



Higher Interest Rates Are on the Horizon

BORROWERS CAN TAKE IMMEDIATE STEPS TO FEND OFF RISKS FROM RISING RATES

AgriThought

AgriBank provides financial solutions to meet the needs of production agriculture in America's heartland. We feature our research and analysis in AgriBank Insights as part of our AgriThought initiative to help inform the financial decisions among those we serve.

Contents

2 *Interest rates past, present and future*

5 *Interest rate risk solutions*

6 *For more information*

Since the Great Recession of 2008-2009, farmers, ranchers, agribusinesses, rural homeowners and other borrowers have enjoyed record-low interest rates for their short- and longer-term debt. The Federal Funds ("Fed Funds") rate, a benchmark for short-term interest rates in the U.S. economy, has effectively been zero since early 2009. However, with the economy slowly improving, the risk of higher interest rates is rising as the Federal Reserve ("the Fed") contemplates "tightening" monetary policy. Now is the time for borrowers to understand and minimize the potential effect of rising interest rates on their operations.

Highlights

- **INTEREST RATES: RECORD LOWS LIKELY TO RISE.** The U.S. economy has been slow to recover from the Great Recession. The Federal Open Market Committee (FOMC), the Federal Reserve committee that makes key decisions about interest rates and the growth of the U.S. money supply, has left the Fed Funds rate near zero while waiting for the overall economy and the labor and housing markets to improve. The consensus among economists and market participants is for the Fed to begin raising interest rates by the middle of 2015 or early 2016. This would follow the Fed's decision in October 2014 to end its \$3 trillion bond-buying program, which it had been using to stimulate the economy.
- **FIXED RATES: AN OPPORTUNITY TO LOCK IN LOW RATES.** Most producers who borrow money for operating expenses have revolving lines of credit or loans with variable interest rates. With the growing prospect that rates will rise in the next year or so, these borrowers should analyze the impact of rising interest rates on their operations and determine if a portion of their debt should be financed with prepayable fixed rate debt to reduce interest rate risk. This may involve locking in today's interest rates by converting variable rate debt into fixed rate debt, or by financing new equipment or land purchases at today's fixed rates.
- **CASH MANAGEMENT: MORE SAVINGS OPPORTUNITIES.** A revolving line of credit combined with cash management solutions may offer additional ways to save on interest payments — and even earn interest.

Interest Rates Forecast to Rise as Economic Indicators Improve

Interest rates have stayed low since the end of the Great Recession in 2009. Whether fixed or variable, low interest rates have been financially beneficial for producers who rely on lines of credit to finance their operations, or who have invested in new equipment, facilities or land with longer-term loans. However, as the economy continues to improve, interest rates are likely to rise.

Fed Funds rate: a harbinger of interest rates

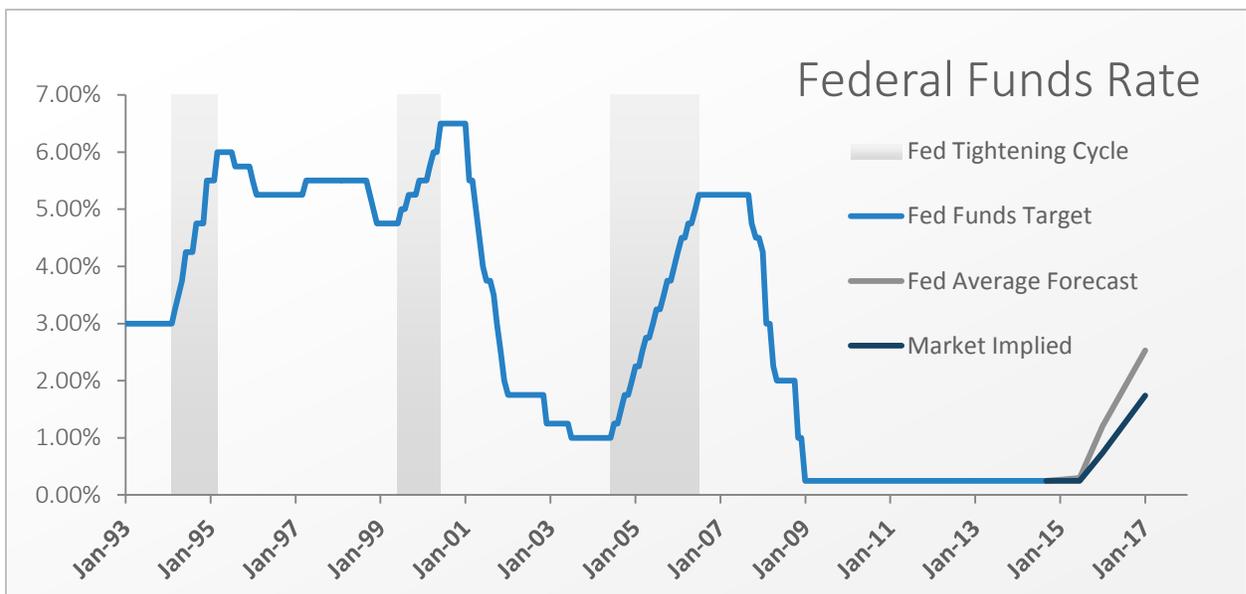
The Fed Funds rate is the short-term interest rate set by the Fed and upon which other short-term U.S. interest rates are based. The FOMC has left the Fed Funds rate at zero since early 2009. Why?

