Flaherty & Crumrine Incorporated

First-Quarter U.S. Economic Update
May 2018

Summary of Recent Economic Developments

The U.S. economy expanded by 2.3% in the first quarter, down from 2.9% in Q4, mostly due to muted consumer spending. Economists continue to forecast solid real GDP growth of 2.8% in 2018 and 2.7% in 2019. Real personal consumption expenditures slowed to 1.1% in Q1 as spending on hurricane rebuilding, which boosted Q4 spending, eased. Personal income rose 4.4% before inflation on continued strong hiring, rising wages and higher investment income. Residential investment was flat, but business investment jumped 6.1%. Productivity held about steady, but rising investment should boost it over time, which will be critical to sustaining economic growth as the economy moves into full employment. The trade deficit narrowed and inventories grew modestly, turning last quarter's headwind into a tailwind for GDP in the first quarter. However, trade policy is in flux and presents downside risks to the economy. Government spending rose slowly, but federal spending is slated to pick up over coming quarters and widen already-large budget deficits. Inflation rose close to the Federal Reserve's target, but we do not expect it to accelerate rapidly. Monetary policy tightened, and 10- and 30-year Treasury rates pushed above 3%. Credit spreads widened despite strong credit fundamentals. Benchmark interest rates now incorporate almost all of the monetary tightening we expect in this cycle. We believe preferred securities continue to offer an attractive combination of good credit quality, high income and moderate interest-rate risk for long-term investors.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	2018:1	2017:4	2017:3	2017:2	2017:1	2016:4	2016:3	2016:2
Real GDP, Chg QoQ (%, SA, AR)	2.3	2.9	3.2	3.1	1.2	1.8	2.8	2.2
Real Personal Consump Expnds, Chg QoQ (%, SA, AR)	1.1	4.0	2.2	3.3	1.9	2.9	2.8	3.8
Real Business Inv ex Stuctures, Chg QoQ (%, SA, AR)	4.5	7.0	7.9	6.6	5.3	0.8	0.9	4.0
Real Residential Investmt, Chg QoQ (%, SA, AR)	0.0	12.8	-4.7	-7.3	11.1	7.1	-4.5	-4.7
Real Private Domestic Final Sales, Chg QoQ (%, SA, AR)	1.7	4.8	2.2	3.2	3.1	2.7	2.6	3.3
Nominal GDP, Chg QoQ (%, SA, AR)	4.3	5.3	5.3	4.1	3.3	3.8	4.2	4.7
Corporate Profits, After Tax, Chg YoY (%, SA, AR)	9.9f	4.8	7.7	7.8	3.7	14.1	-2.2	-8.0
Nonfarm Productivity, Chg QoQ (%, SA, AR)	0.7	0.3	2.6	1.7	0.2	1.2	2.4	1.0
Nominal Personal Income, Chg YoY (%, AR)	3.6	4.3	3.1	2.4	3.4	1.6	2.4	2.5
Personal Savings Rate (%, SA)	3.1	2.4	3.0	3.6	3.9	3.2	4.5	5.1
Unemployment Rate (%, SA)	4.1	4.1	4.2	4.3	4.5	4.7	5.0	4.9
Nonfarm Payrolls, Chg QoQ (000, SA)	635	662	425	569	532	492	764	493
Household Employment, Chg QoQ (000, SA)	1157	-303	1074	186	831	418	651	-65
Federal Budget, 12-mo Def or Surp (% of GDP)	-3.7	-3.5	-3.5	-3.7	-3.4	-3.1	-3.2	-2.9
Consumer Price Index, Chg YoY (%, AR)	2.4	2.1	2.2	1.6	2.4	2.1	1.5	1.0
CPI ex food & energy, Chg YoY (%, AR)	2.1	1.8	1.7	1.7	2.0	2.2	2.2	2.2
Capacity Utilization (%, SA)	78.0	77.3	75.7	76.2	75.5	75.7	75.1	75.3
Rate or Spread (End of Quarter)	**2018:1**	**2017:4**	**2017:3**	**2017:2**	**2017:1**	**2016:4**	**2016:3**	**2016:2**
Federal Funds Rate Target (%)	1.75	1.50	1.25	1.25	1.00	0.75	0.50	0.50
3-month LIBOR (%)	2.31	1.69	1.33	1.30	1.15	1.00	0.85	0.65
10-Yr Treasury Note Yield (%)	2.74	2.41	2.32	2.30	2.39	2.43	1.59	1.49
30-Yr Treasury Bond Yield (%)	2.97	2.74	2.86	2.84	3.01	3.05	2.32	2.31
ICE-BofAML US Corporate Index Yield to Worst vs Gvt	116	97	104	112	120	126	138	158
10-Yr Interest Rate Swap Spread (bp)	3.8	-1.5	-4.5	-2.3	-0.8	-11.3	-14.0	-11.3

* Figures are either quarterly or, if more frequent, end of period. f = Forecast[1] ; N/A = not available Source: Macrobond, ICE, Bloomberg LP

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

Economic Outlook

The U.S. economy moderated in the first quarter after nine months of strong growth. Inflation-adjusted gross domestic product (real GDP) expanded by 2.3% in Q1, down from 2.9% in Q4. That was enough to push real GDP growth over the past four quarters up to 2.9%, its best pace since mid-2015. Looking ahead, economists expect 2.8% real GDP in 2018, unchanged from last quarter's forecast.[1] We continue to expect 2.7-3.2% growth in 2018, although Q1's slow start biases us toward the lower half of that range. For 2019, economists project 2.7% growth, up 0.2% from last quarter's survey.

