First-Quarter U.S. Economic Update

May 2021

Summary of Recent Economic and Market Developments

Economic growth rose unexpectedly in the first quarter as vaccinations expanded and new COVID-19 cases declined sharply. In real GDP terms, the U.S. economy should surpass its prior peak sometime this quarter. Job growth accelerated and the unemployment rate fell, although total employment remains about 8.2 million jobs below its peak. Personal income soared, boosted by two rounds of stimulus payments. Personal consumption expenditures also rose substantially (+10.7% in Q1) but did not keep pace with income, adding to personal savings. Those savings should help sustain strong personal spending growth this year. Residential investment rose briskly, but limited availability of homes for sale dampened sales in recent months and drove home prices higher. Industrial production was hampered by cold weather and supply chain disruptions, but orders suggest rising output ahead. Business investment rose. Government spending surged, and monetary policy remained extremely loose. Inflation rose sharply and helped drive interest rates up substantially, while faster economic growth brightened an already solid credit outlook and narrowed credit spreads.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	2021:1	2020:4	2020:3	2020:2	2020:1	2019:4	2019:3	2019:2
Real GDP, Chg QoQ (%, SA, AR)	6.4	4.3	33.4	-31.4	-5.0	2.4	2.6	1.5
Real Personal Consump Expnds, Chg QoQ (%, SA, AR)	10.7	2.3	41.0	-33.2	-6.9	1.6	2.7	3.7
Real Business Inv ex Stuctures, Chg QoQ (%, SA, AR)	13.0	17.5	34.4	-25.5	-7.4	0.9	1.5	-0.4
Real Residential Investmt, Chg QoQ (%, SA, AR)	10.8	36.6	63.0	-35.6	19.0	5.8	4.6	-2.1
Real Private Domestic Final Sales, Chg QoQ (%, SA, AR)	10.6	5.5	38.7	-32.2	-5.7	1.5	2.7	2.9
Nominal GDP, Chg QoQ (%, SA, AR)	10.7	6.3	38.3	-32.8	-3.4	3.9	4.0	4.1
Corporate Profits, After Tax, Chg YoY (%, SA, AR)	11.8f	-2.4	2.8	-18.8	-5.7	1.3	-0.3	0.5
Nonfarm Productivity, Chg QoQ (%, SA, AR)	5.4	-3.8	4.2	11.2	-0.8	1.6	0.5	1.9
Nominal Personal Income, Chg YoY (%, AR)	29.0	3.7	6.0	8.2	1.8	2.9	3.5	3.8
Personal Savings Rate (%, SA)	27.6	13.5	14.1	19.0	12.9	7.2	7.3	7.1
Unemployment Rate (%, SA)	6.0	6.7	7.8	11.1	4.4	3.6	3.5	3.6
Nonfarm Payrolls, Chg QoQ (000, SA)	1,539	638	4,025	-13,000	-1,079	590	609	457
Household Employment, Chg QoQ (000, SA)	1,018	2,287	5,443	-13,436	-3,199	505	1,099	322
Federal Budget, 12-mo Deficit(-) or Surplus (% of GDP)	-19.9	-16.5	-15.5	-14.8	-4.8	-4.8	-4.7	-4.4
Consumer Price Index, Chg YoY (%, AR)	2.6	1.4	1.4	0.6	1.5	2.3	1.7	1.6
CPI ex food & energy, Chg YoY (%, AR)	1.6	1.6	1.7	1.2	2.1	2.3	2.4	2.1
Capacity Utilization (%, SA)	74.4	74.7	72.5	68.9	73.6	77.2	77.4	77.7
Rate or Spread (End of Quarter)	**2021:1**	**2020:4**	**2020:3**	**2020:2**	**2020:1**	**2019:4**	**2019:3**	**2019:2**
Federal Funds Rate Target (upper bound, %)	0.25	0.25	0.25	0.25	0.25	1.75	2.00	2.50
3-month LIBOR (%)	0.19	0.24	0.23	0.30	1.45	1.91	2.09	2.32
10-Yr Treasury Note Yield (%)	1.74	0.93	0.69	0.66	0.70	1.92	1.68	2.00
30-Yr Treasury Bond Yield (%)	2.41	1.65	1.46	1.41	1.35	2.39	2.12	2.52
ICE-BofAML US Corporate Index Spread to Worst vs Gvt	91	98	139	155	302	99	120	121
10-Yr Interest Rate Swap Spread (bp)	3.6	0.8	2.5	-1.8	2.5	-2.8	-10.5	-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

Springtime arrived early for the U.S. economy as rapid progress administering vaccines and a sharp downturn in new COVID-19 cases prompted relaxation of restrictions on both businesses and consumers over the course of the first quarter. Most forecasters expected economic growth would slow over the winter months; instead, it accelerated. Inflation-adjusted gross domestic product (real GDP) rose by 6.4% in Q1, following a 4.3% gain in Q4. Economists also raised their GDP growth forecasts for the rest of 2021 to 9.3% in Q2 and 6.6% for 2021 overall, 1.7% higher than February's consensus forecast.[1] Stronger U.S. growth is also expected next year, with the consensus 2022 GDP forecast rising to 4.3% today from 3.7% in February.

An earlier and stronger rebound means the U.S. economy will surpass 4Q2019's level of real GDP during the current quarter (it fell just short in Q1). Moreover, if current GDP forecasts are correct, the U.S. economy will recoup growth lost to the pandemic by the end of this year. Specifically, if real GDP had continued to expand at a 2.0% rate each quarter since 4Q2019, it would have grown to $20.03 trillion at year-end 2021, which is slightly below the current consensus forecast of $20.07 trillion for 4Q2021 GDP. That would be several years earlier than expected using forecasts from last summer. It reflects almost unimaginable scientific and therapeutic progress against COVID-19, extraordinary fiscal and monetary support, and a dynamic and flexible economy. Let's see how it happened.

The **labor market** recovery accelerated throughout the first quarter, with large employment gains arriving several months earlier than expected, in part due to rapid deployment of COVID vaccines. Nonfarm payrolls jumped by 1.54 million jobs in Q1 and added 266,000 in April, leaving overall nonfarm employment at 144.3 million (Figure 2). Despite that growth, total nonfarm payroll employment remains 8.2 million jobs below the February 2020 peak and roughly 10 million below where it might have been absent the pandemic. As more segments of the economy reopen or expand capacity, businesses will be looking to add more workers, and strong employment growth should continue.

There is a caveat, however. Job openings have significantly outpaced hiring in recent months, leaving some 8.1 million unfilled jobs in March, up from 6.75 million in December 2020. This is unusual when unemployment is relatively high: 6.1% in April compared to 3.5% in February 2020 (Figure 3). Reasons for slower uptake of available employment could include concerns over contracting COVID while working, need to remain home to care for another household member (especially children unable to attend school in person), and willingness to remain on unemployment benefits rather than taking a job.[2] Those headwinds should diminish over

[1] Unless noted otherwise, forecasts are from the *Survey or Professional Forecasters*, Federal Reserve Bank of Philadelphia, February 12, 2021 and Bloomberg® *U.S. Monthly Economic Survey*, May 14, 2021.

