CAPITAL MARKETS *monthly*

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GENERAL MARKET OVERVIEW

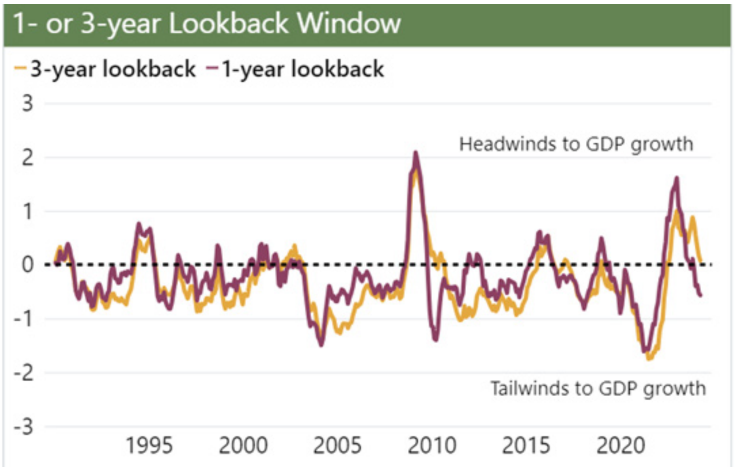
Nearly no bears are left standing after a prolonged period of recession-watch fatigue. We have been talking about recession and weakness for a couple of years with the persistent threat of downturn, and many bears have thrown in the proverbial towel. Consensus is the U.S. economy is settling into a no-landing or, at worst, a soft-landing scenario. The labor market remains strong with stocks, commodities and risk assets lifting as housing refuses to quit. Although mixed, taking a broad panoramic view of economic data suggests continued caution and vigilance. After a period of disinflation, central bankers are worried about consumer price inflation getting stuck and the potential for structurally higher prices going forward.

As risk managers and capital allocators, we, along with Fed Chair Jerome Powell, **want** lower rates, but is that what we **need**?

Let us contemplate two questions: **1)** Are financial conditions restrictive? and **2)** Are higher rates actually exacerbating inflationary growth rather than curtailing it as conceived by conventional monetary wisdom?

First, see the accompanying chart on page two on the Federal Reserve's index designed to gauge net financial conditions' impact on economic growth. Recall that this new index, launched in June 2023, 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. The index most recently topped out with "headwinds to GDP growth" in December 2022 and has been dropping into "tailwinds to GDP growth" despite the Fed's ongoing efforts to curtail the highest price inflation in 40 years. *Continued on page 2*

The National Financial Conditions Index is the loosest it has been since the Fed began the rate-hiking cycle. Which brings us to point number two. A theory picking up steam in the financial press (**including this Bloomberg article**) is that higher rates could be perversely causing higher economic growth rather than weakness. In simplistic terms, conventional monetary policy attempts to either slow down or promote economic activity through a restrictive or accommodating stance by raising or lowering near-term interest rates. In both cases, markets are forward looking and adaptive, so the monetary transmission mechanism is noisy with "long and variable lags," as famed economist Milton Friedman observed. As discussed in the Bloomberg article above, JPMorgan strategist Jack Manley speculates that higher rates at this point embolden rather than weaken inflation. Is he correct? It's all about the timing of assets versus liabilities and public versus private balance sheets. Higher rates create both additional income and higher debt-servicing costs. From the article, "Households receive income on more than $13 trillion of short-term interest-bearing assets, almost triple the $5 trillion in consumer debt, excluding mortgages, they pay interest on. At today's rates, that translates to a net gain for households of some $400 billion." Further, a fed funds rate above 5% isn't as meaningful to those that locked in 30-year fixed mortgages or prudently termed out debt. Higher rates can temporarily be stimulative.

