

Second Quarter 2008

# SVB Asset Management Economic Commentary

This commentary is authored  
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## *Thoughts From the Desk*

*Activity in the bond markets began to recover during the quarter as the yield curve steepened and recent interest rate cuts were digested. Oil prices continued to rise creating a tug-of-war between inflationary and economic concerns.*

*The Fed is now in an increasingly difficult position: higher interest rates could send the economy into a recession while lower (or even steady) interest rates could create runaway inflation. This tightrope walk will increase market volatility, creating opportunities for nimble investors to capture higher yields.*

The second quarter can best be characterized as a transitional period; the only question is “to where are we transitioning?” During the quarter, Ben Bernanke went from hero to goat, the economy went from recession to growth and inflationary perceptions went from heated to nuclear. A close examination reveals the Fed is left in no man’s land as it ponders its next move.

Unfortunately, the falling dollar, along with potential higher interest rates abroad, has created solid inflationary concerns in the form of skyrocketing energy costs. Now, after cutting the interest rate by 325 basis points over the last ten months, the Fed is taking heat for ignoring inflationary concerns in the marketplace, as evidenced by their decision not to raise the interest rate on June 25.

Expecting such an increase, Treasury and other fixed income markets reset during the quarter to higher yield levels by some 50 to 100 basis points or more, as credit issues continue to plague the financial sector with over \$400 billion in write-offs due to the subprime mortgage crisis.

For its part, the mortgage market is looking no healthier than three months ago, as investors remain skittish regarding any risk in that sector. Until the mortgage market begins to recover, we look for the economy to continue to flounder. Even in the face of further inflationary pressures, it is hard to imagine the Fed raising the interest rate in a move that would certainly drive the economy into recession.

### **ECONOMIC DATA**

The expected recession has not yet occurred as economic growth came in at 1.0 percent in the first quarter and looks

to be in that neighborhood for the second quarter. Job losses have averaged 64,800 through June, far below the 150,000 or so average during recent recessions. Continuing jobless claims have reached their highest level since 2004 when the Fed funds rate was set at 1.0 percent.

Though most economic activity measures have exhibited some upside volatility, we have not yet established any base for recovery. The best news of the quarter is continued stable job losses, as opposed to an accelerated decline which would lead to more forced home sales, creating a second downward leg for the overall economy. Even so, there is no reason to believe the overall economy has turned the corner.

### **MONETARY POLICY**

Most of the new liquidity-enhancement programs initiated by the Fed were expanded during the quarter as trading activity in the bond markets remained well below normal levels. The Federal Open Market Committee (FOMC) met only twice during the period, cutting the interest rate one time from 2.25 to 2.0 percent on April 30. At the subsequent meeting, the Fed held rates steady on June 25 even as the markets were hoping for an interest rate increase.

Late in the quarter, the Treasury market benefited from an FOMC policy statement that was more balanced than expected, and a surge in flight-to-quality flows as fears abound that the financial sector will continue to deteriorate, leading high-quality securities to increased premiums. These fears offset other views that the Fed is “behind the curve” in addressing inflationary pressures resulting from oil prices over \$140 per barrel.

During the month of June, bond market expectations regarding monetary policy were quite volatile. Based on the Fed funds futures market, market players initially expected a steady Fed late into the year, then became excessively hawkish toward mid-month expecting as much as three interest rate hikes by 2009 and finally settled into an intermediate posture on the likely trajectory of monetary policy.

We believe market perceptions of monetary policy will remain volatile, but that market expectations for higher rates will also continue to be tempered by the combination of the ongoing financial distress and an economy that continues to remain sluggish. The tax rebates have temporarily provided a boost to the consumer sector that will end abruptly after the last rebate payments on July 11 have been spent.

The federal government seems to be avoiding any serious support for the mortgage market in the forms of subsidies, leaving the Fed to face the considerable task of addressing the financial system problems while preventing the economy from going into a recession. At the same time, they must stay vigilant about inflationary pressures due to surging energy and food prices that could trigger a more widespread inflation acceleration.

Accelerated commodity prices have placed greater pressure on the Fed to tighten in the face of this slowing economy, which appears to create a no-win situation for policymakers. Their activities over the past year have included very creative steps to revive the credit and financing markets, but also consider their activities over the last few decades taking the at-times painful steps to keep both inflation and inflation expectations under wraps. The wrong move today could reverse these important steps toward credibility.

At this point, the FOMC officials have no choice but to be more patient with inflation developments than would normally be their preference or risk driving the economy into a recession, destroying the fragile financial stability that has taken so much effort to forge over the past year.

## MARKET ACTION

Treasury yields rose during the quarter as expectations for higher short-term rates grew based on inflationary fears. After touching 1.46 percent in mid-March, the two-year Treasury rose 1.03 percent during the quarter, the largest quarterly rise since summer 2004. As benchmark Treasury yields began to rise, activity picked up on the high-quality, non-finance corporate sector possibly indicating some greed overtaking fear in those markets.

Commercial paper and other money markets experienced a continued slowing of activity as investors favored money market mutual funds whose yields are calculated on a cost basis. By the end of the quarter, however, many investors had returned to the market, given the premiums offered by the turmoil in the LIBOR markets.

## SAM MARKET STRATEGY

We continue to view market opportunities with a wary eye as there will be more fallout from the subprime and liquidity crises to come. Having said that, there are certainly more opportunities to gain acceptable yield in high-quality investments than were available in the first quarter.

The recent increases in market rates, as participants expect a higher Fed funds target, has created some opportunities in the one- to two-year part of the yield curve. Given our outlook that the Fed will remain on hold (or at least, nearly so) until the economy — and therefore the mortgage market — can get back on track, we will capture these opportunities for clients whose investment policies and liquidity needs allow.

Looking forward, all market activity will revolve around Fed actions and, more importantly, market expectations of Fed actions. As noted above, we expect these to be volatile providing both excellent opportunities and potentially treacherous waters for investing new cash.

Our disciplined focus on principally safe investments has continued to provide necessary liquidity and competitive yields throughout the current downturn, and we expect that strategy to continue to pay dividends in the future. In addition, utilizing a selective and methodical process has helped steer us comfortably through this rough period. During the third quarter, we expect more investment opportunities to arise as we shift from money market mutual funds to individual securities.

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