An analysis by McQueen Financial Advisors, Inc.

McQueen Financial Advisors

December 2017

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MFA Economic Outlook

December 2017

ECONOMIC PRESENTATION POINTS
ALM AND INVESTMENT REPORTS

Brrrr – Winter is here in the north! We have closed out 2017, and 2018 is upon us. This is our year-end view point on the economy, interest rate projections, and the industry. If I was to compare the current economic environment to a body of water, I would consider it a swiftly flowing river.

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Please see important disclosures on Page 9 of this document.

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ABSTRACT

This paper describes our current view of the economic environment.

COMMENTARY

What is going on with the Federal Open Market Committee (FOMC)?

Short-term Federal Funds:
The FOMC is planning on increasing the Federal Funds rate throughout this year. The Fed Funds rate is projected to go up 0.25% in March 2018, from 1.50% to 1.75%, based on the Fed Funds futures, or betting in the bond market. The bond market is expecting an increase in June 2018, which will result in a 2.00% Fed Funds rate. There is the possibly of a third rate increase in November or December of 2018. At the last FOMC meeting in 2017, they provided guidance that they expect to increase the Fed Funds rate three times in 2018. This would result in a 2.25% Fed Funds rate by the end of 2018.

Federal Reserve Meeting Dates & Rate Probability

2.75%									
2.75%								2.0%	2.1%
2.50%						2.7%	5.3%	15.9%	16.1%
2.25%				0.7%	5.1%	35.0%	35.8%	38.2%	38.2%
2.00%			0.9%	64.6%	62.3%	45.3%	42.8%	33.1%	32.9%
1.75%		87.9%	87.4%	31.7%	29.7%	15.7%	14.5%	9.9%	9.8%
1.50%	99.7%	11.8%	11.7%	3.1%	2.9%	1.4%	1.3%	0.8%	0.8%
1.25%									
Date	1/31/18	3/21/18	5/2/18	6/13/18	8/1/18	9/26/18	11/8/18	12/19/18	1/30/19
Projected Rate	1.50%	1.72%	1.72%	1.91%	1.92%	2.06%	2.08%	2.16%	2.16%

" As of today, the forward yield curve is projecting a 0.25% increase in the Fed Funds rate in March, June and December."

Long-term Open Market Activities:

The FOMC is continuing to shrink the quantitative easing (QE) portfolio, which currently holds roughly $4.5 trillion in assets. The FOMC is rapidly reducing their mortgages and US Treasury holdings as I type this article. The portfolio currently has between $20 trillion and $50 billion maturing a month. The schedule below allows the portfolio to slowly contract as maturities happen, which means the FOMC will not be selling bonds. The contraction will be as follows per month:

- Q1 – 2018 - $20 billion a month
- Q2 – 2018 - $30 billion a month
- Q3 – 2018 - $40 billion a month
- Q4 – 2018 - $50 billion a month
- Going forward - $50 billion a month. At this pace it will take approximately 8 years for the portfolio to get to pre-QE size.

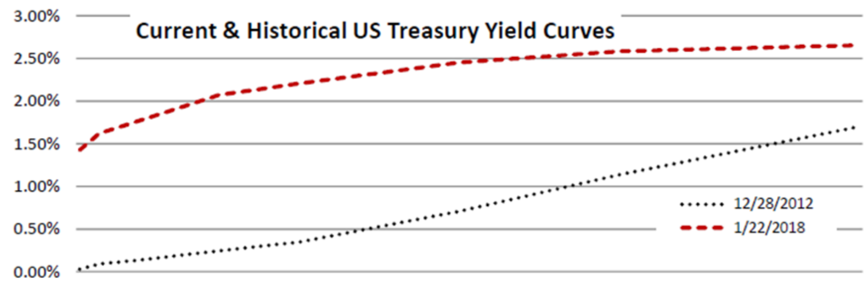
The fear is inflation.

Inflation is still low overall, but we are seeing an increased amount of wage-based inflation. The fear (and a bit of reality as we are under 5% unemployment) of inflation is rising. As the fear grows, so do interest rates. The FOMC has a dual mandate: price stability and full employment. The fear is that there is no longer price stability (increasing wages), and by definition, we are at full employment (lower than 5% unemployment). This fear of increasing wages has caused a significant drop in equity prices and an increase of yields in the bond market.

" It is important to see that a trend of higher interest rates is emerging. Embrace it and use it to your advantage."

US Treasury yields are increasing due to inflation concerns.

There is a change in the flow of interest rates; yields are rising just like a river after a good rain storm. As the economy improves, so do bond yields.



