First-Quarter U.S. Economic Update
April 2015

Summary of Recent Economic Developments

Adverse winter weather and West Coast port strikes got U.S. economic growth off to a poor start in 2015. Inflation-adjusted gross domestic product is likely to grow by no more than 1% in the first quarter. We expect this soft patch to be temporary, however, and continue to forecast real GDP growth of 2.5-3.0% for 2015. Effects of weather and port strikes are visible across many sectors. While the unemployment rate edged lower, employment growth slowed, and wages remained stuck in low gear. Personal income jumped, but consumption was weak. Housing activity was subdued. Industrial production slumped, and orders fell. Business investment likely slowed again. The trade deficit appears to have restrained domestic growth again. Inflation remains low but edged upward. Benchmark Treasury yields fell, credit spreads were stable to narrower, and prices of preferred securities rose. The Federal Reserve eliminated "patient" from its statements, but not (yet) from its actions: An initial 25 bp rate hike will probably not happen until September or even later. Credit conditions remain favorable, though the nonfinancial corporate sector bears watching. With investors still hungry for yield, we anticipate credit spreads on U.S. preferred securities should narrow and at least partially offset eventual higher Treasury yields. Although they are no longer the bargains they once were, we think prospective returns on preferred securities remain attractive for long-term investors.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	2013:2	2013:3	2013:4	2014:1	2014:2	2014:3	2014:4	2015:1
Real GDP, Chg QoQ (%, SA, AR)	1.8	4.5	3.5	-2.1	4.6	5.0	2.2	1.4f
Real Personal Consump Expnds, Chg QoQ (%, SA, AR)	1.8	2.0	3.7	1.2	2.5	3.2	4.4	2.0f
Real Business Inv ex Stuctures, Chg QoQ (%, SA, AR)	0.2	4.0	9.8	1.3	8.9	10.0	4.4	NA
Real Residential Investmt, Chg QoQ (%, SA, AR)	19.0	11.2	-8.5	-5.3	8.8	3.2	3.8	NA
Corporate Profits, After Tax, Chg YoY (%, SA, AR)	6.0	4.5	3.4	-11.8	-8.9	-6.3	-6.4	18.1f
Current Account Balance, Annualized (% of GDP, SA)	-2.6	-2.4	-2.0	-2.4	-2.2	-2.2	-2.6	-2.4f
Federal Budget, 12-mo Def or Surp (% of GDP)	-4.2	-4.0	-3.3	-2.9	-3.1	-2.7	-2.8	-2.8a
Unemployment Rate (%, SA)	7.5	7.2	6.7	6.6	6.1	5.9	5.6	5.5
Household Employment, Chg QoQ (000, SA)	651	272	374	1125	451	360	835	889
Nonfarm Payrolls, Chg QoQ (000, SA)	533	570	651	579	852	712	973	591
Nonfarm Productivity, Chg QoQ (%, SA, AR)	0.9	3.4	3.0	-4.7	2.9	3.9	-2.2	NA
Capacity Utilization (%, SA)	77.8	78.3	78.5	79.1	79.2	79.4	79.5	78.4
GDP Price Index, Chg QoQ (%, SA, AR)	1.2	1.7	1.5	1.3	2.1	1.4	0.1	0.6f
Consumer Price Index, Chg YoY (%, AR)	1.8	1.2	1.5	1.5	2.1	1.7	0.8	-0.1
CPI ex food & energy, Chg YoY (%, AR)	1.6	1.7	1.7	1.7	1.9	1.7	1.6	1.8
Nominal Personal Income, Chg YoY (%, AR)	2.9	2.8	-2.1	3.7	3.7	3.8	4.8	4.5a
Personal Savings Rate (%, SA)	5.3	5.2	4.1	4.8	5.1	4.6	4.9	5.8a
Rate or Spread (End of Quarter)	**2013:2**	**2013:3**	**2013:4**	**2014:1**	**2014:2**	**2014:3**	**2014:4**	**2015:1**
Federal Funds Rate Target (%)	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3-month LIBOR (%)	0.27	0.25	0.25	0.23	0.23	0.24	0.26	0.27
10-Yr Treasury Note Yield (%)	2.49	2.62	3.03	2.72	2.53	2.50	2.17	1.93
30-Yr Treasury Bond Yield (%)	3.50	3.69	3.96	3.56	3.36	3.20	2.75	2.54
Moody's Baa Long Corp Spread (bp)	185	170	141	143	135	161	193	195
10-Yr Interest Rate Swap Spread (bp)	21	16	7	12	10	14	12	10

* Figures are either quarterly or, if more frequent, end of period. f = Forecast[1]; a = Actual through February 2015 Source: Reuters EcoWin

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

Economic Outlook

Adverse winter weather once again chilled U.S. economic growth in the first quarter. Last year, inflation-adjusted gross domestic product (real GDP) fell 2.1% in the first quarter as frigid temperatures and heavy snowfall blanketed much of the country. In 2015, similarly cold temperatures and localized heavy snowfall – compounded by supply-chain disruptions from (now resolved) West Coast port strikes – have pushed forecasts for first quarter real GDP growth down from 2.7% as recently as February[1] to 1.4% in April.[2] Moreover, that forecast is likely to be revised down again on weaker-then-expected retail sales and industrial production data. At this point, first quarter real GDP growth appears to be no better than 1%.

A sluggish first quarter does not change our full-year 2015 forecast of 2.5-3.0% real GDP growth, however. Winter 2014 was followed by two strong quarters in which growth averaged 4.8%. While we do not anticipate as strong a rebound this year – largely because 1Q2015 is unlikely to be as weak as 1Q2014 – we think second and third quarter U.S. economic growth will look a lot better than Q1.

