CoBank's Financial Risk Management Publication

OUTLOOK

Volume 5 Number 3 March 2008

View of the Marketplace:
Recession Avoidance Actions Underway
Monetary and Fiscal Policy Being Brought to Bear

By Dr. Ed Seifried

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On January 22, 2008, the Federal Reserve, in a rare unscheduled meeting, stunned the financial world by slashing interest rates by 0.75 percent, one of the largest cuts in over two decades. A week later, at the first regularly scheduled meeting of 2008, the Fed dropped the second bombshell of the new year by cutting rates again by 0.5 percent, creating a total cut, in a matter of eight days, of a hefty 1.25 percent.

Needless to say, panic struck the financial world, and pundits were checking their dictionary for any word that could describe such a bold and decisive strike against the looming economic downturn.

The Fed's policy statement released after the January 30, 2008 meeting indicated that it fears the economy may be moving into a slow growth period. This is a significant change, because the Fed has been, for the most part, on an inflationary watch since the beginning of 2005.

Now, apparently, the fear of recession has replaced the concern over inflation. Acknowledging the shift, the Federal Open Market Committee (FOMC) declared:

"Financial markets remain under considerable stress, and credit has tightened further for some businesses and households. Moreover, recent information indicates a deepening of the housing contraction as well as some softening in labor markets…[and] downside risks to growth remain."

> "Economy may be moving into a slow growth period"
>
> Dr. Ed Seifried

GDP growth is slowing

The economy in the fourth quarter registered close to empty with a small 0.6 percent rise in the growth of the Gross Domestic Product (GDP). That brought the 2007 full-year growth to only 2.2 percent, which was the slowest pace since 2002, when the economy was struggling out of a recession rather than teetering on the brink of one.

The 0.6 percent advance for the GDP fell below the 1.9 percent-forecasted gain and was significantly lower than the 4.9 percent rate in the third quarter. The fourth quarter report also provided additional evidence that a recession is knocking on the door; the signs of a possible, though not definite, recession have been stalking the economy for months.

Labor markets decline

Back-to-back job reports for December and January were grim. The December report showed that unemployment had jumped from 4.7 percent in November to 5.0 percent in December. By historical standards, this 0.3 percentage advance was severe and was certainly a surprise given the consensus forecasts of a modest rise of 4.8 percent. Worse still, job creation was at a paltry 18,000, which the Labor Department characterized as "essentially unchanged." Forecasts had been for job creation in the 50,000 - 70,000 range.

Bad news riddled the January job report, which revealed further deterioration in the labor market as employers eliminated 17,000 jobs. That was the first decline in

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ECONOMIC AND INTEREST RATE PROJECTIONS

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

2007	GDP	CPI	Fed Funds	2-year	10-year
Q4	0.60%	4.40%	4.50%	3.50%	4.30%
2008	**GDP**	**CPI**	**Fed Funds**	**2-year**	**10-year**
Q1	-1.00%	3.50%	3.24%	2.20%	3.70%
Q2	-1.50%	2.00%	2.32%	2.00%	3.60%
Q3	-0.50%	2.50%	2.00%	1.90%	3.60%
Q4	1.00%	2.80%	2.00%	1.90%	3.50%

THE PRODUCT QUOTATIONS on these pages were updated as of 2/15/08. 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	2.760%	-0.26%
3-yrs	3.077%	-0.14%
4-yrs	3.397%	-0.04%
5-yrs	3.681%	0.04%

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	3	2600%	5	96%	4	82%	3	36%
90	7	518%	13	60%	11	58%	9	25%
180	15	577%	27	65%	24	63%	18	28%
365	55	118%	66	52%	54	55%	39	27%

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	5.5%	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	92	1%	35	15%	27	19%	21	22%	107	-32%	71	-35%	54	-13%	42	-11%
3-yrs	137	17%	105	22%	84	26%	66	25%	224	-19%	165	-19%	130	-8%	97	-6%
4-yrs	264	22%	209	25%	167	28%	135	29%	374	-11%	289	-10%	231	-1%	185	-1%
5-yrs	414	25%	334	28%	271	30%	222	31%	550	-5%	436	-3%	353	5%	285	6%

	3-Month LIBOR Floors								Prime Floors							
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	6.5%	Chg. from prior month	7.0%	Chg. from prior month	7.5%	Chg. from prior month	8.0%	Chg. from prior month
Term 2-yrs	171	12%	256	8%	346	6%	439	5%	293	60%	380	9%	469	8%	561	7%
3-yrs	326	2%	338	2%	460	0%	588	0%	401	46%	524	7%	644	6%	773	4%
4-yrs	260	-3%	395	-3%	543	-4%	701	-4%	474	38%	618	3%	772	3%	933	2%
5-yrs	292	-7%	445	-7%	615	-2%	798	-6%	529	33%	696	-1%	872	-1%	1061	-1%

3-month LIBOR is currently 3.07000% **Prime is currently 6.00%**

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.

Recession avoidance

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nonfarm payrolls in four years. In addition, approximately 1.7 million people wanted and were available for work and had looked for a job sometime in the prior 12 months. That compared to 1.6 million in January 2006.

