

Third-Quarter U.S. Economic Update October 2011

Summary of Recent Economic and Market Developments

Economic growth improved in the third quarter of 2011 after a weak first half as headwinds from higher oil prices and the earthquake and tsunami in Japan receded. Real GDP is expected to grow by 2.2% in Q3 and 2.6% in Q4, about 1% lower than last quarter's forecasts. Job growth returned, but only by enough to bring down the unemployment rate by 0.1%. Employers continue to be extremely reluctant to hire workers. Wage growth remains stagnant. As a result, personal income growth was slow. Personal consumption strengthened during Q3 but remains subdued, and the savings rate edged lower. Business investment has slowed but remains a bright spot, while housing is stuck in neutral. The trade deficit narrowed slightly. Government spending continues to shrink, but the federal budget deficit remains elevated at about 8.7% of GDP. Inflation increased, but core inflation is still at or below 2% and should ease in the months ahead. Treasury yields fell sharply in response to weaker-than-expected economic data and the Fed's "Operation Twist." Credit spreads widened sharply and preferred securities' prices fell over worries about economic growth, the European sovereign debt crisis, and regulatory uncertainty – despite generally improving credit fundamentals. Although there are numerous risks on the horizon, we see good value for patient investors in preferred securities at today's lower prices.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	2009:4	2010:1	2010:2	2010:3	2010:4	2011:1	2011:2	2011:3
Real GDP, Chg QoQ (%)	3.8	3.9	3.8	2.5	2.3	0.4	1.3	2.2f
Real Personal Consump Expnds, Chg QoQ (%)	0.4	2.7	2.9	2.6	3.6	2.1	0.7	1.2a
Real Busi Investmt, Eqp & Sftware, Chg QoQ (%)	11.7	21.7	23.2	14.1	8.1	8.7	6.2	NA
Real Residential Investmt, Chg QoQ (%)	-3.8	-15.3	22.8	-27.7	2.5	-2.4	4.2	NA
Corporate Profits, After Tax, Chg YoY (%)	65.6	36.0	36.2	23.3	17.4	10.6	9.4	5.5f
Current Account Balance, Annualized (% of GDP)	-2.9	-3.3	-3.3	-3.3	-3.0	-3.2	-3.1	NA
Federal Budget, 12-mo Def or Surp (% of GDP)	-10.4	-9.5	-9.2	-8.9	-8.6	-9.5	-8.4	-8.7
Unemployment Rate (%)	9.9	9.7	9.5	9.6	9.4	8.8	9.2	9.1
Household Employment, Chg QoQ (000)	-831	992	140	286	-172	658	-530	691
Nonfarm Payrolls, Chg QoQ (000)	-406	118	543	-137	416	497	290	287
Nonfarm Productivity, Chg QoQ (%)	5.5	4.6	1.2	2.1	2.2	-0.6	-0.7	NA
Capacity Utilization (%)	70.8	72.8	74.5	75.7	76.8	77.0	76.6	77.4
GDP Price Index, Chg QoQ (%)	1.1	1.5	1.5	1.4	1.9	2.5	2.5	NA
Consumer Price Index, Chg YoY (%)	2.7	2.3	1.1	1.1	1.5	2.7	3.6	3.8a
CPI ex food & energy, Chg YoY (%)	1.8	1.1	0.9	0.8	0.8	1.2	1.6	2.0a
Nominal Personal Income, Chg YoY (%)	-1.7	2.6	3.9	4.9	5.1	5.9	5.3	4.5a
Personal Savings Rate (%)	4.5	4.8	5.8	5.4	5.2	4.7	5.3	4.5a
Rate or Spread (End of Quarter)	2009:4	2010:1	2010:2	2010:3	2010:4	2011:1	2011:2	2011:3
Federal Funds Rate Target (%)	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3-month LIBOR (%)	0.25	0.29	0.53	0.29	0.30	0.30	0.25	0.37
10-Yr Treasury Note Yield (%)	3.84	3.83	2.93	2.51	3.29	3.47	3.16	1.92
30-Yr Treasury Bond Yield (%)	4.64	4.71	3.89	3.69	4.34	4.51	4.38	2.91
Moody's Baa Long Corp Spread (bp)	175	160	216	189	164	154	152	231
10-Yr Interest Rate Swap Spread (bp)	13	-2	7	6	9	11	12	19

* Figures are either quarterly or, if more frequent, quarterly averages. f = Forecast¹; a = Actual through August 2011 Source: Reuters EcoWin

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

Economic Outlook

The U.S. economy appears to have recovered a bit in the third quarter of 2011 after a weak first half. Economists forecast inflation-adjusted **Gross Domestic Product** (real GDP) of 2.2% in Q3 and 2.6% in Q4.¹ These forecasts are roughly 1% lower than last quarter’s forecasts and reflect the lack of momentum in the economy coming out of the first half of the year, when growth averaged just 0.8%. As we explained in last quarter’s Update, we expected sluggish growth in Q2 due to temporary headwinds from higher oil prices (due to supply constraints resulting from the Arab Spring uprisings) and supply chain disruptions (due to the tragic earthquake and tsunami in Japan), followed by stronger growth in Q3.² Although that general pattern is playing out, the first half of the year was weaker than expected, and the rebound in the second half is also likely to be subdued. Moreover, much of the weakness in GDP was not visible until (downwardly) revised GDP data was published in late July. As a result, it now appears highly unlikely that real GDP will achieve the 2½ - 3% growth rate for all of 2011 that we had previously expected. Nonetheless, as long as the European sovereign debt crisis does not spin out of control, we think a 2 - 3% growth rate is achievable in 2012. While that represents a relatively sluggish pace of growth for a typical recovery from recession, it should be fast enough to accommodate ongoing deleveraging and balance sheet improvement. In addition, although there are numerous risks to growth, we do not anticipate a recession anytime soon.

