Fourth-Quarter U.S. Economic Update
February 2020

Summary of Recent Economic Developments

U.S. economic growth held steady at a moderate pace in the fourth quarter. Real GDP rose 2.1% in Q4 and 2.3% in 2019 overall. Economists expect a slowdown to 1.8% growth in 2020; we remain more optimistic at 2.0–2.5% on strength in consumer spending, a recovery in housing and improvement in business investment, although COVID-19 poses unknown risk. The labor market was a source of strength once again, as employment gains and rising wages drove solid gains in personal income. Consumer spending growth slowed to 1.8% in Q4 after two strong quarters, but consumers have both income and savings to boost spending in 2020. Residential investment rose by 5.8% in Q4 as home sales accelerated, but business investment slipped by 1.5%, weighed down by sluggish exports and trade uncertainty. A trade agreement reached in January should help lessen those headwinds, but it probably will take time before investment spending accelerates significantly. A narrower trade deficit added to Q4 GDP, but inventory reductions offset most of that. Government spending rose by 2.7%. CPI inflation rose modestly, but core PCE inflation at 1.6% YoY remained below the Federal Reserve's 2% target. Monetary policy eased in Q4 as the Fed cut rates; we expect a stable fed funds rate in 2020. Interest rates rose in Q4 but fell year-to-date, leaving rates little changed from Q3, while credit spreads tightened. A global hunt for yield combined with good credit fundamentals to produce strong returns in U.S. credit markets. Looking ahead, we think preferreds still offer long-term investors an attractive combination of good credit quality, relatively high income and moderate interest rate risk.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	2019:4	2019:3	2019:2	2019:1	2018:4	2018:3	2018:2	2018:1
Real GDP, Chg QoQ (%, SA, AR)	2.1	2.1	2.0	3.1	1.1	2.9	3.5	2.6
Real Personal Consump Expnds, Chg QoQ (%, SA, AR)	1.8	3.1	4.6	1.1	1.4	3.5	4.0	1.7
Real Business Inv ex Stuctures, Chg QoQ (%, SA, AR)	0.6	-0.4	1.6	4.5	8.5	3.2	7.1	8.0
Real Residential Investmt, Chg QoQ (%, SA, AR)	5.8	4.6	-3.0	-1.0	-4.7	-4.0	-3.7	-5.3
Real Private Domestic Final Sales, Chg QoQ (%, SA, AR)	1.4	2.3	3.3	1.6	1.7	2.9	4.2	2.4
Nominal GDP, Chg QoQ (%, SA, AR)	3.6	3.8	4.7	3.9	2.9	4.8	7.1	5.0
Corporate Profits, After Tax, Chg YoY (%, SA, AR)	0.5f	-0.3	1.3	-2.9	10.1	11.3	8.3	10.3
Nonfarm Productivity, Chg QoQ (%, SA, AR)	1.4	-0.2	2.5	3.5	0.1	1.2	1.8	0.9
Nominal Personal Income, Chg YoY (%, AR)	3.9	4.6	4.6	4.7	5.0	5.4	6.1	5.7
Personal Savings Rate (%, SA)	7.6	8.1	7.8	8.4	8.8	7.5	7.6	8.0
Unemployment Rate (%, SA)	3.5	3.5	3.7	3.8	3.9	3.7	4.0	4.0
Nonfarm Payrolls, Chg QoQ (000, SA)	553	578	456	521	700	568	728	683
Household Employment, Chg QoQ (000, SA)	505	1150	407	-84	793	282	559	1214
Federal Budget, 12-mo Deficit(-) or Surplus (% of GDP)	-4.8	-4.7	-4.4	-4.2	-4.2	-3.9	-3.8	-3.7
Consumer Price Index, Chg YoY (%, AR)	2.3	1.7	1.6	1.9	1.9	2.3	2.9	2.4
CPI ex food & energy, Chg YoY (%, AR)	2.3	2.4	2.1	2.0	2.2	2.2	2.3	2.1
Capacity Utilization (%, SA)	77.0	77.4	77.7	78.4	79.5	79.3	78.6	78.2
Rate or Spread (End of Quarter)	**2019:4**	**2019:3**	**2019:2**	**2019:1**	**2018:4**	**2018:3**	**2018:2**	**2018:1**
Federal Funds Rate Target (upper bound, %)	1.75	2.00	2.50	2.50	2.50	2.25	2.00	1.75
3-month LIBOR (%)	1.91	2.09	2.32	2.60	2.81	2.40	2.34	2.31
10-Yr Treasury Note Yield (%)	1.92	1.68	2.00	2.41	2.69	3.05	2.85	2.74
30-Yr Treasury Bond Yield (%)	2.39	2.12	2.52	2.81	3.02	3.19	2.98	2.97
ICE-BofAML US Corporate Index Yield to Worst vs Gvt	99	120	121	126	158	112	129	116
10-Yr Interest Rate Swap Spread (bp)	-2.8	-10.5	-4.5	0.0	3.0	6.0	7.5	3.8

* 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 steady in the fourth quarter of 2019, as consumer spending slowed but housing improved and a narrower trade deficit added to growth. Inflation-adjusted gross domestic product (real GDP) rose 2.1% in Q4 and 2.3% in calendar year 2019. Economists[1] expect 1.6% real GDP in 1Q2020 and 1.8% in 2020 overall, improving slightly to 1.9% in 2021. These forecasts are unchanged to 0.1% higher than three months ago. We continue to think the U.S. economy should do better than consensus in 2020, and our forecast range for GDP growth is 2.0–2.5%.

When we wrote our last Update in November 2019, we had expected to narrow our 2020 forecast range upon resolution of a trade deal with China early in 2020. Indeed, an agreement was reached in mid-January, and while it still leaves some important issues unresolved, it should contribute to a rebound in exports and greater certainty surrounding supply chains, both of which would support U.S. economic growth. However, emergence of a novel coronavirus (COVID-19) as a serious global health threat has increased forecast uncertainty. While we are hopeful that the COVID-19 outbreak will pass quickly and have only limited human and economic impacts, it is simply too early to know.

