Second-Quarter U.S. Economic Update
August 2016

Summary of Recent Economic Developments

The U.S. economy turned in another lackluster performance in the second quarter. Inflation-adjusted gross domestic product (real GDP) expanded by 1.2% in the second quarter, better than Q1's 0.8% pace but well below expectations of 2.6% growth. However, inventories sapped 1.2% from Q2 GDP growth, and private domestic final sales rose 2.7%. Still, a slow first half means growth for 2016 overall is likely to be 1.5-2.0%. Employment growth slowed but remained strong, and wages accelerated. Income growth slipped and prospects for faster income growth have faded, but personal consumption rose strongly. Residential investment slowed after a strong Q1 for housing; it should rebound over coming quarters. Business investment fell again, although prospects for stronger investment and industrial production have improved modestly. The trade deficit added slightly to Q2 growth but appears poised to turn negative again. Inventories, in contrast, were very weak in Q2 but should rebound in the second half of 2016. Government spending eased. Core inflation edged up, as did aggregate borrowing. Treasury rates fell and credit spreads narrowed. Credit conditions remain strong overall, though pockets of weakness are visible. Although yields on preferred securities are lower than where they started the year, we believe they still offer value in today's low-yield world.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	2016:2	2016:1	2015:4	2015:3	2015:2	2015:1	2014:4	2014:3
Real GDP, Chg QoQ (%, SA, AR)	1.2	0.8	0.9	2.0	2.6	2.0	2.3	5.0
Real Personal Consump Expnds, Chg QoQ (%, SA, AR)	4.2	1.6	2.3	2.7	2.9	2.4	4.6	3.7
Real Business Inv ex Stuctures, Chg QoQ (%, SA, AR)	-0.8	-4.3	-0.1	6.1	2.8	5.5	-2.5	11.6
Real Residential Investmt, Chg QoQ (%, SA, AR)	-6.1	7.8	11.5	12.6	14.8	13.4	11.3	3.6
Real Private Domestic Final Sales, Chg QoQ (%, SA, AR)	2.7	1.1	1.8	3.3	3.2	2.7	3.9	4.4
Nominal GDP, Chg QoQ (%, SA, AR)	3.5	1.3	1.8	3.2	4.9	2.1	2.8	6.7
Corporate Profits, After Tax, Chg YoY (%, SA, AR)	-10.9f	-6.5	-18.3	-6.0	-2.9	7.9	6.9	6.7
Nonfarm Productivity, Chg QoQ (%, SA, AR)	N/A	-0.6	-1.7	2.0	3.1	-0.8	-1.7	3.1
Nominal Personal Income, Chg YoY (%, AR)	3.8f	4.6	4.3	4.4	4.6	4.0	5.2	4.5
Personal Savings Rate (%, SA)	5.3f	6.0	5.3	5.0	5.0	4.9	5.0	4.6
Unemployment Rate (%, SA)	4.9	5.0	5.0	5.1	5.3	5.5	5.6	6.0
Nonfarm Payrolls, Chg QoQ (000, SA)	442	587	846	576	752	570	823	736
Household Employment, Chg QoQ (000, SA)	-223	1391	987	220	389	894	605	620
Federal Budget, 12-mo Def or Surp (% of GDP)	-2.9	-2.5	-2.7	-2.5	-2.5	-2.9	-2.8	-2.8
Consumer Price Index, Chg YoY (%, AR)	1.0	0.9	0.7	0.0	0.1	-0.1	0.8	1.7
CPI ex food & energy, Chg YoY (%, AR)	2.3	2.2	2.1	1.9	1.8	1.8	1.6	1.7
Capacity Utilization (%, SA)	75.4	74.8	75.4	76.4	76.4	77.3	78.6	78.4
Rate or Spread (End of Quarter)	**2016:2**	**2016:1**	**2015:4**	**2015:3**	**2015:2**	**2015:1**	**2014:4**	**2014:3**
Federal Funds Rate Target (%)	0.50	0.50	0.50	0.25	0.25	0.25	0.25	0.25
3-month LIBOR (%)	0.65	0.63	0.61	0.33	0.28	0.27	0.26	0.24
10-Yr Treasury Note Yield (%)	1.49	1.78	2.27	2.06	2.33	1.93	2.17	2.50
30-Yr Treasury Bond Yield (%)	2.31	2.62	3.01	2.87	3.11	2.54	2.75	3.21
BAML U.S. Corp. Bond Index Yield to Worst vs Govt	158	165	168	172	141	131	138	113
10-Yr Interest Rate Swap Spread (bp)	-11.3	-14.0	-8.8	-5.5	11.3	10.0	11.5	14.3

* Figures are either quarterly or, if more frequent, end of period. f = Forecast[1]; a = Actual through May 2016 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 again grew at a lackluster pace in the second quarter, although we expect somewhat better performance ahead. Second-quarter inflation-adjusted gross domestic product (real GDP) expanded by 1.2%, faster than last quarter's downwardly-revised 0.8% pace but well below earlier expectations of 2.6% growth.[1] However, inventory reductions were primarily responsible for the quarterly slowdown – something that should reverse over the next several quarters. Private domestic final sales[2] rose 2.7% in Q2. The economy should do better over the balance of the year, though with first-half growth averaging just 1%, it will be a stretch for 2016 overall to match the 2% average growth rate of recent years.

As usual, we will explore major sectors of the U.S. economy in the paragraphs that follow. It remains an uneven story.

