

Observation Deck

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What Have You Done For Me Lately?

Joe Morgan, CFA, *Head of Portfolio Management*

Since taking the helm at the Fed in January 2006, Federal Reserve Chairman Ben Bernanke has been under fire. First, it was for the continuation of interest rate increases begun by Alan Greenspan to help fight inflationary pressures. Then, when reacting to signs of a coming economic slowdown, it was believed he did not cut interest rates fast enough. Now, many homeowners and politicians want the Fed to actually buy mortgage debt in order to prohibit further meltdown in the financial community. Reading the daily press, you'd think the Fed has been on the sidelines this whole time. That is simply not true.

The fact is the Fed, under Chairman Bernanke, has reacted aggressively to recent economic indicators, particularly in the housing and employment sectors and the liquidity issues facing the markets. In contrast to his predecessor, Bernanke is taking decisive and aggressive actions in attempt to get this economy back on track. Whether these actions will work remains to be seen, but no one should deny the Fed's aggressiveness or intentions.

Let's take a look at the recent governing actions undertaken at the Fed.

First, since September 2007, the Fed has cut interest rates a total of 300 basis points. Even after the dot-com fiasco of March 2001, Greenspan only cut interest rates by 275 basis points in reaction to much greater loss in wealth for the economy. In this cycle, the Fed began cutting rates slowly as employment

continued to grow and inflationary indicators had to be considered. However, once the jobs market turned, the Fed immediately became aggressive, cutting rates 200 basis points in just three moves so far this year.

Second, in December 2007 the Fed introduced the Term Auction Facility (TAF) in order to lend 28-day term money directly to banking institutions. As the Fed was cutting rates last year, LIBOR was actually on the rise, so the Fed created the TAF in order to compete directly with LIBOR, bringing it more in line with the Fed Funds rate. In recent weeks, the Fed has increased its reliance on this tool and it is entirely possible the TAF is here to stay.

Third, on March 7, 2008, the New York Fed announced a 28-day term repurchase program that is expected to accumulate to \$100 billion. While there is no public reporting of the participants in this program, many Wall Street firms have freely admitted to tapping this resource as a cheaper cost of funds, thereby minimizing any stigma associated with borrowing from the Fed in this manner.

Fourth, on March 11, 2008, the Fed created a Term Securities Lending Facility that essentially allows Wall Street firms to swap their AAA-mortgage or other collateral for U.S. Treasuries on a 28-day basis. This is intended to shore up the balance sheets of these firms and help instill confidence.

Fifth, on March 16, 2008, the Fed announced the establishment of a Primary Dealer Credit Facility (PDCF). The intent of this facility is to provide financing to primary dealers who are non-banking institutions through its discount window for at least the next six months. Such emergency credit availability would have helped Bear Stearns fight off Jamie Diamond and other potential buyers, perhaps allowing for a higher share price or even the ability to stay afloat as a stand-alone entity.

The Fed is certainly not done. The next step may be to purchase mortgage debt outright and re-securitize it with an explicit government guarantee. This was done once before in the real estate crisis of the early nineties with the creation of the Resolution Trust Corporation which allowed the government to bail out the banking industry without great cost to the taxpayers.

In summary, Ben Bernanke and the Fed have made it clear that the financial sector is "too big to fail." The creativity and expediency shown in these actions are fighting the tide of fear that is gripping today's markets. In the long run, the Fed will win; however there will be many bumps along the way.

Markets

Treasury Rates

3-Month	1.32%
6-Month	1.48%
2-Year	1.58%
5-Year	2.48%
10-Year	3.41%

March Total Returns

ML 3-Month Treasury	0.23%
ML 6-Month Treasury	0.26%
ML 12-Month Treasury	0.31%
S&P 500	-0.43%
Nasdaq	0.41%

Source: Bloomberg, as of 04/01/08

Economic Vista

Debra Hanson, *Portfolio Manager*

March economic data brought more distressing news to the market as the economy weakened further. On March 7, the nonfarm payroll numbers were released showing that 63K jobs were lost making two negative months in a row. Additionally, we have seen confidence fall, spending drop, and mortgage delinquencies go up. The headline inflation numbers were slightly down from the previous month (PPI 6.4 percent and CPI 4.3 percent) and core (ex. food and energy) rising minimally (2.3 and 2.4 percent respectively), but still above the Fed's comfort level.

