Fourth-Quarter U.S. Economic Update
January 2016

Summary of Recent Economic Developments

The U.S. economy ended an already mediocre year on a soft note. Fourth-quarter real GDP expanded by only 0.7% in Q4 and 1.8% in 2015. Consumer spending rose 2.2%, down from Q3, but still a respectable result. Employment growth remained solid, averaging 284,000 new jobs per month. Wages also accelerated a bit and combined to boost personal income growth to about 4.4% and the savings rate to 5.5%. Consumers have the ability to increase spending, and we believe they will over coming quarters. Residential investment was up 8.1% in the fourth quarter, and it should remain a bright spot in 2016. Good economic news pretty much ended there, however. Industrial production and orders fell. Business investment contracted by 1.8% and is likely to remain soft for several quarters. The trade deficit widened and inventory growth slowed, together shaving 0.9% from Q4 real GDP growth. Government consumption slowed. Inflation edged up but remains very low. Leverage mostly declined, although we are watchful of nonfinancial borrowing. Long-term Treasury rates rose in Q4 but pulled back in January. Credit spreads were mixed in Q4 and wider in January. Fundamental credit conditions were mostly strong and steady, although soured energy loans prompted some deterioration in commercial lending books. Despite slower Q4 growth, we believe the U.S. economic, credit and interest rate outlooks remain relatively favorable for long-term investors in preferred securities.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	**2015:4**	**2015:3**	**2015:2**	**2015:1**	**2014:4**	**2014:3**	**2014:2**	**2014:1**
Real GDP, Chg QoQ (%, SA, AR)	0.7	2.0	3.9	0.6	2.1	4.3	4.6	-0.9
Real Personal Consump Expnds, Chg QoQ (%, SA, AR)	2.2	3.0	3.6	1.7	4.3	3.5	3.8	1.3
Real Business Inv ex Stuctures, Chg QoQ (%, SA, AR)	-0.9	5.4	3.5	4.1	-0.3	12.2	5.7	5.4
Real Residential Investmt, Chg QoQ (%, SA, AR)	8.2	8.2	9.4	10.1	9.9	3.4	10.4	-2.7
Real Private Domestic Final Sales, Chg QoQ (%, SA, AR)	1.8	3.2	3.9	2.0	3.9	4.3	4.2	2.2
Nominal GDP, Chg QoQ (%, SA, AR)	1.5	3.3	6.1	0.8	2.2	6.0	6.9	0.6
Corporate Profits, After Tax, Chg YoY (%, SA, AR)	-5.6f	-8.2	-0.6	4.7	2.7	4.9	-2.6	-7.5
Nonfarm Productivity, Chg QoQ (%, SA, AR)	N/A	2.2	3.5	-1.1	-2.2	3.1	2.8	-3.5
Nominal Personal Income, Chg YoY (%, AR)	4.4a	4.6	4.6	4.0	5.2	4.5	4.2	4.2
Personal Savings Rate (%, SA)	5.5a	5.2	5.0	4.9	5.0	4.6	4.8	4.9
Unemployment Rate (%, SA)	5.0	5.1	5.3	5.5	5.6	6.0	6.1	6.7
Nonfarm Payrolls, Chg QoQ (000, SA)	851	521	692	586	973	712	852	579
Household Employment, Chg QoQ (000, SA)	987	220	389	894	605	620	442	1088
Federal Budget, 12-mo Def or Surp (% of GDP)	-2.7	-2.5	-2.5	-2.9	-2.8	-2.8	-3.2	-2.9
Consumer Price Index, Chg YoY (%, AR)	0.7	0.0	0.1	-0.1	0.8	1.7	2.1	1.5
CPI ex food & energy, Chg YoY (%, AR)	2.1	1.9	1.8	1.8	1.6	1.7	1.9	1.7
Capacity Utilization (%, SA)	76.5	77.9	77.5	78.2	79.0	78.5	78.2	77.8
Rate or Spread (End of Quarter)	**2015:4**	**2015:3**	**2015:2**	**2015:1**	**2014:4**	**2014:3**	**2014:2**	**2014:1**
Federal Funds Rate Target (%)	0.50	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3-month LIBOR (%)	0.61	0.33	0.28	0.27	0.26	0.24	0.23	0.23
10-Yr Treasury Note Yield (%)	2.27	2.06	2.33	1.93	2.17	2.50	2.51	2.72
30-Yr Treasury Bond Yield (%)	3.01	2.87	3.11	2.54	2.75	3.21	3.34	3.56
BAML U.S. Corp. Bond Index Yield to Worst vs Govt	168	172	141	131	138	113	102	111
10-Yr Interest Rate Swap Spread (bp)	-8.8	-5.5	11.3	10.0	11.5	14.3	9.8	12.0

* Figures are either quarterly or, if more frequent, end of period. f = Forecast[1]; a = Actual through November 2015 Source: Macrobond, Bloomberg LP

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

Economic Outlook

The U.S. economy ended an already mediocre year on a soft note. Fourth-quarter inflation-adjusted gross domestic product (real GDP) expanded by only 0.7%, substantially lower than estimates of 2.0-2.5% growth from a month or two ago.[1] As a result, real GDP growth averaged only 1.8% for all of 2015, the slowest pace since 2012 and nearly a percentage point lower than we anticipated as 2015 began. Prospects for next year are better, however. Economists expect about 2.5% real GDP growth in 2016.