As usual, we will run through major sectors of the U.S. economy in turn. We will not repeat the story of adverse weather and port strikes except where their impact is outsized, but recognize that these were important negative factors for most sectors in the first quarter.

Figure 2: Slower Job Growth; Sluggish Wages

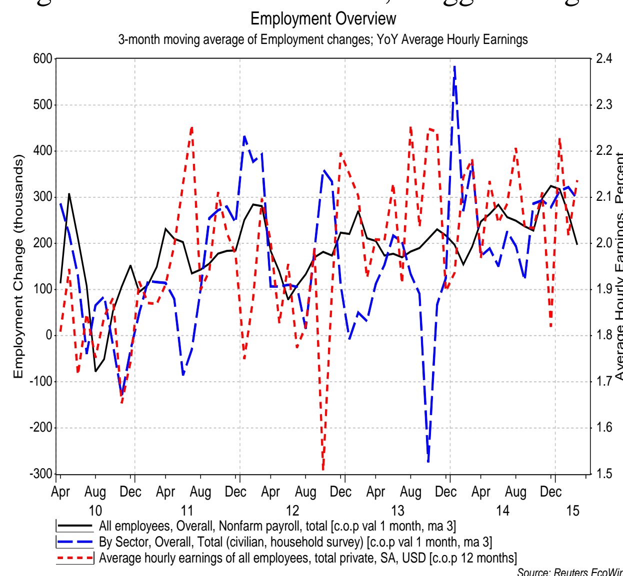
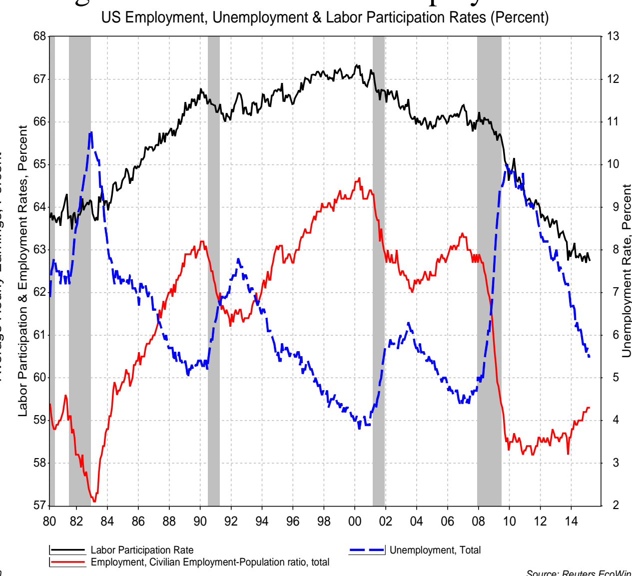


Figure 3: Mixed News on Employment Rates



The **labor market** cooled in the first quarter but still posted good job growth in light of very rapid hiring in prior quarters. Nonfarm payrolls rose by an average of 197,000 jobs per month in 1Q2015, down from monthly averages of 324,000 in 4Q2104 and 260,000 in 2014 as a whole. The more-volatile household survey of employment reported faster job growth averaging 296,000 new jobs per month in 1Q2015 compared to 278,000 in 4Q2014 and 231,000 in 2014 overall (Figure 2). We think the payroll survey is a better gauge currently, simply because we would expect poor weather and supply chain disruptions to slow hiring.

[1] *Survey of Professional Forecasters*, Federal Reserve Bank of Philadelphia, February 13, 2015.
[2] *Bloomberg Monthly Economic Survey*, Bloomberg L.P., April 9, 2015.

The unemployment rate edged lower in the first quarter, ending at 5.5%, down 0.1% from year-end and fully 1.2% lower than a year ago. However, the labor participation rate remains depressed, and the employment rate has recovered only slowly (Figure 3). We want to see both falling unemployment and rising labor participation to have greater confidence that employment growth will drive faster wage growth, which remains stuck around 2% (Figure 2). These figures suggest substantial remaining labor market slack. Until they pick up more meaningfully, the Federal Reserve is likely to move very slowly in tightening monetary policy.

Figure 4: Spending Slowed, Income Steady

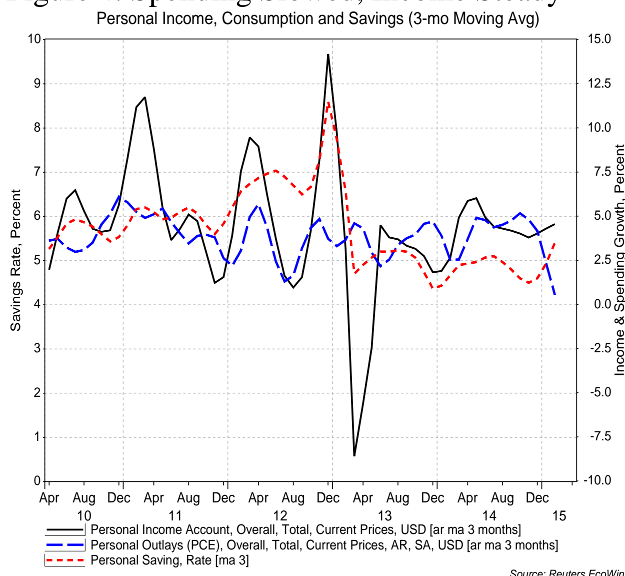
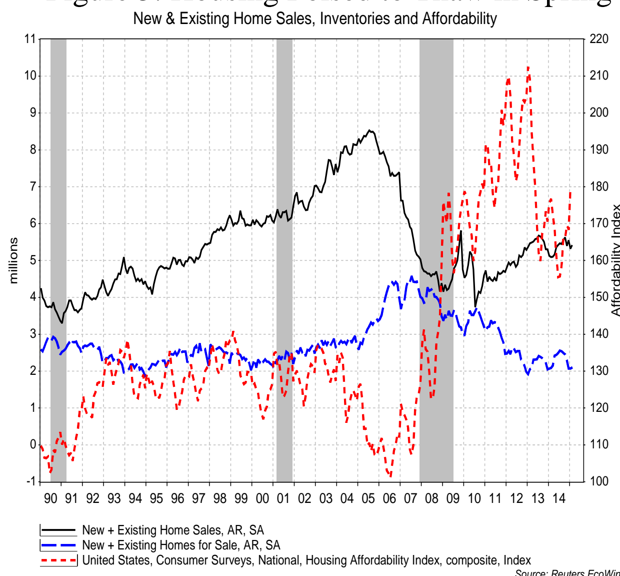


