OUTLOOK

ECONOMIC DATA AND COMMENTARY

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The Reasons Behind the Federal Reserve's Recent Rate Cut

In July, the U.S. economy officially passed a significant milestone for the longest period of sustained expansion on record: 121 months. One might assume that the biggest threat during such a stretch would be over-exuberance: investors throwing money at the latest "sure thing," companies expanding like mad and the Federal Reserve raising interest rates to prevent the economy from overheating. Yet on July 31, the opposite happened when the Fed lowered rates by 25 basis points. The last time the Fed cut rates, in 2008, the Great Recession was underway and the cut, to near zero, was part of efforts to pull the U.S. economy back from the edge of catastrophe. So, what caused this latest action, at a time when the economy is still growing and unemployment remains low?

For answers, Outlook turned to Patricia C. Mosser, an economist at Columbia University's School of International and Public Affairs. Now the leader of the school's Initiative on Central Banking and Financial Policy, Mosser worked at the Federal Reserve Bank of New York for more than 20 years, analyzing markets and helping implement monetary reform. Despite the length of the current recovery, the Fed sees signs of potential trouble, Mosser says. There's an inverted yield curve that has historically been the harbinger of downturns, for example, plus a minefield of geopolitical tensions, particularly around trade policy, and an inflation rate that seems perpetually stuck below where the Fed wants it to be. Mosser discusses what makes this expansion different from others, what economists fear, and what the Fed hopes this latest move will accomplish.

OUTLOOK: Why did the Fed choose to cut rates? Was the size of the cut in line with expectations?

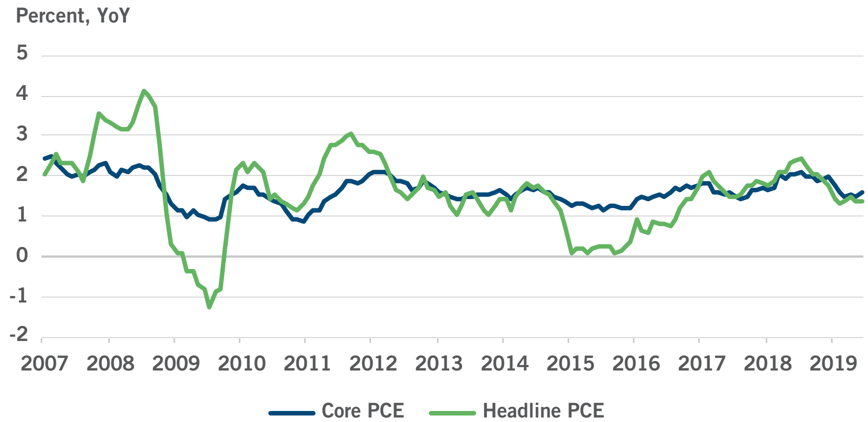
Patricia Mosser: I would call this an insurance cut. That might not be how the Fed would frame it, but it's definitely a risk-management move. They did this not because the current economic outlook is bad, but because they don't want it to deteriorate in the future. They want to sustain the economic recovery. Of course, there are people who disagreed with the decision, who wanted to wait and stand pat on rates and see what happens with the economy. The size of the cut wasn't surprising, especially because Chairman Jerome Powell had telegraphed what he was thinking, and what he understood the Federal Open Market Committee members to be thinking.

This Month's Expert

Patricia C. Mosser is director of the MPA Program in Economic Policy Management at Columbia University's School of International and Public Affairs and leads the school's Initiative on Central Banking and Financial Policy. Previously, Mosser was head of the Research and Analysis Center at the Office of Financial Research, U.S. Treasury Department. She spent more than 20 years at the Federal Reserve Bank of New York, where she was a senior manager at the Fed's open market desk overseeing market analysis, monetary policy implementation, foreign exchange operations and analysis of financial stability and reform.

Mosser has written on financial stability and monetary policy topics including financial reform, crisis policy tools and the monetary transmission mechanism. She serves as a consultant to the Bank of England and was previously a member of the Deputies Committee of the Financial Stability Oversight Council, the Board of the American Economic Association's Committee on the Status of Women in the Economics Profession, and numerous international central banking and financial policy committees. She earned a bachelor's degree from Wellesley College, a master's of science degree with distinction from the London School of Economics and Political Science, and a doctorate in economics from MIT.

