



Q4

QUARTER FOUR
2008 ECONOMIC & MARKET OUTLOOK



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Q4

QUARTER FOUR 2008 EXECUTIVE SUMMARY

U.S. ECONOMY – The U.S. economy remains deeply entrenched in a recession that began a year ago, and has now entered the period of maximum economic risk. The recession of 2008-2009 is unlike any of the 10 previous recessions since 1945, and is on track to be the most severe downturn since the 1930s. Similar to the 1930s, the U.S. economy is suffering from a classic debt deflation cycle, the result of the housing bubble bursting along with a massive accumulation of private sector debt. Our forecast assumes that policymakers will continue to adopt progressively more aggressive nonconventional monetary policy initiatives in order to unfreeze credit markets and spark a resumption of economic growth. A major fiscal stimulus package is expected in early 2009. Stabilization of the U.S. economy is expected during late 2009, followed by a subpar economic recovery in 2010 and 2011, the result of a protracted deleveraging cycle. The silver lining in this grim economic outlook is an extended period of historically low inflation and interest rates, accompanied by a temporary period of depressed prices for both energy and commodities.

U.S. BONDS – Market yields on U.S. Treasury securities declined to record lows during the fourth quarter, providing investors in government bonds with their best returns since 1995. Conversely, investors in corporate and asset-backed bonds suffered severe losses during the year as credit spreads widened to the highest levels since the 1930s. The Federal Reserve lowered its federal funds target to essentially zero in December and has embarked on a policy of quantitative easing. The Treasury market is extremely overvalued and will provide disappointing returns in 2009 and beyond. Most attractive sectors in the bond market are high-quality non-treasury bonds, such as agency bonds, agency-backed mortgage-backed securities (MBS), long-duration municipal bonds and high-grade corporate bonds. High-yield corporate bonds offer extremely attractive valuations on a default-adjusted basis, but could remain vulnerable in the short term until there are signs of economic stabilization.

U.S. STOCKS – The 37% negative total return on domestic equities in 2008 was the worst equity market decline since the negative 43% total return of 1931.* The collapse in stocks was in response to prospects of the most severe economic and financial crisis since the 1930s. While economic and financial risks remain elevated, equity market valuations appear attractive over a 1-2 year horizon. However, despite attractive valuations, common stocks will remain vulnerable until there is convincing evidence that the normal functioning of credit markets has been restored. The most plausible scenario for the equity market is a prolonged base-building phase accompanied by continued volatility. Large-capitalization growth stocks should outperform small company stocks over the next several years. Advance signals of a durable equity market advance will be a sustained narrowing in credit spreads in the corporate bond market and a sustained rise in the index of leading economic indicators.

INTERNATIONAL MARKETS – Cyclical trends within international markets are similar to those of the U.S. These include widespread economic weakness, sharp declines in manufacturing and construction, declining employment and corporate profits, rising credit losses, falling inflation and steep declines in government bond yields. The collapse in world oil and commodity prices has reinforced the decline in global inflation and interest rates. Most central banks are aggressively easing monetary policy, while fiscal policy stimulus has increased in many economies.

Government bond markets in the UK, Europe, Australia and New Zealand appear more attractive relative to those of Japan, Canada and the U.S. However, European high-grade corporate bonds offer very attractive valuations and should outperform government bonds over a 1-2 year horizon. Most developed economy equity markets will likely lag that of the U.S., most notably Japan. The single best-performing equity markets during 2009 will likely be in Emerging Asia, led by China.

U.S. ECONOMY

The U.S. economy is in the middle of a recession that began around year-end 2007 and is currently entering the stage of maximum economic weakness. Contraction in real GDP in Q4 of 2008 and Q1 of 2009 could be well in excess of 5% at an annual rate, the most severe quarterly GDP decline since the recession of the early 1980s. All sectors of the economy are contracting, most notably consumer spending, which is suffering its first decline since the 1991 recession. The U.S. economy is unlikely to stabilize until the second half of the year, at the earliest. Corporate profits will likely decline significantly over the next several quarters, and the unemployment rate could rise to 8.5% or higher in 2010. Credit losses and defaults will likely linger into 2010.

