Flaherty & Crumrine Incorporated

# Third-Quarter U.S. Economic Update
## October 2014

*Summary of Recent Economic Developments*

The U.S. economy returned to a moderate pace of growth in the third quarter of 2014 after a sharp springtime rebound from winter doldrums. Economists forecast 3.1% real GDP growth both in Q3 and for 2015 overall; we expect slightly slower growth of 2.9% in Q3 and 2.5-3.0% next year. Employment expanded moderately, but wage growth remained slow. The unemployment rate fell to a post-recession low of 5.9% in September, though that probably understates true slack in labor market resources. Personal income growth outpaced spending again in Q3, and savings rose. Home sales were up and should continue to add to growth over coming years. Industrial production slowed during Q3, but orders and shipments were up and manufacturers remain optimistic; output should accelerate again in Q4. Business investment remained strong, though it may settle back a bit over coming quarters. Although net exports are likely to be a headwind to growth going forward, trade probably added considerably to GDP in Q3. Government consumption is turning upward, removing a meaningful headwind to growth in recent years. Inflation slowed. Deleveraging resumed, albeit at a gradually slowing pace. Slower global growth and lower inflation drove down long-term Treasury yields even as the Federal Reserve reduced its securities purchases. Credit spreads widened, especially for high-yield securities, despite continued improvement in credit fundamentals. We continue to think prospective returns on preferred securities remain attractive for long-term investors.

Figure 1: Key Macroeconomic Indicators and Interest Rates

| Economic Indicator* | 2012:4 | 2013:1 | 2013:2 | 2013:3 | 2013:4 | 2014:1 | 2014:2 | 2014:3 |
|---|---|---|---|---|---|---|---|---|
| Real GDP, Chg QoQ (%, SA, AR) | 0.1 | 2.7 | 1.8 | 4.5 | 3.5 | -2.1 | 4.6 | 3.1f |
| Real Personal Consump Expnds, Chg QoQ (%, SA, AR) | 1.9 | 3.6 | 1.8 | 2.0 | 3.7 | 1.2 | 2.5 | 2.6f |
| Real Business Inv ex Stuctures, Chg QoQ (%, SA, AR) | 6.7 | 5.2 | 0.2 | 4.0 | 9.8 | 1.3 | 8.9 | N/A |
| Real Residential Investmt, Chg QoQ (%, SA, AR) | 20.4 | 7.8 | 19.0 | 11.2 | -8.5 | -5.3 | 8.8 | N/A |
| Corporate Profits, After Tax, Chg YoY (%, SA, AR) | 0.4 | 2.5 | 6.0 | 4.5 | 3.4 | -11.8 | -8.9 | -5.2f |
| Current Account Balance, Annualized (% of GDP, SA) | -2.6 | -2.6 | -2.6 | -2.4 | -2.0 | -2.4 | -2.3 | N/A |
| Federal Budget, 12-mo Def or Surp (% of GDP) | -6.5 | -5.5 | -4.2 | -4.0 | -3.3 | -2.9 | -3.1 | -3.0a |
| Unemployment Rate (%, SA) | 7.9 | 7.5 | 7.5 | 7.2 | 6.7 | 6.7 | 6.1 | 5.9 |
| Household Employment, Chg QoQ (000, SA) | 265 | 181 | 682 | 195 | 316 | 1156 | 479 | 379 |
| Nonfarm Payrolls, Chg QoQ (000, SA) | 642 | 618 | 603 | 515 | 595 | 569 | 800 | 671 |
| Nonfarm Productivity, Chg QoQ (%, SA, AR) | -2.0 | 0.8 | 0.5 | 3.6 | 3.3 | -4.5 | 2.3 | N/A |
| Capacity Utilization (%, SA) | 77.5 | 78.0 | 77.8 | 78.3 | 78.5 | 79.1 | 79.1 | 78.8a |
| GDP Price Index, Chg QoQ (%, SA, AR) | 1.3 | 1.3 | 1.2 | 1.7 | 1.5 | 1.3 | 2.1 | 1.8f |
| Consumer Price Index, Chg YoY (%, AR) | 1.7 | 1.5 | 1.8 | 1.2 | 1.5 | 1.5 | 2.1 | 1.7a |
| CPI ex food & energy, Chg YoY (%, AR) | 1.9 | 1.9 | 1.6 | 1.7 | 1.7 | 1.7 | 1.9 | 1.7a |
| Nominal Personal Income, Chg YoY (%, AR) | 9.0 | 2.3 | 2.9 | 2.8 | -2.1 | 3.7 | 4.1 | 4.3a |
| Personal Savings Rate (%, SA) | 10.5 | 4.9 | 5.3 | 5.2 | 4.1 | 4.8 | 5.4 | 5.4a |
| **Rate or Spread (End of Quarter)** | **2012:4** | **2013:1** | **2013:2** | **2013:3** | **2013:4** | **2014:1** | **2014:2** | **2014:3** |
| Federal Funds Rate Target (%) | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 |
| 3-month LIBOR (%) | 0.31 | 0.28 | 0.27 | 0.25 | 0.25 | 0.23 | 0.23 | 0.24 |
| 10-Yr Treasury Note Yield (%) | 1.76 | 1.85 | 2.49 | 2.62 | 3.03 | 2.72 | 2.53 | 2.50 |
| 30-Yr Treasury Bond Yield (%) | 2.95 | 3.10 | 3.50 | 3.69 | 3.96 | 3.56 | 3.36 | 3.20 |
| Moody's Baa Long Corp Spread (bp) | 168 | 173 | 185 | 170 | 141 | 143 | 135 | 161 |
| 10-Yr Interest Rate Swap Spread (bp) | 6 | 16 | 21 | 16 | 7 | 12 | 10 | 14 |

