OUTLOOK

ECONOMIC DATA AND COMMENTARY

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Opportunity and Risk: The Outlook for U.S. Trade

After extensive debate about trade policy inside and outside the Trump administration, March brought a flurry of action. A March 1 announcement of pending across-the-board tariffs of 25 percent on imported steel and 10 percent on imported aluminum was followed quickly by a presidential Tweet suggesting that trade wars are both “winnable” and “good.” Next came a signed presidential order that imposed the tariffs but exempted Canada and Mexico (at least temporarily) amid renegotiations on the North American Free Trade Agreement. President Trump also offered relief from the tariffs to other allies that adjust trade policies to benefit the United States.

The tariffs hearken back to Trump’s America First campaign and the early days of his presidency, when he signed an executive order withdrawing the United States from the Trans-Pacific Partnership, a free-trade agreement that would have joined the U.S. with 11 other Pacific Rim countries.

Such steps are part of the administration’s stated goals of protecting jobs and chipping away at the U.S. trade deficit, which in 2017 totaled $566 billion, the widest gap in nine years. But is the administration’s strategy the answer? Joshua P. Meltzer, senior fellow in the Global Economy and Development program at the Brookings Institution, argues that imposing trade restrictions won’t eliminate the trade deficit, which he says is driven by larger macroeconomic forces. Meanwhile, U.S. agricultural exports, in particular, have grown in recent years, rising from about $71 billion in 2006 to $134 billion in 2016—a healthy trend that could continue if favorable trade conditions persist amid current uncertainty. Outlook spoke with Meltzer to gain greater insights into the tariff news, and where the U.S. trade may be headed next.

OUTLOOK: What are your thoughts on the new U.S. steel and aluminum tariffs, and their likely impact on the economy?

Joshua Meltzer: There’s some upside potential for steel and aluminum manufacturers in the United States, and there’s a lot of downside in the form of higher costs and higher prices for all of the U.S. industries that use steel and aluminum—such as automobiles and much of the manufacturing sector. There will likely be a substantial net loss for the economy in terms of jobs and growth. Many of those job losses will be in low-skilled positions that the president says he supports.

This Month's Expert

Dr. Meltzer is a senior fellow in the Global Economy and Development program at the Brookings Institution in Washington D.C. At Brookings, Meltzer works on international trade law and policy issues arising under the World Trade Organization and free trade agreements.

Meltzer is an expert on digital trade issues and co-directs Brookings Digital Economy and Trade Project. He teaches digital trade law at Melbourne University Law School and a digital trade seminar at Columbia University Law School. He has taught international trade law as an adjunct professor at Georgetown University Law School and Johns Hopkins School for Advanced International Studies.

Meltzer has testified on trade issues before the U.S. Congress, the U.S. International Trade Commission and the European Parliament. He has been an expert witness on digital trade and privacy issues in the EU and a consultant to the World Bank on digital trade matters.

Meltzer's views have been featured in *The New York Times, The Washington Post, CNN, Bloomberg, The Asahi Shimbun, The Economist* and *China Daily*. Meltzer holds an S.J.D. and LL.M. from the University of Michigan Law School in Ann Arbor and law and commerce degrees from Monash University in Melbourne, Australia.

OUTLOOK: What did you make of the president's remark that trade wars can be easy to win?

Meltzer: There's no such thing as winning a trade war. Trade benefits and broad economic welfare come from reducing one's tariffs, and from the competition and efficiency gains that go with that. These tariffs are based on a mercantilist approach to trade, which views imports as bad and exports as good. In 2002, President Bush launched temporary steel tariffs that were much more targeted and limited than what are being put into place now. Studies analyzing the impact of those tariffs have concluded that they caused overall job losses greater than the total number of people employed in the steel industry at that point.

OUTLOOK: Some see the tariff threats as mainly about gaining leverage with trading partners, and the president did exempt Canada and Mexico during the current NAFTA negotiations. What's your take?

