U.S. Economic Outlook

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**Stagnation:**

1. Rising income inequality will concentrate income and wealth at the upper income range, reducing middle class spending power.
2. Falling home prices and rising commodity prices are squeezing the middle class.
3. Congress will fail to address the deficit and entitlements problems, creating a bond market capitulation.
4. State pensions are underfunded by $3 trillion creating the possibility of a bond or pension promise default.
5. The labor force is declining as middle age men retire early, file for disability or return to school.
6. Pay is stagnating for the middle and lower classes.
7. The number of workers to pensioners will fall from 4.6 today to 2.6 in 40 years, crippling the living standards of younger workers.
8. 25% of mortgage holders are underwater, leading to massive foreclosures.
9. The large number of long-term structurally unemployed will weigh down economic growth.
10. The U.S. infrastructure (roads, railways, bridges, ports, airports) is deficient or functionally obsolete, putting the U.S. at a competitive disadvantage relative to the rest of the world.

**Expansion:**

1. Productivity growth is strong signaling a dynamic, growing economy.
2. Strong economic growth in the emerging market economies will boost exports and help rebalance the economy away from consumption spending.
3. Financial institutions are returning to health which will foster additional lending in the near future.
4. Job growth is rising as the labor market builds momentum which will lead to a self-sustaining economic expansion.
5. Rising stock prices will produce a wealth effect which will foster faster consumption spending.
6. Aggressive monetary and fiscal policy will ensure robust economic growth.
7. Consumer confidence should return to normal levels in the near future, restoring consumption expenditures to reduce pent-up demand for durable goods.
8. The housing market is near bottom and will soon experience a turnaround in housing construction.
9. Manufacturing activity and employment is rising rapidly, after years of steadily declining employment.
10. A decrease in the overall level of uncertainly is creating a more favorable business environment which will lead to greater business investment spending.
The economic recovery continues, but is disappointing and is vulnerable to external shocks. GDP is back to its pre-recession 2007 peak. Final sales of domestic product – GDP minus change in inventories – grew 3.6% annualized. Inventories subtracted 1.1% from growth as firms reduced stocks in response to weak first half demand. Stronger aggregate demand will lead to job growth, rising confidence and further spending (a self-sustaining expansion).

The expiry of the pay-roll tax cut and extended jobless benefits in December could shave 2% off 2012 GDP growth. Actual GDP is 5% below potential GDP.

A “balance sheet recession” is the process whereby households and companies pay down debts rather than embark on new spending. The lack of demand for loans is due to the debt-strapped private sector.

### 3rd Quarter 2011 GDP

\[
\text{Spending} = C + I + G + X - M
\]

\[
\% \text{ of total} = (70.7) \quad (13.5) \quad (18.8) \quad (13.3) \quad (-16.4)
\]

\[
\text{Growth rate} = (2.0) \quad (-0.9) \quad (-0.1) \quad (4.3) \quad (0.5)
\]

\[
\text{Contribution} = (1.6) + (-0.1) + (0.0) + (0.6) + (-0.1) = 2\%
\]

“Change in private inventories” contribution = -1.55%

\[
(1+0.02)^{1/4} - 1 = 0.005 = 0.5\%
\]
Business investment spending has been strong and firms still have lots of cash to invest and hire.

Business spending on equipment and software have been very strong, leading to strong labor productivity growth over the last few years.
Weak fundamentals are restricting sales:
Few new jobs, low income growth, low unemployment, low and volatile wealth, limited access to credit, deleveraging and low confidence consistent with a deep recession.

Factors supporting consumer spending:
Private sector job growth, consumer are fixing their budgets, falling debt payments through debt reduction and refinancing, consumers who have stopped making mortgage payments but not yet defaulted have extra cash.

Housing Market Strengths:
➢ 30-year mortgage interest rate = 4.0%  (thanks to Federal Reserve)
➢ Falling/low home prices => record levels of affordability
➢ Private sector job growth
➢ Public and private foreclosure mitigation efforts.

