CoBANK

OUTLOOK Economic Data and Commentary

August 2013 Volume 10 Number 8

Outlook for the U.S. Housing Market

Overall the performance of the U.S. economy has remained lackluster over the past several quarters. GDP growth has averaged only 1.4 percent in the past year. Unemployment remains high. Businesses throughout the country continue to operate in an uncertain political and regulatory environment due to gridlock in Washington, D.C.

The real bright spot in the economy has been the housing market, which has been in strong recovery mode since early 2012.

Home prices have jumped more than 20 percent in some U.S. markets, especially in the western United States. While home prices in the northeast are increasing at much slower rates, housing sales across the country are strong and growing.

A key question hanging over the housing market is what will happen when the Federal Reserve begins to tighten monetary policy. The Fed deliberately pushed interest rates to historic lows to get the economy moving in the wake of the 2008 financial crisis. That has made it cheaper to borrow money for housing purchases and helped drive residential sales and home values upward. But can the real estate market continue to improve if interest rates increase?

To understand what is happening in the U.S. housing market, *OUTLOOK* recently spoke with David Blitzer, managing director and chairman of the Index Committee of the S&P Dow Jones Indices, which issues the S&P/Case-Shiller Home Price Indices, the leading measure of U.S. home prices. Blitzer is generally optimistic about the housing market but sees some potential issues on the horizon.

OUTLOOK: Give us a high-level look at what's been happening in the U.S. housing market in recent months.

David Blitzer: The U.S. housing market has been in active recovery for the past 12 to 18 months. While home prices in a few cities have fully recovered, others are growing but still lag behind their peaks of 2005-2006. Housing starts have rebounded substantially, too, but are still below long-term trends. And sales of new homes are a bit below trend, too. However, existing home sales have rebounded substantially and are fairly close to long-term trends.

The Fed has poured liquidity into the market with the objective of boosting home prices. It's been a big factor in the rebound.

About this article

David M. Blitzer is managing director and chairman of the Index Committee for S&P Dow Jones Indices. He is responsible for index security selection, as well as index analysis and management.

Prior to becoming chairman of the Index Committee, Dr. Blitzer was Standard & Poor's chief economist. Before joining Standard & Poor's, he was corporate economist at The McGraw-Hill Companies, S&P's parent corporation. He also has served as senior economic analyst with National Economic Research Associates, Inc. and did consulting work for various government and private sector agencies. Dr. Blitzer has won numerous awards for economic forecasting and is often quoted in the global business press, including the *New York Times, Wall Street Journal, USA Today* and *Financial Times.*

A graduate of Cornell University with a bachelor's degree in engineering, Dr. Blitzer received his master's in economics from the George Washington University and his doctorate in economics from Columbia University.

Affordability – that's how much income it takes to buy a house and pay your mortgage – is incredibly good from the homebuyer's point of view because interest rates are exceedingly low.

OUTLOOK: What economic factors have contributed to the rebound?

DB: Low interest rates are a primary driver, for sure, but so is overall Federal Reserve policy. QE3, the current Fed asset purchase program, boosted liquidity and is encouraging banks to lend and to ease qualification of borrowers. The recent Senior Loan Officer Survey published by the Fed confirms these shifts. The Fed has poured liquidity into the market with the objective of boosting home prices. It's been a big factor in the rebound.

Side-by-side with that is some decline in the unemployment rate, which has led to an increase in consumer confidence. Consumers feel better about spending in general and they're more interested in buying houses.

OUTLOOK: The economy is still in a slow recovery and the housing market is a bright spot – why is that?

DB: In a typical recession/recovery pattern – and this one is not typical – the economy starts to slump and interest rates come down. Once rates get low enough, housing is one of the first things to rebound because home sales are heavily dependent on the cost of mortgages.

What sets apart this situation from many of those in the past is while monetary policy is very easy and stimulative, fiscal policy is tight. The federal government has cut spending significantly because of the sequestration and debt ceiling issues. As a result, there is a lot of concern about the low GDP numbers and what lies ahead for the overall economy.

OUTLOOK: Are home values back to where they were before the crisis?

