Economic & Credit Union Update

October 2017

If you have any questions or comments, please contact:
Steven Rick, Chief Economist
CUNA Mutual Group – Economics
800.356.2644, Ext. 665.5454
steve.rick@cunamutual.com

5 Minute Federal Reserve Board Meeting

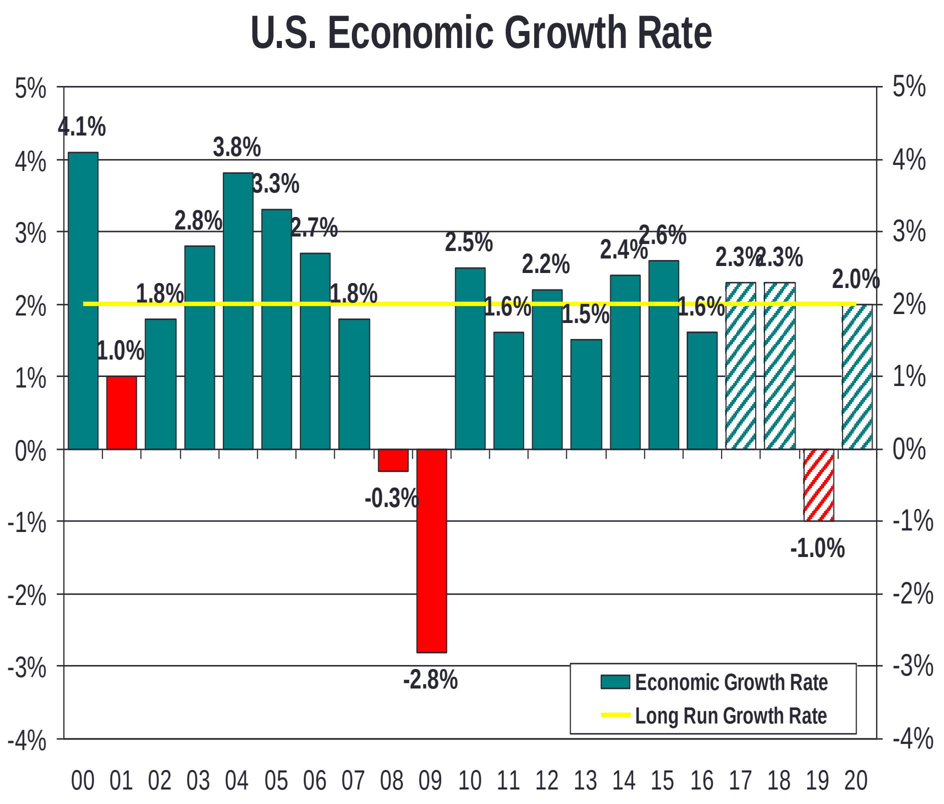
Federal Reserve's Dual Mandate

1. Stables Prices
2. Full Employment of Resources

Federal Reserve Critical Measures

	Long-Run Equilibrium Goal	Actual
Inflation Rate	2%	1.4%
Unemployment Rate	5%	4.4%
Economic Output Gap	0%	-0.5%
Fed Funds Interest Rate	3%	1.15%
10-Year Treasury Rate	4%	2.3%

Stronger Economic Growth in 2017, around 2.3%



Source: Department of Commerce.

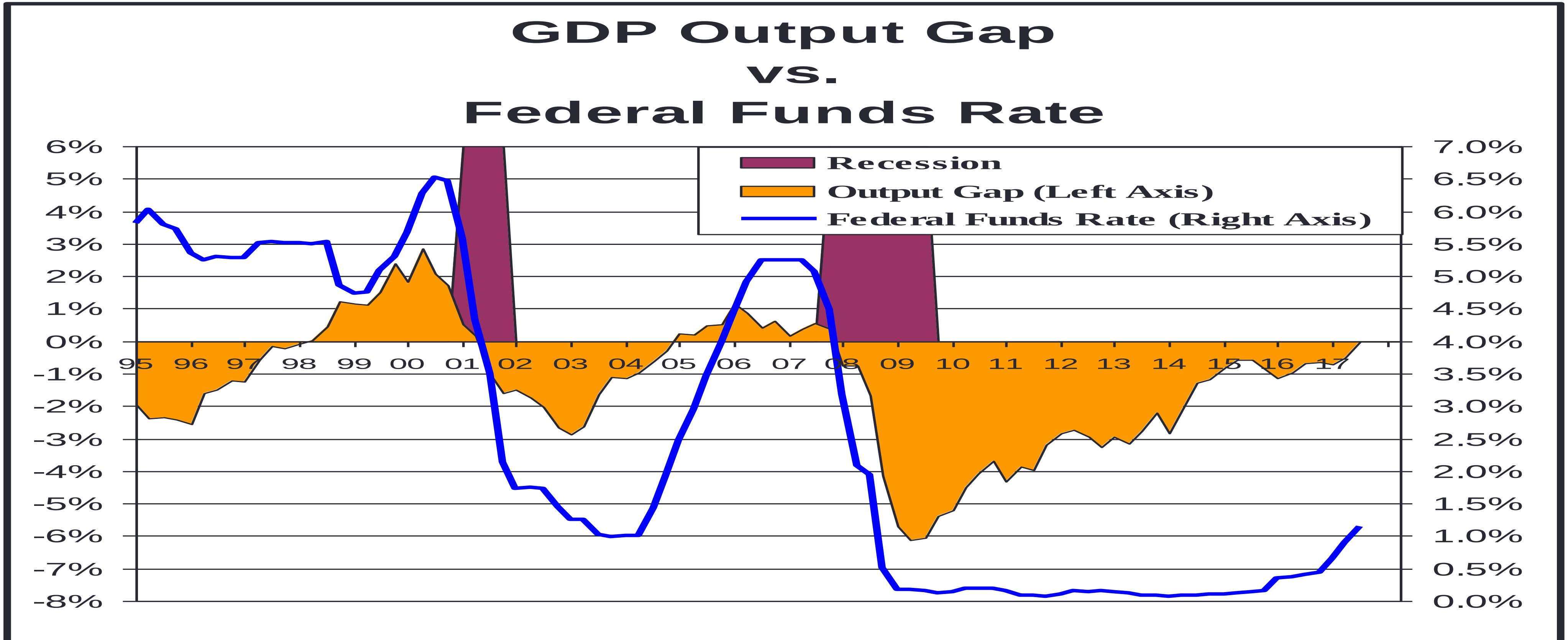
Trump's policies if implemented could boost short-run economic growth above the base case forecast (see chart).

1. Infrastructure Spending ($1 trillion in spending over 10 years)
   - Roads, bridges, water/sewer systems, border wall
   - Fiscal policy will take on a bigger role versus monetary policy
   - $100 billion in spending => faster economic growth (0.5% to 1%)
2. Tax Reform ($4.6 trillion in lower taxes over 10 years)
   - Lower headline corporate income tax rate (35% to 15%).
   - Lower personal tax rates and fewer brackets (7 tax brackets down to 3) (12% up to $37,500, 25% on $37,500-$112,500, 35% above $112,500).
   - One-off offer to repatriate foreign profits at 10% rate.
   - Move from global to territorial tax system.
   - Repeal estate tax and alternative minimum tax.
   - Full expensing of capital costs => increasing business investment.
3. Repeal and Replace Affordable Care Act
4. Modify Dodd-Frank Act to decrease credit supply constraints
5. Loosen environmental regulations, scale back climate change regulations and remove restrictions on energy production.
6. Anti-globalization and Trade Protectionism Policies => Trade War
   - Withdrawal/renegotiate trade deals (NAFTA, TPP)
   - Tariffs on Mexican (35%) and Chinese (45%) goods
   - Label China currency manipulator

But policy uncertainty can have profound effects on spending:

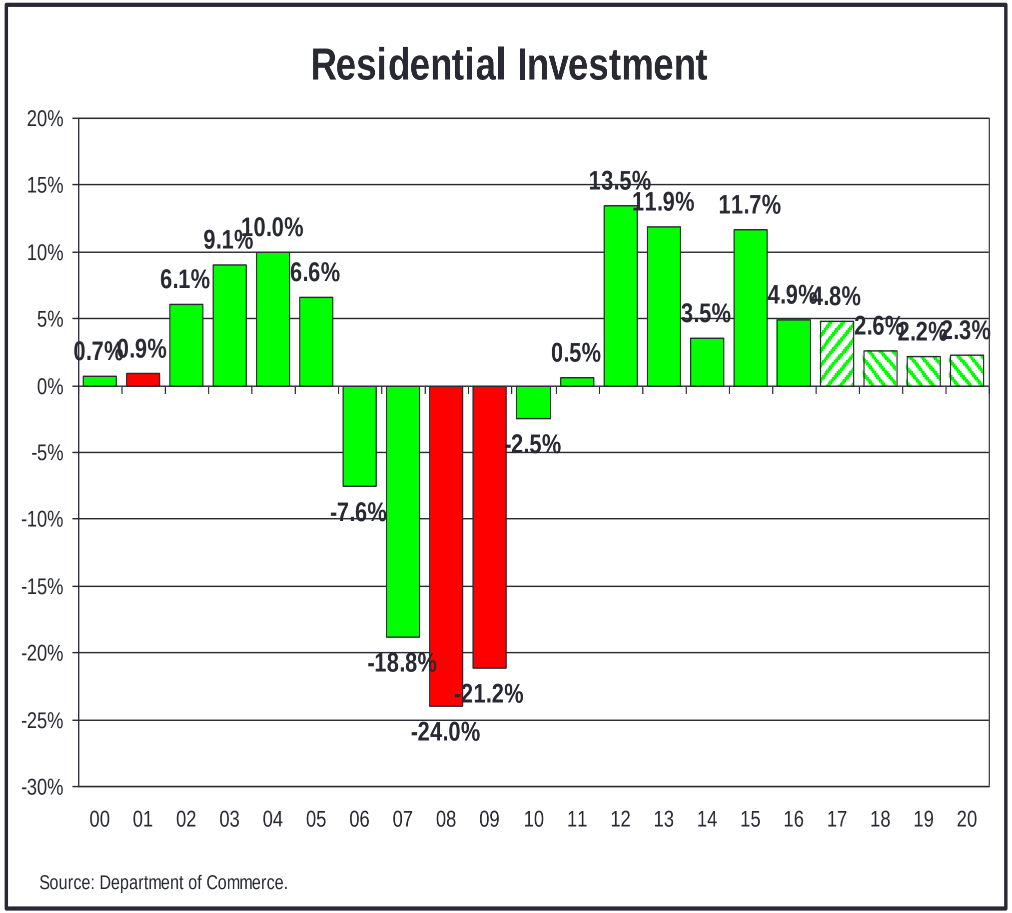
- Business delay hiring and capital investment (but mostly hiring)
- Consumers delay durable goods purchases

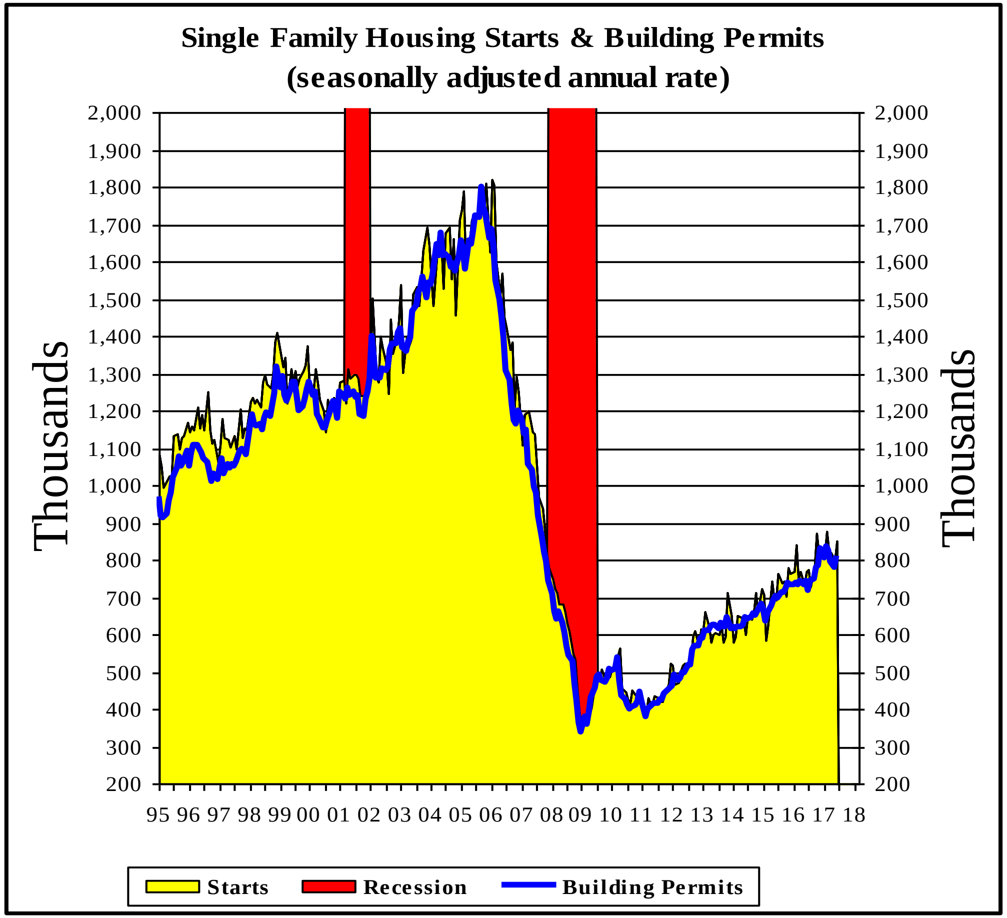
Falling GDP Output Gap in 2017
With the Economy Reaching its Potential Level of Output



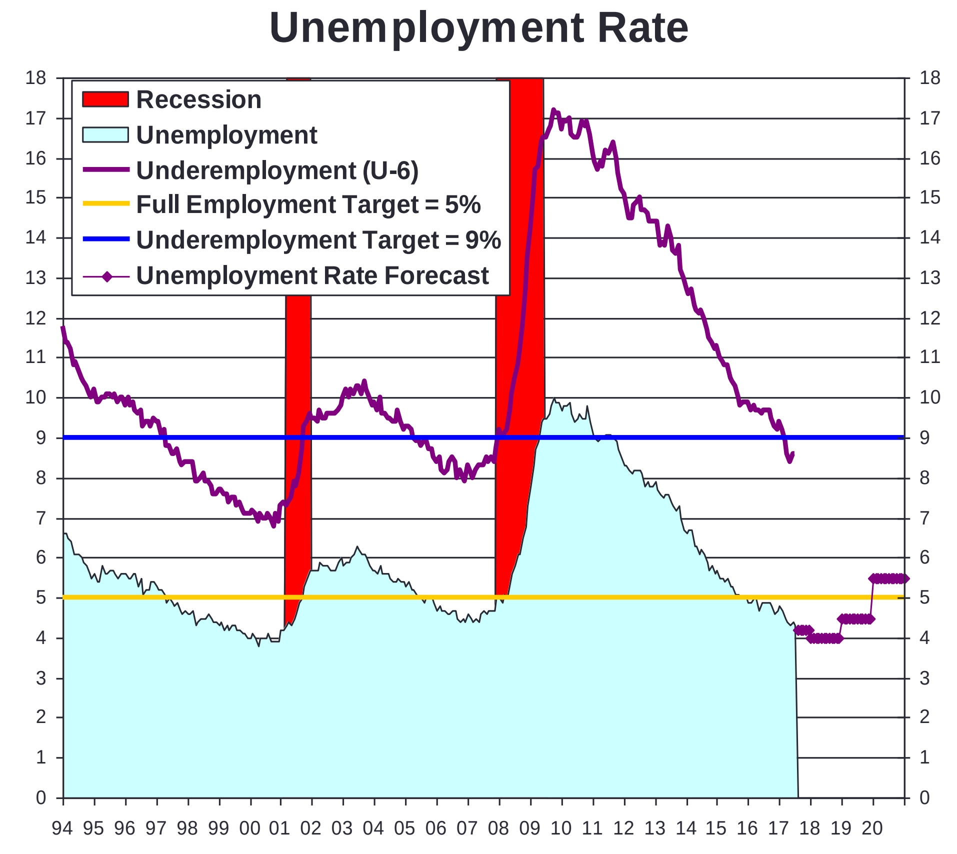
Source: CBO & Federal Reserve.

