

# OUTLOOK

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## View of the Marketplace: Economy Marked By Turbulence Review of Events Leading to Current Situation

By Dr. Edmond J. Seifried

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Clearly 2008 will go down as one of the most tumultuous years in U.S. economic history. Famed financial institutions have either vanished or their remnants have been absorbed by surviving institutions. The economy is poised to enter what many consider a long and tortuous economic downturn. In an effort to prevent additional economic damage, the federal government has earmarked unprecedented amounts of taxpayer funds to assist wounded industries, businesses and consumers. Amazingly, these events occurred in the relative blink of an eye.

The roots of the financial crisis that has pummeled the U.S. and battered nations across the globe are deep, wide and tangled. Complicating any analysis of recent events is the massive global deleveraging of assets that occurred just as the U.S. economy was teetering on the down slope of a normal business cycle.

### Multiple contributing factors

The blame game for the extraordinary financial meltdown has spawned a host of targets, including, to name a few: cheap money policy by the Federal Reserve Board; lax-to-negligent regulators; financial instruments such as derivatives that were designed to offset risk and make money for financial institutions, but instead multiplied and obscured risk; and uninformed or just plain greedy ratings agencies which liberally dispensed credit ratings. Others implicated were

they could afford when balloons and interest rate resets kicked into the payment equation, and federal officials imprudently pushing home loan programs to people who could not afford the cost of home ownership.

The result of this combination of factors has been a worldwide devaluing of assets initially sparked by the burst of the U.S. housing bubble. Financial fear and market turmoil ensued. That should have been no surprise for a nation that borrowed extravagantly in order to spend liberally, and for its citizens who spent more than they saved and consumed more than they produced.

Bewilderment and pain are the results of the unwinding of such injudicious actions and trends. The deleveraging of over-valued assets will mean a lower standard of living for years to come. The only heartening aspect is that most of the rest of the world will likely suffer as much or even more than the U.S.

### Timing exacerbates downturn

The financial crisis was made even worse by the timing of what might have been a normal business cycle, in which economic expansion and contraction traditionally has been triggered by consumers who reduce spending when household debt becomes burdensome. Business responds by depleting inventories which lowers production and capacity utilization. Prices drop and consumers begin spending again.

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Roots of  
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Dr. Edmond Seifried

mortgage bankers who made imprudent loans, homeowners who borrowed more than

## ECONOMIC AND INTEREST RATE PROJECTIONS

FORECASTS COURTESY OF INSIGHT ECONOMICS, LLC

U.S. TREASURY SECURITIES

| 2008 | GDP    | CPI    | Fed Funds | 2-year | 10-year |
|------|--------|--------|-----------|--------|---------|
| 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    | Fed 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%   |
| Q3   | -0.50% | 2.00%  | 0.88%     | 1.80%  | 3.50%   |

▶ **THE PRODUCT QUOTATIONS** on these pages were updated as of 11/24/08. 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               | 2.138%               | -0.28%                |
| 3-yrs               | 2.410%               | -0.45%                |
| 4-yrs               | 2.691%               | -0.54%                |
| 5-yrs               | 2.882%               | -0.62%                |

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                    | 13                   | 19%                   | 12   | -4%                   | 10   | 100%                  | 6     | 83%                   |
| 90                    | 27                   | 21%                   | 26   | -10%                  | 22   | 1%                    | 11    | -27%                  |
| 180                   | 42                   | 19%                   | 42   | -15%                  | 38   | -1%                   | 17    | -33%                  |
| 365                   | 77                   | 0%                    | 77   | -25%                  | 86   | 15%                   | 33    | -34%                  |

COSTS ARE STATED IN BASIS POINTS PER YEAR

| 3-MONTH LIBOR INTEREST RATE CAPS AND FLOORS |      |                       |      |                       |      |                       |      |                       |      |                       |      |                       |      |                       |      |                       |
|---|------|-----------------------|------|-----------------------|------|-----------------------|------|-----------------------|------|-----------------------|------|-----------------------|------|-----------------------|------|-----------------------|
| 3-Month LIBOR Caps                          |      |                       |      |                       |      | Prime Caps            |      |                       |      |                       |      |                       |      |                       |      |                       |
| Strike Rates                                | 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                                  | 82   | 0%                    | 45   | 15%                   | 37   | 21%                   | 31   | 25%                   | 162  | 21%                   | 139  | 28%                   | 120  | 36%                   | 104  | 44%                   |
| 3-yrs                                       | 143  | -5%                   | 120  | 0%                    | 102  | 6%                    | 88   | 12%                   | 314  | 20%                   | 267  | 23%                   | 232  | 30%                   | 205  | 38%                   |
| 4-yrs                                       | 252  | -7%                   | 215  | -1%                   | 186  | 5%                    | 162  | 12%                   | 494  | 8%                    | 434  | 13%                   | 383  | 19%                   | 340  | 25%                   |
| 5-yrs                                       | 368  | -9%                   | 317  | -4%                   | 275  | 2%                    | 241  | 9%                    | 717  | 2%                    | 635  | 5%                    | 564  | 10%                   | 503  | 14%                   |