DB: No, we have not recovered all the way. On a national basis, the 20 cities we follow in the S&P/Case-Shiller Index dropped about 35 percent after the housing bubble burst and they've recovered about half of that. Some cities have recovered almost everything – and more. Others have recovered very little.

Some cities may not see their old highs for another 10 or 15 years. But nationally speaking, we were down about a third and we're still down by about one-fifth compared with the prior highs.

OUTLOOK: Which regions and cities are doing well and which ones are still struggling? And how are the regions that were hit particularly hard by the crisis – such as California, Arizona, Nevada and Florida – doing now?

DB: California is going gangbusters. The S&P/Case-Shiller Home Price Indices cover San Francisco, Los Angeles and San Diego, the three major cities. San Francisco is especially strong and had a 3 percent month-over-month increase from April to May and a 24.5 percent year-over-year increase in home prices. Las Vegas and Phoenix followed fairly closely behind with 23.3 percent and 20.6 percent year-over-year increases, respectively. Dallas and Denver reached record levels in the S&P/Case-Shiller Index for May, surpassing their pre-financial crisis peaks in June 2007 and August 2006. This is the first time any city has made a new all-time high since the crisis.

MAJOR U.S. HOUSING MARKETS

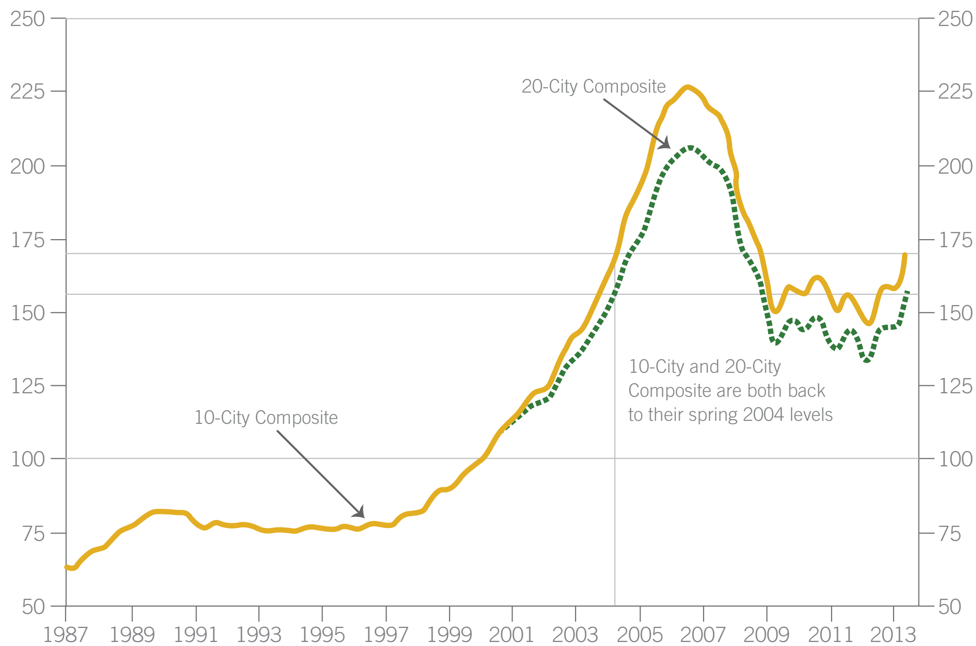
The table below summarizes the results for June 2013. The S&P/Case-Shiller Home Price Indices are revised for the 24 prior months, based on the receipt of additional source data.