Housing Construction will Accelerate in 2017
Housing Starts Limited by Few Unemployed Construction Workers





Unemployment Rate Hitting 4.0% in 2018, below Full Employment



Source: Department of Labor.

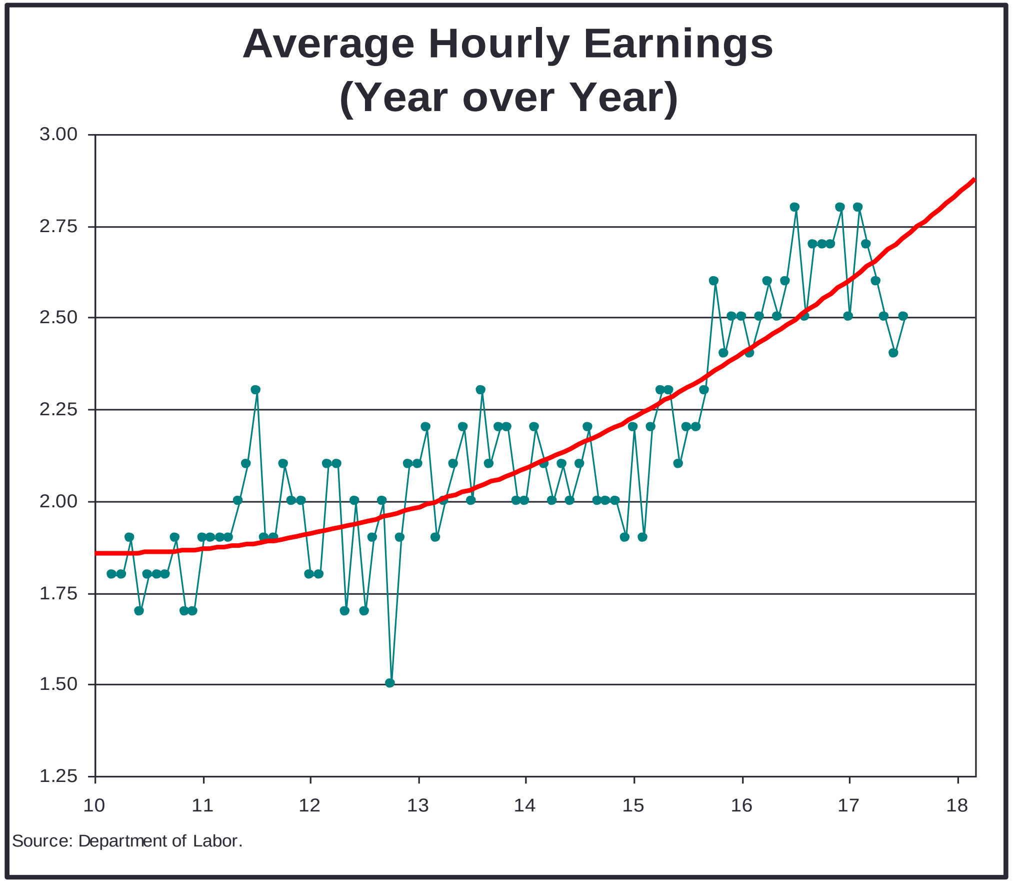
Trump's Policies on Labor Market

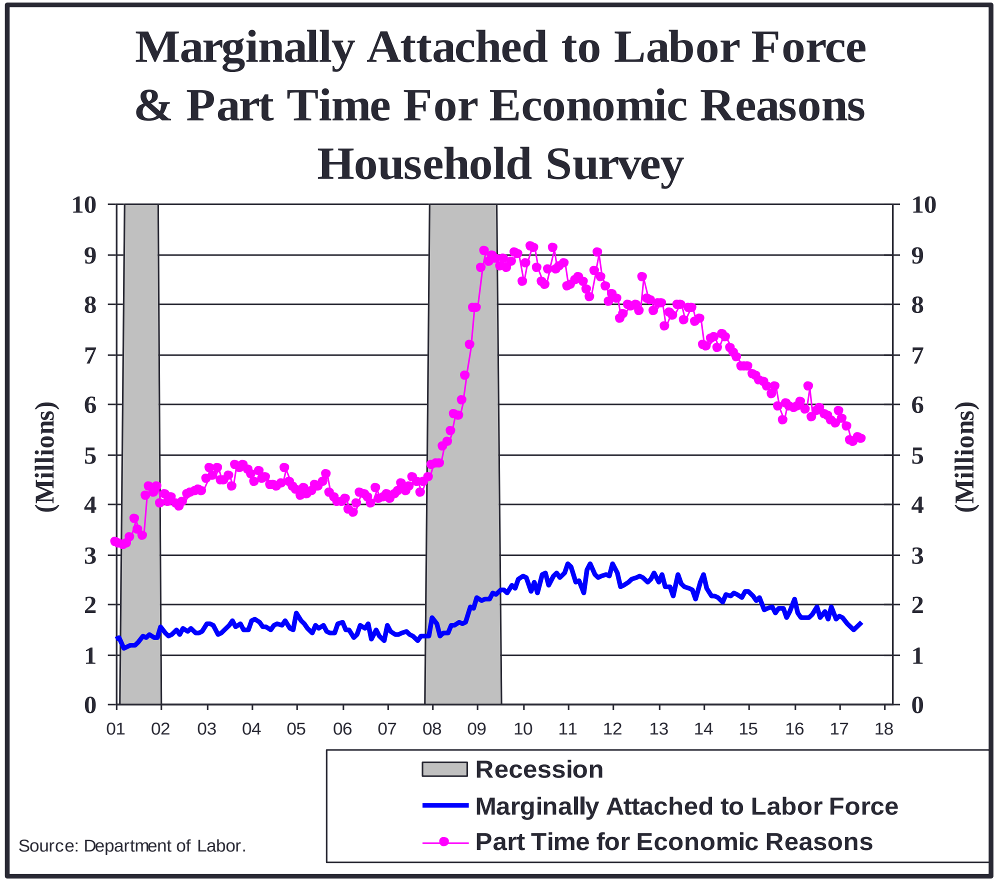
1. Trump's policies would lower the unemployment rate below the base case unemployment rate forecast (see chart).
2. Infrastructure Spending ($1 trillion in spending over 10 years)
   - $100 billion in spending => lower unemployment rate 0.3 percentage points compared to base case.
3. Hiring workers for infrastructure projects will put even more upward pressure on wage inflation.
4. Trump prefers minimum wage determined at state and local level

General Labor Market Trends

1. The unemployment rate is expected to fall to 4% in 2018, which is below full employment by this metric.
2. Wage inflation will accelerate from 2.8% annual rate today, to 3.5% in 2018 when the labor market is at full employment
3. The tightening labor market is now benefiting workers which will support consumer spending.
4. Payroll employment will growth 1.2% in 2017 and 1.0% for 2018-2020.
5. 2 million jobs will be added in 2017 (170,000 per month), down from the 200,000 pace set in 2014-2015
6. The employment-to-population ratio for prime age workers is now 77.9%, and is expected to reach the full employment 79.5% figure in late 2017, pushing wage growth above 3%.

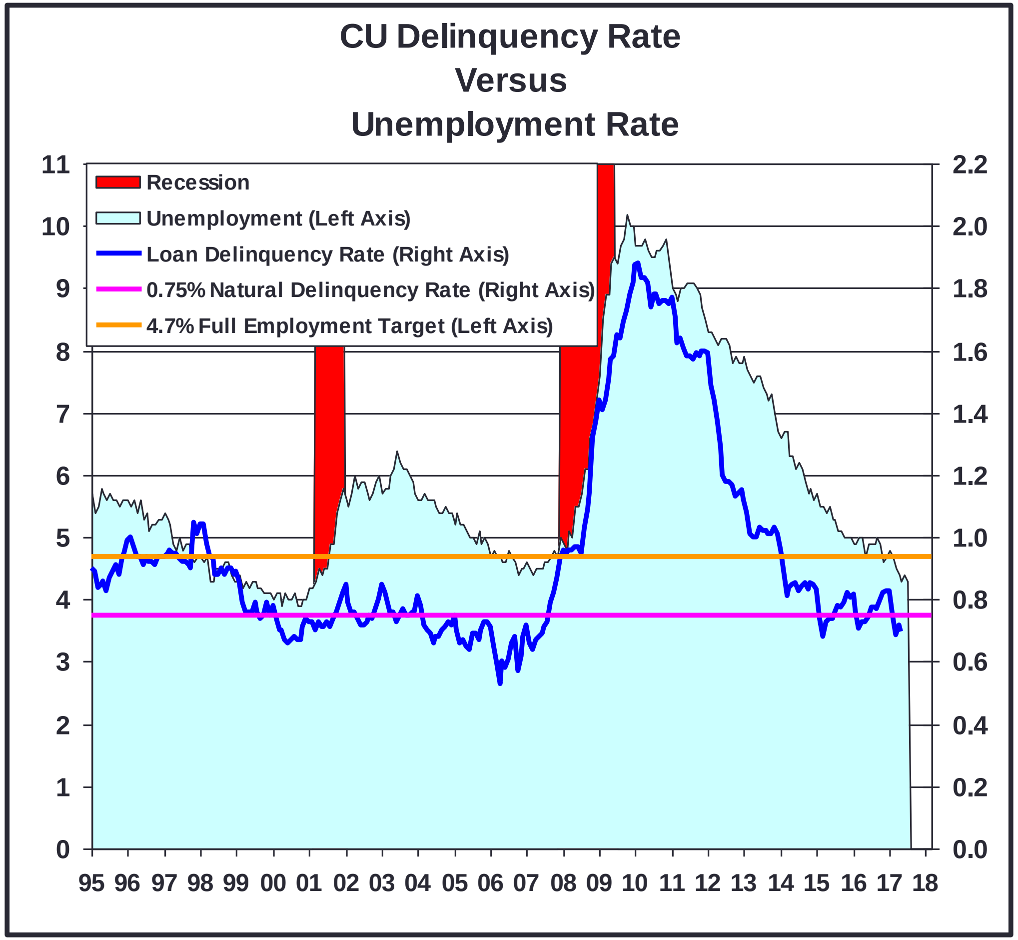
Average Hourly Earnings will Rise 3% in 2017 as Labor Market Slack Dissipates

