Flaherty & Crumrine Incorporated

First-Quarter U.S. Economic Update
May 2019

Summary of Recent Economic Developments

The U.S. economy expanded at a 3.2% pace in the first quarter, Economists forecast 2.0% real GDP growth in Q2 and 2.6% in 2019 overall, slowing to 2.0% in 2020. We are slightly more optimistic, although how much more largely depends on when and if a trade deal is reached. Payroll growth slowed but remained strong, wage growth was steady, and the unemployment rate fell to 3.6%. Despite strong personal income growth, real personal consumption expenditures rose a disappointing 1.2%; we expect faster growth over coming quarters. Home sales rebounded. Industrial production fell, and widening trade tariffs remain a headwind. Business investment slowed and is likely to grow only modestly for now, but a trade deal would reduce uncertainty and could unleash investment spending over coming quarters. The trade deficit narrowed and inventories rose, accounting for over half of Q1's real GDP growth. Government spending rose. Private domestic final sales slowed to 1.3% due to sluggish PCE. Inflation remained near but still below the Federal Reserve's 2% target. Treasury rates fell and now anticipate rate cuts by the Fed. Credit spreads narrowed, and credit fundamentals were stable to firmer. We think 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*	2019:1	2018:4	2018:3	2018:2	2018:1	2017:4	2017:3	2017:2
Real GDP, Chg QoQ (%, SA, AR)	3.2	2.2	3.4	4.2	2.2	2.3	2.8	3.0
Real Personal Consump Expnds, Chg QoQ (%, SA, AR)	1.2	2.5	3.5	3.8	0.5	3.9	2.2	2.9
Real Business Inv ex Stuctures, Chg QoQ (%, SA, AR)	3.6	7.9	4.1	7.3	10.9	5.8	5.9	8.3
Real Residential Investmt, Chg QoQ (%, SA, AR)	-2.8	-4.7	-3.6	-1.3	-3.4	11.1	-0.5	-5.5
Real Private Domestic Final Sales, Chg QoQ (%, SA, AR)	1.3	2.6	3.0	4.3	2.0	4.4	2.3	3.1
Nominal GDP, Chg QoQ (%, SA, AR)	3.8	4.1	4.9	7.6	4.3	5.1	4.8	4.2
Corporate Profits, After Tax, Chg YoY (%, SA, AR)	6.9f	14.3	19.6	15.8	15.1	7.3	6.4	6.2
Nonfarm Productivity, Chg QoQ (%, SA, AR)	3.6	1.3	1.9	2.9	0.7	-0.3	2.3	1.7
Nominal Personal Income, Chg YoY (%, AR)	3.8	5.0	4.3	4.6	4.3	4.6	4.6	4.3
Personal Savings Rate (%, SA)	6.5	7.7	6.4	6.5	7.2	6.2	6.6	6.6
Unemployment Rate (%, SA)	3.8	3.9	3.7	4.0	4.0	4.1	4.2	4.3
Nonfarm Payrolls, Chg QoQ (000, SA)	557	700	568	728	683	654	409	570
Household Employment, Chg QoQ (000, SA)	-197	876	477	432	1095	-334	1223	218
Federal Budget, 12-mo Def or Surp (% of GDP)	-4.2	-4.3	-3.9	-3.8	-3.7	-3.5	-3.5	-3.7
Consumer Price Index, Chg YoY (%, AR)	1.9	1.9	2.3	2.9	2.4	2.1	2.2	1.6
CPI ex food & energy, Chg YoY (%, AR)	2.0	2.2	2.2	2.3	2.1	1.8	1.7	1.7
Capacity Utilization (%, SA)	78.8	79.5	79.3	78.6	78.2	77.9	76.1	76.6
Rate or Spread (End of Quarter)	**2019:1**	**2018:4**	**2018:3**	**2018:2**	**2018:1**	**2017:4**	**2017:3**	**2017:2**
Federal Funds Rate Target (upper bound, %)	2.50	2.50	2.25	2.00	1.75	1.50	1.25	1.25
3-month LIBOR (%)	2.60	2.81	2.40	2.34	2.31	1.69	1.33	1.30
10-Yr Treasury Note Yield (%)	2.41	2.69	3.05	2.85	2.74	2.41	2.32	2.30
30-Yr Treasury Bond Yield (%)	2.81	3.02	3.19	2.98	2.97	2.74	2.86	2.84
ICE-BofAML US Corporate Index Yield to Worst vs Gvt	#N/A	#N/A	112	129	116	97	104	112
10-Yr Interest Rate Swap Spread (bp)	0.0	3.0	6.0	7.5	3.8	-1.5	-4.5	-2.3

* 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 expanded significantly faster than expected in the first quarter of 2019. Inflation-adjusted gross domestic product (real GDP) rose 3.2% in Q1, compared to an early January forecast of 2.1%. The composition of growth was weaker than in recent quarters, however, as a narrower trade deficit and faster inventory accumulation accounted for just over half of Q1 growth. Economists[1] expect 2.0% real GDP in Q2 and 2.6% in 2019 overall, slowing to 2.0% in 2020. Those forecasts are on the low end of our expectation for 2.5–3.0% growth (Q4/Q4) in 2019 and 2.0–2.5% in 2020.

While each of those forecasts implies some slowdown from 3.0% real GDP growth in 2018, we remain more optimistic than most for a few reasons. First, we think there is still some "gas in the tank" from tax reform that will drive business investment higher. That should support rising labor productivity and help offset a slower pace of hiring and higher wages as the labor market tightens. Second, higher wages should support continued strength in personal income, even with slower job growth. Third, the immigration situation has become so untenable that we may actually see some policy reform that helps alleviate some labor shortages and benefits economic growth. Finally, financial conditions are substantially easier than they were at the end of 2018, which should support the economy over the next several years.

Of course, there are still risks to the outlook. Global economic growth is expected to slow again to about 3.3% in 2019 and 2020, down from about 3.5% in 2018 and 3.7% in 2017. Trade policy remains highly uncertain. Although trade tariffs appear to have had only a mild impact on U.S. economic growth (albeit with outsized impact on certain sectors), they likely have contributed to slower global growth. And while we are modestly optimistic on immigration policy, there is plenty of room for disappointment given policy differences between Republicans and Democrats – and even within each caucus. We explore these in the paragraphs that follow.