[2] Persons receiving unemployment insurance fell from 5.18 million in the week ending December 27, 2020 to 3.84 million as of March 13, 2021, a decline of 1.34 million over 11 weeks. On March 11, supplemental unemployment benefits of $300 per week were extended from March 14 to September 6 under the American Rescue Plan Act. Over the next eight weeks to May 8 (latest data available), continuing claims fell by only 100,000

coming months as COVID vaccinations expand, in-person school resumes and care providers become more widely available, and supplemental unemployment benefits expire, increasing financial incentives to work. Of course, there are some longer-term headwinds too, including skill or geographical mismatches between job openings and job seekers, as well as early retirements or other permanent or long-term withdrawal from the labor force. Nonetheless, some of the temporary headwinds are likely to remain in place through the summer months, and job growth may lag demand for a time.

Figure 2: Jobs Recovering; More to Do

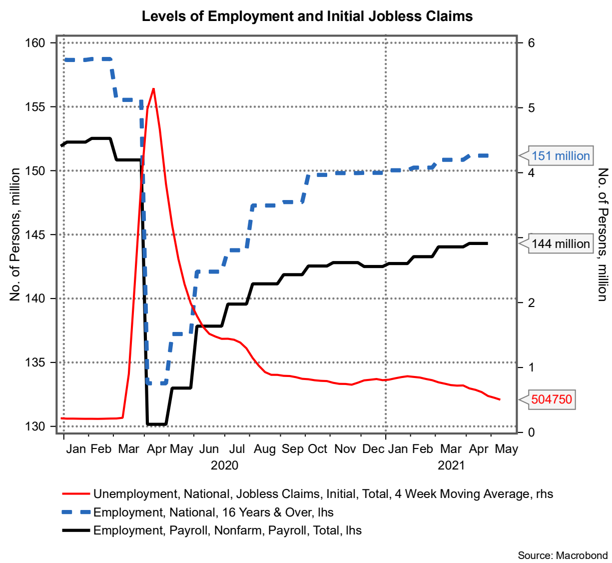
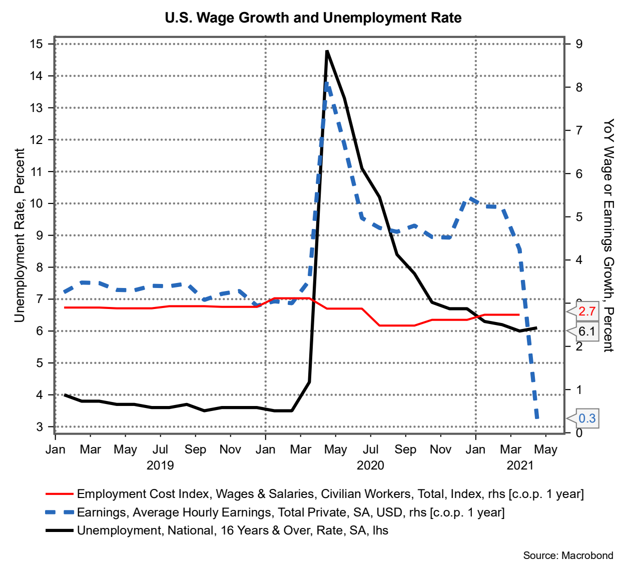


Figure 3: Unemployment Down; Wages Mixed



Strong labor demand should encourage wage increases. For now, the picture on wages is mixed (Figure 3). Average hourly earnings growth slowed sharply in March and April, although that largely reflects changes in employment composition. Higher-wage workers who could work remotely boosted average hourly earnings at this time last year. Today, lower-wage employees are returning to work — especially in leisure and hospitality, where there has been rapid job growth since February —and average hourly earnings growth slowed. The employment cost index, which adjusts for compositional shifts, shows wage growth near its pre-pandemic pace, which is impressive given much higher unemployment today. We expect wages to rise and boost income over coming quarters. It could also invite inflation, which we will discuss later.

Fueled by two rounds of fiscal stimulus[3], **personal income** soared in the first quarter (Figure 4). Nominal personal income, which includes transfer payments, rose 59% annualized in Q1 and 29% over 12 months ending in March 2021. Wage and salary income over the same periods was less eye-popping at 6.7% and 4.4%, respectively, but it is still impressive —

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even as initial jobless claims declined rapidly (Figure 2). That does not mean extended unemployment benefits caused the slower transition to work, but they are an incentive to remain unemployed, and the timing is curious.

[3] $900 billion in stimulus relief included in the Consolidated Appropriations Act of 2021 passed on December 27, 2020 followed by the $1.9 trillion American Rescue Plan Act of 2021, passed on March 11. The bills authorized payments to individual taxpayers of $600 and $1,400, respectively, among other provisions.

particularly over the one-year period given substantially lower total employment today. Transfer payments provided major support to households through the pandemic, totaling $5 trillion over 12 months ending in March, $1.8 trillion higher than the same period a year earlier. While additional transfer payment benefits have been proposed, it is unlikely that they will increase so substantially over coming quarters. Low interest rates are likely to hold down investment income as well. Personal income growth will have to come primarily from wage & salary and proprietors' (i.e., businesses owners') income. Employment and wage gains should drive the former, and rising demand as consumers and businesses boost spending should drive the latter.

Figure 4: Income, Spending Soar on Stimulus

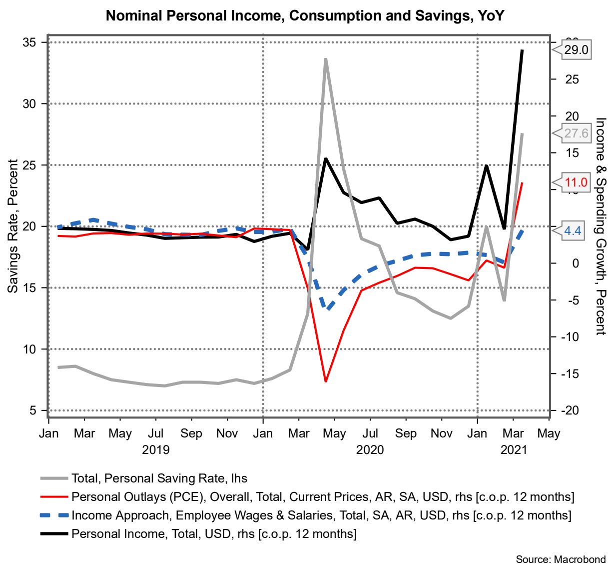
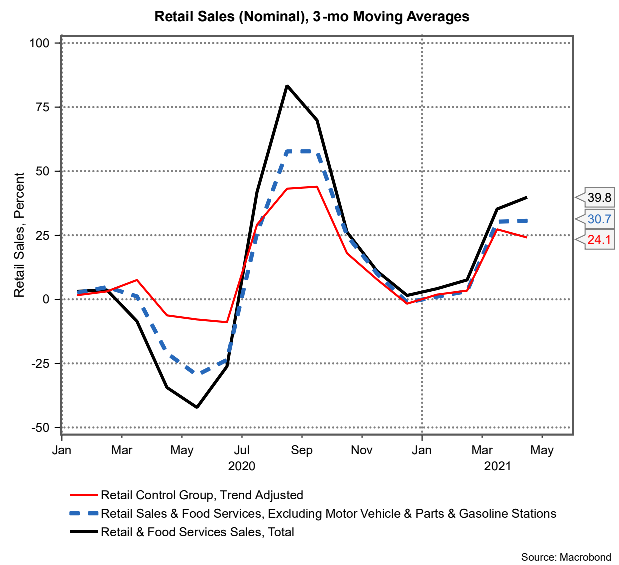


