

Zero Hour: What the Fed's Next Move Could Mean for the Economy

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One of the biggest questions hanging over the U.S. economy right now is when the Federal Reserve will begin raising short-term interest rates. The Fed lowered its benchmark fed funds rate to near zero in 2008 in response to the financial crisis and to stabilize the U.S. economy. For seven years since – long after the crisis and resulting recession ended – the Fed has kept short-term rates unchanged as a means to spur economic growth.

At the start of 2015, it was widely assumed the Fed would begin tightening at either its June or September meetings, thanks to stronger levels of growth and an improved employment picture throughout most of last year. But now that is in doubt, due to surprisingly sluggish growth in the first quarter.

To help understand the Fed's next move, *OUTLOOK* turned to Alex Pollock, resident fellow at the American Enterprise Institute. Pollock, the former head of the Federal Home Loan Bank of Chicago, discussed the Fed's thinking, his views on interest rate manipulation, and the strange science of trying to predict the Fed's actions.

OUTLOOK: The Federal Open Market Committee (FOMC) – which has eight regularly scheduled meetings per year and sets the fed funds rate – is meeting again in June. Do you expect the Fed to raise interest rates then?

AP: Like most people, I don't think they're going to do anything in June. They might or might not. It's terrible that we're all trying to guess what the Fed is going to do instead of trying to make financial decisions on the economic realities, and that interest rates depend on their theories instead of on market-clearing prices.

OUTLOOK: Why is it problematic to be watching the Fed?

AP: It is perverse that economic actors, instead of making investing and borrowing decisions based on economic risks and the financial characteristics of the enterprising economy, instead are trying to guess what a committee of economists thinks.

This Month's Expert

Alex J. Pollock is a resident fellow at the American Enterprise Institute (AEI), where he works on policy issues relating to

mortgage finance, banking, the Federal Reserve, government-sponsored enterprises, retirement finance, corporate governance, and the role of uncertainty and risk in financial systems.

Immediately before joining AEI, Pollock was president and CEO of the Federal Home Loan Bank of Chicago from 1991 to 2004. A prolific writer and speaker, he has also testified before Congress on numerous financial issues. He is the author of "Boom and Bust: Financial Cycles and Human Prosperity" (AEI Press, 2011) and, in 2007, created a one-page mortgage information form to help borrowers understand their mortgage obligations.

Pollock is a director of the CME Group, the Great Lakes Higher Education Corporation, and the Great Books Foundation (where he was chairman of the board from 2006 to 2014). He is a past-president of the International Union for Housing Finance and a member of the Business Advisory Council of the Graham School of Management at Saint Xavier University.

He has master's degrees in international relations from Princeton University and in philosophy from the University of Chicago and a bachelor's degree from Williams College.

William McChesney Martin, who was the Fed chairman from 1951 to 1970, made the same critique half a century ago. "Instead of making market judgments for themselves," he complained, "they are chiefly interested in trying to find out what the Federal Reserve plans to do." As the Fed has grown more adventurous, this problem gets worse.

OUTLOOK: Based on what we know now, do you think a rate hike sometime in 2015 is likely, or that the Fed will be inclined to wait until next year?

AP: It seems to me a Fed interest rate increase in September or December is quite likely. They have delayed this for so long, and have worked so hard to prepare everybody to expect "normalization," that they will feel forced to finally do something. But such an increase, or several of them, will still be far from normal. What would a true market short-term interest rate be now, in the absence of manipulation by the Fed? My guess is 2.5 to 3 percent.

OUTLOOK: Once it begins to raise rates, how long do you think it will take for the Fed to return short-term rates to their long-term norms of about 3.5 percent?

AP: Very long. It will be hard for markets to withdraw from the drug of ultra-cheap leverage. Moreover, if long-term interest rates also rise to normal levels, the Fed itself will experience huge market value losses on its \$4.5 trillion portfolio of long-term bonds and very long-term mortgages.

OUTLOOK: Overall, how fragile do you think our economy is right now? How likely is an increase in rates to cause the recovery to stall out?

AP: Not very fragile. What we have is the underlying strength of an enterprising and entrepreneurial economy, being slowed down by huge government regulatory burdens and experiencing massive financial distortions caused by the Fed.

OUTLOOK: What criteria does the Fed consider in making its decisions?

AP: Their theories and ideology change over time. The Federal Reserve is dominated by the Chairman of the Board of Governors in Washington, now Janet Yellen. She is very focused on employment and unemployment, and on enforcing the 2 percent inflation target that the Fed made up. Moreover, they really seem to be in love with this amazingly extended period of negative real interest rates, which is crushing savers in order to benefit borrowers.

