

## Second-Quarter U.S. Economic Update August 2020

### Summary of Recent Economic and Market Developments

As statistics in Figure 1 attest, COVID-19 and efforts to slow its spread resulted in an unprecedented drop in economic activity in the second quarter of 2020. Real GDP slumped by 32.9%, including a 34.6% drop in personal consumption as consumers stayed home and many businesses shuttered. Business and residential investment fell 27.0% and 38.7%, respectively. Employment fell by more than 13 million jobs during the quarter, and the unemployment rate jumped to 11.1%. Federal government spending rose 17.4% on nearly \$3 trillion in fiscal stimulus, providing important relief, but state and local government consumption fell. Net exports also offered a modest boost, though trade volumes plunged. Inflation fell as energy prices slumped. After bottoming in April, however, the economy began to grow as segments of the economy gradually if not fully reopened in May and June. Economists expect strong growth in the second half of 2020 and continued, more-moderate expansion in 2021 and 2022. The Federal Reserve left rates steady but rolled out emergency lending programs announced in March; financial conditions eased significantly. Treasury rates held near all-time lows, and credit spreads tightened sharply as economic activity resumed. Loan quality remains relatively good, but we expect deterioration over coming quarters. Although risk from COVID-19 remains elevated, we think preferred securities continue to offer attractive credit quality and income in today's low-yield world.

Figure 1: Key Macroeconomic Indicators and Interest Rates

<b>Economic Indicator*</b>	<b>2020:2</b>	<b>2020:1</b>	<b>2019:4</b>	<b>2019:3</b>	<b>2019:2</b>	<b>2019:1</b>	<b>2018:4</b>	<b>2018:3</b>
Real GDP, Chg QoQ (% SA, AR)	-32.9	-5.0	2.4	2.6	1.5	2.9	1.3	2.1
Real Personal Consump Expn, Chg QoQ (% SA, AR)	-34.6	-6.9	1.6	2.7	3.7	1.8	1.6	2.7
Real Business Inv ex Structures, Chg QoQ (% SA, AR)	-25.0	-7.4	0.9	1.5	-0.4	3.2	9.9	5.0
Real Residential Investmt, Chg QoQ (% SA, AR)	-38.7	19.0	5.8	4.6	-2.1	-1.7	-5.2	-5.4
Real Private Domestic Final Sales, Chg QoQ (% SA, AR)	-33.5	-5.7	1.5	2.7	2.9	2.1	1.8	2.3
Nominal GDP, Chg QoQ (% SA, AR)	-34.3	-3.4	3.9	4.0	4.1	4.0	3.3	3.8
Corporate Profits, After Tax, Chg YoY (% SA, AR)	-11.2f	-5.7	1.3	-0.3	0.5	-3.3	5.8	8.6
Nonfarm Productivity, Chg QoQ (% SA, AR)	7.3	-0.3	1.6	0.3	2.0	3.7	0.8	0.5
Nominal Personal Income, Chg YoY (% AR)	7.4	1.8	2.9	3.5	3.8	4.6	5.2	5.1
Personal Savings Rate (% SA)	19.0	12.8	7.2	7.3	7.1	8.0	9.1	7.9
Unemployment Rate (% SA)	11.1	4.4	3.5	3.5	3.7	3.8	3.9	3.7
Nonfarm Payrolls, Chg QoQ (000 SA)	-13,271	-908	630	609	477	417	517	460
Household Employment, Chg QoQ (000 SA)	-13,590	-3,031	505	1,150	407	-84	793	282
Federal Budget, 12-mo Deficit(-) or Surplus (% of GDP)	-14.8	-4.8	-4.8	-4.7	-4.4	-4.2	-4.2	-3.8
Consumer Price Index, Chg YoY (% AR)	0.6	1.5	2.3	1.7	1.6	1.9	1.9	2.3
CPI ex food & energy, Chg YoY (% AR)	1.2	2.1	2.3	2.4	2.1	2.0	2.2	2.2
Capacity Utilization (% SA)	68.5	73.6	77.2	77.4	77.7	78.4	79.5	79.3
<b>Rate or Spread (End of Quarter)</b>	<b>2020:2</b>	<b>2020:1</b>	<b>2019:4</b>	<b>2019:3</b>	<b>2019:2</b>	<b>2019:1</b>	<b>2018:4</b>	<b>2018:3</b>
Federal Funds Rate Target (upper bound, %)	0.25	0.25	1.75	2.00	2.50	2.50	2.50	2.25
3-month LIBOR (%)	0.30	1.45	1.91	2.09	2.32	2.60	2.81	2.40
10-Yr Treasury Note Yield (%)	0.66	0.70	1.92	1.68	2.00	2.41	2.69	3.05
30-Yr Treasury Bond Yield (%)	1.41	1.35	2.39	2.12	2.52	2.81	3.02	3.19
ICE-BofAML US Corporate Index Yield to Worst vs Gvt	155	302	99	120	121	126	158	112
10-Yr Interest Rate Swap Spread (bp)	-1.8	2.5	-2.8	-10.5	-4.5	0.0	3.0	6.0

\* Figures are either quarterly or, if more frequent, end of period. f = Forecast<sup>2</sup>; N/A = not available Source: Macrobond, ICE, Bloomberg LP  
Legend for all Figures: AR = Annual Rate; SA = Seasonally Adjusted; MA = Moving Average; C.O.P. = Change over Period

## Economic Outlook

The COVID-19 pandemic and public and private responses to it dealt a severe blow to the economy in the second quarter of 2020. Safer at Home orders prompted many businesses to suspend or sharply reduce operations early in the quarter. While most businesses began to reopen in May, many remain closed or are operating at substantially reduced capacity. Leisure and hospitality businesses have been hit particularly hard. The National Bureau of Economic Research (NBER) declared March the beginning of a recession, which second quarter GDP data strongly confirmed. Inflation-adjusted gross domestic product (real GDP) fell by 32.9% in Q2, led by a 34.6% plunge in personal consumption expenditures.<sup>1</sup> This was by far the largest one-quarter decline in the economy since quarterly GDP statistics began in 1947.

