

Observation Deck

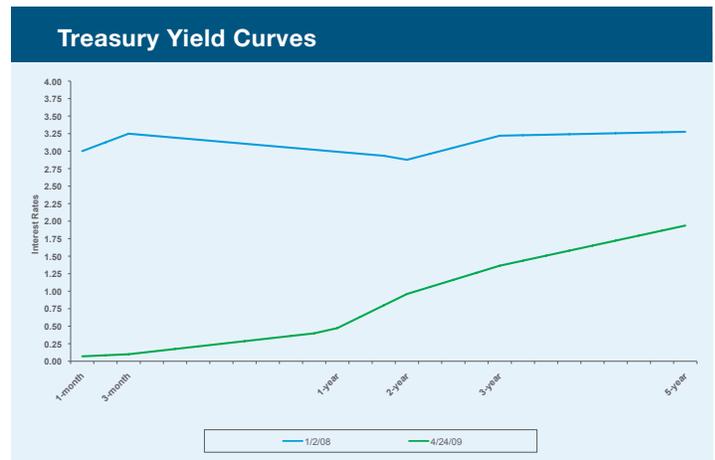
May 2009

A Familiar Shape

Ninh Chung, *Portfolio Manager*

Believe it or not, the yield curve is looking like its old normal self again; that is if you can overlook the near-zero-yielding portion of the curve. Normalcy in bond-speak is when interest rates rise gradually as the term increases. The upward-sloping curve is a result of higher interest rates offered to compensate for the greater risk associated for longer term-investment commitments. In general, a normal, positively sloped yield curve indicates that investor expectation is for strong future economic growth, and thus inflation expectation is high. Conversely, an inverted curve would indicate investor expectation of economic growth is sluggish to contracting. A flat curve illustrates economic growth and inflation uncertainty. The reappearance and potential durability of the normal curve is a beautiful and much-welcomed sight for various reasons — but more importantly, investors should consider taking advantage of the shape of the current yield curve.

The normal curve is perhaps an early indication that investors are beginning to migrate back to their specific “preferred habitats.” The term, preferred habitat, refers to an investor tendency to stay in certain types of bonds or maturity ranges because of their investment objectives. At times, investors would leave their comfort band or preferred habitat (bond type or maturity band) in an attempt to capture higher yields by increasing sector or duration risk or by flying to high-quality asset classes with vast liquidity. Over the past two years investors have opted for the latter strategy, as evidenced by the growth of the money market mutual fund industry. This asset class ballooned from \$2 trillion to \$3.5 trillion during the same period. With a combination of zero-like yields on the extremely short end, perhaps non-traditional money



Source: Bloomberg

market investors will no longer be able to forgo higher-yielding opportunities. These investors will redeploy their capital from the shorter end to the longer end of the curve and in return could restore some yields to the short-end of the curve.

Historically, long-term rates are higher than short-term rates during economic expansions because long-term rates are viewed as predictors of future short-term rates. During an expansionary environment, investors expect the Fed to raise short-term rates, thus investors in the long end of the yield curve will require higher compensating yields. Conversely, if the economy is expected to contract, investors will anticipate that the Fed will slash short-term rates in an effort to stimulate the economy. The yield curve will then take on a negatively sloped shape. However, caution must be taken because a normal yield curve does not necessarily imply that the economy will expand immediately — the current economic crisis could be just such an example. With the federal funds rate resting near zero, the Fed does not have any more room to cut the rate.

Ride the Curve

Given the current positively sloped yield curve and the uncertainty of an immediate and sharp economic recovery, corporate cash investors should be mindful to maintain a conservative liquidity position and find opportunities to ride the positively sloped yield curve. A sufficient concentration of money market funds will not only serve to meet liability obligations, it will also provide investors with reinvestment power should the yield curve shift up in the future and offer higher yields. Furthermore, corporate cash portfolio managers should seek reinvestment protection by investing further out on the yield curve and locking in these higher yields.

