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CAPITAL MARKETS *monthly*

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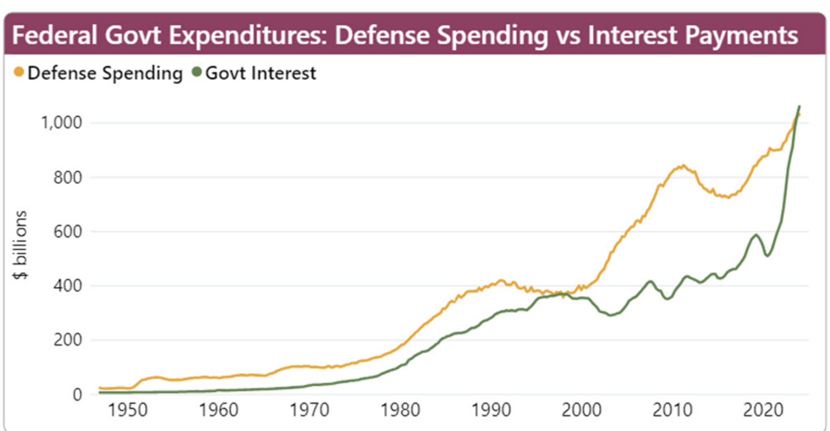
GENERAL MARKET OVERVIEW

According to historian Niall Ferguson, "Any great power that spends more on debt service than on defense will not stay great for very long. True of Habsburg Spain, true of *ancien régime* France, true of the Ottoman Empire, and true of the British Empire… and this law is about to be put to the test by the U.S. beginning this very year."

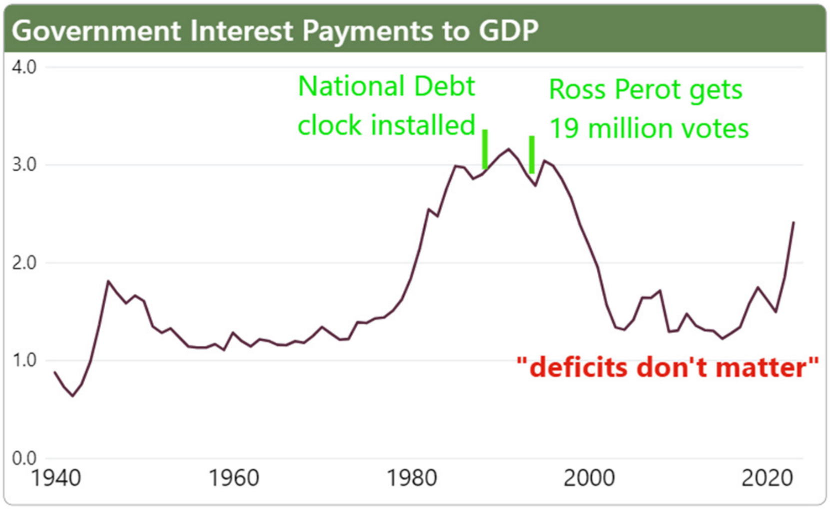
This quote, known as Ferguson's Law, was cited in a recent *The Wall Street Journal* article, **"Will Debt Sink the American Empire?"**.

Looking at the graph, you will notice that U.S. defense spending began increasing in the 1980s and '90s, and with it, the concern about public debt. The national debt clock was installed in 1989, and in 1992, independent presidential candidate Ross Perot received over 19 million votes largely running on debt and deficits. But then China and a post-Soviet era opened up globalization and shepherded in a prolonged period of disinflation. Interest rates and interest expense as a percent of GDP began to fall even as public debt was increasing, which led many to believe that "deficits don't matter." Fast forward to today, deglobalization, supply-chain friction, higher rates and accompanying interest expense have weighed on the pendulum to swing back towards debt concern. *Continued on page 2*



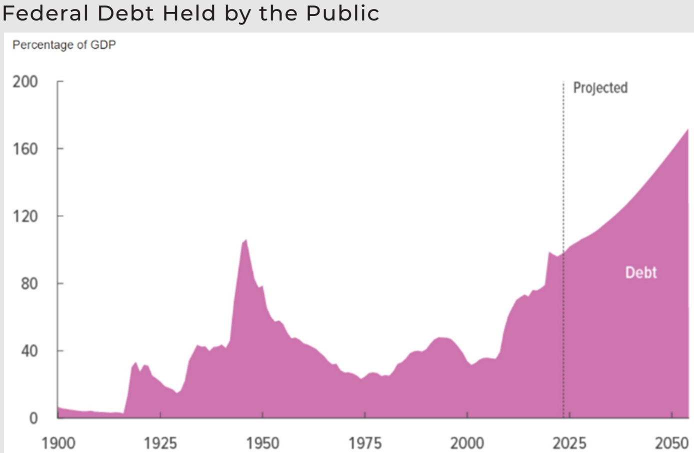
What does this mean for bonds? Nominally, bonds will probably be okay, but in real terms, and especially on long-term government debt, they will underperform.