Before COVID-19, recent global economic data suggested that a growth slowdown appeared to be ending. Manufacturing activity turned up in many regions, and global monetary policy remains easy. The International Monetary Fund in January estimated that global economic activity expanded by 2.9% in 2019, and growth is expected to accelerate to 3.3% in 2020 and 3.4% in 2021.[2] Those forecasts are 0.1% lower than in the IMF's last report in October 2019, but their trajectory is upward. However, they do not reflect any impact from COVID-19, which was only beginning to be recognized as a global health threat at the time the IMF's report was published. More recent forecasts by many private economists show significant slowing of economic growth in China and more modest slowdowns elsewhere in the first quarter, but whether the virus subsides quickly or broadens into a wider pandemic is unclear. If it is contained quickly, economic impacts should be mostly temporary, even in China, with shortfalls in output mostly recovered over subsequent quarters. We should know much more in a few months and hope for good news.

We will start our review of major U.S. economic sectors with the **labor market**. Job growth has remained solid. Payroll jobs rose by an average of 198,000 jobs per month in Q4 and were up 211,000 in January 2020. After far outpacing the payroll survey in Q3, the more-volatile household employment survey posted an average of 168,000 job gains per month in the fourth quarter but fell by 89,000 in January. These are impressive gains at this point in the expansion, but the rate of job growth has cooled. Nonfarm payroll employment was up 1.4% YoY in January, down from 1.7% at the same time last year and more than 2% five years ago (Figure 2). That is still considerably faster than labor force growth of 0.9% over the last 12 months, however. As a result, the unemployment rate declined to 3.6% in January from 4.0% a year ago and more than 5.5% five years ago (Figure 3). Despite a tighter labor market, average hourly earnings gains slipped to around 3% and the wage and salary index held about steady at 2.9%

[1] Unless noted otherwise, forecasts are from the *Livingston Survey*, Federal Reserve Bank of Philadelphia, December 13, 2019 and Bloomberg® *U.S. Monthly Economic Survey*, January 10, 2020.
[2] International Monetary Fund, *World Economic Outlook*, January 9, 2020.

growth in 2019. That downshift partly reflects slower productivity gains due to weaker business investment last year. We expect wages to resume a gradual acceleration in 2020 as trade uncertainty diminishes and investment recovers.

Figure 2: Hiring Still Outpacing Labor Force

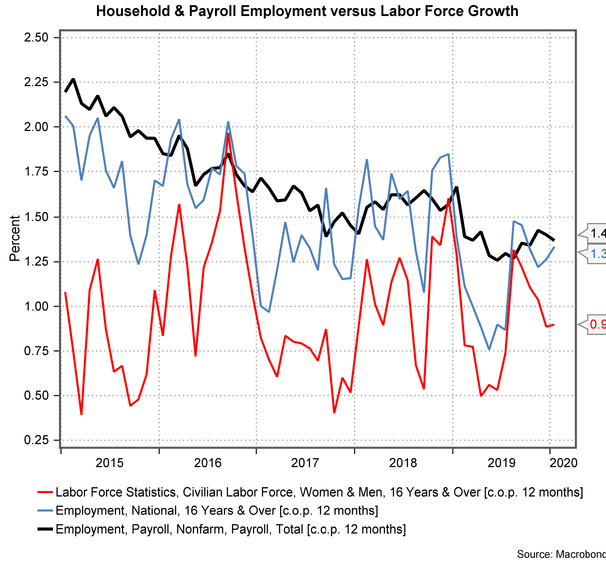
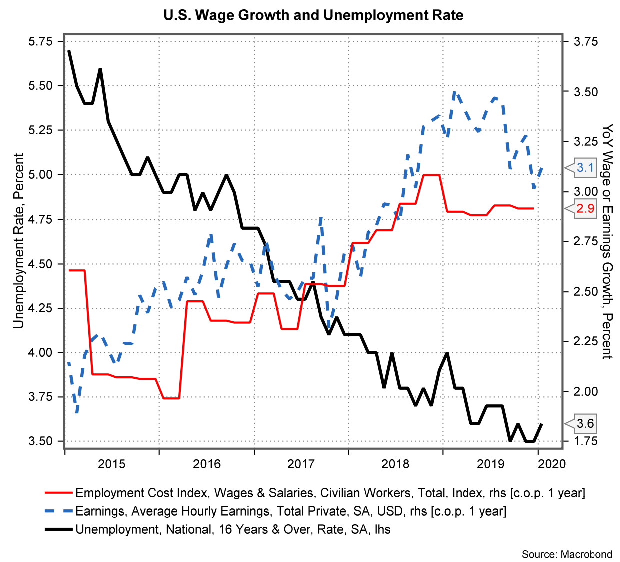


Figure 3: Wages Mixed, Unemployment Down



Nominal **personal income** rose by 3.2% in the fourth quarter and 3.9% over 12 months ending in December (Figure 4). Rising employment and continued wage gains pushed wage and salary income up 4.3% in Q4 and 5.2% YoY. Investment income was soft: up just 0.5% in Q4 and down 1.4% YoY. Adjusted for inflation, real disposable personal income rose 2.8% YoY in December.