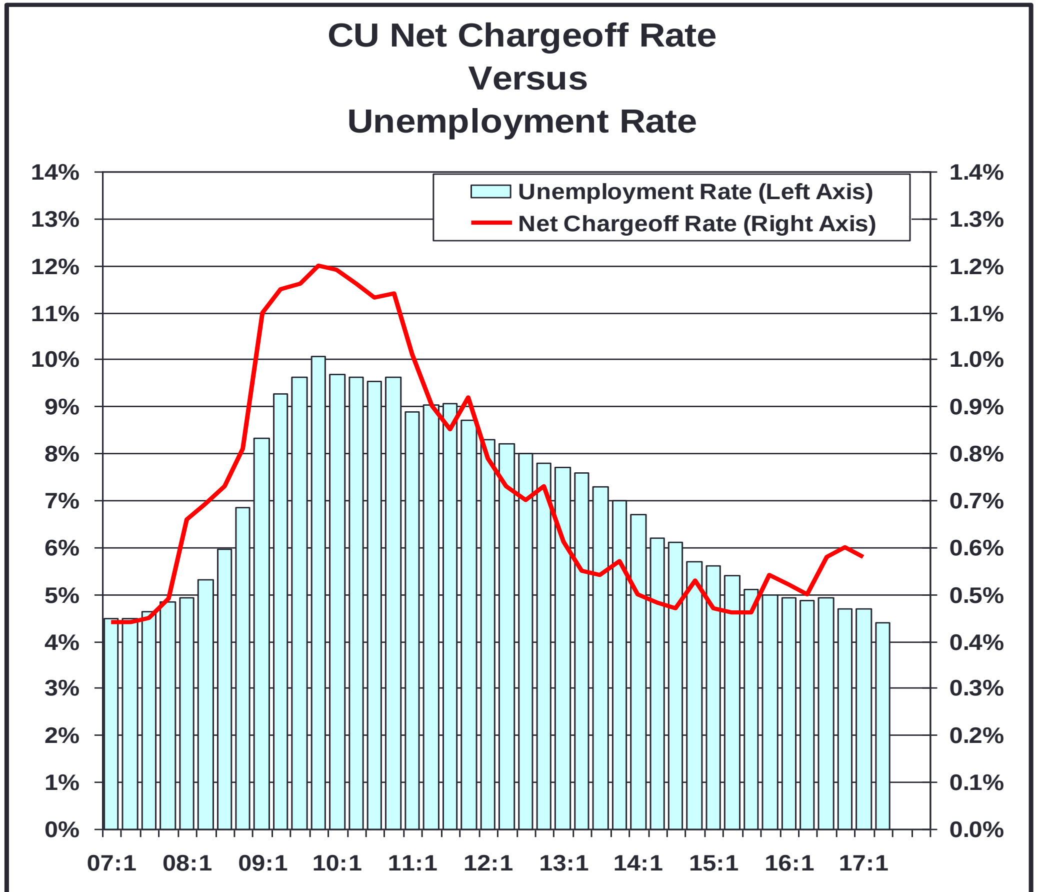




CUNA MUTUAL GROUP

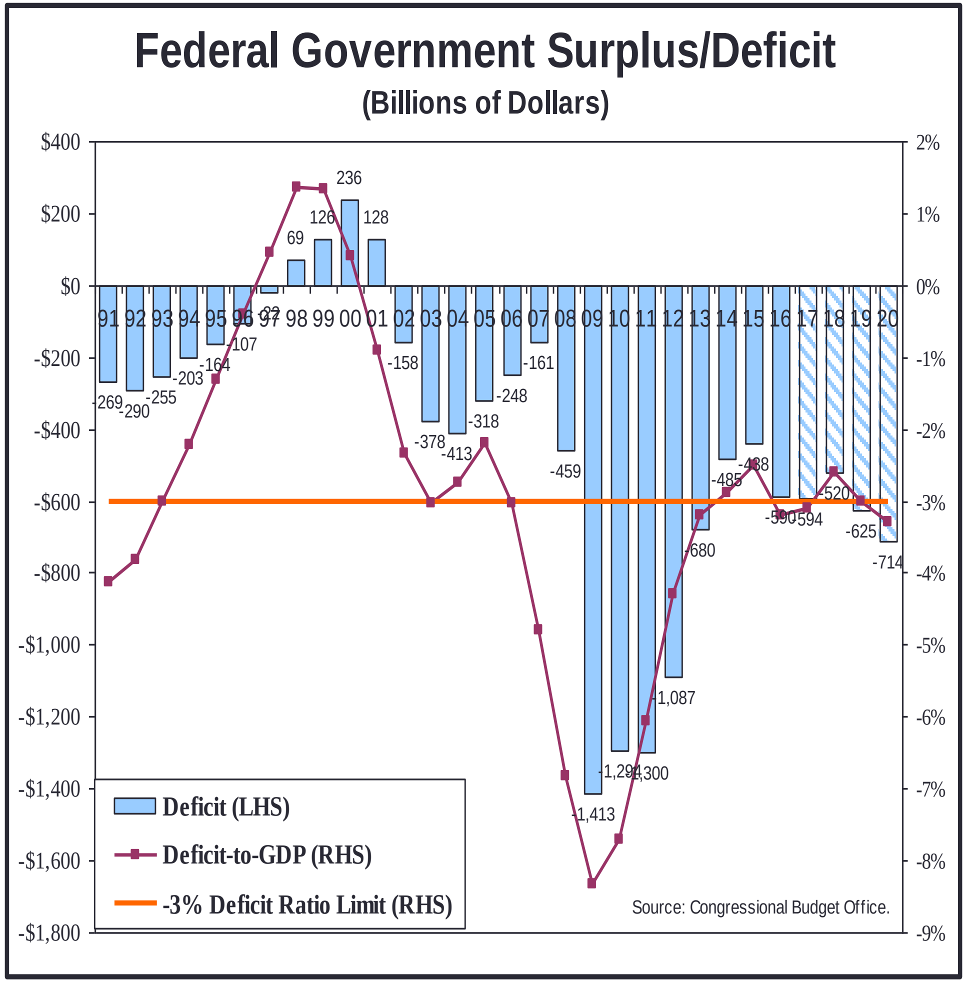
Improving Credit Quality As Unemployment Falls





Source: Department of Labor, NCUA,CUNA

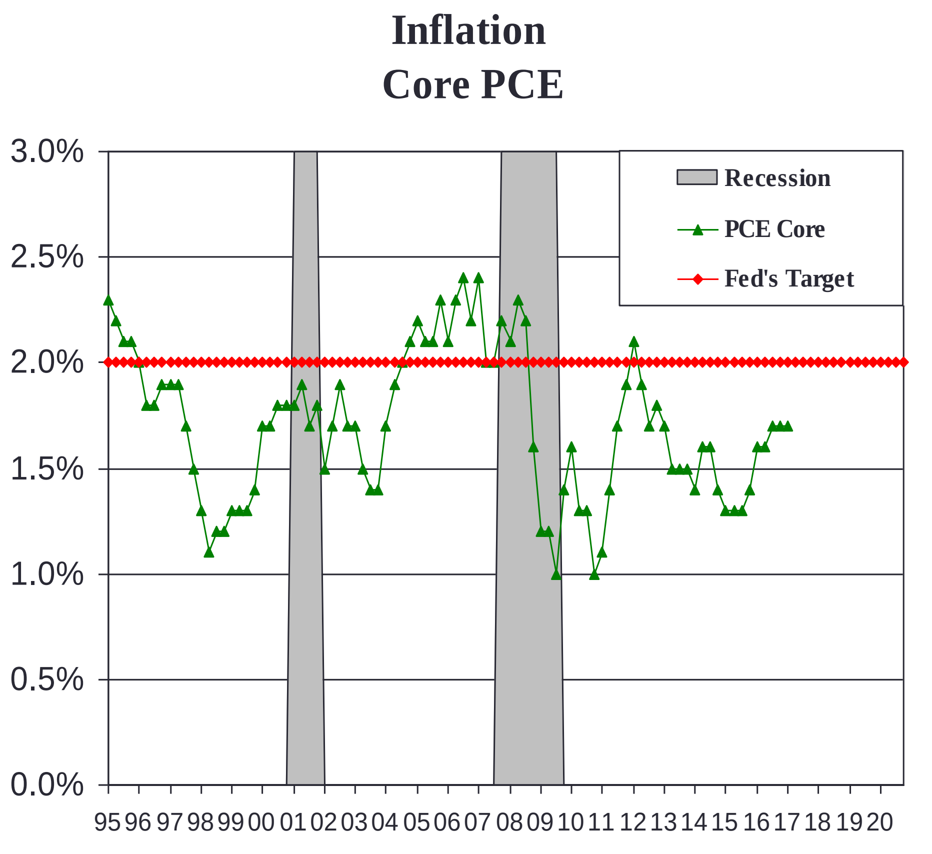
Rising Deficits Over Next 4 Years



Trump's Fiscal Policies on Deficits

1. Trump's deficit financing of government spending and tax cuts could double the deficit over the next 4 years compared to the base case deficit forecast (see chart).
2. Increased infrastructure and military spending along with tax cuts will result in large increases to the CBO forecasted budget deficit (see chart). The deficits will, however, lead to faster economic growth and inflation in the short run.
3. Trump's fiscal plan would increase the deficit $5.6 trillion over 10 years, or $560 billion per year, which is a fiscal expansion of 2.5% of GDP per year. This would take the forecasted deficit-to-GDP ratio from the current 3% to 5.5%.
4. Unified government increase chances of implementing Trump's policy after years of political gridlock. Fiscal policy legislative changes only need majority vote in house and senate.
5. Repatriation of overseas corporate profits => $180 - $250 billion in tax revenues.
6. Economic theory estimates the fiscal multiplier for a **$1 increase in government spending** can have a **$0.5 to $2.5 cumulative effect on GDP** over the next year, if the economy is operating below potential and the Federal Reserve interest rate responses are limited.
7. Economic theory estimates the fiscal multiplier for a **$1 tax cut for low-to-middle income households** can have a **$0.3 to $1.5 cumulative effect on GDP** over the next year.
8. Economic theory estimates the fiscal multiplier for a **$1 tax cut for higher income household** can have a **$0.1 to $0.6 cumulative effect on GDP** over the next year.
9. Deficit financing will increase interest rates because the Federal Reserve will not be purchasing the debt due to a desire to reduce their balance sheet, and private funders will be reluctant to purchase new bonds due to low current interest rates and their expectations for rising inflation. So nominal interest rates are poised to rise due to rising real interest rates and rising inflation expectations.

Core PCE Inflation Will Approach Fed's 2% Target



Source: BEA and BLS

Trump's Policies on Inflation.

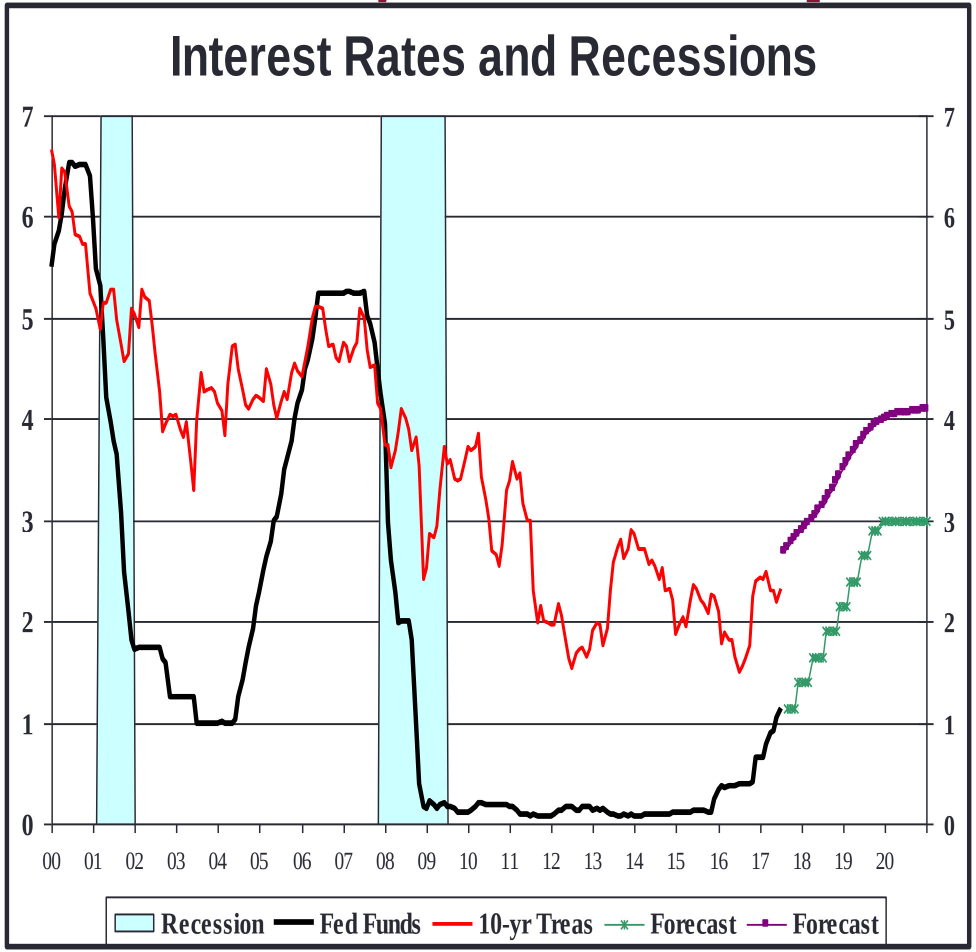
1. Increased government infrastructure and military spending will boost aggregate demand and inflation above the base case forecast (see chart).
2. Trade and immigration restrictions will lead to supply-side constraints and inflationary pressure.
3. Import tariffs on Mexico (35%) and China (45%) will be inflationary.
4. Trump can raise tariffs without congressional approval, but only for a short time period and only with limited scope.
5. Rising inflation will entice the Federal Reserve to raise interest rates sooner and faster than previous estimates.
6. Rising inflation expectations will increase the 10-year Treasury interest rate.

General Inflation Trends

1. Rising commodity prices (oil and metals) will push up inflation in 2017.
2. With the economy approaching full employment and potential output, wage and price inflation will accelerate soon.

Federal Reserve will Raise Fed Funds Interest Rate 0.75 pp in 2018

10-Year Treasury will increase 0.40 percentage point in 2018



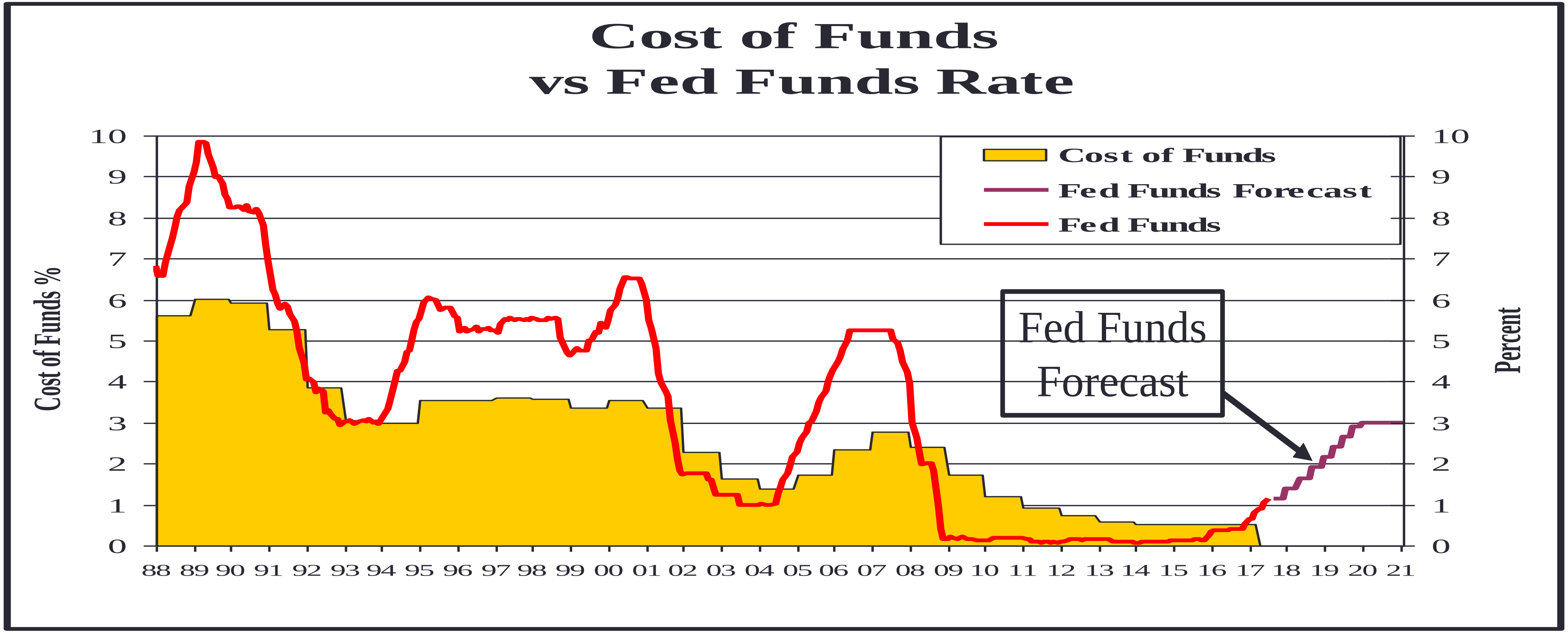
Trump's Policies on Interest Rates

1. Trump has stated he will appoint more hawkish Federal Reserve Governors which will mean short-term rates move higher sooner and faster than expected.
2. Trump will replace Janet Yellen as Fed Chair with a more hawkish individual when her appointment runs out in January 2018.
3. The Fed will raise the fed funds rate 0.75 percentage point in 2017 and 2018.
4. The Fed will raise the fed funds rate 1.00 percentage point in 2019.
5. The fed funds rate will reach the 3% "neutral" fed funds rate at the end of 2019. The long run equilibrium fed funds rate is lower today due to slow productivity and labor force growth.
6. Bigger deficits will increase Treasury interest rates and interest payments.
7. The 10-year Treasury interest rate jumped from 1.76% in October to 2.25% right after the election, which is a tightening in financial conditions.
8. The 10-year Treasury "term premium" jumped 20 basis points in 2 days after the election, from -19 basis points to a positive 1 basis point. The term premium is still significantly below its 20-year average of 1.2%.
9. Interest rate "normalization" has begun.