Housing Market Risks:
• Expiration of tax credits in April 2010 (pulled forward demand)
• ↑ foreclosure sales (2.5 million in 2010) => ↓ PH
• Buyers expectations of future lower home prices => lower demand
• Double dip recession => housing crash
PMI = 51.6 (Expansion territory) PMI is signaling the recovery remains intact but sluggish. Strong foreign demand.

- New Orders are contracting (49.6). Inventories are up (52). Production was up (51.2)
- Employment was up (53.8). Price paid were up (56)

Leading indicators: (Two “gaps” are proxies of future production)

- New Orders - Inventories = -2.4
- Production – New Orders = 1.6 (foreshadows weaker output)

The gaps are a bad omen for future production

Businesses have strong balance sheets and high profits.

Record high “quick ratio” = liquid assets (mostly cash) to short-term liabilities.

**Factory orders** fell -0.2% in August. Durable good orders fell -0.1%. Nondurable good orders fell -0.3%

**Core capital goods** new orders rose 0.9%

- Nondefense capital goods, excluding aircraft
- a proxy for business investment spending
- Core capital goods new orders are a leading indicator of future hiring.

Modest manufacturing expansion => rising hiring => 2nd half GDP growth = 2.5%
Business Barometer Index = 60.4 (Expansion territory)
Strong and broadening Midwest manufacturing due to rising business investment and auto sales.
New orders 65.3 (leading indicator). Production 63.9. Inventories 60.3. Prices paid 62.3 (building price pressures => falling profits)
Production < new orders foreshadows an upshift in output.
The gap between new orders and inventories – a good proxy for future production – is 5.
The gap points toward additional increases in production.

Current Activity (November) = 3.6
• Factory output should remain solid through 2011 and into 2012
• Inventory replenishment will keep buoy production
• Leading Indicators: (future production proxy = New orders – Inventories)
  - New Orders Index = 1.3
  - Inventories Index = 6.6
• Rising Prices Paid Index (inputs) = 22.8
• Rising Prices Received Index (output pricing power) = 2.6

6-Month Forecast Activity (September) = 41.9
• Firms expect higher new orders and are becoming more optimistic. Capital expenditure plans are rising
**US Payroll Employment**

*Monthly Changes SA*

Over the past 6 months payrolls increased by an average of 90,000 well below the 200,000 needed to meaningfully lower the unemployment rate.

Average hourly earnings rose by 0.2%, indicating little evidence of wage pressures.

Forward looking indicators (temp hiring and average weekly hours) suggests little additional hiring in coming months.

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**Unemployment Rate**

- Unemployed
- Involuntarily working part-time
- Marginally attached (want jobs but haven’t searched in a month)
- Discouraged workers (stopped looking for work)

**Structural Unemployment Disease:** Joblessness is becoming chronic with the average unemployment at 40 weeks. Long-term unemployment is harder to cure because workers' skills atrophy (human capital degradation) and they become detached from the work force. High long-term unemployment decreases future economic growth, raises future deficits and decreases social order.
The labor force is declining as middle age men retire early, file for disability or return to school.

Credit Risk (2 types)
1. Default Risk – borrowers’ willingness and ability to repay debt (unemployment rate)
2. Collateral Risk – market value decline of the asset securing the loan. (home price changes)
• 390,000 initial unemployment insurance benefit claims, lowest level since first quarter.
• This signals the labor market is on track for accelerating improvement.
• The slowly improving economic picture has given firms the confidence to retain employees.
• Weak private sector hiring, rising public sector firing
  • Level is consistent with rising unemployment rate
  • 350,000 is consistent with stable unemployment rate
  • Firms remain wary of hiring new workers despite strong profitability, but want to hold on to their current workers.