INFLATION: PCE PRICE INDICES



Note: Core PCE is the personal consumption expenditures price index. Headline PCE is an all item index.

Source: Federal Reserve

OUTLOOK: What was the Fed most concerned about?

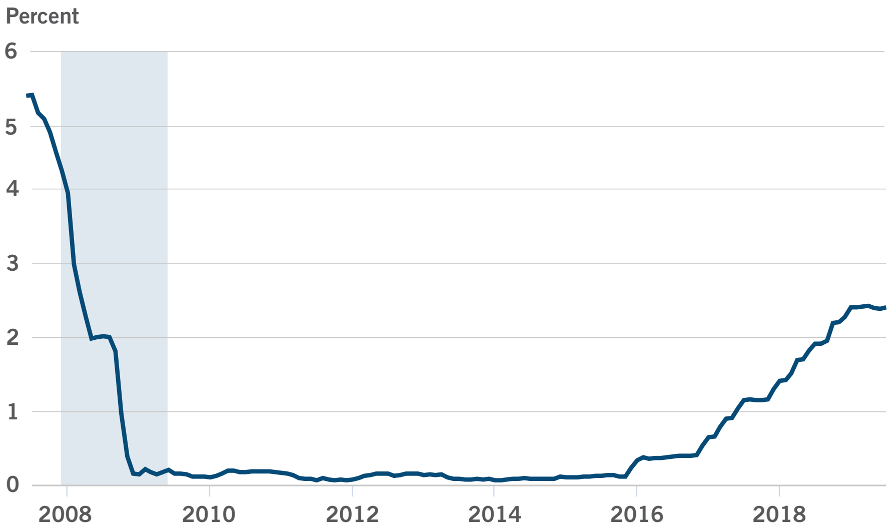
Mosser: The emphasis was on inflation not being where the Fed wanted it to be. The Fed would be happy if the inflation rate, excluding food and energy, fluctuated from a little below to a little above 2%, but it has remained stubbornly below that target. This relatively small cut in the policy rate actually eased financial conditions from the moment the Fed started talking about it. I assume that was one of their intentions. In other words, we probably saw some benefit from the cut before it was announced. Powell framed the cut as a "mid-cycle adjustment" and pointed to historical precedents for this type of move when rates were similarly lowered in 1995 and 1998. In both cases the economy was relatively strong, but the Fed worried it was going to slow down, and cut rates preemptively.

OUTLOOK: Why the worries now, when the U.S. economy is doing well?

Mosser: The rest of the world isn't doing as well economically as the United States. The Euro area in particular has been struggling, there's some weakness in Japan, and Chinese growth has slowed. The U.S. is a big country with a big economy, but it's not immune to the effects of slowdowns elsewhere. Powell sees two main areas of concern globally.

First is the slowdown in manufacturing, which has been seen in the U.S. and everywhere else. Manufacturing is often considered a predictor of the rest of the economy, and I think the Fed is concerned that manufacturing weakness could spread to other parts of the economy. Second, they are concerned about ongoing trade tensions between the U. S. and China, the world's two largest economies. That was borne out dramatically just a week

EFFECTIVE FEDERAL FUNDS RATE



Note: Shaded area indicates U.S. recessions

Source: Board of Governors of the Federal Reserve System (U.S.)

after the rate cut when the U.S. announced new tariffs on Chinese consumer goods. China responded by devaluing the yuan and curtailing U.S. agriculture imports, and the Dow dropped 767 points in a single day. These concerns are reflected in the fact that major U.S. companies have been holding back on investment and expansion plans, in part because they are very uncertain about the global trade outlook.

OUTLOOK: Eric Rosengren and Esther George, presidents of the Boston and Kansas City Feds, dissented from the decision. Was that unusual?

