

Observation Deck

April 2010

The Fed's Exit Strategy

Minh Trang, CFA, Portfolio Manager

In response to the severe market disruption to the economy two years ago, the Federal Reserve created multiple liquidity programs aimed at stabilizing the financial system. Since then, market conditions have improved and the Fed is now tasked with implementing a strategy to normalize monetary policy that accommodates a stable economic recovery. The purpose of this strategy is to prevent a flare-up in inflation and to neutralize any potential undesired financial imbalances created by the "extended" accommodative policy.

The Fed has already taken a few steps to adjust its monetary activities. In February, the Fed raised the discount rate by 0.25 percent to 0.75 percent. In addition, several of its liquidity programs have expired or been phased out. These include ending the purchase programs for \$1.25 trillion in agency mortgage-back securities, \$175 billion in agency debt and the term lending facilities, which allowed short-term borrowing for depository institutions from the Fed.

In addition to targeting its overnight benchmark rate, the Fed has outlined several other tools as part of the exit strategy to reduce excess liquidity. One option is to engage in reverse

repurchase agreements with financial institutions, including banks and money market participants. This process would involve the sale of securities by the Fed with an agreement to buy back those securities at an agreed upon price at a later date. This would help drain bank reserves and temporarily remove liquidity from the system. Over recent months, the Fed has tested these transactions on a small scale.

Another option would be paying interest on reserves. In October 2008, Congress gave the Fed authority to pay interest on bank reserves held at the Fed. This provides depository institutions with a risk-free return for these funds, which currently is less than 0.25 percent. By controlling this interest rate, the Fed can tighten money supply and put upward pressure on short-term rates since banks are unlikely to lend short-term funds at a level below what they can earn on these reserves. Additionally, the Fed can offer interest-bearing term deposits to banks, which would be equivalent to certificates of deposits that banks offer customers. This would tie up bank funds for a specified amount time, and the desired effect would be reducing liquidity in the banking system.

Finally, the Fed also has the option of selling securities that it owns. Many of these holdings are a result of the various purchase programs that the Fed had completed. The Fed can apply additional monetary restraint by liquidating these securities, which would reduce both banking reserves and the size of the Fed's balance sheet. It is unlikely that this option will be utilized in the near term, at least until the economy is clearly in a stable recovery and a tight monetary policy has been established.

Like a surgeon operating on a patient, these tools become scalpels in the hands of the Fed. Which blades they use and how deep they cut will greatly depend on the evolving economic environment and financial conditions, which will affect the timing of the Fed's exit from the current accommodative monetary policy. No strategy is without risk, however, and like any other operations, policy makers will need to apply the proper remedy to create a sustainable recovery.

Markets

Treasury Rates

3-Month	0.15%
6-Month	0.23%
1-Year	0.38%
2-Year	1.02%
3-Year	1.57%
5-Year	2.54%
7-Year	3.28%
10-Year	3.83%

March Total Returns

ML 3-Month Treasury	0.00%
ML 6-Month Treasury	0.01%
ML 12-Month Treasury	-0.28%
S&P 500	6.03%
Nasdaq	7.19%

Source: Bloomberg, as of 03/31/10

Economic Vista

Debra Hanson, *Portfolio Manager*

March brought a mixed bag of economic data. The core inflation numbers, excluding food and energy, were very tame. Including these two volatile components, we see a slightly different story, as energy prices have jumped. Employment, as measured by non-farm payroll, was reported down 36,000. This was much better than expected, given the weather in February, and the market, in turn, liked this. Consumer spending and retail sales picked up with a nice rise in auto sales. And, the final fourth-quarter GDP report came in at 5.6 percent, giving us strong growth in the third and fourth quarters of 2009.

Housing did not fair so well. Pending home sales fell 7.6 percent, month over month, existing home sales fell 0.6 percent, and new home sales fell 2.2 percent. Home prices also fell, according to S&P/CaseShiller. Home prices and sales affect how the consumer feels, and we are not seeing any real up-tick in consumer confidence.