Figure 2: Employment Growth Slowed…

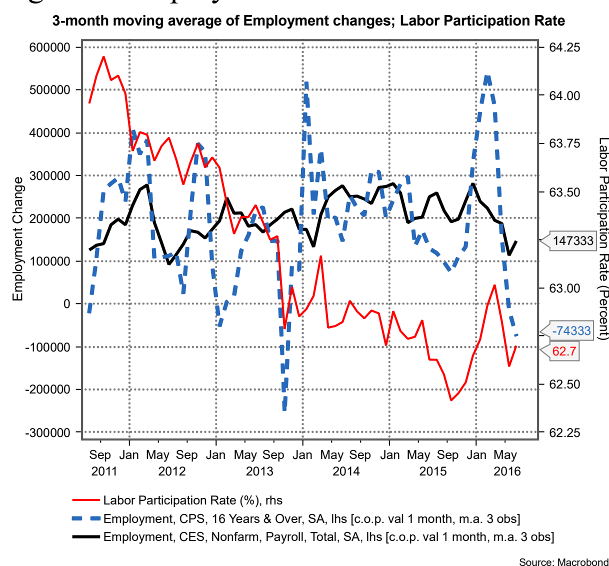
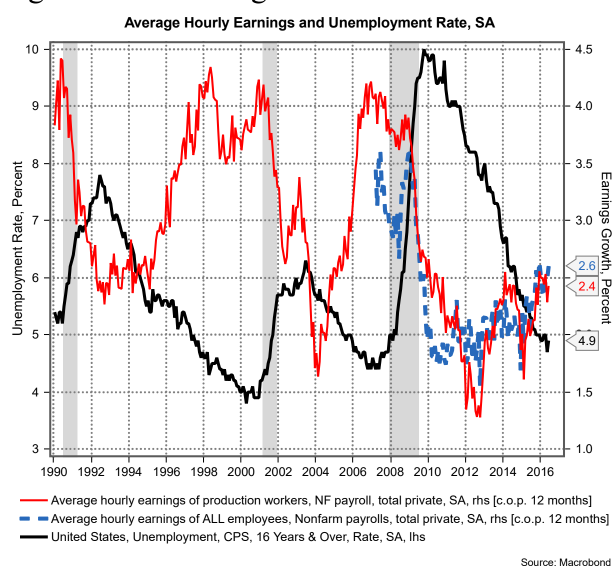


Figure 3: …but Wages Still Accelerated



The **labor market** continued to strengthen in the second quarter, albeit at a slower pace than in recent quarters (Figure 2). Payroll jobs rose by an average of 147,000 jobs per month, a slowdown from Q1's 196,000 pace but still good in light of a very weak May report (+11,000 jobs). The household employment survey estimated that employment actually shrunk by 74,000 jobs per month. We think that overstates the slowdown, however; year-to-date, both payroll and household surveys show similar job gains. Moreover, both surveys show nearly equal rates of job growth: nonfarm payrolls were up 1.7% YoY in June and household employment was up 1.6% YoY. Those are well above a roughly 1% growth rate in the labor force, meaning labor market slack is gradually diminishing.

The unemployment rate edged down to 4.9% in June from 5.0% in March, although this was due to lower labor participation during the quarter. After falling to a low of 62.4% in September 2015, labor participation rose to 63% in March 2016 but eased back to 62.7% in June. We are not

[1] Unless noted otherwise, forecasts are from the *Livingston Survey*, Federal Reserve Bank of Philadelphia, June 8, 2016 and Bloomberg® *Monthly Economic Survey*, July 14, 2016.

[2] Private domestic final sales is Total GDP less net exports, inventories, and government consumption.

concerned about quarterly oscillations in this statistic, but rising employment along with rising labor participation paints a stronger labor market picture than rising jobs alone.

Although job growth slowed, average hourly earnings accelerated. Hourly wages rose 2.6% YoY in June compared to 2.3% YoY in March (Figure 3). This reflects a gradual tightening in labor market resources as job growth has outstripped labor force growth. However, productivity growth drives long-term growth in real wages, and it remains low: Nonfarm productivity was up only 0.7% YoY in March (latest data available), about where it has been for the past several years. A gap between real wages and productivity creates inflationary pressure. For now, that gap remains relatively small and has not been present for long, but it is something we are watching.

Figure 4: Consumers Earning, Spending…

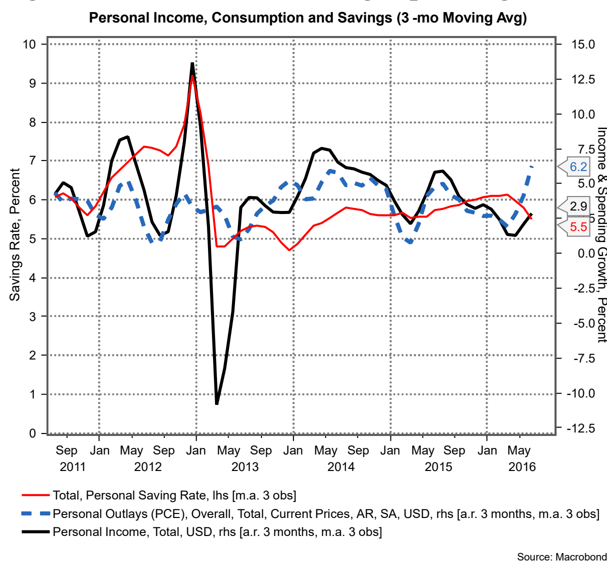
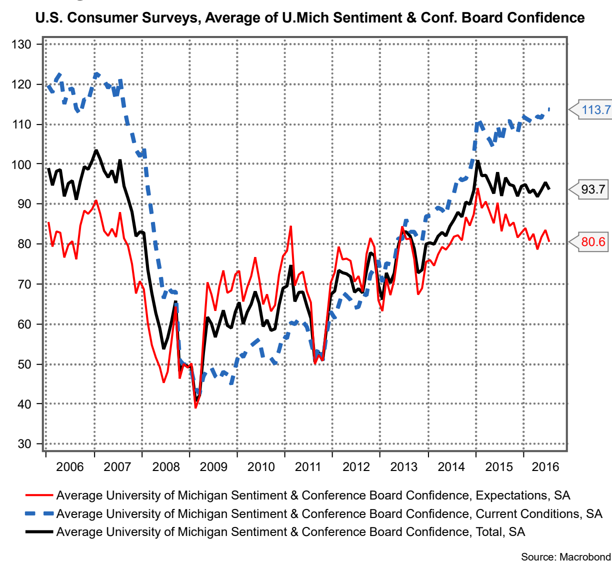


Figure 5: …but Confidence Mixed



Continued growth in employment and earnings boosted **personal income** in the second quarter after a soft start in Q1 (Figure 4). Nominal personal income rose 2.9% in Q2 over Q1, and it was up 2.7% YoY in June. That's considerably slower income growth than over the past few years, and it is worth exploring what's behind the slowdown.

