

# Observation Deck

December 2008

## When Is it Safe to Go Back into the Water?

Minh Trang, CFA, Portfolio Manager

Since at least mid September, all corporate investment options have rightfully received unprecedented investor scrutiny, and corporate debt has been avoided regardless of its underlying credit strength. To better ensure that their safest investments remain safe, many corporations have reallocated much of their cash towards government funds and out of prime funds that invest in corporate debt. Funds that invest solely in U.S. agency and Treasury securities have grown by \$423 billion to \$1.1 trillion in November. In contrast, investors withdrew almost \$380 billion from prime money market funds over the same period, bringing their total down to \$1.07 trillion.

Though preservation of capital and liquidity is the overwhelming priority today, it is reasonable to assume that the significantly lower yields of government or Treasury-only funds will not be ignored permanently, many investors are now wondering when, and under what circumstances, should they return to the prime funds vehicle.

### Government Programs

To stave off the potential for large scale redemptions that could threaten the liquidity of capital markets worldwide, the U.S. Federal Reserve and Treasury have launched several asset support programs aimed specifically at maintaining the liquidity and stability of money funds and the commercial paper market. On September 19 the Treasury deployed the Temporary Guarantee Program for Money Market Mutual Funds to protect the \$1 NAV value of participating money funds. This guarantee was originally set to expire December 18 but has been extended to April 30, 2009. The Fed has also implemented several lending- and asset-purchase facilities to increase liquidity in

## Money Market Funds Trends



Source: ICI.org

the commercial paper space and provide a backstop to money market mutual funds directly. These facilities help by providing money funds a liquidity backstop in the event of another surge in redemptions. There are some signs that these programs in aggregate have helped to improve stability in the markets.

### Flight to Quality

The extreme flight to quality in recent months has created an historic imbalance in yield spreads. The average institutional prime fund, which is yielding roughly 2.38 percent, is now about one percentage point above agency funds, and two percent above Treasury funds. This is more than twice the normal spread between these types of funds and is a result of investors still demanding a high premium to take on anything riskier than Treasury assets. The spread between LIBOR and the 3-month Treasury bill hovers around 200 basis points today. In normal environments this spread is only 25-50 basis points.

### Conclusion

Until the barrage of negative economic and corporate news abates, the credit markets will have a difficult time attracting buyers interested in capital preservation. In time we expect that the numerous government programs will gain more traction and ultimately convince cash managers and their clients that prudent investment alternatives to Treasuries exist. The FDIC's explicit guarantee of certain commercial paper issuances, a recent stabilization of asset levels in prime money funds, and growing global government support of financial markets all point to opportunities to invest with greater certainty of safety... eventually. Today we continue to recommend staying in government agency or Treasury-backed funds. These funds will provide investors with a high degree of safety and liquidity, and greater transparency to the underlying risk.

### Markets

#### Treasury Rates

3-Month	0.04%
6-Month	0.42%
1-Year	0.90%
2-Year	0.98%
5-Year	1.91%
10-Year	2.92%

#### November Total Returns

ML 3-Month Treasury	0.10%
ML 6-Month Treasury	0.34%
ML 12-Month Treasury	0.61%
S&P 500	-7.18%
Nasdaq	-10.60%

Source: Bloomberg, as of 11/28/08

## **Economic Vista**

Debi Hanson, *Portfolio Manager*

It is 3:00 a.m. and the telephone rings. It is the Economy calling for help.

November economic data has only reinforced the fact that economy is in terrible trouble. Unemployment has risen to 6.5 percent and the number of jobs lost this year has reached 1.179 million through the month of October. Continuing jobless claims have exceeded the 2003 level already. The Federal Reserve Board estimates that the unemployment rate will climb to 7.6 percent next year, a dismal thought.

Other economic data released this month has also been bleak, in most cases, worse than expected. Home prices went down once again and the entire housing market continues to be a problem. With job losses increasing, conditions may worsen. Retail sales data is exceedingly soft. Unable to sell cars, the big three automakers asked Washington for a handout to stay in business only to be sent home to come up with a strategic plan for the rescue money. The back-to-school numbers were dismal and this has carried through November. Expectations for the holiday shopping season are not good and retailers are already discounting items in the hopes of drawing in buyers. Consumers, it seems, fearful of losing their homes or jobs, have closed their wallets and have lost their confidence. The University of Michigan consumer confidence measurement fell to a 28-year low in November.

There is little good news to share other than inflationary pressures falling along with commodities prices. The price of oil continues to come down bringing gas prices with it and the national average is \$1.82 per gallon. The Commodity Research Bureau Price Index has come down more than 230 points since its high in July of this year.

## **Credit Vista**

Sook Kuan Loh, *CFA, Senior Credit Analyst*

The lack of available credit in the market appears to be hurting even companies with seemingly no ties to current market turmoil. Corporate debt issuance fell further in the month of October as evidenced by Bloomberg's league table for U.S. corporate debt. Total issuance for October 2008 was only \$28.5 billion compared to a whopping \$109 billion in October 2007 and \$30 billion in September 2008. It appears that the market has thrown out the baby with the bath water. Companies which were perceived as safe havens previously, saw their credit default swap spreads skyrocket to new levels.

Although earnings pressure will continue for the foreseeable quarters, we believe that many of the investment-grade non-financial companies have prepared well to weather the current storm. Most companies have taken proactive steps by reducing dividends or ceasing their share buyback program to improve their capital positions. This frees up cash flow to pay for future

capital expenditures and reduces reliance on wholesale funding which has become expensive and difficult to obtain in the last few months. These companies lessened their dependency on the short-term debt market and opted for longer-term funding. They are also opting for plain vanilla investments instead of exotic products that are difficult to understand. With these companies being more cognizant of asset-liability management, credit metrics are likely to improve going forward creating a healthier investment environment in the long run.

The government is undertaking various initiatives to stimulate the economy and create jobs. In addition to the industries that will benefit from various economic stimulus packages, mainstays such as discount grocery stores, companies serving basic consumer needs and pharmaceuticals are expected to thrive. Technology companies providing vital services to their clients' efficiency that have locked-in, long-term contracts will also be among those least affected by the downturn. Although no company is completely immune to these unprecedented credit market conditions, we expect that highly rated investment grade companies, especially the non-financials, will emerge out of this challenging environment safely.

## **Trading Vista**

Hiro Ikemoto, *Money Market Trader*

Another month, another set of acronyms for programs to address the liquidity crisis. In late October, the Federal Reserve Board created the MMIFF, or Money Market Investor Funding Facility, which will support a private-sector initiative designed to provide liquidity to U.S. money market investors. The Fed hopes the MMIFF will allow qualified money fund providers to sell back their commercial paper holdings to the government. MMIFF combined with the CPFF, or Commercial Paper Funding Facility, should help thaw out the short-term corporate market.

The TLGP, or Treasury Liquidity Guarantee Program, is another government initiative designed to support the short-term market. General Electric was the first to take advantage of this program on November 13. It is still too early to say whether or not these initiatives have increased liquidity, but rates on 90-day commercial paper have fallen 1.03 basis points this month alone.

In other news, yields on the three-month LIBOR declined for the 23rd consecutive trading session, before it finally bounced up on November 13. The enticing low yields in the credit market were out-dued by even lower yields in the Treasury bills market. This tremendous flight to quality rally in Treasuries may now be the norm rather than the exception as we approach the sixth quarter of the current credit crisis.

## **Contact**

SVB ASSET MANAGEMENT

185 Berry Street, Suite 3000 San Francisco, California 94107

PHONE 1.866.719.9117 [service@svbassetmanagement.com](mailto: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. 1208-0376