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About this article

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The U.S. Economy: A Case for Optimism

Anyone looking at the future of the American economy and seeing nothing but rain clouds has plenty of company. Forecasts of gloom abound. According to one recent survey by the global research firm StrategyOne, 65 percent of Americans believe we are headed for a “double-dip” recession. Of those, 77 percent believe the next round will be as bad or worse than the so-called “Great Recession” of 2008 and 2009.

Against that bleak backdrop, are optimists simply Pollyannas looking for silver linings? On the contrary, insists Ross C. DeVol, executive director of economic research at the Milken Institute in Santa Monica, California. The Milken institute works with high level policy makers on ways to improve access to capital, job creation and economic development. If anything, DeVol insists, it is the doom-and-gloom set who are allowing their fears and emotions to obscure persuasive factual evidence that the current recovery is likely to gain rather than lose momentum in the coming months.

According to a recent paper by DeVol, *From Recession to Recovery: Analyzing America’s Return to Growth*, real GDP for the United States is on track to grow by 3.7 percent in 2011 and 3.8 percent in 2012. Private sector employment, meanwhile, will grow by 3.1 million jobs next year. Not spectacular growth, by any means, but certainly encouraging considering all the predictions of a double-dip.

Even so, DeVol warns that Americans risk derailing the recovery in two ways: by giving in to our pessimism, in which case failure becomes a sort of self-fulfilling prophecy, or by failing to enact needed policies to control the federal deficit and spur private growth.

OUTLOOK: Americans like to think of themselves as optimists. Where does this “doom and gloom” outlook you speak of come from?

RD: From April to July 2010 we searched all media for phrases used to describe the recession and recovery. “Double-dip” was the single most common phrase running through these stories. I don’t think economists



Ross C. DeVol is executive director of economic research at the Milken Institute

There are a lot of serious issues facing the U.S. and world economies, but the fact is we're experiencing slow but steady growth.

and pundits who talk about the possibility of a second round of recession are consciously willing us into a double-dip, but they are naturally always looking for the next big story. In a 24-hour news cycle, slow and steady growth isn't exactly a headline-grabber. It isn't nearly as exciting as, say, worrying about how the European sovereign debt crisis will drag down the rest of the world. There are a lot of serious issues facing the U.S. and world economies, but the fact is we're experiencing slow but steady growth.

OUTLOOK: You've warned that such projections of a double-dip recession can become self-fulfilling, or, at least, slow down the recovery.

RD: If you're the CEO of a large company, or a small business owner, and you hear over and over about the coming double-dip, chances are you're going to be more reluctant to make investments or hire someone.

OUTLOOK: How do we combat this?

RD: By taking a closer look at objective numbers that are sometimes obscured in the haze. Economics is a social science rather than a hard science, so it is possible to overemphasize the importance of hard numbers. On the other hand, science does offer certain tools that can help you remove subjective biases and consider the underlying structures of the economy. For example, look at consumer spending. It's a common belief that the U.S. consumer is dead in the water and will have to restrain purchases for years to come. And, certainly, the consumer has been hit hard with declines in employment. But since the start of the recession, consumers have very quietly been reducing their debt servicing burden. Their financial obligation ratio – consumer credit as percent of disposable income – has dropped from a peak of 6.5 percent in the summer of 2005 to 5.1 percent in the third quarter of 2010. That's the lowest since 1995, and from a media perspective, it's something very few people have been talking about. These numbers suggest that as employment improves and income rises, consumers won't be saddled with as much debt as in the past. They will be able to increase their purchases at a rate that matches income growth. In fact, this has already started. From August through October of 2010, retail sales rose at an annualized rate of 11 percent. We're starting to see people fulfilling some of the pent up demand that was created during the recession.

OUTLOOK: Yet unemployment remains stubbornly high.

