CoBank's Financial Risk Management Publication

OUTLOOK

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View of the Marketplace:
Recovery from a Credit Meltdown
Recession Worries Beginning to Diminish

By Dr. William Griggs

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To determine how the economy can be expected to perform this year it will be necessary to focus attention on what has shaped it up to this point, as well as to consider how recent events may have altered the picture. The conclusion that emerges from this analysis is that the softness the economy has experienced since the middle of last year has been driven mainly by problems in the credit markets and by rising energy prices rather than by sustained, widespread cyclical weakness.

In the absence of new credit market difficulties or significant additional increases in energy prices, therefore, it is likely that the underlying cyclical forces already at work will, with significant help from monetary and fiscal policy, allow the economy to avoid a recession and establish a favorable growth platform for next year. Avoiding recession could well be a close thing and, even if a relatively positive economic outcome is achieved, the year will not be a picnic. To the contrary, 2008 will likely be a difficult year for many households and businesses.

Mortgage woes have broad impact

The turmoil in financial markets that has dominated economic and financial events for almost a year now grew out of three defining realities. The first of these was that there was essentially no regulation of the subprime mortgage market and no oversight, which might have revealed how events were altering that market's risk profile. Second, and closely related to the first, was the fact that inappropriate lending practices were widespread in the subprime mortgage market and, most particularly, in the adjustable rate sector of that market. Third, almost no one involved in the adjustable rate sector of the subprime mortgage market – lenders, borrowers, investors, regulatory authorities, the Fed and the credit rating agencies – appreciated the risks involved in being exposed to that market.

> **It is likely that the economy will avoid recession**
>
> Dr. William Griggs

The resulting turmoil engulfed not only all sectors of the mortgage market but most financial markets, both in the U.S. and abroad. As a result, many financial market participants found access to much-needed credit greatly reduced or unavailable. Not surprisingly, avoiding risk became the driver to decision making in the economy and this served to spread the softness in real growth well beyond the housing sector.

Unfortunately for many lenders, borrowers, investors and even innocent bystanders, the depth and breadth of these financial problems made it difficult or impossible to avoid being damaged to some extent. Equity markets could not avoid the whirlwind either, and all of the major stock indexes moved sharply lower, further damaging the economy.

Other pressures amplify problems

The economic impact of this financial market turmoil was accentuated by four events. The first of these was acceleration in the ongoing collapse of the residential housing market, a collapse that would ultimately send housing starts, home sales and home prices down to levels that challenged or

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ECONOMIC AND INTEREST RATE PROJECTIONS

Forecasts courtesy of Insight Economics, LAC — *U.S. Treasury Securities*

2008	GDP	CPI	Fed Funds	2-year	10-year
Q1	0.50%	4.30%	3.18%	2.00%	3.70%
Q2	-2.00%	3.40%	2.08%	1.80%	3.60%
Q3	0.50%	2.80%	1.65%	1.80%	3.60%
Q4	-1.00%	3.00%	1.50%	1.80%	3.60%
2009	**GDP**	**CPI**	**Fed Funds**	**2-year**	**10-year**
Q1	0.50%	3.00%	1.71%	1.90%	3.70%

THE PRODUCT QUOTATIONS on these pages were updated as of 4/15/08. 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.

INTEREST RATE SWAPS

Term	Mid-Market Swap Rate	Chg. from prior month
2-yrs	2.568%	0.19%
3-yrs	2.866%	0.18%
4-yrs	3.147%	0.14%
5-yrs	3.386%	0.12%

Mid-market swap indications are based on three-month LIBOR floating with semi-annual fixed payments for a AA credit-rated counterparty.

FORWARD FIXED RATES

COST OF FORWARD FUNDS

Forward Period (Days)	Average Life of Loan							
	2-yr	Chg. from prior month	3-yr	Chg. from prior month	5-yr	Chg. from prior month	10-yr	Chg. from prior month
30	2	-17%	4	-10%	4	-18%	3	-4%
90	6	-22%	13	-11%	11	-18%	8	-5%
180	12	-32%	27	-15%	22	-21%	16	-8%
365	48	-23%	63	-18%	50	-19%	35	-9%