Figure 2: Employment Gains, Ratio Strong

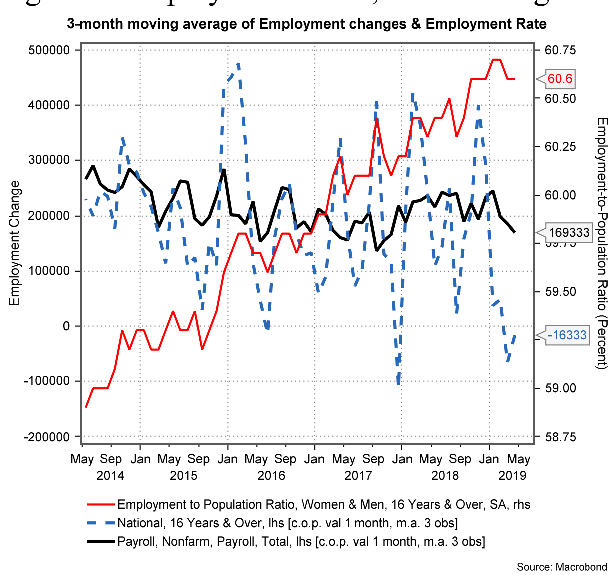
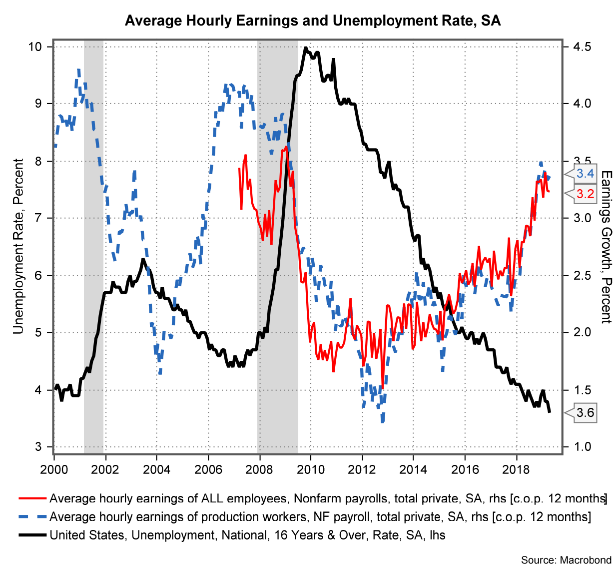


Figure 3: Labor Market Slack Diminishing



[1] Unless noted otherwise, forecasts are from the *Survey of Professional Forecasters*, Federal Reserve Bank of Philadelphia, May 10, 2019 and Bloomberg® *U.S. Monthly Economic Survey*, May 9, 2019.

The **labor market** posted another quarter of solid growth, although a divergence between payroll and household employment surveys widened (Figure 2). Payroll jobs rose by an average of 186,000 jobs per month in Q1 and rose by a further 263,000 in April 2019, up 1.8% YoY. In contrast, the household employment survey reports that jobs *fell* by an average 66,000 jobs per month in the first quarter and was down another 103,000 in April, leaving jobs up just 0.9% YoY in this survey. Typically, the two surveys track pretty closely over longer periods, but the nonfarm survey tallies 2.62 million job gains over 12 months ending in April, while the household survey counts 1.43 million. We do not know why the gap has become so large, but both surveys suggest jobs are outpacing population growth (around 0.7%) and that the labor market continues to tighten. Certain jobs remain difficult to fill, reducing output and income. That's something that changes to immigration policy could address to the economy's benefit.

The unemployment rate edged down to 3.6% in April (Figure 3), and the employment-to-population ratio (60.6%) continued to trend upward (Figure 2). Similarly, wage gains continued to build slowly. Average hourly earnings rose 3.2% YoY in April, up from 2.8% at the same time last year (Figure 3). We continue to expect wages will accelerate gradually and support personal income even when employment growth eventually slows.

Figure 4: Consumption Regained Footing

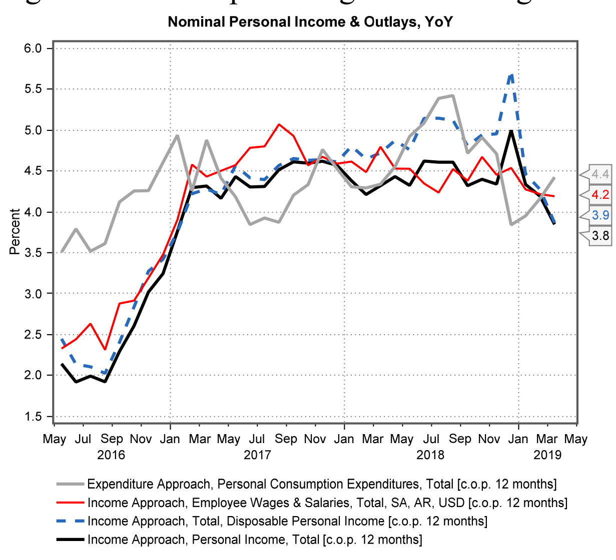
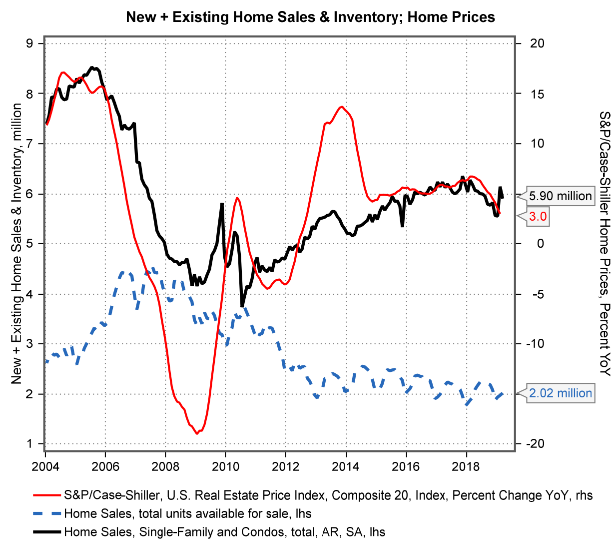


Figure 5: Housing Bottoming Out?



