#### A Member of SVB Financial Group

# First Quarter 2012 Economic Commentary



## Tugs of War

When the going gets tough, people sometimes revert to playground antics. Today's choice seems to be "tug of war." This traditional game pits two sides pulling on a line with the objective being to gain enough of the line so that it cannot be brought back from the other. The losing team typically ends up flat on their faces, while the winning team celebrates a hardfought victory.

Many issues facing the marketplace today are taking shape in this form, unfortunately. In the box nearby, we have a brief list of such tugs of war going on today. At first look, the possible outcomes seem binary — much like those in the playground version. However, it's obvious to us the solutions lie somewhere in between.

While in the midst of battle, there is much blustering of opinion — favorable on one side and denigrating to the other. Rarely does it seem there's room for true negotiation and compromise, when in fact we all know the solutions must reside there.

As we enter another election year faced with great economic uncertainty around the world, expect 2012 to bring much the same as 2011 when it comes to confusion and volatility. None of the questions being faced today are simple and none require simple solutions.

- A potential return to recession seems an academic discussion when you consider all activity (think employment!) is local
- · Consumers are acting strong, but signaling weak activity in the near future
- · The housing market is sparking, but continued mortgage difficulties remain a tremendous challenge
- The jobs market is growing, but too weak to offset population
- The Fed seems split down the middle, even as the most dovish policy voters fall out of rotation
- · Washington seems wrapped up in indecisiveness, waiting on election outcomes

- Europe is led by France and Germany which can't seem to agree on any policy (nevermind Britain's recent snub)
- · Asia is either experiencing inflation due to growth or a slow motion bubble-popping
- The U.S. stock market is caught between solid current economic growth and worries about Europe and the future of the consumer
- The IPO market is open for revenue-producers, but concerns remain over market valuations post-IPO
- The M&A market looks strong due to high cash balances, but valuations are becoming more difficult

In short, the riverbed we entered in 2008 will extend through 2012. Making progress on these and other challenges facing the markets will be key to reducing volatility and increasing confidence of CFOs in all industries.

Here's hoping we make significant progress on these challenges in the New Year!

### Today's Tugs

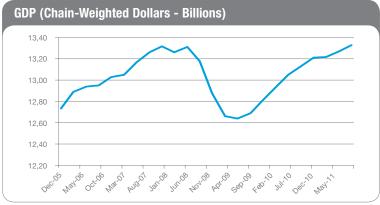
- GDP: Double-dip vs. continued recovery
- Consumption: Strong today vs. dim outlook
- · Housing: Low mortgage rates vs. true availability
- Employment: Efficiency gains vs. low job growth
- Fed: Doves vs. hawks
- DC: Lack of progress on fiscal policy
- Europe: France vs. Germany on best way forward
- Asia: Inflation vs. growth
- Stock Market: U.S. economy vs. European challenges
- IPO: Possible bubble valuations vs. revenue
- M&A: Cash balances vs. valuations

Joe Morgan, CFA Chief Investment Officer SVB Asset Management

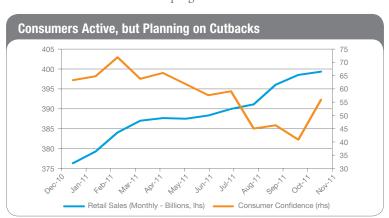
**JANUARY 2012** 

## Charting the Course

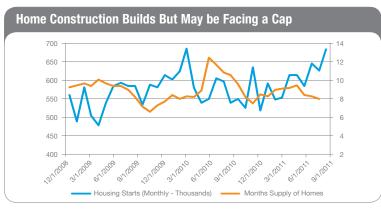
Confusion continues to reign as the markets are faced with a multitude of diverse and divisive questions that either point to potential strength or weakness. Wide-ranging viewpoints and data points tell a story that seems to have eventual outcomes that are binary. But we believe the truth, or really, the solutions, will be found somewhere in between. The only question that remains is: How much progress will be made in 2012?



The word "recovery" has lost its meaning. Given GDP has dipped and now regained its previous peak, the recovery has ended and we are now in a new growth phase (according to text books). Ask anyone on the street if they believe this is true and you are likely to only receive a look of bewilderment.



Throughout the year, retail sales continued to grow even as consumer confidence remained stagnant or declined. Today, even with the slight recovery in confidence, consumer outlooks remain dim - the current measure of 56 compares to the index's base measure of 100 taken in 1985.



The housing sector is showing signs of life on the construction front as November starts neared the 700,000 mark which would be the highest level since 2008. However, it is taking 8 months to sell homes today vs. about half as much time before the crisis hit. Existing supply will likely remain a cap on current production, all other inputs equal.



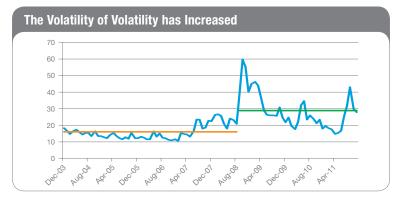
Productivity growth since 2008 has been steeper than even the "productivity miracle" of the nineties. The red line above is an index of output per hour with a 100 benchmark at 2005. Technology growth will continue to boost productivity in the near future as job growth will have to come from a boost in end consumer demand.

#### A Significant Change in Voting Members

Member	Voter in 2011?	Voter in 2012?	Majority View?	Dove/Hawk?
Bernanke	Yes	Yes	Yes	Neutral
Yellen	Yes	Yes	Yes	Neutral
Tarullo	Yes	Yes	No	Dove
Duke	Yes	Yes	Yes	Neutral
Raskin	Yes	Yes	Yes	Neutral
Pianalto	No	Yes	Yes	Neutral
Lacker	No	Yes	No	Hawk
Fisher	Yes	No	No	
Plosser	Yes	No	No	
Lockhart	No	Yes	Yes	Neutral
Rosengren	No	No	Yes	Dove
Evans	Yes	No	No	
Bullard	Yes	Yes	Yes	Hawk
Dudley	Yes	Yes	Yes	Neutral
Kocherlakota	Yes	No	No	Dove
Williams	No	Yes	Yes	Dove

Of the rotating members on the FOMC, 2012 should bring more agreement regarding monetary policy at the Fed. The above subjective look shows that all four members that lose their votes seem to disagree with current policy, while only one of the new voters has openly objected to the current course.

Source: Federal Reserve, SVB Asset Management



Since the liquidity crisis hit in 2008, implied volatilities have not only increased but the change in volatility has been wild and unrelenting. Above, we've plotted the implied volatility of S&P 500 options which shows not only an increase in average volatility, but spikes as high as 2 times the new, higher average.

Source: Bloomberg and SVB Asset Management

#### **SVB** Asset Management

555 Mission Street, Suite 900 San Francisco, California 94105 866.719.9117

service@svbassetmanagement.com

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