

## Fourth-Quarter U.S. Economic Update February 2021

### Summary of Recent Economic and Market Developments

The U.S. economy continued to recover from a sharp, pandemic-driven decline in the first half of 2020. Fourth-quarter real GDP rose by 4.0% following a 33.4% gain in Q3, although that still left the economy 2.5% smaller than a year earlier. With coronavirus vaccinations accelerating, economic prospects brightened. Economists expect 4.9% real GDP growth in 2021 and 3.7% in 2022, which would help absorb some 10 million jobs that remain lost to the pandemic. Fiscal and monetary stimulus supported personal income, which rose in 2020 despite the pandemic. Income outpaced personal consumption, however, which fell slightly in 2020. As a result, personal savings rose to record levels – savings that should boost consumption as the pandemic recedes. Industrial output rose strongly as the economy grew and firms restocked. Business investment rose briskly. Home sales and prices soared, and residential investment should remain a bright spot. Inflation picked up from lows earlier in the pandemic, but excess capacity is likely to limit gains for some time. The Fed kept short-term interest rates steady and monetary policy loose, but long-term interest rates rose as the economy gained pace and inflation risks emerged. Credit conditions improved with a stronger economy and a brightening outlook. Credit spreads narrowed substantially, driving good returns but lower yields on preferred and contingent capital securities.

Figure 1: Key Macroeconomic Indicators and Interest Rates

<b>Economic Indicator*</b>	<b>2020:4</b>	<b>2020:3</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>
Real GDP, Chg QoQ (% SA, AR)	4.0	33.4	-31.4	-5.0	2.4	2.6	1.5	2.9
Real Personal Consump Expn ds, Chg QoQ (% SA, AR)	2.5	41.0	-33.2	-6.9	1.6	2.7	3.7	1.8
Real Business Inv ex Structures, Chg QoQ (% SA, AR)	16.2	34.4	-25.5	-7.4	0.9	1.5	-0.4	3.2
Real Residential Investmt, Chg QoQ (% SA, AR)	33.5	63.0	-35.6	19.0	5.8	4.6	-2.1	-1.7
Real Private Domestic Final Sales, Chg QoQ (% SA, AR)	5.6	38.7	-32.2	-5.7	1.5	2.7	2.9	2.1
Nominal GDP, Chg QoQ (% SA, AR)	6.0	38.3	-32.8	-3.4	3.9	4.0	4.1	4.0
Corporate Profits, After Tax, Chg YoY (% SA, AR)	13.3f	2.8	-18.8	-5.7	1.3	-0.3	0.5	-3.3
Nonfarm Productivity, Chg QoQ (% SA, AR)	-4.8	5.1	10.6	-0.3	1.6	0.3	2.0	3.7
Nominal Personal Income, Chg YoY (% AR)	4.1	6.4	8.2	1.8	2.9	3.5	3.8	4.6
Personal Savings Rate (% SA)	13.7	14.4	19.0	12.9	7.2	7.3	7.1	8.0
Unemployment Rate (% SA)	6.7	7.8	11.1	4.4	3.6	3.5	3.6	3.8
Nonfarm Payrolls, Chg QoQ (000, SA)	717	4,025	-13,000	-1,079	590	609	457	355
Household Employment, Chg QoQ (000, SA)	2,287	5,443	-13,436	-3,199	505	1,099	322	64
Federal Budget, 12-mo Deficit(-) or Surplus (% of GDP)	-16.5	-15.5	-14.8	-4.8	-4.8	-4.7	-4.4	-4.2
Consumer Price Index, Chg YoY (% AR)	1.4	1.4	0.6	1.5	2.3	1.7	1.6	1.9
CPI ex food & energy, Chg YoY (% AR)	1.6	1.7	1.2	2.1	2.3	2.4	2.1	2.0
Capacity Utilization (% SA)	74.5	72.3	68.9	73.6	77.2	77.4	77.7	78.4
<b>Rate or Spread (End of Quarter)</b>	<b>2020:4</b>	<b>2020:3</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>
Federal Funds Rate Target (upper bound, %)	0.25	0.25	0.25	0.25	1.75	2.00	2.50	2.50
3-month LIBOR (%)	0.24	0.23	0.30	1.45	1.91	2.09	2.32	2.60
10-Yr Treasury Note Yield (%)	0.93	0.69	0.66	0.70	1.92	1.68	2.00	2.41
30-Yr Treasury Bond Yield (%)	1.65	1.46	1.41	1.35	2.39	2.12	2.52	2.81
ICE-BofAML US Corporate Index Spread to Worst vs Gvt	98	139	155	302	99	120	121	126
10-Yr Interest Rate Swap Spread (bp)	0.8	2.5	-1.8	2.5	-2.8	-10.5	-4.5	0.0

\* Figures are either quarterly or, if more frequent, end of period. f = Forecast<sup>1</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

In response to the COVID-19 pandemic, the U.S. economy fell sharply in the first and, especially, second quarters of 2020 as businesses halted or curtailed operations in response to both weaker demand and government restrictions. The economy tumbled into a recession in March, but as COVID restrictions eased, it rebounded strongly in the second half of the year. Inflation-adjusted gross domestic product (real GDP) fell by 5.0% in Q1 and 31.4% in Q2 before rising 33.4% in Q3 and 4.0% in Q4. Those Q2 and Q3 swings were by far the largest one-quarter changes in the economy since quarterly GDP statistics began in 1947. The onset of colder weather across most of the U.S. in November and December 2020 brought a surge in COVID-19 infections and renewed economic restrictions in some regions, albeit more-targeted ones than earlier in the pandemic. Consumer spending slowed, ending the year on a soft note. Although the economy's rebound was considerably stronger than most economists expected when the pandemic surged in April 2020, real GDP was 2.5% smaller in the fourth quarter than it was a year earlier and about 5% smaller than it probably would have been absent the pandemic.

The U.S. approved two coronavirus vaccines in December 2020, and several additional promising vaccines are in or have completed late-stage trials. These vaccines set the stage for a more optimistic outlook for 2021. Winter weather – which encourages spread of respiratory viruses – and limited vaccine availability could suppress U.S. economic growth in the first quarter, but it should gain pace thereafter as vaccinations expand and COVID gradually recedes. Economists expect real GDP to expand by 3.2% in Q1 and accelerate to 5.6% in Q2 and 4.9% for 2021 overall.<sup>1</sup> Growth is expected to remain sturdy at 3.7% in 2022, though that would still leave the economy modestly below its expected growth path prior to the pandemic.