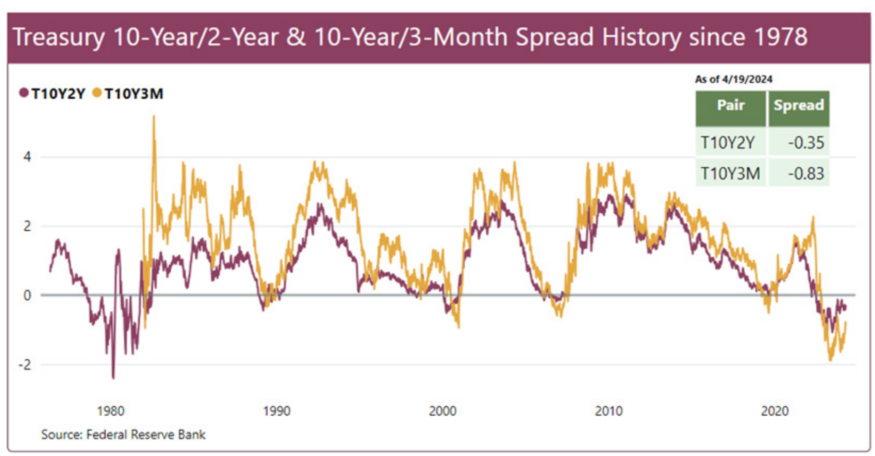


As an aside, this rhymes with a comment recently made by the CEO of Redfin, Glenn Kelman. Kelman believes that even though rates are up and sales volume has plummeted, home prices have not dropped as a consequence of Fed-induced incentives keeping homeowners where they are saying, "It actually has the perverse effect of keeping home prices high."

The bottom line is higher interest rates might be stimulative until a tipping point of households and corporations have to refinance debt, at which point the market's recession fatigue will find a second wind. Milton Friedman also explained, "One of the great mistakes is to judge policies and programs by their intentions rather than their results."

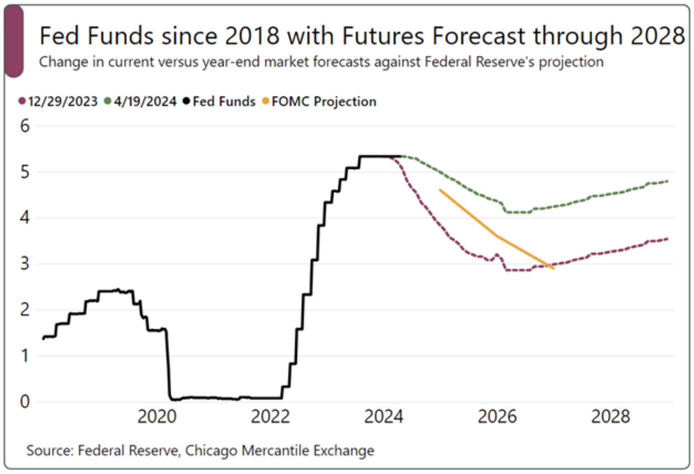
Yield Curve Inversion

The inverted yield curve (10-year minus 3-month) has now been inverted for the longest duration in history. Historically, inversions have been a near-perfect signal to forecast recessions. So, why hasn't the inversion foretold a recession? First and foremost, this is due to fiscal dominance, which was discussed in the **November 2023 issue of *Capital Markets Monthly***. Secondly, recessions historically do not materialize until after the yield curve reestablishes its normal upward slope. Strictly speaking, the pattern is: The yield curve first inverts and then un-inverts before a recession. We need to wait until the curve normalizes for a material length of time without recession before we can say this time is different. *Continued on page 3*