Mosser: Consensus is more typical. There's a lot of staff analysis that's shared across the Fed system, much of it generated by the staff of the Board of Governors in Washington, and there's a lot of internal conversation before these votes. Usually, that's where differences tend to be hashed out, so there's consensus by the time a vote occurs. That said, dissents do happen. Both presidents were reluctant to lower rates when the economy is generally doing well. President George is more hawkish and has dissented in favor of tighter monetary policy in the past. President Rosengren has dissented occasionally, but sometimes in favor of easier monetary policy and other times, such as this meeting, in favor of tighter policy.

OUTLOOK: What's the likelihood that we'll see further rate cuts?

Mosser: If the economy remains reasonably robust, there wouldn't be much of a rationale for cutting rates again. But if the trade tensions continue, if the slowdown in investment and manufacturing persists, the Fed may feel it's appropriate to make another risk-management rate reduction. This decision will be very data dependent. At present, financial markets are predicting that the Fed will lower the federal funds rate target again at their September meeting.

> "The Fed sees its target of 2% inflation as more or less consistent with price stability…With zero inflation you run the risk of moving into deflation and recession."

OUTLOOK: Why is low inflation a problem?

Mosser: It's all about trying to maintain price stability. The Fed sees its target of 2% inflation as more or less consistent with price stability. The reasons get rather technical, but a slightly positive number seems to work best. With zero inflation you run the risk of moving into deflation if a recession happens.

Part of this has to do with the difference between nominal and real interest rates. Real rates are nominal rates minus inflation, and now, with short-term interest rates just above 2% and inflation below 2%, the real interest rate is only slightly above zero. If inflation goes lower, then the real rate of interest could begin to rise, potentially slowing down the economy even more, which in turn could cause inflation to fall even further below the target (and raise the real interest rate). So the Fed has acted now, to lower nominal (and real) interest rates to help sustain the economic expansion.

OUTLOOK: But doesn't reducing rates now leave the Fed less room to maneuver if there's a recession?

Mosser: That could become an issue. Right now, it's a bigger problem for the European Central Bank, the Bank of Japan and other central banks that already have their rates at zero (or slightly negative) and have economies with very slow growth. But in a typical recession, the Fed tends to cut the short-term interest rate target by between three and five percentage points. The current policy rate target is 2% to 2.25%, so the Fed obviously won't be able to cut rates by that much. That's one reason the Fed is so eager to stave off a recession – because if there is one, it won't have enough space to cut rates as it has in the past.

The Fed has said that it wants to use interest rates as its main policy tool. But it has also said that it wouldn't hesitate to use its balance sheet again in a recession, through quantitative easing, as it did during the 2008-09 financial crisis. That would mean buying Treasuries and other debt to help the economy.

OUTLOOK: The Fed had been allowing the securities that it acquired during the crisis to mature, gradually reducing the assets on its balance sheet. But now it has said it will stop doing that, ahead of schedule. What led to that decision?

Mosser: I think it was pretty much expected. The Fed had already slowed the pace at which it was rolling off assets in anticipation of stopping in September. Recently its balance sheet had not been shrinking very rapidly – by only $20 billion or $30 billion a month, which isn't much relative to the overall size. I think the Fed has achieved the vast majority of what it wanted to do when it started rolling off assets a year and a half ago, in terms of reducing the balance sheet to a more manageable size.

> "The U.S. is a big country with a big economy, but it's not immune to the effects of slowdowns elsewhere."

OUTLOOK: How much has the balance sheet been reduced?

Mosser: It was $4.5 trillion in 2017 when the Fed began to let maturing assets roll off, and now it's about $3.8 trillion. That sounds like a lot, but about $1.7 trillion of that is required simply because of the amount of U.S. dollar currency that's in circulation. Currency is a liability of the Federal Reserve, and so it has to be offset by an asset on the other side of the balance sheet. That by itself accounts for 45% of the assets on the Fed's balance sheet.

Another very large part of balance sheet liabilities, about $1.5 trillion, are the reserves that commercial banks hold at the Fed. That's a big number compared to bank reserves held at the Fed before the financial crisis, but changes in banking regulations now require the largest banks to hold extremely large quantities of liquid assets on their balance sheets – and the safest, most liquid asset available is an account at the Fed.

OUTLOOK: Earlier in the year, President Trump criticized the Fed for not lowering interest rates. Could this latest move be seen as responding to political pressures?