Figure 5: Housing Poised to Thaw in Spring



Despite somewhat slower job growth, **personal income** growth picked up a bit in early 2015, partly due to higher minimum wage laws taking effect in a number of states in January. Personal income was up 4.5% over three months ending in February 2015 (latest data available), a bit better than its Q4 pace, but little changed from recent months (Figure 4). It grew by the same 4.5% over the past 12 months. However, because inflation over the past three months was negative, real disposable personal income was up 6.6% over three months ending in February; over the past 12 months, it was up 4.0%. These are healthy income gains that should facilitate sturdy growth in personal spending over coming quarters.

Nowhere was adverse winter weather more visible than in **personal consumption expenditure** (PCE). Despite solid income growth, nominal PCE growth slowed to 0.5% and 3.3% over three and 12 months, respectively, ending February 2015 (Figure 4). Real spending held in a bit better at 2.7% over the past three months and 3.0% over 12 months, but that is still considerably slower than recent quarters. Encouragingly, stronger retail sales in March – up 0.9% (not annualized) after declines in January and February – suggest that PCE should pick up as weather improves. Better March data is unlikely to overcome earlier weakness, however, and first quarter real PCE is likely to look pretty soft when it is reported later this month.

A higher savings rate is one favorable result of solid income growth but slower spending. The savings rate rose to 5.8% in February and averaged 5.4% over the past three months (Figure 4). It appears that consumers have yet to spend much of their savings from lower gasoline prices. That’s likely to change as weather improves and gasoline prices remain relatively low. We

expect that consumers will spend a bit more freely over coming months, which would push savings down somewhat but boost PCE from its sluggish first quarter pace.

The **housing market** also slowed in recent months. New and existing home sales edged down to a 5.4 million unit pace in February (Figure 5). That's much better than last year, when homebuyers had to contend with cold, snow *and* higher mortgage rates. This winter brought cold and snow, but mortgage rates are near all-time lows, home price gains have slowed, and personal income is growing. Housing affordability is improving again as a result (Figure 5). We expect that housing activity will accelerate with spring's late arrival.

Figure 6: Industrial Production Slumped…

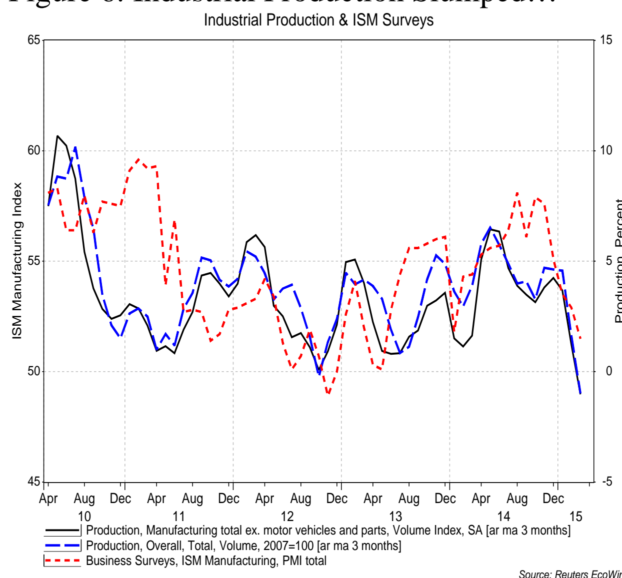
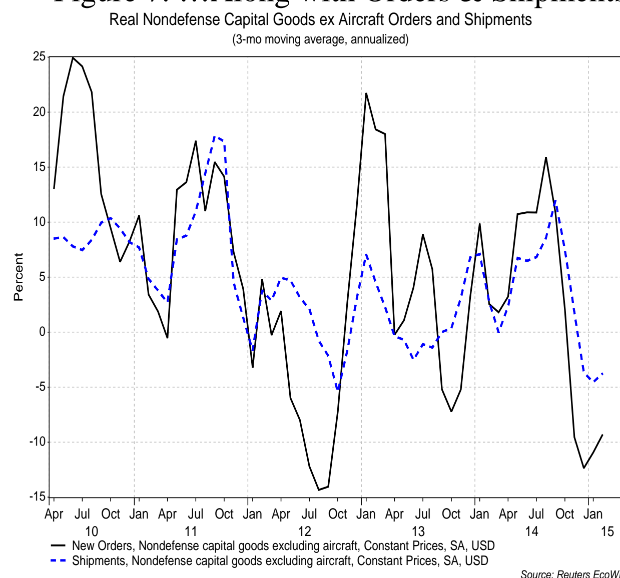


Figure 7: …Along with Orders & Shipments



Industrial production fell by 1.0% in the first quarter after rising 4.6% in 4Q2014 (Figure 6). Not surprisingly, mining – which includes oil and gas extraction – led the way with a 6.0% pullback. Utility output surged 11.1% on cold weather, but that is likely to drop back as weather normalizes over coming months. Manufacturers surveyed by the Institute for Supply Management lowered their assessment of output growth throughout Q1, although it remains above 50, which separates growth in output from contraction.