We will move through the major sectors of the economy fairly quickly, since the basic story of why we anticipate modest economic growth has not changed much recently. We will spend more time on the risks to the outlook – risks that have knocked around preferred securities with some vigor recently.

Figure 2: Unemployment Depressing Wages

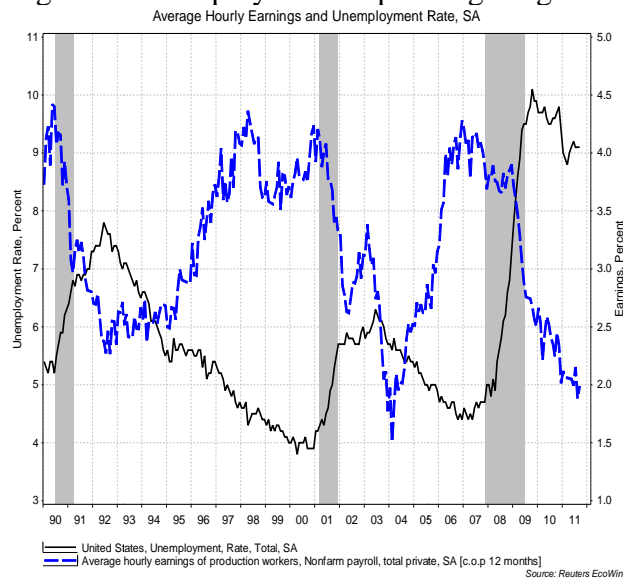
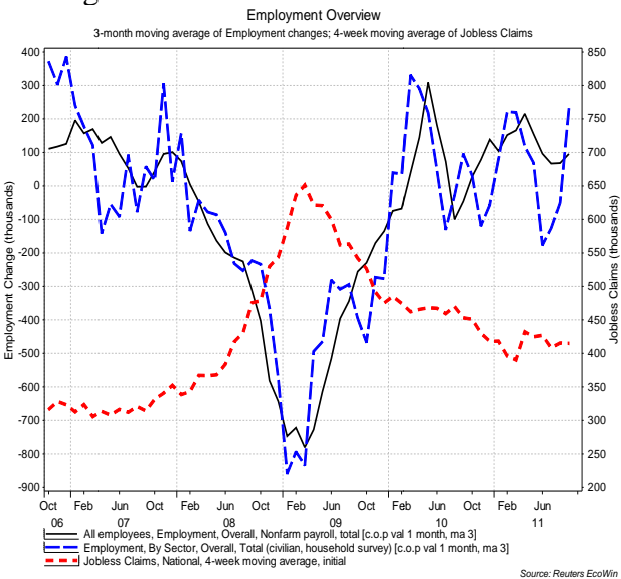


Figure 3: Job Growth Slow but Positive



¹ All growth rates are annualized unless noted otherwise. Forecasts in this Update are from *The Survey of Professional Forecasters*, Federal Reserve Bank of Philadelphia, August 12, 2011.

² See *Second-Quarter U.S. Economic Update*, Flaherty & Crumrine Incorporated, July 15, 2011; available at www.preferredincome.com, www.flaherty-crumrine.com or www.fcclaymore.com.

The **labor market** improved in the third quarter, but only by enough to push down the unemployment rate by 0.1% to 9.1%. Wage growth remains stuck around 2%, barely above core inflation, and wages are unlikely to accelerate until the unemployment rate drops more significantly (Figure 2). Overall nonfarm payroll jobs rose by 287,000 during the quarter despite the loss of 65,000 jobs in the government sector. This is roughly the same pace of job growth as in Q2, but it is a clear slowdown from late 2010 and early 2011, when job formation appeared to be accelerating (Figure 3). Household employment was much stronger in Q3 (+691,000), but followed much weaker performance in Q2 (-530,000). Although the household survey probably overstates the actual volatility of employment, it does capture the uncertainty of the current economic environment – uncertainty that is making employers extremely reluctant to hire. We expect those concerns will dissipate only gradually.

The combination of slow job growth and limited wage increases means that **personal income** growth has also been slow. Personal income was up just 2.2% in the three months ending in August (the latest data available) and 4.5% YoY (Figure 4). The year-on-year figure looks pretty good, but it is boosted by the reduction in social security taxes that began in January and runs through the end of 2011. Even if that tax incentive is extended for another year³, it will not provide another lift to personal income, only prevent a decline. We continue to expect only modest improvement in personal income through at least next year.