The FOMC has been concerned about the persistently low inflation rate below its 2 percent target level, combined with its assessment of significant slack remaining in the labor force. Low interest rates were intended to encourage economic activity and remove the slack from the labor force, while keeping inflation from falling too far or turning into deflation. Deflation, or falling prices, is harmful to the economy, because it leads businesses and consumer to postpone purchases. The FOMC has also expressed concern over the tepid

recovery of the housing market, which produced a surge in foreclosures and short sales. The FOMC responded to this concern by using Fed purchases of mortgage-backed securities and Treasuries to lower longer-term yields to boost home sales and prices.

No one knows exactly when the Fed will raise interest rates. Once it does begin to raise the Fed Funds rate, then normally a series of rate increases follows to keep inflation in check. The Federal Funds Rate chart shows the previous tightening cycles when the Fed raised interest rates (see page 3). The chart clearly illustrates that short-term interest rates are likely to move higher from their current levels. If inflation remains close to the Fed's 2 percent target, then it's likely the Fed would raise rates more slowly than in previous cycles. However, if inflation increases faster than the FOMC expects, then the Fed would likely respond by faster and more aggressive interest rate increases such as occurred in 1994.





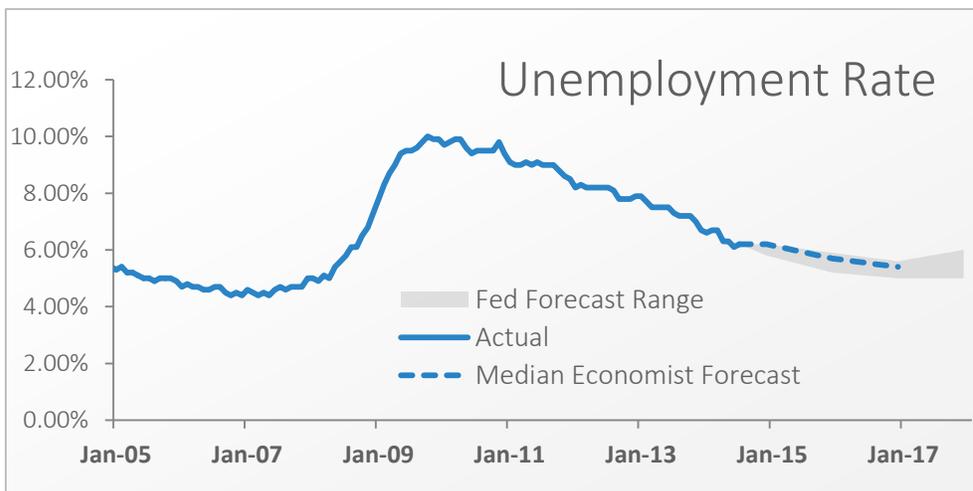
Source: www.federalreserve.gov

Key interest factors: unemployment and inflation

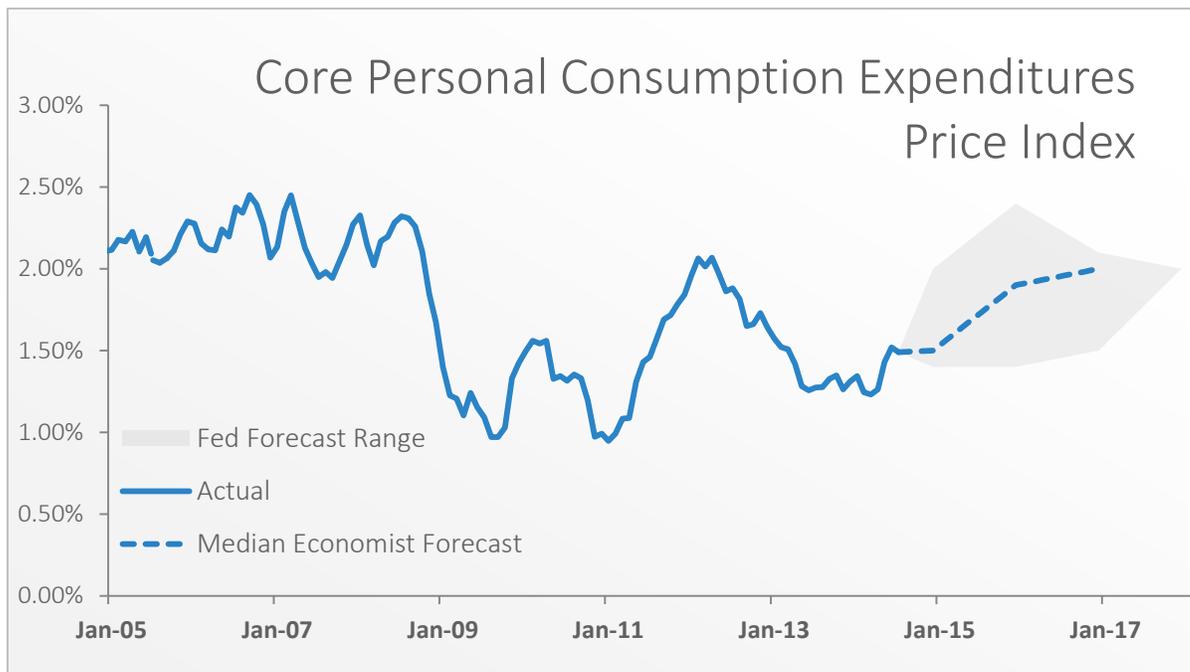
The FOMC has said it is committed to keeping interest rates low until unemployment falls below 6 percent and inflation reaches its 2 percent long-term target. However, now that the unemployment rate has reached 5.9 percent (see Unemployment Rate chart), the FOMC has broadened this goal to encompass a wide set of labor market indicators to ensure that the labor market is fully healed before raising interest rates. Some of these indicators currently show that slack remains in the labor force. As a result, the consensus forecast is for the Fed to wait until the middle of 2015 or later to begin raising the Fed Funds rate.

The FOMC has also expressed concern about inflation remaining below its 2 percent target [see Core Personal Consumption Expenditures (PCE) Price Index chart on page 4]. The majority of FOMC members forecast the core PCE inflation rate to rise over the next few years, which means that the FOMC will

