February 2018

NCUA's supervisory stress test (SST) consists of baseline, adverse, and severely adverse scenarios, which are to be provided to covered-credit unions by 28 February of each year. As in past SST exercises, NCUA's 2018 SST scenarios closely follow the domestic baseline, adverse, and severely adverse scenarios published by the Federal Reserve for the CCAR and DFAST exercises.

The baseline scenario follows a profile similar to the January 2018 consensus projections from *Blue Chip Economic Indicators*. The adverse and severely adverse scenarios describe hypothetical sets of conditions designed to assess the resilience of credit unions under adverse conditions. These scenarios do not represent forecasts of NCUA or the Federal Reserve.

Each scenario is summarized as follows:

<u>Baseline Scenario</u> - The baseline scenario is a moderate economic expansion. Accompanying this moderate expansion, Treasury yields rise steadily through the scenario period:

- Real GDP grows between 2 and 2.8 percent, with higher growth generally earlier in the testing period;
- Unemployment falls below 4 percent in 2018 and remains below 4 percent until the third quarter of 2020;
- CPI inflation averages 2 percent in 2018 and 2.25 percent through the end of the scenario period;
- Short-term Treasury rates increase from about 1.5 percent at the beginning of 2018 to about 2.5 percent by the second half of 2019;
- 10-year Treasury securities rise from about 2.5 percent to 3.6 percent by the end of the scenario period;
- Prime rates increase in line with short-term Treasury rates, and mortgage rates rise in line with long-term Treasury rates;
- Spreads between investment grade bonds and long-term Treasury yields widen slightly;
- Equity prices increase by about an average of 5.00% per year and equity volatility increases slightly;
- Nominal housing prices rise about 2.5 percent in 2018 and 2019, and an average of about 3 percent thereafter.

<u>Adverse Scenario</u> – The adverse scenario is characterized by weakening economic activity throughout the scenario. The economic downturn is accompanied by declines in long-term rates and flattening yield curves.

- Real GDP falls for the first five quarters of the scenario and gradually increases to above 3 percent in 2020;
- Unemployment rises steadily, peaking at 7 percent in the third quarter of 2019;
- CPI inflation initially decreases, then steadily rises to roughly 2 percent by mid-2019;

- Short-term Treasury rates immediately fall and remain near zero to the end of the scenario;
- 10-year Treasury yields immediately drop to below 0.75 percent and gradually rise to near 2 percent by end of the scenario;
- Spreads between investment grade bonds and long-term Treasury yields widen to about 3.75 percent, and mortgage spreads increase to about 2.75 percent above 10-year Treasuries.
- Equity prices fall approximately 30 percent by early 2019 with a rise in equity market volatility;
- Housing prices fall 12percentby the first quarter of 2020.

The main difference relative to the 2017 adverse scenario is that this year's adverse scenario features lower long-term interest rates and a flatter yield curve.

<u>Severely Adverse Scenario</u> – The severely adverse scenario is characterized by a severe global recession accompanied by an aversion to long-term fixed-income assets and a broad-based asset decline.

- Real GDP declines for the first seven quarters of the scenario and rapidly increases to 4.5 percent by the end of 2020;
- Unemployment increases to 10 percent by mid-2019 and only decreases slightly;
- Inflation falls below 1 percent in the second quarter of 2018 and rises to about 1.5 percent by the end of the scenario;
- Short-term Treasury rates immediately fall and remain near zero for the entire horizon;
- The 10-year Treasury rate begins at 2.4 percent and remains unchanged for the entire scenario;
- Investment grade spreads increase to 5.75 percent by the start of 2019, and mortgage rate spread over the 10-year Treasury widens to 3.5 percent over the same time;
- Equity prices fall 65 percent by early 2019 and market volatility surges;
- Home prices decline by about 30 percent by the third quarter of 2019.

The 2018 severely adverse scenario presents a more severe downturn than the 2017 severely adverse scenario. The unemployment peak of 10% is to be perceived as a greater shock due to the lower unemployment rate at the end of 2017. Additionally, this year's severely adverse scenario incorporates a steepening yield curve and a deeper correction in asset prices.