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Cautious Optimism for the U.S. Economy

Pessimists about the U.S. economy had their views reinforced a few weeks ago when the government released preliminary growth numbers for the first quarter of 2016. On an annualized basis, the economy grew at a paltry rate of 0.8 percent, compared to 2.4 percent for all of 2015. A substantial majority of the little growth there was came from personal consumption, while business investment, inventories, and exports were all weak or negative for the period. The economy’s listless performance caused many to speculate that the U.S. Federal Reserve, which had indicated a willingness to raise short-term interest rates at its June meeting, may need to once again hold off.

Those with a more optimistic outlook include James D. Hamilton, a professor of economics at University of California San Diego. Hamilton believes that the bad first quarter number isn’t a harbinger of a bad growth year ahead. He believes the economy will continue to chug along consistent with the 2 to 2.5 percent growth rate of the past several years. And he professes not to be worried about a recession in the near term.

OUTLOOK: First quarter GDP for the U.S. was disappointing – a 0.8 percent annualized growth rate vs. 2.4 percent for all of 2015. How worried should people be?

James Hamilton: I would caution against reading too much into the first quarter numbers. For each of the last three years, we saw a seemingly disappointing first quarter, and then the second quarter was much stronger. An apples-to-apples comparison is to compare the first quarter this year with the first quarter last year. Real GDP in this year’s first quarter was almost 2% higher than the level we saw in 2015’s first quarter. I’m not alarmed by the first quarter number. Having said that, we’re going to have to get used to slower growth rates of real GDP than we experienced 20 years ago as a result of slower growth of the labor force.

This Month's Expert

James D. Hamilton has been a professor in the Economics Department at the University of California at San Diego since 1992, and has also taught at Harvard University and the University of Virginia. He received his Ph.D. in economics from the University of California at Berkeley in 1983.

Dr. Hamilton's research in areas including econometrics, business cycles, monetary policy, and energy markets has been cited by more than 40,000 other studies. He also contributes to Econbrowser, a popular economics blog. His academic honors include election as a fellow of the Econometric Society and research associate with the National Bureau of Economic Research, recipient of the Best Paper Award for 2010–2011 from the International Institute of Forecasters, and a 2014 award for Outstanding Contributions to the Profession from the International Association for Energy Economics. Dr. Hamilton has been a visiting scholar at the Federal Reserve Board in Washington, D.C., as well as the Federal Reserve Banks of Atlanta, Boston, New York, Richmond, and San Francisco.

OUTLOOK: What were the immediate causes of the slowing economy?

JH: The two most disappointing spots were business investment and exports. Consumption growth was down from the previous quarter as well. But in this economic environment, it's also important to look at the year-over-year change. Real consumption spending in 2016's first quarter was 2.7% higher than in the first quarter of 2015. That's not that much slower growth than we've been seeing recently. If you look at the year over year change, it's just not that evident that there's been a slowdown.

OUTLOOK: Which segments of the economy look strongest right now?

JH: The number of new homes under construction in March of this year increased by nearly 17.5% over the prior year, so new home construction is making a positive contribution. I think it will continue to do so for the rest of this year and next year. A rebound in home construction is typically one of the main things we see coming out of a recession that helps bring a little bit stronger growth than normal. That didn't happen in the first several years of recovering from the Great Recession, because we had such long-lasting problems with the housing sector.

The housing industry is a very cyclically volatile component of GDP. It often goes up very high in a boom, and goes down very low in a recession. It went extremely high prior to the Great Recession and then extremely low during the recession. With such an extreme hit to housing, it has taken many years for us to dig out from under it.

We're just now starting to see new home construction get back to what I think is a more normal level. Since it was so depressed, just starting to move toward normal means growth. That was one of the strong points in the first quarter numbers. I think it will continue to be a favorable component of the GDP numbers throughout this year.