Figure 4: Spending Catching Up to Income

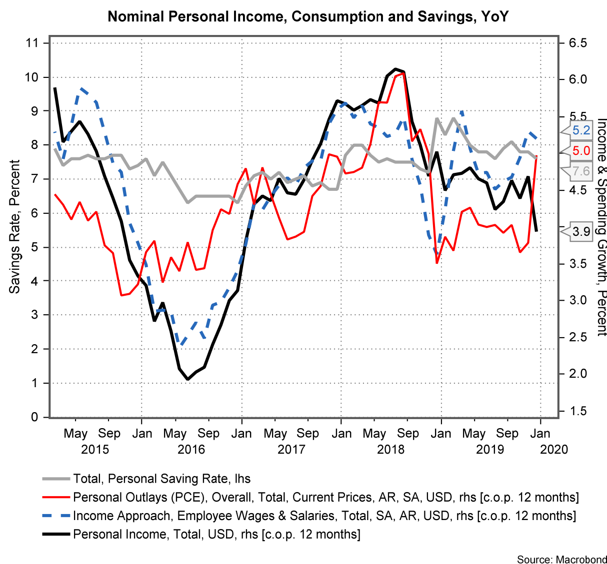
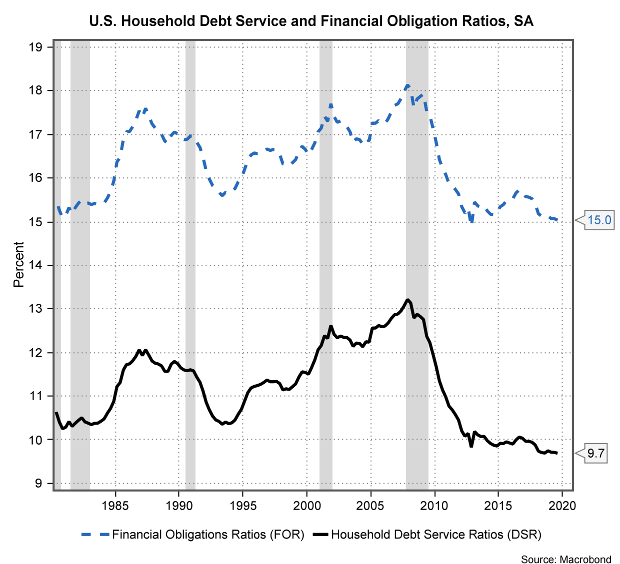


Figure 5: Consumer Debt Burden Low



Personal consumption expenditure (PCE) had its ups and downs in 2019 but rose at a solid pace over the full year. Nominal PCE rose 3.4% in Q4 and 5.0% YoY in December (Figure 4).

Adjusted for inflation, real PCE rose by 1.8% in Q4 and 3.3% YoY. Because personal income growth outpaced spending for most of 2019, the **savings rate** averaged 8.0% in 2019, up from 7.7% in 2018; it ended the year at 7.6%. Each of those numbers is substantially above the 6.5% average savings rate since 1990. Moreover, consumer debt burdens are at or near historic lows (Figure 5). The household debt service ratio (interest expense on debt relative to disposable income) held steady at 9.7% in Q3 (latest data available), and households' financial obligation ratio (which adds rent and lease payments) dropped to 15.0%. Strong savings and modest debt support our outlook for continued strength in consumer spending and good consumer loan performance in 2020.

Figure 6: Home Sales Up, Inventory Down

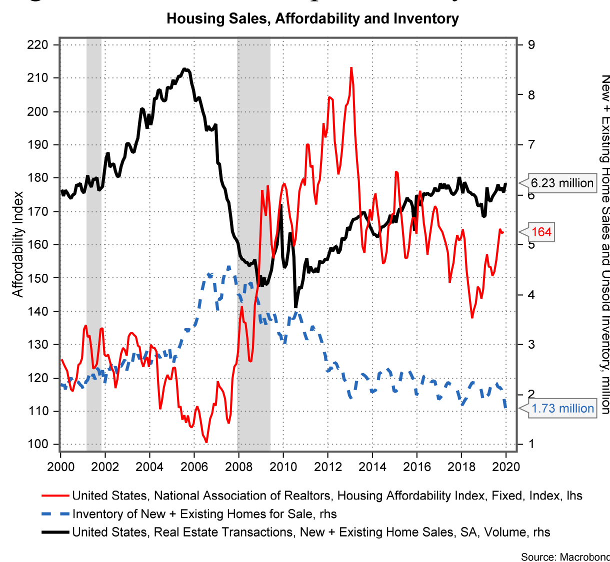
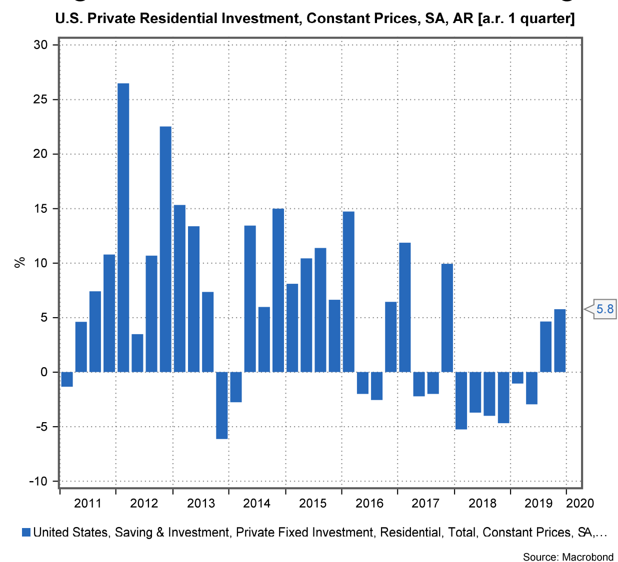


Figure 7: Residential Investment Firming



After sliding in 2018 and the first half of 2019, the **housing market** turned up in the third quarter and did even better in Q4. Tax reform that passed in late 2017 limited itemized deductions for property, state and local taxes, and rate hikes by the Federal Reserve through the end of 2018 raised mortgage interest rates. Together, they significantly raised after-tax costs of buying a home, and home sales (Figure 6) and residential investment (Figure 7) fell sharply. However, the Federal Reserve reversed course in 2019 and cut rates by 0.75%, while employment and personal income grew solidly, boosting demand for housing. Combined new and existing home sales ended 2019 near a 6¼ million unit pace, and home affordability improved as mortgage rates fell, incomes rose and home price gains moderated (Figure 6). Real residential investment rose 5.8% (annualized) in Q4 (Figure 7). With inventories of homes for sale depleted and new construction still lagging household formation, residential investment should continue to rise over the next several years.

The news on industrial output remains mixed but has begun to show signs of improvement. **Industrial production** fell 0.5% over three months ending in December on sluggish exports and troubles with Boeing's 737MAX aircraft, although that is up from the middle of last year (Figure 8). Likewise, the Institute for Supply Management's manufacturing survey rebounded to 50.9 in January, its best reading since July 2019. Orders for core capital goods (nondefense, excluding aircraft) remain about flat. Orders should pick up as the trade situation improves in the wake of recent trade agreements, although COVID-19 could disrupt industrial supply chains if factories in

China remain closed for an extended period. Nonetheless, we see room for modestly higher manufacturing output this year, especially in the second half.

