Flaherty & Crumrine Incorporated

Second-Quarter U.S. Economic Update
August 2019

Summary of Recent Economic Developments

The U.S. economy expanded by 2.1% in the second quarter and averaged 2.6% in the first half of 2019. Economists expect 2.3% real GDP growth this year, dropping to 1.8% in 2020. We expect 2.2–2.7% growth this year and 2.0–2.5% next, although we acknowledge that risks lie mostly to the downside. Employment growth remained sturdy, albeit slower than last year, and the unemployment rate edged down. Personal income grew quickly and drove a 4.1% rebound in real personal consumption in the second quarter. The personal savings rate was revised up to 8.1%. Residential investment slipped 1.5% in Q2 but was a smaller drag on growth than in 2018. Industrial production fell and business investment slowed; both are likely to remain subdued amidst heightened uncertainty over trade policy. Net exports and inventories combined to subtract 1.5% from Q2 growth, reversing a similar gain in Q1. Government spending rose 5.0%, and federal outlays under a recent budget agreement should rise relatively quickly in fiscal years 2020 and 2021. Inflation remained near but still below the Federal Reserve's 2% target. Treasury rates fell sharply, and the Fed cut rates by 25 bp in July; financial conditions eased. Credit spreads were little changed, and credit quality was mostly stable – although nonfinancial companies showed some deterioration. Low rates continued to drive investors into preferred and other income securities. 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*	2019:2	2019:1	2018:4	2018:3	2018:2	2018:1	2017:4	2017:3
Real GDP, Chg QoQ (%, SA, AR)	2.1	3.1	1.1	2.9	3.5	2.6	3.5	3.2
Real Personal Consump Expnds, Chg QoQ (%, SA, AR)	4.3	1.1	1.4	3.5	4.0	1.7	4.6	2.4
Real Business Inv ex Stuctures, Chg QoQ (%, SA, AR)	1.9	4.5	8.5	3.2	7.1	8.0	9.2	5.2
Real Residential Investmt, Chg QoQ (%, SA, AR)	-1.5	-1.0	-4.7	-4.0	-3.7	-5.3	9.9	-2.0
Real Private Domestic Final Sales, Chg QoQ (%, SA, AR)	3.2	1.6	1.7	2.9	4.2	2.4	5.4	2.2
Nominal GDP, Chg QoQ (%, SA, AR)	4.6	3.9	2.9	4.8	7.1	5.0	6.4	5.4
Corporate Profits, After Tax, Chg YoY (%, SA, AR)	-0.9f	-2.9	10.1	11.3	8.3	10.3	3.3	3.9
Nonfarm Productivity, Chg QoQ (%, SA, AR)	2.0f	3.4	1.3	1.9	2.9	0.7	-0.3	2.3
Nominal Personal Income, Chg YoY (%, AR)	4.9	4.7	5.0	5.4	6.1	5.7	5.7	4.9
Personal Savings Rate (%, SA)	8.1	8.3	8.8	7.5	7.6	8.0	6.7	6.8
Unemployment Rate (%, SA)	3.7	3.8	3.9	3.7	4.0	4.0	4.1	4.2
Nonfarm Payrolls, Chg QoQ (000, SA)	471	521	700	568	728	683	654	409
Household Employment, Chg QoQ (000, SA)	257	-197	876	477	432	1095	-334	1223
Federal Budget, 12-mo Def or Surp (% of GDP)	-4.4	-4.2	-4.2	-3.9	-3.8	-3.7	-3.5	-3.5
Consumer Price Index, Chg YoY (%, AR)	1.6	1.9	1.9	2.3	2.9	2.4	2.1	2.2
CPI ex food & energy, Chg YoY (%, AR)	2.1	2.0	2.2	2.2	2.3	2.1	1.8	1.7
Capacity Utilization (%, SA)	77.9	78.4	79.5	79.3	78.6	78.2	77.9	76.1
Rate or Spread (End of Quarter)	**2019:2**	**2019:1**	**2018:4**	**2018:3**	**2018:2**	**2018:1**	**2017:4**	**2017:3**
Federal Funds Rate Target (upper bound, %)	2.50	2.50	2.50	2.25	2.00	1.75	1.50	1.25
3-month LIBOR (%)	2.32	2.60	2.81	2.40	2.34	2.31	1.69	1.33
10-Yr Treasury Note Yield (%)	2.00	2.41	2.69	3.05	2.85	2.74	2.41	2.32
30-Yr Treasury Bond Yield (%)	2.52	2.81	3.02	3.19	2.98	2.97	2.74	2.86
ICE-BofAML US Corporate Index Yield to Worst vs Gvt	121	126	158	112	129	116	97	104
10-Yr Interest Rate Swap Spread (bp)	-4.5	0.0	3.0	6.0	7.5	3.8	-1.5	-4.5

* 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 slowed in the second quarter of 2019, but consumer spending rebounded strongly. Inflation-adjusted gross domestic product (real GDP) rose 2.1% in Q2 and averaged a solid 2.6% rate in 2019's first half. A wider trade deficit and inventory reductions subtracted 1.5% from Q2 GDP, offsetting a 1.3% addition a quarter earlier. Economists[1] expect 1.8% real GDP in Q3 and 2.3% in 2019 overall, slowing to 1.8% in 2020. These forecasts are 0.1–0.3% lower than three months ago. We also have lowered our 2019 GDP forecast by 0.3% to 2.2–2.7% (Q4/Q4) due to fading prospects for a near-term trade deal but think 2.0–2.5% growth in 2020 remains achievable if a trade agreement with China is reached later this year or early in 2020.

Our reasons for optimism on the U.S. economy have not changed materially. We think business investment should pick up again following a trade deal, which would boost labor productivity and help offset a slower pace of hiring and rising wages from a tighter labor market. Second, higher wages should support continued strength in personal income, even with slower job growth. Third, immigration reform could help alleviate some labor shortages and benefit economic growth, although the politics around it make progress difficult. Finally, despite a recent pullback, financial conditions eased considerably in the first half of 2019 and are likely to ease further, which should support the economy over the next several years.