• 3.615 million continuing claims
• Enrollment in extended benefit programs = 575,791
• Benefit exhaustion and shift to supplemental benefit rolls is reducing continuing claims

Emergency Unemployment Compensation Program
• Additional 20 weeks of federally funded benefits
  • + 13 weeks in high unemployment states
• 2.954 million enrollment
October Data:
- Inflation = -0.1% m/m, (due to falling energy prices) 3.6% y/y
- Core inflation = 0.1% m/m, 2.1% y/y, (close to Federal Reserve's target)

Expect lower inflation in 2012 as retail energy prices decline. Lower inflation will boost real disposable income.

If inflation deceleration is too great expect the Federal Reserve to implement another round of quantitative easing “QE-3” (print money to buy assets)

Businesses are unlikely to slash prices (deflation) because inventories are lean.

Monetary policy options to prevent deflation and increase inflation expectations:
1. Quantitative easing: print money to buy long-term government debt
2. Buy private-sector debt
3. Change expectations by announcing it will keep short-term rates low for a long time
4. Raise its long-run inflation target (encourage borrowing, discourage cash hoarding)
5. Reduce the interest rate paid on excess reserves.
6. Move from inflation targeting (rate of change) to price level targeting
The Big Question.
Will rapid CU mortgage portfolio growth set up CUs for falling earnings in the future if inflation and interest rates head back up?

Probably not. We expect controlled reflation of the economy because:

1. The slack (output gap) in the U.S. economy is the largest its been since the early 1970s.
2. Significant slowdown in worldwide economic activity.
3. Continued worldwide wage differentials and a huge savings glut will keep disinflation in effect.
4. The bursting of an asset bubble has historically been deflationary.
5. No possibility of a wage-price spiral with unemployment rate headed into double-digit territory.
6. Global decline in market based inflation expectations.
7. World wide economic growth will remain below potential for the next few years.
8. The Federal Reserve will counteract inflationary pressures caused by rising private sector demand by withdrawing bank liquidity and raising short-term rates.
9. New financial regulations will lower the velocity of money (rate of money turnover). Hence, today’s large increase in the supply of money is offset by lower velocity of money and the “money multiplier”
Interest Rates and Recessions
1988-2011

Asset-Shortage Theory: U.S. Government bond yields are low because of a worldwide shortage of safe assets (MBSs and PIIGS sovereign debt are no longer considered safe assets) and a glut of global savings (business parking surplus cash and consumers savings more). Is the savings glut temporary? We could go from fretting about scarce assets to about scarce capital and the accompanying rising interest rates.

Bond yields today are not a true “market price” since central banks are such big players in the market.

Asian central banks are helping to keep interest rates low as they recycle their foreign exchange reserves into government bonds.

Federal Funds Futures
30 Day Fed Funds
(December, 2011)

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<th>Month</th>
<th>Rate</th>
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</tr>
<tr>
<td>January</td>
<td>0.08</td>
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<td>August</td>
<td>0.09</td>
</tr>
<tr>
<td>September</td>
<td>0.10</td>
</tr>
</tbody>
</table>
Operation Twist

Despite political resistance to additional monetary policy, the Federal Reserve chose to go bold with a $400 billion “operation twist” whereby they will sell $400 billion of short-term Treasury notes (less than 3 year maturity) and buy $400 billion of 6-30 year notes and bonds through June 2012. This is an attempt to “twist” the yield curve by lowering long-term market interest rates. This will extend the average maturity of the Fed’s security holdings and expose them to greater interest rate risk. The Fed hopes the lower interest will increase investment and consumer spending to jump start a stagnant recovery.