Three months ago, we laid out four key expectations underlying our outlook.[2] First, tax reform should prompt greater business investment and boost labor productivity. Second, higher wages due to a shrinking pool of available workers should support income growth above 4%, even as job growth slows as the economy reaches full employment. Third, global economic activity – which expanded by 3.8% in 2017 according to the International Monetary Fund – should remain around that level in 2018. Finally, we assume that immigration and trade policies do not lead to worker shortages or trade wars that damage U.S. and global growth. With the first quarter behind us, we feel even more confident in the first three views. Business investment grew rapidly, productivity accelerated, wages rose, and the IMF now forecasts 3.9% global growth this year and next. However, we are considerably less confident on trade policy. We cannot predict what direction trade negotiations will take or their impact on U.S. economic growth, but risks are skewed to the downside. Nonetheless, we think an optimistic outlook remains warranted, and we briefly review major sectors of the economy below.

Figure 2: Employment Growth Remains Strong

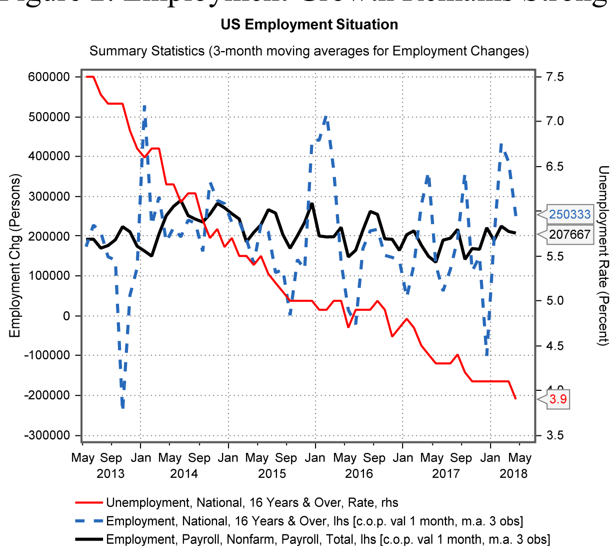
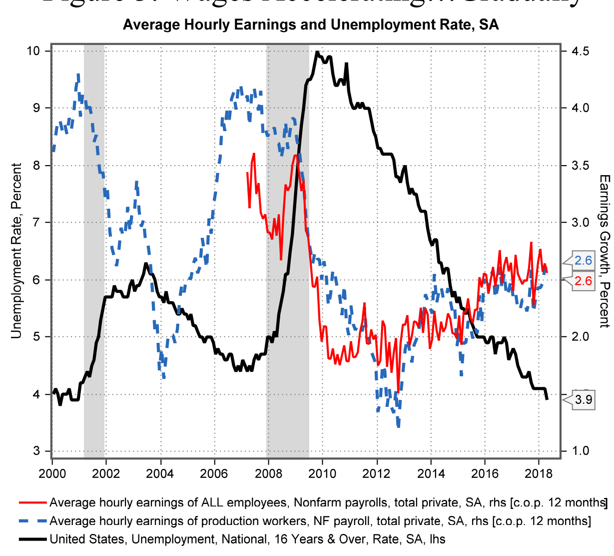


Figure 3: Wages Accelerating…Gradually



The **labor market** posted another quarter of solid employment gains (Figure 2). Payroll jobs rose by an average of 212,000 jobs per month in Q1 – about the same as Q4 – and added another

[1] Unless noted otherwise, forecasts are from the *Survey of Professional Forecasters*, Federal Reserve Bank of Philadelphia, May 11, 2018 and Bloomberg® *U.S. Monthly Economic Survey*, May 10, 2018.
[2] *Fourth-Quarter U.S. Economic Update*, Flaherty & Crumrine Incorporated, February 12, 2018. Available at www.flaherty-crumrine.com.

164,000 in April 2018. The household employment survey showed very strong gains of 386,000 per month in the first quarter, although that followed 101,000 average monthly *losses* in Q4; the survey was essentially flat at +3,000 jobs in April. Payroll job growth picked up slightly to 1.6% YoY in April, while household employment growth slowed to 1.3%, though it averaged 1.5% in the first four months of 2018. Those job gains drove the unemployment rate down to 4.1% in March and 3.9% in April, the lowest rate since December 2000. Labor participation was 62.8% in April, about where it has been since late 2014 – a decent result in light of an aging workforce.

Despite strong hiring, average hourly earnings rose 2.6% YoY in April, a little below December 2017's 2.8% YoY pace (Figure 3). Last quarter, we cautioned that wage gains around year-end often fade over following months, and that is what happened so far this year. Nonetheless, a gradual acceleration in wages that began in 2012 appears intact, and we expect it to continue to support personal income growth over coming quarters.

Figure 4: Income Steady, Spending Slower

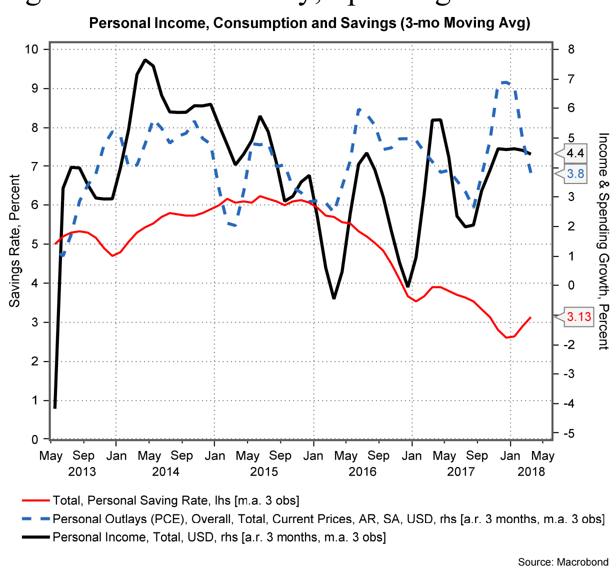
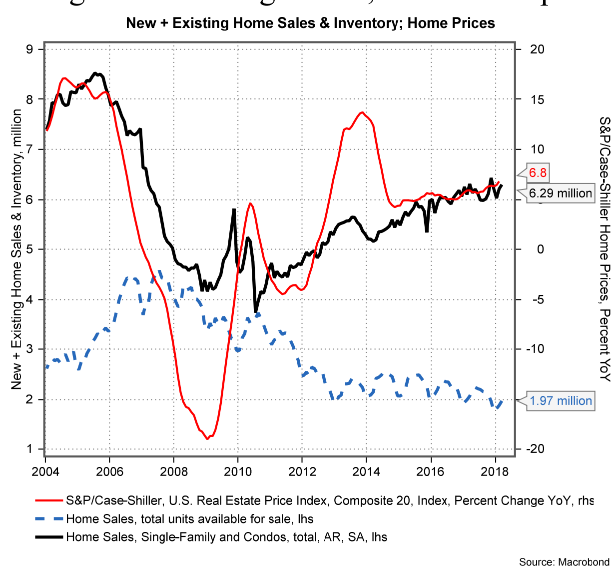


