Flaherty & Crumrine Incorporated

Fourth-Quarter U.S. Economic Update

February 2018

Summary of Recent Economic Developments

The U.S. economy performed well in 2017 and is poised for still-faster growth in 2018. Fourth-quarter real GDP rose by 2.6%, which lifted annual growth to 2.5% in 2017. Economists expect real GDP to expand by 2.8% in 2018. Personal consumption expenditures snapped back after hurricane-related weakness in Q3. Personal income also rose solidly but failed to keep pace with consumption for a second consecutive year. Residential investment jumped in Q4 on hurricane rebuilding, but it grew only 2.3% in 2017. Home prices rose significantly faster than inflation, however, and we expect a stronger residential investment over the next several years. Business investment expanded briskly, up 6.8% in Q4 and 6.3% YoY. Tax reform should raise business investment over the next several years, which would help boost productivity and sustain economic growth as job growth slows. A wider trade deficit and slower inventory growth were sizable drags on fourth quarter real GDP. Government spending was a small positive for GDP in 2017 overall, but a recent budget agreement will make the federal government's contribution to GDP significantly higher in 2018 and 2019 – and exacerbate already-large budget deficits. Inflation picked up from mid-year but remained subdued. Treasury rates were little changed in Q4 but are up 40-50 bp since then. Markets now price in most of the rate hikes we anticipate through 2019. Credit fundamentals remain favorable. We think preferred securities continue to offer an attractive combination of good credit quality, high income and moderate interest-rate risk – although investors should anticipate lower returns than they provided in 2017.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	**2017:4**	**2017:3**	**2017:2**	**2017:1**	**2016:4**	**2016:3**	**2016:2**	**2016:1**
Real GDP, Chg QoQ (%, SA, AR)	2.6	3.2	3.1	1.2	1.8	2.8	2.2	0.6
Real Personal Consump Expnds, Chg QoQ (%, SA, AR)	3.8	2.2	3.3	1.9	2.9	2.8	3.8	1.8
Real Business Inv ex Stuctures, Chg QoQ (%, SA, AR)	8.2	7.9	6.6	5.3	0.8	0.9	4.0	-5.5
Real Residential Investmt, Chg QoQ (%, SA, AR)	11.6	-4.7	-7.3	11.1	7.1	-4.5	-4.7	13.4
Real Private Domestic Final Sales, Chg QoQ (%, SA, AR)	4.6	2.2	3.2	3.1	2.7	2.6	3.3	1.4
Nominal GDP, Chg QoQ (%, SA, AR)	5.0	5.3	4.1	3.3	3.8	4.2	4.7	0.8
Corporate Profits, After Tax, Chg YoY (%, SA, AR)	3.7f	7.7	7.8	3.7	14.1	-2.2	-8.0	-4.2
Nonfarm Productivity, Chg QoQ (%, SA, AR)	-0.1	2.7	1.5	0.1	1.3	2.5	0.8	-1.2
Nominal Personal Income, Chg YoY (%, AR)	4.1	2.9	2.4	3.4	1.6	2.4	2.5	2.8
Personal Savings Rate (%, SA)	2.4	3.0	3.6	3.9	3.2	4.5	5.1	5.7
Unemployment Rate (%, SA)	4.1	4.2	4.3	4.5	4.7	5.0	4.9	5.0
Nonfarm Payrolls, Chg QoQ (000, SA)	647	425	569	532	492	764	493	595
Household Employment, Chg QoQ (000, SA)	-303	1074	186	831	418	651	-65	1094
Federal Budget, 12-mo Def or Surp (% of GDP)	-3.5	-3.5	-3.7	-3.4	-3.1	-3.2	-2.9	-2.5
Consumer Price Index, Chg YoY (%, AR)	2.1	2.2	1.6	2.4	2.1	1.5	1.0	0.9
CPI ex food & energy, Chg YoY (%, AR)	1.8	1.7	1.7	2.0	2.2	2.2	2.2	2.2
Capacity Utilization (%, SA)	77.9	76.1	76.6	75.9	76.0	75.6	75.8	75.4
Rate or Spread (End of Quarter)	**2017:4**	**2017:3**	**2017:2**	**2017:1**	**2016:4**	**2016:3**	**2016:2**	**2016:1**
Federal Funds Rate Target (%)	1.50	1.25	1.25	1.00	0.75	0.50	0.50	0.50
3-month LIBOR (%)	1.69	1.33	1.30	1.15	1.00	0.85	0.65	0.63
10-Yr Treasury Note Yield (%)	2.41	2.32	2.30	2.39	2.43	1.59	1.49	1.78
30-Yr Treasury Bond Yield (%)	2.74	2.86	2.84	3.01	3.05	2.32	2.31	2.62
ICE-BofAML US Corporate Index Yield to Worst vs Gvt	97	104	112	120	126	138	158	165
10-Yr Interest Rate Swap Spread (bp)	-1.5	-4.5	-2.3	-0.8	-11.3	-14.0	-11.3	-14.0

* Figures are either quarterly or, if more frequent, end of period. f = Forecast[1] ; N/A = not available Source: Macrobond, Bloomberg LP

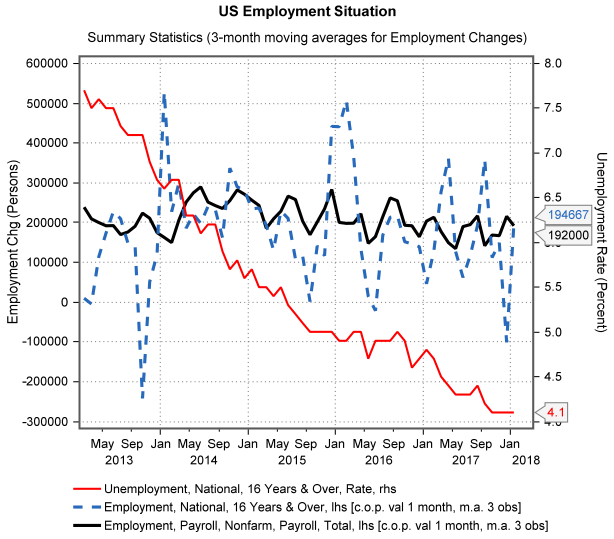
Legend for all Figures: AR = Annual Rate; SA = Seasonally Adjusted; MA = Moving Average; C.O.P. = Change over Period

Economic Outlook

The U.S. economy was buffeted in the fourth quarter by aftereffects of flooding in Texas, hurricanes in the Southeast and wildfires in California. Nonetheless, fourth-quarter inflation-adjusted gross domestic product (real GDP) rose by 2.6%, pushing annual growth to 2.5% in 2017 (Q4 to Q4) – at the top end of our 2.0-2.5% GDP forecast and a bit better than economists' consensus estimate of 2.3% starting 2017. Looking ahead, economists expect 2.8% real GDP in 2018, near the low end of our own 2.7-3.2% forecast.[1] For 2019, economists project 2.5% growth.