Looking at monthly data within the quarter (details in the paragraphs that follow), it is clear that the economy hit bottom in April when Safer at Home restrictions were in full force. It began to recover in May and June as those restrictions were dialed back, government support funds flowed freely, financial conditions eased, and the rate of new COVID-19 infections slowed. While Q2's GDP is nothing to cheer about, in the end, it turned out better than the 40+% decline that looked possible in April and May.

The second quarter should mark the low for this contraction. Economists<sup>2</sup> expect real GDP to jump by 19.1% in the third quarter and 5.8% in Q4, and the Atlanta Fed's most recent GDPNow model puts Q3 GDP up 25.6%.<sup>3</sup> For the full year, economists forecast -5.2%, 3.2% and 3.5% growth in 2020, 2021 and 2022, respectively. That growth path would still leave the economy smaller and unemployment higher than expected to be prior to the pandemic, however.

We preface our remarks on various sectors of the economy by acknowledging the tragic loss of life and ongoing health adversity that COVID-19 has imposed on society. We do not minimize its impact on peoples' lives. When assessing prospects for the economy, however, we also observe that while COVID-19 significantly reduced economic *output*, its impact on productive *capacity* is limited. As a result, assuming one or more effective vaccines become available in 2021 and fiscal and monetary policies remain supportive, we see potential over coming years for the U.S. economy to recoup much of the growth that was lost to the pandemic.

Developments in the **labor market** clearly illustrate the impact of coronavirus this year. Nonfarm payroll jobs rose by an average of 199,000 jobs per month in January and February but fell by 870,000 jobs in March as Safer at Home orders were instituted and consumer and business spending slowed. Employment then plunged by 20.8 million in April before posting gains of 2.7, 4.8 and 1.8 million in May, June and July, respectively (Figure 2).

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<sup>1</sup> GDP is reported each quarter at an *annual rate*; the 32.9% annualized decline in Q2 means real GDP fell by 9.5% in absolute terms (i.e., not annualized).

<sup>2</sup> Unless noted otherwise, forecasts are from the *Survey of Professional Forecasters*, Federal Reserve Bank of Philadelphia, August 14, 2020 and Bloomberg® *U.S. Monthly Economic Survey*, August 14, 2020.

<sup>3</sup> Federal Reserve Bank of Atlanta, *GDPNow*, August 18, 2020.

In addition, gradually declining initial jobless claims suggest that employment gains remained strong in August, albeit at a slower pace than in July. While the recent rebound in employment is impressive, it still leaves nonfarm payrolls about 12.8 million jobs below February's peak. The unemployment rate started 2020 at 3.5%, rose to 14.7% in April but remained at 10.2% in July (Figure 3). Although many layoffs were temporary, it will take time for businesses to return to prior levels of employment, and some jobs will not come back.

Figure 2: Jobs Climbing out of April Abyss...

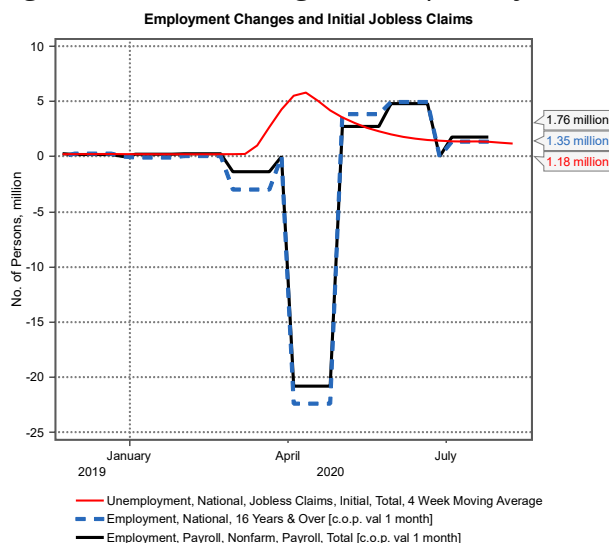
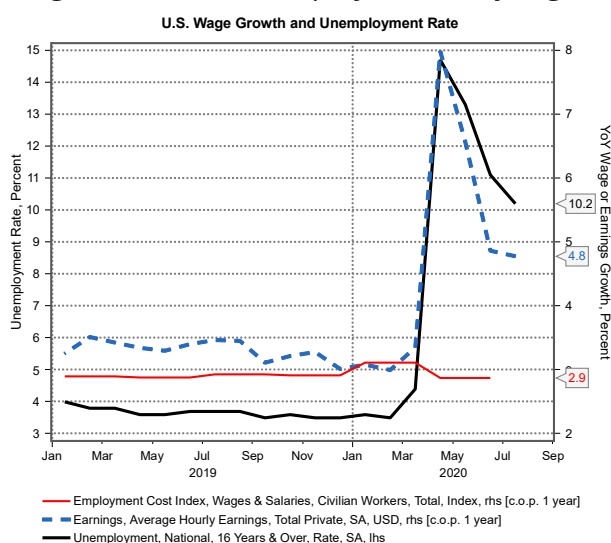


Figure 3: ...but Unemployment Very High



Although payroll employment is down about 7.5% from a year ago, nominal **personal income** actually jumped 32.6% in Q2 and 7.4% over 12 months ending in June (Figure 4). Wage and Salary income plunged by 25.6% in the second quarter and was down 2.4% YoY. Transfer payments – mainly stimulus payments to taxpayers and unemployment benefits – were up 833% (74.8% not annualized) in Q2, which more than made up for weakness in other types of income. Because stimulus checks are unlikely to be repeated and supplemental unemployment benefits of up to \$600 per week expired at the end of July, transfer payments are set to fall sharply in Q3.<sup>4</sup> Higher employment should support wage and salary income, but overall personal income probably will be lower in Q3.