METROPOLITAN AREA	JUNE 2013 LEVEL	JUNE/MAY CHANGE	MAY/APRIL CHANGE	1-YEAR CHANGE
Atlanta	109.15	3.4%	3.4%	19.0%
Boston	164.75	1.7%	1.8%	6.7%
Charlotte	123.41	1.3%	1.2%	7.8%
Chicago	121.81	3.3%	3.7%	7.3%
Cleveland	105.35	1.9%	1.5%	3.5%
Dallas	129.78	1.7%	2.0%	8.0%
Denver	143.37	1.7%	2.0%	9.4%
Detroit	87.41	1.7%	3.8%	16.4%
Las Vegas	117.29	2.8%	2.7%	24.9%
Los Angeles	202.10	2.3%	2.6%	19.9%
Miami	167.10	2.1%	2.6%	14.8%
Minneapolis	132.47	2.3%	2.1%	11.5%
New York	168.65	2.1%	1.6%	3.3%
Phoenix	137.36	1.8%	1.9%	19.8%
Portland	154.80	1.9%	2.2%	11.8%
San Diego	184.57	2.8%	3.1%	19.3%
San Francisco	173.01	2.7%	4.3%	24.5%
Seattle	156.46	1.8%	3.1%	11.8%
Tampa	147.69	2.1%	1.8%	11.1%
Washington, D.C.	200.09	1.0%	2.0%	5.7%
Composite-10	173.37	2.2%	2.5%	11.9%
Composite-20	159.54	2.2%	2.5%	12.1%

Source: S&P Dow Jones Indices and CoreLogic

AN INCOMPLETE RECOVERY

As of May 2013, average home prices across the United States are back to their spring 2004 levels. Measured from their June-July 2006, peaks, however, the peak-to-current decline for both composites is approximately 24-25 percent.



Source: S&P Dow Jones Indices & CoreLogic

On the eastern end of the sunbelt, Florida is in middle of the pack. They are not keeping up with Las Vegas and Phoenix, although they are recovering.

The weakest part of the country is the Northeast. Over the 12 months ended with May 2013, New York had a 3.3 percent increase, Cleveland was up 3.4 percent and Washington, D.C. was up 6.5 percent. Detroit is one of the weakest cities, but that is a combination of past issues with the automobile industry and recent developments.

OUTLOOK: Tell us about existing home sales versus new homes sales.

DB: Among single-family homes, the market for existing houses has recovered much better than the market for new homes. In the first quarter of this year, there were 4.6 million existing single-family home sales versus 476,000 new single-family home sales.

This is a big issue for the economy because home resales do very little for the GDP. Real estate brokers make some money and that goes into GDP, but it doesn't do much to boost GDP at all. New homes sales and the jobs they create are what feed the GDP from the housing perspective.

Ramping up new home sales requires ramping up residential construction as well as having a lot of interested and willing buyers. It is a two-step process. Looking at existing homes, there are willing buyers and a lot of potential sellers were waiting for a long time to see prices improve. With prices rising, there is more available supply among existing homes.

OUTLOOK: Do you expect new home sales to come back in a significant way?

DB: Yes, I think they will, but gradually. The rule of thumb is that we should build 1.25 to 1.5 million new homes each year for new families to make up for areas that are not growing or for homes that are lost because fire or flood or are just too old to refurbish.

New housing starts nationally are at about 1 million so we're still a bit short right now. During the crisis and the intervening years from 2009–2011, they got down to about 600,000, so we haven't filled that backlog yet.

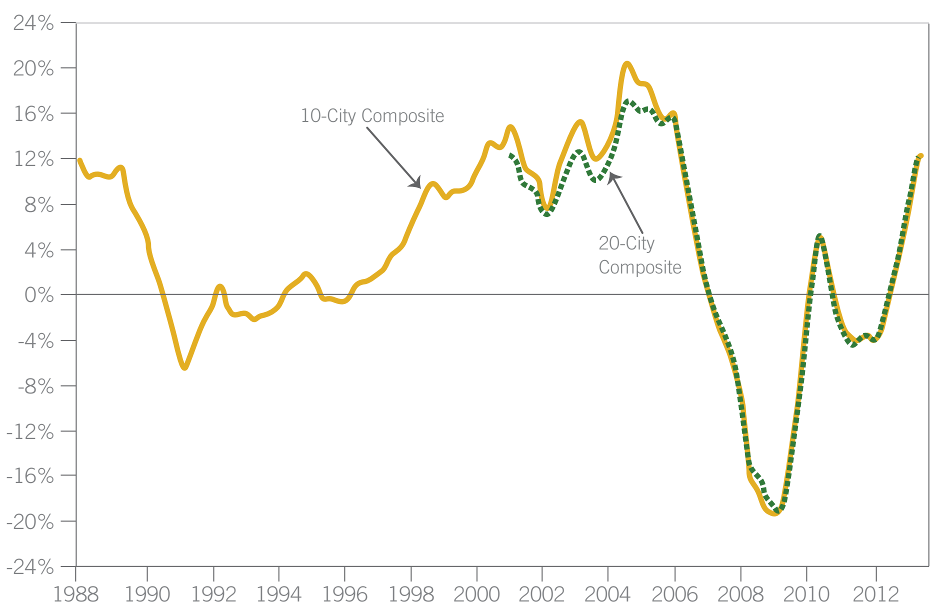
OUTLOOK: From the perspective of price, which portions of the housing market are the most active – low, middle, high?

