

January 23, 2009

Fourth Quarter 2008 Economic Commentary

Thoughts From the Desk

Fear drove most decision-making processes in the fourth quarter as investors and consumers alike planned for the worst. Job losses continued to mount during the quarter which will put off any economic recovery until at least late 2009 but more likely into 2010. Treasury rates dropped to zero as investors traded any potential return for assurance of capital preservation. Even with the new administration in place and many changes occurring at the government level, confidence will remain in hiding until investors and consumers can see an actual recovery on the horizon.

The Fed and Treasury have deeply penetrated uncharted waters and continue to show great creativity in the face of such dismal circumstance. Global investors are betting with their dollars that the U.S. economy will eventually pull through as evidenced by low Treasury rates. The only question is how long until recovery? We believe the first step toward housing market stabilization lies in determining the role of Fannie and Freddie in future mortgage creation. Unfortunately, this is an agenda item for Congress who has shown an inordinate ability to drag their feet when making big decisions, so we don't look for this first step to be complete until late in the second quarter of this year. Until then, the housing market will continue to founder and potentially get much worse from here as employment declines.

Today, we are in the depths of a liquidity and credit crunch not seen since perhaps World War II. Though many market indicators show interest rates at historic

lows, investors and lenders alike are unwilling to transact with any significant risk. The multitude of government “bailout” or guarantee programs are beginning to provide some level of trading activity but that has yet to carry over significantly into non-government opportunities.

2009 will begin not only with a continuation of these government bailout programs but with rapid expansion into the “main street” sector. Nonetheless, investor and consumer confidence will not begin to rebuild until time can pass without significant negative surprises such as the Madoff scandal. In addition, capital will be unable to flow to the housing sector in size until well after Congress solves the Fannie/Freddie conundrum. No sizable commitment can be made to this sector without knowing where these two 800 - pound gorillas will reside.

The economy continues to slow, led by the 2.6 million jobs lost in 2008. Most of these losses occurred in the most recent quarter, the effects of which will not be seen until early 2009. In particular, the massive foreclosure rate we are experiencing is a result of faulty mortgage underwriting or structure — not job losses. Now, in 2009, we expect to see a significant increase in foreclosures due the spike in job losses, perhaps sending the housing market into another, though perhaps less extensive, downward spiral.

Economic Data

The economy came to a near standstill in the fourth quarter as investors and consumers lost any remaining confidence. The holiday shopping numbers are still coming in but it is easy to see that disappointment across the board is occurring. Outstanding consumer debt dropped for two months in a row (ending November) for the first time since 1992, and news that the credit card industry was unable to issue even one asset-backed security in October hit issuers hard, forcing them to further restrict credit availability and increase interest rates.

Though we have a culture of spending in this country, many potential consumers are either being forced to spend less through lower credit availability or are choosing to spend less for perhaps the first time in their lives. Should this credit contraction continue we could see a culture shift toward saving which would further restrict long-term potential GDP across the globe.

Housing continued to struggle as expected, however, the big story here was the mounting job losses as shown in the chart on page 3. The economy lost a staggering 1.53 million jobs during the quarter with no sign of slowing. For the year, we are down 2.6 million jobs and counting. In comparison, during the last downturn in the economic cycle, we lost just 2.2 million jobs. The long term effects of these job losses will be seen in the first quarter's economic data and beyond.

The economy continues to slow even as the focus of government bailout programs is on the functioning of the markets. Even once confidence returns bringing investors and consumers back to the marketplace, the reality of a much slower economy whose growth prospects have been radically reduced will have to be faced.

