

Macroeconomic Outlook for 2006 and What It Means To Credit Unions

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Outline

- A Forecast For The U.S. Economy
- Effects Of A Forecast On ROA
- Acting On The Greenspan Conundrum
- Risks Of Other Outcomes For The Economy
- Summary

Near-Term Macro Outlook

- Strong economic and job outlook
 - Growth at 3.5% and unemployment at 4.8%
 - Despite GDP growth in 2005Q4 of 1.6%
 - Forecasters confident growth will continue
- Inflation near the top of Bernanke's comfort zone
- Short-term interest rates likely rise a bit more
 - More because of easy federal tax-and-spending
 - More if long-term interest rates don't rise more
 - More if housing markets don't stabilize
- Housing not built on solid foundation

Forecast for 2006

	2006Q2	2006Q4
GDP growth (%)	3.5	3.3
Budget deficit (\$ billion)	302	256
Inflation (%)	3.5	3.0
Oil price (\$/barrel)	59	52
Federal Funds Rate (%)	4.89	5.00
10-year Treasuries (%)	5.00	5.25

New Sheriff in Town: Ben Bernanke as Fed Chairman

- Ben and the Fed will tell more and tell it sooner
 - What they see happening currently
 - What they worry might happen
 - What they might do about it
 - Inflation targets?
- Greater reliance on established economic relationships
- Faster and bigger changes in interest rates
- Will openness and transparency survive the first crisis?
 - European Central Bank transparency roiled markets
 - So they reverted to vague and incomprehensible “Greenspeak”
- Housing-related issues might give us a first test

Is There Some "Pop" Left in Housing?

- Perhaps still some more upside
 - Prices, sales, construction, associated markets like furniture and insurance
- Fed admits there is "froth in local markets"
 - Lots of bubbles in smaller areas
- Froth covers the coasts, at least
- As lots of its little bubbles pop, even froth flattens

Are We Watching Froth Flatten?

- We are probably past the peaks in some parts of housing
 - Purchase and refinance mortgage applications
 - New and existing home sales
 - House price increases
- We are probably near the peaks in
 - Homebuilding
 - House price levels
- Probably haven't approached peak of unsold homes
- Slowdowns are likely for some parts of housing markets
 - Homebuilding
 - Mortgage financing
 - Consumer spending financed by home equity

The Outlook for Interest Rates and Repercussions on CU Earnings

- Based on projected interest rate paths thru 2007
 - Higher Fed Funds, 1-year, and 10-year Treasury rates
- Based on current assets and liabilities
 - Assuming no changes in balance sheet composition
- Based on how A&L rates track market rates
 - CU rates may move lower and slower
- Based on how quickly A&Ls reprice
 - Generally assets reprice more slowly than liabilities

Responses of Some CU Rates Are Low and Slow

- Glaciers
 - Rates for regular shares and drafts track market rates loosely
 - Rates for new fixed rate mortgages track market rates
 - But existing fixed rate mortgages reprice only as they terminate
 - And stay in the books seemingly forever
- Walkers
 - Rates for new auto loans track market rates
 - Existing auto loans also reprice only as they terminate
 - But are paid off much faster than mortgages
- Gazelles
 - ARMs reprice speedily and their rates track fully
 - New certificates reprice fairly speedily and their rates track fully

Market Interest Rates Rise First, ROAs Decline Later

- We project interest rates for several quarters for loans and savings
- Use them to get projections for ROA
 - Baseline scenario
 - Also, some weaker, some stronger scenarios
- Several scenarios point to weaker ROAs

Assets and Liabilities at Credit Unions

(Percent of 2005 National CU Assets)

- Assets
 - Fixed mortgages (14%)
 - Variable mortgages, auto loans, etc. (41%)
 - Uncollateralized loans (10%)
 - Investments (31%)
- Liabilities
 - Share drafts (12%)
 - Regular shares (33%)
 - Money market accounts (16%)
 - Certificates, IRAs, and borrowings (29%)

Assets:

Tracking and Repricing Assumptions

- Fixed mortgages
 - Rates track 10-year Treasuries plus a fixed premium
 - Reprice in 10 years (or 1/40 per quarter)
 - Loans repriced faster in their way down, didn't they?
- Variable mortgages, equity lines of credit, etc.
 - Rates track 1-year Treasuries plus a fixed premium
 - Reprice quarterly in full

