First Quarter 2011 Economic Commentary

At the Mercy of Politics

Fall always seems to be an eventful season for the markets. Although the fourth quarter did not see outsized drama in market prices, many changes occurred that will affect market prices in quarters to come.

First, as expected, the Republicans took the House and gained significantly in the Senate. It's likely that voters were expressing their displeasure with current economic activity rather than looking toward the GOP as a savior. Little reaction was seen in the markets as this outcome was widely expected. Now, the focus shifts to whether successful action will be taken in Washington to get the private sector economy growing again.

Second, Federal Reserve Chairman Ben Bernanke and team announced a $600 billion plan to buy Treasuries across the yield curve. The desire is to lower the cost of borrowing in order to support economic activity, but question remains whether the cost of money (interest rates) is really holding activity back. Instead, could it be tremendous uncertainty around all the recent major government activities?

In the past few years we've seen massive healthcare reform (18 percent of the economy), financial regulatory reform (financial companies are necessary at every step of the economy), and the destruction of the mortgage market (mortgages drive values of homes which are the single largest asset of the consumer) with little talk of resurrection.

Is it any wonder investors and consumers are pushing the "pause" button?

Third, and on the bright side, compromise was achieved on the income tax front — one of those great outstanding uncertainties. Certainly, one could argue for more or less taxes at different times of the economic cycle and from different starting points. The fact markets rallied on the back of this compromise news is a testament toward lower government uncertainty more than a desire for a particular tax structure.

The reduction of uncertainty was cheered by the markets more than the actual details of the compromise.

Now, looking forward, it is difficult to know whether Republicans will "work with" Democrats to reduce some of the uncertainty about government actions. The 24-hour news cycle, combined with a politicians' DNA-laced desire to win elections, could drive them further away from the controlling party's ideals.

This would be a worst-case scenario.

Turning back to the Fed's QE2 for a moment, we saw interest rates actually rise by 30 - 100 bps since the original announcement on November 4 (depending on maturity). Think about that for a moment. The Fed announces its intention to buy $600 billion of Treasuries and the price of Treasury yields actually rises.

It could be that we are putting too much responsibility on the Fed to get us out of the doldrums. Instead, perhaps we should be pushing our legislators to set the rules of engagement for the economy.

Get Used to Zero

Depending on Washington for anything is perilous at best.

For this reason, the independence of the Fed has served us quite well in recent decades. Independence, that is, of the political process. But as Bernanke continues to pull back the curtain, appearing on "60 Minutes" and the like, I am concerned this independence may fade.

Should we devolve toward setting economic policy by popular vote, business forecasting will become increasingly difficult and more people will move to the sidelines.

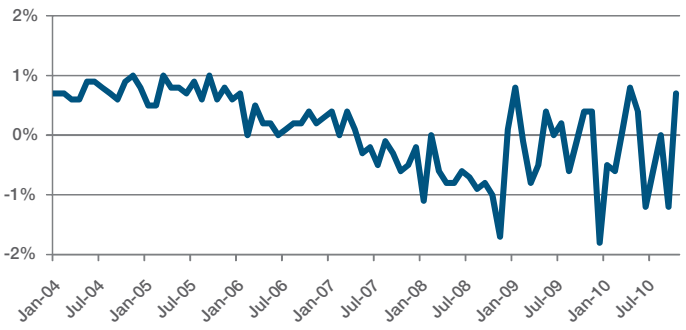
Today, for the first time in memory, recovery depends on those in Washington other than the Fed. The sooner we face up to that fact, the sooner we will reach the other side of this riverbed.

Joe Morgan, CFA
Chief Investment Officer, SVB Asset Management

Charting the Course

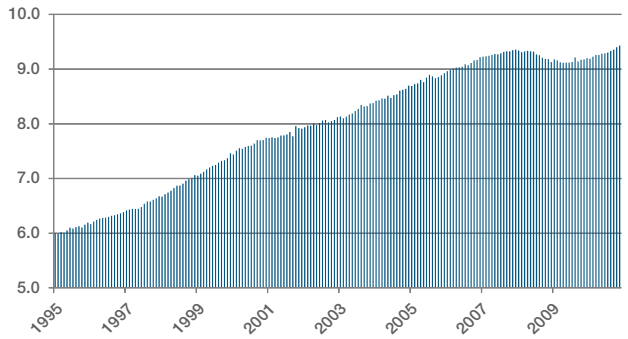
Volatility of economic opinions is high and will remain high for some time. But the fact is, there is a very definite cause of our troubles and until it is addressed, the economy will continue to languish. It is important to resolve uncertainty in Washington over new regulation, stimulus, and other government activities. For any long-term plans to be made by either consumers or investors, the new "rules of the game" must be clear.

