

SVB Asset Management Economic Commentary

This commentary is authored by SVB Asset Management's Portfolio Management Team.

Thoughts From the Desk

Bond trading activity has dried up as investors continuously shift toward safer alternatives. In response, the Fed created several new avenues of providing liquidity to the markets which has staved off any major financial firm failures for now.

The Fed has essentially bought time for the markets to recover. But the question remains as to whether Wall Street can get the mortgage market back in shape before the housing sector, and therefore the economy, takes another violent swing downward.

In coming years, the financial industry will look back on the first quarter of 2008 as the defining period when the Fed said “the financial markets will not fail.”

As economic data continued to affirm the current slowdown, the Fed tossed aside any concerns of inflation and focused on the liquidity and credit crisis at hand. In addition, financial players made shifts in their corporate strategies that helped calm the markets by the end of the quarter, though many more potential troubles loom on the horizon.

But the light at the end of the tunnel may be an oncoming train in the form of a deteriorating employment market which will add momentum to the housing downturn. In addition, the potential inability of Wall Street to solve deteriorating mortgage flow problems will likely delay any housing market recovery for some time. Until a fully functional mortgage market allows creditworthy borrowers to appropriately leverage themselves, the housing market will not recover.

On the bright side, our calculations estimate that approximately \$100 billion in fees will arise from the mortgage industry every five to seven years, providing plenty of “carrot” for Wall Street to solve this issue. While the lower interest rates and increased liquidity provided by the Fed will certainly help improve the economic environment, only time will allow the wizards on Wall Street to develop the necessary creative solutions that will get the mortgage market back on track.

We believe this timeframe could be as long as six to nine months in development and then another nine months or so for the housing market to improve significantly. This implies we will not consistently achieve GDP growth north of 3 percent until at least the fourth quarter of 2009. In the meantime, we expect

growth will trough in the second or third quarter of 2008, and then move slightly into positive territory for most of 2009.

ECONOMIC DATA

After dropping to an annualized rate of 0.6 percent in the fourth quarter of 2007, many economists are expecting GDP growth to be negative in the first quarter 2008 for the first time since 2001. In addition, nonfarm payrolls decreased all three months for a total drop of 232,000 jobs, wiping out the job growth experienced in the fourth quarter. Continuing jobless claims — those that are receiving unemployment benefits — topped the post-Katrina level in late March and seem to be gaining momentum.

Looking forward, the economic scene does not look to be improving. A deteriorating jobs performance will necessarily lead to more “forced sales” of homes that are no longer affordable as households move from dual- to single-income. Should nonfarm payroll losses approach the peak of 328,000 per month achieved in the 2001 downturn, today's housing market will begin to look like the “good old days” as the downturn in home prices would gain momentum.

MONETARY POLICY

After the first negative nonfarm payroll report in early January, the Fed shifted its efforts into high gear, cutting interest rates by 75 basis points in an inter-meeting move on January 22, and then another 50 basis points just eight days later. Altogether, the Fed cut interest rates by two full percentage points during the quarter, ending the period at 2.25 percent. In addition — and potentially more importantly — the Fed initiated several new programs with the goal of adding liquidity to the marketplace.

Beginning in December, the Fed introduced the Term Auction Facility (TAF) in order to lend 28-day term money directly to banking institutions. Realizing the rate cuts and liquidity efforts of 2007 were not reaching the entire banking system, this program essentially put the Fed in the business of competing with LIBOR which had spiked considerably due to liquidity concerns in the marketplace. The continuation and expansion of this program in the first quarter can be credited with much of the decline of LIBOR in the first quarter.

On March 7, the New York Fed announced a 28-day term repurchase program that is estimated to be \$100 billion. While there is little public reporting of the participants in this program, many banks have freely admitted to tapping this resource as a cheaper cost of funds, thereby implying any stigma associated with borrowing from the Fed in this manner is minimal.

Then, on March 11, the Fed created the Term Securities Lending Facility that essentially allows Wall Street to swap their AAA-rated 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 encourage liquidity across the Street.

Most recently, on March 16, the Fed announced it will lend to non-bank primary dealers, similar to discount window access, for at least the next six months. Providing this backstop for institutions who are dependent on daily funding sources such as Lehman Brothers and Merrill Lynch, has helped calm investor concern. Had this initiative been in place prior to the current crisis, it is quite likely Bear Stearns would have been able to remain independent, at least for a bit longer.

Clearly, the Fed is approaching the current liquidity and credit crisis with great creativity and boldness, assuring short-term investors the financial markets will remain intact. Though there will continue to be damage along the way in the form of further credit-rating downgrades and increased loss reserves, the U.S. financial system is simply too big and too important to the overall economy to fail and the markets are now assured that the Fed "gets it."

MARKET ACTION

Treasuries continued their rally as investors demanded liquidity and creditworthiness. The extreme squeeze in the repurchase markets, illustrating high demand from investors who don't normally buy Treasuries, was fought off effectively by the Fed as they pared back their holdings, allowing for increased availability of this highly desirable collateral source.

Short-term corporate issues came under extreme pressure during the quarter with some stressed issues with maturities of under six months trading in the low \$70s. These included large financial

institutions rated as high as single-A. This market action was fought off effectively by the Fed initiatives listed above as none of these issues have defaulted to date.

Commercial paper markets continue to trade well in the primary market as money flooded into money market mutual funds. These funds, guided toward safety and liquidity by SEC Rule 2a-7 of the Investment Company Act of 1940, have grown in size from around \$2.5 trillion in June 2007 to approximately \$3.3 trillion today.

SAM MARKET STRATEGY

It is times like these that SAM's strategy of erring on the side of safety and liquidity shines through. As market sector implosions – including the recent destruction of the auction rate securities market – have severely affected many investors in the cash space, our portfolios have retained full liquidity. While many investors are now leaning toward the extreme safe end of the spectrum and advising portfolios entirely focused on Treasury investments, we maintain a greater faith in the American financial system as an ongoing entity.

While SAM continues to focus on investments that are highly liquid and of solid credit, we do not feel that exiting the corporate or even the entire financial sector entirely is appropriate. Instead, we are focusing our clients' investments in rated money market mutual funds whose management philosophy and strategies are aligned with our client base. These funds allow for daily liquidity, maintaining a daily net asset value of \$1 and are providing a higher return than individual investments due to their accrual accounting methodology in today's rapidly declining rate environment.

Looking ahead, it is likely these individual investments will once again look attractive during the second quarter at which time we will reenter this sector focusing on issuers who have shown great resiliency during the current market downturn.

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