Observation Deck

What's an Investor to Do?

Renuka Kumar, *Portfolio Manager*

Much of the rhetoric in recent months has been focused around a faltering global economic recovery and concerns over a possible double-dip recession. Whether we are still in a recessionary period or heading into another one is up for debate, but the fact remains that there are still many headwinds that face the economy. Uncertainty in the euro zone combined with a struggling labor and housing market at home have been the main factors holding back the recovery and weakening expectations for global growth. Gross domestic product for the year is only expected to be about half of what it was for 2010, at 1.70 percent.

In response, a greater number of Federal Reserve officials have been calling for further stimulus measures to support growth in the context of their dual mandate of maximum employment and price stability. The Fed's latest plan of "Operation Twist" has not had much impact as of yet (long-term rates have actually risen since the announcement with the 10-year Treasury at 2.11 percent, up from 1.86 percent at announcement date). Some are now calling for measures, which include another round of quantitative easing and additional mortgage-related security purchases in an effort to support the housing market and keep borrowing costs low. Additionally, in the last two meetings of the Federal Reserve Open Market Committee, policy makers have remained committed to an accommodative monetary policy by stating that they will hold the target interest rate at the 0.00-0.25 percent range until at least mid-2013.

What this means for corporate cash investors is that it will remain difficult to generate value by sitting on the sidelines. Money market mutual funds have been yielding zero or near-zero for years and many prime money fund providers have been prudent in scaling back on European banking exposure given the sovereign debt crisis, making it even more challenging for these funds to generate return. The current seven-day yield for the Crane 100 Money Fund Index, an average of the 100 largest money market mutual funds, is at 0.04 percent, or four basis points.

In spite of the outlook for rates to remain on hold for the next two years, we believe opportunities exist to create value if the portfolio is positioned appropriately. Financial disruptions in the global market have limited value in the government space with the one-year Treasury bill yielding 0.11 percent and the two-year Treasury note yielding only 0.25 percent. Opportunities for greater return potential are available by extending duration and by taking advantage of wider spreads in the high-quality credit space. For a one-year corporate security, the yield pickup over a government security has been ranging from 0.25 percent to 0.70 percent.

Certain sectors also prove to be attractive, such as callable agencies, which provide a meaningful spread over bullet agencies, and AAA-rated asset-backed securities, which provide diversification in the portfolio by limiting concentration in any one issuer. It should be noted that although credit metrics have been improving and corporate earnings remain strong in certain sectors, it is even more important to have investments that are thoroughly vetted in the portfolio as economic conditions remain uncertain.

What we've learned in the past few years is that uncertainty created by headlines will continue to dominate; however, it is important to stay disciplined with a long-term approach when investing. This will ensure that you are also managing to the return objective in your investment policy, while maintaining capital preservation and liquidity.

Markets

Treasury Rates

3-Month	-0.01%
6-Month	0.04%
1-Year	0.11%
2-Year	0.25%
3-Year	0.38%
5-Year	0.96%
7-Year	1.55%
10-Year	2.11%

October Total Returns

ML 3-Month Treasury	0.00%
ML 6-Month Treasury	0.01%
ML 12-Month Treasury	0.03%
S&P 500	10.92%
Nasdaq	11.19%

Source: Bloomberg, as of 10/31/11

Economic Vista

Paula Solanes, *Portfolio Manager*

October had some stronger-than-estimated economic data signaling that the U.S. curbed the double dip recession that some were anticipating in the second quarter. Nonfarm payrolls came in better than expected at 103,000 compared to a flat number the prior month. The stronger payroll number was a relief; however, the positive jobs number was in part due to 45,000 telecommunication employees who returned to work after being on strike. The payroll number was not enough to put a dent in the unemployment rate which remains where it's been for the last three months at 9.1 percent.

Retail sales also came in better-than-expected as consumers showed more confidence despite the high unemployment number and bleak economic outlook. Retail sales rose 1.1 percent and the prior month was revised higher. On the wholesale side, prices in the U.S. rose more than forecast driven by gasoline, food and transportation.

The Producer Price Index increased 0.8 percent, the biggest increase in five months, the core measure which excludes food and energy increased 0.2 percent, which was also more than expected. On the other hand, consumer prices excluding food and energy were relatively moderate, rising only 0.1 percent as producers were hesitant to pass on higher costs to customers. GDP was a positive way to end the month. Third quarter GDP came in at 2.5 percent, the fastest pace all year. The main driver was household purchases which increased 2.4 percent as consumers reduced savings to step up purchases.

Credit Vista

Sook-Kuan Loh, *CFA, Sr. Credit Risk & Research Officer*

Considering the weight of the European sovereign crisis, many market participants have overlooked the fundamentals as U.S. banks and corporates began to report earnings for the quarter.

The banks show signs of wear from the tumultuous European sovereign crisis and the uncertainties swirling around it. However, certain strong banks continue to weather through this storm fairly well with some entities reporting loan and deposit growth. Other banks, however, relied on accounting gains from their own debt valuation as their credit spreads widened in a volatile and uncertain environment. Asset quality continues to improve, albeit at a slower rate than exhibited earlier this year. Flight to quality remains apparent as large banks are saddled with more deposits.

In general, the technology sector remained a bright spot in the U.S. economy. Large players in the technology sector reported continued growth in revenue, supported by emerging markets business. The beverage industry was able to pass on higher commodity costs to the consumers and expand their global reach. Fast food restaurants are also benefitting from growth in the globalization of their revenues, and have been able to pass costs to their customers.

A global diversified machinery company benefitted from the continued growth in the emerging market, with healthy backlogs and a strong balance sheet. Another diversified conglomerate was able to report better earnings via acquisitions and through improved earnings from its financial unit.

Issuers on SVB Asset Management's Approved List generally have had good financial performance, as their strong fundamentals have relatively shielded them from the impact of a fragile recovery and changing market conditions. With a weak economic and business environment, it is especially important to focus on fundamentals. A bottoms-up approach could yield investment opportunities otherwise not identified if company specific performance is ignored. The earnings season provides this opportunity to thoroughly assess quality of earnings in a slow macro recovery.

Trading Vista

Hiroshi Ikemoto, *Money Market Trader*

With the Fed on hold and Operation Twist, there was almost no volatility in the bond markets. Treasury yields were extremely flat. The two-year Treasury note yielded 0.24 to 0.30 percent throughout the month, with movement triggered more by European news than by the U.S. economy. Treasury bills remained well-bid with zero to near-zero yields throughout the curve.

The one-year LIBOR spot curve cheapened 9 basis points to 0.56 percent. Bonds issued by financial companies were being offered in the 0.65 percent to 0.80 percent range, while industrial issues are anywhere from 0.35 percent to 0.55 percent. Though credit products were more attractive, secondary inventory was scarce as many institutions held their positions. And according to data released by the Fed, dealer inventories of corporate bonds dropped to the lowest level since July 2003. The yield for 180-day commercial paper was 40 basis points, slightly higher than in September.

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