

OUTLOOK

VOLUME 5 NUMBER 4

APRIL 2008

View of the Marketplace: Economic Slowdown Continues Federal Reserve Working to Alleviate the Downturn

By Dr. Steven Wood

Dr. Wood is president and chief economist with Insight Economics, LLC, a macroeconomic advisory and consulting firm based in California. Prior to founding the firm, he was chief economist for Financial Oxygen. Previously, he was a senior capital markets economist with Banc of America Securities for 15 years. Dr. Wood also teaches economics at the University of California, Berkeley.

Although the Business Cycle Dating Committee of the National Bureau of Economic Research, which is the arbiter of when recessions begin and end, has not officially declared a recession, the weight of the economic data suggests that a business downturn began in January. The best evidence for the recession is the job losses that have occurred so far this year. In addition, manufacturing activity is stagnant, income growth has slowed, and consumer spending – which accounts for 70 percent of the economy – has stalled.

This recession was caused by the bursting of the housing bubble and subsequent meltdown in the housing market. The housing bubble between 2003 and 2006 was very extended. Home sales climbed by 34 percent. Home prices soared by 60 percent, and had doubled between 2000 and 2006.

The bursting of this bubble was clearly going to be painful. Once the speculative fever in the housing market broke in early 2006, it was inevitable that the economy would eventually slip into recession. The magnitude of the housing bubble, and the extent of the unconventional financing of the bubble, virtually guaranteed it although it took somewhat longer than expected to arrive.

New mortgage structures add to problem

If the economy only faced the bursting of the housing bubble, it would more likely

purchases were financed by unconventional means, with a dramatic expansion of very high loan-to-value, low quality sub-prime and alt-A, adjustable rate mortgages (ARMs) made to lower income families.

Most of these ARMs included initial teaser rates that were far below market interest rates. After an initial period, the interest rate on these mortgages adjusted higher, in some cases sharply higher. There were also new option ARMs where the homeowner had a menu of payments from which to choose, with one alternative being a minimum payment that resulted in the negative amortization of the principal value.

Mortgage securities also play a role

The original mortgage loans were sold to Wall Street investment banks, Fannie Mae and Freddie Mac. These institutions combined large pools of mortgage loans into packages of residential mortgage backed securities (RMBS). The RMBS were then further split into different tranches, each with a different claim on the underlying cash flows from the individual mortgages.

These tranches were then rated by the rating agencies, with those tranches with first priority on the underlying cash flows being given an AAA rating. The various tranches were then sold to a variety of investors

continued on page 2

“The housing bubble was very extended”

Dr. Steven Wood

experience a slowdown in economic growth rather than an outright recession. However, during the housing boom, many home

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%	4.40%	3.20%	2.00%	3.70%
Q2	-1.50%	3.00%	2.08%	1.70%	3.60%
Q3	0.50%	2.30%	1.65%	1.50%	3.50%
Q4	-0.50%	3.00%	1.50%	1.50%	3.40%

▶ **THE PRODUCT QUOTATIONS** on these pages were updated as of 3/17/08. 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	2.382%	-0.38%
3-yrs	2.687%	-0.39%
4-yrs	3.008%	-0.39%
5-yrs	3.265%	-0.42%

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	-11%	5	4%	4	10%	3	-7%
90	7	9%	15	14%	13	16%	9	-1%
180	18	18%	32	17%	28	17%	18	1%
365	62	11%	77	16%	61	13%	39	1%

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	80	-13%	35	2%	29	8%	24	12%	144	-5%	108	1%	85	20%	68	26%
3-yrs	115	-16%	95	-9%	78	-7%	64	-3%	277	-7%	220	-2%	179	8%	147	13%
4-yrs	215	-19%	177	-15%	145	-13%	120	-11%	399	-15%	358	-4%	296	2%	246	7%
5-yrs	332	-20%	271	-19%	222	-18%	184	-17%	585	-13%	517	-6%	432	-1%	362	3%

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	155	47%	238	39%	327	28%	419	21%	200	31%	276	28%	358	22%	444	17%
3-yrs	211	55%	433	33%	445	32%	574	25%	297	45%	403	38%	517	29%	643	23%
4-yrs	247	60%	383	47%	572	45%	692	27%	366	54%	494	44%	678	43%	790	28%
5-yrs	283	64%	439	50%	652	47%	799	30%	423	61%	573	50%	779	47%	916	32%

3-month LIBOR is currently 2.59875%

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.

Slowdown continues

continued from page 1

and speculators including hedge funds, some of which were owned by the investment banks that created the securities. A prominent feature of the hedge funds was that the purchase of these securities was almost always done on leverage, i.e., with borrowed money.