* Figures are either quarterly or, if more frequent, end of period. f = Forecast[1]; a = Actual through August 2014 Source: Reuters EcoWin

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

*Economic Outlook*

U.S. economic growth appears to have returned to moderate growth in the third quarter. Inflation-adjusted gross domestic product (real GDP) fell 2.1% due to adverse winter weather in Q1, rebounded 4.6% in Q2, and probably grew about 3% in Q3. Economists' consensus forecast calls for 3.1% third-quarter real GDP growth.[1] We estimate 2.9% growth, at the upper end of our earlier expectation of 2.5-3.0% growth in the second half of 2014.

For 2014 as a whole, the Federal Reserve now expects 2.0-2.2% real GDP growth, down from earlier forecasts of 2.1-2.3% (June 2014) and 2.8-3.2% (December 2013). The Fed's current forecast is in-line with a consensus of private economists, who expect real GDP growth of 2.1% in 2014. We are sticking with our long-standing 2.0-2.5% growth forecast for this year; it probably will be at the low end of that range given a contraction in Q1 real GDP.

Looking ahead, we think 2.5-3.0% growth looks about right for 2015. That is in-line with the Fed's recently reduced forecast of 2.6-3.0% growth in 2015 and only slightly below economists' 3.1% consensus forecast. As regular readers of this Update know, our growth outlook has been consistently below the Fed's and economists' consensus forecasts in recent years. While convergence has occurred mostly by others coming down toward our more-moderate forecast, we think economic prospects are looking a little brighter currently. Diminishing headwinds to growth (end of fiscal drag and slower pace of deleveraging) and continued gradual improvement in private-sector activity should make for an above-trend year of growth in 2015.

As usual, we will run through major sectors of the U.S. economy in turn. It's mostly good news.

Figure 2: Modest Job Growth; Sluggish Wages

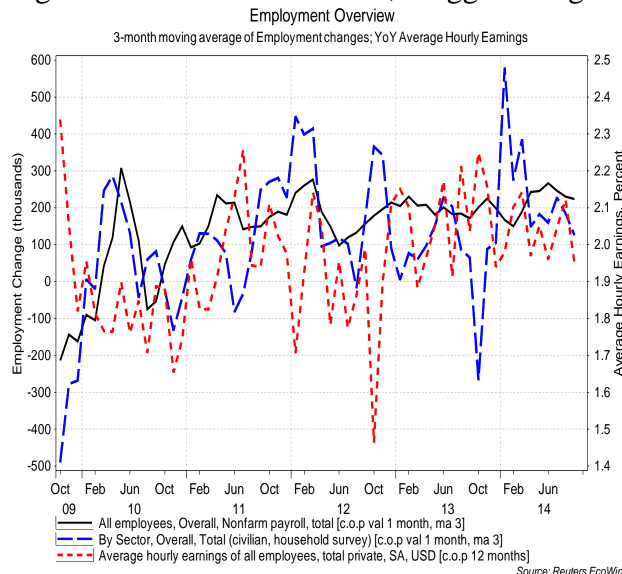
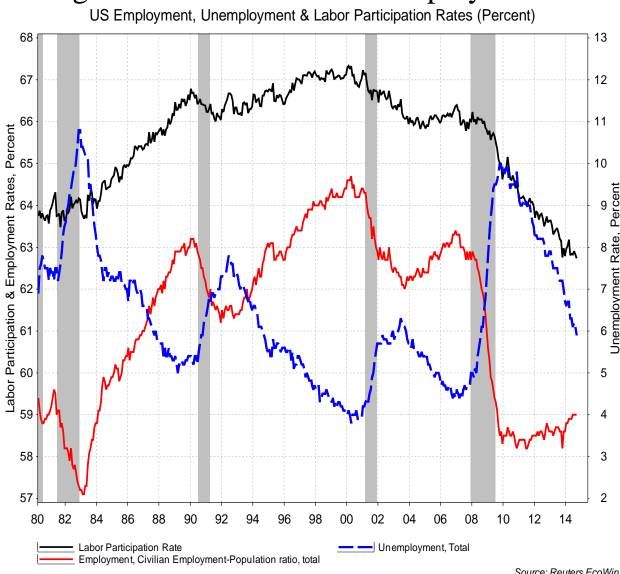



Figure 3: Mixed News on Employment Rate




The **labor market** posted further improvement in the third quarter, but continued slack in labor resources should keep policymakers at the Federal Reserve in an accommodative stance. Strong employment gains in September capped an otherwise lackluster quarter. Nonfarm payrolls expanded by 671,000 jobs in Q3 (an average of 224,000 per month), while the household

[1] Unless noted otherwise, forecasts are from the *Survey of Professional Forecasters*, Federal Reserve Bank of Philadelphia, August 15, 2014.

employment survey tallied 371,000 new jobs (126,000 per month; see Figure 2). Those job gains were down from second-quarter results but were still sufficient to push the unemployment rate down to 5.9% in September (Figure 3). Job gains were broadly based, and total payroll jobs are now 1.9% higher than a year ago. Wage growth, however, remains sluggish, at about 2.0% YoY, barely above 2010's pace. We continue to believe wage growth is a better indicator of labor market tightness than the unemployment rate – and wages point to ongoing slack.