If the nominal interest rate is one eighth of one percent and the inflation rate is 2 percent, then you have a negative real interest rate of $1\frac{7}{8}$ percent. This has now gone on for a very long time. Negative real interest rates from time to time are not unusual, but to have them for so long is highly so.

U.S. ANNUAL INFLATION RATES

CPI-U 12-MONTH CHANGES, 2005–PRESENT



Source: Bureau of Labor Statistics

OUTLOOK: What is the economic rationale for such sustained low rates?

AP: The Fed, and many other central banks, set out to increase asset prices, and succeeded. If you make interest rates very low, you can make asset prices go up. We now have extremely high bond prices – which are often described as being in a bubble – as well as high stock prices and housing prices. House prices had a great bubble that peaked in 2006 and then collapsed. They have now recovered and, in fact, are back over their long-term trend line. When discount rates are very low, present values and thus asset prices rise.

The theory is that increasing asset prices will get you more economic growth. While we have had moderate growth, it hasn't been the kind of rapid growth that often happens after deep recessions.

The other important theory is that low interest rates would create inflation that would decrease real wages without reducing nominal wages and thus make labor cheaper. Cheaper labor means increased employment and higher productivity.

That is one of the most important arguments the Fed made to itself in private as it was adopting its target inflation rate of 2 percent a year. I have never seen the Fed admit in public that it wished to reduce real wages, but that is obviously what its inflation does. At the rate of 2 percent a year, by the way, prices will quintuple in an average life of 82 years or so. With a straight face, the Fed calls that “price stability.”

OUTLOOK: What are the dangers associated with keeping interest rates so low?

AP: Asset bubbles are a big danger, because of what happens when they end. In terms of growth, the financial crisis is long over, but we haven't had a snap back to rapid growth in spite of these negative real rates.

The theory is that low interest rates should spur growth, but some people point to Japan, which has had zero interest rates for a very long time, but has gotten stagnation instead of growth.

There's probably something wrong with any economic theory you can think of except for the law of supply and demand. The macroeconomic theories and models that the Fed runs on are questionable. Macroeconomics is certainly not a science and leads to many unintended and unexpected results.

I think a lot of the buoyancy in equity markets does reflect these astonishingly low interest rates. That is also true with bond prices and house prices.

OUTLOOK: How would a rate increase affect equity markets?

AP: I think a lot of the buoyancy in equity markets does reflect these astonishingly low interest rates. That is also true with bond prices and house prices. Almost everybody has to borrow a lot of money to buy a house, and if the interest rate on that mortgage goes up, house prices will correspondingly decline.

OUTLOOK: Would it be the same for the corporate sector?

AP: Since any initial rate increase the Fed eventually makes will be small, in itself, it is going to be a “so what?” If the high quality corporates were paying another ¼ percent or so on their bonds, I can’t imagine that having a very big effect. The question is: what do market actors expect after that? Suppose the Fed increased short-term rates by ¼ percent six times in a row. They would still be historically low. But asset prices would no longer be so high.

One thing we have to consider is the impact of an interest rate increase on the foreign exchange rate of the dollar. If increasing interest rates cause even more dollar strength, it will hurt corporations’ foreign sales and earnings, and it will make it harder to export. A strong dollar is also tough on farmers, who are a big export sector.

OUTLOOK: To what extent would an increase in rates affect consumer spending?

AP: There are at least two theories about that. One theory says people want to borrow in order to spend, so if you make it cheaper to borrow, then they will spend more. The other theory is the exact opposite – that if people aren’t getting any return on their savings, then they spend less because they’re worried about putting enough aside for old age and for life’s other uncertainties.

The second theory makes some sense to me, and it seems to be consistent with consumer spending since the financial crisis. Again, exceptionally low interest rates, and negative real interest rates, have not led to the kind of growth that has been typical after other recessions. As always, it is very difficult to forecast well, and nobody, including the Fed, is very good at it.

The Fed is not good at economic forecasting. Nobody is good at forecasting; the Fed is just equally as bad as everyone else.

OUTLOOK: *Many observers credit the Fed's actions for preventing a truly catastrophic meltdown of the economy in 2008. Do you agree?*

AP: There are two things that the Fed does quite well. The Fed is very good at lending money it can print in order to get through a crisis. They did this in 2008-09, as they have done in previous crises.

The other thing the Federal Reserve is really good at, like all central banks, is lending money to the government. The Federal Reserve is now lending \$2.5 trillion to the government. It's very handy if you're a government and you want to run large deficits, to have a central bank of your own that will buy your bonds.