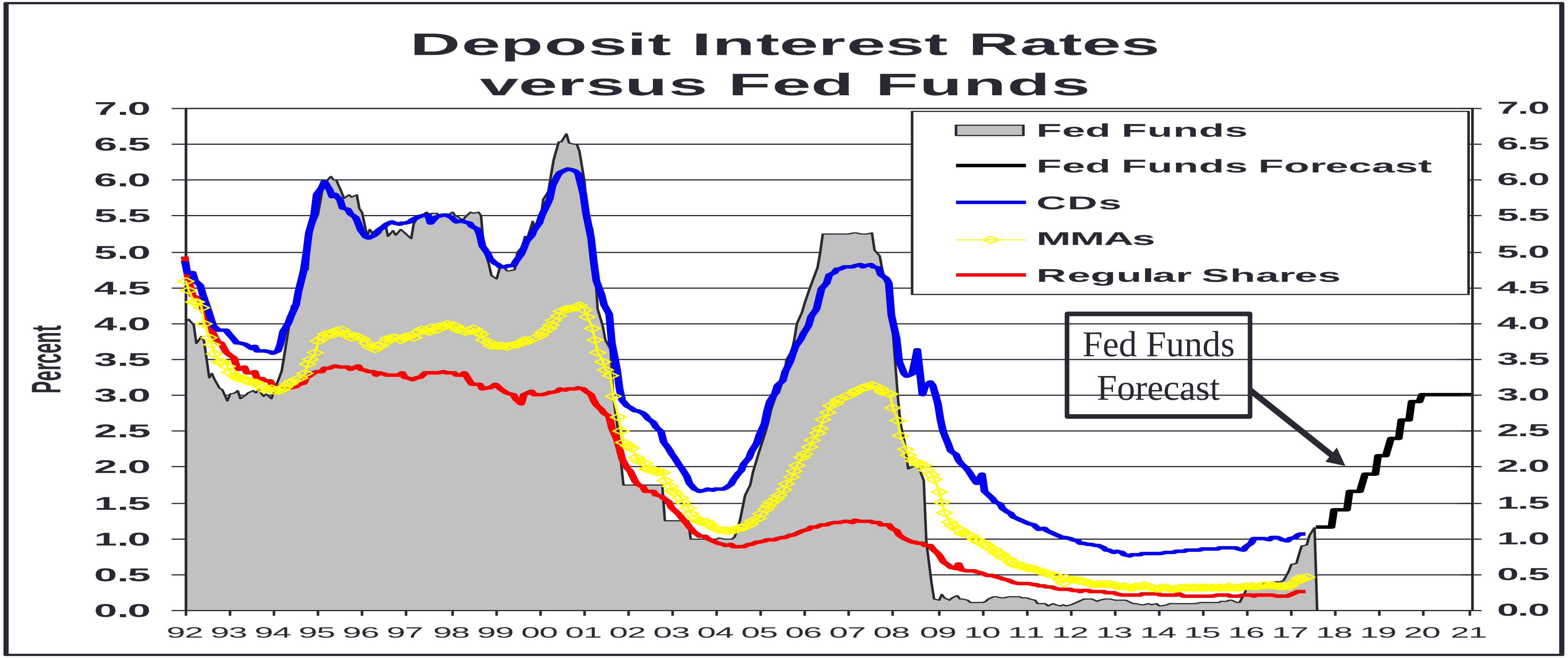
General Interest Rate Trends

1. Strong job growth, accelerating wages, rising inflation and rising commodity prices will cause upward pressure on interest rates.

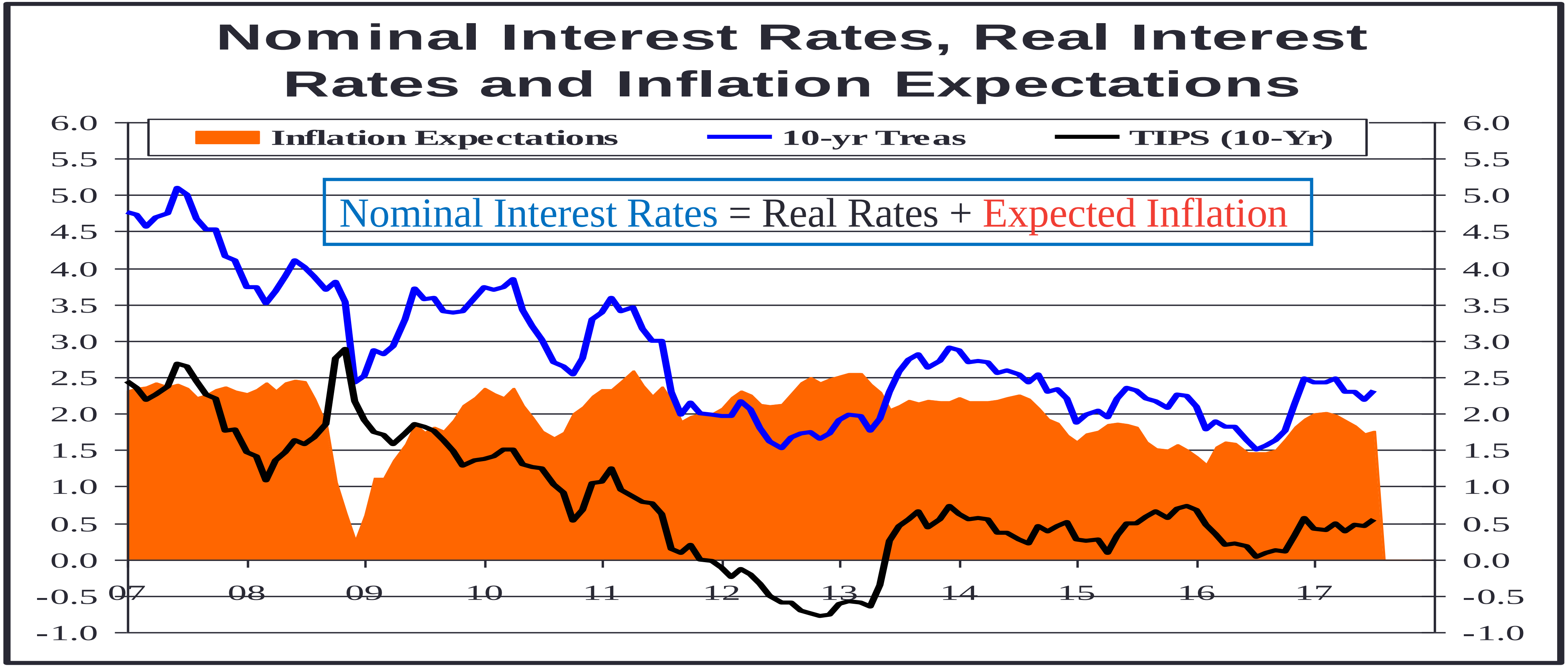
CU Cost of Funds will Rise with Fed Funds Rate



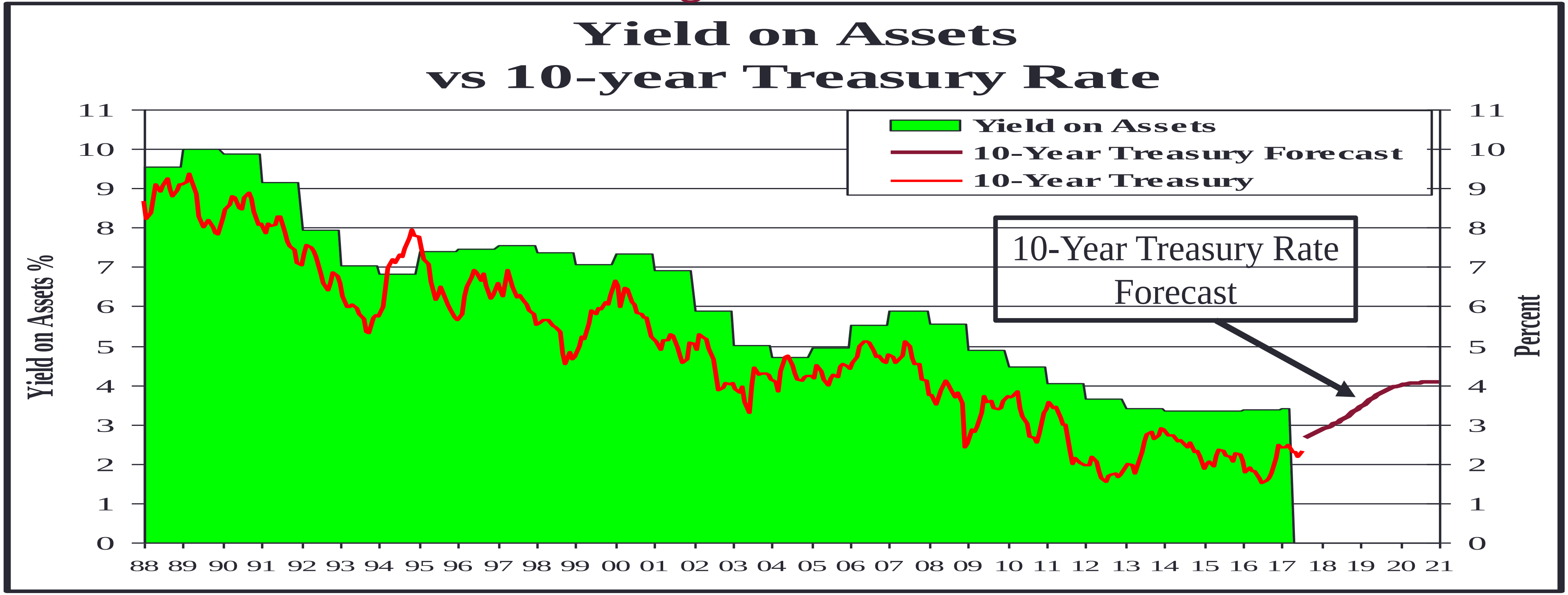
CD and MMA Interest Rates Poised to Rise in 2018



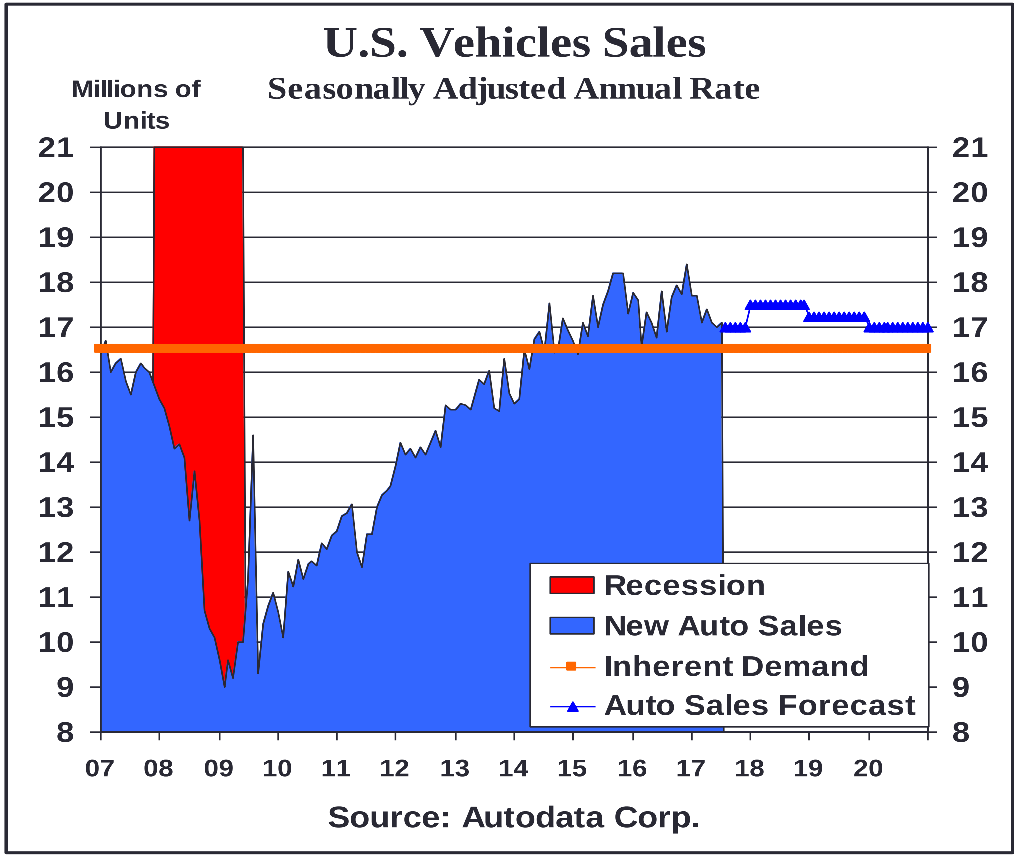
Rising Inflation Expectations and Real Interest Rates will Push the 10-Year Treasury to 2.5% by Year End 2017