Figure 5: Housing Mixed, but Prices Up



Personal income growth held about steady in recent months, rising 4.4% in Q1 and 3.6% over 12 months ending in March (Figure 4). Proprietors' income (+4.5% YoY in March) edged out wage and salary income (+4.4%), while investment income (+3.1%) also posted good gains. In addition to an expanding economy and solid hiring, tax reform lowered personal income tax rates and should boost disposable personal income, which is reported on an after-tax basis. Tax reform also reduced corporate tax rates significantly, which should support investment and (some) proprietors' income. We expect disposable personal income to expand by at least 4% in 2018.

As spending on hurricane and flood recovery subsided, **personal consumption expenditure** (PCE) slowed sharply in Q1. Nominal PCE rose 3.8% in the first quarter, down significantly from 6.9% in the prior quarter (Figure 4). After inflation, real PCE rose a tepid 1.1% in Q1, but it was still up a respectable 2.4% YoY. Because disposable personal income (+6.2%) outpaced PCE (+3.8%) during the first quarter, the **savings rate** rose to 3.1% in March from 2.4% in December, although it remains well below 2015 and 2016 levels. We still expect spending growth to lag income growth over coming quarters as consumers look to boost savings. However, Q1's wide gap between income and spending is likely to narrow from here.

The **housing market** again turned in a mixed performance during the first quarter. Residential investment was unchanged after surging 12.8% in Q4 on hurricane rebuilding. New and existing home sales managed a 6.2 million unit pace during Q1, but that is little changed since mid-2016 (Figure 5). Rising employment and low inventories of unsold homes continued to push up home prices. The S&P/Case-Shiller 20-city home price index rose 6.8% YoY in February (latest data available), up from 5.9% a year earlier. We continue to expect residential investment will rise to meet demand that's being signaled by higher home prices, but it's likely to be a gradual process.

Figure 6: Industry Slowed but Still Strong

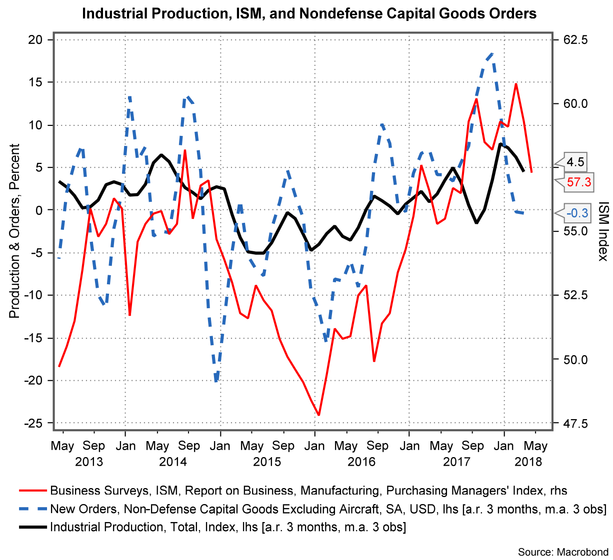
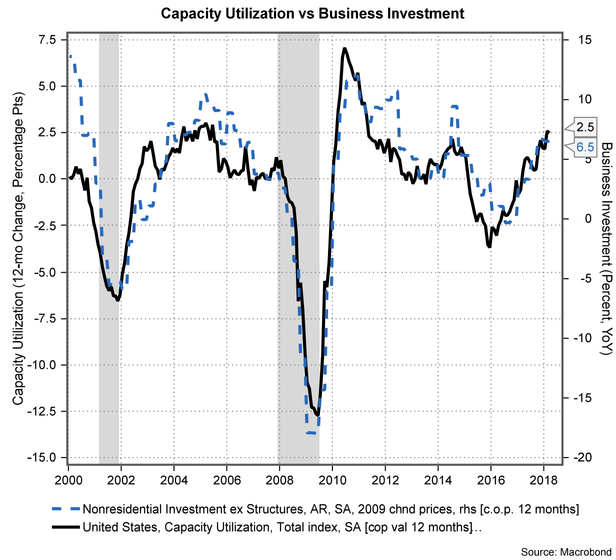


Figure 7: Capacity Constraints Driving Investment



Industrial production rose 4.5% in the first quarter and 3.9% YoY (Figure 6). While that represents a slowdown from last quarter, it is still a very strong result. Manufacturing output rose 3.3% for the quarter. Utility output was up 6.1% on cold weather. And mining output, which includes oil and gas extraction, jumped 10.8%, spurred by higher oil prices. The Institute for Supply Management's manufacturing survey slipped to 57.3 in April, but it continues to point toward moderate gains in output. However, orders for core capital goods (nondefense, excluding aircraft) slipped by 0.3% in the first quarter. Much of that is probably payback from a surge in orders for hurricane rebuilding in Q4, but it may reflect some uncertainty over the impact on export industries from proposed (and in some cases, implemented) trade tariffs. We still expect that tax reform will drive higher business investment and support continued expansion in industrial output, but – as we mentioned at the outset – trade policy is a wildcard in the outlook.

Real **business investment** rose 6.1% in the first quarter, about in-line with our expectations. However, the composition of that growth was skewed more toward structures (+12.3%) and less toward "core" business investment (business equipment and intellectual property, +4.5%) than expected. A steady rise in capacity utilization should drive further gains in "core" business investment (Figure 7). We expect business investment to remain a bright spot this year.

