Flaherty & Crumrine Incorporated

Third-Quarter U.S. Economic Update
November 2019

Summary of Recent Economic Developments

The U.S. economy expanded by 2.1% in Q3 and averaged 2.4% growth over the first three quarters of 2019. Economists expect 1.7% real GDP in Q4 and 2.3% in 2019 overall, slowing to 1.8% in 2020. We agree with the 2019 consensus forecast but are more optimistic for 2020, when we anticipate 2.0–2.5% growth. Moreover, we think risks to our outlook are only modestly to the downside in 2020 in light of support already in place from monetary and fiscal policy. Employment growth picked up in Q3 and contributed to strong growth in personal income. Personal consumption was solid but lagged income, boosting the savings rate. Residential investment turned up in Q3 and should expand moderately next year. Federal government consumption was strong, but state and local spending was soft. Business investment contracted, and the outlook for 2020 appears binary. Closing of trade agreements could reignite business investment that was put on hold in 2019, or it could remain on hold as trade uncertainty lingers. The Federal Reserve cut the fed funds rate by 25 bp twice in Q3 and again in late October. Financial conditions eased substantially and should support the economy into 2020. Inflation remained subdued. Treasury rates fell in response to the Fed's rate cuts and lower business investment. Credit quality was mostly stable, and credit spreads were little changed. Low rates drove investors to seek yield in preferred and other income securities, and returns remained strong. We believe preferred securities continue to offer long-term investors an attractive combination of good credit quality, high income and moderate interest rate risk.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	**2019:3**	**2019:2**	**2019:1**	**2018:4**	**2018:3**	**2018:2**	**2018:1**	**2017:4**
Real GDP, Chg QoQ (%, SA, AR)	2.1	2.0	3.1	1.1	2.9	3.5	2.6	3.5
Real Personal Consump Expnds, Chg QoQ (%, SA, AR)	2.9	4.6	1.1	1.4	3.5	4.0	1.7	4.6
Real Business Inv ex Stuctures, Chg QoQ (%, SA, AR)	-0.4	1.6	4.5	8.5	3.2	7.1	8.0	9.2
Real Residential Investmt, Chg QoQ (%, SA, AR)	5.1	-3.0	-1.0	-4.7	-4.0	-3.7	-5.3	9.9
Real Private Domestic Final Sales, Chg QoQ (%, SA, AR)	2.1	3.3	1.6	1.7	2.9	4.2	2.4	5.4
Nominal GDP, Chg QoQ (%, SA, AR)	3.8	4.7	3.9	2.9	4.8	7.1	5.0	6.4
Corporate Profits, After Tax, Chg YoY (%, SA, AR)	0.4	1.3	-2.9	10.1	11.3	8.3	10.3	3.3
Nonfarm Productivity, Chg QoQ (%, SA, AR)	-0.3	2.5	3.5	0.1	1.2	1.8	0.9	0.9
Nominal Personal Income, Chg YoY (%, AR)	4.9	4.9	4.7	5.0	5.4	6.1	5.7	5.7
Personal Savings Rate (%, SA)	8.3	8.1	8.4	8.8	7.5	7.6	8.0	6.7
Unemployment Rate (%, SA)	3.5	3.7	3.8	3.9	3.7	4.0	4.0	4.1
Nonfarm Payrolls, Chg QoQ (000, SA)	565	456	521	700	568	728	683	654
Household Employment, Chg QoQ (000, SA)	1264	257	-197	876	477	432	1095	-334
Federal Budget, 12-mo Def or Surp (% of GDP)	-4.7	-4.4	-4.2	-4.2	-3.9	-3.8	-3.7	-3.5
Consumer Price Index, Chg YoY (%, AR)	1.7	1.6	1.9	1.9	2.3	2.9	2.4	2.1
CPI ex food & energy, Chg YoY (%, AR)	2.4	2.1	2.0	2.2	2.2	2.3	2.1	1.8
Capacity Utilization (%, SA)	77.5	77.7	78.4	79.5	79.3	78.6	78.2	77.9
Rate or Spread (End of Quarter)	**2019:3**	**2019:2**	**2019:1**	**2018:4**	**2018:3**	**2018:2**	**2018:1**	**2017:4**
Federal Funds Rate Target (upper bound, %)	2.00	2.50	2.50	2.50	2.25	2.00	1.75	1.50
3-month LIBOR (%)	2.09	2.32	2.60	2.81	2.40	2.34	2.31	1.69
10-Yr Treasury Note Yield (%)	1.68	2.00	2.41	2.69	3.05	2.85	2.74	2.41
30-Yr Treasury Bond Yield (%)	2.12	2.52	2.81	3.02	3.19	2.98	2.97	2.74
ICE-BofAML US Corporate Index Yield to Worst vs Gvt	120	121	126	158	112	129	116	97
10-Yr Interest Rate Swap Spread (bp)	-10.5	-4.5	0.0	3.0	6.0	7.5	3.8	-1.5

* 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 held about steady in the third quarter of 2019, as consumer spending slowed but housing improved and drag from trade and inventories diminished. Inflation-adjusted gross domestic product (real GDP) rose 2.1% in Q3 and averaged 2.4% over 2019's first three quarters. Economists[1] expect 1.7% real GDP in Q4 and 2.3% in 2019 overall, slowing to 1.8% in 2020. These forecasts are nearly unchanged from three months ago. With most of 2019 behind us, we agree with consensus 2.3% GDP growth for this year, but we continue to think 2.5% growth in 2020 remains achievable if a trade agreement with China is reached in the next several months. Given the importance of a trade truce for business investment – and the uncertainty of achieving it – our forecast range for GDP growth in 2020 is 2.0–2.5%.

We think U.S. economic fundamentals remain solid and believe some activity lost to trade uncertainty can be recouped in 2020. Financial conditions are supportive, and U.S. fiscal policy is mildly expansionary. Consumer spending should expand near its year-to-date average pace of 2.9%, although we expect some gradual slowing as job gains moderate through 2020. Residential investment is looking brighter and should add to growth. The outlook for business investment appears binary and accounts for most of the 0.5% range in our forecast; a trade deal should unleash pent up investment, while it's likely to languish without one. Finally, federal government consumption should grow slightly faster than overall GDP, while state and local spending should rise at about half that pace.

We think downside risks to the economy have diminished, at least for 2020. Global economic growth slowed over the past 1½ years, but recent data suggests that the worst may be behind us. The International Monetary Fund now forecasts 3.0% global growth in 2019, picking up to 3.4% in 2020.[2] As it did in the U.S., global monetary policy eased in 2019, which should help support a modest recovery next year, although fiscal policy has changed little and trade tensions remain unresolved. A modestly better global economy should benefit the U.S.