| 3-Month LIBOR Floors |      |                       |      |                       | Prime Floors |                       |      |                       |      |                       |      |                       |      |                       |      |                       |
|----------------------|------|-----------------------|------|-----------------------|--------------|-----------------------|------|-----------------------|------|-----------------------|------|-----------------------|------|-----------------------|------|-----------------------|
| Strike Rates         | 2.5% | Chg. from prior month | 3.0% | Chg. from prior month | 3.5%         | Chg. from prior month | 4.0% | Chg. from prior month | 4.5% | Chg. from prior month | 5.0% | Chg. from prior month | 5.5% | Chg. from prior month | 6.0% | Chg. from prior month |
| Term 2-yrs           | 148  | 38%                   | 237  | 36%                   | 320          | 26%                   | 407  | 20%                   | 215  | 53%                   | 285  | 38%                   | 360  | 29%                   | 440  | 23%                   |
| 3-yrs                | 208  | 55%                   | 335  | 54%                   | 562          | 32%                   | 575  | 32%                   | 312  | 62%                   | 411  | 46%                   | 519  | 36%                   | 631  | 29%                   |
| 4-yrs                | 252  | 65%                   | 409  | 71%                   | 555          | 53%                   | 711  | 42%                   | 382  | 76%                   | 505  | 57%                   | 638  | 45%                   | 779  | 37%                   |
| 5-yrs                | 297  | 71%                   | 482  | 82%                   | 655          | 63%                   | 841  | 50%                   | 429  | 83%                   | 581  | 67%                   | 737  | 53%                   | 903  | 44%                   |

**3-month LIBOR is currently 2.19625%** **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 marked by turbulence

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Interest rate cycles and the yield curve are linked to the business cycles. In an expanding economy, the Federal Reserve often tightens money supply with rate hikes to avert inflation, but lowers rates as the economy softens to forestall a recession.

Likewise, flat-to-inverted yield curves often signal downturns and recessions. Steep yield curves frequently forecast inflation, while normal yield curves reside somewhere between the two extremes.

### Experts debate conditions

Since the mid-1980s, the economies of developed nations had enjoyed moderate volatility between the highs and lows of business, a phenomenon dubbed the "Great Moderation." By the end of 2006, the expanding economy was on course for slower growth.

In the current economic environment, some economists contend that the Great Moderation was an illusion. Others argue that the current economic maelstrom would be even more destructive without the forces of the Great Moderation. That debate will be part of a long-term political and

economic discussion and a generation of academic studies.

### An economic timeline

In decades to come, historians will dissect and analyze the underlying causes and long-term effects of the financial meltdown. For now, a brief chronicle of the major events and developments may serve to put things into context.

The U.S. economy was set for more moderate growth compared to the healthy 3.4 percent annual growth in the 2006 gross domestic product (GDP). The deflation of the housing bubble continued and bank regulators warned about elevated risk associated with complex structured finance activities.

On February 27, 2007, stock market prices around the world took a nosedive, starting with the Shanghai Com-

posite Index which fell 8.8 percent. The press dubbed the sell-off a "panic" as the Dow Jones industrial average plunged 546 points, and ended the day 416.03 points lower, which translated to a 3.3 percent market drop. The Federal Open Market Committee (FOMC) held the federal funds rate at 5.25 percent and warned that inflation was a greater danger than slow growth. The National Association of Realtors admitted that the subprime lending marketplace was creating challenges, but forecast "a recovery is likely this year."

In June of 2007, burdened with a huge chunk of rapidly devaluing mortgage securities, two hedge funds of Bear Stearns imploded. The failure was the precursor to the full-fledged panic that would rock the debt and equity markets in the months to come. Evidence began to mount that risky lending was expanding from subprime loans to other areas, creating the possibility of corporate debt defaults.

Investors took the traditional flight to safety in U.S. Treasuries, and banks became more reluctant to finance leveraged buyouts involving hedge funds. The interest-rate-spread widened between U.S. Treasuries and corporate debt. Retail and investment banks as well as brokerage firms and mutual funds realized that not only did they hold the type of investments that destroyed the Bear Stearns hedge funds, but they had no idea how to value many of their complex investments.

