Third-Quarter U.S. Economic Update
November 2021

Summary of Recent Economic and Market Developments

The U.S. economy cooled in the third quarter as inflation ran hot, turning rapid nominal growth into sluggish real growth. Real GDP rose 2.1%, down considerably from an average 6.5% gain in Q1 and Q2. Hiring picked up, the unemployment rate fell to 4.8%, and job openings hit a record high in Q3. Personal income rose modestly, led by wages and salaries, but real personal consumption slowed as goods prices rose quickly. Home sales rose, and residential construction spending was strong, but high inflation pushed real residential investment down again. Industrial output rose but remained constrained by widespread supply-chain bottlenecks. Business investment increased modestly. Inflation remained high and steady in Q3, but it has accelerated since and is likely to remain elevated well into 2022. Rising employment and faster inflation prompted the Federal Reserve to begin tapering its asset purchases, with rate hikes likely to follow in 2022. Long-term Treasury rates were little changed in Q3 but declined since then, despite higher inflation. Credit conditions remained favorable, with declining bankruptcies and few problem loans. Nonetheless, credit spreads widened, leading to mediocre returns for credit in Q3 and YTD.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator*	2021:3	2021:2	2021:1	2020:4	2020:3	2020:2	2020:1	2019:4
Real GDP, Chg QoQ (%, SA, AR)	2.1	6.7	6.3	4.5	33.8	-31.2	-5.1	1.9
Real Personal Consump Expnds, Chg QoQ (%, SA, AR)	1.7	12.0	11.4	3.4	41.4	-33.4	-6.9	1.7
Real Business Inv ex Stuctures, Chg QoQ (%, SA, AR)	2.8	11.8	14.5	17.4	28.1	-25.5	-9.8	0.0
Real Residential Investmt, Chg QoQ (%, SA, AR)	-8.3	-11.7	13.3	34.4	59.9	-30.7	20.4	1.1
Real Private Domestic Final Sales, Chg QoQ (%, SA, AR)	1.1	10.1	11.7	6.2	38.1	-32.6	-5.9	1.2
Nominal GDP, Chg QoQ (%, SA, AR)	8.1	13.4	10.9	6.6	38.7	-32.4	-3.9	3.6
Corporate Profits, After Tax, Chg YoY (%, SA, AR)	19.1	43.4	14.7	1.1	2.1	-18.3	-3.8	-0.3
Nonfarm Productivity, Chg QoQ (%, SA, AR)	-5.0	2.4	4.3	-3.4	4.6	11.2	-1.8	0.6
Nominal Personal Income, Chg YoY (%, AR)	5.2	3.1	29.5	4.8	6.2	8.6	1.9	3.0
Personal Savings Rate (%, SA)	8.2	9.5	26.6	14.0	14.3	19.3	13.1	7.3
Unemployment Rate (%, SA)	4.8	5.9	6.0	6.7	7.8	11.1	4.4	3.6
Nonfarm Payrolls, Chg QoQ (000, SA)	1,886	1,845	1,554	638	4,025	-13,000	-1,079	590
Household Employment, Chg QoQ (000, SA)	2,078	754	1,018	2,287	5,443	-13,436	-3,199	505
Federal Budget, 12-mo Deficit(-) or Surplus (% of GDP)	-12.5	-12.0	-19.9	-16.6	-15.6	-14.8	-4.8	-4.8
Consumer Price Index, Chg YoY (%, AR)	5.4	5.4	2.6	1.4	1.4	0.6	1.5	2.3
CPI ex food & energy, Chg YoY (%, AR)	4.0	4.5	1.6	1.6	1.7	1.2	2.1	2.3
Capacity Utilization (%, SA)	75.2	75.6	74.8	74.1	72.1	68.7	73.4	76.5
Rate or Spread (End of Quarter)	**2021:3**	**2021:2**	**2021:1**	**2020:4**	**2020:3**	**2020:2**	**2020:1**	**2019:4**
Federal Funds Rate Target (upper bound, %)	0.25	0.25	0.25	0.25	0.25	0.25	0.25	1.75
3-month LIBOR (%)	0.13	0.15	0.19	0.24	0.23	0.30	1.45	1.91
10-Yr Treasury Note Yield (%)	1.52	1.45	1.74	0.93	0.69	0.66	0.70	1.92
30-Yr Treasury Bond Yield (%)	2.08	2.06	2.41	1.65	1.46	1.41	1.35	2.39
ICE-BofAML US Corporate Index Spread to Worst vs Gvt	84	82	91	98	139	155	302	99
10-Yr Interest Rate Swap Spread (bp)	2.3	-2.6	3.6	0.8	2.5	-1.8	2.5	-2.8

* 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 slowed considerably in the third quarter as supply-chain disruptions continued, the Delta coronavirus variant raised COVID worries, and high inflation sapped real growth. Inflation-adjusted gross domestic product (real GDP) rose by 2.1% in Q3, down from the second quarter's 6.7% pace. Economic growth appears to have picked up in October and November, but so has inflation, which has taken a sizable bite out of real growth. Economists now expect Q4 GDP to expand by 4.8%.[1] Above-trend U.S. growth is expected to continue in 2022, with the consensus GDP forecast currently at 3.9%, down from October's survey mostly due to expectations for higher inflation. Although the U.S. economy surpassed 4Q2019's level of real GDP in the second quarter, it has yet to recoup growth lost to the pandemic. Current forecasts now project that will not happen until 4Q2022, a full year later than seemed possible as the economy accelerated last spring.

Before we begin our review of the major sectors of the U.S. economy, we want to highlight the divergence between inflation-adjusted, or *real*, economic growth and mostly rapid gains in current-dollar, or *nominal*, growth. The table below shows real and nominal quarterly GDP growth since 1Q2020. The gap between nominal and real growth is inflation, which has run much hotter in 2021 than previously. The implicit GDP deflator averaged 5.5% so far in 2021, compared to an average of 1.6% in 2019, before the COVID pandemic struck.

Figure 2: Chained and Current Dollar GDP Growth — Mind the Gap!