Assets:

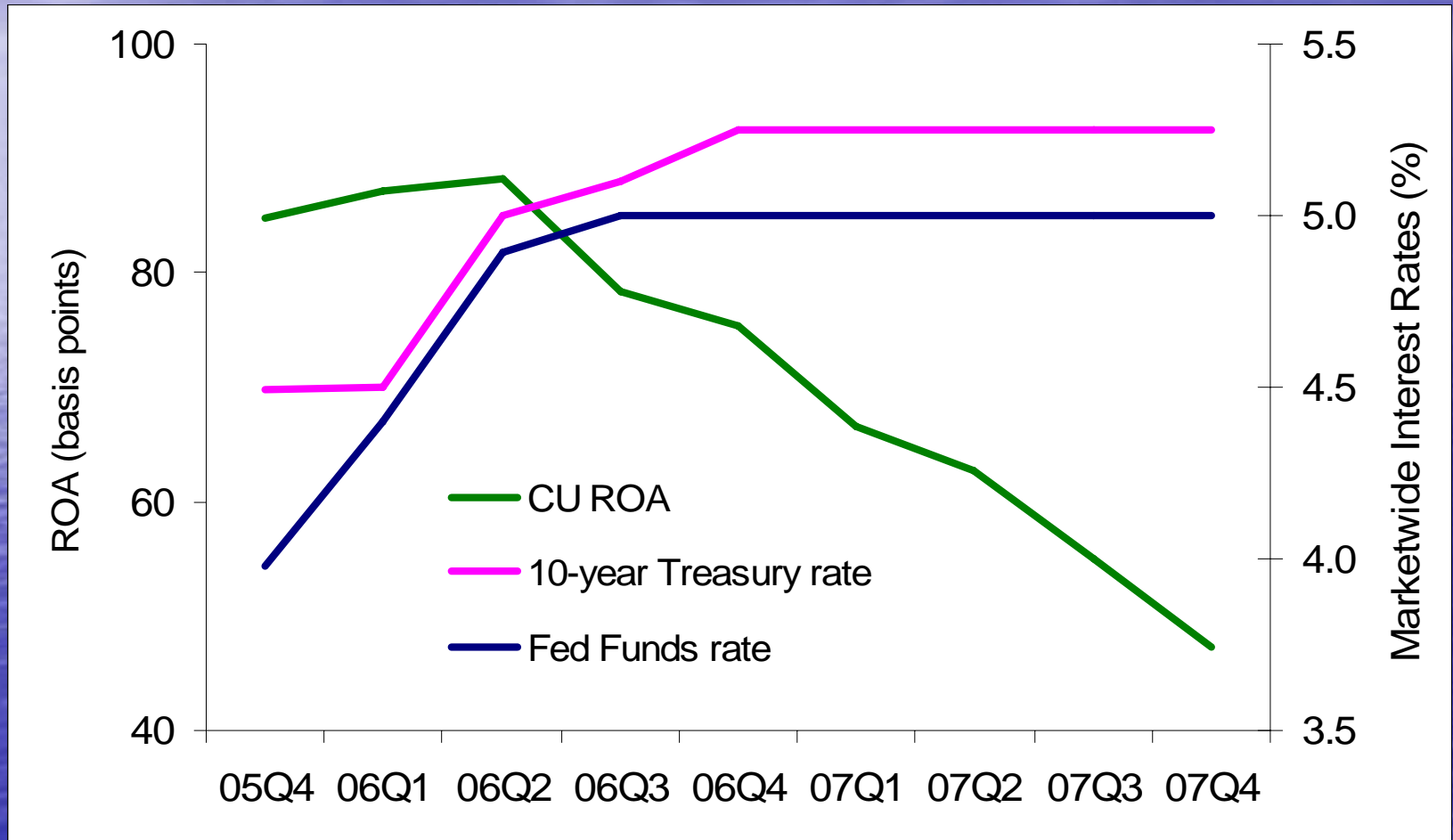
Tracking and Repricing Assumptions

- Auto loans
 - Rates track 1-year Treasuries plus a fixed premium
 - Reprice in 2½ years (or 1/10 per quarter)
- Uncollateralized loans
 - Rates track the Fed Funds rate plus a fixed premium
 - Reprice in 1 year (or ¼ per quarter)
- Investments
 - Rates track the Fed Funds, 1-year, and 10-year rates
 - Reprice based on their maturities