Nominal **personal income** grew by a relatively slow 3.3% in the first quarter, or 2.3% on an inflation-adjusted basis, partly due to a partial Federal government shutdown for most of January. Proprietors' Income, which includes independent contractors, was down 0.7% in Q1. Over the past 12 months, nominal personal income and disposable income rose 3.8% and 3.9% YoY, respectively, in March (Figure 4). Lower personal income tax rates in 2018 contributed to strong growth in disposable personal income, which is reported on an after-tax basis, last year. Because tax rates did not fall again this year, we expect a slower pace of growth in disposable income, and we are seeing that. Nonetheless, solid job growth and rising wages have boosted wage and salary income (+4.2% YoY in March). Overall income growth remains relatively strong.

Nominal **personal consumption expenditure** (PCE) was up just 1.8% in nominal terms in the first quarter but rose 4.4% YoY in March as consumption rebounded from a slow start in January and February (Figure 4). Adjusted for inflation, real PCE rose by 1.2% in Q1 and 2.9% YoY. Consumption trailed income growth, bumping the average **savings rate** to 7.0% during the quarter, up from an already-high 6.8% in the fourth quarter. Consumers have a relatively cautious view on the current expansion's life expectancy. Averaging the University of Michigan's and Conference Board's consumer confidence surveys, consumers' view of *current* economic conditions was 140.3 in April (latest data available), which is up about 4 points from a year earlier and up more than 20 points since 2016. In contrast, consumer *expectations* averaged 95.2, down about one point from a year ago and little changed since 2016. Although plenty of risks to the economy are lurking, we think most of them will remain in the background and reinvigorate consumption over coming quarters.

After sliding since early 2018, the **housing market** may be in the process of bottoming out. Real residential investment fell 2.8% (annualized) in Q1 after dropping 3.3% in 2018. However, combined new and existing home sales rebounded to an average 6.0 million unit pace in February and March, up from a 5.6 million unit pace in December and January (Figure 5). Home price gains continued to moderate. The S&P/Case-Shiller 20-city home price index rose 3.0% YoY in February (latest data available), down from a peak of 6.7% a year earlier. In 2018, higher home prices, rising mortgage rates and tax reform raised the after-tax cost of home ownership. Slowing sales and softer home prices were a result. However, job growth continues and wages are up, while home prices have moderated and mortgage rates have dropped in 2019. The recent rebound in home sales and housing surveys suggests that housing may be bottoming out. Residential investment should be a smaller drag and perhaps even provide a small boost to GDP going forward.

Figure 6: Soft Patch for Manufacturing

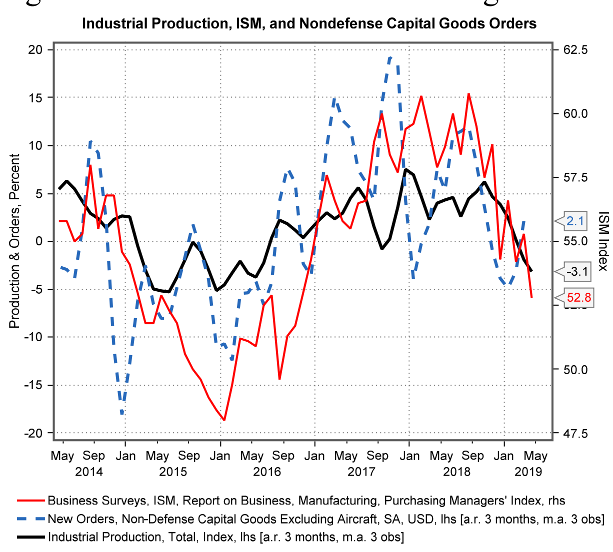
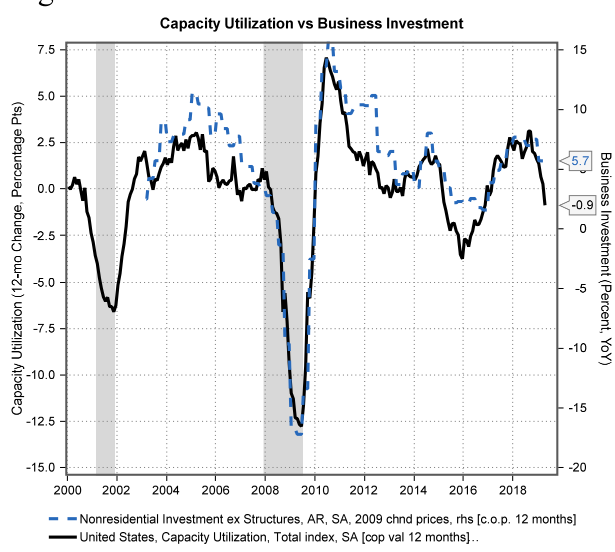


Figure 7: Business Investment Set to Slow



Industrial production hit a soft patch. Industrial output fell 1.9% in Q1 and 3.1% over three months ending in April (Figure 6), although it remains up 0.9% from a year ago. Higher energy prices supported mining output, which rose 2.6% in Q1 and 10.4% YoY in April, but other sectors fared poorly. Manufacturing and utility output fell 2.0% and 7.4%, respectively, in Q1 and were up a modest 1.0% and 2.8% YoY, respectively, in April. The slowdown was consistent with the Institute for Supply Management's manufacturing survey, which fell to 52.8 in April.

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After sliding in the second half of last year, however, orders for core capital goods (nondefense, excluding aircraft) recovered a bit in the first quarter (Figure 6). With trade tensions increasing and tariffs expanding, at least for now, it's difficult to see orders and output picking up strongly, despite a likely improvement in consumer spending over coming months. A trade deal and rollback of tariffs could provide a sizable boost to business confidence and spending over coming quarters. We expect a deal in the end, but its timing is highly uncertain – and the longer it takes, the greater the risks to the economy in the interim.

Real **business investment** slowed moderately in the first quarter. Overall business investment was up 2.7% in Q1 after rising 7.0% in 2018. "Core" business investment (business equipment and intellectual property) rose 3.6% in Q1 after a 7.5% gain in 2018, in-line with gains in capacity utilization (Figure 7). Recent declines in capacity utilization signal that business investment is likely to remain modest for now.

While lower corporate tax rates likely drove some business investment in 2018, Figure 7 indicates investment was not outside historical norms given higher output and an attendant rise in capacity utilization. Concerns over monetary policy tightening and trade policy probably restrained some investment last year. Today, with Fed worries much reduced but trade fears more elevated, many investments likely remain on hold. On balance, we expect moderate growth in business investment for now but could see considerably more investment spending if a deal cutting tariffs and opening markets were achieved.

Figure 8: Three Cheers for Productivity!

