

U.S. First-Quarter Economic Update

April 2005

Summary of Recent Economic Developments

Economic growth in the United States has remained healthy so far in 2005, with few surprises relative to the outlook we gave in our last Economic Update¹. Accordingly, we will keep this Update brief, with a focus on factors affecting monetary policy and credit spreads.

Private forecasters expect real GDP growth of 3.7% in 2005:Q1 and 3.5% for all of 2005, both about unchanged from the consensus a quarter ago². The steady if unspectacular growth rate has pushed the unemployment rate down and capacity utilization and core consumer price inflation up. Personal consumption expenditures have slowed, while business investment remains very firm. Employment gains slowed in the first quarter, but should pick up again if the economy expands at its projected pace. Trade continues to be a major drag on GDP, and slowing economies among a number of our trading partners will likely prevent improvement in the trade balance this year. Inflation continues to inch higher, and the Federal Reserve has adopted a more hawkish tone in response. This has pushed short rates up while longer-term rates have risen only a little or not at all. Finally, corporations have begun to borrow money again; eventually, this should lead to wider corporate spreads and investment opportunities for the Funds.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator	2003:2	2003:3	2003:4	2004:1	2004:2	2004:3	2004:4	2005:1
Real GDP, Chg QoQ (%)	4.1	7.4	4.2	4.5	3.3	4.0	3.8	3.7f
Real Personal Consump Expnds, Chg QoQ (%)	3.9	5.0	3.6	4.1	1.6	5.1	4.2	3.5a
Real Busi Investmt, Eqp & Sftware, Chg QoQ (%)	11.0	21.7	12.0	8.0	14.2	17.5	18.4	
Real Residential Investmt, Chg QoQ (%)	9.1	22.4	9.6	5.0	16.5	1.6	3.4	
Corporate Profits, Pretax, Chg YoY (%)	13.6	20.6	23.3	27.8	19.0	5.8	12.4	7.6f
Current Account Balance, Annualized (% of GDP)	-4.9	-4.7	-4.5	-5.1	-5.7	-5.6	-6.3	
Federal Budget, 12-mo Def or Surp (% of GDP)	-2.9	-3.4	-3.5	-3.7	-3.7	-3.5	-3.3	
Unemployment Rate (%)	6.3	6.1	5.7	5.7	5.6	5.4	5.4	5.2
Household Employment, Chg QoQ (000)	324	-156	790	-1	750	369	629	345
Nonfarm Payrolls, Chg QoQ (000)	-53	99	302	531	693	401	569	477
Nonfarm Productivity, Chg QoQ (%)	6.7	8.7	2.8	3.8	3.9	1.3	2.1	
Capacity Utilization (%)	74.9	75.8	76.8	77.4	77.8	78.0	79.2	79.4a
GDP Price Index, Chg QoQ (%)	1.1	1.4	1.6	2.8	3.2	1.4	2.3	
Consumer Price Index, Chg YoY (%)	2.1	2.3	1.9	1.7	3.2	2.5	3.4	3.0a
CPI ex food & energy, Chg YoY (%)	1.5	1.2	1.1	1.6	1.9	2.0	2.2	2.3a
Nominal Personal Income, Chg YoY (%)	2.6	3.9	4.9	4.9	5.2	5.2	8.9	5.8a
Personal Savings Rate (%)	1.2	1.4	1.2	1.0	1.5	0.5	3.7	0.7a
Rate or Spread	2003:2	2003:3	2003:4	2004:1	2004:2	2004:3	2004:4	2005:1
Federal Funds Rate Target (%)	1.00	1.00	1.00	1.00	1.25	1.75	2.25	2.75
3-month LIBOR (%)	1.12	1.16	1.15	1.11	1.61	2.02	2.56	3.12
10-Yr Treasury Note Yield (%)	3.52	3.94	4.25	3.84	4.58	4.12	4.22	4.49
30-Yr Treasury Bond Yield (%)	4.56	4.89	5.07	4.78	5.29	4.90	4.83	4.76
Moody's Baa Long Corp Spread (bp)	163	191	153	133	149	138	132	130
10-Yr Interest Rate Swap Spread (bp)	34.4	42.5	40.6	40.0	51.3	45.6	43.0	47.2

* Figures are either quarterly or, if more frequent, quarterly averages.

f = Forecast²; a = Actual through Feb 2005

Source: EcoWin

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

¹ See Flaherty & Crumrine Incorporated, *U.S. Fourth-Quarter Economic Update*, January 2005.