Even after the recession has ended, the economy faces formidable headwinds, implying a sluggish economic recovery in 2010 and 2011. The most important economic headwind is a massive deleveraging cycle within the banking and household sectors that could persist for many years. The silver lining in this otherwise grim outlook is that inflation and interest rates will likely remain at historically low levels for an extended period. The weakness in energy and commodity prices as well as lower shipping costs should help cushion the decline in both consumer spending and profits.

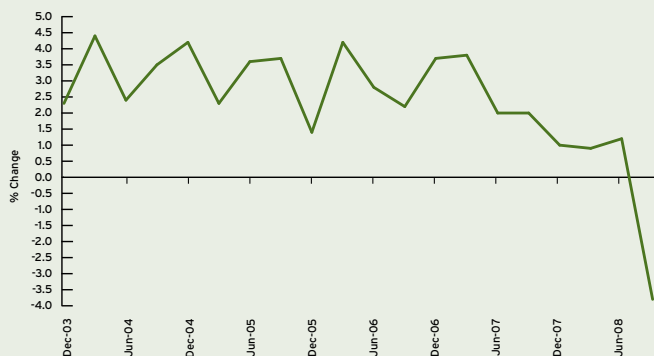
The current recession is expected to be the longest and most severe recession since the 1930s. Similar to the U.S. in the 1930s and Japan in the 1990s, the U.S. economy is suffering from a classic debt deflation cycle, a combination of excessive debt accumulation and deflation in asset prices. This dangerous combination produces a rise in real effective debt burdens within the private sector. A debt deflation cycle triggers a self-perpetuating downward spiral of deleveraging, asset liquidation, declining asset prices, growing insolvency risk and progressive economic weakness, all of which tend to reinforce the deleveraging process. A debt deflation cycle is self-reinforcing, not self-correcting, and therefore requires massive government intervention.

While unprecedented policymaker initiatives have achieved some success in unfreezing certain segments of the credit markets, the banking system and credit markets remain dysfunctional and the credit crunch has not ended. Policymakers will continue to emphasize non-conventional measures until credit markets are unfrozen and normal functioning is restored. With the federal funds target rate close to zero, the Federal Reserve has effectively adopted a policy of quantitative easing, which implies an unlimited injection of reserves to the banking system until credit markets stabilize. The Fed's balance sheet has already grown from \$900 billion to \$2.2 trillion in only several months, the result of expanded lending facilities and outright purchases of debt securities. With respect to fiscal policy, a massive fiscal stimulus package is expected to be passed by the new Congress early in the new year that could be well in excess of \$500 billion.

The lesson of history is that aggressive and non-conventional monetary policy measures, along with Keynesian fiscal policy stimulus, are necessary to prevent a debt deflation cycle from evolving into a depression. Unlike the U.S. in the 1930s and Japan in the 1990s, policymakers fully understand the need for an open-ended policy response in order to achieve financial and economic stability. While the current economic and financial crisis is unprecedented, so is the magnitude of government policy stimulus during the past year, and further massive stimulus is expected in 2009. The outlook for the economy is heavily predicated upon policy actions that will be implemented in future months. While it is likely that these policy measures will succeed in averting a depression, it is too late to prevent the longest and most severe recession since the 1930s.

