Flaherty & Crumrine Incorporated

Third-Quarter U.S. Economic Update
November 2018

Summary of Recent Economic Developments

The U.S. economy expanded rapidly again in the third quarter, with real GDP up 3.5% during the quarter, putting growth on track to slightly exceed 3% over four quarters ending in December. Economists forecast 2.5% and 1.8% growth in 2019 and 2020, respectively. Job gains remained sturdy, pushing the unemployment rate down to 3.7% and boosting wages and income. Real personal consumption expenditures rose 4.0%, outpacing personal income. Home sales fell and price gains eased. Industrial production improved modestly and orders rebounded, although widening trade tariffs remain a risk. Business investment slowed after a stellar first half of 2018 but should grow moderately over coming quarters. The trade deficit widened sharply but was more than offset by higher inventories. Government consumption rose on higher defense spending, but federal spending is set to slow in 2020. Private domestic final sales (+3.4% YoY) continued to outpace overall GDP (+3.0%YoY). Inflation eased in the third quarter but was up from a year ago; it remains near the Fed's 2% target. Treasury rates rose and now incorporate most of the monetary tightening we expect in this cycle. Credit spreads widened despite mostly supportive credit fundamentals, especially at financial companies. While returns have been disappointing this year, preferred securities yield around 6.25%, 1% higher than a year ago, and credit quality remains solid. 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*	2018:3	2018:2	2018:1	2017:4	2017:3	2017:2	2017:1	2016:4
Real GDP, Chg QoQ (%, SA, AR)	3.5	4.2	2.2	2.3	2.8	3.0	1.8	1.8
Real Personal Consump Expnds, Chg QoQ (%, SA, AR)	4.0	3.8	0.5	3.9	2.2	2.9	1.8	2.6
Real Business Inv ex Stuctures, Chg QoQ (%, SA, AR)	3.1	7.3	10.9	5.8	5.9	8.3	8.7	0.3
Real Residential Investmt, Chg QoQ (%, SA, AR)	-4.0	-1.3	-3.4	11.1	-0.5	-5.5	11.1	7.7
Real Private Domestic Final Sales, Chg QoQ (%, SA, AR)	3.1	4.3	2.0	4.4	2.3	3.1	3.3	2.4
Nominal GDP, Chg QoQ (%, SA, AR)	4.9	7.6	4.3	5.1	4.8	4.2	3.9	3.9
Corporate Profits, After Tax, Chg YoY (%, SA, AR)	19.6f	15.8	15.1	7.3	6.4	6.2	6.0	7.3
Nonfarm Productivity, Chg QoQ (%, SA, AR)	N/A	3.0	0.3	-0.3	2.3	1.6	0.4	1.3
Nominal Personal Income, Chg YoY (%, AR)	4.4	4.9	4.3	4.6	4.6	4.3	4.3	3.2
Personal Savings Rate (%, SA)	6.2	6.7	7.2	6.2	6.6	6.6	7.0	6.3
Unemployment Rate (%, SA)	3.7	4.0	4.1	4.1	4.2	4.3	4.5	4.7
Nonfarm Payrolls, Chg QoQ (000, SA)	569	651	655	662	425	569	532	492
Household Employment, Chg QoQ (000, SA)	386	398	1157	-303	1074	186	831	418
Federal Budget, 12-mo Def or Surp (% of GDP)	-3.9	-3.8	-3.7	-3.5	-3.5	-3.7	-3.4	-3.1
Consumer Price Index, Chg YoY (%, AR)	2.3	2.9	2.4	2.1	2.2	1.6	2.4	2.1
CPI ex food & energy, Chg YoY (%, AR)	2.2	2.3	2.1	1.8	1.7	1.7	2.0	2.2
Capacity Utilization (%, SA)	78.5	77.8	77.5	77.3	75.7	76.2	75.5	75.7
Rate or Spread (End of Quarter)	**2018:3**	**2018:2**	**2018:1**	**2017:4**	**2017:3**	**2017:2**	**2017:1**	**2016:4**
Federal Funds Rate Target (%)	2.25	2.00	1.75	1.50	1.25	1.25	1.00	0.75
3-month LIBOR (%)	2.40	2.34	2.31	1.69	1.33	1.30	1.15	1.00
10-Yr Treasury Note Yield (%)	3.05	2.85	2.74	2.41	2.32	2.30	2.39	2.43
30-Yr Treasury Bond Yield (%)	3.19	2.98	2.97	2.74	2.86	2.84	3.01	3.05
ICE-BofAML US Corporate Index Yield to Worst vs Gvt	112	129	116	97	104	112	120	126
10-Yr Interest Rate Swap Spread (bp)	6.0	7.5	3.8	-1.5	-4.5	-2.3	-0.8	-11.3

* Figures are either quarterly or, if more frequent, end of period. f = Forecast[1] ; N/A = not available Source: Macrobond, ICE, Bloomberg LP

Legend for all Figures: AR = Annual Rate; SA = Seasonally Adjusted; MA = Moving Average; C.O.P. = Change over Period

Economic Outlook

The U.S. economy continued to expand at a rapid pace in the third quarter. Inflation-adjusted gross domestic product (real GDP) rose 3.5% in Q3, down only modestly from Q2's blistering 4.2% pace. Personal consumption was the star in the third quarter, and government spending played a supporting role. Economists[1] expect 2.9% real GDP in 2018 overall and 3.1% from 4Q2017 to 4Q2018, consistent with our expectation of 3.0–3.3% growth (Q4/Q4) in 2018. For 2019 and 2020, economists project 2.5% and 1.8% growth, respectively. We broadly agree with forecasters' 2019 outlook but think 2020 should be closer to 2.0%.

Four key expectations were behind our outlook for 2018. First, we expected tax reform to prompt greater business investment and boost labor productivity. Second, higher wages due to a shrinking pool of available workers would support income growth above 4%, even as job growth slows as the economy reaches full employment. Third, global economic activity – which expanded by 3.8% in 2017 – would remain near that level in 2018. Finally, we assumed that immigration and trade policies would not lead to worker shortages or trade wars that damage U.S. and global growth.

