Shanta: Good afternoon and welcome to *Harland Clarke, The Informed Banker w*ebcast financial industry 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 the presenters. I will now turn the call over to Sheila Easley of Harland Clarke. Sheila, you have the call.

Sheila Easley: Thanks, Shanta. Welcome to all who have joined us today for this month's installment of the informed banker. This series is designed to bring you succinct and timely information on topics that are critical to community financial institutions. For today's session, we're lucky to have Jordan Van Rijn, a senior economist with Credit Union National Association or CUNA for short. We'll be discussing trends in the economy through the lens of the community financial institution. Jordan has 10 years of experience in the economic development, microfinance, economic research in Latin America, Africa, Southeast Asia, and the United States. Jordan, we are so thrilled to have you back and the floor is all yours.

Jordan Van Rijn: Thanks, Sheila. Thanks to Harland Clarke for the opportunity. It's great to be here with you all. Let's go ahead and move to the first slide. There we go. Yes, let's go to the one after this, please. All right, so we'll get started with just an overview of US economic growth. This is the percentage change in the sum total of all goods and services produced in the economy in a year. You can see that back in the financial crisis, we had, probably, the worst recession since the Great Depression, and growth fell 2.5%. Since then, we've had pretty strong economic growth. Last year was 2.9% tied for the fastest growth since the financial crisis. In 2015, we also had 2.9% growth.

In the first quarter, we had even stronger growth of 3.1%. That did drop off quite a bit in the second quarter to 2% and most economists, and ourselves included, expect economic growth to fall to around 2% and maybe even a little bit less. That's due to a number of factors. Long-term economic growth is really driven by two main components. One is population growth and the other is productivity growth, so basically, the number of workers and how productive those workers are.

Population growth, of course, has fallen dramatically since, a few decades ago, and is only about .6%, .7%. Productivity growth has slowed quite a bit as well. Also, the recent high in economic growth was really driven by the tax cuts, and we're starting to see those wear off a bit. Economic growth going forward will probably be closer to about 1.82%. Let's go ahead to the next slide.

Fortunately, labor markets are very strong. Most folks are probably aware that the unemployment rate remains at 3.7%, near a 50-year low. We see this a lot among credit unions, that folks are finding a little bit difficult, actually, to attract and retain workers due to so much competition in labor markets, but that's also helped driven up wages. We see relatively strong wage growth of about 3.2% to 3.3%. This has really helped consumers stay confident, and really driven consumer spending, which has been kind of main buttress in the economy at this moment. Next slide.

Now, inflation has been quite muted. You can see here this is the Federal Reserve's preferred measure of inflation, the core personal consumption expenditures or PCE index, and it's only of about 1.6% year over year. The feds target, of course, is 2%. This has been one of the big mysteries of today's economy. With such low unemployment, such as strong labor markets, we would expect wage growth to be faster and really drive inflation as well, but prices have not gone up as much as expected. That has really kept the pressure off the fed from raising interest rates. As we know, of course, yesterday, they just lowered interest rates for the second time in the last couple of quarters.

It's really a mystery as to why this is occurring. I think if you heard Jerome Powell talk, he still expects inflation to pick up over the long run, although he's been saying that for a number of years now. My personal sense is that there's a number of reasons to believe that inflation may just end up being lower than people expect. There's a bunch of theories about why this could be but I think probably the best theory is just the increased role of technology and competition. You can imagine nowadays, you can go online, you can go to Amazon, and you can shop around a bunch of different prices. That really keeps prices down, due to all of that competition.

Really, this low inflation is not just in the US either. It's really a global phenomenon. It's probably, at least, partly due to the increased use of technology and increased competition. We could see that continue going forward even with the lowering of the interest rates. Next slide, please.

This slide just shows the sum total of overall household debt and you can see at the bottom, broken up into mortgage debt, which, of course, is the biggest component of household debt, revolving debt, auto loan, credit cards, student loan, and other debt. You can see that actually, now, the total household debt is even higher than it was prior to the financial crisis. A lot of people see this is a warning sign and you might see a lot of headlines saying, "Household debt is now higher than prior to the financial crisis." Let's go ahead and look at the next slide.

You can see that actually, if you look at household debt, for example, as a percent of GDP, gross domestic product, household debt is the lowest it has been in, at least, 15 years or so, and actually much lower than prior to the financial crisis, when this figure was about- you can see almost 100% now it's only 76% of GDP, so actually quite a bit lower as a percentage of GDP. Let's go to the next slide.