In just four short months, the **Congressional Budget Office** (CBO) increased the 10-year projected deficit to $22.1 trillion from $20.0 trillion. The additional $2.1 trillion (10% in four months!) came from a $1.6 trillion increase in legislative changes, $1.1 trillion increase in technical changes and a reduction of $0.6 trillion in economic changes. Debt held by the public is projected to increase at a 45-degree angle for the next 30 years reaching 172% in 2054, well beyond any historical precedent.



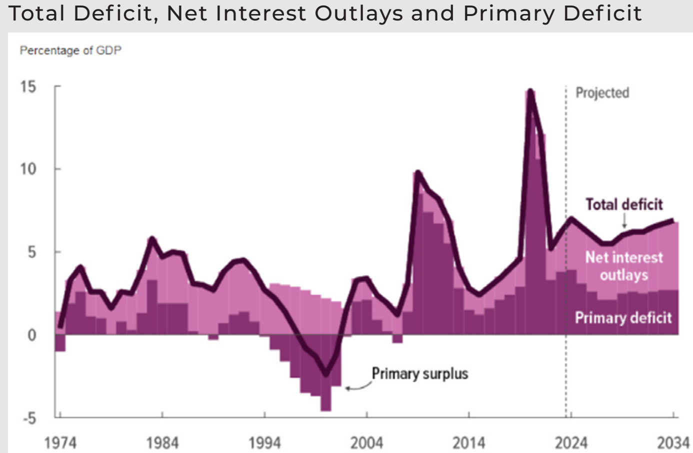
There are three ways out of this excessive debt: 1) austerity, 2) default and/or 3) inflate. Austerity and default are not going to happen. Deficits expand regardless of which lever is pulled in the voting booth. The game theoretical outcome is to pay future debt with a debased dollar through rolling bouts of inflation and volatility and through kicking the proverbial can through lower rates and increased leverage. Namely, preserving the status quo. Net interest outlays are projected to be the bulk of the fiscal deficit going forward. One must ask what is more likely: that Congress makes hard choices like entitlement reform or exerts pressure on the Fed to find a more appropriate (*cough cough lower*) rate path? *Continued on page 3*

Federal Debt Held by the Public



Source: Congressional Budget Office

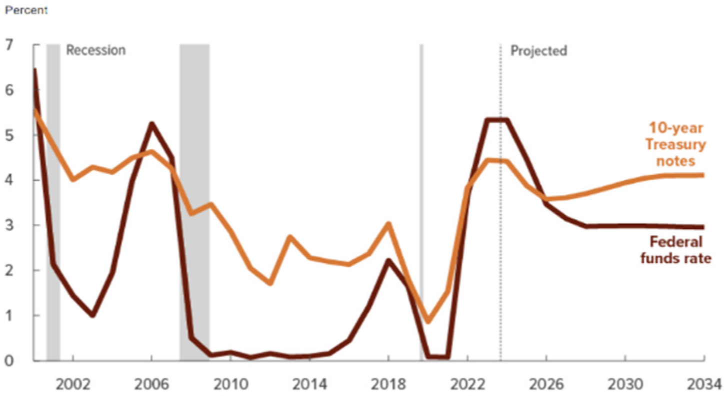
Total Deficit, Net Interest Outlays and Primary Deficit



Source: Congressional Budget Office

In June 2024, some foreign central banks began their rate cut cycle, but the U.S. Fed is still in a wait-and-see mindscape. The Fed is correct to hold off on cuts to avoid the contradiction put forth by the European Central Bank (ECB). Perversely, the ECB cut rates *AND* raised their inflation outlook for the next two years. The consensus in the U.S. is still hovering on soft-landing with a base case on both higher inflation and interest rates. Regarding CBO rates forecasts, they project the yield curve will normalize in 2025 as the fed funds rate drops to 3% and the 10-year Treasury normalizes around 4%.

Interest Rates



Source: Congressional Budget Office

Miraculously, every CBO projection is little more than drawing a gradual line from the current value to the desired future value, which is then carried forward indefinitely. They do not forecast any pesky recessions, nor any under-or-over-shooting of targets.

In reality, surprises and deviation from forecast are the norm. So, who will absorb all these Treasuries? Foreign holders continue to divest, and just last week a large Japanese agriculture bank was forced to sell $63 billion in U.S. and European sovereign debt due to large unforeseen losses. The graph below shows the Fed's balance sheet going back to 2000, a large portion of which is Treasuries. Currently, the Fed is shrinking its balance sheet through a quantitative tightening (QT) runoff, but not for long. Accompanying the "Federal Reserve Assets" graph below are three comments made by Former Fed Chair Ben Bernanke in 2011, 2015 and 2017 pontificating as to the direction of the size of the Fed's balance sheet.