² Source: Federal Reserve Bank of Philadelphia, *Survey of Professional Forecasters*; data courtesy EcoWin.

Economic Outlook

Consumer spending is still growing faster than incomes, which has put further downward pressure on the savings rate (Figures 2 and 3). Nonetheless, spending has slowed a bit in recent months – not by enough to derail the economy, but by enough to bring spending about in-line with income growth. This may be an indication that households have decided that a personal savings rate near zero is unacceptable. We hope so, since the sooner households address this imbalance, the less painful the adjustment to a higher savings rate will be for the economy.

Figure 2: Spending Moderating...

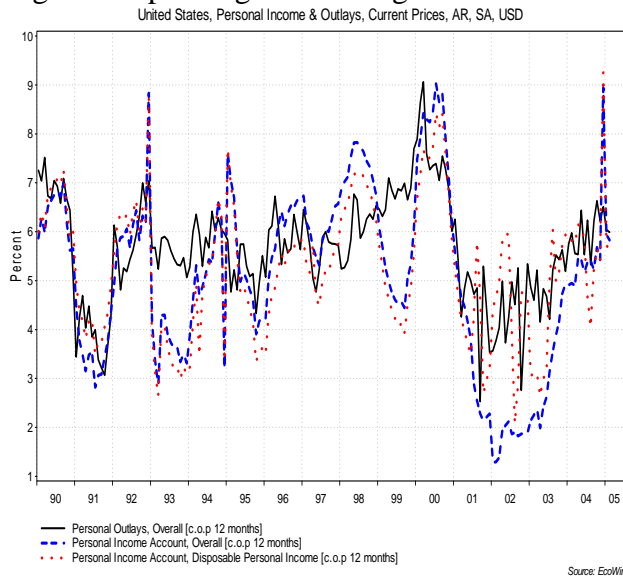
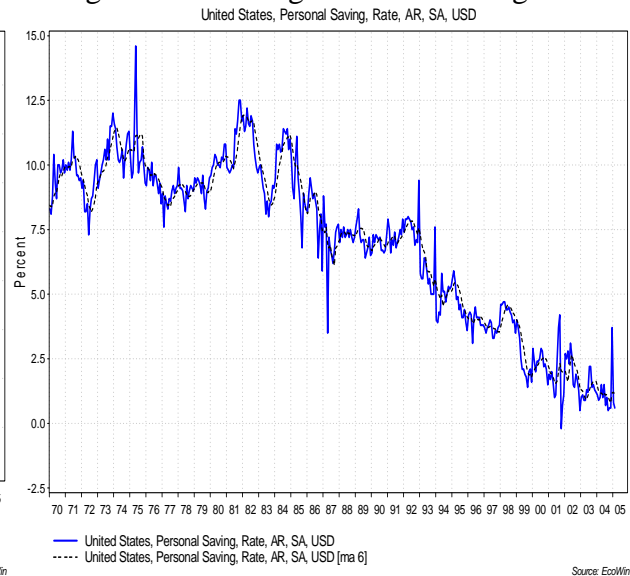


Figure 3: ...Savings Rate Bottoming?



The **labor market** decelerated a bit in the first quarter of the year, producing 159,000 jobs per month on average, compared to about 190,000 per month in the fourth quarter. Nonetheless, employment surveys remain optimistic and the economic outlook is solid, so we are not concerned with this apparent job slowdown just yet. We suspect that employment growth will pick up again soon as long as the economy continues to grow at its anticipated pace.

