

MEMBERS™ CAPITAL ADVISORS

Mid-Quarter Update

May 2009

The U.S. economy is in a state of transition. Following the most severe 6-month period of economic decline since the 1930s - triggered by the failure of Lehman Brothers - the U.S. economy has transitioned to a period of more moderate economic decline that is likely to persist for another several months. But the economy should stabilize near yearend, followed by a sustained but fragile recovery in 2010.

The current recession is unlike any of the previous ten recessions since 1945, and involves a debt deflation cycle similar to that of the U.S. in the 1930s and Japan in the 1990s. The crucial implication is that investors should not use recessions of recent decades as a guide for forecasting the shape and pattern of this recovery.

The central theme in my forecast is that the recession will be followed by a protracted period of sub-par economic growth. Powerful headwinds will act as a lingering constraint to economic growth, including the ongoing deleveraging by the household and banking sectors and structural changes within labor markets.

It is critical for investors to use caution in future months in interpreting key government economic data. While monthly and quarterly economic data may exhibit strong growth from deeply depressed levels, I believe the U.S. economy will not rise to levels of full employment until 2013 at the earliest.

The surprising rebound in Q1 consumer spending was an aberration; it is my opinion renewed weakness will be apparent in Q2 GDP. Households will remain in a retrenchment mode well into 2011, driven by debt reduction, a rebuilding of savings, and persistent weakness in labor markets.

While the worst of the banking crisis has ended, stringent bank lending standards will constrain credit availability through 2010 as banks attempt to rebuild depleted capital ratios. Despite the considerable success achieved by the Federal Reserve in unfreezing key credit markets, credit flows will not likely be restored to normal until 2011.

Investor fears over inflation are premature in an environment of massive economic slack. Excess productive capacity and protracted weakness in labor markets imply a record output gap that will limit pricing power and keep wages under intense downward pressure. Corporate profits should reach a cyclical bottom in Q3 and possibly surprise on the upside in 2010 and 2011 because of fierce cost-cutting.

Market interest rates will likely also remain at historically depressed levels well into 2010, the result of weak credit demands associated with deleveraging; a continued low rate of inflation; and continued monetary ease by the Federal Reserve.

Financial markets are currently in transition from extreme risk aversion to a gradual increase in risk appetites. It is likely that the worst of the equity bear market has passed, and I believe stocks and corporate bonds should outperform government bonds over the next 1-2 years. However, the equity market will likely remain in a prolonged base-building or consolidation phase before a new cyclical bull market begins later this year. In view of the enlarged role of the federal government in the economy and financial markets, the initiatives of policymakers are of particular importance at this time.

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