> *"The amount of the Fed's balance sheet will be normalized and there will be no permanent increase either in money outstanding, in the Fed's balance sheet or in inflation."*
>
> – Bernanke, February 2011

> *"The Federal Reserve does not need to shrink its $4 trillion-plus balance sheet by even 'a dime' for it to normalize monetary policy when the time comes."*
>
> – Bernanke, May 2015

> *"I think they're aiming for something in the vicinity of $2.3 to $2.8 trillion, something like that."*
>
> – Bernanke, May 2017

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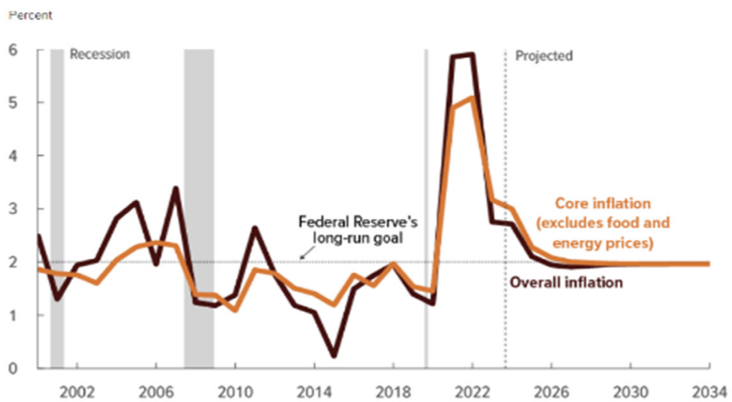
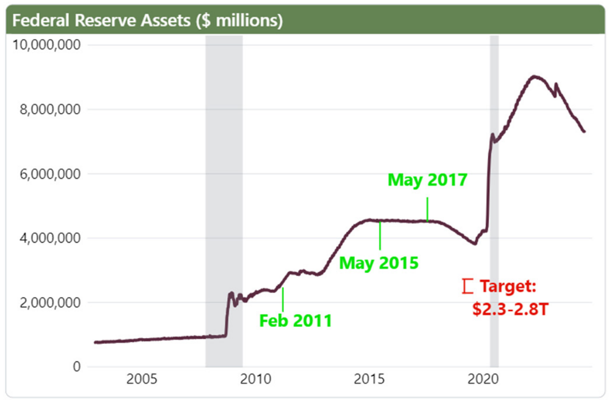
Overall Inflation and Core Inflation



Source: Congressional Budget Office



The point of the aforementioned graph and quotes (see page 3) is to illustrate how nobody knows if the Fed balance sheet is going to $2 or $20 trillion. There is an old saying, “He who tells the future lies, even when telling the truth.” Nobody has a crystal ball, neither the market nor the central officials, and so our proposition to the reader is that the way forward is to trust your own judgement and intuition.

CBO's Baseline Projections of Federal Debt
Billions of dollars

	Actual, 2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034
Federal Reserve's holdings of debt held by the public	4,958	4,406	4,482	4,958	5,476	6,038	6,621	7,171	7,679	8,194	8,714	9,245

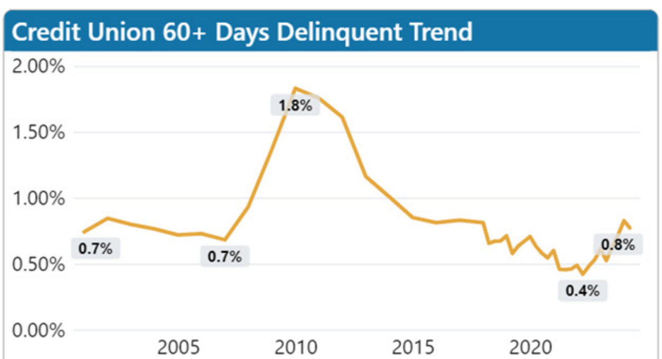
Source: Congressional Budget Office

QT is unlikely to go much further. The Fed tells us they are shrinking the balance sheet, but the CBO is projecting that the Fed’s Treasury holdings will nearly *double* over the next 10 years – and that is without any economic shocks in their forecasts.

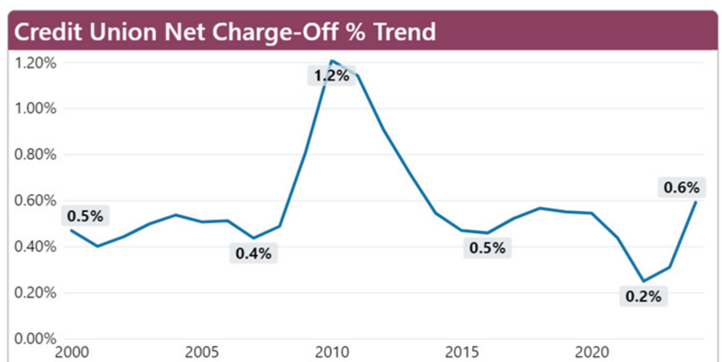
Skirmishes and proxy wars aside, keep in mind these projections are based on a “peacetime” economy. Perhaps Ferguson’s Law is more of a foreshadowing. The historical expenditures relationship between debt service and national defense can be maintained by increasing defense spending or by reducing debt service interest costs.

