OUTLOOK Economic Data and Commentary

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Outlook on the U.S. Jobs Market

As 2013 draws to a close, the U.S. economy is exhibiting signs of marked improvement when it comes to jobs. The recently released November jobs report showed the unemployment rate improving three tenths of a point to 7.0 percent from the prior month, its lowest level since late 2008. Economic observers cheered the news, while investors wondered whether unexpectedly strong job gains will prompt the U.S. Federal Reserve to begin dialing back its monetary stimulus programs.

From a historical perspective, however, the employment picture remains weak. The labor force participation rate continues to hover at 35-year lows, and job creation continues to be hampered by the new health care law and other political and regulatory uncertainties.

For an update on the overall situation in the United States, *OUTLOOK* turned to economist David Hale. Hale is a Chicago-based economist whose clients include asset management companies in North America, Europe, Asia, and Africa. He is the founding chairman of David Hale Global Economics and previously worked as chief economist for Kemper Financial Services and Zurich Financial Services.

OUTLOOK: The most recent jobs report was very positive. What's your take? Have we turned a corner?

David Hale: The November employment report was quite encouraging. More than 200,000 new jobs were created last month, and November marked the second consecutive month of job gains of 200,000 or more. The results in both months exceeded market expectations. The employment gains in November were broad-based across goods-producing and service sectors.

The decline in the unemployment rate reflected a big rebound in household employment – that is, non-farm jobs – after a large decline in October. The labor force participation rate actually rose a little.

OUTLOOK: Should we be encouraged or discouraged?

DH: Since unemployment reached its nadir in early 2010, more than 7 million jobs have been created. However, we're still missing more than 1.3 million jobs compared to what we had before the downturn. One of the reasons for the big drop in the unemployment rate in previous months was falling labor force participation rate. Many people who are unemployed have simply stopped looking for work and have dropped out of the labor force.

About this article

David Hale is a Chicago-based economist whose clients include asset management companies in North America, Europe, Asia, and Africa. He is the founding chairman of David Hale Global Economics. He formerly worked as chief economist for Kemper Financial Services from 1977 to 1995 and Zurich Financial Services, which he joined as chief economist when it purchased Kemper in 1995. He advised the group's fund management and insurance operations on both the economic outlook and a wide range of public policy issues until 2002, when he founded David Hale Global Economics.

Mr. Hale is a member of the National Association of Business Economists and the Academic Advisory Board of the Federal Reserve Bank of Chicago. He is also a member of the Council on Foreign Relations in both New York and Chicago. He has written on a broad range of economic subjects for the *Wall Street Journal*, the *Financial Times*, the *New York Times*, *Harvard Business Review*, *Foreign Affairs* and others.

Mr. Hale holds a bachelor's degree in international economic affairs from the Georgetown University School of Foreign Service and a master's degree in economics from the London School of Economics.

If the labor force participation rate was still where it was five or six years ago, the unemployment rate would be around 11 percent. We've made progress, but the reality is unemployment would be a lot higher if we factored in those who have dropped out.

So, over the next two or three years as the economy gets gradually better, if those people begin to re-enter the market, the unemployment rate will decline very, very slowly. If they don't re-enter, and we have moderate job growth like we've had in the past year or two, the unemployment rate will drop next year to 6.5 percent or less, and by 2015 it could be below 6 percent.

OUTLOOK: Why has the labor participation rate dropped so much?

DH: A lot of this is simply demographics. It's not just the job market; it's the change in the population. Baby boomers are getting old and simply deciding to retire. We've also seen a big drop in the rate for those between 18 and 24 years old, and that's gone hand in hand with a very large increase in university enrollment. A lot of young people are staying in school for a variety of reasons. We've had a bad economy so there hasn't been as much job creation. They may also be aware that those who don't have a college education are much more likely to be unemployed than those who do. The unemployment rate for college graduates is 4.5 percent. For high school dropouts, it's 12 or 13 percent.