In last quarter's *Update*, we highlighted a need for rising labor **productivity** to sustain faster economic growth without substantially higher inflation, given slowing labor force growth and an already-low unemployment rate. Accordingly, we will keep readers posted on productivity developments over coming quarters. So far, it's too soon to tell the impact of higher business investment spending on productivity, but it should give productivity a boost over time. Nonfarm productivity rose 0.7% QoQ and 1.3% YoY in the first quarter, about flat with recent results (Figure 8). That probably reflects subdued GDP growth in Q1, as productivity tends to mirror economic activity. If business investment and economic growth stay strong, as expected, we could soon see a return to 2% overall productivity growth over coming quarters.

Figure 8: Productivity Paused in Q1

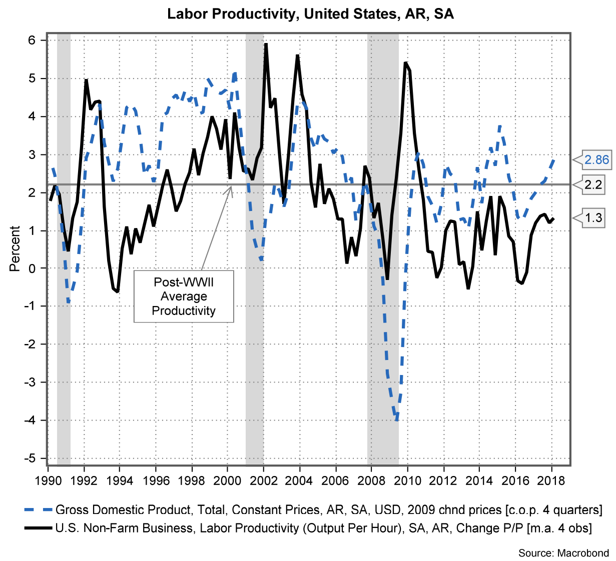
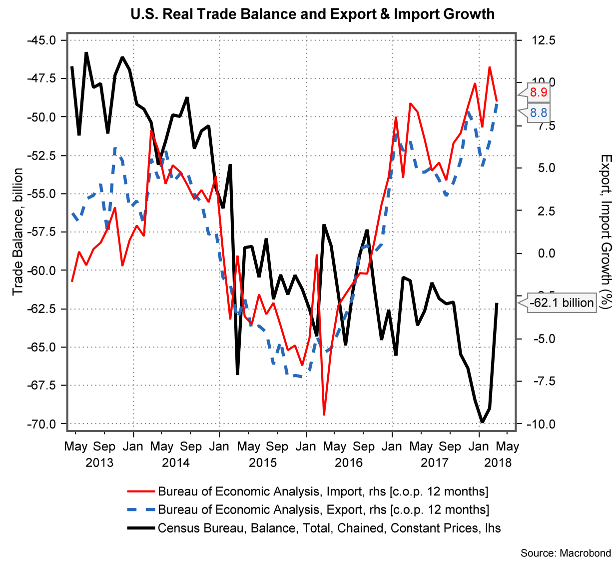


Figure 9: Trade Neutral in Q1, Future Unclear



After widening sharply in the fourth quarter of last year, the **trade deficit** mostly reversed during the first quarter (Figure 9). The advance GDP report estimated that net exports added 0.2% to real GDP growth in Q1, although more recent data suggests that will be revised to about flat in the next report in late May. Imports and exports expanded by 8.9% and 8.8% YoY, respectively, although both face headwinds prospectively from potentially higher tariffs. Stronger U.S. economic growth combined with recent dollar strengthening should boost demand for imported goods while making U.S. exports more expensive. That suggests that net exports are likely to exert modest drag on real GDP in 2018. Trade actions could alter that trajectory, however, and we cannot predict their impact.

Inventories added 0.4% to first quarter real GDP after subtracting 0.5% in Q4. Although inventory growth is often volatile quarter-to-quarter, it generally has minimal impact on long-term GDP, averaging just +0.04% growth contribution since 1990. With growth improving, we expect some inventory rebuilding in 2018 – especially if importers accelerate purchases ahead of potential tariffs – but it is not a major factor in our outlook.

After rising sharply in the fourth quarter, **government consumption** slowed in the first quarter. Federal spending rose 1.7% while state and local spending edged up just 0.8% in Q1. We think state and local governments probably will face taxpayer resistance to additional spending in light of tax reform's new $10,000 annual limitation on deductibility of state and local taxes on individual federal tax returns. We expect sluggish growth in state and local spending to continue. In contrast, federal government spending is slated to pick up substantially this year and next, despite lower revenues due to tax reform. The Congressional Budget Office (CBO) projects that discretionary outlays will increase 6.6% in fiscal year 2018 and 6.4% in FY2019; they are projected to decline by 1.6% in FY2020 – at which point the annual federal budget deficit is projected to exceed $1 trillion. That pullback in spending and a rapidly expanding deficit represent headwinds to growth after 2019, something the Federal Reserve will consider when setting monetary policy next year and beyond.

Summarizing the first-quarter economic situation, real GDP growth of 2.3% adds up as follows: Personal Consumption Expenditures (+0.73%), Residential Investment (0.0%), Business Investment (+0.76%), Inventory Change (+0.43%), Net Exports (+0.20%), and Government Consumption (+0.20%). The first three components equal **Private Domestic Final Sales**, which grew by 1.7% during the quarter[3] and 3.0% over the past year (Figure 9). Private sector growth was led by business investment, while PCE contributed less than normal. Looking ahead, we expect continued gains in business investment, better growth in residential investment, and a higher contribution from personal consumption – though PCE should lag income growth as consumers seek to boost savings.