CALL REPORT UPDATE

First, let’s check in on the health of credit union members. Below are trend charts for both delinquencies and charge-offs. Both 60+ day delinquencies and net charge-off rates are elevated but still well below highs reached during the Global Financial Crisis. As of Q1 2024, 60+ day delinquencies were 0.77% while the net charge-off percent was 0.59%.



Credit Union 60+ Days Delinquent Trend



Credit Union Net Charge-Off % Trend

Credit unions continue to outperform banks in several key performance indicators. Notably, the delinquency rates on credit card loans are a full percentage point lower for credit unions compared to banks. Delinquency rates for banks are 3.1% but only 2.1% for credit unions.

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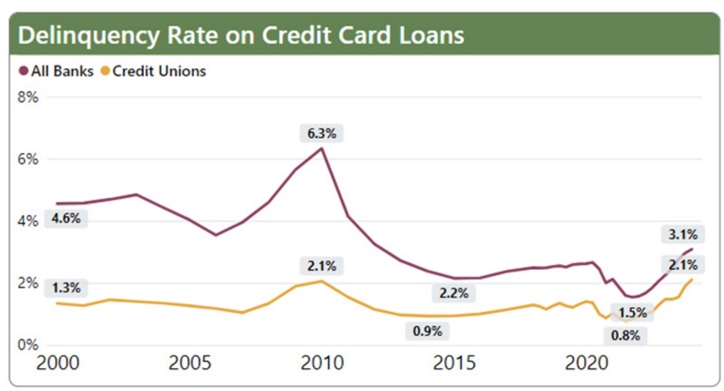
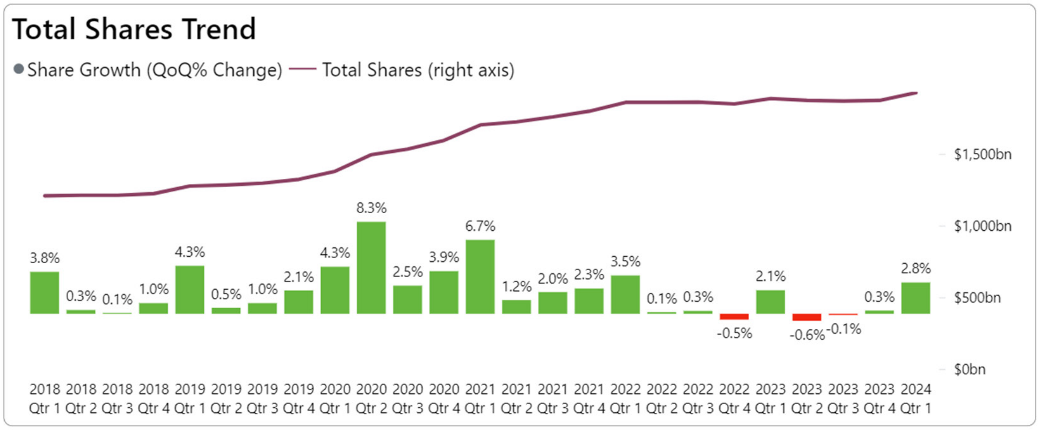
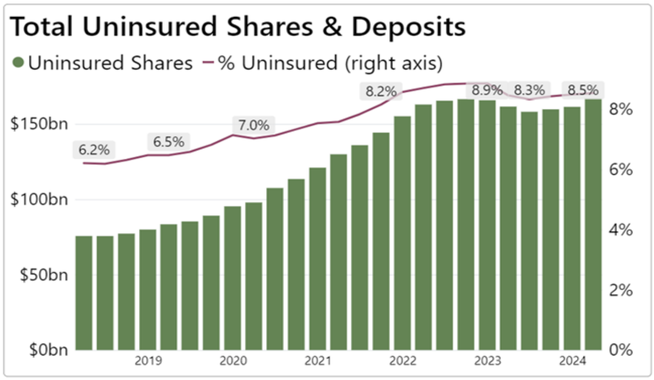


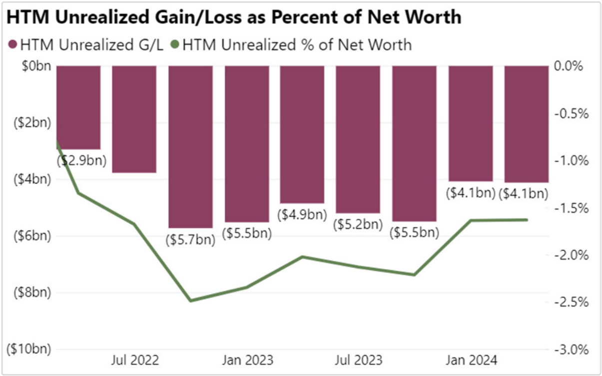
Delinquency Rate on Credit Card Loans

Total shares increased by 2.8% in Q1 to over $1.9 trillion, the largest increase in quarterly growth since the first quarter of 2022.