We will explore major sectors of the U.S. economy in the paragraphs that follow, and it's an uneven story. Households and financial businesses are in good shape, but exporters and manufacturers are struggling. Sharply lower energy prices hurt business investment more quickly than it helped consumer spending, although that will change at some point. Despite a mixed outlook, U.S. domestic economic growth should post 2.0-2.5% growth while monetary policy should remain accommodative – if a little less so than in 2015. Let's take a look under the hood.

Figure 2: Employment Picture Brightened

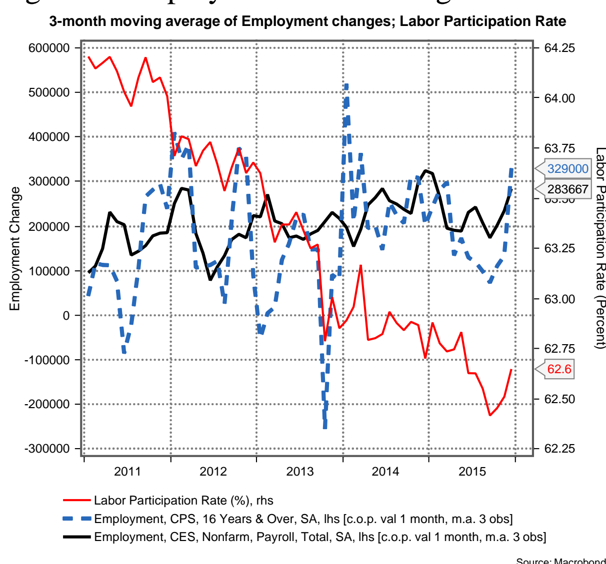
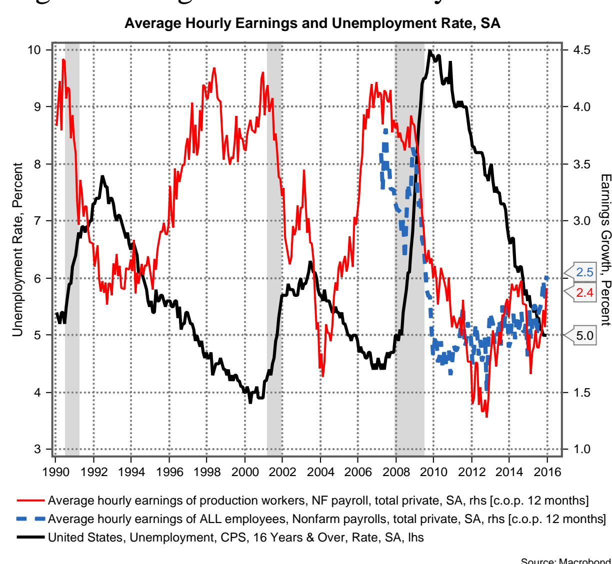


Figure 3: Wage Growth Gradually Accelerated



Labor market conditions rebounded in the fourth quarter (Figure 2). Payroll jobs rose by an average of 284,000 jobs per month, over 100,000 jobs per month better than in Q3. The household employment survey lagged the payroll survey for most of 2015 but leapfrogged it in Q4, posting an average of 329,000 job gains per month. In spite of these strong job gains, the unemployment rate merely edged down to 5.0% in December from 5.1% in September as labor participation rose by 0.2% to 62.6%. A rising labor participation rate signals that job growth pulled more adults back into the labor force. Although labor participation remains relatively low historically, its improvement in recent months is encouraging.

Rising wages likely prompted at least some increase in labor participation. Average hourly earnings rose to 2.4% YoY in December after starting the year well below 2% (Figure 3). Of course, wage growth rose impressively in 2013-14 only to fall back again, so we can't be sure

[1] Unless noted otherwise, forecasts are from the *Livingston Survey*, Federal Reserve Bank of Philadelphia, December 10, 2015 and Bloomberg® *Monthly Economic Survey*, January 14, 2016.

that wages will continue their recent march higher. On one hand, most sectors of the U.S. economy are doing relatively well. Overall employment has expanded around 2% per year for four years now, well above a 1% long-term average growth rate in the labor force. As a result, slack in labor market resources has diminished, which should drive up wages. On the other hand, low inflation, intense competition from abroad, and downward pressure on profit margins are likely to prompt employers to keep wage increases modest. Moreover, productivity growth, which drives long-term growth in real wages, remains low. We are hopeful that wage growth will rise further, but we are not yet convinced that it will.

