First-Quarter U.S. Economic Update
May 2016

Summary of Recent Economic Developments

The U.S. economy got off to a slow start in 2016, posting real GDP growth of just 0.5% in the first quarter. Economists expect 2% growth for the year overall. Employment growth continued at a solid pace and wages accelerated slightly. Personal income growth slowed but remained strong on a year-over-year basis. Despite good job and wage gains, consumer spending eased as confidence fell, and the savings rate rose. Housing strengthened further. Economic performance in other sectors was weaker. Industrial production fell, led by another large decline in mining output, and capacity utilization slipped further. Business investment fell and is likely to remain muted for another several quarters. Trade reduced real GDP growth once again, and it's likely to be a persistent headwind to growth this year. Government spending rose slightly. Inflation edged higher in the first quarter but remained well below the Fed's 2% target. Faced with slowing growth, markets were volatile in the first quarter. Treasury yields fell and credit spreads widened, though the latter mostly recovered to or below year-end levels. Credit conditions turned mixed. Nonfinancial corporate borrowings are experiencing higher rates of default and delinquency, especially at lower-rated companies. For financial companies, which are the primary issuers of preferred securities, we believe the credit outlook remains good despite some earnings headwinds presented by rising defaults and delinquencies. We are optimistic that the current slow-growth macroeconomic backdrop will remain favorable for investors in preferred securities.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	2016:1	2015:4	2015:3	2015:2	2015:1	2014:4	2014:3	2014:2
Real GDP, Chg QoQ (%, SA, AR)	0.5	1.4	2.0	3.9	0.6	2.1	4.3	4.6
Real Personal Consump Expnds, Chg QoQ (%, SA, AR)	1.9	2.4	3.0	3.6	1.7	4.3	3.5	3.8
Real Business Inv ex Stuctures, Chg QoQ (%, SA, AR)	-4.6	-1.4	5.4	3.5	4.1	-0.3	12.2	5.7
Real Residential Investmt, Chg QoQ (%, SA, AR)	14.9	10.1	8.2	9.4	10.1	9.9	3.4	10.4
Real Private Domestic Final Sales, Chg QoQ (%, SA, AR)	1.2	2.0	3.2	3.9	2.0	3.9	4.3	4.2
Nominal GDP, Chg QoQ (%, SA, AR)	1.2	2.3	3.3	6.1	0.8	2.2	6.0	6.9
Corporate Profits, After Tax, Chg YoY (%, SA, AR)	1.2f	-15.0	-8.2	-0.6	4.7	2.7	4.9	-2.6
Nonfarm Productivity, Chg QoQ (%, SA, AR)	-1.3f	-2.2	2.0	3.1	-0.8	-1.7	3.1	2.4
Nominal Personal Income, Chg YoY (%, AR)	4.2	3.9	4.4	4.6	4.0	5.2	4.5	4.2
Personal Savings Rate (%, SA)	5.4	5.0	5.0	5.0	4.9	5.0	4.6	4.8
Unemployment Rate (%, SA)	5.0	5.0	5.1	5.3	5.5	5.6	6.0	6.1
Nonfarm Payrolls, Chg QoQ (000, SA)	628	846	576	752	570	823	736	829
Household Employment, Chg QoQ (000, SA)	1391	987	220	389	894	605	620	442
Federal Budget, 12-mo Def or Surp (% of GDP)	-2.5	-2.7	-2.5	-2.5	-2.9	-2.8	-2.8	-3.2
Consumer Price Index, Chg YoY (%, AR)	0.9	0.7	0.0	0.1	-0.1	0.8	1.7	2.1
CPI ex food & energy, Chg YoY (%, AR)	2.2	2.1	1.9	1.8	1.8	1.6	1.7	1.9
Capacity Utilization (%, SA)	74.8	75.4	76.4	76.4	77.3	78.6	78.4	78.6
Rate or Spread (End of Quarter)	**2016:1**	**2015:4**	**2015:3**	**2015:2**	**2015:1**	**2014:4**	**2014:3**	**2014:2**
Federal Funds Rate Target (%)	0.50	0.50	0.25	0.25	0.25	0.25	0.25	0.25
3-month LIBOR (%)	0.63	0.61	0.33	0.28	0.27	0.26	0.24	0.23
10-Yr Treasury Note Yield (%)	1.78	2.27	2.06	2.33	1.93	2.17	2.50	2.51
30-Yr Treasury Bond Yield (%)	2.62	3.01	2.87	3.11	2.54	2.75	3.21	3.34
BAML U.S. Corp. Bond Index Yield to Worst vs Govt	165	168	172	141	131	138	113	102
10-Yr Interest Rate Swap Spread (bp)	-14.0	-8.8	-5.5	11.3	10.0	11.5	14.3	9.8

* Figures are either quarterly or, if more frequent, end of period. 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

For the third year in a row, U.S. economic growth started the year slowly. Inflation-adjusted gross domestic product (real GDP) rose by just 0.5% in the first quarter. Over four quarters ending in 1Q2016, real GDP growth was 1.9%, close to its 2.0% average since 2010. Despite that disappointing start, growth should improve over the balance of the year. Economists expect about 2% real GDP growth once again in 2016 overall, and we generally agree with that forecast.[1] Underlying U.S. domestic economic growth remains pretty good, led by personal consumption and housing investment, although persistent headwinds from net exports and more-temporary ones from inventories are likely to keep growth modest overall. We outline our thoughts in the following paragraphs.

