Flaherty & Crumrine

First-Quarter U.S. Economic Update
May 2020

Summary of Recent Economic and Market Developments

The coronavirus pandemic has upended economic growth in the United States and globally. Real GDP in the U.S. fell 4.8% in the first quarter, and economists expect Q2 GDP to post the largest decline on record: -32.2%. Few segments of the economy were spared in Q1. Personal consumption fell by 7.6%; business investment skidded 8.6%; and even government spending slowed to just 0.7% as state and local spending flatlined. Job losses totaled more than 20 million through April, and the unemployment rate jumped to 14.7%. Stock and credit markets plunged, and credit spreads widened sharply. The Federal Reserve responded swiftly and forcefully. It cut rates to near zero, reinstated quantitative easing and resurrected and expanded lending facilities from the financial crisis. Congress passed the CARES Act and other stimulus measures worth about $3 trillion, with more probably on the way. Markets rebounded as policy responses, social distancing and medical progress reduced downside risk to the economy. The second quarter should mark a bottom for economic growth, but it's likely to take a number of years to recover growth lost in the current recession. With Treasury yields low, credit spreads high and emerging prospects for recovery, we see good opportunity for long-term investors in preferred and contingent capital securities – but be prepared for a bumpy journey.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	2020:1	2019:4	2019:3	2019:2	2019:1	2018:4	2018:3	2018:2
Real GDP, Chg QoQ (%, SA, AR)	-4.8	2.1	2.1	2.0	3.1	1.1	2.9	3.5
Real Personal Consump Expnds, Chg QoQ (%, SA, AR)	-7.6	1.8	3.1	4.6	1.1	1.4	3.5	4.0
Real Business Inv ex Stuctures, Chg QoQ (%, SA, AR)	-8.4	-1.3	-0.4	1.6	4.5	8.5	3.2	7.1
Real Residential Investmt, Chg QoQ (%, SA, AR)	21.0	6.5	4.6	-3.0	-1.0	-4.7	-4.0	-3.7
Real Private Domestic Final Sales, Chg QoQ (%, SA, AR)	-6.5	1.4	2.3	3.3	1.6	1.7	2.9	4.2
Nominal GDP, Chg QoQ (%, SA, AR)	-3.5	3.5	3.8	4.7	3.9	2.9	4.8	7.1
Corporate Profits, After Tax, Chg YoY (%, SA, AR)	-12.4f	2.2	-0.3	1.3	-2.9	10.1	11.3	8.3
Nonfarm Productivity, Chg QoQ (%, SA, AR)	-2.5	1.2	-0.3	2.7	3.9	0.6	1.7	2.1
Nominal Personal Income, Chg YoY (%, AR)	1.4	3.7	4.3	4.6	4.7	5.0	5.4	6.1
Personal Savings Rate (%, SA)	13.1	7.5	7.8	7.8	8.4	8.8	7.5	7.6
Unemployment Rate (%, SA)	4.4	3.5	3.5	3.7	3.8	3.9	3.7	4.0
Nonfarm Payrolls, Chg QoQ (000, SA)	-416	630	609	477	417	517	460	634
Household Employment, Chg QoQ (000, SA)	-3031	505	1150	407	-84	793	282	559
Federal Budget, 12-mo Deficit(-) or Surplus (% of GDP)	-4.8	-4.8	-4.7	-4.4	-4.2	-4.2	-3.9	-3.8
Consumer Price Index, Chg YoY (%, AR)	1.5	2.3	1.7	1.6	1.9	1.9	2.3	2.9
CPI ex food & energy, Chg YoY (%, AR)	2.1	2.3	2.4	2.1	2.0	2.2	2.2	2.3
Capacity Utilization (%, SA)	73.2	77.2	77.4	77.7	78.4	79.5	79.3	78.6
Rate or Spread (End of Quarter)	**2020:1**	**2019:4**	**2019:3**	**2019:2**	**2019:1**	**2018:4**	**2018:3**	**2018:2**
Federal Funds Rate Target (upper bound, %)	0.25	1.75	2.00	2.50	2.50	2.50	2.25	2.00
3-month LIBOR (%)	1.45	1.91	2.09	2.32	2.60	2.81	2.40	2.34
10-Yr Treasury Note Yield (%)	0.70	1.92	1.68	2.00	2.41	2.69	3.05	2.85
30-Yr Treasury Bond Yield (%)	1.35	2.39	2.12	2.52	2.81	3.02	3.19	2.98
ICE-BofAML US Corporate Index Yield to Worst vs Gvt	302	99	120	121	126	158	112	129
10-Yr Interest Rate Swap Spread (bp)	2.5	-2.8	-10.5	-4.5	0.0	3.0	6.0	7.5

* 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

Flaherty & Crumrine

Economic Outlook

Three months ago in our *Fourth-Quarter U.S. Economic Update,* we wrote, "emergence of a novel coronavirus (COVID-19) as a serious global health threat has increased forecast uncertainty. While we are hopeful that the COVID-19 outbreak will pass quickly and have only limited human and economic impacts, it is simply too early to know." Today, we see the devastating impact that coronavirus has had and is having on the U.S. and other countries around the world. It has caused major changes to our outlook. We will briefly address what happened to the U.S. economy in the first quarter of 2020, though that now feels like ancient history and tells us only a little about what lies ahead. We also will review what we know so far about economic activity in the second quarter. Be forewarned: the current landscape is bleak. However, while the course of COVID-19 will determine the breadth, pace and timing of economic recovery, there are some tentative signs of improvement.

The U.S. economy slowed sharply in the first quarter of 2020 as Safer at Home orders proliferated in the second half of March and many businesses – especially in travel and hospitality – suspended or curtailed operations. While we will not have an official start date for some time, a recession likely began in March. Inflation-adjusted gross domestic product (real GDP) fell by 4.8% in Q1, led by a 7.6% drop in personal consumption. Economists[1] expect the second quarter of 2020 to post the largest decline on record: -32.2%. Moreover, retail sales and industrial production reports released after those forecasts were published suggest that Q2 GDP could fall by 40% or more.[2]

The second quarter should mark the low for this contraction. With businesses set to reopen, growth expectations for Q3 and Q4 are 10.6% and 6.5%, respectively. For the full year 2020, economists forecast a decline in GDP of 5.6%, rebounding to +3.1% in 2021. These forecasts compare to expectations for growth of about 2% in 2020 and 2021 prior to the coronavirus pandemic. Beyond 2021, the economy should expand a bit faster than the prior 2% trend for several years as businesses that closed are replaced by new ones and absorb workers whose jobs disappeared during the recession. It's likely to take a number of years to recover economic growth that will be lost during the current recession, however.

Developments in the **labor market** over the past few months vividly illustrate the sudden and devastating economic impact of coronavirus and public and private responses to it. Job growth remained solid early in the first quarter. Nonfarm payroll jobs rose by an average of 199,000 jobs per month in January and February before falling by 870,000 jobs in March and a staggering 20.5 *million* in April (Figure 2). That took the rate of payroll job growth from 1.5% YoY in February to -12.9% YoY in April. The household employment survey paints a similar picture, with a total of 464,000 jobs lost in Q1 and another 19.5 million in April, pushing the unemployment rate to 14.7% in April from 3.5% as recently as February (Figure

---

[1] Unless noted otherwise, forecasts are from the *Survey of Professional Forecasters*, Federal Reserve Bank of Philadelphia, May 15, 2020 and Bloomberg® *U.S. Monthly Economic Survey*, May 15, 2020.

