U.S. Economy

The U.S. economy reaccelerated in the fourth quarter. Inflation-adjusted gross domestic product (real GDP) expanded 7.0%, its fastest pace since the recovery from the coronavirus pandemic began in 3Q2020. Personal consumption and investment rose, and inventories jumped, while government consumption slipped. Amid a sea of improving economic indicators in Q4, inflation reached levels unseen in over 30 years. Excluding the 3Q2020 "reopening" rebound in the early days of the pandemic, this combination of rapid real growth and 7.2% inflation (GDP implicit deflator) in Q4 produced the fastest nominal GDP growth (14.6%) in 40 years. Of course, Russia's invasion of Ukraine in late February 2022 — in addition to being a human tragedy — introduced new risks and uncertainty to the economic outlook.

Looking ahead, economists expect 1.5% real GDP growth in Q1 and an average of 3.6% growth in 2022 overall, slowing to 2.3% in 2023. Those are reasonable forecasts if inflation moderates in the second half on improvements to the supply side of the economy and the Fed follows a gradual tightening path. However, stickier inflation would probably turn strong nominal GDP growth into less-impressive real GDP growth, as we have seen in recent quarters. That could lead to more-aggressive monetary tightening by the Federal Reserve, boosting recession risk in 2023 or 2024.

Here's how the economy's major segments did in 4Q2021.

The labor market remained very strong in the fourth quarter. Nonfarm payrolls rose by 1.9 million jobs, and there were over 11.4 million job openings compared to 6.3 million unemployed persons in December 2021, a ratio of 1.8 to one. This extraordinarily high demand for labor drove up average hourly earnings at a 6.1% pace. Job growth continued in early 2022, with almost 1.2 million jobs added in January and February, albeit with more moderate wage gains. Hiring remains broad-based, and employer surveys continue to point toward sturdy demand for workers. While hiring is bound to slow from its recent exceptionally rapid pace, job gains should remain sturdy.

Consumer spending grew moderately, as rising inflation trimmed strong nominal spending. Real personal consumption expenditures (PCE) rose 3.1% in Q4 on a 3.9% rise in services spending. Inflation ran hot in this sector, with the overall PCE deflator up 6.3% on a 10.4% jump in goods prices; service prices rose a comparatively moderate, but still high, 4.4%. Personal income growth slowed to just 2.4% before inflation as a sharp drop in transfer payments largely offset a surge in wage and salary income. Rising employment and wages, personal savings accumulated earlier in the pandemic, and healthy consumer balance sheets should keep PCE on an upward path, but persistent inflation, an uncertain outlook over Russia's invasion of Ukraine, and a rising interest rate environment suggest gains in PCE should remain modest.

Business and residential investment spending posted modest gains in the fourth quarter after falling in Q3. Real business investment rose 3.1% in Q4 on a 10.9% jump in spending on intellectual property, despite rapid inflation averaging 7.7% in the sector. With labor in short supply, businesses should continue to boost investment spending to enhance productivity. Already, shipments of nondefense capital goods in the first two months of 2022 are up at a 15.5% annualized rate over Q4. We remain optimistic on the outlook for investment spending, although renewed supply chain disruptions from COVID restrictions in China and war in Ukraine could push some investments to the second half. Similarly, real residential investment managed to post a 1.0% real gain despite 12.1% inflation in that sector in Q4. While demand for housing and construction activity remain strong, rapid inflation is likely to keep real investment subdued until supply constraints diminish and input prices slow. We do not expect much real growth in residential investment this year.

Real government consumption fell 2.6% overall in Q4 on a 4.5% drop in federal government spending as fiscal stimulus spending ebbed – though that was a slightly smaller decline than in the prior quarter. State and local government spending slipped 1.4%. As in other parts of the economy, inflation was elevated in the government sector, with the implicit deflator up 7.7% in Q4.

With those major sectors of the economy posting moderate growth or worse, how did the US economy grow by 7.0% in the fourth quarter? The answer is inventory accumulation. Supply chain disruptions improved somewhat, while domestic final sales growth was modest at 2.0%. That led to very large inventory accumulation, which added 4.9% to real GDP. Inventories remain historically lean, and we expect continued inventory growth in 2022. However, it is changes in inventory accumulation that contribute to GDP growth, and it is unlikely that inventories will continue to rise so substantially over coming quarters. Indeed, slowing inventory growth will probably put downward pressure on GDP in Q1. We could see a lot of quarterly volatility in inventory's contribution to GDP growth this year.

Before turning to a review of Fed policy, we offer a short table of inflation rates below. A glance reveals rapid acceleration of inflation from 2020 to 2021, especially in the second half, with no relief so far in 2022.

