



Q1

QUARTER ONE
2009 ECONOMIC & MARKET OUTLOOK



Capital Advisors

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Q1

QUARTER ONE 2009 EXECUTIVE SUMMARY

U.S. ECONOMY – Recessionary forces persisted throughout the quarter, although there has been some very preliminary evidence in recent weeks of a moderation in the severe rate of economic decline. Nonetheless, the economy remains trapped in a negative feedback loop, whereby forces within the economy and financial system have become mutually reinforcing, triggering a vicious downward spiral in the economy and in asset prices. Following another several quarters of economic contraction, stabilization in the U.S. economy is likely later this year. The most critical assumption in the outlook is that continued nonconventional policies by the Federal Reserve and Treasury will ultimately resolve the housing and banking crises and restore the normal functioning of the financial system, a vital precondition for sustained economic growth. Economic recovery in 2010 and 2011 will likely be sluggish as a result of headwinds associated with a protracted deleveraging cycle. Deflation, rather than rising inflation, poses the greater risk in 2009 and 2010.

U.S. BONDS – Credit market conditions have improved somewhat, but the functioning of the financial system remains far from normal. Yields in the U.S. Treasury market drifted higher during the quarter on fears of future government debt issuance stemming from expected massive federal budget deficits in future years. However, a sustained rise in government bond yields is unlikely in the current environment of profound economic weakness, deleveraging of balance sheets, mounting deflationary pressures and near-zero rates in the federal funds market. The Federal Open Market Committee (FOMC) is unlikely to begin to raise short-term interest rates until the second half of 2010 at the earliest. While Treasury securities are likely to remain in overvalued territory for all of 2009, the long-term outlook for the Treasury market is unfavorable in view of unattractive valuations. Conversely, high-grade corporate bonds offer attractive valuations and could provide equity-like total rates of return in 2009.

U.S. STOCKS – The domestic equity market suffered another major setback in the quarter, as investors remain concerned over the impact of the banking crisis on the economy, corporate profits and cash dividends. The 57% plunge in the S&P 500 Index over the past 18 months is the most severe since the 1930s. While stocks remain vulnerable to further declines in the months ahead, the vast majority of market losses appear to have already occurred. The primary positive factors for common stocks are the unprecedented policymaker response to the economic and financial crisis, the mountain of cash on the sidelines and very attractive equity market valuations. The most likely scenario is for an extended base-building phase with continued extreme volatility that could persist for another several months. Beyond that, investors can expect above-average returns from common stocks over a 1-2 year time horizon from current depressed valuations.

INTERNATIONAL MARKETS – The performance of international financial markets was even worse than that of the U.S. during the quarter, a reflection of the greater relative weakness in many foreign economies and the strength of the U.S. dollar. Global GDP and the volume of world trade are both expected to contract in 2009 for the first time since 1945. Policymakers in virtually all major economies have adopted highly aggressive monetary and fiscal policies similar to that of the U.S. Recovery in the global economy is expected to lag that of the U.S., with the notable exception of China. International bonds will continue to outperform stocks until there is evidence of economic and financial market stabilization. Equity markets in most developed economies will lag that of the U.S. during 2009. The best-performing international equity markets during 2009 and 2010 will likely be in the developing economies, especially emerging Asia, because of much improved structural economic and financial fundamentals, attractive valuations and favorable relative longer-term secular growth prospects.

U.S. ECONOMY

Recessionary conditions prevailed during the first quarter, although the rate of decline in economic output appeared to be moderating at quarter end. Real GDP contracted at an estimated 6% annual rate in the quarter, similar to that of the previous quarter, led by continued weakness in residential construction and consumer spending along with accelerating declines in manufacturing, business investment and commercial construction. Inflation was nonexistent in the quarter, as deflationary forces remain dominant. Corporate earnings declined in Q1 for an unprecedented seventh consecutive quarter, and further declines are inevitable in future quarters.