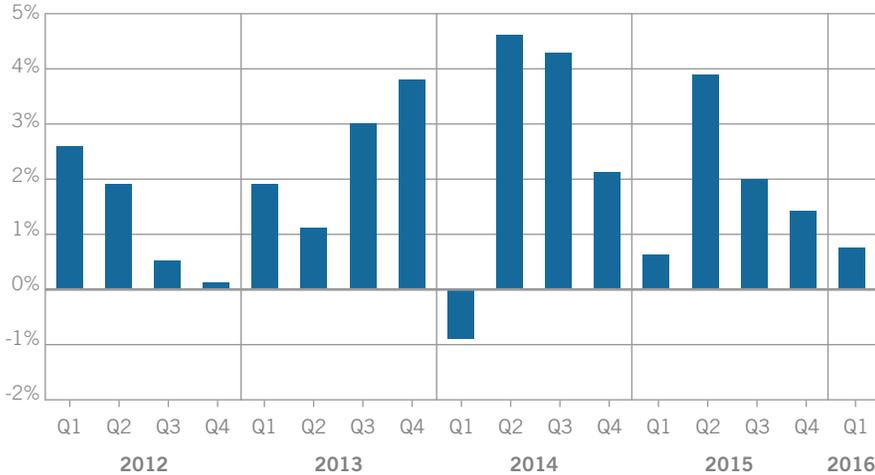
The fiscal drag from state and local government spending had also been holding GDP growth back, but that now seems to be behind us. That and consumer spending were the only real positive contributors to growth in the first quarter.

OUTLOOK: How does the labor market look right now?

JH: On a broader level, the labor market is certainly strong, as well. Unemployment is down to 5 percent now and we're starting to see wages improve a little bit. The Department of Labor's April report on non-farm payroll numbers was a bit weak, coming in at 160,000 jobs created, versus an average of 232,000 for the prior 12 months. But I think the longer trend there is more favorable and fairly solid.

U.S. GDP GROWTH, BY QUARTER

2012–Present (Annualized)



Source: U.S. Bureau of Economic Analysis

OUTLOOK: Which segments of the economy are underperforming right now?

JH: Exports continued their trend downward. Exports to each of our top 10 trading partners declined in 2015 from the prior year, with the sole exception of the United Kingdom, with which we had positive growth. I expect that trend to continue largely because of the strong dollar and the weakness in the economies of some of our trading partners. In China, for instance, imports fell by more than 10 percent in April from a year earlier, and that was their 18th consecutive monthly decline.

The dollar has come back down from where it was in the first quarter, and that may be a little help. But I'm a little more optimistic about the situation outside the United States than I was at the start of the year.

OUTLOOK: What are some of the factors that are increasing your optimism about foreign economies?

JH: It has mostly to do with potential problems that some economists were anticipating but haven't happened. For example, there was some fear that Europe might revert to a sovereign debt crisis with the negotiation of the Greek loans. The Greek economy is still weak by any measure and, indeed, contracted by 0.4 percent in the first quarter. But that result was better than the 0.7 percent contraction that many economists had projected.

There also continues to be a lot of political instability in China at the moment, and they're going to have to navigate a slower growth path than they have had historically. There's always a big question whether or not they can pull that off. And Japan has been stuck in a bad situation for a very long time and is, in fact, fighting deflation.

Still, what I don't see is any situation that appears to be falling off a cliff, which some people were anticipating four months ago. It's better news than it could have been, and the market has responded fairly well.

Oil investment constitutes only about a half-percent of the GDP, but in this environment that's the difference between a good quarter and an OK quarter. Unfortunately, oil investment is going to be a drag on the U.S. economy throughout the year.

OUTLOOK: What else could help narrow the trade deficit?

JH: The weaker dollar is definitely going to help the trade gap. We saw a huge surge in the dollar in 2015 through the start of this year. That was definitely a factor discouraging exports, but we've seen some relief from that.

It's still a question where things are going to settle down in Europe, China and Japan. They all buy a lot from the U.S. and if any of them go into a recession – or significantly worsen, in Japan's case – that could bring our exports down further. At the moment, I'm hopeful we won't get there.

OUTLOOK: Consumer spending continued to slow in the first quarter. What were the reasons for that?

JH: Again, you really need to consider year-over-year rather than just quarterly growth. First-quarter consumer spending increased at a 1.9 percent rate, which was down from an increase of 2.4 percent in the fourth quarter of 2015. But like the GDP, consumer spending has been weak in each of the last three first quarters, and then consumer spending somehow rebounded quite nicely in the second quarter the last two years.

Remember also that consumption spending is by far the largest component of GDP and one of the least volatile. So it's not that surprising that, despite some disappointing numbers for investment and exports, consumption spending has continued to grow and bring GDP up with it.