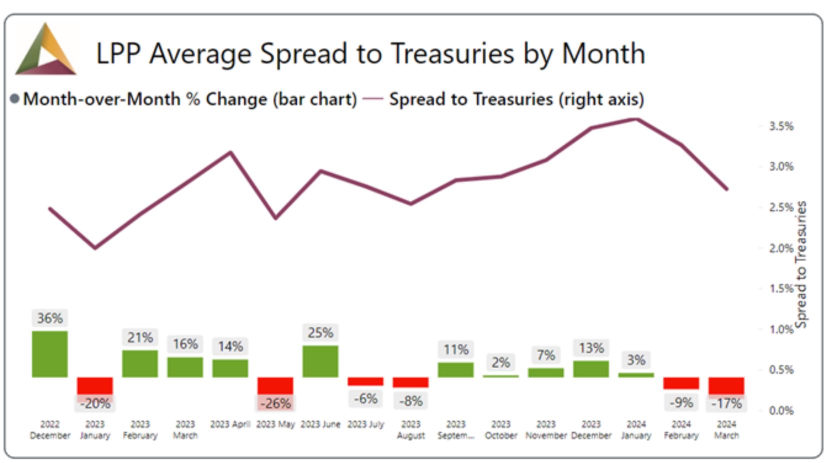
Fed Funds Futures

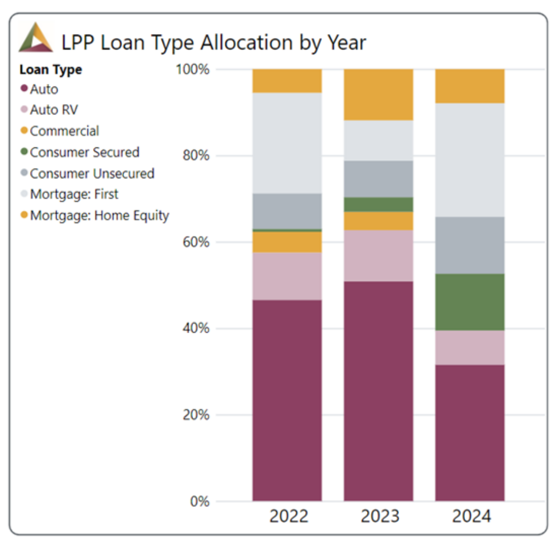
Sticky inflation and a resilient economy created tremendous rate volatility in the futures markets. The Federal Open Market Committee continues to project a steady straight-line decline in fed funds with a projected year-end 2026 rate under 3%. Contrast the Fed's projection with the market's expectation. At year-end 2023, markets priced in 150 basis points of cuts by year-end 2024, with further cuts below 3% by early 2026, before beginning to climb again after mid-2026. Compare that outlook with the market's expectation as of mid-April (green dotted line). Now the market only expects one 25-basis-point cut in 2024, and a much more modest cutting cycle of only 120 basis points into 2026. Futures markets are distilled probability distributions condensing a cone of possibility into a futures rate. Unthinkable just months ago, the bold with variant perspectives are using futures and options to bet that rates could actually go up within that cone of probability. Regardless, those seeking relief from rate cuts will need to wait longer.



LP MARKET OVERVIEW

Liquidity is coming back! Buyers have funds and are hungry to increase their loan participation (LP) allocation. With slower originations, LP buyers are looking to shore up their loan books and loan-to-share ratios. Spreads are still very attractive compared to other investment opportunities. The weighted average net spread across all loan types is still over 250 basis points above Treasuries, even with significant buyer demand and an uptick in mortgage-related LP activity, which has traditionally seen tighter spreads. Whether you're looking to buy or sell, visit our Loan Participation Platform (LPP) marketplace today to take advantage of the current opportunity set. The platform continues to service win-win deals across many loan types. In general, buyers are back looking for reasonable yields, and a number of sellers are happy to offload loans securing profits and managing risk.





Sale-Leaseback Strategy

A sale-leaseback transaction can be a beneficial financial strategy for credit unions, offering advantages in terms of capital management, liquidity and operational flexibility.

Sample Transaction for $1 billion CU		Sale Leaseback Only - Reinvestment in Cash	
	Current Financial Statement	Pro Forma	Change
Impact on Earnings			
Net Interest Income	$28,000,000	$28,600,000	$600,000
Net Interst Margin	2.80%	2.90%	0.10%
Net Income	$9,000,000	$8,913,000	-$87,000
ROA	0.90%	0.88%	-0.02%
Impact on Net Worth			
Net Worth	$80,000,000	$86,000,000	$6,000,000
Net Worth Ratio	8.00%	8.60%	0.60%
Liquid Asset Ratio	9.00%	10.08%	1.08%
Assets	$1,000,000,000	$1,012,000,000	$12,000,000
Liquid Assets	$90,000,000	$102,000,000	$12,000,000
Sale Leaseback Transaction			
Building Sale Price	$12,000,000	Assumes Investing in Cash	
Gain on Sale- Building	$6,000,000	$600,000 Earnings at 5%	
Annual Lease Expense	$840,000	7% cap rate	
Foregone Depreciation	-$153,000		
Net New Expense	$687,000		

By selling a property and then leasing it back, credit unions can unlock the capital tied up in real estate assets. This influx of capital can be used to fund strategic initiatives, such as technology upgrades, expansion or other investments, without having to resort to traditional loans or other forms of debt. Sale-leasebacks can also act as a source of liquidity and the full purchase price can be utilized to help offset the new lease expense, in addition to the capital gain. Credit unions who enter into a sale-leaseback agreement will be able to remain operational with a triple net lease structure, giving you full control of your buildings to meet your members' needs.