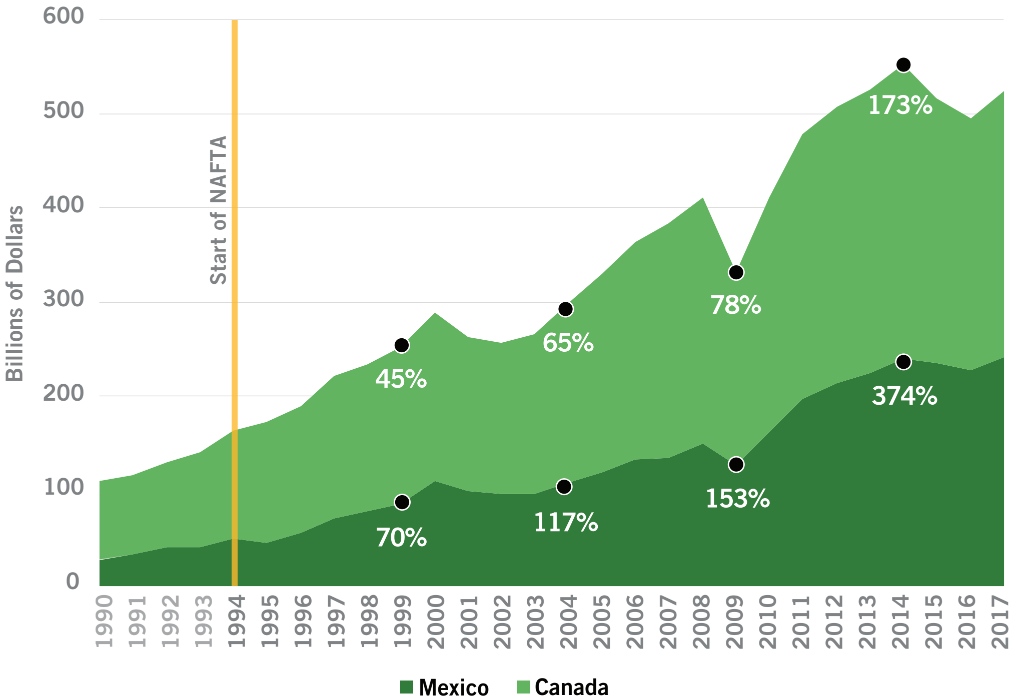
Meltzer: Large countries don't make major changes to their trade settings because of such economic threats. Leaders can't afford to simply buckle in response to what their own countries see as unfair trade measures by the United States.

Europeans very quickly said they would retaliate by raising tariffs. They are trying to make clear to the Trump administration that there are going to be costs of doing this. They're going to target blue jeans, Harley Davidsons, bourbon and other cultural exports. Trump, in response, has said he will raise tariffs on European automobile exports. The Chinese are considering what their response should be. All of this raises the chances of tit-for-tat retaliation, which would further increase the economic costs to the U.S. of these tariffs.

OUTLOOK: Looking beyond the tariff issue, what are the most promising trade areas for the United States right now?

Meltzer: Certainly, agriculture has been a bright spot for exports. As the global middle class grows, demand for protein and fresh produce grows as well, and the United States is very well situated to fulfill that need. Supply chains in U.S. agriculture are increasingly sophisticated and digitized. They rely on a wide range of technologies that help ensure food safety and allow for greater segmentation based on whether certain products are genetically modified organisms, or organic, or what types of beef products meet a given market's needs. Segmentation to meet diverse needs and tastes of specific markets around the world represents a whole industry waiting to be exploited, and one in which the United States has the opportunity to lead.

U.S. EXPORTS TO MEXICO AND CANADA



Source: U.S. Census

Note: The percentages represent increases over the 94 baseline of the same country

The U.S. is also very competitive in service industries. And one area that may surprise people is manufacturing. Though we've grown accustomed to a narrative of decline, manufacturing's share of U.S. economic growth has actually been constant for many years. And there's a real opportunity for trade growth because U.S. manufacturing is increasingly sophisticated and high end. It has become a very high tech sector that employs fewer workers, but ones who are highly qualified. If you look across aerospace, pharmaceuticals, chemicals, various forms of high-end optical equipment and the like, the United States is a world leader in many of these areas.

OUTLOOK: What do you see as the most pressing trade challenges?

Meltzer: The market for American companies is increasingly outside of the United States. So trade agreements are all the more crucial to make sure that as these new middle-class countries develop, they are conducive and open to U.S. exports. Despite the advantages I outlined above, agriculture and other industries have been placed at a competitive disadvantage by the fact that the United States is becoming more isolated on trade.

