U.S. Third-Quarter Economic Update
October 2004

Summary of Recent Economic Developments

Economic growth appears to have improved modestly in the United States over the past quarter, with private forecasters calling for real GDP growth of about 3.8% in 2004:Q3 and 4.1% in Q4. – although the averages mask an unusually wide range of opinions on the growth outlook[1]. Still, it seems that even the "soft patch" in the second quarter now does not look quite so soft as was previously thought: The Commerce Department recently increased its estimation of Q2 GDP growth from a decidedly sluggish 2.8% to a just slightly below-trend 3.3%. Figure 1 provides a summary of some key economic data over the past two years. It shows that the economy accelerated very rapidly during the early phase of the recovery from 2002:Q4 to 2003:Q3 and (not surprisingly) has slowed down to somewhere around trend growth currently. The composition of growth has shifted around considerably, with personal consumption expenditures (PCE) and government spending growing strongly early in the cycle but fading recently, while business and residential investment has remained strong. The trade sector has been a continuous drag on growth, particularly in the past two quarters, when the current account hit a record deficit of 5.7% of GDP.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator	**2002:4**	**2003:1**	**2003:2**	**2003:3**	**2003:4**	**2004:1**	**2004:2**	**2004:3**
Real GDP, Chg QoQ (%)	0.7	1.9	4.1	7.4	4.2	4.5	3.3	3.8f
Real PCE, Chg QoQ (%)	2.5	2.7	3.9	5.0	3.6	4.1	1.6	3.9a
Real Busi Inv, Eqp & Software, Chg QoQ (%)	-2.0	4.5	11.0	21.7	12.0	8.0	14.2	
Real Residential Inv, Chg QoQ (%)	4.2	7.5	9.1	22.4	9.6	5.0	16.5	
Corp Profits w IVA & CCAdj, Chg YoY (%)	15.4	8.8	13.6	20.6	23.3	27.8	19.0	
Current Account Balance, Annualized (% of GDP)	-4.8	-5.1	-4.9	-4.7	-4.5	-5.1	-5.7	
Federal Budget, 12-mo Def or Surp (% of GDP)	-2.2	-2.6	-2.9	-3.4	-3.5	-3.7	-3.7	
Unemployment Rate (%)	6.0	5.8	6.3	6.1	5.7	5.7	5.6	5.4a
Household Employment, Chg QoQ (000)	-878	841	373	-29	835	-181	733	650a
Nonfarm Payrolls, Chg QoQ (000)	-163	-175	-62	-3	179	595	628	180a
Nonfarm Productivity, Chg QoQ (%)	1.6	3.7	6.7	9.0	3.1	3.7	2.5	
Capacity Utilization (%)	74.9	74.8	74.0	74.9	75.8	76.6	76.9	77.3a
GDP Price Index, Chg QoQ (%)	2.0	2.7	1.1	1.4	1.6	2.8	3.2	
CPI, Chg YoY (%)	2.5	3.1	2.1	2.3	1.8	1.7	3.2	2.7a
CPI ex food & energy, Chg YoY (%)	2.0	1.7	1.5	1.2	1.1	1.6	1.8	1.7a
Nominal Personal Income, Chg YoY (%)	1.9	2.4	2.6	3.9	4.9	4.9	5.1	5.0a
Personal Savings Rate (%)	0.5	0.9	1.2	1.4	1.2	1.0	1.4	0.7a
Rate or Spread	**2002:4**	**2003:1**	**2003:2**	**2003:3**	**2003:4**	**2004:1**	**2004:2**	**2004:3**
Federal Funds Rate Target (%)	1.25	1.25	1.00	1.00	1.00	1.00	1.25	1.75
3-month LIBOR (%)	1.38	1.28	1.12	1.16	1.15	1.11	1.61	2.02
10-Yr Treasury Note Yield (%)	3.82	3.81	3.52	3.94	4.25	3.84	4.58	4.12
30-Yr Treasury Bond Yield (%)	4.78	4.83	4.56	4.89	5.07	4.78	5.29	4.90
Moody's Baa Long Corp Spread (bp)	267	212	163	191	153	133	149	138
10-Yr Interest Rate Swap Spread (bp)	39.7	44.1	34.4	42.5	40.6	40.0	51.3	45.6

* Figures are either quarterly or, if more frequent, quarterly averages. f = Forecast; a = Through August 2004 Source: EcoWin

