

# Observation Deck

February 2009

## Good Yield Hunting

Ninh Chung, *Portfolio Manager*

Capital preservation and liquidity provision have always been the central investment objectives for a corporate cash investor. With the return of market volatility and the near silencing of the capital markets, cash investors fled the corporate debt sector in pursuit of the market's safest harbor: U.S. Treasury securities. While cash investors shouldn't be faulted for seeking to ensure return of capital versus return on capital, we believe other safe and liquid options do exist that don't completely ignore yield.

## Invest in Banks and Financials

No, we are not recommending debt from banks you frequently see and read about on CNBC and the WSJ — at least not entirely. The bank and financial debt we're referring to is the debt issued under the FDIC's Temporary Liquidity Guarantee Program (TLGP). With backing by the full faith and credit of the U.S. government and the guarantee of timely payment of both principal and interest by the FDIC through June 30, 2012, we believe these financial issues are attractive investments relative to Treasury securities, albeit at a moderately improved yield. ([See our TLGP white-paper for a full description of this program](#)).

Be aware, however, that not all FDIC-backed investments are created equal. The allure of FDIC insurance, in addition to regional banks' desire to attract bank deposits, have prompted the advent of relatively new certificate of deposit (CD) placement

programs to efficiently attract urgently needed cash to smaller banks' balance sheets. These programs bundle multiple FDIC-guaranteed, \$250,000 increment, non-negotiable (untradeable) CD investments across numerous regional banks. The yield offered is slightly higher than other options, but investors are subject to steep penalties should the investment be liquidated prior to maturity. In addition to significant broker markups on these products, corporate investors are indirectly buying small issues of debt with no secondary market and usually without an investment grade credit rating. TLGP debt on the other hand is actively traded in the secondary market. For investors considering CDs, review their suitability within your investment policy, and consider direct investment through a trusted advisor working on your behalf versus a broker aggregator. When the opportunity comes to invest safely in more liquid and creditworthy opportunities, your advisor will be poised to point out those opportunities, while CD placement programs will encourage you to stay where you are.

## Continuing the Theme...

Money market mutual funds governed by SEC Rule 2a-7 will continue to be a viable investment option, particularly given the temporary insurance guarantees and asset support programs offered by the U.S. Treasury. Government money market mutual funds should be strongly considered as a possible substitute for Treasury-only funds. Government funds permit investment in Freddie Mac, Fannie Mae, and Federal Home Loan Banks, and these government sponsored entities (GSEs) may be stronger credits than at any time in their history. Specifically, Fannie and Freddie are under the direct stewardship of the federal government and each is receiving large capital infusions and is further supported by the Federal Reserve's commitment to direct debt purchases of these GSEs.

## At Last

Let's not forget that despite the global economic contraction, financially healthy companies with strong business models and the ability to service their debt obligations exist. For example, bonds issued by Wal-Mart and Procter & Gamble are still in high demand due to their remote default risk. Furthermore, holders of their debt have benefited from declining yields and narrowing credit spreads.

### Markets

#### Treasury Rates

3-Month	0.23%
6-Month	0.34%
1-Year	0.47%
2-Year	0.95%
3-Year	1.33%
5-Year	1.88%
10-Year	2.84%

#### January Total Returns

ML 3-Month Treasury	-0.01%
ML 6-Month Treasury	-0.01%
ML 12-Month Treasury	-0.10%
S&P 500	-8.43%
Nasdaq	-6.35%

Source: Bloomberg, as of 1/31/09

## Economic Vista

Debi Hanson, *Portfolio Manager*

Last month's fears are turning into reality with the release of this month's economic data. Jobs fell yet again by more than 500,000 bringing the total nonfarm payroll job losses to nearly 2.6 million for 2008. The unemployment rate has spiked up to 7.2 percent nationally and is expected to rise significantly before the recession ends.

The holiday shopping season was a big disappointment and retail sales were reported down more than double what economists had expected (-2.7 percent). This was the sixth straight month of negative retail sales figures (month over month). This is having a terrible effect on the retail sector as companies announce store closures or, even worse, file for bankruptcy.

There has been little change in direction in the housing industry, with sales and prices still heading south. The good news is that mortgage rates have come down. The bad news is that you must have excellent credit, a job, verifiable income, and, most importantly — equity in your home to qualify for a mortgage! This makes it much more difficult for recent home buyers to refinance into a lower rate mortgage.

Lastly, fourth quarter GDP was announced on January 30 and was as bad as expected. The preliminary reading was reportedly down to -3.80 percent. There will be two revisions before we know the final results, but needless to say, it was a very bad quarter.

## Credit Vista

Adam Dean, *CFA, President*

When looking at the cash investment options available to corporations today, many are having an increasingly difficult time ignoring the money being left on the table by continuing to avoid "spread products," those securities that trade at premium or "spread" above government-guaranteed securities. The spread products, which are mostly corporate debt with credit ratings below AAA, were ubiquitous in most corporate cash portfolios at the start of 2008. By the end of 2008 demand had virtually disappeared.

By now, most treasurers and CFOs have become quite familiar with the remaining options and the rapidly diminishing returns that come with their implicit or explicit U.S. government guarantees. Treasuries, overnight Treasury repo, TLGP government-guaranteed corporate debt, \$250,000-increment bank CDs and of course the agency debt of Fannie and Freddie all are offering yields that are a fraction of where they were three months ago and each continues marching steadily towards zero percent return. Well advertised is the fact that one-month Treasuries are already there.

While the past year's shift to these low- to no-risk investments is understandable and desirable, we're obligated to remain attentive to

the corporate investment-grade options outside of the government's protective umbrella. Our list of approved issuers, while decidedly shorter than it was in mid-2007, is comprised of many issuers in industries with historically high cash levels. Alongside these strengthening balance sheets, investment-grade corporate paper is trading at yield spreads wider than any seen since the 1930s.

Coupled with the U.S. government programs that support prime money markets, mutual funds and the liquidity of their investments therein, we remain convinced that the time when a majority of corporate investors will reconsider investment in corporate debt is not a matter of if, but when. For some investors that time is now. Crane Data has observed Treasury money fund assets dropping while prime and government/agency fund investments have steadily gained since the market disruptions of September.

Expect to hear more from us on the merits of considering government and prime funds in the days and weeks ahead.

## Trading Vista

Hiro Ikemoto, *Money Market Trader*

For the first time since mid-August 2008, the TED spread, which is a widely used indicator of perceived credit risk, fell below 100 basis points. This spread is the difference between the three-month Treasury bill and the three-month LIBOR rate, which hit 1.09 percent on January 13. The tightening of this spread in normal times would imply that liquidity is slowly coming back to the markets. Unfortunately, we can no longer rely on typical market indicators in the same way since the aggregate impact of multiple government support programs are skewing the data to a significant degree. In any case, today's "medicated" version of LIBOR implies borrowing costs are falling, which could lure levered investors back to the markets, assuming the banking sector can pass along this advantage. Turning to the Treasury markets, we are still seeing Treasury bills with a maturity of six months and under being offered from zero to thirty basis points, with agency discount notes up twelve to fifteen basis points over T-bills. The two-year Treasury note seemed to be locked in around 0.75 percent for the last two weeks of the month.

Ninety-day day TLGP commercial paper yields increased to 0.40 percent by month-end, while the non-guaranteed commercial paper yielded 0.95 percent. Nine-months to one-year industrial corporate bonds were being offered at flat to plus 40 to LIBOR, with yields ranging from 0.90 to 1.40 percent.

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