One concern is the Trump administration, as evidenced by the tariff issue, views trade mostly in terms of trade deficits. That approach is not supported by economic analysis. The main cause of our deficit is that Americans don't save enough to finance all of the investments in this country. Investment capital flows in from overseas, and that in turn helps Americans pay for imports in excess of what we export. Making our deficits a driving force in trade negotiations means that other countries are just not on the same page. A second concern is the administration's focus on bilateral rather than multilateral trade agreements.

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OUTLOOK: Why are bilateral trade agreements a concern?

Meltzer: As a nation, we've been negotiating bilateral deals for a long time, and they do have some real benefits. Since they involve just two countries, they are easier to negotiate and can be a very good way to experiment with new rules and standards to meet changing economic conditions and cutting-edge business developments. International organizations such as the World Trade Organization often have a hard time moving forward on those things.

At the same time, the limitations of bilateral trade policy are becoming clear in a world increasingly dominated by global supply chains and large, regional trade systems such as NAFTA, the European Union and now the TPP in Asia. Bilateral agreements just map onto those systems in a very awkward way, and may even undermine the economics of multilateralism. If two countries reach an agreement with special preferences, there's a perception that you're diverting trade rather than creating it. Whereas in the past many countries sought bilateral deals with the United States, we're seeing less interest now.

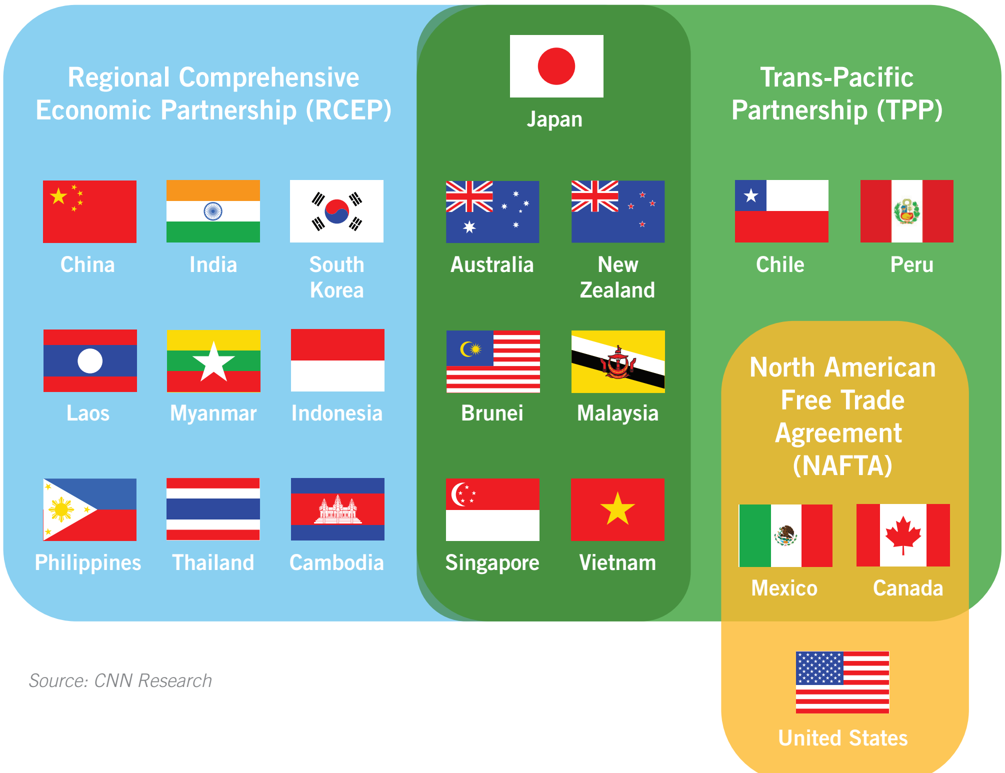
OUTLOOK: Overall, how do you think the current NAFTA negotiations are going?

Meltzer: There has been good progress in a number of areas. One sticking point has been the Trump administration's proposed changes to domestic content rules for automobiles. NAFTA rules currently require cars to contain about 62 percent North American—U.S., Canadian and Mexican—content to qualify for duty free status. The administration has proposed that 50 percent of content would have to be made specifically in the United States to enter the country duty free. It's an attempt to bring back auto manufacturing jobs, but it's at sharp odds with how modern supply chains are set up. Using trade policy to bring jobs back would be very costly, and consumers would pay for it through higher prices.