On the other hand, downside risks have increased. Global economic growth has been weaker than expected so far in 2019. The International Monetary Fund now forecasts 3.2% global growth in 2019 and 3.5% in 2020, both down 0.1% from a quarter ago.[2] Although we expect a deal eventually, trade negotiations between the U.S. and China have backtracked, and their outcome remains highly uncertain. Trade tariffs and policy uncertainty have chilled global trade, contributed to slower global growth, and prompted businesses to postpone or reduce investment. And while we are optimistic on immigration reform at some point, a path to compromise remains elusive and may not be achieved before 2021.

Turning to major segments of the U.S. economy, the **labor market** posted another good quarter, although the pace of gains has slowed this year (Figure 2). Payroll jobs rose by an average of 157,000 jobs per month in Q2 and rose by a further 164,000 in July 2019. The household employment survey continued to trail the broader payroll survey in Q2, averaging 86,000 job gains per month, but caught up a bit by adding 283,000 jobs in July. Both surveys reveal a slowdown in job growth. Nonfarm payrolls were up 1.5% YoY in July compared to 1.7% at the same time last year. Employment in the household survey was up 0.8% YoY in July versus 1.6% a year ago. Employment continues to expand more rapidly than the working-age population (around 0.7%), but job growth slowed as the pool of available workers diminished.

The unemployment rate dipped to 3.7% in July from 3.8% at the end of Q1 (Figure 3), while the employment-to-population ratio (60.7%) held about steady at a 10-year high (Figure 2). Average hourly earnings were up 3.2% YoY in July, down slightly from a peak of 3.4% YoY in February but up considerably from a couple of years ago (Figure 3). Wages should continue to accelerate gradually and support personal income even as employment growth slows.

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[1] Unless noted otherwise, forecasts are from the *Survey of Professional Forecasters*, Federal Reserve Bank of Philadelphia, August 9, 2019 and Bloomberg® *U.S. Monthly Economic Survey*, August 8, 2019.
[2] International Monetary Fund, *World Economic Outlook*, July 18, 2019.

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Figure 2: Job Growth Slowing…

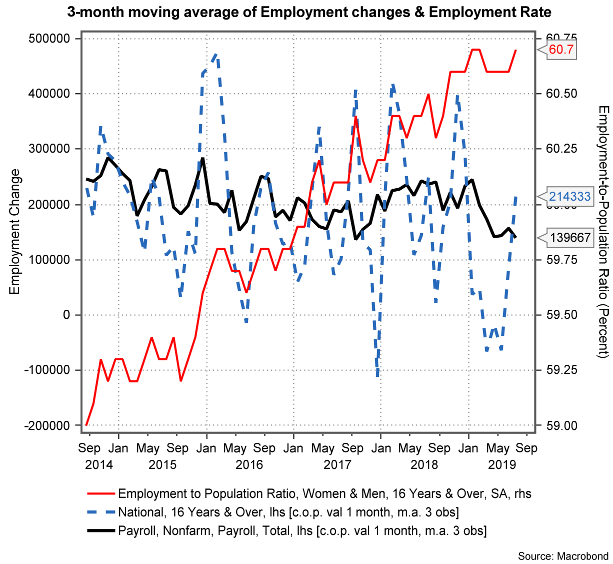
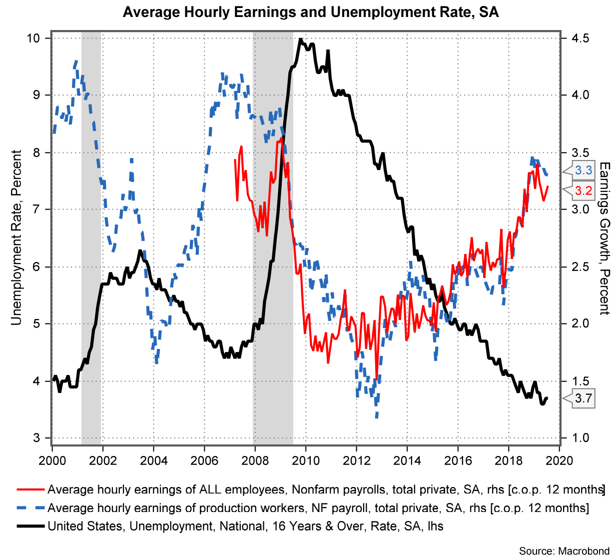


Figure 3: … as Labor Market Tightens



The Commerce Department made some significant revisions to its personal income data for the past several years, substantially raising estimates of income in 2018 and 2019. Nominal **personal income** rose by 5.4% in the second quarter after a 6.1% jump in Q1. Over 12 months ending in June, nominal personal income and wage and salary income rose 4.9% and 5.5% YoY, respectively (Figure 4). Adjusted for inflation, real disposable personal income rose 2.5% in Q2 and 3.3% YoY in June. In total, revisions added 2.4% to the estimated level of overall personal income, including a 2.6% addition to wages and salaries. Personal income already looked healthy; it looks even better after these revisions.