With most of 2018 behind us, we think we did pretty well with those expectations, although the jury is still out on the fourth. Business investment strengthened and productivity is up, albeit less than we hoped. Income growth remained strong, and employment growth has been even better than expected. Global economic growth looks a bit weaker than last year, but only by 0.2–0.3%. New trade tariffs were higher and more extensive than expected. Their impact on domestic growth appears small so far, but they likely have contributed to slower global growth, especially in emerging markets. And while immigration has captured a lot of news headlines, policy changes thus far have had little impact. Trade and immigration remain areas of potential support for or risk to the U.S. economy over the next several years, depending on how policies develop.

Figure 2: No Slowdown in Job Growth

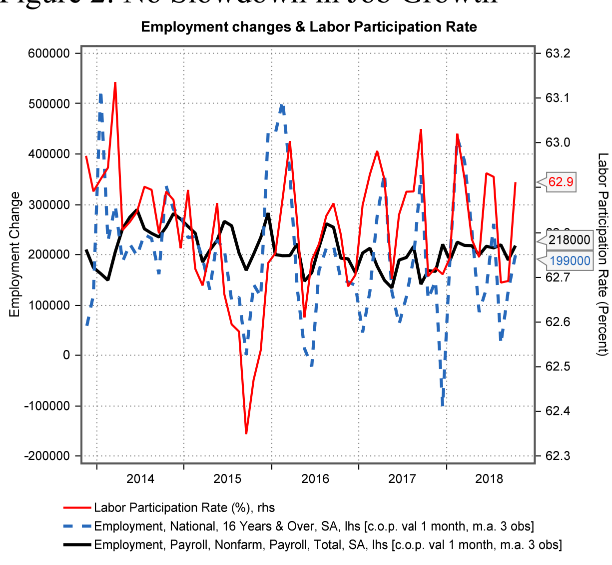
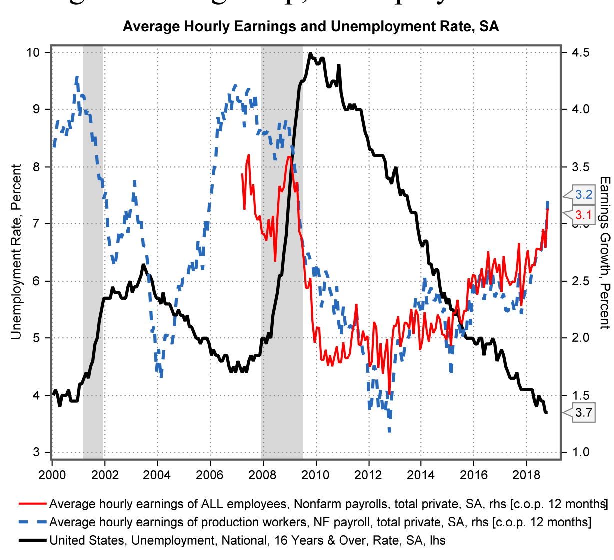


Figure 3: Wages Up, Unemployment Down



[1] Unless noted otherwise, forecasts are from the *Survey of Professional Forecasters*, Federal Reserve Bank of Philadelphia, November 13, 2018 and Bloomberg® *U.S. Monthly Economic Survey*, November 9, 2018.

We'll begin our assessment of major sectors of the economy with good news. The **labor market** again posted strong growth in the third quarter (Figure 2). Despite being held back by Hurricane Florence in September, payroll jobs rose by an average of 190,000 jobs per month in Q3 and jumped by 250,000 in October 2018. The household employment survey painted a sluggish picture in Q3 (129,000 per month), but it rebounded by 600,000 in October for a 4-month average of 247,000 monthly job gains. Over 12 months ending in October 2018, payroll and household survey jobs were up 1.7% and 1.8% YoY, respectively – impressive growth at this point in the recovery.

The unemployment rate dipped to 3.7% in October from 4.1% in December 2017 (Figure 3), while labor participation rose to 62.9% from 62.7% over the same period (Figure 2). Despite aging demographics, the labor force grew rapidly over the past year – up 1.4% YoY, double its 2017 pace – and helped contain wage gains. Average hourly earnings rose 3.1% YoY in October, up from 2.7% in December 2017 (Figure 3). We expect wages will continue a gradual acceleration that began in 2012 and support personal income even as employment growth inevitably slows.

Figure 4: Income & Consumption Growth Solid

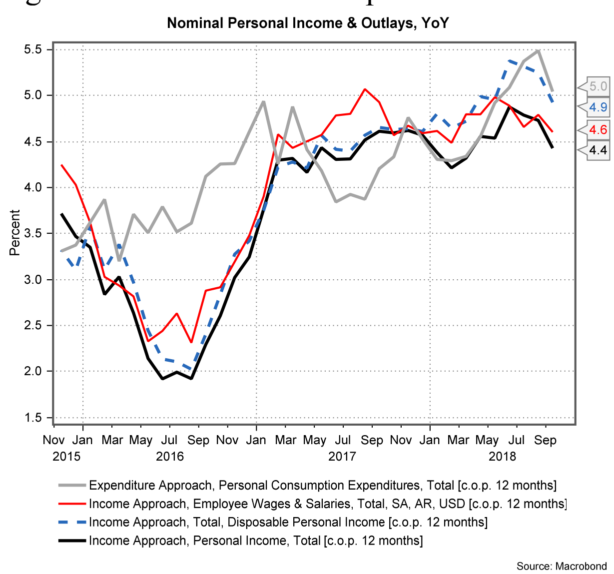
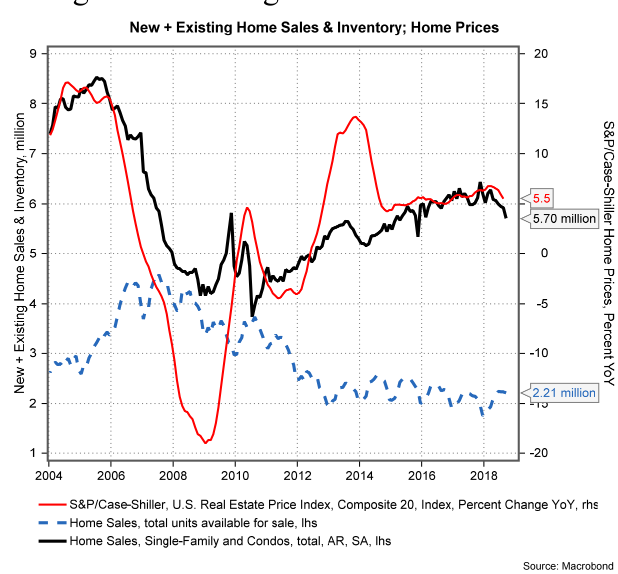