Figure 4: Income Sagging, PCE Steady

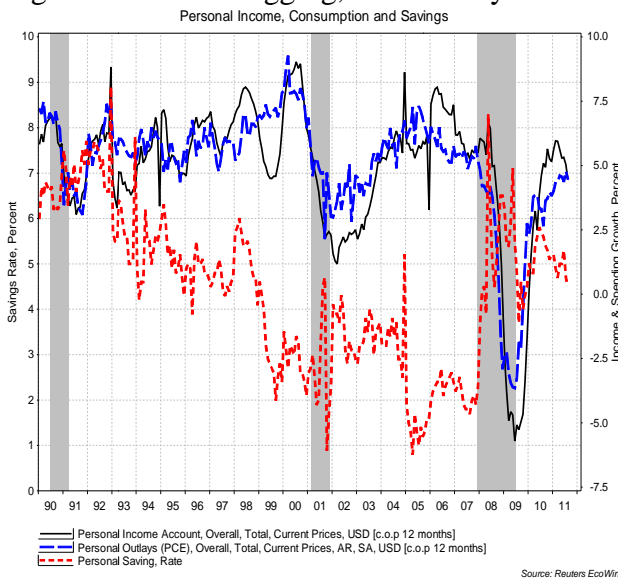
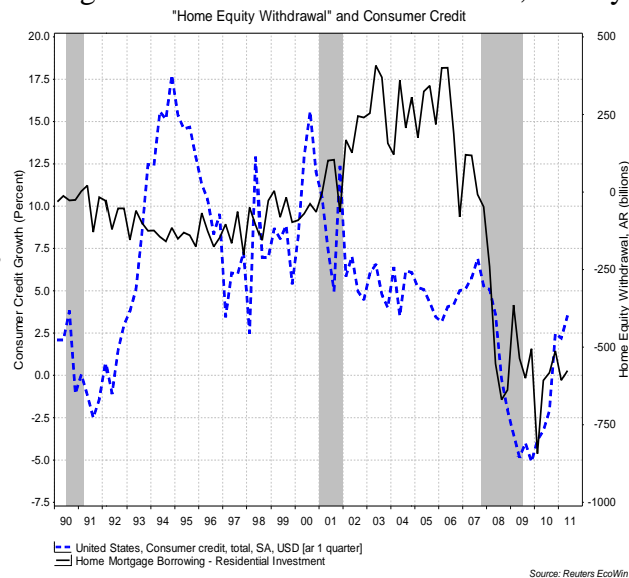


Figure 5: Debt Reduction Continues, Mostly



Slow growth in personal income also means subdued growth in **personal consumption expenditure** (PCE). PCE grew by only 2.3% over the three months ending in August, compared to 4.7% YoY (Figure 4), although retail sales data released today suggest somewhat firmer PCE for the full quarter. As Figure 4 shows, PCE has held about steady in YoY terms in recent months, while income growth has slowed, which has pushed the savings rate down. We think income will improve with further gains in employment, so we are not troubled by what looks to

³ The Obama administration has proposed extending through 2012 the 50% reduction in Social Security taxes paid by employees as part of its recent jobs/stimulus package. The political prospects for the proposal are unclear at this time.

be a temporary drop in the savings rate. Households continue to reduce debt, especially in mortgages, but consumer credit is starting to edge higher (Figure 5). However, since we are focusing on risks to the outlook, the prospect for slow personal income growth is one of them. If households decide to reduce consumption and boost savings in response to weak income growth, the economy could tip back into recession. We don't think this is the most likely case, since there has not been a spending "binge" that requires correction, but it remains a risk.

Figure 6: Home Sales Flat, Inventories Down

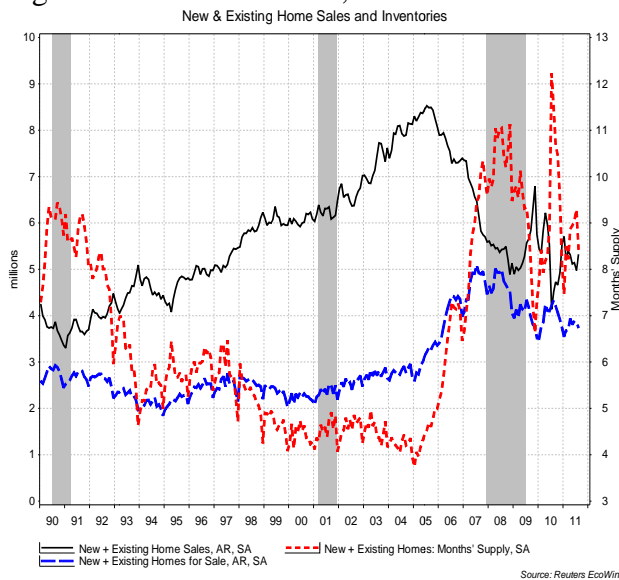
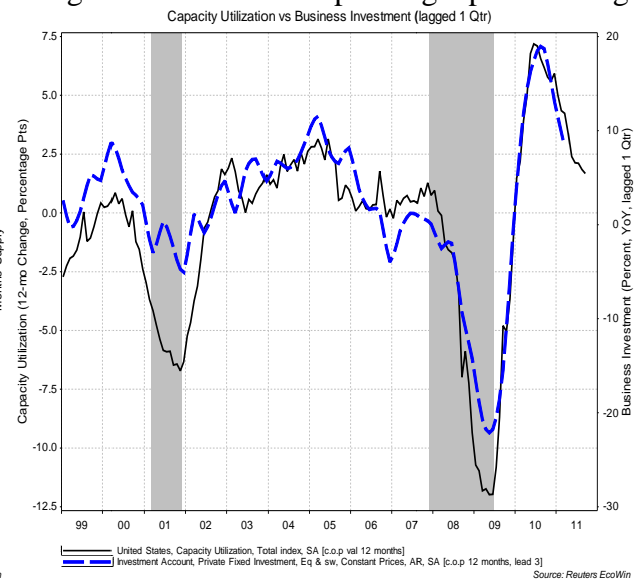


Figure 7: Investment Spending Up but Easing



The **housing market** continues to bounce along the bottom, neither setting new lows nor showing any signs of sustained improvement. New and existing home sales in August were about in the middle of the 5.0-5.7 million unit pace range seen so far in 2011. Inventories of unsold homes are edging lower (Figure 6), and affordability remains near the recent record high. Home prices have shown signs of stabilizing or even increasing in recent months, though they remain down by 3-4% YoY. Construction of new homes remains well below the long-term replacement rate, which should continue to drive down inventories of unsold homes. Although a rebound in housing is not imminent, it is inevitable.

