



CAPITAL CONNECTIONS

Economic Supplement

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The Federal Reserve: “Economic Strength Remains Uncertain”

The Federal Reserve, at its last meeting, kept the benchmark interest rate at a 40-year low of 1.75 percent and indicated it will not increase borrowing costs until the economic recovery gains strength.

The 10-0 decision by the Fed’s rate-setting committee left the overnight bank lending rate at 1.75 percent, where it has been since December. Fed policymakers also retained their assessment that the risks to the economy are balanced between weakness and inflation—a neutral stance that suggests rate increases are not imminent. The decision came as stocks and the U.S. dollar fell shortly after the announcement from WorldCom Inc. that it misstated \$3.9 billion in expenses.

“Economic activity is continuing to increase,” the Fed’s policy-setting Open Market Committee said in a statement. The Fed tempered its assessment by adding “the degree of strengthening remains uncertain.” Low interest rates have increased the likelihood that home sales will break last year’s record. Refinancing of existing mortgages has surged, putting cash into consumer pocketbooks.

The Fed is not likely to raise rates until December at the earliest, based on trading in federal funds futures contracts. “They are not going to raise rates in August, September, or November,” according to Wayne Angell, a former Fed governor who runs his own economic consulting firm.

GDP Growth Slowing

While Fed officials, in recent public comments, have said the economy is recovering from the recession that began in March 2001, none has indicated the rebound has strengthened much. After expanding at a 5.6 percent annual rate in the first three months of 2002, the economy most likely slowed to about half that pace in the second quarter, the latest Blue Chip consensus showed. The economy has lost 142,000 jobs this year on top of 1.4 million eliminated in 2001.

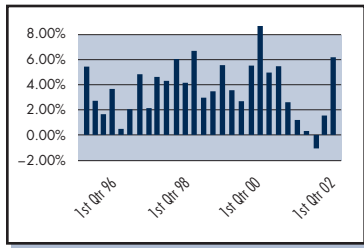
June consumer confidence numbers slipped the most in any month since the September 11 attacks, according to surveys by the Conference Board, the University of Michigan and Bloomberg News. Weak job growth, too, may limit the willingness of consumers to increase their spending. Unemployment increased to 5.9 percent in June, up from 5.8 percent in May. According to many economic analysts, the unemployment rate will most likely continue to rise after recent job-cut announcements by some Fortune 500 companies.

Key Interest Rates

On May 30, 2002

FEDERAL FUNDS RATE	3-MONTH LIBOR	BANK PRIME RATE
1.75%	1.8975%	4.75%

GROSS DOMESTIC PRODUCT *On June 27, 2002*



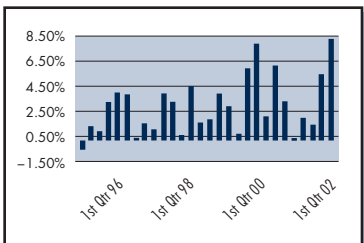
- The U.S. economy expanded during the first quarter at a revised 6.1 percent annual rate, the fastest in more than two years, boosted by the first increase in business spending on equipment and software since 2000.

- A smaller trade deficit than previously estimated also contributed to the Commerce Department's revision to gross domestic product.
- The pace, previously calculated as 5.6 percent, is the fastest since the fourth quarter of 1999. The economy grew 1.2 percent in 2001, when the recession began.

GDP INFLATION MEASURES *On June 27, 2002*

- The Commerce Department offered evidence of solid consumer and corporate demand.
- The personal consumption expenditures (PCE) price index rose 3.3 percent in the first quarter of 2002 and is expected to remain solid.

U.S. PRODUCTIVITY *On May 31, 2002*



- U.S. productivity grew during the first quarter at the fastest pace in almost 20 years as companies kept payrolls lean while making goods in a recovering economy.

- The Labor Department's measure of how much an employee produces for every hour of work rose at a revised 8.4 percent annual rate from January to March 2002.
- While down from the 8.6 percent initially estimated, it was the fastest since mid-1983 and up from a 5.5 percent increase in the final three months of 2001.
- In an effort to boost productivity, companies reduced worker hours for the fourth straight quarter. This measure helps determine how fast the economy can expand without triggering inflation.