Figure 4: Income Strong, Consumption Cooled

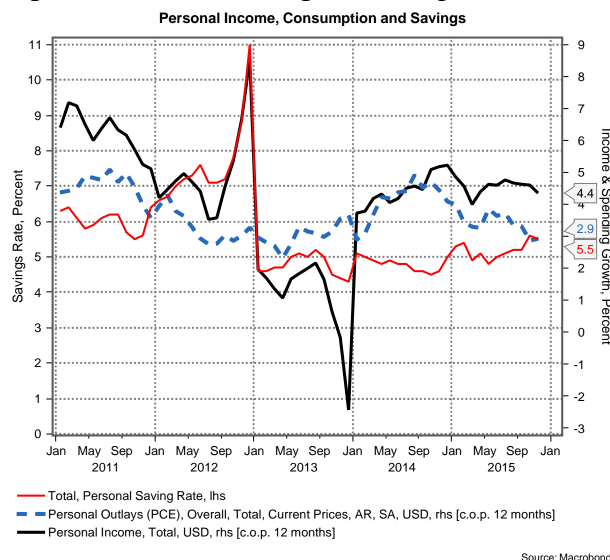
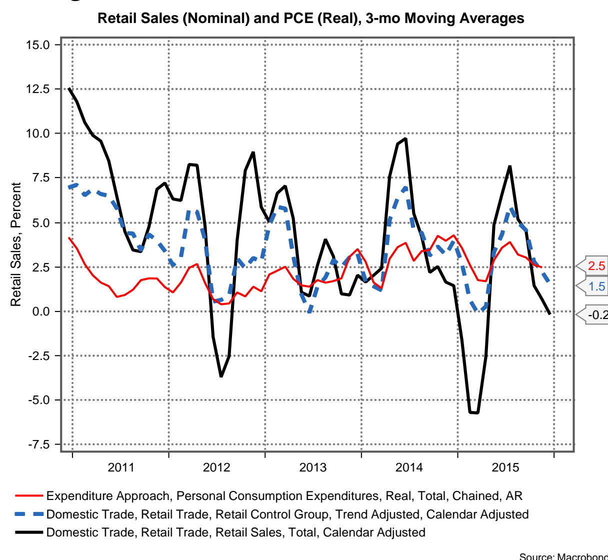


Figure 5: Soft Retail Sales Isn't Just Gas



Rising employment and wages contributed to solid **personal income** growth of 4.4% YoY through November (Figure 4, latest data available); it's up 3.9% over the past three months. Nonetheless, real **personal consumption expenditure** (PCE) slowed in the fourth quarter. Real PCE was up a respectable 2.5% over three-months ending in November (Figure 5) but rose just 2.2% in Q4 as consumers trimmed spending in December. Nominal core retail sales ("retail control," which excludes autos, gas, food and building materials) posted a 1.5% gain in Q4, down from 4.6% in Q3. Overall retail sales fell slightly (-0.2%) in Q4, partly due to lower gasoline prices. Warmer than usual weather probably depressed sales of winter clothing and other cool-weather gear in the fourth quarter, but consumers have repeatedly shown caution despite solid income gains.

Strong income growth combined with tepid spending pushed the **savings rate** up to 5.5% in November (Figure 4). This is reminiscent of late 2104 and early 2015, when lower oil and gas prices reduced nominal spending on energy but did not immediately translate into additional spending on other items. As the year wore on, however, the savings rate eased as consumers spent more of that energy windfall. We expect a similar, albeit more restrained, pattern in 2016. While oil prices dropped nearly as much in percentage terms in recent months as they did in the latter half of 2014, they fell much less in dollar terms. As a result, the dollar impact on gasoline and heating bills is less for a typical household today than it was a year ago.

The **housing market** performed well in 2015, although recent mixed sales data makes the outlook for housing a little murkier than it was a year or two ago. Residential investment grew by 8.1% in the fourth quarter and 8.9% YoY. New and existing home sales hit a post-crisis peak of 6.1 million units in July 2015 and subsequently eased to 5.8 million units in October (Figure 6). November posted a sharp drop to 5.25 million units but then recovered to 6.0 million units in December. This may be statistical noise (most likely), a reaction to relatively low inventories/inadequate selection (probably part of the story given low inventory), or a harbinger of slowdown (unlikely). Rising income, pent-up demand from the housing bust, low mortgage rates, and still-good affordability should cause home sales to pick up over coming months. Those same factors should also encourage new homebuilding and housing upgrades. Moreover, the S&P/Case-Shiller 20-city home price index was up 5.8% YoY in November (latest data available), which suggests demand for housing remains solid (Figure 6). While residential investment growth will probably slow from its current rapid pace, we expect housing will remain a bright spot for the U.S. economy in 2016.

Figure 6: Home Sales Mixed, Prices Up

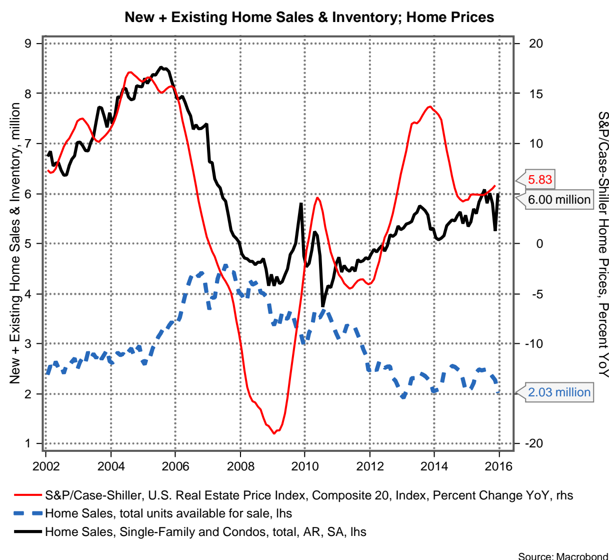
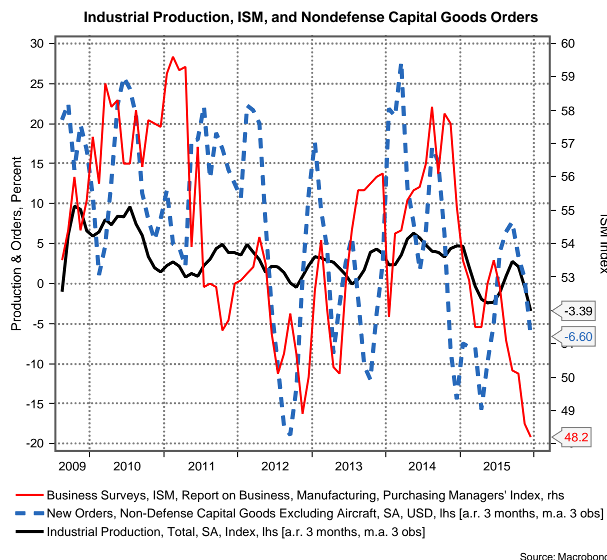


