Observation Deck

Cheap or Rich? Buying the Two-Year Treasury Note

Debi Hanson, *Portfolio Manager*

In the time since the Federal Reserve Board brought the target fed funds rate to 0.00–0.25 percent, there has been more volatility and opportunity in the two-year Treasury note than short Treasury bills. Given these changes in price, when is the two-year a buy?

Over the current environment of low rates, our strategy has been to be neutral to slightly long of the benchmark. We have opportunistically taken advantage of the spread trade when variance was wide, and abstained from buying when the spread was tight. Essentially, our philosophy is to buy when the market is cheap and stay away when the market is rich.

Going back to 1988, the spread between the effective fed funds rate and the two-year Treasury has been as high as 67 basis points and as low as a negative 52, during an inverted yield curve. The average spread has been about 47 basis point over. Therefore, the current spread of about 54 basis points over would be considered cheap. Adding a small position of 5 percent of the portfolio is not making a big statement, but it is adding yield and duration to the portfolio.

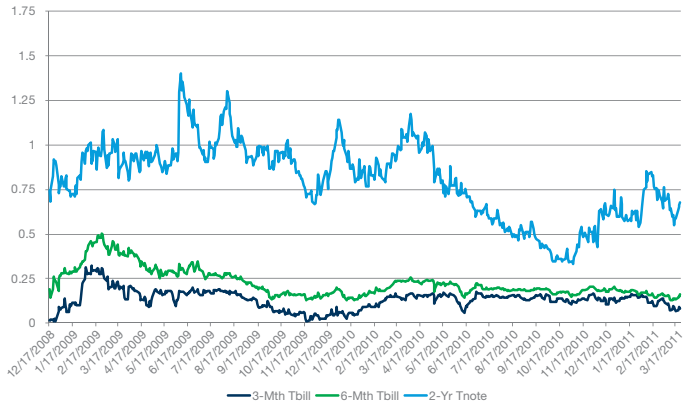
Our clients choose a benchmark for performance comparison of their investment portfolio against an industry standard and we manage our duration within a narrow range of the benchmark. Our strategy has been to be neutral to slightly long of the benchmark. When the two-year was trading down at its lows of 0.33 percent, we were not buyers. The spread was only about 15 over fed funds and very rich. However, rates have increased and the two-year has come back into play.

Short Treasury bills trade off of the fed funds rate and with no change in monetary policy have remained in a tight trading range. The two-year Treasury does not follow the same pattern. This maturity is purchased by more investors (corporate cash, bond funds, pension funds, and foreign governments, etc.) for different reasons. The two-year is more actively traded than bills and it is not bound by the fed funds rate.

As portfolio managers, we make decisions every day as to which securities are cheap or rich and which sector is most attractive and adds the most value at that time — all while adhering to our overall strategy. At the current level, the two-year is attractive and, depending on the current duration of the portfolio, would certainly be considered for purchase.

It is unlikely we will see the two-year yield revisit its low of .33 percent. However, if oil prices stay high for a longer period of time, inflationary pressures could cause interest rates two years and out to rise further, whether the Fed changes monetary policy or not. Should that happen, the portfolio management team would again determine the most appropriate strategy for each of the benchmarks and the two-year may be a buy at those higher levels.

Treasury Yields (in Percent)



Source: Bloomberg, as of 03/31/11

Markets

Treasury Rates	
3-Month	0.09%
6-Month	0.17%
1-Year	0.27%
2-Year	0.83%
3-Year	1.30%
5-Year	2.28%
7-Year	2.92%
10-Year	3.47%

March Total Returns	
ML 3-Month Treasury	0.026%
ML 6-Month Treasury	0.027%
ML 12-Month Treasury	0.020%
S&P 500	-0.007%
Nasdaq	0.021%

Source: Bloomberg, as of 03/31/11

Economic Vista

Renuka Kumar, *Portfolio Manager*

In the latest meeting of the Federal Reserve Open Market Committee, policy makers voted to maintain the target fed funds rate at the range of 0 to 0.25 percent and continue its program of purchasing $600 billion of longer-term Treasury securities by the end of the second quarter. The committee did note, however, that the "economic recovery is on a firmer footing, and overall conditions in the labor market appear to be improving gradually."