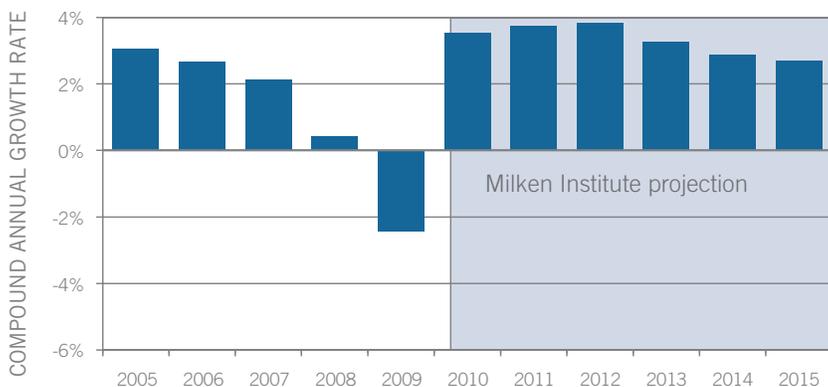
RD: From the time that private sector employment bottomed in December 2009, it has risen by 1.1 million jobs. That's nothing to get excited about. We haven't had strong enough overall GDP growth to drive employment much higher. But the trend is what's important. Every month this year, we've added to private sector payrolls. The biggest concern is really small businesses. They're still very reluctant to hire. Part of this reluctance has been the fear of the recession expanding into a new Great Depression. Also, we saw a marked contraction in credit available to small businesses – and credit is their biggest engine of expansion. But we're seeing some positive signs, for example, in the retail trade as we head into the holiday season. Shoppers are going to the mall again. Maybe they're not buying quite as much, but there is demand out there, and that means more hiring by stores.

Even more encouraging are the signs we're seeing from bellwether sectors such as transportation and warehousing. Transportation executives I speak with tell me that business is much stronger right now than they predicted – and that's being reflected in new hiring. In Los Angeles, the largest port in the United States, international shipments fell by about 30-35 percent from 2008 to 2009. In 2010, they've risen by about the same amount. Companies are restoring inventory throughout their supply chains. And the inventory-to-sales ratio hasn't increased. What that tells us is they're not just stockpiling goods. Fresh inventories are simply keeping pace with pent up demand.

OUTLOOK: So, the period of companies cutting their way back to profitability is over?

RD: If you look at structures – buildings and office space – those areas are still hurting. And people tend to focus on that because real estate is so visible. But what's really intriguing and encouraging is how businesses are reinvesting in new equipment, particularly high-end software and machines. In the third quarter of 2010, investment in IT equipment and software was 19.1 percent higher than in the same quarter of 2009. IT companies have seen strong profits and new orders all through the year. They've consistently beaten analyst expectations. The media have

REAL GDP OUTLOOK: UNITED STATES



Source: Bureau of Economic Analysis, IHS Global Insight, Milken Institute.

INDUSTRIAL PRODUCTION INDEX SHOWS PROMISE



Sources: Federal Reserve Board, IHS Global Insight

generally viewed this development skeptically, as though there's some sort of disconnect. But in fact, this makes perfect sense. American businesses are afraid of losing their competitive position in international markets. We are in a global economy and the single greatest U.S. competitive advantage is innovation. Innovation requires investment. Businesses are quietly investing in labor-saving technology, information technology and other forms of sophisticated equipment, such as laser-guided machine tools.

OUTLOOK: What does history tell us to expect about the recovery moving forward?

RD: Recoveries are seldom mirror images of the recessions they follow. The idea of a “V-shaped recovery” – improvements coming at precisely the same rate and in the same way as the decline – rarely happens. On the other hand, recoveries are in some ways proportional. We've had a very serious recession, and that means there's a lot of pent-up demand. In 2009, the United States scrapped more cars than were sold. In other words, the nation's overall fleet actually declined. You can do that for a year or maybe two, but that trend simply can't continue. That pent up demand that will sooner or later have to be satisfied.

OUTLOOK: What about housing, which, after all, started this whole economic crisis?

RD: This is one area that is actually weaker than we anticipated. We haven't seen much recovery in existing home sales and prices remain weak. Part of this has to do with home buying incentives in 2009 and earlier this year, which pulled some sales forward in time. Problems with the foreclosure market may be contributing, too. But after an economic shock of the sort we've experienced as a country, the recovery isn't going to fire on all cylinders at once. I think we'll have to get all the way through 2011 before housing adds anything to economic growth.