DB: From the beginning of our indices in 1987 until about 2005, the respective indices for low-, mid- and high-priced homes moved up very closely together. Around 2005, they began to spread apart with low-priced homes having the biggest percentage increase. Then it all collapsed and low-priced homes had the biggest percentage decrease in price. That reflects the high concentration of exotic mortgages and corresponding foreclosures in this segment.

Now they're coming back together, which suggests to me that the trend is a little more normal. Second, there is activity across all three price categories, but the low-priced segment has probably the weakest amount of activity.

RISING HOME VALUES

The chart below depicts the annual returns of the 10-City Composite and the 20-City Composite Home Price Indices. In May 2013, the 10- and 20-City Composites posted annual increases of 11.8 percent and 12.2 percent, respectively.



Source: S&P Dow Jones Indices & CoreLogic

> At the depth of the financial crisis, the entire state of Nevada was underwater. The amount borrowed exceeded the total value of the homes in the state. It was an absurd state of affairs.

OUTLOOK: Has the recent rise in prices dramatically affected the numbers of homeowners who are underwater on their mortgages?

DB: Yes, there is gradual improvement. It's better than it was a year ago because prices are up substantially.

Nationally, average home prices are about where they were in about 2004, maybe 2005. Chances are reasonably good that houses purchased in the 2005 or 2006 timeframe are still underwater. That's because prices were so dramatically inflated and mortgages as a percent of purchase price were extremely high – probably 85 percent plus.

Still, things are significantly better than they were. At the depth of the crisis, there was one point at which the entire state of Nevada was underwater. The amount borrowed exceeded the total value of the homes that were in the state. That's the most dramatic example of underwater mortgages I can think of – it was an absurd state of affairs.

OUTLOOK: Let's talk about credit. In the two or so years after the initial crisis, banks tightened their lending criteria. Has that changed? Are credit requirements stricter than they were before the crisis?

DB: It is still harder to get mortgage money now than it was in 2006, but it has loosened up somewhat. According to the Fed's quarterly survey of lending standards, banks have become a bit more generous and have reduced some of their lending standards so that has been an improvement. Still, I don't think anybody's buying a house with a 95 percent mortgage and 5 percent down. Certainly, nobody's doing it with 125 percent mortgages anymore.

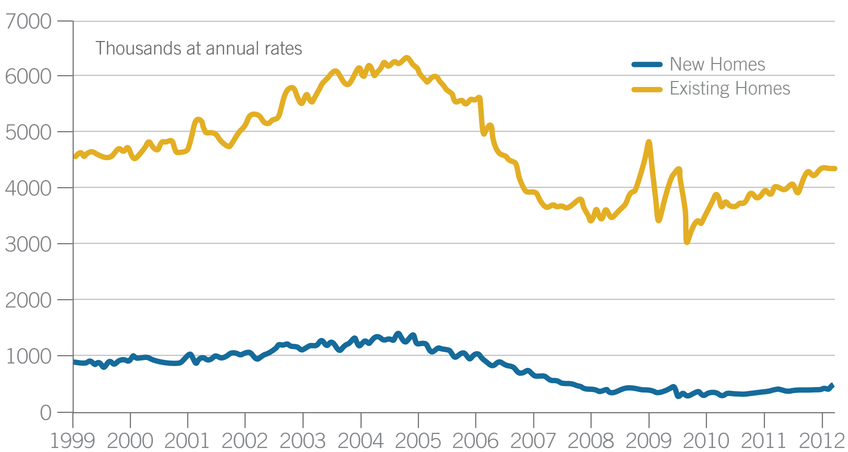
While banks will gradually become even more generous, there's an underlying question about reforming the entire mortgage finance system between Fannie Mae, Freddie Mac and their regulator, the Federal Housing Finance Agency. There's quite a bit of uncertainty there, but my sense is that the federal government will continue to favor homeownership and encourage it. That means there would be some kind of mortgage support in the system but it's hard to say exactly what it would be.