Figure 8: Manufacturing Looking a bit Better

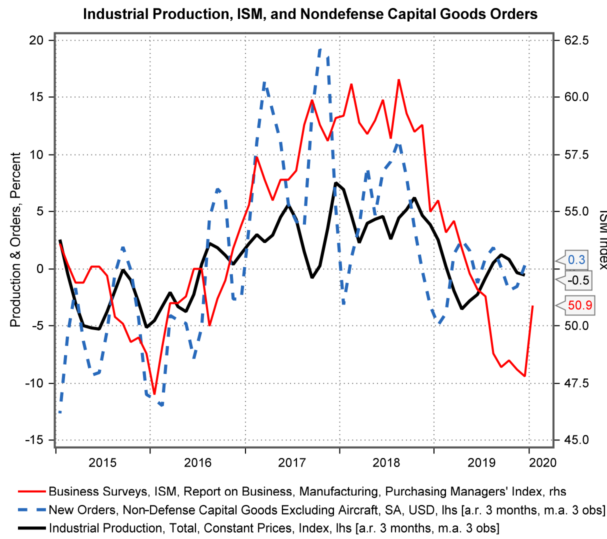
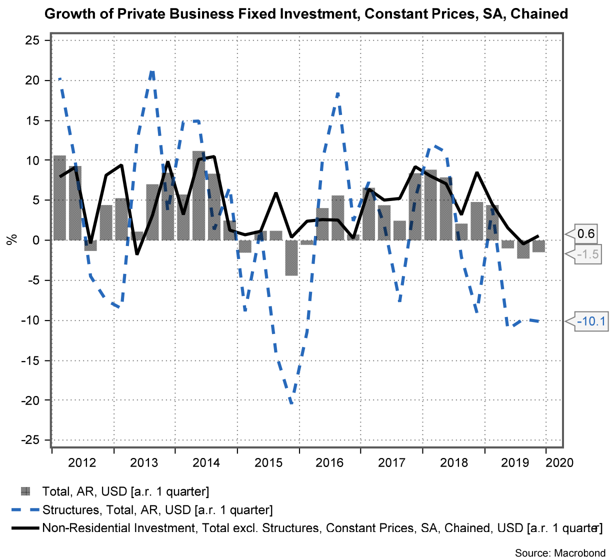


Figure 9: Business Investment Still Soft



Consistent with softer industrial output, real **business investment** fell by 1.5% in the fourth quarter, slightly better than Q3's 2.3% decline. Investment in business structures fell 10.1%, while business equipment and intellectual property eked out a 0.6% gain (Figure 9). While spending on structures is bound to recover before too much longer, core investment in equipment and intellectual property is likely to remain sluggish for now. Capacity utilization rates continued to fall in Q4, which suggests only limited need for investments to expand capacity (Figure 10). Service businesses, whose output significantly outpaced industrial firms last year, should boost investment this year, but industrial investment could remain muted in 2020's first half.

Figure 10: Lower Utilization, Less Investment

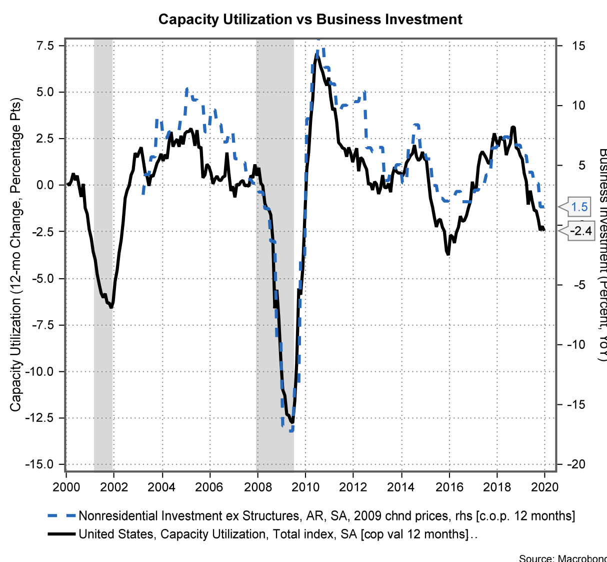
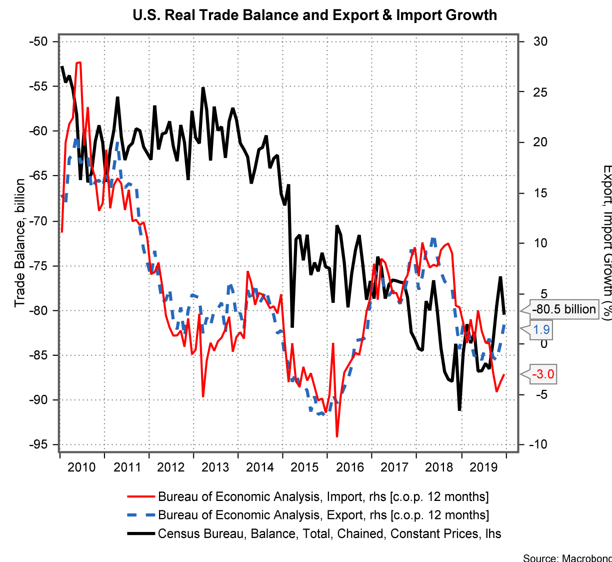


Figure 11: Narrower Deficit, Muted Activity



The **trade deficit** narrowed significantly in the fourth quarter, but trade volumes remained muted (Figure 11). Net exports added 1.5% to real GDP growth in Q4 and 0.3% in 2019 overall. However, tariff uncertainty and slower global growth drove a sizable decline in trade volume in 2019. Imports to the U.S. fell 3.0% YoY in December, while exports staged a mild recovery, up 1.9% over the same period. Signs of stabilizing global growth – at least before the COVID-19 outbreak – could extend an export rebound, although uncertainty is high.

While net exports were a positive for real GDP, **inventories** offset much of it. Inventories subtracted 1.1% and 0.4% from real GDP in Q4 and 2019, respectively. With trade agreements now signed, inventories lean in many sectors and consumer spending still strong, we expect a modest positive contribution to GDP from restocking in 2020.

