Economic Update

February 2023

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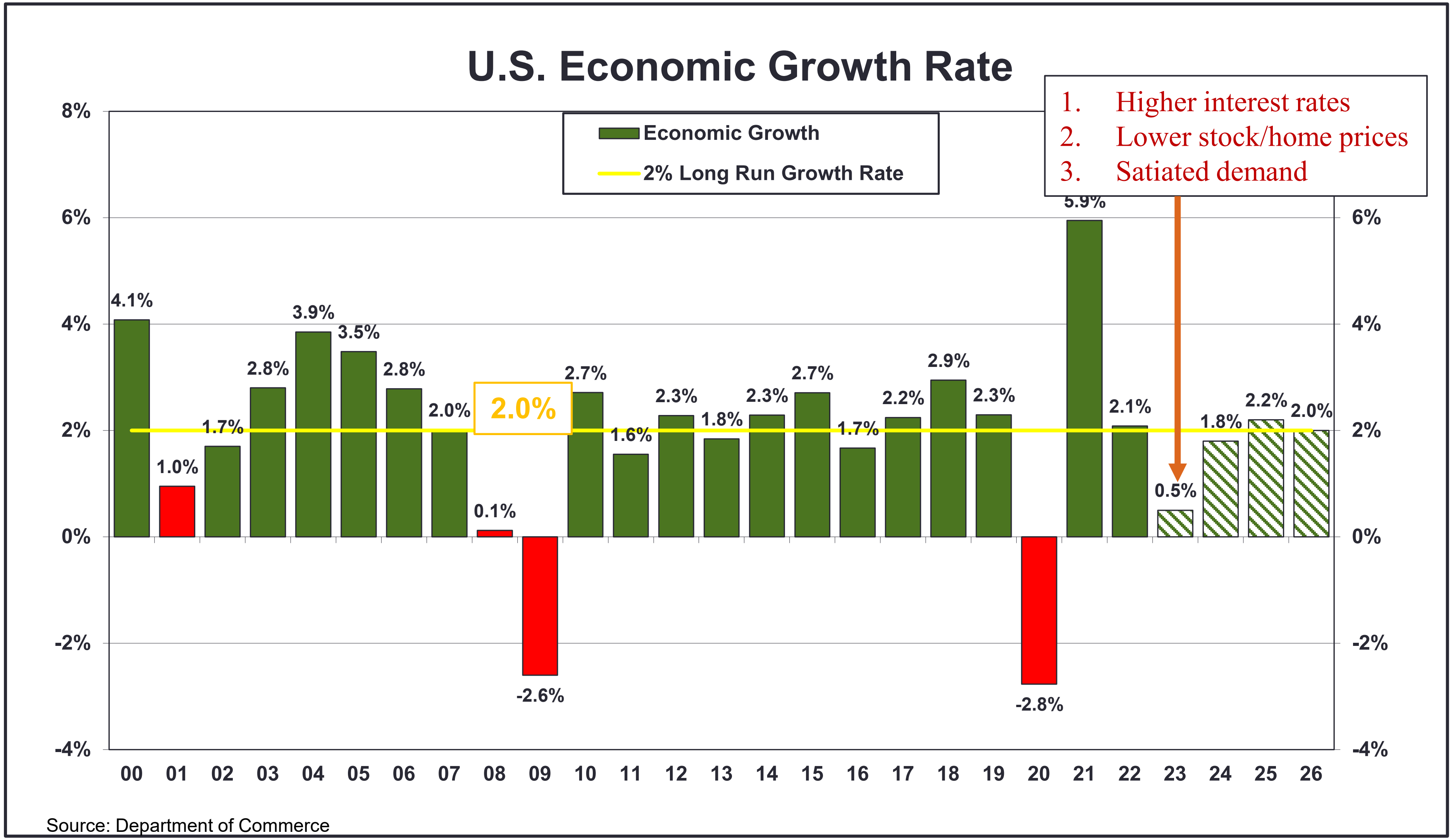
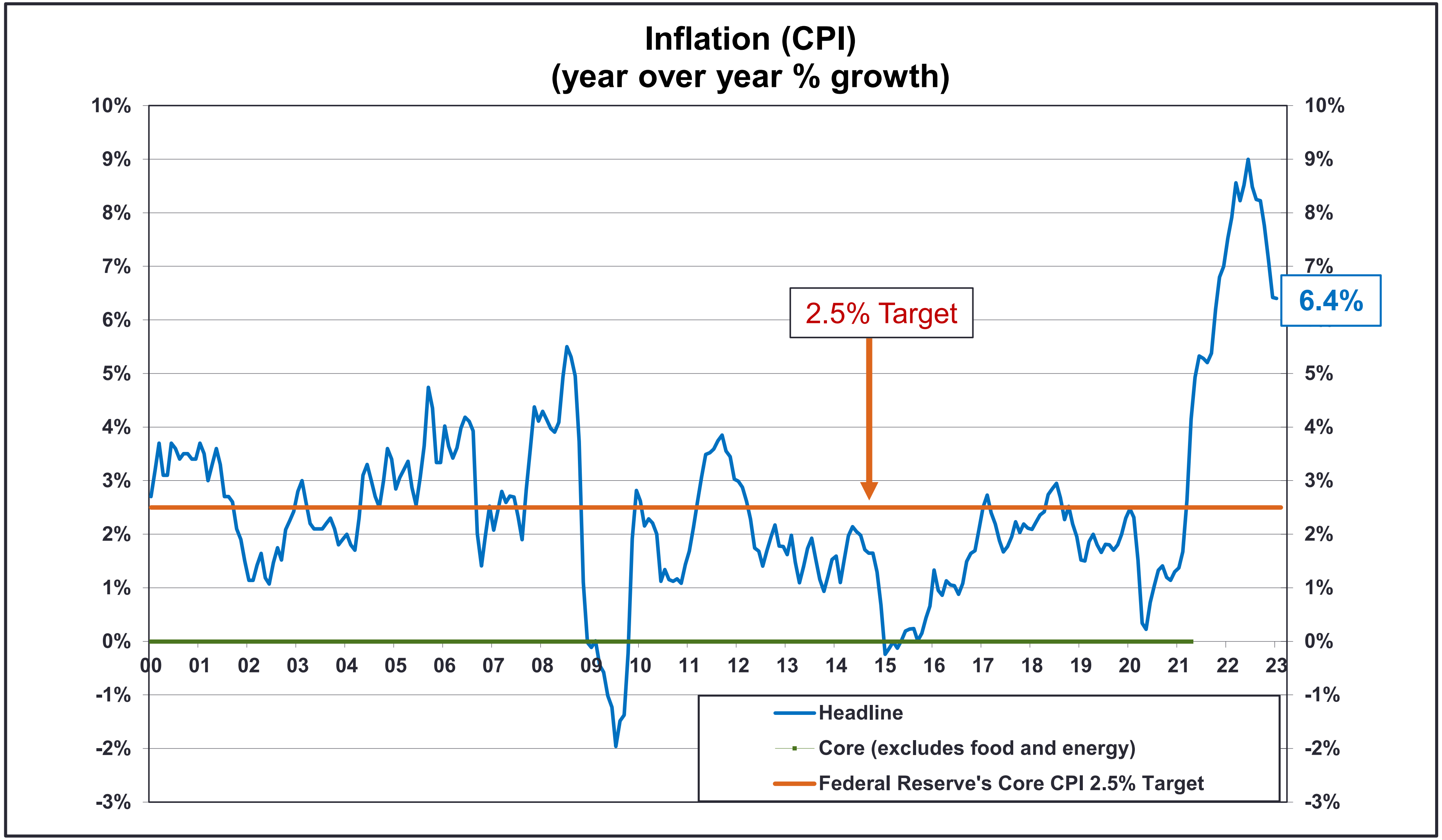
Weak Economic Growth in 2023



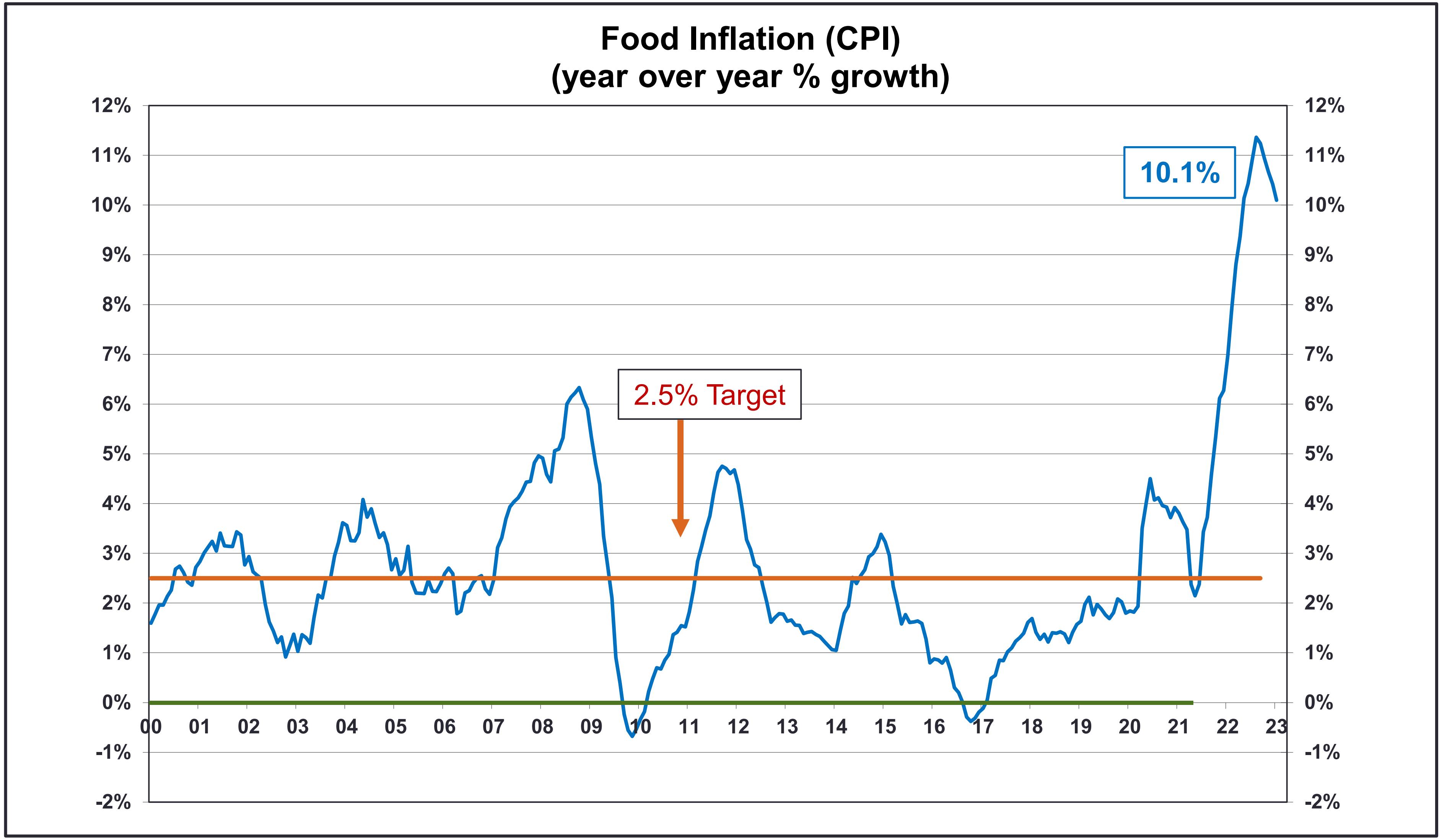
The Big Question

Inflation or Deflation
tell me if you can
will we be Zimbabwe
or will we be Japan?

High Inflation for the Next Year

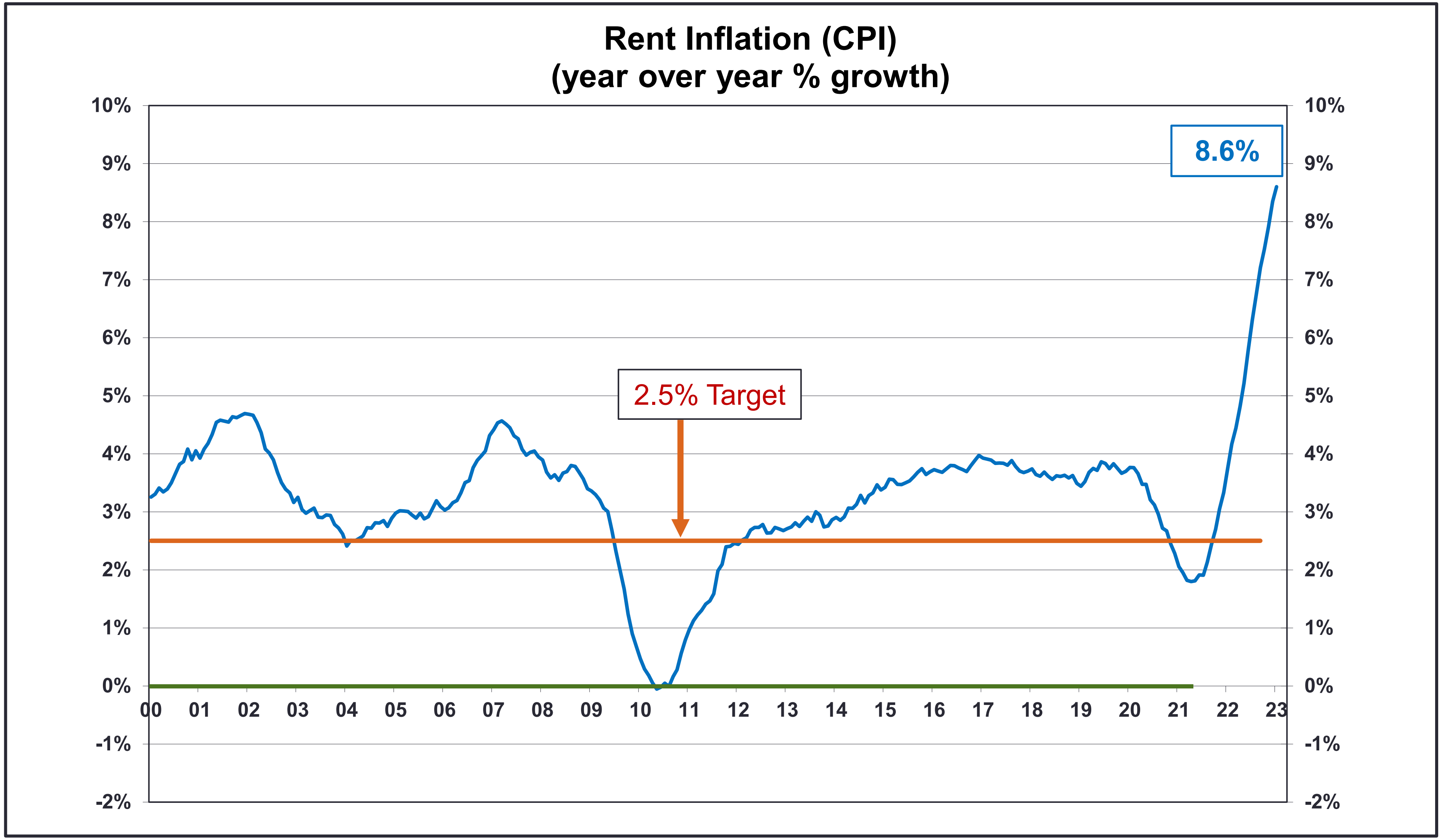


Food Prices

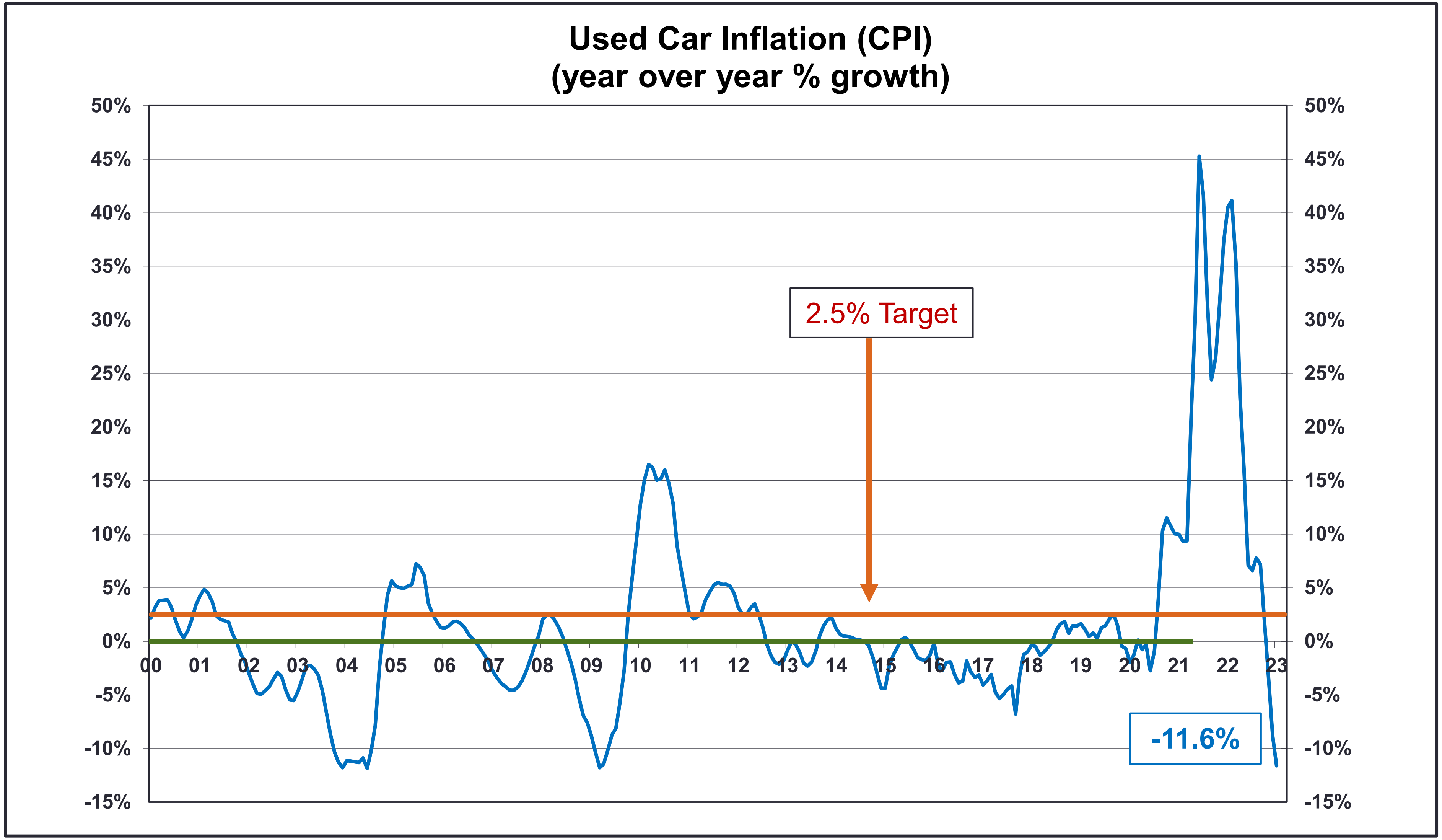


Food Inflation (CPI)
(year over year % growth)
12%
11%
10%
9%
8%
7%
6%
5%
4%
3%
2%
1%
0%
-1%
-2%
00 01 02 03 04 05 06 07 08 09 10 11 12 13 14 15 16 17 18 19 20 21 22 23
10.1%
2.5% Target

