# Observation Deck

## Wet Powder

Minh Trang, *CFA, Portfolio Manager*

With QE2 now complete, the ongoing debate centers on whether the Federal Reserve Board should or will implement another round of quantitative easing. At the heart of the discussion is whether this economic stimulus program is necessary, based on its effectiveness and benefits, given possible unforeseen negative outcomes. Though there are compelling reasons to implement a QE3, the current environment may not warrant increasing the Fed's balance sheet further. Support for more stimuli is based on the fact that the economy is yet again in a soft patch, as it was last fall, and the contagion danger in Europe persists. The economy has certainly exhibited weakening metrics regarding jobs, housing, and overall growth in recent months. In addition, the sovereign credit crisis of Greece and the earthquake in Japan have caused some barriers to the current recovery. However, there are significant differences in the current environment that would argue against the need for a QE3.

First, the labor market has improved from last fall. The private sector has produced almost 1 million jobs so far this year and is on pace to double the 2010 level. Corporate profits remain strong and companies continue to improve their balance sheets.

### Markets

| Treasury Rates | |
|---|---|
| 3-Month | 0.02% |
| 6-Month | 0.09% |
| 1-Year | 0.19% |
| 2-Year | 0.46% |
| 3-Year | 0.80% |
| 5-Year | 1.76% |
| 7-Year | 2.50% |
| 10-Year | 3.16% |

| June Total Returns | |
|---|---|
| ML 3-Month Treasury | 0.01% |
| ML 6-Month Treasury | 0.03% |
| ML 12-Month Treasury | 0.03% |
| S&P 500 | -1.72% |
| Nasdaq | -2.11% |

*Source: Bloomberg, as of 06/30/11*

Though growth has slowed to 1.9 percent in the first quarter of 2011 from the previous quarter of 3.1 percent, much of the slowdown was attributed to a decrease in manufacturing due to the Japanese earthquake back in March. This would suggest that the softness is temporary as companies realign production and output. The Fed commented in the June meeting that it "expects the pace of recovery to pick up over coming quarters and the unemployment rate to resume its gradual decline."

Second, part of the reason behind QE2 was to inflate prices and avoid a deflationary spiral. The Fed's purchases of $600 billion in Treasuries have certainly increased price levels. The flood of cash weakened the dollar against most global currencies. Though it did help exports, it also caused import prices to surge. The year-on-year core Consumer Price Index growth has almost doubled from 0.8 percent last fall to 1.5 percent in May. The market has also endured a spike in commodity prices, as well as higher costs at the pump. This of course led to diminished disposable income on the consumer front and likely contributed to some of the economic slowdown. Adopting another round of QE may exacerbate inflation to a level that could be detrimental to long-term growth for the U.S. economy.

Another reason behind QE2 was to keep yields down and borrowing costs low, especially for housing. The current 10-year Treasury yield is roughly at the same level as when QE2 started. However, it peaked in February at 3.75 percent and has hovered well above 3 percent for most of the period since QE2 began. In addition, housing remains depressed and credit and lending continue to be tight. If the program did little to improve lending, it is unlikely that bringing on QE3 will have a material impact.

It could be argued that QE2 did keep the economy moving long enough to avoid another recession. However, the landscape has certainly changed enough to signal that additional liquidity may not be the answer. It's possible that benefits of such a program have become limited and QE3 would just slow the market's progress back to normalization. Maybe that's why so many Fed officials have spoken against quantitative easing.

## Economic Vista
### Paula Solanes, *Portfolio Manager*

The economic recovery's momentum may have slowed – but on a positive note commodity prices have dropped and the Japanese earthquake's effects on the supply chain have subsided. The third and final revision of first-quarter GDP was shifted upward by a tenth of a percent to 1.9 percent.

The employment market, which saw on average strong job creation in the first four months of the year, has experienced considerable deceleration, adding only 54,000 jobs in May. The slight increase in jobs was the smallest gain in eight months and contributed to a bump in the unemployment rate, edging the jobless rate up to 9.1 percent. Initial jobless claims have also been a concern as the average has held steady at over 400,000, indicating that companies are treading very carefully when it comes to hiring permanent employees.

Wholesale prices, including food and fuel, have increased 7.3 percent year over year. The wholesale increase in May was led by higher prices for fuel, plastics, and the fastest increase in 30 years for apparel and textile costs. Meanwhile, the Consumer Price Index increased 3.6 percent, signaling that producers continue to hesitate to pass increased costs to consumers, given the fragile state of consumer spending.

Existing homes sales dropped in May to the lowest point in six months, a clear sign that the housing market continues to be one of the weakest parts of the economy. Purchases of existing homes fell 3.8 percent to an annual pace of 4.81 million. The persistently high unemployment rate combined with higher credit standards means that it may take years to soak up the 1.8 million distressed homes in the market and that home prices will continue to be depressed for an extended period.

## Credit Vista
### Melina Hadiwono, *CFA, Head of Credit Research*

Market speculation has been intensifying over the past several weeks about a possible restructuring of Greece's sovereign debt and the ramification for European banks with Greek debt exposures. For European banks in general, transparency and disclosures of country risks are rather poor. Based on the latest disclosures, the Greek debt exposures for some of the highly rated European banks seem to be limited. However, with non-disclosures to the private sector, the exposure might be higher. Along with the European Union decisions, markets are paying close attention to the banking linkages within the region. European banks hold $162 billion in exposure to Greece's economy, according to BIS data, with French and German banks holding the greatest exposure at $65 billion and $40 billion respectively. The main threat would be possible contagion involving the other weaker countries such as Ireland and Portugal, especially if this leads to debt restructuring in much bigger economies such as Spain. One concern for banks has been the European Central Bank stance that it would not accept Greek collateral if private-sector involvement was not fully voluntary or would trigger a default.

In a recent meeting, Euro zone finance ministers chose to postpone the disbursement of the next €12 billion tranche of the original EU/IMF aid package of €110 billion until July, placing renewed pressure on the Greek government to meet austerity measures. Facing pressures from national protest, the Greek Prime Minister called for a vote of confidence within Parliament. There is a risk that the Greek government opposition may call for renegotiation of the bailout package, which may test EU's government's goodwill to the limit. The interrelations between sovereign solvency, banking exposures and local politics will continue to evolve. Orderly and cohesive policy solutions are crucial to end this market uncertainty.

## Trading Vista
### Hiroshi Ikemoto, *Money Market Trader*

With the lack of supply in short-term investments and worries over Greece defaulting, the quarter-end yield compression started early in June. By the third week, Treasury bills going all the way out to October 2011 were yielding zero and some were at negative yield. The two-year Treasury note yield was relatively flat month over month, but, at mid-month was down to 0.33 percent, an historic low. In contrast, the Eurodollar Synthetic Forward Rate curve cheapened up with one-year EDSF rates at 0.40 percent by month end, for an increase of 6 basis points. The street reacted by tightening spreads from minus 5 to flat, a drop of about 10 basis point on corporate bonds. However, absolute yield was still 2 to 3 basis points better than in May.

With Greece in the headlines, the yield on commercial paper of foreign banks with exposure to the troubled country cheapened up, with 180 day maturities yielding 35 to 38 basis points. Nordic, Australian and Canadian banks stayed rich averaging 24 basis points for the same maturities. Agencies remained right on top of Treasuries.

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