

OUTLOOK

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View of the Marketplace: Economy Remains Primarily Stable Recession still possible, but not a certainty

By Dr. Lawrence Chimerine

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As everyone knows, the U.S. economy has been characterized by unprecedented turmoil and uncertainty during the last year. It has not only been difficult to forecast accurately, it has also been more challenging than normal to even monitor the economy's performance during this period.

Slow growth continues

The slowdown in economic growth that began more than two years ago has continued during the first half of this year. The leading factors, of course, are the sharp decline in housing construction, the related chaos in mortgage and financial markets, and the impact of an unprecedented increase in energy prices. The latter has not only hurt the economy by squeezing household purchasing power and raising business costs, but also by its direct effect on energy-sensitive industries such as automobiles and airlines.

The job market has also weakened thus far this year, primarily in response to slower economic growth and corporate efforts to keep costs under control. The result has been a modest rise in the unemployment rate.

The second quarter Gross Domestic Product (GDP) numbers overstate the economy's strength due to some building in auto inventories early in the quarter after a strike at a major parts supplier was settled, as well as the impact of tax rebates on consumer spending. It can be said, though, with a high degree of certainty that the deep recession that many were forecasting has not occurred

"It is unclear whether even a mild recession has begun"

Dr. Lawrence Chimerine

thus far. In fact, it is unclear whether even a mild recession has begun.

Defense, exports shoring up economy

The economy would have been considerably weaker if not for the big buildup in defense spending, reflecting wars in the Middle East, a sizeable increase in homeland security expenditures and replacement of old military aircraft and weapons systems.

In addition, a substantial decline in the U.S. trade deficit, largely reflecting a surge in U.S. exports and a big increase in the number of foreigners traveling to the country, has offset some of the weakness in domestic economic activity.

Major economic shift is unlikely

Going forward, the underlying drivers impacting the macroeconomy are still mixed and suggest an extended period of no growth or continued slow growth, with some risk that an actual recession will develop. The major drags on the economy will come from additional declines in home prices and new housing construction, as the adjustment from the huge overbuilding in earlier years continues and as foreclosures continue to add to the inventory of unsold homes.

The credit crunch will also continue because of declines in bank capital as banks write-down more real estate and consumer loans and because of regulatory pressure to raise lending standards. Also, the increase in oil and food prices has had a major impact

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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	1.00%	4.30%	3.18%	2.00%	3.70%
Q2	2.50%	4.40%	2.09%	2.40%	3.90%
Q3	-0.50%	4.00%	2.00%	2.50%	4.00%
Q4	-1.50%	3.00%	1.79%	2.30%	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 7/22/08. 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	3.696%	-0.17%
3-yrs	4.068%	-0.15%
4-yrs	4.292%	-0.14%
5-yrs	4.440%	-0.12%

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	9	-3%	8	0%	5	-9%	3	0%
90	24	0%	22	1%	14	-7%	9	3%
180	38	4%	38	4%	25	-7%	16	6%
365	79	14%	71	15%	51	5%	32	418%

COSTS ARE STATED IN BASIS POINTS PER YEAR

3-MONTH LIBOR INTEREST RATE CAPS AND FLOORS																
3-Month LIBOR Caps					Prime Caps											
Strike Rates	3.5%	Chg. from prior month	4.0%	Chg. from prior month	4.5%	Chg. from prior month	5.0%	Chg. from prior month	5.0%	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	179	-16%	79	-14%	53	-12%	36	-8%	574	2%	544	0%	496	-2%	457	-2%
3-yrs	275	-7%	203	-6%	149	-6%	109	-4%	1026	-1%	968	-1%	912	-1%	852	-2%
4-yrs	436	-5%	335	-5%	254	-5%	190	-4%	1500	-2%	1426	-2%	1355	-2%	1279	-2%
5-yrs	596	-4%	465	-3%	358	-3%	273	-2%	1975	-2%	1888	-2%	1803	-2%	1714	-2%

3-Month LIBOR Floors					Prime Floors											
Strike Rates	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	30	13%	73	13%	131	12%	203	11%	430	4%	489	4%	551	4%	614	3%
3-yrs	46	9%	164	10%	172	10%	263	9%	717	3%	805	3%	895	3%	990	3%
4-yrs	63	8%	127	9%	213	9%	320	8%	1014	3%	1130	3%	1248	3%	1369	3%
5-yrs	87	8%	161	8%	260	8%	382	8%	1316	3%	1460	3%	1606	3%	1755	3%

3-month LIBOR is currently 2.79938% **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.

Economy remains stable

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on family budgets, not all of which has yet been fully reflected in household spending.

There are a number of positives, however, which some of the pessimists are overlooking and which will likely prevent a severe recession going forward.

Housing rebound possible

Congress has enacted legislation designed to help highly distressed housing markets. The legislation includes government support to enable Fannie Mae and Freddie Mac to increase the mortgages they purchase from mortgage originators. This is important at present because the mortgage-backed security market remains depressed. Now that the two agencies can purchase more mortgages, it provides an incentive for banks and other mortgage originators to make more loans.