The **labor market** remains a bright spot for the U.S. economy, and wages finally are edging up. Payroll jobs rose by an average of 209,000 per month in the first quarter – a little bit slower than 2015's average of 229,000 new jobs per month, but still impressive (Figure 2). The household employment survey recorded very high monthly average growth of 464,000 jobs in 1Q2016. The latter survey is much more volatile than payrolls and likely overstates employment strength in Q1 – especially in light of tepid GDP growth. Nonetheless, both surveys paint a similar picture over the past year (about 240,000 new jobs per month), and both point to continued solid gains in employment during the quarter.

Figure 2: Employment Remained Strong

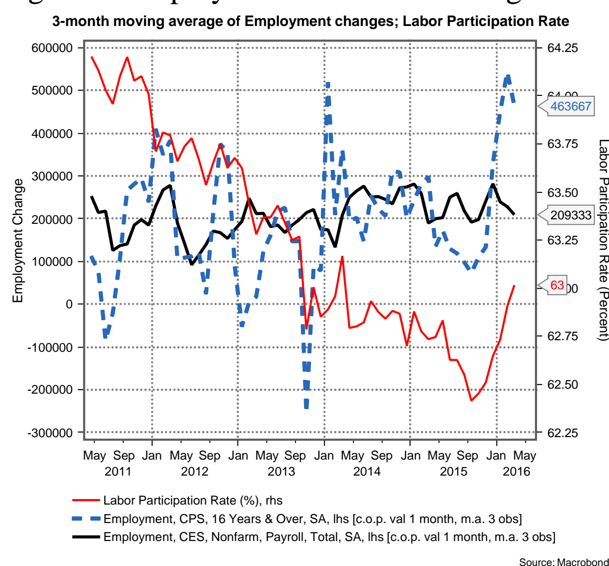
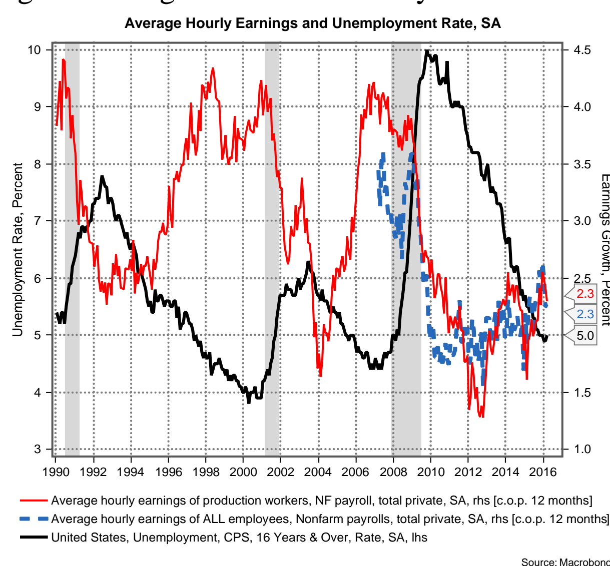


Figure 3: Wage Growth Gradually Accelerated



That good pace of job growth gradually reduced slack in labor resources and contributed to higher wages. Average hourly earnings were up 2.3% YoY in March, a modest acceleration from 1.7-2.0% wage growth that had been typical since the end of the financial crisis (Figure 3).

The unemployment rate held steady at 5.0% in the first quarter as labor force growth kept pace with job growth – a rare occurrence during this recovery (Figure 2). The labor participation rate increased from a low of 62.4% in September 2015 to 63.0% in March 2016. While that rate is

[1] Unless noted otherwise, forecasts are from the *Survey of Professional Forecasters*, Federal Reserve Bank of Philadelphia, February 12, 2016 and Bloomberg® *Monthly Economic Survey*, April 7, 2016.

still low historically, it appears that higher wages and improved job prospects brought people back into the labor force. In turn, that suggests some slack remains in the labor market that is not being reflected by a low unemployment rate – something regular readers know we have long suspected. Labor availability is important (especially to the Federal Reserve) because it means that employment should be able to continue to grow quickly without creating unwelcome inflation pressure.[2] We'll discuss Fed policy in greater detail below, but good job growth, stable-to-lower unemployment and gradually rising wages are exactly what the Fed hopes will continue.

Figure 4: Income Solid, Consumption Eased…

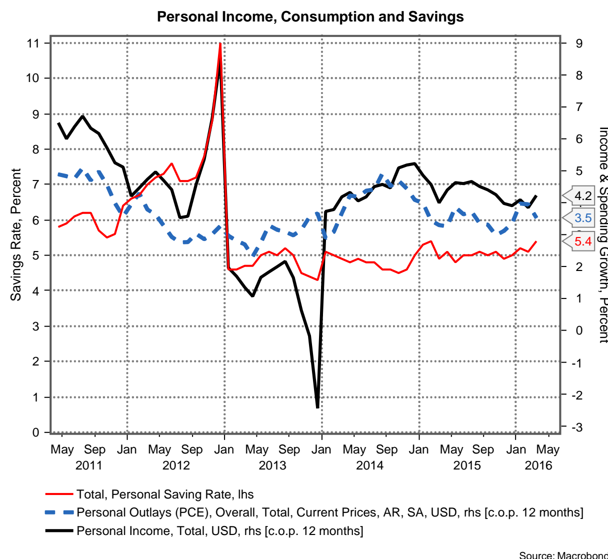
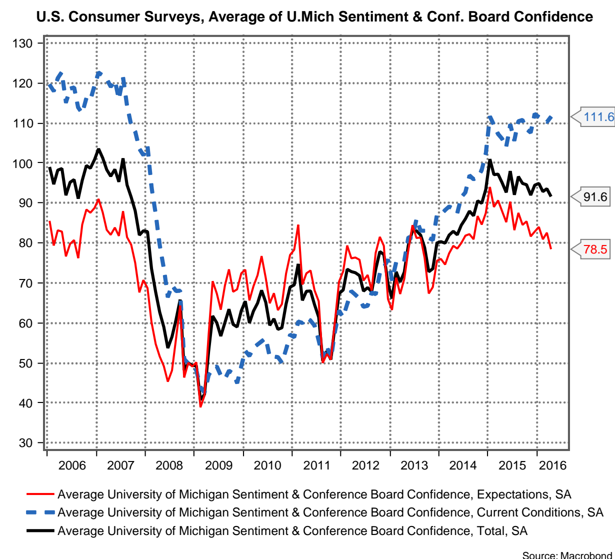