Negative Feedback Loop – The U.S. economy remains trapped in a negative feedback loop. Forces within the economy and financial system become mutually reinforcing and trigger a downward spiral in both economic output and asset prices. The primary catalyst in this self-feeding process is a powerful deleveraging cycle within the banking and household sectors, which involves a liquidation of debt and a rebuilding of capital, savings and liquidity. Although necessary for future economic stability, this process is highly contractionary and deflationary. The paydown of private sector debt involves forced liquidation of assets and a contraction in spending, profits, employment and household wealth, triggering an escalation of financial sector credit losses. The implication is that recessionary forces of this nature cannot be stabilized by traditional monetary and fiscal policies, and therefore, require radical government measures in order to break the vicious downward spiral.

Role of Government – History clearly reveals that the government must act boldly to fill the vacuum within the banking and credit markets created by highly risk-averse lenders. It must also fill the void in aggregate spending resulting from the collapse in private sector demand. The Treasury and the Federal Reserve have responded with unprecedented policy stimuli; however, despite some progress, they have failed to achieve an ultimate resolution to the crisis. More aggressive policy actions are likely to continue as the year unfolds. A major assumption in our forecast is that policymakers are fully committed to adopting increasingly radical policies until the crisis has been fully resolved.

New Policy Initiatives – There were four major government initiatives implemented during the first quarter. These include a \$787 billion traditional Keynesian fiscal stimulus package; a \$275 billion homeowner relief package designed to stem the tidal wave of foreclosures; further expansion of lending facilities by the Federal Reserve through the Term Asset-Backed Securities Loan Facility (TALF) program to revitalize the securitization market and to provide credit directly to households and businesses; and a long-awaited Treasury plan to restructure the crippled banking industry. The latter is of greatest importance: an increase in bank capital and removal of toxic assets from bank balance sheets are two necessary preconditions in triggering new bank lending. The hope is that these initiatives will begin to have a favorable impact on the economy later this year and in 2010.

Outlook – Our forecast assumes that the recession will persist during all of 2009. The rate of economic decline should decelerate as the year unfolds in response to the unprecedented policy actions by the government. Following stabilization around yearend, the domestic economy should expand at a sustained but moderate pace in 2010 and 2011. Real GDP growth is unlikely to exceed 2% during this period, constrained by persistent deleveraging in the household and banking sectors. Corporate profits should decline by 25% in 2009, followed by an increase of 10%-15% in both 2010 and 2011. As a classic lagging indicator, employment is likely to remain depressed during all of 2009, with the unemployment rate peaking at 10% or higher later in 2010. Inflation is also a lagging indicator; following zero inflation in 2009, consumer inflation should average no more than 1% in 2010 and 2% in 2011.

Past performance does not guarantee and is not indicative of future results.

U.S. INITIAL CLAIMS UNEMPLOYMENT BENEFITS

Thousands



Source: Bloomberg

U.S. % CAPACITY UTILIZATION RATE

Manufacturing Sector



Source: Bloomberg



U.S. BONDS

U.S. fixed-income markets suffered a minor setback in the quarter following solid returns over the previous several quarters. Compared with a total return of 10% over the past year, the Barclays Capital Aggregate Bond Index was unchanged in the quarter. Market yields on U.S. Treasury securities bounced from record low levels at yearend, stemming from investor concerns over massive government debt issuance to finance the surging federal budget deficit. The result was an 11% loss in the quarter on the longest maturity U.S. Treasury bonds. At the same time, corporate bonds suffered from widening credit spreads relating to concerns over rising defaults, resulting in a decline of 2%. The best-performing sector within the Barclays Index was agency-backed MBS, with a total return of 2.2%. Following its worst calendar year on record, the high-yield corporate bond market registered a total return of 6.0% in the quarter.

Credit Conditions – Despite scattered evidence of thawing, many segments of the credit market remain frozen, most notably the securitization and high-yield (junk) corporate bond markets. Moreover, the banking system remains crippled, and bank lending is contracting. Credit spreads have declined from their September 2008 peaks but remain at historically high levels. Further aggressive policy initiatives announced by the Federal Reserve and the Treasury during the quarter are aimed at a rehabilitation of bank balance sheets and an expansion in credit flows. These measures should be successful in gradually restoring the normal functioning of the financial system. Outright market purchases of mortgage securities by the Federal Reserve have pushed 30-year fixed-rate mortgages to all-time lows, and should ultimately spark a recovery in home sales.