FHFA Home Price Change Index



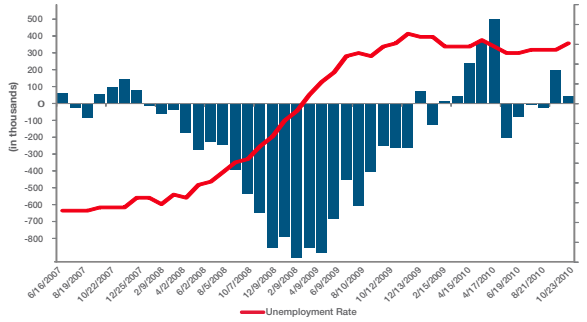
The consumer's largest asset remains volatile causing wealth concerns. Long-term, sustained consumption will only return once this important asset class stabilizes.

Personal Consumption Expenditures



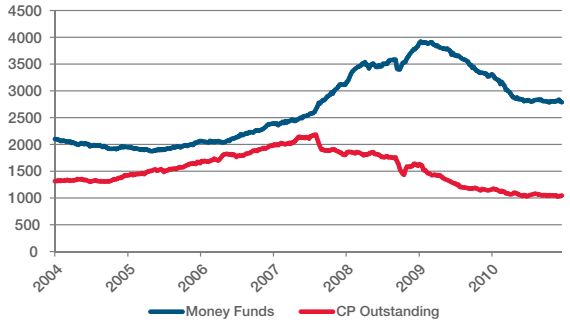
Despite volatile home prices, consumption has resumed growing, although we remain some $800 billion off-pace. Investors and consumers need to realize this "lost consumption" will not return and future growth may not be supported by fiscal stimulus.

Unemployment and the Jobless Rate



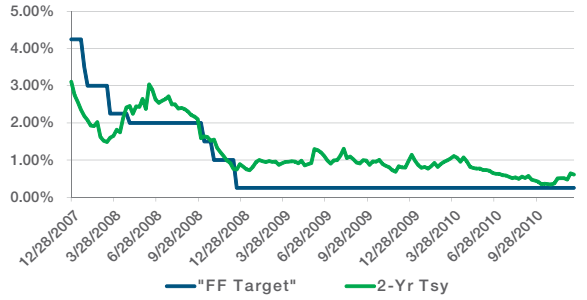
A continuing weak recovery in the jobs sector will not offset massive losses in 2008 and 2009. We need consistent job growth of at least 200,000 per month before we begin to see a dent in this challenge to the economy.

Supply/Demand in the Front End



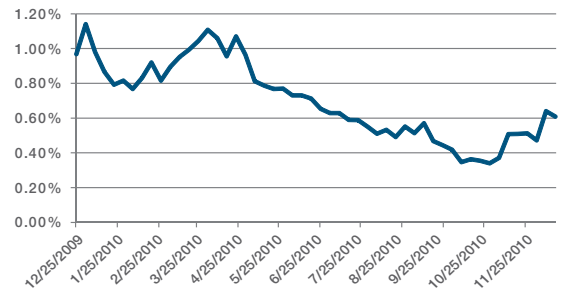
Technical and regulatory pressures are reducing CP Outstanding, even while demand remains elevated. Investors remaining on the sidelines create demand for short, high-quality instruments primarily through money fund holdings.

Market Rates



Entering our third year of near zero Fed Funds rates, other market rates remain depressed. Without signs of inflation, which would likely emanate from consumer demand, expect these rates to remain low throughout 2011.

Two-Year Treasury Yield



More recently, we've seen short Treasury yields rise offering some opportunity for yield. These short yields will remain range-bound, but volatile, offering return-gathering opportunities for investors with some ability to invest longer than six months.

Source: Bloomberg and SVB Asset Management

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