HARLAND CLARKE®

Harland Clarke Webcast 12/5/18
CUNA Economic Update
TRANSCRIPT

Presenter Christine Ahlgren, Director, Strategic Business Alliance, Harland Clarke
Presenter Jordan van Rijn, Senior Economist, CUNA

Nathan: Good day, and welcome to Harland Clarke's *The Informed Banker* webcast, CUNA "Economic Update." This webcast is being recorded and a replay will be provided to you within a few days. If you have questions, please use the question box located in the control panel. Your questions are private and are only seen by our presenters. I will now turn the call over to Christine Ahlgren of Harland Clarke. Christine, you have the call.

Christine: Thanks, Nathan, and welcome to all of you who have joined us today for this Month's installment of *The Informed Banker*. This series is designed to bring you succinct, timely information on topics that are critical to the community financial institution. For today's session, we are lucky to have Jordan van Rihn, Senior Economist with Credit Union National Association or CUNA. Today, we'll be discussing trends in the economy through the lens of the community financial institutions. Jordan has years of experience in economic development, microfinance, and economic research in Latin American, Africa, Southeast Asia, and the United States. Jordan, we're thrilled to have you. The floor is all yours.

Jordan: Thanks, Christine; thanks so much for the opportunity. As was mentioned, I'm going to be talking a little bit about the economy and then giving an overview from the perspective of credit unions using credit union data. I think and hope it will be helpful for those of you from the community banking sector as well. We can go ahead onto the agenda. I'm going to be talking at the beginning just an overview of the economy. Then I'm going to dive into a topic that's front of mind for a lot of folks which is this trade war and what's going on there, and how it might affect credit unions and banks, other financial institutions. Then I'm going to talk more specifically about credit unions, the outlook for credit unions, and what that might imply for the rest of the financial sector.

Let's go ahead and move on to the economic overview. Go ahead to the next slide as well; thank you. This is US economic growth percentage changes in gross domestic product, which is the combination of everything, all of the goods and services produced in the US in a year. You can see that since the financial crisis back in 2008/2009, there's been positive economic growth. This year you can see with the light pink economic growth has been particularly strong. We saw 4.2% economic growth in the second quarter, 3.5% in the third quarter. That's very strong economic growth; I think the fastest six months in about four years.

Puts the economy on track to expand probably over 3% for the year or close to 3%. That would be the first time that we had economic growth of over 3% since the financial crisis; very strong economic growth.

However, we do expect this to drop off in the coming year as do most economists. You can see next year's forecast, this is at 2.5%. We think it will probably drop to about 2% in following years. Some people are even forecasting a recession in 2020. We wouldn't go quite that far, but probably dropping off to maybe 2%; somewhere around there. It's due to a number of factors. Overall, although the economy is doing well, in the long run, there's low population growth and historically low productivity growth as well. When both of those two factors are low, it leads to low overall economic growth. Also, as you guys probably know, we have rising interest rates. That's also going to also probably decrease business investment, decrease consumer spending, and put some downward pressure on economic growth as well.

Going onto the next slide, we can see the unemployment rate which is down to 3.7%. In October, we had 250,000 new jobs added which was even higher than economists expected. The unemployment rate is extremely low. It's basically the lowest level since 1969; that's almost 50 years. It's really affecting the entire economy even for example people without a high school education, without a college education are also finding jobs. I was just reading this morning how college dropouts, even among those folks the unemployment rate is only a little over 5%, so really very strong labor markets. One of the mysteries is why wages aren't increasing more, why inflation isn't picking up despite such a strong labor market. We are starting to see a little bit more movement in that direction. We do expect wages to pick up even faster.

If we go to the next slide, I'll show you one of the reasons we think that. This is an amazing graphic. This shows the difference between job openings and the number of people looking for work in the past couple of decades. You can see that for the first time since these statistics have been recorded in 2001, job openings actually exceed the number of people looking for work by about one million people. In other words, we've got about seven million open jobs, but six million people looking for work. Again, very strong labor market.

