT). Returns quoted are price returns only, not total return, which includes income and is higher.

YoY growth at the end of Q1. Commercial and industrial loans continued to grow at a brisk pace, up 10.5% YoY. Consumer loan growth at banks was still slow at 2.8% YoY.⁴

Acceleration in lending has been concurrent with slower growth in excess reserves at the Federal Reserve. QE3 continues to add to banking system reserves, albeit at a diminishing pace, but excess reserves have largely flattened out since early 2014 (Figure 16). As a result, incremental reserves created by the Fed are being lent by banks. In other words, the Fed’s net balance sheet (the red line in Figure 16) is growing. We think this is a healthy development so long as lending bubbles do not emerge. With the possible exception of leveraged lending, we do not see any potential credit bubbles developing currently. However, we recognize that this is a lot of fuel in the form of excess reserves sitting on the Fed’s balance sheet that banks could deploy rapidly as loans, and we are watching this closely.

Despite economic weakness in the first quarter, fundamental **credit conditions** generally continued to improve. Corporate profits slipped in Q1 but remain near record levels as a proportion of GDP (Figure 17). Corporate balance sheets remain strong: 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 liquidity remains solid (Figure 18). Loan delinquencies and charge-offs fell and, for the most part, are back to pre-crisis levels, strengthening bank earnings and balance sheets (Figure 19). Finally, nonfinancial corporations continued to generate more cash internally than they are spending on capital investments, despite increasing their issuance of corporate bonds (Figure 20). The “financing gap,” while shrinking, remained negative, indicating that internally generated funds exceeded capital expenditures. Credit conditions remain favorable for preferred securities.

Figure 17: Corporate Profits Down in Q1

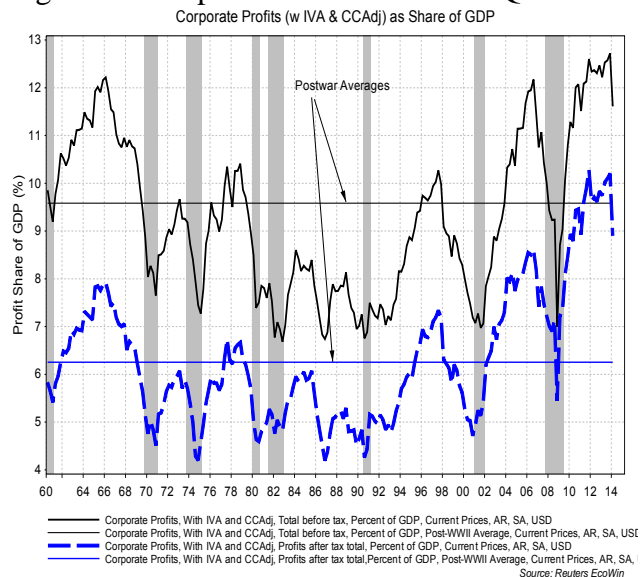
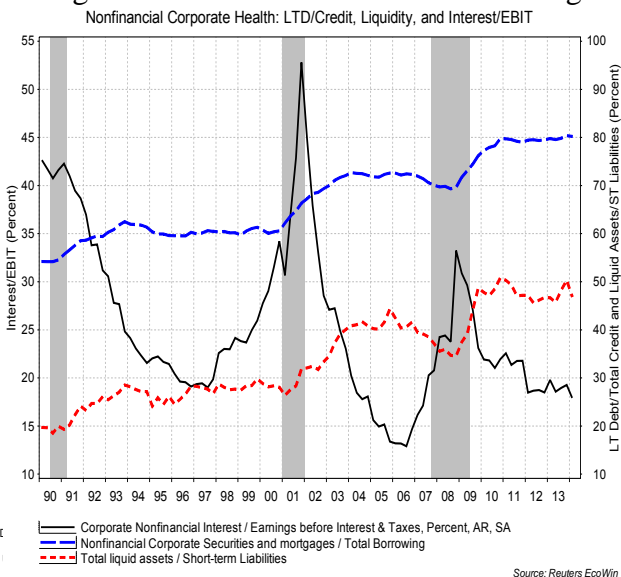


Figure 18: Balance Sheets Remain Strong



⁴ Overall consumer credit growth is higher, driven by non-bank automobile lending and direct student loans. From all lending sources tracked by the Fed, consumer credit through May (latest data available) was up 6.6% YoY.

