

U.S. Third-Quarter Economic Update October 2005

Summary of Recent Economic Developments

Economic growth appears to have held its ground in the third quarter, despite the tragic toll taken by Hurricanes Katrina and Rita. Private forecasters¹ currently expect real GDP growth of 4.2% in 2005:Q3 and 3.6% for the fourth quarter, although revised estimates to account for the impact of the hurricanes probably will put growth in the range of 3.0-3.5% in the second half of the year; thereafter, GDP is likely to pick up as rebuilding accelerates. Consumer spending firmed in the third quarter, largely due to increased purchases of automobiles, and business spending appears to have remained strong. Payroll jobs slowed, but the Department of Labor indicates that, absent the impact of the hurricanes, employment appears to be expanding around its prior pace of about 190,000 jobs per month. The trade balance probably worsened along with surging energy prices and import volumes, but the core trade balance continued to show improvement. Inflation pressures appear to be gradually building and are of particular concern to the Federal Reserve, which has signaled its intention to continue to tighten monetary policy. Long-term yields finally rose in response to sustained economic growth and accompanying inflation worries, leaving the yield curve only slightly flatter than at the end of the second quarter.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator	2003:4	2004:1	2004:2	2004:3	2004:4	2005:1	2005:2	2005:3
Real GDP, Chg QoQ (%)	3.6	4.3	3.5	4.0	3.3	3.8	3.3	4.2f
Real Personal Consump Expnds, Chg QoQ (%)	3.1	4.7	1.9	4.4	4.3	3.5	3.4	4.4a
Real Busi Investmt, Eqp & Sftware, Chg QoQ (%)	5.5	12.0	15.2	15.5	12.4	8.3	10.9	
Real Residential Investmt, Chg QoQ (%)	11.5	5.2	17.8	2.6	1.6	9.5	10.8	
Corporate Profits, After Tax, Chg YoY (%)	16.0	22.2	13.3	4.4	7.0	4.1	9.9	21.3f
Current Account Balance, Annualized (% of GDP)	-4.5	-5.1	-5.7	-5.7	-6.3	-6.5	-6.3	
Federal Budget, 12-mo Def or Surp (% of GDP)	-3.6	-3.7	-3.7	-3.5	-3.3	-3.3	-2.7	
Unemployment Rate (%)	5.7	5.7	5.6	5.4	5.4	5.2	5.0	5.1
Household Employment, Chg QoQ (000)	790	-1	750	369	629	345	1137	794
Nonfarm Payrolls, Chg QoQ (000)	302	531	693	401	569	546	593	453
Nonfarm Productivity, Chg QoQ (%)	0.8	2.1	4.5	1.3	2.5	3.2	1.8	
Capacity Utilization (%)	76.8	77.4	77.8	78.0	79.2	79.5	79.8	78.6
GDP Price Index, Chg QoQ (%)	1.9	3.6	3.9	1.5	2.7	3.1	2.6	
Consumer Price Index, Chg YoY (%)	1.9	1.7	3.2	2.5	3.4	3.2	2.5	4.7
CPI ex food & energy, Chg YoY (%)	1.1	1.6	1.9	2.0	2.2	2.4	2.1	2.0
Nominal Personal Income, Chg YoY (%)	4.8	5.3	5.2	5.6	9.8	6.2	6.4	2.8a
Personal Savings Rate (%)	1.9	1.7	1.5	1.0	4.4	0.4	-0.3	-0.9a
Rate or Spread	2003:4	2004:1	2004:2	2004:3	2004:4	2005:1	2005:2	2005:3
Federal Funds Rate Target (%)	1.00	1.00	1.25	1.75	2.25	2.75	3.25	3.75
3-month LIBOR (%)	1.15	1.11	1.61	2.02	2.56	3.12	3.52	4.07
10-Yr Treasury Note Yield (%)	4.25	3.84	4.58	4.12	4.22	4.49	3.92	4.33
30-Yr Treasury Bond Yield (%)	5.07	4.78	5.29	4.90	4.83	4.76	4.19	4.57
Moody's Baa Long Corp Spread (bp)	154	137	142	136	127	138	162	158
10-Yr Interest Rate Swap Spread (bp)	40.6	40.0	51.3	45.6	43.0	47.2	46.2	46.2

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

f = Forecast¹; a = Actual through August 2005

Source: EcoWin

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

¹ Source: Federal Reserve Bank of Philadelphia, *Survey of Professional Forecasters, August 15, 2005*; data courtesy EcoWin.