We'll now review the major sectors of the U.S. economy. With GDP growth about steady, the **labor market** turned in mixed results in the third quarter: strong job growth but more moderate wage gains. Payroll jobs rose by an average of 188,000 jobs per month in Q3 and were up 128,000 in October 2019 (Figure 2). The household employment survey surged ahead of the broader payroll survey over the past four months, bringing 12-month gains to similar levels: 1.9 and 2.1 million, respectively. Both surveys reveal a slowdown in job growth, however. Nonfarm and household employment were up 1.4% and 1.2% YoY, respectively, in October, compared to 1.8% for both surveys at the same time last year. Encouragingly, the labor participation rate rose to 63.3% in October, its highest level in six years, and the employment rate rose to 61.0%. Widespread job availability and higher wages continued to attract new working-age persons to the labor force, which is particularly impressive given aging demographics in the U.S.

Employment gains continued to outpace growth in the working-age population, albeit at a gradually diminishing rate. The unemployment rate edged down to 3.6% in October from 3.7% at the end of Q2 and 3.8% a year ago (Figure 3). However, even as the labor market continued to tighten this year, wage gains slowed to around 3% as productivity slipped and businesses sought

[1] Unless noted otherwise, forecasts are from the *Survey of Professional Forecasters*, Federal Reserve Bank of Philadelphia, November 15, 2019 and Bloomberg® *U.S. Monthly Economic Survey*, November 8, 2019.
[2] International Monetary Fund, *World Economic Outlook*, October 15, 2019.

to counter margin erosion. If economic growth picks up next year as we expect, wages should resume a gradual acceleration.

Figure 2: Strong Job Market Attracts Workers

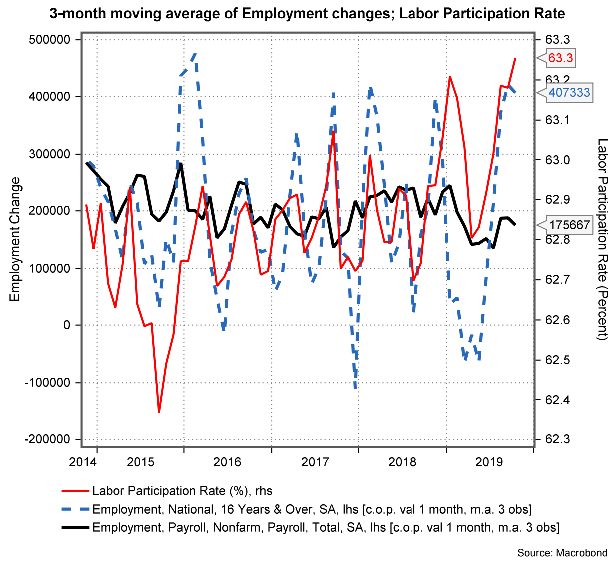
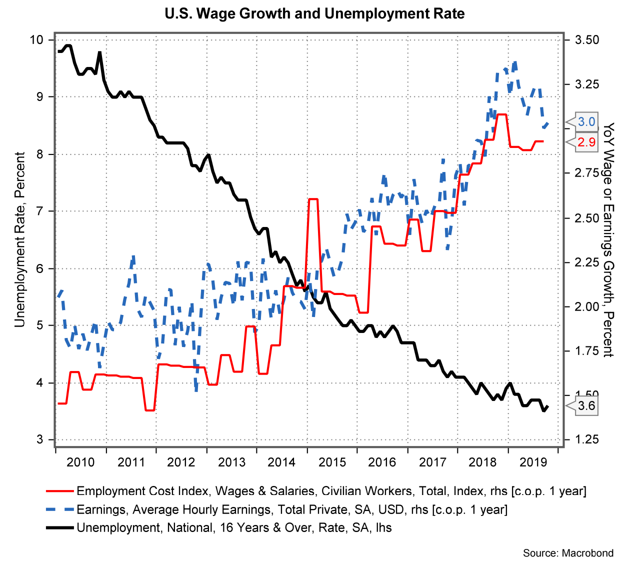


Figure 3: Wage Gains Pause with Slower GDP



Nominal **personal income** rose by 3.8% in the third quarter and an impressive 4.4% over 12 months ending in October, led by a 4.9% YoY increase in wage and salary income (Figure 4). Adjusted for inflation, real disposable personal income rose 2.9% in Q3 and 2.8% YoY in October. With relatively low interest rates, consumer debt burdens remain very manageable (Figure 5). The household debt service ratio (interest expense on debt relative to disposable income) hit an an all-time low in Q2 (latest data available), and households' financial obligation ratio (which adds rent and lease payments) is within 0.1% of its record low. Strength in personal income should support spending and investment – as well as good consumer loan performance – over coming quarters.

Figure 4: Income Outpacing Consumer Spending

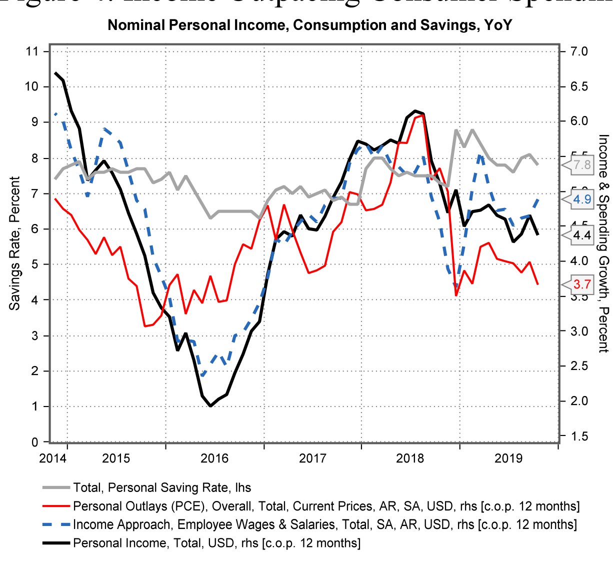
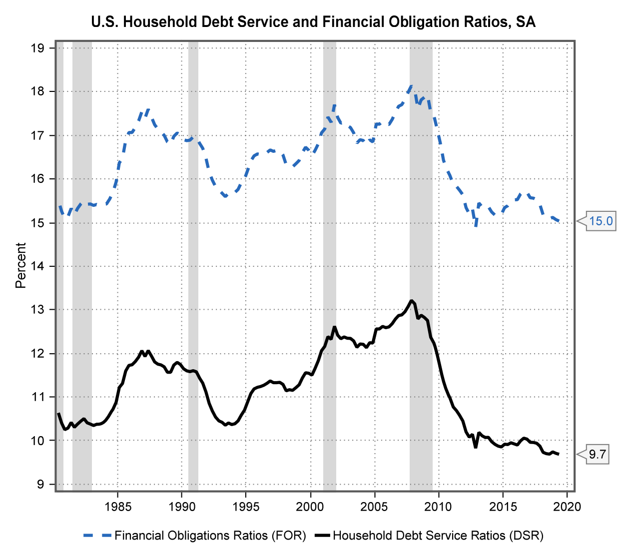