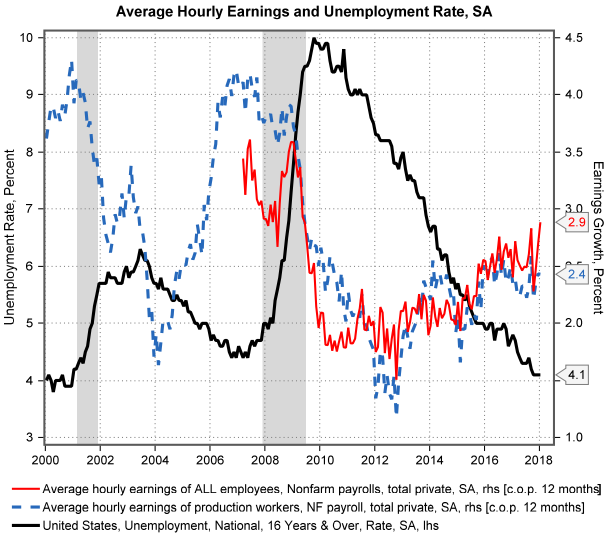
Our forecast of stronger economic growth in 2018 rests on four main expectations. First, the Tax Cut and Jobs Act of 2017, passed in December, will prompt greater business investment and further support recent improvement in labor productivity. Second, higher wages as businesses compete for workers will hold personal income growth a little above 4% (in nominal terms) even as job growth slows with the economy approaching full employment. Third, global economic activity – which the International Monetary Fund estimates expanded by 3.7% in 2017 – remains around current levels. Finally, we assume that immigration and trade policies do not lead to worker shortages or trade wars that damage U.S. and global growth.

Figure 2: Employment Growth Steady…



Source: Macrobond

Figure 3: …Wage Gains Accelerating?



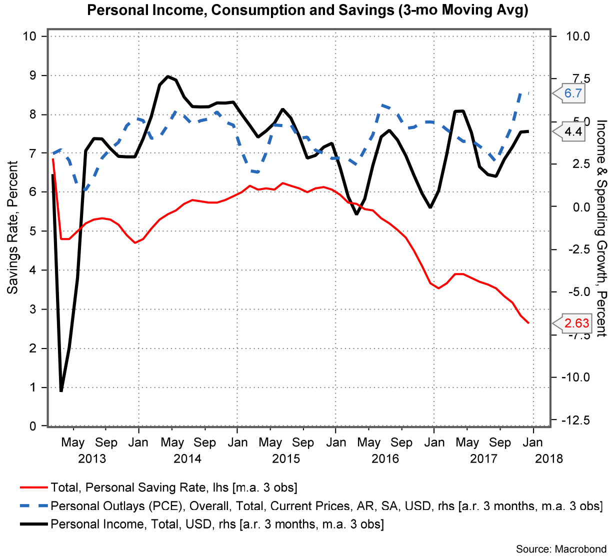
Source: Macrobond

The **labor market** bounced back strongly from hurricane-related weakness in the third quarter (Figure 2). Payroll jobs rose by an average of 215,000 jobs per month in Q4 and added another 200,000 in January 2018. The more-volatile household employment survey recorded job *losses* of 101,000 jobs per month in the fourth quarter, but strong January gains pushed the 3-month average up to about 195,000, almost identical to the payroll survey's 192,000 average over the same period. Both payroll and household job growth held steady at 1.5% YoY in January. While that was down from 2% less than two years ago, it still drove the unemployment rate down to 4.1%, the lowest rate since December 2000. Labor participation was flat at 62.7% in January, down from 62.9% a year ago.

[1] Unless noted otherwise, forecasts are from the *Survey of Professional Forecasters*, Federal Reserve Bank of Philadelphia, February 9, 2018 and Bloomberg® *U.S. Monthly Economic Survey*, February 8, 2018.

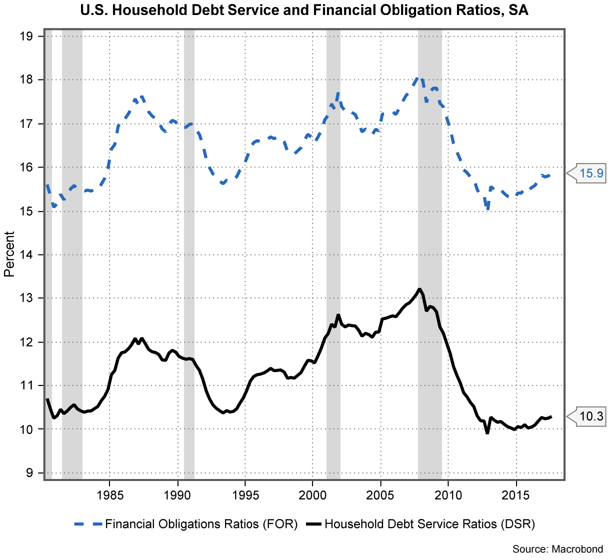
With job gains pushing the labor market closer to full employment, wages jumped in the fourth quarter. Average hourly earnings rose 2.7% YoY in December 2017 and 2.9% YoY in January 2018, up from 2.5% in mid-2017 (Figure 3). While this may (finally) mark an acceleration of wage gains after years of falling unemployment, we need to see those gains persist for a few more months before reaching that conclusion. We often have seen wages jump in the past, only for those gains to fade over following months. That may be especially true this year. Tax reform was cited as a reason for a number of firms to pay bonuses to their employees, which may have distorted wage figures around year-end. In addition, hourly wages for production workers rose by only 2.4% YoY, about where it's been for the past two years (dashed blue line in Figure 3). If wages continue to rise at a more-rapid pace over coming months, we'll be considerably more confident that a tightening labor market is responsible for higher wages – and therefore likely to persist. That has implications for personal income, monetary policy and inflation, which we discuss later in this Update.

Figure 4: Spending Outstripped Income



Source: Macrobond

Figure 5: Debt Burdens not Burdensome



Source: Macrobond

Personal income growth improved in the second half of 2017, rising 4.4% in Q4 and 4.1% over 12 months ending in December (Figure 4). Wage and salary income led the way in 2017 (+4.9%), but investment income (+4.1%) and proprietor's income (+4.3%) also made significant contributions. There is a good chance these income gains persist. If wages sustain recent gains, wage and salary income should at least maintain its current pace even as job growth inevitably slows. Tax reform should boost after-tax income of many "pass-through" businesses that report income on personal tax returns, which is included in proprietor's income. Finally, higher interest rates and rising corporate profits (in part due to tax reform) should support continued growth in investment income. We expect personal income growth above 4% in 2018.