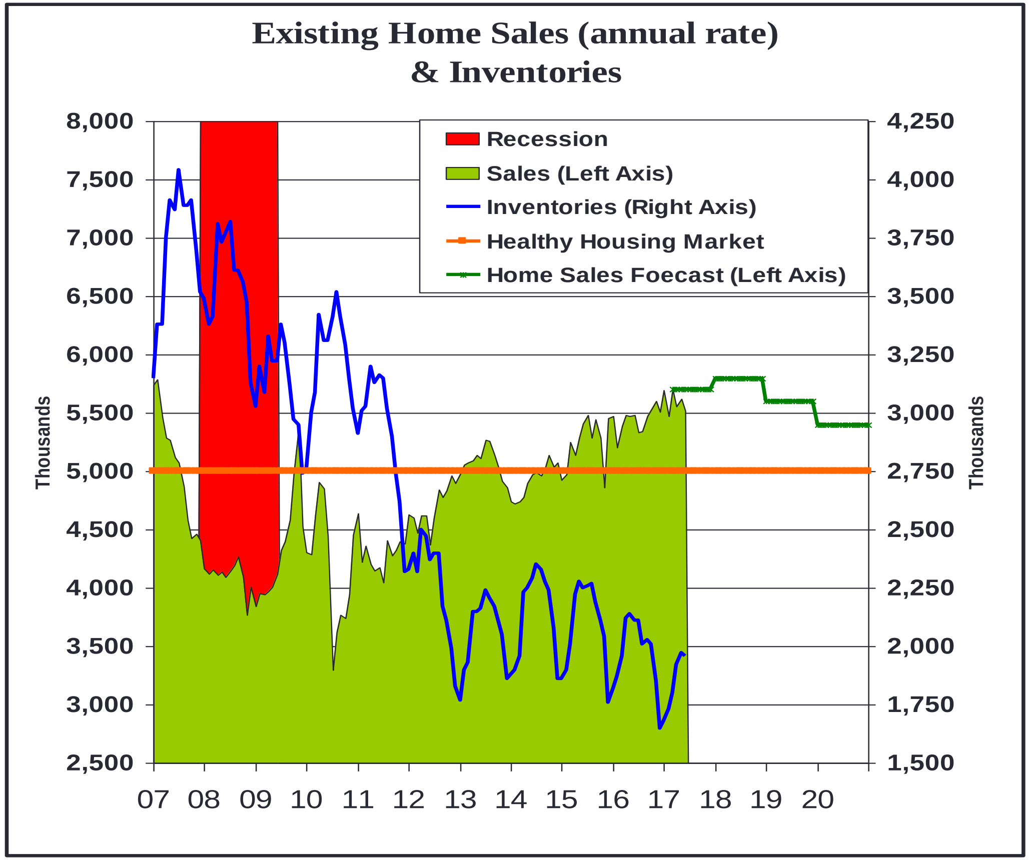


CU Yield on Assets will Rise in 2017 as Interest Rates Rise and Loan Growth Remains Strong

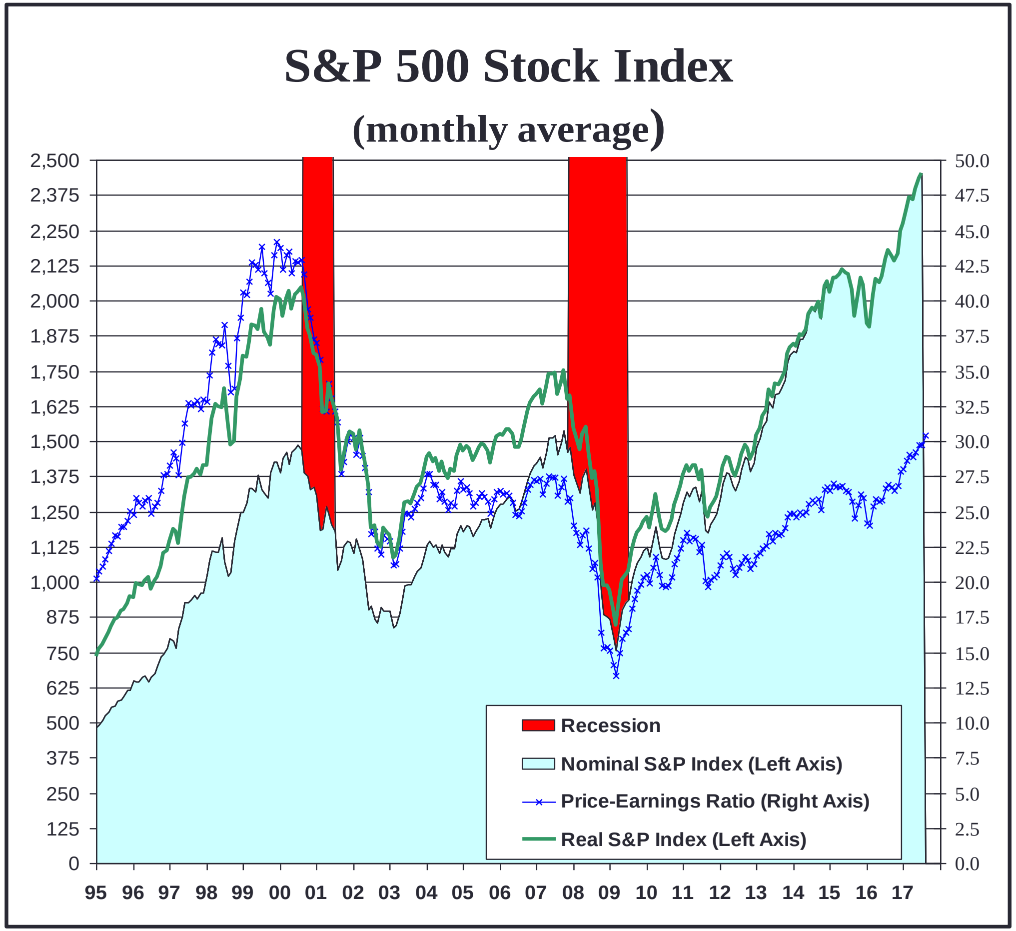


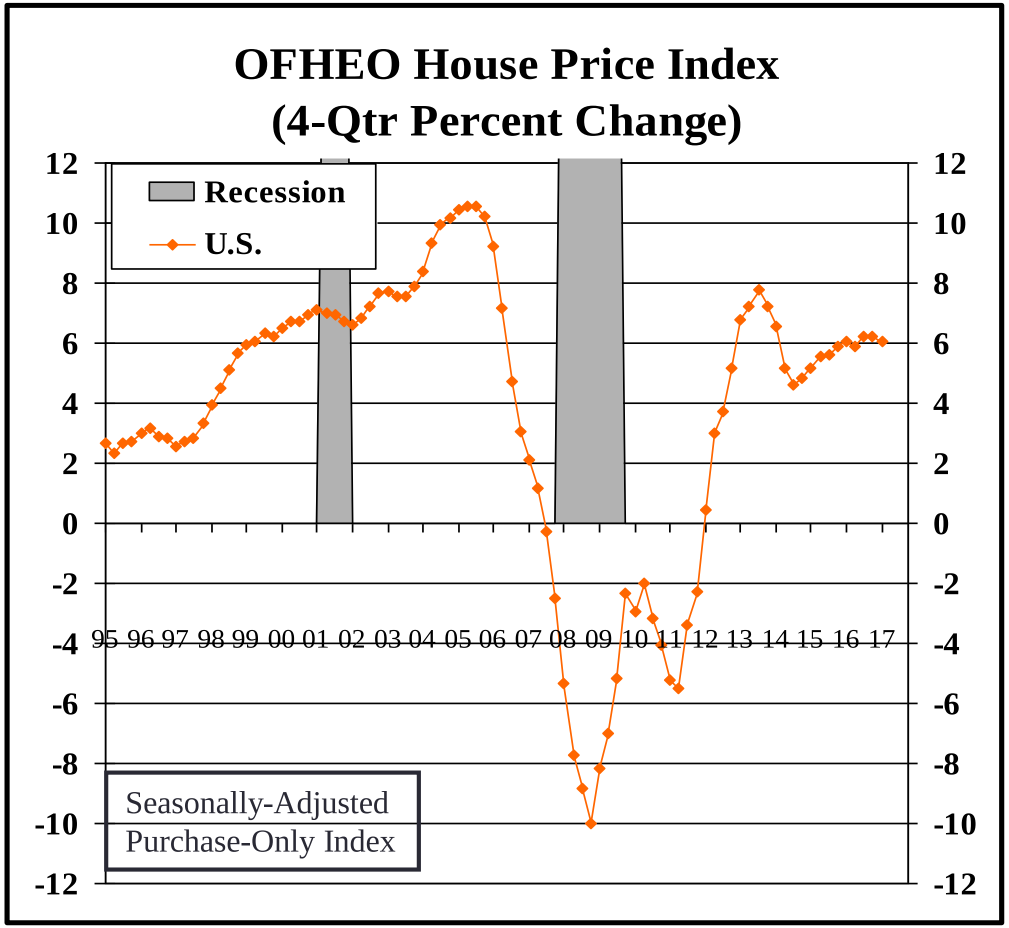
Vehicle Sales over 17 million in 2018
Home Sales will Accelerate to 5.5 million in 2018





High Stock Prices Producing "Wealth Effect" among High-Income Households
Home Prices will Rise 5% in 2018

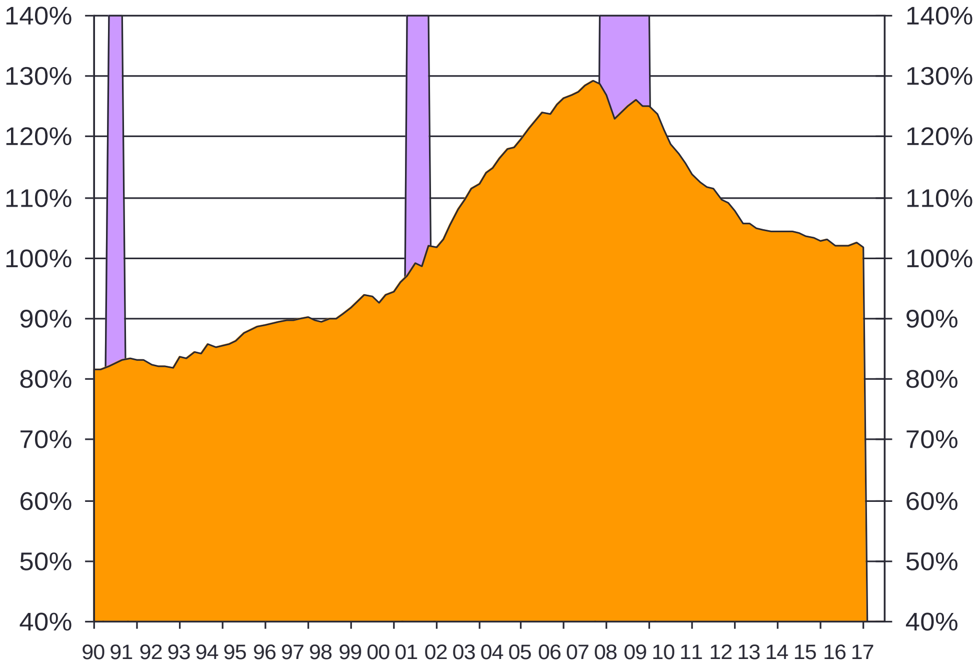




Household Balance Sheets will be Strong in 2018

Household Debt

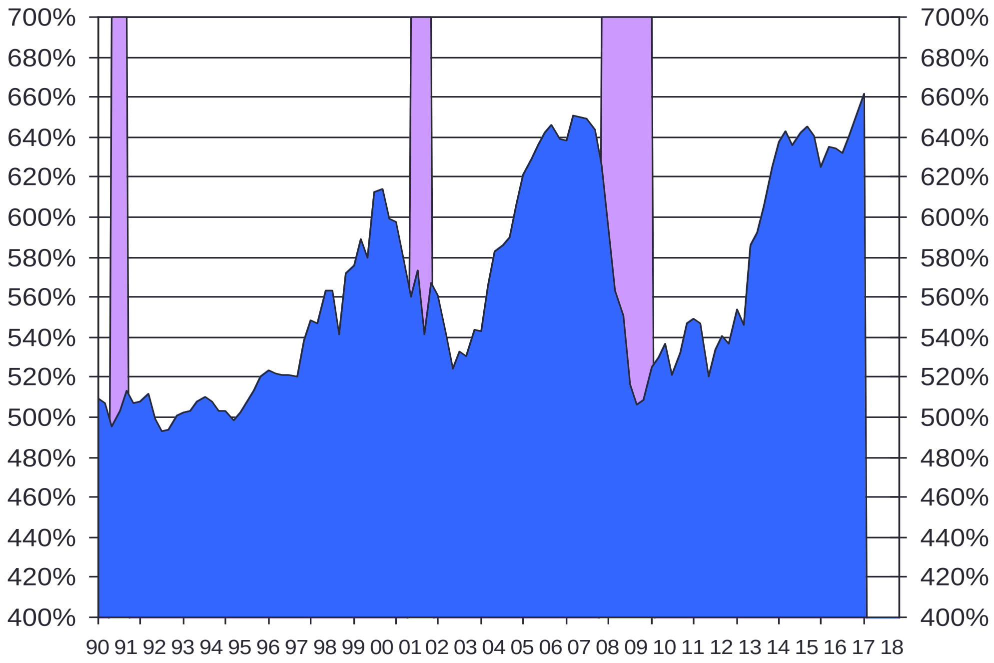
(As a Percent of Disposable Household Income)



Source: BEA & Federal Reserve.