Liabilities: Tracking and Repricing Assumptions

- Certificate shares, IRAs, and borrowings
 - Rates track 1-year Treasuries minus a fixed premium
 - Reprice in 1 year (or $\frac{1}{4}$ per quarter)
- Draft, regular, and money market shares
 - Rates track the Fed Funds rate
 - But partially and with a variable lag
 - Each with different gaps to the Fed Funds rate
 - Reprice quarterly in full

Forecasted ROA Through 2007 Based on Interest Rate Forecast



Rising Rates Reduce ROA

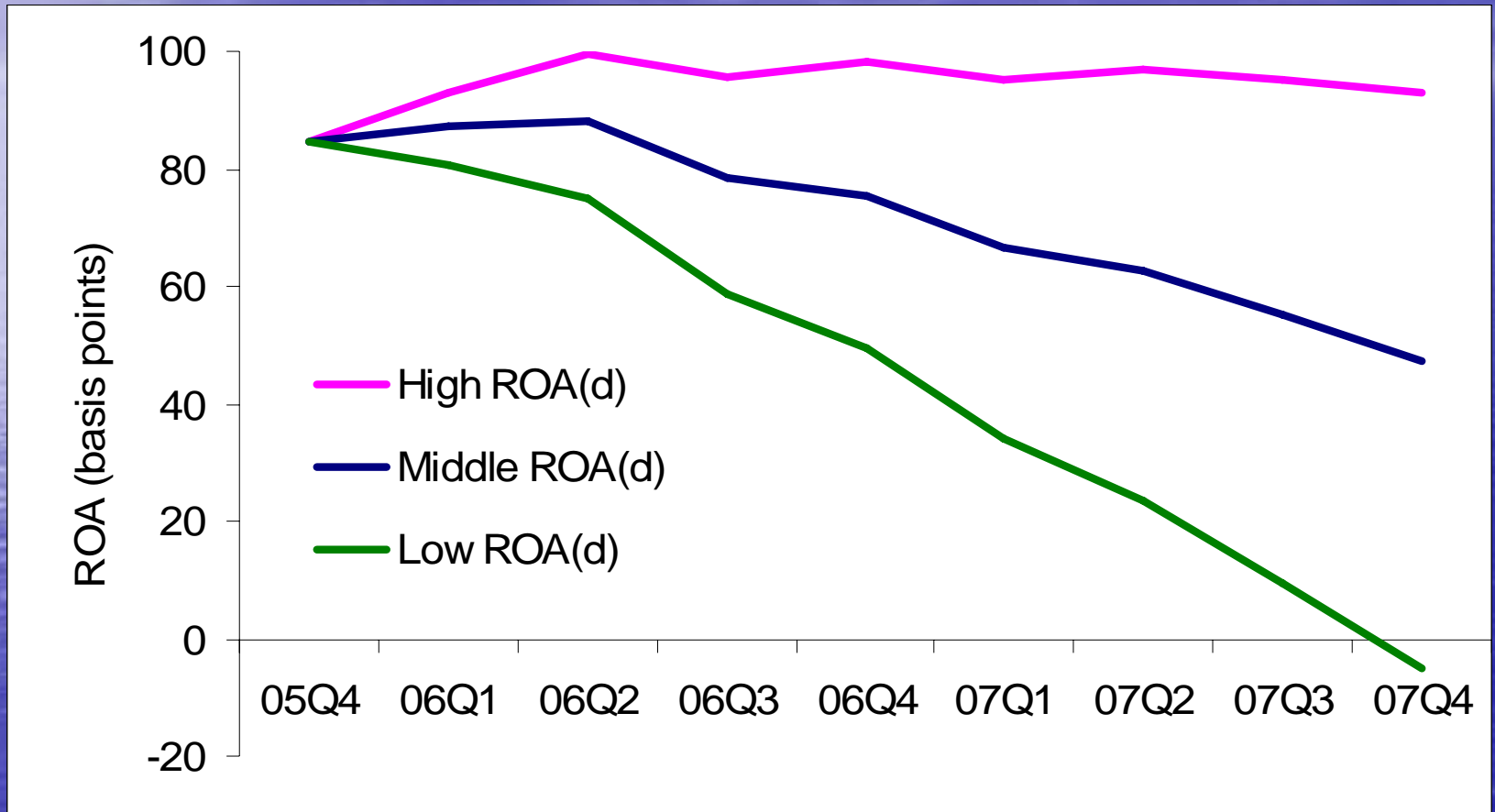
- Larger, longer liability rate rises reduce ROA
 - From 106 bp in 2002
 - To 85 bp in 2005
 - Since 2002, national ROA has already fallen 21 bp
 - To 88-75 bp in 2006
 - Falls an additional 10 bp
 - To 67-47 bp in 2007
 - Falls an additional 28 bp
 - Total fall of 59 bp compares to 48 bp in the 1990s