	3 Mo	1 Yr	2 Yr	3 Yr	5 Yr	7 Yr	10 Yr
12/28/2012	0.03%	0.14%	0.25%	0.35%	0.71%	1.14%	1.70%
1/22/2018	1.43%	1.77%	2.07%	2.21%	2.45%	2.58%	2.66%
Change	1.40%	1.63%	1.83%	1.86%	1.74%	1.45%	0.95%

As we examine the outlook on long-term US Treasuries, we expect the 10-year US Treasury yield will remain relatively low (but higher than where we are today) for the foreseeable future. A rate between 2.75% and 3.50% appears reasonable, given the economic environment.

What is going on with mortgages and mortgage volumes?

The volume of new home sales is improving, but not fast enough to keep up **with demand. The old supply and demand issue is here again. Why are there** not enough new houses?

- Regulatory cost of homes is up significantly.
- Starter homes are too expensive to build.
- The number of people working in the home building trades has declined.

Interest rates are higher and as a result, 30-year mortgage rates have increased. The amount of people refinancing mortgages is heading towards zero. Why refinance my 3% mortgage with a 3.75%?

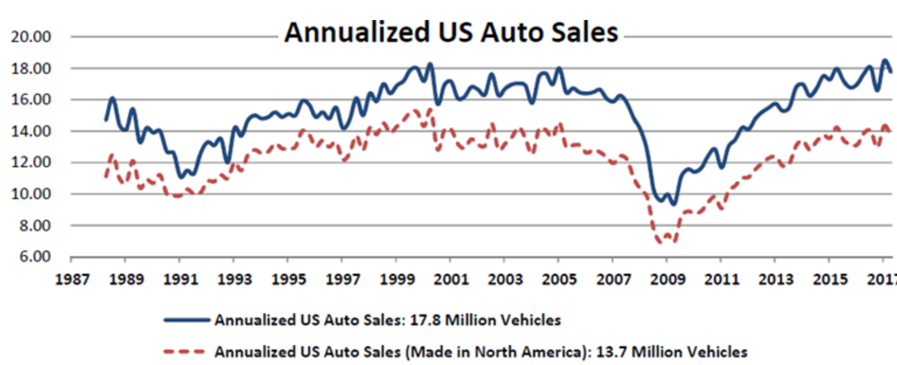
"Mortgage rates are down."

We expect that volumes will continue to decline due to the following:

- Affordability declining
- Limited supply
- Yields rising

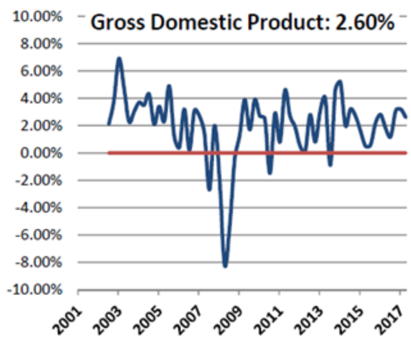
The Automotive Industry.

The automotive industry has been on fire the last few years. As we look into 2018, we see a lot of 3-year leases coming due and significant pricing pressures. A 3-year-old leased car costs roughly $14,000 less than a new car. That is a lot of savings for a used car. So, we do expect pricing pressures on new cars and we expect volumes to slow a little.

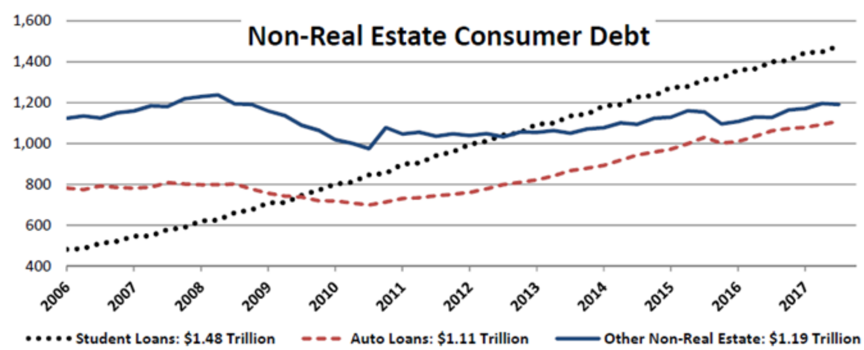


When we look into the Crystal clear ice on Lake Michigan, what do we see?

We see that we have an improving economy. The pace of the recovery is quickening, and the metrics keep pointing in a good direction. Unemployment is very low, and the underemployment rate is improving. Inflation is picking up and projections for GDP growth are increasing with a 3% to 4% range.



There are some headwinds that may keep the pace of growth slow or even derail the positive growth. The explosion of student loans is a significant concern as this is damaging the financial position of young adults beginning life after graduation. We are concerned about the affordability of housing and the fading of the American dream to own a home.



"We expect a continued slow increase in the Federal Funds rate."

The unknown is at times something we worry about.

Black Swan events, or unpredicted events, can cause interest rates to move substantially. There are a plethora of national and world wide issues that keep jumping up into the spotlight. The unknown can cause significant market changes which have historically resulted in lower stock prices and lower bond yields.

Where do we go from here?