U.S. PERSONAL CONSUMPTION EXPENDITURES

Adjusted for Inflation; Quarterly % Change at an Annual Rate



Source: Bloomberg

U.S. CONSUMER PRICE INDEX

Year-Over-Year % Change



Source: Bloomberg



U.S. BONDS

Despite unprecedented policy initiatives of the Federal Reserve and the Treasury, credit conditions generally deteriorated during the year, particularly in the weeks and months following the failure of Lehman Brothers in mid-September. Risk spreads in both the short-term funding markets and corporate credit markets surged following the largest bankruptcy in history. The TED spread – a measure of banking system strains – rose from 1% in early September to a peak of 4.82% in mid-October, while risk spreads on high-yield corporate bonds widened from 8% prior to the Lehman failure to nearly 17% at year-end.[†]

Conversely, market yields on U.S. Treasury securities plunged to record post-World War II levels, most notably the 5-year note (1.25%), the 10-year note (2.05%) and the 30-year bond (2.52%).[†] The ultimate manifestation of this flight to safety was a zero market yield on 91-day T-bills. Not surprisingly, U.S. Treasury securities were the single best-performing major asset class, and massively outperformed all segments of the bond market. U.S. Treasury securities enjoyed its best calendar year in more than a decade, with a total return of 13.75%.^{*} The longest duration Treasury securities performed best with a 41% rate of return on 30-year bonds. Agency bonds registered returns of 9%, followed by agency-backed MBS with returns of 8%.[†]

The highest risk sectors registered record losses during the year, including corporate bonds and securitized debt. Specifically, the worst-performing sectors for 2008 were investment-grade corporates (-5%), commercial mortgage-backed bonds (-20%) and speculative-grade corporate bonds (-26%). Within the investment-grade universe, AAA-rated bonds (+8%) significantly outperformed medium-grade corporate (BBB-rated), which suffered a loss of 9%.[†]

While there is some preliminary evidence of thawing, credit markets remain far from normal and further progress is necessary. The Federal Open Market Committee lowered its target for the federal funds rate to near zero at its December meeting, and has effectively adopted a policy of quantitative easing. The Fed and the Treasury have also adopted a strategy of bypassing the crippled banking system with direct involvement in credit markets. Yields and

spreads in those sectors specifically targeted by the Federal Reserve have declined, most notably in the commercial paper, agency and agency-backed MBS markets. Evidence of success can be seen in the decline in 2-year swap spreads from a peak of 1.65% to less than 0.75% at year-end.[†]

With respect to investment strategy, the U.S. Treasury market appears grossly overvalued and extremely unattractive for long-term investors. Nonetheless, the Treasury yield curve should remain at historically depressed levels for all of 2009, as the combination of profound economic weakness, very low levels of inflation and an extended period of monetary ease by the Federal Reserve provides continued strong demand for U.S. Treasury securities. Despite the prospects for trillion dollar federal budget deficits and a massive increase in government borrowing requirements in 2009 and 2010, government bond yields should remain depressed. Heavy government borrowing will be overwhelmed by the protracted deleveraging of private sector balance sheets and the sharp increase in private sector savings.

The most attractive segments within the fixed-income market for 2009 are high-quality non-treasury sectors, where risk spreads appear to be at cyclical peaks. These include agency bonds, agency-backed MBS, high-grade corporates and high-quality 20-year municipal bonds. Speculative-grade corporate bonds with market yields in excess of 20% are attractively valued, but will remain vulnerable until investors can quantify the peak level of corporate bond defaults. Because junk bond spreads typically peak roughly six months in advance of the peak in bond defaults, investments in high-yield corporate bonds could be premature at this time. However, this sector offers substantial excess return potential for long-term investors and could be the single best-performing asset class over a 2-year time horizon.