In contrast to personal income, **personal consumption expenditure (PCE)** fell sharply in the second quarter and accounted for most of the weakness in GDP. Nominal PCE slumped by 35.8% in Q2 and 4.8% YoY in June (Figure 4). Adjusted for inflation, real PCE fell by 34.6% in Q2 and 5.5% YoY. Substantially all of the damage to real PCE occurred in March and April, which cumulatively fell 18.1% (not annualized). Even though it rose by 14% (not annualized)

<sup>4</sup> Congress and the Trump Administration are negotiating another stimulus package that may include continued supplemental unemployment benefits, perhaps at a lower level, and possibly another stimulus payment to taxpayers in the fourth quarter. As of August 21, 2020, no agreement has been reached. President Trump signed an executive order directing the Federal Emergency Management Agency to offer funds to states to pay \$300 per week in supplemental unemployment benefits (half the prior maximum). However, funds are limited and many states are not set up to administer payments. It will take time for those benefits to start flowing.

in May and June, real PCE was still down sharply for the second quarter. With income up and spending down, the **savings rate** hit a record-high 25.7% in the second quarter. As spending picked up, it eased to 19.0% in June. Elevated savings should help support consumption even if supplemental unemployment benefits are reduced or expire.

Figure 4: Quick Rebound in Spending

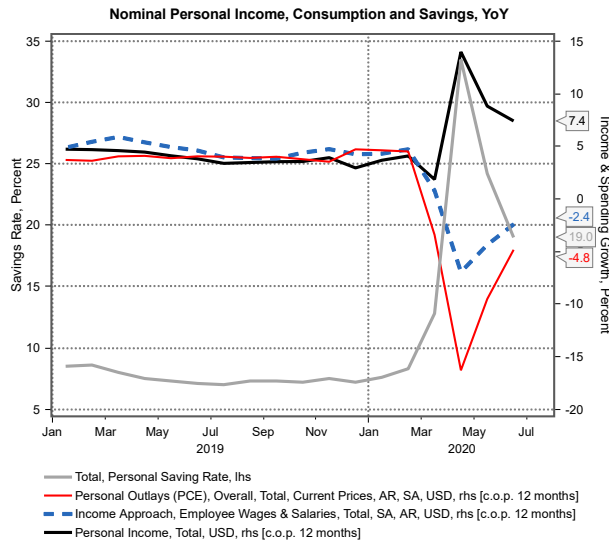


Figure 5: Strong Gains in Retail Sales

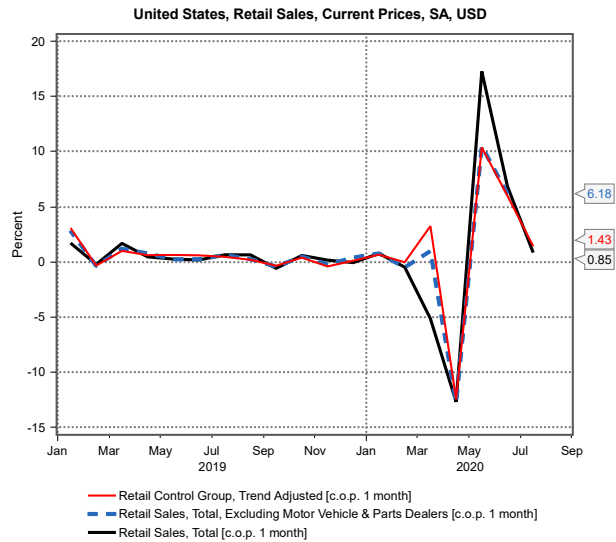


Figure 6: Second-Quarter Housing Plunge ...

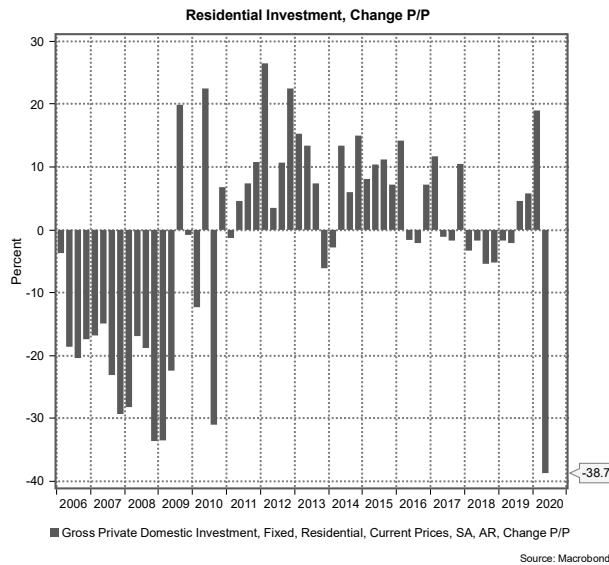
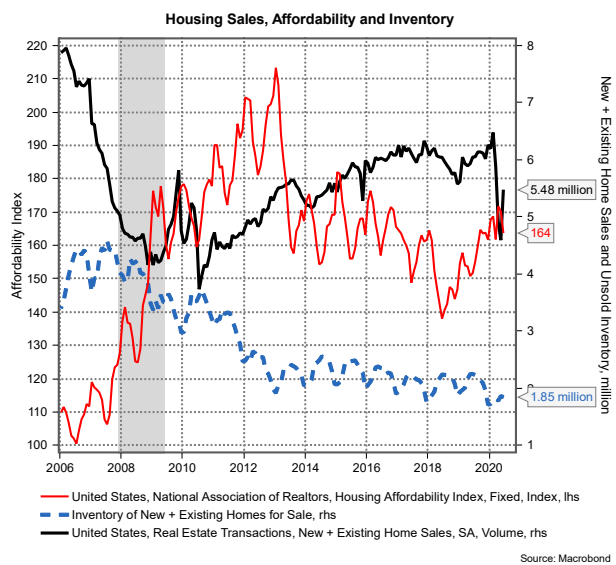


Figure 7: ...to Strong Rebound in Sales



The good news looking ahead is that the current pace of consumer spending would make for roughly 27% real PCE growth in Q3 even if it only holds steady at June's level. Retail sales data suggest PCE should do better than that (Figure 5). July retail sales were up 1.2% overall and 1.4% in "core" sales excluding automobiles, building materials, gasoline and food – putting them above their recent peak from January 2020. While it's treacherous to annualize one month's data, July's pace was nearly 60% and 40% higher than the Q2

average for overall and core retail sales, respectively. It's impossible to know where consumption settles out, but Q3 numbers should be up significantly from Q2.

