Economic Recovery On Horizon Despite 2020's Widespread Damage

Economic Damage from Pandemic Widespread

- Labor market significantly impacted, with millions unemployed
- Change in consumer spending patterns has reshaped economy
- A difficult winter is forecast as vaccine rollout takes time

Government Policy Response

- Federal stimulus programs are primary factor keeping economy from further collapse, significant loan losses
- Additional stimulus is likely as economy cannot yet safely reopen

Fed Policy

- FOMC still is focused on providing monetary stimulus to economy
- Change in monetary policy approach further delays likely date of possible rate increase to late-2023 or beyond
- New policy means inflation must run above target to make up for current inflation undershoot

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Interest Rates

- No chance of near-term changes in overnight rates
- Longer-term yields likely to move higher with increase in economic activity; however, Federal Reserve will likely moderate that impact in order to avoid stifling recovery

Lending Trends

- Lower interest rate environment has, and will continue to, negatively impact NIM
- Material loan losses not yet realized, but strong possibility remains as labor market is still weak

Strategy

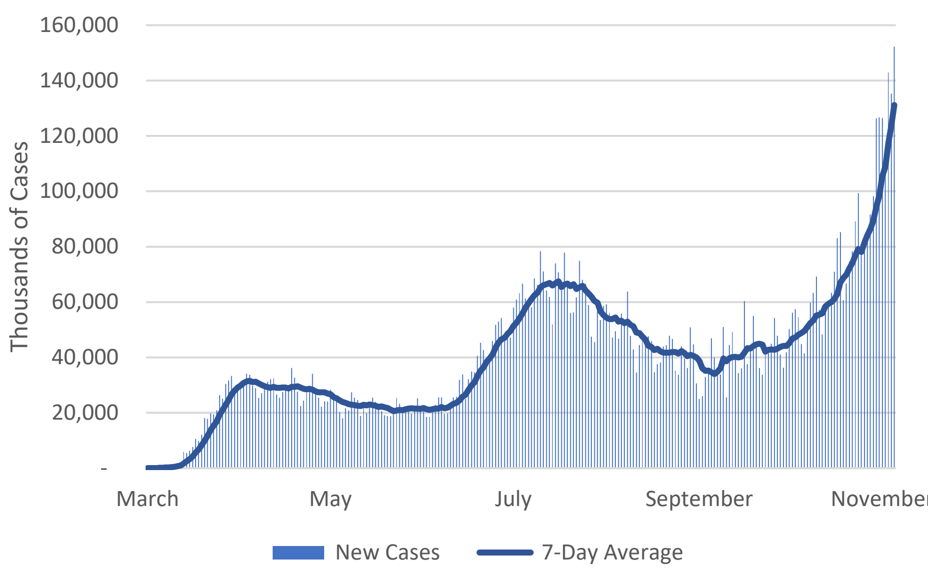
- As interest rates are expected to remain low, opportunities to capture excess spread are minimal, but should be prioritized
- Despite low levels of rates, the positively sloped yield curve still rewards duration extension
- Variable rate investments currently very difficult to find, but will play increasingly important role
- SOFR's rollout has been slow, leaving few regulator-friendly variable rate options
- Spreads have compressed across all sectors which may make bullet products more attractive

Impacts of COVID Recession and Timing of Recovery

The economic and personal toll inflicted by the Coronavirus continued through the latter half of 2020 and is the predominant factor in evaluating the likely economic and interest rate environment in 2021. Markets have slowly come to terms with the lower rate environment enacted by the Federal Reserve, pushing rates and spreads tighter as the pandemic continues. The development and rollout of COVID vaccines has provided a light at the end of the tunnel; however, the country appears likely to suffer another quarter of depressed economic activity before a recovery can fully take hold.

The recent acceleration in COVID infections and deaths has come as Americans are desperate to resume normal daily movements and social interactions. With cases expected to peak on or slightly after the holiday season, the near-term prognosis for the economy is weak, despite the near-certainty that a vaccine rollout will bring an end to the pandemic in 2021.