^{*} Source: Morningstar SBBI

[†] Source: Bloomberg

BENCHMARK 10-YEAR U.S. TREASURY NOTE

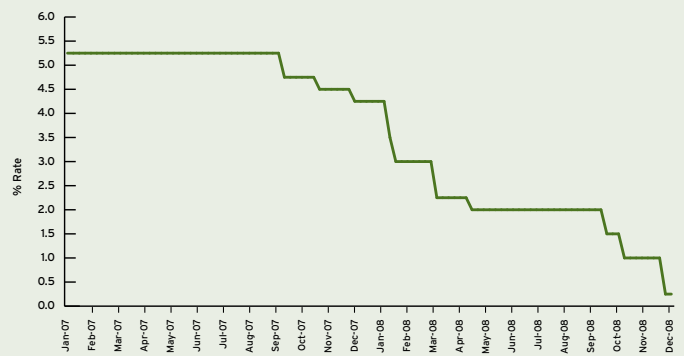
% Market Yield to Maturity



Source: Bloomberg

THE FEDERAL RESERVE % TARGET RATE

For Overnight Federal Funds



Source: Bloomberg

U.S. STOCKS

The U.S. equity market remains in a bear market that began in October of 2007. The 37% negative total return in the S&P 500 Index in calendar year 2008 is the biggest decline since the 43% decline in 1931. On a peak-to-trough basis, the cumulative decline from its October 2007 all-time high to the lows reached during Q4 2008 has been 52%.[†] While the vast majority of losses appear to be over, the equity market is vulnerable to some further declines. The most plausible outlook for the equity market is an extended base-building phase that could persist over a period of months, with continued high volatility. Common stocks will remain at risk until credit market conditions improve and there is evidence of stabilization in the economy, as signaled by the leading indicators.

While the numerous negative factors facing the equity market are well known, there are five important positive factors for stocks. These include monetary conditions, investor sentiment, record cash reserves, capital flows and valuation. Various measures of investor sentiment are at negative extremes, which is a positive from a contrarian perspective. The record level of outflows and redemptions from mutual funds is another positive contrarian indicator. Similarly, the level of cash sitting on the sideline as a percentage of equity market capitalizations is also near all-time record levels. Finally, and most importantly for long-term investors, a number of traditional valuation measures suggest that the equity market is significantly undervalued.

Equity market valuations have declined to very attractive levels, as measured by price-to-earnings (P/E) ratios. While the reliability of P/E ratios in the current uncertain profit environment has diminished, other traditional valuation measures using variables with greater stability than earnings also indicate significant market undervaluation. These include price-to-sales, price-to-book value and price-to-cash flow measures of equity market valuation. In addition, the ratio of the total capitalization of the equity market relative to nominal GDP is at historically depressed levels. The ratio of stock prices to the replacement cost of net corporate assets (Tobin's Q-ratio) suggests that the equity market is undervalued. Perhaps most compelling is the relative dividend yield on common stocks. For the first time since 1958, the level of current dividend yields on the S&P 500 (3.25%) is above the level of 10-year government bond yields (2.25%).

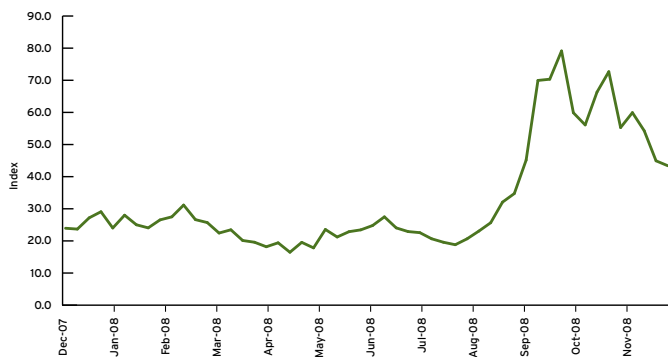
However, market valuations alone are not sufficient to trigger a sustained recovery in stock prices. The specific catalyst necessary to spark a sustained equity market advance is the ability of investors to gauge the depth and duration of the recession and the cumulative decline in corporate earnings. In addition, evidence that policymakers have achieved success in unfreezing the credit markets is an important precondition to signal that the end of the bear market is imminent. More specific advance signals of a durable equity market advance will be a sustained narrowing in corporate bond credit spreads, a sustained reversal in the monthly Index of Leading Economic Indicators and evidence of a sustained improvement in liquidity conditions within the banking system and money markets, for which banking spreads and the price of gold will be important indicators for investors to monitor.