Business investment has continued to grow in 2011, albeit at a decelerating pace. As the growth in capacity utilization has slowed, so has business investment (Figure 7). It has remained positive, however, and we expect that to continue. Similarly, orders and shipments for core capital goods (nondefense capital goods excluding aircraft) have slowed a bit but remain healthy (Figure 8). **Industrial production**, which slowed earlier in the year in the face of headwinds from higher oil prices and supply chain problems, has picked up (Figure 9). Survey data has been more tentative (e.g., the ISM manufacturing data shown in red in Figure 9), but that too has turned a bit more positive recently. In addition, inventories remain lean across manufacturing, wholesale and retail segments. All of this is consistent with moderate growth or better, with no signs of imminent recession.

The **trade deficit** narrowed a bit in July and August compared to the second quarter average (Figure 10), making it likely that net exports will provide a small positive contribution to GDP growth in Q3. That compares to slight drag on GDP growth in the first half. Trade probably will

not be a major contributor to GDP growth this year or next, given the outlook for subdued global growth.

Figure 8: Capital Goods Still Solid

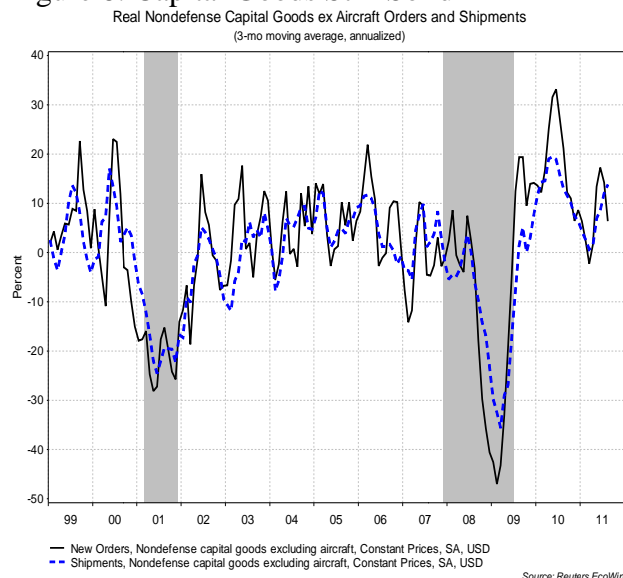


Figure 9: Industrial Production Recovering

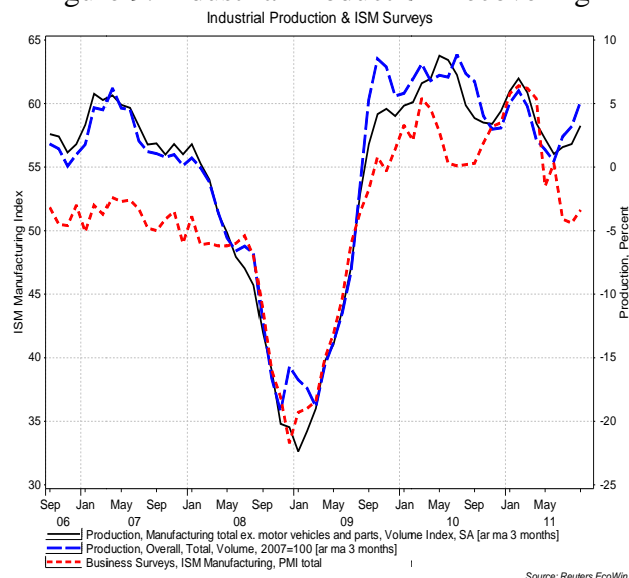


Figure 10: Trade Deficit Holding About Steady

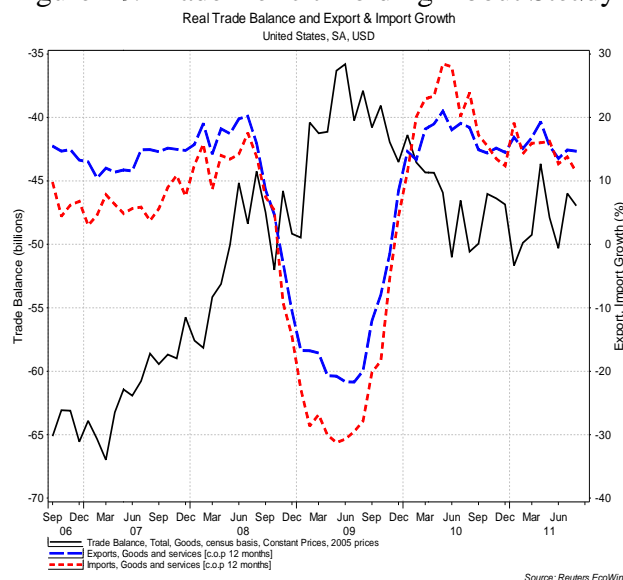
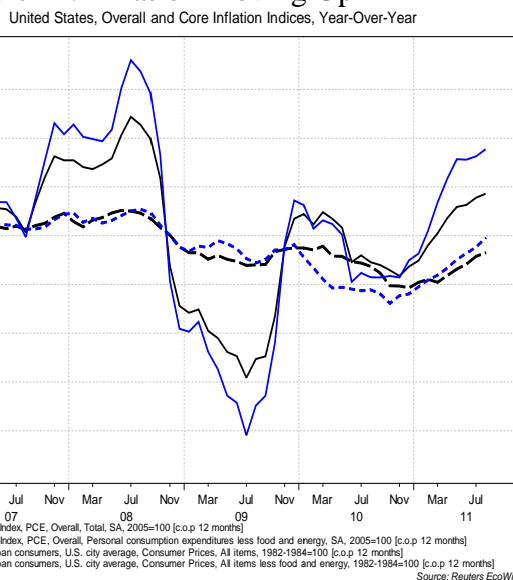