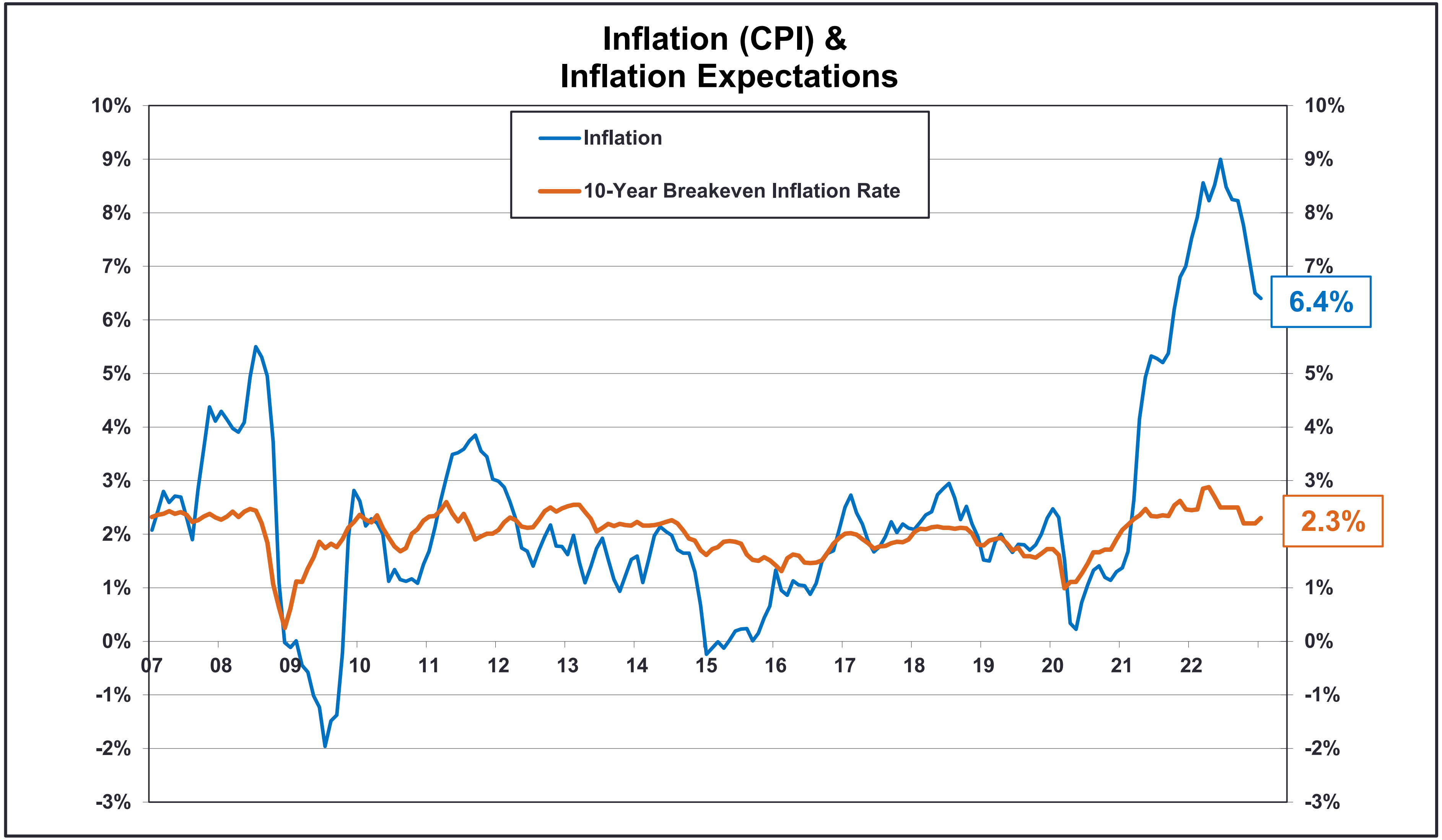
Rent of Primary Residence



Used Car Prices



Expected Inflation and Actual Inflation



The Inflation Debate:

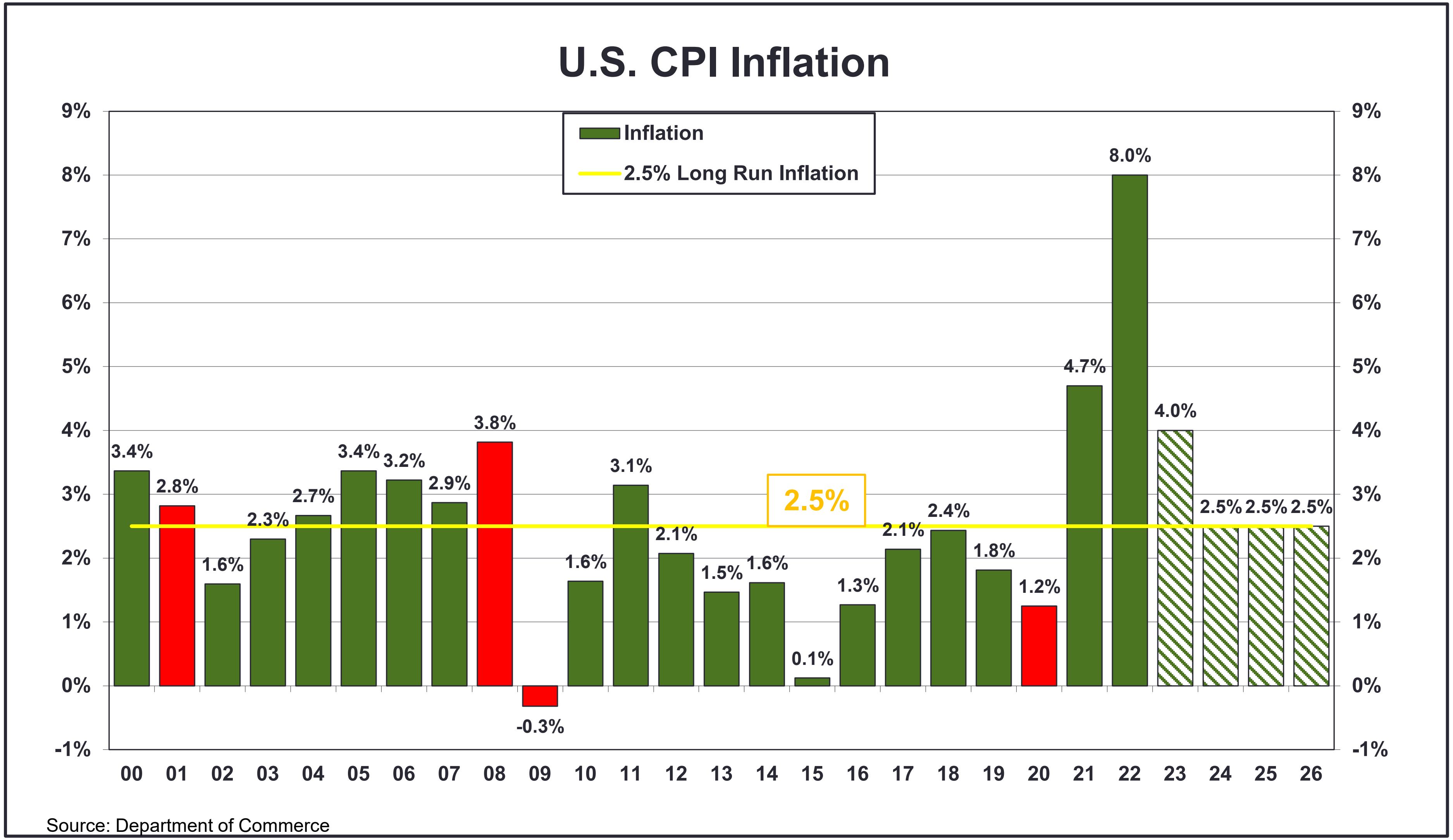
Higher Inflation Factors:

1. Pent up demand for goods and services
2. Tight labor market and rising wages
3. Supply chain disruptions reducing inventories
4. Rising energy & commodity prices
5. Massive monetary and fiscal stimulus
6. Lower dollar exchange rate => import prices
7. Rising housing and medical care costs
8. Positive output gap and little excess production capacity

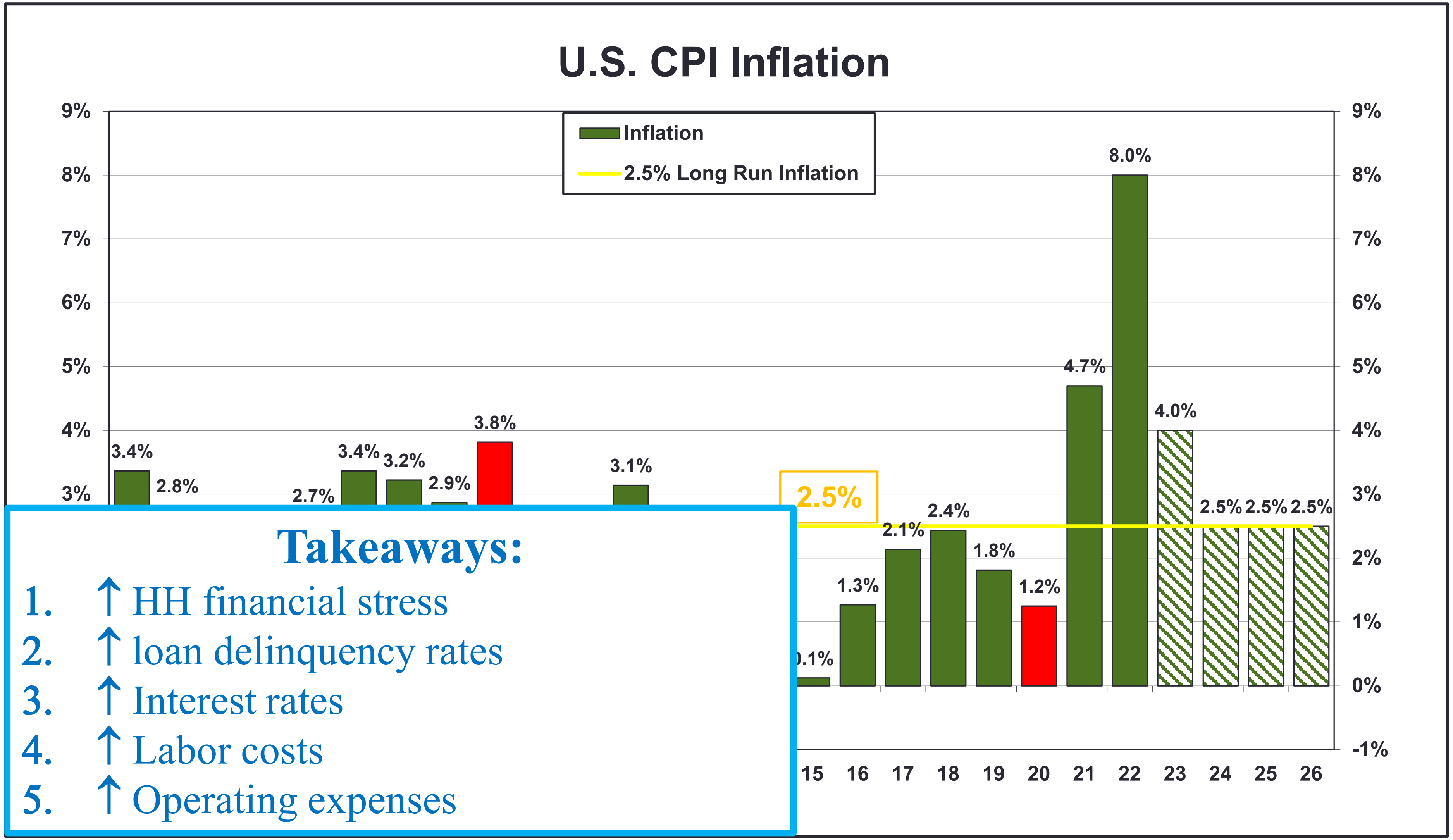
Lower Inflation Factors:

1. eCommerce is a powerful deflationary force
2. Rising competition from globalization
3. Rising productivity => falling costs per unit
4. Low population growth

Inflation Above Target Until 2024



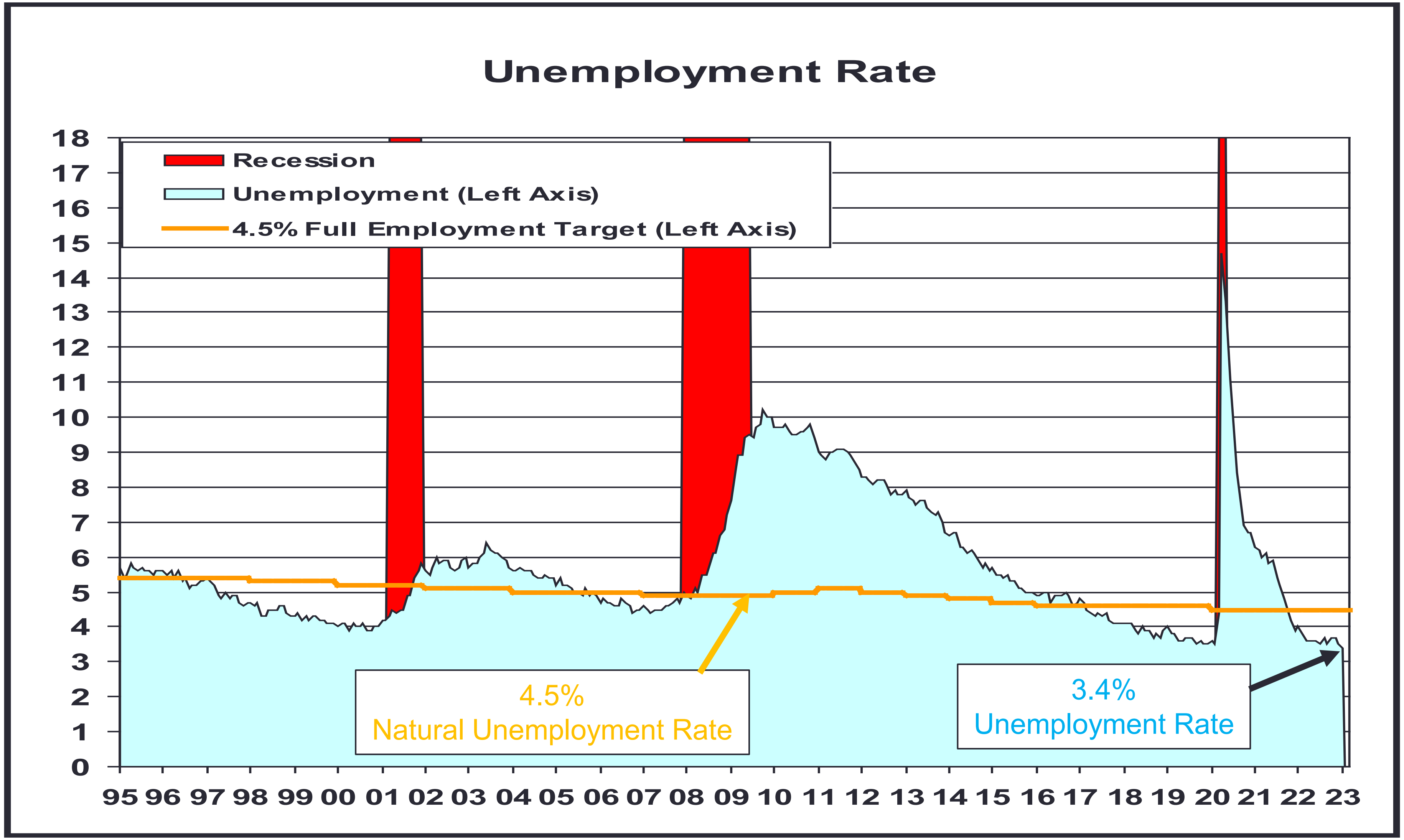
Inflation Above Target Until 2024



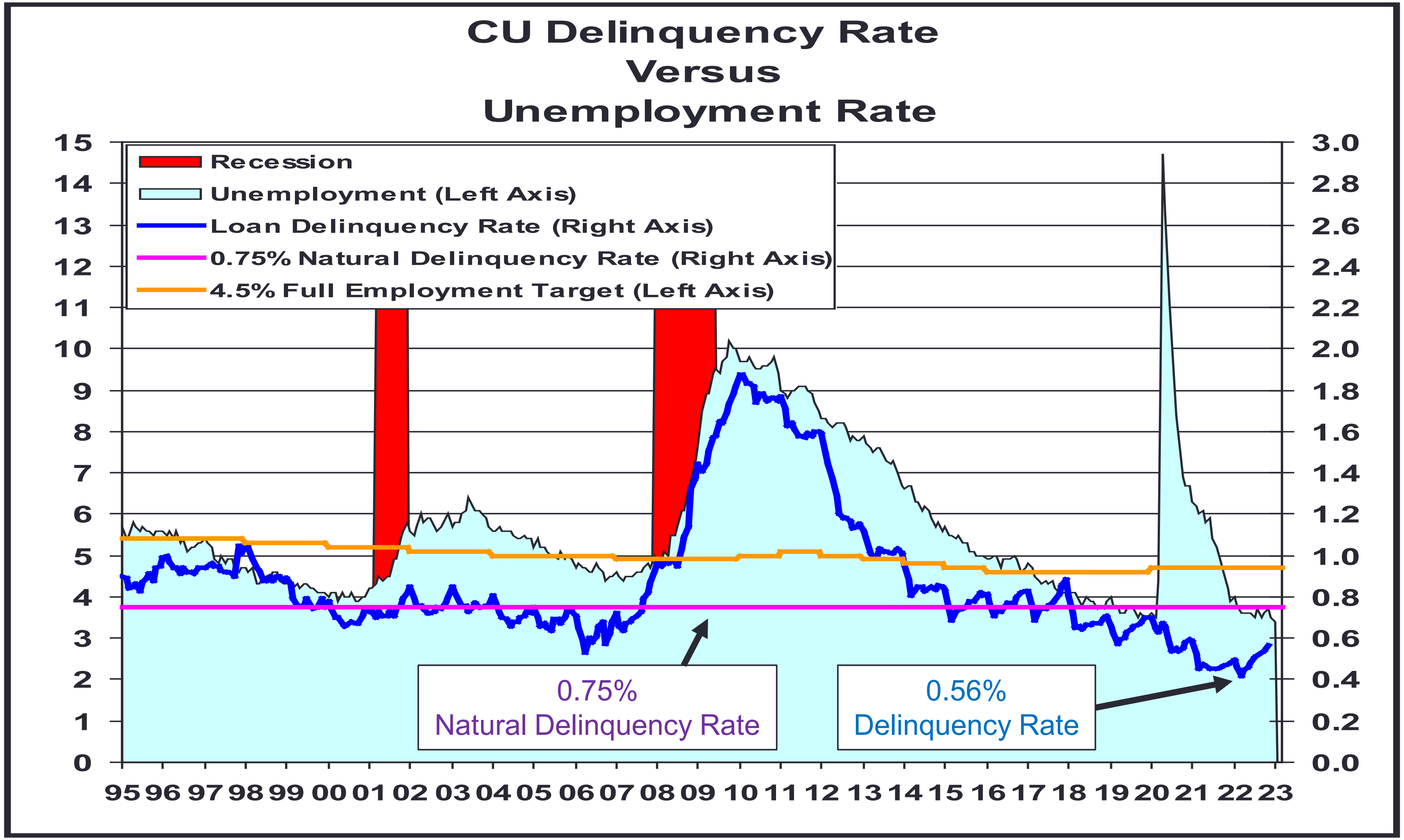
Takeaways:

1. ↑ HH financial stress
2. ↑ loan delinquency rates
3. ↑ Interest rates
4. ↑ Labor costs
5. ↑ Operating expenses

Unemployment Rate Below Natural Unemployment Rate



CU Loan Delinquency Rates are Low but Heading Up



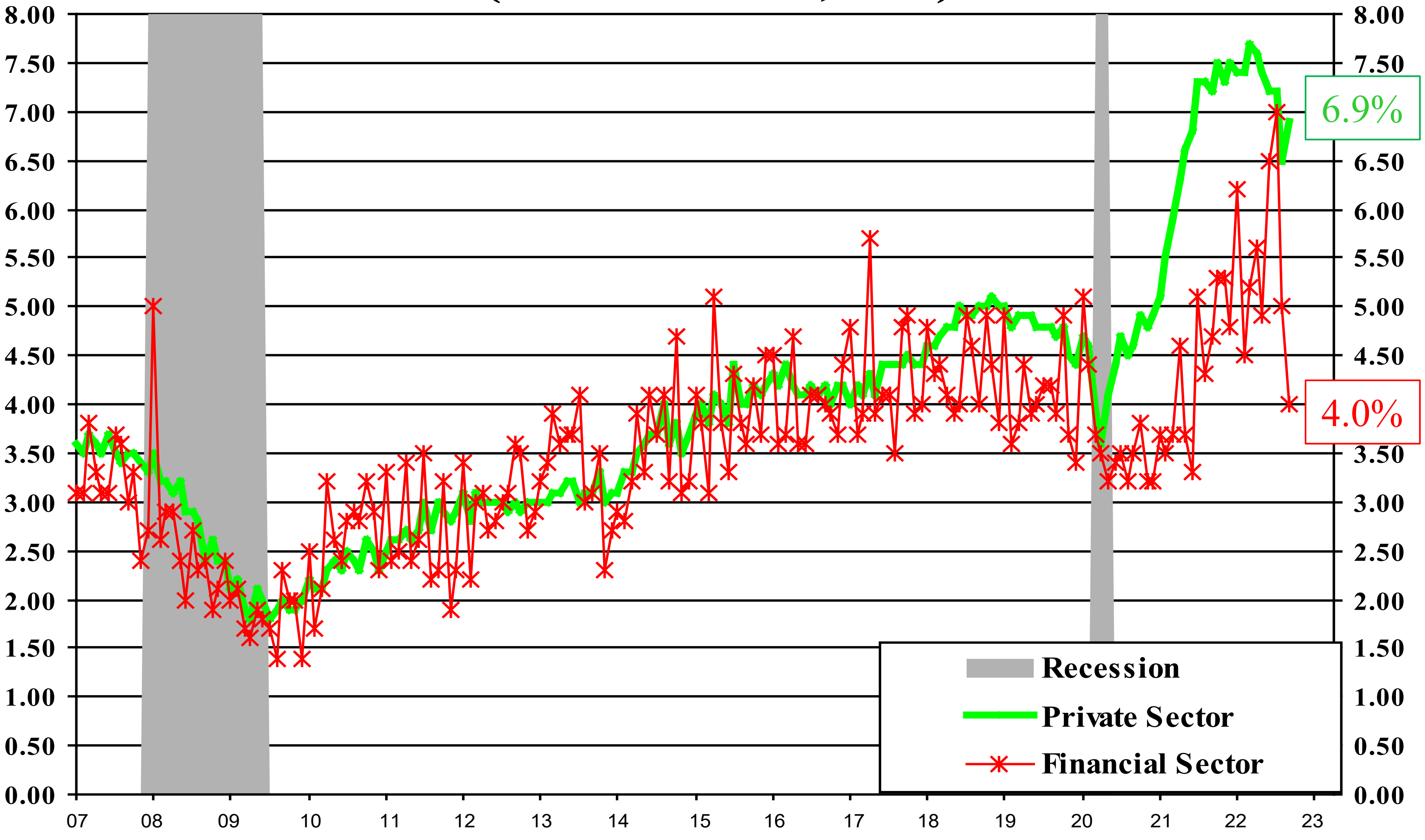
Job Openings Rate is the number of job openings on the last business day of the month as a percent of total employment plus job openings.

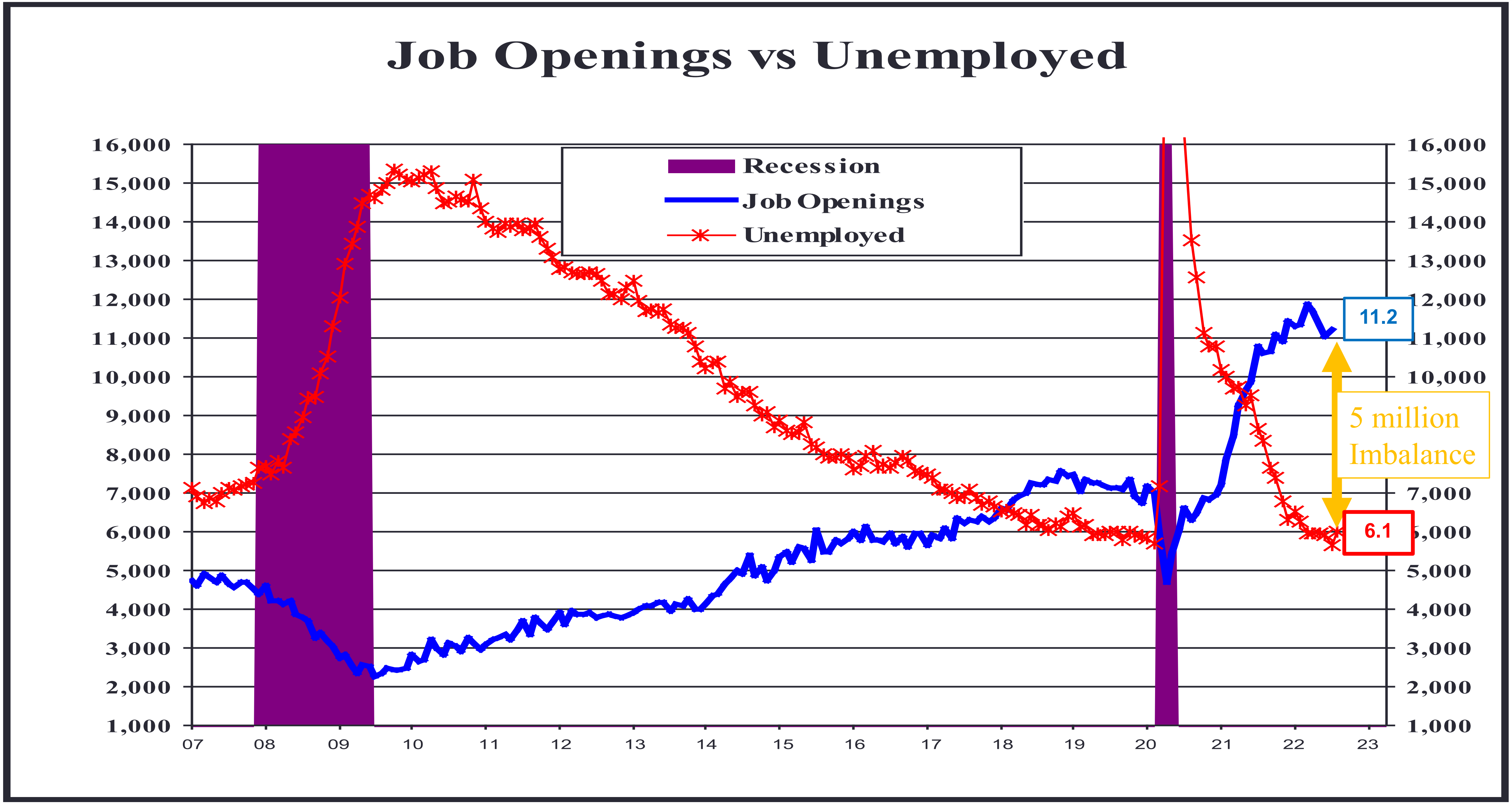
Job Openings Rate VS Quit Rate

Quit Rate is the number of voluntary separations by employees as a percent of total employment

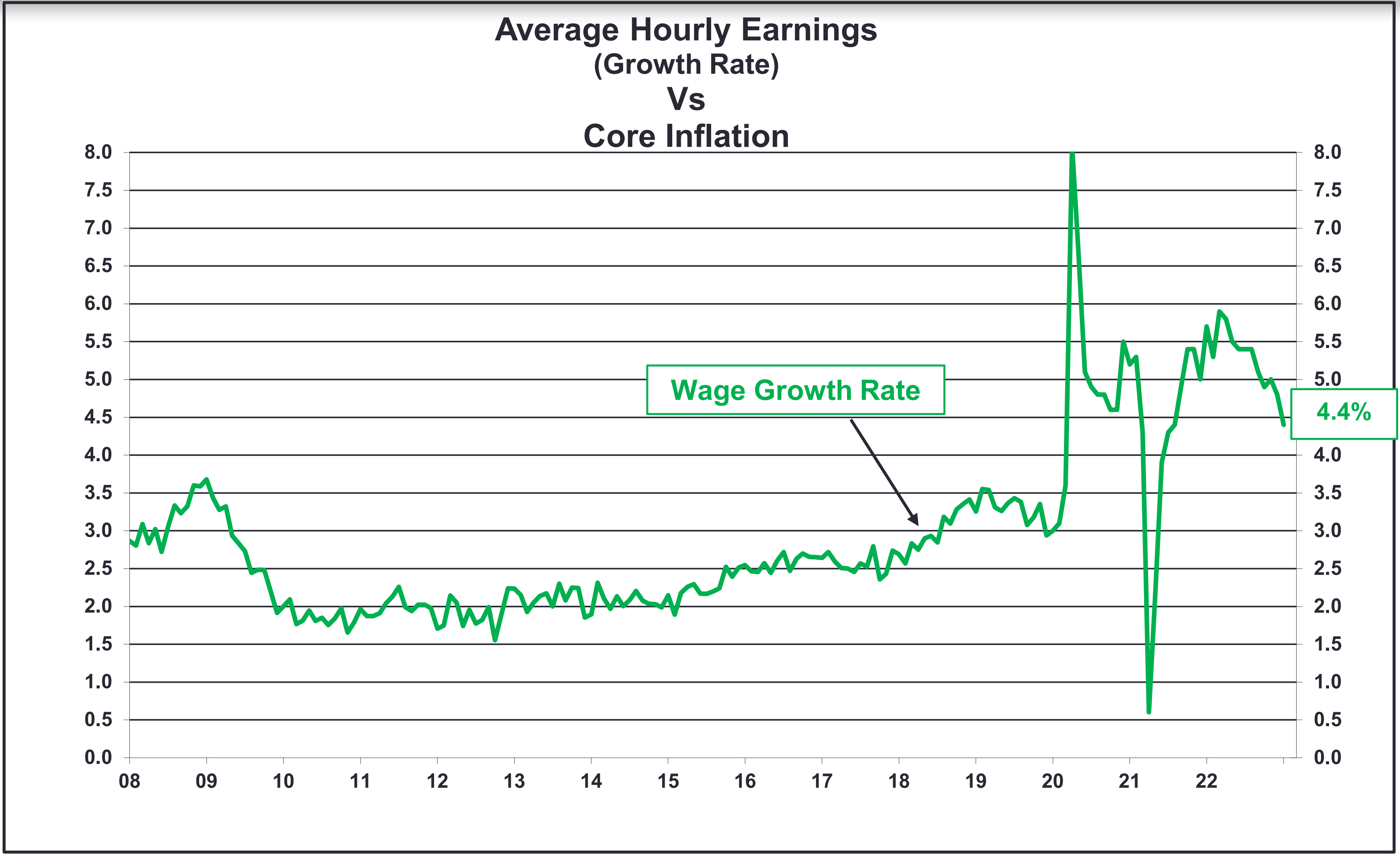
Job Openings Rate is the number of job openings on the last business day of the month as a percent of total employment plus job openings.

Job Openings Rate (Thousands, SA)

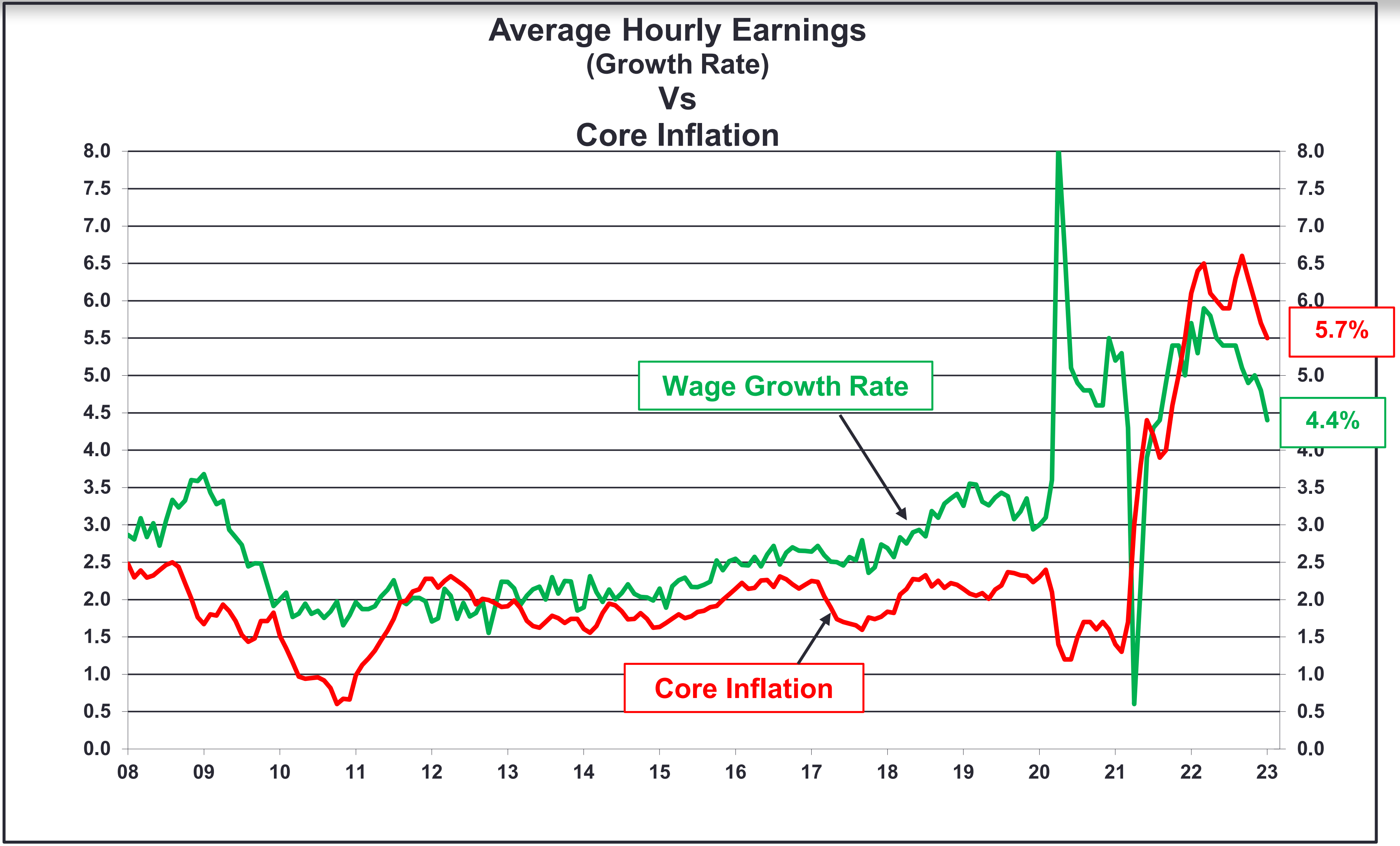



Job Openings vs Unemployed
Recession
Job Openings
Unemployed
16,000
15,000
14,000
13,000
12,000
11,000
10,000
9,000
8,000
7,000
6,000
5,000
4,000
3,000
2,000
1,000
07
08
09
10
11
12
13
14
15
16
17
18
19
20
21
22
23
11.2
5 million
Imbalance
6.1