The **housing market** was hit hard by Safer at Home orders and mandatory halts to construction in many states. Residential investment plummeted by 38.7% in the second quarter (Figure 6). Combined new and existing home sales slid from 6.5 million units in February to just 4.6 million in May. However, sales rebounded to 5.5 million in June (Figure 7), and existing home sales in July by themselves hit a 5.86 million unit pace; adding in new home sales should push July sales to 6.5 million units or more. This rebound came sooner than we expected. We thought people would be both hesitant to commit to a major purchase given economic uncertainty and nervous about looking for homes during a pandemic. However, those concerns appear to be outweighed by a desire to leave urban areas and move to less densely populated exurban and suburban areas. In turn, sellers in those areas are themselves moving. High housing turnover is a result, which is likely to drive substantial residential investment spending. Low mortgage rates also support demand. While elevated unemployment is likely to prevent a boom in housing, demand is firm at the moment.

Figure 8: Manufacturing Coming Back Slowly

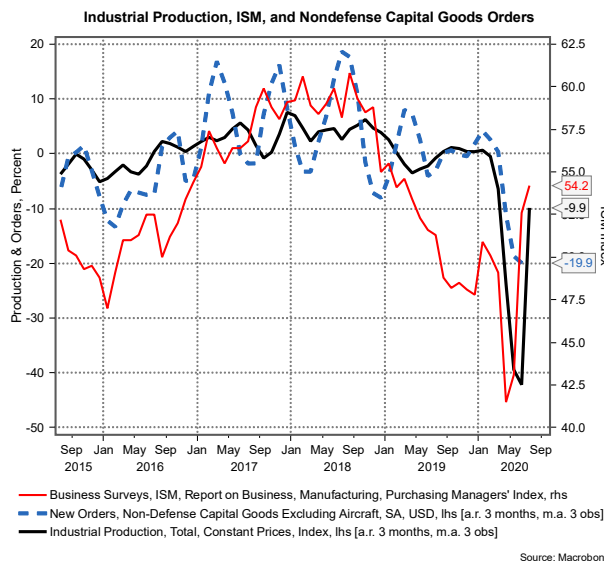
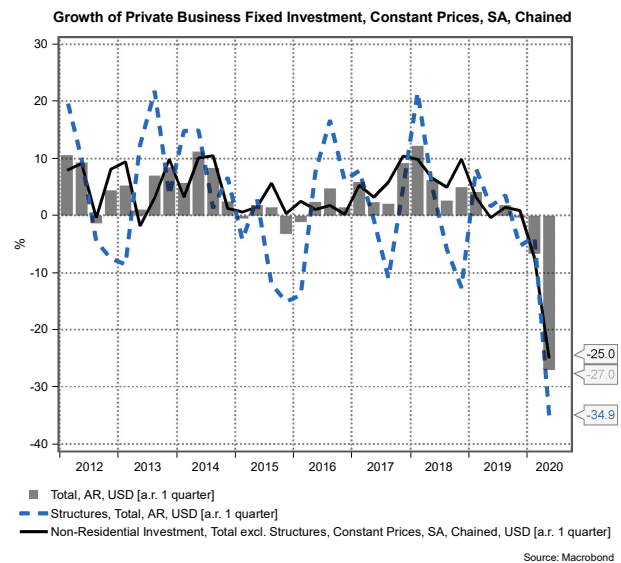


Figure 9: Business Investment Hit Hard



COVID-related shutdowns hit industrial sectors very hard. **Industrial production** skidded 43.2% in the second quarter, including output declines of 47% in manufacturing and 49% in mining (Figure 8). Industrial output recovered substantially since bottoming in April, but July output is still down 8.4% (not annualized) compared to February's pre-COVID peak. The Institute for Supply Management's manufacturing survey recovered to 54.2 in July (50% is neutral), though that's a fairly tepid rebound given how far output fell during the shutdowns. Similarly, orders for core capital goods (nondefense, excluding aircraft) recovered since April's low, but they were down about 20% in the second quarter (Figure 8). Given strength in consumer demand, we expect higher industrial output in Q3, although weakness in export markets is likely to remain a drag.

As expected, real **business investment** fell sharply in the second quarter, down 27.0% (Figure 9). Investment in business structures fell 34.9%, business equipment skidded 37.7% and intellectual property slipped 7.2%. Capacity utilization rates plunged along with industrial output. Overall capacity utilization fell from 73.6% in February to a low of 64.8% in April and back up to 70.6% in July, though that is still well below a utilization rate in the upper-70s that is associated with strong investment spending. While business investment should rise from depressed Q2 levels, businesses still have substantial excess capacity that should limit investment spending in the third and fourth quarters (Figure 10).

Figure 10: Limited Need for New Investment

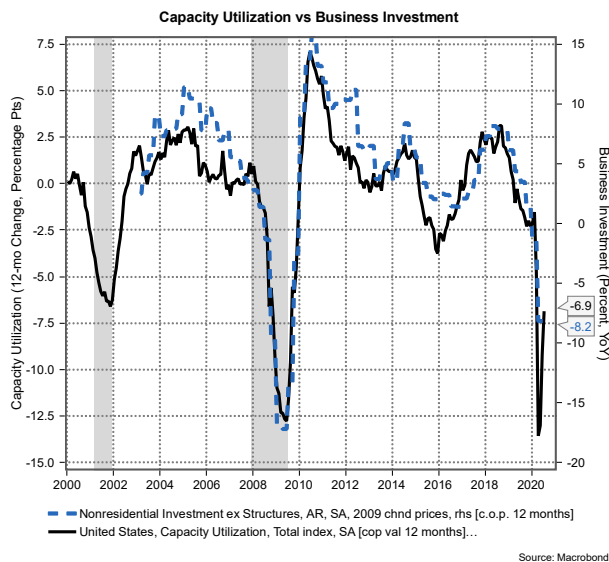
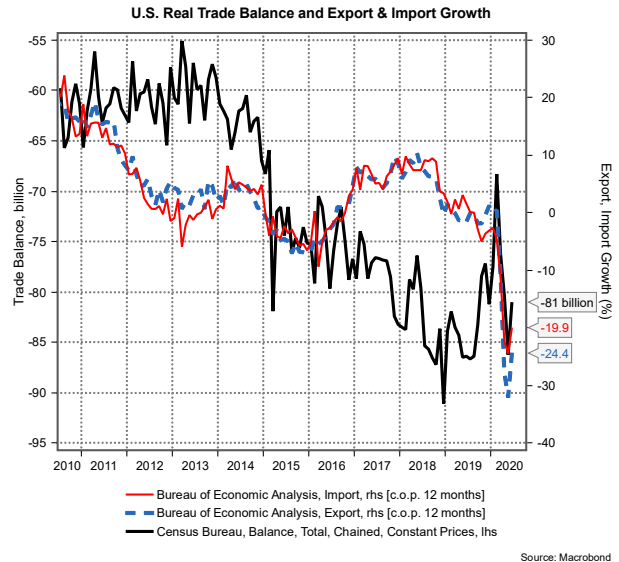


