

U.S. Fourth-Quarter Economic Update

January 2006

Summary of Recent Economic Developments

Economic growth probably slowed in the fourth quarter but should improve again in 2006. Private forecasters¹ expect real GDP growth in Q4 to slow to 3.2% (and more recent surveys have trimmed that estimate to a bit below 3%), rebounding to 3.7% in 2006:Q1 and 3.4% for 2006 overall as the negative economic impact of Hurricanes Katrina, Rita and Wilma recedes and rebuilding expenditures accelerate. Consumer spending grew by just 2.3% in Q4, largely due to a sharp decline in automobile and gasoline purchases. The housing market slowed modestly, although we do not subscribe to the view that a housing slowdown will prompt Fed easing by late 2006 or early 2007. Payroll job growth failed to rebound as much as expected, but recent declines in jobless claims indicate that the pace of hiring may have picked up in 2006. Manufacturing showed mixed results, with weakness in autos and mining more than offset by strength in non-auto manufacturing. The trade balance deteriorated due to surging energy imports, while the non-petroleum balance held about steady. Core inflation eased, although there are still pressures in the pipeline that will prevent the Fed from declaring victory over inflation just yet: The Fed is widely expected to raise the fed funds rate to 4.5% at the end of January. Credit spreads widened modestly, and long-term Treasury yields drifted slightly lower, leaving the yield curve essentially flat and term premiums nonexistent.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator	2004:1	2004:2	2004:3	2004:4	2005:1	2005:2	2005:3	2005:4
Real GDP, Chg QoQ (%)	4.3	3.5	4.0	3.3	3.8	3.3	4.1	3.2f
Real Personal Consump Expnds, Chg QoQ (%)	4.7	1.9	4.4	4.3	3.5	3.4	4.1	0.4a
Real Busi Investmt, Eqp & Sftware, Chg QoQ (%)	12.0	15.2	15.5	12.4	8.3	10.9	10.6	
Real Residential Investmt, Chg QoQ (%)	5.2	17.8	2.6	1.6	9.5	10.8	7.3	
Corporate Profits, After Tax, Chg YoY (%)	22.2	13.3	4.4	7.0	4.1	9.9	8.7	16.0f
Current Account Balance, Annualized (% of GDP)	-5.1	-5.7	-5.7	-6.3	-6.5	-6.4	-6.2	
Federal Budget, 12-mo Def or Surp (% of GDP)	-3.7	-3.7	-3.5	-3.3	-3.3	-2.7	-2.5	
Unemployment Rate (%)	5.7	5.6	5.4	5.4	5.1	5.0	5.1	4.9
Household Employment, Chg QoQ (000)	-1	750	369	629	445	1149	685	344
Nonfarm Payrolls, Chg QoQ (000)	531	693	401	569	546	593	442	438
Nonfarm Productivity, Chg QoQ (%)	2.1	4.5	1.3	2.5	3.2	2.1	4.7	
Capacity Utilization (%)	77.6	78.4	78.7	79.7	79.9	80.3	79.1	80.7
GDP Price Index, Chg QoQ (%)	3.6	3.9	1.5	2.7	3.1	2.6	3.3	
Consumer Price Index, Chg YoY (%)	1.7	3.2	2.5	3.4	3.2	2.5	4.7	3.4
CPI ex food & energy, Chg YoY (%)	1.6	1.9	2.0	2.2	2.4	2.1	2.0	2.2
Nominal Personal Income, Chg YoY (%)	5.3	5.2	5.6	9.8	6.2	6.1	6.2	5.2a
Personal Savings Rate (%)	1.7	1.5	1.0	4.4	0.4	-0.6	-0.5	-0.2a
Rate or Spread	2004:1	2004:2	2004:3	2004:4	2005:1	2005:2	2005:3	2005:4
Federal Funds Rate Target (%)	1.00	1.25	1.75	2.25	2.75	3.25	3.75	4.25
3-month LIBOR (%)	1.11	1.61	2.02	2.56	3.12	3.52	4.07	4.54
10-Yr Treasury Note Yield (%)	3.84	4.58	4.12	4.22	4.49	3.92	4.33	4.40
30-Yr Treasury Bond Yield (%)	4.78	5.29	4.90	4.83	4.76	4.19	4.57	4.54
Moody's Baa Long Corp Spread (bp)	137	142	136	127	138	162	158	167
10-Yr Interest Rate Swap Spread (bp)	40.0	51.3	45.6	43.0	47.2	46.2	46.2	51.9

* 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*, November 14, 2005.