Although income growth was solid, **personal consumption expenditure** (PCE) outpaced it. Nominal PCE rose 6.7% in the fourth quarter and 4.6% YoY in December – both faster than personal income over the same periods (Figure 4). After inflation, real PCE rose 3.8% in Q4 and 2.8% YoY, equal to its 2016 pace. A strong labor market, high consumer confidence and rising wealth from higher stock and home prices brightened consumers' spirits. Spending on goods and services to repair or replace items damaged or destroyed in hurricanes, floods and fires likely added to Q4 spending, although that should not be repeated over quarters ahead.

While consumer spending was an economic bright spot in 2017, it cannot run so far ahead of income indefinitely. As of December 2017, the personal **savings rate** fell to 2.4%, down from 3.2% and 5.8% one and two years prior; it averaged 2.6% in Q4. We'll start by saying that we are not worried about a lower savings rate from a credit perspective. Consumer balance sheets are strong. Debt service (interest expense relative to disposable income) and financial obligation (which adds lease and rent obligations) ratios have risen only slightly over the past several years and remain low historically (Figure 5).

However, an aging population needs more savings, not less. Moreover, periods of unusually high investment returns tend to be followed by periods of lower returns. Banking on continued outsized gains to support current spending is bound to end in disappointment. We expect that consumer spending will trend back down around – and eventually below – personal income growth. That would still mean solid consumer spending, but it is likely to be a mild headwind to economic growth in 2018.

Figure 6: Housing Mixed, but Prices Up

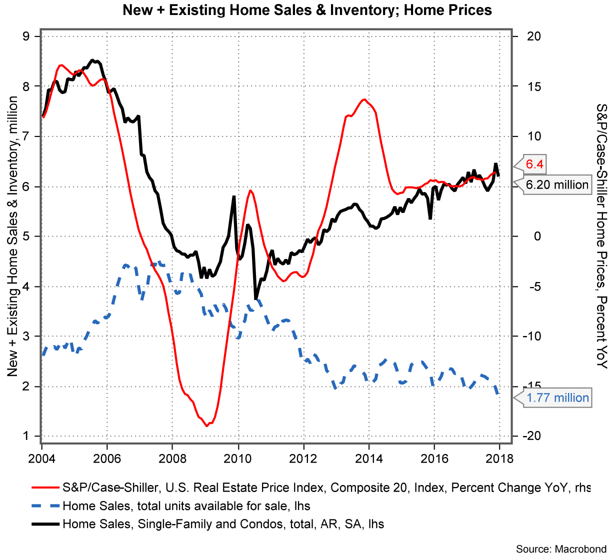
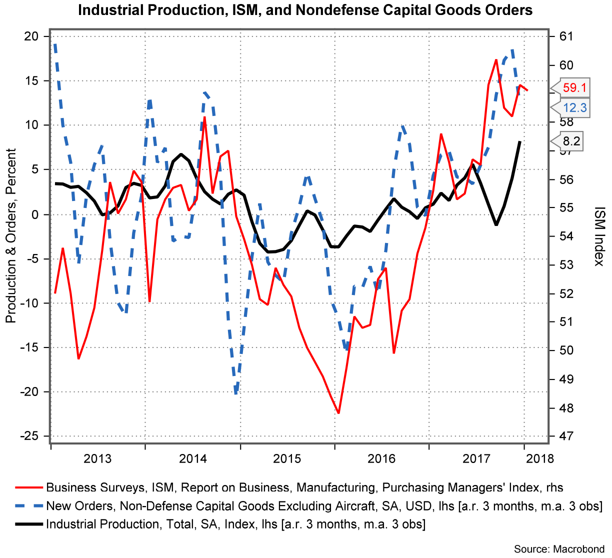


Figure 7: Manufacturing Surged

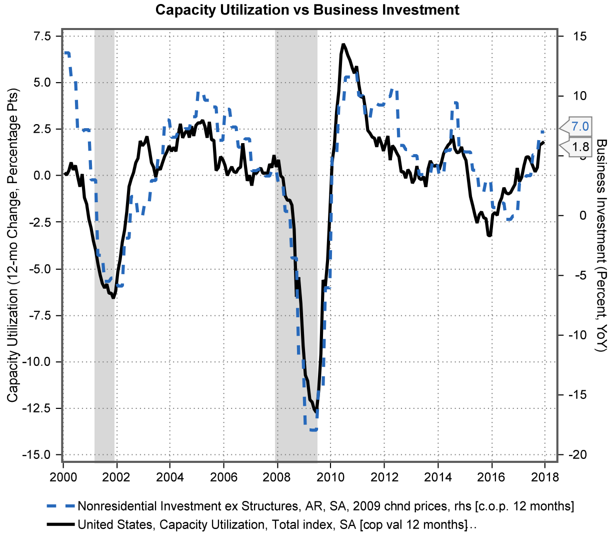


The **housing market** turned in a mixed performance in 2018, with expansion in Q1 and Q4 and contraction in Q2 and Q3. Residential investment jumped 11.6% in the fourth quarter – partly due to hurricane rebuilding – but rose an unremarkable 2.3% over the past four quarters. New and existing home sales ended 2017 running at a 6.2 million unit pace and averaged 6.16 million units for the full year (Figure 6). Firm demand and low inventories of unsold homes pushed up home prices considerably faster than inflation. The S&P/Case-Shiller 20-city home price index rose 6.4% YoY in November 2017 (latest data available), a bit faster than the past several years.

Higher home prices have prompted more home construction. The number of U.S. households is estimated to have grown by about 1.3 million in 2017.[2] Where did they find housing? There were 612,000 sales of newly built homes in 2017, up about 9% from 2016. Overall housing unit completions in 2017 (including rental units) totaled 1.15 million. In the housing bust's wake, households shifted into rentals, and the homeownership rate fell steadily from 69% in late 2006 to just under 63% in 2Q2016. It has since begun to rebound and rose to 64.2% in 4Q2017, signaling a renewed preference for residential ownership. We think there is still a housing supply gap to be filled, and we expect residential investment to post stronger gains over the next several years.

