

Observation Deck

September 2007

The Market's Wild Ride

Debra Hanson, *Portfolio Manager*

As we continue to see the fallout from the distress in the subprime mortgage sector, let us take a look back at just what happened and why.

For some time, investors knew that the mortgage market had come under pressure as adjustable rate mortgages taken out over the past three to five years reset — some as much as 3 percent higher than the original rate. But when the delinquency and default rates began to rise, it wasn't just the homeowners who were worried. Investors around the world were concerned about their portfolios, particularly about the derivatives backed by these mortgages.

Of greatest concern were the holdings of CDOs (collateralized debt obligations) in their portfolios. CDOs are created by packaging mortgages, loans, bonds and other derivatives into a new security and then selling them to other investors. Many of these were rated AAA. Unfortunately, most of these buyers did not know what their CDO was comprised of and their resulting exposure to the subprime market.

At the end of July, the first big blow came to the market when American Home Mortgage Investment Corp was unable

to fund new loans as their bank credit lines were cut off. Then, Bear Stearns announced that they were not allowing withdrawals from a third hedge fund after two others had collapsed earlier in the month. Fear and panic spread through the credit markets as more hedge funds announced losses due to their exposure to the subprime market. To make matters worse, the exposure wasn't exclusive to U.S.-based entities. Announcements of losses were made from firms across the globe. The "credit crunch" had begun.

Credit woes spilled over in to the commercial paper market as issuers of asset-backed commercial paper (ABCP) found their access to easy cheap funding dry up after one issuer of extendable ABCP delayed payment (extended maturities) on their outstanding issues. Those issuers who did find buyers were forced to pay much higher rates.

As investors fled the credit sectors of the market, Treasuries experienced a flight-to-quality rally. With Treasury yields falling, spreads in all other sectors of the markets widened dramatically. On August 17, the Federal Reserve Board cut the discount rate by 50 basis points from 6.25 percent to 5.75 percent in response to these events. This was a sign from the Fed that they are aware of and following the deterioration in the markets. The Fed said the changes would remain in place until the Federal Reserve determines that market liquidity improved materially. It was an acknowledgement that they saw the problems facing financing in this unstable market. While this allows for the banks to borrow from the Fed for up to 30 days with a wide variety of collateral, it does not change the fact that this will not alleviate the problems in the subprime sector, nor the liquidity issues facing the markets today. The Fed continues to inject liquidity into the markets daily through the repo market.

Will this cut in the discount rate be enough to tame these wild markets, or will the Fed need to lower the target Federal funds rate? With the continued slump in home sales and credit requirements being tightened, it is likely consumption will weaken. If this happens, as some are saying, the economy could falter. Mr. Bernanke will then have to decide which is more important, inflation or growth.

Markets	
Treasury Rates	
3-Month	4.11%
6-Month	4.20%
2-Year	4.13%
3-Year	4.15%
5-Year	4.24%
10-Year	4.53%
July Total Returns	
ML 3-Month Treasury	0.56%
ML 6-Month Treasury	0.72%
ML 12-Month Treasury	0.74%
S&P 500	1.50%
Nasdaq	2.07%

Source: Bloomberg, as of 8/31/07

Economic Vista

Ninh Chung, *Portfolio Manager*

“*The Fed is asleep!*” Jim Cramer – CNBC’s Mad Money Host

Contrary to Jim Cramer’s diatribe, the Fed is fully engaged and in tune with financial markets and, more importantly, focused on the long-term health of the U.S. economy. While the housing-related downturn is worse than most analysts forecast at the beginning of the year, the Fed is attempting to pump liquidity into the system without a broad-based injection. The Fed’s decision on August 17 to cut the seldom used discount rate to 5.75 percent (50 bps cut) was one direct attempt to add order to the market for short-term borrowing after several asset-backed commercial paper programs failed to attract investors.

The discount rate (depository’s borrowing cost from the Fed) is one of the Fed’s three monetary policy tools, along with open market operations and reserve requirements. Since June 29 of last year, the Fed has kept the target Fed funds rate at 5.25 percent with the effective Fed funds rate (daily trading of overnight loans by banks) normally within 0.02 percent of the target rate. In response to the liquidity fallout during the month, the Fed allowed the effective rate to fall well below the target rate. This move essentially lowered the cost of funds in the market.

Credit Vista

Melina Hadiwono, *Manager of Credit Research*

The risk aversion and the subsequent liquidity crisis that hit the market recently may have a dramatic impact on the credit markets in the months ahead. As problems in the subprime mortgage markets have spread, investors have become much more focused on risk. The securitized mortgage market has experienced the greatest investor pullback, but risk aversion has extended well beyond that market, with spreads widening across the board from corporate issuance and structured products. Investors are demanding higher yield and have pulled back from many issuances with innovative features or added risk, such as covenant-lite deals.

According to S&P, both high-grade and high-yield corporate bond issuance have fallen significantly and high-yield issuance has nearly frozen. Hence, the risk for further leverage activities — which were the major cause of negative rating actions last year — is significantly reduced as the

high yield debt used to finance buyout activities seizes up. However, the risk has been replaced with liquidity risk, which tends to have a greater impact on lesser quality credits. Eventually, liquidity will re-emerge when the repricing of risk reaches a new level, although we expect that the market will remain volatile as news alternatively calms or alarms investors.

Trading Vista

Hiro Ikemoto, *Money Market Trader*

The markets this month can be summarized in one word: volatile. Commercial paper yields jumped as a result of the credit and liquidity events this month, with yields at 5.40 to 5.55 percent in the 20- to 75-day range, after staying at 5.30 to 5.33 percent for almost one year. One-year LIBOR ranged from 5.25 to 5.03 at month-end, with spreads widening dealer-to-dealer on the same bank/finance issuers, reflecting the liquidity concerns in the market. The 2-year Treasury benchmark started the month yielding 4.6 and ended at 4.12, due to the flight-to-quality rally in the markets. The 1-month and 3-month Treasury bills hit their lows in yield on August 21 at 2.29 and 3.47, respectively. Although inventory is roughly 50 percent of the levels prior to the credit and liquidity issues, we have currently been buying high-quality commercial paper in the 1- to 3-month range, where the yield curve has been most attractive. We expect volatility to remain higher than pre-subprime fear-induced levels. However, the markets have already begun to reverse toward more “normal” yield relationships and we anticipate this to continue over the next several months.

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New Fixed Income Advisory

SVB Asset Management has recently published an overview of the auction rate securities market. The report provides an explanation of the auction process and a discussion of recent accounting treatments and regulatory actions involving the securities. We invite you to download this valuable report at <http://www.svbassetmanagement.com/pdfs/AuctionRateSecurities0907.pdf>. (PDF, 96 KB)

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