Despite a sharply lower *un*employment rate, the *employment* rate remains low and has improved only slightly since economic recovery began in mid-2009 (Figure 3). Just 59% of working-age adults were employed in September, up less than one percentage point from its post-recession low despite a four percentage-point drop in the unemployment rate. Falling labor participation reconciles these two series. Lower labor participation (i.e. a shrinking workforce) pushed down the unemployment rate even as the employment rate was little changed. While some of this decline in labor participation was due to an aging population, some reflects persistent labor market weakness that has pushed people out of the workforce. Better employment prospects – and especially higher wages – should lure some of those people back into labor markets; they represent slack in labor market resources that is difficult to quantify but is present nonetheless.

Total hours worked grew fairly rapidly in Q3, rising 2.6% in the private sector. Unfortunately, productivity growth probably remained slow, so we anticipate that real GDP growth will be only a little faster than growth in hours worked during the quarter.

Figure 4: Income Outpaced Spending

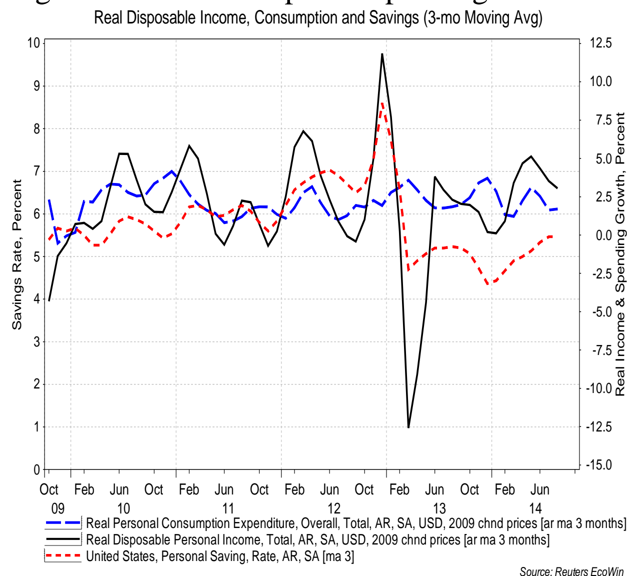
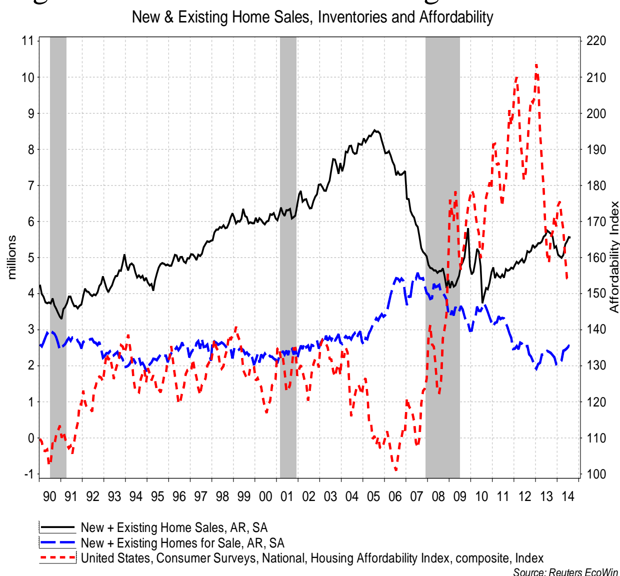



Figure 5: Home Sales Recovering from Shocks




Modest growth in jobs and wages translated into similarly modest growth in **personal income**. Nominal (i.e., not inflation-adjusted) personal income was up 3.6% in July and August (latest data available) compared to its Q2 average. Over 12 months ending in August, nominal personal income was up 4.3%. After inflation and taxes, real disposable personal income grew at a 3% pace following a dip in winter and rapid recovery in spring (Figure 4). We anticipate acceleration in income as the labor market improves, but more rapid income gains will have to wait for higher wages, which are not yet evident.

**Personal consumption expenditure** (PCE) has been subdued in 2014, and Q3 was no exception (Figure 4). Real PCE was up 1.6% in July and August, 1.7% over the past three months and 2.6% YoY – all modest results. Soft retail sales reported today for September suggest that consumers remained cautious on spending in that month as well. Income outpaced spending during most of 2014, pushing the savings rate up to 5.4% in August. Although consumer confidence is improving gradually, consumers remain cautious about spending and continue to pay down debt (more on that later). Faster wage growth would probably open consumers' wallets, but, as we have pointed out, they are still waiting on that.

On a brighter note, the **housing market** continued to recover from a slowdown in sales in the second half of 2013 and early 2014. Higher mortgage rates last year and unusually cold and snowy weather last winter depressed new and existing home sales (Figure 5). They have rebounded impressively since spring 2014, however. Residential investment was up 8.8% in Q2; while it probably will grow a little more slowly in Q3, it should easily outpace overall GDP growth.