You can also look at household debt service payments as a percent of disposable personal income. This just gets at your monthly loan payments and how much that is relative to your income. Once again, you can see that it's quite a bit lower, actually the lowest in at least about 30 years, and much lower than it was prior to the financial crisis. Why might that be? Why is household debt increasing, but household debt service payments remain low?

Well, there's a number of reasons. One, of course, is interest rates, historically, still remained very low. For quite a while, after the financial crisis, they were basically at zero. That helps, of course, keep loan payments relatively low. The other factor is that loan terms are beginning to increase. You see this, for example, in automobiles, auto loan terms now or maybe six, seven years, whereas before they were maybe five years. Also, a lot of this debt, as I'll show in the next slide, is student loan debt. Student loan debt, even though it's growing dramatically, it tends to also have long terms, low interest rates, and pretty flexible repayment plan. That, also, helps keep payments relatively low. You actually see that consumer finances on relatively decent shape.

Next slide, please. A lot of people, of course, when we think about the possibility of an upcoming recession, think to the financial crisis. This basically gives you an idea of what happened with mortgages. This is total annual mortgage loan origination broken up by credit score. You can see at the bottom, the pink and the red were a lot of the subprime borrowers that had FIFO scores, maybe in the 500 to low 600s. You can see a couple of things in this graph.

Prior to the financial crisis in the early 2000s to mid-2000s, you see there was a lot of mortgages go into subprime borrowers, so fairly risky mortgages. Also, if you look at the total, the total size of those peaks prior to the crisis, we were doing about double the amount of mortgages that we're doing today. If you look off to the right, around 2017, 2018, the amount of mortgages that financial institutions are doing today is about half of what it was prior to the financial crisis. At least according to this, it doesn't seem like there's any big challenges in the mortgage market, and certainly no bubble like we saw prior to the financial crisis.

Next slide, please. Let's look at that household debt and now take away mortgages. These are all of the remaining components of household debt without mortgages. I'll give you a moment to look at this and see if you notice any particularly interesting trends. One trend you might notice is one of these components has grown much more than the others and that's, of course, student loan debt. In the last 5 to 10 years, student loans actually overtook auto loans as the second biggest component of household debt. Now, your average undergraduate is coming out with about $30,000 in debt, your average graduate student comes out with about $40,000 in debt. Let's go to the next slide.

The total student loan debt has risen dramatically to about 1.5 trillion. This is due to a number of factors. Tuition rates continue to increase, there's less support for universities at the state level, and you have just a lot more people going to university than you had in the past. All of that has really caused this big increase in student loan debt. There is some evidence that this is preventing young people from getting their first mortgage and making some of those early big investments.

That said, I'm not exactly in the camp of people who say that this is a big bubble or anything like that. You can see it's still a relatively small component of household debt, much smaller than mortgages for example. Over 90% of these loans are government loans so there are a lot of programs to forgive the debts or at least manage payments, such as deferment and forbearance options. Next slide, please.

One question we get a lot, that we'll spend a little bit of time on is when do we expect the next recession to occur? This is a recent Wall Street Journal survey of economists from July. You can see here that over 50% of surveyed economists expect a recession by the end of next year and over 90% expect a recession by 2021. Why might they all be expecting a recession? Let's go to the next slide. We're going to look at a few different indicators people are looking at. Of course, there's a lot of different ways you can look at this but these are some of the probably most important indicators that folks look at. Let's move on to the next slide and we'll talk about the yield curve.

This is just the difference between long-term rates and short-term rates. Of course, normally long-term interest rates like the 10-year Treasury yield should be higher than short-term rates to compensate investors for risk and potential inflation. When it's the opposite and short-term rates go higher than long-term rates, that's what we call an inverted yield curve. A yield curve inversion has preceded every recession in the last 60 years. You can see the gray bars are all recessions and if you look at the difference between the red and black lines before each recession, you can see there was a yield curve inversion.

That's just what happen recently as well. The yield curve was inverted for about two to three months so a lot of people are pretty concerned that that might be leading to another recession. That said, the 10-Year Treasury actually just picked up quite a bit in the last week or so, so the yield curve, at least according to this measure, is actually no longer inverted, but you can see there that it's still very close. Let's go to the next slide. Another indicator that people look at is the change in unemployment rates, but you can see actually there hasn't been much of an increase in the unemployment rate at all. It remained at about very low 3.7%. At least according to this indicator, there's no cause for concern. Next slide, please.