Although adverse weather and supply-chain disruptions no doubt slowed production, weak PCE and lower export demand (partly due to a substantially stronger U.S. dollar) also weighed on production. Moreover, real orders and shipments of nondefense capital goods excluding aircraft dropped by nearly 10% and 5%, respectively, over three months ending in February (Figure 7). That suggests weakness in manufacturing could continue for at least a few more months.

Although the near-term outlook for production is soft, we believe that orders and production will recover as consumer and housing demand warms up over coming months. By the third quarter, we should see production on a strong upward path again.

Business investment probably slowed further in the first quarter. After very strong growth averaging about 9.5% in the second and third quarters of 2014, business investment excluding structures (what we consider "core" business investment) cooled to a still-strong 4.4% pace in 4Q2014. However, core business investment has been running ahead of capacity utilization for about a year. Typically, businesses increase investment spending when capacity utilization is

rising, and they slow spending when utilization rates fall (Figure 8). Over the past 12 months capacity utilization fell, and shipments of core capital goods have dropped so far in Q1, as noted earlier. We expect slower business investment spending for the next two or three quarters.

Figure 8: Business Investment Poised to Slow

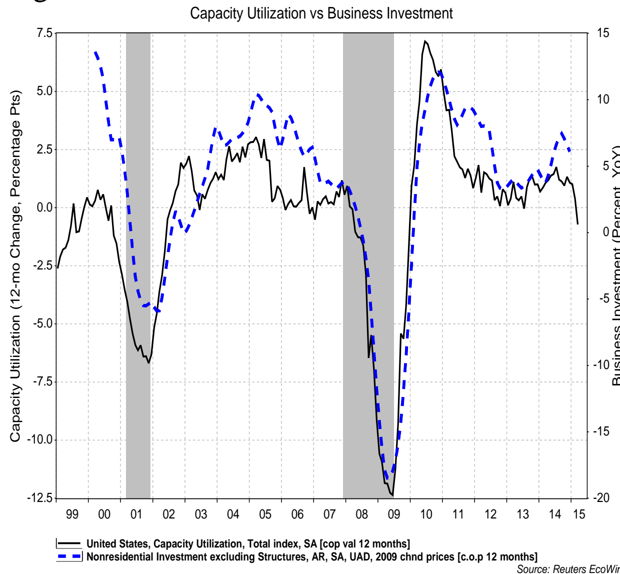
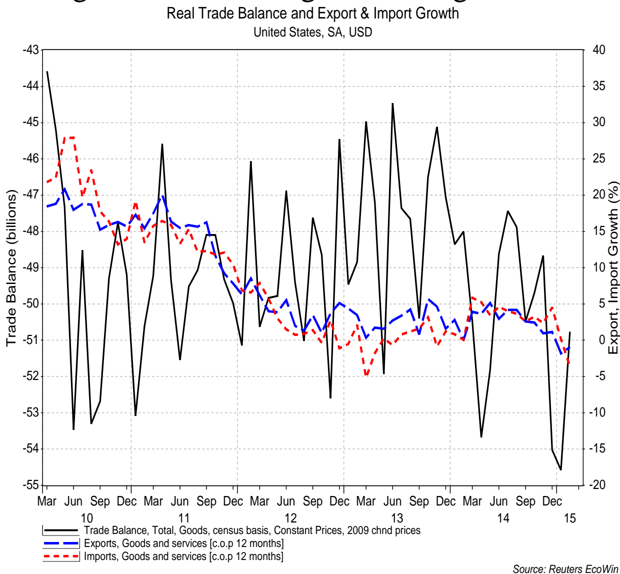


Figure 9: Trade Drag Continuing



A sharply wider **trade deficit** subtracted 1.0% from GDP growth in 4Q2014, but a sizable narrowing of the trade deficit in February 2015 (Figure 9) suggests that drag from net exports is likely to be about half that amount in the first quarter. Although this modest narrowing of the trade deficit is welcome, it probably will reverse in the second quarter. Over 100% of February's narrower trade deficit came from Pacific Rim countries – a region whose exports were probably significantly affected by West Coast port strikes. With those strikes now settled, imports from that region should pick up again. Some of that should be visible in March data and more in April.

We continue to think that trade will be a meaningful drag on U.S. real GDP growth in 2015. Economic growth abroad remains subdued in most major countries, and central bankers are easing monetary policy aggressively in most if not all of those places. A few data points. European real GDP growth was just 1.2% (0.3% not annualized) in 4Q2014, and that was cause for celebration. Despite 1.5% growth in 4Q2014, Japan's economy still contracted by 0.7% in 2014. China's growth rate slowed to 5.3% in the first quarter (7.0% YoY), which is brisk in absolute terms but down substantially from its recent pace. Finally, the International Monetary Fund last week revised down its 2015 global GDP growth outlook to 3.5% from 3.8%. With this weaker global growth backdrop, a strengthening U.S. economy and tighter monetary policy that eventually will accompany it have pushed the U.S. dollar up 13.5% on a trade-weighted basis and 21.1% versus major currencies over the past year. That's a stiff headwind for U.S. exporters to face, especially when overseas demand is tepid to begin with. In addition, it makes imported goods that much cheaper for U.S. consumers. A wider trade deficit will not sink economic recovery in the U.S., but it will take some wind out of its sails.