Figure 5: Consumer Debt Burden Low



Personal spending has been volatile this year. **Personal consumption expenditure** (PCE) started off slowly in Q1, weighed down by a partial government shutdown, rebounded strongly in Q2, and moderated in Q3. Nominal PCE rose 4.4% in Q3 and 3.7% YoY in October (Figure 4). Adjusted for inflation, real PCE rose by 2.9% in Q3 and 2.3% YoY in October. Personal income growth – especially from wages and salaries – has outpaced spending this year. As a result the **savings rate** rose to 7.8% in October from 7.3% a year ago. This is good news for consumer balance sheets and supports our outlook for continued strength in consumer spending next year.

Figure 6: Home Sales Recovering…

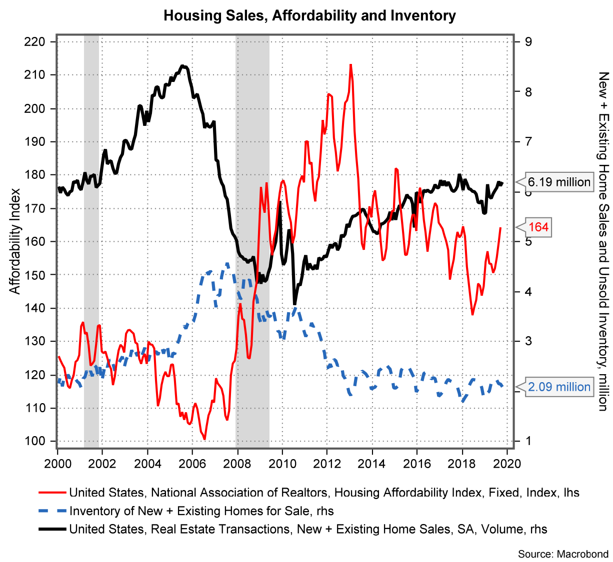
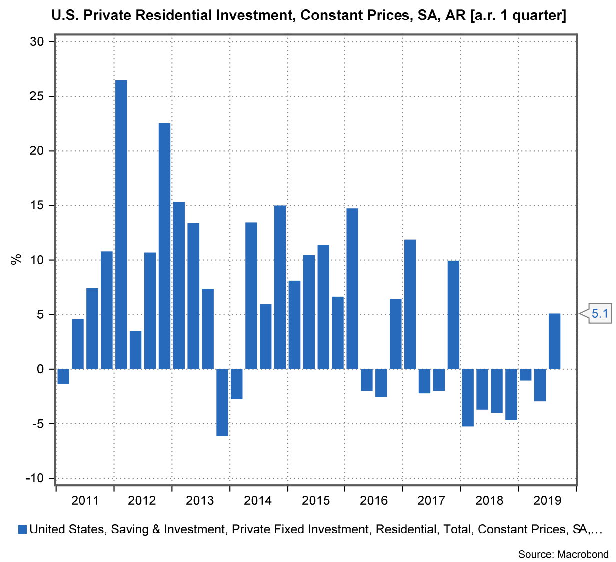


Figure 7: …and Residential Investment Turning Up



The **housing market** was a soft patch in an otherwise strong economy last year. Tax reform passed in late 2017 limited deductibility of mortgage interest and state and local income and property taxes, and rate hikes by the Federal Reserve raised mortgage interest rates. Together, they significantly raised after-tax costs of buying a home. As a result, home sales (Figure 6) and residential investment (Figure 7) fell sharply in 2018, even as employment growth, higher wages and a rising population boosted demand for housing.

We have said for some time that underlying strength in demand for housing eventually would prompt a rebound in residential investment. With a sizable assist from rate cuts by the Federal Reserve this year, that recovery began in the third quarter. Combined new and existing home sales averaged a 6.1 million unit pace in Q3, and affordability improved as mortgage rates fell, incomes rose and home price gains continued to moderate – and sales could have been stronger if more inventory had been available (Figure 6). Real residential investment rose 5.1% (annualized) after sliding by a total of 5.4% in the prior six quarters (Figure 7). With a sizable amount of pent-up demand to satisfy and mortgage rates near historic lows, we think residential investment should provide a modest boost to GDP over the next several years.

In contrast to housing, manufacturing is mired in a soft patch, although it too may be bottoming out. **Industrial production** rose 0.7% over three months ending in October but is down 1.1% compared to a year earlier (Figure 8). Even mining output, which had been a source of strength for industrial output, was down 3.1% YoY in October. However, while energy prices remain below year-ago levels, they have rebounded from recent lows. Similarly, the Institute for Supply

Management's manufacturing survey touched a low of 47.8 in September but recovered to 48.3 in October. Orders for core capital goods (nondefense, excluding aircraft) remain soft but are also off lows from earlier in 2019. Trade uncertainty and export weakness remain headwinds to industrial production. However, with U.S. consumer spending still rising at a healthy pace, if the Trump administration is able to deliver a reasonable (if not comprehensive) trade deal with China and Congress passes legislation on pending trade accords with Mexico/Canada and Japan, we could see a nice boost to manufacturing next year.

Figure 8: Manufacturing Soft, Bottoming?

