OUTLOOK Economic Data and Commentary

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The U.S. Housing Market: Finding Normal

Has the U.S. housing market finally recovered from the subprime crisis? Nationwide, new home prices have recovered to levels that hadn't been seen since before the recession, but all is not rosy. Home prices are up, but new construction is down. Existing home sales are strong, but inventory is low. Despite the recent runup, prices of existing homes are still slightly below their 2005 peak. Overall, the U.S. housing market is still struggling to find normal, something we haven't seen since the early 2000s.

To help us understand the current housing market and the lingering effects of the subprime catastrophe in 2005-07, *OUTLOOK* recently sat down with Michael Fratantoni, chief economist with the Mortgage Bankers Association, which represents the real estate finance industry in the U.S. Fratantoni explained some of the anomalies in the current market and the factors that he sees affecting the housing market in the near future.

OUTLOOK: Housing prices across the U.S. have been increasing for three years now - and rapidly enough in some markets that some commentators are worried about a bubble. How would you describe the recent run-up?

Michael Fratantoni: I don't really see it as a bubble. Depending upon the measure you look at, home prices dropped between 25 and 30 percent nationally when the bubble burst and the recession started. It was much more than that in certain markets, such as Arizona, Nevada or the Inland Empire in California.

Some of those markets – especially those that are good retirement locales – have had some very strong rebounds as demand has returned. But supply has been slow to come back. Homebuilders are trying to increase production but they don't have the land inventory that they had pre-crisis, and they're also facing some staffing challenges, particularly in the skilled trades.

Also, some existing owners are still underwater on their mortgages. They're not ready to list their properties yet, and the net impact is that inventories are fairly tight. You're seeing bidding wars in many of these markets.

This Month's Expert

Michael Fratantoni is chief economist and senior vice president of research and industry technology with the Mortgage Bankers Association (MBA). He is responsible for overseeing MBA's industry surveys, benchmarking studies, economic and mortgage originations forecasts, industry technology efforts, and policy development research for both single-family and commercial/multifamily markets. Mr. Fratantoni is also president of the Mortgage Industry Standards Maintenance Organization.

Mr. Fratantoni has nearly 20 years of industry experience, including risk management and senior economist positions with Washington Mutual and Fannie Mae. In these roles, he was responsible for assessing macroeconomic, regional, housing, and mortgage market trends, and providing technical expertise regarding credit pricing and mortgage policy issues.

Mr. Fratantoni received a doctorate in economics from Johns Hopkins University and a bachelor's degree in economics from the College of William and Mary. He has served as an adjunct professor at the University of Washington, and Johns Hopkins, George Washington, and Georgetown universities and has published papers on housing and mortgage topics in leading economics and real estate finance journals.

Prices are going up and the percentage gains look large, but I think nationally we're still 5 to 10 percent below the peak of '06 and '07. If you look at price-to-income ratios, they're really not out of bounds the way they were during the boom period.

OUTLOOK: How do you expect housing prices to perform over the next couple of years?

MF: I expect that prices will continue to increase – about 5 percent this year and a little less than that next year. We will likely see more inventory because more people will be able to poke their heads above water and be willing to list in an environment that will still have fairly good demand.

OUTLOOK: Beyond home prices, what do other indicators tell us about the state of the housing market?

MF: It certainly has improved relative to the years immediately following the crisis, but we're not back to where we were pre-crisis. With respect to the level of home sales, we're not even back to what you would consider a more normal time period – the late 1990s or early 2000s.

The extent of housing turnover – home sales as a portion of all available homes – isn't as robust as it used to be. People are just not as mobile as they were pre-crisis, and there are several potential explanations for that.

One is home equity. If people don't have enough equity in their current home to move up, they're going to wait for prices to rise further before they're able to have a down payment to buy that next home.

We're also not seeing much strength in the entry-level market. The share of first-time homebuyers as a proportion of all sales is still very low – about 30 percent of the market, where more typically it would be closer to 40 percent.

Even though the job market has improved, we still have large numbers of young households and young adults who are nervous about their financial security and waiting longer to jump into the market. Some of them are burdened with student debt. Even if they could qualify, maybe they're not interested in taking on more debt.

Credit is still tight. We've seen some greater availability of lower down payment loans, but credit is not just about down payment. It's also about what types of credit people with different histories are able to qualify for, how much documentation is required and the intensity of the qualification process.

All of those are really much more restrictive, certainly compared to the '05 to '07 period, but even compared to a more typical period early last decade or in the '90s.

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OUTLOOK: Talk a little about trends in homeownership. Does it still seem to be something that most Americans aspire to?

MF: We're seeing a slow increase in home sales now, but the homeownership rate has declined in recent years. It peaked at about 69 percent in 2005, and now it's below 64 percent. In rough numbers, each one of those percentage points is a million households. That's 5 million households that were owners and are now renters.

