



Risk becoming unbalanced

- **An inflation mentality is taking hold** at the same time the Federal Reserve is focused on providing various forms of monetary accommodation.
- **The U.S. current account remains significantly in deficit** while trade surpluses among some key trade partners have risen meaningfully.
- **Record high oil prices**, despite U.S. economic weakness, highlight U.S. vulnerability to growing global wealth and demand.
- **Expectations are low** over near-term U.S. economic prospects.
- **Cash balances** in money market mutual funds fell in April signaling some growing appetite for risk has emerged.

Now versus later policy

Over the past year, the narrowing in the U.S. trade deficit had been one of the few bright spots in the GDP data helping to offset the deterioration in residential investment. When the advance report on Q1 U.S. GDP was learned at the end of April, however, one of the key disappointments was the relatively small 1.5% narrowing in the U.S. net export gap – the weakest improvement seen in the past 4 quarters despite the substantial weakening in the U.S. dollar.

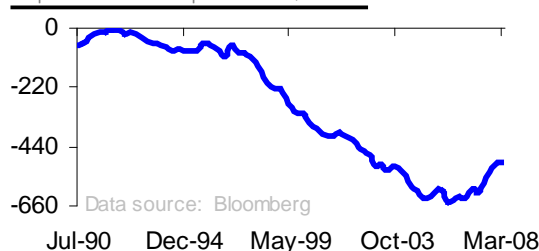
With crude oil prices up nearly 28% so far in Q2 combined with a relatively unchanged U.S. dollar since March, improvements in U.S. net exports may be limited this quarter.

The U.S. net export deficit highlights America's global dependence on energy imports, which ultimately might limit the Fed's independence. In a world where global demand considerations impact prices and growth, it seems increasingly unsustainable that major central banks can maintain significantly different policies. How is it that the Federal Reserve can cut its target rate 325 bps since September while the European Central Bank has not reduced its base rate at all amid similar global inflation concerns? The huge disparity between the 2 central bank policies puts into focus the Fed's desire to aggressively manage near-term market stress and economic weakness while risking the potential for future inflation. Current conditions therefore;

- Limit the Fed's ability to control the inflation that comes from global sources.
- Limit the potential for export led U.S. GDP growth to flourish and meaningfully narrow the trade deficit subjecting the U.S. to a continued dependence on foreign capital sources.

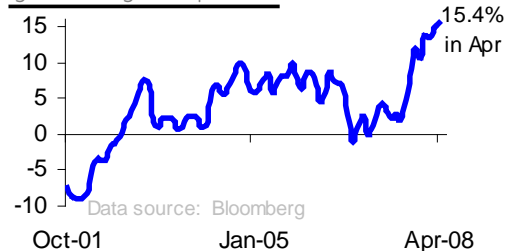
U.S. net exports - annual rate

imports minus exports - in \$ bn's



U.S. import prices

year-over-year in percent



What are the implications for U.S. interest rates

Medium and long-term U.S. Treasury yields face continued volatility due to the present situation of weak growth, potential benefits from fiscal stimulus, unsettled financial markets and higher inflation. Offsetting considerations for overall yield direction are substantial.

<u>Considerations for lower Treasury yields</u>	<u>Considerations for higher Treasury yields</u>
- Investor uncertainty	- Shifting inflation psychology
- U.S. economy	- More risk taking, asset reallocation
- Fed policy	- Impact of recent monetary & fiscal stimulus
	- Increasing supply of U.S. Treasuries, fiscal deficit
	- Shifting foreign buying sources of U.S. Treasuries

Although U.S. Treasury yields have risen noticeably from their March 2008 lows amid higher stock prices overall and some narrowing in credit spreads, near-term considerations might present some opportunity for lower rates and at a minimum, might offset some of the pressures that could lead to higher rates.

- **Investor uncertainty:** We do not anticipate a return to the extreme flight-to-quality investment behavior witnessed between August '07 and March '08. Overall markdowns in asset values from last year combined with the availability of numerous liquidity facilities from the Federal Reserve, since Q4 '07, have improved investment dynamics. All said, a capital preservation mentality is **still** visible, reflected in U.S. Treasury yields out to 5-years below the headline U.S. CPI and in the extremely large level of unallocated balances sitting in money market funds and cash equivalents.
- **U.S. economy:** The latest Bloomberg consensus forecast (dated May 9) anticipates close to zero real U.S. GDP growth in Q2. Expectations are low due to the effects of extremely tight credit conditions, housing market weakness, the crowding out of purchasing power from surging food and energy prices and a weakened job market showing minimal wage growth.
- **Fed policy:** Although there's a growing expectation that the FOMC will pause from cutting its funds rate further in this cycle (consistent with fed funds futures), Fed rate hikes over the next 6 months are unlikely. The April 30 FOMC statement showed the Fed was worried about "economic growth over the next few quarters."