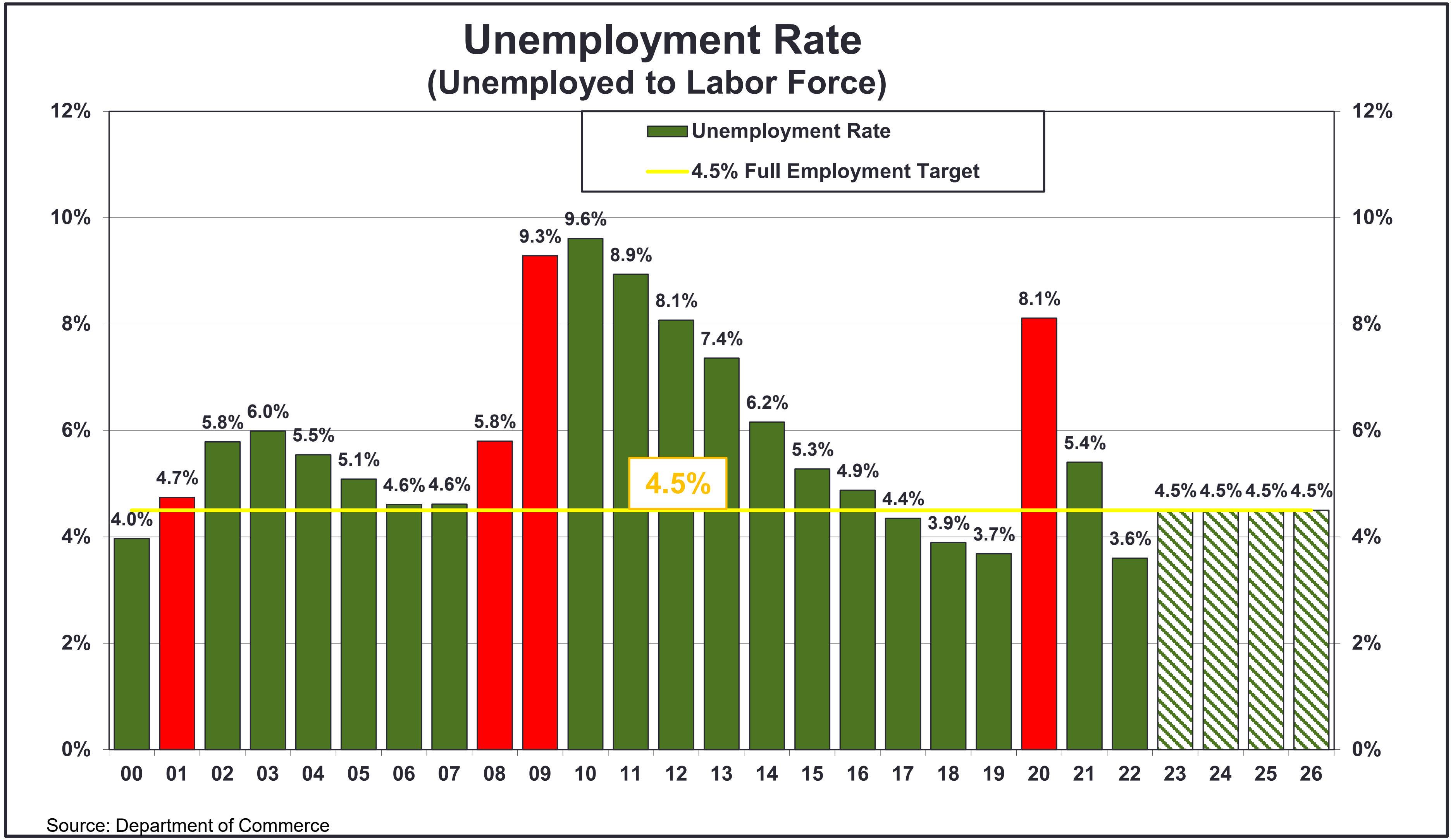
Wage Growth Exceeds 5%
Since October 2021



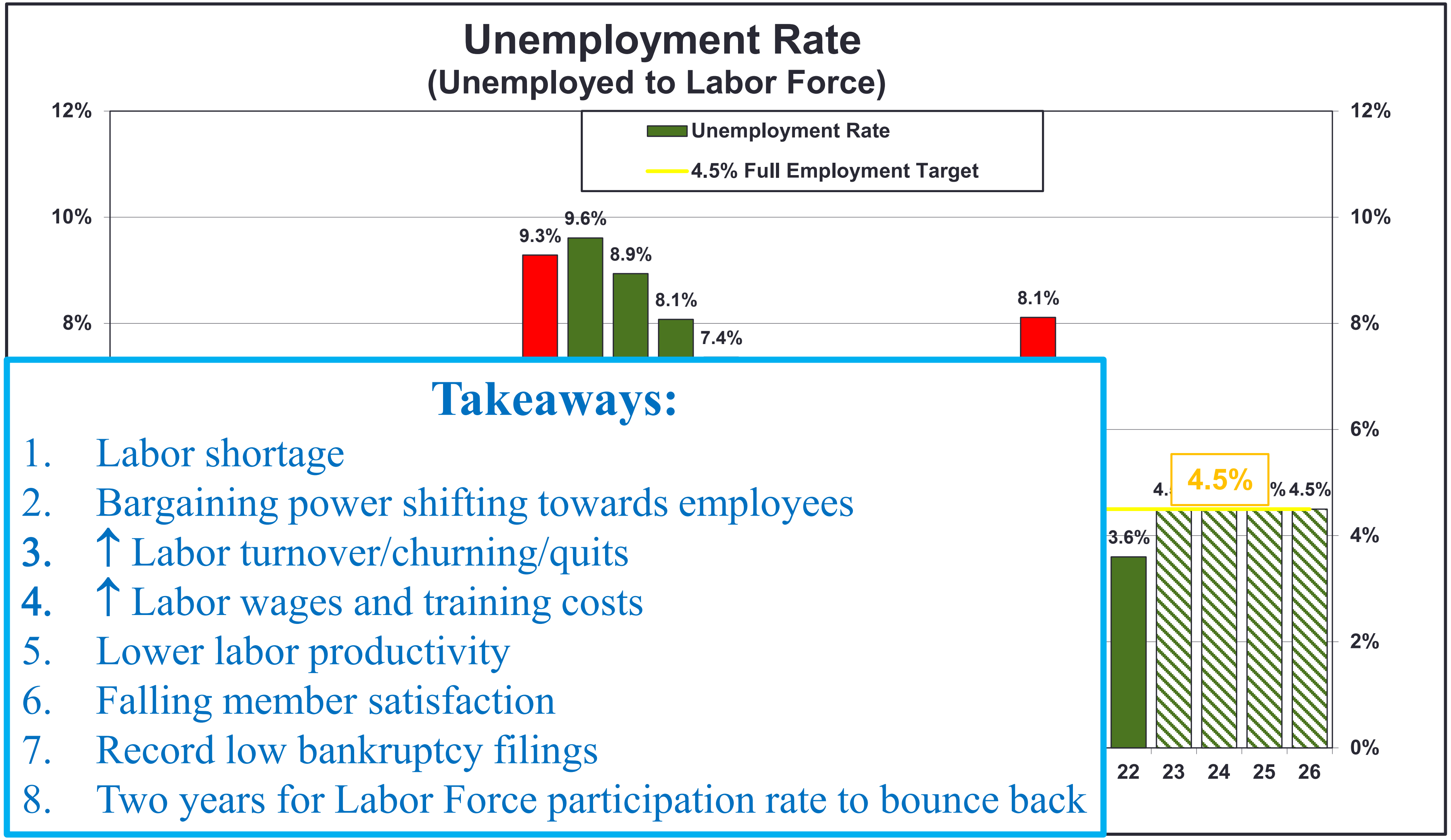
Wage Growth Exceeds 4.4% Since August 2021



Unemployment Rate Rising to the Natural Rate in 2023



Unemployment Rate Below Normal for Next 2 Years



Takeaways:

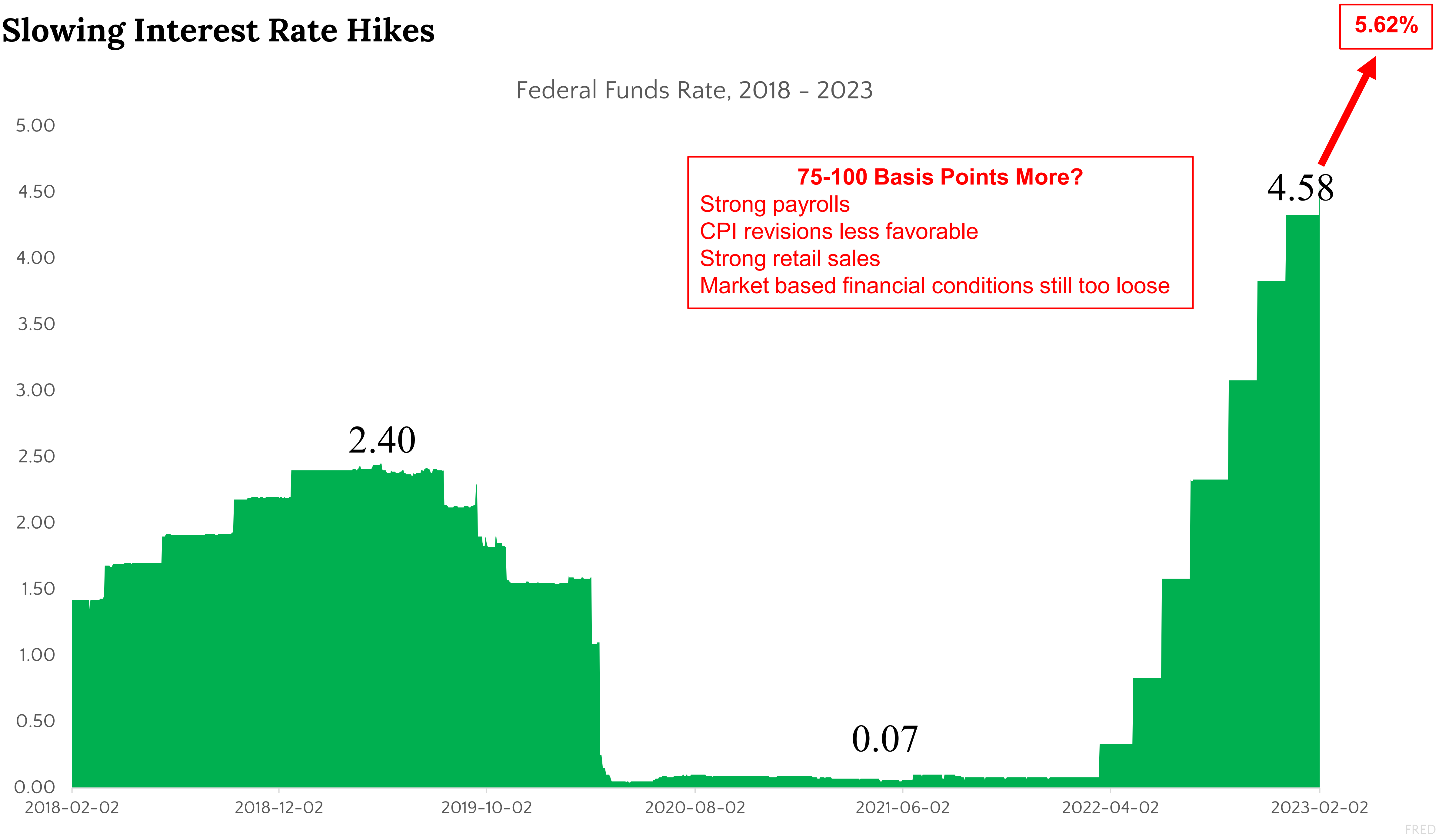
1. Labor shortage
2. Bargaining power shifting towards employees
3. ↑ Labor turnover/churning/quits
4. ↑ Labor wages and training costs
5. Lower labor productivity
6. Falling member satisfaction
7. Record low bankruptcy filings
8. Two years for Labor Force participation rate to bounce back

What is the most important price in any economy?

