

Observation Deck

October 1, 2008

We're from the Government and We're Here to Help

Joe Morgan, CFA, Chief Investment Officer

History is being made before our eyes, we all know that. What we don't know, and certainly wish we did, is how it ends. As of press time the government still had not risen to the occasion with a rescue plan for the financial system, that the nation and without question the world, depends on. With the credit markets at almost a standstill, Treasury Secretary Henry Paulson has convinced Washington that the best course of action is to purchase illiquid investments, whose performance is quite uncertain. Who better to hold these securities to maturity than the U.S. government, the only institution in the world that can remain liquid longer than the markets can remain irrational. If confidence can be restored to the system, perhaps the government (the taxpayers) will actually receive a positive return on these investments.

We're a Long Way from Kansas....

The dirty little secret that the financial markets are entirely a "con" game is out. That word typically has negative connotations, but in fact, is simply short for "confidence," meaning that the markets rely on confidence in the system. Fifty-one years ago and repeating incessantly each holiday season, George Bailey aptly described our financial system using much more elegant terms, but a spade is a spade all the same. As long as the majority of participants in the system (be they depositors at a bank, investors in a money market fund or purchasers of corporate stocks) retain faith in the system, it will hold true. Unfortunately, September was the month that faith threatened to fade to oblivion.

Markets	
Treasury Rates	
3-Month	0.90%
6-Month	1.61%
1-Year	1.79%
2-Year	1.96%
5-Year	2.98%
10-Year	3.82%
September Total Returns	
ML 3-Month Treasury	0.30%
ML 6-Month Treasury	0.46%
ML 12-Month Treasury	0.45%
S&P 500	-8.91%
Nasdaq	-11.6%

Source: Bloomberg, as of 10/01/08

Leading up to the failure of Lehman Brothers, financial market participants retained great confidence the Fed would not let Lehman fail. They were wrong. For the Fed's part, they have repeatedly tried to dismiss this notion and felt that the markets have had six months to prepare for Lehman's failure, post the Bear Stearns collapse. The "con" was about to be broken.

Once it became clear Lehman was going down, to say "the markets froze" would be quite the understatement. The only sellers participating in the corporate bond markets were taking significant losses, indicating they were in a position that somehow forced them to sell. Buyers were repeatedly "bidding back" or dropping the price at which they were willing to purchase securities — sometimes by tens of percentage points. With the possibility that the government was done bailing out investors, no one wanted any risk, especially for financials who rely heavily on daily funding sources.

...But Can't We Just Click Our Heels?

So, now that the government has tested the market's confidence and the market has failed miserably, what should be done? Paulson's plan to purchase "troubled assets" from the banking industry has the goal of shoring up balance sheets, encouraging those firms to lend. But why should this make sense?

At 30,000 feet, the idea makes great sense. The banking industry holds large amounts of poorly performing loans which are incredibly difficult to value. Potential investors in the banking industry are reluctant to invest so long as their financial figures are uncertain. We don't know what these investments are worth because we don't know how much worse the housing market is going to get. However, if one could secure long-term funding, buy these troubled loans at a discount and then hold them to maturity, it's possible that investor could make a profit. Especially if the very act of this purchase were to help restore the "con," thereby allowing fewer mortgage defaults than previously estimated.

In comes the Treasury, which has the ability to buy a significant amount of these assets and hold them to maturity as it doesn't rely on the daily blessings of the investment markets for its funding.

Of course, the devil is in the details. Since it literally takes an "act of Congress" to get this done, we expect many diversions and wasteful efforts along the way. In addition, it's important to remember that this is probably only step two or so of the 12 step program toward recovery. Steps three and four? The Fannie and Freddie plans still need to be put on paper.

Economic Vista

Minh Trang, *CFA, Portfolio Manager*

In the September 16 meeting, the FOMC left its target rate unchanged at 2 percent. Given the bankruptcy of Lehman Brothers just days earlier, and distress at AIG, many market participants had expected the FOMC to cut rates by at least 25 basis points. The Fed, however, stated that monetary policy remains accommodative and that they would continue to address credit market turbulence with lending and liquidity facilities.