OUTLOOK: What do you see as the likely outcome?

Meltzer: The Canadians have suggested some creative solutions. For example, if you included things such as intellectual property, design and other value-added components, you might get closer to 50 percent U.S. value added. Eventually, I think the parties will reach a compromise in close consultation with the auto industry, where Canada and Mexico give something to the U.S. without the industry having to unwind an efficient supply chain.

WHO'S INVOLVED?



Source: CNN Research

OUTLOOK: Is there a chance that the United States will simply pull out of NAFTA, as President Trump has at times suggested?

Meltzer: That's a risk. But I do think the administration will do its best to avoid that. Whereas six months ago, President Trump thought the threat of leaving NAFTA was a smart negotiating ploy, he's heard enough from agriculture, auto and other industries as well as from many senators what a terrible idea that would be. I wouldn't say that leaving is off the table, but the bar is higher than it was.

OUTLOOK: Why would leaving the agreement be a mistake?

Meltzer: You'd see new trade barriers, an increase in costs for exporters, and new and costly frictions in what has become a very integrated North American economic unit. For the United States, you'd see a loss of manufacturing competitiveness, essentially undermining every one of President Trump's major goals in terms of manufacturing, jobs and risks.

OUTLOOK: What impact will the U.S. departure from the Trans-Pacific Partnership have on American trade?

Meltzer: The other countries are moving ahead without the U.S., which is something I don't think the administration anticipated. Free-trade preferences and beneficial rules are going to go to those 11 TPP countries and U.S. businesses are going to be locked out. Here's one example. Australia currently has a free-trade agreement with Japan that gives Australian beef preferred access. The U.S. beef industry had been looking forward to a more level playing field under the TPP. But now, with Australia and Japan in the TPP and the U.S. out, we're back to a situation where U.S. beef is being priced out.

> "The other countries in the TPP are moving ahead without the U.S., which is something I don't think the administration anticipated. Free-trade preferences and beneficial rules are going to go to those 11 countries and U.S. businesses are going to be locked out"

OUTLOOK: How will our withdrawal affect U.S. relations with Pacific Rim countries?

Meltzer: One of the main themes of the TPP was to create an alternative narrative for Asia that was about U.S. leadership and engagement in the region as opposed to what China offers. The Chinese were quite concerned about this, so our decision to pull out of the agreement amounted to a huge gift from the United States to China. Many Pacific Rim countries are just as concerned as we are about greater access to Chinese markets and the unfair advantages that state-subsidized Chinese companies have when competing overseas. One of the purposes of the TPP was to set some standards and norms around these practices—standards that China, if it hopes at some point to join the TPP, would have to adhere to.

OUTLOOK: How would you describe our current trade relations with China?

Meltzer: Even before the new tariffs on steel and aluminum, the risk of a serious trade disruption between the U.S. and China had gone up in the past year. In August 2017, President Trump called for formal review of whether China's intellectual property practices are damaging U.S. competitiveness. The review, launched under Section 301 of the Trade Act of 1974, is in its final stages and pretty clearly will point to a whole range of things China does that are inconsistent with its intellectual property commitments. The question is what the United States will do in response. There's a lot of legitimate concern, not just in the United States, but globally, about China's economic policies and how to fix trade. And it might be possible to build a coalition of countries to pressure China through a carrot-and-stick approach to change how it does business. But if we go it alone, in a tit-for-tat manner, by raising trade barriers, that might actually isolate the U.S. from its potential allies, and instead of changing China's behavior, it would likely lead it to retaliate.

OUTLOOK: What would a serious disruption potentially mean for U.S. agriculture and other industries?

Meltzer: China has been a very important U.S. trading partner, with total trade valued at well over $600 billion a year. And agricultural exports to China totaled $21 billion in 2016, making China the second-largest market for those exports. Serious disruptions in this relationship would reverberate across the U.S. economy.