I would also add one other reason for the decline in labor participation rates: We are now approaching 12 million people getting disability payments. That's way up from five or six years ago. During the downturn, we had record job losses. People had unemployment benefits for one or two years but once those benefits ran out they had to go on welfare. However, many of them thought disability payments were a better way to support themselves than just going on welfare. Workers were able to find some doctor to say they had a problem with their back or something else so disability enrollment has skyrocketed. These are people who might re-enter the labor force if there's a good job offer.

OUTLOOK: How does the labor participation rate affect the economy?

DH: Thirty years ago, labor force growth in the United State was 2 percent each year. Now it's around 0.5, 0.6 percent, which brings down the economy's potential growth rate. The average growth rate of the American economy over the last 100 years is about 3 percent per year but many economists now think our potential growth rate may be less than 2 percent, partially because we have less labor force growth. Plus productivity growth has slowed down in recent years.

"We'll know when we're getting closer to full employment when we see an upward pressure on wages. Once you have labor scarcity, supply and demand forces will tend to give you higher wages.

OUTLOOK: What is the "normal" level of unemployment for the U.S. economy? When do you think we will get back to that level?

DH: Many years ago we regarded full employment as 4.5 percent. Now we tend to think it's more like 5.5 percent. We'll know when we're getting closer to full employment when we see an upward pressure on wages. Wage growth has been very subdued now for the last four or five years. It's been averaging only around 2 percent. Once you have labor scarcity, supply and demand forces will tend to give you higher wages.

OUTLOOK: What industries are doing better in creating jobs? Are there any general patterns in the "quality" of jobs being created?

DH: The mix of job growth is quite diverse. We've gained back several hundred thousand manufacturing jobs, but we lost millions over the previous decade. We also have regained about 300,000 construction jobs but we lost 2.3 million of them during the downturn. Still, housing starts are up across the country. Depending on where you are, commercial real estate development is a very mixed picture. In cities with high vacancy rates there won't be much construction.

The business services category, which includes areas such as legal services, architectural services, and management-related occupations, has had a good recovery in the last couple of years, especially in administrative support, computer systems design, and management and technical consulting. We've also had a good recovery of employment in leisure and hospitality services. The service sector of the economy as a whole has grown but it has not been as robust as previous recoveries.

We've had a very good recovery in the auto sector that has produced a few hundred thousand jobs.

A big opportunity for growth could be state and local governments. We had a big reduction in spending on infrastructure by state and local governments during the downturn but there's since been a recovery in tax receipts. State and local governments are in better shape, and there's a big backlog in spending on infrastructure, although there will also be demands on state and local governments to hire back many of the hundreds of thousands of workers they have been forced to let go.

OUTLOOK: What regions of the country are doing better in terms of employment? Which are doing worse?

