PA HealthCare Credit Union

2009 Economic and Financial Forecast

The PA HealthCare Credit Union is making your financial health better.
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Welcome & Introduction

- The PA HealthCare Credit Union is proud to sponsor this event to better educate members and non-members on the 2009 forecast of economic and financial indicators.

- Paul Fero is the CEO of the PA HealthCare Credit Union and is also part of the Adjunct Faculty of Robert Morris University, LaRoche College and the University of Phoenix teaching in areas of Economics and Finance.

- Weekly commentary available at our website under Member Service\Weekly Commentary or directly at www.PAHealthCareCU.com/wc.html

- DISCLAIMER: The views and comments, are solely the views of the presenter and do not necessarily reflect the views of the PA HealthCare Credit Union.

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What we said was going to happen…

- Each economic cycle can be generally characterized as having a couple or few major contributing factors. When those factors change, so does the economic cycle. In this cycle, it was the real estate industry.
- The excessive real estate markets in the past few years will see dramatic declines, as these markets begin to moderate to more rationale levels.
- The “sub-prime” and “credit crisis” will continue and worsen into 2008. There will be spill over effects into other areas of lending, including auto loans, unsecured loans and credit cards.
Recap of 2008 Forecast

- **Overall Forecast - Right on the money**
  - Although results were more dramatic than anticipated as the credit and financial crisis escalated beyond forecasted and punctuated by huge government intervention which helped just a couple of areas, namely short term credit liquidity it otherwise aided in escalating the crisis.

- **Interest Rate Forecast - Right on the money**
  - Short-term rates – The Federal Reserve moved away from “measured” rate cuts in favor of a “slash and burn” approach which added to the some of disruptions in the credit markets. Short term US Treasuries by the end of the year saw a flight to safety with nearly a 0% yield.
  - Medium and long term rates declined significantly especially in the final few months as credit markets “froze” and flight to safety to US Treasuries brought yields to all time lows.

- **Stock Market Forecast – Right on the money**
  - It was expected that the market would began a downward trend. Not many other forecasts included a retreat of 20% on the S&P, so with that, our forecast was pretty good. Given the dramatic events that unfolded it’s not surprising the S&P 500 exceeded that.

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Interest Rates

1. Low interest rates in the aftermath of 9/11 and “fragile” economy created an environment for new creative mortgage lending.

2. The low interest rates created an environment for many investment firms, financial institutions, mutual funds, retirement plans to look for newer investment vehicles to increase return to their respective stakeholders. So they invested in Mortgage Backed Securities and Collateralized Debt Obligations. Also Fannie Mae and Freddie Mac secured greater amounts of residential mortgages.

3. In the end – it wasn’t that low interest rates that caused the problems of today. It was the behaviors and actions (excluding the illegal and greedy) that resulted from that environment without the hindsight of what the results could be.
Real Estate Bubble

1. Low interest rates in the aftermath of 9/11 and “fragile” economy created an environment for new creative mortgage lending.

2. Exotic and non-traditional mortgages accounted for nearly a 1/3 of all residential mortgages during the peak cycle. Such as “sub-prime”, “Alt-A” and “Option ARM’s” which included “teaser rates”, “no document” loans, “interest only” and more adjustable rate mortgages than ever before.

3. Various areas of the country, namely California, Arizona, Texas, and Florida saw annual real estate prices increase of 25%-50% each year for 5 or more years.

4. The ability to obtain 100% or more financing for real estate regardless of credit condition or market conditions.

5. In the end – with all of the above going on there were no changes to lending criteria during these years of hyper growth. It was a just a matter of time for these to go bad.
Making of the Financial Crisis

Investments

1. As the real estate mortgages got bundled together to become Mortgage Backed Securities (MBS) these were purchased by investors seeking higher returns versus alternative investments.

2. Various other Collateralized Debt Obligations (CDO’s are pools of loans or bonds bundled together and sold as investments, much like Mortgage Backed Securities) were being sold to investors with greater frequency to seek higher returns.

3. These investors failed to appropriately evaluate the credit, interest rate, default, and collateral risk inherent within the details of these Mortgage Backed Securities and Collateralized Debt Obligations. This should have been painfully obvious in real estate markets that experienced hyper growth.

4. In the end – These firms made bad investment choices.
Leverage

1. Investment banks such as Bear Stearns, Lehman Brothers and the like (as there are no more) had the ability to acquire 20 to 30 times the amount of securities for each dollar of capital. So for each $1 of capital they could purchase $20 to $30 of an investment.

2. Failure to provide adequate hedging strategies to offset the highly leveraged investments.

3. In dramatic market conditions and volatile markets, the values of these investments can change quickly and dramatically. In which a firm could fail overnight.

4. In the end, the dramatic market conditions brought these firms to collapse and/or near collapse.
Making of the Financial Crisis

Derivatives – the value of investment derived from that of something else, such as stock price, interest rate or some other investment

1. Derivatives inherently provide a great deal of leverage
   - This creates large percentages of gains or losses based on small percentage change of the underlying security unless adequately hedged to minimize gain or loss

2. Some derivatives were specifically excluded from regulation through the Commodities Futures Moderation Act of 2000, such as the now famous Credit Default Swap, think AIG here.
   - It’s not the fault of regulation, these were just poorly managed and not appropriately funded in case of default.