	2021:3	2021:2	2021:1	2020:4	2020:3	2020:2	2020:1	2019 Avg.
Real GDP	2.1%	6.7%	6.3%	4.5%	33.8%	-31.2%	-5.1%	2.6%
Nominal GDP	8.1%	13.4%	10.9%	6.6%	38.7%	-32.4%	-3.9%	4.2%
Implicit Deflator	*5.9%*	*6.2%*	*4.3%*	*1.9%*	*3.7%*	*-1.7%*	*1.3%*	*1.6%*

Economists expected inflation to pick up in 2021 as the economy recovered from recession, but inflation has been higher, broader, and more persistent than anticipated. There are three reasons for this. First, the demand side of the U.S. economy rebounded briskly in response to large fiscal and monetary stimulus, as well as rapid development and deployment of effective coronavirus vaccines. Further, while it has been faster in some places than in others, this demand recovery is global in scope. Second, the supply side of the economy has recovered more slowly. Labor supply remains constrained, employers report difficulty hiring workers, and job openings hit a record high in the third quarter. Shortages of materials ranging from basic commodities to advanced semiconductors hampered production, and supply chain bottlenecks proliferated. Finally, monetary policy remained very loose, and money supply growth accelerated sharply. A rapid increase in inflation followed, turning strong nominal GDP growth into more-moderate real growth. Although inflation should come down in 2022, it is likely to remain elevated well into 2022, and perhaps beyond. We expand upon these themes in the paragraphs that follow.

[1] Unless noted otherwise, forecasts are from the Bloomberg® *U.S. Monthly Economic Survey*, November 12, 2021.

The **labor market** recovery continued apace in the third quarter (Figure 2). Nonfarm payrolls rose by 1.89 million jobs, slightly faster than the second quarter. An additional 531,000 jobs in October brought total nonfarm employment to 148.3 million, about 4.2 million below the February 2020 peak. Rapid hiring pushed the unemployment rate down to 4.6% in October, compared to 5.9% at the end of Q2 and 3.6% in February 2020.

Despite rapid hiring in the third quarter, job openings hit a record high, averaging over 10.7 million unfilled jobs (6.8% of total nonfarm employment), or about 1.3 times the number of unemployed persons. Job quitters are also on the rise, as workers expressed confidence that they can find better and/or higher-paying jobs at a new employer. Greater competition for workers boosted wages, and average hourly earnings were up 5.5% in October compared to three months earlier (Figure 3). Normally, rising employment and wages prompts people to reenter the labor force, but labor participation remained subdued at 61.6%, little changed since August 2020. A tight labor market is an important supply-side constraint.

Figure 2: Job Recovery Continuing

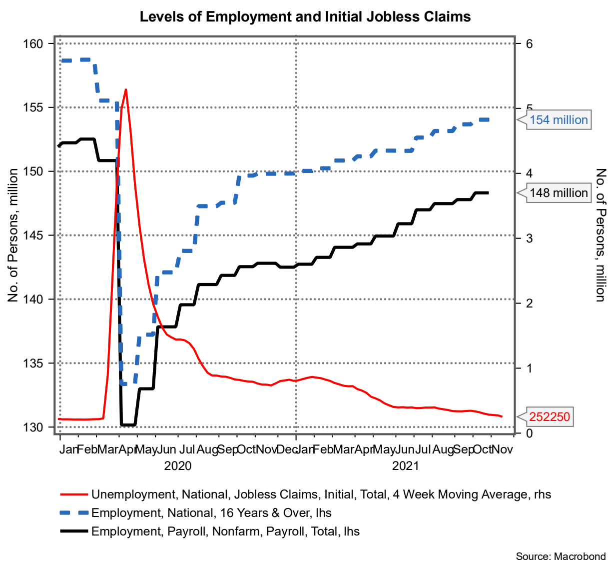
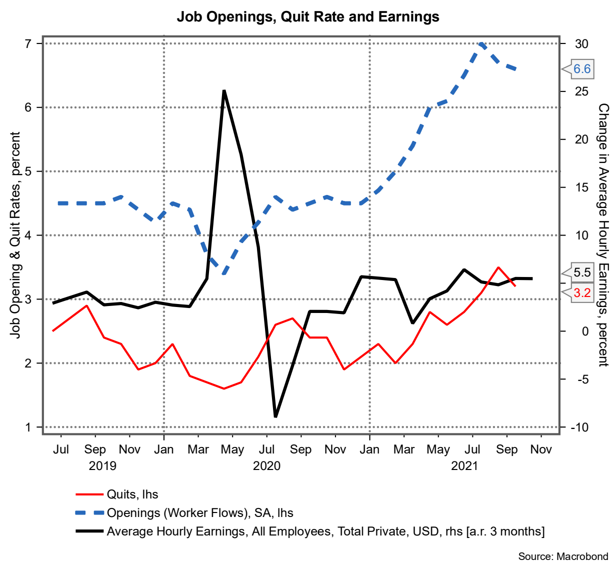


Figure 3: Unfilled Jobs Pushing Wages Up



Personal income posted modest gains in the third quarter, driven by big gains in wages and salaries (Figure 4). Nominal personal income rose by 2.6% in Q3 despite a 15.6% drop in transfer payments as stimulus spending ebbed. Over 12 months ending in October, those were up 5.9 and 3.4%, respectively. Wages and salaries were up 11.6% in Q3 and 9.8% YoY in October. Looking ahead, we expect continued job gains and rising wages will support good growth in personal income, although inflation will offset much of those gains in real terms.

Spending rose briskly in nominal terms but only modestly in real terms. Nominal **personal consumption expenditure** (PCE) rose 7.1% in Q3 and 12.0% over 12 months ending in October (Figure 4). Adjusted for inflation, real PCE in Q3 was up by 1.7% and 6.6%, respectively. Spending on goods (-1.7%) lagged services (7.6%), but goods have gained on services in recent months as rising COVID infections from the Delta variant prompted a retreat from some in-person activities (Figure 5). For example, retail sales in eating and drinking establishments were nearly flat from August through October after surging during spring and early-summer months. A new coronavirus variant, Omicron, threatens to further dampen services spending over coming months. Although COVID remains a risk, ongoing gains in personal income should keep PCE growing at a solid pace, even after inflation.