Looking forward, we remain optimistic on housing over coming years. Inventory of homes available for sale is back around a "normal" level, signaling that most excess supply has been absorbed. New home construction is well below a pace necessary to accommodate growth in households and replacement of older homes. Residential investment will need to rise over time to meet long-term demand. Home affordability, while down (i.e., less affordable) from its peak in 2012, is still relatively good. With mortgage lending standards gradually easing and employment expanding, sales should continue to move upward.

Figure 6: Industrial Production Slowed…

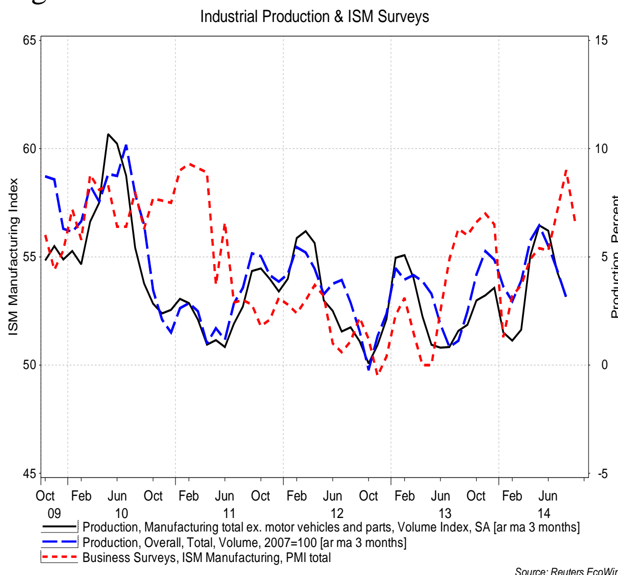
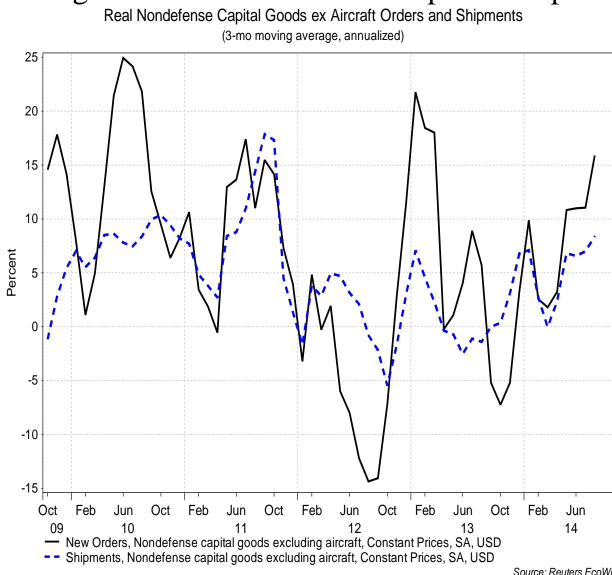



Figure 7: …But Orders & Shipments Up




**Industrial production** sagged in July and August (latest data available) after rebounding strongly from a winter slowdown (Figure 6). Utility output dropped due to cooler than normal summer weather, but slower growth was evident across industrial sectors. However, although down a bit in September, the Institute for Supply Management's survey of manufacturing activity suggests that activity should pick up over coming months. In addition, orders and shipments for

nondefense capital goods excluding aircraft (so-called core capital goods) surged in recent months (Figure 7), which should keep factories busy for several quarters.

Figure 8: Investment Ahead of Capacity

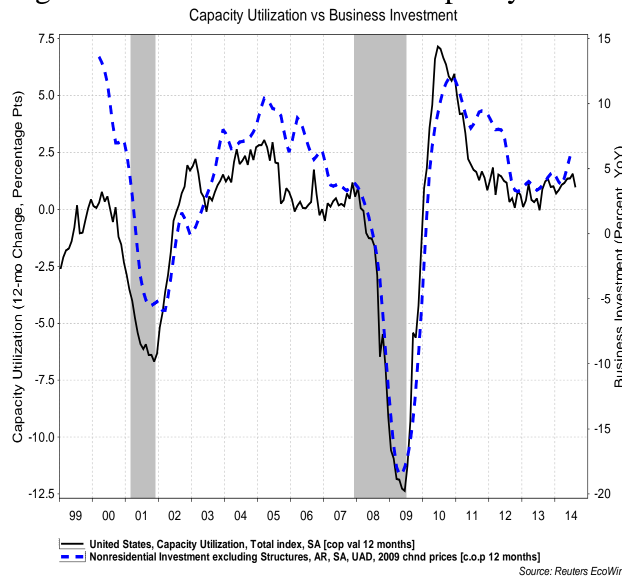
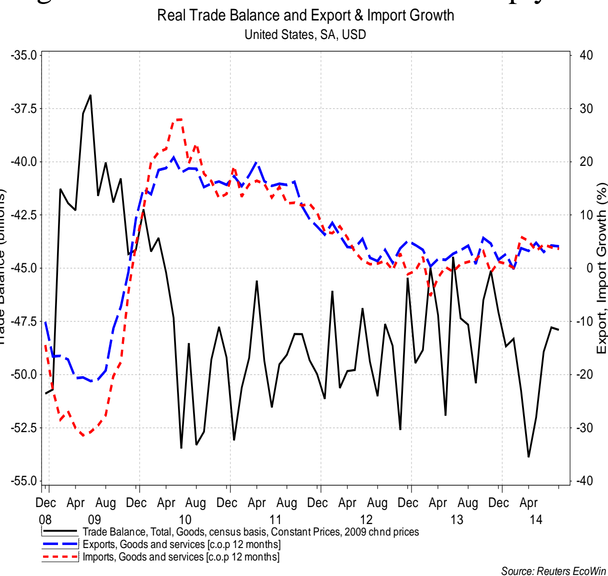