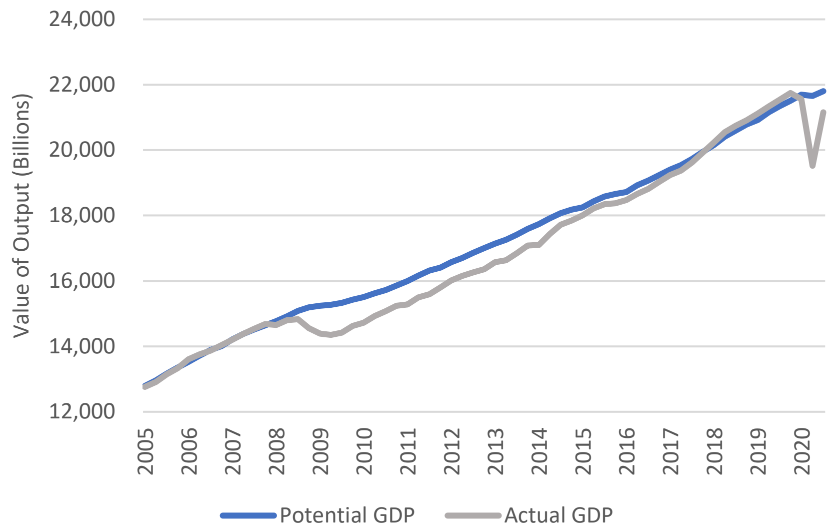
Figure 1: US COVID Infections



Efforts by state and federal authorities to contain and counteract the virus' spread have played an outsized role in the economy's performance during the year – a trend which is likely to continue heading into the new year. However, the structure of the US economy and labor market in 2021 is going to look significantly different than the similar period just a year ago. It is these changes that are going to shape the economy's performance in a post-COVID environment.

The economy's resilience in the face of the COVID epidemic (and the impact of the federal stimulus) is apparent in the country's economic output figures, as gross domestic product has already recovered approximately ¾ of the losses registered in the early part of the year. The remaining output gap will be more of a challenge to close until a widespread vaccine is in place.

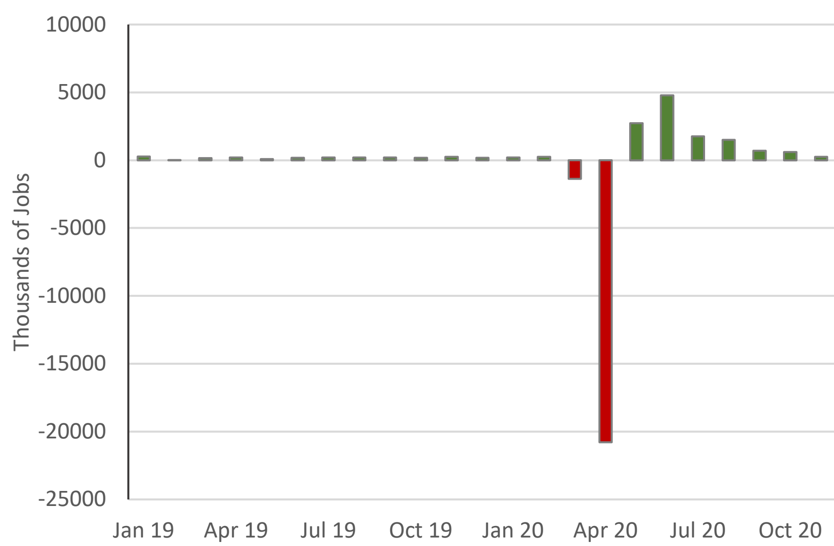
Figure 2: Potential GDP Vs. Actual GDP



Dramatic Impacts on Labor Market

The largest economic impact of the Coronavirus epidemic is faced by the millions of Americans who lost their jobs as fellow citizens were forced to change their consumption habits. While some jobs have returned as economic reopening has been attempted across the country, the number of employed Americans is still far below the level heading into the year, and the pace of new jobs has slowed to a crawl. After taking into account the new jobs added this year, the US labor market still has lost nearly 10mm net jobs with scarce near-term job prospects for those impacted.