In addition to the Lehman and AIG debacles, economic data for the month was relatively bleak. The labor market weakened further, as August non-farm payrolls fell by 84K. This was the eighth consecutive month of job losses, bringing the year-to-date total decline to 605K. In contrast, in 2007 the economy created 1.1 million jobs. Correspondingly, the unemployment rate climbed to a five-year high of 6.1 percent, as firms continued to cut back on hiring.

In the face of job losses, retail sales (excluding autos) fell 0.7 percent in August. The drop was more than the forecasted decline of 0.2 percent. Electronics, building material, clothing and department stores all saw a drop in sales as consumers had spent their tax incentive checks in June and July. The expectation is that the ongoing economic weakness will keep consumer spending tight. In the coming months, we will closely monitor the depth of the economic repercussions from the turmoil on both Wall Street and Main Street.

Credit Vista

Melina Hadiwono, *CFA, Head of Credit Research*

On September 19, the U.S. government announced a set of extraordinary proposals, including the creation of a \$700 billion relief program for troubled assets (TARP) and several additional measures to stabilize the short-term credit markets, and restore investor confidence. The liquidity measures proposed focus on supporting the inter-bank market, broker/dealers and money market funds. TARP's objective is to remove residential and commercial mortgage-backed assets from the financial system through asset purchases by the Treasury. The scope and details of the program have not been finalized. There is still uncertainty with regard to the prices of these assets, the definition of eligible assets, and the eligible financial institutions. In the near term, if passed, this program is expected to benefit the financial institutions since it will allow them to eliminate the risk and restore the capital required for mortgage related assets. In addition, by establishing market prices on mortgage-related securities, the market will be able to find a price discovery on these assets to value their own assets. The goal is to enable

financial institutions to have better access to the debt and the equity markets and allow them to start lending, thereby reducing the risk of a broad recession. It remains unclear whether this program will improve the underlying mortgage performance and stabilize home prices.

While these government actions should ease the credit crunch, over the near term we expect that the credit condition will tighten further as banks adapt to the economic slowdown and become more cautious about using liquidity and capital. Over the longer term, the proposed program will not remove the need for further recapitalization of the banking system, particularly if the future regulatory environment demands higher capital levels as part of a more stringent regulatory framework. If these measures are enacted, we can expect sweeping reform of capital market regulation with the goal of providing for less risk, more transparency and greater accountability.

Trading Vista

Hiro Ikemoto, *Money Market Trader*

In case you were lucky enough to be on vacation last week, you may have missed the news: the third week of September 2008 turned out to be one of the most volatile periods in the financial markets in memory. On the surface, the two-year Treasury note ended the month at 1.92 percent, a difference of 45 basis points from August. That range seems relatively tight compared to the 94 basis point swing that occurred after the announcement of the government's proposed rescue package where yields went from 1.36 percent on September 18 to 2.29 percent the following day. Corporate issues with similar terms were trading from 175 to 380 basis points over the two-year Treasury yield, much wider than in August, due to the Lehman bankruptcy and the troubles with AIG. Agency yields remained at around 90 basis points over Treasuries.

Interest rates at the front end of the yield curve were also quite volatile, with one-year LIBOR ending the month at 3.24, an increase of 25 basis points from August. Higher-quality industrial corporate notes were being offered from flat to plus 50 basis points over LIBOR. In three-month maturities, commercial paper yielded 3.70 by month-end, while Agencies yielded 2.30. There was a "flight-to-quality" rally in Treasuries, which led to such demand that market indicators showed negative yields on short Treasury bills.

Contact

SVB ASSET MANAGEMENT
185 Berry Street, Suite 3000
San Francisco, California 94107
PHONE 1.866.719.9117
service@svbassetmanagement.com

© 2008 SVB Asset Management, a registered investment advisor, is a non-bank affiliate of Silicon Valley Bank and member of SVB Financial Group. Products and services offered by SVB Asset Management are not FDIC insured, are not deposits or other obligations of Silicon Valley Bank, and may lose value.

This material, including without limitation to the statistical information herein, is provided for informational purposes only. The material is based in part on information from third-party sources that we believe to be reliable, but which have not been independently verified by us and for this reason we do not represent that the information is accurate or complete. The information should not be viewed as tax, investment, legal or other advice nor is it to be relied on in making an investment or other decision. You should obtain relevant and specific professional advice before making any investment decision. Nothing relating to the material should be construed as a solicitation, offer or recommendation to acquire or dispose of any investment or to engage in any other transaction. 0908-0301