CAPITAL MARKETS *monthly*

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GENERAL MARKET OVERVIEW

A soft landing is now the consensus despite Moody lowering the outlook on U.S. credit from “stable” to “negative”. Meanwhile, the U.S. Treasury is neutralizing the Federal Reserve’s attempt at cooling the economy with the emergence of fiscal dominance. Investors are weighing the challenges to portfolio positioning and risk management amid strong cross currents of tightening monetary policy and widening fiscal deficits. It is difficult for the Fed to rein in markets with government spending at wartime levels. The many false starts on predicting a recession that has not materialized contribute to the heightened volatility with the 10-year Treasury yield moving higher before retreating from the 5-handle back below 4.5%.

In June 2023, the Federal Reserve released a new index that can be used to gauge broad financial conditions. As seen here, the Financial Conditions Impulse on Growth (FIC-G) aggregates changes in seven financial variables: the federal funds rate, the 10-year Treasury yield, the 30-year fixed mortgage rate, the triple-B corporate bond yield, the Dow Jones total stock market index, the Zillow house price index and the nominal broad dollar index.

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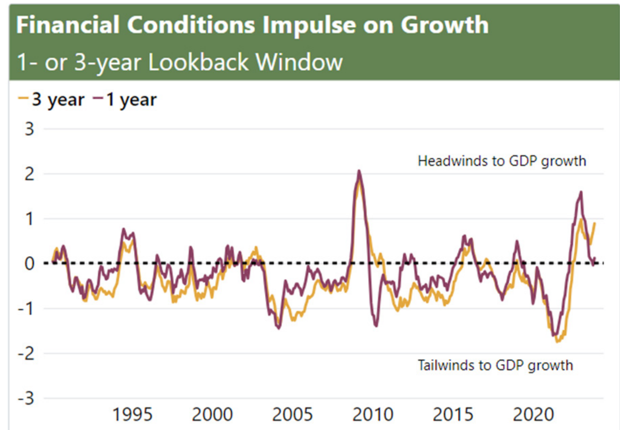
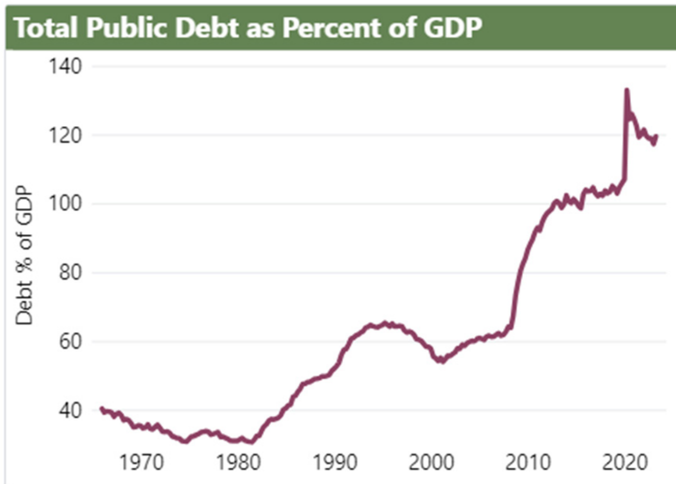


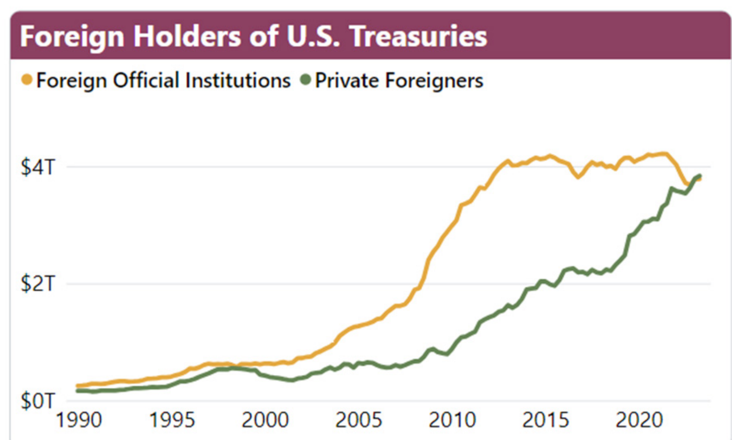
The Fed has tightened conditions and created headwinds for GDP growth, but have they done enough? The ongoing tug-of-war between the Fed and Treasury has investors discussing the economic state of fiscal dominance, where debt and deficits are sufficiently high enough that monetary policy loses its effectiveness in controlling inflation. Indeed, high interest rates risk exacerbating inflation as the higher policy rates increase debt servicing costs. This leads to a rise in deficits, which creates the need for further inflationary monetization of debt. Fed Chairman Jerome Powell recently tipped his hat to the Treasury's largess by citing an expanding term premium.



