



Mid-Year Report – 2010 Economic and Financial Outlook and the Nation’s Credit Unions

Overview

Coming out of a perilous recession and devastating collapse of the housing sector that led to near fatal destruction of the financial sector, it was difficult not to believe that things had to improve significantly from that point. But the first half of the year proved to be a period of continued anticipation more than one of significant improvement – at least to spark a steady, sustainable economic recovery.

Mathematically, the numbers have reflected improvement. Jobs have been created, consumer spending has increased, home prices have risen and household debt burden has declined. While the numbers themselves seem to indicate that hopefully the worse is behind us, they don’t provide evidence that we are on an upward path to full recovery as of yet.

How the economy will perform going forward rests directly on those same factors – employment, consumer spending and corporate profitability. Each of these elements have been greatly impacted by the depth and protracted nature of the last recession to the point that it has the potential to alter consumer behavior patterns over the next decade. Adding to these, regulatory and other government intervention into the fold has the potential for creating another perfect storm that could have major implications in the scope and breadth of future economic recovery.

At this point we suggest a “cautiously optimistic” outlook.....

Economic Points

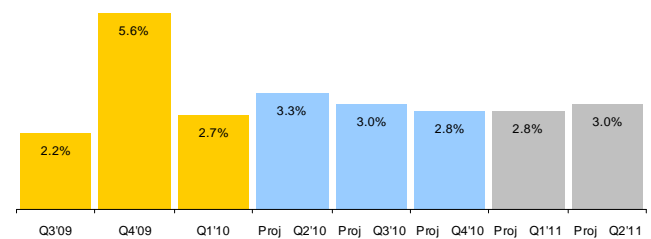
Whenever an economy has the level of spending injected into its system to the degree this country has permitted, some aspect of growth will be realized. The question remains whether a government injection of trillions of dollars through deficit spending (usually an inflation-fighting conduit) will provide sustainable growth – something that historically can only come from the private sector.

Through the first half of the year, GDP has improved for those reasons alone. However, the sustainability of that growth, supported by the private sector, is more in doubt.

Personal spending rose five of the past six month but apparently many are still holding back a bit in a wait and see mode in light of a weak labor market, rising commodity prices and declining household wealth. This puts extreme pressure on personal income growth to keep the consumer on the front edge of the recovery.

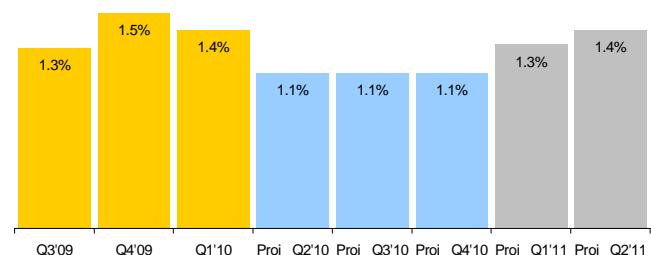
Gross Domestic Product

(quarter-over-quarter growth rate)



Consumer Spending (PCE)

(quarter-over-quarter growth rate)



The recession might have had a greater impact on the consumer than what most believe. The depths of the decline, the corresponding loss of jobs, household wealth and overall malaise could have altered future consumer spending behavior that could be realized over the next decade.

In fact, over the past twelve months, consumers have deferred their spending on big ticket items such as new homes, cars and appliances and instead have elected to reduce their household burden. Fundamentally, that is the right thing to do given that household debt servicing has recently hit an all-time high of 19 percent of disposable income. Whereas, it will reward the consumer in the long run, it certainly makes it difficult for an industry which relies on making loans and extending credit.

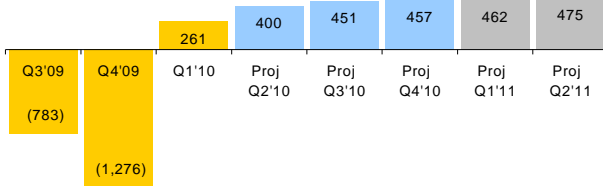
When surveyed, a majority of consumers acknowledge that their goal is to avoid ever getting themselves so highly leveraged and commit to stay more within their means. Frankly that kind of commitment is probably good for at least five years. Certainly, that has been realized in credit union loan growth and virtual reallocation of balance sheets.

