

The Next Fed Chair

Assessing the impact of Jerome Powell, Trump’s pick to replace Janet Yellen

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President Trump’s nomination in November of Jerome Powell to succeed Janet Yellen as Chair of the Federal Reserve’s Board of Governors seemed notable mainly for its lack of controversy. Powell, a lawyer and former investment banker and Treasury official who joined the Fed’s Board of Governors in 2012, is known as a political and economic centrist likely to maintain the moderate policies of the departing Yellen, whose final act as Fed chair was a much expected quarter-point hike in the Fed funds rate in December.

Still, Powell and the Fed face enormous tasks in continuing to normalize the economy after the extraordinary measures it took during and after the 2008 global financial crisis. These tasks include unwinding some \$4.5 trillion in government bonds that the Fed purchased to help stimulate the economy, and bringing interest rates back from historic lows—all while trying to keep the economic expansion going.

“We should expect no surprises from Governor Powell,” says Robert Eisenbeis, Ph.D., vice chairman and chief monetary economist for the Florida-based investment advisory firm Cumberland Advisors. Eisenbeis, who has held senior advisory positions at both the Federal Reserve Bank of Atlanta and the Federal Reserve Board, spoke with *Outlook* about what we can expect from Powell and the Fed in the years to come.

OUTLOOK: Do you expect Jerome Powell’s appointment as Fed chair to have much impact on the larger economy?

Robert Eisenbeis: It will have an impact. Will it be different from Janet Yellen’s impact? Probably not. He will essentially help control and direct the path of normalization back from what is presently a very accommodating policy environment. I don’t expect that path to look much different from the one Yellen has been pursuing, towards a state where you’re not overly loose, and where interest rates aren’t too low relative to the growth path for the economy.

This Month's Expert



Robert A. Eisenbeis, Ph.D. serves as vice chairman and chief monetary economist for Cumberland Advisors, an investment advisory

firm based in Sarasota, Florida. Eisenbeis was formerly executive vice-president and director of research at the Federal Reserve Bank of Atlanta, where he advised the bank's president on monetary policy for Federal Open Market Committee deliberations and was in charge of basic research and policy analysis. Previously, he served as the Wachovia Professor of Banking at the Kenan-Flagler School of Business at the University of North Carolina at Chapel Hill. He has also held senior positions at the Federal Reserve Board and FDIC.

Eisenbeis is currently is a member of the Financial Economist Roundtable and a fellow member of both the National Association of Business Economics and Wharton Financial Institutions Center. He was formerly a member of the Shadow Financial Regulatory Committee. He holds a Ph.D. and M.S. degree from the University of Wisconsin and an undergraduate degree from Brown University.

OUTLOOK: What is Powell likely to do differently from Janet Yellen?

RE: Powell comes at this position from a different perspective, in that he's not an economist. He's had a lot of experience in Washington, D.C. He's been in the hedge fund business, has been in the Treasury and has a lot of policy experience. For some people, the fact that he has a market background will be regarded as a very big positive. Others would rather see an economist in the position. We'll have to see what happens down the road.

OUTLOOK: What concerns economists about Powell?