The Fed also decided to reinvest their maturing agency debt to reduce mortgage interest rates further in an attempt to stimulate a weakening housing sector. Over the past couple of months mortgages rates have not come down as fast as the 10-year Treasury interest rate. But the housing market faces significant headwinds however in the form of falling home price expectations among households, weak job growth and falling consumer confidence.
Why QE-3 policy was not implemented:

- The risk of deflation is now minimal with core inflation running close to the Fed’s target.
- There was little evidence QE-2 affected the real economy in any significant way.
- Banks are holding $1.6 trillion of excess reserves, up from $2 billion 3 years ago. So liquidity in the banking sector is not a problem.
- We are in a “liquidity trap” with money being held by banks and corporations in record amounts, but little being spent due to great economic uncertainty. Additional monetary policy can do little to affect uncertainty.
- Any additional monetary stimulus would be as effective as “pushing on a string” when attempting to get banks to lend out their excess reserves.
- The European sovereign debt crisis and weak economic data have done more to reduce the key 10-year Treasury interest rate (around 2.1% today from 3.1% one month ago) than any QE-3 program could.
The New Monetary Policy Tools

Conventional monetary policy has reached its limit - (0-0.25 federal funds rate)

Broader use of Fed’s balance sheet to achieve objectives

New policies are intended to influence financial conditions
- Purchase longer-term Treasuries (lower long-term interest rates, term spreads).
- Purchase private assets (agency MBS, consumer ABS): offset credit shock, lower credit spreads, increase credit availability
- Working in conjunction with expansionary fiscal policy.
- Monitor credit conditions to gauge success
- But no explicit targets

Quantitative easing of a different sort
- Policies will inject large amounts of reserves
- But goal is not the level of reserves

No single measure to summarize Fed actions
- Watch the H.4.1
- Makes communications challenging
- Policy commitment language

Governance issues
- All decisions made by FOMC
- Even though 13(3) programs under authority of Board
Monetary policy options to prevent deflation and increase inflation expectations
1. Quantitative easing: print money to buy long-term government debt
2. Buy private-sector debt
3. Change expectations by announcing it will keep short-term rates low for a long time
4. Raise its long-run inflation target (encourage borrowing, discourage cash hoarding)

Fed’s Exit Strategy From Accommodative Policies

Inflationary Scenario:
Economic recovery => banks find profitable lending opportunities => ↓ reserves => ↑ credit => ↑ money supply => ↑ aggregate demand => ↑ inflation

Countervailing Policy Measures/Tools That Tighten Monetary Policy
1. Improving private credit conditions => decrease use of Fed’s short-term lending facilities.
2. Maturing Fed-held securities will reduce reserves.
3. Raise interest rate paid on bank reserves – currently 0.25% - held at Fed to reduce incentive of banks to lend out reserves. This reserve/deposit interest rate effectively places a floor under short-term market interest rates.

Four options to reduce bank reserves, raise short-term interest rates and limit credit/money growth:
1. Arrange large-scale reverse repurchase agreements, RRPs, with financial market participants. RRPs involve the sale by the Fed of securities from its portfolio with an agreement to buy the securities back at a slightly higher price at a later date.
2. Treasury could sell bills and deposit the proceeds with the Federal Reserve (Supplementary Financing Program).
3. Offer term deposits (CDs) to banks so reserves would not be available for federal funds market.
4. Sell long-term securities into the open market.
The value of the dollar is at the lowest level since the post-Bretton Woods era of floating exchange rates. Foreign exchange markets are worried that “beggar thy neighbor” currency devaluation policies (to gain a bigger share of world trade) could lead to trade wars. Exchange rates are a function of: 1) yield differentials; 2) relative inflation rates; 3) trade flows and 4) growth prospects.

Dollars and gold are currency substitutes. Both serve as a store of value. A fall or expected fall in the value of the dollar create incentives to shift towards gold. A stronger dollar makes dollar-denominated gold appear more expensive for buyers using other currencies.

Price of Gold is rising because:
1. Low interest rates (opportunity cost) of holding gold
2. Expected depreciation of the dollar
3. Unusual levels of uncertainty
4. Fears that central banks may inflate their way out of the debt crisis.
The Housing Market

- 4.67 million annualized units sold in July, down 3.5% m/m, up 21% y/y.
- July median price $174,000, down from $230,000 in July 2006
- -4.4% decline in median home price (y/y)
- Months supply of homes = 9.45

Demand side factors:
1. Low mortgage interest rates
2. Falling consumer confidence
3. Expect home prices to fall further into 2011, as foreclosed property eventually enters the market.