Economic recovery is likely to mirror progress against COVID-19, and risks to the near-term outlook are skewed to the downside. However, as weather warms and vaccinations expand in Q2 and beyond, we see prospects for even stronger than expected growth in the second half of 2021 and into 2022. The pandemic has suppressed both the supply (e.g., business capacity limits or outright closures) and demand (e.g., consumer fear of many travel and leisure activities) sides of the economy. They could rebound strongly as infection risk declines, particularly considering massive fiscal and monetary support for consumers and businesses. We will explore these themes in our review below.

After shedding more than 22 million jobs between February and April 2020, the **labor market** staged an impressive rebound (Figure 2). However, its pace of recovery slowed in recent months, and total nonfarm payroll employment of 143 million in January 2021 (latest data available) remains nearly 10 million jobs below the February 2020 peak. Moreover, payrolls are roughly 12 million jobs below what they would have been had they continued to expand at the same pace (1.3%) as in 2019. Initial jobless claims remain elevated, reflecting ongoing

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<sup>1</sup> Unless noted otherwise, forecasts are from the *Livingston Survey*, Federal Reserve Bank of Philadelphia, December 18, 2020 and Bloomberg® *U.S. Monthly Economic Survey*, February 12, 2021.

business disruption from the pandemic. The unemployment rate behaved similarly, starting 2020 at 3.5%, jumping to 14.7% in April and falling to 6.3% in January 2021 (Figure 3). It would be even higher if labor participation had not fallen by about 2% to 61.4% over the same period. Higher average hourly earnings offer some consolation to people who remained employed, although a sizable part of those gains reflect a shift in the job mix. A disproportionate share of job losses was in leisure and hospitality and other lower-wage businesses. That pushes up average wages but is not a sign of labor market strength.

Figure 2: Jobs Recovering; 10m below Peak

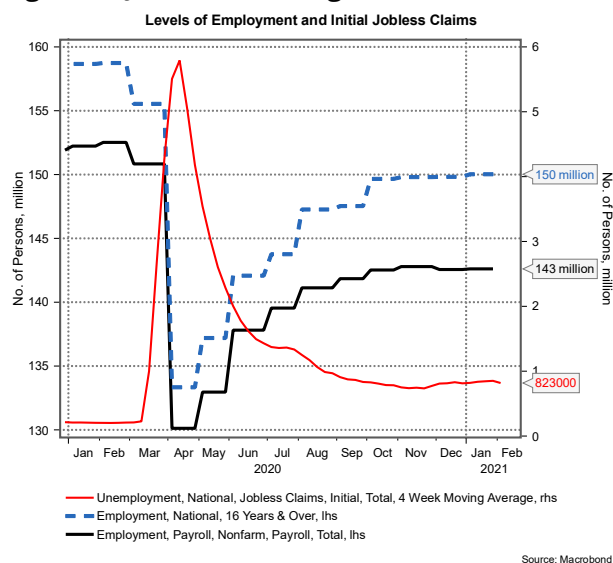
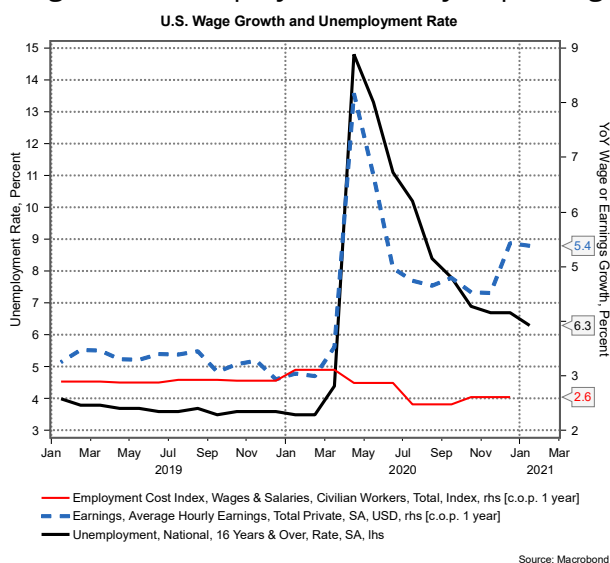


Figure 3: Unemployment Slowly Improving



Despite this incomplete recovery, we are optimistic that most jobs lost during the pandemic will recover as COVID-19 recedes. For example, hotels and restaurants will reopen or expand services and rehire employees as consumer demand returns. After a year or more of COVID-related restrictions, there is likely substantial pent-up demand among consumers. As that is unleashed, employment should jump not just at businesses that were closed or operated at reduced capacity but also at producers and distributors up and down the supply chain. We expect strong employment growth in the second half of 2021.

Although employment fell, nominal **personal income** rose 4.1% over 12 months ending in December 2020 (Figure 4). That was largely due to a 20.5% jump in transfer payments – stimulus checks, supplemental unemployment benefits and other assistance – that largely replaced income lost during the pandemic. Personal income excluding transfers rose just 0.8% over the same period, or about -0.5% in inflation-adjusted terms, although that is still remarkable performance given the pandemic’s dire impact in the first four months of the year. Personal income ended the year on a soft note (-6.7% in Q4) as unemployment programs established early in the pandemic expired. A new \$900 billion stimulus plan passed in December should boost income in 1Q2021. Growth in employment should keep income on an upward path beyond that, and additional stimulus currently working its way through Congress is likely to provide further support.

Figure 4: Income Outpaced Spending in 2020...