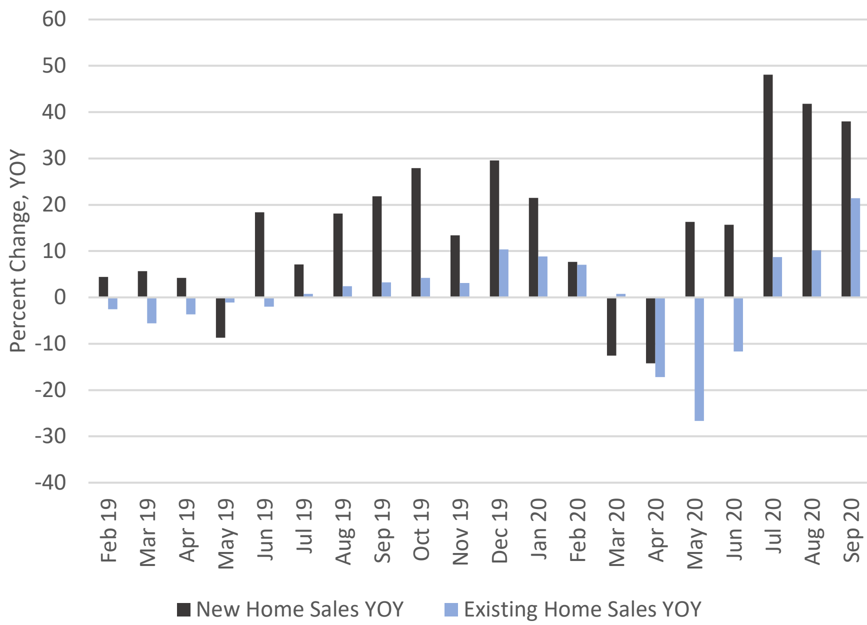
Figure 3: Jobs Recovery Has Slowed



The impact of the COVID epidemic has not been shared equally across industries and states. The low interest rate environment and the relatively small impact on white-collar employment levels has been a boon for the housing market. The move lower in mortgage rates has created the opportunity for homeowners to meaningfully improve their financial picture by lowering their monthly mortgage payment, while creating an opportunity for others to enter in homeownership for the first time.

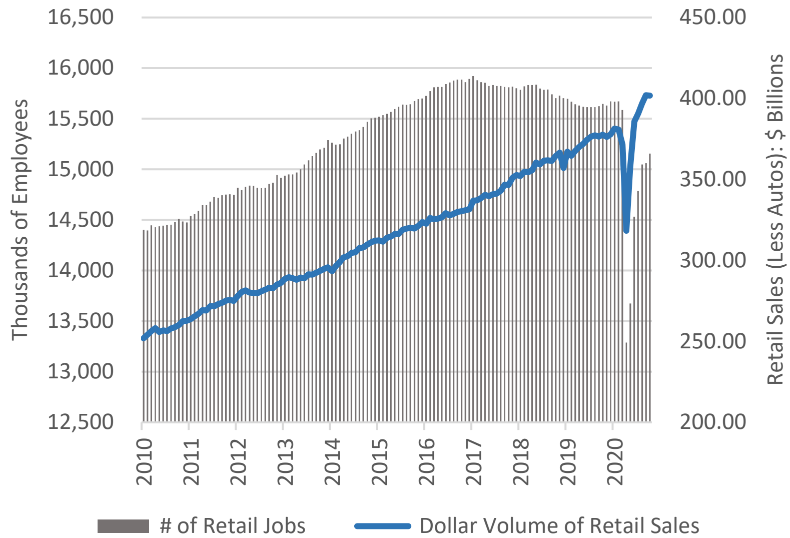
After initially declining during the onset of the pandemic, both new and existing home sales have recovered strongly, defying typical seasonal patterns and continuing to rise heading into the holidays. The significant increase in demand has led to increases in home valuations, with the US median existing home price climbing over $310k. This has contributed to lower levels of supply, as homebuilders cannot keep up with the pace of demand. At the existing pace of home sales, there is only 2.5 months' worth of supply available. This has supported employment in the sector, although homebuilders have been wary of adding too many new jobs, recalling how quickly the sector declined in the last recession.