In response to the weak economic data, the Federal Reserve Board came in and cut the target Fed Funds rate by 75 basis points at the March 18 meeting. The Fed has cut the funds rate by 300 basis points since September 2007 in an effort to stimulate the economy and bring liquidity back to the markets. Unfortunately, these lower rates have done nothing to help the consumer and thus the decline in spending.

Commodities prices continued to soar with oil hitting \$111/barrel and gold going as high as \$1,008/ounce until mid-month when we began to see a sell-off. While many factors affect oil prices, including geopolitical issues, gold tends to be an inflationary hedge and a safe haven from the turmoil in the stock and bond markets and the weak dollar.

Credit Vista

Melina Hadiwono, *CFA, Manager of Credit Research*

The ongoing credit crisis in U.S. financial markets has claimed a huge and high profile victim: Bear Stearns. According to the SEC, the capital and liquidity position of Bear Stearns had been relatively stable, ranging between \$15 and \$20 billion in the weeks preceding March 11. However, on March 10, rumors spread about liquidity problems at Bear Stearns which eroded investor confidence in the firm. This unwillingness to fund on a secured basis placed stress on the liquidity of the firm, which forced an extraordinary emergency borrowing pact with JPMorgan Chase and the Federal Reserve and led to Bear's March 16 announced acquisition by JP Morgan Chase. Upon closing of the transaction, which is expected to be around May 2008, Bear Stearns's debt is expected to be assumed by JPMorgan Chase.

While the Fed was slow to clue into how things could unravel, recent events show that the regulators now fully understand the immediate risks to the economy and financial system. They appear prepared to move quickly to avert liquidity crises at individual institutions and for the financial system at large. Regulators and central bankers globally have stepped up as lenders of last resort, injecting funds into financial systems and furnishing liquidity directly to banks and brokers. The Fed has

created facilities to allow institutions to borrow against their holdings of mortgage backed securities, which should help them avoid having to take realized losses on the liquidation of such assets at fire sale prices. Our view is that this and other measures will ultimately succeed in restoring confidence and thus liquidity.

However, we note that the unprecedented steps required to rescue Bear Stearns increases pressure on the Fed and the Administration to stabilize the underlying problem of the housing market. If the supply of the mortgage credit does not become more plentiful, it may be necessary to consider a much more aggressive policy action to stimulate rejuvenation. Otherwise, the credit crunch will intensify, exacerbating the problems investors face in the real economy.

Trading Vista

Hiroshi Ikemoto, *Money Market Trader*

The NCAA might have trademarked this, but you can say that it's been March Madness in the bond market this month. With the economic reports generally negative, the Bear Stearns bailout, financials being downgraded or put on watch, along with quarter-end, liquidity has been squeezed out of the market. We saw one-month and three-month T bills yielding under 1.00 percent intraday which were 50-year lows. The two-year Treasury note, however, remained relatively flat yielding 1.59 percent by month-end, about 3 bps lower than the start of the month. As for the corporate sectors, 90-day commercial paper was yielding 2.65 percent by the end of the month, about 20 bps lower than the start of March. However, financial bonds were volatile with yields ranging from 2.80 to 4.20 percent depending on issuer and time of month, while broker names were trading even higher. Agencies were yielding 50 to 60 bps above Treasuries.

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New SVB Asset Management Advisory

SVB Asset Management has recently published an advisory "A Tale of Two Eras," about the differences between Bernanke and Greenspan with regard to their leadership of the Fed. We invite you to download this report at http://www.svbassetmanagement.com/pdfs/SAMFixedAdvisory_ATaleofTwoEras.pdf (PDF, 232 KB)

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