The major components of personal income, their current proportions of it, and their growth rates for 12 months ending in June are shown in the table below:

Personal Income Composition	Pct. of Pers. Inc.	YoY Growth
Total Personal Income	100.0%	2.7%
Wages & Salaries	50.9%	3.2%
Supplements to wage & salary	11.9%	3.8%
Proprietors' Income	8.9%	2.9%
Rental Income	4.4%	6.5%
Interest & Dividend Income	14.3%	-1.9%
Current Transfers	17.4%	3.4%
less Contribs. for social insurance	-7.8%	2.9%
equals Net Transfers	9.6%	3.9%

The first thing that's striking about this table is that wage and salary income is only about half of total personal income. Benefits, which have tended to grow slightly faster than wages and are less volatile, are another 12%, and proprietors' income (businesses whose income is taxed as personal income to their owners) is about 9% of personal income. Thus, a little over 70% of personal income is comprised of employment income in some shape or form. The balance is rental income, investment income, and transfers (mainly Social Security, Medicare and Medicaid; net transfers take out personal Social Security and Medicare taxes).

As the recovery ages and the economy approaches full employment, employment growth should slow and wages should accelerate. Earlier in the expansion, employment grew about 2% while wages grew more slowly, around 1.5%. For a while, job growth stayed around 2% and wage growth accelerated. More recently, we've seen employment growth slow and wages accelerate – consistent with an economy that's approaching full employment. We expect employment income to continue to grow moderately, but if labor availability is becoming more limited, it's hard to see employment income taking off from here.[3]

Rental income is a bright spot, driven by rising demand for housing and office space. However, interest and dividend income, which is more than three times larger than rental income, fell over the past year. This is an unintended (albeit understood) consequence of highly accommodative monetary policy. Even if the Federal Reserve gradually raises short-term interest rates over coming quarters, it is going to take a long time for that to affect investment income significantly.

Finally, transfer payments should continue to rise as the population ages, increasing the number of people entitled to transfer benefits. However, while those payments add to personal income, they have to be paid through taxes (reducing disposable personal income of taxpayers) or borrowing (reducing investment spending). Thus, they do little to add to overall economic growth.

Putting this together, we think personal income growth is likely to remain modest. We should see some acceleration in the second half as output rises to replenish inventories, but it will be difficult for personal income to grow much faster than 4% over the next several years.

Although income growth was mediocre in the second quarter, real **personal consumption expenditure** (PCE) rose briskly. Real PCE was up 4.2% in Q2, much faster than Q1's 1.6% pace. For 2016's first half, however, PCE is about in-line with its average over the past two years – a reminder not to get too worried about one quarter's weak (or strong) results. One reason why PCE may be so volatile is a wide gap between consumers' current economic sentiment and expectations for the future. Consumers are confident about current conditions but clearly worried about the future (Figure 5). It's not unusual for current views to outpace expectations in a long expansion (people expect some mean reversion), but the gap between these two measures is unusually wide. It suggests a somewhat fragile consumer and is another risk factor for the economy.

Strong consumption growth combined with modest income growth pushed the **savings rate** down to 5.3% in June and an average of 5.5% in Q2 (Figure 4). We are not concerned about this drop at all. Consumers increased their savings rates for four quarters despite strong job growth

[3] We assume that labor participation will increase somewhat as wages rise, which would allow for more rapid employment growth. However, its limited rebound so far suggests it's unlikely to increase quickly.

and accelerating wages. Consumer balance sheets are strong and debt service is low. Consumers are simply spending a little of what they saved, and there is room for more of that.

The **housing market** took a step back in the second quarter. Residential investment fell by 6.1% in Q2 after rising 7.8% in Q1; it was up 6.2% YoY. New and existing home sales hit another post-crisis peak of 6.2 million units in June (Figure 6). Rising income, pent-up demand from the housing bust, low mortgage rates, and still-good affordability should continue to boost home sales. In turn, that should encourage new homebuilding and housing upgrades (i.e., residential investment). Prices also continue to rise modestly. The S&P/Case-Shiller 20-city home price index was up 5.2% YoY in May (Figure 6, latest data available), which indicates good demand. We expect housing will remain a bright spot for the U.S. economy for at least several more years.