Figure 7: Manufacturing Facing Recession



Industrial production has yet to recover from weaker growth abroad and lower energy investment domestically. Overall industrial production fell 3.4% in the fourth quarter, compounding lower output earlier in 2015 (Figure 7). Utility and mining output (both down 15.6% in Q4) were responsible for the decline; manufacturing did better, but output there was only up 0.5%. Industrial weakness was also evident in the Institute for Supply Management's manufacturing survey. Its main index dropped to 48.2 in December, which signals a mild recession in the manufacturing sector. Orders for industrial goods, which recovered nicely in Q3, slowed again in Q4. Core capital goods orders (nondefense, excluding aircraft) were down 6.9%. We think continued growth in consumer spending will prompt higher industrial activity over time, but muted business investment and strong competition from imports are likely to weigh on industrial output for the next several quarters.

Real **business investment** contracted by 1.8% in the fourth quarter, and it is likely to remain subdued in the first half of 2016. With industrial output and orders down, capacity utilization fell in 2015 (Figure 8). Those businesses won't need to make big investments in plant and equipment

to meet demand until utilization rises. As a result, we anticipate that core business investment (excluding structures) will shrink or grow only marginally for several more quarters. We think stronger consumer spending (and more normal weather) will absorb that excess capacity over time, but prolonged weakness in business investment would be a risk to our growth outlook.

The **trade deficit** widened in the third quarter but was little changed in October and November (Figure 9). For the fourth quarter, however, net exports subtracted 0.5 percentage points from real GDP growth, implying a substantially wider December trade deficit. A strong U.S. dollar and slower growth abroad will continue to restrain exports, which were down 7.1% YoY in November. U.S. growth is likely to outpace most of its trading partners over the next year or two, and trade drag is likely to persist over that time.

Figure 8: Business Investment Slowing

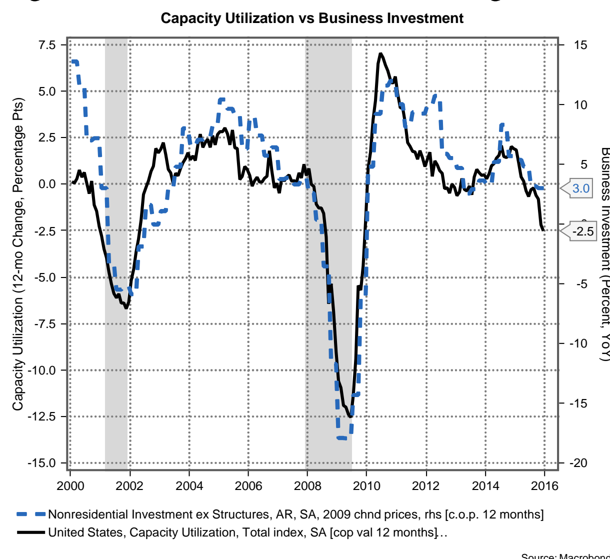


Figure 9: Trade Drag Paused, Not Over

Along with weaker consumer and business spending, **inventory** growth slowed in the fourth quarter, subtracting 0.4% from real GDP. Unfortunately, inventory-to-sales ratios generally rose during the quarter. We don't expect a major inventory correction, but we think inventory liquidation is likely to reduce GDP growth modestly again in 1Q2016.

Government consumption growth slowed to 0.7% in the fourth quarter from to 1.8% in Q3, in-line with overall GDP growth. State and local spending fell 0.6% in Q4. In contrast, federal spending rose 2.7% after shrinking 1.1% over the prior four quarters. Federal spending should continue to grow under a budget deal reached last autumn. Higher spending will be paid in part by higher taxes and in part by a wider budget deficit – the first time since 2009 that the deficit has widened relative to GDP. Its overall GDP impact should be mildly positive in 2016, although the budget deal did little to address problems in entitlements or obstacles to productivity, while higher debt will only subtract from economic growth down the road.

Inflation edged upward in the fourth quarter but remains low (Figure 10). Energy prices fell, while core inflation was stable or slightly higher. For 12 months ending in December, the consumer price index (CPI) was up 0.7% overall and up 2.1% excluding food and energy. Over 12 months ending in November (latest data available), the PCE deflator was up 0.4% overall and 1.3% excluding food and energy. Falling import and export volumes and a stronger dollar

continued to drive down prices of globally traded goods. Service prices are moving up more quickly however (Figure 11). CPI's services excluding energy index is up 2.9% YoY in December, about ½ percent faster than a year ago. Although energy prices have been weak recently, at some point they will stabilize. As that disinflationary impulse wanes, overall inflation should move up toward core inflation.