If the Fed and fiscal authorities won't rein in deficit spending, "bond vigilantes" will demand higher rates. Coined by economist Ed Yardeni in 1983, "bond vigilantes" are market-moving investors that conclude monetary and fiscal policy are reckless and take over the credit markets. The last era of prominence for "bond vigilantes" was the 1990s during the Clinton administration when advisor James Carville made President Clinton aware of the power of the bond market. Today, with so much more leverage in the system, and with total public debt at 120% of GDP, the bond market is even more powerful.

The vigilantes receded into hibernation during the post-Global Financial Crisis zero interest rate (ZIRP) policy era when central banks purchased huge swaths of bonds, and again with the COVID-19 pandemic response. Now, investors are concerned about deficits and will push bond yields up to whatever level it takes to get the attention of Pennsylvania Avenue. Bond investors were less concerned when deficits widened during bouts of economic weakness and recession and then shrank during periods of strength. Recently, however, deficits increased even outside a recessionary period.

What's particularly concerning now is the component of the deficit attributed to a rapidly rising interest expense. Compounding the issue is the volume of debt that needs to be rolled over in the near term, which begs the question: Why didn't the Treasury take the opportunity to borrow long-term when interest rates were at 5,000-year lows? When the 10-year dropped to 50 basis points in 2020, homeowners refinanced into sub-3% mortgages for 30 years, corporations termed out their debt and issued long-term and Austria issued 100-year bonds. But there was one entity that didn't extend borrowings. The U.S. Treasury issued short, 2-year paper instead. Powell's mention of the expanding term premium is a subtle way of saying the Treasury missed the boat when rates were low.



The glut of short-term paper needs to roll over and the Treasury is searching for buyers to solve the supply and demand imbalance. The Fed and other central banks are not accumulating, and banks are letting their portfolios mature and foregoing reinvestment to shore up balance sheets in response to deposit outflows. Surprisingly, Treasuries are finding a home with private foreign investors, who now hold more U.S. debt than foreign official institutions. *Continued on page 3*

So, it's no surprise that U.S. Treasury Secretary Janet Yellen welcomed Chinese President Xi Jinping on the tarmac of the San Francisco International Airport on November 14. China's investment in U.S. Treasuries is down 40% from 10 years ago.

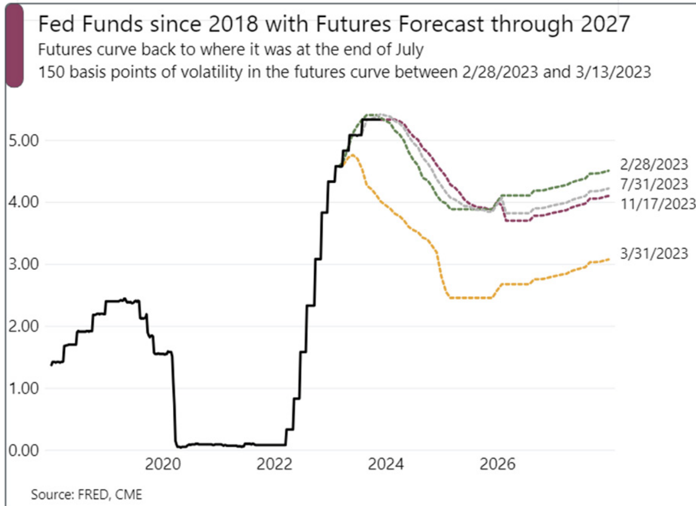
On the positive front, we welcome a respite from recent rising geopolitical tensions with a successful summit meeting between President Biden and President Xi Jinping. Xi Jinping's speech to U.S. CEOs from November 15 is well worth a read.

