

Observation Deck

July 2010

Extending Extended

Minh Trang, CFA, Portfolio Manager

The Federal Open Market Committee has once again reiterated the proverbial “extended” remark, regarding leaving the target interest rate unchanged in the range of zero to 0.25 percent. The Fed in its June 23 meeting kept the benchmark rate at this level, where it has remained since December 2008. and any hope for a change in language will have to wait for yet another meeting. The “extended period,” however, provides little insight into when the Fed will actually move rates. It is becoming more likely that the first rate increase is about a year away. This expectation revolves around several factors.

European Debt Crisis

The recent European debt crisis has shown that the financial markets remain fragile and investor fears can quickly return to produce a short period of instability and uncertainty. The crisis isn't without substance, as Europe must now work through its economic linkage, regarding its currency and coalesced financial system. Any austerity measures that countries adopt will take time, and this issue is expected to linger for the foreseeable future. Therefore, the threat to the fledging recovery in both Europe and the U.S. will exist for some time.

Mixed Economic Indicators

On the economic front, unemployment remains high and is expected to hold at about 9 percent into 2011. Inflation remains

benign, with excess capacity and substantial slack in utilization. Commodity prices have declined and there is little wage pressure. In addition, housing sales remains subdued; in May, existing home sales dropped 2.2 percent from April, and new home sales hit a record low of a 300,000-unit annual pace. Retail sales have improved over the previous year, and GDP growth has benefited from government stimuli. However, private sector growth will require more time and more confidence in demand before taking on more hiring. The mixed economic data and lack of inflation will enable the Fed to hold rates flat for the foreseeable future.

Regulatory Environment

Outside of the credit markets and economic conditions, there is still much uncertainty surrounding the political wrangling on financial reform and housing. Treasury Secretary Timothy Geithner and Fed Chairman Ben Bernanke have indicated their preference to push to 2011 the debate regarding the future of Fannie and Freddie. These two mortgage giants make up at least half of the \$13 trillion housing market. In addition, the financial reform bill, which covers regulation of the banking industry, remains opaque even as the President is slated to sign it. Provisions in the bill include the infamous “Volcker” rule, which will limit banks’ ability to make certain investments with proprietary capital, and to participate in derivative trading. It remains unclear how these regulations will be enforced. These uncertainties will keep Wall Street cautious with deploying new investments and will slow the credit market’s return to normalization. Hence, the Fed will more than likely stay the course until clearer signs of growth are supported.

The timeline for any rate movement by the Fed has obviously been pushed back for the above reasons. The recent developments in Europe and the new regulations for Wall Street have substantial impact on the outlook for economic growth. These dynamics are continuously being incorporated into the Fed’s forecast and certainly affect its decision process. Though growth has improved over last year, there are still pockets of headwind that may slow progress. Until those factors are resolved and the economy strengthens further, there is little impetus for the Fed to change its stance or even remove the recurring “extended” mantra.

Markets

Treasury Rates

3-Month	0.17%
6-Month	0.22%
1-Year	0.31%
2-Year	0.60%
3-Year	0.96%
5-Year	1.77%
7-Year	2.41%
10-Year	2.93%

June Total Returns

ML 3-Month Treasury	0.01%
ML 6-Month Treasury	0.03%
ML 12-Month Treasury	0.15%
S&P 500	-5.23%
Nasdaq	-6.49%

Source: Bloomberg, as of 06/30/10

Economic Vista

Ninh Chung, *CFA, Head of Portfolio Management*

The Federal Open Market Committee voted on June 23 to keep the benchmark lending rate unchanged in the range between zero and 0.25 percent. Citing that the economic recovery is “proceeding” but the labor market is only “improving gradually,” the committee restated the need to keep the federal funds rate at low levels for “an extended period.”

The Federal Reserve further suggested that the European debt crisis has affected financial conditions to the extent where it’s “less supportive of economic growth.” With inflationary pressures in check and a benign economic recovery with sluggish job growth, the Fed is expected to maintain its accommodative policy for some time.

The U.S. economy grew less than expected in the first quarter at a 2.7 percent annual rate, according to the third revision by the Bureau of Economic Analysis. The moderate recovery was led by consumer spending but the largest contributor (at 70 percent) to GDP is not growing as fast as in prior economic recoveries.

In other economic news, existing home sales fell in May by 2.2 percent or 5.6 million units as tax credit incentives expired. New home sales were also hurt by the government pullback as it reached the lowest level on record in May. Sales dropped by an astonishing 33 percent from April to a dismal annual rate of 300,000.

Credit Vista

Melina Hadiwono, *CFA, Head of Credit Research*

The European Council has announced that member states and their regulatory authorities are conducting a European bank stress test and will publish the results of the 25 largest European banks in the second half of July.

Italian and Spanish authorities have also suggested that they might decide to disclose the results of more banks from their respective systems.

We view this development as a positive first step because, by conducting this stress test, the EU authorities are signaling their coordinated effort to provide greater transparency into the financial health of banks, and to identify future capital needs. However, to have a lasting positive impact on the markets, investors will want to see a credible stress test with transparent underlying loss assumptions that convince them that bank capital levels are adequate. One of

the key questions is whether the loss assumptions will include government-debt-related claims and whether the assumptions will be published.

The hope is that these stress tests with transparent capital targets and specific capitalization plans will increase investor confidence, as in the case with the U.S. banks’ stress test conducted last year.

Going forward, while improved supervision, stronger capital and greater liquidity buffers are expected to make banks more resilient, the cyclical nature of the business will likely continue to affect the credit profile of the banking sector, which is structurally highly leveraged. The main challenge for regulators is to ensure coordination of initiatives at the international level, and to ensure that the regulatory framework will yield a more stable environment whereby banks’ risk profiles will be reduced and excessive risk-taking policies will be penalized.

Trading Vista

Hiroshi Ikemoto, *Money Market Trader*

With continuing bad news from the Euro-zone, BP’s on-going challenges, fears of a housing double-dip, and the Federal Reserve’s dovish statement and quarter-end repositioning, Treasuries have rallied to near-historic lows. The two-year Treasury note auction this month stopped at 0.738 percent, the lowest on record, on high demand. The note continued to rally after the Federal Open Market Committee reiterated that its target interest rate will remain unchanged. The two-year note was at a low of 0.59 percent and finished the month at 0.60 percent. Also, as with every quarter end for the past two years, short-end Treasury bill market yields fell to a range of zero to near zero, with a few of the July bills offered at negative yields. Yields on one-week to one-year paper ranged from zero to 0.31 percent. Agency spreads against Treasuries remained unchanged within a year maturity, from plus 6 to plus 20 in the six-month to one-year area, but they did tighten to plus 12 in the two-year part of the curve.

Yields on corporate bonds maturing within a year held steady as both spreads and LIBOR did not move. Three-month LIBOR stayed at 0.53 percent throughout June. Going out two-years, there was a widening in spread as Treasury yields fell.

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