	Implicit Deflator (AR)			
	2021:4	**2021:3**	**2021**	**2020**
Gross Domestic Product (GDP)	7.2%	5.9%	5.9%	1.3%
Personal Consumption Expenditures	6.3%	5.3%	5.5%	1.2%
PCE: Goods	10.2%	7.3%	8.2%	-0.5%
PCE: Services	4.4%	4.3%	4.1%	2.0%
Investment	8.9%	7.0%	6.0%	1.7%
Business Investment	7.7%	4.3%	3.4%	0.8%
Residential Investment	12.1%	14.8%	13.6%	4.6%
Government Consumption	7.7%	6.1%	6.3%	1.8%
Federal	5.8%	5.0%	4.7%	1.7%
State & Local	8.8%	6.7%	7.3%	1.9%

	Other Key Inflation Rates (AR)				
	LTM	**2021:4**	**2021:3**	**2021**	**2020**
Consumer Price Index (Feb)	7.9%	7.9%	6.7%	4.7%	1.2%
excl. Food & Energy	6.4%	5.6%	5.3%	3.6%	1.7%
PCE Deflator (Jan)	6.1%	6.3%	5.3%	3.9%	1.2%
excl. Food & Energy	5.2%	5.0%	4.6%	3.3%	1.4%

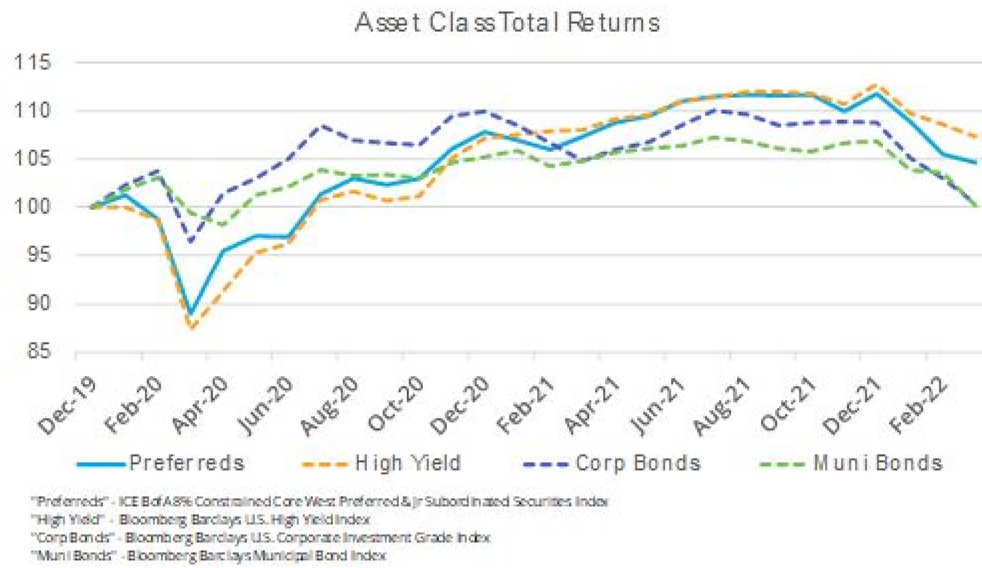
Quarterly rates are QoQ. Yearly rates YoY. LTM is latest month (noted) vs 12 months ago.

Economists and the Fed expected inflation to pick up in 2021 as the economy recovered from recession. However, inflation turned out to be much higher, broader, and more persistent than anticipated. Although monetary policy did not spark this inflation — a rapid, global recovery in demand combined with supply constraints did that — it remained very loose. Sharply negative real interest rates and rapid money supply growth accommodated higher inflation. As we noted in our 1Q2021 Economic Update, higher inflation was a policy choice by the Fed. It has turned into a policy mistake — one that the Fed is now addressing.

The Federal Reserve left the target fed funds rate near zero in the fourth quarter, but it did begin to taper securities purchases and ended them in March. As inflation rose to new heights, the Fed hiked rates by 25 bp on March 16 and signaled an additional 150 bp of rate hikes this year plus 75-100 bp in 2023, which would bring the fed funds rate near 2.75%. The Fed's median "dot plot" expectation for core PCE inflation at year-end 2023 is 2.6%, meaning a 2.75% fed funds rate would be neutral or only mildly restrictive, even if inflation slows sharply from current levels.

Inflation should slow in the second half of this year, albeit probably not as low as the 2.6% core PCE year-end inflation rate projected by the Fed. However, given a tight labor market, geopolitical risk to supply chains, and still-sturdy demand, we believe inflation risks are skewed to the upside and could require both faster and larger rate hikes than the Fed outlined on March 16. In fact, only a week after its opening rate hike and press conference guidance, the Fed is signaling a more aggressive pace of rate hikes. Expect continued rate volatility as markets and the Fed digest incoming news on the economy and inflation.