Real **government consumption** picked up to 2.7% in the fourth quarter. Real federal government spending rose 3.6%, and state and local spending was up 2.2% in Q4 (Figure 12). For 2019 overall, real government spending rose by 3.0%, with federal spending up 4.3% and state and local spending up 2.2%, considerably above 2018's pace of 2.7% and 0.9%, respectively. With prospects for additional spending agreements in Washington limited in an election year, economists expect growth in overall government spending to slow to 1.7% in 2020.

Summarizing the fourth-quarter economic situation, real GDP growth of 2.1% adds up as follows: Personal Consumption Expenditures (+1.20%), Residential Investment (+0.21%), Business Investment (-0.20%), Inventory Change (-1.09%), Net Exports (+1.48%), and Government Consumption (+0.47%). The first three components equal **Private Domestic Final Sales**, which grew by 1.4% during the quarter and 2.2% over the past year. Looking ahead, consumption and government spending probably will be the largest contributors to growth, and residential investment should play an important supporting role. Business investment probably remains sluggish in the first half of 2020 but should improve thereafter. Contributions from trade and inventories are harder to predict, but together they should provide a modest boost to GDP this year. While COVID-19 adds an unusual degree of near-term risk to the outlook, we continue to believe 2.0-2.5% growth in 2020 is achievable.

Figure 12: Stronger Federal Spending

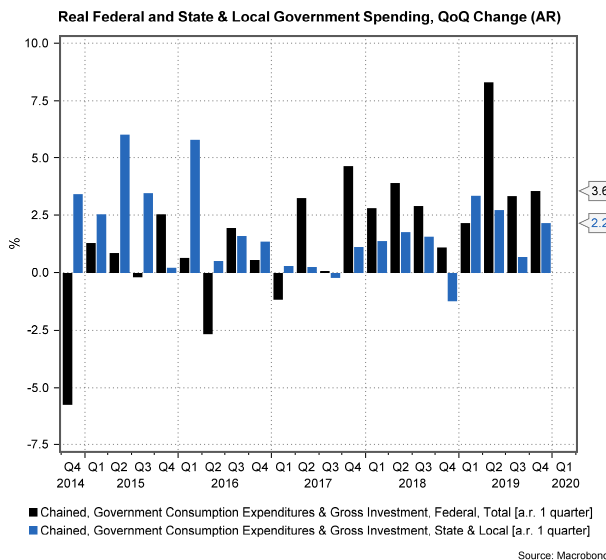
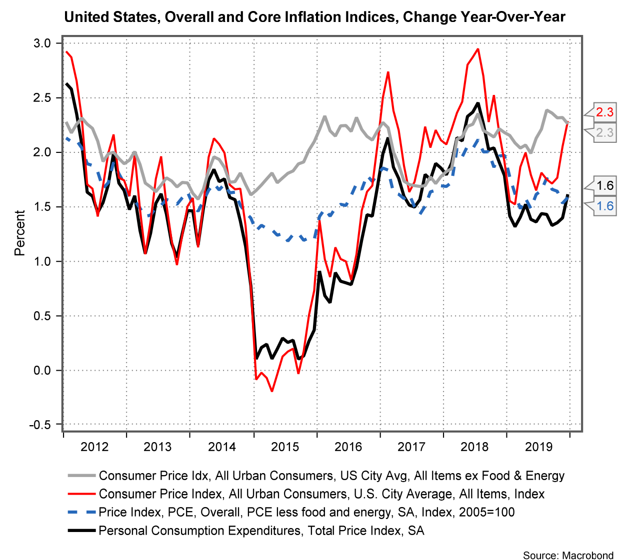


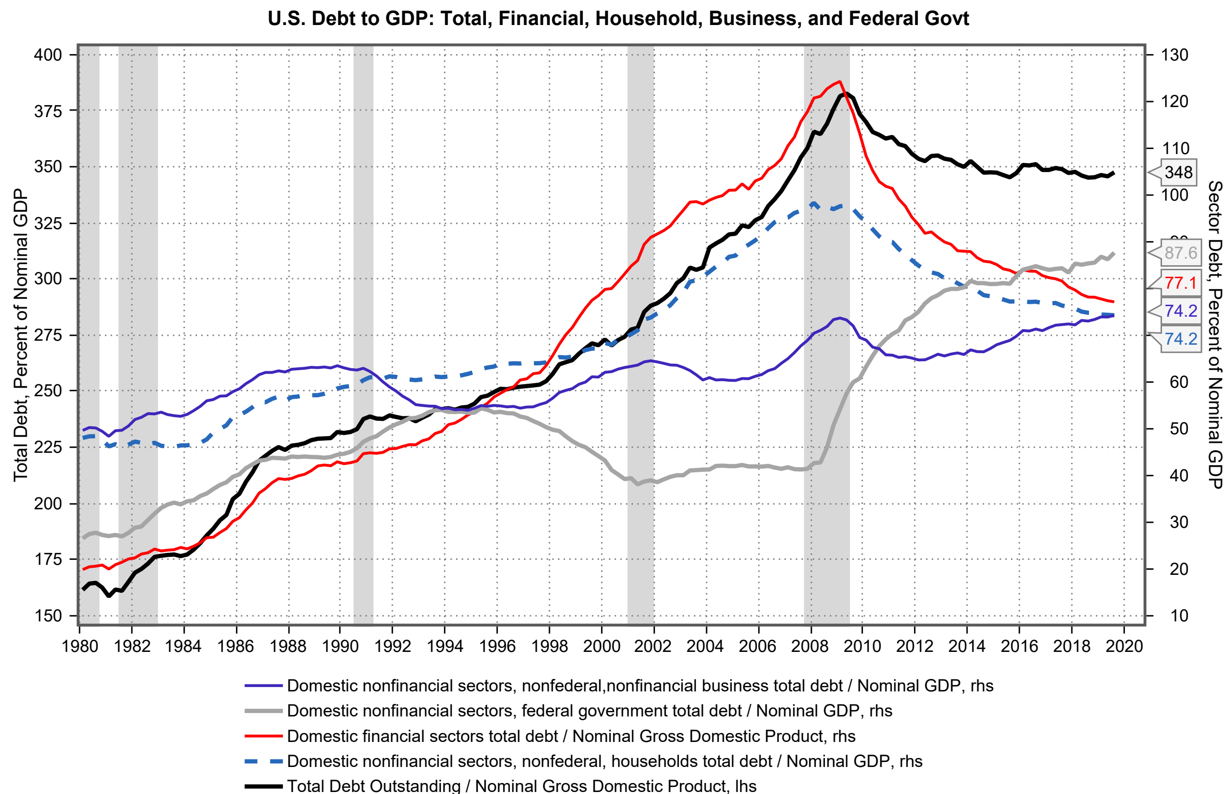
Figure 13: PCE Inflation Lagging 2% Target



