

Observation Deck

January 2009

Bye-bye! Buy!

Debi Hanson, *Portfolio Manager*

Contrary to holiday ads screaming, buy, buy, buy... the current sentiment is clearly bye-bye buy.

Personal consumption dropped 3.8 percent in the third quarter of 2008. No surprise. This year we have seen the strong effects of the credit crunch and market turmoil on the consumer who has gone into hiding, and is devastating the economy.

Americans have historically spent money in both good times and bad. In fact, there have only been three quarters since 1982 of negative consumer spending. Americans have historically had easy access to credit when banks and other financial institutions were willing to lend. That is, until now.

Outstanding consumer credit debt (nonresidential) today stands at \$2.578 trillion — still near its all time high in September 2008. There is little doubt these numbers will decline. Banks are now extending credit only to those with the highest credit scores and documented income. Credit card companies are informing some customers that their credit limit has been cut drastically, or closing their accounts outright. Without available credit, consumers will be forced to spend only what they have earned.

An economy in recession, with a total of 1.9 million jobs lost through the end of November is certainly not helping matters. We do not expect to see meaningful growth in the job market any time soon. Expectations are for unemployment to rise as high as 9.0 percent in the event of a prolonged recession.

Markets

Treasury Rates

3-Month	0.08%
6-Month	0.26%
1-Year	0.33%
2-Year	0.76%
3-Year	1.00%
5-Year	1.59%
10-Year	2.27%

December Total Returns

ML 3-Month Treasury	0.01%
ML 6-Month Treasury	0.18%
ML 12-Month Treasury	0.47%
S&P 500	0.78%
Nasdaq	2.70%

Source: Bloomberg, as of 1/02/09

The consumer is reacting to a variety of fears: Fear that gas prices will go back up; they will lose their job; they won't be able to keep their home; they won't be able to put sufficient food on the table for their family. So, at a time of the year when the American consumer was supposed to be going from store to store buying gifts to put under the tree, we held back to the detriment of retailers nationwide.

Same store sales are down 2.7 percent year over year. Back to school shopping was down this year and this trend has continued through the holiday season. Hopes were raised when Black Friday sales proved strong, but what followed has been a disappointment. Luxury and discount stores alike are discounting much of their inventory with offers of 10 to 70 percent off. But still consumers are fearful of spending too much in this uncertain economy. As a result, it is estimated that dozens of retailers will either go bankrupt or close stores in those locations hit hardest. American consumers are not only feeling the effects of a recession, we are inadvertently prolonging it at the same time.

Luckily, we're kicking off a new year, which psychologically brings hope and a sense of resilience. While it will not happen overnight, we do expect to see the first indications of an economic recovery in the second half of 2009. Confidence will be restored when we start to see the housing market stabilize and the return of mortgage originations. Normalcy will return to the credit markets and consumer spending habits alike. Consumers may not be as spend-happy in the future, but the American consumer will ultimately return to the mall, auto dealerships and restaurants, and their historical role as the underpinning of a stable economy. Then we can say hello again to "buy."

Webinar

[Cash Management: How Companies Can Safely Make the Most of Capital on Hand](#)

Interested in finding out what you, your board, and your audit committee should consider in making the most of your capital in this uncertain economy? Learn more through a complimentary webinar, [sponsored by SVB Asset Management and hosted by Dow Jones](#).

Once you've registered, you'll receive an e-mail with instructions to access the webinar.

Economic Vista

Minh Trang, CFA, *Portfolio Manager*

Third quarter U.S. GDP left unchanged an economic contraction of 0.5 percent. This, however, is ancient history as economic growth for the last three months of 2008 is expected to be much worse.

Three events are driving our expectations for continued weakness well into 2009: First, the labor market has plunged with job losses reaching 1.91 million for the first 11 months of the year. In addition, jobless claims are at a 26 year high and the unemployment rate is expected to continue to rise from the current level of 6.7 percent. Over recent months, employers have only increased layoffs in an economy that is now “officially” in recession. Second, the housing sector has yet to bottom-out completely. Existing home sales in November fell to a nine-year low, as the median price of a home decreased 13.2 percent from a year ago. The inventory of available homes for sale remains elevated at 11.2 months. Lastly, retail sales fell for a record fifth consecutive month in November. Given job losses and low consumer confidence, consumers have reacted to the slowing economy by reducing their spending.

In response to the credit crisis and weakening economic conditions, the FOMC reduced its target rate to a range between zero and 0.25 percent on December 16. This is a historic low. Its objective is to maintain an accommodative monetary environment designed to alleviate the strain on the financial markets. The expectation is that growth will remain low in the new year, but may begin to improve by the end of 2009.

Credit Vista

Melina Hadiwono, CFA, *Manager Credit Research*

As we begin 2009, the financial market’s primary focus will be the improvement of its own credit conditions. From the policymakers’ perspective, reinvigorating lending is a priority in order to mitigate the downturn. The government introduced the Term-Auction Lending Facility (TALF) in November 2008 to increase credit availability and support economic activity by facilitating the issuance of consumer and small business asset-backed securities, which historically have funded a substantial share of consumer credit and SBA-guaranteed small business loans. The need to offer functional securitized investments remains high both for mortgage markets and other underlying asset classes. Doing so frees up bank capital, spreads risks to willing counterparties, promotes financial stability and allows more financing projects to be undertaken. Securitization provides originators much wider and often cheaper sources of funding than they could obtain

through conventional sources, such as retail deposits. Mortgage securitization also substantially reduces the originator’s exposure to interest rate, credit, prepayment, and other risks associated with holding mortgages to maturity, thereby reducing the overall costs of providing mortgage credit and helping to sustain homeownership and stabilize the housing sector.

With the securitization market for private-label mortgage-backed securities essentially shut down, Fannie, Freddie, and Ginnie Mae are currently the only conduits through which mortgages can be securitized and sold to investors. This is primarily due to their central role in mortgage financing in the U.S. Most recently, the Federal Reserve announced that it will purchase \$600 billion in debt issued by the housing-related GSEs and in mortgage-backed securities backed by Fannie Mae, Freddie Mac, and Ginnie Mae which should help reduce mortgage rates. Going forward, we expect that the reorganization of the GSE structure will be a priority for the new administration and Congress. GSE debt is widely held by financial institutions around the world and its continued strength is important in maintaining confidence and stability in the U.S. financial system. In recent discussions, Bernanke has rightfully noted that “even if alternative organizational structures are considered for the future, the U.S. government’s strong and effective guarantee of the obligations issued under the current GSE structure must be maintained.” Despite the continued headline risks and the uncertainty of the future legal status, we believe that the recent government actions underscore the importance the U.S. government places on both Fannie Mae and Freddie Mac.

Trading Vista

Hiro Ikemoto, *Money Market Trader*

Big news in bond land was the issuance of the first TLGP (Temporary Liquidity Guarantee Program) bonds. By the end of the year there were 66 new issues ranging in maturity from 18 months to three years. However, once the market embraced the safety of the government guarantee, yields quickly tightened up with two-year fixed bullets trading at 1.38 after being initially offered at 1.71 percent. TLGP commercial paper, which is currently being offered by GE and Citigroup, plunged from 1.50 percent to 0.10 percent in the secondary market for 90 day maturities. Agency Discount Notes were yielding 0.20 percent for 90 day maturities with Treasury Bills at 0.00 percent from 7 to 100 day maturities.

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