Figure 5: … as Consumers Remain Cautious



Personal income growth remained about steady at 4.2% YoY in March, although it was up only 3.4% during the first quarter (Figure 4). Wages and salaries grew a bit faster (4.7% YoY) owing to good job and faster wage growth, but low interest rates and softer business profits slowed income growth from those sources. In addition, household net worth rose 3.1% YoY in 4Q2015 (latest data available) to a new record of $86.8 trillion, and consumer balance sheets continued to improve.

Despite this generally favorable backdrop for household finances, consumer confidence has been mixed (Figure 5). Although consumers' assessments of current conditions remain around late 2015's peak, expectations for future conditions sagged, which has pulled overall confidence down. It's hard to reconcile rising employment, wages and wealth – not to mention low energy prices – with this cautious outlook. Perhaps it reflects a decidedly downbeat tone to the presidential primary campaigns, which have tended to focus disproportionately on negatives.

Whatever the reason for fading expectations, consumers spent cautiously in the first quarter (Figure 4). **Personal consumption expenditures** (PCE) were up 3.5% YoY in March (latest data available) and just 2.1% in the first quarter, largely due to slower automobile sales. On an inflation-adjusted basis, real PCE was up 1.9% QoQ and 2.7% YoY. Over either period, consumption lagged growth in income, which boosted the personal savings rate to 5.4% in March from 5.0% in December 2015 and an average of 5.1% over the past year. With debt burdens low

[2] The Fed wants to see wages and inflation move up, but not too rapidly.

and savings accumulating more rapidly, consumers should be able to increase spending if and when they feel more optimistic. We expect PCE will improve over the balance of 2016.

Housing, however, is one area where consumers are still spending strongly. Residential investment was up 10.1% in 4Q2015 and it accelerated to 14.8% growth in Q1, making it the strongest major segment of the U.S. economy. New and existing home sales averaged 5.8 million units in the first quarter, and inventories of unsold homes remained low (Figure 6). Home prices rose about 5.5% in 2015 and have roughly sustained that pace through February (latest data available). Although home construction has increased, new housing supply remains below the pace of household formation. As a result, home building and prices should remain economic bright spots for at least several more years.

Figure 6: Housing Market Still Trending Up

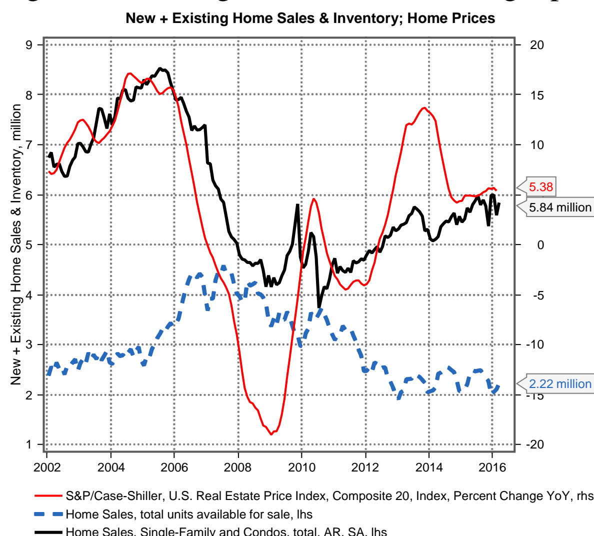
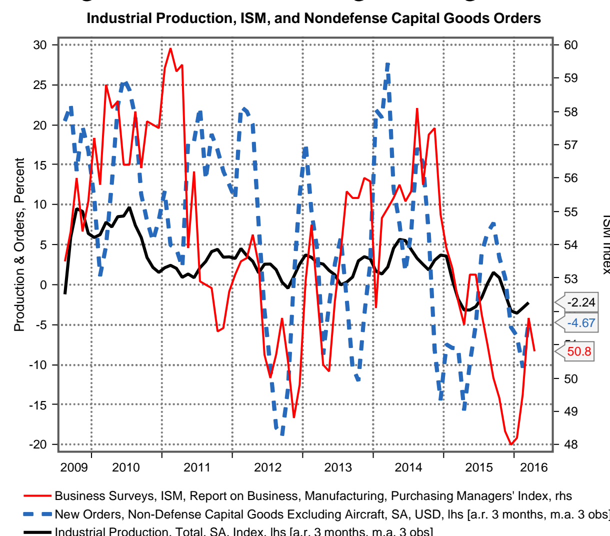


Figure 7: Manufacturing Turning Corner?



Unfortunately, economic news generally gets worse from there. **Industrial production** slowed further in the first quarter, although the pace of decline did ease a bit (Figure 7). Mining, which includes oil and gas extraction, extended last year's 15% drop by another 5.4% (not annualized) in Q1. Utility output also fell 1.6% on warmer-than-normal winter weather. Manufacturing managed to post a 0.7% gain – not great, but better than 4Q2015's 0.4% decline – though that was not strong enough to offset weakness in those other sectors. Orders for nondefense capital goods excluding aircraft, what we consider to be "core" orders, were up marginally from December but fell 4.9% at an annual rate compared to 4Q2015. However, the Institute for Supply Management's survey of manufacturers rebounded considerably in the first quarter (red line in Figure 7), and we are guardedly optimistic that manufacturing activity is in the process of recovering from a mild recession in 2015.