Economic Outlook

Consumer spending slowed to a 2.3% annualized rate in the fourth quarter following a 6.9% pace last quarter, which has contributed significantly to the recent lowering of expectations for Q4 GDP growth. Most of the deceleration was due to slower automobile sales, however, and “core” retail sales (retail sales less autos, gasoline, and building materials) actually improved to a very sturdy 7.4% annual pace, up from 5.2% in Q3 (Figure 2). This is consistent with the rebound in consumer confidence following Hurricanes Katrina and Rita (Figure 3). Confidence as measured by the three major surveys has almost fully recovered since October. Combining this with steady job gains, increasing wages and rising household wealth (more on these below), consumer spending should post solid if not spectacular growth in 2006.

Figure 2: Steady Core Spending; Choppy Autos

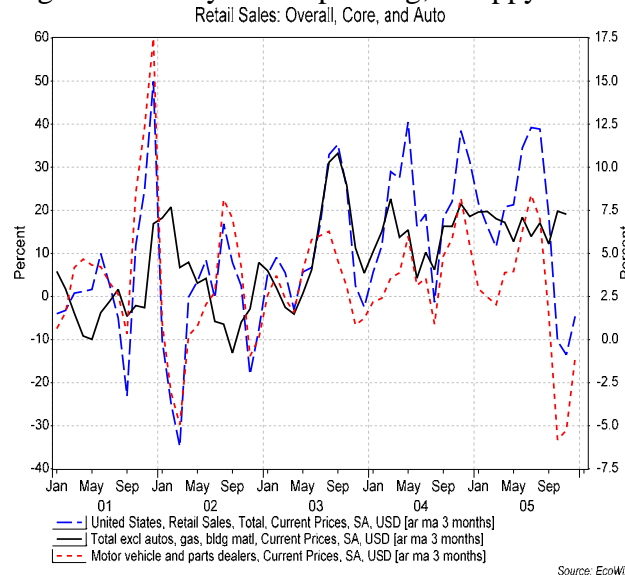
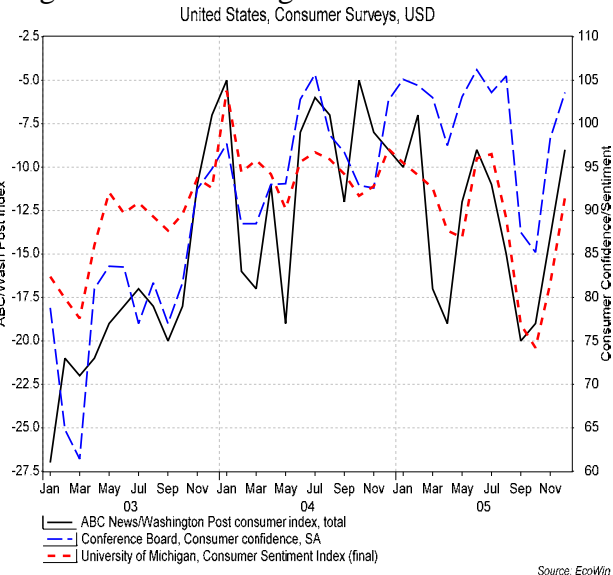