3. In the end, derivatives tend to magnify the outcomes, especially during significant market moves and market volatility which can have hugely dramatic outcomes, and in this case bad outcomes.
Government intervention

1. US Treasury Department
   - The initial bailout of Bear Sterns created an environment where the mentality was “too big to fail”.
   - After Bear Sterns, and public outcry, the opposite effect with Lehman Brothers to let fail created the credit markets to freeze.
   - The big dramatic push for the $700 billion “bailout” Trouble Asset Relief Program (TARP) which was supposed to be used to buy troubled assets, namely mortgage backed securities. Which suddenly became a preferred stock program for banks. Banks benefit from re-capitalization with cheap cost of equity funding.

2. The Federal Reserve
   - Overly managed the reduction of the Fed Funds rate earlier in the year to provide support to a declining market environment.
   - Slow to recognize that the frozen credit markets needed short term liquidity.
Government intervention (continued)

3. Securities and Exchange Commission
   - The limiting of certain activities, namely short selling, to artificially prop up a stock prices of financial institutions during the various market moving events proved counter productive.

4. White House
   - The lack of leadership was all too apparent and left primarily to the Treasury Secretary.

5. Congress
   - During an election year and during a Presidential election cycle the primary focus was looking for relief for “Main Street” issues, namely foreclosures and declining retirement savings.

6. In the end, the government with its good intentions of trying to minimize the downturn created an environment of the “bailout” that will ultimately prolong the downturn. Given the size and the scope, the government was the only one that could help.
Correcting the Financial Crisis

With all components leading up to the financial crisis, when will it end?

- Interest Rates – With interest rates back to the lows, the cost of financing is cheap once again, assuming you can get it.

- Real Estate Bubble - When housing market corrects which will take 3 to 5 years as many more mortgages look to reset/reprice. As 3 year and 5 year adjustable mortgages are more common especially for the non-traditional mortgage and the boom years being from 2004 through 2007 this will extend well into 2012.

- Investments – With descriptions like “toxic” used to describe some investments, this should be self apparent. However, with interest rates coming to new lows, these new investments will pose significant interest rate risk in the future.
Correcting the Financial Crisis

- Leverage – As institutions now going through the deleveraging process this should help correct the issue. And now investment banks no longer have the ability to overly leverage as these are now gone, for the moment.
- Derivatives – Look for more regulation especially in the area of credit default swaps.
- Government Intervention – Look for Congress and new Presidential administration to provide multiple stimulus packages and more focus on “Main Street” issues with assistance in the foreclosure arena and attempts to “force” lending by banks who received TARP funds.

In the end this will be a long and arduous process and not an event. And all the efforts made to correct the crisis will have costs and future risks. This isn’t quite solving all the problems and in some cases just moving new ones to a future date.
The Value of the US Dollar

- The US dollar lost value from 2006 and into 2008 as US economy began to weaken and as fallout from the initial “sub-prime” crisis began in the US.

- As the “sub-prime” crisis extended to Europe and Asia, by mid-summer the US looks to become a “safe haven”. The result is huge demand for the US dollar and a strong reversal as the dollar gains in value.

- As the credit and financial crisis escalated, money from around the world sought safety in US, primarily US Treasury securities. The result is the value of the US dollar strengthened significantly in relatively short period of time.

- In the end, for all our own “issues”, the global money flowed here which isn’t a bad thing considering we’ll need trillions of dollars to correct things.
The Value of the US Dollar – (Con’t)

US dollar value declines

US dollar value increases

As of 12/08/08
The Oil Price Shock of 2008

- We’ve been hearing that the price of oil has climbed from $80 a barrel to $147 a barrel and back down to $45 a barrel based on supply and demand…not exactly.
- The price of oil does move based on supply and demand over the long term and slightly over the short term given dramatic supply or perhaps demand events.
- As the value of the dollar declined, the value of oil priced in US dollars rises and conversely oil declines when dollar strengthens.
- In the end, it’s all about money or in this case investment dollars and the value of the US dollar (as oil is based in US dollars) relative to other currencies. As the dollar goes, so will the price of oil.
The Oil Price Shock – (Con’t)

Price plummets with sharp rise in value US dollar loses value

Price increases as US dollar loses value

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Commodity Price Shock of 2008

- Not only did the price of oil climb dramatically but also other commodities such as food, metals and materials.
- The Reuters/Jefferies CRB Index since 2005 has included: aluminum, cocoa, coffee, copper, corn, cotton, crude oil, gold, heating oil, lean hogs, live cattle, natural gas, nickel, orange juice, silver, soybeans, sugar, unleaded gas and wheat. (Source: www.jefferies.com)
- As the US dollar lost value and the price of oil rose, investment dollars flowed into commodities as a hedge fearing higher inflation. This cycle creates even higher prices until the value of the US dollar turned.
Commodity Price Shock – (Con’t)