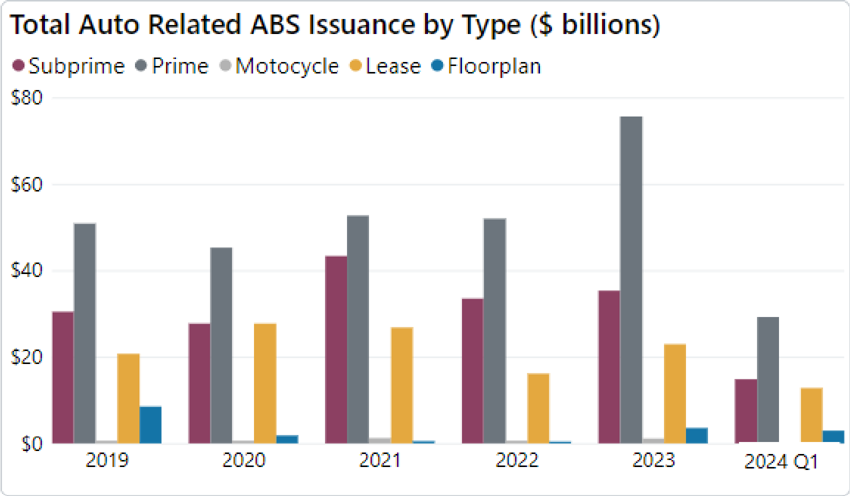
Many credit unions are seeing healthy gains on their properties, with real estate prices increasing steadily over the past five years. These gains, coupled with tight liquidity, have made this type of transaction an exciting opportunity for credit unions across the country. There is very little upfront leg work to get a free valuation done on your buildings, and the process can typically be completed in under two weeks.

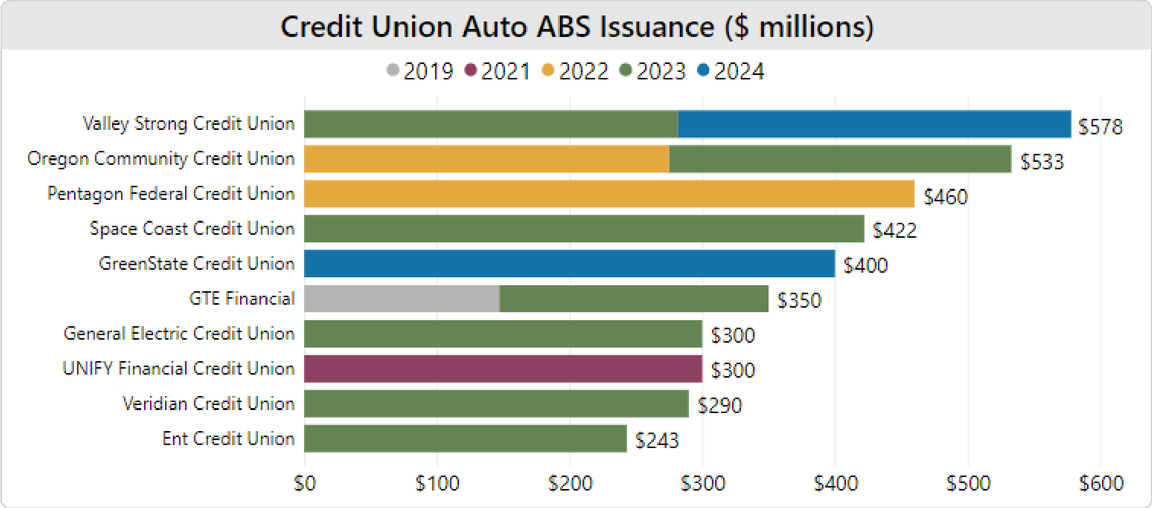
Valley Strong Credit Union 2024-1

Class	Size ($M)	WAL	Rating	Spread	Coupon	Yield	Price
A1	29	0.13	P-1	18	5.58%	5.58%	100
A2	115	0.79	Aaa	70	5.79%	5.87%	99.99377
A3	67.65	1.94	Aaa	100	5.62%	5.69%	99.98635
B	53.21	2.88	Aa3	135	5.77%	5.84%	99.98943
C	9.01	3.45	A3	210	6.44%	6.53%	99.98839
D	22.1	3.78	Baa3	300	7.29%	7.40%	99.9992
E	35.7	4.45	NR	-	-	-	Retained

Valley Strong Credit Union brought their second auto asset-backed security (ABS) to market with a $296 million issuance. Note that the originator retained the $35.7 million unrated Class E tranche.