Costs are stated in basis points per year

3-MONTH LIBOR INTEREST RATE CAPS AND FLOORS

Strike Rates	3-Month LIBOR Caps								Prime Caps							
	3.5%	Chg. from prior month	4.0%	Chg. from prior month	4.5%	Chg. from prior month	5.0%	Chg. from prior month	5.0%	Chg. from prior month	5.5%	Chg. from prior month	6.0%	Chg. from prior month	6.5%	Chg. from prior month
Term 2-yrs	65	-19%	27	-22%	22	-23%	18	-23%	118	-18%	83	-23%	63	-26%	49	-27%
3-yrs	113	-1%	89	-7%	71	-9%	58	-10%	271	-2%	211	-4%	169	-6%	137	-7%
4-yrs	218	2%	173	-2%	139	-4%	113	-6%	436	9%	348	-3%	283	-4%	231	-6%
5-yrs	336	1%	269	0%	217	-2%	177	-4%	605	3%	489	-5%	400	-7%	328	-10%

Strike Rates	3-Month LIBOR Floors								Prime Floors							
	3.0%	Chg. from prior month	3.5%	Chg. from prior month	4.0%	Chg. from prior month	4.5%	Chg. from prior month	5.5%	Chg. from prior month	6.0%	Chg. from prior month	6.5%	Chg. from prior month	7.0%	Chg. from prior month
Term 2-yrs	118	-24%	201	-16%	290	-11%	383	-8%	159	-21%	237	-14%	322	-10%	411	-7%
3-yrs	162	-23%	380	-12%	386	-13%	521	-9%	224	-25%	329	-18%	442	-14%	567	-12%
4-yrs	188	-24%	318	-17%	464	-19%	621	-10%	274	-25%	324	-35%	539	-20%	689	-13%
5-yrs	212	-25%	359	-18%	527	-19%	709	-11%	317	-25%	400	-30%	625	-20%	800	-13%

3-month LIBOR is currently 2.70875% **Prime is currently 5.25%**

Upfront premiums are stated in basis points.

Premiums for caps and floors are quoted separately. To construct an interest rate collar, simply choose your desired cap premium from the table, and subtract the desired floor premium to arrive at your collar's net cost.

Caps and collars are quoted in upfront premiums where the customer will purchase a cap and sell a floor. Swaps are quoted as all-in fixed rates. Forward fixed loan premiums are added to the customer's loan rate for the current day. For all products, please obtain firm quotations from CoBank's Treasury Division or your relationship manager. Quotations are available based on additional rate indices and payment structures.

Recovery from Meltdown

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exceeded all-time lows. The second event was the sharp rise in energy and food prices that occurred over the past year, pushing consumer prices sharply higher and adding to the strain on household budgets.

The third event, closely related to the second, was the fact that the behavior of energy prices and the dollar became intertwined. This came about because OPEC decided that, to maintain the purchasing power of its oil revenues, it would seek to increase the price of oil sufficiently to offset any significant loss of oil revenues associated with a decline in the value of the dollar. (Oil is priced in dollars.) Of course, raising the price of oil tended to put downward pressure on the dollar, which encouraged yet another rise in the price of oil. This oil/dollar cycle kept repeating, a cycle that attracted significant interest from oil price speculators.

> **"Modest positive real growth is likely"**
>
> **Dr. William Griggs**

The final item that accentuated the economic impact of the financial market turbulence was the fact that the Fed's reaction as the turmoil emerged last summer was both tardy and timid, a response that allowed the problem to gain a degree of momentum that a more timely and aggressive response might very well have prevented.

Economic improvement likely

The unhappy history outlined here set the stage for a noticeably slower rate of growth this year. Despite this, the data appear to be painting a picture for this year of subdued real growth but not recession, a conclusion supported by the improved functioning of financial markets recently and enhanced credit availability. Thus, the softness of the past six months can be expected to give way to an improving economic performance going forward. Indeed, modest positive real growth is likely in the current quarter and the pace of growth will accelerate in the second half of the year.

Considering, however, that any economic recovery will start from a rather low point, that financial markets are not yet fully healed and that energy prices are not well anchored to supply and demand realities, the real growth performance this year will be modest. Indeed, real growth is not likely to exceed 1.5 percent this year, although the view beyond is likely to be considerably better.

The improving performance anticipated for this year will be built on the underlying strength still residing in many areas of the economy, the beneficial effects of a Fed policy that is back on the right track, plus a large fiscal boost. In addition, it is worth considering that the second quarter begins with the economy fully employed – a condition rarely associated with recession.

Monetary policy will be a critical player this year, and a key consideration to keep in mind is that Fed policy works on the economy only with a lag. That lag is variable, but the consensus view seems to be that it is approximately six months. This timing is important because the Fed's first move toward ease in its policy posture occurred in September of last year, just slightly more than six months ago. In other words, the effects of Fed easing to date are probably only now beginning to significantly impact the economy, but they will continue to do so going forward.