OUTLOOK: And what about demographics – particularly household incomes? Who's buying? What about age?

DB: People in the middle and upper income brackets are accounting for most of the buying. On an intuitive level, people who are employed are more likely to buy than those who are not. And according to employment statistics, the worst hit are people in their 20s and their 30s, so that segment is not doing a lot of home buying. Home buying becomes more robust with older age groups.

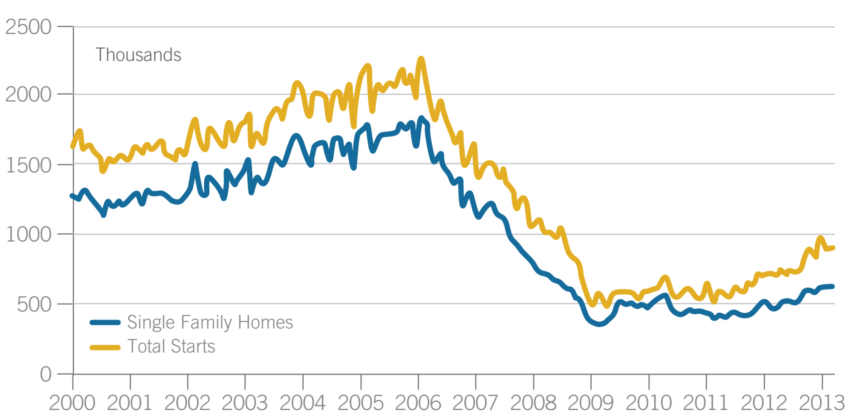
Overall, owner-occupied home ownership is down three or four percentage points from its peak in 2004. We're currently at 64 percent compared to a peak of 67–68 percent around 2004.

HOME SALES



Source: New Homes – US Bureau of the Census, Existing – National Association of Realtors.

HOUSING STARTS



Source: US Bureau of the Census

OUTLOOK: Let's look ahead. Mortgage rates have been at historic lows for quite some time and now they're creeping back up. How will rates affect home sales in the coming year or two?

DB: It will slow them down, there's no question. The one mitigating factor that has shown up in the past, and I think it will show up again here, is that people will again start to switch from fixed to adjustable rate mortgages, or ARMs, which have a lower rate at the outset of the loan. I would suspect that if mortgage rates move up over the next couple years, we'll see the percentage of ARMs in the total mortgage pool rise over time. It's never going to be all ARMs, but it will rise.

If we do go back to ARMs, hopefully they'll be of the sane variety tied to the cost of credit and not the arbitrary teaser variety that were essentially designed to go bad, which is one of the factors that created the crisis.

MORTGAGE RATES

As of August 23, 2013, the 30-year fixed mortgage rate stood at 4.58 percent, compared to 4.40 percent the previous week and 3.62 percent the previous year. The long-term average is 8.63 percent.

Source: www.bankrate.com

OUTLOOK: Will this new housing "boom" go bust anytime soon?

DB: Some recent indicators suggest that while we will continue to recover, the rate of improvement may ease back a bit. Housing will continue to improve for the next few years but we're not going to get the 20 percent year-over-year price jumps that we've seen in some spots. The economy may be growing, but it is not surging ahead. Recently it was reported that the median income remains below its 2007 peak. Without much faster economic growth, we couldn't sustain large and continuing home price increases – the pool of potential buyers would shrink. Remember that the housing boom peak was a period of strong economic growth after the weak 2001 recession.

OUTLOOK: What is the effect of the housing market on the overall economy? If the housing market were to slow considerably would there be a significant economic downturn?

DB: Housing is actually a very small portion of the economy. What we spend on building new houses each year comprises only 3 percent to 6 percent of the Gross Domestic Product, depending on the level of activity. However, because it's tied to interest rates, it's one of the more volatile segments of the economy.

