

# Observation Deck



## What the Latest FOMC News Means to Investors

Ninh Chung, *Head of Portfolio Management*

The first Federal Open Market Committee meeting of the year shed additional light on the committee's decision-making process and provided investors further information that must be factored into their investment process. Specifically, fixed income investors must now incorporate the committee's approved statements and the participants' rate forecast when constructing a balanced, comprehensive portfolio that weighs both risk and reward. Here's what I mean.

Before I begin, let's quickly recap the January meeting. Markets were jubilant and rallied after the Fed pledged to keep the benchmark federal funds rate exceptionally low "at least through late 2014." The economy has been expanding as suggested by recent economic data such as the addition of 200 thousand jobs by the private sector in December and renewed optimism that consumers may be back after pulling out their wallets en masse during the holiday season. Unfortunately, some strong headwinds still exist and could slow the recovery momentum. For example, the unemployment rate is still stubbornly high; the housing sector continues to search for a bottom; and global austerity measures could put the brakes on any prospects of a recovery.

Along with the statements, the Fed also introduced its anticipated published forecasts. The forecasts revealed 11 of 17 Fed governors believe that the appropriate path of policy firming is to increase the overnight rate through 2014 — much more hawkish when compared to the statement. At this moment the added view into the Fed's decision making process is interesting and provides extra data points to consider when forming your predictive model, but the process is still at its infancy. Only time will tell if any predictive value results from the added transparency. We think Fed watchers should take caution when interpreting the statement to mean that policy makers will keep rates at zero through 2014. The projections and certain sections of the statement leave room for the Fed to take action prior to 2014.

So, what does this all mean for fixed income investors? The answer depends how the portfolio is currently positioned and the long-term investment objectives of the investor.

Investors with a fully invested portfolio should count their blessings and enjoy the relatively higher income streams. Re-investing maturities will be the biggest challenge assuming there are no adverse credit events in the near future — a factor that can't be ignored for any fixed income portfolio. If duration extension opportunities exist and fall within your investment policy parameters, and future liquidity needs are thought through, then opportunistic extension trades should be considered and seized.

Heavily cash concentrated portfolios must consider strategic extension trades when patches of weakness occur. We never advise clients to chase yield especially in this environment; therefore, these trades should only be executed within the parameters of your investment objectives and constraints. To fully maximize opportunities, the entire yield curve should be examined along with the credit spectrum that is consistent with your investment policy. This approach will ferret out the best available relative value trades.

We found the FOMC statement and projections to be informative and we support the Fed's commitment to provide accommodative policies to meet its dual mandate of maximizing growth and price stability. We warn that interpreting the Fed statement to mean that Fed governors have agreed to a zero policy through 2014 could be premature and investors should continue to manage their portfolios based on their specific investment needs and objectives.

### Markets

#### Treasury Rates

3-Month	0.05%
6-Month	0.08%
1-Year	0.11%
2-Year	0.22%
3-Year	0.29%
5-Year	0.70%
7-Year	1.23%
10-Year	1.79%

#### January Total Returns

ML 3-Month Treasury	0.00%
ML 6-Month Treasury	0.00%
ML 12-Month Treasury	0.03%
S&P 500	4.48%
Nasdaq	5.30%

Source: Bloomberg, as of 01/31/12

## Economic Vista

Renuka Kumar, *Portfolio Manager*

Although we saw some better economic data this month, the Federal Open Market Committee announced in their latest meeting that current economic conditions are likely to warrant exceptionally low interest rates at least through late 2014, citing specifically high unemployment and a depressed housing market, combined with a subdued outlook for inflation. This compares to their prior guidance of keeping rates low until at least mid-2013.

The advanced estimate of fourth quarter GDP showed that the economy grew by 2.8%, well above third quarter's GDP of 1.8%. The consumer led much of the growth with personal consumption growing by 2.0%, compared to 1.7% in the prior quarter. Consumer sentiment numbers showed an upward trend across all surveys with the University of Michigan index jumping to 75, the highest level in eight months. Consumers also continued to spend during the holidays with chain store sales rising 3.5% year-over-year and advanced retail sales rising 0.1% month-over-month. One surprise release this month was the increase in consumer credit rising from \$6 billion in October to \$20.4 billion in November.

On the jobs front, the unemployment rate came down to 8.5% and the U.S. economy created 200 thousand jobs during the month of December, bringing total job growth to 1.6 million in 2011. Housing data was mixed with housing starts and new home sales falling in December, while existing home sales and pending home sales increased during the same period. The bottom line is that some borrowers are taking advantage of low interest rates and home values, but the housing market has yet to really gain traction.

## Credit Vista

Melina Hadiwono, *CFA, Head of Credit Research*

Improving credit metrics for many industrial sectors continue to offer encouragement in the face of multitude macroeconomic risks. Many investment-grade corporates have stronger positions in 2012 to face the downturn as they have benefitted from industry consolidation, lower leverage and continued cost cutting. The improved operating performance along with the large cash balances and accommodative capital markets of the last two years have been positive factors for the corporate sector.

According to S&P, in early 2012 the ratings for 90 percent of U.S. investment-grade (IG) corporates have a stable outlook compared to 74 percent in early 2007. In addition, 5 percent of IG companies have negative outlook in early 2012 versus 18 percent in 2007.

However, with such strong liquidity positions companies could be forced to turn the focus more on shareholder friendly action as lagging equity returns in a slow growth environment have been a catalyst for the event risk such as share buybacks, spinoffs, acquisitions and other potential credit negative events. That said, the experience of the credit crisis has hammered home the advantage of remaining an investment-grade company.

Although the accommodative capital markets have continued to push out the refinancing cliff, in light of the slow growth environment, 2012 is likely to be an inflection point for companies to demonstrate their ability to tap the capital markets. The economic downturn has pushed many companies to focus on increasing cash flow and refinancing debt to improve liquidity and reduce debt. Nonetheless, with the global growth forecasts regularly being ratcheted down and the impact of global austerity programs a continuing concern, most corporate issuers will remain cautious in their outlook.

## Trading Vista

Hiroshi Ikemoto, *Money Market Trader*

Big news this month was of course the Fed stating that their benchmark rate will remain low through at least late 2014. As expected, Treasuries rallied with the yield curve slightly steepening out to 30 years. However, with yields already at historic lows there wasn't much movement in the benchmark 2's, which have hovered in the 0.22 basis point level throughout the past few months. Treasury bills remained at near-zero levels with six-month bills yielding 6 basis points and the one-year bill at 10 basis points.

As inventory is drying up, and investors are still cautious about a global economic recovery, there was a big appetite for U.S. corporate bonds. Investment-grade rated bonds were well-bid for both industrial and financial names maturing in 12 to 18 months as yields tightened (were lower) by roughly 20 basis points from the prior month. Discount rates on three-month commercial paper remained in the range of 25 to 40 basis points depending on the global region of issuing bank.

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