Interest Rates – The back-up in market yields since yearend does not appear sustainable. Investor concerns over the record issuance of debt by the federal government should be overwhelmed by countertrends in the private sector. These include the continued high risk of deflation; weakening credit demands within the private sector as a result of the ongoing deleveraging cycle; and a continuation of the zero interest rate policy by the Federal Reserve.

The market yield on the benchmark 10-year Treasury note (currently 2.65%) should fluctuate within a range of 2.5% to 3% for the remainder of the year, with only a moderate rise during 2010. The FOMC is unlikely to raise short-term interest rates until the second half of 2010 at the earliest, implying a continued steeply sloped yield curve well into 2010.

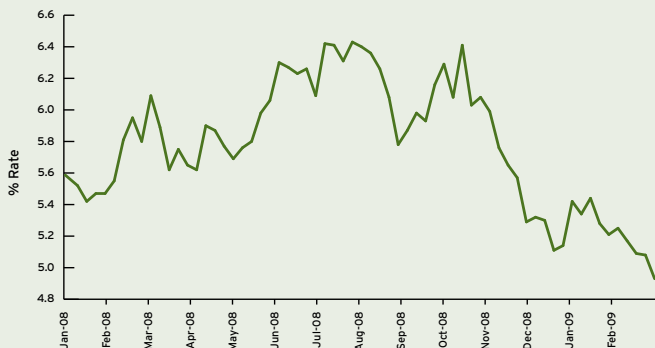
Outlook – With the notable exception of corporate bonds, fixed-income markets continue to offer little appeal for long-term investors in view of the historically depressed level of yields. This is especially true for Treasury securities, which have benefited from widespread risk aversion among investors and a prolonged flight to safety. While government bonds might enjoy periodic trading rallies as a result of further economic weakness during 2009 along with investor concerns over deflation, expected returns from the Treasury market beyond 2009 are almost certain to be disappointing. Government agency debt and agency-backed MBS should easily outperform the Treasury market over the next year.

Corporate Bonds – The most attractive segment of the U.S. bond market is high-grade corporate bonds. Option-adjusted credit spreads currently in excess of 500 basis points are well above normal and should narrow over the next year as recessionary forces moderate, providing investors with equity-like returns. High-quality municipal bonds also offer very attractive yields for taxable accounts that can tolerate liquidity risk. Finally, the high-yield corporate bond market offers very attractive value, with credit spreads and market yields at 1500 basis points and 18%, respectively. However, default rates are in a steep uptrend and may not peak until the middle of 2010, implying further market risk in the short term. Nevertheless, high-yield corporate bonds could be the single best-performing asset class beginning later this year and during 2010.

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U.S. HOME MORTGAGE RATES

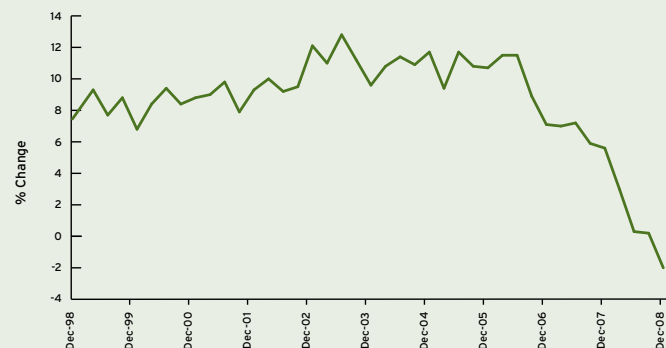
Conventional 30-Year Fixed Rate



Source: Bloomberg, Bankrate.com

U.S. HOUSEHOLD DEBT OUTSTANDING

Year-Over-Year % Change



Source: Bloomberg

U.S. STOCKS

The domestic equity market suffered its sixth consecutive quarterly decline, a manifestation of continued investor risk aversion and the flight to safety. The S&P 500 registered a negative total return of 11% in the quarter following a nearly 22% decline in the previous quarter, while the small-cap Russell 2000 declined by an even greater 15%. The cumulative decline in the equity market from its all-time peak of October 2007 to its March low is 57%, the steepest decline in stock prices since the 1930s. The peak-to-trough decline in the financial sector has exceeded 80%, worse than the collapse of the technology sector during its bubble earlier in the decade. Equity markets suffer from a lack of visibility regarding the outlook for the economy and corporate earnings, and the ultimate magnitude of credit losses in the financial sector. There is also a growing lack of confidence regarding the ability of policymakers to resolve the current economic crisis.