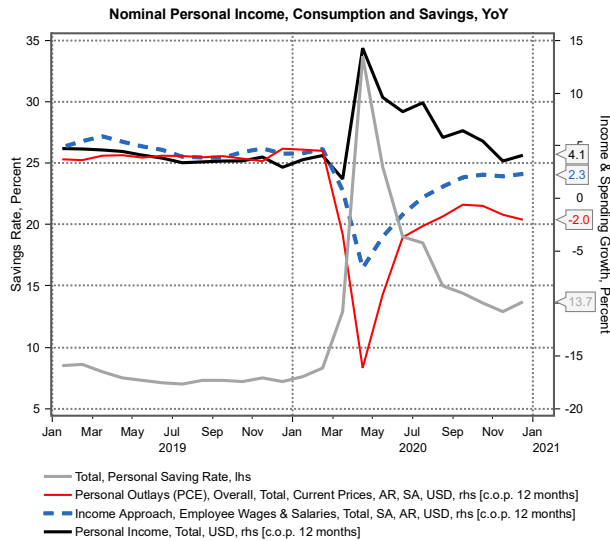
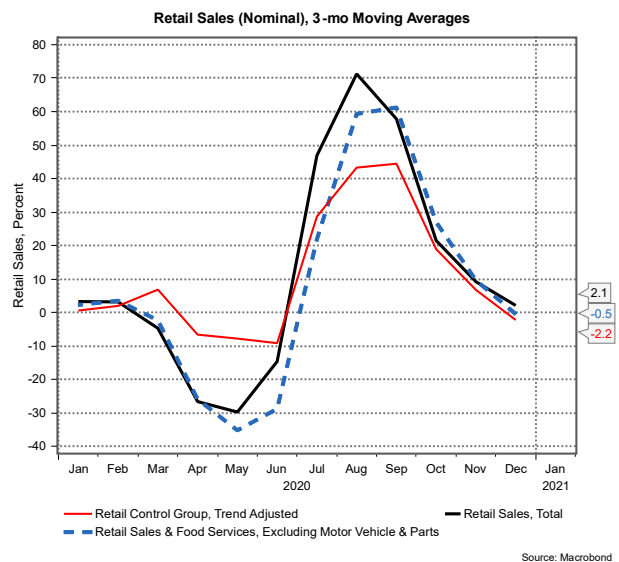


Figure 5: ...but Retail Sales Slowed in Q4

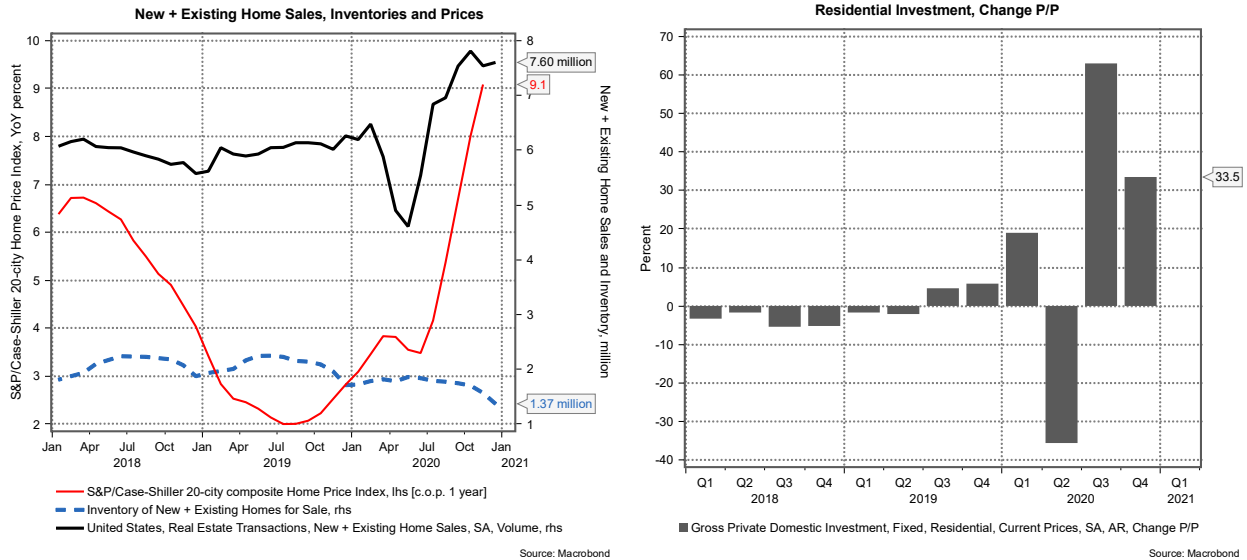


**Personal consumption expenditure** (PCE) fell sharply as the pandemic unfolded and recovered quickly as the economy reopened. Nominal PCE rose 4.1% in Q4 but fell 2.0% over 12 months ending in December 2020 (Figure 4). Adjusted for inflation, real PCE rose by 2.5% in Q4 and fell 3.3% YoY. However, retail sales, which led the rebound in PCE in Q3, slowed in the fourth quarter at COVID restrictions expanded along with the onset of winter (Figure 5). Some of those restrictions were eased in recent weeks, which should prompt improvement in 1Q2021. In addition, record stock prices and rising home values add to consumer wealth; they too should support consumer spending this year.

Although income outpaced spending in 2020, the reverse was true in the fourth quarter. As a result, the **savings rate** ended the year at 13.7%, below its record 16.2% average for 2020 but still very high historically (Figure 4). Transfer payments already in the pipeline probably will boost the savings rate again in Q1. As the pandemic recedes, however, the savings rate is likely to fall as consumers spend more freely.

The **housing market** came roaring back after tumbling in the second quarter when COVID-19 restrictions limited both sales and construction. Combined new and existing home sales rose from a low of 4.6 million units in May 2020 to 7.6 million units in December (Figure 6). Low mortgage rates and homebuyers' desire to move to less densely populated exurban and suburban areas during the pandemic were behind the surge. Home prices also accelerated on strong demand and low inventory of available homes. The S&P/Case-Shiller 20-city composite home price index was up 9.1% over 12 months ending in November 2020 (latest data available), compared to just 2.5% at the same time a year earlier. In turn, residential investment jumped 33.5% in Q4 on the heels of an even-larger 63% gain in Q3. Apparently, buyers updated their newly purchased homes, and many remote workers renovated their living spaces to work from home. While residential investment growth is bound to slow from these extraordinarily high levels, housing should remain a bright spot for the economy over the next several years.

Figure 6: Surge in Demand for Housing... Figure 7: ...Drove Gains in Residential Investment



As in other sectors, **industrial production** was a mixed bag in 2020. It entered the year near zero growth, plunged as the pandemic took hold, rebounded strongly in the third quarter, and posted 8.4% growth in Q4 (Figure 8). Despite that recovery, industrial output remained down 3.6% in December compared to a year earlier. We anticipate output will soon surpass its pre-pandemic level, however. The Institute for Supply Management’s manufacturing survey was at 58.7% in January 2021 (50% is neutral), which suggests good growth in manufacturing over coming months. Similarly, orders for core capital goods (nondefense, excluding aircraft) remain very strong, up 21.1% in Q4 (Figure 8). Those orders should keep manufacturers busy during the winter months when COVID-19 risks are highest, and stronger consumer spending in Q2 and beyond should keep industrial output rising thereafter.