likely consider raising interest rates as soon as its employment goals are met, provided this inflation expectation is met. More recently, the FOMC has been concerned that falling oil prices and the stronger dollar may cause inflation gauges to decline. However, the stimulative impacts of lower oil prices on the economy may negate the impact of declining oil prices on core price inflation, which is the FOMC's focus.



Sources: Bureau of Labor Statistics, Bloomberg Consensus Forecasts, and www.federalreserve.gov



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The Target Fed Funds Rate table shows the most recent consensus forecast of FOMC members. They expect short-term interest rates to rise from near zero to 2.875 percent by 2016 — and then to 3.75 percent on a longer-term basis when the U.S. economy, the labor market and inflation return to acceptable levels.

Target Fed Funds Rate

FOMC member forecasts for year-end

2014	2015	2016	LONGER TERM
.25%	1.375%	2.875%	3.75%

Released after the September 2014 FOMC meeting

In addition to driving short-term interest rates, the Federal Funds rate also usually leads to rising longer-term rates during the early stages of a Fed interest rate tightening cycle. Higher inflation expectations or above-trend economic growth could also contribute to longer-term interest rates rising further than current expectations due to apprehension from longer-term fixed income investors.



Interest Rates: Risk to Be Managed

The consensus of economists' forecasts is that the Federal Reserve will begin raising short-term interest rates in the middle of 2015 if improvements in the economy and labor market remain on track. That means interest rates on new and existing variable rate loans will rise in tandem with increases in the Fed Funds rate. It is highly likely that rates on longer-term fixed rate loans will also rise toward historical norms. As a result, borrowers should assess their exposure to rising interest rates and explore the alternatives that are available to limit this risk to a level that is well within their tolerance levels.

Fixed rates: Current level of fixed rates is very low relative to history

Longer-term fixed rates have little room to decline but significant potential to increase, as the 5-year U.S. Treasury Yield chart indicates. Borrowers should review their exposure to rising interest rates and determine whether fixed rate financing alternatives may benefit them.