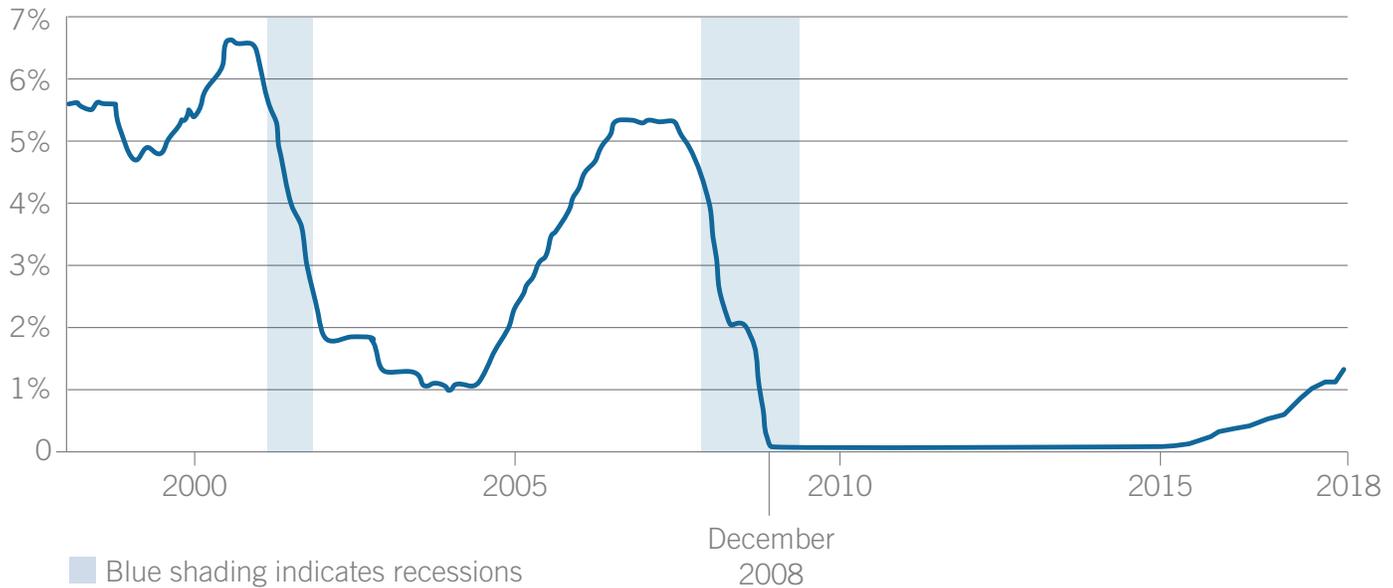
RE: One concern is that he's less likely to have an analytic framework to assess economic progress and to evaluate where things are. A non-economist is much less likely to understand the nuances of things like the DSGE [dynamic stochastic general equilibrium] models, among many others, that the Fed uses to assess the overall path of the economy and the impact of its policies. If you don't understand that, you don't necessarily have your hands on where the weaknesses and the strengths of those models are and you don't necessarily know what questions to ask. So he's less likely to have an analytic framework to assess the progress and to evaluate where things are with the economy. He is going to be dependent on staff to interpret the results, and he will have no way of second-guessing them.

OUTLOOK: Why might markets people welcome this appointment?

RE: Particularly after the financial crisis, some people felt that the Fed was behind the curve in terms of understanding how interconnected markets are. For example, leading up to the crisis, Chairman Greenspan and the Fed economists welcomed the growth of mortgage-backed securities because they increased the supply of mortgage funds. Smaller institutions could originate mortgages, sell them off and buy securities backed by lots of mortgages, diversifying their portfolios and making themselves less dependent on their local housing markets. What economists didn't understand was the interconnectedness of these institutions, the role that complex instruments such as credit default swaps would come to play and what might happen if things went wrong. The feeling is that somebody with a markets background might have better understood those forces—but of course that's all said with the benefit of hindsight.

As I understand, though, some markets people have criticized Powell because he was on the buy side rather than the sell side. He was with a hedge fund, which meant he purchased investment vehicles as opposed to constructing, issuing, marketing and selling them. Some people have said that's a weakness in his background as opposed to a strength. It doesn't matter where you've been: Somebody is not going to be happy. In the end, management style and personality often play as big a role as background.

FEDERAL FUNDS RATE 2000-2017



Source: St. Louis Fed

OUTLOOK: How so?

RE: Arthur Burns, who was chairman of the Fed from 1971 to 1978, was an economist, but he had a reputation as something of a tyrant with staff, and he was not politically independent. He was very much in tune with the Nixon administration, and essentially saw himself as conducting policy to facilitate its agenda. That's not what you want the Fed chairman to do. Paul Volcker, who served from 1979 to 1987, had less formal training as an economist, but he had a lot of independence and courage. When he saw the need to break the back of inflation, he made the courageous move to do so by knowingly seeking a recession. That was a tumultuous time, but those policies helped bring inflation down and helped make possible the long, successful run of the economy under Alan Greenspan.