Figure 4: Wages Driving Consumption

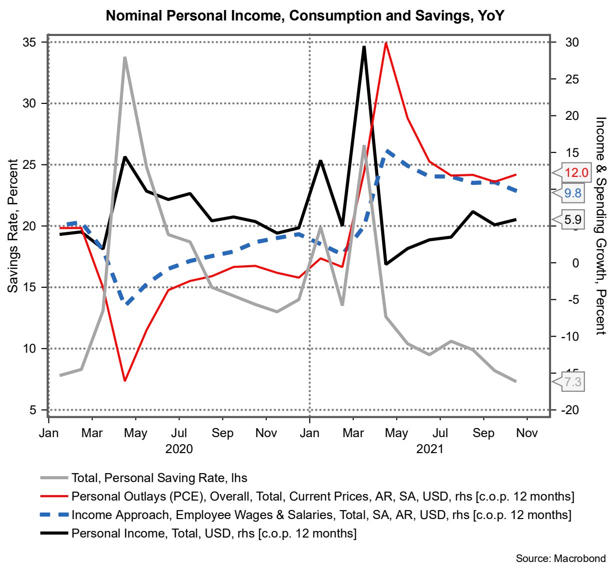
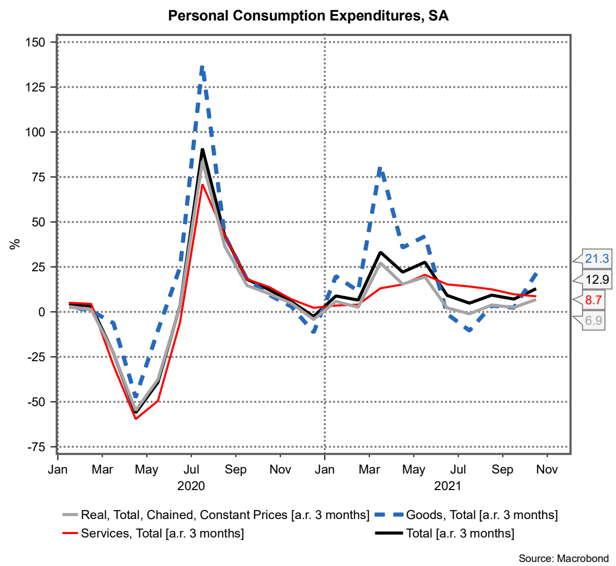


Figure 5: Goods Spending Resumes on Delta



With spending outpacing income in recent months, the **savings rate** slipped to an average of 9.6% in Q3 and 7.3% in October (Figure 4). We continue to think rising employment and wages will prompt consumers to spend down some savings accumulated during the pandemic. As that happens, the savings rate will fall even though consumer balance sheets should remain in good shape. However, that strength in demand is likely to keep inflation elevated, especially for goods, until the supply side of the economy can catch up.

Figure 6: Inflation Burglarizes Housing

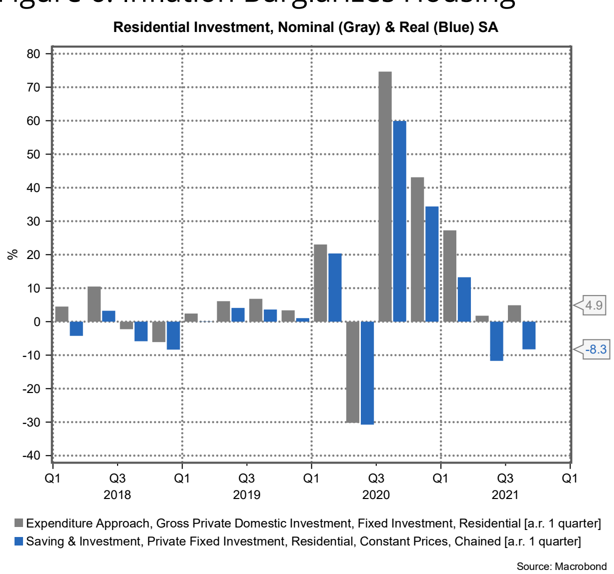
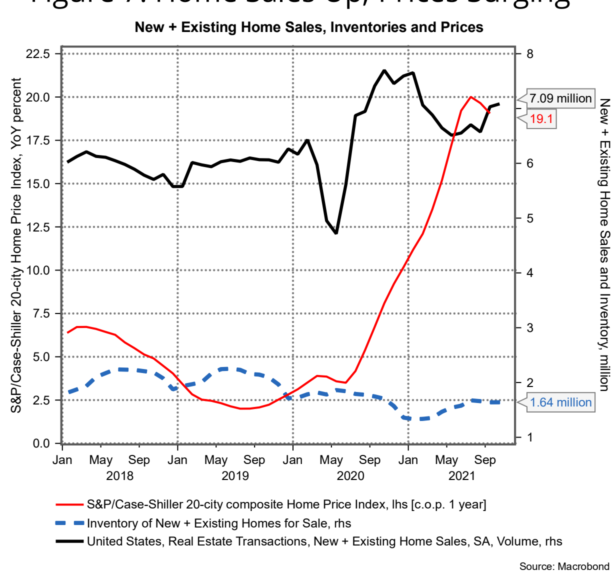


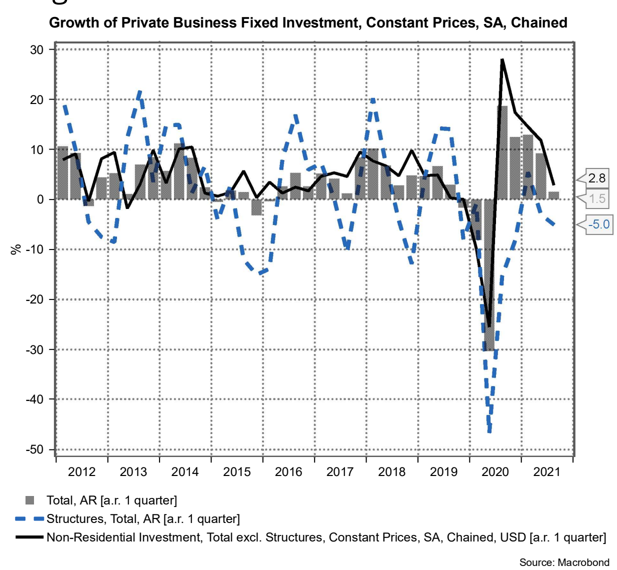
Figure 7: Home Sales Up; Prices Surging



The **housing market** picked up in the third quarter, as home sales and construction spending rose. In nominal terms, residential investment was up by 4.9%. However, after *14.4% inflation* in this sector, real residential investment fell by 8.3% (Figure 6). Housing is the current poster child for inflation: strong demand for homes, a limited supply of skilled labor, and shortages of building materials together sharply raise both construction costs and existing home prices. Combined new and existing home sales ran above 7 million units, and inventory of homes for sale remained low (Figure 7). The S&P/Case-Shiller 20-city composite home price index rose 19.1% over 12 months ending in September, just below July's record 20% pace. It is nearly impossible for real residential investment to expand amid inflation this high. We will have to wait for it to cool before we can expect this sector to contribute to real GDP growth. While home price inflation has not been elevated for very long, the longer it runs hot, the greater the risk to home prices from tighter monetary policy, which is inevitable. It is something the Federal Reserve should be getting nervous about — and something we will be watching closely over coming quarters.