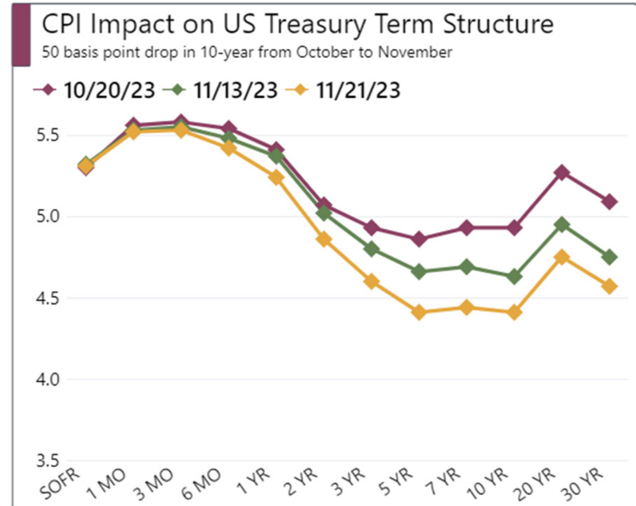
If U.S.-China relations devolve, Xi Jinping's speech will be remembered as an example of China working to avoid a Thucydides's Trap.

Read President Xi Jinping's November 15 speech to U.S. CEOs.

Fed Fund Futures Continue the Whiplash

Turning to the futures market to anticipate rates, the fed funds futures curve is back to where it was at the end of July after some volatility around the November Consumer Price Index (CPI) print. Going forward, we can expect continued volatility. A single curve masks the underlying dynamic where rate traders have split into two camps with their respective forecasts. Instead of anticipating a base case fed funds rate 6-18 months out, the futures curve is the net result of two opposing camps. The first camp in the bimodal distribution is a sustained elevated fed funds rate from a resilient economy, higher fiscal spend and sticky inflation. In the second camp, we have the tail risk of a hard stop that would necessitate the Fed cutting – not 25 basis points – but a whopping 300 basis points if (when) the economy falters. These are the two lumps in a bimodal probability distribution: higher for longer and something material just broke.





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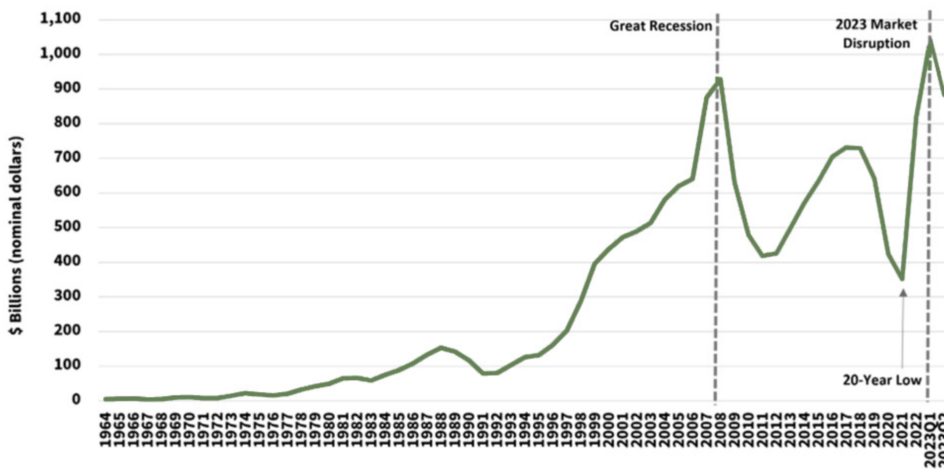
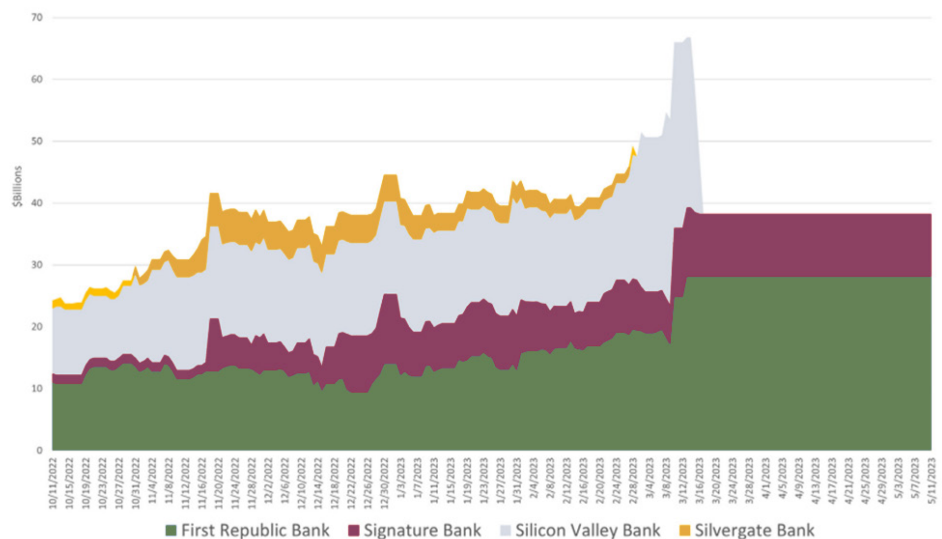
FHFA No Longer a "Lender of Last Resort"

