

U.S. Third-Quarter Economic Update October 2006

Summary of Recent Economic Developments

Economic growth appears to have dipped slightly in the third quarter, with most published forecasts putting real GDP growth around 2–2¼ % in Q3, down from earlier forecasts of 2.9% growth¹. On the positive side, real personal consumption has held up better than most economists expected, growing 2.4% annualized through August. Business investment also appears to have rebounded from a surprisingly weak second quarter. Inflation moderated, though it remains well above the Fed's comfort zone. Consistent with the so-so GDP growth rate, job gains were moderate and the unemployment rate ended the quarter where it started at 4.6%, though wages accelerated. On the negative side, the housing market slumped further in the third quarter. Existing home sales were down 21% (annualized) in August compared to the second quarter average, and prices are now down 1-2% compared to year-ago levels. The trade deficit widened significantly in the third quarter, though a gradually improving core deficit and lower energy prices should bring trade improvement in Q4. In response to the more sluggish growth outlook, the Fed ended (at least for now) its two-year tightening campaign. Long-term interest rates rallied sharply as inflation fears receded and economic growth slowed. Finally, corporate credit spreads moved mostly sideways, although preferred spreads narrowed as an important source of regulatory uncertainty was resolved.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator	2004:4	2005:1	2005:2	2005:3	2005:4	2006:1	2006:2	2006:3
Real GDP, Chg QoQ (%)	2.6	3.4	3.3	4.2	1.8	5.6	2.6	2.2f
Real Personal Consump Expnds, Chg QoQ (%)	4.3	2.7	4.2	3.9	0.8	4.8	2.6	2.4a
Real Busi Investmt, Eqp & Sftware, Chg QoQ (%)	12.3	6.3	7.9	11.0	2.8	15.6	-1.4	
Real Residential Investmt, Chg QoQ (%)	-0.6	11.1	20.0	7.1	-0.9	-0.3	-11.1	
Corporate Profits, After Tax, Chg YoY (%)	12.9	4.8	7.9	3.7	5.7	21.0	17.4	8.7f
Current Account Balance, Annualized (% of GDP)	-6.2	-6.3	-6.3	-5.8	-7.0	-6.6	-6.6	
Federal Budget, 12-mo Def or Surp (% of GDP)	-3.3	-3.3	-2.7	-2.5	-2.5	-2.5	-2.1	
Unemployment Rate (%)	5.4	5.1	5.0	5.1	4.9	4.7	4.6	4.6
Household Employment, Chg QoQ (000)	638	468	1149	685	344	862	722	487
Nonfarm Payrolls, Chg QoQ (000)	631	481	500	464	536	529	346	362
Nonfarm Productivity, Chg QoQ (%)	0.4	3.6	2.3	4.4	-0.1	4.3	1.6	
Capacity Utilization (%)	79.7	79.9	80.3	79.1	81.1	81.3	82.5	82.4a
GDP Price Index, Chg QoQ (%)	3.2	3.5	2.4	3.3	3.3	3.3	3.3	
Consumer Price Index, Chg YoY (%)	3.3	3.2	2.5	4.7	3.4	3.4	4.3	3.8a
CPI ex food & energy, Chg YoY (%)	2.2	2.4	2.0	2.0	2.2	2.1	2.7	2.8a
Nominal Personal Income, Chg YoY (%)	9.3	5.6	5.5	6.2	2.6	7.0	7.3	9.4a
Personal Savings Rate (%)	4.3	0.2	-0.5	-0.5	-0.3	-0.4	-0.6	-0.5a
Rate or Spread	2004:4	2005:1	2005:2	2005:3	2005:4	2006:1	2006:2	2006:3
Federal Funds Rate Target (%)	2.25	2.75	3.25	3.75	4.25	4.75	5.25	5.25
3-month LIBOR (%)	2.56	3.12	3.52	4.07	4.54	5.00	5.48	5.37
10-Yr Treasury Note Yield (%)	4.22	4.49	3.92	4.33	4.40	4.86	5.15	4.64
30-Yr Treasury Bond Yield (%)	4.83	4.76	4.19	4.57	4.54	4.90	5.19	4.77
Moody's Baa Long Corp Spread (bp)	127	138	162	158	167	165	163	160
10-Yr Interest Rate Swap Spread (bp)	43.0	47.2	46.2	46.2	51.9	53.0	64.3	52.6

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

f = Forecast¹; a = Actual through August 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, *The Livingston Survey*, June 7, 2006.