When it comes to setting the tone and how things get done, the board's policy discussions are critical. Ben Bernanke, chair from 2006 to 2014, made a point of never being the first one to share his opinions. He always waited until everyone else had spoken. That may seem like a small point, but it really freed up the discussion once people weren't put in the position of agreeing or disagreeing with the chairman.

As for Powell, all I know about him is what I read. In terms of both his style and his personality, he seems to get favorable marks.



Powell comes at this position from a different perspective, in that he's not an economist. He's been in the hedge fund business, has been in the Treasury and has a lot of policy experience."

OUTLOOK: Given that Powell's views seem fairly consistent with his predecessor's, why didn't President Trump simply reappoint Yellen?

RE: Because she's a Democrat. Everybody currently on the Federal Reserve Board was appointed by President Obama. Powell was, too, but he's a long-time Republican who has been involved with previous Republican administrations.

OUTLOOK: What do you think the Trump administration hopes to see from the Fed over the next three years?

RE: The president wants to see policies that spur economic growth. The people in the administration are not going to be particularly bothered if interest rates remain low, other things being equal. A lot of their policies hinge upon getting something more than the 2.3 percent real GDP growth that most economists believe the economy is capable of right now. That objective has gained momentum given real GDP growth in the second and third quarters of this year. The consensus is that the budgets that the administration has proposed and the tax proposals it has put forward would increase the deficit. The only way you can moderate that impact is to have real GDP growth. In other words, grow your way out of the problem. That's what they need in order to succeed from a policy perspective. So, they don't want to be constrained by an overly tightened Fed.

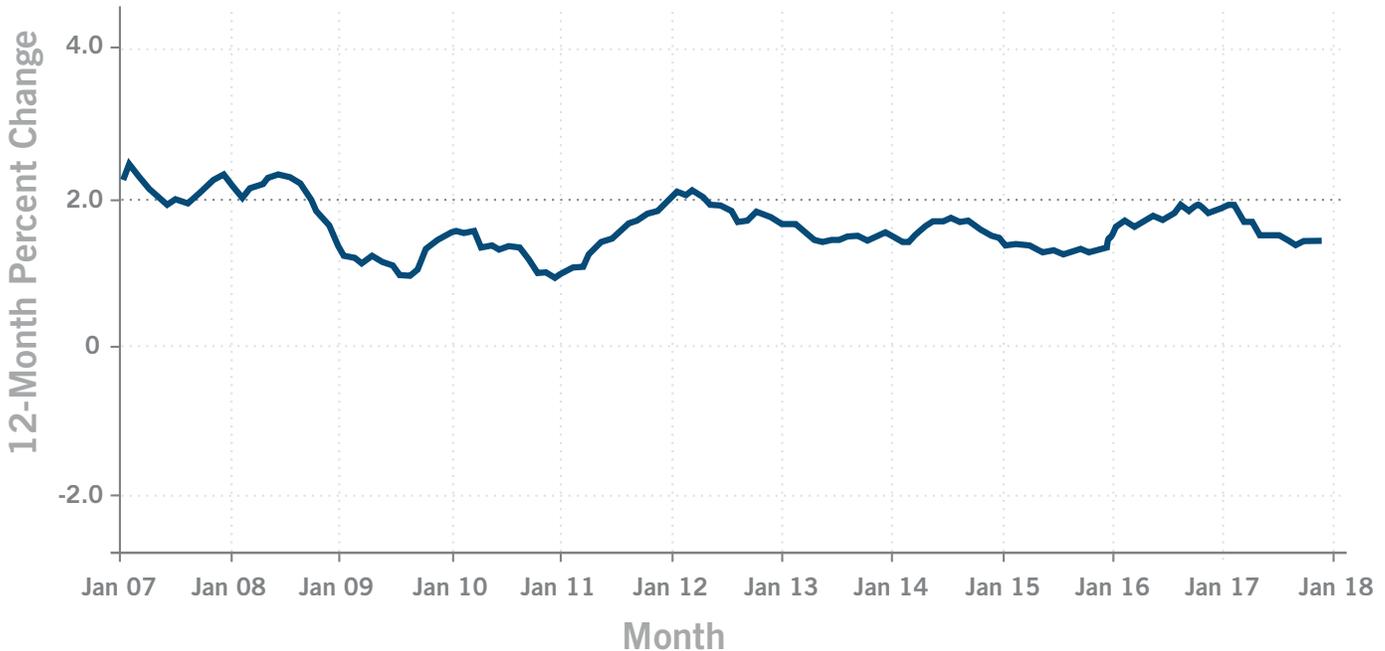
OUTLOOK: Could President Trump remove Powell from office if he doesn't approve of his actions?