The collapsing housing sector took its toll on construction employment, which fell by 27,000 in January and has declined by 284,000 since its peak in September 2006. Job losses totaled 10,000 in residential building and 18,000 among residential specialty trade contractors. Manufacturing lost 28,000 jobs in January, with small declines spread among many durable and nondurable goods industries. Manufacturing has lost 269,000 jobs from January 2006 to January 2007.

"There were a few bright spots in the labor market"

There were a few bright spots in the labor market, specifically in the health care and food service industries where compensation traditionally is at the low-end of pay scales.

Adding to the cracks in the labor markets, which had been relatively healthy during most of 2007, was a negative report from the Institute for Supply Management (ISM) on the service sector. The ISM report showed the service economy indicator at 44.6 percent, the lowest level in six years. This level indicates a contraction in the non-manufacturing sector. Worse still, the ISM's Non-Manufacturing Business Activity Index in January registered 41.9 percent, indicating a significant contraction in business activity in January from the seasonally adjusted 54.4 percent registered in December. This was the first contraction in the non-manufacturing sector since March of 2003 when the index registered 46.3 percent. It was also the lowest Business Activity Index since registering 40 percent in October 2001.

Signals are not new

The most recent signs of recession were foreshadowed more than a year ago, when the yield curve inverted. While every U.S. recession has been preceded by an inverted yield curve, economic optimists have contended that the reverse is not true, that not every inverted yield curve has foreshadowed a recession.

Former Federal Reserve Chairman Alan Greenspan disagreed as early as February 2007. At that time, he warned that the American economy might slip into recession by year's end. He pointed to signs that economic expansion was coming to an end.

"When you get this far away from a recession, invariably forces build up for the next recession, and indeed we are beginning to see that sign," Greenspan told a business conference in Hong Kong. [The previous U.S. recession occurred in 1991.]

Negative forces constricting growth

The economy was able to register the modest 2.2 percent annual growth in 2007 despite major potential drags beginning with the Gulf Hurricanes in 2005. In addition, the collapsing housing market, coupled with the even more worrisome credit market dislocations, created huge hurdles and obstacles for economic growth.

Weak dollar a blessing and a curse

A falling dollar is good news for U.S. exporters, which see increased demand for their products abroad. However, some businesses that are highly dependent on foreign products and services are harmed by the weak dollar. The lower dollar drives foreign raw materials and production input costs higher, so businesses then have the

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unfortunate choice of cutting profit margins or raising prices for their products. These increased prices add to inflationary pressures.

Confidence declines

Given these negative developments, consumers are showing less confidence in the economy. The Consumer Confidence Index, put out monthly by The Conference Board, fell in January to 87.9 from 90.6 in December (1985 = 100).

The Conference Board's Expectations Index revealed even greater concerns among consumers, with that Index plunging from 75.8 to 69.6. Consumers are worried about the short-term future and expect business conditions and employment to deteriorate further in the months ahead. In addition, the percentage of consumers anticipating an improvement in their earnings has declined, which could potentially impact spending decisions.

Forces softening the recession threat

The forces underlying the Great Moderation may well have worked to counter the powerful gravity of the negative factors in the economy.

The Great Moderation theory holds that better monetary policy, increased productivity from technology and improved business processes, as well as a dose of good luck, have smoothed the peaks and valleys of the traditional business cycle to moderate both the highs and the lows in the economy – including such lows as recessions. Moreover, while the housing markets in some areas may take several years to recover, the Great Moderation suggests that any recession will be mild and relatively brief.

Fiscal and monetary actions also may serve as moderating forces. The Federal Reserve has been using every old tool and some new ones to jump start the stalled credit markets and to help stimulate economic growth. The key Fed Funds rate has been cut by 2.5 percent in the last six months, with additional cuts anticipated if the economic falters.

Liquidity, cash injected into economy

In December, the Fed—along with major central banks across the globe—took an "unprecedented move" to create a new way to provide liquidity to the credit markets. The Fed characterized the new liquidity funnel as a measure "designed to address elevated pressures in short-term funding markets." The Fed's new plan also called for a creation of a temporary Term Auction Facility (TAF) and the establishment of foreign exchange swap lines with the European Central Bank and the Swiss National Bank.

The Fed seems to be acknowledging that things have deteriorated to such an extent that it needs new tools, and it needs the concerted efforts of the world's most important central banks to get the credit markets working in a more normal manner.

A fiscal stimulation package signed by President Bush in February may offer another bit of ballast for the economy: taxpayers are slated to get rebate checks, and small businesses will have new tax breaks. Debate has been heated concerning how effective the package may be for the economy, although it seems clear that it is the politically correct move for senators and representatives in an election year.

Forecast

The resiliency of the economy will be tested over the next 12-18 months. The subprime mortgage debacle is not over and will accelerate in intensity through the first six months of 2008. In addition, if commodity prices continue to rise, the effect on consumer spending could be another factor to push the economy into a recession. It will take a firm hand on the part of the Fed to steer the economy through this brewing storm.