When in mid-2004 the Federal Reserve began steadily raising interest rates, monthly payments on adjustable rate mortgages would rise with each rate re-set. If initial teaser rates were also expiring, mortgage payments would shoot sharply higher. These higher mortgage payments caused severe financial difficulties for many lower income families, causing the number of delinquencies and foreclosures to increase dramatically, especially on subprime and alt-A loans. Meanwhile, homeowners with option ARMs increasingly chose the minimum payment option and allowed their principal value to climb.

Declining home values initiate cycle

When home prices were rapidly increasing, mortgage lenders and the holders of RMBS and their derivative securities were relatively unconcerned about rising delinquencies and foreclosures. This was because the mortgage house could always be sold

for more than the outstanding mortgage balance. Similarly, home owners with option ARMs saw their home equity increase even as the mortgage principal value was rising.

However, once home prices stopped climbing and particularly when they began to decline, the game was up. Bursting asset bubbles almost always lead to a self-reinforcing downward spiral that greatly exacerbates the

downturn, and the bursting of this housing bubble is no exception.

Declines in home sales amid rising inventories led to a demand-supply imbalance that pushed home prices down. Falling home prices reduced the demand for housing further because people are reluctant to purchase a depreciating asset. Falling demand for housing widened the demand-supply imbalance and pushed home prices even lower, continuing the cycle.

Falling home prices have led to another atypical phenomenon in this housing cycle because a substantial portion of mortgages made in recent years have been very high loan-to-value. Once home prices fell, an increasing number of homeowners found themselves in a negative equity position, where the market value of the house is less than what is owed on the mortgage.

Some of these homeowners have decided to default on their mortgages even though they had been current on their payments and were not under any undue financial stress to make the mortgage payments. These "walk away" loans have placed additional property on the market, putting further downward pressure on home prices.

Mortgage-backed securities take a hit

This dynamic in the housing market led to a sharp markdown on the price of the

Demand-supply imbalance pushed down home prices

continued on page 3

Slowdown continues

continued from page 2

RMBS and the derivative securities that were created out of the pools of underlying mortgage loans. Because these were often held by highly leveraged hedge funds and other financial institutions, a major un-winding of portfolio positions began. While this made sense for every individual institution, when all financial market participants tried to reduce their portfolios, the imbalance in sell orders pushed prices down even more sharply.

Consequently, it became increasingly difficult to value the RMBS and derivative securities because that required valuing each piece of each underlying mortgage that was included in the particular tranche of the particular RMBS that was owned. In addition, because financial institutions were reluctant to reveal exactly what securities they owned, the lack of transparency between buyers and sellers led to sharp declines in both trading volume and securities prices. Liquidity in the financial markets dried up and it became increasingly difficult and expensive for financial institutions to get financing.

Fed attempts to stop downturn

The Fed began attacking these problems last September with its traditional tool of cutting short-term interest rates. It followed up the initial September rate cut with further reductions in both October and December, and again in January and March. The magnitude of these rate reductions has been substantial.

As the financial crisis deepened, however, the Fed introduced more unconventional measures to try to restore liquidity to the market. These measures included a new lending facility that was introduced in December to promote greater liquidity in the market. This lending facility was first expanded in January and then extended in March.

As the financial crisis reached a boil, the Fed helped engineer a rescue package for

investment bank Bear Sterns, which was on the brink of failing. If this failure had occurred, it would have sent major shock waves through the global financial markets and caused a significant seizure in the stock and credit markets.

The Fed has done heroic work over the past six months, reacting to an unfolding housing and financial crisis with speed, flexibility and inventiveness. It has been attacking the financial market's liquidity and transparency problems at their source, and its aggressive and innovative actions have relieved much of those pressures in the market. This has been critical for the economy's health because modern capitalistic economic systems can't

function without having well-functioning capital markets.

Rate reduction not a cure-all

The Fed actions can only affect those sectors of the economy that are responsive to short-term interest rates and liquidity issues. Little of what the Fed has done has addressed the fundamental issue confronting the economy: declining home prices.

It is not clear that the Fed even has the tools to effectively influence this decline. Even the economic stimulus package passed

by Congress and signed by the President with great fanfare will not have much of an impact on home prices. While it will temporarily boost consumer spending, it will not affect the dynamics in the housing market.

To break the downward housing cycle, either enough time must pass for the housing market to reach a new equilibrium or bold government action is needed, something that is unlikely in a presidential election year. Until the housing cycle is broken, the economy will experience either recession or sluggish growth.