In a boom, housing can add a full percentage point to GDP with no problem. Since the GDP's long-term growth rate is about 3 percent a year, that's an extra percentage point of growth. Or, it can also take away a third of the growth very quickly. So in terms of speeding up or slowing down things, housing can have a big impact.

It also has an outsize effect on peoples' opinions of what's going on. For most people who own a house, it's the largest single asset they own. If the value decreases by 20 percent, they're probably going to feel like they're broke. If the value increases by 20 percent, they might feel like Bill Gates. Clearly, they're neither broke nor as rich as Bill Gates, but it's the feeling that makes a difference in many cases. So it does have a big impact on the way people behave and if they're willing to spend money.

Interest Rates and Economic Indicators

The interest rate and economic data on this page were updated as of 7/31/13. 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	
2013	**GDP**	**CPI**	**Funds**	**2-year**	**10-year**
Q3	2.30%	2.10%	0.10%	0.35%	2.45%
Q4	2.70%	1.90%	0.12%	0.47%	2.63%
2014	**GDP**	**CPI**	**Funds**	**2-year**	**10-year**
Q1	2.70%	1.90%	0.15%	0.57%	2.79%
Q2	2.80%	2.00%	0.18%	0.70%	2.91%
Q3	2.80%	2.20%	0.24%	0.82%	3.03%

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	0.27%	0.33%	0.81%	1.62%	2.26%	2.85%
0.25	0.32%	0.40%	0.96%	1.79%	2.40%	2.96%
0.50	0.35%	0.46%	1.14%	1.96%	2.54%	3.07%
0.75	0.43%	0.55%	1.31%	2.13%	2.68%	3.18%
1.00	0.49%	0.65%	1.51%	2.32%	2.83%	3.29%
1.50	0.68%	0.97%	1.95%	2.67%	3.11%	3.51%
2.00	1.05%	1.44%	2.40%	3.02%	3.37%	3.73%
2.50	1.60%	1.96%	2.81%	3.32%	3.61%	3.91%
3.00	2.15%	2.48%	3.22%	3.62%	3.86%	4.08%
4.00	3.07%	3.34%	3.78%	4.03%	4.20%	4.33%
5.00	3.66%	3.88%	4.14%	4.28%	4.42%	4.50%

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

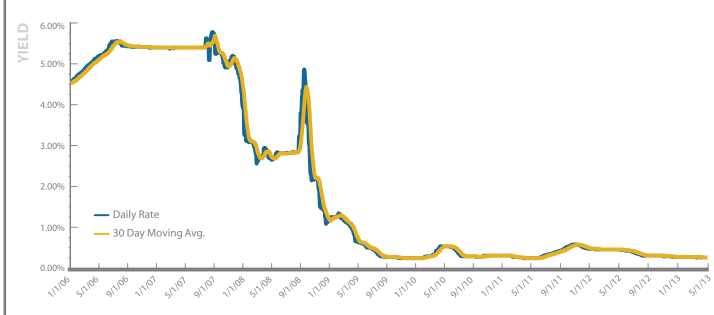
Forward Period (Days)	Average Life of Loan			
	2-yr	3-yr	5-yr	10-yr
30	6	8	9	6
90	13	21	22	14
180	23	39	42	27
365	60	85	86	53

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.

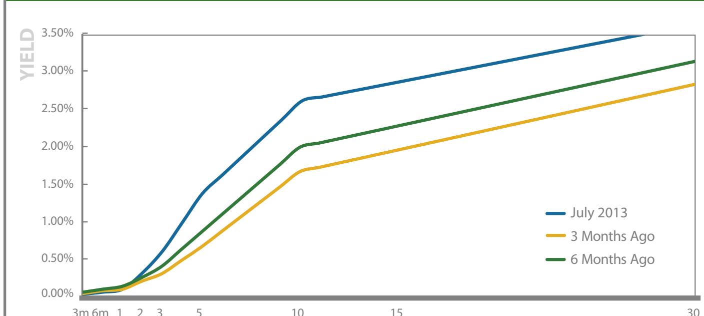
3-MONTH LIBOR



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 Reports Second Quarter Financial Results

CoBank this month announced financial results for the second quarter and first six months of 2013. Net income for the quarter decreased 16 percent to $212.0 million, from $252.4 million in the second quarter of 2012. For the first six months of 2013, net income decreased 13 percent to $420.8 million.