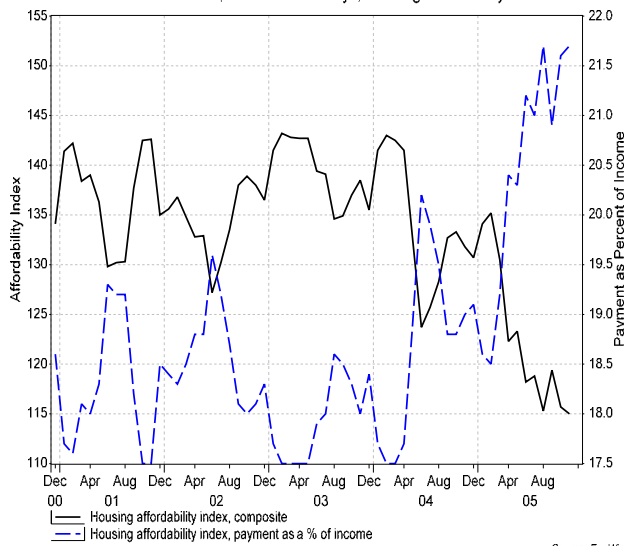
Figure 3: Rebounding Consumer Confidence



One consumer sector that is likely to slow down in 2006 is **housing**. Housing affordability declined significantly in 2005, whether measured on an absolute basis or relative to income (Figure 4). The primary reason for this is higher home prices rather than higher interest rates. Through the third quarter (the most recent data available) the national home price index compiled by the Office of Federal Housing Enterprise Oversight was up 12% over the prior year and 22.6% since the end of 2003, when housing affordability last peaked. In addition, after growing steadily for ten years, the home ownership rate dipped in 2005 as affordability deteriorated. For many households, the rise in home prices coupled with a modest rise in mortgage rates made renting a home more attractive than buying one.

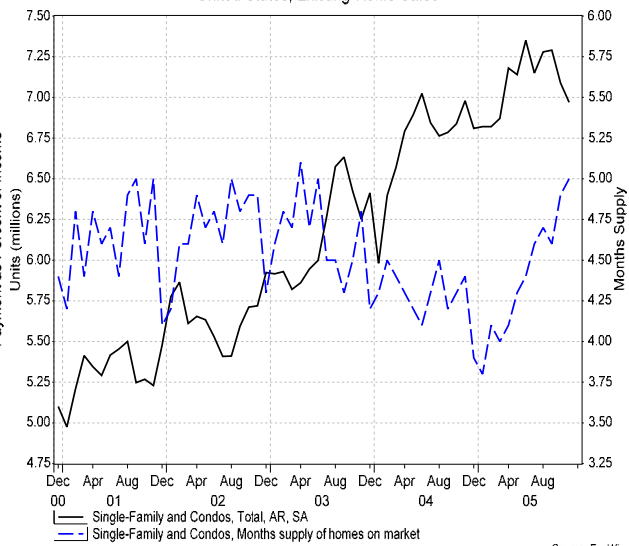
Not surprisingly, housing activity is beginning to slow. Existing home sales peaked over the summer while inventories of unsold homes are piling up, pushing the supply of unsold homes up to about 5-months supply at the current sales pace from a low of 3.8-months in early 2005 (Figure 5). Although home sales remain near record highs and inventories are still low historically, the froth is beginning to come off the housing market. We expect that residential investment, which grew by 7.2% year-over-year through Q3 and contributed roughly 1/2% to GDP growth over the past four quarters, will be either neutral or a small drag for GDP growth in 2006, particularly after hurricane-related rebuilding expenditures slow down in the second half of the year.

Figure 4: Home Affordability Down, Prices Up
United States, Consumer Surveys, Housing Affordability



Source: EcoWin

Figure 5: ...Home Sales Down, Inventory Up
United States, Existing-Home Sales



Source: EcoWin

We are not persuaded, however, by arguments that a slowdown in housing – and in particular a decline in “mortgage equity withdrawal” – will push the economy toward recession and Fed easing by the end of the year. The pessimists’ thinking is that as interest rates rise and home prices stabilize, households will no longer extract as much equity from their homes in the form of cash-out mortgage refinancings or home equity loans, leading to weaker consumer spending and a sharp slowdown in GDP.