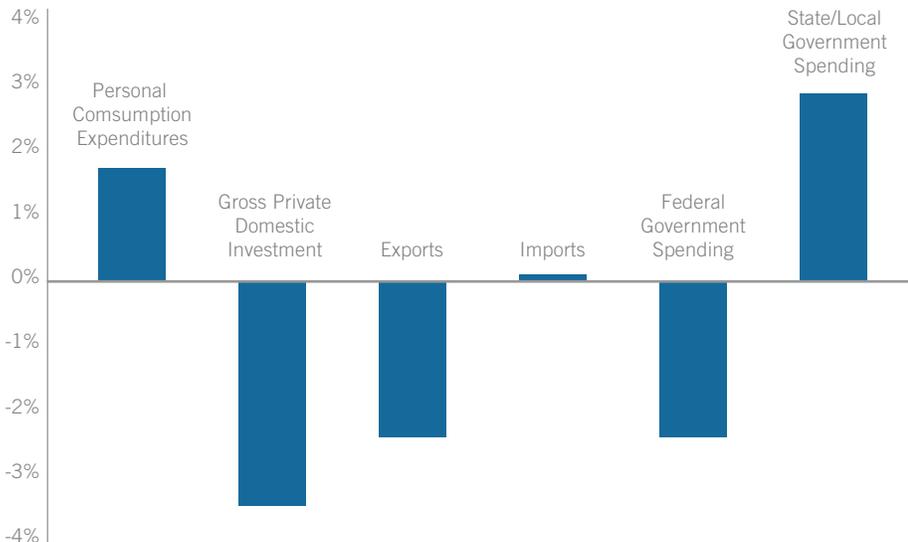
OUTLOOK: Business investment posted its worst performance since the tail end of the last recession. Is there any reason to think that will rebound any time soon?

JH: Business investment is always one of the last sectors to pick up in any expansion. Businesses wait until they see solid demand before they start investing again. This has certainly been a factor in our delayed recovery.

A big factor here at the moment is investment in the oil industry, which is about 70 percent lower than it was a year ago. Oil investment constitutes only about a half-percent of the GDP, but in this environment that's the difference between a good quarter and an OK quarter. Unfortunately, oil investment is going to be a drag on the U.S. economy throughout the year.

PERCENTAGE CHANGE IN GDP COMPONENTS

First Quarter 2016



Source: Bureau of Economic Analysis

We have had some rebound in oil prices lately, but I don't think it's enough. It may help some of companies that left half-drilled wells – drilled but not fracked to produce the resources, also called *fracklog* – leaving the more expensive part until the price picked up. As long as they get a price that covers their operating cost, they may go back in for those. We may see a little rebound from that. But even at \$50 a barrel, I don't think it is enough to cover the long-term cost of most of these projects, and I think we're going to continue to see very low investment in the energy sector.

OUTLOOK: Why hasn't cheap oil been more of a boon to the consumer economy?

JH: That's a great question. What we often see is that when consumers have to spend less on gasoline, they end up spending more on other items. However, that isn't showing up in the data we have so far.

Consumers are definitely saving money. It also looks like they're paying down some debts, which may have been accumulated when unemployment was high. That may make sense for them to do with their budget, but it means we're not seeing the added boom in consumption spending. They're spending a lot less on gasoline and heating than they were a year or two ago, but they're not spending more on other items.

OUTLOOK: You have studied the correlation between oil price spikes and recessions in the U.S. economy. What is the current environment telling you?

JH: We've seen historically that a sudden increase in oil prices often produces some economic problems. In fact, a number of U.S. recessions were preceded by a big move up in the price of oil.

We have substantially less experience with big downward moves in the price of oil. But the experience we do have suggests that it doesn't produce a boom by itself. A leading example of that would be in the mid-1980s, when the collapse in the price of oil was very much on par with what we've seen in the last year and a half. There was no boom at all in the U.S. economy then. In fact, it was even a little slower growth than usual.

Everybody is watching the Fed, but the reality is that the Fed is reacting to what's going on rather than causing major changes all by themselves. The bottom line is the U.S. economy can grow with or without the Fed.

OUTLOOK: How do you explain three straight years of slow first quarter growth? Is it a coincidence, or is there something structural going on?

JH: It's not a coincidence, but it doesn't mean something is structurally wrong with the economy either. What it primarily suggests is that there's a problem with the way the Bureau of Economic Analysis (BEA) – the part of the Commerce Department that tracks GDP growth – is adjusting for seasonal factors.

Given the way they calculate the numbers, I don't find three years of lower first-quarter growth that alarming. I think it's just another reason not to overreact to one quarter's numbers. The year-over-year change provides a more reliable gauge in this kind of setting. Those numbers indicate growth of about 2 percent growth, which I think is about what we should be expecting.

OUTLOOK: What is the Fed thinking right now? Are interest rates going to remain steady, or is there any second guessing about what they did raising the rate in December?

JH: I think they jumped the gun in December, and they now realize that. In December, the Fed seemed to be thinking they were going to have maybe four rate hikes this year, for 100 basis points – a full percentage point. That's certainly off the table, although they recently signaled that a June hike is still possible. Part of their thinking will involve international developments in the Eurozone, China, Japan and with other key trading partners.