Monetary Policy

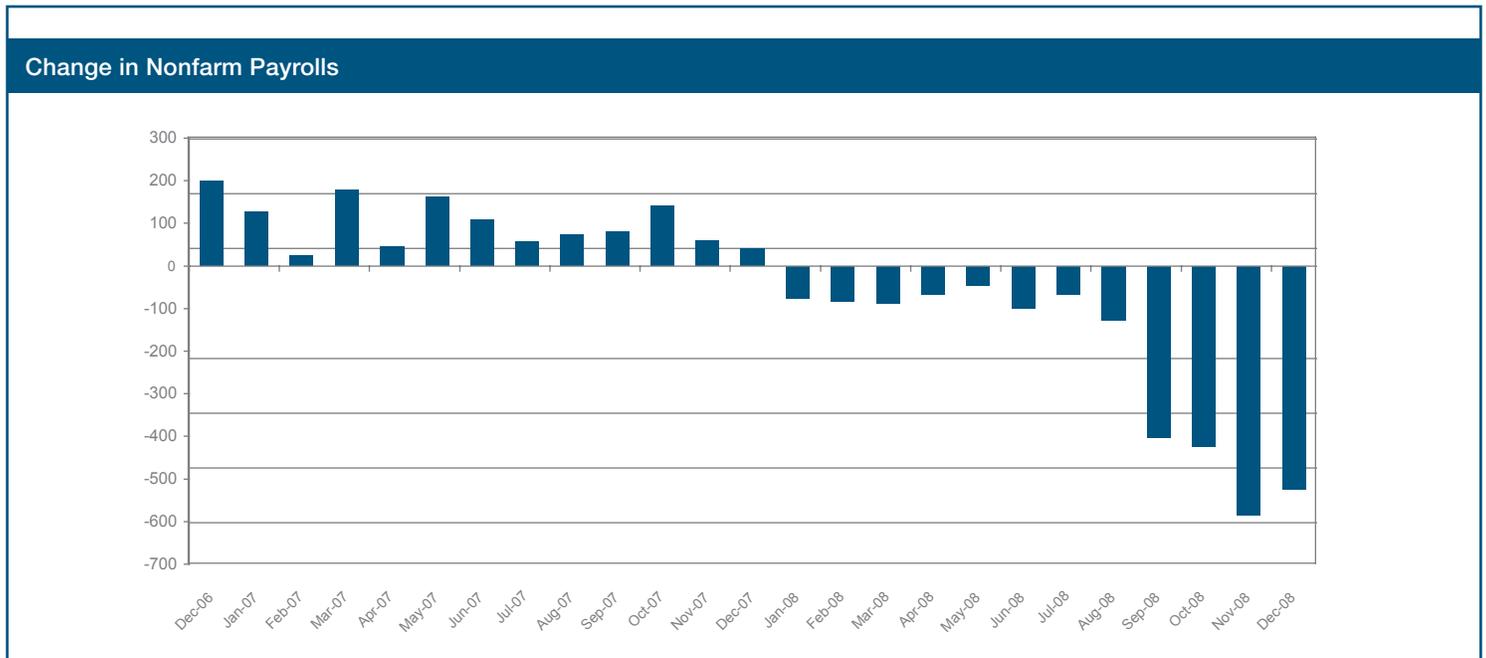
During the fourth quarter, the Fed dropped its target Fed Funds rate from 2 percent to a "range" of 0-25 basis points. Effectively, the Fed has killed this rate as a means of managing the economy and is now focused on using other tools. Fortunately, this is not an overnight change in strategy. In fact, the Fed has been using other measures since at least the introduction of the Term Auction Facility (TAF) in December 2007.

Nonetheless, the market perceives a great deal of uncertainty with regard to the Fed given the wide range of tools now being considered. Uncertainty breeds lower confidence. Since market pundits can no longer point to a single numerical measure to interpret the Fed's intentions, investors are less confident in the coming measures to be used by the Fed.

On the plus side, Bernanke and company may get high marks for creativity in 2008 even though their individual decisions were not entirely effective. Market confidence in Bernanke, it seems, remains upbeat – one of the only areas where market confidence can be deemed a positive.

Market Action

In the aftermath of the Lehman collapse, no investor, it seemed, wanted any risk. Though the Treasury nearly doubled the amount of T-bills outstanding, demand overwhelmed supply. Yield on the three-month maturity T-bill dropped from 90 basis points to just 8 basis points at the end of the fourth quarter, providing promised interest income of just \$179 for a \$1 million investment. New issuance dried up and the Temporary Liquidity Guarantee Program (TLGP) began to dominate.



Source: Bloomberg

The TLGP provides a 100 percent guarantee of timely payment of both principal and interest for participating financial issuers from the FDIC through maturity or June 30, 2012. This could be a dream come true for cash investors, providing positive yields with a “full faith and credit” government guarantee. Unfortunately, issuers to date have focused on longer term maturities of one to three years as opposed to commercial paper programs in the 90 day area.

Turning to money market funds, there is still great fear of another prime or corporate fund “breaking the buck.” Even with several government initiatives in place to support these funds, investors seem to recoil at any opportunities that do not have direct support from the government.

SVB Asset Management Market Strategy

Today, we are focused on Treasury and government money market funds along with some TLGP-backed securities and high quality corporate issuers. Given our

clients’ primary focus on preservation of capital and today’s unprecedented uncertainty, we are comfortable giving up yield in favor of ensuring that funds are both safe and available for client use.

We continue to evaluate the prime fund sector given the many new supporting mechanisms in place as well as the conservative investment strategies taken by these managers. While the yield pickup over government funds is shrinking, we realize that achieving an appropriate return is still an important third objective of all our clients.

Throughout this crisis, our credit analysis and portfolio management decisions have protected client funds from loss of principal and liquidity – which is not something many other managers of corporate cash can say. We are proud of our ability to say this in the wake of such unprecedented market turbulence. Our central objective is to continue to preserve your capital and provide you full liquidity regardless of the market environment.

SVB▶ *Find a way*

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