The size of loans that they can purchase has also been increased, which will put high-housing-cost areas in play as well. The other significant aspect of the legislation is to provide funding to permit the Federal Deposit Insurance Corporation (FDIC) to enable

many families with high-interest-rate adjustable rate mortgages to refinance them with lower-rate fixed mortgages.

The combination of all of the above will likely reduce new foreclosures and speed up the adjustment in housing markets.

Inflation worries diminish

Despite the unprecedented increases in gasoline and other energy prices and the big spike in food prices, overall inflation remains relatively contained. This, of course, is largely the result of structural changes which have made the economy much more competitive and have prevented the spillover of oil and food price increases to other sectors and to wages and salaries.

Furthermore, the huge increases in agricultural and energy commodity prices in recent years have been at least partially reversed recently. In particular, better growing conditions in the United States, Australia, India and other countries have led to a significant decline in the prices of wheat, corn, rice and other key staples. The decline in energy demand resulting from higher prices and slower economic growth has brought the price of crude oil down by about \$20 a barrel. Thus, commodity-induced inflation is likely to taper off in the months ahead.

“There were a few bright spots in the labor market”

Fed likely to keep rates stable

Despite the hand-wringing by some members of the Federal Reserve Board and some economists regarding possible inflation, the Fed is unlikely to raise interest rates any time soon. First, the economy is soft and highly fragile and the Fed almost never raises rates when unemployment is rising and when a significant recession risk exists.

Second, the fears of inflation are grossly overstated. We have learned many times in recent decades that oil price increases are more deflationary than a cause of sustained higher inflation, because of their negative effect on economic growth and because spikes in oil prices generally are at least partially reversed in the months thereafter.

Third, the credit crunch already in place because of the losses that banks are currently experiencing would only be worsened by a tightening of monetary policy – clearly, this would greatly increase the risk of a major economic decline.

Finally, higher short-term interest rates would negatively affect the housing crisis by

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Economy remains stable

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pushing up rates on adjustable-rate mortgages, likely causing an even faster acceleration in the number of foreclosures.

Exports, other sectors remain bright

The growth in U.S. exports has offset some of the decline in housing and consumer spending in recent months. This has been the primary effect of a more fairly priced U.S. dollar on foreign exchange markets. We are also now beginning to experience at least a partial reversal of the huge increase in import penetration in many manufacturing industries in recent decades. Thus, even if export growth slows in response to less buoyant economic conditions overseas, the trade deficit is likely to continue to improve and be an important source of economic growth.

Other growing sectors of the economy, which have helped prevent a severe contraction, continue to show strength. These not only include industries that largely depend on defense spending, but also include oil services, investments in commodity-producing industries, the entire agricultural complex and those technology-based industries that help their customers increase productivity and become more cost-efficient.

Fiscal policy could improve outlook

There is one other potential factor – tax measures – that could impact U.S. economic performance in the period ahead. Fiscal actions are not only likely to be influenced by prevailing economic trends but also by the presidential election. One possibility is that the Federal tax cuts that were enacted in 2001 and 2003 will be restructured in a manner designed to provide more stimulus for the economy.

In particular, despite the vast size of those earlier tax cuts, their impact on the economy in recent years has been far less than the effects of the housing boom and the big increase in defense spending. The tax cuts had a relatively small impact because they primarily benefited people with relatively high incomes and a relatively low marginal propensity to spend. In effect, the impact of those tax reductions was so low that the total stimulative effect was extremely modest. Any changes to those tax cuts that shift the benefits to lower- and middle-income families would be a plus for short-term economic growth.

In addition, there is increasing talk in Congress and in the current administration of a second short-term tax rebate to offset the impact of higher energy prices on family budgets. Either of these or other fiscal actions would also help spur economic growth in the

COBANK Reports Financial Results for Second Quarter

COBANK announced mid-year 2008 financial results, reporting exceptional growth in loan volume, net income and regulatory capital as well as continued good overall credit quality.

Net earnings for the first six months of the year rose 50 percent to \$307.9 million, compared with \$205.3 million for the same period in 2007. Net interest income rose 39 percent to \$449.4 million, from \$322.4 million the year before. Total loans and leases outstanding for COBANK increased to \$49.4 billion at June 30, 2008, compared to \$40.5 billion at year-end 2007.

Each of the bank's business groups saw increases in earnings and loan volume. However, as in recent quarters, higher prices in the grain, oilseed and farm supply markets were the primary factor behind total loan and earnings growth for COBANK.

"Extraordinary conditions in U.S. agricultural markets continue to drive extraordinary financial performance for CoBank," said Robert B. Engel, president and chief executive officer. "Persistent grain market volatility has pushed our loan volumes to historic levels during what is normally the start of a seasonal slowdown in our business. We continue to stand by our agribusiness customers to provide them with the debt capital and other financial services they need to be successful through this truly remarkable period in the industry."

short term, especially if they are designed in a manner so as to not increase the budget deficit on a permanent basis.