Source: Bloomberg

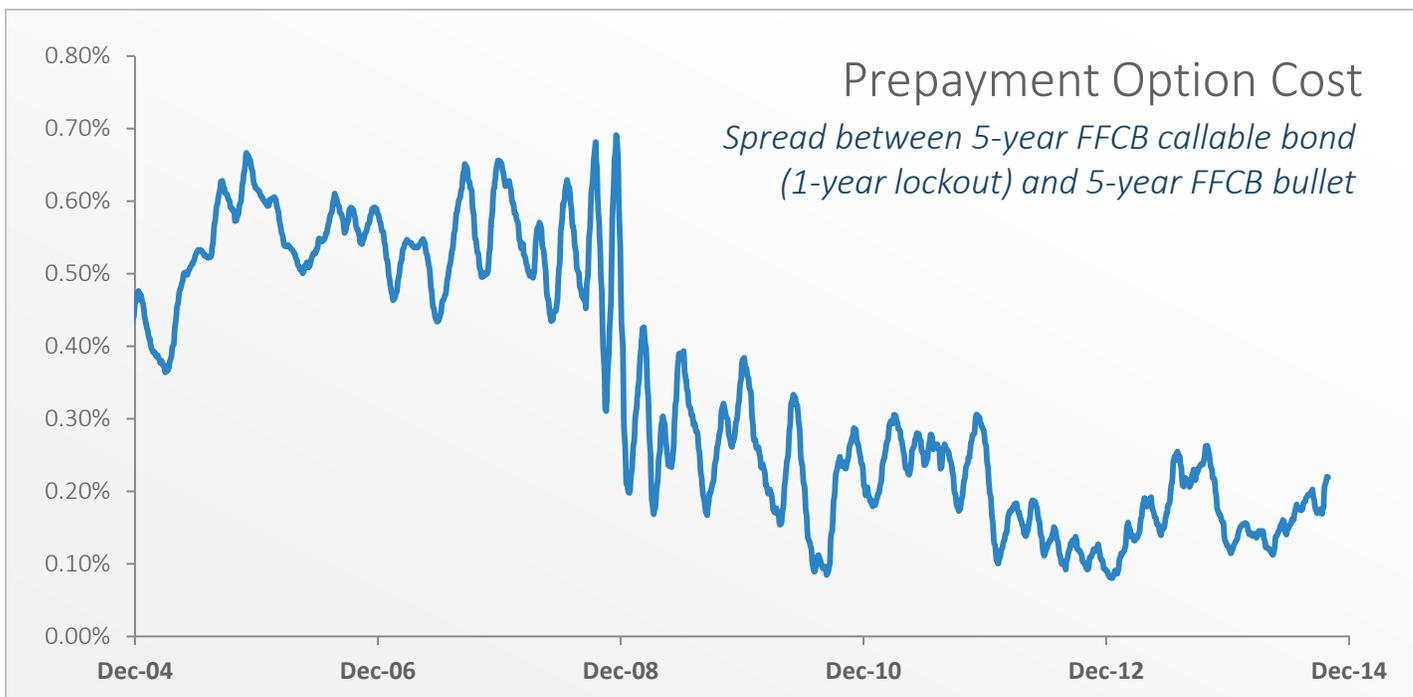


Some borrowers choose to borrow money at variable interest rates, because the initial interest rate on a variable rate loan is typically significantly lower than a fixed rate loan for the same term. The borrower accepts the risk that interest rates could rise, resulting in even higher payments at a time when the borrower may be least able to afford them. Lenders are willing to lend at variable rates, because they are easy to match fund with floating rate borrowings or short-term deposits.

In an environment such as today's — when interest rates are likely to rise — a borrower may typically benefit from locking in a low rate. The lender, therefore, faces taking the interest rate risk or needs to match fund the loan in the capital markets. Farm Credit System lenders have excellent access to the longer-term capital markets via Federal Farm Credit Banks Funding Corporation fixed rate debt issuance. As a result, they can offer a full range of fixed rate borrowing alternatives to borrowers wanting to limit interest rate risk over the term of their debt.