Three ROA(d)s for ROA

- High ROA(d)
 - Low rates paid to members
 - Roughly maintain current, atypically large shortfall below the Fed Funds rate
 - Growth of savings likely to be anemic
- Middle ROA(d)
 - Return by 2007Q4 to rate gaps typical during long expansions
- Low ROA(d)
 - High rates paid to members
 - Unlikely return by 2007Q4 to average historical rate gaps
 - Net worth ratios likely to decline

ROA(d)s	Spread of Fed Funds rate over		
	Share drafts	Regular shares	Money market shares
High	4.0	3.0	3.0
Middle	3.5	2.5	1.5
Low	2.5	1.5	1.0

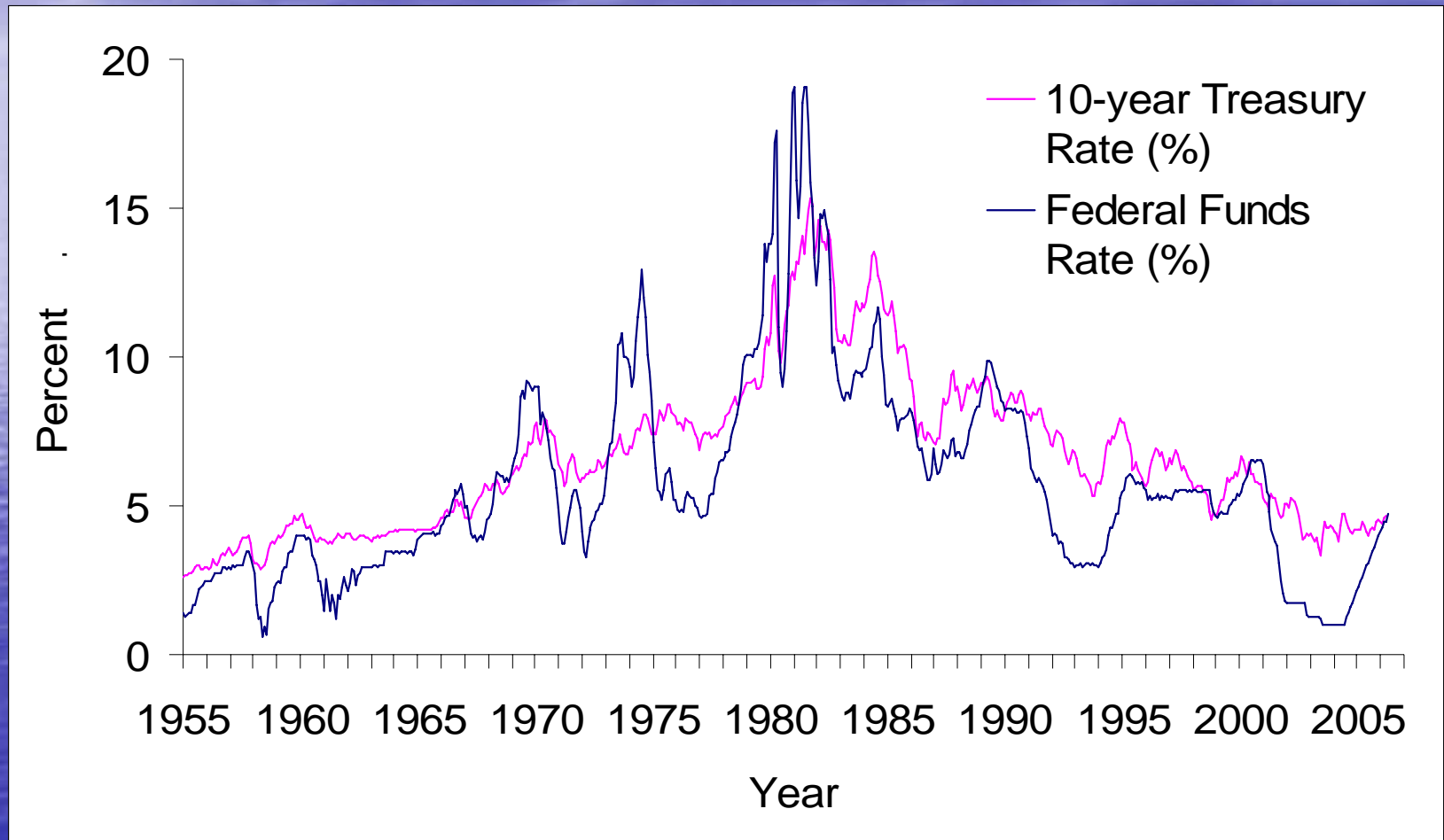
Alternative Paths for ROA



As Usual, CU Interest Rate Risks Have Already Been Taken

- CUs often benefit from falling interest rates