Figure 10: Private Sector Slower, still Strong

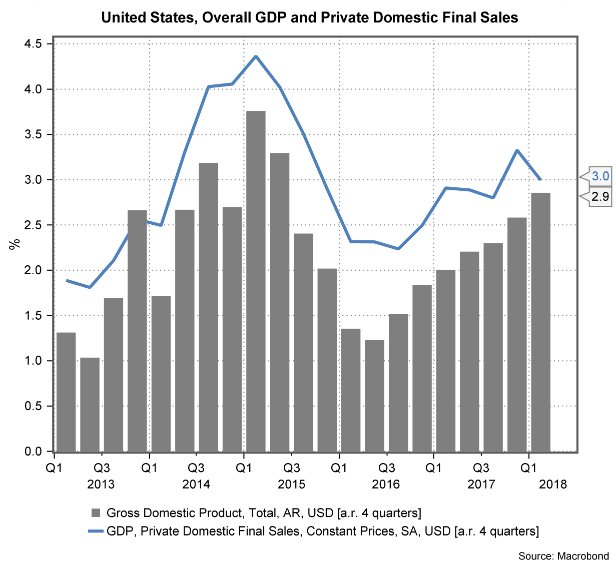
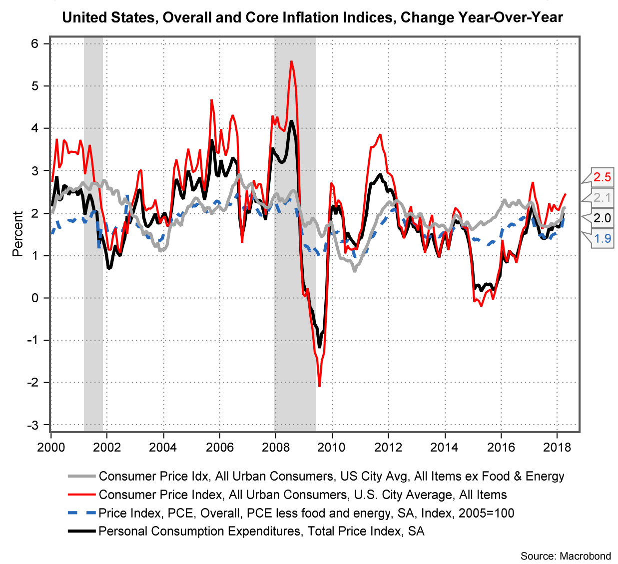


Figure 11: Inflation Approaches Fed Target

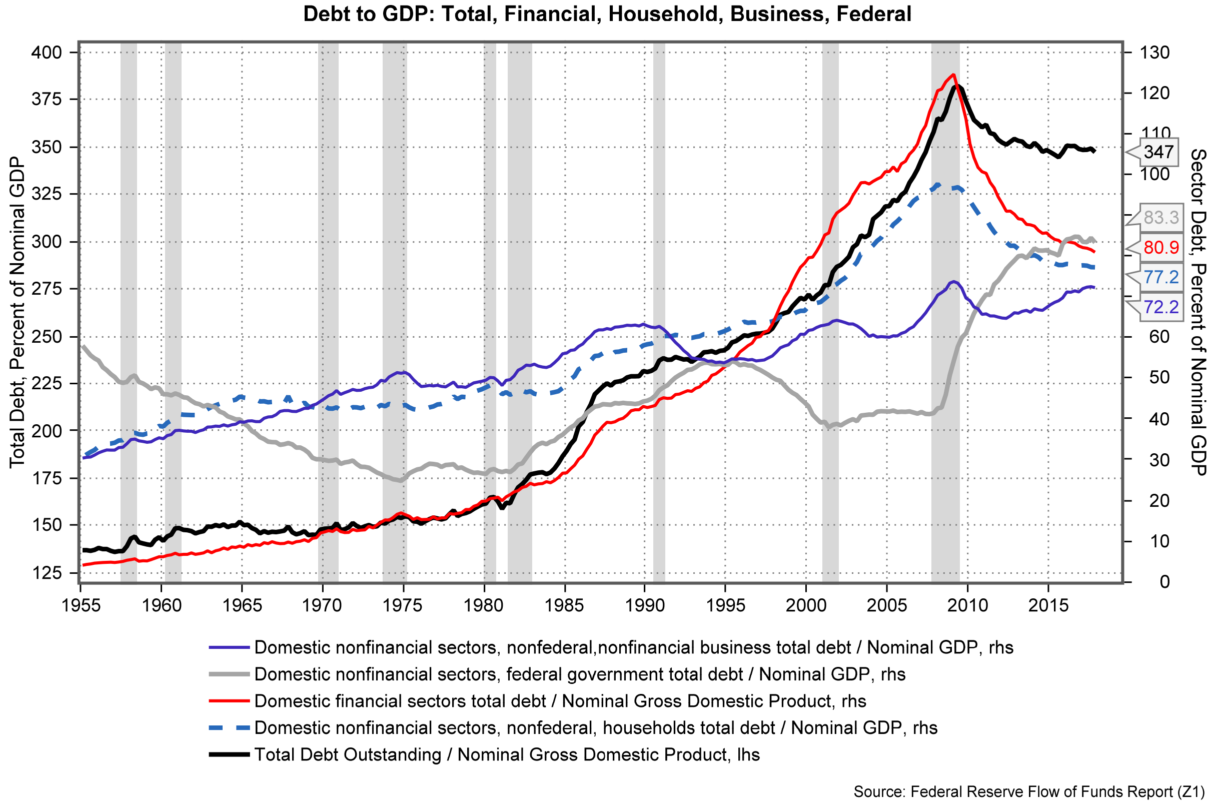


Inflation accelerated during the first quarter, bringing it close to the Federal Reserve's 2% inflation target (Figure 11). For 12 months ending in April, the consumer price index (CPI) was up 2.4% overall and 2.1% excluding food and energy. The Federal Reserve's preferred inflation gauge, the PCE deflator, was up 2.0% overall and 1.9% excluding food and energy over 12 months ending in March, up from 1.7% and 1.5%, respectively, in December 2017. Part of this acceleration in inflation is due to base effects. Inflation indices in March 2017 fell as mobile network providers cut prices on cellular service plans, and that restraint has now rolled out of YoY inflation calculations. Inflation in 2018 has also ticked up (e.g., the core PCE deflator was up 2.6% over the past three months), although we view annualized inflation rates over such short periods with a healthy dose of skepticism. We think inflation should move somewhat higher due to rising wages, still-accommodative monetary policy, higher energy prices and the lagged effect of a weaker dollar. However, several of these influences are diminishing (monetary stimulus is

[3] These three GDP components sum to 1.5%, but their combined growth rate was 1.7% because the former rate's denominator is total GDP, which is larger than its subset, private domestic final sales.

turning toward restraint) or reversing (the dollar has strengthened considerably in recent months), and we do not expect inflation to break rapidly upward.

