

Observation Deck

October 2010

Q.E. 2.0

Paula Solanes, *SVB Asset Management*

The Federal Reserve Board's Federal Open Market Committee continues to convey the sentiment that the economy is still fragile and the future remains uncertain. A clear message on September 21 was that the Fed would step in if necessary to support the recovery and assure that inflation returns to a level that is in accordance with the Fed's mandate. Ideally, the Fed would like inflation to be between 1.5 and 2 percent; currently it is at 1.1 percent.

One tactic that the Fed has at its disposition is to enter into another round of quantitative easing, cleverly called "Q.E. 2.0" on the street. The Fed would likely buy longer-dated treasuries because individual and corporate borrowing rates are based on long-term yields. The idea would be that the Fed would buy treasuries from the market as other assets on its balance sheet begin to naturally roll off, as well as buy additional treasuries to expand the total of the balance sheet, which, by the way, has tripled since the start of the financial crisis. The effect that the Fed anticipates is that the additional liquidity pumped into the economy would ignite growth while getting inflation at a preferred level. As the Fed purchases treasuries, prices will rally with increased demand and drive down yields. Reduced yields would encourage

banks to lend money in order to earn a higher return than what they would earn in treasuries, and would encourage companies to find alternative uses for their cash.

Treasury yields are the benchmark for other asset classes. This implies that prices of other asset classes will also rally, leading to opportunities for companies to sell out of their investments at a profit and use the cash for growth-inducing activities such as hiring new employees, purchasing new machinery, or strategically acquiring other companies – all events that would help spur the economy. However, there is no assurance that the economy will react as the Fed anticipates. Unfortunately, economics is not a precise science and exogenous factors might interfere, or counteract the Fed's actions. Some potential repercussions include increased devaluation of the dollar, revisit of inflationary fears, and all-time highs in the price of gold.

In the short run, especially through November until the Fed decides whether to implement Q.E. 2.0, the market will anticipate some kind of quantitative easing and in the meantime treasuries will rally and other related securities will follow suit. In the long run, if the Fed does decide to move forward with the purchase of treasuries in November, there is no guarantee Q.E. 2.0 will ward off deflation or bring inflation to a comfortable level. Until companies feel that the consumer is back and their profits are sustainable, it is hard to imagine that they will start to hire employees on a greater basis. Lower interest rates will heighten the chances that U.S. financial institutions will look to take on more risk lending to private borrowers and business. Lower rates would also help encourage the private sector to invest in itself and spur growth. However, there is no sure outcome, and so it is most probable that the Fed will err on the side of re-igniting the economy and deal with the consequences later. The Fed has battled high inflation in the past and is willing to do it again to stimulate the sluggish economy.

Markets

Treasury Rates

3-Month	0.13%
6-Month	0.15%
1-Year	0.24%
2-Year	0.42%
3-Year	0.63%
5-Year	1.26%
7-Year	1.91%
10-Year	2.51%

September Total Returns

ML 3-Month Treasury	0.00%
ML 6-Month Treasury	0.03%
ML 12-Month Treasury	0.06%
S&P 500	8.92%
Nasdaq	12.68%

See Federal Reserve Balance Sheet Trends

<http://www.svb.com/pdfs/sam/fedfunds0910.pdf>

Economic Vista

Ninh Chung, CFA, *Head of Portfolio Management*

The National Bureau of Economic Research reported the Great Recession that began in December 2007 technically ended in June 2009, marking it the longest recession since World War II. The NBER also cautioned “economic activity is typically below normal in the early stages of an expansion, and it sometimes remains so well into the expansion.” September economic reports validated that warning.

The unemployment rate edged up in August to 9.6 percent and overall employment, which includes government agencies, fell 54,000. The decline was largely a result of the termination of 114,000 temporary workers hired by the government to conduct the 2010 census. On a brighter note, the private-sector growth in nonfarm payrolls remained positive. Private-sector payrolls averaged monthly gains of 200,000 for March and April but slowed to a 72,000 pace for the next four months. While gains in private payrolls remain sluggish, they were gains nonetheless.

The residential real estate market remains in an abysmal state; however it is healing on its own. Previous government tax credits which artificially lifted demand have expired and have now worked their way out of the system. Existing home sales rose 7.6 percent in August to an annual pace of 4.13 million units. On a year-over-year, sales were down 19.0 percent in August after being down 25.3 percent in July. Overall, August sales were at the second-lowest pace on record, dating back to 1999, with July the lowest. Median home prices fell to \$178,600 from \$182,100, while average home prices fell to \$228,700 from \$231,700. Removing monthly price data distortion, the median price on a year-over-year basis was up 0.8 percent in August and the average price was up 2.9 percent in August.

Credit Vista

Melina Hadiwono, CFA, *Head of Credit Research*

On September 12, the Basel Committee for Banking Supervision (BCBS) announced its regulatory framework on capital and liquidity standards, commonly called “Basel III.” Under the new framework, banks will be required to hold more capital of higher quality, with Tier 1 minimum capital raised to 6 percent from 4 percent. For the first time, all banks will be required to adhere to a minimum common equity requirement, referred to as Core Tier 1 capital of 4.5 percent. In addition, banks will be required to set up a capital buffer of 2.5 percent, made up of common equity, which is expected to act as cushion in times of distress. The agreement also makes material amendments in a broad range of areas including treatment of deductions, capital calculations, and counterparty risk, as well as the introductions of leverage and liquidity ratios. Nonetheless, important issues such as the capital surcharges for banks deemed too big to fail and the treatment of contingent capital have not been addressed.

We would expect these items to be finalized during the November G20 summit in Korea. Once terms are finalized, implementation of the reform would be phased in over a multi-year period of at least five years, starting at the end of 2012. This timeline seems to point to challenges that many banks would need to confront, such as insufficient earnings or inability to raise capital and increase in liquidity buffer.

The liquidity ratio is considered a much more significant challenge for banks, with potentially significant implications for the ability of banks to lend and for their funding structures. However, the implementation will not be subject to the new rule before 2015. While many large banks have anticipated tighter rules, markets, along with supervisors, are also likely to pressure banks to observe the new rules before 2019. From the point of view of fixed income investors, the agreement is generally positive in the long run as it will contribute to the ability of banks to cope with distressed markets. Ultimately, the banking sector will still need to address shortcomings on risk assessment, which have been the cause of recent market disruptions.

Trading Vista

Hiroshi Ikemoto, *Money Market Trader*

With economic data in September “less bad” and the speculation of more quantitative easing, we saw mixed moves in the Treasury market during the month, with the bulls winning out by month-end. The two biggest moves were on September 9, when the two-year note hit a yield of 0.57 percent on lower-than-expected jobless claims numbers, and on September 21, when the two-year hit an all-time low of 0.42 percent, as the Federal Reserve Board’s Federal Open Market Committee indicated that it is prepared to ease rates further to help revive the economy. By month-end, the yield on the two-year was 0.42 percent.

With this slow march to zero, many companies took advantage of these low yields and issued over \$150 billion worth of bonds, eclipsing the high of \$125.1 billion in September 2009. Leading the way were Microsoft Corp., Hewlett-Packard Co., and Ford Motor Co. Microsoft’s three-year bond was initially priced at plus 25 to the three-year Treasury note, with an all-time low coupon for a corporate issue of 0.875 percent. As an interesting note, that bond was being offered on the street the next day, September 23, at plus 16, which equates to a yield of 0.84 percent. Ironically, this is the same yield as the three-year Treasury note 10 days earlier, on September 13.

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