Any rebound in **business investment** is likely to be muted, however, until capacity utilization picks up. Lower energy and commodity prices sharply reduced investment in energy, mining and farm equipment – as well as in industries that supply or provide logistics to those businesses. Capacity utilization dropped along with lower output, and lower business investment followed (Figure 8). Real business investment fell 5.9% in Q1, and "core" investment (excluding structures) fell 2.5% YoY. However, if energy and commodity prices do not take another sharp

leg down, those investment cutbacks should soon be coming to a close. Rising orders for equipment from consumer-goods and housing businesses should boost capacity utilization and lead to stronger business investment as the year progresses – though it may take a couple more quarters to become visible.

Along with weaker consumer and business spending, **inventory** growth slowed in the first quarter, subtracting 1/3 percentage point from real GDP. Unfortunately, inventory-to-sales ratios remain somewhat elevated, and inventory growth may again be a drag on GDP next quarter. This does not appear to be a self-sustaining inventory correction, however, and we think inventory weakness will prove temporary.

Figure 8: Business Investment Fell

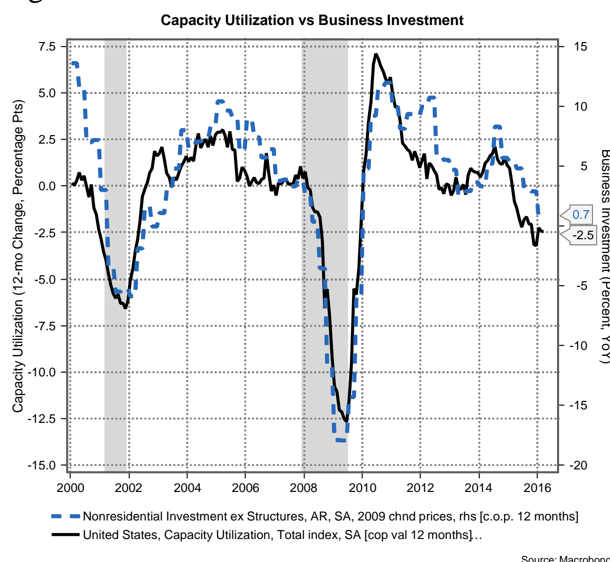


Figure 9: Trade Drag Continued

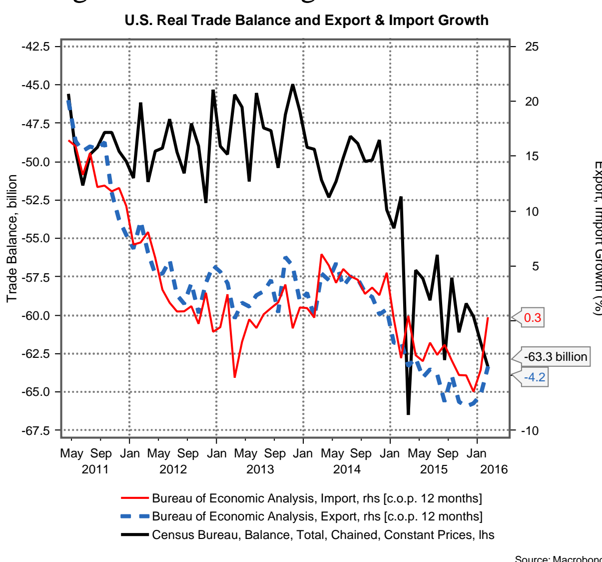


Figure 10: Dollar Off Earlier Highs

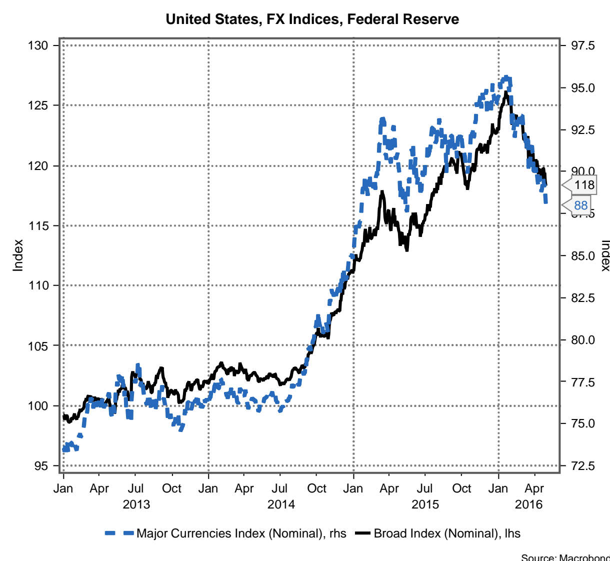
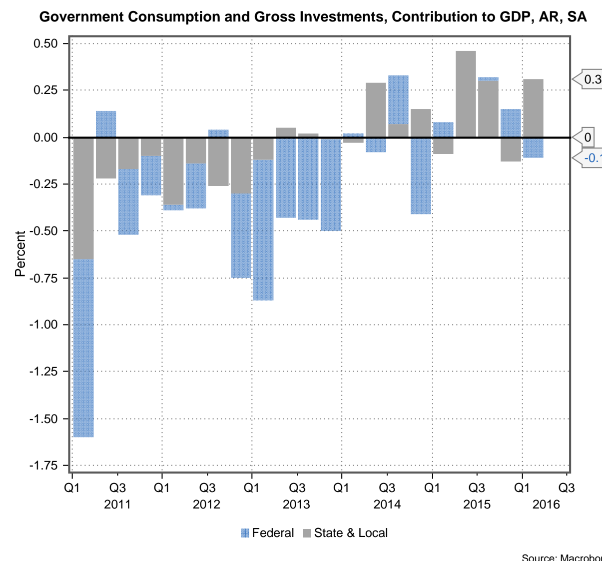


Figure 11: Government Spending Up



The **trade deficit** widened in January and February (latest data available), and the Commerce Department estimated that net exports subtracted about 1/3 percentage point from first quarter

GDP growth. Exports continued to shrink in response to slower growth abroad and a stronger U.S. dollar. Imports fell throughout 2015 (albeit less than exports, on average) but they edged up in early 2016, pushing the trade deficit wider. We are encouraged, however, by the recent improvement in import and export growth trends, which may signal better – or at least less bad – global economic growth.