Inflation remains under gradual upward pressure, having bottomed in 2003. All of the factors creating upward pressure on inflation that we noted in our last Update – above trend growth, rising import prices, and sharply higher energy and core intermediate goods prices – remain in place (see Figures 4 and 5 on the next page). It is the gradual increase in inflation and persistent pressure supporting it – along with continued solid economic growth – that prompted the Federal Open Market Committee (“FOMC”) to change the tone of its monetary policy statement on March 22. In it, the FOMC noted that it expected inflation to remain “contained,” but only “with appropriate monetary policy action.” We’ll have more to say about the Fed in a moment, but suffice to say that the Fed sees inflation pressures building and is acting to suppress them.

Figure 4: Inflation Moving Higher

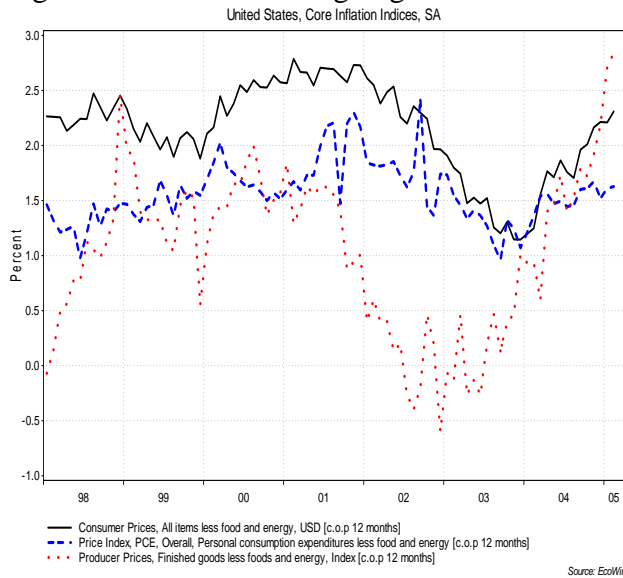
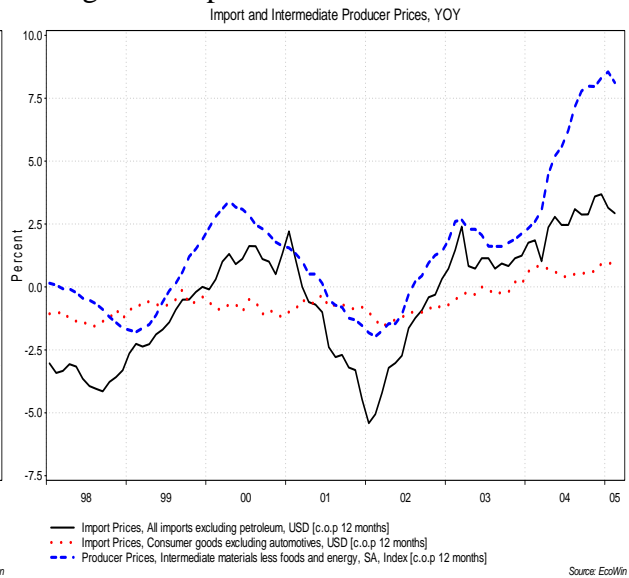


Figure 5: Pipeline Pressures Persist



The **business sector** has kept the expansion humming as the consumer has scaled back expenditures in recent months. Business investment spending on property, software and equipment accelerated throughout 2004. Judging by the growth rate of non-defense capital goods orders excluding aircraft (i.e. core capital goods), which are up at a 17% annualized pace through February, business investment should continue to be strong in the first quarter. Much of this investment seems to be targeted to enhancing productivity rather than expanding capacity outright. This is visible in the stronger-than-expected 2.1% productivity gain in the fourth quarter and the fact that capacity utilization is trending up despite heavy investment (Figure 6). Moreover, it may help explain why job growth has been less than what economists have expected given the growth rate of the economy, since productivity-enhancing equipment allows producers to increase output with less labor input (i.e. jobs). In any event, business investment spending should remain a positive for the economy and for productivity.