The latest GDP figures show that the U.S. economy grew at a 3.1 percent annual rate in the fourth quarter, up from the previous estimate of 2.8 percent, led by a surge in consumer spending. While consumer credit and retail sales have been showing signs of strength in recent months, there has been a pullback in confidence as rising oil prices have the potential to erode consumers' purchasing power. With the recent rise in commodity prices, the effect on inflation is expected be only transitory, with longer-term inflation expectations still subdued, according to the Fed. The Producer Price Index rose 1.6 percent in February and the Consumer Price Index rose 0.5 percent.

Along with the elevated unemployment rate of 8.9 percent, another headwind to the economy continues to be the housing sector. New home sales declined 16.9 percent in February, the U.S. Commerce Department reported the slowest pace on record, and existing home sales fell 9.6 percent.

Credit Vista

Melina Hadiwono, *CFA, Head of Credit Research*

Moody's has published its new global methodology for rating money market funds, clearing way for changes aimed at more fully assessing fund vulnerability to market risk and liquidity risk. The new methodology, which uses a set of objective measures to assess portfolio credit quality and stability, includes market and liquidity risks in stress scenarios, as well as other considerations such as sponsor quality, a fund's management, and legal considerations, in order to differentiate among funds. The methodology was published on March 10 and is scheduled to become effective on May 20. At that time all existing money market ratings will be migrated to new rating symbols based on the methodology.

This methodology is in line with the update Moody's provided in January. The new set of rating symbols will be implemented to reflect the distinct meaning of the money market fund ratings, compared to Moody's credit ratings on long-term bonds, using an "mf" modifier to highlight the distinct meaning of money market fund ratings, for example, Aaa-mf, Aa-mf, A-mf, Baa-mf, B-mf, C-mf. Moody's is currently obtaining updated information from rated funds and is beginning to evaluate those funds using the new approach. In the new methodology, Moody's will explicitly factor a sponsor's creditworthiness into the ratings, especially for funds in the top Aaa-mf rating, including the expectation that funds in that top category will be sponsored by firms having an investment-grade or equivalent credit profile. If a sponsor is unrated, Moody's will conduct a credit assessment. In previous releases, Moody's said it anticipates only a modest number of funds to receive lower ratings. We believe that the funds we have utilized for our clients are well-positioned and we will continue to monitor developments closely.

Trading Vista

Hiroshi Ikemoto, *Money Market Trader*

The big news in March was Japan's disaster, the unrest in Libya and the ongoing European debt crisis. Despite the turmoil, the U.S. Treasury market, the haven for nervous investors, was yielding moderately higher by the end of the month. The two-year Treasury note started the month yielding 0.65 percent and actually ended the month at 0.82 percent. There was a strong rally on March 16 when news came out that Japan's nuclear disaster was worsening, but investors quickly sold off as further news stated that danger was under control. One-year spot LIBOR stayed at or near 44 basis points even with the downgrades to Portugal.

Corporate spreads remained stable, with high-grade corporate bonds yielding plus 10 to plus 50 basis points to similar-maturing Treasury notes. Ninety-day commercial paper also remained at 0.27 percent for the month. Finally, as has happened every quarter end, Treasury bills maturing after April 1 were yielding one to five basis points with many institutions buying to window-dress their books.

SVB Asset Management
555 Mission Street, Suite 900
San Francisco, California 94105
866.719.9117
service@svbassetmanagement.com

©2011 SVB Financial Group. All rights reserved. SVB> and SVB>Find a way are registered trademarks SVB Financial Group. SVB Asset Management, a registered investment advisor, is a non-bank affiliate of Silicon Valley Bank and member of SVB Financial Group. Products 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. 0411-0079.