Figure 9: Trade Deficit Narrowed Sharply




**Business investment** excluding structures was up 8.9% in Q2 and 5.9% over the past four quarters. We expect business investment to remain a bright spot for the U.S. economy, but it appears to be a little ahead of an increase in capacity utilization over the past year (Figure 8). Given strong shipments of core capital goods so far in Q3, business investment should turn in another strong performance this quarter, but we expect investment spending will settle back to roughly 4% growth over coming quarters.

A wider **trade deficit** subtracted 0.3% from GDP growth in the second quarter, but a substantially narrower deficit so far in Q3 should more than offset last quarter's drag (Figure 9). If September's real goods balance equals its July and August average, net exports would add 1.2% to Q3 real GDP. Looking ahead, we still anticipate that trade will, on average, reduce GDP growth over coming quarters. U.S. domestic economic growth should outperform most of its trading partners, and the U.S. dollar has rallied more than 5% against major currencies on a trade-weighted basis over the past 12 months. Both should drive higher import and slower export growth in the U.S. and widen the trade deficit. Rising domestic oil and gas production should help reduce net energy imports, but it probably will not be enough to offset a wider deficit in non-petroleum products.

**Government consumption** has imposed meaningful drag on GDP growth in recent years (an average of -0.3% contribution to GDP since 1Q2010), but that should be coming to an end (Figure 10). State and local spending has already turned up, and federal fiscal drag should turn to mild growth by 2014's fourth quarter. With Congress and the administration likely to remain divided, we don't expect government consumption will add a lot to GDP growth over the next several years. However, if government's 0.3% average drag on GDP switches to just a 0.2% contribution, that would boost GDP growth by 0.5% relative to its prior trend. Add in some improvement in private-sector demand, which is likely, and GDP could accelerate to 2.5-3.0% from its average of 2.2% since 2010, even after some deterioration in net exports.

Figure 10: Fiscal Drag Coming to an End

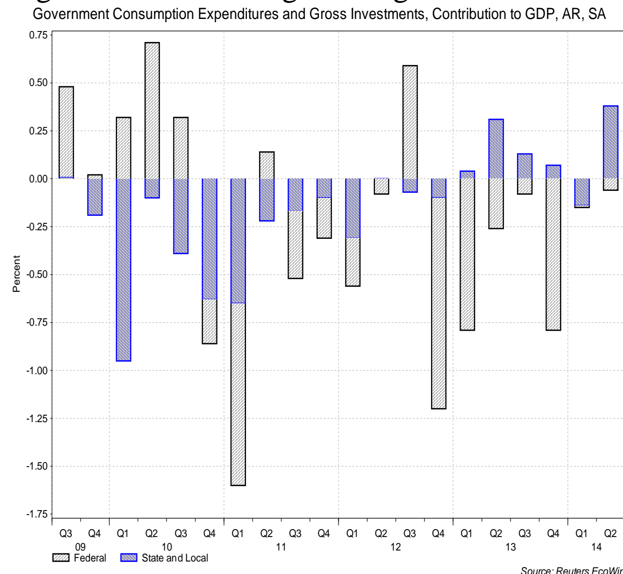
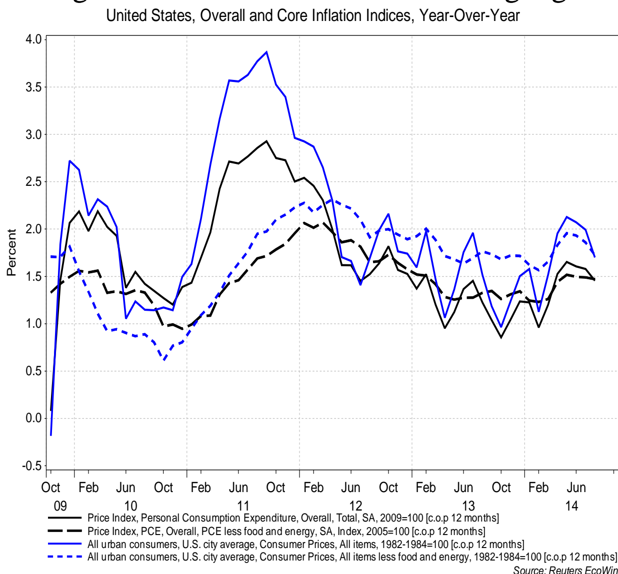



