

# Observation Deck

August 2007

## The Tale of Two Subprimes

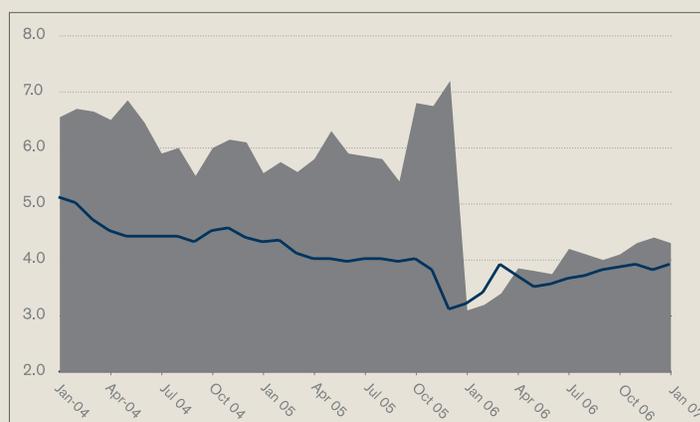
Melina Hadiwono, *Manager of Credit Research*

The recent rise in delinquencies and defaults in the subprime mortgage sector has prompted increased speculation about what other asset classes may be impacted.

One broad asset class under scrutiny is asset backed securities (ABS), which are backed by a specified pool of assets that generate cash flow. The pool of assets underlying the ABS can include credit card receivables, auto loans, home equity loans, student loans, equipment loans and other cash-flow generating assets. Typically, the security is issued through a Special Purpose Vehicle (SPV) with specific segments, or tranches, of the debt rated AAA/Aaa. An SPV is a bankruptcy-remote entity which is set up to separate the credit risk of the issuer from the structured credit of the pool of assets.

The credit card sector, in particular, has been scrutinized as a potential area where deterioration in the mortgage sector could spread next. *While we believe the subprime mortgage debacle might affect other aspects of the economy, we feel this specific concern about contagion to the credit card sector is unwarranted.* Based on a recent Moody's report, credit card collateral performance remains within Moody's expectations, and further, Moody's expects no immediate impact on the ratings for issuers and asset backed securities in the sector. The long-term performance trends of residential mortgage backed securities versus credit card sectors indicate that borrowers defaulting on

Historical Charge-off and Delinquency Rate



Source: Moody's

mortgages are not necessarily more likely to default on credit card payments.

Unlike the troubled subprime mortgage players with relaxed underwriting and documentation standards, we feel the major card issuers have demonstrated more rational underwriting and growth practices. The underwriting process is typically highly automated for applicants with relatively strong credit profiles, whereas the process for lower credit quality applicants requires more scrutiny.

The two segments also have historically correlated to different macroeconomic variables. The subprime mortgage market is significantly influenced by factors such as housing values, interest rates and the level of unemployment, whereas the subprime credit card market is correlated to unemployment and income fundamentals.

In addition, many new mortgage products such as second lien loans, hybrid ARMs, high LTV, interest only and no doc/low doc products have contributed to the difficulty assessing risk in the subprime mortgage sector, while in the credit card sector, the product offerings have been fairly consistent. By historical standards, credit performance was exceptionally strong for nearly all 2006. The sustained impact of the October 2005 changes to the personal bankruptcy law clearly contributed to the degree of improvement in delinquency and charge off rates. Both measures fell to a record low in early 2006 after peaking in late 2005. Going forward, we expect the credit card sector to continue to outperform the subprime mortgage sector in terms of credit performance.

### Markets

#### Treasury Rates

3-Month	4.94%
6-Month	4.97%
2-Year	4.52%
3-Year	4.50%
5-Year	4.56%
10-Year	4.74%

#### July Total Returns

ML 3-Month Treasury	0.39%
ML 6-Month Treasury	0.41%
ML 12-Month Treasury	0.57%
S&P 500	-3.20%
Nasdaq	-2.13%

Source: Bloomberg, as of 8/1/07

## **Economic Vista**

Ninh Chung, *Portfolio Manager*

Advanced estimates of economic growth in Q2 exceeded expectations, coming in at a 3.4 percent annualized rate compared to early estimates of a 3.2 percent growth. Net exports rebounded sharply, reflecting the weaker dollar as real exports jumped by 6.4 percent while real imports slipped by 2.6 percent. Private and government spending were also positive contributors to growth. Conversely, residential investment was the weakest sector, subtracting 0.5 percentage points from Q2 growth. Consumer spending showed signs of fatigue as it grew a mere 1.3 percent after a stellar 3.7 percent growth in the first quarter.

The recent shakeup in the subprime market, potential slowdown in LBO activities and revaluation of credit spreads could challenge the FOMC's forecasts for trend-like (2.25 to 2.75 percent) growth in 2007 and 2008. However, a tight labor market — with a historically low 4.5 percent unemployment rate — and strong ISM figures in both manufacturing and non-manufacturing support the committee's economic outlook. Additionally, robust corporate profits and corporate cash buildups present favorable environments for a sustained rebound in business fixed investments. We continue to believe the Fed will remain on hold for the remainder of 2007.

## **Credit Vista**

Melina Hadiwono, *Manager of Credit Research*

Corporate bond and asset backed credits are facing a scrutiny they have not seen for years, and investors are rightly focusing on diversification of credit risks. Under a steadily increasing trend of credit-impacting events such as mergers, leveraged buyouts, share repurchases and exposure to subprime mortgage losses, event risk and downgrade risk remain the biggest concern in corporate bond sectors. In the past several months, multiple events that were difficult to forecast— such as the First Data leveraged buyout, Sallie Mae's proposed leveraged buyout, Home Depot's major share repurchase and Bear Stearns hedge funds issues —have resulted in rating downgrades or meaningful reputational risk to the respective issuers.

Many market watchers have pointed out that tremendous liquidity and low interest rates have played major contributing roles in the current environment of higher credit risk and declining credit quality. In the past few years, a large and growing proportion of high-yield issuance has come from LBOs. The high-yield market exposure can multiply quickly, as LBO investment grade targets have been and may continue to be quickly downgraded multiple notches to a speculative rating. In addition, covenant-lite and higher leveraged loans are increasing in frequency. Recently, the trends seem to have moderated. Although the terms for high-yield issuance are becoming more demanding in terms of return and protection on the debt, M&A activity was higher in July than in June. In this environment, we continue to recommend investments in non-mortgage asset backed securities, which we consider a good alternative for investment diversification.

## **Trading Vista**

Hiro Ikemoto, *Money Market Trader*

The yield curve peaked during the first week in July presenting opportunities in the 1-year area where the LIBOR yields reached the 5.43-5.45 range. However, during the final days of July, there was an incredible flight-to-quality bid, as investors retreated from risky asset classes amid market fears. Investors sold stocks in favor of bonds, driving the Dow Jones Industrial Average down 788 points from its peak on July 19. The 2-year Treasury rallied with yields dropping from 4.92 on July 13 to end the month at 4.52. LIBOR also ended lower at 5.19.

The commercial paper market stayed flat with the 3-month yield hovering in the 5.28-5.31 area and the 6-month at 5.27. Agency discount note yields remained at the 5.17 area, while the yield on the 1-year dropped to 5.11 from a peak of 5.31 on July 6.

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