Consumers have also stayed quite confident. Now, last month we did see the biggest drop in consumer confidence in about six years and it was at its lowest level in about three years. That was due to the ramping up of the trade war, but consumer confidence did come back up from about 89 to 92 and still is quite a bit above the long-run average. Consumers remain still quite confident and we see still quite a bit of consumer spending. Next slide, please.

One other indicator that has been on a downward trend is the manufacturing index. The manufacturing index, if it's above 50, it indicates expansion of the manufacturing sector, below 50 indicates contraction. We just went into contraction territory for the first time in about three to four years. That indicates we have a bit of a contraction in the manufacturing sector and it could be an indication of a recession on the horizon. That said, historically, we typically haven't had a recession until the manufacturing index goes below about 43 or so but it is certainly a worrying trend. Next slide, please.

Another indicator we look at, and this is particularly important for us in the Credit Union world where about a third of credit loan portfolios are auto loans, is total auto sales. You can see that, once again, prior to most recessions, you see quite a bit of a decrease in auto sales, and you see a decreasing trend and it's leveled off a little bit. This is a good indicator because, of course, most vehicles nowadays are financed so it's an indication as to whether people feel confident that they can continue to pay a loan over the next six to seven years or so. Again, you see that trending down but no big drop as of yet like you've seen in previous recessions. Next slide, please.

You can see how hard this is nowadays for us economists and I keep joking with our team that we actually need to hire a political scientist because so much where the economy is heading really depend on the political situation and the trade war. At least according to these indicators, it doesn't seem like a recession is imminent but we do see quite a few, like the manufacturing index and auto sales, that are trending towards a possible recession. Next slide, please.

Another way you could look at this is, is take all of the leading indicators. These are indicators that typically go down prior to a recession and put them together in an index. If you do that, this is what you get. Once again, a bit of a downward trend over the last few years, but still much higher than other levels that have preceded a recession. Next slide, please. There's also a number of reasons to believe that the yield curve inversion is perhaps not the best indicator of a recession nowadays and that's for a number of reasons.

It could be that the 10-year Treasury rate has fallen, historically, for a number of reasons that are not related to the possibility of a recession. One of these could be that inflation is just very low and could be expected to stay low for some of those reasons that I've talked about earlier such as technology and increased competition. Also, the Federal Reserve, of course, purchased a bunch of long-term government bonds and other assets and that's actually driven down those long-term yields.

There was a recent Federal Reserve study that showed that without that, actually, the yield curve would not have inverted recently. Also, of course, if investors are looking for a safe investment, there aren't that many options, to be honest. If you look at Europe and Japan, some of those yields are actually negative or very, very close to zero. At least with the US Treasuries, you get a bit of a positive return. That could also, of course, be driving down US Treasury yields. Next slide, please.

Speaking of the government, as I mentioned, so much depends on what happens with the trade war. This is really starting to affect confidence, especially business confidence. Now, nearly 90% of economists agree that we are in an all-out trade war. Next slide, please. Thank you. The Federal Reserve on even just the first $200 billion in tariffs found that the cost was being passed onto consumers to the tune of about the $831 per household per year. That's about $70 per month. That was just the first tranche of $200 billion in tariffs. That has since been doubled. Now, China and the US have backed off a little bit, so there are some positive signs, but this is definitely starting to have an impact on consumers. Next slide. Let's go into the next slide. Thank you.

The global economy is also really suffering. This is the International Monetary Fund's growth projections and they've reduced the growth projections for this year and next year from 4% to 3.2% this year and 3.5% next year. That would be the slowest growth since the financial crisis and they mention the trade war as a major factor, as well as other factors such as slowing growth in China, Brexit. and even the effects of climate change. Next slide. Let's go on just briefly to what we see in the credit union world next slide.

We are starting to see loan growth drop quite rapidly. Actually, we had about four years of double-digit loan growth after the financial crisis from 2014 to 2017 but it's dropped the last couple of years. As of June, year over year loan growth was only 6.6%. Next slide. This has really been due to a decline in auto loans. You can see on the left are credit cards and other unsecured debt. That stayed relatively steady, but if you look at the middle of graphs of new auto loans and used auto loans, you can see that year over year, as of June, that has dropped all the way down to 5%, whereas it was in the double digits as recently as last year so big decline in auto loans.

