FARMER MAC

Economic and Interest Rate Market Update

November 2017

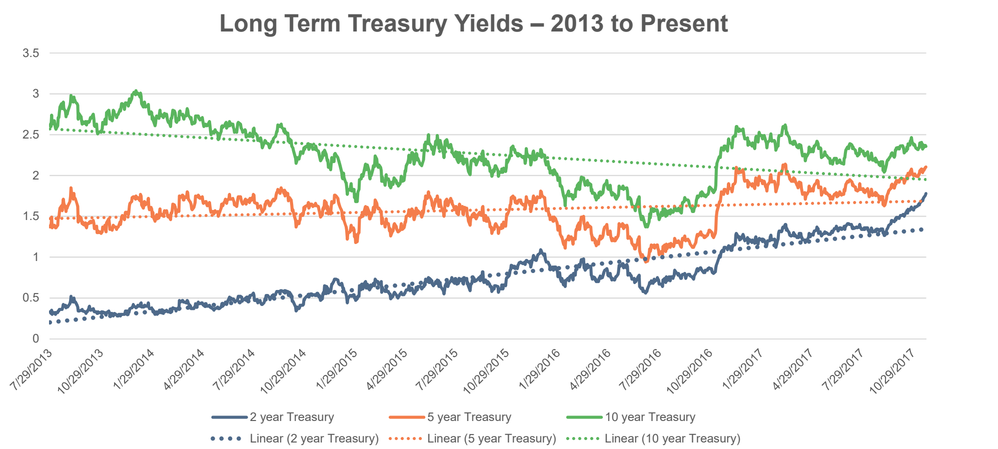
Economic & Interest Rate Environment: A flattening yield curve

Mike Schmid – Manager – Capital Markets

Economic and Interest Rate Environment

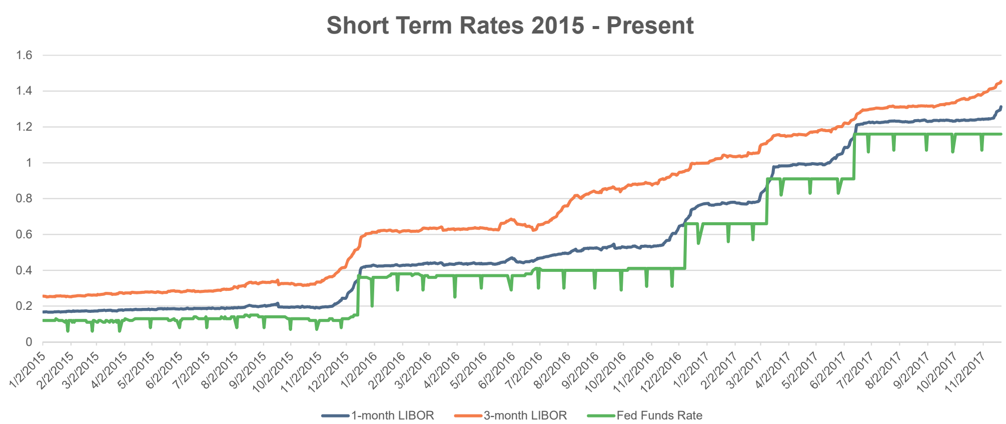
- Job growth remains steady with unemployment at 18-year low of 4.1%
- Average monthly nonfarm payroll job growth of 173,000 in 2017
  - Just below the 182,500 pace from 2016 but off 2015 pace of 226,000
  - Economy needs fewer new jobs on a monthly basis with unemployment rate so low
  - Focus for the Fed and policy makes now is to increase the Labor Force Participation rate
- Continued weak readings on inflation keeping longer term interest rates in check
  - Core Consumer Price Inflation (CPI) has fallen from 2.3% in January to 1.8% in October
  - Core Personal Consumption Expenditures (PCE) at 1.3% with the Fed's goal at 2%
- Wage growth measures also reveal weakness in wage inflation
  - Fed seeking to balance full employment with price stability, wants to see further signs of wage growth
  - Pace of further rate increases likely to ultimately depend on a pick up in wage growth and inflation