Supply-side factors:
1. Large inventory of discounted foreclosed homes (shadow inventory) adds to supply overhang.
2. Falling inventory of homes
3. Falling distressed home sales.
August new home annual sales pace 295,000  
Inventory of new homes = 162,000, below long-run average  
New Home Market Factors:  
Slow job growth, tight credit, low confidence, underwater potential trade-up buyers, low-priced foreclosed home sales are  
substituting for new home sales, low inventory.  
Housing backlog is falling fast as builders slow housing starts  
6.6 months supply at current sales rate (relative inventory levels) (45 year average natural rate)  
Economist expect a 2012 housing recovery
Home price depreciation will continue through early 2012. In 2011, loan processing problems (robo-signing) led to banks and states imposing foreclosure moratoriums which led to an artificial deflation in the number of distressed home sales. In 2012, banks will increase pace of foreclosure processing, increasing supply of homes faster than a reviving economy will increase demand for homes.

### Why are home prices falling?

**Demand-Side Effects**
- Low pent up demand
- Fewer investors
- Tighter underwriting
- Expected lower future home prices
- Falling incomes

**Supply-Side Effects**
- Foreclosed houses
- Expected lower future home prices
- Rising unemployment

### Home Price Bottom Brings Clarity to:
- Home Equity, MBS Collateral, Bank/CU Asset Values, Bank/CU Capital Levels
Total Vacant Housing Units For Sale

- Third Quarter homeowner vacancy rate = 2.5%
- 50-year average = 1.5%

http://www.census.gov/hhes/www/housing/hvs/historic/
Table 8: Housing Inventory

2,871,891 U.S. properties received a foreclosure filing in 2010, up 2% from 2009

- Nevada = 9.42%
- Florida = 5.51%
- Arizona = 5.73%
- California = 4.08%

Percent of US Housing Units Receiving Foreclosure Filings

- 2,871,891 U.S. properties received a foreclosure filing in 2010, up 2% from 2009
- % of Housing Units
  - Nevada = 9.42%
  - Florida = 5.51%
  - Arizona = 5.73%
  - California = 4.08%
Purchase index = 170.8, 7% w/w, 2% m/m, -7% y/y.
Refinance index = 3,361, 6% w/w, -14% m/m, -24% y/y

- Refi’s were 77% of total applications
- Adjustable-rate mortgages = 7% of total applications

Housing Market Strengths:
- 30-year mortgage interest rate = 4.17% (thanks to Federal Reserve)
- ↑ refis => ↓ mortgage payments => ↑ saving, ↑ spending, ↓ debt
- Falling/low home prices => record levels of affordability
- Private sector job growth => ↑ purchase applications (necessary condition)

Housing Market Risks:
- Large inventory of foreclosed homes => ↓ PH (bottoming in 1st half 2012)
- Buyers expectations of future lower home prices => lower demand
- Potential buyers have low confidence and high uncertainty
- 25% of homeowners cannot refinance because their mortgages exceed the value of their homes
Credit Risk (2 types)

1. Default Risk – borrowers’ willingness and ability to repay debt (unemployment rate)

2. Collateral Risk – market value decline of the asset securing the loan. (home price changes)

The labor force is declining as middle age men retire early, file for disability or return to school.
Personal Income & Consumption Expenditures
[Year Over Year % Change]

• Personal income rose 4.4% y/y, up 0.1% m/m
  Wage income rose 0.3% m/m
    Unemployment rate = 9.1% => employers with labor market power
    Lower interest rates => lower interest income
    High profits => higher dividend and proprietors’ income
• Nominal spending rose 5.3% y/y, rose 0.6% m/m
  Real spending rose 0.5% m/m (adjusted for inflation)
    Consumers resumed durable goods spending. Lower debt payments is freeing up income for spending
    Less borrowing => lowering cash flows
• Saving rate (savings / disposable personal income) = 3.6%
  Consumers increased their spending despite falling incomes, lowering the savings rate.