Figure 4: Consumption Good, Income Better

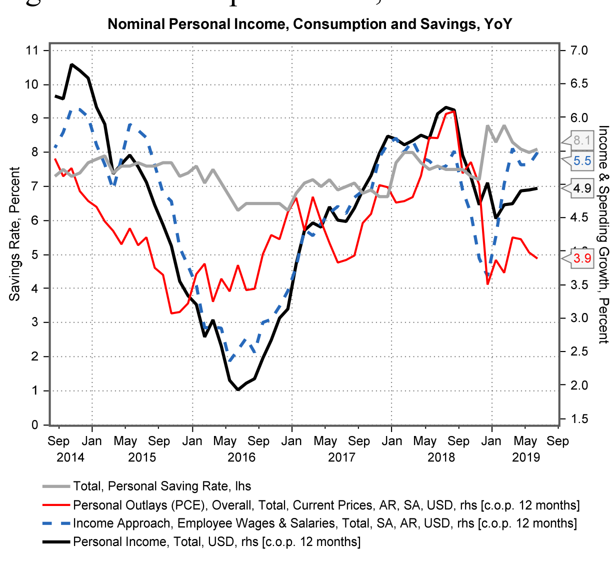
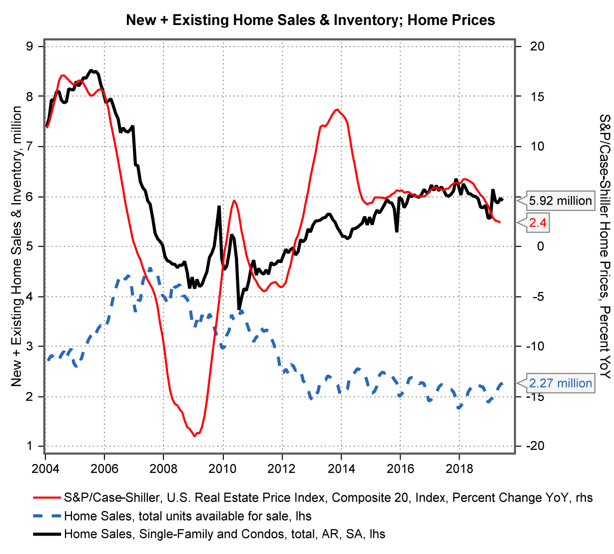


Figure 5: Housing Flat; Price Gains Slower



Personal spending rose strongly in the second quarter after a slow start in early 2019, when spending was weighed down by a partial government shutdown. Nominal **personal consumption expenditure** (PCE) jumped 6.7% in Q2 and was up 3.9% YoY in June (Figure 4). Adjusted for inflation, real PCE rose by 4.3% in Q2 and 2.5% YoY. Consumption outpaced income growth in the second quarter but trailed it over the past year. Moreover, although the Commerce Department's revisions to income were large, they added just 0.2% to the level personal spending. As a result, the **savings rate** was revised up to 8.1% at the end of the second quarter, about 1.5% higher than earlier estimates. This is very good news for consumer balance sheets, and supports our outlook for continued strength in consumer spending.

Activity in the **housing market** edged lower again in the second quarter. Real residential investment fell 1.5% (annualized) in Q2 after sliding 4.4% in 2018. Combined new and existing home sales averaged a 5.9 million unit pace in Q2, about unchanged from Q1 (Figure 5). Home price gains continued to slow. The S&P/Case-Shiller 20-city home price index rose 2.4% YoY in May (latest data available), down from 6.5% a year earlier. While 2017's tax reform raised the after-tax cost of home ownership, good job growth, rising wages and lower mortgage rates should boost demand for housing over time. We continue to think residential investment will be a smaller drag on, and perhaps even provide a small boost to, GDP over coming quarters.

Figure 6: Manufacturing Takes a Hit

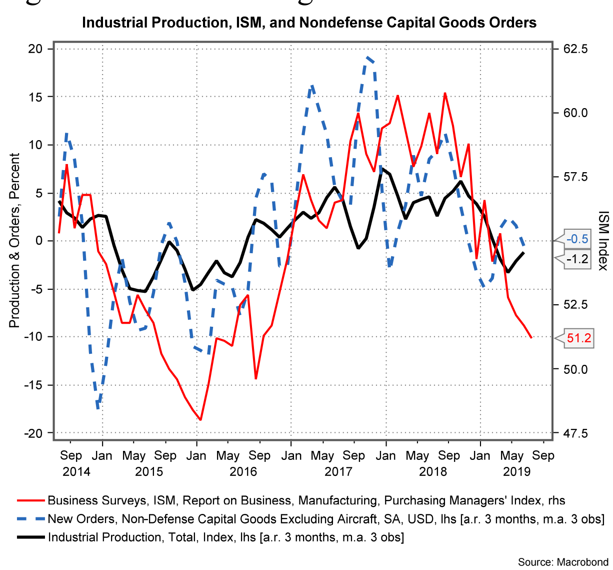
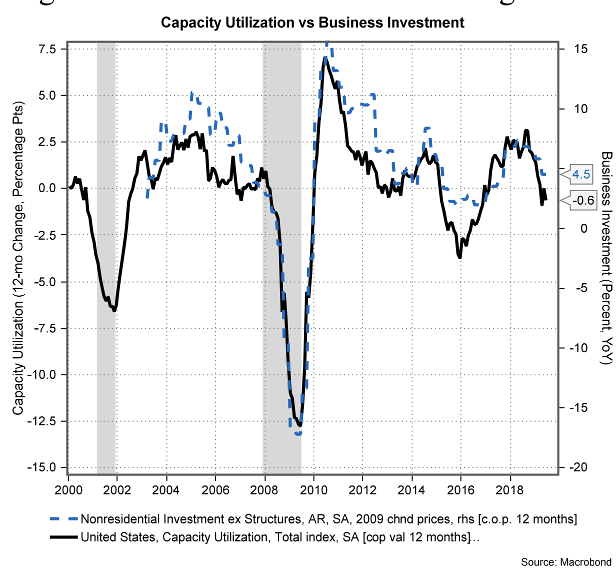


Figure 7: Business Investment Slowing



Manufacturing remains in a soft patch. **Industrial production** fell 1.2% in Q2 and is off 1.5% in the first half of 2019 (Figure 6), although it remains up 1.3% from a year ago. Higher energy prices supported mining output in Q2, which rose 8.9% in the quarter and 11.9% YoY in June, although oil prices have fallen about 10% so far in Q3. However, manufacturing was weak, with output down 2.1% in Q2 but up 3.8% YoY due to strong growth in the second half of last year. The Institute for Supply Management's manufacturing survey fell to 51.2 in July, and orders for core capital goods (nondefense, excluding aircraft) fell 0.5% in Q2 (Figure 6). Despite a favorable outlook for consumer spending, this data and ongoing trade uncertainty suggest that a slowdown in manufacturing has further to run.