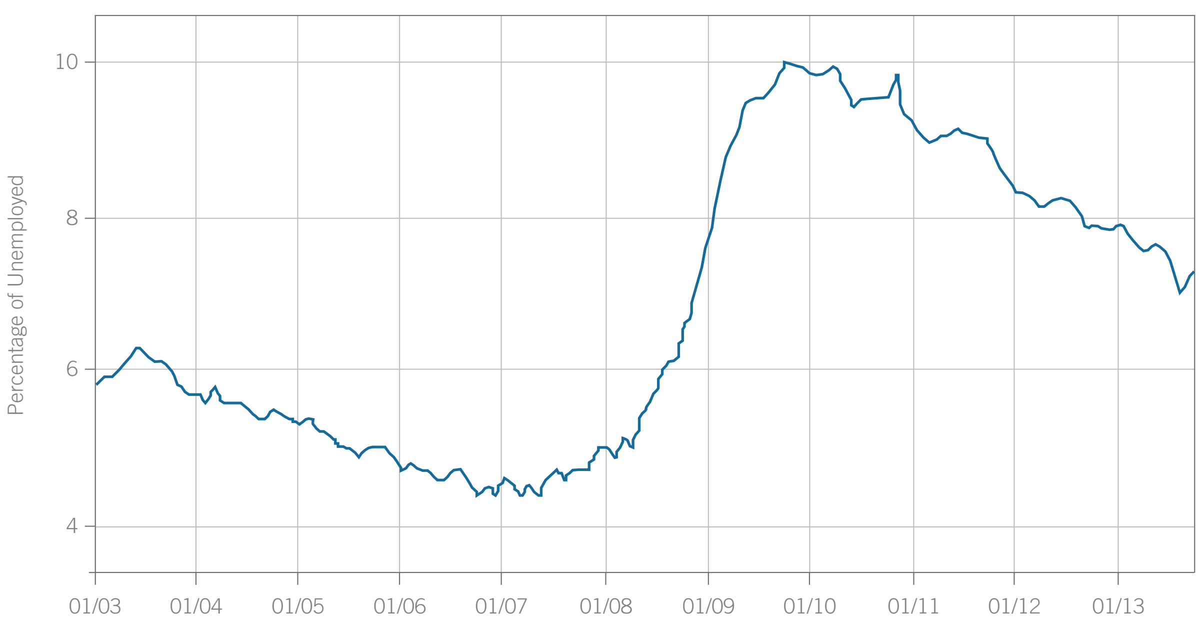
DH: Because we've had this comeback in the auto industry, Michigan's actually looked a lot better in the last year and a half than it did before. Michigan had a horrible decade with massive job losses. But it's showing signs of progress and what affects the auto industry also has effects in Ohio and Indiana because they have a lot of automobile-related companies.

Silicon Valley is booming. That's not a very big region but it has given California a real shot in the arm. Texas has done very well for the last 10 years and that continues.

The areas that got hit very hard by the real estate downturn three or four years ago – Phoenix, Las Vegas, some California cities – have seen a great recovery in real estate prices. We've seen recovery in Florida. So where you had huge wealth losses three and four years ago, you're now getting wealth gains. Arizona, California, and Nevada went from having on average the 46th fastest rate of job creation between the peak in housing values and the trough to the 14th fastest since the housing price trough in January 2012.

U.S. UNEMPLOYMENT RATE

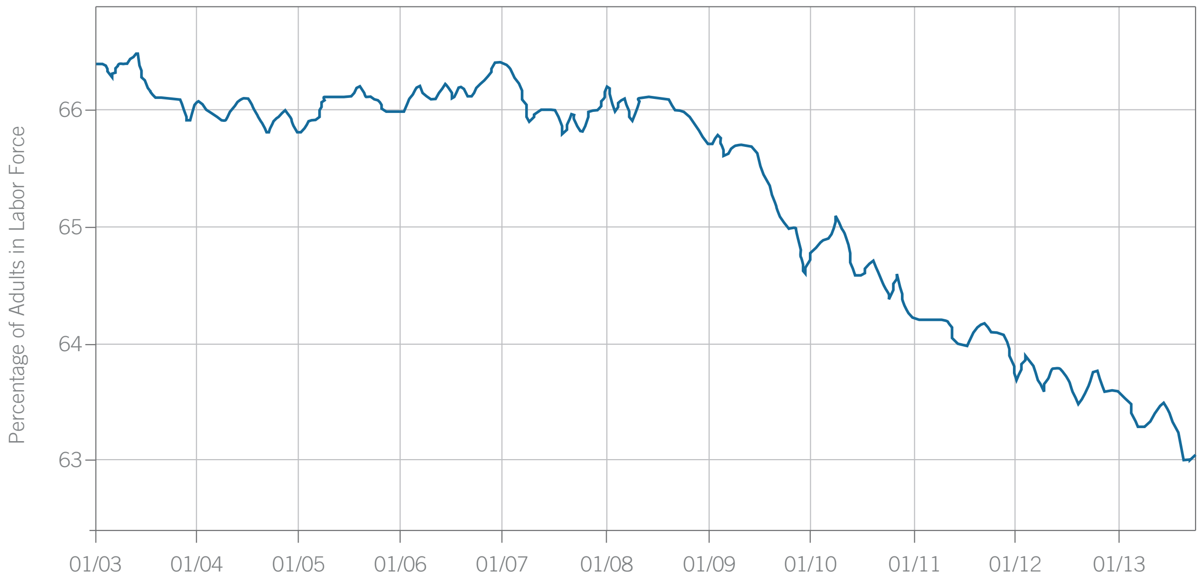
The jobless rate in the United States has decreased from its peak of 10 percent in 2009.



