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Annual Conference
Las Vegas, NV
Harrah's Las Vegas
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U.S. Economic Outlook & Its Impact on Financial Institutions

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Black Swans – low probability, but high impact events

- Currency War => Trade War (protectionism)
- Deflation
- Financial regulatory reform
- Massive fiscal consolidation
- Double dip recession
- Dollar collapse
- Rapid inflation
- Euro-zone sovereign debt default
- Federal bailout of state budgets

What will be the “new normal”?

- Subdued economic growth
- Weak demand will weigh on supply
- New era of thrift
- High unemployment
- Smaller securitization markets
- Costlier finance
- Less investment
- Public debt will rise so that private debt can fall
- Stagnant household income
- Higher tax levels

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

- Medium-term spending cuts: lower public sector wages and welfare payments.
- Develop credible fiscal consolidation plan.
- Tax reforms: tax consumption and property, not income or savings.
- Slow down pension and health care spending.
- Increase retirement age.
- Increase immigration and tempt more people into labor force.

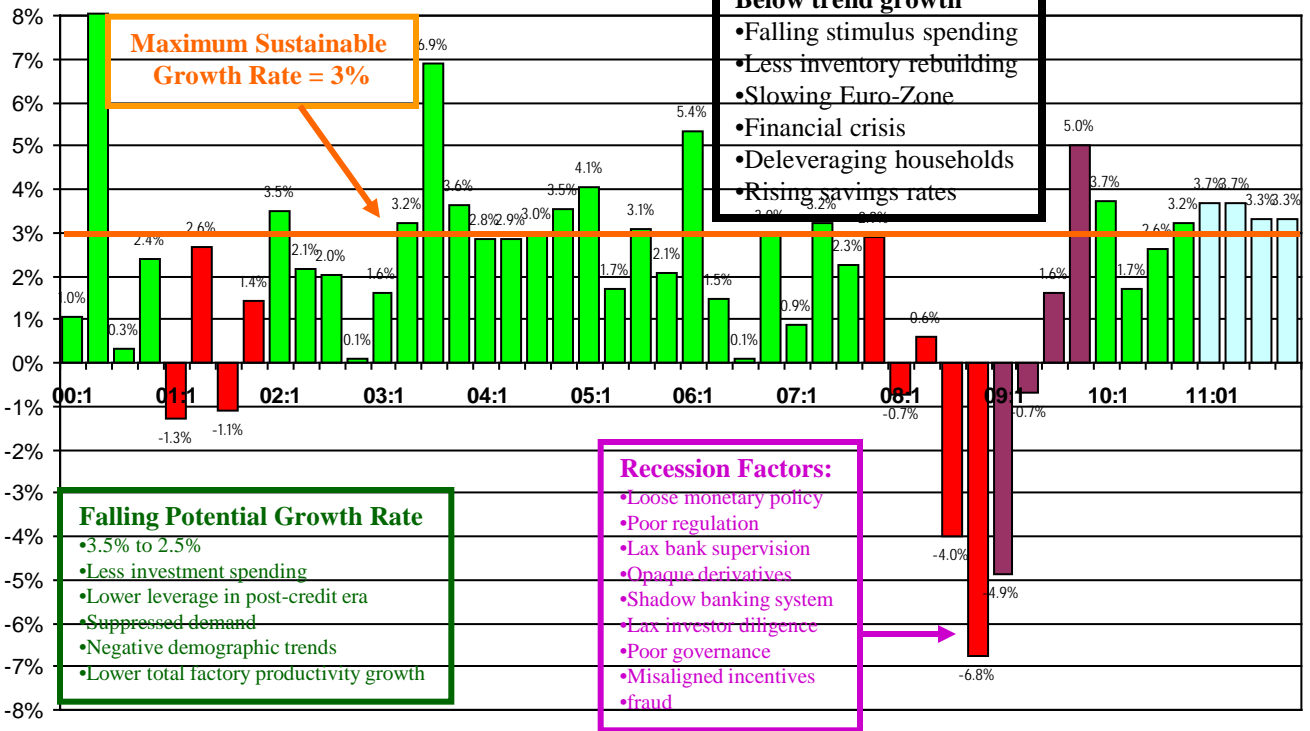
The art of progress is to preserve order amid change
and to preserve change amid order.

Alfred North Whitehead

Recent Economic Trends

1. The longest, deepest, and broadest recession since the Great Depression has passed its nadir and the economy has moved into a recovery. But a double dip recession is not out of the range of possibility.
2. Debt deflation, deleveraging and the credit reckoning process continues.
3. The labor market has stabilized but job creation is both a necessary and sufficient condition for a self-sustaining recovery.
4. U.S. fiscal budget concerns could lower the value of the dollar and raise interest rates.
5. The Federal Reserve will keep short-term interest rates low through 2011 and additional quantitative easing remains a possibility.
6. Government intervention into the economy has proved to be less than effective and may have many unintended consequences.
7. Falling home prices will continue into 2011.
8. Loan credit quality will improve through 2011 and lending underwriting standards will begin to ease.
9. The steep yield curve and rising deposit growth will be a silver lining for depository institutions in 2011.
10. Threats to economic recovery include rising foreclosures, falling confidence, weak state budgets, slow job creation, and rising interest rates. Consumers may not be in a good position to accept the “economic growth baton” once government stimulus spending wanes in 2011.

Quarterly % Change in U.S. Economic Output (Real GDP - Chainweighted 2005\$)



Source: Department of Commerce.

4th Quarter 2010 GDP

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

% of total = (70.4) (13.0) (19.3) (12.8) (-15.7)

Growth rate = (4.4) (-22.5) (-0.6) (8.5) (-13.6)

Contribution = (3.04) + (-3.2) + (-0.11) + (1.04) + (2.4) = 3.2%

$$(1+0.032)^{1/4} - 1 = 0.008 = 0.80\%$$

Weak fundamentals are restricting sales:

Few new jobs, low income growth, high 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.

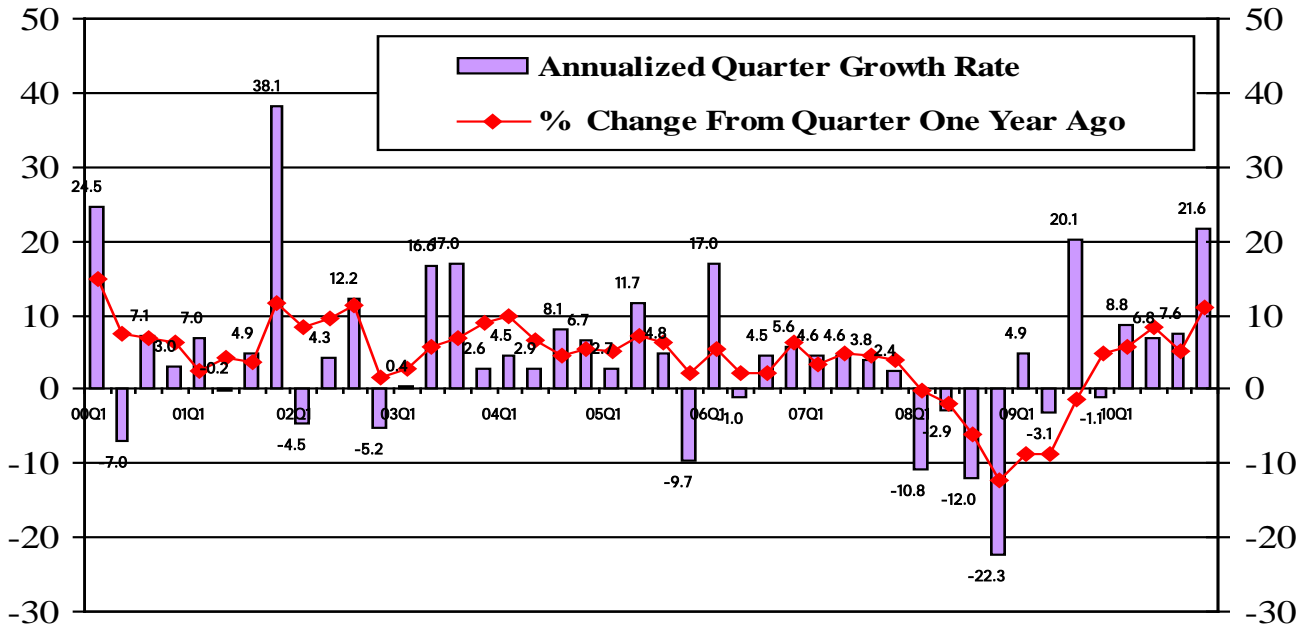
Housing Market Strengths:

- 30-year mortgage interest rate = 4.5% (thanks to Federal Reserve)
- Falling/low home prices => record levels of affordability
- Private sector job growth
- Public and private foreclosure mitigation efforts.

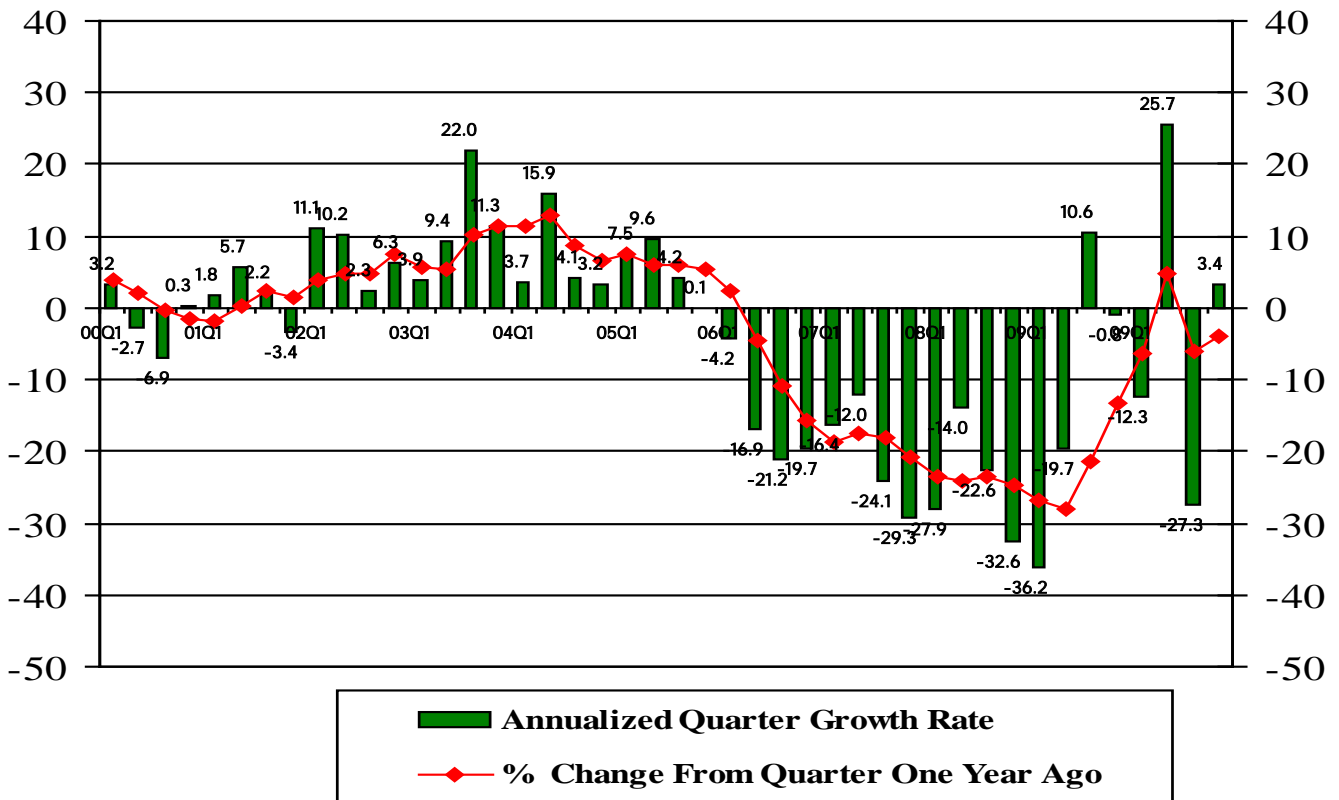
Housing Market Risks:

- Expiration of tax credits in April (pulled forward demand)
- \uparrow foreclosure sales (2.5 million in 2010) => $\downarrow P_H$
- Buyers expectations of future lower home prices => lower demand
- Double dip recession => housing crash

Real Personal Consumption Expenditures (Durable Goods)