There might not be a more important factor related to the economy, and the nature of its recovery, than employment. During the past recession, the economy lost approximately 8-million jobs. Even though consumer inflation has been held in check, at one

time last year, wholesale inflation was running at a 10 percent annualized pace. With weak consumer demand, producers were unable to pass on higher raw material and energy prices leaving them with no alternative but to trim payroll costs.

Non-Farm Payrolls

(avg quarterly change, seasonally adjusted, in 000s)



It will take a very long time to recover the depth of loss, possibly five to six years. Jobs did increase during the first quarter but most of those were attributable to hiring of temporary census workers and are destined for termination in mid- to late-July.

But currently, the economy maintains an unemployment rate of 9.5 percent (slightly lower due primarily to those leaving the workforce) with about 15-million workers idle. The number of

long-term unemployed (those jobless for 27 weeks and (greater) is about 6.8-million, or about 46 percent of unemployed base. The so-called underemployment rate, which includes the unemployed plus those part-time workers seeking full-time employment and those not actively seeking, stands at 16.6 percent.

A more stabilized employment picture certainly is a foundation for future growth. It determines consumer spending behavior, facilitates demand, spurs construction and investment and fuels profitability. There is a direct correlation between disposable income and credit union share growth. As such, it becomes instrumental in credit union growth strategies and the ability to create stable and sustained net interest margins. This assessment supports such an outlook; however, we could be faced with another downturn sometime over the next two years if the economy stays in a weak, sluggish state.

From a household wealth point of reference, the news has been good. S&P/Case-Shiller reported that its home price index showed that growth rates in all of its surveyed metropolitan areas improved in April (its latest report) compared to March. Its 20-city composite rose 0.8% in April and is up 3.8 percent versus this same time last year. Areas such as Dallas, Denver, San Diego and San Francisco have now posted six consecutive months positive annual rates (+3.3%, +4.4%, +11.7% and +18.0% in April, respectively).

The report still shows that many of the gains are still rather modest and, notwithstanding the afore-mentioned cities, somewhat concentrated in California. S&P notes that nine of the twenty cities had reached new lows at some time

since the beginning of the year. Eighteen cities experienced month-to-month gains in April compared to six during the previous month. Only Miami and New York City were the two that fared the worst in April compared to March.

The most improved, year-over-year, area is San Francisco with an 18.0 percent improvement. It previously had one of the largest declines. The worst performance was in Las Vegas with a -8.5 decline from April 2009. Las Vegas has been the hit the hardest during the housing collapse.

The data shows that, as of April 2010, average home prices across the nation are at similar levels to where they were in late summer/early spring of 2003. From their peak in June/July 2006 through the trough in April 2009, the 20-city composite index is down 32.6 percent. According to the Mortgage Bankers Association, refinancing applications are again on the rise and drove a good portion of the increase in overall applications last month. Unfortunately, soft demand pushed home sales toward a 13-year low. Average fixed rate conventional mortgage rates have flirted with the 4.65 percent level recently helping to spark a 12.6 percent increase in refinancing applications and contributing to an 8.8 percent increase in overall applications.

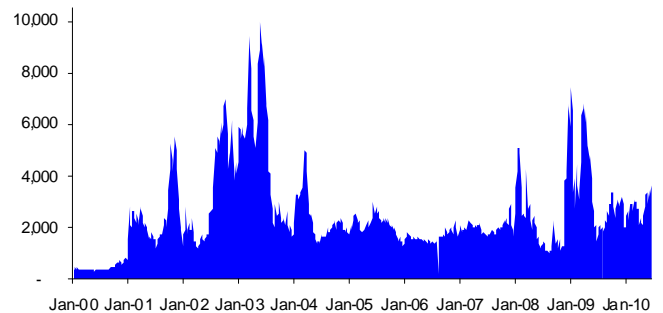
Nearly 77 percent of all applications were for refinancing, reaching its highest level since April 2009 which reached 79.7 percent. Still, the April level was still well below the most recent peak of 85.3 percent in Jan 2009 and, before that, 80.5 percent in Mar 2003.

What makes the refinancing report interesting is the relationship between the cost/benefit still available versus the cost/economic malaise to today's consumer. The Fed reports that the total charge-off rates for loans actually dropped in March from 2.71 percent to 2.39% with the FNMA's ratio of those seriously delinquent falling from 5.59 percent to 5.47 percent.