Looking ahead in the economic cycle

A typical recession lasts ten months. A long recession, of which there have been two during the post-World War II period, lasts 16 months. If January was the first month of the recession, and if history is any guide, this economic contraction could be over by October if it is a short recession or no later than April 2009 if it is a long recession.

The length of this recession depends on how quickly housing prices stabilize. Given the current pace of home sales and housing starts, as well as the magnitude of the inventory of unsold homes, it will likely take another six to nine months before housing bottoms. Thus, this recession will likely extend into early 2009 before a slow recovery can begin.

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.

The Federal Reserve has done heroic work

IMPLIED FORWARD RATES

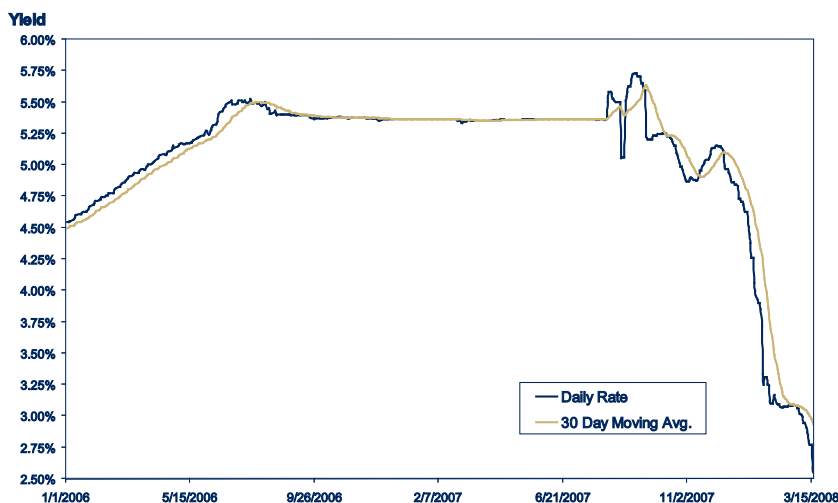
Years Fwd	3-month LIBOR	1-yr Swap	3-yr Swap	5-yr Swap	7-yr Swap	10-yr Swap
Today	2.60%	2.34%	2.69%	3.27%	3.65%	4.03%
0.25	2.40%	2.28%	2.78%	3.36%	3.73%	4.10%
0.50	2.11%	2.27%	2.90%	3.46%	3.82%	4.17%
0.75	2.18%	2.34%	3.06%	3.59%	3.92%	4.26%
1.00	2.34%	2.39%	3.22%	3.72%	4.03%	4.34%
1.50	2.38%	2.78%	3.54%	3.97%	4.23%	4.51%
2.00	3.02%	3.30%	3.89%	4.22%	4.44%	4.67%
2.50	3.34%	3.64%	4.14%	4.40%	4.59%	4.79%
3.00	3.70%	3.97%	4.36%	4.57%	4.73%	4.91%
4.00	4.17%	4.40%	4.64%	4.80%	4.94%	5.07%
5.00	4.49%	4.70%	4.84%	4.98%	5.09%	5.19%

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

MARCH 17, 2008



OUTLOOK

APRIL 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
Corporate Relations	Karen DiVincent

Editorial Staff

Managing Editor Karen DiVincent

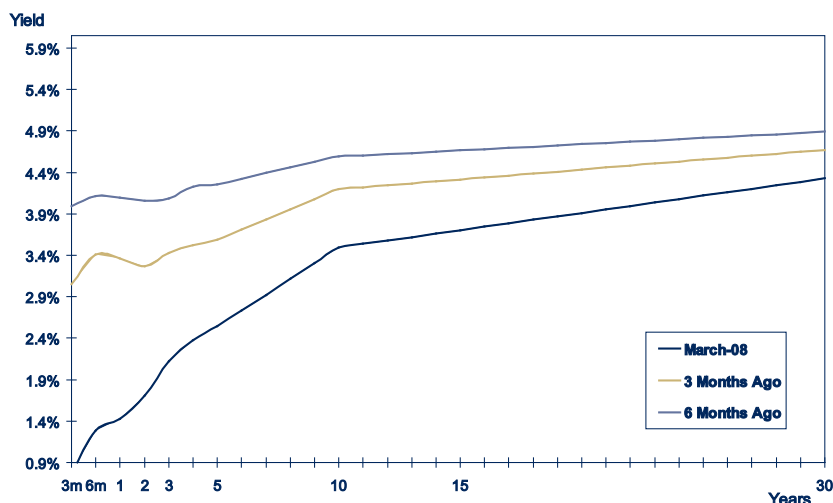
About CoBANK

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.

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

TREASURY YIELD CURVE

MARCH 17, 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