Figure 10: Inflation Checked by Energy…

Figure 11: …but Service Prices Accelerated

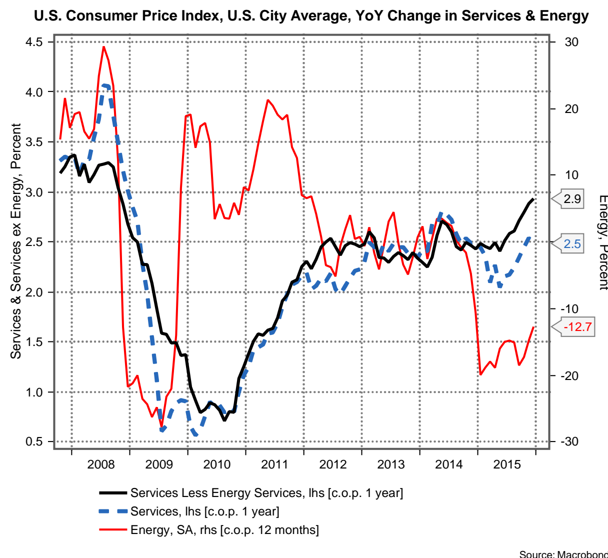
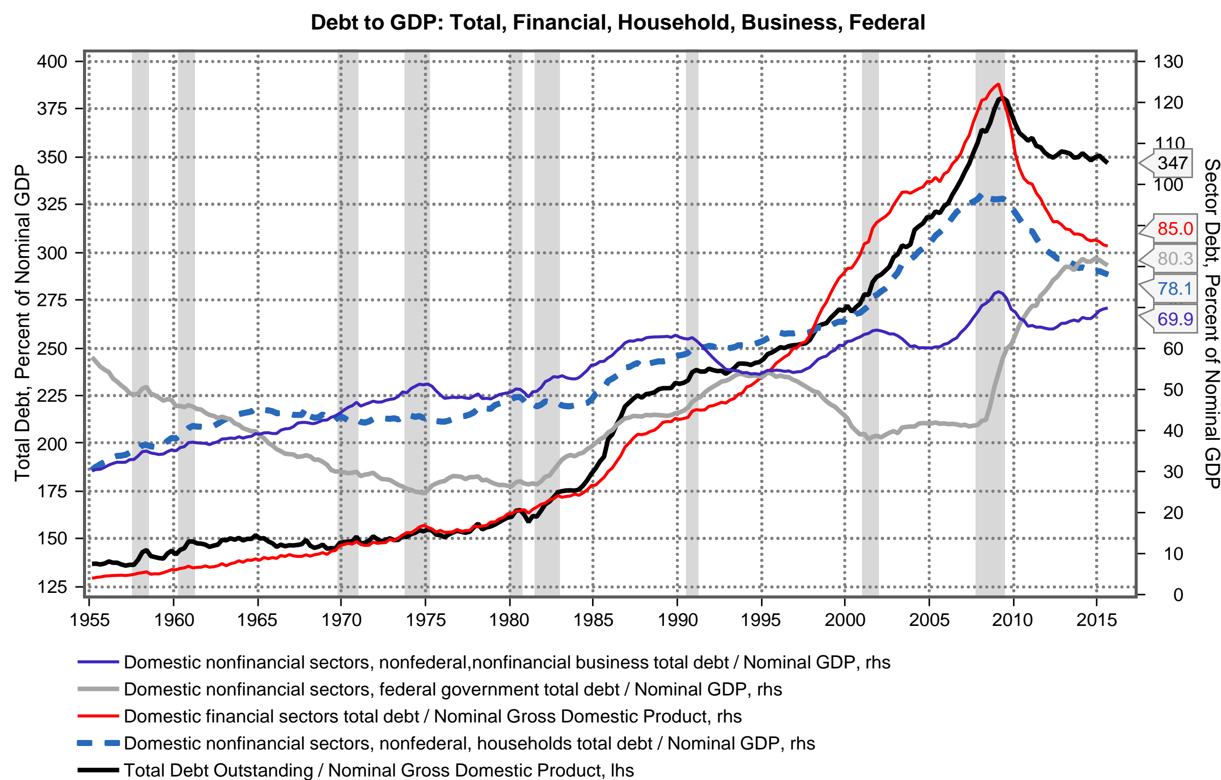


Figure 12: Leverage Higher at Nonfinancial Businesses, Lower Elsewhere



Finally, broad **balance sheet trends** in the U.S. were little changed in recent quarters (Figure 12). Overall debt-to-GDP continued to edge lower to 347% in the third quarter (latest data available). Leverage was slightly lower for households (78.1% debt-to-GDP), federal government (80.3%) and financial businesses (85.0%). Nonfinancial businesses, however, continued to increase borrowing as a share of GDP. Leverage there remains manageable at 69.9% of GDP, but it has trended higher while other sectors have reduced leverage. This sector includes energy producers, many of which will struggle to repay or refinance their debts with oil and gas prices at current levels. Defaults by nonfinancial business borrowers are likely to increase in 2016. Fortunately, these companies are relatively small issuers in the preferred securities market.

Market Outlook

Long-term **Treasury rates** rose in the fourth quarter as the Federal Reserve decided to hike the federal funds rate after seven years of near-zero rates. The 30-year benchmark Treasury yield increased by 14 bp to 3.01% on December 31, and the 10-year Treasury note yield rose by 21 bp to 2.27% (Figure 13). Yields retraced those increases so far in January, however. Ten- and 30-year yields were 1.93% and 2.75%, respectively, on January 29 – a little below where they started the fourth quarter.

