CATALYST
Corporate Federal Credit Union

December 13, 2011

Market & Investment Call Recap

Once again, the troubles in Europe maintained a strong shadow over the U.S. financial markets. Even a positive job report wasn't enough to sustain the temporary stock market rally we saw early in the period. Treasury yields barely moved during the past 14 days. The two-year note finished just three basis points lower at 0.23 percent, while the 10-year note closed five basis points higher in yield at 2.04 percent.

There were lots of meetings and even more attempts at formulizing new solutions for correcting the debt crisis in Europe, and investors are still waiting for an answer. Several small steps were made that only provided short-term calm to the jittery markets. In a startling move, the Federal Reserve and five other central banks announced a joint plan to boost liquidity for European banks after leaders failed to increase the region's bailout fund as much as needed. The Bank of Canada, Bank of England, Bank of Japan, European Central Bank, and Swiss National Bank were involved in the coordinated action, which also extends the authorization through February 1, 2013. "The purpose of these actions is to ease strains in financial markets and thereby mitigate the effects of such strains on the supply of credit to households and businesses and so help foster economic activity," the Fed said in a statement.

Standard & Poor's downgraded the ratings on many of the world's major banks, including top U.S. banks. Worries persist as to whether the banks can withstand another recession and the worsening situation in Europe, where such countries as Greece and Italy teeter on the edge of debt default. Days later, just as the European Union (EU) leaders were preparing to meet to rewrite the EU's governing rules to tighten economic cooperation, Standard & Poor's announced it was putting the euro nations on credit watch review for possible downgrade. This could strip six of the countries of their coveted triple A rating, including Germany and France.

It seems that with every move designed to bring relief, Europe only gets more bogged down in political strife. In one of his first actions as leader of the European Central Bank (ECB), President Mario Draghi reversed the ECB's actions from earlier this year and cut interest rates. He also offered banks unlimited cash for three years. But just as the financial markets were beginning to feel positive about these critical steps, Draghi stole the thunder by quelling speculation that the ECB will buy more government bonds. There has been talk of amending the European treaties to tighten controls on the budget. This motion has only brought bitter arguments, with England very vocally assuring everyone it will not join the euro.

With the attention focused almost entirely on Europe, any reports about the U.S. economy become relegated to the background. Fortunately, little economic data was released the past couple of weeks. The most significant report was the monthly jobs data. The country added 120,000 jobs during November, slightly less than consensus. Revisions to September and October's numbers added an additional 72,000 jobs. Although the unemployment rate finally dropped below 9 percent, to 8.6 percent, the drop in unemployment was largely due to a sharp contraction in the labor force, or the number of people actually looking for work. It is estimated over 300,000 people left the workforce. The upside of the headline number reflecting unemployment below 9 percent is its potential to boost confidence among consumers. Most

people who hear the number will simply "feel better" about the prospects for jobs, which could help the holiday season sales.

FORECAST FOR 2012

With the numerous challenges the financial markets felt in 2011, it would seem unlikely that 2012 could be worse. Maybe the worst is over, in terms of economic fundamentals, but there are still many issues to resolve.

Debt problems top the list of almost all countries, not just the European nations. As the global economies remain weak, government spending continues to escalate to fund public programs designed to assist the unemployed, while tax collection revenues decelerate. Everyone agrees that real solutions need to be found to ease the growing debt burden. Unfortunately, with 2012 an election year, more than likely neither party will be willing to commit to a solution. With no solution at hand, the debt imbalance will be a constant thorn to getting the economy back on track.

Putting the debt issues aside, we are beginning to see some signs of advancement in the U.S. economy. Initial unemployment claims are declining, consumer spending for the holiday season is above expectations, and job growth has been positive for 14 months in a row. Construction spending appears to be gaining ground, with residential construction up 3.4 percent, placing its level up 19 percent at an annualized rate. Wholesale inventories rose 1.4 percent, the largest rise since May. According to a report from Deutsche Bank, inventory restocking could total $20 billion this quarter; every $30 billion in inventories is worth one full percentage point in GDP.

GDP growth estimates for 2012 center around job creation and how close we get to an 8.0 percent unemployment rate and steady monthly job growth from the private sector of 190,000. The odds of getting to these levels are slim. In fact, some economists predict the U.S. will barely be able to create 100,000 jobs per month in 2012, putting unemployment at 9.0 percent in 2012.

With the tepid labor market and falling household wealth due to declining house values, consumers are not going to feel as free to continue spending and will remain more cautious on what they buy. Big-ticket items such as cars, houses and appliances will probably not make the top of their list. Credit unions will feel the impact, since these are the types of items for which credit unions extend credit to members. Spending is projected to increase to a moderate 2.1 percent in 2012; economists estimate consumers need to be adding closer to 4 percent to bring our economy back to sustainable levels.

Most economists are calling for GDP in 2012 to range between 2.1 and 2.5 percent, with the odds favoring the lower end of the scale. While growth for the fourth quarter of this year may be over 2 percent, the general view is that growth will subside again in 2012. Consumer spending accounts for two-thirds of the nation's GDP and 2 percent spending is not enough to restore the economy.

Inflation does not appear to be a threat at this time, providing some measure of assistance in working through the problems. The Fed continues to have room to implement further non-traditional monetary policy initiatives—including more mortgage-backed security purchases—in order to offer more aid to the housing market. Declining inflationary pressures should also allow the European Central Bank and emerging market central banks to cut interest rates.