Figure 8: Manufacturing Looking Solid

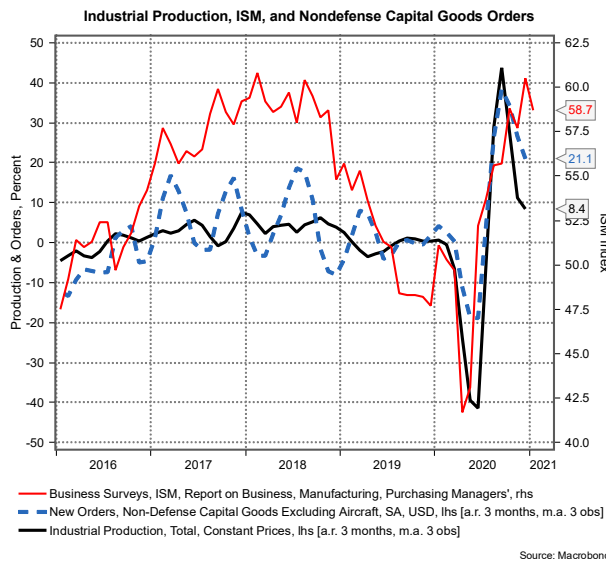
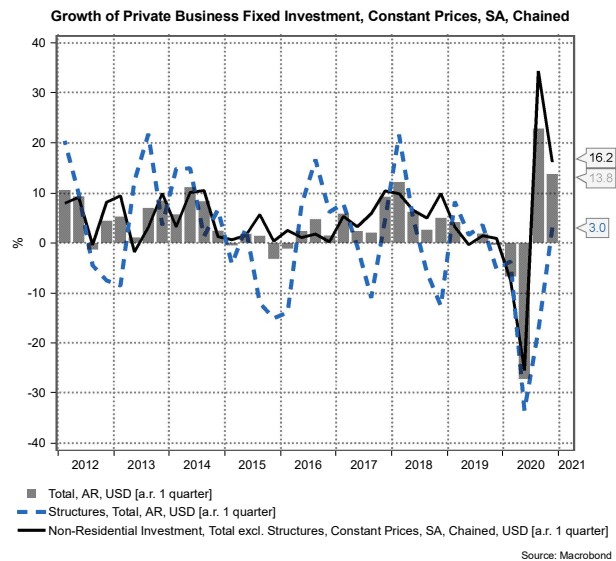


Figure 9: Business Investment Up but Mixed



Real **business investment** mirrored industrial output in 2020, down in the first half, up in the second, and finishing the year 1.3% below its 4Q2019 level (Figure 9). Investment in business structures was down 14.1% for the year (Q4/Q4) despite a 3% gain in the fourth quarter. With many businesses continuing to operate remotely, there is little need for new office construction, and this sector is likely to remain weak for some time. “Core” business investment excluding structures fared better. It was up 16.2% in Q4 and 1.9% YoY – about in-line with changes in capacity utilization during the year (Figure 10). Capacity utilization recovered from the lows early in the pandemic and ended December at 74.5%, although that remains below the upper-70s that is associated with strong investment spending. Rising industrial output should boost utilization rates this year, but investment spending is likely to be modest until they do.

Figure 10: Business Investment to Moderate

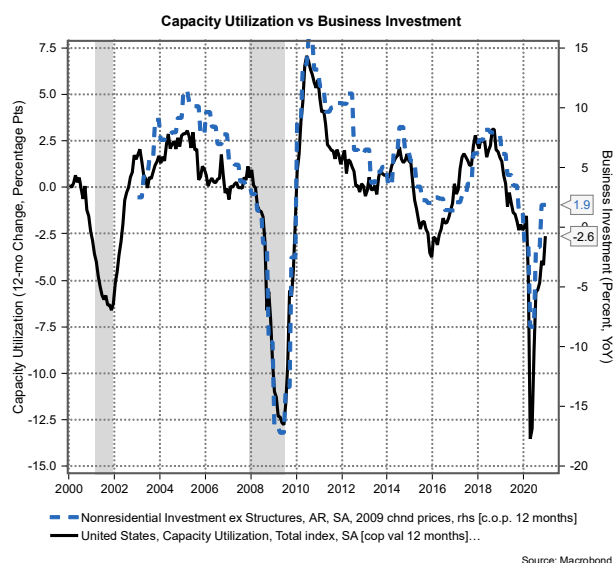
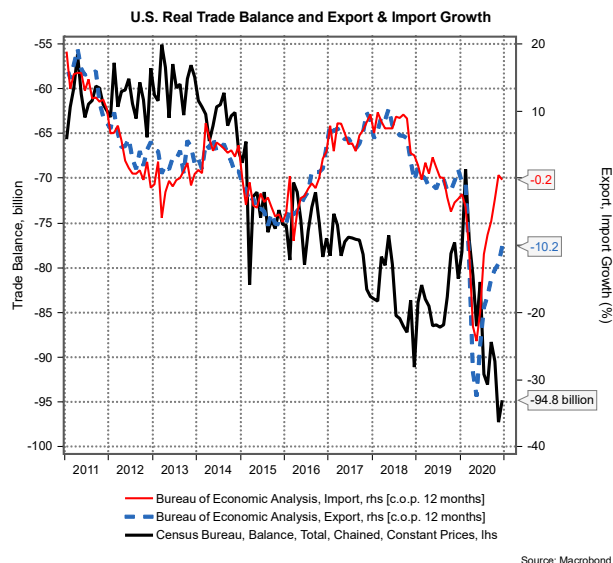


Figure 11: Sharply Wider Trade Deficit



The **trade deficit** widened sharply in the fourth quarter, although trade volumes recovered a bit (Figure 11). Net exports subtracted 1.5% from real GDP growth in Q4 after shaving 3.2% in Q3. Imports climbed back to -0.2% YoY in December after falling 25%. Exports posted a similar improvement, though they remained down 10.2% YoY. Economic recovery in the U.S. has outpaced most other developed nations, leading to faster rebound in imports than exports. A weaker U.S. dollar (down about 7% over the past 12 months) should encourage stronger exports as foreign demand revives.

However, if U.S. economic growth accelerates as we expect, business and residential investment should increase while consumer saving declines and government deficit spending remains elevated. The U.S. would need to run a larger capital account surplus to fill that gap between domestic savings and investment. In turn, that is likely to mean a wider trade deficit. It is notoriously difficult to predict the timing and magnitude of these related flows, but we see greater scope for trade to be a negative than a positive for GDP this year.

