

Observation Deck

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Inflation Assumptions Implicit in New Yield Curve

Joe Morgan, CFA, Head of Portfolio Management

Since bond yields bottomed out on April 30, much of the yield curve has been marching upwards in steady fashion. As the adjacent graph shows, two-year Treasuries rose 0.28 percent while ten-year Treasuries rose 0.45 percent over the last two months. Short Treasuries, on the other hand, declined slightly over the same period.

For some time now, we have been touting a “stand-off” between the Fed and the markets. The Fed has been concerned about inflation and strength in the economy while brushing aside possible effects of the sub-prime market difficulties — besides the fact that some further regulation is obviously needed. Meanwhile, the markets have been entirely consumed with a slowing economy and have predicted interest rate cuts continuously for over a year.

We have believed that this “verbal battle” would come to an end sometime this year. In fact, that’s exactly what seems to

Markets

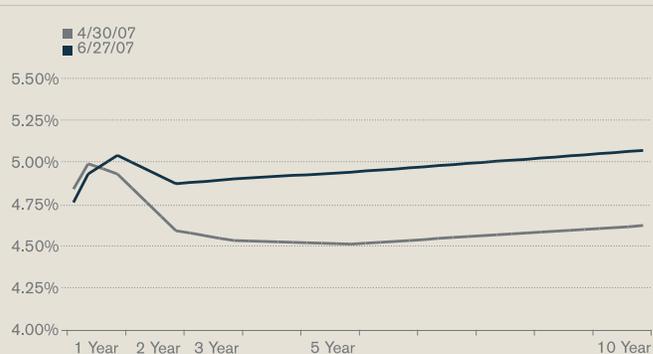
Treasury Rates

3-Month	4.80%
6-Month	4.94%
2-Year	4.86%
3-Year	4.88%
5-Year	4.92%
10-Year	5.02%

June Total Returns

ML 3-Month Treasury	0.39%
ML 6-Month Treasury	0.39%
ML 12-Month Treasury	0.49%
S&P 500	-1.66%
Nasdaq	0.01%

Source: Bloomberg, as of 7/2/07



Source: Bloomberg, SVB Asset Management

be happening now. The markets are surrendering toward the Fed’s point of view and finally coming around to the idea that the Fed does not need to cut interest rates after predicting three cuts to occur during 2007, as late as last December. This capitulation is displayed by the shifting of the yield curve that is taking place currently.

On the other hand, the financial press will tell you this sell-off is due to “inflationary fears.” It is fascinating that the markets could be so unconcerned about inflation when it was running north of 2.5 percent from June 2006 to February 2007, but now that inflation is in the low 2s, all of a sudden it’s something to worry about?

The biggest source of this fear is from commodities prices, particularly oil. By the way, oil averaged \$64.90 during the Jun. 2006 - Feb 2007 period and actually hit a high of \$77 in July 2006. Today, oil sits comfortably at \$69, a recent high, but still 10 percent below the level achieved when we weren’t concerned about inflation.

We believe the market has finally figured out the Fed will not reduce interest rates simply to micromanage the economy. We applaud this non-activity and believe the Fed is doing an excellent job of protecting its credibility as an inflation-fighter. Without that credibility, where would our economy be?

Economic Vista

Ninh Chung, *Portfolio Manager*

The Federal Reserve kept the overnight Fed funds rate unchanged at 5.25 percent following the fourth FOMC meeting of the year. In the committee minutes, the Fed reemphasized that inflation remains a concern while acknowledging the recent economic slowdown was largely due to the ongoing adjustments in the housing sector. In order for the Fed to break its yearlong 'hold' policy, it will largely "depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information."

Although real GDP in the first quarter was an anemic 0.7 percent, the economy is expected to grow at 2.5 – 3.0 percent for the year, which is right in line with long-term trends. Second quarter growth is off to a great start as consumers seem to be shaking off the twin threats of housing sector weakness and record gasoline prices by ringing up sales at shopping mall registers.

Credit Vista

Melina Hadiwono, *Manager of Credit Research*

The recent crisis of the two Bear Stearns hedge funds has sparked concern in the market. The funds' portfolio investments included collateralized debt obligations (CDOs), which are financial vehicles consisting of pools of securities including mortgages, bonds and other loans that are divided into tranches with varying degrees of risk. In addition, CDOs use borrowed money to amplify returns.

Many of the CDOs the Bear Stearns funds invested in were pools of mortgage-backed bonds which have fallen in value due to the spike in mortgage delinquencies. Also, as these particular tranches of CDOs do not often trade, it's tough to get an accurate price. A forced sale of the Bear Stearns funds' assets could trigger a broader repricing of mortgage-backed bonds and lead to losses and margin calls. So far, the turmoil doesn't seem to be hurting the broader bond markets significantly.

Trading Vista

Hiroshi Ikemoto, *Money Market Trader*

On June 12, the two-year Treasury yielded 5.09 percent, the highest it has been since June 2006. This was mainly due to global inflationary concerns and fear of foreign governments continuing to tighten their monetary policies. The Treasuries' stay at this level was brief as the yield came back down to 4.86 percent by the end of the month on weak durable goods numbers and flight-to-quality on concerns over the Bear Stearns hedge fund/CDO pricing issues.

The LIBOR curve remained flat throughout the month with the only volatility being in the one-year area, where yields started at 5.39, peaked at 5.49 mid-month, then settled back to the 5.39 percent level.

Yield on commercial paper picked up 2 basis points in the 90-day to 180-day maturity range during June, while government agency securities remained flat for the month.

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