In terms of equity market leadership, large-capitalization stocks as a group should outperform both mid-cap and small-cap stocks. The economic and financial environment of the next several years will be extremely challenging for small companies. The shares of companies with strong balance sheets, dominant market positions and the ability to fund expansion plans through internally generated cash flow should perform best. In terms of economic sectors, defensive groups such as consumer staples and health care should perform best. Select capital goods companies serving infrastructure markets both domestically and in emerging market economies should also perform well. In general, the shares of companies with global exposure should perform better than domestic-only businesses. The most attractive group is the large-cap U.S. multinationals with dominant industry positions along with steady and predictable growth in earnings and dividends.

[†] Source: Bloomberg

EQUITY MARKET VOLATILITY INDEX

Implied Future U.S. Equity Market Volatility
Chicago Board Options Exchange



Source: Bloomberg

U.S. CORPORATE OPERATING PROFITS

Year-Over-Year % Change



Source: Bloomberg

INTERNATIONAL MARKETS

Economic and financial conditions in international markets are similar to those of the U.S.: Dysfunctional credit markets combined with a banking crisis in many countries; progressive economic weakness; a collapse in manufacturing activity; falling real estate prices; large credit losses and defaults; rising unemployment and declining corporate profits; broad deflationary pressures; aggressive central bank and fiscal policy stimulus; and steep declines in government bond yields. Most equity markets have suffered even worse declines than that of the U.S. in both local currencies and on a dollar-denominated basis.

As in the U.S., the global economy is entering its period of maximum economic weakness, and recessionary conditions should persist for most of 2009. World economic growth is expected to slow to only 1% in 2009, down from 3% in 2008 and 5% in 2007. Export activity in Europe, Japan and China has weakened significantly, accentuating the weakness in the global manufacturing sector stemming from massive inventory liquidation. World trade could decline in 2009 for the first time in many years, following growth rates of 8%-10% during the 2004-2006 period. Real estate prices are under severe pressure, most notably in Spain and the UK, triggering sharp declines in retail sales and banking industry turmoil. Finally, intense recessionary conditions should continue to exert downward price pressure on both crude oil and industrial commodities for much of 2009.

Most major central banks have responded by slashing policy rates, including Canada (1.5%), Europe (2.5%), Sweden (2.0%), Japan (0.10%) and the UK (2.0%). Whereas the U.S. Federal Reserve and Japan have reduced policy rates to near zero, other central banks are expected to reduce rates further during 2009, with the European Central Bank (ECB) expected to reduce its policy rate to 1%. Policy rates have also been slashed in many Asian economies, including China. In addition to aggressive monetary stimulus, most countries are also implementing fiscal policy stimulus packages consisting of tax cuts and increased government spending.

The euro will likely fluctuate within a volatile trading range of \$1.30-\$1.50 with the U.S. dollar, while the Japanese yen is significantly overvalued and should drift lower versus both the dollar and the euro. Most Asian currencies will likely strengthen versus the dollar in 2009. While vulnerable to tight global liquidity conditions and a shakeout in manufacturing, Emerging Asia enjoys superior long-term secular growth potential and should exhibit the best relative economic performance in 2009 and 2010. Real GDP in China will likely slow temporarily to less than 5% in 2009, down from roughly 12% in both 2006 and 2007, and well below its long-term growth potential of 9%.

With respect to the major asset classes, government bonds should continue to provide the best relative returns until there is clear evidence of economic and credit market stabilization. The government bond markets in the UK, Europe, Australia and New Zealand appear more attractive relative to those of Japan, Canada and the U.S. As in the U.S., high-grade corporate bonds offer very attractive valuations and should outperform governments over a 1-2 year time horizon. Among the developing economies, sovereign bonds of Mexico and Brazil appear most attractive.

International equity markets will likely remain vulnerable until liquidity pressures improve and leading indicators are signaling an economic recovery, which appears unlikely until 2010. Most developed economy equity markets will lag that of the U.S. during 2009, most notably Japan, which has fallen back into deflation. The best-performing equity markets during 2009 will likely be in Emerging Asia, for several reasons: Asian economies should weather the global recession better than most regions, longer-term secular growth prospects are well above average and market valuations are attractive once again following the steep market declines suffered during 2008 from previously overbought levels. China, India and Hong Kong appear to be the most attractive equity markets within the region.

