

OUTLOOK

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View of the Marketplace: The "Muddle Through" Economy No Recession, But Growth Remains Sluggish

By Dr. Steve 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.

The economy is not now officially in recession. In fact, there has not been even one quarter of contracting economic activity, let alone two consecutive quarters. Regardless, this popular rule-of-thumb for a recession is not an official definition. If it were, there would not have been a recession in 2001.

In order for the economy to be officially in recession, the index of coincident economic indicators needs to decline substantially for a sustained period of time. This composite index consists of four individual indicators: payroll employment, industrial production, personal income excluding transfer payments in real terms, and manufacturing and trade sales, adjusted for inflation. During the last recession, the index reached a peak in late 2000 and declined by 1.8 percent over the subsequent 11 months.

Currently, each of these individual indicators has reached a peak and started to drift lower. The composite index reached a peak in October 2007 but has declined by only 0.4 percent during the past six months. Unless the index is revised much lower, or the economic situation deteriorates significantly more, this is not a substantial enough decline to be classified a recession.

Regardless of whether the current economic period is ever classified as a recession, it is clearly a period of significant economic

Decline is
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distress. Many sectors of the economy are reeling, particularly housing construction, motor vehicle production and finance.

However, several other sectors of the economy are booming, including energy, agriculture and exports. This has produced a bifurcated economy that is growing sluggishly at the present time.

Housing at the core of economic slide

The root problem that the economy is experiencing is the bursting of the housing bubble.

Total home sales peaked in July 2005 at more than 8.5 million units. Since then, they have tumbled by more than 36 percent. Existing home sales have declined by almost 33 percent while new home sales have plunged by more than 62 percent.

The sharp decline in home sales, particularly for new homes, has led to a substantial decline in housing starts. Single-family housing starts topped out at more than 1.8 million in January 2006. Despite a 63 percent decline since then, the inventory of unsold new homes has ballooned to more than a 10-month supply at the current sales pace. This large overhang of unsold new homes will pressure housing starts even lower in the quarters ahead.

Falling home prices cause concern

The major consequence of the overbuilding of new homes is that there is now a

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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	0.90%	4.30%	3.18%	2.00%	3.70%
Q2	0.00%	4.00%	2.09%	2.40%	3.90%
Q3	-1.00%	2.80%	1.96%	2.90%	4.20%
Q4	-0.50%	3.00%	1.56%	2.40%	3.90%
2009	GDP	CPI	Fed Funds	2-year	10-year
Q1	0.50%	3.00%	1.50%	2.30%	3.80%

▶ **THE PRODUCT QUOTATIONS** on these pages were updated as of 6/17/08. 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	3.870%	0.48%
3-yrs	4.218%	0.54%
4-yrs	4.432%	0.53%
5-yrs	4.561%	0.50%

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	10	56%	8	32%	6	21%	3	3%
90	24	49%	22	28%	15	17%	9	-1%
180	37	42%	36	21%	27	10%	15	-9%
365	69	27%	61	11%	48	1%	6	-81%

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	213	64%	92	74%	60	78%	39	74%	564	3%	543	7%	504	7%	467	7%
3-yrs	294	52%	217	60%	158	67%	114	73%	1041	6%	982	6%	924	6%	869	6%
4-yrs	461	42%	353	47%	267	53%	199	59%	1524	6%	1449	6%	1376	7%	1306	6%
5-yrs	618	34%	482	34%	369	42%	279	47%	2011	6%	1921	6%	1835	5%	1751	5%

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	26	-45%	65	-36%	116	-31%	182	-26%	413	-9%	472	-8%	532	-8%	594	-8%
3-yrs	42	-41%	150	-31%	157	-30%	241	-27%	694	-8%	780	-7%	869	-10%	962	-7%
4-yrs	59	-37%	117	-32%	196	-29%	295	-26%	984	-7%	1098	-7%	1214	-7%	1332	-7%
5-yrs	81	-33%	149	-29%	240	-27%	355	-24%	1281	-7%	1422	-7%	1565	-7%	1711	-7%

3-month LIBOR is currently 2.80875%

Prime is currently 5.00%

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.

Muddle through economy

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major supply-demand imbalance that is pressuring home prices lower. As a consequence, home prices have tumbled by about 16 percent over the past two years.

Moreover, the pace of price depreciation has accelerated in recent quarters. In addition, relative to rents, it appears that another 10 to 15 percent decline in home prices is needed in order to re-establish the long-term relationship between rents and home prices.

Further price declines will push more homeowners into a negative equity situation, where the amount they owe on their mortgages exceeds the market value of their homes.