The coupon distribution for fixed rate mortgages has shifted significantly over the past 10 years, declining to a level that brings into question that, although we certainly could see the percentage of refi applications approach previous highs, will it translate into sufficient volume that would materially impact balance sheets. That might be restricted to the occurrence of a more meaningful recovery in the housing market which in turn would spark home sales and overall financing applications.

MBA Refinancing Index

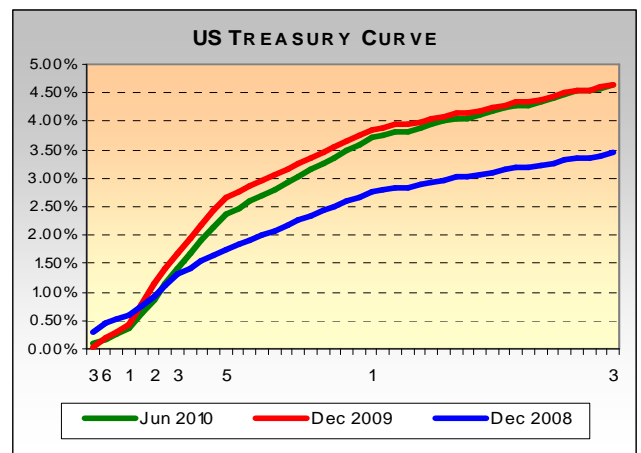
(Weekly)



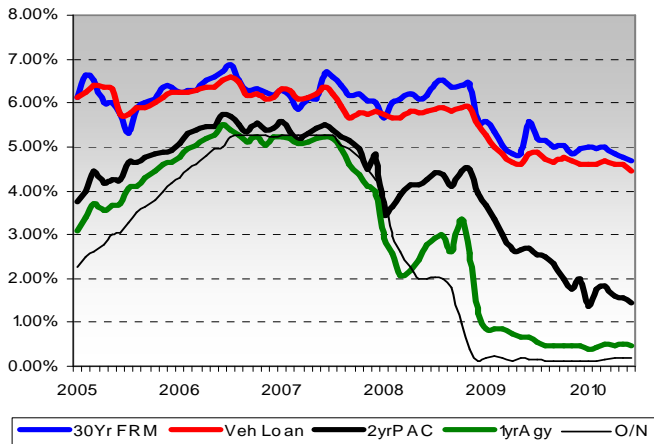
Impact on Interest Rates

Over the first half of 2010, saw little change in overnight but lower term rates. In comparison to December 2008, short-term rates are slightly lower but longer-term rates are significantly higher. This creates a steepness in the slope of the curve which enables financial institutions to realize marginal spreads between what/where they loan and invest (should relative spreads hold) versus what they have to pay for funding.

The effective fed funds rate averaged 0.16 percent during the first half of 2010 compared with 0.18 percent for the same period last year and equal to its average for all of 2009. The FOMC met four times and virtually retained their prevailing monetary policy citing the weak labor market, finicky consumer spending but low inflation.



The benchmark 2-year and 10-year US treasury note rates fell 53 and 91 basis points, respectively to 0.60 percent and 2.93 percent. This change in nominal rates slightly shifted the slope of the curve. The spread between the 3-month and two-year treasury rates fell from 109 basis points to 43 basis points while the spread between the two-year and ten-year note rates fell from 270 basis points to 233 basis points. That, in essence, took 104 basis points out of the slope of the curve.



We are now into our 19th consecutive month of a protracted low rate environment with few underlying signs that we will see a meaningful (or at least sustainable) rising rate environment - at least over the next six to nine months.

During this period, the spread between core assets (loans) and secondary asset activities (investments) has widened significantly. The steep environment has also increased the relative cost of liquidity in that the spread between overnight funds and term rates (both core and secondary assets) is very wide.

During a protracted trough like we've had, spread differentials can determine an institution's ability to absorb what might be considered relative low rate levels - namely for conventional fixed rate mortgage loans. The point is, when determining the

“how low can we go (and hold)” if concerned over the subsequent extension in average life of an earning asset, an institution also has to include the cost associated with not holding the asset. That's when the concepts behind relative value and total return come into play.