Although mortgage equity withdrawal may dip this year, we don’t think it will decline by enough to curtail consumption significantly. First, mortgage rates remain very low by historical standards, and as adjustable rate mortgages have become more expensive, borrowers are switching to fixed-rate loans, where rates are only slightly higher than last year. Second, much of the recent mortgage equity withdrawal is simply a normal byproduct of a strong housing market – not overleveraging on the part of households. For example, if a family makes a \$100,000 capital gain on the sale of one home but applies only \$60,000 of that gain to the down payment on a new home purchase, some portion of the remaining \$40,000 is likely to be spent, often to make improvements to the newly purchased home. This \$40,000 shows up as “mortgage equity withdrawal” because new mortgage debt exceeds net residential investment. This turnover-related home equity extraction will persist even if home prices stop rising; it disappears only if prices fall by enough to eliminate the capital gains accumulated over prior years of ownership, and there is no reason to expect so severe a rout in home prices. Third, as consumers have become more financially sophisticated, they have reduced reliance on consumer credit (primarily credit cards) and increased mortgage borrowing, which not only carries lower interest charges but is generally tax-deductible. In fact, growth in consumer credit has been essentially flat at about \$100 billion per year for the past ten years, while mortgage debt has increased sharply (Figure 6). Put simply, consumers have made rational decisions to finance purchases with cheaper mortgage debt rather than more expensive credit card debt. Finally and most importantly, despite the negative savings rate observed in last quarter’s update, consumer balance sheets are healthy. According to estimates from the Federal Reserve, household net worth is at an all-time high of \$51 trillion, and owners’ equity in their homes actually has been *increasing* over the past several years – despite sizable mortgage equity withdrawal – and is now

over 57% in aggregate (Figure 7). Despite criticism that people are using their homes as an ATM, homeowners appear to be managing their real estate assets and overall financial situations fairly prudently. As a result, we don't think that the economy will swoon – or that the Fed will have to ease – if housing cools.

Figure 6: Mortgages Replace Credit Cards
United States, Flow of Funds Borrowing, Current Prices, AR, SA, USD

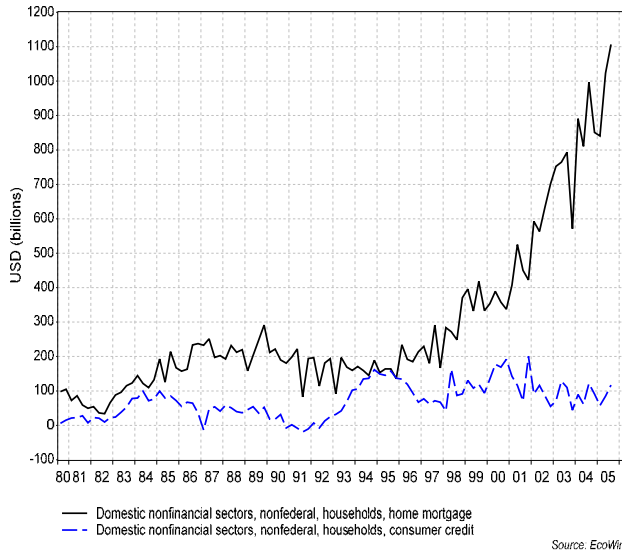
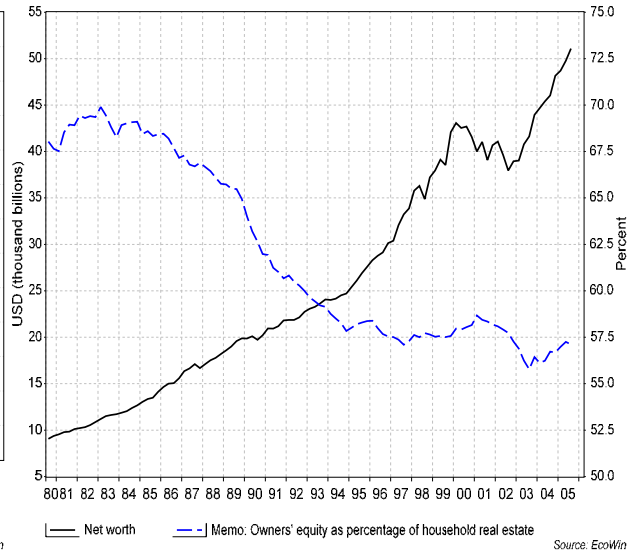