Figure 4: YOY Change in New, Existing Home Sales



However, the housing market is not representative of the entire US economy. The retail sector of the US economy tells a very different picture as the sector does not have a similar exposure to the level of interest rates. As quarantines and lockdowns were enacted across the country, consumers were prevented from shopping and purchasing goods in person, shifting much of their expenditures online. Although retail sales initially declined, they have since fully recovered and are now above pre-COVID levels. The same cannot be said for employment in the sector, as retail employment has not recovered from its precipitous decline. Despite the robust recovery in retail sales, there are 430,000 fewer jobs in the retail sector. Given the importance of consumer spending to US GDP, the shifts in consumer spending behavior are likely to have long-term implications for the structure of America's economy.

Figure 5: Retail Sales Recovered, Not Jobs

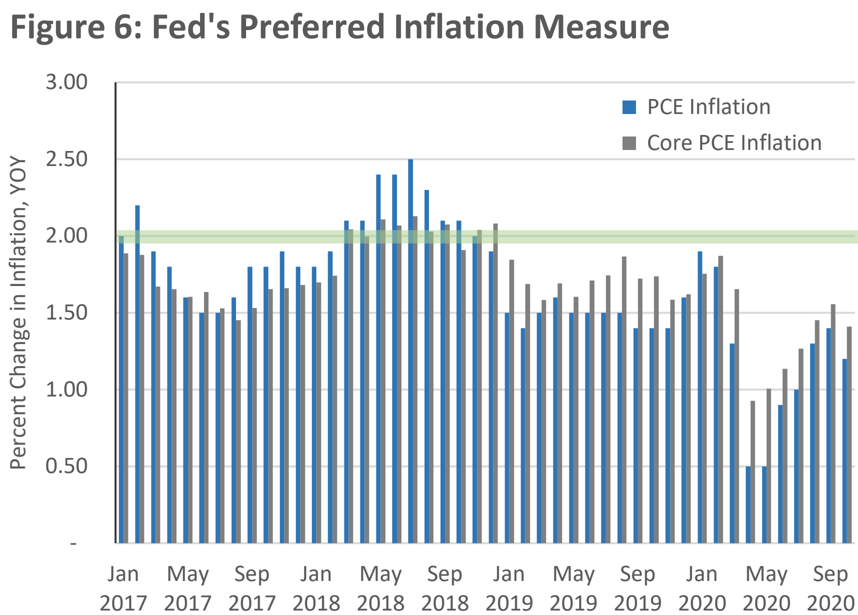


Government Response and FOMC Policy

The Federal Reserve dipped into their usual recession playbook and lowered overnight rates to near-zero earlier this year while also resuming asset purchase programs designed to push interest rates down in several different markets. Additional programs funded by the economic stimulus package also broadened the Fed's reach to ensure stability in investment markets beyond the traditional Treasury and MBS markets. While some of those newer programs expire at the end of the year, the Fed has made clear that it will still provide as much stimulus to the market as it can.

At the FOMC's final meeting of the year, the Committee indicated that their purchase of Treasury and mortgage-backed bonds will continue "until further progress has been made" towards their goals of higher employment and stable inflation. According to the dot plot which accompanies bimonthly FOMC releases, officials do not expect to reach those goals for years. Of the 17 FOMC members who contributed official rate forecasts, 12 of those members saw short-term interest rates remaining near zero through the end of 2023.