Consistent with soft industrial output, real **business investment** fell by 0.6% in the second quarter. A 10.6% drop in business structures accounted for the entire decline in overall business investment. "Core" business investment (business equipment and intellectual property) rose 1.9% in Q2 after a 4.5% gain in Q1 and 6.7% jump last year. While the big drop in structures probably was an outlier, a slowdown in core investment is clearly visible. Moreover, core investment has still outpaced capacity utilization, which has slipped this year (Figure 7), at least in part on weaker exports. Business investment is likely to remain modest for now, although a trade deal reducing tariffs and opening markets could provide a sizable boost to confidence and investment.

Figure 8: Productivity Sustains Wage Growth

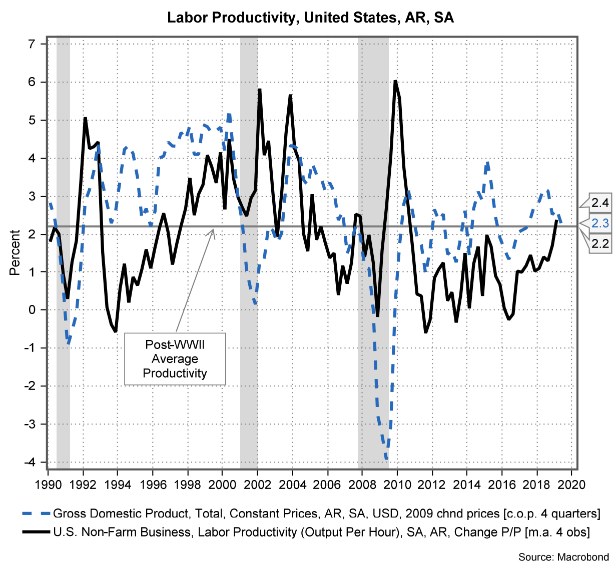
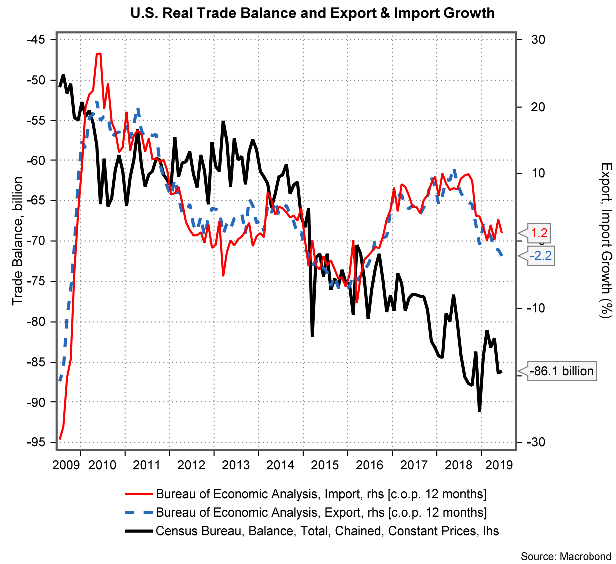


Figure 9: Trade Deficit Wider, Activity Down



Although second quarter data is not yet available, **labor productivity** improved substantially since early 2018 and supports growth in real wages. Nonfarm productivity rose 3.6% QoQ and 2.4% YoY in Q1(Figure 8), and economists expect a 1.4% rise in Q2. That would imply a 2.0% gain in productivity over the past four quarters, slower than Q1's pace but consistent with a modestly slower economy. We remain optimistic that productivity will sustain recent gains given strength in business investment over the past several years and a lighter regulatory burden from Washington. Because higher productivity reduces unit labor cost, it gives businesses room to raise wages in a tight labor market while limiting their inflationary impact.

The **trade deficit** widened in the second quarter, and trade volumes continued to slow, especially for exports (Figure 9). Net exports subtracted 0.7% from real GDP growth in Q2 after adding a similar amount in Q1. Import growth slowed to 1.2% YoY in June while exports fell by 2.2% YoY. U.S. import tariffs and export restrictions on some technology goods, along with other countries' responses to them, prompted a material slowdown in trade volumes – as expected. Looking ahead, a relatively strong U.S. economy and currency should tend to boost demand for imported goods while making U.S. exports more expensive for foreign buyers, even before possible tariffs imposed by other countries on U.S. products. Of course, higher import tariffs tend to reduce demand for foreign goods, at least those with domestic substitutes. While the impact of all this on *net* exports is difficult to predict, it's easy to predict that trade volumes should continue to decline until trade policy is more settled, which could take some time.

Similar to net exports, **inventories** subtracted 0.9% from second quarter real GDP after adding 0.5% in Q1. As a result, GDP contributions from net exports and inventories nearly offset one another over the first and second quarters of 2019. We expect little average contribution to growth from inventories over the long term.

Government consumption rose 5.0% in the second quarter as spending deferred during a partial federal government shutdown in January was disbursed. Real federal government spending rose 7.9%, including a 15.9% surge in nondefense spending and a 2.8% increase for defense. Over the past four quarters, those categories were up 3.5, 1.9 and 7.6%, respectively. Real federal spending is set to rise even more quickly (4-5%) for the next two fiscal years under a budget deal passed by Congress in July. State and local government spending rose 3.2% in Q2, about equal to its first-quarter pace. This is significantly faster growth in government spending than in recent years, and almost all of the federal spending increase has been and will be deficit financed.