Figure 6: Business Investment Still Strong

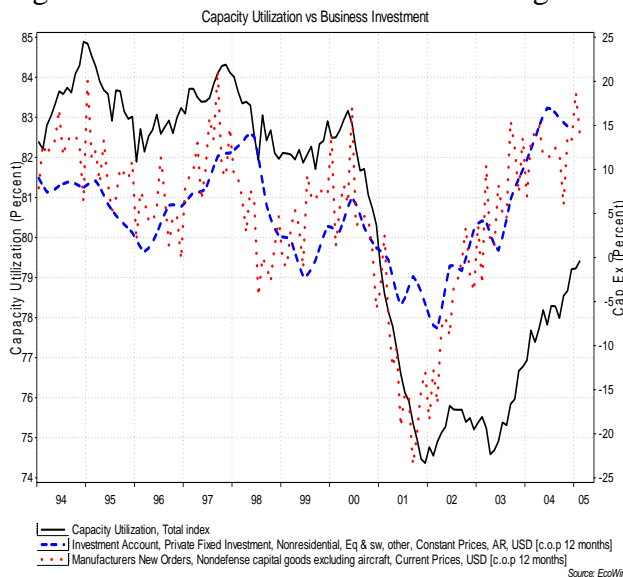
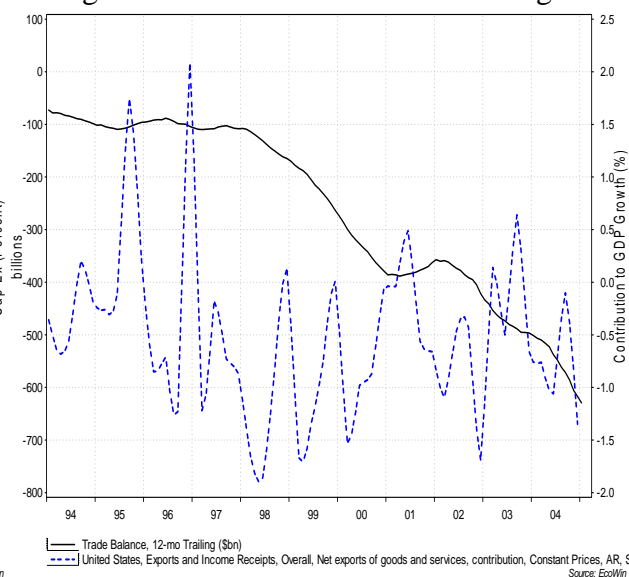


Figure 7: Trade Remains Growth Drag



The **trade sector** remains a major drain on economic growth, subtracting 1.3 percentage points from GDP in 2004:Q4 (Figure 7). Although the monthly trade gap has retreated slightly from the record set in November, it will be extremely difficult for it to narrow meaningfully this year. As we have noted in the past, exports need to grow more than 60% faster than imports just to stabilize the deficit at its current level. With the economies of many of our trading partners growing more slowly than the U.S., it would take a massive decline in the dollar, a recession in the U.S, or a sharp reacceleration of growth abroad for exports to grow 60% more quickly than imports – none of which appears probable at the moment. Don't expect the trade deficit to narrow this year.

Market Outlook

At the risk of sounding like a broken record, we once again have to report that long-term **interest rates** have been broadly stable over the past few months, as the yield statistics in Figure 1 make clear. Despite 50 bp of rate hikes so far this year and potentially prolonged monetary policy tightening by the Federal Reserve, the 30-year U.S. Treasury bond yield today sits at 4.73%, *exactly* where it was when we last wrote this Update in January. In fact, we anticipated a placid yield environment, and we have been managing the Funds' hedges with this lower-volatility environment in mind. Still, as one would expect, the lack of movement in long-term yields has not suited our option-based hedging strategy very well. Having said that, we do expect volatility to return at some point, probably accompanied by higher rates, and we remain committed to hedging the interest rate exposure of the Funds while managing the long-run cost of that protection.