Source: Bureau of Labor Statistics

LABOR FORCE PARTICIPATION RATE

The U.S. unemployment rate has dropped steadily in 2013 but part of that decrease is due to the large number of unemployed people who have simply stopped looking for work and are no longer considered part of the labor force.



Source: Bureau of Labor Statistics

One new factor we're seeing in the real estate market is institutional buying of single family homes. Blackstone, which is an investment and advisory firm, has bought 28,000 single family homes in the past two years. A few weeks ago they sold a new security based on the rental income from these single family homes. These purchases have helped to drive double-digit annual growth in house prices since 2012. This has played a part in the share of underwater homes going from 31 percent in the first quarter of 2012 to 21 percent in the third quarter of 2013. These homeowners who are no longer underwater will be able to spend more freely, and this trend will continue to help drive job growth in the coming years. Morgan Stanley recently issued a report that private equity investors have put $18 billion into single family homes and it might be $100 billion by 2015 or 2016. This is a very, very major new development. Before, the people who bought real estate as an investment lived in the community and looked after the properties. We've never had firms like Blackstone come in and buy thousands of homes. That's one reason we've had this good recovery in real estate and such a great recovery in real estate prices.

OUTLOOK: Have men and women fared differently in terms of employment in this recovery?

DH: Women weren't hit as hard in the first stage of the recession when the big job losses were in manufacturing and construction. That heavily impacted men. But then when we had the big job losses in state and local governments, women got hit very hard by that. We laid off 300,000 teachers. We laid off thousands of government bureaucrats. The big drop in state and local government employment fell much more heavily on the female part of the population.