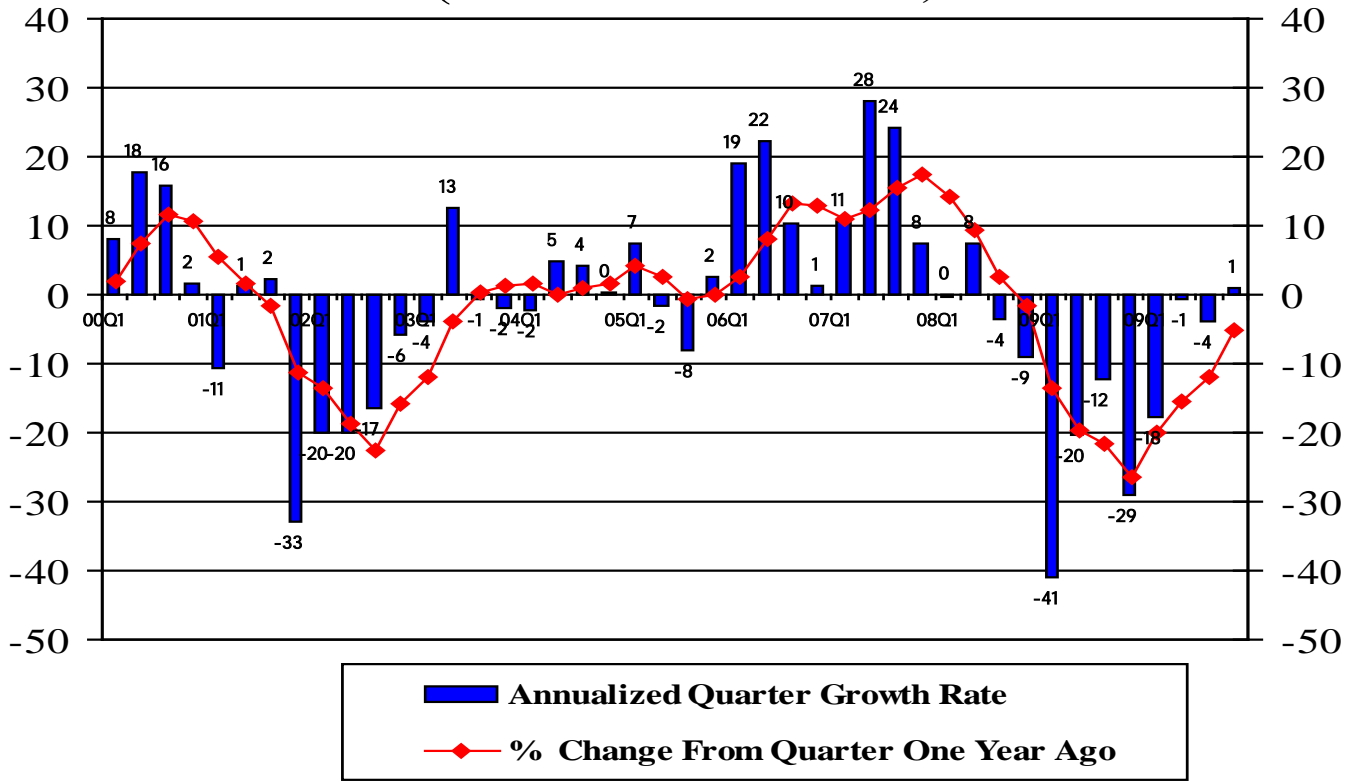


Residential Investment



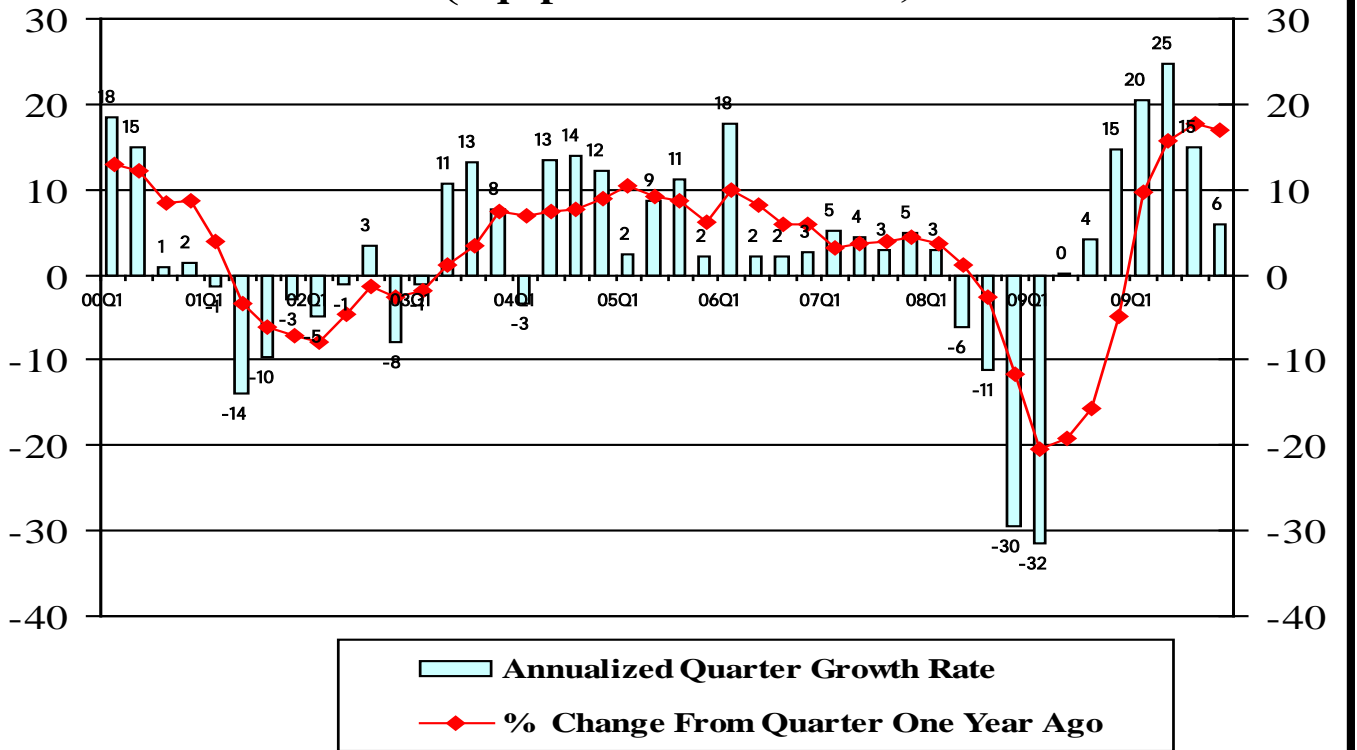
Business Fixed Investment

(Nonresidential Structures)



Business Fixed Investment

(Equipment and Software)



Inflation:

1. Inflation typically lags money supply growth by 3.5 years.
2. Noble prize winning economist Milton Friedman's famous quote: "Inflation is everywhere and always a monetary phenomenon".
3. The Federal Reserve may not be willing or able to tighten monetary policy at the appropriate time.
4. If the Federal Reserve actions don't lead to inflation, then massive spending by the Treasury will.
5. Foreign investors' concerns over the U.S. fiscal position could lead to a significant drop in the value of the dollar and a jump in import prices.
6. Deleveraging periods are typically followed by periods of rapid debt accumulation and spending.
7. The current period is looking eerily similar to the 1970s: resurgence of Keynesian policy prescription, volatile commodity prices, loose monetary policy.
8. Historically, severe economic contractions have been followed by rapid economic expansions.
9. Rapid emerging market economic growth will create upward pressure on commodity prices and worldwide inflation.
10. Congressman Ron Paul has put forth legislation for the GAO to audit the Fed's FOMC decision making activities. This could erode the Fed's independence and increase market participants' inflation expectations.

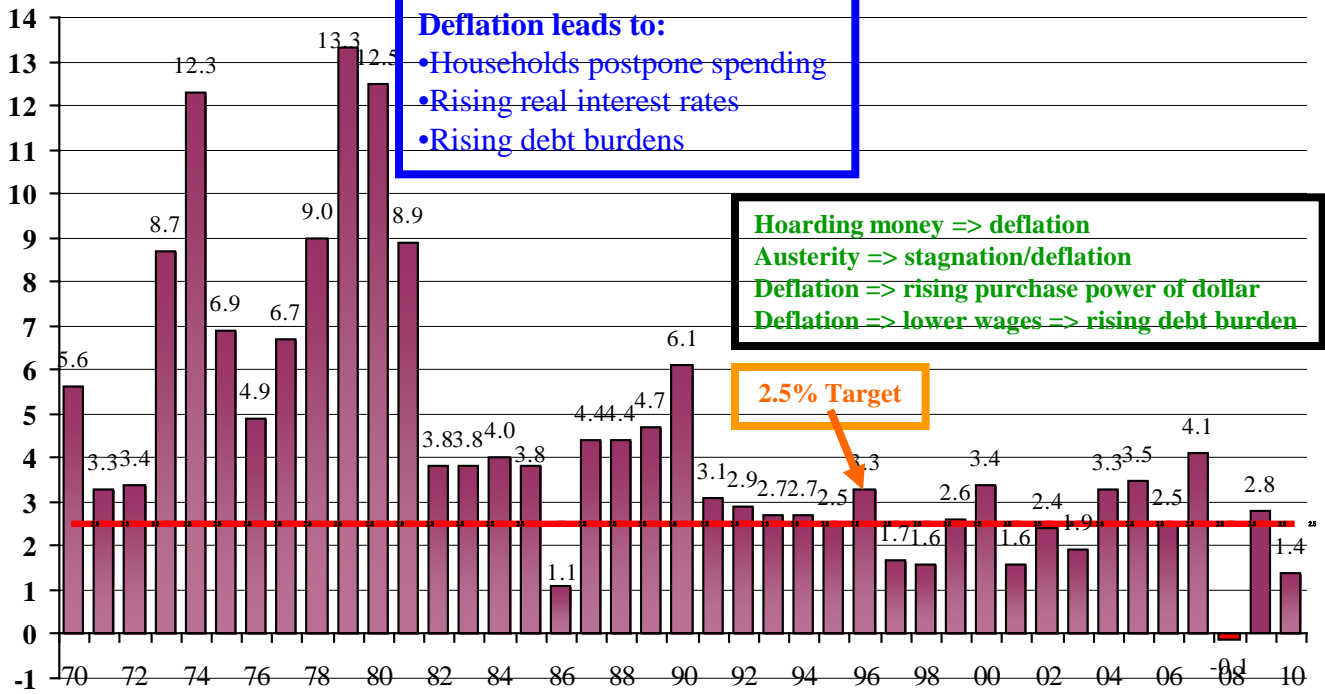
Deflation:

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".
10. Resurgence of the Ricardian Equivalence Theorem: Large government deficits are offset by rising household expectations of higher future taxes and savings rates.

Consumer Price Index

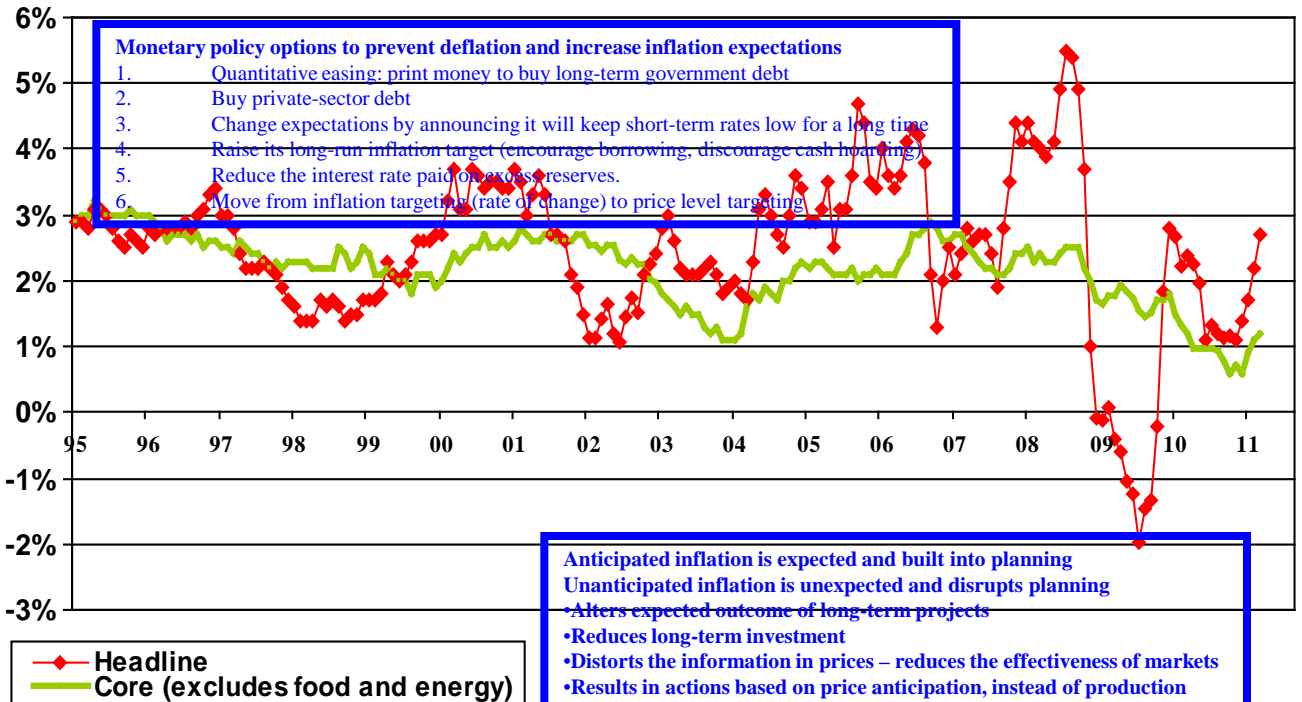
1970 to Present

Annual Percentage Change

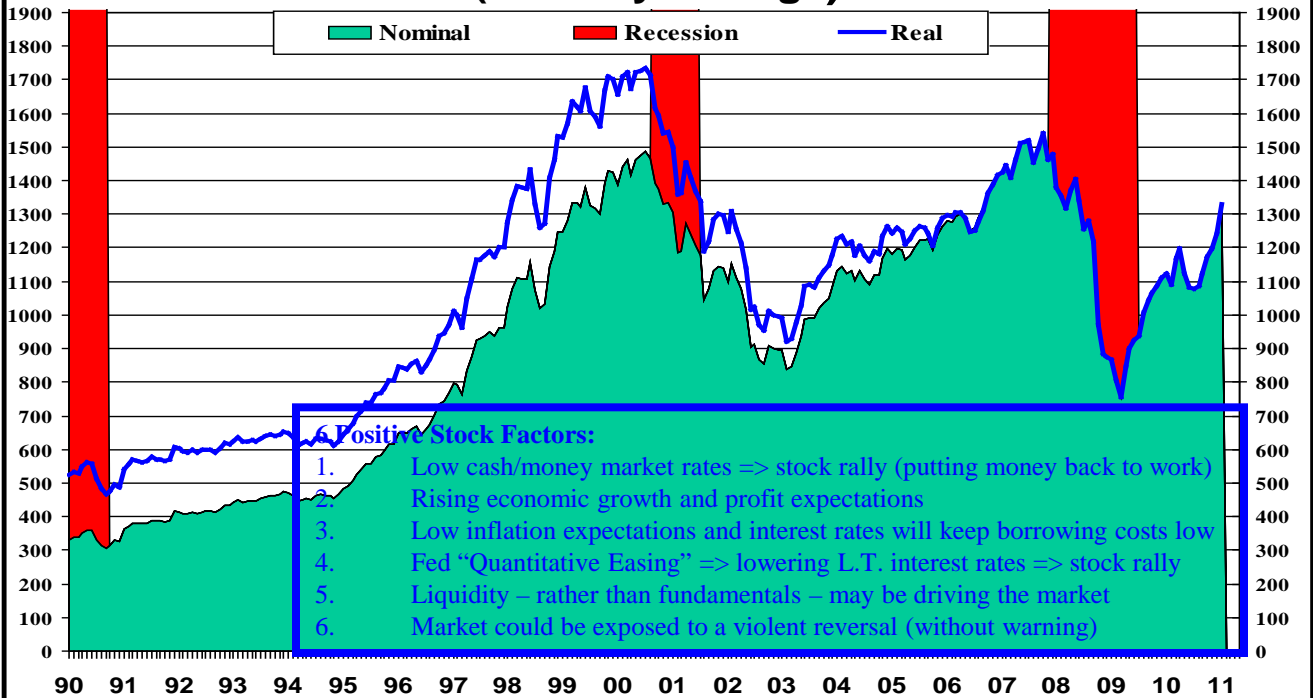


Inflation (CPI)