Figure 5: Housing Slowdown Continues



Nominal **personal income** growth held steady at 4.2% in the third quarter, or 2.6% on an inflation-adjusted basis. Taking a longer-term view, nominal personal income and disposable income rose 4.4% and 4.9% YoY, respectively, in September (Figure 4). Lower personal income tax rates in 2018 contributed to strong growth in disposable personal income, which is reported on an after-tax basis. Both overall and disposable personal income improved substantially over the past several years as economic growth accelerated.

Nominal **personal consumption expenditure** (PCE) was up 5.6% in the third quarter and 5.0% YoY (Figure 4). Adjusted for inflation, real PCE rose by 4.0% in Q3 and 3.0% YoY. These strong consumption gains were supported by higher disposable income (Figure 4), but with new tax cuts unlikely to give another boost to disposable income in 2019, we anticipate still-good but more-modest growth in personal consumption next year.

Because personal consumption growth outpaced disposable income, the **personal savings rate** dipped to 6.2% in September from 6.7% in June. This is still a healthy savings rate, but we do expect it to stabilize or move a little higher as PCE growth slows after two very strong quarters.

In contrast to strength in other consumer-driven sectors, the **housing market** slowed considerably in the third quarter. Real residential investment fell 4.0% in Q3 and is down 2.2% (not annualized) since 4Q2017. Combined new and existing home sales plunged to a 5.7 million unit pace in September, although inventories of unsold homes remained relatively low (Figure 5). Moreover, home prices – which continued to rise briskly even after home sales peaked, slowed in the third quarter. The S&P/Case-Shiller 20-city home price index rose 5.5% YoY in August (latest data available), down from a peak of 6.8% in March.

Higher home prices, rising mortgage rates and tax reform's limitations on deductibility of mortgage interest and state and local taxes raised home ownership cost this year. These appear to have dampened demand for housing, and they are likely to persist for a while. A period of slower home price gains and rising employment eventually should boost demand for housing, but we are not penciling in much contribution to GDP growth from residential investment over the next year or two.

Figure 6: Production Up, but ISM Mixed

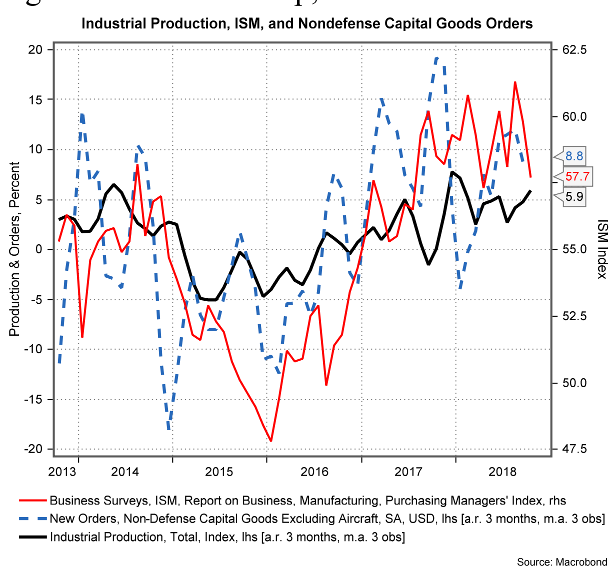
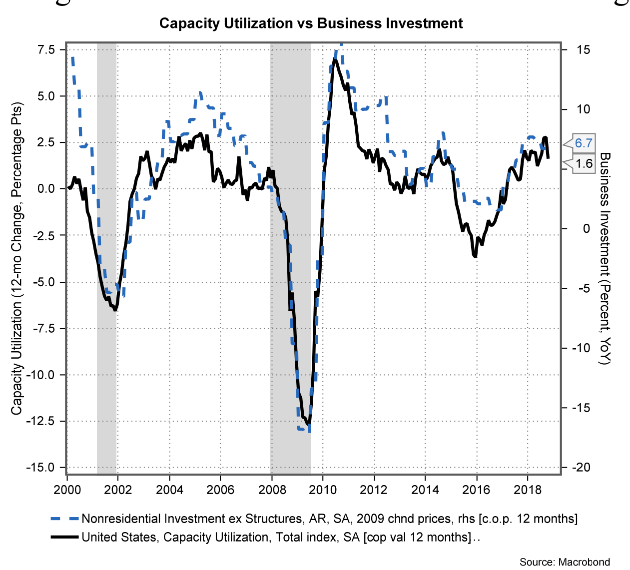


Figure 7: Business Investment Remains Strong



Industrial production rebounded from a brief summer slowdown, rising 4.7% in Q3, 5.9% over three months ending in October (Figure 6) and 4.1% YoY in October. Mining output led the way and was up 17.1% in Q3 and 7.4% YoY in October; it represented about 14% of total industrial output in 2017. Utility output (~10% of total) remained subdued, up 1.7% over both three and 12 months ending in October. The much-larger manufacturing sector (~76% of total) posted moderate growth of 5.1% and 3.0% over the same periods. Although the Institute for Supply Management's manufacturing slipped to 57.7 in October (Figure 6), it continues to signal moderate gains in output over coming months. Orders for core capital goods (nondefense, excluding aircraft) rose 8.8% in the third quarter and should drive higher output over coming months. Expanding trade tariffs remain a risk for the industrial sector, but we have seen only limited impact on orders and shipments so far.

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Real **business investment** slowed sharply in the third quarter, although we expect it will prove mostly temporary. Overall business investment was up just 0.4% in Q3 after unsustainably large gains averaging 10.1% in the first half of 2018. Investment in structures drove the weakness; it was down 7.9% in Q3 after rising 14.5% and 13.9% in Q2 and Q1, respectively. "Core" business investment (business equipment and intellectual property) rose 3.1% in Q3 and 6.7% YoY, about in-line with gains in capacity utilization (Figure 7). Lower corporate tax rates and rising labor costs should spur continued investment spending, and we expect it to remain a bright spot in 2019.