Economic Outlook

Consumer spending held about steady, rising at a 2.4% real (5.8% nominal) annual rate in the third quarter and about 6% nominal over the past year (Figure 2). While not stellar, that growth pace is still better than most economists expected given the sharp slowdown in the housing sector. Moreover, the decline in energy prices in recent weeks should support real consumption in the fourth quarter, as money that would otherwise have gone toward paying for gasoline or home heating oil gets spent on other goods and services². In addition, incomes continue to rise roughly in-line with spending, leaving the savings rate steady around negative 0.5%. Note that the surge in income shown in Figure 2 in August reflects the drop in income from Hurricane Katrina in August 2005 rather than acceleration in trend growth.

Figure 2: Spending and Income Growth Steady...

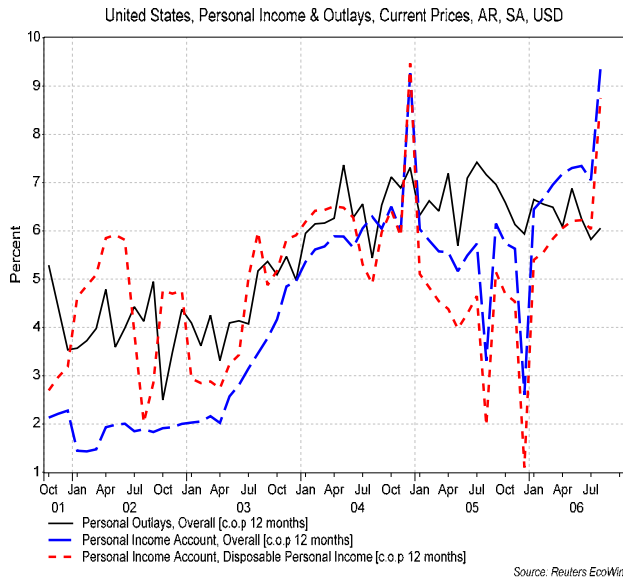
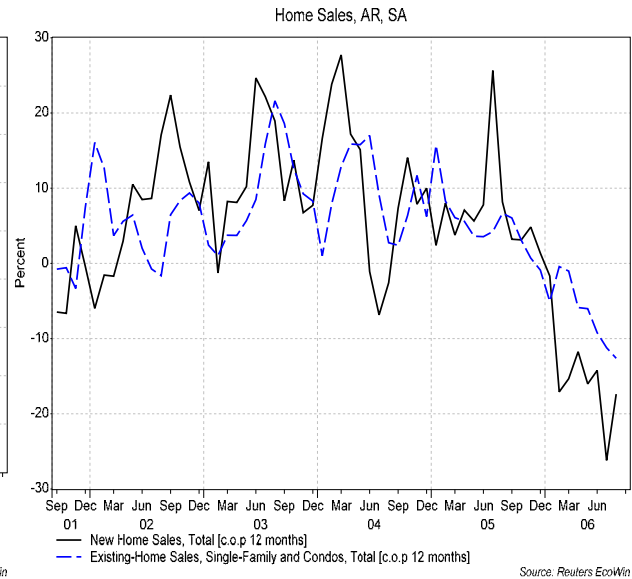


Figure 3: ...While Housing Slumps



The slide in the housing market accelerated in the third quarter, exceeding all but the direst forecasts. New and existing home sales plunged by annual rates of -18.3% and -21.2%, respectively, compared to the Q2 average and are now down by -12.6% and -17.4%, respectively, over the past year (Figure 3). Existing home prices dipped into negative territory (down 1-2%) on a year-on-year basis for the first time since the housing slump of the early 1990s, and housing affordability remains relatively low. Inventories of unsold homes continue to build, and some smaller homebuilders who over expanded during the boom have declared bankruptcy. Finally, residential construction spending has fallen by more than 5% over the past year and shows no signs of bottoming (Figure 4). All of this indicates that home prices probably still have some downside.