Figure 7: Household Balance Sheets Healthy
Household and nonprofit organizations, Current Prices, USD

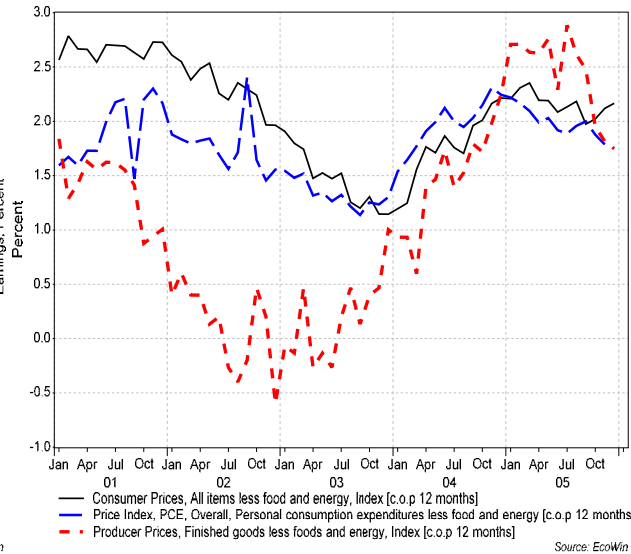


The **labor market** is still recovering from the disruptions caused by this fall's hurricanes, but looking back over the past year, we see that the United States created slightly more than 2 million nonfarm jobs in 2005 for an average of 168,000 per month. Although the pace slowed to 146,000 jobs per month in the fourth quarter, this was still enough to pull the unemployment rate down from 5.4% at the end of 2004 to 5.1% at the end of Q3 and 4.9% by year-end (Figure 8). Moreover, jobless claims figures in January indicate that employment gains may be accelerating again, as both initial and continuing claims have fallen sharply early in the New Year.

Figure 8: Wages Up, Unemployment Down...
Average Hourly Earnings and Unemployment Rate, SA



Figure 9: ...But Inflation Retreats, For Now
United States, Core Inflation Indices, SA



Along with this tightening in the labor market came rising wages. Average hourly earnings rose by 3.1% in 2005 compared to 2.6% in 2004, and they have risen at a 3.8% annual rate over the past three months. Employers have worked hard to offset some of this wage inflation, and the employment cost index (ECI), a broader measure of labor costs than hourly earnings, slowed to 3.1% year-on-year through the third quarter (the most recent data available) compared to 3.7% in 2004. From the perspective of the Federal Open Market Committee (FOMC), it's important to know whether wage inflation is accelerating or decelerating, and the available data are somewhat at odds. With the unemployment rate falling, however, it would be unusual for wages not to accelerate at least a little at this point in the cycle, so we think the Fed probably will give a bit more weight to the average hourly wage data than to the ECI, if for no other reason than the fact that it's more current than the three-month old ECI data.

Headline **inflation** has mostly eased over the past few months, after threatening to break upward in the wake of Hurricanes Katrina and Rita (Figure 9). Nonetheless, core inflation remains near or slightly above the upper end of the Fed's presumed "comfort zone" of 1–2%, and inflation pressures in the pipeline, whether measured by intermediate goods prices or the prices paid components of the Institute for Supply Management's manufacturing and non-manufacturing surveys, remain elevated. Indeed, the recent cooling of inflation may reflect some unwinding of price increases in the immediate aftermath of the hurricanes and may prove temporary. Moreover, the recent rise in oil prices, despite warmer than usual temperatures in North America, may presage renewed inflation pressures as the summer driving season approaches and as economic growth abroad continues to gather momentum.

