U.S. First-Quarter Economic Update
April 2006

Summary of Recent Economic Developments

Economic growth appears to have rebounded strongly in the first quarter after a sluggish fourth quarter. Private forecasters[1] expect real GDP growth in Q1 to increase to 4.4% from just 1.7% in Q4. For 2006 overall, they expect the growth pace to moderate to a still-respectable 3.2%, which most economists would contend is near the long-term sustainable growth rate for the U.S. economy. These forecasts are little changed since the last survey, as the economy has delivered few surprises in recent months: Consumption has rebounded, despite a slowdown in housing; employment is growing, providing support to income and consumption; production and investment should remain strong as capacity utilization rates creep higher; inflation has remained quiescent, although upward pressures remain visible; and the trade deficit appears to be gradually improving. Similarly, there have been few surprises in credit spreads or Federal Reserve policy lately, with spreads about unchanged overall from Q4 levels and two more 25 bp rate hikes from the Fed. The one surprise (for the market) has been the increase in long-term bond rates in recent weeks, as the word "risk" seems to be reentering the lexicon of fixed income investors.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator	**2004:2**	**2004:3**	**2004:4**	**2005:1**	**2005:2**	**2005:3**	**2005:4**	**2006:1**
Real GDP, Chg QoQ (%)	3.5	4.0	3.3	3.8	3.3	4.1	1.7	4.4f
Real Personal Consump Expnds, Chg QoQ (%)	1.9	4.4	4.3	3.5	3.4	4.1	0.9	4.9a
Real Busi Investmt, Eqp & Sftware, Chg QoQ (%)	15.2	15.5	12.4	8.3	10.9	10.6	5.0	
Real Residential Investmt, Chg QoQ (%)	17.8	2.6	1.6	9.5	10.8	7.3	2.8	
Corporate Profits, After Tax, Chg YoY (%)	13.3	4.4	7.0	4.1	9.9	8.7	14.6	12.6f
Current Account Balance, Annualized (% of GDP)	-5.7	-5.7	-6.3	-6.5	-6.4	-5.9	-7.0	
Federal Budget, 12-mo Def or Surp (% of GDP)	-3.7	-3.5	-3.3	-3.3	-2.7	-2.5	-2.5	
Unemployment Rate (%)	5.6	5.4	5.4	5.1	5.0	5.1	4.9	4.7
Household Employment, Chg QoQ (000)	729	314	638	468	1149	685	344	862
Nonfarm Payrolls, Chg QoQ (000)	597	346	631	481	500	464	536	590
Nonfarm Productivity, Chg QoQ (%)	4.5	1.7	2.0	3.8	2.4	4.2	-0.5	
Capacity Utilization (%)	78.4	78.7	79.7	79.9	80.3	79.1	81.2	81.2a
GDP Price Index, Chg QoQ (%)	3.9	1.5	2.7	3.1	2.6	3.3	3.5	
Consumer Price Index, Chg YoY (%)	3.2	2.5	3.3	3.2	2.5	4.7	3.4	3.6a
CPI ex food & energy, Chg YoY (%)	1.9	2.0	2.2	2.4	2.0	2.0	2.2	2.1a
Nominal Personal Income, Chg YoY (%)	5.2	5.6	9.8	6.2	6.1	6.5	2.3	6.1a
Personal Savings Rate (%)	1.5	1.0	4.4	0.4	-0.6	-0.2	-0.3	-0.5a
Rate or Spread	**2004:2**	**2004:3**	**2004:4**	**2005:1**	**2005:2**	**2005:3**	**2005:4**	**2006:1**
Federal Funds Rate Target (%)	1.25	1.75	2.25	2.75	3.25	3.75	4.25	4.75
3-month LIBOR (%)	1.61	2.02	2.56	3.12	3.52	4.07	4.54	5.00
10-Yr Treasury Note Yield (%)	4.58	4.12	4.22	4.49	3.92	4.33	4.40	4.86
30-Yr Treasury Bond Yield (%)	5.29	4.90	4.83	4.76	4.19	4.57	4.54	4.90
Moody's Baa Long Corp Spread (bp)	142	136	127	138	162	158	167	165
10-Yr Interest Rate Swap Spread (bp)	51.3	45.6	43.0	47.2	46.2	46.2	51.9	53.0

* Figures are either quarterly or, if more frequent, quarterly averages. f = Forecast[1]; a = Actual through Feb 2006 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*, February 13, 2006.

Every now and then, the economy surprises us by not surprising us. The first quarter was one of those times: It pretty much followed the script laid out by the consensus forecast. As a result, our economic overview will be brief this quarter. We will, however, spend a little more time than usual on the interest rate outlook, which was an arena that did offer some surprises to the market in the form of significantly higher long-term rates. As always, we welcome your comments and suggestions on how we can make this more relevant and useful.