Economic Outlook

Consumer spending got a major boost from “employee discount pricing” promotions by major auto manufacturers over the summer before slowing in response to Hurricanes Katrina and Rita in September (Figure 2). Consumer spending appears vulnerable at least in the near term for four reasons. First, consumer confidence plunged following the human suffering and higher energy prices wrought by Katrina, and it has recovered only slightly in recent weeks. Although consumers often continue spending despite sagging confidence, a decline of this magnitude bears watching. Second, higher energy prices may reduce consumer spending on other goods and services, especially if prices remain high during the winter heating season. Third, the personal savings rate is already negative as a result of consumers dipping into savings to pay higher gasoline prices; this is an unprecedented development, and we don’t think they will tolerate a negative savings rate for long (Figure 3). Finally, higher interest rates are making financing consumption with debt more expensive. As long as job growth and therefore personal income growth remains solid, we don’t expect a rapid (i.e. recession-producing) decline in consumption, but the risk of recession increases the more stretched consumer balance sheets become.

Figure 2: Retail Sales Still Strong...

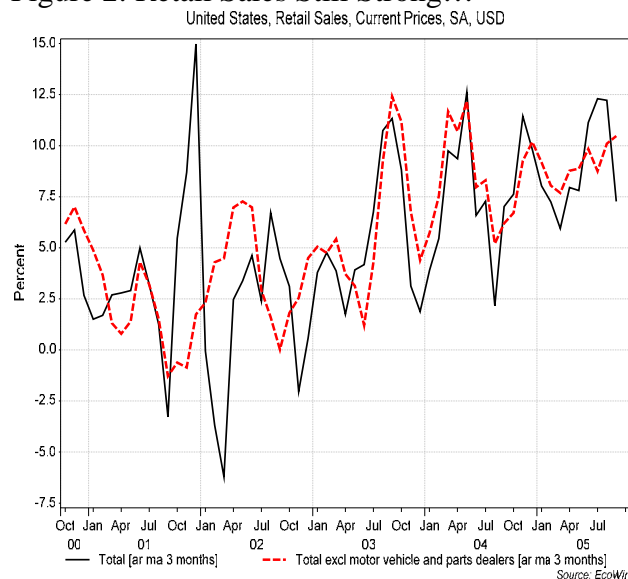
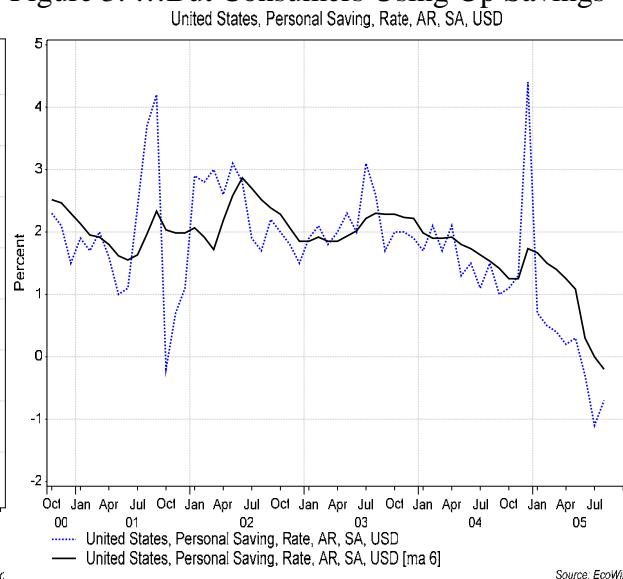


Figure 3: ...But Consumers Using Up Savings



The hurricanes introduced significant distortions into the **labor market** data, making it impossible to get a clear picture of how the job market is faring through the disasters. Despite a drop in employment in September, the payroll survey of employment grew by an average of 150,000 jobs per month in the third quarter. Although well below the (upwardly revised) 197,000 jobs-per-month average of the prior quarter, it is still fast enough to tighten the labor market. Moreover, the Labor Department indicated that job growth outside the areas directly affected by the hurricanes appeared to be running at about the pace of prior months. If so, we should expect job growth to resume its upward trajectory as businesses in hurricane-affected areas gradually reopen and employees get back to work.

