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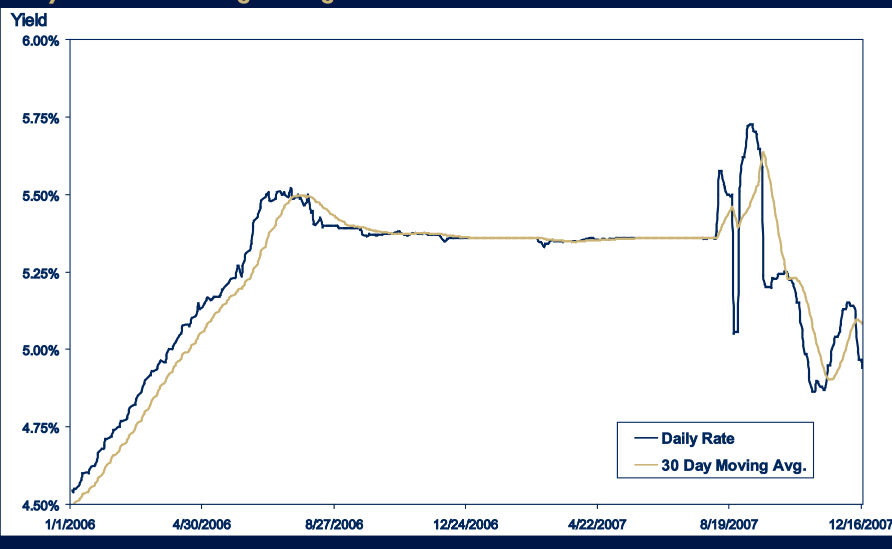
- Tax-exempt environmental bonds

3-MONTH LIBOR — DECEMBER 18, 2007

Daily Rates vs. Moving Average



OUTLOOK

JANUARY 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.

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With $47 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.

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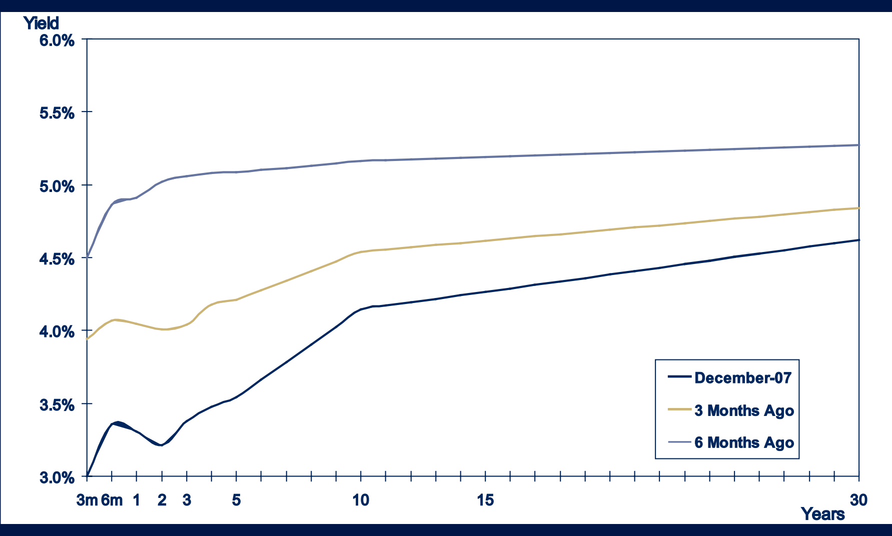
TREASURY YIELD CURVE — DECEMBER 18, 2007



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U.S. Headquarters
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CoBank's Financial Risk Management Publication

OUTLOOK

Volume 5 Number 1 January 2008

View of the Marketplace:
Between a Rock and a Hard Place
Federal Reserve Working Toward Recovery

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.

As of mid-December, the economic forecast is for growth between only 1 percent and 2 percent for fourth quarter 2007 and the first half of 2008. A modest acceleration is anticipated during the second half of 2008 because some of the headwinds that are currently restraining growth will begin to abate. In addition, high energy and commodity prices, a weakening dollar, a relatively tight labor market and slowing productivity growth are likely to push headline inflation even higher. Rapid energy and commodity inflation is also likely to generate some modest spillover into core inflation rates.