I imagine there's, probably, similar trends at community banks and other financial institutions. First mortgages have also dropped off a bit due to kind of affordability issues. Second mortgages, we do see, actually, increasing likely due to the lowering interest rates. That may continue to stay relatively strong and at least among credit unions, commercial lending has stayed pretty strong as well. Next slide, please.

Overall though, we're really not seeing any effect of a worse scene in economy on credit union loan portfolio. In fact, Credit Union delinquency rates are the lowest in, at least, about 30 years. Although this is, of course, a bit of a lagging indicator so we wouldn't expect to see this rise until the economy really starts to worsen a bit. Next slide.

All right, that's it for my presentation. Back to Sheila in case there are any questions from the audience.

Sheila: Thank you so much Jordan. Just a reminder, if you do have a question, if you can type those into the question control panel and I'll be looking for those. We have had a couple of questions come in. We'll take those through 12th, through 30 minutes past the hour. Jordan, the first question is, do you expect the decline in auto sales and auto loans to continue?

Jordan: Yes, we do expect that to continue. It's hard to know exactly how far it will drop. We also collect data of a survey of, a sample of credit unions just to get a sense. At least, new auto loans, so far this year, actually, in the negative. Used auto loans are still up a bit but I think only about 3% or 4%. We do expect that to continue. It's hard to know how low it'll go but it is a worrying sign for credit unions because so much growth for credit unions comes from auto loans and it is an indication that consumers are maybe getting a little bit concerned and pulling back on some of those bigger investments, like an auto loan.

Sheila: Awesome. Thank you. Another question coming in is, do you see any bubbles out there like what we saw with the housing market before the last financial crisis?

Jordan: Yes. We definitely don't see any bubbles anywhere near the extent, of course, as what I showed earlier, with the mortgages and housing prices. People bring up student loans, as I mentioned, but I don't see any big bubble there, partly because student loans- really, they do have a good return on their investment in general. Most of those are government loans. The other potential bubbles would be in kind of as markets, as stocks, I think could very well be overpriced, especially with such low-interest rates, but I wouldn't expect a huge decrease in the stock market but I definitely wouldn't be surprised if there was some 10% to 15% correction in the next 6 to 12 months or so.

The other area where there is some concern is corporate debt. We do see that corporate debt as a percent of GDP. It's the highest it's been in quite a while. The Federal Reserve, the Treasury, the IMF have all mentioned that as a potential area of concern, particularly because it looks like some of that is due to lowering credit standards. Of course, we have very low-interest rates. Corporations are going to make a lot of investments because debt is very cheap. That could be a cause for concern, especially if interest rates go up quite a bit or if the stock market really drops. Again, it's actually much less than where mortgages were at during the financial crisis.

If any of those bubbles pop a little bit, it could precipitate a bit of a recession, but even though we think a lot about the financial crisis, because that was the most recent recession, if a recession does occur, I don't think it'll be nearly anywhere as bad as the mortgage crisis.

Sheila: Awesome. Very insightful, Jordan. I'm going to go ahead and pose one more question from the audience. What are the forecasts for deposit growth in 2020?

Jordan: Yes, great question. We are starting to see deposit growth pick up at credit unions at least. I think that's due to a number of factors. Credit unions have started to pay a little bit more on their deposits and of course, as consumers get a little bit jittery in terms of their outlook for the future, they might start to save a little bit more as well. Actually this year is the first year in quite a while that deposit growth was faster than loan growth at credit unions. That's helping with some of the liquidity challenges. We expect that trend to continue. Interest rates are leveling off a little bit but I think to the extent that consumers are a little bit worried about a recession. They might pull back on spending and try and maintain a little bit more of a savings cushion.

Sheila: Fantastic. Great questions, and as always, Jordan, great responses. It looks like that's all the time that we have for today. As a follow-up to today's program, you can expect an email from Harland Clarke with links to a recording and the transcript of this presentation. Feel free to share the recording with any of your colleagues who may have missed a session.

Jordan, of course, thank you again for sharing with us today. I'd also like to send a sincere thank you to the many financial services professionals who made time in their busy schedules to be with us today. Please come back and join us on October 17th for the next installment of the informed banker series where we will focus on thinking like a strategist. Keep an eye on your inbox over the next couple of weeks for your invitation.

That concludes today's session. Thank you, Shanta, and thanks to everyone for joining us this afternoon.

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