U.S. Mid-year Economic Update
July 2004

Summary of Recent Economic Developments

Economic growth in the United States surprised most economists to the upside in the first quarter (4.5% GDP growth) and to the downside in the second quarter (3.0%). Private forecasts center around 4-4¼% real GDP growth in the second half of the year. Employment, which lagged the recovery last year and early in 2004, has surged recently, with more than 1 million nonfarm payroll jobs added from March through June. Most economic surveys as well as jobless claims and help-wanted figures point to continued employment growth over the coming months. Job creation had been the critical risk to the sustainability of the economic expansion, since most personal income (and hence support for personal consumption, which represents 70% of economic activity) comes from wages and salaries. With that risk now receding, the economic outlook has solidified, although persistently high oil prices represent a new risk factor to growth going forward.

Inflation has also accelerated faster than expected due to slowing productivity growth, tighter labor markets, higher energy and commodity prices, and a weaker dollar. For example, year-on-year consumer price inflation through June is now up 3.3% overall and 1.9% excluding food and energy, compared to 1.8% and 1.1%, respectively, at the end of 2003. Some of the pickup in inflation surely is due to the surge in commodity and energy prices over the past several years. While most commodity prices appear to have peaked, oil and other energy prices remain persistently high – and are poised to move higher still on any meaningful disruption of supplies. In addition, rising employment and slowing productivity growth, in combination with a somewhat weaker dollar and some residual commodity inflation pass-through to consumer prices, imply that inflation pressures may prove stickier than previously thought. The productivity trend is particularly worrisome, as slower productivity growth and rising wages imply higher unit labor costs – a key ingredient of inflation. After peaking at a clearly unsustainable pace of 9.8% in 2003:Q3, labor productivity fell to 3.8% in 2004:Q1 and probably fell below 2% in Q2, compared to real compensation cost growth of about 4% for the past several years. Thus, it appears that unit labor cost growth has gone from negative to flat to positive in recent quarters. The Federal Reserve clearly indicated that it wanted the inflation rate to rise, but it may wind up with a sharper increase than it bargained for.

In response to tightening labor markets and accelerating inflation, the Federal Open Market Committee raised the federal funds rate by 25 bp to 1.25% on June 30th. This marks the beginning of what the FOMC expects will be a series of "measured" rate increases designed to move monetary policy from an accommodative to a neutral (or possibly restrictive) setting. Long-term interest rates have responded to these developments by rising erratically. The 10-year Treasury note yield began the year around 4¼%, peaked at 4.9%, and is currently around 4½%. Market rates now reflect a steady, measured stream of interest rate hikes by the Fed over the next several years.

Credit markets have responded to these developments with only a slight widening in spreads overall. Strong profitability (corporate profits were up 32.3% year-on-year in 2004:Q1), modest capital expenditures relative to internal cash generation (the financing gap stood at *minus* $63 billion in Q1[1]), and solid corporate liquidity (liquid assets relative to short-term liabilities are at a 35-year record high for nonfinancial corporations) have meant that corporations have had only limited need to borrow funds. Combine that with improving balance sheet fundamentals at most corporations and declining loan charge-offs and delinquencies at banks, and credit spreads have remained tight despite higher interest rates.

Market Outlook

The bond market has adjusted to levels that more sensibly reflect the likely path of Fed tightening, but we have no doubt that these expectations – like those earlier this year – will prove to be wrong. In our last Economic Update letter[2], we indicated that market volatility would be concentrated around employment releases, based on the idea that the Federal Reserve had staked out employment and inflation as the two primary factors that would determine the pace and timing of monetary policy tightening. While that has proven accurate, with employment gains now anticipated by the market (only the lack of job growth would be a surprise), inflation news will take on greater importance – and likely generate more volatility than it has in the past. As always, we don't try to predict the direction of those changes, but our option-based hedging strategy affords us the opportunity to take advantage of those shifting expectations. Unlike most funds, we benefit from volatility, and we anticipate more opportunities to benefit from it over the coming months.

So far this year, the rise in long-term rates has about matched the rise in short rates. In other words, the slope of the yield curve from short- to long-end has not changed, and it remains exceptionally steep. That's likely to change going forward. The yield curve should flatten as the Fed raises short rates but long-term rates rise by a smaller amount (or even rally, as they have since June 30). The simple reason for this is that the market now discounts about 25 bp of tightening at each FOMC meeting from now through the end of the year. If that's what we get, long-term rates (which already anticipate this) should be little changed, while short term money market rates should move up in-line with the fed funds rate. Of course, there will be plenty of volatility in this process, since long-term rates will discount probable moves by the FOMC long before any policy action. However, it's normal for the yield curve to flatten during periods of Fed tightening.

Yield curve flattening has two largely offsetting impacts on the funds' portfolios. First and most obviously, a flatter curve increases the cost of leverage (borrowed money) relative to the yield we earn on our assets. That's bad, although it affects only the 34-36% of the portfolios funded by the leverage. Second and less obviously, a flatter curve decreases the cost of hedging, since the market charges an amount equal to the slope of the yield curve to convert a long-duration asset into a short-duration one. That's good, and it affects 100% of the portfolio, since we hedge all of the assets, not just the levered portion.

[1] The financing gap equals capital expenditures minus the sum of internally generated funds and an inventory valuation adjustment; a negative number indicates that those internal sources of funds were greater than capital expenditures.

[2] See Flaherty & Crumrine Incorporated *2004 Economic and Interest Rate Outlook*, February 2004.

It turns out that the lower cost of hedging from a flatter yield curve is usually a bit greater than the higher cost of leverage, meaning that curve flattening is usually beneficial to the funds on balance. The exact benefit (or cost) depends upon the cost of preferred funding relative to benchmark rates, the yield on portfolio assets relative to benchmark rates, and the structure of our option position as the curve flattens. There are some distributional issues to keep in mind, since leverage costs affect net investment income while hedge costs affect net asset value. From a total return perspective, however, we are not concerned about the prospect of a flatter yield curve, especially if it's accompanied by higher rates overall.

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July 30, 2004