Positive Factors – While the numerous negative factors facing the equity market are well known, there are several 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. Deposits in money market mutual funds currently exceed the cumulative value of all equity market mutual funds. Similarly, cash as a ratio of total domestic equity market capitalization has risen to unprecedented levels in excess of 90%. Finally and most importantly for long-term investors, various valuation measures suggest that the equity market is significantly undervalued.

Equity Valuations – The most important measure of equity market valuations is the price-to-earnings (P/E) ratio. While less reliable in the current highly uncertain profit environment, P/E ratios using smoothed or normalized earnings suggest a significantly undervalued market. Other traditional valuation measures indicate that stocks are undervalued, including the price-to-sales ratio, the price-to-book value ratio, the price-to-cash flow ratio and the ratio of current stock prices to the replacement cost of net corporate assets. Finally, the ratio of total equity market capitalization to nominal GDP is at the lowest level since the early 1980s.

Large-Cap Stocks – The economic and financial market environment ahead should favor growth versus value managers and large-cap versus small-cap stocks. The shares of companies with global exposure should perform better than domestically oriented companies, favoring large-cap stocks. Moreover, in the risky and challenging economic and financial environment that lies ahead, shares of strong dividend-paying companies with healthy balance sheets that enjoy a dominant competitive position in their markets should perform best. In addition, the shares of companies that are able to finance growth through internally generated cash flow should also be favored. Shares of U.S. multinationals appear especially attractive on a risk-adjusted basis.

Outlook – While the vast majority of declines appear to have already occurred, common stocks are still vulnerable to further temporary weakness in future weeks and months. Investor confidence has been shattered and there is a lack of concrete evidence confirming that an end to the recession is imminent. Moreover, the outlook for corporate earnings is highly uncertain, and the financial crisis has not yet been resolved. The major positives for the equity market are the massive efforts initiated by policymakers to resolve the economic crisis and the depressed level of equity market valuations, which have declined to the most attractive levels in more than a quarter century. The most likely scenario for common stocks is for an extended base-building phase with continued extreme volatility that could persist for months before the equity market embarks on a sustained advance later in the year. Beyond the short-term period of continued risk and uncertainty, investors should expect above-average returns from common stocks over a 1-2 year time horizon.

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S&P 500 STOCK INDEX



Source: Bloomberg

U.S. CORPORATE OPERATING EARNINGS

National Income and Product Account



Source: Bloomberg

INTERNATIONAL MARKETS

Financial markets in most foreign economies performed poorly in the quarter, with moderate declines in many fixed-income markets and more significant declines in equity markets. Developed economy bond markets registered a decline of 5.5% in the quarter as measured by the Barclays Capital Aggregate Index (ex-US and unhedged). Equity markets were mixed, with Morgan Stanley's MSCI EAFE Index registering a loss of 14% while emerging markets rose by nearly 1%, helped by a record monthly market surge in March. European and Japanese equity markets registered losses of roughly 15% for the quarter, and cumulative bear market losses since 2007 of 60%, all denominated in dollars. The single best-performing major global equity market in the quarter was China, with gains considerably in excess of 30%.

Business Conditions – Economic and financial conditions in international markets are similar to those of the U.S., including banking and housing crises, along with broad economic weakness. Manufacturing activity has collapsed in most regions, accompanied by rising unemployment and declining corporate profits. Economic and banking conditions in many economies are worse than those of the U.S. Policymakers have responded to the economic crisis with aggressive central bank and fiscal policy stimuli, including large tax cuts and government spending programs, and aggressive interest rate cuts by central banks.

World Trade – Following consistently strong growth rates of 8%-10% during the 2004-2006 period, world trade has collapsed and is expected to post its worst calendar year decline since 1945. Countries dependent upon exports such as Japan, Singapore and Korea have suffered the most severe declines in Q1 GDP. Japan has fallen into a deep recession, with exports and industrial production plunging by 45% and 25%, respectively. The 25% decline in China's exports has contributed to a sharp slowdown in China's GDP, and slumping Chinese imports have been extremely detrimental to many of its primary trading partners. The U.S. dollar appreciated by nearly 5% in the quarter on a trade-weighted basis, benefiting from the global flight to safety. The dollar has appreciated by more than 15% since the middle of 2008.