Figure 6: Housing Remains a Bright Spot

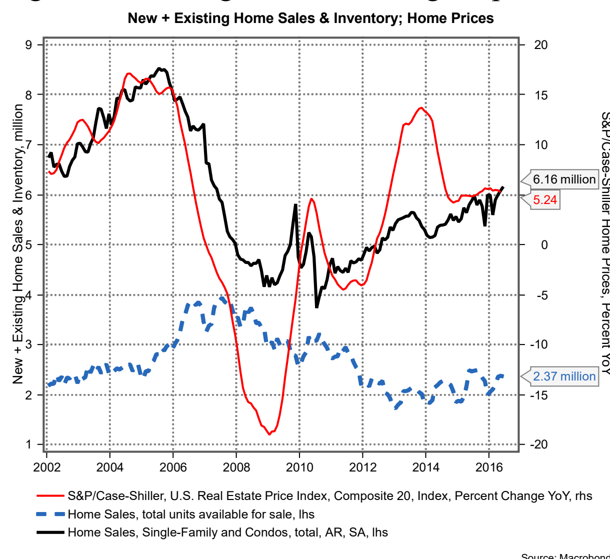
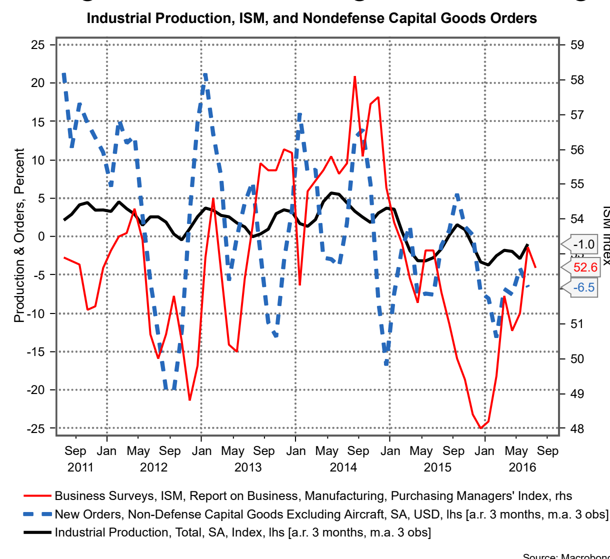


Figure 7: Manufacturing Soft but Turning



Industrial production appears to be recovering from a mild recession, but output continued to contract in the second quarter. Overall industrial production fell 1.0% in Q2 (Figure 7) and was down 0.7% YoY. Lower mining output (down 15.9% in Q2) was primarily responsible for the decline, but manufacturing (-0.8%) was also lower. These declines were less than in recent quarters, however. The Institute for Supply Management's manufacturing survey rebounded to 52.6 in July after touching 48.0 in December 2015, which suggests expanding manufacturing activity. Orders for industrial goods paint a similar picture. Core capital goods orders (nondefense, excluding aircraft) were down 6.5% in the second quarter – not good but still on an upward path. We think continued growth in consumer spending and inventory restocking will prompt higher industrial activity over coming quarters, although soft business investment and weak export growth probably mean recovery will be modest.

Real **business investment** was down 2.2% in the second quarter, but it should turn upward over coming quarters. As noted above, we expect industrial output to recover soon. Already, a decline in capacity utilization has slowed (Figure 8), and output gains should boost utilization. In turn, that should drive higher core business investment (excluding structures) over coming quarters. Recovery is likely to be slow in light of sluggish productivity growth and headwinds from falling exports, but we think business investment should turn positive over the next quarter or two.

The **trade deficit** narrowed unexpectedly in the second quarter but is likely to widen again in response to better U.S. economic growth and renewed strength in the U.S. dollar (Figure 9). Net exports added 0.2 percentage points to second-quarter real GDP growth after being a neutral factor in Q1. Both imports (-3.1% YoY in May) and exports (-4.2% YoY) continued to shrink, reflecting sluggish economic growth both here and abroad. Looking ahead, U.S. growth should improve in the second half, which should boost imports. In addition, the United Kingdom's decision to leave the European Union triggered a substantial rally in the U.S. dollar and threatens to slow economic growth for a time in the UK and Europe, both of which are likely to weigh on U.S. exports. We expect that net exports will be a headwind to real GDP in the second half.

Figure 8: Business Investment Bottoming?