The 2012 results included significantly higher noninterest income due to $44.6 million in refunds from the Farm Credit System Insurance Corporation received in the second quarter of 2012. The continuing low interest rate environment and increased insurance fund premium expenses also reduced earnings in 2013.

Net interest income declined in the second quarter by 3 percent to $296.7 million, from $307.1 million in the second quarter of 2012. For the first six months of 2013, net interest income decreased 3 percent to $599.1 million. The decreases were driven primarily by the continuing low interest rate environment, which has impacted the bank's returns on invested capital, its balance sheet positioning and its portfolio of liquidity investment securities. These decreases, however, were partially offset by increases in average loan volume.

Average loan volume for the quarter rose 3 percent to $71.6 billion, compared to $69.4 billion in the same period last year. For the first six months of 2013, average loan volume increased 4 percent. The increases were driven by higher levels of borrowing by affiliated Farm Credit associations and rural electric customers, which more than offset a decline in lending to agribusiness cooperatives. The decrease in agribusiness lending resulted primarily from lower grain inventories at many agribusiness cooperatives around the country, which reduced demand for seasonal financing. Total loan volume at June 30, 2013 was $71.2 billion.

Robert B. Engel

"Overall, CoBank continues to perform well despite market conditions that remain challenging," said Bob Engel, CoBank's chief executive officer. "In the midst of a slow economy and increased competition, demand for credit and financial services has held steady across most of the industries we serve, and we're pleased with the overall growth we've seen in our loan portfolio. Like most banks, we are feeling the impact of low interest rates on our earnings, but we remain highly profitable and in a strong position to continue fulfilling our mission and meeting the needs of our customers."

About CoBank

CoBank is a $93 billion cooperative bank serving vital industries across rural America. The bank provides loans, leases, export financing and other financial services to agribusinesses and rural power, water and communications providers in all 50 states. The bank also provides wholesale loans and other financial services to affiliated Farm Credit associations serving farmers, ranchers and other rural borrowers in 23 states around the country.

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

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

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

Credit quality in the bank's loan portfolio remained favorable. At quarter end, 1.11 percent of the bank's loans were classified as adverse assets, compared to 1.01 percent at December 31, 2012. The bank's provision for loan losses during the second quarter of 2013 was $5.0 million, the same amount as in the second quarter of last year. Nonaccrual loans were $212.7 million, compared to $170.2 million at

December 31, 2012. The bank's allowance for credit losses totaled $624.6 million at quarter end, or 1.99 percent of non-guaranteed loans when loans to Farm Credit associations are excluded.

Capital levels at the bank remain well in excess of regulatory minimums. As of June 30, 2013, shareholders' equity totaled $6.7 billion, and the bank's permanent capital ratio was 16.9 percent, compared with the 7.0 percent minimum established by the Farm Credit Administration (FCA), the bank's independent regulator. The bank redeemed $200 million of its Series C non-cumulative perpetual preferred stock subsequent to quarter end, given its high cost relative to other recent preferred stock issuances and the bank's strong overall capital position.

David P. Burlage

"We continue to monitor the capital markets closely for additional opportunities to optimize our capital structure and cost of capital," said David P. Burlage, CoBank's chief financial officer.

At quarter end, the bank held approximately $20.7 billion in cash and investments. The bank had 200 days of liquidity at June 30, 2013, compared with the 90-day FCA minimum.

Engel noted that it's impossible to predict when the interest rate environment will return closer to historical norms. "Over the past few months, the Federal Reserve has begun talking publicly about tapering its quantitative easing program, and the reaction of the market has been volatile," Engel said. "While the Fed and other central banks have exerted considerable influence over the level of interest rates, long-term rates will ultimately be determined by market forces that policymakers do not control. Though CoBank's business results will generally benefit if rates increase, we have the financial strength and flexibility to continue delivering on our promises regardless of the monetary environment."