This also is the case when it comes to picking the proper marginal earning asset duration in this environment. The slope of the curve, and associated loan/investment spreads, questions which provides a better total return profile even in a rising rate environment - 1) the textbook approach of short marginal asset durations that would subsequently be reinvested into higher rates along the way, or 2) pursue a longer 2.5 to 3.5-year duration, taking the value that the steep curve provides.

Of course, this is not applicable across the board especially for those institutions with sensitive liquidity profiles or possibly higher loans-to-asset ratios. *So caveat emptor.....*

Currently, conventional wisdom expects the Fed to retain their overnight benchmark target at 0 to 0.25 percent through most of 2010 and possibly through the first quarter of next year. Even the futures market isn't pricing much of an increase (currently positioned at 0.50 percent by April). Of course, last spring the future's market was pricing in a funds rate that exceeded 1.00 percent by June 2010 - proving again that the problems that arise by using prevailing futures market levels for forecasting purposes.

The change in loan rates seemed to move parallel with change in nominal rates although relative spreads on conventional fixed rate mortgages widened slightly (to the 10-year UST).

On average, marginal loan rates fell about 30 basis points from their respective December 2009 levels. Given that the average spread to each specific index fell 8 basis points on average, this implies that nominal rates themselves fell about 22 basis points.

Investment yields fell during the first six months of 2010 as well. The average yield on a 3-year Agency bullet decreased by 82 basis points from 1.92 percent to 1.10 percent. Three-year MBS structures fell only 34 basis points from 2.44 percent to 2.10 percent. One-year Agency bullets fell 5 basis points.

	Dec'09 Avg	Jun'10 Avg	Period Change	Spread Change
LOANS				
Unsecured/Credit Cards-				
Classic	11.64%	11.63%	-0.01%	-0.01%
Unsecured Fx-36mos	10.19%	10.58%	0.39%	0.39%
Vehicle Loans-				
New Car - 60Mos	5.22%	4.77%	-0.45%	0.08%
Used Car - 48Mos	5.37%	4.88%	-0.49%	0.04%
Real Estate-				
Home Equity -5yr 80%	6.31%	5.88%	-0.43%	-0.43%
Home Equity LOC	4.85%	4.43%	-0.42%	-0.42%
5/1yr ARM	4.79%	4.31%	-0.48%	0.07%
15yr FLM	4.73%	4.34%	-0.39%	0.16%
30yr FLM	5.31%	4.84%	-0.47%	0.18%

Average shares rates fell 20 basis points on average – mostly due to narrower index spreads for short certificates. Longer term certificate rates showed wider spreads from December 2009 levels.

Given that the index used for non-term shares (fed funds) did not change during the first two quarters, lower share rates were directly attributable to narrower spreads – mostly likely a function of credit unions’ strong liquidity profile and efforts to keep cost of funds down to offset growing downward pressure on net interest margins.

It is projected that net operating cash flow increased about 11 percent.

SHARES	Dec'09 Avg	Jun'10 Avg	Period Change	Spread Change
Non-term Shares				
Share Drafts	0.30%	0.25%	-0.05%	-0.05%
Regular Savings	0.41%	0.34%	-0.07%	-0.07%
Money Market Shares - 10k	0.75%	0.59%	-0.16%	-0.16%
Money Market Shares - 50k	1.03%	0.81%	-0.22%	-0.22%
Term Certificates-				
3 months	0.78%	0.58%	-0.20%	-0.32%
6-months	1.09%	0.82%	-0.27%	-0.30%
1 year	1.42%	1.11%	-0.31%	-0.18%
2 years	1.83%	1.55%	-0.28%	0.25%
3 years	2.19%	1.94%	-0.25%	0.46%

Impact on Credit Unions

Credit union balance sheets certainly have experienced a slight shift in allocation – beyond the traditional influx of shares. This has overwhelmed cash coffers and during a period of modest loan demand, put downward pressure on most asset yields. Thank goodness credit unions operate on a spread basis though and the slope of the yield curve, along with downward pressure on cost of funds, gives many institutions some opportunity to manage an acceptable net interest margin.