Mosser: I don't think the president's statements affected the Fed's decision. There is a very long history of the Fed making policy decisions based on the economic data and on the policy goals that Congress has given them – inflation and employment. They justified this latest cut in exactly those terms.

OUTLOOK: Are there risks to this interest rate cut?

Mosser: Absolutely. One is the potential for financial instability. In the past 10 years the European Central Bank, the Fed, and the Bank of Japan have maintained a very accommodative monetary policy by historical standards. This extended period of low interest rates is making it quite easy for even risky companies to borrow money. That's fine as long as the economy is healthy and companies are generally doing well. A lot of businesses look great when financial conditions are easy. But there's an old saying that bad loans are made during good times, and a slowing economy could pretty quickly expose some of the underlying weaknesses in these companies. Some of them could end up defaulting or having to be restructured, which could precipitate some sizeable losses for investors, potentially leading to financial instability.

"The latest analysis I saw from the Congressional Budget Office was pretty stark. It showed that eventually the U.S. debt will grow to the point that if interest rates do go up, interest payments could become the largest U.S. government expenditure."

Human beings naturally become complacent and we tend to extrapolate from recent experience. In this situation, people may be forgetting that investment prices can go down and things can get very volatile. Moreover, it's not just the private sector that can be lulled into this way of thinking. Low interest rates make it very inexpensive for governments to borrow. It's much easier to run big deficits because it doesn't cost much to finance that borrowing. The U. S. has significantly increased its deficits and its issuance of Treasury securities during the past two years and appears likely to continue to do that for the next couple of years. The latest analysis I saw from the Congressional Budget Office was pretty stark. It showed that eventually the U.S. debt will grow to the point that if interest rates do go up, interest payments could become the largest U.S. government expenditure.

OUTLOOK: Some observers cited an inverted yield curve as another reason for cutting rates. What does an inverted yield curve tell us about the economy?

Mosser: Normally, bond investors expect a rate premium for buying a 10-year bond versus, say, a 1-year bond, to compensate for the liquidity risk of lending money over a longer term. An inverted yield curve means that interest rates for longer-term bonds are actually lower than rates for short-term bonds. That's long been seen as a sign that the economy may be headed for a slowdown – because it typically happens when the Fed raises the policy rate, but long-term rates go up by less. But today, I see it more as a reflection of the low interest rates and low volatility that we've had for such a long time. So, it's hard to know whether the yield curve is signaling something important about the economy.

Interest Rates and Economic Indicators

The interest rate and economic data on this page were updated as of 7/31/19. 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

				U.S. Treasury Securities	
2019	**GDP**	**CPI**	**Funds**	**2-year**	**10-year**
Q3	1.90%	2.00%	2.01%	1.86%	2.10%
Q4	1.90%	2.10%	1.56%	1.87%	2.15%
2020	**GDP**	**CPI**	**Funds**	**2-year**	**10-year**
Q1	1.80%	2.10%	1.37%	1.88%	2.20%
Q2	1.80%	2.00%	1.23%	1.91%	2.23%
Q3	1.60%	2.00%	1.14%	1.92%	2.26%

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	2.30%	2.10%	1.83%	1.80%	1.85%	1.95%
0.25	2.15%	1.97%	1.76%	1.76%	1.81%	1.92%
0.50	1.99%	1.86%	1.74%	1.76%	1.81%	1.92%
0.75	1.87%	1.77%	1.71%	1.76%	1.84%	1.95%
1.00	1.78%	1.70%	1.68%	1.74%	1.83%	1.94%
1.50	1.66%	1.69%	1.71%	1.79%	1.87%	1.99%
2.00	1.62%	1.65%	1.70%	1.80%	1.89%	2.00%
2.50	1.64%	1.68%	1.75%	1.85%	1.93%	2.05%
3.00	1.66%	1.71%	1.79%	1.89%	1.97%	2.09%
4.00	1.73%	1.78%	1.89%	1.99%	2.06%	2.14%
5.00	1.84%	1.90%	1.99%	2.10%	2.14%	2.20%