[2] Remember that real GDP is reported each quarter at an *annual* rate; a 40% annualized decline means GDP fell by 12.0% (not annualized) during the quarter.

3). Job losses in April alone far exceed a cumulative 8.2 million (household survey) to 8.6 million (payroll survey) jobs lost in the global financial crisis from December 2007 and December 2009. While we expect many of the current job losses to be temporary, we cannot say to what extent and how soon they will return.

It is little solace that average hourly earnings jumped by 7.9% over 12 months ending in April (Figure 3). Job losses were disproportionally among lower-wage workers, especially in leisure and hospitality and retail trade businesses. Businesses that tend to pay higher wages, such as information and financial services, suffered fewer job losses. As a result, average wages of those still employed rose significantly in April – though this is the opposite of a sign of labor market strength. One bit of good news from the April employment report is that roughly 80% of layoffs were reported as temporary, although many could become permanent if businesses remain closed beyond the next several months or if demand rebounds more slowly than expected.

Figure 2: Unprecedented Job Losses

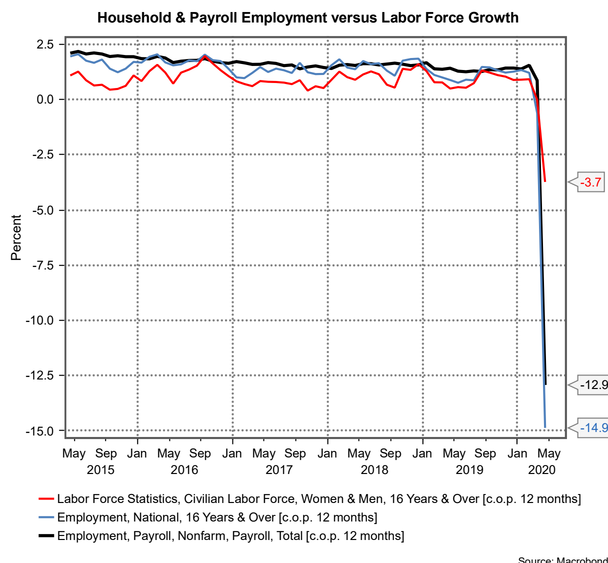
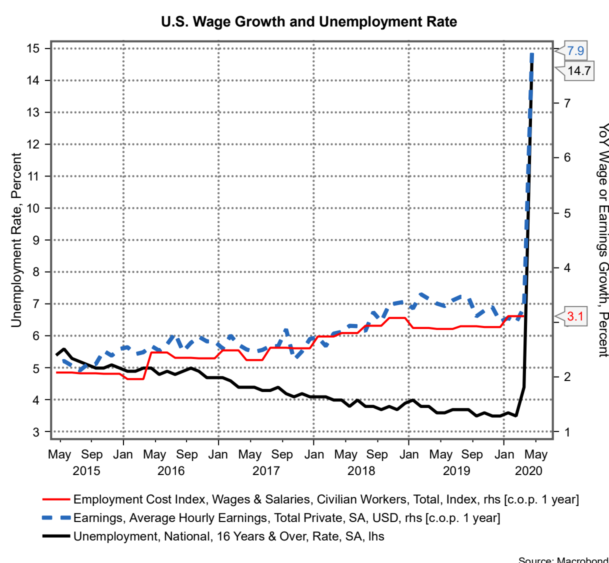


Figure 3: Higher Unemployment…and Wages



Because most job losses occurred late in the quarter, nominal **personal income** actually rose by 2.0% in Q1 and 1.4% over 12 months ending in March (Figure 4). Wage and Salary income was weak at +0.1% QoQ and -0.8% YoY, but transfer payments (+8.7% QoQ and +6.3% YoY) kept overall personal income in the black. April income data is not yet available, but it should be down sharply given job losses in that month, despite some offset from unemployment benefits.

While income held up fairly well, **personal consumption expenditure** (PCE) fell sharply in the first quarter. Nominal PCE fell by 6.3% in Q1 and 3.8% YoY in March (Figure 4). Adjusted for inflation, real PCE sank by 7.6% in Q1 and 5.0% YoY, even though stay at home orders only rolled out in the second half of March. Moreover, bleak retail sales figures for April suggest that PCE fell sharply as the second quarter began (Figure 5). Retail sales were down by more than 15% in April alone, whether we look at overall sales, sales excluding automobiles and parts, or "core" sales excluding autos, gasoline, building materials and

food. That was much weaker than economists expected and is more than triple the prior weakest month on record.

Figure 4: Income, Spending Slowed as Jobs Lost

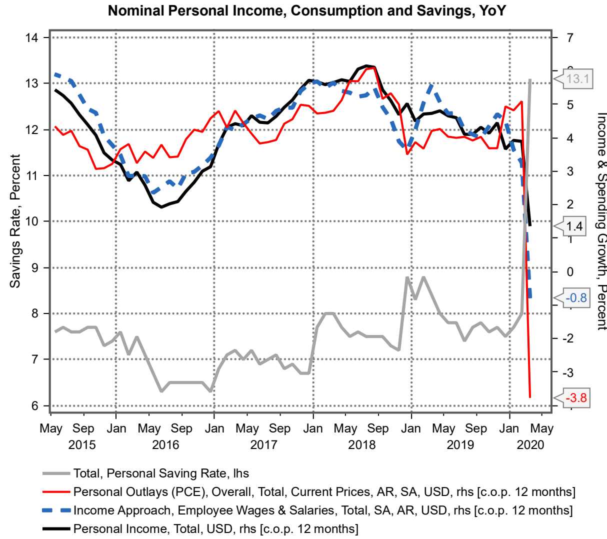
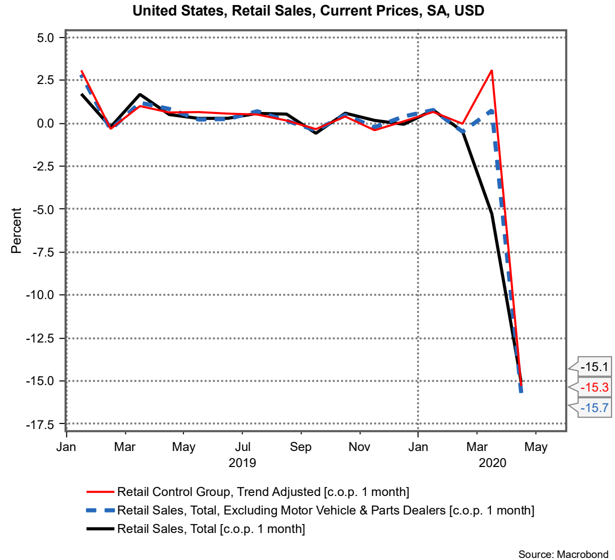


Figure 5: Retail Sales Plummeted in April



Because spending fell far faster than income, the **savings rate** soared to 13.1% in March from about 7.6% before shutdowns began. Fortunately, consumer debt burden was at or near historic lows entering this recession (Figure 6), and the savings rate is elevated. They should provide some resilience to spending when businesses reopen and confidence recovers, although those benefits will not be shared equally by all households. Unemployment benefits and other forms of government support (discussed below) should provide incremental support, but we expect higher delinquencies and charge-offs on consumer loans over coming quarters.