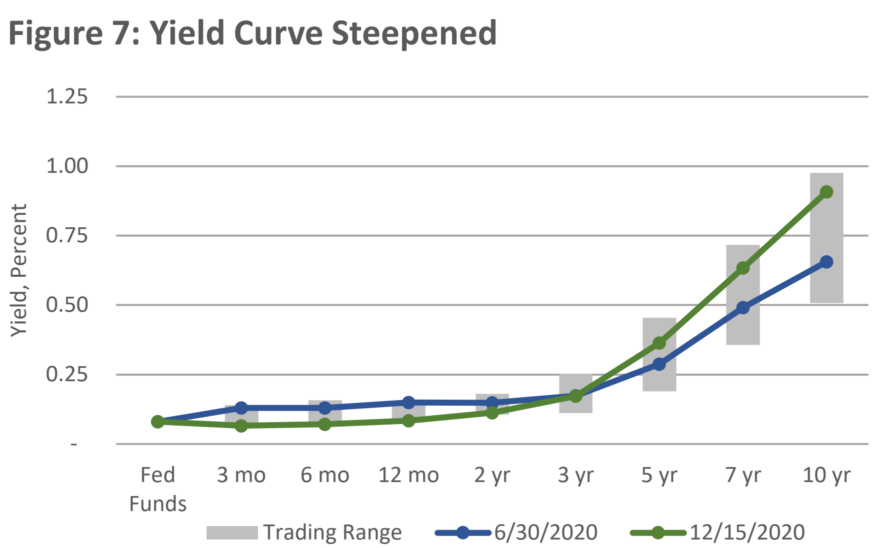
Those expectations are seemingly confirmed by the poor state of the labor market as well as recent inflation readings. According to the Fed's revised monetary policy approach, the recent low levels of inflation will need to be offset by inflation above the Fed's 2% target before the Committee considers raising overnight interest rate targets. This aggregate inflation gap is growing with every passing month, pushing back any potential revision to the Fed's overnight rate target.



The federal government's action to enact the largest economic stimulus package in history has significantly forestalled the usual effects of an economic shock of this size and scope. In addition, foreclosure and eviction moratoriums have staved off the customary impact of job losses on this scale. However, these programs largely come to an end on December 31, making the possibility of any future stimulus of extreme importance.

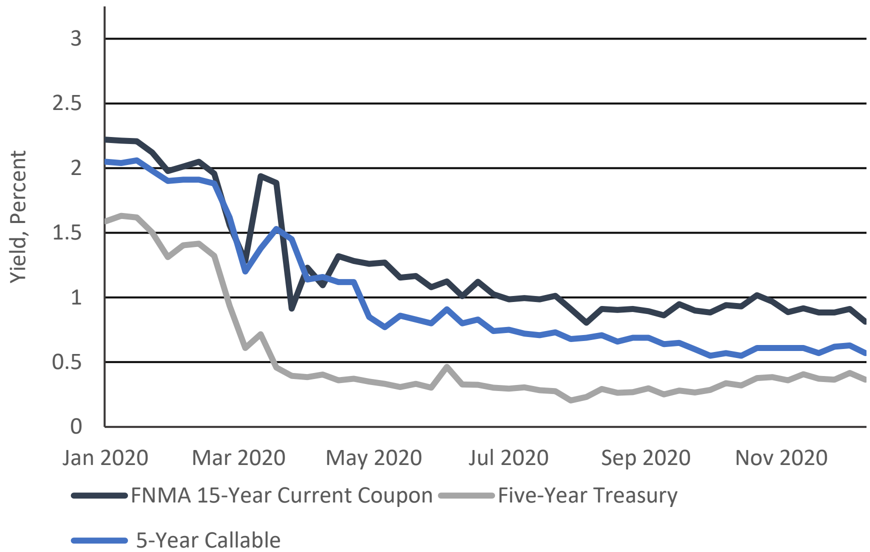
Interest Rates

The FOMC's actions this year, in addition to their likely lack of action in coming years, has floored interest rates on the short end of the yield curve. Since our last semi-annual outlook, rates on the short end of the curve have declined slightly as volatility has subsided and rates have moved into their likely position for the coming two to three years. Further out on the yield curve, the story is a bit different as projected economic boosts from the vaccine's and expectations for additional stimulus has caused interest rates to rise.