² The reason this works is because lower energy prices don't reduce *real* energy consumption, while the money spent on other goods and services does increase real spending. For example, suppose a family spends \$100 per week on energy and \$100 on non-energy goods. If energy prices fall by 25% and the family's unit energy use remains unchanged, it will spend \$75 on energy (lower nominal spending) but its real energy spending is unchanged. If the family spends the remaining \$125 and non-energy prices are unchanged, then real consumption rises by \$25. Of course, this ignores the potentially negative impact on spending by energy producers, but since the United States is a large net importer of energy, the overall impact of lower energy prices should be positive on real consumption.

As we discussed in last quarter's Update³, the key question for the economic outlook remains "How much does the housing slump matter?" We believe that the evidence so far – specifically the fact that consumer spending and the economy overall has held up well despite a housing slump that began a year ago – supports our view that housing will reduce growth moderately but not push the economy into recession or require the Federal Reserve to ease monetary policy aggressively. Moreover, to the extent that resources that would have gone into housing investment are diverted into other forms of investment, the slowdown in housing could have beneficial long-term effects on the economy. We recognize, however, that there may be a considerable lag between the onset of the housing slowdown and its negative impact on consumption, especially since the housing market has worsened significantly over just the past two quarters. We continue to watch carefully for spillover effects from housing in other sectors.

One area that appears to have had a *positive* spillover effect from the slowdown in housing is nonresidential construction. Nonresidential construction spending has surged by more than 17% over the past year as residential construction has slowed (Figure 4). Some of this spending no doubt would have occurred regardless of what was happening in housing, since commercial occupancy rates have been increasing steadily over the past several years. Nonetheless, some of the resources that have been freed up from the housing sector are being absorbed in the nonresidential sector. Given that the residential sector is larger than the nonresidential one, overall construction spending is still slowing, but the economic impact would have been much worse if the nonresidential sector had not stepped in. This is yet another example of the flexibility and resilience of the U.S. economy.

Figure 4: Construction Spending Diverges

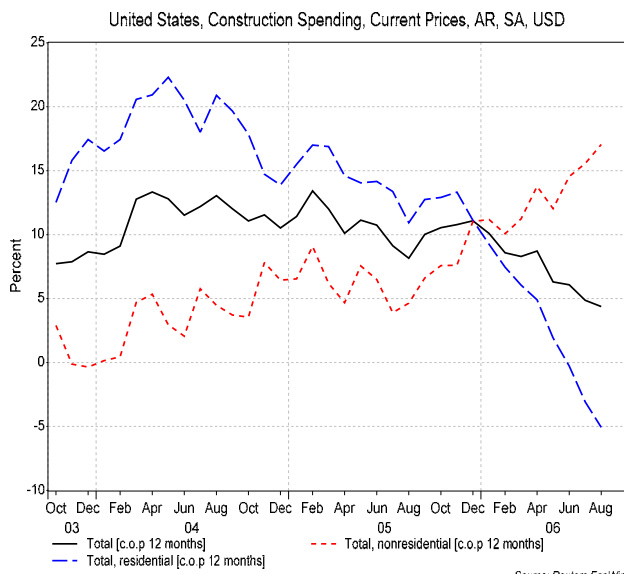
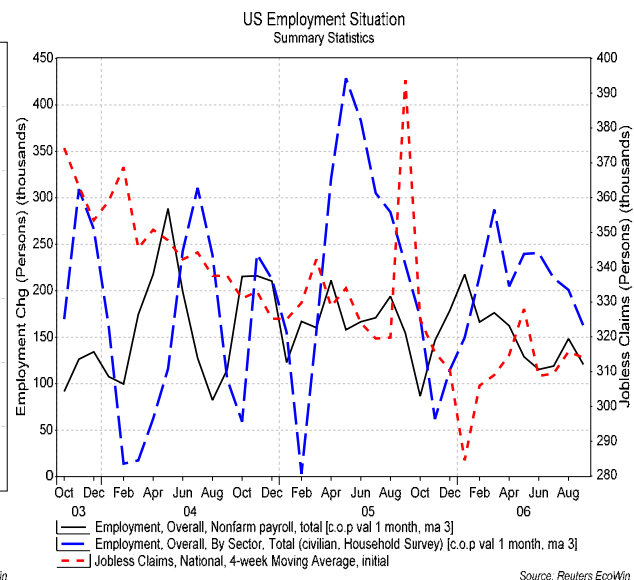