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

[1] Source: *Wall Street Journal* Economic Forecasting Survey, August 2004

Consumer spending has clearly slowed in recent months (see Figure 2). Retail sales – even excluding the volatile automotive sector – is growing at a 4% nominal pace (roughly 3% real) over the past three months, down from as much as 13% earlier in the year. Nonetheless, spending growth is still running ahead of income growth, pushing the savings rate back down below 1% (see Figure 3). The savings rate is a number that simply has to rise over the next few years. The Baby Boom generation is nearing retirement and can no longer rely on double digit investment gains to provide a nest egg. That means we're likely to see a higher savings rate over the coming years, which would trim consumption in the process. Longer term, of course, it should boost productivity and allow for faster economic growth, but it's one reason to expect that the peak growth rate of this economic cycle is likely to be lower than the historic norm.

Figure 2: Retail Sales Slowing

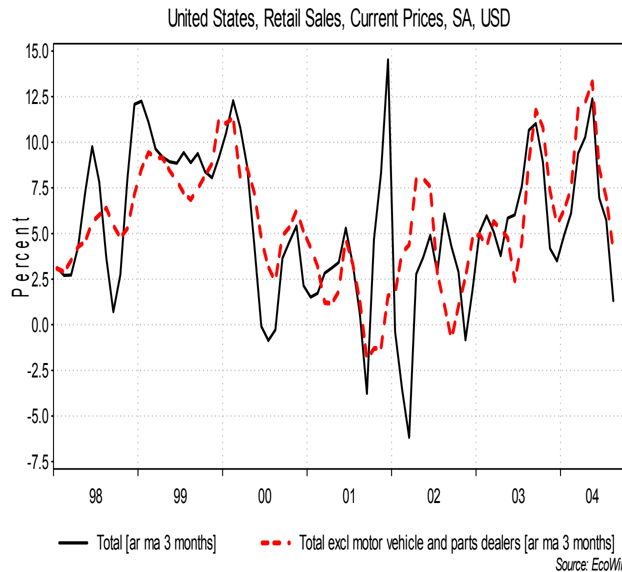
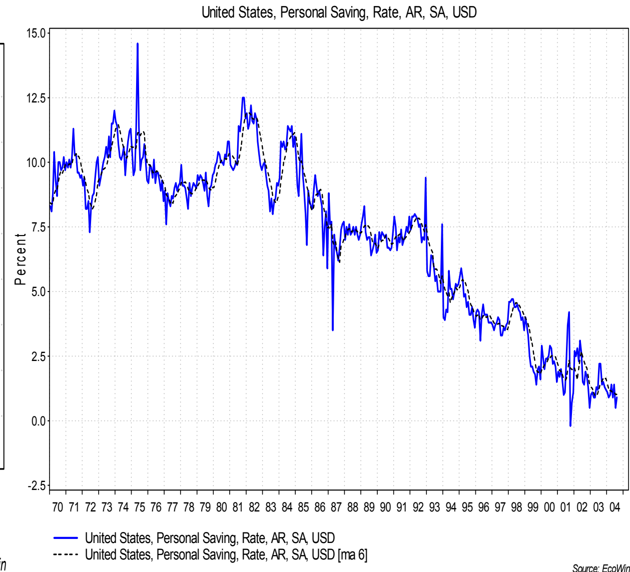


Figure 3: Abysmal Savings



While the consumer is looking a little tapped out – at least until employment growth picks up – investment spending on business equipment and software is growing at an impressive rate. Following the investment boom of the late 1990s, companies sharply reduced their capital expenditures for three years beginning in 2000 (see Figure 4 on the next page). It's likely that the pace of spending increases will slow going forward, but rising capacity utilization rates and the necessity of remaining globally competitive should keep business investment spending on a solid upward trajectory.

We are more cautious on the outlook for residential investment, which grew strongly even through the recession. However, the long period of low and falling interest rates that drove the housing market to record levels of activity and prices cannot be counted upon to continue to stimulate the sector. As interest rates have risen from last summer's lows and, importantly, home prices have risen well in excess of growth in personal income, housing affordability has dropped back near the lows of the past decade (see Figure 5), meaning buying a home has become more expensive. Moreover, homeownership rates have already risen significantly, from around 64% of households in the early- to mid-1990s to a record 69.2% in the second quarter of this year. As a result, the housing sector is probably in the process of peaking. There's no doubt that rebuilding in the Southeast following this year's vicious hurricane season will keep construction spending strong for another several quarters, but we expect some slowing thereafter.