The dollar weakened so far in 2016 as prospects for interest rate hikes in the U.S. diminished, but it remains much stronger than when a rally began in mid-2014 (Figure 10). On balance, we expect that trade will remain a headwind to U.S. GDP growth in 2016, and it should continue to be a restraining influence on monetary policy throughout the year.

Real **government consumption** rose by 1.2% last quarter, adding 0.2% to Q1 real GDP (Figure 11). Government spending is likely to trend up slightly this year, but it will not be a significant driver of GDP growth. Divided government in Washington held down federal spending in recent years; while that has loosened a bit in recent quarters, federal spending growth is likely to remain slow this year. Next year is anyone's guess, however, and we will withhold judgment on that until after November's elections. State and local spending growth should remain around 1% after inflation, where it has been for the past two years.

Inflation remained subdued in the first quarter, but both overall and core inflation edged up (Figure 12). The consumer price index (CPI) rose 0.9% overall and 2.2% excluding food and energy over 12 months ending in March 2016, up from 0.7% and 2.1% YoY, respectively, in December 2015. The PCE deflator rose 0.8% overall and 1.6% excluding food and energy over the same period, also up slightly from December's levels. Rising wages are pushing up prices of services, while energy and other commodity prices have mostly stabilized or moved up this year (Figure 13). It's unclear where commodity prices are headed, but wage growth is likely to continue to rise gradually given solid employment growth. At the same time, excess capacity should restrain prices of many goods. On balance, we expect core inflation to end the year about where it is today. We also expect the gap between overall and core (ex food and energy) prices to narrow, with overall inflation moving up.

Figure 12: Inflation Edged Up but Remains Low

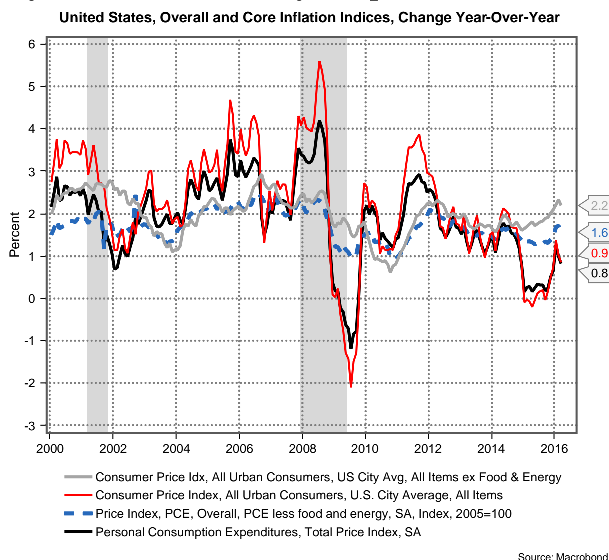


Figure 13: Service Prices Accelerated

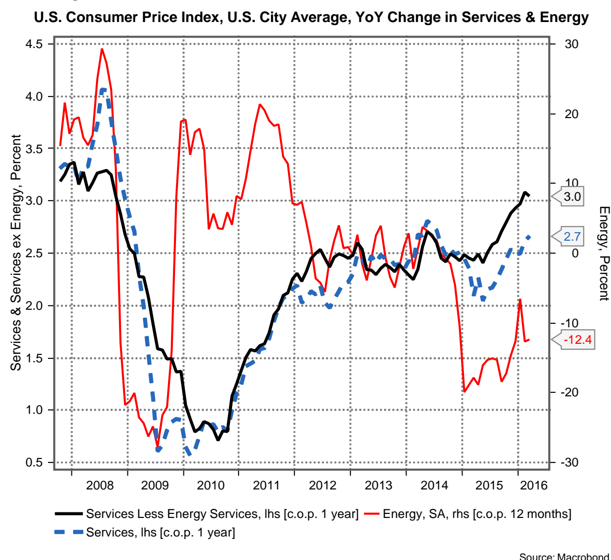
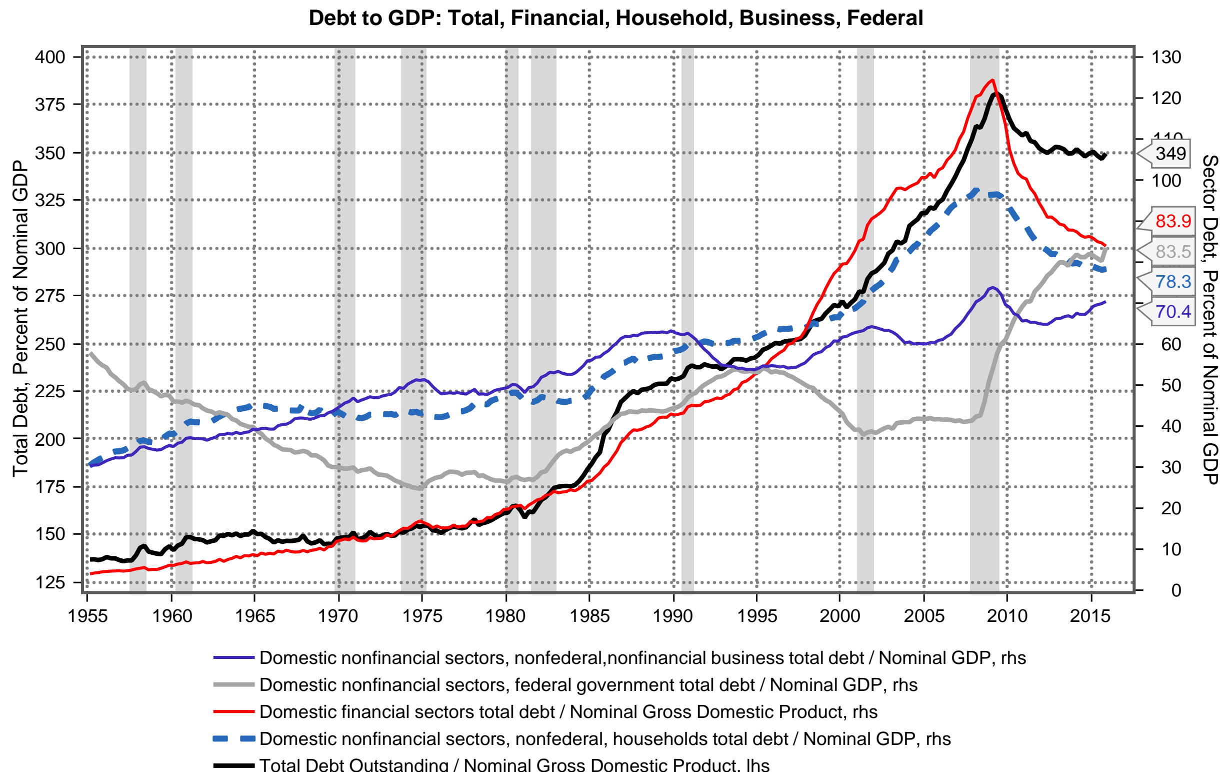