**"The economy was set for moderate growth"**

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## Economy marked by turbulence

continued from page 2

In September 2007, to encourage lending, the Fed dropped the discount rate from 5.25 to 5.00 percent. The turmoil continued in the credit markets, forcing the Fed to cut the federal funds rate again. The Fed said that it cut rates to “forestall some of the adverse effects on the broader economy.” With little improvement through the fall of 2007, in December, citing strains in financial markets, the Fed again lowered the target federal funds rate from 4.50 percent to 4.25 percent.

The Fed created the Term Auction Facility (TAF) which was designed to provide funds over a longer period to a wider range of banks. It also created foreign exchange swap lines with the European Central Bank and Swiss National Bank. The TAF program allowed the Fed to inject short-term funds through a broader range of counterparties and against a broader range of collateral than open market operations. TAF was the first of many different programs or facilities the Fed will create to inject liquidity into various trouble spots.

### Downward trend continues

The Fed continued to lower interest rates throughout the first six months of 2008. The rate reductions, coupled with the Bush tax rebates, bolstered a faltering economy. GDP growth, which had been only 0.9 percent in the opening quarter of 2008, bounced back to a solid 2.8 percent in the second quarter. Unfortunately another shock was on the horizon: by July consumers were again under attack, this time by record gasoline prices. The price for a barrel of oil peaked at \$147.

Then suddenly, more financial calamity struck. With Fannie Mae and Freddie Mac stock and debt prices tumbling and rumors swirling of a possible collapse, the Fed authorized the institutions to borrow from the Fed’s discount window, saying the move was “intended to supplement the Treasury’s existing lending authority and to help ensure the ability of Fannie Mae and Freddie Mac to promote the availability of home mortgage credit during a period of stress in financial markets.” That was government-speak for “rescue” and street talk for “bailout.”

Conversely, Lehman Brothers Holdings Inc., one of the most respected of all Wall Street firms, was unable to receive help. Rumored to be short of capital and heavy on bad investments, the stock price of Lehman Brothers plummeted and the firm went under.

To mitigate the fallout from Lehman Brothers’ failure, the Fed opened another source of liquidity. For the first time ever, the collateral used to borrow from the Fed was broadened to include equities. Previously,

collateral had been limited to investment-grade debt securities.

More trouble arose when redemptions by investors caused the money market fund, The Reserve Primary Fund, to “break the buck,” a euphemism for going under. When the subprime-linked credit default derivatives issued by the giant U.S. insurer American Insurance Group (AIG) turned sour, their losses mounted. This prompted still another rescue.

Next, U.S. Treasury Secretary Henry Paulson sent a mere three-page proposal to Congress asking for expanded spending powers totaling \$700 billion. Accustomed to thick, detailed documents, Congress requested more information before considering the rescue package. After an initial rejection, and with reluctance and loud grumblings, Congress finally passed the \$700 billion rescue plan, The Emergency Economic Stabilization Act of 2008. A major provision of the plan allows the government to take equity investments in banks and bank holding companies.

The Federal Reserve was actively trying to stabilize the financial system. First, they created the Commercial Paper Funding Facility (CPFF) to bypass banks and directly “purchase three-month unsecured and asset-backed commercial paper directly from eligible issuers.” The move was designed to

“provide a liquidity backstop to U.S. issuers of commercial paper.” Second, the Fed moved rates from 2.0 percent to 1.0 percent with two separate rate cuts. The initial cut was coordinated with other central banks in Europe and Asia.

### Future remains uncertain

During the fourth quarter of 2008, the National Bureau of Economic Research (NBER), the organization that dates the turning points in the U.S. business cycle, declared the U.S. economy is in an official recession. The NBER concluded the recession actually began in December of 2007. The Bureau also announced that the length of the last expansion covered the period between November 2001 and December 2007, or 73 months. The length and depth of the current recession is unknown. Early indications are such that the fourth quarter GDP will most certainly show substantial negative economic growth. It now seems likely that additional monetary and fiscal policy moves will be required to turn the economy around. Given the lags associated with economic policies, the earliest this recovery could begin is probably in the summer of 2009.