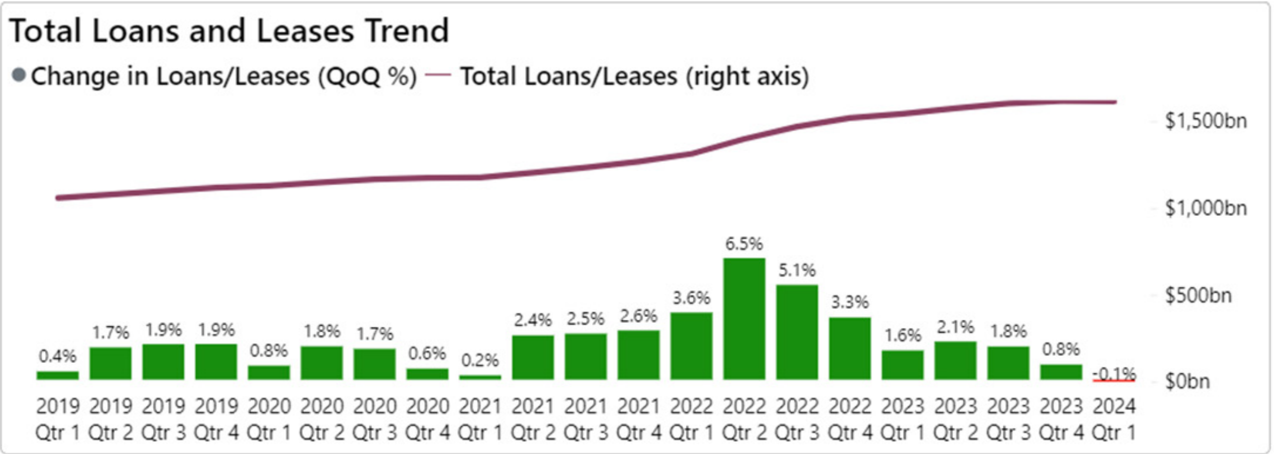
Total uninsured shares increased modestly to $166.9 billion, or 8.5% of shares. Recall that uninsured deposits became relevant in March 2023 in the wake of high-profile bank failures triggered by the twin sins of high uninsured deposits coupled with large unrealized losses on held-to-maturity (HTM) investment securities. Credit unions' unrealized losses on HTM securities remained flat at a paltry $4.1 billion, or 1.6% of net worth. Banks, on the other hand, continue to make headlines with excessive unrealized losses leading to declining bank equity prices and regulatory solvency concerns. We will continue to monitor this important dynamic for the reader.