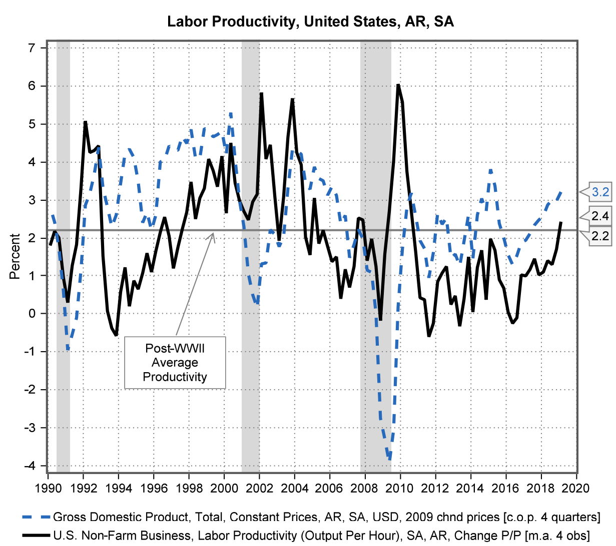
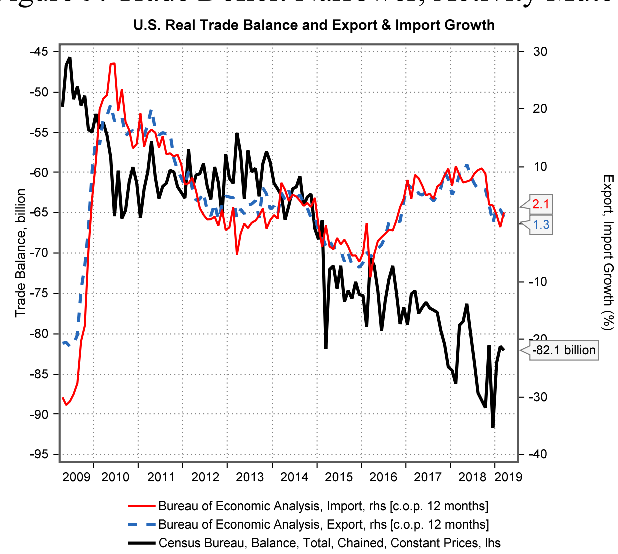


Figure 9: Trade Deficit Narrower, Activity Muted



After a long period of tepid performance, **labor productivity** soared over the past few quarters. Nonfarm productivity rose 3.6% QoQ and 2.4% YoY in the first quarter (Figure 8). This is good news for growth prospects, as higher productivity enables output to continue expanding even as hours worked decelerate – something that is inevitable in a tightening labor market. Of course, as Figure 8 clearly illustrates, productivity is cyclical. It tends to rise or fall along with GDP, and faster GDP growth over the past several years has gone hand-in-hand with higher productivity. Still, a sharp pickup in productivity recently suggests a lagged response to rising business investment as well as an ongoing deregulatory push by the Trump administration, effects that probably have further to run. Higher productivity also reduces unit labor cost, which creates room for rising wages without boosting overall inflation pressure, giving the Fed another reason to be patient with monetary policy.

The **trade deficit** narrowed in the first quarter and trade volumes slowed (Figure 9). Net exports added 1.0% to real GDP growth in Q1. Import growth slowed to just 2.1% YoY in March while export growth slipped to 1.3% YoY, as a mid-2018 rush by importers (and exporters to a lesser degree) to deliver goods ahead of tariffs subsided. This is much as we expected when tariffs were announced last year. From a fundamental perspective, solid U.S. economic growth and a stronger U.S. dollar tend to boost demand for imported goods while making U.S. exports more expensive for foreign buyers. Higher tariffs offset some impact from a stronger dollar, however, making it difficult to predict the impact on net exports. Trade volumes probably will continue to ebb until trade policy is more settled.

Inventories added 0.7% to first quarter real GDP. By itself, that is not an outsized contribution, but combined with net exports, the two accounted for a little over half of GDP in the quarter – something that's not likely to happen again in Q2. Longer term, we expect little average contribution to growth from inventories.

Government consumption rose 2.4% in the first quarter, led by state and local spending. Federal government spending was flat, as a 4.1% increase in defense spending was offset by a 5.9% drop in nondefense spending, though that was mainly a timing issue. Federal spending should rise in Q2, but it is slated to moderate in the second half of 2019 – although a budget deal that includes higher spending could change that. State and local government spending rose 3.9% in real terms after falling 1.3% in 4Q18. We expected that state and local governments would face taxpayer resistance to spending in light of limitations on state and local tax deductions on individual federal tax returns. However, for now, state treasurers are collecting higher tax revenues in a growing economy, leading to higher spending. Voters may demand restraint someday, but it is not visible yet.

Summarizing the first-quarter economic situation, real GDP growth of 3.2% adds up as follows: Personal Consumption Expenditures (+0.82%), Residential Investment (-0.11%), Business Investment (+0.38%), Inventory Change (+0.65%), Net Exports (+1.03%), and Government Consumption (+0.41%). The first three components equal **Private Domestic Final Sales**, which grew by 1.3% during the quarter and 2.8% over the past year (Figure 10). A slowdown in private sector growth was mainly due to softer PCE. Looking ahead, we expect better PCE growth but a smaller contribution from business investment, at least until trade tensions subside. Residential investment probably will not make a major contribution to GDP, but we think it could be a small positive over the next few quarters. Inventories probably will be a mild negative next quarter. Government spending should speed up a bit. Net exports should reverse some of their Q1 gain next quarter, but they remain a wildcard for the rest of the year. We expect 2.5–3.0% real GDP growth in 2019; a near-term trade deal probably puts growth near the high end of that range, while a late deal should put it near the low end.

Inflation was mixed in the first quarter as energy prices rose, boosting overall inflation, but core PCE inflation remained below the Federal Reserve's 2% target. For 12 months ending in April, the consumer price index (CPI) was up 2.0% overall and 2.1% excluding food and energy (Figure 11). The PCE deflator, was up 1.5%% overall and 1.6% excluding food and energy over

12 months ending in March – about 0.5% below year-ago levels – although they are expected to accelerate a bit in April's report. Inflation has yet to move higher despite impressive economic growth.