Figure 6: Debt Burden Low, but Income Sinking

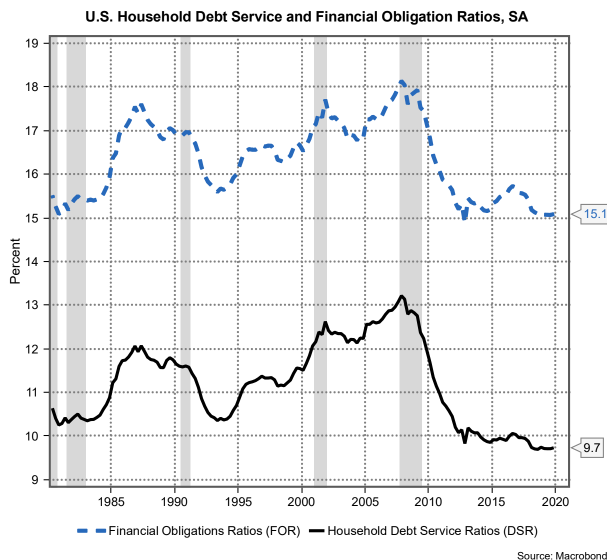
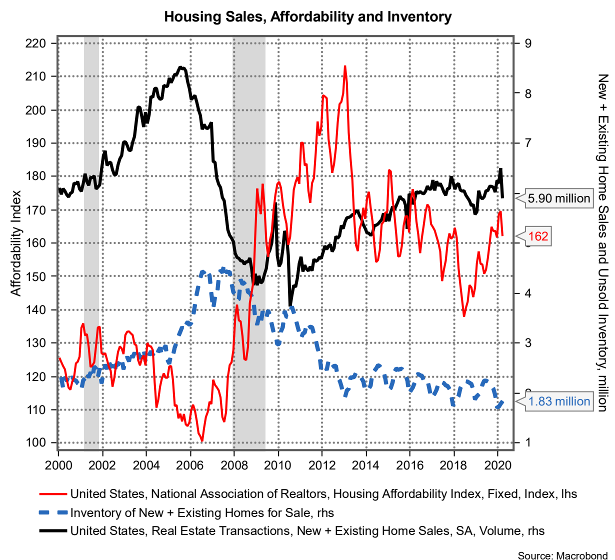


Figure 7: Housing Recovery on Hold



Before COVID hit, the **housing market** was staging an impressive rebound from a slump in 2018. After falling by a total of 4.7% from 4Q2017 to 1Q2019, residential investment rose by 7.0% from 1Q2019 to 1Q2020 as the Fed cut rates and strong job growth fueled demand for housing. New and existing home sales hit a new post-financial-crisis high of 6.5 million units in February 2020 (Figure 7). Then COVID shutdowns began, and home sales quickly slipped to 5.9 million units in March. April data on housing starts (-43% from February levels) and permits (-25%) point toward an even sharper slowdown in home sales in Q2, although that should mark the bottom – at least for now. The strength of any housing rebound beyond that, however, will depend on job recovery, which remains uncertain.

Figure 8: Manufacturing Hits Brakes Again

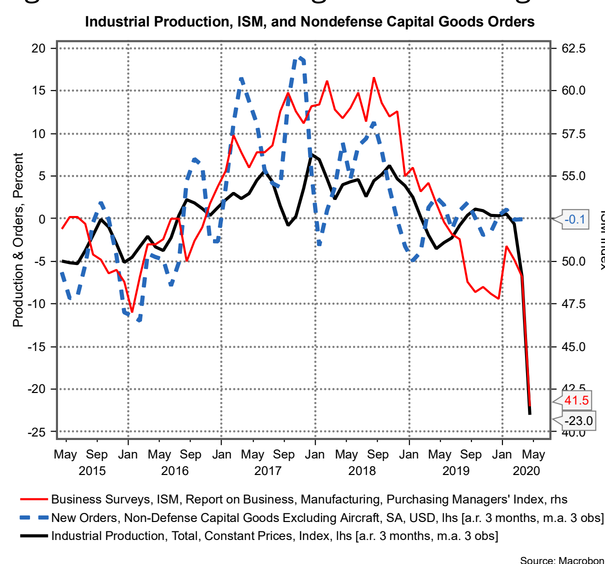
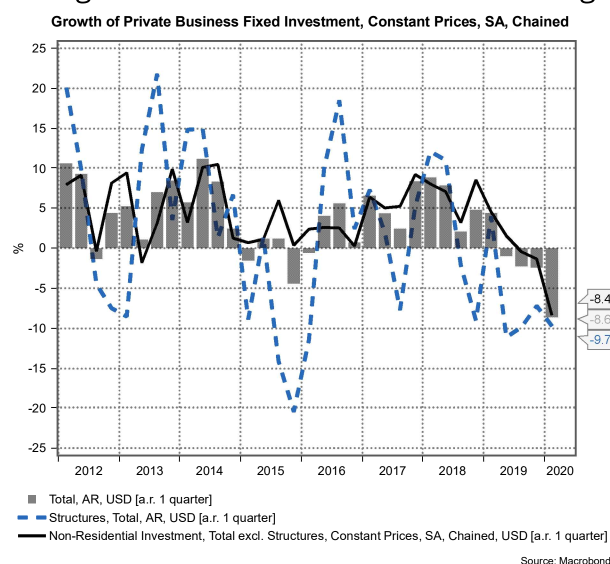


Figure 9: Business Investment Shrinking



COVID-related shutdowns hit the industrial sector even harder. **Industrial production** fell 7.1% (annualized) over three months ending in March with an *additional* 11.2% (not annualized) drop in April. In real terms, industrial production fell 23.0% (annualized) over three months ending in April (Figure 8). Declines were both worse than expected and widespread, with output down in manufacturing (especially motor vehicles), utilities and mining. These declines are consistent with the Institute for Supply Management's manufacturing survey, which fell to 41.5 in April, its lowest level since March 2009 in the depths of the financial crisis. Orders for core capital goods (nondefense, excluding aircraft) edged only slightly lower in Q1 (latest data through March), but they are poised to fall substantially in the second quarter. Once again, Q2 is expected to look horrendous for industrial output, with a gradual recovery beginning in Q3.

Real **business investment** mirrored the drop in industrial output, falling by 8.6% in the first quarter (Figure 9). Investment in business structures fell 9.7%, while business equipment and intellectual property dropped by 8.4%, led by a 15.2% hit to equipment spending. As both business and consumer demand sagged in response to Stay at Home orders, capacity utilization rates fell sharply in the first quarter and in April. Overall capacity utilization fell from 76.7% in February to 73.2% in March and just 64.9% in April. With

substantial excess capacity currently available, business investment is likely to shrink further, and we may not see much recovery there until next year (Figure 10).