Economic Outlook

Consumer spending bounced back strongly in the first several months of 2006, with real personal consumption up by 4.9% at an annual rate, driven by a blistering 13.4% annualized increase in nominal retail sales. Moreover, this strength in retail spending was broad-based, with major categories of spending posting solid growth rates so far this year (Figure 2). Consumer confidence remains neutral overall, although it displays a curious dichotomy between consumers' assessments of current economic conditions and economic expectations. All of the major surveys show that while people believe that present economic conditions are good, they are likely to get considerably worse in the future. This general relationship isn't unusual – people historically have been more pessimistic about the future than the present, despite all evidence to the contrary – but the size of the difference is unusually wide (Figure 3). This suggests that either the outlook should improve, which may drive stronger consumption down the road, or the economy really is poised to weaken, bringing current confidence down with it. We suspect that optimism will gradually increase, but the dichotomy does highlight one of the risks to the outlook, namely consumption.

Figure 2: Retail Sales Rebound in Q1

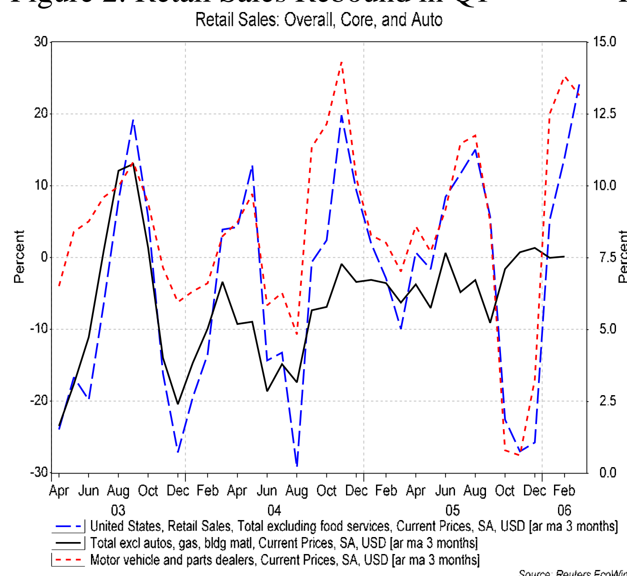
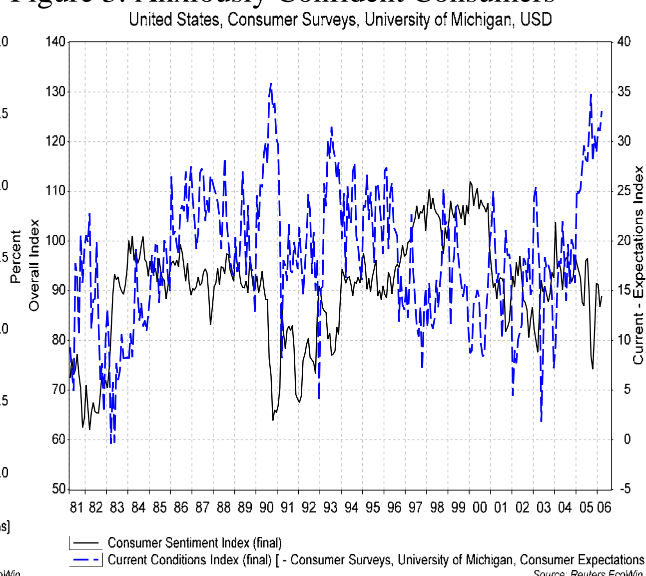


Figure 3: Anxiously Confident Consumers



The **housing** market has clearly slowed from the breakneck pace of last summer, but the sector does not appear to be headed toward a bust. As we discussed last quarter[2], a slowdown in housing activity is both likely and desirable following the sharp run-up in home prices over the past two years. Certainly, we will be keeping our eye on this sector, but so far the housing market is behaving essentially in-line with our expectations.

[2] See the Flaherty & Crumrine "U.S. Fourth-Quarter Economic Update," January 23, 2006

The **labor market** was very strong in the first quarter (Figure 4). The economy added 590,000 nonfarm payroll jobs, while the household survey showed that 862,000 new jobs were created. This job growth pushed the unemployment rate down to 4.7% by the end of the quarter to the lowest level in almost five years. Moreover, indicators of future employment – from jobless claims to the Monster Employment Index to the ISM Employment surveys to the Manpower Outlook survey – continue to point to solid, if not accelerating, job gains. Those employment gains, in turn, should support personal income, consumption, confidence, and business investment going forward.