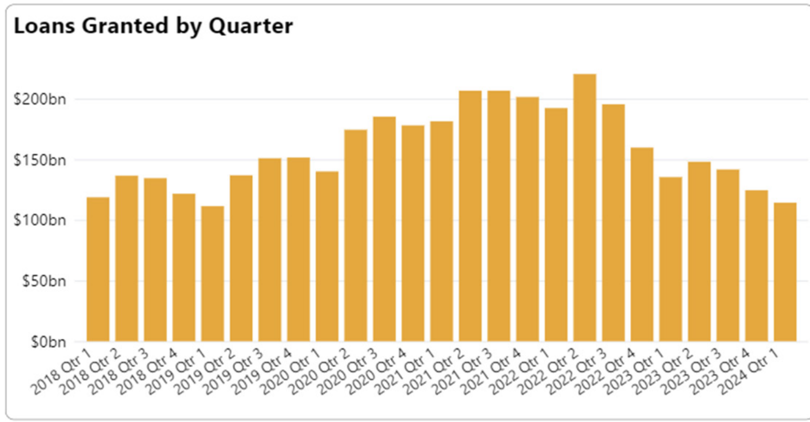


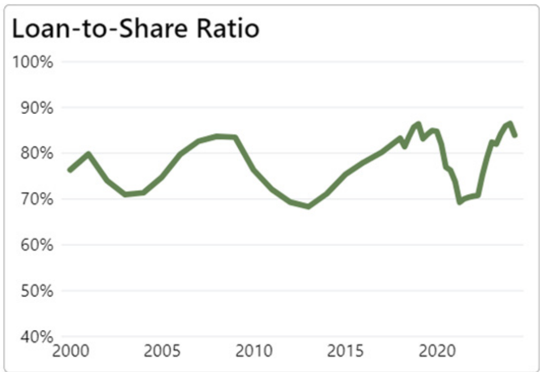


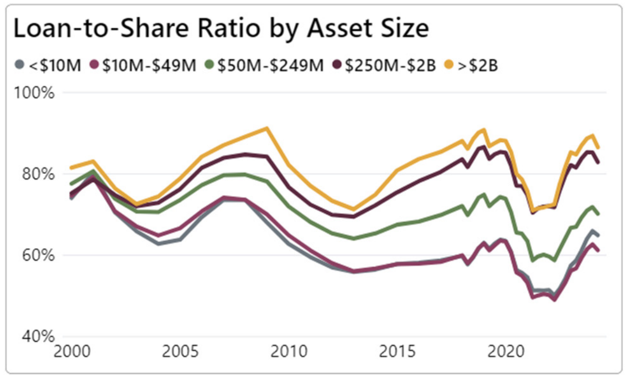
Total loans and leases outstanding decreased modestly by 11 basis points. The net growth in loans outstanding has been steadily falling since Q2 2022 and finally went negative. At $114 billion, quarterly loan originations were the lowest since Q1 2019, leading to the decline in net outstanding loans. *Continued on page 6*



The rise in shares coupled with a slowdown in loan originations led to lower loan-to-share (LTS) ratios across the board. The industry LTS dropped to 84% from the all-time high of 86% reached at year-end 2023. Larger credit unions over $250 million continue to run higher LTS than those under $250 million by a noticeable margin. Share growth has largely accrued to the larger credit unions who pay up for those shares with higher deposit rates.

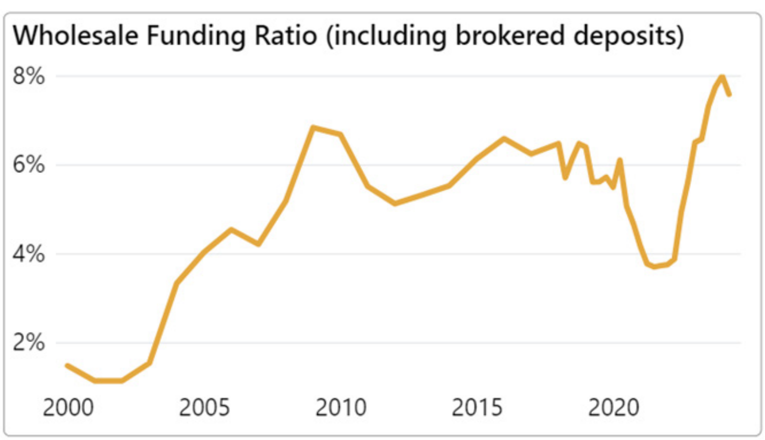






2-Year Change in Shares and Loans By Assets Size

Asset Size	# of CUs	% of CUs	2 Yr $ Shares Change	2 Yr % Shares Change	2 Yr $ Loans Change	2 Yr % Loans Change
<$10M	926	20%	($0.5bn)	-13%	$0.2bn	13%
$10M-$49M	1274	27%	($4.0bn)	-12%	$1.5bn	10%
$50M-$249M	1348	29%	($10.6bn)	-7%	$9.4bn	11%
$250M-$2B	875	19%	($28.9bn)	-5%	$37.0bn	9%
>$2B	247	5%	$111.6bn	10%	$253.7bn	31%
Total	**4670**	**100%**	**$67.5bn**	**4%**	**$301.8bn**	**23%**



Wholesale funding usage decreased for the first time since Q1 2022. The wholesale funding ratio, the percent of funding from wholesale sources, dipped to 7.6% from a record-high of 8% at year-end 2023.