Figure 5: Moderate Job Growth



The labor market showed modest growth in the third quarter, in keeping with the slightly below-trend growth in GDP. The unemployment rate ticked up early in the quarter but then settled back down to 4.6%, where it ended last quarter. Wage growth continued to accelerate, reaching 4.0% year-on-year in September, the fastest pace since early 2001. The household employment survey showed that monthly job gains averaged 162,000 in the quarter, while the larger payroll survey

³ See the Flaherty & Crumrine Incorporated *U.S. Second-Quarter Economic Update*, July 2006.

registered 121,000 average employment gains (Figure 5). While these job differences may seem slight, they are important for policy makers. Job growth of more than 150,000 per month likely would push the unemployment rate down further, increasing the chances of wage inflation, while job gains closer to 100,000 (or less) likely would cause the unemployment rate to rise, easing wage pressures. Thus, if the household employment survey, which has consistently shown more rapid employment growth in this recovery than the payroll survey, is telling the right story on jobs, then incomes, GDP growth, and ultimately inflation are likely to turn out to be higher than economists – and the Federal Reserve – currently expect.

As we have indicated in the past, we think the household survey is doing a better job capturing the state of the labor market currently. In its last employment report, the Bureau of Labor Statistics (BLS) provided some evidence to support that view. The BLS now estimates that 810,000 more jobs were created between March 2005 and March 2006 than previously reported. This is a preliminary estimate, and it will be finalized with the release of the January 2007 employment report. Over the period from March 2005 to March 2006, the household survey registered 1,011,000 more job gains than the payroll survey, so the preliminary BLS revision goes a long way toward closing that gap, and it indicates that the household survey gave a better estimate of job gains over that period than the original payroll survey. There is no guarantee that the household survey will retain that edge, but until we have evidence to the contrary, we will continue to put more weight on the household survey – and the view that the labor market remains strong.

Turning briefly to business investment, we were surprised by the dip in spending on business equipment and software in the second quarter (we had expected a slowdown, but not a negative number). We anticipate a rebound this quarter, though it probably will be modest. Core capital goods orders are up about 6.5% on the quarter, capacity utilization rates are still rising, and corporate balance sheets are healthy, suggesting an ongoing need and ability for businesses to expand capacity (Figure 6).

Figure 6: Investment Trails Utilization Rates

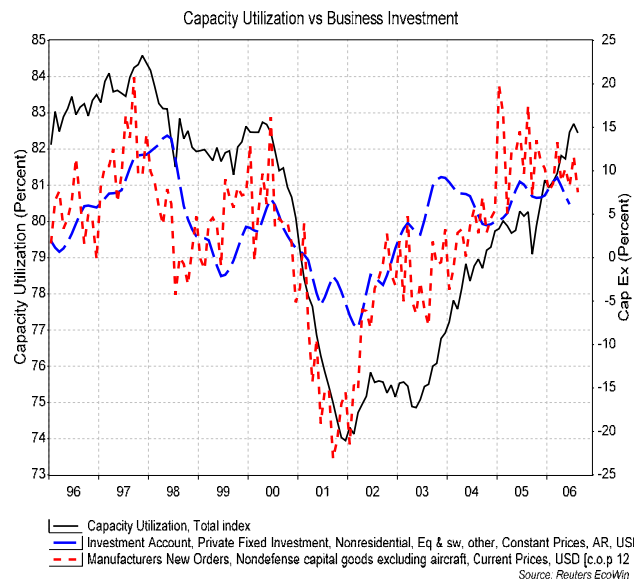
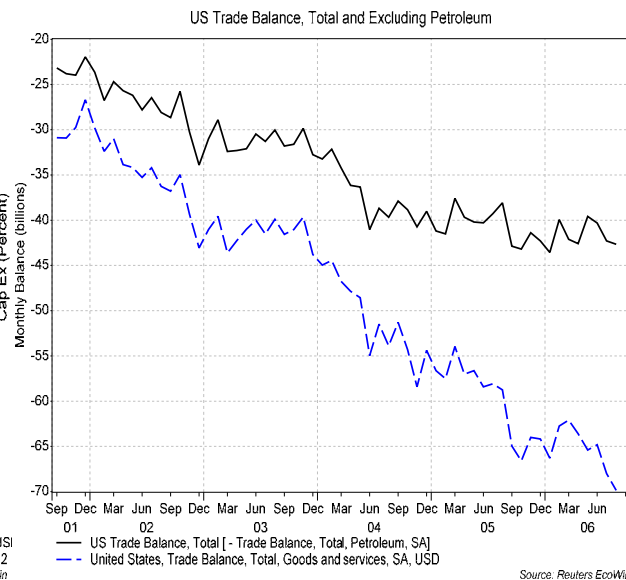