Figure 11: Inflation Moving Up



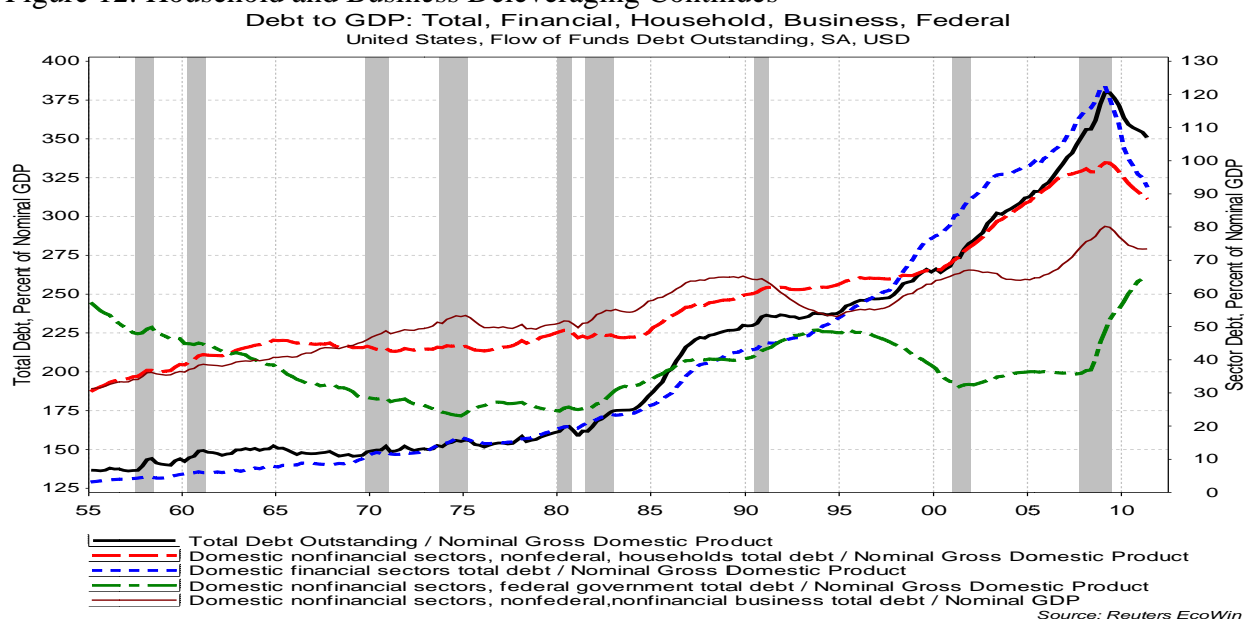
Overall **government spending** continues to decline, subtracting 0.18% from GDP in Q2. State and local government has been an especially persistent drag on GDP growth, with negative contributions to real GDP in 8 of the past 10 quarters. This should continue for at least several more quarters. However, state and local governments began to cut their budgets relatively soon after the recession trimmed tax revenues, so the fiscal drag from those budget cuts should begin to diminish next year.

In contrast, fiscal drag from the federal government is really just starting. The federal budget deficit for fiscal year ending in September 2011 was \$1.3 trillion, or about 8.7% of GDP. As part of legislation passed (with some drama) in August to extend the federal debt ceiling, Congress

must agree on \$1.2-1.5 trillion in budget savings over the next 10 years.⁴ If it cannot agree on those changes, then automatic across-the-board spending cuts, beginning in 2013, will be imposed. If Republicans and Democrats can reach agreement, then budget cuts will probably be modest initially and increasing over time. This would prevent fiscal drag from harming a fragile recovery over the near term while putting the federal budget on more stable footing over the long term. If they are unable to reach agreement, however, then sizable fiscal drag will begin in 2013, which would modestly increase the risk to growth. We are hopeful that, under the circumstances, the two sides will come to an agreement. However, little has been said about the work of the supercommittee, and we cannot accurately handicap the outcome.

Inflation in the U.S. has increased meaningfully this year (Figure 11). Overall PCE inflation is up by 2.8% YoY and the consumer price index (CPI) is up 3.8% YoY. “Core” (i.e., excluding food and energy) prices on those indices also have marched steadily upward and are now up by 1.6% and 2.0% YoY, respectively. Recent declines in food and energy prices are likely to pull inflation down over the next several quarters, however. For now, the Federal Reserve remains unconcerned about inflation getting out of control given ongoing deleveraging and substantial excess capacity across the U.S. economy. Although we do not anticipate it, if inflation continues to move upward, the Fed may be forced to pull back on some of the extraordinary monetary accommodation that is currently in place. That too is a risk factor we are watching closely.

Figure 12: Household and Business Deleveraging Continues



As usual, we will conclude this section with a brief recap of **balance sheet trends** (Figure 12). Deleveraging is continuing in the household and financial sectors, and it likely will continue for an extended period. Deleveraging has bottomed out in the nonfinancial business sector, where borrowing is just starting to increase again. We are not concerned about this small uptick in

⁴ The specifics of the spending cuts and/or tax increases are assigned to a “supercommittee” of representatives and senators (three Republicans and three Democrats from each of the House and Senate). The recommendations of the committee, which are due by November 23, will be put to an “up or down” vote in the House and Senate. If the committee cannot reach agreement, or the recommendations do not pass the House and Senate, then automatic cuts will begin in January 2013.

nonfinancial corporate borrowing. Leverage in the sector is relatively modest, interest rates are low, profitability continues to be strong, and businesses remain cautious on the economic outlook, which should prevent the sorts of debt-fueled investment excesses that have created financial strain in the past.