INVESTMENT STRATEGY

With all that said, now what do we do? The quandary most investors and economists find themselves in today is a mismatch of the basic lessons of Economics 101. In many ways, we are beginning to see some glimmers of progress in economic growth that would tempt us to believe we are at the beginning of a growth cycle, leading to higher interest rates. Which means buying short-term investments, right? However, we have heard many times over the Federal Reserve's intentions to keep interest at extreme low levels until mid-2013, not to mention the European Central Bank's recent move to actively lower interest rates. So, that means locking up yields for longer periods, right? See the confusion we all share?

The increase in deposits and lack of loans during 2011 have been enough to make us want to either lock our doors when we see money flow in or throw a dart when making an investment decision. After all, the rules and strategy we have learned in our years in the business seem to be meaningless now. While the two strategies above obviously aren't the answer, there are some things we can keep in mind that may make 2012 a little more tolerable, and income-producing.

CUNA is calling for loan growth of 3 percent in 2012, but it may take a while to materialize. This means credit unions will continue to strongly rely on investment portfolio income to replicate current revenue streams. Currently, every $1 in loan principal received requires $2.65 in investment principal.

At the same time, it will be more important than ever in 2012 for credit unions to pay close attention to their liquidity and schedule of callable bonds, in case the tide of cash flow changes.

A general consensus for credit unions investing at this time is to stay invested, buy callables with longer lockouts and consider three to four years as your upper limit on maturity. As we have said all year, even though the historically low interest rates are hard to digest, being invested will provide you with more income than keeping excess funds in cash, as you wait for rates to rise. Whatever increase you can earn over your cost of funds is a boost to the bottom line.

If you purchase Agency securities, structures with more call protection (longer lockouts) will provide you better protection against reinvestment risk now. With the front end of the yield curve

relatively flat now, there is very little to gain in this market by adding more call options. For instance, if the three-month lockout option is being exercised, then rates have moved lower and you will be investing at the reduced levels. With interest rates virtually stagnant now, it pays to know you are going to earn "better than a bullet" yield for a longer period of time.

Deciding on your investment portfolio duration is not always straightforward. In most cases, the decision is based on what "you are used to doing." Strategically, investment duration targets depend on the credit union's prevailing loan-to-asset ratio. The lower the ratio, the further out on the curve an investment option can be considered. For most active portfolios, that means investing in the three- to four-year part of the curve. Even though credit union liquidity is strong now, it is still necessary to protect your longer-term liquidity profile. Extending much past four years at this time will not provide you with enough yield to make up for the lack of liquidity.

A good rule of thumb for the right type of investment to buy moving into 2012 is to look at the type of ladder you have, and that varies with the size of your credit union, your loan-to-share ratio and your member base. Short-term cash flow ladders can be filled with premium callable structures that are better yielding than bullet Agencies. Also known as cushion callables, these structures provide you with a higher yield-to-call return, while giving you some protection if the bond is not called and lasts until maturity. These are typically secondary structures and are worth the search if you can find the structures. If you typically buy Certificates of Deposit, consider the higher-paying negotiable, or DTC, CDs. These CDs offer the same guarantee protection, with a little more yield to boost your ladder.

For that interim ladder of two to five years, callable structures with protection, as discussed above, are ideal. Amortizing investments also fit well into this portion of your portfolio. Credit unions have been heavily involved in 10-15 year mortgage backed securities (MBS) and CMO paper the past few months. The shorter final maturities equal average lives of two to five years, generally with yields better than most callable structures, and have less prepay volatility. Be careful of the premium in the shorter mortgage paper.

Unfortunately, there is no one perfect investment formula that fits all credit unions. But all credit unions can benefit from keeping a close eye on liquidity levels in the coming year, especially for any changes in patterns. Whether deposits continue to grow, or instead shrink, and whether members' appetites for loans increase will be good indicators for when to adjust your investing patterns.

Please feel free to contact your Investment Representative at Catalyst Corporate FCU for more information and suggestions for your investment portfolio. The choices can be confusing, but talking out your needs with a representative will make the process easier.

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MARKET RECAP

For the week of: 12/12/2011

	US Treasuries	SimpliCD CD	Agency Bullets	Agency Step-Ups (YTC/YTM)	Agency Callables	Agency MBS (Ave. Life)	Agency CMO's (Ave. Life)
6 months	0.05%	0.22%	-	-	-	-	-
1 Year	0.09%	0.50%	0.16%	-	-	-	-
2 Years	0.23%	1.10%	0.38%	-	0.50%	0.83%	1.52%
3 Years	0.36%	1.55%	0.62%	.65%/1.03%	0.75%	1.91%	1.59%
4 Years	-	1.75%	0.90%	.75%/1.24%	1.05%	2.18%	1.75%
5 Years	0.89%	2.10%	1.19%	1.12/1.66%	1.50%	-	2.02%

Rates shown are indications of the category and term and not a specific bond. The term shown for comparison purposes is maturity for all securities except MBS and CMOs where average life is shown.

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Index	11/29/11	12/13/11
1 month LIBOR	.27	.28
2-yr SWAP spread	52bps	44bps
2-yr Agency spread	13bps	8bps

Treasury Yields	11/29/11	12/13/11
6 mth TBill	.04	.04
1 year note	.11	.09
2 year note	.25	.22
5 year note	.93	.86
10 year note	1.99	2.04

SimpliCD	11/29/11	12/13/11
6 mths	.22	.22
1 year	.50	.50
2 years	1.05	.90

Date	Economic Report	Forecast
12/15	PPI	0.2%
12/16	CPI	0.1%
12/22	GDP, 4th Quarter final	2.0%

Please contact the Investment Services Group at 800.442.5763, option 4 if you have any questions or concerns.

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