Now, we might wonder why those people looking for jobs can't find the open available jobs. There are many reasons for that. Of course, many of the job openings might be in places where people aren't located. There's, for example, an oil boom in North Dakota or Texas. It's tough to be able to relocate to those areas. Some of those jobs are also in sectors where maybe people don't have the right skills or education, so there's a little bit of friction there. Overall, you

can see a really strong labor market. We do expect this to put more pressure on wages to go up and inflation to go up as well going forward.

Moving on to the next slide, we can see probably something that interests a lot of us. These are interest rates. The red line is the effective federal funds rate. The blue line is the average 30-year fixed mortgage rate. We can see all of these rates are going up. The Fed funds rate is now at a range of about 2 to 2.25%.

Average mortgage rates have gone up from about 3.5% at their low to now they're right around about 5%, about 4.9% or so. This is, of course, going to affect loan demand. We're seeing it in the credit union world mostly in the demand for mortgages. While it's still increasing, we're starting to see that demand slow down a little bit, particularly home equity lines of credits, other types of second mortgages. People are just a lot less likely to take out those loans if rates go up to 4, or 5, 6% as opposed to where they were at before.

There's also a bit of a slowdown in first mortgages. It hasn't been quite as dramatic, but we do expect that trend to continue especially as interest rates continue to rise. We haven't seen as much of an effect on auto loans or other types of loans. Typically, when we look at how demand responds to rising interest rates, we see it a little bit more on things like mortgages that take up a really big portion of people's household income. We don't see loan demand decrease quite as much for things like auto loans or credit cards. That may occur as well maybe to a smaller degree.

We love to hear from you guys. Maybe we can move to this question for the audience: to what extent do you guys see rising interest rates affecting loan demand at your bank or credit union? When we go around the country and talk to different folks in the credit union world, we do see that people are saying that the rising interest rates are lowering demand for mortgages, first and second mortgages, but not quite other areas quite just yet. I think you can go ahead and click on one of the responses there and then maybe we can see the poll results in just a moment. Alright, it looks like we got about 60% of you say that the rising interest rates are affecting loan demand a little bit, 32% a fair amount, 9% not at all, and then 0% greatly. I think that's about what we're seeing as well. It's starting to affect loan demand a little bit, but not too bad just yet.

Moving on to the next slide, there we go, household net worth. One of the positive things with the economic recovery the last 10 years, we've seen pretty consistent economic growth is that household net worth is now at the highest it's been in decades. This is really a broad-based increases in household wealth which is a very positive thing. We also see this at the typical household. If you

look in median wealth, that's also increasing. We're also seeing decreases of the percentage of people living in poverty. This is affecting wealthier households, but it's also affecting more middle income and lower income households as well which is a very positive thing.

Moving on to the next slide, we can see that as household net worth is increasing. As you guys probably see it at your institutions, household debt is also increasing. You can see it dipped a little bit during the financial crisis and right after but has increased since then. Now, household debt is actually higher than what it was prior to the financial crisis. You can see in this graph, households they've actually broken up into its different categories. For example, blue is total household mortgage debt which comprises the biggest portion of household debt. We have auto loans, credit cards, student loans, and other debt.

It might be interesting if you guys don't know this already, but student loan debt in the past decade or so has actually surpassed auto loans as the second biggest component of household debt. You can see that yellow bar, it's a little bit small because of the mortgage debt, but you can see that yellow bar actually increases quite a bit relative to other types of debt. It is now at about $1.5 trillion overall. Some people wonder whether this is going to lead to another financial crisis. It is something to be concerned about. Certainly, student loan debt is unsecured. A lot of folks coming out with a fair amount of student loan debt. You can also see there that it's still a relatively small portion of total household debt; much smaller than mortgages for example which led to the last financial crisis.

