October 1, 2009

Third Quarter 2009 Economic Commentary

Thoughts from the Desk

The current economic landscape has improved as the turmoil that we experienced 12 months ago dissipates. The credit market is relatively subdued, and the money fund industry is operating without a government guarantee again — both are positives for the financial system. These factors support the likelihood that the recession is over, and that the economy is now poised for a rebound from the first half of the year. Unlike recent recoveries, however, we expect a much slower return to normalized growth. For example, unemployment continues to be a drag as the jobless rate is just shy of 10 percent and the average duration of unemployment is approximately 26 weeks. An encouraging sign is that the severity of job losses has been curbed, but we have yet to see a month of net positive job creation. Although economists may point out that these labor statistics are lagging indicators, the large number of unemployed workers will continue to weigh on consumer confidence and spending.

Over the quarter, the balances in money market funds declined $300 billion to $3.4 trillion as some investors have reallocated out of cash. Yields in this space have neared zero, and investors are now more willing to accept marginal risk to garner additional return. As third quarter earnings are set to be released in the coming weeks, it would not be surprising to see further gains in the equity market if companies report better-than-expected earnings.

Sideline cash continues to make its way into the equity markets. In the third quarter, the three major equity indices again posted large gains despite having gained 15-20 percent in the previous quarter. The Dow Jones Industrial Average returned 14.2 percent during the quarter or 70.3 percent on an annualized basis. Not to be outdone, the Nasdaq and S&P 500 returned 14.99 percent and 15.89 percent, respectively. Annualized these indices returned 75.11 percent and 92.79 percent. Certainly investors who missed last quarter's run up must have felt compelled to not miss the boat this time around.

On other fronts, the government has begun paring back some of its liquidity programs, which were created to restore stability to the financial markets. This is a positive sign that conditions have improved. Reducing these programs accordingly will also be important in controlling future inflationary pressures because of the immense amount of liquidity they have pumped into the system. Interest rates are expected to remain suppressed for the near future, and the ongoing challenge will be finding value in an extended low-yield environment.

Economic Data

Economists may look back to the second half of 2009 as the official end of the recession of 2008-2009, the longest and deepest of the postwar period, but the economy is nowhere near full recovery. Third quarter real domestic product (GDP) is expected to have picked up from the second quarter at an annual pace of 3.0 percent or better, largely due to government-supported consumer spending which resulted in inventory replenishment and residential construction.

The government's $3 billion Consumer Assistance to Recycle and Save Act (CARS) — also known as the "Cash for Clunkers" program — sparked vehicle sales in July and August, perhaps to the detriment of future sales. This government program unleashed the consumer's pent-up demand for big-ticket purchases and gave reason for auto dealers to restock their show rooms. As a result, production of cars and light trucks is expected to increase in the fourth quarter. Car sales in July were the highest since August 2008 and up 13 percent over June. According to the Council of Economic Advisers (CEA), 60 to 70 percent of auto sales during the program's existence were likely borrowed from future demand and contributed approximately 0.2 percent to Q3 GDP. Proponents of such government programs argue in favor of shifting future demand to the present during contractionary periods, but only time will tell the true long-term impact of such programs.

The most recent data on pending sales of existing homes showed a 3.2 percent increase in July for an increase of six consecutive months, reiterating that the housing market is stabilizing. Price declines driven by foreclosures, low borrowing cost and tax incentives for first-time buyers have certainly helped to drive up demand despite challenges from the labor market. These activities have in turn lifted home values as the S&P/Case-Shiller home price index rose 1.2 percent in July from the prior month. The $8,000 tax credit for first-time buyers is due to expire at the end of November, which could dampen future demand.

With unemployment forecasted to rise to 10 percent this year in addition to tighter credit conditions and sluggish income growth, consumer confidence took a larger-than-expected hit. The Conference Board's confidence index dropped to 53.1 in September, versus expectations for an increase to 57, from a revised 54.5 reading in August. Having already lost 7 million jobs during the recession, the pace of job losses has eased and the economy appears to be heading in an early recovery stage. Consumer confidence should rebound in the coming months.