Government consumption is gradually turning positive again. It dipped in 4Q2014 on lower defense spending, but that should reverse in the first half of 2015. State and local government spending has been adding to GDP growth since 2013, and federal spending is set to do the same

in 2015 (Figure 10). We do not think government consumption will be a major contributor to economic growth, but it should no longer be a headwind.

Figure 10: Fiscal Drag Turning to Mild Stimulus

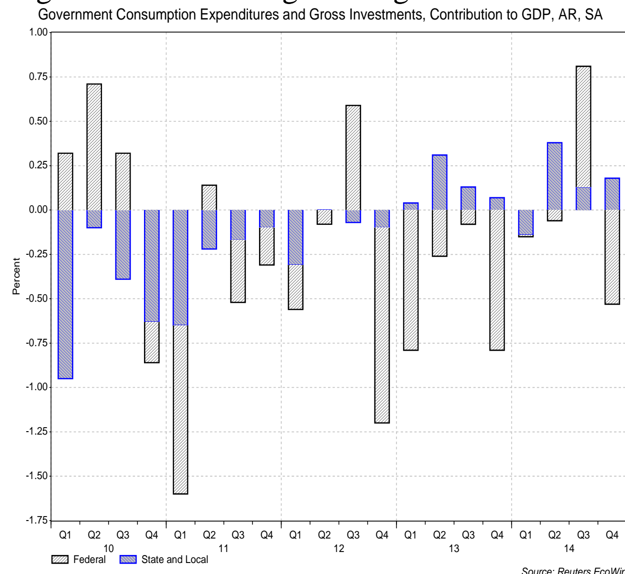
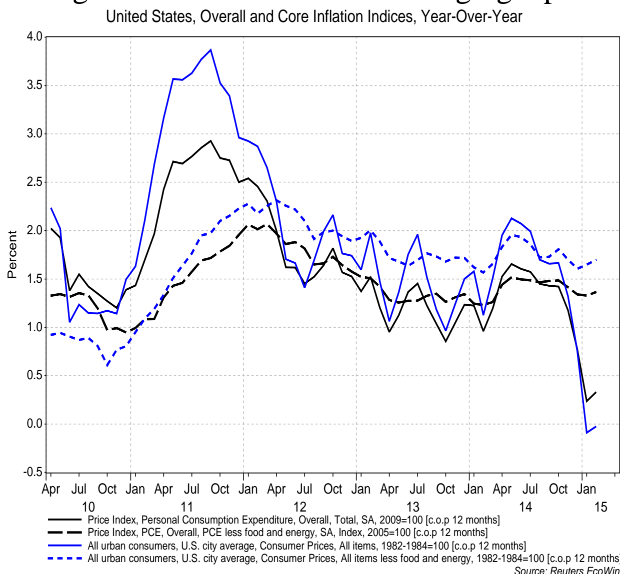
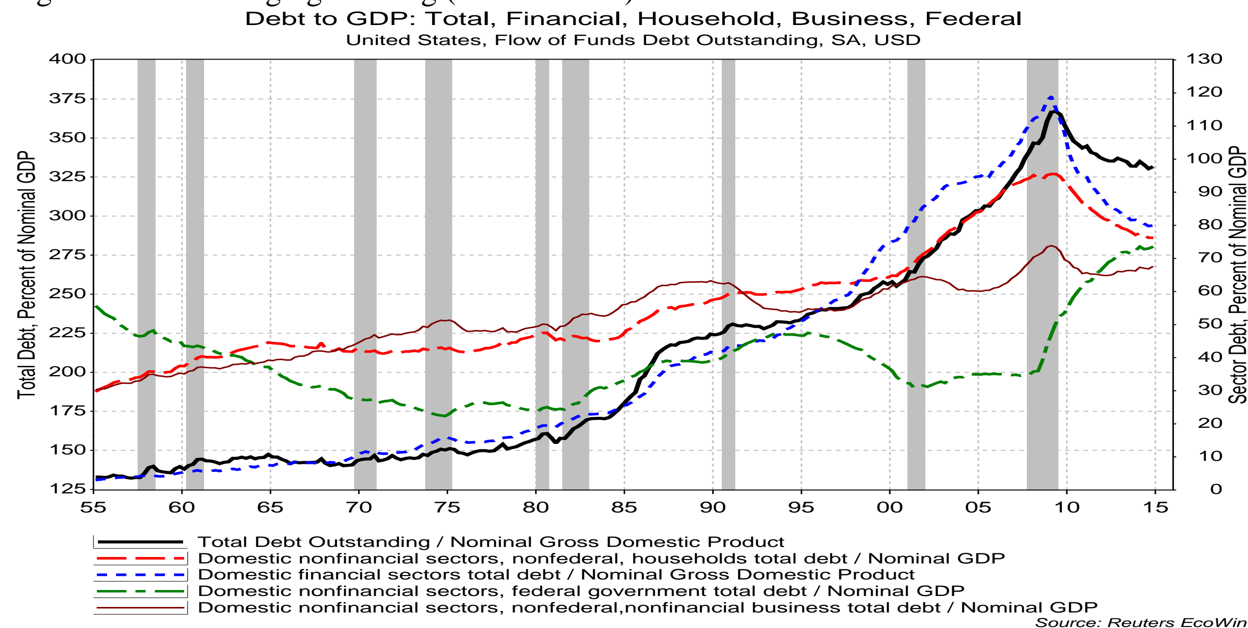


Figure 11: Inflation Low but Edging Upward



Inflation remains low, but it edged upward in February and March as energy prices stabilized. The consumer price index (CPI) was down 0.1% over 12 months ending in March, driven by sharply lower energy prices. Excluding food and energy, it rose 1.8% YoY, up from 1.6% in December 2014. The PCE deflator edged upward recently; it was up 0.3% overall and 1.4% excluding food and energy over 12 months ending in February (latest data available), still well below the Fed's 2% inflation target but up a bit from the end of 2014 (Figure 11). Low inflation should keep monetary policy accommodative, even though the Federal Reserve is likely to raise the federal funds rate later this year.