Figure 5: Spending on Goods Jumped



Flush with income, households spent freely in the first quarter as more parts of the economy reopened. Nominal **Personal consumption expenditure** (PCE) rose 14.6% in Q1 and 11.0% over 12 months ending in March 2021 (Figure 4). Adjusted for inflation, real PCE rose by 10.7% in Q1 and 8.5% YoY. Spending on goods was particularly strong. Retail sales, which are weighted more toward goods rather than services, rose 35.2% in Q1 and 39.8% over three months ending in April compared to the prior 3-month period (Figure 5). Although retail sales were flat in April, they were still 17.9% higher than in February 2020. With employment and wages rising and more opportunities to engage in activities that were restricted earlier in the pandemic, consumption growth should remain a bright spot for the economy. In addition, record stock prices and rising home values add to consumer wealth; they too should support consumer spending this year.

Despite large PCE gains, income substantially outpaced spending in the first quarter. That pushed the **savings rate** up to 21.0% in Q1 overall and 27.8% in March, second only to a record 33.7% savings rate at the height of lockdowns in April 2020 (Figure 4). The high amount of personal savings — some $4.1 trillion in Q1 compared to $1.2 trillion in 4Q2019 — should provide additional support to consumer spending over coming quarters.

The **housing market** continued to grow solidly in the first quarter, although low inventory of homes for sale as well as homebuilding material and labor shortages limited gains relative to very strong demand. Combined new and existing home sales averaged 7.3 million units in Q1 and slipped to 6.7 million in April, down from an average of 7.6 million in 4Q2020 (Figure 6). Homes available for sale fell to an average of just 1.35 million units, or 2.2 months' supply, in the first quarter. It rose to 1.5 million (2.6 months' supply) in April. Although mortgage rates rose modestly, they remain low, and demand for homes was robust, especially outside urban areas. Not surprisingly, home prices jumped. The S&P/Case-Shiller 20-city composite home price index was up 13.3% over 12 months ending in March (latest data available), much faster than just a few quarters ago (Figure 6).

Despite a modestly slower pace of home sales, residential investment rose 10.8% in the first quarter as homebuyers spent to update their newly purchased homes. In addition, a tight market convinced other homeowners to stay put and renovate their existing homes, which also adds to residential investment. Strong demand and rising prices will generate a supply response (i.e., more building), but it takes time to acquire land, obtain permits, and build homes before they can be sold. Residential investment should remain a bright spot for the economy over the next several years.

Figure 6: Sellers' Market for Houses

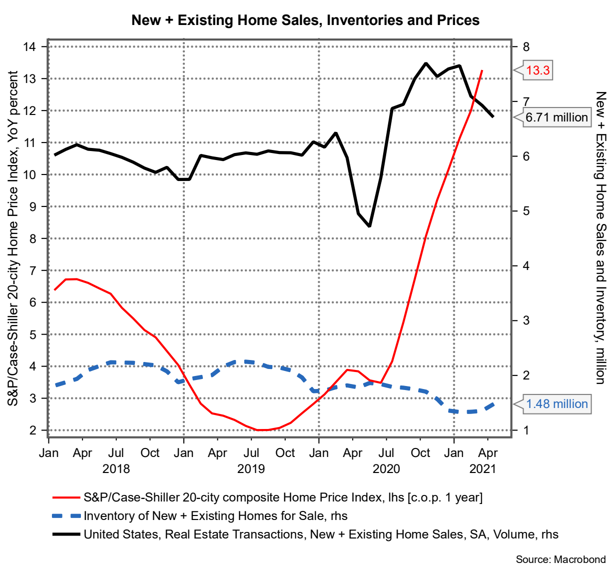
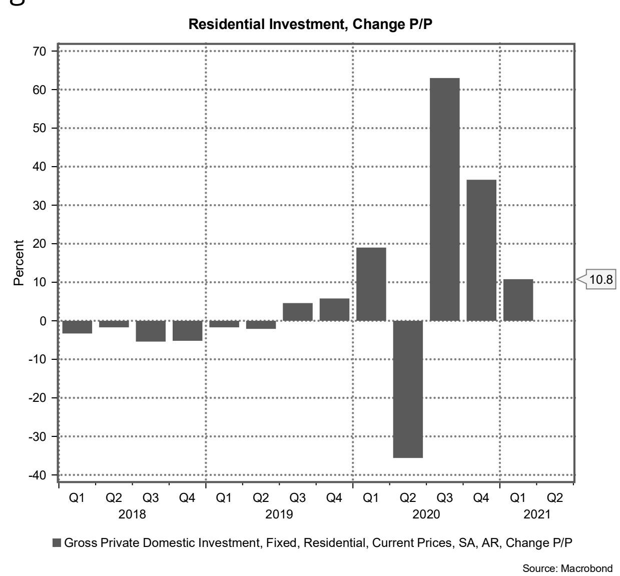


Figure 7: More Gains in Residential Investment



Industrial production rose only modestly in the first quarter, hampered by a sharp decline in output in February as unusually cold weather caused power outages and production shutdowns in many areas, particularly in Texas. Industrial output rose 1.2% in Q1 but slipped 3.2% over three months ending in April compared to the prior 3-month period (Figure 8). Output remained down 2.7% in April compared to its pre-pandemic peak in February 2020, However, forward-looking data suggest industrial production should surpass that level soon. The Institute for Supply Management's manufacturing survey was at 60.7% in April 2021 (50% is neutral) showing orders growing, backlogs rising and inventories falling. Factory orders were up 18.3% in Q1, and orders for core capital goods (nondefense, excluding aircraft) were up 8.3%. Current orders and backlogs should keep manufacturers busy for some time, and rising consumer spending should keep industrial output moving sustainably upward. As with housing, however, manufacturers face materials and labor constraints that will slow production until supplies recover or labor-saving investments can be made. Automobile manufacturers, for example, announced some plant shutdowns due to tight supplies of semiconductor chips used in cars and trucks. These bottlenecks will clear, but it will take time.