Figure 8: Productivity Not Yet Accelerating

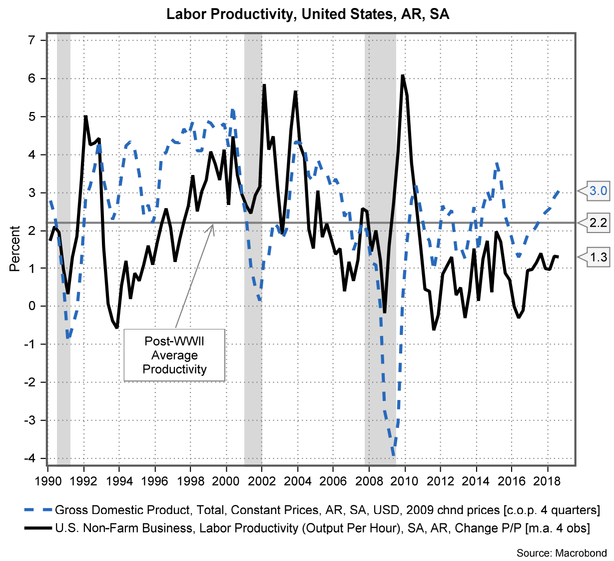
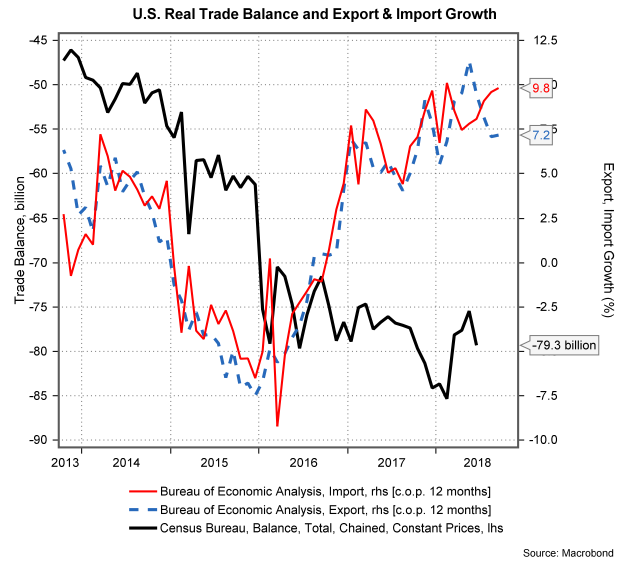


Figure 9: Trade Deficit Narrowed, Future Unclear



Labor productivity held about steady in the third quarter, which was a mild disappointment given strong growth in real GDP. Nonfarm productivity rose 2.2% QoQ and 1.3% YoY in the third quarter, about flat with recent results (Figure 8). It is unclear why productivity is not rising more quickly despite strong investment spending. Perhaps employers are hiring workers ahead of when they really need them it a tightening labor market (i.e., hire while you can still find workers), increasing hours worked and reducing productivity. High levels of job openings support that notion. Perhaps recent hires are more "green" (new entrants or those coming back to work after long absences) who will take time to catch up to more experienced employees' productivity. Nonetheless, rising business investment should boost productivity growth over time, especially as employment growth eventually slows, reducing growth in hours worked.

The **trade deficit** widened sharply in the third quarter (Figure 9). Net exports subtracted 1.8% from real GDP growth in Q3. Import growth rebounded to 9.3% YoY in September while export growth slipped to 7.2% YoY, as both importers and exporters rushed to deliver goods before tariffs kicked in. Importers won that battle in Q3. Fundamentally, stronger U.S. economic growth and a stronger U.S. dollar should boost demand for imported goods while making U.S. exports more expensive for foreign buyers. Import tariffs offset some of that increase in U.S. demand by boosting import prices, however. We expect the net result of this will be slower import *and* export growth, although tariffs' impact so far appears to be modest. Stay tuned.

Producers and importers responded to a surprise drawdown in inventories in the second quarter by boosting them sharply in the third. **Inventories** added 2.1% to Q3 real GDP after subtracting 1.2% in Q2. Inventory growth is often volatile quarter-to-quarter, and this year certainly illustrates that. Although inventory growth will continue to add volatility to quarterly real GDP, it is not a major factor in our medium-term outlook.

Government consumption accelerated again in the third quarter. Real federal spending rose 3.3%, led by a 4.6% increase in defense spending. Real state and local spending was up 3.2% in Q3 compared to 1.8% in Q2. We think state and local governments will face taxpayer resistance to more rapid spending in light of limitations on state and local tax deductions on individual federal tax returns. Consequently, state and local spending growth should remain subdued overall. In contrast, federal government defense spending is rising, and nondefense spending should pick up soon. The Congressional Budget Office (CBO) reported that total spending was up 3.2% in nominal terms in fiscal year 2018, and the budget deficit rose to $779 billion, or 3.8% of GDP.[2] CBO has not updated projections since April,[3] but that report forecast growth of 6.8% in mandatory spending, 6.4% in discretionary spending and 7.9% in total spending in FY2019. Those are expected to ease to 5.2%, -1.6% and 4.8% growth, respectively, in FY2020. Thus, the federal government's contribution to GDP growth should peak next year and pull back modestly in 2020.