Figure 4: Employment Growing Nicely

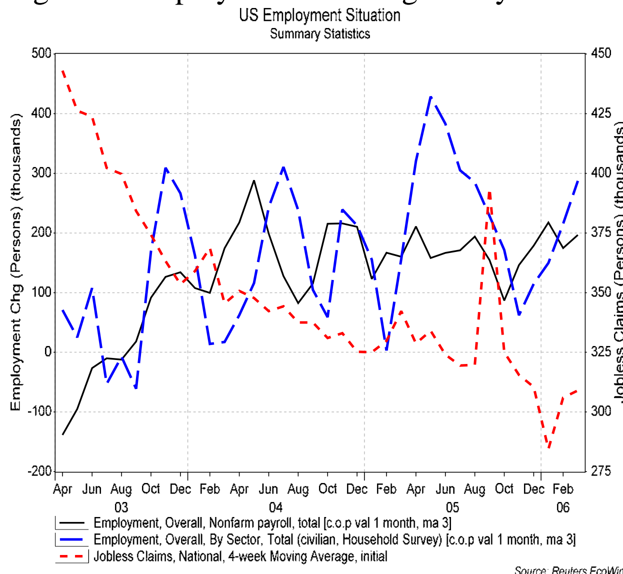
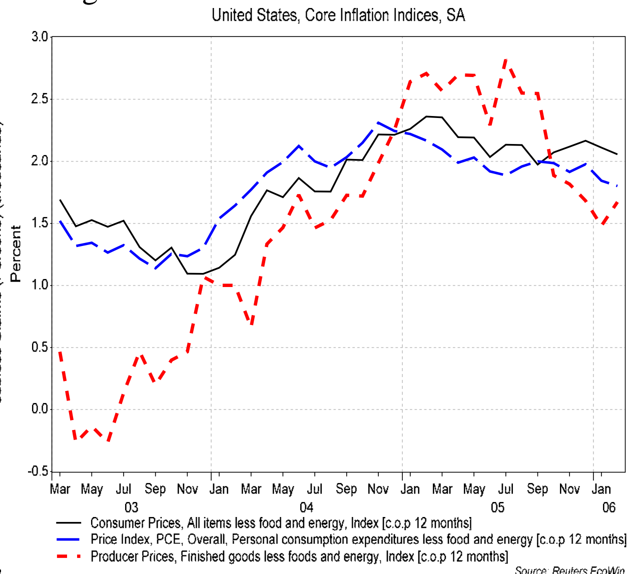


Figure 5: Inflation Tame For Now



Inflation eased slightly in the first quarter but remains near the upper end of the Fed's 1–2% "comfort zone" (Figure 5). With wage growth picking up, commodity prices surging, and economic slack diminishing, the Fed no doubt remains concerned about inflation moving higher.

The **business sector** continues to show impressive profitability, posting after-tax profit growth of 14.6% year-on-year in the fourth quarter, with expectations of another double-digit gain in Q1. This, along with rising industrial production and capacity utilization, is driving strong gains in business investment. Although expenditures on business equipment and software dipped to "only" 5% in Q4, they still should post double-digit gains in 2006 given the relative underinvestment in these items for several years following the dot.com bust.

Finally, the **trade sector** probably remained a small drag on growth in the first quarter as elevated energy imports held the trade deficit near its record level. The good news is that export growth continues to pick up as economic conditions abroad improve, while import growth has slowed. Although outright improvement in the trade deficit probably will require lower energy prices, at the least the trade sector should be a smaller drag on GDP growth; and with lower energy prices, it could be a small positive.

Market Outlook

Turning to the outlook for **credit spreads**, we continue to expect that spreads will gradually widen over the course of the year as a growing economy and a slightly higher risk appetite on the part of corporations drive up demand for credit by borrowers. Indicators of corporate credit

health such as loan delinquencies and charge-offs, interest coverage, and liquidity all remain near the strongest levels in decades, but as we noted last quarter, they generally have stopped improving. Nonetheless, with credit spreads significantly wider than a year ago (Figure 6) as supply has increased, we remain sanguine on the prospects for corporate and preferred securities.

