U.S. Economy

The U.S. economy continued to expand rapidly in the second quarter as COVID-19 vaccines became more widely available to U.S. residents, hospitalizations slowed, and many activities curtailed during the pandemic resumed. Inflation-adjusted gross domestic product (real GDP) rose by 6.7% in Q2, slightly faster than Q1's 6.3% pace. Growth appears to have slowed in Q3 and forecasts for the second half have moderated. Economists now expect Q3 and Q4 GDP to expand by 3.5% and 4.9%, respectively, down from earlier forecasts. Solid U.S. growth is expected to continue next year, with the consensus 2022 GDP forecast currently at 4.0%, little changed from prior estimates.

As expected, the U.S. economy surpassed 4Q2019's level of real GDP in the second quarter. It remains on track to recoup growth lost to the pandemic in the next few quarters, but it seems unlikely to do so by year-end 2021. Rising COVID-19 infections from the Delta virus variant, labor shortages, supply chain disruptions, and higher inflation have been headwinds to the economy in recent months, and they are likely to persist into 2022. As those diminish next year, the current economic recovery should continue at a slower but still above-trend pace and push the level of real GDP above its pre-pandemic trendline (about 2% growth) sometime during the first half of 2022.

Above trend growth has been driven by the labor market's continued recovery, which has been strong throughout 2021. Nonfarm payrolls rose between 1.55 million jobs and 1.85 million jobs in each of the three quarters of 2021 thus far. Overall nonfarm employment was 147.6 million in September. Although that remains 5.0 million jobs below the February 2020 peak, labor demand remains very strong. According to the latest job openings report, there were 10.4 million unfilled jobs in August, more than enough to absorb all unemployed persons age 16 and over. Of course, there are numerous frictions to matching employers and employees, including geographic and skill mismatches, ongoing health concerns about COVID-19, and difficulty finding suitable childcare, eldercare, or other assistance that potential employees might need to take a job. As daily activities gradually return to normal and in-person school and care services resume, some of those frictions should diminish. We expect sturdy employment growth for some time to come despite headwinds from COVID-19.

Strong demand for labor prompted faster wage increases. Average hourly earnings in September rose at a 5.5% pace in Q3 and 4.6% over 12 months, even as a rebound in lower-paid leisure and hospitality employment pulled down the average. The employment cost index, which adjusts for compositional shifts, was up at a 3.4% rate in Q2, moderately above its pre-pandemic pace. In addition, anecdotal reports, including the Federal Reserve's Beige Book, suggest continued upward pressure on labor costs.

After surging in Q1 thanks to fiscal stimulus, personal income slipped in recent months. Nominal personal income fell by 21.8% in Q2 after jumping 56.8% annualized in Q1, although that still left overall personal income in August up 6.1% compared to a year earlier. Transfer payments were to blame for the drop in income since one-time stimulus payments were mostly complete by Q2. Excluding transfers, nominal personal income rose 9.4% in Q2 and 6.9% YoY in August. Looking ahead, we expect continued job gains and rising wages will support good growth in personal income.

Despite that slowdown in income, personal consumption expenditure (PCE) accelerated. Nominal PCE rose 11.6% over 12 months ending in August 2021. Adjusted for inflation, real PCE rose 7.0% YoY in August. Nominal spending on services accelerated while goods spending cooled. Many service sector activities that were restricted earlier in the pandemic are now growing rapidly, especially in leisure and hospitality. The shift from goods to services spending is likely to continue and should sustain good growth in PCE over coming months. Of course, COVID-19 remains a particular risk to the outlook for services activity if infections spike again and demand for services drops or rising infections prompt renewed restrictions on service activities. Indeed, retail sales at eating and drinking establishments flattened out in July and August after rising rapidly since February. For now, we are optimistic on consumer spending, but we remain watchful of COVID's ongoing impact.

Lower income and higher spending pushed the savings rate down to 9.4% in August, a big decline from almost 27% in March following stimulus payments. Today's gradually falling savings rate reflects that it took consumers time to spend savings accumulated earlier in the pandemic. Overall, we think rising employment and wages combined with still-high levels of personal savings mean PCE will remain a source of strength for the economy over coming quarters, although recent rapid gains are bound to slow.

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 September, the consumer price index (CPI) was up 5.4% overall and 4.0% excluding food and energy. The PCE deflator was up 4.3% overall and 3.6% excluding food and energy in August. These are the fastest gains in core inflation since 1991. As we explained last quarter, base effects from falling prices last year contributed to these sharply higher inflation rates. However, looking at the past three months, the core PCE deflator was up at a 4.6% pace while core CPI was up 5.4%. Rising wages, shrinking excess capacity, supply shortages and rising input prices remain with us and should keep inflation elevated at least through year-end and likely well into 2022. Whether they become more entrenched or begin to fade next year will be a key question facing monetary policymakers in 2022.