The **business sector** turned in a mixed performance in the fourth quarter, though the outlook for 2006 is fairly bright. In the first two months of the quarter, core capital goods orders (nondefense capital goods excluding aircraft) dipped slightly, but aircraft orders surged, leaving overall capital goods orders up sharply. For the full quarter, industrial production rose by a respectable 3.8% over the Q3 average after slowing earlier in the year as producers pared inventories. Focusing on manufacturing excluding automobiles tells a more upbeat story, however, displaying growth of 9.3% quarter-over-quarter (Figure 10). Two industrial sectors showed sizable declines in production: Automobiles (in response to a fall sales slowdown in the wake of summer discounting) and mining (primarily oil and gas shutdowns in the Gulf of Mexico after the hurricanes). With new product launches by automobile manufacturers and good progress being made repairing damaged oil and gas infrastructure, these sectors should post production increases going forward. When we combine that rebound with the ongoing strength in other manufacturing sectors, the outlook for industrial production appears solid. In addition, producers continue to whittle down spare capacity. Capacity utilization rose to 80.7% in December, the highest level in five years, despite below-normal utilization in the mining sector (again, due to damage from the hurricanes). While this utilization rate is still well below the normal cyclical peak of about 85%, it is a clear improvement from the low of about 74% reached in early 2002.

Although there is little high-frequency data tracking the service sector, the data available point to essentially steady or perhaps slightly slower growth in services in the fourth quarter. Employment in services excluding retail trade (where seasonal adjustments are especially large around this time of year) slowed to about 1½% in the fourth quarter, down from about 2% earlier in the year. Much of this probably relates to disruptions from the hurricanes, but it may mean slightly lower than expected service-related GDP for the quarter. In addition, the non-manufacturing ISM survey has moved sideways since October, albeit at a high level.

Figure 10: Recovering from the Hurricanes

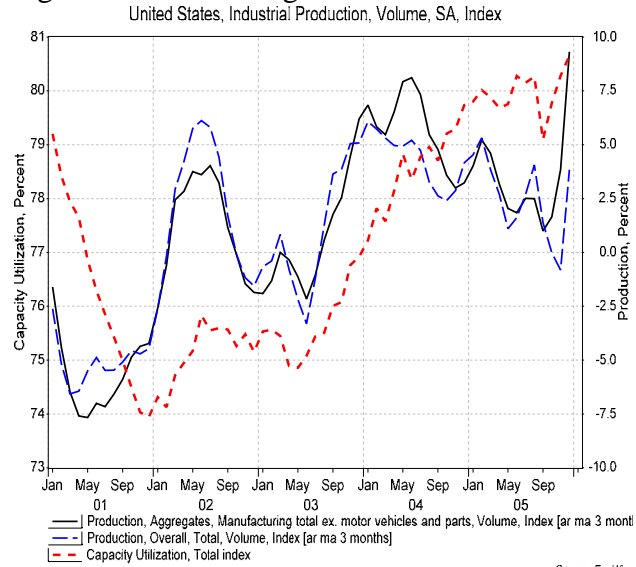
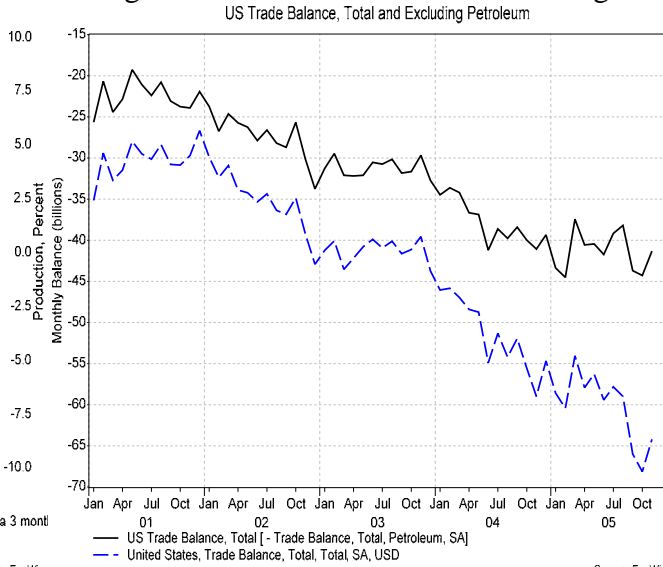