Interest Rate Environment



- Long-term rates are roughly unchanged in 2017 after increasing significantly in Q3 and Q4 2016
- 2-year Treasury rates have climbed as the Fed has continued to raise the Federal Funds rate
- Yield curve flattening is being driven by low inflation and a Fed that is determined to increase short-term interest rates to prevent the economy from overheating

Interest Rate Environment



- Short-term rates such as Fed Funds and LIBOR have all been steadily increasing since 2015, however the pace of increases has been gradual compared with other Fed hiking cycles
  - Prime Rate moved from 3.25% to 4.25% since 2015

Federal Reserve, Treasury Supply and Market Impacts

Federal Reserve, Treasury Supply & Market Impacts

- Four rate hikes since 2015 have brought the target Fed Funds range to 1.00% to 1.25%
  - Following 0.25% increases in March and June of 2017 the futures market is now projecting a 96% chance of a December rate hike in 2017 and 1.5 additional rate hikes in 2018
  - Fed projections call for three rate hikes in 2018 for a target Fed Funds range of 2.00% to 2.25%

- The Fed has announced that they will begin to taper reinvestments of their mortgage bond and treasury bond holdings
  - Maturing investments had been reinvested over the past several years
  - New policy will reinvest less of the maturing investments to bring down the portfolio size
  - Ultimate size and composition of Fed balance sheet remains unclear, likely to consist of only Treasuries
  - Could lead to higher mortgage rates relative to recent past as spreads on mortgage bonds widen

- Reduced reinvestments from the Fed's portfolio will increase Treasury debt supply to the public
  - Increased supply likely to come in the front-end of the yield curve (inside of 5-years)
  - Higher interest rates likely a result from additional supply and could cause the yield curve to flatten further
  - Additional Treasury supply from higher deficits due to tax cuts could cause interest rates to rise further

Federal Reserve, Treasury Supply & Market Impacts

- Economists are forecasting short term rates to increase roughly the same as long term rates over the next 12 months in a parallel yield curve shift
  - Economists and the Fed projecting three more rate hikes in 2018
- Market pricing via futures market implies slower rate hike pace than Fed member indications and economist forecasts
- A new Fed chairman and the potential for four new Fed governors is a wild card for how the Fed may react to below trend inflation with a strong job market
  - A more aggressive Fed hiking cycle combined with additional Treasury supply and continued weak inflation has the potential to invert the yield curve

Interest Rate Forecasts	Current	12/31/2017	06/30/2018	12/31/2018
Overnight Fed Rate	1.25%	1.50%	1.85%	2.15%
3-month LIBOR	1.48%	1.51%	1.85%	2.13%
2-year US Treasury	1.75%	1.65%	1.97%	2.26%
10-year US Treasury	2.33%	2.39%	2.64%	2.86%

Estimates pulled via Bloomberg consensus forecasts of Economists polled. Surveys include greater than 20 economists estimates however do not include the view of Farmer Mac's on staff Economist

Product and Pricing Update

Product Impact – Farm & Ranch

- Long Term Rates are modestly lower over the course of 2017, however intermediate term rates are mostly unchanged
  - Less demand for short term floating rate products (1-month ARM, AgEquity)
  - 15-year products remain very attractive relative to other products
  - 5-year ARM beginning to see more volume due to relative attractiveness on the yield curve

Product	January 2016	August 2016	January 2017	November 2017
1-month ARM, 25-year AM	1.91%	2.20%	2.46%	3.04%
5-year ARM, 25-year AM	3.56%	3.02%	3.65%	3.58%
10/1 ARM, 25-year AM	3.70%	3.28%	4.07%	4.02%
15-year Fixed, 25-year AM	4.48%	3.72%	4.39%	4.30%
15-year Reset, 30-year AM	4.51%	3.74%	4.43%	4.35%
25-year Fixed, 25-year AM	4.83%	3.93%	4.98%	4.75%