OUTLOOK: Housing aside, does your bullish outlook on the economy mean you believe full recovery is a sure thing?

RD: Not at all. Any number of factors could derail the recovery. Apart from giving in to our fears, as I mentioned earlier, the biggest dangers have to do with government policy. The tax picture, for example, needs to be cleared up in a hurry. With all of the changes set to come with the end of the Bush-era tax cuts in January, much remains unresolved.

OUTLOOK: Which taxes are of most concern to businesses?

RD: That all depends on who you are. If you're a small business owner, you care mostly about the top personal income tax rising from 35 percent to 39.6 percent. If you're in financial services, you care about capital gains increasing from 15 percent to 20 percent. If you're a CEO, you're worried about how all the uncertainty will affect client demand. You can make an argument that as capital gains and dividend taxes go up, it can harm stock prices, because investors won't see the same after-tax rate-of-return.

At the end of the day, though, the real killer is uncertainty. You can debate the precise effect of a specific tax incentive or tax increase. But there's no question that uncertainty is damaging. It doesn't give a small business owner or CEO of a large company much confidence in a period where everybody's already feeling risk-averse. If you don't know what your tax bill is going to be come January 1, how can you plan? In business, planning is everything, yet everyone is still guessing.

OUTLOOK: What's the best-case scenario on taxes?

RD: Well, certainly, you'd like to see the Bush cuts extended for a couple of years at least. But it's important that they reach some sort of decision by the end of the year. The Republicans could very well stall until they take control of the House of Representatives, and the Democrats could easily dig in and make a case about cuts for the middle class versus the wealthy. Both approaches would be a big mistake. The two sides really have to get together to decide on these things.

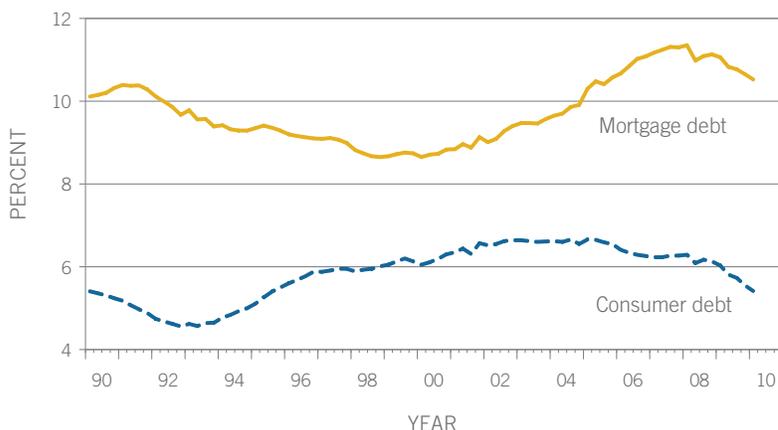
OUTLOOK: What role could regulation of businesses play in helping or hurting the recovery?

RD: The Administration has allowed itself to get sidetracked on a number of issues, such as cap and trade and health care. In a stronger economy you might be able to put forth an argument in favor of cap and trade to reduce the levels of CO2. But if you're coming out of the most severe recession of the post-war period, that's not the best time to make that case.

But the biggest misstep may be the confrontational stance the Administration has taken towards business – not just Wall Street but the Chamber of Commerce. Anti-business rhetoric is not something that instills confidence in the private sector, or that's going to encourage them to go out and hire new employees. And

HOUSEHOLDS SHEDDING DEBT

Financial obligations ratio – (homeowners' debt as percent of disposable income)



Sources: Federal Reserve Board, Moody's Economy.com

We've had a very serious recession, and that means there's a lot of pent-up demand. That pent-up demand will sooner or later have to be satisfied.

when you go after the Chamber, you're not just going after big corporations or Wall Street traders, but the guy who owns the shoe store or the hair salon on Main Street. Somehow, that message was lost on the White House. When you attack the Chamber of Commerce you're seen as attacking small business. Recently, we've seen the Administration working to mend fences, and that's a good thing.