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

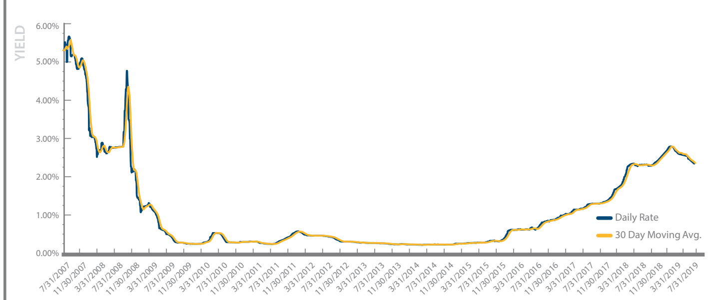
Forward Period (Days)	Average Life of Loan			
	2-yr	3-yr	5-yr	10-yr
30	5	5	5	5
90	5	5	5	5
180	5	5	5	6
365	5	5	10	11

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.

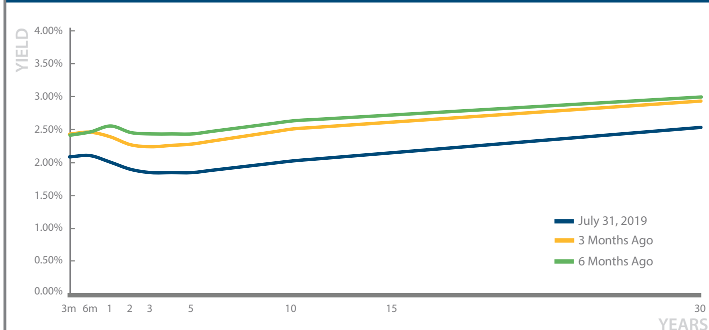
3-MONTH LIBOR



RELATION OF INTEREST RATE TO MATURITY

The yield curve depicts 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 Financial Results

CoBank recently reported financial results for the second quarter and first half of 2019, which demonstrated that the bank remains in strong financial condition and highly focused on serving the needs of its customers and fulfilling its mission of service to the U.S. rural economy.

Net income for the second quarter of 2019 was $279.9 million, compared to $361.4 million during the second quarter of 2018. Net income for the first six months of 2019 was $552.4 million, compared to $645.8 million in the same period last year.

Thomas Halverson

"We experienced a year-over-year decline in net income due to the effect of non-recurring items recorded in 2018 in combination with a number of marketplace trends that have impacted core earnings," said Thomas Halverson, CoBank's President and CEO. "That said, CoBank continues to generate robust earnings and remains in strong financial condition overall. We are investing in the business in order to build our long-term capabilities and enhance the value and level of service we provide to our customers."

Year-over-year comparisons of CoBank's second quarter and year-to-date financial results are affected by the fact that it recorded a number of significant non-recurring items in the first half of 2018 that elevated its earnings in those periods. That included a higher return of excess insurance funds from the Farm Credit System Insurance Corporation in the first quarter of 2018 and significant gains from the sale of investment securities in the second quarter of 2018. Earnings in the first half of 2019 have also been impacted by a number of ongoing marketplace trends including spread compression, the shape of the yield curve, and higher operating expenses driven by an increase in headcount and employee compensation to support new business initiatives, maintain high levels of customer service and invest in technological enhancements.

About CoBank

CoBank is a $138 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 www.cobank.com.

The above notwithstanding, the bank experienced loan growth during the first half of 2019. Average loan volume rose 3% and 4% in the quarterly and year-to-date periods, respectively, and its loan portfolio totaled $104.3 billion at June 30, 2019. Credit quality remained favorable overall despite some continuing deterioration due to volatile commodity prices and other challenges impacting the bank's customers. The bank ended the period with a strong capital and liquidity position and both measures were well above regulatory minimums.

David P. Burlage

"We're pleased that credit quality for CoBank is strong despite some deterioration in the first half of the year due to stresses in the rural economy. The percentage of adverse assets in our loan portfolio remains in line with long-term averages, as does our level of non-accrual loans," said David Burlage, CoBank's CFO. "In addition, we have a strong allowance for credit losses totaling over $720 million, which protects the bank and its capital base from losses inherent in our portfolio. We continue to monitor credit quality carefully while also working collaboratively with borrowers experiencing distress, consistent with our mission."