Household Budget Constraint
Income + Chg Debt = Taxes + Debt Interest + Spending + Savings

Consumer Credit Outstanding
(monthly change & annual growth rate)

1. Pay off (deleveraging) = 1/3
2. Charge-off = 2/3

Credit rose $7.4 billion in September ($8 billion in non-revolving, -0.6 billion revolving) due mainly to rising auto sales.
Credit will continue to rise in 2011 and accelerate its pace in 2012.
Paradox of Thrift
Everyone increasing their savings leads to a recession.

The “De” Era
Debt => Deleveraging => Deflation => Defaults => Depression

Some CU members may be experiencing rising real debt burden (Debt/Income)
↓ wages, hours, prices, profits => ↓ income => ↑ real debt burden

Consumers are deleveraging to work off a mountain of debt. The Great Recession has led to a fundamental attitude shift towards debt.
The benign macroeconomic environment of the past two decades masked a buildup of financial instability; it may also have been storing up the elements of prolonged social discontent.
October retail sales rose 7.2% y/y, 0.5% m/m.
Third quarter consumer spending was strong and is gathering momentum.
Signals sustainability of the recovery and no evidence of consumer retrenchment.

Factors Reducing Consumer Demand:
1. Few new jobs
2. Low income/wage growth 3.5% y/y (employers have market power)
3. High unemployment
4. Low confidence (budget and Euro-zone concerns)
5. Falling home and stock prices (wealth effect)

Factors Supporting Consumer Demand:
1. Reduced social security withholdings
2. Private sector job growth
3. Pent-up demand
4. Falling debt payments through debt reduction and refinancing
5. Increased credit availability
Consumer Confidence Index = 39.8
Consumers fears remain intense and threaten spending growth. Consumers are concerned about the state of the economy, job growth, low wage growth, volatile stock prices, falling home prices, Washington policies, high unemployment, limited credit availability and higher gas prices than one year ago.

Consumer Sentiment Index (sensitive to household finances) = 64.2
(5-year inflation expectations = 2.6%, 1-year inflation expectations = 3.2%)

Uncertainty has fed and fed on a weak economic recovery, creating a negative feedback loop that results in a downward economic spiral. The current level of risk aversion is unsustainable.

Labor Productivity and Costs (Nonfarm Business) (% chg from year ago)

- Productivity fell in Quarter 2 as labor growth exceeded output growth.
- It is becoming difficult to get additional output from current workers.
- With aggregate demand still rising, firms will have to increase hiring in 2012.
- Wage growth is accelerating
- Unit labor costs are rising quickly, but still down 2% from 2008 peak.
- So labor is relatively inexpensive leading to higher profits.
- This allows for additional capital for expansion plans to offset tighter credit conditions.
Oil Economics

\[ \uparrow P_{\text{oil}} = 10 \Rightarrow \uparrow P_{\text{Gas}} = 0.25 \Rightarrow \downarrow \text{growth 0.3-0.5\%} \]

6 Positive Stock Factors:
1. Low cash/money market rates => stock rally (putting money back to work)
2. Rising economic growth and profit expectations
3. Low inflation expectations and interest rates will keep borrowing costs low
5. Liquidity – rather than fundamentals – may be driving the market
6. Market could be exposed to a violent reversal (without warning)
Aging depresses asset prices, which in turn makes deleveraging tougher because debt used to finance assets is harder to pay off without incurring losses. The young and middle-aged save for old age by buying assets, the old sell them to pay for retirement. As the working age population rises (ex. baby boom generation) asset prices rise because of increased demand. As baby-boomers reach retirement, the reverse may happen. House and stock prices will face significant headwinds as the population ages. High correlation between the ratio of Americans aged 40-49 to those aged 60-69, and the price/earnings ratio of the stock market. Share prices expected to fall 13% between 2010-2021. Strong equity recovery after 2025.
Policy Prescriptions