Figure 12: Leverage Slightly Lower, but Government Borrowing Poised to Rise



As shown in Figure 12 above, broad **balance sheet trends** in the U.S. generally improved a bit during the fourth quarter of 2017 (latest data available). Overall debt-to-GDP was 347%, down slightly from 349% last quarter. Leverage at households dropped by 0.1% to 77.2% debt-to-GDP. Financial business leverage dropped faster, falling to 80.9% from 81.5% last quarter. Even federal government debt (83.3%, down from 84.4%) declined relative to GDP, though it is poised to rise substantially over coming years. Nonfinancial businesses leverage edged 0.1% higher to 72.1% of GDP as business investment rose. We remain watchful on nonfinancial corporate leverage, but government debt is the sector that probably bears most scrutiny over the next several years as annual deficits continue to rise.

Market Outlook

Long-term **Treasury rates** jumped in the first quarter after four quarters of relative stability. The 30-year benchmark Treasury yield rose by 23 basis points (bp) to 2.97% on March 30, while the 10-year Treasury note yield rose by 33 bp to 2.74% (Figure 13). Ten- and 30-year yields were 3.08% and 3.20%, respectively, on May 15 – well above where they ended the first quarter.

The Federal Open Market Committee (FOMC) hiked short-term rates by 25 bp in March and is expected to do so again at its June 12-13 meeting. The FOMC also continued with its plan to reduce holdings of Treasuries and mortgage-backed securities.[4] The Fed is shrinking its portfolio by gradually reducing reinvestment of maturing securities. That began in October 2017 at $10 billion per month (60% in Treasuries and 40% in mortgage-backed and agency securities) and stepped up to $30 billion per month (same proportions) in April 2018. The Fed plans to increase the pace of portfolio reductions by $10 billion every three months until it reaches a cap of $50 billion per month, which would occur in October 2018 on the current timetable.

Figure 13: Rates Higher; Forwards Flatter

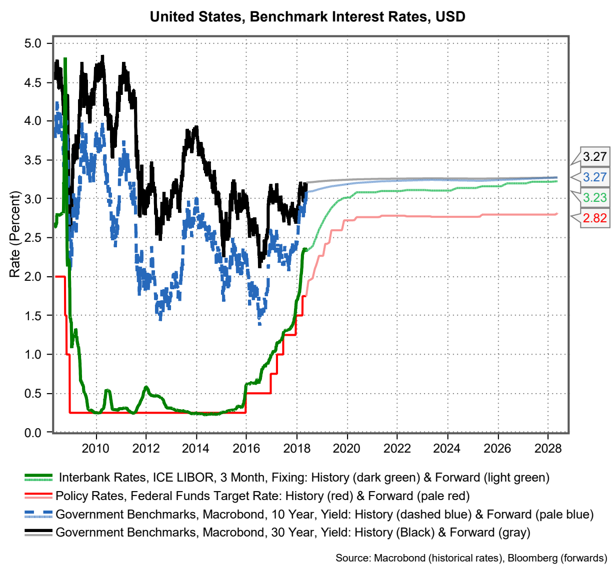
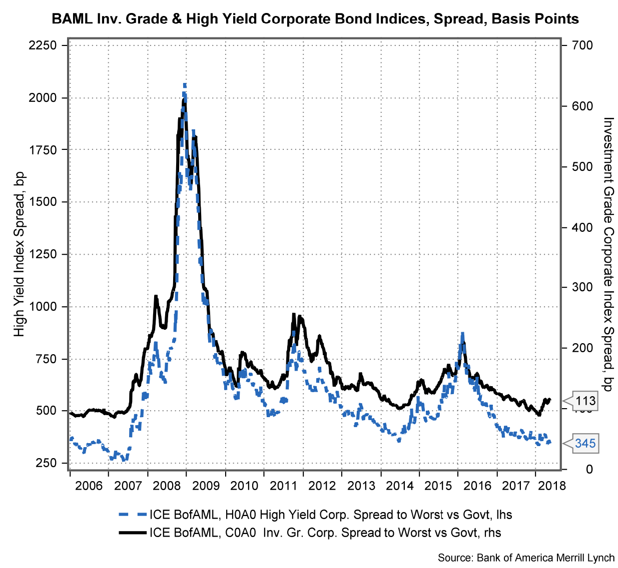


Figure 14: Corporate Spreads Mostly Wider



As Fed portfolio reinvestments shrink, two things happen. First, private investors will have to absorb a larger quantity of Treasury and mortgage securities – and Treasury auction sizes already are rising to finance a wider budget deficit. Second, the stock of Treasury and mortgage securities held by the public will rise, which require investors to increase allocations to those assets relative to other assets. There are many reasons why Treasury rates have increased in 2018, but rising issuance and a shrinking Fed portfolio have contributed. As we have noted, higher Treasury rates are part of the FOMC's game plan for tightening financial conditions. So far, that appears consistent with the Fed's intentions, although that could change if rates move significantly higher from here.

As illustrated in Figure 13, markets currently price in two to three additional 25 bp rate hikes in 2018, bringing the fed funds rate to about 2.25% by year-end, up from 1.7% currently. That is a little above the Fed's March 2017 median projection of 2.1%. Thereafter, markets price in one to two additional 25 bp rate hikes in 2019 and a fed funds rate of about 2.75% at the end of 2020, compared to the FOMC's projections of 2.7% and 3.1% at the end of 2019 and 2020, respectively.