Figure 10: Low Utilization Implies Cutbacks

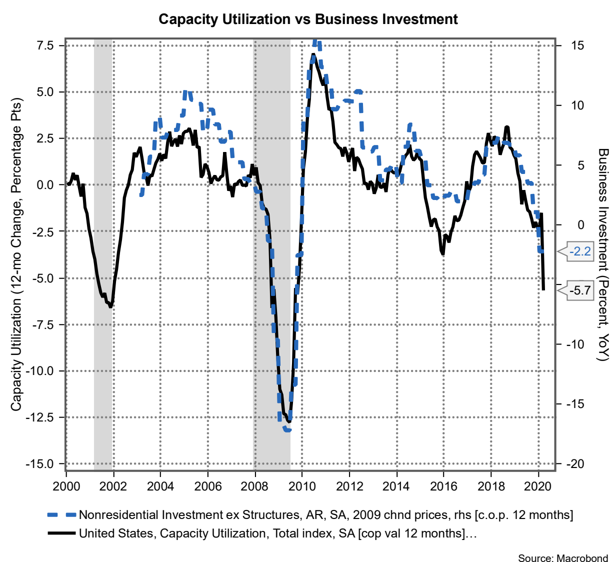
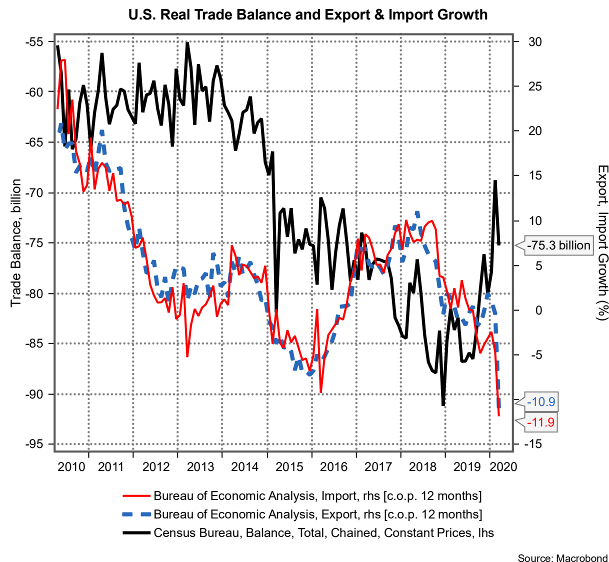


Figure 11: Deficit Narrower, but Trade Plunges



The **trade deficit** narrowed again in the first quarter, but trade volumes dropped sharply (Figure 11). Net exports added 1.3% to real GDP growth in Q1 after adding 1.5% in Q4, helping to offset weakness in domestic demand from other sectors. Trade volumes sank as both U.S. and foreign demand pulled back. Imports fell 11.9% YoY in March, and exports dropped 10.9% over the same period. While it's very tough to predict the direction of the trade deficit over the next quarter or two, supply chain disruptions and rising trade tensions suggest trade *volumes* will decline further, and U.S. dollar strength poses a particular headwind to U.S. exports.

Inventories had a comparatively modest impact on GDP in the first quarter, subtracting 0.5% in Q1 after a -1.0% impact in Q4. Given a sharp decline in domestic demand, we were relieved that stockpiles did not jump, which in turn could set a negative inventory cycle in motion. So far, inventories look to be roughly in-line with sales, with both falling. We would not be surprised to see some unintended inventory accumulation in Q2 given a sharp drop in consumer spending in April, but that should unwind as the economy gradually reopens and consumer spending picks up. It would be a reason to expect that orders and output should lag a pickup in final demand, however.

Real **government consumption** slowed to 0.7% in the first quarter from 2.5% in Q4. Real federal government spending rose 1.7%, down from 3.4% in Q4, and state and local spending was up just 0.1%, compared to 2.0% a quarter earlier (Figure 12). After passing nearly $3 trillion in fiscal stimulus to support the economy through current shutdowns, Federal government spending should increase considerably over coming quarters – although its ultimate impact on the economy is unclear. Much of the stimulus spending is loans and transfer payments. Those will support private sector spending, but results will depend on private decisions, and some of the money will be saved by consumers or

returned by borrowers. Legislation also includes payments to health-care providers and state and local governments, which should be spent quickly. Currently, economists expect federal government spending to rise 4.8% in Q2 and gradually taper thereafter, while state and local spending is projected to be down slightly (0.2%) in Q2 and rise gradually after that. We expect that another round of fiscal stimulus over coming months will boost those numbers.

Figure 12: Slower Q1 Government Spending

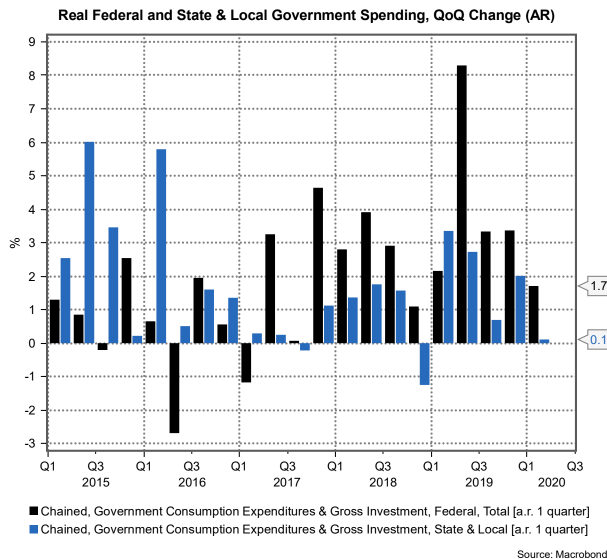
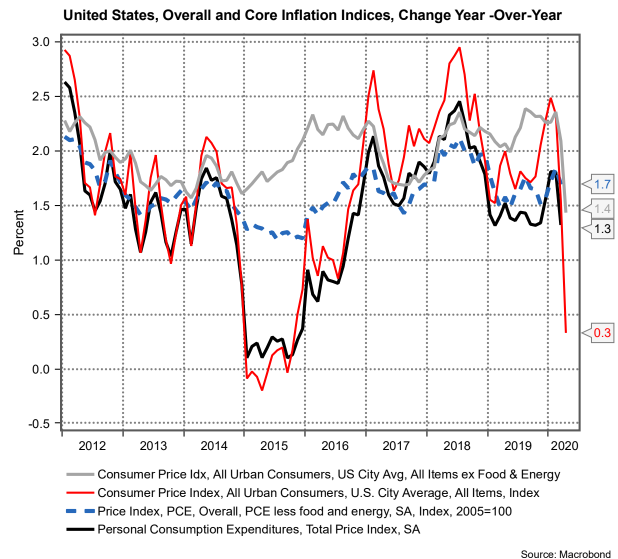