*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.*

### 2009 CoBANK Customer Meeting Schedule

| Meeting                         | Date        | Location    |
|---------------------------------|-------------|-------------|
| Northeast Customer Meeting      | Feb. 25-26  | Albany, NY  |
| Pacific West Customer Meeting   | March 2-4   | Carmel, CA  |
| Great Lakes Customer Meeting    | March 9-10  | Chicago, IL |
| Midwest Customer Meeting        | March 19-20 | Omaha, NE   |
| Western Plains Customer Meeting | March 24-25 | Wichita, KS |
| Southeast Customer Meeting      | June 16-17  | Biloxi, MS  |

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### IMPLIED FORWARD RATES

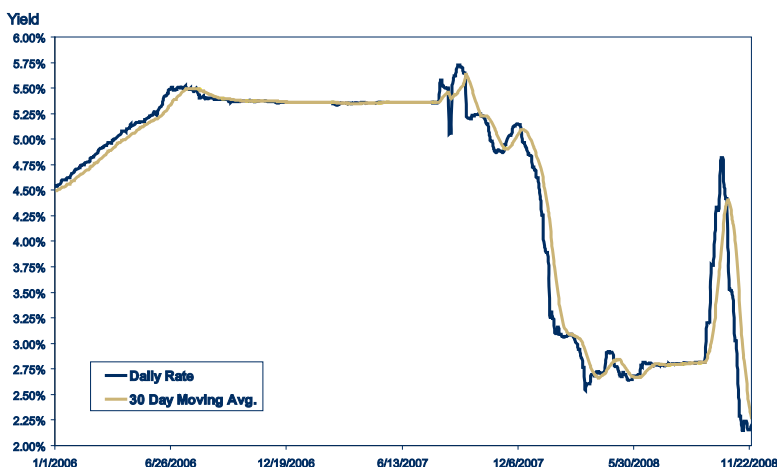
| Years Fwd | 3-month LIBOR | 1-yr Swap | 3-yr Swap | 5-yr Swap | 7-yr Swap | 10-yr Swap |
|-----------|---------------|-----------|-----------|-----------|-----------|------------|
| Today     | 2.20%         | 2.84%     | 2.38%     | 2.86%     | 3.09%     | 3.20%      |
| 0.25      | 3.02%         | 2.76%     | 2.47%     | 2.93%     | 3.14%     | 3.24%      |
| 0.50      | 2.91%         | 2.38%     | 2.50%     | 2.96%     | 3.16%     | 3.25%      |
| 0.75      | 3.09%         | 1.93%     | 2.55%     | 2.99%     | 3.18%     | 3.27%      |
| 1.00      | 1.93%         | 1.34%     | 2.58%     | 3.02%     | 3.19%     | 3.28%      |
| 1.50      | 1.14%         | 1.85%     | 2.90%     | 3.22%     | 3.33%     | 3.36%      |
| 2.00      | 2.66%         | 2.94%     | 3.40%     | 3.53%     | 3.53%     | 3.49%      |
| 2.50      | 2.99%         | 3.22%     | 3.54%     | 3.61%     | 3.59%     | 3.53%      |
| 3.00      | 3.25%         | 3.48%     | 3.65%     | 3.66%     | 3.62%     | 3.54%      |
| 4.00      | 3.55%         | 3.74%     | 3.74%     | 3.67%     | 3.63%     | 3.53%      |
| 5.00      | 3.57%         | 3.69%     | 3.69%     | 3.61%     | 3.54%     | 3.48%      |

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- Tax-exempt environmental bonds

## 3-MONTH LIBOR Daily Rates vs. Moving Average

NOVEMBER 24, 2008



# OUTLOOK

DECEMBER 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.

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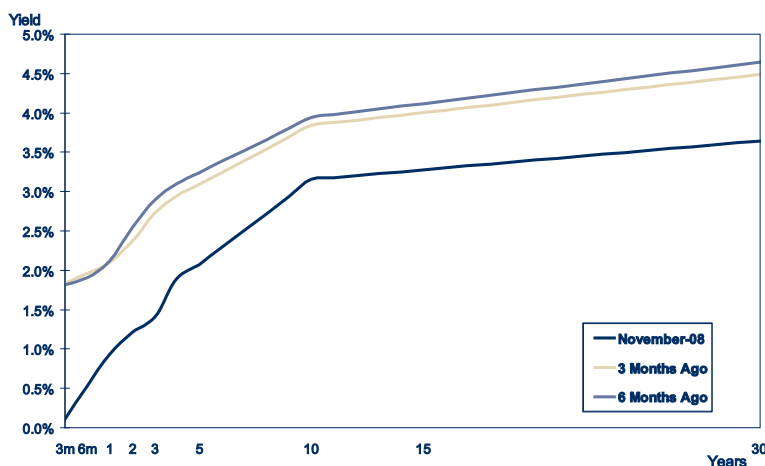
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NOVEMBER 24, 2008



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