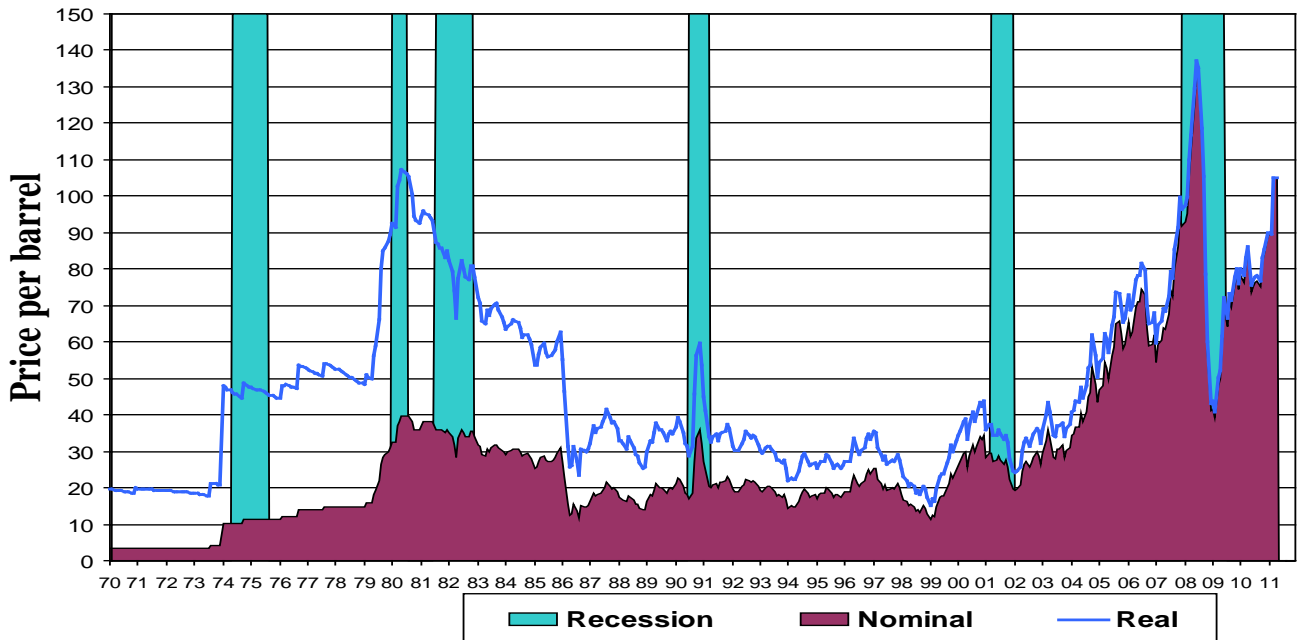
(year over year % growth)



S&P 500 Stock Index (monthly average)



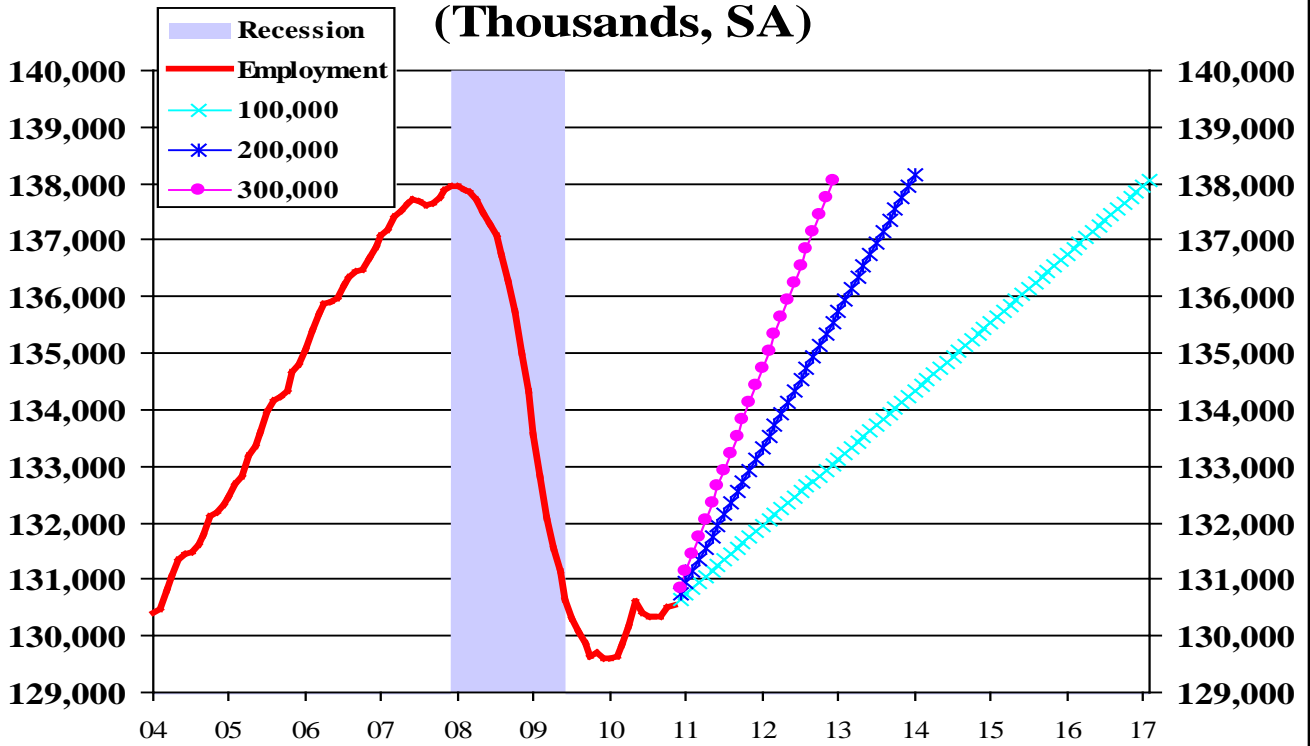
Oil Price per Barrel (West Texas Intermediate Crude)



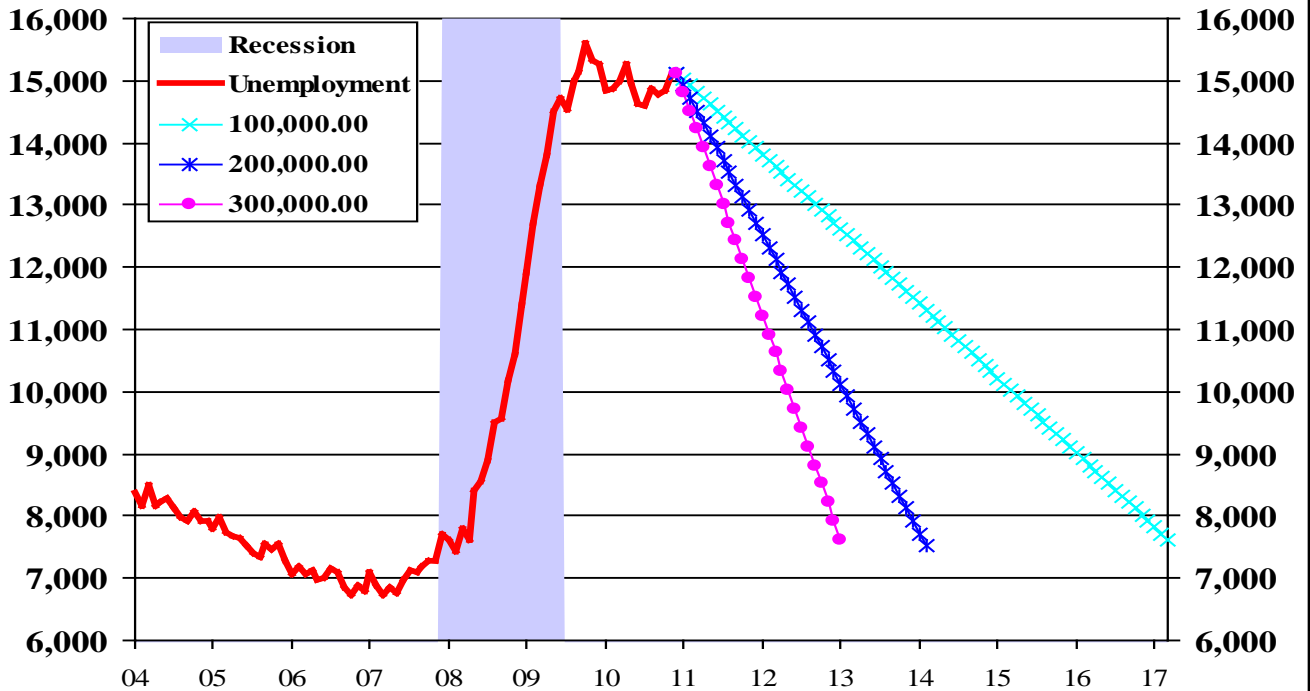
Oil Economics

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

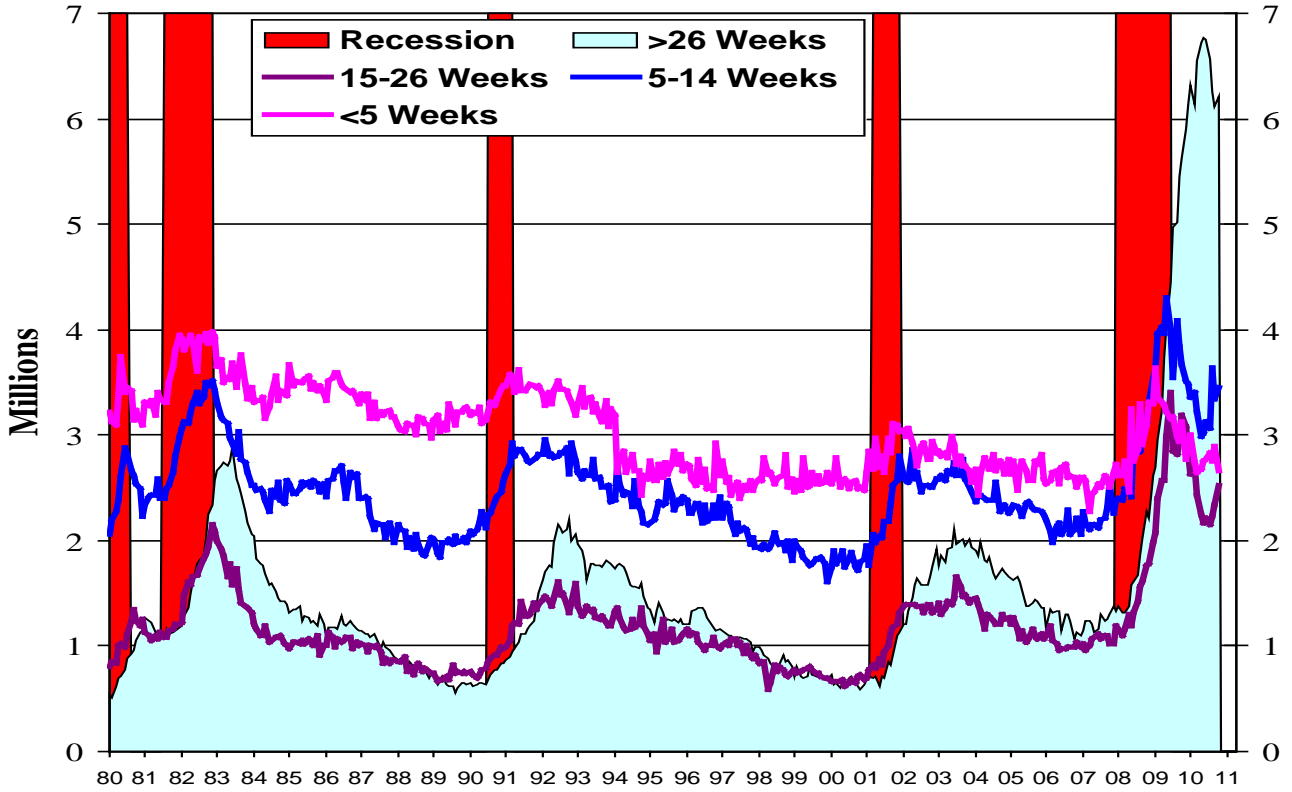
Total Nonfarm Employment (Thousands, SA)



Household Survey Unemployment (Thousands, SA)