Figure 8: Cold, Shortages Hit Manufacturers

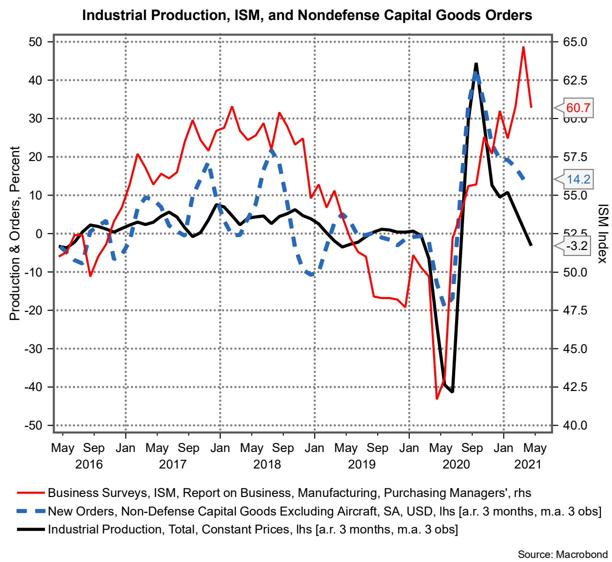
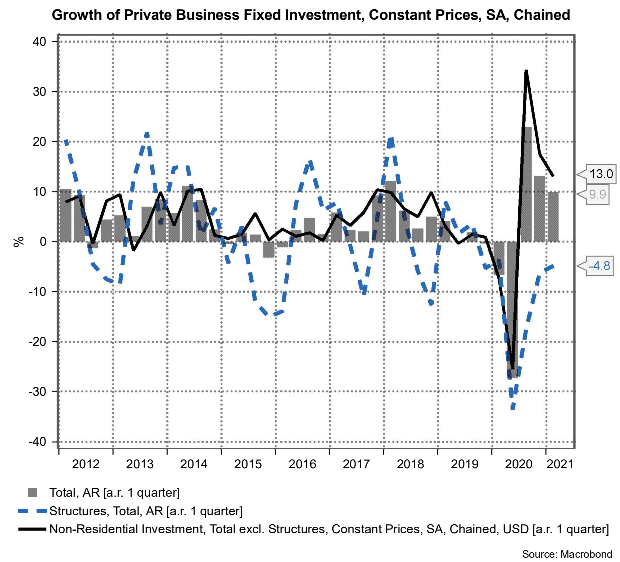


Figure 9: Core Business Investment Strong



Real **business investment** posted strong gains in the first quarter (Figure 9). Investment in business structures remained a drag; it was down 4.8%. As we have noted for some time, with many businesses continuing to operate remotely, there is little need for new office construction. On the other hand, "core" business investment excluding structures again rose briskly, up 13.0% in Q1, as companies scrambled to catch up with earlier investment cutbacks and rising demand. Capacity utilization was at 74.5% in April, little changed since year-end 2020 and still 2.0% below its February 2020 level. Nonetheless, the fact that utilization is flat despite heavy investment is another sign of strengthening demand. Given our positive outlook for continued economic growth, investment spending is likely to remain hotter than we previously expected, although it could cool quickly when utilization rates pull back.

The **trade deficit** widened in Q1 for the third consecutive quarter, although trade volumes improved considerably (Figure 10). Net exports subtracted 0.9% from real GDP growth in Q1. Imports and exports jumped 18.1% and 8.1% YoY, respectively, in March. Of course, trade volumes plunged in spring 2020, so while those annual gains show a sizable recovery, they don't say much about the current trajectory of trade flows. However, quarterly changes in imports and exports for Q1 reveal 21.1% and 18.7% annualized growth, respectively. This is good news for both the global economy and U.S. exports, which substantially lagged imports earlier in the recovery. With consumer demand strengthening, we expect import growth to remain firm, so it is encouraging to see exports expanding as well. While trade is likely to remain a drag on U.S. real GDP growth this year, it may be smaller than we feared a quarter or two ago.

Figure 10: Global Trade Rebounds

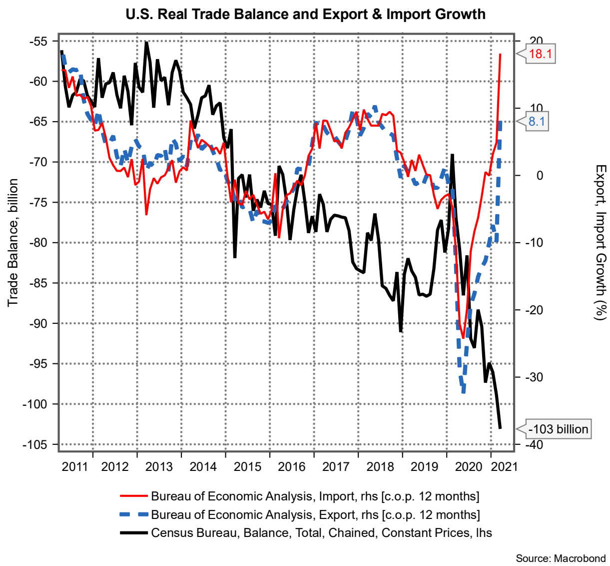
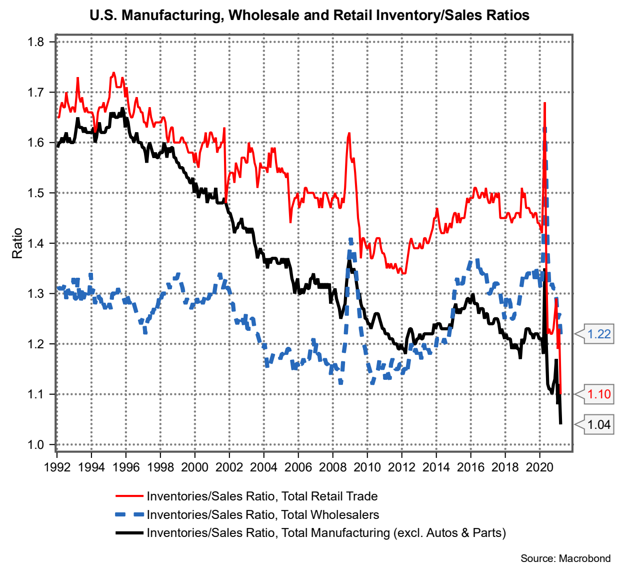


Figure 11: Lean Inventories to Boost Orders



We already noted that demand was unexpectedly strong in the first quarter while output rose only modestly. As a result, businesses cleared their shelves, and falling **inventories** subtracted 2.6% from real GDP growth in Q1. Because inventories were relatively lean even before the quarter started, they are at or near record lows relative to sales across major goods sectors today (Figure 11). We expect inventories to rebound, adding to orders and boosting GDP, although strength in consumer demand may delay it for a quarter or two.

Federal stimulus bills lifted real **government consumption** rapidly in the first quarter (Figure 12). Federal government spending rose 13.9%, and state and local spending rose by 1.7%, the first increase since 1Q2020. Because the American Rescue Plan Act passed only in March, nearly all of its spending lies ahead. We expect continued growth in federal government spending this year, albeit smaller than in Q1. With the economy — and consequently, tax receipts — recovering, we also expect moderate gains in state and local spending over coming quarters.