Certainly the strong dollar has been a drag on the U.S. economy. If the Fed were to continue with their original plans for hiking rates, we would definitely see a much stronger dollar, and that would amount to even bigger problem for U.S. exporters. I think the Fed is mindful of that. They aren't going to drop rates, but I think they'll be much more cautious in raising rates than they were expecting to be back in December.

OUTLOOK: What are your expectations for the economy over the rest of the year?

JH: I'm optimistic, but I think we also have to factor in that the U.S. isn't the same country it was 40 years ago. We have an aging population, much slower growth of the working age population, and within that it looks like a

If you look at the duration of recessions, they can be as short as a year from one to the next, or as long as 10 years. We call these business cycles, but they're not cycles in the sense that every X years you can count on another one.

permanent decline in the labor force participation rate. Given all that, I don't think we should be thinking of 3 percent GDP growth as the norm – maybe a number closer to 2 percent. That's something we can live with.

Meanwhile, everybody is watching the Fed, but the reality is that the Fed is reacting to what's going on rather than causing major changes all by themselves. The bottom line is the U.S. economy can grow with or without the Fed and with or without Europe. I think we sometimes dwell too much on what the latest news is here or there. I guess maybe that's one of the reasons I'm more optimistic than some other people at the moment.

I think the most logical forecast is that this year will look a lot like the last three did. We had improvement in the unemployment rate. We had improvement in the number of people working, and I think that barring a new shock, that's the logical thing to expect for 2016.

OUTLOOK: Is there any way to know how close we are to the next recession in the U.S.?

JH: Recessions, of course, are not something like clockwork. If you look at the duration of recessions, they can be as short as a year from one to the next or as long as 10 years. We call these business cycles, but they're not cycles in the sense that every X years you can count on another one.

It is true that at some point we're going to have another recession. It's another matter to say just when that's going to be. There are plenty of people out there who've been saying for each of the last five years that the U.S. is about to have a recession. So far, they've been wrong, but eventually they'll be right.

One of the things that is associated with the onset of recessions is something unanticipated – some big shock. As I mentioned, oil price shocks have contributed to past recessions. But by their nature, you can't really anticipate or predict these kinds of events. A major banking crisis in China or something similar that could happen wouldn't shock any of us but, on the other hand, we're not predicting it. Unless the unexpected comes, I think we're going to see growth in the U.S. for this year. ■

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 4/30/16. 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.

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	9	8	7
90	12	15	14	12
180	14	21	21	19
365	31	41	40	34

Costs are stated in basis points per year.

ECONOMIC AND INTEREST RATE PROJECTIONS

Source: Insight Economics, LLC and Blue Chip Economic Indicators

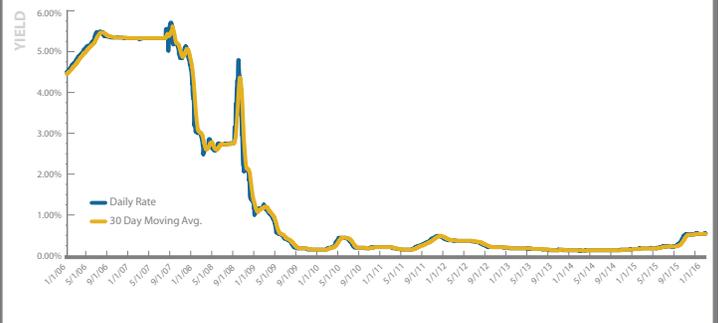
US Treasury Securities

2016	GDP	CPI	Funds	2-year	10-year
Q2	2.30%	2.10%	0.39%	0.87%	1.87%
Q3	2.40%	2.20%	0.47%	1.00%	2.00%
Q4	2.40%	2.30%	0.56%	1.19%	2.15%
2017	GDP	CPI	Funds	2-year	10-year
Q1	2.30%	2.20%	0.63%	1.36%	2.30%
Q2	2.30%	2.30%	0.68%	1.55%	2.46%

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



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.

