

# OUTLOOK

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## View of the Marketplace: Recession Officially Declared Actions being taken to shorten contraction

By Dr. Steven Wood

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On December 1, 2008, the National Bureau of Economic Research (NBER), the official arbiter of economic turning points, announced what many people already knew. The U.S. economy has been in recession since December 2007.

This means the current recession is now 13 months long, making it the third most protracted downturn of the past 75 years.

If the recession continues for just another four months, it will be the longest downturn since the August 1929 - March 1933 contraction that ushered in the Great Depression.

### Downturn follows unique path

One of the unique features of the current downturn is its unusual trajectory. From December 2007 through August 2008, economic activity contracted at a fairly slow pace.

Even this slow contraction was punctuated by a brief uptick in spending during the spring in response to the distribution of tax stimulus checks. During this period, the unemployment rate climbed slowly, from 5.0 percent to 6.1 percent.

However, beginning in mid-September 2008, and especially after the failure of Lehman Brothers Holdings Inc., economic activity dropped dramatically, and the rate of decline in business activity accelerated through year-end. Between September and November, joblessness jumped from 6.1 to 6.7 percent.

“Several measures of leverage are at record levels”

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### Credit quality aggravated decline

The proximate cause of this economic downturn was the collapse in the housing market. With home prices falling, the value of mortgage-related securities plunged. Tumbling prices for hard-to-value mortgage-related securities threatened the liquidity and solvency of the many financial institutions that held these securities on their balance sheets.

This would not have been nearly as significant a problem if consumers and financial institutions had not gone on a borrowing and lending binge during the previous decade. That binge resulted in both households and financial institutions becoming greatly over-leveraged, with a significant number of poor quality loans.

Several measures of leverage are at record levels. For example, the debt-to-Gross Domestic Product (GDP) ratio is now 242 percent compared to an average of 188 percent from 1987 to 2000.

Similarly, the ratio of household debt-to-disposable income has climbed to 130 percent from its 1987-2000 average of only 85 percent.

Meanwhile, credit quality has deteriorated significantly. Since the early 2000s, the proportion of all subprime mortgages tripled while the share of all mortgages with adjustable interest rates more than doubled.

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## 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	-0.50%	6.70%	1.94%	2.40%	3.90%
Q4	-6.50%	-9.00%	0.53%	1.20%	3.30%
2009	GDP	CPI	Fed Funds	2-year	10-year
Q1	-3.50%	1.00%	0.13%	0.70%	2.40%
Q2	-1.50%	2.00%	0.13%	0.50%	2.20%
Q3	-0.50%	1.50%	0.13%	0.50%	2.20%

**▶ THE PRODUCT QUOTATIONS on these pages were updated as of 12/17/08. 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	1.453%	-0.69%
3-yrs	1.633%	-0.78%
4-yrs	1.796%	-0.89%
5-yrs	1.901%	-0.98%

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	-21%	10	-18%	9	-6%	5	-9%
90	16	-42%	17	-34%	18	-16%	8	-21%
180	21	-51%	26	-38%	31	-16%	13	-23%
365	41	-46%	44	-43%	67	-23%	25	-25%

COSTS ARE STATED IN BASIS POINTS PER YEAR

## 3-MONTH LIBOR INTEREST RATE CAPS AND FLOORS

Strike Rates	3-Month LIBOR Caps				Prime Caps			
	3.0% Chg. from prior month	3.5% Chg. from prior month	4.0% Chg. from prior month	4.5% 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
Term 2-yrs	33 -59%	27 -68%	22 -52%	19 -48%	129 -41%	121 -34%	100 -38%	83 -40%
3-yrs	83 -55%	70 -51%	70 -42%	52 -49%	260 -38%	243 -33%	205 -35%	174 -35%
4-yrs	146 -55%	123 -51%	105 -51%	91 -51%	413 -37%	384 -33%	328 -34%	281 -35%
5-yrs	215 -55%	175 -52%	149 -53%	128 -53%	597 -36%	545 -33%	469 -35%	405 -36%

Strike Rates	3-Month LIBOR Floors				Prime Floors			
	1.5% Chg. from prior month	2.0% Chg. from prior month	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
Term 2-yrs	56 73%	136 87%	222 50%	314 32%	107 37%	163 32%	235 9%	313 10%
3-yrs	85 98%	197 96%	317 53%	447 34%	169 46%	245 34%	346 11%	457 11%
4-yrs	105 126%	247 113%	439 74%	563 38%	221 57%	311 39%	438 15%	577 14%
5-yrs	129 137%	300 122%	522 76%	680 41%	271 64%	373 42%	523 22%	688 18%

3-month LIBOR is currently 1.5775%

Prime is currently 3.25%

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.

## Recession officially declared

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### Deleveraging will take time

Rapid increases in leverage with poorer credit quality combined with innovations in the financial markets created a new set of economic time bombs: subprime mortgages, collateralized debt obligations and credit default swaps. These new financial tools are now wreaking havoc on the banking and credit markets and aggravating the economic downturn.