Market rates are now closely aligned with our rate expectations, but we think the Fed's forecast for 2020 is a little high. We anticipate somewhat slower economic growth in 2020 as federal government spending slows and early stimulus from tax reform wanes. In addition, rising Treasury supply and reduced portfolio reinvestment (-$600 billion annualized) by the Fed should

[4] See "FOMC Communications related to Policy Normalization" on the Federal Reserve's website for details. Available at: https://www.federalreserve.gov/monetarypolicy/policy-normalization.htm

combine to tighten financial conditions without multiple rate hikes by the FOMC in 2020. Since forward curves already reflect our anticipated rate hikes, we think intermediate Treasury rates will rise only moderately from current levels – perhaps by 25-50 bp over the next several years – although they could be more volatile than in recent years.

Corporate **credit spreads** widened in the first quarter, as relatively stable benchmark rates and rising corporate profitability attracted more investors to credit investments. Investment-grade corporate bond spreads[5] widened by 19 bp to 116 bp on March 30; spreads recovered slightly to 113 bp as of May 15, although corporate bond yields were higher given higher Treasury rates. High yield bond spreads[6] widened by 13 bp to 382 bp in Q1; they narrowed to 345 bp as of May 15 (Figure 14).

Spreads on preferred securities are more difficult to illustrate. Nearly all preferred securities are callable, and yield-to-worst often understates economic yield when prices are above par – as most are today – because not all of those securities will be called by their issuers on first call date. Yields on newly-issued preferred securities (priced at par) may give a better indication of yield and spread. In December 2017, three rated U.S. dollar preferred securities were issued with a weighted-average yield of 5.25% and a weighted-average spread to Treasuries of 249 bp.[7] In March 2018, there were 11 new issues with a weighted-average yield of 6.07% and a weighted-average spread to Treasuries of 325 bp. By that measure, preferred spreads widened by 76 bp in the first quarter, compared to 19 bp and 13 bp for investment grade and high yield corporate bonds, respectively. For the first quarter of 2018, total return on the ICE BofAML preferred index[8] (-1.04%) fell between returns on the high yield (-0.91%) and investment-grade corporate bond (-2.20%) indices.[9] Return on the preferred index may seem at odds with substantially greater spread widening compared to high yield and investment-grade corporate indices in Q1, but that reflects a relatively small sample size of new issues. As we said, quantifying spreads on preferred securities is difficult!

Fundamental **credit conditions** were stable to a bit better in the fourth quarter of 2017 (latest data available), and banks' first-quarter earnings reports suggest that loan performance remained good. Corporate earnings rose strongly: up 4.8% in the fourth quarter compared to a year earlier, and economists expect them to be up 9.9% YoY in Q1, partly due to lower corporate tax rates. Profits remain high as a proportion of GDP, and that ratio is likely to rise this year due to tax reform and stronger economic growth (Figure 15). Over time, however, we expect that competition for workers and higher after-tax margins from lower tax rates will boost wages and push the profit share of GDP back toward its long-term average.

Internally generated cash relative to spending on capital investments (the "financing gap") at nonfinancial businesses improved substantially in the fourth quarter (Figure 16). Internally

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[5] Investment-grade corporate bond spread is represented by the ICE BofAML U.S. Corporate Index℠ (C0A0) "Yield to Worst versus Government" yield spread series. "Spread to Worst" is the lower of yield to call and yield to maturity minus yield on a comparable Treasury security.
[6] Below-investment-grade corporate bond spread is represented by the ICE BofAML U.S. High Yield Index℠ (H0A0) "Yield to Worst versus Government" yield spread series.
[7] Includes issues rated BB- or higher by one or more of Moody's, Standard & Poor's and Fitch.
[8] Preferred index is the ICE BofAML 8% Constrained Core West Preferred & Junior Subordinated Securities Index℠ (P8JC).
[9] Total return is not annualized and includes both price change and income.

generated cash rose as the economy expanded, and companies slowed capital investments, generating a negative financing gap. As a result, corporate bond issuance slowed. Looking ahead, we expect corporate borrowing to increase in 2018 as companies boost investment spending, but higher after-tax corporate profitability should keep credit metrics favorable.