- Continued increases in the target Fed Funds rate along with additional Treasury supply will put upward rate pressure on short-term products
  - These products are much more sensitive to actions by the Federal Reserve than products with initial fixed rate periods greater than 5-years
  - Products at risk include 1-month LIBOR, 1-year ARM, 3-year ARM and 5-year ARM
  - Longer term products will see less of an impact from Fed rate hikes and Treasury supply

Product Impact – USDA

- Long Term Rates have moved lower in 2017 however remain well above the 2016 lows
  - Long term fixed rate products remain most popular, led by the 20-year and 30-year fixed rate
  - Reset products provide attractive initial pricing with flexibility of longer amortizations
  - Short Term 3-month COFI has increased over 0.50% year to date
  - 20-year Fixed remains attractively priced relative to 30-year Fixed
    - 20-year fixed has averaged approximately 49bps lower than the 30-year fixed over the last 18 months

Product	January 2016	August 2016	January 2017	November 2017
3 month COFI	1.86%	2.05%	2.24%	2.72%
5-year Reset, 30-year AM	3.07%	2.53%	3.29%	3.39%
10-year Reset, 30-year AM	3.56%	2.88%	3.87%	3.76%
15-year Reset, 30-year AM	3.90%	3.10%	4.15%	4.00%
20-year Fixed, 20-year AM	3.85%	3.04%	4.04%	3.89%
30-year Fixed, 30-year AM	4.39%	3.43%	4.55%	4.40%

Tax & Budget Deadlines
Pushback from Farm Bill

Legislation likely to be discussed early 2018

Chris Bohanon – VP – Corporate Relations

Congress faces a slew of tight deadlines in December

- What key agenda items does Congress seek to tackle before the end of the year?

Tax reform: Senate Republicans are eager to pass their tax plan, recently voted out of the Senate Finance Committee. They can only lose two GOP votes, and Sen. Ron Johnson (WI) has already said he can't support the current bill. Other GOP senators have criticized or expressed concern over the bill. If it passes, Republicans will need to reconcile the House and Senate bills.

Health care: Since their failure to repeal and replace the Affordable Care Act, Republicans have struggled to gain footing on health care. Hence, the current Senate GOP tax plan includes a provision that would repeal the ACA's individual mandate. Some Senate Republicans have criticized this, and Trump's budget chief announced earlier this month that they weren't committed to keeping the provision.

Flood insurance: The House passed a reauthorization of the National Flood Insurance Program earlier this month, but the Senate has not taken steps to do the same. They will need to work out flood insurance before Dec. 8.

Immigration: Trump announced an end to DACA earlier this year. It would not phase out until March 2018, and it was not incorporated into the spending bill. However, Democrats will push the issue, and House Republicans – in need of Democratic support to prevent a government shutdown – may need to revise their strategy.

Intelligence reforms: On Dec. 31, Section 702 – a provision authorizing the NSA's warrantless surveillance program – will expire if not reauthorized. It faces opposition from privacy advocates in Congress, and two committees have advanced their own versions.

Funding: Government funding expires on Dec. 8. Speaker Paul Ryan (R-WI) has suggested a resolution to extend this deadline but still seeks to pass a full 2018 funding bill by the end of December. To complicate matters, current spending is higher than caps set in 2011; if these caps aren't raised, automatic spending cuts will be triggered in January.