RE: Technically, the president could fire the Fed Chair, but apparently only for cause. What would constitute "cause" is not clear. Since the Fed is a creature of Congress, and given the separation of powers, this is a road we don't want to travel.

OUTLOOK: Where do you think interest rates may go over the next couple of years?

RE: I think we're looking at a Fed funds rate somewhere in the vicinity of 2.5 to 2.75 percent, from its current 1.25 percent to 1.5 percent, to put the economy in equilibrium. How fast they get there depends upon what happens with inflation. If inflation doesn't pick up, interest rates will stay low for longer.

**THE FED'S PREFERRED INFLATION INDICATOR:
Personal Consumption Expenditures Price Index, 2007-2017**



Source: Bureau of Labor Statistics

OUTLOOK: Do you think that Powell is inclined to let inflation run a little hotter than it's been?

RE: The real issue is how much inflation over the target rate of 2 percent would be tolerated. I don't think at this juncture, since they've undershot for so long, there's going to be much stomach to allow inflation to creep up much over 2 percent, because then it becomes very hard to ratchet it back. I personally think a 2 percent inflation target is a misplaced objective. I see nothing wrong with the inflation situation that we have right now. The way I look at it, 2 percent inflation doubles price levels every 35 to 38 years. That, to me, is a very expensive option and a high-cost policy for the economy and for people living on fixed incomes.

OUTLOOK: How do you expect Powell to deal with unwinding the \$4.5 trillion in assets the Fed has built up in recent years, and what impact will that have on the economy?

RE: I think they've thought that through pretty carefully. They have things on a path that should enable them to unwind the balance sheet just through normal attrition without having to sell securities on the open market. Part of the reason for avoiding a sale has to do with accounting. The Fed keeps those assets on their book at par value. If interest rates go up and the



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securities drop in value, they would have to sell them at a loss, which in turn would have to be recognized on the balance sheet. But the Fed is limited in how far it can go in that direction. It has only \$40 billion worth of capital on the balance sheet right now because Congress took part of the Fed's surplus away to fund the highway bill a couple years ago.

A more far-reaching reason for avoiding a sale is the potential impact on the economy. Increasing the supply of securities in the market would put downward pressure on prices and cause interest rates to rise.

Attrition, also known as runoff, is a less disruptive process. The Fed reduces the Treasury bonds it holds by letting them mature and not reinvesting the proceeds. As the Treasury pays off the bonds, the asset side of Fed's balance sheet gradually goes down. It's purely an intra-governmental transfer of funds, so there's far less impact on markets and interest rates. But the important point is that how the Treasury responds in replacing the maturing issues will determine the interest rate impacts, and not what the Fed does.

OUTLOOK: Powell has a reputation for saying little about the economy, despite the fact that many people listen very closely to the Fed chairman's pronouncements. Do you think that will have much effect on his ability to do his job?

RE: I think his style will change. By convention, the chairman is mainly the one who speaks on monetary policy issues. The other members tend not to want to step in and take positions that are too different from what the chairman would like. That's not always been the case. There have been some very disruptive people on board from time to time. They have been very outspoken in the past. It just depends on their own personalities. More recently, particularly since Greenspan, there's been a lot more deference. Of course, the chairman is the one who testifies and represents the committee's views. I would expect Powell to become more outspoken in his new position.

OUTLOOK: What do you think Janet Yellen's legacy will ultimately be?