Figure 4: Capital Expenditures Recovering…

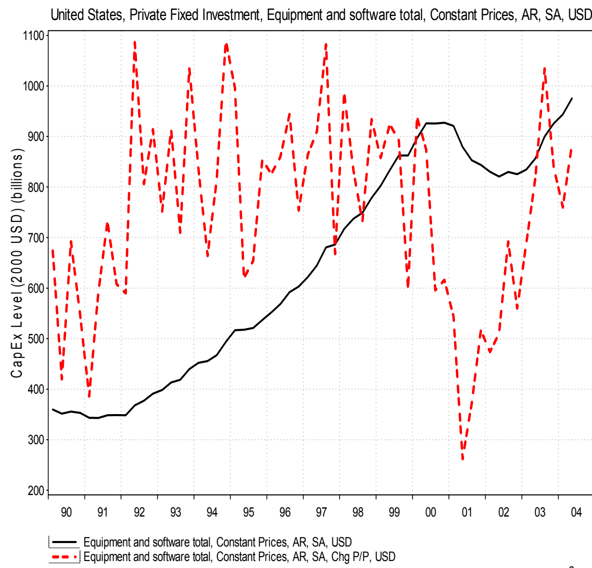


Figure 5: …But Housing Peaking

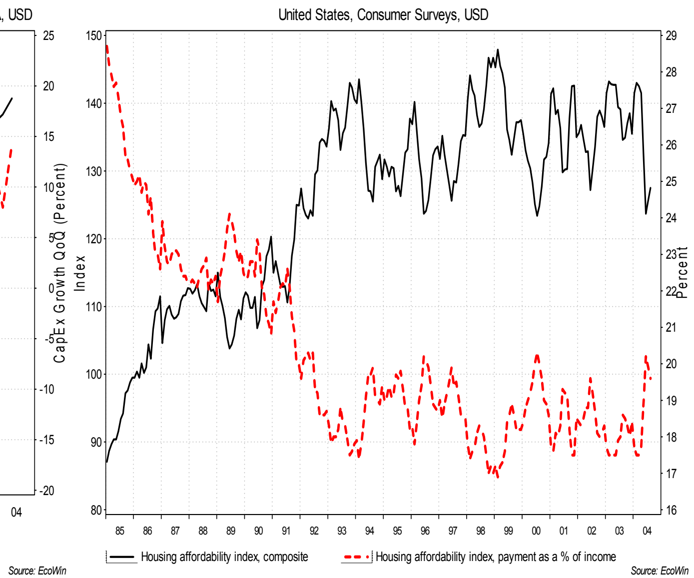


Figure 6: Inflation Moderating…

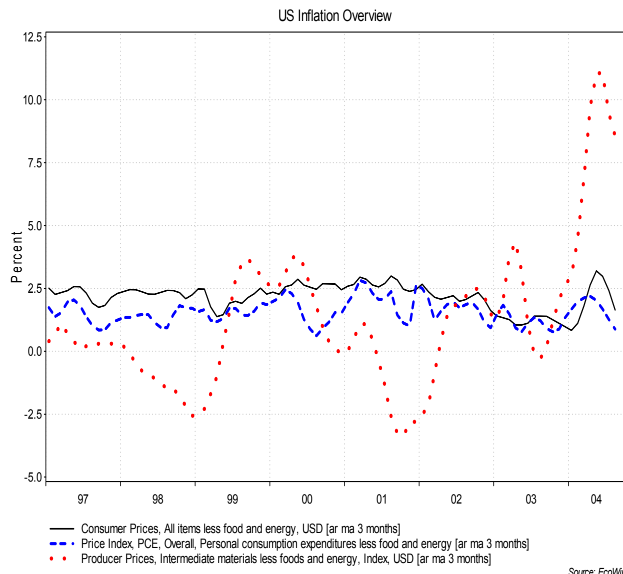
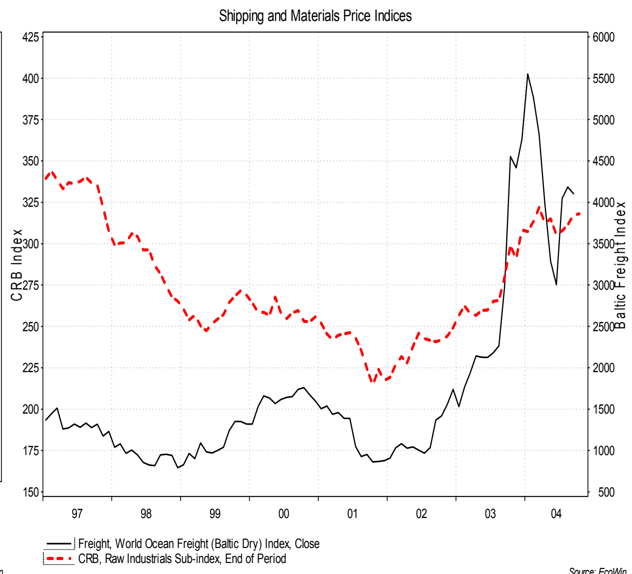