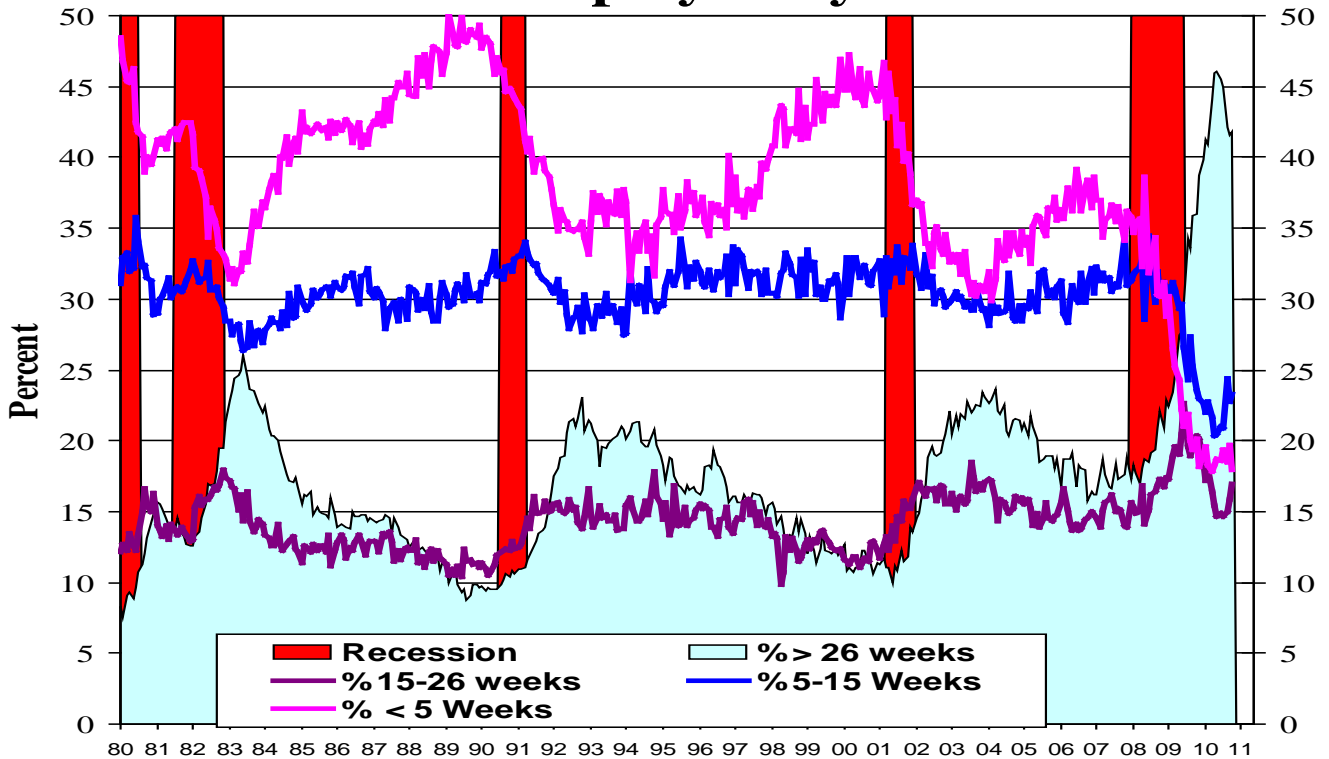


Number Unemployed by Duration



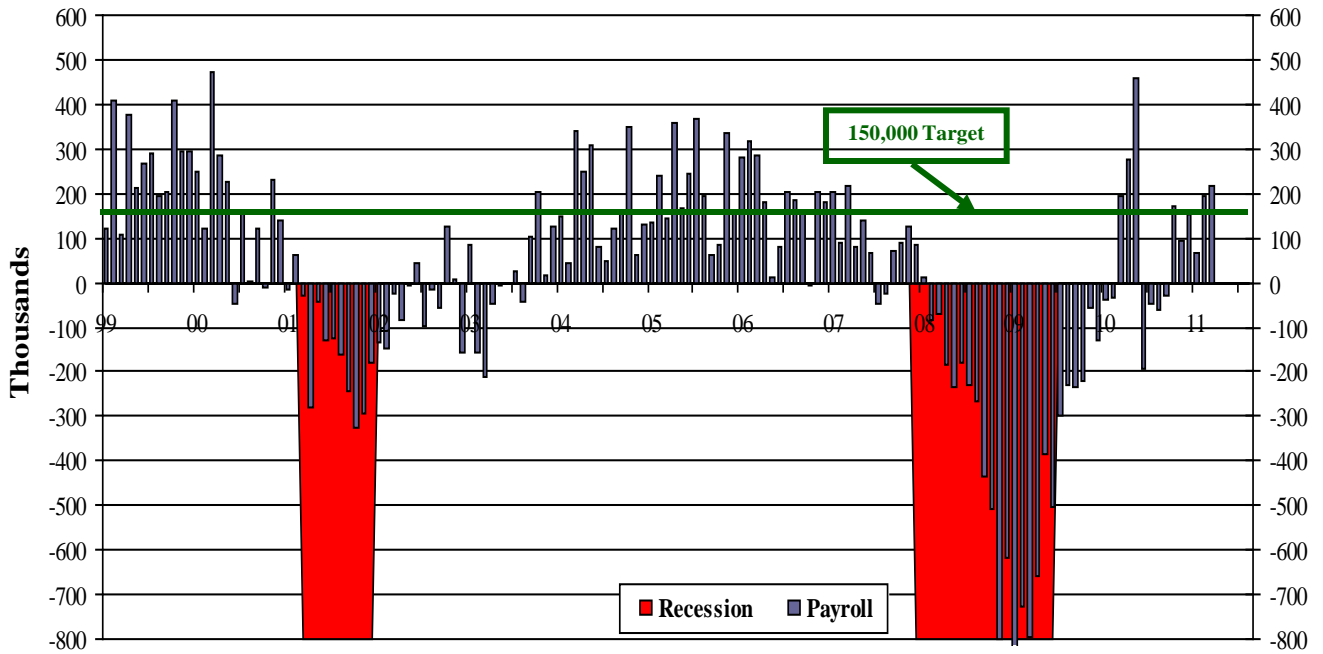
Source: Department of Labor. <http://data.bls.gov/PDQ/servlet/SurveyOutputServlet>

Percent Unemployed by Duration

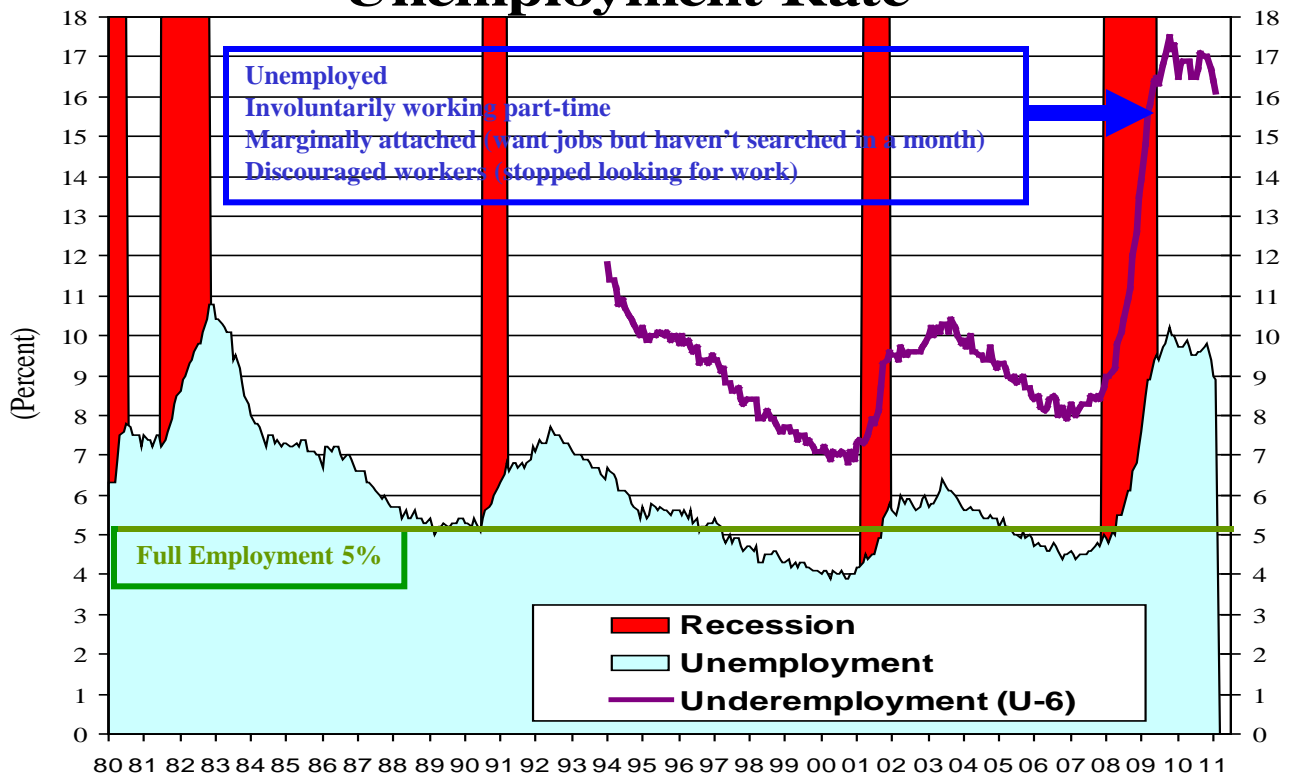


Source: Department of Labor. <http://data.bls.gov/PDQ/servlet/SurveyOutputServlet>

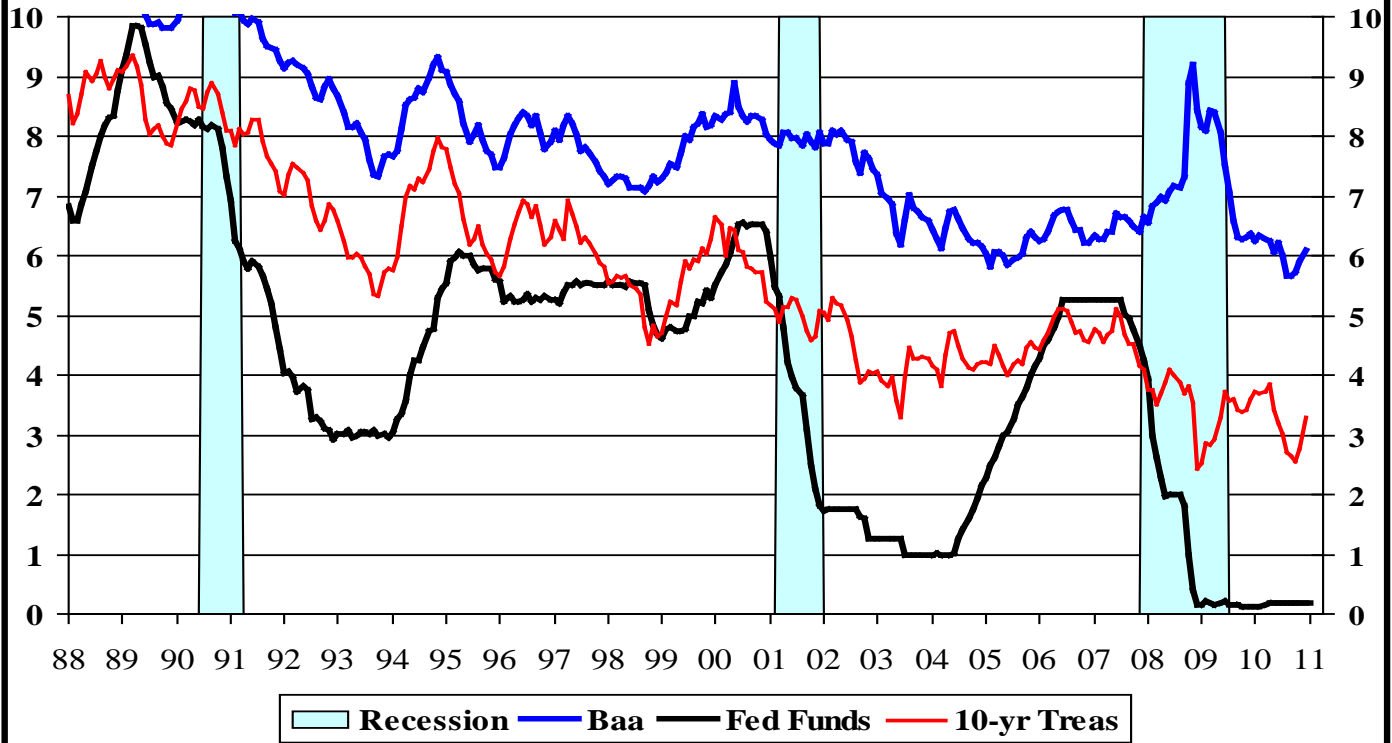
US Payroll Employment Monthly Changes SA