RE: I think she will be viewed favorably for her role in guiding the economy out of a protracted and very damaging recession. This recovery has been very long, and she has pursued policies that have been calm and patient. She's tried to be articulate in her communications, though the Fed has struggled for some time with how best to communicate. I think she'll go down as having had a very successful but incomplete career as Fed chair. ■

Interest Rates and Economic Indicators

The interest rate and economic data on this page were updated as of 11/30/17. 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	
2017	GDP	CPI	Funds	2-year	10-year
Q4	2.70%	2.80%	1.29%	1.65%	2.39%
2018	GDP	CPI	Funds	2-year	10-year
Q1	2.30%	2.20%	1.44%	1.79%	2.52%
Q2	2.40%	1.90%	1.61%	1.97%	2.64%
Q3	2.30%	2.10%	1.68%	2.13%	2.76%
Q4	2.20%	2.20%	1.79%	2.26%	2.86%

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	1.49%	1.78%	2.05%	2.05%	2.25%	2.36%
0.25	1.68%	1.89%	2.10%	2.10%	2.27%	2.37%
0.50	1.90%	1.99%	2.16%	2.16%	2.30%	2.41%
0.75	2.00%	2.08%	2.20%	2.20%	2.34%	2.44%
1.00	2.03%	2.12%	2.21%	2.21%	2.35%	2.44%
1.50	2.14%	2.18%	2.27%	2.27%	2.40%	2.49%
2.00	2.18%	2.25%	2.29%	2.29%	2.42%	2.50%
2.50	2.21%	2.28%	2.32%	2.32%	2.45%	2.52%
3.00	2.24%	2.31%	2.36%	2.36%	2.48%	2.54%
4.00	2.30%	2.35%	2.42%	2.42%	2.54%	2.58%
5.00	2.38%	2.43%	2.49%	2.49%	2.57%	2.62%

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

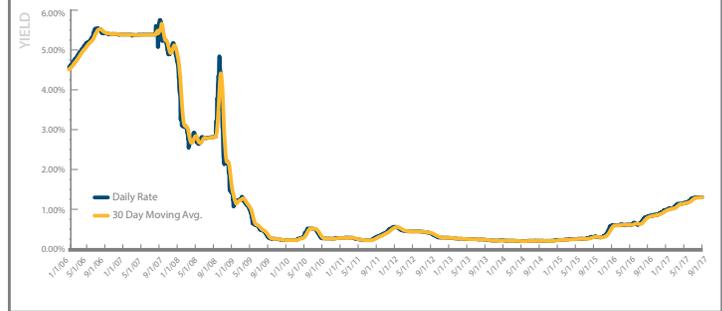
Forward Period (Days)	Average Life of Loan			
	2-yr	3-yr	5-yr	10-yr
30	5	5	5	5
90	10	10	9	7
180	16	17	15	13
365	26	28	27	23

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.

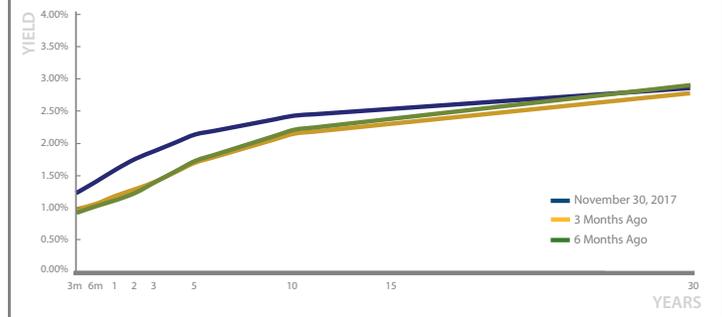
3-MONTH LIBOR



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 Third Quarter Financial Results



Tom Halverson

CoBank has announced financial results for the third quarter and first nine months of 2017. Net income for the third quarter was \$211.6 million, compared to \$231.7 million for the same period last year. The 9 percent decrease resulted primarily from balance sheet positioning activities by the bank, including an increase of \$22.8 million in losses on early extinguishments of debt net of prepayment income. For the first nine months of the year, net income increased 2 percent to \$734.2 million, primarily due to higher net interest income as well as lower provisions for loan losses and income taxes.