Figure 11: Non-Petrol Trade Stabilizing



The **trade sector** deteriorated sharply – as expected – in the fourth quarter due to higher fuel imports (in both volume and price terms) following Hurricanes Katrina and Rita. The story away from petroleum is quite different, however. The non-petroleum trade deficit has been broadly steady for the past year or so, even as the total figures continued to deteriorate (Figure 11). With economic growth improving abroad, U.S. export growth has improved, while import growth has moderated. To be sure, the U.S. has a long way to go in turning around its massive trade deficit, but since the U.S. will be a net energy importer for the foreseeable future, the non-petroleum trade balance is the place where sustainable improvement must originate. It appears to be doing just that. In addition, as U.S. oil and gas production recovers to pre-hurricane levels, the nation’s imported energy bill should recede, which will contribute to still further trade improvement. As we said last quarter, 2006 may (finally!) be shaping up as a year where trade is neutral or even slightly positive for GDP growth.

Market Outlook

Credit spreads widened modestly at the end of 2005 as corporate issuance picked up, with the busiest December new issue calendar in recent memory. Although credit metrics remain very strong, the stunning credit improvement that the market has experienced over the past few years has probably peaked. Long-term debt as a percentage of total liabilities is starting to edge down, and interest coverage (measured as interest expense as a percentage of earnings before interest and taxes), while holding at a 25-year high, has hit a plateau in recent quarters (Figure 12). Similarly, delinquency rates on bank loans, although still very low overall, have turned upward in several sectors (credit cards, mortgage loans) and have stopped improving in most other sectors. This is consistent with our long standing view that credit spreads will widen modestly as corporations increase leverage and as the Federal Reserve gradually drains liquidity from the market. We do not anticipate any sharp widening in credit spreads, however, given our optimistic view on the economy. In essence, we think the widening will be driven by higher credit demand rather than by widespread credit problems.

Figure 12: Credit Metrics Peaking?

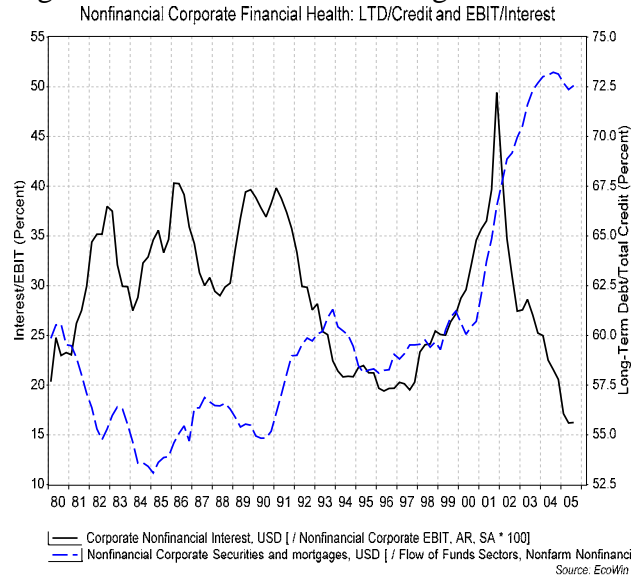
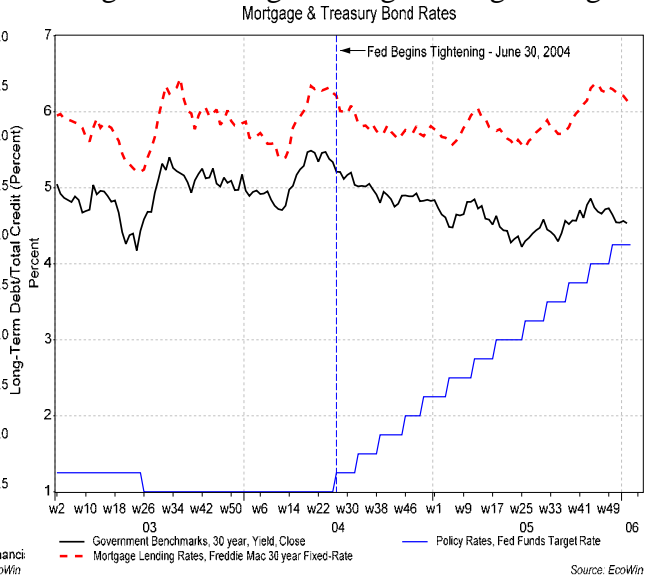