Figure 7: …But Pressures Rebuilding



Inflation cooled off over the summer after a worrisome acceleration earlier in the year. For example, core PCE inflation has dropped back below 1% over the three-months ending in August (the most recent data available), compared to a 2.2% pace in the springtime, while core CPI has fallen to 1.6% over the past three months from 3.2% earlier in the year (see Figure 6). This is certainly good news, but there are still upside risks to inflation. In addition to the well-known surge in energy prices, materials prices and shipping rates have rebounded from their own summer soft patch, as rising global demand puts pressure on those prices (see Figure 7). As a result, inflation is building up in the production pipeline and may show up in consumer prices over time. These divergent signals – slowing inflation now, but pressure for higher prices in the future – will keep the Federal Reserve and the market on the alert over the coming months.

Although it took awhile, payroll employment growth finally took off in the first and second quarters, only to stall again in the June to August period. After averaging more than 200,000 monthly payroll gains from January through May, job growth has slowed to a little over 100,000 jobs per month on average since then – not bad, but not enough to reduce the unemployment rate over time. Weakness in the payroll employment data sparked a sizable rally in the bond market, pushing 10-year Treasury yields down from 4.56% on the day before the June payroll report to a low of 3.98% in late September. Nonetheless, other employment indicators, including jobless claims and the household employment survey, point to ongoing improvement in the labor market (see Figure 8).

Figure 8: Whither the Job Market?

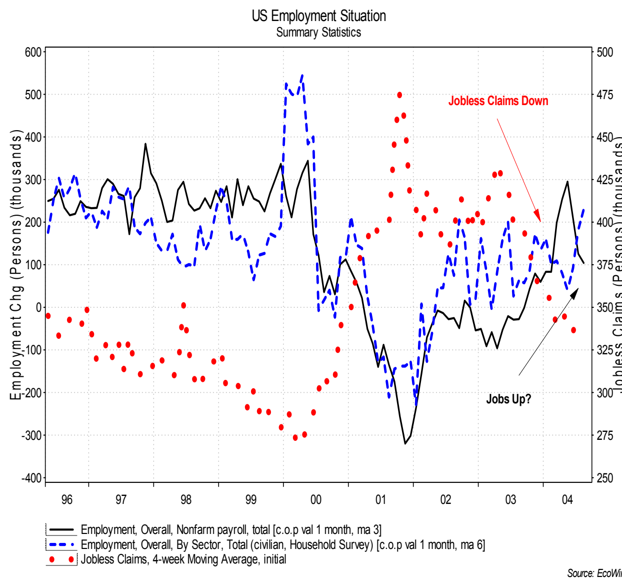
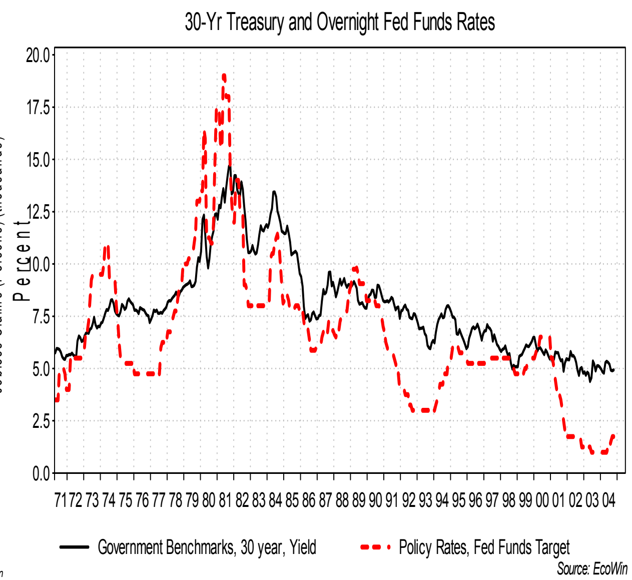