Figure 11: Deficit Narrower, Volumes Weak



The **trade deficit** narrowed slightly in the second quarter, but trade volumes plummeted (Figure 11). Net exports added 0.7% to real GDP growth in Q2 – a rounding error in the context of a 32.9% drop in GDP. Imports fell 19.9% YoY in June, and exports dropped 24.4% over the same period. Trade volumes should begin to pick up at least a little from here, and a weaker U.S. dollar (off roughly 6% over the past 3-4 months) should encourage stronger exports when foreign demand revives. With trade tensions still elevated, we do not look for trade to make a major contribution to economic growth in the second half of this year, however.

**Inventories** subtracted 4.0% from real GDP in the second quarter as production cutbacks outpaced even large declines in sales. While inventory liquidation was a negative for Q2 GDP, it should be a positive for orders and production going forward. Producers may be cautious about accumulating inventory at this stage, and we do not expect inventories to add a lot to Q3 GDP, but they probably do not want to see them slip much further either. If consumer spending remains strong, as we expect, orders and output should move up quickly in response.

Real **government consumption** was up a modest 2.7% in the second quarter despite heavy stimulus spending by the federal government. Real federal government spending jumped 17.4%, on a 39.7% surge in nondefense spending. State and local spending fell 5.6%

as states were squeezed by sharply lower tax receipts – especially sales taxes (Figure 12). The Federal government authorized nearly \$3 trillion in fiscal stimulus, with much of that spent in the second quarter. There is a chance Congress passes another stimulus bill before year-end, although the current gulf between Republicans and Democrats is wide.

Summarizing the second-quarter economic situation, real GDP growth of -32.9% breaks down as follows: Personal Consumption Expenditures (-25.0%), Residential Investment (-1.8%), Business Investment (-3.6%), Inventory Change (-4.0%), Net Exports (+0.7%), and Government Consumption (+0.8%). The first three components equal **Private Domestic Final Sales**, which fell by 33.5%. That should mark the low point for this recession.