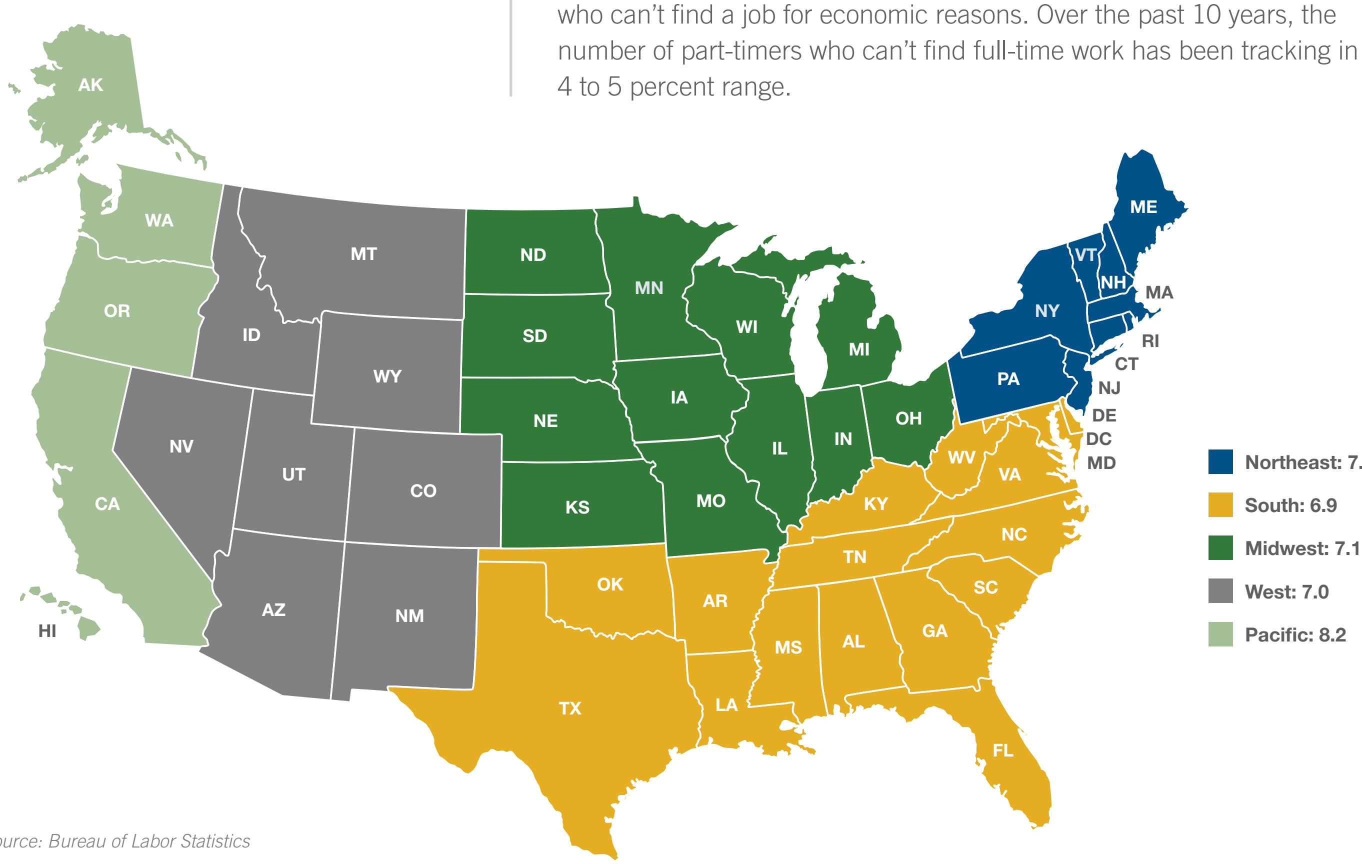
OUTLOOK: Something like 75 percent of the new jobs created in 2013 have been part-time. How does that compare to a normal year?

DH: The bulk of part-time hiring occurred during the first half of the year when businesses were preparing for Obamacare and either trying to stay below 50 employees, the threshold for providing them health insurance, or relying more heavily on part-time workers because they wouldn't need to supply them with insurance.

Then, the Obama administration announced in June that they were going to exempt the corporate sector from compliance with the new healthcare system until 2015. Giving them another year to implement changes took the pressure off to hire part time workers.

If you look at the data, we have two categories of part time workers: Those working part-time for non-economic reasons, i.e., a lifestyle choice to spend more time with their children, and those who are part time for economic reasons. That is, because they cannot find a full time job. In October of this year, 81.3 percent of all workers were full time. About 13.1 percent were working part time for non-economic reasons and 5.6 percent were working part time for economic reasons. That's down from 6.5 percent in the spring of 2009. We're making some progress there. But there will always be people who can't find a job for economic reasons. Over the past 10 years, the number of part-timers who can't find full-time work has been tracking in the 4 to 5 percent range.

U.S. UNEMPLOYMENT RATE BY REGION



Source: Bureau of Labor Statistics

> A big issue for next year will be how many workers are forced by their employers to give up their corporate health insurance program and go to Obamacare.

Although 75 percent of new jobs created during the first three quarters of 2013 were part-time in nature, the share of new full-time jobs created after the recession's trough in June 2009 is greater than during the previous business cycle. During the business cycle expansion of November 2001 until December 2007, 88 percent of new jobs created were full-time positions. By contrast, since June 2009, 118 percent of new jobs created have been full-time positions due to a decline of a million part-time jobs that existed because of economic conditions.

OUTLOOK: Will next year's Obamacare mandates on business cause that part-time number to go up again?