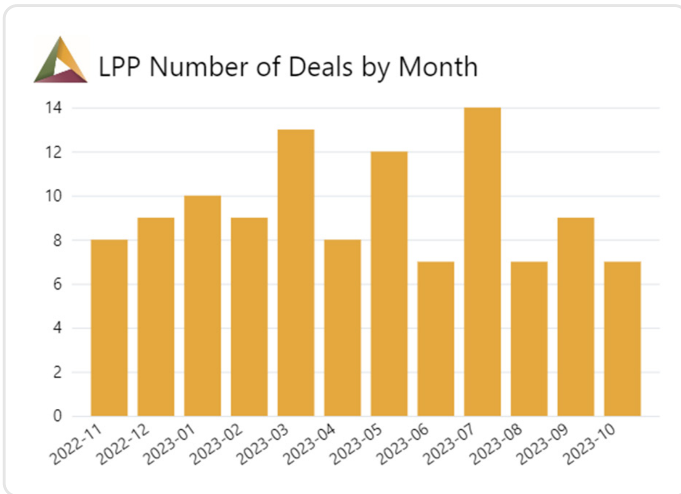
The Federal Housing Finance Agency (FHFA), which oversees housing agencies Fannie Mae and Freddie Mac as well as the Federal Home Loan Bank (FHLB) system, published a report regarding the future of the FHLB. The document, which details the FHLB's mission as a source of stable and reliable liquidity with a housing and community development focus, delves into operational efficiency, structure and governance considerations, and includes recommendations for how the FHLB system can effectively fulfill its mission. Notably, the key recommendation is for the FHLB system to return to its core mission of housing and move away from being a "lender of last resort" for troubled banks. This FHFA project was long in the works before the Q1 2023 bank failures of Silicon Valley, Signature and Silvergate. The failure of these technology-focused banks and subsequent speculations about the role of FHLB San Francisco added more fuel to the FHFA's case to curtail lending to troubled institutions.