At the end of the first quarter of 2008, it was estimated that slightly more than 8 million homeowners owed more on their homes than they were worth. However, with home prices continuing to fall, that number is expected to increase by about 50 percent to

more than 12 million by the middle of next year.

The danger of an increasing number of homeowners with negative home equity is a resulting rising mortgage delinquency rate. The probability of mortgage delinquency rises with decreases in home equity or with larger negative equity. Consequently, falling home prices threaten further increases in delinquency rates, which have already soared.

Credit crunch continues

Commercial banks are still heavily exposed to residential real estate and construction loans. Despite significant write-offs during the past year, real estate loans still account for nearly one-third of total bank assets. As a result, financial institutions are still liable to experience increasing mortgage delinquencies and foreclosures.

Fed able to accommodate liquidity demand

The lack of transparency with many mortgage backed securities, and their derivative products, will continue to exacerbate banks' funding issues. This will force financial institutions to remain heavy users of the Federal Reserve's expanded credit facilities. Fortunately, the Fed's balance sheet still has substantial room to accommodate this demand for liquidity.

However, the era of surprise write-offs, earnings disappointments and capital-raising is not yet over. This will force banks to be much more conservative in extending new credit.

These tighter credit standards will reduce the amount of lending available to consumers and businesses, and with slower debt expansion, the economy will begin to de-leverage and economic growth will remain slow.

The broader economy takes a hit

For a while, the problems in the housing market seemed to be contained within the housing and housing finance sectors of the economy. But as the problems in these sectors have intensified, the rest of the economy has also felt the effects.

Job losses have been accumulating since December 2007. In addition, soaring food and energy prices have boosted inflation.

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Muddle through economy

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As a result, real wage growth has slowed sharply over the past nine months.

With home equity values dropping, mortgage equity withdrawals – which were a substantial source of spending power during the housing boom – has faded into insignificance. This has caused real consumer spending to slow sharply.

Slow recovery likely

Recessions do not last forever. Eventually the economy will recover and begin to grow more quickly. However, the rebound from this current period of sluggishness is likely to be particularly weak for several reasons.

First, many economic recoveries are stimulated by lower interest rates engineered by the Federal Reserve, and the Fed has done its job with regards to the current situation. However, dislocations in the financial markets have prevented private sector intermediate and longer-term interest rates from following short-term rates. Private sector yields are little changed, or are actually higher, than they were a year ago. Thus, there is little interest rate stimulus for the private sector.

Second, banks have significantly tightened credit standards. This is particularly true for real estate loans, both residential and commercial, but it is also true for credit card loans and commercial and industrial loans. If banks are less willing to lend, then credit expansion will be slower and spending will likely diminish.

Third, consumers are already highly leveraged with little capacity for additional borrowing. Household liabilities as a percent of disposable income are at record high levels. Consumers are also devoting a record share of their income to making the principle and interest payments on their debts.

Fourth, there is limited scope for further fiscal expansion. The budget deficit this year and next is estimated at more than \$400 billion. Given the longer-run fiscal challenges the government faces, any future tax relief will be both limited in size and temporary in nature.

These factors strongly suggest that any rebound from the current economic lethargy is likely to be fairly limited. This means that the economy will experience yet another “jobless recovery” and that the unemployment rate will continue to climb well into 2009.

Optimism remains

There are a number of positive factors that should keep the economy afloat. First, the dollar has weakened significantly over the past five years against the currencies of most of the country’s major trading partners. This has made U.S. goods and services much less expensive to the rest of the world. As a result, exports have been booming.

Second, the boom in agricultural and energy prices has been demand-driven, providing substantial support to these sectors of the economy. Although these goods

are sold internationally in dollar terms, the weaker dollar has minimized the amount of demand reduction that typically takes place when prices spiral higher.

Third, the health care sector continues to grow at a rapid pace along with the aging of the baby boom generation – over the past year, the health care sector has created twice as many jobs as the entire economy. Because health care spending is largely insulated from the vagaries of the business cycle, this sector should continue to expand strongly.

Fourth, lackluster economic activity will dampen inflation. Nearly three-quarters of all costs in the economy are due to labor costs. An economy that is growing so slowly that the unemployment rate continues to climb will not generate the tightness in the labor market for wages to rise rapidly. Combined with intense competitive pressures, labor productivity should continue to rise. This will keep unit labor costs and inflation pressures in check, particularly if oil prices stabilize.

Silver lining present in current conditions

The economy is going through a rough patch at present. There are significant risks that the situation will get worse because of a vicious cycle in the housing market. Even if the economy manages to avoid a recession, any rebound from the present sluggishness is likely to be restrained.