We expect a continued slow increase in the Federal Funds rate. We expect this is being done to "normalize" rates and allow for the FOMC to lower rates if we get into a problem. We expect the 10-year Treasury to increase in yield a bit as the FOMC unwinds the QE portfolio. We expect continued slow growth, especially with the dysfunction in Washington.

What is keeping me up at night?

Deposit Generation – or lack thereof.
Non-maturity deposit costs – when do people start increasing rates?

As we move forward and further into 2018, we expect deposit generation is going to be difficult. Certificates of Deposit as a percent of deposits is nearly 15% on average. This is down from an industry average of nearly 30% just a few years back. As consumers continue to spend and potentially chase the stock market, deposits will become more difficult to generate. Today is a good day to start a deposit campaign that does not focus on interest rates.

Interest Rate projection for 2018:

	2/18	3/18	6/18	9/18	12/18
Fed Funds	1.50	1.75	2.00	2.00	2.25
2-year US Treasury	2.14	2.25	2.50	2.52	2.55
5-year US Treasury	2.58	2.70	2.90	2.93	2.95
10-year US Treasury	2.84	2.90	3.00	3.20	3.25
GDP	2.60	2.70	2.75	2.80	2.95
CPI-X-YOY	1.80	1.90	1.95	2.00	2.00

About McQueen Financial Advisors, Inc.

McQueen Financial Advisors, Inc. (MFA) is a leading nationwide provider of financial advisory services that has been serving financial institutions since 1999. An SEC-registered investment advisory firm, MFA works only for financial institutions. We provide our services to institutions throughout the United States, with assets ranging from $20 million to over $5 billion.

Products and Services

McQueen Financial Advisors provides the following services to financial institutions throughout the country:

Investment Portfolio Management: As a fixed income investment advisor, we will bring professional, in-house fixed income investment portfolio management to your financial institution at substantial savings. Our process is designed to develop a desired portfolio structure while focusing on your current income and total return with safety of principal.

Municipal and Corporate Credit Review: On a quarterly basis, we provide you with a detailed credit review on all municipal and corporate credits. Having and reporting our strong credit culture is a paramount philosophy and daily practice at McQueen Financial Advisors. We focus on credit to ensure that we are able to harness the benefit of credit spread products and take advantage of the additional yield, without taking unnecessary risk.

Asset Liability Management: McQueen Financial Asset Liability Management reports will provide you with recommendations and strategies that are designed to fit your unique needs and provide you with the information you need to make the most informed decisions and add income to your bottom line.

Core Deposit Studies: This report will be an integral part of your Asset Liability Management report. The Core Deposit Study is comprised of two sections. The first is a historical comparison of your deposit rates to market interest rates. The second section is the determination of the duration of your core deposits.

Prepayment Speed Analysis: McQueen Financial has developed a process to determine your actual prepayment speeds. Our analysis provides a report that shows your actual prepayment speeds, the national or state speeds and our recommended prepayment speeds for your ALM report.

Liquidity Analysis: The liquidity stress testing report covers 30-day, 60-day and 90-day liquidity in current, moderately stressed and severely stressed scenarios. The report is designed to be easy to understand and provide significant detail to allow for a comprehensive view of your liquidity position.

Assumption Stress Testing: McQueen Financial provides a detailed list of the assumptions in your Asset Liability Management report. We have developed a model that stress tests your assumptions and provides you with a detailed analysis of the results. The goal is to understand if an unanticipated change in assumptions would significantly hurt your projected financial performance or risk profile.

ALM Backtesting: The objective of the back testing report is to determine the net interest income projection in your ALM report was reasonable. Our analysis focuses on volume as well as booked interest rates of each interest-sensitive component of the balance sheet. The backtesting analysis is a useful management tool that provides you with a cross-check of ALM inputs and assumptions.

ALM Validation: The objective of the ALM validation report is to provide you with an independent review of your ALM model, your ALM policy, and procedures used to measure interest rate risk. The validation process involves a detailed study of your financial statements, ALM reports, ALM policy and inputs to your model.

Mortgage Servicing Rights Valuations: The Mortgage Servicing Rights Valuation (MSR) process is an integral step in determining the overall financial success of a financial institution's mortgage operations. By outsourcing your MSR Valuation to McQueen Financial, you will receive an independent third party market valuation.

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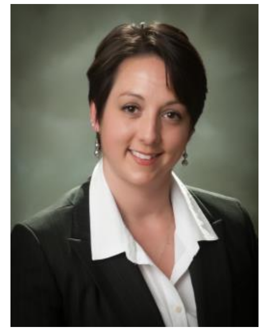

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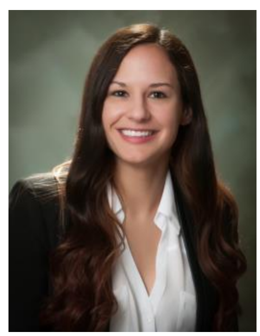

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