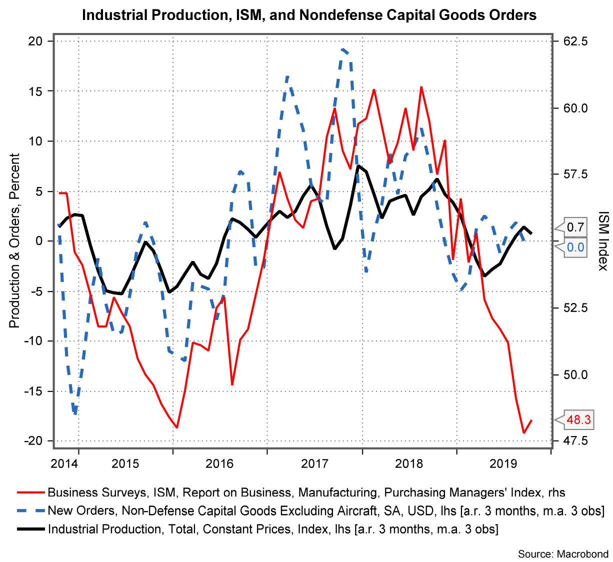
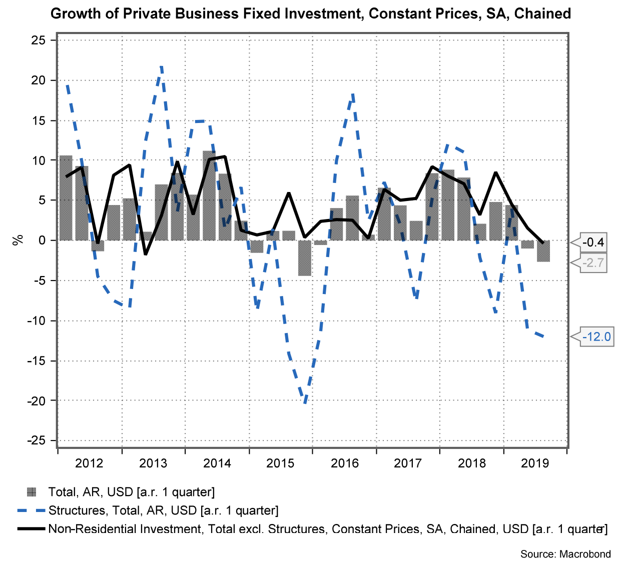


Figure 9: Business Investment Slowdown



In-line with tepid industrial output, real **business investment** fell by 2.7% in the third quarter. Business structures fell 12.0% and accounted for most of the decline in overall business investment. "Core" business investment (business equipment and intellectual property) slowed again, falling by 0.4% (Figure 9) in Q3. Although spending on structures is volatile and has amplified weakness in business investment recently, core investment slowed for the past four quarters as trade uncertainty intensified. Nonetheless, core investment still outpaced capacity utilization, which slipped 2.6% this year (Figure 10). Business investment is likely to remain modest for now, although a trade deal reducing tariffs and opening markets could provide a sizable boost to business confidence and investment next year.

The **trade deficit** widened slightly in the third quarter, while trade volumes fell farther into negative territory (Figure 11). Net exports subtracted 0.1% from real GDP growth in Q3. Tariff uncertainty has compounded slower global economic growth, chilling global trade volume. Imports to the U.S. fell 2.8% YoY in September, and exports fell 1.8%. However, easier monetary policy in the U.S. and most other major nations along with fiscal stimulus in some are showing signs of stabilizing growth. In particular, global purchasing managers' surveys of manufacturers have mostly turned up since summer – an important signal that the worst of the slowdown may be over. However, politics has taken a populist turn in many of these countries, and it is unclear if a rise in globalization that greatly expanded trade (and boosted economic growth) over the past 20 years has simply paused or is in retreat. For now, we think pending trade deals mentioned earlier, if concluded and passed into law, should boost trade activity next year and be a net positive for the U.S. economy, even if it results in a somewhat wider trade deficit.

The politics of this is unpredictable, however, and agreements that look achievable today could remain out of reach.

Figure 10: Falling Utilization, Less Investment

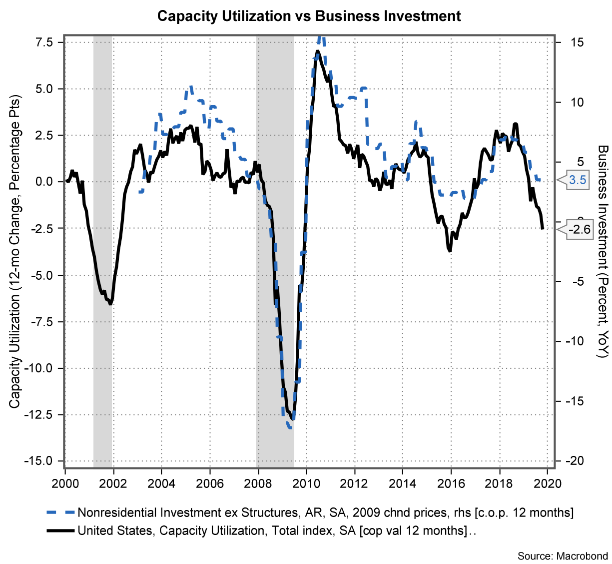
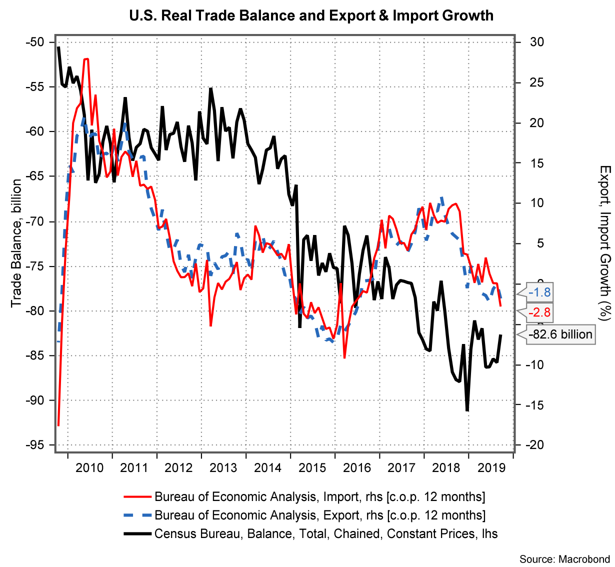


Figure 11: Trade Activity Sliding, Deficit Flat



Inventories added 0.2% to third quarter real GDP after shaving 0.9% from Q2 growth. Inventories currently appear lean in many sectors, and we expect a continued modest positive contribution to growth from restocking over the next several quarters, especially if growth accelerates next year. Over the long term, inventories are roughly neutral to economic growth.

Government consumption rose 1.6% in the third quarter. Real federal government spending rose 3.4%. Economists expect real federal spending to be up 2.6% in 2020 – faster than overall GDP growth. In contrast, state and local government spending has been more modest, rising just 0.5% in Q3. Economists forecast 1.3% growth in state and local government spending next year.

Summarizing the third-quarter economic situation, real GDP growth of 2.1% adds up as follows: Personal Consumption Expenditures (+1.97%), Residential Investment (+0.18%), Business Investment (-0.36%), Inventory Change (+0.17%), Net Exports (-0.11%), and Government Consumption (+0.28%). The first three components equal **Private Domestic Final Sales**, which grew by 2.1% during the quarter and 2.2% over the past year. Over the next quarter or two, economic growth rests mostly with consumption and government spending. Residential investment should add only modestly to growth, but that's a welcome change from being a drag on GDP. Trade uncertainty probably will continue to dampen exports and restrain business spending for now, although progress on trade deals could prompt a significant turnaround in both. While there are risks to the outlook, we think 2.0-2.5% growth in 2020 is quite achievable.