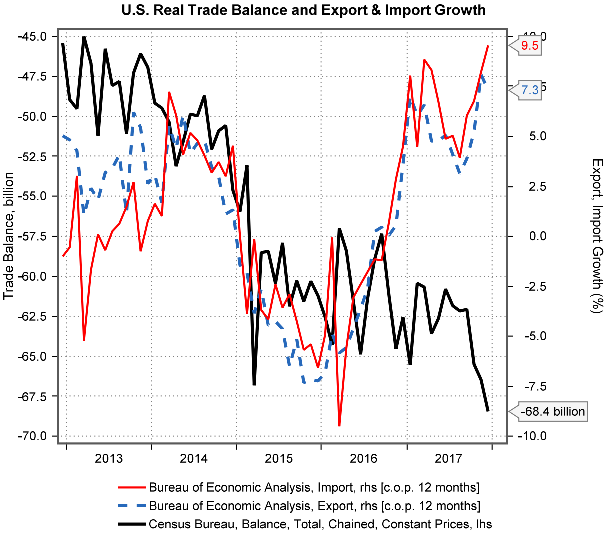
Industrial production rose 8.2% in the fourth quarter and 3.6% YoY, with all major segments contributing to higher output (Figure 7). Manufacturing was up 7.3% for the quarter and 2.6% YoY. Utility output rose 10.3% QoQ and 1.8% YoY. And mining, which includes oil and gas extraction, jumped 12.7% in Q4 and 8.4% YoY in response to continued strength in energy and non-agricultural commodity prices. The Institute for Supply Management's manufacturing survey slipped to 59.1 in January, but it remains near its recent peak and suggests further gains in output. In addition, orders for core capital goods (nondefense, excluding aircraft) surged by 12.3% in Q4, partly due to hurricane rebuilding. While these heady gains are likely to moderate over coming quarters, tax reform should drive additional business investment and support continued expansion in industrial output.[3]

Figure 8: Business Investment Gains Strength


Capacity Utilization vs Business Investment

Source: Macrobond

Figure 9: Wider Deficit Despite Higher Exports


U.S. Real Trade Balance and Export & Import Growth

Source: Macrobond

Real **business investment** rose 6.8% in the fourth quarter and 6.3% YoY, which was about twice as fast as we anticipated coming into 2017. A steady rise in capacity utilization drove sizable investment in business equipment and intellectual property; "core" business investment was up

[2] According to the U.S. Census Bureau, there currently are about 120 million U.S. households, and that number has grown by an average of 0.8% annually since 2010. That pace tends to rise (and fall) with employment growth: More people working means fewer people living in parents' basements.

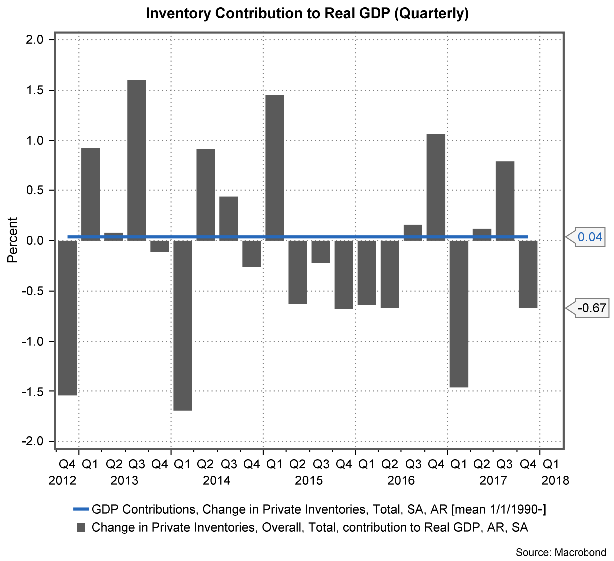
[3] Tax reform provides for immediate expensing of many capital expenditures, which should accelerate business investment. A lower corporate tax rate increases the after-tax return on investment, which should further boost investment spending.

8.2% in Q4 and 7.0% YoY (Figure 8). We expect business investment to be a bright spot again in 2018.

Although net exports added to real GDP for most of 2017, the **trade deficit** widened sharply in the fourth quarter (Figure 9). Net exports subtracted 1.1% from real GDP growth in Q4 and about 0.1% from 2017 real GDP. Import growth accelerated to 9.5% YoY, its strongest pace since 2011, which more than offset a 7.3% gain in exports as global growth improved. Strong consumer spending boosted imports of consumer goods, and business investment drove demand for capital goods. Recent trade deterioration is somewhat surprising in light of a weaker U.S. dollar in 2017, declining energy imports, and improving export growth. However, with U.S. economic growth poised to improve further, net exports could remain a modest drag on growth in 2018.

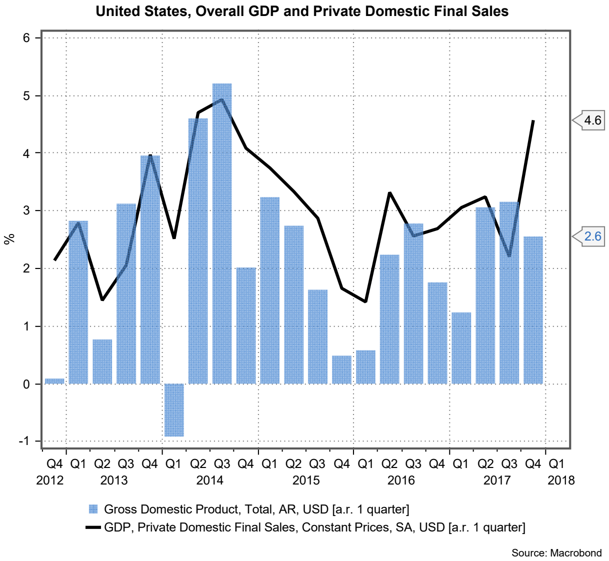
Inventories subtracted 0.7% from fourth quarter real GDP after adding a similar amount in Q3 (Figure 10). Although inventory growth is often volatile quarter-to-quarter, it generally has minimal impact on long-term GDP, averaging just +0.04% growth contribution since 1990. With growth improving, we expect some inventory rebuilding in 2018, but it is not a major factor in our outlook.