Figure 12: Federal Surge but Local Slump

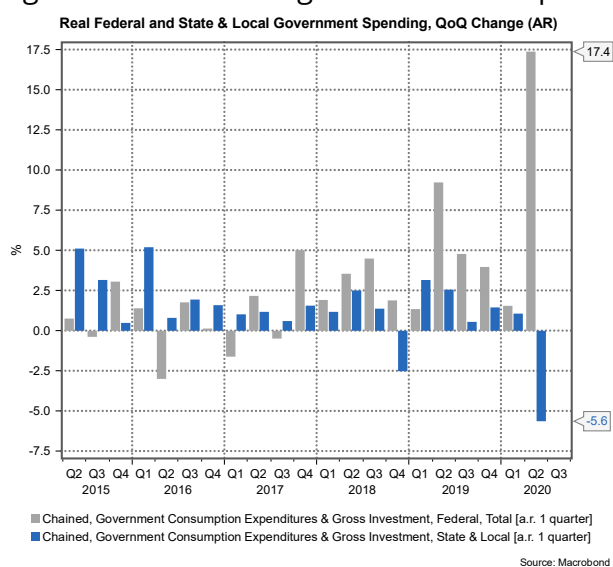


Figure 13: Still Little Inflation Pressure

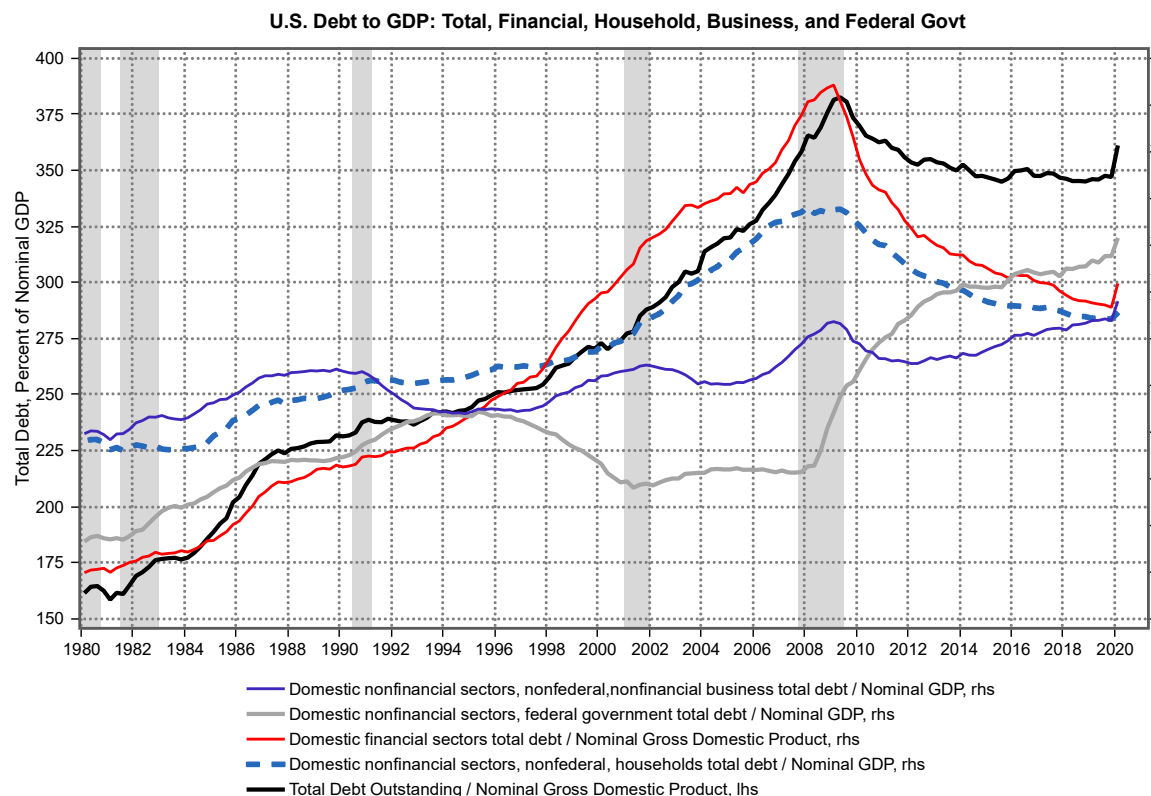


**Inflation** remained subdued in the second quarter but picked up more recently as parts of the economy reopened and energy prices rebounded from April lows. For 12 months ending in July, the consumer price index (CPI) was up 1.0% overall and 1.6% excluding food and energy, both lower than comparable figures in March (Figure 13). The PCE deflator was up 0.8% overall and 0.9% excluding food and energy over 12 months ending in June (latest data available), also below Q1 levels. However, PCE inflation did pick up in June (+0.4% overall and +0.2% excluding food and energy; not annualized), and CPI inflation jumped in both June and July (cumulatively +1.2% overall and 0.9% excluding food and energy over those two months, not annualized). We view the recent pickup in inflation as a short-term snap-back in prices as businesses reopened, not beginnings of surging inflation. As noted earlier, there is still substantial excess capacity both here and abroad to meet rising demand. Although inflation should move up from Q2 lows, we still think it will be difficult for it to move significantly above the Federal Reserve's 2% target for the core PCE deflator.

Broad **balance sheet trends** through the first quarter of 2020 (latest data available) reveal a sizable jump in debt outstanding relative to GDP (Figure 14). Overall debt rose by \$2.4 trillion and debt-to-GDP jumped to 361% from 347% at the end of 2019. Federal government debt rose by almost \$700 billion, which pushed its debt-to-GDP ratio to 91.6%.

Household debt was up \$150 billion, pushing that debt-to-GDP ratio up modestly to 75.5% from its post-financial-crisis low of 74.1% in Q4. Nonfinancial business borrowing rose by about \$750 billion as many companies issued debt and drew down revolving lines of credit to shore up liquidity in the face of mandated shutdowns, pushing that debt ratio up to 78.0% of GDP. Financial business borrowing rose by almost \$1.0 trillion, as loan demand jumped (largely via credit-line drawdowns) and banks funded those loans. Financial business debt-to-GDP rose to 81.8%, though as we discuss below, we do not see that as a negative for creditworthiness.

Figure 14: Debt-to-GDP Up on Stimulus, Balance Sheet Growth; Household Debt Subdued



Source: Federal Reserve Flow of Funds F

These numbers are likely to move even higher when second-quarter data is released in September, due to both a larger numerator (higher borrowing) and a smaller denominator (lower GDP). Data on consumer credit suggests household borrowing remained subdued in Q2. However, corporate bond issuance was robust and bank lending expanded in Q2, which suggests that both nonfinancial and financial business borrowing remained strong. And federal government borrowing surged to pay for stimulus programs. With interest rates very low, borrowing is likely to remain elevated for some time as the economy gets back on its feet.



## Market Outlook

After declining sharply in the first quarter in response to the COVID-19 pandemic, long-term **Treasury rates** were little changed in the second quarter. The benchmark 10-year Treasury note yield edged down by four basis points (bp) to 0.66%, while the 30-year Treasury bond yield rose by six bp to 1.41% at the end of the second quarter (Figure 15). Those yields have dropped slightly since quarter-end, with 10- and 30-year Treasuries yielding 0.63% and 1.35%, respectively, on August 21. Market forward rates also saw limited movement; markets continue to expect a long period of very low rates ahead.

In contrast to an extremely active first quarter, the Federal Open Market Committee (FOMC) kept the fed funds rate target at 0–0.25% and broadly left monetary policy unchanged in Q2. The Fed’s focus during that period was providing liquidity, getting funding markets operating smoothly again and implementing emergency lending measures announced in Q1. All of those were accomplished, albeit with some delays in several new lending programs. In addition, funding for many of the Fed-administered lending programs expanded under the Coronavirus Aid, Relief and Economic Security (CARES) Act, which became law in April.<sup>5</sup> These actions, along with progress reducing COVID-19 infections and other fiscal support included in the CARES Act, helped fuel recoveries in credit and equity markets and prompted substantial easing in financial conditions (Figure 16).

Figure 15: Rates Mostly Steady since Q1<sup>6</sup>

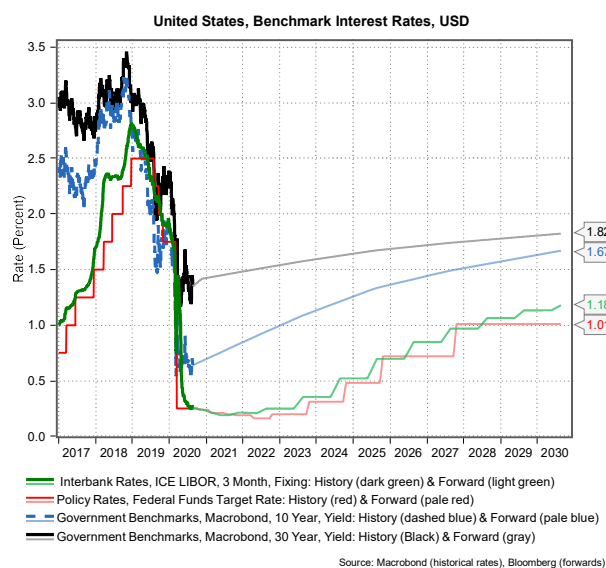


Figure 16: Financial Conditions Much Improved



After widening in the first quarter by the most since the global financial crisis, corporate **credit spreads** narrowed substantially since the beginning of the second quarter. Investment-grade corporate bond spreads widened by 203 bp to 302 bp in Q1 and

<sup>5</sup> See our [First-Quarter U.S. Economic Update](#), May 21, 2020 for more details.