These rate movements have largely been paired with a reduction in excess spread available from purchasing different types of investment products. The tightening in spreads has been an intentional component of the Federal Reserve's policy as they seek to incent risk-taking activity in the economy versus investment purchases. The spread tightening has also been driven by market forces, as the reduction in term interest rates has investors scrambling for extra basis point of yield.

FIgure 8: YTD Yields on Select Investments



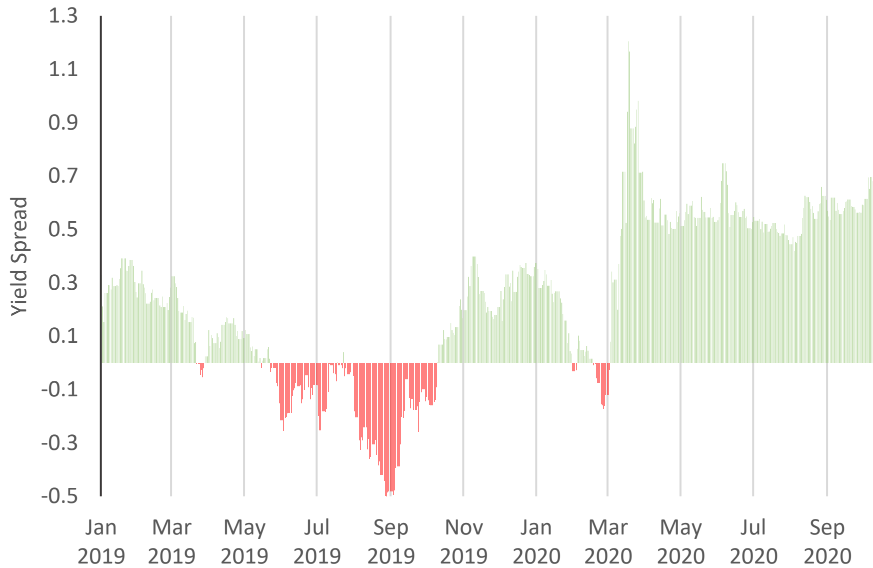
Strategy

It appears clear that the low interest rate environment which we are in will be present for the coming years. Prospects of higher interest rates appear remote at best, unless looking at significantly longer terms. The positive news of the vaccine rollout does provide some hope from an economic output perspective, but this will not translate into a change in interest rates until the Federal Reserve sees very significant improvements in the labor market and a long-awaited rise in inflation. Even though interest rates are unlikely to change materially during the coming year, credit unions can optimize current income levels and prepare their balance sheets for the future by taking proactive measures.

The significant influx of deposits seen earlier in the year has persisted and it appears that those balances will remain as long as the labor market is uncertain. If credit union managers have not yet adjusted deposit pricing, it may be prudent to do so. Attractive options for deploying that excess liquidity are even more limited than they were earlier in the year; but as long as deposit pricing reflects current market levels, the credit union may be able to profitably absorb those deposits, despite their negative impact on net interest margins.

Duration extension also continues to be a source of potential spread, with the spread between 3-month Treasury and the 10-year Treasury currently near its highest levels since early summer. The risk associated with extending investment duration is of course a material consideration, but it is one which can be taken in context of the likely interest rate environment over the coming years. A steep yield curve offers the opportunity to purchase relatively higher yielding products which will roll down the curve and be relatively attractive shorter term investments in the future, even if interest rates rise a bit.