Figure 10: Inventories Unwind Q3 Buildup



Source: Macrobond

Figure 11: Private Sector Growth Solid



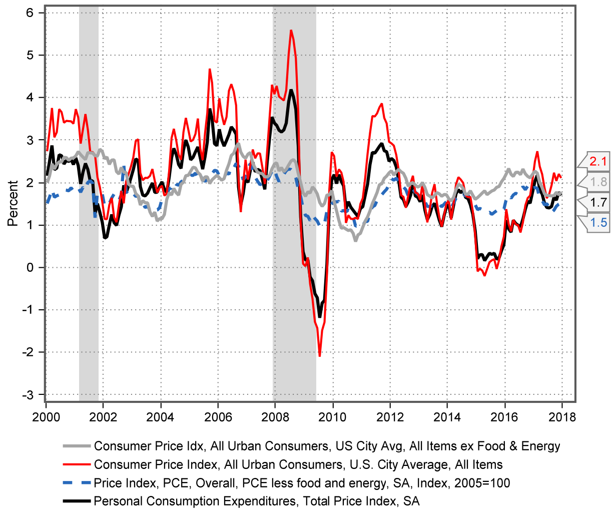
Source: Macrobond

Government consumption accelerated in the fourth quarter, all due to higher defense spending. Federal spending was up 3.5% in Q4 and 1.1% YoY. State and local spending rose 2.6% in Q4 and 0.5% YoY. Looking ahead, growth in state and local spending will probably face higher taxpayer resistance in light of tax reform's new $10,000 annual limitation on deductibility of state and local taxes on individual federal tax returns, beginning in 2018. We expect slow state and local spending growth to continue. However, federal government spending is slated to pick up under a budget agreement signed into law in early February 2018. The new budget expands government spending by $296 billion (split roughly 55% defense and 45% nondefense) spread out over the next six fiscal years, mostly in 2018-2020. We estimate the bill will add 0.4% and 0.8% to real GDP growth in 2018 and 2019, respectively. It also will add to wider budget deficits already in store from tax reform. Combining the impact of tax reform and the new budget deal, we estimate that *annual* deficits will exceed $1 trillion in FY2019, and grow from there.[4] Of course, faster economic growth – which we expect – may reduce those deficits, or at least make them more manageable. However, the current deficit trajectory is unsustainable and remains a risk to the longer-term outlook.

Getting back to the present economic situation, fourth-quarter real GDP growth of 2.6% adds up as follows: Personal Consumption Expenditures (+2.58%), Residential Investment (+0.42%), Business Investment (+0.84%), Inventory Change (-0.67%), Net Exports (-1.13%), and Government Consumption (+0.50%). The first three components equal **Private Domestic Final Sales**, which grew by 4.6% during the quarter[5] and 3.3% over the past year (Figure 11). Private sector growth was led by consumer spending and business investment, with a more modest contribution from residential investment. To reiterate, we expect housing to improve and business investment to remain strong in 2018, although we expect some moderation in PCE as consumers seek to boost savings.

Figure 12: Inflation Pressure Still Subdued

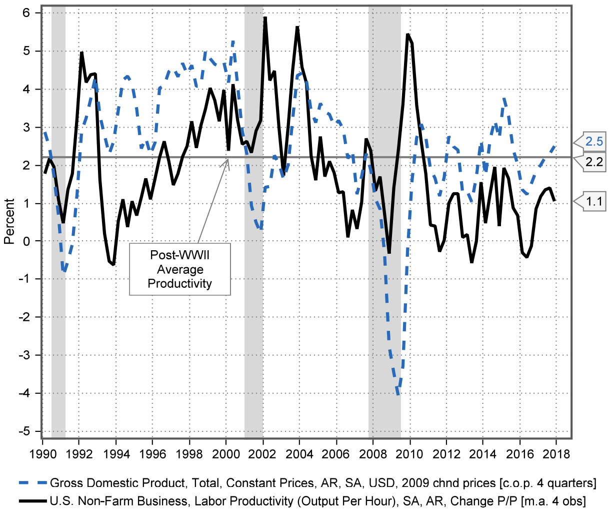
United States, Overall and Core Inflation Indices, Change Year-Over-Year



Source: Macrobond

Figure 13: Productivity Set to Accelerate

Labor Productivity, United States, AR, SA



Source: Macrobond

Inflation picked up a bit in the second half of 2017, although core inflation remains stubbornly low (Figure 12). For 12 months ending in December, the consumer price index (CPI) was up 2.1% overall and 1.8% excluding food and energy. Although higher than at mid-year, YoY CPI overall was unchanged from a year ago and 0.4% *lower* excluding food and energy. The Federal Reserve's preferred inflation gauge, the PCE deflator, was up 1.7% overall and 1.5% excluding food and energy over 12 months ending in December 2017, down from 1.8% and 1.9%, respectively, in December 2016. A rebound in productivity may be having a moderating impact on service inflation, which exceeded 3% in 2015 and 2016 when productivity was weak but has retreated to 2.6% with productivity improving again.

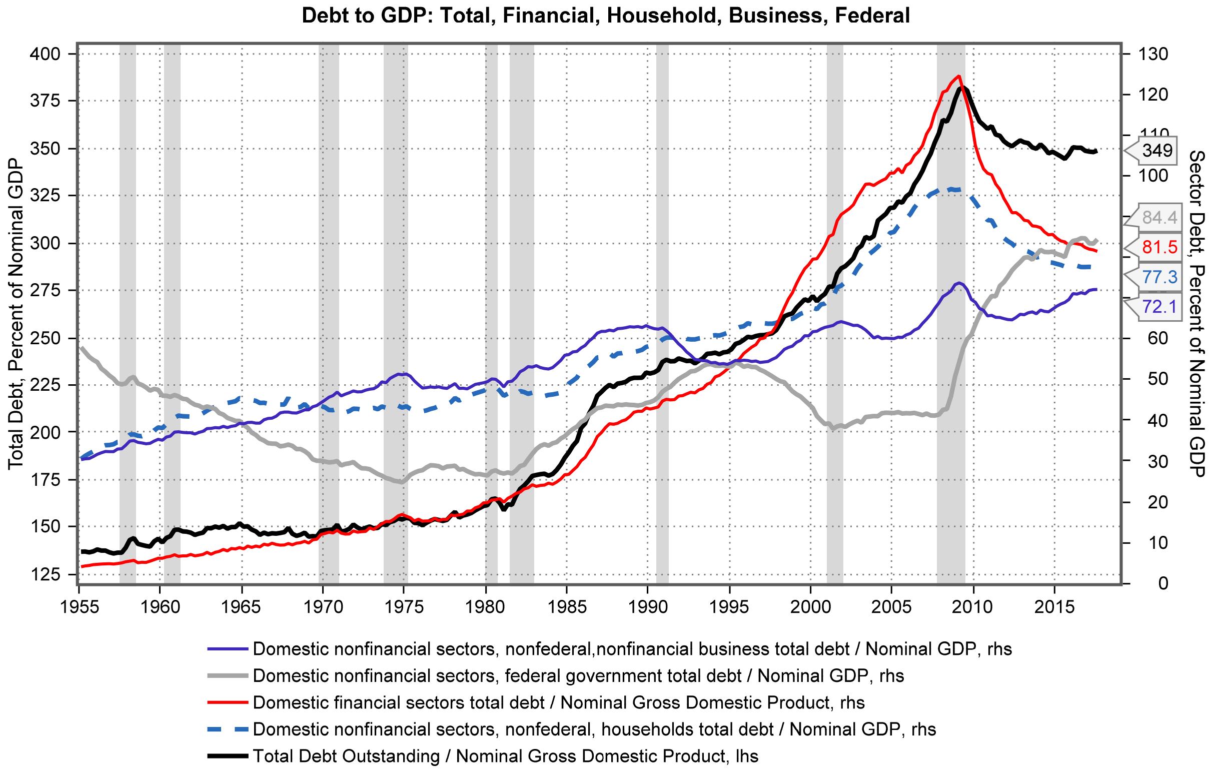
[4] Congressional Budget Office (CBO), June 2017 *10-Year Budget Projections* as baseline adjusted for recent CBO deficit estimates for the Tax Cut and Jobs Act of 2017 and the Bipartisan Budget Act of 2018; our calculations.