Figure 10: GDP Strong, Composition Weaker

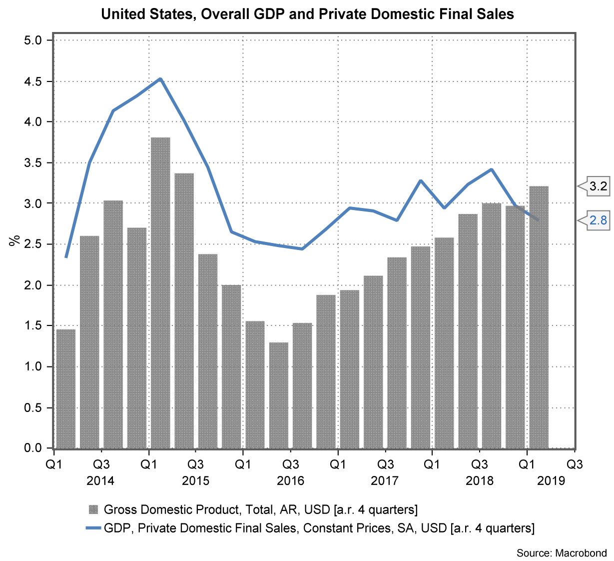
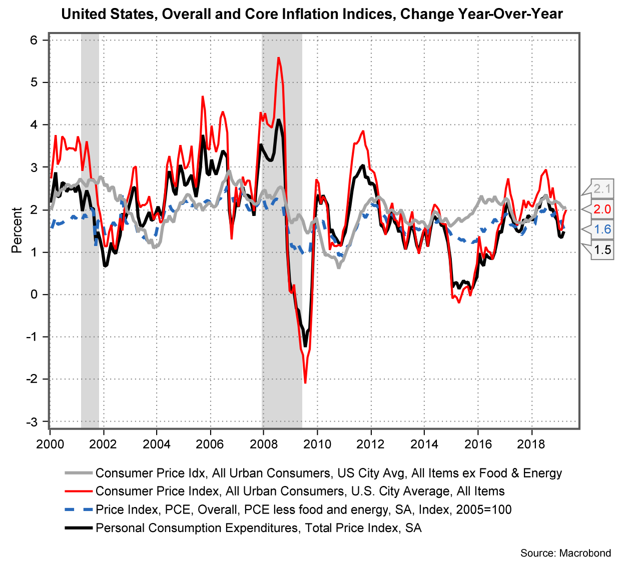


Figure 11: Inflation Near 2% FOMC Target



A new uncertainty in the inflation outlook is trade tariffs, especially in light of a recent setback in trade negotiations with China. Economists at Goldman Sachs analyzed two detailed papers recently published by the National Bureau of Economic Research assessing tariffs' impact on inflation.[2] They estimate that tariffs imposed by the U.S. on all countries' imports prior to May 10, 2019 added about 0.2% to core PCE prices in early 2019, from a combination of direct tariff impact and higher pricing from domestic producers of goods exposed to those tariffs. Because earlier rounds of tariffs began to take effect about a year ago, their impact has probably peaked and should trail off to about zero (assuming tariff rates hold steady) over the next six months.[3] However, if tariffs announced in early May are implemented and not withdrawn, core inflation could rise by about 0.5% over the coming year before fading in the second half of 2020. Of course, most of the boost to inflation from tariffs should reverse if they were rescinded. We expect that the Federal Reserve would not tighten monetary policy in response to a temporary rise in inflation caused by tariffs, unless domestic economic growth and inflation otherwise warrant it. Nonetheless, tariff-induced inflation is another complication the Fed will need to consider in setting monetary policy.

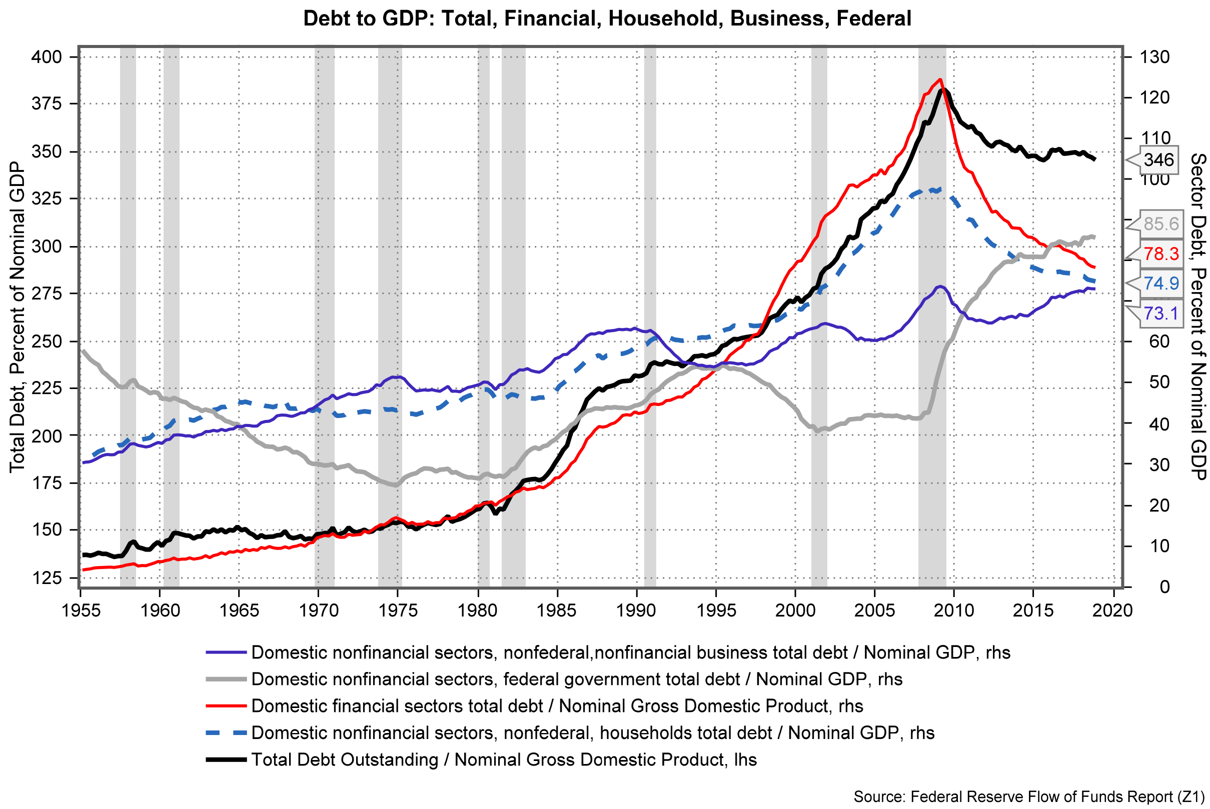
As shown in Figure 12, broad **balance sheet trends** in the U.S. show that debt leverage generally fell in the fourth quarter of 2018 (latest data available). Overall debt-to-GDP was 346%, down slightly from 347% in Q3. Leverage at households edged down to 74.9% from 75.1%; household balance sheets remain in very good shape. Financial business leverage continued to decline relatively quickly, falling to 78.3% from 78.6% debt-to-GDP last quarter. Nonfinancial

[2] *US Economics Analyst*, Goldman Sachs, May 11, 2019, using data and analysis from the following *NBER Working Paper Series*: https://www.nber.org/papers/w25672.pdf and https://www.nber.org/papers/w25638.pdf.

