

# Observation Deck

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## Stagflation?

Debi Hanson, *Portfolio Manager*

Stagflation: [stag-fley-shuhn n.] sluggish economic growth coupled with a high rate of inflation and unemployment.

As if the credit crunch and housing woes aren't enough for the markets to bear, the economy is slowing and the Fed is taking aggressive measures to keep it afloat. While we haven't seen enough evidence to definitively state that we are in or going into a recession, Q4's preliminary GDP number of 0.6 percent is reason enough for the Fed and the U.S. government to try and jump start economic growth by easing monetary policy and offering government tax rebates. This is fine and we are all for a stimulus package, but with commodities prices still elevated are we running the risk of higher inflation coupled with slower growth? Surely we are not going into a period of stagflation, but there are warning signs we should note.

This month the government reported headline wholesale inflation (PPI) at 6.3 percent. Both November and December releases were at the highest levels since 1990. When you look at the core number, that is, ex food and energy, it came in at a more moderate 2.0 percent. But, is it misleading to take these very important items out of the picture and keep telling us inflation is not really a problem? The Consumer Price Index (CPI) was reported at 4.1 percent with the core number at 2.4 percent while the core Personal Consumption Expenditure (PCE) came in at 2.7 percent. These core numbers are significantly above the Federal Reserve Board's so-called "comfort zone" of 1 to 2 percent. And, while just over 2 percent doesn't seem very high, we could see a quick acceleration of these numbers.

The chart depicting the CRB index shows that commodities prices are definitely elevated. Oil continues to hover in the

### Commodity Research Bureau (CRB): Commodity Price Index



Source: Bloomberg

\$90-neighborhood and gold is above \$900 an ounce. West Texas crude was up 92 percent in 2007. The national average gasoline price rose just over 28 percent for the year. Grocery prices are up 5.4 percent overall. Milk prices have gone up 30 percent as demand for dry milk in Asia has skyrocketed. We know that most grain prices are up as the demand for ethanol has risen. Even German beer makers have raised prices to cover the rising cost of barley.

Inflation is not just a domestic concern. Developing countries are feeling the pain, particularly in Asia where food prices are a much larger component of CPI. In China, food prices represent 33 percent of CPI, in the Philippines, 35 percent. In July, Fed Chairman, Ben Bernanke said "the state of inflation expectations greatly influences actual inflation." By aggressively cutting the target Fed Funds rate, the Fed's focus has clearly changed from inflation to growth.

As for the economy, if you listen to the pundits on television, they will tell you that we are already in a recession and it will be the worst since the great depression. We have not yet seen the data that supports this view and we doubt we will. The housing market is still a major drag to the economy. Job growth has been on a downward trend. Jobs have been lost in the construction industry and banking sector. Expectations are for further contraction in the job market as the economy slows and companies tighten their belts and reduce expenses.

But, we do not believe that we are going in to a period of stagflation. The hope is that with slower growth, demand will weaken, thus easing inflationary pressures. Bernanke has cut the target Fed Funds rate by 255 basis points since last September. Once the economy is revived, we may be in for some dramatic rate increases. He who giveth, also taketh away.

### Markets

#### Treasury Rates

3-Month	1.94%
6-Month	2.05%
2-Year	2.09%
5-Year	2.76%
10-Year	3.59%

#### January Total Returns

ML 3-Month Treasury	0.50%
ML 6-Month Treasury	0.84%
ML 12-Month Treasury	1.28%
S&P 500	-6.00%
Nasdaq	-9.86%

Source: Bloomberg, as of 02/01/08

## **Economic Vista**

Minh Trang, *CFA, Portfolio Manager*

The year began with several weak economic numbers. December retail sales dropped by 0.4 percent, as retailers failed to encourage greater consumer spending for the holidays. Home sales have continued their decline, with purchases of existing homes dropping 2.2 percent to an annual rate of 4.89 million units. Increased foreclosures and stricter lending standards have continued to add pressure to the real estate market. On the job front, the Labor Department said that January payrolls fell by 17K, compared to the forecast of a 70K gain. However, the unemployment rate dropped slightly to 4.9 percent from 5.0 percent. Initial jobless claims and continuing claims, however, have remained stable, but continue to trend modestly upward.

With the 75 basis point inter-meeting cut and another 50 basis point ease on January 30, the Federal Reserve has clearly signaled that they will aggressively lower rates to aid the economy and keep it from falling into a recession. In addition, Congress and the White House agreed on a stimulus deal that would provide \$146 billion in tax rebates. They also temporarily raised the dollar limit on mortgages that FNMA and FHLMC can purchase, in the hope that this would provide cheaper borrowing for some home buyers and help improve the housing sector. It will take several months before we can properly gauge the benefits from the monetary easing and stimulus package in boosting the economy.

## **Credit Vista**

Melina Hadiwono, *CFA, Manager of Credit Research*

Amid the market volatility and headline risk in the financial sector, investors' appetite for non-financial credit sectors is hard to argue. Nonetheless, there are two factors that should be considered carefully about non-financial credits: the lack of availability of high-quality issuers and yield considerations. In the short-term space, the financial sector is by far the primary issuer of debt. According to S&P data, U.S. industrial bonds with a minimum credit rating of single A, and with a maturity of two years or less, make up approximately 2.1 percent of the total U.S. debt. In the commercial paper market, as of December there was \$175 billion of U.S. CP issued by non-financial issuers versus \$824 billion of financial issuers. The strong cash balance positions and availability of relatively inexpensive longer term financing has reduced the need for industrial and other non-financial firms to issue CP. While the incentives for locking in cheap long-term funding remain, this feature is less pronounced for financial firms as they prefer to stay with short term debt to match their receivables.

In addition, the credit profile has weakened further in the industrial sector. In 2007, industrials with an S&P rating of A or better were only 11 percent of total industrials versus 17

percent in 1998 and 50 percent in 1980. For non-U.S. financial issuers, the median rating was BB- in 2006 down from BB in 2005 and A- in 1991. Much of the ratings shift over the past fifteen years is due to corporations implementing more aggressive financial strategies to grow shareholder returns amid rising foreign competition. This has prompted firms to apply more leverage and take on more risk. Conversely, financial sectors have held at the A rating level since 2000. For the financial sector, the need for investment-grade ratings and the lower borrowing costs that come with these ratings are vital to their business models. This should keep the majority of banking and insurance firm ratings predominately investment grade for the foreseeable future.

When there is an opportunity to invest in a non-financial issuer, the yield offers are typically 25 basis points or more lower. We are always looking for an opportunity to add those few available high-quality industrial issuers into the portfolio. The firms with investment-grade rankings tend to be better diversified, better capitalized, and generally have more qualified management teams than was the case in prior cycles.

## **Trading Vista**

Hiroshi Ikemoto, *Money Market Trader*

With liquidity coming back to the market and the 125 bps easing this month on the Fed target overnight rate (which included a 75 bps inter-meeting Fed cut) all the available short-term investments dropped in yield: one-month LIBOR dropped from 4.57 percent to 3.14; one-year LIBOR from 4.19 to 2.84; and the two-year Treasuries from 3.05 percent to 2.09. Commercial paper yields have rapidly declined, falling 125-150 bps across the curve with the current ninety-day issues being offered around 2.95. Spreads on corporate bonds widened slightly, with one-year financials trading at LIBOR +30 to +70 and two-year financials +130 to +170 to the two-year Treasury, with the difference ensuing from the level of headline risk. However, with both indexes rallying, yield levels were in the 3.50 to 3.90 range—about 100 bps lower than December. The days of 4 percent yields, a.k.a. “the four handle” are gone... at least for the time being.

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