Silicon Valley Bank
A Member of SVB Financial Group

Second Quarter 2011 Economic Commentary

The Treasury Tightens?

No, the title to this commentary is not a typo.

On March 22, the Treasury announced it would sell its mortgage holdings, plunking a cool $10 billion of the securities back into the market on a monthly basis until its entire $142 billion of holdings have been depleted. On the other side of this transaction, the Treasury will do… nothing.

That's right, they are taking money out of the system and that action falls under the textbook definition of a tightening. Certainly, this is nothing like the Fed raising rates or selling off the extra $2 trillion or so of securities that it holds over and above its 2008 balance sheet, but a tightening is a tightening, no?

Does this move signal the beginning of a trend? I think the answer is decidedly "no," but let's look at both sides of the coin. First, the positive. Consumer spending and credit growth have been on the rebound recently. As a consumer-led economy, growth figures like the 4.1 percent annualized growth of consumption in the fourth quarter are nothing to sneeze at. In fact, as you can see on the graph on the next page, consumers are even able to borrow more than they have recently with credit up some $17.5 billion over the last four months.

Digging into these figures, we find there are some mitigations to any potential euphoria, including the fact many of these loans are actually student loans, implying many have given up on finding a job and returned to school. However, that will be good for the economy at some point in the future.

And what of the employment figures? As of this writing, the March figures have yet to be released, but what we saw for February was quite encouraging. Total jobs gained were 192,000 putting the three-month average at an encouraging 135,000. This is not where we need to be, but the trend continues to be upward and included a private sector boost of 222,000 jobs — the most since last April.

Perhaps in response to encouraging employment and consumer data, various Fed speakers seem to have signaled they would end QE2 on time and there likely will not be a QE3 (though the door is still open). Many market participants wonder what will happen to prices when the Fed stops buying securities — much less than when they start selling. The Fed's strategy is more important than the Treasury's, of course, given the relative size.

Also, the ECB's President Jean-Claude Trichet signaled a desire to actually raise interest rates in April. We are not confident an increase will occur, but the mere fact it is being discussed seriously can engage the effects of an actual tightening move.
On the flip side, unfortunately, there has been a tremendous increase in general uncertainty around the world. Not only do we have many sovereign concerns due to financial mismanagement, but the first quarter brought the first wave of political uprisings in the very economically important region of North Africa/ Middle East.

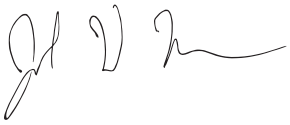
The incredible disaster in Japan is creating tremendous uncertainty on markets across the globe and disrupting supply chains for most every global corporation in existence.

The employment figures mentioned earlier, while encouraging, are a far cry from recovering the total eight million jobs or so that were lost during the crisis, not to mention all the underemployed workers that will need to move back into positions appropriate to their skill set.

In summary, there is still a lot of slack in the economy and, at the end of the day, this will keep prices low and the Fed on the sidelines.

So, did the Treasury tighten? Yes, their action is undeniably a tightening. But the message received by the markets should not include a plan for further tightening in the near future. Instead, this is more a balance sheet repositioning than anything else.

Expect this low rate environment to continue for some time into the future.

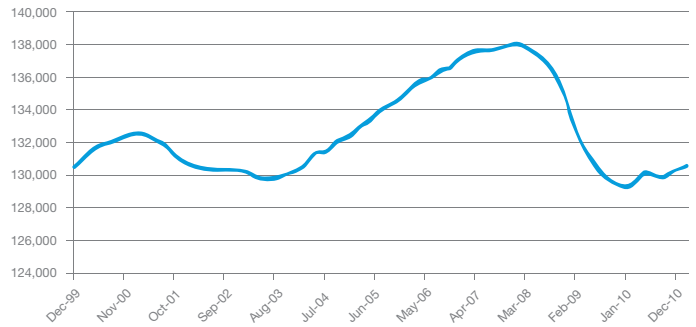


Joe Morgan, CFA
Chief Investment Officer
SVB Asset Management

Charting the Course

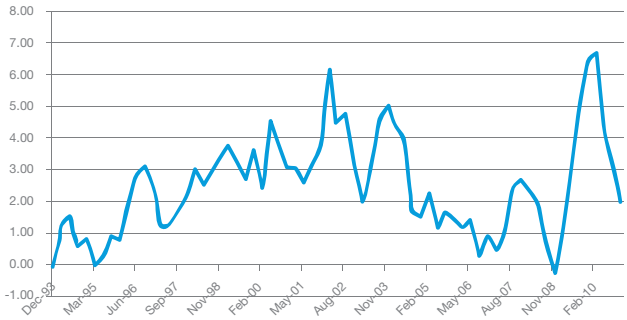
Greater uncertainty entered the market information arena during the quarter in the form of sovereign concerns, natural disasters in Japan and, on the flip side, potential strength by the consumer. Balancing these new inputs, it is still difficult to see aggressive Fed action on the horizon. We maintain our outlook that the cause of the current downturn — the mortgage market — must be addressed before recovery arrives.