Figure 12: Deleveraging Slowing (but Not Over)



Broad **balance sheet ratios** in the U.S. have changed little in recent quarters (Figure 12). Across all sectors, debt-to-GDP stood at 332% in 4Q2014 (latest data available), down from a peak of 367% in 2009 but little changed since mid-2013. Financial companies continued to reduce debt and increase equity in response to stricter regulations. Households left their ratio of debt-to-GDP about unchanged in Q4, but we anticipate further gradual deleveraging over coming years. Government borrowing also held about steady relative to GDP; higher borrowing is in store beyond 2017 absent entitlement reforms, however. In contrast to other sectors, nonfinancial companies continued to increase borrowing. Although individual borrowers can, and no doubt will, get in trouble, we do not see broadly worrisome credit trends at the moment. In summary, although debt in the U.S. remains high historically, future deleveraging should present a mild but not troublesome headwind to economic growth.

Market Outlook

Long-term **Treasury rates** fell in the first quarter as U.S. economic growth slowed and quantitative easing in the Europe ramped up. The 30-year benchmark Treasury bond yield fell 21 basis points (bp) to end Q1 at 2.54% (Figure 13). The ten-year Treasury yield dropped 24 bp to 1.93%. Benchmark yields are a few basis points lower since quarter-end.

The Federal Open Market Committee (FOMC) left the federal funds rate unchanged at 0.25% and made no major changes to the Fed's securities portfolio. It did keep busy tweaking forward guidance on monetary policy, however. It removed a commitment to be "patient" regarding interest rate hikes while simultaneously emphasizing that it would not necessarily be *impatient* over raising rates.

Figure 13: Rates Down on Growth, Patient Fed

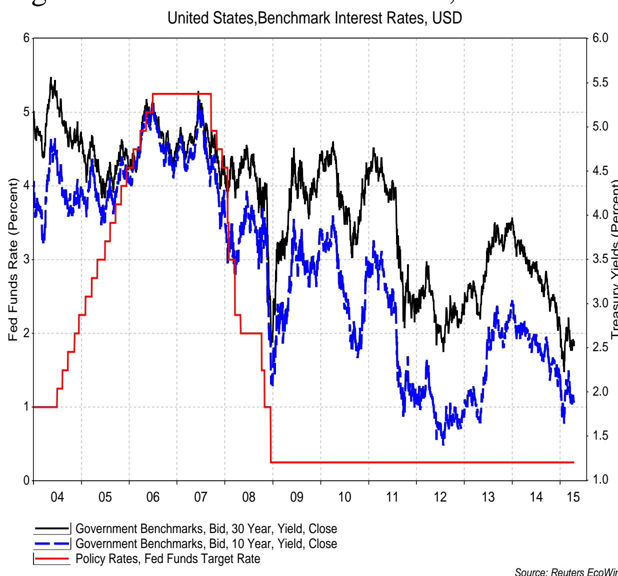
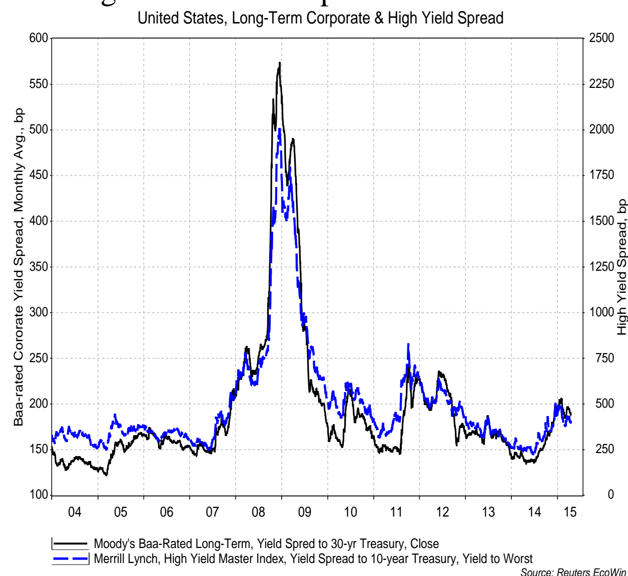


Figure 14: Credit Spreads Narrower



We have felt for some time that the Fed would begin raising the federal funds rate in June or September of this year, with some risk that could be delayed until 2016. Given slow economic growth in the first quarter – not all of which can be attributed to adverse weather and supply-chain disruptions – the FOMC will need clear evidence that the economy has recovered from that soft patch before hiking rates. Although we think a post-winter rebound is coming, there

probably will not be strong enough evidence that the economy is back on the Fed's expected growth trajectory by the June FOMC meeting. We think September 2015 is a more likely time for the Fed to begin a gradual series of 25 bp rate hikes, though we do not totally rule out a June move if data are persuasive. The FOMC knows it will be alone among major economies in tightening monetary policy. It will proceed cautiously.

Corporate **credit spreads** were stable to narrower in the first quarter. High-grade corporate bonds mostly kept pace with lower Treasury yields (Figure 14). Long-term Baa-rated corporate bond spreads widened by 2 bp in Q1 to 195 bp, although they narrowed by 8 bp so far in April. High yield spreads narrowed by 20 bp to 428 bp at quarter-end, and they have dropped by another 21 bp in April. Preferred securities' prices rose: a broad-based U.S. dollar-denominated preferred securities index[3] posted pre-tax price returns (*before* income) of 1.6% in Q1, and option-adjusted spreads narrowed. The index is up slightly (+0.1%) so far in April.