Markets

Treasury Rates

3-Month	0.13%
6-Month	0.27%
1-Year	0.46%
2-Year	0.90%
3-Year	1.36%
5-Year	2.01%
7-Year	2.69%
10-Year	3.12%

May Total Returns

ML 3-Month Treasury	0.03%
ML 6-Month Treasury	0.13%
ML 12-Month Treasury	0.20%
S&P 500	7.76%
Nasdaq	10.73%

Source: Bloomberg, as of 4/30/09

Economic Vista

Minh Trang, CFA, *Portfolio Manager*

As the second quarter of 2009 begins, the economy is still showing many signs of weakness. Unemployment remains a focus, as the labor sector shed another 663,000 jobs in March. Total job losses have climbed to over five million in the last 15 months, bringing the unemployment rate up to 8.5 percent. In addition, advance retail sales fell 1.1 percent during March as consumers pare back spending on electronics, restaurants, and automobiles. As for the real estate sector, home sales remain stagnant. Existing home sales declined to 4.57 million units, while new home sales held at 356,000 in March.

Finally, the Federal Open Market Committee left rates unchanged in their April meeting, saying that the economy remains fragile. The initial estimate for first-quarter 2009 GDP came in at -6.1 percent, following a horrific -6.3 percent in the fourth quarter of 2008. Though most headline news continues to be negative, the frequency has abated somewhat. The focus in the coming weeks will be on corporate earnings, and hopefully, these companies will reveal some positive outlook on things to come.

Credit Vista

Melina Hadiwono, CFA, *Head of Credit Research*

U.S. Policymakers are still keen on restoring confidence to the financial sector, with the goal of helping banks deal with deteriorating asset quality through asset-protection programs or direct capitalization. Following the TARP preferred capital infusions, while the regulatory capital ratios soared to their highest level in more than a decade, investors remained concerned about the quality of the capital, due to much reliance on preferred stock and not enough tangible common equity. Recent studies show that while many banks have reported an increase in Tier 1 ratios in the fourth quarter of 2008 because of TARP injections, many show declines in their tangible common equity ratio. In response, banks are taking steps to improve the quality of their capital. During the first quarter of 2009, many banks cut their dividends to retain more earnings. In addition, banks have been taking advantage of the low market value of their liabilities by announcing tender offers or debt exchanges as tools to create tangible common equity. We expect that these liability-management transactions will continue as banks will want to monetize this source of capital.

In the U.S., the regulators are in the process of completing “stress tests” on the nation’s top banks, the results of which are expected to be released early this month. If deemed undercapitalized, the

banks will have a six-month window to find additional financing sources from private investors or take funding through TARP. The test results and the actions following their release will be a key area of focus in the next several weeks — providing a test of the government’s ability to address investors concerns and to restore confidence in banks.

Finally, and related to capitalization, the Financial Accounting Standards Board recently relaxed the controversial mark-to-market accounting rules. While this could provide capital relief, from an accounting perspective, the banks will have to disclose any change in valuation associated with this accounting change. Nonetheless, there are concerns that this change will create an unfair advantage for U.S. banks compared to European banks, thereby adding pressure for international standards of financial regulation.

Trading Vista

Hiro Ikemoto, *Money Market Trader*

The flavor of the month is the declining yields in short-term Treasury bills. Many observers have pointed to the fact that foreign central banks are buying U.S. T-bills instead of longer-dated maturities. Other investors are also staying in the short-term due to a potential prolonged recession or inflation risk. In addition, starting May 1, there will be a new penalty fee on brokers failing to deliver on Treasury trades. This has already discouraged dealers from selling Treasuries they do not own (short selling), as they fear they will not be able to cover the order by settlement date.

Yields on Treasuries at month-end were 0.13 percent for three-month bills, 0.27 percent for six-month bills, and 0.45 percent for one-year bills. Bills maturing within two months were yielding single digits. Agencies tightened up in April, with spreads against Treasuries of two basis points for six-month and in, and 18 basis points out to a year.

There was high demand for three- to 12-month high-grade industrial corporate bonds, with spreads at minus fifteen to flat against LIBOR. Financial issuers were wider at spreads of 150 to 300 to LIBOR. Commercial paper yields also fell with the three-month paper yielding 0.50 percent by month-end, down 30 basis points from the previous month.

SVB Asset Management

185 Berry Street, Suite 3000

San Francisco, California 94107

Phone 1.866.719.9117

service@svbassetmanagement.com

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