

Observation Deck

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What Does 'Extended Period' Really Mean?

Ninh Chung, *Portfolio Manager*

The Federal Reserve decided on January 27 to keep interest rates at historically low levels despite pronouncing a continued pickup in economic activity and a deceleration of job losses. Faced with a double digit unemployment rate, tight credit conditions, and real estate price depreciation, the decision was not surprising. However, the federal funds rate has been pegged between 0 percent and 0.25 percent since December 2008, and the Fed's ongoing comment that economic conditions "are likely to warrant exceptionally low levels of the federal funds rate for an extended period" does cause us to re-ask the following questions: "What does the Fed mean by 'extended period,' and how should client portfolios be positioned?"

Look for Signals

We believe the Fed is unlikely to raise interest rates in the immediate future, and perhaps will remain on the sideline all of this year. It is hard, to almost impossible, to be specific on when the Fed will reverse course and adopt a tightening monetary policy. But more important than an actual rate hike itself will be when the Fed first decides to change the language that accompanies future Federal Open Market Committee (FOMC) meetings, and signals a change of stance.

Markets	
Treasury Rates	
3-Month	0.07%
6-Month	0.14%
1-Year	0.27%
2-Year	0.81%
3-Year	1.35%
5-Year	2.32%
7-Year	3.06%
10-Year	3.58%
January Total Returns	
ML 3-Month Treasury	0.01%
ML 6-Month Treasury	0.05%
ML 12-Month Treasury	0.23%
S&P 500	-3.60%
Nasdaq	-5.34%

Source: Bloomberg, as of 01/29/10

It's Not All About the Federal Funds Rate

Besides lifting the federal funds rate to fight against inflation, the Fed is exploring other methods of removing excess liquidity. Historically, the Fed's open market operation of selling and buying of Treasury securities was a method to add or withdraw cash from the financial system. But this failed during the financial crisis as the market was flooded with cash. To manage the real federal funds rate, keeping it from deviating too far from the target, the Fed began paying interest on depository institutions' required and excess reserve balances on October 2008. By increasing interest paid on balances, the Fed sought to curb bank lending activities by narrowing the income differential stemming from lending and risk-free investment (Fed interest) activities.

Another policy tool in the Fed's arsenal is the use of reverse repurchase agreements. These transactions allow the Fed to finance its investment portfolio from dealers. In exchange for cash the Fed will systemically drain excess funds. By increasing the use of the aforementioned tools, the Fed can embark on a tighter monetary policy without increasing the target federal funds rate.

Benefit from an Active Approach

With the Fed unmotivated to increase short term rates until the economy is on a clear path to recovery, we believe corporate cash investors could benefit from adopting a more active approach to managing their portfolio. Investors should be mindful of the overall duration of the portfolio to ensure that excess cash is invested appropriately across the yield curve. Additionally, investors should continue to diversify their portfolios across a broad set of asset classes to capture yield differentials within each investment vehicle. During periods of high interest rate volatility, investors could also benefit from locking in investments at higher interest rate levels. While opportunities do exist in the marketplace, clients should continue to balance their investment objectives of 1) capital preservation 2) liquidity provision and 3) generating current income.

For a detailed discussion on how your cash portfolio may benefit from an active management approach, please refer to our advisory, "Creating Value with Active Cash Management" at <http://svb.com/publicationlist.aspx?id=753>

Economic Vista

Debi Hanson, *Portfolio Manager*

January began with unexpectedly bad jobs numbers. Non-farm payrolls declined by 85,000 after only an 11,000 drop reported in December. This sent yields down and dashed hopes that the jobs market would turn around. Retail sales for December came in significantly less than expectations, at -0.3 percent, after a strong November. Despite the employment problems and lack of consumer spending, the government is propping up the economy. Surprisingly, Bloomberg's economic survey for fourth-quarter GDP looks for a strong number north of 4.0 percent, much stronger than third quarter's 2.2 percent.