TRADE DEFICIT *On June 21, 2002*

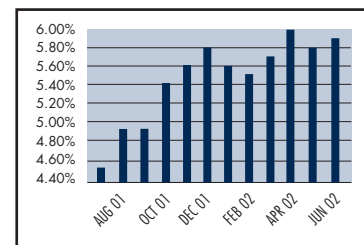
According to the Commerce Department, the trade deficit for goods and services grew to a record \$35.9 billion in April. Exports rose 2.2 percent in April, as compared to March, to \$80.1 billion. Meanwhile, imports grew at more than twice that rate, to \$116 billion.

Labor Market: Layoffs Announced

The unemployment rate rose to 5.9 percent in June, up 0.1 percent from May figures. Wall Street economists had forecasted the increase, yet new job creation was only 36,000 in June—half as much as expected.

Payroll increases will probably be minimal in July, as WorldCom, EDS, and Manugistics Group are among major companies that have announced layoffs. Additionally, companies are still somewhat reluctant to create new jobs, as the economic recovery remains sluggish. This is evidenced in the manufacturing sector where employers are asking existing workers to put in overtime.

EMPLOYMENT REPORT *On July 5, 2002*



- Unemployment increased to 5.9 percent in June, up from 5.8 percent in May. The unemployment rate will most likely continue to rise after recent job-cut announcements by some Fortune 500 companies.

- Average hourly earnings rose 0.4 percent in June, or 6 cents following a 0.1 percent increase in May.
- Analysts were expecting payrolls to increase by 75,000 jobs. The actual 36,000 that was reported fell considerably short. Additionally, May's initially reported payroll increase of 41,000 jobs was revised downward to a gain of only 24,000.

EMPLOYMENT COST INDEX *On April 25, 2002*

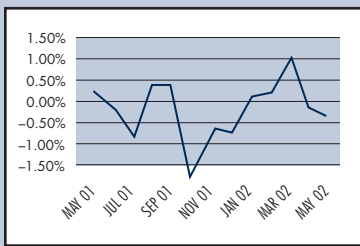
- The first-quarter employment cost index, the government's best measure of how workers are compensated, rose 0.8 percent in Q1 of this year. This was the slowest quarterly reading since the first quarter of 1999.
- Wages and salaries increased 1.0 percent during the final quarter of 2001, identical to the change in Q3.
- The lack of wage pressure provides salary relief for corporations, which allows executives to authorize more capital expenditure.

Inflation: Remains Tame

Inflation remained tame during the month of May with producer prices falling and consumer prices remaining flat—providing evidence companies don't have a whole lot of pricing power at the moment.

"There's little evidence of price pressure in the U.S.," said Anthony Santomero, president of the Philadelphia Fed. Numbers this tame give the Fed plenty of room to leave the benchmark overnight bank-lending rate at a 40-year low. Federal Reserve Chairman Alan Greenspan was quoted pronouncing inflation as "remarkably quiescent."

PRODUCER PRICE INDEX *On June 13, 2002*



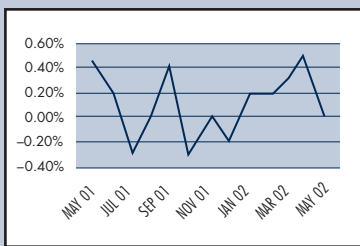
- Producer prices fell 0.4 percent in May after a 0.2 percent drop a month earlier. Economists were expecting a 0.1 percent increase in May.

- The "core" index, which excludes the

volatile food and energy sectors of the economy, remained unchanged in May from the previous month. Analysts were expecting a 0.1 percent increase.

- The PPI fell 2.7 percent for the 12 months ended in May. The core rate is 0.4 percent higher than the previous year's posting.

CONSUMER PRICE INDEX *On May 15, 2002*



- Consumer prices remained flat in May after a 0.5 percent increase in April. Economists expected a 0.1 percent increase during the month.

- Meanwhile, the "core"

index rose 0.2 percent in May after a 0.3 percent increase in April—matching Wall Street's expectations.