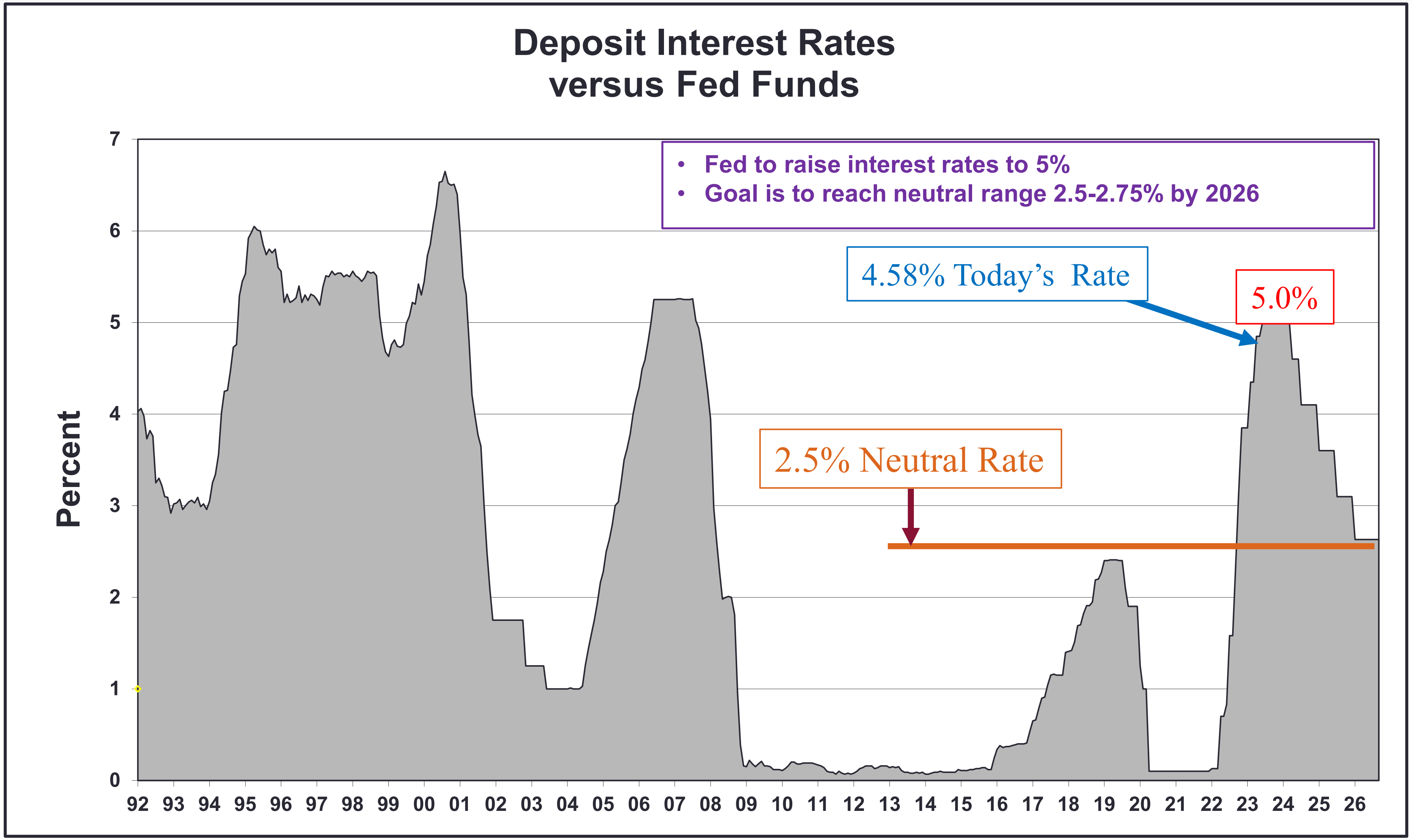
The Price of Money

Interest Rates

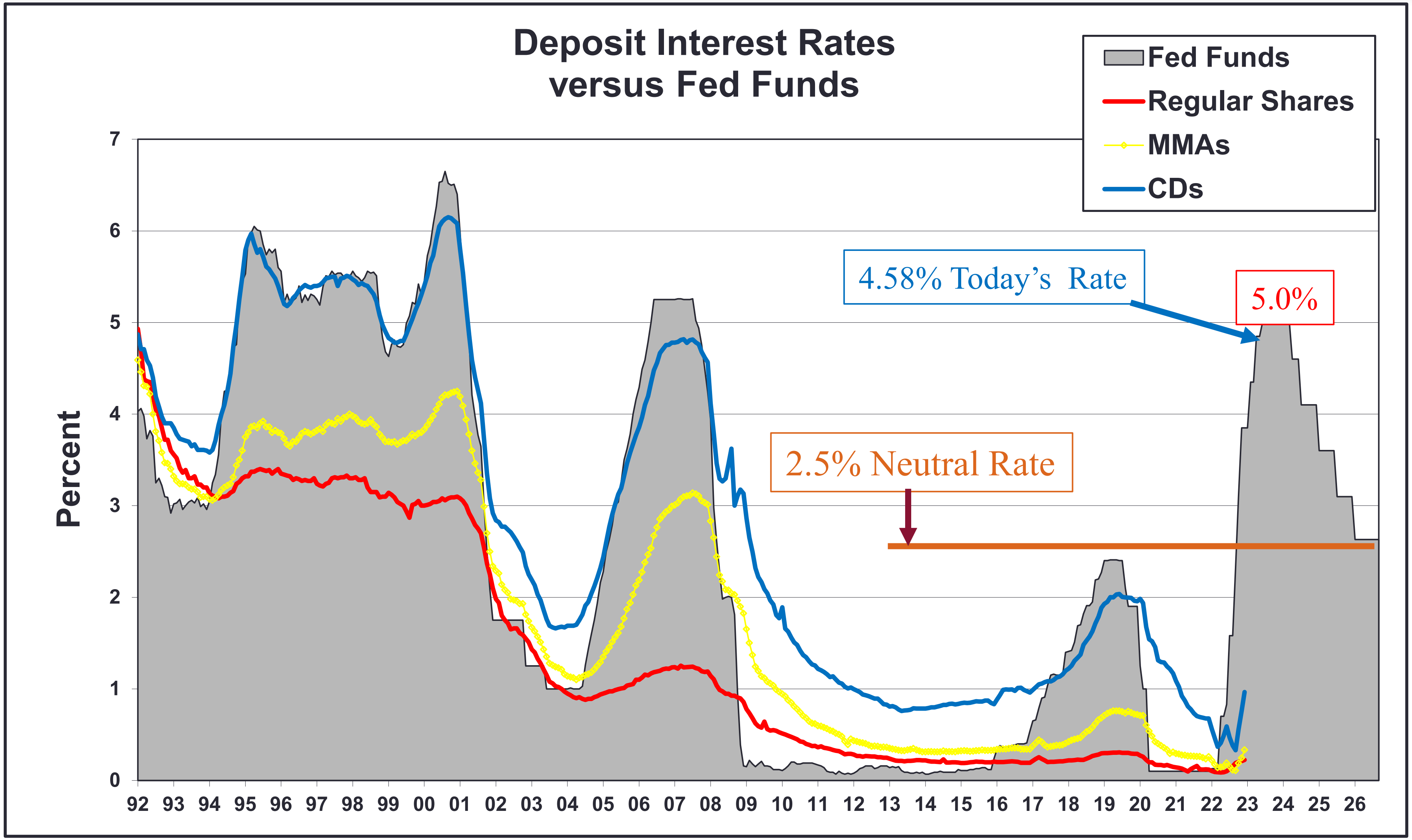
Slowing Interest Rate Hikes

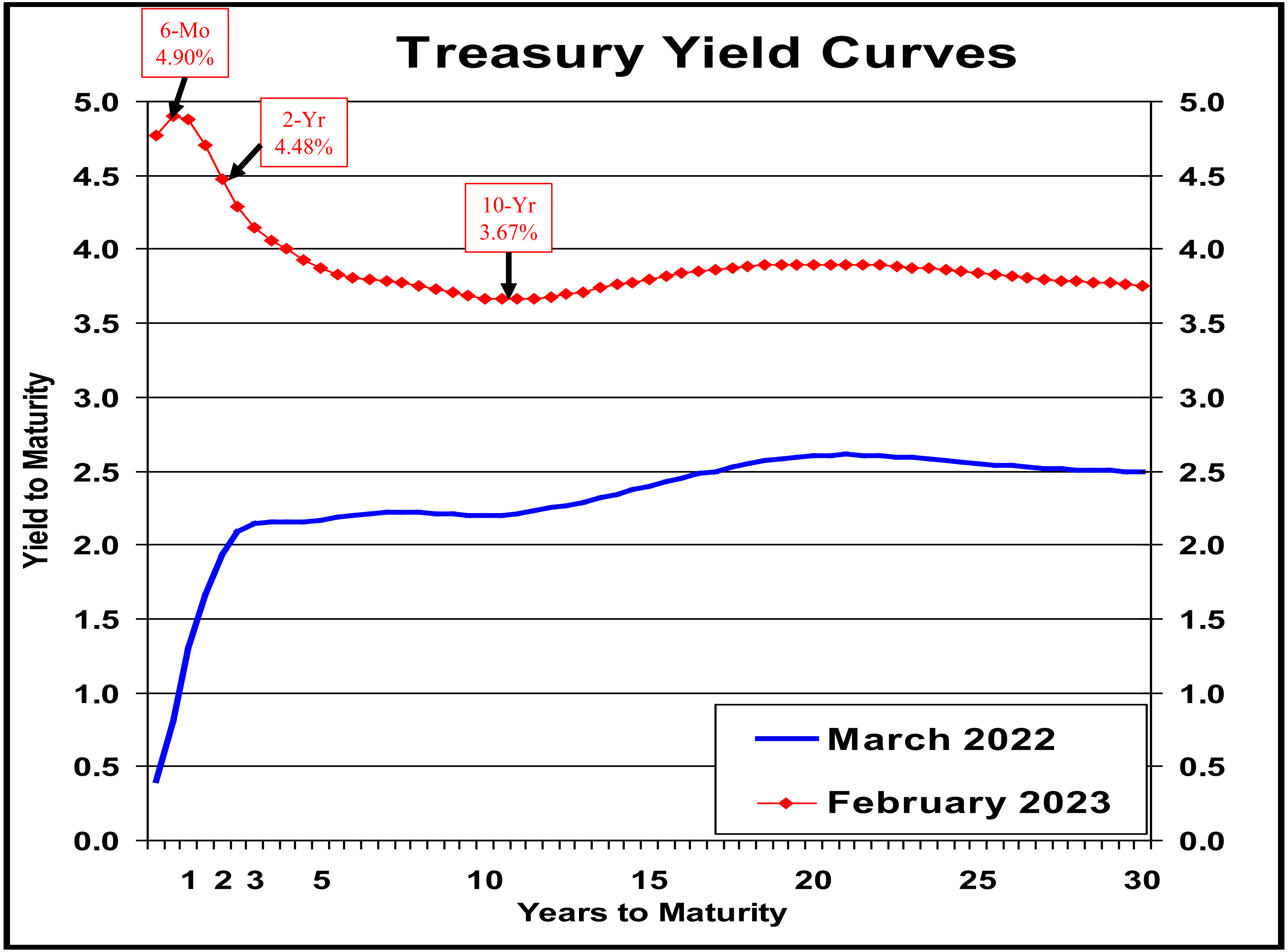


Rising Fed Funds Interest Rate and Deposit Pricing

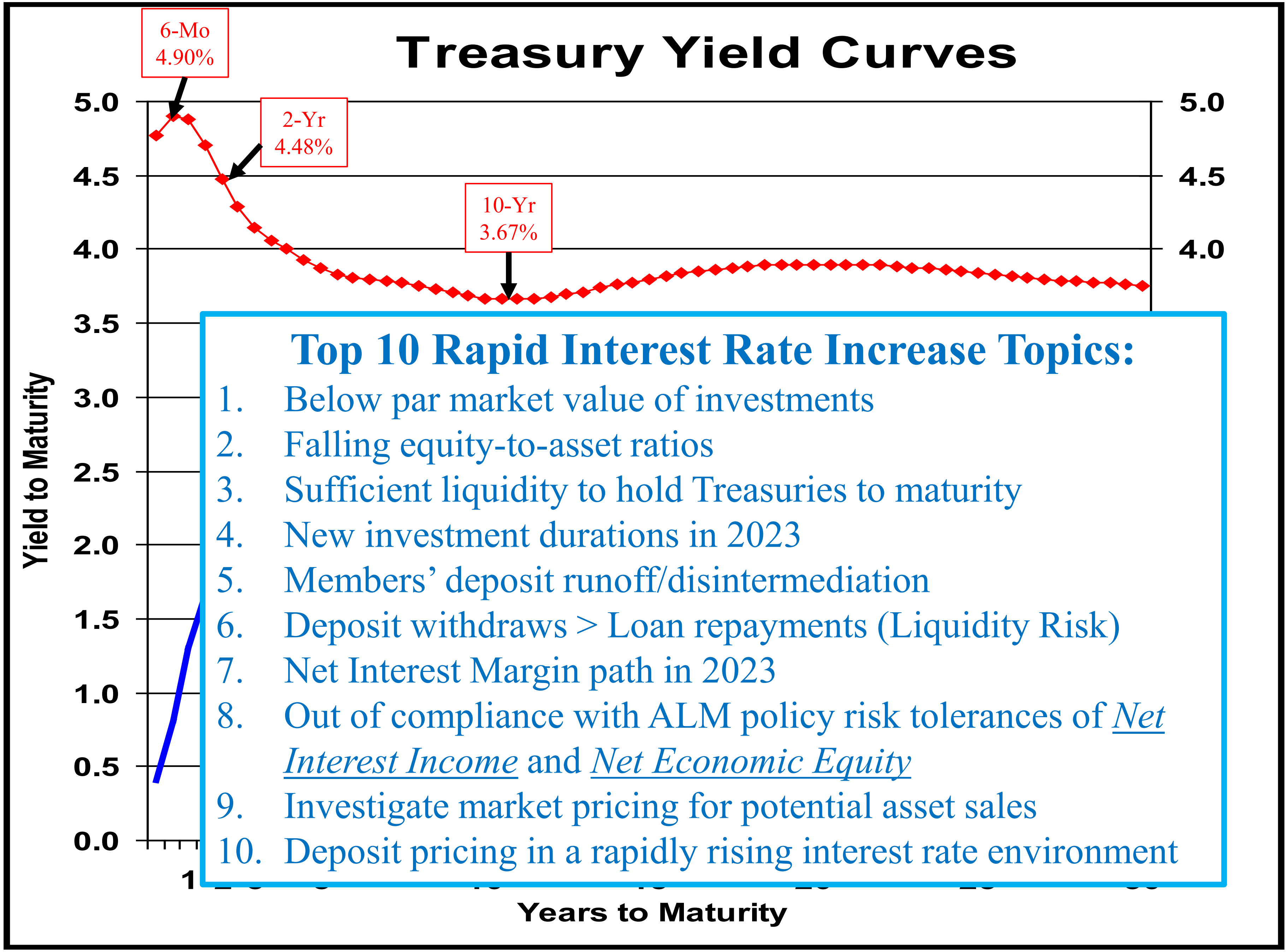


Rising Fed Funds Interest Rate and Deposit Pricing





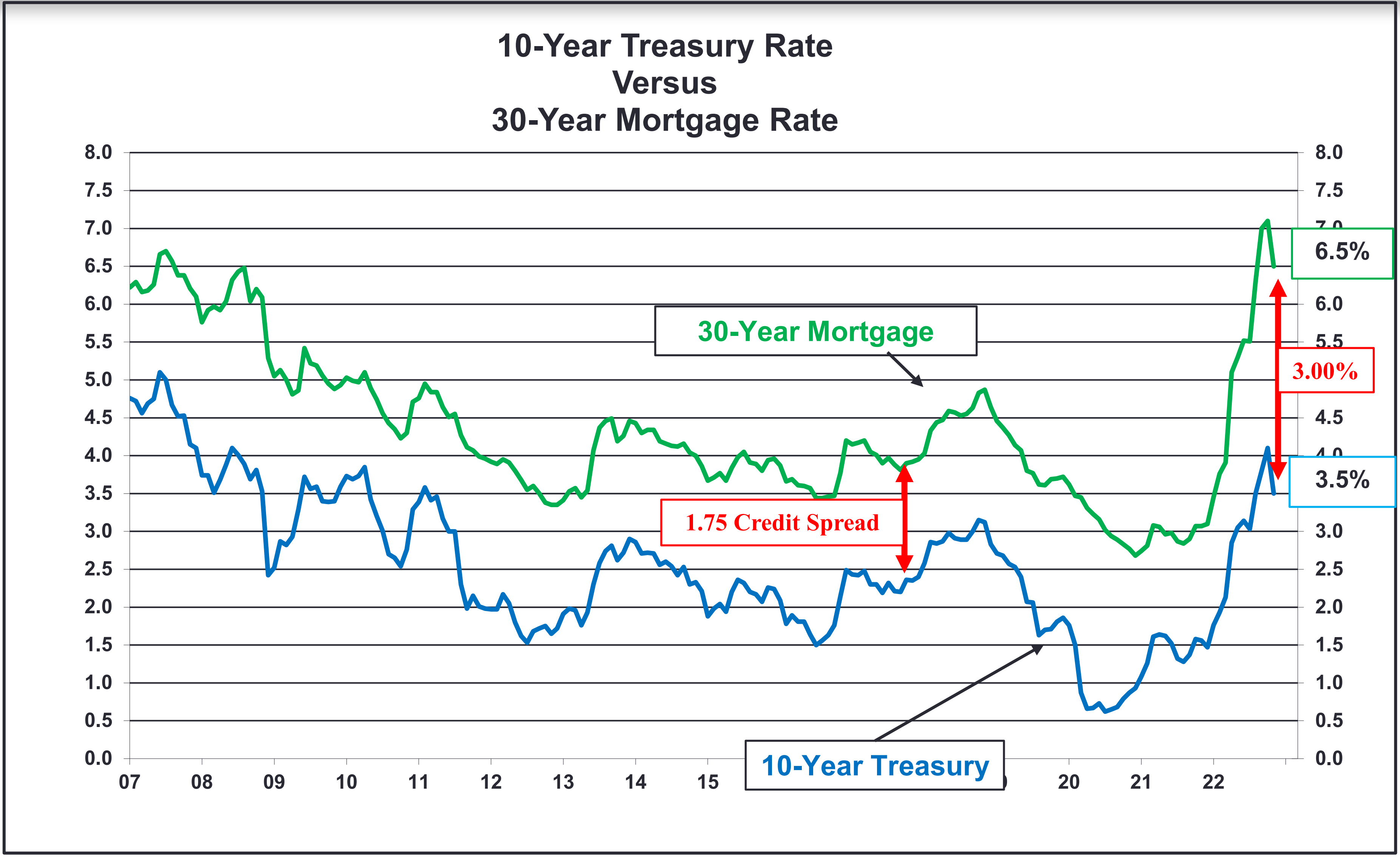
Treasury Yield Curves
6-Mo
4.90%
2-Yr
4.48%
10-Yr
3.67%
Yield to Maturity
Years to Maturity
5.0
4.5
4.0
3.5
3.0
2.5
2.0
1.5
1.0
0.5
0.0
1 2 3 5 10 15 20 25 30
March 2022
February 2023

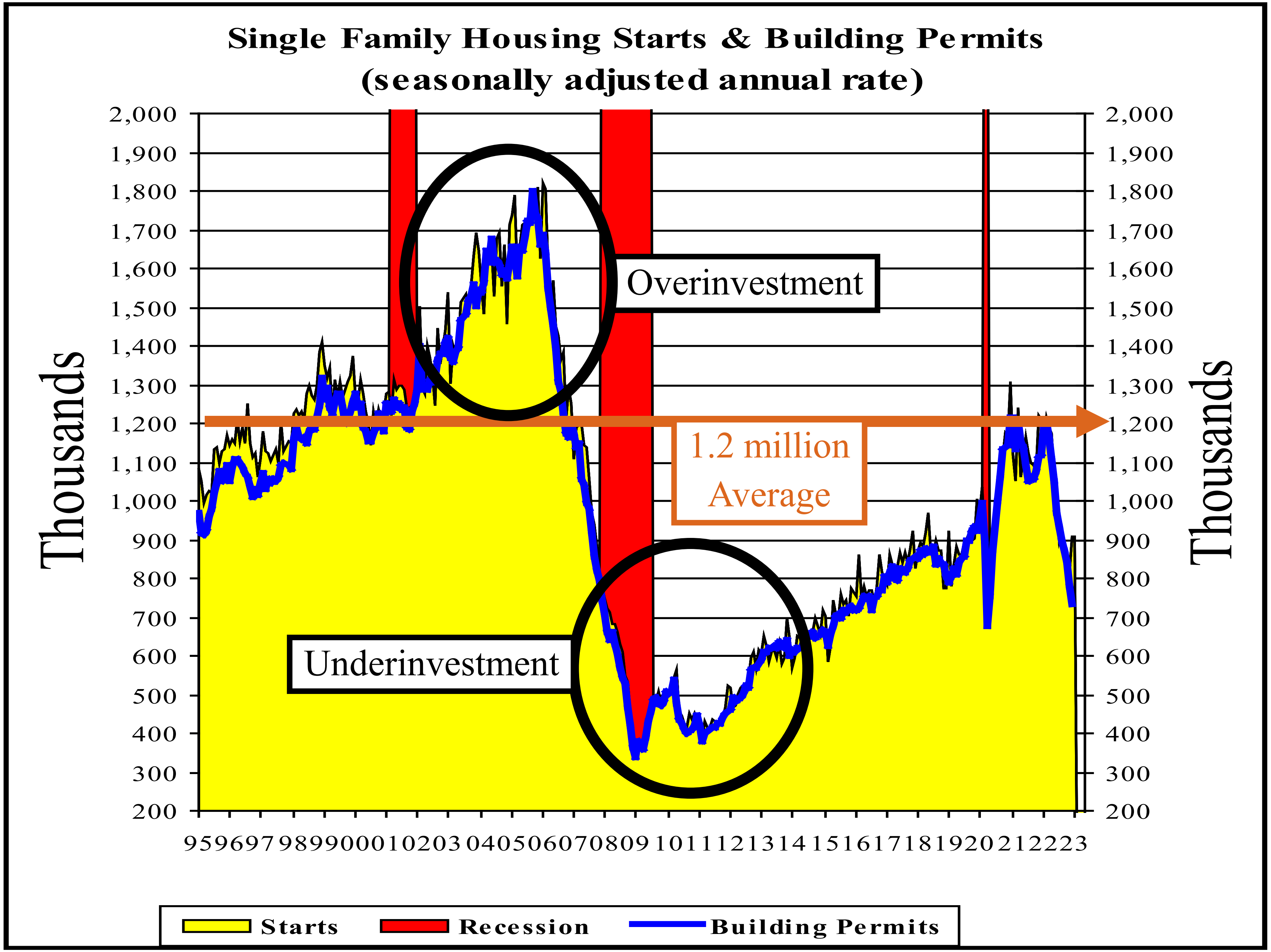


Top 10 Rapid Interest Rate Increase Topics:

1. Below par market value of investments
2. Falling equity-to-asset ratios
3. Sufficient liquidity to hold Treasuries to maturity
4. New investment durations in 2023
5. Members' deposit runoff/disintermediation
6. Deposit withdraws > Loan repayments (Liquidity Risk)
7. Net Interest Margin path in 2023
8. Out of compliance with ALM policy risk tolerances of *Net Interest Income* and *Net Economic Equity*
9. Investigate market pricing for potential asset sales
10. Deposit pricing in a rapidly rising interest rate environment