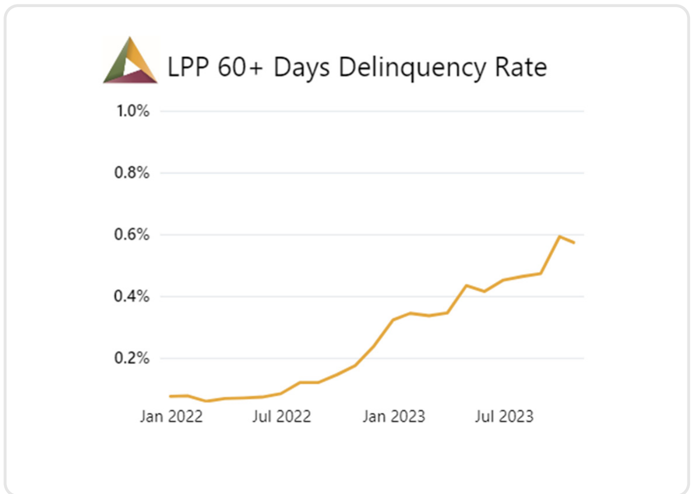


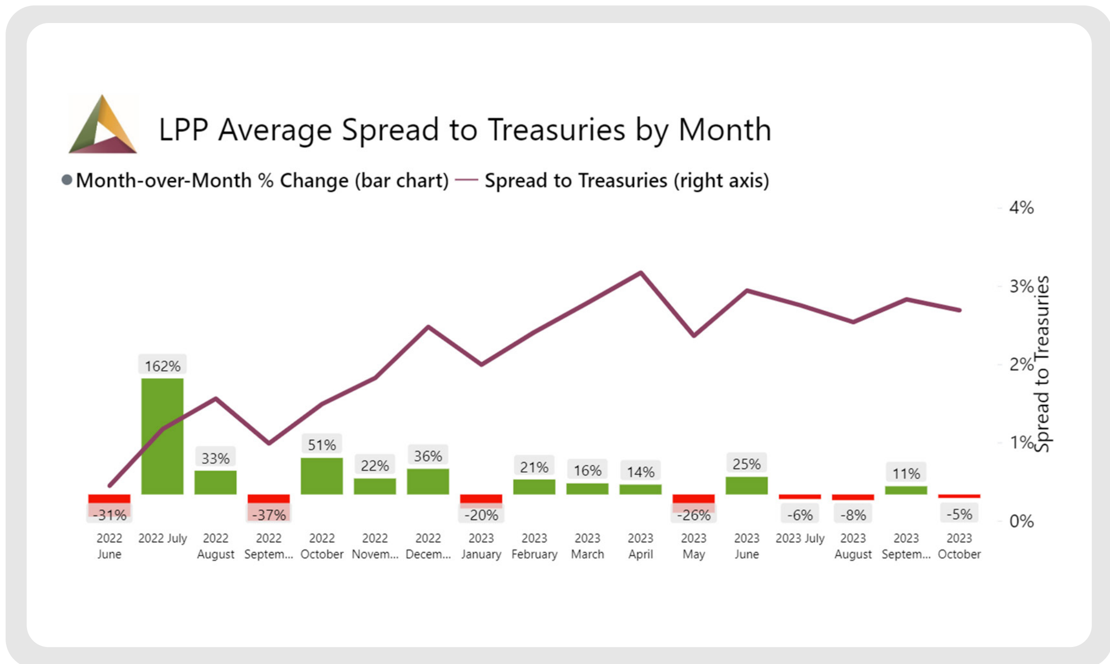
The diminishing role of the FHLB provides both challenges and opportunities – not to mention, these are recommendations that Congress will need to act on. Aside from the risk of rising funding costs, there are potential material changes to the plumbing of the financial system. For instance, with the FHLB as the largest lender of cash in the market for fed funds, a shrinking FHLB balance sheet means less excess cash to lend and a smaller fed funds market. Also, with fewer FHLB advances, the Office of Finance will then issue less FHLB conciliated obligations, which in turn means money market funds will likely park cash in the Fed's reverse repo facility instead of FHLB paper. And, of course, there will undoubtedly be unforeseen consequences. We will continue to keep you abreast of FHLB policy changes.



Loan participation deal flow has picked up among smaller credit unions who are looking to purchase. Large institutions continue to experience lower liquidity levels. The net yields of loan participation pools are an attractive spread to Treasuries across all loan types. Performance continues to be exceptional, with 60+ day delinquency rates ticking down in October below a paltry 60 basis points. Whether big or small, credit unions know that loan participations are a key ingredient in an all-weather investment portfolio. Plus, participations are a win-win, supporting credit union members in the credit union industry while bolstering earnings and balance sheet composition.







SUB DEBT MARKET & SPREAD OVERVIEW

Subordinated debt issuance has ended the year in a flurry, with multiple issuances set to close in November and December for credit unions. With 2024 planning well underway, now is a great time for education on subordinated debt and how it can contribute to your credit union's growth strategy and success. Subordinated debt contributes directly to net worth for low-income-designated credit unions and can help strengthen financials as they look to expand their products and services for members. Current target rates for issuing subordinated debt are 8.50% to 9.00% but can vary depending on size and strength of credit union. These market rates are expected to retreat in 2024 as the Fed continues to lower inflation.

With yields likely peaking for 2023, investing in subordinated debt presents a great opportunity to capture rates ranging from 8.50% to 9.00% over a 10-year period. With multiple strong offerings in the market during Q4, investors are looking to lock in these higher yields before year-end as the Fed is expected to cut interest rates in 2024. Deals are typically structured with a 10-year, 5-year no-call feature, and can be offered with a fixed or fixed-to-floating rate structure. We expect to have offerings available for sale throughout the rest of 2023, making this a great time to address board education and policies. Alloya has the above offerings for sale. If you're looking to invest in an upcoming issuance, consider discussing these opportunities with your Alloya Investment Services representative.

Current Market Rates

Issuance Size	IG Egan Jones	Kroll BBB-	Kroll BBB	Kroll BBB+	Unrated
50MM	8.750% +/-	8.750% +/-	8.750% +/-	8.750% +/-	8.500%-9.000% +/-
50MM-100MM	8.750% +/-	8.750% +/-	8.750% +/-	8.750% +/-	-
100MM+	8.500% +/-	8.500% +/-	8.500% +/-	8.500% +/-	-

ABS Market & Securitization

No new credit union asset-backed security (ABS) issuances have occurred since last month's publication. The two securities issued in September by Ent Credit Union in Colorado Springs, CO and Oregon Community Credit Union (OCCU) in Eugene, OR are the most recent deals that pushed year-to-date credit union prime auto ABS issuance to $1.3 billion. Below is a summary table of credit union auto ABS issuance since 2021. In 2023, deal sizes ranged between $200-300 million.