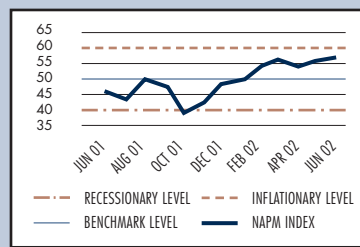
- So far this year, the CPI is running at a 3 percent annual pace, compared with a 3.9 percent rate at this time last year. Core inflation is running at a 2.3 percent annual rate.

Industrial Sector: Manufacturing Still Strong

The manufacturing sector continues to remain strong as the Institute for Supply Management's factory index rose to 56.2 in June, compared to a reading of 55.7 in May. The posting beat economists expectations of a 55.5 rating, according to a median of 44 forecasts in a Bloomberg News survey.

As consumer demand remains robust, production is not keeping pace with consumption, which has resulted in shrinking inventories and a backlog of orders. A sub-component reading within the ISM Manufacturing Index shows that manufacturers are still drawing down their inventory stockpiles. If this trend continues, companies may be able to regain some power to improve profit margins in the near term, which will bode well for the stock market. This industry sector growth will also contribute significantly to the number of payroll jobs in manufacturing.

THE INSTITUTE FOR SUPPLY MANAGEMENT'S FACTORY INDEX *On July 1, 2002*



- U.S. manufacturing expanded in June at the fastest pace in more than two years as production grew and inventories were reduced. Strong gains in productivity and a longer workweek have allowed employees to

boost production without hiring new workers.

- The Institute for Supply Management's factory index rose to 56.2 June, the highest posting since February 2000. A reading above 50 signals expansion, and the index has stayed above that level for five straight months.

- The Institute's survey is based on data from more than 400 companies in 20 industries, including clothing, furniture, and plastics. Manufacturing accounts for about one-sixth of the U.S. economy.

- Contributing to the strong new orders domestically is a weaker U.S. dollar and stronger economic activity abroad, which translates into higher export orders.

- **Industrial production (6/14)** rose less than expected in May as auto making and utility output declined, contributing to a slower pace of economic growth this quarter. May's increase marked the fifth straight rise in industrial production, which hasn't happened in almost two years. Manufacturing is rising because inventories have fallen below levels needed to keep meeting demand.

- **Capacity utilization (6/14)**—the amount of factory, mine and utility capacity in use—rose last month to 75.5 percent, the highest number since September, and up 0.1 from 75.4 percent in April. The plant-use rate had fallen to an almost 19-year low of 74.4 percent in December and is still well below the average 81.8 percent rate posted during the record expansion from March 1991 to March 2001.

- **Orders for durable goods (6/26)** rose in May for the fifth time in the last six months as the recovery in manufacturing

takes hold. Demand increased for computers, metals, and communications equipment. Continued growth in manufacturing is a result of companies paring down inventories by a record amount late last year while at the same time consumer spending stayed resilient.

- **Factory orders (7/3):** Manufacturing continues to be the strongest part of the economy as factory orders placed with U.S. factories rose more than expected in May. The 0.7 percent increase in new orders to \$321 billion followed a 0.7 percent rise in April that was larger than previously calculated, the Commerce Department said.
- **Construction spending (7/1)** unexpectedly fell in May, reflecting less work on offices and other nonresidential buildings. Housing construction held at a record as low mortgage rates boosted sales.

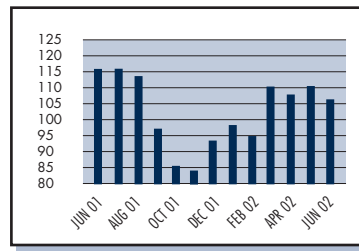
Housing: Still a Bright Spot

The housing market continues to be one of the bright spots in the sluggish economy, as sales of new single-family homes jumped to a record pace in May. Consumers appear to be turning to homes as an investment because of the deteriorating conditions in the stock market. The housing market should remain strong, as housing starts and building permits both increased in May, which opens the door for more new home sales in the future. Additionally, the low interest rate environment is also propelling the home sale market. Home sales should remain strong, even if there is a slight drop-off, as the rate of home sales is at or very near record pace.