In addition to resolving the large number of bad loans outstanding, the deleveraging of consumers and the financial system is likely to be a long, drawn-out affair. This suggests that the economy may turn in a subpar performance for an extended number of years. Even when the economy returns to positive growth, it is likely to be a jobless recovery at first, with the unemployment rate remaining high.

### Past not likely to be repeated

The current banking, credit and financial crises are the worst this country has experienced since the beginning of the Great

Depression. However, for a number of reasons, this is not, nor will it likely become, another Great Depression.

The institutional and regulatory changes put into place after the initial collapse of the economy in the early 1930s, when one-third of the banking system and their assets disappeared, have prevented a wholesale collapse of the modern banking system.

In addition, evolution in the composition of economic output – much smaller agricultural and manufacturing sectors and much larger service and government sectors – has greatly reduced volatility in business activity. Innovations in inventory management techniques have also helped minimize the severity of downturns.

Finally, the monetary and fiscal policy lessons learned from the 1930s provide a wealth of information about good, and poor, policy choices.

Although policy mistakes will likely still be made, they are unlikely to be the same policy

mistakes that turned an economic downturn in 1929 into the Great Depression.

### Contraction may hit historic levels

The current recession is likely to be the longest of the post-World War II period. The longest post-war recessions have lasted 16 months, from late 1973 through early 1975 and then again between mid-1981 and late 1982. With the current contraction already at 13 months and counting, and with the downturn intensifying, this recession will probably last at least through mid-2009 and could easily extend through the end of the year.

It is also likely to be the deepest recession experienced in the post-war period in terms of unemployment. The current champion in this category is the 1981-1982 recession when employment fell by 3.1 percent and the unemployment rate jumped by 3.3 percentage points, from 7.5 to 10.8 percent.

So far in the current downturn, employment has declined by 1.4 percent and the unemployment rate has increased by 1.7 percentage points from 5.0 percent to 6.7 percent, as of November 2008.

The recession is ongoing and is even intensifying, however, suggesting that job losses will continue to accumulate. Current job losses and unemployment are both likely to more than double over the next six months.

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**“This is not another Great Depression”**

## Recession officially declared

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### Fed takes aggressive approach

In response to the substantial dislocations in the financial markets and the deteriorating economic situation, the Federal Reserve has aggressively slashed its target for short-term interest rates.

In just 15 months, from September 2007 through December 2008, the Fed cut its target federal funds rate from 5.25 percent to a range of just zero percent to 0.25 percent. These rate reductions were the most aggressive that the Fed has ever engineered, and the Fed's current target range is the lowest in the post-World War II period.

With the Fed's short-term interest rates now nearly zero, the central bank has no further room to maneuver rates lower. However, the Fed has said it intends to keep short-term interest rates extremely low for an extended period of time in an attempt to drive intermediate- and long-term interest rates lower, which are to some extent based on expectations of where short-term interest rates will be in the future.

In addition, since the mid-September collapse of Lehman Brothers, the Fed has massively expanded its balance sheet, a process known as "quantitative easing." In just three months, the Fed's balance sheet exploded from less than \$1 trillion to more than \$2.2 trillion as the central bank either purchased outright or provided financing for an increasingly wide array of financial assets. Furthermore, the Fed has already pre-committed to another \$800 billion in purchases of financial assets in early 2009.

This quantitative easing is injecting massive amounts of liquidity into financial institutions in an attempt to restore normal functioning to the credit markets. So far these liquidity injections have met with limited success.

Nevertheless, the Fed has said it will continue to use its balance sheet and widen the range of financial products that it will purchase or finance until the credit markets return to more normal operation.

### New stimulus package expected

The economy's performance in 2009 will depend greatly on how quickly and smoothly the banking and credit crises resolve themselves. It will also depend on the timing, size

and composition of the economic stimulus program the Obama administration is expected to initiate.

President Obama has assembled an experienced team to staff the key economic positions in his administration. It is anticipated that they will be prepared with a fiscal stimulus package shortly, which based on preliminary reports has all of the hallmarks of a highly effective short-term fiscal stimulus. It will be implemented quickly, it will be substantial and it will be sustained.

## The U.S. still has a resilient and dynamic economy

Preliminary indications suggest that the stimulus package will be in the neighborhood of \$500 billion to \$1 trillion of additional spending and include tax cuts spread over a two year period.

This fiscal stimulus should provide a substantial offset to the declines in private sector spending that are presently occurring. Although this will not by itself immediately return

the economy to a sustained economic expansion, it should help moderate the severity of the recession.

### Housing inventories remain high

By almost any measure, housing is still a fundamental problem affecting the economy and the financial markets. Simply stated, too many housing units were built during the housing boom.