In contrast to the private sector, government debt continues to increase sharply. Federal government debt now stands at about 67% of GDP (as of September), up from less than 36% at the end of 2007. Although the deficit reduction agreement reached in August will slow the increase in debt, it appears unlikely that a “grand bargain” to put the budget on a sustainable long-term path – a deal that necessarily will include tax and entitlement reform in addition to discretionary spending restraint – will be struck before the next presidential election in 2012. As a result, the U.S. remains vulnerable to its own debt problems at some point in the future. That is not imminent, however, and for now U.S. Treasury securities remain a global safe-haven investment. But it is another risk factor for fixed-income markets to contend with over time.

Market Outlook

Treasury rates fell dramatically in the third quarter in response to slower economic growth, the worsening of the European sovereign debt crisis, and changes in monetary policy (Figure 13). The thirty-year Treasury yield dropped by 147 basis points (bp) to 2.91%, although it has retreated to 3.13% as of today. This puts long-term Treasury rates at the lowest level since the mid-1950s. In the short end, the fed funds target rate remained unchanged at zero to 0.25%.

Figure 13: Long-term Yields Down Sharply

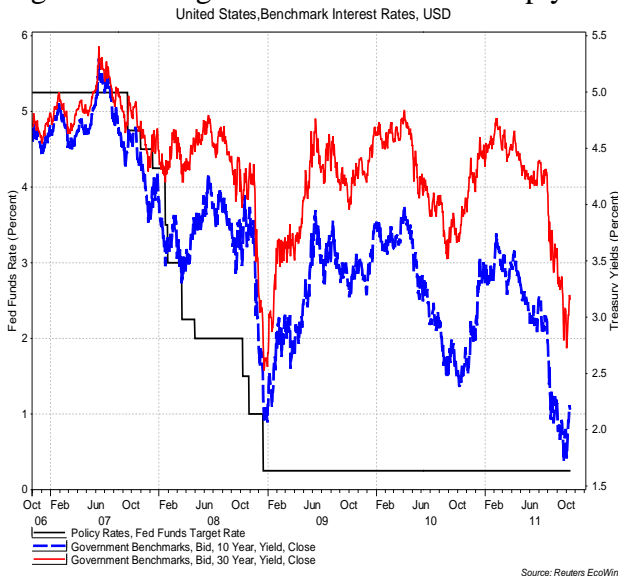
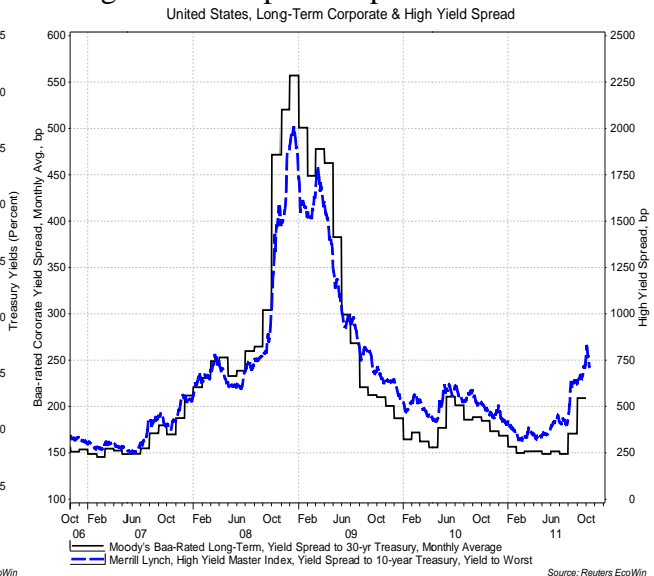


Figure 14: Corporate Spreads Much Wider



In response to slower economic growth, the Federal Reserve implemented several **monetary policy** changes during the third quarter. In August, the Federal Open Market Committee put a fine point on its expectation that policy rates would remain exceptionally low for an “extended period.” At that meeting, the Fed announced that it intended to hold short rates around current levels *at least until mid-2013*. Prior to that announcement, markets had been pricing in a modest amount of tightening beginning in mid-2012; short rates rallied as a result.

Subsequently, at the September FOMC meeting, the Fed announced that it will make some important changes to its securities portfolio holdings. Recall that the Fed had earlier purchased \$200 billion agency debt, \$1,250 billion agency mortgage-backed securities, and \$300 billion of Treasuries in its first quantitative easing program begun in 2008 (QE1), and \$600 billion of Treasuries in a second round of purchases that finished in June 2011 (QE2). Except for the mortgages, the bulk of the debt purchased by the Fed was in the short to intermediate part of the yield curve, with relatively few purchases of issues with maturities longer than 10 years. The Fed had been reinvesting principal proceeds from those portfolios into Treasuries with like maturities. In September, the FOMC announced that it will (1) sell \$400 billion of Treasuries maturing in three years or less to buy Treasuries maturing in more than six years, and (2) reinvest agency debt and mortgage principal in more mortgage-backed securities. This change meant that the Fed would be selling shorter-term securities to buy longer-term securities, in an effort to lower the yields on those longer-term issues. The market promptly called this “Operation Twist,” which was the name of a similar program conducted in the early 1960s, with the same goal of “twisting” the yield curve to lower long-term rates. Long-term Treasury rates rallied sharply on the news.