Figure 8: Manufacturers Struggle to Keep Up

Figure 9: Core Business Investment Slowed



Industrial production rose modestly in the third quarter, with good gains in manufacturing partly offset by weaker mining. Industrial output rose 3.9% in Q3 but slowed to 1.7% over three-months ending in October (Figure 8). Output was up 5.1% in October compared to a year earlier. Labor and materials shortages continued to constrain output, although they appear to have stabilized or improved slightly, which is progress after a long period of rising bottlenecks. The Institute for Supply Management's manufacturing survey remains firm at 60.8 in October (50 is neutral) and suggests moderate gains in output ahead. Factory orders slowed but also remained strong, with orders for core capital goods (nondefense, excluding aircraft) up 8.7% over three months ending in October. Backlogs for core capital goods rose 13.1% over the same period. The data highlights both ongoing production constraints and strong demand for industrial businesses over coming quarters.

Real **business investment** slowed sharply in the third quarter, rising just 1.5% compared to 9.2% a quarter earlier (Figure 9). Business structures were weak, falling 5.0%, while investment excluding structures slowed to 2.8% growth. While investment in structures is likely to remain subdued, businesses having trouble hiring workers and meeting strong demand should look to raise productivity by adding capital equipment and software. As a result, core investment should pick up as production bottlenecks clear (investment spending is recorded when goods and services are delivered to customers, not when orders are placed). Capacity utilization was 76.4% in October, up slightly from recent months. It too was held down by supply constraints, and its rise over coming quarters should reinforce the need for higher investment spending. Unlike its residential counterpart, inflation in business investment was moderate: the implicit deflator was "only" 4.3% in Q3.

The **trade deficit** widened again in Q3, and trade volumes rose quickly, albeit at a slower pace than earlier in the recovery (Figure 10). Net exports subtracted 1.2% from real GDP growth as importers looked to build inventory heading into the fourth quarter. Over 12 months ending in October, imports and exports rose 19.9% and 16.6%. Exports accelerated as growth outside the U.S. strengthened. Although net exports are likely to remain a modest drag on real GDP over coming quarters, we expect it to be smaller than it has been over the past year or so.

Figure 10: Trade Up; Drag Set to Diminish

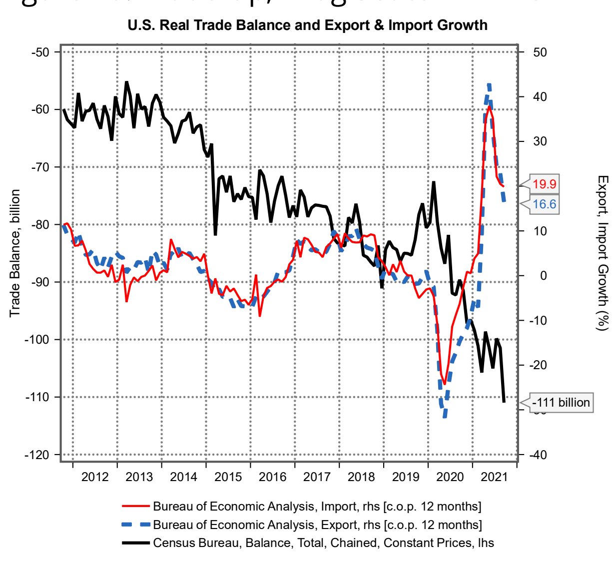
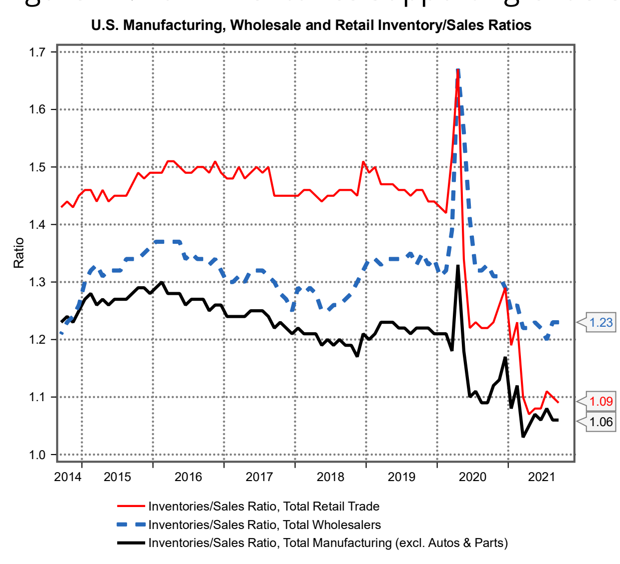


Figure 11: Low Inventories Supporting Orders



Businesses finally made some progress rebuilding **inventories** in Q3. Inventory accumulation added 2.1% to real GDP growth, as inventory-to-sales ratios edged up (Figure 11). Inventories should add to orders and GDP over coming quarters, although strength in consumer demand and ongoing supply-chain constraints may prompt an occasional drawdown. We believe an inventory cycle is just getting started.

With no new federal fiscal stimulus in the third quarter, real **government consumption** rose only 0.9% (Figure 12). Federal government spending fell 4.9%, but (larger) state and local spending ended a long period of weakness and rose by 4.7%. The economic recovery and rising inflation boosted state and local tax receipts and led to higher spending. Congress passed a physical infrastructure bill in November; that spending will occur over many years and should add only slightly to near-term GDP growth. Congress continues to debate a larger social spending bill, but we cannot measure its fiscal impact until it passes (or not).