Moving onto the next slide, you can also see that despite the big increase in total household debt if you look at household debt service payments as a percentage of disposable income, it's actually at an all-time low of less than 10%. You can see it there at about 9.8%. Even though there's a lot more debt, we're seeing that this debt tends to be with longer terms, more flexible terms with things like student loans have a lot of forbearance deferment programs. Also, of course, historically low interest rates in the past decade or so. All of this has made that debt a lot more affordable on a monthly basis which still leaves a lot of room for people to take on more debt.

Moving onto the next slide, we can also see that this strong economy has led to increased FICO Scores. In fact, the FICO Score is now at an all-time high. This was from I think a couple of years ago. It's now at an average FICO Score of 704 which is the highest ever recorded. People are a lot more qualified now to take on more debt.

Moving onto the next slide, this is an interesting graph. There's a lot going on there, but it's basically mortgage origination volume broken up by different credit scores. You can see for example all of the yellow part, those are people that have taken out mortgages that have very high credit scores of over 760. The light blue is people with pretty good credit scores in the 700's. Then you can see on the other end the dark blue and the gray are people that have taken out mortgages with a little bit more questionable credit scores of under 620 or in the low to mid-600's.

I really like this graph because it shows a number of things. One of the things is if you look back on the left around 2003, 2004 leading up to the financial crisis, you can notice a couple of things. One thing is that the total amount of annual mortgage origination was very large. It's over twice as much as we are doing in total mortgage originations today. Not only that, there was a much higher portion of people taking out mortgages that had pretty low FICO Scores in the low-600's to mid-600's.

Today, if you look around 2017, 2018 on the far right, you can see that the total mortgage originations is much less; about half as what it was then. Also, the proportion of people in the low credit score range that are taking out mortgages is much less. You have a much higher proportion of people taking out mortgages with strong credit scores. This leads us to believe that the housing market is much more sustainable now. Maybe we don't have the same explosion in mortgage growth and home prices that we've seen in the past, but that's partly because we're doing much better mortgage loans. It's a lot more sustainable. We don't see any kind of crisis in the housing market going forward.

Moving on, you can see the same type of graph, but now for auto loans. Auto loans, you see there was a big dip there during the financial crisis when of course many people were unemployed; couldn't get approved for auto loans. That's picked back up. You can see the distribution of credit scores is about the same as it was pre-crisis as well. This is a really important area for credit unions. We do about a third of our lending is for auto loans. It's really taken off in the last couple of years. As you can see, that pent-up demand where people wanted to get auto loans during the financial crisis couldn't so they got auto loans later on when they started getting jobs, getting that income back up, getting their credit scores back up. That we see is really driving a lot of the loan growth especially in auto loans at credit unions in the last few years. I imagine there's a similar trend for folks at community banks as well.

Alright, let's move onto the topic of the trade war. We can go to the next slide as well. You can see, the White House has already put tariffs on about $250 billion worth of Chinese goods. A lot of that is at 10%. They have threated to increase

© Harland Clarke 2018

that to 25% and add an additional $267 billion on Chinese goods. Of course, the Chinese have retaliated. We did see just recently in the news that it looks like President Trump reached a 90-day truce with China to put off that increase in tariffs, but it's hard to say what's going to happen going forward.

Moving onto the next slide, we can see why trade is so important. This graph shows you can see the yellow line is overall inflation over the last couple of decades. Then all of those other lines represent increases or decreases in prices in different sectors relative to inflation. One of the things that we really like about this graph and make it really interesting is that you can see for all of the things where you see increasing prices, those things are things that don't face foreign competition, things for like for example hospital services, college tuition, childcare, medical care. All of these things don't face foreign competition. Of course, those are the things were prices have really risen for consumers.