Inflation was mixed in the fourth quarter, but it remained below the Federal Reserve's 2% target for the PCE deflator excluding food and energy. For 12 months ending in December, the consumer price index (CPI) was up 2.3% both overall and excluding food and energy (Figure 13). Over the same period, the PCE deflator was up 1.6% overall and excluding food and energy. Inflation has remained subdued despite strong employment and rising wages. Eventually, higher labor cost will translate to faster PCE inflation, but excess capacity both in the U.S. and globally is likely to make that a slow process.

Broad **balance sheet trends** through the third quarter of 2019 (latest data available) show an increase in debt outstanding relative to GDP, due mostly to rising federal government debt (Figure 14). Overall debt-to-GDP rose to 348%, up 2% from Q2. Household debt edged down to 74.2%, though you might not think so from press reports warning that consumer debt hit a new record in 2019. That is true in dollar terms – indeed, it happens regularly when incomes and GDP are rising – but it misses the more important point that household debt *relative to* both GDP and personal income has declined. As noted earlier, consumer debt burdens are at or near record lows (Figure 5). In short, household balance sheets are very healthy. Similarly, financial business leverage fell to 77.1%, its lowest level in 20 years. In contrast, nonfinancial businesses leverage rose to 74.2% in Q3, above its prior peak during the financial crisis. Federal government debt-to-GDP rose to a post-World War II record of 87.6% as deficit spending quickened – with more to come. We remain watchful of nonfinancial business and federal government debt longer-term but do not think they present significant obstacles to economic expansion over the next several years.

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



Market Outlook

Long-term **Treasury rates** rose modestly in the fourth quarter despite another rate cut by the Federal Reserve, although short-term interest rates fell (Figure 15). The benchmark 10-year Treasury note yield rose 24 basis points (bp) to 1.92%, and the 30-year Treasury bond yield rose 27 bp to 2.39% at the end of the fourth quarter. Those yields have fallen about 30 bp since year-end, with ten- and 30-year Treasuries yielding 1.63% and 2.09%, respectively, on February 12. Market forward rates are little changed since our last Update, and the yield curve continues to suggest a long period of relatively low rates ahead.

The Federal Open Market Committee (FOMC) cut the federal funds rate target by 25 bp on October 30, its third and final cut in 2019. The Fed also added liquidity via Treasury bill purchases and a series of repo operations in a largely successful effort to avoid a repeat of reserve shortages that pushed up money market rates several times in the third quarter. Financial conditions eased and are near their most accommodative level over the past five years (Figure 16). Easier financial conditions contributed to lower mortgage rates and a pickup in housing activity this year, and they helped boost economic growth through a slow patch for business investment. Monetary policy should continue to support the economy in 2020.

Figure 15: Rates Down, Forwards Steady[3]

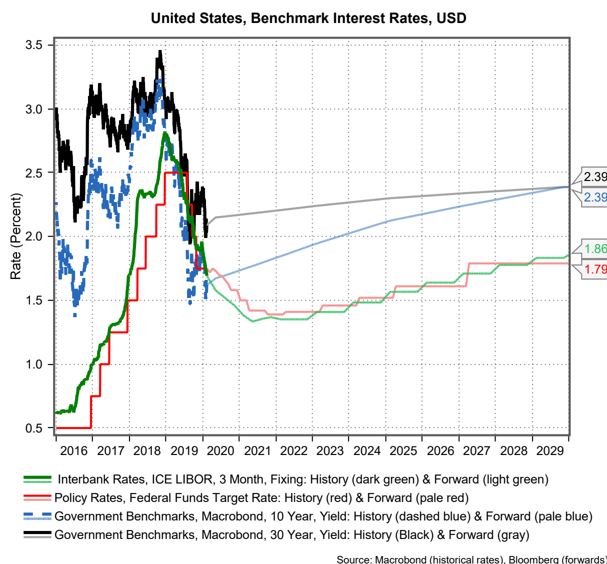
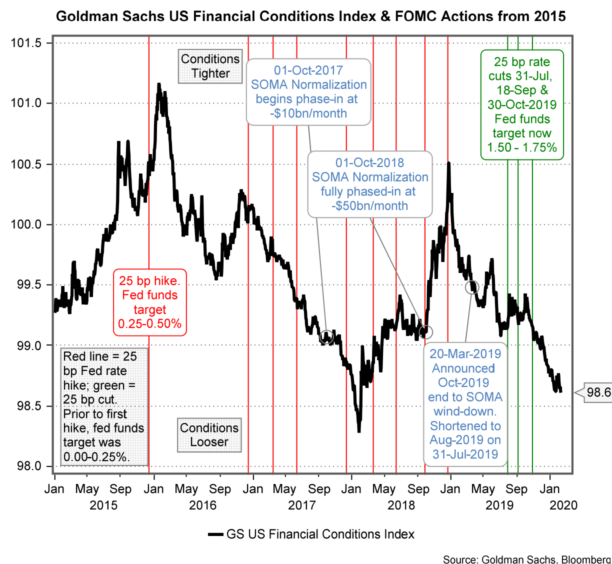


Figure 16: Financial Conditions Support Growth



Comments from FOMC members and Fed Chairman Powell's *Semiannual Report to Congress* on February 11, 2020 indicate that the Fed currently believes its 75 bp of rate cuts in 2019 complete a "mid-cycle adjustment" to monetary policy that should support economic growth and move inflation up toward the Fed's 2% target. With employment strong, wages up and a trade agreement with China reached in January, we concur with the Fed's assessment and think rates are likely on hold through 2020. However, markets recognize that the FOMC is more likely to reduce rates if the economy slows this year than it is to raise them if the economy does better than forecast. Accordingly, markets are pricing in one rate cut by year-end 2020, with about a

[3] The fed funds effective rate recently has traded about 17 bp below the top end of the FOMC target range. In Figure 15, we add 17 bp to forward rates implied by overnight index swaps (OIS) to align them with historic target rates.