Figure 7: Trade Deficit Hits Record Wide



The trade sector will subtract significantly from third quarter growth, barring a sharp turnaround in the deficit in September (those numbers won't be released for another month). The trade

deficit expanded sharply in July and August to -\$68.0 and -\$69.9 billion (a new record), respectively, from an average of -\$64.6 billion in Q2 (Figure 7). Both energy and non-energy balances deteriorated, although the ex-petroleum deficit still appears to be moving broadly sideways. Regardless of the poor Q3 result, however, if today's lower energy prices are sustained, it's highly likely that the trade deficit for Q4 will be meaningfully lower, which will add to the quarter's GDP growth.

Core inflation slowed in the third quarter, though year-over-year core Consumer Price (CPI) and Personal Consumption Expenditure (PCE) indices continue to move higher (Figures 8 and 9). Lower energy and commodity prices obviously contributed to the drop in headline inflation and probably helped ease core inflation as well, given how broadly energy prices influence input and transportation costs. One shouldn't take too much solace from the (slightly) better inflation news, however. Even on a three-month basis, core CPI and PCE inflation are well above the Fed's 1-2% "comfort zone." As a result, we will need to see continued deceleration in inflation to be sure that the Fed has finished tightening in this cycle.

Figure 8: Inflation Pressures Ease in Q3...

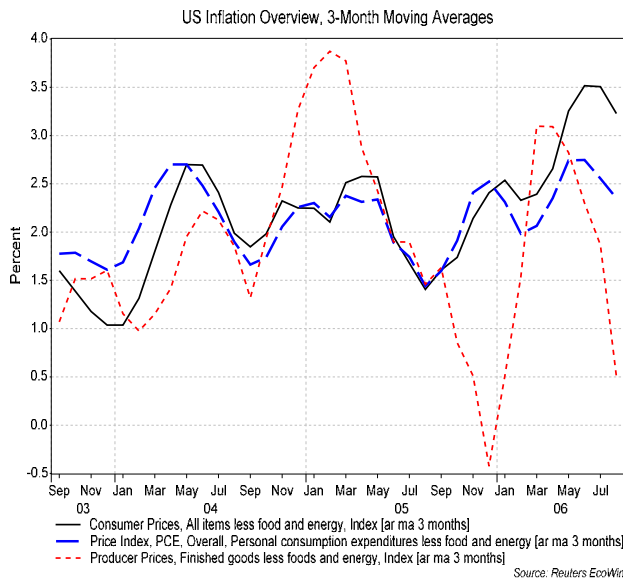
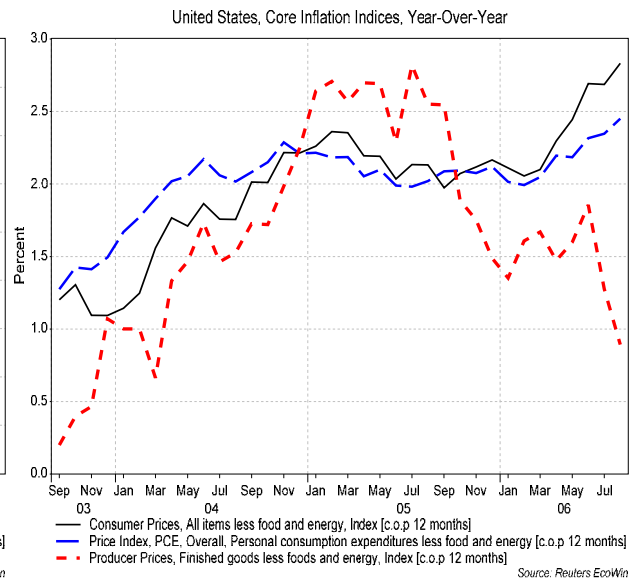