Credit spreads widened significantly in Q3, partly on rising credit concerns and partly due to the sharp, policy-driven rally in Treasuries. The Moody’s long Baa-rated corporate spread to Treasuries widened by 79 bp, and high yield spreads widened by a stunning 342 bp (Figure 14). Preferred securities’ prices fell, with Bank of America – Merrill Lynch preferred indices down by 1.8-6.5% in price terms during the quarter.

We have written extensively on preferred market conditions elsewhere, but the sizable widening of credit spreads merits a brief summary of those comments here.⁵ Preferred securities’ prices suffered from three main worries during the third quarter. First, as we have discussed, the U.S. economy performed worse than expected in the first half of the year, with much of that poor performance not visible until the third quarter. Second, the European sovereign debt crisis worsened materially in the third quarter. Greece and Portugal struggled to hit their budget deficit reduction targets, and yields on Spanish and Italian government bonds rose significantly. Meanwhile, European leaders moved only slowly toward a solution to the crisis – though they recently have acquired a more appropriate sense of urgency. Finally, regulatory uncertainty left financial companies unsure of what capital instruments are appropriate for dealing with any capital inadequacies and investors unsure of what will happen to preferred securities in a stress scenario. These combined to raise investor concerns over fundamental credit quality, potential losses on preferreds in the event of official support for banks in the Eurozone, and financial contagion in general. Many preferred investors headed for the exits.

Let us assess these worries. We have already addressed the economy: sluggish growth but no recession, which should keep credit quality improving (more on that in a moment). The Eurozone problems will take time to resolve, but we finally see policymakers moving in the right direction and with appropriate speed. Banks there will be recapitalized, which should avert financial contagion and give countries more time to get their fiscal houses in order and pursue structural reforms to improve their growth prospects. Although some banks probably will be forced to impose losses on their preferred capital providers, we do not currently anticipate that will be the case at any of the banks in our portfolios.

⁵ See Preferred Market Update, October 2011, available at www.preferredincome.com, www.flaherty-crumrine.com or www.fcclaymore.com.

Returning our attention to the U.S. economy, **credit quality** generally continues to improve. Leverage at financial companies is declining, and it was up only slightly at nonfinancial companies. Corporate profitability is at record levels as a share of GDP (Figure 15). Interest expense relative to earnings before interest and taxes continues to decline. Liquidity is at a record high, as is the proportion of long-term debt to total debt, both of which reduce short-term funding risk (Figure 16).