Figure 6: Credit Spreads Gradually Widening

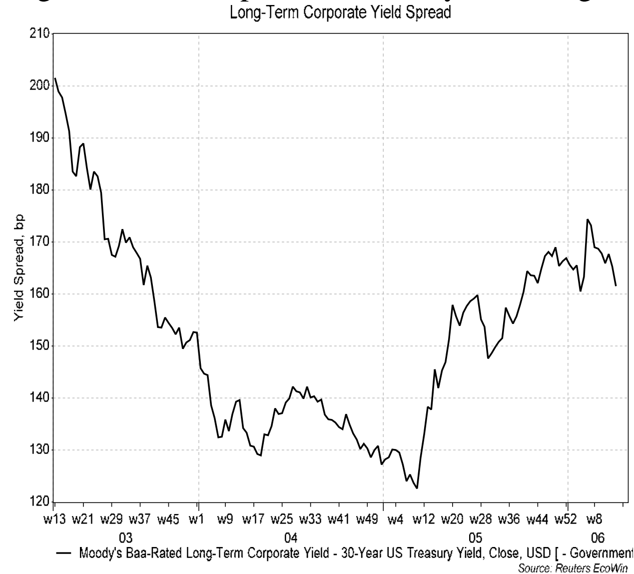
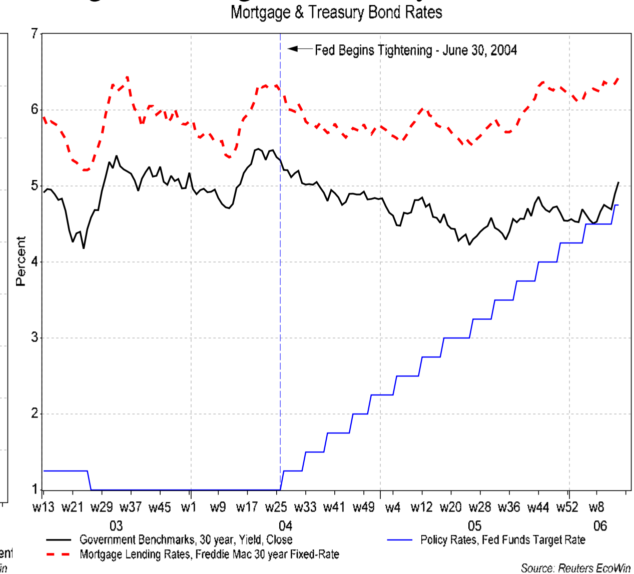


Figure 7: Long Rates Finally Rise



The **Federal Reserve**, now chaired by Ben Bernanke, hiked the fed funds rate twice in the first quarter to 4.75% in response to the strength in the economy and, perhaps, to the stubborn refusal of long-term rates to rise, a development that has damped the impact of tighter monetary policy. The market now expects that the fed funds rate will plateau around 5.2% by late summer; more precisely, the market assigns a very high probability that the Fed will raise the funds rate to 5% at its May 10 meeting and about an 80% probability that it will hike rates by another 25 bp at either the June or August FOMC meetings. In one respect, this is little different than market expectations for at least the past year: After each Fed hike, the market assumed that the Fed would be done after two more rate hikes. Obviously, at some point the market will be right in its expectation that the Fed will have just 50 bp left to tighten, and it may be right this time. But we still feel that with the outlook for the U.S. economy reasonably good, the global economy gathering strength, and inflation pressures still present, the market should be pricing in some modest risk premium that either inflation will move up or the Fed will have to hike short rates by more than expected to prevent the former from happening.

Late in the first quarter, long-term **Treasury bond yields** finally began to heed that line of reasoning (Figure 7). The yield on the 5.375% Treasury due 2/15/2031 rose by 46 bp from December 30 to March 31, and it has risen by a further 20 bp to 5.20% as of the time of this writing. While that's not much of a risk premium relative to short rate expectations, it's a start.

Looking ahead, it appears highly likely that the Fed will raise the fed funds rate to 5% on May 10 – the economy simply has too much momentum right now for the Fed to feel confident that its job is done. At that point it will have raised the funds rate by 400 bp and, assuming that long rates don't stage a big rally over the coming weeks, long-term rates will finally have increased by enough to be noticeable to borrowers. As a result, it would not be at all surprising if the Fed

were to pause with the funds rate at 5% to see how the economy responds to the tightening that has already been put in place. Of course, by the time of the June 29 FOMC meeting, the economy may still be threatening to push inflation higher, and if so the Fed likely will tighten policy again. With the endpoint still uncertain, it stands to reason that long-term yields should be at least a little above the fed funds rate, which means that long-term rates could still move higher under this scenario.

If the Fed does leave rates unchanged at 5% at its June meeting, however, it would be premature to call that decision an end to this tightening cycle. A pause at 5% could well be just that: A pause. If the economy does not slow and inflation pressures do not diminish over the following months, the Fed is likely to resume tightening later in the year. That prospect is decidedly not priced into the market, and we think it warrants a higher risk premium on longer-dated securities. Although we aren't predicting higher long-term rates, we can clearly see the risk that they may push higher. As always, we will continue to hedge the Funds' portfolios against a significant increase in long-term interest rates. Hearkening back to our old homeowner's insurance analogy, even though it's been a long time since we've filed a claim, we're not about to let our insurance lapse – particularly when there's smoke in the house.

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