Bank credit continued to grow at a moderate – albeit slightly slower – pace in the first quarter (Figure 15). Total bank credit was up 7.9% YoY in Q1, led by commercial and industrial loans, which were up 12.6% YoY. Consumer borrowing at banks remains subdued, up 4.5% YoY, with most of that growth coming from automobile and student loans. Looking ahead, we think commercial and industrial loan growth will ease further as businesses investment spending slows. However, consumer borrowing should move up along with a recovery in personal consumption expenditures that we expect this spring and summer. Similarly, mortgage borrowing should gradually expand over coming quarters as housing activity picks up.

Figure 15: Bank Lending Growing Moderately

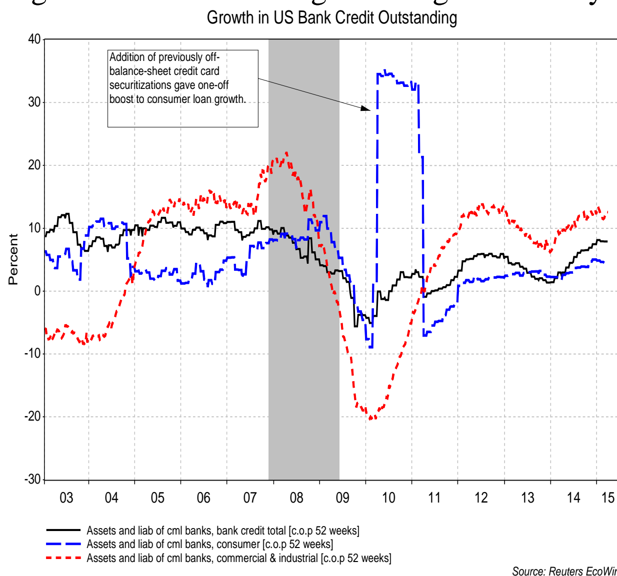
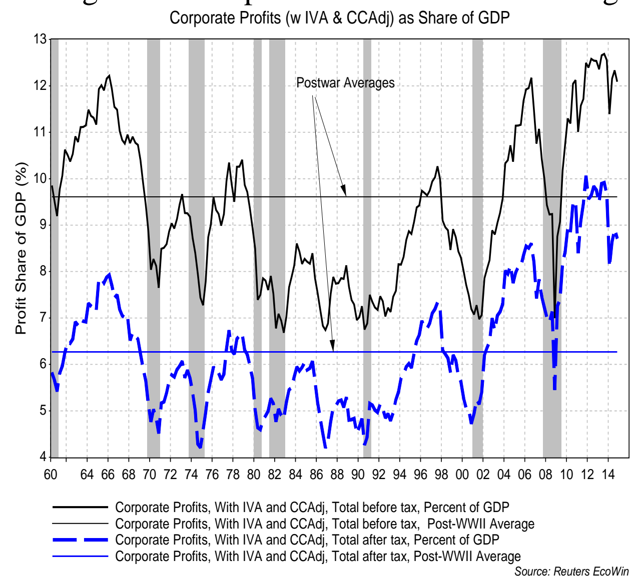


Figure 16: Corporate Profits Remain Strong



Broad credit fundamentals generally continue to improve. This is not a new story, but it is mostly a good one for investors in preferred securities. Corporate profits as a share of GDP, while down from a peak in 2013, remain strong and are well above long-term averages (Figure 16). Interest expense as a percentage of earnings before interest and taxes remain near a post-recession low in Q2 (latest data available); long-term debt to total debt is holding near its record high; and

[3] Index is the Bank of America Merrill Lynch 8% Constrained Core West Preferred & Junior Subordinated Securities Index[SM] (P8JC). Return quoted is price return only; total return, which includes income, is higher.

liquidity remains strong (Figure 17). Loan delinquency and charge-off rates are stable or declining across all major loan categories and are back to or below historic norms (Figure 18). Household debt burdens relative to income are at or near their lowest levels of the past thirty years (Figure 19). Finally, 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.