Figure 10: Core GDP Growth has Moderated

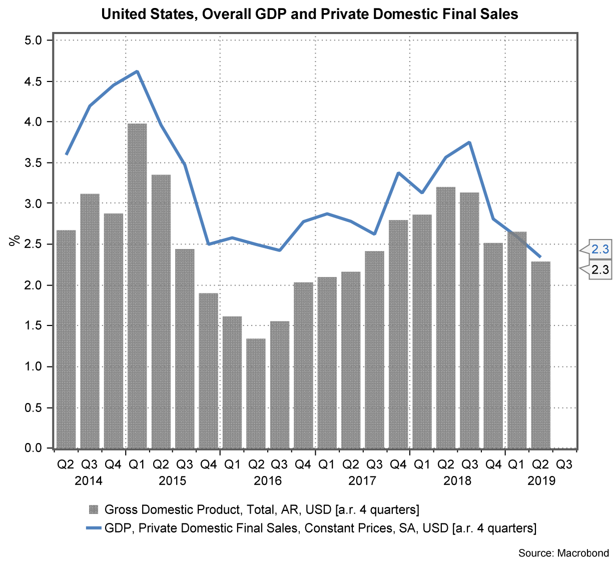
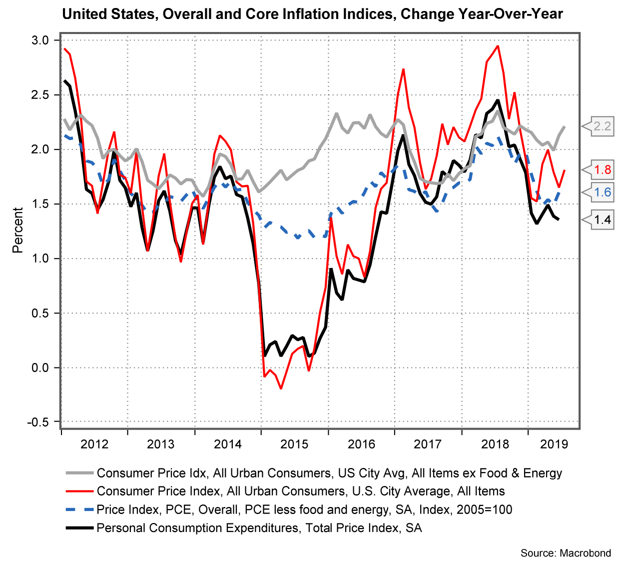


Figure 11: Inflation Lagging 2% FOMC Target

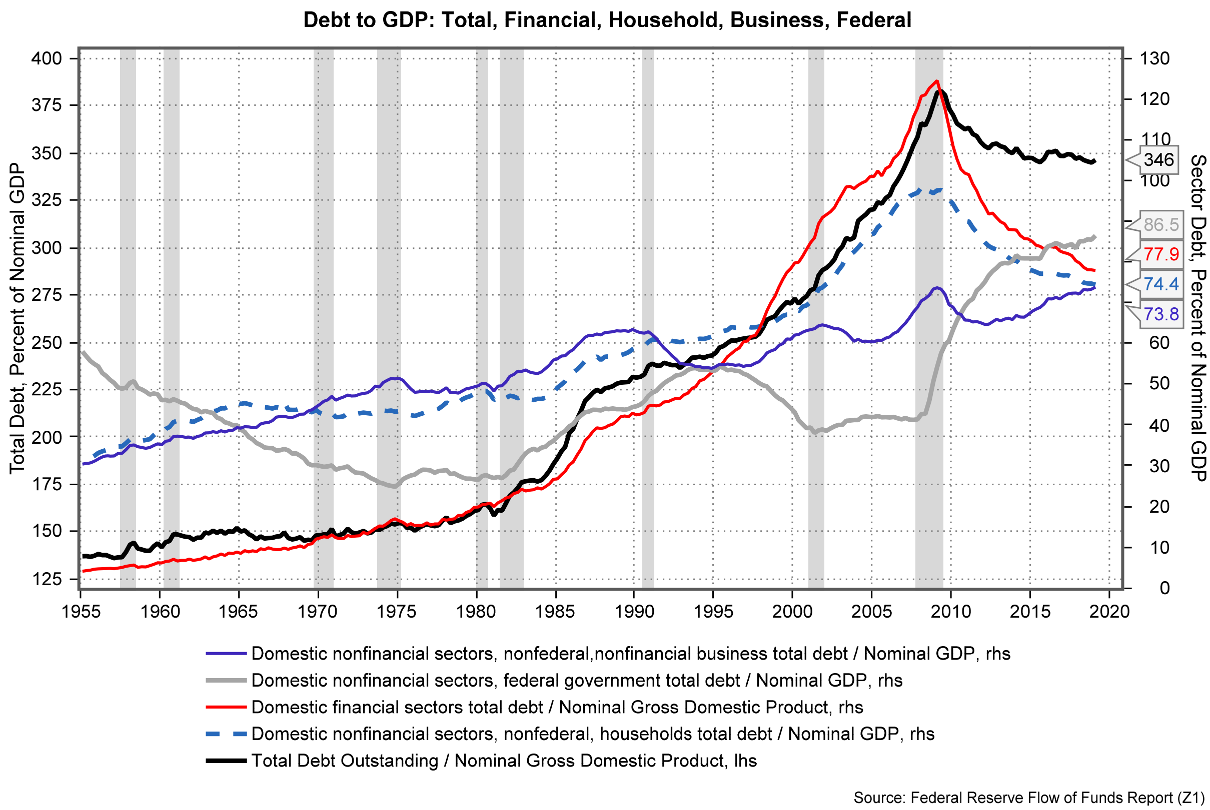


Summarizing the second-quarter economic situation, real GDP growth of 2.1% adds up as follows: Personal Consumption Expenditures (+2.85%), Residential Investment (-0.06%), Business Investment (-0.08%), Inventory Change (-0.86%), Net Exports (-0.65%), and Government Consumption (+0.85%). The first three components equal **Private Domestic Final Sales**, which grew by 3.2% during the quarter and 2.3% over the past year (Figure 10). With housing still unlikely to make a significant contribution to growth and trade uncertainty dampening exports and restraining business spending for now, economic growth rests squarely on consumer spending. Although consumers are in excellent shape currently, a decline in confidence or other shock could hit PCE and put the economy at risk. That likely drove a recent decision by the Federal Reserve to ease monetary policy, which we discuss in detail below.

Inflation was little changed in the second quarter and remained below the Federal Reserve's 2% target. For 12 months ending in July, the consumer price index (CPI) was up 1.8% overall and 2.2% excluding food and energy (Figure 11). For 12 months ending in June (latest data available), the PCE deflator, was up 1.4%% overall and 1.6% excluding food and energy over the same period. Inflation has yet to move higher despite impressive economic growth, tariffs that boosted import prices, and rising wages.