DH: To be honest, because Obamacare is such a mess, it's not clear what the law will be in a few months or what changes might be made to it. I think a big issue for next year will be how many workers are forced by their employers to give up their corporate health insurance program and go to Obamacare. There was a recent report saying private employers may drop the insurance policies for 6 million people. I think it could be 15 or 20 million. Health insurance is expensive. If you can get rid of the liability by making people go to Obamacare, the temptation to do that for many businesses will be very, very strong.

OUTLOOK: How will what's happening in Washington impact jobs numbers next year?

DH: Actually, there are three or four factors that are positive for the economy next year.

First there will be a lot less fiscal drag coming out of Washington. It was massive this year – almost 2 percent of GDP. We had the $110 billion increase in the Social Security tax in January. We raised the top marginal income tax rate on high income people. That was probably worth about $40 billion. We began the sequestration of federal spending in March. That was about $45 billion. And we had some other spending cuts also. The growth rate of the private sector this year was over 3 percent but the growth rate of GDP as a whole was only 1.7 percent because of this government drag. We won't have that next year. Analysts have estimated that U.S. monthly job growth in 2013 would have been more than 400,000 had there been no fiscal drag compared to a rate below 200,000 for the first ten months of the year.

> The oil and gas boom is helping to create thousands of jobs, and it also creates demand for steel and things like that. The output is driving down the price of natural gas and that's a big positive for industry in the United States.

Congressman Paul Ryan has ruled out any tax increases whatsoever. What they may do to try and reduce the deficit is go for higher user fees, things like that. They're also going to try and reduce farm subsidies. But there won't be any tax increases.

The second positive is the housing market is coming back. It did stall late in the summer because we had higher mortgage rates with all of the talk of tapering the Fed's bond buying program. But mortgage rates are still quite low by historical standards. Banking systems also have had a good recovery. Bank profits are now higher than they were in 2007. Equity asset ratios are over 11%. That should be a positive for credit creation. As firms take on new investment projects, they will have to hire more workers who would otherwise be idle.

We also have the oil and gas boom going on. That's helping to create thousands of jobs, and it also creates demand for steel and things like that. The output is driving down the price of natural gas and that's a big positive for industry in the United States. Some European firms have announced plans to move production from Europe to North America to take advantage of these very low gas prices. All of those things point to a growth rate next year closer to 3 percent. This year, we're a bit under 2 percent.

Interest Rates and Economic Indicators

The interest rate and economic data on this page were updated as of 11/30/13. 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.

KEY ECONOMIC INDICATORS

Gross Domestic Product (GDP) measures the change in total output of the U.S. economy. The Consumer Price Index (CPI) is a measure of consumer inflation. The federal funds rate is the rate charged by banks to one another on overnight funds. The target federal funds rate is set by the Federal Reserve as one of the tools of monetary policy. The interest rate on the 10-year U.S. Treasury Note is considered a reflection of the market's view of longer-term macroeconomic performance; the 2-year projection provides a view of more near-term economic performance.

ECONOMIC AND INTEREST RATE PROJECTIONS

Source: Insight Economics, LLC and Blue Chip Economic Indicators

				US Treasury Securities	
2013	**GDP**	**CPI**	**Funds**	**2-year**	**10-year**
Q4	1.80%	1.40%	0.08%	0.37%	2.74%
2014	**GDP**	**CPI**	**Funds**	**2-year**	**10-year**
Q1	2.60%	1.80%	0.09%	0.45%	2.90%
Q2	2.80%	1.90%	0.10%	0.61%	3.07%
Q3	2.90%	2.10%	0.11%	0.77%	3.23%
Q4	2.90%	2.10%	0.13%	0.93%	3.40%

PROJECTIONS OF FUTURE INTEREST RATES

The table below reflects current market expectations about interest rates at given points in the future. Implied forward rates are the most commonly used measure of the outlook for interest rates. The forward rates listed are derived from the current interest rate curve using a mathematical formula to project future interest rate levels.