[3] Tariffs cause a one-time increase in prices. They permanently reduce purchasing power (as long as tariffs remain in effect), but they only temporarily raise inflation.

businesses leverage dipped to 73.1% from 73.3%, although that is only slightly below a peak of 73.7% during the financial crisis, and it remains a risk factor when the next recession strikes. Even federal government debt-to-GDP eased in the fourth quarter, falling to 85.6% from 85.9% in the prior quarter. However, that is still up 1.9% from a year ago and is likely to move materially higher over coming years. Overall, while we are 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 financials are positives for credit.

Figure 12: Leverage Edged Lower; Nonfinancial Business and Government Debt Still a Worry



Market Outlook

Long-term **Treasury rates** fell sharply in the first quarter as the Fed signaled that previously anticipated rate hikes would be eliminated or scaled back substantially. The benchmark 10-year Treasury note yield declined by 28 basis points (bp) to 2.41%, and the 30-year Treasury bond yield fell by 20 bp to 2.82% at the end of the first quarter (Figure 13). Ten- and 30-year yields have been volatile since then but closed on May 17 at 2.39% and 2.83%, respectively, within a couple basis points of quarter-end levels.

Despite market weakness in the last few months of 2018, the Federal Open Market Committee (FOMC) continued its plan for gradual monetary tightening, raising short-term rates by 25 bp on December 19. The FOMC did dial back projected future rate hikes by 25 bp, but it still anticipated raising the fed funds rate from about 2.4% in December 2018 to 2.9% in December 2019 and 3.1% in December 2020. It also left in place plans to reduce System Open Market Account (SOMA) securities holdings at a rate of about $50 billion per month, where it had been since October 2018. With inflation still subdued despite strong economic growth and hiring, markets viewed such "autopilot" policy as a serious policy mistake. Equity markets extended losses, Treasury bond yields fell and credit spreads widened. Financial conditions tightened sharply (Figure 14).

Figure 13: Rates Down; Pricing in Fed Cuts[4]

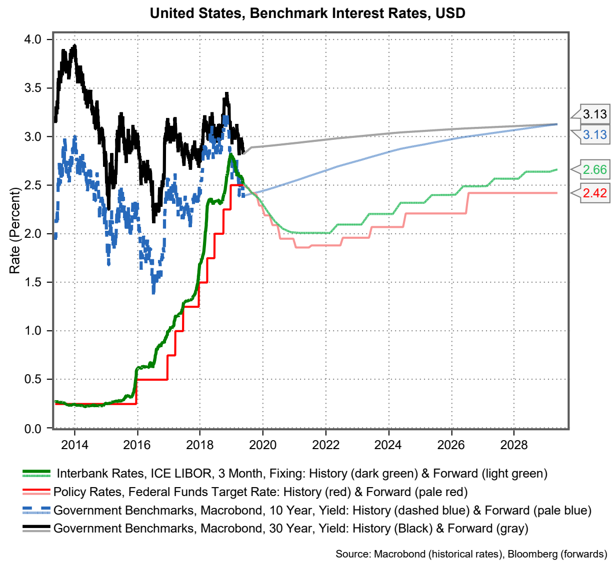
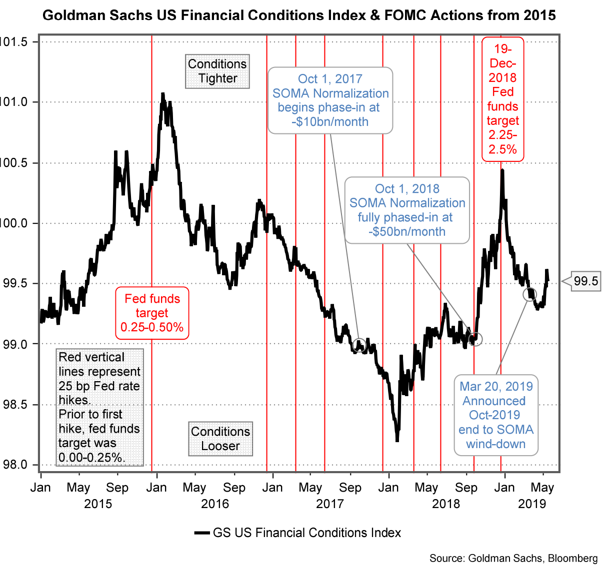


Figure 14: Financial Conditions Looser



Entering the first quarter of 2019, with financial conditions tighter and economic growth looking soft, the FOMC signaled a shift to significantly more accommodative monetary policy. At its January 2019 meeting, the FOMC introduced a new wait-and-see regime emphasizing "patience" on monetary policy during a period of economic uncertainty. It followed that up in March with projections for the fed funds rate that eliminated rate hikes in 2019 (50 bp lower than prior expectations), though it did preserve one final rate hike that would bring the fed funds rate to 2.6% by year-end 2020. The FOMC also announced plans to slow SOMA portfolio runoff beginning in May 2019 and end it in October 2019 – substantially earlier than prior expectations. As a result, the monetary base will remain higher than previously expected. Financial conditions eased considerably (Figure 14).

Markets took the FOMC's more-dovish policy stance one step further. Markets now price in rate *cuts* beginning late in 2019, bringing the fed funds target (upper bound) down from 2.5% currently to about 1.9% by the year-end 2020, well below the Committee's 2.6% median "dot plot" expectation from March.