Summarizing the first-quarter economic situation, sector contributions to real GDP growth of 6.4% break down as follows: Personal Consumption Expenditures (+7.0%), Residential Investment (+0.5%), Business Investment (+1.3%), Inventory Change (-2.6%), Net Exports (-0.9%), and Government Consumption (+1.1%). The first three components equal **Private Domestic Final Sales**, which rose by 10.6% and reflects impressive progress against COVID-19, extraordinary fiscal and monetary support, and a dynamic and flexible private sector economy.

Inflation rose sharply as economic activity expanded in the first quarter and "base effects" from lower prices a year ago rolled into annual inflation calculations. For 12 months ending in April, the consumer price index (CPI) was up 4.2% overall and 3.0% excluding food and energy (Figure 13). The PCE deflator was up 2.4% overall and 1.8% excluding food and energy over 12 months ending in March (latest data available). That is the largest annual increase in CPI excluding food and energy since January 1996; the core PCE deflator last saw this inflation rate in February 2020. CPI inflation is likely to peak in the next several months. Part of that is base effects: consumer prices fell in March to May 2020, but then rose quickly (around ½ percent per month) in June and July. Inflation in May 2021 will almost certainly exceed last year's *lower* prices, but it's not likely to top June and July's roughly 1% increase. In addition, with foreign oil producers set to increase output over coming months, we should not see another rapid runup in energy prices. However, we recognize that near-term shortages could keep prices running hot for a time, and inflation may not peak until late in the third quarter.

Figure 12: May I Have Some More (Stimulus)?

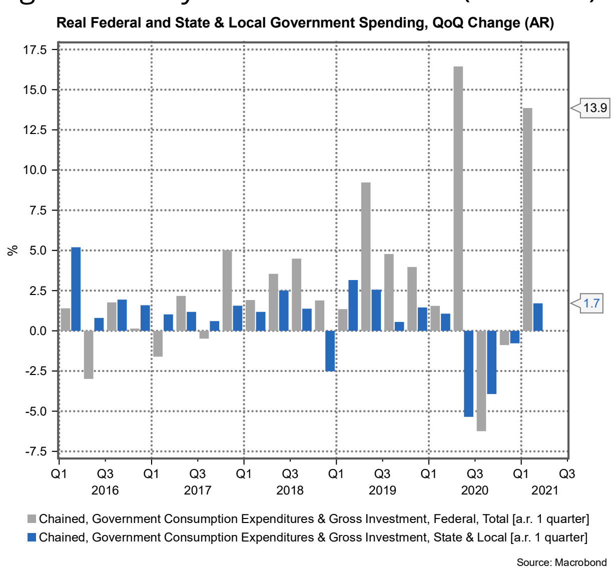
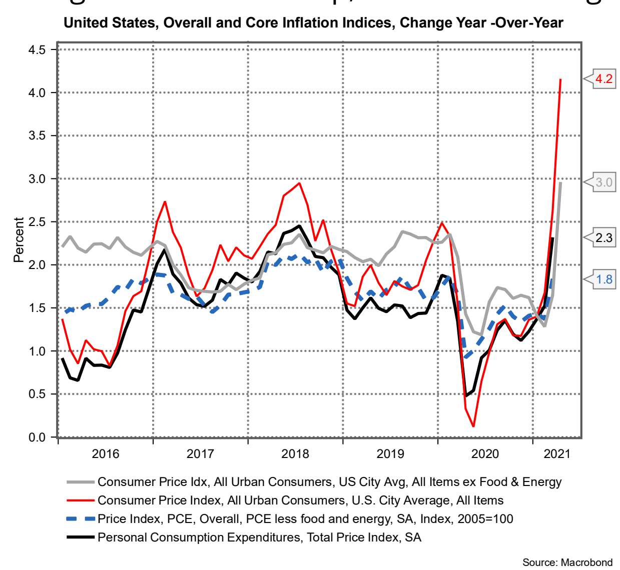


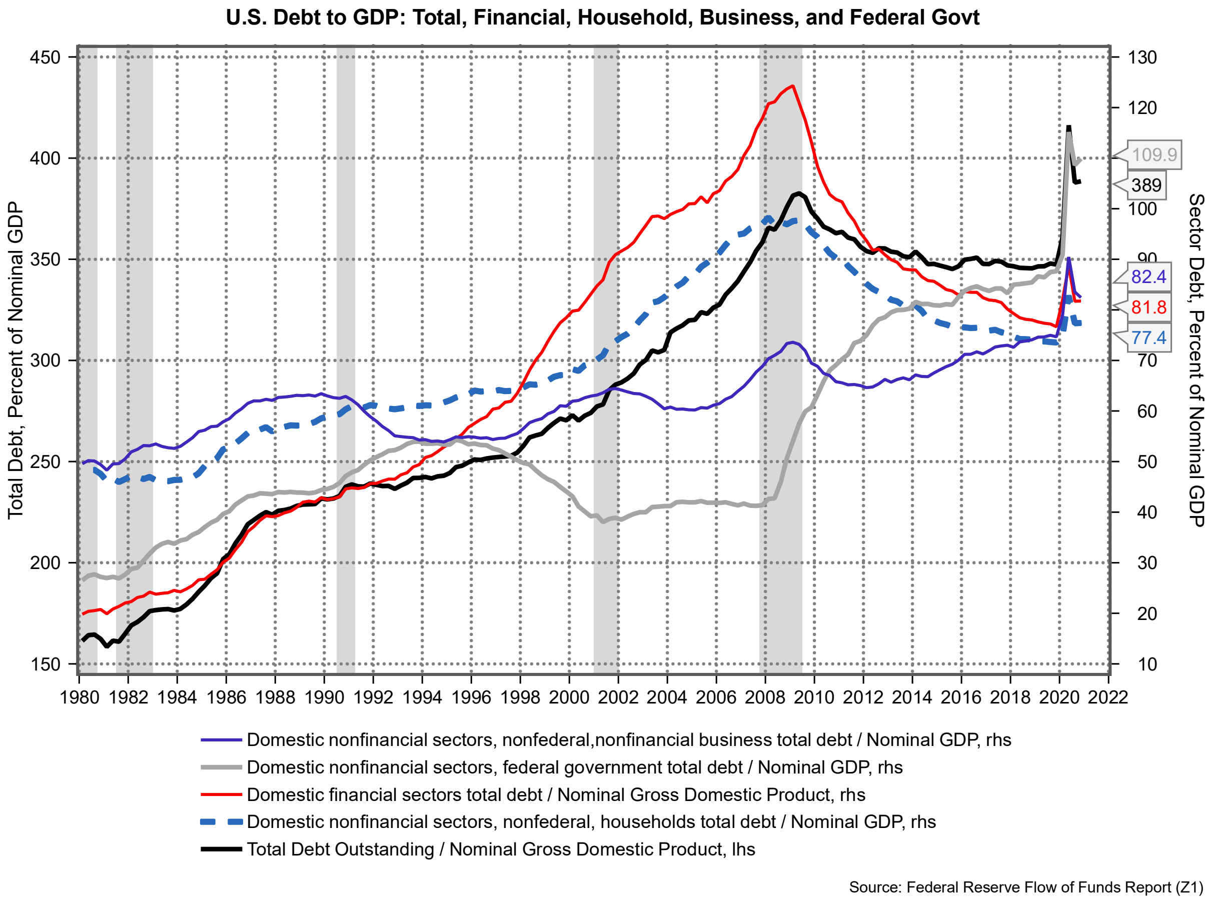
Figure 13: Inflation Up, but for How Long?