Inflation was stable in the third quarter and most indices remained below the Federal Reserve's 2% target. For 12 months ending in October, the consumer price index (CPI) was up 1.8% overall and 2.3% excluding food and energy (Figure 12). Over the same period, the PCE deflator was up 1.3% overall and 1.6% excluding food and energy – each below year-ago levels. Inflation has remained subdued despite above-trend economic growth, tariffs that boosted import prices, and rising wages. Although core CPI inflation is up modestly this year, it appears it will take considerable time before the Fed reaches its inflation target and quite a while after that before it would become concerned about inflation getting too hot.

Figure 12: Inflation Mostly Lagging 2% Target

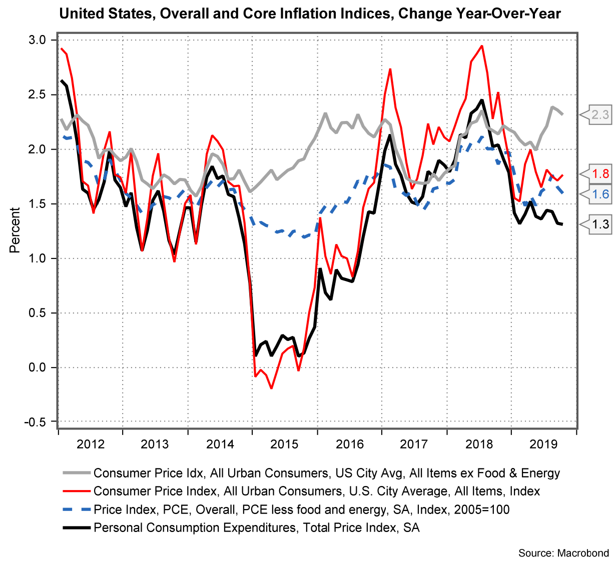
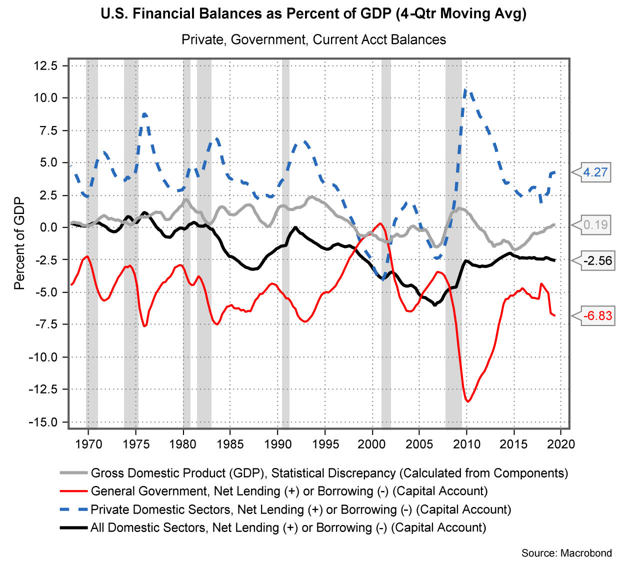


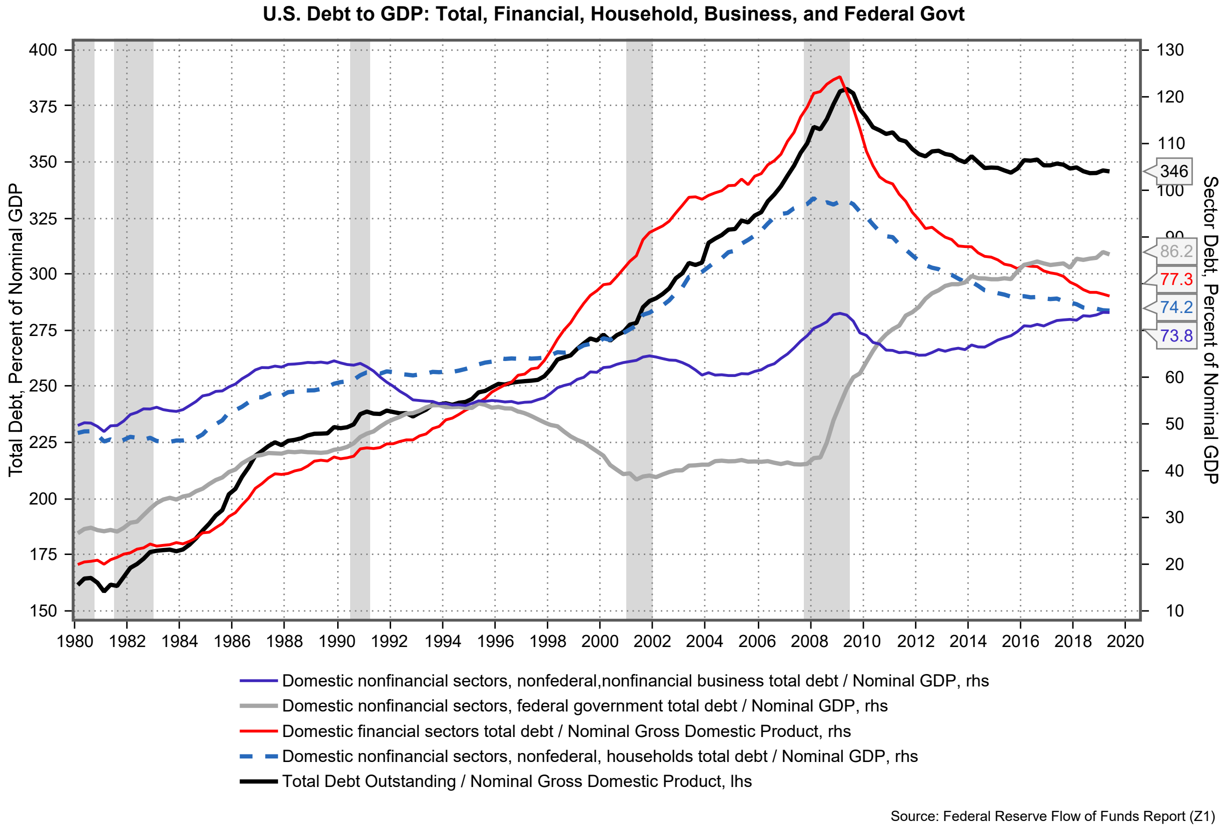
Figure 13: Healthy Private Financial Balance



As shown in Figures 13 and 14, broad **balance sheet trends** through the second quarter of 2019 (latest data available) reveal a healthy private-sector financial balance and stable debt leverage relative to GDP. Financial balances data reflect periodic (here, trailing 4-quarter values) lending (positive values) or borrowing (negative values) relative to GDP, as compiled by the Federal Reserve (Figure 13). Overall, U.S. domestic entities borrowed 2.6% of GDP over four quarters ending in 2Q2019. That's what it means to run a current account deficit; the U.S. needs to borrow from overseas sources. However, private sector (households and businesses) lending has increased recently, and government borrowing has increased by a similar amount. Gray bars in Figures 13 and 14 show recession periods. Notice that the private sector financial balance has tended to fall before a recession. While not a definitive signal, U.S. recessions have tended to follow periods of deteriorating financial balances in the private sector, and this is one reason why we think recession risk in the U.S. remains low for now.