The fourth quarter's big news was the Federal Open Market Committee's (FOMC) decision to hike the federal funds rate target by 0.25% at its December meeting. At that meeting, FOMC officials forecast four more 25 basis point rate increases for 2016. Events in January probably have them rethinking that timetable; certainly, market participants have. Although employment growth appears to have remained solid in January, GDP growth was soft, energy prices took another leg down, the U.S. dollar rose, stock and credit markets swooned, and U.S. Treasury rates fell. In particular, lower energy prices would mute the impact of rising service inflation. That won't prevent the Fed from tightening monetary policy in 2016, but it probably will slow its timetable until inflation rises more convincingly.

Regular readers of this Update know that we have long anticipated a relatively slow path of Fed tightening of 25 bp per quarter for 6-8 quarters once it got underway. Even that now looks too fast for 2016, although not impossibly so. Energy- and commodity-producing companies and countries are scaling back spending and investment, slowing near-term global economic growth. Meanwhile, consumers, who benefit from lower energy and commodity prices, have not yet boosted consumption to the same degree. That should happen eventually, as cheaper and more abundant energy and commodities drive faster global economic growth.[2] It's difficult to say when it will happen – only that it has not happened yet. The FOMC will probably want to see evidence of stronger growth and/or higher inflation before raising rates further.

Current market rates generally reflect that view, as forward rates in Figure 13 demonstrate. Markets now expect both slower and, cumulatively, less tightening by the Fed in this cycle. We agree with the direction of this change, but we think it's a little overdone. As we stated above, lower energy and commodity prices should spur stronger economic growth in the U.S., which is a sizable consumer of those products. In short, we agree with the market's assessment of a slower pace of tightening, but we disagree with less tightening overall. Accordingly, long-term interest

[2] Many commentators who said high oil and commodity prices would choke off recovery are now saying low prices will do the same; they can't be right on both points.

rates should drift higher in 2016, although a replay of 2013's "taper tantrum," when long-term interest rates jumped by over 100 bp in a short period, appears unlikely.

Figure 13: Rates and Forwards Down

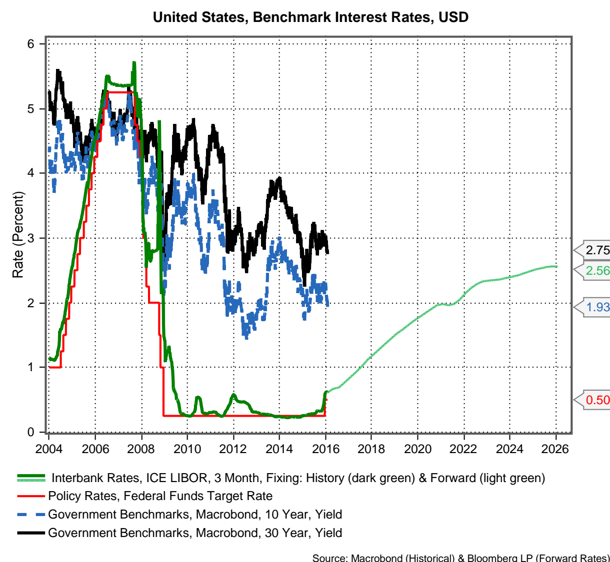
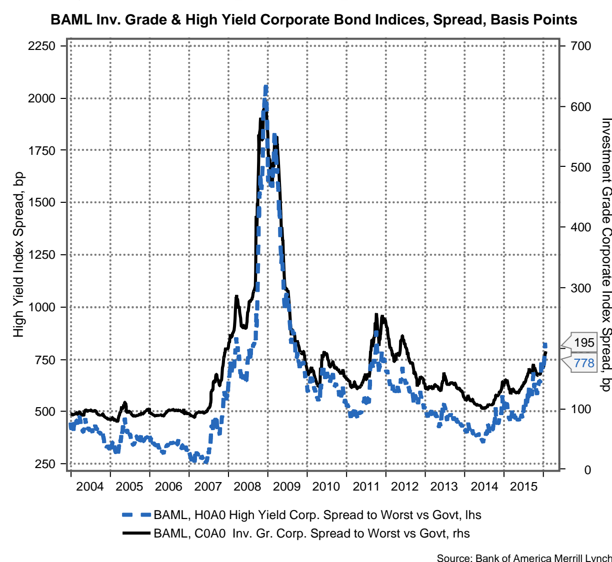


Figure 14: Corporate Spreads Wider



Corporate **credit spreads** were mixed in the fourth quarter. Investment-grade corporate bond spreads[3] narrowed by 4 bp to 168 bp, but high yield bond spreads[4] widened by 33 bp to 698 bp (Figure 14). Spreads on those indices widened by 27 bp and 80 bp, respectively, in January. Preferred securities outperformed both corporate bonds and high yield bonds during the fourth quarter. "Spread to Worst" on a broad Bank of America Merrill Lynch preferred securities index narrowed by 26 bp to 282 bp in Q4; it is 33 bp wider in January.[5] Total return on the preferred index (+2.43%) outperformed both the corporate (-0.56%) and high yield (-2.17%) indices during the quarter.[6]

