

Observation Deck

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Why Long-Term Rates are Rising

Debi Hanson, *Portfolio Manager*

Late last year, the Federal Open Market Committee cut the target Federal Funds rate to a range of between 0 – 0.25 percent, in an effort to stimulate the economy. Shortly thereafter, the government announced that it would embark on what is called “quantitative easing.” The goal for quantitative easing is to force long-term rates down. In theory, this should have brought consumer lending rates down, and especially mortgage rates.

But, if we look at the yield curve from December 31, 2008, to June 15, 2009, we can see that the curve has instead steepened. The two-year to 10-year Treasury spread has widened from 145 basis points to 249 basis points. In fact, the entire yield curve has steepened dramatically since the end of last year, with the latest 10-year Treasury auction clearing at nearly 4 percent.

Why has this happened and what are the ramifications?

Traditional long-term investors, such as pension plans, insurance companies, and foreign governments, have been selling their long securities and reinvesting those proceeds in the shorter end of the yield curve, thus pushing long-term rates up. This is because longer-term investors are looking at the spiraling projected deficits and the amount of Treasury supply coming (presently and in the

future) and can make only one conclusion — easy money leads to inflationary pressures and those traditional buyers see pain ahead. Long-term rates therefore go up as demand for long Treasuries go down, to lure investors.

One of the results of these higher rates in the longer end of the yield curve is higher mortgage rates. Mortgage rates, which are traditionally spread over the 10-year Treasury yield, have gone up by nearly 100 basis points. As recently as five weeks ago, Freddie Mac 30-year conforming loans were at an historic low of 4.85 percent. Now, we are seeing these rates in the high 5s. This will have a detrimental effect on the already slow housing market, as higher rates stall the already slow housing market recovery.

The government’s intent has been pure. It is trying to pull the economy out of this prolonged recession and to strengthen the credit markets. Unfortunately, its solutions have had unintended effects. By printing so much money and increasing deficits, inflationary fears loom ahead. The dollar has weakened and foreign buyers, while still in our markets, are pulling back, as are traditional U.S. buyers.

President Obama has obviously been briefed on this increase in Treasury yields and has ordered Congress to find ways to pay for any new programs without having to further increase the burgeoning deficits. Hopefully, this mandate will work. If not, we run the risk of 1) losing more foreign capital and seeing a decline in the value of the dollar, 2) stalling the recovery with higher interest rates, and 3) placing a much higher tax burden on the public to pay for these skyrocketing deficits.

For our clients, who invest primarily in the short end of the yield curve, yields are still low. Demand has increased as those typically long-term buyers park their cash in shorter maturities. Thus it is unlikely that we will see meaningful change in short-term rates for the foreseeable future.

See Also: “Quantitative Easing or What to do when Rates Hit Zero,” by Joe Morgan, SVB Asset Management, January 12, 2009, at www.svb.com/pdfs/sam/quantitativeeasing.pdf

Markets

Treasury Rates

3-Month	0.18%
6-Month	0.34%
1-Year	0.48%
2-Year	1.11%
3-Year	1.62%
5-Year	2.56%
7-Year	3.21%
10-Year	3.53%

June Total Returns

ML 3-Month Treasury	0.10%
ML 6-Month Treasury	0.02%
ML 12-Month Treasury	0.05%
S&P 500	0.20%
Nasdaq	3.47%

Source: Bloomberg, as of 6/30/09

Economic Vista

Minh Trang, CFA, *Portfolio Manager*

The buzz that dominated most of June was that the economy may be approaching the bottom. Though data points such as unemployment and jobless claims remain substantial, the rate of deterioration has slowed. The latest initial claims in June came in at 627,000, while continuing claims remained high at 6.73 million. The unemployment rate has also spiked to 9.4 percent. However, job losses of 345,000 in May were much lower than the forecast loss of 520,000.

In regards to interest rates, the Federal Open Market Committee (FOMC) kept the target rate unchanged in the range between 0 – 0.25 percent. The FOMC noted that pockets of weakness remain in the credit markets, and the economy has yet to substantiate recovery — with first quarter 2009 GDP contracting at 5.5 percent. The focus now will turn toward second-quarter performance, as corporate earnings are released in the coming weeks. The hope is that the various government programs and Fed involvement will continue to help the financial sectors repair their balance sheets and sustain their profitability.

Credit Vista

Sook Kuan Loh, *Senior Analyst*

On June 17, 2009, President Obama unveiled the Financial Regulatory Reform plan. The plan covered five key areas: (1) improving supervision and regulations of financial firms; (2) establishing comprehensive regulation of financial markets; (3) protecting consumers and investors from financial abuse; (4) arming regulators with necessary tools to manage financial crises and (5) raising international regulatory standards and improving international cooperation.

A notable recommendation is the identification of systemically important firms, regardless of the industry of the firms, and subjecting such firms to stricter and more conservative capital, liquidity and risk management standards. A new National Bank Supervisor role would be created to supervise all federally chartered banks, with a goal of eliminating loopholes that allowed some institutions to avoid bank holding-company regulation by the Federal Reserve. The President's Working Group on Financial Markets is tasked with preparing a report considering fundamental changes for money market funds, to enhance investor protection and mitigate the risk of runs, such as the one in September 2008, which may have resulted in a money market fund breaking the buck. The creation of the Consumer Financial Protection Agency is to consolidate the powers currently residing in different agencies and provide better protection to consumers and investors.

By harmonizing regulation by the SEC and CFTC and encouraging greater coordination between both agencies, the government expects to strengthen the oversight of futures and securities markets. Meanwhile,

promotion of standardized but more robust international regulations would limit arbitrage opportunities for firms that wish to avoid prudential standards. Accounting standard setters are encouraged to take into account more forward-looking metrics for loan loss provisioning and fair valuation. Cooperation between the Financial Accounting Standards Board and the International Accounting Standards Board aims to promote global consistency in financial reporting.

The plan seeks to provide the foundation for more robust financial regulation and supervision, leading to a healthier credit environment. The introduction of increased transparency would allow investors to make better decisions for their portfolios, whereas stronger regulatory capital and liquidity standards would help prepare financial institutions for future economic downturns. However, most of the proposal currently remains in flux, as some recommendations would need to be ratified by Congress and final recommendations need to be made by the respective regulatory agencies. For example, Fannie Mae and Freddie Mac are expected to remain in conservatorship, as the report on the future role of government-sponsored entities will only be tabled at the time of the President's 2011 budget.

Trading Vista

Hiro Ikemoto, *Money Market Trader*

The two-year Treasury note yield peaked at 140 basis points on June 8, after being relatively unchanged at around 95 basis points since late January. It appeared that many investors feel the labor market is stabilizing, as non-farm payrolls were down by 345,000 instead of the expected 520,000 job losses in May. However, the two-year note firmed up by the end of June with a yield of 1.11 percent, as the World Bank provided a bleak outlook on the global economy. The shorter end of the Treasury market remained relatively unchanged even with the quarter-end effect, as economic uncertainties kept investors at bay. Yields in the three-month bill ended the month at 0.18 percent, six-month at 0.34 and the one-year at 0.48. Agencies remained tight to Treasuries as supplies are still scarce with yields 5 to 10 basis points more than Treasury bills inside a year.

Three-month LIBOR rates continued to decline, ending the month at 0.595 percent. Three-month commercial paper was averaging 25 basis points less than LIBOR. Spreads on high-grade industrial bonds were minus 25 to plus 10 basis points to LIBOR in the one-year area, while high-grade financials tightened up to plus 15 to 80 basis points to LIBOR.

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