Figure 15: Corporate Profits at Record Highs

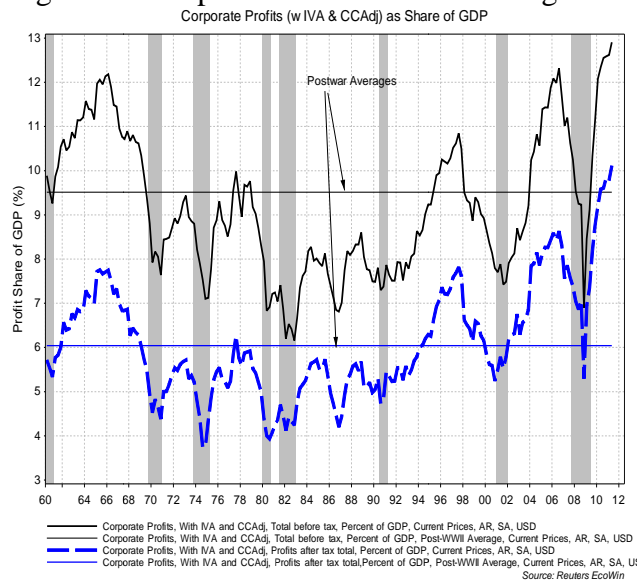


Figure 16: Balance Sheets Strong

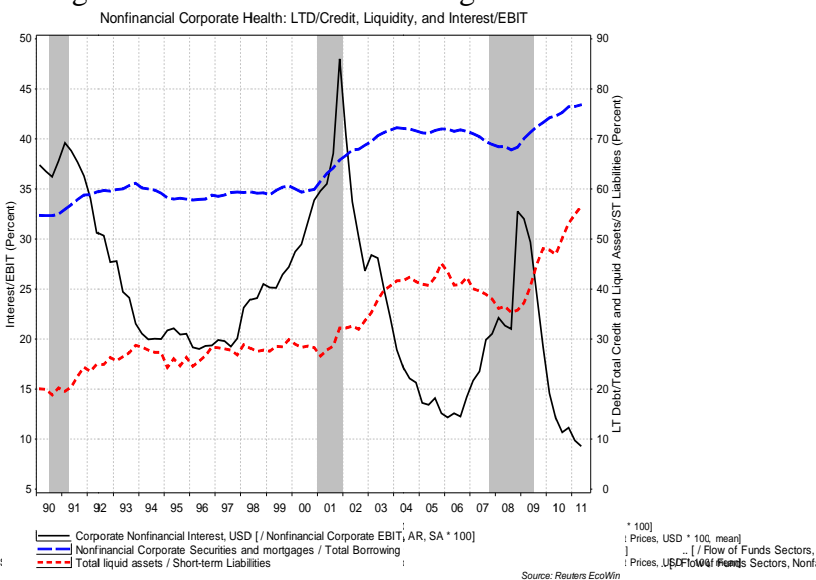


Figure 17: Loan Quality Still Improving

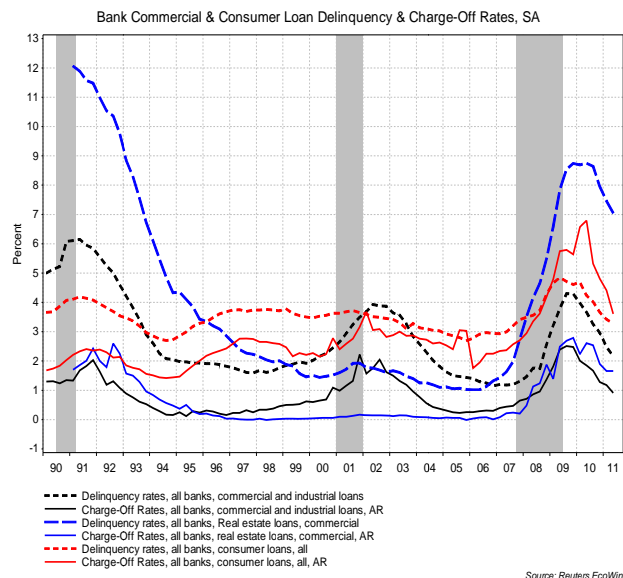
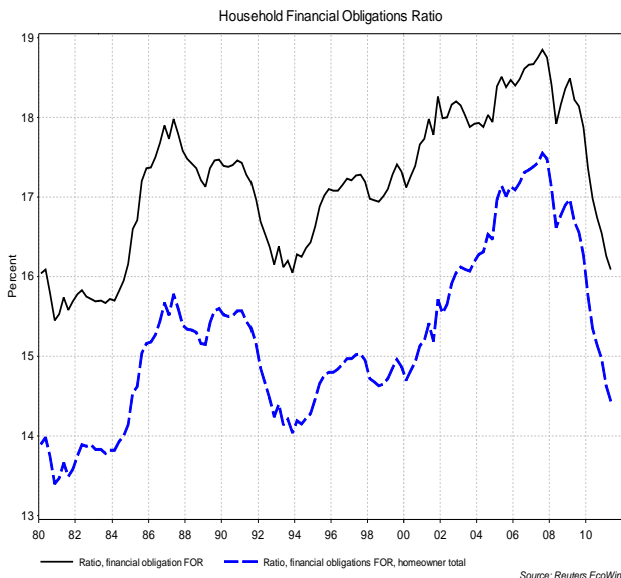


Figure 18: Consumer Debt Burdens Falling



Bank loan delinquencies and charge-offs, while still high historically, continue to trend down across all major loan categories (Figure 17). This improved lending environment has increased banks' willingness to lend, and commercial and industrial loans are rising again. Consumers continue to reduce debt, however, which has kept overall bank credit roughly flat. The decline in household borrowing and lower interest rates have reduced the proportion of household income

devoted to debt and lease payments (the “financial obligations ratio”), strengthening consumer balance sheets and reinforcing these positive credit trends (Figure 18). The better lending environment also has allowed banks to reduce provisions for loan losses, contributing to improved earnings and capital at banks. We anticipate that banks will slow releases of loan loss provisions given the uncertainty over the economic outlook, but charge-offs should continue to trend down. Finally, capital ratios at banks have rebounded to well above pre-crisis levels, and they continue to increase.

Other categories of preferred issuers show generally stable to modestly improving capitalization and operating fundamentals. Life insurers will probably report smaller unrealized gains in their corporate bond portfolios, but underlying business fundamentals remain good, although they will face some longer-term challenges if interest rates remain around today’s low levels for more than a few years. Property and casualty insurance and reinsurance companies have had to pay sizable claims on recent natural disasters, but we anticipate that most will post only small to moderate losses, and they should benefit from premium increases in the wake of these disasters. Regulated utilities continue to operate conservatively and generate stable earnings. Allowed returns are under some downward pressure given low interest rates, but steady infrastructure investment and low borrowing costs are making for stable credit profiles in the sector.

Turning to **regulatory matters**, there was only one major development during the third quarter. The Basel Committee on Banking Supervision released its final decision on the incremental capital buffer that systemically important financial institutions (SIFIs) will need to hold over and above Basel III minimum requirements. The Committee decided that SIFIs will need to hold an additional 1.0-2.5% of *common equity* capital; the amount within that range will depend upon the bank’s size, global interconnectedness, and systemic importance. In addition, the Committee reserved an extra 1% common equity requirement that might be applied if a bank becomes even more systemically important in the future. The U.S. has endorsed these requirements for U.S. banks. It bears repeating that this is good news for preferred investors.

One thing that we did *not* get during the third quarter was the Fed’s proposal for bank capital rules under Dodd-Frank in the U.S. We had anticipated that proposed rules would be published by the end of September, but it now appears that the Fed will not release them until late this year or early in 2012. That means final rules will not be published until the end of 1Q2012 at the earliest – even though they go into effect on January 1, 2013. This will not give banks a lot of time to prepare for the new rules, and it leaves both banks and investors uncertain about the rules of the road until then. Although we think the final rules will be beneficial for preferred investors, the uncertainty over their details has contributed to the volatility of the market this summer.

We continue to anticipate a volatile environment for preferred securities. However, we think the selloff in preferreds since June represents an opportunity for patient investors. Strong credit fundamentals, an economy that should avoid recession, and low yields on competing investments eventually should drive investors back into preferred securities. And while we may have to wait a bit longer, regulatory clarity and, especially, a comprehensive solution to the European sovereign debt crisis should also contribute to better performance for preferreds. It may be bumpy for preferred investors while these things play out, but we think it will be worth the wait.

Flaherty & Crumrine Incorporated
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