**Inventories** added 1.0% and 6.6% to real GDP in the third and fourth quarters, respectively, as businesses replenished inventories run down earlier in the pandemic. Moreover, business

sales have continued to outpace inventory growth, leaving inventories lean despite recent accumulation. We expect inventories to add to GDP for the next several quarters.

Real **government consumption** performed its usual countercyclical role during a recession, rising sharply as the pandemic unfolded and slipping as spending programs either slowed or expired over subsequent quarters (Figure 12). Support came from the federal government; state and local spending fell in all but Q1. Real federal government spending rose 2.5% YoY, including a modest 0.5% drop in Q4. State and local spending fell 2.5% YoY and 1.7% in Q4 as many states were squeezed by lower tax receipts. Looking ahead, federal government spending should rise in the wake of a \$900 billion assistance bill passed by Congress in December. Another stimulus bill is working its way through Congress now with a price tag that could reach \$1.9 trillion. Although the final bill may be smaller, it is still likely to be sizable and should mean federal government spending will rise in the first half of 2021 before easing in the second half. State and local spending, on the other hand, probably will remain soft in the first half, but it should gain strength as tax receipts respond to an advancing recovery.

Summarizing the fourth-quarter economic situation, real GDP growth of 4.0% breaks down as follows: Personal Consumption Expenditures (+1.7%), Residential Investment (+1.3%), Business Investment (+1.7%), Inventory Change (+1.0%), Net Exports (-1.5%), and Government Consumption (-0.2%). The first three components equal **Private Domestic Final Sales**, which rose by 5.6% and reflects impressive underlying domestic economic resilience and extraordinary government support during the pandemic.

Figure 12: Countercyclical Spending Fading?

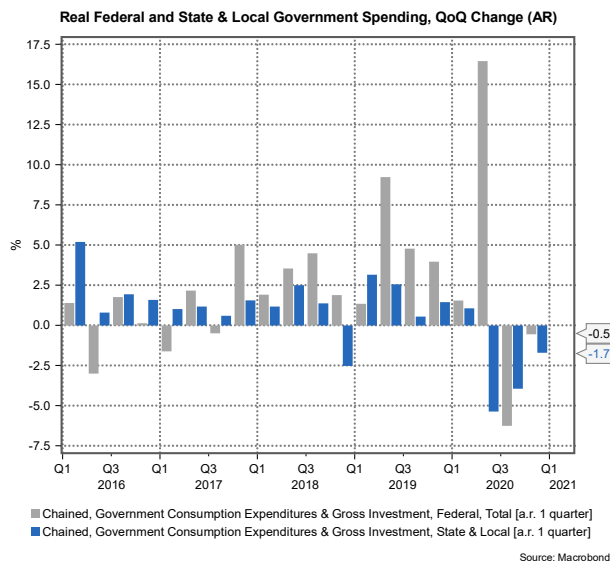
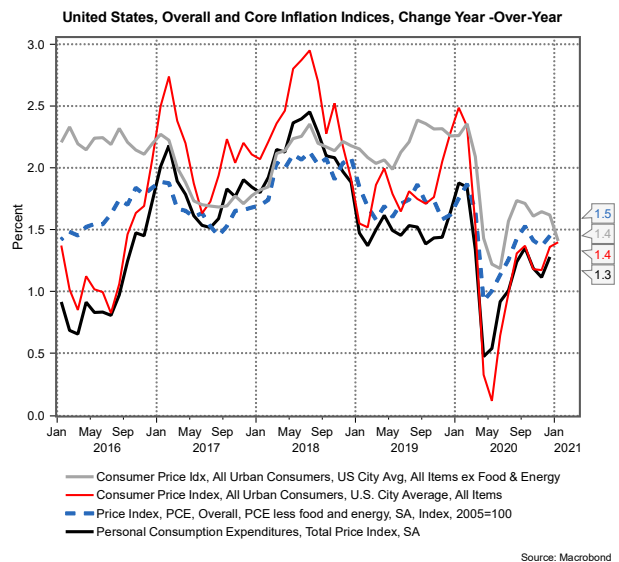