Figure 9: An Unusual Flattening



It's not clear which set of data is telling the "right" story, but Federal Reserve policy will turn on the outcome, and it's a key reason why the interest rate outlook is so uncertain. If it turns out that job growth is sluggish, the Federal Open Market Committee (FOMC) will soon end (or at least, pause) its tightening of monetary policy, which would allow bond yields to fall again. If job growth rebounds, the Fed will tighten at a pace faster than currently anticipated by the bond market, and yields will rise. This high degree of uncertainty suits our options-based hedging strategy well, although we acknowledge that a long period of waiting for the resolution of the employment outlook will be more expensive than a rapid one.

Market Outlook

The bond market reacted to the mixed economic picture by rallying impressively over the third quarter. Thirty-year Treasury yields dropped from 5.29% on June 30 to 4.89% on September 30, although long bond rates have backed up to about 4.95% as this letter goes to press. Investment-grade corporate spreads tightened as well. The Lehman Brothers Credit Index OAS® tightened from 93 to 85 bp over Treasuries during the quarter, the Moody's Baa Long Corporate spread tightened by 9 bp, and swap spreads tightened by about 5 bp. In addition, the yield curve moved strongly and quite unusually – flattening by 80 bp from overnight to 30-years even as long yields fell. As shown in Figure 9, long rates have usually increased when the Fed tightens, resulting in a

moderately flatter yield curve. Obviously, that didn't happen this time. This unusual pattern of flattening was good news for Fund net asset value. It also has reduced the prospective cost of hedging but has increased the cost of leverage, which rose about in-line with the 50 bp increase in the fed funds rate over the quarter.

Currently, the market is anticipating at least one more 25 bp rate hike by the Federal Reserve before the end of the year, bringing the fed funds rate to 2%, with about a 50% chance of another 25 bp tightening before year-end. Looking out to next year, the spread between Eurodollar futures in December 2004 and December 2005 now stands at 100 bp, down from about 150 bp on June 30. Although some unknown portion of those figures represents risk premiums rather than pure rate expectations, it indicates that the market now expects much less tightening in 2005 than it did just three months ago but that there is still considerable tightening priced into the market. Given the wide range of reasonable estimates of a "neutral" fed funds rate[2], it's impossible (at least for us) to gain much insight into how much the Fed may tighten by thinking in terms of policy neutrality. In our view, what the Fed does will depend upon how the economic data comes in. Again, we expect a fair amount of volatility in rates as a result.

Turning briefly to credit spreads, we believe that the favorable credit environment in the United States (and globally in most cases) will continue. Bank loan delinquencies and charge offs continue to fall, as do business bankruptcy filings. Corporate liquidity is holding at a 35-year high, and corporate interest expense as a proportion of earnings before interest and taxes has fallen some 26 percentage points since the peak in 2001 and is now below levels that prevailed in the 1980s.

However, there are some clouds on the horizon. Corporate profit growth is slowing, and if history is any guide, economy-wide profits are likely to grow more slowly than overall GDP over the next several years as the profit share of GDP retreats from today's elevated levels, especially on an after-tax basis (see Figure 10 on the next page). Slower profit growth and rising capital expenditures mean that internally generated funds will no longer meet all capital requirements, leading to rising borrowing in the capital markets. We already see this in the Federal Reserve's Flow of Funds data, which showed that the corporate financing gap moved into positive territory in the second quarter for the first time in more than a year (see Figure 11). Admittedly, the net borrowing requirement was small – only $15 billion at an annual rate compared to nearly $350 billion at the peak of the boom – but the financing gap does appear to have turned the corner, and bond borrowing is likely to follow. Indeed, if the economy continues to improve, this development is not only welcome but virtually inevitable.

In our view, spreads on average reflect the clear improvement in credit quality that has taken place over the past few years, and the gathering clouds are still too distant for most market participants to worry about. However, it's simply hard to see spreads *in general* tightening much further – while it's easy to see them widen if credit conditions take a turn for the worse or

[2] One could argue this point on either an historical or theoretical basis. Starting with the historical notion, the average of the fed funds rate over core consumer price index inflation over the past 20-years is about 2.75%. Adding that to an inflation rate of 2-2.5% (the Fed's presumed comfort zone for CPI) gives a "neutral rate of 4.75-5.45%. Alternatively, one could argue that in equilibrium there should be no (or only a small) expected after-tax return on cash. An economy-wide average tax rate of about 20% and a 2% inflation target thus implies a neutral rate of 2.5% to perhaps 3%. Admittedly, these inputs are on the low end of the "reasonable" spectrum, but they represent a reasonable lower bound. This simple exercise leaves us with "neutral" fed funds estimates of between 2.5% and 5.25% – a very wide range!