Net interest income for the quarter rose by 1 percent to \$338.5 million, primarily driven by higher average loan volume offset by slightly lower margins in the bank's loan portfolio. For the first nine months of the year, net interest income increased 2 percent to \$1,041.8 million. In addition to lower margins, a decrease in fair value accretion income related to CoBank's 2012 merger with U.S. AgBank also negatively impacted net interest income in both the quarter and year-to-date periods.

Average loan volume rose 4 percent in the third quarter to \$94.1 billion, from \$90.9 billion in the same period last year. For the first nine months of 2017, average loan volume rose 5 percent to \$95.8 billion. For both the quarter and year-to-date periods, loan growth was driven by increased borrowing by affiliated Farm Credit associations, agricultural cooperatives, agricultural export finance customers, rural electric cooperatives and project finance customers.

"We're pleased with our solid business performance in market conditions that continue to be challenging," said Tom Halverson, CoBank's president and chief executive officer. "Net income in the third quarter was impacted by debt extinguishment losses, as we took advantage of market opportunities to buy back debt that will reduce interest expense and benefit earnings in future periods. Overall, CoBank remains financially strong and well-positioned to serve the borrowing needs of its customers."

Net interest margin for the quarter declined to 1.09 percent from 1.11 percent in the third quarter of 2016. For the first nine months of the year, net interest margin was 1.11 percent compared to 1.15 percent in the prior-year period. The reductions in net interest margin reflected the impact of slightly lower overall loan spreads as well as lower fair value accretion income.

About CoBank

CoBank is a \$124 billion cooperative bank serving vital industries across rural America. The bank provides loans, leases, export financing and other financial services to agribusinesses and rural power, water and communications providers in all 50 states. The bank also provides wholesale loans and other financial services to affiliated Farm Credit associations serving farmers, ranchers and other rural borrowers in 23 states around the country.

CoBank is a member of the Farm Credit System, a nationwide network of banks and retail lending associations chartered to support the borrowing needs of U.S. agriculture, rural infrastructure and rural communities. Headquartered outside Denver, Colorado, CoBank serves customers from regional banking centers across the U.S. and also maintains an international representative office in Singapore.

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

CoBank Reports Third Quarter Financial Results *(continued)*

At quarter-end, 0.94 percent of CoBank's loans were classified as adverse assets, compared to 0.81 percent at December 31, 2016. Nonaccrual loans increased to \$268.2 million as of September 30, 2017, from \$207.2 million at December 31, 2016, primarily due to a limited number of loans to agribusiness customers. The bank's allowance for credit losses totaled \$699.6 million at quarter-end, or 1.50 percent of non-guaranteed loans when loans to Farm Credit associations are excluded.



David P. Burlage

"It's possible we will see additional declines in credit quality in our loan portfolio as a result of continuing low commodity prices and other stresses in the rural economy," said David P. Burlage, chief financial officer. "Overall, however, loan quality remains favorable in comparison to long-term historical averages, and we are adequately reserved against credit losses."

The bank's capital levels remained in excess of regulatory minimums. As of September 30, 2017, shareholders' equity totaled \$8.9 billion, and the bank's total capital ratio was 15.4 percent, compared with the 8.0 percent (10.5 percent inclusive of the fully phased-in capital conservation buffer) minimum established by the Farm Credit Administration (FCA), the bank's independent regulator. At quarter-end, the bank held approximately \$29.1 billion in cash, investments and overnight funds and had 171 days of liquidity, which was in excess of FCA liquidity requirements.

During the quarter, the bank announced changes to its capital plans and patronage programs for eligible customer-owners. The changes, which for most borrowers take effect in 2018 for patronage distributed in 2019, include reductions in targeted patronage levels and the creation of a separate capital plan for rural electric and water customers. The changes are designed to strengthen CoBank's long-term capacity to serve customers' borrowing needs, enhance the bank's ability to capitalize future customer growth, and ensure equitability among different customer segments.

"The modifications we are making to our capital plans and patronage programs will have a positive impact on CoBank's earnings retention in 2018 and future years," Halverson said. "We appreciate the expressions of understanding and support we have received from our customers in the wake of this decision, which will help us fulfill our mission in rural America over the long term." ■