One of the few noteworthy developments on the interest rate front in recent months is the change in the tone of monetary policy at the Federal Reserve. As we indicated earlier, the FOMC took a decidedly more hawkish tone in its March 22 monetary policy statement. Specifically, the Fed expressed greater concern over inflation, saying that “pressures on inflation have picked up in recent months and pricing power is more evident.” It then went on to say that “*with appropriate monetary policy action*” [emphasis added] risks to inflation and growth could be contained. This evolution in the Fed's thinking initially sent rates higher, but the longer end of the market has subsequently returned to where it was trading prior to the FOMC's announcement. Short rates remain higher, however, and the market is now pricing in a fed funds rate around 3.85%, up by about 50 bp from three months ago. Given the Fed's greater anxiety over inflation and the pipeline pressures that are pushing inflation higher, there is clearly room for the market's estimate of the year-end fed funds rate to move higher. If, as it now seems likely, the Fed were to tighten by 25 bp at each FOMC meeting between now and the end of the year, the fed funds rate would be at 4.25%. We have a hard time seeing 30-year Treasury rates at 4.73% if the funds rate is 4.25%. As we said three-months ago, we'll stay hedged, thanks.

Finally, the outlook for **credit spreads** is developing essentially in-line with our expectations. Credit trends continue to improve and spreads remain historically tight, but corporate borrowing is beginning to pick up. As a result, we believe that we are gradually moving toward a world of wider spreads on corporate and preferred securities. Starting with the positives for spreads, corporate profitability, while slowing from the unsustainable levels early in the recovery, remains solid and has allowed companies to significantly improve their credit positions. Due to a combination of debt reduction and higher profitability over the past several years, corporate interest expense as a percentage of earnings before interest and taxes (EBIT) is now well below the average level of the past 25 years (Figure 8). Similarly, bank loan delinquencies and charge-

offs are back down to the rates that prevailed in the mid-1990s, while business bankruptcy filings are holding near record lows (Figure 9).

Figure 8: Corporate Interest Expense Falling

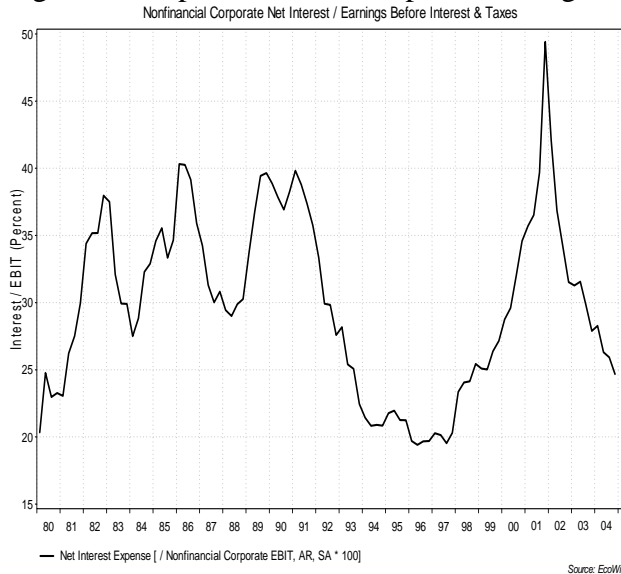
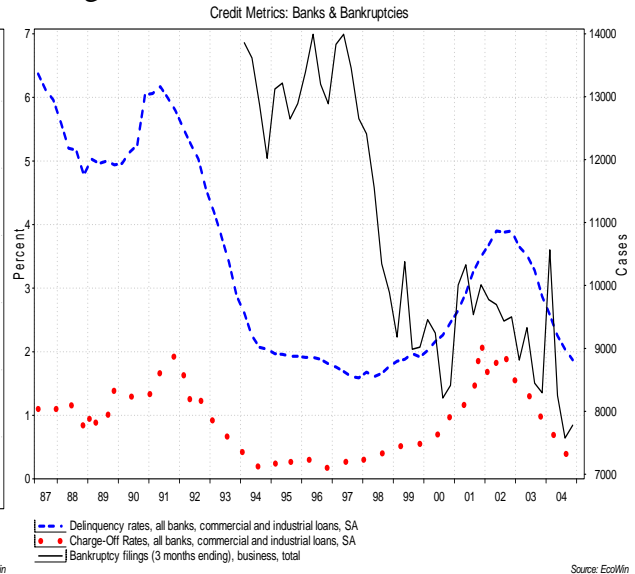