Interest Rates and Economic Indicators

The interest rate and economic data on this page were updated as of 2/28/18. 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

Forecasts courtesy of Bloomberg and Blue Chip Economic Indicators

				US Treasury Securities	
2018	**GDP**	**CPI**	**Funds**	**2-year**	**10-year**
Q1	2.80%	2.70%	1.50%	2.22%	2.74%
Q2	2.90%	1.90%	1.79%	2.31%	2.82%
Q3	2.70%	2.30%	1.91%	2.44%	2.92%
Q4	2.60%	2.10%	2.12%	2.58%	3.02%
2019	**GDP**	**CPI**	**Funds**	**2-year**	**10-year**
Q1	2.30%	2.20%	2.16%	2.55%	2.97%

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	2.07%	2.30%	2.64%	2.74%	2.80%	2.87%
0.25	2.20%	2.42%	2.69%	2.75%	2.81%	2.87%
0.50	2.35%	2.54%	2.78%	2.79%	2.84%	2.89%
0.75	2.48%	2.65%	2.80%	2.85%	2.89%	2.94%
1.00	2.63%	2.73%	2.81%	2.84%	2.88%	2.93%
1.50	2.73%	2.81%	2.88%	2.90%	2.93%	2.98%
2.00	2.81%	2.86%	2.86%	2.90%	2.92%	2.97%
2.50	2.83%	2.87%	2.87%	2.91%	2.94%	2.98%
3.00	2.86%	2.88%	2.88%	2.92%	2.95%	2.99%
4.00	2.83%	2.88%	2.92%	2.95%	2.99%	3.02%
5.00	2.88%	2.92%	2.96%	3.02%	3.02%	3.00%

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

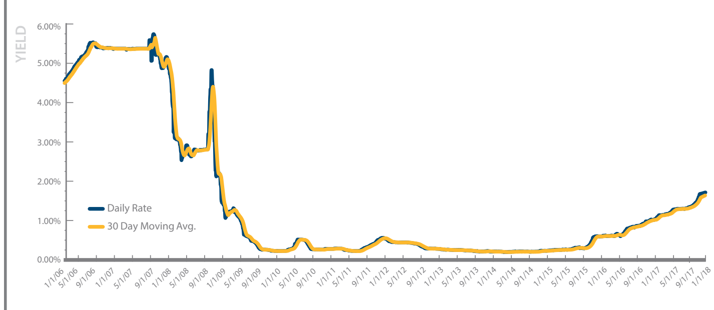
Forward Period (Days)	Average Life of Loan			
	2-yr	3-yr	5-yr	10-yr
30	6	5	5	5
90	11	10	9	7
180	19	16	15	11
365	38	32	29	21

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.

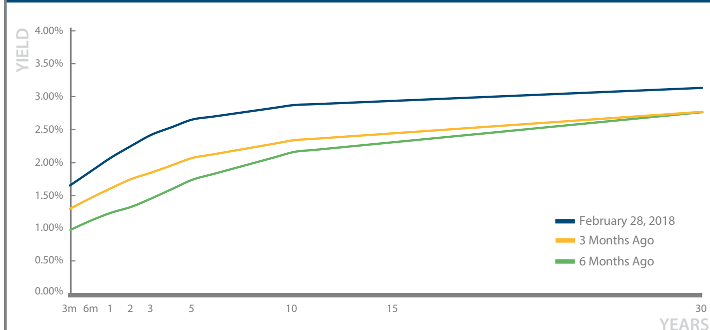
3-MONTH LIBOR



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 UPDATE

CoBank Reports Full Year Financial Results for 2017

February 22, 2018 – CoBank announced financial results for the full year and fourth quarter of 2017.

Average loan volume for CoBank increased 5 percent to $96.0 billion, reflecting increased lending across all three of the bank's operating segments. Net interest income increased 2 percent to $1.393 billion, driven primarily by higher average loan volume. Net income for 2017 rose 19 percent to $1.125 billion due in large part to recently enacted federal tax reform legislation. Excluding the impact of tax reform, net income rose 4 percent to $983.0 million from $945.7 million in 2016, due to the combination of greater net interest income and a lower provision for loan losses.

"We're pleased with our financial performance for the year, which reflected solid organic growth in our business as well as an unexpected benefit from the new tax law," said Thomas Halverson, CoBank's president and chief executive officer. "Despite ongoing challenges in the financial services industry as well as many of the rural industries we serve, we ended the year in strong financial condition and well-positioned to continue fulfilling our mission in rural America."