Figure 14: Leverage Higher at Nonfinancial Businesses, Lower Elsewhere



Source: Federal Reserve Flow of Funds Report (Z1)

Finally, **broad balance sheet trends** were little changed in 4Q2015 (Figure 14, latest data available). Overall debt-to-GDP was 349%, about where it has been since early 2012. Household debt fell to 78.3% on rising savings and limited growth in consumer borrowing, mostly to purchase automobiles and finance higher education. Likewise, financial sector debt eased to 83.9% of GDP, and it should remain on a downward path as financial institutions continue to lend cautiously and increase capital. Corporate nonfinancial leverage increased further, however, as corporate profits and free cash flow fell, especially at energy businesses. As we discuss more below, we expect this debt burden will result – indeed, already has resulted – in rising default rates among nonfinancial companies in 2016. Finally federal government borrowing rose to 83.5% of GDP as the government loosened its purse strings in the second half of 2015. Most forecasters, including the Congressional Budget Office, expect gradually widening budget deficits over coming years. While debt is moving up in some sectors and down in others, we expect overall debt to remain roughly steady relative to GDP, making it neither a headwind nor a tailwind to overall economic growth.

Market Outlook

Financial markets got off to a volatile start in 2016. Worries over slowing U.S. and global growth pushed down equity prices in nearly all major markets in January and February. **Treasury rates** fell sharply as equity markets sold off, and they remained low even as equity prices rebounded substantially in March and April. The yield on the 10-year U.S. Treasury note fell 49 basis points (bp) in the first quarter to 1.78% after touching a low of 1.65% in February; it is little changed

from quarter-end as of today. Likewise, the yield on the 30-year benchmark Treasury bond fell 39 bp to 2.62% in Q1, also about where it trades today (Figure 15).

When it raised the federal funds rate by 25 bp from near zero in December 2015, the Federal Open Market Committee's (FOMC) "dot plot," which shows members' rate expectations as dots through time, suggested that the Federal Reserve would raise rates by 100 bp in 2016, presumably about once per quarter. However, slower U.S. and global economic growth and volatile equity and credit markets persuaded the Fed to slow its timetable for rate hikes, and the FOMC left the fed funds target unchanged at 0.25-0.50% at its January, March and April 2016 meetings.

The Fed has to navigate a delicate set of domestic and global economic circumstances. Domestically, U.S. growth remains moderate, and labor market slack has gradually diminished. As we mentioned earlier, U.S. real GDP growth has averaged 2% since 2010. Employment growth has been solid for four years, and wages have accelerated recently. Inflation has increased, though it remains below the Fed's 2% target. While 2% real GDP growth is sub-par for a typical post-recession recovery (particularly one as deep as the 2008-09 recession), with productivity growth of less than 1%, it's still fast enough to absorb excess capacity in labor resources, which is why wages are moving up at last. Domestically, the Fed has room to tighten monetary policy.

Globally, however, economic growth has slowed. Monetary policy is easing (or at a minimum stable) in most large economies outside the United States. The U.S. economy already faces significant drag on growth from a wider trade deficit. Another sharp rise in the U.S. dollar – which could be a consequence of higher U.S. interest rates – would only make matters worse. Prices of globally-traded goods are flat or falling in U.S. dollar terms. Moreover, many U.S. companies earn profits from overseas operations. Those profits have fallen sharply from a combination of slower growth in those economies and currency translation back to (more-expensive) U.S. dollars. Globally, the Fed needs to tread lightly.