Congress faces a slew of tight deadlines in December

- Key deadlines in December

Nov. 27
Congress returns from Thanksgiving recess

Nov. 28
GOP and Dem. Congressional leaders will meet Trump for summit

Dec. 8
Budget must pass by Dec. 8 to avoid gov't shut-down; Congress must also reauthorize National Flood Insurance Plan

Dec. 12
Ala. special election to replace Jeff Sessions in the Senate; could leave Senate GOP with only a one-seat majority

Dec. 31
NSA's warrantless surveillance program will expire if not renewed

Dec. 31
GOP in Congress seek to pass a FY 2018 funding bill by Christmas

First Issue to Resolve: Reconciling the House and Senate Tax Reform Bills

- Major individual tax provisions

Current law	House bill	Senate bill
Income tax Seven individual tax rates: 10%, 15%, 25%, 28%, 33%, 35% and 39.6%	Reduces to **four brackets: 12%, 25%, 35% and 39.6%**	**Keeps seven brackets:** 10%, 12%, 22%, 24%, 32%, 35%, 38.5%
Standard deduction $6,350 for single filers and $12,700 for married couples	**Raises** to $12,000 for single filers, $24,000 for married couples	**Raises** to $12,000 for single filers, $24,000 for married couples
State and local taxes Taxpayers can deduct both state and local income and property taxes	**Keeps state and local property tax deduction** (capped at $10,000), **eliminates deduction for income taxes**	**Fully eliminates** state and local income and property tax deduction
Estate tax Top rate of 40%, with exemptions of up to $5.49 million for an individual and $10.98 million for a married couple	**Doubles exemption** to $11 million for an individual and $22 million for a married couple, **repeals estate tax in 2025**	**Doubles exemption** to $11 million for an individual and $22 million for a married couple**, no repeal**

The 2018 Farm Bill Timeline

- Recent key developments and past legislative actions

October 9, 2017:
Farm Bill listening session: House Ag Committee listened to farmers in the major dairy and apple state of NY and is launching a weekly video series "highlighting the importance of a strong farm bill for all Americans."

October 11-15, 2017:
Fourth round of NAFTA negotiations: The fourth round of negotiations, held in Arlington, ended with progress made in non-contentious areas, but US proposals to include a sunset clause and stricter rules-of-origin cast doubt over their future success. Little word came out of the negotiations about opening seasonal agricultural products to the NAFTA dispute-resolution system.

October 26, 2017:
House and Senate pass FY2018 budgets: The budget mostly maintains baseline funding for Farm Bill programs, forgoing the major cuts requested by the White House. The final budget did not include a provision for cottonseed to be labeled as an "other oilseed." It also did not include reconciliation instructions for the Farm Bill, so 60 votes will be needed to pass it.

2014	February 2017	Feb-April 2017	Feb / May 2017
Farm Bill passes two years late: Contention around cutting funds for SNAP and removing direct payments to farmers, among other issues, delayed the legislation	*Hearing: "Setting the Stage for the Next Farm Bill"* House Committee on Agriculture, chaired by Rep. Mike Conaway (R-TX11), listened to testimony by UDSA's chief economist and academics	House Ag Subcommittees held hearings on conservation policy, rural development and energy programs, specialty crops, livestock and dairy issues, commodity markets, SNAP and the Farm Credit System	Senate Ag Committee held hearings in Chairman Roberts' home state of Kansas and Ranking Member Stabenow's home state of Michigan

The 2018 Farm Bill Timeline

- Potential actions

- The current Farm Bill **expires** in September 2018
- Leaders of both the House and Senate agriculture committees have expressed dedication to **maintaining a unified bill with nutrition and farm programs**
- Free market and environmentalist groups may team up to **oppose maintaining commodity supports**
- A depressed commodity market will likely produce support across the aisle for **maintaining crop insurance programs**
- **OMB Director Mulvaney** voted against the 2014 bill and may try to influence the president to call for more stringent cuts to crop insurance and SNAP
- There have been multiple versions of the bill sent by the House Agriculture Committee to the **CBO for cost scores**
- Rep. Mike Conway (R-TX), chairman of the House committee, told reporters that the Farm Bill is likely to advance through his committee in **January or February 2018**, and the bill should get to the floor by early spring

Thank You!

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