We expect to see the job numbers turn positive, particularly due to hiring of government census workers. The government is expected to hire 1.25 million people for the census project; unfortunately, these are temporary jobs. Surveys show that companies expect to begin adding employees later this year. If not, and the consumer pulls back, we could see economic activity decline as we go into the second half of the year.

Credit Vista

Melina Hadiwono, *CFA, Head of Credit Research*

On March 15, U.S. Senator Christopher Dodd released his draft bill titled “*Restoring American Financial Stability*,” which is broadly consistent with the Wall Street Reform and Consumer Protection Act of 2009 (H.R. 4173) that the House of Representatives passed on December 16.

Key highlights include: An independent agency for consumer protection; ending “too big to fail” risk by establishing a fund and ensuring that there is a safe way to liquidate large financial firms; new capital and leverage requirements that would make it undesirable to get too big; allowing the Fed to provide system-wide support and establish more rigorous standards and supervision; establishing a council to identify and address systemic risk; eliminating loopholes that allow risky and abusive practices; streamlining bank supervision; providing shareholders with a say on executive compensation and corporate governance; and establishing new rules for transparency and accountability for credit-rating agencies.

On the plus side, this proposal has several features that may ultimately reduce financial risk in the U.S. banking system,

enhancing prudential standards with higher capital requirements, better liquidity, less concentration, curtailment of risky activities, and better transparency.

But by seeking to end “too big to fail” risk, the bill creates a legal framework that could allow for the resolution of a failing large bank holding company. A key component here is that it attempts to keep the systematically important functions of a failing company viable and in operation while exposing unsecured creditors to losses according to their priority of claim. This could result in rating agencies reconsidering the assumptions made in rating systematically important financial institutions regarding the potential for future extraordinary financial support. The restrictions on aiding individual firms could lead ratings agencies to downgrade certain banks that received uplift notching. The proposed bill is in the early stages of the legislative process. The timetable for potential enactment is unclear. However, the bill will likely have major credit implications to major banks.

Trading Vista

Hiro Ikemoto, *Money Market Trader*

With the relatively strong economic data this past month, and increased Treasury issuance by the U.S. government, yields have ticked up across the curve. The two-year Treasury note stopped at 1 percent in the March 23 auction, the highest level since December, and ended the month at 1.02, the highest since December 31. Yields for three-month, six-month, and one-year Treasury bills ended the month at 0.15 percent, 0.23 percent and 0.38 percent, respectively. Government agency debt also increased in yield and spread, primarily in the nine- to 12-month maturity areas. The nine- to twelve-month papers’ spreads were plus six to plus 10 at the end of the month. Spreads in the two-year maturity agencies stayed plus 10 to 15, to Treasuries with similar dates.

Similarly, high-grade corporate industrial bonds maturing in the one-year area increased to roughly 0.48 to 0.65 percent, as the one-year spot LIBOR increased to 0.56. Spread to LIBOR remained flat to plus 10. The spread on financial-issued debt in the one-year area widened with bonds trading plus 15 to plus 40 compared to plus 10 to 20 a month earlier. In the two-year maturity area, industrials remain tight with spreads ranging from plus five to plus 20 to the two-year Treasury note. Financials were trading at plus 50 to plus 120.

SVB Asset Management

185 Berry Street, Suite 3000

San Francisco, California 94107

Phone 1.866.719.9117

service@svbassetmanagement.com

©2010 SVB Asset Management, a registered investment advisor, is a non-bank affiliate of Silicon Valley Bank and member of SVB Financial Group. Products and services offered by SVB Asset Management are not FDIC insured, are not deposits or other obligations of Silicon Valley Bank, and may lose value.

This material, including without limitation to the statistical information herein, is provided for informational purposes only. The material is based in part on information from third-party sources that we believe to be reliable, but which have not been independently verified by us and for this reason we do not represent that the information is accurate or complete. The information should not be viewed as tax, investment, legal or other advice nor is it to be relied on in making an investment or other decision. You should obtain relevant and specific professional advice before making any investment decision. Nothing relating to the material should be construed as a solicitation, offer or recommendation to acquire or dispose of any investment or to engage in any other transaction. 0410-0073.