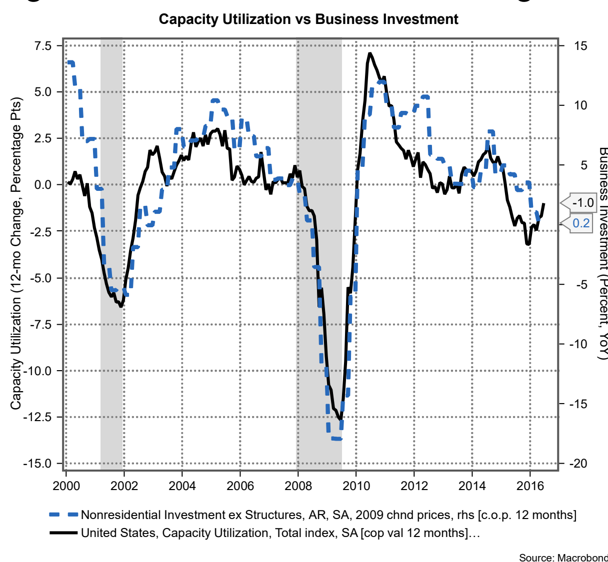


Figure 9: Trade Improvement Temporary

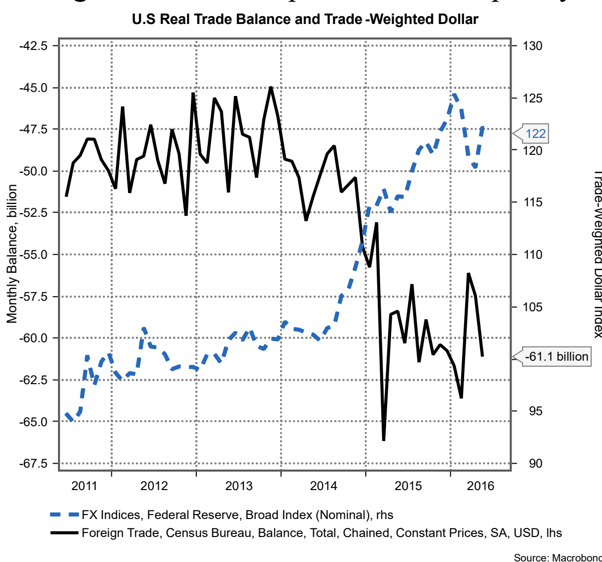


Figure 10: Inventories Sapped Growth

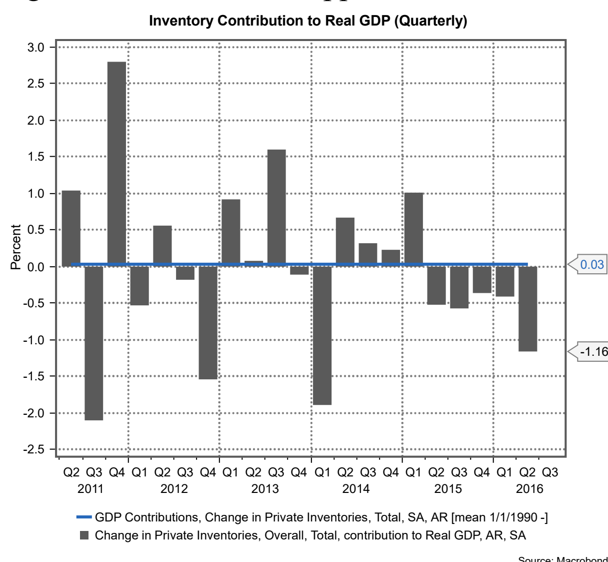
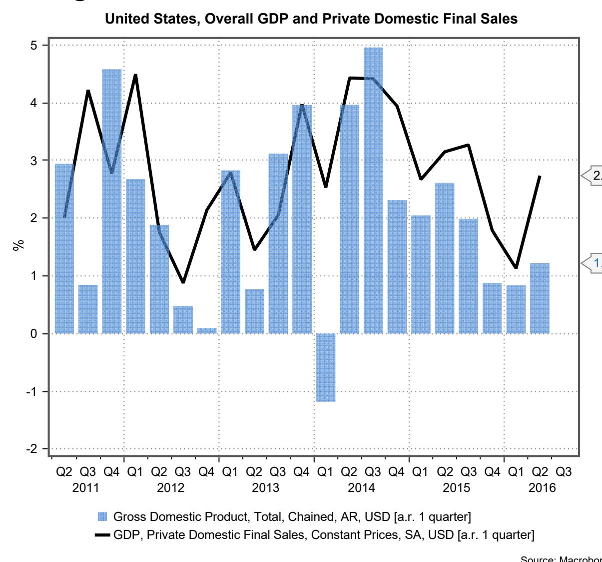


Figure 11: Private Sector Growth Solid



An **inventory** drawdown subtracted 1.2% from second quarter real GDP, substantially more than in recent quarters (Figure 10). Some of this was probably intentional, especially among

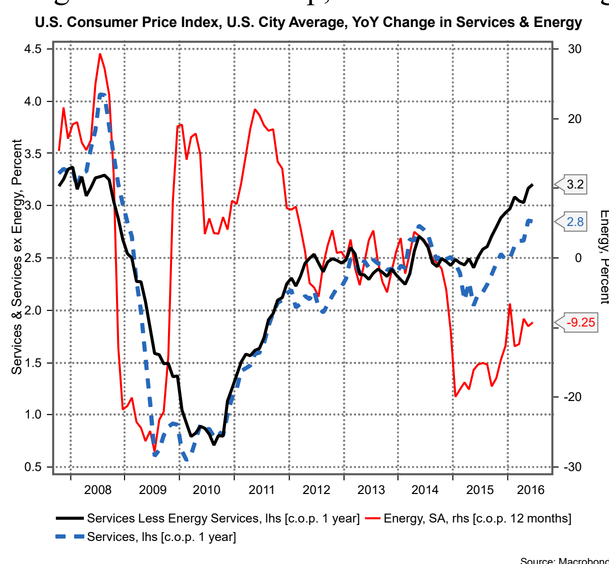
manufacturers, as investment spending has been lean. But lower inventories of consumer goods were probably unintentional – a result of unexpectedly strong consumer spending in Q2. We suspect that inventory growth will rebound over the next quarter or two, as an unusually large change in inventories is typically followed by an opposite, though not necessarily offsetting, change in short order.

Government consumption fell by 0.9% in the second quarter after rising 1.6% in Q1. Federal spending was about flat, while state and local spending eased 1.3%. Federal spending should grow under the current budget deal; the budget anticipates a wider deficit, and that is already visible in rising federal government debt relative to GDP (see Figure 14 below). We expect government consumption to turn modestly positive again over the balance of 2016.

Putting these sectors together, second-quarter real GDP growth of 1.2% added up as follows: Personal Consumption Expenditures (+2.83%), Residential Investment (-0.24%), Business Investment (-0.28%), Inventory Change (-1.16%), Net Exports (+0.23%), and Government Consumption (-0.16%). The first three components equal **Private Domestic Final Sales**, which grew by 2.7% during the quarter[4] and 2.2% YoY (Figure 11). Private sector growth, led by strong consumer spending, remains solid, and it is the basis for our expectation of continued moderate economic growth ahead.