OUTLOOK: What about the government deficit? Until very recently one could hear widely respected economists suggesting that deficits don't really matter.

RD: When the budget deficit represents, say, 1-3 percent of GDP, they're not as important because they're not crowding out the private sector. But when your deficit represents better than 10 percent of GDP, as it is now, and your annual deficit is \$1.3 trillion or higher, it matters a great deal. Right now there's still a lot of slack in the economy so there's not a lot of crowding out. But as the recovery improves in the next year or two, if the markets don't believe we have a credible plan in place to bring down the trajectory of our deficits and our growing federal debt burden, investors will demand a higher interest rate to keep buying our debt. That increases the cost of capital and places the sustainability of economic growth in jeopardy. If we don't get our budget deficit on a sustainable track, there's going to be an increase in interest rates much higher than people imagine and, potentially, inflation. I think the markets will give us about two more years to get our financial house in order.

OUTLOOK: Are politicians getting this message?

RD: That remains to be seen. When you talk about cutting budgets, somebody always starts screaming. But the clear message from this election was, to paraphrase James Carville: It's jobs, the economy and the deficit, stupid. Voters want Congress and the White House to focus like a laser beam on job creation. Everything else is secondary.

Interest Rates and Economic Indicators

The interest rate and economic data on this page were updated as of 10/31/10. 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 & Blue Chip Economic Indicators **US Treasury Securities**

2010	GDP	CPI	Fed Funds	2-year	10-year
Q3	1.90%	1.50%	0.19%	0.50%	2.80%
Q4	2.30%	1.60%	0.20%	0.50%	2.60%
2011	GDP	CPI	Funds	2-year	10-year
Q1	2.50%	1.70%	0.20%	0.50%	2.60%
Q2	2.70%	1.60%	0.25%	0.60%	2.70%
Q3	3.00%	1.80%	0.25%	0.60%	2.70%

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 RATES

Years Forward	3-month LIBOR	1-year Swap	3-year Swap	5-year Swap	7-year Swap	10-year Swap
Today	0.29%	0.38%	0.74%	1.44%	2.08%	2.70%
0.25	0.35%	0.42%	0.87%	1.57%	2.20%	2.80%
0.50	0.40%	0.48%	0.99%	1.75%	2.33%	2.89%
0.75	0.44%	0.56%	1.16%	1.91%	2.49%	3.01%
1.00	0.51%	0.65%	1.30%	2.08%	2.61%	3.09%
1.50	0.69%	0.88%	1.68%	2.41%	2.90%	3.33%
2.00	0.95%	1.19%	2.08%	2.74%	3.16%	3.53%
2.50	1.38%	1.64%	2.48%	3.05%	3.41%	3.71%
3.00	1.81%	2.10%	2.88%	3.36%	3.65%	3.89%
4.00	2.73%	2.95%	3.53%	3.85%	4.01%	4.17%
5.00	3.29%	3.63%	3.96%	4.17%	4.29%	4.39%

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	4	7	7	6
90	7	16	18	14
180	9	27	32	24
365	20	47	60	44

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.

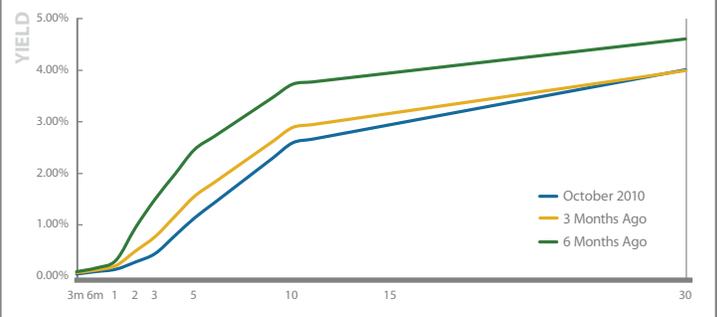
3-MONTH LIBOR



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





About CoBank

CoBank is a \$60 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.

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. In addition to serving its direct borrowers, the bank also provides wholesale loans and other financial services to affiliated Farm Credit associations and other partners across the country.

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.