Summarizing the third-quarter economic situation, sector contributions to real GDP growth of 2.1% break down as follows: Personal Consumption Expenditures (+1.2%), Residential Investment (-0.4%), Business Investment (+0.2%), Inventory Change (+2.1%), Net Exports (-1.2%), and Government Consumption (+0.2%). The first three components equal **Private Domestic Final Sales**, which rose by 1.1%.[2]

Figure 12: Government Spending Shift to S&L

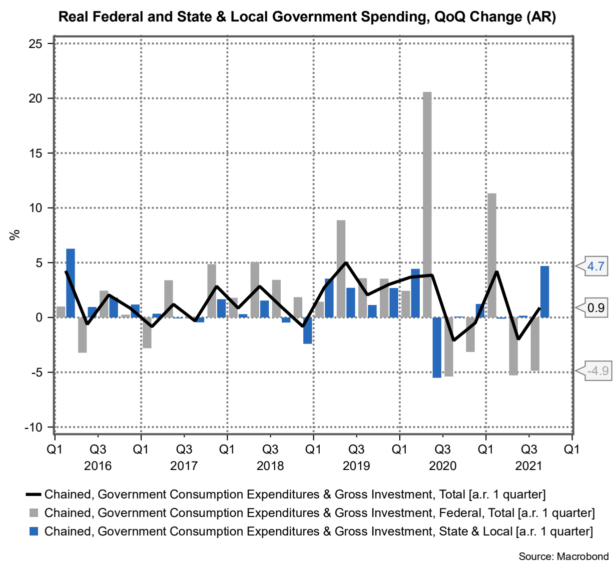
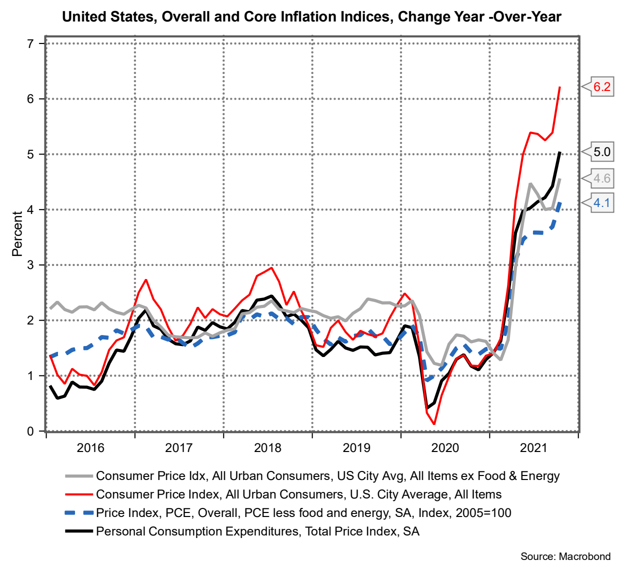


Figure 13: Inflation Gets Ahead of Fed



Inflation continued its rapid ascent and has far exceeded the Federal Reserve's earlier forecasts. For 12 months ending in October, the consumer price index (CPI) was up 6.2% overall and 4.6% excluding food and energy (Figure 13). The PCE deflator was up 5.0% overall and 4.1% excluding food and energy over the same period. These are the highest annual inflation rates since 1990-91. Although base effects from last year play a role in these high inflation rates, inflation also has risen quickly over the past three and six months. Falling unemployment and record job openings are raising wages, while materials shortages and supply-chain bottlenecks are boosting input prices. Coupled with strong demand and accommodative monetary policy (see below), inflation should remain elevated well into 2022. The key question facing monetary policymakers is whether inflation becomes entrenched or begins to fade next year.

At a minimum, inflation is likely to be significantly less transitory than the Fed expected only a few months ago. As we explained in the sector reviews, inflation is high, broad-based, and has accelerated quickly. Figure 14 provides a recap. Inflation is likely to remain high in the

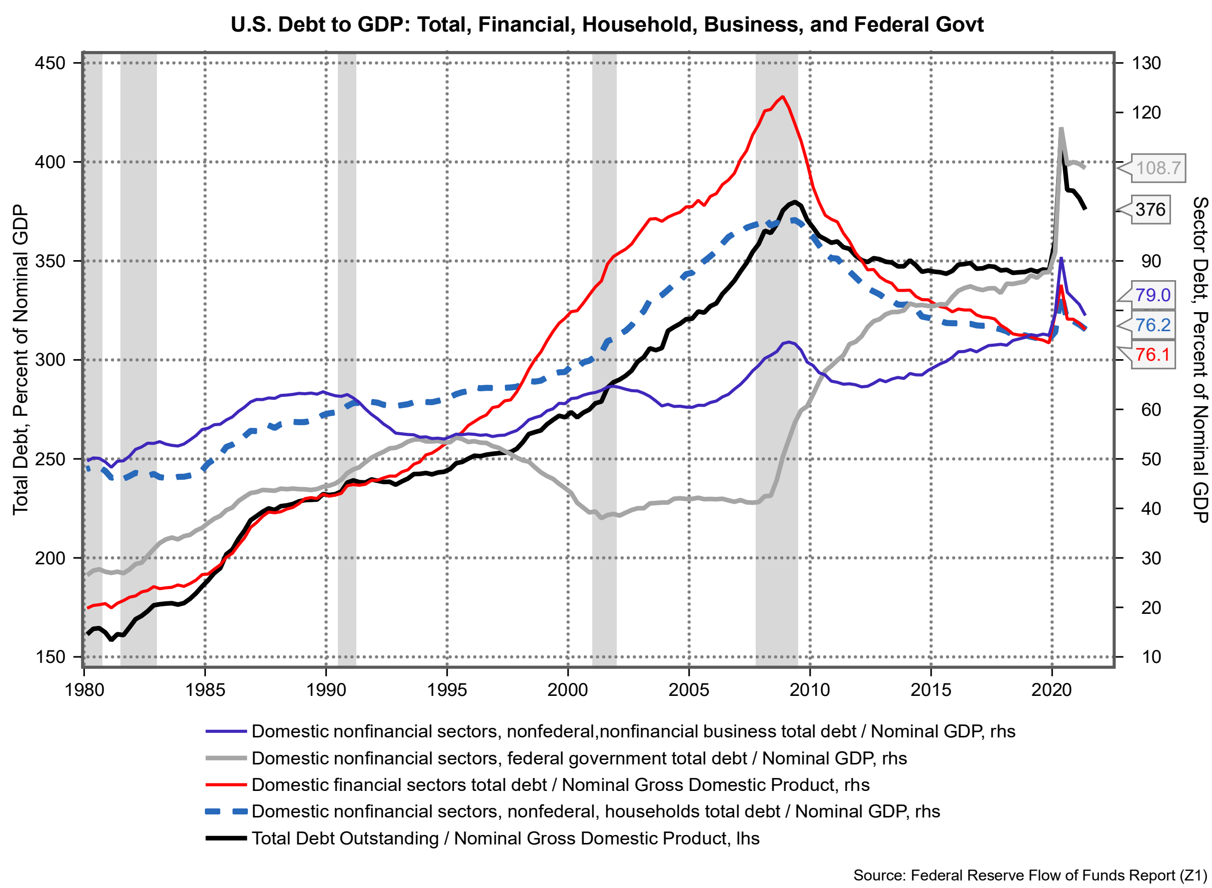
[2] These three GDP components sum to 1.0%, but their combined growth rate was 1.1% because the former rate's denominator is total GDP, which is larger than its subset, private domestic final sales

fourth quarter, given strong demand and ongoing supply constraints. There is room for some longer-term optimism, however. Goods inflation should moderate as supply-chain bottlenecks diminish and business investment raises productivity, although services inflation (both private and public) is likely to be stickier as today's high inflation gets built into tomorrow's wages. Home prices and construction cost inflation are bound to slow eventually, but supply is especially tight in that sector. On balance, we expect inflation to moderate in 2022, although it is likely to be a gradual process that requires tighter — rather than just less-accommodative — monetary policy. More on that in the next section.