Figure 9: ...But Remain Above Comfort Zone



Market Outlook

The Federal Reserve left the federal funds rate unchanged at 5.25% in the third quarter, and it is likely to do so again at the October 24 Federal Open Market Committee (FOMC) meeting. The bond market celebrated the end of Fed tightening by pushing the yield on the 30-year Treasury down by 42 basis points (bp) over the course of the third quarter (Figure 10). As of quarter-end, all Treasury note and bond yields across the yield curve were well below the fed funds rate, indicating that the market expected the Fed to begin easing relatively soon. Over the past two weeks, the market has given back 15-20 bp of those gains, though it continues to price in easing by the Fed beginning in the second quarter of 2007.

Remember that the Fed *expects* the economy to slow moderately and in turn reduce inflation: Its central tendency forecast for GDP in 2006 implies growth of 2.4-2.9% in the second half of the year. It's not difficult at all to imagine growth coming in either at the upper end or above that

expected range. Moreover, the Fed staff recently reduced its estimate of the potential growth rate of the economy; in plain terms, this means that the staff believes that it will require less growth to generate more inflation or a larger slowdown to generate lower inflation than previously thought. If the FOMC adopts that view, then for the Fed to begin easing in six-month's time would require a sharp slowdown in the economy. As we indicated earlier in this Update, although we can't rule out such a housing-led slump, we don't expect it. As a result, we remain cautious on the outlook for interest rates. Given the depth of the housing market slowdown, we think the Fed's tightening is finished, at least for the next several quarters. However, we believe the Fed will leave rates on hold for longer than the market currently expects, which should lead to moderately higher long-term rates. As always, we aren't explicitly betting on that view, but the nature of our long-duration, hedged portfolios means that we can benefit from such an outcome should it occur.

Figure 10: Long Rates Rally, Inverting Curve

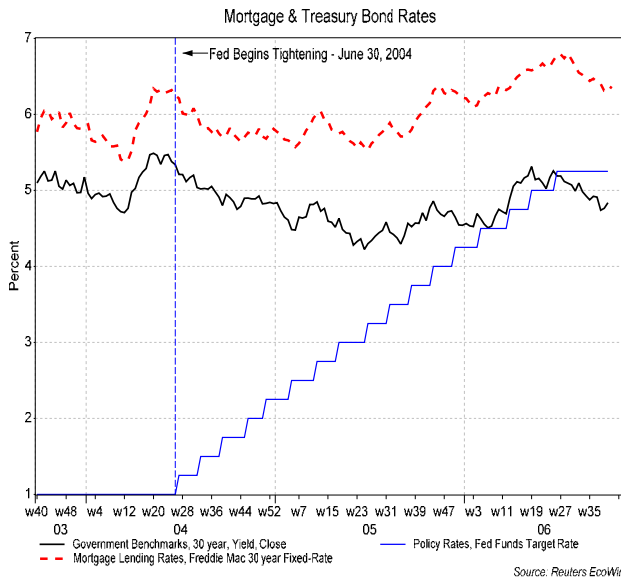
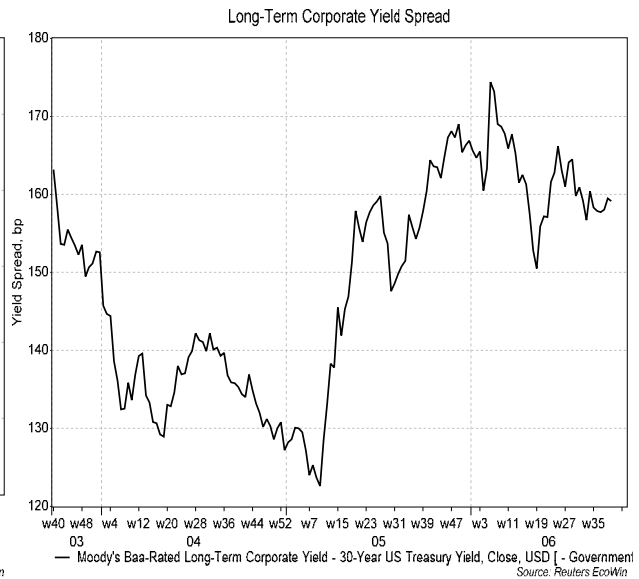