Monetary Policy

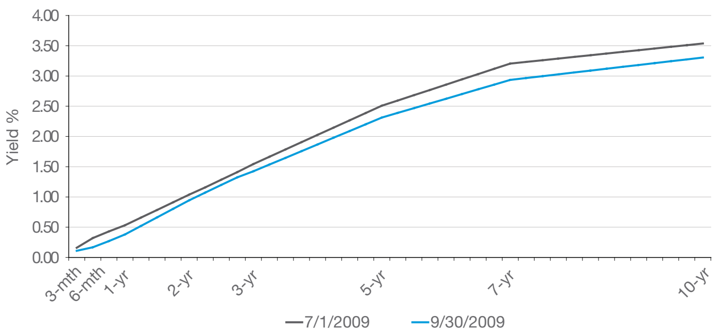
The Federal Reserve Board left its target rate unchanged during the quarter at a range between zero and 0.25 percent. The September FOMC statement was more upbeat regarding economic recovery than the August statement as the Fed recently asserted "economic activity has picked up following its severe downturn." In August the Fed stated that "economic activity is leveling out." Additionally, the Fed reiterated its purchase of $300 billion of Treasury securities will be completed by the end of October 2009.

We believe the stage of economic recovery is not at the point where the Fed can raise the overnight target rate; however, the Fed is exercising prudence in exploring other methods of removing excess reserves in the banking system without raising their target rate. One such tool under consideration is the use of reverse repurchase agreements whereby banks and dealers lend cash to the Fed in exchange for securities as collateral. At maturity of the loan, the securities and cash (along with interest) will be returned.

To protect the Fed's creditability as an inflation fighter, Fed Governor Kevin Warsh reminded investors that "'(w)hatever it takes'... cannot be an asymmetric mantra, trotted out only during times of deep economic and financial distress, and discarded when the cycle turns." Gov. Warsh further stated, "Policy likely will need to begin normalization before it is obvious that it is necessary, possibly with greater force than is customary, and taking proper account of the policies being instituted by other authorities. We keep inflation in check; we believe the punch bowl must be taken from the party a bit early."

Market Action

Yields continue to compress downward during the quarter as inflationary fears appear to have shifted to deflationary concerns. Despite record issuance of Treasury securities, Treasury auctions were largely well received across the curve.



Source: Bloomberg, SVB Asset Management

Rates on the 2-year Treasury note declined 7.7 basis points from 1.038 percent to 0.96 percent during the quarter, while the 10-year rate dropped by 22 basis points to 3.316 percent. Although at lower levels, the shape of the yield curve has changed little as the curve continues to be steep. This steepness has offered investors with longer investment horizons to benefit from locking in higher-yielding investments.

Some market participants expected the expiration of the money market insurance program to have negative effects on the industry, but the expiration came and left without much fanfare. When the Reserves Prime fund "broke the buck" back in September 2008, investors fled to safer havens in Treasury and agency funds. We believe, however, that the quick government response provided time for managers in the industry to shorten duration and scale back credit risk. As a result, money funds have weathered the credit storm. Additionally, market participants (including SVB Asset Management) have provided feedback to the SEC on proposed regulatory reform to further strengthen this asset class. Our comment letter to SEC is enclosed for your review at http://www.sec.gov/comments/s7-11-09/s71109-123.pdf.

SVB Asset Management Market Strategy

We continue to favor portfolio constructions with an emphasis towards investments that have high credit quality and a favorable liquidity profile. We continue to deploy overnight cash investments in approved prime money market funds for our credit-tolerant clients, along with opportunistic allocation out the yield curve to balance reinvestment and credit risk. Additionally, our duration-focused clients have benefited from our extension trades as yields were well anchored during the quarter.

Our credit process continues to be thorough and rigid — rightfully so given the uncertainty in the marketplace. Continuing yield compression and malaise in the economy further supports our credit process as we have diligently added selective high-quality corporate issuers to our truncated approved list. We are entirely comfortable with waiting for further evidence that the recent economic rebound is sustainable and that credit conditions have indeed improved before we begin to meaningfully expand our approved list.

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