The Fed expands rate cuts

The Federal Reserve has acted aggressively since the credit market turmoil began to unfold in early August. In mid-month, it reduced its discount rate—the rate at which depository institutions can borrow from the Fed—by 50 basis points to 5.75 percent, and it widened the array of collateral that it would accept. This move was intended to provide another source of funding to banks that were experiencing liquidity problems due to bad loans.

In mid-September, the Federal Open Market Committee (FOMC) cut both the federal funds target rate and the discount rate by 50 basis points to 4.75 percent and 5.25 percent, respectively. This move was intended to reassure market participants that the Fed was alert to the dangers that the credit market dislocations posed for the broader economy. They also hinted that further rate cuts and policy actions would be forthcoming if there were no improvements in the functioning of the credit markets and/or in the outlook for economic growth.

> "The Federal Reserve has acted aggressively"
>
> Dr. Steven Wood

During the following six weeks the seizures in the credit markets appeared to be waning, although there were further signs that the economy was poised for a sharp slowdown in the months ahead. As a result, at the end of October, the Fed cut both the federal funds target rate and the discount rate by 25 basis points to 4.5 percent and 5 percent, respectively. Once again, they hinted that further rate cuts would be forthcoming if the economic outlook didn't improve.

By mid-December the credit markets were beginning to freeze up again and the outlook for the economy had deteriorated further. Consequently, the FOMC again reduced both the federal funds target rate and the discount rate by 25 basis points, to 4.25 percent and 4.75 percent, respectively.

Liquidity requirements addressed

Although this rate cut might help the deteriorating economic outlook, it did nothing for the disruptions in the credit markets. Recognizing this, a day later, the Fed announced an expanded lending facility to ensure that depository institutions had adequate liquidity at year-end. Moreover, in light of the international scope of the credit market problems, the Fed entered into agreements with the Bank of Canada, the Bank of England, the European Central Bank and the Bank of Switzerland to provide

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ECONOMIC AND INTEREST RATE PROJECTIONS

Forecasts courtesy of Insight Economics, LAC — *U.S. Treasury Securities*

2007	GDP	CPI	Fed Funds	2-year	10-year
Q3	4.90%	1.90%	5.07%	4.40%	4.70%
Q4	1.50%	4.50%	4.50%	3.50%	4.30%
2008	**GDP**	**CPI**	**Fed Funds**	**2-year**	**10-year**
Q1	1.00%	2.50%	4.04%	2.90%	4.00%
Q2	1.50%	3.50%	3.62%	2.80%	3.90%
Q3	2.50%	2.50%	3.50%	2.70%	3.90%
Q4	3.00%	3.50%	3.50%	2.70%	3.80%

THE PRODUCT QUOTATIONS on these pages were updated as of 12/18/07. 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	4.077%	-0.10%
3-yrs	4.129%	-0.11%
4-yrs	4.248%	-0.10%
5-yrs	4.376%	-0.10%

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	0	0%	0	0%	0	-83%	1	-29%
90	0	0%	0	0%	1	700%	2	67%
180	0	0%	0	0%	2	-14%	5	21%
365	0	0%	10	-29%	15	6%	15	15%

Costs are stated in basis points per year

A Rock and a Hard Place

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additional dollar liquidity to address any issues that might arise in their markets.

In just four months, the Fed had reduced the federal funds target rate by 100 basis points, cut the discount rate by 150 basis points, and greatly enhanced the liquidity facilities available to financial institutions. This was among the most aggressive central bank actions on record.

Unfortunately, all of this activity may not do very much good, especially for economic growth. The anticipated slowdown in economic growth is not caused by interest rates being too high. Rather it has been caused by the bursting of the housing bubble, the resultant credit market fallout, and the associated effects on consumer spending.

Moreover, lower interest rates may aggravate the inflation outlook by causing additional weakness in the dollar. Although the current account is narrowing and European central banks are expected to reduce their short-term interest rates, the psychology in the foreign exchange market remains quite dollar-negative. A lower dollar would push imported goods prices even higher, adding to inflationary pressures. In addition, by reducing interest rates, the Federal Reserve (and other central banks) may be laying the groundwork for yet another liquidity driven bubble.