As shown in Figure 12, broad **balance sheet trends** in the U.S. show that debt leverage rose slightly in the first quarter of 2019 (latest data available). Overall debt-to-GDP was 346%, up from 345% in 4Q2018. Leverage at households edged down to 74.4% from 74.7%; household income and balance sheets remain in very good shape. Financial business leverage continued to decline, albeit at a slower pace, dropping to 77.9% from 78.1% debt-to-GDP last quarter. Nonfinancial businesses leverage rose to 73.8% from 73.3%, and this sector's slow but steady increase in debt remains a risk factor when the next recession strikes. After a brief pause, federal government debt-to-GDP jumped to 86.5% in Q1 from 85.5% in the prior quarter. Although it will take a decade or more, federal government leverage is on track to reach levels that have been problematic for other countries historically. Overall, 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 financials are positives for credit.

Figure 12: Leverage Up on Higher Government Debt, Nonfinancial Corporate Borrowing



Market Outlook

Long-term **Treasury rates** again fell sharply in the second quarter as the Fed signaled that it was prepared to ease monetary policy in response to rising economic risks. The benchmark 10-year Treasury note yield declined by 41 basis points (bp) to 2.00%, and the 30-year Treasury bond yield fell by 29 bp to 2.52% at the end of the second quarter (Figure 13). The rally in ten- and 30-year Treasuries accelerated since then, with yields falling to 1.58% and 2.02%, respectively, on August 14. That marked a record low yield for the long bond.

The Federal Open Market Committee (FOMC) already signaled a shift to more accommodative monetary policy in the first quarter. At its January 2019 meeting, the FOMC turned away from continued rate hikes toward "patience" on monetary policy during a period of higher economic uncertainty. In March, it eliminated projections of additional rate hikes in 2019 and announced that System Open Market Account (SOMA) portfolio runoff would slow in May 2019 and end in October 2019. The second quarter began with rising hopes for a U.S.-China trade deal. Interest rates rose modestly and the stock market rallied. However, in early May, trade negotiations between the U.S. and China broke down, and President Trump announced new 10% tariffs on a wider range of Chinese imports, rattling financial markets and denting business investment. In June, the FOMC opened the door to future rate cuts but left the fed funds rate target unchanged at 2.25-2.50%. It walked through that door on July 31, cutting the fed funds rate by 25 bp and accelerating the end of SOMA runoff to August 1, two months ahead of its prior schedule. As a result of this series of increasingly accommodative policy changes, financial conditions mostly eased during the second quarter and in the weeks since that time (Figure 14).

Figure 13: Rates Plunge, pricing Easier Fed[3]

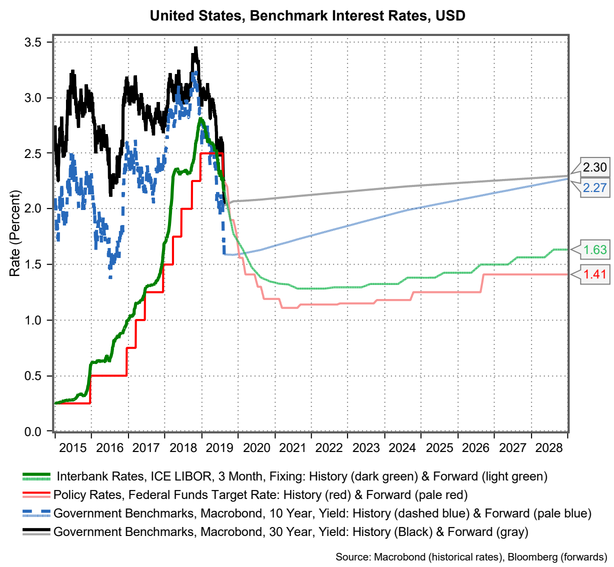
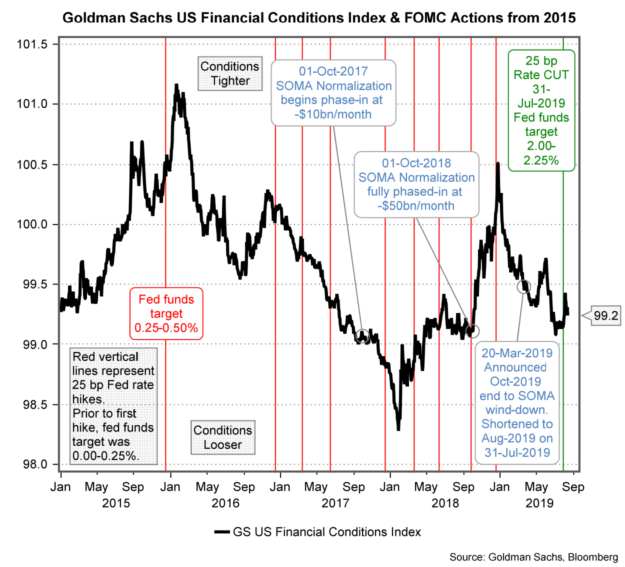


Figure 14: Financial Conditions (Mostly) Looser



Although we will not get updated economic projections from the FOMC until its next meeting concludes on September 18, barring a dramatic shift in its thinking, it's safe to say that markets are currently pricing in much larger rate cuts than the Fed. Markets now price in a little more than 50 bp of rate cuts by year-end 2019 and an additional 50 bp of rate cuts next year, bringing the fed funds rate target to 1.00-1.25% by late 2020 (Figure 13).

We currently expect a second 25 bp rate cut in September 2019 and a stable fed funds rate from then through 2020. However, risks lie mostly to the downside. If the U.S. and China do not reach a trade agreement by late 2019, the Fed could cut rates by an additional 25 bp in December and perhaps another 25 bp in 2020 in an effort to reinvigorate stalled business spending. More importantly, if consumer spending turns soft, the Fed almost certainly would respond forcefully to it. To be clear, we think a trade deal is more likely than not by year-end 2019 and we see strength in consumer spending continuing, which should prompt somewhat higher intermediate- and long-term Treasury rates from current levels. But we also see downside risks that not only justify current Treasury yields but could push them even lower.