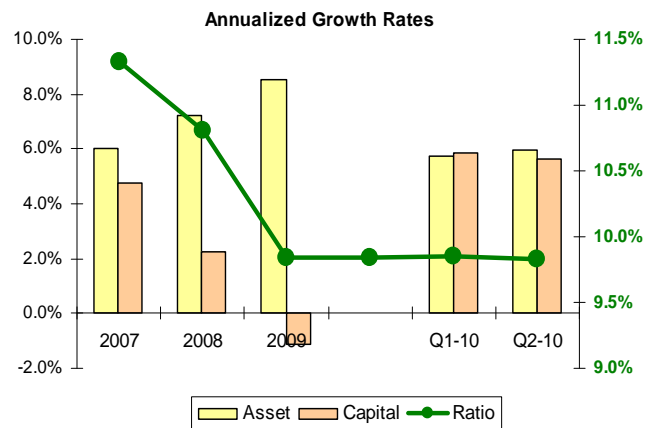
Still, the lack of consumer loan demand continues to be the bellwether of the industry. Loan growth continues to exist in residential mortgages but many are troubled that the only core asset growth opportunity is associated with relatively long-duration asset options. However, as noted before, the steepness of the curve and the relative rate levels of our alternatives enable most credit unions to realize acceptable net interest margins without adversely affecting future income streams - even in a rising rate environment.

It is estimated that, as an industry, total assets increased at an annualized 6 percent pace through the first half of the year – this from a 9 percent annualized growth in overall shares.

Many institutions experienced little change in their net interest margin (due mostly from improved loan quality) but had to deal with additional insurance assessments and lower non-interest income – enough at least to temper equity growth. Still, capital formation for the industry as a whole should remain about 10 percent.

The end of the second quarter should also see a modest shift in the funding profile of the industry. The allocation of non-term shares is expected to have increased while term certificates continue to decline. This helps to moderate cost of funds but it also creates some exposure, particularly with the associated growth in money market accounts. In some respect, that growth comes on the heels of a falling equity market causing members to flee from their stock portfolio to the safety of their credit union.

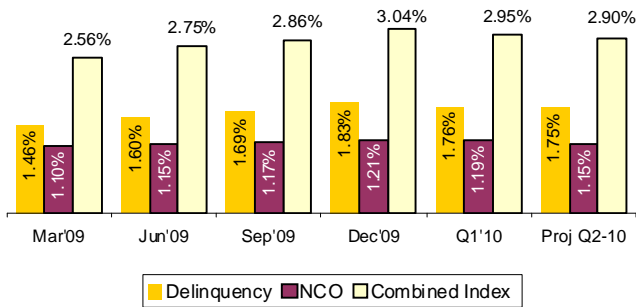
But challenges remain in the loan portfolio. It is projected that loans outstanding fell 2 percent during the first six months of 2010 – this on top of the anemic 1.2 percent growth in 2009. Vehicle loans are down about 3 percent with new vehicle loans falling 8 percent and used loans increasing 1 percent. Vehicle loans account for less than 30 percent of credit union loans outstanding – palling in comparison to a 40 percent allocation of total loans a decade ago.



Real estate loans are little changed during the year and still account for about 47 percent of total loans outstanding. When the final data is released, it most likely will show that a 1 percent increase in first-lien mortgages was offset by a 5 percent decline in second-lien mortgages. Home equity loan allocation will remain about 8 percent of loans outstanding.

Delinquencies and Net Charge-offs

(Annualized)



What might be a welcome surprise are improvements in both loan delinquency and net charge-offs which had been experiencing an upward trend over the past few years.

The highest area of delinquency continues to be associated with member business loans with a rate of 4.11 percent, as of March 2010. This was followed by a 3.2 percent delinquency rate for first-lien ARMs and 1.9 percent rate for unsecured/credit cards.

First-lien fixed rate mortgages and the remaining consumer loans each have a 1.4 percent delinquency rate.

Strategically, credit unions will continue to struggle with retaining current revenue streams in a climate of modest loan demand. Opportunities continue to exist but it might require many to recognize systematic and organic changes that have occurred due to depth of the most recent recession, their impact on consumer spending behavior and the nature of products and services that credit unions must be in a position to deliver.

We will discuss those very topics after the final release of the second quarter data.

For comments or questions pertaining to this or other subject matters, you can reach Brian at 1-800-442-6427 or e-mail him at turnerb@swcorp.org

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