The Fed pushed rates down to zero to try to get through the crisis. But the crisis ended six years ago, in the spring of 2009. What are we doing still with these ultra-low interest rates? One of the things we're doing is making it really cheap for the government to finance itself.

What is the Fed not good at? The Fed is not good at managing the economy and it is not good at economic forecasting. They have no special knowledge or insight that other people don't have. Nobody is good at forecasting; the Fed is just equally as bad as everyone else. As the saying goes, "Economic forecasting was invented to make astrology look good."

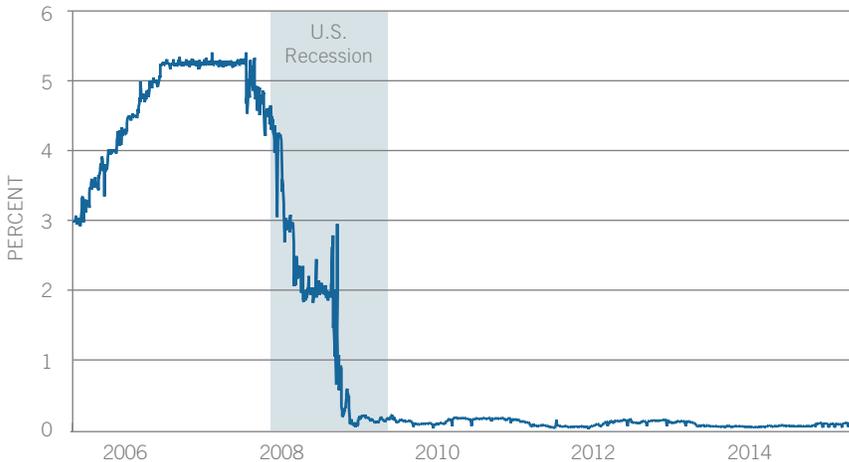
OUTLOOK: *In layman's terms, explain the role of the federal funds rate.*

AP: As the central bank of the United States, the Federal Reserve Bank is a bank for all other banks. If banks have more deposits with the Fed than they want to keep on hand, they can lend them to other banks. Those are called federal funds.

Banks lend their federal funds to other banks – generally on an overnight basis – at the federal funds rate, which is now averaging about $\frac{1}{8}$ percent. The Federal Reserve manages the federal funds rate. You can accurately think of the Fed as the national price-fixing committee for short-term interest rates.

EFFECTIVE FED FUNDS RATE

2006–PRESENT



OUTLOOK: How is the federal funds rate manifested in the marketplace?

AP: The Fed funds rate affects other interest rates. All of these rates react to and are related to the fundamental short-term rate – the rate at which financial institutions can borrow to carry leveraged assets. Of course, there are many different interest rates for different risks, different types of loans and different amounts of time for which money is committed. There’s a big difference between lending for one day or for 30 years.

The fundamental interest rates tend to be very short-term rates among banks. In addition to

federal funds, there is the Eurodollar rate – Eurodollars provide large U.S. banks with an alternative to short-term borrowing in the federal funds market – as well as commercial paper rates. These are all highly correlated. They’re also highly correlated with Treasury bills or short-term government obligations. They form the basis on which other rates are built.

OUTLOOK: What is the interest rate environment like in other developed economies?

AP: Japan is a very interesting case right now. They have been maintaining interest rates at about zero for a very long time without success. But they have succeeded in pumping up debt to very high levels and have high bond prices. Then we have Europe, where now there are \$2 trillion or more of European debt securities that have negative nominal yields.

This is really fascinating. I first wrote on negative nominal interest rates some years ago, saying negative interest rates are perfectly possible, in spite of the fact that many central bankers and economists said they were impossible. The reality of negative nominal interest rates has now been demonstrated by experience.

That is truly uncharted territory. Nobody knows how it’s going to turn out, including the European Central bank, and including the Fed.

OUTLOOK: Globally, what are the implications of the Fed beginning to tighten at the same time the European Central Bank and the Bank of Japan are launching aggressive quantitative easing programs?

AP: The Fed will especially worry about pushing up the foreign exchange value of the dollar. Previous experience with creating an excessively strong dollar has been painful. ■

Commentary in Outlook is for general information only and does not necessarily reflect the opinion of CoBank. The information was obtained from sources that CoBank believes to be reliable but is not intended to provide specific advice.

Interest Rates and Economic Indicators

The interest rate and economic data on this page were updated as of 4/30/15. They are intended to provide rate or cost indications only and are for notional amounts in excess of \$5 million except for forward fixed rates.