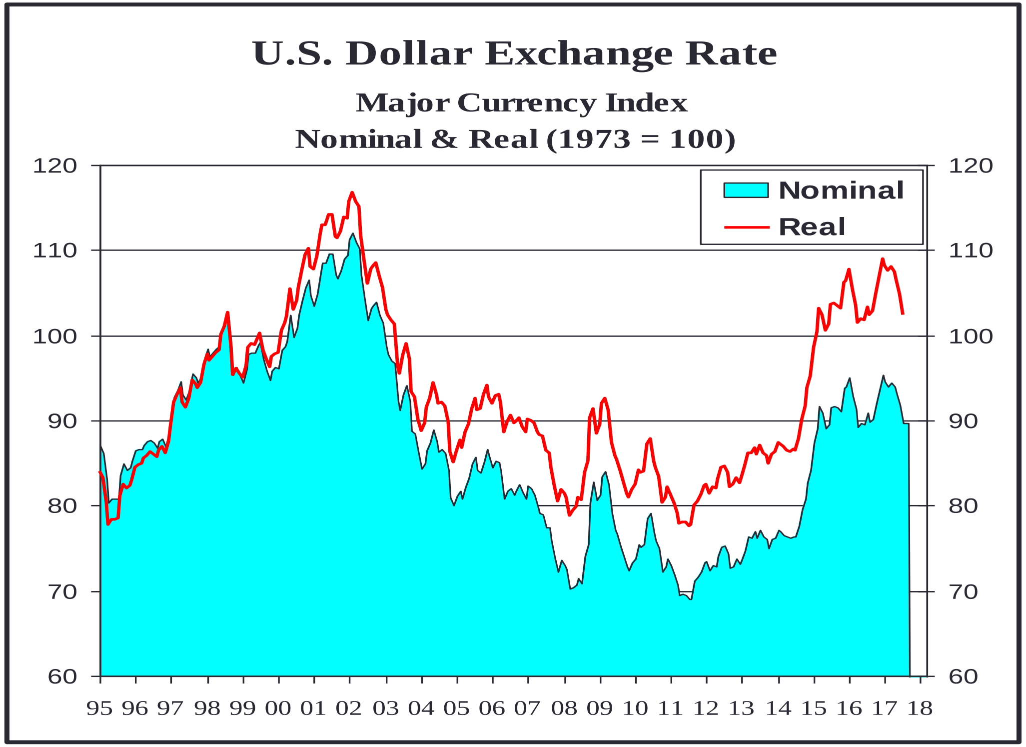
Household Net Worth

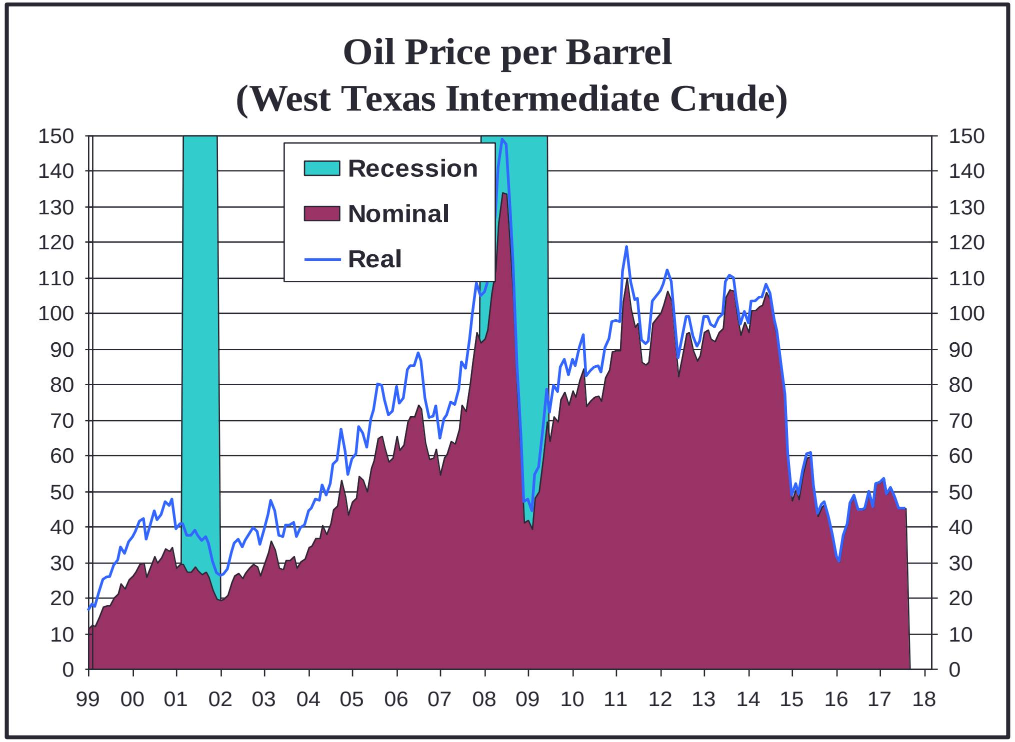
(As a Percent of Disposable Household Income)



Source: BEA & Federal Reserve.

Rising Interest Rates will Increase Value of Dollar
Low Oil Prices will Support Deposit Growth in 2017



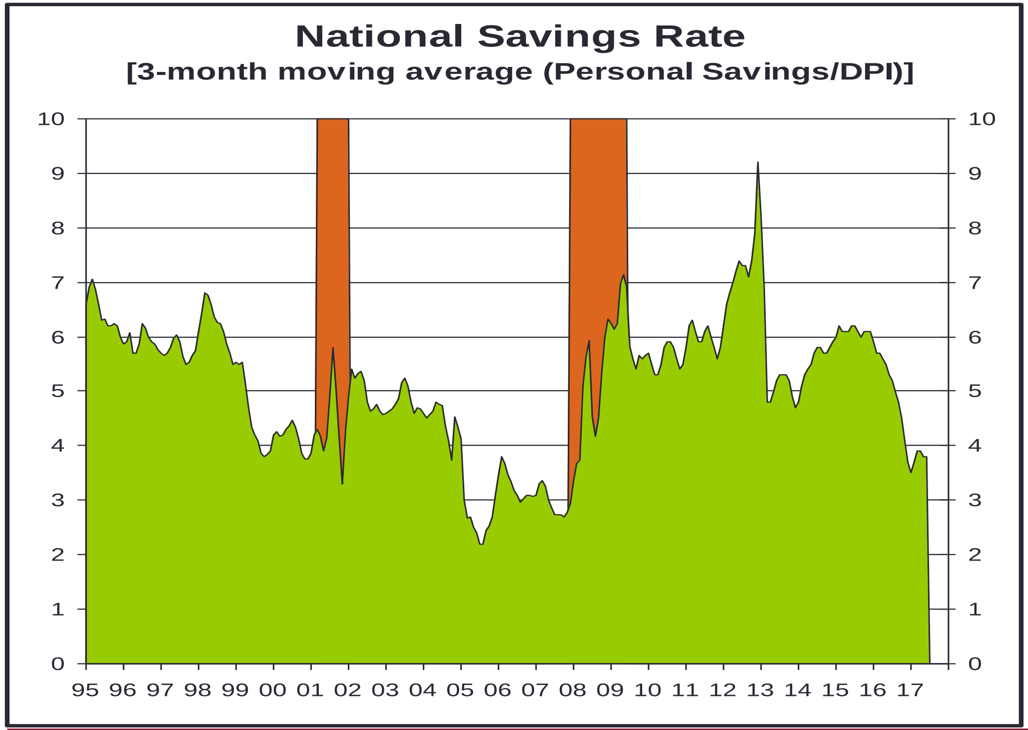


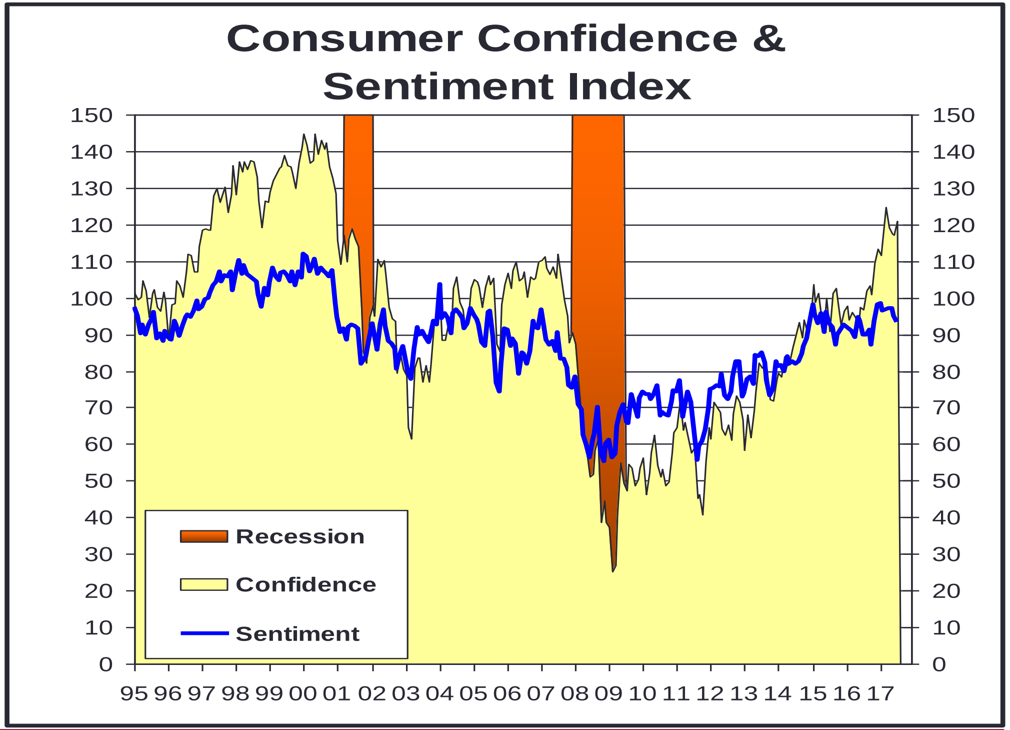
The **U.S. dollar fell 2.26%** in July and fell 1.3% over the last 12 months. Market expectations are for the Fed to raise interest rates 0.75% in 2018 which will increase the value of the dollar. The rise in the value of the dollar will reduce the cost of imports to U.S. residents but raise the cost of exports from the point of view of foreign buyers. This will worsen the trade deficit and slow economic growth.

A country's exchange rate partly represents international investors' confidence in its government policies.

The **price of a barrel of oil** averaged \$45 in June 2017, down from \$49 one year earlier, a 8% decrease. This will decelerate energy investment but boost consumer spending. Oil Economics: ↓ P_{oil} = \$10 => ↓ P_{Gas} = \$0.25 => ↑ growth 0.3% - 0.5% over next two years.

Consumers' Confidence Will Remain High in 2017





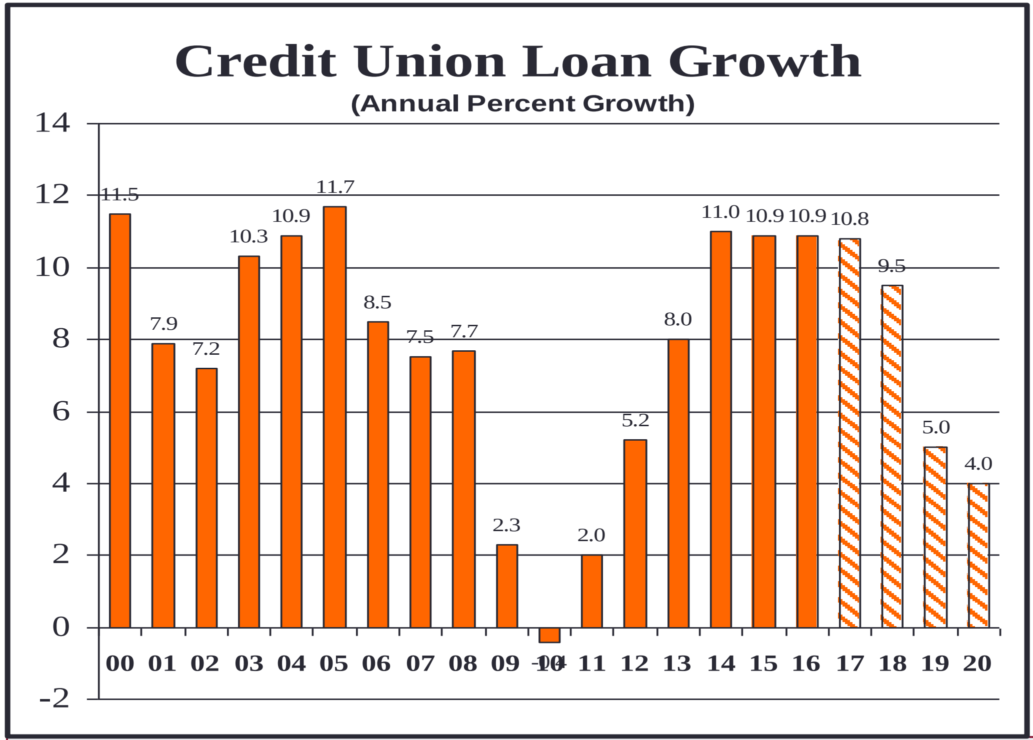
The saving rate (savings / disposable personal income) fell to 3.8% in June from 3.9% in May. Savings should decline as households begin spending some of their gasoline savings windfall. In this environment of modest savings, spending gains will be highly dependent on income growth and consumers preferences for additional savings.