The good news is that even in a period of weak economic growth, some sectors of the economy – exports, agriculture, energy and health care – will significantly outperform the rest of the economy. In addition, weak economic growth will allow inflationary pressures to recede without the need for a significant recession or Fed tightening.

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.

Positive factors should keep economy afloat

IMPLIED FORWARD RATES

Years Fwd	3-month LIBOR	1-yr Swap	3-yr Swap	5-yr Swap	7-yr Swap	10-yr Swap
Today	2.81%	3.59%	4.21%	4.56%	4.74%	4.90%
0.25	3.58%	3.87%	4.39%	4.68%	4.83%	4.97%
0.50	3.80%	3.97%	4.51%	4.76%	4.90%	5.02%
0.75	3.98%	4.05%	4.63%	4.83%	4.96%	5.06%
1.00	3.88%	4.12%	4.73%	4.90%	5.01%	5.09%
1.50	4.12%	4.51%	4.91%	5.03%	5.11%	5.19%
2.00	4.61%	4.95%	5.08%	5.15%	5.20%	5.27%
2.50	4.94%	5.07%	5.15%	5.21%	5.25%	5.32%
3.00	4.90%	5.12%	5.17%	5.24%	5.27%	5.34%
4.00	4.97%	5.14%	5.23%	5.28%	5.29%	5.38%
5.00	5.09%	5.24%	5.31%	5.34%	5.38%	5.42%

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OUTLOOK

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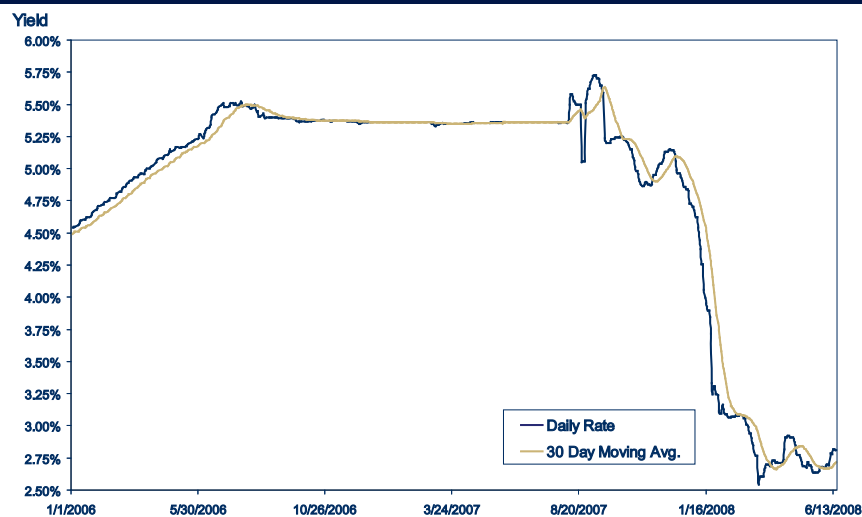
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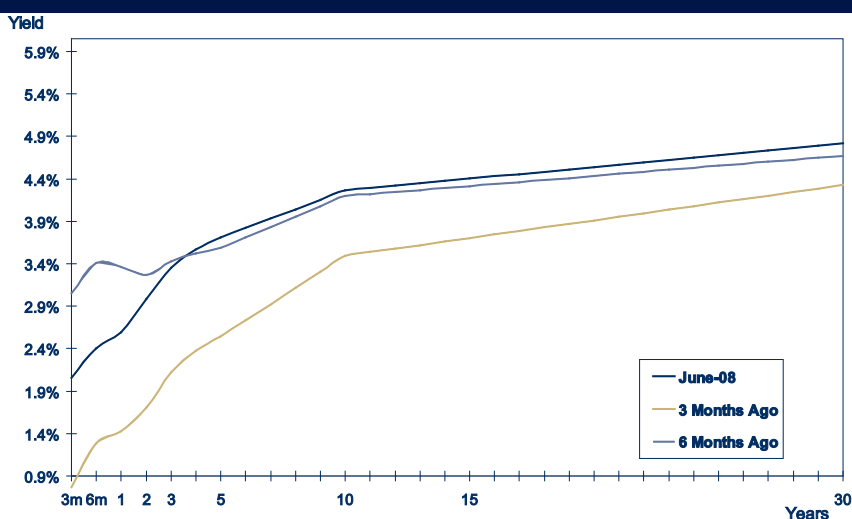
3-MONTH LIBOR Daily Rates vs. Moving Average

JUNE 16, 2008



TREASURY YIELD CURVE

JUNE 16, 2008



CoBANK
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