Our rate expectations are close to the FOMC's. We expect relatively solid economic growth this year with gradually rising wages and inflation. If a trade deal happens soon, the Fed could hike rates by 25 bp late this year or, more likely, early next year, bringing the fed funds target to 2.5–2.75%. That should mark the end of this tightening cycle. However, we certainly see policy paths and economic outcomes that lead toward market forwards. In particular, escalating tariffs could weigh on business investment. In turn, that would reduce prospects for further gains in

[4] The fed funds effective rate recently has traded about 9 bp below the top end of the FOMC target range. In Figure 13, we add 9 bp to forward rates implied by overnight index swaps (OIS) to align them with historic target rates.

productivity, reducing potential economic growth, especially amidst stasis on immigration policy. Moreover, global economic growth – which space prevents us from exploring here – could slow more than we expect under those circumstances. For now, we view those as risks to our forecast, and we will continue to evaluate them as 2019 progresses.

Figure 15: Q4 Spread Widening Retraced…

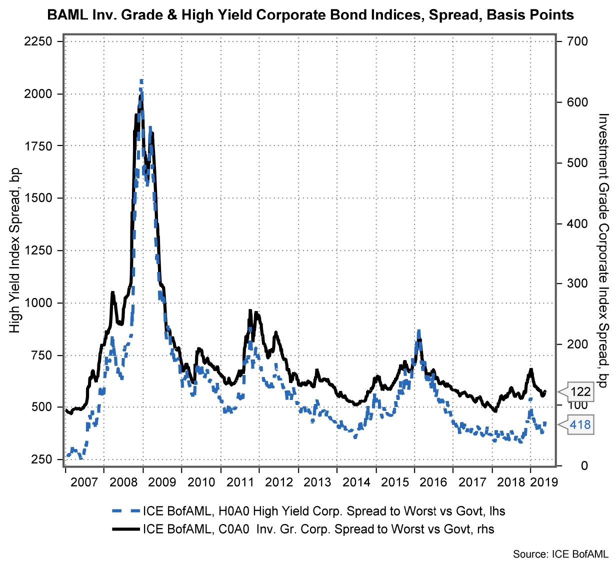
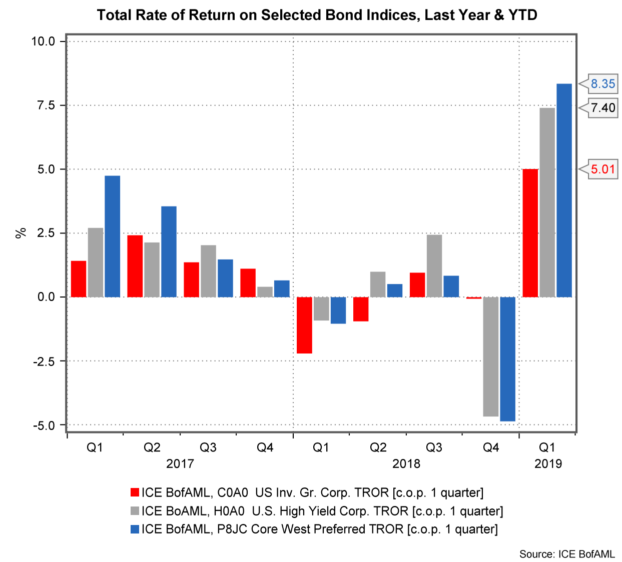


Figure 16: …Turning Poor 2018 into Strong Q1



As fears of a policy mistake by the Federal Reserve receded in the first quarter, corporate **credit spreads** narrowed sharply, recovering most of a substantial widening in the fourth quarter of last year. After widening by 46 bp in 4Q2018, investment-grade corporate bond spreads[5] tightened by 32 bp to 126 bp in the first quarter. They closed on May 16 at 122 bp. High yield bond spreads[6] were significantly more volatile, widening by 199 bp in 4Q2018, then tightening by 122 bp in Q1 to 415 bp and closing at 418 bp on May 16 (Figure 15). Because Treasury yields fell and credit spreads narrowed in the first quarter, prices on investment-grade corporate and high yield bonds rose strongly.

Spreads on preferred securities are more difficult to illustrate, though they followed a similar pattern to corporate and high yield 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 16 shows total returns on selected ICE BofAML indices in recent quarters. In the fourth quarter of 2018 and first quarter of 2019, total return on the preferred index[7] (-4.85% and +8.35%, respectively) cumulatively outperformed the high yield index (-4.67% and +7.40%, respectively) and the investment-grade corporate bond index (-0.06% and +5.01%, respectively).[8]

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[5] 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.

[6] 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.

[7] Preferred index is the ICE BofAML 8% Constrained Core West Preferred & Junior Subordinated Securities Index[SM] (P8JC).

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

Quarter-to-date through May 16, preferreds (+1.76%) continued to outperform both high yield (+0.80%) and investment grade corporates (+0.85%).

Figure 17: Strong Corporate Profits…

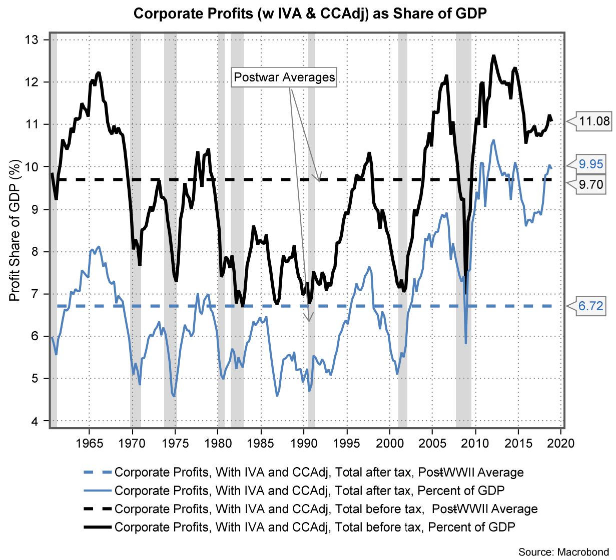
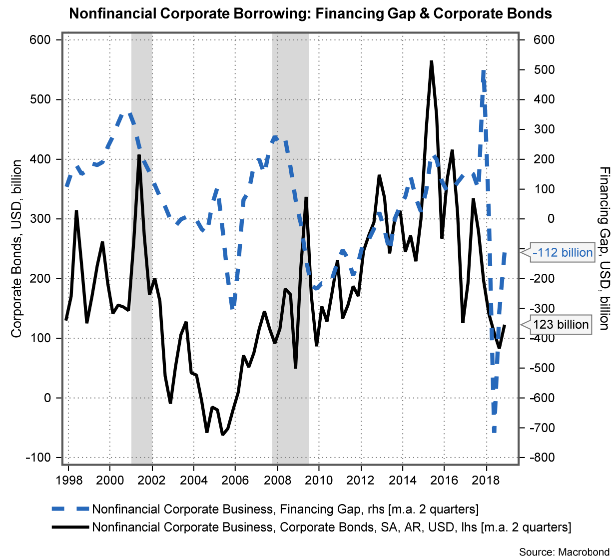