1. **Productivity enhancing structural reforms**
   - Overhaul training schemes to decrease long-term structural unemployment and improve a sclerotic labor market.
   - Bankruptcy reform to allow judges to decrease mortgage debt and increase worker mobility.
   - Hiring subsidies for hard-to-employ.
   - Deregulate professional services to increase competition and innovation.

2. **Global rebalancing**
   - Decrease U.S. consumption, increase U.S. exports
   - Encourage market determined exchange rates

3. **Deficit Reduction & Tax Reforms**
   - Medium-term spending cuts and tax increases around a 3 to 1 ratio
   - Lower public sector wages and welfare payments.
   - Develop credible fiscal consolidation plan.
   - Tax reforms to increase the efficiency of the tax code: tax consumption and property, not income or savings. Eliminate deductions to increase tax base and lower marginal tax rates.
   - Equalize the top tax rates on wages and capital.
   - Eliminate corporate taxes to avoid taxing investment twice.
   - Slow down pension and health care spending.
   - Increase retirement age.
   - Increase immigration and tempt more people into labor force.

The art of progress is to preserve order amid change and to preserve change amid order.

Alfred North Whitehead
The budget deficit will narrow in fiscal 2012 to $1 trillion as spending falls and the recovery boosts payroll, personal income tax, and corporate income tax revenues. Large personal income tax cuts enacted under President Bush are scheduled to expire at the end of 2012.
ECONOMIC FORECAST

• The U.S. economy has stalled and is expected to grow at a very slow pace of 2.5% in the second half of 2011 and 3% for all of 2012. The possibility of a double dip recession has dropped significantly. The economy is being negatively impacted by the Euro-zone debt crisis, falling stimulus spending, deleveraging households, and less inventory rebuilding. With economic growth this low, any negative economic shock could push growth into recessionary territory.

• Core inflation will remain below the Federal Reserve’s implicit inflation target of 2% through 2012. Core inflation (excluding food and energy prices) will trend up to 1.5% in 2011 and 2012 due to rising commodity prices. Low core inflation will keep inflation expectations low and therefore also keep long-term interest rates low.

• The unemployment rate will slowly decline over the next two years. The unemployment rate will decline as employers increase hiring faster than new entrants coming into the labor force. The higher than normal unemployment rate will keep credit union delinquency rates above historical averages.

• The fed funds interest rate will (as advertised) not begin an upward path until 2013. Labor and credit market conditions will be the major factors influencing the Federal Reserve’s decision to raise interest rates. The Federal Reserve will wait until loan demand picks up and the unemployment rate falls before beginning its exit strategy from its extraordinarily easy monetary policy.

• The 10-year Treasury interest rate will average 2.69% in 2011 and 2.00% in 2012. The Federal Reserve’s “operating twist” will keep downward pressure on long term interest rates through 2012.

• The Treasury yield curve will flatten in 2012 because of the Federal Reserve’s “operation twist”. Long-term interest rates will fall over the next few months, flattening the yield curve. This will produce downward pressure on credit union’s net interest margins as borrowing short term and lending long term becomes less lucrative.

CREDIT UNION FORECAST

• Credit union savings balance growth is expected to remain at 5% for the next two years. Despite rising disposable incomes, savings balance growth will remain below its 5-year average of 6.3%, as members begin to spend again to relieve some pent up demand and deleveraging continues. Currently, members are paying off debt rather than save any additional surplus funds due to the large interest rate differential between loan and deposit interest rates.

