

# Observation Deck



## Investing for a Lower-Rate Environment

Renuka Kumar, *Portfolio Manager*

With the economy said to be on a firmer footing this year, given stronger economic data and greater confidence, investors are anxious for improved returns in their investment portfolios. However, despite some positive economic news and the recent debate among Federal Reserve policy makers regarding when to begin tightening monetary policy, short-term rates dropped considerably this past month.

Three-month Treasury bills have been yielding between 0.03 and 0.05 percent, repurchase agreement yields (“repo”) were as low as zero to 0.01 percent, and top-tier commercial paper has come down to 0.18 to 0.22 percent for three-month notes. Money funds have also followed suit, with yields at record lows. The key driver behind these lower short-term rates has been a shortage of supply combined with a robust demand for short-term assets and the liquidity they provide. What exacerbated this effect in April was a change in the way the Federal Deposit Insurance Corp. assesses its deposit fees, along with a reduction in the Treasury department’s \$200 billion Supplementary Financing Program as the U.S. approaches its debt ceiling. Both of these events effectively removed supply from the market, dragging all short-term interest rates down. The effect was so severe at one point that some investors accepted negative yields for Treasuries, essentially paying to

lend money. For a more in-depth look on these factors, please see the recent [commentary](#) by SVB Asset Management’s Chief Investment Officer, Joe Morgan.\*

The challenge for investors is how to balance a desire to pick-up incremental yield, without over-extending duration. Although most factors currently driving down short-term rates will eventually reverse, we anticipate that rates will be depressed for the rest of the year. That said, for clients with the ability and willingness to invest one year out or more, we are comfortable extending duration and maintaining a neutral to slightly long position to the three- and six-month benchmarks. As the yield curve steepens in anticipation of inflationary pressures and monetary policy tightening, securities rolling in will allow us to reinvest at higher interest rates as they become available. High-investment-grade corporate credit spreads, albeit tighter in recent months, also continue to provide additional relative value.

For clients with uncertain or high liquidity needs in the short term, it is prudent not to reach for yield that may have the potential to sacrifice principal should unanticipated cash outflows arise. For this reason, we have been holding more cash in money market mutual funds rather than extending duration or buying into credit in these situations. As government securities have only been yielding 0.01 to 0.03 percent out to one month, the “give up” is nominal. With an actively managed portfolio, your portfolio manager is able to assess your liquidity needs and adjust the allocation as the market environment changes.

Even though our outlook is for the Fed to remain on hold for the remainder of the year, we do anticipate the short end of the yield curve to normalize prior to the first rate increase. A contributing factor will be how the market responds to the end of the Fed’s quantitative easing program, also known as QE2, in June. In the months that follow the end of the program, we will be monitoring this closely, as will the Fed, and adjust our investment strategy accordingly.

\* See SVB Asset Management Chief Investment Officer Joe Morgan’s recent commentary, “Interest Rate Pain,” at <http://www.svb.com/blogs/jmorgan/interest-rate-pain/>

### Markets

Treasury Rates		April Total Returns	
3-Month	0.05	ML 3-Month Treasury	0.02
6-Month	0.10	ML 6-Month Treasury	0.05
1-Year	0.19	ML 12-Month Treasury	0.10
2-Year	0.60	S&P 500	2.93
3-Year	0.99	Nasdaq	3.37
5-Year	1.97		
7-Year	2.67		
10-Year	3.29		

Source: Bloomberg, as of 04/29/11

## Economic Vista

Paula Solanes, *Portfolio Manager*

On Wednesday, April 27, after the Federal Reserve Board policy meeting, Fed Chairman Ben Bernanke did something that no other Fed chief has done before; he met with a room full of journalists to discuss the practices and decisions of the central bank. Bernanke's motive was to create more transparency into the Federal Reserve and to be the first to answer questions after the policy meeting and dispel any misconceptions in the market.

Earlier in the month, several Fed presidents reiterated Bernanke's thoughts that rising commodity prices are temporary and will not have a permanent effect on consumer inflation. March's Consumer Price Index rise of 0.5 percent supported the Fed's view, matching projections and unchanged from February. The rise was driven by food and fuel, while other prices decreased; excluding food and energy, the most volatile components, the CPI increased 0.1 percent, less than expected.

One of the more positive notes was in regards to a stabilized labor market. In March, the unemployment rate dropped to 8.8 percent, confirming the Fed's Beige Book view that "most districts reported that labor market conditions were generally stronger than their last reports." The Beige Book also reported that jobless rates decreased in 34 states.

The housing market remains the weak part of the economic recovery, as existing home sales continue to struggle. However, sales rose 3.7 percent in March, driven by an increased supply of foreclosure properties that attracted investors.

## Credit Vista

Melina Hadiwono, *CFA, Head of Credit Research*

On April 18, 2011, Standard & Poor's affirmed its 'AAA/A-1+' sovereign credit rating on the United States of America. However, the rating Outlook was revised to Negative from Stable due to S&P's view of the increased risks associated with the implementation of medium- and long-term fiscal budgetary policies before national elections in 2012. S&P's definition of outlook change states that there is a one-in-three likelihood that S&P could lower the long-term rating on the U.S. within two years (although there is no real history on such implications for U.S. Treasuries). Initially, the stock market reacted negatively to the announcement but the bond market was muted.

The U.S. remains the last of its AAA-rated peer countries without concrete plans to address its increasing debt levels, and policy makers remain divided on the implementation of a strategy. The rating action serves as a warning for both Congress and President Obama to agree on a credible fiscal strategy and to start implementation.

As the largest economy in the world, with a GDP of more than \$14 trillion, U.S. key strengths are supported by flexible markets, abundant natural resources and a productive labor market. The U.S. has a distinct advantage in that most of its obligations are denominated in its own currency, giving it the flexibility to adjust monetary policy when necessary. In addition, the U.S. dollar serves as the world reserve currency and the dominant global foreign exchange currency.

In the strained political environment, it may take time before any concrete strategy will be adopted. Hence, both federal and general government debt affordability is more vulnerable to shifts in market confidence that can lead to higher interest rates. However, we expect that the U.S. will be able to retain its strong standing in the credit markets, and the leading position of Treasury obligations as a safe investor haven.

## Trading Vista

Hiro Ikemoto, *Money Market Trader*

Two major events in April caused both the short- and long-end bonds to rally. Both events are discussed elsewhere in this issue of the *Observation Deck*. As stated in the main article, by Renuka Kumar, yields in short-end bonds ground to near zero for April as new Federal Deposit Insurance Corp. reassessment rules caused banks to lighten their balance sheets, which flooded the market with cash. One-month Treasury bills yielded 0.02 percent, while six-month bills were offered at 0.10 percent. With a lack of Treasury issuance, agency discount notes as well as commercial paper were also well-bid. Discount notes were yielding one basis point better than Treasuries, while 90-day commercial paper was at 0.18 percent, about 7 basis points richer than in March. In "Credit Vista", Melina Hadiwono discusses the lowering of the United States' outlook to negative by Standard & Poor's. Ironically, once it was announced, there was an investor flight-to-quality to ... United States Treasuries. One-year bills ended the month yielding 0.19 percent, 8 basis points less than the yield in March, and two-year Treasury notes ended at 0.60 percent, a 22 basis point drop from March.

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