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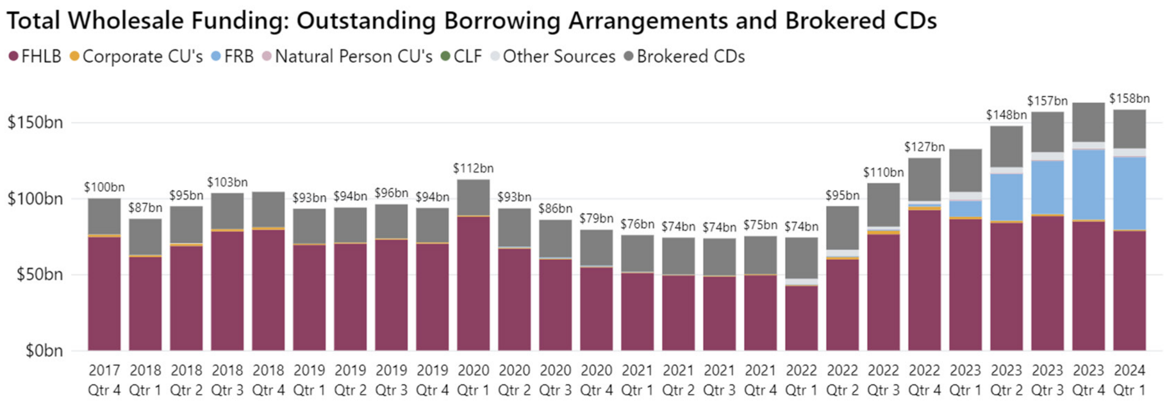
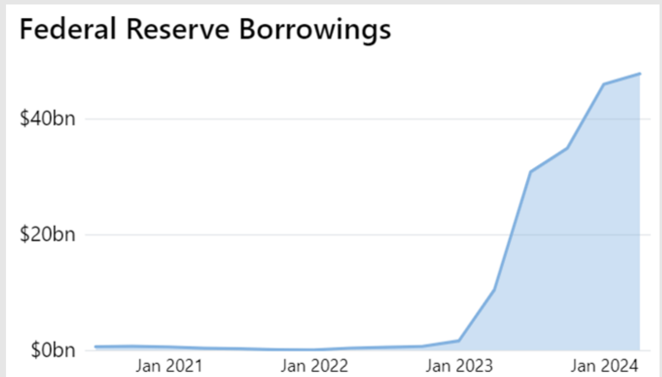
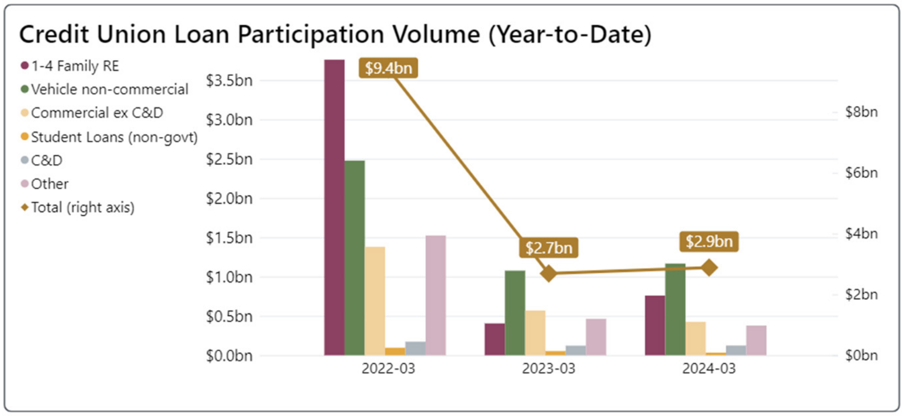
Looking under the hood by lender, the decrease in wholesale funding came from a decrease in Federal Home Loan Bank (FHLB) advances.

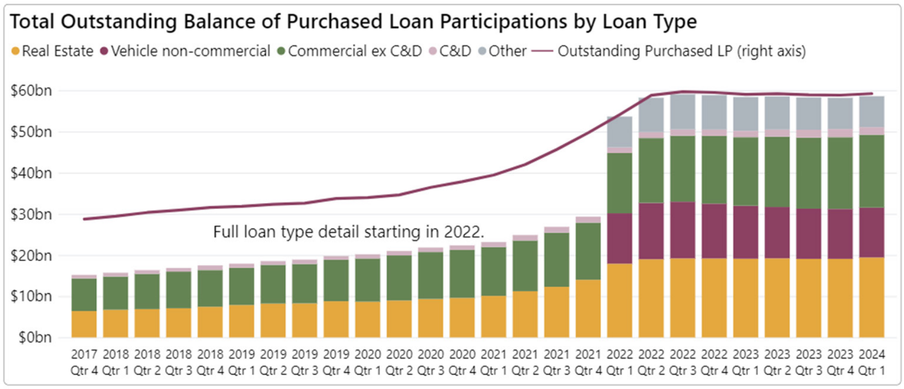


Despite the Fed's Bank Term Funding Program ending, Federal Reserve borrowings increased another $1.8 billion to $47.7 billion.





Q1 2024 saw loan participation volume increase modestly from Q1 2023, but volume is still well below 2022 levels. Loan types stayed consistent from last year, with some additional volume from 1-4 family real estate. New volume did exceed portfolio runoff after several quarters of flat-to-dwindling participations outstanding.



		3/31/2024
CU's with LP Outstanding		2041
% of CU's with LP Outstanding		44%
CU's with LP Purchased		1950
CU's with LP Sold		856
5 Yr Change in # of CU's with LP	▲	110
5 Yr Change in % of CU's with LP	▲	6%
LP Purchased Outstanding		$59bn
5 Yr $ Change in LP Purchased Outstanding	▲	$27bn
5 Yr % Change in LP Purchased Outstanding	▲	86%

CAPITAL SOLUTIONS MARKET & BALANCE SHEET STRATEGY

Credit unions use subordinated debt proceeds to support various initiatives, such as expanding operations, making strategic investments or meeting regulatory capital requirements. By accessing this additional capital, credit unions can better adapt to changing economic conditions and ensure their ability to serve members.