[5] These three GDP components sum to 3.8%, but their combined growth rate was 4.6% because the former rate's denominator is total GDP, which is larger than its subset, private domestic final sales.

Higher **productivity** will be needed to achieve faster economic growth without substantially higher inflation. Output can be described as a function of labor input (hours worked), capital input (business and government investment), and multi-factor productivity (how effectively labor utilizes capital investment). The latter two inputs comprise overall productivity. Taking these three inputs in turn, employment growth has slowed as the economy approaches full employment. Although declining labor participation could suddenly reverse and boost worker availability, demographic trends suggest that's unlikely.

The outlook for investment, as described above, is more favorable. Corporate tax reform should encourage greater investment and allow companies to allocate profits earned overseas into U.S. domestic investments without a sizable tax penalty. There is a lag involved in this relationship – investments have to be made before output increases – so we are not troubled by a relatively modest increase in productivity in 2017 (Figure 13). Higher capital input should drive higher productivity over time. Multi-factor productivity is very difficult to forecast. However, with technology advancing at a rapid pace, we would not be surprised to see substantial improvement in this component of productivity. Finally, productivity has tended to mirror growth in real GDP (Figure 13), and we expect faster GDP growth this year. We could soon see a return to 2% overall productivity growth over coming quarters.

Figure 14: Leverage About Steady, but Government Borrowing Poised to Rise



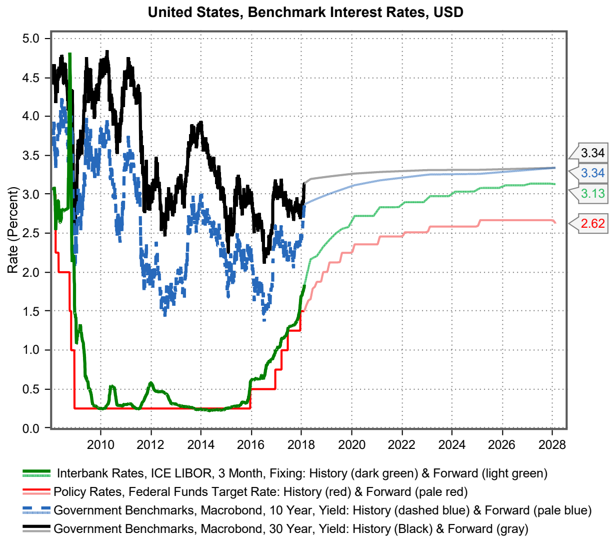
Source: Federal Reserve Flow of Funds Report (Z1)

As shown in Figure 14 above, broad **balance sheet trends** in the U.S. were again little changed the third quarter of 2017 (latest data available). Overall debt-to-GDP was 349%, down slightly from 350% at the end of 2016. Leverage at households continued to edge lower (77.3% debt-to-GDP) as mortgage debt grew more slowly than GDP even as consumer debt expanded. Financial business leverage (81.5%) also fell, albeit at a slower pace than a couple of years ago. Federal government debt (84.4%) rose on higher spending, and it is projected to rise more rapidly over coming years. Nonfinancial businesses leverage held steady at 72.1% of GDP as rising corporate profits limited external funding needs despite sizable investment outlays. We remain watchful on leverage, but government debt is the sector that probably bears most scrutiny over the next several years.

Market Outlook

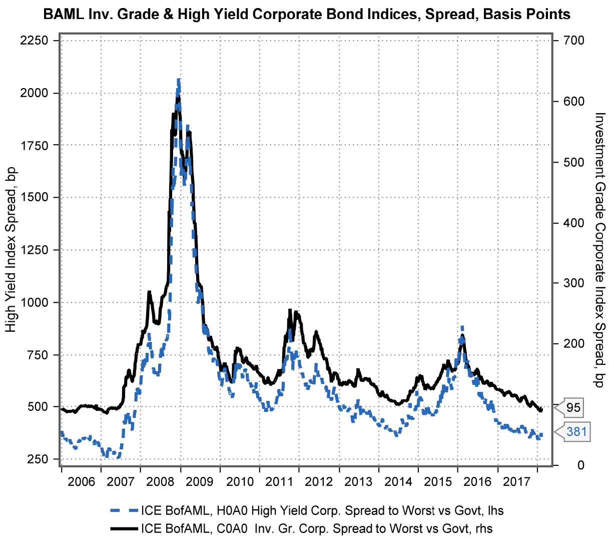
Long-term **Treasury rates** were mixed in the fourth quarter despite solid economic growth, passage of tax reform and continued tightening by the Federal Reserve. The 30-year benchmark Treasury yield fell by 12 basis points (bp) to 2.74% on December 29, while the 10-year Treasury note yield rose by 9 bp to 2.41% (Figure 15). Ten- and 30-year yields were 2.84% and 3.13%, respectively, on February 12 – considerably above where they ended 2017.