On the other hand, goods and services that face a lot of foreign competition, all of those prices have tended to decrease; things like prices on toys, TVs, software, vehicles. To the extent that we put up more tariffs is going to increase prices really for consumers. Although that process gets a little bit dissipated, it takes a little while, we do expect to see some form of inflation, increased prices if this continues. On the business side, of course, businesses that are connected to industries that are facing tariffs, for example, we know about Harley Davidson, vehicle producers, soy farmers, construction, other companies that want to import steel, these companies have been hit pretty good. For example, the Nebraska Farmers' Association just came out saying that they lost $1 billion in revenue due to tariffs since they've started being imposed.

Overall, if we go to the next graph, this is just one estimate of what might happen if all of the tariffs were enacted. You can see the long-run GDP would decrease by about 0.59% or about $150 billion. Wages could decrease by about 0.38% and a loss of about 460,000 jobs. In the grand scheme of things, these are big impacts but not huge; not disastrous. It wouldn't lead in and of themselves to a recession, but if we combine them with other forces for example like the rising interest rates, the low productivity growth, some of these geopolitical issues that are going on, it could combine to cause significant challenges.

At credit unions, one of the biggest things we're concerned about is the potential tariffs on auto loans. The administration has threatened potential tariffs of 25% on auto imports and auto part imports. As I mentioned, since credit unions do so many auto loans, that would be a big concern for us. For now, at least, that's not currently on the table, so we'll see what happens with that going forward.

Alright, moving on; what does all of this mean for credit unions? Again, this is our perspective, the data we work with. I'll provide that perspective, but it's probably pretty similar for folks in the community banking sector. Overall, this graph shows the very strong positive relationship between US economic growth and credit union loan growth. You can see for example that when economic growth is high, credit union loan growth is high as well; and vice versa, when the economy goes down, loan growth goes down. That may seem very natural, but from an economist perspective, it's pretty rare when you see such strong positive correlations like you do in this graph.

Moving on, you can see what credit union loan growth has looked like in the last few years and our forecast for the next couple of years. It's been incredibly fast. We've had four years of double-digit loan growth. That's the first time that's happened since the '90s. We expect another strong year this year and then to taper off a little bit going forward. Of course, we know that a lot of this has been driven by historically low interest rates on a really strong economy. As interest rates go up, the economy falls a little bit. It's likely that loan growth is going to drop off a bit going forward. We have for example credit union loan growth dropping to about 8% next year.

Moving on, you can see credit union earnings which have been pretty strong especially since the financial crisis period. You can see that they've been in the range of about 75 to 80 basis points. Historically, they've been closer to about 1% or 100 basis points but seem to have more of a long-term sustainable level of about 75 to 80 basis points now. Probably due to a number of factors like increase in use of technology in competition from online lenders and other places like that has really driven down those margins; lower interest rates as well, lower interest margins. We see credit union earnings being about 85 basis points this year and then dropping to 75 next year.

Moving on to the next slide, it's clear from the credit union world as one of the biggest challenges we face at our organization is how do we support all credit unions including the smallest ones who are really struggling. This shows growth memberships, loans, and assets at credit unions broken up by asset size. You can see on the far left, those credit unions with under $20 million in assets or $20 to $50 in assets are really struggling. All of them on average are losing members and the loan growth is rather slow as well. Of course, these credit unions tend to have five employees, $30 to $40 million in assets. Really pretty small, so it's tough for them to keep up with the technological changes, the regulations. This, of course, has led to a lot of consolidation in the credit union industry, which I believe is pretty similar in the banking industry as well. We want to think about how can we support those smaller institutions as well.

© Harland Clarke 2018

Moving onto the next slide, this just shares some of the concerns we see when we go around the country. We talk to folks at credit unions. Of course, a big concern is rising interest rates, the trade war to some extent. A little bit further down the line, there's a lot of concern about what might happen if the economy moves more towards driverless cars and ridesharing. Might there be a lot less demand for auto loans? That would, of course, affect credit unions significantly, so how are we preparing for that shift. Competition from FinTech, of course, cybersecurity is a big issue right now. Then we're also concerned about some of these regulatory changes that might happen as well.

