

Observation Deck

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Why the Fed and Politics Shouldn't Mix

Ninh Chung, *Portfolio Manager*

President Obama's reappointment of Ben Bernanke to a second term as chairman of the Federal Reserve was widely viewed as a positive for the financial markets, removing the cloud of uncertainty that surrounded the Fed's future. The next challenge for the Fed is to maintain political independence as this is a key factor in ensuring that monetary policy will remain sound, going forward. We believe an independent Fed with a focus on long-run objectives, such as pursuing full employment and price stability without unnecessary political pressures, will bode well for investors.

The President credited Bernanke, a scholar on the Great Depression, with preventing a second such event with his bold and creative actions during the 2007-2009 financial crisis. Acting as lender of last resort as the crisis worsened in 2007, the Fed created new lending facilities to inject liquidity into not only depository institutions, but investment banks and corporate commercial-paper issuers. Furthermore, the Fed created emergency loans to prevent the failure of systemically important institutions such as AIG and Bear Stearns, along with partnering with the Treasury and Federal Depositary Insurance Corporation to guarantee losses of over \$400 billion on Citigroup and Bank of America's distressed assets. These unconventional programs were created to deal with the scale of the crisis, but have ballooned the Fed's balance sheet to

over \$2 trillion, compared to \$850 billion in 2006. These creative and uncharted programs have opened a window to criticize the Fed's authority and independence.

The Rationale for an Independent Fed

We acknowledge that the Fed is not completely independent of political pressure, as Fed governors and more importantly, the chairman, are appointed by the President. But comparatively, no other government agency in the United States operates with more independence from policy pressures than the Federal Reserve. By law, Congress may not audit the Fed or approve its budget. This must remain intact.

The most compelling argument for an independent Fed is based on the view that a politically pressured Fed would lean toward an inflationary-biased monetary policy. The need for politicians to win the next election could pressure an influenced Fed to pursue short-run goals with potentially dire long-run results. As an example, in a high-interest-rate environment, the Fed may impart an expansive economic policy despite inflationary pressures looming on the horizon. This short-term action would have a large negative impact on bond investors as inflationary conditions erode the price of fixed assets.

Viewing the same argument slightly differently, imagine if our monetary policy were left to our politicians who have demonstrated on numerous occasions their lack of discipline and expertise in making tough economic decisions. We would expect monetary policy to be based on the election calendar rather than economic conditions.

Conclusion

The Fed has not been perfect during this financial crisis as it was slow in acknowledging the housing problem and some of the new credit facilities did not function as intended. But overall, it performed admirably as lender-of-last-resort. During the financial crisis, the Fed has worked tirelessly to unlock the credit crunch, restore confidence in the marketplace, and provide leadership in challenging economic times. Much of this effectiveness can be directly attributed to the Fed's independence and autonomy, which enable it to inject the appropriate degree of expansionary policy in pursuit of long-term full employment, and price stability.

Markets

Treasury Rates

3-Month	0.13%
6-Month	0.22%
1-Year	0.42%
2-Year	0.97%
3-Year	1.47%
5-Year	2.39%
7-Year	3.03%
10-Year	3.40%

August Total Returns

ML 3-Month Treasury	0.03%
ML 6-Month Treasury	0.06%
ML 12-Month Treasury	0.13%
S&P 500	3.61%
Nasdaq	1.67%

Source: Bloomberg, as of 8/31/09

Economic Vista

Debi Hanson, *Portfolio Manager*

Once again, job numbers dominated the markets during the early part of August. Non-farm payroll came in much lower than consensus, down 247,000, for the least number of jobs lost since fall 2008. More surprising was the unemployment rate, which had been expected to rise, but instead dropped 0.1 percent to 9.4 percent.

The inflation reports showed a drop in the numbers, leading many to squawk at the inflation hawks amongst us. Of course, we are sure to see volatility in the food and energy area, so headline inflation may have a bumpy path ahead, but for now deflation is the concern. We further believe, the lack of spending on the part of the consumer will continue to force many prices down. Have you seen any stores not offering sales? There are no high expectations for the back-to-school shopping season, which is upon us now. The only bright spot has been the auto dealers, aided by the government-run "cash for clunkers" program. It is anticipated that about 500,000 auto sales resulted from this program.

Existing home sales have come in positive for four months in a row. This is good news, even if those homes were in foreclosure or sold through a short sale. The fact is, existing home sales were up 7.2 percent month over month. The bad news is that defaults are at their highest level ever at 9.24 percent.

We still have a bumpy road ahead, particularly on the jobs front, but there are clear signs that we are in the beginning of a recovery.

Credit Vista

Melina Hadiwono, *CFA, Head of Credit Research*

The market rally last month was driven primarily by the "beat expectation dynamics" for the second-quarter earnings season. In the U.S., nearly 72 percent of S&P 500 companies have reported surprisingly positive results. However, much of the reported earnings growth came from cost-cutting efforts by companies which have a limited ability to drive longer-term results, while the revenue growth continues to be disappointing. From a longer-term perspective, revenue and profitability growth still remain tied to consumer spending. The U.S. consumer continues to be the main driver of the economic outlook. As U.S. consumers remain exceptionally challenged by high unemployment, high debt servicing levels, tighter lending standards, and a dramatic loss of net worth, we can expect that the de-leveraging consumer will be spending less and saving more for the foreseeable future. This will ultimately drive companies to adjust to a lower domestic aggregate demand.

Companies are adopting more prudent financial strategies in response to the current challenging operating environment. They are downsizing to adjust to the new reality of a lower level of aggregate demand,

cutting costs, paying down and/or terming out debt, limiting capital expenditures, halting stock repurchase programs and reducing dividends. Mergers and acquisitions are now funded in a more balanced manner that is not as reliant on large positions of debt financings.

We continue to expect that non-financial, investment-grade issuers will have access to the credit markets, similar to the robust issuance level enjoyed in the first half of 2009. Total U.S. investment-grade corporate bond issuance reached a record level of \$672 billion at end of July 2009, which is equal to the 2008 issuance. The increase in bond issuance was mostly associated with terming out of short-dated maturities, providing a more stable capital base. In parallel, outstanding commercial paper declined by 24 percent year-to-date as companies reduce reliance on short-term funding. Going forward, companies will continue to face challenges such as refinancing issues given rising maturities in the upcoming years, the impact of the unemployment rate on consumer confidence, and weak business investments, which would undermine the sustainability of a recovery. While the worst is likely behind us, it is still too early to consider that the improvement in recent economic data is an assurance that the current rebound can be sustained. The question is what will the next economic expansion look like?

Trading Vista

Minh Trang, *CFA, Portfolio Manager*

General trading activities were relatively muted for August, which is typical as many traders are out for summer vacations. Yields continued to decline in most sectors, as the Federal Reserve reiterated its stance in maintaining low interest rates for some time to come. Overall demand in the short end of the yield curve remains strong and a decreasing supply of commercial paper issuance has put further downward pressure on spreads.

The two-year Treasury note remains in a trading range between 1.00 and 1.30 percent. The two-year began the month at 1.18 percent and ended at 0.97 percent. Yields on T-bills were mostly unchanged in August. The six-month and three-month bills closed the month where they started, at 0.22 and 0.13 percent, respectively. The one-year T-bill dropped 6 basis points, from 0.46 to 0.40 percent. Other sectors remain tight to Treasuries, with six-month agency discount notes trading +5 and 1-year at +8 to Treasury equivalents. Commercial paper provided a bit more cushion, with 90- and 180-day yields averaging 0.27 and 0.40 percent, respectively.

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