Figure 15: Rates Higher; Forwards Flatter



Source: Macrobond (historical rates), Bloomberg (forwards)

Figure 16: Corporate Spreads Mixed



Source: Bank of America Merrill Lynch

The Federal Open Market Committee (FOMC) hiked short-term rates by 25 bp three times in 2017, most recently at its December 12-13 meeting. The Fed also implemented previously-announced plans to reduce its holdings of Treasuries and mortgage-backed securities.[6] The Fed is shrinking its portfolio by gradually reducing reinvestment of maturing securities. That began in October 2017 at $10 billion per month (60% in Treasuries and 40% in mortgage-backed and agency securities) and stepped up to $20 billion per month (same proportions) in January 2018. The Fed plans to increase the pace of portfolio reductions by $10 billion every three months until it reaches $50 billion per month, which would occur in October 2018 on the current timetable. Therefore, investors will have to absorb a larger quantity of those securities as time passes. A smaller Fed portfolio is *intended* to raise interest rates and tighten financial conditions – just as quantitative easing was designed to lower interest rates and ease financial conditions. Portfolio reductions so far have not been large enough to cause market indigestion. That could change as

[6] See "FOMC Communications related to Policy Normalization" on the Federal Reserve's website for details. Available at: https://www.federalreserve.gov/monetarypolicy/policy-normalization.htm

reductions increase, however, especially since wider budget deficits already mean more Treasury supply for investors – although we think the Fed would scale back its planned portfolio reduction if market reaction were to turn meaningfully adverse.

As illustrated in Figure 15, markets currently price in about 60 bp of rate hikes in 2018, bringing the fed funds rate to about 2.0% by year-end. That is 15 bp less than the Fed's December 2017 median projection of three 25 bp moves. Thereafter, markets price in one additional 25 bp rate hike in 2019 and a fed funds rate of about 2.35% at the end of 2020, well below the FOMC's projections of 2.7% and 3.1% at the end of 2019 and 2020, respectively.

Although market rates have now moved up very close to forecasts we first articulated in our second-quarter Update[7], our U.S. economic growth forecast for the next several years has increased in the wake of tax reform and stronger than expected global economic growth. We now anticipate 75 bp of rate hikes in 2018 (fed funds rate target to 2.0-2.25% at year-end), with the risk of an additional rate hike greater than the risk of one less. We expect one 25 bp rate hike in 2019, as somewhat slower economic growth, rising Treasury supply and sharply reduced (-$600 billion annualized) portfolio reinvestment combine to tighten financial conditions without more aggressive rate hikes by the FOMC. Forward curves already reflect all but about 15 bp of those increases. As a result, we think intermediate Treasury rates will rise only moderately from current levels – perhaps by 25-50 bp over that horizon.

Corporate **credit spreads** were stable to slightly lower yet again in the fourth quarter, as relatively stable benchmark rates and rising corporate profitability attracted more investors to credit investments. Investment-grade corporate bond spreads[8] narrowed by 7 bp to 97 bp on December 29; spreads narrowed slightly further to 95 bp as of February 12, although yields were higher given higher Treasury rates. High yield bond spreads[9] were little changed in Q4, closing at 369 bp (+2 bp for the quarter), but they widened to 381 bp today (Figure 16).

Spreads on preferred securities are more difficult to illustrate. Nearly all preferred securities are callable, and yield-to-worst often understates economic yield when prices are above par – as most are today – because not all of those securities will be called by their issuers on first call date. Yields on newly-issued preferred securities (priced at par) may give a better indication of yield and spread. In December 2016, five rated U.S. dollar preferred securities were issued with a weighted-average yield of 6.11% and a weighted-average spread to Treasuries of 403 bp.[10] In December 2017, there were three new issues with a weighted-average yield of 5.25% and a weighted-average spread to Treasuries of 249 bp. By that measure, preferred spreads narrowed by 154 bp in 2017, compared to 29 bp and 325 bp for investment grade and high yield corporate bonds, respectively. For the fourth quarter of 2017, total return on the ICE BofAML preferred

[7] We previously expected 50 bp of rate hikes in 2018 and another 25 bp in 2019, bringing the fed funds target to 2.0-2.25% at the end of 2019.

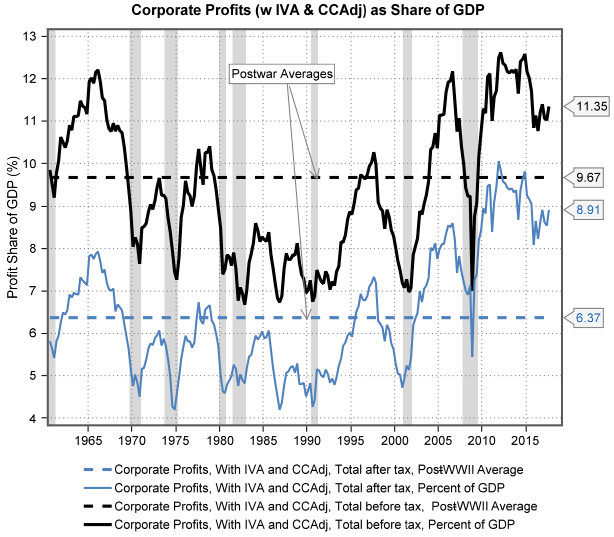
[8] Investment-grade corporate bond spread is represented by the ICE BofAML U.S. Corporate Index^{SM} (C0A0) "Yield to Worst versus Government" yield spread series. "Spread to Worst" is the lower of yield to call and yield to maturity minus yield on a comparable Treasury security.

[9] Below-investment-grade corporate bond spread is represented by the ICE BofAML U.S. High Yield Index^{SM} (H0A0) "Yield to Worst versus Government" yield spread series.

[10] Includes issues rated BB- or higher by one or more of Moody's, Standard & Poor's and Fitch.

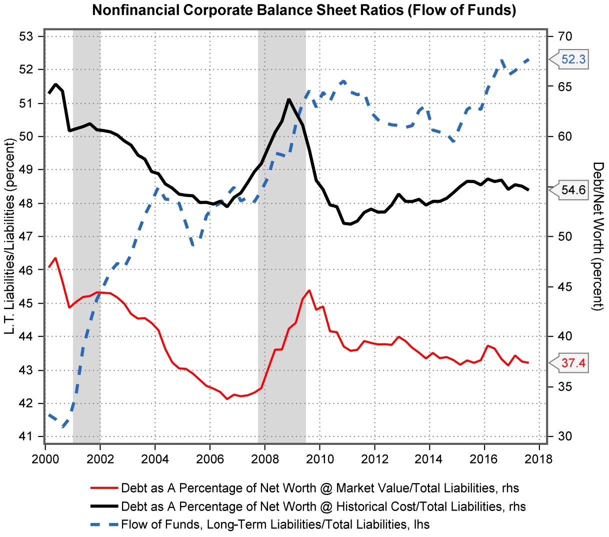
index[11] (+1.48%) fell between returns on the corporate (+1.37%) and high yield (+2.04%) indices.[12] For all of 2017, those indices returned 10.80%, 6.48%, and 7.48%, respectively.