Figure 13: Inflation Poised to Rise, Slowly

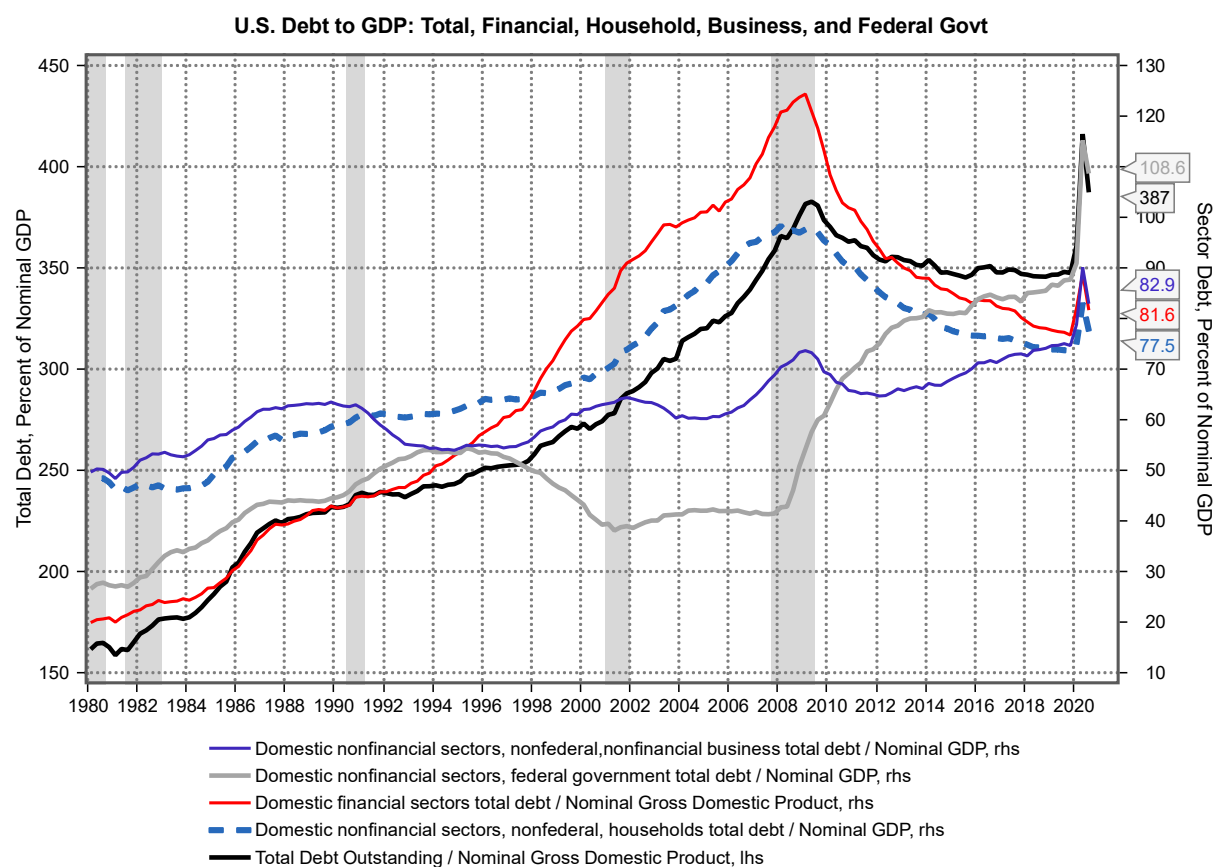


**Inflation** fell sharply as economic activity slowed in the first half of 2020, and it remains well below the Federal Reserve’s 2% target for the “core” PCE deflator excluding food and energy. For 12 months ending in January, the consumer price index (CPI) was up 1.4% both overall and excluding food and energy (Figure 13). The PCE deflator was up 1.5% overall and 1.3% excluding food and energy over 12 months ending in December (latest data available). Inflation should accelerate over coming months, for several reasons. First, prices fell as the

economy tumbled into recession. When year-over-year inflation rates are calculated from those lower base levels, they will rise even if monthly inflation does not accelerate. Second, energy prices increased sharply over the past three months, with spot crude oil prices up by almost 50% (not annualized). Admittedly, prices excluding food and energy have been tame over that period, but they should move up as higher energy prices filter into broader prices and as overall economic activity expands.

Nonetheless, a pickup in inflation is likely to be modest. Core inflation appears likely to accelerate to about 2% over coming months as strengthening growth and base effects take hold. However, excess capacity both here and abroad is available to meet rising demand. Unemployed workers can facilitate expansion in service-providing industries without spurring rapid wage and price inflation. In goods-producing industries, capacity utilization remains well below levels that have been associated with rising inflation in the past. And easy financial conditions (discussed below) mean companies can readily finance capital investments to boost productivity or add new capacity. Each of these should restrain inflation – not indefinitely, but at least for the next year or so.

Figure 14: Debt-to-GDP Up on Stimulus Spending; Private-sector Debt Growth Subdued



Broad **balance sheet trends** through the third quarter of 2020 (latest data available) show a dramatic increase in debt outstanding relative to GDP since the end of 2019 (Figure 14).



Overall debt-to-GDP rose to 387% in Q3 from 347% in 4Q2019. Federal government debt incurred to address COVID-19 and the recession it produced rose by nearly \$4 trillion over that period, pushing federal government debt-to-GDP to 108.6%, a post-World War II record. Household debt-to-GDP rose about 4% to 77.5%, and nonfinancial business borrowing rose from 74.6% to 82.9% of GDP over the same period. Many businesses issued debt and participated in Treasury's "Paycheck Protection Program" and other lending facilities to shore up liquidity during the recession. Financial business borrowing rose about 5% to 81.6% of GDP as consumers and businesses increased deposit balances at banks.

Private-sector debt ratios should resume a gradual downward trend as the economy recovers, although it will take time for them to fall below year-end 2019 levels. Government debt, on the other hand appears to be moving up under nearly any scenario; the only question is how quickly. Accommodative monetary policy and low interest rates make it easy for the U.S. Treasury to issue and service that debt, but that does not mean its growth is risk-free. With ample excess capacity for now, it is probably not a near-term risk. It will not always be that way, and long-term investors should be mindful of it.

## Market Outlook

A stronger than expected economic recovery and brighter outlook for the next several years pushed up long-term **Treasury rates** substantially in the fourth quarter and so far in 2021 (Figure 15). The benchmark 10-year Treasury note yield rose 24 basis points (bp) to 0.93% in Q4 and added another 37 bp so far this year, closing at 1.30% on February 16. The 30-year Treasury bond yield rose 19 bp to 1.65% in Q4 and jumped 43 bp to 2.08% as of February 16, its highest level in more than a year. Short rates held steady, leading to a steeper yield curve and higher market forward rates. The 10 year forward 10-year Treasury rate is now a little over 2.6%, compared to about 1.8% at the end of 3Q2020 and 2.7% at the end of 2019, before the pandemic struck. To be sure, markets continue to expect a long period of historically low rates ahead, but it is encouraging to see investors pricing in a more optimistic economic outlook.

The Federal Reserve kept monetary policy unchanged in the fourth quarter and so far in 2021. The Federal Open Market Committee (FOMC) left the fed funds rate target at 0-0.25% and the Fed will continue to buy at least \$80 billion Treasuries and \$40 billion agency mortgage-backed securities per month "until substantial further progress has been made toward the Committee's maximum employment and price stability goals."<sup>2</sup> While that language is deliberately vague, it probably means large-scale balance sheet expansion through the end of this year, with a shift to slowing purchases beginning in 2022 – hopefully without a repeat of 2013's "taper tantrum." In addition, the FOMC's last "dot plot" from December 2020 shows Committee members expected the fed funds rate to remain near zero through year-end 2023. That contrasts with market forward rates showing a rate hike in early 2023, reflecting

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<sup>2</sup> Board of Governors of the Federal Reserve System, *FOMC Meeting Statement*, January 27, 2021.

a strong economic outlook and risk that inflation could pick up sooner than the FOMC currently expects.