Figure 10: Private Sector Still Driving Growth

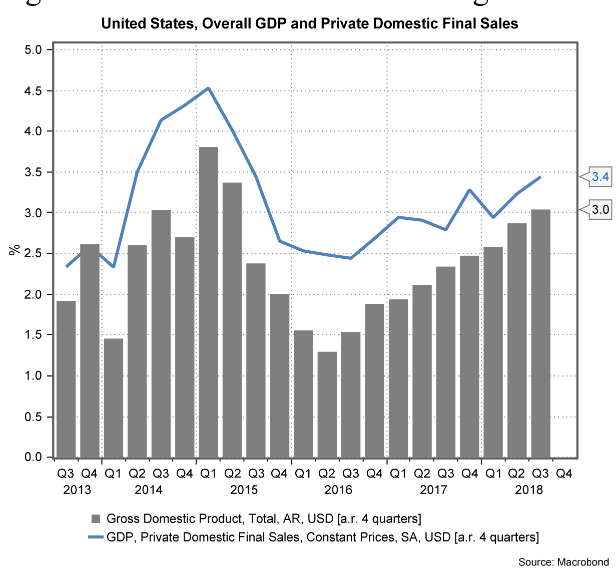


Figure 11: Inflation at Fed's 2% Target

Summarizing the third-quarter economic situation, real GDP growth of 3.5% adds up as follows: Personal Consumption Expenditures (+2.69%), Residential Investment (-0.16%), Business Investment (+0.12%), Inventory Change (+2.07%), Net Exports (-1.78%), and Government Consumption (+0.56%). The first three components equal **Private Domestic Final Sales**, which grew by 3.1% during the quarter and 3.4% over the past year (Figure 10). Private sector growth was led by PCE. Looking ahead, we expect solid PCE growth to continue along with a stronger contribution from business investment. Residential investment may get a Q4 boost from

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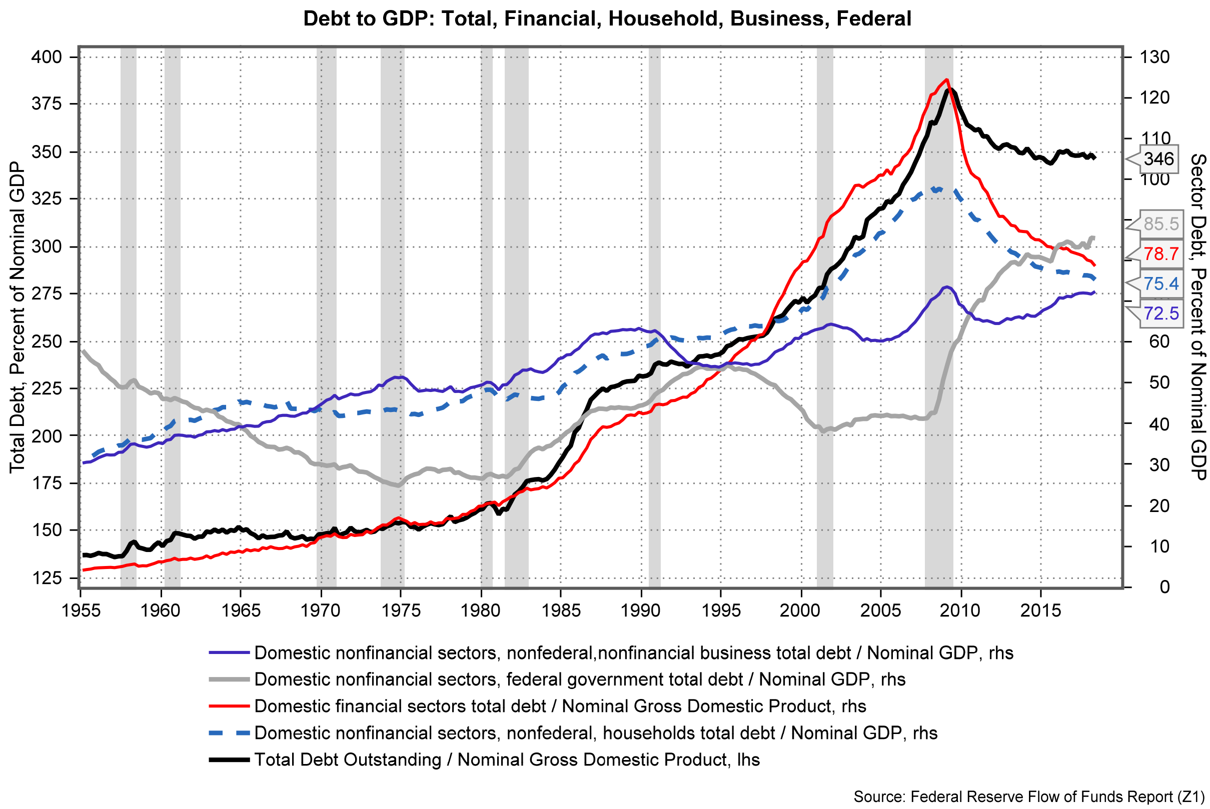
[2] *Monthly Budget Review: Summary for Fiscal Year 2018*, Congressional Budget Office, November 7, 2018.
[3] *The Budget and Economic Outlook: 2018 to 2028*, Congressional Budget Office, April 2018.

hurricane and wildfire rebuilding, but it's not likely to provide a significant lift to GDP. Inventories probably turn negative after Q3's big add, while government spending should look similar to Q3. Net exports remain a wildcard.

Inflation eased a little in the third quarter, leaving it equal to the Federal Reserve's 2% inflation target (Figure 11). For 12 months ending in October, the consumer price index (CPI) was up 2.5% overall and 2.1% excluding food and energy. The Federal Reserve's preferred inflation gauge, the PCE deflator, was up 2.0% both overall and excluding food and energy over 12 months ending in September. Lower energy prices contributed to lower headline inflation numbers, and core inflation was muted. We continue to expect inflation will move upward as the labor market tightens and wages pick up, but we think it will be a gradual process, particularly in light of sharply lower oil prices in November, which is not yet reflected in those inflation figures.

Figure 12: Leverage Lower Overall; Nonfinancial Business and Government on Watch List



As shown in Figure 12 above, broad **balance sheet trends** in the U.S. were generally lower in the second quarter of 2018 (latest data available). Overall debt-to-GDP was 346%, down from 348% last quarter. Leverage at households fell to 75.4% from 76.1%; household balance sheets are in very good shape. Financial business leverage continued to decline quickly, dropping to 78.7% from 79.6% debt-to-GDP last quarter. However, federal government debt edged up to 85.5% from 85.2%, and it's set to continue to rising as the federal budget deficit widens over coming years. Nonfinancial businesses leverage rose to 72.5% from 72.0% of GDP and remains a risk factor when the next recession hits. Overall, however, there are no red flags in these numbers, and the deleveraging trends at households and financials are clear positives.