 - Typically, more long assets than long liabilities
 - That is, more longer-term, fixed-rate loans and shorter liabilities
 - As NCUA may have brought to your attention
- Shift to variable-rate or short loans?
 - Low ARM rates weren't appealing in 2002
 - Slow process if wait until long loans terminate
 - Long, quite likely way to accept the pain

Short- and Long-Term Interest Rates, Historically, Danced to Same Tune



Before 2000, Higher Short Rates Raised Long Rates

	Feb. 1994	Feb. 1995	Change
Federal Funds rate	3.00	6.00	+3.00
10-year Treasury rate	5.97	7.47	+1.50

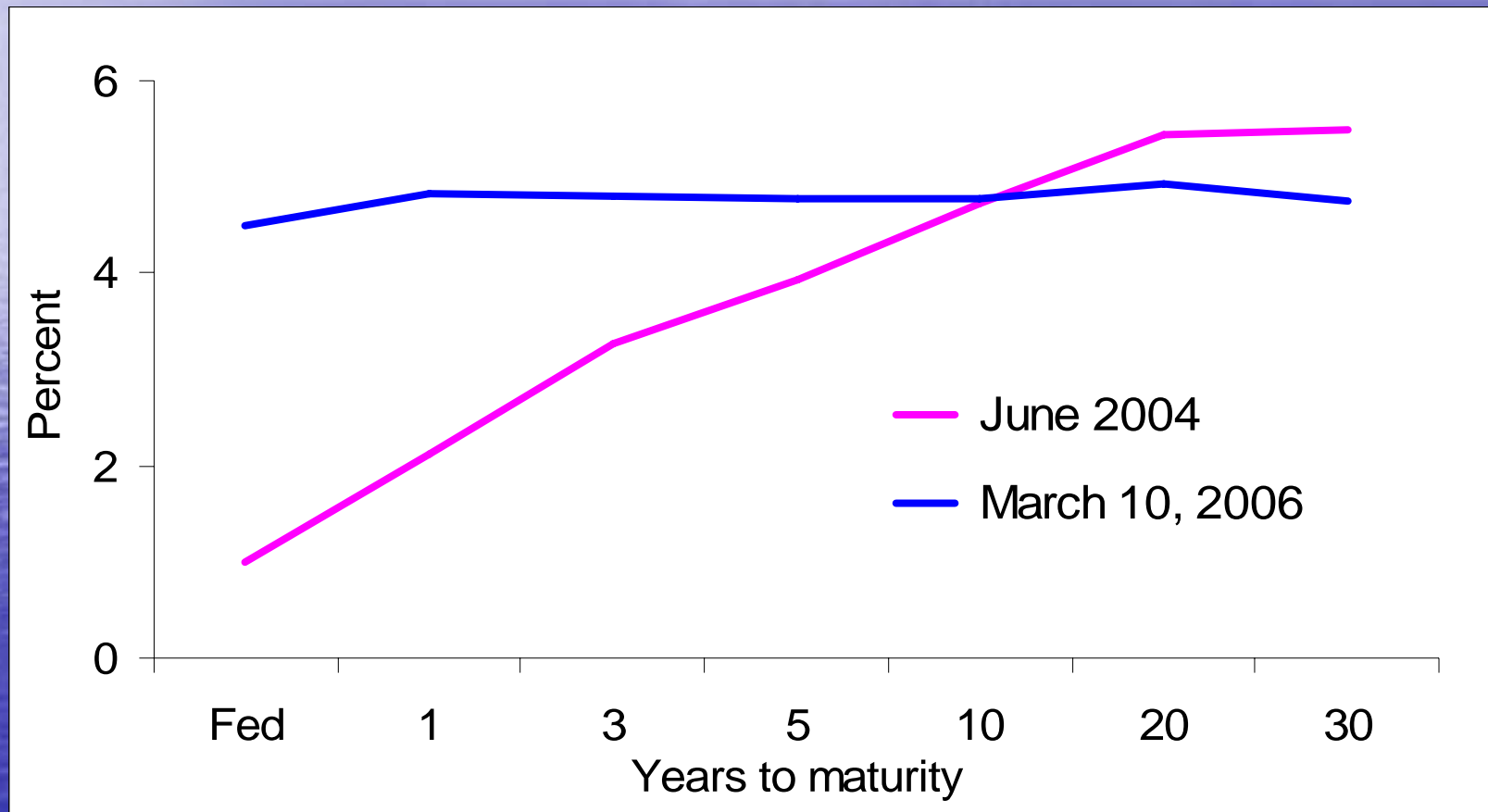
	June 1999	May 2000	Change
Federal Funds rate	4.75	6.50	+1.75
10-year Treasury rate	5.90	6.44	+0.54