Over time, those changes in borrowing and lending affect the stock of debt outstanding, which we track in terms of debt relative to GDP. For the second quarter, overall debt-to-GDP was 346%, down marginally from the prior quarter. Household debt edged down to 74.2% from 74.4%; household balance sheets remain in very good shape. Financial business leverage declined to 77.3% from 77.7%, continuing a long trend of deleveraging since the financial crisis. Nonfinancial businesses leverage was unchanged at 73.8% in Q2, which is good news in light of a gradual but meaningful increase in debt over the past seven years. Federal government debt-to-GDP eased a bit to 86.2% in Q1 from 86.7% in the prior quarter, although deficits over coming years are projected to bring government debt to levels that have been problematic for other countries historically. While we remain watchful of nonfinancial business and federal government debt, there are no near-term red flags in these numbers, and continued deleveraging trends at households and financial businesses are positives for credit.

Figure 14: Overall Leverage Steady while Sector Borrowing Trends Remained Intact



Market Outlook

Long-term **Treasury rates** fell again in the third quarter as the Fed continued to ease monetary policy in response to slower growth and a cloudy outlook. The benchmark 10-year Treasury note yield declined by 32 basis points (bp) to 1.68%, and the 30-year Treasury bond yield fell by 40 bp to 2.12% at the end of the third quarter (Figure 15). Rates are up slightly since quarter-end, with ten- and 30-year Treasuries yielding 1.76% and 2.19%, respectively, on November 27. Market forward rates rose modestly as the yield curve steepened on Fed rate cuts.

The Federal Open Market Committee (FOMC) cut rates three times since the end of the second quarter, with 25 bp cuts announced on July 31, September 18 and October 30. The Fed brought forward an end to portfolio reductions in its System Open Market Account (SOMA) by two months, to August 1. The Fed also added Treasury bill purchases to increase the quantity of excess reserves and reduce pressure on repo rates that developed – largely for technical reasons – in September. As a result of these policy changes, financial conditions eased during the third quarter and are significantly more accommodative than they were in late 2018 (Figure 16). Easier financial conditions provided a tailwind for housing activity this year, and they helped support economic growth through a trade-related slowdown in manufacturing. They should continue to assist the economy into 2020.

Recent commentary from FOMC members and minutes from the Committee's October 29-30 meeting suggest that the Fed thinks it has completed a "mid-cycle adjustment" to monetary policy that should help support economic growth and move inflation up toward the Fed's 2%

target. While additional rate cuts are possible if the economy slows, rates are likely on hold for the next several meetings while the FOMC assesses economic conditions in early 2020. The Fed will update its economic projections at its next meeting on December 10-11; we expect they will show no change in the fed funds rate next year. Markets are currently pricing in a bit more than one additional 25 bp rate cut by year-end 2020, with the fed funds rate about stable around 1.25% through 2022 and moving gradually back up to around its current level (1.55%) thereafter (Figure 15). We think a stable fed funds rate is likely in 2020, but risk is mostly for a lower rate, and markets have to incorporate that risk. Accordingly, market forward rates look about right to us today, although that means intermediate- and long-term rates should move modestly higher over the course of 2020 if the Fed leaves rates steady as we expect.

Figure 15: Rates Down, Forwards Up[3]

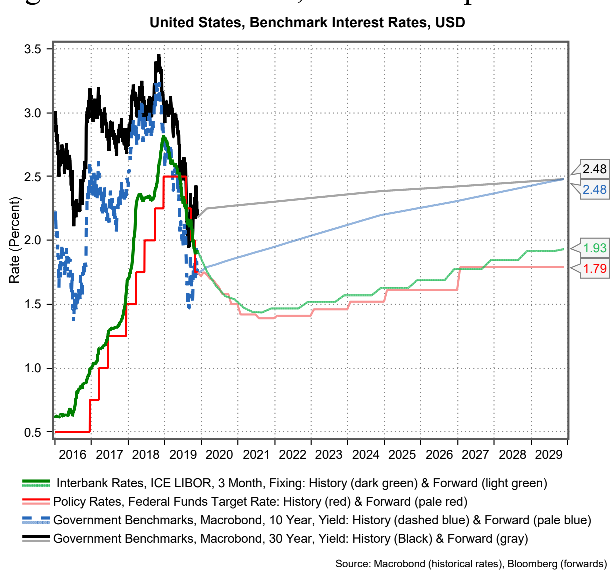
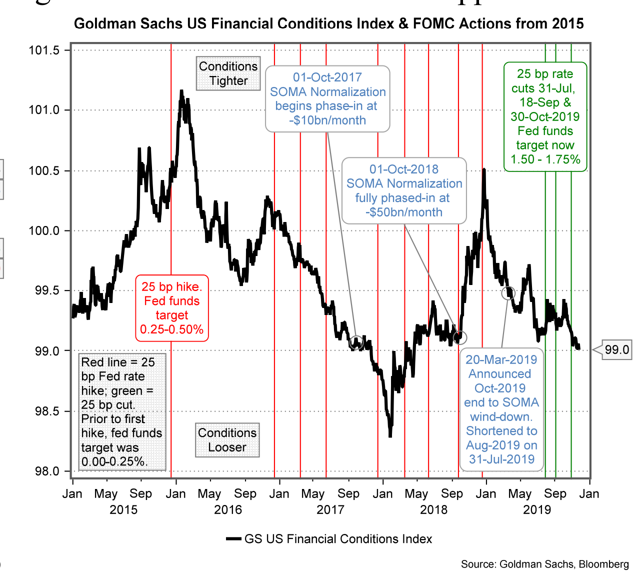


Figure 16: Financial Conditions Support Growth



As the Fed eased monetary policy and yields on intermediate- and long-term Treasuries fell, corporate **credit spreads** were little changed in the third quarter. Investment-grade corporate bond spreads tightened by 1 bp to 120 bp in Q3.[4] Spreads tightened more since quarter-end, closing on November 26 at 110 bp (Figure 17). High yield bond spreads started and ended the third quarter at 420 bp and were little changed at 419 bp on November 26.[5] Because Treasury yields fell and credit spreads were flat in Q3, investment-grade corporate and high yield bonds again produced solid returns (Figure 18).