- Additionally, as higher food prices around the world rose even higher, some countries that are typically exporters stopped fearing food shortages within their own countries. This reduced the “tradable” supply of certain food items, namely rice.
- In the end, it’s still all about money or in this case investment dollars and the value of the US dollar. So as the fear of inflation is gone, so are high commodity prices, relatively speaking. Food prices in the grocery stores will be slow to come down and will moderate in price.
Commodity Prices – CRB Index
2009 Economic Forecast-Overview

- 2009 will bring about a further worsening of the economy as the credit and financial crises continue with a contraction of the US economy all year as unemployment continues to rise.
- One of the areas of positive GDP growth in 2008 was the huge increase in exports. With the dramatic rise of the US dollar in the second half of 2008, exports will diminish dramatically.
- The federal government will continue with its loans/bailouts. It will continue to provide aid to the financial sector including the remaining $350 billion TARP funds. The hedge fund industry will be seeking assistance in the first half as a huge wave of redemptions occur. (Most hedge funds require minimum 3 to 6 months notice for redemption.)
- Next on the list seeking assistance will be state and large local governments as tax revenues drop and the needs for state services increase with increasing unemployment.
2009 Economic Forecast–Overview (Con’t)

- Look for the new Obama administration to offer initial stimulus packages on the magnitude of $750 billion, of which $600 billion will be used for long term related projects, such as infrastructure, “green” technologies, and healthcare initiatives. Also look for $150 billion stimulus for taxpayers.

- Look for “new” programs intended to help those with foreclosures which will prolong the recovery.

- Look for residential real estate median prices to drop an additional 10%-20% nationally for 2009.

- The next area of real estate concern will be the commercial real estate area very similar to the residential issues. With many areas over developed, huge surpluses of retail space and slowing economy will add additional supply to the market. Refinancing of commercial space will be difficult given a still frozen credit market.

- The Federal Reserve will cut Fed Funds Rate to 0% in effort to show they did all they could.

- Look for the federal budget deficit to easy exceed $1 trillion.
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<th>2009 Q2</th>
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<td><strong>Forecast</strong></td>
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<td>Oil per barrel *</td>
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<td>CPI - Urban - Annual</td>
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<tr>
<td>Unemployment Rate</td>
<td>7.00%</td>
<td>7.50%</td>
<td>8.00%</td>
<td>8.50%</td>
<td>9.00%</td>
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<td>GDP</td>
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<td>Fed Funds Rate</td>
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<td>10 Year US Treasury Yield</td>
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<td>2.85%</td>
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<td>S&amp;P 500 Index</td>
<td>850</td>
<td>800</td>
<td>650</td>
<td>750</td>
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* West Texas Intermediate / Light Sweet Crude
Median Home Prices

Look for levels to drop 10% - 20% in 2009
We’re a Consumer Debt Nation

With the credit crisis – consumers are seeing their credit availability forced downward

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Gross Domestic Product - GDP

Look for GDP to decline 2.5% for 2009
Look for the Unemployment rate to rise to 9% by end of 2009.
Interest Rate Forecast

- Short term interest rates, as controlled by the Fed, will continue the decline to 0%.
- The 0% move for the Fed Funds Rate is intended to show they did all they could to improve the economy and didn’t leave anything on the table.
- Medium and Long term rates will move very little as the Federal Reserve will be active in keeping market rates low in an effort to improve the economy.
- In the end…low rates don’t matter if access to credit is frozen. And it’s unlikely that banks are eager to lend.
- And for those long term loans primarily mortgage related will have huge interest rate risks for the future. So while it may appear to solve this problem it creates a huge problem down the road as interest rates ultimately began to “normalize”.

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Interest Rate Forecast – Short Term Rates

Fed begins to lower rates

Effective Federal Funds Rate: Percent

Now at 0.25%

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Interest Rate Forecast – Medium Term Rates

Yields now below 1%

Support/Resistance Level
Interest Rate Forecast – Long Term Rates

Yields now below 3%

Support/Resistance Level
Overall, the stock market got pretty hammered in 2008. So this year’s activity will seem to pale in comparison (from an absolute number perspective).

Look for the markets to decline a bit more as the economy slows and maintains a weak performance. The percentage declines during the year could be near 25%.

We’ll continue to have some “dramatic” events in 2009 but will begin to diminish somewhat.

In the end, the market will likely put in a bottom at the 650 level on the S&P 500 index but will trade sideways most of the year.
Stock Market Forecast

Look for S&P 500 to test 650 level

Support/Resistance

Support/Resistance

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Putting It All Together

- The economy will continue with its contraction throughout 2009 as unemployment rises to levels not seen since the early 1980’s.
- The Credit Crisis and Financial Crisis will also continue throughout 2009 as financial institutions struggle with their own survival reducing any ability to lend government funds.
- The Federal Government will work on “Main Street” issues with little to no effect.
- This downturn will be the worst since the Great Depression in terms of duration – see GDP graph since WWII on next page.
- The efforts made to pull the economy out from the downturn will ultimately have negative impacts in the future especially for mortgage relief programs whether government sponsored or private sector held as interest rate risks will be dramatic.
GDP since 1947 (bars indicate recession periods)
Questions?

The End