Market Outlook

Long-term **Treasury rates** rose in the third quarter as the Fed continued to raise short-term rates and signaled that hikes are likely to continue next year. The benchmark 10-year Treasury note yield rose by 20 basis points (bp) to 3.05%, and the 30-year Treasury bond yield rose by 21 bp to 3.19% on September 28 (Figure 13). Ten- and 30-year yields continued upward after quarter-end, peaking at 3.24% and 3.46%, respectively, in early November before falling in response to equity and credit market weakness later in the month. They closed at 3.04% and 3.30%, respectively, on November 23.

The Federal Open Market Committee (FOMC) maintained its gradual pace of monetary tightening, raising short-term rates by 25 bp in September. Strong economic growth and hiring probably outweigh recent declines in equity and credit markets, and we expect the FOMC to hike rates again on December 19. That would raise the fed funds target rate to 2.25-2.50% and bring inflation-adjusted short rates meaningfully above zero for the first time since before the financial crisis. As expected, the Fed also increased runoff of maturing securities in its System Open Market Account (SOMA) to about $50 billion per month beginning in October 2018, where it should remain until the Fed's portfolio reaches a "normal" size. The FOMC has not specified what "normal" will be other than to say the Fed's balance sheet will be larger than it was prior to the financial crisis.

Figure 13: Rates Up, Anticipate More Hikes[4]

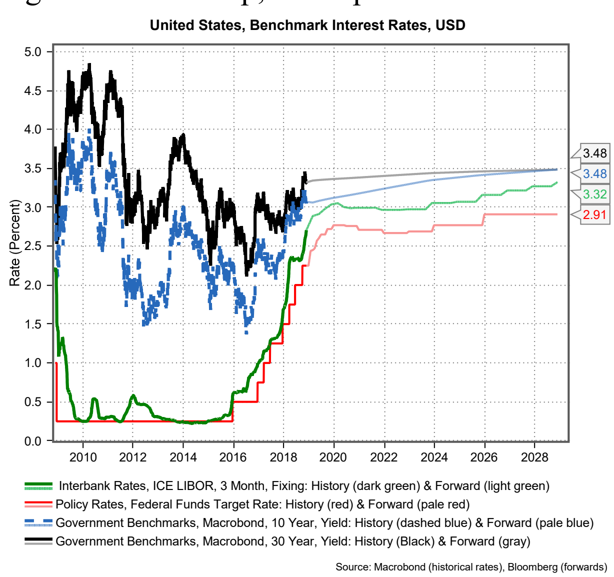
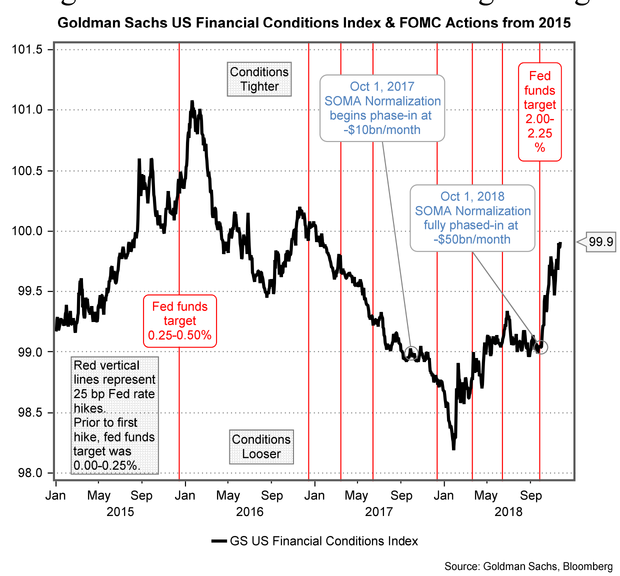


Figure 14: Financial Conditions Tightening



Short-term rate hikes and a smaller Fed balance sheet each push in the direction of higher intermediate and long-term interest rates, which are part of the FOMC's plan for tightening financial conditions. Early in the current tightening cycle, however, lower long-term interest rates, rising stock prices, narrower credit spreads and other market factors *loosened* financial conditions. It took five rate hikes and a shrinking balance sheet to turn financial conditions toward a tighter posture (Figure 14). Tightening accelerated following the FOMC's September

[4] The fed funds effective rate recently has traded about 5 bp below the top end of the FOMC target range. In Figure 13, we add 5 bp to forward rates implied by overnight index swaps (OIS) to align them with historic target rates.

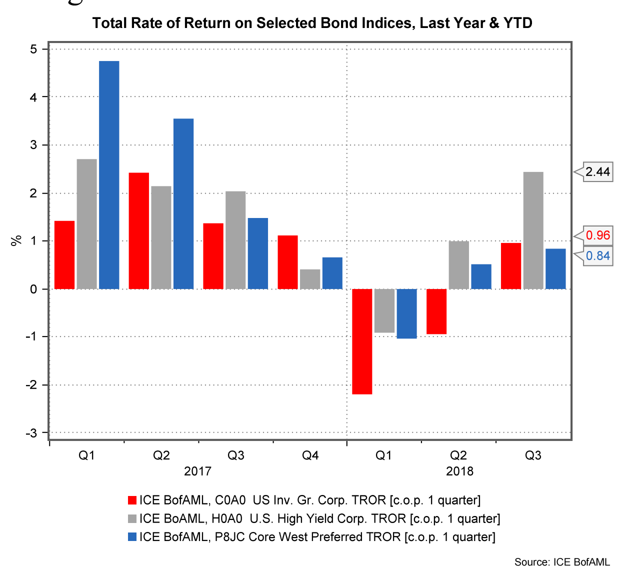
26 rate hike as interest rates rose and equity and credit markets weakened. It's likely that the Fed believes financial conditions should tighten further. However, with inflation-adjusted short rates turning positive, risky asset prices down, market volatility increasing and housing activity falling, we believe the Fed will move more cautiously as the fed funds rate approaches 3%.