Figure 13: Disinflationary Forces in Play



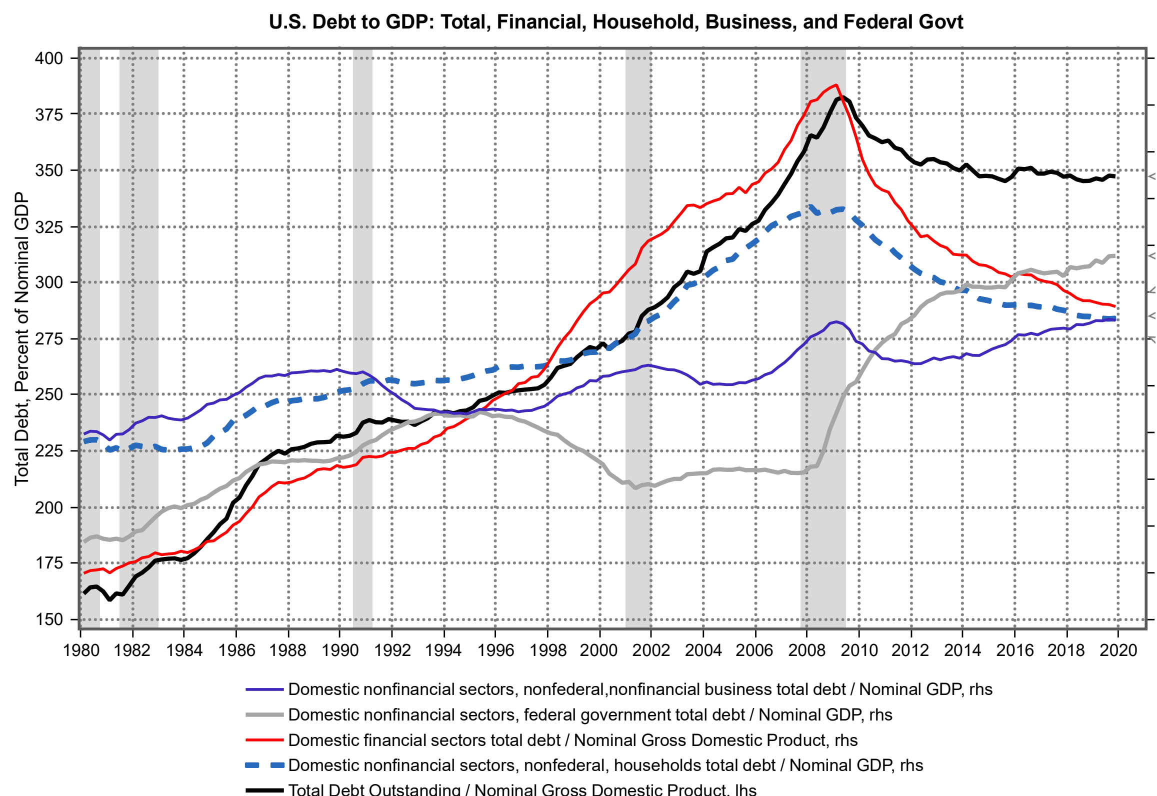
Summarizing the first-quarter economic situation, real GDP growth of -4.8% breaks down as follows: Personal Consumption Expenditures (-5.26%), Residential Investment (+0.74%), Business Investment (-1.17%), Inventory Change (-0.53%), Net Exports (+1.30%), and Government Consumption (+0.13%). The first three components equal **Private Domestic Final Sales**, which fell by 6.6%. Unfortunately, that's going to look fantastic compared to what's coming in the second quarter.

Inflation slowed in the first quarter and plunged in April as Safer at Home orders prompted layoffs and much weaker consumer spending. For 12 months ending in April, the consumer price index (CPI) was up just 0.3% overall and 1.4% excluding food and energy (Figure 13). Through March (latest data available), the PCE deflator was up 1.3% overall and 1.7% excluding food and energy. A dramatic decline in energy prices was primarily responsible for slower inflation. For example, energy prices in the CPI index were down 5.8% in March and 10.1% in April (not annualized). Slack demand and sizable excess capacity should keep a lid on inflation for an extended period, which leaves the Federal Reserve firmly focused on its "maximum employment" objective.

Broad **balance sheet trends** through the fourth quarter of 2019 (latest data available) show little change in overall debt outstanding relative to GDP over the past several years and largely unchanged trends among underlying segments of borrowers over that time (Figure 14). Overall debt-to-GDP was flat at 347%, down fractionally from Q3 and essentially unchanged since 2014. Household debt edged up to 74.3% but remained just above its low

since the financial crisis. Financial business leverage fell to 76.9%, its lowest level in more than 20 years. Nonfinancial businesses leverage dipped to 73.9%, although it remains above its prior peak during the financial crisis. With the economy now in recession, we think this sector is likely to experience more problems supporting its debt than financial companies or households. Federal government debt-to-GDP set another post-World War II record of 87.7% as deficit spending quickened. Taking into account COVID-related fiscal stimulus borrowing, the Congressional Budget Office projects federal debt-to-GDP will rise to 101% by the end of September 2020.

Figure 14: Overall Debt Manageable, but Nonfinancial Firms Face Challenges



We expect leverage to rise in the first quarter and especially in Q2, due to both a larger numerator (higher borrowing) and a smaller denominator (lower GDP). As noted earlier, we expect very large increases in federal government debt. Nonfinancial businesses are likely to boost borrowing over the near term to "make it to the other side" of the crisis, although much of that borrowing could be temporary (or forgivable in the case of some "Paycheck Protection Program" loans). We don't expect much borrowing for investment purposes until next year. Financial companies have expanded their balance sheets to meet business loan demand, and most of that will be debt financed (deposits); expect debt-to-GDP to rise in the financial sector too. Households, on the other hand, will probably increase debt only modestly, and it could even shrink. With consumer spending down, credit card balances have declined and auto and home mortgage lending has slowed; even student loan growth

may slow if college-bound students opt to defer enrollment next autumn. We will be paying close attention to these statistics in 2020.

Before turning to markets, we want to highlight some recent – and more-current – economic data offering tentative but encouraging signs of improvement. First, initial claims for unemployment insurance (jobless claims) soared in March as Safer at Home orders were imposed across much of the nation (Figure 15). After peaking at almost 6.9 million in late March, initial claims have slowed to about 2.4 million in the week ending May 16. Similarly, gains in continuing unemployment have slowed (there's a one-week lag for this data, and we use a 2-week moving-average to smooth some week-to-week volatility in the data) after peaking at over 4 million persons added to unemployment insurance rolls each week in late March and early April. These numbers are still much higher than before COVID-related shutdowns began, but they do indicate that the pace of job losses has slowed over the past few weeks.