Spreads on preferred securities are more difficult to illustrate, though they followed a similar pattern to corporate bonds. Total rate of return, which incorporates both income and price changes, combines the impacts of credit spread and Treasury yield changes on bond returns. Figure 18 shows total returns on selected ICE BofAML indices in recent quarters. In the third

[3] The fed funds effective rate recently has traded about 8 bp below the top end of the FOMC target range. In Figure 15, we add 8 bp to forward rates implied by overnight index swaps (OIS) to align them with historic target rates.

[4] Investment-grade corporate bond spread is represented by the ICE BofAML U.S. Corporate Index[SM] (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. Index data through 11/26/2019.

[5] Below-investment-grade corporate bond spread is represented by the ICE BofAML U.S. High Yield Index[SM] (H0A0) "Yield to Worst versus Government" yield spread series. Index data through 11/26/2019.

quarter, total return on the preferred index[6] (+3.32%) outperformed the high yield index (+1.22%) and the investment-grade corporate bond index (+3.07%).[7] Year-to-date through November 26, preferreds (+16.88%) substantially outperformed both high yield (+11.93%) and investment grade corporates (+14.00%). Credit investments in general, and preferreds in particular, have benefited from strong investor demand for yield in a low-rate environment. While overall interest rates could rise modestly next year, we think demand for incremental yield should remain sturdy.

Figure 17: Credit Spreads Steady to Narrower

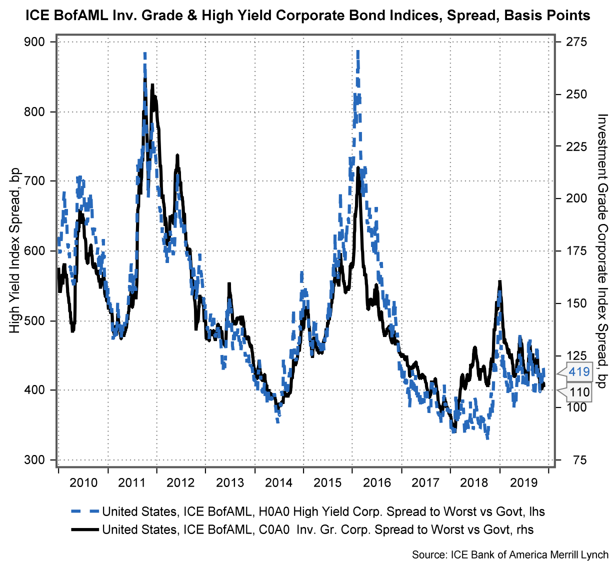
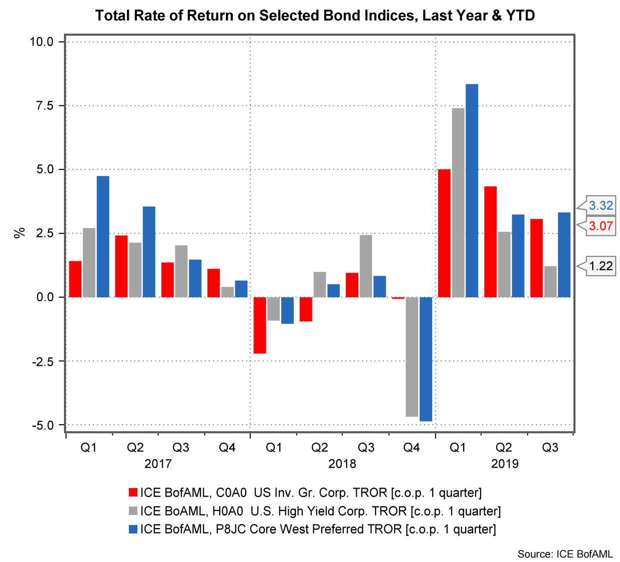


Figure 18: Bond Returns Remained Strong



Credit conditions overall were stable in the second quarter (latest data available), although commercial and industrial loan charge-offs and delinquencies rose modestly. U.S. banks' recent earnings reports indicate good loan performance continued through the third quarter. Corporate earnings were about flat after rising strongly last year. Third quarter profits were down 0.8% YoY on a pretax basis and up 0.4% on an after-tax basis. Margin erosion is visible in businesses' profit share of GDP. The pretax profit share of GDP was 9.7% in Q2, equal to its long-term average but down from over 12% in 2015 (Figure 19). Profits have held up better on an after-tax basis, in part due to tax reform, but some profit erosion in recent years is visible there too. As the labor market tightened, wages outpaced inflation, squeezing profit margins in a low-inflation environment where businesses have a difficult time raising prices. Higher productivity over the past year has offset some but not all of that. Although corporate profits are down from unsustainably high levels a few years ago, they remain a credit positive.

The nonfinancial business "financing gap," spending on capital investments minus internally generated cash, turned positive (i.e., investments exceeded cash flow) in the first half of 2019. With rates falling, nonfinancial companies increased issuance of corporate bonds to meet that gap. Figure 20 shows a two-quarter moving average of those statistics to reduce quarterly

[6] Preferred index is the ICE BofAML 8% Constrained Core West Preferred & Junior Subordinated Securities Index^{SM} (P8JC). Index data through 11/26/2019.

[7] Total return is not annualized and includes both price change and income. Past performance does not guarantee future performance.

volatility of this series. These amounts are well within recent results, and nothing here suggests a worrisome imbalance currently.