Markets currently price in a high likelihood of one more 25 bp rate hike in 2018, one to two additional 25 bp rate hikes in 2019 and no move in 2020. The FOMC's median fed funds projections from September 26 suggest agreement with markets through about mid-2019 but are more hawkish thereafter. Markets expect fed funds to reach 2.75% by year-end 2019 and then hold about steady. In contrast, the FOMC projects 3.1% and 3.4% at year-end 2019 and 2020, respectively before declining to a "longer run" rate of 2.9%.

Our rate expectations are little changed from our last Update. We expect a fed funds target range of 2.75-3.00% at year-end 2019 and 2020, although 25 bp higher would not be a surprise. We anticipate modestly slower economic growth in 2020 as federal government spending slows and stimulus from tax reform wanes. Lower equity prices and wider credit spreads suggest rising investor caution over the outlook, which could magnify the impact of future rate hikes by the Fed. Finally, rising Treasury supply and reduced portfolio reinvestment by the Fed should combine to tighten financial conditions without multiple rate hikes by the FOMC in 2020. We think most of the move up in intermediate and long-term Treasury rates is behind us.

Figure 15: Wider, More Volatile Credit Spreads

Figure 16: Low Credit Returns in 2018



There is risk that continued strong economic growth and higher inflation prompt the FOMC to tighten more aggressively than we expect, but we also see downside risks from trade tariffs, slower foreign economic growth, and potential for a sharper slowdown in the U.S. in 2020. Markets already reflect most of our anticipated rate hikes and imply that intermediate and long-term Treasury rates should rise only 15-40 bp over current forward rates to year-end 2020, which should pose a headwind but not a major obstacle to preferred securities. Recent economic data and higher market volatility suggest that risks surrounding that outlook have increased, however.

Corporate **credit spreads** narrowed during the third quarter but widened sharply since quarter-end as worries over prospects for economic growth mounted and equity markets fell. Investment-grade corporate bond spreads[5] tightened by 17 bp from 129 bp to 112 bp in the third quarter but jumped to 137 bp as of November 23. High yield bond spreads[6] were significantly more volatile, narrowing by 44 bp in Q3 to 338 bp but widening to 436 bp as of November 23 (Figure 15), their highest level since December 2016.

Spreads on preferred securities are more difficult to illustrate. Nearly all preferred securities are callable, and yield-to-worst often understates economic yield when prices are above par – as many are today – because not all of those securities will be called by their issuers on first call date. Instead, we will focus on total rate of return, which incorporates both income and price changes. Figure 16 shows total returns on selected ICE BofAML indices in recent quarters. In the third quarter of 2018, total return on the preferred index[7] (+0.84%) substantially underperformed the high yield index (+2.44%) and was slightly behind the investment-grade corporate bond index (+0.96%).[8] Year-to-date through November 23, preferreds (-2.54%) lagged high yield (-0.48%) and outperformed investment grade corporates (-3.55%).

Figure 17: Corporate Profits Very Strong

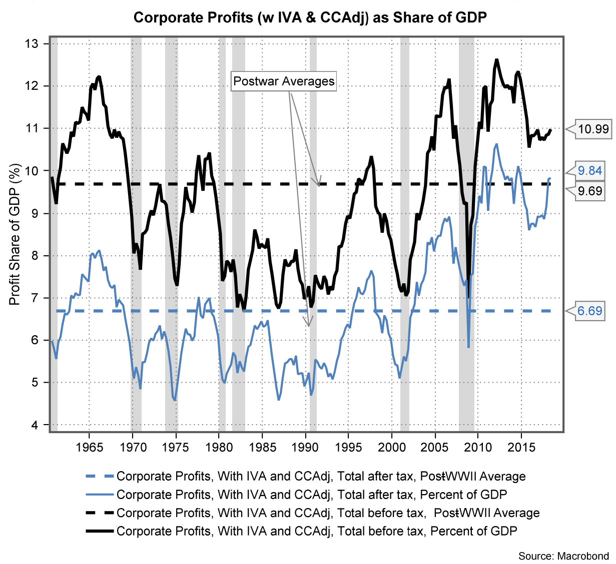
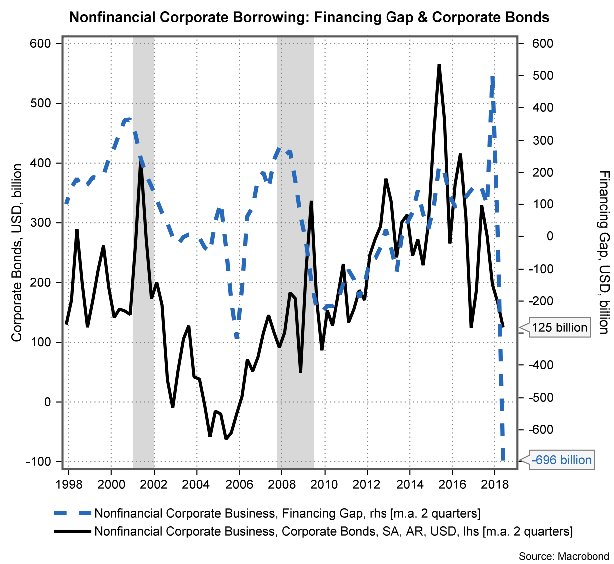


Figure 18: Financing Gap, Borrowing Down



Although recent credit spread widening might suggest otherwise, **credit conditions** improved a bit in second quarter (latest data available), and banks' third-quarter results generally showed better loan performance and higher earnings. Economy-wide corporate earnings after taxes rose 15.8% in the second quarter compared to a year earlier, and economists forecast that to accelerate to 19.6% in Q3. While lower corporate tax rates in 2018 provided a sizable lift to profits, pre-tax earnings also rose quickly, up 7.3% YoY, reflecting strong economic growth. The profit share of

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[5] Investment-grade corporate bond spread is represented by the ICE BofAML U.S. Corporate Index[SM] (C0A0) "Yield to Worst versus Government" yield spread series. "Spread to Worst" is the lower of yield to call and yield to maturity minus yield on a comparable Treasury security.

[6] Below-investment-grade corporate bond spread is represented by the ICE BofAML U.S. High Yield Index[SM] (H0A0) "Yield to Worst versus Government" yield spread series.

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

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

GDP also rose (Figure 17). Eventually, competition for workers should boost wages and push the profit share of GDP back toward its long-term average, but for now, higher profits provide businesses with an additional margin of safety against a downturn.