Unemployment Rate



Interest Rates and Recessions 1988-2011

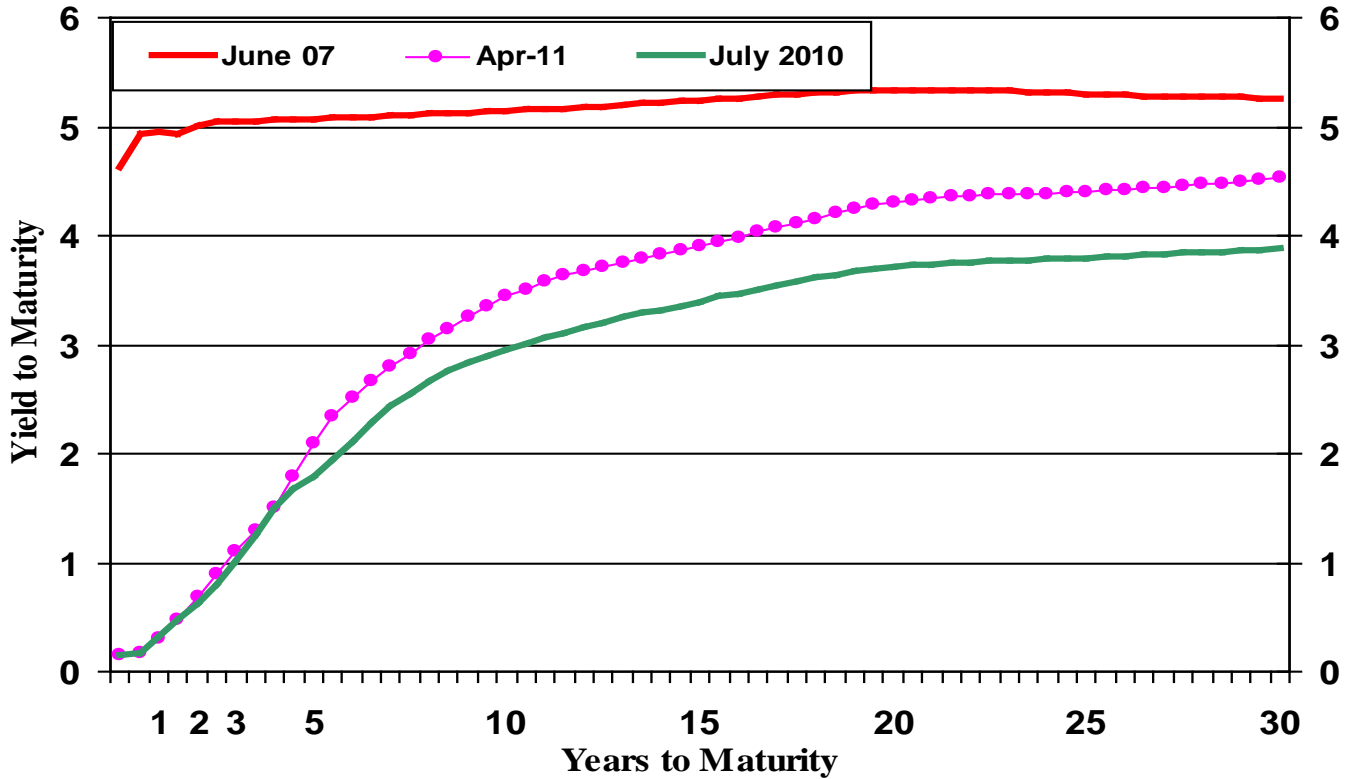


Federal Funds Futures 30 Day Fed Funds

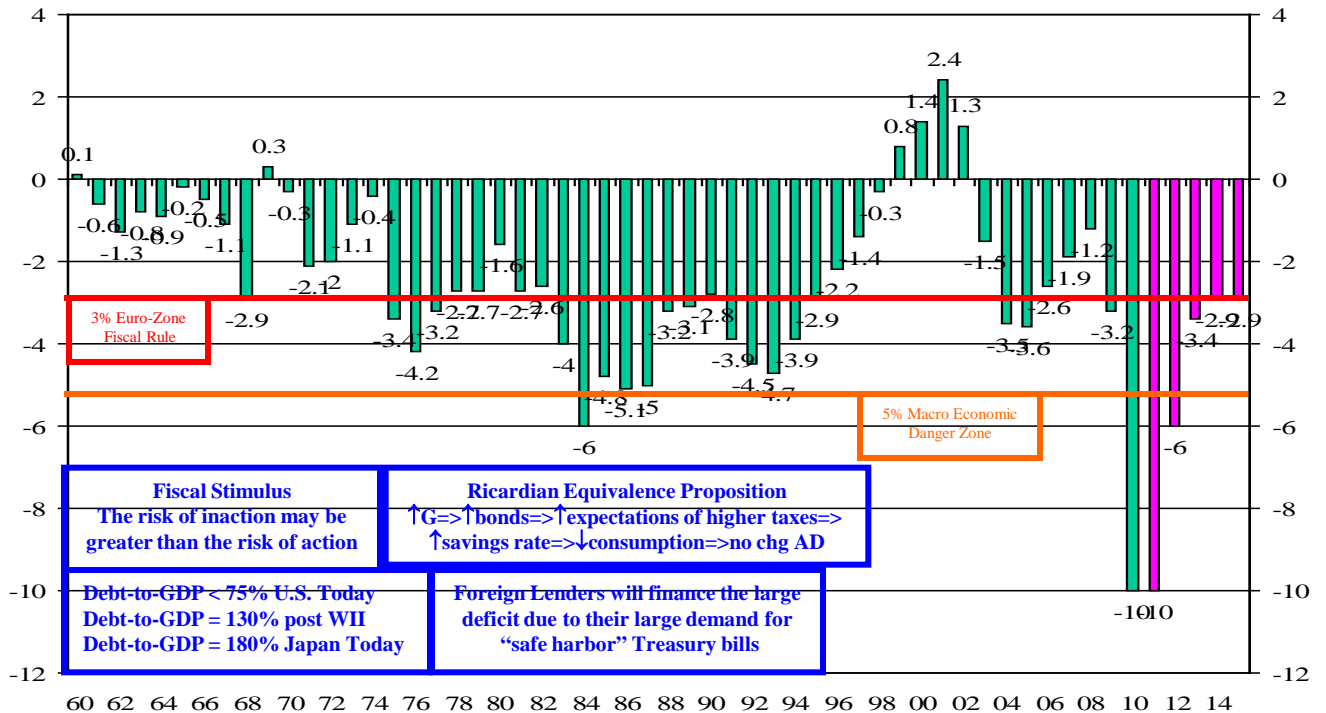
(April, 2011)

April	0.17	(FOMC meeting April 26/27)
May	0.17	
June	0.17	(FOMC meeting June 21/22)
July	0.19	
August	0.21	(FOMC meeting August 9)
September	0.23	(FOMC meeting September 20)
October	0.25	
November	0.30	(FOMC meeting November 1/2)
December	0.33	(FOMC meeting December 13)

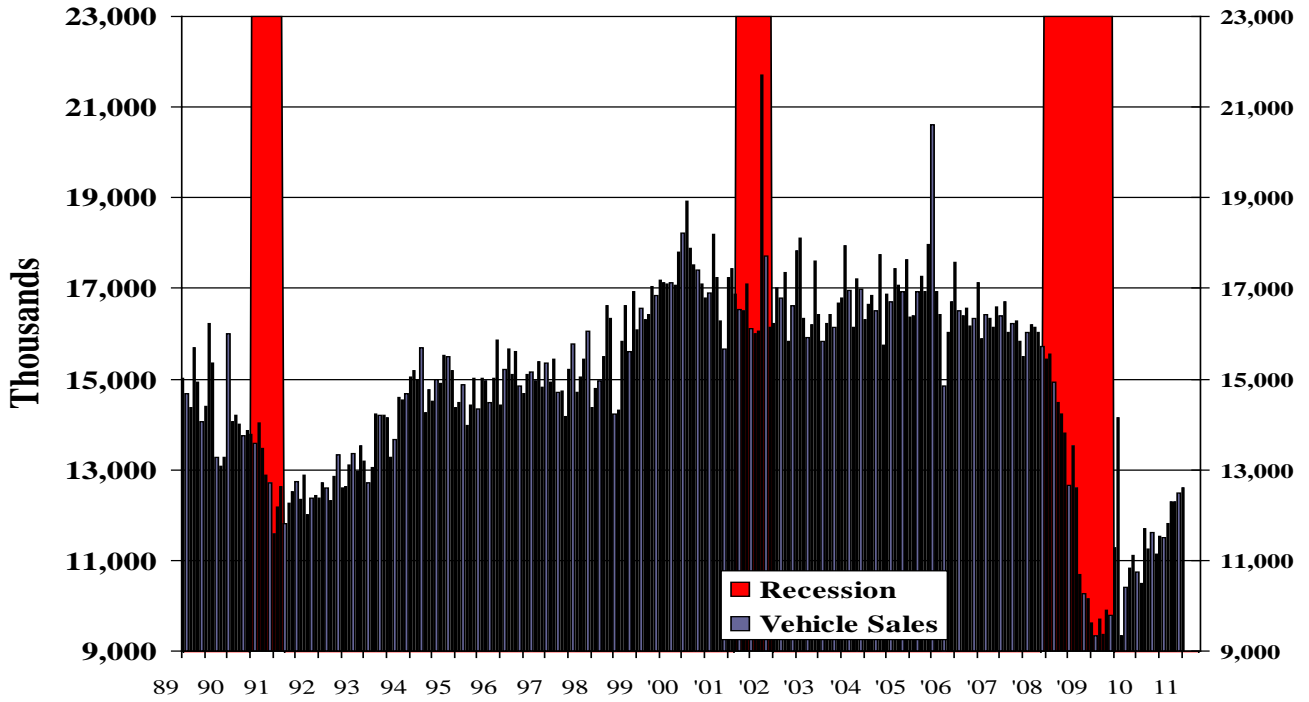
Treasury Yield Curves



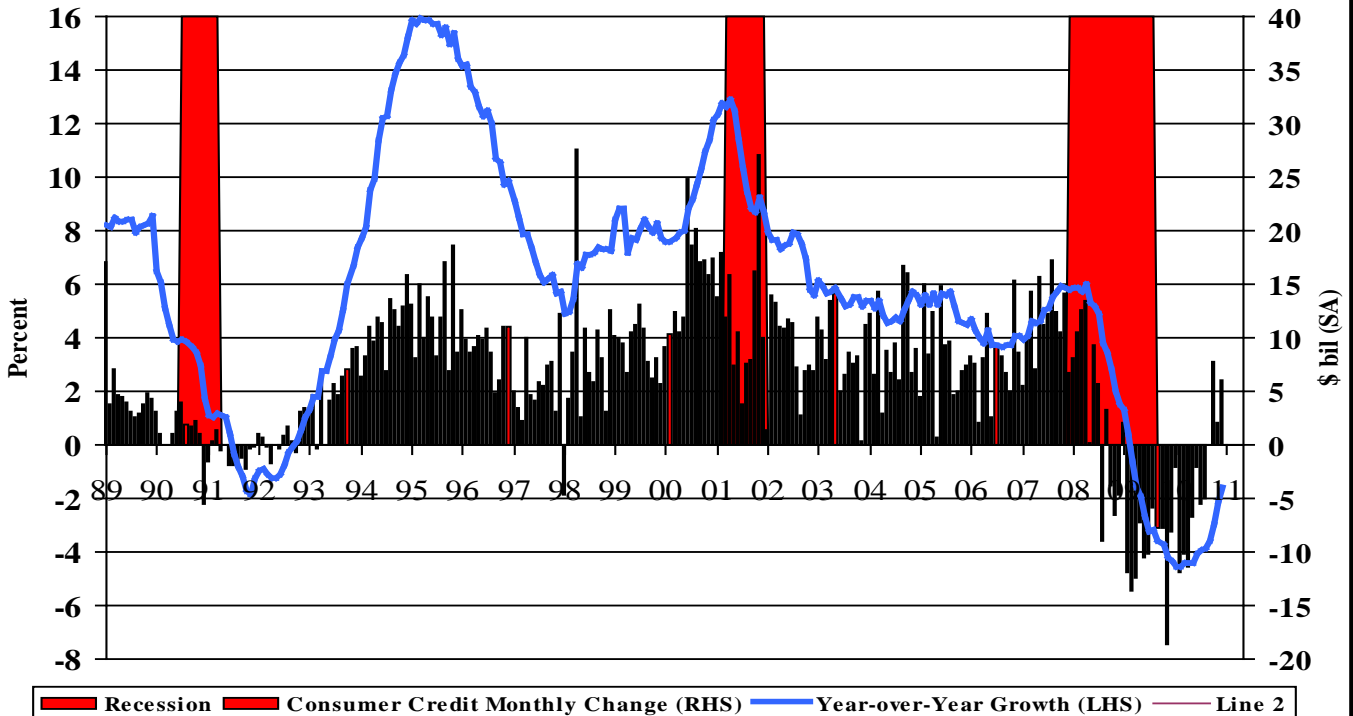
U.S. Federal Budget Surplus or Deficit (as a % of GDP)



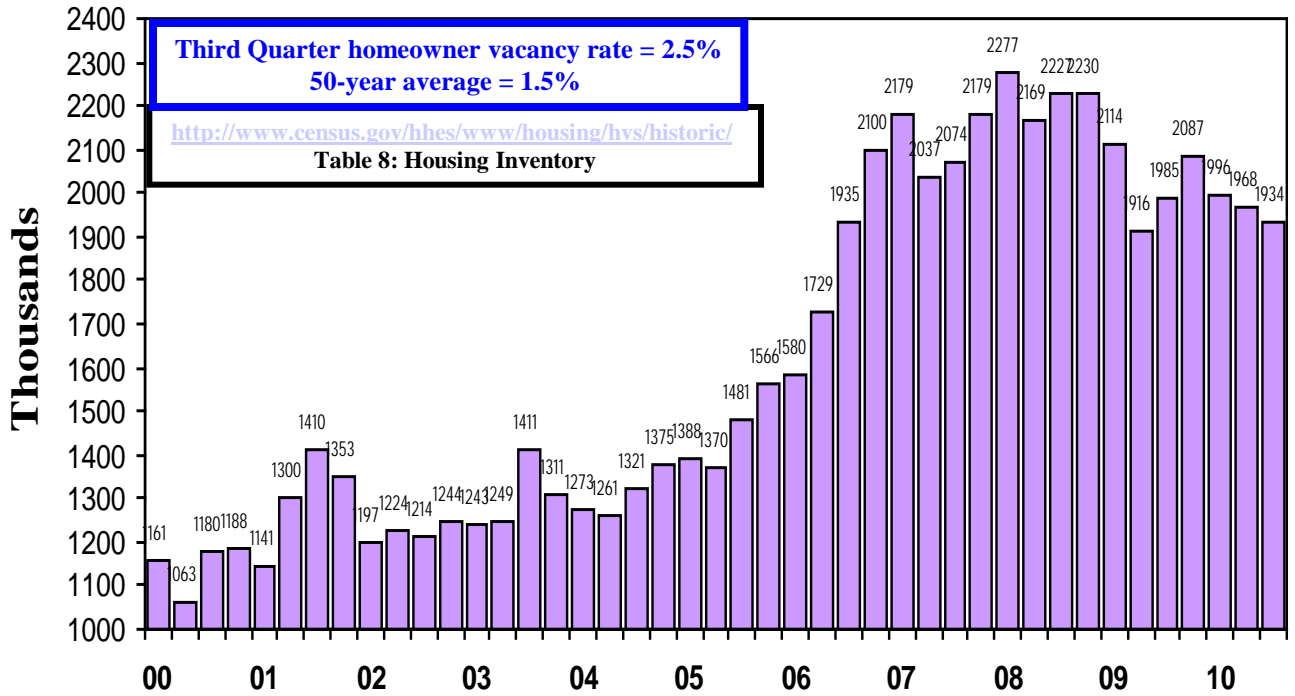
Vehicle Sales (auto & light trucks) Monthly Data, SAAR