Figure 12: Inflation Low, Pressure Building

Figure 13: Services Up, Oil Headwind Fading

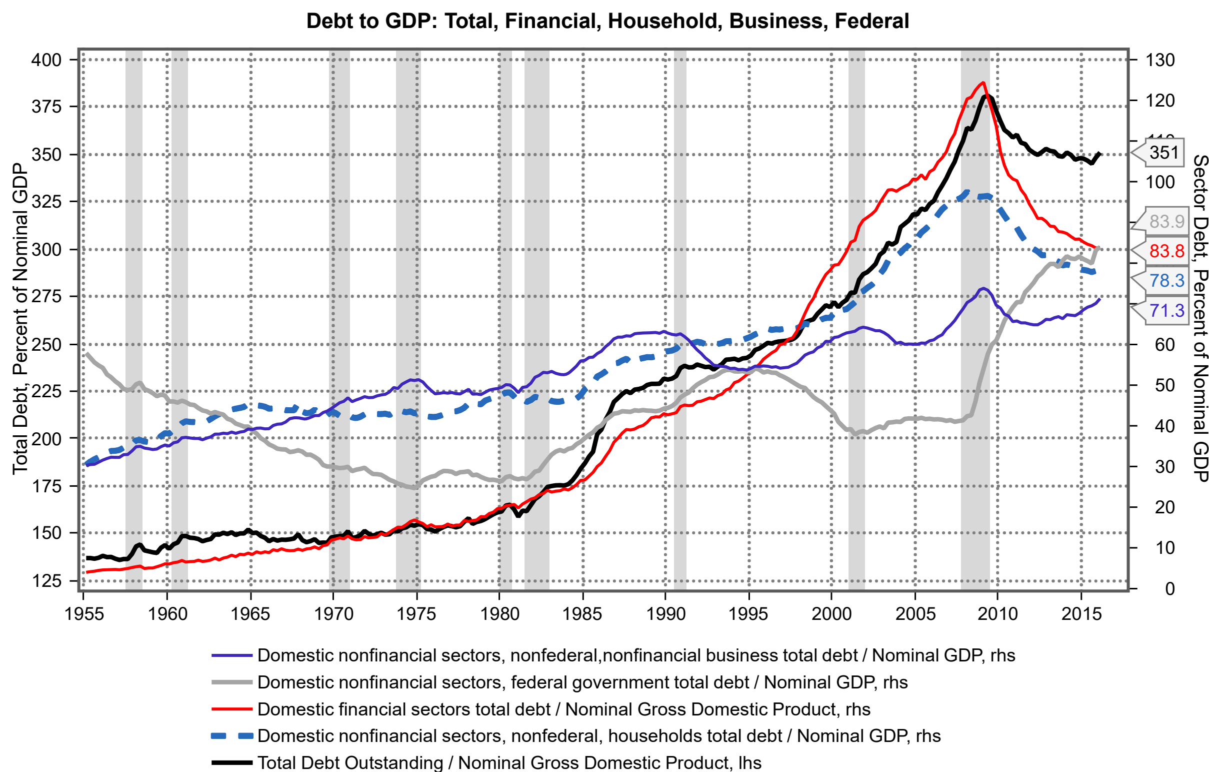


Inflation edged upward in the second quarter but remains low (Figure 12). Energy prices remain volatile. They rose about 7% (not annualized) in the second quarter, but oil prices dropped 14% in July, which should restrain headline inflation in the third quarter. Core inflation was stable or slightly higher. For 12 months ending in June, the consumer price index (CPI) was up 1.0% overall and up 2.3% excluding food and energy. Over the same period, the PCE deflator was up 0.9% overall and 1.6% excluding food and energy. Although globally-traded goods prices remain contained, service prices are accelerating (Figure 13). CPI's services excluding energy index is up 3.2% YoY in June, compared to 2.9% in December 2015. Although energy prices have

[4] These three GDP components sum to 2.3%, but their combined growth rate was 2.7% because the former rate's denominator is total GDP, which is larger than its subset, private domestic final sales.

weakened again recently, at some point they will stabilize. As that disinflationary impulse wanes, overall inflation should move up toward core inflation.

Figure 14: Leverage Edging Up in Most Sectors, but Government Borrowing Jumped



Finally, broad **balance sheet trends** in the U.S. deteriorated slightly over the past several quarters, primarily due to rising government debt (Figure 14). Overall debt-to-GDP rose to 351% in the first quarter (latest data available) from a recent low of 345% in 3Q2015. Leverage also rose slightly among households (78.3% debt-to-GDP) and sharply at the federal government (83.9%). Financial business leverage (83.8%) edged down. Nonfinancial businesses continued to increase borrowing as a share of GDP, rising to 71.3% of GDP, up from 68.6% a year ago and a low of 64.8% in 2012. As we have noted in the past, this sector includes energy producers, many of which borrowed heavily to expand when energy prices were much higher. Some of them will be unable to repay those debts. Defaults by highly-leveraged nonfinancial business borrowers are likely to continue at an elevated rate at least through the end of 2016, although investment-grade default rates should remain low.

Market Outlook

Long-term **Treasury rates** fell again in the second quarter as the Federal Reserve refrained from raising short-term interest rates and the United Kingdom voted to leave the European Union. The 30-year benchmark Treasury yield fell by 31 bp to 2.31% on June 30, and the 10-year Treasury note yield dropped by 29 bp to 1.49% (Figure 15). Ten- and 30-year yields were 1.55% and 2.30%, respectively, on August 2 – little changed from where they ended the second quarter.

There were two primary drivers of lower rates in the second quarter. First, GDP growth in Q1 turned out to be weaker than most economists' forecasts, which meant that Q2 growth needed to be substantially stronger to prompt the Federal Open Market Committee's (FOMC) to hike rates again. A weak payroll employment report for May (+38,000 jobs, subsequently revised down to +11,000 jobs), released on June 3, eliminated any chance of a rate hike at the June 14-15 FOMC meeting and reduced odds of a hike before September. Treasury bonds rallied.

Second, Britain's decision to leave the European Union on June 23, so-called "Brexit," increased market uncertainty and lowered near-term prospects for economic growth – most acutely in the UK and Europe but also globally. Although markets quickly recouped losses from the immediate aftermath of Brexit – in part due to expectations that central banks in Europe and the UK will ease policy in response – its impact on growth cannot yet be discerned. Because the Fed is approaching monetary policy from a "risk management" perspective, an uncertain, but likely negative, impact from Brexit on U.S. economic growth further reduced odds that the FOMC would tighten policy this summer. (Indeed, the Committee left policy unchanged at its July 26-27 meeting.)