Figure 11: Inflation Pressures Easing Again



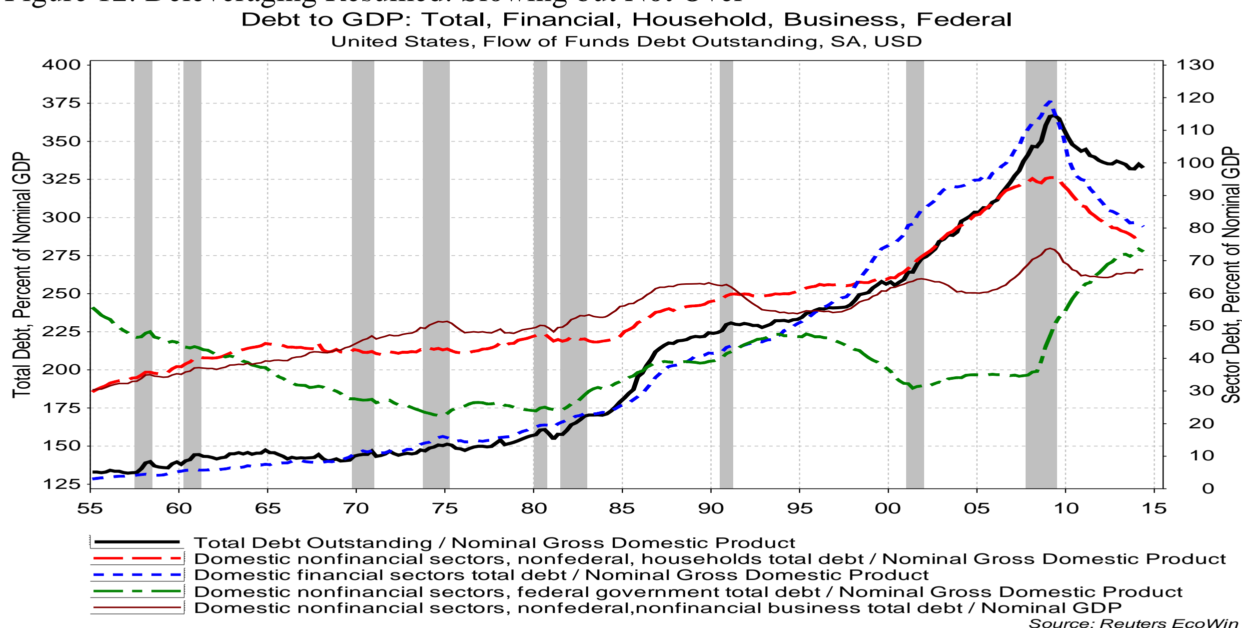

**Inflation** generally slowed during the third quarter. The consumer price index (CPI) was up 1.7% both overall and excluding food and energy over 12 months ending in August (latest data available) and has trended lower since May. The PCE deflator edged lower; it was up 1.5% overall and excluding food and energy over a comparable period, one-half percent below the Federal Reserve's 2% inflation target (Figure 11). Higher inflation is not on the Fed's current worry list.

Broad **balance sheet ratios** in the U.S. have changed little in recent quarters (Figure 12). Households continue to pay down debt at a moderate pace. During the second quarter (latest data available), mortgage debt fell and credit card debt grew modestly in dollar terms. Student loans (+8.3% YoY) and auto loans (+9.2% YoY) continued to grow rapidly. Nonfinancial business borrowing rose, and the "financing gap"[2] turned positive in 2014 for the first time since mid-2008. Leverage at nonfinancial companies continued to rise in the second quarter. Although not worrisome in aggregate (interest expense relative to earnings before interest and taxes remains low), the Fed has expressed concern over "froth" in the leveraged lending market.

Financial companies continued to deleverage, albeit at a slightly slower pace in recent quarters. This is generally good news for preferred investors, since the preferred securities market is dominated by financial issuers. Federal government borrowing actually declined slightly relative to GDP owing to rapid improvement in the federal budget deficit. For fiscal year ending in September, the federal budget deficit fell to about 2.8% of GDP, compared to nearly 10% in 2009.

[2] The financing gap is the difference between capital expenditures and internally generated funds. A positive number means capex exceeded cash flow; to finance that gap, companies must borrow or reduce securities holdings.

Figure 12: Deleveraging Resumed: Slowing but Not Over




Across all sectors, debt-to-GDP stands at 332%, down from a peak of 367% in 2009. Leverage remains high historically, however, and deleveraging should continue to present a modest, albeit diminishing, headwind to economic growth.

*Market Outlook*

Long-term **Treasury rates** fell in the third quarter as global economic growth slowed – even though U.S. growth was pretty good – and inflation pressures eased. The 30-year benchmark Treasury bond yield fell 14 basis points (bp) to end Q3 at 3.20% (Figure 13). The ten-year Treasury yield dropped 3 bp to 2.50%. However, as fears of slower global economic growth intensified, those yields have dropped an additional 28-35 bp since quarter-end, bringing them back to their lowest levels since the Federal Reserve announced it was considering tapering its securities purchases in May 2013.

Although we have not been worried that long-term interest rates would move sharply higher, we have been surprised by a continued decline in Treasury yields in the second half of this year. Slower growth and lower yields abroad have contributed to low yields here, and dimming prospects for more rapid growth abroad may hold down U.S. interest rates for some time. Nonetheless, we continue to expect long-term interest rates will rise moderately and gradually over the next few years. Credit conditions also should continue to improve, especially for financial companies, which should support narrower credit spreads. Improving fundamentals and wide yield spreads on preferred securities (preferred prices have not participated in much of the recent Treasury market rally) should at least partially absorb higher Treasury yields.