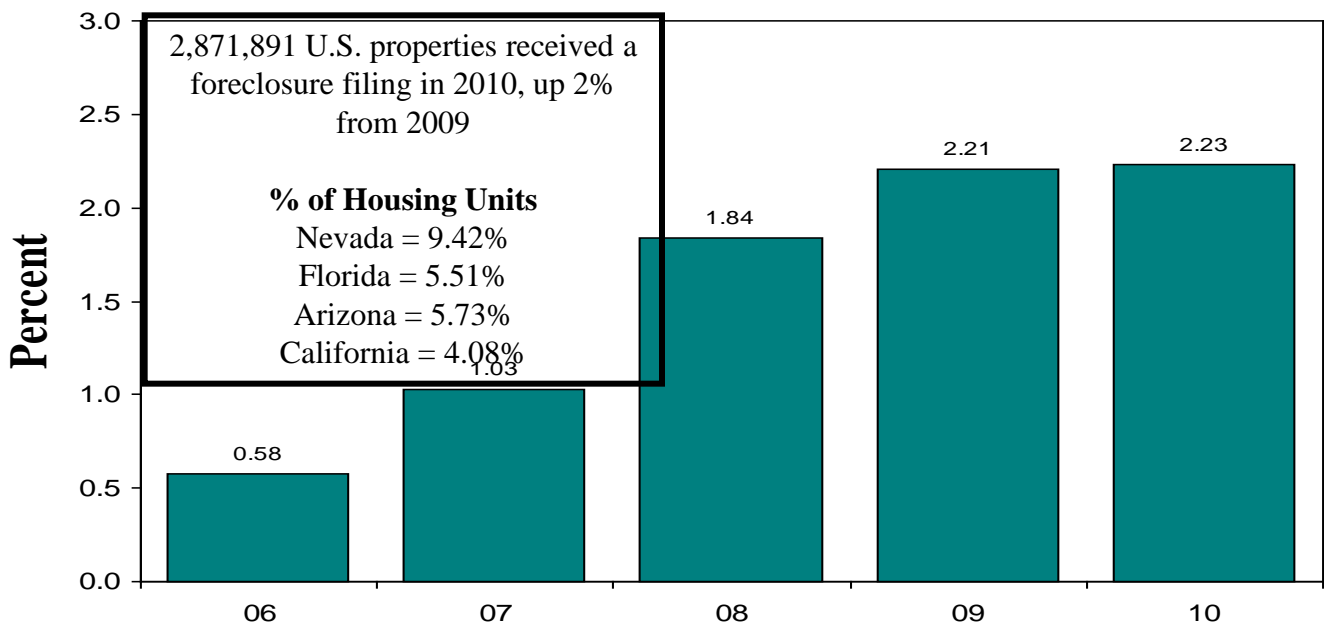
Consumer Credit Outstanding (monthly change & annual growth rate)



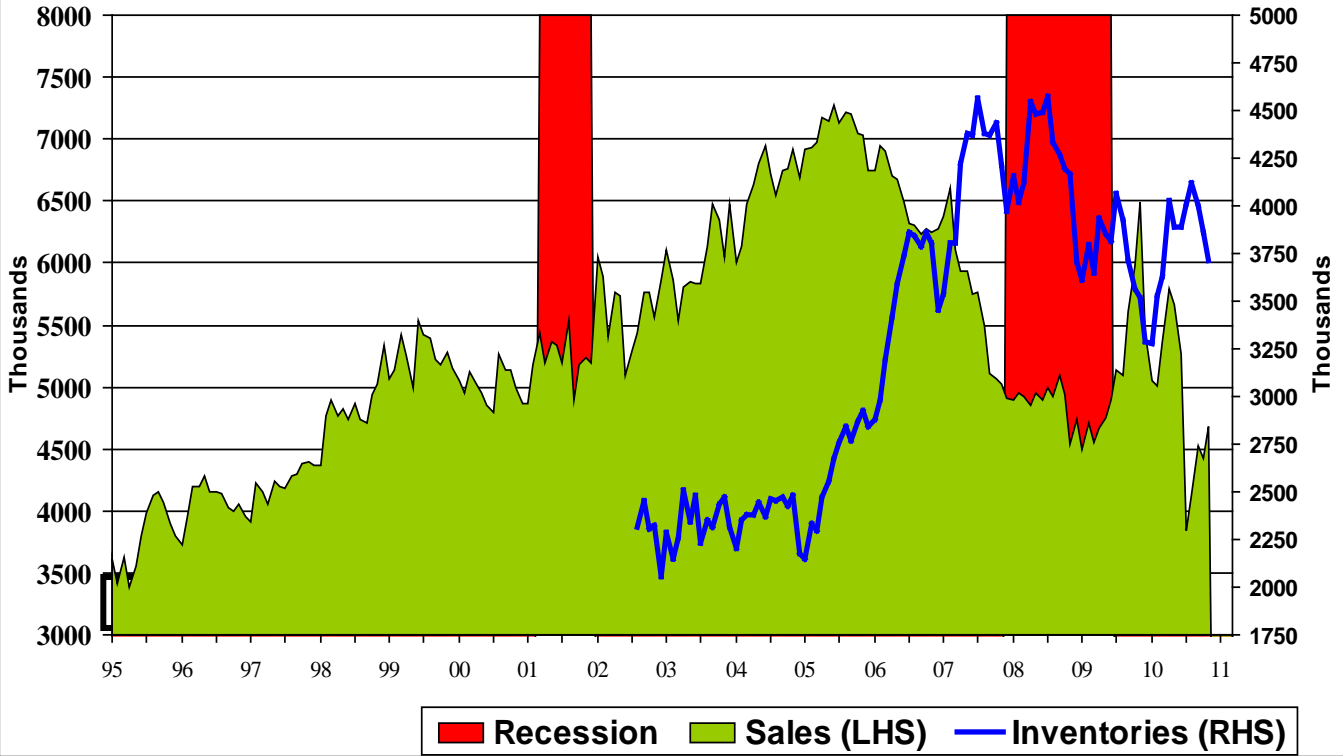
Total Vacant Housing Units For Sale



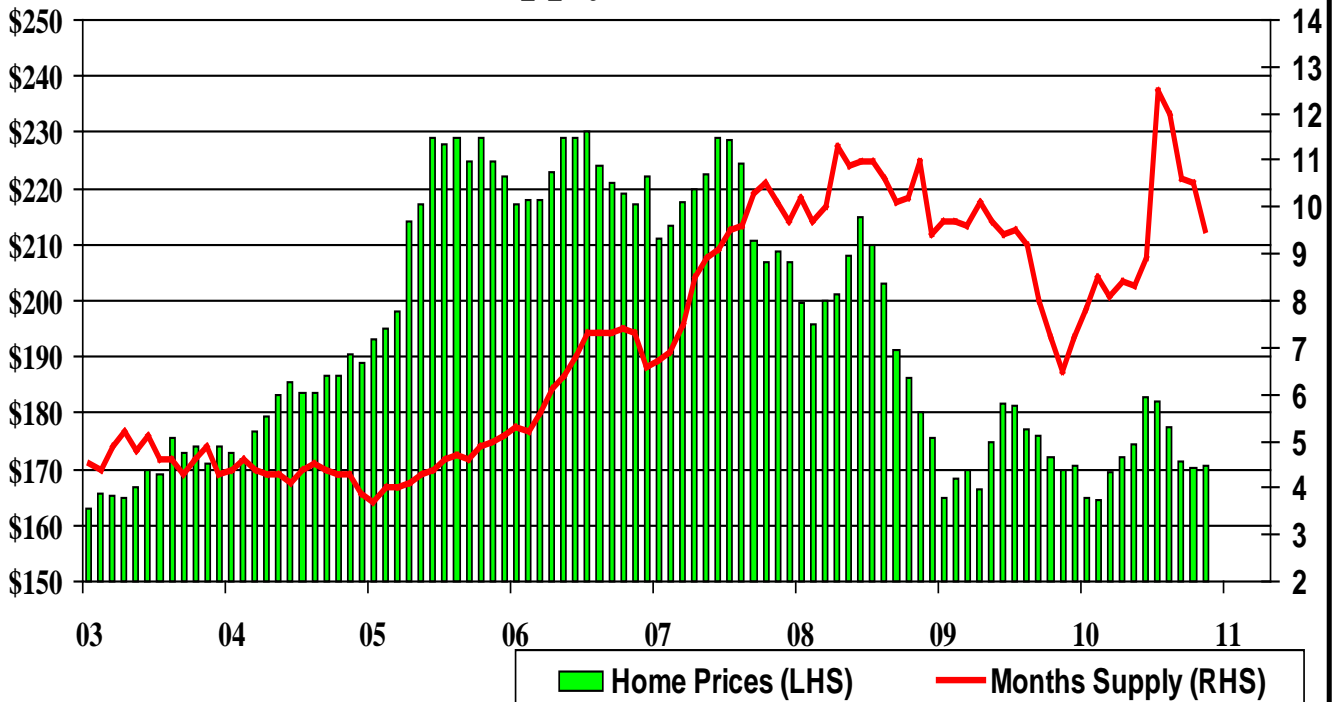
Percent of US Housing Units Receiving Foreclosure Filings



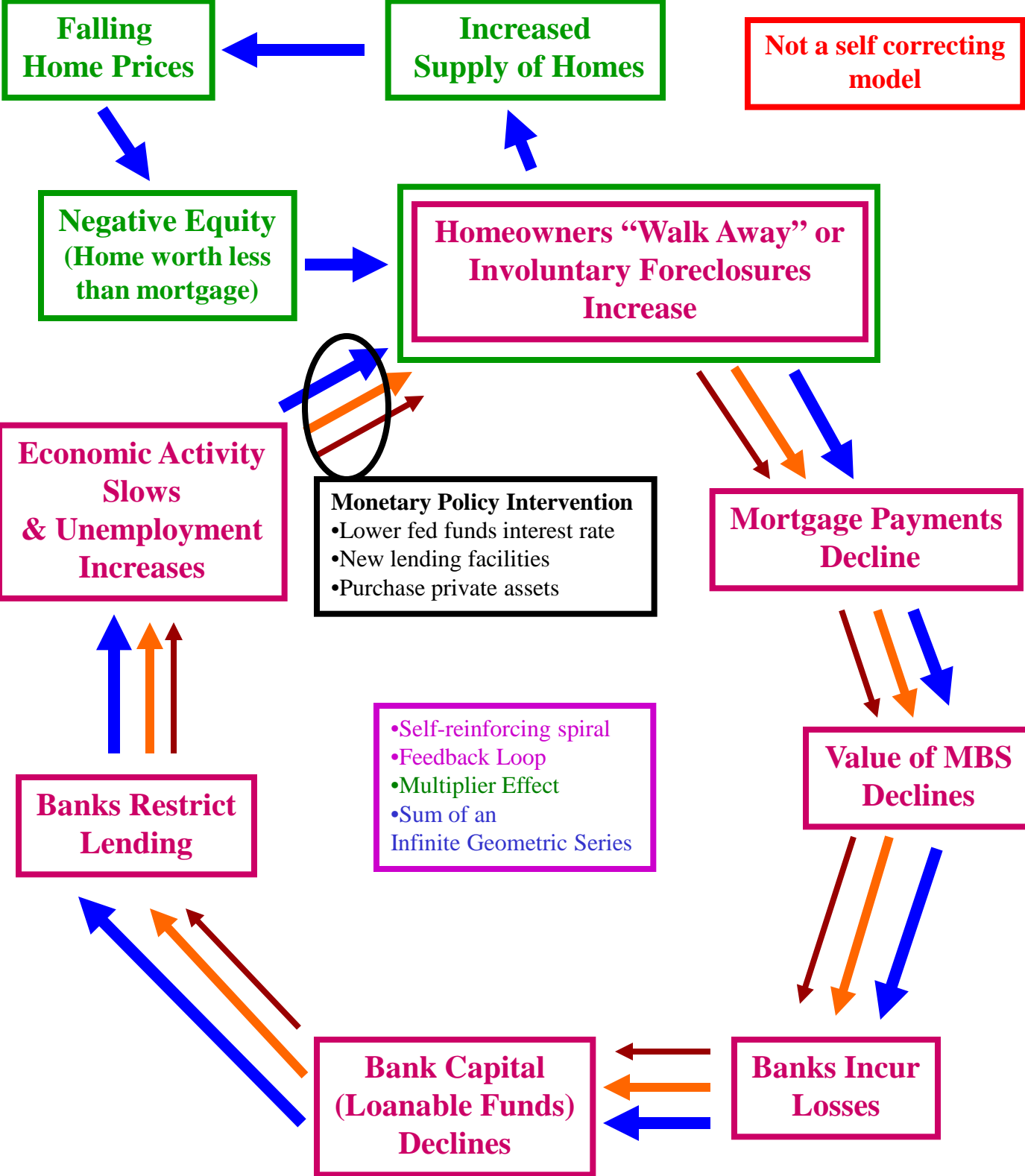
Existing Home Sales (annual rate) & Inventories