Figure 15: Rates and Forwards Lower Again

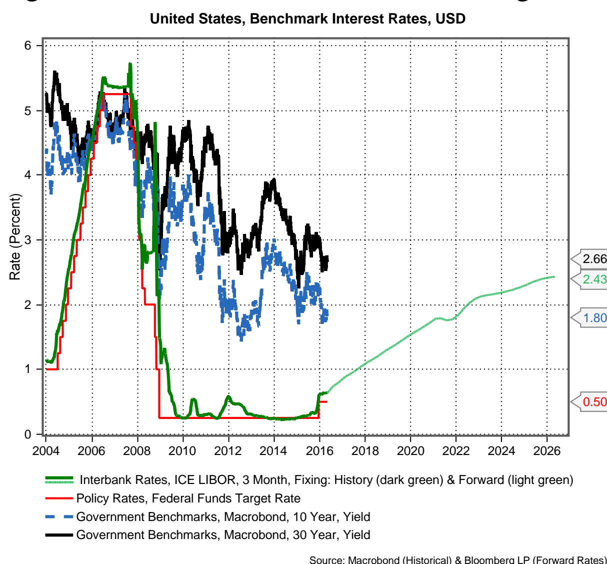
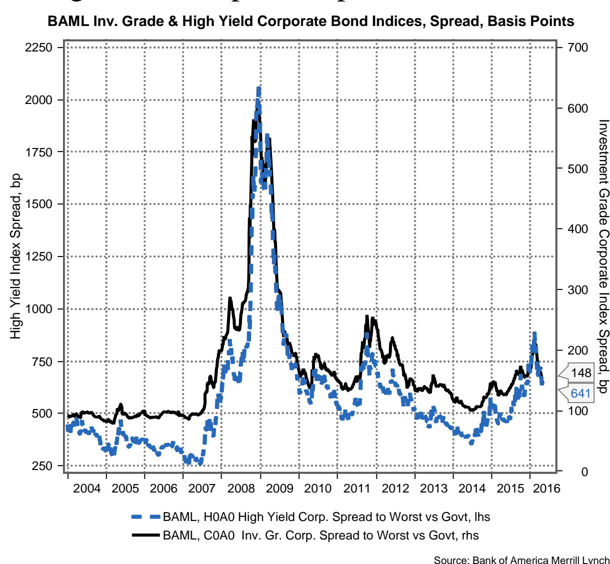


Figure 16: Corporate Spreads Volatile



The FOMC has to navigate these crosscurrents and markets' reactions to them. It's not an easy job. We think the Fed will take a middle path and tighten rates twice this year. Our guess is June and December; the market expects one 25 bp tightening around September. As before, timing of these moves is less important than the idea that the Fed will move gradually as long as it faces such tightly constraining circumstances. We continue to expect that long-term interest rates will drift higher in 2016 but that a sharp rise similar to 2013's "taper tantrum" is unlikely.

Turning to the credit side of markets, corporate **credit spreads** were extremely volatile but, in the end, little changed in the first quarter. Investment-grade corporate bond spreads[3] started the year at 168 bp, widened to a peak of 215 bp in mid-February, ended the quarter at 165 bp, and narrowed to 148 bp today. High yield bond spreads[4] followed a similar path. They started the year at 698 bp, widened almost 200 bp to 888 bp in mid-February, finished the quarter at 712 bp, and narrowed further to 641 bp today (Figure 16). Spreads on preferred securities followed a similar pattern but remain somewhat wider than where they started the year. "Spread to Worst" on a broad Bank of America Merrill Lynch preferred securities index started 2016 at 282 bp, widened to 355 bp in mid-February, ended March at 325 bp, and narrowed to 310 bp today.[5] Total return on the preferred index (+0.55%) underperformed both the corporate (+3.92%) and high yield (+3.25%) indices during the quarter.[6]

Figure 17: Corporate Profits Sagged

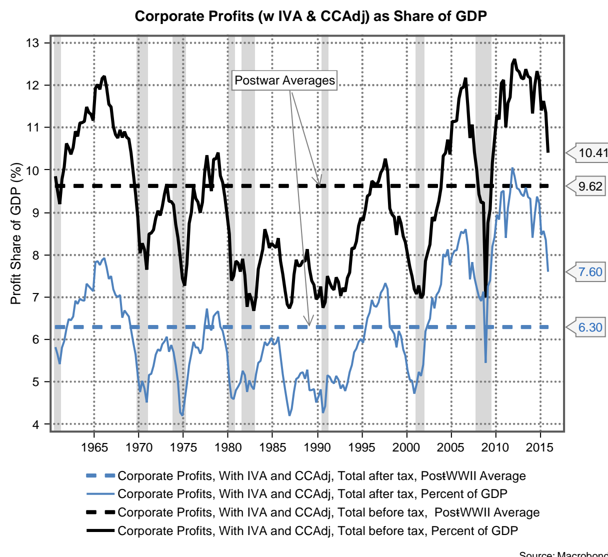
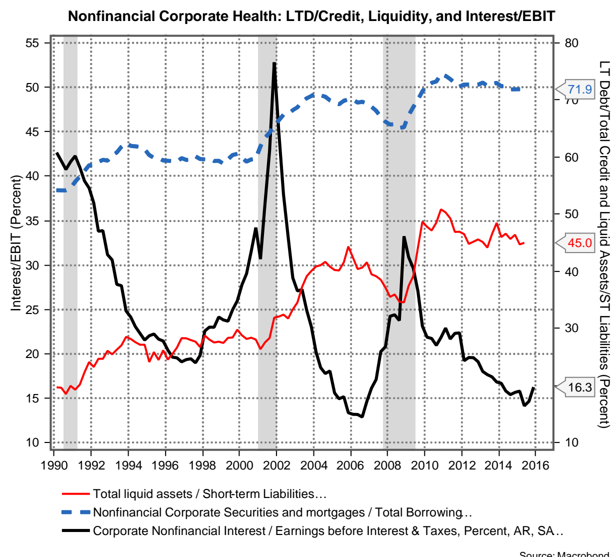


Figure 18: Balance Sheets Strong, but Turning?



