

OUTLOOK

VOLUME 5 NUMBER 11

NOVEMBER 2008

View of the Marketplace: An Economy Shaped by Crisis

Rescue Package Aimed at Shortening Downturn

By Dr. William Griggs

Dr. Griggs is managing director of Griggs & Santow, an economic and financial consulting firm in New York City. Before coming to Wall Street, he was deputy assistant secretary for economic policy at the U.S. Treasury Department, and financial economist for the Federal Reserve Bank in Dallas. A native of Oklahoma, Dr. Griggs holds a Ph.D. from The Ohio State University.

The meltdown of the global financial markets that dominated headlines throughout the month of October may have felt like a sudden event. But the truth is that this year was destined to be difficult for the U.S. economy. Two key forces – both at work before the calendar turned to 2008 – were certain to slow real economic growth, limit credit availability and accentuate inflation.

The first of these forces is the ongoing collapse in the residential housing market, which has been underway since the middle of 2005 and which has now forced the level of home prices, home sales and housing starts down to levels not seen in years. Indeed, this freefall in housing activity, particularly in housing prices, explains in very large part the substantial and sustained slowdown in real economic growth of the last few years.

The second force was the ongoing rise in the price of oil, a rise that accelerated sharply in the spring of this year and took the per-barrel price of oil above \$140. This steady rise in oil prices added directly and substantially to the pace of inflation, although energy consumption held steady because energy goods are necessities with few substitutes.

Rising energy prices have had a significant depressing impact on real disposable income and real consumption outside the energy area. This situation was even more significant because personal income and consumption were already under downward pressure from declining employment and rising unemployment. True, the price of oil has

“Benefits of falling gasoline prices will be partly offset”

Dr. William Griggs

fallen sharply since hitting its peak in July of this year, but it nonetheless remains high by historic standards. Moreover, the benefits

associated with falling gasoline prices will be partly offset for many households by higher heating costs this winter.

Tighter credit slows GDP

Those two key trends – a faltering housing market and high energy costs – combined to form the backdrop against which the credit market meltdown has unfolded. This meltdown grew out of dramatic asset write-downs on the books of financial institutions. The assets being written down were, for the most part, subprime and other mortgages written on U.S. properties that were subsequently packaged into bond instruments and sold aggressively to investors around the world with, as is now apparent, disastrous consequences.

In the environment that subsequently emerged, the commercial paper market essentially shut down, prominent financial institutions failed, others were bailed out and still others pulled through with serious wounds. Access to credit became seriously restricted – even in cases where the association between lender and borrower had been one of long duration.

Particularly noteworthy is the fact that banks became reluctant, even unwilling, to extend credit to other banks overnight, a development that sent inter-bank lending rates sharply higher. Moreover, it pushed business and consumer confidence down to

continued on page 2

ECONOMIC AND INTEREST RATE PROJECTIONS

FORECASTS COURTESY OF INSIGHT ECONOMICS, LLC			U.S. TREASURY SECURITIES		
2008	GDP	CPI	Funds	2-year	10-year
Q2	2.80%	5.00%	2.09%	2.40%	3.90%
Q3	-0.30%	6.70%	1.94%	2.40%	3.90%
Q4	-4.50%	-2.50%	0.95%	1.60%	3.80%
2009	GDP	CPI	Funds	2-year	10-year
Q1	-2.50%	2.00%	0.67%	1.60%	3.70%
Q2	-1.00%	1.50%	0.50%	1.50%	3.60%

▶ **THE PRODUCT QUOTATIONS** on these pages were updated as of 11/06/08. 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	2.416%	-0.51%
3-yrs	2.862%	-0.37%
4-yrs	3.232%	-0.21%
5-yrs	3.504%	-0.08%

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	11	117%	12	100%	5	-9%	3	-29%
90	22	100%	28	99%	22	80%	15	69%
180	36	120%	50	112%	38	88%	26	78%
365	76	42%	103	144%	75	71%	50	77%

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	5.5%	Chg. from prior month	6.0%	Chg. from prior month	6.5%	Chg. from prior month		
Term 2-yrs	82	17%	39	2%	31	8%	25	12%	134	2%	108	8%	88	15%	72	21%
3-yrs	151	-10%	120	0%	96	1%	79	2%	263	-1%	217	95%	179	6%	149	9%
4-yrs	271	1%	218	11%	177	6%	145	6%	456	5%	383	8%	322	11%	272	14%
5-yrs	406	6%	330	10%	269	10%	221	10%	705	11%	602	15%	514	18%	440	22%