Conclusion

The bottom line is that the worst-case scenario for the U.S. economy is not likely. But equally unlikely is a vigorous, V-shaped recovery of the type that has followed most U.S. recessions since World War II. Thus, a flat- to slow-growth economy for the rest of this year and for 2009 would appear to be the appropriate scenario on which to base business plans and forecasts.

Nonetheless, there are clearly risks in both directions which should be taken into account in the normal planning process. Perhaps the most significant is the direction

of oil prices – a sharp decline would bolster family incomes and confidence and lead to more consumer spending, especially among families in the bottom 50-60 percent of the income distribution who generally spend all that they earn. On the other hand, of course, another spike up in oil prices, whether because of instability in the Middle East, possible hurricanes in the Gulf of Mexico (which could damage oil platforms in the Gulf and refineries in neighboring states), or any other reason, could tip the economy into recession.

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	2.80%	3.36%	4.06%	4.44%	4.66%	4.86%
0.25	3.46%	3.59%	4.23%	4.56%	4.75%	4.93%
0.50	3.41%	3.70%	4.36%	4.64%	4.82%	4.99%
0.75	3.58%	3.86%	4.49%	4.74%	4.90%	5.04%
1.00	3.72%	4.01%	4.62%	4.83%	4.97%	5.10%
1.50	4.03%	4.42%	4.82%	4.98%	5.09%	5.20%
2.00	4.50%	4.84%	4.99%	5.11%	5.20%	5.28%
2.50	4.84%	4.97%	5.08%	5.18%	5.26%	5.33%
3.00	4.80%	5.02%	5.13%	5.23%	5.29%	5.36%
4.00	4.90%	5.08%	5.24%	5.32%	5.36%	5.42%
5.00	5.09%	5.26%	5.35%	5.40%	5.44%	5.48%

Products and Services

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- Equity partnerships
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OUTLOOK

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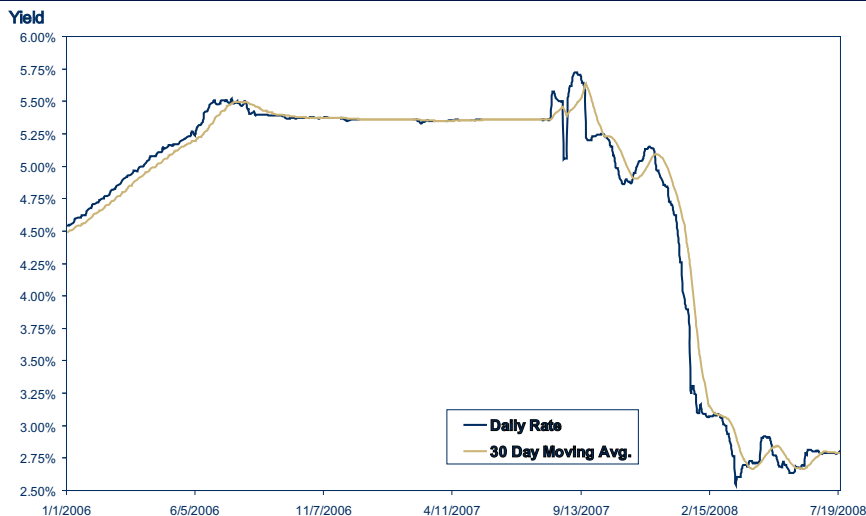
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With \$62 billion in assets, CoBANK is an internationally recognized cooperative bank serving agriculture and rural America. We specialize in financing for cooperatives, agribusinesses, rural energy, water and communications companies, Farm Credit associations and agricultural exports.

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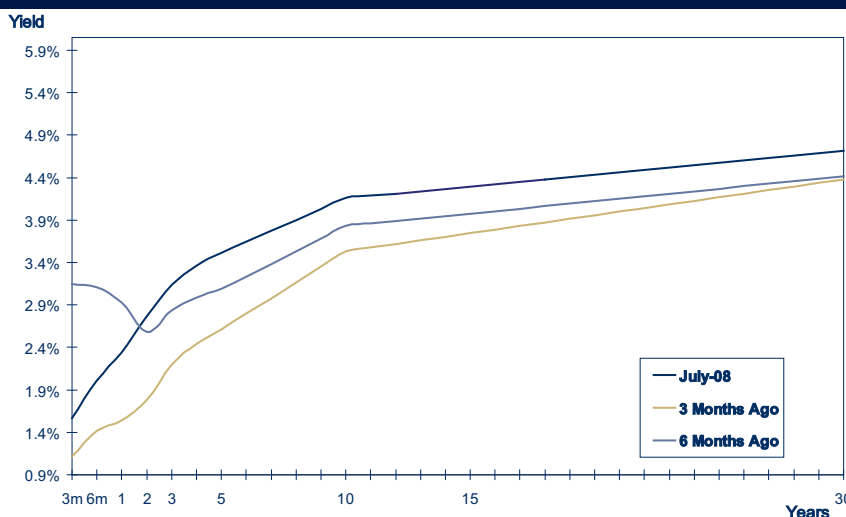
3-MONTH LIBOR Daily Rates vs. Moving Average

JULY 22, 2008



TREASURY YIELD CURVE

JULY 22, 2008



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