Figure 15: Job Losses High but Slowing

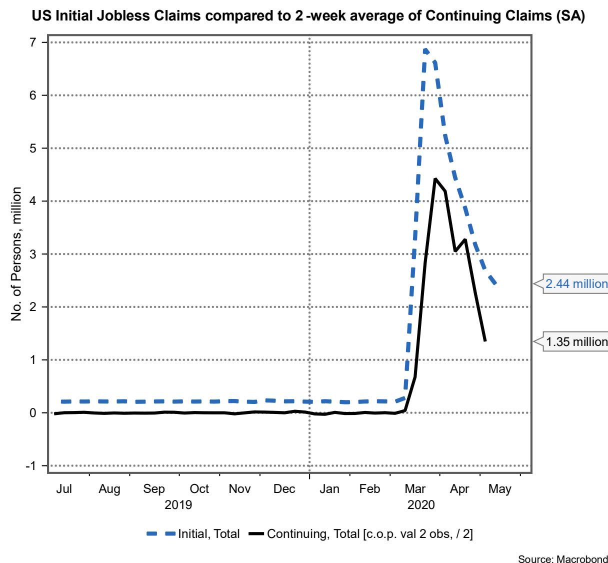
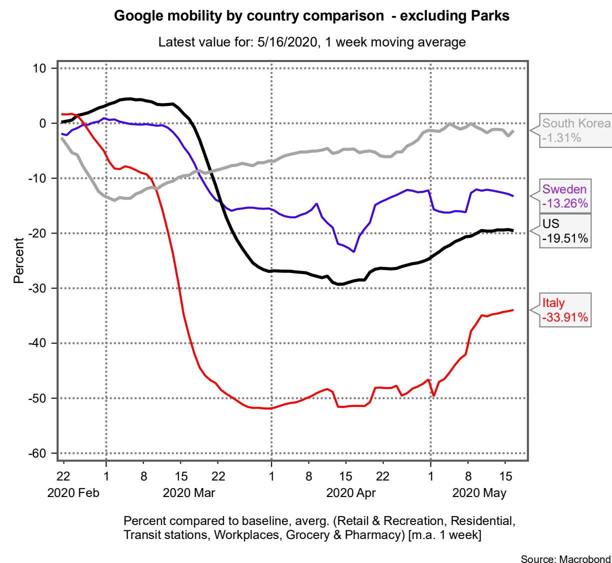


Figure 16: Mobility Down but Increasing



Mobility data also indicates more activity in recent weeks. To illustrate this, we use Google's mobility data for trips to grocery stores, pharmacies, residential addresses, retail and recreation facilities, transit stations and workplaces; we excluded parks, which have only begun to reopen within the last week or two in most places. In the U.S., Google's data shows that, after falling about 30% from mid-March to mid-April, mobility has rebounded by about 10% (Figure 16). In Sweden, which imposed far fewer mandatory restrictions than in the U.S. and most other developed nations, mobility fell less (about 15%) and has increased little since late March. In Italy, where a rapid increase in COVID-19 hospitalizations put severe strain on the medical system, people have only started to increase mobility in the past week or two. South Korea is an interesting model. Novel coronavirus spread rapidly there in February, but widespread testing and contact tracing suppressed spread of the virus relatively quickly; mobility fell early and gradually worked its way back to pre-COVID levels as cases receded. While we cannot draw firm conclusions

from this data, it appears that (1) economic activity is gradually increasing globally after bottoming in April but (2) even as restrictions are lifted, people are likely to remain more cautious than before until greater progress is made against the coronavirus – perhaps not until a vaccine is widely available or the pandemic otherwise subsides.

As we noted early in this update, we're starting to see beginnings of recovery. That does not mean that activity levels will rebound quickly or that things will soon be back to "normal," but they do suggest that the second quarter should mark the bottom for economic growth. Policy response has been timely and substantial, and several promising vaccines and COVID-19 treatments are being developed rapidly. These offer potential for a fast recovery, and we are hopeful on that front, if not counting on it. More importantly from an investor's perspective, strong policy responses, generally good compliance with social distancing regimes and medical progress on the disease reduce downside risk to the economy that could lead to highly adverse outcomes. That risk was at the forefront of markets in the first quarter, which we explore next.

Market Outlook

Markets entered the first quarter after a period of modestly rising long-term interest rates in the second half of 2019, despite three 25 basis point (bp) rate cuts by the Federal Reserve during that time. As 2020 began, trade uncertainty was elevated and business investment and consumer spending, which had already slowed in 4Q2019, remained subdued. Long-term **Treasury rates** began to slide even before coronavirus risks were apparent. Interest rates accelerated lower as a viral outbreak in Wuhan became a global COVID-19 pandemic (Figure 17). The benchmark 10-year Treasury note yield plunged 122 basis points (bp) to 0.70%, and the 30-year Treasury bond yield fell 104 bp to 1.35% at the end of the first quarter. Those yields are little changed but slightly steeper since quarter-end, with 10- and 30-year Treasuries yielding 0.67% and 1.39%, respectively, on May 21. Market forward rates also dropped sharply, and the yield curve now anticipates a long period of very low rates ahead.

In response to economic risks posed by the novel coronavirus, the Federal Open Market Committee (FOMC) cut the federal funds rate target by 50 bp in an emergency meeting on March 3. As the coronavirus spread and was declared a pandemic on March 11 by the World Health Organization, equity and credit markets sold off sharply, tightening financial conditions (Figure 18). On March 15, at another unscheduled meeting, the FOMC cut rates by an additional 100 bp, bringing the fed funds rate target back to its financial crisis low of 0–0.25%. With unemployment elevated and disinflationary forces at play, the Fed is likely to hold rates near zero at least through 2021 and probably for some time thereafter.

The Fed reinstated quantitative easing for the fourth time (QE4) since it was first used during the financial crisis. On March 15, the Fed announced at least $500 billion of US Treasury and $200 billion of agency mortgage-backed securities purchases. It subsequently eliminated those targets, making QE4 essentially unlimited, and expanded eligible assets to

include certain commercial mortgage-backed securities. Combined with other lending programs (see below) financial markets recovered to varying degrees, easing financial conditions, although they remain tighter than they were prior to the FOMC's emergency actions (Figure 18). That reflects ongoing economic risks from COVID, which cannot be alleviated solely with monetary policy.

Figure 17: Rates & Rate Expectations Sink[3]