IMPLIED FORWARD SWAP RATES

Years Forward	3-month LIBOR	1-year Swap	3-year Swap	5-year Swap	7-year Swap	10-year Swap
Today	0.24%	0.27%	0.68%	1.52%	2.23%	2.89%
0.25	0.25%	0.29%	0.82%	1.69%	2.38%	3.00%
0.50	0.28%	0.34%	0.99%	1.87%	2.53%	3.12%
0.75	0.31%	0.40%	1.17%	2.06%	2.69%	3.24%
1.00	0.34%	0.49%	1.36%	2.25%	2.84%	3.36%
1.50	0.53%	0.81%	1.82%	2.64%	3.15%	3.59%
2.00	0.88%	1.26%	2.31%	3.03%	3.43%	3.83%
2.50	1.44%	1.82%	2.77%	3.37%	3.71%	4.02%
3.00	2.01%	2.37%	3.23%	3.71%	3.99%	4.21%
4.00	2.98%	3.34%	3.86%	4.20%	4.37%	4.50%
5.00	3.69%	4.02%	4.34%	4.48%	4.61%	4.68%

HEDGING THE COST OF FUTURE LOANS

A forward fixed rate is a fixed loan rate on a specified balance that can be drawn on or before a predetermined future date. The table below lists the additional cost incurred today to fix a loan at a future date.

FORWARD FIXED RATES

Cost of Forward Funds

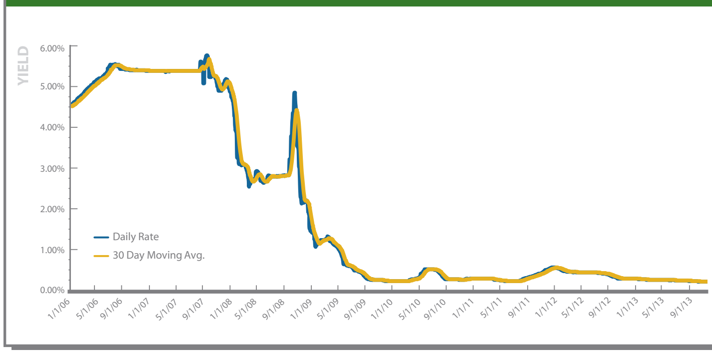
Forward Period (Days)	Average Life of Loan			
	2-yr	3-yr	5-yr	10-yr
30	5	8	9	6
90	12	19	22	15
180	21	37	42	29
365	56	81	88	57

Costs are stated in basis points per year.

SHORT-TERM INTEREST RATES

This graph depicts the recent history of the cost to fund floating rate loans. Three-month LIBOR is the most commonly used index for short-term financing.

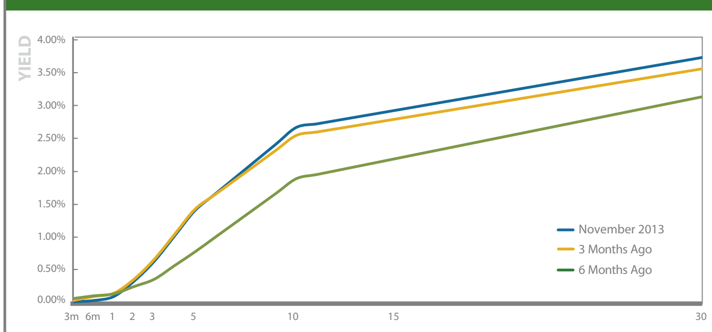
3-MONTH LIBOR



RELATION OF INTEREST RATE TO MATURITY

The yield curve is the relation between the cost of borrowing and the time to maturity of debt for a given borrower in a given currency. Typically, interest rates on long-term securities are higher than rates on short-term securities. Long-term securities generally require a risk premium for inflation uncertainty, for liquidity, and for potential default risk.

TREASURY YIELD CURVE



CoBank Reports Third Quarter Financial Results

CoBank recently announced financial results for the third quarter and first nine months of 2013.