I'll go on maybe to just this last question for you guys. Then I believe there's going to be an opportunity for you guys to ask questions for me as well if you would like. I'd be curious; what do you guys see as your biggest concern at your bank or credit union whether it's interest rates, trade war, FinTech competition, cybersecurity, regulatory changes? I think we didn't have room to put up like driverless cars, but maybe think about more of your current concerns. What's top of mind that you guys are thinking about right now? We'll give you guys a moment to answer there and then put up the responses. Alright, yeah, it seems pretty natural rising interest rates is the biggest concern, almost 40% of you. It looks like FinTech competition is a pretty big concern as well at 26%, followed by cybersecurity at 15%, and then trade war, regulatory changes both at about 11% of you guys. Alright, I think we've got a few minutes left perhaps for questions if that's correct, Christine?

Christine: It is; thank you so much, Jordan, for this fascinating content. We do have some questions in queue. Just to let folks know if you do have anything you want to ask, please use the chat box in your go-to webinar panel. First question, Jordan, is: what do increasing interest rates mean for other forms of debt besides mortgages like auto loans or credit cards? Do you also expect demand for those forms of debt to drop off?

Jordan: Yeah, that's a good question. When interest rates rise, typically from an economics perspective you're going to see the decrease in loan demand in the loans that take up the biggest share of household income. Mortgages, because as we saw on the graphs, they're such a big part of household debt and where household debt payments go to, if those interest rates go up even just a little bit it's really going to affect those monthly payments, and we'll see much bigger decrease in loan demand. You can imagine for example now if second mortgages go up 3 to 5%, that's certainly not as good of a deal. Or if people have locked in mortgages at 3 to 4%, they're going to be a lot less likely to maybe sell their home and get a new mortgage at a higher rate. That really decreases overall demand for mortgages. Other things like auto loans is a much smaller portion of overall debt service payments; credit cards, it's similar. As

those rates go up, we don't see quite as much of a decrease in demand. We expect those sectors to still stay relatively strong.

Christine: Thanks, Jordan. In the next question, I think you covered it briefly, but it might be worth asking if there's anything else you want to add. This question is: there seems to be more concern about a possible recession in 2020. I just want to seek any additional thoughts on that one.

Jordan: Yeah, thanks. That's a question that often comes up. We can't, of course, see the future. There's a lot of possible things that could happen especially now with emerging markets, with the trade war, with Brexit, but certainly, there's a lot more concern among economist going forward for a number of reasons. One, of course, is the rising interest rates. Historically, as the Fed has raised interest rates, and you have things like an inversion in the yield curve, which is also occurring right now where long-term interest rates on treasuries are actually lower than short-term rates. That is often followed by a recession historically. That's one factor that will almost definitely slow economic growth; it's possible could create a recession. Things like the trade war, of course, and the longer-term things as well such as slow population growth, slow productivity growth, demographic changes, more people retiring, all of those things does put a lot of headwind on the economy, so it's quite possible.

That said, the economy is also doing very well as you guys saw on the figures, especially the labor market. That really is going to prop up the economy. As long as people have jobs, for the most part, they're going to be having income coming in; be able to spend and take on more debt. Although interest rates are rising, they're also rising at a much slower pace than in the past. They're also historically a lot lower than what they've been for example pre-financial crisis when they were over 5%. Because of those factors, I don't think a recession is going to occur at least in 2020 or anytime soon, but it's hard to say. There are a lot of factors that come into that.

Christine: Thanks, Jordan. Unfortunately, it looks like that's all we have time for today. As a follow up to the presentation, we'll send an email to all of the participants with a recording and a transcript of this presentation. Please feel free to share that with any of your colleagues who may have missed today's session. Jordan, again, thank you so much for sharing with us today. I'd like to extend a very sincere thank you as well to the many financial services professionals who made the time to be with us today. Please come back and join us as the *Informed Banker* series continues in 2019. Keep an eye on your inbox in January for that invitation. Thanks again, that concludes today's session.

© Harland Clarke 2018