Figure 11: Little Change in Credit Spreads



Credit spreads were roughly unchanged in the third quarter overall (Figure 11), although preferred securities fared better than the market overall as uncertainty over the treatment of “enhanced” preferreds by the National Association of Insurance Commissioners (NAIC) was resolved. As we explained last quarter, the NAIC threw the hybrid preferred market into some turmoil when it classified many of the newer enhanced preferreds as common equity, which carry much higher regulatory capital charges for insurance companies. Since insurance companies are large investors in preferreds, the NAIC ruling caused spreads to widen sharply. In September, the NAIC temporarily put the securities back under the “preferred” category (albeit with a slightly higher capital charge) pending final rules in 2007. The decision caused spreads to narrow back to approximately “pre-NAIC” levels, giving preferreds a boost in the third quarter.

Figure 12: Corporate Balance Sheets Healthy...

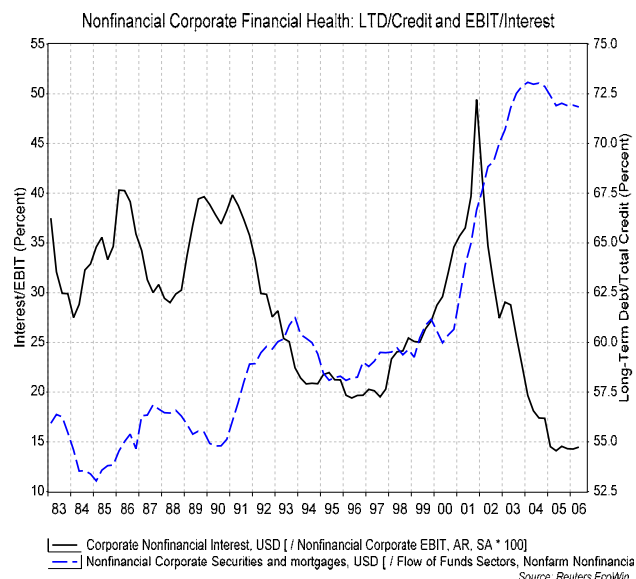
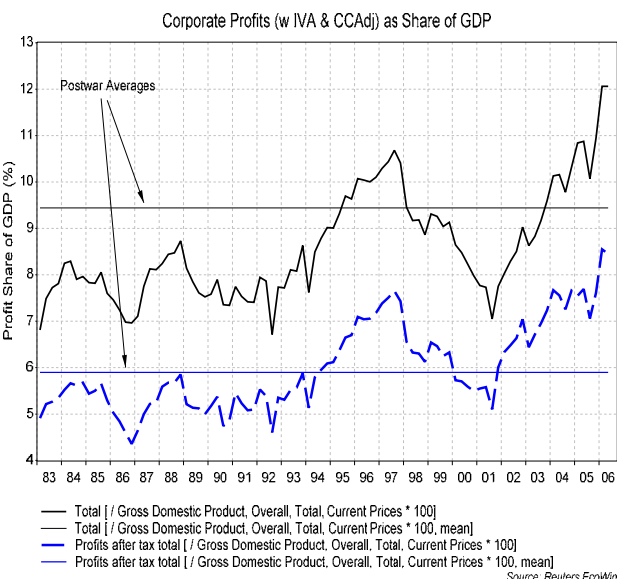


Figure 13: ... And Profits Are Strong



Looking ahead, we continue to expect a relatively benign spread environment. Although the economy is likely to grow a bit more slowly for a few quarters, we don't expect a recession that would prompt significantly higher defaults. Meanwhile, corporate balance sheets remain healthy, measured both in terms of financial flexibility (high) and the proportion of pretax earnings going to service debt (low) (Figure 12). Profits are exceptionally strong and are at or near records on both an absolute basis and as a percentage of GDP (Figure 13). Finally, capital investment remains disciplined, given that investment is lagging both nominal GDP growth and the rise in capacity utilization (Figure 6). We remain mindful that leveraged buyout and other event risks remain prominent features on the credit landscape and are highly significant for affected credits, but we do not expect that these events will widen spreads generally. Thus, although corporate borrowing and leverage are bound to increase at some point and will eventually push spreads wider, we believe that credit spreads for at least the next several quarters will remain within the range we have experienced so far this year.

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 October 12, 2006

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