There appear to be approximately 3 million excess housing units. Annual absorption

from a growing population is around 1 million units per year. However, more than 0.5 million new housing units are still being constructed. Thus, net absorption is only about 0.5 million units per year. At this rate, it would take nearly six years to work off all of the excess housing stock, assuming no further declines in housing construction.

As long as there is an excess stock of housing, home prices will continue to decline, although probably at a slower pace than what has been experienced so far.

Nevertheless, as long as home prices are falling, the value of mortgage-related securities will be depressed and financial institutions' balance sheets will be stressed. Until the housing market is rationalized, it will be difficult for the economy to sustain a robust recovery.

### An optimistic outlook

The near-term business outlook is indeed challenging. Current difficulties will necessitate a deleveraging and restructuring of the economy that will wash out many of the excesses of the past decade.

Despite the difficulties it currently faces, the U.S. still has one of the most resilient and dynamic economies in the world. Political stability, flexible labor markets, a strong entrepreneurial spirit, many globally-competitive industries, global economic engagement, usually deep and liquid capital markets, and active and responsible policymaking will eventually propel the economy towards sustained, non-inflationary growth.

*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.*

### IMPLIED FORWARD RATES

Years Fwd	3-month LIBOR	1-yr Swap	3-yr Swap	5-yr Swap	7-yr Swap	10-yr Swap
Today	1.58%	2.10%	1.66%	1.91%	2.08%	2.22%
0.25	2.19%	2.03%	1.71%	1.95%	2.11%	2.24%
0.50	2.23%	1.72%	1.71%	1.96%	2.12%	2.26%
0.75	2.31%	1.31%	1.71%	1.97%	2.13%	2.26%
1.00	1.32%	0.81%	1.71%	1.97%	2.14%	2.27%
1.50	0.64%	1.20%	1.89%	2.11%	2.25%	2.36%
2.00	1.83%	2.04%	2.21%	2.33%	2.41%	2.49%
2.50	2.09%	2.16%	2.29%	2.40%	2.45%	2.53%
3.00	2.12%	2.25%	2.35%	2.45%	2.48%	2.55%
4.00	2.21%	2.29%	2.45%	2.51%	2.54%	2.60%
5.00	2.37%	2.46%	2.56%	2.57%	2.62%	2.65%

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# OUTLOOK

JANUARY 2009

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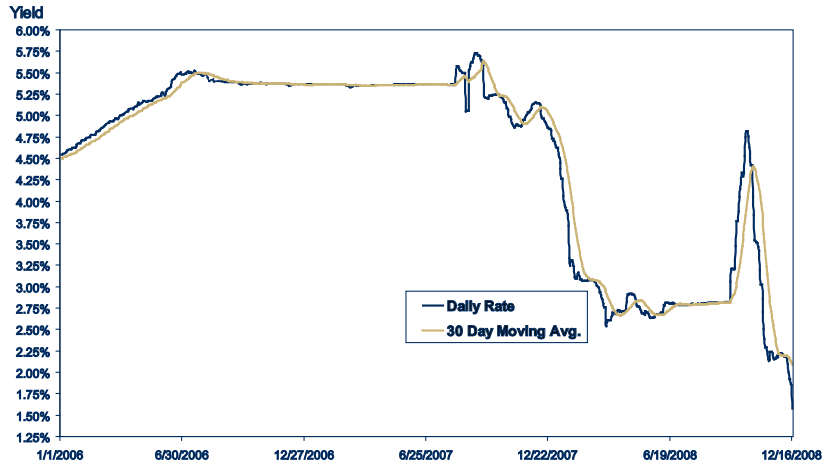
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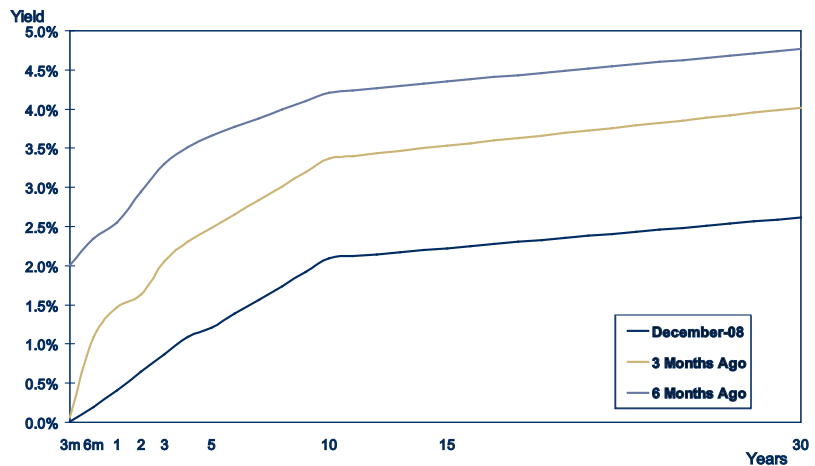
## 3-MONTH LIBOR Daily Rates vs. Moving Average

DECEMBER 17, 2008



## TREASURY YIELD CURVE

DECEMBER 17, 2008



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