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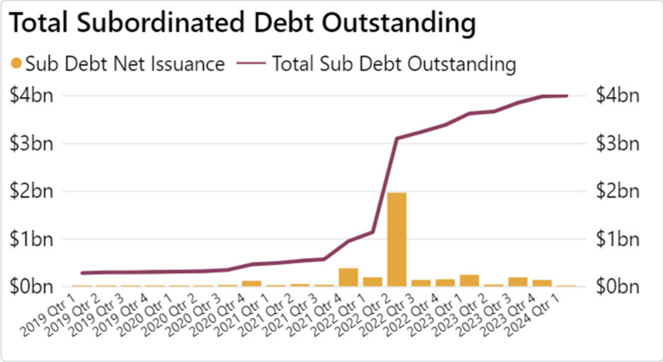
Current Subordinated Debt Issuance Rates

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

The sub debt market had its slowest quarter in a couple of years as credit unions anticipated falling rates and a more attractive entry point with an issuance. Industry outstanding sub debt increased slightly to $3.996 billion even as the number of credit unions with sub debt fell from 167 to 164.



	12/31/2019	12/31/2020	12/31/2021	12/31/2022	12/31/2023	3/31/2024
Number of CUs with Sub Debt	68	80	106	150	167	164
Sub Debt Outstanding	$301M	$460M	$948M	$3,381M	$3,981M	$3,996M
Combined Sub Debt as % of NW	9.2%	8.8%	11.9%	19.8%	18.6%	18.4%
Avg. Asset Size of Issuing CUs	$486M	$698M	$757M	$1,059M	$1,205M	$1,257M
Avg. Net Worth Ratio of Issuing CUs	9.8%	9.2%	10.4%	12.3%	12.5%	12.6%

ABS MARKET & SECURITIZATION

Congratulations to First Community Credit Union of Houston, Texas on their inaugural asset-backed security (ABS) issuance! This $263 million deal offers investors yields ranging from 5.6% to 6.9% depending on the risk tranche. The weighted-average FICO score of the deal is 754 with individual FICOs ranging from 680 to 886.

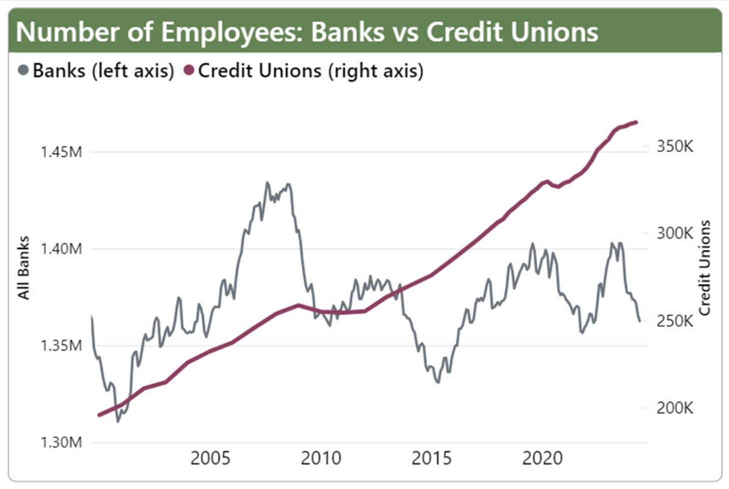
First Community Credit Union 2024-1

Class	Size ($M)	WAL	Rating	Spread	Coupon	Yield	Price
A1	26.3	0.22	A-1+	20	5.60%	5.60%	100
A2	100	1.06	AAA	70	5.76%	5.83%	99.9966
A3	66	2.41	AAA	85	5.54%	5.61%	99.9867
A4	43.09	3.62	AAA	95	5.46%	5.53%	99.9815
B	5.71	4.13	AA	125	5.71%	5.78%	99.9896
C	4.82	4.13	A	155	6.00%	6.08%	99.9794
D	5.11	4.13	BBB	235	6.78%	6.88%	99.9830

FINAL THOUGHTS

As capital markets professionals, we focus on risk and potential causes for concern. However, it's also important to periodically acknowledge our successes.

Employment within the credit union industry continues to rise, even as our banking contemporaries shed employees. Banks have yet to replace their staff from the highs reached in 2007, while credit unions continue to steadily increase the number of employees. Bank staff is down 5% since 2007 while total credit union employee headcounts are up a *staggering 43%* over the same period. We have been a source of stability in our communities, both as lenders as well as employers. With gratitude, we should be proud of this good fortune.



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