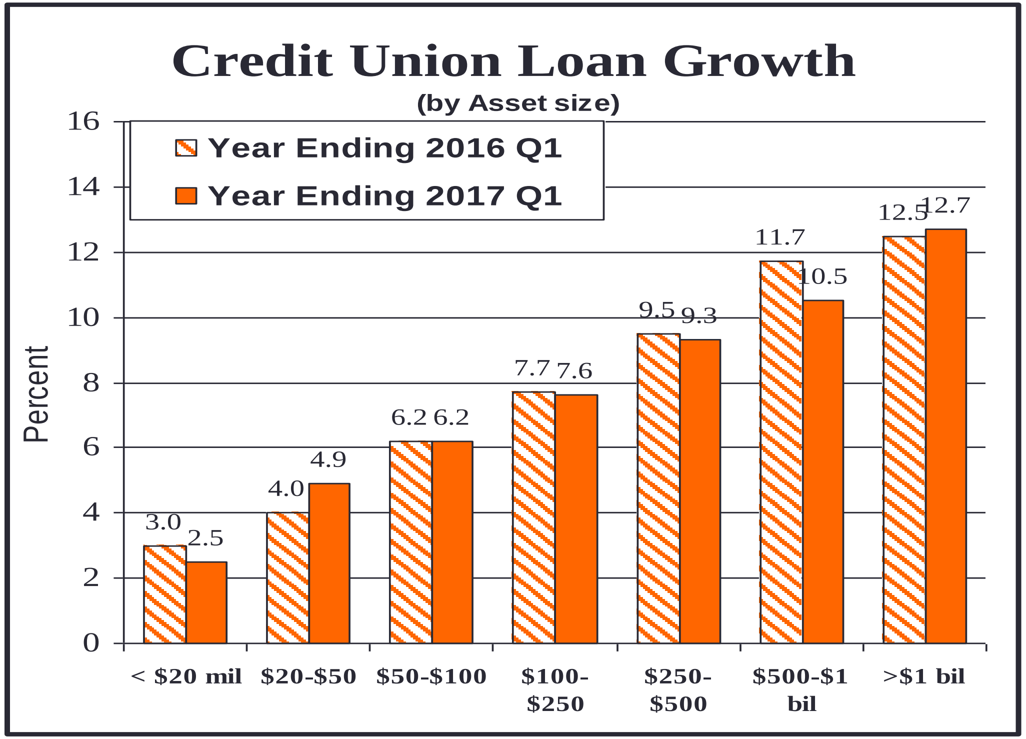
Consumer Confidence Index rose to 121.1 in July from 117.3 in June.

Consumer Sentiment Index fell to 93.4 in July from 95.1 in June.

Improving GDP growth will boost consumer confidence and also the demand for credit.

Rapid Credit Union Loan Growth

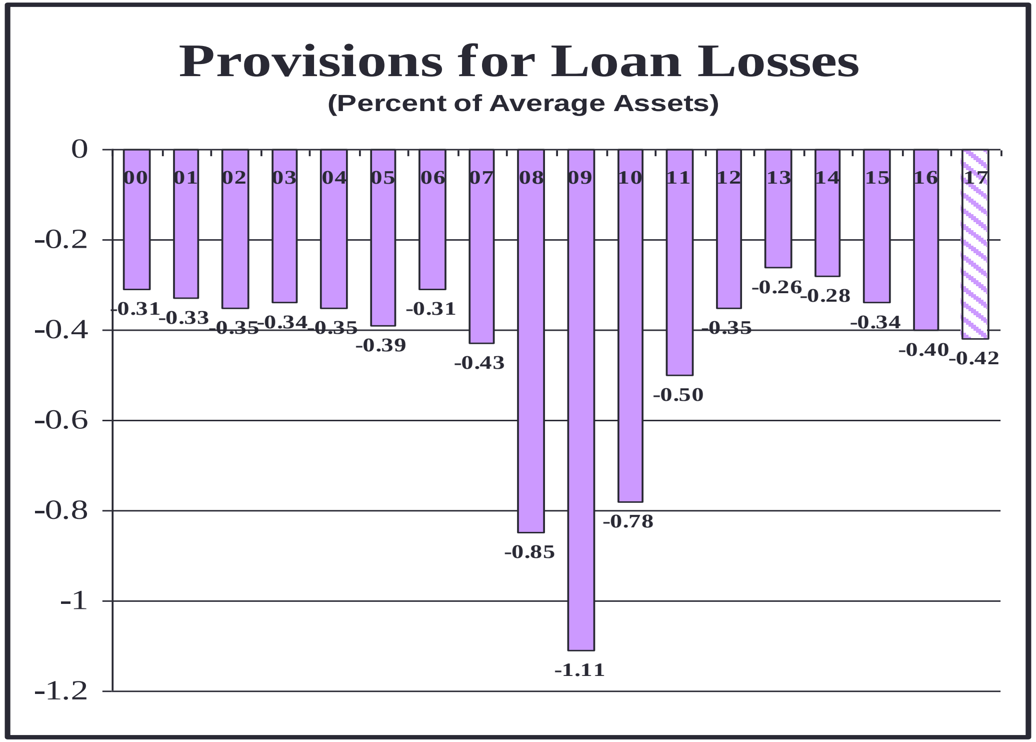


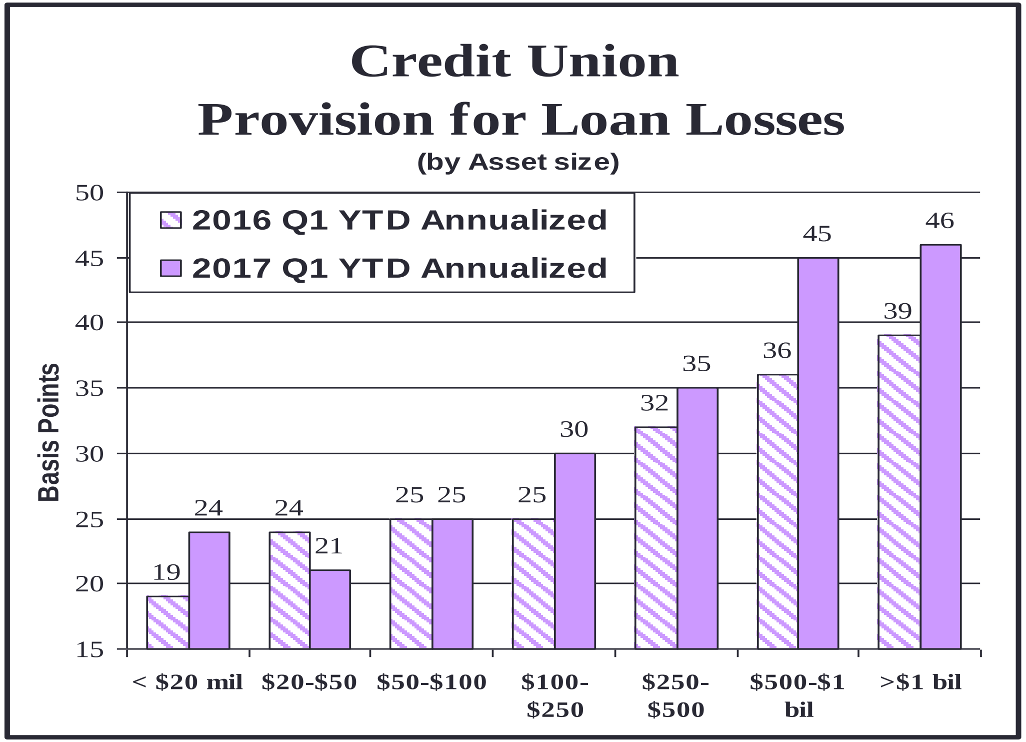


Expect loan balances to grow 10.8% in 2017 and 9.5% in 2018 as the strengthening economy boosts members' willingness and ability to accumulate debt and therefore satisfy some of their pent up demand that was accumulated during the weak and uncertain economic recovery of the last six years. But the loan growth disparity between small and large credit unions is rather large.

In the last 12 months ending in Q1 2017, credit unions with assets greater than $1 billion reported an 12.7% increase in loan balances versus credit unions with assets less than $20 million reported loan growth of only 2.5%.

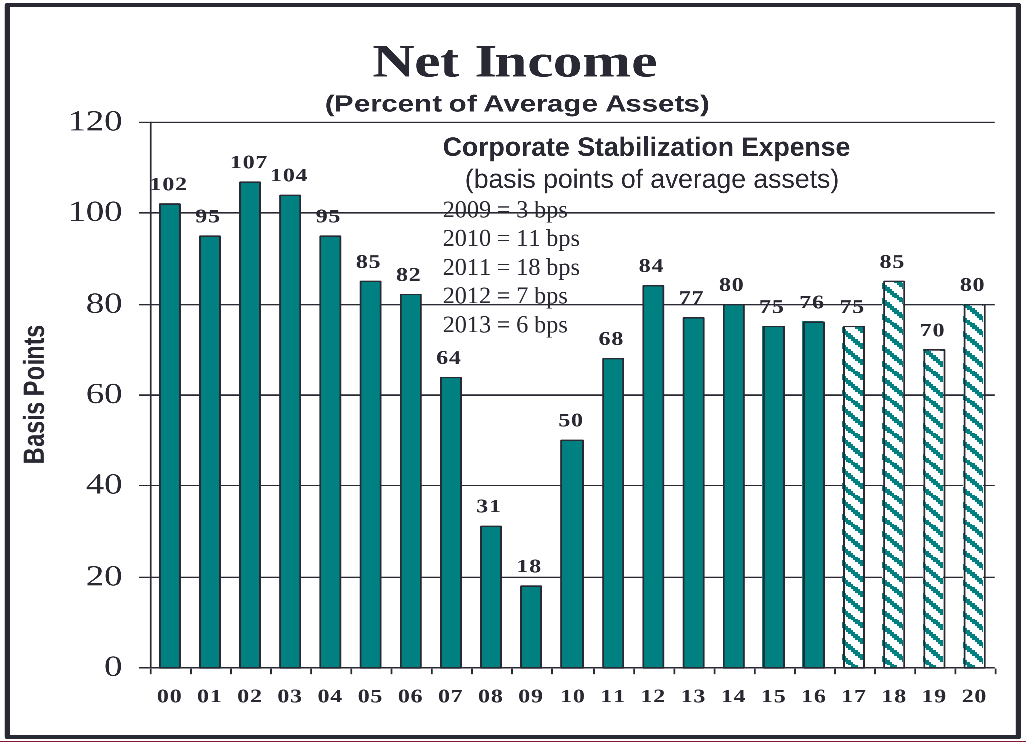
Rising Provisions for Loan Loss Ratios

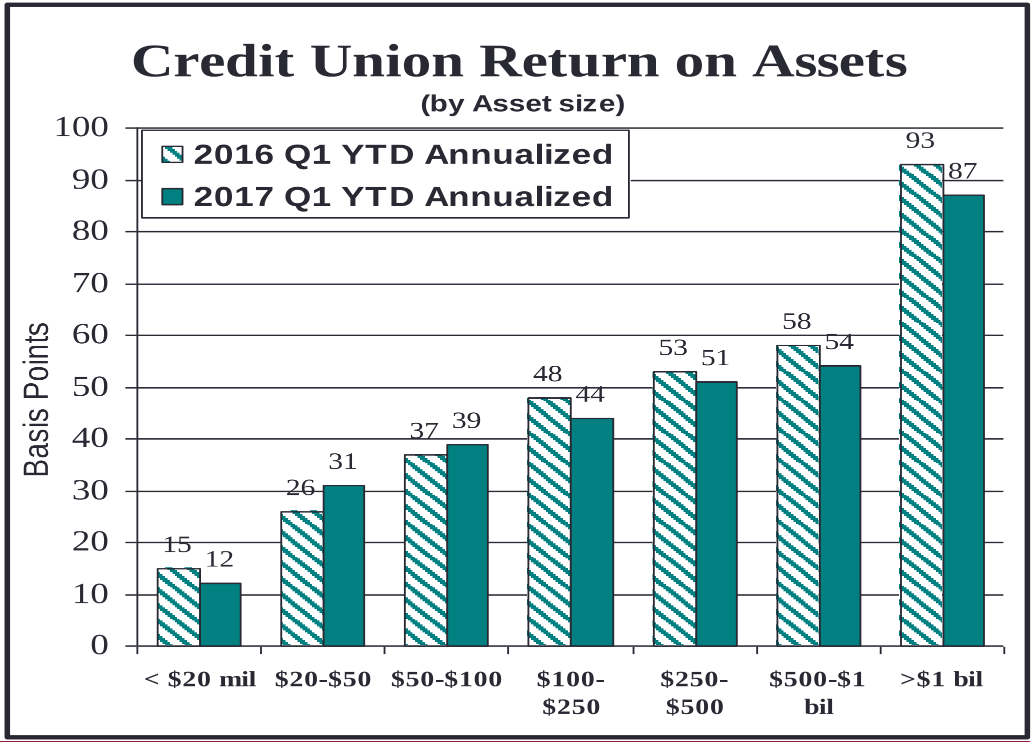




Provision for loan loss ratios will increase slightly in 2017 due to strong loan growth. But stable loan net charge-offs ratios (0.55%), strong underwriting standards, an improving labor market, and rising home prices will keep loan loss provisions around the historical average of 0.35%-0.40% of assets. Credit unions have stabilized their ***allowance for loan loss account*** at around 0.9% of loans, down from 1.6% in 2010, but above the 0.7% average reported before the Great Recession.