The Fed has also recently begun to provide reserves and credit access to financial markets through other techniques, and this will likely continue even if the Fed decides to stop reducing its funds target. Indeed, the

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Fed has been very aggressive in providing these funds to the market, which has done much to calm the turbulence.

In its efforts to encourage economic recovery, the Fed is getting help from delayed tax refunds and will get more help from the fiscal stimulation package recently enacted. Additional assistance will also come from the enhanced role that Fannie Mae and Freddie Mac are now permitted to play in the mortgage market; the efforts currently underway to aid home owners facing foreclosure on their mortgages may be of some help as well.

Another, even more substantial, source of economic stimulation this year is coming from the sharp rise in the Federal budget deficit. After recording a deficit of $162 billion in 2007, the deficit this fiscal year is likely to reach around $425 billion, which includes the fiscal stimulus package noted above, estimated at about $160 billion. This leaves another $265 billion fiscal stimulation this fiscal year from the overall budget behavior of outlays and receipts. Further, this stimulation will continue into the next fiscal year. Without defending such a large Federal budget deficit, in current circumstances the timing is propitious.

Economic future looks more positive

The improvement in the economic picture will be most pronounced in the second half of this year, giving a boost to business profits and to equity markets. Important in this regard is the likelihood that, in providing earnings guidance for this year, many companies painted an excessively pessimistic picture. As this becomes clear later in the year, it should lift the mood in equity markets.

Short term interest rates will likely decline if the Fed continues its easing policy, as is widely expected, but once the Fed has indicated that its easing is at an end, these rates will stabilize. Longer term rates will likely increase moderately as the risk of recession fades and concern about energy prices continues to grow. The dollar will likely lose some more ground near term, but it has room to improve when it becomes clear the economy is doing better and that the Fed has stopped easing.

This economic commentary is for general information only and does not necessarily reflect the opinion of CoBank. The information was obtained from sources that CoBank believes to be reliable, and is not intended to provide specific advice.

CoBank Issues $500 Million in Subordinated Debt

CoBank announced in April that it successfully issued $500 million in fixed-rate subordinated notes due 2018.

The net proceeds of the offering will be used to increase regulatory capital ratios, which have been reduced as a result of the bank's exceptional growth over the last year, as well as for general corporate purposes. The debt is unsecured and subordinate to all other categories of creditors, including general creditors, and senior to all classes of shareholders. The debt bears interest at an annual rate equal to 7.875 %.

The securities were issued at a rating of "A+" from Fitch Ratings and "A" from Standard & Poor's.

"This transaction creates significant additional strength for CoBank's capital base and enhances our flexibility to meet our customers' borrowing needs at a time of tremendous growth and volatility in the industries we serve," said Robert B. Engel, president and chief executive officer of CoBank. "The ability to secure third-party capital remains an important competitive advantage for CoBank as we continue to expand the business and deliver value to our customer-owners in the market."

The issuance brings the total amount of third-party capital raised by CoBank in the last seven years to $1.5 billion. The bank issued $500 million of subordinated debt in June 2007. In June 2001, the bank issued $300 million of Series A cumulative preferred stock. An additional $200 million in Series B cumulative preferred stock was issued in November 2003.

Earlier this year, CoBank shareholders authorized the bank to issue up to $250 million in aggregate of Series C non-cumulative preferred stock in 2008 or 2009. Shareholders also approved an amendment to the bank's bylaws enabling it to increase the overall level of preferred stock from $500 million to $1 billion.

Brian Jackson, CoBank's chief financial and administrative officer, noted that the latest subordinated debt offering was significantly oversubscribed. "The robust investor interest we saw in this transaction underscores the fundamental strength of our business model and the benefits that CoBank securities offer to institutional investors," Jackson said. "We continue to manage our capital strategy carefully in order to leverage this demand on behalf of our customer-owners."

Lehman Brothers served as structuring coordinator and bookrunner on the transaction. Merrill Lynch & Co. served as joint lead manager.