Fundamental **credit conditions** remained strong in the fourth quarter (latest data available), but deterioration is visible in several metrics. Corporate profits sagged in the fourth quarter (Figure 17), and early reports of first-quarter earnings were soft too. As credit investors, we are more

[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.

concerned that companies are profitable (as opposed to making losses that erode capital) than we are about profit growth, and the profit share of GDP remains well-above average. We expect that profits will recover in the second half of the year as headwinds from energy losses subside and U.S. economic growth improves, but this is something that bears watching. Corporate balance sheets likewise remain strong but have weakened a little in recent quarters. Interest expense as a percentage of earnings before interest and taxes is up, due in part to weaker profits and in part to slightly higher interest rates and leverage. Liquidity, while still very strong, has also declined a bit. More positively, long-term debt to total debt remained stable at a high level (Figure 18). These are signals that credit risk has increased (more on that in a moment), though we should keep in mind that we are still some distance from levels that would make us worried about overall credit conditions.

Loan delinquencies and charge-offs paint a mixed picture. Consumer loan books continued to improve slightly, but delinquency and charge-off rates on commercial and industrial loans increased (Figure 19). That deterioration appears to be due mostly to soured energy loans. We continue to 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. Banks continue to post modest profits (albeit with lower return on equity) and increase common equity capital that protects preferred securities. They also should benefit from higher short-term interest rates if and when the Federal Reserve moves to hike rates. Overall, the banking system continues to get healthier.

Figure 19: Loan Quality Good, C&I Weaker

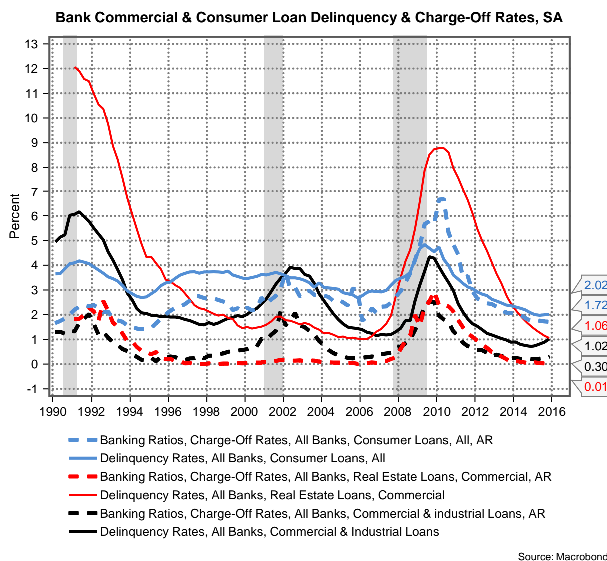
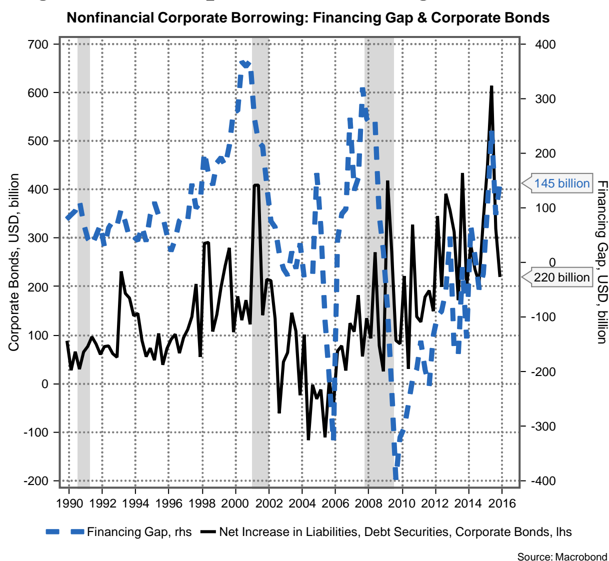


Figure 20: Corporate Borrowing Slowed



For the past several quarters, we have highlighted deterioration in overall borrowing requirements at nonfinancial corporations. Internally-generated cash dropped below spending on capital investments at these companies, rising to a level in 2Q2015 that preceded credit trouble in the past. Fortunately, that increase in the "financing gap" mostly reversed in 3Q2015 and held about steady in Q4. Corporate bond issuance by these companies also fell (Figure 20). While this improvement in the financing gap is encouraging, companies are still spending more than they

are making and need access to bank or corporate bond financing. We will be keeping a close eye on this data over coming quarters.

Adding this up, we see stable-to-improving credit conditions at financial companies but weakening credit conditions at nonfinancial companies. Already, default rates on high-yield bonds, which are issued almost exclusively by nonfinancial companies, have increased considerably. According to Standard & Poor's, the default rate for speculative-grade U.S. companies jumped to 3.8% for 12 months ending in April 2016. That is the highest rate in seven years and is up from 2.8% and 1.6% in December 2015 and 2014, respectively.[7]

As we have argued for several years now, we believe the current macroeconomic backdrop is favorable for preferred securities. Moderate growth in the economy and debt make asset bubbles unlikely. Slowly rising short-term rates should mean only modest and gradual increases in long-term rates, which markets have already partly – though not fully – priced into forward rates. Higher rates should benefit net interest margins at banks and finance companies and raise interest spreads at insurance companies. Those businesses comprise about 80% of the U.S. dollar preferred securities market. Their credit outlooks remain good despite some earnings headwinds presented by rising defaults at nonfinancial companies. We're keeping our fingers crossed for more of the "slow and steady" growth we've had for the past five years.

Flaherty & Crumrine Incorporated
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[7] Source: Standard & Poor's Global Credit Portal, April 28, 2016.