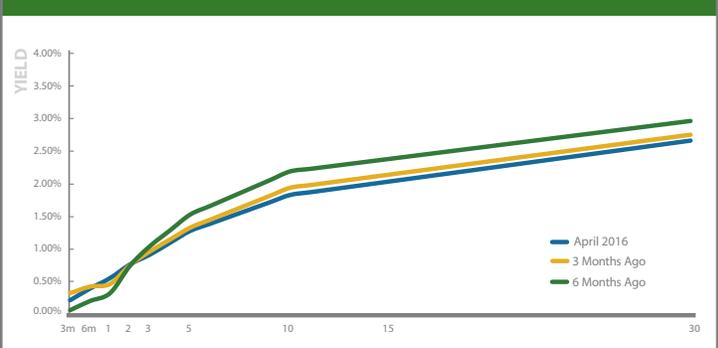
IMPLIED FORWARD SWAP RATES

Years Forward	3-month LIBOR	1-year Swap	3-year Swap	5-year Swap	7-year Swap	10-year Swap
Today	0.65%	0.79%	1.06%	1.28%	1.49%	1.73%
0.25	0.76%	0.86%	1.13%	1.35%	1.55%	1.76%
0.50	0.84%	0.95%	1.19%	1.40%	1.60%	1.79%
0.75	0.90%	1.02%	1.25%	1.46%	1.65%	1.87%
1.00	0.99%	1.08%	1.30%	1.52%	1.70%	1.88%
1.50	1.13%	1.21%	1.42%	1.62%	1.79%	1.99%
2.00	1.24%	1.33%	1.49%	1.69%	1.88%	2.03%
2.50	1.35%	1.42%	1.61%	1.80%	1.96%	2.11%
3.00	1.46%	1.51%	1.74%	1.91%	2.04%	2.19%
4.00	1.67%	1.74%	1.94%	2.08%	2.15%	2.30%
5.00	1.89%	1.96%	2.07%	2.22%	2.32%	2.40%

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 \$118 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, rural infrastructure and rural communities. 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 has announced its financial results for the first quarter of 2016. Net income for the quarter was \$243.3 million, a 5 percent increase from \$232.2 million in the first quarter of 2015. The increase in earnings primarily resulted from higher net interest income, partially offset by increased operating expenses.

Net interest income for the quarter rose 7 percent to \$336.9 million, from \$315.3 million in the same period last year, primarily due to higher average loan volume.

Average loan volume rose 11 percent in the first quarter to \$89.8 billion, from \$80.6 billion in the same period last year. The increase was driven by higher levels of borrowing from affiliated Farm Credit associations as well as customers in a number of industries, including rural electric cooperatives, rural communications service providers, and food and agribusiness companies.



Robert B. Engel

"We're pleased with CoBank's results for the quarter and the strong start we've experienced this year," said Robert B. Engel, CoBank's chief executive officer. "Though operating conditions are challenging in a number of the industries we serve, the strength of the CoBank value proposition is helping to drive broad-based growth across all segments in our portfolio."

The bank's financial results for the first quarter of 2016 included an \$8.0 million provision for loan losses as compared to a \$10.0 million provision recorded in the prior-year period. The provision primarily reflected the increase in average loan volume and a slight deterioration in credit quality in CoBank's agribusiness portfolio. At quarter-end, 0.71 percent of CoBank's loans were classified as adverse assets, compared to 0.70 percent at December 31, 2015. Nonaccrual loans increased to \$212.8 million at March 31, 2016, from \$156.8 million at December 31, 2015, primarily due to credit issues involving a small number of customers in our agribusiness operating segment. The bank's allowance for credit losses totaled \$609.7 million at quarter-end, or 1.31 percent of non-guaranteed loans when loans to Farm Credit associations are excluded.



David P. Burlage

“Overall credit quality in our loan portfolio remains very strong,” said David P. Burlage, CoBank’s chief financial officer. “To date, we have not seen significant impacts to loan quality measures as a result of lower commodity prices and other challenges facing rural industries. While it’s possible we could see further credit quality deterioration in the future, we remain confident in the risk-bearing capacity of the bank and its ability to serve our customers’ borrowing needs.”

Capital levels for CoBank remained well in excess of regulatory minimums. As of March 31, 2016, shareholders’ equity totaled \$8.1 billion, and the bank’s permanent capital ratio was 14.8 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 \$26.4 billion in cash and investments and had 180 days of liquidity, which was in excess of FCA liquidity requirements.

Engel noted that, despite solid first quarter results, CoBank continues to face a number of persistent challenges, including ongoing low interest rates, a flat yield curve and intense competition from other lenders. In addition, the bank is making substantial investments in people, processes and systems designed to enhance the value it delivers to the marketplace.

“Our cooperative structure remains an important advantage in this environment,” Engel said. “Under the guidance of our board, we have built the flexibility we need to stay focused on the long-term needs of our borrowers, many of whom are dealing with significant headwinds of their own. CoBank remains financially strong, and well positioned to continue fulfilling its broad mission of service to rural America.” ■