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	4.5%	Chg. from prior month	5.0%	Chg. from prior month	5.5%	Chg. from prior month	6.0%	Chg. from prior month
Term 2-yrs	175	108%	254	72%	340	36%	429	27%	141	112%	206	92%	279	56%	357	41%
3-yrs	218	74%	425	37%	437	27%	559	20%	192	119%	281	96%	380	45%	489	34%
4-yrs	240	55%	363	37%	501	18%	651	13%	217	99%	321	79%	439	38%	569	29%
5-yrs	264	40%	403	27%	562	12%	736	8%	234	73%	349	58%	480	33%	627	24%

3-month LIBOR is currently 2.50625%

Prime is currently 4.00%

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.

Economy in crisis

continued from page 1

such an extent that the shutdown of the credit markets soon replaced housing as the main roadblock to returning financial markets and the economy to health.

Given these conditions, it is no surprise that real growth has slowed significantly this year or that this slowing has broadened to impact every sector of the economy. The slowing is perhaps most readily apparent in the fact that nonfarm payrolls are currently on track to record close to 1.3 million job losses this year and the unemployment rate will end the year above 6.5 percent, up from 5.0 percent in December of 2007.

The extent to which the economy has softened did not really show up in first half real GDP growth because the second quarter benefited so much from the fiscal stimulus package passed during the quarter and implemented largely through tax rebates. The latter is apparent in the fact that real growth turned from moderately positive in the first half of the year to negative in the third quarter. Real growth will be even more negative in the fourth quarter and will remain negative in the first half of 2009.

How negative the pace of growth will be going forward and whether growth will continue to contract in the second half of next year remains to be seen.

Increasing liquidity, trust

Looking out over the next year, it is clear that the current economic and credit market picture is not favorable and that the critical player shaping the near future is the rescue plan the Fed and the Administration recently formulated. The first goal of the rescue plan has been to re-liquefy the credit market, a task that has fallen, for the most part, to the U.S. Federal Reserve. Accordingly, the Fed has poured a heavy volume of funds into the banking system, money funds and the commercial paper market. The Fed is late coming to the party, but it has been very aggressive in this lat-

"It is no surprise that growth has slowed."

est effort and the needed liquidity seems now to be in place.

While restoring liquidity was essential, that action by itself will not be sufficient to restore the credit market to health. The missing ingredient the credit market must acquire is trust – the belief that credit that is extended will be repaid. Credit markets cannot function effectively without trust and, to that end, a program to recapitalize critical financial institutions has been launched by the Bush administration. Furthermore, to deal with the risks growing out of what had become a world-wide capital market meltdown, the governments and central banks of the major industrial nations of the world, in a coordinated effort, took actions similar to those of the U.S.

The U.S. plan calls for providing capital to selected banks and possibly other institutions that need to enhance their capital and are willing to give the government a preferred stock ownership position in the firm. The plan also calls for the government to acquire non-performing loans from banks and others to encourage them to make additional loans. An effort will also be made to limit additional mortgage foreclosures.

Officials have always made it clear that changes in the program, both plan elements and procedures, might be made because of new developments. There could also be additions to the program that had not been thought of at the time it was put together. In short, the rescue plan remains a work in progress, which is why details at this point are sketchy.

continued on page 3

Economy in crisis

continued from page 2

Second fiscal stimulus program possible

Another significant issue destined to come up soon is whether a second fiscal stimulus program will be proposed and enacted. If there is another stimulus package, the hope seems to be that it will have a longer lasting impact than the first stimulus package. As laudable as this hope is, it is not easy to accomplish if one also wants the program to produce prompt results. This matter is further complicated by the issue of who will enact the stimulus – the outgoing Bush administration or the incoming administration led by Obama. It is an issue that will not go away and, unless the economic picture improves much faster than there is any reason to expect it will, it is likely that a new fiscal stimulus plan of some sort will be enacted in the next few months.