Figure 17: Balance Sheets Remain Strong

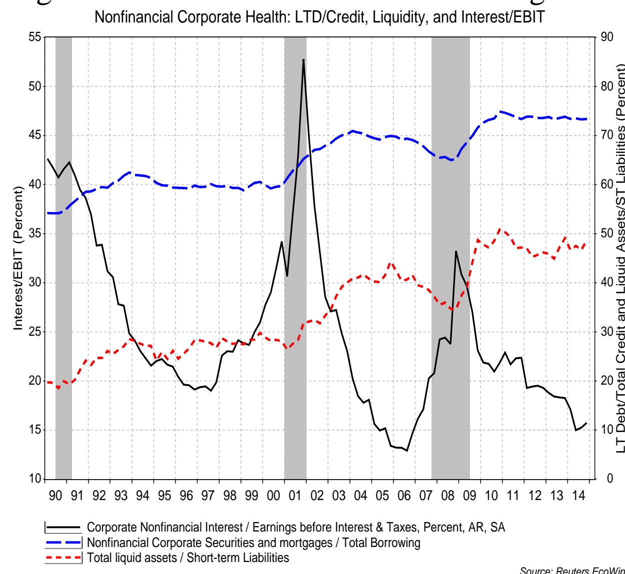


Figure 18: Loan Quality Stable to Improving

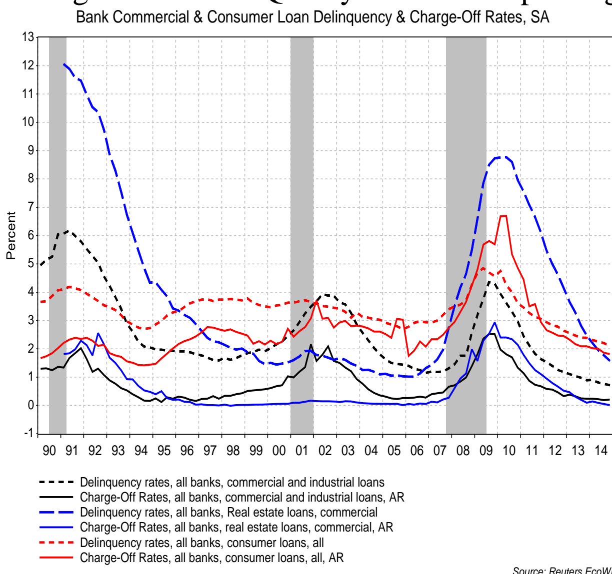


Figure 19: Household Debt Burdens Low…

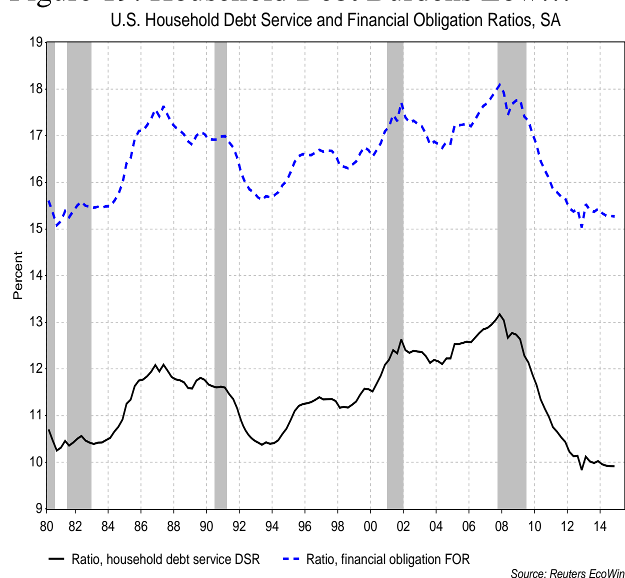
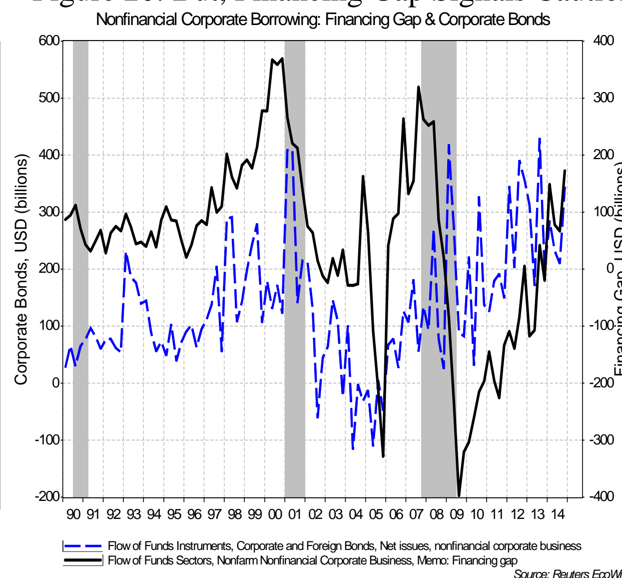


Figure 20: But, Financing Gap Signals Caution



In contrast to most other sectors, nonfinancial corporations have ramped up borrowing considerably in recent years. During the financial crisis, these companies cut borrowing and investments sharply. As recently as 4Q2013, they generated more cash from internal operations than they spent on business (i.e., nonfinancial) investments. Thus, the “financing gap” (capital investment minus internally generated cash) was negative. It turned positive in 2014 and hit a

new post-crisis peak of $172 billion (annualized) in 4Q2014 (Figure 20). This is not yet a worrisome gap in light of our expectation of slower business investment over the next several quarters, strong corporate profitability and generally subdued borrowing by households, financial corporations and government. However, history shows that periods of rapidly expanding borrowing generally do not end well. We are keeping a cautious eye on nonfinancial borrowing.

Although preferred securities are no longer the bargains they were at the end of 2013, our outlook for them remains relatively optimistic. Monetary policy is loose globally, inflation is low and demand for yield remains strong. Credit quality, while deteriorating in spots, is improving in most sectors. 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. Finally, we remind readers that, 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.

Flaherty & Crumrine Incorporated
April 17, 2015

© 2015, Flaherty & Crumrine Incorporated. All rights reserved. This commentary contains forward-looking statements. You are cautioned that such forward-looking statements are subject to significant business, economic and competitive uncertainties and actual results could be materially different. There are no guarantees associated with any forecast; the opinions stated here are subject to change at any time and are the opinion of Flaherty & Crumrine Incorporated. Further, this document is for personal use only and is not intended to be investment advice. Any copying, republication or redistribution in whole or in part is expressly prohibited without written prior consent. The information contained herein has been obtained from sources believed to be reliable, but Flaherty & Crumrine Incorporated does not represent or warrant that it is accurate or complete. The views expressed herein are those of Flaherty & Crumrine Incorporated and are subject to change without notice. The securities or financial instruments discussed in this report may not be suitable for all investors. No offer or solicitation to buy or sell securities is being made by Flaherty & Crumrine Incorporated.