Net income for the quarter decreased 4 percent to $208.1 million, from $217.7 million in the third quarter of 2012. For the first nine months of 2013, net income decreased 10 percent to $628.9 million. Results for the first nine months of 2012 included significantly higher noninterest income due to $44.6 million in refunds from the Farm Credit System Insurance Corporation; 2013 year-to-date net income declined 6 percent when the impact of the refunds is excluded. Earnings were also reduced by lower net interest income and higher insurance fund premium expenses for the quarter and nine-month period.

Net interest income declined in the third quarter by 9 percent to $276.4 million, from $305.1 million in the third quarter of 2012. For the first nine months of 2013, net interest income decreased 5 percent to $875.5 million. The decreases were driven primarily by the continued low interest rate environment, which has impacted the bank's returns on invested capital, its balance sheet positioning and its portfolio of liquidity investments.

Average loan volume for the quarter was $70.3 billion, essentially unchanged from the same period last year. For the first nine months of 2013, average loan volume increased 3 percent. The year-to-date increase was driven by higher levels of borrowing by affiliated Farm Credit associations and rural electric customers, which more than offset a decline in lending to agribusiness cooperatives. The decrease in agribusiness lending resulted primarily from lower grain inventories at many agribusiness cooperatives around the country, which reduced demand for seasonal financing. Total loan and lease volume at September 30, 2013 was $70.4 billion.

Robert B. Engel

"We're pleased with the continued strength of CoBank's business and financial performance," said Bob Engel, CoBank's chief executive officer. "In the broader financial services industry, market conditions remain challenging. Weak loan demand and increased competition have pressured earnings for many banks, as has the low interest rate environment engineered by the Federal Reserve. While our earnings and net interest income have declined moderately from last year's record levels, we remain well positioned to fulfill our mission and serve the borrowing needs of our customers across all the industries we serve."

Credit quality in the bank's loan portfolio remained favorable. At quarter end, 0.76 percent of the bank's loans were classified as adverse assets, compared to 1.01 percent at December 31, 2012. Nonaccrual loans were $151.7

About CoBank

CoBank is a $94 billion cooperative bank serving vital industries across rural America. The bank provides loans, leases, export financing and other financial services to agribusinesses and rural power, water and communications providers in all 50 states. The bank also provides wholesale loans and other financial services to affiliated Farm Credit associations serving farmers, ranchers and other rural borrowers in 23 states around the country.

CoBank is a member of the Farm Credit System, a nationwide network of banks and retail lending associations chartered to support the borrowing needs of U.S. agriculture and the nation's rural economy.

Headquartered outside Denver, Colorado, CoBank serves customers from regional banking centers across the U.S. and also maintains an international representative office in Singapore.

For more information about CoBank, visit the bank's web site at www.cobank.com.

million at September 30, 2013, compared to $170.2 million at December 31, 2012. The bank recorded no provision for loan losses during the quarter, compared to a $10.0 million provision in the third quarter of last year. The bank's allowance for credit losses totaled $625.0 million at quarter end, or 2.08 percent of non-guaranteed loans when loans to Farm Credit associations are excluded.

David P. Burlage

"CoBank's credit quality continues to benefit from the general strength of the U.S. agricultural sector and the other rural industries we finance," said David P. Burlage, CoBank's chief financial officer.

Capital levels at the bank remain well in excess of regulatory minimums. As of September 30, 2013, shareholders' equity totaled $6.6 billion, and the bank's permanent capital ratio was 17.3 percent, compared with the 7.0 percent minimum established by the Farm Credit Administration, the bank's independent regulator. At quarter end, the bank held approximately $22.7 billion in cash and investments.

The bank had 218 days of liquidity at September 30, 2013, compared with the 90-day regulatory minimum.

Engel noted that many now believe the Federal Reserve will not reduce its quantitative easing program until sometime in 2014. "The artificially low rate environment is likely to persist until the Fed signals its intention to taper asset purchases," Engel said. "Though CoBank's business results will generally benefit if rates increase, we continue to generate strong earnings despite the current monetary policy environment. We remain focused on serving our customers in rural America and on building our financial strength and flexibility for the long term."