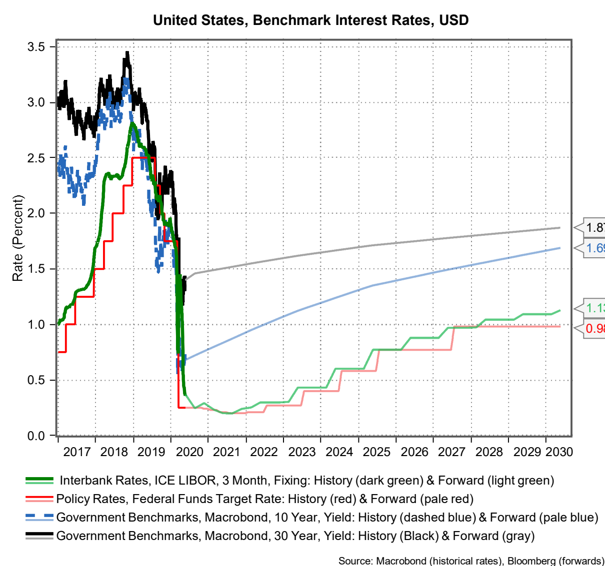


Figure 18: Fed Moved Quickly to Ease Policy

In addition to rate cuts and quantitative easing, the Fed quickly reinstated lending facilities developed during the financial crisis and, with backing from Treasury's Exchange Stabilization Fund, expanded them to include a broader array of asset classes, including corporate credit. These programs include a new Primary Market Corporate Credit Facility (PMCCF) to lend to large U.S. businesses; a Secondary Market Corporate Credit Facility (SMCCF) to provide liquidity to outstanding corporate bonds; a Term Asset-Backed Securities Loan Facility (TALF) to support asset-backed borrowers; a Money Market Mutual Fund Liquidity Facility (MMLF) to provide collateralized financing to money market funds, including municipal money market funds; a Primary Dealer Credit Facility (PDCF) to provide collateralized loans to primary dealers; a Commercial Paper Funding Facility (CPFF) to provide financing to commercial paper borrowers; a Main Street Business Lending Program to provide loans to small and medium businesses; and a Paycheck Protection Program Lending Facility (PPPLF) to purchase PPP loans originated by banks and guaranteed by the Small Business Administration under the Coronavirus Aid, Relief and Economic Security Act (CARES Act). If fully utilized, the Fed could provide more than $2.6 trillion in lending through those facilities. The Fed also expanded swap lines to major central banks and extended collateralized dollar liquidity to a broader range of foreign central banks to address US dollar funding strains in offshore markets. Together, these facilities significantly expanded

[3] The fed funds effective rate recently has traded about 20 bp below the top end of the FOMC target range. In Figure 17, we add 20 bp to forward rates implied by overnight index swaps (OIS) to align them with historic target rates.

liquidity available to credit and funding markets, helping to stem a rout in those markets as coronavirus fears mounted.

Figure 19: Credit Spreads on a Rollercoaster

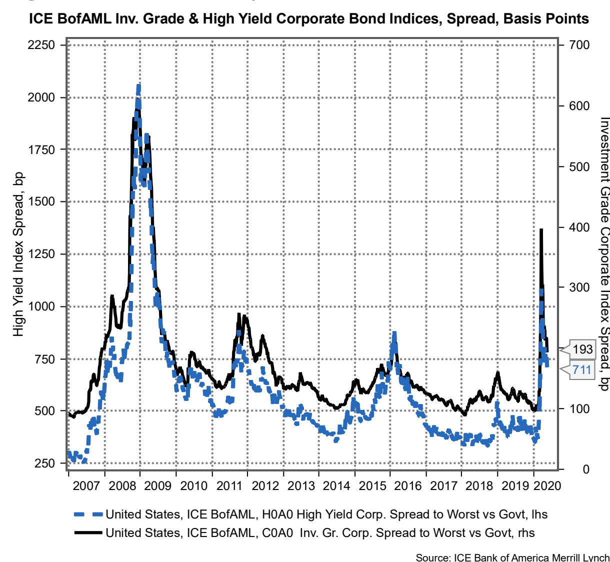
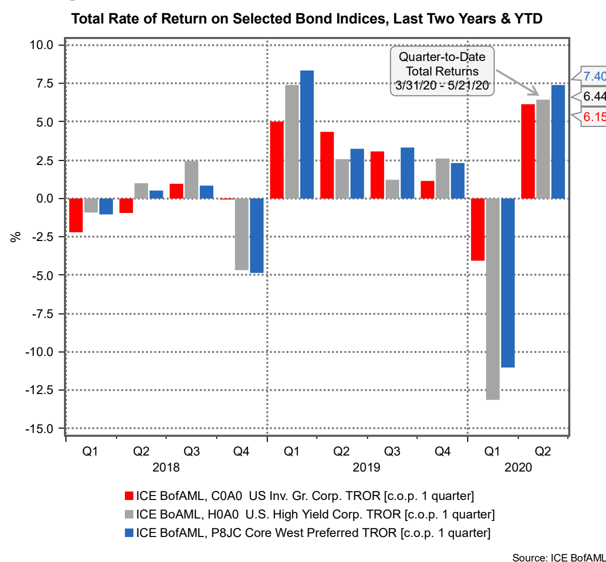


Figure 20: Q1 COVID Rout to Q2 Rebound



As coronavirus risks grew, corporate **credit spreads** widened by the most since the global financial crisis of 2008–09. Investment-grade corporate bond spreads widened by 203 bp to 302 bp in the first quarter.[4] In response to both monetary and fiscal policy, spreads narrowed further in April and May, closing on May 21 at 193 bp (Figure 19). Not surprisingly, high yield bond spreads fared much worse, widening by 503 bp to 875 bp in the first quarter. Since quarter-end, they narrowed to 711 bp as of May 21.

Spreads on preferred securities were somewhere between those of investment grade corporate and high yield bonds, although their complex call features makes 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 BofAML indices in recent quarters. In the first quarter of 2020, returns on all three credit indices were negative. Total return on the preferred index[5] (-11.01%) underperformed the investment-grade corporate bond index (-4.05%) and outperformed the high yield index (-13.12%).[6] All three markets have recovered somewhat in the second quarter through May 21 (see Figure 20 for QTD returns). Year-to-date through May 21, the investment grade corporate index (+1.84%) recovered all of its Q1 losses and turned positive. The preferred index (-4.43%) trailed investment-grade

[4] Investment-grade corporate bond spread is represented by the ICE BofAML U.S. Corporate Index℠ (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 5/21/2020.

[5] Preferred index is the ICE BofAML 8% Constrained Core West Preferred & Junior Subordinated Securities Index℠ (P8JC). Index data through 5/21/2020.

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

corporates but outperformed the high yield index (-7.53%). While they have narrowed from their highs in March, credit spreads remain wide compared to levels in recent years. If the economy rebounds in the second half of the year, as we expect, we see scope for additional spread tightening, although risks remain elevated.

We will dispense with most of the charts illustrating **credit conditions**, as that data generally is available only with a one-quarter lag (i.e., from 4Q2019 – ancient history). Overall credit conditions typically change incrementally, and we look for trends that give clues about areas where credit might be deteriorating or improving. Suffice to say that credit conditions coming into the current recession were generally healthy. Although off their best levels of recent years entering 2020, corporate earnings remained high and interest expense relative to earnings before interest, taxes and depreciation and amortization (EBITDA) was relatively low. As noted earlier, nonfinancial corporate leverage remained a watch point – and indeed that has been borne out in the performance of high yield bonds this year. However, the composition of that debt was good, with a high proportion of long term debt relative to short-term debt and elevated levels of liquidity. Of course, individual companies can look very different from aggregate averages. Careful credit analysis is always important!