Although the rapid inflation gains described above will subside relatively quickly, we think core PCE inflation will remain above 2% for some time. Among U.S. goods producers, capacity utilization has tightened — only modestly so far, but rising demand should keep it moving upward. Manufacturing firms have been reporting that they are paying much higher prices for materials and other inputs, with the ISM Purchasing Managers' prices paid index at 89.6 in April, its highest level since before the global financial crisis. Skilled labor shortages in many goods-producing industries cannot be addressed rapidly, which may limit their ability to increase output despite higher capital investment. As the global economy recovers, commodity prices should remain under upward pressure, and already strained supply chains may become even more stretched. While there remains substantial excess goods-producing capacity abroad, it will take time for it to ramp up to meet rising demand, and trade barriers still constrain or raise prices on some imports. In services, a large pool of unemployed persons can facilitate expansion, but elevated job openings in the U.S. could spur wage inflation and, in turn, higher prices. Rapidly rising demand should drive higher prices for travel, leisure and other services that were restricted during the height of the pandemic.

We do expect higher supply in response to rising demand, but the frictions described above could delay it and keep core PCE inflation above consensus estimates of about 2% in 2022-23. We will be joining the Federal Reserve in keeping a close eye on inflation data over coming quarters.

Figure 14: Debt-to-GDP Up on Federal Deficit Spending; Private Debt Growth Subdued



Broad **balance sheet trends** through the fourth quarter of 2020 (latest data available) show little change in level or trend compared to 3Q2020 (Figure 14). Overall debt-to-GDP rose to 389% in Q4, up by less than 1% over Q3. Federal government debt continued to rise quickly, pushing federal government debt-to-GDP up by 1.3% in Q4 to 109.9%. Household debt-to-GDP was unchanged at 77.4%, while nonfinancial business borrowing dropped from 83.5% to 82.4% in Q4. Financial business borrowing edged up by 0.1% to 81.7%.

Our views on overall debt trends have not changed. Private-sector debt ratios should trend lower as the economy recovers, although it will take time for them to fall below 4Q2019 levels. However, government debt to fund recent stimulus packages will rise substantially in 2021. Current projections from the Congressional Budget Office show federal government debt-to-GDP flattening for a handful of years beyond that, but proposed legislation could tilt it up or down. The Federal Reserve' purchases of Treasury securities and low interest rates make servicing Treasury debt easy, but its growth is not risk-free, especially as inflation moves up. Long-term investors should not forget that.

Market Outlook

A broadening economic recovery and more optimistic growth outlook for 2021 and 2022 pushed up long-term **Treasury rates** sharply in the first quarter (Figure 15). The benchmark 10-year Treasury note yield rose 81 basis points (bp) to 1.74% in Q1, although it dropped back to 1.56% as of May 25. The 30-year Treasury bond yield rose 76 bp to 2.41% in Q1 and closed at 2.25% on May 25. Short rates held steady, leading to a steeper yield curve and higher market forward rates. Reflecting a brighter economic outlook and prospects for moderately higher inflation, the 10 year forward 10-year Treasury rate is now just under 2.9%, compared to about 1.8% at the end of 3Q2020 and 2.7% at the end of 2019.

Figure 15: Rates Up on Stronger Outlook[4]

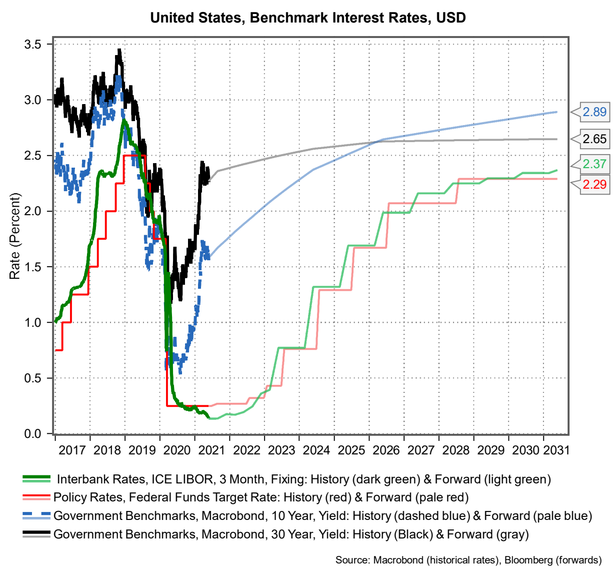
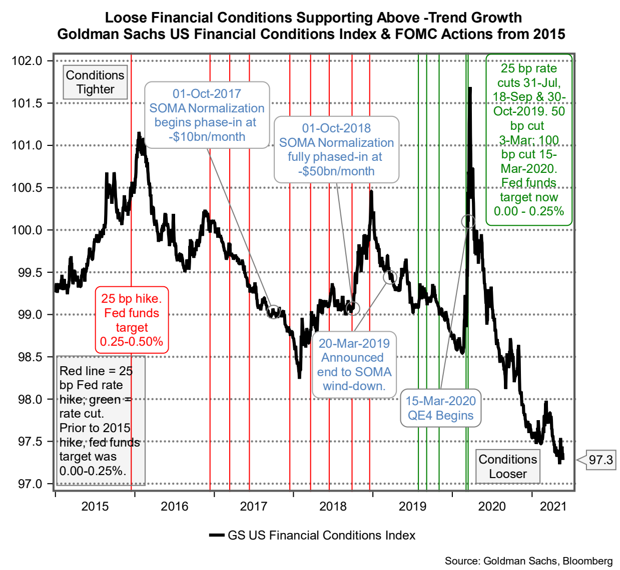


Figure 16: Monetary Policy Very Loose



Consistent with its prior guidance, the Federal Reserve left monetary policy unchanged in 2021. The Federal Open Market Committee (FOMC) held the fed funds rate target at 0-0.25% and the Fed purchased approximately $80 billion Treasuries and $40 billion agency mortgage-backed securities per month in its System Open Market Account. It expects to continue those purchases “until substantial further progress has been made toward the Committee’s maximum employment and price stability goals.”[5] While that language is deliberately vague, markets currently expect the FOMC to begin trimming asset purchases in late 2021 or early 2022 over the course of about 10 months. The Fed may signal that shift at its annual Jackson Hole conference in August or at the September 22 FOMC meeting. Despite

[4] The fed funds effective rate recently has traded about 19 bp below the top end of the FOMC target range. In Figure 15, we add 19 bp to forward rates implied by overnight index swaps (OIS) to align them with historic target rates.