Inflation pressures did an about-face in September as energy and materials prices surged in the wake of Hurricanes Katrina and Rita, which shut down virtually all oil and gas production in the Gulf of Mexico as well as about 20% of total U.S. petroleum refining capacity for at least some portion of the month of September. Indeed, as of the date of this Update, 65% of oil production

and 53% of natural gas production was still shut down; cumulative losses amount to 11.3% and 8.5% of total annual production of oil and natural gas, respectively, from the Gulf of Mexico. These are very sizable supply losses in an already tight energy market. Not surprisingly, energy prices have surged. Similarly, many materials prices have also increased, both in anticipation of higher demand for rebuilding and due to higher input costs for energy and petroleum.

Although the Federal Reserve typically looks beyond volatile monthly energy price statistics, there are four reasons why the Fed is probably unusually concerned about the recent rise in energy prices. First, today's higher energy prices are a result of a supply shock – much like the oil embargos of the 1970s, albeit less severe. The Fed learned from those episodes the dangers of monetary accommodation of a supply shock, especially when fiscal policy is expansionary: Inflation expectations became deeply embedded, and it took painfully high interest rates and several deep recessions to wring them out. Second, purchasing managers report almost uniformly higher prices, with the Prices Paid components of the Manufacturing and Non-manufacturing ISM Surveys coming in at 78.0 and 81.4, respectively, in September (Figure 4). Third, anecdotal reports indicate that, with everyone facing higher energy prices and overall demand still solid, businesses are finding less resistance to price increases from consumers; in short, inflation may be gaining a toehold. Finally, inflation is bumping up against the top of the Fed's presumed 1-2% comfort zone for core personal consumption expenditure inflation, while other core inflation indicators already are well above 2% (Figure 5). As a result, any meaningful increase in inflation expectations may require that the Fed move rates beyond neutral to restrictive to prevent those expectations from becoming embedded in wages and prices.

Figure 4: Input Prices Rising...

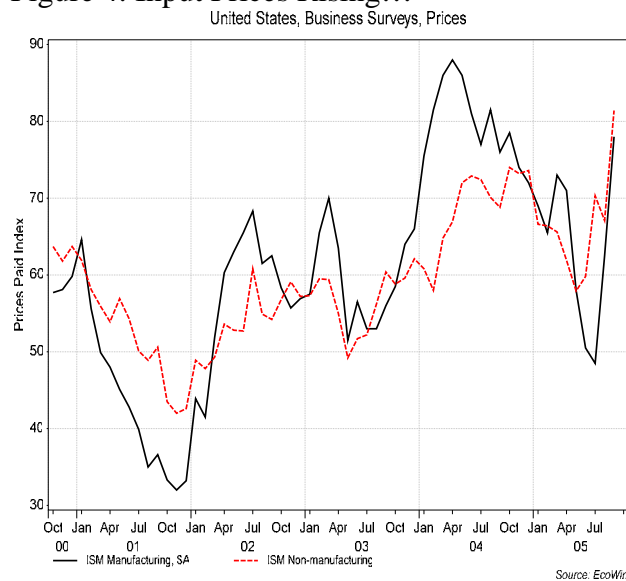
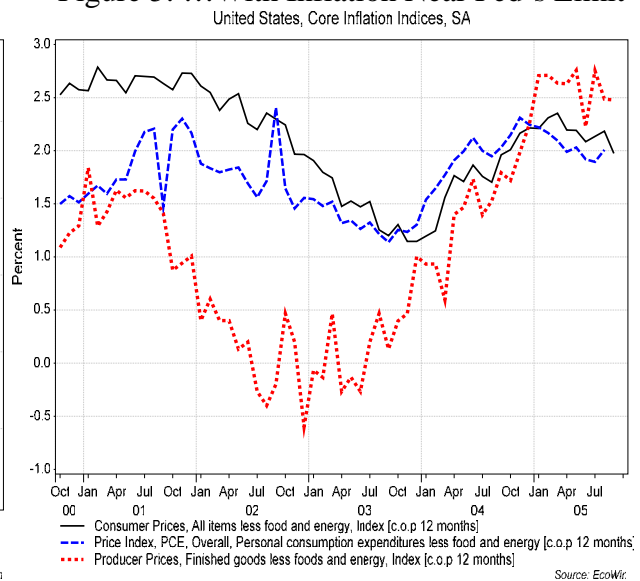


Figure 5: ...With Inflation Near Fed's Limit



The **business sector** recovered in the third quarter following an inventory-driven slowdown earlier in the year. Manufacturing production recovered, aided by a solid rebound in non-defense capital goods excluding aircraft (Figure 6). The service sector appears to have slowed in September but should recover as the effects of the hurricanes recede. Finally, although more recent numbers are not yet available, business investment spending continues to look solid, with spending on equipment and software up at a 10.9% annual rate in the second quarter.