The Greenspan Conundrum

	June 2004	March 10, 2006	Change
Federal Funds rate	1.00	4.50	+3.50
10-year Treasury rate	4.73	4.78	+0.05

- In Webster's dictionary
 - It is "puzzle, unanswerable, unsolvable"
- In Greenspan's dictionary
 - "Conundrum" is a mistake – and implicitly a warning
- Now, conundrum means "long rates are too low"
 - The bond market has it wrong
 - The bond market will, eventually, get it right
 - Long rates are going to rise, more

A Picture of a Conundrum: As Short-Term Rates Rose, Longs Fell



Is His Puzzle Your Answer?

- What if CUs sell existing, longer loans?
 - Usually, today feel present value of the future pains
 - At higher long rates, discounts mean capital losses
- Now, the “conundrum” may help out
 - Conundrum of low long rates
 - Equals conundrum of high prices on long assets (FRMs)
 - Perhaps sell long assets at surprisingly high prices
 - May be a limited time offer...operators are standing by now
 - If conundrum resolved, long rates rise and values fall
- In 2002, long assets may have been the right choice
 - Big spread of longs over shorts rewarded the risks
 - Is about ½% enough reward to hold FRMs rather than ARMS?
 - It’s a “Big Ben Bet”

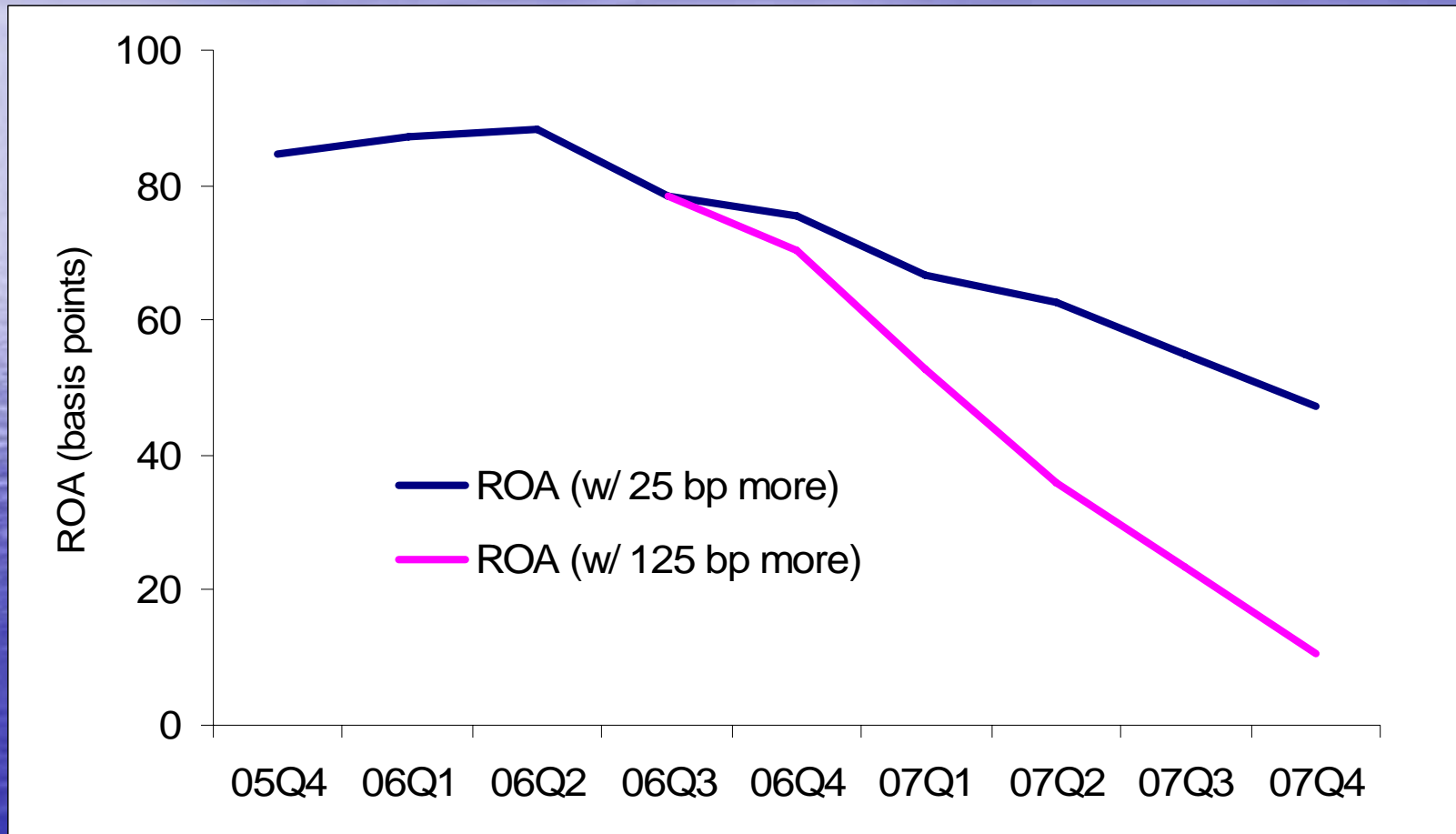
But, Will Long Rates Rise, More? Or, Some Dirty Laundry

- Many confident, eminent forecasters predicted
 - Long rates would rise in 2003-04
 - In anticipation of rising Fed Funds rates
 - After all, long rates rose a lot in 1994 and 1999
- Long rates still haven't risen all that much
 - In lots of good, but wrong, company
- Lesson
 - Prepare for other outcomes (i.e., wrong forecasts)

Some Other, Plausible Scenarios

- Economy roars ahead
 - Rates rise more than forecast
 - Note: Since 2003, the Fed Funds rate has risen more than predicted by Fed Funds futures markets
- Or, economy recedes
 - Higher rates and oil prices prove too burdensome
 - Housing froth could flatten
 - If big, fast, and widespread enough, percussion goes “Pop”!
 - Fed funds rate cut to partially offset repercussions