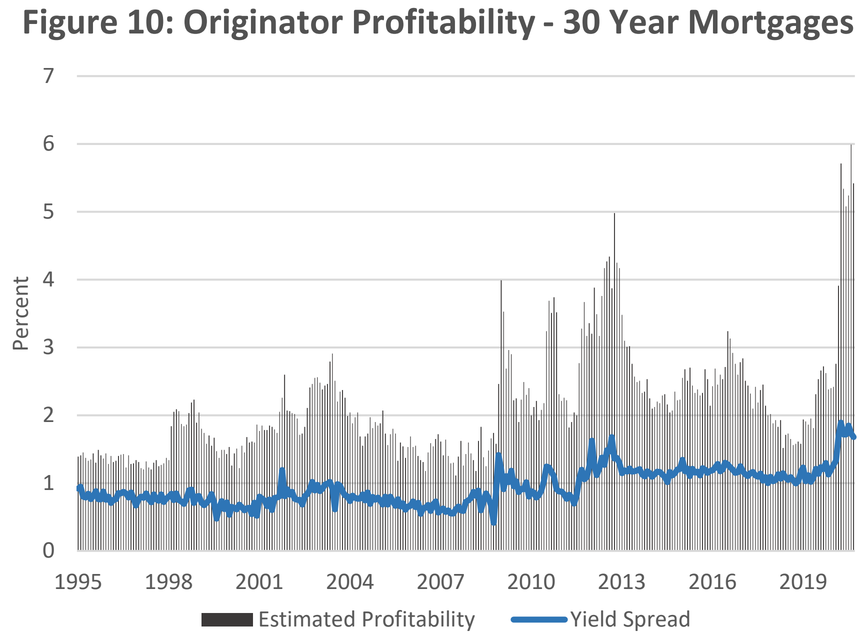
Figure 9: 3 Mo. vs. 10 year UST Yields



On the short end of the yield curve, options remain very limited as variable rate CMO's have not yet widely adopted SOFR as their reference benchmark rate. Although there have been discussions around extending the lifetime of selected LIBOR rates, products using SOFR would be easier to own and explain to regulators. The timing for SOFR's use in the agency CMO marketplace is uncertain, although all indications are that those products will be available at some point in early 2021.

While spreads on new issue callable securities have meaningfully receded this year, there are select opportunities to purchase older, or higher coupon, callable securities on a yield to call basis. This is especially true where callables were originated at slightly longer terms and have rolled down and now carry higher interest rates than similar bonds with shorter maturities. The purchase of these securities at premium prices on a yield to call basis can provide higher yields than overnight or other short-term investments. Should interest rates unexpectedly rise, the security's yield would step up to the bond's coupon rate should the call option not be exercised, providing some protection against potential (although unlikely) rate movements.

A final opportunity continues to be in mortgage origination and mortgage-backed securities. The Federal Reserve's actions to push yields on mortgage backed securities has been largely successful. This has caused yields on MBS investments to decline at a faster rate than the actual rate on newly issued retail mortgages. The current yield differential between the average borrower's 30-year mortgage rate and the yield at which the loans are sold into the secondary mortgage market is 1.70%. According to New York Federal Reserve calculations, this is resulting in near-record levels of mortgage originator loan profitability (on a per-loan basis) with approximately $6 (per $100 loan) being retained by mortgage originators.



While the previous analysis is focused on mortgage origination, spreads on mortgage-backed securities are also relatively attractive versus other investment types (although not nearly as profitable as loan origination). Throughout the year, there has been (and will likely continue to be) varying trade-offs between MBS pools and structured mortgage products (CMOs) with regards to the levels of expected yield and premium risk. Current premiums on new issue MBS pools are above $2.50, introducing a meaningful amount of premium risk into a relatively short duration investment. It is difficult to decisively say that CMOs are more attractive than MBS pools (or vice versa) as the relative value of each sector has varied back and forth. Determination of the investments' relative values requires more detailed individual analysis.

As we stated earlier in the year, the economic impact of the COVID-19 epidemic has been without precedent in modern times, delivering significant and long-lasting damage to the US economy and labor market. With a vaccine currently being rolled out, it seems clear that the economy will be in recovery mode in the later part of 2021. However, the future is more opaque for the millions of Americans put out of work or otherwise impacted by the virus. The forecast for interest rates seems fairly straightforward as there is no prospect of an increase in short-term rates in 2021 while the economy's outlook is inextricably tied to the speed of the vaccine rollout, the expected additional fiscal stimulus, and Americans' collective response to this crisis.