Stable Return-on-Asset Ratios

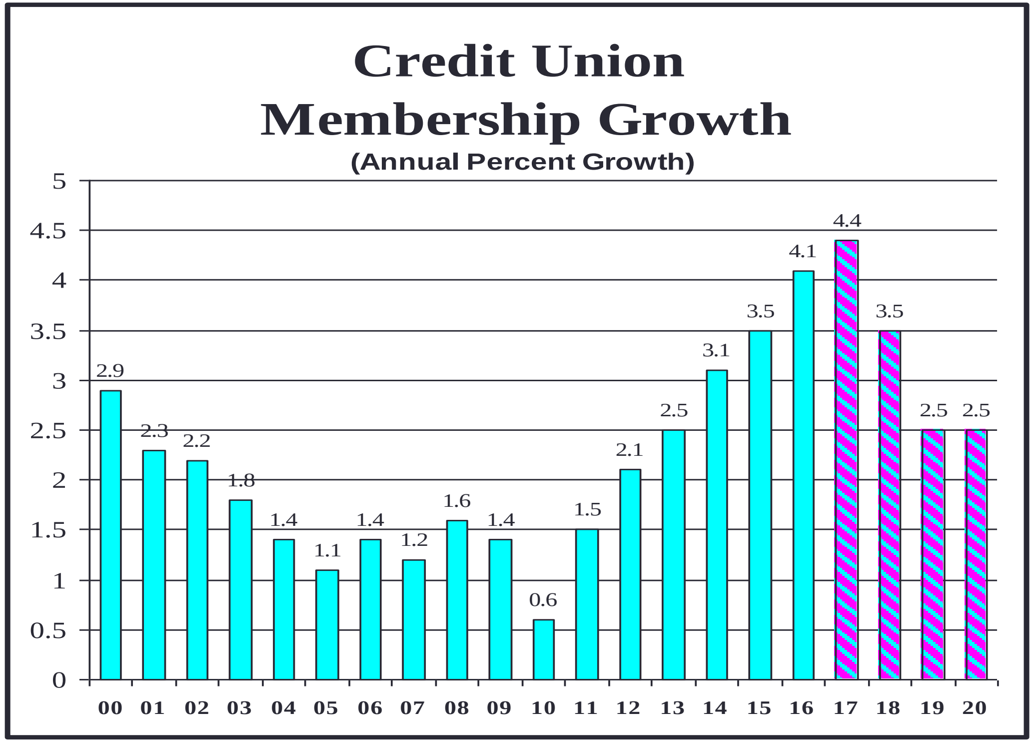


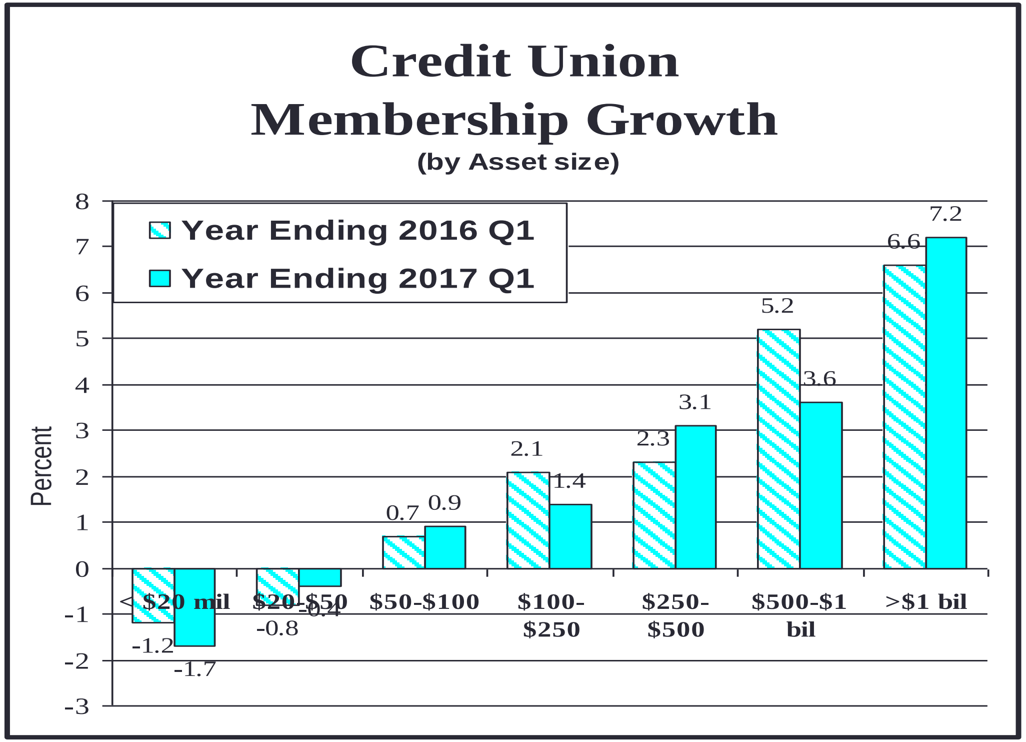


Credit union return-on-asset ratio will rise to 0.75% in 2018. Rising asset yields – due to faster loan growth and modestly higher market interest rates - will outpace higher funding costs. This will increase net interest margins. But rising provision for loan loss expense, rising operating expenses and falling fee income will reduce net income.

The disparity between large and small credit unions return-on-asset ratios remained large in Q1 2017. Credit unions with assets exceeding $1 billion reported ROA ratios of 0.87%, more than twice that reported by credit unions with assets less than $100 million.

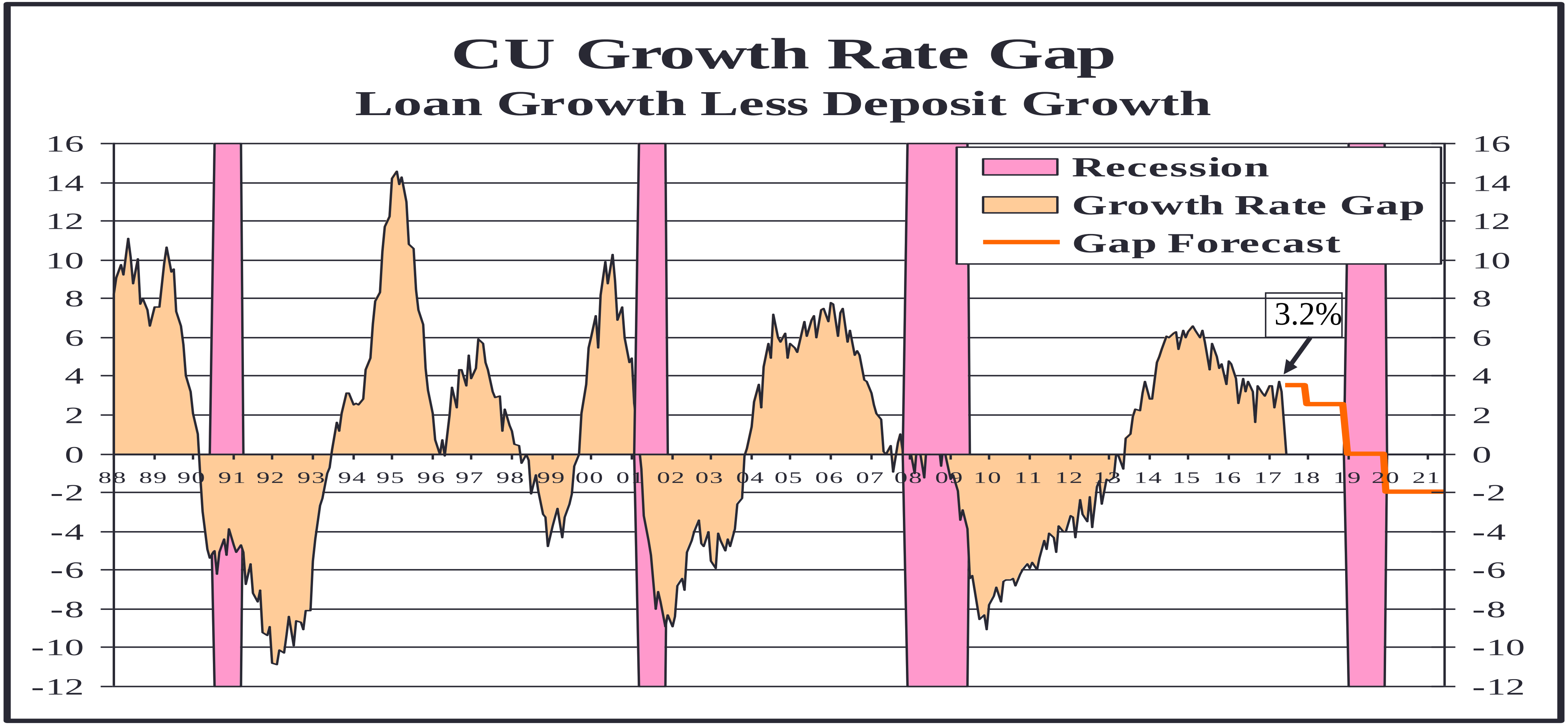
Membership Growth Surges





Credit unions should expect membership growth to exceed 4.0% in 2017 due to strong loan growth and job growth. This will push the total number of credit union memberships to 113.9 million by year end 2017, which is equal to 33% of the total U.S. population. In the last 12 months ending in Q1 2017, credit union with assets over $1 billion reported 7.2% membership growth, compared with less than 1% for credit unions with assets less than $100 million. The 2,569 credit unions with assets less than $20 million reported a 1.7% decline in memberships.

The Short-Term Debt Cycle and Forecasting Recessions



Economic Forecast

- **We expect the U.S. economy to grow by 2.3% in 2017 and 2018**. The economy continues to grow at a moderate pace, propelled by confident consumers, home equity gains, consumer spending and business investment. Projecting into the next year or two, government spending on infrastructure and potential tax cuts could further boost growth; however, the likelihood of legislative movement on these initiatives now seems lower. Furthermore, the uncertain political environment, potential trade wars, and proposed changes to healthcare and immigration may lower growth in the long run.
- **Headline and core (excluding food and energy prices) inflation will both be 2.0% in 2017 and 2.3% in 2018.** These numbers were revised down slightly from our previous forecast, as energy and commodity prices continue to fall and wages have grown slower than expected. Nonetheless, rising employment, consumer spending and wealth will all contribute to continued moderate inflation into 2018.
- **The unemployment rate will finish at 4.2% in 2017 and fall to 4.0% in 2018**. Strong monthly job gains continue to put downward pressure on the unemployment rate. As the economy reaches full employment, competition for workers will increase, leading to higher quality jobs and higher wages, although the adjustments will continue to be gradual. Discouraged workers are likely to re-enter the job market, off-setting some of the gains in unemployment and wages. However, we expect job growth to remain strong as unemployment bottoms out around 4.0% next year.
- **The Federal Funds interest rate will increase to 1.4% by the end of 2017 and 2.25% by the end of 2018.** Increased spending, tighter labor markets, and looming inflation will cause the FOMC to continue to raise its target interest rate gradually, with another quarter-point hike this year and further increases of 75 basis points in 2018, if the economy continues on its current path.
- **The 10-year Treasury interest rate will continue to increase ending at 2.5% by December 2017 and 3.0% by December 2018.** Although slightly below our last estimates, we expect the 10-year Treasury interest rate to increase gradually as the economy continues to improve.

Economic Forecast

September 2017

	Actual Results		Quarterly Results/Forecasts					Annual Forecasts	
	5Yr Avg	2016	2017:1	2017:2	2017:3	2017:4	2018:1	2017	2018
Growth rates:									
Economic Growth (% chg GDP)*	2.10%	1.90%	1.20%	3.10%	2.10%	2.50%	1.75%	2.30%	2.50%
Inflation (% chg CPI)*	1.30%	2.10%	1.53%	0.06%	3.20%	3.20%	2.00%	2.00%	2.30%
Core Inflation (ex. food & energy)*	1.90%	2.20%	1.57%	1.01%	2.60%	2.70%	2.00%	2.00%	2.30%
Unemployment Rate	6.00%	4.70%	4.50%	4.40%	4.30%	4.20%	4.20%	4.20%	4.00%
Federal Funds Rate (effective)	0.23%	0.54%	0.82%	1.06%	1.25%	1.40%	1.50%	1.40%	2.25%
10-Year Treasury Rate	2.31%	2.45%	2.40%	2.31%	2.32%	2.50%	2.60%	2.50%	3.00%
10-Year-Fed Funds Spread	2.08%	1.91%	1.58%	1.25%	1.07%	1.10%	1.10%	1.10%	0.75%

*Percent change, annual rate. All other numbers are end-of-period values.

Credit Union Forecast

- **Credit union savings balances will grow by 7.0% in 2017 and 6.0% in 2018.** These numbers were revised downward, as the U.S. savings rate has turned down over the last year. We expected outflows into money market mutual funds, but this might not occur until late 2017 or 2018.
- **Memberships will increase in 2017 by 4.4%.** Credit unions continue to see strong increases in membership, due primarily to recognition of the positive credit union value proposition, particularly in auto lending rates. We expect this number to fall slightly to 3.5% in 2018, as the auto lending boom slows and indirect borrower memberships decline from loan pay-offs.
- **Credit union loan balances will increase by 10.5% in 2017 and 9.5% in 2018**. With a stronger economy, we expect increases in consumer spending and consumer loans. As interest rates rise, fence-sitters will enter the market to lock in low rates. Coupled with all-time high credit scores across much of the country, we expect strong growth in new auto loans, credit cards and mortgages.
- **Credit quality will remain healthy in 2017 and 2018**. Although these numbers vary by sector of the economy and region, on average the improving job market, fast loan growth, and rising wealth will keep delinquencies and charge-offs at relatively low levels.
- **Credit union return on assets will decline modestly to 0.80% in 2017 and increase to 0.85% in 2018**. Strong loan growth will continue to sustain interest margins, leading to healthy earnings in 2017 and 2018. However, mortgage refinances are likely to decline due to increasing interest rates and this will push gains on loan sales lower. Furthermore, higher operating expenses due to a tighter labor market, higher funding costs, and lower fee income from overdrafts and NSFs will put downward pressure on credit union returns through 2018. Finally, a share insurance fund dividend (from Corporate Credit Union Stabilization Fund repayment) should add about five basis points to bottom-line results.
- **Net worth ratios will remain relatively stable at 10.9% in 2017 and 10.8% in 2018.** The increases are a bit higher than previously forecasted due to modestly higher earnings outlook and slower asset growth.

Credit Union Forecast

September 2017

	Actual Results		Quarterly Results/Forecasts					Annual Forecasts	
	5Yr Avg	2016	2017:1	2017:2	2017:3	2017:4	2018:1	2017	2018
Growth rates:									
Savings growth	5.7%	7.6%	4.4%	0.6%	1.0%	1.0%	4.0%	7.0%	6.0%
Loan growth	8.7%	10.6%	2.0%	3.2%	3.5%	1.8%	1.8%	10.5%	9.5%
Asset growth	6.1%	7.4%	3.5%	0.7%	1.5%	1.5%	4.0%	7.2%	6.0%
Membership growth	3.1%	4.1%	1.2%	1.3%	1.0%	0.9%	0.8%	4.4%	3.5%
Liquidity:									
Loan-to-share ratio**	74.5%	79.8%	78.0%	79.6%	81.6%	82.2%	80.4%	82.2%	84.9%
Asset quality:									
Delinquency rate**	0.93%	0.83%	0.68%	0.75%	0.76%	0.80%	0.70%	0.80%	0.85%
Net charge-off rate*	0.57%	0.55%	0.58%	0.56%	0.54%	0.54%	0.55%	0.55%	0.60%
Earnings:									
Return on average assets (ROA)*	0.81%	0.76%	0.71%	0.81%	0.75%	0.75%	0.75%	0.75%	0.85%
Capital adequacy:									
Net worth ratio**	10.8%	10.9%	10.7%	10.8%	10.9%	10.9%	10.7%	10.9%	10.8%

*Annualized Quarterly Data. **End of period ratio. Additional information and updates available on our MCUE website.

PRESENTER

STEVEN RICK

Chief Economist

CUNA Mutual Group

Steve.rick@cunamutual.com

800-356-2644, Ext. 665-5454