CoBank Reports Third Quarter Financial Results

Net Income Increases 13 Percent to \$132.0 Million; Capital and Liquidity Levels Remain Strong

CoBank recently announced financial results for the third quarter of 2010.

Quarterly net income rose 13 percent to \$132.0 million, compared with \$116.8 million in the third quarter of last year. Net interest income for the quarter was \$226.3 million, compared with \$223.1 million a year ago. Average loan volume for the third quarter was \$44.5 billion, compared to \$43.4 billion for the same period in 2009.

For the first nine months of 2010, net income increased 4 percent, to \$451.0 million, in part due to the impact of refunds of insurance fund premiums paid in prior years. Net interest income for the first nine months of 2010 was \$674.9 million, compared to \$716.0 million in the same period of 2009. Average loan volume for the period was \$44.1 billion, compared to \$45.0 billion the year before. Total loan volume for the bank at September 30, 2010, was \$46.5 billion.

"CoBank continues to deliver solid financial performance on behalf of customer-owners across rural America," said Robert B. Engel, CoBank's president and chief executive officer. "Earnings, credit quality, capital and liquidity all remain strong, despite persistently sluggish conditions in the broader economy. We remain focused on preserving the strength and stability of the bank while meeting the borrowing needs of our customers and providing them with a superior overall customer experience."

Higher average loan volumes recorded during the quarter reflected the impact of recent sharp increases in prices for certain agricultural commodities, which drove greater seasonal borrowing requirements for grain cooperatives and other agribusiness customers. In addition, the bank experienced growth in its Rural Infrastructure operating segment, primarily due to increased borrowing by rural electric cooperatives, partially offset by declines in lending to service providers in the communications industry. Meanwhile, CoBank's wholesale lending to other banks and associations in the Farm Credit System declined slightly, indicating a low rate of growth in demand for credit at the producer level of the U.S. farm economy.

At quarter end, 1.88 percent of the bank's loans were classified as adverse assets, compared with 1.74 percent at June 30, 2010 and 2.17 percent

at December 31, 2009. Nonaccrual loans improved to \$240.4 million, compared to \$272.1 million at the end of the second quarter. During the third quarter, the bank recorded a \$21.0 million provision for loan losses, in addition to \$16.5 million in provision recorded earlier in the year. The provision for loan losses in the first nine months of last year totaled \$55.0 million. The bank's reserve for credit exposure totals \$497.5 million or 1.81 percent of non-guaranteed loans outstanding when loans to Farm Credit associations are excluded.

"We're pleased that loan credit quality continues to stabilize following impacts from the recent recession on many of the industries we serve," Engel said. "Overall, credit quality remains well within the bank's risk-bearing capacity."

Capital and liquidity levels at the bank remain strong and in excess of regulatory minimums. At quarter end, the bank held approximately \$12.1 billion in cash and investments. The bank averaged 253 days of liquidity during the first nine months of the year, compared with the 90-day minimum established by the Farm Credit Administration, the bank's regulator. At quarter end, the bank's liquidity was 202 days. The bank expects to continue adjusting its liquidity position closer to its management target of 180 days over the balance of 2010 given the ongoing stabilization of global credit markets that has occurred over the past several months.

During the quarter, the bank recorded \$25.0 million in impairment losses primarily as a result of continued weakness in the financial condition of a bond insurer that insures certain of the bank's investment securities. "Credit risk in our investment portfolio remains limited, since approximately 94 percent of our investment securities carry an implied or explicit guarantee from the U.S. government," said David P. Burlage, CoBank's chief financial officer.

Engel noted that the recent jump in agricultural commodity prices was triggered in part by the summer's severe drought in Russia and Eastern Europe and a decision by the Russian government to suspend wheat exports to international markets. "That event underscored once again how interconnected the global economy is today, and the degree to which volatility has become the 'new normal' for U.S. agribusiness and the other vital industries we serve across rural America," Engel said. "For CoBank it also highlights the importance of maintaining our financial strength and capacity to serve customers and of managing the business with a long-term view. We are committed to fulfilling our mission and to providing our customers with the dependable credit they need in a challenging and complex economic environment."

Commentary in Outlook 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 but is not intended to provide specific advice.