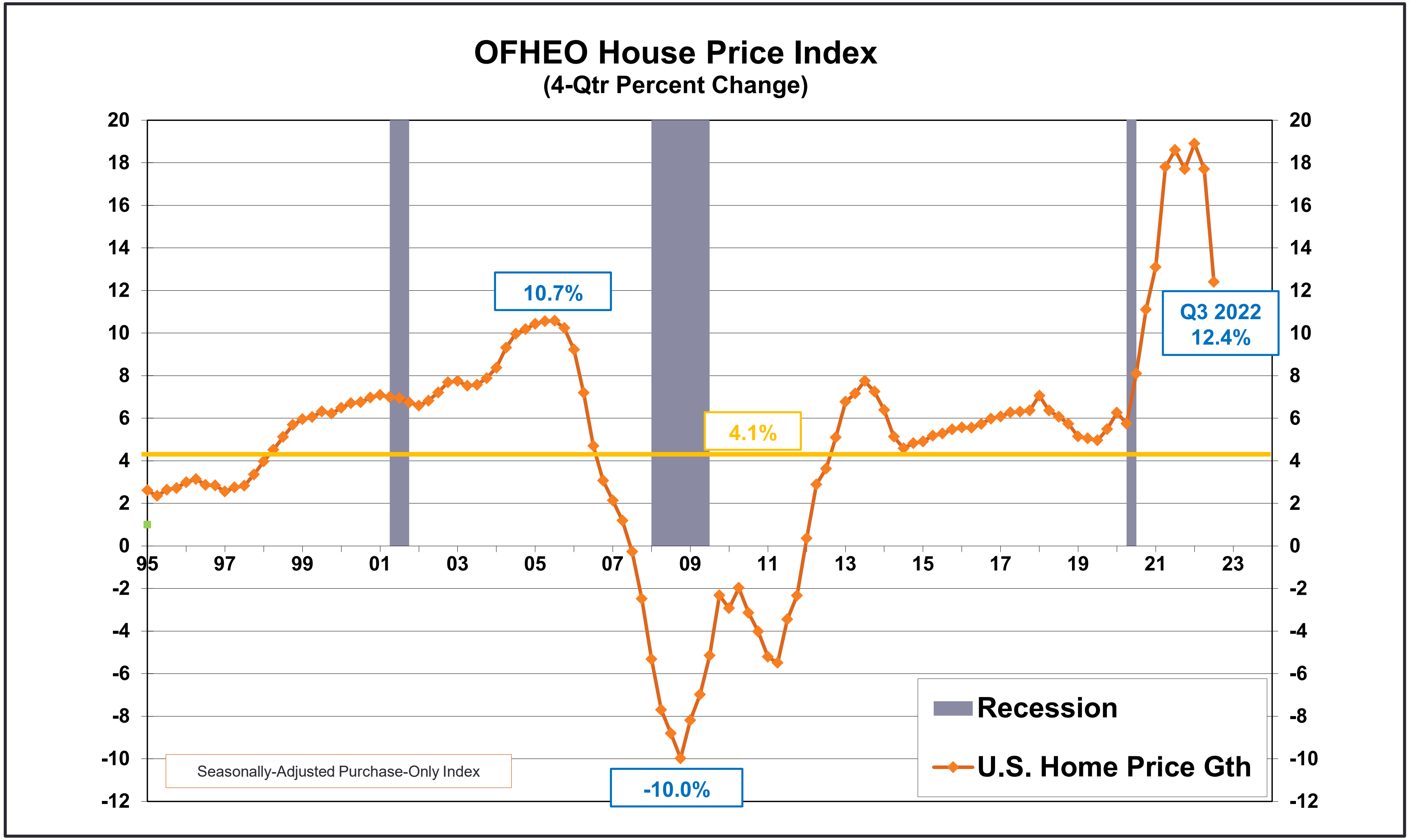
Rising Real Interest Rates, and Rising Inflation Expectations will Push Up Nominal Interest Rates



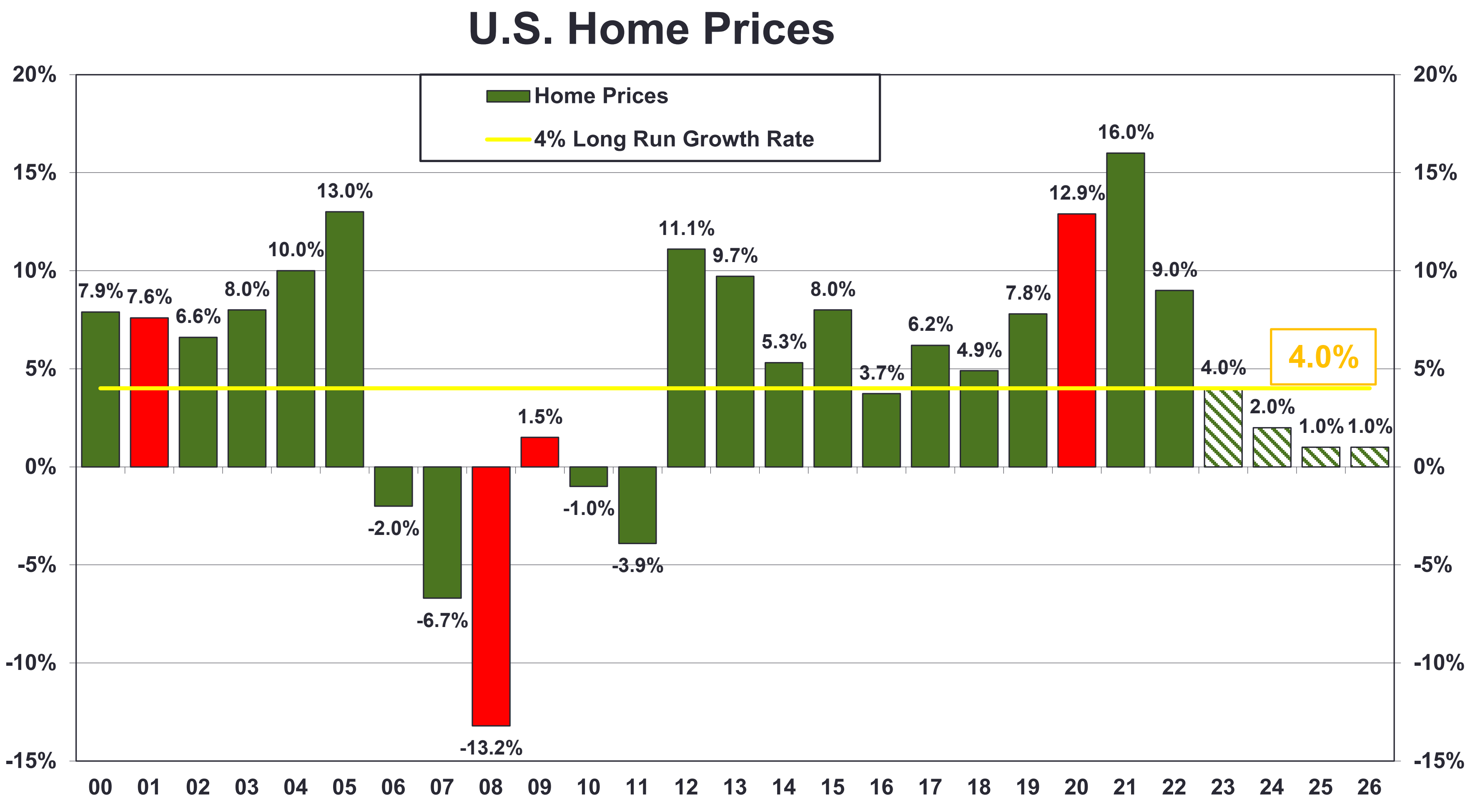


Single Family Housing Starts & Building Permits
(seasonally adjusted annual rate)
Thousands
2,000
1,900
1,800
1,700
1,600
1,500
1,400
1,300
1,200
1,100
1,000
900
800
700
600
500
400
300
200
95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10 11 12 13 14 15 16 17 18 19 20 21 22 23
Overinvestment
Underinvestment
1.2 million Average
Starts
Recession
Building Permits

Home Price Appreciation is Slowing

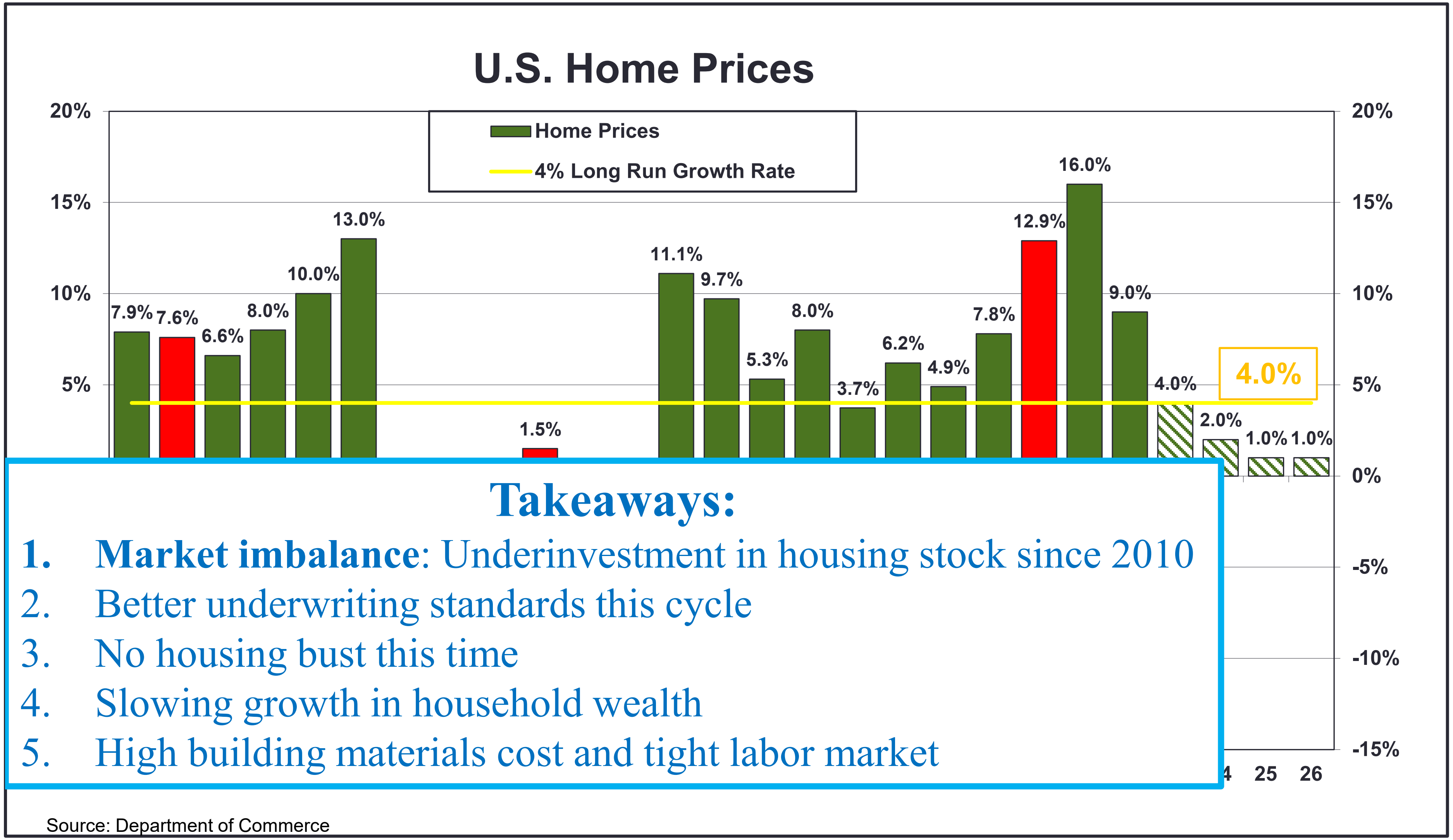


Home Price Growth Rate Slowing



Source: Department of Commerce

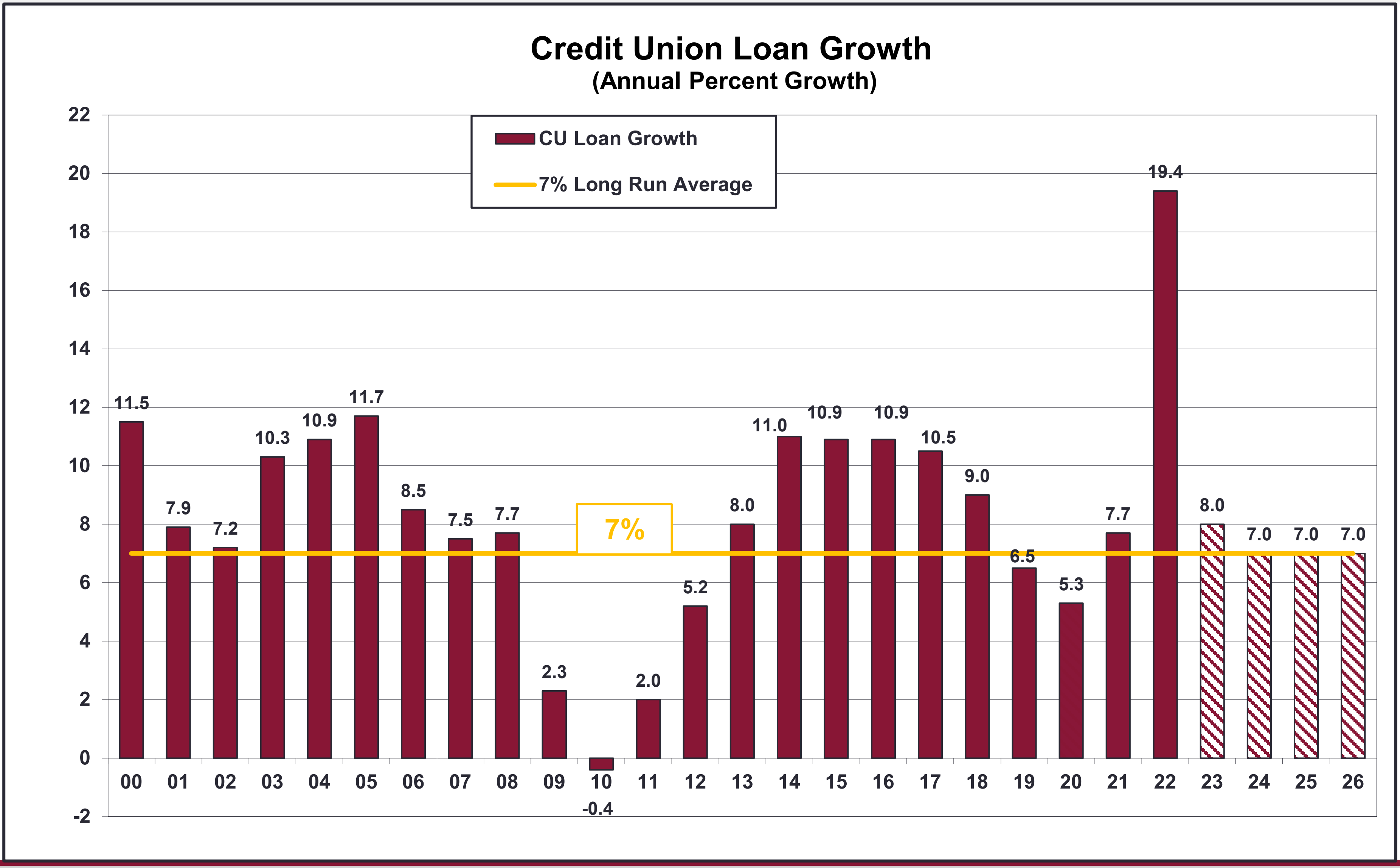
Home Price Growth Rate Slowing



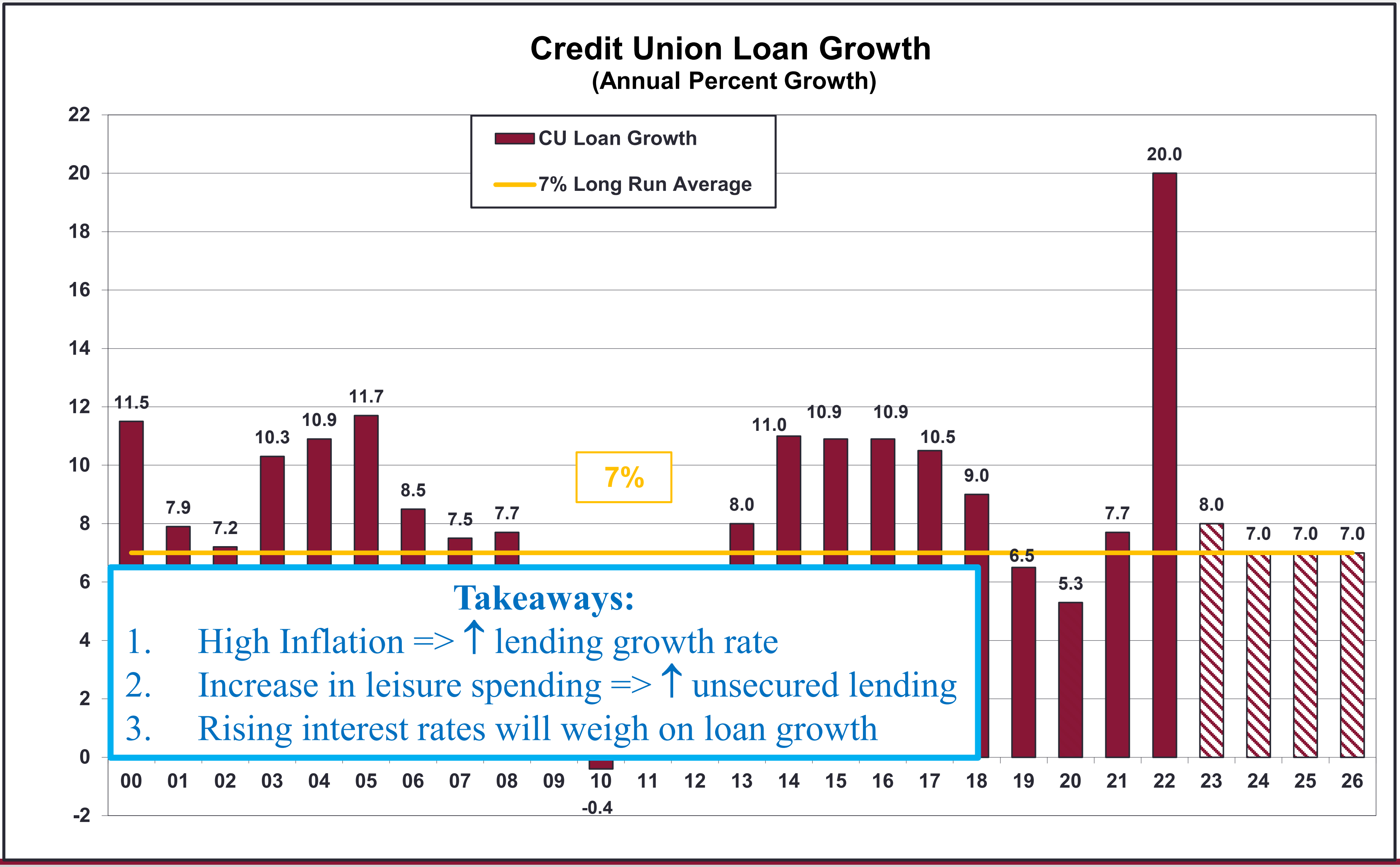
Takeaways:

1. **Market imbalance**: Underinvestment in housing stock since 2010
2. Better underwriting standards this cycle
3. No housing bust this time
4. Slowing growth in household wealth
5. High building materials cost and tight labor market

Above Trend Credit Union Loan Growth

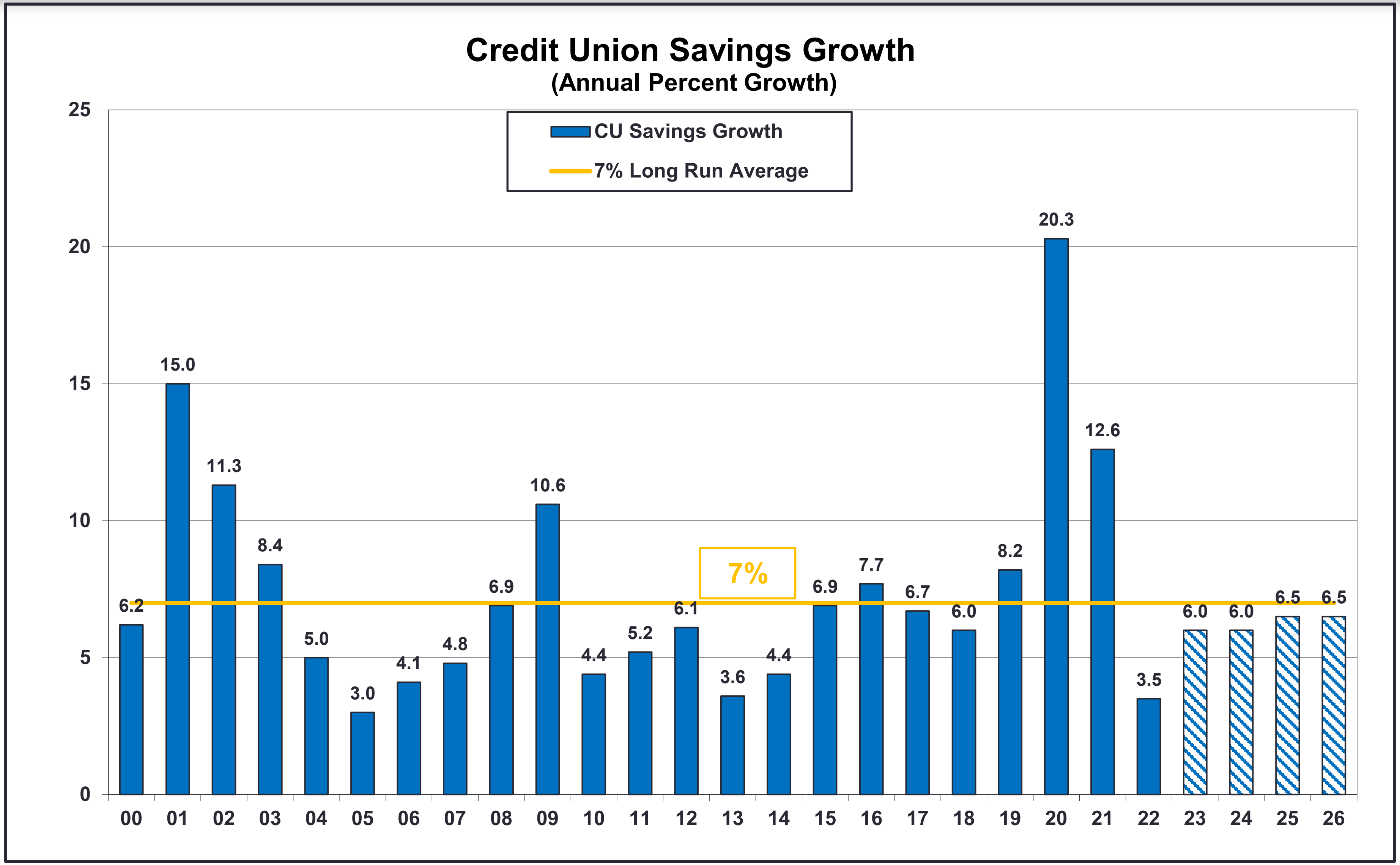


Above Trend Credit Union Loan Growth

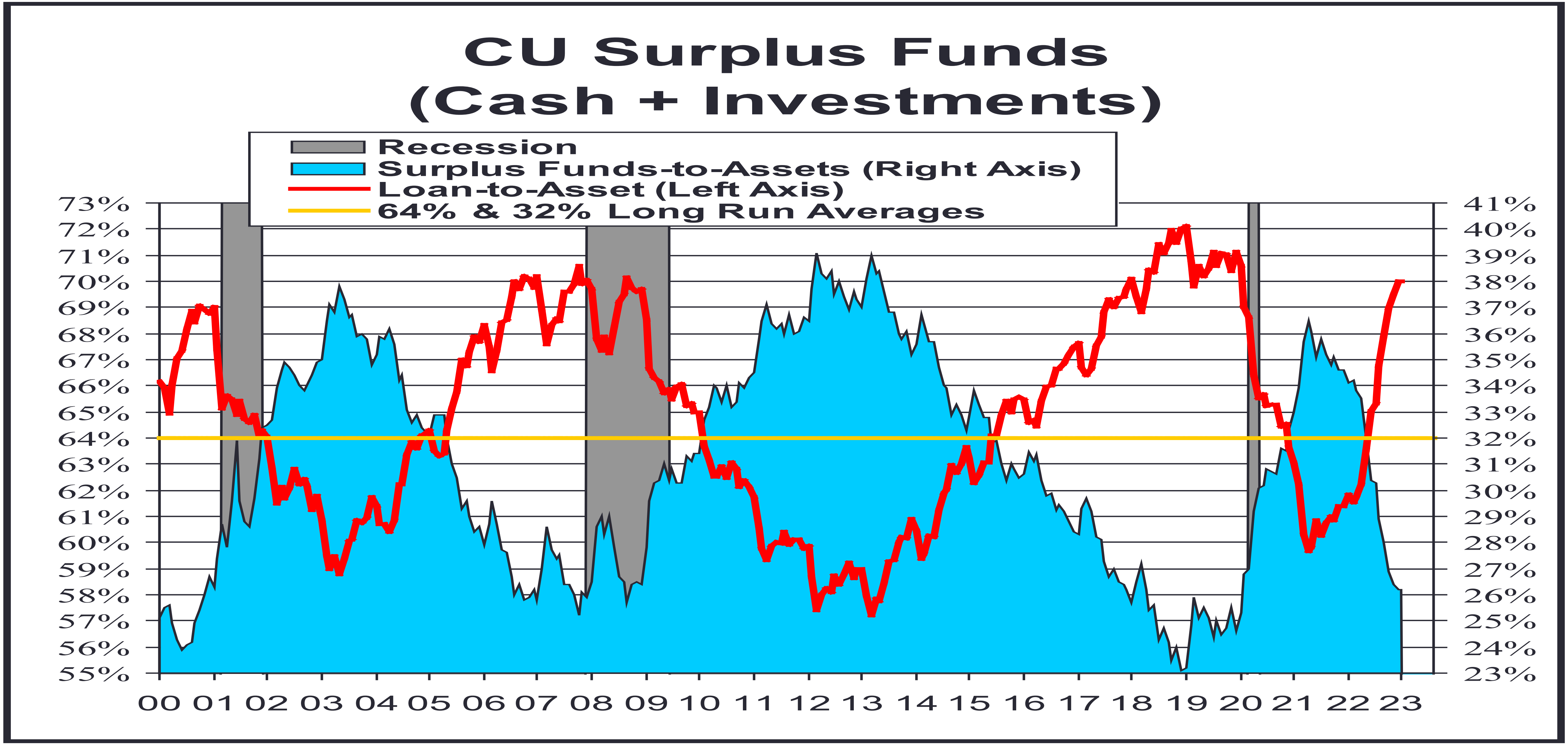


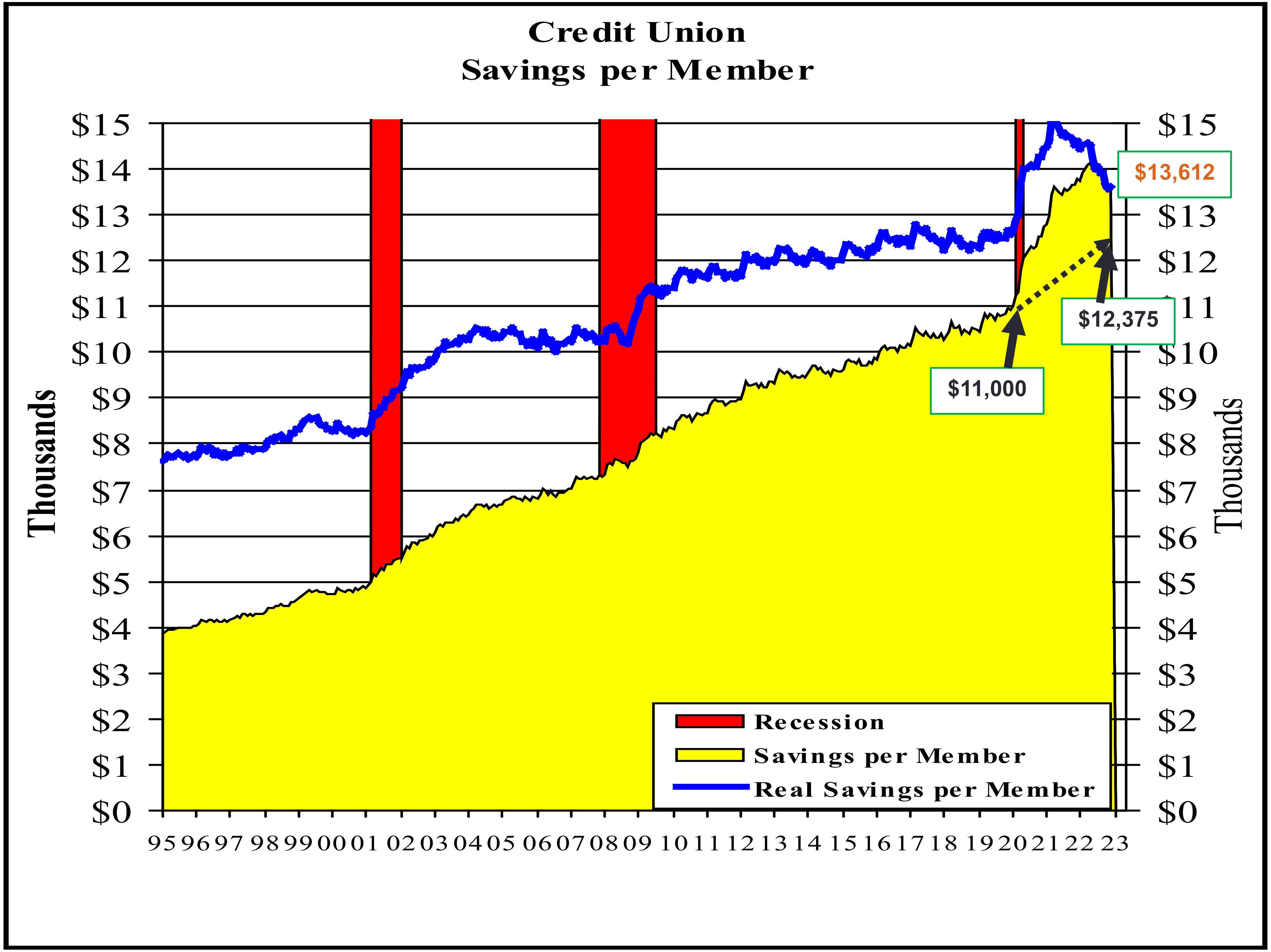
Takeaways:
1. High Inflation => ↑ lending growth rate
2. Increase in leisure spending => ↑ unsecured lending
3. Rising interest rates will weigh on loan growth

Below Trend Credit Union Saving Growth in 2023

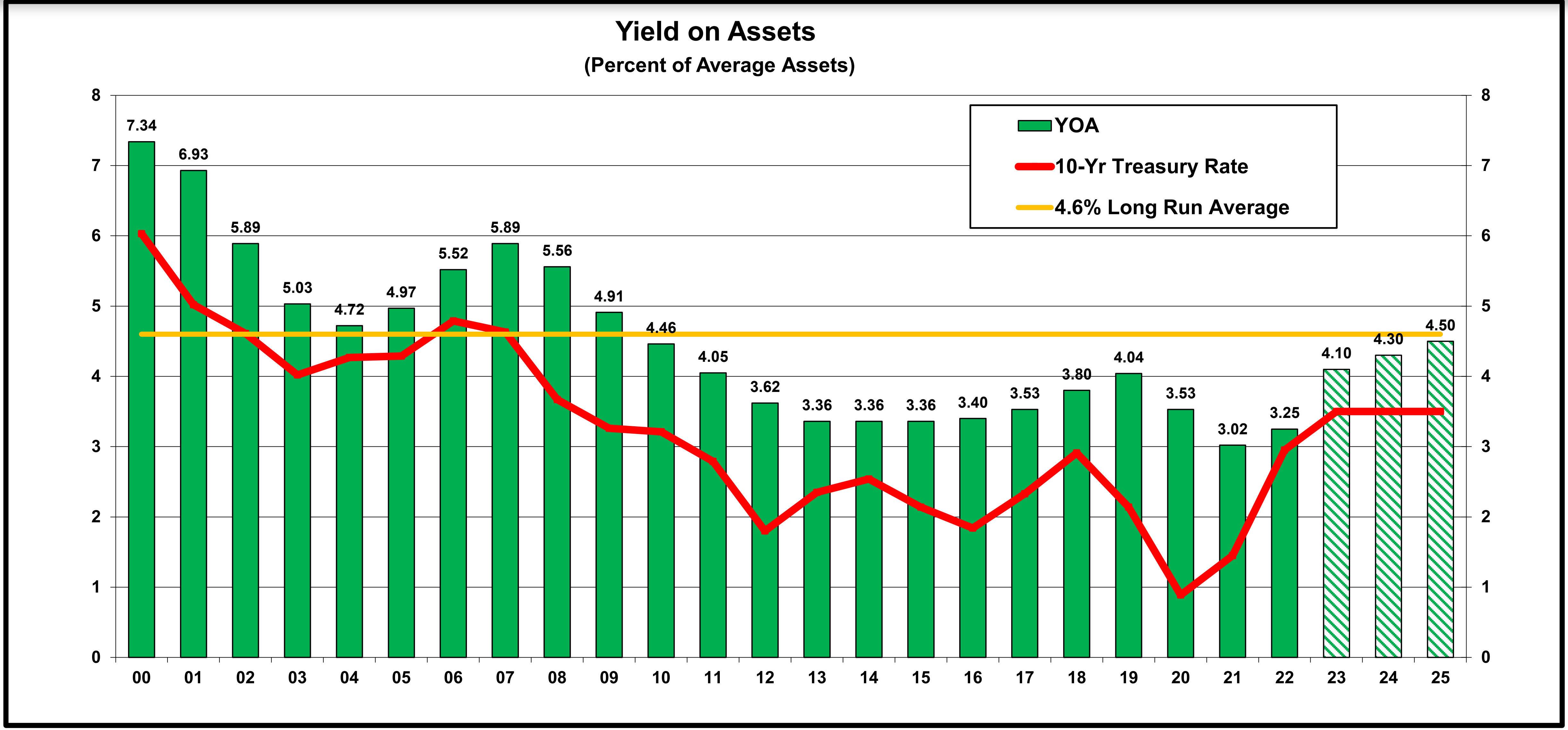


Investments Are Falling and Yields Are Rising

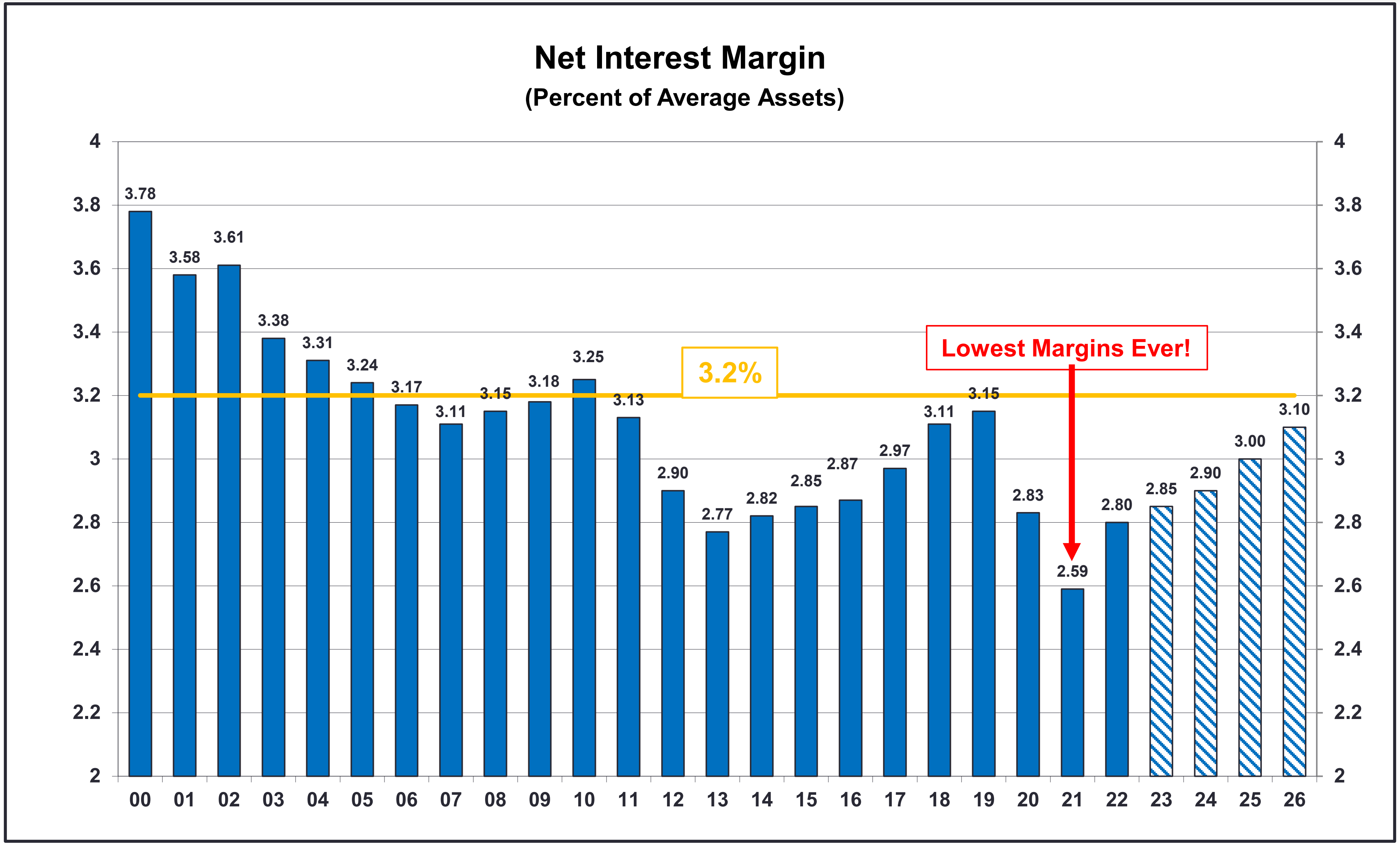



Credit Union
Savings per Member
$15
$14
$13
$12
$11
$10
$9
$8
$7
$6
$5
$4
$3
$2
$1
$0
Thousands
$13,612
$12,375
$11,000
Recession
Savings per Member
Real Savings per Member
95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10 11 12 13 14 15 16 17 18 19 20 21 22 23