The Fed "greatly enhanced liquidity facilities"

Solving the credit crunch

Financial institutions are now requiring more income and asset verification from consumer and business borrowers. In similar fashion, financial institutions are now requiring more asset verification from other financial institutions with which they do business. Unfortunately, because of the rapid rise in delinquencies and foreclosures in the mortgage market, as well as rising delinquencies on credit cards and consumer loans, it has become increasingly difficult, if not impossible, to accurately value these assets.

There are two solutions to this situation—one slow, the other quick. The slow approach is for financial institutions to just wait and deal with the viability of the assets as they evolve. The good assets can be kept on the balance sheet while the bad assets can be written off as they fail. This approach requires a lot of time because it continues the opacity that has plagued the credit markets since mid-2007.

The quick approach would be for financial institutions to make their best estimate as to the value of the assets and write-off those that are likely to fail. This approach would quickly clean up the balance sheet and, provided that the institution is still cash-flow positive, other financial counterparties would resume normal inter-bank lending activity.

While this approach has the benefit of getting bad assets off the balance sheet as quickly as possible and restoring capital market functionality, it does raise questions as to capital adequacy. Although there appears to be plenty of global liquidity for capital raising activities, capital adequacy issues will make financial institutions relatively reluctant to lend.

It is likely that the actual approach taken by financial institutions will be a mix of these approaches. Some financial institutions will be aggressive in writing down their bad assets and will attempt to return to normal inter-bank financing as quickly as

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3-MONTH LIBOR INTEREST RATE CAPS AND FLOORS

	3-Month LIBOR Caps								Prime Caps							
Strike Rates	5.0%	Chg. from prior month	5.5%	Chg. from prior month	6.0%	Chg. from prior month	6.5%	Chg. from prior month	8.0%	Chg. from prior month	8.5%	Chg. from prior month	9.0%	Chg. from prior month	9.5%	Chg. from prior month
Term 2-yrs	28	3%	19	4%	15	4%	13	3%	25	21%	19	17%	16	14%	14	10%
3-yrs	71	-1%	52	-1%	40	-1%	32	-2%	66	22%	49	21%	38	18%	31	16%
4-yrs	129	-1%	97	-2%	75	-2%	60	-2%	100	8%	75	8%	57	7%	45	6%
5-yrs	195	-2%	148	-2%	116	-3%	92	-3%	130	-4%	95	-5%	71	-6%	54	-7%

	3-Month LIBOR Floors								Prime Floors							
Strike Rates	4.0%	Chg. from prior month	4.5%	Chg. from prior month	5.0%	Chg. from prior month	5.5%	Chg. from prior month	7.0%	Chg. from prior month	7.5%	Chg. from prior month	8.0%	Chg. from prior month	8.5%	Chg. from prior month
Term 2-yrs	69	-1%	122	-1%	190	-1%	277	0%	144	-3%	222	-4%	308	-4%	399	-3%
3-yrs	113	-1%	193	-1%	292	0%	414	0%	209	-9%	320	-5%	428	-7%	554	-6%
4-yrs	147	-1%	249	-1%	374	-1%	527	0%	262	-6%	393	-6%	542	-5%	702	-4%
5-yrs	180	-2%	301	-1%	449	-1%	629	-1%	318	-2%	475	-19%	652	-2%	844	-1%

3-month LIBOR is currently 4.92625% **Prime is currently 7.25%**

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.

A Rock and a Hard Place

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possible. Other financial institutions will be more reluctant to do so. Consequently, further surprises will occur from time to time that will disrupt the financial markets.

Economic growth facing challenges

There are significant headwinds for economic growth during the first half of 2008. Home sales and housing construction have yet to reach bottom. After falling by about 50 percent over the past 18 months, there is probably another 25 percent downward adjustment coming over the next six months. Home sales and housing construction should then begin to stabilize, although there is unlikely to be any significant rebound.

These further declines will eliminate many jobs in housing related areas. Slower job creation will dampen income growth. In addition, weakness in the housing market will push home prices even lower, erasing substantial amounts of consumer wealth and adversely impacting consumer confidence.

Despite a substantial debt burden, slower growth in jobs and income, tighter credit standards and higher energy prices, real consumer spending is expected to only slow, not to decline. Because consumer spending accounts for nearly 70 percent of aggregate economic activity, this slowdown will have a big impact on overall economic growth.