<sup>6</sup> The fed funds effective rate recently has traded about 17 bp below the top end of the FOMC target range. In Figure 15, we add 17 bp to forward rates implied by overnight index swaps (OIS) to align them with historic target rates.

narrowed by 147 bp to 155 bp in Q2.<sup>7</sup> That recovery continued in July and so far in August, with investment grade credit spreads closing on August 21 at 132 bp (Figure 17). Similarly, high yield bond spreads widened by 503 bp to 875 bp in the first quarter, narrowed to 647 bp at the end of Q2 and closed on August 21 at 531 bp. Given continued uncertainty over both the economy and the course of COVID-19 as well as Treasury rates near historic lows, spreads remain wider than where they began 2020, but their recovery has been impressive.

Figure 17: Major Credit Spread Recovery

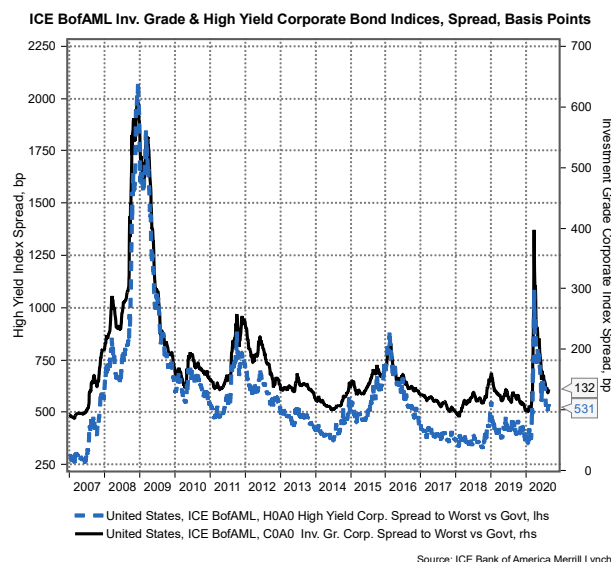
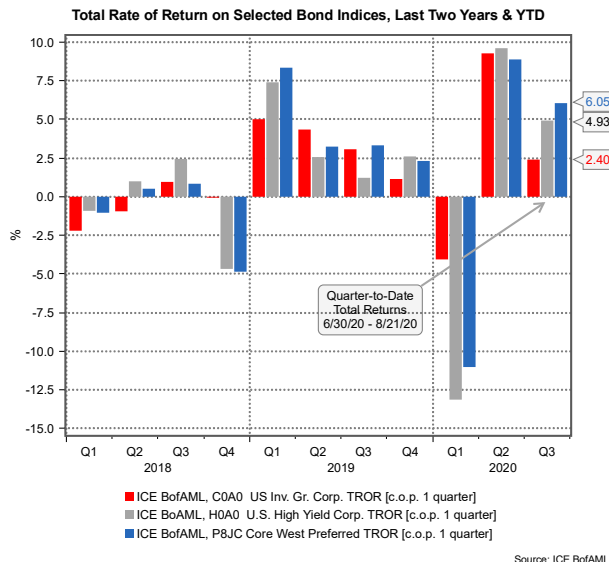


Figure 18: Strong Returns since Q1 Rout



Spreads on preferred securities fell between those of investment-grade and high yield corporate bonds, although their complex call features makes simple spread measures difficult to illustrate. Total rate of return, which incorporates both income and price changes, combines the impacts of credit spread and Treasury yield changes on bond returns. Figure 18 shows total returns on selected ICE BofA indices in recent quarters. As our commentary on spreads and rates suggests, returns on all three credit indices were very strong in the second quarter. Total return on the preferred index<sup>8</sup> (+8.88%) lagged the investment-grade corporate bond index (+9.27%) and the high yield index (+9.61%).<sup>9</sup> All three markets extended gains in the third quarter through August 21 (see Figure 18 for QTD returns). Year-to-date through August 21, the investment grade corporate index (+7.36%) posted very strong returns. The preferred index (+2.75%) trailed investment-grade corporates but outperformed the high yield index (-0.09%), which is now nearly flat on the year. If the economy continues to recover over the rest of the year, as we expect, we see scope for additional spread tightening, although risks remain elevated.

<sup>7</sup> Investment-grade corporate bond spread is represented by the ICE BofA U.S. Corporate Index<sup>SM</sup> (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. Index data through 8/21/2020.

<sup>8</sup> Preferred index is the ICE BofA 8% Constrained Core West Preferred & Junior Subordinated Securities Index<sup>SM</sup> (P8JC). Index data through 8/21/2020.

<sup>9</sup> Total return is not annualized and includes both price change and income. Past performance does not guarantee future performance.

Current credit conditions generally remain good, although some sectors face challenges. Judging by public companies that have reported Q2 earnings, it appears that corporate earnings declined only moderately even as the economy slowed sharply, with most companies reporting earnings that exceeded analysts' estimates. Most banks reported decent earnings, though some posted losses as they boosted reserves. Banks added significantly to loan loss reserves and, in most cases, increased common equity capital ratios, both of which help support preferred securities. Loan loss reserves now typically range from 2-4 times nonperforming loans, almost double their level prior to the pandemic, leaving a lot of room for banks to absorb higher loan losses without dipping into capital.

In contrast, energy companies had a tough quarter. Recession cut demand for energy – especially transportation fuels – and lower prices drove a sizable reduction in output. While pipeline companies have only limited commodity price exposure, they are exposed to long-term declines in volumes. In addition, political winds have turned more hostile to fossil fuels, even relatively clean natural gas, and some projects have been scrapped. Credit spreads in the energy sector narrowed in Q2, but by less than in most other sectors – hurting their relative performance.