[5] Board of Governors of the Federal Reserve System, FOMC *Meeting Statement*, April 28, 2021.

an improved economic outlook, the FOMC's last "dot plot" from March showed Committee members expected the fed funds rate to remain near zero through year-end 2023. We will find out if those views have changed when the Fed's updated projections are released on June 16. Reflecting inflation and other risks noted above, market forward rates show a rate hike in late 2022 and a fed funds target of 50-75 bp at the end of 2023 (light green line in Figure 15), 50 bp above the Fed's median forecast in March.

Figure 17: Money Supply Up, but Not Crazy

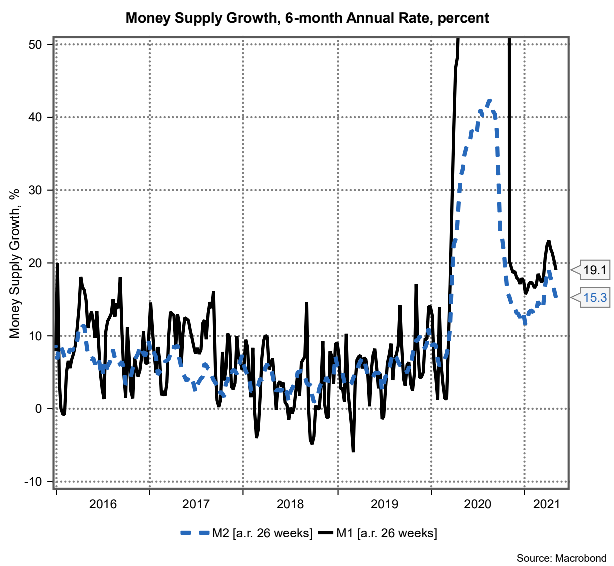
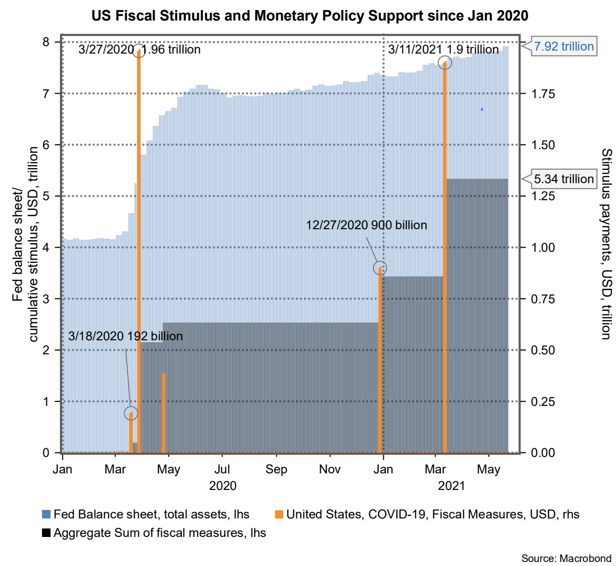


Figure 18: Unprecedented Policy Support



Highly accommodative monetary policy has kept financial conditions very loose. Indeed, financial conditions eased further this year even as economic growth picked up (Figure 16). Easy Fed policy spurred faster money supply growth (Figure 17). Note that the spike in money supply last year resulted from a change in bank reserve requirements for deposits. The Fed eliminated deposit reserve requirements in March 2020, which meant reserves held for that purpose suddenly were included in money supply, exaggerating their growth rates, especially for M1, which exceeded 1800% during the 6-month period following the change. (We have limited the y-axis to 50% make more relevant movements visible.) Current 6-month growth rates of 19% for M1 and 15% for M2 are high but aligned with the Fed's objective of raising inflation. Of course, the policy challenge is achieving higher inflation without pushing it too high. Time will tell if the Fed gets it right, but inflation risk clearly has increased in the U.S. As inflation rises, markets should price in a buffer for potential inflation overshoot. We expect longer-term interest rates to trend moderately higher over the balance of 2021.

Figure 18 combines the federal government's COVID fiscal support with the Federal Reserve's balance sheet expansion.[6] The orange bars show fiscal stimulus legislation enacted to address the COVID-19 pandemic; dates when each major bill passed and bill size are labeled. Black bars show cumulative fiscal stimulus since the pandemic started, now over \$5.3 trillion. Blue bars show the Federal Reserve's balance sheet, which has grown from \$4.2 trillion to

[6] With thanks to our economic data provider, Macrobond Financial AB, for assistance preparing this graphic.

$7.9 trillion currently. Even for the U.S. government, those are big numbers! And they did what they were intended to do: support the U.S. economy through the worst of the pandemic and help it recover lost output and employment sooner than it would have otherwise. Fiscal and monetary stimulus may be larger than they needed to be (even recognizing that some overshoot is desirable) to achieve this result, but they were effective. And still more is on offer, with additional spending working its way through Congress and continued asset purchases by the Fed. *The higher inflation that has ensued is a policy choice, not a policy mistake — at least not yet*.

Figure 19: Credit Spreads at Post-GFC Lows

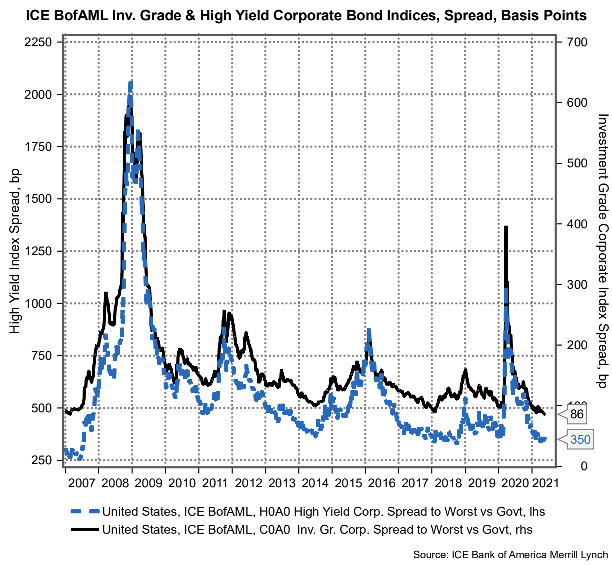
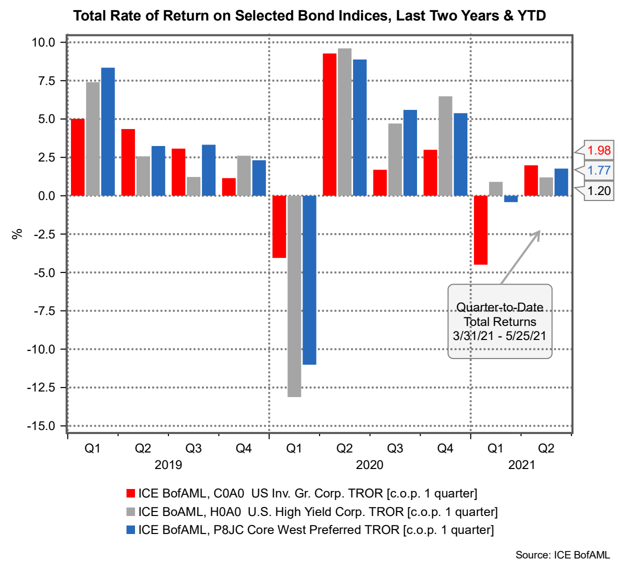


Figure 20: Rate Headwinds Dampen Returns



A strengthening economy, rising corporate profits and easier financial conditions continued to push corporate **credit spreads** tighter in the first quarter and so far in Q2, bringing spreads to their lows since the global financial crisis. Investment-grade corporate bond spreads narrowed by 7 bp to 91 bp in Q1 and edged down to 86 bp as of May 25 (Figure 19).[7] High yield bond spreads narrowed as well, moving from 390 bp to 353 bp during the first quarter; they have held about steady since then, closing on May 25 at 350 bp.