Figure 10: Corporate Profit Share Peaking

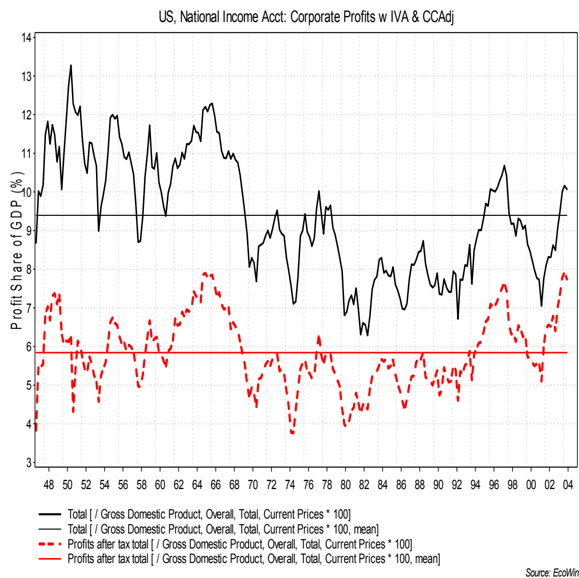
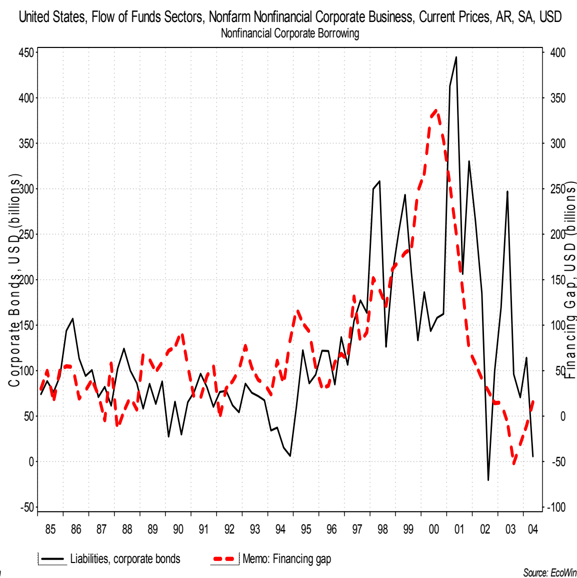


Figure 11: Corporate Borrowing Turning



demand for credit picks up more substantially. As a result (and as usual!) our efforts are focused squarely on identifying attractive credits and taking advantage of pricing anomalies in the preferred and debt securities markets. We've increased our credit research capabilities over the past year, which has allowed us to cast a wider net in search of those opportunities.

In conclusion, we remain optimistic that the U.S. economy can achieve moderate growth of around 3.5%, with investment spending leading the way as consumers rebuild savings and await more robust job formation. The inflation outlook is murkier and potentially more troublesome. If higher energy and materials prices are absorbed by producers and not passed along to consumers, that will be good news for inflation and interest rates, but bad news for corporate profitability. If producers are able to pass along those prices, then the Federal Reserve is likely to be more aggressive in tightening monetary policy, leading to higher rates but better corporate profits – at least for awhile. Finally, credit fundamentals should continue to improve along with the economy, but spreads may give a little ground. That's not a worry for the long-term investor (indeed, it's a positive, since it means higher spreads on reinvested funds), but it may increase volatility over the next few quarters. The Fund is structured to take advantage of these uncertain environments for rates and credit, and we aim to do just that.

Brad Stone
Flaherty & Crumrine Incorporated
October 6, 2004

© 2004, Flaherty & Crumrine Incorporated. All rights reserved. This document is for personal use only and is not intended to be investment advice. Any copying, republication or redistribution in whole or in part is expressly prohibited without written prior consent. The information contained herein has been obtained from sources believed to be reliable, but Flaherty & Crumrine Incorporated does not represent or warrant that it is accurate or complete. The views expressed herein are those of Flaherty & Crumrine Incorporated and are subject to change without notice. The securities or financial instruments discussed in this report may not be suitable for all investors. No offer or solicitation to buy or sell securities is being made by Flaherty & Crumrine Incorporated.