But I don't think it's going to stay at this very low level, for a number of reasons. According to industry survey data, 75 to 80 percent of Americans across most age groups say that homeownership is an aspiration and something they are willing to work and save for. The tighter credit environment, the student debt issue and some of the other lingering uncertainties make it likely that they're going to own a home later in life than they would have before. Maybe they would have bought at age 26 or 27. Now they're going to buy at 29 or 30, but they're still interested in buying.

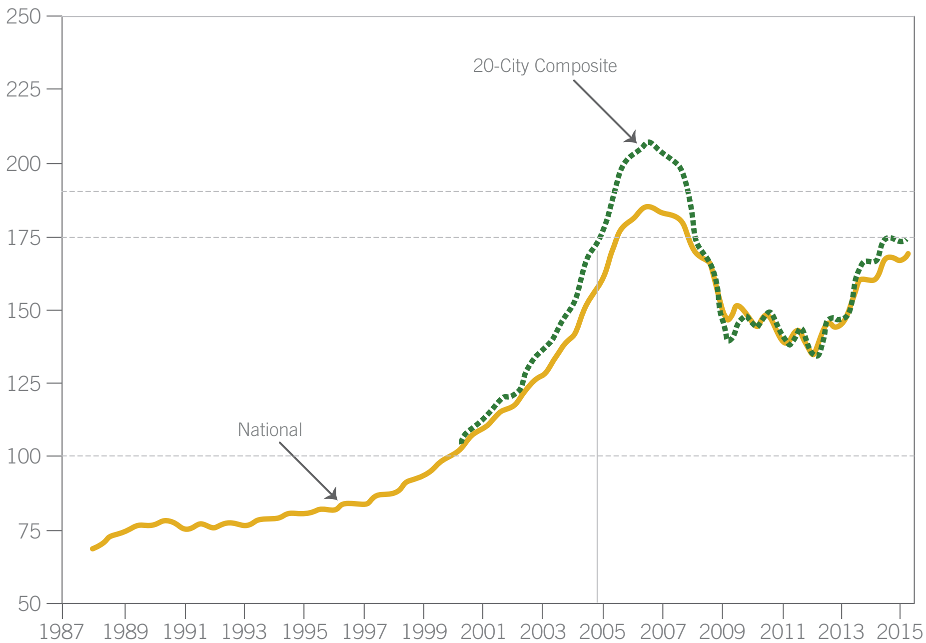
The one exception is people in the 30 to 35 age group, where that aspiration to own is a little bit lower. Instead of 70 to 80 percent, it's 60 to 65 percent. These are the people that were hurt the worst during the subprime crisis as first-time homebuyers. They are less anxious to get back into homeownership again, but they'll likely be back at some point.

OUTLOOK: Has there been much difference in the recovery between the way the urban housing markets and rural housing markets have performed?

MF: There has been a lot of attention focused on the desire of millennials to live in urban settings, and a concern that this represents a longer-lasting trend away from suburbs, rural areas, and homeownership in general. My read of the data is that young households are not living in urban areas to a greater extent than prior generations. However, the millennial generation is so large, that the folks who do decide to live in urban apartments while they are in their 20s are having a big impact on rental markets, driving down vacancies and pushing up rents.

I expect that this cohort will follow the typical pattern: When they get married and have kids, they will want to move to homes with more space and more land, and will be looking to buy rather than rent.

S&P/CASE-SHILLER HOME PRICE INDICES



Source: S&P Dow Jones Indices & CoreLogic

OUTLOOK: What do strong home sales have to say about consumer confidence? Does stronger consumer confidence correlate to stronger home sales?

MF: Consumers now have an expectation of greater financial security in terms of keeping their jobs. They're also seeing wage growth, and there is a higher certainty that they will find a new job fairly easily if they lose their current one. All of these are positive backdrops for the housing market.

OUTLOOK: What are the hot markets or regions right now? And conversely, which markets are still struggling to regain their footing?