Median Existing Home Price & Months Supply at Current Sales Rate

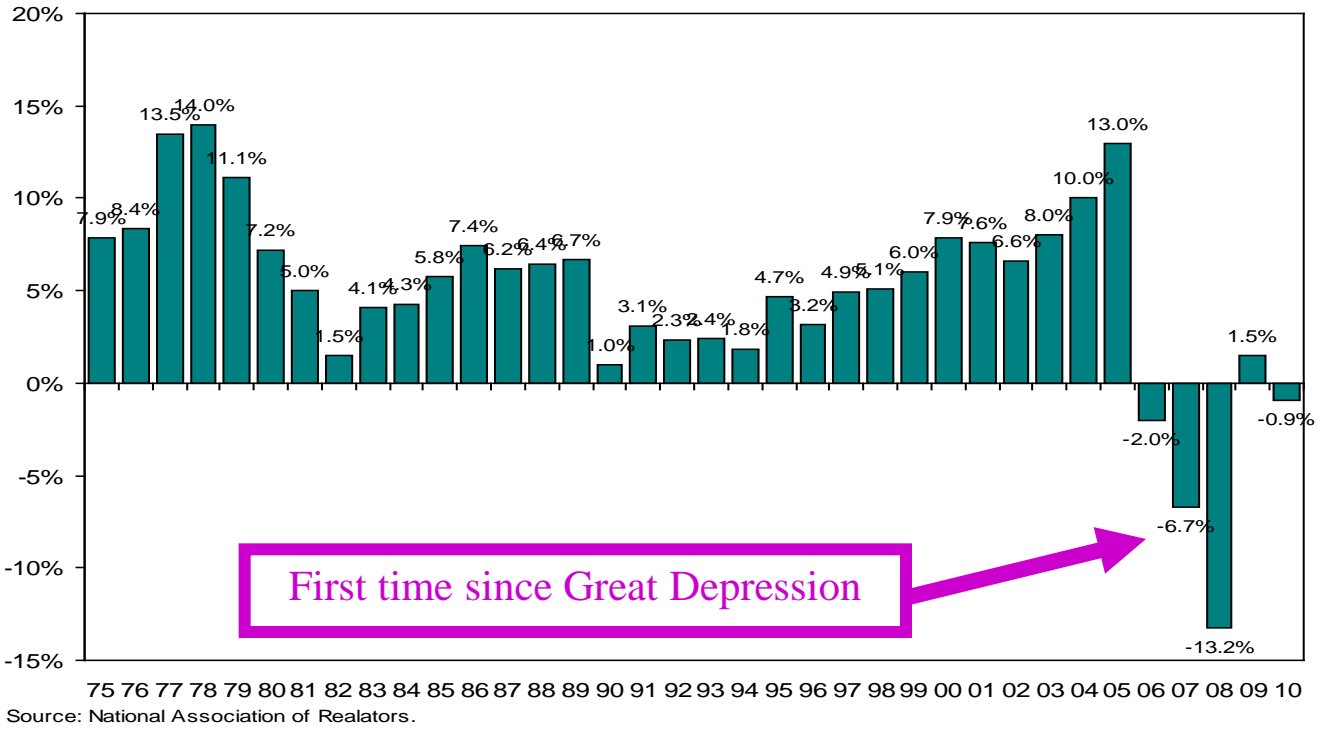


Vicious Cycles of the Mortgage Crisis



The Housing Bubble Has Popped

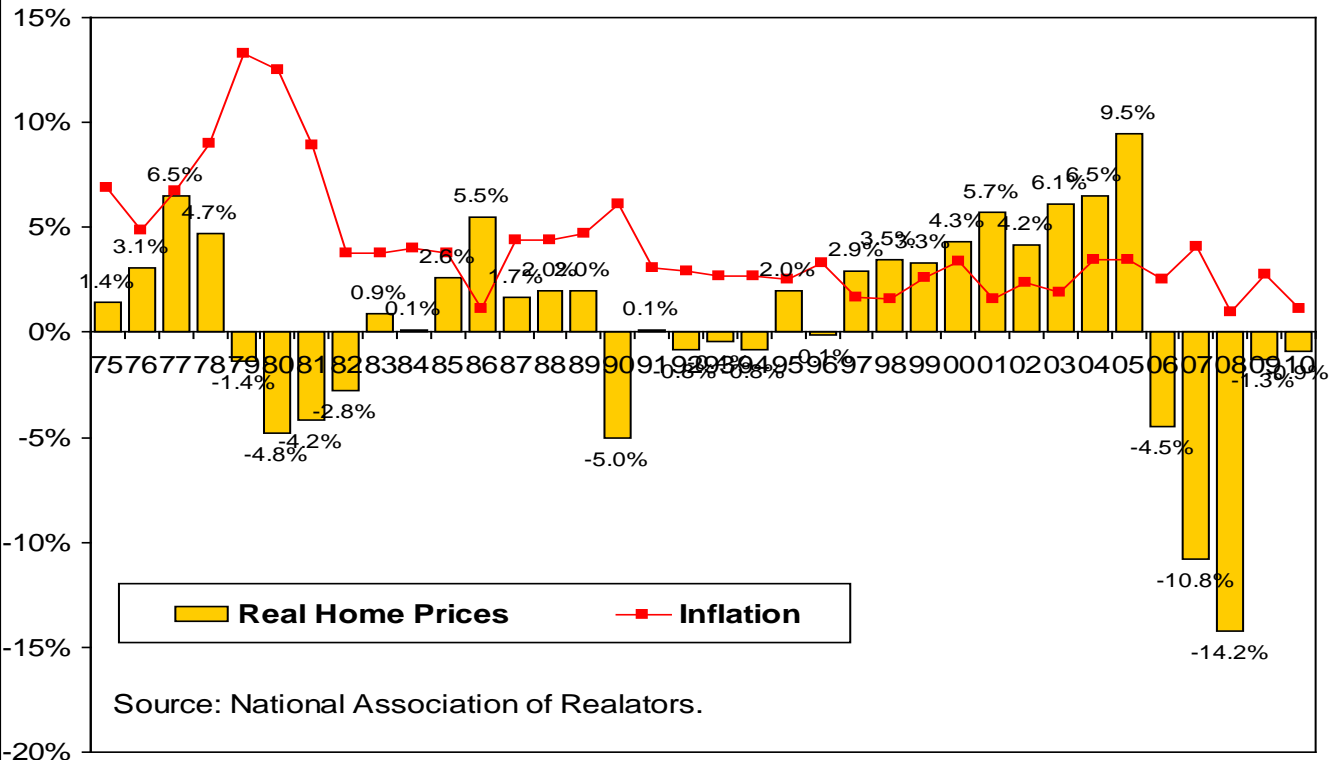
(Nominal Annual Home Price Increases)



First time since Great Depression

The Housing Cycle

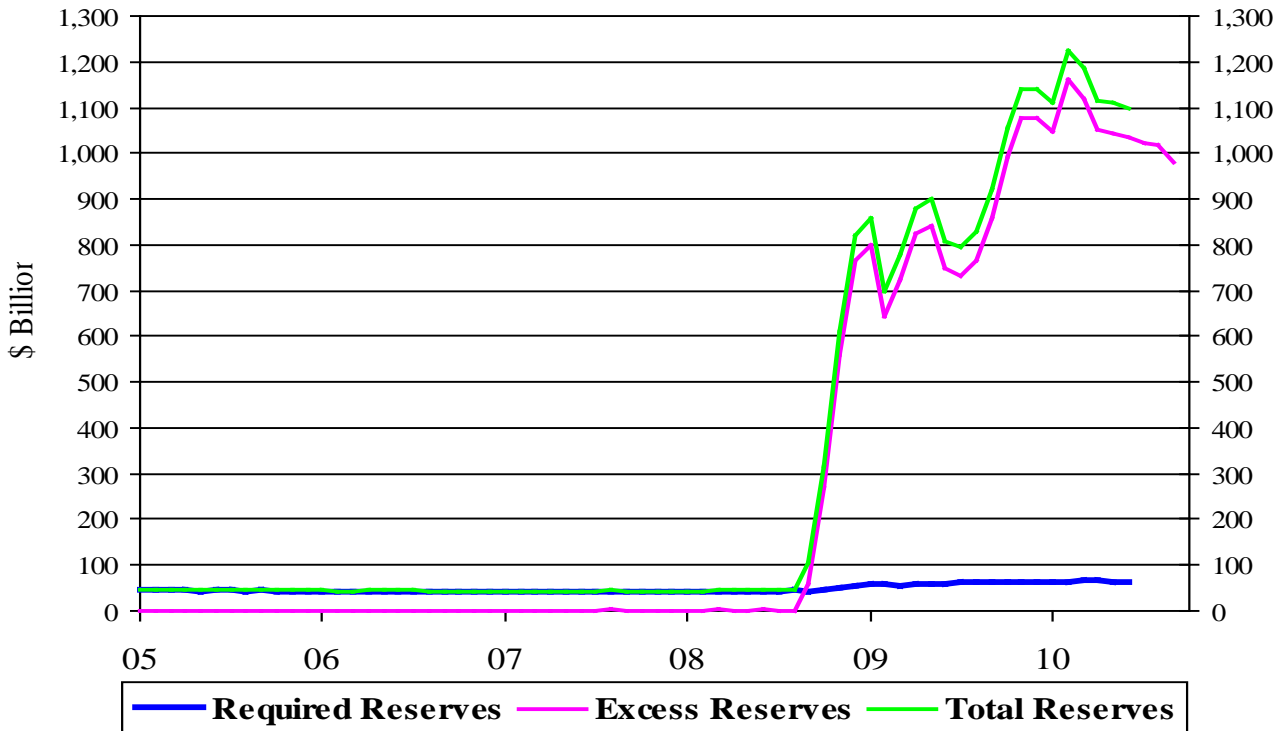
(Inflation-Adjusted Annual Home Price Increases)



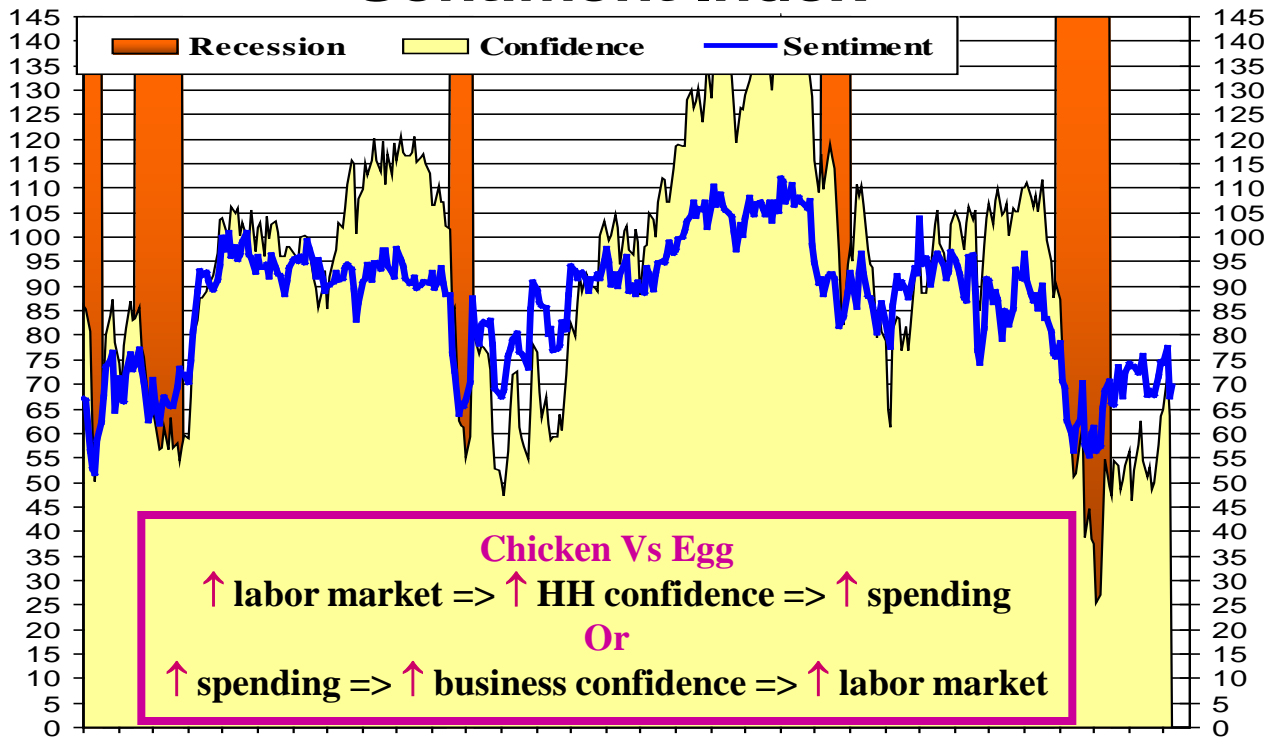
Real Home Prices

Inflation

Total Reserves = Required Reserves + Excess Reserves (NSA)