Figure 14: Growth and Inflation by Major Sector in Selected Recent Quarters

	Real GDP (QoQ%, AR)			***Nominal GDP (QoQ%, AR)***			***Implicit Deflator***		
Sector	**2021:3**	**2021:2**	**2020:4**	**2021:3**	**2021:2**	**2020:4**	**2021:3**	**2021:2**	**2020:4**
Gross Domestic Product (GDP)	2.1%	6.7%	4.5%	8.1%	13.4%	6.6%	5.9%	6.2%	1.9%
Personal Consumption Expenditures	1.7%	12.0%	3.4%	7.1%	19.3%	5.0%	5.3%	6.5%	1.5%
PCE: Goods	-8.4%	13.0%	-0.3%	-1.7%	23.6%	0.0%	7.3%	9.3%	0.3%
PCE: Services	7.6%	11.5%	5.3%	12.1%	17.0%	7.6%	4.2%	4.9%	2.1%
Business Investment	1.5%	9.2%	12.5%	5.9%	10.2%	13.0%	4.3%	0.9%	0.4%
Residential Investment	-8.3%	-11.7%	34.4%	4.9%	1.8%	43.1%	14.4%	15.3%	6.5%
Federal Govt Consumption	-4.9%	-5.3%	-3.1%	-0.3%	-1.4%	-0.7%	4.8%	4.1%	2.5%
State & Local Govt Consumption	4.7%	0.2%	1.2%	11.8%	7.5%	4.6%	6.7%	7.3%	3.3%
Domestic Final Sales	1.1%	8.0%	5.0%	6.8%	14.5%	6.9%	5.7%	6.0%	1.8%

Figure 15: Debt-to-GDP Falls as Economy Rebounds; Federal Debt High but Stable—for Now



Broad **balance sheet trends** through the second quarter of 2021 (latest data available) show that debt-to-GDP ratios continued to decline across borrowing sectors after spiking in early 2020 due to a sharp drop in GDP induced by the pandemic (Figure 14). Overall debt-to-GDP fell to 376% in Q2, down from 382% in the prior quarter. Household debt-to-GDP fell 0.9% to 76.2%. Nonfinancial and financial business borrowing dropped from 79.0% and 76.1%, respectively, each down 2.2% from the prior quarter. Federal government debt declined 0.9% to 108.7%, although it remains much higher than before the pandemic and is responsible for most of the increase in overall debt-to-GDP over that time.

Market Outlook

Long-term **Treasury rates** rose slightly in the third quarter as slower real economic growth offset higher inflation (Figure 15). The benchmark 10-year Treasury note yield rose 7 basis points (bp) to 1.52% in Q3 and slipped to 1.45% as of November 30, although it was as high as 1.70% in mid-October. The 30-year Treasury bond yield edged up by 2 bp to 2.08% in Q3, traded as high as 2.17% in mid-October, then fell to 1.79% as of November 30 as markets began to price in risk that high inflation could prompt the Fed to overshoot monetary tightening, leading to lower rates in the future. Short rates held steady, and the yield curve steepened from short to intermediate tenors and flattened from intermediate to long maturities.

Figure 16: Markets Expect 2022 Tightening[3]

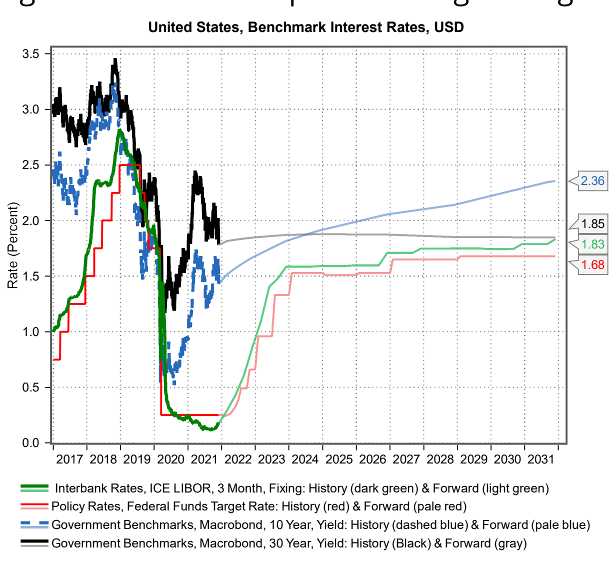


Figure 17: Fed Still Filling the Punch Bowl

Markets continue to be influenced by highly accommodative monetary policy, limited net private sector borrowing, and accumulated savings from a period of reduced spending earlier in the pandemic. These combined to hold interest rates at these relatively low levels despite

[3] The fed funds effective rate recently has traded about 17 bp below the top end of the FOMC target range. In Figure 15, we add 17 bp to forward rates implied by overnight index swaps (OIS) to align them with the upper band of historic target rates.

sharply higher inflation — and a growing concern that it is not temporary. We continue to believe private sector investment and borrowing will rise and the personal savings rate will decline over coming quarters, keeping the demand side of the economy firm. The Federal Reserve has begun to dial back accommodation, and it should tighten monetary policy soon thereafter. We expect interest rates will rise as a result, although a substantial increase in intermediate- and long-term interest rates from autumn 2020 until now already incorporates some of what is in store.