Total Nonfarm Payrolls



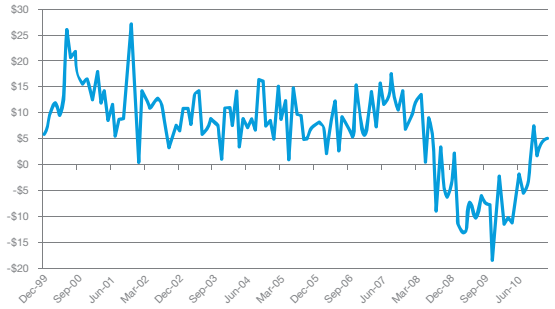
This chart depicts the total number of people working. You can see the job recovery has begun, but you can also see how long it will take to set a new high. One question we should begin to ask is whether the peak in early 2008 was actually too high and unsustainable to begin with.

Annual Productivity Gains



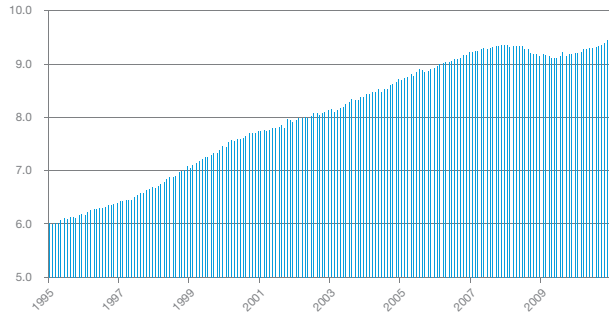
We are reminded of the Greenspan "productivity miracle" era of the nineties when thinking about the last several quarters. By illustration, the dollar value of goods and services produced in the U.S. during 2010 was equivalent to that produced in 2007 — with 8 million fewer workers.

Growth in Consumer Credit (in billions)



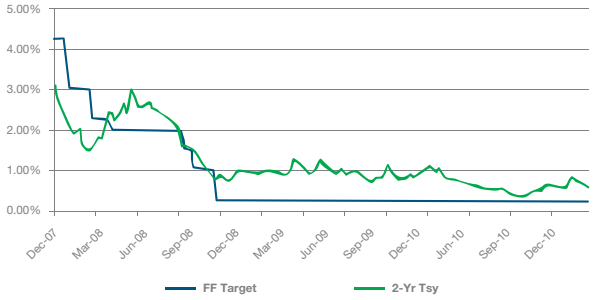
Amazingly, consumer credit growth has rebounded significantly, though these figures are being led by student loans. The trend toward greater outstanding credit is confirmed in other data including the Senior Loan Officer Survey.

Personal Consumption Expenditures



Consumption has rebounded with production, though we are unlikely to regain the original trendline. The sooner business and consumers accept this new reality, the sooner realistic long-term strategies can be put into place. We don't believe this is occurring yet.

Market Rates



Market rates remain depressed and interest rate increases appear nowhere on the horizon. Instead, expect the rate environment to remain range-bound, though the range of the two-year could be fairly wide. Opportunities to enter the market at over 1 percent may present themselves prior to year's end.

Two-Year Treasury Yield

Risk of a fed funds rate increase diminished during the quarter as investors continue to worry about consumption and employment. The two-year Treasury, which typically leads fed funds, continued to grind lower.

Source: Bloomberg and SVB Asset Management

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

©2011 SVB Financial Group.® All rights reserved. SVB, SVB> and SVB>Find a way are all service marks of SVB Financial Group. SVB Asset Management, a registered investment advisor, is a non-bank affiliate of Silicon Valley Bank and member of SVB Financial Group. Products offered by SVB Asset Management are not FDIC insured, are not deposits or other obligations of Silicon Valley Bank, and may lose value. Rev. 03-30-11.