The Tax Cuts and Jobs Act of 2017 was signed into law in December and lowered the U.S. corporate tax rate from 35 percent to 21 percent beginning in 2018. For CoBank, a key impact was the effect that the legislation had on assets in the bank's leasing subsidiary. In accordance with Generally Accepted Accounting Principles, CoBank was required to remeasure the deferred tax liabilities recorded against those assets at the new lower corporate tax rate, which when netted with other deferred tax adjustments resulted in a significant one-time tax benefit of $142.3 million.

About CoBank

CoBank is a $129 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 70,000 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, 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 Full Year Financial Results for 2017 *(continued)*

Tom Halverson

"More important than the one-time boost to CoBank's 2017 financials will be the long-term benefit of the lower corporate tax rate in future years," Halverson said. "Given the current size and makeup of our business, we expect the reduced rate to lower our effective tax rate by roughly one third. As a customer-owned cooperative, it will be important that we make sure the incremental value created by the tax legislation predominantly benefits our customer-owners and other key stakeholders. Our board and executive team will be considering this matter carefully in 2018 to determine the most appropriate course of action for our business and our shareholders."

For the fourth quarter of 2017, average loan volume increased 4 percent to $96.7 billion as compared to the fourth quarter of 2016. Net interest income increased 2 percent to $351.0 million, driven by growth in overall loan volume. Net income for the quarter was $391.1 million compared to $227.3 million in the prior-year period, primarily due to the benefits of tax reform legislation described above. Excluding the impact from tax reform, net income for the quarter increased $21.5 million over the fourth quarter 2016, due to increased net interest income, a lower provision for loan losses and higher fee income.

In March of this year, CoBank will distribute $610.4 million in patronage to customer-owners, including $491.8 million in cash and $118.6 million in common stock. "Strong, sustainable patronage is a key component of the CoBank value proposition," Halverson said. "We're pleased with the level of patronage approved by our board and look forward to delivering this benefit to our eligible borrowers."

Net interest margin declined to 1.12 percent in 2017 from 1.14 percent in 2016, and interest rate spread decreased to 1.00 percent from 1.06 percent. The reduction in net interest margin included the impact of lower fair value accretion income and slightly lower overall loan spreads. For the fourth quarter 2017, net interest margin declined to 1.12 percent from 1.13 percent in the same period in 2016.

CoBank Reports Full Year Financial Results for 2017 *(continued)*

David P. Burlage

"Margins in the financial services industry have declined steadily in recent years due to a combination of marketplace challenges, including intense competition and low interest rates," said David P. Burlage, chief financial officer. "While we certainly hope that margin pressure eases in the coming year, there is no guarantee that will occur. We will continue to manage our assets and liabilities to position the bank optimally for the current and anticipated interest rate environment."

Credit quality in CoBank's loan portfolio declined slightly during 2017 but remained favorable overall. Nonaccrual loans totaled $246.8 million, or 0.25 percent of total loans, as of the end of the year compared to $207.2 million, or 0.22 percent of total loans, at the end of the prior year. The bank recorded a $42 million provision for loan losses during the year due to overall loan growth as well as a slight deterioration in credit quality in its Agribusiness operating segment, compared to a $63 million provision in 2016. CoBank's allowance for credit losses, which protects the bank's capital base against losses embedded in its loan portfolio, totaled $670.8 million at year-end or 1.33 percent of nonguaranteed loans when wholesale loans to Farm Credit associations are excluded.

The bank's capital and liquidity levels remain well in excess of regulatory minimums. As of December 31, 2017, shareholders' equity was $9.1 billion, and the bank's total capital ratio was 15.24 percent, compared with the 8.0 percent minimum (10.5 percent inclusive of the fully phased-in capital conservation buffer) established by the Farm Credit Administration (FCA), the bank's independent regulator. At year-end, the bank held approximately $29.2 billion in cash and investments. The bank had 176 days of liquidity at the end of 2017, which exceeded the FCA minimum.

"Financial strength and stability are critical to our ability to serve customers and fulfill our mission in rural America," Halverson said. "We hope our customers and other stakeholders continue to have confidence in our financial stewardship given the strong results delivered last year on their behalf."