- **Housing starts (6/18)** soared 11.6 percent to a seasonally adjusted annual rate of 1.733 million units in May—the largest increase since July 1995. Meanwhile, permits to build new units rose 2.6 percent, a promising indicator of future activity.
- **Sales of existing family homes (6/25)** fell 0.3 percent in May to a seasonally adjusted annual rate of 5.75 million units. Despite the slight drop, the existing home sales market remains robust; it will be difficult to match the record gains recorded earlier this year.
- **New home sales (6/26)** surged in May, increasing 8.1 percent to a seasonally adjusted annual rate of 1.030 million units. The increase in May follows a revised 3.9 percent increase in April. The median price of a new home actually fell in April to \$170,200 from \$186,600.

Consumer Sector: Confidence Plunges

Consumer confidence fell during June by the most since the terrorist attacks last September, as Americans expressed concern about finding work. The confidence index slid to 106.4 from a revised 110.3 in May.



Economists were predicting a level of 106.

A deteriorating stock market and questionable business practices also contributed to eroding consumer confidence.

Meanwhile, the Present

Situation Index, which measures consumers' attitudes about the present state of the economy, fell to 105.7 from 111.2, while the Expectations Index, measuring hopes or fears about the future, dipped to 106.9 from 109.7 in May.

Many economists worry continued drops in confidence threaten to slow the pace of consumer spending, which accounts for two-thirds of economic growth.

- **Personal income (6/28)** rose 0.3 percent in May after rising 0.2 percent in April, matching economists expectations. At the same time, the savings rate—personal savings as a percentage of disposable income—rose to 3.1 percent in May from 2.8 percent in April.
- **Personal consumption (spending) (6/28)** fell 0.1 percent in May after rising 0.6 percent in April. Economists were looking for spending to remain flat. This was the first spending decline since a 0.3 percent drop in November.
- **Retail sales (6/13)** declined more in May than at any time in the last six months as consumers scaled back purchases at auto dealers. Sales slumped 0.9 percent, which is three times the decline economists had expected. The decrease followed a 1.2 percent increase in April.

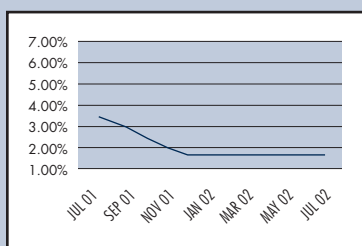
Looking Ahead: Scandals Shake Confidence

The WorldCom accounting scandal, the restatement of earnings by Xerox, and the questions behind Martha Stewart's trading activities have caused consumer confidence in equities to erode. As a result, consumers might be more reluctant to increase their spending, keeping economic growth at a slow to moderate pace. However, inventories have fallen over the past few months, which could help growth in the manufacturing sector, as businesses will need to replenish.

- **Retail Sales (7/12)** The consensus outlook is for sales to rise 1.0 percent, rebounding into positive territory from May's 0.9 percent decline. Sales could be somewhat weaker during the third quarter if consumer confidence in corporate reporting and job prospects doesn't improve.
- **Employment Cost Index (7/25)** ECI is not expected to show a large increase from the first quarter, as the economy remains sluggish and there's not much pressure for firms to boost wages.

- **Consumer Confidence (7/30)** The recent accounting scandals with WorldCom and Xerox will most likely cause confidence to drop again in July, as consumers are fearful of the next major corporate scandal.
- **Gross Domestic Product (7/31)** Forecasts from Wall Street economists indicate that the first estimate of second quarter growth is expected to come in between 2 and 2.5 percent. The drop-off from the first quarter's strong 6.1 percent showing is largely a result of a significant increase in savings rates over the past few months—most likely due to the erosion in the equity markets.

Eye on the Fed



The Fed kept the benchmark interest rate at a 40-year low and indicated that it will not be increasing borrowing costs until the economic recovery gains strength. The Rate remains at 1.75 percent, where it

has been since last December, and the 10-0 decision by the Fed to leave rates unchanged suggests a tightening bias will not be adopted for quite some time. “Economic activity is beginning to increase,” the Fed said in a statement following the decision, “but the degree of strengthening remains uncertain.” Analysts believe the Fed was about as optimistic on the economy as could have been expected, but continuing economic uncertainty will put a damper on the recovery. By year-end, the Fed is expected to raise interest rates by 25 basis points, with the first rise coming at the Fed’s December 10 meeting.