IMPLIED FORWARD RATES

Years Fwd	3-month LIBOR	1-yr Swap	3-yr Swap	5-yr Swap	7-yr Swap	10-yr Swap
Today	2.71%	2.57%	2.86%	3.38%	3.75%	4.11%
0.25	2.65%	2.53%	2.94%	3.47%	3.82%	4.17%
0.50	2.42%	2.49%	3.05%	3.57%	3.91%	4.23%
0.75	2.42%	2.50%	3.19%	3.68%	4.00%	4.30%
1.00	2.51%	2.52%	3.34%	3.80%	4.10%	4.37%
1.50	2.49%	2.90%	3.63%	4.03%	4.29%	4.53%
2.00	3.18%	3.44%	3.97%	4.28%	4.49%	4.70%
2.50	3.47%	3.74%	4.19%	4.45%	4.63%	4.82%
3.00	3.78%	4.04%	4.39%	4.61%	4.76%	4.92%
4.00	4.20%	4.43%	4.68%	4.84%	4.93%	5.07%
5.00	4.48%	4.68%	4.88%	5.00%	5.10%	5.17%

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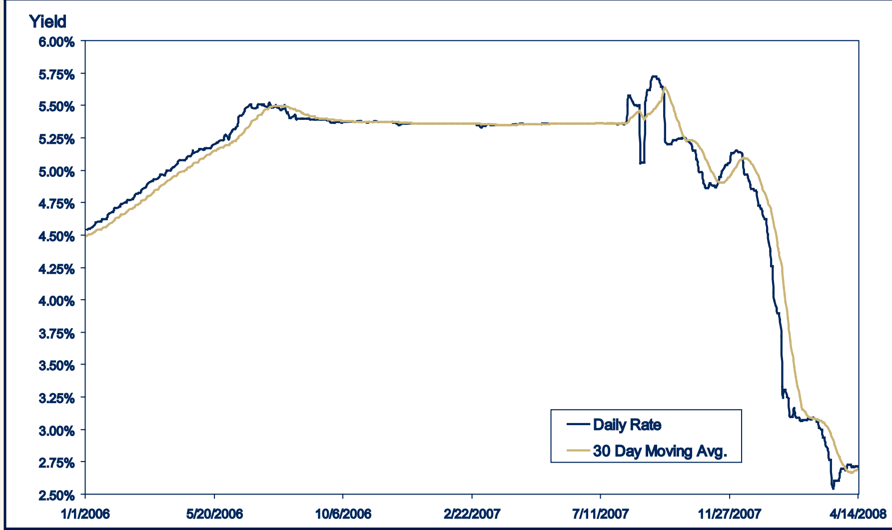
3-MONTH LIBOR — APRIL 15, 2008

Daily Rates vs. Moving Average



OUTLOOK

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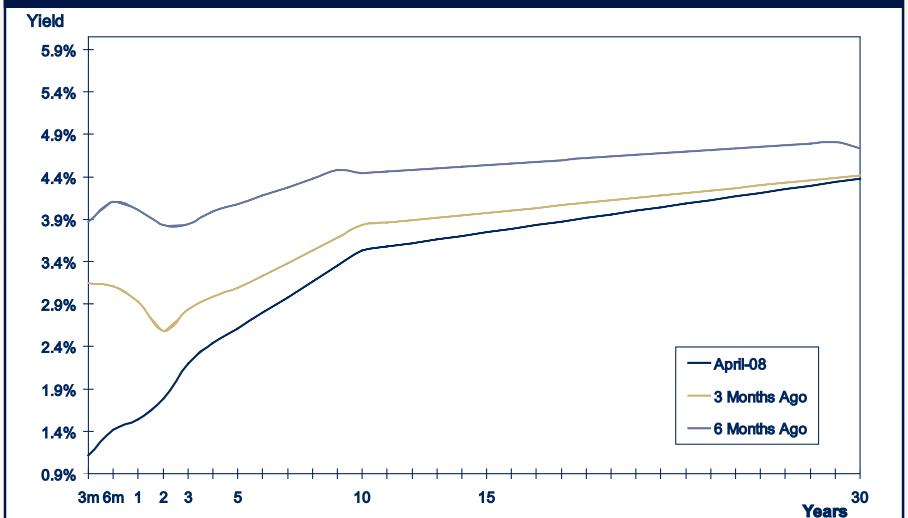
OUTLOOK is published monthly by CoBank to provide our customers with information about financial markets and risk management products as well as analysis of interest rate movement and Fed policy. Also included is a periodic insert featuring agribusiness, energy, water and communications industry groups as well as features on CoBank's non-credit services and the U.S. Farm Credit System.

TREASURY YIELD CURVE — APRIL 15, 2008



About CoBank

With $52 billion in assets, CoBank is an internationally recognized cooperative bank serving agriculture and rural America. We specialize in financing for cooperatives, agribusinesses, rural energy, water and communications companies, Farm Credit associations and agricultural exports.

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