FINANCIAL TERMS

FISCAL POLICY

Fiscal policy refers to the government action that is aimed at influencing the economy through changes in taxes or by means of government spending.

GDP (GROSS DOMESTIC PRODUCT)

The GDP of a country is defined as the market value of all goods and services produced within a country in a given period of time. For media and reporting purposes, a calendar-year period is the unit normally used.

INTER-BANK LENDING

The inter-bank overnight lending market is a market where depository institutions buy or sell funds needed to meet a reserve requirement at the end of the trading day. In this market, banks can sell their excess reserves to other banks with insufficient reserves and charge the overnight inter-bank lending rate for the service.

MONETARY POLICY

Monetary policy refers to the government action that is aimed at influencing the economy through changes in interest rates or money supply.

MORTGAGE-BACKED SECURITIES (MBS)

Mortgage-backed securities are bonds that are backed by mortgages of different types such as fixed rate, floating rate, residential, commercial, etc. MBSs are backed by the principal and interest payments of the pool of mortgages upon which the MBS is based.

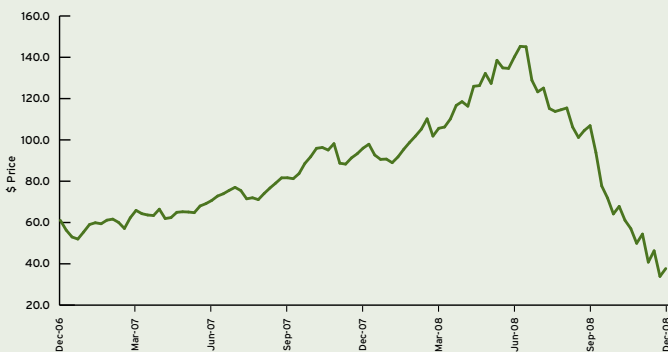
TED SPREAD

The TED spread is the difference between the interest rates on inter-bank loans and short-term U.S. government debt ("T-bills"). The acronym TED refers to T-bill and Eurodollar with a ticker symbol of ED. The TED spread is calculated as the difference between the three-month T-bill interest rate and three-month Eurodollars contract as represented by the London Interbank Offered Rate (LIBOR). For example, if the T-bill rate is 5.10% and ED trades at 5.50%, the TED spread is 0.40% or 40 bps. The TED spread fluctuates over time, but historically has often remained within the range of 10 and 50 bps (0.1% and 0.5%), until 2007. A rising TED spread indicates that liquidity is being withdrawn from the banking system, further indicating a rise in the perception of riskiness or stress.

YIELD

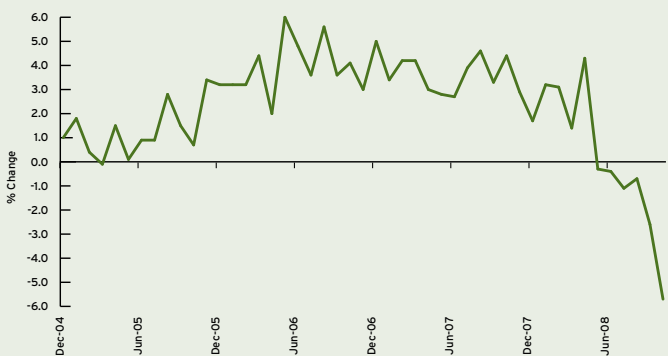
The yield on fixed income instruments is the prospective annual rate of return if the bond is held to maturity, and is expressed as a percentage. Investors can use the yield percentage to compare it to the yield on other investments or securities. Higher-risk securities generally offer higher expected yields as compensation for the additional risk incurred through ownership of the security.

CRUDE OIL U.S. DOLLAR PRICE PER BARREL New York Mercantile Exchange



Source: Bloomberg

EUROZONE INDEX OF INDUSTRIAL PRODUCTION Year-Over-Year % Change



Source: Bloomberg

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