• Expect little change in credit union loan balances 2011 and a muted 3% increase in 2012. After falling over one percent in 2010, we expect a modest rebound in credit union loan balance growth in 2012 as the economy and consumer confidence slowly recovers. Auto loans, credit card loans and purchase mortgage loans will be strong growth areas.

• Credit quality will improve in 2011 and 2012. Overall loan delinquency and chargeoff rates will fall as job growth picks up. Provisions for loan losses will also decline as credit unions shift from building their allowance for loan loss account to maintaining the current level.

• Credit union return on assets will recover to 0.56% in 2011 and 0.75% in 2012. Lower loan loss provisions will boost net income in 2011 as CUs allow their allowance for loan loss accounts to decline. We expect NCUA assessments to come in at 20 and 11 basis points of average assets in 2011 and 2012, respectively.

• Capital-to-asset ratios have stabilized at 10%. For the first time since the start of the great recession in 2007, capital contributions will outpace asset growth, raising net worth ratios.
## Economic Forecast

September, 2011

<table>
<thead>
<tr>
<th>Growth rates:</th>
<th>Actual Results</th>
<th>Quarterly Results/Forecasts</th>
<th>Annual Forecasts</th>
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<tbody>
<tr>
<td>*Economic Growth (% chg GDP)</td>
<td>0.96%</td>
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<td>Inflation (% chg CPI)</td>
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</tr>
<tr>
<td>Fed Funds Rate</td>
<td>2.50%</td>
<td>0.18%</td>
<td>0.18%</td>
</tr>
<tr>
<td>10-Year Treasury Rate</td>
<td>3.91%</td>
<td>3.21%</td>
<td>3.46%</td>
</tr>
</tbody>
</table>

* Percent change, annual rate
All other numbers are averages for the period.

## Credit Union Forecast

September, 2011

<table>
<thead>
<tr>
<th>Growth rates:</th>
<th>Actual Results</th>
<th>Quarterly Results/Forecasts</th>
<th>Annual Forecasts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Savings growth</td>
<td>6.3%</td>
<td>4.5%</td>
<td>3.2%</td>
</tr>
<tr>
<td>Loan growth</td>
<td>4.3%</td>
<td>-1.5%</td>
<td>-1.3%</td>
</tr>
<tr>
<td>Asset growth</td>
<td>5.9%</td>
<td>3.3%</td>
<td>2.7%</td>
</tr>
<tr>
<td>Membership growth</td>
<td>1.3%</td>
<td>0.7%</td>
<td>0.4%</td>
</tr>
</tbody>
</table>

| Liquidity:                                 |          |     |       |       |       |       |      |     |
|                                            |          |     |       |       |       |       |      |     |
| Loan-to-share ratio**                      | 79.5%   | 72.2%| 69.1%  | 69.7%  | 69.5%  | 69.7%  | 69.7%| 68.4%|

| Asset quality:                             |          |     |       |       |       |       |      |     |
|                                            |          |     |       |       |       |       |      |     |
| Delinquency rate                           | 1.31%   | 1.75%| 1.70%  | 1.60%  | 1.60%  | 1.50%  | 1.60%| 1.35%|
| Net chargeoff rate*                        | 0.83%   | 1.14%| 1.00%  | 0.90%  | 0.90%  | 0.80%  | 0.90%| 0.70%|

| Earnings                                   |          |     |       |       |       |       |      |     |
|                                            |          |     |       |       |       |       |      |     |
| Return on average assets (ROA)*            | 0.40%   | 0.39%| 0.73%  | 0.79%  | 0.70%  | 0.70%  | 0.73%| 0.85%|

| Capital adequacy:                          |          |     |       |       |       |       |      |     |
|                                            |          |     |       |       |       |       |      |     |
| Net worth ratio**                          | 10.7%   | 10.1%| 9.9%   | 10.1%  | 10.2%  | 10.3%  | 10.3%| 10.6%|

* Annualized Quarterly Data
**End of period ratio

See also our MCUE website
If you have any questions or comments send an email to srick@cuna.coop