The Federal Open Market Committee (FOMC) left the federal funds rate unchanged at 0.25% and continued reducing securities purchases. The Fed's quantitative easing program (QE3) has dropped from a peak of $85 billion to $15 billion per month currently. QE3 is set to end this month. The program expanded the Fed's balance sheet to almost $4.5 trillion from about $2.8 trillion before it started in September 2012.

Recapping outlooks for growth from page 2, the Federal Reserve expects 2.6-3.0% real GDP growth in 2015, slightly below economists' 3.1% consensus forecast and in-line with our 2.5-3.0% view. We think the Fed's projected path of interest rates remains too high, however. Labor market slack is likely to be taken up only slowly. Inflation is low, and slower global economic growth may put further downward pressure on prices. Weak growth abroad and a significantly stronger dollar are risk factors to the outlook. Add it up, and we think the Fed will raise rates very cautiously, delaying its initial rate hikes or moving more slowly than expected once they begin. We continue to think long-term rates will rise gradually but by less than is priced into markets currently.

Figure 13: Rates Down on Slower Global Growth

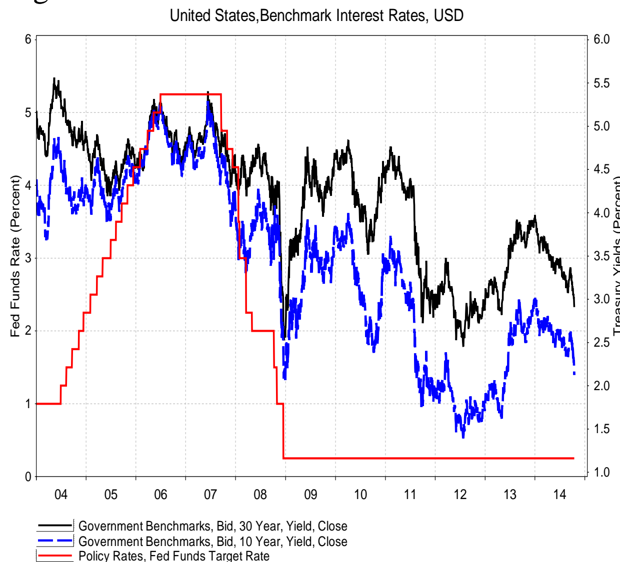



Figure 14: Credit Spreads Wider

Corporate **credit spreads** widened in the third quarter as corporate bonds failed to keep pace with lower Treasury yields (Figure 14). Long-term Baa-rated corporate bond spreads widened by 26 bp in Q3 to 161 bp; they have increased about 5 bp more so far in October. High yield spreads increased sharply, widening by 117 bp to 365 bp, and they have widened by another 67 bp in October. Preferred securities' prices fell modestly: Bank of America – Merrill Lynch® preferred indices posted pre-tax price returns (*before* income) ranging from -0.6 to -1.0% in Q3, and option-adjusted spreads widened. Preferred index prices are up slightly (+0.2 to +0.3%) since quarter-end but have substantially lagged a 6% gain in long-term Treasury prices over that period.

After slowing for most of the prior two years, bank credit growth accelerated notably in 2014 (Figure 15). Total bank credit us up 6.0% YoY in Q3, led by commercial and industrial loans, which are up 12.1% YoY. Consumer borrowing at banks is considerably slower, up 3.7% YoY, with nearly all of that growth coming from automobile and student loans. Even so, that is up from just 2.2% at the beginning of 2014. Many banks that had been trimming loan portfolios to de-risk their balance sheets began lending again in late 2013 and 2014, and business investment has been expanding briskly. So far, this appears to be more credit normalization than credit bubble. However, this is something we will be monitoring carefully.