Bank credit growth was little changed in the fourth quarter and for 2015 overall (Figure 15). Aggregate bank lending was up 7.8% in the 12-month period ending in December, led by commercial and industrial loan growth of 10.2% YoY. Consumer loans at banks accelerated slightly and were up 6.1% YoY in December, about one percent higher than a year ago. Although bank lending has grown more rapidly than GDP, overall debt has not, which indicates that banks recaptured market share from other sorts of lenders coming out of the financial crisis. As credit investors, we are comfortable with this balance sheet expansion as long as lending standards remain high and bank capital keeps pace – and they are. The Fed's loan officer survey indicates that lending standards have not eased, despite some improvement in margins (Figure 16). And

[3] Investment-grade corporate bond spread is represented by the Bank of America Merrill Lynch U.S. Corporate Index[SM] (C0A0) "Yield to Worst versus Government" yield spread series. See note 5 below for definition.
[4] Below-investment-grade corporate bond spread is represented by the Bank of America Merrill Lynch U.S. High Yield Index[SM] (H0A0) "Yield to Worst versus Government" yield spread series. See note 5 below for definition.
[5] Preferred index is the Bank of America - Merrill Lynch 8% Constrained Core West Preferred & Junior Subordinated Securities Index[SM] (P8JC). "Spread to Worst" is the lower of yield to call and current yield (or yield to maturity for dated hybrids) minus yield on a comparable Treasury security.
[6] Total return is not annualized and includes both price change and income.

the average banks' ratio of tangible common equity to tangible assets has doubled since the financial crisis. U.S. banks have not been this strong in many years.

Figure 15: Loan Growth about Steady

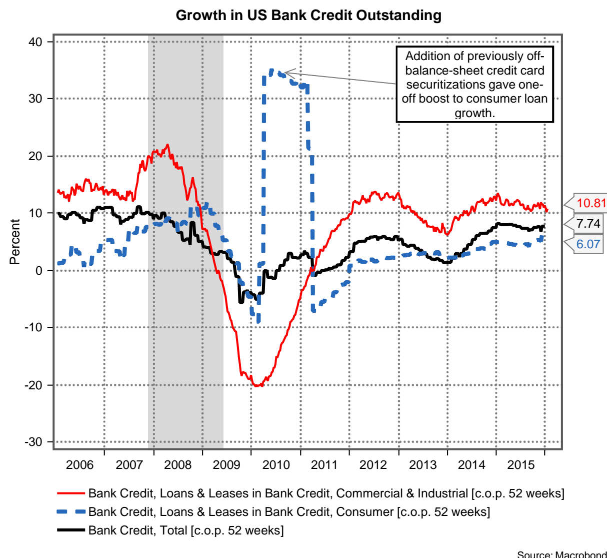
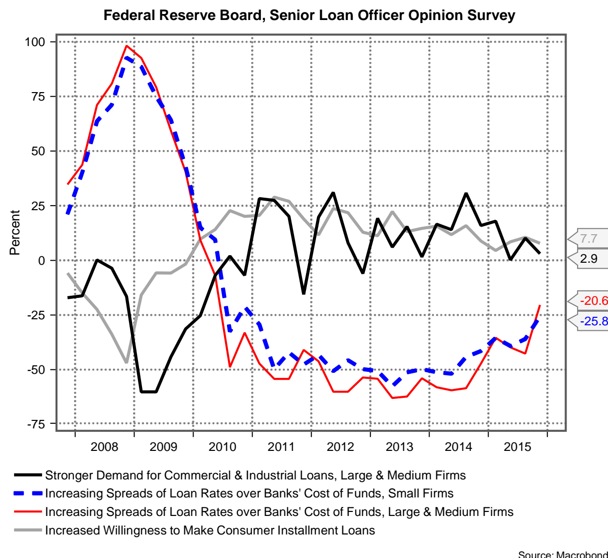


Figure 16: Loan Standards Flat, Margin Better



Fundamental **credit conditions** were mostly steady in the third quarter (latest data available), although commercial loan delinquencies and defaults edged upward. Corporate profits were little changed and remain very high as a proportion of GDP (Figure 17). Corporate balance sheets remain strong: interest expense as a percentage of earnings before interest is low; liquidity, while down a bit in 2015, is still high; and long-term debt to total debt is stable at a high level (Figure 18).

Figure 17: Corporate Profits Slightly Weaker

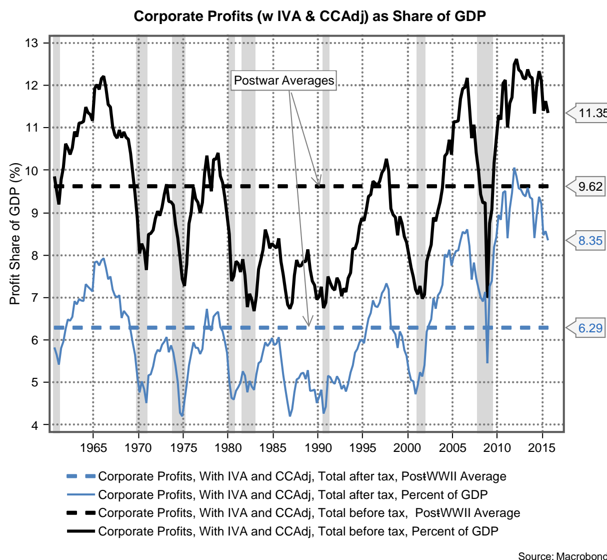
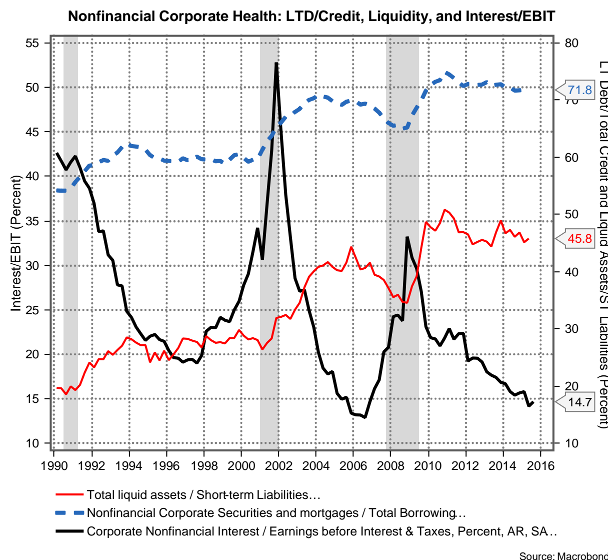