Figure 15: Rates Up on Stronger Outlook<sup>3</sup>

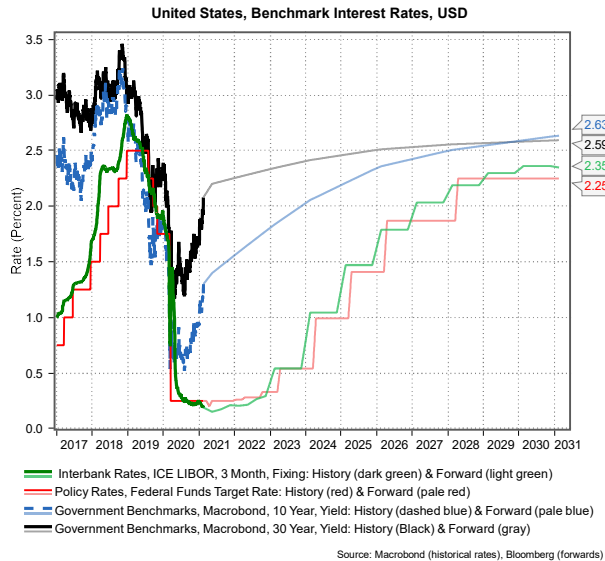
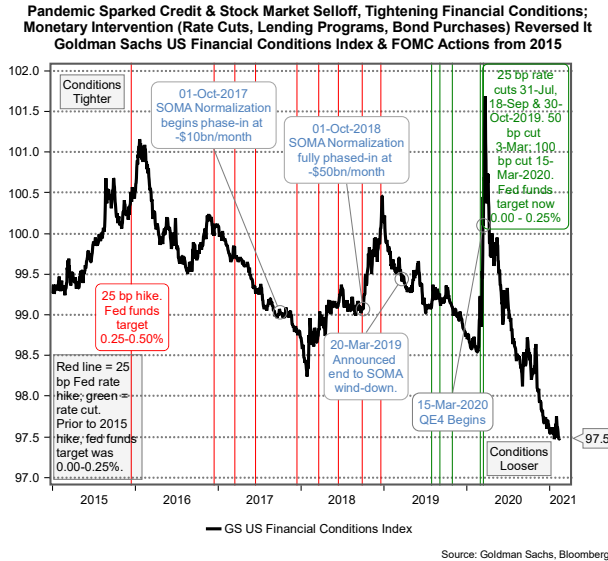


Figure 16: Monetary Policy Extremely Loose



Before turning to credit market conditions, we will discuss the Fed’s asset purchases and inflation risk. The Fed’s balance sheet in December 2019 was about \$4.2 trillion. It ended 2020 at \$7.4 trillion, an expansion that took more than five years to accomplish following the global financial crisis. If the Fed buys \$120 billion in Treasuries and mortgages each month in 2021, it will end the year over \$8.8 trillion. Concurrently, money supply growth has soared. M2, which includes cash and most bank deposits, was growing around 8% YoY in late 2019; it is up 28% YoY now. MZM, a broader measure of money supply, adds “zero maturity” assets such as money market funds; it jumped from 3% to 25% YoY growth over the same period. The Fed appropriately flooded the market with liquidity as fear gripped markets and financial conditions tightened last spring (Figure 16).

Today, ample liquidity represents fuel to support a vigorous recovery as COVID recedes, which is still a hope but not yet a reality. The Fed faces a delicate task of how and when to pare back monetary accommodation when that is a reality – especially if Congress passes additional fiscal stimulus, which appears likely. If the Fed waits too long, inflation could build quickly. If it acts too soon, economic recovery could stall. Given those risks, the Fed will probably wait too long. The Fed revised its longer-run inflation policy in August 2020 to target *average* inflation of 2%. Core PCE inflation has been below 2% for most of the last decade and would have to run considerably above 2% to achieve that goal.<sup>4</sup> As we noted earlier, we do

<sup>3</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.

<sup>4</sup> The FOMC has not defined a period over which “average” inflation will be measured. It could decide to recoup a relatively short period of below-target inflation, or a much longer one. As a result, it is unclear how much inflation above 2% the Fed would tolerate, or for how long, an uncertainty that adds risk.

not see much inflation risk in 2021 and into 2022, when inflation should move up near the Fed’s 2% target but not advance quickly beyond it. Risks mount thereafter, and we think it is why markets have priced in rates moving up faster and sooner than the Fed’s projections.

A recovering economy, improving outlook and all that liquidity drove corporate **credit spreads** tighter in the fourth quarter and so far in 2021, bringing spreads near their lows since the global financial crisis. Investment-grade corporate bond spreads narrowed 41 bp to 98 bp in Q4 and edged down to 89 bp as of February 16 (Figure 17).<sup>5</sup> High yield bond spreads narrowed dramatically, tightening 155 bp to 390 bp in Q4; they continued to drop in 2021 and closed on February 16 at 349 bp.

Figure 17: Spreads Near Post-GFC Lows

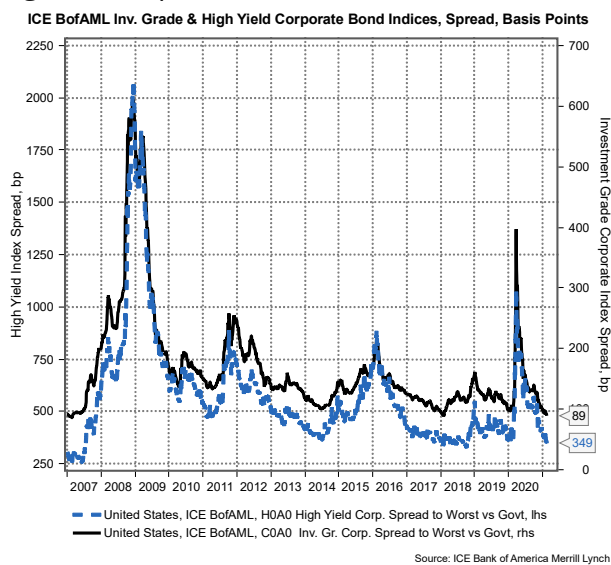
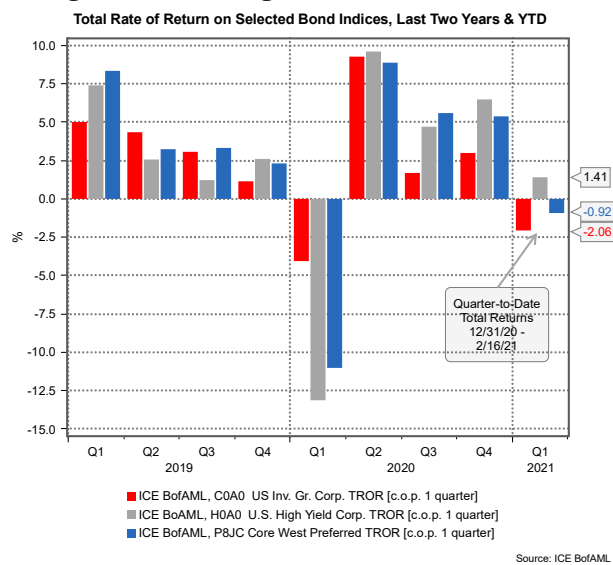


Figure 18: Strong Returns, Lower Yields



Spreads on preferred securities fell between those of investment-grade and high yield corporate bonds, although their complex call features make 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 since the first quarter of 2020. Total return in Q4 on the preferred index<sup>6</sup> (+5.38%) lagged the high yield index (+6.48%) but outperformed the investment-grade corporate bond index (+2.99%).<sup>7</sup> For all of 2020, the investment grade corporate index led the way (+9.81%) as interest rates fell and spreads ended the year about where they started (with a big selloff and rebound along

<sup>5</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 2/16/2021.