Figure 15: Bank Lending Picking Up

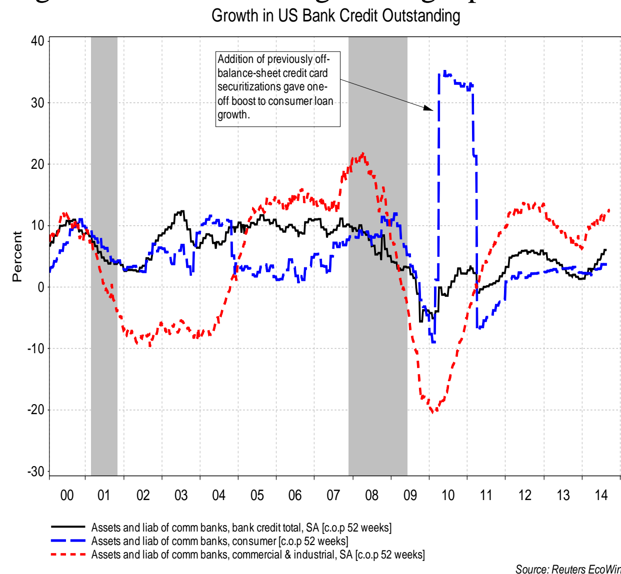



Figure 16: Balance Sheets Remain Strong

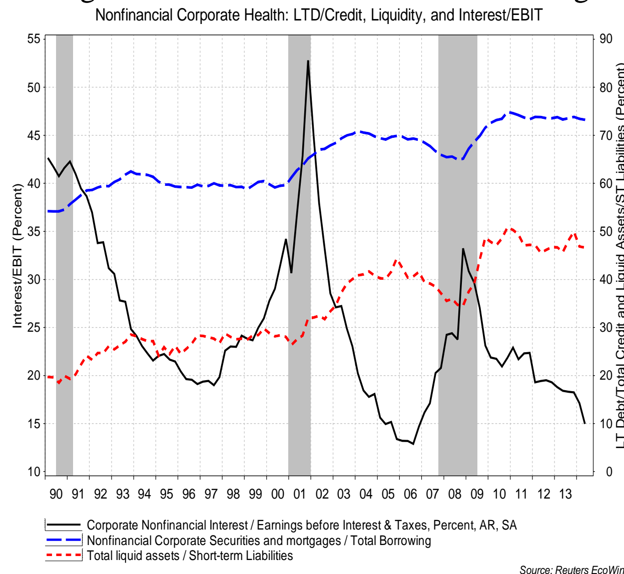



Figure 17: Loan Quality Still Improving

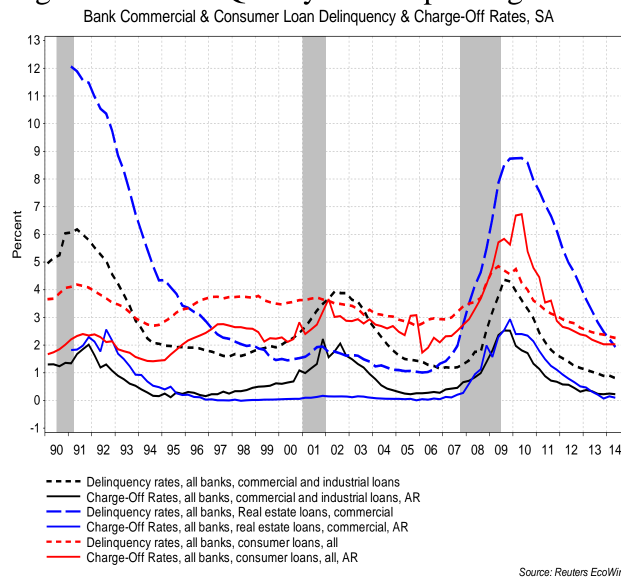
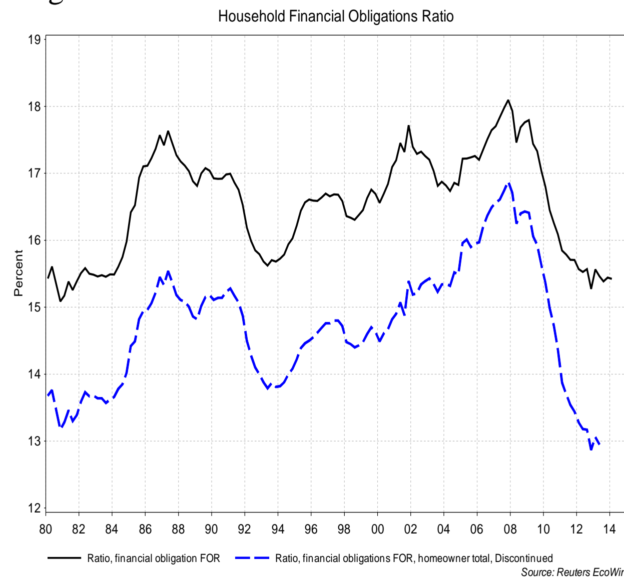



Figure 18: Household Debt Burdens Low




As they have for over four years now, broad credit fundamentals continue to improve. Corporate profits as a share of GDP, while down from a peak at the end of 2014, remain strong and are well above long-term averages. Interest expense as a percentage of earnings before interest and taxes fell to a post-recession low in Q2 (latest data available); long-term debt to total debt is holding near its record high; and liquidity remains strong (Figure 16). Loan delinquency and charge-off rates are stable or declining across all major loan categories and are back to or below historic norms (Figure 17). Household debt burdens stabilized as deleveraging slowed and interest rates rose beginning in the middle of 2013, but they remain near record lows (Figure 18). And at financial companies, regulators continue to push companies to hold more and higher-quality forms of capital. Gradually improving economic growth should reinforce these trends.

Our outlook for preferred securities remains relatively optimistic. Moderate U.S. economic growth in a sluggish global economic environment should provide a constructive environment for preferred-securities investors, even if interest rates move upward gradually over the next few years. We continue to expect that economic growth will be fast enough to facilitate further improvement in bank and household balance sheets and better loan performance, while being slow enough to restrain inflation and keep monetary policy accommodative for some time. We think this argues for narrower credit spreads on U.S. preferred securities over coming quarters, which should at least partially offset eventual higher Treasury yields.

More importantly, preferred securities continue to offer relatively high yields compared to most other fixed-income investments such as corporate bonds. Over a three- to five-year horizon, dividend payments on preferred securities can turn modest principal losses due to higher interest rates into positive total returns. Volatility may increase over coming quarters, but we think prospective returns on preferred securities remain attractive for long-term investors.

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