As we indicated above, the FOMC kept monetary policy on hold in the second quarter and again in July. Current market rates reflect expectations that the Fed will raise rates very slowly and end tightening at a much lower rate than in earlier cycles, as forward rates in Figure 15 illustrate. While we agree with that idea, we continue to think market expectations are a little overdone. The U.S. labor market is getting closer to full employment, wage growth is accelerating, productivity growth is lackluster, core inflation (especially for services) is rising, and overall inflation will catch up eventually. We think the Fed will raise the fed funds rate at least once, maybe twice, in 2016. Accordingly, long-term interest rates should drift higher over the balance of 2016, and volatility is likely to remain high.

Figure 15: Rates and Forwards Down Again

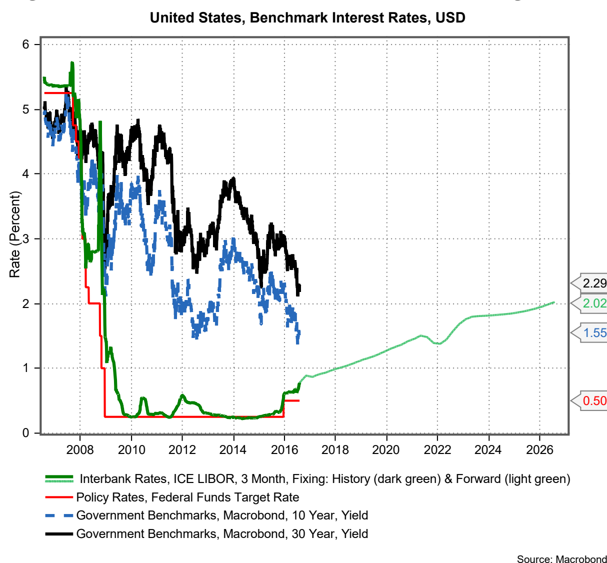
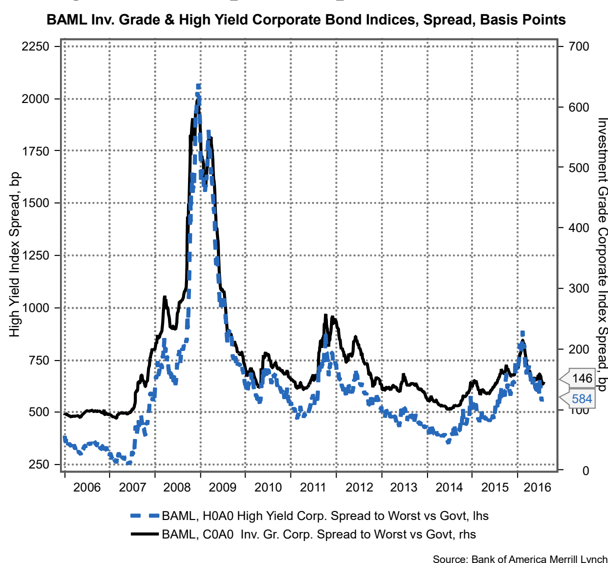


Figure 16: Corporate Spreads Narrower



Corporate **credit spreads** rallied strongly in the second quarter, and that rally has continued through today. Investment-grade corporate bond spreads[5] narrowed by 7 bp to 158 bp on June 30; spreads narrowed further to 146 as of today's close. High yield bond spreads[6] did even better, narrowing 81 bp to 631 bp on June 30 and tightening further to 584 bp on August 2 (Figure 16). This is in contrast to most other Treasury rallies since the financial crisis. Credit spreads have tended to widen when Treasury rates dropped, even when absolute yields on credit instruments fell. This substantial drop in credit spreads along with falling Treasury yields keenly illustrates a global hunt for yield that we have talked about for some time. With global monetary policy easy and in most places poised to get even easier, we do not see that hunt ending anytime soon.

Yield spreads on preferred securities were little changed during the second quarter. "Spread to Worst" on a broad Bank of America Merrill Lynch preferred securities index widened by 5 bp to 323 bp in Q2 and narrowed to 315 bp as of August 2.[7] Total return on the preferred index (+3.42%) was similar to the corporate index (+3.50%) but substantially lagged the high yield index (+5.88%) during the quarter.[8]

Fundamental **credit conditions** were mostly steady in the first quarter (latest data available), although commercial loan delinquencies and charge-offs continued to move up. Corporate profits stabilized and remain 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 remains high; and long-term debt to total debt is stable at a high level (Figure 18).