The "financing gap," internally generated cash relative to spending on capital investments, for nonfinancial businesses improved in the second quarter as revenues and profits rose. Figure 18 show a 2-quarter moving average to reduce quarterly volatility of this series. As a result, nonfinancial corporations reduced net corporate bond issuance in the first half of 2018 after rising significantly last year. If this continues, we should see leverage stabilize or ease a bit at these companies over coming quarters.

Figure 19: Rising Interest Costs a Risk

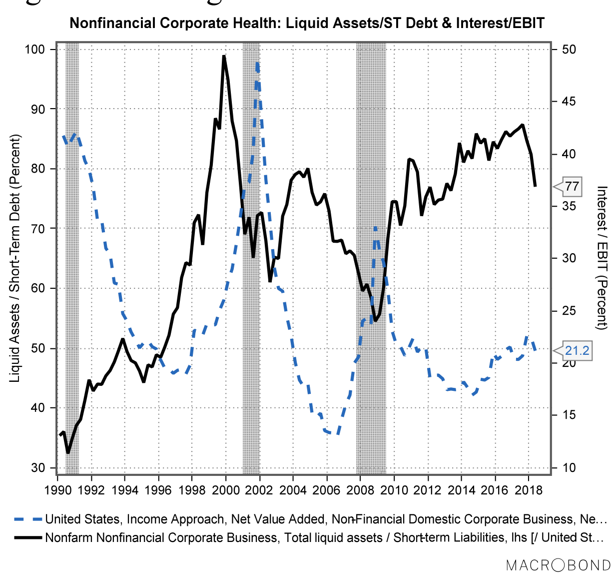
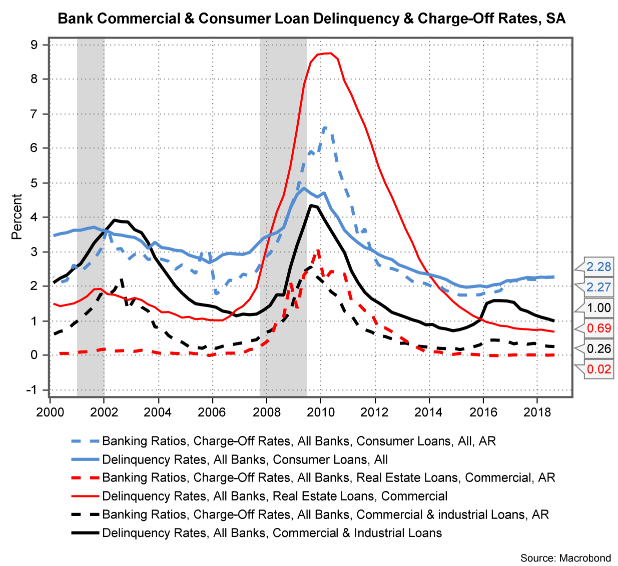


Figure 20: Loan Quality Still Improving



Debt at nonfinancial companies relative to tangible assets held about steady at 40% in the second quarter (latest data available), but liquidity was down. Nonfinancial corporate holdings of liquid assets relative to short-term liabilities dropped from a recent peak of 87% to about 77% in Q2 (Figure 19). Interest expense as a percentage of earnings before interest and taxes (EBIT) improved a bit to 21.2% in Q2, but that's up from about 17% in 2014, when the Fed held short-term interest rates near zero. This modest weakening of credit metrics isn't currently a red flag, but combined with rising leverage noted earlier, we are more watchful of credit conditions at nonfinancial companies.

In contrast to some deterioration at nonfinancial companies, credit metrics at financial companies continued to improve. Overall bank loan delinquencies fell to 1.59% in Q3 from 1.64% in Q2 and 1.83% a year earlier (Figure 20). Overall loan charge-off rates held steady at 0.46% in the third quarter, about where they have been since late 2016. Delinquency rates on commercial and industrial loans (0.69%) and real-estate loans (1.92%) drifted lower, while consumer loan delinquencies (2.28%) and charge-offs (2.27%) were about flat. Bank earnings were strong, and capital ratios held about steady.

Summarizing our main views, with most of the year behind us, we expect 2018 real GDP to expand by 3.0–3.2% over 4Q2017. While job growth is bound to slow eventually, wage growth should make up for most of that and keep income growth comfortably above 4% (2–2½ percent real) through 2019, which should support consumer spending at or a little above that pace. Business investment should rebound from a Q3 slowdown, but it's unlikely to match 2018's rapid first half pace. Residential investment continues to look soft. Rising employment should boost demand for housing over time, but lower home prices may need to come first. Government spending should rise in 2019 before turning down in 2020 under current spending plans, and we see little room for further fiscal stimulus. We continue to expect that higher business investment and regulatory reform will boost productivity and enable faster economic growth without substantially higher inflation. However, uncertainty over trade and immigration policies and sharply higher federal budget deficits cloud longer-term outlooks for the economy and interest rates.

It has been a difficult year for credit investors, with modestly negative total returns across corporate and high-yield bonds and preferred securities. Higher benchmark interest rates and wider credit spreads dampened returns in 2018. However, higher rates and wider spreads mean preferred securities now yield around 6.25% (with a lot of variation around that average), 1% more than they did a year ago.

Looking ahead, we expect benchmark rates to move only modestly higher over the next year or two as the economy's growth rate slows and Fed rate hikes come to an end. Moreover, we think recent credit fears in the preferred market are overblown. Financial companies make up over 70% of the preferred market, and among them we observe broadly lower leverage, stable or improved loan quality, and earnings that should benefit from higher interest rates. Of course, individual companies will perform better or worse than average, but we see generally improving credit conditions at most issuers of preferred securities. In contrast, leverage is up at nonfinancial companies, and higher interest rates eventually will boost interest expense at these companies. Although we believe the odds of a U.S. recession are low next year, financial companies – which have significantly strengthened their balance sheets since the financial crisis – should be well positioned to weather an economic downturn when it comes. We think preferred securities continue to offer long-term investors an attractive combination of good credit quality, high income and moderate interest rate risk.

Flaherty & Crumrine Incorporated
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