50% chance of another 25 bp cut in 2021 – little changed from a quarter ago. Thereafter, markets project the fed funds rate to hold a little over 1% through 2023 before gradually rising back near its current level (1.55%) in 2027 and beyond (Figure 15). Market forward rates, which changed little in recent months, continue to look about right to us given the balance of risks. However, that implies intermediate- and long-term rates should move modestly higher over the course of 2020 if the Fed leaves rates steady, as we expect.

As intermediate- and long-term Treasury yields rose, corporate **credit spreads** narrowed sharply in the fourth quarter. Investment-grade corporate bond spreads tightened by 21 bp to 99 bp in Q4.[4] Spreads held steady as Treasuries rallied since year-end, closing on February 12 at 100 bp (Figure 17). High yield bond spreads narrowed by 48 bp to 372 bp at year-end and were unchanged at that level on February 12.[5] Investment-grade corporate and high yield bonds produced solid returns for the quarter and 2019 overall (Figure 18).

Figure 17: Credit Spreads Narrower

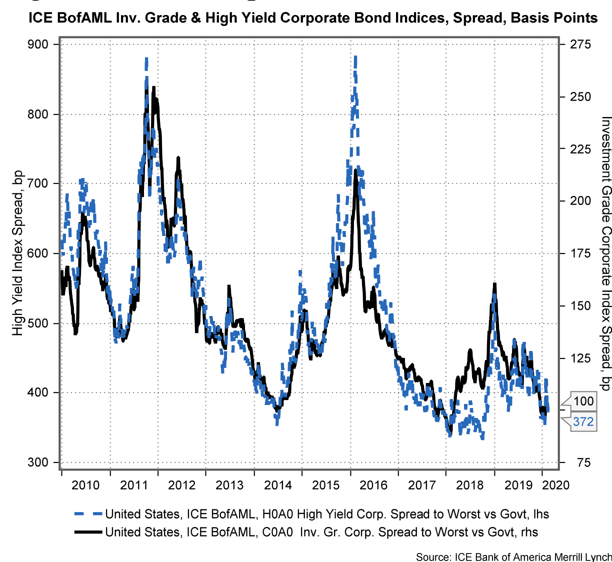
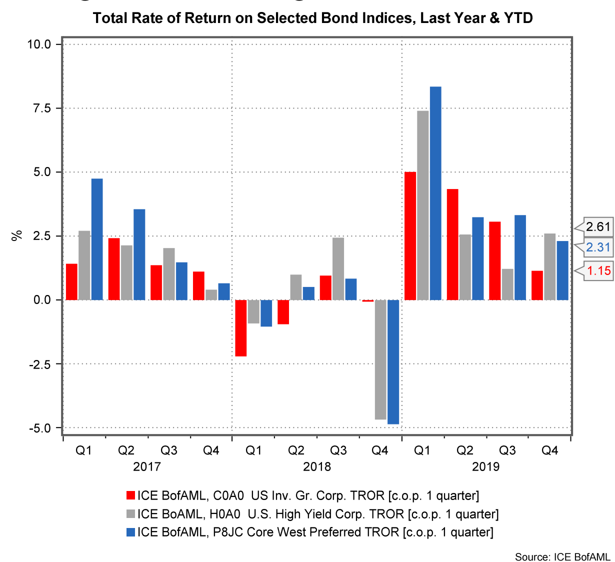


Figure 18: A Strong Year for Credit



Spreads on preferred securities followed a similar pattern. 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 fourth quarter of 2019, total return on the preferred index[6] (+2.31%) outperformed the investment-grade corporate bond index (+1.15%) and lagged the high yield index (+2.61%).[7] In the full year 2019, the preferred index (+18.25%) substantially outperformed both high yield (+14.41%) and investment grade corporates (+14.23%). In the new year to

[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.

[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.

February 12, 2020, preferreds (+2.09%) and investment grade corporates (+2.23%) have outpaced the high yield index (+1.06%) – though all three are off to a strong start. Credit investments continued to benefit from strong investor demand for yield in a low-rate environment, and we think demand for incremental yield should remain sturdy, even if Treasury rates increase modestly this year.

Credit conditions generally improved a bit in the third quarter (latest data available), and fourth-quarter bank earnings releases indicate good loan performance continued into year-end. Corporate earnings after taxes and inventory adjustments are expected to be up marginally (forecast +0.5%) in 4Q2019 compared to a year ago after rising strongly in 2018, when corporate tax rates were reduced and economic growth was stronger. The pretax profit share of GDP was unchanged at 9.7% in Q3, equal to its long-term average but considerably below its recent peak (Figure 19). Profits after-tax have held up better over the past several years, in part due to tax reform. However, rising wages appear to be putting downward pressure on margins. Renewed business investment could help boost labor productivity and support margins, but some margin erosion should be expected in a tight labor market Although corporate profits are down from unsustainably high levels a few years ago, they remain a credit positive.

Nonfinancial companies continued to issue corporate bonds at a relatively rapid clip, although most of that went to pay off maturing debt or build liquidity, as investment spending was modest. The nonfinancial business "financing gap," spending on capital investments minus internally generated cash, returned to slightly negative territory (i.e., cash flow exceeded investments) over six months ending in Q3 (Figure 20).