Outlook – World GDP in 2009 is expected to post its first decline since World War II, with real GDP declines of 3% or greater in the developed economies and anemic growth in the emerging market economies. China is likely to be the first economy to stabilize and to embark upon a sustained economic recovery, while both Europe and Japan could lag significantly. Foreign government bonds should continue to outperform common stocks for a while longer until there is clear evidence of economic and credit market stabilization. The government bond markets in the UK, Europe, Canada, New Zealand and Norway appear more attractive relative to those of Japan, Switzerland and the U.S. As in the U.S., high-grade corporate bonds offer attractive valuations and should outperform government bonds over a 1-2 year time horizon.

Equity Markets – International equity markets will likely remain vulnerable until liquidity and credit pressures improve and leading indicators begin to signal an economic recovery, both of which appear unlikely until 2010. Most developed economy equity markets will lag that of the U.S. during 2009. The best-performing international equity markets during 2009 and 2010 will likely be in the developing economies. Emerging Asia appears especially attractive because of its favorable longer-term secular growth prospects and attractive valuations, following the steep market declines suffered during the second half of 2008. China, India and Hong Kong appear to be the most attractive equity markets on a longer-term basis. Currently at a 26-year low, the Japanese equity market is extremely cheap and a possible candidate for contrarian investors, although a currency-hedged strategy is strongly advised. The European equity market is also cheap, with a current dividend yield in excess of 6%, and prospects of a rising currency over the next 1-2 years.

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FINANCIAL TERMS

DEFLATION

A general decline in prices often caused by a reduction in the money supply or credit, or a decrease in spending. Deflation often leads to lower profits and hence, unemployment, as there is a lower level of overall demand for goods and services.

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.

KEYNESIAN

Economic theories developed by John Maynard Keynes, an economist during the Great Depression. The major focus of Keynesian Economics relates to government fiscal policy, specifically that the federal government should adopt a budgetary policy of deficit spending in order to achieve full employment, using tax cuts and increased spending to fill the void created by a shortfall in aggregate private spending.

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)

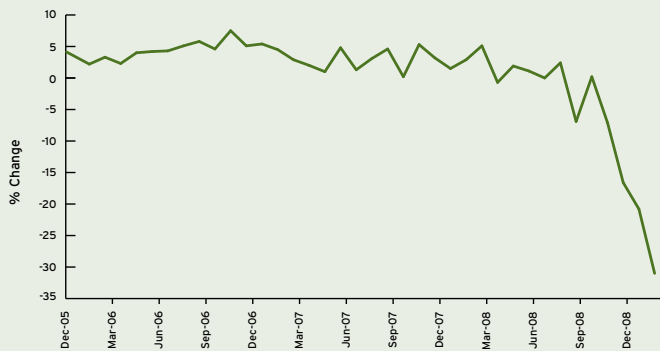
Mortgage-backed securities are bonds that are backed by mortgages of different types such as fixed rate, floating rate, residential, commercial, etc. MBSs are backed by the principal and interest payments of the pool of mortgages upon which the MBS is based.

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.

JAPAN INDUSTRIAL PRODUCTION

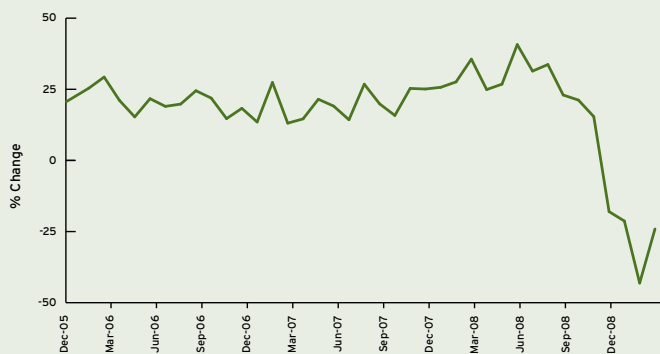
Year-Over-Year % Change



Source: Bloomberg

CHINA MERCHANDISE TRADE IMPORTS

Year-Over-Year % Change



Source: Bloomberg

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