Figure 6: Manufacturing Rebounds

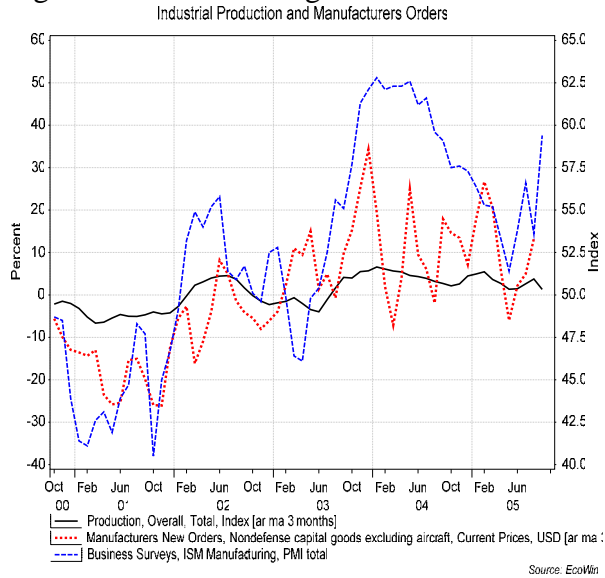
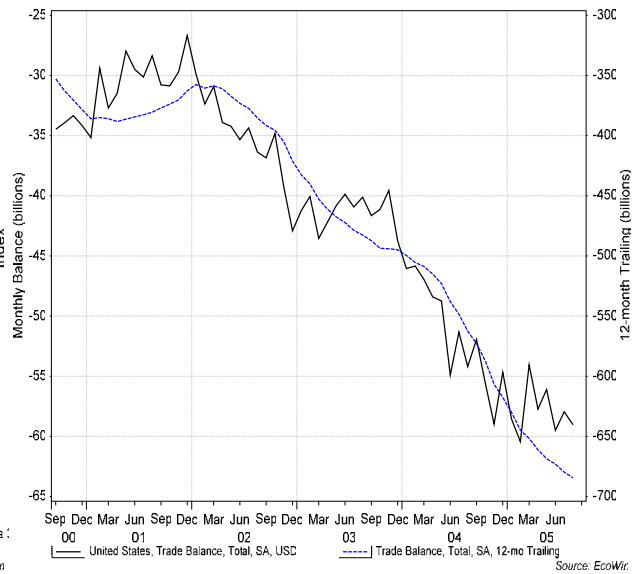


Figure 7: Trade Drag Slowing?



The **trade sector**, which has been a major drain on economic growth, staged a sharp turnaround in the second quarter, adding about 1% to GDP. With energy imports replacing domestic production from the Gulf of Mexico for at least a few months, trade will probably subtract from GDP growth again in Q3 and Q4. Nonetheless, brighter growth prospects in Japan and more recently in Europe may finally mean that the trade deficit will show some improvement after energy imports (both prices and volumes) normalize. While the 12-month trailing trade deficit continues to widen, monthly figures have been moving sideways since the beginning of the year (Figure 7), and export growth has finally begun to outpace import growth. Of course, exports have to grow more than 50% faster than imports just to stabilize the deficit, but at least things have been moving in the right direction. For the first time in a long while, trade may be neutral or even a slight positive to GDP growth next year.

Market Outlook

Credit spreads narrowed marginally in the third quarter as shown in Figure 1, although this may just reflect the removal of several auto manufacturers’ debt from the Baa-rated corporate index in August. Measures of credit quality generally continued to improve, albeit only slightly. Delinquencies and charge-offs on bank loans fell (Figure 8), and interest expense as a proportion of income before interest and taxes (EBIT) for nonfinancial corporations declined to the lowest level in more than 25 years. On balance, we continue to expect that spreads will widen modestly as the economy recovers from the hurricanes, business confidence improves, and corporations gradually pick up the pace of borrowing. With the federal budget deficit expanding, however, we believe that the amount of credit spread widening should be limited over the near term.