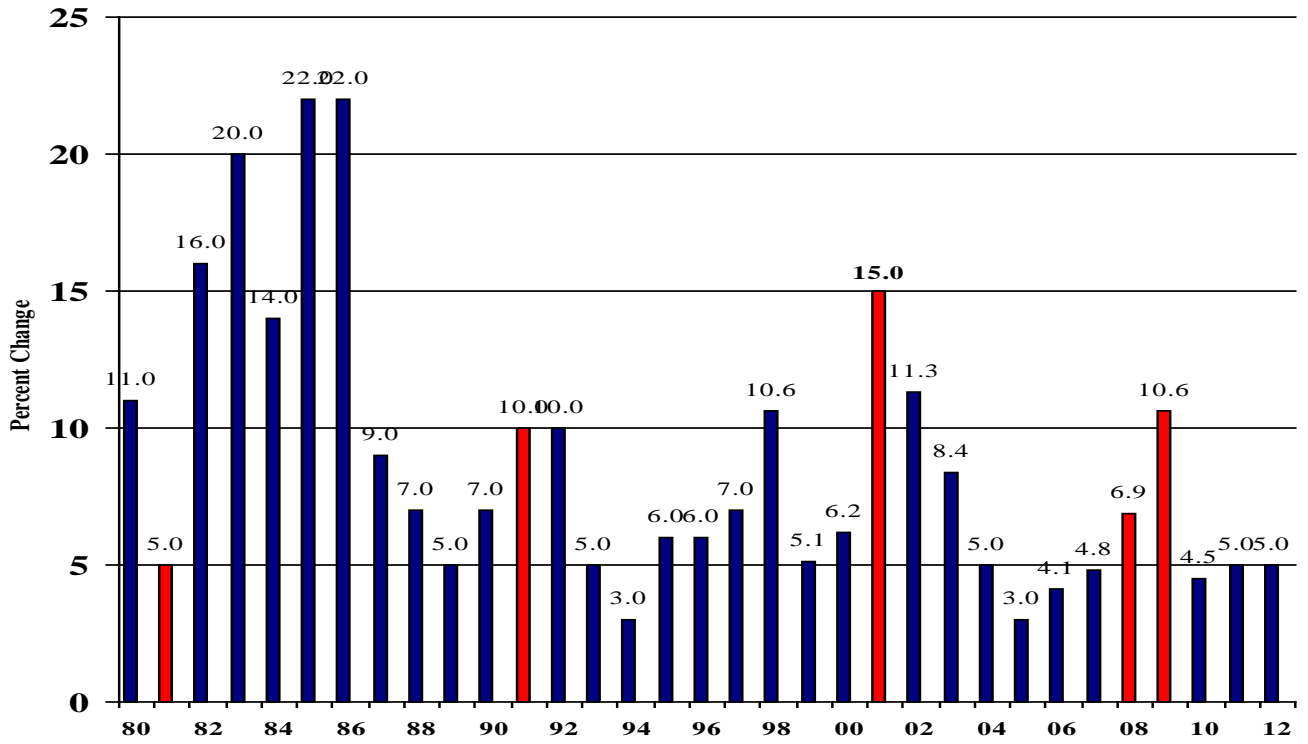


Consumer Confidence & Sentiment Index

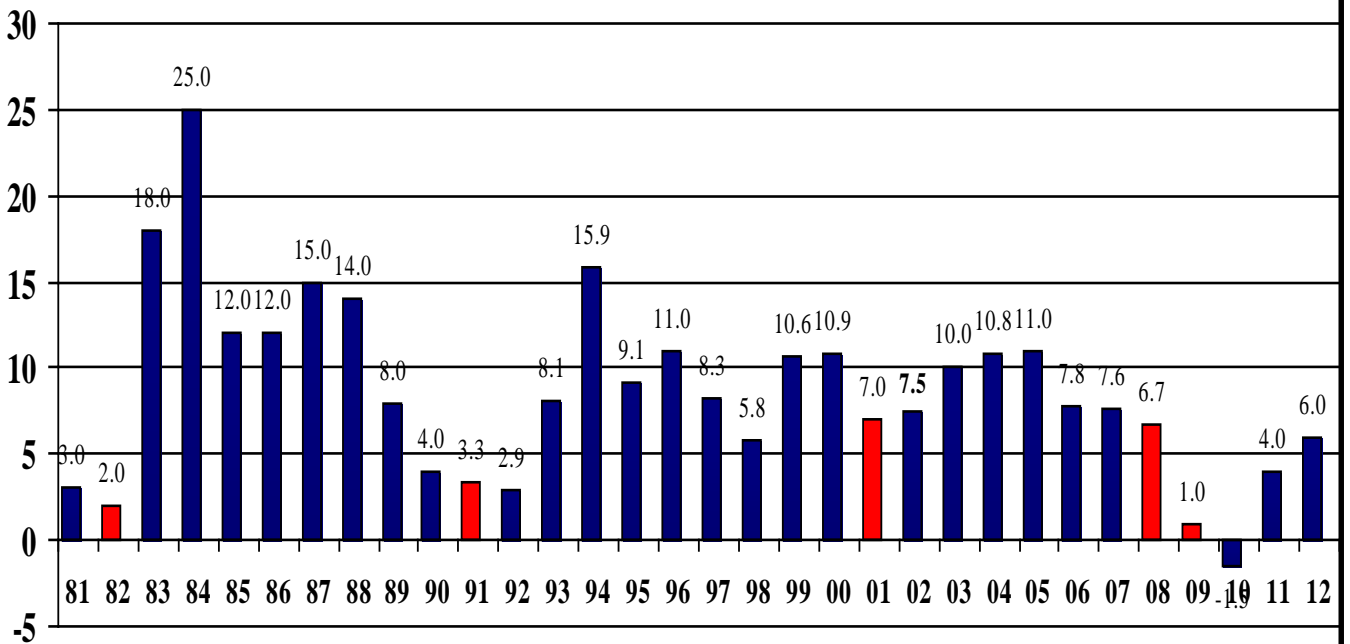


Source: Conference Board.

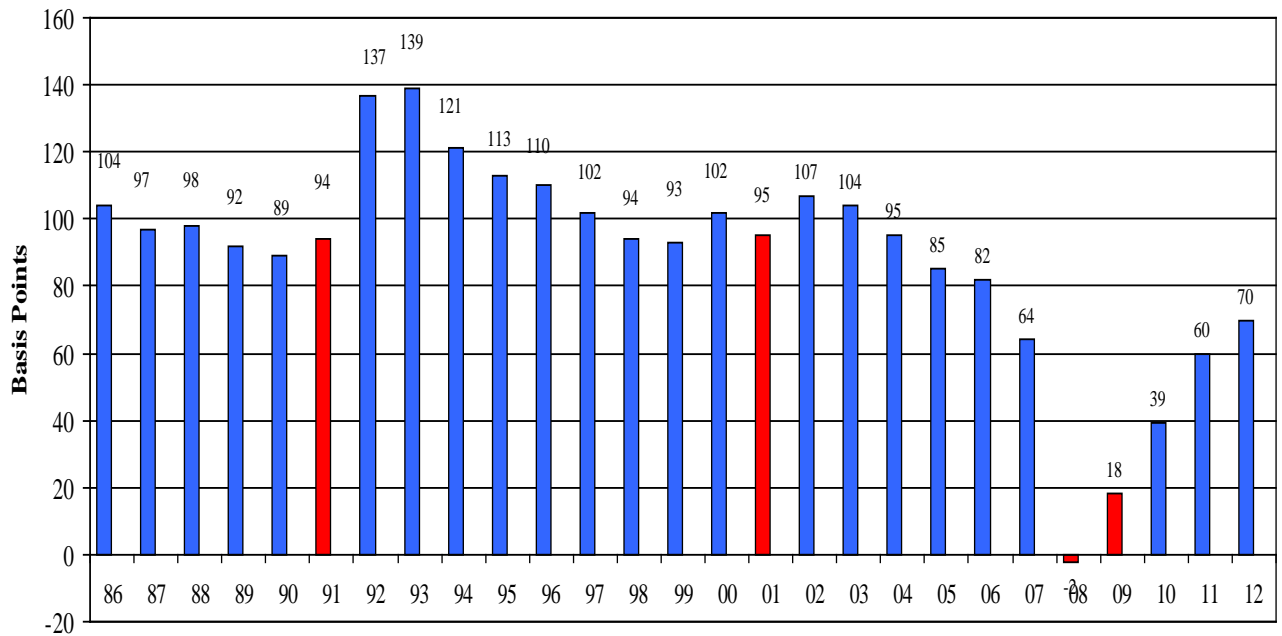
Credit Union Savings Growth (Annual Percent Growth)



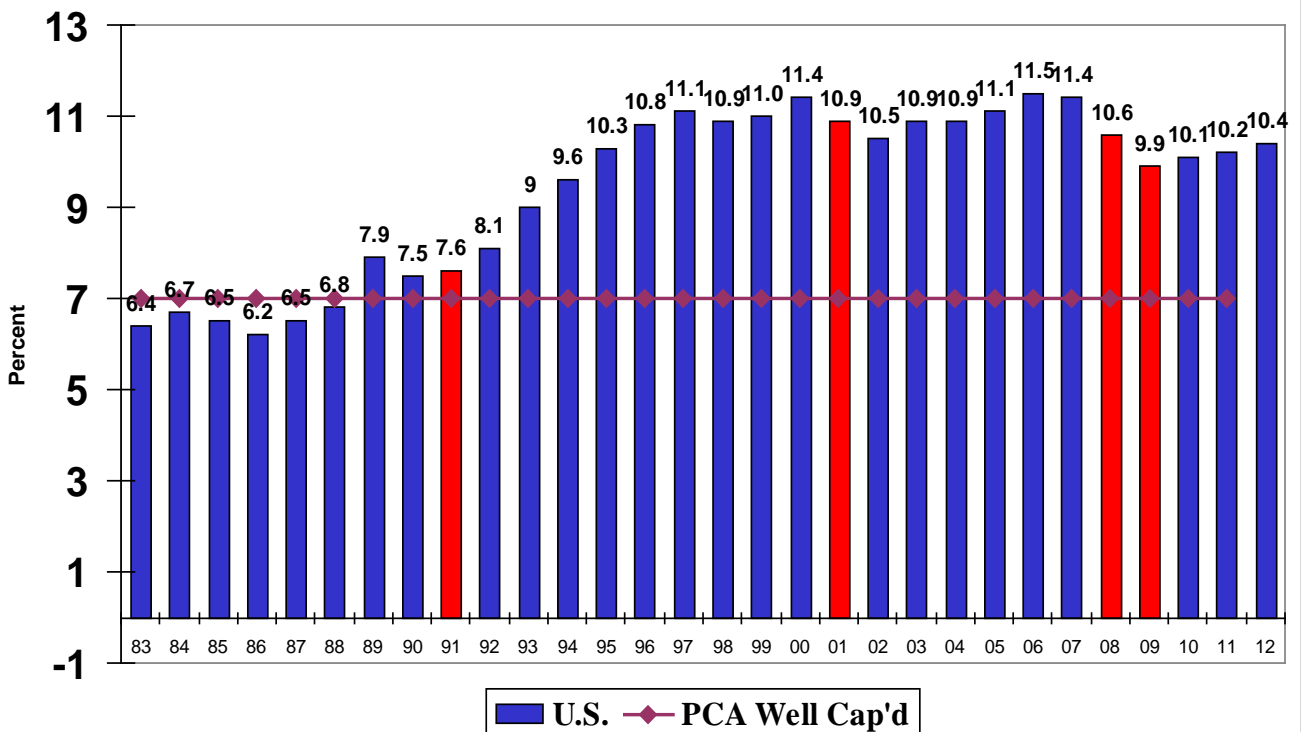
Credit Union Loan Growth (Annual Percent Change)



Net Income to Average Assets



Net Capital to Assets



CUNA's Economic and Credit Union 2011-2012 Forecast As of March 2011

ECONOMIC FORECAST

- **The U.S. economy will grow above trend 2011 and slow to 3.25% in 2012.** Expansionary monetary and fiscal policy along with the natural dynamics of the business cycle will support economic growth in the 2011. Economic growth will slow in 2012 as government stimulus programs are withdrawn.
- **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 as the U.S. recovery accelerates. 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 not begin an upward path until the end of 2011.** 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. We expect a 25 basis point interest rate move at the end of 2011 followed by a 2 percentage point increase in 2012.
- **The 10-year Treasury interest rate will average over 3.80% in 2011 and 4.5% in 2012.** A faster growing economy and rising inflation will entice investors into riskier assets and away from Treasury bonds, pushing up long-term interest rates.
- **The Treasury yield curve should flatten in 2012.** If short-term interest rates rise faster than long-term interest rates in 2012 we will see a flattening of the Treasury yield curve. This could put downward pressure on credit union net interest margins as borrowing short term and lending long term becomes more 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.
- **Credit union loan balances are expected to rise to 4% in 2011 and 6% in 2012.** After falling over one percent in 2010, we expect a rebound in credit union loan balance growth in the next two years as the economy and consumer confidence 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 0.60% in 2011 and 0.70% in 2012.** Lower loan loss provisions, rising net interest margins and cost containment efforts will boost earnings. We expect NCUA assessments to come in at 20 and 15 basis points of average assets in 2011 and 2012, respectively. We don't expect a significant drop in interchange income in 2011, but possibly a 10 basis point hit in 2012.
- **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

March, 2011

	Actual Results		Quarterly Results/Forecasts				Annual Forecasts	
	5Yr Avg	2010	2011:1	2011:2	2011:3	2011:4	2011	2012
Growth rates:								
*Economic Growth (% chg GDP)	0.96%	2.80%	3.70%	3.70%	3.30%	3.30%	3.50%	3.25%
Inflation (% chg CPI)	2.10%	1.40%					2.50%	2.00%
Core Inflation (ex. food & energy)	2.00%	0.60%	2.00%	1.70%	1.30%	1.00%	1.50%	1.50%
Unemployment Rate	6.80%	9.70%	8.80%	8.70%	8.60%	8.50%	8.65%	8.00%
Fed Funds Rate	2.50%	0.18%	0.18%	0.18%	0.18%	0.39%	0.23%	1.50%
10-Year Treasury Rate	3.91%	3.21%	3.50%	3.70%	3.90%	4.10%	3.80%	4.50%
* Percent change, annual rate								
All other numbers are averages for the period								

Credit Union Forecast

March, 2011

	Actual Results		Quarterly Results/Forecasts				Annual Forecasts	
	5Yr Avg	2010	2011:1	2011:2	2011:3	2011:4	2011	2012
Growth rates:								
Savings growth	6.3%	4.5%	2.7%	0.7%	0.5%	0.6%	5%	5%
Loan growth	4.3%	-1.5%	-0.5%	2.1%	1.7%	0.9%	4%	6%
Asset growth	5.9%	3.3%	2.7%	0.7%	0.5%	0.6%	5%	5%
Membership growth	1.3%	0.7%	0.4%	0.2%	0.2%	0.2%	1.0%	1.0%
Liquidity:								
Loan-to-share ratio**	79.5%	72.2%	70.0%	70.9%	71.7%	71.9%	71.9%	72.6%
Asset quality:								
Delinquency rate	1.31%	1.75%	1.70%	1.60%	1.40%	1.30%	1.50%	1.20%
Net chargeoff rate*	0.83%	1.14%	1.00%	0.90%	0.90%	0.80%	0.90%	0.80%
Earnings								
Return on average assets (ROA)*	0.40%	0.39%	0.50%	0.55%	0.65%	0.70%	0.60%	0.70%
Capital adequacy:								
Net worth ratio**	10.7%	10.1%	9.9%	10.0%	10.1%	10.2%	10.2%	10.4%

* 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