UPCOMING FOMC MEETINGS	WALL STREET EXPECTATIONS	FED OUTLOOK	FORECASTED FED FUNDS RATE
August 13, 2002	No Change	Neutral	1.75
Sept. 24, 2002	No Change	Neutral	1.75
Nov. 6, 2002	No Change	Neutral	1.75

Treasury Focus

The yields on U.S. Treasuries tumbled in June due to reports that the economic recovery was beginning to slow. The largest move in Treasuries occurred in mid-June when the Fed stated that while inflation remains tame, the economic recovery was still not taking hold. The yield curve steepened over the course of the month as short-term rates saw a larger decrease, followed by longer-term securities. The yields on the two-year note fell 42 basis points, while the yield on the 30-year note fell only 17 basis points. Investors began to sell off stocks and buy government

securities as growing political tension and continuing accounting problems initiated a flight to quality.

Treasury Rates

MATURITY	SPOT RATES ON 5/30/2002	SPOT RATES ON 7/3/2002	SPREAD DIFFERENTIALS
2-Year	3.18%	2.76%	-42 Bp
5-Year	4.34%	3.95%	-39 Bp
10-Year	5.05%	4.73%	-32 Bp
30-Year	5.62%	5.45%	-17 Bp

MARKET MOVERS IN JUNE

- Treasury yields remained unchanged for the first week of June as the effects of tumbling stock prices on Treasuries were offset by positive economic data released. Although investors pumped money into Treasuries, better than expected employment and NAPM reports helped Treasury prices remain stable.
- In the second week of June, Treasuries had their largest gain in five months after several economic reports suggested inflation remains tame and the economic rebound may be slowing. Treasury yields fell 25 basis points on average across the curve, while the 10-year benchmark fell 26 basis points to 4.80 percent—its lowest level since December 4.
- Treasury yields gained in the final week of June due to better-than-expected first quarter growth, a rise in the government’s debt ceiling, and a weakening dollar. Stock markets managed a modest rebound after equities plunged to levels seen after September 11 due to WorldCom’s announcement that it misstated earnings.

Streetwatch: Wall Street Firms Forecast

Wall Street firms believe the economy will start to turn around in the third quarter of 2002 as many market indicators are starting to show signs of an economic recovery. On average, Wall Street firms predict a 3.4 percent annual growth rate by the third quarter of 2002. Unemployment is expected to rise to around 6.0 percent by mid-year before beginning to fall in the fourth quarter of 2002. Treasury yields are expected to start rising again after the recent drop in yields. Continuing uncertainty in equities and further fallout from the recent accounting scandals has left analysts with many variables to contemplate when making their forecasts. Inflation is also expected to remain under control—even in the current low interest rate environment.



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Interest Rate Forecasts as Predicted by the Futures Market

On July 3, 2002

PERIOD	30-DAY FED FUNDS	2-YEAR T-NOTE	5-YEAR T-NOTE	10-YEAR T-NOTE	30-YEAR T-NOTE
Current	1.75%	2.76%	3.95%	4.73%	5.45%
Sep 02	1.74%	3.27%	4.21%	4.97%	5.74%
Dec 02	1.92%	3.39%	4.47%	5.14%	5.81%
Mar 02	2.24%	3.49%	4.53%	5.19%	5.86%

Energy Price Forecasts as Predicted by the Futures Market

On July 3, 2002

PERIOD	CRUDE OIL	HEATING OIL	HENRY HUB NATURAL GAS	PROPANE GAS
Aug 02	25.77	.6796	3.145	.3775
Sep 02	25.48	.6860	3.180	.3775
Oct 02	25.37	.6930	3.200	.3825
Nov 02	25.19	.6970	3.545	.3875
Dec 02	25.01	.7070	3.830	.3900
Jan 03	24.79	.7100	3.930	.3925

Stock Market Forecasts as Predicted by the Futures Market

On July 3, 2002

PERIOD	DOW JONES IND. AVG	NASDAQ 100	S&P
Current	8,929	1,346	939
Sep 02	8,930	970	941
Dec 02	8,965	972	944
Mar 03	9,015	977	950

CFC's finance experts can answer your questions about specific economic information. Contact:

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