For the first quarter since the Fed began tightening in June 2004, thirty-year **Treasury bond yields** rose in the third quarter. The Federal Open Market Committee (FOMC) didn’t do anything new – it tightened by ¼% per meeting – but long-term interest rates finally moved higher in response to the 3.75% fed funds rate and the prospects for more tightening over the coming months. For the reasons we explained in last quarter’s Update,² we still expect that if the

² See Flaherty & Crumrine Incorporated, *U.S. Mid-Year Economic Update, July 2005*.

Fed continues tightening monetary policy, then both short- *and* long-term interest rates should head higher.

Figure 8: Credit Quality Still Improving

Credit Metrics: Banks & Bankruptcies

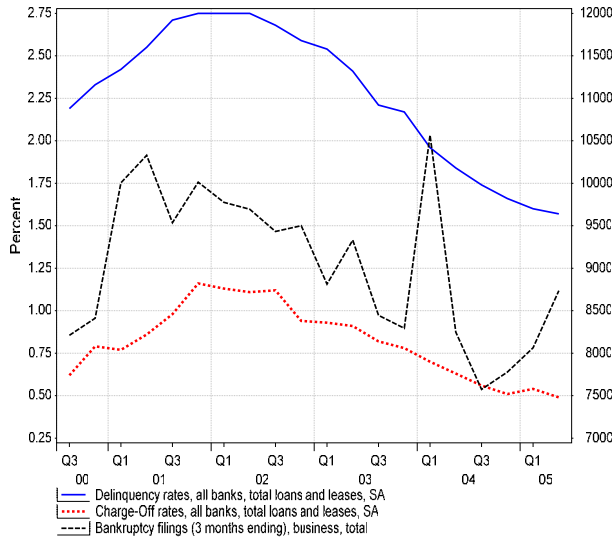
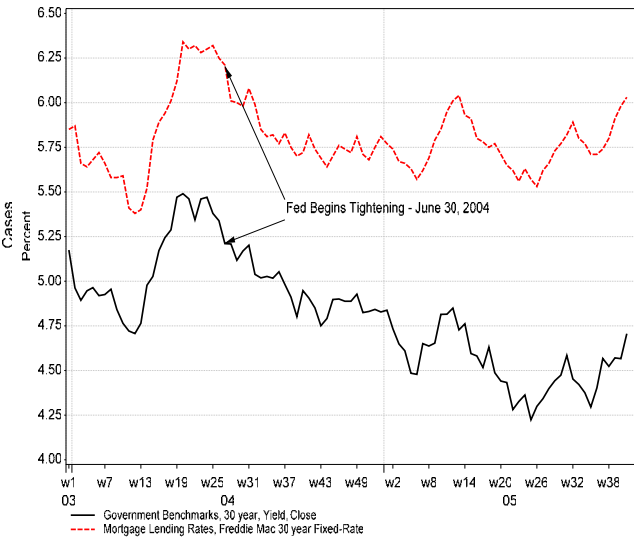


Figure 9: Long-term Rates Still Low

Mortgage & Treasury Bond Rates



Although a higher rate environment appears to be the most likely outcome over the next few quarters, there is a great deal of uncertainty in that outlook. The Fed has already raised rates by 2.75% since June 2004. At some point, those higher interest rates will begin to dampen demand more significantly. That point doesn't appear imminent, since long-term rates – including mortgages – remain below their June 2004 levels (Figure 9). As a result, those rates have not really had a chance to constrain consumption yet. However, if rates do continue to move higher, demand will slow eventually. Given the importance of mortgage-financed consumption in the U.S., it will be difficult for the Fed to gauge when the “correct” amount of tightening has become “too much.” And if the Fed overdoes the tightening, it may have to reverse course and cut the fed funds rate. Moreover, the Fed will have to navigate these uncertain waters under the leadership of a new chairman; Alan Greenspan is slated to depart the Board of Governors at the end of this year. We believe that this is a recipe for higher volatility, especially after hurricane-related distortions to economic data diminish in another month or two, and it's another reason why we continue to favor our options-based hedging strategy.

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 October 18, 2005

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