Figure 18: Balance Sheets Still Solid



Loan delinquencies and charge-offs mostly edged lower, although delinquency rates on commercial and industrial loans ticked up slightly (Figure 19). That deterioration appears to be due mostly to soured energy loans. We expect higher delinquencies and charge-offs in that sector

over coming quarters. However, energy loans are relatively small at most banks – typically 2-4% of total loans – and are not large enough to cause material credit deterioration at most of them. Moreover, consumer, residential and most other commercial loan books continue to improve – and they are much larger than energy loan books. Overall, bank earnings continue to improve and balance sheets are very strong.

Figure 19: Loan Quality Good, C&I Weaker

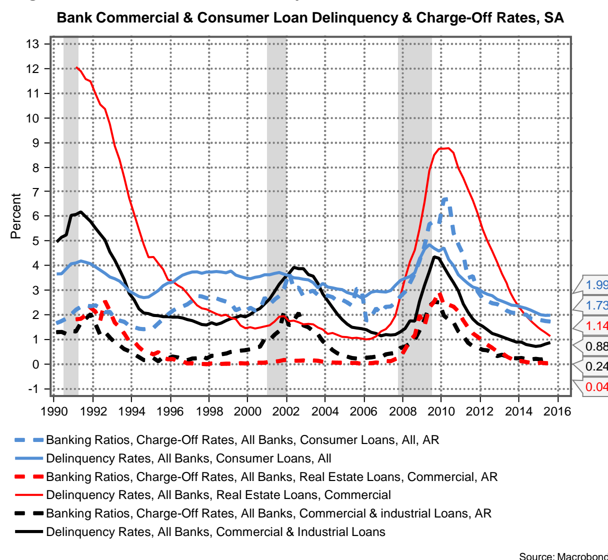
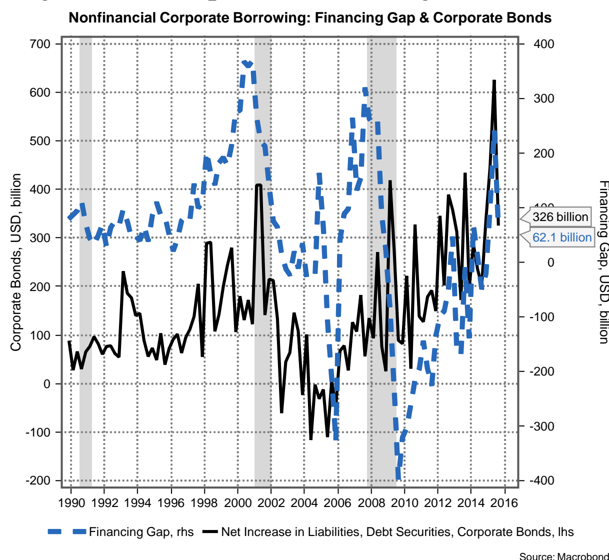


Figure 20: Corporate Borrowing Slowed



In last quarter's Update, we contrasted this picture of general improvement in credit conditions with some deterioration in overall borrowing requirements at nonfinancial corporations. Internally generated cash dropped further below spending on capital investments at these companies in the second quarter – unnervingly so. Fortunately, that increase in the "financing gap" mostly reversed in Q3, and corporate bond issuance by these companies also dropped (Figure 20). Low interest rates make debt relatively easy to support, as interest-to-EBIT figures show (Figure 18), but we were still relieved to see companies restrain borrowing in the third quarter. We will be keeping a close eye on this data over coming quarters.

Looking ahead, we still believe the U.S. economy can achieve real GDP growth of 2.5-3.0% as consumer spending and business investment pick up and headwinds from trade diminish. That did not happen in 2015 and probably will not in 2016 either. U.S. economic growth is likely to be stuck in a 2.0-2.5% range until global growth improves – in part due to benefits from lower energy and commodity prices. While inflation should rise as a disinflationary impulse from lower energy prices fades, it is likely to remain low by historical standards. These constraints should keep Fed rate hikes on a slow upward path, and long-term rates should rise only gradually as the economy improves.

Credit quality, while deteriorating in some sectors, remains strong at most issuers of preferreds – especially banks. Preferred securities continue to offer an attractive combination of high yield, intermediate duration, and good credit quality in today's markets; spreads should have room to narrow over time. 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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