Figure 17: Corporate Profits Rising Again



Source: Macrobond

Figure 18: Balance Sheets About Steady



Source: Macrobond

Fundamental **credit conditions** were stable in the third quarter of 2017 (latest data available), and banks' most recent earnings reports suggest that loan performance improved a bit since then. Corporate earnings rose strongly: up 7.7% in the third quarter compared to a year earlier, and they are expected to be up 3.7% YoY in Q4. Profits remain relatively high as a proportion of GDP, and tax reform – which reduced the federal corporate tax rate from 35% to 21% – should raise that in 2018 – at least on an after-tax basis. Over time, competition for workers along with higher margins from lower tax rates are likely to boost wages and push the after-tax profit share of GDP back toward its long-term average (Figure 17).

As noted earlier, leverage at nonfinancial companies was about steady relative to overall economic activity in the third quarter, and it fell relative to (rising) market value (Figure 18). Companies continued to take advantage of low interest rates to increase the proportion of long-term liabilities (bonds, mortgages and direct investments) on their balance sheets, which may reduce interest-rate sensitivity that companies would feel with more short-term debt. Interest expense as a percentage of earnings before interest and taxes remains historically low and has been steady at about 19% for the past two years. Higher corporate profits should mostly offset higher interest rates, at least for the next several years.

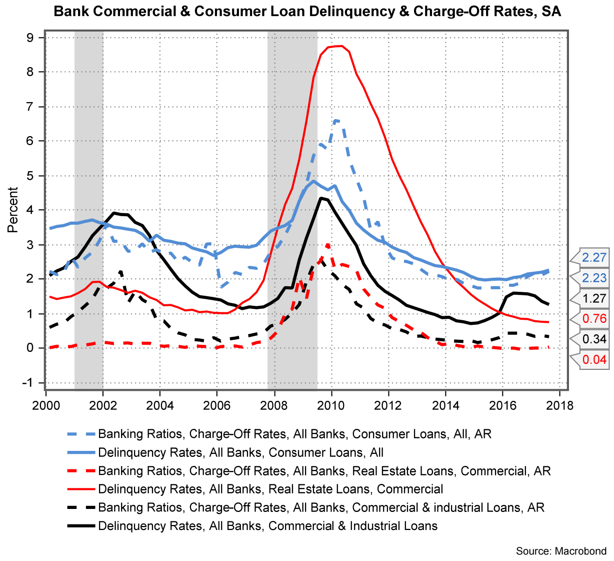
Loan delinquencies and charge-offs were about flat overall in the third quarter, and fourth-quarter bank earnings revealed steady or slightly fewer credit problems at most banks. Delinquency rates on commercial and industrial loans continued to drift lower, while consumer loan delinquencies and charge-offs again rose slightly (Figure 19). Those shifts roughly offset one-another in aggregate. With short-term interest rates up, bank earnings improved, and additional gradual rate hikes should further boost bank earnings. We expect most of these earnings to be distributed to

[11] Preferred index is the ICE BofAML 8% Constrained Core West Preferred & Junior Subordinated Securities Index^{SM} (P8JC).

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

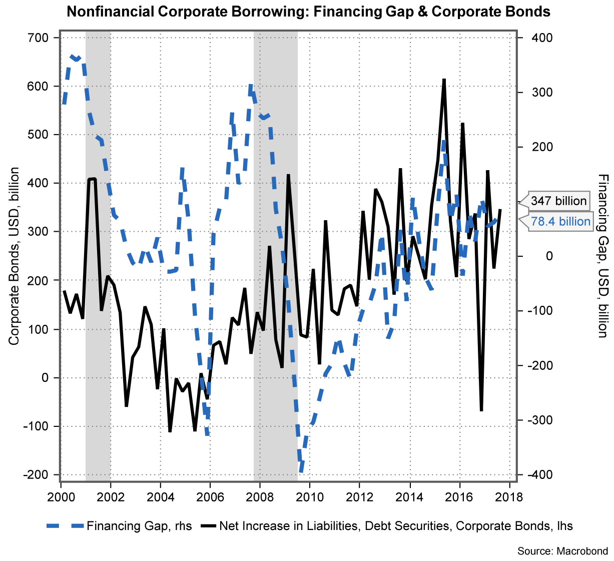
shareholders through dividends and share repurchases. Banks will retain capital to support balance sheet growth, but we think a long period of capital accumulation at banks has transitioned to one of overall stability. We remain watchful for signs of financial excess, but aside from the stunning rise in the prices of some crypto-currencies, we do not see them.

Figure 19: Loan Quality Good but Mixed



Source: Macrobond

Figure 20: Financing Gap Held Steady



Source: Macrobond

Internally generated cash relative to spending on capital investments (the “financing gap”) at nonfinancial businesses edged down in in 2017 (Figure 20). Nonfinancial companies generated less cash from operations than they used to make new capital investments (i.e., the financing gap was positive), but the gap remains relatively low and is well below levels that signaled credit excesses in the past. Corporate bond issuance was relatively modest as a result. Looking ahead, we expect corporate borrowing to increase moderately in 2018 as companies boost investment spending, but higher after-tax corporate profitability should keep credit metrics favorable.

To summarize our main views, we expect real GDP to expand by 2.7-3.2% in 2018, substantially above a 2.2% average rate since the recovery began in June 2009. Consumer spending should moderate in 2018 as consumers rebuild savings, but we think that would extend the expansion rather than end it. Business investment, spurred by tax and regulatory reform, is likely to lead economic growth again, and residential investment also should pick up after a lackluster 2017. Government spending is set to rise over the next several years, although prospects for sharply higher federal budget deficits cloud longer-term outlooks for the economy and interest rates. We are hopeful that higher business investment and regulatory reform will boost productivity and enable faster economic growth without substantially higher inflation. Stronger economic growth would make deficits both smaller (as tax revenues increase) and more manageable relative to a larger economy.

There are plenty of risks surrounding that optimistic view, however. We believe the FOMC is mindful of those risks, especially as financial conditions tighten. By year-end 2018, we expect the fed funds rate to be a little over 2% (roughly zero percent after inflation), followed by a substantially slower pace of tightening thereafter, which should push long-term rates only modestly above current levels.

For preferred investors, we see this outlook as mixed news. Credit fundamentals are very strong, especially at financial institutions, and higher economic growth should support credit spreads. Although the interest rate environment is less benign than it was last year, we think much of the adjustment in intermediate- and long-term interest rates has already occurred, and we anticipate only modestly higher yields over the next several years. On balance, we think preferred securities continue to offer an attractive combination of good credit quality, high income and moderate interest-rate risk – although investors should anticipate lower returns than they provided in 2017.

Flaherty & Crumrine Incorporated
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