

Observation Deck

July 2008

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Credit Perspective: Financial Sector Update

Melina Hadiwono, CFA, *Manager of Credit Research*

The financial market events since last summer have raised the question “What’s the next shoe to drop?” Total global banking system write-downs have approached \$400 billion, with close to \$300 billion capital raised. The global financial sector appears to have already disclosed the majority of the valuation write-downs of subprime ABS. Significant write-downs have dominated 2007 and 1Q08 results. Indeed, these institutions may benefit from future recoveries in market prices if the performance of subprime borrowers stabilizes and risk premiums for uncertainties dissipate.

We are seeing signs of progress as credit markets have stabilized somewhat. For the past few months, financial institutions have been actively engaged in raising capital which is strongly improving market confidence. It is also encouraging to see that different types of investors — such as sovereign wealth funds and private equity firms — are participating in investments. In addition, investors have been very receptive to the issuance of hybrid securities. The government has taken decisive actions to stabilize the market and is working on improving financial services regulatory oversight in view of the challenges posed by the increasingly interconnected global capital markets. Despite this improvement, the difficulty in the credit market still exists. The unsecured interbank financing market and many securitization markets related to the housing market remain strained.

As the U.S. economy continues to slow in 2008, banks will likely continue to face a vastly changed credit landscape, and a further increase in credit costs seems inevitable. Accordingly,



Source: Bloomberg

quarterly earnings trends in the banking industry should become more volatile as institutions face heightened risks in loan quality and capital management. We expect that increased charge-offs and the need to build reserves should depress the financial institutions’ earnings for the remainder of the year and into 2009 which may add pressure on ratings. Nonetheless, despite the severe trials that these banks are enduring, the credit ratings for the major diversified banks should remain high due to their recently demonstrated access to capital. In addition, solid core earnings power, revenue diversification, access to liquidity and a healthy deposit base should provide banks with a buffer against losses related to increasing industry credit risks. We expect that as the de-leveraging and re-pricing of risk continues, financial institutions will continue to raise additional capital, announce dividend cuts, and bolster cost-cutting efforts. Ultimately, the liquidity facilities central bankers are providing, the current government discussions to address housing issues and the regulatory push for early recognition of problems and capital bolstering will show support for the U.S. banking system.

By focusing on our client objectives of principal safety and liquidity we have been able to weather the storm while experiencing few bumps along the way. To compensate for market volatility, we are maintaining adequate liquidity positions by overweighting MMFs while maintaining competitive yields. We continue to invest in high-credit-quality, non-financial issuers and selected financial issuers with a limit of approximately 3 percent to any single issuer. Finally, we remain attentive to ensure we can react quickly to a credit event.

As always, we encourage a thorough review of your investment portfolio with your portfolio manager and advisor.

Markets

Treasury Rates

3-Month	1.73%
6-Month	2.15%
1-Year	2.33%
2-Year	2.62%
5-Year	3.33%
10-Year	3.97%

June Total Returns

ML 3-Month Treasury	0.18%
ML 6-Month Treasury	0.13%
ML 12-Month Treasury	0.05%
S&P 500	-8.42%
Nasdaq	-9.06%

Source: Bloomberg, as of 06/30/08

Economic Vista

Debra Hanson, *Portfolio Manager*

The economic data released this month was, for the most part, bleak. But let's look at the good news first. Surprisingly, pending sales were up 6.3 percent as sales of foreclosures lured buyers. Retail sales also came in at a strong 1.0 percent, double expectations. It appears that with the stimulus checks going out a month early, consumers were in the mood to buy. Of course, they may have spent most of the money at the gas station or grocery store — which leads me to the bad news.

Inflationary pressures have not eased. Oil hit \$143/barrel and other commodities are still at elevated levels. The headline inflation numbers are high with PPI at 7.2 percent (YoY) and CPI at 4.2 percent (YoY), while the core numbers are more moderate at 3.0 percent and 2.3 percent respectively. The concern with inflation has changed the view on the street from further easing on the part of the Fed, to tightening. The Fed Funds futures market is now showing a probability of at least a 25 basis point increase in the Fed Funds rate to nearly 64 percent at the September 16 FOMC meeting. However, the economy is still in pretty bad shape. We had our fifth straight month of job losses when the nonfarm payroll number came in at a negative 49,000 and the unemployment rate unexpectedly spiked up to 5.5 percent. The housing market continued its struggle as home prices fell and foreclosures surged. Consumer confidence is at a 16 year low. Mortgage rates have gone up and we the consumers, the drivers of this economy, are keeping our faith that the Fed will do the right thing.

Credit Vista

Melina Hadiwono, *CFA, Manager of Credit Research*

To reignite the struggling U.S. mortgage market, the regulators are looking into a method of financing popular in Europe called a "covered bond" which could make it easier for home buyers to obtain loans. A covered bond is a senior secured debt, typically issued by banks, and is secured by specific assets such as high-quality mortgages or public sector assets which must meet certain criteria. The covered bond assets remain on the issuer's balance sheet. They are quite different from the problematic mortgage-backed products which are backed by subprime mortgages and were held off the bank's balance sheet. They are considered safer investments because the investors have the right to claim recourse against both the cover pool assets and the issuing entity. As a result, the issuer can typically achieve higher ratings on its covered bond in comparison to the ratings on its unsecured senior debt. With around \$2.75 trillion debt outstanding, covered bonds have a long history in Europe with their roots in Germany and Denmark. However, it was not

until the 1990s that the use of covered bonds began to spread across Europe. The market in the U.S. has been hobbled by unfamiliarity with the concept and regulatory hurdles. Only two U.S. banks have issued covered bonds — Bank of America and Washington Mutual. The regulators hope to persuade some major banks to spearhead the idea and are expected to provide more regulatory clarity.

Trading Vista

Hiro Ikemoto, *Money Market Trader*

With a strong retail sales report for May, Treasury yields increased in June as the Fed signaled they would stop cutting interest rates and shift their concerns back to inflation from economic growth. The two-year Treasury note yield rose to 3.041 percent on June 13 after the retail report, though it settled back down to 2.62 by month-end. High-grade financial-sector corporate bonds were being offered in the plus 145 range to the two-year, with industrial names in the plus 45 area. One-year LIBOR yields also picked up during mid-June going as high as 3.55 percent and ending the month at 3.31. The spread on corporate bonds in this part of the yield curve was plus 25 for financials and flat for industrials. Three-month commercial paper was trading in the 2.50 to 2.65 percent for most of the month, while agency discount notes were 30 to 35 BPS less than commercial paper. With Fed Funds futures traders now increasing the probability for a 25 basis point rate hike to 2.25 percent from zero at the start of the month, we are continuing to see the short-term yield curve steepen.

Contact

SVB ASSET MANAGEMENT
185 Berry Street, Suite 3000
San Francisco, California 94107
PHONE 1.866.719.9117
service@svbassetmanagement.com

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