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.

Upcoming Customer Meetings

March 25-26	Nebraska Meeting, Hilton Omaha, Omaha
April 1-2	Minnesota Meeting, The Northland Inn, Minneapolis
May 14-15	Washington Meeting, The Davenport Hotel, Spokane
July 17-18	Tennessee Meeting, Gaylord Opryland Resort, Nashville

Meetings with CoBank-Sponsored Programs and Speakers

June 20	Mid-America Cooperative Council Annual Meeting
July 10-12	Mid-South Managers Association Annual Meeting
September 9-10	South Dakota Association of Cooperatives Annual Meeting
November 5-6	University of Wisconsin Center for Cooperatives Annual Conference
November 21	Nebraska Cooperative Council Annual Meeting
November 25	Iowa Institute for Cooperatives Annual Meeting

Call 800-542-8072, extension 04040 for more information.

IMPLIED FORWARD RATES

Years Fwd	3-month LIBOR	1-yr Swap	3-yr Swap	5-yr Swap	7-yr Swap	10-yr Swap
Today	3.07%	2.74%	3.07%	3.67%	4.12%	4.54%
0.25	2.86%	2.65%	3.14%	3.76%	4.19%	4.60%
0.50	2.51%	2.61%	3.26%	3.87%	4.29%	4.68%
0.75	2.46%	2.65%	3.42%	4.02%	4.41%	4.77%
1.00	2.68%	2.71%	3.60%	4.16%	4.53%	4.86%
1.50	2.68%	3.12%	3.95%	4.44%	4.75%	5.04%
2.00	3.39%	3.71%	4.34%	4.74%	4.99%	5.23%
2.50	3.74%	4.06%	4.61%	4.95%	5.17%	5.37%
3.00	4.11%	4.41%	4.86%	5.14%	5.32%	5.49%
4.00	4.64%	4.91%	5.24%	5.43%	5.55%	5.68%
5.00	5.04%	5.28%	5.49%	5.64%	5.73%	5.81%

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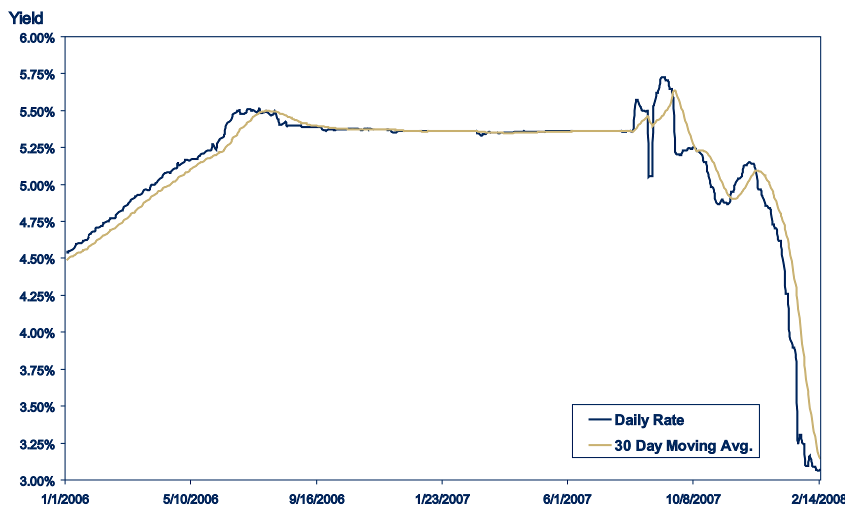
3-MONTH LIBOR — FEBRUARY 15, 2008

Daily Rates vs. Moving Average

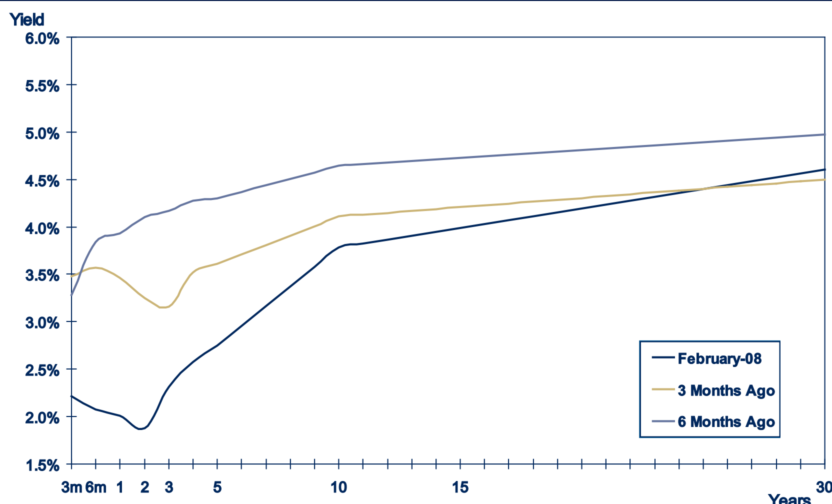


OUTLOOK

MARCH 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.

TREASURY YIELD CURVE — FEBRUARY 15, 2008



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