The Fed publishes weekly data on bank balance sheets, and we include some of that below. Overall bank lending expanded 5.3% last year, only a little faster than nominal GDP at 4.0%. As the coronavirus crisis erupted, however, loans at banks jumped (Figure 21). The largest increase was in commercial and industrial loans, as borrowers drew down revolving lines of credit to ensure they had liquidity on hand if needed. Consumer loan volume drifted lower as spending declined, consumers paid down credit card balances, and new borrowing slowed. Most other lending categories showed modest increases in balances. Simultaneously, deposits increased even more than loans as depositors sought the safety of bank deposits over volatile financial markets and the Federal Reserve flooded the market with liquidity – much of which returned as bank deposits. This sudden increase in bank balance sheets caused capital ratios to drop modestly at most banks and prompted renewed issuance of bank preferred securities that qualify as Tier 1 capital. Some of these issues have offered much more attractive terms than were available a few months ago, and they are one benefit that the current crisis has brought to long-term investors.

Although it will take time to assess loan performance in this recession, it was strong entering the crisis. In 4Q2019 (latest data available), overall bank loan delinquencies edged down to 1.44% from 1.53% a year earlier (Figure 22). Overall loan charge-off rates were little changed at 0.48% in Q4 compared to 0.44% a year ago. Performance of most loan categories was little changed, as Figure 22 illustrates. Commercial and industrial (C&I) loan delinquency rose to 1.14% in Q4 from 0.96% a year earlier, although that is still low historically. Given rising leverage at nonfinancial companies, we have anticipated higher C&I delinquencies and think most banks are prepared for some strain there.

Figure 21: Bank Lending & Deposits Up

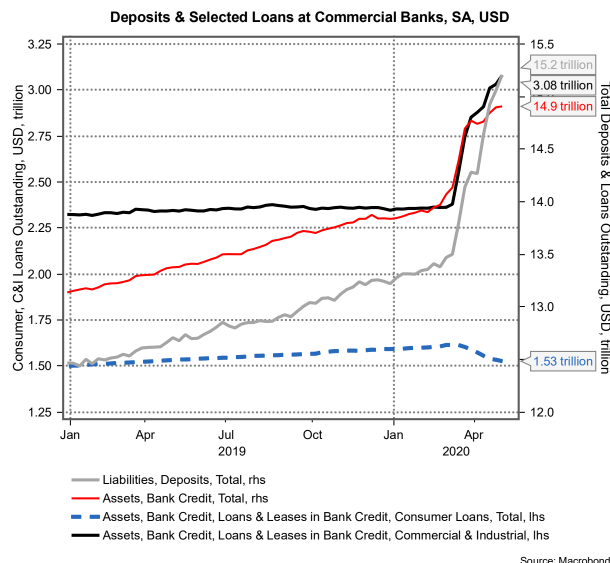
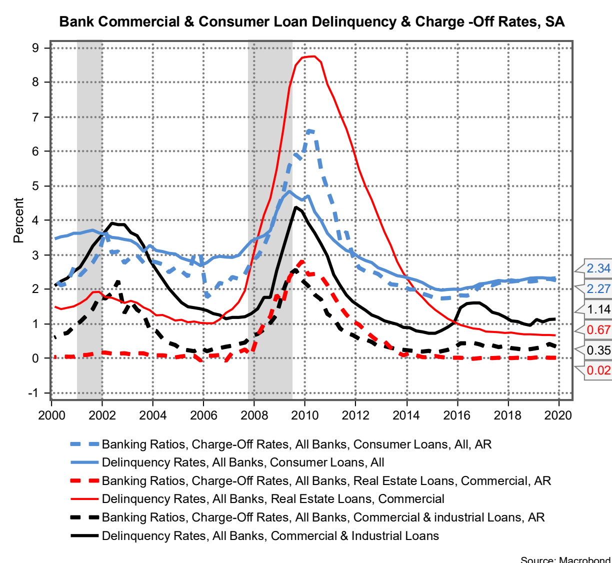


Figure 22: Loan Performance Set to Worsen



We absolutely expect loan delinquency and charge-off numbers to get worse given reductions in economic activity from coronavirus and efforts to contain it. U.S. banks have largely completed first-quarter earnings announcements, and they are preparing to address higher levels of problem loans. Banks substantially increased loan loss reserves in Q1, with most raising the ratio of reserves to nonperforming loans from roughly 125–200% in Q4 to 200–400% in Q1. Most reported little change in delinquencies and charge-offs in the quarter, but they noted requests for forbearance jumped. Although allowing borrowers to defer payments during a time when many businesses have been ordered closed and many people are temporarily out of work is an appropriate response to the crisis, forbearance may only delay some inevitable defaults. We expect banks will take another large round of provisions in Q2 if GDP is as bad as forecast, but we may not see a significant rise in delinquencies and charge-offs until Q3 or Q4. As we have said before, we think the U.S. banking system is well prepared for a recession, even one as nasty as this.

Summarizing our main views, we expect a severe but brief recession, with real GDP in the vicinity of -40% in the second quarter. Recovery should begin in the third quarter, assuming most of the economy gradually reopens over the next several months. However, consumer spending in many areas is likely to remain constrained and probably will not regain prior levels for several years, although residential investment could turn around sooner if employment recovers relatively quickly. Business investment is likely to trail the overall recovery until excess capacity has been reduced, which will take time. Federal government spending should expand and help support the economy through the next few quarters, but state and local government spending is likely to remain subdued. Net exports could be a modest positive to GDP if the trade deficit continues to shrink, but that probably would signal weaker trade flows and softer global growth. In short, we expect a relatively rapid rebound in the second half of 2020 from a shockingly bad second quarter followed by a relatively slow recovery that takes at least several more years to recapture economic

activity lost to the coronavirus – and that assumes an effective vaccine becomes available in the next year or two.

We think that credit markets have largely adjusted to that outlook. Treasury rates have declined and are likely to remain low through the recession and for several years thereafter. Credit spreads have widened but are well off their recent highs, reflecting both ongoing risks from the coronavirus and strong monetary, fiscal and medical responses to it. The market for preferred and contingent capital securities is dominated by issuers in the banking, insurance and other financial services industries, which we think are well-positioned to manage through this recession. The market has relatively limited exposure to energy, real estate and industrial companies, which face greater challenges.

As long-term investors, we must consider overall macroeconomic, sector and company-specific risks that affect portfolio performance. We acknowledge those risks are elevated currently. We also believe they are manageable and offer substantial compensation for accepting those risks. We see good opportunity for long-term investors in preferred and contingent capital securities to earn solid returns over coming years. But please be prepared for a bumpy ride.

Flaherty & Crumrine Incorporated
May 21, 2020

© 2020, Flaherty & Crumrine Incorporated. All rights reserved. This commentary contains forward-looking statements. You are cautioned that such forward-looking statements are subject to significant business, economic and competitive uncertainties and actual results could be materially different. There are no guarantees associated with any forecast; the opinions stated here are subject to change at any time and are the opinion of Flaherty & Crumrine Incorporated. Further, this document is for personal use only and is not intended to be investment advice. Any copying, republication or redistribution in whole or in part is expressly prohibited without written prior consent. The information contained herein has been obtained from sources believed to be reliable, but Flaherty & Crumrine Incorporated does not represent or warrant that it is accurate or complete. The views expressed herein are those of Flaherty & Crumrine Incorporated and are subject to change without notice. The securities or financial instruments discussed in this report may not be suitable for all investors. No offer or solicitation to buy or sell securities is being made by Flaherty & Crumrine Incorporated.