KEY ECONOMIC INDICATORS

Gross Domestic Product (GDP) measures the change in total output of the U.S. economy. The Consumer Price Index (CPI) is a measure of consumer inflation. The federal funds rate is the rate charged by banks to one another on overnight funds. The target federal funds rate is set by the Federal Reserve as one of the tools of monetary policy. The interest rate on the 10-year U.S. Treasury Note is considered a reflection of the market's view of longer-term macroeconomic performance; the 2-year projection provides a view of more near-term economic performance.

ECONOMIC AND INTEREST RATE PROJECTIONS

Source: Insight Economics, LLC and Blue Chip Economic Indicators

US Treasury Securities

	2015	GDP	CPI	Funds	2-year	10-year
Q2	3.30%	1.80%	0.14%	0.78%	2.06%	
Q3	3.00%	2.00%	0.22%	1.06%	2.30%	
Q4	2.90%	2.20%	0.36%	1.29%	2.45%	
2016	GDP	CPI	Funds	2-year	10-year	
Q1	2.80%	2.10%	0.53%	1.58%	2.66%	
Q2	2.80%	2.20%	0.71%	1.82%	2.84%	

PROJECTIONS OF FUTURE INTEREST RATES

The table below reflects current market expectations about interest rates at given points in the future. Implied forward rates are the most commonly used measure of the outlook for interest rates. The forward rates listed are derived from the current interest rate curve using a mathematical formula to project future interest rate levels.

IMPLIED FORWARD SWAP RATES

Years Forward	3-month LIBOR	1-year Swap	3-year Swap	5-year Swap	7-year Swap	10-year Swap
Today	0.29%	0.49%	1.19%	1.66%	1.96%	2.23%
0.25	0.39%	0.66%	1.35%	1.78%	2.05%	2.27%
0.50	0.56%	0.84%	1.50%	1.89%	2.14%	2.34%
0.75	0.74%	1.05%	1.65%	2.01%	2.23%	2.43%
1.00	0.94%	1.23%	1.78%	2.11%	2.31%	2.45%
1.50	1.35%	1.60%	2.02%	2.29%	2.45%	2.60%
2.00	1.71%	1.85%	2.22%	2.41%	2.56%	2.66%
2.50	1.92%	2.04%	2.35%	2.51%	2.64%	2.73%
3.00	2.13%	2.23%	2.49%	2.62%	2.72%	2.80%
4.00	2.39%	2.53%	2.69%	2.78%	2.79%	2.89%
5.00	2.62%	2.72%	2.79%	2.87%	2.92%	2.95%

HEDGING THE COST OF FUTURE LOANS

A forward fixed rate is a fixed loan rate on a specified balance that can be drawn on or before a predetermined future date. The table below lists the additional cost incurred today to fix a loan at a future date.

FORWARD FIXED RATES

Cost of Forward Funds

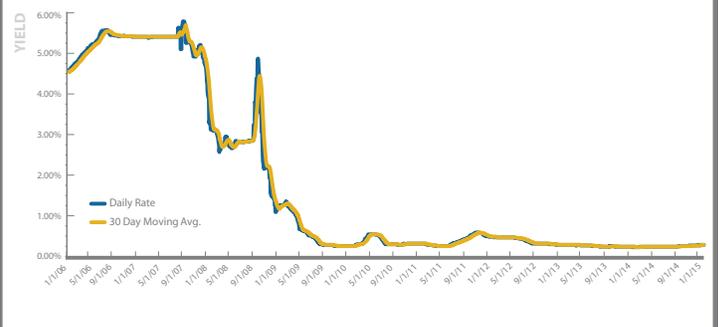
Forward Period (Days)	Average Life of Loan			
	2-yr	3-yr	5-yr	10-yr
30	8	8	6	5
90	17	18	15	11
180	30	32	27	21
365	67	67	55	40

Costs are stated in basis points per year.

SHORT-TERM INTEREST RATES

This graph depicts the recent history of the cost to fund floating rate loans. Three-month LIBOR is the most commonly used index for short-term financing.