Figure 19: Loan Quality Stable to Improving

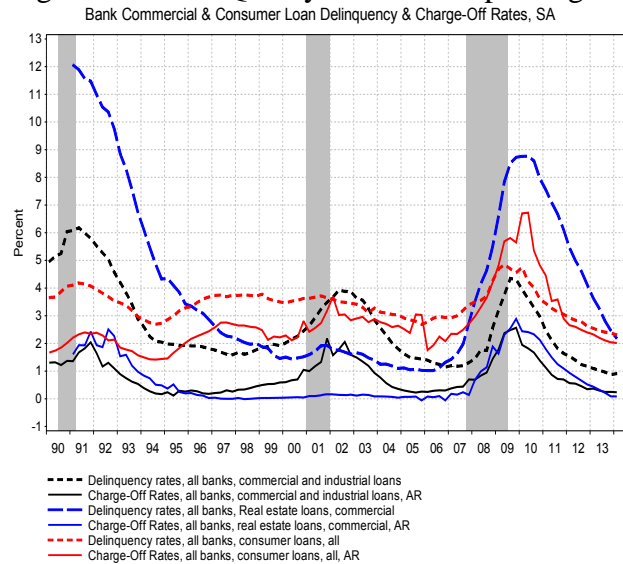
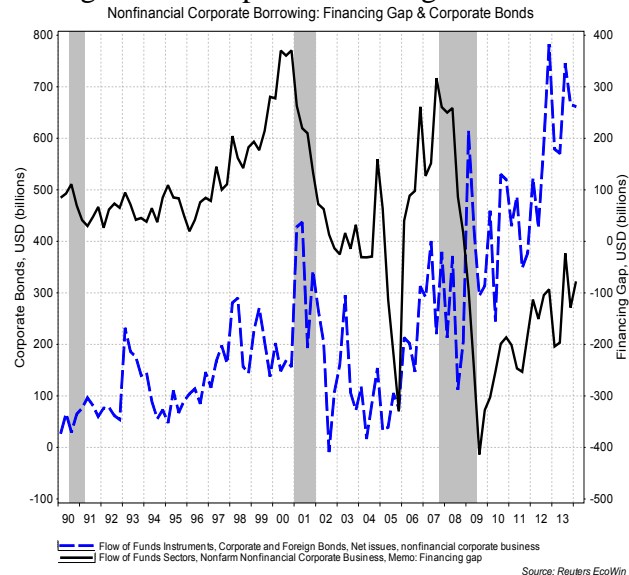


Figure 20: Corporate Funding Needs Low



Looking ahead, we expect U.S. real GDP growth to (finally) accelerate to 2.5-3.0% in the second half of 2014 as private consumption and investment post respectable growth and headwinds from government fiscal restraint and private-sector deleveraging diminish. Employment growth should continue to drive down unemployment, although faster wage gains may be slow in coming. Despite an above-trend growth rate, we think the output gap will close only slowly, which should keep inflation in check. In turn, that should allow the Fed to be patient about raising short-term interest rates. Although long-term rates are likely to rise gradually as the economy improves, we do not expect higher rates to shock markets the way they did in May and June of 2013.

Credit conditions remain favorable for preferred securities. With preferred securities offering one of the few sources of attractive yield and good credit quality in today's markets, spreads should have room to narrow further. Higher long-term interest rates may put some pressure on prices of preferred securities, but over a three- to five-year horizon, relatively high dividend yields on these securities can convert modest principal losses into positive total returns. We think prospective returns on preferred securities remain attractive for long-term investors.

Flaherty & Crumrine Incorporated
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