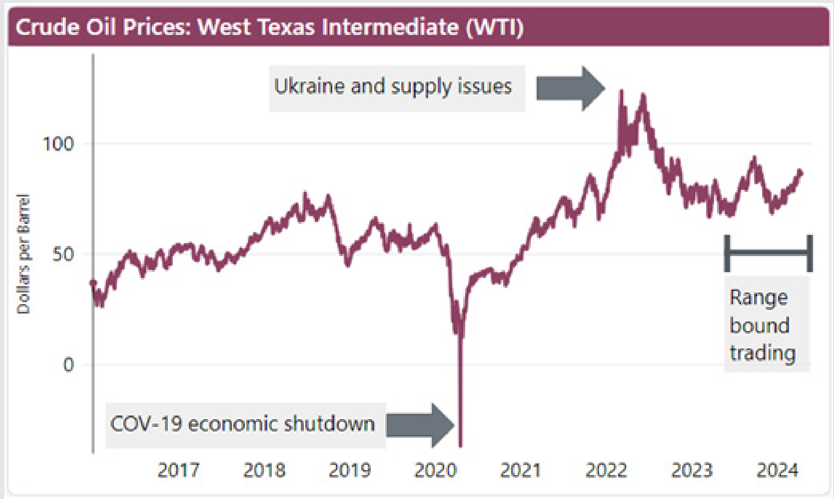
In October 2023, Valley Strong issued $282 million, bringing their total marketable ABS issuance to an impressive $578 million, pushing Valley Strong to be the largest issuer of credit union auto ABS paper. It is worth noting that Valley Strong is making headway as the first credit union to issue a non-prime ABS. While there are many nuanced differences between prime and subprime, the dominant characteristic is credit (FICO) score, both at the loan level, as well as the weighted average deal aggregate. The difference in credit quality impacts the deal structure, loss forecasts and credit enhancements, as well as the various tranche ratings and prices. In coming publications, we will provide a more detailed analysis of credit union ABS deal characteristics for both prime and subprime. Over the last couple of years, total subprime ABS issuance has been about half the amount of prime auto. We anticipate more credit unions participating in subprime as investors grow more comfortable with credit union practices and performance.





FINAL THOUGHTS

The Fed is in a holding pattern, but we all continue to push forward, managing risk and meeting the needs of our members. Between the Red Sea shipping disruption and escalating kinetic interaction between Israel and Iran, we have plenty of geopolitical tension to consider as we calibrate our portfolios and revise outlooks. Geopolitical tension impacts investor and consumer behavior and sentiment. Look to the impact on oil prices to gauge the net market's opinion on the significance of any particular geopolitical event. Oil prices did not jump materially on news of Israel/Iran tension.



Without minimizing the humanitarian crisis and real cost to those directly involved in the conflict, oil is signaling that the military escalation will not spill over into broader markets. Oil is the largest commodity input into an economy and oil prices today anticipate future supply issues. That being said, thus far, the move in oil has not warranted a change to the Fed's reaction function.

John D. Rockefeller, the small-time financier from Cleveland, Ohio turned oil magnate, was well known for his ability to keep his head while everyone was losing theirs. A reporter asked him if he was born this way. He replied with an emphatic "no" and attributed his stoic demeanor to "the school of adversity and stress." Liquidity is coming back, but we know how quickly things can change. We can't control markets, but we can control our response to changing conditions. With the right mindset, shifts in liquidity, inflation expectations, growth and risk premia all lead to opportunities.

> *You can't always get what you want,*
> *But if you try sometimes,*
> *Well, you might find*
> *You get what you need.*
>
> \- The Rolling Stones

We may not want an inverted yield curve with 5%+ short-term rates, but perhaps it's what we need.