<sup>6</sup> Preferred index is the ICE BofA 8% Constrained Core West Preferred & Junior Subordinated Securities Index<sup>SM</sup> (P8JC). Index data through 2/16/2021.

<sup>7</sup> Total return is not annualized and includes both price change and income. Past performance does not guarantee future performance.

the way). Return on the preferred index was next at 7.81%, followed by the high yield index at 6.17%. Returns have been mixed so far this year through February 16 (see Figure 18 for QTD returns). Although last year's strong returns are welcome, they also mean that yields have dropped substantially, and those returns probably will not be repeated this year.

Credit conditions also took a rollercoaster ride in 2020 but finished the year on a strong note. Although factors unfavorable to bankruptcy filings as measured by the National Association of Credit Management spiked in early 2020, they rapidly declined as monetary and fiscal stimulus blunted financial fallout from the pandemic. Business bankruptcy filings *slowed* as the year progressed (Figure 19). As risks from the pandemic mounted and the economy slowed, U.S. banks about doubled loan-loss reserves relative to nonperforming loans in 2020 in expectation of significant credit deterioration. Instead, loan quality remained good. Consumer loan charge-offs and delinquencies were 1.9% and 1.8%, respectively, in Q3 (latest data available), down about 0.4% from 4Q2019 (Figure 20). Commercial and industrial loan problems did increase, with Q3 charge-offs and delinquencies at 0.55% and 1.9%, respectively, but that is only about 0.2% higher than in 4Q2019. While official data has not yet been released for the fourth quarter, banks noted in their earnings reports that loan delinquencies and charge-offs mostly held steady or declined in Q4, prompting many of them to release some reserves. There is risk that loan defaults could increase in 2021, but we believe banks have ample reserves to absorb them. Indeed, it seems more likely that problem loans remain subdued as economic growth picks up in 2021.

Figure 19: Bankruptcy Filings Eased in 2020

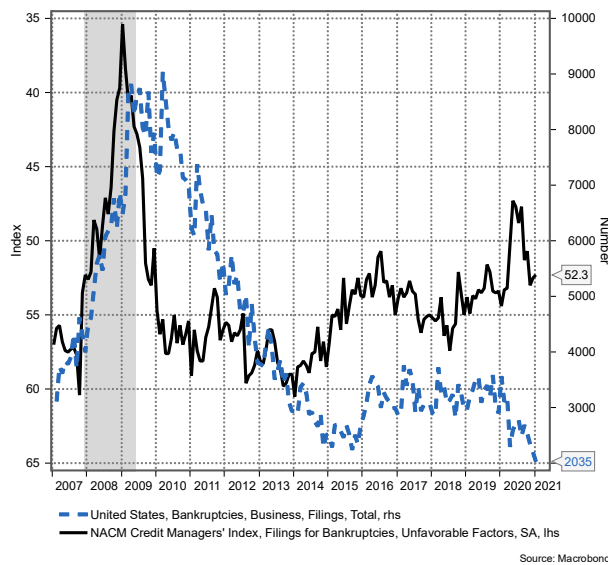
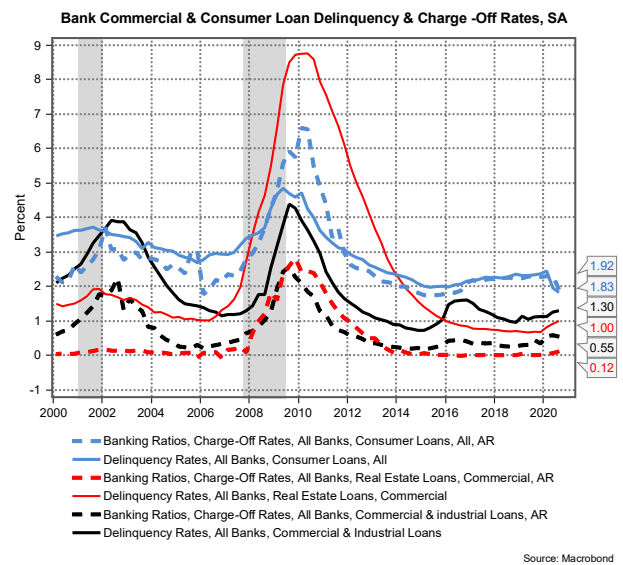


Figure 20: Loan Quality Better than Feared



As COVID-19 spread, banks reduced payments to shareholders, with steady or lower dividends and little to no share repurchases since 1Q2020, all while making respectable profits. As a result, despite significantly increasing loan-loss reserves, banks' capital ratios improved substantially. Capital and reserve strength were evident in a second round of stress tests that the Federal Reserve conducted on the nation's largest banks and released in December. From an average starting common equity Tier 1 ("CET1") ratio of 12.2%, that ratio

fell to 9.6-9.7% under severe economic assumptions used in the tests, a smaller decline than in earlier tests. Elevated loan-loss reserves protected capital, leaving it well above the 4.5% minimum set by the Fed. Moreover, no bank in the exercise failed its stress tests. We think these results highlight the major improvement in bank credit quality since the financial crisis. Apparently, the Fed agrees: it allowed many banks to boost shareholder returns (share repurchases and/or dividend increases) beginning in Q1.

Although not all sectors look as good as banks, insurance and other financial services, utilities and communications businesses remain broadly healthy. Even energy companies, which seemed at risk as economic activity plummeted in Q2, revived in the fourth quarter as vaccine rollouts and a brighter economic outlook drove up energy demand and prices.

We see risk from the pandemic receding in 2021, leading to above-trend growth with low but gradually rising inflation: in short, a favorable credit environment. Although longer-term risks are emerging, they should not present themselves this year and possibly well beyond that. Investors continue to search for yield, and elevated savings and ample liquidity have accelerated flows into credit investments. After a sustained rally since the lows in March 2020, overall credit spreads reflect our optimistic view. That means credit selection will be of paramount importance, and it remains at the heart of our investment process. We continue to see opportunity in the preferred and contingent capital securities markets.

Flaherty & Crumrine Incorporated  
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