[3] The fed funds effective rate recently has traded about 8 bp below the top end of the FOMC target range. In Figure 13, we add 8 bp to forward rates implied by overnight index swaps (OIS) to align them with historic target rates.

As the Fed guided markets toward more accommodative monetary policy, corporate **credit spreads** were little changed on balance in the second quarter. Investment-grade corporate bond spreads tightened by 5 bp to 121 bp in Q2.[4] They widened a bit since quarter-end, closing on August 14 at 128 bp. High yield bond spreads were more volatile but also ended Q2 near where they started.[5] The high yield bond index yield widened by 5 bp to 420 bp on June 30 but jumped to 467 bp on August 14 (Figure 15). Because Treasury yields fell and credit spreads were about flat in Q2, investment-grade corporate and high yield bonds again produced strong returns.

Figure 15: Spreads Flat as Treasuries Rallied…

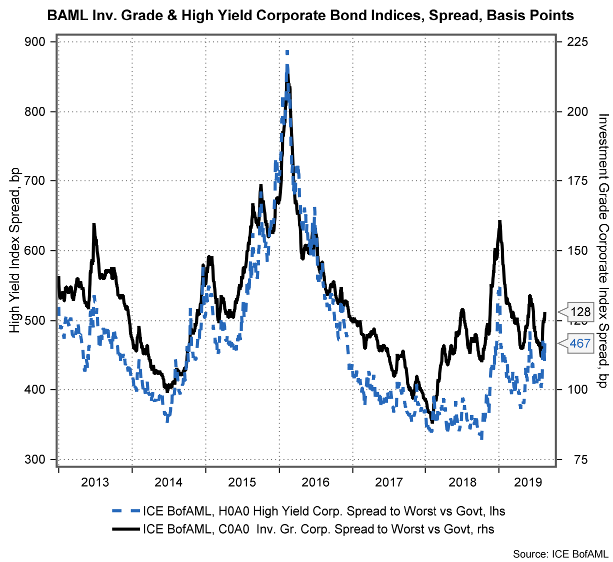
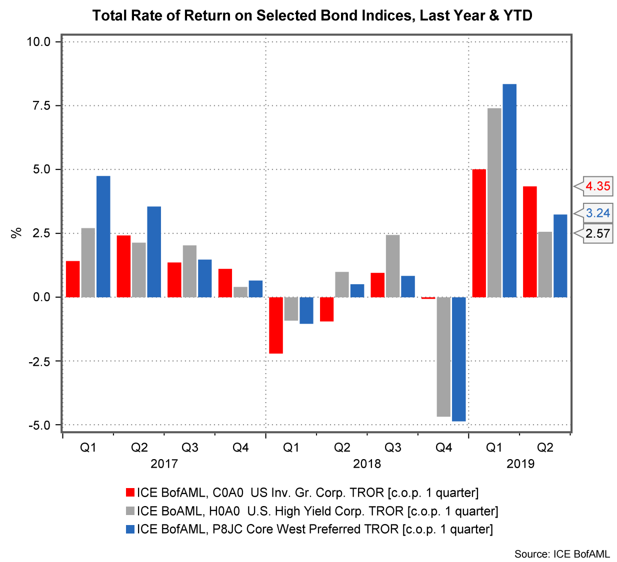


Figure 16: …Producing Strong Returns in Q2



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 second quarter, total return on the preferred index[6] (+3.24%) outperformed the high yield index (+2.57%) but lagged the investment-grade corporate bond index +4.35%).[7] Year-to-date through August 14, preferreds (+14.09%) outperformed both high yield (+9.56%) and investment grade corporates (+12.70%).

Credit conditions were about flat in the first quarter (latest data available), although nonfinancial companies showed some deterioration. U.S. banks' recent earnings reports indicate good performance continued in that sector through the second quarter. A statistic that did slip is corporate earnings after taxes, which fell 4.1% in the first quarter after gaining 10.1% in 2018. In

[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.

[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.

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

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

addition, the profit share of GDP slipped to 9.5% on a pre-tax basis and 8.5% after tax (Figure 17). Profit statistics were revised down with GDP benchmark revisions noted earlier, largely due to higher wage and salary income. As we noted in earlier Updates, we expected that competition for workers would boost wages and push the profit share of GDP back toward its long-term average, and new data reveal that is happening. Looking ahead, however, higher productivity, if sustained, should offset most or all of an increase in real wages from a tighter labor market. Corporate profits should remain a credit positive.

Figure 17: Profits Solid but Slowing Pretax

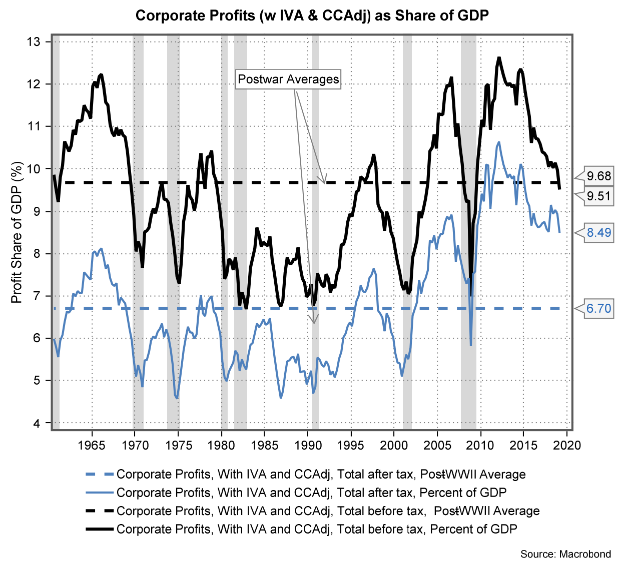
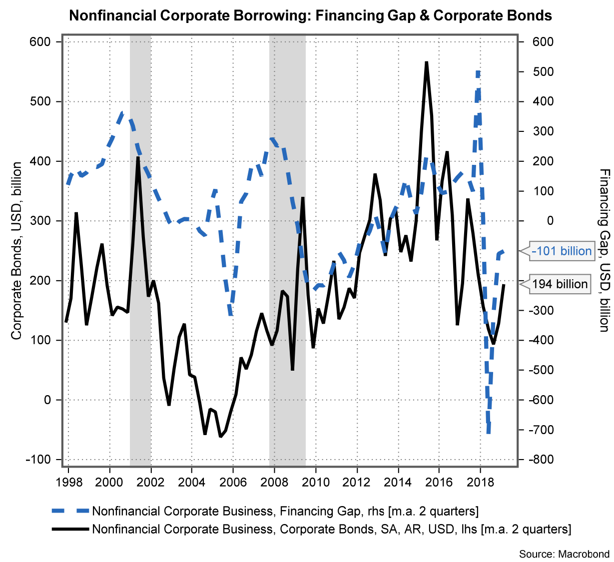