The Federal Reserve published results of its 2020 Stress Tests of large banks in late June. Even under the Fed's severely adverse scenario, all 33 banks "passed" the stress test, meaning no bank breached minimum capital requirements during the stress period, although one would need to take small capital actions to do so. In addition to its normal stress test, the Fed included downside scenarios related to coronavirus. Under all of these scenarios, all tested banks maintained capital buffers that were higher than the Fed's required minimum, after capital actions. The Fed will also require these banks to run updated coronavirus stress-test scenarios and potentially revise their capital plans in light of those results. Given heightened uncertainty from COVID-19, the Fed will not allow large banks to buy back common stock at least through the third quarter of 2020 and imposed limits on quarterly common stock dividends. Preferred dividends are not subject to these limitations, although, as always, they could be suspended without triggering an event of default.

After soaring as the coronavirus pandemic erupted, both bank loans and deposits stabilized in recent months (Figure 19). Commercial and industrial loans dropped back from their peak as businesses repaid revolving lines of credit tapped for liquidity as the pandemic unfolded. Consumer loan balances dropped along with spending in April and remained flat despite a rebound in consumption. Securities holdings rose as deposits outpaced loans, giving banks ample liquidity. In short, aggregate bank balance sheets look healthy.

Although comprehensive data on bank loan quality is not yet available for the second quarter, banks that we track generally reported only slight deterioration in loan quality compared to first-quarter levels, which are shown in Figure 20. Overall loan delinquency and charge-off rates were both up just 4 bp to 1.49% and 0.53%, respectively, in Q1. Commercial and industrial (C&I) loan delinquency was unchanged at 1.12%, but charge-offs jumped 20 bp to 0.55%. Given rising leverage at nonfinancial businesses, we have long

expected higher loan losses in this sector in a recession, and it's no surprise that we are seeing them now. Consumer loan delinquencies (up 3 bp to 2.30%) and charge-offs (up 11 bp to 2.47%) rose modestly. Real estate delinquencies rose 14 bp to 0.82%, but charge-offs remained minimal at just 0.02%.

Figure 19: Bank Lending & Deposits Up

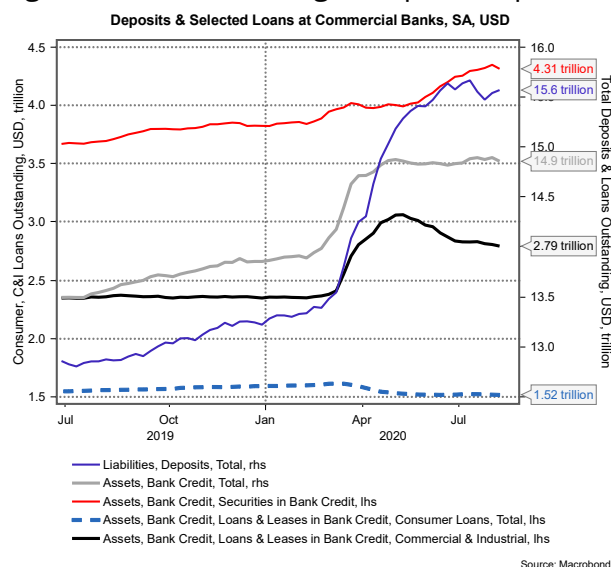
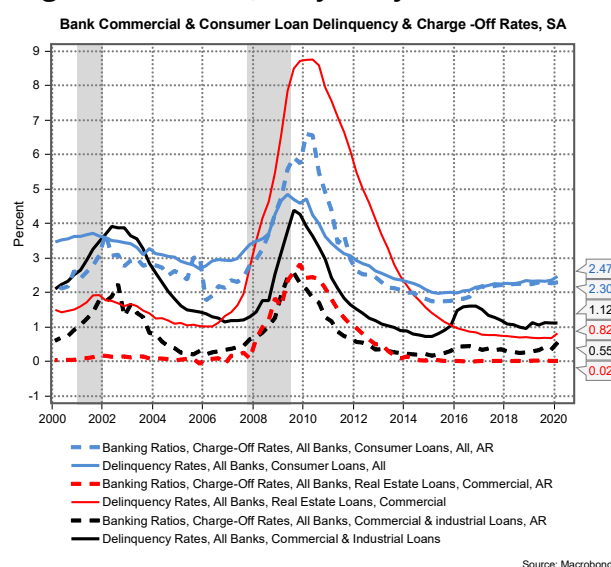


Figure 20: Loan Quality Okay; Set to Worsen



While it is good news that current loan statistics still appear good, many loans are currently in forbearance; borrowers in these programs can make reduced (even zero) payments with deferred amounts typically added to the end of a loan's term. These loans are considered performing until forbearance ends, which for most of programs should happen in August or September. Not all of those borrowers are going to resume regular payments, and recently-released statistics on mortgage delinquencies may offer some guidance. Data reported by the Mortgage Bankers Association of America show that overall mortgage delinquencies on 1-4 family homes jumped from an average of about 4% in 3Q2019-1Q2020 to 8.2% in the second quarter. We should have a better sense of the scale of banks' problem loans when they report third quarter earnings beginning in mid-October, and we certainly expect a sizable increase. However, given elevated loan loss reserves already in place at most banks, we think most banks are prepared for substantial increases in delinquencies and charge-offs.

The U.S. economy has performed remarkably well since hitting bottom in April, with a stronger rebound in May and June than we expected. Recovery should continue at a rapid pace in the third quarter despite renewed restrictions in certain areas. Consumer spending recovered quickly, with retail sales already above pre-pandemic levels, and industrial output should follow. Residential investment appears robust. However, business investment is likely to remain subdued for some time. Federal government spending surged in Q2 and should help support the economy through the pandemic, but state and local government spending will probably remain constrained. Trade may continue to be a modest positive to GDP, but exports are likely to remain weak.

Treasury rates have stabilized at low levels and, despite wider budget deficits, are likely to remain low for several years. Credit spreads narrowed substantially as the economy performed better than feared, and we see prospects for incremental spread tightening as economic recovery unfolds and progress is made against COVID-19. However, we remain mindful of ongoing risks from the coronavirus. There are likely to be setbacks on the road to recovery. Fortunately, the preferred market is dominated by issuers in the banking, insurance and other financial services industries, which we think are well-positioned to manage through current challenges. We close as we did last quarter: seeing good opportunity for long-term investors in preferred and contingent capital securities to earn competitive returns over coming years, albeit with some bumps along the way.

Flaherty & Crumrine Incorporated  
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