Despite the rise in U.S. Treasury yields and swap rates since late March, interest rates remain low from an historical context, particularly when lined up against the headline CPI (3.9% in April). **Significant safe-haven U.S. Treasury buying** accompanied by increased foreign demand for U.S. Treasuries since last summer's credit turmoil began, leave interest rates vulnerable to increase. Consider the following:

- **Inflation pressure:** U.S. inflation psychology is at risk of meaningfully shifting given the magnitude of energy, food and commodity price increases seen recently. In early May, K.C. Fed's Thomas Hoenig (not a current voting member of the FOMC) said consumers were gaining an "inflation psychology" to an extent that he had "not seen since the 1970's and early 1980's."
- **Asset reallocation has begun:** As demonstrated in late March throughout April and intermittently in May, gains in U.S. stock prices came at the expense of higher Treasury yields amid some asset reallocation. Between late January and late April, the correlation between 2-10 yr Treasury yields and the S&P 500 was the highest seen in at least 3 years. This most recent outcome suggests that in the event U.S. stock gains resume, higher yields are a likely outcome.
- **Impact of stimulus when expectations are low:** Expectations for near term U.S. economic improvement is low as reflected in consensus GDP forecasts. The impact of > 130 million households receiving economic stimulus payments combined with months of monetary stimulus remain considerations for some favorable economic data surprises occurring in the coming months.
- **Deficit to increase:** The fiscal standing of federal, state and municipal governments is being impacted by higher costs and in many cases, lower tax receipts. The combination suggests increased debt



supply in at least this fiscal year. At the Federal level, the U.S. Congressional Budget Office estimated in March a fiscal '08 deficit of \$396 bn compared to a \$162 bn deficit in fiscal '07.

- **Foreign ownership of U.S. Treasuries:** The combination of the recent flight-to-quality and surging dollar oil revenues has led to increased foreign holdings of U.S. Treasury debt - particularly noticeable since last summer. Through March (most recent data), foreign holdings had risen nearly 15% yoy. In the event oil prices fall and/or the credit markets stabilize in a sustainable manner, there's an increased risk of diminished foreign demand for U.S. Treasury assets.

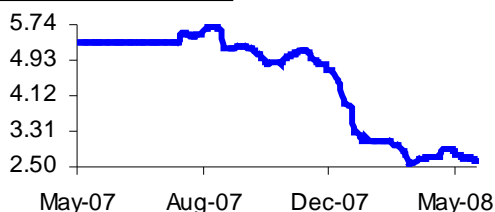
What it means for corporate borrowers

In May so far, 2 and 3-year U.S. swap rates have risen as U.S. Treasury yields increased amid shifting inflation psychology and a net narrowing in most credit spreads. The increase in swap rates this month follows April's larger increase, which came forcefully following 9 previous uninterrupted monthly declines. This cycle's low in U.S. swap rates remains March 17, which corresponded with the Bear Stearns liquidity crisis. Although Treasury yields and swap rates have risen noticeably since March 17, 2 and 3-year **U.S. swap rates remain below the U.S. headline CPI (Apr '08 yoy - latest), a highly infrequent occurrence from an historical perspective.**

- The futures market currently anticipates short-term LIBOR increasing about 70 bps over the next 12 months followed by a similar increase the subsequent year. The futures market anticipates the FOMC beginning to raise its target funds rate as early as late Q4 '08.
- Customers can currently hedge future U.S. LIBOR exposure for the next 3 years by swapping to a fixed rate approximately 90 bps above current 3-month Libor. Alternatively, customers can enter into a one-year forward starting swap for 2 years at approximately 115 bps above current 3-month Libor. The forward starting swap enables borrowers to fund in short-term LIBOR for the next year while achieving fixed rate certainty for years 2 and 3 at current pricing. Pricing for the above solutions is indicative and subject to change with market conditions.

U.S. 3-month Libor

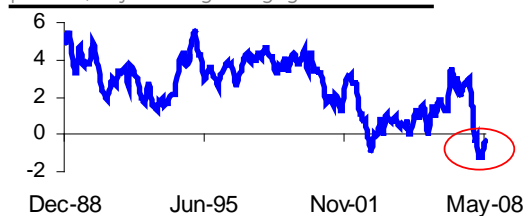
in percent - past year



Data source: Bloomberg

"Real" 3-year U.S. swap rate - in

percent, adjusted by U.S. yoy headline CPI



Data source: Bloomberg

Please see disclosure on page 4 of this report.



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