The Federal Reserve left short-term policy rates unchanged, with the federal funds rate set at 0-0.25% and the interest paid on reserve balances at the Fed (IOER) set at 0.15%. On November 3, the Federal Open Market Committee (FOMC) also announced that the Fed would begin tapering its pandemic-era $120 billion per month of securities purchases ($80 billion of Treasuries and $40 billion of agency mortgage-backed securities) starting in mid-November at the rate of $15 billion per month.[4] Because the Fed will still be buying securities, “taper” does not mean “tighten” — it means “less loose.” If the Fed maintains that pace of $15 billion per month in reductions, its securities purchases would end in mid-June 2022, and monetary policy would return to a neutral stance. Tighter monetary policy will come when the FOMC hikes policy rates (after the “taper” concludes) and, perhaps later, reduces its securities holdings. That suggests rate hikes beginning in the second half of 2022 or, if the Fed concludes that its employment goal is unmet after the taper has concluded, in early 2023.[5]

Figure 18: Money Supply Growing Quickly

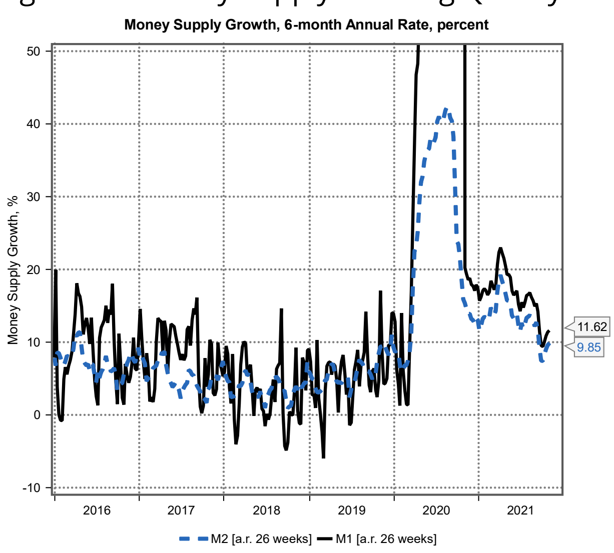
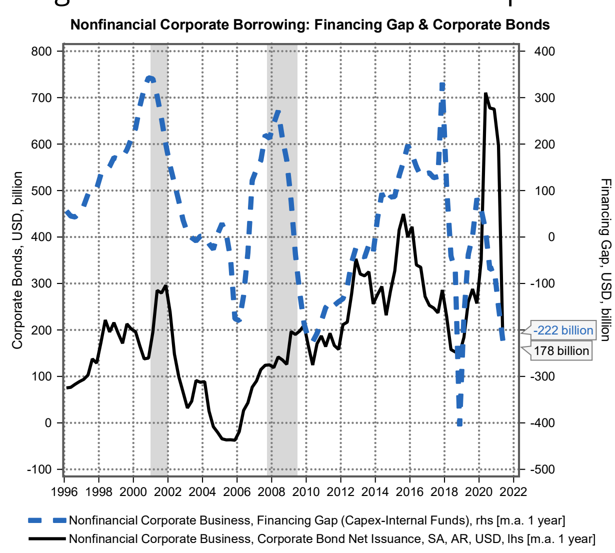


Figure 19: Issuance Slowed with CapEx



Given strong nominal GDP growth and elevated inflation, we think the Fed will move more quickly than guidance from the November 3 FOMC statement suggests. Final demand is growing rapidly, and the supply side of the economy is struggling to meet that demand for reasons that monetary policy can do little to resolve. As a result, inflation has surged.

[4] Initial monthly reductions are in proportion to purchases, i.e., $10 billion in Treasuries and $5 billion in MBS.

[5] Markets as of 11/30/2021 expect two 25 bp rate hikes by year-end 2022, beginning in the third quarter.

Nonetheless, financial conditions remain extremely loose (Figure 17), and money supply continues to expand quickly (Figure 18).[6]. While the current 6-month growth rates of 11.8% for M1 and 9.9% for M2 are not far above the pre-pandemic average, they are no longer consistent with the Fed's objective of raising inflation to its 2% long-term average target. Inflation was running below target prior to the pandemic; now it is far above target. The Fed's inflation objective has been met for the foreseeable future, and unemployment is declining quickly. The FOMC should move faster, and we think it will accelerate its taper timetable at its upcoming December 14-15 meeting.

Nonfinancial corporate businesses borrowing slipped as its need to fund capital expenditures was limited over the past year. Net nonfinancial corporate bond issuance over the past four quarters ending in June (latest data available) slipped to $178 billion from over $700 billion as the pandemic unfolded (Figure 19). Even the lower number was more than required to pay for capital expenditures net of internally generated funds (the "financing gap"). That leaves nonfinancial businesses with high liquidity in aggregate, which has contributed to stellar bank loan performance. We still expect the financing gap to turn positive again (i.e., companies will spend more on business investment than they generate internally) as the economy grows and competition shrinks margins, but they have financial assets they can sell to reduce their external financing needs. That could limit upward pressure on corporate bonds spreads when capital expenditures pick up again.[7]

Figure 20: Bankruptcies Remain Subdued

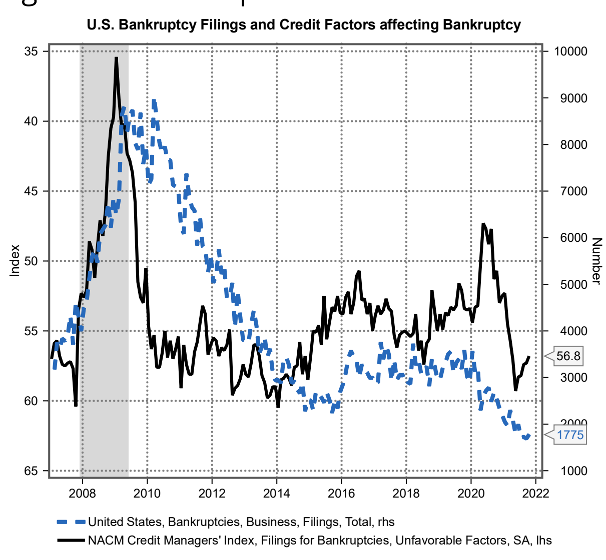
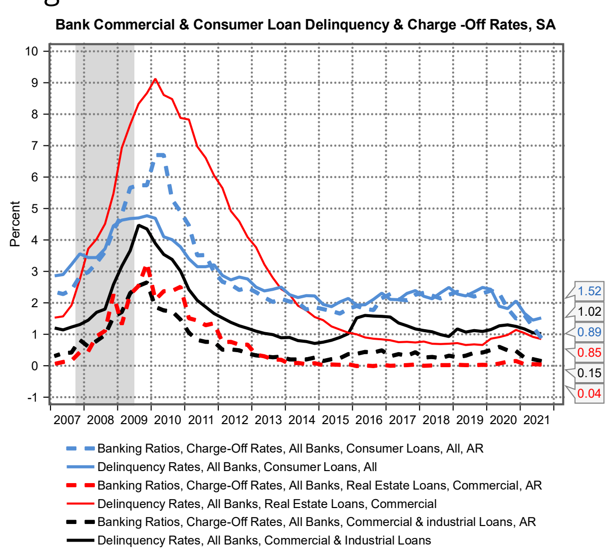


Figure 21: Problem Loans Near Record Lows



[6] The spike in money supply last year resulted from a change in bank reserve requirements for deposits. The Fed eliminated deposit reserve requirements in March 2020, which meant reserves held for that purpose suddenly were included in money supply, exaggerating their growth rates, especially for M1, which exceeded 1800% during the 6-month period following the change. (We have limited the y-axis to 50% make more relevant movements visible.)