Figure 13: Long Rates Ignore Tightening



Long-term **Treasury bond yields** resumed their downward drift in November and now sit nearly 100 basis points below their level when the Fed began tightening in June 2004. For those keeping track, the Fed has now raised rates 13 times, each by 25 bp for a total of 3.25%, and the fed funds rate stands at 4.25%. It is widely anticipated that the Fed will hike rates by another 25 bp at the end of January to 4.5%. Looking beyond that, the market is assigning about 3-to-1 odds that the Fed will tighten one more time to 4.75% sometime this spring before easing monetary policy in 2007. With the yield on the 30-year Treasury bond at 4.53% currently, that puts the bond risk premium somewhere around zero, or perhaps even a little negative.

There is some justification for a low bond risk premium at the time. Some economists recently have made the insightful observation that the volatility of inflation has decreased sharply relative to the volatility of real interest rates. If this is expected to persist (i.e. if monetary policy is credible), then the bond risk premium should be low, since it eliminates one of the biggest risks facing holders of long-term Treasury bonds: Inflation². Stated slightly differently, if inflation is expected to be low and stable, then investors can lock-in a long-term real rate of return by purchasing long-term bonds, which in turn can be used to satisfy long-duration liabilities such as pension obligations. Such purchases lower the bond risk premium. In contrast, real short term rates would be expected to be more volatile than inflation, since short-term rates are the means by which the Federal Reserve attempts to create inflation stability. Real short term rates rise when inflation pressures build, and they fall when those pressures recede. This volatility of real short-term interest rates creates uncertainty for long-term investors.

Setting aside for the moment the possibility that the Fed may need to push (and leave) rates above 4.75% and acknowledging that bond risk premiums should be lower when monetary policy is credible, we still do not think a risk premium of zero is sustainable. First, it assumes that borrowers would not care to lock-in long-term borrowing costs with no risk premium

² When we consider long term bonds other than U.S. Treasuries, other risks enter the picture, particularly credit risk and/or foreign exchange risk.

relative to (for them) riskier short-term borrowings³. That doesn't seem like a reasonable prospect, and indeed the U.S. Treasury seems to agree: It is reintroducing 30-year bonds in February after a four-and-a-half-year hiatus. Second, a risk premium of zero suggests that investors are indifferent to mark-to-market volatility in their assets, something that flies in the face of financial theory, not to mention long-term experience. Finally, it implies that investors will permanently (or at least for a very long time) believe that the Fed will be able to contain inflation to a low and stable level. Although we have every confidence in the Fed over the next few years, we aren't willing to extend that confidence to a 30-year horizon. With baby boomers beginning to retire over the next decade, Social Security and particularly Medicare will put enormous strains on the economy, and a renewed bout of inflation is hardly unthinkable. Similarly, political risks, especially in energy-producing areas of the world, could prompt another round of energy-induced inflation over a long horizon. This investor wants to be compensated for those as well as myriad other inflation risks.

When we couple our skepticism over the current low bond risk premium with our optimistic view on the economy over the coming year, we believe that long-term bond rates eventually will move upward, although when such a move will occur is highly uncertain. Accordingly, we will continue to hedge our portfolios against a significant rise in long-term rates without betting the farm that those rates can't possibly go lower.

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January 23, 2006

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³ Recall that a borrower looking to finance a long-term project should prefer locking-in a long-term borrowing rate over issuing a series of shorter-term instruments, unless the expected cost of doing so is significantly higher than rolling short-term obligations. The long-term financing reduces both rollover (refinancing) risk and allows the issuer to assure that its cost of borrowing is below the expected rate of return on the project.