Figure 9: Bank Credit Metrics Solid



As we noted earlier, business investment spending is growing quite rapidly. If rising investment spending and slowing profitability persist, corporations will begin to step up their borrowing. In fact, higher borrowing is already visible in commercial and industrial loan and non-financial commercial paper volumes (Figure 10). In addition the non-financial corporate financing gap has turned positive after 18 months in negative territory³ (Figure 11). In short, corporations are borrowing again.

Figure 10: CP and C&I Loans and ...

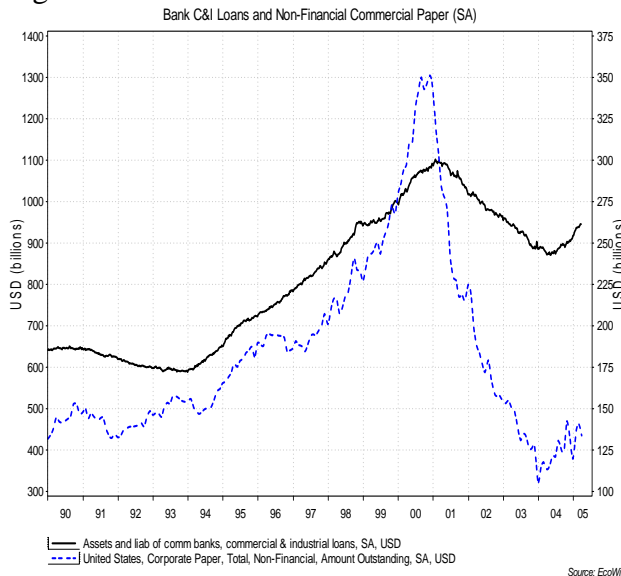
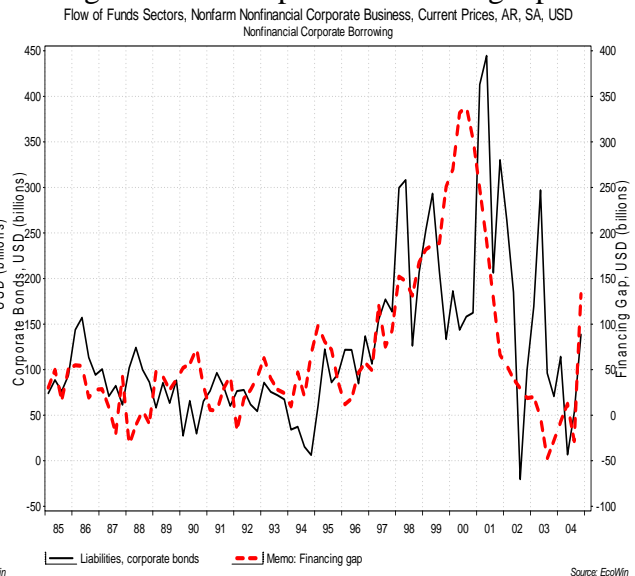


Figure 11: ...Corporate Borrowing Up



³ A positive financing gap means that corporations, on an aggregate basis, have borrowed money from banks and investors, while a negative financing gap means that corporations have repaid debt.

As borrowing in the corporate sector ramps up, the Treasury's borrowing requirement should begin to trend down at some point over the next year or so as rising tax collections and pressure to reduce deficit spending prompt a bottoming in the federal budget deficit. This combination of rising corporate borrowing and declining federal borrowing should eventually put upward pressure on corporate bond spreads. However, given still-low interest rates and improving credit trends, there seems to be more than ample demand for corporate and preferred securities at the moment, which has held corporate and preferred spreads at or near their recent lows. The intersection of narrow spreads and rising corporate borrowing is bound to create some volatility – and opportunities – in the securities we buy. We remain selective about the credits we own while we await those opportunities.

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