Exports remain strong

On the positive side, exports are booming. Robust growth in the largest emerging markets and solid gains in many advanced economies have increased the demand for American-made goods and services. In addition, the multi-year weakening trend in the dollar has made U.S. products less expensive for most foreigners.

Moreover, slower domestic demand and the weaker dollar will dampen import growth. Consequently, the trade deficits should slowly shrink, boosting real net exports and contributing positively to economic growth.

Pressures expected to continue

Unfortunately, inflationary pressures will intensify during the first half of 2008, and productivity growth will slow. Because labor compensation reacts to changes in unemployment with a lag of about a year, unit labor costs should drift higher. This, combined with rising costs for energy and commodities, will pressure businesses to raise prices. A modest acceleration in core inflation measures through the middle of next year should result. Thereafter, core inflation will slowly retreat again.

Amid all of this, the Federal Reserve is expected to reduce the target federal funds rate several more times. Although lower interest rates are unlikely to provide much stimulus to the economy or much lubrication to the credit markets, the central bank will need to be seen as actively involved in the evolving economic trends. Because inflation will be drifting higher, the Fed will need to temper the pace of its rate reduction. Nevertheless, the federal funds rate is expected to fall to 3.5 percent by mid-2008.

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.

CoBank Board Elects New Chairman

The CoBank board of directors will undergo a leadership change when longtime bank Chairman J. Roy Orton is succeeded by Everett Dobrinski on January 1, 2008.

Orton is retiring from the board after a five-year term as chairman and 13 total years of board service. Dobrinski was named as his successor at the board's December meeting in Denver. A director since 1999, he is the owner and operator of Dobrinski Farm, a cereal grain and oilseed farm in Makoti, North Dakota. In addition, he serves as chairman of Verendrye Electric Cooperative and as a director of the Dakota Pride Cooperative and the North Dakota Coordinating Council for Co-ops. He is also a member of the board of the Farm Credit Council.

"CoBank operates as one of the premiere financial institutions serving the needs of rural America today," Dobrinski said. "The bank's ongoing growth and strong reputation in the market are a direct result of the capacity, dependability and responsiveness it offers to customers in the industries it serves. Our entire board is committed to CoBank's continued success and looks forward to working with bank management to deliver growth and value on behalf of customer-owners in the future."

The bank's directors also re-elected Daniel T. Kelley as First Vice Chairman and elected Mary E. Fritz as Second Vice Chairman. Kelley has been a CoBank director since 2004. He is chairman and president of GROWMARK Inc., a farm supply and grain marketing cooperative in Bloomington, Illinois. He also produces corn and soybeans in a family farming partnership near Normal, Illinois. In addition, he serves as director and president of Evergreen FS Inc., chairman of FS Financial Services, director of Nationwide Mutual Insurance Company and director of the Illinois Agricultural Leadership Foundation.

Fritz has been a director since 2003. She is the owner of a wheat, grain and cattle operation in Chester, Montana, and the owner of Quarter Circle JF Ranch. She also serves as a director and past chair of Northwest Farm Credit Services, located in Spokane, Washington.

IMPLIED FORWARD RATES

Years Fwd	3-month LIBOR	1-yr Swap	3-yr Swap	5-yr Swap	7-yr Swap	10-yr Swap
Today	4.94%	4.52%	4.13%	4.37%	4.59%	4.82%
0.25	4.71%	4.24%	4.08%	4.37%	4.60%	4.82%
0.50	4.18%	3.95%	4.05%	4.38%	4.61%	4.84%
0.75	3.96%	3.75%	4.08%	4.42%	4.65%	4.87%
1.00	3.83%	3.54%	4.13%	4.48%	4.70%	4.91%
1.50	3.38%	3.76%	4.31%	4.63%	4.82%	5.01%
2.00	4.10%	4.25%	4.60%	4.84%	4.99%	5.14%
2.50	4.22%	4.42%	4.75%	4.96%	5.09%	5.22%
3.00	4.43%	4.58%	4.90%	5.07%	5.19%	5.30%
4.00	4.79%	4.96%	5.15%	5.26%	5.35%	5.42%
5.00	4.99%	5.16%	5.29%	5.38%	5.44%	5.49%