Preferred Market Conditions

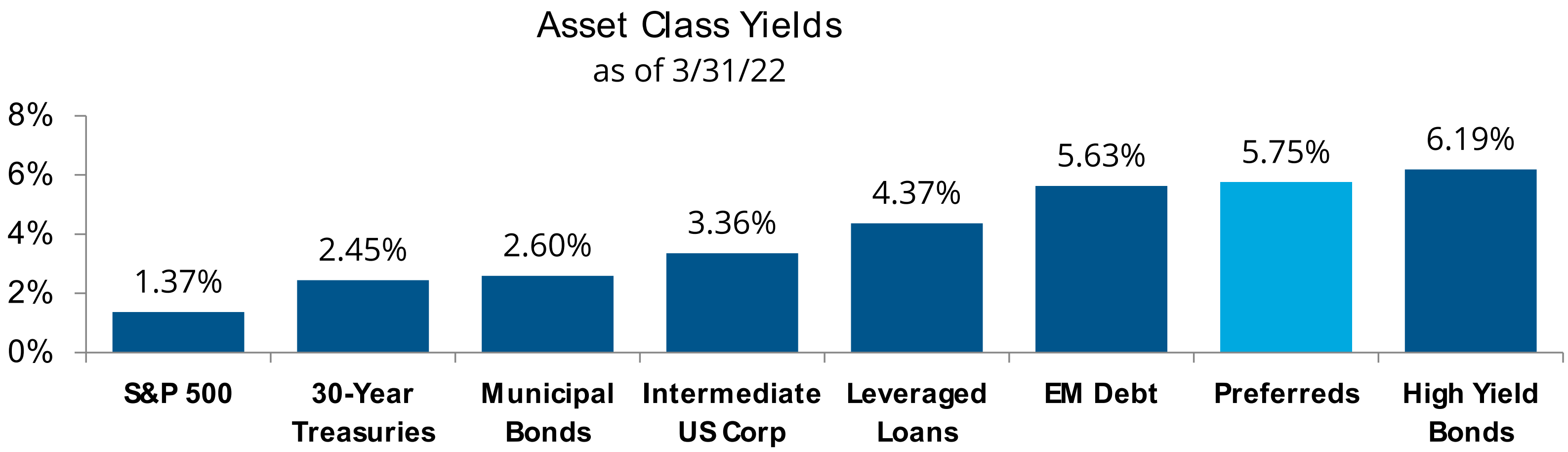


A new wall of worry began to build as we turned calendars to 2022, with inflation levels unseen in over 30 years, concern that Fed policy is behind the curve, and an unprovoked invasion of Ukraine by Russia in late February. These worries advanced for most of Q1 as interest rates moved higher and the yield curve flattened. Credit markets experienced negative flows and volatility in all markets increased. Spikes in commodity prices related to Russia-Ukraine have only heightened inflation concerns. Credit spreads widened as a result of these conditions. Investors are requiring higher rates of return in all credit sectors, and senior bonds entered 2022 at historically tight levels. Preferreds earned extra spread over senior bonds given subordination premiums, and they have weathered the storm comparatively well considering uncertainty in markets.

While uncertainty has increased over the last quarter, and we are only one rate hike into a Fed cycle that likely includes at least 6-7 additional hikes, we continue to believe credit quality is a highlight of the preferred market. Banks remain very well capitalized, highly regulated, and most are asset-sensitive – which means earnings will increase with higher interest rates. Direct exposure to Russia-Ukraine appears to be limited and contained to manageable earnings events, if anything. Insurance companies have been longing for higher interest rates to boost portfolio yields, and they finally have arrived. Energy issuers, pipelines in our case, have been buoyed by higher commodity prices and potential increases in usage because of a shifting energy landscape. Higher interest rates are likely to be more concerning for high-yield (junk) issuers as they have weaker balance sheets and greater exposure to rising interest costs.

In the long-run, modestly higher interest rates and spreads should be a healthy adjustment for credit markets, including preferreds. Investors have struggled to find income for years and have often increased risk chasing income goals. Additionally, higher interest rates could eventually be positive for coupons of certain fixed-reset or floating securities. Ultimately, we believe preferreds will provide investment-grade credit risk (low rates of default and deferral), intermediate duration, and a subordination premium that more than compensates for a move down in capital structure – and much of the income remains tax-advantaged.

Nevertheless, there remains much to consider as we navigate the current environment. An overly aggressive Fed, prolonged Russia-Ukraine war causing more severe economic disruptions, COVID resurgence, or other risks could push global economies towards recession. However, preferred market valuations are attractive, and we look forward to managing the transition to higher rates and taking advantage of dislocations in the market as they present themselves.



	S&P 500	30-Year Treasuries	Municipal Bonds	Intermediate US Corp	Leveraged Loans	EM Debt	Preferreds	High Yield Bonds
Duration	**N/A**	20.8	5.6	4.4	< 1	6.8	4.0	3.9
Avg Credit	**N/A**	AA+	AA-	BBB+	BB-	BBB-	BBB-	B+

Source: Flaherty & Crumrine, Bloomberg, Barclays Live, S&P

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