The housing market took a dive in December as existing home sales fell 16.7 percent (month-over-month). Hopefully, this decline was due to the holiday season, and the positive trend we have been in will continue. Inflation continues to be tame and there are no signs of a potential jump. Both the Producer Price Index (PPI) and Consumer Price Index (CPI) at the core level, excluding food and energy, came in for the month at 0.02 percent and 0.1 percent respectively. This, along with the employment issues, will keep the Federal Funds target rate at 0 - 0.25 percent for an extended period of time.

Credit Vista

Melina Hadiwono, *CFA, Head of Credit Research*

The regulatory landscape for the banking industry is likely to undergo major changes in 2010, which will primarily affect the largest banks. For example, President Obama has proposed a Financial Crisis Responsibility Fee, imposed on financial firms with \$50 billion or more in consolidated assets, in order to help recoup the government's Troubled Asset Relief Program (TARP) costs, even though most of the cost is outside the banking system directly. In addition, along with the recent proposed financial reform bill, the administration proposed limiting the scope of banks' proprietary trading operations as well as excessive growth of the largest financial firms' liabilities. These proposed changes mostly focus on helping consumers and limiting bank activities in order to rein in excessive risk taking and to protect taxpayers. As the regulatory pendulum swings from too loose to too tight, this may weigh heavily in the banking system profit model. The general sentiment seems to be that the financial sector became too large a component of overall economic activity in the last 20 years and the goal is to bring the industry back to more conservative balance sheets, less risk-taking, less leverage, lower fees, and lower compensation.

Recently, the U.S. bank regulatory agencies issued a joint statement focused on interest rate risk management. For a number of institutions, increased loan losses and sharp declines in the value of certain securities portfolios are reducing capital and earnings. In

this interest rate environment, taking advantage of a steeply upward-sloping yield curve by funding longer-term assets with shorter-term liabilities may pose risks to an institution's capital and earnings, should short-term interest rates rise. Depository institutions are expected to manage interest rate risk exposures using policies and procedures commensurate with their complexity, business model, risk profile, and scope of operations. Banks would have to rely on floating loan originations and higher-yielding loans, which in the past were usually sourced in the consumer, commercial, and commercial real estate areas, to mitigate the interest rate risk. However, the ability to grow loans and cheap deposits has been on the wane since 2008. In addition, interest rate hedges may be more costly and less abundant, and thus not as effective a tool to deal with higher interest rates.

Overall, we expect that banks should be better positioned to weather a rising rate environment, especially compared to the S&L crisis two decades ago. Nonetheless, if interest rates ramp up more aggressively, some banks may be caught off guard and will be more severely pressured.

Trading Vista

Hiro Ikemoto, *Money Market Trader*

On January 21, President Obama proposed a plan that would prohibit banks from running proprietary trading operations and other risk-taking endeavors. This ignited a flight-to-quality into government debt, as the market grew uncertain of the plan's implications. The two-year Treasury note, which started the month at 1.14 percent, hit a low of 0.79 percent on January 22, and ended the month at 0.81. The one-year Treasury bill yields also fell as it ended the month at 0.27 percent from a high of 0.44 percent at the start of January.

Corporate industrial bonds maturing in the one-year area yielded 0.40 to 0.45 basis points as spreads tightened to minus 4 to 10 against the LIBOR spot curve. Financial issuers also tightened up, with yields at 0.45 to 0.60 basis points. In the two-year maturity area, higher-grade issues yielded 0.85 to 0.95 percent, or plus 3 to 10 basis points better than the two-year Treasury note. One-year agencies were yielding 0.35, or 8 basis points better than Treasury bills, and two-year agencies are plus 10 to 15 basis points on top of two-year Treasury note. Incredibly, some AA industrial bonds were trading "through," meaning yielding less than, comparable AAA-rated agency bonds.

SVB Asset Management

185 Berry Street, Suite 3000

San Francisco, California 94107

Phone 1.866.719.9117

service@svbassetmanagement.com

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