[7] To the extent corporations sell financial assets to cover a financing gap, that could cause credit spreads to widen. However, it is likely that a substantial portion of those assets would be lower-risk assets such as money market instruments or Treasuries, whose sales should have little impact on corporate bond spreads.

Credit fundamentals continued to improve in the third quarter. Business bankruptcy filings remained on a downtrend through October (Figure 20). Factors unfavorable to bankruptcy filings as measured by the National Association of Credit Management ticked up from a historically low level; they are not troubling but bear watching. Bank loan quality was steady or slightly better in the third quarter. Total bank loan delinquencies and charge-offs of 1.28% and 0.20%, respectively, held steady near historical lows. Consumer loan delinquencies were about flat at 1.52%, while charge-offs fell by 0.3% to 0.89% (Figure 21). Commercial and industrial loan performance was steady, with delinquencies at 1.02% and charge-offs at 0.15%. Commercial real estate charge-offs remained under 0.1% and delinquencies were 0.85%. In short, bank loan quality remains outstanding.

Figure 22: Spreads Wider on COVID Worries

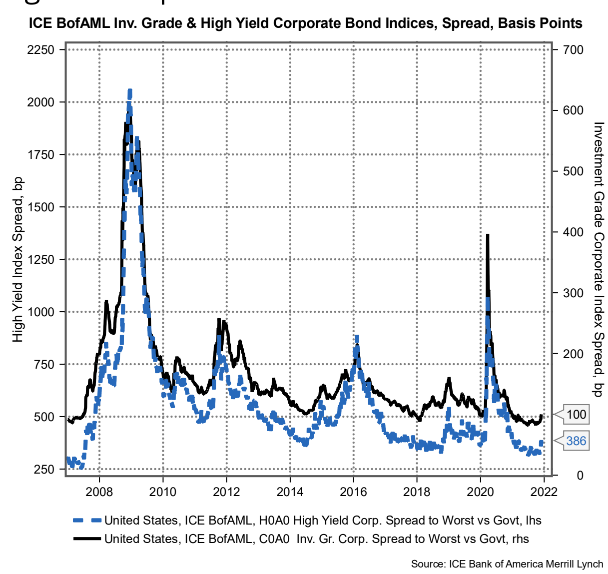
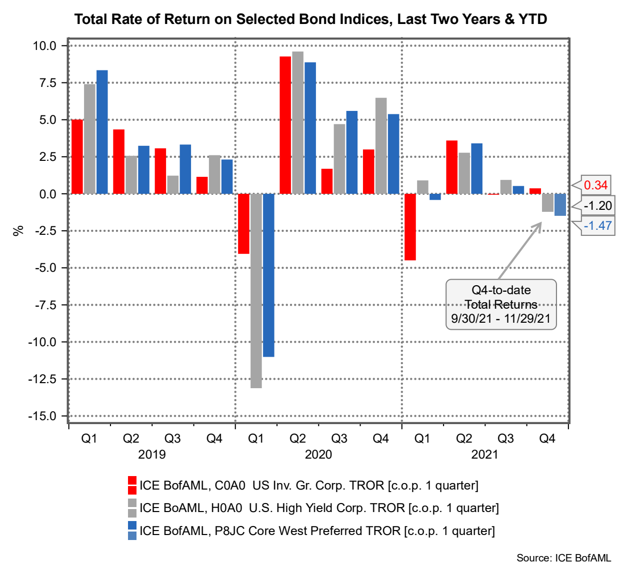


Figure 23: Mediocre Year for Bond Returns



Despite strong credit fundamentals, high corporate and investor liquidity, rapid nominal GDP growth, and buoyant profits (up 4.2% after tax, not annualized), worries over rising inflation and new strains of the coronavirus pushed corporate **credit spreads** wider in the third quarter and Q4 to date. Investment-grade corporate bond spreads widened by 2 bp to 84 bp in Q3 but rose to 100 bp as of November 30 (Figure 22).[8] High yield bond spreads widened by 13 bp to 330 bp in Q3 and jumped to 386 bp as of November 30.

Spreads on preferred securities fell between those of investment-grade and high yield corporate bonds in the third quarter, although they looked more like high yield spreads so far in Q4. Because preferreds' complex call features make simple spread measures difficult to illustrate, we like to compare total rate of return, which combines the impacts of issuer redemptions, credit spread and Treasury yield changes on bond returns. Figure 23 shows total returns on selected ICE BofA indices in recent quarters. After very strong returns last year, 2021 has been a mediocre year for investment-grade and high yield corporate bonds

[8] Investment-grade corporate bond spread is represented by the ICE BofA 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 11/30/2021.

and preferred securities. Total return in Q3 on the preferred index[9] (+0.53%) slotted between the investment-grade corporate bond index (-0.06%) and the high yield index (+0.94%).[10] For year-to-date 2021 through November 30, the high yield bond index led the pack, returning 3.42%. The preferred index returned 2.00%, while the investment-grade corporate bond index had a negative return (-0.78%) over the same period.

With the Fed likely to begin tightening sometime over the coming year, we think higher yields will remain a headwind to returns for now. However, while higher rates and wider spreads hurt returns as they occur, they build a foundation for potentially better returns in periods to come. Rather than attempting to time changes in interest rates, which is notoriously difficult, we believe long-term investors should focus on securities that offer moderate interest rate risk, relatively high income and good credit quality — things that preferred and contingent capital securities continue to offer.

Flaherty & Crumrine Incorporated
November 30, 2021

[9] Preferred index is the ICE BofA 8% Constrained Core West Preferred & Junior Subordinated Securities Index℠ (P8JC). Index data through 11/30/2021.
[10] Total return is not annualized and includes both price change and income. Past performance does not guarantee future performance.