Figure 19: Profits Okay but Margins Narrowed

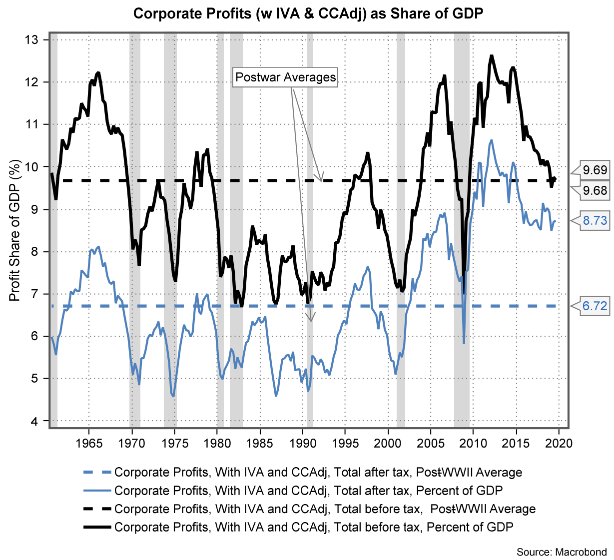
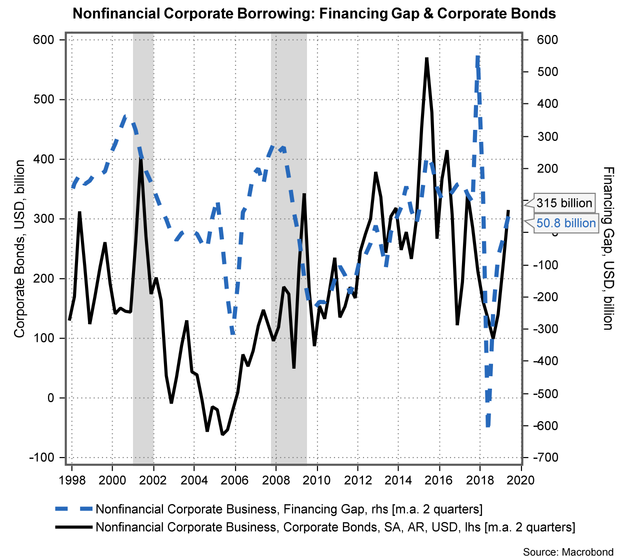


Figure 20: Lower Rates Boost Issuance



Nonfinancial corporate holdings of liquid assets relative to short-term liabilities improved to 75.5% in the second quarter, a meaningful improvement over last quarter (Figure 21). Similarly, interest expense as a percentage of earnings before interest and taxes (EBIT) edged down to 23.6% in Q2 as profits rose modestly and financial conditions eased. Although these are welcome near-term developments, we expect this sector will experience some incremental credit strain in the next recession from leverage added over the past seven years, but it should be closer to a normal cyclical deterioration than a widespread wash-out.

Figure 21: Fed Gives Nonfinancials a Hand

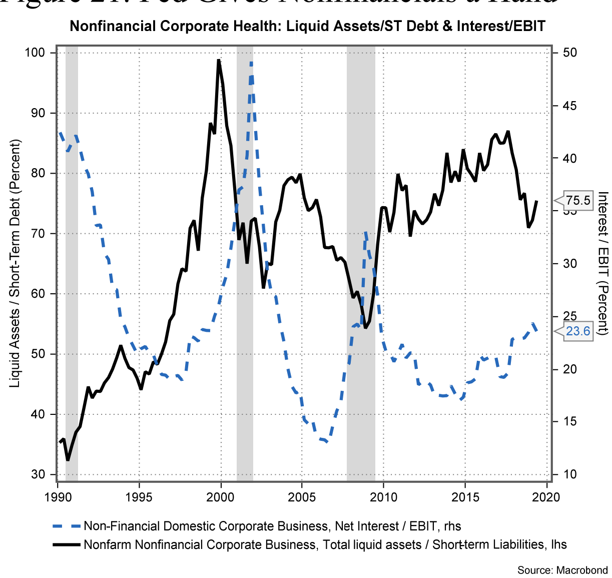
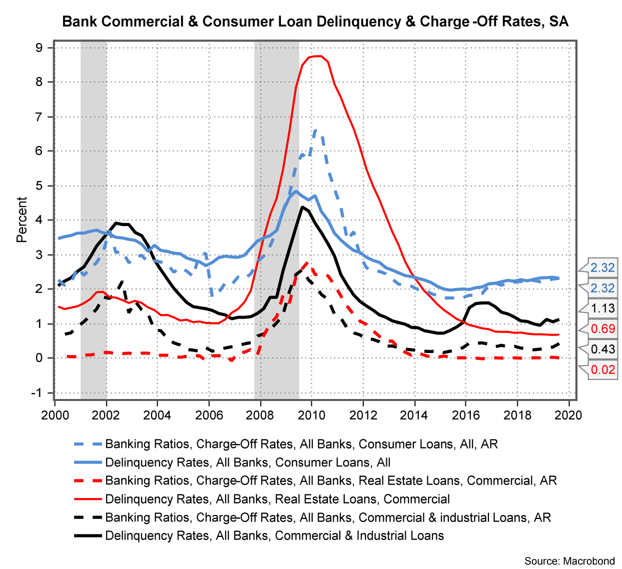


Figure 22: Loan Quality Steady, but C&I Weaker



Credit metrics at financial companies were little changed overall, although commercial and industrial loan delinquencies and charge-offs continued to edge up. Overall bank loan delinquencies declined to 1.46% in the first quarter compared to 1.50% in Q1 and 1.60% a year earlier (Figure 22). Overall loan charge-off rates rose slightly to 0.51% in Q2 from 0.49% in Q1 and 0.45% a year ago. Delinquency rates on real-estate loans fell to 1.59% from 1.92% a year ago, primarily due to better residential loan performance. Commercial and industrial loan delinquency rose to 1.13% in Q2 from 1.00% a year earlier. Delinquency rates on consumer loans were about flat at 2.32%; charge-offs rose slightly to 2.32%. Bank earnings were strong, loan growth remained modest and capital ratios held about steady at very healthy levels. U.S. banks have sizable cushions from earnings, loan-loss provisions and common equity capital protecting creditors. They are well prepared for the next recession, whenever it arrives.

Summarizing our main views, we expect 2.3% real GDP growth this year and 2.0–2.5% in 2020. Higher wages and good job growth should support continued strength in personal income and consumption. Residential investment appears to have turned a corner and should expand moderately next year. Government consumption should grow slightly faster than the economy overall. Business investment is a wildcard. Closing of trade agreements could reignite investments that were put on hold in 2019. Alternatively, it could remain subdued as trade uncertainty lingers and election risks loom later in 2020. Financial conditions have eased substantially and should support the economy through 2020. Inflation is likely to remain below the Fed's target over the near term but should move up gradually if GDP growth is in the upper end of our forecast range. The FOMC should leave rates on hold in 2020, which likely would push intermediate- and long-term interest rates up by 25–50 bp as the market unwinds rate cuts that are priced into today's yield curve. We think risks to that outlook are only modestly to the downside in 2020 in light of support already in place from monetary and fiscal policy.

Credit markets have posted strong returns so far in 2019 on lower Treasury rates and stable to narrower credit spreads as investors searched for yield in a low-rate environment. Higher Treasury rates may present a modest headwind to performance over the next year or two, but credit conditions mostly remain supportive, especially for financial companies, and credit spreads have room to narrow further in this environment. We think preferreds continue to offer long-term investors an attractive combination of good credit quality, high income and moderate interest rate risk.

Flaherty & Crumrine Incorporated
November 26, 2019