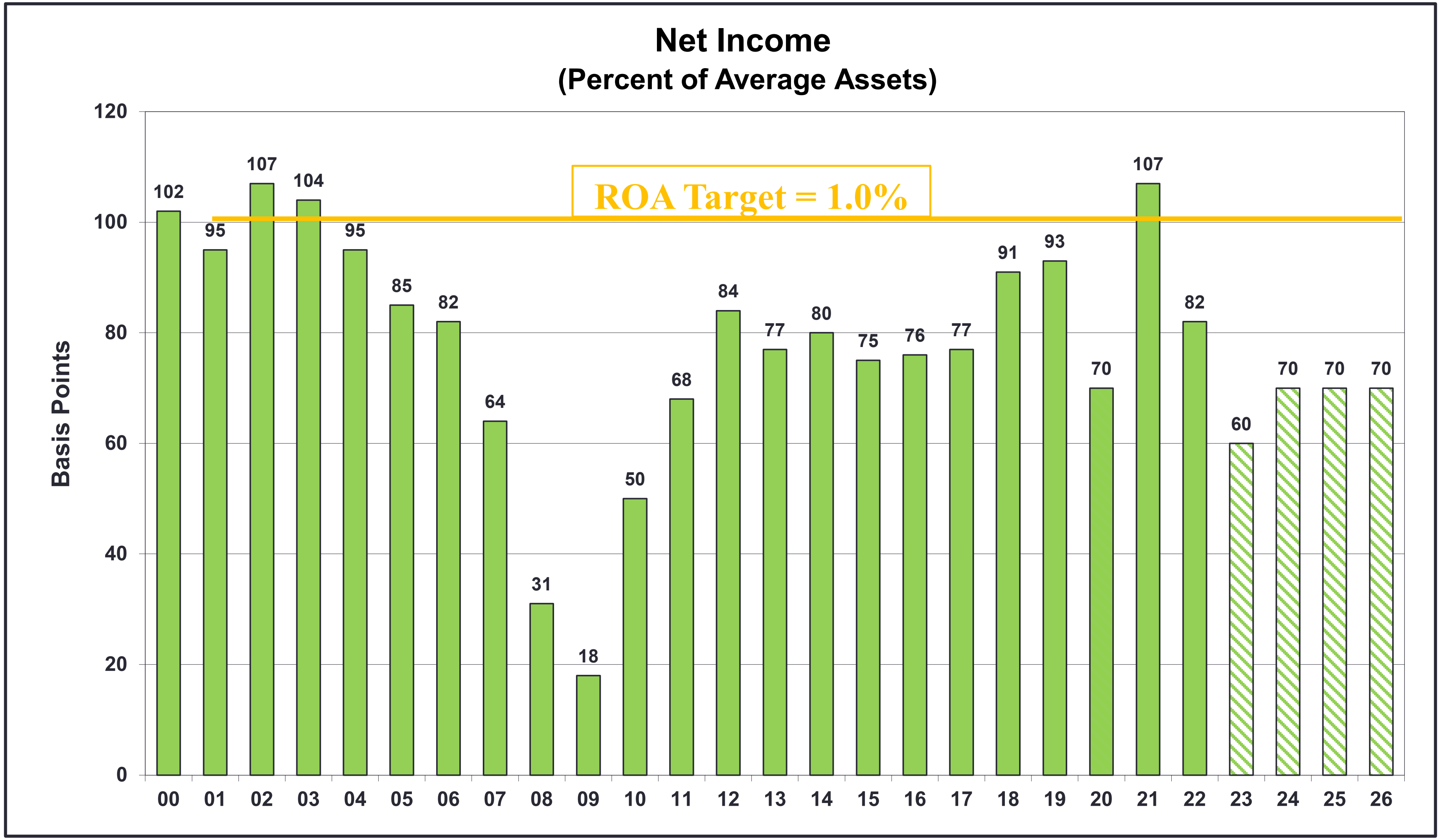
Rising Yield-on-Asset Ratios



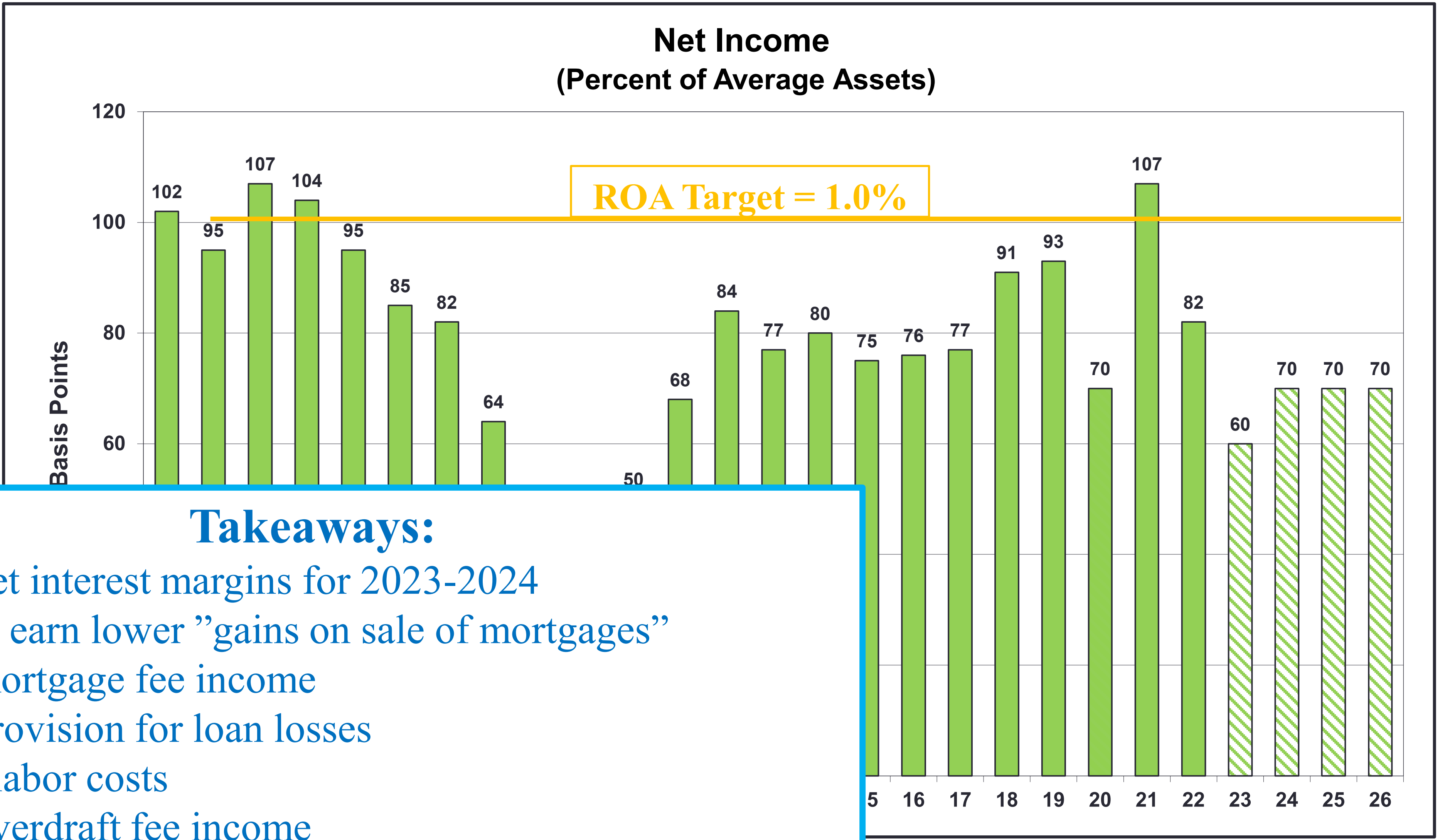
Net Interest Margins will Rise in 2023



Credit Union Earnings Below Trend in 2023



Credit Union Earnings Below Trend in 2023



Takeaways:

1. Rising net interest margins for 2023-2024
2. CUs will earn lower ”gains on sale of mortgages”
3. Lower mortgage fee income
4. Rising provision for loan losses
5. Surging labor costs
6. Lower overdraft fee income

Economic Update Summary For 2023

1. Slow economic growth for the next year
2. Falling inflation rate during the next 2 years
3. Unemployment rate rising to natural rate in 2023
4. Short-term interest rates above long-term interest rates in 2023
5. Credit union loan growth slowing in 2023
6. Rising net interest margins in 2023
7. Credit union mortgage originations falling 15-20% in 2023

Economic forecast
February 2023

	Past results		Quarterly results/forecasts				Annual forecasts	
	Previous 10 Yr. Avg	2022	2023:1	2023:2	2023:3	2023:4	2023	2024
Growth rates:								
Economic Growth (% chg GDP)*	2.1%	2.1%	1.5%	1.5%	-1.0%	0.0%	0.5%	
Inflation (CPI, 12 mth % chg)	2.2%	6.5%	6.0%	5.0%	4.0%	3.5%	3.5%	
Unemployment Rate (BLS)	6.0%	3.5%	3.7%	3.8%	4.0%	4.2%	4.2%	
Federal Funds Rate (effective)	0.58%	4.33%	4.88%	5.10%	5.10%	5.10%	5.1%	
10-Year Treasury Rate	2.11%	3.88%	3.50%	3.50%	3.50%	3.50%	3.5%	
10-Year-Fed Funds Spread	1.53%	-0.45%	-1.38%	-1.60%	-1.60%	-1.60%	-1.60%	

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

Economic Forecast
January 2023

Economic Growth. After small declines in real GDP in the first two quarters of 2022, modest growth resumed in the third quarter. The fourth quarter started out quite strong but showed signs of softening in December. We expect continued weakness moving into 2023, with a mild recession beginning in the second half. With the Federal Reserve keeping the Federal Funds rate close to 5% throughout the year, the headwinds to various spending categories will mount. Residential construction and business investment will be hardest hit, but higher interest rates will also slow consumer spending. Weak growth or outright recessions at many or the US's major trading partners will hurt exports. We expect GDP growth of 0.5% for the full year 2023, down from 1% in 2022.

Inflation. The really encouraging news as 2022 came to a close was the substantial improvement in inflation over the past several months. After peaking at 9% in June, the trailing twelve month increase in the consumer price index (CPI) was down to 6.4% as of December. The "core" inflation rate (all items less food and energy) peaked at 6.7% in September and was down to 5.7% in by yearend. The slowdown in the all-items measure is due to a sharp drop in inflation in the fourth quarter (to only 1.8% at an annualized rate) caused largely by falling gasoline prices. The more sticky core index also fell in the fourth quarter, but only to 3.2% at an annual rate. It's too early to declare victory in the battle against inflation, but if it continues to moderate as it did in the fourth quarter, the chances of avoiding a recession increase. We expect inflation for all of 2023 to come in at 3.5%.

Unemployment. The labor market has softened but by historical measures it is still quite strong. The three-month moving average number of monthly non-farm payrolls increases was 247,000 in December, down from 580,000 in January. The unemployment rate began 2022 at 4%, and has been bouncing between 3.5% and 3.7% since June. These are full-employment type numbers. If the unemployment rate remains between 3.5% and 4% while inflation continues to slow and approach the Fed's 2% target, the economy will have achieved a soft landing. So far so good, but if the slowing in job growth overshoots and becomes a contraction, a recession will have begun. We forecast unemployment to end the year at 4.25%which is consistent with a mild recession.

Interest Rates. As we entered 2023, the Fed Funds rate at between 4.25% and 4.5% was 4.25 points higher than a year ago. Other short-term rates rose by similar amounts. The yield on the 10-year Treasury Note was just over 3.5%, up from 1.5% a year ago. We expect the Fed Funds rate to finish 2023 at around 5%, and the 10-year Treasury rate to remain in a trading range around 3.5% throughout the year. The fact that that long-term rates rose by so much less than short rates last year suggests that the bond market is quite convinced there will be a recession this year. Last January, the ten-year yield was about 80 basis points above the two-year rate. As of January 2023, the two-year rates exceeds the ten-year rate by 70 bp, a reversal of 150 bp. As we've noted before, since World War II, **every** time the yield curve has inverted this much, a recession has followed within six to twelve months. Perhaps this time will be different. The smaller increase in long rates could be due not to investors expecting a recession, but instead expecting a return to more modest inflation a year or two down the road without a recession. But don't count on it.

Credit union forecast
January 2023

	Past results		Quarterly results/forecasts				Annual forecasts	
	10 Yr Avg	2022	2023:1	2023:2	2023:3	2023:4	2023	2024
Growth rates:								
Savings growth	7.8%	3.7%	*3.6%*	0.9%	0.5%	1.0%	6.0%	
Loan growth	7.5%	20.0%	*0.4%*	2.6%	2.5%	1.6%	7.0%	
Asset growth	7.7%	4.5%	*3.7%*	0.9%	0.5%	1.2%	6.25%	
Membership growth	3.3%	4.8%	*1.0%*	0.9%	0.8%	0.4%	3.0%	
Liquidity:								
Loan-to-share ratio**	76.3%	82.1%	*79.5%*	80.8%	82.4%	82.8%	82.8%	
Asset quality:								
Delinquency rate**	0.87%	0.58%	*0.60%*	0.64%	0.67%	0.70%	0.70%	
Net charge-off rate*	0.56%	0.32%	*0.40%*	0.45%	0.50%	0.50%	0.45%	
Earnings:								
Return on average assets (ROA)*	0.82%	0.82%	*0.55%*	0.55%	0.65%	0.60%	0.60%	
Capital adequacy:								
Net worth ratio**	10.6%	10.5%	*10.1%*	10.1%	10.2%	10.3%	10.3%	

*Quarterly data, annualized. **End of period ratio.

Credit Union Forecast
January 2023

Savings (Deposit) Growth. Savings growth for all of 2022 came in at a paltry 3.7%, following the torrid 35% growth over the preceding two years. Last year's sharp slowdown was in part due to that previous strength: drawing down excess savings accumulated during COVID shutdowns. Disintermediation and cross-intermediation to internet banks and money funds also played a large role in the second half as short-term interest rates soared. We expect savings growth to strengthen to 6% in 2023 as a recession turns consumers more cautious. Our forecast for only another 50 bp to 75 bp increase in the Fed Funds rate this year (compared to the 425 bp increase last year) coupled with the possibility that much of the money that might have been attracted by higher rates might already have moved (perhaps wishful thinking) imply that the worst of the disintermediation pressure may be over. However, this will remain a very competitive year for deposit acquisition and retention.

Loan Growth. Credit union lending was on a tear so far last year, with the 19% increase in loans outstanding the strongest calendar-year growth in almost four decades. This robust growth had several causes: a surge in pent up consumer demand after COVID, the higher prices of products members financed, slower prepayments on mortgage loans due to higher interest rates, and the fact that many credit unions were slow to raise loan rates as market rates rose. With credit union pricing largely having caught up with the market and a slowing economy, in 2023 loan growth will slow to around 7%.

Liquidity. The combination of very soft deposit growth and torrid loan growth caused credit union liquidity to plummet last year. The average loan-to-savings ratio rose by more than twelve points during the year to 82.1%, by far the largest one-year increase in the past four decades. This follows close on the heels of the largest one-year decrease in the ratio, by just over ten points in 2020. For credit union liquidity flows, last year was largely a reversal of the earlier dramatic effects of the COVID pandemic. We look for the the loan-to-savings ratio to drift up by less than a point this year.

Asset Quality. Credit union delinquency and net charge-off rates ended 2022 at historically low levels because of a strong job market, robust household balance sheets, and the rapid growth of the denominator (loans) in these ratios. With a weakening job market and slowing loan growth, delinquency and charge-off rates will rise in 2023 but will still end the year below their long-term averages.

Earnings. Last year's return on assets (ROA) of 0.82% was a reduction from the 1.07% of 2021, but in line with the average for the preceding ten years. We expect a further decline to 60 bp in 2023 because of: an increase in provision expense (due more to a rise in charge-offs than the effects of CECL), pressure on net interest income caused by an inverted yield curve, and the scarcity of the income that flows from mortgage refinances. It will be difficult to lower operating expenses this year considering the need to increase compensation in response to the inflation of the past eighteen months.