Credit Union	Issued	Deal Size ($ millions)	Total Assets ($ billions)	Loan-to-Share Ratio	Net Worth Ratio
UNIFY	March 2021	$300	$3.6	0.79	8.7
GTE	Nov 2021	$175	$2.8	0.78	8.3
PenFed	Aug 2022	$460	$36.7	1.17	9.0
OCCU	Oct 2022	$275	$3.2	1.12	10.5
GTE	May 2023	$202	$2.9	0.93	10.8
Veridian	May 2023	$300	$6.9	1.09	10.7
GECU	Aug 2023	$307	$4.9	1.19	7.9
OCCU	Sept 2023	$258	$3.5	1.23	9.4
ENT	Sept 2023	$243	$9.9	1.11	9.9
Average		**$280**	**8.3**	**1.05**	**9.5**

* Credit union data at time of issuance

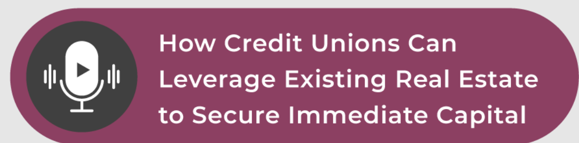
BALANCE SHEET STRATEGY

Credit unions utilize their assets as collateral to pledge for liquidity purposes. Whether it's a corporate credit union, the FHLB system or the Federal Reserve Bank's Discount Window, lenders to credit unions generally require collateral to secure their credit extension.

However, not all collateral is viewed in the same light from each lender. Furthermore, some lenders may not accept collateral that other lenders do. That's why it's imperative that credit unions understand the margins (think: haircuts) that lenders place on their pledged collateral and continuously update their positions. By consistently monitoring their collateral positions, credit unions can extract more liquidity from certain lenders depending on the credit cycle. *Continued on page 8*

Curious about sale-leasebacks?

Alloya's own Bill Paton was recently a guest on the ***C.U. on the Show*** podcast to discuss this creative strategy that credit unions are using to generate capital. Give it a listen!



BILL PATON
VP, Loan Participations & Lending

This does require additional work and monitoring by the credit union. However, this additional workload is offset in three ways:

1. The additional liquidity that comes from better management of collateral.
2. Positive view from examiners that credit unions are actively engaged with their collateral and liquidity planning.
3. Positive view from liquidity providers that credit unions are engaged with their collateral and liquidity planning.

From our perch, when a credit union is more active with their liquidity management, there is a lesser chance for disruptions within operations and the credit union management is viewed much stronger.

Something as simple as keeping updated quarterly collateral valuations and updated liquidity provider margin tables can go a long way for credit unions to manage their funds as well as help with their next audit.

Collateral Type	AVG Effective Lending Value
Single-family mortgage loans	72%
Multifamily mortgage loans	69%
Other U.S. government-guaranteed loans	90%
Home equity loans and lines of credit	67%
Community Financial Institutions (CFI) loans	53%
Commercial real estate loans	66%
Other real estate loans	73%
Cash and U.S. Obligations	94%
State and local government securities	88%
Municipal debt	79%
U.S. agency securities (excluding MBS)	95%
U.S. agency MBS and CMOs	94%
Private-label MBS and CMOs	82%
CFI securities	93%
Commercial MBS	85%
Other securities	85%
Student loan securities	94%

Source: Office of Finance November 2023 Investor Presentation

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FINAL THOUGHTS

Does it feel like credit unions are being squeezed by economic uncertainty? While that may be true to an extent, as lenders typically tighten credit standards during economic downturns (something many credit unions also do), our movement is ready to face these challenges head on.

Credit unions are relying on their ingenuity to ensure ample liquidity for the future by engaging in loan and asset sales, accessing the ABS market and engaging in the DTC market with brokered CDs. It's often said that uncertainty creates possibility. This statement rings true in today's volatile liquidity market. It is thanks to discomfort that credit unions are getting creative and solving their own problems – something that is sure to serve the industry well today and for generations.

Wishing you and your loved ones a happy and healthy holiday season. We look forward to continuing our journey through the capital markets with you in 2024!