Figure 18: Less Investment, Lower Issuance



Despite modestly lower profits, the "financing gap," spending on capital investments minus internally generated cash, for nonfinancial businesses held about steady in the first quarter but remained negative. Figure 18 shows a two-quarter moving average to reduce quarterly volatility of this series. Internally generated cash continued to exceed capital investment, and net corporate bond issuance was modest. Until trade policy is more settled, capital expenditure growth and net corporate bond issuance should remain modest.

Nonfinancial corporate holdings of liquid assets relative to short-term liabilities improved slightly to 69.8% in the first quarter, but that is still well below a recent peak of 87% (Figure 19). Interest expense as a percentage of earnings before interest and taxes (EBIT) increased to 24.4% in Q1 as profits slipped, interest rates rose, and debt edged up. Although the Fed's recent rate cut and prospects for modest improvement in profits should ease interest burdens, we remain watchful of credit quality at nonfinancial companies, given increased leverage over the past decade.

Credit metrics at financial companies were generally steady, but commercial and industrial loan quality slipped. Overall bank loan delinquencies were unchanged at 1.53% in the first quarter compared to 1.70% a year earlier (Figure 20). Overall loan charge-off rates rose slightly to 0.47% in Q1 from 0.44% in 4Q2018 and 0.46% a year ago. Delinquency rates fell to 1.74% on real-estate loans but rose 18 bp to 1.14% on commercial and industrial loans. Delinquency rates on consumer loans were unchanged at 2.33% and charge-offs rose slightly to 2.25%. 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 the next downturn.

Figure 19: Liquidity Down; Interest Cost Up

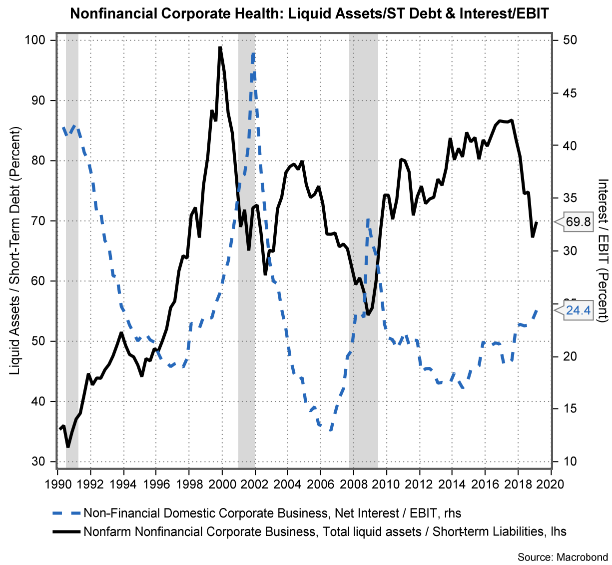
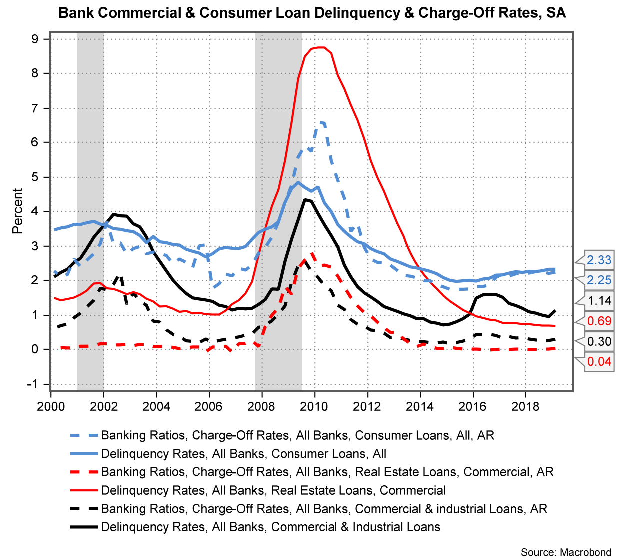


Figure 20: Loan Quality Good, but C&I Off



Summarizing our main views, we expect 2.2–2.7% 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 is likely to remain subdued for now but should accelerate with a trade deal and support rising labor productivity. Residential investment should be a smaller drag on growth over coming quarters and could even add a bit to GDP, but it is unlikely to be an engine of growth. Finally, financial conditions have eased substantially and should support the economy over the next several years. Inflation is likely to remain below the Fed's target. The FOMC probably will cut rates 25 bp in September, but that should be it for 2019 and 2020 if our forecast is correct. That 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. Risks to that outlook are mostly to the downside, however.

Credit markets posted strong returns so far in 2019 as Treasury rates fell and credit spreads narrowed as investors sought yield in a lower-rate environment. If U.S. economic growth remains above 2% – not a high bar – higher Treasury rates may present a modest headwind to performance over the next year or two. However, credit conditions mostly remain supportive, especially for financial companies, and credit spreads have room to narrow further. 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
August 14, 2019