Figure 15: Corporate Profits Stable, Strong

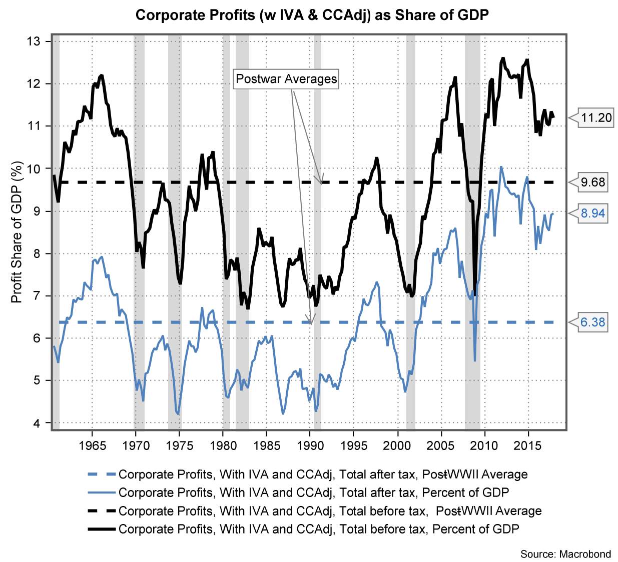


Figure 16: Financing Gap Improved

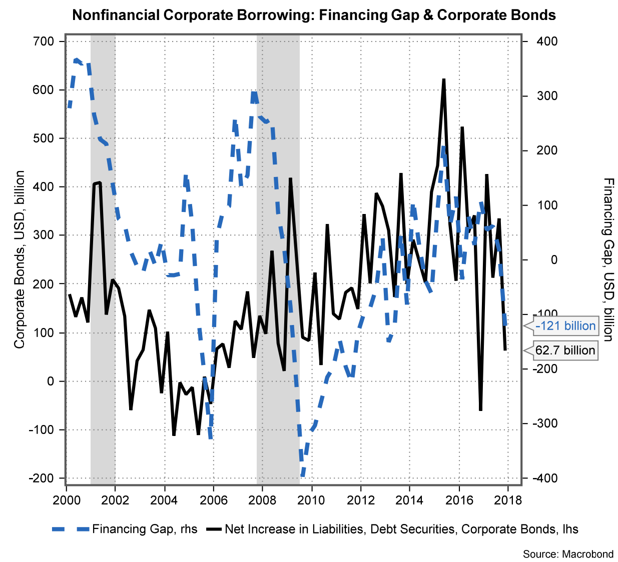


Figure 17: Balance Sheets Slightly Stronger

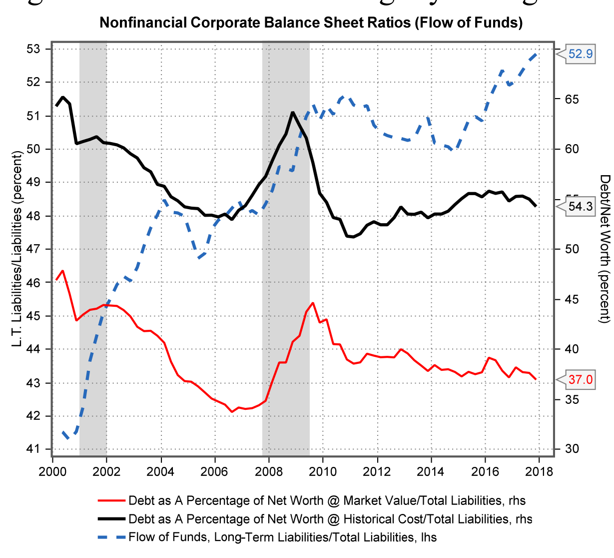
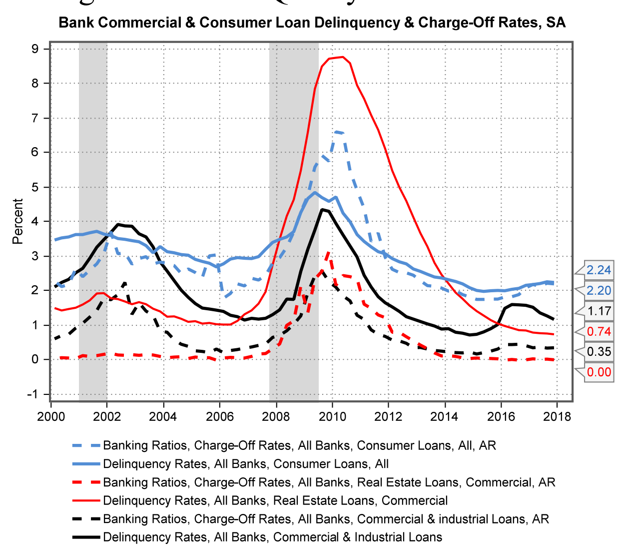


Figure 18: Loan Quality Stable to Better



Debt relative to total liabilities edged lower at nonfinancial companies in the fourth quarter (Figure 17), although it increased slightly relative to GDP, as noted earlier. Companies again took advantage of low interest rates to increase the proportion of long-term liabilities (bonds, mortgages and direct investments) on their balance sheets. While that likely reduced interest-rate sensitivity as the Fed raised short-term rates, interest expense as a percentage of earnings before interest and taxes still ticked up to 20.3% in Q4 from 19.0% the prior quarter. Interest expense remains historically low, and higher corporate profits should provide a cushion against rising rates going forward, but this bears watching.

Loan delinquencies and charge-offs were stable to better in the fourth quarter, and first-quarter earnings showed continued good credit metrics at most banks. Overall loan delinquencies at banks dipped to 1.79% in Q4 from 1.83% in Q3 and 2.04% a year earlier. Overall loan charge-off rates were essentially flat at 0.48%, compared to 0.47% in both Q3 and a year earlier. Delinquency rates on commercial and industrial loans continued to drift lower, and consumer loan delinquencies and charge-offs improved slightly after trending higher over the past seven quarters (Figure 18). Bank earnings rose, and capital ratios held steady or edged lower. With capital already very strong, we expect banks to pay out 100% or more of current earnings, retaining only what is needed to support balance sheet growth – which has been modest overall.

Summarizing our main views, we expect real GDP to expand by 2.7-3.2% in 2018. Consumer spending should rebound from a slow first quarter but lag personal income growth as consumers rebuild savings. Business investment, spurred by tax and regulatory reform, is likely to lead economic growth again, and residential investment should improve. Government spending is set to rise in 2018 and 2019, although prospects for sharply higher federal budget deficits cloud longer-term outlooks for the economy and interest rates. We remain hopeful that higher business investment and regulatory reform will boost productivity and enable faster economic growth without substantially higher inflation. Stronger economic growth would make deficits both smaller (as tax revenues increase) and more manageable relative to a larger economy.

There are plenty of risks surrounding that view, however, with trade policy chief among them at the moment. We do not know how trade negotiations will affect U.S. economic growth, but risks lie mostly to the downside. We believe the FOMC is aware of those risks, especially as financial conditions tighten more meaningfully. Although the Fed is likely to hike the fed funds rate to about 2.25% by year-end, we expect a substantially slower pace of tightening thereafter, which should push long-term rates only modestly above current levels.

For preferred investors, we see this outlook as good news following modestly negative returns since the start of 2018. Credit fundamentals are strong, especially at financial institutions, and solid economic growth and rising profits should support credit spreads. Although short rates are likely to rise further, we think most of the adjustment in intermediate- and long-term interest rates has already occurred. We believe preferred securities continue to offer an attractive combination of good credit quality, high income and moderate interest-rate risk for long-term investors.

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