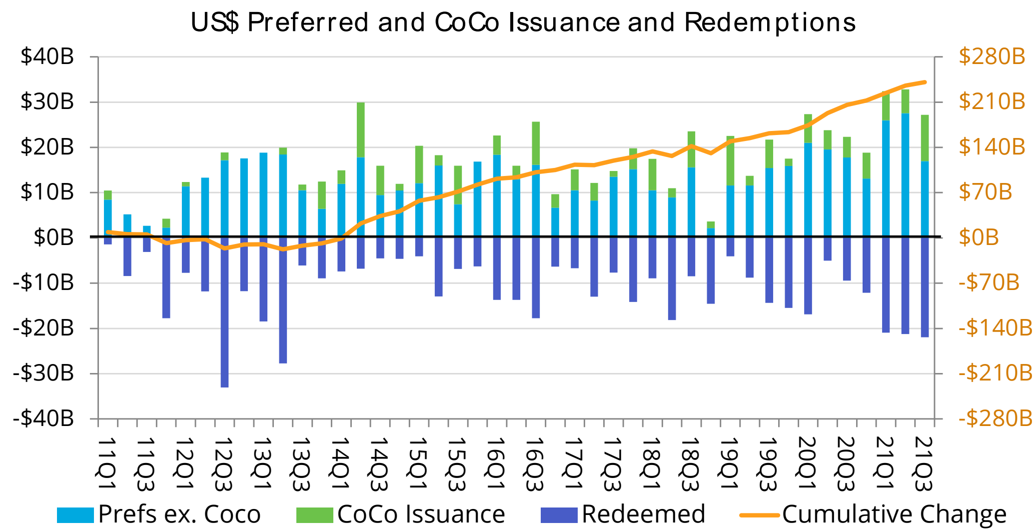
As expected, the Federal Reserve left monetary policy unchanged after its most recent meeting on September 22. The Federal Open Market Committee (FOMC) held the fed funds rate target at 0 0.25%. It also continues to purchase approximately $80 billion Treasuries and $40 billion agency mortgage-backed securities per month. However, the FOMC's post-meeting statement noted that "if progress continues broadly as expected…a moderation in the pace of asset purchases may soon be warranted". In post-meeting comments Fed Chairman Powell indicated that a gradual tapering of asset purchases that concludes in the middle of next year is likely to be appropriate. Given these indications, markets expect that the Fed will announce the reduction of asset purchases starting at its next meeting on November 3.

In addition, the FOMC's most recent "dot plot" from September showed Committee members expect the fed funds rate to remain near zero through 2022 but penciled in 75 bp of rate hikes in 2023. Firmer inflation readings have pushed up interest rates since that meeting, however, and market forward rates now show rate hikes starting in late 2022 and a fed funds target of 1.00-1.25% at the end of 2023, above the Fed's median forecast. We expect the Fed to be patient and avoid rate hikes in 2022 but make up for it by hiking rates to or above current market forwards in 2023. In turn, longer-term interest rates should rise moderately as the economic expansion continues and the Fed tapers accommodation and later tightens monetary policy.

Preferred Market Conditions

The preferred securities and CoCo markets continued their strong performance in Q3, resulting in impressive returns year-to-date. Despite a few pauses along the way, low interest rates, a strong economic rebound from COVID, and continued accommodative monetary policy have provided a stiff tailwind for equity and fixed-income markets so far in 2021. Savings accumulated during earlier periods of COVID restrictions and consumers' own limits on their activities increased investable funds, and options for earning a respectable yield have diminished. The result has been highly technical markets, where investors are more worried about earning virtually nothing holding cash than potential market downturns if interest rates or equity-market valuations were to normalize.

As discussed earlier in previous updates, flows into fixed-income investments have been robust. These flows have continued at a steady pace, but cash from issuer redemptions of callable securities was notably strong in Q3. Nearly every preferred security is callable at some point in time – it is just a matter of how far into the future. Interest rates have remained very low for an extended time, and credit spreads have compressed. Many securities became callable in 2021 at a time when refinancing was especially attractive for issuers. Issuers took advantage of this, and much of the issuance in Q3 was directly refinancing older securities, often at the lowest coupons that issuers have ever achieved. The chart below provides additional information on issuance and redemption activity over a longer timeframe.



Source: Flaherty & Crumrine

We have always valued call protection, viewing it as an important part of generating more sustainable income over time by providing greater control over reinvestment timing. As a result, our portfolios' redemption experience in 2021 has been well below the broader market. Nonetheless, our portfolios experienced some redemptions and reinvestment at lower yields. This wave of refinancing – along with future redemptions if interest rates and spreads remain low – will negatively impact distributable income over time.

From a credit perspective, Q3 continued to provide good news, with most issuers maintaining strong capital positions and healthy earnings, especially as the economy rebounded from earlier COVID restrictions and consumers and businesses resumed many activities. Banks once again passed stress tests with flying colors; insurance companies continue to wrestle with low interest rates but seem to be navigating the situation quite well; and energy has rebounded strongly as the pandemic receded. The Fed continues to stand behind the recovery and has indicated a willingness to let the economy "run hot", if necessary, to achieve long-run inflation and employment targets. Accommodative monetary policy both here and abroad should continue to support markets, although volatility may increase as we get closer to achieving the Fed's goals and central banks begin to dial back accommodation.

Today's preferred securities and CoCo markets can be difficult to evaluate from a historical perspective, as coupons have moved materially lower with interest rates and spreads. By that measure, many securities appear fully priced, if not excessively priced. However, we also measure valuation in terms of credit spreads, and although they are tighter than a year ago, preferred securities and CoCos still offer a healthy subordination premium relative to senior securities of the same issuer. Lower coupons and tighter spreads in most cases can be explained by improved credit profiles, especially for financial issuers. Recent issuance remains concentrated in a fixed-reset structure, and the reset index has broadly changed from 3M LIBOR (or SOFR) to 5Y Treasuries. This change, in addition to healthy back-end credit spreads, results in an attractive combination of strong credit quality, relatively high income, intermediate interest-rate duration, and moderate extension risk. Although we would like to see higher front-end coupons (mostly a function of interest rates), we continue to like this structural combination and think these instruments compare favorably to most other fixed-income securities.

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