Although the cost of borrowing at fixed rates will initially be higher than borrowing at current variable rates, fixed rates offer several advantages, especially when interest rates are expected to rise:

- **CERTAINTY.** With fixed rate loans, borrowers know what their monthly payments will be for the full term of the borrowing. This eliminates the risk of higher debt service payments in the later years of the loan. The certainty of interest costs over the term of the borrowing may be especially welcome to agricultural producers. That's because other input costs, such as energy and fertilizer, as well as commodity prices, may move in directions that reduce profit margins by increasing operating costs or reducing revenues.
- **VALUE.** A variable interest rate loan requires less cash flow to service the debt initially than a fixed rate loan. However, if interest rates rise, a producer who locked in a fixed rate may benefit from significantly lower interest costs over the long term. This would be especially true if the FOMC is forced to raise rates more aggressively due to an unexpected or unwanted increase in inflation. Prepayable fixed rate loans through Farm Credit offer the borrower additional value, because the cost of the prepayment option is priced at a relatively low cost versus the risk due to the cost-efficient funding for these loans.
- **FLEXIBILITY.** Extending out maturities and locking the availability of borrowings for longer terms delays rollover funding risk until the loan matures. Borrowers should strongly consider prepayable fixed rate loans to reduce the risk of longer-term fixed rates falling to new lows. This could happen due to an unforeseen economic or geopolitical event, or if the FOMC is faced with inflation well below its target, or deflation. In the past, prepayable fixed rate loans have enabled many borrowers to refinance at lower fixed rates when longer-term fixed rates have declined. Furthermore, the incremental cost of financing using prepayable loans is currently very low relative to fixed rate make-whole loans (see Prepayment Option Cost chart on page 7).



Source: Federal Farm Credit Banks Funding Corporation (FFCB)

Cash management: another interest-saving solution

Obtaining a low interest rate and locking in a fixed interest rate aren't the only ways to save on borrowing costs. Cash management solutions combined with a revolving line of credit may also yield significant savings on interest and fees.

Many large farm operations have a revolving line of credit as their operating account. Some lenders offer the opportunity to combine a revolving line of credit with cash management solutions, including an account much like a liquid money market investment account that can be used to receive and make payments. Such an account may also help borrowers save on interest costs or even earn interest.

The customer can:

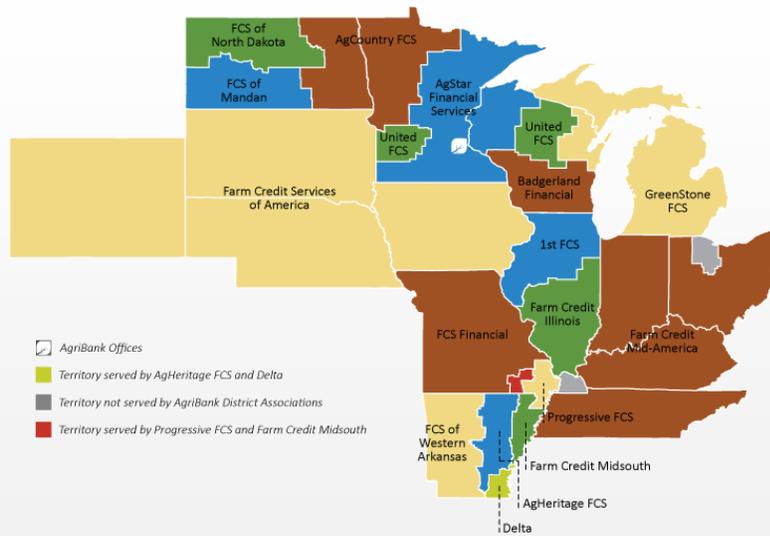
- Deliver business receipts directly to the revolving line of credit, minimizing the loan balance and related interest charges
- Use credit line drafts to pay bills, incurring interest charges only once a draft is actually processed
- Earn interest that's comparable to a three- to six-month CD — when placing more funds into an account than needed for the loan, the excess funds are automatically invested into the money market-like investment account

Yet another cost-saving opportunity: A combined revolving line of credit, cash management and money market-like investment account enables customers to keep all their banking activities at one institution. This eliminates fees for transferring funds between institutions.

For more information

Whether farmers, ranchers or other borrowers are looking to expand operations, take advantage of new opportunities or manage day-to-day operations, Farm Credit can help them access needed financing. Farm Credit offers a wide range of competitive agricultural loans — including operating, equipment, real estate and home mortgage — to help meet their operation's unique needs. Offerings include multiple interest rate options and cash management solutions that can help hold down the cost of borrowing. Find a local Farm Credit Association at www.AgriBank.com.

Associations in the AgriBank District



About AgriBank

AgriBank is one of the largest banks within the national Farm Credit System, with more than \$90 billion in total assets. Under the Farm Credit System's cooperative structure, AgriBank is owned by 17 affiliated Farm Credit Associations. The AgriBank District covers America's Midwest, a 15-state area from Wyoming to Ohio and Minnesota to Arkansas. More than half of the nation's cropland is located within the AgriBank District, providing the Bank and its Association owners with exceptional expertise in production agriculture. For more information, visit www.AgriBank.com.

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