Figure 18: …Slower Investment, Less Issuance



Despite market volatility, **credit conditions** generally were stable to better in the fourth quarter (latest data available), and U.S. banks' recent earnings reports suggest good performance continued through the first quarter as well. Economy-wide corporate earnings after taxes rose 14.3% in the fourth quarter compared to a year earlier. While tax reform gave after-tax earnings a lift, pre-tax earnings also jumped, up 7.4% YoY, on the back of strong economic growth. The profit share of GDP held about steady at high levels in Q4 (Figure 17). We expect that competition for workers will continue to boost wages and nudge the profit share of GDP back toward its long-term average, although rising productivity has prevented that so far. Profits provide businesses with a buffer against a slowdown and contribute to current credit strength.

The "financing gap," spending on capital investments minus internally generated cash, for nonfinancial businesses increased in the fourth quarter but remained negative. Figure 18 shows a two-quarter moving average to reduce quarterly volatility of this series. With internally generated cash continuing to exceed capital investment, nonfinancial corporations reduced net corporate bond issuance in 2018. This has contributed to slightly lower leverage among these companies over the past year. As indicated earlier, we expect capital expenditure growth to remain modest for now, and with profits still strong, net bond issuance should be muted as well.

While debt leverage declined a bit in 2018, liquidity also fell. Nonfinancial corporate holdings of liquid assets relative to short-term liabilities dropped from a recent peak of 87% to about 67% in Q4 (Figure 19). Interest expense as a percentage of earnings before interest and taxes (EBIT) remained low at 21.1%, where it should stay for now given a steady Fed and slightly reduced pace of GDP growth. We remain watchful of credit conditions at nonfinancial companies, however, given higher leverage these companies accumulated over the past decade.

Credit metrics at financial companies continued to improve. Overall bank loan delinquencies fell to 1.53% in the fourth quarter of 2018 from 1.59% in Q3 and 1.78% a year earlier (Figure 20). Overall loan charge-off rates dipped to 0.44% in Q4 from 0.46% in Q3 and 0.48% a year ago.

Delinquency rates fell on real-estate loans (1.78%) and commercial and industrial loans (0.94%). Delinquency rates on consumer loans ticked up 5 bp to 2.34%, but charge-offs (2.22%) fell slightly. Bank earnings were strong, loan growth remains modest and capital ratios held about steady at very healthy levels. U.S. banks remain highly resilient and are well prepared for a downturn, whenever that arrives.

Figure 19: Interest Cost Okay but Liquidity Down

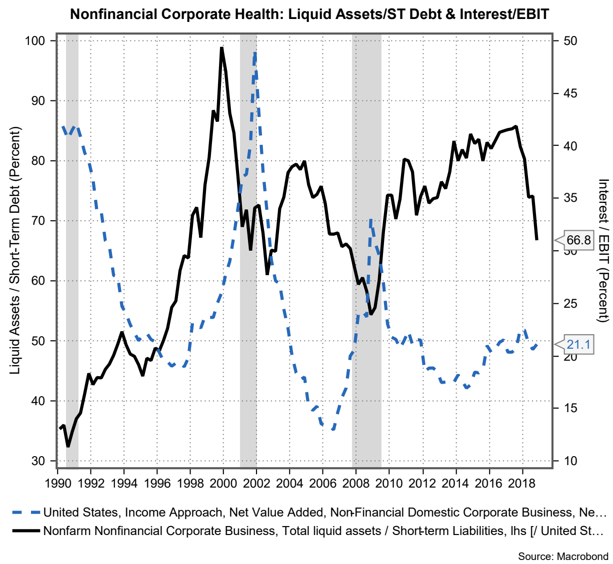
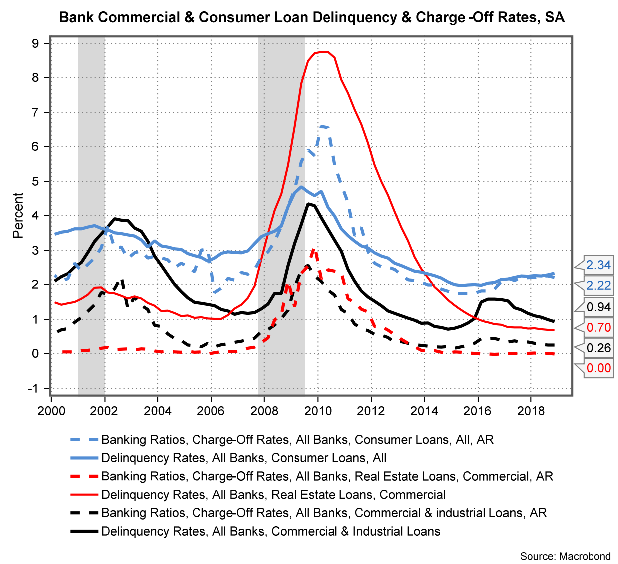


Figure 20: Loan Quality Stable to Better



Summarizing our main views, we expect 2.5–3.0% 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. Business investment should accelerate upon conclusion of a trade deal and support rising labor productivity, although a trade deal may not happen until late 2019 or even 2020. Residential investment could add a bit to GDP growth after dragging it down a little last year. Finally, financial conditions have eased substantially and should support the economy over the next several years. Inflation should see a boost from rising wages and tariffs, though the latter should be temporary and neither should be enough to alarm the Fed. The FOMC is likely to leave rates on hold for now, although we expect one more 25 bp rate hike in late 2019 or 2020 if our growth forecast is correct. As a result, intermediate- and long-term interest rates should increase modestly (25–50 bp) as the market reevaluates rate cuts that are priced into today's yield curve.

Credit markets recovered dramatically in 2019 as Treasury rates fell and credit spreads narrowed. Higher Treasury rates over the next year or two should present a modest headwind to future performance, but spreads still have room to narrow. Credit conditions remain supportive, especially for financial companies, which comprise over 70% of the preferred securities market. 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
May 17, 2019