Conclusions

A number of failures combined to produce the crisis currently facing the nation and the world. The federal government failed to properly regulate financial markets, particularly in the case of their subprime mortgages. Regulators should have known that these mortgages were frequently being extended without the exercise of appropriate due diligence, adding greatly to the risk attached to these obligations. Practically everyone failed to understand how the risk profile in the mortgage and other credit markets had been changed by the lending and hedging instruments that became so prominent in the last few years. A large number of mortgage lenders failed to behave in a professional manner and a considerable number of borrowers stretched the truth to obtain mortgages they couldn't support.

The Obama administration will need to address these failures in an effort to assure that they do not happen again. As a result of this experience, financial markets and financial behavior will undoubtedly need to change moving forward.

That said, this crisis is now being addressed by the Fed and the Treasury, whose efforts are likely to be successful. Credit markets can be expected to slowly return to normal, and equity markets will recover much of the ground that was recently lost. Though they will not likely prevent the recession that is coming or that may already be here, they should pave the way for an economic recovery of consequence in 2010.

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 Reports Financial Results for First Nine Months of 2008

Net Earnings Increase 48 Percent To \$449 Million

COBANK recently announced financial results for the first nine months of 2008, reporting strong growth in loan volume, net income and regulatory capital as well as continued good overall credit quality.

Net earnings for the first nine months of the year increased 48 percent to \$449 million, compared with \$304 million for the same period in 2007. Total loans and leases outstanding for COBANK were \$43.1 billion at September 30, 2008, compared to \$40.5 billion at year-end 2007.

"We are pleased with the ongoing strength of CoBank's financial performance, which has enabled us to continue meeting the borrowing needs of our customers at a time of extraordinary dislocation in the world economy and in global financial markets," said Robert B. Engel, president and chief executive officer of COBANK.

At quarter end, approximately 97 percent of the bank's total loan and lease portfolio was classified in the highest regulatory category used to measure credit quality. "Current credit quality levels remain better than historic norms," Engel said. "As we have noted previously, we expect a moderate deterioration of credit quality in future quarters as a result of continued volatility in commodity pricing and the overall weakness in the global economy. However, we remain comfortable with the level of risk in our portfolio and continue to carefully and prudently manage our overall credit quality."

Capital levels at the bank remain well in excess of all regulatory minimums. As previously announced, the bank successfully issued \$200 million of Series C preferred stock in early July. In September, COBANK shareholders authorized the bank to issue or reissue preferred stock over the next 10 years, so long as the total amount of preferred stock outstanding does not exceed the bank's bylaw limit of \$1 billion.

"The carefully planned actions we have taken with the support of our stockholders over the last several years to strengthen and diversify our capital base have resulted in the bank having the necessary capital to serve the exceptional financing requirements of our customers over the last 18 months," said Brian P. Jackson, COBANK's chief financial and administrative officer.

Engel said that COBANK's financial strength has enabled the bank to maintain the confidence of investors and, as a result, access to the debt capital markets that the bank relies on to fund loans and serve customers.

"The strong reputation of CoBank and the Farm Credit System as a whole has proven to be an important competitive advantage in the face of recent market turmoil," Engel said. "Successfully balancing our mission to serve customers in rural America with our fiduciary duty to preserve the safety and soundness of the bank has been critically important in that regard. We're committed to standing by our customers throughout this period of extreme market volatility as well as to continued business discipline and prudent management of the bank's finances for the long-term."