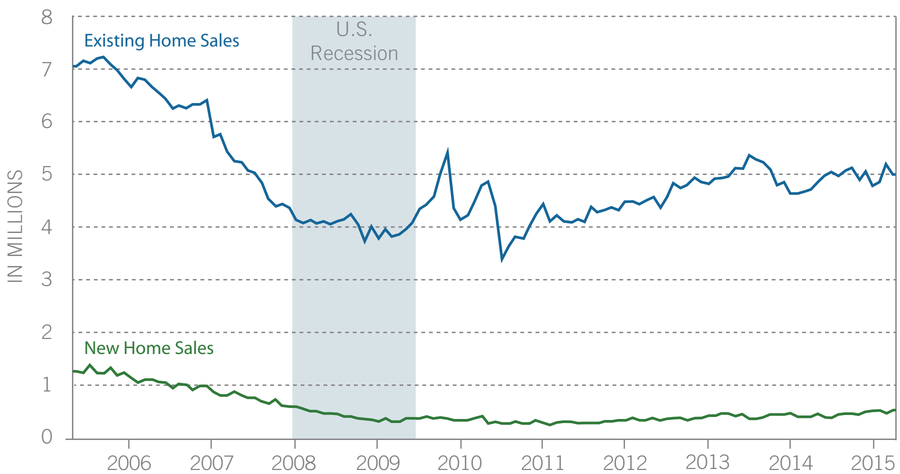
MF: We're back to a more normal world where those markets that have stronger job market growth are going to have stronger housing markets. According to the most recent data, over the last 12 months the top four states in terms of price increases were South Carolina, Washington, Colorado, and Florida. The Bay Area is also booming again.

Conversely, the Washington, D.C., market is having trouble right now. The greater D.C. metro area has traditionally been somewhat buffered from downturns by the extent to which government spending supports the local job market. But over the past couple of years, between sequestration and other efforts to reduce government spending and bring down the deficit, contractors have pulled back, and as a result, there's been very little job growth.

The other places seeing some weakness are energy-intensive areas: Houston and now North Dakota, being so heavily focused on gas and oil, and the fracking revolution. Those were really the strongest markets until the drop in oil prices over the past 12 months.

EXISTING & NEW HOME SALES

Homes sold over the past 10 years



Source: The Wall Street Journal — U.S. Housing Market Tracker, U.S. Commerce Department, Federal Reserve Bank of St. Louis, National Association of Relators

OUTLOOK: What is the inventory of existing homes on the market? How does that compare to normal trends?

MF: A good rule of thumb is that if you have six months of inventory relative to the current sales pace, that's a balanced market. Neither the buyer nor the seller really has leverage. We're currently running a little above five months on the existing-home side, and a little below that on the new-home-construction side. Inventory is tight. There are a little more than 200,000 homes available for sale on the new-home side and about 2.2 million on the existing side. The new home side is exceedingly low. You would expect between 400,000 and 500,000 in a more typical market.

Over the course of the next couple of years, given the home price gains we're likely to see, that inventory will grow. But until it gets in excess of six months of supply, it's still going to be a seller's market.

OUTLOOK: Interest rates remain very low and are expected to rise once the Fed begins tightening later this year or in 2016. What are your thoughts on the future interest rate environment? How much of an increase in interest rates would it take to cool off housing sales?

MF: In the aggregate, you can think about housing affordability as a three-legged stool – one leg is home prices, the second is interest rates on mortgages and the third is household incomes. Interest rates are just one leg of the stool. The rate increases that we're forecasting – a half percent to a percent over the next couple of years – are really just reflecting a stronger economy. In terms of the housing market, the benefits from that stronger economy are going to outweigh somewhat higher rates.

The Federal Reserve's likely move to raise short-term rates later this year will be necessary to prevent inflation and maintain price stability in the economy. If the Fed were late to move, I would worry about bond markets and longer-term rates moving ahead of the Fed. We could get a spike in rates if people lose confidence in the Fed's ability to control inflation.

If mortgage rates go from 4 percent, where they are today, to 5 percent by the end of next year, given a growing economy and small increases by the Fed, I think we'll be in a good place. However, if we jump up to 6 or 6.5 percent, that would really put the brakes on this housing market recovery.

CASE-SHILLER INDEX FOR MAJOR HOUSING MARKETS

METROPOLITAN AREA	MARCH 2015 LEVEL	1-YEAR CHANGE
Atlanta	119.89	5.4%
Boston	176.14	4.6%
Charlotte	131.36	5.8%
Chicago	127.77	3.4%
Cleveland	105.00	1.0%
Dallas	147.12	9.3%
Denver	163.01	10.0%
Detroit	97.70	4.2%
Las Vegas	138.79	5.7%
Los Angeles	229.62	5.5%
Miami	196.77	8.7%
Minneapolis	141.27	3.0%
New York	175.12	2.7%
Phoenix	149.23	3.1%
Portland	173.90	6.9%
San Diego	208.92	4.8%
San Francisco	205.98	10.3%
Seattle	174.18	7.5%
Tampa	167.36	8.1%
Washington	207.61	1.0%
Composite-10	190.04	4.7%
Composite-20	175.20	5.0%
U.S. National	168.03	4.1%

Source: S&P Dow Jones Indices and CoreLogic
Data through March 2015

OUTLOOK: Is it possible that we could ever have another housing market crisis, or have controls been put in to prevent that?

MF: I think it's really unlikely that we're going to see another crisis due to lax lending like we had in the '05 to '07 period. That's largely because the current regulations prohibit a lot of the types of loans that were made during that time period.