Spreads on preferred securities fell between those of investment-grade and high yield corporate bonds, although their complex call features make simple spread measures difficult to illustrate. 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 20 shows total returns on selected ICE BofA indices in recent quarters. Benchmark interest rates (higher) and credit spreads (lower) have moved in opposite directions so far in 2021, which is typical in a strengthening economic environment. Higher interest rates affected investment-grade corporate bonds more than high yield bonds and preferred and contingent capital securities (the high yield and preferred indices have similar interest rate durations,

[7] Investment-grade corporate bond spread is represented by the ICE BofA 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 5/25/2021.

while the corporate bond index duration is longer). Investment-grade corporate bond spreads also narrowed by less than high yield bond and preferred and contingent capital securities' spreads. Total return in Q1 on the preferred index[8] (-0.42%) lagged the high yield index (+0.90%) but outperformed the investment-grade corporate bond index (-4.49%).[9] So far in 2021, the high yield bond index is ahead (+2.11%) as those credit spreads fell more substantially. Return on the preferred index was also positive (+1.35%), while return on the investment-grade corporate bond index was in the red (-2.60%).

Figure 21: Bankruptcies Trending Down

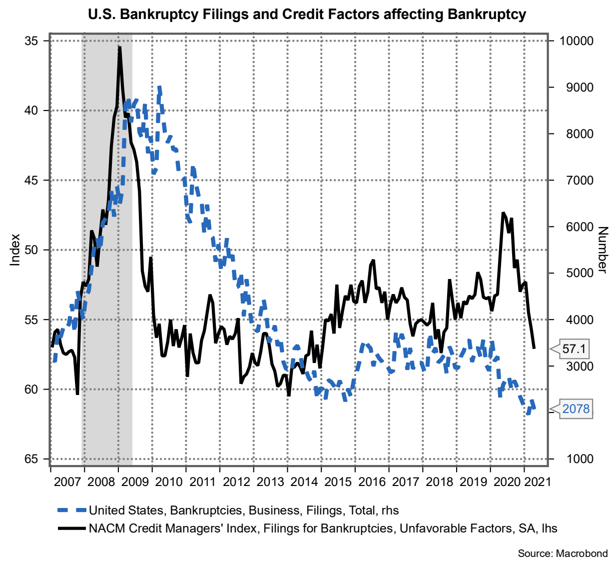
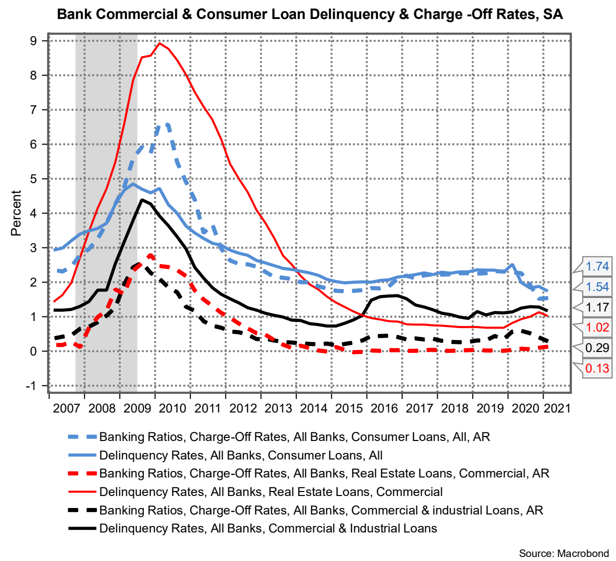


Figure 22: Loan Quality Better than Feared



Credit conditions broadly continue to improve along with the economy. Factors unfavorable to bankruptcy filings as measured by the National Association of Credit Management continued to decline, and business bankruptcy filings remain very low (Figure 21, data through April 2021). Similarly, bank loan quality remained good and improved in most categories in the first quarter. Total bank loan delinquencies and charge-offs in Q1 were 1.5% and 0.3%, respectively, down 0.1% compared to last quarter and flat or down slightly compared to 4Q2019, before the pandemic struck (Figure 20). Consumer loan delinquencies and charge-offs were 1.5% and 1.7%, respectively, little changed from the prior quarter. Commercial and industrial loan performance improved by 0.1-0.2% in Q1, with delinquencies at 1.2% and charge-offs at 0.3%. Real estate loans showed no material change, with delinquencies at 1.9% and charge-offs under 0.1%. This is much better loan performance than expected given the severity of the economic slowdown in 2020, and problem loans should remain subdued as economic growth continues in 2021.

[8] Preferred index is the ICE BofA 8% Constrained Core West Preferred & Junior Subordinated Securities Index[SM] (P8JC). Index data through 5/25/2021.
[9] Total return is not annualized and includes both price change and income. Past performance does not guarantee future performance.

The industries that are major issuers of preferred and contingent capital securities remain broadly healthy. As we discussed in last quarter's Update[10], we think banks lead that list, but higher interest rates also have improved the outlooks for insurance and other financial services, while utilities, and communications businesses benefit from faster economic growth. Even energy companies, which seemed most at risk as economic activity plummeted in 2Q2020, revived in recent quarters as vaccine rollouts and a brighter economic outlook drove up energy demand and prices.

We continue to see risk from the pandemic receding in 2021, leading to above-trend economic growth. At the same time, enormous fiscal and monetary stimulus means higher inflation risk than we anticipated a quarter or two ago. Those translate to a favorable credit environment and a moderately higher interest rate environment, which should favor fixed income sectors with higher credit spreads and moderate interest rate risk — precisely what preferreds offer today. After a sustained rally since the lows in March 2020, we have had to lower our expectations for returns this year. However, given short-term rates near zero, intermediate Treasury yields below 1.6%, record household savings, and ample liquidity, investors should continue to search for yield. We continue to see opportunity in the preferred and contingent capital securities markets.

Flaherty & Crumrine Incorporated
May 25, 2021

[10] *Fourth-Quarter U.S. Economic Update*, Flaherty & Crumrine Incorporated, February 17, 2021.