Figure 19: Profits Steady but Below Peaks

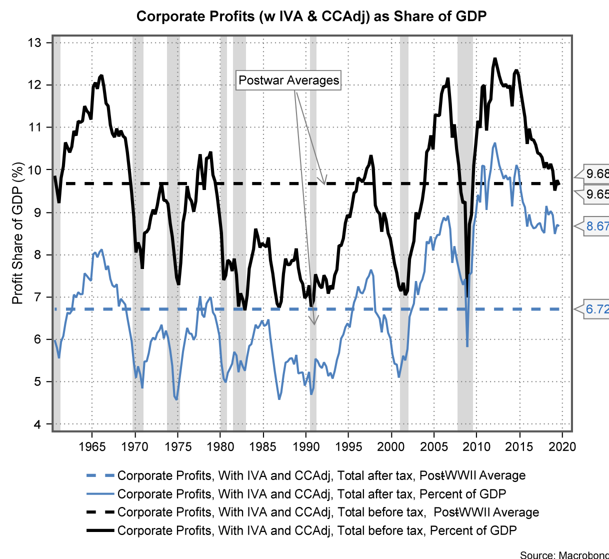
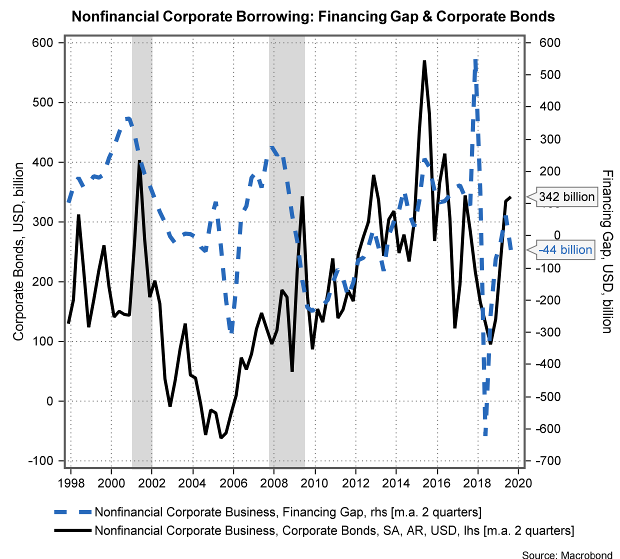


Figure 20: Lower Rates Boost Issuance



Nonfinancial corporate holdings of liquid assets relative to short-term liabilities improved to 78.7% in the third quarter, up more than 8% from the end of 2018 (Figure 21). Interest expense as a percentage of earnings before interest and taxes (EBIT) rose slightly to 24.0% in Q3. Low interest rates have made this sector's debt increases manageable, but interest expense has risen. We continue to keep a watchful eye on the nonfinancial corporate business sector.

Credit metrics at financial companies have told a pleasantly boring story for the past several years: credit quality has held about steady at strong levels. Overall bank loan delinquencies declined to 1.46% in the third quarter (latest data available), compared to 1.60% a year earlier (Figure 22). Overall loan charge-off rates rose slightly to 0.51% in Q3 from 0.49% in Q2 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 Q3 from 1.00% a year earlier, although it remains low historically. That's consistent with higher nonfinancial corporate leverage that we have discussed at length, and it's one of the few segments of banks' loan portfolios where we see some deterioration. Delinquency rates on consumer loans were 2.32%, matching charge-offs in Q3; they are little changed from a year ago. Bank earnings were up modestly, balance sheet growth remained slow 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. While we do not anticipate a recession in 2020, banks are well prepared for the next recession.

Figure 21: Liquidity Up, but so is Debt

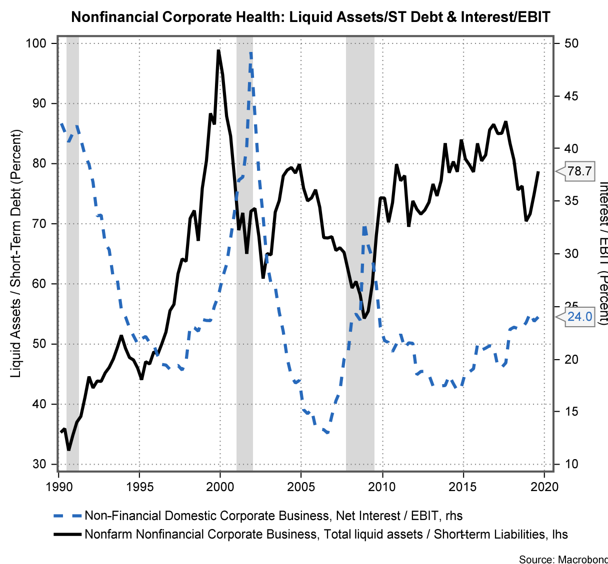
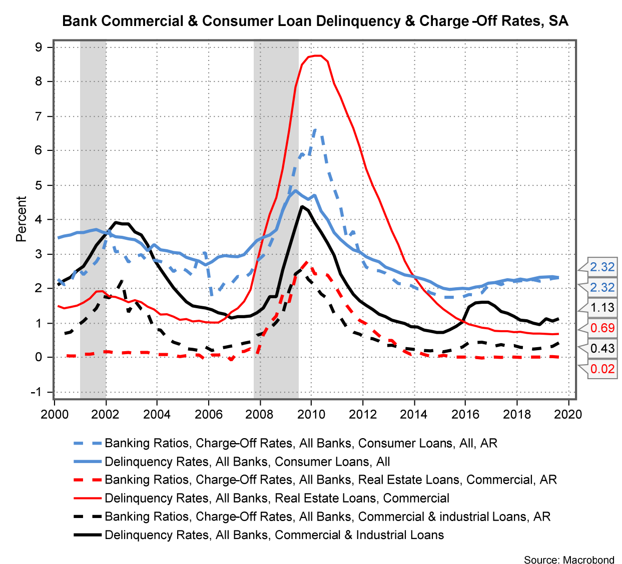


Figure 22: Loan Quality Strong and Steady



Summarizing our main views, we continue to expect 2.0–2.5% real GDP growth in 2020. Solid job growth and rising wages should sustain good growth in personal income and consumption. Residential investment should be a bright spot, and government consumption should match or slightly outpace the economy overall. Business investment is likely to remain soft in the first half of 2020 but should improve in the second half as trade picks up and any supply chain disruptions from COVID-19 diminish. Financial conditions are likely to remain accommodative, and inflation should move up gradually if our GDP growth forecast is right. The FOMC is likely to leave rates on hold in 2020, which should 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. Election risks loom later in 2020, but solid fundamentals should keep the expansion moving forward at a healthy pace.

Credit markets have continued to produce strong returns so far in 2020 as investors search for yield in a low-rate, moderate-growth 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, particularly if Treasury rates increase. We think preferreds continue to offer long-term investors an attractive combination of good credit quality, relatively high income and moderate interest rate risk.

Flaherty & Crumrine Incorporated
February 12, 2020

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