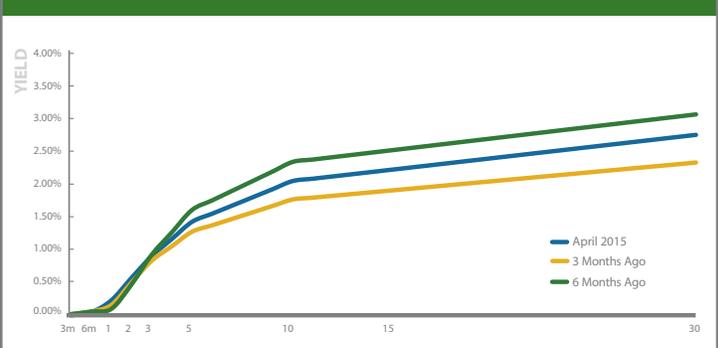
3-MONTH LIBOR



RELATION OF INTEREST RATE TO MATURITY

The yield curve is the relation between the cost of borrowing and the time to maturity of debt for a given borrower in a given currency. Typically, interest rates on long-term securities are higher than rates on short-term securities. Long-term securities generally require a risk premium for inflation uncertainty, for liquidity, and for potential default risk.

TREASURY YIELD CURVE





About CoBank

CoBank is a \$106 billion cooperative bank serving vital industries across rural America. The bank provides loans, leases, export financing and other financial services to agribusinesses and rural power, water and communications providers in all 50 states. The bank also provides wholesale loans and other financial services to affiliated Farm Credit associations serving farmers, ranchers and other rural borrowers in 23 states around the country.

CoBank is a member of the Farm Credit System, a nationwide network of banks and retail lending associations chartered to support the borrowing needs of U.S. agriculture and the nation's rural economy.

Headquartered outside Denver, Colorado, CoBank serves customers from regional banking centers across the U.S. and also maintains an international representative office in Singapore.

For more information about CoBank, visit the bank's web site at www.cobank.com.

CoBank Reports First Quarter Financial Results

CoBank, a cooperative bank serving agribusinesses, rural infrastructure providers and Farm Credit associations throughout the United States, recently announced financial results for the first quarter of 2015.

Net income for the quarter was \$232.2 million, up from \$231.3 million in the first quarter of 2014. A \$10.0 million provision for loan losses recorded in the first quarter of 2015 largely offset the positive impacts of higher net interest income as well as increased prepayment income. The provision primarily reflected an increase in average loan volume. Net interest income for the quarter increased 2 percent to \$315.3 million, from \$309.0 million in the same period last year. Higher average loan volume was a key driver of the increase.

Average loan volume rose 5 percent in the first quarter to \$80.6 billion, from \$76.4 billion in the same period last year. The increase resulted from higher levels of borrowing from customers in a number of industries, including rural electric cooperatives, rural communications service providers, affiliated Farm Credit associations and food and agribusiness companies.



Robert B. Engel

“We’re pleased with CoBank’s results for the quarter, which reflect solid growth in our portfolio across all of our operating segments,” said Robert B. Engel, CoBank’s chief executive officer. “Though market dynamics vary widely across the rural industries we serve, the strength of the CoBank value proposition is helping to drive broad-based growth throughout the business. We remain focused first and foremost on delivering value to our borrowers and providing them with an outstanding customer experience.”

At quarter-end, 1.76 percent of CoBank’s loans were classified as adverse assets compared to 1.84 percent at December 31, 2014. Nonaccrual loans decreased to \$126.1 million at March 31, 2015 from \$130.3 million at December 31, 2014. The bank’s allowance for credit losses totaled \$607.1 million at quarter-end, or 1.51 percent of non-guaranteed loans when loans to Farm Credit associations are excluded.



David P. Burlage

“We continue to benefit from strong credit quality,” said David P. Burlage, chief financial officer. “The provision for loan losses taken during the quarter was driven primarily by growth in loan volume. In addition, our allowance for credit losses provides protection for the bank and its shareholders against losses embedded in our loan portfolio.”

Capital levels for CoBank remain well in excess of regulatory minimums. As of March 31, 2015, shareholders’ equity totaled \$7.5 billion, and the bank’s permanent capital ratio was 15.6 percent, compared with the 7.0 percent minimum established by the Farm Credit Administration (FCA), the bank’s independent regulator. At quarter-end, the bank held approximately \$24.1 billion in cash and investments and had 168 days of liquidity, which was in excess of FCA liquidity requirements.

Despite the strong first quarter, Engel noted that the bank is dealing with a number of market dynamics that have impacted and could continue to impact earnings and overall financial performance this year. “A strengthened dollar, continuing low interest rates and intense competition in the banking industry create a challenging earnings environment for CoBank,” Engel said. “In addition, the bank continues to make investments in people, technologies, public-private partnerships and other strategic initiatives that will position CoBank to generate returns over the long term. That said, the bank remains strong and well-positioned to continue serving as a dependable financial partner for its customers and fulfilling its mission in rural America.” ■