Figure 17: Corporate Profits Off but High

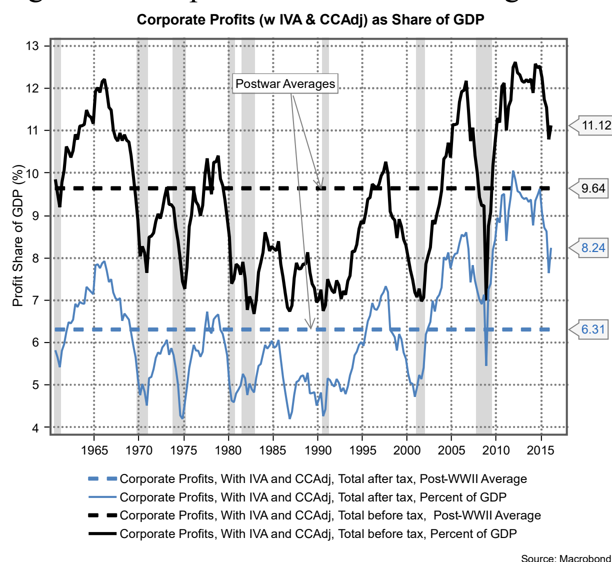
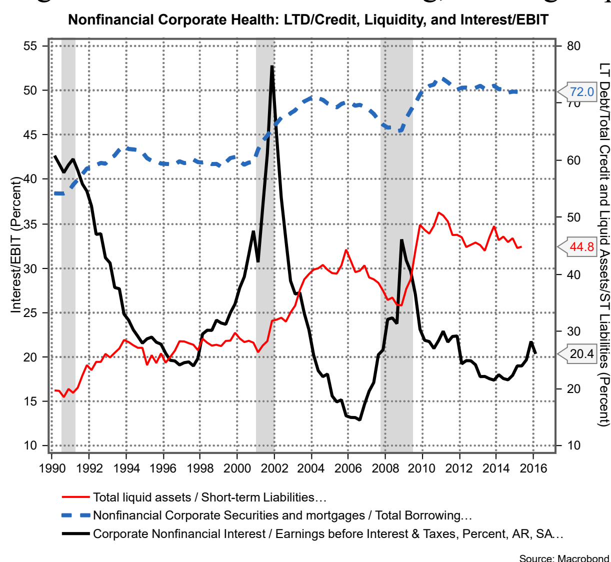


Figure 18: Balance Sheets Strong, Leverage Up



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[5] 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.

[6] 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.

[7] 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.

[8] Total return is not annualized and includes both price change and income.

Loan delinquencies and charge-offs were about flat overall, although delinquency rates on commercial and industrial loans continued to rise (Figure 19). Weaker loan performance is due largely to troubled energy loans, and we expect ongoing but manageable delinquencies and charge-offs there through 2017. Energy loans are not large enough to cause material credit deterioration at most banks, especially among larger issuers of preferred securities. Moreover, consumer, residential and most other commercial loan books continue to improve – and they are much larger than energy loan books. Overall, bank earnings should gradually improve, especially when short-term rates rise, and balance sheets are very strong.

Figure 19: Loan Quality Good, C&I Weaker

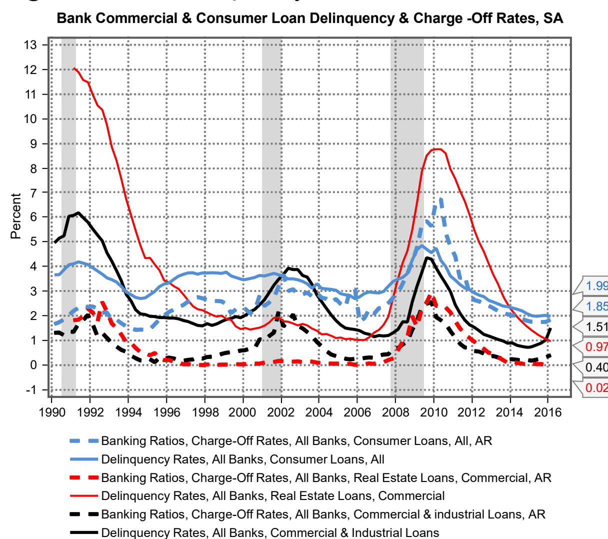
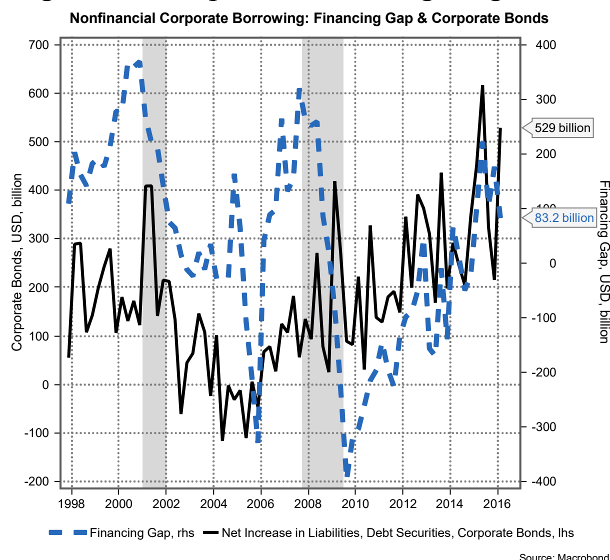


Figure 20: Corporate Borrowing Surged



We have been monitoring deterioration in overall borrowing requirements at nonfinancial corporations. Encouragingly, internally generated cash relative to spending on capital investments (the “financing gap”) at these companies improved in recent quarters after rising sharply last year (Figure 20). However, corporate bond issuance by these companies surged in response to strong investor demand and historically low rates (Figure 20). Bond issuance appears to have remained high in the second quarter. On balance, we put more weight on the financing gap as an indicator of possible credit excess than bond issuance. Corporations *must* raise cash from investors if they do not internally generate sufficient cash to finance operations. But they may issue corporate bonds for a number of reasons, including increasing liquidity (at relatively low cost) or paying down other borrowings. We are watching carefully, but for now we are not alarmed by the current high volume of corporate bond issuance, and we are pleased to see a narrower financing gap.

Looking ahead, we have lowered our expectation of 2.0-2.5% growth in 2016 to 1.5-2.0%; we continue to expect growth around 2% next year, although election uncertainty makes that forecast rather tentative. Regardless of that political outcome, the U.S. economy should continue to grow moderately. Although inflation eventually should climb 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.

We continue to believe the current macroeconomic environment is favorable for preferred securities. Credit quality, while deteriorating in spots, remains strong at most issuers of preferreds – especially banks. Higher interest rates may put some pressure on prices of preferred securities, but they also should benefit net interest margins at banks and finance companies and raise interest spreads at insurance companies – companies that comprise over 80% of the preferred market. Although yields on preferred securities are lower than where they started the year, we believe they still offer value in today's low-yield world.

Flaherty & Crumrine Incorporated
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