The worst offender was the "NINJA" loan - no income, no jobs, no assets. People were being approved for mortgages without having to show proof of employment, income or any assets. That's bad underwriting - or really no underwriting at all. The Ability-to-Repay and Qualified Mortgage Rule implemented as part of the Dodd-Frank Wall Street Reform Act was a positive step and effectively eliminated that activity.

On the mortgage securitization side, issuers of securities for loans that have riskier features now must retain 5 percent of that security. Overall, it's an approach that makes sense. If you're making loans that have riskier features, you've got to hold some of that risk – you've got to eat your own cooking.

For banks, the Basel III capital requirements that are now in place tighten up the amount of capital they have to hold against various types of assets. The requirements on mortgage holdings didn't change much, but there are significantly heavier capital requirements for mortgage servicing.

We think this is an area where it went a bit too far. For a bank that has more than 10 percent of its Tier One capital in mortgage servicing rights, it becomes extremely punitive.

Taking the bigger picture view, getting more equity capital into the banking system is going to lead to a more stable system. We have a much safer system, whether it's the product or improvements to consumer disclosures. Whether it's the consumer-facing rules, the securitization rules, the banking system, or insurance, it's belt and suspenders all around.

Interest Rates and Economic Indicators

The interest rate and economic data on this page were updated as of 5/31/15. 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

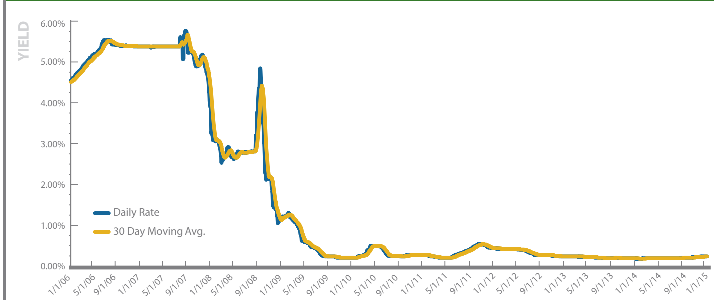
Forward Period (Days)	Average Life of Loan			
	2-yr	3-yr	5-yr	10-yr
30	8	8	6	5
90	17	18	15	11
180	30	32	27	21
365	67	67	55	40

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.

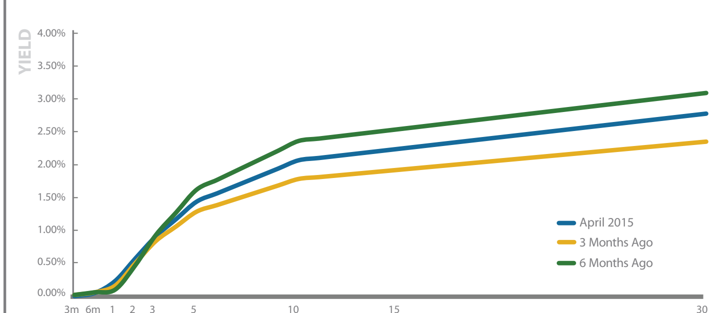
3-MONTH LIBOR



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



CoBank Shareholders Approve Amendments to Governance Bylaws

CoBank shareholders have approved board-proposed amendments to the bank's governance bylaws. The changes will begin to take effect on January 1, 2016, and include the following:

- Gradually reducing the number of elected directors on the board from 24 to 14 over a four-year transition period concluding in 2020.
- Increasing the maximum number of appointed directors from three to four, in order to provide the board with more flexibility to fill in experience and industry representation gaps. In addition, the board will continue to have two additional outside directors with no customer or Farm Credit System affiliations.
- Modifying director experience requirements to create better balance between board members with agricultural, Farm Credit and rural infrastructure experience.

The bylaw amendments, which had been recommended by the board following a governance review in 2014, were approved by substantial majorities on both a one-member-one-vote basis and a modified equity basis. Under the new governance structure, the bank will maintain its current six voting regions, as well as an even balance between one-member-one-vote and modified equity seats.

Everett Dobrinski

"On behalf of our entire board, I would like to thank our customer-owners for their ongoing support of CoBank," said Everett Dobrinski, chairman of the board. "Strong board oversight is a hallmark of the cooperative model and an important component of CoBank's business and financial success. Our goal with this restructuring is to ensure we remain aligned with governance best practices as well as the needs of the rural industries we serve."

CoBank's bylaws require that the board formally review its governance structure and practices every five years. In 2014, the board appointed a Restructuring Committee to examine every key aspect of governance at CoBank, including board size, director terms, voting methods, the number and geography of voting regions, and eligibility requirements for director candidates. The committee included an equal number of current board members and non-board customer representatives.

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 more than 75,000 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.