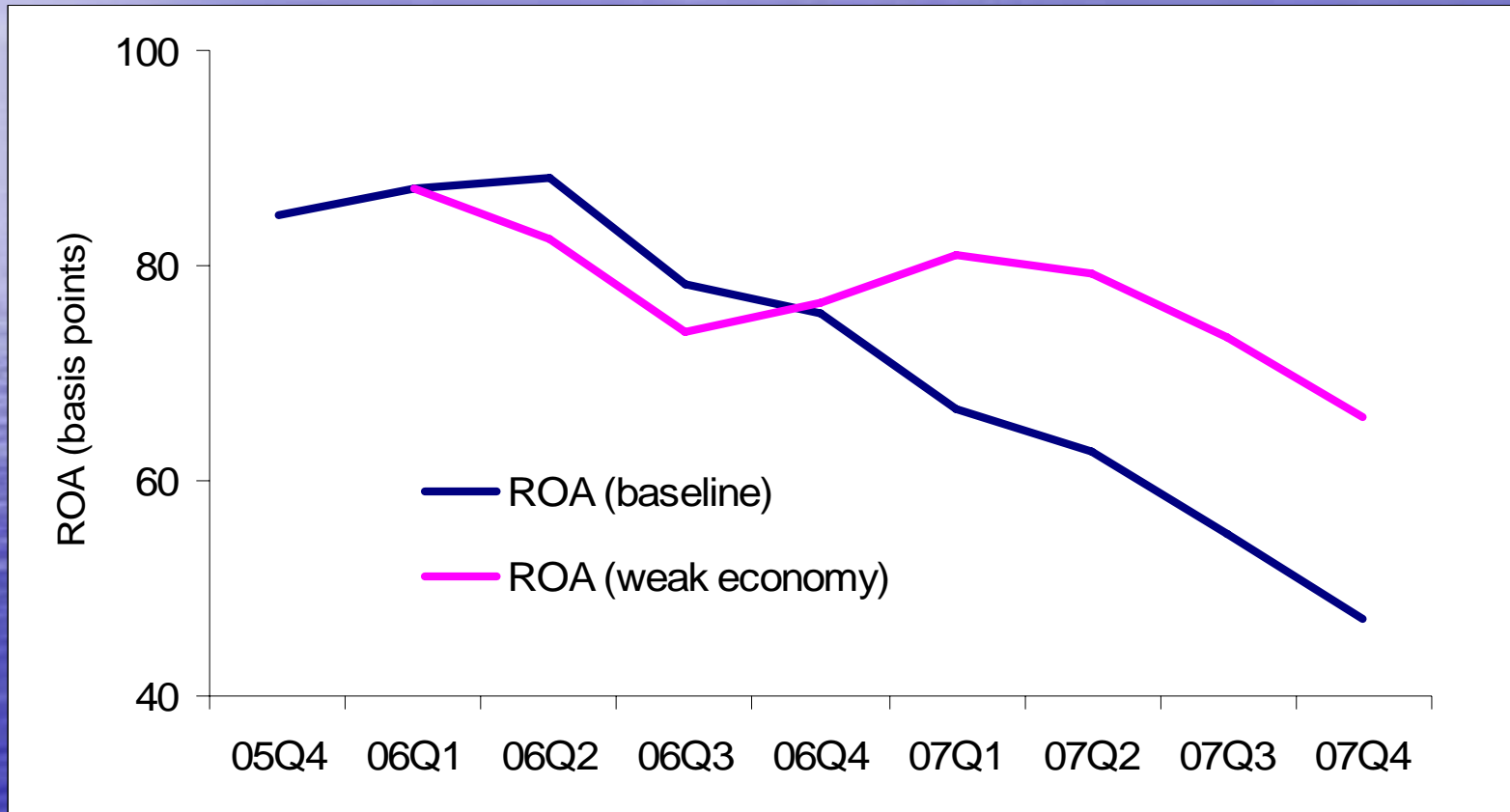
If the Economy Roars Ahead and Rates Rise More Than Forecast



A Scenario for Some Rate Cuts

- Most likely due to a much weaker economy
 - Significant rise in unemployment
 - House price froth flattens
 - Taking lots of housing-related jobs down with it
 - Increasing mortgage defaults and discounts
 - Particularly on “seconds”, HELOCs, etc.?
- One scenario for some rate cuts
 - Loan loss provisions rise from 0.40 to 0.48%, which would be highest percentage over past 20 years
 - Banks' provisions vary more, mostly due to business lending
 - Rose by 40 bps – from 0.55 in 1988 to 0.95 in 1990
 - Rose by 30 bps – from 0.38 in 1999 to 0.68 in 2002

If a Weaker Economy Prods the Fed To Cut Rates From Current Levels



Summary

- Short and long interest rates may rise a bit more
- CUs are in the interest rate risk business
 - Rate rises reduce ROA
 - Conundrum may offer a way out, for a limited time
- ROAs declines may be large and predictable
 - 20-30 bp declines in ROAs shouldn't be surprising
 - Aggregate CU ROAs fell 50 bps over 1993-1999
- Forecasts miss the bulls-eye
 - For short and long rates, for GDP, for house prices
- Risk management requires allowing for misses