IMPLIED FORWARD RATES

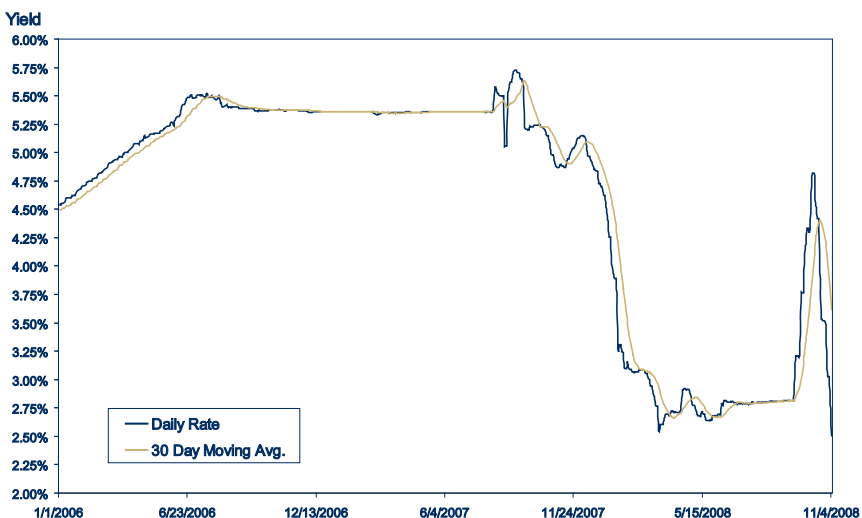
Years Fwd	3-month LIBOR	1-yr Swap	3-yr Swap	5-yr Swap	7-yr Swap	10-yr Swap
Today	2.51%	2.97%	2.87%	3.50%	3.87%	4.10%
0.25	3.12%	2.90%	3.00%	3.61%	3.95%	4.16%
0.50	3.02%	2.61%	3.09%	3.69%	4.01%	4.20%
0.75	3.09%	2.27%	3.20%	3.77%	4.07%	4.25%
1.00	2.26%	1.84%	3.32%	3.86%	4.14%	4.29%
1.50	1.68%	2.53%	3.72%	4.15%	4.33%	4.42%
2.00	3.35%	3.77%	4.28%	4.53%	4.59%	4.59%
2.50	3.83%	4.11%	4.49%	4.67%	4.69%	4.65%
3.00	4.07%	4.39%	4.65%	4.76%	4.75%	4.68%
4.00	4.44%	4.69%	4.86%	4.83%	4.81%	4.68%
5.00	4.65%	4.85%	4.91%	4.84%	4.76%	4.65%

Products and Services

- Tailored loan programs with short-, intermediate- and long-term maturities
- Letters of credit
- Cash management services
- Leasing through Farm Credit Leasing
- International banking services
- Loan participations and syndications
- Interest rate risk management services
- CoLink® online financial solutions
- Equity partnerships
- Private placements
- Tax-exempt environmental bonds

3-MONTH LIBOR Daily Rates vs. Moving Average

NOVEMBER 6, 2008



OUTLOOK

NOVEMBER 2008

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.

Editorial Board

Banking Group/Division Representatives

Agribusiness	Bob Egerton, Dean Moreau
Corporate Finance	Scott Trauth
Communications	Rob West
Energy and Water	Jake Udris
Capital Markets	Antony Bahr
Non-Credit Services	Rick Scholz
International	Manny Fernandez
Treasury	Tim Steidle, Susan Mahler

Editorial Staff

Managing Editor Karen DiVincent

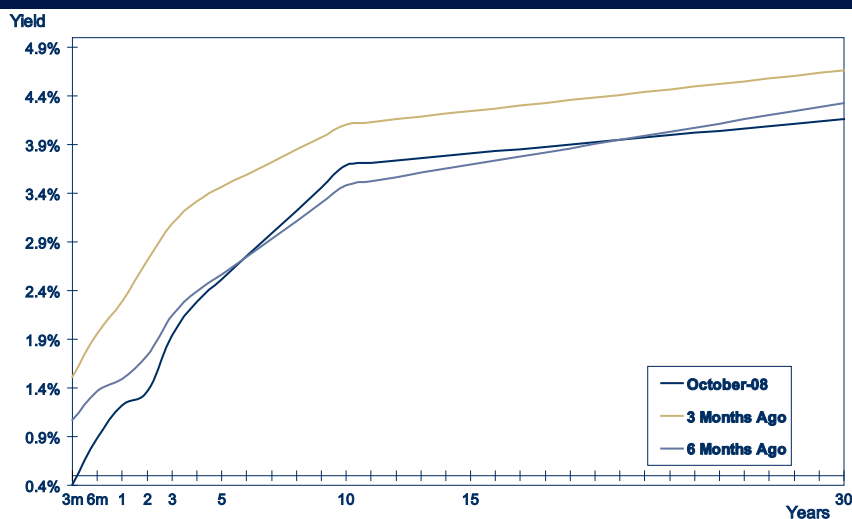
About CoBANK

With \$62 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.

1 (800) 542-8072
www.cobank.com

TREASURY YIELD CURVE

NOVEMBER 6, 2008



CoBANK
U.S. Headquarters
5500 South Quebec Street
Greenwood Village, CO 80111

Presorted
First-Class Mail
U.S. Postage Paid
Permit No. 277
Englewood, CO